

THE UNIVERSITY OF MICHIGAN
REGENTS COMMUNICATION

REQUEST FOR ACTION

Subject: Long Term Portfolio Asset Allocation

Action Requested: Approval of Model Portfolio and Allowable Ranges

Background and Summary: In 1986, the Board of Regents established a broad asset allocation policy to guide the investment of the Endowment that called for 70 percent Equities and 30 percent Fixed Income, reflecting the relatively limited investment opportunities available to institutional investors at that time. The university broadened its investment portfolio in the ensuing years with the agreement of the Board as new areas of investing developed and added investments in Venture Capital, Real Estate, and Oil and Gas (now Natural Resources) in 1989, Private Equity in 1993, and Absolute Return in 1998. These categories of investments were regarded as coming within the Equities allocation.

To allow for increased diversification of the Long Term Portfolio (LTP), which by then had been created as the primary investment vehicle for the Endowment, and to permit greater exposure to investments in Equities and other, similar new asset classes of investments, the Board lowered the Fixed Income target in 1994 and again in 1996, ending at 20 percent. At the same time, to provide for greater flexibility for the university's investment professionals, the Board began to establish the concept of allowable investment ranges around the allocation targets.

A broad 80/20 Equities/Fixed Income target remained in place until 2000 when it was replaced by a more detailed and flexible Model Portfolio framework that included specific model allocations for each major investment asset class. The Model Portfolio framework continues today and serves to establish an annual investment return benchmark by which the Board measures the success of the professionals who invest the LTP.

The actual asset allocation of the LTP can vary from that of the Model Portfolio, as the university's investment professionals are encouraged to explore investment opportunities within the Board approved asset classes that can add to overall portfolio investment return without adding substantially more risk to the combined long-term portfolio of investments. Practically speaking, tactical investment positions based on relative valuations typically would be expected to revert closer to the Model Portfolio over time as prices correct.

The university does not typically seek to take large tactical positions, but rather identify longer-term trends and to build up investment positions over time. In such cases, initial tactical positions may evolve into more strategic positions as capital markets evolve and new investment areas become institutionally available and more generally accepted. The Board can authorize changes to the asset class weights in the Model Portfolio as new opportunities arise. There have been five such adjustments to the Model Portfolio since it was first adopted in 2000.

To date, there have been no formal constraints for individual asset class allocations other than for Fixed Income. Since asset allocation is a primary driver of risk and return in the investment portfolio, properly constructed limits on maximum and minimum exposures for individual asset classes in the portfolio ensures diversification and balances risk and return, positioning the university to earn an investment return sufficient to sustain the distribution rate without assuming an inappropriate level of risk.

Based on a recommendation from consultants recently engaged by the university to review its practices around governance and Board oversight of investments and in consideration of common practices employed by other Boards with similar responsibilities, university leadership believes there is an opportunity to further strengthen the Board's strategic oversight and public transparency for investments by modifying its current practices.

University leadership recommends that the Board annually (1) review in public session the investment results and summary composition of the investment portfolio and (2) establish and discuss investment allocation ranges for each individual asset class in the Model Portfolio as the guidelines for the investment of the portfolio for the ensuing fiscal year. Doing so will also allow for the practical flexibility needed by the university's investment professionals to properly manage the investments in the LTP.

Board oversight of a large long-term portfolio by the establishment of allowable investment allocation ranges for each individual asset class is a common practice at other institutions that manage investment portfolios of similar sizes and investment goals where items that are determined to be of strategic importance typically are presented to the governing body for approval on an annual basis. Strategic items typically include the overall investment policy, asset allocation policy, performance benchmarks, and review of investment performance.

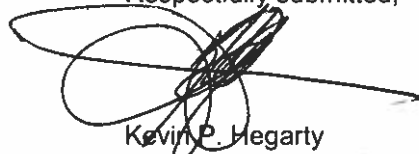
The table below sets forth the Model Portfolio with recommended allowable ranges for each asset class. These allowable allocation ranges are sufficiently wide to delegate to staff flexibility to manage allocations between the various asset classes, yet sufficiently narrow to ensure maintenance of desired levels of diversification and adherence to a specific risk-return profile for the LTP.

LTP - Model Portfolio with Recommended Allowable Ranges

	Model	Maximum	Minimum	Allowable
MARKETABLE SECURITIES	Portfolio	Allocation	Allocation	Range
Equities	28.0%	40.0%	20.0%	+12%/-8%
Fixed Income	12.0	20.0	4.0	+8/-8
Cash	2.0	10.0	0.0	+8/-2
Absolute Return	18.0	26.0	10.0	+8/-8
TOTAL MARKETABLE SECURITIES	60.0%	80.0%	50.0%	+20/-10%
	Model	Maximum	Minimum	Allowable
ALTERNATIVE ASSETS (ILLIQUID)	Portfolio	Allocation	Allocation	Range
Venture Capital	10.0%	15.0%	5.0%	+5%/-5%
Private Equity	12.0	17.0	7.0	+5/-5
Real Estate	10.0	15.0	5.0	+5/-5
Natural Resources	8.0	12.0	4.0	+4/-4
TOTAL ALTERNATIVE ASSETS (ILLIQ.)	40.0%	50.0%	20.0%	+10/-20%

We request that the Board of Regents adopt the Model Portfolio with the recommended allowable ranges as outlined above and review them on an annual basis.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kevin P. Hegarty", is written over the typed name. The signature is stylized with several loops and a long horizontal stroke extending to the right.

Kevin P. Hegarty
Executive Vice President and
Chief Financial Officer

October 2018