UNIVERSITY OF CALIFORNIA, ACADEMIC SENATE

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University of California
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August 10, 2007

ROBERT C. DYNES
PRESIDENT

Re: Academic Council Statement on the University of California Retirement Plan (UCRP)

Dear Bob,

I am pleased to present you with the enclosed *Academic Council Statement on UCRP* that the Council adopted unanimously on July 25, 2007. Based on a draft conceived and authored by the University Committee on Faculty Welfare (UCFW) and the Task Force on Investment and Retirement (TFIR), the statement provides information to concerned members of the University community about the management and investment performance of UCRP.

On behalf of the Academic Council, I respectfully request your assistance in distributing the *Academic Council Statement on UCRP* to University administrators and officials, the campuses, University employees, members of the general University community, and such other interested parties as you may deem suitable recipients.

Sincerely,

John B. Oakley, Chair
Academic Council

Copy: Academic Council
María Bertero-Barceló, Executive Director

Enclosure: 1

JO/MAR

ACADEMIC COUNCIL STATEMENT ON UCRP

July 25, 2007

There has been considerable criticism in the press, and by employee groups, of the management of University of California Retirement Plan (UCRP) assets. The criticism is unfounded. UCRP is well managed by The Regents, who set investment policy but do not choose individual investments, and the Office of the Treasurer, which chooses individual investments following the policy set by The Regents. Consistent with the Academic Senate's role in the shared governance of the University, faculty on two Senate committees—the University Committee on Faculty Welfare (UCFW) and its Task Force on Investments and Retirement (TFIR)—carefully monitor UCRP investment policy and returns. The Senate also nominates two faculty to serve on the University of California Retirement System (UCRS) Advisory Board.

It is truly extraordinary that we have been able to maintain a fully funded plan without contributions for the last sixteen years; this attests to the overall soundness of UCRP's management. Contributions will eventually be needed to UCRP—not because of poor management, but because UCRP's liabilities increase each year as UC employees earn additional service credit. Each additional year of service credit earned by an employee increases the pension benefits that UCRP will be required to pay. The large surplus that was built up as a result of the strong performance of the stock market in the period 1982-2000 has slowly been eroded by the annual growth of liabilities, which were not offset by annual contributions.

Understandably, faculty and other UC employee groups are concerned about the proposed restart of contributions—especially because UC salaries significantly lag the market—and about the safety of their pensions. These concerns, amplified by allegations reported in the press and elsewhere that poor management and conflicts of interest have produced investment returns that are too low, have created considerable anxiety among UC employees. They have also created the impression that the restart of contributions to UCRP is necessary because of this alleged poor performance. The Academic Senate is convinced that these concerns are unfounded.

Concerns about UCRP have also led to demands for changes in the governance structure, to some form of joint governance. The Academic Senate believes that some change in the role of the UCRS Advisory Board would be advisable, but that ultimate authority over UCRP investment and policy decisions should be left with The Regents.

The purpose of this document is to provide a statement of current Academic Senate policies concerning UCRP, and to provide information to the UC community about UCRP and the Senate's role in its management and oversight. The document is based on an independent analysis by TFIR. It explains the current governance structure of UCRP, how UCRP liabilities are calculated, and why it is important to maintain UCRP at fully funded status. It also explains the changes in UCRP investment policy made in 2002 and why those changes enhanced the long-run security of UC employee pensions. The document also gives a brief account of what determines investment returns and how investment performance should be measured, and then compares UCRP investment returns with those of CalPERS and CalSTRS, the main pension plans for state employees and teachers, over the last ten years. The document also states current Academic Senate policies with respect to UCRP and the restart of contributions. Finally, it concludes with a recommendation for change in the UCRS Advisory Board.

1. How UCRP's Funding Ratio Is Calculated:

The funded status of a defined benefit pension plan like UCRP is computed in the following way. The first step is to compute the actuarial accrued liability (AAL) of the plan. This is the present discounted value of the pension benefits that will be paid in the future, based on the service credit earned to date. As an example, consider a 50-year-old employee with 20 years of service credit who plans to retire ten years from now, at age 60, when this individual's service credit will have grown to 30 years. At retirement, this individual will be entitled to a pension of 75% (30 years of service credit times an age factor of 2.5%) of their highest average plan compensation (HAPC), the highest average covered compensation earned over a period of thirty-six consecutive months. The computation of AAL as of today takes into account the twenty years of service credit that have already been earned, and thus calculates an accrued pension benefit equal to 50% (20 years of service credit times 2.5%) of an estimate of this individual's eventual HAPC. (Future salary growth is assumed and factored into the calculation, as is the increase in the age factor that occurs from age 50 to age 60, but service credits from future years of employment are not included in current liability.) This stream of pension payments is discounted back to its present value today at the actuarial assumed rate of return (7.5% per annum) on the UCRP assets. The second step is to compute the Market Value of Assets (MVA). The funding ratio is simply MVA divided by AAL.[1]

A 100% funding ratio means that, if the plan's actuarial assumptions about investment returns, salary increases, mortality, and so on, actually happened and no further service credit was earned, the current assets would be exactly sufficient to pay

[1] The UCRP actuary also computes the so-called Actuarial Value of Assets (AVA), which smooths out volatility in market returns by spreading out each year's market performance over 5 years. For simplicity in this discussion, we will focus on MVA.

off all the pension benefits earned to date. However, nothing would be left to pay off the pension benefits that will be earned in the future, i.e., in the example above, the benefits arising from the additional ten years of service credit. Thus, with a 100% funding ratio, contributions are required each year to cover the normal cost of the plan, which is essentially the increment to AAL resulting from the service credit earned in the year. Virtually all defined benefit pension plans require contributions each year to cover the additional service credit earned.

The assumption of a 7.5% rate of return is a reasonable, and slightly conservative, estimate of the expected long-run investment return on the portfolio, given an acceptable level of volatility for a pension portfolio. In practice, investment returns will vary tremendously from year to year; over the past ten fiscal years, returns have ranged from +21.82% in 1997-98, as the stock market bubble inflated, to -9.20% in 2001-02, as the bubble deflated. Even over long periods, the investment return could be significantly above or below the assumed rate. A shortfall in investment returns would be very painful, requiring large contributions to fund the benefits owed to present and future retirees. Thus, it is appropriate to make the assumption slightly conservative, since this reduces the chances of a painful shortfall.

For simplicity, the above discussion is based on the payment of a certain stream of UCRP benefits to retirees. In reality, the stream of pension benefits actually paid to a retiree depends on the number of years that employee spends in retirement, *i.e.*, how long he/she lives; assumptions must also be made concerning payments to survivors. In calculating the AAL, an average present discounted value is used for the expected payments, based on weighting various potential streams of payments by associated probabilities of particular retirement dates, mortality, etc. The averages are based on actual experience with UC's population of retirees. Periodically, The Regents commission the UCRP actuary, The Segal Company, to conduct experience studies and recommend appropriate changes in assumptions about mortality and other parameters. The most recent experience study was presented to The Regents in May 2007.

2. Why UCRP's Funding Ratio Should Not Be Allowed to Fall Below 100%:

The AAL is the present value of UC's legal liability to pay future pension benefits; these pension benefits must be paid. Therefore, if the funding ratio falls below 100%, then the excess liability has to be offset by even larger contributions. Assuming that UCRP investments earn the actuarially assumed 7.5% rate of return, 16% of UC's payroll must be paid into the plan each year to cover the additional pension obligations incurred in that year. This is called the "normal cost" of maintaining UCRP at a fully funded status. What happens if a plan is allowed to fall below fully funded status is illustrated by CalPERS. If it were fully funded, its normal cost would be about the same as that of UCRP—16%. However, its funding was allowed to fall below 100% so at present, 20.9% of payroll is being contributed, a burden which is shared by employers and employees. Deferring contributions to a pension plan substantially increases the total amount that must be contributed, due to the foregone returns that would have been earned on the deferred contributions.

Beyond the risk that employer and employees will, in the future, have to contribute more than 16% of payroll to UCRP, allowing funding levels to fall below 100% also threatens the future well-being of retirees. Basic UCRP pension benefits and partial COLAs (cost of living increases) are legally guaranteed by the University and would have to be paid regardless of the funding status. However, the legally required COLAs are not sufficient to keep up with a rate of inflation above 2%. As a result, The Regents have also authorized occasional ad hoc COLAs to retirees. These ad hoc COLAs are valuable to all retirees, and are critically important for retirees who live into their eighties and nineties, who historically have depended on the ad hoc COLAs to prevent substantial erosion of the purchasing power of their pensions. If UCRP funding falls below 100%, these ad hoc COLAs may well be at risk.

3. Plans for Restarting Contributions:

As of June 30, 2006, the funding ratio of UCRP was approximately 107.5%. Assuming that investment returns would just equal the assumed 7.5% rate, the funding ratio would have dropped below 100% in the 2008-09 fiscal year. As a result, The Regents voted to restart contributions at a low level, effective July 1, 2007, intending that they be slowly raised over several years to an 11% employer contribution and a 5% employee contribution, which would be sufficient to sustain UCRP in the long run. This split between employer and employee contributions mirrors the split that CalPERS would have if it were 100% funded. Universities which compete with UC for faculty typically make an employer contribution of about 10% of salary to a defined contribution pension plan; this gives the faculty member the choice between contributing approximately 6% of salary and having roughly the same expected pension benefit provided by UCRP, or contributing less and having a lower expected pension benefit. Because the Governor and Legislature declined to provide funding for the restart of employer contributions at this time, however, the restart of employee contributions to UCRP has also been postponed.

The markets did very well in 2006-07, and we anticipate that the funding ratio of UCRP, as of June 30, 2007, will be approximately 115%. This is very fortunate, but it is unreasonable to expect the market to continue to provide this kind of performance year after year. The one-time windfall in 2006-07 provides us with some breathing room, and contributions can probably be postponed for another two or three years. However, unless we achieve truly extraordinary investment returns going forward, contributions will eventually need to be restarted. The only question is when. The Academic Senate strongly supports restarting employer and employee contributions when needed to maintain UCRP's funding ratio above 100%.

4. Effect of Employee Contributions on Total Remuneration:

The restart of employee contributions will mean a substantial reduction in total employee remuneration at a time when UC faculty and staff salaries are already seriously uncompetitive. The Academic Senate's position is that the restart of employee contributions must not reduce UC's competitiveness in total remuneration. Hence, the Academic Senate's position is that the restart of contributions must be accompanied by substantial salary increases, both to compensate for the restart of contributions and to move cash compensation quickly toward competitive levels.

5. UCRP Investment Policy and Returns:

UCRP assets have been well managed over the years. The annual return over the ten-year period ending June 30, 2006, was 9.04%, a period that included the deflation of the stock market bubble in 2000-2002. This is 1.54% above the rate of return assumed in the actuarial calculation of the funding ratio. In the 2006-07 fiscal year through May 31, the return was 19.70%.

There have been allegations in the press and by employee organizations that we should have done better. The arguments advanced for this position have included the following:

- CalPERS and CalSTRS have had higher investment returns than UCRP in some recent years, and consequently UCRP must be doing something wrong.
- The Regents forced the resignation of former Treasurer Patricia Small in 2000 and "outsourced" the management of the funds; had Ms. Small continued as Treasurer, we would have had higher returns.
- UCRP's investment returns have been reduced as a result of serious conflicts of interest.

None of these arguments has merit.

The primary determinant of investment return and investment risk in a portfolio is the allocation of investment dollars among the various classes of assets: domestic stocks, foreign stocks, bonds, private equity, real estate, absolute return, and so on. The asset allocation is set by The Regents, based on advice from the Treasurer and an outside consultant. The outside consultant, Richards & Tierney, advises on the asset allocation but plays no role in choosing individual investments and receives no commissions or fees in relation to the holding or trade of individual investments. Those who do receive fees for managing assets receive a flat fee, plus, in some cases, incentive payments based on the returns they achieve. This structure is consistent with the practices of other well-managed public pension funds, and notably avoids conflicts of interest that could arise if the consultant received fees for trading.[2]

The investment risk of the portfolio is determined in part by the risk of the individual asset classes and the amounts allocated to them. It is also determined, to a substantial extent, by the *correlations* between asset classes (the extent to which they rise and fall together). For example, although foreign stocks are somewhat more volatile than domestic stocks, the inclusion of foreign stocks in the portfolio provides diversification. This diversification can reduce the overall volatility of the portfolio because the factors affecting the value of foreign stocks are, to some extent, different from those affecting the value of domestic stocks.

The outside consultant and The Regents choose the asset allocation that, in their judgment, maximizes expected return, subject to the level of volatility they are willing to tolerate. If they were willing to tolerate higher volatility, they could obtain the possibility of higher returns, but at the cost of a higher probability of investment losses. Since the UCRP portfolio is a pension fund, The Regents have appropriately chosen an asset allocation with lower volatility than the asset allocation used in the UC General Endowment Pool.

Asset returns are volatile and unpredictable. In any given year, the actual return on an asset class consists of the predictable expected return on that asset class plus a random return outcome which cannot be predicted in advance. It is important to note that, for most asset classes, the random, unpredictable component is larger than the predictable expected return. Thus, two portfolios with prudent but different asset allocations are likely, in any given year, to produce very different returns; the portfolios could have identical expected returns and overall volatility, with the difference in one year’s results attributable to the unpredictable portion of returns. Simply comparing realized returns does not provide a sound basis for judging the quality of investment managers.

The asset allocation of UCRP is different from that of CalPERS. Because the asset classes that are heavily weighted in the CalPERS portfolio have done well in a few recent years, the overall return on the CalPERS portfolio in those years has been higher than that of UCRP. In other years, however, that same asset allocation would not have

[2] The Regents, the Office of the Treasurer, and consultants act in accordance with State and University policies governing conflict of interest and ethical conduct.

fared as well. Over the ten-year period ending June 30, 2006, CalPERS reports its annual return was 9%, which just matches UCRP's performance.

The main difference between UCRP and CalPERS is that CalPERS is less than 100% funded and currently requires a combined employer/employee contribution of 20.9% of salary; UCRP is slightly over 100% funded, despite having had no contributions for 16 years.

It is very important that the asset allocation of a portfolio remain stable over time, with adjustments made infrequently and based on careful analysis. Research has shown that frequent reallocation of assets within a portfolio, or "market timing"—a strategy in which the investor tries to guess which asset class will do best in a given month or year—has a poor track record compared to a strategy of maintaining a stable asset allocation over extended periods of time. It is certainly correct that investing more funds in the asset classes that performed relatively well in recent years would have led to higher returns for UCRP. But this outcome was not predictable and cannot be expected to occur in the future. Those who criticize the investment performance by comparing UCRP to CalPERS or other pension funds over a period of just a few years are implicitly asking that we adopt market timing as our investment strategy; that would be a very bad idea.

In addition to asset allocation, diversification within each of the asset classes is very important to reduce risk without a resulting reduction in expected return. The current Chief Investment Officer and Acting Treasurer, Marie Berggren, and her predecessor, David Russ, have established a disciplined and effective policy of diversification. A large part of the equity portfolio is invested in index funds, which will track very closely the average performance of the asset class because of their diversification, and which involve very low expenses. By essentially buying "the market", the riskiness of holding large shares of the portfolio in individual stocks is avoided. Part of the equity portfolio is actively managed by outside managers. Each outside manager controls only a small portion of the portfolio, so the actively managed portfolio is much better diversified than it would be if it were managed by a single manager, whether internal or external. Russ and Berggren have carefully measured the performance of the external managers and the internal staff who monitor them, and have replaced managers when warranted by a shortfall in their investments' return compared to the appropriate benchmark.

The best way to judge the quality of management is to compare the return of each asset class within the portfolio to an appropriate benchmark for that class, usually a broad index of all the assets within the class. For example, the benchmark for domestic equity is the Russell 3000 index, which represents approximately 98% of the market value of U.S. publicly traded securities. Every three months, The Treasurer publishes a detailed breakdown of the return of each asset class, in comparison to the return on the benchmark for that class. If the return on domestic equity matches its benchmark in a given quarter, it means that the return on domestic equity just equaled that of the Russell 3000 for that quarter. The overall benchmark for the UCRP portfolio is an average of the benchmarks for the individual asset classes, weighted by UCRP's asset allocation. The current investment policy was put into effect in November, 2002, so only the last four full fiscal years 2003-04 through 2006-07 reflect the current policies established by The Regents, Russ, and Berggren. In each of those years[3], investment returns in each asset class closely track the benchmark for the class, and the overall return is slightly above the overall benchmark.

Prior to 2002-03, the equity portion of the UCRP portfolio was managed internally. The treasurers in this period did not practice the type of risk management that is expected in a pension portfolio of this size. The portfolio was concentrated in a relatively small number of large-capitalization stocks that the internal managers hoped would outperform the market. As a consequence, the portfolio was poorly diversified. This increased the volatility of the portfolio without producing a compensating increase in the expected rate of return. Investment returns varied substantially from the benchmarks, being well above the benchmarks in some years and well below in others. Investment returns were on average near the benchmark in this period; we attribute this fact to a combination of low investment expenses and good luck, rather than to any inherent advantages of the strategy that was followed.

We have seen other instances in which California public portfolio managers obtained attractive results for a period of time, but then suffered substantial losses because they had not put adequate risk management measures in place, and we were very concerned by the potential for a substantial loss. We were greatly relieved when The Regents, and Treasurers Russ and Berggren, put in place appropriate risk management measures to safeguard the UCRP portfolio. We are convinced that UC and its employees and retirees have been, and continue to be, well served by those changes.

Much has been made of the fact that in the 2005-06 fiscal year, UCRP paid $32 million in fees to outside managers. This amounts to about 0.075% of the UCRP assets. The total expenses, including internal costs and fees to outside managers, amount to 17 basis points: 17/100ths of 1 percent. As a comparison, CREF, which offers retirement plans for many competing universities, has expense ratios at least twice as high for all their funds, including their index funds. UCRP uses a mix of active and passive management of its funds allocated to domestic, publicly-traded, securities. The jury is

[3] Results for 2006-07 are through May 31, 2007.

still out on whether the returns produced by these active managers justify the additional fees for active management, but these fees are very modest in proportion to the size of the portfolio.

The specific allegations of conflict of interest seem either far-fetched or inconsequential. More important, we see no evidence whatsoever that the alleged conflicts of interest have had any adverse impact on UCRP investment returns.

6. UCRP Governance:

Currently, The Regents have the responsibility for managing UCRP. They have the fiduciary responsibility to see that the promised benefits are paid. They set investment policy, but delegate the implementation of that policy to the Treasurer's Office.

Some employee groups have called for joint governance of UCRP. While the exact definition of joint governance is unclear, they appear to want The Regents to delegate all or a substantial part of the fiduciary responsibility for UCRP to a new board, which would be equally divided between appointees of UC's management and representatives elected by employees.

Much of the impetus for the call for joint governance appears to arise from the erroneous perception that UCRP investment performance has been substandard, and that is the reason we will need eventually to restart contributions. The need to restart contributions was not caused by the current UCRP governance structure, and it cannot be avoided by changing that structure.

Depending on how it is implemented, joint governance might carry some significant dangers:

- It is unclear whether faculty and staff would run in separate elections, or faculty and staff would compete in an at-large election; since staff vastly outnumber faculty, an at-large election might result in the election of no faculty to the new board. Currently, the Academic Senate has substantial input into UCRP policies, so joint governance could decrease, rather than increase, the influence of faculty. The Senate policy remains that faculty have a special role to play, given the Senate's shared governance of the University established under the Standing Orders of The Regents and the California Constitution.

- A number of those calling for joint governance have expressed the view that it would be better to defer restarting contributions until the funding ratio of UCRP declines to 80-85%. For the reasons explained above, this would not be in the interests of UC, its employees, or retirees.

- A number of those calling for joint governance have argued that we should return to the investment policies practiced prior to 2002. For the reasons explained above, this would not be in the interests of UC, its employees, or retirees.

UCRP currently has a very weak form of joint governance structure, the UC Retirement System Advisory Board (UCRS Board). This board is composed of five representatives of UC management, two faculty chosen by the Academic Senate, and two representatives elected by staff. At one time, the UCRS Board had considerable influence over UCRP policies and practices. However, for the last several years, the Board's actions have been severely limited by the Office of the General Counsel, over concerns that its operation might violate the "direct dealing" provisions of the California Higher Education Employee Relations Act (HEERA), the labor law governing UC, its employees, and unions. These provisions prevent UC from "dealing directly" with employees, rather than the unions that represent them, over the terms and conditions of employment. According to court precedents, the direct dealing provisions prevent the UCRS Board from making recommendations to The Regents. The Senate believes that the University should respond to the calls for joint governance by asking the Legislature to amend HEERA to exempt the UCRS Board from the HEERA "direct dealing" provisions, to restore the ability of the UCRS Board to function effectively in providing employee input into the management of UCRP. If HEERA is amended, The Regents should establish procedures to ensure that the UCRS Board's recommendations must be considered by The Regents before The Regents enact any changes in UCRP. However, in the Senate's view, the ultimate authority over UCRP should be retained by The Regents.