The Regents of the University of California

COMMITTEE ON FINANCE
COMMITTEE ON INVESTMENTS
January 19, 2000

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, Connerly, Davies, Hopkinson, S. Johnson, Lee, Montoya, Pannor, Parsky, and Preuss; Advisory member Miura

Representing the Committee on Investments: Regents Atkinson, Davies, Hopkinson, Lee, Moores, Nakashima, Parsky, and Taylor

In attendance: Regents Khachigian, Kozberg, and Vining, Regent-designate Kohn, Faculty Representatives Coleman and Cowan, Secretary Trivette, General Counsel Holst, Treasurer Small, Assistant Treasurer Stanton, Provost King, Senior Vice President Kennedy, Vice Presidents Broome, Darling, and Hershman, Chancellors Berdahl, Carnesale, Cicerone, Greenwood, Orbach, Tomlinson-Keasey, and Vanderhoef, and Recording Secretary Nietfeld

The meeting convened at 10:50 a.m. with Committee on Investments Chair Parsky presiding.

1. **ADOPTION OF EXPENDITURE RATE FOR THE GENERAL ENDOWMENT POOL, OFFICE OF THE PRESIDENT**

The President recommended that, with the approval of the Committee on Investments, the Committee on Finance recommend to The Regents that the expenditure rate per unit of the General Endowment Pool (GEP) for distribution in the 2000-01 fiscal year be 4.35 percent of a 60-month moving average of the market value of a unit invested in the GEP.

Vice President Darling recalled that in October 1998 The Regents adopted a long-term target endowment expenditure rate of 4.75 percent, with a first-year payout of 4.35 percent. For all future years, the President and the Treasurer committed to review GEP performance, inflation expectations, and the University's programmatic needs, and to recommend to The Regents a rate that would provide appropriate increases in the dollar value of the payout. The recommended rate is expected to produce an increase in the dollar payout for expenditure in 2000-01 of almost 16 percent over the prior fiscal year if the GEP meets the fund's expected long-term total return of 8.5 percent. Keeping the endowment expenditure rate at 4.35 percent reflects the objective of The Regents to increase the actual dollar payout of the endowment in both good and bad market years. Thus, when, as in the case this year, market momentum is sufficient to result in actual dollar increases that are substantially in excess of University cost increases, no increase may be recommended. This practice will improve the ability of The Regents to increase spending to keep pace with inflation when adverse market conditions might otherwise result in a decrease in spending.

A chart prepared by the Treasurer's Office provided estimates, in dollar terms, of GEP payouts based on a range of assumed GEP investment returns through the end of fiscal year 1999-2000, which ends the 60-month averaging period. At the recommended payout rate of 4.35 percent, the increase in the dollar payout is estimated to range from 13.2 percent to 16.1 percent. This range of dollar payouts is considered to be an appropriate balance among the following objectives that were discussed with the Regents in October 1998:

- Maximize long-term total return
- Preserve the real (i.e., after inflation) 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 the accountability of asset management
- Promote the fundraising effort.

Consistent with the policy adopted by The Regents in March 1998 to recover the endowment administrative costs from the endowment payout, each campus may recover its actual administrative expenses or 15 basis points (0.15 percent), whichever is lower, from the payout. The endowment cost recovery program produced $2.5 million in 1998-99, which released a like amount that the chancellors have committed to spend to augment the University's fundraising efforts.

The President and the Treasurer will continue to review annually the expenditure rate in the context of the performance of the GEP to form their recommendation to The Regents for the continuation or modification of the endowment expenditure rate.

Treasurer Small reported that the Office of the Treasurer agrees with the President's recommendation that the spending rate remain at 4.35 percent for fiscal year 2000, in part due to the 16.9 percent gain in the General Endowment Pool's total return in fiscal year 1999 and an estimated 8.5 percent increase for fiscal year 2000. She recalled that, of the $120 million distributed in 1999, 2.9 percent came from principal. The Regents allow for spending from income and principal as long as there is no invasion of the historical book value of the gift. Given the increases in market value over the past five years, the fund's value is well above the historic book value of most of the gifts in the GEP.

Regent Parsky reported that he had met with the Academic Council concerning the expenditure rate and had received aggressive presentations on why the payout rate should be increased. He believed that, from the standpoint of Regental policy, it would be important to bear in mind that fiscal discipline during positive economic times is a good signal to the outside marketplace, but it is not a substitute for a long-term commitment to move the expenditure rate to 4.75 percent.

Regent Hopkinson spoke in favor of raising the payout rate to the full amount as expeditiously as possible. She reported that, at her request, Vice President Darling would provide the Regents with a document which would track by year the amount of money that is available from dividends, the amount that is required from the equity increase in the stock portfolio and other investments, and the balance that will be returned to the fund.

In response to a question from Regent Davies, Vice President Darling stated that a specific target with respect to the amount of money to be paid out had not been set.

Regent Vining expressed his support for the use of a 60-month moving average because it permits an accurate prediction of the payout for the next fiscal year. In addition, because of this method, the distribution will increase even if the market declines in a future year. Vice President Darling added that, if the GEP market value were to decline by 20 percent in 2000, the dollars paid out would still increase by 12 percent.

Faculty Representative Coleman echoed Regent Parsky's account that the Academic Council would like the payout rate to rise to 4.75 percent as expeditiously as possible, especially in light of the fact that costs at the University rise faster than the rate of inflation.

Upon motion duly made and seconded, the Committee on Finance, with the concurrence of the Committee on Investments, approved the President's recommendation and voted to present it to the Board.

2. TREASURER'S OFFICE BUDGET FOR FISCAL YEAR 1999-2000

The Treasurer recommended that:

A. The FY1999-2000 Treasurer's Office Operating Budget in the amount of $7,456,375 be approved.

B. The investment portion ($6,970,296) be charged to the investment assets under Regental management and the finance portion ($486,079) be charged to outstanding Regental debt.

Assistant Treasurer Stanton noted that a revised budget request had been distributed which was based upon actual expenditures for the first six months and which better reflects the needs of the

Office of the Treasurer for the remainder of the fiscal year. As a result, the Treasurer is now recommending a total budget which is less than the figure that was presented in the Regents item.

The Committee was informed that the budget request will fund 3.5 percent merit increases for employees, consistent with the merit increase provided to all eligible employees. Operating expenses include $810,380 for systems and research data. The increase in the travel budget reflects both an increase in planned travel and the need to travel outside of the United States given the global nature of the economy. The requested increase in the consulting budget reflects the need for ongoing planned system integration assessments.

No new employee positions are being requested for 1999-2000. It is anticipated that a management position opening in January 2000 will be reconfigured into two analyst positions. The total number of full-time employees will increase from 52 to 53.

Regent Parsky observed that, from the standpoint of the Regents, the Treasurer's budget process had been inadequate. He pointed out that the fiscal year 1999-2000 budget was being presented for approval in January, which was not appropriate. He recommended that the Committee express its conviction that, for fiscal year 2000-01, the budget should be reviewed in the spring and presented within a normal budget process prior to the beginning of the fiscal year. Regent Parsky suggested that the process should involve a review of the Treasurer's budget by the Office of the President, which has not occurred recently, in order to determine whether or not any elements of the proposal were inconsistent with University policy, particularly in the areas of salaries and bonuses. He continued that the Committee, perhaps with the assistance of the Investment Advisory Committee, would need more information about the capabilities of the office staff as well as the objectives of the office. This type of analytical review has not taken place. Mr. Parsky explained that the revised budget which was presented by Assistant Treasurer Stanton reflects actual expenditures through December 31, 1999 and a projection of salary needs through the end of the fiscal year. With respect to operating expenses, he suggested that systems would need to be evaluated in conjunction with what the Treasurer's Office is being asked to do, and he asked that any recommendations for new systems come forward in this context.

Regent Connerly asked to what extent the budget request for the Office of the Treasurer is consistent with the budget process for the University as a whole, noting that the level of detail being asked for by Regent Parsky suggested that the Committee would be managing the Treasurer's budget. Regent Parsky reiterated the fact that the University has a budget review process in which the Office of the Treasurer does not take part. In order to avoid micromanagement by the Regents of the Treasurer's budget, he had asked that her budget go through the University's normal budget process. A series of meetings took place with Senior Vice President Kennedy to attempt to do this. He suggested the need for an entity which would analyze the budget from the standpoint of its objectives. It may be possible for the Investments Advisory Committee to play a role in the budget process. Regent Connerly questioned whether this would add another layer of oversight to the budget process. Regent Parsky noted that the Committee on Investments would be considering the adoption of an asset allocation plan. Decisions relating to the oversight of the portfolio are inherent in the adoption of such a plan, as is the role of the Treasurer. In this context, the Committee must define what functions the Office of the Treasurer will continue to have.

Regent Preuss observed that the Office of the Treasurer occupies an unusual position within the University because it reports directly to The Regents. As a result, it does not come under the oversight of the Office of the President. As a first step in normalizing the Treasurer's budget process, he requested that Senior Vice President Kennedy play a consulting role to the Regents similar to the one which he provides to other entities within the University.

In response to a question from Regent Lee, Treasurer Small stated that employees in the Office of the Treasurer had not received bonuses. Regent Lee questioned whether bonuses should be awarded if they were to be based upon the value of the portfolio. Regent Parsky pointed out that Regent Lee's question goes directly to the need for a process for the Treasurer's budget. The current document does not provide the Regents with the information they require to determine whether or not Office of the Treasurer salaries are in line with those of other University employees.

Regent Taylor endorsed the proposal put forward by Regent Preuss that Senior Vice President Kennedy be retained as a consultant on the Treasurer's budget to ensure that appropriate University policies are being followed. He stressed that the compensation program for the Treasurer should be consistent with that of the University as a whole. Regent Taylor stated that it would never be appropriate to present a budget for approval six months into the fiscal year.

Regent Hopkinson supported the use of the Office of the President in a consulting role but cautioned that it should not be put in the position of having to negotiate with the Treasurer on behalf of The Regents.

In response to questions from Regents Parsky and Hopkinson, Director Harrington reported that expenses for the first five months of the 1999-2000 fiscal year had been approximately $3 million. Of this amount, salaries totaled approximately $1.7 million. Based on this figure, salaries for the fiscal year would total $4.1 million, while the Treasurer has requested $4.2 million.

In response to a question from Regent Hopkinson about funding for outside consultants, Regent Parsky stated that these expenses should be included in the budget. He suggested that it might be appropriate in understanding the total costs to indicate in the Treasurer's budget the services that are provided to the office by the University.

Regent Hopkinson pointed out that the Treasurer is requesting $17,000 for space planning without any indication of why it is required. She believed that the Regents should be provided with a description of any major ongoing activities.

Regent Miura asked if the budget review process in the Office of the President goes into as much detail as that being requested of the Treasurer. Senior Vice President Kennedy responded that there is a detailed budget process for the Office of the President, adding that the budgets for the campuses are the responsibility of Vice President Hershman. In recent years the University has had few dollars to allocate apart from salary increases. If a unit does not spend the amount that it has been allocated, the University has most recently reallocated funds to update technology.

In response to a question from Regent Davies, General Counsel Holst advised the Committee that a noticed item would be required in order to establish an ongoing review process for the Treasurer's budget. Chairman Davies asked that such an item be prepared for the March meeting. Regent Parsky stated that the budget would be approved at this meeting with the understanding that a process will be adopted prior to the beginning of the next fiscal year.

Senior Vice President Kennedy pointed out that there are years in which the State budget is approved after the start of the fiscal year, and the State budget determines what level of funding will be available to the University. Regent Hopkinson recalled that the Regents wish to receive information about the State budget from the administration even if it has not been approved by the Legislature.

In response to a question from Regent Lee, Treasurer Small reported that her budget represents .001 percent of the value of the portfolio.

Regent Connerly asked whether, by adopting the Treasurer's budget, it would foreclose the Committee's ability to address the issues which had been raised by Wilshire Associates. Regent Parsky did not believe that approval of the budget would play any role in the consideration of the Wilshire Associates report.

In response to a question from Regent Kozberg regarding the source of funding for the office, Treasurer Small explained that her budget is funded by assets under management. Regent Kozberg suggested that in that case the budget was not dependent upon the State. Senior Vice President Kennedy responded that in general the University has followed the State budget with respect to salary increases.

Vice President Hershman stated that it would be possible to present a budget proposal to The Regents in the spring, based upon the Governor's January budget.

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 11:40 a.m.

Attest:

Secretary