The Regents of the University of California

INVESTMENTS COMMITTEE
September 28, 2021

The Investments Committee met on the above date by teleconference meeting conducted in accordance with Paragraph 3 of Governor Newsom's Executive Order N-29-20.

Members present: Regents Anguiano, Cohen, Leib, Lott, Makarechian, and Sherman; Advisory members Blas Pedral, Cochran, and Pouchot; Chancellors Hawgood, Khosla, Muñoz, and Wilcox; Advisors Lybarger and Zager; Staff Advisor Tseng

In attendance: Regents Hernandez, Reilly, Torres, and Zaragoza, Regent-designate Timmons, Faculty Representative Horwitz, Secretary and Chief of Staff Shaw, Senior Counsel Katz, Chief Investment Officer Bachher, Provost Brown, Executive Vice President and Chief Financial Officer Brostrom, Chancellor Larive, and Recording Secretary Li

The meeting convened at 2:30 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 May 11, 2021 were approved, Regents Anguiano, Leib, Lott, Makarechian, and Sherman voting "aye."[1]

2. **REVIEW OF FISCAL YEAR 2020–21 PERFORMANCE OF UC PENSION, ENDOWMENT, RETIREMENT SAVINGS PROGRAM, 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 began his remarks by providing an overview of the last quarter. The Standard and Poor's 500 has grown 1.5 percent, and the global market remained flat. The short-term and long-term bond markets also remained flat. As of June 30, 2021, the University had $168 billion in investment assets, an increase of $37.7 billion from the start of the fiscal year. Investment assets have grown by $73 billion since Mr. Bachher joined UC seven years ago, a testament to the strength of the equity markets after the 2008 global financial crisis. It had taken the Office of the CIO 68 years to grow its first $38 billion, so the growth of the last fiscal year was historic. Although Mr. Bachher anticipated decreases after such an unprecedented rise in the markets, the Office of the CIO was making investments decisions for the long term.

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

The Office of the CIO has invested 69 percent of assets in North America and was making changes to its global portfolio given the rise of economies in Asia, especially in China and India. Over the last seven years, the Office of the CIO has earned $5.2 billion in value added and cut fees by $2.2 billion. Last year, the Regents approved an increase of the equity allocation, which has helped returns. Seven years ago, UC was 50 percent invested in public equities; this year, the University was 55 percent invested in public equities. The one-year returns as of June 30 were as follows: the endowment earned 33.7 percent, the pension earned 30.5 percent, the Total Return Investment Pool (TRIP) earned 21.3 percent, and the Short Term Investment Pool (STIP) earned 0.6 percent. In the last 25 years, the endowment earned 8.9 percent, the pension earned 8.1 percent, and STIP earned 3.4 percent. The Office of the CIO aimed to meet or exceed the discount rate of the pension, and the spending rate of the endowment, as well as meet the operating needs of the campuses through TRIP and STIP. The pension was 94 percent funded based on market value and 83 percent funded based on actuarial value. Over the last six years, the payout of the endowment has been $2.6 billion while $4.5 billion has come in from new clients, such as campuses and other pools. Since 2014, UC's passive investments have grown from $30 billion to $108 billion, and active investments have decreased from $65 billion to $60 billion. The Office of the CIO has passively invested where it could not surpass the public market's performance, opting for active investing in the private market. Mr. Bachher credited UC investments' $38 billion growth in the last year to passive investments. While operational costs at similar organizations totaled 0.3 percent of assets under management, costs at the Office of the CIO were 0.023 percent, or less than $39 million.

Chief Operating Officer Arthur Guimaraes provided an update of the Office of the CIO's diversity, equity, and inclusion (DEI) efforts as an employer, investor, and shareholder. As an employer, the Office of the CIO has changed its hiring process to increase the diversity of its candidate pool. Using this new process for its latest hire, the Office chose from a fully diverse group of finalists. The Office was committed to using this process in the long term. As an investor, the Office added five investment managers last year, three of whom were diverse. Although performance was the primary driver of manager selection, two of the top three active public equity managers were black-owned, and a Latino(a)-owned private equity manager achieved 100 percent return on investment. The Office of the CIO was halfway to reaching its goal of investing an additional $2 billion with diverse investment managers. As a shareholder, the Office of the CIO had an obligation to vote $90 billion in shares. The Office has voted against nominating committees without at least one woman and one person of color. After 178 engagements by the Office of the CIO with public companies, 16 of those companies added women and people of color to their boards.

Mr. Bachher shared that the Office of the CIO's prevailing concerns included climate change, risks and opportunities presented by technology companies, inflation, COVID-19, Federal Reserve (Fed) action, and U.S.-China tensions.

UC Berkeley Professor of Economics Christina Romer stated that the Consumer Price Index (CPI) has ranged from negative eight percent early in the pandemic to 12 percent this summer, while the price index for personal consumption expenditures (PCE) less food and energy peaked at 7.5 percent over the summer. Temporary inflation due to supply bottlenecks had been anticipated as the country was emerging from the COVID-19 pandemic, and, in Ms. Romer's view, this was largely true. High index numbers from the summer were declining, and the CPI showed a striking deceleration earlier in September. At the meeting of the Fed the previous week, the Federal Open Market Committee forecast that inflation this year would average 3.5 to four percent and decrease to 2.5 percent in 2022. Private sector forecasts were similar. The Fed's forecasts assumed appropriate monetary policy, and Ms. Romer predicted that the Fed might begin tapering its bond purchases and that policy interest rates might rise sometime in 2022. She was less confident that inflation would decrease to the Fed's two percent target. Supply disruptions seemed to persist, and companies reported difficulty finding workers. Significant federal fiscal stimulus was anticipated, such as the $1 trillion infrastructure bill and $3.5 trillion in other types of spending. Much of this stimulus would be paid for by tax increases but not all of it. On the other hand, the Delta variant of COVID-19 has slowed return to normalcy, consumer spending has slowed, and the forecast of gross domestic product growth slowed down for the third quarter. The debt ceiling presented a risk to the economy, and any risk to the economy could lower growth, raise unemployment, and slow inflation.

Sharon Yuan, President of the Asia Group, stated that the relationship between the U.S. and China, which she regarded as at its lowest point in decades, was unlikely to dramatically change course in the near term. Like the Trump administration, the Biden administration has characterized China as a strategic competitor, but its approach and tactics differed. U.S. Secretary of State Antony Blinken described the Biden Administration's China strategy as competitive when it should be, collaborative where it can be, and adversarial when it must be. This strategy focused on three key areas: sovereignty issues pertaining to Xinjiang, Hong Kong, Taiwan, and the South China Sea; China's innovation in emerging technologies such as artificial intelligence and quantum robotics, which could provide economic and strategic advantages; and unfair trade practices. Ms. Yuan expected that the U.S. would push China to address long-standing structural concerns such as State-owned enterprises and government procurement. These bilateral dynamics were unfolding during a consequential period in Chinese politics, when Chinese President Xi Jinping was expected to be named as President for a third term. Given these circumstances and little direct engagement between the two governments, there was little room for compromise. However, there were signs of potential movement. The two presidents engaged in a telephone conversation, and senior-level engagement was expected at the Group of Twenty (G20) meeting and 2021 United Nations Climate Change Conference. Sustained, high-level engagement between the two countries would be needed for any real progress, but it was unclear if either side sought fruitful engagement. Until progress is made on key issues, this competitive and confrontational relationship was likely to continue.

Mr. Bachher noted that, in the last six months, the question of whether to invest in China has become less straightforward given the potential expropriation of companies. The lower-rate environment in the next three years would have an effect on stocks and bonds.

Managing Director of Public Equity Investments Ronnie Swinkels stated that UC's passive exposure in public equities was held in the Morgan Stanley Capital International All

Country World Index (MSCI ACWI), which also served as the benchmark. The Office of the CIO paid one basis point for this exposure. The MSCI ACWI included over 9,000 stocks spread over 23 developed markets and 27 emerging markets. The Office of the CIO increased its passive exposure significantly since 2014 because of the relative efficiency of the market, but the team believed that there were active investment opportunities in the pension and endowment. Active managers could beat the MSCI ACWI by selecting stocks that were in regions or sectors with less competition and concentrating their positions. These managers tended to invest in stocks for two to five years, unlike the U.S. market average of less than six months. U.S. and global returns were similar in passive equities, which was rare given outperformance by the U.S. in the last decade. India's market performed well despite high rates of COVID-19, and China and Japan both underperformed but still grew by 25 percent. Small-cap stocks outdid large-cap stocks, as smaller companies tended to perform better than larger companies in a strong economy. In the active program, the pension outperformed the benchmark by 0.9 percent, and the endowment added 0.2 percent of value. Mr. Swinkels attributed the pension's lower performance due to a greater allocation to China and biotechnology stocks, which both underperformed the last fiscal year. In the last three years, the pension beat the benchmark by 1.2 percent, and the endowment beat the benchmark by 1.8 percent. In ten years, the active program has added over $2.5 billion in value. Despite recent selloffs, the equity markets had very high valuation. Most market gains came from better-than-expected company earnings rather than equities becoming more expensive. The Office of the CIO believed that equities remained attractive. As a long-term investor, the University could deal with short-term volatility.

Senior Portfolio Manager of Asia Investments and Global Rates and Trading Satish Ananthaswamy stated that his team managed $45 billion in fixed income assets. Fixed income remained a challenging environment. His team has reduced UC's exposure to higher interest rates by shortening portfolio maturity, but this would result in negative returns. The overall allocation to fixed income has been reduced to the lowest it had ever been, and fixed income has been removed from active management for the first time. Currently, STIP had about $10 billion, which was invested in high-quality securities with an average maturity of under three months. In FY 2020–21, STIP returned 0.6 percent and was expected to return close to zero in this fiscal year. TRIP had $6 billion in fixed income, which was invested passively in high-quality, short-maturity U.S. corporate bonds and U.S. government securities and returned 0.4 percent. Bloomberg Barclays 1 to 5 Year Government/Credit index, whose average maturity was under three years, served as the benchmark. The less than $1 billion invested in fixed income in the General Endowment Pool (GEP) was expected to return 40 basis points. The Office of the CIO ran underweight in fixed income last fiscal year and would likely do the same this fiscal year. Fixed income was also underweighted in the pension, making up about $16 billion, or about 17 percent, $10 billion of which was passively managed core fixed income that earned about ten basis points last fiscal year. The remainder was invested in growth fixed income; high yield bonds returned almost 15 percent and emerging market debt returned 7.5 percent. The Office of the CIO would continue to passively manage core fixed income at a shorter maturity to minimize sensitivity to higher interest rates. Housing, wages, and supply chain problems were pushing inflation. Prices have doubled across all truck transportation in the

U.S., and the price of transporting a container from China to the U.S. was ten times higher than usual. This could force interest rates to go up. On the other hand, interest rates could remain low for the foreseeable future because of global fiscal and monetary stimulus, a demand for high-quality U.S. securities, and negative returns in developed market bonds. UC Investments was positioned appropriately for these outcomes.

Investment Officer in Private Equity, Real Assets Matt Webster stated that the Office of the CIO played to its strengths, was patient, and concentrated on its best ideas. The University began investing in technology start-up companies in the late 1960s. In 1979, UC enlisted venture capital (VC) firms to manage its money. By 2001, this program generated a return of over 50 percent over a ten-year period. Due to lawsuits in 2003, UC lost access to one VC firm and missed several opportunities. Due to the decline of ten-year returns in 2011, the Office of the CIO and the Regents launched the co-investment program, where the team could hand-select companies and invest in them directly and on a no-fee, no-carry basis. The Regents doubled the private equity asset allocation in 2017. In 2021, the ten-year performance was 23 percent for the endowment and 17 percent for the pension. The co-investment program generated 33 percent over the past ten years, and VC generated 22 percent returns. The program currently had $11.6 billion, having grown by $4.7 billion last year. In the last fiscal year, private equity generated 59 percent returns for the endowment and 55 percent returns for the pension. Significant investor demand, low interest rates, and free-flowing credit have driven up valuations of companies in UC’s portfolio. The top 100 companies in the UC private equity portfolio represented over 50 percent of its assets. The Office of the CIO planned to focus its efforts in the co-investment program by building strategic partnerships with 20 of the best global investors and introducing them to UC talent and intellectual property ecosystem. The University had unparalleled resources at its campuses, health centers, and laboratories, as well as among UC alumni. Recently, for instance, the Office of the CIO invested in an artificial intelligence platform developed at a UC Berkeley laboratory. Three of the six largest companies in the world were started on college campuses or by college students.

Managing Director of Defined Contributions Products Marco Merz stated that the UC Retirement Savings Program (UCRSP) had 316,000 participants who saved $34.6 million, as well as a growth of more than $7 billion over the previous year that was driven mostly by equity market returns. Early in the pandemic, the Office of the CIO hosted live webinars encouraging participants not to divest; most participants did not divest and were able to participate in the rebound in the equity market. In the last seven years, the Office of the CIO made Pathway, the target date fund, the default option, increasing expected and realized returns; reduced the number of fund choices from 75 to 14; and reduced its management fee to 0.04 percent, or four basis points, which meant free alpha, or excess return, to participants. About 61 percent of UCRSP was invested in equities, 30 percent in fixed income, and the remainder in the brokerage window, where participants could choose from a wide range of exchange-traded funds and mutual funds. Roughly 40 percent of assets were in Pathway, which had ten asset classes and a glide path that reduced risk over time, and about $18 billion was spread over 14 funds. Currently, UCRSP was over 75 percent passively invested, up from 38 percent seven years ago. Performance was very close to the benchmark. Last month, the Office of the CIO incorporated a deferred annuity into UCRSP. In late March, the Office launched the UC Global Equity ex Fossil Fuel Fund, which provided the same passive exposure as in the pension and the endowment. To ensure participants had the right tools for retirement, the team was researching how it could incorporate private assets into the target date fund and how to create bespoke, sustainable investing solutions.

Mr. Bachher attributed current performance to changes in asset allocation and increasing UC's exposure in equities, adding that asset allocation drove the success of the portfolio. He stressed patience over a long period of time despite volatility, as well as how difficult it was to outsmart the market, especially given the large amount of money that the Office of the CIO managed. The team opted to meet the benchmarks through passive investment so that it could focus on private market investments. The team must focus on long-term decisions and maintain consistent execution to ensure returns. Mr. Bachher did not believe that the high returns of the last fiscal year would occur this year.

Regent Leib asked about the difference between the market value and actuarial value in pension funding. Mr. Bachher replied that market value was calculated on a one-year basis, while actuarial value was calculated over five years. Regent Leib asked which was normally used. Mr. Bachher replied that actuarial value was typically used.

Regent Makarechian asked how the Office of the CIO was thinking about asset allocation given current events, such as the possibility of Fed action, inflation, U.S.-China relations, and China increasing control over its companies. Mr. Bachher replied that a change in interest rates and inflation rising up to five percent would affect equity markets, commodities, and other areas. Mr. Ananthaswamy added that, based on the minutes of the last Fed meeting, interest rates were expected to rise soon. Whether inflation would be transitory was unknown but there were significant supply chain disruptions, such as long lines of ships backed up and waiting to unload goods at ports, stores struggling to stock shelves, and a shortage of computer chips. Natural gas and gasoline prices were rising, as were transportation costs. How quickly the Fed raises interest rates after tapering, or pulling back stimulus, would be a significant issue, along with many geopolitical concerns. Mr. Bachher stated that the Office of the CIO would be observing equities over the next several months to determine whether to take a more conservative approach. He distinguished between good inflation, such as wage increases, and bad inflation.

Regent Makarechian asked what portion of high yield bonds that UC was invested in came from the global market. Mr. Ananthaswamy replied that, with regard to high yield bonds, UC invested only in U.S. companies rated BBB minus or below and had a high correlation to stocks. U.S. dollar-denominated emerging market bonds, which were sovereign securities lent to governments and whose debt was in U.S. dollars, returned 7.5 percent. Mr. Bachher added that the Office of the CIO has given away a large amount of returns in emerging market debt because of issues in the Chinese real estate market.

Regent Makarechian asked if UC owned any Evergrande bonds. Mr. Bachher replied that the University's Evergrande public equity exposure was $696,000 in U.S. dollars across the UC Retirement Program and GEP.

Regent Makarechian asked if the $12 billion in private equity included co-investment. Mr. Webster responded in the affirmative. In response to a question from Regent Makarechian regarding what portion of private equity was co-investment, Mr. Webster replied that $1.6 billion of the pension and about $1 billion of the endowment was co-investment.

Regent Makarechian asked if UC sat on the boards of the companies in which it was co-investing. Mr. Webster responded in the negative. UC sometimes held observer seats and was looking for ways to support these companies, such as involving UC talent. Mr. Bachher added that it was difficult for UC to sit on boards. The Office of the CIO was working with the Office of the General Counsel to determine how UC can be involved with these companies.

Regent Makarechian inquired about the role of job descriptions in the Office of the CIO's diversity efforts. Mr. Guimaraes stated that the Office of the CIO used software that writes job descriptions with more equitable, culturally competent wording in order to attract a more diverse set of candidates.

Advisor Zager asked Ms. Romer what caused Fed Chair Jerome Powell's forecast to become more aggressive, noting that central banks have followed suit. Ms. Romer replied that she was not completely certain, but there was much volatility in the inflation numbers. The Fed invested a great deal in forecasting, so it might be seeing indicators of inflation that others were not, but the Fed might also be noting the supply chain issues. The amount of congressional fiscal action might be a reason to strengthen growth in the future.

Advisor Lybarger asked how much UC spent annually in fees. Mr. Bachher responded that it cost $39 million to run the Office of the CIO. This year, the Office of the CIO paid $400 million in external management fees and $1 billion in carry. State law required transparency in disclosing annual fees. Fee increases were not necessarily a bad thing. The Office of the CIO paid both management and incentive fees, and higher incentive fees were expected in a year with strong returns. Regent Sherman asked what internal and external fees were in basis points. Mr. Bachher stated that fees made up 1.5 percent of the endowment, where there was more active management and incentive fees, and 0.6 percent of the pension, where there was more passive investment and therefore lower fees.

Regent Zaragoza asked about ethical considerations in investment decisions, such as ensuring no displacement in real estate investments. Mr. Bachher replied that the Office of the CIO engaged in investment and operational due diligence and considered all kinds of risks, including environmental, social, and governance risks. He stated that the Office had not yet experienced the displacement issue in a real estate investment. Affordable housing, multi-family housing, and housing near universities presented attractive investment opportunities. The Office of the CIO was interested in investments that solved problems instead of creating them.

Regent Hernandez asked what triggered asset reallocation. Mr. Bachher stated that UC was currently overweight in equities in both the pension and the endowment. The Office of the

CIO, influenced by guidance like Fed policy, was rebalancing regularly and considering the changing environment. Mr. Bachher also sought guidance from Regents.

Regent Makarechian asked Mr. Bachher for his opinion on remote work. Mr. Bachher replied that, while he enjoyed working remotely, the nature of the work required some physical interaction. The social dynamic, energy, and bonding during a recent, in-person meeting of several members of the team was much better than months over teleconference. He was supportive of remote work but wished to ensure that staff do not feel isolated.

The meeting adjourned at 4:05 p.m.

Attest:

Secretary and Chief of Staff