The UC Berkeley Foundation

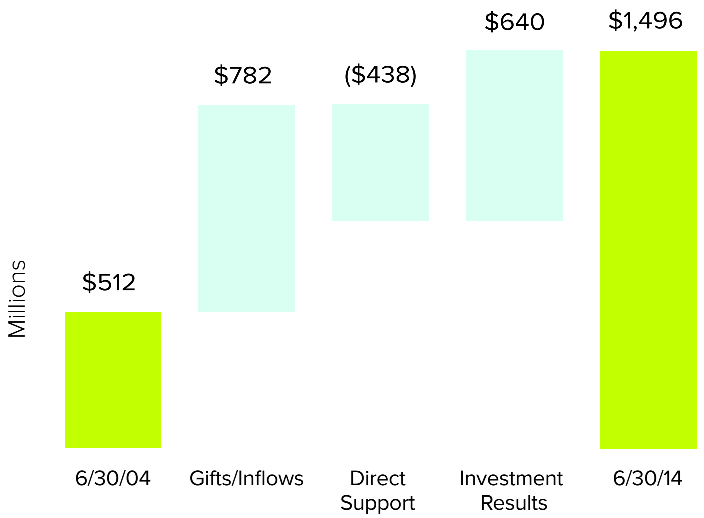
ENDOWMENT RETURNS AND INVESTMENT POLICY

by **John-Austin Saviano**, *Chief Investment Officer, Berkeley Endowment Management Company*

It is my pleasure to report that the endowment assets of the UC Berkeley Foundation closed fiscal 2014 at an all-time high of $1.496 billion. The year saw investment gains totaling $192 million, contributions to endowments of $117 million, and outflows of $54 million in support of Berkeley's students and programs. The portfolio's 15.4% gain for the year largely reflected the strong returns of public equities and other segments of the capital markets. Please refer to the chart below to see how the Foundation's endowment has grown over the last 10 years.

Over the last decade, the assets of the UC Berkeley Foundation general endowment pool have nearly tripled, supported by the contributions from our community of donors and investment gains. Cumulatively, payout from the Foundation's endowments over the past 10 years totals $438 million.

GROWTH OF THE FOUNDATION'S ENDOWMENT
OVER THE LAST 10 YEARS



BEMCO

The Berkeley Endowment Management Company (BEMCO) is tasked with investing the Foundation's general endowment pool assets. Now entering its sixth year of operations, BEMCO is staffed with seven investment professionals and governed by a board of directors made up of leading investment specialists and dedicated Cal Bears.

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ASSET ALLOCATION

BEMCO's approach to asset allocation starts with a mindfulness of the students, faculty, and programs dependent on the Foundation's annual endowment payout, which underwrites an enormous breadth of activities at Berkeley. As such, our focus is on delivering a sustainable payout to the university in real (inflation-adjusted) dollars.

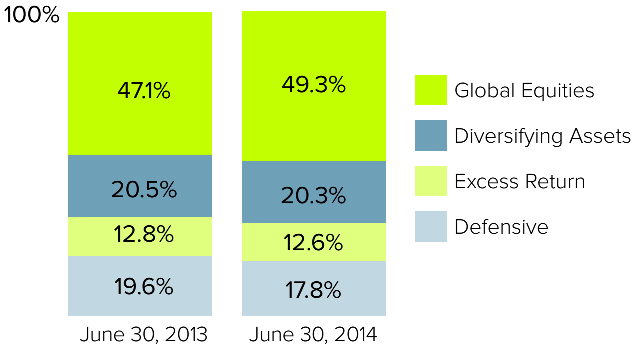
We believe that a diversified approach is the best way to generate these sustainable returns over the long term, and that diversification comes from holding assets that behave differently from one another. By focusing on expected behaviors, we can build a portfolio that avoids unintended overexposure to any one driver of return or risk. (Our Investment Policy Statement is available at www.berkeleyendowment.org.)

This diversified approach is more important than ever, as we face many markets in which results are likely increasingly tied to the recent and continuing stimulus from global central banks. As noted below, this stimulus has undeniably pushed asset valuations to levels that are full by historical standards, and increasingly vulnerable to changing expectations for interest rates. To put it another way, while this tide has lifted all boats, we are aware the reverse may happen just as broadly when it ebbs.

In this context, we made good progress in broadening the portfolio's diversification and strengthening relationships with leading investment managers. Below are comments on activity in each of our major asset categories:

Global Equities: Equity markets have risen sharply in recent years, adding a 23% gain (MSCI ACWI) during fiscal 2014. We have maintained our strong equity orientation, but we have increasingly sought to do so with more active management and in strategies with marginally less direct exposure to the market. So while the portfolio's overall allocation to equities increased modestly during the year, the underlying components have changed substantially.

EVOLUTION OF THE FOUNDATION'S ASSET ALLOCATION SINCE THE INCEPTION OF BEMCO



Long-short hedge funds with material directional exposures to the market are included in this category, and we increased this allocation from 11% of the total portfolio at June 30, 2013 to 16% at June 30, 2014. Correspondingly, we pared back our exposure to long-only equities from 36% to 32% and lowered our exposure to indexed equities from 12% at June 30, 2013 to 5% as of August 2014.[1]

Diversifying Assets: These investments can generate equity-like returns over the long term, but have low correlations to the markets and/or lower volatility generally. They are

[1] *We note the August level as we held more indexed exposure on 6/30/14 in anticipation of having to make the portfolio's payout to campus in August. The post-payout level is most indicative of the portfolio's current positioning.*

highly desirable to portfolios like ours and, not surprisingly, sourcing high-quality investments of this type requires patience and hard work. During the year, we were able to maintain consistent exposure to this category, even as our overall asset base grew by more than $250 million, by deploying additional capital to new and existing relationships in absolute return hedge funds and private natural resources strategies.

Excess Return: We allocate a portion of our capital to strategies that we believe can meaningfully exceed public markets returns over the long term, and where we recognize that we will have to accept higher levels of volatility and/or illiquidity. Generally these investments are private and take years to come to fruition (e.g., venture capital investments), so building a full program can take even longer. Our existing investments had a terrific year and resulted in distributions during the year that totaled 30% of their June 30, 2013 balances. During the year, we saw continued unrealized appreciation and added new investments representing 2% of the overall portfolio's capital. Since private markets are as fully valued, if not more so, than the public markets, we are being highly selective in committing new capital.

Defensive: These are assets we expect will retain their value and liquidity in times of market stress. Holding them ensures we will always be able to meet our payout obligations to the university, and to be nimble as market opportunities arise. We hold Treasury bonds and cash in this category, shifting positioning as rates move. We remain quite wary of capital markets' sensitivity to unexpected increases in rates.

INVESTMENT RESULTS

The capital markets were characterized by strong results this past year, and really for the last 36 months, which is how long it has been since the S&P 500 experienced a decline of 10% or more. It is much the same for global markets, with the ACWI also posting double-digit returns and 27 months from its last 10% pullback.

The table below shows the portfolio's results for periods ending June 30, 2014. For context, we provide results of our portfolio benchmark, equity markets, a measure of an inflation-adjusted spending rate (CPI +5%), and peer college and universities' results.

ANNUALIZED RESULTS

	10 Yrs	5 Yrs	3 Yrs	1 Yr
UC Berkeley Foundation	7.7%	11.5%	8.7%	15.4%
Portfolio Benchmark*	7.4%	11.3%	9.5%	19.4%
S&P 500	7.8%	18.8%	16.6%	24.6%
MSCI ACWI	7.8%	14.6%	10.6%	23.3%
CPI + 5%	7.3%	7.1%	6.8%	7.1%
College & Univ. Median**	7.7%	11.9%	9.1%	16.4%

* *Current Portfolio Benchmark is 82.5% MSCI ACWI / 17.5% US Treasuries*
** *Source: Cambridge Associates. 154, 161, 163 and 163 institutions, respectively.*

Over longer periods of time, the portfolio's results are ahead of its benchmark and broad market measures. Over shorter periods of time we can see how our diversified approach, and that of other endowments, has fared in a market that has not rewarded diversification. For the past five years, the portfolio has done well to keep up with its benchmark despite taking considerably less risk.

A deeper dive into the returns reported by our university peers shows that fewer than six of them had results ahead of our portfolio benchmark in this fiscal year.

RETURN ON RISK

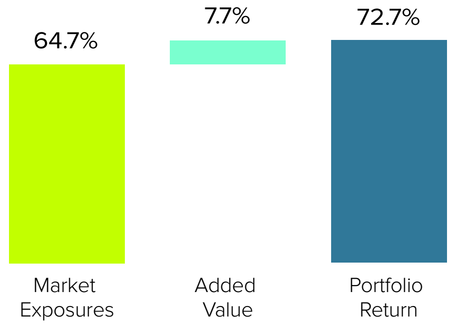
In the asset allocation section above, we discuss how we have positioned the portfolio to generate strong long-term results. As stewards of capital supporting Berkeley's public mission, we must be careful not to take on excessive levels of risk. Taking prudent risks and earning good returns on those risks is what will drive our long-term results.

RETURN ON RISK (5 YEARS ENDING 6/30/14)

	Return	Sharpe
Portfolio	11.5%	1.54
Portfolio Benchmark*	11.3%	1.10
S&P 500	18.8%	1.41
Barclays US Treasury	3.6%	0.98

As a measure of the return on risks taken, we can look at the portfolio's Sharpe ratio[2], which evaluates results generated for the level of volatility experienced. The portfolio's five-year annualized return was 11.5% with a Sharpe ratio of 1.5. When compared to our benchmark or the S&P 500, the portfolio delivered a better return per level of volatility than either of these.

FIVE-YEAR RESULTS



As a further measure of returns on risks taken, we can compare the results of our roster of managers with their individual benchmarks (i.e., how well did the firms we hired do vs. what we hired them to do). The table above shows the cumulative results over the past five years on this measure. Our active choices of investments added $62 million of additional earnings for the endowment beyond what average market exposures would have earned.

As we continue to broaden Berkeley's relationships with more high-quality investment managers, we expect this gap to widen even more.

CURRENT ENVIRONMENT

If rates are "lower for longer,"[3] then a good deal of the appreciation in asset prices can be seen as a rational response to falling discount rates. Furthermore, the rise in asset prices has been the whole aim of global central bankers as a means to avoid a deflationary spiral and to instead inspire a massive "wealth effect" that might reignite growth.

[2] *Adapted from Morningstar.com: "This risk-adjusted measure was developed by Nobel Laureate William Sharpe. It is calculated by using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance."*

[3] *Credit to PIMCO, and perhaps others, for this phrase.*

While animal spirits have certainly been stirred, there seems to be a diminishing return on market intervention. U.S. GDP grew 0.5% during for the first six months of 2014, after growing 1.9% in all of 2013. Major overseas economies are generally turning in even less inspiring growth with similar or greater levels of stimulus. Additionally, complacency may be rising broadly,[4] as reflected in loosening credit standards, rising equity valuations, and greater use of leverage to boost returns.

We share the concerns of many about the potential headwinds from the macro environment, the path of global central bank interventions, a challenging political environment and the ever-present geopolitical risks. None of these risks, nor others on which the world has not yet focused, has taken a meaningful toll on the capital markets in a long time — certainly not in the years since BEMCO's launch.

Notwithstanding these ongoing concerns, our diversified approach and strong execution from our managers have enabled the portfolio to participate very meaningfully in the continued run-up in asset prices without taking excessive levels of risk.

THE YEAR AHEAD

In the 2014-15 fiscal year, we will look for pockets of value where we can find them and expand our reach through more differentiated exposures overseas. Likewise, we will continue to selectively develop new relationships in the private markets and seek opportunities with unusual and attractive risk-return characteristics.

The BEMCO team strives to live up to the standards set by Berkeley's students, faculty, and alumni. We aspire to their level of excellence and, with the support of our donors, the UC Berkeley Foundation's staff and volunteers, and the larger Berkeley community, we are getting closer each year.

BERKELEY ENDOWMENT MANAGED BY THE UC BERKELEY FOUNDATION

	6/30/14	6/30/13	6/30/12	6/30/11	6/30/10
Market Value ($ thousands)	1,496,436	$1,278,030	$1,126,822	$1,091,985	$895,456
Annual Return on Investment	15.4%	12.8%	-1.0%	18.98%	11.7%

UC BERKELEY FOUNDATION PAYOUT

	2013–14	2012–13	2011–12	2010–11	2009–10
Annual Payout Policy Rate	4.25%	4.25%	4.27%	4.75%	4.75%

	Aug–14	Aug–13	Aug–12	Aug–11	Aug–10
Payout ($ thousands)	$45,351	$39,354	$38,443	$37,676	$36,570

The UC Berkeley Foundation payout is based on a 12-quarter moving average rate. The payout figures above reflect actual distributions. While the majority of payout is distributed in August of each year, distributions do occur throughout the year, and those incremental distributions are included. The August 2013 figure reflects, for example, the total of distributions made in the 2013–14 fiscal year.

Please refer to the enclosed "Berkeley's Endowment: The Bright Future of Our University" for more information about gift and cost recovery fees.

For additional detailed information regarding the management of Berkeley's endowment, please refer to the Annual Endowment Report, published by the Office of the Chief Investment Officer of the Regents. It is located online at **www.ucop.edu/investment-office/**.

[4] *For example, on the day in early September that the U.S. announced it would commit to new military action in the Middle East, the S&P 500, NASDAQ, gold prices, and Treasury bonds all posted gains.*