The Regents of the University of California

INVESTMENTS COMMITTEE
September 19, 2024

The Investments Committee met on the above date at the UCLA Luskin Conference Center, Los Angeles campus and by teleconference meeting conducted in accordance with California Government Code §§ 11133.

Members present: Regents Cohen, Lee, Makarechian, Matosantos, and Robinson; Ex officio members Drake and Reilly, Advisory members Emiru and Wang; Chancellors Hawgood, Khosla, Lyons, Muñoz, and Wilcox

In attendance: Regent Beharry, Regents-designate Brooks and Komoto, Faculty Representative Cheung, Staff Advisor Frías, Secretary and Chief of Staff Lyall, General Counsel Robinson, Chief Investment Officer Bachher, Executive Vice President and Chief Operating Officer Nava, Interim Senior Vice President Turner, Vice President Kao, Chancellors Larive and Yang, Interim Chancellor Hunt, and Recording Secretary Li

The meeting convened at 2:00 p.m. with Committee Chair Robinson presiding.

REVIEW OF FISCAL YEAR 2023–24 PERFORMANCE FOR UC RETIREMENT, ENDOWMENT AND WORKING CAPITAL ASSETS

[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 provided a review of investment performance in fiscal year 2023–24, which he noted was driven by the "Ten Pillars" philosophy and office culture. The Office of the CIO adopted a growth mindset and planned to add staff and seek opportunities despite difficult times in the world. In Mr. Bachher's view, the U.S. would remain the best place to invest in the next decade. In FY 2023–24, total assets rose $16 billion for a total of $180 billion; retirement assets stood at $137.6 billion, the endowment at $29.5 billion, and working capital at $12.8 billion. The one-year net return was 11.7 percent for the General Endowment Pool (GEP), 15.7 percent for the Blue and Gold Pool, 12.2 percent for the pension, and 9.7 percent for working capital. On a 30-year basis, the endowment had a return of 9.3 percent and the pension had a return of 8.6 percent. Mr. Bachher compared the one-year returns of the GEP, which the Office of the CIO managed for the UC system, campus endowments that the Office of the CIO wholly or partially managed, and management companies at UCLA, UCSF, and UC Berkeley. Campuses have invested $13 billion with the Office of the CIO in the last decade.

Similar to the prior year, global equities earned a 20 percent return. Ten years ago, he had been advised not to invest in the U.S., to invest in emerging markets, to invest heavily in China, and to invest in companies for value instead of growth. However, U.S. equities outperformed global equities, and India surpassed China in the global index. Mr. Bachher contrasted the potential for growth in the U.S. and India with the diminished aspirations of entrepreneurs in China. He noted how the top companies in the Standard and Poor's 500 (S&P 500) have changed over the last several decades, and the Office of the CIO would try to determine what companies would top the list in the future. As of August, the U.S. inflation rate was 2.5 percent, and the federal funds rate dropped 50 basis points on September 18. Given the earnings of companies and the strength and growth of the U.S. economy, Mr. Bachher opined that the U.S. was not likely heading into a recession; gross domestic product was still growing at about three percent.

Mr. Bachher presented a table of the asset allocation, noting that the Office of the CIO had allocated less to cash and used fixed income as a proxy for cash, and shared his projections for the coming year. He anticipated that short-term bonds would return 3.5 to 4.5 percent, that stocks would return six to seven percent per year, and that private equity could return 12 to 14 percent. Mr. Bachher believed that the University's investment in Blackstone was well timed and that real estate would benefit from the Federal Reserve's future interest rate cuts. At a future meeting, he would present his plan to reallocate assets from a hedge fund absolute return portfolio to other asset classes. Mr. Bachher presented graphs comparing asset allocation in 2014, 2023, and 2024, adding that the governance structure between his office and the Board of Regents enabled the Office of the CIO to be flexible and dynamic when investing. Presently, 72 percent of UC investments were in the U.S., 12 percent in Europe, and 11 percent in Asia. In the future, Mr. Bachher planned to increase investment in the U.S. and decrease investment in Europe. Despite the complexity of investing in Asia, demographics were favorable there. The challenges that the Office of the CIO faced while managing the portfolio included national debt and U.S. politics, wars that could expand, artificial intelligence, new solutions for climate change and energy transition, demographics, China-U.S. relations, and deglobalization.

Mr. Bachher indicated that, since its launch, the UC Investments Academy has enrolled 2,500 students and helped bring about 150 job placements. Mr. Bachher predicted that the Academy would meet its enrollment goal of 10,000 students in the next three years, and it was his goal that one in three UC students have a sophisticated level of financial literacy. He announced that UC and Blackstone were partnering to form UCBX, a program that would offer paid internships at real estate operating companies. Mr. Bachher concluded his presentation by noting that each UC Investments Academy participant would receive a lapel pin inspired by the star from the University seal. This star also represented a new identity for the Office of the CIO. He expressed hope that the culture at the Office of the CIO and the "UC Investments Way" make an impact at UC and beyond.

Committee Chair Robinson asked how decisions made by the Federal Reserve (Fed), such as lowering the interest rate, could affect how the Office of the CIO proceeds. Satish Ananthaswamy, Senior Managing Director of Asia Investments, Global Rates and Trading, and Real Estate, replied that the Office of the CIO did not act on market predictions following the last rate increase in 2023 or when markets predicted six to seven interest rate cuts at the start of 2024, because the team believed that inflation was decreasing and that the labor market was stable. Jobs were being added, the Fed was bringing down inflation, and personal consumption expenditure was expected to drop to two percent in a few years. While no longer worried about inflation, the Fed still seemed nervous about the labor market. The Office of the CIO was surprised by the interest rate cut of 50 basis points, and, despite Fed Chair Jerome Powell's comments about future rate cuts, markets were still pricing in a rate reduction of 175 basis points by August 2025. Mr. Ananthaswamy predicted that the current rate cut would revive credit markets, encourage banks to lend, and encourage consumers and small- to medium-sized enterprises to borrow. The cut could also help the real estate market and developers.

Mr. Bachher asked when the Office of the CIO should switch to longer duration in its fixed income portfolio. Mr. Ananthaswamy opined that the Office of the CIO was right to lower duration in 2020 given zero to negative interest rates at that time, but now was not the time to add duration. Even if short-term rates continue to decrease, long-term rates might not decrease much due to high supply and low demand in the U.S. Treasury market. One could still continue to maintain a short duration and reduce carry in the bond market. Following the amount of debt the U.S. government issued to finance the deficit, there was still much liquidity in money market funds, and some of this money would go into equities. Long-term rates were unlikely to decrease unless there was a recession, which was not being forecasted. The economy was expected to grow at 1.9 to 2.1 percent. Mr. Bachher added that borrowing costs for private equity would also come down, which would encourage more activity. He predicted a “risk-on” environment, capitalization rate compression in the real estate market, and the attractiveness of private lending. Microsoft and Apple were buying back their stocks. There was an indication of alternative pathways and of recovery.

Regent Makarechian asked how UC should proceed given the substantially diminished performance of private equity. Matt Webster, Managing Director of Private Equity, replied that the performance of private equity in 2020 and 2021 was attributed to interest rates going down to zero. The Office of the CIO acquired high-quality companies at very high multiples and, as interest rates rose and markets normalized, valuation multiples needed to compress. Over the last three years, these businesses have been growing into the valuations that UC initially paid. Sixty percent of the private equity portfolio was invested in buyout—both funds and co-investments. From 2020 to 2022, the Office of the CIO was borrowing at rates of six to eight percent to enter into these deals, but rates later spiked to 12 to 14 percent, and cash was moved from private equity to private credit. In 2022–23, UC private equity performance flatlined. In the last 12 months, the earnings of the top 100 businesses in UC’s portfolio have grown 11 percent, but valuations have either compressed or held flat. Interest rate cuts would be helpful. UC’s businesses were repricing debt, which meant more cash to pay down debt or pay dividends. Buyout firms seemed more comfortable with acquiring assets. Several companies in the portfolio were preparing to go public, and the opening of the public markets would help UC mark to market. Mr. Webster expressed hope that these factors would improve value creation. Mr. Bachher added that, while one hoped that companies in the portfolio would grow quickly, UC might not ultimately be able to earn the returns it anticipated when it underwrote these assets. The private equity portfolio had three prongs: funds, co-investments, and venture capital and growth. He took responsibility for the lag in growth, which he attributed to poor timing. Mr. Bachher still wished to invest in private companies that might yield positive results in the long term.

Regent Cohen observed that there was a lack of a true benchmark for real assets and suggested that the Regents discuss a way for the Board to evaluate its performance. Mr. Bachher replied that the Office of the CIO would invest according to a benchmark that the Regents set. The real assets portfolio had long been comprised of oil and gas commodities, which the Office of the CIO worked to remove and replace with infrastructure investments. Real assets have been benchmarked using the core price index or a blend of stocks and bonds, both of which Mr. Bachher regarded as lacking meaning. He believed creating a benchmark could drive behaviors that are not appropriate. UC's real assets portfolio has not had a benchmark in 15 years, and he asked that it remain this way. Given that the benchmark was 6.75 percent for the pension and eight percent for the endowment, there was an implicit benchmark for real assets. The cost of capital could be considered the benchmark for real assets.

The meeting adjourned at 2:55 p.m.

Attest:

Secretary and Chief of Staff