Performance Review

Managed Investment Pool (MIP)

- As of 12/31/2011, preliminary results show the MIP with a fiscal year to date net of fees return of -6.7%, with a trailing one year net of fees return of -2.6%, and a trailing seven year return of 4.5%.
- During the past year, active strategies have been challenged by the market as correlations within and across asset classes have been elevated. Positions that worked included asset classes holding Treasuries and high quality large cap equities.
- Managers and strategies have added value over all trailing time periods except the fiscal year-to-date and the trailing one year.
- Active managers in aggregate detracted 60 basis points of value (net of fees) during the trailing one year.
- Aberdeen, an investment manager in the MIP, outperformed its respective benchmark by 720 basis points, net of fees for the year ending 12/31/11. They are a defensive manager that tends to protect assets during a market decline and may lag their benchmark if significant market rallies.
- Wellington was the greatest underperformer in 2011 as they lagged their respective benchmark by 1330 basis points, net of fees. The negative performance was impacted by a larger allocation to emerging markets as well as asset allocation positions such as an underweight to U.S. Treasuries.
- While the MIP underperformed the median endowment in the trailing one year time period, it outperformed the median in the fourth quarter and the three, five, seven, and ten year trailing time periods, ending 12/31/2011.
- With Blenheim underperforming its benchmark by 1030 basis points, Jack Moore asked NEPC to review performance compared to its peers during 2011 and over a longer trailing period.
**Pension Plan**
- As of 12/31/2011, the Plan had a fiscal year to date net of fees return of -6.5%, with a trailing one year net of fees return of -2.7% and a trailing seven year return of 3.2%.
- Active managers in aggregate underperformed the benchmarks during the trailing year by 290 basis points (net of fees).
- In seven out of the last ten fiscal years, the Plan has ranked at or above the median endowment. However, the Plan has fallen short of the median over the trailing time periods on a calendar year basis as of 12/31/2011.
- During the December 12, 2011 Committee meeting, NEPC noted the impact low interest rates can have on pension funding. Declining interest rates increase liabilities which are actuarially determined by taking the present value of future obligations using a certain interest rate. If interest rates fall, liabilities increase because there will be less assumed discounting on future benefit payments. As a result, depending on the Plan funding level, financial statement liabilities could be impacted.
- As of the last actuarial valuation on 7/1/2011, the actuarial value of assets was $47.7 million and the UMS’ Defined Benefit Plan was 97% funded. This is a frozen plan with annual benefit payments of approximately $4.8 million.
- After reviewing the potential impact of interest rates on UMS’ liabilities and the funded status of its Defined Benefit Plan and other obligations, NEPC estimates the Plan’s funded status is 100% as of 12/31/2011. The Plan’s 7.25% expected return continues to be supported by NEPC; however, any future change of that rate could impact the funded status of the Plan. NEPC estimates that a 1% decrease in this rate would increase the liability of the Plan by 9%; however, due to actuarial requirements and smoothing of Plan asset market values, the impact on the financials and funded status may not be as great.

**Operating Funds**
- As of 12/31/2011, the Operating Fund had a fiscal year to date net of fees return of -1.6%, with a trailing one year net of fees return of -0.1% and a trailing 5 year return of 2.3%.
- The Operating Fund performance was strong during the quarter ended 12/31/2011 returning 2.0% and has been positive over the trailing two, three, and five trailing years (net of fees).
- At its December 12, 2011 meeting, the Committee discussed market risk related to the Operating Fund portfolio and whether UMS should put a larger percentage allocation into cash, thereby protecting a greater portion of the Fund from losses but also reducing potential returns. NEPC took these comments into consideration when reviewing asset allocation and, with January being a high cash inflow month, increases in operating cash were placed in the liquidity pool.

**Asset Allocation Study and Recommendations**
NEPC provided an overview of their 2012 capital market observations, including investment opportunities and related recommendations. NEPC made the following Asset Allocation recommendations:

**Managed Investment Pool**
- Increase the allocation to emerging markets equity from 5% to 7%, funding the increase from current international equity managers.
• Approve a 5% allocation to high yield fixed income, initiate a manager search, and fund the mandate from the core fixed income allocation.

**Pension**
• Approve a 5% allocation to emerging markets equity using Aberdeen which is an existing manager in the MIP.
• Approve a 5% allocation to high yield fixed income, initiate a manager search, and fund the mandate from the core fixed income allocation.

**Operating Fund**
• Reduce PIMCO exposure by initiating a short-term Treasury manager search to replace the PIMCO Low Duration allocation.

Lacking a quorum, the above recommendations will be presented for review and approval at the March 19th Board of Trustees meeting. NEPC will be available by phone to answer any questions that may arise.

Discussion included asking NEPC to provide peer information about portfolio asset allocations, particularly percentage allocations to Emerging Markets. In light of the above recommendations, the Committee supported asking Aberdeen to attend the next Investment Committee meeting to provide an update including information about its company, strategies, and their risk mitigation process.

**Gift Fees**
The Investment Committee continued its discussion regarding UM’s and USM’s proposal for charging two gift reinvestment fees – one on outright gifts and the other on endowments. This agenda item was discussed in detail at the Committee’s September and December 2011 meetings.

UM and USM were previously asked to answer the following questions at the Committee’s February meeting:
• What amount of reinvestment revenue would be generated by the proposed gift fees?
• If the gift fees were approved, how would the funds be used?
• What would be the return on investment?

In addition, the following advice was offered by the Committee:
• There will be no fees charged to endowment funds that are “underwater.”
• The proposed endowment fee should be part of, rather than in addition to, the annually approved endowment spending rate.
• A five percent fee on outright gifts may be high compared to peers, so a lesser amount should also be modeled.
• Disclosure needs to be up front, transparent and thorough.
• Annual reporting of fundraising expenses and results will be expected.
• There needs to be a process for allowing exceptions.
• Legal opinions provided by Eaton Peabody must be taken into account.
UM and USM reviewed materials responding to the above questions including: assumptions used in revenue and return on investment projections; potential gift fee revenue generation; Development expenses, gift fee, and bridge funding; and annual reporting and up-front disclosures. The Committee further discussed the legal opinions received from Eaton Peabody and UM’s desire to explore other authoritative materials. Lacking a quorum, the recommendations to permit the fees as indicated along with discussion of any additional authoritative guidance will be discussed at a subsequent Committee meeting.

**UMS Endowment Spending Rate**

At its February 2011 meeting, the Shared Services Advisory Council (SSAC) reviewed the results of the 2010 NACUBO-Commonfund Study of Endowments. The study showed that the average annual effective spending rate for educational endowments was 4.5% (with 4.4% the preceding year and 4.3% prior to that.) The SSAC recommended at that time to reduce the spending rate gradually over a two year period – from 5.0% in FY11 to 4.75% in FY12, moving to a 4.5% spending rate for FY13. At its January 9, 2012 meeting, the SSAC reaffirmed its recommendation of a 4.5% rate for FY13. Dropping the rate allows UMS to be more in line with other educational endowments and to better preserve corpus.

A 4.5% endowment spending rate (which includes the management fee, where charged) equates to a rate per share of $13.30079. Using this rate, an estimated $4.4 million will be available for endowed spending and $222 thousand allocated for management costs in FY13. Because the endowment distribution formula uses a 3-year endowment pool market value average, the dropping off of a low return year (2008) and the addition of a higher return year (2011) results in the estimated dollar distribution for FY13 compared to FY12 being relatively flat, despite the effective spending rate dropping by .25%.

The Committee supports the recommended rate but, lacking a quorum, the endowment distribution rate for FY13 of $13,30079 per share will be presented for approval at the March 19th Board of Trustees meeting.

Adjournment.

Submitted by
Tracy Elliott for
J. Kelley Wiltbank, Clerk