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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

TO: Commission on Higher Education Funding
FROM: Jeb Spaulding, State Treasurer
RE: Annual Report on the Higher Education Trust Fund
DATE: August 15, 2006

I am pleased to present the State Treasurer's seventh annual report on the Higher Education Trust Fund. This fund was established in the Office of the State Treasurer by the 1999 General Assembly (16 V.S.A. § 2885). Appropriations totaled \$7,635,881.49 through 2002, \$2,363,355.61 in 2005, and, as discussed further below, \$5,823,449.94 in 2006. The statute was amended in 2001 to provide that in August of each year, the State Treasurer shall withdraw 5% of up to a 12-quarter moving average of the fund's assets and divide the amount equally among the University of Vermont, the Vermont State Colleges, and the Vermont Student Assistance Corporation.

During fiscal year 2006, the Higher Education Trust Fund dollar weighted return was 5.86%. This return compares to the Lehman Aggregate Bond Index return of -0.81% and to the S&P 500 Stock Index return of 8.63% for the same period, and exceeds the Fund's target rate (based on actual asset allocation and index returns) of 2.19%. The 5% distribution available this year is \$469,095.23 in total, or \$156,365.08 each for UVM, VSC, and VSAC; the distribution made following Fiscal Year 2005 was \$140,552.61 for each institution. (See Appendix A for quarterly market values and distributions for fiscal year 2006.)

16 V.S.A. § 2885 further provides that in August of each year, the Commission on Higher Education Funding may authorize the State Treasurer to make an additional amount equal to 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. The amount appropriated, however, cannot exceed an amount that would bring the fund balance below total contributions to principal.

At its meeting last year, the Commission authorized this 2% appropriation in the amount of \$168,663.14, or \$84,331.57 each, for distribution to the University of Vermont and the Vermont State Colleges dependent upon a finding by the Commission that the terms of this appropriation have been met. Each institution is required to match the appropriation by raising twice that

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amount, or \$168,663.14, and to certify to the Commissioner of Finance and Management 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. Each of these institutions is in the process of establishing the required certification.

After payments of \$469,095.23 and \$168,663.14, the balance in the fund at the beginning of fiscal year 2007 totals \$10,550,941.39.

All principal contributions to June 30, 2006, total \$9,999,237.10 (see Chart #1). This represents the current minimum balance that must be maintained in the fund. The 2% distribution proposed for this year of \$187,638.09 would leave a balance of \$10,363,303.30 excluding contributions received, 5% distribution, and any gains from investment activity in Fiscal Year 2007. If the committee authorizes this distribution, each institution's share will be \$93,819.05 with a required match to be raised by each entity in Fiscal Year 2007 of \$187,638.09. Chart #2 is a graphical depiction of distributions, including this 2% distribution subject to committee approval.

An accounting of the fund balances is provided below:

Ending balance FY 2005	\$8,855,599.91
Contributions received FY 2006	<u>2,363,355.61</u>
Opening balance FY 2006	11,218,955.52
Distribution August 2005	(584,237.33)
Income earned fiscal year 2006	490,132.24
Appreciation (Depreciation) FY 2006	106,439.80
Fees and Other Charges FY 2006	<u>(42,590.47)</u>
Balance June 30, 2006	11,188,699.76
5% of 12-Quarter Moving Average June 30, 2006	(469,095.23)
Distributions: University of Vermont	(156,365.08)
Vermont State Colleges	(156,365.08)
Vermont Student Assistance Corp.	(156,365.08)
2% Income Available for Endowments from FY 2005	<u>(168,663.14)</u>
Balance after distributions	10,550,941.39
Total contributions as of 6/30/2006	9,999,237.10
2% Income Available for Endowments from FY 2006 (requires institutional match in FY 2007)	\$187,638.09

I have attached a spreadsheet as Appendix B that shows the total return of the entire Trust Investment Account, of which the Higher Education Trust Fund at \$11,188,699.76 (prior to cash distributions to be made in fiscal year 2007) comprises approximately 23%. The Tobacco Trust Fund comprises 71% of the account, or \$35,253,339.24, and the remaining 6% is made up of

eight small unexpendable trusts that total \$488,640.88, the ANR Stewardship Fund at \$609,728.76, two Veterans' Home trusts totaling \$1,027,586.57, and the Fish and Wildlife Trust Fund at \$1,112,957.74. Chart #3 displays the relative share of the Higher Education Trust Fund compared to the entire fund. Chart #4 identifies the major asset classes in the portfolio and their performance over the past six years.

As noted in Chart #5, assets increased significantly due to receipt of funds raised by the Estate Tax (\$2,363,355.61 derived from FY 2005 and received into the fund in FY 2006) as well as investment return. Fixed income continues to be the principal source of total return over the life of the Fund due to a combination of asset allocation and market forces. However, the Fund's equity investments have once again provided a significant contribution to the Fund's performance for the most recent fiscal year. The asset allocation of the Fund at June 30, 2006, comprised 32.5% equities and 67.5% fixed income securities versus 30.4% equities and 69.6% fixed income securities, respectively, at June 30, 2005. Currently, allocations of contributions and sources of distributions in the Trust Investment Account are used to target a 70% - 30% ratio in favor of fixed income securities. This balance addresses joint investment objectives of investment return and capital preservation.

The Higher Education Endowment Trust Fund Act provides that contributions shall include "... in any fiscal year in which a general fund surplus exists and the general fund stabilization reserve is funded to its required statutory level, funds raised by the estate tax under chapter 190 of Title 32 which are more than 125 percent of the amount projected by the emergency board in the July annual forecast made pursuant to section 305a of Title 32." This year a substantial contribution in the amount of \$5,223,449.94 derives from fiscal year 2006, and this contribution became part of the Higher Education Trust Fund in July 2006. In addition, the Higher Education Trust Fund will receive another \$600,000 from the State's Unclaimed Property Fund, as a result of legislation proposed by the State Treasurer and enacted into law this year. Under the new statute, all unclaimed property worth less than \$100 under State custody for ten years or longer will be turned over to the Higher Education Trust Fund. Thus the Fund's investment base is significantly increased for fiscal year 2007, and depending upon investment market conditions can be expected to generate additional returns to the Fund.

In summary, while the investment performance of the Trust Investment Account once again far exceeded its target return, market conditions and a conservative asset allocation created a return below a level fully supporting this year's distributions. Going forward, distributions will depend on the ongoing performance of the Fund, and will require continued monitoring of the Fund's investment performance, as well as ongoing consideration of optimal asset allocation in evolving investment marketplaces.

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

cc: James Reardon, Commissioner of Finance & Management
Anne Winchester, Legislative Council

Appendix A Quarterly Market Values June 30, 2006

	Balance 9/30	Balance 12/31	Balance 3/31	Balance 6/30	
Education Trust					
FY2004	\$8,242,399.79	\$8,505,386.89	\$8,697,470.84	\$8,625,716.81	
FY2005	\$8,241,108.63	\$8,566,614.41	\$8,617,473.66	\$8,855,599.91	
FY 2006	\$10,849,205.23	\$10,921,067.11	\$11,272,112.39	\$11,188,699.76	
Twelve Quarter Average	\$9,381,904.62				
5% Distribution 2006	\$469,095.23				
VSAC		\$156,365.08		<u>Contributions</u>	
UVM		\$156,365.08			
VSC		\$156,365.08		Initial	\$6,000,000.00
				2001	\$1,000,000.00
2% FY2005	\$168,663.14			2002	\$635,881.49
UVM		\$84,331.57		2003	\$0.00
VSC		\$84,331.57		2004	\$0.00
				2005	\$2,363,355.61
Balance after Distributions	\$10,550,941.39			Total	\$9,999,237.10
2% FY2006	\$187,638.09				
UVM		\$93,819.05			
VSC		\$93,819.05			

Appendix B

VERMONT COMMON TRUST FUND

TOTAL RETURN ANALYSIS

June 30, 2006

MANAGER	Quarter Ended 9/30/2005	Quarter Ended 12/31/2005	Calendar Year 2005	Quarter Ended 3/31/2006	Quarter Ended 6/30/2006	Fiscal Year 2006	Portfolio Market 6/30/2006	Portfolio Percent 6/30/2006
DOMESTIC EQUITY								
Hanson Investment Management	8.40%	2.26%	19.18%	13.33%	-3.60%	21.10%	\$8,781,896	17.7%
Prentiss Smith & Co.	7.92%	0.86%	10.68%	6.40%	-0.10%	15.77%	\$7,369,828	14.8%
<i>S&P 500</i>	3.60%	2.09%	4.91%	4.21%	-1.44%	8.63%		32.5%
DOMESTIC FIXED INCOME								
NL Capital Management	-0.50%	0.44%	3.07%	0.16%	0.17%	0.26%	\$33,529,229	67.5%
<i>Lehman Aggregate</i>	-0.67%	0.59%	2.43%	-0.65%	0.08%	-0.81%		
TOTAL FUND DOLLAR WEIGHTED RETURN	2.15%	0.80%	6.64%	3.37%	-0.55%	5.86%		
<i>Total Fund Target</i>	0.64%	1.05%	3.27%	0.91%	-0.42%	2.19%		
TOTAL FUND MARKET VALUE (\$mil)	\$48.3	\$48.6	\$48.6	\$50.1	\$49.7	\$49.7	\$49,680,953	100.0%

Appendix B

VERMONT COMMON TRUST FUND

TOTAL RETURN ANALYSIS

June 30, 2006

MANAGER	Fiscal Year 2001	Calendar Year 2001	Fiscal Year 2002	Calendar Year 2002	Fiscal Year 2003	Calendar Year 2003	Fiscal Year 2004	Calendar Year 2004	Fiscal Year 2005
DOMESTIC EQUITY									
Hanson Investment Management	29.41%	17.41	(7.78)	(18.01)	-1.89%	42.55%	29.10%	15.92%	22.25%
Prentiss Smith & Co.	7.59%	13.69	3.60	(7.35)	7.70%	18.17%	11.47%	13.25%	11.00%
<i>S&P 500</i>	-13.56%	-11.89%	-17.99%	-22.11%	0.25%	28.69%	19.14%	10.90%	6.32%
DOMESTIC FIXED INCOME									
NL Capital Management	10.34%	10.07%	9.41%	9.48%	8.92%	5.43%	3.48%	5.56%	7.42%
<i>Lehman Aggregate</i>	10.23%	8.44%	8.63%	10.25%	10.40%	4.10%	0.32%	4.34%	6.80%
TOTAL FUND DOLLAR WEIGHTED RETURN	11.27%	11.62	7.94	5.15	8.59%	11.24%	7.59%	8.14%	10.17%
<i>Total Fund Target</i>	7.52%	6.57	3.12	3.29	9.23%	9.94%	4.96%	6.23%	6.76%
TOTAL FUND MARKET VALUE (\$mil)	\$26.5	\$32.6	\$33.3	\$34.9	\$37.3	\$38.8	\$39.3	\$41.1	\$43.5

Chart #1
Higher Education Trust Fund
Fund Contributions (Fiscal Years)

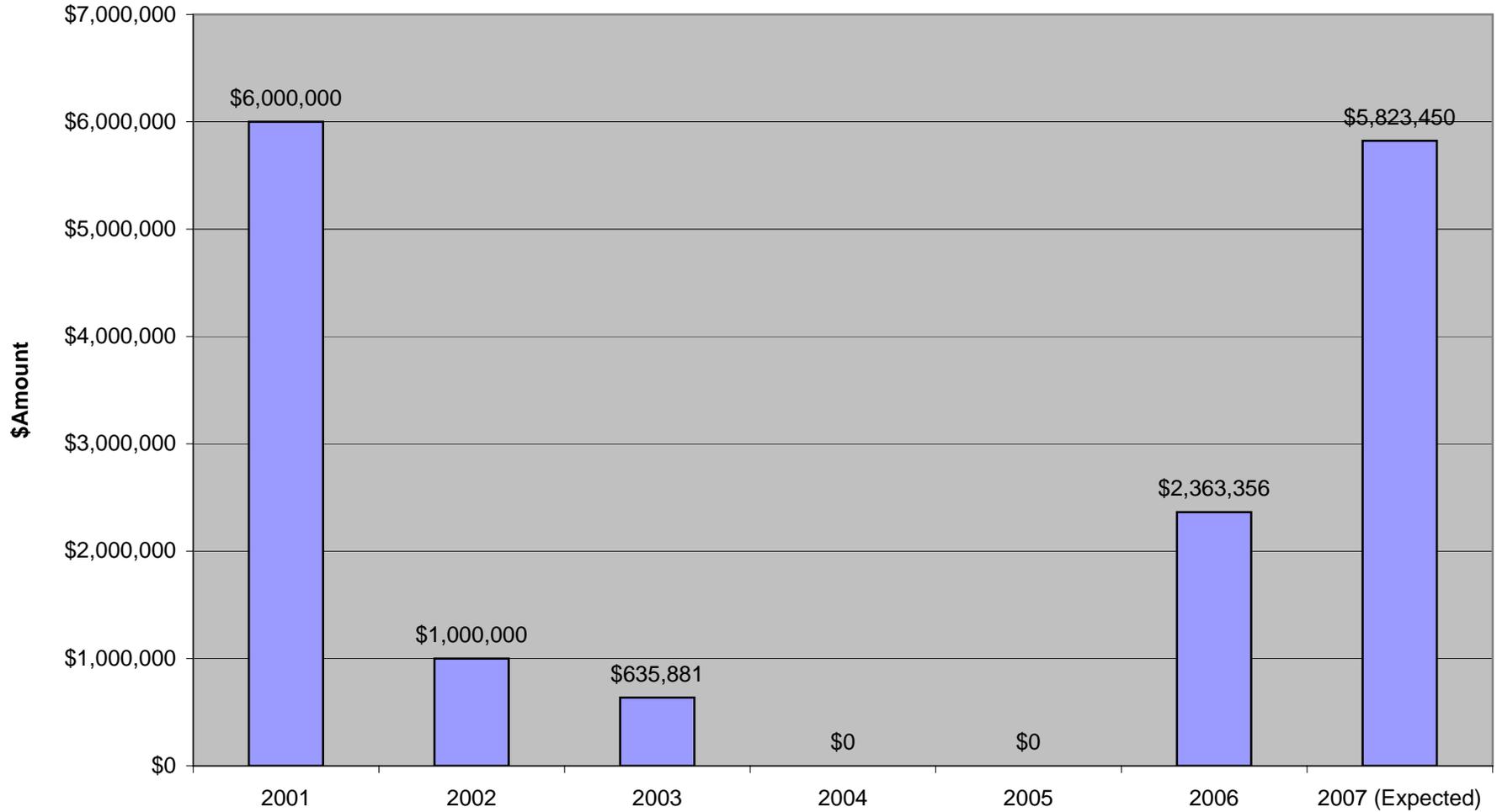


Chart #2
Higher Education Trust Fund
Authorized Distributions by Year and Type

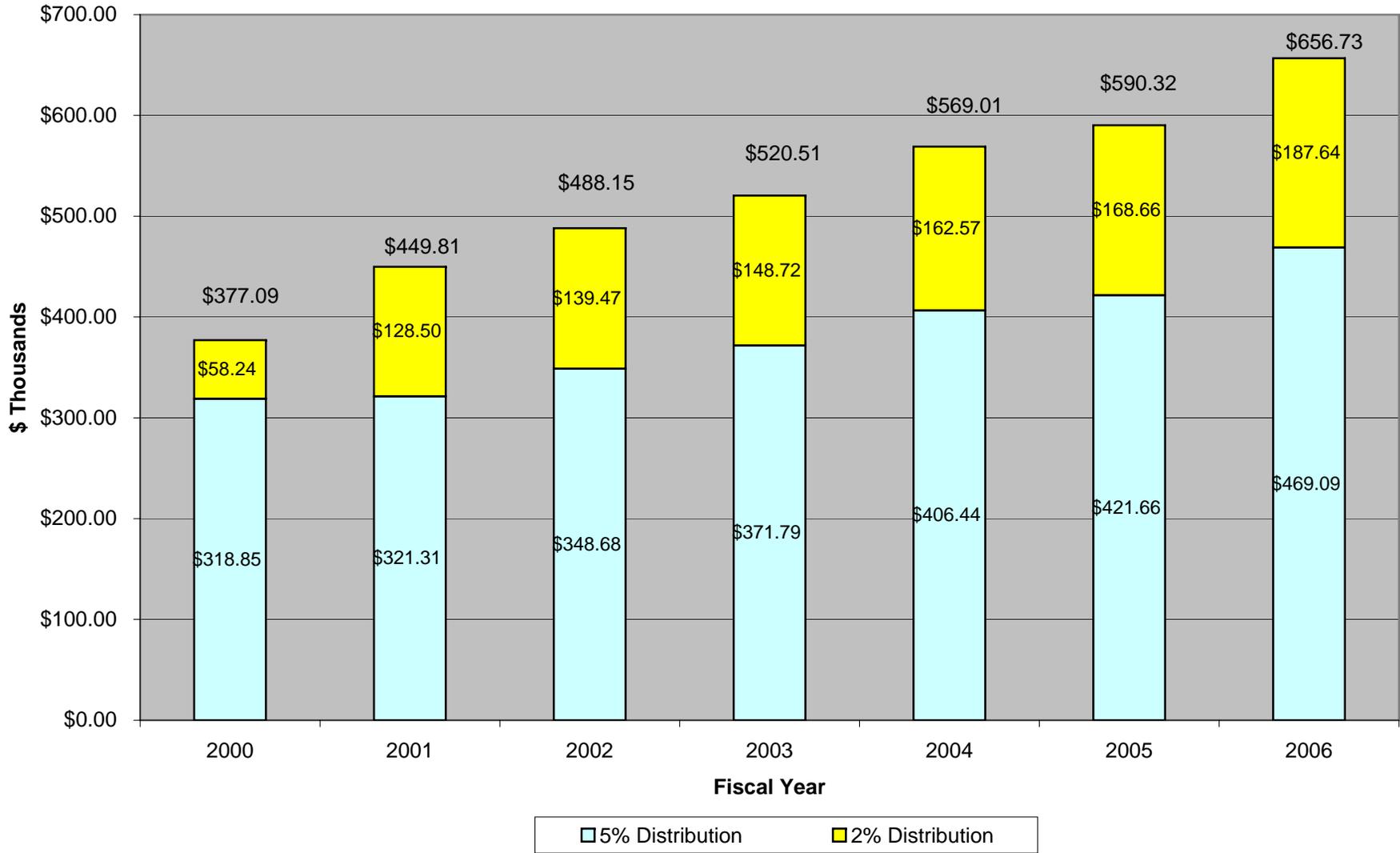


Chart #3
Common Trust Fund Breakdown as of June 30, 2006

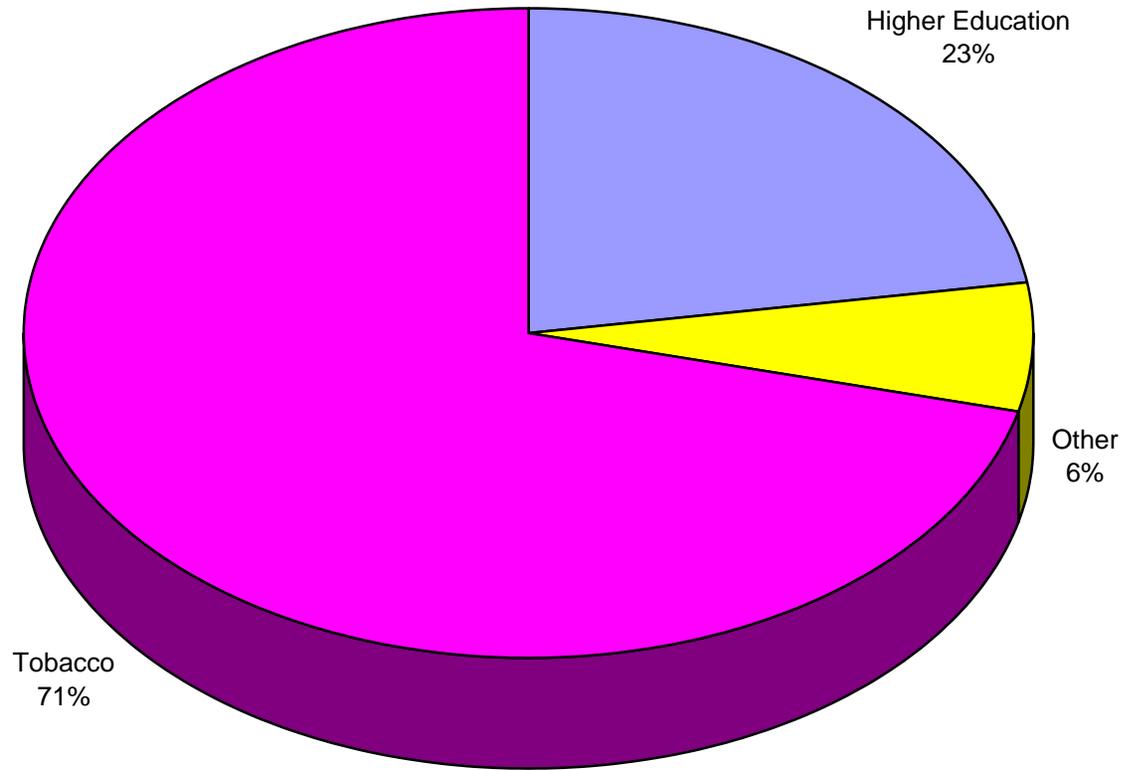
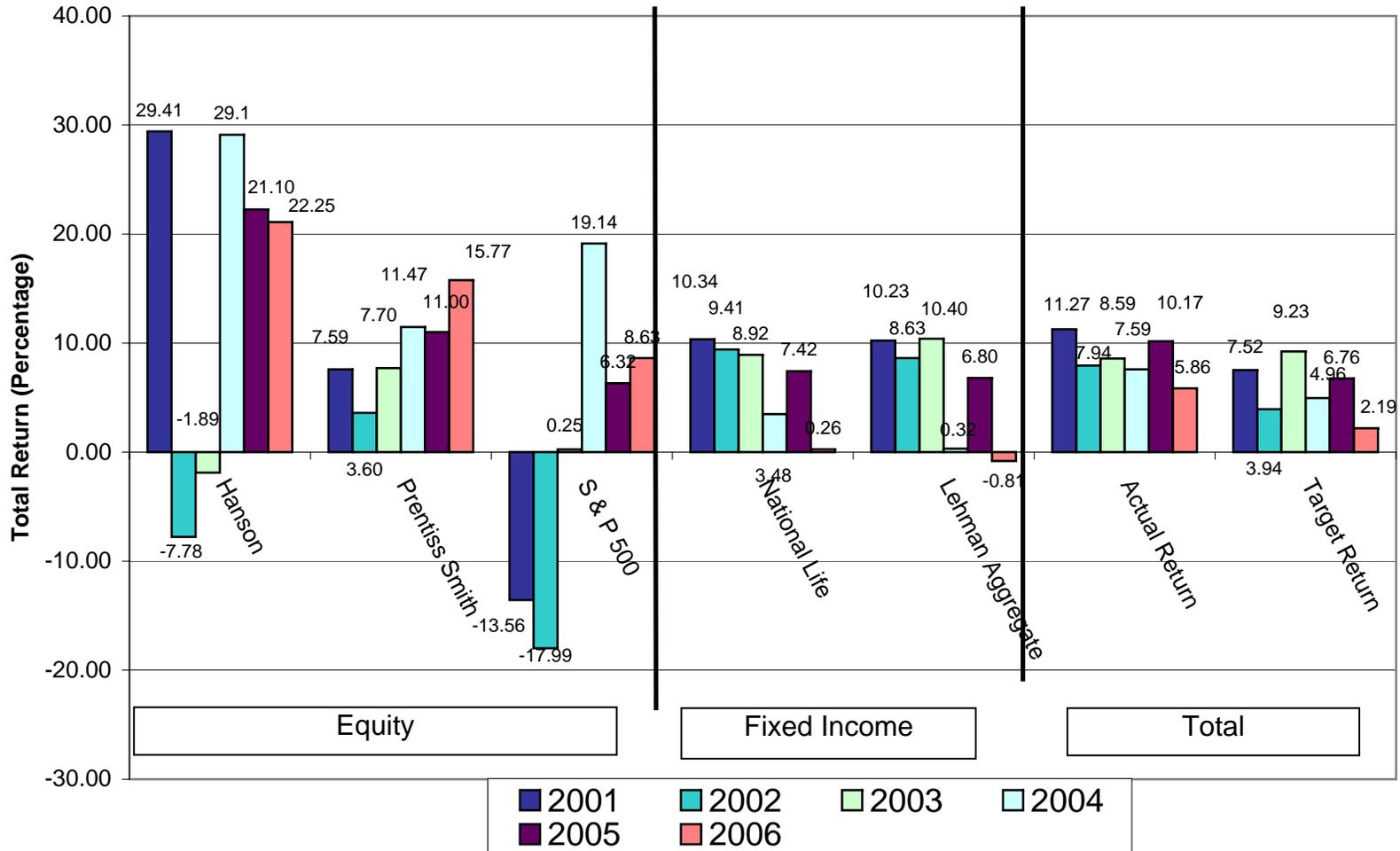


Chart #4
Higher Education Trust Fund
Total Return by Asset Class Fiscal Years 2001- 2006



Note: Some performance figures are restated to reflect a uniform reporting methodology.

Chart #5
Higher Education Trust Fund
Asset Growth, 6/30/2000 to 6/30/2006
(Includes Distributions)

