Minutes*

Senate Committee on Finance and Planning
Tuesday, November 18, 2003
2:30 - 4:15
238A Morrill Hall

Present: Charles Campbell (chair), Stanley Bonnema, David Brown, Daniel Feeney, Joseph Konstan, Michael Korth, Yi Li, Cleon Melsa, Richard Pfutzenreuter, Terry Roe, Rose Samuel, Kate VandenBosch, Susan Van Voorhis, Warren Warwick, Susan Carlson Weinberg

Absent: Calvin Alexander, Brittny McCarthy Barnes, David Chapman, Thomas Klein, Timothy Nantell, Charles Speaks, Thomas Stinson, Alfred Sullivan, Michael Volna

Guests: Stuart Mason (Chief Investment Officer)

[In these minutes: (1) endowment investment strategy; (2) a personnel matter; (3) financial structure of the University]

Professor Campbell convened the meeting at 2:35. Before turning to the business items, he called for a round of introductions for new committee members Steve Fitzgerald, Cleon Melsa, and Kate VandenBosch.

1. Endowment Investment Strategy

Professor Campbell then welcomed Stuart Mason, the University's Chief Investment Officer for the University endowment.

Mr. Mason explained that Professor Campbell had asked him to talk about the current investment strategy for the University's endowment (which has a value of about $560 million). He handed out copies of a report he made to the Board of Regents in September on asset allocation strategy prepared by Cambridge Associates. There were two goals. One was to examine the existing portfolio and evaluate the impact of different market scenarios: How vulnerable is the portfolio? The report indicated the portfolio is quite vulnerable to market swings since it is weighted to public stocks, which are more volatile than other investments. The result was that the value of the endowment increased sharply in the late 1990s and 00-01 and then declined steeply in the recession.

Professor Campbell asked Mr. Mason about the relationship between his office and the University of Minnesota Foundation. Mr. Mason said that his office manages the University's endowment (which is separate from the Foundation funds), the TIP and GIP funds, the Ruminco reserves, and the cash management account (they balance the University's checkbook, fund payroll, etc.). The Foundation is in a different location run by a different group and the funds in the Foundation (e.g., the $1.6 billion raised in the capital campaign) are managed there. The Foundation funds consist of recent contributions; the endowment has existed a very long time. The endowment does not receive a lot of new money--perhaps $2 million per year from rents, leases, mineral rights, and so on). The value of the Foundation holdings is

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about $750 million. Both the Foundation and the endowment pay out about 5% of their value each year, about $30-35 million, to fund various operations throughout the University.

The Foundation is organized about the same way as the management of the endowment is, Mr. Mason said, and has the same long-term investment objectives: they want long-term growth. Both organizations are in the equities market rather than bonds because historically the return in the equities market is 9-10% while the bond market typically produces 5-6%. A long-term investment strategy usually consists of a mixture of stocks and bonds. The endowment is 75-80% equities and 20-25% bonds.

Cambridge Associates spent about six months evaluating model portfolios and made suggestions regarding which asset classes the endowment should be invested in. He has talked with the Board of Regents about moving to more private investments (real estate, hedge funds) rather than traditional stocks and bonds. Mr. Mason drew the attention of Committee members to a graph and table entitled "Efficient Frontier Analysis," which depicts the optimal balance between the risk one takes and the investment return one should expect. The endowment wants a return that will allow it to pay out 5% annually, keep pace with inflation (approximately 2.5%), and pay operating costs of about 0.5%, so it needs to earn about 8% per year. (It will not earn that amount each year; the endowment in any given year could be up or down 20%.)

How much of the decision is based on risk adversity, Ms. Samuel asked? And who makes the decision? Mr. Mason said that his office makes the decision, in conjunction with the Finance and Operations Committee of the Board of Regents. He noted data on the table he had distributed. There are various categories in which endowment funds might be invested: U.S. equity markets, non-U.S. equity, alternative investments (hedge funds, venture capital funds, private equity, real estate investment trusts, oil and gas, timberland), and fixed income investments. The "efficient frontier analysis" suggests ranges on the amount of endowment funds that should be invested in each (e.g., 30-50% should be in U.S. equities); the endowment has a target percentage that is established in consultation with the Board of Regents. Each investment category has an associated risk and potential rate of return. At present the endowment is invested as follows:

41.2%	U.S. equities
21.7	non-U.S. equities
16.1	alternative investments
21.0	fixed income investments

The risk in the stock market is about 15%: it is highly volatile and difficult to predict. They are trying to reduce the risk while not giving up too much in return on the investments. If one is invested in the stock market, the data suggest, one should earn 10-12% annually. Mr. Mason said he believed the risk could be reduced to 10%, which would still permit a return of 8.5-10%. The risk would be much less.

Professor Konstan asked about the endowment's approach to rebalancing the investments, and how that approach is modeled in the simulations. Mr. Mason said they revisit the balance as they examine the investment targets (and the ranges for each target category). They take a serious look at rebalancing annually when they reset the ranges and the target. This annual rebalancing is reflected in the simulations.

The idea is to be as close as possible to the efficient frontier, Professor Roe observed. It is, Mr. Mason agreed; the efficient frontier provides the maximum return with the minimum risk. The graph had a line plotted showing the efficient frontier, plotted on points reflecting risk on the X axis and average annual return on the Y axis; the current endowment is not on the line (it is at a point on the graph where the risk is higher and the return is lower than optimal). Could they get closer to the line if they just sit longer and wait, and not rebalance, Ms. Samuel asked? To a certain extent that is what the University did with the endowment before he took his position about 13 months ago, Mr. Mason said, although doing so was not part of a plan. Ultimately, rebalancing regularly is a better idea. They have conducted retroactive analyses and concluded that if they had rebalanced in the late 1990s and early 2000s, the endowment would have done better. Getting the targets right means the endowment will do better over the long term.

The average annual risk of the current portfolio is 11.8% and the average annual return is 7.21%; including inflation, it is geared to produce 10.21%. One proposed portfolio (A1) would produce a projected annual return of 10.5% and a risk level of 10.79%, which would be a significant decrease in volatility. A second proposed portfolio (B1) would produce about 10.5% with a risk level of 9.82%, which is very low risk (bonds typically have a risk of about 6%, stocks 15-18%). Cambridge Associates recommended that the University consider increased alternative investments and a little less in bonds and stocks. The Board of Regents has agreed that the A1 portfolio is the near-term goal and that the B1 portfolio is the long-term goal, to be achieved by the spring of 2005.

The biggest changes are in private equity and real estate, Professor Konstan said. Private universities have a lot of their endowment money in real estate and private investments; did Cambridge Associates consider whether the University should go farther in that direction with the endowment, and perhaps own buildings downtown? The endowments at Yale and Harvard are $15 and $18 billion, Mr. Mason commented, they are heavily invested in real estate and private equity, and they also invest in hedge funds. Cambridge, which consults with virtually every major university in the country, did do a group mean of its top 15 clients; that group has an average of 42% of endowments in alternative asset classes. The University is currently at about 12%; the goal is 35%. If it achieves that goal, it will represent a dramatic change in the mix of the endowment investments and it should become one of the better-performing endowments in the country. Cambridge also recommended the University move from 4% to 6% in real estate, a goal they are aggressively pursuing.

Ms. Weinberg asked what form the alternative investments would take. Would the University take title to buildings or invest in limited partnerships? Many universities take title to buildings, Mr. Mason said; the University of Minnesota does not. It invests in private partnerships, which in turn take the money, buy office and apartment buildings, and so on, around the country and manage them for the University and the other investors. They also buy, improve, and sell properties; the return to the University with this kind of investment is 14-16% and it can be as high as 20%. The University is also invested in timber, distressed debt (companies in bankruptcy, which is not as risky as it sounds), commercial loans, and a little venture capital. (In terms of distressed debt, Mr. Mason explained that a partnership might buy, for example, $1000 Enron bonds for $50 - 60, and when the company emerges from bankruptcy, the bonds will be paid off at perhaps $500. Those making these investments study the companies and make investments based on decisions about whether the company will emerge from financial difficulties.)

Is the University's relationship with Cambridge Associates short-term or long-term, Ms. Samuel asked? The University has had them on a retainer as a consultant for 25 years, Mr. Mason said, to provide a semi-annual report to the Board of Regents. They hired them for additional time to do the focused portfolio study and hire them occasionally for other small projects as well.

How much bigger does the endowment have to be to be in direct asset management, Professor Konstan asked? Are the Big Ten endowments large enough to collectively go into asset management? The Big Ten is probably large enough, Mr. Mason said. Michigan has the largest endowment, at about $3 billion; the University is in the middle, and many are in the $300-500 million range. Only a few institutions are in direct asset management--Harvard, Stanford, Yale. One institution has a staff of 10 people who do nothing but manage real estate. Is there an advantage to being in that position, Professor Konstan asked? Would it be wise to open a Big Ten real estate office? It is a useful question, Mr. Mason said. In terms of the overhead costs, however, he doubted it would be worth it. The fees the University pays to partnerships and the like are not that onerous. The teams the University uses have been in the business (e.g., real estate) for 25 years and know what they are doing--and in some cases, they are investing their own money as well as the University's.

Does Cambridge Associates do a contingency analysis, Professor Roe asked? Like what happens to the portfolio if U.S. budget deficits continue, or if inflation increases, and so on. They have, Mr. Mason said. They looked at the likelihood the endowment could decline by 25% and never get back to where it is now. At present, that risk is 7%. He said he thinks that is a large number that he needs to pay attention to. For portfolio alternative B1, the risk is 3%--a dramatic reduction in risk that the world would change and significantly reduce the endowment. Buffering the endowment means they would have to give up some potential growth on the upside, but they do not need to see big swings, they only need to guarantee about 8-8.5% per year. They will give up the potential for a 25% increase but also avoid the risk of a decrease of 25%.

Professor Campbell thanked Mr. Mason for his presentation and said the Committee would like to hear from him again in the future. Mr. Mason said he would be glad to join the Committee whenever it wished.

2. A Personnel Matter

Professor Campbell explained that one Committee member has missed three consecutive meetings, which by Senate rules means the seat has been vacated. A committee may, however, vote to reinstate the individual. He has spoken with the Committee member, who has expressed a wish to remain on the Committee and indicated he will attend meetings in the future. He asked for a vote of reinstatement; the Committee so voted.

3. The Financial Structure of the University

Professor Campbell next noted a chart containing a depiction of the former and current (Incentives for Managed Growth--IMG) financial structure of the University: The "conceptual model" identifies sources of revenue and how they are distributed within the institution. The question, he said, is whether the structure could be significantly better or worse. There are several groups looking at this issue and it clearly falls within the charge of this Committee. The other groups include the Twin Cities Deans' Council, the Academic Health Center Finance and Planning Committee (chaired by Professor Feeney), and the Budget Advisory Committee (which is chaired by the Provost and includes Associate Vice President Pfutzenreuter, finance officers, deans, and two faculty, and the charge to the group includes, as an option, a comprehensive review of Incentives for Managed Growth).

The chart was prepared by Mr. Pfutzenreuter and answers questions from the 30,000-foot level about the University's financial model. He suggested that the Committee might discuss the chart and then decide what the Committee can do. It has several options:

-- become educated about the model (invite people to discuss it and ask questions), which serves the University through the Committee's probing and distribution of its minutes.

-- begin to do more detailed analyses in order to have a deeper understanding of what is going on and make recommendations that might dovetail with those from the other groups that are also looking at these issues.

-- invite the heads of those other groups to learn what they are doing (i.e., Mr. Pfutzenreuter and Provost Maziar, Dean Rosenstone, and Professor Feeney).

Professor Roe said the chart is useful but that the Committee needs more detail to understand the process. Data by college might be too detailed, but there should be information that allows one to trace revenues to that level. Mr. Pfutzenreuter said such an analysis is prepared every year for the Board of Regents.

This chart was produced several years ago to show how dollars flowed before and after the change to IMG, and especially tuition and ICR funds, Mr. Pfutzenreuter explained. There is need to produce another version that incorporates the Institutional Revenue Sharing (IRS) tax, the Enterprise tax, the University fee, to show where they flow. He said he could add those elements and bring the chart to the next meeting. The IRS tax is a lot like tuition money in the earlier budgeting system: the money flows into the O&M funds and is then allocated to units, not to one particular activity, with other green money. The University Fee is an allocation directly to certain activities and those funds are not lost site of in a central pool. That is not done with the IRS funds.

In response to a question about the acronyms, Mr. Pfutzenreuter clarified that IMG changed the way the University allocates revenue, with tuition now going directly to the units that generates it, rather than into central coffers and then reallocated by the administration to the units. Indirect cost recovery funds were also allocated (in part) to the units that generated them. At the same time, however, there are central costs that need to be paid so the IRS was imposed. The Enterprise tax is paying off the cost of installing the PeopleSoft human resources and student systems; the money is allocated directly to retirement of the outstanding debt.

Professor Konstan said he would like to see a regression analysis of tuition and external research funds to see if there has been any difference in the distribution of money with the change to the IMG system. "We don't know what the University's financial model really is," he said. The model is known, Mr. Pfutzenreuter said; the outcomes of the decisions are not. They know the outcomes, Professor Konstan said; if the decision process could be reverse-engineered to figure out what the actual process had been, the Committee would both know whether IMG has changed anything and what policies have been implemented by the process. (For example, he conjectured that one might find out that IMG is shifting funds towards colleges with large enrollments, or one might find that it is shifting funds away from those colleges.) He said he did not know how productive the Committee could be on this matter; it depends on its ability to get the data.

Mr. Pfutzenreuter said they know the base budgets and the decisions that are made. When the President puts together the budget, he knows what must be paid in order to get to a net figure. What the University does NOT have is the compact allocations post-budget. If one wants the sum of the cuts and post-budget allocations, that information must come after the budget has been set. More important, Professor Konstan said, than knowing why a decision was made is having college statistics (enrollment, research expenditure, etc.), because there may be an unconscious model in place that affects the flow of funds--or it may be that IMG has NOT changed anything and that people are unhappy largely because there simply are fewer funds in the University.

Professor Campbell said that there is definitely an adjustment in the endgame of the budget--he has been consulted on the decisions--based on notions of who has been hurt or helped. The administration tries to balance out those effects. It is part of the process and it must be, he said. But he agreed with Professor Konstan that a regression analysis would be a very good idea. A lot of the allocations have been for facilities, technology, and the cost of compensation, Mr. Pfutzenreuter said. The rest of the allocations are relatively minor.

Once the static picture has been obtained, Professor Roe said, the numbers that Professor Konstan asked for would be needed to see changes over time, major trends, and how significant the variance is.

Ms. VanVoorhis asked if the other groups are looking at these same issues; Professor Campbell said the Budget Advisory Committee is meeting for the first time this week; he did not know what the other groups are doing.

There are other questions, Professor Campbell told the Committee. One related one is about subsidies. One perception is that some colleges are subsidizing others as a result of the way the formulae work out. That depends on what one looks at, Professor Feeney said, such as the benefits pool, ICR, and so on. The question no one understands is whether the system is revenue-neutral at the end of the day. Professor Campbell said he was not sure what "revenue-neutral" means. IMG was intended to be revenue-neutral when it was first established, so units would be funded at the same level as they were before, but then IMG would allow the units to manage their future better and to do more than they could in the past to control events.

Professor Feeney agreed. The issue from the viewpoint of the Academic Health Center is this: Because of the varied funding sources of colleges, one must ask if there should be the same budget model for all of them. The differential effects of the original system led to the hybrid model that is now in place, with the IRS and Enterprise tax and so on. The AHC Finance and Planning Committee did a report a few years ago comparing taxes, changes in revenues, and so forth in the different units, before and after IMG and the change to semesters (and one must work hard to tease out the different impacts of those two changes). A major issue in the AHC is that tuition is about 10% of the revenue. Did the change to IMG with respect to tuition do the AHC any good? Probably not, he said. Does the model work in the way that was intended? That is not clear, and it is time for a reassessment. When the tuition increases went to the administration, the result was the cut and paste model the University now has.

Tuition went to the units but their O&M support was reduced by about the same amount, Professor Campbell observed.

The basic mythology about IMG is that if a college did not have a high percentage of revenue from tuition, it would lose, but at the same time if a college had a high percentage of its revenue from tuition, it will lose if students go away, Professor Konstan said. Some units face low risk and low reward, others have more risk but also potentially more dollars. So everyone dislikes the system. The problem is costs on the margin: It costs less to generate a dollar in tuition or research than the dollar earned, but everyone knows that average costs of both teaching and research are more than what they generate in revenue. So it LOOKS like one can increase revenue on the margin but then one loses it on the average--and it is the average which is long term. Units that manage growth cannot sustain it on the new incentive revenue alone, and therefore must look to the central administration to allocate some of the IRS and state funds back to them. Mr. Pfutzenreuter said that was a fair summary.

With respect to unhappiness with the financial system, Professor Campbell said, with substantial cuts from the legislature, EVERYBODY loses, and that complicates evaluation of the system. And there are certain things for which it is difficult to see the revenue stream (e.g., opening new buildings, increases in utility costs--there is no revenue stream associated with them and the legislature will NOT fund them), including the compact pool and academic priorities. The $100 million provided by the IRS is how those items are paid for--things that have no revenue stream cause the need for the IRS. That leads to what used to be called retrenchment and reallocation (R&R)--some programs were started while others were cut, to support growth in priority areas. He said he did not want to return to the days of R&R as the way to change programs, with a specific percentage cut followed by the opportunity to get money back by arguing for a fancy program that got the attention of the administration.

It seems that a lot of what is happening, as noted in the Budget Advisory Task Force report of a couple of years ago, is the underfunding of common goods, Mr. Fitzgerald said. There are still institutional costs that must be paid for from somewhere. That problem has never been adequately dealt with; the University has put band-aids on to address it. There was a lack of interest in reducing operating budgets to fund common goods, Mr. Pfutzenreuter said, and that idea was in the original IMG report.

Common goods are underfunded, and always so when there are cutbacks, but private goods in the colleges are also underfunded, Professor Konstan said. He said he was not sure whether common goods would be better funded if the University received a large infusion of additional funds. The problem is that the University is cursed to now be in a time of no inflation: If there were higher inflation, to leave a budget the same would mean a cut. In this period it takes bolder action--and one does not see presidents and deans making such actions. Instead the taxes are increased across the board and units struggle to make do. Mr. Pfutzenreuter said that this year there were targeted cuts; not everything was formulaic. There will be more such cuts next year. The units facing those cuts have already been informed.

Professor Feeney said he was concerned that all understand the system and that all participate in the discussion about it so they know how the game is played. In the AHC, revenue-generating units are negatively affected by the institutional taxes. Right now, education and research endeavors are underfunded, but as soon as they try to work out additional support, they have to pay more in taxes. But research space, for example, is also the most expensive space the University operates, Mr. Pfutzenreuter pointed out. The question a unit must get to, Professor Feeney said, is how much space it needs. The system must get to the point where it does not tax on revenues but units also do not use as much space and thus save costs. Taxation means that some units will never get their heads above water. He sat on the Budget Advisory Committee last year and learned that there is the Michigan model, which taxes expenses for the previous year. The AHC Finance and Planning Committee will examine that model.

Professor Roe said there is a similar environment for most colleges. The question is what allocation mechanism to use so that the opportunity costs are about the same for all of them. The Committee needs symmetric information, and there will be mistakes, but over time they can be reduced.

Most University expenses are space and staff, Professor Konstan said. In his view, the taxes on expenses or on revenues are both wrong. In bad times, units will cut expenses and retain revenues (if there is a tax on expenses), and then will see taxes go up to cover for the reduction in revenues because units are keeping expenses down. They will similarly be discouraged from certain lightly revenue-raising opportunities if the taxes are based primarily on revenue. One could do a balance between the two. What the Committee does not know is how effective central allocations are in making up for the problems. Most feel it is not doing well but that is probably because everyone has been cut.

If one could do an analysis of representative years before and after IMG, Professor Konstan continued, one could see if the trends are going in different directions or if perverse incentives are leading to perverse behavior. The Committee should probably look from the present to the future rather than to the past, Professor Campbell commented. One question about IMG is this, Professor Konstan said: In the old system, did increased enrollments mean more dollars to a unit? Did research? The answer to that question needs to be brought to light. And if different opportunity costs were exacerbated or moved in the right direction, Professor Roe added.

Space is the problem, Mr. Pfutzenreuter said. It was in the RCM original plan, Professor Konstan pointed out. One cannot know what IMG is doing without space costs, Mr. Pfutzenreuter maintained. And one must attribute higher costs to research space, Ms. Weinberg added. That is a complicated problem, Professor Roe agreed, but it must not be allowed to derail the process.

Professor Campbell said it would be useful for the Committee to have more information; what it can get will determine in part what it does next. He invited Committee members to send him emails with more thoughts and suggestions; he would work with Fitz to move the process along and try to determine if the Committee could do more than just learn.

An open dialogue will help, Professor Feeney said, and it could help the administration solve the problems it faces. He said that the deans have a budget problem and have different revenue streams; no matter how one pushes the levers, there will be differential effects on units. It would help to talk about the problems and it may be that there will be a better solution if the model is refined. It may be that space is a key. All want more of it, and want it better equipped; maybe units need to decide how much they really need. The situation will not get better; tuition increases are raising the costs so they are getting to be not too far from non-state institutions and the University could be at risk in enrollments. He said he was concerned that if the University increases tuition, enrollment may actually drop. That will not happen yet, Professor Campbell said, but demographics are not in the University's favor; units living on tuition income could be at risk. Instead of living off tuition gains, they may have to live off efficiency gains, Professor Roe commented.

Professor Campbell adjourned the meeting at 4:00.

Gary Engstrand

University of Minnesota