

September 10, 2009

MEMORANDUM

TO: The Finance Committee:

Vincent J. Mastracco, Jr., Chair  
Daniel R. Abramson  
A. Macdonald Caputo  
The Honorable Alan A. Diamonstein  
Helen E. Dragas  
Robert D. Hardie  
Randal J. Kirk  
Austin Ligon  
Warren M. Thompson  
John O. Wynne, Ex Officio  
Daniel M. Meyers, Consulting Member

and

The Remaining Members of the Board:

Susan Y. Dorsey	The Hon. Lewis F. Payne
W. Heywood Fralin	Don R. Pippin
Rahul Gorawara	E. Darracott Vaughan, Jr., M.D.
Glynn D. Key	

FROM: Susan G. Harris

SUBJECT: Minutes of the Finance Committee Meeting on  
September 10, 2009

The Finance Committee of the Board of Visitors of the University of Virginia met, in Open Session, at 1:45 p.m., Thursday, September 10, 2009, in the Board Room of the Rotunda; Vincent J. Mastracco, Jr., Chair, presided. Present were Daniel R. Abramson, A. Macdonald Caputo, The Hon. Alan A. Diamonstein, Ms. Helen E. Dragas, Robert D. Hardie, Randal J. Kirk, Austin Ligon, and John O. Wynne, Rector.

Also present were W. Heywood Fralin, Ms. Glynn D. Key, The Hon. Lewis F. Payne, Don R. Pippin, E. Darracott Vaughan, Jr., M.D., and Rahul Gorawara.

Present as well were John T. Casteen III, Leonard W. Sandridge, Ms. Susan G. Harris, Paul J. Forch, Ms. Susan A. Carkeek, Steven T.

DeKosky, M.D., James L. Hilton, R. Edward Howell, Ms. Patricia M. Lampkin, David J. Prior, Ms. Yoke San L. Reynolds, Ms. Colette Sheehy, Thomas C. Skalak, Christopher Brightman, and Ms. Jeanne Flippo Bailes.

The Chair asked Mr. Sandridge, Executive Vice President and Chief Operating Officer, to present the Agenda.

CONSENT AGENDA

Mr. Sandridge presented two consent agenda items, State budget requests for the 2010-2012 biennium, and signatory authority for Medical Center procurement of House Staff medical benefits. On motion, the Committee adopted the following resolutions and recommended them to the full Board for approval:

APPROVAL OF STATE OPERATING BUDGET AMENDMENTS FOR THE 2010-2012 BIENNIUM FOR THE ACADEMIC DIVISION

WHEREAS, the 2010-2012 budget requests to the Governor were submitted on September 1, 2009, pending approval by the Board of Visitors; and

WHEREAS, the proposed 2010-2012 biennial budget requests have been reviewed carefully; and

WHEREAS, the proposed biennial budget requests represent the highest priority initiatives and are aligned with the mission of the institution;

RESOLVED, the Board of Visitors of the University of Virginia approves the 2010-2012 biennial budget requests accompanying this resolution; and

RESOLVED FURTHER, the Board of Visitors understands that to the extent these initiatives are not included in the Governor's 2010-2012 biennial budget, the Academic Division may want to pursue similar requests to the Legislature; and

RESOLVED FURTHER, the Executive Vice President and Chief Operating Officer is authorized to transmit to the General Assembly any request not funded by the Governor as long as there are no material differences from the items already endorsed by the Board of Visitors.

APPROVAL OF SIGNATORY AUTHORITY FOR MEDICAL CENTER PROCUREMENT OF HOUSE STAFF MEDICAL BENEFITS

RESOLVED, the Board of Visitors authorizes the Executive Vice President and Chief Operating Officer of the University to execute a contract for house staff medical benefits, based upon the recommendation of the Vice President and Chief Executive Officer of the Medical Center in accordance with Medical Center procurement policy.

ACTION ITEM

Mr. Sandridge said the endowment spending rate is the distribution from the pooled endowment for this year. This was deferred from June because more would be known about the market than was known last Spring. He said he knew the Board made it clear that the endowment is to be used in tough times and these are unusual times. He introduced Ms. Reynolds who gave the report.

Ms. Reynolds said in 1984 the endowment was valued at \$213 million. The peak of the endowment was at June 30, 2008 at \$3.2 billion. A year later the market value is \$2.5 billion. Most of the increase has been performance.

The endowment is made up of over 1,800 accounts that fund a variety of programs. The spending policy is the "snake in the tunnel" method of determining distribution, also known as "inflation growth within a band". Currently, the band is 4% to 6% of market value. If the limits of the band are reached, the Board of Visitors may re-set the payout to an appropriate point within the band.

Ms. Reynolds said there are several options for fiscal year 2010 spending. If the distribution is 6% of the band or \$240 per share, this would be at the top of the band. If there is another decline this year, this would limit next year's payout to less than \$240 per share to stay within the band. If the payout is \$220, or 5.5% of market value, this would provide some room to maneuver within the band. Ms. Reynolds recommended a payout of 5.5% or \$220 per share. Last year's payout was 5% or \$253 per share, so this is a decrease in the distribution amount. To pay out the same amount as last year would put the distribution above the current band.

Mr. Sandridge explained that the administration does not recommend the top of the band because this would be a great departure from past practice. In past years, the University has paid out no more than 5% of the market value. Mr. Ligon expressed his opinion that if there is any year to pay out the top of the band it is this year. He said if the Board chooses not to do this, then 6% is not truly the top of the band. Mr. Kirk commented that he believes the current economy is fundamentally different than it has been in the

past several years and the Board also ought to take into consideration the funds available and unencumbered to make the distribution.

On motion, the Committee adopted the following resolution and recommended it to the full Board for approval:

APPROVAL OF ENDOWMENT SPENDING DISTRIBUTION FOR FISCAL YEAR 2009-2010

WHEREAS, the University wishes to provide reliable and predictable distributions to support programs; and

WHEREAS, the Board of Visitors wishes to fund institutional priorities, including the recommendations of the Commission on the Future of the University; and

WHEREAS, recent decreases in state support have placed significant strain on University budgets; and

WHEREAS, the endowment spending policy calls for a percentage increase in the annual distribution from the endowment, unless such increase causes the distribution to fall outside a band defined as four percent to six percent of the market value of the Pooled Endowment Fund; and if the distribution falls outside of this range, the Finance Committee may recommend either raising or lowering the rate of increase; and

WHEREAS, applying the spending policy with the usual inflator would result in an annual payout for fiscal year 2009-2010 of 6.6 percent of the market value of the Pooled Endowment Fund, which is outside of the approved band of four percent to six percent.

RESOLVED, the Finance Committee recommends setting the annual endowment distribution for fiscal year 2009-2010 at 5.5 percent of the June 30, 2009 market value of the Pooled Endowment Fund.

VICE PRESIDENT'S REMARKS

Mr. Sandridge said this week the Governor announced a 15% further reduction for state agencies, but with an offset from federal stimulus monies the reduction for the University is about 8%. The Governor also announced a one day furlough for all state employees. There are many unanswered questions about how the furlough will be implemented.

The Eminent Scholars program was reduced again this year. The match from the state currently is one-half of one percent.

Academic units have been told that the Governor's cuts will result in a 2.5% reduction in their budgets. Administrative units will receive a 3% budget cut. Excluding stimulus money, the state support is \$120 million this year.

Other matters besides the budget include the Restructuring agreement which requires a six-year plan, and must be updated every two years. It will be brought to the Board in November.

The General Accounting Office has selected the University for review of many aspects of the University's endowment including the size and growth of the endowment, the amount distributed annually, the amount distributed for financial aid, and the extent to which the endowment is restricted. This is not an audit; they are gathering information for a report. The process will begin later this month.

Mr. Sandridge provided an update on H1N1 flu at the University: there are students who have been diagnosed with H1N1 and the University is managing those cases.

#### FINANCIAL MODEL OF THE FUTURE: DEBT AND LIQUIDITY

Mr. Sandridge said that debt and liquidity were thoroughly reviewed in the Spring, so Ms. Reynolds' presentation will be an update. He said the University does not use debt for operations.

Ms. Reynolds reminded the Board of the white paper on Debt and Liquidity in their materials, which is attached to these Minutes. She said she would provide only an update. The University's floating rate debt as of August 28, 2009 is \$138 million. Fixed rate debt is \$853 million, for a total of \$991 million. Current cost of capital is 4.4%.

Through the Build America Bonds program, the University successfully marketed \$250 million of bonds on April 15, 2009 with a maturity of 30 years and a net interest rate of 4.04%.

Cash and short-term balances total \$397 million, with 87% same-day liquidity. All of the working capital is FDIC insured, Treasury, or Agency.

#### FINANCIAL MODEL OF THE FUTURE: ENDOWMENT

Mr. Sandridge began the presentation by explaining that Mr. Caputo and Mr. Brightman would talk about the structure of UVIMCO as well as performance of the endowment. Mr. Sandridge introduced Mr. Caputo, who discussed the organization and governance of UVIMCO and the investment process. He said Mr. Brightman would expand on the investment process and cover performance, peer comparisons, expected returns, and risk. The white paper on Endowment Distribution is attached to these Minutes.

Mr. Caputo explained that UVIMCO is governed by a 10-member board: three Board of Visitors appointees, a President's appointee,

and the rest appointed by the UVIMCO Board. The Board meets four times a year. Mr. Caputo reviewed the background and qualifications of each of the UVIMCO Board and staff members, and provided an overview of the UVIMCO investment process. He said the UVIMCO Board believes in the importance of investing in different asset classes and UVIMCO hires outside managers who are experts in their areas. Performance is measured against a policy portfolio benchmark of 60% global equity, 10% real estate, and 30% fixed income. UVIMCO's objective is to maximize long-term real return commensurate with the risk tolerance of the University.

Following a variety of questions to Mr. Brightman and Mr. Caputo about aspects of the investment process and upon approval of the following motion, the Board continued the discussion in executive session at 3:50 p.m.:

That the Finance Committee of the Board of Visitors go into Closed Session to review and discuss investment of the University's endowment, and in that regard, to also evaluate the performance of specific University representatives responsible for investment oversight, as provided for in Section 2.2-3711 (A) (1) and (6) of the Code of Virginia.

The Finance Committee resumed its meeting in Open Session at 4:35 p.m., and adopted the following resolution certifying that its discussions in Executive Session had been conducted in accordance with the exemptions permitted by the Virginia Freedom of Information Act:

That we vote on and record our certification that, to the best of each Board member's knowledge, only public business matters lawfully exempted from open meeting requirements and which were identified in the motion(s) authorizing the closed session, were heard, discussed or considered in closed session.

#### ANNUAL REPORT ON THE UVA HEALTH CARE PLAN AND REVIEW OF UNIVERSITY BENEFITS

Mr. Sandridge mentioned the written report on the health care plan. It is financially healthy with the necessary reserves. There are two plans, the low premium plan and the high premium plan. The low premium plan will continue with the same rates, whereas the high premium plan's rates will increase.

#### FACULTY SALARY RANKINGS

Mr. Sandridge said faculty salary rankings have declined because of the freeze on salaries. Mr. Ligon remarked that the University may move up this year just by standing still. He also said employees do not recognize they received a 2-3% raise this year because of deflation.

REMEMBRANCE OF FRANK BATTEN

The Rector asked for a moment of silence in remembrance of Frank Batten who passed away this morning. Mr. Batten was a great friend and benefactor of the University, including providing the funds to create the Frank Batten School of Leadership and Public Policy.

The Chair adjourned the Finance Committee meeting at 4:45 p.m.

SGH:lah

These minutes have been posted to the University of Virginia's Board of Visitors website.

<http://www.virginia.edu/bov/financeminutes.html>

**ATTACHMENT**

**WHITE PAPERS**

FINANCIAL MODEL OF THE FUTURE  
DEBT AND LIQUIDITY  
WHITE PAPER

The University of Virginia manages liquidity for capital and operating needs. Capital projects are funded with a variety of external and internal sources, including external debt. Operations are funded with external and internal sources as well, but not external debt. This paper traces the history of our debt and liquidity management program, including the implementation of a new financial model between 2002 and 2007, outcomes to date, the impact of the current turbulent economy and strategies for future expansion of the new model.

Background: Debt and liquidity before the new financial model

For new construction and major renovations, UVa began in the 1990's to move from full dependence on the State for capital appropriations to greater reliance on private gifts and external debt financing, typically tax-exempt bonds. The Code of Virginia authorizes the Board of Visitors (BoV) to issue debt either on its own, or through participation in the bond pools managed by the Virginia College Building Authority (VCBA). Debt service payments on such bonds are the University's responsibility and prior to 2002 were passed-through to the benefiting/sponsoring units within the University. The outstanding balance of such University debt at June 30, 2001 was \$351 million or 7 percent of total assets, and the average weighted cost of capital was 5.27 percent.

Until 2007, the investment of cash varied with the source of the funds. 1) For state appropriations, tuition and fees, we had a daily cash settlement with the State. The State funded any daily net cash deficit and invested any net cash surplus. It retained the net earnings on the float, except for interest on auxiliary and Medical Center reserves, which usually was returned at the close of the year. 2) Endowment gifts were invested directly in UVIMCO's Long-Term Pool (LTP). 3) For non-endowment private funds (current gifts, endowment income and auxiliary reserves), there was a daily cash sweep into the Aggregate Cash Pool (ACP) housed at UVIMCO and managed by Standish Mellon. The ACP, our pool of short-term investments, was invested to comply with the State's Investment of Public Funds Act (IPFA): only governmental fixed income instruments, high-quality corporate bonds rated A or better, and asset-backed securities rated AAA all with a maximum maturity of five years.

## Implementation of a new financial model 2002-2007

In 2002, the University developed a plan to implement a new financial model for debt and liquidity management through two new programs.

### *New Debt Portfolio Program*

The Vice President and Chief Financial Officer (VP&CFO) performed an analysis of the cost of borrowing through the VCBA and proposed a new university program to reduce costs and increase flexibility. Instead of the VCBA's 20-year amortizing fixed-rate debt structure, the new program uses a mixed debt structure, reducing borrowing costs by taking on measured and acceptable risks: bullet maturities and variable rate debt. Included in the proposal were risk mitigation strategies, including establishing an interest rate buffer, capping total variable-rate debt, and executing master contracts with counter-parties for swaps as a defensive risk management tool. Other objectives of the program are: (1) achieving and retaining a AAA rating from all three major rating agencies, (2) establishing predictable and stable repayment schedules for internal borrowing units and (3) extracting cost savings to fund University priorities. The last two objectives are accomplished by using operating funds to create an interest rate buffer to absorb the volatility in cash flows, and investing a portion of balances in equities. Meanwhile, internal borrowers can budget based on a known interest rate, currently 4.75 percent, and pay debt service on a 20-year amortization schedule.

Contracts were established in 2002 for financial advisors, bond counsel and underwriters, who all assisted with the implementation of the vision. Master agreements were negotiated in 2003-2004 with five potential counter-parties for future swap transactions. Long-term bonds were issued in connection with this new program in March 2003, July 2005, May 2008, and April 2009. As a feature of the new debt approach, a commercial paper program was implemented also in 2003 to provide for bridge-financing needs, moving away from using internal funds.

Oversight and monitoring mechanisms include the Board of Visitors-approved debt policies, an annual debt report to the Finance Committee, an annual report to the President, and rating agency reviews. The University Comptroller developed a compliance program with external bond counsel. In 2008, the Internal Revenue Service performed an audit of private use

associated with our 2003 Variable Rate Demand Bonds (VRDB) and complimented UVa on having the best compliance program their auditors had encountered.

The Auditor of Public Accounts performed a review of debt at state supported institutions of higher education in 2006 and singled out UVa as the only one out of seven universities with debt policies that address debt capacity. The audit report describes our debt capacity model and states: "The University of Virginia can serve as an example framework for other institutions in the Commonwealth".

At the February 2008 Board of Visitors meeting we provided a comprehensive report on the University's debt portfolio management program, including the program's objectives, strategies to achieve the objectives, metrics to evaluate success, results of the program to date, and peer comparisons.

#### *New Treasury Management Program*

The second program in the new financial model for debt and liquidity is the extension of the debt pooling approach to the management of working capital. Having obtained approval to establish a Treasury Operations Office, in the fall of 2005 we hired a director who began to develop the infrastructure needed for a modern treasury function. This involved buying and installing a treasury management system, collecting data needed for liquidity forecasts, developing cash models, creating treasury management policies and procedures, and building a small but effective organization.

In July 2007, we rolled out our Internal Bank (IB) which built on the framework established under the debt portfolio program by consolidating it with investment and cash management activities across all funding "buckets". The objectives of the IB are to: (1) manage internal and external assets and liabilities collectively to reduce cash flow volatility and achieve positive margins, (2) use cash modeling to project more precise liquidity requirements and identify amounts to invest longer-term for higher return, (3) provide enhanced banking services such as loans, investments, and cash management to internal units, and (4) act as a settlement agent to facilitate the flow of capital between University units and between the units and UVIMCO. We launched the Internal Investment Program, providing three investment pools differentiated by maturity. This provides investment returns for our internal departmental investors, in exchange for the implicit information about the

timing of their liquidity requirements, which in turn allows us to make informed decisions in allocating funds between the ACP and the LTP.

#### *Investment legislation effective July 1, 2007*

The final prerequisite for long-term success of the new financial model was to obtain full investment flexibility, beyond the restrictions of the IPFA. The VP&CFO proposed a legislative amendment in the fall of 2004 and obtained the support of the State Treasurer. However, the Secretary of Finance asked us to defer the action for a year. Our legislation, sponsored by Delegate William H. Fralin, Jr. was passed with an effective date of July 1, 2007.

This new legislation allows the University of Virginia to invest in equities as well as the vehicles sanctioned by the IPFA. No other state agency or institution has been given this flexibility. We were able immediately to invest a large portion of the debt program's interest rate buffer balances in the UVIMCO LTP. This allowed us to reach our target buffer earlier, so that in 2008 we identified \$50 million in operating funds to put towards University priorities. Additionally, certain long-term reserves that had been invested in short-term investments were moved to the LTP. Examples of these are auxiliary units' capital reserves, the contingency reserves for our self-insured employee health plan and the Medical Center depreciation reserve. We also began transitioning to the LTP the IB balances that were demonstrably not needed in the near future.

The 2007 investment legislation and IB framework have allowed the management of a large pool of operating funds, reducing the number of invested "buckets" of resources.

#### Debt and liquidity challenges in fiscal year 2008-2009

The economic turmoil that began in September 2008 has intensely tested our strategic approach to debt and liquidity as well as the effectiveness of our new treasury function that was built from scratch over the last four years. Our strategy of implementing a treasury system to track cash flows and developing a cash projection model served us in good stead. While other universities experienced liquidity shortages for operations and construction, we were able to "make payroll" and meet other disbursement needs because of the reliability of our projections.

Additionally, in the spring of 2008, as depressing financial news began to emerge, we took two actions that turned out to provide some protection six months later:

#### *Debt Portfolio Program*

Concerned about Lehman Brothers' future, we began the lengthy process to hire a second remarketing agent for our VRDB's. When the Lehman Brothers' bankruptcy hit in mid-September, we were able to insert a replacement remarketer in one week, minimizing the disruption. We did have to repurchase \$9.9 million (or 12 percent) of our outstanding VRDB's during the two weeks following the beginning of the crisis. Also, with the credit freeze, the interest rate on our VRDB's jumped from the immediate pre-crisis level of 1.5 percent to 5.5 percent, 7.7 percent and 5.4 percent over the next three weeks, respectively, before dropping to 1 percent by October 22, and subsequently staying at between 0.10 percent and 1.3 percent. The average weekly rate on our VRDB's since the 2003 inception is 2.11 percent. The credit freeze had no discernible impact on our commercial paper program which continued to market well even for tranches with the maximum maturity, with the average cost since inception being 2.27 percent.

In April 2009, we were able to capitalize on the Build America Bond program when we issued \$250 million of bonds for construction. We developed risk mitigation solutions to address concerns about the new program, and marketed at the fixed-rate net interest of 4.04 percent. UVA was the first university to utilize the favorable terms of this program in a benchmark-sized bond. Since then we have been a resource to other universities and financial market analysts. We may issue through the Build America Bonds program again before its expiration in 2010 if warranted by our capital requirements.

At June 30, 2009 our outstanding debt is \$991 million, of which 14 percent is variable rate, and our weighted borrowing cost is approximately 4.4 percent.

#### *Internal Bank (IB)*

The second action we took, also in the spring of 2008, was to review the investment allocation of the ACP, which had been established by UVIMCO in January 2004 to maximize return subject to the restrictions of the IPFA. The ACP primarily contained mortgage-backed securities, asset-backed securities and corporate bonds. We decided on a new investment philosophy for

the ACP: with the 2007 Investment legislation we can now take all our investment risk in equities through the LTP and we should keep our short-term pool (ACP) 100 percent in Treasury and agency instruments. We instructed Standish Mellon to start transitioning our portfolio to reduce its average weighted maturity from over one year to approximately 90 days, increase the percentage of the portfolio with same-day and one-day liquidity, and move the asset allocation to 100 percent Treasury and agency instruments.

Fortunately, by mid-September, Standish Mellon had converted the ACP to contain 80 percent Treasuries and repurchase agreements, which subsequently became highly demanded and therefore expensive to acquire. Some of our foundations and several colleges and universities were not so fortunate and were unable to access their short-term assets. Our short-term pool did contain some exposure to corporate bonds including Lehman and other banks, which we had to sell at a loss this fiscal year, but by June 30, 2009, we had achieved our asset allocation goal of 100 percent Treasury and agency securities, and shifted the portfolio focus to safety and liquidity with less emphasis placed on return.

In this tumultuous year, the Assistant Vice President for Treasury Operations and Fiscal Planning also started managing liquidity related to the University's endowment transactions. In the past, shares were liquidated to make the approved spending distributions. We now provide liquidity from IB cash where feasible, thereby reducing the need to lock in market losses when investments are liquidated. Additionally, we began netting offsetting endowment trades made by units to reduce the amount of gross cash flow moving into and out of the endowment each month. This function has been very valuable during the recent financial crisis by helping manage University and UVIMCO liquidity.

#### Peer Comparisons

Our peers and our financial advisors consider University of Virginia's debt and liquidity program to be best-in-class. Other universities, especially the private institutions, also pool debt and working capital to take advantage of market opportunities. What distinguishes us is that we do cash modeling and management instead of just a cash sweep. This enables us to hold a smaller portion of working capital in cash and invest a larger portion, while managing the risks. More importantly, most of the universities that have pooled-debt programs and IBs

pass-through the revenues and expenses to internal customers. In our case, we provide our internal customers competitive market-based rates for debt and working capital, while our innovative approaches allow us to generate additional revenues that can be used to fund University priorities.

Our internal borrowing rate has remained 4.75 percent since the inception of the program in 2002. Of our peers that pool debt, Duke currently charges 5.5 percent, Hopkins 5.35 percent, Harvard 5.55 percent, Emory 4.4 percent. Cornell, Penn, the California system and Michigan all pass-through actual costs. In addition to charging a relatively low rate compared with our peers, this year we made our first contribution (\$50 million) from the debt program's interest rate buffer towards the construction of the College research building and SEAS' research building (Rice Hall). In fiscal year 2007-2008, the IB distributed \$12.2 million to internal investors to support their operations. The revenue distributed in fiscal year 2008-2009 was one-tenth of the prior year's because of market losses. As the market recovers and after we build adequate capital reserves for the IB, we expect to provide a stream of revenues to fund University priorities.

#### Strategies for Future Expansion

We are now engaged in enhancing the new financial model in several directions. In April 2009, the VP&CFO reported on the impact that falling endowment values have had on reducing debt capacity, and suggested that we may wish to consider developing guidelines to allocate debt capacity as a scarce resource. With a new CFO on board, the University of Virginia Foundation has been working closely with us to coordinate debt and liquidity approaches for our mutual benefit. We will perform sensitivity analysis to develop a plan for future infusion of funds from the debt program interest rate buffer for institutional priorities, beyond the \$50 million already committed.

In fiscal year 2008-2009, several wealthy private institutions took the unprecedented step of issuing taxable debt to fund operations, filling the funding gap left by drastically decreased endowment distributions. Although we believe that using taxable debt for continuing operations is not sustainable, we will monitor the experience of these peers, and might consider positioning ourselves to use taxable debt as a bridging or backup tool for certain types of operations, when market conditions improve.

The strong treasury operations infrastructure that has been built by the Assistant Vice President for Treasury Operations and Fiscal Planning and his experience managing within this framework through two challenging years, will allow planning for the IB to be a future source of unrestricted funds for institutional priorities. We will formalize investment allocation policies and develop risk management policies including capital reserve requirements for the IB.

We are also in a position to begin developing analyses to support long-term strategic financial planning, which would position the University to make strategic investments during the recession and especially post-recovery.

**8-14-09**  
**Board of Visitors Meeting**  
**September 10, 2009**

**Endowment Distribution**

**Background**

At June 30, 2008, the University of Virginia (UVa) reported a total endowment of approximately \$4.6 billion, with \$3.2 billion held by the Rector and Visitors (R&V) and the balance held by the seven related foundations that we report as component units. About 97% of the R&V endowment is held in the UVIMCO Long-Term Pool (LTP), with the remaining 3% not eligible for pooled investment. Early reports indicate that the amount held by R&V at June 30, 2009 is \$2.5 billion, down 21% from the \$3.2 billion.

The LTP is operated like a mutual fund, with the investors purchasing shares when they create a new endowment or add to an existing one, and selling shares when they divest principal. Prices are based on the monthly Net Asset Value (NAV) set by UVIMCO. An investment management fee is charged by UVIMCO. Within the R&V endowment there are over 1800 separate endowment funds, established for specific purposes. Besides True Endowments that are created through an endowment gift, where the principal must be held permanently, there are also quasi endowments that are established by internal designation of the Board of Visitors (BoV).

Where decisions on investment allocation of the LTP are the responsibility of the UVIMCO board of directors, it is the University's BoV that has authority to determine distributions from the R&V endowment. In general, there are three types of distribution from an endowment: (1) distribution for spending to support the endowment purposes, generally determined in accordance with a "spending policy" approved by the board, (2) an administrative fee (separate from the investment management fee) for management of the programs funded by endowment and (3) extraordinary distributions, which are extremely rare in universities. Distributions from endowments are governed by the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and by the endowment gift agreements.

This whitepaper summarizes the history and current status of distributions for administrative expenses, and for spending to fund the programs supported by endowment accounts. The focus is on distributions from the endowment held by the R&V, with occasional reference to our foundations' policies applicable to the endowments that they hold.

**Administrative Fee**

- **Expenses associated with managing endowment programs**

Beyond UVIMCO's investment management and fund administration, there are many services performed by the University in the administration of the endowment. These services include but are not limited to:

- (1) Supporting the purpose of the gift with University infrastructure, such as human resources, procurement, financial aid, student services, audit and legal counsel, general administration, campus security and environmental safety, information technology, and physical space;
- (2) Securing and handling gifts and communicating with donors;
- (3) Translating the UVMCO aggregate-level accounting and reporting to the level of the over 1,800 individual accounts within the University through the unitization process; and
- (4) Calculating the distributions from endowment in compliance with the University's spending policy, and transferring funds to allow spending from endowment.

Many universities and most of our related foundations that hold endowments charge an administrative fee. Traditionally R&V have absorbed these costs of administration. However, the idea of an administrative fee was broached at the April 2008 BoV meeting, with the goal of recouping at least a portion of the administrative expenses, and a specific administrative fee was approved in June 2008.

- **Objective of the administrative fee**

The extensive services listed above require the use of unrestricted University resources. Through assessing an administrative fee, these resources can be at least partially recovered for strategic use, including advancing the priorities identified by the Commission on the Future of the University.

- **Legal Framework**

Prevailing laws, UMIFA (Uniform Management of Institutional Funds Act) or UPMIFA (Uniform Prudent Management of Institutional Funds Act), permit "appropriate and reasonable" costs to be charged. The University's endowment gift agreements were revised approximately ten years ago to add similar language: "any reasonable fees associated with securing and administering such funds."

- **Peer Practices**

The National Association of College and University Business Officers (NACUBO) sponsors an annual Endowment Study. The most recent survey for fiscal year 2007-2008 found that for the 784 institutions that responded, the average administrative fee assessed was 0.7%, with the average assessed by the subset of public universities being 1.6%.

Darden Foundation also performed its own survey in 2006 of 52 public university endowments, and reported a median administrative fee of 100bps, and mean of 101bps. The highest administrative fees were assessed by Florida State University at 250 bps and the University System of Maryland Foundation at 200 bps. The Virginia Tech Foundation has a policy of 120 bps, and the fee for various University of Virginia-related foundations ranges from 40 bps (Law School) to 100 bps (Medical School Alumni Foundation).

- **Cost Allocation Model**

The Vice President & Chief Financial Officer directed an analysis to estimate costs associated with administration of the endowment, based on the University Comptroller's existing cost allocation model for developing the proposed federal government facilities and administrative (F&A) rate charged to sponsored programs. This cost allocation model is governed by OMB Circular A-21 and audited by federal auditors to support negotiation of the F&A rate. Our internal General and Administrative fee to allocate overhead costs to our auxiliaries is also based on this federal model. When we applied the methodology to endowment accounts for fiscal year 2007, we concluded the University could have justified assessing a 1.34% administrative fee.

- **Current UVa Administrative Fee**

At its June 2008 meeting, the BoV approved an annual endowment administration fee of 50 bps (or .5%), effective for fiscal year 2008-2009. Of that fee, 25 bps is to be distributed to deans for departmental support of endowments and 25 bps to be transferred to a central pool for University priorities. The financial impact of this policy in fiscal year 2008-2009 was to recover \$16 million of expenses incurred for endowment management.

### **Spending Policy**

- **Introduction**

Typically, endowment assets are invested to maximize total return rather than actual yield. Thus, endowment boards have resorted to adopting a specific spending policy to provide some discipline and consistency in determining annual payouts to support the programs funded by the endowment. The selection of a specific spending approach and formula is influenced by the institution's view of the spending goals.

- **Objectives of a Spending Policy**

The two primary objectives of any endowment spending policy are to: (1) provide reliable, predictable and preferably inflation-protected distributions to support programs; and (2) preserve purchasing power of endowment principal in order to fund programs in perpetuity. Institutional boards have to manage the tension between these two competing goals, and balance the priorities of budgetary support and asset preservation. In effect, boards make decisions about inter-generational equity: how much to spend this year on the current generation of beneficiaries versus how much to re-invest in order to benefit future generations. At UVa, with the completion of recent long-term academic planning activities, endowment spending policy is also instrumental in our efforts to invest in priorities identified by the Commission on the Future of the University.

- **History of UVa's Spending Policy**

The University of Virginia spending policy is described as "inflation growth within a band" or "snake in the tunnel". This policy was maintained for a couple of decades through fiscal year 2002. Then for fiscal years 2003 through 2005, the BoV used the spending policy of distributing a calculated percentage of a twelve-quarter moving average of market value (4.5% for Class A shares and a higher percentage for Class B shares).

After three years of this experiment, the University returned to the “snake in the tunnel” policy. Effective with fiscal year 2005-2006 spending was increased by inflation each year within a band of 3.5 to 5.5 percent of market value. In subsequent years, extraordinary market growth caused our spending rate to fall below the pre-determined band, and the BoV consequently reset the endowment payout three times. The fiscal year 2007 spending rate was increased to 4.0 percent of the LTP market value; the 2008 spending rate was increased to 4.5 percent; and the 2009 spending rate was reset to 5.0 percent. With the 2009 reset, the BoV also adjusted the parameters of the band or tunnel, to 4-6 percent of endowment market value. Our University-related foundations develop their spending policies independently, but are required in their 2008 memoranda of understanding with the University to “adopt endowment spending disciplines consistent with University policy”.

- **Peer Spending Policies**

The most common spending policy among our peers is distributing a fixed percentage of endowment market value. According to the 2008 NACUBO Endowment Study, a strong majority (73.4 percent) of universities has adopted some variation of this approach. Included in this group are Duke, Brown, William & Mary, Virginia Tech Foundation, Johns Hopkins and Vanderbilt, and most of our University-related foundations.

A small group of our peers (including Princeton and Swarthmore) has adopted a policy similar to ours, increasing prior year spending by either an inflation index or by a fixed percentage, and either readjusting within a band or not. A third small but highly-regarded group of our peers (including Yale and Stanford) incorporate a hybrid of the two, calculating a weighted average of the two aforementioned policies. This approach was pioneered by Dave Swensen and is widely known as the Yale Model. And finally, other universities (such as Harvard) decide on an appropriate spending rate each year.

Comparing the two most common methods, fixed percentage of market value versus consistent year-to-year growth within a band, the advantages and disadvantages have been discussed regularly with the BoV. The fixed percentage of market value policy is mathematically derived and easy to calculate. However, it guarantees that the payout amount varies every year. With smoothing techniques, such as moving average of 12 quarters’ market value (which UVA used for three consecutive years as described in the history section above), the distribution volatility is mitigated. However, in our experience using moving averages, in one year out of the three we did see a decrease in the payout. Even if there were no decrease, year-to-year fluctuations make it difficult for managers of the funded programs to plan or make commitments to permanent continuing expenses like salaries.

The snake-in-the-tunnel policy emphasizes stability of distribution flows and purchasing power protection for the funded programs. The linkage of payout to market value is accomplished through a requirement that spending must fit within an established range, rather than a fixed percent. When the asset markets are rising, this approach produces modest growth in annual payout. In a falling market this policy puts a mathematically calculated cap on the decrease, but provides room for judgment to consider the holistic financial situation encountered by the University.

- **Establishment of Spending Rate for Fiscal Year 2009-2010**

During fiscal year 2008-2009, market value of the LTP fell 21%. For R&V endowments, applying an inflation factor to the prior year's spending to determine the spending for fiscal year 2009-2010 would result in the payout falling above the 4-6 percent band. Therefore, at the BoV's September 2009 meeting, the administration will be presenting a proposal to re-set the spending rate for fiscal year 2009-2010 to fall within the band.