UNIVERSITY OF TORONTO

THE GOVERNING COUNCIL

REPORT NUMBER 183 OF THE BUSINESS BOARD

September 27, 2010

To the Governing Council,
University of Toronto

Your Board reports that it met on Tuesday, September 27, 2010 at 5:00 p.m. in the Council Chamber, Simcoe Hall, with the following members present:

Ms Shirley Hoy, (In the Chair)
Professor C. David Naylor, President
Ms Catherine J. Riggall, Vice-President, Business Affairs
Professor Angela Hildyard, Vice-President, Human Resources and Equity
Mr. P. C. Choo
Mr. Jeff Collins
Mr. William Crothers
Ms Mary Anne Elliott*
Mr. J. Mark Gardhouse
Ms Paulette L. Kennedy
Mr. Kent Kuran
Mr. Gary P. Mooney
Ms Deborah Ovsenny
Mr. Tim Reid
Professor Arthur S. Ripstein
Ms Melinda Rogers
Ms Penny Somerville
Mr. Olivier Sorin
Mr. John David Stewart
Mr. W. John Switzer
Ms B. Elizabeth Vosburgh
Mr. David Palmer, Vice-President, Advancement
Professor Judith Wolfson, Vice-President University Relations
Ms Sheila Brown, Chief Financial Officer
Mr. Louis R. Charpentier, Secretary of the Governing Council
Mr. Paul Donoghue, Chief Administrative Officer, University of Toronto at Mississauga
Professor Scott Mabury, Vice-Provost, Academic Operations
Ms Christina Sass-Kortsak, Assistant Vice-President, Human Resources
Mr. Nadeem Shabbar, Chief Real Estate Officer
Ms Elizabeth Sisam, Assistant Vice-President, Campus and Facilities Planning
Mr. Ron Swail, Assistant Vice-President, Facilities and Services

Mr. Neil Dobbs, Secretary

Regrets:

Mr. Steve (Suresh) Gupta
Mr. George E. Myhal
Professor Janice Gross Stein
Mr. W. David Wilson

In Attendance:

Ms Karen Coll, Managing Director, Public Markets, University of Toronto Asset Management Corporation
Ms Sheree Drummond, Assistant Provost

* Participated by telephone.

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In Attendance (Cont'd)

Dr. Anthony Gray, Special Advisor to the President
Professor George Luste, President, University of Toronto Faculty Association
Mr. Michel Malo, Managing Director, Investment Strategy and Co-Chief Investment Officer, University of Toronto Asset Management Corporation
Mr. William W. Moriarty, President and Chief Executive Officer, University of Toronto Asset Management Corporation
Mr. Daren Smith, Director, Hedge Funds, University of Toronto Asset Management Corporation
Mr. Henry T. Mulhall, Assistant Secretary of the Governing Council
Ms Mae-Yu Tan, Assistant Secretary of the Governing Council
Mr. Anwar Kazimi, Committee Secretary, Office of the Governing Council

ITEM 4 CONTAINS A RECOMMENDATION TO THE GOVERNING COUNCIL FOR APPROVAL.

ALL OTHER ITEMS ARE REPORTED TO THE GOVERNING COUNCIL FOR INFORMATION.

1. Report of the Previous Meeting

Report Number 182 (June 17, 2010) was approved.

2. Calendar of Business, 2010 – 11

The Board received for information its Calendar of Business for 2010-11. The Chair stressed that the Calendar was subject to change. Among other changes, items might be added as the result of the emergence of new priorities. The Board would continue to focus its attention each meeting on a main theme to ensure a good overview and time for in-depth consideration. The Chair invited members to advise of any items they thought the Board should be considering that were not on the Calendar of Business. No suggestions were made.

3. Approvals under Summer Executive Authority: Annual Report

The Chair recalled that each year, the Governing Council delegated authority to the President of the University to approve, subject to the concurrence of the Chair of the Governing Council, certain urgent matters that arose in the summer and that could not be considered by the Council and its Committees over the summer break. Any approval under summer executive authority was to be reported to the appropriate Board or Committee for information. There were no matters within the terms of reference of the Business Board that had been approved under summer executive authority in 2010.

4. Pension Committee: Establishment and Terms of Reference, and Corresponding Revisions to the Terms of Reference of the Business Board and the Audit Committee

Mr. Charpentier (speaking on behalf of the Chair, Mr. Wilson and the past-Chair, Mr. Nunn) presented the proposal to establish a new Pension Committee of the Governing Council, to approve its terms of reference, and to approve related changes to the terms of reference of the Business Board and the Audit Committee.* A copy of the proposal is attached hereto as Appendix "A". The proposal had emerged as a result of lengthy negotiations with the Faculty Association, a ruling from the arbitrator, talks with unions representing administrative staff and talks with non-union staff. There had been substantial advice provided on the proposal by the University's administration, by the Governing Council Secretariat and by the sponsors of the proposal: the Chair and past-Chair of the Business Board. While the proposal before the Board reflected the outcome of consultation, negotiations, and arbitration, it clearly reflected the interest of good governance of the pension plans. The proposal would not take from the Governing Council its responsibility as sponsor and administrator of the pension plans; it would move oversight of that responsibility from the Business Board to a dedicated Pension Committee.

Discussion focused on the following topics.

(a) Membership. A member noted that of the total membership of twenty (excluding the *ex officio* members), eleven members were to be members of the Governing Council. Given that the functions of the proposed Pension Committee were currently exercised by the Business Board, the member asked whether the members of the new Committee should include the co-opted members of the Business Board who were not also members of the Governing Council. Ms Riggall replied that section 2(14)(e) of the *University of Toronto Act* required that where the Governing Council delegated authority to a committee to act on Council's behalf, the "majority of members of the committee shall be members of the Governing Council."

(b) Quorum. A member observed that a quorum for the proposed Committee would require "one half of the voting members of the Committee." That would mean that while members of the Governing Council would form a majority of members of the Committee, at any particular meeting the majority of members present might be people other than Governing Council members. Therefore the Committee could make a decision binding on the University without a majority of Governing Council members participating in the decision. That certainly appeared to be contrary to the spirit of the *University of Toronto Act*. Another member asked whether the Committee, with (at the extreme) nine employee representatives present and only one member of the Governing Council could make decisions concerning benefits, the type of pension plan offered, or contribution rates.

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* The Chair noted that there was an error in the item as mailed to members. Members had been notified of the error by e-mail. The corrected version had been posted on the web, and a copy of the corrected version had been placed on the table. The correction concerned the composition of the proposed Pension Committee. Under item 1.1 of the proposed Terms of Reference, in the fourth bullet point, there was a corrected description of the four members appointed on the recommendation of administrative staff. The error has been corrected in Appendix "A" hereto.

4. Pension Committee: Establishment and Terms of Reference, and Corresponding Revisions to the Terms of Reference of the Business Board and the Audit Committee (Cont'd)

Mr. Charpentier replied that the quorum requirement, expressed solely as a proportion of voting members of the Committee, was consistent with the quorum requirements for other Boards and Committees of the Governing Council. Only the quorum requirements for the Governing Council itself and the Executive Committee made any specification concerning the composition of the quorum (both required a given number of members elected by the alumni or appointed by the Lieutenant-Governor in Council). The *University of Toronto Act* was silent on quorum requirements for other committees, specifying only that such requirements be established by resolution of the Governing Council. In the case of the proposed Pension Committee, the requirement for quorum was to be one half of the voting members. The requirement for most other committees was only one third of the voting members. The specification of the quorum requirement without reference to the composition of the quorum was the outcome of negotiations and arbitration.

With respect to the ability of the Committee, in the absence of a majority of members of the Governing Council, to establish such things as pension benefits or contribution rates, Professor Hildyard stated the Committee's jurisdiction specifically excluded benefits and contribution rates. Any proposals to change such matters would be subject to negotiations between the University and the Faculty Association or union, with the outcome continuing to require the approval of the Business Board.

(c) *Ex officio* members. A member observed that in addition to the twenty members of the Committee, the proposed terms of reference stated that "the Chairman and Vice-Chairman of the Governing Council, the President and the Chancellor are *ex officio* voting members of all Standing committees . . . of Governing Council." Did that mean that the proposed Committee would in fact consist of twenty-four members rather than twenty, and that its quorum would be twelve rather than ten? Mr. Charpentier replied in the negative. The terms of reference specified that no more than eleven of the Governing Council members would be regarded as voting members at a Committee meeting, and therefore the voting membership would remain as twenty and the quorum as ten.

Another member asked how it would be determined which eleven Governing Council members would vote if more than eleven members, including the *ex officio* members, were in attendance at a meeting. Mr. Charpentier replied that the provision for the *ex officio* membership was required to accommodate (a) section 29(e)(i) of By-Law Number 2, which required that the four officers would be *ex officio* voting members of all standing and special committees, in combination with (b) the arbitrated specification of the voting membership of the proposed Pension Committee. He did not anticipate that there would ever be need for protracted discussion of the matter in the proposed Committee, but in the event that there was some dispute, the matter would be determined by the Chair of the Committee.

4. Pension Committee: Establishment and Terms of Reference, and Corresponding Revisions to the Terms of Reference of the Business Board and the Audit Committee (Cont'd)

On motion duly made, seconded and CARRIED,*

YOUR BOARD RECOMMENDS:

(a) THAT the proposal to establish a Pension Committee, as a Committee with delegated authority from the Governing Council and reporting to the Governing Council, be approved;

(b) THAT the Terms of Reference of the Pension Committee, a copy of which is attached to Appendix "A" hereto as Attachment 1, be approved;

(c) THAT the amendments to the Terms of Reference of the Business Board, as described in Attachment 2 of Appendix "A" hereto, be approved; and

(d) THAT the amendment to the Terms of Reference of the Audit Committee, as described in Attachment 3 of Appendix "A" hereto, be approved.

5. Investments: Semi-Annual Update on Investment Performance

The Chair said that the terms of reference stated that the Business Board was responsible for the "review of annual reports on investment performance, or more frequent reports as the Board may from time to time determine." UTAM's fiscal year was the same as the calendar year, and it therefore presented its annual report and financial statements in the spring. Given the importance of UTAM's activities to the University's financial health, the Business Board had asked that UTAM also provide a semi-annual update. Ms Riggall concurred with respect to the importance of UTAM's work. The outcome of the investment portfolio was usually the key

* In response to a member's question, Mr. Charpentier said the conflict-of-interest provision in Section 27(d) of By-Law Number 2 did not prevent any University employee from moving or seconding this motion or voting on it. The provision concerned only matters that were directly related to compensation. The proposal before the Board did not concern compensation; rather it concerned the formation of a new Committee of Council. That Committee was precluded from dealing with the pension plans as compensation. It was "not responsible for recommending or determining the terms of the pension plans, including the benefits to be paid to the retired members of the pension plans, the contributions required from the active members of the plans to earn those benefits, and the groups of employees who are to be members of the plans. Such matters are determined through the University's usual processes including the budget process and, where applicable, collective bargaining or some similar process."

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

factor in determining whether the University completed its budget year with a positive or negative financial result.

Mr. Moriarty presented UTAM's semi-annual update on investment performance for the period ended June 30, 2010. Among the highlights of his presentation were the following.

- **Performance summary to June 30, 2010**. The pension fund and the Long-Term Capital Appreciation Pool (the L.T.CAP or "the endowment fund")* had enjoyed modestly positive returns in the first six months of 2010, and they had earned returns of just over 8% over the past year to June 30. That return was roughly in line with the two portfolios used as benchmarks: (a) the "benchmark portfolio" representing returns on securities indices in the same proportion as UTAM's target asset mix, and (b) the "reference portfolio" representing returns on securities indices in a typical asset mix of 60% equities (30% Canadian, 15% U.S. and 15% international) and 40% bonds. Returns over the year ended June 30, 2010 had readily exceeded the University's target return of inflation plus 4%, but that had been a relatively easy task in the favourable market conditions over the past year. (The University target return had been a much more difficult hurdle over the past six months.) Over the past year, the pension fund had slightly outperformed the endowment fund.

- **Performance in recent quarters**. In the first quarter of 2010, the markets had been relatively firm and the two main funds had earned a return of just over 2%, in line with the benchmark and reference portfolios and well in excess of the University's target return. The second quarter had been a much more difficult one, with the funds giving up much of the gain they had made in the first quarter and not achieving the University's target return. The funds had, however, outperformed the reference portfolio.

  After strong returns in 2009 and the first quarter in 2010, equity markets had corrected sharply in the second quarter of 2010. Investors had been concerned about fiscal stress in Europe, slowing economic growth in China, and negative economic data from the United States. Fixed-income securities had provided reasonably good performance in the second quarter, but the best performing asset classes in the first half of the year were private investments and real assets. Mr. Moriarty cautioned that there was a lag of one or even two quarters in the reporting of returns for those asset classes; therefore the positive performance numbers really represented returns for the quarters ended December 2009

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* The Long-Term Capital Appreciation Pool is used to invest not only most of the University's endowment funds (the largest element of the L.T.CAP) but also (a) the monies set aside by the University to deal with its liability under its Supplemental Retirement Arrangement, and (b) the Long-Term Borrowing Pool (monies set aside by the University from repayments by Faculties and other units of internal loans for construction projects – monies to be used to repay the principal of the "bullet" debentures taken out by the University when those debentures become due.)

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

and March 2010. Currency values had been volatile over recent quarters, with UTAM's half-hedged exposure to investments denominated in a wide range of currencies, showing the benefits of diversification. Overall, the investment environment in the first half of the year had been a difficult one for earning the University's target return.

Returns in the third quarter had been much better. In July, the major funds had earned approximately 2%. August had been a difficult month, but September had been a strong one to date. Mr. Moriarty therefore hoped that the funds would end the third quarter with good performance numbers.

- **Asset allocation**. The asset allocation policy targets had been determined through the modeling of the anticipated returns for various asset classes, their volatility and their correlation with each other. UTAM had moved to implement the target allocations, as far as possible, early in 2010. The changes had been as follows:

    - **Private investments**. The target had been reduced from 15% to 10%. UTAM had placed a moratorium on new private-investment commitments until it developed a more detailed strategy for making them.

    - **U.S. equities**. UTAM had reduced its target weighting from 15% to 12½%. Because so large a proportion of the private investments were made or committed to be made in the U.S., the exposure to that country would be larger than desirable.

    - **Canadian equities**. UTAM had increased its target weighting from 10% to 12 ½ %. Because so large a proportion of the Canadian market consisted of resource companies, that increase would also provide some increase in the portfolio's protection against inflation.

    - **Hedge funds**. UTAM had increased the target weight of hedge funds from 15% to 17½%. Because of the high likelihood that the market would remain within a trading range rather than trending higher over the next many months, hedge funds, which could employ more diverse strategies than regular equity investment funds, should do well.

    - **Fixed income**. To reduce the level of risk of the overall portfolio, the allocation to bonds and other fixed-income securities had been increased from 15% to 17½%.

    - **Real assets**. The target weighting for real assets had remained unchanged at 15% in spite of the fact that UTAM's projections showed that an increased weight to the category (which included real estate and commodities) would be appropriate. UTAM did not wish to increase investments in this area until it had developed a more detailed strategy for doing so.

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

- **International equities**. The target remained at 15%, but UTAM planned to shift a portion of its international equity investments to the emerging markets in an effort to take advantage of their high rates of economic growth.

Mr. Moriarty observed that one consequence of the policy-asset-mix changes would be a reduction in exposure to foreign currencies.

Mr. Moriarty stressed that there were differences between UTAM's actual asset allocation and the policy targets. That was the case simply because it took a substantial amount of time to change the actual asset mix, in particular because private investments were inherently illiquid. UTAM was at this time much closer to its target allocations than it had been for quite some time.

- **Risk**. Risk was currently measured in terms of the volatility of returns. That was a very high-level measurement, which was in many ways inadequate. UTAM was therefore working on adding a set of tools that would measure risk on a much more detailed basis. UTAM used the risk budget provided by the University and monitored risk relative to that risk tolerance. That risk budget limited volatility to a standard deviation of 10% over ten years. Mr. Moriarty displayed graphs showing the rolling standard deviation of returns over four-year periods. On that basis, the risk level had been just above the University's tolerance for the past two years and just above the risk level of the benchmark and reference portfolios. The high level of volatility during the market correction of 2008 had been a factor in that development. On a one- two- and three-year basis, actual portfolio volatility had been less than that of the reference portfolio.

- **Investment performance: First half of 2010**. Compared to the University target of 4% per year beyond the growth of the Consumer Price Index, over the first half of 2010, returns had fallen short. The investment environment in the first half had been a difficult one in which to earn that return. Returns were, however, marginally positive, compared to the negative return of the 60% stock 40% bond reference portfolio. The outcome was a reflection of the different asset mix of the two portfolios, with the UTAM portfolio benefitting from its allocation to alternative assets, particularly private investments and real assets. The performance of the portfolio was largely in line with that of the benchmark portfolio, although slightly below it. Manager selection had added value in the areas of international equities, hedge funds and fixed-income securities. UTAM's tilt towards the value style of investing had detracted from performance in the first half of 2010, particularly in the international equity category. While a value bias had proven to be the correct position over the long term, it had underperformed in the first six months of 2010.

- **UTAM management focus in the first half of 2010: Infrastructure improvement**. A major focus of efforts during 2010 had been the improvement of the infrastructure for

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

UTAM's management of the University's portfolios. UTAM had been understaffed, particularly with respect to experienced staff. It had filled gaps in 2009 and had spent substantial time in 2010 integrating the new staff members into operations. Substantial work had been completed on revising and improving the system for performance measurement and attribution. The previous system had aggregated data at too high a level, not providing sufficient information on the contribution of each manager to overall performance. The fine-tuning of the performance attribution system had brought to clear light certain concerns with respect to the foreign-exchange hedging process and the asset-mix balancing process, and those processes had since been refined to improve outcomes and reduce costs. The subject of risk analysis was a real concern. UTAM had added tools to enable it to examine certain areas of risk, but it still lacked an integrated system. It had therefore looked into third-party suppliers of risk analysis systems and had asked a favoured supplier to provide information on pricing and time-lines for implementation. If the supplier's response was satisfactory, UTAM management would make a proposal to the UTAM Board. A substantial amount of analysis had been completed on UTAM's private-investment portfolio, which was a large and complex one including investments in, and commitments to, about 45 funds. The outcome of that analysis was the conclusion that the status quo was not in the best interest of the University. UTAM had examined a number of alternatives for managing the private investment portfolio and would make a proposal to the UTAM Board in the next week. UTAM was examining alternative approaches and strategies for real-estate investments, an area where assets were currently under-deployed. That work was not yet complete.

- **UTAM management focus in the first half of 2010: Portfolio simplification and evolution**. The process for strategic asset allocation had been improved, leading to the changes in asst mix described above. A significant proportion of U.S. equity investments had been moved to passive management. A sizeable proportion of investments in the U.S.A. had been in large companies, an area where it was very difficult to outperform the index. UTAM's portfolio was not outperforming, leading to the move to passive management in the area. The outcome to date had been encouraging. UTAM continued to restructure the hedge-fund portfolio. At this time, over 50% of that portfolio was invested directly in individual hedge funds rather than funds of hedge funds. That enabled UTAM to have a much better understanding of the strategies being employed by its funds, to choose appropriate funds, and to achieve considerable cost savings. A substantial amount of time had been spent on changes to the processes for managing foreign-currency hedging and portfolio rebalancing. That included a change in the external manager responsible for the foreign-exchange hedging program. It had been decided to make no additional commitments to private investments for the time being, including real estate and commodity investments. Such investments could resume when UTAM had developed a well-resourced, cogent strategy for making further investments in those areas. Finally, there had been significant governance changes at UTAM, with the resignation of most members of the previous Board, the formation of a brief interim

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

Board, and the appointment of a much smaller on-going Board to oversee UTAM operations. In addition, investment advice would be provided to the University administration and to UTAM by a new Investment Advisory Committee.

- **Current investment environment**. UTAM foresaw no significant changes in the investment environment from that in the previous year. There were a large number of impediments to business as usual. In the developed world, there were: (a) government fiscal deficits and extensive consumer debt, both requiring a substantial period of deleveraging; (b) a great deal of unused capacity, preventing business investment from leading growth; and (c) need to restructure the financial system. As a result, UTAM anticipated a significant period of below-trend growth. Inflation was likely to remain moderate, especially in the near term, but there was some risk of the resumption of inflation in the mid-term. The risk of inflation was somewhat greater in the emerging markets. Increases in interest rates were not a concern in the short term. Rates were, however, below their equilibrium level, and rate increases were therefore likely at some time in the future. Credit spreads had declined dramatically since 2008-09, but there were areas where attractive spreads still remained. UTAM was therefore searching for areas where good opportunities were to be found with relatively low risk. Equities were not currently expensive when compared to such years at 2000 or 2007. From a longer term perspective, however, they were fairly valued and were likely to generate growth only to match the trend in nominal Gross Domestic Product plus dividend yield. The primary attraction of equities was their value compared to alternative areas of investment. Therefore, as it did in 2009, UTAM continued to anticipate a range-bound market, with perhaps some uptrend, particularly in the emerging markets.

Among the matters that arose in questions and discussion were the following,

(a) Range-bound market. In response to a question, Mr. Moriarty anticipated that the equity markets would trade between an upper and lower range, involving run-ups and then corrections. Markets had been range-bound in the late 1970s, with a difference of perhaps 20% between market tops and bottoms. In the late 1970s, markets had been limited by concerns about the rising price of oil and concerns about the apparently growing power of the oil-exporting states of the Middle East, by the acceleration of inflation, and by the consequent very high interest rates. The concerns of the current period were almost the mirror image of those in the late 1970s, with deleveraging (the need for repayment of very high levels of debt by governments and consumers) causing very slow growth, a low rate of inflation and low interest rates. Markets had traded within a surprisingly narrow 10% range since October 2009. Mr. Moriarty anticipated a period of perhaps three to four years of deleveraging, a transitional period, and then perhaps three to four years of recovery back to the economies' potential growth rate.

(b) Fixed-income investments. In response to a member's questions, Mr. Moriarty said that at the beginning of 2009, most of UTAM's fixed-income investments had been indexed. That

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

meant that the portfolio (apart from the investments in real-return bonds), containing the DEX Universe index, was 26% invested in corporate debentures. UTAM had, at that point, taken the view that a greater weight in corporate credits would be valuable, and it had engaged two active managers to invest in the area: one in Canada and one in the Unites States. The outcome had been to increase corporate credits to about 60% of the fixed-income allocation. The result had been highly positive. One factor that had limited the gains from that move had been the system used for rebalancing, which relied on futures contracts. Because it was not possible to obtain futures contracts on corporate debentures, the manager responsible for rebalancing had been forced to use government issues, which had limited gains somewhat. The current duration of the fixed-income portfolio was about six years. The matter was the subject of on-going attention, which was complicated because distressed debt formed about 6% of the private investment portfolio and was also represented to a limited degree in the hedge-fund portfolio. UTAM took the view that the area of corporate credits remained attractive; the portfolio continued to be well served by those securities selected to have a shorter duration but higher coupon than the government bond portfolio.

(c) U.S. equity investments. A member observed that the allocation to U.S. equities had been reduced significantly. While the United States economy had suffered drastically as the result of the recession, it was a very strong economy over the long-term. Would it not have been more reasonable for the University, as a long-term investor, to remain invested in U.S. equities until they recover their value rather than to have sold them at a significant loss? Mr. Moriarty said that there were three factors behind the decision to reduce the U.S. equity component in the public-market investments. The first was valuation. Over the long term U.S. equities traded at about 1.8 – 2.0 times their book value. In 2000, U.S. equities had traded at an average of five times their book value. Over the period leading to the correction in 2008-09, U.S. equities had declined in price to again about two times their book value. Mr. Moriarty therefore had concluded that the reduction in exposure had resulted in sales of U.S. company shares at their fair value. Second, while the policy target for U.S. equities trading on the public markets had been reduced from 15% to 12.5%, the commitment to private investments was at this time, at about 15% - 16% (which was above its policy allocation) and a substantial proportion of the investments by the private equity managers was in U.S. companies. Therefore, the overall exposure to the United States remained very high. Finally, investments in the U.S. public market had to be compared to alternatives elsewhere, and those opportunities made a fairly small re-allocation a reasonable one. It was important to make investment decisions for the long-term, and that was the reason why the University's return target was stated over a ten-year period. Mr. Moriarty normally sought to judge investment decisions over a period of about four years, or in some cases a minimum of two years.

(d) Double-dip recession. There had been numerous recent expressions of concern about the risk of a "double dip" recession in the United States. Were the portfolios well positioned to deal with such a risk? Mr. Moriarty replied that the basic question was the reaction of the markets to the risk, and that would depend on the severity of any renewal of the recession. Mr. Moriarty thought that the difficulties encountered by the markets during the second quarter of 2010 might

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

well have been a reflection of concerns about a renewal of the recession, and he did not think that there was a large risk of a further negative effect. The factors likely to drive a renewed recession were not in place, apart from the possibility of a further deterioration in the financial sector. However, governments were very likely to do everything possible to prevent such an outcome.

(e) Conservatism of the portfolio. A member commented that a mix of 75% equities and 25% debt appeared to be rather aggressive for an institution that should conduct its financial affairs in a conservative manner. Mr. Moriarty replied that UTAM determined it asset mix using a "building block" process. It considered various economic scenarios, and forecasted returns on various types of investments in each scenario. It then considered the volatility of returns for each asset class, based on historical volatilities but modified by judgements concerning the current economic environment. Finally, UTAM looked at the correlation among returns for the various asset classes. The outcome was then run through an optimization model to build an ideal portfolio based on the building block methodology. Then, UTAM applied stress testing to determine risk in the worst case scenario, and it modified the mix accordingly. The outcome was the current policy asset mix. UTAM did, however, face one major constraint in seeking to implement the policy mix. A significant portion of the portfolio had been devoted to relatively illiquid investments, which UTAM was contracted to hold for several years. In addition, it had commitments to add to those investments over the same periods of time. Therefore, a portion of the portfolio would have to be invested in relatively liquid areas so that the investments could be sold to meet capital calls. When Mr. Moriarty had arrived at UTAM, the equity beta of the portfolio was about 0.75. The equity beta of the policy portfolio, on the other hand, was about 0.61 – a normal beta exposure for a pension fund and a relatively conservative one for an endowment fund.

(f) Foreign exchange exposure. Because most of the University's spending was in Canadian dollars, a member was surprised to see so high a proportion of the portfolio invested abroad. Mr. Moriarty replied that when he had arrived at UTAM, approximately 75% of the portfolio was invested in securities denominated in currencies other than the Canadian dollar. That proportion had been reduced to between 60% and 65%. He cited work completed in UTAM and elsewhere that demonstrated that diversification in currencies did not have a substantial impact on return but it did reduce the level of volatility of returns over time.

(g) Investment in hedge funds. A member asked about the significant exposure of the portfolio to hedge funds. Mr. Moriarty cited research by Roger Ibbotson, which demonstrated that hedge funds had as an asset class provided returns that were about 400 basis points above those of long-only portfolios.

In later discussion, a member asked when Mr. Moriarty had joined UTAM. Ms Riggall replied that he had joined the Board in April 2008, at the beginning of the crisis in the financial markets.

5. Investments: Semi-Annual Update on Investment Performance (Cont'd)

In the course of discussion, a member asked that subsequent reports include written information distributed in advance of the Board meeting. Among other reasons, the slides provided to illustrate the oral report were difficult to read, especially for members sitting at some distance from the screen.

6. Endowments: Annual Report for the Year ended April 30, 2010

Ms Brown said that the endowment funds were restricted funds that had originated primarily from donations, with some government grants made to endowed funds and some internal University funds designated to form part of the endowed funds (often funds that matched donations). The total value of the endowment was about $1.4-billion. It consisted of over 5,000 individual funds, each with its own restrictions as to treatment of the capital and use of the income, often based on an agreement with the donor. Almost all of the endowment funds were invested in a unitized pool: the Long-Term Capital Appreciation Pool (L.T.CAP). The University's key policy with respect to the endowed funds was the Policy for the Preservation of the Capital of Endowment Funds, approved in its most recent version in 2000. That policy required the protection of the capital of the endowed funds against the effects of inflation over time so as to preserve the purchasing power of the income that the funds generated. That was achieved by the reinvestment of earnings in good years when amounts were available in excess of the endowment payout. In some years, it was possible not only to maintain the value of the endowment funds against inflation but also to build a reserve to fund spending in years when investment returns were poor. The spending formula established the objective of a payout from the endowment of 4% of the market value of the pool, which payout was planned to increase each year along with inflation, within a corridor of 3% to 5% of the market value. Ideally, the payout would increase each year by the rate of inflation. To achieve that payout, the University specified a real (after inflation) return objective of 4%, with a risk tolerance of a standard deviation of 10%, both over ten-year periods.

Ms Brown displayed a number of ten-year charts showing the development of the endowment over time. The largest elements of the endowment supported student aid and endowed chairs and professorships. Smaller elements supported particular academic programs and research programs. Donations to the University, including donations to the endowment, fluctuated over the years, tending to reflect the strength of the investment markets. In years of good investment returns, the investment earnings were used to make the payout for spending with a remaining amount being reinvested to preserve the capital value of the endowment against the effects of inflation and to build up a reserve for years of poor returns. In those years of poor investment returns, the reserves could be drawn down. At the end of the 2007-08 year, the value of the endowment had been more than sufficient to maintain its value against inflation, and there was a substantial reserve amount or cushion. In the very poor markets of 2008-09, (a) that cushion had disappeared and (b) the value of the endowment had declined below the amount required for inflation protection. In order to preserve the long-term value of the endowment as much as possible and to benefit from the anticipated market recovery, the University had made no payout from the endowment for 2008-09. In 2009-10, the endowment had made a good, but

6. Endowments: Annual Report for the Year ended April 30, 2010 (Cont'd)

partial recovery. The investment return of $188.2-million (net of fees and expenses), had enabled a payout of $62.4-million plus the reinvestment of $125.8-million to partially restore the inflation protection of the endowment. After the effects of inflation, and after further donations, grants and transfers, there remained a shortfall of $191.6-million needed to restore full inflation protection to the endowment fund overall. It was, however, important to remember that the endowment consisted of over 5,000 individual funds. In some longer-established funds, or funds established when the unit value of the L.T.CAP was low, the funds had recovered their full inflation-adjusted value. In other newer funds, or funds established when the unit value was high, the current value of the fund was below its historical value. That factor would be taken into account in the University's thinking about its endowment spending and investment policies going forward.

The following matters arose in questions and discussion.

(a) Investment return and the inflation-protected value of the endowment. A member noted that the value of the endowment had increased from about $1.2-billion at the end of the 2002 fiscal year to $1.4-billion at the end of 2010. The total amount of the increase was about $237-million. At the same time, the amount of donations and grants to the endowment was $393-million. Looking only at investment returns, since the end of the 2001-02 fiscal year, the total investment return on the endowment fund over the eight years had been between 18% and 19% - well below the objective of an annual real return of 4% per year. Was it expected that investment returns would continue at that low rate, which was not even enough to cover distributions? Was the University at risk of losing the inflation-protected value of the endowment? Ms Brown replied that looking at long-term figures since the inception of the endowment pool and the Policy for the Preservation of the Capital of Endowment Funds, the University had until the end of the 2006-07 enjoyed a very significant positive return and had built up a very substantial cushion over the inflation-adjusted value of the endowment fund. In 2007-08 there had been a loss, but one still leaving a substantial cushion. That had been followed by the very serous loss in 2008-09, in which the fund had lost both its cushion and its inflation protection. The challenge for the University would be to rebuild, over time, the inflation-adjusted value of the endowment and eventually to reestablish a cushion to provide some flexibility for years of bad investment markets.

(b) The University's endowment compared to U.S. endowments. A member recalled that the University frequently measured itself against six major universities in the United States. Did the uniqueness of the University of Toronto as a Canadian institution lead to any restrictions on the endowment, compared to the U.S. institutions? Ms Brown replied that there were two very substantial areas of difference. First, the University of Toronto endowment was, by and large, much newer than major endowments in the U.S. While the University of Toronto had some individual endowment funds dating from early in the twentieth century, most dated from 1990 and thereafter with the largest proportion of them established in the mid-1990s and later. As a result, they had not had the many years enjoyed by U.S. endowments to build up a cushion against inflation. The University of Toronto endowment pool and its individual endowments were, therefore, much more vulnerable to severe market volatility. Second, almost all of the University

6. Endowments: Annual Report for the Year ended April 30, 2010 (Cont'd)

of Toronto's individual endowment funds were restricted as to their use. In the U.S., a high proportion of university endowments – as much as 75% in some universities - was unrestricted and could be used to support general operations. That enabled some universities to fund as much as one third or even 40% of their operating budgets from endowment income. That had been a great advantage for those universities, although it could also be highly problematic in years of poor investment performance when losses on the endowment would place the funding of basic operations in a highly constrained situation.

(c) Endowment reserve. A member noted references to the reserve or cushion that had been built up above the inflation-adjusted value of the endowment before the major market correction in 2008-09. Were there criteria for the desirable size of the reserve? Ms Brown replied that there were none. That reserve or cushion had grown to a peak of $416-million at the end of 2006-07, which had appeared to be a significant amount relative to the size of the endowment. It had then declined to $286-million at the end of 2007-08, and it had been eliminated entirely by the end of 2008-09. When the reserve had been in place, many members of the University had complained that it had been too large and that the payout should be increased substantially. In the very unusual circumstances of 2008-09, it had proven to be inadequate. It was clear that the University should over time reestablish a cushion for years of negative investment returns. It was not meant to be a long-term holding but rather a protection against fluctuation.

The member referred to the language in the cover memorandum to the Business Board, which spoke of the reserve having been "carefully and responsibly built up." Ms Brown replied that the history of the endowment payout rate had demonstrated amply the careful and responsible approach. The payout from the endowment had for many years been 5% of the average value of the endowment over three years. That was the rate in effect at most other universities. However, given problems that had arisen with maintaining the inflation-adjusted value of the endowment, the payout came to be determined on the basis of the four-year average value. In the market downturn in 2001-02, it was recognized that the 5% payout rate could not be sustained if the inflation-adjusted value of the endowment was to be maintained, and in 2003, the target payout had been changed to 4%.

(d) Investment management changes. The President said that Ms Riggall was leading a process to re-examine the return objective and risk tolerance for the endowment and pension funds. The University had obligations to be met by earnings from the endowment fund, and it was clear that it would have to produce a steady stream of income to meet those obligations. Alternatively if the University were to rely on capital growth, there would have to be substantial reserves to deal with years of shortfalls. The need for earnings to meet the University's obligations made it clear that the endowment would have to be managed in a manner that was different from personal wealth in circumstances where there was no obligation to provide substantial income from year to year. That factor had been borne in mind in making appointments to the new Investment Advisory Committee, where many members had considerable experience in managing trust funds that were required to fund annual spending.

6. Endowments: Annual Report for the Year ended April 30, 2010 (Cont'd)

(e) Investment return and risk. Later in the meeting, a member observed that the investment return of the endowment fund over the past fourteen years appeared to be about 5% per year or only about 2% to 3% per year after inflation. In his view, that return had been achieved by means of a very risky portfolio in which returns varied widely from year to year. He believed that it would be possible to obtain nearly as high a return – perhaps 2% per year after inflation - by purchasing risk-free government real-return bonds. Ms Riggall replied that the University required a long-term return of 4% per year after inflation in order to meet its needs.

Later in the meeting, two members observed that it would be helpful if Mr. Moriarty would be present for future reports on the endowment and for the reports on the pension plans. The person responsible for investments of the funds should be aware of the conditions of the endowment fund and the pension plan overall and of concerns raised in the Business Board. The matters of the condition of the funds and their investments were in fact inseparable. Ms Riggall assured the Board that Mr. Moriarty was very familiar with the condition of the endowment fund and pension plans overall, but she undertook to pass along the member's suggestion that he be present for future discussions of those matters.

Ms Brown stressed that the report from UTAM on investments was devoted entirely to that matter. In contrast, the objective of the report on the endowment fund was much broader: a stewardship report on the endowment funds for donors and others. In her view, the discussion of investments should appropriately take place in connection with the report from UTAM, and the discussion of the endowment fund, and at the December meeting the pension fund, should focus on broader matters.

The Chair noted that questions on the matter of the investment of the endowment and pension funds had arisen in connection with the broader reports. She therefore undertook to ensure that members' suggestion about Mr. Moriarty being present for discussions of those reports would be taken under advisement.

7. Health and Safety Requirements: Report on Compliance, 2009 Second Quarter

The Chair reminded Board members that the report was a very important one from the point of view of the University. It was also very important from the point of view of individual members, who could be held personally liable for any failure to carry out due diligence to ensure conformity to health and safety requirements.

Professor Hildyard said that the report outlined visits to the University by officials from Ministry of Labour and health and safety orders issued by the Ministry The University had complied with those orders and, to the best of Professor Hildyard's knowledge, the University was in compliance with all health and safety obligations.

8. Report on Capital Projects as at August 31, 2010

The Board received for information: (a) the Report on Capital Projects Under Construction as at August 31, 2010, providing information on projects with a total budgeted cost of $380.36-million, and (b) the Report on Occupied Capital Projects that were completed but not formally closed as at August 31, 2010, providing information on projects costing a total of $28.37-million. Mr. Shabbar noted that the report was provided at each meeting of the Board at which a capital project was presented for Board approval. Elaborating on the report on projects under construction, Mr. Shabbar said that the date of the project was the date of Business Board approval. The budget cost figure was the total project cost including not only the "hard cost" of construction but also such "soft costs" as design, consulting fees, furniture and equipment. The construction cost per square foot dealt with only the hard construction cost. The comments provided were at a high level of generality intended to provide the Board with a broad view of the progress of the various projects relative to their budget and their schedule.

9. Report on Borrowing as at August 31, 2010

The Board received for information the Borrowing Status Report as at August 31, 2010. Ms Brown said that this report also was presented at each meeting of the Board. It was intended to provide context for the consideration of proposed expenditures that might require additional borrowing.

Ms Brown said that borrowing was undertaken pursuant to the Borrowing Strategy, which had been in place since June 2004 and which had been most recently reconfirmed in February, 2010. Borrowing capacity consisted of two components. First, the maximum external borrowing capacity had been defined at 40% of the University's net assets averaged over the past five years. Updated as at April 30, 2010, that capacity was $771.5-million. In addition, there could be internal borrowing of up to $200-million from the University's Expendable Funds Investment Pool, leading to maximum borrowing capacity of $971.5-million. The borrowing already allocated by the Business Board, net of repayments that could re reallocated, was $894.1-million. The difference of $77.4-million was the amount available for allocation to future projects. Actual external borrowing against the $771.5-million maximum was $525.9-million. The Governing Council had approved further external borrowing of $200-million, which had not yet been executed. Actual internal borrowing amounted to $212.8-million, slightly above the policy limit of $200-million. The University was able to handle the additional financing through its internal fund, and it had done so to retain the flexibility to go to the external market to secure financing only when the time appeared to be right and when the external funds were needed.

Ms Brown said that the proceeds of the borrowing were used to make internal loans for individual capital projects. Those loans were made at market rates. They were fixed-rate loans that required blended principal and interest payments. The proceeds of the loan payments were used partly to pay borrowing and related expenses, including interest on the bullet debentures, and the remaining sums were captured, invested and accumulated to fund the repayment of the bullet debentures when they become due. The first of those debentures would become due in July 2031.

9. Report on Borrowing as at August 31, 2010 (Cont'd)

Ms Brown noted that in addition to the regular status report on borrowing, a review of the borrowing strategy was presented annually in January, in which the University's borrowing was compared with certain external benchmarks.

10. Report Number 94 of the Audit Committee – June 16, 2010

The Chair recalled that the Board, at its meeting in June, had endorsed the Audit Committee's recommendations to approve the audited financial statements and to appoint the external auditors. The Audit Committee's written report was received by the Board for information.

11. Reports of the Administrative Assessors

(a) Investment Oversight

Ms Riggall recalled that the Board had in the spring received a report, and had approved arrangements, for the reorganization of oversight of University investments. They included the restructuring of the Board of the University of Toronto Asset Management Corporation (UTAM) and the formation of an Investment Advisory Committee. Those steps had now been implemented.

The UTAM Board had been reduced in size, and it consisted of the President, Ms Riggall, Ms Brown, Mr. Moriarty, and Professor Luste as the nominee of the Faculty Association. It would be responsible for the oversight of the business affairs of UTAM as a corporation: ensuring that all due diligence was completed, that controls were in place and in operation, that appropriate procedures were in place for the selection and monitoring of external investment managers, and so on. The Board would not, however, be responsible for the oversight of investment strategy. That responsibility would now reside more directly in the University. For the Long-Term Capital Appreciation Pool, the approval of the return target and risk tolerance would be the responsibility of the Business Board. Ms Riggall thanked members of the Board who had attended one of four sessions the previous week to discuss that matter. She anticipated bringing a recommendation to the Board in December. That recommendation would be based on a number of steps, including the discussion sessions the previous week. In addition Ms Brown and her colleagues in the Finance group were working with the assistance of Hewitt Associates – the actuaries and pension plan consultants – on quantitative and qualitative means of expressing the risk tolerance as well as the return target.

The outcome of their work would be taken to the recently formed Investment Advisory Committee, a nine-member committee that would provide advice to the President and the University's senior administration. That Committee had held its first meeting. The University had been very fortunate to secure the service on the Committee of an exceptionally knowledgeable group of people. They included: Mr. Geoffrey Matus (Chair; past-Vice-Chair of the Business Board), Mr. Brent Belzberg (Senior Managing Partner of Torquest Partners), Mr. David Denison (President and Chief Executive Officer of the Canada Pension Plan

11. Reports of the Administrative Assessors (Cont'd)

(a) Investment Oversight (Cont'd)

Investment Board), Mr. Martin Hubbes (Chief Investment Officer and Vice-President of AGF Investments Inc.), Ms Heather Hunter (head of Canadian Equities at Invesco Trimark), Mr. Brian Lawson (Senior Managing Partner and Chief Financial Officer at Brookfield Asset Management), Mr. Robert Luba (retired; past President and C.E.O. of Royal Bank Investment Management), Mr. Craig Rimer (C.E.O. of the Cidel Financial Group) and Mr. Chris Wansbrough (retired; past Chairman and President of the National Trust Company). The Committee would review and advise on the return target and risk tolerance for the L.T.CAP. The President would approve the asset allocation and the general investment strategy for the L.T.CAP, on the basis of advice from the Investment Advisory Committee. For the pension fund, the return target, risk tolerance, asset allocation and general investment strategy would be approved by the soon-to-be-established the Pension Committee. It too would have the benefit of advice from the Investment Advisory Committee.

A member observed that management of the pension plan required the matching of the plans' assets with their liabilities. She asked the location of accountability for that matching.

Ms Riggall replied that the responsibility was ultimately that of the Governing Council as plan sponsor and administrator. It was expected that the responsibility would be carried out by the planned Pension Committee, with the advice of the administration and the actuaries. Professor Hildyard stated that the Pension Committee would not have authority in the areas that determined the liabilities - pension benefits. It would also not have authority in the matter of determining contributions. The member stressed that there was still need for governance to address the question of matching assets and liabilities, and she urged that there be answers to the question of matching when the annual financial report on the pension plans was to come forward at the December meeting of the Business Board.

(b) Pan-Am Games, 2015

Ms Riggall recalled that the Governing Council had some time ago approved the University's involvement in the Pan-Am Games and the Para-Pan Games to be held in Toronto in 2015. The major area of involvement would be aquatic events to take place at the planned new facility at the University of Toronto at Scarborough. University sites were also under consideration for three other aspects of the Games. Varsity Stadium was a possible site for opening and closing ceremonies for the Para-Pan Games. Field Hockey events might well be hosted on the St. George back campus. Finally the futsal events might be hosted at an upgraded Varsity Arena. The matter was progressing well, and Ms Riggall would report further as plans developed.

11. Date of Next Meeting

The Chair reminded members that the Board's next regular meeting was scheduled for Monday, November 1, 2010 at 5:00 p.m. The main theme would be Advancement and Alumni Relations, and the Board would receive the annual report of the Vice-President, Advancement. The second part of the Board orientation was scheduled for the same day at 4:00 p.m. It would deal with human-resources matters and the pension plan.

THE BOARD MOVED INTO CLOSED SESSION

12. Quarterly Report on Donations over $250,000, May 1 –July 31, 2010

The Board received for information the Quarterly Report on Donations over $250,000 for the period May 1 – July 31, 2010.

13. Other Closed Session Reports: Collective Bargaining

Professor Hildyard reported on the status of collective bargaining with the Faculty Association on salary and benefits matters for 2009-10 and 2010-11 and on collective bargaining with two unionized staff groups.

14. Other Closed Session Matters

The Chair referred to item 17 on the agenda, a real-estate transaction. She reported that the matter had not been concluded, and there was no proposal for the Board to consider at this time.

THE BOARD RETURNED TO OPEN SESSION

The meeting adjourned at 7:05 p.m.

Secretary　　　　　　　　Chair

October 20, 2010

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