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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, 2012

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 thirteenth 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 2012, the Fund's dollar weighted investment return was 4.10% gross of fees. This return compares to the Barclays Aggregate Bond Index return of 7.47% and to the S&P 500 Stock Index return of 5.45% 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 approximately 7.6%. It should be noted that the Fund has outperformed since its inception in 2000, returning 7.77% on an annualized basis against 6.30% for its benchmark. At the same time, the conservative positioning of the fund is consistent with the objective of providing a high likelihood of annual distributions from the Fund. While recent performance has not met expectations, the Fund has also outperformed its benchmark over the past seven and ten fiscal year periods. In the most recent fiscal year, underperformance relative to the target return can be attributed both to the lower performance of mortgage debt instruments as well as the overall weakness of equities in the early part of fiscal 2012. Going forward, the exposure to mortgage debt instruments would be expected to benefit from the recently announced efforts by the Federal Reserve (i.e. "QE3"). A detailed discussion of the Fund's performance is included in this report.

5% Distribution from Fiscal Year 2012

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, 2012 have been \$28,537,615.38.

The 5% distribution available this year is \$1,132,227.76 in total or \$377,409.25 each for UVM, the Vermont State Colleges, and VSAC. This amount represents a 24.1% increase over the distribution made following Fiscal Year 2011 of \$304,014.79 for each institution. **Appendix A** to this report includes quarterly market values and distributions for Fiscal Year 2012, and **Chart #1** shows principal contributions to date.

2% Distribution from Fiscal Year 2011

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 (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 \$364,817.75, or \$182,408.87 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 2012, the Fund will be able to make the full distribution amount.

After payments of \$1,132,227.76 and \$364,817.75, the Fund balance at the end of Fiscal Year 2012 totals \$28,998,181.71. An accounting of the Fund balances is provided below:

Ending balance prior FY 2011	\$19,739,011.70
Contributions received FY 2012	<u>11,036,791.72</u>
Opening balance FY 2012	\$30,739,011.70
5% Distributions :	
University of Vermont	(304,014.79)
Vermont State Colleges	(304,014.79)
Vermont Student Assistance Corp.	(304,014.79)
2% Distributions :	
University of Vermont	(177,917.90)

	Vermont State Colleges	(177,917.90)
	Income earned FY 2012	1,283,527.22
	Appreciation (Depreciation) FY 2012	(186,571.04)
	Fees and Other Charges FY 2012*	<u>(109,652.22)</u>
Balance June 30, 2012		\$30,495,227.22
	5% of 12-Quarter Moving Average as of June 30, 2012	(1,132,227.76)
Distributions :	University of Vermont	(377,409.25)
	Vermont State Colleges	(377,409.25)
	Vermont Student Assistance Corp.	(377,409.25)
	2% Income Available for Endowments from FY 2011	<u>(364,817.75)</u>
Balance after distributions		\$28,998,181.71
Total contributions as of June 30, 2012		\$28,537,615.38
	2% Income Available for Endowments from FY 2012 (requires institutional match in FY 2013)	\$452,891.10

2% Distribution for Fiscal Year 2012

All principal contributions to the Fund through June 30, 2012 total \$28,537,615.38, which also represents the minimum balance that must be maintained in the Fund. The 2% distribution proposed for this year of \$452,891.10 would leave a balance of \$28,545,290.61 excluding contributions to be received, the 5% distribution following FY 2013, and any gains from investment activity in FY 2013. If the Secretary and the Subcommittee authorize this distribution, each institution's share will be \$226,445.55 with a required match to be raised by each entity in FY 2013 of \$452,891.10. 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 2012. 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 FY2011 from a strong equity market and Estate Tax contributions in FY 2010 and FY2012.

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, 2012, the Account's actual allocation was 68.5% in fixed income securities and 31.5% in equities, versus 68.8% fixed income securities and 31.2% equities, respectively, on June 30, 2011. 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 has achieved sufficient returns to fully fund distributions in fiscal years 2010, 2011 and 2012. 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 and the asset allocation structure has enabled the Fund to perform in both adverse and positive markets, reinforcing the belief in the appropriateness of the allocations.

In FY 2012, the Account return underperformed its benchmark, due in part to conservative fixed income managers lagging their benchmark as well as to the equity markets being volatile during the year. The lag in the fixed income segment was due primarily to an underweight in Treasuries and Corporate credit compared to the benchmark, which outperformed mortgage-backed securities. The primary exposure of the Sentinel fund is mortgage-backed securities, which are expected to outperform in the upcoming year due to the Fed's QE3 program, but have lagged in the last year. Compared to a mortgage-backed index Sentinel outperformed by 4bps. Equity performance during the fiscal year was impacted primarily by underperformance stemming from investments in international stocks.

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 equity managers have outperformed their benchmark (gross of fees) for seven of the last twelve fiscal years. Sentinel has outperformed its benchmark (gross of fees) for eight of the last twelve 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 has lagged the benchmark in fiscal years 2010, 2011 and 2012 (but in those years has posted

returns equal to or higher than Sentinel). As such, this investment is meeting its goals of capital preservation and investment return, along with providing benefits to Vermonters.

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 have performed in a manner consistent with these goals, we believe a re-examination of the expected annual distribution rate may be appropriate. Expected returns over an intermediate term horizon for both equity and fixed-income classes have been reduced due to prospects for higher inflation, 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 would be 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.

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)

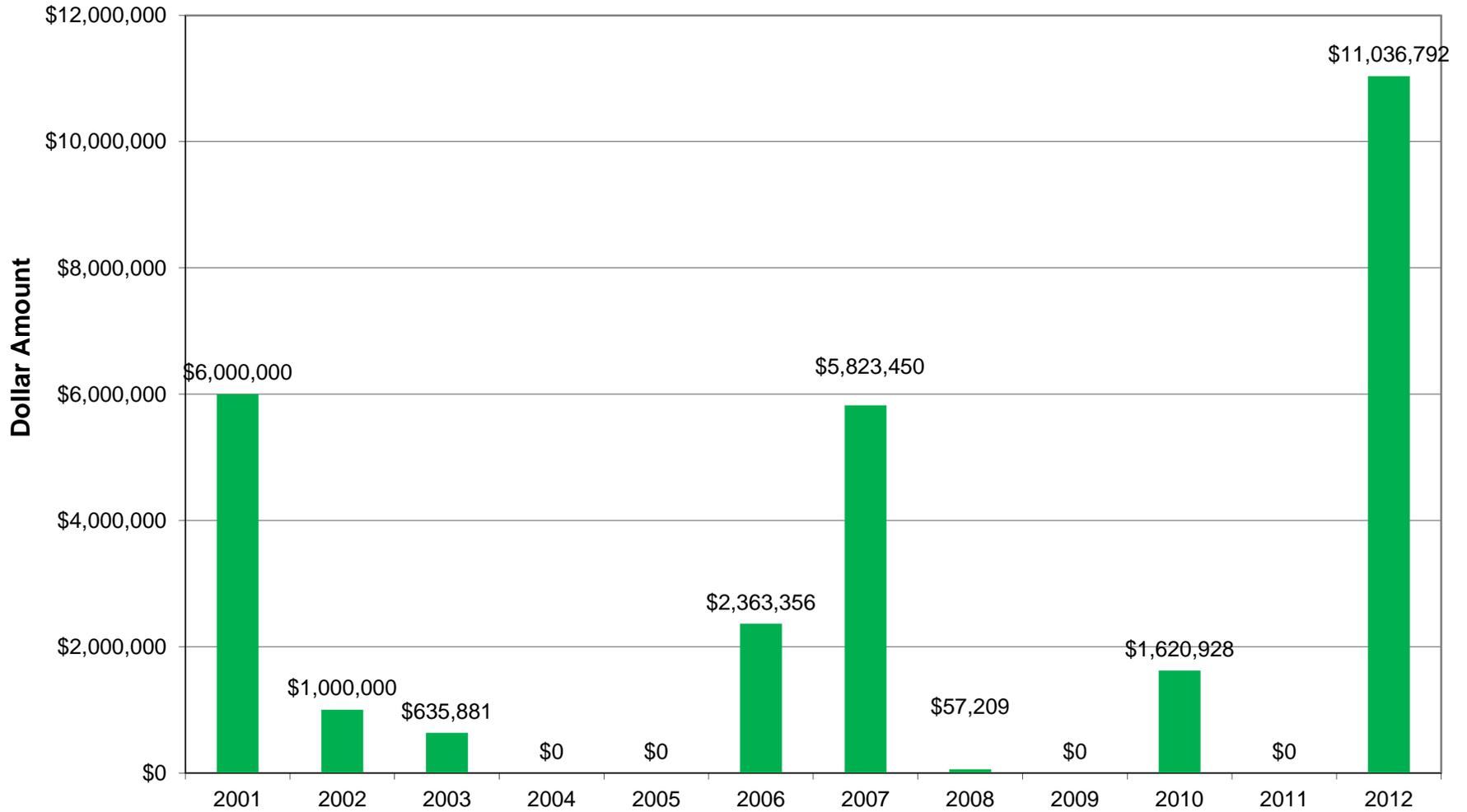
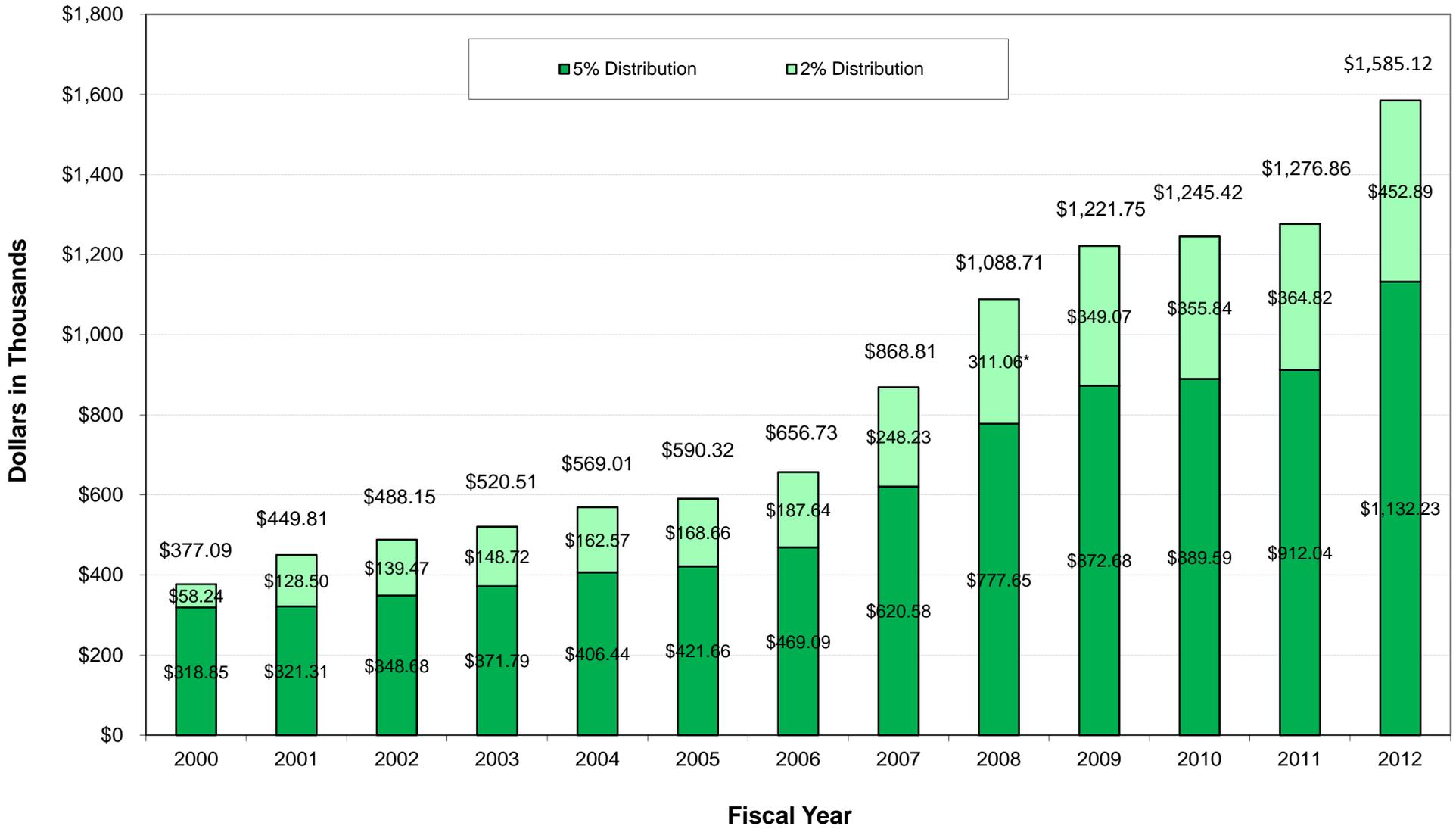


Chart #2
Higher Education Endowment Trust Fund
Authorized Distributions by Year and Type



* Actual 2% distribution for 2008 was \$298,227.18.

Chart #3
Trust Investment Account Fund Composition as of June 30, 2012

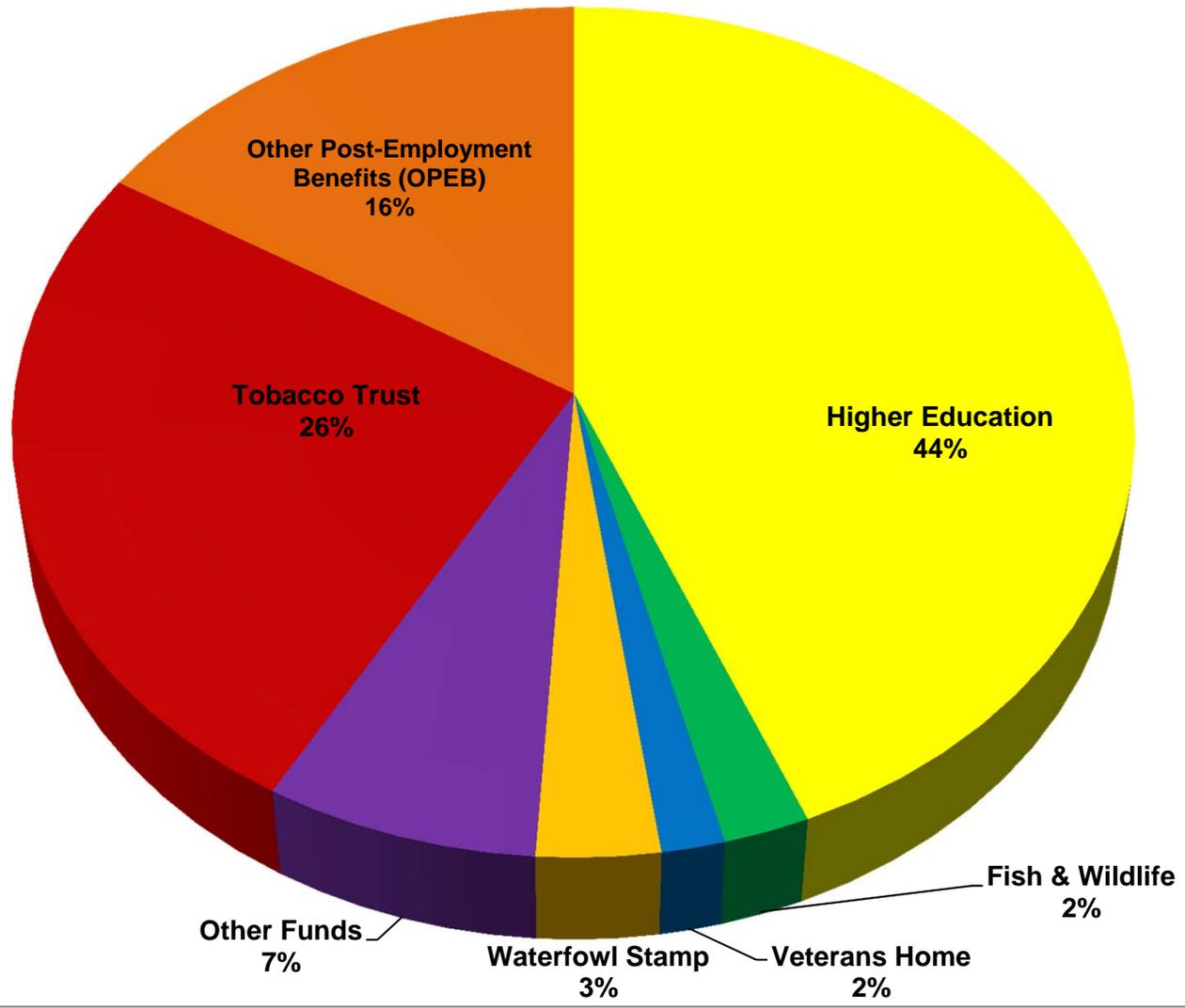
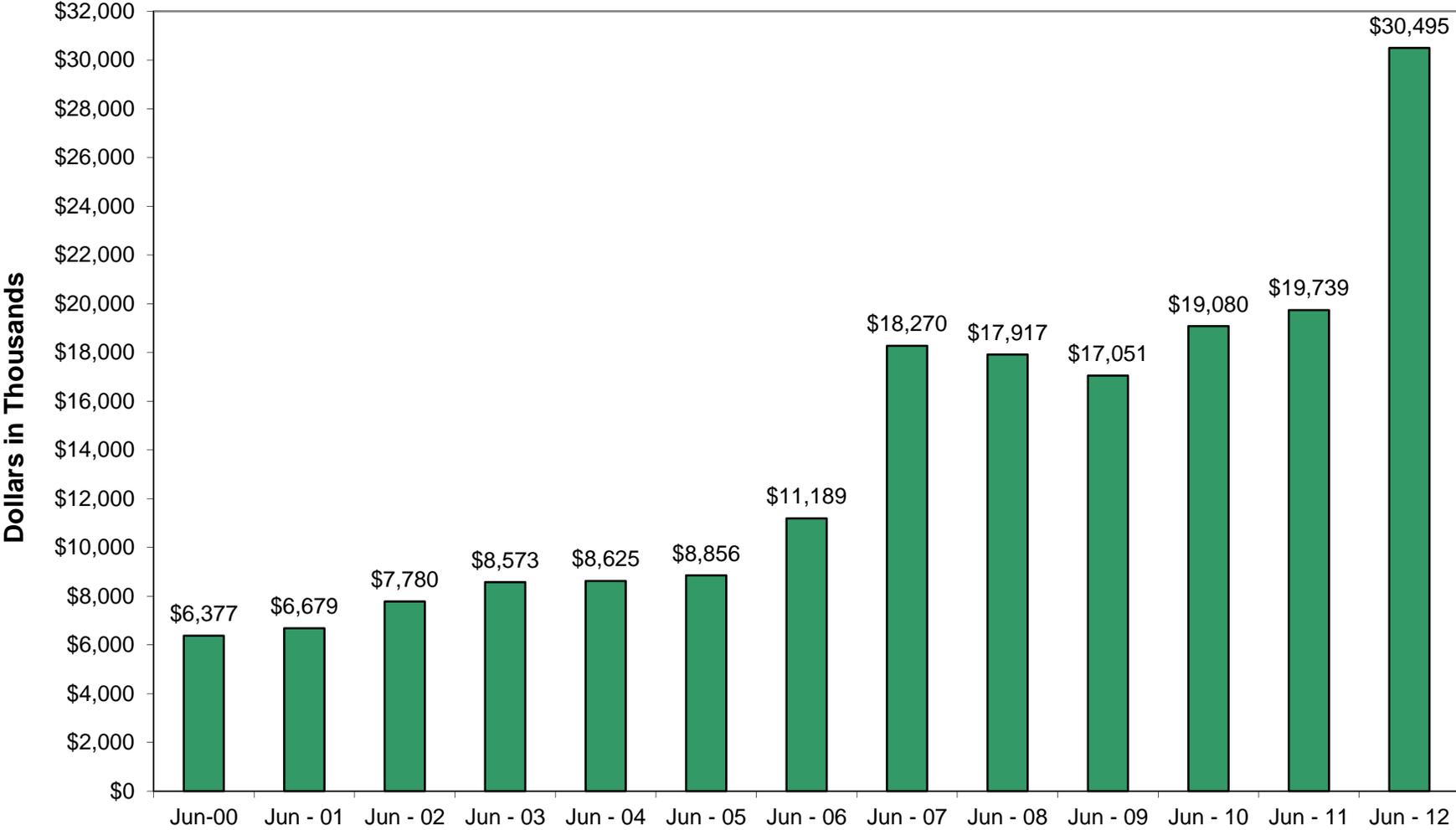


Chart #4
Higher Education Endowment Trust Fund
Asset Growth, 6/30/2000 to 6/30/2012
(Includes Distributions)



**APPENDIX A
HIGHER EDUCATION ENDOWMENT TRUST FUND - DISTRIBUTIONS
For Period Ending June 30, 2012**

<u>Quarter-End Balances</u>	<u>September 30</u>	<u>December 31</u>	<u>March 31</u>	<u>June 30</u>
Fiscal Year 2010	\$18,084,136.99	\$18,649,777.82	\$19,114,425.82	\$19,080,449.90
Fiscal Year 2011	\$19,046,186.38	\$19,080,907.03	\$19,442,411.23	\$19,739,011.70
Fiscal Year 2012	\$28,788,444.91	\$29,571,316.31	\$30,642,367.21	\$30,495,227.22
 <u>Twelve Quarter Average</u>	 \$22,644,555.21			
 <u>5% Distribution FY2011</u>	 \$1,132,227.76			 <u>Total Contributions</u>
VSAC		\$377,409.25		2001 \$6,000,000.00
UVM		\$377,409.25		2002 \$1,000,000.00
Vermont State Colleges		\$377,409.25		2003 \$635,881.49
				2004 \$0.00
 <u>2% FY2010 (Projected)</u>	 \$364,817.75			2005 \$0.00
UVM		\$182,408.87		2006 \$2,363,355.61
Vermont State Colleges		\$182,408.87		2007 \$5,823,449.94
				2008 \$57,208.95
 <u>2% FY2010 (Actual)</u>	 \$364,817.75			2009 \$0.00
UVM		\$182,408.87		2010 \$1,620,927.67
Vermont State Colleges		\$182,408.87		2011 \$0.00
				2012 <u>\$11,036,791.72</u>
				Total: \$28,537,615.38
 Balance after Distributions	 \$28,998,181.71			
 <u>2% FY2012 (Projected)</u>	 \$452,891.10			
UVM		\$226,445.55		
Vermont State Colleges		\$226,445.55		

APPENDIX B
TRUST INVESTMENT ACCOUNT - TOTAL RETURN ANALYSIS¹
 Period Ending June 30, 2012

<u>MANAGER</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>	Fiscal Year <u>2006</u>	Calendar Year <u>2006</u>	Fiscal Year <u>2007</u>	Calendar Year <u>2007</u>
DOMESTIC EQUITY										
Hanson & Doremus Investment Management	-1.89%	42.55%	29.10%	15.92%	22.25%	19.18%	21.10%	20.28%	29.13%	14.32%
Prentiss Smith & Co.	7.70%	18.17%	11.47%	13.25%	11.00%	10.68%	15.77%	16.61%	20.09%	10.85%
S&P 500	0.25%	28.69%	19.14%	10.90%	6.32%	4.91%	8.63%	15.80%	20.60%	5.50%
DOMESTIC FIXED INCOME										
Sentinel Asset Management, Inc.	8.92%	5.43%	3.48%	5.56%	7.42%	3.07%	0.26%	5.31%	6.12%	7.61%
RBC Global Asset Management (Access Capital) ²										2.83%
Barclays (formerly Lehman) Aggregate	10.40%	4.10%	0.32%	4.34%	6.80%	2.43%	-0.81%	4.33%	6.12%	6.96%
TOTAL FUND DOLLAR WEIGHTED RETURN										
	8.59%	11.24%	7.59%	8.14%	10.17%	6.64%	5.86%	9.48%	12.02%	9.47%
Total Fund Target	9.23%	9.94%	4.96%	6.23%	6.76%	3.27%	2.19%	7.96%	10.62%	6.80%
TOTAL FUND MARKET VALUE (\$ million)										
	\$37.3	\$38.8	\$39.3	\$41.1	\$43.5	\$48.6	\$49.7	\$52.8	\$55.5	\$58.8

<u>MANAGER</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>	Calendar Year <u>2010</u>	Fiscal Year <u>2011</u>	Calendar Year <u>2011</u>	Fiscal Year <u>2012</u>	Calendar Year <u>2012</u>
DOMESTIC EQUITY										
Hanson & Doremus Investment Management	-14.64%	-38.44%	-28.04%	22.93%	10.42%	18.90%	32.15%	-6.02%	-0.85%	
Prentiss Smith & Co.	-4.96%	-23.98%	-9.34%	35.30%	12.30%	11.04%	26.57%	1.73%	-0.05%	
S&P 500	-13.13%	-37.00%	-26.21%	26.42%	14.43%	15.16%	30.73%	2.09%	5.45%	
DOMESTIC FIXED INCOME										
Sentinel Asset Management, Inc.	9.10%	7.81%	8.77%	5.03%	7.95%	6.67%	3.27%	6.26%	5.31%	
RBC Global Asset Management (Access Capital) ²	3.52%	3.71%	8.72%	9.76%	8.67%	5.40%	3.80%	5.84%	5.31%	
Barclays (formerly Lehman) Aggregate	7.12%	5.24%	6.06%	5.94%	9.49%	6.54%	3.90%	7.84%	7.47%	
TOTAL FUND DOLLAR WEIGHTED RETURN										
	3.10%	-3.62%	2.40%	13.06%	9.93%	9.76%	10.79%	4.04%	4.10%	
Total Fund Target	1.14%	-6.59%	-1.19%	13.18%	12.06%	9.88%	11.68%	6.67%	7.65%	
TOTAL FUND MARKET VALUE (\$ million)										
	\$59.3	\$55.7	\$59.2	\$66.1	\$60.6	\$61.2	\$64.0	\$67.2	\$69.7	

<u>MANAGER</u>	Quarter Ended <u>9/30/2011</u>	Quarter Ended <u>12/31/2011</u>	Calendar Year <u>2011</u>	Quarter Ended <u>3/31/2012</u>	Quarter Ended <u>6/30/2012</u>	Fiscal Year <u>2012</u>	Portfolio Value <u>6/30/2012</u>	Portfolio Percent <u>6/30/2012</u>
DOMESTIC EQUITY								
Hanson & Doremus Investment Management	-14.82%	7.97%	-6.02%	12.75%	-4.38%	-0.85%	\$11,011,081	15.8%
Prentiss Smith & Co.	-10.94%	7.87%	1.73%	8.22%	-3.86%	-0.05%	\$10,930,225	15.7%
S&P 500	-13.87%	11.82%	2.09%	12.59%	-2.75%	5.45%		31.5%
DOMESTIC FIXED INCOME								
Sentinel Asset Management, Inc.	2.44%	0.80%	6.26%	0.49%	1.49%	5.31%	\$44,541,679	63.9%
RBC Global Asset Management (Access Capital) ²	1.81%	1.03%	5.84%	1.15%	1.22%	5.31%	\$3,234,388	4.6%
Barclays (formerly Lehman) Aggregate	3.82%	1.12%	7.84%	0.30%	2.06%	7.47%		68.5%
TOTAL FUND DOLLAR WEIGHTED RETURN								
	-2.16%	2.94%	4.04%	3.70%	-0.32%	4.10%		
Total Fund Target	-1.48%	4.31%	6.67%	4.21%	0.52%	7.65%		
TOTAL FUND MARKET VALUE (\$ million)								
	\$64.8	\$67.2	\$67.2	\$70.0	\$69.7	\$69.7	\$69,717,372	100.0%

Notes:

1. Includes cash balances of: Hanson - \$452K, Prentiss - \$1.09M as of June 30, 2012.
2. Access Capital added to Trust Investment Account on October 12, 2007.

**APPENDIX C
TRUST INVESTMENT ACCOUNT PERFORMANCE ¹**

<u>MANAGER</u>	<u>Fiscal Year 2012</u>	<u>Calendar Year 2011</u>	<u>Last 3 Fiscal Years</u>	<u>Last 5 Fiscal Years</u>	<u>Last 7 Fiscal Years</u>	<u>Last 10 Fiscal Years</u>	<u>Since Inception in FY2000</u>
DOMESTIC EQUITY							
Hanson & Doremus Investment Management	-0.85%	-6.02%	13.10%	-2.33%	4.81%	7.96%	8.18%
Prentiss Smith & Co.	-0.05%	1.73%	12.42%	4.13%	7.89%	8.53%	8.03%
<i>S&P 500</i>	5.45%	2.09%	16.41%	0.22%	4.10%	5.34%	1.48%
DOMESTIC FIXED INCOME							
Sentinel Asset Management, Inc.	5.31%	6.26%	5.49%	6.86%	5.78%	6.02%	6.66%
RBC Global Asset Management ²	5.31%	5.84%	5.91%	5.98%	N/A	N/A	N/A
<i>Barclays (formerly Lehman) Aggregate</i>	7.47%	7.84%	6.93%	6.79%	5.58%	5.63%	6.25%
TOTAL FUND DOLLAR WEIGHTED RETURN	4.10%	4.04%	8.23%	6.01%	6.82%	7.41%	7.77%
<i>Total Fund Target</i>	7.65%	6.67%	10.45%	6.13%	6.19%	6.42%	6.30%
TOTAL FUND MARKET VALUE (\$ millions)	\$69.7	\$67.2					

Notes:

1. Returns for periods longer than one year are annualized.
2. Formerly Access Capital Management, inception date of September 17, 2007.