**TOPIC**: University System of Maryland: Proposed Board of Regents Policy on Endowment Fund Investment Objectives

**COMMITTEE**: Finance

**DATE OF COMMITTEE MEETING**: September 1, 2011

**SUMMARY**: The Board of Regents Finance Committee is charged with oversight over approximately $198 million of endowment funds that collectively are referred to as the Common Trust Fund. The Common Trust Fund represents more than 400 individual funds which each have a specific donor purpose for spending income and a stipulation that the original gift be invested in perpetuity.

Since 2005, the System has contracted with the University System of Maryland Foundation to perform investment management services for the Common Trust Fund. The USM Foundation also invests, in a single, 'unitized' (meaning that each individual fund in the portfolio is treated equally according to a set of rules) portfolio of close to $800M, endowments of most of the System's affiliated foundations along with the Common Trust Fund. The legislation enacted in 2004 enabling the System to select the USM Foundation directly as its investment manager also required that the System adopt an Investment Policy which would guide the Board of Regents in its assessment of the Foundation's performance as investment manager over the Common Trust Fund.

The proposed policy establishes investment objectives for the Common Trust Fund under 2 possible investment arrangements; (1) direct investment management, in which the Finance Committee decides itself the appropriate asset allocation and specific fund managers to be hired, retained or fired, and (2) indirect investment management, in which the Finance Committee selects an investment manager which is charged with the responsibility to decide asset allocation and hire, retain or fire individual fund managers. The current arrangement with the USM Foundation is an example of indirect investment management under the proposed policy.

The policy sets as a standard for indirect investment management meeting or exceeding risk-adjusted investment returns for the 65$^{th}$ percentile of similarly-sized endowment portfolios as measured the Wilshire / Trust Universe Comparison Service (TUCS) index in at least 3 out of every 5 fiscal years, and at least every other fiscal year. This assessment would be performed annually as a part of the annual performance reporting, and in years where the investment manager does not meet the standard, a review of the investment manager's performance and current operating circumstances would be conducted using an outside consultant.

**ALTERNATIVE(S)**: The Finance Committee could adopt a different standard for assessing investment manager performance.

**FISCAL IMPACT**: None

**CHANCELLOR'S RECOMMENDATION**: That the Finance Committee recommend that the Board of Regents approve for the University System of Maryland Proposed Policy on Endowment Fund Investment Objectives

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| COMMITTEE RECOMMENDATION: | DATE: |
| BOARD ACTION: | DATE: |
| SUBMITTED BY: Joseph F. Vivona (301) 445-1923 | |

277.0 VIII-5.50 - POLICY ON ENDOWMENT FUNDS INVESTMENT OBJECTIVES

(Approved by the Board of Regents )

## I. Purpose

The purpose of this policy is to:

A. Establish guidelines for evaluating investment manager and fund manager (where appropriate) performance,
B. Specify a general framework for arriving at asset allocation and fund manager selection decisions under a direct investment management approach, and
C. Identify and set general considerations and requirements associated with the investment of University System of Maryland endowment investments.

## II. General

A. Role of the USM and the Board of Regents Finance Committee. In accordance with Maryland law, the University System of Maryland has received endowments, funds functioning as endowments, and gifts that are invested separately outside of the State Treasurer. The Board of Regents Finance Committee, as specified in its By-laws, is to 'receive reports and recommendations from the University System of Maryland investment adviser and investment manager and provide recommendations to the Board regarding the endowment policies of the University System of Maryland'.

B. Common Trust Fund. The aggregate of endowments, funds functioning as endowments, and gifts that are invested separately from those operating funds held by the State Treasurer, is known as the Common Trust Fund.

C. Indirect Investment Management. The Board of Regents Finance Committee may choose to hire an investment manager to oversee, hire and fire individual investment fund managers, and make decisions as to the appropriate asset allocation, risk attributes, and portfolio liquidity. This is to be considered the ***indirect investment management*** approach to investing and Board of Regents oversight.

D. Direct Investment Management. Alternatively, the Finance Committee may directly manage the investment of the Common Trust Fund by engaging one or more investment managers in asset types or categories that would produce an appropriately diversified investment approach that balances expected investment returns of different asset categories and investment vehicles against the associated types of risks. The System should retain an independent investment advisor to provide guidance and advice on the overall asset allocation and selection and dismissal of individual investment managers. This is to be considered the ***direct investment management*** approach to investing and Board of Regents oversight.

E. Goal of the Common Trust. The Common Trust Fund is invested with a goal of maintaining the value of funds at an amount that will yield, over time, a consistent level of purchasing power of the spendable income used to satisfy donor-specified purposes.

## III. Investment Performance Reviews, Reports and Presentations

As part of the Board of Regents Finance Committee's periodic review of investment performance and the performance of individual investment managers, investment managers shall present a review of the portfolio investment performance, risk profile, and asset allocation on at least an annual basis, as follows:

### *A. Indirect Investment Management*

1. Annual Evaluation. Investment managers selected to oversee individual investment assets, or oversee groups of individual fund managers, will be evaluated at a minimum of annually on the basis of investment results realized, recognized or reported, as compared with an appropriate investment return benchmark. The benchmark used to evaluate the performance of the investment manager will reflect the Board of Regents needs for investment returns in the context of investment opportunities and spending needs.

2. Advisory Firm. An investment advisory firm will be retained annually to assist with quantitative analysis and performance comparisons for the Common Trust Fund. The firm selected will be independent and recognized in the field as having appropriate experience and expertise in assessing endowment fund investment performance.

3. Quantitative Evaluation Benchmark. For purposes of evaluation of investment managers the change in the Wilshire / Trust Universe Comparison Service (TUCS) index will be the benchmark for evaluating investment performance where the System has hired a single investment manager to direct the investment of the Common Trust Fund. In the event that investment performance for the Common Trust Fund falls below the 65$^{th}$ percentile of the Wilshire / Trust Universe Comparison Service (TUCS) on a risk-adjusted basis for portfolios of the size or value of the Common Trust Fund, for two (2) consecutive fiscal year periods, or more than (2) fiscal year periods out of any running five year period, the Finance Committee will be required to review the investment manager's performance since inception and make a decision on whether or not to continue investing with the same investment manager as specified in paragraph 5.

4. Non-Quantitative Evaluation Criteria. Other non-quantitative attributes will be considered annually, including:

   a. Unexpected and non-strategic changes in the asset allocation;
   b. Unexpected changes in investment strategy;
   c. Extreme and unanticipated levels of volatility of investment returns;
   d. Changes in general economic conditions; and
   e. Failures on the part of the investment manager to meet reporting requirements to the Finance Committee or failures in meeting attendance expectations.
   f. staff turnover and organizational changes
   g. instances of fraud or illegal acts associated with investment manager

h. legal, Securities Exchange Commission or other regulatory proceedings

5. Post-Review Actions. If the investment manager fails to meet investment benchmark criteria, or should consideration of the above non-quantitative attributes warrant, the investment advisor will be engaged to perform an assessment of investment manager performance and present a review, alternatives, and a recommendation to the Finance Committee.

6. Socially Responsible Investment Goals or Strategies. The Board of Regents must balance the needs of satisfying its obligations as fiduciaries over the Common Trust Fund with socially-responsible investment goals or strategies. Specifically, in instances where the Board of Regents would like to adopt socially-responsible investment goals or strategies, the Finance Committee of the Board of Regents is to collaborate with the investment manager to arrive at a workable goal that:
   a. Minimizes the exposure of Board of Regents goals on the performance evaluation of the Investment manager; and
   b. Minimizes or mitigates the impact of socially-responsible investment goals or strategies on the ability of the investment manager to serve its clients generally.

## *B.* ***Direct Management of Investment***

1. Independent Investment Advisor. The Finance Committee will engage an independent investment advisor to assist and support the Finance Committee in:

   a. Evaluating the investment environment;
   b. Assessing an appropriate level of risk tolerance;
   c. Developing an asset allocation strategy, including re-balancing mechanisms, to be used in making investment decisions; and
   d. Identifying appropriate asset class benchmarks for use in evaluating the performance of investment fund managers.

2. Periodic Review of Assumptions and Strategies. A periodic review and reassessment of basic investment assumptions and asset allocation strategy should be done no less frequently than every five years.

3. Selection and Review of Fund Managers

   a. Selection. Selection of fund managers will be based on efficient and time-aware competitive selection processes that satisfy any and all relevant state or System procurement policies applicable. At the presentation of a new fund manager for the hiring approval of the Finance Committee, a performance benchmark is to be identified for use in evaluating the fund manager's investment performance.

   b. Reporting. Each fund manager will be expected to provide an annual report to the Finance Committee summarizing investment performance for the past year and since engaged as a fund manager for the System. The report should compare investment performance compared with asset class benchmarks selected and approved by the Finance Committee.

c. Review by the Independent Investment Advisor. The independent investment advisor will also review the investment performance of the Common Trust Fund in the aggregate in terms of meeting the investment objectives for the portfolio as a whole, as well as providing comments and analysis of the performance of each individual fund manager.

4. Post-Review Actions. Fund managers whose investment performance falls below the appropriate benchmark more than 1 year out of any running 5 year will be reviewed for replacement. Fund managers that invest to a significant and ongoing degree in investments outside of the asset class for which the fund manager was selected will be reviewed for replacement. The Finance Committee will consider recommendations from staff or the independent investment advisor for the dismissal of existing fund managers.

## IV. Conflicts of Interest

Investment managers hired to oversee the investment of the Common Trust Fund must have in place, or adopt, a conflict of interest policy which protects against and mitigates risks that the Investment manager, or its employees and volunteers, might have a personal financial interest, either in appearance, or in fact, in the decisions that they make involving the Common Trust Fund or the investment portfolio in which it participates.