The Regents of the University of California

COMMITTEE ON INVESTMENTS
COMMITTEE ON FINANCE
COMMITTEE ON EDUCATIONAL POLICY
May 14, 1998

The Committees on Investments, Finance, and Educational Policy met jointly on the above date at Covel Commons, Los Angeles campus.

Members present:	Representing the Committee on Investments: Regents Atkinson, Khachigian, Lee, Levin, Montoya, Nakashima, and Parsky; Advisory member Espinoza Representing the Committee on Finance: Regents Atkinson, Johnson, Khachigian, Lee, Levin, and McClymond; Advisory members Espinoza, Miura, and Willmon Representing the Committee on Educational Policy: Regents Atkinson, Chandler, Khachigian, Lee, Levin, McClymond, Montoya, and Soderquist; Advisory members Espinoza, Miura, and Willmon
In attendance:	Regents Davies and Ochoa, Faculty Representatives Dorr and Weiss, Secretary Trivette, General Counsel Holst, Treasurer Small, Provost King, Senior Vice President Kennedy, Vice Presidents Broome, Darling, and Gomes, Chancellors Berdahl, Dynes, Orbach, and Yang, Vice Chancellor Bainton representing Chancellor Debas, Laboratory Director Browne, and Recording Secretary Bryan

The meeting convened at 5:15 p.m. with Committee on Investments Chair Lee presiding.

PRINCIPLES AND OBJECTIVES OF THE REGENTS' GENERAL ENDOWMENT POOL (GEP) EXPENDITURE POLICY

It was recalled that in filling their fiduciary duties, trustees for an endowment portfolio face important issues when determining an expenditure policy: how much to spend currently for today's beneficiaries and how much to reinvest for the needs of future beneficiaries. In the creation of an expenditure policy, trustees should take into account any policy characteristic that would favor one group over another. Academic and industry research on endowment fund management and expenditure policy consistently highlight similar goals for all endowment trustees. For UC, these goals are as follows:

- 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 accountability of asset management (disclosures to donors, performance reporting, etc.); and
- Promote the development effort.

The purpose of the University's endowments is to provide a permanent stream of income to support the donor's specified purposes. The following should be considered under the specific expenditure policy that The Regents adopts that balances the competing needs of current and future beneficiaries:

Expenditure policy should be based on long-term investment performance expectations. Given the extremely long-term time horizon (infinity) of an endowment portfolio, expenditure policy should be linked to the portfolio's long-term investment performance expectations. While various "smoothing" mechanisms can be used in an expenditure formula, inflation is the real driver of expense growth. Capital market cycles are far longer than the number of years (usually three or five) typically used for smoothing purposes in many expenditure policies. Relying on a time period that is too short, relative to the portfolio's time horizon, can produce shortfalls in the endowment distributions. The trade off becomes that of low variability/ fluctuation in spending rate for high variability/fluctuation in spending dollars. Minimizing the volatility/fluctuation in spending dollars is more important than minimizing, or locking into, an established spending rate.

Switching to a new expenditure policy or formula should not produce a windfall or shortfall to current beneficiaries. During periods of low inflation and favorable market returns, the expenditure formula might "reserve" excess assets in a "stabilization," or reserve, fund for possible expenditure during higher inflation and "less favorable" market periods while still avoiding inappropriate accumulations.

Preservation of the real value of the endowment principal. After distributions to beneficiaries, growth of the principal at a rate at least equal to inflation is a primary responsibility for endowment fund trustees.

Endowment Distributions are stable and sustainable. Fair and equitable treatment of endowment beneficiaries suggest the importance of future beneficiaries receiving the same real (after inflation) endowment distributions as those received by current beneficiaries. Therefore, the distributions would need to grow at a rate that equals or exceeds inflation.

Endowment Distributions are predictable and permit budgeting and forecasting. Consistent growth lends predictability to budget planning and eases concerns that distributions could actually decline (both in nominal and real dollars) in flat/down market cycles. Depending on the specific campus/department's budget tolerance for adjustments, this "shortfall risk" could have a significantly detrimental effect. Currently, GEP distributions to individual funds are accumulated during the fiscal year and transferred to the campuses for use by the beneficiaries in the following fiscal year. An estimate of these distributions is provided to the campuses prior to the end of the fiscal year to use in the campus budget process (i.e., for fiscal year 1997: the budget estimate was provided to the campuses in May 1997, the transfer of the actual GEP distributions occurred in August 1997 and are available for expenditure by the beneficiaries during the 1998 fiscal year).

It is important to note that while approximately 45 percent of the GEP assets support scholarships/financial aid and research, the majority (78 percent) of GEP's assets have restricted purposes. Endowment assets at private institutions are generally unrestricted and are used primarily to support operations.

<u>All endowment expenditures are incorporated in the University's planned budgeting process that includes all revenue sources</u>. Endowment distributions, from both the GEP and the campus Foundations available to the University, should be predictable and used in the University's annual planned budgeting process that will include all revenue sources.

<u>Promote disclosure/accountability</u>. Solicitation materials describing the investment performance, expenditure policies and expenses associated with the GEP and Foundation endowment pools can facilitate donor understanding and giving.

<u>Encourage gifts to UC</u>. The ultimate goal is to increase support from private giving. Adopting a "total return" expenditure policy gives the GEP a label more easily understood in the philanthropic arena. An endowment expenditure policy that produces comparable net payouts (after all expenses) to beneficiaries, whether the gift is given to UC via The Regents or via a campus Foundation, may remove confusion among current and potential donors.

Treasurer Small provided a brief summary which highlighted the main principles and objectives of the endowment expenditure policy. She noted that some of the primary goals for overseeing endowment assets may seem to be in conflict. Maximizing long-term total return means having volatile or fluctuating asset returns, while maximizing the predictability and stability of distributions infers little volatility in asset returns. The goals of promoting accountability of assets via performance reporting and promoting the development effort clarify the donors' choices, ensuring proper administration and stewardship and providing a growing asset base.

Ms. Small emphasized that endowment assets should be viewed as the permanent capital of the institution and that development is important as a means of growing that permanent capital. The expenditure policy should be based on the long-term investment performance expectations for the portfolio.

Regent Parsky stated that he found the summary provided by Treasurer Small to be helpful. He urged the Regents to think over time about the issues involved, including how the costs that are incurred by the foundations should be defined. Faculty Representative Dorr suggested that they should think about the principles involved, also, when considering the rate of reimbursing the foundations for their costs.

The meeting adjourned at 5:25 p.m.

Attest:

Secretary