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An Audit Report on Endowment Fund Investment Management at the Texas State University System

January 1999

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Key Points of Report

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Overall Conclusion

The Texas State University System (System), its components, and the Angelo State University Carr Scholarship Foundation (Carr Foundation) need to improve the investment management of endowment and similar funds to protect their value. An investment strategy resulting in a low allocation to equities increases the risk that the earnings from these gifts and other assets will not keep pace with inflation. As a result, the value of scholarships these funds can support is likely to erode over time.

The System does not manage its \$51.4 million combined endowment and similar funds like most endowment funds. The System's low allocation to equities (stocks) results in long-term investment returns that are likely to be far below that of average endowments.

Similarly, the \$45 million Carr Foundation's allocation to equities and resulting long-term investment returns are significantly below the average of other endowment funds.

Key Facts and Findings

- As of August 31, 1997, the System's equity allocation was 17 percent while the average small endowment fund's was 63 percent. We estimate that the System's combined endowment and similar fund investments underperformed the rate of return of the average endowment by 8 percentage points (11 percent versus 19 percent) for the year ended June 30, 1997. An 8 percentage point increase on the System's \$51.4 million endowment and similar fund investments as of August 31, 1997, would have generated an additional \$4.1 million.
- The System should seriously consider pooling its universities' endowment and similar fund investments. Currently, each university manages its own endowment with little guidance from the System. By pooling investments, the System could (1) invest all the universities' funds consistently, (2) increase potential return, and (3) pay less in management cost per dollar invested.
- As of March 31, 1998, the \$45 million Carr Foundation's equity allocation was 11 percent while the median equity allocation was 64 percent for 209 endowments and foundations. As a result, the Carr Foundation's investments earned only 65 percent of the median annualized rate of return of those 209 funds (8.8 percent versus 13.6 percent) for the previous ten-year period.

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This audit was conducted in accordance with Government Code, Section 321.0131.

Executive Summary

With improved endowment and similar fund¹ investment management, the Texas State University System (System), its universities, and the Angelo State University Carr Scholarship Foundation (Carr Foundation) could ensure that donors' gifts and other assets are used to their full potential.

Are the System and the Carr Foundation managing their endowment funds to maximize donors' gifts?

We estimate that returns on the System's \$51.4 million combined endowment fund investments underperformed the rate of return of the average small endowment fund by 8 percentage points (11 percent versus 19 percent) for the year ended June 30, 1997. An 8 percentage point increase in the System's investment return would have generated an additional \$4.1 million on the System's

investments have a low allocation to equities (17 percent in stocks) so long-term investment return is likely to remain far below that of the average small endowment fund (which had 63 percent in stocks and other equity-like investments).

Similarly, the \$45 million Carr Foundation's returns significantly underperformed a comparison group of 209 endowment funds and foundations. The Carr Foundation earned only 65 percent of the median annualized rate of return of those 209 funds (8.8 percent versus 13.6 percent) for the ten-year period ending March

What are endowment funds?

Donors establish endowments as permanent sources of funds for universities to spend on scholarships, professorships, or other programs that benefit the universities. These gifts are memorials to the donors' generosity.

If endowment funds do not grow with inflation, then the benefits they can provide decline in value (purchasing power) over time. This in turn diminishes the value of the donor's gift.

Donations to endowment funds cannot be spent, but they can be invested. The investment earnings are either made available to the university or reinvested for future use.

endowments as of August 31, 1997. The combined endowment fund

¹ "Endowment and similar funds" refers to endowments and quasi-endowments. For endowments, the donor requires the gift's principal to be retained and invested for income. For quasi-endowments, the governing board voluntarily sets aside funds to be retained and invested. In the remainder of this report, "endowment fund" refers to endowment and similar funds.

Universities in the Texas State University System

We reviewed five universities in the System. Their endowment investments as of August 31, 1997, were:

- Angelo State University (Angelo State) \$8.8 million
- Lamar University - Beaumont (Lamar) \$7.2 million
- Sam Houston State University (Sam Houston) \$19.4 million
- Southwest Texas State University (Southwest Texas) \$11.9 million
- Sul Ross State University (Sul Ross) \$4.1 million

31, 1998. The Carr Foundation's low comparative allocation to equities (11 percent versus 64 percent) caused most of this underperformance.

Do the System and the Carr Foundation use typical endowment fund investment strategies to ensure that inflation does not reduce the future value of donors' gifts?

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Unlike typical endowment funds, the System's and universities' current investment policies (with the exception of Southwest Texas) do not focus on endowment funds or on the critical relationships between investment return, inflation, and spending. As a result, money donated to provide for the education needs of future Texans might lose some of its value (purchasing power) over time.

For example, if a donor funded an endowment for scholarships, and the endowment fund (1) invested the funds but (2) distributed all investment returns for scholarships, and (3) if annual inflation averaged 3 percent, then (4) by the 20th year, the fund could award only 57 percent as many scholarships as it awarded in the first year. (See Table 2 on page 8.)

Only when the universities retain an amount of their investment returns at least equal to the rate of inflation can they ensure that the number of scholarships (or the purchasing power of other benefits) will not decline in the future. In addition, the universities can provide the greatest number of scholarships every year if they maximize their investment returns, within acceptable levels of risk, by allocating more of their assets to higher-returning investments.

Critical aspects of the Carr Foundation's investment policy differ substantially from those of the typical

endowment fund. As a result of spending and asset allocation policies, investment results alone do not protect the Carr Foundation and its distributions for scholarships from erosion by inflation.

How could the System and the Carr Foundation manage endowment funds better?

The System and universities should establish policies that address the long-term nature of endowment funds. To ensure that investment returns are adequate to protect against inflation, endowment fund policies should include four key elements, developed in relation to one another: long-term objectives, spending policies, asset allocation targets, and performance evaluation.

The System should seriously consider pooling its universities' endowment funds. Each university manages its own endowment fund with little guidance from the System. The System's and universities' investment policies (except for Southwest Texas) lack all four key elements.

Each university has opportunities to improve its endowment fund management. However, if the System pooled its universities' endowment fund investments it could maximize the improvement by:

- Investing the universities' endowments consistently.
- Increasing potential return through more diversification and increased allocation to higher-returning investments.

What are the objectives of the typical endowment fund?

- Provide an adequate level of support (payout) to meet the needs of current beneficiaries.
- Increase the level of support by at least the rate of inflation to protect future beneficiaries.
- Increase the endowment fund's assets by at least the rate of inflation.

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- Paying less in investment management costs per dollar invested.

The members of the System's Board of Regents (Board), who are the trustees for the Carr Foundation, should revise the Carr Foundation's policies to:

- Improve expected long-term investment return.
- Ensure that all new contributions fund new scholarships instead of making up for purchasing power lost to inflation.

Because the policies do not protect investment and distribution levels against inflation, the Carr Foundation uses a portion of new contributions (revenues from the oil and gas interests donated by the Carrs) to counteract inflation instead of funding new scholarships.

For example, during the seven-year period ended August 31, 1997, the Carr Foundation needed 25 percent (or \$4.2 million) of the \$16.7 million in new contributions to offset the effect of inflation on the fiscal year 1990 ending investment balance. Without the new contributions, distributions for scholarships and expenses in fiscal year 1997 might have been only two-thirds of the inflation-adjusted fiscal year 1990 level. (See Figure 5 on page 28.)

Like the endowment funds of the individual System universities, the Carr Foundation's policies are very different from those of typical endowment funds. The Carr Foundation's objectives, asset allocation, and spending policy do not attempt to ensure that investment results will preserve the fund's purchasing power. Unlike the System

universities' endowment funds, which are governed by the Uniform Management of Institutional Funds Act, the Carr Foundation operates under the Texas Trust Act. The Texas Trust Act and certain terms of the wills may keep the Board from making some desirable policy changes. However, the Board can still take steps to improve the Carr Foundation's objectives, spending policy, and asset allocation to increase total return and long-term scholarship growth.

Summary of Management's Responses

System management has generally agreed to consider the points we raised (Sections 1 and 4) as the System and its universities develop new investment policies. However, management did not agree at this time to pool all of the System's endowment fund investments (Section 2).

Management indicated that the Board of Regents, as Trustees of the Carr Foundation, would consider implementing some of our recommendations in the future. However, the Trustees were advised that our recommendation to pay the Carr Foundation's expenses from principal to facilitate a higher allocation to equities would violate the terms of the Carrs' wills (Section 3).

Summary of Objective and Scope

The primary objective of this audit was to assess the System's and its universities' management of endowment and similar fund investments. The audit covered the

Executive Summary

five System universities responsible for \$51.4 million in endowment fund investments as of August 31, 1997.

The methodology used included interviews with management, review of investment policies and investment reports, comparison of investment

policies to actual practice, comparison of endowment fund management with peer institutions and standard practice, and estimation of the System's endowment fund investment performance for one year based on market index performance.

Section 1:

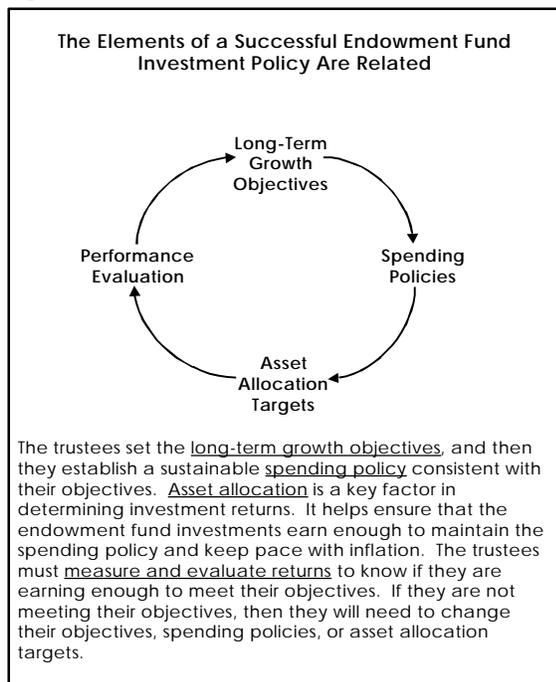
To Improve Endowment Fund Management, the System and Its Universities Need Investment Policies Specifically for Endowment Funds

The Texas State University System's (System) component universities might have been able to earn as much as 8 percentage points more in the year ended June 30, 1997, if their endowment and similar fund² investment practices were more in line with average endowment fund management. (We can only estimate the potential return because the universities do not appropriately measure how their \$51.4 million of endowment funds perform. See Sections 1-C and 1-D for more information.) In addition, except for Southwest Texas, the System's and its universities' existing investment policies do not guide endowment fund management.

The current policies address the Public Funds Investment Act's requirements, which focus on shorter-term investment funds. To manage as successfully as the average endowment fund, the System and universities need policies that focus on the unique aspects of endowment funds. Endowment fund investment policies should include at least the following:

- Long-Term Objectives - the fund's expectations for growth of principal and for stability and growth of annual distributions

Figure 1



- Spending Policies - the formal method used to determine the annual amount of accumulated investment returns the fund will distribute
- Specific Asset Allocation Targets - the relative mix of different investment types
- Measurement and Evaluation of Long-Term Investment Returns - the method used to determine how well the fund's investments are performing

Without these elements, it is likely that the System's and universities' endowment funds (1) will not keep pace with inflation, (2) will not perform as well as endowment funds of their peer group, and (3) will not meet long-term expectations. Because the System and universities do not appropriately measure their endowments' investment performance, management has no way to know when

² "Endowment and similar funds" refers to endowments and quasi-endowments. For endowments, the donor requires the gift's principal to be retained and invested for income. For quasi-endowments, the governing board voluntarily sets aside funds to be retained and invested. In the remainder of this report, "endowment fund" refers to endowment and similar funds.

endowment funds are performing poorly.

It is important that those responsible for fund management develop these elements in relation to each other (see Figure 1). This will help ensure that the fund's long-term spending does not exceed its inflation-adjusted investment return so that its purchasing power does not diminish over time. If purchasing power diminishes, donors' gifts cannot provide a constant level of benefits forever.

Taken as a whole, the System manages endowment funds differently than management of "typical" endowment funds. According to the *1992 College and University Business Administration*:

The National Association of College and University Business Officers (NACUBO) publishes an annual comprehensive endowment study that contains performance, asset allocation, and other data on endowment management practices supplied by participating institutions. Participants typically include institutions representing more than 90 percent of the total endowment of American higher education, and the study has become an important resource for governing boards and administrators seeking to compare their policies and practices to those employed by peer institutions.³

The major differences between System endowment funds and those in the NACUBO study include spending policies (see Section 1-B), asset allocation (see Section 1-C), and performance measurement (see Section 1-D). Furthermore, combined endowment fund investment performance for the System's universities was probably substantially below the average reported in the NACUBO study (see Section 1-C). The *1997 NACUBO Endowment Study* included 498 public and private institutions of higher education.

The System and universities also manage their endowments differently than other Texas institutions. A rider in Article III of the General Appropriations Act (74th and 75th Legislatures) requires all institutions of higher education to consider the Permanent University Fund's (PUF) investment strategies when developing their own investment policies. The investment policy of The University of Texas System's Long Term Fund also serves as a useful model. The Long Term Fund, like the Texas State University System's endowment funds, is not subject to constitutional spending restrictions imposed on the PUF. As shown in Table 1, the Texas State University System's and most of its universities' policies lack critical elements contained in these two University of Texas System investment policies.

³ Reprinted with permission from the *1992 College and University Business Administration*, page 445. Copyright 1992, National Association of College and University Business Officers.

Table 1

Comparison of Investment Policy Elements Relevant to Endowment Funds Texas State University System Versus The University of Texas System								
Investment Policy Element	System	Angelo State	Lamar	Sam Houston	Southwest Texas	Sul Ross	Permanent University Fund	Long Term Fund
Does the investment policy address expectations for growth of principal, and for stability and growth of current expenditures? (See Section 1-A.)	No	No	No	No	Yes	No	Yes	Yes
Does the investment policy clearly define spending policy? (See Section 1-B.)	No	No	No	No	Yes	No	Yes	Yes
Does the investment policy clearly define expected asset allocation targets? (See Section 1-C.)	No	No	No	No	Yes	No	Yes	Yes
Does the investment policy specify how investment performance will be measured, such as by the use of an outside expert to measure and evaluate performance against objectives? (See Section 1-D.)	No	No	No	No	No	No	Yes	Yes

Source: Texas State University System and component university investment policies, fiscal year 1997; PUF and Long Term Fund investment policies, February 12, 1998

Section 1-A:

Establish Overall Endowment Fund Objectives

The System's and universities' investment policies (with the exception of Southwest Texas) do not state the high-level objectives of endowment fund management. The purpose of an endowment is to provide perpetual support for scholarships, professorships, and other initiatives. To fulfill this long-term purpose, the primary objectives of endowment fund policies typically include some or all of the following:

- Provide an adequate level of support (payout) to meet the needs of current beneficiaries.
- Increase the level of support by at least the rate of inflation to protect future beneficiaries.
- Increase the value of the endowment fund by at least the rate of inflation.

Funds create policies that will help meet their objectives. By not acknowledging these high-level endowment fund objectives, the System's universities might unknowingly adopt endowment spending and investment policies that cause the benefits provided by today's gifts to decline in future years.

To achieve these overall objectives, endowment fund investment policies commonly state that total investment return (current income and capital gains) minus spending (management expenses plus distributions to beneficiaries) should at least equal inflation. The scenarios in Table 2 demonstrate how policies can affect this

relationship, determining whether the benefits from today's gifts are diminished or preserved over time.

Table 2

Impact of Spending and Investment Policies on Achieving Long-Term Objectives		
Objective	Investment Strategy	Spending Policy
1. Emphasize benefits for current needs	<ul style="list-style-type: none"> Fixed income and cash equivalents 7% expected return 	Distribute all investment return 7%
2. Provide benefits for current and future needs	<ul style="list-style-type: none"> Fixed income and cash equivalents 7% expected return 	Distribute part of investment return 4%
3. Provide <u>more</u> benefits for current and future needs	<ul style="list-style-type: none"> Equities and fixed income 9% expected return 	Distribute part of investment return 6%

Objective	Earn	Distribute	Number of Scholarships Provided			Ending Balance Year 20
			Year 1	Year 10	Year 20	
1	7%	7%	23.3	17.9	13.3	\$1,000,000
2	7%	4%	13.3	13.3	13.3	\$1,806,111
3	9%	6%	20.0	20.0	20.0	\$1,806,111

Assumptions: \$1 million gift; scholarship cost, year 1 = \$3,000; annual tuition/fees inflation = 3%; expenses = \$0

Source: Scenarios by the State Auditor's Office

The above scenarios show that a gift's current level of benefits can be maintained in perpetuity only when spending is less than investment return by the amount of inflation. In scenario 1, endowment spending and investment policies produced a high level of benefits for current recipients, but only at the expense of benefits for future recipients. Moreover, scenario 3 demonstrates that, by managing for higher investment returns and providing for inflation, policies can produce a reasonably high level of benefits for both current and future beneficiaries.

The Uniform Management of Institutional Funds Act (UMIFA), made applicable to institutions of higher education in 1993, provides appropriate high-level guidance for endowment fund management (see Appendix 3 for the text of UMIFA). UMIFA permits "endowment funds to be invested for the long-term goals of achieving growth and maintaining purchasing power without adversely affecting availability of funds for current expenditure."

The System's and most of its universities' investment policies, on the other hand, only address the requirements of the Public Funds Investment Act (PFIA). The PFIA's emphasis on safety of principal, liquidity, and yield (in that order) is appropriate for the investment of most university funds because those funds will ultimately need to be expended.

However, UMIFA best addresses the needs of endowment funds, which are unique because of their permanence—donors’ contributions must never be expended. In order to achieve investment returns adequate for annual distributions and growth, UMIFA explicitly permits investments that have higher expected returns and risk (variability of returns) than the investments listed in the PFIA.

Section 1-B:

Create a Written Spending Policy for Endowments That Is Consistent With Prudent Endowment Management

The System and its universities (except for Southwest Texas) have not documented their endowment fund spending policy. However, the universities have apparently adopted an informal spending policy of distributing an amount equal to the current income (interest and dividends, but not gains) their investments earn. Three universities (Angelo State, Sam Houston, and Sul Ross) primarily invest in securities that generate only current income but little or no long-term gains. For these universities, total investment return will tend to equal current income. It is likely that these three universities will not meet the long-term objectives discussed in Section 1-A, because total return minus spending will be less than inflation.

Lamar and Southwest Texas have significant investments in equities, which tend to generate gains. If these two universities spend only current income, their retained gains might be sufficient to offset inflation. However, with a high allocation to equities, current income might decline and not be able to support desired long-term spending levels.

Only 6 percent of institutions in the *NACUBO Endowment Study* base endowment spending policy on current income like the universities in the System. A large majority (73 percent) spend a predetermined percentage of the market value of their fund. (See Table 3.) By basing spending on a percentage of the fund’s value, if the fund’s value grows as fast as inflation, spending will also keep up with inflation.

Table 3

Endowment Spending Rules		
Spending Rule	Participating Institutions	
	Number	Percentage
Spend all current income	17	3.4
Spend a prespecified percentage of current income	13	2.6
Spend a prespecified percentage of beginning market value	28	5.6
Spend a prespecified percentage of a moving average of market values	338	67.9
Increase prior year’s spending by a prespecified percentage	32	6.4
Decide on an appropriate rate each year	26	5.2
Other rule	40	8.0
No established policy	4	0.8
Total	498	100.0

Source: Excerpted with permission from the *1997 NACUBO Endowment Study*, Executive Summary, page 4. Copyright 1998, National Association of College and University Business Officers, bold added.

By basing spending only on current income, the System's universities are subject to swings in spending levels as interest rates increase or decline. Such a policy can cause managers to focus on short-term results instead of long-term growth when allocating assets, thereby reducing total investment returns. If current income declines, a university might need to decrease its holdings in higher-returning equities and increase its holdings in fixed-income investments.

Southwest Texas has the only investment policy with a specific spending rate objective as well as an expectation to maintain the endowment fund's purchasing power. However, its spending policy mixes spending current income and spending a percentage of market value. The policy commits to earning and distributing current income equal to 5 percent of the fund's market value. Southwest Texas' goal is to allocate 60 percent of assets to equities and 40 percent to fixed income (primarily short-term U.S. government securities). If Southwest Texas achieves its target asset allocation, it is likely that current income will be less than 5 percent of asset market value. Southwest Texas might need to modify this spending policy to permit the use of some gains to achieve a 5 percent distribution rate.

Section 1-C:

Set an Asset Allocation Target for Endowment Funds That Is Capable of Sustaining Spending Levels and Growth

How important is asset allocation?

Asset allocation (the relative mix of different types of investments such as equities and fixed income) accounts for up to 90 percent of an entity's total investment return. Selecting an asset allocation strategy is one of the most important investment-related tasks the Board of Regents or university management performs.

The System's and universities' investment policies (with the exception of Southwest Texas) do not include specific asset allocation targets for endowment funds. We estimate that the System's universities might have been able to earn as much as 8 percentage points more in the year ended June 30, 1997, if the asset allocation were more in line with that of the average small endowment fund.

A rough approximation, based solely on benchmark performance, suggests that the System's combined asset allocation might have generated an 11 percent total return for

the year ended June 30, 1997. For the same period, the NACUBO study reported a 19 percent rate of return for endowment funds with investments of \$25 million or less. Based on the System's combined endowment investments of \$51.4 million as of August 31, 1997, an 8 percent underperformance in the future would have resulted in \$4.1 million in lower earnings (see Table 4). (System universities do not compute time-weighted returns for their endowment funds to enable direct comparison with performance of other endowment funds. See section 1-D for more information.)

Estimated performance for individual System universities varied substantially, from a low of 7.6 percent for Sam Houston to a high of 16.7 percent for Lamar. This is not surprising considering the differing asset allocations among System components. As of August 31, 1997, Sam Houston had virtually no equities and 27 percent cash equivalents. Lamar, on the other hand, allocated almost 48 percent to equities (see Table 4).

Table 4

Estimated Underperformance of System Endowment Funds Versus the NACUBO Average Small Endowment Fund							
	NACUBO Average Small Endowment Fund	System Combined	Angelo State	Lamar	Sam Houston	Southwest Texas	Sul Ross
Estimated Rate of Return Difference (Year Ended June 30, 1997)							
Total Return Estimate (NACUBO actual)	19.0%	11.0%	8.7%	16.7%	7.6%	15.9%	7.8%
Estimated System Underperformance	N/A	8.0%	10.3%	2.3%	11.4%	3.1%	-11.2%
Dollar Impact of Estimated Underperformance (Based on August 31, 1997, Balances)							
Endowment Fund Size	\$25 million or less	\$51,378,429	\$8,830,018	\$7,188,042	\$19,439,926	\$11,861,049	\$4,059,394
Estimated System Underperformance	N/A	\$4,110,274	\$909,492	\$165,325	\$2,216,152	\$367,693	\$454,652

Sources: The NACUBO average one-year total return is from the *1997 NACUBO Endowment Study*. Copyright 1998, National Association of College and University Business Officers. Benchmark performance for the year ended June 30, 1997, was used to approximate System portfolio performance (90-Day T-Bill; Lehman Brothers Aggregate Bond Index, Wilshire 5000 Index, and NCREIF Property Index). The benchmark information is from the *1997 NACUBO Endowment Study*, and the System universities' asset allocations are from quarterly investment reports as of August 31, 1997.

Our estimate might not precisely reflect the actual rates of return of the System universities' endowment funds. The following factors could reduce the precision of our estimate:

- We used end-of-period market values and allocations, due to their availability.
- System fixed income portfolios might not perform like the benchmarks used in the estimate. For example, the Lehman Brothers Aggregate Bond Index includes some fixed income types that produce higher long-term returns than the fixed income securities that currently compose the System universities' portfolios.
- Angelo State, Sul Ross, and Southwest Texas hold substantial collateralized mortgage obligations (CMOs), most of which are highly volatile. Our estimate treated these CMOs the same as other fixed income investments although their performance might not match the Lehman Brothers Aggregate Bond Index.

The above uncertainties illustrate the need for the System's universities to compute and report endowment fund investment performance according to industry standards.

When viewed as a single entity, the System's combined endowment fund asset allocation differs significantly from the average small endowment fund (\$25

million and under) in the NACUBO study. (See Figure 2.) When considered together, the five universities:

- Allocate substantially fewer assets to equities and related investments (such as real estate and alternative investments) than equivalent-sized endowment funds in the NACUBO study. Equities and related investments tend to generate the highest long-term total return.
- Allocate more assets to cash equivalents than equivalent-sized endowment funds in the NACUBO study. Cash equivalents generate the lowest long-term total return.
- Allocate more assets to fixed income securities than equivalent-sized endowment funds in the NACUBO study.

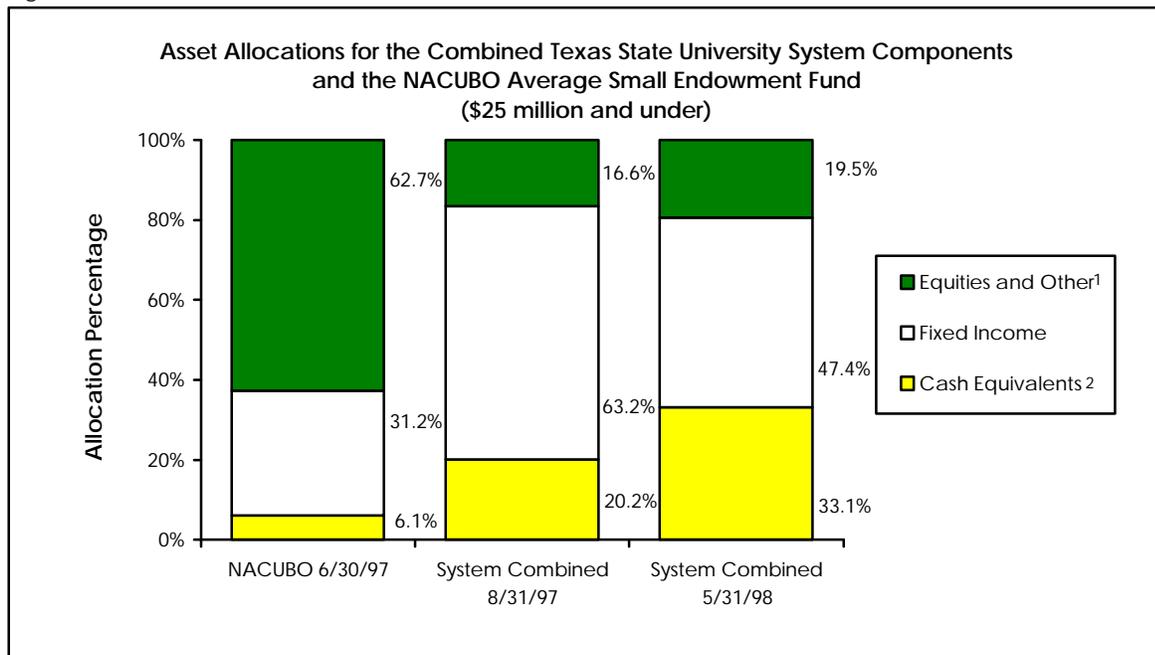
In addition, the five universities' fixed income portfolios only include shorter-term U.S. government and agency securities, which typically generate the lowest total return and lowest risk (volatility) of the fixed income class. Most endowment funds include longer-term fixed income securities and diversify holdings to include corporate bonds and mortgage-backed securities, which generally provide higher returns but at a higher risk.

The universities' asset allocations also differ significantly when compared to each other and to the average small endowment fund. (See Figure 3 and Appendix 2). Primary differences include:

- As of May 31, 1998, Lamar's equity allocation was higher than the NACUBO average small endowment. However, Lamar allocated the remainder of its assets to cash equivalents, which have the lowest long-term total return.
- Three universities (Angelo State, Sam Houston, and Sul Ross) held only negligible amounts in equities, the class with the highest long-term total return. These universities apparently obtained their equity investments from donors rather than from directly investing in this asset class.
- Angelo State, Lamar, Sam Houston, and Sul Ross allocated more to cash equivalents than the NACUBO average. Three of those four (all except Lamar) significantly increased their allocation to this asset class between August 31, 1997, and May 31, 1998.

Furthermore, Southwest Texas has not adhered to its investment policy, which calls for increasing the allocation to 60 percent equities as collateralized mortgage obligations (CMOs) mature or are sold. This percentage would be comparable to the NACUBO average. However, the actual equity allocation declined as of May 31, 1998, despite the sales of some CMOs prior to that date. Southwest Texas instead invested the proceeds in fixed income securities.

Figure 2



Source: Data compiled from the 1997 NACUBO Endowment Study. (Copyright 1998, National Association of College and University Business Officers) and from System quarterly investment reports.

¹NACUBO's "other" includes investments such as venture capital, leveraged buyouts, and real estate. The System's "other" is real estate held for sale by Sam Houston.

²Cash equivalents are short-term liquid assets with maturities of less than one year at the time of purchase.

Figure 3

Asset Allocations for Individual System Universities and the NACUBO Average Small Endowment Fund (\$25 million and under)

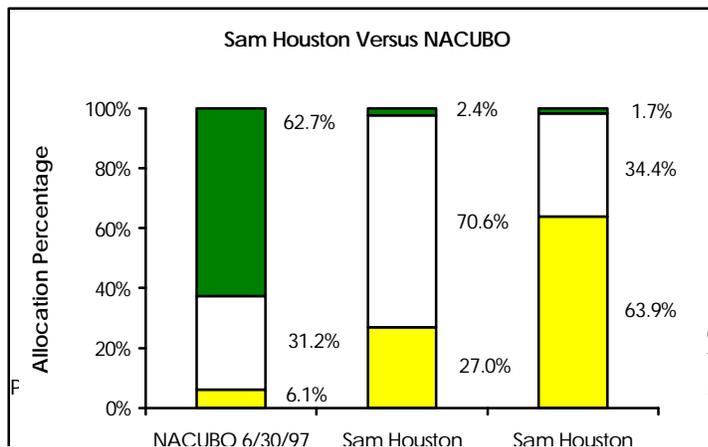
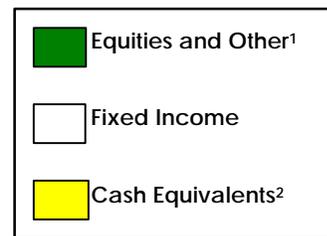
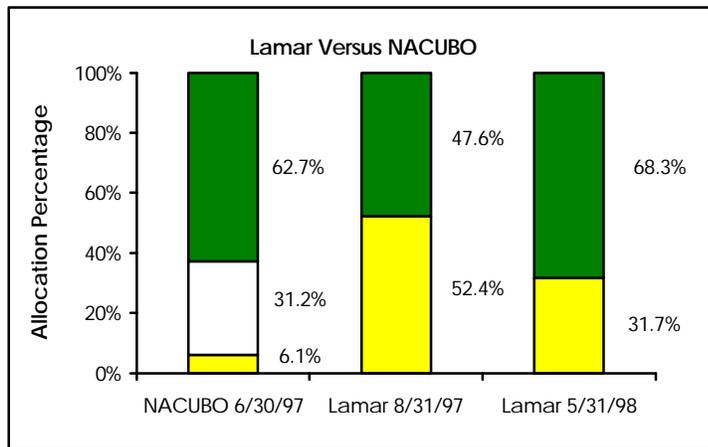
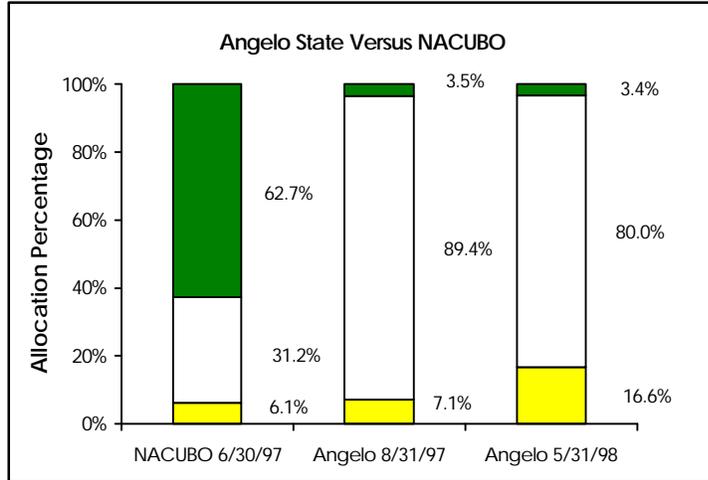
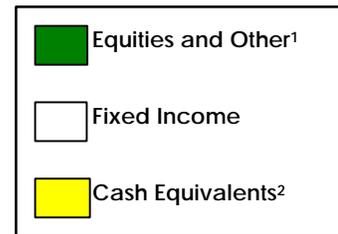
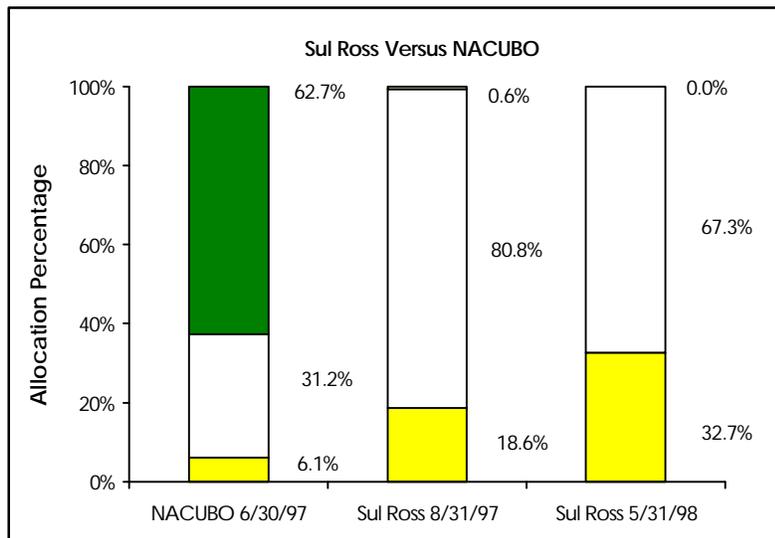
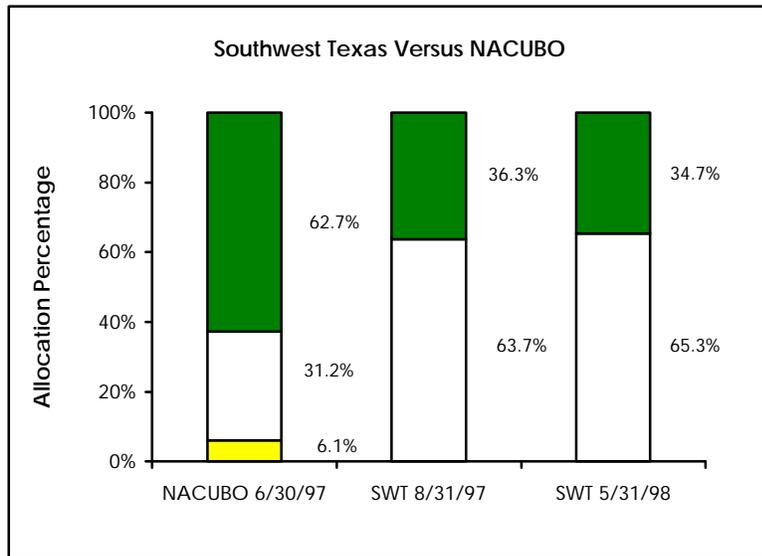


Figure 3, concluded



Sources: Data compiled from the 1997 NACUBO Endowment Study, (Copyright 1998, National Association of College and University Business Officers) and from System quarterly investment reports

¹NACUBO's "other" includes investments such as venture capital, leveraged buyouts, and real estate. The System's "other" is real estate held for sale by Sam Houston.

²Cash equivalents are short-term liquid assets with maturities of less than one year at the time of purchase.

The fund's management must ensure that the long-term asset allocation corresponds to the endowment fund's spending policy. As discussed previously, expected total return should exceed expected spending by at least the rate of inflation. Once management establishes the desired spending level and agrees upon an inflation assumption, the minimum level of total return needed becomes apparent. With the assistance of an investment consultant, or by using long- and short-term historical

rates of return for various asset classes, endowment fund managers can determine various asset class mixes that are likely to provide the needed level of return.

The fund's managers must also consider the risk (volatility, or standard deviation, of periodic returns) associated with the various asset class mixes. Typically, investments that have higher expected returns, such as equities and "alternative investments,"

Long-Term Rate of Return is Related to Asset Allocation

Historical data has shown an asset allocation of 70 to 80 percent to equity securities is required in order to provide an expected average investment return in excess of 8.5 percent. Although there is a higher volatility (standard deviation) associated with an equity oriented portfolio, endowment funds can absorb this risk due to their perpetual nature.

Source: *The University of Texas System Long Term Fund Annual Report, Year Ended August 31, 1997*

also have higher expected risk (see Table 5). However, the combined portfolio can achieve higher expected returns and minimize increases in risk by diversifying among asset classes whose returns are not highly correlated (they do not all behave the same way when market conditions change).

Nevertheless, an allocation weighted heavily toward equities typically has higher volatility than a primarily fixed income allocation. If members of the Board or management are not comfortable with this higher level of risk, they must choose a more conservative asset allocation. As a result, they will need to reduce both their return expectations and their spending level assumption if they expect to preserve the endowment fund's purchasing power.

Table 5

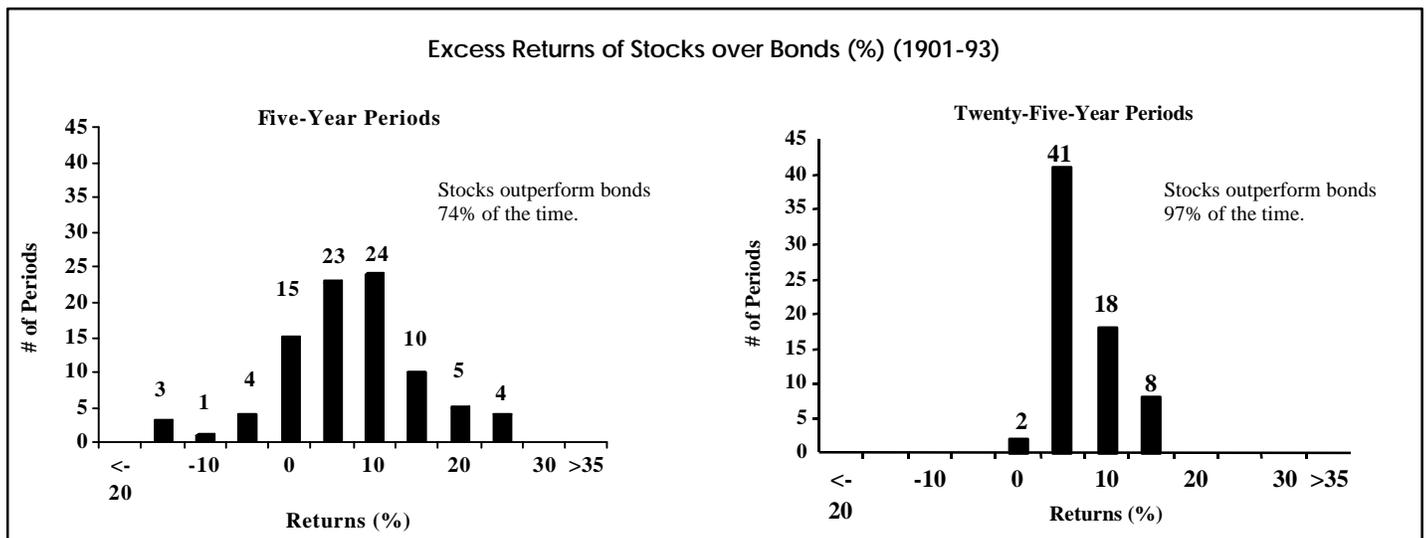
Historical Investment Return and Risk (Standard Deviation) for Various Asset Mixes (U.S. Stocks and Bonds only)				
Ratio of			Annual Average Compound Return (%)	Standard Deviation (%)
U.S. Stocks (Equities)	to	U.S. Bonds (Fixed Income)		
0		100	5.2	9.8
10		90	5.8	9.9
20		80	6.4	10.3
30		70	6.9	11.0
40		60	7.4	12.0
50		50	7.9	13.1
60		40	8.3	14.4
70		30	8.7	15.9
80		20	9.1	17.4
90		10	9.4	19.0
100		0	9.7	20.6

Source: *The University of Texas System Long Term Fund Annual Report, Year Ended August 31, 1997*

In recent years equities have outperformed fixed income by more than the historical average. Therefore, the System endowments' underperformance was probably greater in recent years than it would have been in an "average" year.

As the stock market's performance in the summer of 1998 demonstrated, fixed income investments will sometimes outperform equities. When that happens, the System's overall asset allocation may produce total returns well above the average endowment fund. Nevertheless, history has demonstrated that, over longer time periods, equities have consistently and significantly outperformed fixed income investments. Figure 4 shows that, for example, out of the 69 twenty-five year periods between 1901 and 1993 (1901-1925, 1902-1926, and so on) equities failed to outperform fixed income in only 2 periods. On the other hand, equities outperformed fixed income by around 10 percent for 18 of the twenty-five year periods.

Figure 4



Sources: Ibbotson Associates, Standard & Poor's Statistical Service, and Salomon Brothers; Extracted from a 1994 report prepared by Cambridge Associates, Inc.

Section 1-D:

Appropriately Compute and Evaluate Investment Return for Endowment Funds

The System's and universities' investment policies do not document how endowment fund investment performance should be computed and evaluated. In practice, the universities lack consistent and appropriate methods to measure and report the performance of their endowment fund investments. As a result, the universities cannot validly compare their endowment funds' investment performance to other System universities, outside endowment funds, their own benchmarks, or their long-term investment expectations.

- The universities do not all calculate performance the same way. For example, Angelo State divides current income by the average book and market values for the computation period. However, the other four universities use ending book and market values as the denominator in their computations. If book and market balances increased during the period, the other universities' method would report lower rates of return than Angelo State's method.
- The universities do not separately compute and report their endowment funds' investment performance. Instead, they report the performance of all fund types combined. Endowment funds typically have substantially different investment objectives and strategies than other university funds, so their performance should be separately presented.
- The System does not compute time-weighted rates of return for its investments. Market value changes during the measurement period are not included in return calculations. Time-weighted rate of return is the industry standard for reporting investment performance.
- Comparison to benchmark performance on internal quarterly investment

Time-Weighted Rate of Return Is the Industry Standard for Measuring Performance

Time-weighted rate of return allows evaluation of investment management skill between any two time periods without regard to the total amount invested at any time during that time period. The measure is independent of the total amount invested because the manager normally does not control the inflow or outflow of money.

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reports may be misleading. The universities' calculations exclude market value changes and only include current income. Benchmark performance is based on total return (market value changes plus current income). In addition, if the universities' fixed income portfolio composition were more like that of average endowment funds, most System universities would need longer-term benchmarks for appropriate performance comparisons.

- The universities do not report overall investment performance

for periods longer than one year. Customary practice for institutional investors and money managers is to report performance over periods such as three, five, and ten years in addition to the current period and year.

Recommendation:

The System should develop a separate investment policy for its universities' endowment funds. It should address the related elements of a successful policy.

Long-Term Objectives

The System should document whether it expects to invest and manage endowment funds in a way that protects the donors' gifts and the resulting distributions to beneficiaries against inflation.

Spending Policies

Endowment fund investment policies should clearly document the method used to determine the dollar amount of annual distributions to beneficiaries. The Board of Regents or university management should consider selecting a spending policy that permits them to maintain a relatively consistent distribution level despite short-term fluctuations in the capital markets.

Asset Allocation

Endowment fund investment policies should include asset allocation targets and allowable ranges around those targets. The asset allocation targets should be selected to achieve the long-term return necessary to sustain the desired spending level and achieve any growth objectives stated in the policy. In addition, the allocation should be consistent with risk levels acceptable to the Board of Regents.

If the System and its universities want their endowment funds to perform like the average comparably-sized endowment fund, then they will need similar asset allocation targets. Most of the System's universities would need to increase allocations to equities and longer-term, more diversified fixed income securities.

Measurement and Evaluation of Long-Term Investment Returns

Endowment fund investment policies should acknowledge specific expectations for the measurement and evaluation of investment performance. The process should include comparisons of actual performance against expectations to determine if endowment funds are performing according to long-term expectations. Specific improvements to the System's current performance measurement processes include:

- Ensure that all universities use the same method to compute performance.
- Separately compute and report endowment fund performance due to the unique nature of these funds.
- Ensure that all universities include income and market value changes in their performance measurements. The universities should use the time-weighted rate of return methodology to ensure that results are comparable to other funds and to appropriate benchmarks. Investment consultants, performance measurement specialists, or investment custodians typically have the expertise and software to perform these calculations.
- Report endowment fund investment performance over several periods, such as one, three, five, and ten years, for comparability with other entities' endowment performance.

Although the System could attempt to perform all of the above on its own, we believe that the System could best accomplish these tasks with the assistance of an independent investment consultant. The System should obtain such services through a competitive proposal process and should ensure that the consultant has specific experience with endowment funds. The projected long-term benefits of hiring a consultant to help improve endowment management should outweigh the additional costs incurred.

Management's Response:

The System Administration's staff was in the process of preparing a revised investment policy, when the draft of the Investment Review was released, to specifically address the investment of endowment funds for consideration by the Board at its November 1998 meeting. It is now the intent of the staff to have the revised investment policy presented to the Board of Regents for its consideration at the March 1999 Board meeting. Each component will develop long-term objectives, spending policies, and asset allocations which relate directly to the unique composition of its endowments and the needs of the university. A common performance evaluation will be identified for use by each university.

State Auditor's Follow-Up Comment:

We believe that the Board of Regents should play a leading role in the policy-making process to help ensure success for each component's endowment funds. Management's response does not indicate whether the System's overall investment policy will be changed to provide more guidance to the components on the minimum expectations for endowment fund management. In addition, the System's response does not commit to measuring investment return using time-weighted rate of return over longer time periods. This is the only method that will allow components to adequately assess the success of their endowment fund strategies.

Section 2:

The System Could Benefit From Pooling Endowment Fund Investments

The System's component universities could significantly benefit from pooling their \$51.4 million in endowment fund investments:

- They could probably obtain higher long-term investment returns by investing their endowment funds as a single pool, based on results reported in the *1997 NACUBO Endowment Study*.
- If each university began investing more like the average endowment fund, the pool would incur lower management fees than if each university separately managed such investments.

Other benefits include the potential for additional investment diversification and standardized investment policies and practices. We recognize possible drawbacks to pooling, but we believe that the potential advantages outweigh the disadvantages.

The System and universities could probably obtain higher long-term investment returns. The NACUBO study reported that larger endowment funds had higher returns than smaller ones. Endowment funds of \$25 million or less had an average ten-year return of 10.4 percent, while funds between \$25 and \$100 million had an average return of 11.2 percent. These higher returns were consistent when measured over shorter periods. (See Table 6.)

By pooling their individual endowment funds, which range in size from \$4 million to \$19 million, each university might share in the higher potential returns. A 1 percent increase in performance represents about \$500,000 more in return per year based on the combined size of the current endowments.

Table 6

Investment Pool Returns by Investment Pool Size				
Investment Pool Size (in millions)	Average Annual Compound Returns (in %, years ended June 30)			
	1 Year	3 Years	5 Years	10 Years
	1997	1995-97	1993-97	1988-97
\$25 and under	19.0	15.9	12.0	10.4
Over \$25 to \$100	20.1	17.4	13.4	11.2
Over \$100 to \$400	20.9	18.0	14.1	11.7
Over \$400	21.6	19.4	15.1	12.2

Source: Excerpted with permission from the *1997 NACUBO Endowment Study*, Exhibit 15, page 124. Copyright 1998, National Association of College and University Business Officers.

Of course, a larger investment pool will not by itself guarantee higher returns. The NACUBO study notes that the larger pools have allocated more investments to equities. In addition, they have further diversified their equity portfolios to include more non-U.S. equities and “alternative equity investments” such as real estate, venture capital, and buyout funds.

Pooling investments can reduce investment management fees. Most investment professionals, such as independent consultants and money managers, use a sliding fee structure that charges less per dollar invested as portfolio size increases. (See Table 7.)

Table 7

Representative Management Fees for Various Investment Vehicles of the Common Fund		
Portfolio Size	Fees on Multi-Strategy Equity Fund (in basis points) ¹	Fees on Multi-Strategy Fixed Income Fund (in basis points) ¹
First \$ 2 million	60	40
Next \$ 3 million	50	35
Next \$ 5 million	40	30
Next \$ 15 million	35	25
Next \$ 25 million	30	20
Excess	25	15

Source: *The Common Fund, Information for Members, November 1, 1997*

¹A basis point is 1/100 of one percent, typically in reference to asset value or rate of return. For example, a management fee of 40 basis points is equivalent to 0.4 percent of the market value of the investments managed. The NACUBO study's average investment return of 19.0 percent is 800 basis points higher than our 11.0 percent estimate of the System's return (see Table 4 in Section 1-C).

What is The Common Fund?

The Common Fund for Nonprofit Organizations is a tax-exempt membership corporation operated by and for its Member colleges, universities, and independent schools. The Common Fund provides investment and treasury management services to help its Members maximize risk-adjusted returns for endowment and operating funds.

The Common Fund offers a series of pooled investment funds, each of which has its own investment objectives, policies and strategies

Because of its size, The Common Fund can provide investment and diversification opportunities that would not otherwise be available to most endowments, and it can also provide a level of monitoring of managers and the capacity to make needed adjustments that are not feasible or efficient for most endowments.

As an example of potential savings, Lamar and Southwest Texas each invest in an equity fund offered by The Common Fund. The Southwest Texas Development Foundation, whose investments are managed by Southwest Texas State University, also invests in this particular fund. We estimate annual management fees of approximately \$71,000 on these separate portfolios, which totaled over \$13 million in May 1998. If The Common Fund permitted the System to pool these three accounts into one investment, the annual fees would be \$58,000, saving over \$13,000 (19 percent).

Source: *The Common Fund, Information for Members, November 1, 1997*

Similarly, we estimate that if the System's universities chose to invest all

of their endowment funds through The Common Fund, they could save \$53,000 annually (23 percent) by investing through a single account instead of separately. We assumed, for this estimate, that the System and universities would allocate 60 percent of their assets to equities and 40 percent to fixed income, similar to the average endowment fund. In addition, we assumed that they each invested in the same equity fund and the same fixed income fund of The Common Fund, although several choices are available for each asset class.

Total management fees invested as above in separate accounts would be \$230,000 or 45 basis points. Total management fees for the pool would be \$177,000 or 34 basis points. (See Table 8.)

Table 8

Hypothetical Management Fees (60 percent of funds invested in equities and 40 percent in fixed income)							
University	Total Endowment Assets August 31, 1997	Invested Separately		Invested As A Pool		Annual Fee Savings From Pooling	
		\$	basis points ¹	\$	basis points ¹	\$	%
Angelo State	\$ 8,830,018	41,554	47	30,396	34	11,158	26.9%
Lamar	\$ 7,188,042	34,627	48	24,743	34	9,884	28.5%
Sam Houston	\$ 19,439,926	79,652	41	66,918	34	12,734	16.0%
Southwest Texas	\$ 11,861,049	53,072	45	40,829	34	12,243	23.1%
Sul Ross	\$ 4,059,394	20,673	51	13,974	34	6,699	32.4%
TOTALS	\$ 51,378,429	229,578	45	176,860	34	52,718	23.0%

¹One basis point represents 1/100 of one percent of the value of investments managed.

Source: Hypothesis by the State Auditor's Office based on The Common Fund's fee structure in Table 7

If the System and its universities pool their investments, they will likely encounter the following pros and cons:

- The System could create one uniform investment policy so that each university could benefit from improved investment practices. However, pooling investments goes against the System's decentralized management. For that reason, the universities may resist it.
- Through pooling, all universities would invest a portion of their endowments in equities, based on the System's selected asset allocation target. Some universities may believe that this asset class is too risky, despite the fact that the average fund has over 60 percent of its investments in equities.
- With a larger pool of investments, the System could diversify into multiple equity and fixed income portfolios. The System might choose non-U.S. equities and fixed income securities and possibly some "alternative equity" investments as pool size increases. Larger endowments use alternative equities, such as real estate, venture capital, and buyout funds to enhance expected returns without adding significant overall risk (volatility of returns).

On the other hand, additional diversification would reduce the potential cost savings achieved by investing larger amounts in just a few funds. However, with appropriate guidance from an investment consultant, a diversification strategy should be designed so that expected benefits exceed the additional costs.

- The System would incur some new costs in adopting a pooling strategy, especially if it adopted an asset allocation more like other endowment funds.

For example, the System and universities do not currently use an independent investment consultant for their endowments. A consultant could provide critically needed services, including formulating a System-wide endowment investment policy, analyzing various asset allocation strategies, selecting and evaluating money managers, and measuring and evaluating investment performance. The System and universities are weak in almost all of these areas.

Based on the fee structure paid by the Angelo State University Carr Foundation for similar services, the System might expect to pay less than six basis points, or less than \$30,000, per year for consulting services.

- Other new or increased costs would result if all investments were managed externally, through either The Common Fund or other money managers. Some universities already use external managers for a portion of their portfolio. However, university personnel directly manage the majority of their endowment investments.

The costs added by shifting this duty to professional money managers would not be excessive, as demonstrated in Table 8. The universities would benefit from the additional personnel resources made available by transferring this duty to outside experts. More significantly, professional money managers have the time, resources, and expertise to take advantage of sectors of the capital markets, such as corporate bonds and mortgage-backed securities, in which the universities do not currently invest. The long-term returns expected from professional money management should far outweigh its added cost.

- If, by creating a larger pool, the System were to achieve the increase in long-term return reported in the NACUBO study for the \$25 to \$100 million endowment fund category, its ten-year returns might increase by about 80 basis points per year. This increase alone should more than cover all investment management fees of the pool, including a consultant and money managers, as well as internal accounting costs needed to track each university's share balance. The NACUBO study reported average annual investment management fees of approximately 50 basis points for small- and mid-sized endowment funds.
- Three universities held \$11.7 million of endowment funds in highly volatile collateralized mortgage obligations (CMOs) as of August 31, 1997. These investments are not suitable for pooling due to their volatility. Although that balance has been declining due to recent sales, those universities might not want to sell them immediately to invest the proceeds in an investment pool. A solution would be to permit those universities to hold their CMOs as separate endowment investments and, as they are sold or mature, invest the proceeds in the pool.

In addition to the above pros and cons, the System should also consider the following issues:

- It is possible that The Common Fund would not permit the System to hold its endowment funds as a pool to achieve some of the cost savings or diversification opportunities discussed above. The System itself would need to qualify for membership in The Common Fund. We believe that, if not permissible under the rules of The Common Fund, the System has sufficient investments to warrant consideration of directly contracting with external money managers under a pooled-fund arrangement.
- If pooling is successful at increasing returns and decreasing fees, foundations affiliated with the System's universities might later want to join the pool (if legally permissible). By adding their funds for investment purposes (records would be maintained showing each university's and/or foundation's share of the investments), all participants might enjoy further economies of scale. Three foundations have over \$25 million in addition to the \$45 million Carr Foundation. However, the Carr Foundation's attorney does not believe the Carr Foundation could pool its funds with the System's.

Recommendation:

We recommend that the Board of Regents require pooled management of the universities' endowment funds. The Board would need to take the following steps to accomplish this change:

- Develop a uniform endowment fund investment policy. This uniform policy should include the minimum required elements recommended in Section 1 for each university's policy. The Board should consider obtaining the assistance of an independent investment consultant.
- Determine who will be responsible for day-to-day investment decisions. The simplest, and possibly the most cost effective, investment approach might be to invest through membership in The Common Fund as is done by many universities. However, the independent consultant could advise the System on the benefits and costs of using other money managers.
- Develop strategies for bringing existing funds into the pool. During the transition to a pool, universities could be permitted to retain certain investments, such as CMOs or individual fixed income investments, until maturity.
- Determine how to finance any new costs. Allocation of all internal and external management costs to each university in proportion to its share of the pool seems equitable. Some external costs, such as money manager fees, are likely to be deducted from the portfolio and would not require cash outflows from the System or universities.

Management's Response:

At this time, it does not appear to be advantageous for the System to pool its endowment assets. The Endowment Funds eligible to be pooled are somewhat less than the \$51 million quoted in the report; therefore, the cost of fees for an investment consultant and an investment manager plus the additional System administrative cost appears to exceed any possible savings gained through pooling. Approximately \$28.8 million is available to be pooled at August 31, 1998, this excludes the investment in collateralized mortgage obligations, as you suggested, quasi endowments, and restrictive endowments. The individual universities will be encouraged to develop investment strategies to grow the corpus of the endowments, while maintaining the integrity of any special donor directives, and providing current income to meet operating needs. We are identifying cost saving measures that will assist the universities in maximizing their net income available for current utilization.

Should conditions change or an overriding need arise, this issue of pooling endowment assets of the universities will be revisited.

State Auditor's Follow-Up Comment:

We agree with the System's assessment that not all of the \$51.4 million of endowment funds are currently available for pooling, although the System could include remaining quasi endowments in pooled investments. However, net benefits may still be achieved by pooling the available investments.

If components begin investing more like typical endowment funds to enhance expected investment returns, they will individually incur additional investment management fees. These fees will likely be higher per dollar invested for individual components than for a pool. In addition, larger endowment funds tend to have higher returns.

We believe that an independent endowment fund consultant could provide much needed assistance, particularly at the front end of a major investment strategy change. However, if the System has concluded that endowment fund consultants are not necessary at the component level, no additional risk would be incurred by not hiring a consultant for the pool.

Section 3:

The Board of Regents Should Consider Changing the Angelo State University Carr Foundation's Policies to Improve Performance

The policies of the Angelo State University Robert G. Carr and Nona K. Carr Scholarship Foundation (Carr Foundation):

- Do not ensure that investment returns protect the \$45 million Carr Foundation from inflation. Investment balances and spending levels have relied on

portions of new contributions to keep pace with inflation. Most endowment funds use new contributions to provide an equivalent level of new benefits (scholarships).

- Contribute to the Carr Foundation's poor long-term investment performance. For the ten-year period ending March 31, 1998, the Carr Foundation's total return of 8.8 percent was only 65 percent of the 13.6 percent total return earned by the median fund in a population of 209 endowments and foundations.

If allowed to persist, these two problems will keep the Carr Foundation from (1) using all of the investment income generated by its new contributions to fund new scholarships and (2) maximizing growth.

The members of the Texas State University System Board of Regents (Board), who are the Trustees of the Carr Foundation, are responsible for setting the Carr Foundation's policies. Constraints imposed by laws or donor restrictions may prevent the Board from managing it exactly like most endowment funds. Notable differences include long-term policy objectives, spending policy, asset allocation, and laws under which the Carr Foundation operates. However, to improve the Carr Foundation's performance and protect against inflation the Board could:

- Make addressing inflation an objective.
- Change the way it determines how much of its returns to spend (within the restrictions of the law and the donors).
- Increase the amount of assets allocated to equities.
- Research the Carr Foundation's continued need to operate under the Texas Trust Act rather than the Uniform Management of Institutional Funds Act (UMIFA).

(Ideally, universities should encourage donors to establish their endowments free from restrictions on investment management. Then, universities would be able to better manage the endowments' investing and spending as permitted by the Uniform Management of Institutional Funds Act [UMIFA]. Please see Section 4 for more information.)

Section 3-A:

Address the Impact of Inflation through the Investment Policy's Long-Term Investment Objective

Preserving the purchasing power of the funds and annual distributions (spending) is not one of the Carr Foundation's investment policy objectives. Its stated objective, "achieving an optimal total return while considering the conservation of capital and avoiding undue risk," has not ensured that investment returns alone preserve

purchasing power against inflation. Most endowments' primary investment objective is to grow the principal and spending over time to keep pace with, or even exceed, inflation.

To obtain their primary objective, endowment fund investment policies commonly state that total investment return (current income and capital gains) minus spending (management expenses plus distributions to beneficiaries) should at least equal inflation. If investment results succeed in maintaining purchasing power (scholarship award amounts keep up with tuition and fee increases), an endowment can use new contributions to increase purchasing power (new scholarships can be awarded).

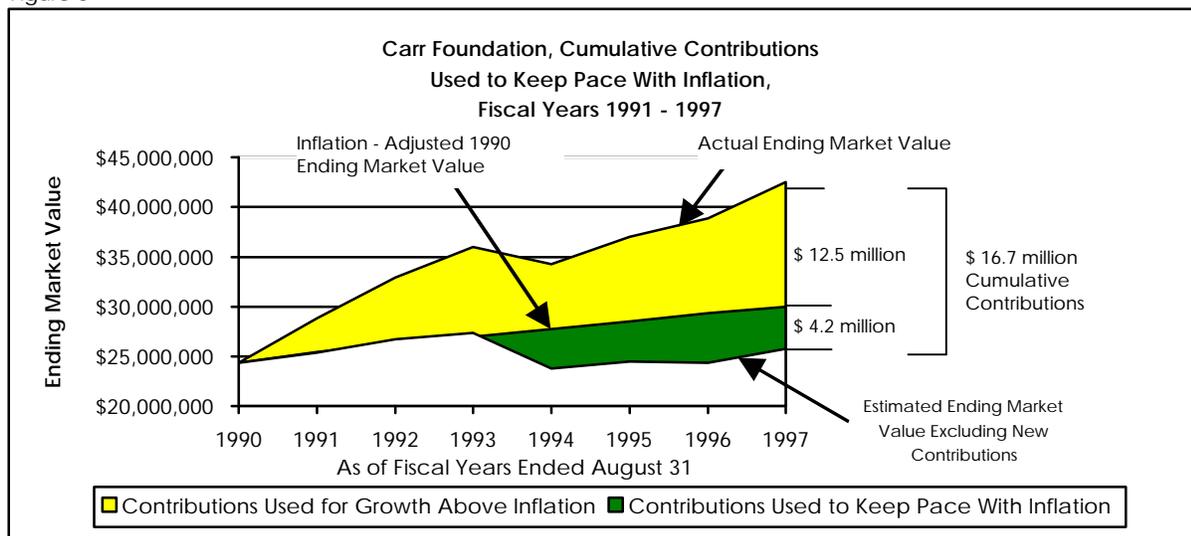
Because the Carr Foundation's investment objectives do not ensure that unspent investment returns maintain purchasing power, the following has occurred during the seven-year period ended August 31, 1997:

- The Carr Foundation's cumulative unspent investment return (6 percent) was much lower than cumulative inflation (23 percent). Consequently, the Carr Foundation had to rely on \$4.2 million (17 percent of beginning assets) of new contributions from annual revenues to maintain the purchasing power of the fund after inflation. During those seven years, oil and gas revenues added 68 percent (\$16.7 million) to the fund—the Carr Foundation used one quarter of that amount to offset the effect of inflation on the fiscal year 1990 ending balance. (See Figure 5).

How is the Carr Foundation funded?

The Carr Foundation is funded by continuing revenues from the oil and gas interests donated by the Carrs. These revenues must be permanently added to principal and invested. Only the investment return, in whole or in part, may be used to fund scholarships for needy and worthy students of Angelo State University.

Figure 5



Sources: Carr Foundation audited financial statements; annual inflation rates from Employees Retirement System of Texas comprehensive annual financial reports

- Spending did not grow in proportion to the increase in the fund. The Carr Foundation spends all current income, while other endowment funds spend an amount equal to a percentage of their funds' market value. If these other funds grow to keep up with inflation, then so does their spending. So, while the Carr Foundation's value increased by 74 percent (with the help of new contributions), spending increased only 36 percent. In addition, the Carr Foundation needed most of the investment income generated by the new contributions to enable annual distributions for expenses and scholarships to keep pace with inflation. (For more information on the Carr Foundation's spending policy, see Section 3-B.)

In fiscal year 1990, the Carr Foundation's investments produced \$2 million in spendable income. To have that level of purchasing power in fiscal year 1997 based on the 23 percent inflation, the same assets (without new contributions) would have needed to produce \$2.5 million in spendable income. However, of the \$2.8 million of actual spendable income in fiscal year 1997, we estimate that only \$1.7 million (61 percent) was generated by the fund's 1990 assets plus retained investment returns. The remaining \$1.1 million (39 percent) came from investment income on the cumulative oil and gas revenues added after fiscal year 1990 (these \$16.7 million in additions represented 39 percent of the \$42.5 million fiscal year 1997 ending balance). Without the new contributions, 1997 spendable income of \$1.7 million would have fallen \$0.8 million below the \$2.5 million inflation-adjusted 1990 level.

Endowment funds typically use new contributions to increase their distributions, which allows them to fund new scholarships or other benefits. The Carr Foundation, on the other hand, had to rely on a portion of annual oil and gas revenues to maintain the fund's purchasing power after inflation. Therefore, these new contributions could not be entirely used to generate a proportionate increase in scholarships.

Section 3-B:

Reassess the Carr Foundation's Spending Policy and Asset Allocation Targets to Increase Returns and Stabilize Distributions

The Carr Foundation's spending policy and asset allocation targets work in opposition, making it difficult to maximize the return on its investments and the number of scholarships it can provide. (See Section 1 for more information on the relationship of the components of an investment policy.)

Spending Policy

The Board's spending policy requires the Carr Foundation to promptly distribute all current income for expenses and/or scholarships. As noted in Section 1-B, only 6 percent of endowment funds use such a policy. As a result of the policy's inflexibility:

- The Carr Foundation cannot rely on a steady stream of money to distribute because current income changes as interest rates rise and fall.

Few Endowments Base Their Spending Solely on Income

Most institutions have now recognized that an endowment spending policy based solely on income tends to result either in unmanageable swings in the operating budget, or in distortions in asset allocation decisions as an effort is made to maintain consistent levels of cash flow in different market environments.

Source: Reprinted with permission from the 1997 *NACUBO Endowment Study*, page 3. Copyright 1998, National Association of College and University Business Administrators.

- There is no guarantee that spending will grow proportionately with fund growth. As previously noted, during the seven-year period ended August 31, 1997, the fund increased by 74 percent, but distributions increased by only 36 percent.
- The Carr Foundation will have trouble reducing its reliance on fixed income securities, which produce higher current income but lower long-term total return than equities. To provide a consistent

level of scholarships, the Carr Foundation has to continue to allocate more of its assets to investments that pay more in the short term but do not produce as much wealth in the long term.

The Carrs' wills permit the Carr Foundation to apply any gains and losses earned from investments to either principal or income—the Board can decide which. However, the Board has elected to apply all gains and losses to principal. If the Carr Foundation chose to distribute some gains, it could do without an equivalent amount of current income without disrupting scholarship distribution levels. It could therefore tolerate the decline in current income that would accompany a shift from fixed income to equity investments.

Asset Allocation

As a result of its low allocation to equities, the Carr Foundation's long-term investment performance has been poor compared to most endowment funds. Historically, total returns of equity investments have significantly outperformed fixed income investments. The Carr Foundation's compound annual total return for the ten-year period ended March 31, 1998, was 8.8 percent versus median performance of 13.6 percent for a large comparison group. (See Table 9.) As of March 31, 1998, the Carr Foundation invested only 11.3 percent of its assets in equities versus 63.6 percent for the median fund in the comparison group. If the Carr Foundation's investments had performed as well as the average endowment fund, and if its spending policy were modified, investment returns might have succeeded in growing both the fund and spending at least enough to keep up with inflation.

Table 9

Compound Annual Investment Performance, Periods Ended March 31, 1998				
	1 Year	5 Years	7 Years	10 Years
Carr Foundation	12.1%	7.3%	8.5%	8.8%
209 Endowments and Foundations (Median)	30.1%	14.7%	14.3%	13.6%

Source: Carr Scholarship Foundation Investment Performance Analysis, As of March 31, 1998, prepared by Holbein Associates, Inc.

The Carr Foundation's investment policy states "The total fund investment performance results of the Carr Scholarship Foundation are expected to rank in the top 50 percent of a universe of total funds having similar investment policies." However, the Carr Foundation's investment consultant's performance report for March 31, 1998, indicates that 98 percent of endowments and foundations performed equal to or better than the Carr Foundation during the ten-year period ending March 31, 1998.

The investment policy also sets a target of allocating 30 percent of assets to equities. As of August 31, 1997, only 9.4 percent of assets were in equities. To reach the target allocation to equities, the Carr Foundation would need to make a substantial reallocation between fixed income and equities. As mentioned, such a reallocation would decrease the amount available under the current spending policy to fund scholarships.

Total Return Investing Helps Stabilize Spending

Endowment management has been significantly affected by the trend toward "total return investing." Until the 1970s, most educational institutions spent only income (yield) of endowment funds, treating appreciation as an addition to principal. In the early 1970s, several published studies suggested that institutions could enhance the return on their endowment funds by investing more heavily in equities, especially low-yield "growth" stocks. To avoid the immediate reduction in distributable endowment earnings that a redeployment of fund assets from relatively high-yield bonds to lower-yield stocks would have entailed, many institutions moving more heavily into stocks adopted spending policies that permitted expenditure of both current income and a portion of appreciation.

Source: Reprinted with permission from the 1992 *College and University Business Administration*, page 427. Copyright 1992, National Association of College and University Business Administrators.

The 30 percent target, composed of 15 percent each to domestic and international equities, is still less than half of the average endowment fund's allocation to equities. To approach its policy objective of consistently ranking in the top 50 percent of similar endowment funds, the Carr Foundation will have to significantly increase its allocation to equities.

Instead of a reallocation, the Carr Foundation has recently begun to change its asset mix gradually by investing all new oil and gas revenues in equities. The Carr Foundation is using this approach to avoid decreasing the spending level. As of March 31, 1998, the actual allocation had increased to 11.3 percent. However, the Carr Foundation is reinvesting any gains realized in fixed income, which somewhat negates the impact of the increase in equities. This approach will not quickly increase the percentage invested in equities.

The Carr Foundation's current spending policy presents the greatest obstacle to allocating more assets to equities to achieve higher long-term total return. As consistently noted in the consultant's report, "the search for income has worked against the total return."

Current income would decline if the Carr Foundation sold fixed income investments to purchase equities. Fixed income investments have recently provided interest yields of about 7 percent or less while equities have provided dividend yields of about 2 percent or less. Therefore, the Carr Foundation's income available for distribution might decline by about 5 percent of the amount reallocated to equities.

The Carr Foundation might avoid a decline in current income by reallocating more assets to equities and simultaneously changing spending policy to (1) pay Carr Foundation expenses from principal and/or (2) permit the distribution of some gains.

By using the latter option, the Board could decide to set its target level of annual distributions slightly higher than the prior year to offset the effects of inflation. Obviously, this approach necessitates that there always be sufficient gains available each year to offset the lower level of current income, and this might not always occur.

Reallocate more assets to equities but pay expenses from principal. The Board might be able to increase its equity allocation and expected total return without disrupting distributions for scholarships if it used principal rather than current income to pay administrative and investment expenses. The Carrs' wills permit the Board to "apportion between such principal and income any gain, loss or expenditure in connection with the trust estate as to the Trustees may seem just and equitable, and the Trustees' decision shall be conclusive." If the Carr Foundation paid expenses with principal, then current income available for scholarships would increase by the amount formerly used to pay expenses. Investments could then be reallocated to equities in an amount that results in an offsetting decrease in current income.

For example, as of August 31, 1997, the Carr Foundation held 9.4 percent of its assets (\$4 million out of \$42.5 million) in equities. The Carr Foundation incurred net expenses of \$470,000 in fiscal year 1997. Consequently, of the \$2.8 million in current income, \$2.3 million was available for distribution to Angelo State University's scholarship fund. As discussed earlier in this section, for simplicity we are assuming that current income would decline by about 5 percent of every dollar moved from fixed income to equities. If the Carr Foundation had reallocated \$9.4 million to equities at the beginning of fiscal year 1997, but paid expenses of \$470,000 from principal, distributions for scholarships should have remained at \$2.3 million. Consequently, the Carr Foundation would have had \$13.4 million, or 31.5 percent, of its assets in equities (assuming no market value changes during the year). The Carr Foundation could thereby have already attained its target allocation of 30 percent in equities.

Reallocate even more assets to equities but change spending policy to permit the distribution of some annual gains. The Board might be able to reallocate more to

equities than the \$9.4 million amount discussed above if it further changed the spending policy so that a portion of gains (but not losses) could be distributed annually. As noted above, the wills give the Board such discretion. Remaining gains, net of any losses, would be used to grow the fund's principal as now occurs with the current spending policy. However, over the long-term, the higher allocation to equities should produce more gains than are generated by the Carr Foundation's current allocation.

The Board has previously tried a policy of including all gains and losses in the income it distributes. The Board abandoned this policy after the Carr Foundation experienced unacceptable fluctuations in income. While the approach we propose here would give the Board more flexibility to adequately manage annual distribution levels, the Board might still encounter some of the risks associated with the variability of equity prices. Equities have higher risk than fixed income investments because their periodic total return fluctuates more. Because dividend payments remain relatively stable, the main contributor to risk, or volatility, is change in market value. The market value of equities can rapidly and significantly decrease as well as increase. During periods of price declines or long periods of flat performance, it is possible that the Carr Foundation could not obtain the gains needed to maintain the desired level of spending.

The Carr Foundation could protect itself from this unpredictability by creating a "reserve" fund held in Angelo State University's scholarship fund. The terms of the wills suggest that once gains have been added to principal they cannot later be distributed. Therefore, in the initial years of this policy change, the Carr Foundation could distribute more gains to the University than it needs to fund existing scholarships. The University could draw from this reserve in later years if sufficient gains were not available.

This approach is cumbersome and not entirely free of the risk of temporary spending level declines. However, the Carr Foundation might lack the flexibility provided under UMIFA to "store" gains for later distribution. Therefore, the Board might want to consider such a change to better accomplish long-term growth through an increased allocation to equities.

Section 3-C:

The Carr Foundation's Legal and Donor Restrictions Impair Effective Management

Because the Carr Foundation operates under the provisions of the Texas Trust Act, it may not be able to take advantage of the spending flexibility provided to endowment managers by UMIFA. Specific donor restrictions in the wills establishing the Carr Foundation may also contribute to this lack of flexibility. The Carr Foundation's attorney indicated to us that the Carr Foundation could not adopt a flexible spending policy based on the fund's market value. The Board could consider further legal research to ensure that it is following the appropriate statutes in managing the Carr Foundation.

UMIFA Removed Barriers to Effective Endowment Fund Management

Texas had no law [prior to its adoption of the Texas Uniform Management of Institutional Funds Act] directly addressing investment and use of funds of non-governmental eleemosynary organizations prior to the Act. . . .

The existing legal uncertainty created real concern and led to voluntary imposition of restrictions on fund management, investment, and expenditure varying widely in nature and degree among institutions. The concern was due not just to the lack of law in the area, but to the particular possibility that use of terms such as "income" and "charitable trust" with reference to endowment funds could lead to principles similar to those of private trust law, rather than to those generally applicable to non-profit organizations, being deemed applicable to such funds. If that were to happen, the management and use of endowment funds would be severely and unnecessarily restricted.

. . . Feature by feature comparison shows that endowment funds of charitable organizations in fact are not analogous to private trusts.

. . . There is, therefore, no logical substantive or policy reason to impose the law of private trusts on endowment funds. The Act does not affect true trusts or other funds in which identifiable third parties have legal or beneficial proprietary interests.

. . . [T]here is a rational basis for allowing prudent use of appreciation of endowment funds, rather than applying "income" and "principal" concepts of private trusts. . . .

A major objective of the Act is to avoid distortion of sound investment policies which seek to maximize total return. That objective may be attained by regarding "income" in the broader accounting sense (as any return on investment) rather than in the narrow private trust law sense (a restricted list of specific types of return such as interest and dividends). Consistent with one of the primary purposes of the Act, Section 163.009 makes it clear that institutional funds subject to the Act are not subject to the Texas Trust Code.

Source: "Texas Uniform Management of Institutional Funds Act," by S. Leon Bennett and Dennis L. Lutes, *Texas Bar Journal*, April 1990, pages 330-334. Reprinted with permission.

A spending policy in which an endowment annually distributes a prudent level of accumulated investment return, regardless of whether the return came from current income or gains, permits adoption of a total return investment strategy. Such an investment strategy can focus on maximizing total return within acceptable levels of risk (variability of periodic returns). Achievement of the investment return objectives over the long-term, combined with a reasonable spending level, will ensure that the endowment preserves the purchasing power of the fund and distributions over time.

The Carr Foundation's spending policy has resulted in an income-focused investment strategy which, as noted by its consultant, has resulted in lower total return. If the Carr Foundation could adopt a total return strategy, it could adopt an allocation to equities similar to comparable funds. However, if the Carr Foundation cannot operate under the provisions of UMIFA, adoption of a total return strategy might pose problems. For example, if the Carr Foundation could not temporarily retain, for subsequent distribution, some of the gains accumulated in years when equities produced high total returns, spending levels might decline when

equities performed poorly. Under the current legal and donor limitations, however, there may still be viable options (as discussed in Section 3-B) for improving asset allocation and performance while adequately managing annual distributions.

Recommendation:

The Board should consider explicitly including in the investment policy an explanation of how the Carr Foundation expects to preserve the purchasing power of the fund and distributions against erosion by inflation. If the Carr Foundation expects investment strategies to accomplish this, the spending policy and asset allocation will need to be revisited to ensure that investments can generate the level of return necessary to sustain adequate spending and still provide growth.

Management's Response:

1. *The Trustees for the Carr Foundation have adopted the policy of investing 25% of the trust funds in equities. This is being accomplished through the investment of all current royalty payments in equities until the 25% plateau has been reached. The Foundation's investment policies dictate that all realized gains and losses from the investment transactions will accrue to the principal account. The financial advisor for the Trustees feels this policy should produce sufficient increases in the fund principal to approximate the rate of inflation.*

The Trustees view the propriety of considering new royalties as a source of growth to the fund's principal as an offset to inflation to be valid.

Recommendation:

The Board should consider changing the spending policy from the inflexible "spend all current income and retain all gains" approach. The Board may wish to consider the following specific changes:

- Pay Carr Foundation administration and investment expenses from the fund's principal rather than from distributable income.
- Permit distribution to Angelo State's scholarship fund of a discretionary level of gains in addition to the required distribution of current income.

Management's Response:

2. *The Foundation's attorney, author of the original wills of the Carrs, has advised the Trustees that any use of the principal of the trust except for investment would not be in keeping with the terms of the wills.*
3. *Should the Trustees decide to change the current policy on asset allocation and invest a larger portion of the fund's principal in equities, a decision may be necessary at that time as to the ultimate distribution of realized gains on the disposition of the equities. An appropriate policy may be one of*

considering a portion of the gains as a return to principal and the balance available for distribution as income.

Recommendation:

Based on implementation of the above, the Board should consider reallocating from fixed income investments to equity investments in a way that would not jeopardize distribution levels for scholarships. The Board probably needs to increase the target equity allocation if it intends to achieve total returns comparable to other endowment funds. If the Board is not comfortable accepting the higher volatility in investment performance that would accompany a higher allocation to equities, it should revisit its spending policy or any commitment that investment results preserve the fund's purchasing power.

Management's Response:

4. *The response to this comment is incorporated in the responses 1 and 3 as previously discussed.*

Recommendation:

To the extent not previously performed, the Board may wish to research the continued need to operate under the Texas Trust Act rather than under UMIFA. If UMIFA were deemed applicable to the Carr Foundation, the Board should further determine whether additional changes to its spending policy, for example to permit spending levels to be based on asset market values, could be made without violating donor restrictions.

Management's Response:

5. *The Foundation's attorney advises that the Carr Foundation is governed by the Texas Trust Act. The Trustees are satisfied that the Texas Trust Act does not unduly hamper their administration of the Foundation.*

State Auditor's Follow-Up Comment:

We acknowledge the Trustees' diligence in their attempts to precisely comply with the investment and spending provisions of the Carrs' wills. However, due to the Carr Foundation's comparative investment underperformance, we continue to believe that the Trustees should try to manage the Carr Foundation more like other, similar-sized endowments. These efforts could include performing additional legal research on the donors' restrictions related to income and spending.

The System's Components and the Board of Regents Should Ensure that All Endowment Fund Donations Take Advantage of UMIFA's Flexibility

The Board of Regents' difficulties in managing the Carr Foundation's asset growth and spending levels call attention to the benefit to the universities of not having such legal and donor restrictions.

It is easier to manage endowments under UMIFA rather than under the Texas Trust Act. Investment policy can focus on maximizing total return within levels of risk (volatility of returns) acceptable to the Trustees. Personnel responsible for endowment fund management can design spending policy to generate an adequate and stable level of distributions that keeps pace with inflation regardless of whether investment returns come from current income or gains.

Institutions should demonstrate to potential donors that their gifts can produce the greatest long-term benefits if investment managers are free to operate within these total return concepts permitted by UMIFA. Consequently, donors may be less likely to impose investment and spending restrictions.

Recommendation:

We recommend that the Board of Regents adopt a policy of attempting to ensure that all gifts to endowment funds take full advantage of the provisions in UMIFA:

- The Board and other university officials authorized to negotiate and accept such gifts should be familiar with good endowment management principles.
- Good endowment management should be explained to potential donors, to the extent practical, so donors will understand that UMIFA already provides guidance to endowment managers.
- A standardized donor agreement form could explain these principles and ask donors to document their willingness to permit their gifts to be managed accordingly or to note specific exceptions.

Universities may wish to contact donors of existing gifts and ask them to consider removing any restrictions that currently prohibit the use of prudent total return investing and spending policies.

Management's Response:

1. *The Board, university presidents and institutional development officers are and will continue to be made aware of good endowment management practices.*
2. *The Board, university presidents and institutional development officers are careful to make these practices known to potential donors. However, should the donors have other ideas, the wishes of the donors will be respected if lawful.*
3. *The System's Vice Chancellor and General Counsel will develop a standardized gift instrument to be available for use by each component institution. This gift instrument will be written to be in compliance with the Uniform Management of Institutional Funds Act and to insure maximum benefit for each university.*

University representatives have in some instances contacted donors of existing gifts on possibly changing their gift directives. This exercise will be encouraged where it is deemed practicable and will not be perceived as annoying the donor.

Objective, Scope, and Methodology

Objective

The primary objective of this audit was to assess the Texas State University System's (System) and its universities' management of endowment and similar fund investments.

Scope

The scope of this audit included the five System universities responsible for significant endowment fund investments:

- Angelo State University
- Lamar University - Beaumont
- Sam Houston State University
- Southwest Texas State University
- Sul Russ State University

These universities' endowment and similar fund investments totaled \$51.4 million as of August 31, 1997.

In addition, the scope included the Board of Regents' management of the investments of the Angelo State University Robert G. Carr and Nona K. Carr Scholarship Foundation (Carr Foundation). The Carr Foundation's investments totaled \$45 million as of March 31, 1998.

Some information and data were verified by us or were based on the Carr Foundation's audited financial statements prepared by other auditors. However, we did not attempt to verify all financial information provided by the System, its universities, and the Carr Foundation, including investment balances and investment income.

We reviewed the following areas related to endowment fund investment management:

- Appropriateness and reasonableness of investment policies
- Spending policy and practice
- Asset allocation policy and practice
- Investment return measurement and evaluation
- Investment management expenses
- Investment management personnel and resources

Methodology

The methodology used included collecting information, performing audit procedures, and analyzing and evaluating information against established criteria.

Information collected to accomplish our objective included:

- Interviews with personnel responsible for investment management
- System, university, and foundation investment policies
- Long-term investment policies of The University of Texas System
- Quarterly investment reports
- Annual Financial Reports
- Internal audit reports
- Internal and external investment performance reports
- Board minutes
- Contracts with professional investment advisory services
- Investment transaction details

Audit, analysis, and evaluation procedures performed included:

- Identification of investment balances for university endowment and similar funds and for the Carr Foundation
- Review of investment policies and comparison to actual practice for endowment funds
- Interviews with management to determine how investment management decisions were made
- Comparison of endowment and Carr Foundation investment policies and results with those of a large peer group of endowment funds
- Review of the universities' methods of computing investment performance
- Estimation of performance of universities' endowment funds based on benchmark performance
- Estimation of the impact of inflation on the Carr Foundation's performance

Criteria used to evaluate information received included:

- Statutory restrictions and requirements, including the Texas Public Funds Investment Act, the Texas Uniform Management of Institutional Funds Act, and the General Appropriations Act
- Annual study of higher education endowment funds by the National Association of College and University Business Administrators (NACUBO)
- Investment policies of the System, the universities, the Carr Foundation, and other entities
- Investment industry performance measurement standards
- Professional literature relating to endowment fund management
- Standard auditing criteria

Other Information

Fieldwork at the various entities was conducted from May 1998 to June 1998, including site visits at the Carr Foundation and all of the universities except Sul Ross State University. The audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor's Office performed the work:

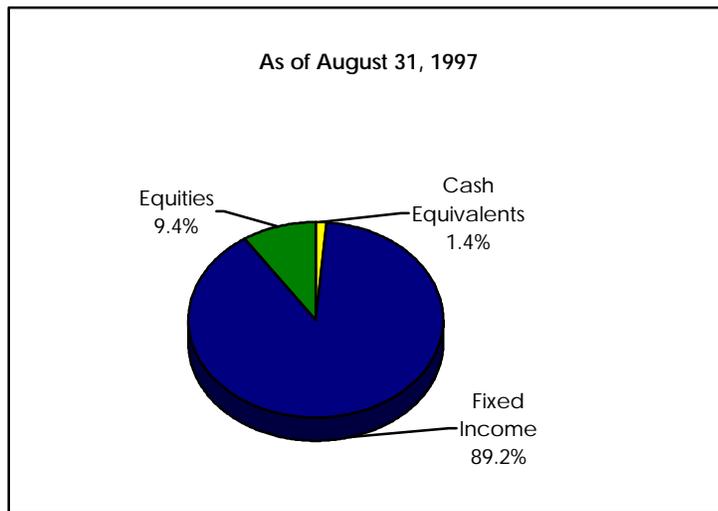
- Roger Ferris, CPA (Project Manager)
- Claudia Cabello
- Jose Carrillo
- Worth Ferguson, CPA (Quality Control Reviewer)
- Carol A. Smith, CPA (Audit Manager)
- Craig Kinton, CPA (Audit Director)

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The Carr Foundation's and Components' Endowment Fund Investments

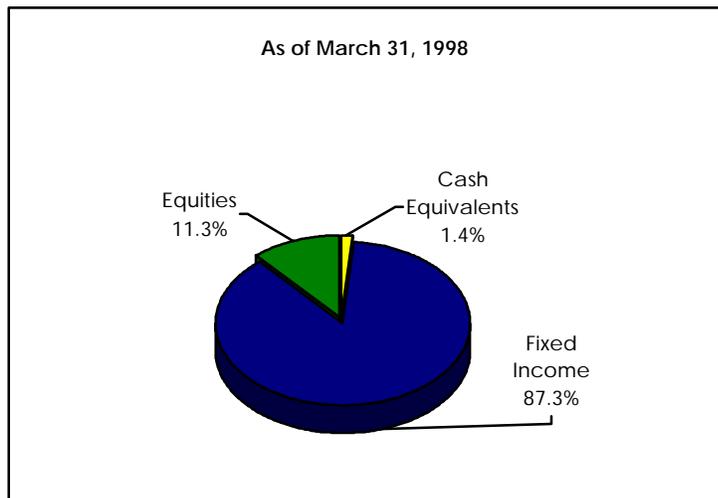
Appendix 2.1:

Angelo State University Robert G. Carr and Nona K. Carr Scholarship Foundation (Carr Foundation) Asset Allocation



Carr Foundation			
Investment at Market Value			
as of August 31, 1997			
Cash Equivalents	\$	603,911	1.4%
Fixed Income	\$	37,886,603	89.2%
Equities	\$	4,001,992	9.4%
Total	\$	42,492,506	100.0%

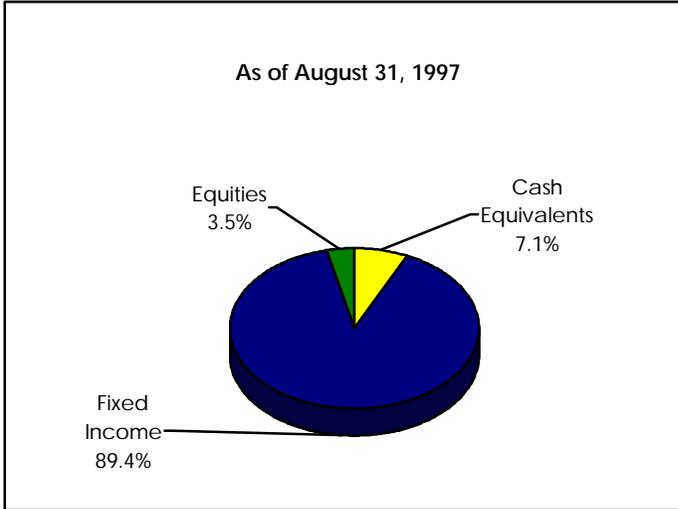
Source: Carr Foundation audited financial statements



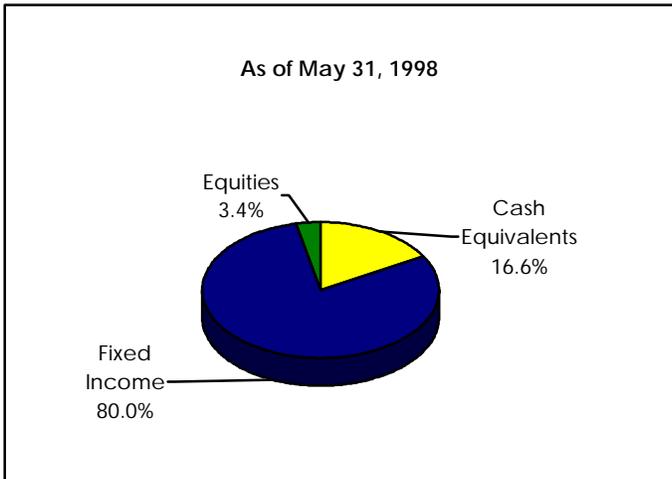
Carr Foundation			
Investment at Market Value			
as of March 31, 1998			
Cash Equivalents	\$	615,844	1.4%
Fixed Income	\$	39,142,436	87.3%
Equities	\$	5,058,514	11.3%
Total	\$	44,816,794	100.0%

Source: Carr Scholarship Foundation Investment Performance Analysis, as of March 31, 1998, prepared by Holbein Associates, Inc.

Angelo State University
Asset Allocation - Endowment Fund Investments



Angelo State University		
Endowment and Similar Funds (excluding Carr Foundation)		
Investments at Market Value as of August 31, 1997		
Cash Equivalents	\$ 624,169	7.1%
Fixed Income	\$ 7,898,536	89.4%
Equities	\$ 307,313	3.5%
Total	\$ 8,830,018	100.0%

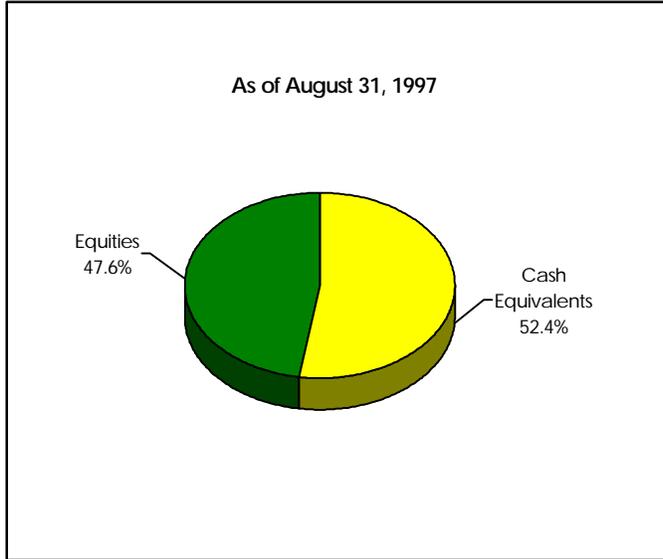


Angelo State University		
Endowment and Similar Funds (excluding Carr Foundation)		
Investments at Market Value as of May 31, 1998		
Cash Equivalents	\$ 1,524,093	16.6%
Fixed Income	\$ 7,338,412	80.0%
Equities	\$ 313,535	3.4%
Total	\$ 9,176,040	100.0%

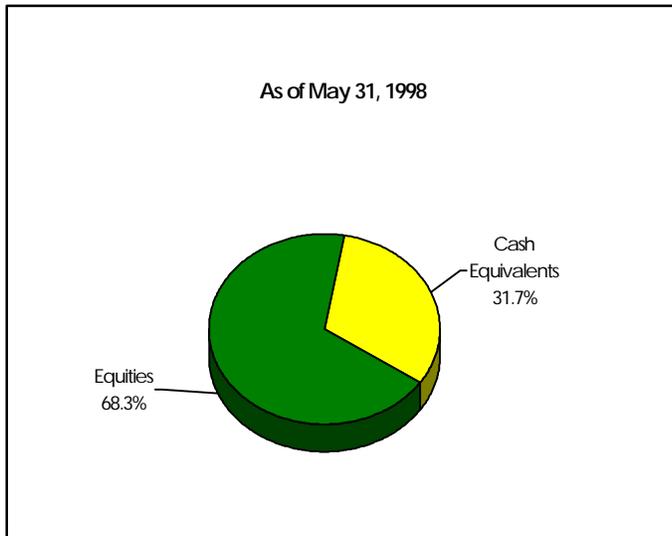
Source: Angelo State University quarterly investment reports.

Appendix 2.3:

Lamar University - Beaumont
Asset Allocation - Endowment Fund Investments



Lamar University - Beaumont		
Endowment and Similar Funds		
Investments at Market Value		
as of August 31, 1997		
Cash Equivalents	\$ 3,763,809	52.4%
Equities	\$ 3,424,233	47.6%
Total	\$ 7,188,042	100.0%

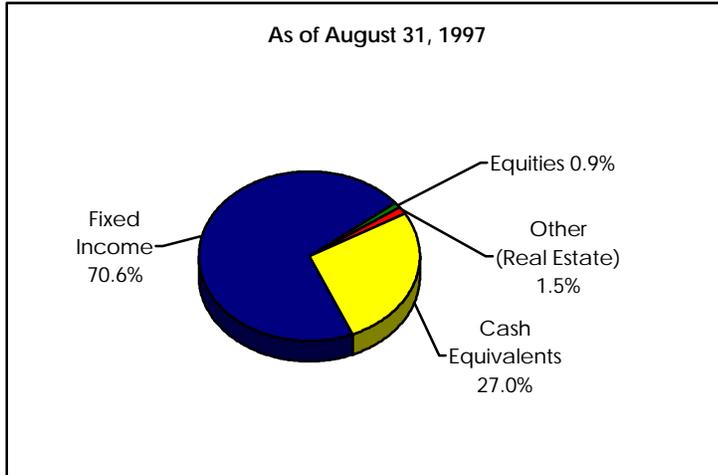


Lamar University - Beaumont		
Endowment and Similar Funds		
Investments at Market Value		
as of May 31, 1998		
Cash Equivalents	\$ 2,503,280	31.7%
Equities	\$ 5,381,159	68.3%
Total	\$ 7,884,439	100.0%

Source: Lamar University quarterly investment reports.

Appendix 2.4:

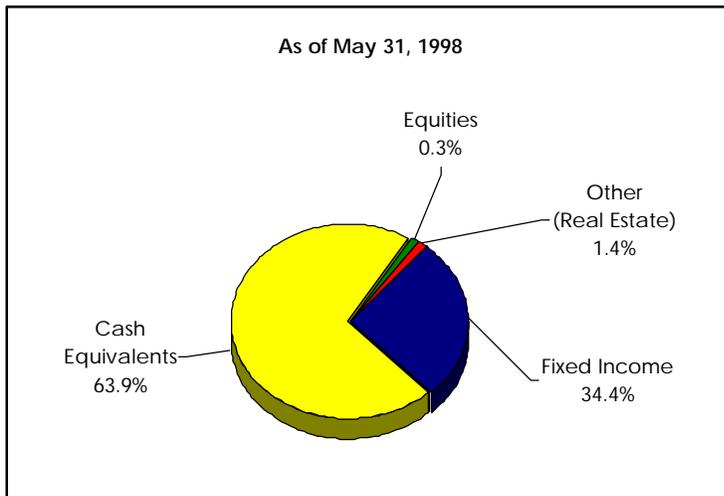
Sam Houston State University Asset Allocation - Endowment Fund Investments



Sam Houston State University

Endowment and Similar Funds
Investments at Market Value
as of August 31, 1997

Cash Equivalents	\$ 5,245,010	27.0%
Fixed Income	\$ 13,735,608	70.6%
Equities	\$ 168,388	0.9%
Other (Real Estate)	\$ 290,920	1.5%
Total	\$ 19,439,926	100.0%



Sam Houston State University

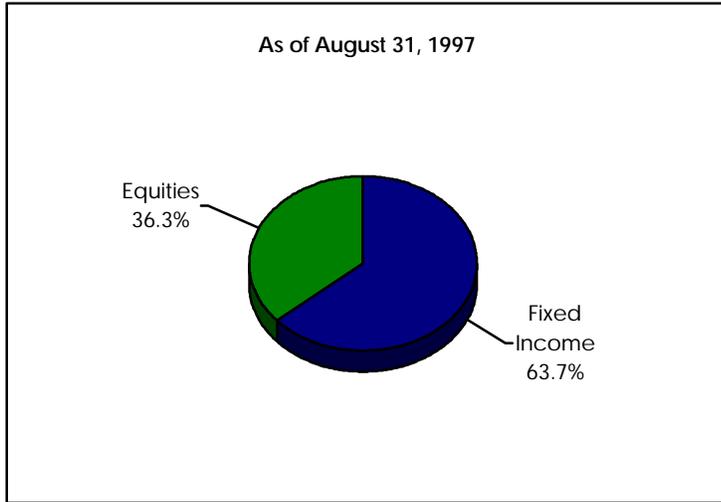
Endowment and Similar Funds
Investments at Market Value
as of May 31, 1998

Cash Equivalents	\$ 13,129,049	63.9%
Fixed Income	\$ 7,065,578	34.4%
Equities	\$ 63,634	0.3%
Other (Real Estate)	\$ 290,920	1.4%
Total	\$ 20,549,181	100.0%

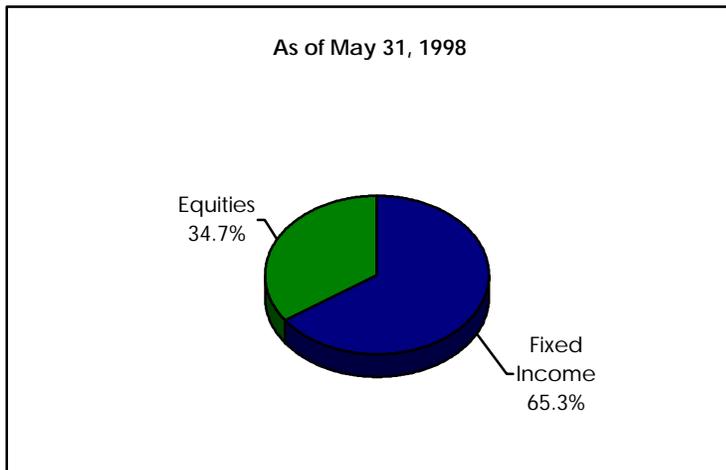
Source: Sam Houston State University quarterly investment reports.

Appendix 2.5:

**Southwest Texas State University
Asset Allocation - Endowment Fund Investments**



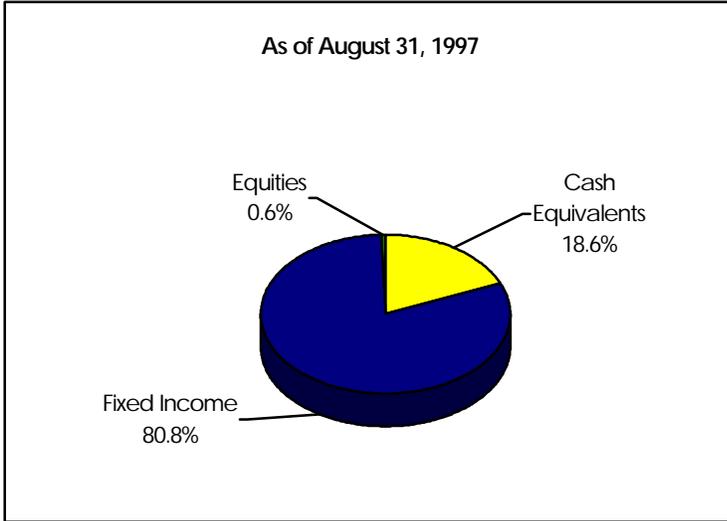
Southwest Texas State University Endowment and Similar Funds Investments at Market Value as of August 31, 1997		
Fixed Income	\$ 7,560,634	63.7%
Equities	\$ 4,300,415	36.3%
Total	\$ 11,861,049	100.0%



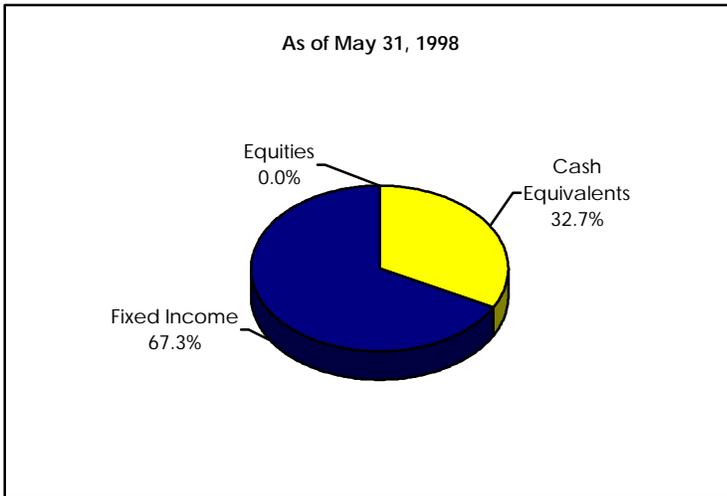
Southwest Texas State University Endowment and Similar Funds Investments at Market Value as of May 31, 1998		
Fixed Income	\$ 9,231,359	65.3%
Equities	\$ 4,899,948	34.7%
Total	\$ 14,131,307	100.0%

Source: Southwest Texas State University quarterly investment reports.

Sul Ross State University
Asset Allocation - Endowments Fund Investments



Sul Ross State University		
Endowment and Similar Funds Investments at Market Value as of August 31, 1997		
Cash Equivalents	\$ 754,191	18.6%
Fixed Income	\$ 3,279,246	80.8%
Equities	\$ 25,957	0.6%
Total	\$ 4,059,394	100.0%



Sul Ross State University		
Endowment and Similar Funds Investments at Market Value as of May 31, 1998		
Cash Equivalents	\$ 1,483,371	32.7%
Fixed Income	\$ 3,051,055	67.3%
Equities	\$ 550	0.0%
Total	\$ 4,534,976	100.0%

Source: Sul Ross State University quarterly investment reports.

The Uniform Management of Institutional Funds Act

Property Code Chapter 163.

Management, investment, and expenditure of institutional funds

Sec. 163.001. Short Title.

This chapter may be cited as the Uniform Management of Institutional Funds Act.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989.

Sec. 163.002. Legislative Findings and Purpose.

- (a) The legislature finds that:
- (1) publicly and privately supported educational, religious, and charitable organizations perform essential and needed services in the state;
 - (2) uncertainty regarding legal restrictions on the management, investment, and expenditure of endowment funds of the organizations has in many instances precluded obtaining the highest available return on endowment funds; and
 - (3) the organizations, their officers, directors, and trustees, and the citizens of this state will benefit from removal of the uncertainty and by permitting endowment funds to be invested for the long-term goals of achieving growth and maintaining purchasing power without adversely affecting availability of funds for current expenditure.
- (b) The purpose of this chapter is to provide guidelines for the management, investment, and expenditure of endowment funds of publicly and privately supported educational, religious, and charitable organizations in order to eliminate the uncertainty regarding legal restrictions on the management, investment, and expenditure of the funds and to enable the organizations to maximize their resources.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989. Amended by Acts 1993, 73rd Leg., ch. 240, Sec. 1, eff. May 22, 1993.

Sec. 163.003. Definitions.

In this chapter:

- (1) “Endowment fund” means an institutional fund, or any part of such a fund, not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument.
- (2) “Gift instrument” means a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document, including the terms of any institutional solicitations from which an institutional fund resulted, under which property is transferred to or held by an institution as an institutional fund.
- (3) “Governing board” means the body responsible for the management of an institution or of an institutional fund.
- (4) “Historic dollar value” means the aggregate fair market value in dollars of:
 - (A) an endowment fund at the time it became an endowment fund;
 - (B) each subsequent donation to the fund at the time it is made; and
 - (C) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund.
- (5) “Institution” means an incorporated or unincorporated organization organized and operated exclusively for educational, religious, or charitable purposes, an institution of higher education, or a foundation chartered for the benefit of an institution of higher education. The term does not include a private foundation as defined by Section 509(a) of the Internal Revenue Code of 1986.
- (6) “Institutional fund” means a fund held by an institution for its exclusive use, benefit, or purposes, except a fund held for an institution by a trustee that is not an institution or a fund in which a beneficiary that is not an institution has an interest other than possible rights that could arise on violation or failure of the purposes of the fund.
- (7) “Institution of higher education” has the meaning assigned by Section 61.003, Education Code.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989. Amended by Acts 1993, 73rd Leg., ch. 240, Sec. 2, eff. May 22, 1993.

Sec. 163.004. Expenditures.

- (a) Except as provided by Subsection (e), the governing board may appropriate for expenditure, for the uses and purposes for which the fund is established, the net appreciation, realized and unrealized, in the fair market value of the assets of an endowment fund over the historic dollar value of the fund to the extent prudent under the standard provided by Section 163.007.
- (b) A determination of the historic dollar value made in good faith by the governing board is conclusive.

- (c) Subsection (a) does not limit the authority of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument, or the charter or articles of incorporation of the institution.
- (d) Subsection (a) does not apply if the applicable gift instrument indicates the donor's intention that the net appreciation not be expended. A restriction on the expenditure of net appreciation may not be implied from a designation of a gift as an endowment or from a direction or authorization in the applicable gift instrument to use only "income." This rule of construction applies to gift instruments executed or in effect before, on, or after the effective date of this chapter.
- (e) The governing board of an institution of higher education as defined by Section 61.003(8), Education Code, may not appropriate for expenditure the net unrealized appreciation of the assets of an endowment fund.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989. Amended by Acts 1993, 73rd Leg., ch. 240, Sec. 3, eff. May 22, 1993.

Sec. 163.005. Investment Authority.

In addition to an investment authorized by other law or by the applicable gift instrument, and without restriction to investments a fiduciary may make, the governing board, subject to any specific limitations in the applicable gift instrument or the applicable law other than law relating to investments by a fiduciary, may:

- (1) invest an institutional fund in any real or personal property, including mortgages, stocks, bonds, debentures, and other securities of profit or nonprofit corporations, shares in or obligations of associations, partnerships, or individuals, and obligations of any governmental entity, whether or not the property produces a current return;
- (2) retain property contributed by a donor to an institutional fund;
- (3) include all or any portion of an institutional fund in a pooled or common fund maintained by the institution; and
- (4) invest all or any portion of an institutional fund in a pooled or common fund, including shares or interests in regulated investment companies, mutual funds, common trust funds, investment partnerships, real estate investment trusts, or similar organizations in which funds are commingled and investment determinations are made by persons other than the governing board.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989.

Sec. 163.006. Delegation of Investment Management.

Except as provided by the applicable gift instrument, the governing board may:

- (1) delegate to its committees, officers, or employees of the institution or the fund, and other agents, including investment counsel, the authority to act for the board in investment of institutional funds;
- (2) contract with independent investment advisors, investment counsel, investment managers, banks, or trust companies to act for the board in investment of institutional funds; and
- (3) authorize payment of compensation for investment advisory or management services.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989.

Sec. 163.007. Standard of Conduct.

In the administration of the powers to appropriate appreciation, to make and retain investments, to develop and apply investment and spending policies, and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. The members shall consider both the long-term and short-term needs of the institution in carrying out its educational, religious, or charitable purposes, its present and anticipated financial requirements, the expected return on its investments, price level trends, and general economic conditions.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989.

Sec. 163.008. Release of Restrictions on Use or Investment.

- (a) With the written consent of the donor, the governing board may release, in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund.
- (b) If written consent of the donor cannot be obtained because of the donor's death, disability, unavailability, or impossibility of identification, the governing board may apply in the name of the institution to the district court for release of a restriction imposed by a gift instrument on the use or investment of an institutional fund. The attorney general must be notified of the application and given an opportunity to intervene in the same manner as provided by Chapter 123 for a proceeding involving a charitable trust. If the court finds that the restriction is obsolete, inappropriate, or impracticable, it may by order release the restriction in whole or in part. A release under this subsection may not change an endowment fund to another type of fund.
- (c) A release under this section may not allow a fund to be used for a purpose other than the educational, religious, or charitable purposes of the affected institution.

(d) This section does not limit the application of the doctrine of “cy pres.”

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989.

Sec. 163.009. Applicability of Other Parts of Code.

Subtitle B, Title 9 (the Texas Trust Code), does not apply to any institutional fund subject to this chapter.

Added by Acts 1989, 71st Leg., ch. 213, Sec. 1, eff. May 26, 1989.

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