Minutes of the Regular Meeting of the
Oregon State Board of Higher Education
Standing Committee on Finance and Administration
May 7, 2010

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Minutes

1. **CALL TO ORDER/ROLL CALL/WELCOME**

Chair Schueler called the meeting to order at 8:06 a.m.; Secretary Hagemann called the roll. Committee members present included Chair Kirk Schueler, Allyn Ford, and Brian Fox. Director Jill Eiland was absent due to a business conflict.

Chancellor’s Office staff present included: Vice Chancellor Jay Kenton, Doug Botkin, Mike Green, Ryan Hagemann, Karen Levear, and Brian Meara.

Others present included: President Bob Davies (EOU), Lindsay Desrochers (PSU), Laura Hubbard (UO), Virginia Keys (EOU), Mark McCambridge (OSU), and Mary Ann Zemke (OIT); Bill McGee (DAS), Mike Mueller (Treasury), and John Meier (SIS). Mr. Steve Schauble, Vice President and Chief Financial Officer, Oregon State Foundation, and Mr. Jay Namyet, Chief Investment Officer, University of Oregon Foundation also participated.

2. **DISCUSSION ITEMS**

a. **OUS, Pooled Endowment Fund Policy Review**

**DOCKET ITEM:**

**BACKGROUND**

The Oregon University System maintains a Pooled Endowment Fund to facilitate the investment of monies donated to System institutions in perpetuity, as well as larger, non-endowment gifts that are invested like endowments. It is intended that the Fund’s investments earn sufficient returns to provide for the ongoing activities for which the monies were donated, as well as maintain the purchasing power of the corpus over time. The market value of the Fund, as of December 31, 2009, was $60 million and the Fund distributes approximately $2.5 million annually to System institutions for spending. The investment of the Fund is guided by the Pooled Endowment Fund Investment Policy.

**ROLES AND RESPONSIBILITIES**

The role of the Board, with respect to the Fund, carried out through its Finance and Administration Committee (Committee), is to develop broad investment guidelines, including
goals and commitments with respect to the spending rate from the Fund, along with investment return expectations and risk tolerance which will shape the Fund’s asset allocation. The Oregon State Treasury, with the assistance of the Oregon Investment Council’s consultant (Strategic Investment Solutions [SIS]), works with the Committee to review the spending rate policy and discuss various risk/return profiles to help develop the Investment Policy. The Investment Policy is then approved by the Committee and the Oregon Investment Council, which, by law, has the ultimate authority for investment decisions related to the Fund. The Investment Policy (attached) was last updated in April 2008 and requires that it be reviewed and updated every two years.

**DISCUSSION AND POLICY REVIEW PROCESS**

Currently, the Investment Policy provides for the distribution of 4 percent of the rolling 5-year average market value of the Fund for spending. This spending model, in use by the System for over 20 years, serves to smooth the effects of temporary market fluctuations on the amounts distributed. A recent survey of System institution management indicated that this model has been working well; no institution requested a change.

Over the past several years, some Committee members have been concerned with the returns of the Fund in relation to the broader market and have questioned the Fund’s performance relative to the returns of the endowment funds of the OSU and UO foundations. In order to help facilitate a comprehensive discussion of these concerns, staff met with the investment officers of the OSU and UO Foundations, Treasury staff, and SIS to review the current Investment Policy and highlight areas for further discussion.

The draft policy is currently under review by the State Treasurer’s Office and their consultant, SIS (Strategic Investment Solutions), and will also be reviewed and approved by the Oregon Investment Council. The full text of the proposed policy and SIS presentation are available at: [http://www.ous.edu/state_board/meeting/dockets/ddoc100507-FA.pdf](http://www.ous.edu/state_board/meeting/dockets/ddoc100507-FA.pdf) [http://www.ous.edu/state_board/meeting/dockets/ddoc100507-FA1.pdf](http://www.ous.edu/state_board/meeting/dockets/ddoc100507-FA1.pdf).

**COMMITTEE DISCUSSION:**

Chair Schueler announced that the order of the published agenda will be adjusted to accommodate guest participants. He then called upon Associate Vice Chancellor and Controller Mike Green who introduced Mr. Mike Mueller (Oregon Department of Treasury) and Mr. John Meier, managing director, Strategic Investment Solutions, Inc., to direct the discussion.

Mr. Meier began with a brief description of the investment process: 1) objectives, policies, and guidelines; 2) asset allocation strategy types; 3) benchmarks; 4) manager structure; 5) manager sourcing; 6) manager evaluation; 7) documentation; and 8) ongoing evaluation. It was noted that the asset allocation is the primary driver of investment results and makes up 80-90 percent of the fund management framework. The Asset Allocation Policy addresses three primary risks: 1) Asset Shortfall Risk (liquid assets insufficient to meet current obligations), 2) Interest Rate...
Risk (changes in spending related to change in interest rates), and 3) Inflation Risk (changes in spending related to changes in inflation).

During the presentation, Director Ford asked if campus endowment funds could be consolidated similar to the Internal Banking structure; Green advised that, because of the separate trust funds and different liability streams, it would be difficult even though the same managers are used. Controller Green added that there has been discussion to negotiate with one foundation to manage all of the foundation funds. Chair Schueler pointed out that this discussion concerns only the presently pooled endowment fund policy.

Typical endowment objectives include maintaining the purchasing power of the corpus, maximizing distributions, limiting distribution volatility, and limitation; while these objectives may be achievable over a long time period (30-plus years) none of them recognizes the market’s risk characteristics and may be impossible to meet in a protracted Bear market.

He asked, with the listed possible objectives, do the “unacceptable outcomes” include: value of corpus? distribution level? or changes in distribution level? Controller Green advised, from a staff viewpoint, the goals to maintain/grow the purchasing power of the corpus and to achieve stable distributions, the unacceptable outcome would be an erosion of the corpus; however, given the size of the fund, the distribution level and changes in distribution level, the fund enjoys more flexibility. Chair Schueler asked, with the current distribution level at 4 percent, would the new policy change that level? Meier replied that there could come a time in the market where the System would not be able to tolerate that distribution percentage level in dollar-terms in the short-term because of the risk being taken in the assets.

In response to Director Ford’s question concerning the average percentage of rate of return on endowments, Mr. Mueller advised that the Oregon State Foundation is 4.5 percent and the University of Oregon Foundation is 4 percent. Mr. Jay Namyet advised that the majority of university foundations across the country maintain a 4 to 5 percent distribution rate. Meier agreed and stated that, with that rate and an inflation rate of 2 to 4 percent, an expected rate of return is 8 to 9 percent.

Ms. Karen Levear asked about the percentage of equity (equity is at approximately 50 percent, with a ratio of 50/50 domestic and international) and asked if Mr. Meier was proposing that a lower percentage would be appropriate. Meier replied that to build an “all weather” portfolio, one that works in a global growth environment as well as working in an inflationary environment, anything higher than 40 percent equity doesn’t earn the required returns with the level of risk that’s suitable for this type of distribution to a university. Everything else must be a “diversifier” that will behave differently than the equity markets.

Director Ford asked what time horizon is used in the presentation; Meier’s replied that a two-to three-market cycle is a 20-year or 30-year horizon. The risk of the 20-year horizon, over any shorter period of time, could be substantially different and therefore risk sensitivity tests are conducted to predict outcomes. Ford asked if, in the assumptions, the market-value of bonds is
considered even though the bonds are held to maturity. Meier stated that the presentation is looking at a broad-based bond type of portfolio and the yield to maturity.

In looking at the dollar size of potential new allocations there were two paths demonstrated, assuming a 15 percent allocation: 1) a TIPS investment of $9.5 million or 2) in diversified real assets ($3.2 million in each: TIPS, real estate, and commodities/hard assets) [TIPS-Treasury Inflation-Protected Securities].

Mr. Meier concluded his presentation by stating next steps include two alternatives: 1) adjust and maintain the current policy to adopt TIPS/real assets allocation funded from fixed income (maintain current public- and private-equity policy allocations), investigate incorporating other real assets into allocation over time, and/or maintain current spending policy or 2) look at a full asset/spending analysis and investigate the range of spending asset mix policies.

Director Ford asked if Alternative #1 was included on the Asset Class Optimization scale presented on slide 16; Mr. Meier noted that, as Mix 3-1 is similar to the current portfolio, to “roughly put half of it as a first step into TIPS and then, over time, if opportunities arose in the Real Asset category, then diversify even further by putting some of that allocation into TIPS and some into some other inflation-sensitive asset that might achieve a slightly higher return.”

Chair Schueler asked Controller Green if the Committee should act on the proposed alternatives and, if there was to be change enacted in the policy, where would that change be reflected. Green advised that, if the Committee chose Alternative #1 to explore, Treasury and SIS would then return in the next Committee meeting with an updated policy to reflect that decision. Amendments to the policy would not be decided in the present meeting. Mr. Mueller advised that the actual asset allocation decision and the policy change would be made by the OIC, with the Committee’s input. Mueller further advised that the OIC has introduced hedge funds into their investment strategy but are very conscious of fees. It was decided by the Committee to recommend that the asset allocation strategy be modified, incorporating Alternative #1, with an annual review until a trend is established (Directors Allyn Ford made the motion and Brian Fox seconded; those voting in favor included Chair Kirk Schueler and Directors Allyn Ford and Brian Fox). Chair Schueler requested that changes to the policy be submitted to the Committee incorporating the approved changes.

b. OUS, Investment Policy for Operating Funds

DOCKET ITEM:

The implementation of the Internal Bank will consolidate all OUS cash balances into one account. This account will hold significant balances that are not needed to meet liquidity needs, which provides the opportunity to invest these balances differently to gain incremental investment returns. The investment policy, that will govern the investment of these balances, is intended to set forth the System’s tolerance for investment risk and expectations for investment returns.
The provisions of the policy include:
- Objective – Clearly stated goals of the investment activity;
- Portfolio Allocation – Stratification of the balances for investment purposes;
- Risk Profile – Clearly stated risk parameters for each allocation within the program;
- Permitted Holdings – Guidelines of the types of investments permitted for each allocation within the program;
- Diversification – Guidelines intended to limit various risks through diversification of the investments within the program;
- Counterparties – Discussion of counterparty risk and procedures intended to mitigate and minimize such risks;
- Strategy – Guidelines regarding the investment of each allocation within the program;
- Liquidity – Procedures related to ensuring adequate liquidity while recognizing the State Treasurer’s timing requirements;
- Portfolio Restrictions – Guidelines related to the types of investments allowed;
- Policy Compliance – Requirements for external managers to remedy compliance issues; and
- Performance Expectations/Reviews – Measurable expectations relating to performance of the fund relative to appropriate benchmarks.

The full text of the proposed policy is available at:
http://www.ous.edu/state_board/meeting/dockets/ddoc100507-FA.pdf

COMMITTEE DISCUSSION:

Chair Schueler called upon Controller Green and Ms. Karen Levear, Director of OUS Treasury Operations, to present the item. Ms. Levear emphasized that the proposed policy is in draft form and has been reviewed for comment by the State Treasurer’s Office. With the Committee’s review and comments, it is anticipated that the policy will then be returned for final Committee approval and submission to the OIC.

Levear explained that, under procedures portfolio allocation, the long-, intermediate-, and short-term portions were determined conducting by a core deposit analysis (core cash on hand) and it was noted that at no time over the past five years has OUS had less than $400 million on hand. Currently, the System maintains over $1 billion on hand, therefore, allocating the $400 million is a conservative approach. However, 25 percent of that amount has been received in bond proceeds, which are designated funds and not available for investment allocation. In response to Director Ford’s question pertaining to matching asset liabilities, Levear advised that, although the System maintains approximately $1 billion in debt and $1 billion in cash on hand, those portfolios are maintained separately. Director Fox asked why dollar amounts are used rather than percentages and Levear advised that setting a dollar amount (the $400 million) would ensure that the funding floor is not compromised. In the long run, a
percentage versus dollar amount may be used, but given the current economic volatility, a floor needs to be established.

Pertaining to the risk profile, in the short-term portion (approximately $600 million) the primary objective is preservation of principal above all else; therefore, the sole permitted holding will continue to be placed in the Oregon short-term investment fund pool—which is a dollar-in/ dollar-out pool and the benchmark for earnings is the 90-day treasury. Treasury will begin the Oregon intermediate-term fund pool, which will look more like a mutual fund and will not have dollar-in/dollar-out guarantee—there will be risk to the net asset value. To that end, a separately managed portfolio of additional individual investments will be maintained; these investments may be invested in the intermediate-term fund pool, however, OUS’ credit quality standards are slightly higher than the Treasury’s intermediate-term fund pool. In the event that the System needs to access the intermediate-term portion to cover liquidity needs and if money cannot be accessed in the intermediate-term funding pool and preserve the principal, there would be alternatives to look to the other investments that perhaps could be liquidated at a better cost.

With the longer-term portion, high credit quality is emphasized and would not acquire anything that is not “AAA”; “we’re willing to hold the investments if they are downgraded as low as ‘A’ and then would require liquidation.” To provide additional investment flexibility, Levear noted that she is recommending the addition of taxable municipal bonds with “AAA” ratings. This recommendation will be discussed with Treasury.

Levear advised that Section 6, Counterparties, is a new addition to the policy and details who the counterparties may be and establishes that they can deliver/perform their expected duties in a timely professional manner (investment brokers, custodial agents, or servicing agents). This section establishes that Treasury affirms that each counterparty have sufficient strength to accomplish the business they have contracted with the System to provide.

Section 9, Portfolio Restrictions, establishes very strong statements/guidelines, including the exclusion of CDOs (Collateralized Debt Obligations), CLOs (Collateralized Loan Obligations), and Z-Tranche (Collateralized Mortgage Obligations) investments. Levear opined that the listed restricted investments provide too much credit risk, therefore, were clearly stated in the policy.

Vice Chancellor Kenton recommended including a two-year review of the policy; General Counsel Hagemann advised that policies are governed by the “Policy on Policies,” which establishes periodic reviews of policies. Kenton recommended inclusion in the policy and Chair Schueler agreed.
3. **ACTION ITEMS**

a. **OUS, Report on Investments – As of March 31, 2010**

**DOCKET ITEM:**

The investment report for the third quarter of FY2010 is presented below. The following is a brief summary of the information contained in the report.

As of March 31, 2010, total OUS investments had a combined market value of approximately $386 million, summarized as follows:

<table>
<thead>
<tr>
<th>Fund</th>
<th>Market Value March 31, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Endowment Funds</td>
<td>$63,133,546</td>
</tr>
<tr>
<td>Donation Funds</td>
<td>65,186,714</td>
</tr>
<tr>
<td>Bond Building Funds</td>
<td>166,338,972</td>
</tr>
<tr>
<td>Bond Sinking Funds</td>
<td>56,430,050</td>
</tr>
<tr>
<td>Auxiliary Enterprise Building Repair and Equipment Replacement Reserves</td>
<td>34,593,688</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$385,682,970</strong></td>
</tr>
</tbody>
</table>

**HIGHER EDUCATION POOLED ENDOWMENT FUND – OREGON STATE TREASURY’S DISCUSSION OF PERFORMANCE**

While the first month of the New Year was negative for stocks, February and March reversed course, with the quarter closing up nearly 6 percent for the broad market Russell 3000 Index. International markets were positive as well, up 1.6 percent for the quarter, as measured by the MSCI All Country World Index (ex-U.S.). The second quarter should provide a test for the domestic stock market which is now up over 50 percent in the last 12 months (who would have predicted that?). As reported in the Wall Street Journal recently: “As the second quarter gets under way, stocks face perhaps their biggest hurdle of the year with the Fed inching forward with its plans to end, and ultimately reverse, its unprecedented easing of credit.”

The HIED account continued to perform well, up 3.7 percent, exceeding the policy benchmark by 20 basis points. With the exception of Columbia Acorn, all the HIED publicly traded securities managers exceeded their benchmarks over the last 12 months. It should be noted, however, that Columbia Acorn’s one year performance of 65 percent and their longer term performance in the OPERF portfolio, makes them perhaps the best manager of the group. As credit spreads tightened, Western Asset beat their benchmark by nearly 261 basis points, year-to-date. All in all, a very solid quarter for the fund and the one year return of 44 percent is remarkable. However, the impact of 2007 and 2008 continues to be felt and will be felt, in the longer-term performance, for some time.
POOLED ENDOWMENT FUND ASSET ALLOCATION
With the addition of Alliance Bernstein Global to the asset mix of the Pooled Endowment Fund, the actual asset allocation, as compared to the policy allocation ranges, became a bit obscured in the Investment Summary (attached). This is because Alliance Bernstein includes both U.S. and Non-U.S. investments. For the purposes of measuring the actual asset allocation against the policy allocation ranges, it is necessary to prorate the Alliance Bernstein Global Fund between U.S. and Non-U.S. equities.

The weighting used to break out the U.S. and Non-U.S. portion of the Alliance Bernstein Global Fund is based on the MSCI All Country World Index. The current break out is: 48 percent U.S. and 52 percent Non-U.S. When this fund is prorated between domestic and international equities using these percentages, the totals fall within the policy allocation ranges as shown below.

<table>
<thead>
<tr>
<th>HIED</th>
<th>Policy</th>
<th>Target</th>
<th>$ Thousands</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Equities</td>
<td>25-35%</td>
<td>30%</td>
<td>$19,054</td>
<td>30.1%</td>
</tr>
<tr>
<td>International Equities</td>
<td>25-35%</td>
<td>30%</td>
<td>20,956</td>
<td>33.1%</td>
</tr>
<tr>
<td>Alternative Investments</td>
<td>0-10%</td>
<td>10%</td>
<td>5,123</td>
<td>8.1%</td>
</tr>
<tr>
<td>Total Equities &amp; Alternatives</td>
<td>65-75%</td>
<td>70%</td>
<td>45,133</td>
<td>71.3%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>25-35%</td>
<td>30%</td>
<td>17,793</td>
<td>28.1%</td>
</tr>
<tr>
<td>Cash</td>
<td>0-3%</td>
<td>0%</td>
<td>335</td>
<td>0.6%</td>
</tr>
<tr>
<td>TOTAL HIED</td>
<td></td>
<td></td>
<td>$63,261</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

DONATION AND OTHER INVESTABLE FUNDS
Donation and other funds available for investment were invested in the Oregon State Treasury Short-Term Fund and returned 0.14 percent for the quarter, which exceeded the 91-Day T-Bill rate of 0.01 percent.

STAFF RECOMMENDATION TO THE COMMITTEE
Staff recommended the Committee accept the Investment Report as of March 31, 2010.

COMMITTEE DISCUSSION AND ACTION:

Chair Schueler called upon Controller Mike Green and Mr. Mike Mueller, State Treasurer’s Office, to present the report. Following the presentation, Chair Schueler called for a motion to approve the report; Directors Allyn Ford made the motion and Brian Fox seconded. Those voting in favor included: Chair Kirk Schueler and Directors Allyn Ford and Brian Fox; motion was approved.
b. OUS, Managerial Reporting – Quarterly Management Report

DOCKET ITEM:

The quarterly management reports as of March 31, 2010, are available at http://www.ous.edu/state_board/meeting/dockets/ddoc100507-FA.pdf. After reviewing the Budget Projections Summary received from each university and comparing prior year results, the following was noted:

EDUCATION AND GENERAL – LIMITED
Revenue collections are projected to be 10 percent above 2008-09 mainly due to a $102 million or 18 percent increase in tuition and resource fee revenues. The increase in tuition and resource fee revenues is primarily due to a combination of tuition rate increases, a projected 7 percent increase in student FTE enrollment and change in the mix of student enrollment.

Revenue collections year-to-date are 7 percent over the prior year due largely to increases in nonresident tuition for all terms. Spending is down 4 percent year-to-date; however, spending is projected to be 1 percent above the prior year spending at year-end. The increase in spending is primarily due to supplies and services expenses related to technology upgrades and supporting enrollment increases.

The ending fund balance of Education and General – Limited is projected to be $140 million, which is $60 million higher than the prior year. The June 30, 2010, ending fund balance of Education and General – Limited is projected to be 12 percent of Operating Revenues, a 59 percent increase from the beginning of the year.

All institutions’ ending fund balance are projected to be within the recommended reserve level of 5–15 percent of operating revenue, WOU’s range is 10 – 20 percent.

AUXILIARY ENTERPRISES
Systemwide, Auxiliary Enterprises are projected to have total revenues of $358 million and expenditures of $347 million, resulting in $11 million of revenues over expenditures. Unrestricted Net Assets are projected to increase $7 million to $67 million. Please refer to the explanatory notes on the institution and Chancellor’s Office reports for additional information.

DESIGNATED OPERATIONS, SERVICE DEPARTMENTS, AND CLEARING FUNDS
Systemwide, Designated Operations and Service Departments are projected to have total revenues of $113 million and expenditures of $110 million, resulting in $3 million of revenues over expenditures. Unrestricted Net Assets are projected to increase $3 million to $31 million. Please refer to the explanatory notes on the institution and Chancellor’s Office reports for additional information.
STAFF RECOMMENDATION TO THE COMMITTEE
Staff recommended that the Committee accept the Quarterly Management Report for March 31, 2010.

COMMITTEE DISCUSSION AND ACTION:

Chair Schueler again called upon Controller Mike Green to present the report for approval. Green noted that in every institution’s report, the state General Fund realization rates ran lower compared to the prior year. That difference is due to a reduction in the appropriations funding that occurred in the prior biennium that impacted the second half of Fiscal Year 2009. Also, pursuant to the provisions of the Optional Retirement Plan, accumulated employer contributions that were forfeited by employees who have left OUS prior to vesting, were used to offset March and part of April employer contributions. As a result, March personnel expenses for OUS, in total, reflects $3 million in reduced employer contributions and April will realize an additional $1.8 million reduction. These reductions accrued to all institutions and all fund types where ORP participant salaries are charged. In the future, this adjustment will be made annually and is not expected to be material as this was an accumulation of a number of years of forfeitures in that Plan and the Plan has specific parameters that require those funds to be utilized in a certain fashion. This is one of the ways in which the Plan can use those assets. Lastly, as mentioned in prior reports, the supplies and services (S&S) burn rates are running lower in 2010 than in FY 2009 due to 1) annual tort property and insurance assessments were expended fully in the first quarter of 2009 versus expenditures occurring quarterly in 2010, which creates a burn rate change; and 2) accounting for debt service payments were re-designated from transfers-out to an S&S expense.

In answer to Director Fox’s query, Vice Chancellor Kenton advised that, with the anticipated $2.5 billion revenue shortfall and the continuing fiscal reduction trend, campuses will be working toward building their fund balances by tightening managerial practices and deferring decisions. He further stated that the state has requested that agencies provide a 25 percent reduction plan in anticipation of a “draconian budget” in 2011-2013.

Following the presentation and discussion, Chair Schueler called for a motion to approve the report; Directors Brian Fox made the motion and Allyn Ford seconded. Those voting in favor included: Chair Kirk Schueler and Directors Allyn Ford and Brian Fox; motion was approved.

4. APPROVAL OF MINUTES

Chair Schueler called for a motion to approve the minutes; Directors Allyn Ford made the motion and Brian Fox seconded. Those voting in favor included: Chair Kirk Schueler and Directors Allyn Ford and Brian Fox; motion was approved.
5. **ADJOURNMENT**

With no further business, Chair Schueler adjourned the meeting at 9:54 a.m.