TO: Business Board

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DATE: October 21, 2010 for November 1, 2010

AGENDA ITEM: **4**

ITEM IDENTIFICATION:

Endowments: Report on Spending Formula and Investment Policy

JURISDICTIONAL INFORMATION:

The Business Board receives reports on financial matters.

PREVIOUS ACTION TAKEN:

The Investment Policy for University Funds was most recently approved by the Business Board on June 21, 2007.

HIGHLIGHTS:

The University of Toronto endowment is the largest in Canada, although it is small in comparison to many of its peer universities in the U.S. At April 30, 2010, University of Toronto endowments totaled $1.437 billion and included over 5,150 individual endowment funds, usually supported by a donor agreement.

Endowments are restricted funds which must be used in accordance with purposes specified by donors or by Governing Council. Almost all endowments, about 96.1% of value and 5,139 funds, are invested in the Long Term Capital Appreciation Pool (LTCAP), a unitized pool that was established in 1991. This discussion of spending formula and investment policy applies to those endowments included in LTCAP.

The key long-term policy objectives for the University of Toronto endowment funds are to maintain a steady and predictable flow of funds for spending that increases with inflation and to maintain the inflation-protection valued of the original endowed gift over time.

The current spending formula, which was established in 2003, has a target annual spending allocation of 4% of market value of endowments which is expected to increase annually with inflation within a corridor of 3% to 5% of the market value of endowments. Since 1992, endowment payouts have totaled $717.3 million.

The associated investment policy for LTCAP is a target investment return of 4% per annum, after inflation, investment fees and expenses, together with a volatility risk target of +/-10%, representing one standard deviation, both over a 10 year period. Over the entire period of the endowment pool, since inception, actual returns have exceeded the University's target return. For the entire 19 year period from 1992-2010, the average annual actual nominal return was 6.9% compared to the average annual target nominal return of 6.4%.

However, in fiscal 2009, the bottom fell out of the market and the result for that one year was a negative return of 31%. The University community reacted with shock and outrage. It became clear that very few people understood what the volatility risk target meant. Therefore, the University has conducted broad discussions with University stakeholders regarding the University's appetite for volatility risk, and Aon Hewitt has updated the quantitative models, to assess what spending levels the University community desires and whether the resulting investment targets can be achieved within the volatility risk levels that the University believes it can tolerate.

To explore the University's appetite for volatility risk, four focus groups, facilitated by Cambridge Associates, were held with a wide range of stakeholders and facilitated by Cambridge Associates. The groups discussed the conflicting objectives of maximize long-term returns, maximizing the stability and predictability of spending from endowments, maximizing the level of annual spending and preserving purchasing power. While survey results indicated that 68% of participants preferred to preserve purchasing over maximizing current spending and that 75% of participants preferred to preserve purchasing power over maintaining spending of no less than 4% per annum, discussion also indicated a strong desire to maintain the current spending level. We concluded from these discussions that we should try to maintain the current spending level and the spending corridor.

While it is easy to decide what the desired return target should be, based on the desired spending rate, it is not as easy to assess whether this target can be achieved at a reasonable or acceptable level of risk. Aon Hewitt considered portfolios with real return targets of 1.9% (least risk portfolio), 3%, 4%, 5% and 6%. For each return target they considered two spending scenarios, one that maintained the current spending level, and one that reset the spending level to match the return target. For each portfolio selected, they modeled market value and spending rate, along with the probability of a spending shortfall exceeding $10 million (that would have to be made up from University operating funds) and the probability of returning to inflation adjusted capital by 2020. Their modeling process included 5,000 independent economic trials.

The results for each portfolio were compared to the preferences expressed by the focus group participants. It was easy to reject the 1.9% portfolio as providing insufficient return to balance capital preservation and spending needs. The 6% portfolio was also easily rejected as having too much volatility. The 3% portfolio was rejected because we would have no choice but to bring down the spending level to 3% under this option.

Both the 4% and the 5% portfolios had some attraction. However, increasing the target return in an "uncertain" investment world might be viewed by some as less than prudent. Ultimately, the 4% real return target would seem to offer the University the opportunity to maintain the current spending target and the current return target within a volatility risk level that sits within the comfort zone identified by focus group participants. However, modeling suggested it could be achieved with a volatility risk lower than 10%. Retaining the same return target but lowering the volatility target would strike many seasoned investors as somewhat unrealistic given today's investment environment.

Consequently, after reviewing all the inputs, both qualitative and quantitative, the University concluded that there should be no change to the target return or the volatility risk target of the endowments (LTCAP).

This report and its conclusions were reviewed with the Investment Advisory Committee. This group held a focused discussion around the reasonableness of the 4% real return target and the 10% volatility risk target, representing one standard deviation, and concluded that these targets are reasonable. We will continue to review these targets regularly.

FINANCIAL AND/OR
PLANNING IMPLICATIONS:

RECOMMENDATION:

THAT for the Long-Term Capital Appreciation Pool (a) the current investment objective of a 4.0% real, inflation-adjusted return over a ten year period, and (b) the current risk tolerance of a standard deviation of 10.0% or less in nominal terms over ten year periods be confirmed.