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**STATE OF VERMONT**  
**OFFICE OF THE STATE TREASURER**

**TO:** Justin Johnson, Secretary of Administration, and the  
Higher Education Subcommittee of the Prekindergarten-16 Council

**FROM:** Elizabeth Pearce, State Treasurer

**RE:** Annual Report on the Higher Education Endowment Trust Fund

**DATE:** September 16, 2015

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I am pleased to present the Secretary of Administration and the Higher Education Subcommittee (“Subcommittee”) of the Prekindergarten-16 Council with the State Treasurer’s fifteenth annual report on the Higher Education Endowment Trust Fund (“the Fund”).

The General Assembly established the Fund in the Office of the State Treasurer in 1999 to provide non-loan financial aid to Vermont students attending the University of Vermont (UVM), the Vermont State Colleges, and other Vermont post-secondary institutions (16 V.S.A. § 2885).

**Performance Summary**

During fiscal year 2015, the Fund’s investment return was 2.4% net of fees. This return compares to the Barclays Aggregate Bond Index return of 1.9% and to the S&P 500 Stock Index return of 7.4% for the same period. The benchmark, 40% S&P 500 / 60% Barclays Aggregate index, returned 4.2% during the fiscal year (gross of fees). Note that as of December 2013, the investments are comprised of mutual fund positions as a result of a Fund restructuring. The results of the restructuring have been fees that were reduced from 38 basis points to 6 basis points annually, along with a more diversified asset allocation that includes international equities and emerging market equities.

**5% Distribution for Fiscal Year 2015**

The statute provides that in August of each fiscal year, the State Treasurer is to withdraw up to 5% of the 12-quarter moving average of the Fund’s assets and divide the amount equally among UVM, the Vermont State Colleges, and the Vermont Student Assistance Corporation (VSAC). The amount distributed cannot exceed an amount that would bring the Fund balance below total contributions to principal. Total principal contributions through June 30, 2015 have been \$28,934,417.

The 5% distribution available this year is \$1,520,355 in total or \$506,785 each for UVM, the Vermont State Colleges, and VSAC. This amount represents a 0.9% increase over the fiscal year 2014 distribution of \$502,433.13 for each institution. **Appendix A** to this report includes quarterly market values and distributions for fiscal year 2015, and **Chart #1** shows principal contributions to date.

### **2% Distribution from Fiscal Year 2015**

16 V.S.A. § 2885 further provides that during the first quarter of each fiscal year, the Secretary and the Subcommittee may authorize the State Treasurer to make an additional distribution of up to 2% of the Fund's average assets available to UVM and the Vermont State Colleges for the purpose of creating, or increasing, a permanent endowment fund. Similar to the 5% distribution, the amount distributed cannot exceed an amount that would bring the Fund balance below total contributions to principal. Further, each institution is required to match the distribution by raising private donations of at least twice the distributed amount, to certify to the Commissioner of Finance and Management ("the Commissioner") that it received private donations in the requisite amount, and that the funds will be used to create or increase a permanent endowment at the respective institution.

At their September 30, 2014 meeting, the Secretary and the Subcommittee voted to forgo this 2% distribution to UVM and the Vermont State Colleges, based upon recognition that lower expected returns in the near term do not support a total distribution of 7% from the Fund.

After payments of \$1,520,355, the Fund balance at the end of fiscal year 2015 totals \$29,368,480. An accounting of the Fund balance is provided below:

<b>Ending Balance Prior FY 2014</b>	<b>\$31,566,056</b>
Contributions received FY 2015	\$286,925
<hr/>	
<b>Opening Balance FY 2015</b>	<b>\$31,852,981</b>
5% Distributions	
<i>University of Vermont</i>	(\$502,433)
<i>Vermont State Colleges</i>	(\$502,433)
<i>Vermont Student Assistance Corp.</i>	(\$502,433)
2% Distributions	
<i>University of Vermont</i>	\$0
<i>Vermont State Colleges</i>	\$0
Income earned FY 2015	\$908,409
Appreciation (Depreciation) FY 2015	(\$361,390)
Fees and Other Charges FY 2015	(\$3,865)
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<b>Balance June 30, 2015</b>	<b>\$30,888,835</b>
5% of 12-Quarter Moving Average (as of June 30, 2015)	(\$1,520,355)
Distributions	
<i>University of Vermont</i>	(\$506,785)
<i>Vermont State Colleges</i>	(\$506,785)
<i>Vermont Student Assistance Corp.</i>	(\$506,785)
2% Income Available for Endowments from FY 2014	\$0
<hr/>	
<b>Balance After Distributions</b>	<b>\$29,368,480</b>
<b>Total Contributions as of June 30, 2015</b>	<b>\$28,934,417</b>
2% Income Available for Endowments from FY 2016	\$608,142
<i>(requires institutional match in FY 2016)</i>	

### **2% Distribution for Fiscal Year 2016**

All principal contributions to the Fund through June 30, 2015 total \$28,934,417, which also represents the minimum balance that must be maintained in the Fund. The 2% distribution proposed for fiscal year 2016 is \$608,142. It is possible that neither the 5% nor 2% distribution next year could be met in full unless returns during the next year are sufficient to cover these amounts. That said, if the Secretary and the Subcommittee authorize this distribution, each institution's share will be \$304,071 with a required match to be raised by each entity in FY 2016 of \$608,142. To re-emphasize, any distribution in the next fiscal year is dependent upon the Fund's balance being greater than \$28,934,417 after the distributions have been made. The attached **Chart #2** provides a graphical depiction of authorized distributions, including this 2% distribution subject to the Secretary's and the Subcommittee's approval.

## **Fund Balances**

**Appendix B** to this report shows the total return of the entire Trust Investment Account, of which the Higher Education Endowment Trust Fund, with a balance of \$30.9 million comprises approximately 45.2%. A State Employee's retirement benefit trust fund comprises 27.6% of the account, or \$18.8 million, and the remaining 27.1% is made up of, in decreasing size, the ANR Stewardship Fund at \$5.37 million, the Tobacco Trust Fund at \$5.25 million, two Fish and Wildlife Trust funds at \$3.4 million, two Veterans' Home trust funds totaling \$1.37 million, and other small trusts totaling just over \$3.14 million. **Chart #3** displays the relative share of the Higher Education Endowment Trust Fund compared to the entire Trust Investment Account.

**Chart #4** presents the Fund's balances, inclusive of distributions, for fiscal years 2000 through 2015. The balance increased significantly in FY 2007 due to Estate Tax receipts of \$5,223,449.94, and a \$600,000 contribution from the State's unclaimed property fund as a result of legislation proposed by the Treasurer in FY 2006. Assets decreased modestly in FY 2008 and FY 2009 due to low investment returns and minimal fund contributions and benefitted in FY 2010 and FY 2011 from a strong equity market. In FY 2010 and FY 2012 the Fund benefitted from contributions of \$1.6 million and \$11 million, respectively. FY 2013 and 2015 had performance that lagged the 7% distribution in 2013 and the 5% distribution in 2015. Alternatively, FY 2014 had strong performance to keep the balance in a position to payout the 5% distribution the following year.

## **Asset Allocation, Investment Managers and Performance**

The Trust Investment Account's target asset allocation is 60% fixed income securities and 40% equities, with the equity allocation being comprised of Large Cap US Equities (20%), International Equities (15%) and Emerging International Equities (5%). As of June 30, 2015, the Account's actual allocation was in line with this allocation. This asset allocation represents the first full year of performance in the new asset allocation, which no longer utilizes active management. This change was made in order to take advantage of a broader range of asset classes at a reduced fee. To minimize transaction costs, the Account is rebalanced semi-annually on March 31 and September 30, and other contributions and withdrawals from the various funds are used to "fine tune" the asset allocation during the year.

The Account currently utilizes four Vanguard mutual funds: Institutional Index (VINIX), Developed Markets Index (VTMNX), Emerging Markets Stock Index (VEMAX) and Total Market Bond Index (VBTIX), creating exposures to three equity asset classes and a broad range of fixed income. Annual fees have also been reduced by 32 basis points to 6 basis points.

Historically, the Account achieved modest positive returns in both FY 2008 and FY 2009, during some of the worst financial market conditions since the 1930s, and has achieved sufficient returns to fully fund distributions in fiscal years 2010 through 2015. The Treasurer's Office has been mindful of the need to balance the allocations to equity and fixed-income assets given the expectation for annual distributions from the Fund while maintaining an appropriate risk profile. In the past, the asset allocation structure has enabled the Fund to perform reasonably well in both adverse and positive markets, reinforcing the belief in the appropriateness of a diversified

structure. However, the outlook for lower returns across all asset classes over the intermediate term horizon required the Treasurer's Office to re-evaluate its approach in fiscal year 2014. During the second fiscal quarter of 2014 the Fund was transitioned away from four active managers and into two index funds, at the same time that the equity allocation was increased. Specifically, an allocation of 30% to domestic equity and 70% to mortgage-backed securities was changed to 40% domestic equity and 60% broad fixed income. This was accomplished by investments in the Vanguard Institutional Index and the Vanguard Total Market Bond Index. Also at this time the policy benchmark was changed from an 30% S&P 500/ 70% MBS mix to 40% S&P 500/60% Barclays Aggregate Bond Index. The actual allocation was further refined at the end of FY 2014 to include exposure to Developed Markets Index and Emerging Markets Stock Index funds. **Appendix B** presents a review of performance during the past fiscal year.

The international equity portion of the allocation, while a diversifying position expected to help reduce the overall volatility in the fund's equity allocation in the long run, was a detractor from the Fund's overall return for fiscal year 2015. This short term underperformance is linked to the global volatility caused most recently by the European Debt Crisis and the slowing Chinese economic environment.

Staff believes that the endowment-nature of the Fund justifies maintaining the equity weighting in the portfolio despite expectations of an interest rate increase by the Federal Reserve. International equities have generally underperformed US equities, but they benefit currently from better valuation characteristics relative to US equities. Staff also believes that interest rate hikes would need to be much larger and sharper than expected in order for the exposure to a broad fixed income index to suffer substantial losses.

### **Fund Management Philosophy**

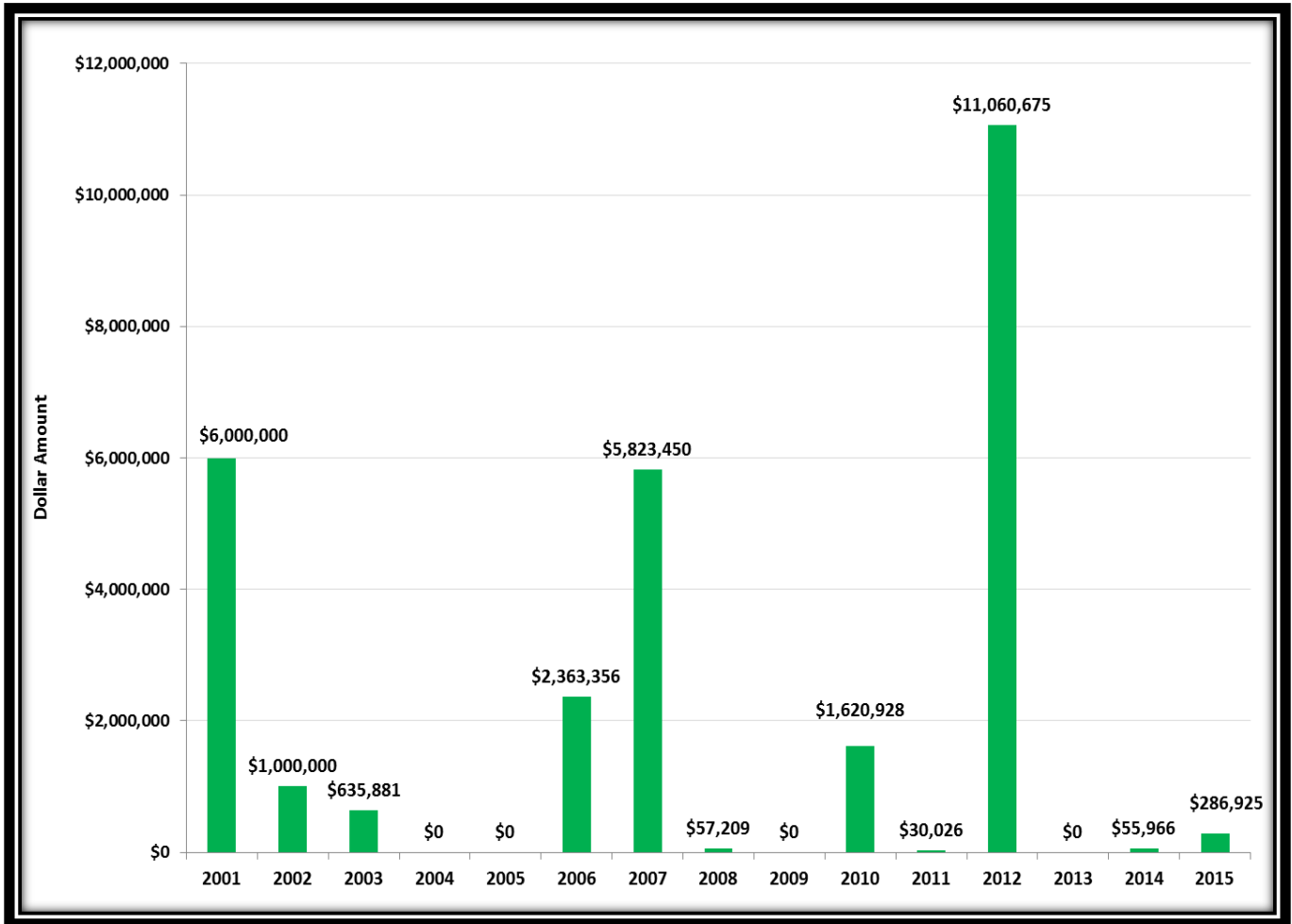
Staff believes that a dependence upon manager performance relative to benchmarks, or alpha, is counterproductive, especially for relatively established asset classes. We believe that administrative effort is better spent analyzing optimal portfolio allocations using total return, standard deviation, and correlation assumptions available from professional investment advisors, and then constructing a portfolio with the lowest expected risk relative to the Account's return objectives.

This philosophy is now reflected in the Account through the use of low-fee, highly liquid indexing vehicles, such as mutual funds (and possibly in the future, exchange-traded funds). This will allow the Treasurer's Office Staff the opportunity to diversify the Fund by evaluating additional asset classes and to structure the portfolio in a manner best suited to meet the Fund's risk and return objectives.

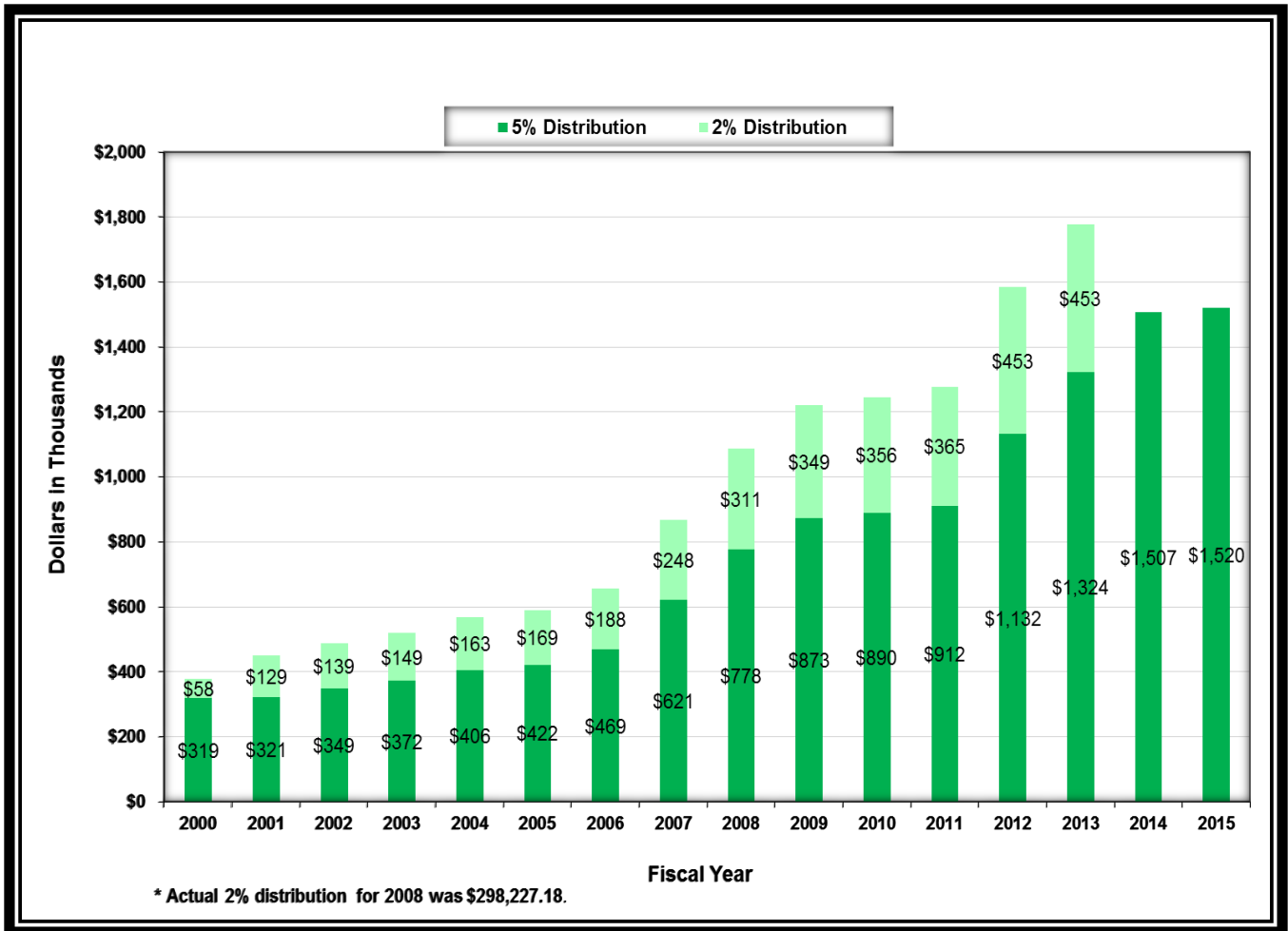
Please feel free to contact me if you have any questions or concerns regarding this report.

cc: James Reardon, Commissioner of Finance & Management  
Donna Russo-Savage, Legislative Council

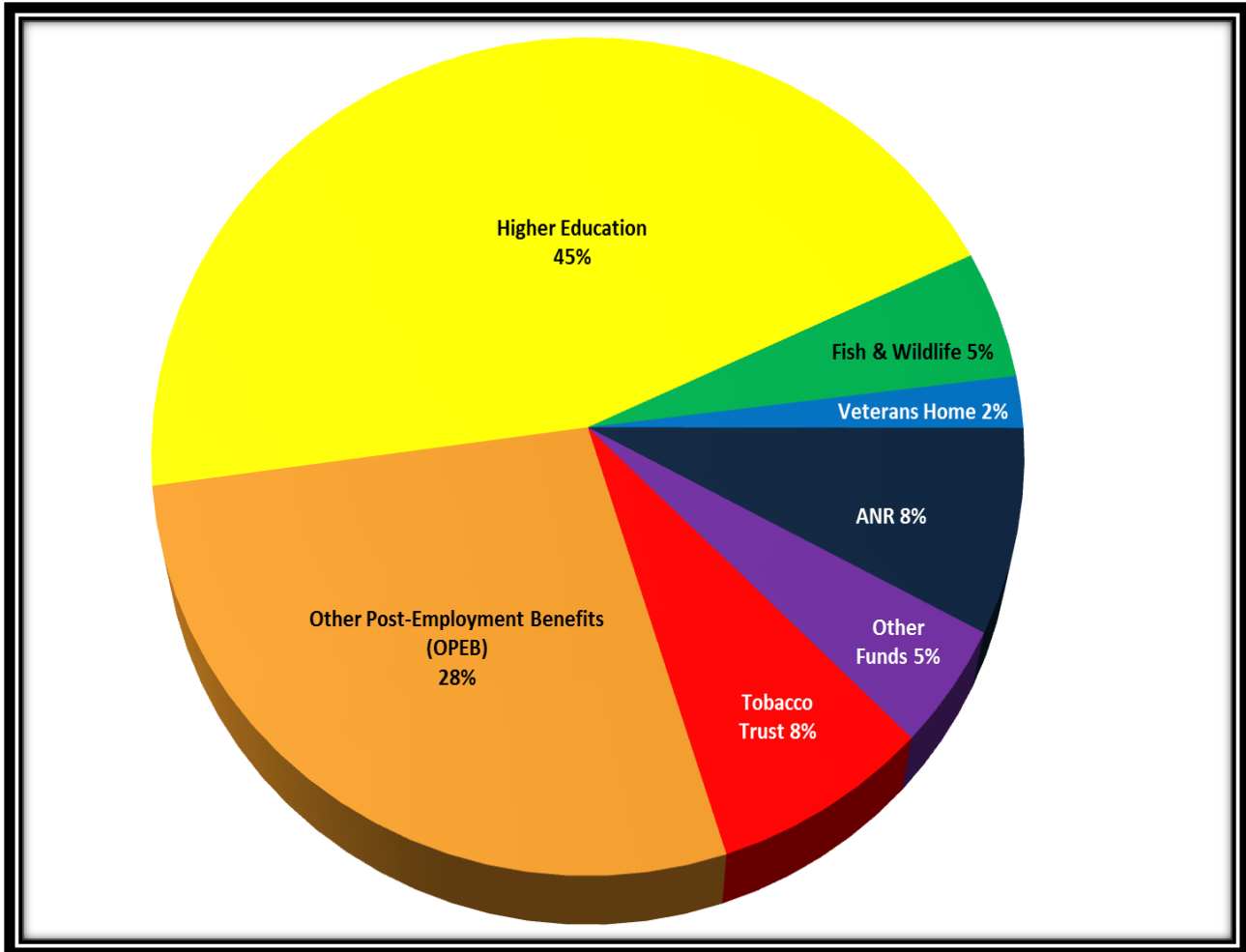
**Chart #1**  
**Higher Education Endowment Trust Fund**  
**Fund Contributions (fiscal years)**



**Chart #2**  
**Higher Education Endowment Trust Fund**  
**Authorized Distributions by Year and Type**

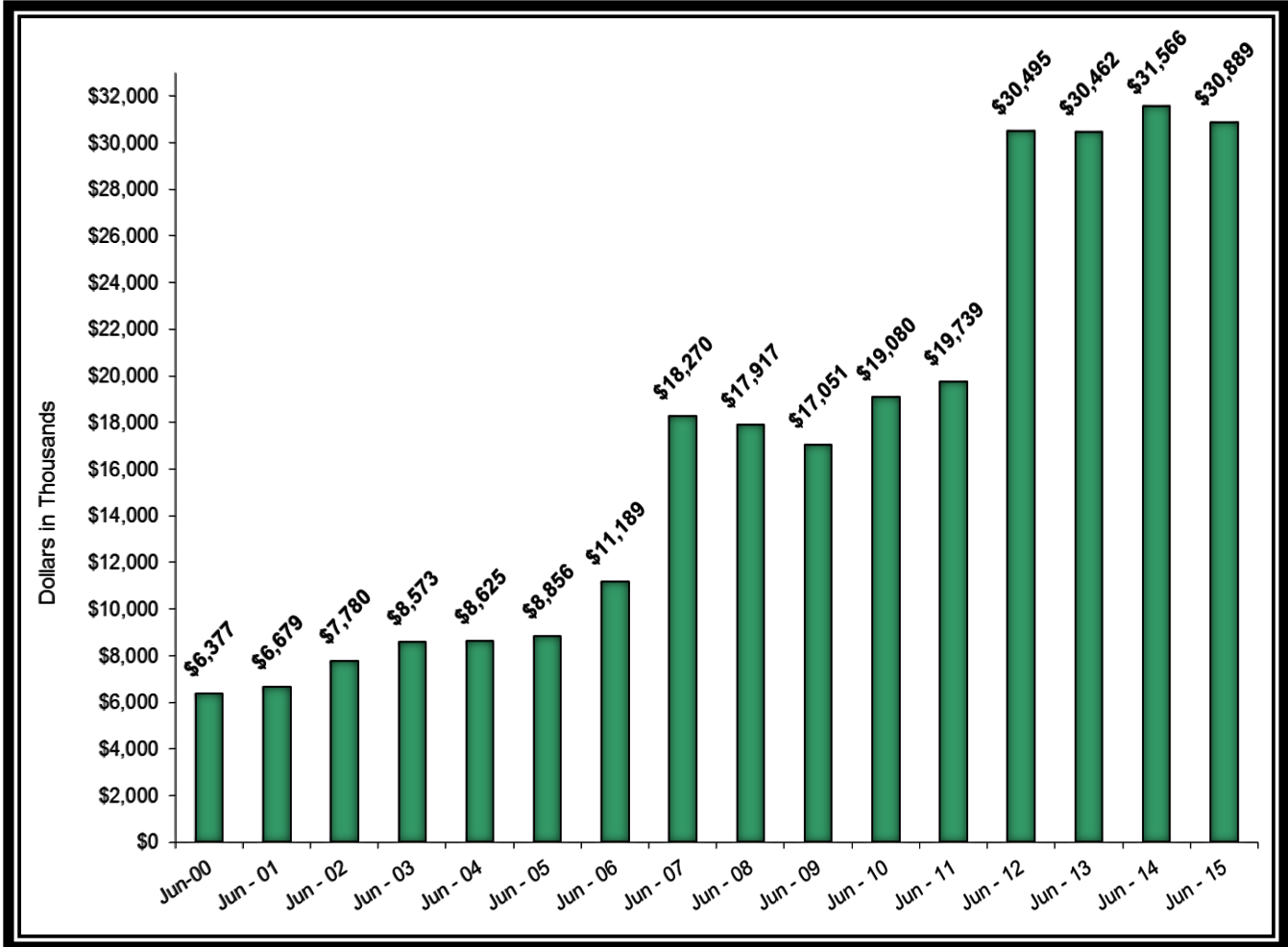


**Chart #3**  
**Trust Investment Account Fund Compositions**  
**As of June 30, 2015**





**Chart #4**  
**Higher Education Endowment Trust Fund Asset Growth**  
**6/30/2000 to 6/30/2015**  
**(Includes Distributions)**



**APPENDIX A  
 HIGHER EDUCATION ENDOWMENT TRUST FUND - DISTRIBUTIONS  
 For Period Ending June 30, 2015**

<u>Quarter-End Balances</u>	<u>September 30</u>	<u>December 31</u>	<u>March 31</u>	<u>June 30</u>
Fiscal Year 2013	\$29,784,761	\$29,937,373	\$30,761,122	\$30,462,454
Fiscal Year 2014	\$29,129,710	\$30,035,917	\$30,577,102	\$31,566,056
Fiscal Year 2015	\$30,125,526	\$30,491,326	\$31,125,036	\$30,888,836

**Twelve Quarter Average**                    **\$30,407,102**

**5% Distribution FY2015**                    **\$1,520,355**

VSAC	\$506,785
UVM	\$506,785
Vermont State Colleges	\$506,785

**2% FY2015 (Projected)**                    **\$602,920**

UVM	\$301,460
Vermont State Colleges	\$301,460

**2% FY2015 (Actual)**                    **\$0.00**

UVM	\$0.00
Vermont State Colleges	\$0.00

**Balance after Distributions**   **\$29,368,480.78**

**2% FY2016 (Projected)**                    **\$608,142.03**

UVM	\$304,071.02
Vermont State Colleges	\$304,071.02

**Total Contributions**

2001	\$6,000,000
2002	\$1,000,000
2003	\$635,881
2004	\$0
2005	\$0
2006	\$2,363,356
2007	\$5,823,450
2008	\$57,209
2009	\$0
2010	\$1,620,928
2011	\$30,026
2012	\$11,060,675
2013	\$0
2014	\$55,966
2015	\$286,925

Total:                    **\$28,934,417**

**APPENDIX B**

Higher Education Trust Fund	Portfolio Value	Portfolio Allocation	QTD	1 Year	3 Year	5 Year	7 Year	10 Year	Fiscal Year End Returns				
									2015	2014	2013	2012	2011
<i>Fund Return</i>	30,888,835		-0.2%	2.4%	5.8%	6.3%	6.1%	6.3%	2.4%	9.9%	5.3%	3.6%	10.7%
<i>Policy Return (60% Barclays Agg/40% S&amp;P 500)</i>			-0.9%	4.2%	7.9%	9.0%	6.8%	6.1%	4.2%	12.2%	7.4%	7.1%	14.2%
<i>Equity Index Fund (S&amp;P 500 Index Fund)</i>			0.3%	7.4%	17.3%	17.3%	9.4%	7.9%	7.4%	24.6%	20.6%	5.4%	30.7%
<i>Vanguard Institutional Index Fund (VINIX)</i>	6,264,973	20%	0.3%	7.4%	17.3%	17.3%	9.4%	7.9%	7.4%	24.5%	20.6%	5.4%	30.7%
<i>Vanguard Developed Markets Index Fund (VTMNX)</i>	4,650,561	15%	5.0%	-0.2%	13.5%	10.7%	2.8%	5.8%	-0.2%	23.5%	18.5%	-13.8%	32.1%
<i>Vanguard Emerging Markets Stock Index Fund (VEMAX)</i>	1,603,466	5%	1.7%	-2.4%	4.2%	4.2%	1.1%	8.0%	-2.4%	14.1%	1.5%	-15.8%	28.9%
<i>Fixed Income Index Fund (Barclays Aggregate Index Fund)</i>			-1.7%	1.9%	1.8%	3.3%	4.6%	4.4%	1.9%	4.4%	-0.7%	7.5%	3.9%
<i>Vanguard Total Bond Market Index Fund (VBTIX)</i>	18,366,318	59%	-1.8%	1.7%	1.7%	3.3%	4.5%	4.4%	1.7%	4.3%	-0.9%	7.7%	3.7%

\* As of 06/30/2015