Senate Committee on Finance & Planning
Minutes of the Meeting
April 21, 2015

[These notes reflect discussion and debate at a meeting of a committee of the University of Minnesota Senate; none of the comments, conclusions or actions reported in these notes represent the views of, nor are they binding on, the Senate, the Administration or the Board of Regents.]

In these minutes: [Update on University endowments; old and new business]

PRESENT: Gary Cohen, chair: Dan Feeney, Megan Wiza, Kara Kersteter, Karen Ho, David Fisher, Quinn Jurgens, Catherine Fitch, Russell Luepker, Paul Olin, Erick van Kuijk, Jill Merriam, Jennifer Gunn, Pam Wheelock, Tracy Peters, Michael Korth, Fred Morrison, Taylor Barker

REGRETS: Renee Cheng, Karen Seashore

ABSENT: Laura Kalambokidis, Lincoln Kallsen, Richard Pfutzenreuter, Michael Volna, Samantha Jensen

GUESTS: Douglas Gorence, president and chief investment officer, UMF Investment Advisors; Andrew Parks, director, Office of Investments and Banking

Professor Cohen welcomed the committee.

1. Update on University endowments

Cohen introduced Douglas Gorence, president and chief investment officer, UMF Investment Advisors, and Andrew Parks, director, University Finance, Office of Investments and Banking, who presented a report on University endowments.

Gorence said there were two separate, distinct governing boards, one for the University of Minnesota Foundation (UMF) and the other for the Consolidated Endowment Fund (CEF) with two separate policies. He is the president and chief investment officer of the Foundation's investment management subsidiary, UMF Investment Advisors. Gorence added that the assets are from private giving, as the Foundation is the official fundraiser for the institution across the system.

Andrew Parks, director, University Finance, Office of Investments and Banking, directed committee members' attention to a presentation, which began with an asset summary:

- Consolidated Endowment Fund (CEF): the primary pool of capital, slightly under $1.3B
- Other pools of capital include short term reserves, a conservative portfolio which has a AA+ credit rating

Parks also noted his office has some fiduciary responsibilities associated with the various retirement plans offered to the faculty and staff, and those assets are about $4.8B. Cohen said that in previous reports to the committee from Stuart Mason, associate vice president, University

Finance, Office of Investments and Banking, he did not recall any mention of any role in oversight of those retirement funds. Cohen asked if that was an omission or a relatively new function of the office. Parks said the office had been responsible for overseeing them for quite some time. There was a newly formalized fiduciary structure, including a fiduciary advisory committee to provide advice to Richard Pfutzenreuter, vice president, University Budget and Finance, regarding the structure; but the primary fiduciary is ultimately the Office of Budget and Finance.

Parks said that the CEF and the Foundation had similar risk and return objectives, but there were some differences in how risks were viewed and portfolios were structured. Parks reviewed objectives and risks for the Endowment and the Foundation:

PROGRAM GOALS	
CEF	**FOUNDATION**
Generate investment returns that meet or exceed the annual payout rate after adjusting for inflation.	Achieve a real return that meets or exceeds total spending.
Provide stable distribution profile to the University	Reduce extended nominal and real drawdowns.
KEY RISKS	
Effectively implementing payout and investment policies that balance the interests of both current and future generations Illiquidity risk ● Rebalancing, reinvestment risk ● Ability to exploit future opportunities	Drawdowns: ● Disrupts spending, reduces total spending and reduces real value of corpus ● Unknown nominal rigidities (underwater funds policy, budgets, debts, sticky wages/salaries, state funding)

Cohen asked about stable distributions and methods to ensure that payouts to the individual endowments are calculated correctly. Parks said it was primarily a function implemented in the Treasury Accounting Department. On an annual basis, DeLoitte audits each of the individual endowments to ensure the methodology is correct. Parks there had not been any concerns raised about miscalculations since this practice began in 2008.

Parks reviewed the CEF and Endowment performance growth since June 1990, noting that long-term performance exceeded expectations. In discussing the rolling period performance, he said returns as of late had driven by private equity strategies and had been strong on both absolute and relative bases. The venture portfolio, about 13% of the total fund, had a 37% return in 2014. Over the five-year period, the public equity portfolio was up 10% and the private equity portfolio was up 18%. Parks said they were optimistic yet cautious about the outlook going forward.

Parks reviewed asset allocations as of 12/31/14:

	CEF	**FOUNDATION**
Bonds & cash	20%	30%
Global equity	34%	25%

Private equity	26%	15%
Real assets	13%	19%
Marketable alternatives	7%	11%

The committee discussed the information in the presentation.

Quinn Jurgens asked about the non-investment grade credit, what credit rating was sought, and what would cause something to not be investment grade. Gorence said they did not focus solely on ratings, as rating agencies are useful to an extent but are not good predictors of credit risks. A critical piece of the strategy was having assets that protected a loan.

Professor Ho asked if the increase in volatility was worth the lack of stability. Gorence said the fund volatility was 8%, half the standard deviation, and that it was only one factor. The greater concern, Gorence noted, was drawn-out risk.

Parks then discussed the next ten years and referred to the presentation:

- Current 10-year bond yields 2.0%
    - Expected bond return = beginning bond yield
- Assume inflation is 2.0% over next ten years
- What do equity returns have to be over the next 10 years to produce a 5% real return from a passive 70/30 stock/bond portfolio?
- Quick answer: >7% real return per year (>9% nominal)

Cohen asked about the fiduciary responsibility to programs, units, scholarships, and fellowships, which are funded by individual gifts with stated purposes. Gorence explained that when a gift is brought into the fund, the Foundation is responsible for the stewardship of those gifts. When they see gifts that are not being used, they communicate with the dean or department to find out why. Gorence said they also issue a stewardship report to the donor, which indicates the account balance and earnings.

Cohen noted the issue of longer-term risks not being able to make the rate of return that meets the income distribution rate plus inflation. A number of the endowments support chairs, professorships, scholarships, or fellowships for particular academic programs, which depend on a predictable payout. Cohen said that there may a decline in the value of the assets or there may be recent new gifts that may then be “under water,” yet a professor has been hired or a scholarship or fellowship is established and the income is not there. Cohen then asked about communicating these risks to the academic officers as budgets and commitments are planned so that they are fully aware of these potential situations. Gorence said they needed to rely on people such as himself, Parks, and Mason to communicate any potential issues.

Cohen said Professor Morrison had been an interim co-dean of the law school, an academic unit with a number of endowed chairs, and asked Morrison about his experience with communication regarding income from endowments. Morrison said the numbers indicated that the current one-year overall rate of return was about 5.7%, and stated he did not understand how it was possible to finance a 4.5% payout and 2% payment for inflation, and still have a positive return. Morrison said it needed to be communicated to departments that they had to plan on a lower level of income for the ensuing years. Gorence said the Foundation had to respond to donors who have choices about where they give their money, which potentially might not be the University of Minnesota. Morrison said the issue must be addressed as to whether it is all spent in twenty years versus having a perpetual endowment. Gorence said that although he was in effect an independent consultant to the Foundation, he would impart that message and added that they had encouraged Foundation trustees to disburse closer to 4%.

Pam Wheelock said comparisons to other institutions were useful but it always came down to what the donor’s intentions were. She said another comparison would be other foundations, and she would be hard-pressed to think of an area foundation that does not use some kind of rolling average to help determine payout. While there is more unpredictability around the annual budgeting, there is more stability over the long run of the principal. Gorence said the last investment policy revision in 1999 explored different spending policy structures, and his recollection was that administering something like that would be too unwieldy for a large, decentralized organization. Cohen said it was typical of large R1 universities that when the payout is changed on endowments, it is done very gradually to minimize impact on the benefiting units, which are counting on the revenue and cannot rapidly replace it.

Ho asked how the 5% became the standard, and how much of that was framed by a reduction in state appropriations to the University. Gorence said they considered spending rates at universities across the United States. At one end, it was 3 to 3.5% and at the other 6-6.5%, with the middle range at 4.5-5.5. Gorence added that the Foundation board wanted some basis for return assumptions, and he used history plus adjustment in determining that.

Kara Kersteter asked if there were any other mechanisms to help funds recover and regrow an endowment. She said the endowment in her department was closely guarded but it had taken a hit. Gorence said there was no way to make up for the losses, and spending would have to be deferred to grow the fund.

Cohen referred the committee to a document that illustrated changes in the market value of an endowment held in the Consolidated Endowment Fund (CEF) from 2010-14. He pointed out the realized growth over the 4½-, 3- and 1- year points, and noted there had been some recovery but it was not sufficient. He emphasized endowed chairs and salaries that cannot be reduced present grave problems for departments.

Professor Luepker said in the past the committee had discussed the merger of the Minnesota Medical Foundation (MMF) and UMF, and felt it made good sense. Gorence said the UMF was able to take a fairly liquid portfolio and turn it into mostly cash, creating a couple of hundred million in liquid assets to deploy much more effectively. The merger also reduced the cost structure, and had been very effective in creating one fundraising and administrative organization, resulting in long-term cost savings.

Cohen directed people to the website for the Office of Investments and Banking for further information. He urged Parks and Gorence to talk to their respective chiefs about communicating with central administration, saying the administration needed to be less sanguine regarding what could be counted on in the long run from endowments.

Cohen thanked Parks and Gorence for the discussion.

2. Old and new business

Cohen discussed upcoming meetings.

Hearing no further business, Cohen adjourned the meeting.

Mary Jo Pehl
University Senate