

ELIZABETH A. PEARCE
STATE TREASURER

RETIREMENT DIVISION
TEL: (802) 828-2305
FAX: (802) 828-5182



UNCLAIMED PROPERTY DIVISION
TEL: (802) 828-2407

ACCOUNTING DIVISION
TEL: (802) 828-2301
FAX: (802) 828-2884

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 17, 2014

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 (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 2014, the Fund's investment return was 9.8% net of fees. This return compares to the Barclays Mortgage Backed Securities Index return of 4.6%, the Barclays Aggregate Bond Index return of 4.4% and to the S&P 500 Stock Index return of 24.6% for the same period. Because the portfolio was transitioned from an active to a passive strategy, as well as to a different target allocation, it is not possible to succinctly provide an accurate benchmark return for the fiscal year. However, by way of comparison a 30% S&P 500 / 70% MBS index would have returned 10.4% and a 40% S&P 500 / 60% Barclays Aggregate index would have returned 12.2% during the fiscal year (gross of fees). Note that beginning in December 2013 the investments comprised of mutual fund positions as a result of a Fund restructuring during the year. The results of the restructuring have been fees that were reduced from 38 basis points to 7 basis points annually at the time of this report. The blended fee for Fiscal Year 2014 was 18 basis points. Annual returns are expected to be very close to the benchmark going forward.

5% Distribution from Fiscal Year 2014

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, 2014 have been \$28,682,971.63.

The 5% distribution available this year is \$1,507,299.38 in total or \$502,433.13 each for UVM, the Vermont State Colleges, and VSAC. This amount represents a 13.8% increase over the distribution made following the Fiscal Year 2013 distribution of \$441,321.64 for each institution. **Appendix A** to this report includes quarterly market values and distributions for Fiscal Year 2014, and **Chart #1** shows principal contributions to date.

2% Distribution from Fiscal Year 2014

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 their September 30, 2013 meeting, the Secretary and the Subcommittee voted to forgo this 2% appropriation for distribution to UVM and the Vermont State Colleges, based upon a recognition that lower expected returns in the near term do not support a total distribution of 7% from the fund. This decision was reaffirmed at the Secretary and Subcommittee’s March 18, 2014 meeting.

After payments of \$1,507,299.38, the Fund balance at the end of Fiscal Year 2014 totals \$30,058,756.62. An accounting of the Fund balance is provided below:

Ending balance prior FY 2013	\$30,462,454.46
Contributions received FY 2014	<u>\$55,966.17</u>
Opening balance FY 2014	\$30,518,420.63
5% Distributions :	
University of Vermont	(441,321.64)
Vermont State Colleges	(441,321.64)
Vermont Student Assistance Corp.	(441,321.64)
2% Distributions :	
University of Vermont	(226,445.55)
Vermont State Colleges	(226,445.55)
Income earned FY 2014	3,565,330.45
Appreciation (Depreciation) FY 2014	(676,896.17)

	Fees and Other Charges FY 2014	(63,944.17)
Balance June 30, 2014		\$31,566,054.71
	5% of 12-Quarter Moving Average as of June 30, 2014	(1,507,299.38)
	Distributions :	
	University of Vermont	(502,433.13)
	Vermont State Colleges	(502,433.13)
	Vermont Student Assistance Corp.	(502,433.13)
	2% Income Available for Endowments from FY 2013	0.00
Balance after distributions		\$30,058,755.32
Total contributions as of June 30, 2014		\$28,682,971.63
	2% Income Available for Endowments from FY 2014 (requires institutional match in FY 2015)	\$602,919.75

2% Distribution for Fiscal Year 2015

All principal contributions to the Fund through June 30, 2014 total \$28,682,971.63, which also represents the minimum balance that must be maintained in the Fund. The 2% distribution proposed for this year of \$602,919.75 would leave a balance of \$29,455,836.87 excluding contributions to be received, the 5% distribution following FY 2015, and any gains from investment activity in FY 2015. Because this balance is near to the minimum required balance noted above, 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 \$301,459.88 with a required match to be raised by each entity in FY 2015 of \$602,919.75. To re-emphasize: **any distribution in the next fiscal year is dependent upon the Fund's balance being greater than \$28,682,971.63 by the end of FY 2015.** 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 \$31.6 million comprises approximately 45%. A State Employee's retirement benefit trust fund comprises 23% of the account, or \$16.4 million, and the remaining 32% is made up of, in decreasing size, the Tobacco Trust Fund at \$9.4 million, two Fish and Wildlife Trust funds at \$5.5 million, the ANR Stewardship Fund at \$5.3 million, two Veterans' Home trust funds totaling \$1.3 million, and other small trusts totaling just over \$970,000. **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 2014. 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.

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, 2014, the Account's actual allocation was in line with this allocation, versus 66.3% fixed income securities and 33.7% equities, respectively, on June 30, 2013. This change in asset allocation represents a shift away from four active managers and towards the use of index-mimicking mutual funds, in order to take advantage of a broader range of asset classes. 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 31 basis points to 7 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, 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. However, and as we have discussed with the Secretary and Subcommittee over the past several years, the outlook for lower returns across all asset classes over the intermediate term horizon has required us to re-evaluate this approach.

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 third fiscal quarter 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.

Performance of the fund during the year reflects as a result of this change a blend of performance from active managers in the first fiscal quarter and exposure to mutual funds in the remaining portion of the year. Staff believes that despite the robust performance of the S&P 500 during a time of increased expectations for interest rate increases, the slight increase in equity exposure is reasonable in light of that exposure being accomplished by diversifying investments in foreign equities, which have lagged 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.

FY 2014 thereby represents a transition year, where the fund went from management by active managers and reporting of gross of fee returns to a much lower fee structure achieved by investments in mutual funds with net of fee performance reporting and a broader asset class exposure.

Fund Management Philosophy

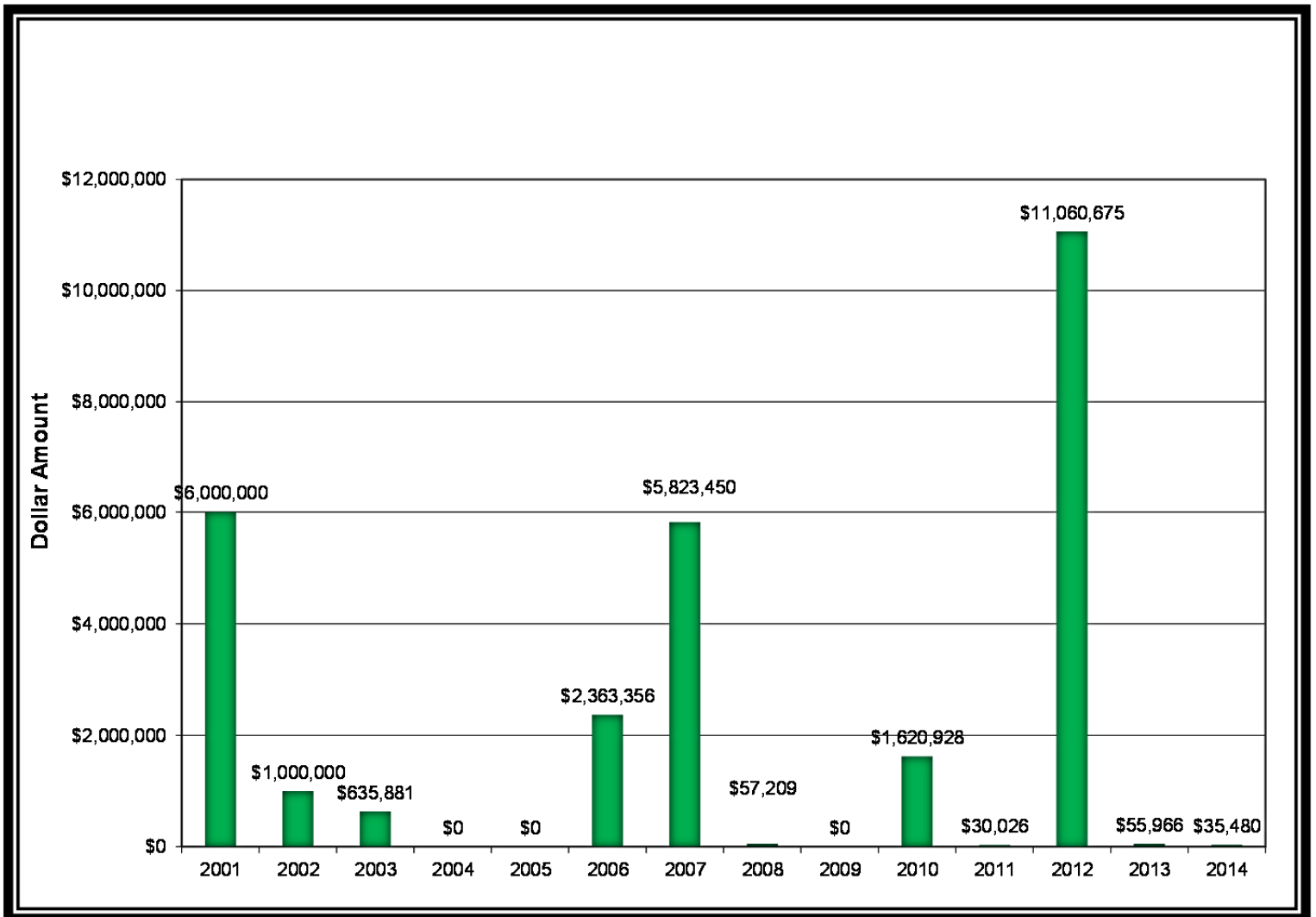
Going forward, we believe that the dependence upon manager performance relative to benchmarks, or alpha, is counterproductive, especially for relatively established asset classes. We believe that administrative effort is better spent analyzing optimal portfolio allocations using total return, standard 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 us the opportunity to diversify the Account by evaluating additional asset classes and to structure the portfolio in a manner best suited to meeting its risk and return objectives

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

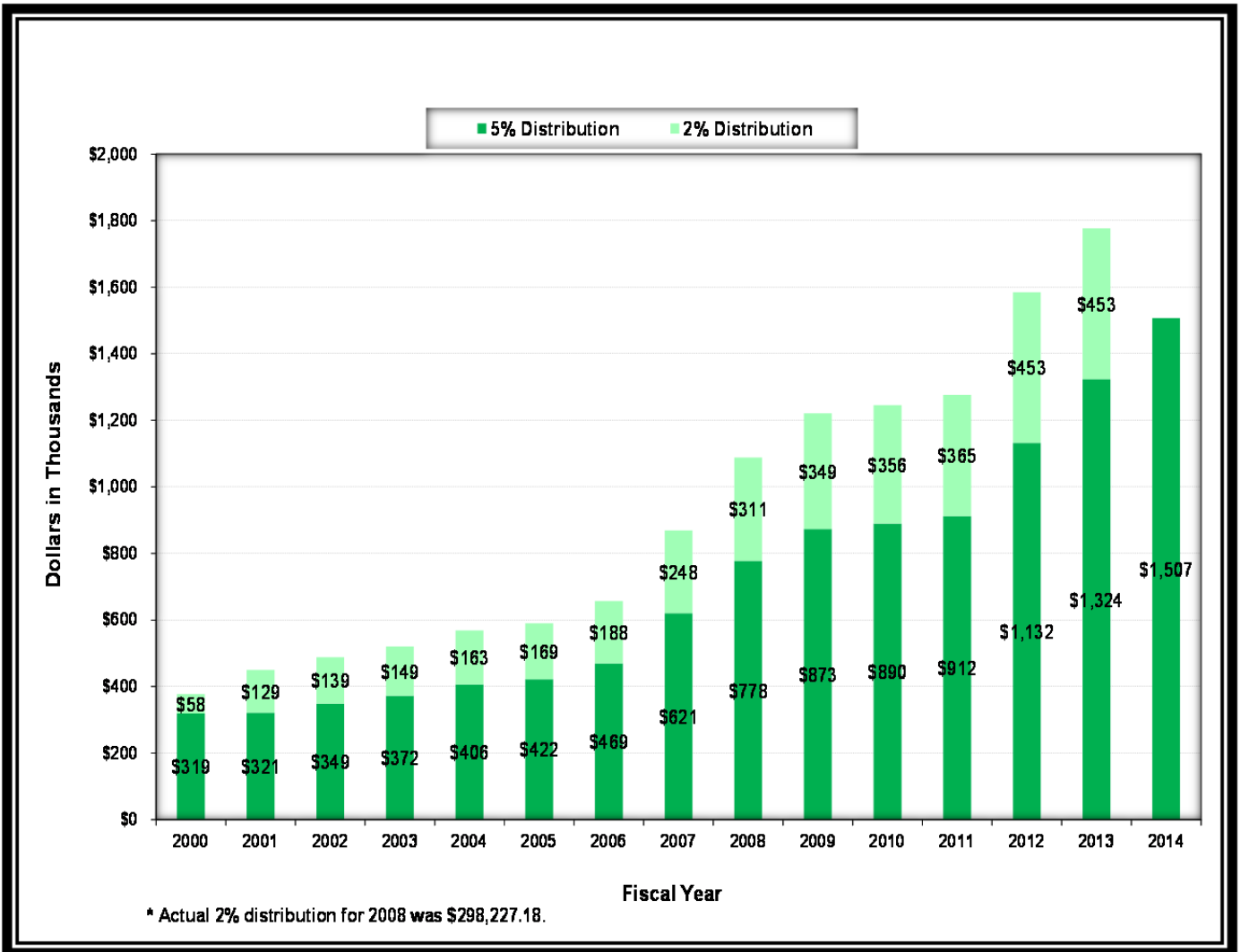
cc: James Reardon, Commissioner of Finance & Management
Donna Russo-Savage, Legislative Council

Chart #1
Higher Education Endowment Trust Fund



Fund Contributions (Fiscal Years)

Chart #2
Higher Education Endowment Trust Fund



Authorized Distributions by Year and Type

Trust Investment Account Fund Compositions
As of June 30, 2014
Chart #3

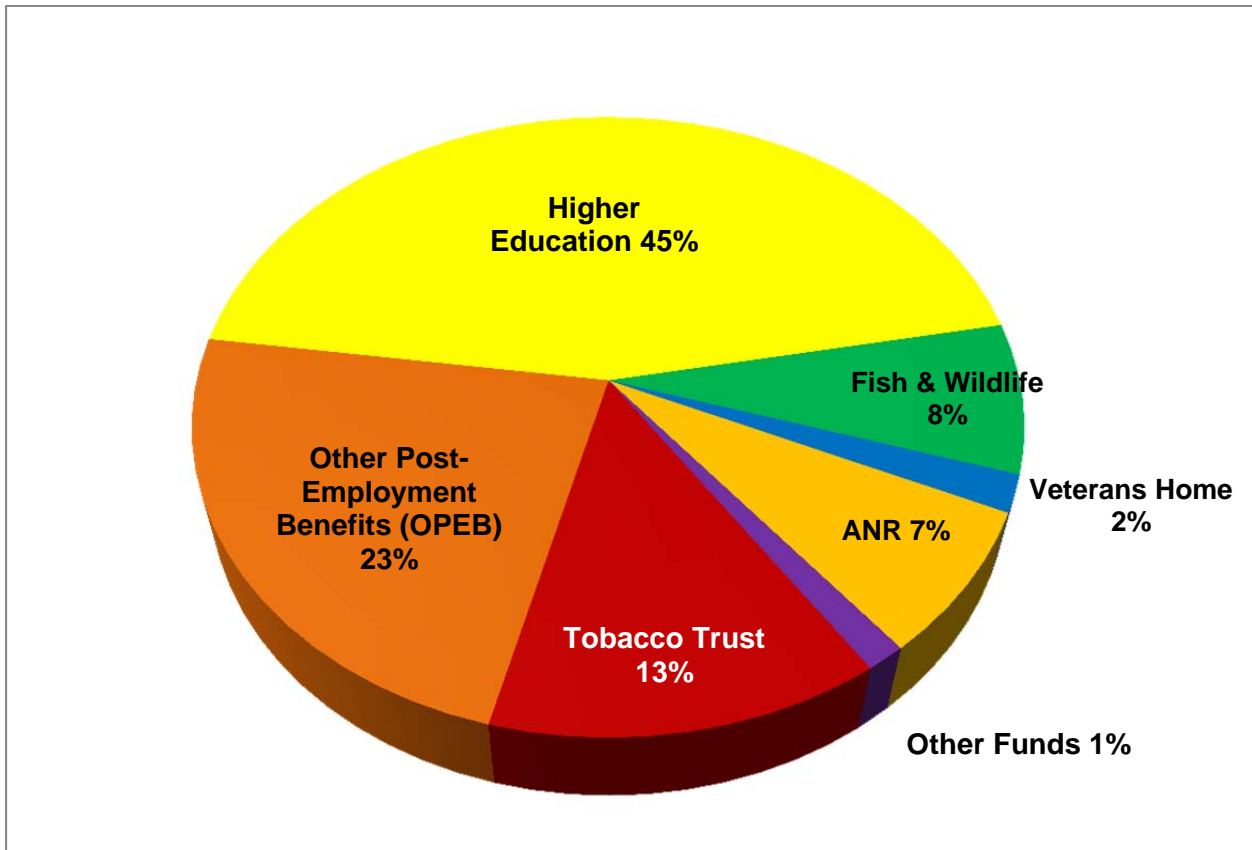
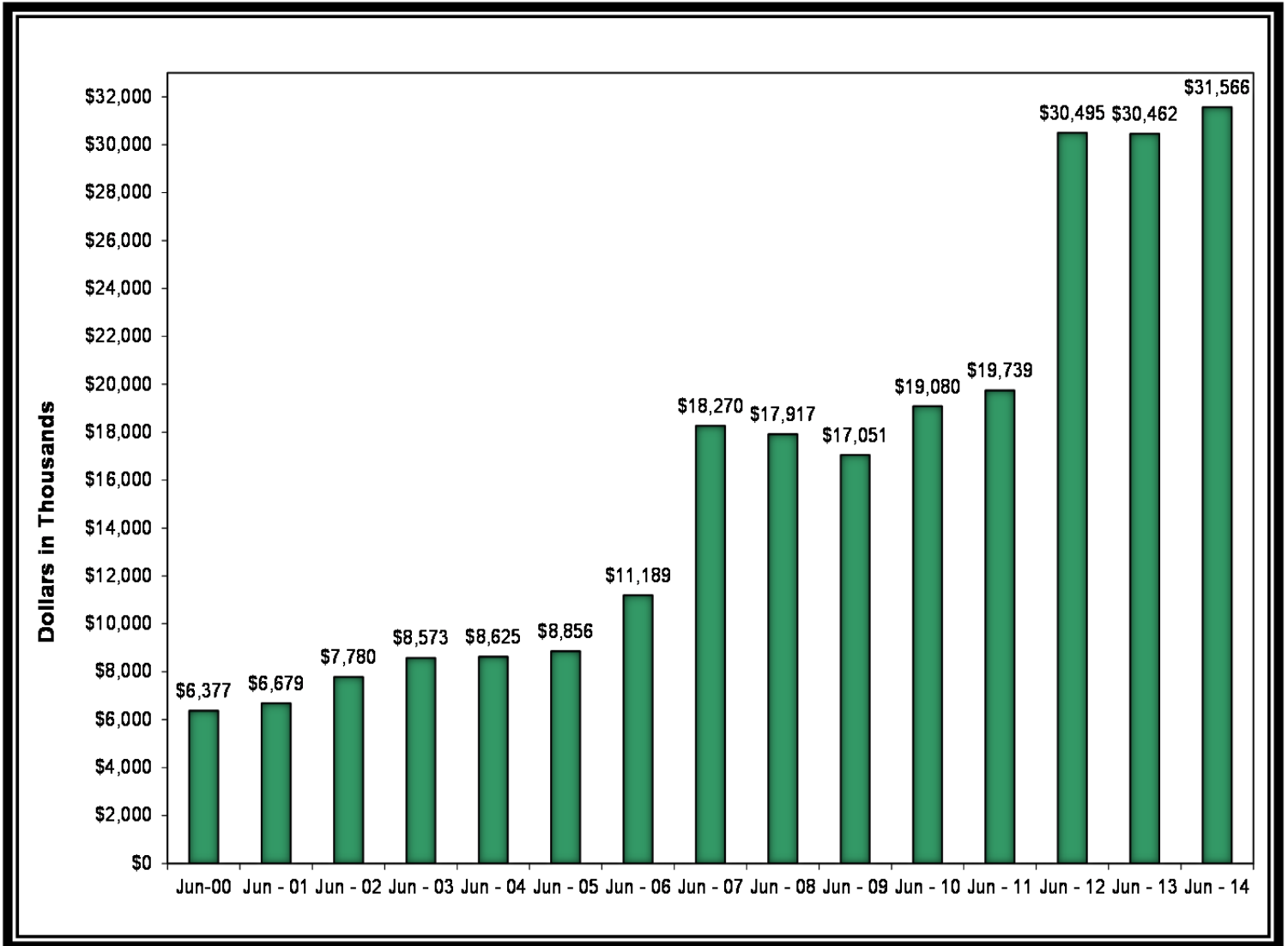


Chart #4
Higher Education Endowment Trust Fund
Asset Growth, 6/30/2000 to 6/30/2014
(Includes Distributions)



APPENDIX A
HIGHER EDUCATION ENDOWMENT TRUST FUND - DISTRIBUTIONS
For Period Ending June 30, 2014

<u>Quarter-End Balances</u>	<u>September 30</u>	<u>December 31</u>	<u>March 31</u>	<u>June 30</u>
Fiscal Year 2011	\$28,788,444.91	\$29,571,316.31	\$30,642,367.21	\$30,495,227.22
Fiscal Year 2012	\$29,784,761.21	\$29,937,373.43	\$30,761,121.84	\$30,462,454.46
Fiscal Year 2013	\$29,129,710.40	\$30,035,917.10	\$30,577,101.94	\$31,566,056.00
<u>Twelve Quarter Average</u>	\$30,145,987.67			
<u>5% Distribution FY2011</u>	\$1,507,299.38			
VSAC		\$502,433.13		
UVM		\$502,433.13		
Vermont State Colleges		\$502,433.13		
<u>2% FY2011 (Projected)</u>	\$529,585.97			
UVM		\$264,792.99		
Vermont State Colleges		\$264,792.99		
<u>2% FY2011 (Actual)</u>	\$0.00			
UVM		\$0.00		
Vermont State Colleges		\$0.00		
Balance after Distributions	\$30,058,756.62			
<u>2% FY2012 (Projected)</u>	\$602,919.75			
UVM		\$301,459.88		
Vermont State Colleges		\$301,459.88		
				Total: \$28,682,971.63

<u>Total Contributions</u>	
2001	\$6,000,000.00
2002	\$1,000,000.00
2003	\$635,881.49
2004	\$0.00
2005	\$0.00
2006	\$2,363,355.61
2007	\$5,823,449.94
2008	\$57,208.95
2009	\$0.00
2010	\$1,620,927.67
2011	\$30,026.35
2012	\$11,060,675.16
2013	\$55,966.17
2014	\$35,480.29

APPENDIX B									
TRUST INVESTMENT ACCOUNT - TOTAL RETURN ANALYSIS									
Period Ending June 30, 2014									
<i>(In Thousands)</i>									
<u>MANAGER</u>	Quarter Ended 9/30/2013	Quarter Ended 12/31/2013	Calendar Year 2013	Quarter Ended 3/31/2014	Quarter Ended 6/30/2014	Fiscal Year 2014	Portfolio Value 6/30/2014	Portfolio Allocation 6/30/2014	
DOMESTIC EQUITY									
Hanson & Doremus Investment Management	6.86%	4.66%		-	-		-	-	
Prentiss Smith & Co.	4.62%	4.10%		-	-		-	-	
INDEX FUNDS									
Vanguard Institutional Index Fund (VINIX)	-	10.50%		1.79%	5.22%		\$14,406	20.43%	
Vanguard Developed Markets Index Fund (VTMNX)	-	-		-	4.26%		\$10,638	15.09%	
Vanguard Emerging Markets Stock Index Fund (VEMAX)	-	-		-	7.43%		\$3,571	5.06%	
S&P 500	5.24%	10.51%	32.39%	1.80%	5.24%	24.61%	-	-	
DOMESTIC FIXED INCOME									
Sentinel Asset Management, Inc.	-0.87%	-0.01%		-	-		-	-	
RBC Global Asset Management (Access Capital)	0.72%	-0.03%		1.78%	-		-	-	
INDEX FUNDS									
Vanguard Total Bond Market Index Fund (VBTIX)	-	-0.19%		1.91%	1.97%		\$41,888	59.41%	
Barclays US MBS Index ₁	1.03%	-0.42%	-1.41%	1.55%	2.40%	4.65%	-	-	
Barclays Capital Aggregate Bond Index ₂	0.57%	-0.14%	-2.02%	1.84%	2.04%	4.38%	-	-	
TOTAL FUND RETURN₁	1.43%	3.03%	6.76%	1.85%	3.24%	12.00%	-	-	
<i>Total Fund Policy Return</i>	2.31%	4.04%	9.18%	1.87%	3.29%		-	-	
TOTAL FUND MARKET VALUE (\$ million)	\$62,601,701	\$66,224,840	\$66,224,840	\$68,737,009	\$70,503,215	\$70,503,215	-	-	

Notes:

- Results reflect transition to new asset allocation as of December 31, 2013.
- Fixed income benchmark changed on 12/31/2013 from the Barclays US MBS Index to the Barclays Capital Aggregate Bond Index.

APPENDIX C
 TRUST INVESTMENT ACCOUNT PERFORMANCE

<u>MANAGER</u>	Fiscal Year	Calendar Year	Last 3 Fiscal Years	Last 5 Fiscal Years	Last 7 Fiscal Years	Last 10 Fiscal Years
	<u>2014</u>	<u>2013</u>	<u>Years</u>	<u>Years</u>	<u>Years</u>	<u>Years</u>
TOTAL FUND RETURN	9.88%	6.76%	6.2%	7.8%	6.2%	7.1%
<i>Total Fund Policy Return</i>	12.00%	9.18%	7.5%	8.7%	6.1%	6.2%
TOTAL FUND MARKET VALUE (\$ millions)	\$70,503,215	\$66,224,840				

Notes:

- Returns for periods longer than one year are annualized.
- Total Fund Last 10 Fiscal Years Return uses quarterly reporting, as opposed to monthly, prior to June 2005.