The Regents of the University of California

INVESTMENTS COMMITTEE
November 16, 2021

The Investments Committee met on the above date at UCSF-Mission Bay Conference Center, 1675 Owens Street, San Francisco and by teleconference meeting conducted in accordance with California Government Code §§ 11133.

Members present:	Regents Anguiano, Leib, Lott, Makarechian, and Sherman; Advisory members Blas Pedral, Cochran, and Pouchot; Chancellors Hawgood, Muñoz, and Wilcox; Advisory member Lybarger; Staff Advisor Tseng
In attendance:	Regents Hernandez, Torres, and Zaragoza, Regent-designate Timmons, Faculty Representative Horwitz, Secretary and Chief of Staff Shaw, Chief of Staff and Special Counsel Drumm, Chief Investment Officer Bachher, Provost Brown, Executive Vice President and Chief Financial Officer Brostrom, Chancellor Larive, and Recording Secretary Li

The meeting convened at 2:20 p.m. with Committee Chair Sherman presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of September 28, 2021 were approved, Regents Anguiano, Leib, Lott, Makarechian, and Sherman voting "aye."[1]

2. **REVIEW OF FIRST QUARTER PERFORMANCE FOR FISCAL YEAR 2021–22 OF UC PENSION, ENDOWMENT, BLUE AND GOLD POOL, AND WORKING CAPITAL**

[Background material was provided to Regents in advance of the meeting, and a copy is on file in the Office of the Secretary and Chief of Staff.]

Chief Investment Officer (CIO) Bachher presented the performance of the University's investments as of September 30. From June 30 to September 30, UC had about $168 billion in investment assets. Private equity, mostly actively invested, saw some growth. Public equity made up about 55 percent of total assets, private markets made up 20 percent, and fixed income made up 25 percent of assets. UC's current cash position was lower than what it had been historically, but fixed income was being regarded as liquidity. In the last quarter, the pension, endowment, and the Total Return Investment Pool (TRIP) saw zero percent returns. From September 2020 to September 2021, the endowment returned 28 percent, the pension returned about 22 percent, TRIP returned 14 percent, and the Short Term Investment Pool (STIP) returned 0.3 percent. Much of this growth occurred in the nine

[1] Roll call vote required by the Bagley-Keene Open Meeting Act [Government Code §11123(b)(1)(D)] for all meetings held by teleconference.

months before the last quarter. At present, total assets have grown from $168 billion to $172.5 billion. Fiscal year to date, the endowment returned about 4.3 percent, the pension returned four percent, TRIP returned about 2.5 percent, and STIP remained at zero percent.

Mr. Bachher provided ten-year, five-year, three-year, and one-year predictions. In ten years, he predicted that UC's investment assets would total $250 billion if they grew four percent per year, and that there would be significant opportunities in real estate given the growing need for housing and laboratory space. Investing long-term in equities could help UC get close to its target of seven percent returns in the pension. In five years, Mr. Bachher predicted more stability, higher wages, inflation reaching long-term averages, and interest rates at below three to four percent. He foresaw investment opportunities in digital and physical infrastructure in light of the enactment of the Infrastructure Investment and Jobs Act, as well as attractive investment opportunities in India. He predicted that, in three years, the U.S. could see three to four percent growth in gross domestic product (GDP), and strong demand in the U.S. and abroad would fuel company earnings. In the short term, he believed that inflation would stay above trend. Financial conditions appeared to support riskier assets like stocks, and there seemed to be a "fear of missing out" on popular assets, but Mr. Bachher emphasized the Office of the CIO's long-term considerations.

Committee Chair Sherman asked for an update on investment manager diversity efforts. Chief Operating Officer Arthur Guimaraes replied that the Office of the CIO had begun work on its third annual diversified returns report. The Office of the CIO continued to find partnership opportunities with diverse firms. Mr. Bachher committed to 100 meetings with diverse and emerging managers over the next six months.

Committee Chair Sherman asked if the Office of the CIO was changing its approach given increases in interest rates. Senior Portfolio Manager Satish Ananthaswamy stated that the persistence of inflation and supply chain issues were exerting significant pressure on the Federal Reserve (Fed) to raise interest rates in 2022, and front-end interest rates were rising in anticipation. The Office of the CIO had taken a lower allocation and lower duration risk position, moved to more passive management, and was using the fixed income portfolio to provide liquidity for the University, all of which were suitable for higher interest rates and more inflation. The Office of the CIO did not anticipate high interest rate cycles. If the Fed were to raise rates, it would likely do so gradually.

Committee Chair Sherman, noting that the ten-year Treasury Inflation-Protected Securities (TIPS)/Treasury breakeven rate was about 2.75 percent, asked if the market would revert to that number in ten years. Mr. Ananthaswamy replied that, with higher energy prices and higher rents, a higher headline inflation rate was possible in the next three to six months. However, Personal Consumption Expenditures were very well-behaved. There was little clarity regarding a solution. In addition, anticipated fiscal spending could lead to growth and inflation rates that are higher than expected.

Regent Makarechian shared his belief that inflation was not transitory. The Fed was not accounting for food and energy costs in inflation rates, and U.S. President Biden was asking the Organization of the Petroleum Exporting Countries (OPEC) to increase oil production.

Regent Makarechian predicted that food and oil prices would increase further with a return to more conventional lifestyles. Americans were unable to spend and amassing large amounts in savings due to supply shortages. Regent Makarechian recalled a time when UC investments saw little to no returns and expressed concern that the market's current good performance might lead to the expectation of strong returns in the future. He asked how the Office of the CIO was defending investments from threats of terrorism, war, and pandemics. Mr. Bachher responded that he anticipated some sort of crisis in the next ten years. He predicted six to seven percent returns if UC was fully invested in equities, which was arguably a risky posture. He acknowledged that UC investments seemed to earn returns more quickly than anticipated, but these returns should not be used to predict the future. There were more defensive assets, like real estate and infrastructure, which had protections against inflation. Regent Makarechian expressed concern that most UC investments were in stock and something could happen to the stock market.

Regent Makarechian asked Mr. Bachher about his thoughts on lowering funding ratios for the UC Retirement Plan, which would be discussed at the Finance and Capital Strategies Committee meeting. Mr. Bachher replied that the pension, for instance, was currently 95 percent to 96 percent funded. Last year, a portion of the pension came from unrealized returns. About 16 percent of the pension was invested in fixed income, which had zero percent returns. The Office of the CIO needed to be mindful of risk and expectations, and could not assume that robust returns would continue into the future. Regent Makarechian underscored UC's extraordinary investment performance of the last six months. In his view, spending money now without saving for the future would do a disservice to UC retirees. Mr. Bachher stated that current returns were not reflective of long-term averages.

Committee Chair Sherman noted that the extraordinary returns of the last three to five years smoothed out the effects of the pandemic, the Great Recession, and the dot-com crash. Committee Chair Sherman believed that, while crises were bound to happen, committing to asset allocations in the long term would help UC overcome volatility. Mr. Baccher stated that, 25 years ago, UC achieved its returns with a 60/40 stock and bond portfolio. Achieving similar returns in the present day required taking risks between public and private assets.

Chancellor Hawgood asked about the University's strategy with regard to cryptocurrency. Mr. Bachher replied that his staff advised against investing in it. He did not understand cryptocurrency enough to invest in it on behalf of UC. Mr. Bachher could not reconcile the stock price of Bitcoin, for instance, with its fundamentals. However, the financial technologies and infrastructure used to create digital currencies could not be ignored. At present, he was more interested in financial and government regulation of cryptocurrency.

Regent Lott asked if the Office of the CIO's recent annual endowment report would be discussed at a future meeting. Mr. Bachher replied in the affirmative. Combined, campus endowments and the General Endowment Pool totaled about $30 billion. The report summarized information from these endowments, such as performance, asset allocation, risks, and benchmarks. Mr. Bachher congratulated the campus endowments for their strong performance, as well as his own team for improving endowment performance over the last ten years. Asset allocation was a significant driver of pension returns across the country.

Advisor Lybarger noted that real estate investments in the endowment and pension recently underperformed the benchmark. In the long term, real estate investments in the endowment have performed well, while those in the pension have lagged behind benchmarks. She asked why there was a difference in performance. Mr. Bachher stated that the Morgan Stanley Capital International (MSCI) US Real Estate Investment Trust (REIT) index has outperformed UC's entire private real estate portfolio. In his view, private real estate investment returns should be better than returns in the MSCI US REIT index. The Office of the CIO was working to determine how best to invest in real estate. Despite high returns in real estate investments, there were intermediary fees and leakage. The University had a competitive advantage in investing in its own student housing and laboratory space.

Ms. Lybarger, noting that private funds did not often disclose their investments, asked how much of UC's real estate portfolio is invested in residential rental or housing. Mr. Bachher responded that 19 percent of the real estate portfolio was invested in multi-family housing, and 2.3 percent of the portfolio was invested in student housing. Real estate was selling at historically unrealistic prices and capitalization rates; it was difficult to purchase residential, industrial, and life sciences real estate at reasonable prices. The Office of the CIO was looking for opportunities to invest in or near UC campuses with specific growth needs and could develop properties within its portfolio. Real estate affordability was a consideration, and the Office of the CIO bought and sold real estate at market price. Mr. Bachher envisioned a homegrown real estate management company that methodically pursued these opportunities.

Ms. Lybarger asked what policies were in place to ensure that companies managing property on the University's behalf were not contributing to the housing crisis. Mr. Bachher replied that managers were aware of UC's environmental, social, and governance (ESG) policies. The Office of the CIO was trying to integrate ESG across all of its asset classes and was currently more focused on monetizing assets and realizing their returns.

Regent Makarechian called attention to real estate assets that have recently become popular, such as storage facilities and data centers. He suggested investing in student housing on any university, not just at UC. Mr. Bachher expressed agreement that demand for real estate close to any university would grow. He stated that a homegrown real estate management company could provide long-term lucrative returns.

Regent Makarechian asked if the University was restricted from investing in its own buildings. Mr. Bachher replied that UC must be careful that related party transactions were not taking place. He underscored the importance of publicly discussing the nature of the asset and transaction, as well as possible solutions. The Office of the CIO decided to work with a partner to develop its real estate assets that are close to campus instead of selling them. In his view, owning many assets across the U.S. could result in poor performance. Regent Makarechian remarked that it took the same level of effort to manage real estate regardless of asset value. Mr. Bachher agreed.

Committee Chair Sherman opined that having one's own real estate management company would create value. Regent Makarechian observed that the majority of the money in the rental market was made by buying land, obtaining approval for rental, and selling the land to a developer. He suggested checking whether some of the Office of the CIO's lease ideas were related party transactions.

Committee Chair Sherman stated that, barring related party issues, Moffett Field presented a very good development opportunity that had built-in tenancy. Mr. Bachher suggested that chancellors and campus real estate offices contact the Office of the CIO during the conceptual phase of an opportunity. UC had the advantage of being a non-taxable entity. Committee Chair Sherman added that, while the University had to comply with the California Environmental Quality Act (CEQA), it was not subject to the same zoning requirements as private developers.

Regent Makarechian stated that the Office of the CIO would approach real estate development from an investment perspective and should be the one to hire the architects, developers, and builders for such projects.

Regent Zaragoza asked if these real estate investments were for portfolio purposes or would provide student housing. Mr. Bachher replied that the Office of the CIO was investing in real estate for the income stream, growth and appreciation, and inflation protection. Lately, the Office of the CIO was shifting its strategy to seeking opportunities that could benefit both the University and its investment portfolio. UC had the competitive advantage of location. He anticipated challenges and constraints, but there were good opportunities.

The meeting adjourned at 3:20 p.m.

Attest:

Secretary and Chief of Staff