The Regents of the University of California

**COMMITTEE ON FINANCE**
**COMMITTEE ON INVESTMENTS**

October 15, 1998

The Committee on Finance and the Committee on Investments met jointly on the above date at UCSF-Laurel Heights, San Francisco.

Members present: Representing the Committee on Finance: Regents Atkinson, Bagley, Davies, Gould, Johnson, Khachigian, Lee, Miura, Parsky, and Willmon; Advisory member Taylor

Representing the Committee on Investments: Regents Atkinson, Bagley, Clark, Davies, Gould, Khachigian, Lee, Parsky, and Preuss

In attendance: Regents Kozberg and Montoya, Regent-designate Vining, Faculty Representative Dorr, Secretary Trivette, General Counsel Holst, Treasurer Small, Provost King, Senior Vice President Kennedy, Vice Presidents Broome, Darling, Gurtner, Hershman, and Hopper, Chancellors Bishop, Carnesale, Orbach, Vanderhoef, and Yang, and Recording Secretary Nietfeld

The meeting convened at 3:40 p.m. with Committee on Investments Chair Parsky presiding.

**ADOPTION OF EXPENDITURE RATE FOR THE GENERAL ENDOWMENT POOL**

The President recommended that the Committee on Finance, with the approval of the Committee on Investments, recommend to The Regents that the expenditure rate per unit of the General Endowment Pool (GEP) shall be 4.75 percent of a sixty-month moving average of the market value of a unit invested in the GEP.

Regent Parsky recalled that in March 1998 The Regents adopted a total return spending policy in order to permit the campuses to recover endowment administrative costs from the endowment payout. In accordance with this policy, the President and the Treasurer annually will review the expenditure rate and the endowment administrative cost recovery program in the context of the performance of the GEP and recommend the continuation or modification of the endowment expenditure rate.

Vice President Darling then presented the joint recommendation of the President and the Treasurer to adopt an endowment expenditure rate of 4.75 percent of a sixty-month moving average of the market value of a unit invested in the GEP as the University's long-term target payout rate and to adopt a phase-in plan to reach this target over several years, with an initial rate for 1998-99 of 4.35 percent. Special care was taken to arrive at a formula that would create a stable and increasing payout, at least equal to inflation, within a range of 4 to 5 percent of a five-year moving average.

Another objective was to arrive at a formula that would minimize the likelihood of year-to-year declines in periods of volatile activity in financial markets, but one which would not impair the ability of the invested assets of the GEP to grow and to sustain a stable and increasing payout. A final goal was administrative simplicity that would not compromise any of the stated objectives and could easily be explained to donors and recipients of the endowment payouts. The model recommended achieves an appropriate balance between these objectives better than any of the several dozen models analyzed. As noted by Regent Parsky, each year the administration will analyze investment results, inflation, and the University's programmatic needs before recommending a payout rate for the year.

Vice President Darling discussed the effect of a six-month shift on the sixty-month moving average period. When the Treasurer initially calculated the projected payout for 1998-99, the projections were based on a calendar year. The next year's payout increase was projected to be in the range of 12 to 14 percent over the current year. When the decision was made to shift the sixty-month moving average to the fiscal year in order to bring it into alignment with the University's financial record keeping, the projected payout increase rose to 20 to 23 percent. For this reason, the President and the Treasurer are recommending an initial payout rate of 4.35 percent. He referred to the Attachment, which briefly describes the endowment expenditure rate phase-in plan and illustrates the 1999 estimated growth in GEP payout dollars versus fiscal 1998. According to the chart, the increase in the projected payout rate for 1999-2000 will be in the range of 10.2 to 13.3 percent. He recalled that 15 basis points will be taken out in order to enable the campuses to recover endowment administrative expenses. As a result, the beneficiaries will receive a year-to-year increase of between 6.4 and 9.4 percent.

Treasurer Small stated that she was pleased with the recommendation of an expenditure rate between 4 and 5 percent, and preferably towards the lower end of that range, due to the tremendous surge in asset growth, especially over the past four years. She was also pleased with the use of a sixty-month moving average of the General Endowment Pool's market value, which will provide a comfortable smoothing period so there is potential for continuous growth in dollars distributed.

The Treasurer then summarized the following key points:

- Analysis of the forty-year history of actual GEP returns shows that rates between 4 and 4.75 percent of a five-year rolling average would not have introduced significant payout volatility.

- Simulations of potential future market returns revealed that a payout rate less than 5 percent of a five-year rolling average market allows a portfolio to provide real (after inflation) adjusted growth in the market value while also producing real growth in the payouts to beneficiaries. A higher expenditure or spending rate results in spending too much of the potential total return early on, which hampers the long-term growth of the corpus and hence produces a lower total of payout dollars over time. Dollar distribution is totally reliant on corpus size and growth. The corpus is the institution's permanent capital in perpetuity.

In summary, Treasurer Small noted that a long-term payout rate of 4.75 percent would not appear to jeopardize the General Endowment Pool's ability to provide real, inflation-adjusted growth in the payout to beneficiaries or in the growth of the corpus. By beginning the payout rate at a lower point and gradually getting to the target rate, The Regents could also achieve a more attractive, steadier transition in dollars distributed to the targeted spending rate. While The Regents' income-only spending policy has served the institution well over the last forty years and has produced an enviable track record, the proposed long-term target expenditure rate of 4.75 percent over a sixty-month moving average market value will also successfully meet The Regents' investment goals and expenditure goals for the General Endowment Pool as well as assisting the campuses' development efforts.

Regent Parsky recalled that the adoption of a total return expenditure policy had a number of objectives. One was to give the responsibility for setting spending policy to The Regents rather than being dependent upon the income that was earned by the portfolio. The President and Treasurer have recommended a targeted spending rate of 4.75 percent on a five-year rolling basis. Each year, however, The Regents will have the flexibility to adjust the spending rate depending on the dollars that are created by applying that rate in relationship to the dollars that were paid out in the previous year. This will ensure beneficiaries that they will be able to receive increases at least commensurate with the costs that they have incurred on an annual basis. Applying the 4.75 percent rate in the current year would result in a disproportionately high payout rate. Exercising the "prudent person" responsibility, and in coordination with the Office of the Treasurer, the recommendation for 1998-99 is a 4.35 percent payout rate. Regent Parsky reiterated the fact that the fiscal year was found to be more appropriate than the calendar year because the spending rate will be assessed in the context of the University's overall budget.

In response to a question from Regent Lee, Treasurer Small explained that the General Endowment Pool is approximately $4 billion. She agreed to provide Regent Lee with an explanation of the average market value that the 4.35 percent expenditure rate is based upon. General Counsel Holst pointed out that the estimated market returns for fiscal year 1999 are measured against the prior year's return. Vice President Darling noted that in 1998 a 17.2 percent increase was paid out. Treasurer Small added that total GEP payout in fiscal year 1998 was $116.5 million. Using the 4.35 percent payout rate in 1999, with an 8.5 percent market gain, the payout will be $131.7 million.

In response to a comment from Regent Clark regarding communicating the new policy to the campus foundations, Vice President Darling recalled that the process began at a joint meeting among the foundations, the Office of the Treasurer, and the Office of the President in January 1997. At this meeting the issues which caused tension between the organizations were identified. The result was a strong recommendation that The Regents adopt a total return expenditure plan. Some of the foundations have indicated a willingness to adopt the same payout rate as the rate adopted by The Regents.

Regent Lee stressed that the key to success rests with the support of the chancellors. President Atkinson assured Regent Lee that they are fully behind the new approach. Chancellor Carnesale added that the intent of the process was to assure a reasonable payout in bad economic times as well as good ones.

Vice President Darling noted that adoption of the spending policy and the formulation of the endowment expenditure rate involved extensive consultation with the Academic Senate.

Upon motion duly made and seconded, the Committee on Investments voted to approve the 4.75 percent expenditure rate.

Regent Parsky explained that the President's original recommendation needed to be amended to include the following sentence: "That rate shall be implemented as set forth in the attachment entitled *Endowment Expenditure Rate Phase-in Plan*."

Upon motion duly made and seconded, the Committees approved the President's recommendation, as amended, and voted to present it to the Board.

The committee adjourned at 4:10 p.m.

Attest:

Secretary