Minutes

Senate Committee on Finance and Planning
Tuesday, February 28, 2012
2:00 – 4:00
238A Morrill Hall

Present: Russell Luepker (chair), Martin Caride, Will Durfee, Catherine Fitch, Susan Hupp, Lincoln Kallsen, Kara Kersteter, Fred Morrison, Michael Rollefson, Ann Sather, S. Charles Schulz

Absent: Brittany Bergemann, Sarah Chambers, Ruth Lane, Cody Mikl, Kathleen O'Brien, Richard Pfutzenreuter, Gwen Rudney, Terry Roe, Karen Seashore, Arturo Schultz, Thomas Stinson, Michael Volna, Aks Zaheer

Guests: Douglas Gorence (President/Chief Investment Officer, University of Minnesota Foundation Investment Advisors); Associate Vice President Stuart Mason (Office of Investments and Banking)

[In these minutes: (1) endowment and foundation returns; (2) graduate program quality metrics; (3) report of the chair]

1. **Endowment (CEF) and Foundation (UMF) Returns**

Professor Luepker convened the meeting at 2:10 and welcomed Messrs. Gorence and Mason to discuss the investment returns and performance of the University of Minnesota Foundation funds (UMF) and the Consolidated Endowment Fund (CEF) and associated assets.

Mr. Mason began by distributing and handout and explaining the funds that are managed by his office. They include (with assets noted as of December 31, 2011, in millions of dollars):

<table>
<thead>
<tr>
<th>Fund</th>
<th>Assets (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated Endowment Fund</td>
<td>925.0</td>
</tr>
<tr>
<td>Long-Term Reserves (GIP)</td>
<td>43.4</td>
</tr>
<tr>
<td>Short-Term Reserves (TIP)</td>
<td>848.8</td>
</tr>
<tr>
<td>RUMINCO, Ltd.</td>
<td>32.8</td>
</tr>
<tr>
<td>Invested Assets Related to Indebtedness</td>
<td>272.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,122.3</strong></td>
</tr>
</tbody>
</table>

Other funds not managed by his office are (assets as of December 31, 2011, in millions of dollars):

<table>
<thead>
<tr>
<th>Fund</th>
<th>Assets (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U of M Foundation</td>
<td>1,282.5</td>
</tr>
<tr>
<td>Minnesota Medical Foundation</td>
<td>209.8</td>
</tr>
<tr>
<td>Basic Faculty Retirement Plan</td>
<td>2,962.9</td>
</tr>
</tbody>
</table>

* These minutes 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 minutes represents the views of, nor are they binding on, the Senate, the Administration, or the Board of Regents.
In the case of the last one, the Basic Faculty Retirement Plan, Mr. Mason explained, it is not managed directly, but his office oversees selection of the fund options that are available to participants and performs due diligence on the General Account funds at Securian.

Professor Morrison inquired about the meaning of "Invested Assets Related to Indebtedness." Mr. Mason explained that the University issues debt (e.g., for construction) and may not spend it all immediately so they invest the debt-issuance proceeds until they are needed. For example, the University issued approximately $147 million in revenue bonds for the TCF Bank stadium but it took more than three years to spend all the money.

Mr. Gorence said that his job was more straightforward than Mr. Mason's. He is responsible for the $1.3 billion in long-term investments which comprises the funds of UMF. Mr. Mason noted that currently, gifts to the University today go to UMF; the CEF is composed of gifts from the days before the Foundation was established plus rents and royalties that make up the land-grant income (mineral and timber rights and so on).

Mr. Gorence said he is responsible for oversight of UMF funds, along with the UMF Board of Trustees, which is an independent board that includes several University representatives. The funds for which Mr. Mason is responsible, he told the Committee, are overseen directly by the University’s Board of Regents.

For the benefit of new Committee members, Professor Luepker asked what RUMINCO is. It is an acronym for Regents of the University of Minnesota Insurance Company, Mr. Mason said, based in Bermuda, that insures the University for auto, general and professional liability, and non-profit organizational liability, and also carries an umbrella policy for large claims that might arise. The $32.8 million are reserves to pay claims. Professor Shultz pointed out that University of Minnesota Physicians (UMP) has its own insurance for the medical practitioners and that it is also self-insured.

Are the TIP funds (Short-Term Reserves) held by departments, Professor Luepker asked? They are, Mr. Mason said; they are departmental checkbook balances all in a single pool. TIP also receives money from the State support some of which is used to pay the University's payroll, make bond payments, and other working capital requirements. The TIP funds can vary by as much as $150 million within a week or two, depending on when bond payments are due and when the state makes its monthly deposit into the University's accounts.

The Long-Term Reserves are dollars scheduled for long-term projects (e.g., a department is saving money for a large equipment purchase). The GIP fund receives a slightly higher rate of return.

TIP funds earn about 1%, Mr. Mason said, and that interest income funds the University’s central reserves which are allocated by the administration. Professor Hupp inquired if a department could be a college. It would, Mr. Mason said; there are about 1800 units within TIP—colleges, departments, etc.—and the TIP funds are cash available to them at any time, to fund their budget expenditures. They do keep track of whose money is whose, he assured the Committee.

Mr. Gorence next referred Committee members to two graphs, one for UMF and one for CEF; he explained the former one. The "Return Goal" (the aim for earnings) was 6% plus the CPI up until April, 2011; since then it is has been 5% plus the CPI. The graph plotted the returns from a passive portfolio and for UMF from 1990 to December 31, 2011 for $1 invested; the passive portfolio earned $4.91, less than the "Return Goal," but UMF funds earned more than the goal, $6.56. The UMF Board of Trustees feels that UMF is doing well as long as it meets its Return Goal. What this means, Mr. Gorence said, is
that if the spending rate from UMF funds is 5%, it must earn 5% plus inflation (in order to preserve the principle against inflation). They have done well even during difficult capital markets. The decision to go from a goal of 6% to 5% was an important discussion by the Board of Trustees, because 6% was too high, and the Board believes that even 5% is aspirational for the future, given the kinds of risks that UMF is managing.

The other graph, for CEF, included two lines: one for the investment objective (an inflation-adjusted dollar) and one for the actual CEF performance. The investment goal for the $1 invested in 1990 was $4.92; the actual return was $6.34. The two organizations, he noted, have a very similar profile. CEF sees a little more volatility for two reasons: One, because it had a later start in having an actively managed portfolio (the early 2000s, versus the late 1990s for UMF), and two, because it has a somewhat different mix of assets. They are meeting the goal of the Board of Regents to maintain the value of the principal of the CEF.

Professor Morrison asked what the management costs for the two funds are. Mr. Gorence reported that in the case of UMF, they pay fees to a third party to invest the assets. His team of eight employees are portfolio managers and provide oversight, which is a layer of cost. The Foundation charges a fee to administer donor funds that is also taken off the top. The administrative fee for the permanent endowment is currently 1% (100 basis points). The fees for his office are about 15 basis points per year for the total pool of funds (which includes some non-University Foundation third-party funds, so the total cost to the University is less than it would otherwise be). In addition, the money-management costs range from the very cheap to about 2% for venture capital funds. All of this on average equates to about 135-145 basis points (1.35 to 1.45%) for management costs. To this must be added the 1% that the Foundation charges for its general operations, so about 235 basis points or 2.35% is deducted from its actual earnings, Professor Morrison said.

The returns are net of investment-management costs, Mr. Gorence said, and do not include Foundation direct expenses or the 1% administration fee. So, as a result, a department realizes only about 550 basis points (5.5%), not 650 or 6.5%, Professor Morrison said. That is correct, Mr. Gorence affirmed. The Foundation is raising money for the University; the question is how to allocate funds within the system.

The 1% charge is assessed against about $800 million, not the entire $1.2 billion, Mr. Gorence clarified, so it amounts to about $8 million. That supports a portion of the Foundation's budget.

Mr. Mason reported that the CEF has the same outside management costs and a similar cost structure as well as about 12 basis points for the cost of his office. His office also provides some funding to support the foundations, so the total is about 14 basis points. They do not have the additional 1% charge because they do not engage in fund-raising.

Professor Morrison noted the $6.34 on the CEF graph and asked if that is before or after the charges for the outside managers. It is after, Mr. Mason said. So his costs are only about 15 basis points (0.15%), Professor Morrison concluded, and the department would net 6.35% on that investment. Mr. Mason agreed. The difference, he repeated, is the 1% for fund-raising costs of the foundations.

Mr. Rollefson observed that over the long term, the two funds have taken different strategies but ended up about the same. How is that? It substantiates modern portfolio theory, Mr. Mason commented.

Professor Shultz inquired how well the funds are doing compared to other universities. Mr. Mason referred to a set of bar graphs depicting the performance of the CEF, UMF, the Minnesota Medical
Foundation, the Cambridge Median, and the 70/30 passive index benchmark, each for 1 year, 3 years, 5 years, and 10 years. The Cambridge Median is the comparison statistic, prepared by Cambridge Associates, a Boston consulting firm that has a relationship with a majority of endowments and foundations. They survey all their clients; the bar graphs for the periods represent the median returns. The point at which one starts and ends the comparisons can significantly affect the results, especially for shorter periods such as one year. The graph for one year would look quite different if it the end date had been six months earlier.

The rates of return for periods ending 12/31/11 for the 5 groups are depicted on the graphs for the four time periods, as follows (all numbers are percents):

<table>
<thead>
<tr>
<th>Time Period</th>
<th>CEF</th>
<th>UMF</th>
<th>MMF</th>
<th>CMedian</th>
<th>70/30 bench</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year</td>
<td>5.3</td>
<td>1.6</td>
<td>-5.0</td>
<td>-1.8</td>
<td>3.3</td>
</tr>
<tr>
<td>Three years</td>
<td>3.6</td>
<td>9.6</td>
<td>9.0</td>
<td>10.8</td>
<td>12.8</td>
</tr>
<tr>
<td>Five years</td>
<td>-1.3</td>
<td>1.6</td>
<td>-0.4</td>
<td>1.8</td>
<td>2.3</td>
</tr>
<tr>
<td>Ten years</td>
<td>4.5</td>
<td>6.9</td>
<td>3.1</td>
<td>5.9</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Mr. Gorence commented, apropos of using peer data, that in the short term the differences tell more about differences in asset allocation than returns (and they don't always know what asset allocation strategy other organizations are using). In the case of the larger schools, with $1 billion or more in assets (about 50 higher-education institutions), the asset allocation is often very similar—and may be quite different from the asset allocation of smaller colleges, which rely more on publicly-traded securities and more domestic assets. While the UMF is not a client of Cambridge they do review the Cambridge data. Mr. Gorence also provides data regarding median returns compiled by the National Association of
College and University Business Officers (NACUBO) to the Board of UMF. He said that the shorter the time period one examines to make comparisons, the greater the variability, so the Board focuses on the long term.

In terms of the two portfolios, Mr. Gorence reported, UMF had a head start with its diversified portfolio construction. As a result, the private equity held by UMF is very different from that held by CEF. UMF has been investing for many years and has a very different level of maturity of its funds.

Professor Hupp commented that the 5-year mark on the graphs was a difficult time. When those numbers become the ten-year mark, will they skip over them? They will not, Mr. Gorence said; they will become the ten-year point and then they will also pass. The data are always point to point, and they have to explain what happened. Were there errors of commission? Of omission? Or was that simply a random outcome?

To emphasize the point about the effect of choosing different dates to start and end the comparisons, Mr. Mason reported that the one-year Cambridge Median return of -1.8% on December 31, 2011, was 20.8% on June 30, 2011. The three-year Cambridge Median return, six months ago, was 2.4%, but at the end of December it was 10.8%. So the numbers change dramatically, he pointed out. They each tell their boards about these fluctuations, which is why they focus on the long-term. Mr. Gorence agreed and observed that the focus needs to be on maintenance of the funds over the long term because they cannot get every investment decision right, and some take longer than others to work out.

Mr. Mason provided a more detailed analysis of the fiscal year performance of the CEF from 2002 to 2011. He noted that he came to the University in 2003 and began to shift the assets to diversify the portfolio (including private investments in addition to public equity) to try to position the CEF to exceed the benchmarks; those efforts did not begin to fully take effect until 2005 and 2006. For the first five years after he took office, the CEF consistently outperformed the benchmark and the passive portfolio. Then they got into private equity and private real estate; the reason the comparative performance dropped was because they developed a real estate portfolio at the worst possible time and the investment did very poorly. That has affected the five-year number. Real estate has come back and stabilized, but there was a three-year period when it affected CEF returns. Real estate is now holding its own in terms of returns but that example explains how decisions can have long-term effects and how good investments can be overshadowed by bad ones. During 2009-10, when stocks did really well, those funds that could move money into them did well; the CEF had money in real estate so lagged behind comparable funds.

Mr. Rollefson asked if the University purchased Apple stock under $100 per share (it currently sells at more than $500). Mr. Mason said there is rarely such a risk in a diversified portfolio. In 2000 and 2001, the CEF was a large shareholder in Enron, which was very costly. CEF also was affected in a positive way in 2005 by a significant ownership position in Google at the time it went public. However these examples of concentrated positions are rare.

Professor Durfee inquired if the 70/30 benchmark is the same as the passive portfolio. It is the same, Mr. Mason said. Mr. Gorence said that the UMF benchmark has evolved from primarily domestic assets to a more global focus; Mr. Mason said they use a couple of indices for the CEF that are primarily domestic. If the University expects the funds to pay out 5% in real dollars over time, it is not possible to avoid equities, Mr. Gorence said; they have to take risks. Mr. Mason said he has told the Board of Regents that they believe the goal is 4.5% plus the CPI (about 3%), so the goal is about 7.5 - 8%. It used to be that the 70/30 passive benchmark produced 11-12% equity returns (in the 70s and 80s) and bond
produced 6-7%, so a 70/30 passive benchmark of 7.5-8% was not difficult to achieve. Today, if equities produce 8% and bonds 3%, it is difficult for the 70/30 benchmark to get to 7.5-8%.

Mr. Gorence said that one only needs to look at the course of long-term interest rates over the past 30 years to gain insight into the returns of stocks and bonds over that period. Valuations in the equity market went from cheap when interest rates were at their peak in the early 1980’s to extremely high during the internet bubble as inflation and long-term interest rates fell. Today, low interest rates are no longer having a stimulating effect on economic growth as governments and central bankers implement polices to keep rates low to boost growth and offset the headwinds from over-indebtedness. Mr. Gorence expressed concern for the negative impact rising inflation expectations and higher interest rates would have on the capital markets. With historically low interest rates as a starting point, the prospects of generating the high nominal rates of rates of return experienced over the past 30 years look bleak (for equities) to mathematically impossible (for bonds). Mr. Gorence described the inflation protection characteristics of the current portfolio stating that equities are generally a good hedge against inflation long-term whereas one does not want to own bonds in inflationary times. Other investments—timber, gas, real estate—provide a substantial element of protection against increasing prices in most cases.

Mr. Mason reviewed two pie charts depicting the asset allocation of the CEF and UMF. The CEF has more private equity and more real assets that includes oil and gas partnerships, timber, and real estate, although they are working to reduce the amount invested in real estate (currently at 12%). The CEF has more money in private equity than the target asset allocation—but that is because of substantial appreciation of the private equity holdings vis-à-vis other asset holdings. Both funds have assets in global equity, bonds and cash, private equity, real assets, and marketable alternatives (hedge funds). Both funds are also significantly invested in domestic assets (CEF: 70%; UMF: 74%), with the remainder in both developed and emerging markets. They tend to be U.S./North America-centric, Mr. Mason explained, because there are a number of investment classes that do not translate outside the U.S. or that they cannot adequately monitor.

Professor Shultz said he appreciate the comparison provided by the Cambridge Median and asked where the University stands with respect to major universities in terms of the size of its endowment. Mr. Mason said that if one combines all three (CEF, UMF, and MMF), the University has about $2.5 billion, which puts it in the mid-20s in terms of rank. Harvard is number 1 at about $30 billion, and the next in order are Yale, Stanford, Texas, and Chicago. Michigan is number 7 at about $8 billion, Northwestern is about $6 billion, and there are a number at $3 – 4.5 billion. Minnesota is fairly high in the Big Ten.

Ms. Sather asked how his office felt about the Enterprise Financial System endowment module. After the second iteration of the treasury module, Mr. Mason said, they are very happy with it. There are a few tweaks they might like, but it works well for them.

Professor Luepker commented that the performance of the Minnesota Medical Foundation seemed not to be as good as that of the CEF and UMF. Mr. Mason said that speaks to differences because of size in asset allocation and managing funds. The size of the MMF does not provide enough money to staff an office, so it relies on an outside manager that invests almost exclusively in public securities such as stocks and bonds. One result is that MMF funds have greater volatility. They try to select investments that have uncorrelated returns, which would have the effect of reducing volatility. Comparisons are not really appropriate, Mr. Gorence said, given the team of professionals at UMF and in Mr. Mason’s office that have full-time investment professionals on staff can make decisions quickly.

Committee members discussed with Mr. Gorence and Mr. Mason the reasons for having separate foundations and how the funds might be managed differently.
Mr. Mason said they would welcome any additional questions. Professor Luepker thanked them
for joining the meeting.

Later in the meeting Committee members discussed the structure and relationship of the
University's foundations.

2. Graduate Program Quality Metrics

Professor Luepker reported that the Faculty Consultative Committee and others were concerned
about the quality metrics used to evaluate graduate programs and to allocate funds. A major concern was
that the allocations were unrelated to the size of the program. This Committee heard from Vice Provost
Schroeder about the metrics and the allocations.

Professor Luepker said he would like to put the issues on the table. It is not completely clear how
the allocations were made and while some units were mostly made whole, others saw larger cuts. Dr.
Schroeder had said that allocations would be different next year. He asked for a sense of the Committee
if it wished the metrics to look more seriously at program size and at the need for more clarity and
transparency as they think about next year's allocations.

Professor Durfee said that many people have questions about the process. Faculty members do
not understand the rationale behind the decision to allocate funds the way they were—it was not well
explained. Moreover, this year the quality metrics were based on productivity, while the two committees
that looked earlier at the development of quality metrics urged that they include more.

Ms. Kersteter said that CLA would appreciate more transparency as well as more information and
discussion about allocations to programs were made. The decisions inside the college are made by the
dean, Professor Luepker observed, and the deans are granted considerable discretion in those decisions.

Professor Hupp said that the College of Education and Human Development also had concerns, in
particular about the one-size-fits-all approach when programs are very different. It would be better to
have a bottom-up process to define good measures.

One complaint he has heard, Mr. Kallsen reported, is that departments had no idea how
dissertation fellowships were allocated. There were also comments that time-to-degree is not, alone, a
good measure. In general, however, people applaud Vice Provost Schroeder for trying for some metrics
that can be argued about. Professor Luepker agreed that the process in the past was a black box, but said
that the system still needs some work.

Mr. Rollefson, a Graduate School employee, indicated that the Graduate School always had
quality measures that were used in the allocation of fellowship funds. There was a long history to his
process that people knew about; much of that is gone, so things were started fresh. He recalled that he
came to the University 26 years ago, he heard then that there were too many graduate programs and the
number needed to be cut; now there are even more programs, many of which are small (but very good),
and there has not been a serious effort to merge or eliminate them. Professor Luepker concurred with Mr.
Rollefson's last point: No one wants to say that a program should be closed. Mr. Kallsen agreed and said
that faculty committees looked at a lot of data to evaluate students and guide the distribution of fellowship
dollars but the results of their work and the final evaluation criteria and decisions regarding fellowship
awards were not always well-communicated to the faculty.
The metrics, as they were used, benefit colleges with many small graduate programs, Dr. Fitch observed. She said the allocation of the transition grants was unclear, and if the metrics will change next year, there are no incentives to departments because they do not know what will happen. Professor Luepker concurred and added that most graduate students are already in the programs, so no dramatic changes can take place.

Professor Luepker said he would draft a message to Dr. Schroeder incorporating the points that Committee members have made; a copy will be sent to the provost so that she also understands the Committee's concerns.

3. **Report From and Comments By the Chair**

-- At the Faculty Consultative Committee meeting last week, they heard from the new provost, the president, and the chair and vice chair of the Board of Regents; one topic that came up in the President's comments was the issue of centers and institutes. There are 264 centers and institutes and many have O&M funds; 46 of the 264 are in vice-presidential offices and are of interest to this Committee with respect to its report to the president on administrative costs.

-- There was an article in the *Star-Tribune* about leave payments to administrators. The Committee will wish to hear more about the policy on leaves.

-- The Committee has four units on the agenda for discussions parallel to those of last year with the vice presidents. Three college deans will discuss administrative costs, staffing, and directions for their colleges, as will Vice President Friedman for the Academic Health Center. He recalled that the Committee decided to have discussions with at least a sample of the deans because not all of the University's administrative costs are in Morrill Hall.

Professor Luepker adjourned the meeting at 3:40.

-- Gary Engstrand

University of Minnesota