THE UNIVERSITY OF MICHIGAN
REGENTS COMMUNICATION

Approved by the Regents
June 16, 2006

REQUEST FOR ACTION

Subject: University Endowment Fund Distribution Policy

Action Requested: Adjustment in the Endowment Distribution Policy

Background and Summary: Prior to November 1986, the University's endowment distributed all ordinary income, comprised primarily of interest on bonds and dividends on stocks as had been common practice among similar institutions at the time. This methodology resulted in a stream of distributions that was volatile, reflecting the volatile nature of financial market investments and so high relative to the endowment investment returns that it eroded the purchasing power of the endowment in a meaningful way.

In November 1986, the Board of Regents adopted a total return-based distribution policy for the pooled University Endowment Fund that was aimed at protecting the purchasing power of the endowment and the stream of distributions it provides. The distribution rate was set at 5.5 percent of the one quarter lagged twelve quarter (three year) average market value of the endowment shares. The use of a twelve quarter average value was to smooth the level of distributions to facilitate budgeting. At the time it was recognized that the 5.5 percent rate represented somewhat of a compromise between distribution levels of the past, which had averaged seven percent for the prior five year period, and distribution levels felt to be sustainable based on long-term historical investment returns.

The University adopted its current endowment distribution policy in June 1995 when the Board of Regents approved a change in the distribution rate from 5.5 percent to 5.0 percent based on a one quarter lagged, twelve quarter (three year) average market value. At the same time, the Board of Regents also limited distributions to a percentage of current market value equal to the distribution rate in effect at the time plus 0.3 percentage points (30 basis points) to protect the value of the endowment in down markets. It was recommended the change in the distribution rate be gradual over a period of up to five years in order to not reduce the dollar amount of distributions. It also was recommended that the Board reexamine the issue once the 5.0 percent rate was achieved and decide whether to continue to lower the distribution rate to 4.5 percent.

The current distribution policy has served the University well since its adoption in June 1995. The endowment has experienced significant and steady growth and provided substantial distributions to support new and ongoing programs over the years with distributions reaching approximately 6 percent of the University's fiscal year 2005 revenues for operating activities.

While the current practice of basing the distribution rate on a twelve quarter moving average market value has reduced the volatility in the stream of distributions, it has not satisfactorily insulated the University's budget from the volatility in the markets. We therefore recommend extending the period for calculating the average market value from twelve quarters (three years) to twenty eight quarters (seven years) to further reduce the volatility in the stream of distributions and better facilitate budgeting and planning.

To lessen the near term impact of this change on budgets, which may already be planned, we suggest the change be implemented gradually over the next three years, by immediately extending the period for calculating the average market value from three years to four years and then adding one more quarter each subsequent quarter until the period reaches seven years.

The strong performance of the financial markets over the last two decades suggests to many that future returns from investing activities will not be as favorable for investors, leaving the University with an unsustainable level of endowment spending. Therefore, we also recommend that the Board of Regents consider gradually lowering the distribution rate to 4.5 percent once the seven year averaging has been achieved. Such a change will leave the University financially stronger in coming years while at the same time provide a reliable and growing stream of distributions.

We recommend that the distribution rate be based on a one quarter lagged, 28 quarters moving average market value, and that the change be implemented gradually over the next three years by immediately (as of July 1, 2006) extending the period for calculating the average market value from the current three years to four years and then adding one more quarter each subsequent quarter until the period reaches 28 quarters.

We also recommend that over the next two years the Board of Regents seriously evaluate and explore ways to reduce the distribution rate from 5.0 percent towards 4.5 percent with an eye toward implementing any such change three years from now, once the 28 quarter averaging has been fully achieved. We will be returning to the Board periodically over the next 24 months with information on investment performance, inflation, and other related factors to help your consideration of any future change to the endowment payout rate.

Respectfully submitted,

Timothy P. Slottow
Executive Vice President and
Chief Financial Officer

June 2006
Enclosures

University Endowment Fund Distribution Policy Adjustment
Supporting Information

The following attachments (I – III) provide support for the proposed changes to the pooled University Endowment Fund distribution policy.

The tables and charts under the heading *HISTORICAL* on the left in **Attachment I** illustrate the anticipated improved stability in the stream of distributions that results from making a change in the calculation of the moving average market value from twelve quarters (three years) to twenty eight quarters (seven years). This section models the difference between the annual growth in per share distributions that would have resulted under the current distribution policy and under the recommended distribution policy. The current policy is illustrated by the light blue bars that correspond to the numbers immediately to their left, and the recommended policy is illustrated by the light yellow bars which correspond to the numbers immediately to their left. The historical annual returns for the University's Long Term Portfolio (in which the pooled endowment funds are invested) are shown on the left.

The tables and charts under the heading *PROJECTED* on the right in **Attachment I** show that a gradual implementation of a change in the calculation of the moving average market value from twelve quarters to twenty eight quarters is expected to provide a stream of distributions that will provide comparable growth with less volatility compared the current policy. The current policy is illustrated by the blue bars that correspond to the numbers immediately to their left. The recommended policy is illustrated by the yellow bars that correspond to the numbers immediately to their left.

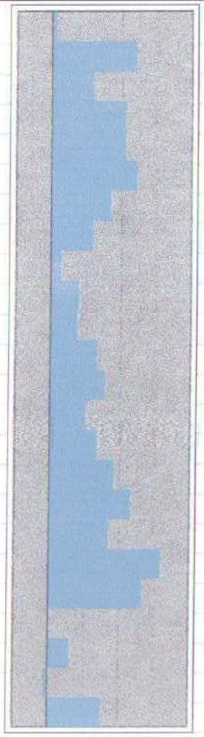
The effect of a change in distribution rate from 5.0 percent to 4.5 percent is illustrated in Attachments II and III. **Attachment II** shows the growth in quarterly per share distributions that would have resulted under various distribution policies. **Attachment III** shows the corresponding growth in per share market value of the endowment.

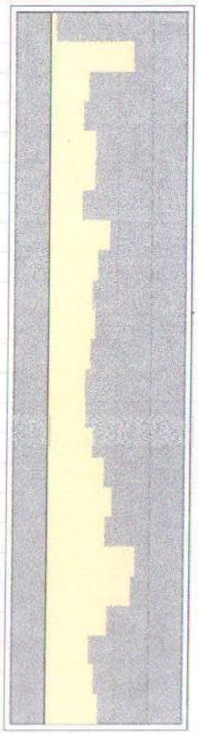
Actual Percent Change in Per Share Distributions

HISTORICAL

Actual Returns Experienced by the University

Historical LTP Returns	Fiscal Year	Current Distribution Policy: Average Market Value: 3-year moving average Spending Rate: 5.0 %	Proposed Distribution Policy: Average Market Value: 7-year moving average Spending Rate: 5.0 %
43.9%	**1983**	0.6%	0.6%
-2.8%	**1984**	12.1%	12.1%
25.3%	**1985**	5.9%	5.5%
23.0%	**1986**	10.4%	4.9%
13.0%	**1987**	10.5%	6.7%
2.5%	**1988**	12.2%	6.6%
13.9%	**1989**	8.4%	4.8%
3.3%	**1990**	5.9%	8.7%
7.8%	**1991**	1.5%	7.1%
12.2%	**1992**	4.0%	6.3%
16.9%	**1993**	3.8%	6.7%
3.9%	**1994**	6.6%	6.1%
13.6%	**1995**	7.7%	5.3%
18.6%	**1996**	5.0%	5.4%
18.2%	**1997**	6.7%	6.5%
13.7%	**1998**	9.1%	8.1%
13.4%	**1999**	11.6%	9.3%
43.7%	**2000**	8.4%	8.4%
-5.5%	**2001**	16.0%	12.8%
-4.4%	**2002**	13.3%	12.2%
5.4%	**2003**	0.1%	8.8%
20.7%	**2004**	3.1%	6.2%
19.1%	**2005**	-0.4%	6.9%
18.7%	**2006***	7.6%	7.6%
	Min	-0.4%	0.6%
	Max	16.0%	12.8%
	Average	7.1%	7.2%



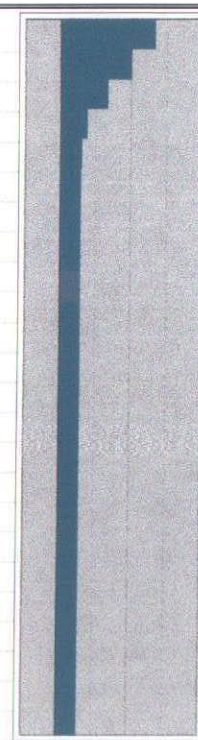


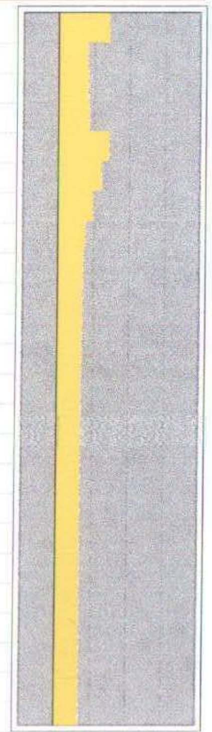
* Projected.

PROJECTED

Assumes a Constant 8 Percent Annual Future Return

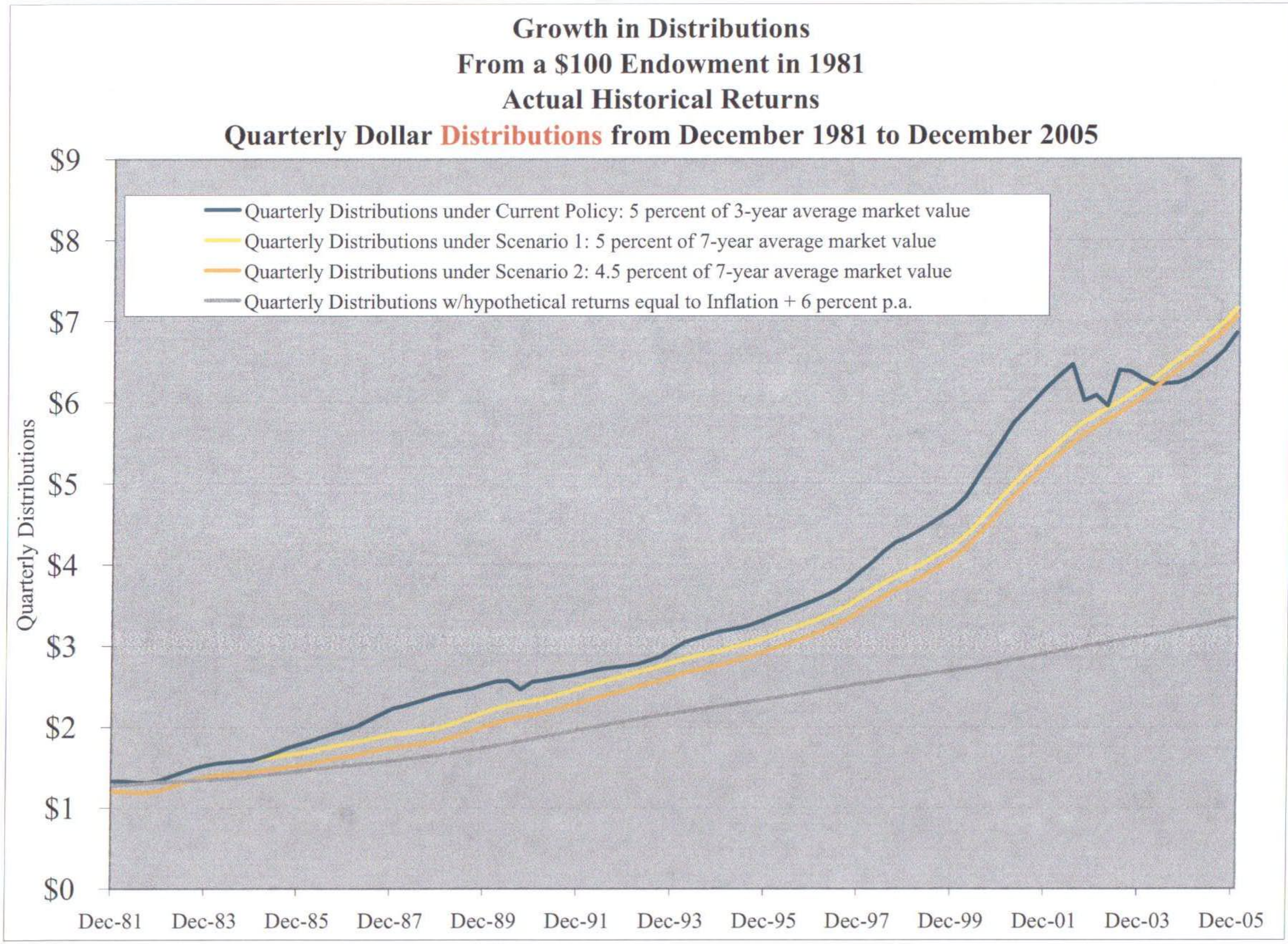
Projected LTP Returns	Fiscal Year	Current Distribution Policy: Average Market Value: 3-year moving average Spending Rate: 5.0 %	Proposed Distribution Policy: Average Market Value: Gradual extension to 7-years* Spending Rate: 5.0 %
8.0%	**2007**	13.4%	7.1%
8.0%	**2008**	10.1%	4.0%
8.0%	**2009**	6.8%	4.1%
8.0%	**2010**	3.8%	4.3%
8.0%	**2011**	3.1%	7.2%
8.0%	**2012**	3.0%	6.1%
8.0%	**2013**	2.9%	4.9%
8.0%	**2014**	2.9%	3.8%
8.0%	**2015**	2.9%	3.5%
8.0%	**2016**	2.9%	3.4%
8.0%	**2017**	2.9%	3.4%
8.0%	**2018**	2.9%	3.3%
8.0%	**2019**	2.9%	3.3%
8.0%	**2020**	2.9%	3.3%
8.0%	**2021**	2.9%	3.3%
8.0%	**2022**	2.9%	3.3%
8.0%	**2023**	2.9%	3.3%
8.0%	**2024**	2.9%	3.3%
8.0%	**2025**	2.9%	3.3%
8.0%	**2026**	2.9%	3.3%
8.0%	**2027**	2.9%	3.3%
8.0%	**2028**	2.9%	3.3%
8.0%	**2029**	2.9%	3.3%
8.0%	**2030**	2.9%	3.3%
	Min	2.9%	3.3%
	Max	13.4%	7.2%
	Average	3.9%	3.9%





* Immediate change to 4-year moving average & gradual extension to 7-year over 12 quarters.

ATTACHMENT II



ATTACHMENT III