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OFFICE OF THE VICE-PRESIDENT, BUSINESS AFFAIRS

TO: Business Board

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AGENDA ITEM: **#6**

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 November 19, 2001.

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. This revision proposes changes to the investment policy for LTCAP and to the general section, and a short to medium term variation to the investment policy for EFIP   Appendix 1 contains the revised policy. Appendix 2 contains the current policy for comparison purposes.

LTCAP – SECTIONS 2, 3 AND 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 and risk tolerance and specifies the associated asset mix. The proposed policy changes are to reduce the return objective from 5.0% real return to 4.0% real return, to establish a risk tolerance expressed as a target standard deviation of 10.0% and to delegate determination of asset mix to UTAM.

A recent study on the endowment concluded that a 5% return objective would likely require too aggressive an asset mix for the University's tolerance to risk. The University requires a steady and predictable flow of income from the endowment to support the programs funded. The study indicated that the current 5% return objective results in an income shortfall seven years out of ten. The likelihood that this shortfall is greater than $10 million is four years out of ten. As such, a lower return objective, recommended at 4%, would enable a less aggressive asset mix to be utilized and would significantly reduce the likelihood of shortfalls on endowment income.

The revised policy, unlike the current one, does not specify an asset mix. It focuses instead on the return and risk objectives. This puts the accountability for the specific choice of asset classes and the resultant asset mix on UTAM, which will also be responsible for portfolio diversification, categories and subcategories of investments, use of derivatives and investment restrictions. A requirement that UTAM develop, approve and review these policies will be incorporated into the service agreement. Performance benchmarks against market indices and peer universes will be established for the fund and described in the service agreement. Sections 2, 3 and 4 of the policy have been modified to reflect these changes.

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 projections, ancillary operations, expendable donations, expendable payouts from endowments and research grants.

The current policy states that "while the purpose of EFIP is to pool for investment purposes capital that is predominately short term in nature, trend-line growth of the capital base over the past several years has created a substantial core balance that is expected to be sustained on an on-going basis. Therefore, a risk profile that is greater than what would be expected for funds with a short-term investment horizon is appropriate for a significant portion of the fund."

The current policy assumes that 40% of the pool will be invested in short-term investments and 60% in longer-term investments including equities. Analysis of actual cash inflows and outflows for the years 1999-2000 through 2001-2002 shows that the University's outflows generally do not exceed inflows by more than about $50 million in a particular month. Even with a margin of safety, this historical data would suggest 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 longer periods of time.

The equity investment results in an investment portfolio which contains significant risk that investment return targets will not be met in any given year. The projected investment income for 2002-2003 is a negative investment return of $8.2 million on a projected average capital balance of $445 million. Overhead fees and interest payments to depositors (including the operating fund) total a further $9.2 million, for a total loss for the year of $17.4 million. Adding this to the $22.6 million at April 30, 2002 results in a total accumulated loss of $40.0 million at April 30, 2003. If we would continue to follow the write off strategy adopted last year, the entire $40 million sum would have to be written off by April 30, 2004.

Due to the current budget situation, a longer write off period is desirable. However, the only prudent way of doing this is to ensure that these losses are capped and do not keep growing. While the above analysis shows that a significant proportion of the EFIP pool may be invested in longer term investments, those investments should have stable and predictable returns. This means that, for the foreseeable future, EFIP should be invested in fixed income investments with a more predictable return, which provides a reasonable justification for smoothing the accumulated investment losses over a longer period of time.

On a go forward basis, for up to five years, the University of Toronto Asset Management Corporation (UTAM) will apply a swap to the long-term investments to convert them to fixed income. This will prevent the occurrence of future investment losses and thus enable amortization of current accumulated losses against the operating fund deficit over a period of longer than one year. The current plan is to amortize the $40 million accumulated losses at the rate of $10 million per annum over the next four years ending in 2006-2007, with no expectation of any additional losses in those years. This swap can be reversed in future if the equity markets recover.

The variations in the short-term component of the pool and the use of fixed income investment for the long-term portion of the pool represent variations to the current investment policy that we recommend putting in place for a period of up to five years. These variations are added to the policy as section 5.3, with an expiration date of April 30, 2008.

Performance benchmarks against market indicators and peer universes will be established for the fund and described in the service agreement between the University and UTAM. The wording of section 5.2 of the policy has been changed to reflect this.

GENERAL

Finally, section 7.2 regarding custody arrangements has been modified to reflect UTAM's accountability.

FINANCIAL AND/OR PLANNING IMPLICATIONS:

The implication of these changes is a steadier, more predictable flow of investment return to the University. In the case of LTCAP, there is a lower risk that the University will be called upon to backstop shortfalls in endowment payout. In the case of EFIP, investment losses should be contained, thus enabling them to be written off over time, and future investment income should be more predictable.

RECOMMENDATION:

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