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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

TO: Jeb Spaulding, 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 20, 2013

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 fourteenth annual report on the Higher Education Endowment Trust Fund (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 2013, the Fund's investment return was 5.3% gross of fees slightly beating its benchmark. This return compares to the Barclays Mortgage Backed Securities Index return of -1.1% and to the S&P 500 Stock Index return of 20.6% for the same period. The Fund's target allocation index rate (that is, the rate of return that would have been realized if 30% of the Fund was invested in the S&P 500 Index, and 70% in the Barclays MBS) was approximately 5.0%.

Consistent with the conservative positioning of the Fund (the objective of which is capital preservation and a reasonable likelihood of annual distributions), the Fund's return has been particularly favorable during periods of financial stress over the past ten years. While the annualized return of the Fund has slightly outperformed its benchmark on a five, seven, and ten fiscal year basis, gross of fees, the recent overall performance of the Fund, and the Trust Investment Account in which it is invested, necessitates a new portfolio structure and approach to management. We discuss this plan to restructure the Trust Investment Account in more detail at the end of this report.

Since the financial crisis of 2008 and 2009, the Federal Reserve has been pursuing policies of quantitative easing – the purchase of trillions of dollars of U.S. Treasury and mortgage-backed securities – in hopes of stimulating the economy by lowering interest rates. This strategy has compressed the yield curve, and real rates of return have decreased over the last five years. This has depressed expectations for future real returns across asset classes – including the fixed income space. In the most recent fiscal quarters, underperformance relative to the target distribution return can be attributed to the Federal Reserve's announcement of their intentions to taper out of their quantitative easing strategy. This led to a sharp rise in rates during the fourth fiscal year quarter across all fixed income asset classes.

5% Distribution from Fiscal Year 2013

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 appropriated, however, cannot exceed an amount that would bring the Fund balance below total contributions to principal. Total principal contributions through June 30, 2013 have been $28,500,823.66.

The 5% distribution available this year is $1,323,964.93 in total or $441,321.64 each for UVM, the Vermont State Colleges, and VSAC. This amount represents a 16.93% increase over the distribution made following Fiscal Year 2012 of $377,409.25 for each institution. **Appendix A** to this report includes quarterly market values and distributions for Fiscal Year 2013, and **Chart #1** shows principal contributions to date.

2% Distribution from Fiscal Year 2013

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 appropriated cannot exceed an amount that would bring the Fund balance below total contributions to principal. Further, each institution is required to match the appropriation by raising private donations of at least twice the appropriated amount, to certify to the Commissioner of Finance and Management (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 its meeting last year, Secretary Spaulding and the Subcommittee authorized this 2% appropriation in the amount of $452,891.10, or $226,445.55 each for distribution to UVM and the Vermont State Colleges, dependent upon a finding by the Commissioner that the terms of this appropriation were met. Each of these institutions is in the process of establishing the required certification. Due to the Fund's positive return in Fiscal Year 2013, the Fund will be able to make the full distribution amount.

After payments of $1,323,964.93 and $452,891.10, the Fund balance at the end of Fiscal Year 2013 totals $28,685,598.43. An accounting of the Fund balances is provided below:

Ending balance prior FY 2012			$30,495,227.22
	Contributions received FY 2013		$53,908.47
Opening balance FY 2013			$30,549,135.69
	5% Distributions :	University of Vermont	(377,409.25)
		Vermont State Colleges	(377,409.25)
		Vermont Student Assistance Corp.	(377,409.25)
	2% Distributions :	University of Vermont	(182,408.87)
		Vermont State Colleges	(182,408.87)
	Income earned FY 2013		1,691,682.31
	Appreciation (Depreciation) FY 2013		(156,480.00)
	Fees and Other Charges FY 2013		(124,838.03)
Balance June 30, 2013			$30,462,454.46
	5% of 12-Quarter Moving Average as of June 30, 2013		(1,323,964.93)
	Distributions :	University of Vermont	(441,321.64)
		Vermont State Colleges	(441,321.64)
		Vermont Student Assistance Corp.	(441,321.64)
	2% Income Available for Endowments from FY 2012		(452,891.10)
Balance after distributions			$28,685,598.42
Total contributions as of June 30, 2013			$28,500,823.66
	2% Income Available for Endowments from FY 2013 (requires institutional match in FY 2014)		$529,585.97

2% Distribution for Fiscal Year 2014

All principal contributions to the Fund through June 30, 2013 total $28,500,823.66, which also represents the minimum balance that must be maintained in the Fund. The 2% distribution proposed for this year of $529,585.97 would leave a balance of $28,156,012.45 excluding contributions to be received, the 5% distribution following FY 2014, and any gains from investment activity in FY 2014. Because this balance would be below the minimum required balance noted above, it is unlikely that either the 5% or 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 $264,792.99 with a required match to be raised by each entity in FY 2014 of $529,585.97. To re-emphasize: **any distribution is dependent upon the Fund's balance being greater than $28,500,823.66 by the end of FY 2014**. 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 $30.5 million comprises approximately 44%. The Tobacco Trust Fund comprises 26% of the account, or $17.8 million, and the remaining 30% is made up of, in decreasing size, a State Employee's retirement benefit trust fund totaling $11.3 million, the ANR Stewardship Fund at $4.6 million, the Waterfowl Stamp Fund at $2.3 million, the Fish and Wildlife Trust Fund at $1.6 million, two Veterans' Home trusts totaling $1.2 million, and eight small trusts totaling just over $470,000. **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 2013. 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 estate tax contributions.

Asset Allocation, Investment Managers and Performance

The Trust Investment Account's target asset allocation is 70% fixed income securities and 30% equities. As of June 30, 2013, the Account's actual allocation was 66.3% in fixed income securities and 33.7% in equities, versus 68.6% fixed income securities and 31.4% equities, respectively, on June 30, 2012. This slight over-allocation to equities was due to a run-up in equity prices and corresponding decrease in fixed income returns due to rising interest rates. To minimize transaction costs, the Account is rebalanced annually in October, and other contributions and withdrawals from the various funds are used to "fine tune" the asset allocation during the year.

The Account has four investment managers, three of whom are Vermont-based and have managed Account assets for at least ten years: two equity managers, Prentiss Smith & Co. of Brattleboro, and Hanson & Doremus of Burlington, and fixed income manager Sentinel Asset Management (a National Life company), of Montpelier.

The fourth manager, Minnesota-based fixed income manager RBC Global Asset Management (formerly Access Capital), manages a fund that invests in debt securities that support affordable housing, job creation and community development for low- and moderate-income individuals and communities in Vermont. RBC underperformed in FY 2008 & 2009, and outperformed in FY 2010-2013. As such, this investment has been meeting its goals of capital preservation and investment return, along with providing benefits to Vermonters.

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, 2011, 2012 and 2013. 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.

In FY 2013, the Account return slightly outperformed its benchmark. May and June performance particularly impacted the fiscal year results as the likelihood of a tapering in bond purchases by the Fed began to be reflected in asset prices. The primary exposure of the Sentinel fund is MBS, which are expected to underperform in a rising rate environment and have downside exposure to Fed actions. This is a concern going forward. Compared to the Barclay's MBS index Sentinel outperformed by 25bps during the FY 2013. The Fixed Income asset classes as a whole are expected to see compressed real returns as the Federal Reserve continues their efforts to stimulate the market and keep real rates compressed, and will experience headline risk and interest rate sensitivity as the Fed reduces their presence in the fixed income market.

Equity relative performance during the fiscal year was impacted primarily by underperformance stemming from investments in international stocks and a conservative posture during a bull market. The managers were hired with the intention of outperforming during periods of down equity markets and lagging the market during surges in equity performance. This strategy's strength can be seen in the relative performance during the Great Recession of FY 2008 and FY 2009.

Trust Investment Account Restructuring

While the Treasurer's Office believes that the Fund's asset allocation has been appropriate to its goals of asset growth, capital preservation and supporting distributions, and that the investment managers generally have performed in a manner consistent with these goals, we believe a re-examination of the expected annual distribution rate and asset allocation is warranted. Expected returns over an intermediate term horizon for both equity and fixed-income classes have been reduced due to the likelihood of higher interest rates over time, expanded equity valuations and the dampening effect that higher debt burdens have on economic growth around the world. Similarly, we believe it is prudent to reconsider the asset allocation and investments in light of asset class risk and return expectations that are markedly different from those that existed at the Fund's inception. These perspectives were reflected to the Subcommittee during the past fiscal year.

We conclude that a more optimal portfolio allocation, utilizing a broader range of asset classes beyond large cap equities and mortgage-backed securities, cannot be achieved using separately-managed accounts by Vermont firms for a fund of the Trust Investment Account's relatively small size. For comparative purposes, most of the 35 investment managers in the $3.6 billion Vermont Pension Investment Committee (VPIC) portfolio manage allocations greater than the Account's entire $65.6 million balance.

Further, we believe that the dependence upon on 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.

Going forward, we anticipate shifting from separate accounts toward low-fee, highly liquid indexing vehicles, such as mutual funds and exchange-traded funds. This will allow us the opportunity to diversify the Account by evaluating additional asset classes. These portfolio changes are expected to be implemented as soon as practicable.

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)

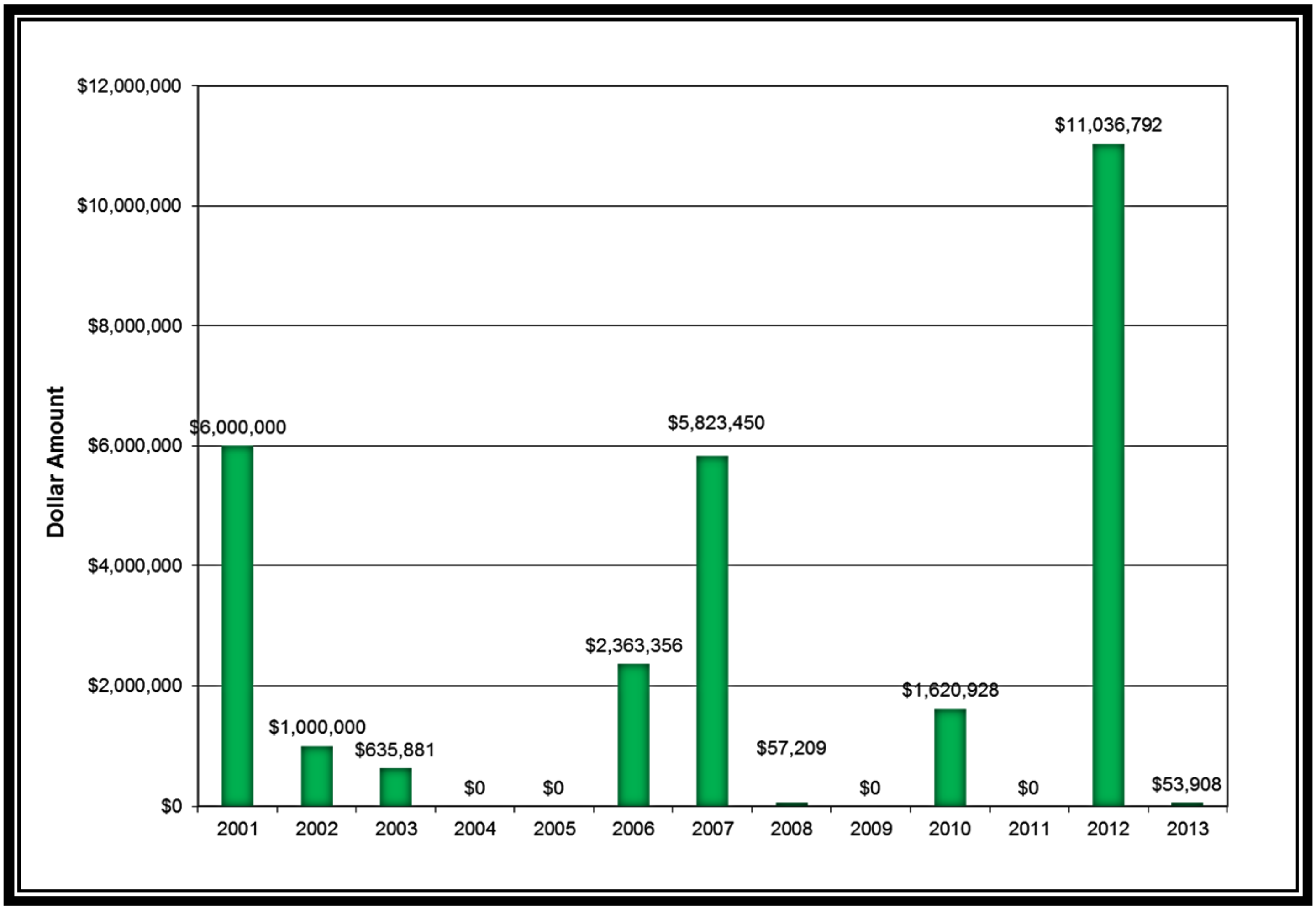


Chart #2

Higher Education Endowment Trust Fund
Authorized Distributions by Year and Type

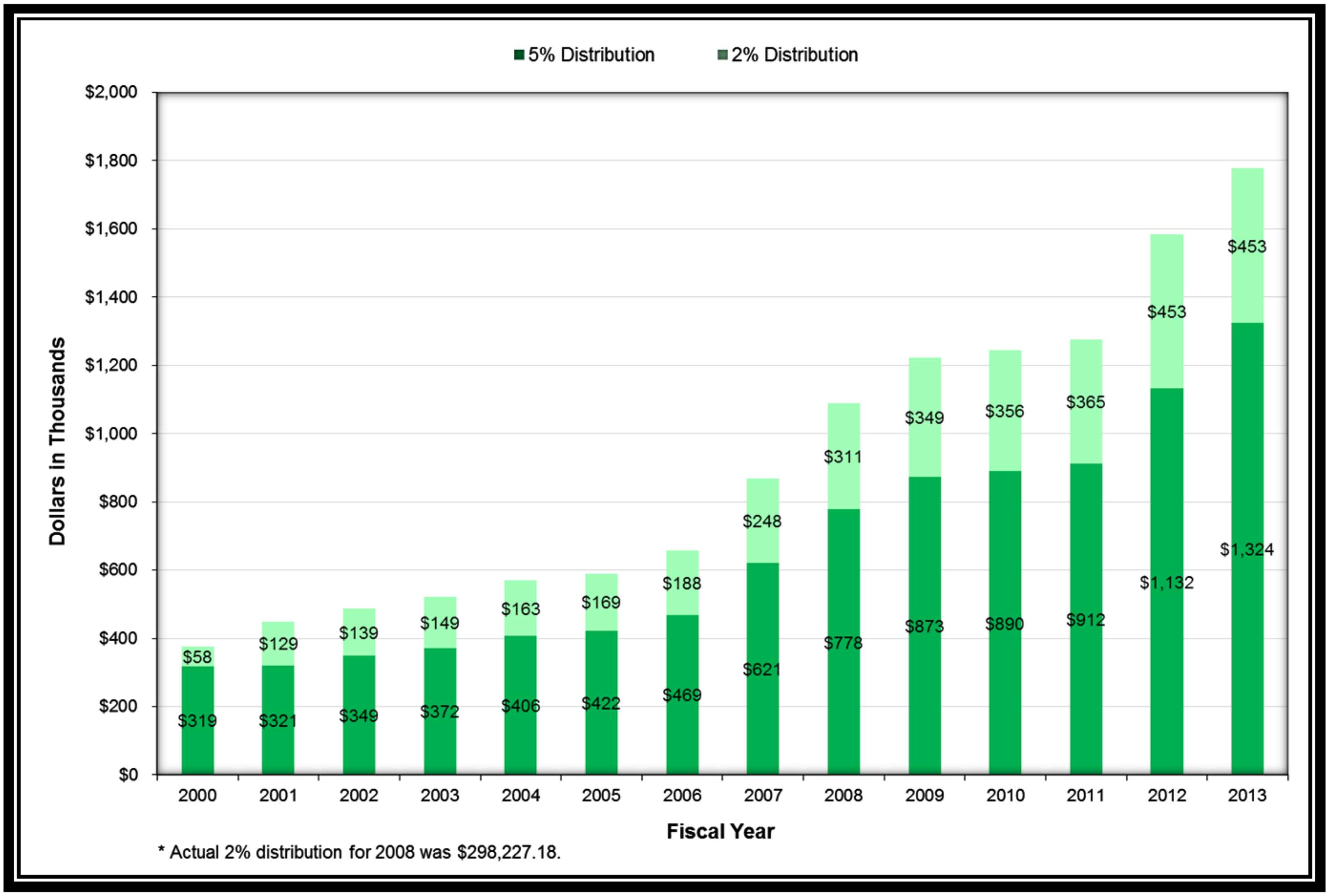


Chart #3

Trust Investment Account Fund Compositions
As of June 30, 2013

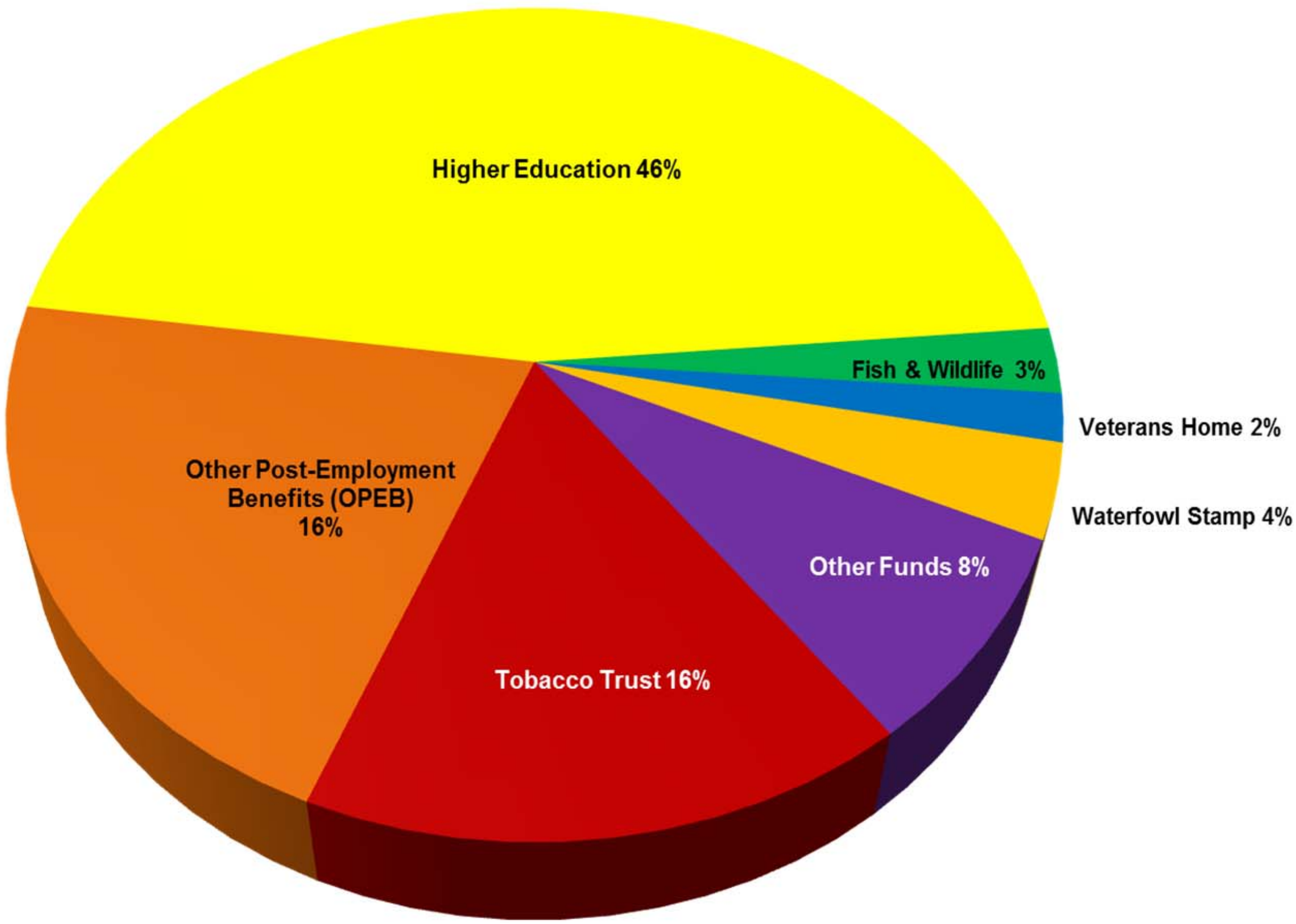
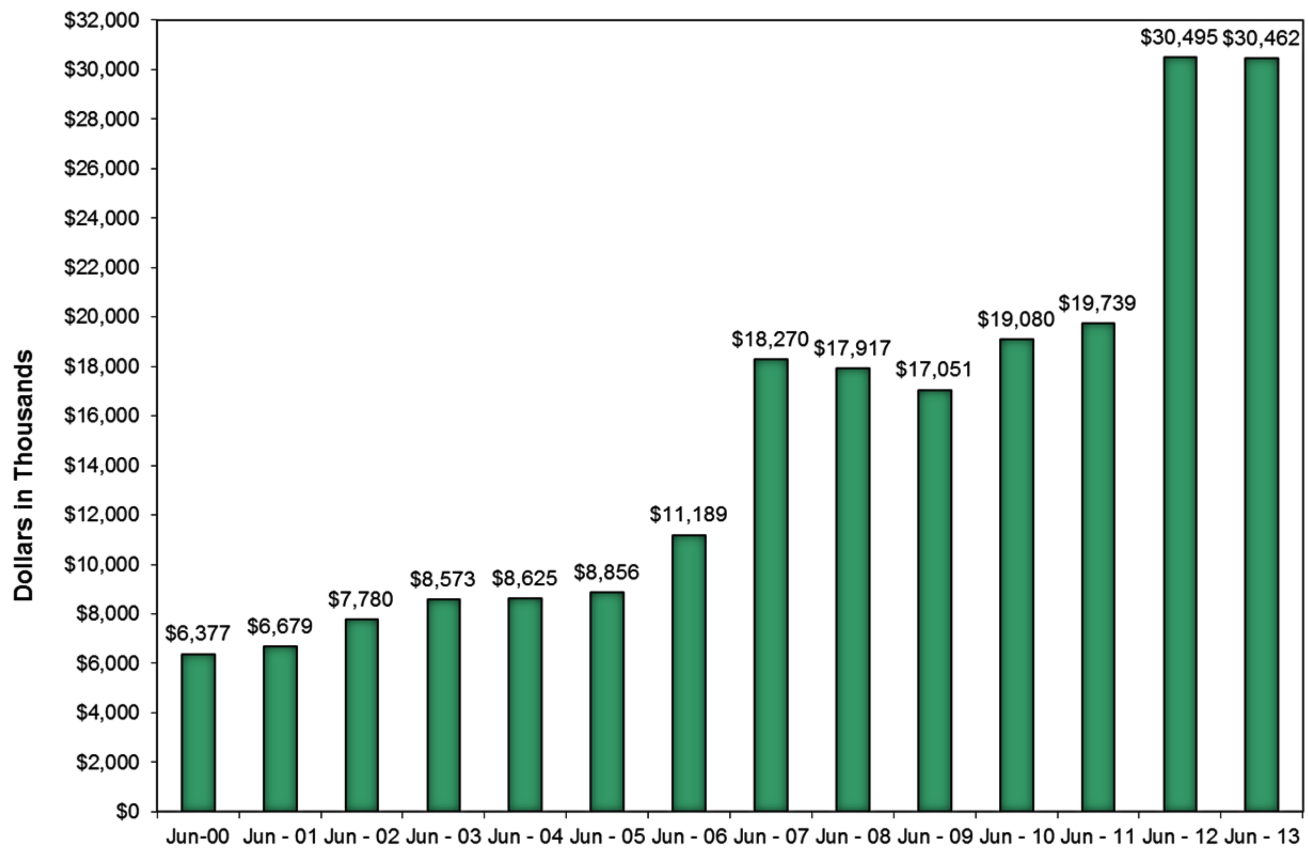


Chart #4

Higher Education Endowment Trust Fund
Asset Growth, 6/30/2000 to 6/30/2013
(Includes Distributions)



APPENDIX B
TRUST INVESTMENT ACCOUNT - TOTAL RETURN ANALYSIS
Period Ending June 30, 2013

MANAGER	Quarter Ended 9/30/2012	Quarter Ended 12/31/2012	Calendar Year 2012	Quarter Ended 3/31/2013	Quarter Ended 6/30/2013	Fiscal Year 2013	Portfolio Value 6/30/2013	Portfolio Allocation 6/30/2013
DOMESTIC EQUITY								
Hanson & Doremus Investment Management	6.9%	0.9%	**16.4%**	9.3%	1.6%	**19.9%**	$11,051,191	17%
Prentiss Smith & Co.	3.4%	0.6%	**8.3%**	10.2%	4.2%	**19.5%**	$11,059,635	17%
S&P 500	*6.4%*	*-0.4%*	***16.0%***	*10.6%*	*2.9%*	***20.6%***	*$22,110,826*	*34%*
DOMESTIC FIXED INCOME								
Sentinel Asset Management, Inc.	1.6%	0.3%	**3.9%**	0.0%	-2.6%	**-0.9%**	$40,283,644	61%
RBC Global Asset Management (Access Capital) [2]	1.8%	0.0%	**4.2%**	0.4%	-2.1%	**0.1%**	$3,214,616	5%
Barclays US MBS Index	*1.1%*	*-0.2%*	***2.6%***	*0.0%*	*-2.0%*	***-1.1%***	*$43,498,260*	66%
TOTAL FUND RETURN	2.7%	0.4%	**6.4%**	3.0%	-0.8%	**5.3%**		
Total Fund Policy Return	2.7%	-0.3%	**6.6%**	3.1%	-0.5%	**5.0%**		
TOTAL FUND MARKET VALUE ($ million)	**$62.9**	**$63.8**	**$63.8**	**$66.2**	**$65.6**	**$65.6**	$65,609,086	**100%**

Notes:
1. Access Capital added to Trust Investment Account on October 12, 2007.
2. Performance calculations in-line with GIPS standards as of June 30, 2005

APPENDIX C
TRUST INVESTMENT ACCOUNT PERFORMANCE

MANAGER	Fiscal Year 2013	Calendar Year 2012	Last 3 Fiscal Years	Last 5 Fiscal Years	Last 7 Fiscal Years	Last 10 Fiscal Years
DOMESTIC EQUITY						
Hanson & Doremus Investment Management	19.9%	16.4%	16.3%	4.5%	4.7%	10.1%
Prentiss Smith & Co.	19.5%	8.3%	14.8%	9.0%	8.4%	9.7%
S&P 500	*20.6%*	*16.0%*	*18.5%*	*7.0%*	*5.7%*	*7.3%*
DOMESTIC FIXED INCOME						
Sentinel Asset Management, Inc.	-0.9%	3.9%	2.7%	5.0%	5.7%	5.1%
RBC Global Asset Management [2]	0.1%	4.2%	3.0%	5.3%	5.6%	4.8%
Barclays US MBS Index	-1.1%	2.6%	2.5%	4.8%	5.5%	4.7%
TOTAL FUND RETURN	5.3%	6.4%	6.5%	6.1%	6.5%	6.4%
Total Fund Policy Return	5.0%	6.6%	7.3%	5.9%	5.9%	5.7%
TOTAL FUND MARKET VALUE ($ millions)	**$65.6**	**$63.8**				

Notes:
1. Returns for periods longer than one year are annualized.
2. Formerly Access Capital Management, inception date of September 17, 2007.
3. Total Fund Last 10 Fiscal Years Return uses quarterly reporting, as opposed to monthly, prior to June 2005.