VII. STANDING COMMITTEES

B. Finance, Audit and Facilities Committee

Amendment to the Consolidated Endowment Fund Investment Policy

INFORMATION:

Today's discussion is intended to provide background on endowment spending practices at the University of Washington and at other colleges and universities. The discussion is topical. Recent market volatility has had a profound negative impact on endowed market values. A significant decline in endowed program spending is inevitable in the near future. If supported by today's discussion, a recommendation to lengthen the averaging period in the endowment investment policy from three to five years and a recommendation to hold endowment distributions in FY09 at FY08 spending levels will be brought before the Board of Regents in January 2009.

BACKGROUND:

In 1988, the Board of Regents adopted the "Statement of Investment Objectives and Policy for the Consolidated Endowment Fund". This policy defines the spending policy as "five percent of the average market value of the CEF for the previous three years." Later policy amendments capped year-to-year spending increases at 5%. The cap was removed in December 2000, resulting in significant increases in payouts in the ensuing years.

Endowment spending policies typically include a smoothing mechanism to create a more predictable payout stream. Extreme positive or negative movements in the capital markets work their way through the spending calculation over a number of years enabling program managers to effectively plan for change.

With financial markets suffering through an unprecedented period of turbulence, global recession is now a reality. It is feared that it will be deeper and more prolonged than originally predicted. Concerns over the impact of extreme volatility and downward price pressures on the endowment, precipitated this review of the endowment spending policy.

OBJECTIVES OF A GOOD SPENDING POLICY:

A good spending policy attempts to achieve a number of objectives. First and foremost, it seeks to balance the needs of current and future program beneficiaries. This objective is met by maintaining or slightly growing the real (net of inflation) endowment value over the long run. The second objective of a

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good spending policy is to provide a reasonable and stable flow of dollars in support of current programs thereby facilitating effective program management. The most common method of dampening spending volatility is to base the distribution itself on a market value averaged over three to five years. The longer the averaging period, the lesser the impact of current market conditions on the distribution.

OPTIONS CONSIDERED:

In developing this proposal, three options were considered:

- No change. *"Spend 5% of a 3 year average market value"*
- Lower the spending rate to 4 ½%. *"Spend 4 ½% of a 3 year average market value"*
- Lengthen the averaging period to 5 years. *"Spend 5% of a 5 year average market value"*

A series of forward looking and conservative return forecasts led to the following conclusions. Without the initiation of a freeze in spending at FY08 levels, near term distributions using both the current spending policy AND the recommended spending policy which lengthens the averaging period will lead to a spending increase over FY08. This increase would require additional liquidation of securities in a down markets, further eroding the endowment market value. Over the subsequent five years, lengthening the averaging period will be dramatically less detrimental to endowed programs than the other options. Rephrased, programs will be better supported (spend more) over this period than in other options. Finally, the impact on endowed market value is similar in all options confirming that the sensitivity of market values to spending is best seen over very long time horizons (20 to 30 year periods).

POLICY IMPACT:

The proposed action holds FY09 spending at FY08 levels. This is 5% below what the policy spending calculation with its current smoothing mechanism would have generated. Importantly, approval will result in a change in spending policy which will lengthen the averaging period to five years. Lengthening the averaging period will have the least detrimental impact on campus during these difficult and troubling times. The longer averaging period has the added benefit of dampening market volatility during market extremes – providing higher levels of support

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when markets are down and lower levels of support when markets are up. A longer averaging period also facilitates forecasting and allows programs to effectively plan for change.

REVIEW AND APPROVALS:

This policy recommendation has been reviewed by the Senior Vice President and the administration, the Chief Investment Officer and by the University's investment consultant, Cambridge Associates. It requires review and approval by the full Board of Regents

Attachment
Consolidated Endowment Spending

University of Washington
Board of Regents

Consolidated Endowment Spending

November 21, 2008

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University of Washington

On Spending Policy

- In light of the weakness in markets and falling endowment values, institutions are reviewing distributions to campus (as well as other ways to preserve liquidity).
- The "spending rule" of distributing 5% of a moving average of endowment values is by far the most common rule.
- By extending the averaging time, near term distributions will be slightly less than with the current policy. When markets are appreciating the longer averaging period distributes slightly less to campus than with a shorter averaging time. The longer averaging time facilitates budgeting because future distributions are more stable and predictable.
- Moving to a distribution policy of 5% of a trailing 20-quarter moving average will distribute slightly less to campus during normal markets but also will reduce the volatility of distributions year-on-year.

Spending Policy Issues

At the heart of endowment investment planning is the attempt to mediate among the following conflicting objectives:

- Maximize long-term total return
- Maximize annual spending from the fund
- Preserve the real value (purchasing power) of the fund's principal and of its spending distributions over the long term
- Maximize the stability and predictability of spending distributions. In other words, minimize spending shortfall risk

The purpose of a spending policy is to determine and document how Institution X intends to balance these objectives. Typically, a spending policy has two components:

- **Target Rate**: The annual amount withdrawn from the endowment expressed as a percentage of the endowment's market value.

  If the Target Rate corresponds with the real return on the endowment over a given period, the real value of the spending stream and of the endowment's assets will have been maintained over that period.

- **Spending Rule**: The formula for determining annual spending withdrawals and the mechanics of its implementation.

  The Spending Rule is designed to reduce annual variability in spending.

Note: *New gifts to the endowment should be used to enhance programs rather than to maintain the status quo. In other words, gifts should not be used to subsidize excessive spending; rather, the spending policy should ensure that over the long term the real value of the fund—adjusted to reflect new additions from gifts—is maintained.*

Alternative Spending Rules

Five common spending rules:

I. **Spend Income Only**: Spend all or a portion of current investment income (dividends and bond coupon payments) and reinvest all capital gains.

- Spending will increase or decrease with interest rates and dividend policies.
- Spending needs may influence portfolio asset allocation as well as sector and security selection (e.g., overweighting higher yielding stocks).
- Spending may exceed a long-term sustainable rate during periods of high inflation.

II. **Spend on a Total Return Basis**: Spend a fixed percentage of the portfolio's average market value (e.g., spend 5.0% of the average market value of the previous 12 quarters).

- Spending increases or decreases with investment results, reflecting the variability of the capital markets. The year-to-year fluctuations in spending can be dampened somewhat by including more periods in the calculation of the average market values.
- If the spending rate is less than or equal to the fund's real return, the fund's purchasing power will be maintained.

III. **Spend a Fixed Amount Every Year Adjusted for Inflation**

- The purchasing power of the spending payout will be maintained over time.
- The real purchasing power of the endowment may erode over time depending on investment performance.

IV. **Spend based on a Constant Growth Rule**: Determine base year spending and increase annually by a specific growth rate (e.g., inflation).

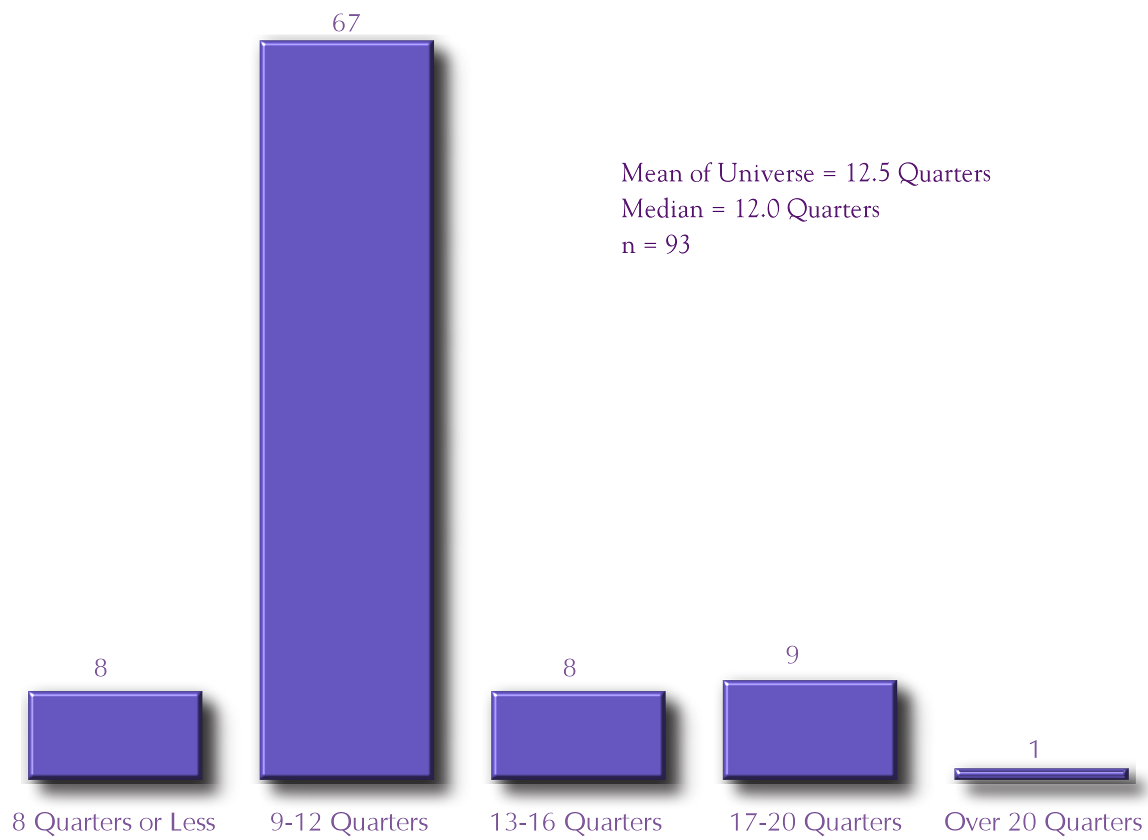
- Spending from the portfolio is easier to budget and exhibits no volatility unless a collar is in place (see below). One needs to make sure this approach does not result in spending that is too high or too low on a percentage basis of the principal value.
- Consider placing a collar on the spending rate (e.g., spend not more that 5% and not less that 2% of principal—calculated as the average principal value over the preceding 12 quarters—in a given quarter). Ensures the principal value of the portfolio is not eroded by reducing spending when portfolio values decline substantially, and will enable increased spending in times of extraordinary capital market performance.
- A constant growth rule with a collar will result in a spending stream that exhibits no volatility unless the cap or the floor of the collar is reached in which case the volatility in that period may be substantial.

V. **Spend based on a Hybrid Rule** – Example: Yale

- Yale's spending rule uses a long-term spending rate of 5.25% combined with a smoothing rule that adjusts spending gradually to changes in the endowment's market value. The amount released under the spending rule is based on a weighted average of prior spending adjusted for inflation (80% weight) and the amount that would have been spent using 5.25% of current endowment market value (20% weight).

College and University Spending Policy

As of June 30, 2007

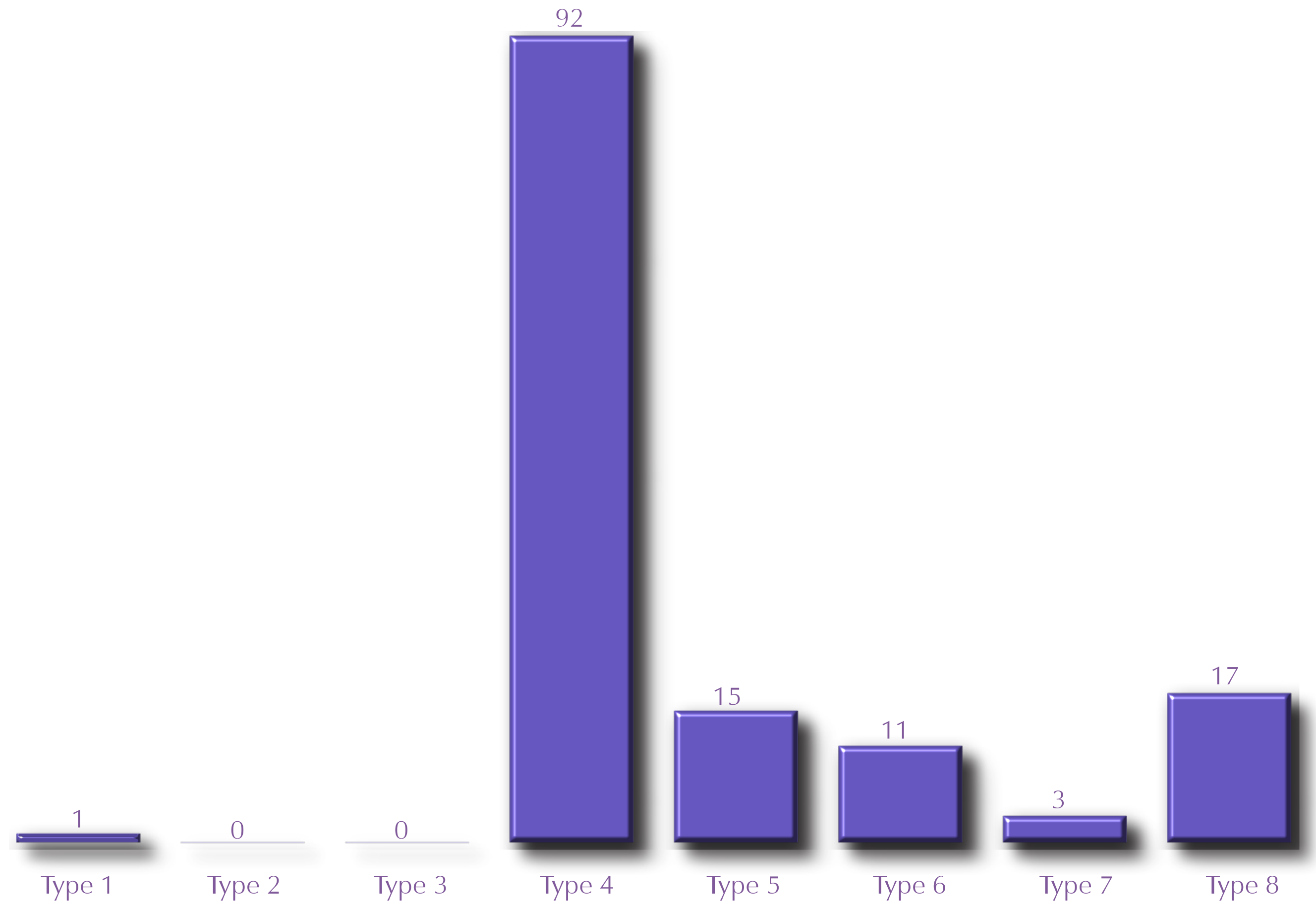


Source: *Cambridge Associates LLC report entitled Analysis of College and University Investment Pool Returns 2006-2007*.

Note: *72% of institutions in this universe use an endowment average of 12 quarters in the market value calculation period*.

College and University Spending Rule Types

Numbers of Institutions as of June 30, 2007

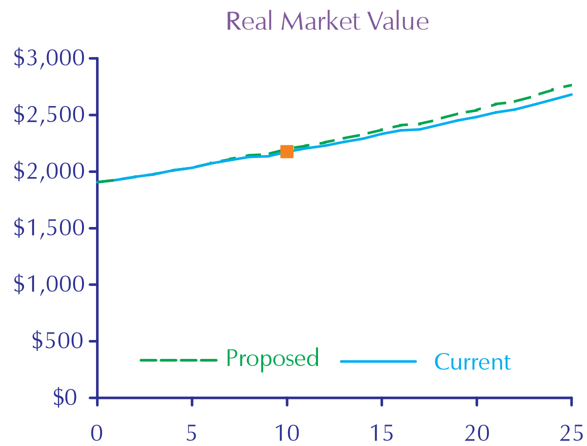


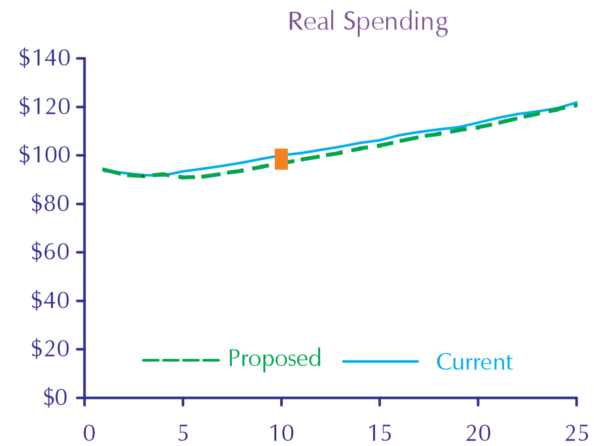
Type 1: Spend all current income.
Type 2: Spend a prespecified percentage of current income.
Type 3: Spend a prespecified percentage of beginning market value.
Type 4: Spend a prespecified percentage of a moving average of market values.
Type 5: Increase prior year's spending by a prespecified percentage.
Type 6: Decide on an appropriate rate each year.
Type 7: No established policy
Type 8: Other rule.

Source: Cambridge Associates LLC report entitled "Analysis of College and University Investment Pool Returns 2006–07."

Baseline Expectations:

Real Spending and Market Values





		Year 5	Year 10	Year 15	Year 20	Year 25
R. Mkt. Value	Current	$2,032	**$2,174**	$2,334	$2,482	$2,680
	Proposed	$2,034	**$2,200**	$2,371	$2,541	$2,766
Real Spending	Current	$93.4	**$100.0**	$106.2	$113.4	$121.8
	Proposed	$90.9	**$96.7**	$104.0	$111.5	$120.7
R. Cum. Spending	Current	$464	**$953**	$1,473	$2,040	$2,657
	Proposed	$461	**$933**	$1,441	$1,994	$2,604

Range of Expectations:

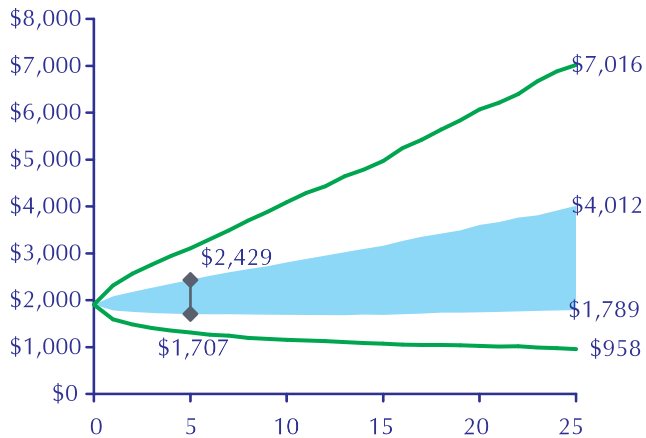
Real Market Values

Probability of Maintaining Purchasing Power

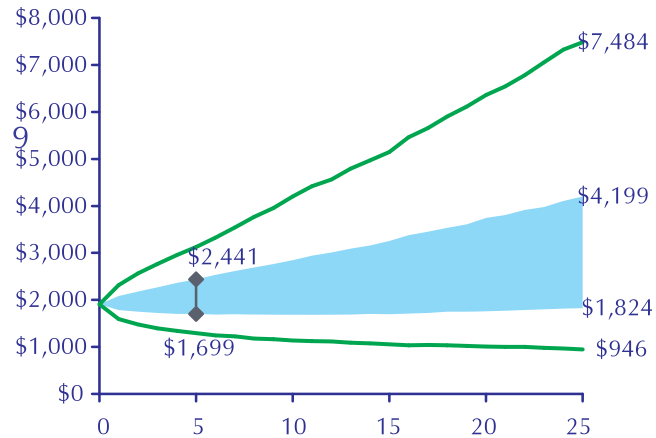
	5 Years	10 Years	15 Years	20 Years	25 Years
Current	60%	64%	68%	70%	72%
Proposed	61%	66%	69%	71%	73%

Expected Range[1] of Real Market Values

Current



Proposed



	5 Years	10 Years	15 Years	20 Years	25 Years
Current	$1707–2429	$1684–2803	$1685–3163	$1739–3604	$1789–4012
Proposed	$1699–2441	$1684–2846	$1693–3253	$1759–3747	$1824–4199

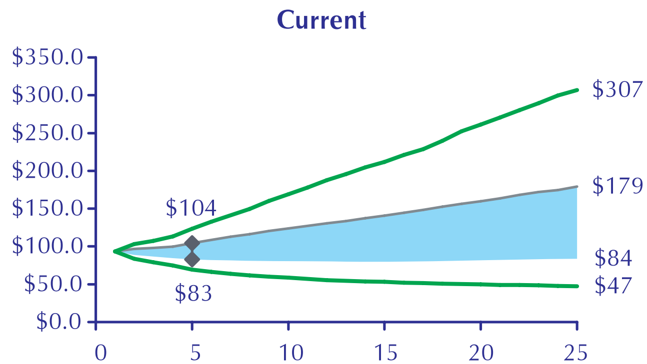
[1] *Range includes 50% of the distribution (25th to 75th percentile)*

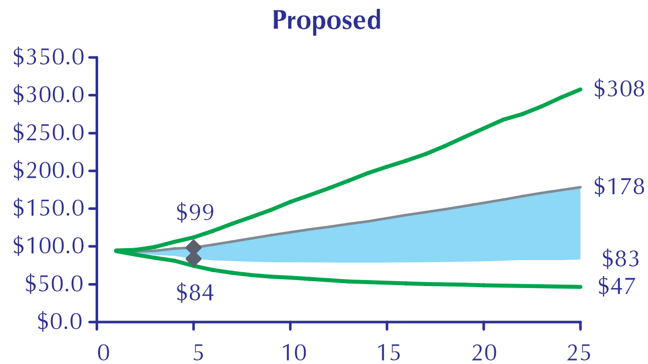
Range of Expectations:

Real Spending

Probability of Maintaining Purchasing Power

	5 Years	10 Years	15 Years	20 Years	25 Years
Current	61%	65%	68%	70%	72%
Proposed	62%	66%	69%	71%	73%





	5 Years	10 Years	15 Years	20 Years	25 Years
Current	$82.9–104.2	$80.7–123.8	$80.0–140.8	$82.2–159.7	$83.8–179.1
Proposed	$83.7–98.6	$79.1–118.6	$78.7–137.5	$80.3–157.8	$82.7–178.3

Expected Range[1] of Real Cumulative Spending

	5 Years	10 Years	15 Years	20 Years	25 Years
Current	$438–491	$854–1068	$1272–1732	$1698–2478	$2146–3317
Proposed	$446–478	$851–1028	$1259–1673	$1675–2409	$2113–3243

[1] *Range includes 50% of the distribution (25th to 75th percentile)*

Spending and Shortfall Model

Summary of Inputs

Spending Rule Summary

Current Spending Rule(s) 5% of average ending market value, trailing 12 quarters

Proposed Spending Rule(s) Move from 5% of average ending market value, trialing 12 quarters, to 5% of average ending market value, trailing 20 quarters, on a quarterly basis.

Beginning Market Value $1907
Inflation Rate 3%

U.S. Equity	16%
Global ex U.S. Equity	17%
Emerging Markets Equity	10%
Absolute Return	18%
Venture Capital	6%
Private Equity	9%
Commodities	1%
Natural Resource Equity	4%
REITs	1%
Real Estate	5%
Oil & Gas	4%
U.S. Fixed Income	4%
U.S. TIPS	1%
Global Fixed Income	2%
Cash	2%
Arithmetic Return	**6.8%**
Standard Deviation	**11.9%**

Consolidated Endowment Spending

Appendix

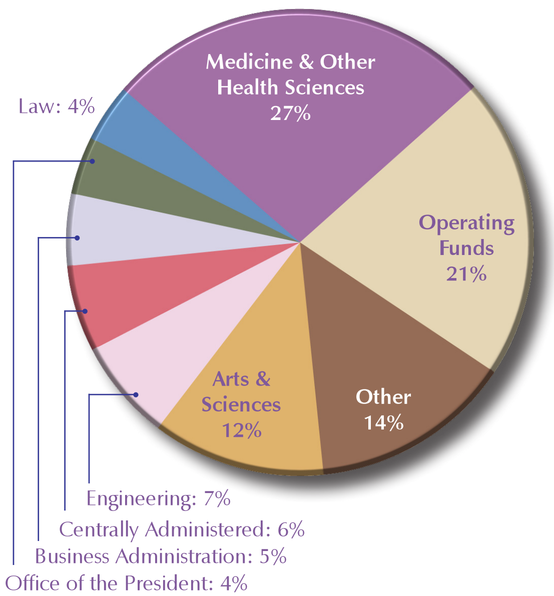
Characteristics of the CEF

Endowment Overview as of June 30, 2008 ($=M)

Endowed Program Support*

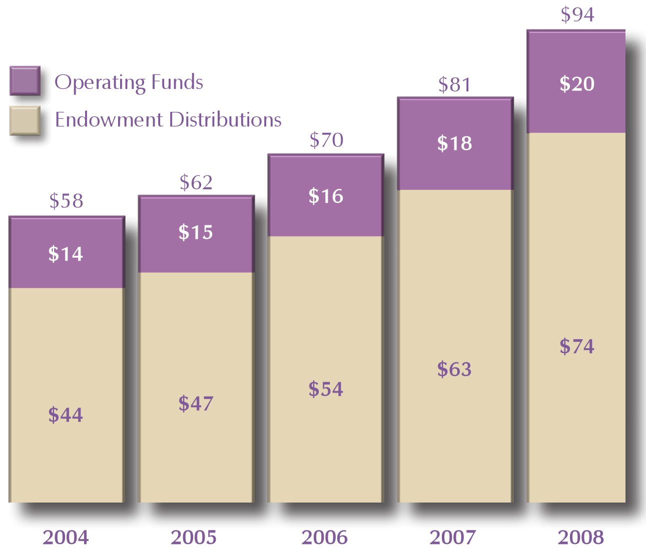
By Purpose

By School and College



* Includes operating funds invested in the CEF

Endowed Dollars Distributed

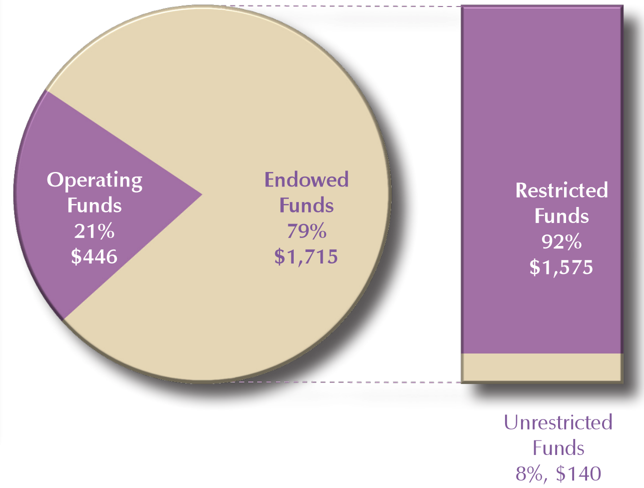


Endowment Distributions as a % of Total UW Revenues

Fiscal Years	Annual UW Revenues	Endowment Distributions	%
2002	$2,322	$55	2.3%
2003	$2,683	$57	2.1%
2004	$2,797	$58	2.1%
2005	$3,025	$62	2.0%
2006	$3,455	$70	2.0%
2007	$4,093	$81	2.0%
2008*	$3,456	$94	2.7%

* Preliminary UW revenue

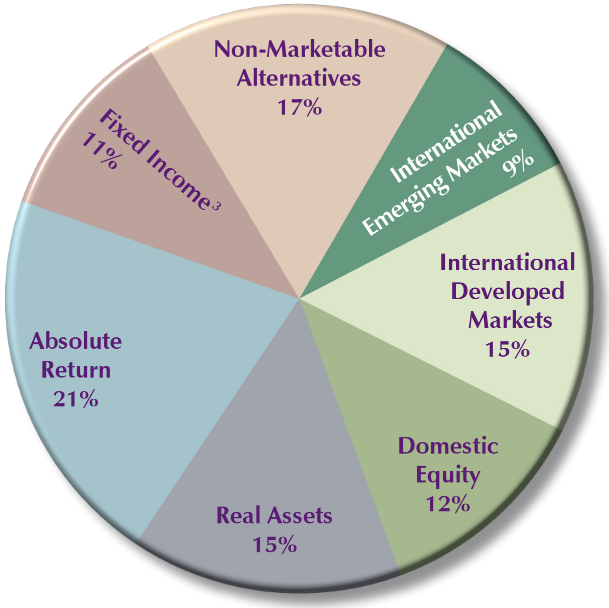
Endowment Composition—$2,161



92% of the University's endowed funds are restricted. In restricted endowments, distributions may be used only for donor-specified purposes. Unrestricted endowment funds may be used for any legitimate purpose of the institution, whether it be scholarships or building maintenance.

Asset Allocation as of October 31, 2008 (est.)

Consolidated Endowment Fund[1]—$1,725 MM



Dollars in Millions

Current Allocation[2]			Policy Target	PolicyRange
Non-Marketable Alternatives	$298	17%	12%	5%-25%
International Emerging Markets	$150	9%	13%	5%-35%
International Developed Markets	$260	15%	16%	5%-35%
Domestic Equity	$209	12%	15%	5%-35%
Equity Fund	$917	53%	56%	45%-75%
Real Assets Fund	$263	15%	15%	5%-25%
Absolute Return	$357	21%	18%	5%-25%
Fixed Income Fund[3]	$187	11%	11%	5%-35%
Total Consolidated Endowment Fund	$1,725	100%		

1. *At 6/30/08: International exposure: 43%, foreign currency exposure: 41%.*
2. *Current exposure percentage may not add to 100% due to rounding.*
3. *Includes allocation to cash.*

Return Required to Meet Current CEF Spending Levels

Total Nominal Return*
Required to Meet Current Spending

Endowment Distributions	5.0%	Policy Spending Level
Development Office	0.8%	Administrative Fees
Treasury Office	0.2%	
Expected Inflation	2.5%	Consumer Price Index
Total Return Required	**8.5%**	

* *Return is assumed net of investment fees (manager, consulting, custodial and legal) of approximately 50 b.p.*

Required Nominal Return Matrix

Spending Level and Administrative Fees

Inflation	**4.0%**	**5.0%**	**6.0%**	**7.0%**
1.0%	5.0%	6.0%	7.0%	8.0%
2.0%	6.0%	7.0%	8.0%	9.0%
3.0%	7.0%	8.0%	9.0%	10.0%
4.0%	8.0%	9.0%	10.0%	11.0%
5.0%	9.0%	10.0%	11.0%	12.0%
6.0%	10.0%	11.0%	12.0%	13.0%
7.0%	11.0%	12.0%	13.0%	14.0%
8.0%	12.0%	13.0%	14.0%	15.0%

Current spending and inflation rate estimate

Endowments Underwater

Status as of September 30, 2008

	Underwater Endowments	Abovewater Endowments	Total
By Number of endowments	812 28%	2,100 72%	2,912 100%
By Market Value	$240.8 M 13%	$1,666.6 M 87%	$1,907.4 M 100%

- *At 9/30/08, most endowments originated in FY06 or later are underwater—that is to say, the market value on these endowments is below cost.*

	Appreciation	Total Market Value
Total CEF	$478.5 M 33.4% over cost	$1,907.4 M 100%

- *Over the next several months, Treasury will meet with beneficiary departments to discuss appropriate spending from underwater endowments.*