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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

TO: Neale Lunderville, Secretary of Administration, and the
Higher Education Subcommittee of the Prekindergarten-16 Council

FROM: Jeb Spaulding, State Treasurer

RE: Annual Report on the Higher Education Endowment Trust Fund

DATE: September 30, 2010

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 eleventh 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 2010, the Fund's dollar weighted investment return was 9.82% gross of fees. This return compares to the Barclays Aggregate Bond Index return of 9.49% and to the S&P 500 Stock Index return of 14.43% for the same period, and is less than 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 Aggregate) of 12.06%. A detailed discussion of the Fund's performance is included in this report.

5% Distribution from Fiscal Year 2010

The statute provides that in August of each fiscal year, the State Treasurer is to withdraw 5% of up to a 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, 2010 have been \$17,500,823.36.

The 5% distribution available this year is \$889,589.50 in total or \$296,529.83 each for UVM, the Vermont State Colleges, and VSAC. This amount represents a 1.94% increase over the distribution made following Fiscal Year 2009 of \$290,892.03 for each institution. **Appendix A**

to this report includes quarterly market values and distributions for Fiscal Year 2010, and **Chart #1** shows principal contributions to date.

2% Distribution from Fiscal Year 2009

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 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. 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 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, the Commission on Higher Education Funding (Commission) authorized this 2% appropriation in the amount of \$349,070.43, or \$174,535.22 each for distribution to UVM and the Vermont State Colleges, dependent upon a finding by the Commission 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 2010, the Fund will be able to make the full distribution amount.

After payments of \$889,589.50 and \$349,070.43, the Fund balance at the end of Fiscal Year 2010 totals \$17,841,789.97. An accounting of the Fund balances is provided below:

| | |
|---|---------------------|
| Ending balance FY 2009 | \$17,050,798.96 |
| Contributions received FY 2010 | <u>1,620,927.67</u> |
| Opening balance FY 2010 | \$18,671,726.63 |
| 5% Distributions: University of Vermont | (290,892.03) |
| Vermont State Colleges | (290,892.03) |
| Vermont Student Assistance Corp. | (290,892.03) |
| 2% Distributions: University of Vermont | (149,113.59) |
| Vermont State Colleges | (149,113.59) |
| Income earned FY 2010 | 948,716.27 |
| Appreciation (Depreciation) FY 2010 | 702,133.18 |
| Fees and Other Charges FY 2010 | <u>(71,222.91)</u> |
| Balance June 30, 2010 | \$19,080,449.90 |
| 5% of 12-Quarter Moving Average as of June 30, 2010 | (889,589.50) |

| | |
|--|---------------------|
| Distributions: University of Vermont | (296,529.83) |
| Vermont State Colleges | (296,529.83) |
| Vermont Student Assistance Corp. | (296,529.83) |
| 2% Income Available for Endowments from FY 2009 | <u>(349,070.43)</u> |
| Balance after distributions | \$17,841,789.97 |
| Total contributions as of June 30, 2010 | \$17,500,823.36 |
| 2% Income Available for Endowments from FY 2010 (requires institutional match in FY 2011) | \$355,835.80 |

2% Distribution for Fiscal Year 2010

All principal contributions to the Fund through June 30, 2010 total \$17,500,823.36, which also represents the minimum balance that must be maintained in the Fund. The 2% distribution proposed for this year of \$355,835.80 would leave a balance of \$17,841,789.97 excluding contributions to be received, and the 5% distribution following FY 2010, and any gains from investment activity in FY 2010. If the Secretary and the Subcommittee authorize this distribution, each institution's share will be \$177,917.90 with a required match to be raised by each entity in FY 2010 of \$355,835.80. 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 Trust Fund, with a balance of \$19.1 million (prior to cash distributions to be made in FY 2010) comprises approximately 32%. The Tobacco Trust Fund comprises 43% of the account, or \$25.8 million, and the remaining 25% is made up of, in decreasing size, a State Employee's retirement benefit trust fund totaling \$6.6 million, the ANR Stewardship Fund at \$4.0 million, the Waterfowl Stamp Fund at \$2.0 million, the Fish and Wildlife Trust Fund at \$1.4 million, two Veterans' Home trusts totaling \$1.1 million, and eight small trusts totaling just over \$500,000. **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 2010. 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. Finally, the fund balance rebounded in FY 2010, owing to both solid investment returns and a rather large Estate Tax contribution in excess of \$1.5 million.

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, 2010, the Account's actual allocation comprised 73.2% fixed income

securities and 26.8% equities, versus 69.4% fixed income securities and 30.6% equities, respectively, on June 30, 2009. 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 achieved modest positive returns in both FY 2008 and FY 2009, during some of the worst financial market conditions since the 1930s, and achieved sufficient returns to fully fund distributions in FY 2010. Given that the asset allocation has enabled the Fund to perform in both exceptionally adverse and very positive markets, the Treasurer’s Office strongly believes the current asset allocation is appropriate going forward.

The Account return underperformed its benchmark in FY 2010, but this was true of all higher-quality investments during the “junk rally” (i.e., the recovery of prices of low-quality stocks and speculative-grade bonds due to the temporary improvement in economic outlook) from March 2009 through April 2010. In general, conservative fixed-income managers and value equity managers lagged their respective benchmarks during this period.

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. Of these managers, Hanson & Doremus has outperformed its benchmark in six out of the past ten fiscal years, and Prentiss Smith and Sentinel have each outperformed in seven of the past ten fiscal years.

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, outperformed in FY 2009, and lagged the benchmark in FY2010 but posted higher returns than Sentinel. As such, this investment is meeting its goals of capital preservation and investment return, along with providing benefits to Vermonters.

In conclusion, the Treasurer’s Office believes that the Fund’s asset allocation is appropriate to its goals of asset growth, capital preservation and supporting distributions, and that the investment managers have performed in a manner consistent with these goals. However, since future distributions depend upon Fund performance, substantial changes to the economic and financial outlook and may warrant asset allocation or manager changes in the future.

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

**APPENDIX A
HIGHER EDUCATION ENDOWMENT TRUST FUND - DISTRIBUTIONS
For Period Ending June 30, 2010**

| <u>Quarter-End Balances</u> | <u>Sep 30, 2009</u> | <u>Dec 31, 2009</u> | <u>Mar 31, 2010</u> | <u>Jun 30, 2010</u> |
|-----------------------------|---------------------|---------------------|---------------------|---------------------|
| Fiscal Year 2008 | \$17,827,605.83 | \$18,164,200.03 | \$18,010,390.14 | \$17,917,152.20 |
| Fiscal Year 2009 | \$16,966,384.87 | \$16,320,715.01 | \$16,315,441.73 | \$17,050,798.96 |
| Fiscal Year 2010 | \$18,084,136.99 | \$18,649,777.82 | \$19,114,425.82 | \$19,080,449.90 |

Twelve Quarter Average **\$17,791,789.94**

5% Distribution FY2010 **\$889,589.50**

| | |
|------------------------|--------------|
| VSAC | \$296,529.83 |
| UVM | \$296,529.83 |
| Vermont State Colleges | \$296,529.83 |

2% FY2009 (Projected) **\$349,070.43**

| | |
|------------------------|--------------|
| UVM | \$174,535.22 |
| Vermont State Colleges | \$174,535.22 |

2% FY2009 (Actual) **\$349,070.43**

| | |
|------------------------|--------------|
| UVM | \$174,535.22 |
| Vermont State Colleges | \$174,535.22 |

Balance after Distributions **\$17,841,789.97**

2% FY2010 (Projected) **\$355,835.80**

| | |
|------------------------|--------------|
| UVM | \$177,917.90 |
| Vermont State Colleges | \$177,917.90 |

Contributions

| | |
|------|----------------|
| 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 | \$57,208.65 |
| 2009 | \$0.00 |
| 2010 | \$1,620,927.67 |

Total: **\$17,500,823.36**

APPENDIX B
TRUST INVESTMENT ACCOUNT - TOTAL RETURN ANALYSIS¹
 Period Ending June 30, 2010

| <u>MANAGER</u> | Fiscal Year <u>2001</u> | Calendar Year <u>2001</u> | Fiscal Year <u>2002</u> | Calendar Year <u>2002</u> | Fiscal Year <u>2003</u> | Calendar Year <u>2003</u> | Fiscal Year <u>2004</u> | Calendar Year <u>2004</u> | Fiscal Year <u>2005</u> | Calendar Year <u>2005</u> |
|---|-------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------------|
| DOMESTIC EQUITY | | | | | | | | | | |
| Hanson & Doremus Investment Management | 29.41% | 17.41% | -7.78% | -18.01% | -1.89% | 42.55% | 29.10% | 15.92% | 22.25% | 19.18% |
| Prentiss Smith & Co. | 7.59% | 13.69% | 3.60% | -7.35% | 7.70% | 18.17% | 11.47% | 13.25% | 11.00% | 10.68% |
| <i>S&P 500</i> | <i>-13.56%</i> | <i>-11.89%</i> | <i>-17.99%</i> | <i>-22.11%</i> | <i>0.25%</i> | <i>28.69%</i> | <i>19.14%</i> | <i>10.90%</i> | <i>6.32%</i> | <i>4.91%</i> |
| DOMESTIC FIXED INCOME | | | | | | | | | | |
| Sentinel Asset Management, Inc. | 10.34% | 10.07% | 9.41% | 9.48% | 8.92% | 5.43% | 3.48% | 5.56% | 7.42% | 3.07% |
| RBC Global Asset Management (Access Capital) ² | | | | | | | | | | |
| <i>Barclays (formerly Lehman) Aggregate</i> | <i>10.23%</i> | <i>8.44%</i> | <i>8.63%</i> | <i>10.25%</i> | <i>10.40%</i> | <i>4.10%</i> | <i>0.32%</i> | <i>4.34%</i> | <i>6.80%</i> | <i>2.43%</i> |
| TOTAL FUND DOLLAR WEIGHTED RETURN | | | | | | | | | | |
| <i>Total Fund Target</i> | <i>11.27%</i> | <i>11.62%</i> | <i>7.94%</i> | <i>5.15%</i> | <i>8.59%</i> | <i>11.24%</i> | <i>7.59%</i> | <i>8.14%</i> | <i>10.17%</i> | <i>6.64%</i> |
| | <i>7.52%</i> | <i>6.57%</i> | <i>3.94%</i> | <i>3.29%</i> | <i>9.23%</i> | <i>9.94%</i> | <i>4.96%</i> | <i>6.23%</i> | <i>6.76%</i> | <i>3.27%</i> |
| TOTAL FUND MARKET VALUE (\$ million) | | | | | | | | | | |
| | \$26.5 | \$32.6 | \$33.3 | \$34.9 | \$37.3 | \$38.8 | \$39.3 | \$41.1 | \$43.5 | \$48.6 |

| <u>MANAGER</u> | Fiscal Year <u>2006</u> | Calendar Year <u>2006</u> | Fiscal Year <u>2007</u> | Calendar Year <u>2007</u> | Fiscal Year <u>2008</u> | Calendar Year <u>2008</u> | Fiscal Year <u>2009</u> | Calendar Year <u>2009</u> | Fiscal Year <u>2010</u> | |
|---|-------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|--|
| DOMESTIC EQUITY | | | | | | | | | | |
| Hanson & Doremus Investment Management | 21.10% | 20.28% | 29.13% | 14.32% | -14.64% | -38.44% | -28.04% | 22.93% | 10.42% | |
| Prentiss Smith & Co. | 15.77% | 16.61% | 20.09% | 10.85% | -4.96% | -23.98% | -9.34% | 35.30% | 12.30% | |
| <i>S&P 500</i> | <i>8.63%</i> | <i>15.80%</i> | <i>20.60%</i> | <i>5.50%</i> | <i>-13.13%</i> | <i>-37.00%</i> | <i>-26.21%</i> | <i>26.42%</i> | <i>14.43%</i> | |
| DOMESTIC FIXED INCOME | | | | | | | | | | |
| Sentinel Asset Management, Inc. | 0.26% | 5.31% | 6.12% | 7.61% | 9.10% | 7.81% | 8.77% | 5.03% | 7.80% | |
| RBC Global Asset Management (Access Capital) ² | | | | | | | | | | |
| <i>Barclays (formerly Lehman) Aggregate</i> | <i>-0.81%</i> | <i>4.33%</i> | <i>6.12%</i> | <i>6.96%</i> | <i>7.12%</i> | <i>5.24%</i> | <i>6.06%</i> | <i>5.94%</i> | <i>9.49%</i> | |
| TOTAL FUND DOLLAR WEIGHTED RETURN | | | | | | | | | | |
| <i>Total Fund Target</i> | <i>5.86%</i> | <i>9.48%</i> | <i>12.02%</i> | <i>9.47%</i> | <i>3.10%</i> | <i>-3.62%</i> | <i>2.40%</i> | <i>13.06%</i> | <i>9.82%</i> | |
| | <i>2.19%</i> | <i>7.96%</i> | <i>10.62%</i> | <i>6.80%</i> | <i>1.14%</i> | <i>-6.59%</i> | <i>-1.19%</i> | <i>13.18%</i> | <i>12.06%</i> | |
| TOTAL FUND MARKET VALUE (\$ million) | | | | | | | | | | |
| | \$49.7 | \$52.8 | \$55.5 | \$58.8 | \$59.3 | \$55.7 | \$59.2 | \$66.1 | \$60.6 | |

| <u>MANAGER</u> | Quarter Ended <u>9/30/2009</u> | Quarter Ended <u>12/31/2009</u> | Calendar Year <u>2009</u> | Quarter Ended <u>3/31/2010</u> | Quarter Ended <u>6/30/2010</u> | Fiscal Year <u>2010</u> | Portfolio Value <u>6/30/2010</u> | Portfolio Percent <u>6/30/2010</u> |
|---|--------------------------------------|---------------------------------------|---------------------------------|--------------------------------------|--------------------------------------|-------------------------------|--|--|
| DOMESTIC EQUITY | | | | | | | | |
| Hanson & Doremus Investment Management | 15.28% | 4.18% | 22.93% | 3.81% | -11.43% | 10.42% | \$7,686,864 | 12.7% |
| Prentiss Smith & Co. | 13.93% | 6.10% | 35.30% | 2.87% | -9.69% | 12.30% | \$8,519,767 | 14.1% |
| <i>S&P 500</i> | <i>15.60%</i> | <i>6.00%</i> | <i>26.42%</i> | <i>5.40%</i> | <i>-11.40%</i> | <i>14.43%</i> | | <i>26.8%</i> |
| DOMESTIC FIXED INCOME | | | | | | | | |
| Sentinel Asset Management, Inc. | 2.48% | -0.90% | 5.03% | 2.08% | 3.98% | 7.80% | \$41,356,202 | 68.3% |
| RBC Global Asset Management (Access Capital) ² | 3.15% | 0.83% | 9.76% | 1.65% | 2.79% | 8.67% | \$3,001,263 | 5.0% |
| <i>Barclays (formerly Lehman) Aggregate</i> | <i>3.74%</i> | <i>0.20%</i> | <i>5.94%</i> | <i>1.78%</i> | <i>3.49%</i> | <i>9.49%</i> | | <i>73.2%</i> |
| TOTAL FUND DOLLAR WEIGHTED RETURN | | | | | | | | |
| <i>Total Fund Target</i> | <i>6.22%</i> | <i>1.13%</i> | <i>13.06%</i> | <i>2.44%</i> | <i>-0.20%</i> | <i>9.82%</i> | | |
| | <i>7.52%</i> | <i>2.06%</i> | <i>13.18%</i> | <i>2.89%</i> | <i>-0.75%</i> | <i>12.06%</i> | | |
| TOTAL FUND MARKET VALUE (\$ million) | | | | | | | | |
| | \$62.8 | \$66.1 | \$66.1 | \$64.5 | \$60.6 | \$60.6 | \$60,564,096 | 100.0% |

Notes:

- Includes cash balances of: Hanson - \$100,595, Prentiss - \$192,870, Sentinel - \$1,953,270 as of June 30, 2010.
- Access Capital added to Trust Investment Account on October 12, 2007.

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

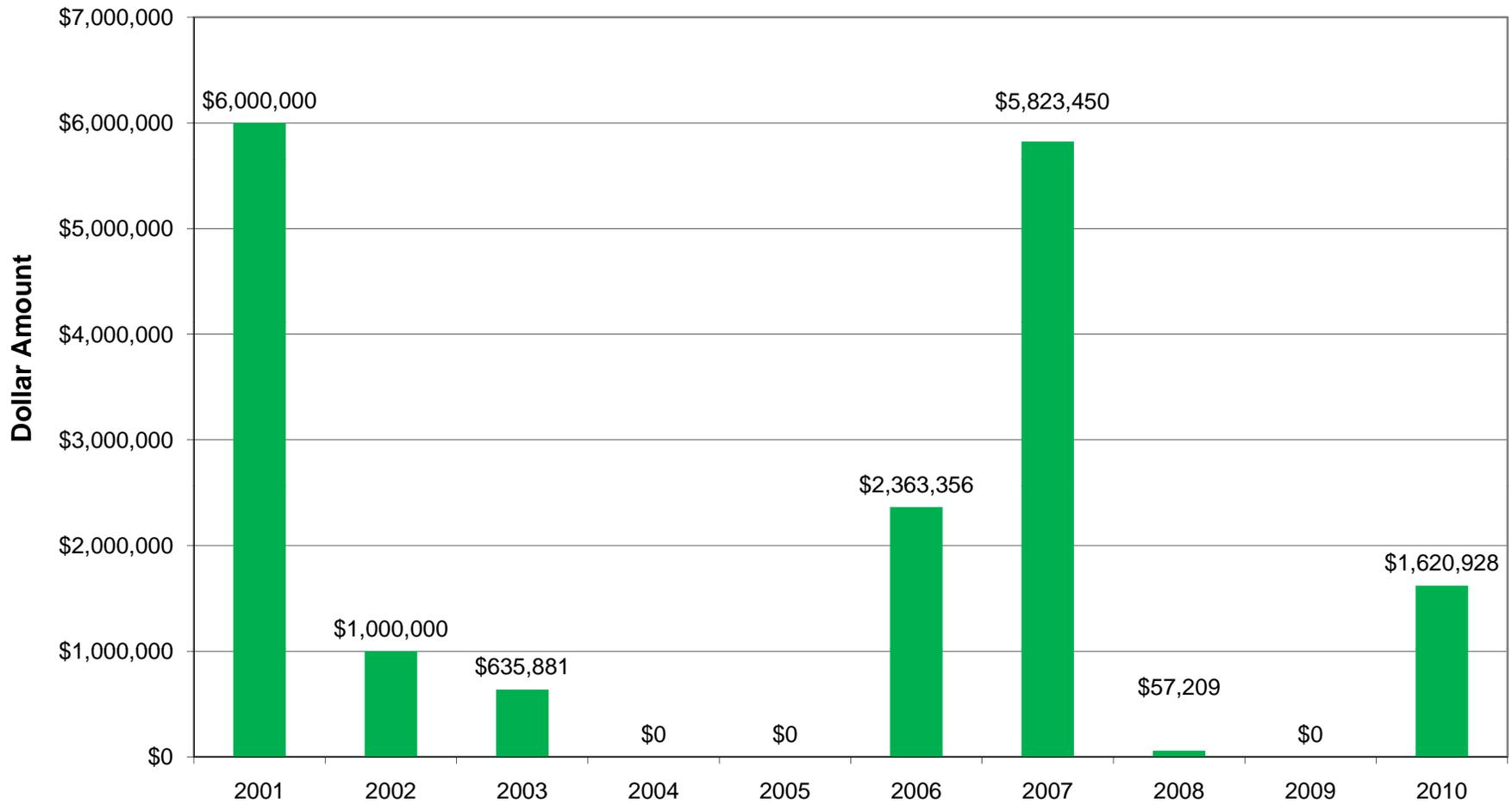


Chart #2
**Higher Education Endowment Trust Fund
 Authorized Distributions by Year and Type**

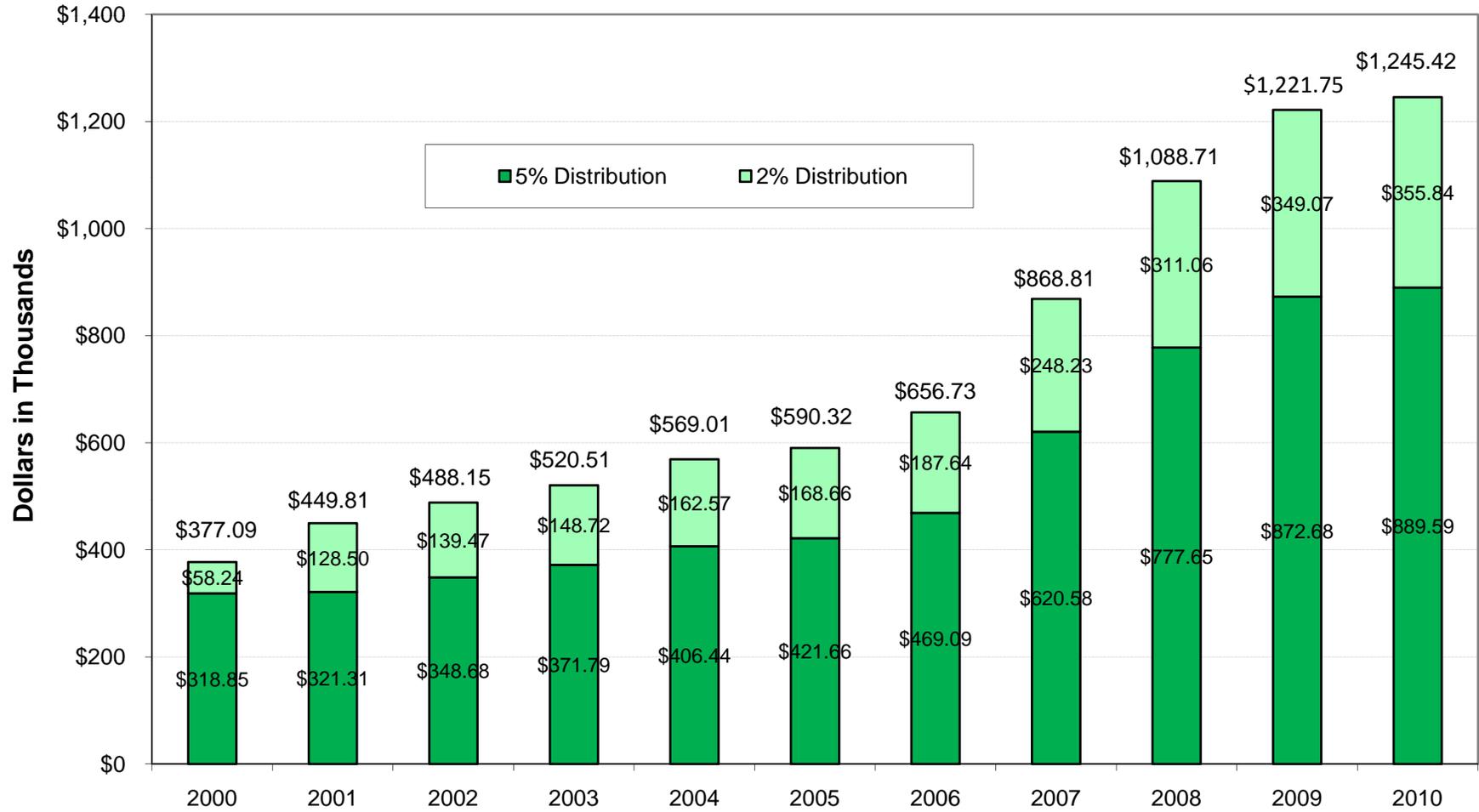


Chart #3
Trust Investment Account Fund Composition as of June 30, 2010

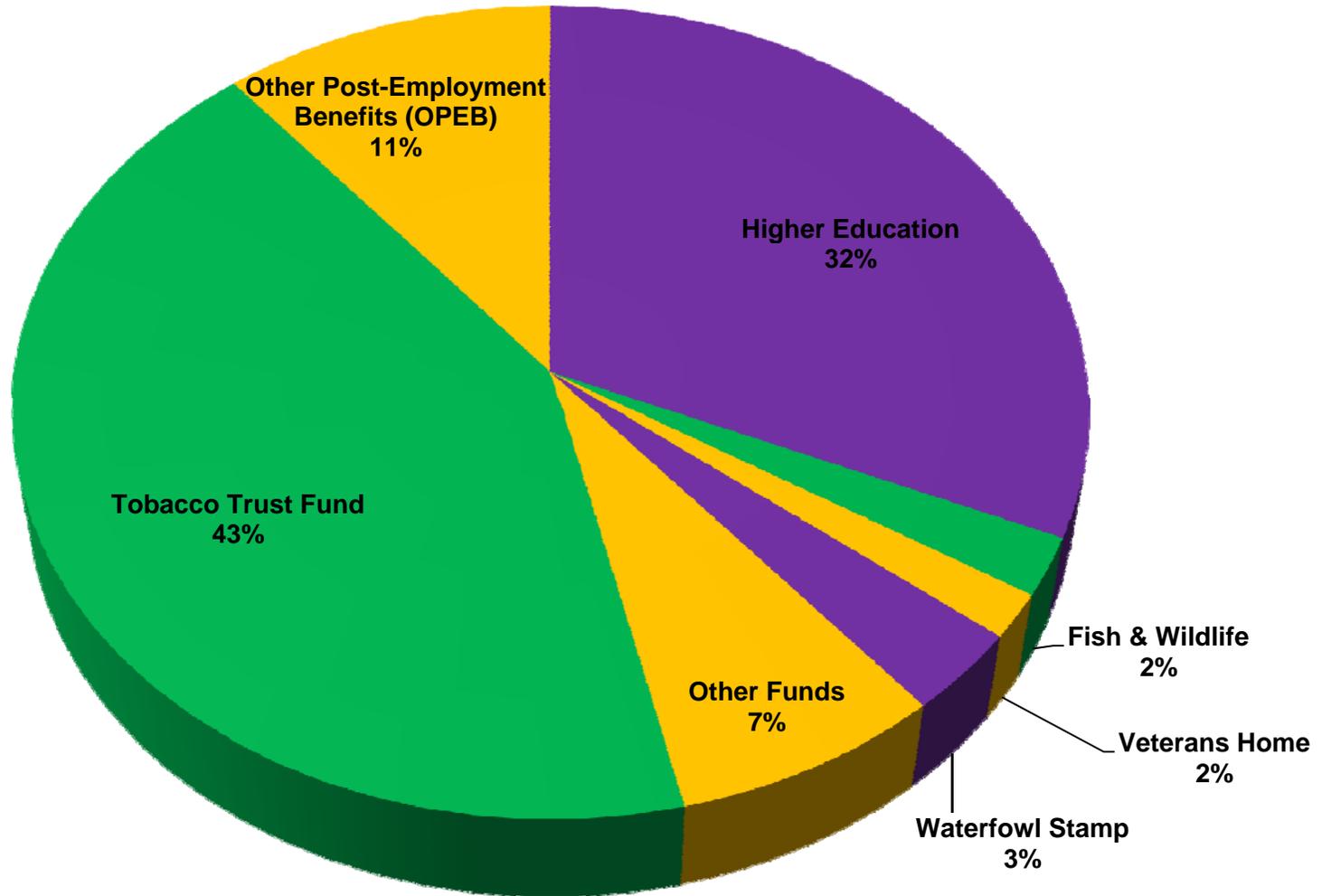


Chart #4
Higher Education Endowment Trust Fund
Asset Growth, 6/30/2000 to 6/30/2010
(Includes Distributions)

