University of Toronto TORONTO ONTARIO M5S 1A1

BUSINESS AFFAIRS

TO: Business Board

SPONSOR: Catherine Riggall
CONTACT INFO: 416-978-7473 or catherine.riggall@utoronto.ca

DATE: December 21, 2004 for January 17, 2005

AGENDA ITEM: 4

ITEM IDENTIFICATION:

University Funds Investment Policy

JURISDICTIONAL INFORMATION:

The Business Board is responsible for:

- The review and approval from time to time of the investment policies for university investment funds and amendments thereto, such policy to include, without limitation: normal asset mixes, asset-mix ranges, risk tolerances, quality criteria, and rate of return objectives including benchmarks for each fund.
- The approval of the conditions for the delegation of authority to a University-controlled asset management corporation of the management of the investment of university funds.

PREVIOUS ACTION TAKEN:

The University Funds Investment Policy was last approved by the Business Board at its meeting of April 3, 2003.

HIGHLIGHTS:

The University Funds Investment Policy provides investment direction from the University to the University of Toronto Asset Management Corporation (UTAM) with respect to the long-term capital appreciation pool (LTCAP, the expendable funds investment pool (EFIP), and specifically invested funds. The policy is reviewed annually and either confirmed or amended as necessary. This revision proposes 1) a minor change to the investment policy for LTCAP, and 2) a changed investment policy for EFIP that defines the investment return targets and risk tolerance and delegates to UTAM the responsibility for investment strategy, including the asset mix. Appendix 1 contains the revised policy. Appendix 2 contains the current policy for comparison purposes.

LTCAP – SECTION 4 OF THE POLICY:

LTCAP consists of the University's endowed funds, and a few other funds of a long-term or permanent nature such as the supplemental retirement arrangement. Investment returns generated through investments of these funds support payouts to faculties and divisions for expenditures in accordance with the terms and conditions of individual endowments and other funds.

The current policy articulates a return objective of a 4.0% real return and a risk tolerance of 10% in nominal terms. The risk tolerance definition has been clarified with the additional wording "over 10 year periods" to clearly indicate the period which over the risk tolerance is being applied.

EFIP – SECTION 5 OF THE POLICY:

The expendable funds investment pool contains expendable funds which are pooled and invested until spent. It includes the University's cash for operations, capital projects, ancillary operations, expendable donations, expendable payouts from endowments and research grants. The size of EFIP varies over the course of a year. Historical data suggests that we need to keep only about $75 million on average in short-term investments and that the remainder of EFIP can be invested for medium and longer periods of time. The current strategy is that EFIP will provide all short-term construction financing, and up to $200 million in long-term loans for internal purposes.

There are therefore three investment strategies for EFIP: the short-term portion to be held in cash and cash-like instruments by the University, the long-term portion of up to $200 million to be held in internal loans to the University, and the remaining balance, which fluctuates over the course of each year, to be invested by UTAM. The short-term cash is held in bank accounts and short-term institutional money market funds. The long-term portion is held in internal loans to University projects requiring borrowing. The remaining funds are to be invested by UTAM in accordance with the investment return target and risk tolerance specified in this policy for funds managed by UTAM.

History of Recent Changes:

Prior to April 2003, the policy assumed that 40% of the pool would be invested in short-term investments and 60% in longer-term investments including equities. The equity investment resulted in an investment portfolio with significant risk that investment return targets would not be met in any given year, and which resulted in losses.

In April 2003, a variation was added to the policy to allow swaps and other fixed income investments to allow EFIP to be invested in fixed income investments with a more predictable return. At the time, this provided a reasonable justification for smoothing the accumulated investment losses of $40 million over the four years ending in 2006-2007.

Proposed Change for Funds Managed by UTAM:

During 2004, a study has been conducted of the funds held with UTAM to assess what investment return could be generated at various risk levels. This study looked at various fixed income portfolios, which included bonds of varying durations. The conclusion of this study was that increasing the risk by adding longer-term bonds generated little additional return. The target investment return of 1 year T-bill rates plus 0.5% generates some additional return over T-bills, with minimal risk over a 10 year period. In any one year of a 10 year period, based on the University's projected cash balances, this return target was projected to generate about $14.3 million at the median, with a return of negative $5.9 million at the 95th percentile. Over the full ten years, this return was projected to generate an expected return of about 4.8%, or 0.5% over T-bill returns, generating about $144.3 million at the median or $109.0 million at the 95th percentile, or an average of $10.9 million per year at the 95th percentile.

Performance benchmarks will be established for the fund and Schedule C of the service agreement between the University and UTAM will be submitted to this Board for approval once the appropriate benchmark has been determined.

FINANCIAL AND/OR PLANNING IMPLICATIONS:

The implication of these changes is a steadier, more predictable flow of investment return to the University with a carefully defined and monitored investment return target and risk tolerance. EFIP investment returns, net of interest payments to certain depositors (trust funds, capital projects and ancillaries with positive balances) are reflected as income in the University's operating fund. A more stable, predictable investment income line aids in planning.

RECOMMENDATION:

It is recommended that the Business Board approve the Investment Policy for University Funds as contained in Appendix 1.