The Regents of the University of California

COMMITTEE ON INVESTMENTS
COMMITTEE ON FINANCE
COMMITTEE ON EDUCATIONAL POLICY
February 19, 1998

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

Members present: Representing the Committee on Investments: Regents Atkinson, Bagley, Davies, Khachigian, Leach, Lee, Levin, Montoya, Nakashima, Parsky, and Preuss

Representing the Committee on Finance: Regents Atkinson, Bagley, Brophy, Bustamante, Connerly, Johnson, Khachigian, Lee, Levin, McClymond, and Sayles; Advisory members Miura and Willmon

Representing the Committee on Educational Policy: Regents Atkinson, Bustamante, Chandler, Connerly, Gonzales, Hotchkis, Khachigian, Levin, McClymond, Montoya, and Soderquist; Advisory members Miura and Willmon

In attendance: Regent Ochoa, Faculty Representatives Dorr and Weiss, Secretary Trivette, General Counsel Holst, Treasurer Small, Provost King, Senior Vice President Kennedy, Vice Presidents Darling, Gomes, Gurtner, and Hopper, Chancellors Berdahl, Carnesale, Dynes, Greenwood, Orbach, Vanderhoef, and Yang, Vice Chancellor Bainton representing Chancellor Debas, Assistant Treasurer Stanton, and Recording Secretary Bryan

The meeting convened at 2:30 p.m. with Committee on Investments Chair Lee presiding.

The following items were discussed together:

1. **UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT (UMIFA)**

It was recalled that the Treasurer has been involved in discussions with the Investment Advisory Group regarding the advantages and disadvantages in the expenditure policy of Regents' endowments under the adoption of the California Uniform Management of Institutional Funds Act, California Probate Code §18500 et seq. The adoption would permit, but not require, the University to spend a portion of the realized or unrealized appreciation in the value of the endowment above historic cost, in addition to current income, subject to the continuing limitations of the "prudent person" standard of Probate Code §18506.

The Regents' current policy is to spend endowment income only. Classically, income is defined to include dividends, interest, rents, royalties, and the like, but not the realized or unrealized appreciation in the value of the endowment.

UMIFA was originally promulgated nationally to apply to all educational, religious, charitable, and eleemosynary institutions and to governmental organizations that hold funds for such purposes. California originally enacted the UMIFA in 1973 to apply only to certain accredited private schools and colleges. The revised UMIFA, supported by the University of California and effective in 1991, broadened the scope of the Act to apply to any public or private charity.

The legislation prescribes the specific investment authority, the authority of governing boards to delegate day-to-day investment management, the standards of care and prudence in the operation of a nonprofit institution and, unless specifically prohibited, the release of donor-specified restrictions on the use or investment of endowed gifts. Pursuant to UMIFA, a total return spending policy has been adopted by the nine University of California campus foundations.

2. REGLNTS' ENDOWMENT EXPENDITURE POLICY

The General Endowment Pool (GEP) assets of The Regents are currently managed for total return, or, to maximize the overall investment performance of both income and market value appreciation or depreciation, within acceptable risk levels. The Regents' investment policy also allows the asset allocation of the GEP to hold equity securities that comprise 60 percent to 75 percent of the portfolio and fixed income securities that comprise 25 percent to 40 percent of the portfolio. The Regents has historically used a spending policy paying out income to beneficiaries, coupled with annual income growth. Income is defined to include "interest income, coupon, dividends, rents and royalties." Capital gains from market value appreciation, whether realized or unrealized, become additions to the original principal of an endowment gift.

The goal of most educational institutions' spending policy is to create a stable, predictable, reliable source of revenue to the beneficiary that grows at, or greater than, inflation. The Regents' investment policy with its emphasis on moderate growth stocks, coupled with a policy permitting modest shifts in asset allocation to take advantage of relative value and attractiveness of the asset classes, has maximized total returns over the long term. This policy, with its emphasis on real returns has also enabled the GEP to achieve a growing payout stream to beneficiaries from a stable, high-quality pool of investible securities, while also growing the principal base to assure continued growing payouts to future beneficiaries.

With the amendment of the Uniform Management of Institutional Funds Act by the State of California, effective 1991, many eleemosynary organizations have adopted a "total return" spending policy whereby a portion of an endowment's total investment return (income plus capital appreciation/depreciation) is paid out for the purpose designated by the donor. The spending policy generally follows a format of "x percent of a y year rolling average of market value."

While switching to a total return spending policy would make The Regents' spending or payout policy to beneficiaries more consistent with industry practices and with the campus foundations' policies, it would introduce more volatility to the GEP's payout and growth patterns. Establishing and tracking such a policy is the more complex issue.

3. **ENDOWMENT ADMINISTRATION COST RECOVERY ON REGENTS' ASSETS**

When the University accepts an endowment, it assumes the responsibility to administer the endowment in accordance with the gift terms and California trust law. These responsibilities include investment, accounting, compliance with gift terms, reporting and the other related activities. These activities are carried out by offices on the campuses and at the Office of the President, as well as by the Treasurer's Office, and in the office of the General Counsel. Chancellors often fund these activities at the campuses by using unrestricted revenues.

The General Counsel has met with representatives of the Attorney General and discussed the possibility of recouping endowment expenses from the endowment payout. The Attorney General's staff has opined that this could be done if the actual costs were reasonable and directly related to the endowments' administration. Many non-profit organizations recover endowment administrative costs from the endowment investment earnings.

If The Regents adopts a policy that permits recovery of endowment administration expenses from endowment earnings, the chancellors will use the funds that are released thereby to support fundraising activities on the campuses. Growing budgetary reliance on private support will require additional, ongoing investment in development efforts to realize the full potential of the University's fundraising enterprise.

In the past ten years, the University's annual private support has increased from about \$300 million per year to \$726 million in 1996-97. In order to continue this growth in private support, the campuses need to increase their expenditures for fundraising. There are very real constraints on the campuses' ability to spend more money on fundraising because of a 1987 statement by the University to the Legislative Analyst that it would not use State funds for direct fundraising activities in its central campus development offices.

To assist with support for fundraising, the President recently allocated funds to each of the campuses to invest in the development program. The adoption of a policy to permit recovery of endowment administration costs from endowment earnings will further enhance the campuses' ability to support their fundraising programs.

The campuses and the Office of the President, with the assistance of the University Auditor for advice on procedures, have examined endowment administrative costs for fiscal 1996. The results show that the overall weighted average administrative costs and investment management costs on Regents' assets would be 0.15 percent (15 basis points) of the endowments' market value if the recovery of 100 percent costs were made.

Committee on Investments Chair Lee emphasized that in the last few years private support has become increasingly important to the University as a financial resource. In the last year the campus foundations have raised the greatest amount of money in the University's history. He believed that ways should be found to support fundraising efforts. He mentioned that in May 1997, Regent del Junco, Chairman of the Board at that time, called a meeting to which he invited four campus foundation trustees and four Regents to begin a process of addressing endowment expenditure issues and the possible adoption of the Uniform Management of Institutional Funds Act. The Treasurer's Office has been working with the Office of the President and General Counsel to discuss this issue. The Investment Advisory Group has met four times for the same purpose.

Vice President Darling noted that the issues involved in the three items listed above are complex. He noted also, however, that countless universities, many charitable organizations, and all nine UC campus foundations have implemented the three items under discussion. The Treasurer, General Counsel, President, Chancellors and heads of campus foundations have considered them at length. Endowments are one of the most powerful ways that a university has to enhance its academic vitality and long-term stability. In the past decade, endowments have grown from $1 billion to over $4 billion due to a very positive investment climate and good performance by the Treasurer, but also due to a steady flow of new gifts and endowments. To be competitive with the best academic institutions, this increase must continue. The amount of endowment per student is inadequate compared to the University's comparison eight institutions. The current endowment expenditure policy is confusing for many prospective donors. Mr. Darling noted that the three items under discussion will not alter the Treasurer's responsibility for investing The Regents' endowments, nor will they necessarily change the payout on those endowments; however, if these items are adopted at a future meeting, they will establish that The Regents is the body that will determine the percentage payout on endowments, they will remove a constraint from the existing investment strategy, they will improve the ability of the campuses to raise more endowments, and they will result in a more uniform set of practices and expenditures between The Regents and the nine campus foundations.

Treasurer Small summarized existing Regents policy governing endowment expenditure and provided additional background information and her perspective on the issues. She commented that currently The Regents has a total return investment policy, that is, a goal of maximizing total return through investment income on securities and the potential for capital appreciation. UMIFA allows, but does not require, trustees to include a portion of the realized or unrealized capital appreciation above historic costs in addition to the investment income when determining how much should be spent or distributed from the endowment to its beneficiaries. This effectively allows trustees to adopt a total return spending policy. In and of itself, adopting UMIFA has no impact on The Regents' existing total return investment policy, and it might provide flexibility for any modifications to the existing Regents' spending policy.

With reference to the possibility of adopting a total return expenditure or spending policy on Regents' General Endowment Pool assets, Treasurer Small reported that currently The Regents uses an income-only spending policy, coupled with annual income growth, in which the payout to beneficiaries consists primarily of interest income on fixed income securities and dividends on common stocks. In determining any spending policy for an endowment, trustees must strive to balance competing needs of current beneficiaries with the needs of future beneficiaries. Endowment management requires that trustees, as fiduciaries, protect the principal value, or the historic cost, of the donor's gift and also ensure that the principal grows at a real rate, adjusted for inflation, in perpetuity to meet the donors goals. Generally, the goal of any endowment spending policy is to produce a reliable, predictable, growing payout stream on which the beneficiaries of the gifts can rely for budgeting and planning purposes. The General Endowment Pool began in 1933. It became an investment pool where all assets were pooled into one fund in 1958 for ease of management. The Regents' endowment investment policy stated that the endowment fund was to be invested, with not less than 60 percent in equities and not more than 40 percent in fixed income securities. At that time, The Regents also established a spending policy of 4 percent of the original GEP asset value and a target of growing the payout to exceed inflation in future years. While the Regents at that time paid attention to the initial payout rate, the focus was on the payout dollars in creating a process to grow both principal and the payout over time. Under this goal, The

Regents' existing spending policy has been extremely successful. Although a spending policy labeled "income payout" may give the impression that the payout is determined on an ad hoc basis or that the income payout restricts the investment choices that investment managers have, it is not true for The Regents. The primary reason that The Regents' spending policy works under a variety of economic and market conditions is due to the flexibility of the endowment pool's asset allocation and the stability and quality of its equity securities. In the early 1970s, the assets to be invested in common stocks were increased several times. In 1988, The Regents' investment policy was modified to range from 60 percent to 75 percent for equity holdings and 25 percent to 40 percent for fixed income, reinforcing the flexibility modestly to shift allocations based on the relative value of the asset classes. As a result of a balanced fund with a heavy emphasis on consistent growth common stocks, The Regents' endowment principal has produced income, or the payout to beneficiaries, that has grown steadily for the last 40 years. In fiscal year 1997, the income paid out to donors' designations totaled $95.7 million, a 40 percent increase since fiscal year 1990 or nearly a 5 percent average annual increase versus an average inflation rate of 2.5 percent. This mechanism of producing a growing income stream also produces a payout rate or dollar distribution that is high during periods of high inflation, when market values normally drop, but the dividends and interest rates are still rising in that environment. It also produces a payout rate that might appear low during periods of low inflation when market values are rising sharply faster than income is growing. While The Regents' policy is not a specific rate on the market value of its assets on an annual basis, the important and attractive outcome is the pattern of growing payout dollars. Under the existing spending policy, the average annual payout rate has been 4.5 percent since 1958 and 4.9 percent since 1970, the average growth in each year's annual income payout of 5.6 percent exceeds the average inflation rate during that period, and the real principal growth was 2.7 percent. Any payout formula is dependent upon the size and growth of the principal. If your needs are growing, then your principal needs to grow; hence the need to maximize existing principal and the importance of the development effort.

When discussing possible endowment spending policy, it is helpful to note that there is a wide variety of policies in practice. There is no one right or wrong policy. The two important points are that trustees need to identify the goal or purpose that their spending policy is to accomplish and to differentiate between relying on a payout rate which may sound consistent when the payout dollars might not be, because market values have volatility, versus the payout dollar amount, which can be structured properly to grow consistently but may not have a consistent rate on the market value of assets at any point.

The Treasurer's Office position is that the existing policy has been very successful; however, the majority of colleges, universities, and charitable organizations have adopted a total return spending policy using a formula of a specific percentage of a three-or five-year rolling average in order to smooth out volatility. It has become an industry standard. The Treasurer's Office would support a total return spending policy that is designed to protect the real and inflation-adjusted principal growth in the endowment and to support the campuses' development effort by having a spending policy donors more readily understand, and to promote consistency between the spending policy of The Regents and the foundations, resulting in more gifts to the University and more equal treatment of UC donors.

Ms. Small addressed the endowment administration cost recovery by campuses on Regents' assets. This is part of the broader issue of funding appropriately campus development, specifically fundraising efforts, which the Treasurer's Office has always supported. The Treasurer's Office recognizes the growing role that private support plays. While endowment administrative costs are a tiny portion of overall development costs, recovery of these costs can free resources that may be used to support development. The total campus administration cost expressed as a percent of Regents' endowment assets, which now total $3.6 billion, is fairly modest. Trust law permits recovery of actual, reasonable costs directly related to the endowments' administration. While recovery of even a modest administration charge reduces the net payout a beneficiary will receive, the Treasurer's Office would support recovery of some or all of these costs if it can be done in a manner that encourages efficiencies at the campuses and also provides an attractive net payout to the beneficiaries.

Mr. Roy Aaron, President of the UCLA Foundation, noted that much of what Treasurer Small addressed deals with spending rate. There is nothing proposed that requires the Regents to determine a rate at this time. He wished to address the underlying policies only. He was pleased that the Treasurer supports adoption of UMIFA, which is supported by all nine foundations. Observing that the total return investment policy of the University is a good one, he commended the Treasurer for her stewardship of the GEP and for moving into alternative investments, such as venture capital interests, which are not likely to show any earnings for a long time. In adopting the recommendations, the Treasurer will continue to handle investments and The Regents will be responsible for determining a spending rate. Once the policy is established, the foundations would like to be able to communicate, through the chancellors, their views and ideas about that rate. That information, along with the recommendations and views of the President and the Treasurer, should be taken into account when the Regents determine a spending rate.

Mr. Aaron noted that the Treasurer's Office would support The Regents' adopting a total return spending policy in order to assist the campus fundraising efforts and to foster more consistent treatment of total University donors. Once The Regents' spending policy is changed to a total return payout rate, the following issues will be reviewed: compliance with trust law; the gift terms of all Regental endowments; the creation of pools within GEP; and the establishment of a regular review of the payout rate with the Regents in the context of the entire University budget. He believed this shift of responsibility to determine the spending rate will result in looking not only at the State budget but also at all the University's resources. It is in that context that a spending rate should be determined.

Regent Leach believed that adopting UMIFA will give The Regents more flexibility in determining annually what the payout may be. He asked whether the foundations anticipate that the payout rate will be increased. Mr. Aaron responded that there is no such expectation. The foundations believe that the disparity between the rates of payout that are available from campus foundations and from The Regents' funds is greater than it should be. The foundations will argue for a change in the rate, but they are not relying on any increase. Mr. Leach observed that it is a question of payout rate versus the growth of the endowment, or savings versus consumption. He expected that there may be an annual tug-of-war between the campuses and The Regents on current spending. Vice President Darling believed that even under a total return expenditure policy the outcome could remain the same. The dollar payouts could grow over time. Regent Leach was concerned that The Regents will need to protect the future as well as to be as responsive as possible to current requests. He did not want there to be any assumption that payouts will increase automatically.

Concerning endowment administration cost recovery by campuses on Regents' assets, Regent Leach noted that there are already charges made by the campuses to gifts in order to recover administrative costs. Vice President Darling explained that there are certain costs embedded in managing an endowment. The campuses are paying those costs out of the Chancellors' discretionary budgets for academic programs. Most charitable organizations do not pay those costs out of operating dollars. It is the intention to shift the source of funds to the endowment from campus operating costs. The separate gift tax that now exists will continue, and in addition there will be administrative costs also recovered from the endowment earnings or realized gain.

Regent Connerly observed that a new level of prudence for the Board is being introduced. Treasurer Small agreed, noting that whenever principal is used, risk is increased, because it is assumed that principal will always be growing. Occasionally, it declines. The Regents will need annual reviews to make sure that the principal is protected but is growing sufficiently to cover inflation. It will put an additional burden on the trustees to make sure the gifts given will last in perpetuity. Regent Parsky commented that, in one sense, currently the Board is not carrying out its fiduciary responsibilities. The responsibility for spending policy rests with the Board. One of the objectives of the new spending policy is to have the

Board fulfill that responsibility. He believed that the new level of prudence that will be required is overdue. Regent Connerly asked whether the level of risk is being changed with the proposed strategy. Regent Parsky explained that The Regents, in setting the rate, will be making a decision that responds to current versus future needs. The investment policy will not change, and the level of risk to the endowment will not change. General Counsel Holst assured the Regents that he was aware of the need to protect the Board and its individual members from liability under the new arrangement.

Regent Davies supported the adoption of UMIFA, but he shared Regent Leach's concern about what he believed was the inevitable pressure to spend more money in the short term. The Regents will have to resist that pressure every year when they set the total return spending rate for that year. He noted that the current policy has worked well for years and has produced a growing revenue stream to support the people who depend on it. He believed also, however, that adopting UMIFA would be a good move in the name of consistency and to provide a legal source of money to spend on development. Mr. Aaron agreed. One of the foundations' problems is that they are in competition. Donors are confused about where to put their money. He believed in a total University approach.

Regent Levin believed that, although the ultimate decision concerning the distribution of Regental funds lies with the Board, that does not mean to say that in each year the Board must determine that the percentage of dollars must be greater than the previous year. She advised looking to the Treasurer and the President for thoughtful recommendations that will result in the protection of money for the future and the appropriate use of current funds.

Regent Soderquist asked whether there are fees attached to all gifts. Vice President Darling explained that each campus has a different policy. Each is outlined in the Treasurer's report on University endowments.

Regent Preuss mentioned that it is of primary importance to devise arrangements that are acceptable to donors and that make it easy for donors to give their money to the University. He observed that a gift may be used right away, while an endowment pays off in the long term. The University needs to be sufficiently flexible to adjust to market conditions at least somewhat in the way that private universities are able to do.

Regent Montoya asked General Counsel Holst whether accepting all three recommendations as policy will continue to allow a donor to give monies under the income-only policy should the donor so wish. Mr. Holst responded that donors may negate the application of the uniform act if they choose to do so, but they must do so explicitly in order to preserve the traditional income-only provisions.

Regent Johnson voiced her strong support of the proposals. She noted that the University's development efforts need more flexibility in order to counteract diminishing State funding. Regent Hotchkis agreed, noting that the University needs to conform to practices that are becoming popular worldwide.

Mr. Darling noted that, before an action item is brought to the Board, a process must be established to ensure that the costs put together by the campuses under the guidance of the University and campus auditors are real costs, attributable solely to endowment administration. These funds must produce a return, and there must be various levels of accountability.

Chancellor Carnesale reported that Harvard University draws more from its endowment each year toward its general budget than UCLA does from the State. It is very dependent on endowments. He believed the proposal to adopt UMIFA would give the University flexibility not just on its spending policy but also on its investment policy. Although the University's investments have been excellent, relying on income to provide the payout creates a constraint. The portfolio must be managed in a way that makes sure that the income satisfies the needs of the campuses, and investment strategies must change as patterns of investment change over time. Concerning the expenditure policies, he noted that it is difficult to decide how much to invest in programs, some of which have income-generating capacity, and how much to invest in the endowment itself. The people who manage the endowment want to pay as little as possible so that the endowment will grow. The people on the campuses want to pay out as much as possible so they can invest it in programs. He believed that the Regents are the best arbiters of this tradeoff. Concerning administrative cost recovery, he noted that the University is not permitted to use State money to raise money and that it would be unusual to receive a gift to support fundraising. He noted that there is no magic formula for determining the payout rate, because it depends at least as much on inflation as on the market. The whole idea of an endowment is to try to insulate the University from the market. If the market suddenly goes up, one does not want suddenly to increase the payout rate if inflation has been low. It would be advantageous steadily to increase the money for programs while at the same time preserving forever a corpus that will permit the process to continue.

Regent Bustamante asked if there were any experience of the costs that are able to be projected in terms of increases in funds as a result of development activity versus growth in principal. He wondered whether there were some ratio that would show that the University should be spending more on development or more on growing principal. Mr. Darling responded that he had never seen a direct comparison. He noted that for doctoral research universities like the University, it costs, on average across the nation, 16 cents to raise a dollar.

Regent Parsky agreed that it is the responsibility of the Regents to determine how much money is to be committed to program development and how much is to be saved for the future. The Regents also have an ongoing responsibility for preserving the financial viability of the institution. He was pleased that the problem is being addressed cooperatively among the segments that are affected and that the Regents are being exposed to all views. He supported the cost recovery proposal as a policy matter. He noted that what is being suggested is the adoption of a policy that would permit the reimbursement of some documented costs, once the three groups come forward with a program that the Regents understand and support, that would allow some administrative costs documented and permissible under law to be reimbursed and that would ensure that the money that would be freed to go toward development would actually go toward development. He was reassured by the fact that the foundations, the Treasurer, and the Office of the President had devised a unanimous proposal on these matters as they relate to policy. Committee on Investments Chair Lee agreed that the cooperation that had resulted in the proposals was admirable. Mr. Darling commented that if the University were private, the Regents would have a major responsibility for raising private money for the institution. The University's foundations take on this burden, and in so doing, they serve as ambassadors to the community and the state.

Assistant Treasurer Stanton provided a brief update on private equity investments. He reported that, as requested by Regent Parsky, proposals for reviewing The Regents' private equity portfolio and a private equity investment management process were solicited. The proposals of the two finalists are undergoing evaluation. Upon completion, the consultant will make a presentation to the Investment Advisory Group summarizing its analysis and disclosing its recommendations.

The meeting adjourned at 3:50 p.m.

Attest:

Secretary