

Office of the Treasurer

**TO MEMBERS OF THE COMMITTEE ON INVESTMENTS / INVESTMENT
ADVISORY GROUP:**

ACTION ITEM

For Meeting of February 26, 2013

UNIVERSITY OF CALIFORNIA RETIREMENT PLAN ASSET ALLOCATION REVIEW AND RECOMMENDATIONS

RECOMMENDATION

The Chief Investment Officer and the Regents' General Investment Consultant recommend that the Committee on Investments recommend to the Regents that the amendments to Appendix One of the University of California Retirement Plan Investment Policy Statement be adopted as shown in Attachment 1, effective April 1, 2013.

BACKGROUND

The objective of an asset allocation review is to ensure congruence between the strategic asset allocation of the University of California Retirement Plan (UCRP) and its investment objectives. In response to the extreme market dislocation and severe recession of 2007-09, the Chief Investment Officer developed and implemented a scenario-based asset allocation process. In particular, this approach has a shortened investment horizon of three years, and a focus on downside risk rather than return volatility. As long as heightened macroeconomic uncertainty impacts capital markets, this approach will be used for all asset allocation reviews.

1. The asset allocation review consisted of the following steps:
 - a. Developed four likely economic scenarios for next three to five years
 - b. Simulated asset returns conditional on each scenario
 - c. Developed optimal portfolios in each scenario (using a downside risk measure)
 - d. Developed a single portfolio designed to perform well in all scenarios, but hedged against extreme downside
 - e. Developed a "proposed" portfolio tilting in the directions suggested by this optimal portfolio

- f. Verified that the proposed portfolio had improved return and risk profile compared to existing (long-term) policy portfolio in all scenarios

2. The following scenarios were considered:

- a. “Optimistic”
 - i. U.S. and Emerging countries grow above trend (i.e., above potential gross domestic product)
 - ii. Europe and Japan grow at trend
 - iii. Inflation above targets due to commodity pressures and decreased slack
- b. “Realistic”
 - i. U.S. and Emerging countries grow at trend
 - ii. Europe and Japan grow below trend
 - iii. Trend inflation; no labor or commodity pressures
- c. “Weak Growth”
 - i. All regions grow below trend
 - ii. Inflation is below Central Bank targets
- d. “Bad”
 - i. Global growth slows to just above zero and fails to recover trend
 - ii. Inflation is well below Central Bank targets
 - iii. Persistent and growing output gaps in all regions

3. Summary Recommendations (compared to existing long-term Policy weights):

- i. Reduce Long-only Developed Equity from 39.5% to 28.5% (-11.0%)
- ii. Increase Emerging Market Equity from 7% to 11% (+4.0%)
- iii. Eliminate Passive Global Equity allocation (2% to 0%) (-2.0%)
- iv. Reduce TIPS from 8% to 3% (-5.0%)
- v. Reduce Absolute Return from 6.5% to 6% (-0.5%)
- vi. Increase Cross Asset Class strategies from 2% to 8% (+6.0%)
- vii. Increase Opportunistic Equity from 0% to 8.5% (+8.5%)

See complete changes in Table 1.

- 4. These new strategic (“long-term”) weights would be effective April 1, 2013, following Board approval.
 - a. No changes to UCRP current Policy weights as these changes will be implemented over the next year.

- b. However, current Policy weights *will* evolve toward the strategic weights as investments are transitioned among the asset classes.
- c. There will be *no change* to the current asset class ranges (lower and upper bounds around target weights) at this time. As some asset classes are increased and others decreased materially, we will revisit the ranges and make appropriate recommendations. See ranges around current Policy weights in Table 2.
- d. Please note that, since the current Policy weights were approved in March 2011, the Chief Investment Officer has transitioned the portfolio toward the existing long-term weights (approved at the same time). Hence the revised policy document accompanying this item indicates the changes that have occurred. See Table 3 comparing the current Policy weights as of March 1, 2011 and the current Policy weights today (January 1, 2013).
 - i. Public equity decreased 4.75 percent toward the long-term weight of 48.5 percent
 - ii. Alternatives increased 4.75 percent toward the long-term weight of 26.5 percent

Attachments:

1. [Appendix 1 of UCRP Investment Policy Statement](#)
2. [Powerpoint slides](#)

TABLE 1

DETAILED RECOMMENDATIONS FOR UCRP ASSET ALLOCATION

UCRP Asset Allocation	Long-Term Policy Weights			Current Policy	
	Proposed	Current	Change vs Proposed	As of Jan 1, 2013	Change vs Proposed
US Equity	15.00	20.50	(5.50)	25.00	(10.00)
Non-US Developed Equity	13.50	19.00	(5.50)	19.00	(5.50)
Emerging Market Equity	11.00	7.00	4.00	6.75	4.25
Global Equity	-	2.00	(2.00)	2.00	(2.00)
US Core Fixed Income	12.00	12.00	-	12.00	-
High Yield Debt	2.50	2.50	-	2.50	-
Emerging Market Debt	2.50	2.50	-	2.50	-
US TIPS	3.00	8.00	(5.00)	8.00	(5.00)
Private Equity	8.00	8.00	-	7.75	0.25
Absolute Return	6.00	6.50	(0.50)	6.00	-
Cross Asset Class	8.00	2.00	6.00	2.00	6.00
Opportunistic Equity	8.50	-	8.50	-	8.50
Real Assets	3.00	3.00	-	1.75	1.25
Real Estate	7.00	7.00	-	4.75	2.25
Liquidity	-	-	-	-	-
TOTAL	100.00	100.00	-	100.00	-
Public Equity	39.50	48.50	(9.00)	52.75	(13.25)
Fixed Income	20.00	25.00	(5.00)	25.00	(5.00)
Alternatives	40.50	26.50	14.00	22.25	18.25
TOTAL	100.00	100.00	-	100.00	-

TABLE 2

RANGES AROUND CURRENT POLICY WEIGHTS

	Current Policy Weights as of January 2013	Lower Bound	Upper Bound	Deviation from Policy (below)	Deviation from Policy (above)
US Equity	25.00	20.00	30.00	-5	5
Non-US Developed Equity	19.00	14.00	24.00	-5	5
Emerging Market Equity	6.75	4.75	8.75	-2	2
Global Equity	2.00	1.00	3.00	-1	1
US Core Fixed Income	12.00	9.00	15.00	-3	3
High Yield Debt	2.50	1.50	3.50	-1	1
Emerging Market Debt	2.50	1.50	3.50	-1	1
US TIPS	8.00	6.00	10.00	-2	2
Private Equity	7.75	4.75	10.75	-3	3
Absolute Return	6.00	1.00	11.00	-5	5
Cross Asset Class	2.00	-	5.00	-3	3
Opportunistic Equity	-	-	3.00	-3	3
Real Assets	1.75	0.75	2.75	-1	1
Real Estate	4.75	1.75	7.75	-3	3
Liquidity	-	-	10.00	0	10
TOTAL	100.00				
Public Equity	52.75	42.75	62.75	-10	10
Fixed Income	25.00	20.00	30.00	-5	5
Alternatives	22.25	15.25	29.25	-7	7
TOTAL	100.00				

Notes:

- Rebalancing ranges are defined around current Policy weights, not long-term weights.
- Current Policy weights reflect gradual movement from current Policy weights adopted in March 2011 toward long-term Policy weights.
- As future changes are made to current Policy, the ranges will be modified in accordance with the deviations shown in the last two columns.

TABLE 3

CHANGES IN CURRENT POLICY WEIGHTS FROM MARCH 2011 to JANUARY 2013

	Current Policy Weights as of March 2011	Current Policy Weights as of January 2013	Changes since March 2011	Long-term Policy Weights as of March 2011
US Equity	28.50	25.00	(3.50)	20.50
Non-US Developed Equity	22.00	19.00	(3.00)	19.00
Emerging Market Equity	5.00	6.75	1.75	7.00
Global Equity	2.00	2.00	-	2.00
US Core Fixed Income	12.00	12.00	-	12.00
High Yield Debt	2.50	2.50	-	2.50
Emerging Market Debt	2.50	2.50	-	2.50
US TIPS	8.00	8.00	-	8.00
Private Equity	6.00	7.75	1.75	8.00
Absolute Return	6.00	6.00	-	6.50
Cross Asset Class	0.50	2.00	1.50	2.00
Opportunistic Equity	-	-	-	-
Real Assets	1.00	1.75	0.75	3.00
Real Estate	4.00	4.75	0.75	7.00
Liquidity	-	-	-	-
TOTAL	100.00			
Public Equity	57.50	52.75	(4.75)	48.50
Fixed Income	25.00	25.00	-	25.00
Alternatives	17.50	22.25	4.75	26.50
TOTAL	100.00	100.00	-	100.00