

Endowment Spending Distribution and Administrative Fee Analysis  
UM

Management is presenting for Board information proposed changes to the Endowment Pool spending policy, which would increase the endowment administrative fee from 1.0% to 1.25% beginning in FY 18 while transitioning the spending distribution rate from 4.5% to 4.0% over a period of up to six years.

Administrative Fee

As the University's funding mix continues to shift away from state appropriations, with increasing reliance on tuition, we must continue to look toward private funding sources to maintain excellence. Privately funded endowments for needs like faculty, scholarships and research efforts are a critical part of a strategic effort to expand and diversify sources of funding.

Since July 2014, gifts to the Endowment Pool for benefit of the UM System's four campuses have totaled nearly \$80 million. A key component to even greater success in this area is our ability to invest additional resources into our development efforts across the campuses. At the same time, with state appropriations and tuition funding already under pressure, those funding sources must be dedicated to the needs of our students and faculty.

After much deliberation over the past 18 months, with clear agreement on the need to invest additional resources in our development function, the recommendation is to allow an increase in the annual endowment administration fee from 1.0% to 1.25% on each campus. As background, this administrative fee is distributed directly to each of the campuses based on the pro rata share of endowments in the Endowment Pool. These funds must be used for development efforts.

The following illustrates the impact of the proposed change, if adopted:

	FY 18 Estimated Admin Fee at <u>1% (current)</u>	FY 18 Estimated Admin Fee at <u>1.25% (proposed)</u>	<u>Increase</u>
MU	\$6,116,000	\$7,640,000	\$1,524,000
Missouri S&T	1,018,000	1,273,000	255,000
MKC	1,058,000	1,322,000	264,000
UMSL	624,000	749,000	125,000

The campus development offices have confirmed that an endowment administration fee of 1.25% would still be well within the range of similar fees assessed by peer institutions.

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### Spending Distribution Rate

In light of diminished investment return expectations, as well as a desire to protect the purchasing power of endowment funds over time, the Board approved several changes to the Endowment Pool spending policy in June 2012. One key change was lowering the spending distribution rate from 5.0% to 4.5%. As intended, this was accomplished in a thoughtful manner by simply freezing the spending distribution for each endowment account in existence at the time of the change. To be clear, spending distributions supporting various programs, faculty and scholarships were not cut. Based on projections at the time, we allowed for a transition period through June 2019 to reach the 4.5% rate. Due to favorable investment performance in the Endowment Pool, we are pleased to report that we will reach the goal of 4.5% by July 2017.

The concerns about diminished investment return expectations expressed in June 2012 have not abated. Those specific concerns will be discussed in detail with the Board at the June meeting as part of an information item discussion on asset allocation for both the Endowment Pool and Retirement Plan.

The following is an excerpt of the Endowment Pool investment policy:

“... investment returns, net of inflation, should be sufficient over time to cover annual spending distributions while maintaining or growing the underlying purchasing power of each endowed gift.”

Given such responsibility, with continued concerns over investment return expectations, we feel that it would be prudent to recommend lowering the spending distribution rate further, from 4.5% to 4.0%. Based on an informal survey of peer endowments, the 4% spending rate appears to have become the new normal, so our recommendation is in line with what other institutions have already done.

We recommend that the transition from 4.5% to 4.0% be accomplished in the same way as the recent transition from 5.0% to 4.5%. Endowment spending distributions would be frozen at FY18 levels for a number of years until such time that market value growth will have effectively lowered the distribution rate down to 4.0%.

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The following illustrates potential timelines for the transition based on different assumed investment returns using a \$100,000 endowment account as an example:

	4% Investment Return	5% Investment Return	6% Investment Return	7% Investment Return
	Annual Spending Distribution	Annual Spending Distribution	Annual Spending Distribution	Annual Spending Distribution
FY18	\$4,255	\$4,255	\$4,255	\$4,255
FY19	4,255	4,255	4,255	4,255
FY20	4,255	4,255	4,255	4,255
FY21	4,255	4,255	4,255	4,255
FY22	4,255	4,255	4,255	4,300
FY23	4,255	4,288	4,372	4,458
FY24	4,308	4,428	4,552	4,680

Under the scenarios illustrated above, spending distributions would be frozen at FY18 levels for up to six years at a 4% assumed return. However, with a higher assumed investment return of 7%, spending distributions could be frozen at FY18 levels for only four years.

## Chapter 140: Investments

### 140.013 Investment Policy for Endowment Pool

Bd. Min 7-22-11. Revised in entirety, Bd. Min. 6-26-12. (Note: Board approval on 6-26-12 replaced previous rules 140.010, 140.011, 140.012 and 140.013 with new language and reissued new rules 140.010 through and including 140.016.) Revised Bd. Min 6-14-13; Revised 9-12-13; Revised 6-25-15; Revised 2-4-16; Revised 4-14-16.

- A. **Introduction** -- The University's Endowment Pool contains gifts, bequests and other funds directed to be used to support a University program in perpetuity. Some donors require such a commitment as a condition of their gift ("true endowments"). Also, funds may be assigned to function as endowments by the Board of Curators or by University administration ("quasi endowments").
- B. **Responsibilities and Authorities** – See CRR 140.010 “*Policy for Management and Oversight of Selected University Investment Pools.*”
- C. **Investment Objectives** -- The Endowment Pool must be managed to provide ongoing support of endowed programs in perpetuity, in conformance with donor stipulations. To accomplish this, investment returns, net of inflation, should be sufficient over time to cover annual spending distributions while maintaining or growing the underlying purchasing power of each endowed gift.
- D. **Authorized Investments** – The Endowment Pool shall be invested in externally managed funds, consistent with the guidelines established in CRR 140.011, “*Policy for Investment Manager Selection, Monitoring and Retention,*” in the following asset sectors:

Sector	Target	Asset	Allowable Range
Global equity	43%		33% - 53%
Private equity	10%		6% - 15%
Global fixed income	4%		2% - 8%
U.S. Treasuries	0%		0% - 20%
Emerging markets debt	5%		3% - 8%
Opportunistic debt	7%		4% - 10%
Hedge funds	6%		4% - 9%
Risk parity	10%		7% - 14%
Real estate/infrastructure	10%		6% - 12%
Inflation-linked bonds	3%		1% - 6%
Commodities	2%		0% - 5%
Cash and cash equivalents	0%		0% - 10%
<b>Total</b>	100%		

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#### **E. Portfolio Rebalancing**

Sector allocations shall be monitored on an ongoing basis as changes in market behavior may result in variations from the target asset mix. Rebalancing of the portfolio shall be considered at least quarterly, and more often if necessary to maintain allocations within the allowable range. The need to rebalance shall take into account any logistical issues associated with fully funding a particular asset sector, as well as any tactical decisions to overweight or underweight a particular asset sector based on current market conditions. The University may utilize external managers to synthetically rebalance portfolio exposures consistent with targets and allowable ranges established by this policy. Synthetic market exposures can be obtained through the use of conventional derivative instruments commonly accepted by other institutional investors, such as futures contracts and swap agreements.

Actual sector allocations shall not fall outside of the allowable ranges, with the exception of violations caused solely by periods of extreme market distress, when it may not be possible or advisable to immediately bring such allocations back to within the allowable ranges.

#### **F. Currency Risk Management**

In the context of a global investment portfolio, currency risk exists to the extent that investments contain exposures to foreign currencies. The desirability of this currency exposure is not necessarily aligned dollar for dollar with the desired exposure to assets denominated in foreign currencies. As such, external managers in any asset sector may implement currency strategies to alter the currency exposure of the portfolio when deemed prudent to do so in the context of the particular investment mandate. In addition, the University may utilize external managers to implement currency strategies to alter exposures in an active or passive manner as part of a portfolio or asset class overlay when deemed prudent to do so.

#### **G. Global Equity Portable Alpha Program**

Within the global equity sector, market exposures may be obtained through the use of passive investment vehicles, traditional long-only active management, active long/short strategies and conventional derivative instruments commonly accepted by other institutional investors, such as futures contracts and swap agreements. Equity market exposure obtained through active long/short strategies and derivative instruments shall not exceed 15% and 35% of the total global equity allocation, respectively.

To the extent that equity market exposure is obtained using derivative instruments, a portion of the underlying cash and cash equivalent balances may be managed in an active fashion by external managers as an additional tool to add excess returns above the global equity benchmark. To maximize the probability of consistently positive returns within the portable alpha portfolio, appropriate alpha strategies should exhibit low correlations to one another, and manage effective equity market beta to target levels. The allowable range of the portable alpha portfolio shall be 0-10% of the total Endowment Pool.

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The Global Equity Portable Alpha Program shall be managed in accordance with prudent risk management practices established by the Treasurer, Vice President for Finance, and Investment Consultant. Such risk management practices shall include a requirement to maintain appropriate levels of margin collateral. Derivative instruments and associated cash and cash equivalent balances shall be managed by an external investment firm with appropriate expertise, experience and depth of resources.

H. **Spending Policy** – To provide ongoing support to endowed programs in perpetuity, the spending policy must be managed in conjunction with investment objectives and other factors in compliance with applicable law, such that the spending rate plus an inflationary assumption shall not exceed expected investment returns over time. At minimum, the spending policy should be reviewed in conjunction with asset/liability studies performed by the Investment Consultant not less than once every three years.

1. The formula used to determine the Endowment Pool spending distribution for each fiscal year shall apply a rate of 4.05% to a base equal to the 28-quarter trailing average of market values as of December 31<sup>st</sup> of the prior fiscal year. Endowment spending distributions shall be paid on a monthly basis.

The transition of the rate from 45.50% to 4.05% shall be accomplished in a methodical manner over a period not to exceed the seven years ended June 30, 202419. In no case shall the transition from 45.50% to 4.05% cause the actual spending distribution to decrease from one year to the next during the transition phase.

2. In addition to the spending distribution noted above, the President shall have the discretion to distribute from the Endowment Pool an administrative fee each fiscal year to be used for support of internal endowment administration and development functions. Such administrative fee shall be calculated by applying a rate of up to 1.25% to a base equal to the 28-quarter trailing average of market values as of December 31<sup>st</sup> of the prior fiscal year. The administrative fee shall be paid on a monthly basis.
3. The spending policy, spending distribution formula and administrative fee may be adjusted over time by the Board to respond to general economic conditions and other factors as appropriate and in compliance with applicable law.
4. Implementation of the spending policy is delegated to the Vice President for Finance ~~and Administration~~ or her/his designees.

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