THE UNIVERSITY OF MICHIGAN
REGENTS COMMUNICATION

Approved by the Regents
July 15, 2010

REQUEST FOR ACTION

Subject: University Endowment Distribution Policy

Action Requested: Adjustment to Endowment Distribution Rate From 5.0 percent to 4.5 percent

Background and Summary: Prior to November 1986, the University distributed all ordinary income, comprised primarily of interest on bonds and dividends on stocks from its endowment funds, as had been common practice among similar institutions at the time. This approach resulted in a stream of distributions that was volatile, and quite high relative to the endowment investment returns, resulting in a meaningful erosion of the purchasing power of the University's endowments.

In November 1986, the Board of Regents adopted a total return based distribution policy for the University's pooled endowment funds to protect the purchasing power of the University's endowments and the stream of distributions they provide. The distribution rate was set at 5.5 percent of the one quarter lagged, 12 quarter (three year) average market value of the endowment shares. The 5.5 percent rate represented a compromise between distribution levels of the past, which averaged seven percent for the prior five year period, and distribution levels considered to be sustainable based on long-term historical investment returns. The 12 quarter average value smoothed distribution levels to facilitate budgeting.

In June 1995, the Board of Regents approved a change to lower the distribution rate from 5.5 percent to 5.0 percent based on a one quarter lagged, 12 quarter (three year) average market value. 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. At that time it also was recommended that the Board consider lowering the distribution rate to 4.5 percent once the 5.0 percent rate was achieved.

In June 2006, the University adopted its current endowment distribution policy which extended the period for calculating the average market value from 12 quarters to 28 quarters. In a gradual process, the period was first extended from 12 quarters (three years) to 16 quarters (four years) and then one quarter was added each subsequent quarter until the period reached 28 quarters (seven years) in June 2009.

This most recent change in the endowment distribution policy served the University well during the financial market turmoil as it reduced the volatility in the stream of distributions and provided for small increases in distributions from the endowment year over year when the prior policy would have called for reduced distributions.

In June 2006, it also was recommended that the Board consider reducing the distribution rate from 5.0 percent to 4.5 percent once the 28 quarter average had been fully achieved to further protect the University's endowments and the stream of distributions they provide because lower future returns from investing activities may not sustain the current level of endowment spending in real terms.

Experience has shown that markets can be volatile and periods of high investment returns often are followed by periods of low investment returns. The brutal end in 2008 of a two decade long period of high investment returns and low inflation suggests a future investment environment that may not be so favorable for investors, supporting lowering the endowment distribution rate to a more sustainable level that will help endowment distributions keep up with inflation.

It is extremely challenging to grow an endowment and preserve its purchasing power while producing consistent and growing revenue distributions from that endowment. To preserve the purchasing power of an endowment corpus, the investment return must be at least equal to the rate of inflation plus the percentage spent from the endowment.

The Higher Education Price Index (HEPI), a measure of inflation for the goods and services purchased by universities, has averaged 4.0 percent annually over the past ten years. During the same time period, the annual median investment return on endowments was 4.1 percent[1]. For the majority of universities with modest endowments, spending three percent to five percent of their endowments each year actually has meaningfully eroded the per share value of their endowment corpus.

Lowering the University's endowment distribution rate by half a percentage point builds upon a series of prudent financial management strategies that have enabled the university to weather the recent recession while avoiding drastic measures taken by many of our most prestigious peers, such as faculty hiring freezes, across-the-board salary cuts, furloughs, program elimination or construction stoppage.

The overarching financial strategies and policies that have allowed UM to avoid such measures while protecting the qualities that define the "Michigan Difference" and absorb significant reductions in state appropriations over the last eight years include:

- using the seven year average market value to calculate endowment distributions
- conservative use of debt
- integrated asset and liability management
- sophisticated cash management
- aggressive space utilization
- administrative expense reductions
- moderate tuition increases with significant investments in financial aid
- consistent investment in plant infrastructure
- disciplined budget strategy

Adjusting the endowment distribution rate to 4.5 percent will help ensure long-term stability and growth in distributions from the University's endowments to support the core operating budgets of the University's schools, colleges, institutes and health system.

To avoid negative impacts of this change on near-term budgets, we recommend the change be implemented gradually over a number of years. Rather than require that the rate be taken down evenly, the distribution rate would be implemented gradually over a number of years in a flexible manner that would keep the dollar amount of distributions per share constant during the implementation. 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 beginning with the distribution for the quarter ending September 30, 2010, the distribution rate begin to be lowered from 5.0 percent to 4.5 percent to more effectively protect the purchasing power of the University's endowments and the distributions they provide. The distribution rate would continue to be based upon the one-quarter lagged 28 quarters average market value of endowment shares. The lowering of the distribution rate would be implemented gradually over a number of years in a flexible manner. Distributions would be managed towards

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1 Cambridge Associates' survey of endowments and foundations at about 140 colleges and universities for the ten years ending June 30, 2009

the 4.5 percent distribution rate by keeping quarter to quarter distributions per share unchanged only when prior increases in share value otherwise would result in higher per share distributions.

We also recommend that the upper limit on distributions remain at 5.3 percent of the current market value to protect the value of the University's endowments in down markets.

Respectfully Submitted,

Timothy P. Slottow
Executive Vice President and
Chief Financial Officer

July 2010
Enclosures

University Endowment Distribution Policy
Supporting Information

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

The tables and charts in **Attachment I** illustrate the annual change in the per share stream of distributions under three spending policy scenarios using actual investment returns for fiscal years 2007 through 2009, estimated investment return for fiscal year 2010, and forecasted returns equal to a nine percent annualized rate thereafter as shown in the column to the left.

The annual changes in per share distributions are illustrated in the three colored charts where the horizontal bars correspond to the values immediately to their respective left.

The chart to the left with the blue bars models the annual change in per share distributions of a policy based on a 5.0 percent distribution rate and a 12 quarter trailing average market value which was the University's practice for ten years until the averaging period was changed to 28 quarters in June 2006.

The middle chart with the yellow bars models the annual change in per share distributions of a policy based on a 5.0 percent distribution rate and a 28 quarter trailing average market value which has been the University's practice since its adoption in June 2006.

The chart to the right with the green bars models a gradual implementation of moving the distribution rate from 5.0 percent to 4.5 percent over a number of years in a manner that keeps quarter to quarter per share distribution amounts unchanged until the 4.5 percent distribution rate is reached. Distributions would be managed towards the 4.5 percent distribution rate by keeping quarter to quarter distributions unchanged only when prior change in share value otherwise would result in higher distributions.

The length of the implementation period will depend on the actual investment returns and resulting changes in share values experienced during the implementation period. Actual investment returns during the implementation period higher than what is assumed in the model would result in a shorter implementation period due to greater increases in share values allowing for larger quarterly adjustments. The implementation period would be longer should investment returns during the implementation period be lower than those assumed in the model because adjustments towards the 4.5 percent distribution rate would take place less frequently.

The effect of changing the distribution policy is illustrated in **Attachment II** which shows the growth in per share market value of the endowment under various distribution policies.

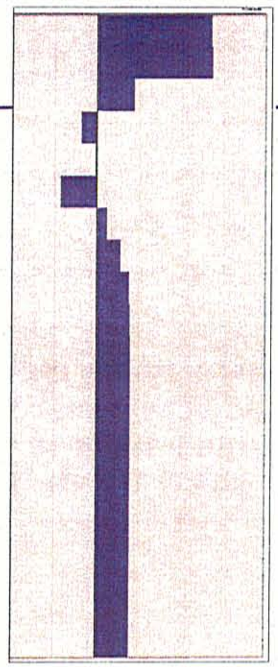
Attachment III shows the effect of spending and inflation on endowments' per share value over the ten year period ended June 2009.

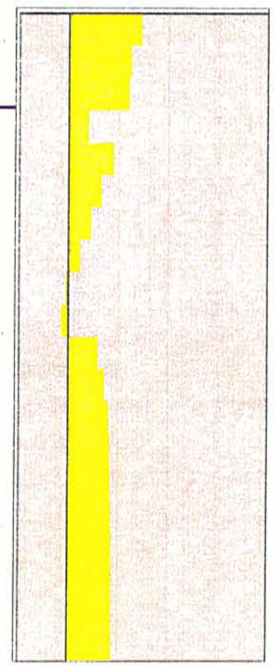
ATTACHMENT 1

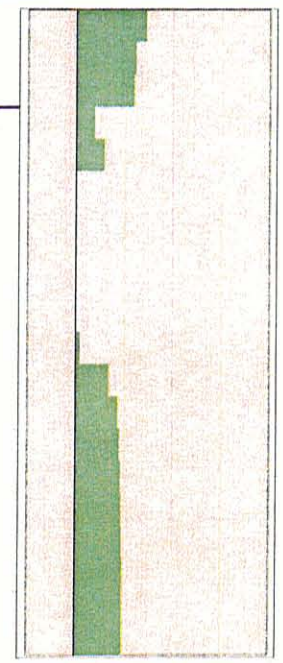
Percent Change in Per Share Distributions

ACTUAL RETURNS THROUGH DECEMBER 31, 2009, ESTIMATED RETURN FOR FY 2010, AND ANNUALIZED RETURNS OF 9% THEREAFTER.

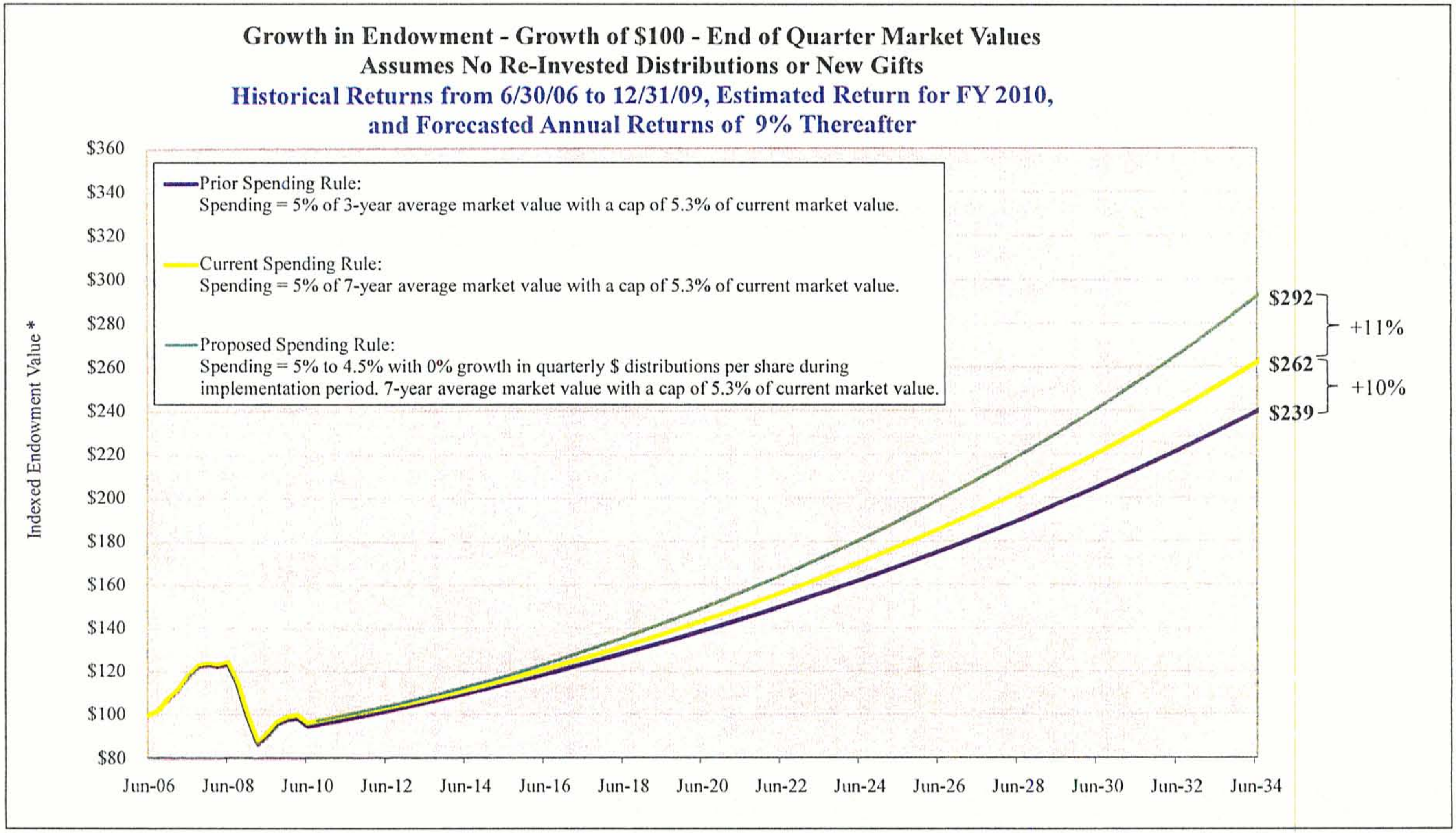
Projected LTP Returns (Actual Returns for years '07 - '09)	Fiscal Year	Model of Prior Spending Rule Distribution Rate: 5.0 % Average Market Value: 3-year moving average	Model of Current Spending Rule Distribution Rate: 5.0 % Average Market Value: 7-year moving average	Model of Proposed Spending Rule Distribution Rate: 5.0 % to 4.5% with flat quarterly $ distributions per share over implementation period beginning with the distribution for the quarter ending 9/30/10. Average Market Value: 7-year moving average
25.6%	2007	13.5%	7.2%	7.2%
6.5%	2008	13.7%	6.2%	6.2%
-23.4%	2009	4.4%	6.0%	6.0%
11.0%	2010	-1.9%	1.9%	1.9%
9.0%	2011	-0.2%	4.5%	2.9%
9.0%	2012	-4.3%	3.2%	0.0%
9.0%	2013	1.2%	2.2%	0.0%
9.0%	2014	2.8%	1.1%	0.0%
9.0%	2015	3.8%	-0.3%	0.0%
9.0%	2016	3.9%	-0.8%	0.0%
9.0%	2017	4.0%	2.9%	0.4%
9.0%	2018	4.0%	3.6%	3.4%
9.0%	2019	4.0%	4.0%	4.4%
9.0%	2020	4.0%	4.1%	4.6%
9.0%	2021	4.0%	4.2%	4.7%
9.0%	2022	4.0%	4.3%	4.8%
9.0%	2023	4.0%	4.3%	4.8%
9.0%	2024	4.0%	4.4%	4.9%
9.0%	2025	4.0%	4.4%	4.9%
9.0%	2026	4.0%	4.4%	4.9%
	Min	-4.3%	-0.8%	0.0%
	Max	13.7%	7.2%	7.2%







ATTACHMENT 2



* Endowment value indexed so that market value under prior spending rule = 100 on June 30, 2006.

Investment Performance & Inflation

10 Years Ending 6/30/09

	Investment Return[a]		Average Inflation[b]		Real Return[c]		Avg. Actual Spending[d]		Per Share Growth[c]
Total LTP	8.9%	-	4.0%	=	4.7%	-	4.4%[e]	=	0.3%
Endowment Universe[f]									
Top Quartile	5.3%	-	4.0%	=	1.3%	-	4.7%	=	-3.3%
Median	4.1%	-	4.0%	=	0.1%	-	4.7%	=	-4.4%

In the past ten years, only 13 out of 349 endowments exceeded an annualized return of 8.9%, which is the estimated required return to sustain an endowment's per share value in real terms when spending at an average rate[d].

(a) Annualized returns.

(b) Higher Education Price Index (HEPI). Source: The Commonfund.

(c) Differences reflect geometric returns, not arithmetic returns.

(d) Actual spending is a way to compare different spending rules. Actual spending is calculated as annual spending divided by the ending market value. As such, in UM's case, it will be less than the 5.0 percent spending rule in rising markets.

(e) Average actual spending is the distributions pursuant to the 5 percent spending rule and excludes withdrawals from the quasi-endowment for strategic capital initiatives. Total spending from the UM endowment has averaged 6.5 percent annually in the past 10 years when all endowment spending is included.

(f) Based on Cambridge Associates' survey of endowments and foundations at about 140 colleges and universities. Universe spending data is using the median actual per share spending rate of 4.7% as measured by Cambridge Associates.