The Regents of the University of California

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

September 17, 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, Connerly, Davies, Johnson, Khachigian, Leach, Lee, Miura, Parsky, and Willmon; Advisory member Taylor

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

In attendance: Regents Chandler, Espinoza, Gould, Kozberg, Montoya, and Ochoa, Regent-designate Vining, Faculty Representatives Coleman and Dorr, Secretary Trivette, General Counsel Holst, Treasurer Small, Assistant Treasurer Stanton, Provost King, Senior Vice President Kennedy, Vice Presidents Darling, Gurtner, and Hershman, Chancellors Berdahl, Bishop, Carnesale, Cicerone, Dynes, and Orbach, Executive Vice Chancellor Grey representing Chancellor Vanderhoef, and Recording Secretary Nietfeld

The meeting convened at 2:20 p.m. with Committee on Investments Chair Parsky presiding.

1. **GENERAL ENDOWMENT POOL EXPENDITURE RATE**

Vice President Darling recalled that in March 1998 The Regents adopted the Uniform Management of Institutional Funds Act (UMIFA), which permits, but does not require, the expenditure of a portion of the realized or unrealized appreciation in the value of the endowment portfolio above historic cost in addition to income as traditionally defined. Also in March and pursuant to UMIFA, The Regents adopted a total return expenditure policy, the spending rate for which is to be recommended by the President, in consultation with the Treasurer, at the October meeting.

Over the past several months, the Office of the President and Office of the Treasurer have conducted extensive reviews of various total return endowment expenditure practices and philosophies in order to develop a policy designed to meet the specific goals of the University. The studies included examination of the practices of other leading institutions; consultation with individuals having expertise in the field, both within and outside of the University; analysis of historic investment performance and payout patterns of both actual General Endowment Pool (GEP) results and testing of selected expenditure rates; and analysis and development of future investment return expectations for the GEP, which were then used in simulations with selected expenditure models. These analyses have been discussed with the Chancellors, other campus administrators, and personnel from the Academic Council and relevant committees.

The new GEP expenditure policy sets the stage for a dynamic balance between GEP investment strategy and spending. As outlined by the Treasurer at the May 1998 meeting, the goals to be achieved through the implementation of a total return expenditure rate are the following:

- Maximize long-term total return.
- Preserve the real long-term purchasing power of the endowment portfolio's principal and of its distributions.
- Optimize annual distributions from the endowment portfolio.
- Maximize the stability and predictability of distributions.
- Promote accountability of asset management.
- Promote the University's fundraising efforts.

Consistent with these six goals, it is the legal requirement and policy objective of an endowment expenditure policy to protect the real, inflation-adjusted value underlying the endowment assets and to provide an increasing payout stream to the University programs supported by the endowment. Academic studies and industry analysis have produced inconsistent results in terms of the optimal endowment expenditure rate. The more conservative view is that an endowment cannot have an expenditure rate greater than 5 percent of the current market value over the long term and still maintain the inflation-adjusted value of the portfolio over the long term.

The President, in consultation with the Treasurer, will propose at the October meeting that the University's endowment expenditure rate be set within a range of 4 to 5 percent of a five-year moving average, the exact amount to be set forth in October, with provisions for maximum and minimum payments to protect the GEP and its related distributions from the adverse impact of inflation. This is within the norm for most universities and other charitable endowments. In addition, the administration is exploring the establishment of a reserve fund with the "one-time windfall" that would result for the conversion from the present income-only expenditure policy to a total expenditure policy.

Vice President Darling then invited Treasurer Small to review the back testing and simulations that were conducted by the Office of the Treasurer.

Treasurer Small recalled that the goal of any spending policy for endowment assets is to achieve a balance between meeting the needs of today's beneficiaries while growing assets to meet the needs of future beneficiaries. An equally desirable goal is that of smoothing the fluctuations of the endowment's payout dollars that beneficiaries receive and to fit the more predictable payout stream into the operating budget process.

With these overall goals in mind, the Office of the Treasurer, in conjunction with the Office of the President, has conducted extensive qualitative and quantitative analysis. As noted by Vice President Darling, this analysis included reviewing and analyzing selective academic and industry data to identify potentially acceptable expenditure models that may meet the University's spending policy goals. This analysis also included discussions with investment managers and development officers at comparable universities to assess some of the advantages and disadvantages of their expenditure models.

These potential expenditure models were then analyzed and backtested against actual GEP return and payout performance for the forty-year period since unitization of that fund in 1958. While backtesting can reveal some interesting patterns and trends, it is much more important to test expenditure models using future market expectations. As future market returns can be reasonably predicted within an acceptable range for long-term periods, the Office of the Treasurer took both current and projected asset mixes in the general endowment pool and developed expected future return and risk assumptions for each asset class based on Wilshire Associates asset class return assumptions. The result was a portfolio with an expected total return of approximately 8.5 percent and a risk level, or standard deviation, of 12.9 percent, which is approximately one and a half times the portfolio's return. A standard deviation attempts to measure price volatility. A large number of simulations were performed on this portfolio using several expenditure policies under a "best," "worst," and "normal" set of market conditions in order to assess the potential distributions of the payouts and the corresponding growth or decline in the portfolio's market value.

Treasurer Small reported that, while further analysis is still under way, from her perspective it appears that a payout model on Regents' endowment assets with a target spending rate in the range of 4 to 5 percent of a five-year rolling average of market value seems reasonable. However, The Regents may find it useful to consider a way to alleviate fluctuations in payouts to beneficiaries. As described by Vice President Darling, the possibilities include creating a minimum spending rate and maximum spending rate in order to smooth out the payout dollars and help maintain and increase the long-term real growth of the GEP, or creating a reserve to support the payout dollars in adverse market conditions. Of the two options, a floor-ceiling combination might be more easily implemented, while a reserve may create significant accounting or tracking problems. Also, an important element of any expenditure policy is the initial rate established for the payout calculation. If the payout rate or dollar level is set too high, maintaining future real payout dollars on the permanent capital base may be difficult.

In concluding her remarks, the Treasurer cited a comment from the **Yale Annual Report** that there are four variables that determine whether an endowment fund can meet its objectives: reasonable time frame; reasonable capital market trends; reasonable asset allocations; and reasonable spending policy.

In response to a question from Regent Parsky, Vice President Darling confirmed that the Board would be asked to approve the initial expenditure rate in October, with rates thereafter being presented to the Committee on Finance in connection with the annual budget process.

Regent Parsky observed that the transition year from the income-only spending policy to the total return spending policy represents an aberration because the amount of income earned by the portfolio during the past year would be greater in dollars than the amount that would be created by applying a recommended rate. As described by Treasurer Small, the Committees will need to consider whether to create a reserve for use when the payout rate might not be enough to satisfy an incremental dollar increase from year to year. He noted that an underlying benefit of adopting the total return spending policy is that the Treasurer will be able to take advantage of good markets to accrue money to be used when the market is down. One issue to be considered in creating a reserve is whether to deposit it in a bank account or to invest it.

Regent Hotchkis asked whether consideration had been given to making the transition to the total return spending policy in stages. Regent Parsky explained that the intention in the first year is to pay out at the agreed-upon rate, keeping any other funds in reserve. In response to a question from Regent Hotchkis regarding the use of a five-year rolling average of market value, Treasurer Small noted that, while many institutions use three years, experts prefer to use as long a time period as possible. Regent Parsky requested that the Treasurer circulate a list showing what expenditure rate is used by comparable universities.

Regent Lee recommended that the reserve be deposited in an interest-bearing bank account rather than being invested in the stock market. Regent Parsky agreed that, if the Regents decide that a reserve should be created, it will be necessary to create a real reserve by placing it in an escrow account.

In response to a question from Regent Davies, Vice President Darling explained that, because of the heavy weighting in the portfolio in fixed income, the income payout growth from last year to the present year under the income-only policy would be 16 percent. Treasurer Small continued that the normal compound income growth in the general endowment pool from 1958 to the present has been 5.4 percent.

Regent-designate Vining pointed out that a strong argument for placing the reserve in an escrow account would be that equities would not have to be liquidated when the market was down.

2. **APPROVAL OF TREASURER'S 1998-99 BUDGET**

The Treasurer recommended that the Committee on Investments recommend to the Comittee on Finance that the following be approved:

A. The 1998-99 Treasurer's Office Budget in the amount of $6,975,706, the investment portion ($6,404,436) to be charged to the assets under Regental management and the finance portion ($571,270) to be charged to outstanding Regental debt.

B. A one-time allocation of $569,000, to be charged to the assets under Regental management, to fund a new investment accounting system in the amount of $337,000, the cost of running the current investment accounting systems simultaneously until the cut-over date in the amount of $60,000, a new private equity performance system in the amount of $72,000, and an additional amount of $100,000 to fund the remaining cost for the office move to 1111 Broadway.

The Committee was informed that the request of $6,975,706 for fiscal year 1998-99 includes a number of items that, while increasing the level of the proposed budget for the current year, do not represent a permanent increase in spending. The rent for the Office of the Treasurer had previously been paid by the Office of the President. Custodian fees and investment accounting systems in the past had been charged directly to the investment funds and not processed through the Treasurer's Office budget. The actual increase for the Treasurer's budget totals 5.2 percent, including 1998-99 merit increases of 3.5 percent.

Regent Parsky reported that the Investment Advisory Group had had the opportunity to review the Treasurer's Office budget and that suggestions made by the advisory group were incorporated in the budget as it is being presented.

In response to a question from Regent Hotckhis, Treasurer Small recalled that the University does not have a bonus system for its employees. She would like to have the flexibility to award bonuses in order to create a stronger office over the long term.

Regent Connerly expressed his concern, as a fiduciary, that he was never provided enough information on the University's budgets to feel that he had done his job in approving them. He asked that more detail be provided when the Board is being asked to approve a $7 million budget. Regent Parsky suggested that it would be useful for the Treasurer to circulate the table which lists the salaries for all personnel in the Office of the Treasurer because salaries and benefits comprise the majority of the budget. He asked that any background material on other elements of the budget be included. He added that it would be helpful to provide an organization chart for the Office for the past five years, a description of the Office philosophy, and the amount of endowment and pension funds under management. Treasurer Small offered to provide a mission statement and goals of the Office of the Treasurer.

Chairman Davies recalled that the information requested by Regent Connerly had been made available to the Investment Advisory Group and thus could be made available to all Regents.

Regent Lee pointed out that the Treasurer's budget is much less complex than most of the University's budgets, consisting mainly of salaries and benefits. The budget comprises only .015 percent of the assets under management.

Treasurer Small noted that, if The Regents were to hire external fund managers, the cost would be over $100 million annually.

Upon motion duly made and seconded, the Committee on Finance approved the Treasurer's recommendation and voted to present it to the Board.

The meeting adjourned at 2:50 p.m.

Attest:

Secretary