The Regents of the University of California

INVESTMENTS COMMITTEE
September 20, 2022

The Investments Committee met on the above date at the Price Center, San Diego campus and by teleconference meeting conducted in accordance with California Government Code §§ 11133.

Members present:	Regents Blas Pedral, Cohen, Makarechian, Pouchot, and Sherman; Ex officio member Drake, Advisory member Ellis; Chancellors May and Muñoz; Advisors Lybarger and Zager; Staff Advisor Lakireddy
In attendance:	Regent Robinson, Regent-designate Raznick, Faculty Representative Cochran, Interim Secretary and Chief of Staff Lyall, Chief Investment Officer Bachher, Executive Vice President and Chief Financial Officer Brostrom, Senior Vice President Colburn, Senior Counsel Adkison, and Recording Secretary Li

The meeting convened at 3:00 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 17, 2022 were approved, Regents Blas Pedral, Drake, Makarechian, Pouchot, and Sherman voting "aye."[1]

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

[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 the presentation.

David Schroeder, Director of Global Rates and Trading, stated that inflation had not yet peaked and was still persistent. Referring to a presentation slide, he stated that the year-over-year run rate for the Consumer Price Index (CPI) was over eight percent. For the last several decades, prices had been stable and low, with the average annual increase in CPI at about two percent, service inflation at about three percent, and goods inflation remaining relatively flat. Mr. Schroeder attributed the current inflation rate to the COVID-19 pandemic, the conflict in Ukraine, deglobalization, supply chain disruption, and stimulus provided by the U.S. government. There were significant changes for all categories of CPI—the CPI for food increased about 11 percent, and the CPI for energy increased roughly 24 percent. Core inflation increased six percent, and goods inflation

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

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increased seven percent. Many private forecasters predicted that inflation would decline at a slow pace through the end of the calendar year, during which the overall inflation rate would be about six percent and the core inflation would be about five percent. Declining energy prices, car prices, and rents, as well as the strength of the U.S. dollar could contribute to declines in inflation. The Federal Reserve (Fed) projected that inflation would decline to a five-year rate of 2.5 percent. In Mr. Schroeder's estimation, inflation would decline to five to six percent in the near term, but when the rate would decline to two to three percent was unknown.

Satish Ananthaswamy, Senior Portfolio Manager of Asia Investments and Global Rates and Trading projected that the Fed would increase interest rates into 2023, noting that the markets expected a Federal Funds Rate of about 4.5 percent in that year. U.S. macroeconomic conditions seemed resilient; the number of jobs continued to grow, and wage income increased 3.5 percent. As a result, the Fed could continue raising interest rates until the unemployment rate increases. According to one employment survey, there were about six million people available for 11 million jobs. Mr. Ananthaswamy presented a chart comparing the Federal Funds Rate, the Ten Year Treasury Rate, and the Two Year Treasury Rate from 2014 to present. Noting that the Ten Year Treasury Rate was lower than the Two Year Treasury Rate, he surmised that the market expected the Fed to increase interest rates. Once the Two Year Treasury Rate peaks, the Fed's raising of interest rates would likely come to an end. Global central banks were raising interest rates aggressively. For instance, the United Kingdom and Europe were facing an economic downturn but have raised interest rates. Given the energy supply issue, inflation was more acute in that region than in the U.S. Mr. Ananthaswamy also projected that the value of the U.S. dollar would remain strong as the Fed continues to raise interest rates and would not peak until interest rates peak.

Mr. Bachher remarked that, as a result of rising interest rates, fixed income investments now saw yields. He presented a table indicating the global distribution of UC investments. As of June 30, 2022, 74 percent of UC investment assets were in the U.S., 13 percent in Asia, and 12 percent in Europe. UC had invested about $4.2 billion in China, $3.37 billion in Japan, $2.71 billion in India, and $3.05 billion in the United Kingdom. Despite the COVID-19 pandemic, the Office of the CIO believed that the U.S. dollar remained strong and that the U.S. was the best option for investment opportunities.

Ronnie Swinkels, Managing Director of Public Equity Investments, presented a chart comparing U.S. and global equity performance. He noted that, while equities would continue to rise, conditions would be volatile as they have been this calendar year. Despite declines in the last fiscal year, the U.S. still outperformed Europe, Japan, and China, the latter experiencing a particularly weak year due to the pandemic, increased regulation, and a troubled real estate market. Mr. Swinkels presented a chart comparing the global underperformance of technology sectors with the strong performance of the energy sector, which he attributed to an increase in demand as economies were reopening and supply shock related to the war in Ukraine and other factors. He compared this with the last ten years, during which the energy sector underperformed about 600 basis points per year. When comparing ten-year annualized performance, the U.S. outperformed global markets,

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while India outperformed other markets when comparing 25-year annualized performance. A strong economy did not guarantee strong returns, as demonstrated by the 25-year annualized performance of the Chinese equity market. Mr. Swinkels foresaw potential deleveraging, or “panic sales,” which could create opportunities for UC.

Mr. Bachher noted that fossil fuel investments performed well in the last 12 to 18 months, and that the worldwide use of coal as an energy source has grown since 2013. In his view, progress in addressing climate change would be slowed by current geopolitical dynamics.

Mr. Bachher presented a chart demonstrating the growth of UC investment assets over the last 30 years, noting that asset growth remained flat from 2000 to 2010, and another chart comparing UC investment assets from June 2019 through August 2022. While the value of assets would rise and fall, the Office of the CIO was focused on long-term investing. As of June 30, 2022, the University held $152 billion in total investment assets. Of these assets, $111 billion were retirement assets, with $30 billion in the UC Retirement Savings Program and $81 billion in the pension. The endowment and working capital were nearly the same size, being $20.4 billion and $20.8 billion respectively. Within the endowment, $18.2 billion was in the General Endowment Pool and $2.2 billion was in the Blue and Gold Pool. Within working capital, $11.7 billion was in the Total Return Investment Pool (TRIP) and $9.1 billion in the Short Term Investment Pool (STIP). Also as of June 30, 52.2 percent of assets were invested in public equity, 26.1 percent in fixed income, 20.4 percent in private assets, and 1.3 percent was being held as cash. In 2021, the Office of the CIO allocated more assets to public equity to take advantage of rising equity markets. During the pandemic, the Regents approved a duration reduction in the fixed income portfolio in light of the rising interest rate environment, as well as an increase in the public equity allocation by ten percent. The latter decision grew assets by $1.8 billion. As of August 31, 2022, the public equity allocation declined to 50.5 percent; the Office of the CIO sold equities when markets were robust during July and August to build up its cash position, now close to $5 billion. Cash, which now earned four percent returns, was now an asset class. Mr. Bachher compared this with the 25-year return of six percent from global equities.

Committee Chair Sherman asked what kind of effect rising interest rates would have on U.S. corporate and consumer debt and whether corporations fixed their interest rates as the University had done. Mr. Swinkels stated that rising interest rates were less of an issue for large-cap U.S. equities, as publicly traded companies were refinancing the little debt that they had. Mr. Schroeder added that even the least creditworthy company fundamentals in the fixed income market were still good. Leverage was low and interest coverage was high. Cash-to-debt was declining but still high. The fixed income portfolio did have an allocation in the high-yield markets, which were performing better than they had been in some time. Delinquencies were de minimis this year.

Mr. Bachher asked Mr. Ananthaswamy to discuss the possible effects that debt would have on real estate. Mr. Ananthaswamy stated that debt and leverage had a profound effect on real estate investments. When interest rates were low during the last four decades, investors focused on equity returns in real estate. With interest rates for real estate investments now

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as high as ten percent, investors could see negative returns. In the last two or three months, transactions in the real estate market have come to a halt due to the lack of available leverage and the unwillingness of banks to lend money. Higher rates also meant a higher cost of funds, and the cost of debt has risen even for real estate investments that were purchased several years ago.

Mr. Bachher asked Steven Sterman, Senior Managing Director of Fixed Income Investments and Credit Research, to speak about what private companies in the University's portfolio were experiencing. Mr. Sterman shared that private companies were facing many of the same issues that publicly traded companies were facing, but inflation was affecting them more than higher rates. Private companies were grappling with whether they could pass their costs to the end market. Some companies in UC's portfolio raised prices early in anticipation of inflation, while other companies were increasing their prices now and expected to increase prices in 2023. A number of companies in the portfolio that borrowed on a floating interest rate were opting for a fixed interest rate. Companies were struggling to borrow a small amount of money on credit line for add-on transactions, because lenders wished to renegotiate and reprice the company's entire credit line.

Committee Chair Sherman, noting the market value of private equity as of June 30 and August 31, asked if the Office of the CIO's reporting lagged by one quarter. Mr. Sterman clarified that, at the beginning of July, the Office of the CIO received estimates of performance as of June 30 and has received over 90 percent of performance statements since then. The Office of the CIO's estimate of the performance of its private equity investments was only several basis points higher than the true performance.

Committee Chair Sherman asked if the Office of the CIO was confident in the numbers it was receiving and whether it was vetting manager valuations. Mr. Sterman replied that valuations in the private markets rise and fall more slowly than in the public markets. The Office of the CIO spent much time discussing with managers how they arrived at their valuations. Chief Operating Officer Arthur Guimaraes shared that Deloitte was engaged to research comparable companies, which led the Office of the CIO to lower the private equity market value by an average of ten percent. In Mr. Bachher's view, private equity was not the panacea that would save pension plans and endowments in the U.S. He expressed concern about the $1 trillion in forward commitments that investors have given to the private equity industry. He believed that only about 20 percent of the University's private equity gains were realized.

Regent Cohen asked if the University had any difficult reporting on valuations. Mr. Bachher responded in the negative, explaining that the valuation of a private asset was certain during the time of purchase and the time of sale. Any valuation in between those two points in time was an estimation.

Regent Cohen asked if the six percent returns in public equity assumed an inflation rate of two percent or less. In his estimation, if cash earned four percent returns, then stocks would earn about ten percent in returns. Mr. Swinkels responded that the answer depended on the horizon for inflation. Given the current rate, there would be negative inflation-adjusted

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returns. With a longer-term timeframe of five or ten years, returns would look different. In his view, active returns were not higher than the long-term average. Mr. Ananthaswamy noted that the ten-year Treasury Inflation-Protected Securities (TIPS)/Treasury break-even inflation rate was 2.5 percent, which implied that the Fed would successfully bring down inflation in the long term. He believed that inflation would not come down easily in light of productivity and technology issues.

Mr. Bachher invited Torsten Slok, Chief Economist at Apollo Global Management Inc., to provide his perspective on the long-term outlook for public equity. Mr. Slok stated that, previously, globalization kept inflation from rising, but more homeshoring, onshoring, and trade wars around the world would put more upward pressure on inflation. Low immigration during the pandemic has led to outcomes such as rising wages and wage inflation. Technology and productivity once kept inflation from rising, but there were now more questions about privacy, and more regulation was anticipated in the U.S. and in China. Mr. Slok expressed concern about the current inflation rate and where it would eventually settle. He believed that it would be more challenging for companies to return to previous behaviors, and that they would opt instead to raise output prices in response to higher wages. Corporations and households were faring relatively well, and the Fed was not succeeding in cooling down the economy. Corporate profit margins and profit as a share of gross domestic product were at their highest levels in 50 years. He suggested holding cash and investing in short-duration, floating-rate product to take advantage of rising short rates.

Advisor Zager noted that the ten-year U.S. Treasury rate was 100 basis points over the long-run inflation rate of 2.5 percent. He asked what role the reduction of the Fed balance sheet played and whether a premium should be received as the Fed reduces its balance sheet over the next few years. Mr. Ananthaswamy replied that the Fed was engaging in quantitative tightening and projected that the Fed would pay down $85 billion per month—$60 billion in Treasury bonds and $25 billion in mortgages. The Fed could also sell short-maturity coupon bonds. UC Berkeley Professor of Economics Christina Romer added that there was much uncertainty because the functioning of quantitative easing or takings was unknown. Mr. Slok stated that the U.S. government's budget deficit had been about $500 billion prior to the pandemic, was now $1 trillion, and was slated to be roughly $1.5 trillion next year. The bid-to-cover ratio, an indication of how many individuals participated in Treasury market auctions, was declining and the size of these auctions was increasing. Quantitative tightening while budget deficits have doubled could make for higher rates.

Regent Makarechian asked if the Office of the CIO was considering the repositioning of UC's global assets in light of geopolitical issues and changes to globalization. Mr. Bachher replied in the affirmative, noting his wish to transfer investments back into the Standard and Poor's (S&P) 500. He cited lack of transparency, lockdowns, and supply chain issues as reasons that the Office of the CIO was seeking to repatriate capital from Chinese investments. The Office of the CIO would continue to make investments in India but would be mindful of politics and corruption there. He predicted that the energy situation in Europe and the disjointed nature of politics there would lead to a longer path to recovery than in

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the U.S. The Office of the CIO would exercise caution regarding UC's exposure in Europe. He wished to invest 80 percent of UC assets in the U.S. and 20 percent globally.

Regent Makarechian remarked that taking investments out of China would help the University achieve its goal of removing fossil fuel investments.

Staff Advisor Lakireddy noted that UC held $5 billion in cash and that there were staff who were struggling financially due to inflation. She asked how UC could invest this money back into the UC community. Mr. Bachher replied that investments in the UC community were coming from working capital and endowment payouts, and were ensuring that current and former staff were receiving payments from the retirement plan. The Office of the CIO had a responsibility to protect the wealth of this client base. Working capital was more liquid.

Regent-designate Ellis asked why alumni donors should give to the General Endowment Pool. Mr. Bachher responded that the endowment has generated nine percent returns on an annualized basis for the last 30 years.

Mr. Bachher continued the presentation, presenting charts of investment returns in fiscal year 2021–22. All asset classes saw negative returns except for STIP. He compared these returns with those ranging from a three-year to 30-year basis. The Office of the CIO has added $5.2 billion of value over the last eight years and saved $2.9 billion in fees. The pension had a 30-year, annualized return of 8.3 percent. Mr. Bachher presented a chart of the pension's growth over 30 years; this demonstrated market performance given UC's contribution holiday. Noting the "lost decade" in the capital markets during this period, he underscored the importance of continuing to fund the pension. Mr. Bachher compared the asset allocation of the pension at the beginning of the fiscal year with the end, noting a decline in percentage allocated to public equity and fixed income and an increase in percentage allocated to cash. The pension was 84 percent funded on an actuarial basis and 80 percent funded on a market value basis.

Marco Merz, Managing Director of Defined Contributions Products, stated that, as of June 30, the UC Retirement Savings Plan (UCRSP) had $30 billion in assets, down $4.6 billion compared with the previous year due to a decline in the equity markets. Forty percent of assets were in the Target Date Fund, where the Office of the CIO could control asset allocation, and nearly 55 percent of UCRSP assets were in the 13 Core Options, which gave participants the opportunity to choose their own asset allocation. About 75 percent of the assets were passively managed, and the management fee was five basis points. UCRSP assets have grown over 30 years despite equity market declines, which Mr. Merz attributed to consistent contribution by employees. The average supplemental voluntary savings rate was 11 percent, the amount that employees saved beyond the mandatory contributions to the pension. In 2014, the default plan was the Savings Fund, a money market fund, which the Office of the CIO changed to the Target Date Fund, which resulted in 50 percent cumulative increased performance. The Office of the CIO was updating the UCRSP asset allocation, increasing risky assets slightly over time. One recent update to the UCRSP was the option to buy a deferred annuity within the Target Date Fund; with higher interest rates,

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annuity payments could increase 40 to 50 percent year-over-year. Another update was the removal of fossil fuel investments as of June 30.

Committee Chair Sherman asked if the default plan was the Target Date Fund. Mr. Merz responded in the affirmative. Some participants wished to start saving but did not elect a plan. Committee Chair Sherman asked how many participants did not elect a plan. Mr. Merz responded that 40 to 50 percent of participants did not elect a plan, and 98 percent of those who defaulted into the Target Date Fund stayed there.

Regent Makarechian recalled that he opposed a proposal to lower the contribution to the pension last year. He asked what the current funding ratio was, and when UC should return to normal contribution levels. Mr. Bachher replied that, last year, the pension was 94 percent funded on a market value basis. Currently, it was 80 percent funded on a market value basis and 84 percent funded on an actuarial basis. In Mr. Bachher's view, one should not modulate the contribution because of good market performance. He agreed that the contribution should not be reduced.

Regent Makarechian clarified that he was not suggesting an increase in the contribution due to inflation. The University should maintain a consistent approach. He suggested a future discussion about what an appropriate contribution amount should be.

Regent Makarechian asked about the pension's net cash flows. Mr. Bachher responded that, in 2022, pension inflows were $4 billion and outflows were $4.6 billion. Since 2019, the net cash outflow has been about $600 million. Other than in 2015, 2016, and 2017, the pension has seen a net cash outflow.

Regent Makarechian asked what caused net cash inflows in 2015, 2016, and 2017. Mr. Bachher replied that this could be attributed to State contributions, as well as internal and external borrowing.

Regent Makarechian asked that causes of and solutions to the pension's cash flow issues be discussed at a future meeting. Mr. Bachher offered to send the inflow and outflow charts for the Regents to review.

Advisor Lybarger remarked that employee contributions to the pension amounted to a pay cut for UC employees, who were disappointed in the Regents' recent decision to reduce contributions. She emphasized the importance of UC continuing to fund the pension and expressed her wish that Regents address the unfunded liability.

Mr. Bachher stated that, in March 2021, campuses resumed investment in the Blue and Gold Pool, which now had about $2.4 billion. Previously, the Blue and Gold Pool had provided liquidity to campuses when they needed it. The Office of the CIO allocated 80 percent of Blue and Gold Pool assets to stocks and 20 percent in bonds. Mr. Bachher credited $5.6 billion in campus deposits since 2014 for the growth in the endowment. Currently, UCSF, UC Berkeley, and UCLA have each contributed over $1 billion, with UC Davis and UC San Diego both approaching this amount.

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Mr. Bachher asked Ms. Romer to provide her views and predictions. Ms. Romer shared that she was part of an advisory group within the University that has met regularly with Mr. Bachher and that, during a recent meeting, group members came to the same conclusions. First was the conclusion that inflation would persist. There had been previous assumptions of aggressive action by the Fed and other central banks, and that supply chain problems would ease, but this had not occurred. Maurice Obstfeld, UC Berkeley professor and former Chief Economist of the International Monetary Fund, reminded the group that this was a world phenomenon. The Fed was committed to bringing down inflation, and prolonged and aggressive action would greatly increase the chance of a recession. The group agreed that the federal funds rate would stay higher for longer, which would affect the real economy. Mr. Obstfeld indicated to the group the number of monetary contractions that have occurred worldwide. The last U.S. employment report was positive, and there was still much pressure on inflation from the labor market. UC Berkeley professor and Nobel laureate David Card shared with the group that there were more vacancies for a given unemployment rate than at any other period during which this data was recorded. Mr. Obstfeld believed that Europe was close to or already in a recession due to energy supply issues and tight monetary policy. Ms. Romer attributed to the slowdown in GDP to the rundown of fiscal stimulus during the pandemic. Monetary policy typically took at least six months to have an effect on the unemployment rate. Any decisions made by the Fed over the next three months could affect the economy in the next year to 18 months. In her view, it was important to think longer-term about where stresses would be and how soon the unemployment rate would increase and inflation would decrease. One was currently only at the beginning of a process that the Fed had embarked on.

The meeting adjourned at 4:40 p.m.

Attest:

Secretary and Chief of Staff

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