# MINUTES

# BOARD OF REGENTS COMMITTEE ON BUDGET AND FINANCE MEETING

# SEPTEMBER 6, 2018

## I. CALL TO ORDER

Committee Chair Moore called the meeting to order at 12:15 p.m. on Thursday, September 6, 2018, at the University of Hawaiʻi at Mānoa, Information Technology Building, 1st Floor Conference Room 105A/B, 2520 Correa Road, Honolulu, Hawaiʻi 96822.

Committee members in attendance: Committee Chair Randy Moore; Committee Vice Chair Wayne Higaki; Regent Simeon Acoba; Regent Michael McEnerney; Regent Michelle Tagorda.

Others in attendance: Board Chair Lee Putnam; Regent Eugene Bal III; Regent Brandon Marc Higa; Regent Jeff Portnoy; Regent Ernest Wilson Jr.; Regent Stanford Yuen (ex officio committee members); President/Interim UH-Mānoa (UHM) Chancellor David Lassner; Vice President for Administration Jan Gouveia; Vice President for Community Colleges John Morton; Vice President for Legal Affairs/University General Counsel Carrie Okinaga; Vice President for Academic Planning & Policy Donald Straney; Vice President for Information Technology/Chief Information Officer Garret Yoshimi; Vice President for Budget & Finance/Chief Financial Officer Kalbert Young; Interim UH-Hilo (UHH) Chancellor Marcia Sakai; UH-West Oʻahu (UHWO) Chancellor Maenette Benham; Executive Administrator and Secretary of the Board of Regents (Board Secretary) Kendra Oishi; and others as noted.

## II. APPROVAL OF MINUTES OF THE AUGUST 2, 2018 MEETING

Regent McEnerney moved to approve the minutes of the August 2, 2018, meeting, seconded by Board Vice Chair Higaki, and the motion carried unanimously.

## III. PUBLIC COMMENT PERIOD

Board Secretary Oishi announced that the Board Office received no written testimony, and no individuals had signed up to provide oral testimony.

## IV. AGENDA ITEMS

### A. FY18 Fourth Quarter UBS Legacy Endowment Fund Investment Performance Report

UBS provided an update on the Legacy Endowment Fund for the fourth quarter of the fiscal year ending on June 30, 2018, and all trades made since the last committee meeting.

As of June 30, 2018, the portfolio is up 1.12%, which puts the performance for the quarter in the middle of the two benchmarks. The quarterly compliance review of the high-level endowment fund and underlying individual investments show no material changes in ownership, investment management team, or pending litigation. All of the six equity funds are in compliance with the board's investment policy. Of the eight fixed income funds, all except for one are in compliance with the investment policy statement, and UBS is comfortable holding this fund as it is performing the way it should be given the low interest rate environment.

UBS indicated that the weighted energy position is currently at 1.72% as of June 30, 2018. UBS provided information on the weighted net expense ratio, portfolio costs, and overall asset composition, and stated that the portfolio is in compliance with the policy statement. UBS sold investments, reduced positions in funds, and made purchases to rebalance the portfolio and increase international equity exposure.

Questions were raised regarding the rationale for allowing investment managers to make asset allocation decisions, fund performance against benchmarks, rationale for asset allocation and long-term projections, and steps UBS has taken to optimally maximize assets.

UBS explained that the portfolio is 60% equities, the vast majority of which are located in the United States, so the portfolio is not expected to keep up with the all stock MSCI World index. Benchmark 2 is heavily weighted towards U.S. equities, which have done well over the past couple of years. In the medium to long-term, the portfolio will likely have returns of approximately 5% to 7% after fees. Since the portfolio has been at UBS, it has averaged 5.9% after all fees and 6.64% in the last few years, which is very good performance without taking too much risk and given the investment policy caps equities at 70%. UBS indicated the details on benchmarking and asset allocation would be covered in the next agenda item on the UBS investment strategy.

**B. <u>Discussion on UBS Investment Strategy</u>**

UBS presented a proposal on portfolio structure for the Legacy Endowment Fund to improve performance while minimizing risks, which will help UBS to better comply with the Regents Policy on Investments and achieve the fossil fuel-free mandate.

A question was raised regarding risk evaluation.

UBS explained that when estimating the long-term return of the portfolio they utilized three levels of review: (1) UBS analysts and chartered financial analysts review the market and political factors, risk, and volatility; (2) fund managers perform due diligence on appropriate asset allocation decisions; and (3) the UBS team assigned to the endowment account then filters the information to make sure the portfolio meets the university's objectives and makes sense.

UBS did not think the endowment currently has enough customization. For the proposed new portfolio structure, they utilized the investment policy statement, an asset allocation study, and an investment manager selection process to select managers that are able to outperform in all types of environments and implement the fossil fuel-free mandate. For the new portfolio structure there is no international debt. However, international equities were increased and domestic equities were decreased. The proposed portfolio is composed of 60% equities, 39% fixed income, and 1% cash; the estimated return is 5.82%; and the overall risk is decreased to 9.53%. The diversification into other asset classes helps reduce the risk of the total portfolio, and with the international equity markets expected to perform better than the domestic equity markets in the next five years, this positions the portfolio to take advantage of opportunities to gain extra return.

Questions were raised regarding the impact of a change in distribution percentages and inflation assumptions. UBS explained that if the distribution threshold was less than 5%, then they would probably not take as much risk with the asset allocation. In addition to the 5% return, some of the fixed income funds and managers also pay dividends. Since the total return is the most relevant measure, equities are the only instruments in today's market that will provide a long-term real return that will exceed inflation. With the targeted payout of 5%, if the combined total return is not 7% or better, then the endowment is losing value to inflation. A comment was made that the equity and fixed income ranges were set with input from the previous UBS team, so the current UBS team should tell the regents if the investment policy needs to be revised. The current inflation expectations are 2.0 to 2.5%, which is partially based on the current low interest rate environment.

Questions were raised regarding the citizenship of the proposed investment management companies and how the total portfolio fees compare to similar investors. UBS explained that the managers of the funds are all based in the United States, but some of them specialize in identifying undervalued or momentum companies outside the United States. Regarding fees for the proposed portfolio structure, the UBS fee of 0.20% remains unchanged and the total underlying investment fee is 0.29%, which equals a total expense of 0.49%, representing an increase of 0.01% over the fees currently paid. A 2016 Commonfund Study of Endowments by the National Association of University Business Officers (NACUBO) showed most endowments and foundations in the $51 to $100 million range average pay 0.77% for expenses and 0.19% for advisory fees. For an endowment the size of the university's, UBS felt the assessed fees were very competitive to those of similar endowments and foundations.

**C. <u>Recommend Board Approval of the Fiscal Biennium 2019-2021 Budget Policy Paper</u>**

VP Young provided an overview of the fiscal biennium 2019-2021 budget policy paper that included background on the state and university fiscal environment, legislative strategy and priorities for both the operating and capital improvement program (CIP) budgets, specific strategies that will be focused on driving enrollment management and growth, and next steps the administration will take in crafting the budget.

Specific areas of the operating budget that administration is proposing to focus its request include the expansion of the Hawaii Promise Program to all four-year students; enrollment management, including student support services and employment opportunities for graduate and undergraduate students; reinstating into the base budget the previously appropriated funds for Hawaii Promise and athletics that were made non-recurring by the Legislature; and modernizing facilities and addressing fringe benefit costs. VP Young explained that there are now two different funding sources for Hawaiʻi Promise that need to be clarified.

A question was raised regarding the request for additional position counts for facilities and athletics that does not include a request for funds. VP Young explained that these are existing positions that are being funded with non-general funds and that the university is utilizing non-general funds to pay for fringe benefit costs of up to 60%.

Regent McEnerney moved to recommend board approval of the fiscal biennium 2019-2021 budget policy paper, Regent Acoba seconded, and the motion carried unanimously.

**D. <u>FY18 Fourth Quarter Financial Report</u>**

VP Young provided an overview of the fourth quarter financial report and results for the 2018 fiscal year. Revenues were slightly higher than projections due to legislative appropriations for collective bargaining and the release of some contingency restrictions. Expenditures for all funds were lower than forecasted projections due to conservative budgeting and increased fiscal prudence. General Fund expenditures were higher than projections as a result of maximizing the use of general funds were released from the contingency restriction to pay for incurred costs related to utilities, personnel costs, and some non-personnel costs.

A request was made for information on the University of Hawaiʻi Cancer Center revenues and expenditures, separate and apart from UHM.

A question was raised regarding the rationale for scholarships not being fully expended at UHWO and how the projected scholarship amounts are determined. UHWO Vice Chancellor for Administration Kevin Ishida explained that every year there are some students that may not be eligible for financial aid due to grades or other issues. There were more ineligible students than projected this past year; the financial aid office reviewed the criteria and will be applying revised criteria this coming fiscal year to better maximize scholarship funding. A request was made for information on the proportional breakdown of the $546,182 between unexpended scholarship funding and programs that changed their operational expenditures.

A question was raised regarding UH's overall financial situation and whether conservative budgeting and expenditures was good or bad, and reflective of anything of significance. VP Young explained that it was good that fiscal officers and chancellors are being responsive to their actual fiscal condition so when anticipated revenues do not show up they are augmenting expenditures to match. There are operational impacts in the field because they may not be providing the level of service that is necessary or intended. The approach that is occurring is that expenditures are being deferred to the next fiscal year, but this is not being done intentionally to garner savings in the current fiscal year. These are necessary expenditures that cannot be avoided, but in some cases are being deferred in case revenues materialize.

Building reserves has been one of the administration's primary objectives. Tuition and fee balances in reserves have increased for the past four years and all campuses are within the target reserve balance range. However, these increased reserve levels were achieved while tuition revenue has declined at most campuses. The revenue generated from tuition and fees is not keeping up with the expenditures. The impact will vary by campus. The university needs to be more strategic on the expenditure of its reserves. The use of reserves to pay for expenditures is not sustainable in the long-term.

Regent Bal left at 1:57 p.m.

A question was raised regarding whether any tuition and fees funds were used for capital improvements. VP Young explained that the tuition rate increase dedicated for capital improvements starts this academic year and 1% to 2% of tuition revenues will be expended on capital improvements and deferred maintenance.

**D. FY17 Bond Post-Issuance Compliance Update**

VP Young provided an overview of the University of Hawaiʻi revenue bond post-issuance compliance review for the 2017 fiscal year. The purpose of the review is to monitor bond post-issuance compliance issues, including the amount of private activity occurring on or within facilities financed with UH revenue bonds. Although this report is required for regulatory purposes it is not required to be presented to the board. Some regents previously expressed interest in this update, in part to monitor previous corrective actions that have since been addressed. There were discussions regarding alternative ways of providing updates to the board.

**E. Review and Approval of Committee Work Plan**

The committee considered updated goals and objectives that were distributed and discussed during the August committee meeting. The draft work plan was revised to include the rolling 6-year operating budget that was suggested by Regent Sullivan and the reporting relationships of the Office of Internal Audit that was suggested by Board Chair Putnam. Committee Chair Moore noted that administration indicated that they will prepare a rolling 6-year operating budget to accompany the 6-year academic program and 6-year CIP, and will notify the board regarding an estimated date.

Regent McEnerney expressed concerns regarding the Committee on Budget and Finance reviewing the reporting relationship of the Office of Internal Audit, when it should be under the jurisdiction of the Committee on Independent Audit. Most of the work conducted by the Office of Internal Audit is approved by the Committee on Independent Audit and changing the lines of authority would impact the committee's ability to supervise the office.

Board Chair Putnam explained that there is a connection in subject matter since Regent McEnerney is also a member of the Committee on Budget and Finance. She wanted to make a clear distinction regarding the performance evaluation of the Director of Internal Audit and felt it is a good idea to review the current structure and determine if it was the best arrangement to support the institutional needs.

Regent McEnerney indicated that any regent can attend meetings of the Committee on Independent Audit and make comments or ask questions. There is not an identity of membership with the members of the Committee on Independent Audit and the Committee on Budget and Finance, so in effect the control essentially moves to the Committee on Budget and Finance. As an auditor and CPA the two roles are different and he is concerned that the lines of authority will get confused.

Committee Chair Moore suggested the review of the reporting relationship of the Office of Internal Audit be removed from the goals and objectives and referred to board leadership for further discussion.

Committee Vice Chair Higaki moved to approve the updated committee work plan that included the addition of the review and approval of the rolling 6-year operating budget and the deletion of the review of reporting relationships of the Office of Internal Audit, which was referred to board leadership for further discussion. Regent Tagorda seconded, and the motion carried unanimously.

## V. ADJOURNMENT

There being no further business, Regent McEnerney moved to adjourn, Committee Vice Chair Higaki seconded, and with unanimous approval, the meeting was adjourned at 2:13 p.m.

Respectfully Submitted,

/S/

Kendra Oishi
Executive Administrator and Secretary
of the Board of Regents