MINUTES

BOARD OF REGENTS’ COMMITTEE ON BUDGET AND FINANCE MEETING

December 21, 2011

I.     CALL TO ORDER

Committee Chair Dennis Hirota called the meeting to order at 9:30 a.m. on Wednesday, December 21, 2011, at University of Hawai‘i, 2444 Dole Street, Bachman 113, Honolulu, Hawai‘i 96822.

Committee members in attendance: Committee Chair Dennis Hirota; Committee Vice Chair Carl Carlson; Barry Mizuno; Saedene Ota; and Jan Sullivan.

Others in attendance: Regents Chair Eric Martinson (ex officio committee member); Regent Coralia Matayoshi; President M.R.C. Greenwood, Ph.D.; Vice President for Budget & Finance/Chief Financial Officer, Howard Todo; Associate Vice President for Capital Improvements, Brian Minnari; Executive Administrator and Secretary of the Board of Regents, Keith Amemiya, Esq., and others as noted.

II.     APPROVAL OF MINUTES OF SEPTEMBER 13, 2011 MEETING

Upon motion by Regent Sullivan and second by Committee Vice Chair Carlson, the minutes of the September 13, 2011 meeting were unanimously approved.

III.     PUBLIC COMMENT PERIOD

Secretary Amemiya announced that no persons submitted written testimony or signed up to orally testify regarding today's agenda items.

IV.     AGENDA ITEMS

Investment Monitor Report

Davin Kubo, of MorganStanley SmithBarney, went over the Investment Monitor Report for the period ended September 30, 2011. He began by providing the economic outlook for 2011-2012. The economy is fragile, but MorganStanley SmithBarney does not anticipate a global recession. Volatility is expected to continue for the next six months.

Kubo then discussed the University of Hawai‘i Endowment Investment Performance Report for the period ending September 30, 2011. The portfolio declined from $58 million at the beginning of the quarter to $53 million at the end of the quarter, which was an 8% performance decline.

As detailed in the Investment Performance Summary for the quarter, most of the shortfall was driven by the Balanced managers: NWQ Balanced and Neuberger Berman Balanced, both which underperformed their benchmarks. Kubo also went over the performances for the other managers in the portfolio: Domestic Equity, International Equity, Fixed Income, and Short Term.
He noted that MorganStanley SmithBarney implemented a Manager Review of Investment Policy Compliance. Brandes failed the specific performance test of Balanced/Equity Managers no less than 30% of Policy Index Fixed Income Managers, no less than 10% of Policy Index, AND universe ranking greater than 35th percentile on a trailing 3 year basis. Brandes has been failing on the universe comparison; it has been in the bottom 15-20th percentile of their peer group for the past couple of years. The challenge is that the policy calls for a relative number of 30%; when the absolute number is close to zero, then 30% doesn’t leave a lot of margin for error. The trailing three year performance for the benchmark was -1.13%. Until this recent quarter, Brandes was meeting the benchmark. By October 2011, Brandes was back in compliance. MorganStanley SmithBarney feels that it is a unique situation because the absolute level of the number is so small, and it didn’t feel that it was warranted to put Brandes on automatic probation because of the legacy policy language in the Board of Regents’ policy. MorganStanley SmithBarney suggested looking at the policy language to make the policy more practical. MorganStanley SmithBarney is still concerned with Brandes’ performance over the last few years and will continue to monitor the fund, but chose not to put Brandes on immediate probation.

Committee Vice Chair Carlson questioned whether UH should continue to use Brandes as a fund manager if its performance is not meeting standards. VP Todo said that Brandes does not have to be put on probation prior to being terminated.

Regents Chair Martinson said that the Investment Task Group is in the process of negotiating with the UH Foundation on taking over oversight and management of the UH Endowment Investments. Because pricing was not at a prudent level for acceptance, the dialogue is still open, but there is no resolution. However, VP Todo and Regents Chair Martinson may go out to the market with a Request for Proposals (RFP). VP Todo drafted parameters for consultants and Regents Chair Martinson is reviewing it. Currently, the Committee on Budget and Finance hires and fires fund managers. However, going forward, the consultant advisor would hire and fire the fund managers, and the Committee would be charged with establishing the policy and parameters for the management. That way, UH won’t miss markets and make decisions off of old data. VP Todo said that potential policy changes are awaiting the decision on negotiations with the UH Foundation or another manager to proceed.

Kubo said that MorganStanley SmithBarney has indicated that one consideration is that there is potential change in the direction of the total portfolio, and having major portfolio reallocations always includes a cost. Earlier in the year, when Peter Backus of MorganStanley SmithBarney recommended terminating two fund managers, it was because the losses of those two managers were significant enough to make a change.

Committee Chair Hirota suggested waiting for the next meeting to see the results of the next quarterly report to determine future action.

Kubo went over the Investment Performance Summary as of October 31, 2011. The portfolio balance ended at $56.2 million. (The portfolio value as of December 20, 2011, was $55.7 million). Kubo pointed out Brandes specifically, noting that its three-year performance of 8.72% (versus 9.90% for the benchmark) is within guidelines.
In light of recent economic volatility, Kubo suggesting reducing some of the exposure, particularly to the Neuberger Berman Balanced fund. They are a balanced manager and have a 50-50 stock-bond target and they are allowed to operate within certain ranges around that. They do use cash tactically. However, with the way that their portfolio is structured, MorganStanley SmithBarney is concerned with their ability to perform over the next 6 to 12 months. Rather than trying to look for another active manager, the suggestion is to reduce exposure and take half of the money that would normally be allocated to fixed income and allocate it to a manager such as Bank of Hawai‘i, which has been doing a good job with fixed income investment. The other half would be put into an Index ETF such as Wisdom Tree, whose focus is on dividend equity strategies. The recommendation is to take at least $8 million, and put $4 million each into fixed income and index equity ETF. It maintains the asset allocation, but reduces the volatility of the equity exposure and replaces it with more stability.

Committee Chair Hirota entertained the motion to redistribute the funds.

Regent Sullivan questioned the decision to make a change now, while UH contemplates what it will do with it endowment fund manager going forward. Kubo responded that it depended on the appropriate hold position; if UH would prefer to overweight its fixed income allocation relative to the total portfolio. Relatively speaking to most foundations and endowment accounts, UH has less equity exposure. It will potentially be less risky going forward, but UH would still be in domestic equities. Regents Chair Martinson said that it does not increase the exposure to the portfolio and might buy some reduced risk and smooth some of the short-term volatility.

Regent Sullivan said that her main concern is with the volatility of international equities. Regents Chair Martinson responded that over time, international equity has gone into global equity; UH’s policy is outdated and doesn’t address that. Kubo said that long-term, a portfolio should have exposure to international equities. MorganStanley SmithBarney is not advocating a tactical call to get out of international equities. Most foundations have 15-20% of their portfolios in international equities; UH has 7%.

Regent Ota moved, and Regent Mizuno seconded the motion to approve the movement of $8 million out of Neuberger Berman Balanced, and allocate $4 million of those monies to Bank of Hawai‘i Fixed Income and use the other $4 million to buy Wisdom Tree ETF that focuses on dividends. The Committee approved the motion unanimously.

Quarterly Financial Status Report as of September 30, 2011

VP Todo went over the Selected Balance Sheet Items and Liquidity Measures (Cash and Investments, Accounts Receivable, Net, Endowment Investment, Bonds Payable, and Net Assets). He also went over the Income Statement Metrics (Total Revenue, Total Operating Expenses, Operating Income (loss), Total Non Operating Revenues (Expenses), and Increase (Decrease) in Net Assets). The analytical comments included in the materials to the Regents by the UH Administration gave some explanation for the changes in amounts of the funds from FY 2010 to FY 2011.

The analytical comments that VP Todo addressed included:
• No. 1: The cash and investment balance increased due to Series 2010A & B revenue bonds issued in October 2010. Cash also includes appropriations from the State general funds. Cash balances are highest at the start of the fiscal year (July 1, 2011) and decreases throughout the year as general funds appropriated for the year are expended.

Committee Chair Hirota asked how UH would protect its funds from being taken by the Legislature. VP Todo said that the Legislature is interested in special and revolving funds, which are specific in nature. For example, Research Training and Revolving Funds (RTRF). Committee Chair Hirota requested that UH segregate the funds in the Selected Balance Sheet Items and Liquidity Measures graphic to clarify the categories (special and revolving funds, general funds, etc.). President Greenwood said that UH must have reserves, especially when hiring new faculty. Regents' Chair Martinson said that their responsibility is to invest those dollars wisely in programs and institutions. If UH is given the incentive to have to spend more quickly, it could compromise UH's fiduciary responsibility to invest wisely.

President Greenwood said that there is no known standard amount of money in reserves held by Universities. She has been looking at businesses instead, to understand their business plans. VP Todo said that Legislators look at unencumbered cash; most of UH's net assets ($2.7 billion) is fixed assets.

President Greenwood said the Kuali Financial System will help because it shows committed funds – which show that UH has plans that sequester money over a period of years for projects that take longer periods of time to execute. VP Todo said that his office will work on providing a breakdown of the cash by segments to be included in the Analytical Comments. Regent Ota requested talking points for discussions with Legislators, especially regarding defense of special funds and tuition. President Greenwood agreed.

A discussion on sweeping general funds followed.

Regent Sullivan asked for an explanation of increased operating expenses while facing cuts to its funding. President Greenwood said that a part of that is due to the growth in research funds, which contributes to an increase in faculty and staff. Regent Sullivan requested that a better explanation for the positions in the employee headcount (Administrative, Professional and Technical; Civil Service; Executive and Managerial; Faculty; Graduate Assistant; and Lecturer) be included. Committee Chair Hirota agreed, asking for better visuals for the information included in the Quarterly Financial Reports.

• No. 2: Accounts receivable increased by $19 million due to an increase in Federal, State and Private contract and grants receivables ($8 million) and an increase of student receivables (tuition and fees) in the Banner system ($11 million).
• No. 3: Bonds payable as of September 30, 2011 as compared to the prior year increased by $293 million due to revenue bond proceeds.
• No. 10: Capital State appropriations represent the State General Obligation Bond Funds released by the Governor for Capital Improvement Projects (CIP)
appropriated by the Legislature in the State CIP Budget. For the September 30, 2011 fiscal year, the Governor released $27 million more in funding.

VP Todo also went over the Consolidated Funding Report as of September 30, 2011. It included the status on Appropriated Operating Funds, Capital Improvement Program (CIP) Funds/General Obligation Funds Only, Federal & Trust Extramural Funds, Other Non-Appropriated Funds, and Total Resources-All Fund Types ($2,060,021,862 in available resources; $606,789,942 in fiscal year to date expenditures and encumbrances; and $1,453,231,920 in current available balance) for the Fiscal Year ending June 30, 2011.

Committee Chair Hirota questioned the $26 million in lapsed funds under CIP. The annotation in the Consolidated Funding Report reads: “Funds prematurely lapsed by the Legislature and/or appropriations from Acts 162/09 and 180/10 that remain unencumbered as of June 30, 2012. FY 2011 Lapsed funds include funds for the Maui College Science Building and the Waianae Education Center, which were lapsed by the 2011 Legislature.” Committee Chair Hirota requested a better explanation/description. President Greenwood suggested coming up with another descriptive title to address similar issues, instead of using “Lapsed.” Associate Vice President for Capital Improvements, Brian Minaai, said that his office meets on a quarterly basis with the other campuses to track projects, including unencumbered funds, to position other campuses to take on unencumbered funds if they become available. Regents Chair Martinson suggested including a schedule that could be referenced and included in the Consolidated Funding Report as part of an exhibit regarding unencumbered allotments.

V. PERSONNEL ACTIONS

Committee Chair Hirota asked what the previous salaries were for the two positions that are being filled. President Greenwood said that she would get the information to Committee Chair Hirota.

VI. ADJOURNMENT

There being no further business, upon motion by Regent Mizuno and second by Committee Vice Chair Carlson, and with unanimous approval, the meeting was adjourned at 11:04 a.m.

Respectfully Submitted,

[Signature]

Keith Y. Amemiya, Esq.
Executive Administrator and
Secretary of the Board of Regents