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: Susanne Young, 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: August 30, 2017

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 eighteenth annual report on the Higher Education Endowment Trust Fund ("the 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 2017, the Fund's investment return was 6.7% net of fees. Note that as of December 2013, the investments are comprised of index fund positions because of a Fund restructuring. The result of the restructuring has been an annual fee reduction of 33 basis points (0.38% to 0.05%) and a more diversified asset allocation that includes corporate bonds and global equities.

5% Distribution based on Fiscal Year 2017 Balances

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); however, the amount distributed cannot exceed an amount that would bring the Fund balance below total contributions to principal. If the later condition cannot be met, the distribution must be reduced accordingly. Total principal contributions through June 30, 2017 have been $29,109,166. The 5% distribution available this year is $1,502,187 in total or $500,728.96 each for UVM, the Vermont State Colleges, and VSAC. **Appendix A** to this report includes quarterly market values and distributions for fiscal year 2017, and **Chart #1** shows principal contributions to date.

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2% Distribution based on Fiscal Year 2016 balances

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 distributed cannot exceed an amount that would bring the Fund balance below total contributions to principal. Further, each institution is required to match the distribution by raising private donations of at least twice the distributed amount, to certify to the Commissioner of Finance and Management ("the 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, 2016 meeting, the Secretary and the Subcommittee decided to forgo this 2% distribution to UVM and the Vermont State Colleges, based upon recognition that lower expected returns in the near term did not support a total distribution of 7% from the Fund. The 2% distribution has been reinvested in the fund to bolster the balance available for future distributions.

Fund Balances

After payments of $1,502,187, the Fund balance at the end of fiscal year 2017 totals $29,639,716. An accounting of the Fund balance is provided below:

Ending balance FY 2016			**$30,192,009**
	FY 2016 Contributions received in FY 2017		$50,288
Opening balance FY 2017			**$30,242,297**
	Actual Distributions FY2016		
	5%:	***University of Vermont***	-$384,432
		Vermont State Colleges	-$384,432
		Vermont Student Assistance Corp.	-$384,432
	2%:	***University of Vermont***	$0
		Vermont State Colleges	$0
	Income earned FY 2017		$822,068
	Appreciation (Depreciation) FY 2017		$1,234,539
	Fees and Other Charges FY 2017		-$3,703
Principal Balance June 30, 2017 [3]			**$31,141,903**
	Statutory Distributions Available [1]		
	5% of 12-Quarter Moving Average as of June 30, 2017		($1,502,187)
	2% of 12-Quarter Moving Average as of June 30, 2017		($602,127)
	Total Projected Statutory Distribution		($2,104,314)
	Balance After Projected Statutory Distribution		$29,037,589
	Total Contributions Received as of June 30, 2017		$29,109,166
	Principal Balance Shortfall After Projected Statutory Distribution		($71,577)
	Adjustments to Distributions Due to Shortfall		
		5% Distribution Adjusted 0.00%	($1,502,187)
		2% Distribution Adjusted -11.89%	($530,550)
	Total Available Distribution Adjusted to Maintain the Principal Balance Floor as Required by Statute		**($2,032,737)**
	Actual Distributions for FY2017		
		5% Distribution	**($1,502,187)**
		2% Distribution [2]	$0
	Total Actual Distribution		**($1,502,187)**
Principal Balance after distributions			**$29,639,716**
	Fundraising target for potential 2% distribution in next FY 2018 *(contingent on an institutional match in FY 2018 and Principal Balance greater than total Contributions)*		$600,875

[1] *Assuming statutory levels (5% distribution & 2% distribution) without regard to statutory requirement to keep balance at or above the total principal contributions.*

[2] *Committee elected to forego the 2% distribution for the fiscal year.*

[3] *Numbers may not add due to rounding.*

<u>2% Distribution based on Fiscal Year 2017 balances to be voted on for FY 2018 fundraising</u>

All principal contributions to the Fund through June 30, 2017 total $29,109,168, which also represents the minimum balance that must be maintained in the Fund. The 2% distribution proposed as a fundraising target for FY 2018 is $600,875. 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 returns were sufficient to make the funds available and if the Secretary and the Subcommittee authorize this distribution, each institution's share would be $300,437 with a required match to be raised by each entity in FY 2018 of $600,875. To re-emphasize, any distribution a year from now is dependent upon the Fund's balance being greater than $29,109,168 after the distributions have been made. 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.

<u>Fund Distributions</u>

Appendix B to this report shows the total return of the entire Trust Investment Account ("Account"), of which the Higher Education Endowment Trust Fund, with a balance of $31.1 million comprises approximately 48%. The State Employees' Other Post-Employment Benefits fund comprises 32% of the account, or $20.7 million, and the remaining is made up of the ANR Stewardship fund, the Tobacco trust fund, Fish and Wildlife trust funds, Veterans' Home trust funds, and other small trusts. **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 2017. In examining the intermediate term period there is a tale of two halves. Fiscal years 2009-2011 were marked by large contributions and strong performance, which easily allowed for the 5% distribution to the systems. The years that followed, fiscal years 2012-2017, have experienced lessened returns due to global central banks' policies that have diminished overall returns across all asset classes. As a result, the three-year annualized return during this period has dipped below the necessary 5% for a full distribution to the systems. The Treasurer's office anticipates returns will remain muted in the coming years due to central banks continuing their policies of keeping interest rates low to stimulate economic activity globally.

<u>Asset Allocation, Investment Managers and Performance</u>

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, 2017, the Account's actual allocation was in line with this target. This asset allocation represents the third year of performance with the new asset allocation, which no longer utilizes active management. This change was made to take advantage of a broader range of asset classes at a reduced fee. 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 33 basis points to 5 basis points as a result of portfolio restructuring undertaken in 2015 by the Treasurer's office. The policy benchmark is 60% Bloomberg Aggregate Bond Index/40% S&P 500.

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 fund required distributions. 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, the outlook for lower returns across all asset classes over the intermediate term horizon required the Treasurer's Office to re-evaluate its approach in fiscal year 2014. The Fund was transitioned away from four active managers and into two index funds, and the equity allocation was increased and diversified from 30% in domestic equity to 40% in global equity. Market performance since FY 2015 is reflective of the diminished return environment markets are experiencing due to global central banks' policies, which the Treasurer's office anticipates will continue for the intermediate term. **Appendix B** presents a review of performance during the past fiscal year.

Fiscal 2017 was a year marked by equity outperformance and an aggressive Federal Reserve position, whereby the fund's exposure to global equities added 7.00% to the fund's return and the fixed income exposure detracted -0.27%. As expected over the long run, the detraction in FY 2016 by the international equity allocation reversed course in FY 2017 and contributed 2.53% to the overall annual return. This diversifying position is expected to help reduce the overall volatility in the fund's equity allocation in the long run. The domestic equity position added 3.63% to the overall return, as investor confidence improved with corporate earnings and was further buoyed by hopes of tax reform and deregulation in the coming years. Bonds, which were a significant driver of return in FY 2016, were a modest detractor to the fund performance this year with a negative contribution of -0.27%. The bond position is entirely domestic and faced headwinds with the three federal funds rate increases from 0.50% to 1.25% in 0.25% increments that took place in December 2016, March 2017 and June 2017. The rate hikes indicate that the Federal Reserve believes that the labor market and possibly inflation are heating up, while the US economy is strong enough to withstand these increases. The federal funds rate has been held low to stimulate the economy after the Great Recession of 2008. This was the fourth rate hike since December 2008. As expressed in prior years, Staff believes that interest rate hikes would need to be much larger and sharper than expected for the exposure to a broad fixed income index to suffer substantial losses. Geopolitical uncertainty and softness in a variety of global macroeconomic factors suggest that Central Banks worldwide are inclined to be cautious when increasing interest rates going forward.

Fund Management Philosophy

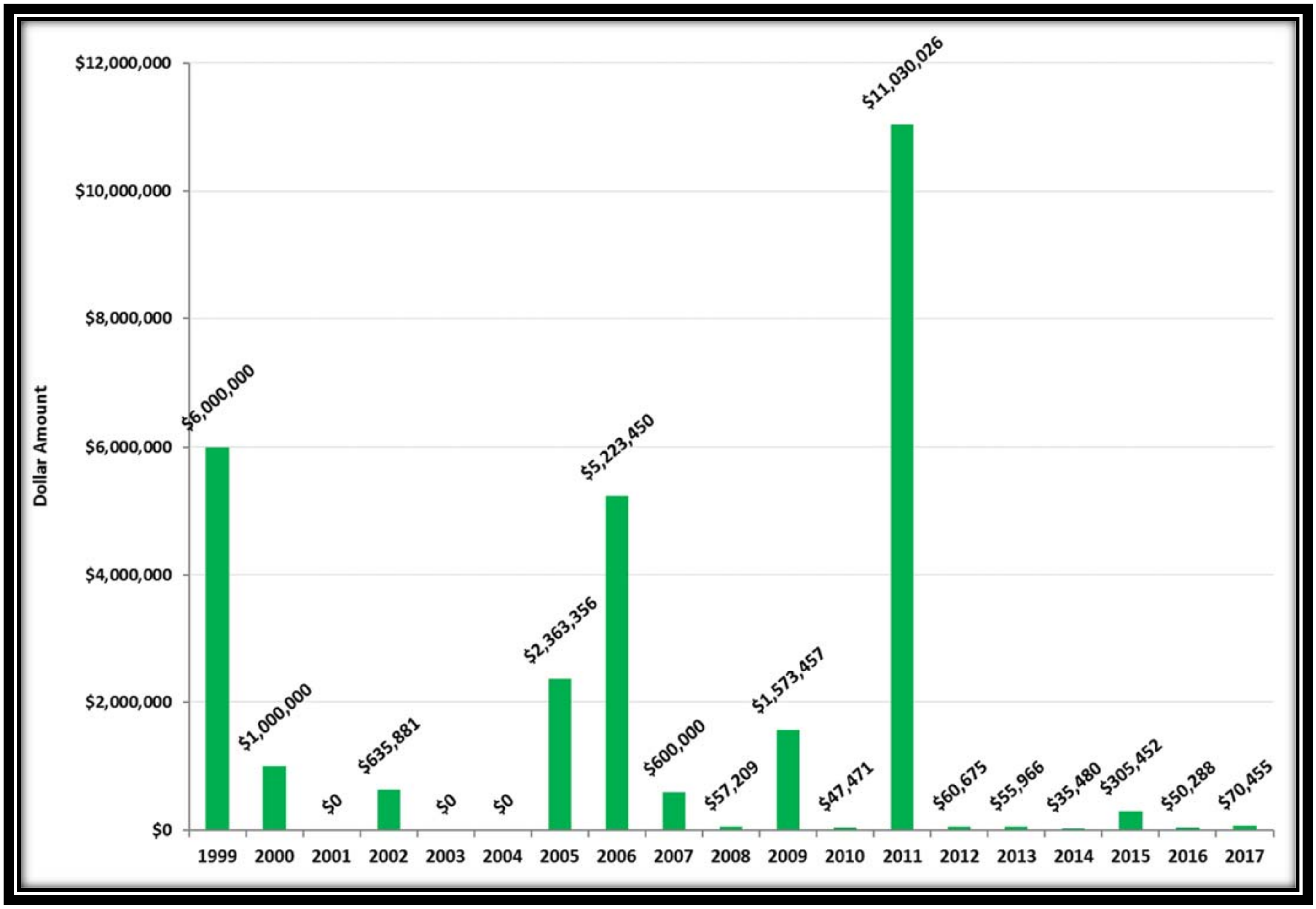
Staff believes that a dependence upon manager performance relative to benchmarks, or alpha, is counterproductive, especially for relatively established asset classes. We believe that administrative effort is better spent analyzing optimal portfolio allocations using total return, standard deviation, 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. This will allow the Treasurer's Office Staff the opportunity to diversify the Fund by evaluating additional asset classes and to structure the portfolio in a manner best suited to meet the Fund's risk and return objectives.

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

cc: Adam Greshin, Commissioner of Finance & Management
Luke Martland, Director & Chief Legislative Counsel
Rebecca Wasserman, Legislative Counsel

Chart #1

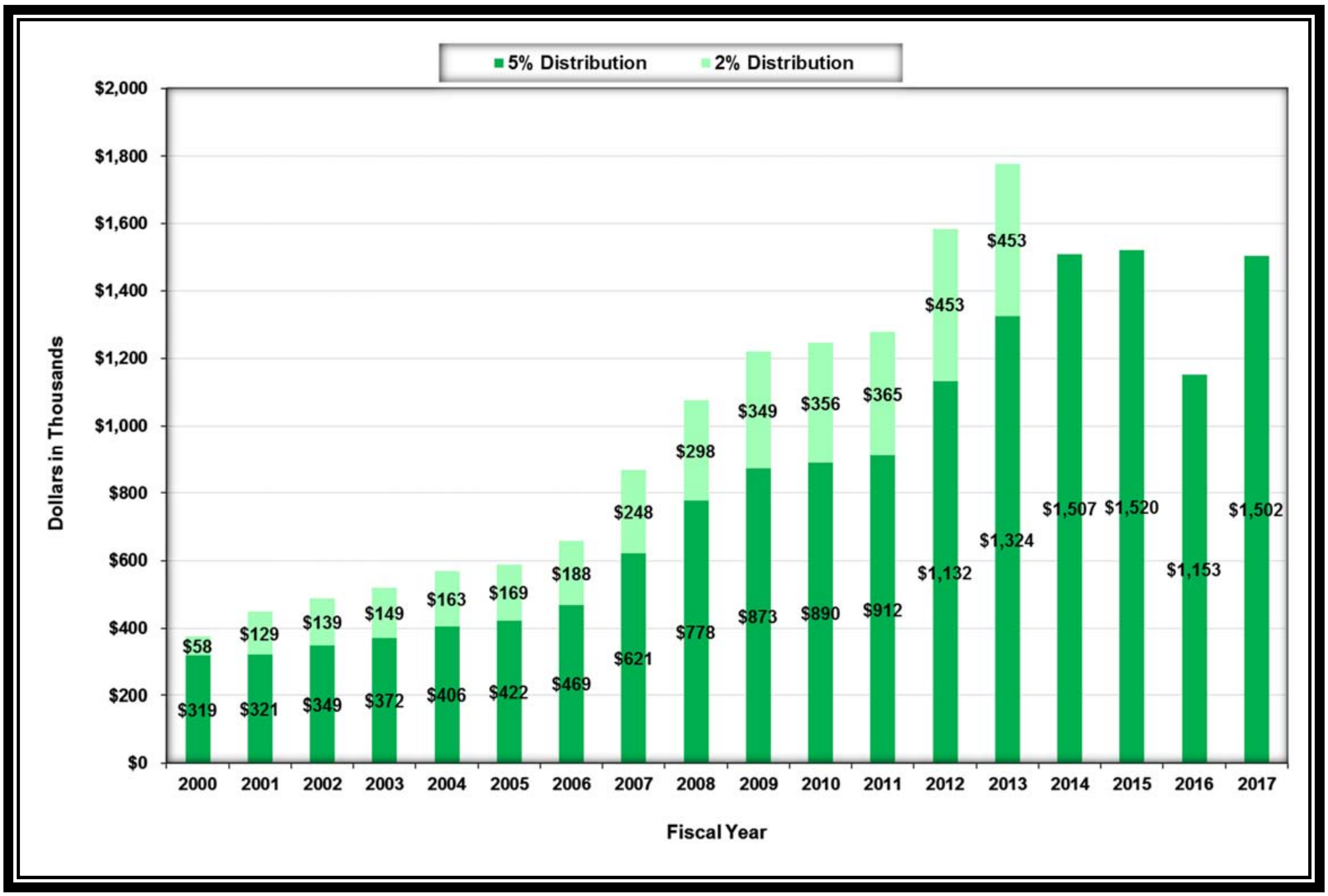
Higher Education Endowment Trust Fund
Fund Contributions (fiscal years) *



* Amounts from prior year reports have been realigned by fiscal year on an accrual basis to correspond to fund operating results and may vary from cash transaction dates in previous reports.

Chart #2

Higher Education Endowment Trust Fund
Authorized Distributions by Year and Type



[1] In 2008, the 2% distribution was reduced by $12,737 to the amount listed to maintain the principal balance above the total contributions.

[2] Due to the expected low market return environment, in years 2014 – 2017 the Sub-Committee chose to withhold the 2% distribution and instead reinvest the funds into the principal balance to maintain a more consistent 5% distribution in the future.

Chart #3

Trust Investment Account Fund Compositions
As of June 30, 2017

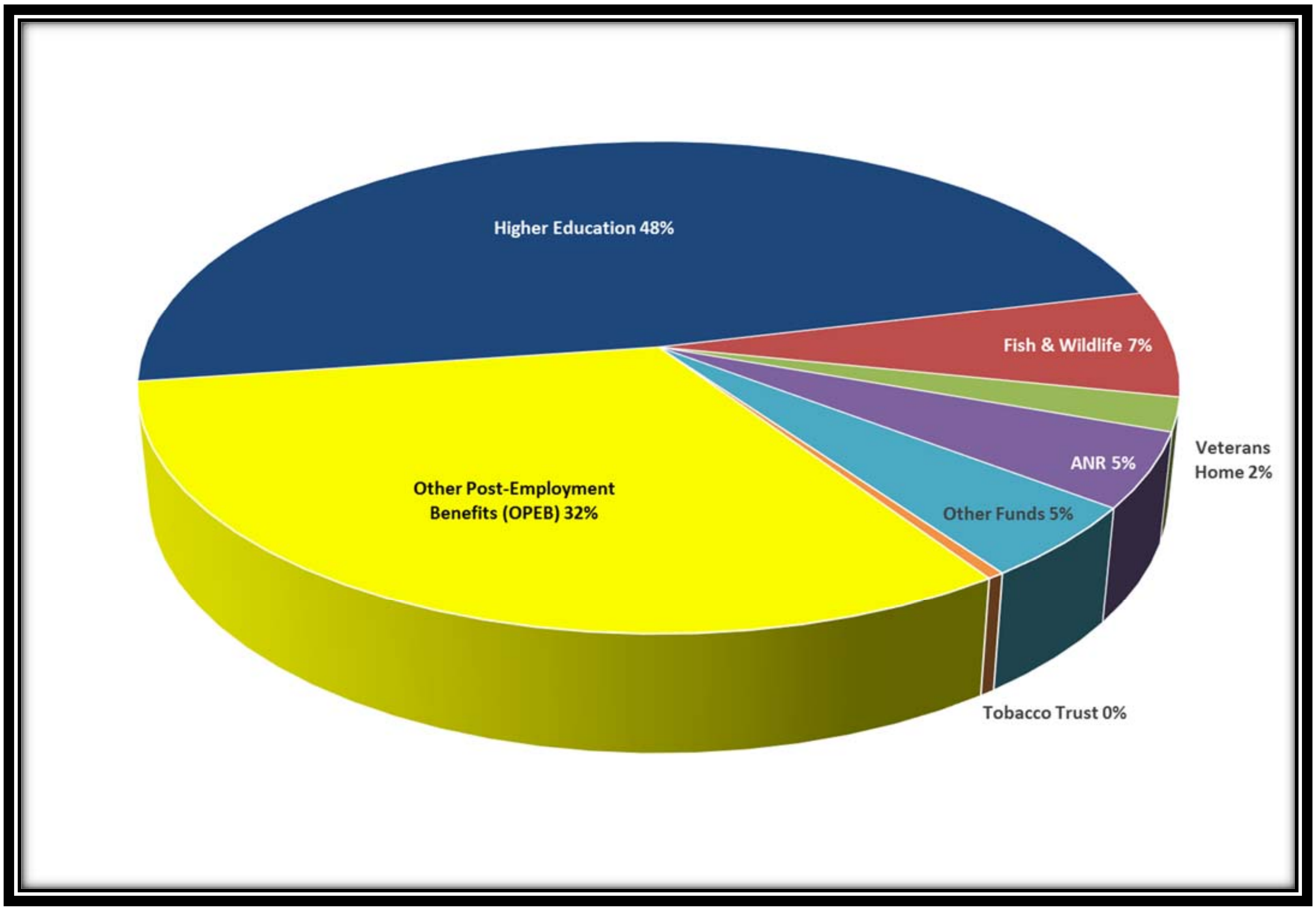
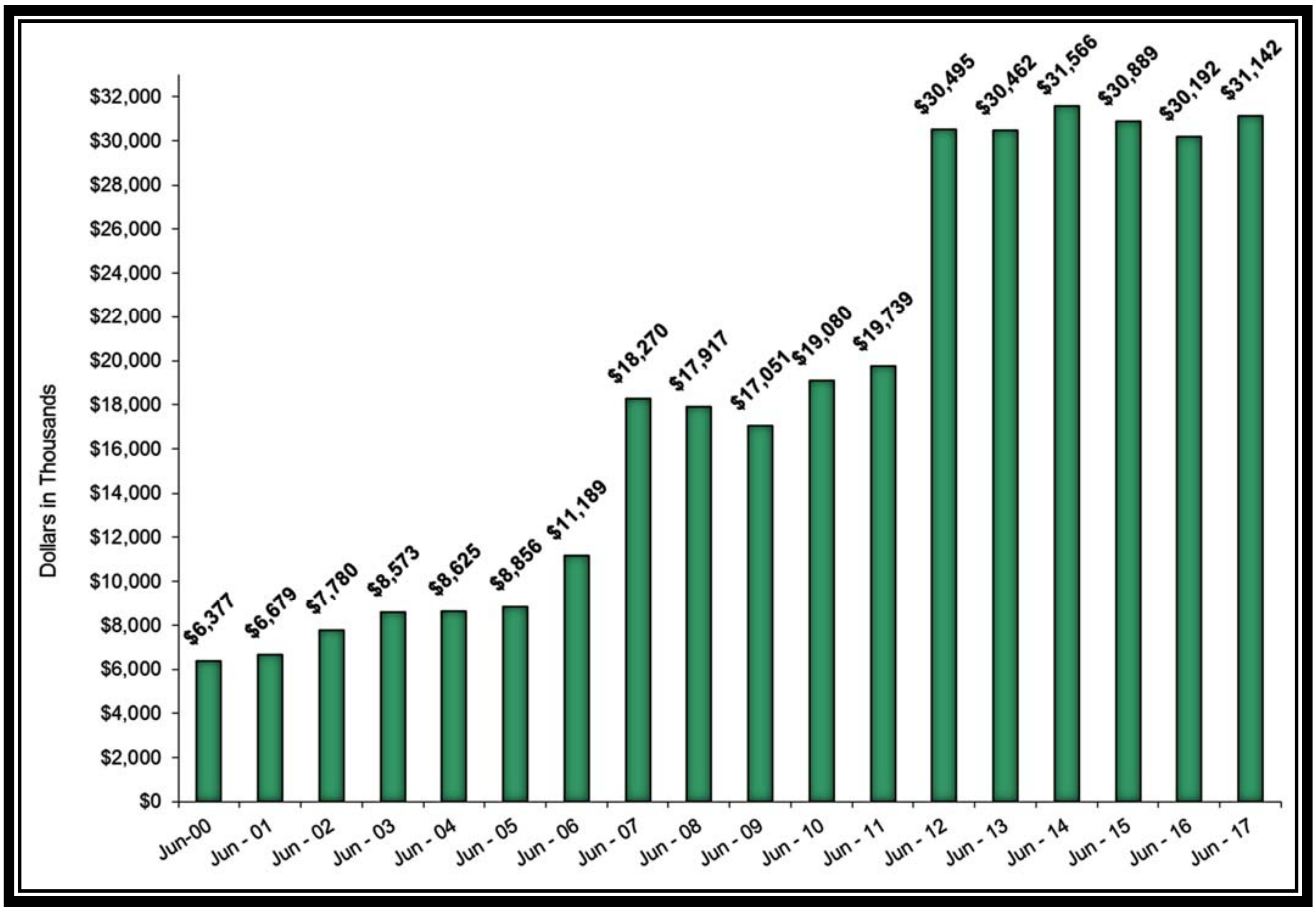


Chart #4

Higher Education Endowment Trust Fund Asset Level
6/30/2000 to 6/30/2017
(Includes Distributions)



APPENDIX B

Higher Education Trust Fund	Portfolio Value	Portfolio Allocation	QTD	1 Year	3 Year	5 Year	7 Year	10 Year	Fiscal Year End Returns 2016	2015	2014	2013	2012
Fund Return	31,141,905		2.7%	6.7%	3.9%	5.3%	5.8%	5.5%	2.5%	2.4%	9.9%	5.3%	3.6%
Vanguard Institutional Index Fund (VINIX)	*6,677,803*	*21%*	*3.1%*	*17.9%*	*9.6%*	*14.6%*	*15.4%*	*7.2%*	*4.0%*	*7.4%*	*24.5%*	*20.6%*	*5.4%*
Vanguard Developed Markets Index Fund (VTMNX)	*4,951,360*	*16%*	*6.4%*	*18.0%*	*2.5%*	*9.6%*	*8.7%*	*1.6%*	*-8.5%*	*-0.2%*	*23.5%*	*18.5%*	*-13.8%*
Vanguard Emerging Markets Stock Index Fund (VEMAX)	*1,570,249*	*5%*	*3.5%*	*18.9%*	*0.6%*	*3.4%*	*3.6%*	*1.6%*	*-12.1%*	*-2.4%*	*14.1%*	*1.5%*	*-15.8%*
Vanguard Total Bond Market Index Fund (VBTIX)	*17,941,454*	*58%*	*1.5%*	*-0.4%*	*2.4%*	*2.1%*	*3.1%*	*4.5%*	*6.1%*	*1.7%*	*4.3%*	*-0.9%*	*7.7%*

** As of 06/30/2017*