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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:	September 7, 2018

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 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 2018, the Fund's investment return was 4.1% net of fees. In reviewing historical data, please 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 2018 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. Principal contributions through June 30, 2018 totaled \$29,181,264. The total 5% distribution available this year is \$1,506,799 or \$502,266 each for UVM, the Vermont State Colleges, and VSAC. **Appendix A** to this report includes quarterly market values and distributions for fiscal year 2018, and **Chart #1** shows principal contributions to date.

2% Distribution based on Fiscal Year 2018 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 27, 2017 meeting, the Secretary and the Subcommittee decided to forgo this 2% distribution for FY 2019 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. Our current projections are that the full 2% distribution for receipt in FY 2020 is not likely to be available.

Fund Balances

After payments of $ 1,506,799, the Fund balance at the end of fiscal year 2018 totals $29,430,748. An accounting of the Fund balance is provided below:

Ending balance FY 2017			**$31,141,905**
	FY 2017 Contributions received in FY 2018		$70,455
Opening balance FY 2018			**$31,212,360**
	Distributions FY2017		
	5%:	***University of Vermont***	($500,729)
		Vermont State Colleges	($500,729)
		Vermont Student Assistance Corp.	($500,729)
	2%:	***University of Vermont***	$0
		Vermont State Colleges	$0
	Income earned FY 2018		$917,647
	Appreciation (Depreciation) FY 2018		$313,583
	Fees and Other Charges FY 2018		($3,856)
Principal Balance June 30, 2018 [3]			**$30,937,547**
	Statutory Distributions Available [1]		
	5% of 12-Quarter Moving Average as of June 30, 2018		($1,506,799)
	2% of 12-Quarter Moving Average as of June 30, 2018		($600,875)
	Total Projected Statutory Distribution		**($2,107,674)**
	Balance After Projected Statutory Distribution		$28,829,873
	Total Contributions Received as of June 30, 2018		$29,181,264
	Principal Balance Shortfall After Projected Statutory Distribution		($351,391)
	Adjustments to Distributions Due to Shortfall		
		5% Distribution Adjusted (0.00%)	($1,506,799)
		2% Distribution Adjusted (-58.48%) [2]	($249,484)
	Total Available Distribution Adjusted to Maintain the Principal Balance Floor as Required by Statute		**($1,756,283)**
	Actual Distributions for 2018		
		5% Distribution	**$1,506,799**
		2% Distribution [2]	$0
			$1,506,799
Principal Balance after distributions			**$29,430,748**
	Fundraising target for potential 2% distribution in 2020 *(Contingent on an institutional match in FY 2019 and Principal Balance greater than the total Contributions)*		$602,720

[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*

2% Distribution based on Fiscal Year 2018 balances to be voted on for FY 2019 fundraising

All principal contributions to the Fund through June 30, 2018 total $ $29,181,264, which also represents the minimum balance that must be maintained in the Fund. The 2% distribution proposed as a fundraising target for FY 2019 is $602,720. 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 $301,360 with a required match to be raised by each entity in FY 2019 of $602,720. To re-emphasize, any distribution a year from now is dependent upon the Fund's balance being greater than $29,181,264 after the distributions have been made. The attached **Chart #2** provides a graphical depiction of authorized distributions.

Fund Distributions

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 $30.9 million comprises approximately 47%. The State Employees' Other Post-Employment Benefits fund comprises 33% of the account, or $21.5 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 2018. 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 2012-2018, have experienced compressed returns due to global central banks' policies that have diminished overall return potential 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 expects over the short-term to see fixed income returns move closer to historical averages prior to the financial crisis in 2008, as the Fed continues to raise interest rates on a cautious and calculated basis. In the transitionary years, we expect returns to continue to be muted. This is with the assumption that there is not a market dislocation that causes the Fed to return to a policy of quantitative easing. The Treasurer's office continues to assess the asset allocation prudently over time and in the near term it is anticipated that the allocation will remain unchanged.

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 Market Equities (5%). As of June 30, 2018, the Account's actual allocation was in line with this target. This asset allocation represents the fourth 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 Bond Market Index (VBTIX), creating exposures to three equity asset classes and a broad range of fixed income securities. Annual fees were reduced by 33 basis points (bps) to 5 bps because of portfolio restructuring undertaken in 2014 by the Treasurer's office. The policy benchmark is 60% Bloomberg Aggregate Bond Index/40% S&P 500 Index.

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 adequate returns to fund required distributions. The Treasurer's Office has been mindful of the need to balance the allocation's equity and fixed-income assets given the Fund's expectation for annual distributions 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 in FY 2014 for lower returns across all asset classes over the intermediate term (5-7 years) required the Treasurer's Office to re-evaluate its approach. The Fund was transitioned away from four active managers and into 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 as noted above the Treasurer's office anticipates will continue over the short-term. **Appendix B** presents a review of performance during the past fiscal year.

Fiscal 2018 was a year marked by equity outperformance and a policy of slow and steady federal funds rate increases by the Federal Reserve. The Fund's exposure to global equities added approximately 10.8% to the total return. As expected over the long run, the detraction in FY 2016 by the international equity exposure reversed course in FY 2017 and continued in FY 2018 with a positive return of 7.1%. 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 14.3% to the overall return, as corporate earnings and economic growth outpaced investor expectations.

Fixed income securities, which were a significant driver of return in FY 2016, were a modest detractor in FY 2017 and again in FY 2018 to the Fund's performance with a negative contribution of -0.5% this year. These securities lower the Fund's risk profile given their historically low correlation to equity markets and low standard deviation relative to other asset classes. The fixed income allocation in the Fund is entirely domestic and over the last two fiscal years has faced headwinds with the Federal Reserve continuing their slow and steady federal funds rate increases. This year the federal funds rate increased from 1.25% to 2.00% in 0.25% increments that took place in December 2017, March 2018 and June 2018. The decision in June 2018 marked the seventh rate hike since they began in December 2015. The rate hikes indicate that the Federal Reserve believes that the labor market is on solid footing, inflation is not heating up, and the US economy is strong enough to withstand these rate increases. Prior to December 2015, the federal funds rate had been held low at 0.25% to stimulate the economy and inject easily available liquidity into the market after the Great Recession of 2008. As expressed in prior years, unexpected interest rate hikes that are larger and sharper than expected would need to occur for the exposure to a broad fixed income index to suffer substantial losses from a decision related to the federal funds rate. 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 in the coming years.

Fund Management Philosophy

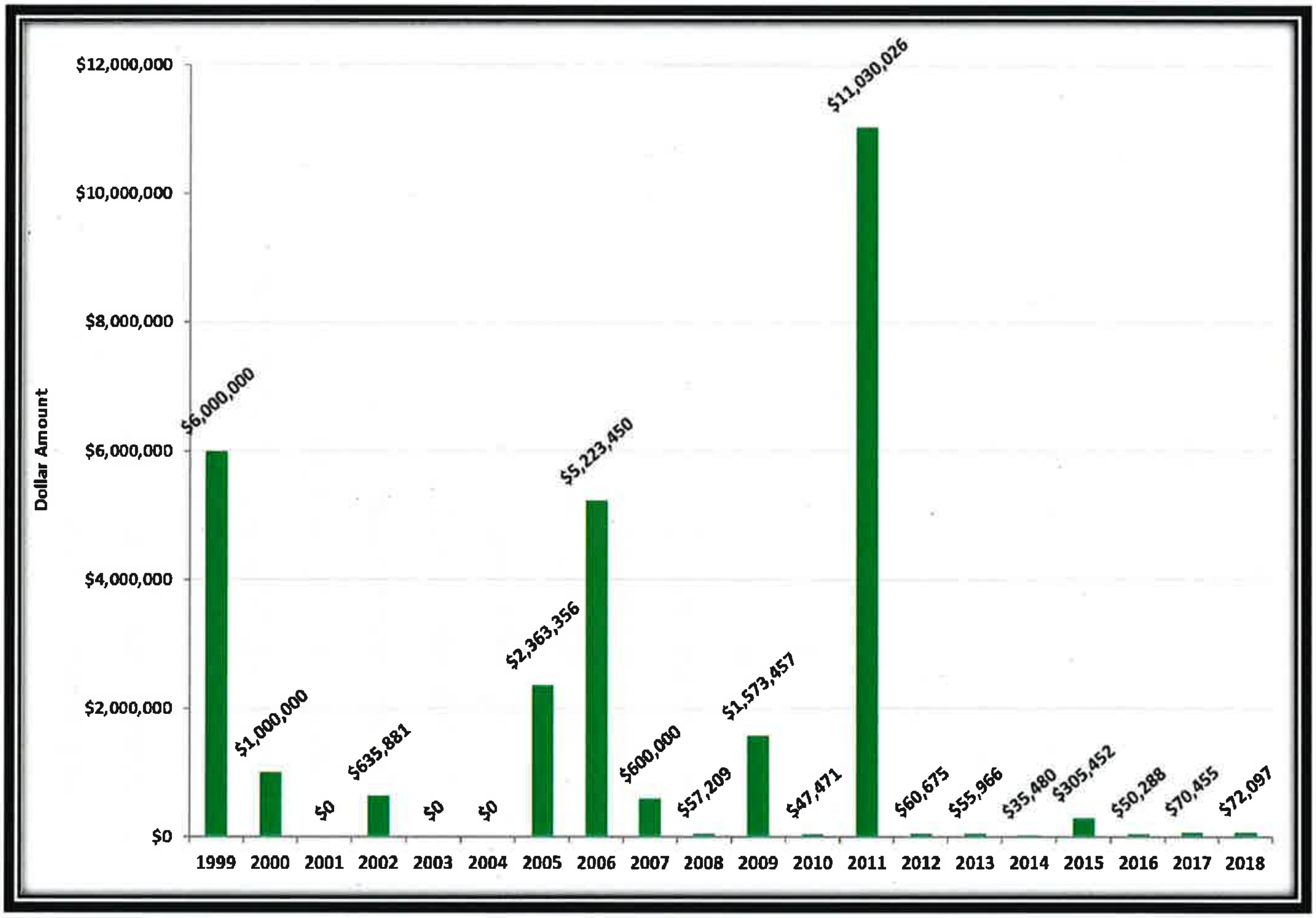
The Treasurer's office Staff believes that a dependence upon manager performance relative to benchmarks, or alpha, is counterproductive, especially for relatively established asset classes. We believe that administrative effort is better spent analyzing optimal portfolio allocations using total return, 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 using low-fee, highly liquid indexing vehicles. This will allow the Treasurer's Office 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

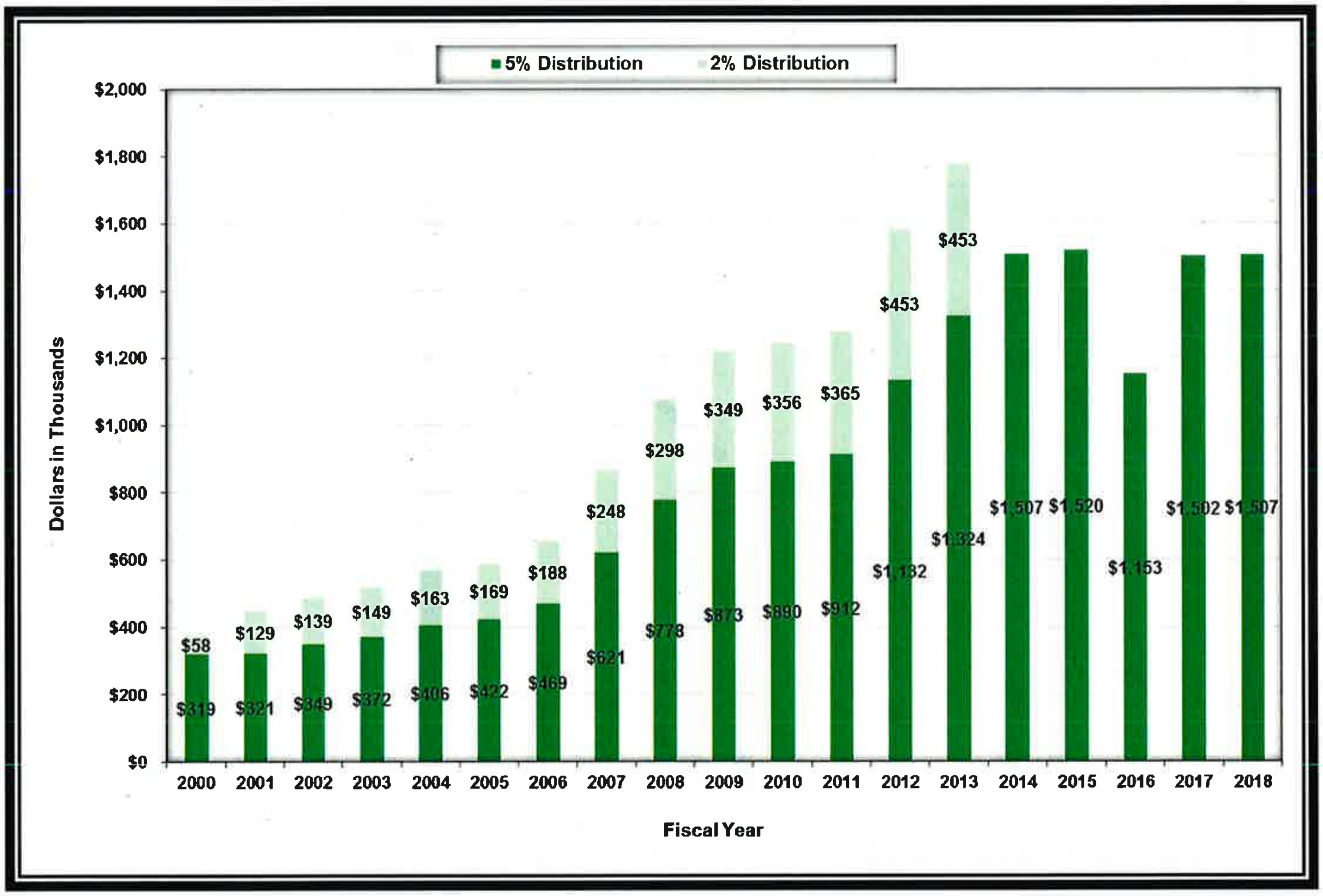
Higher Education Endowment Trust Fund
Fund Contributions (fiscal years) *



* 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

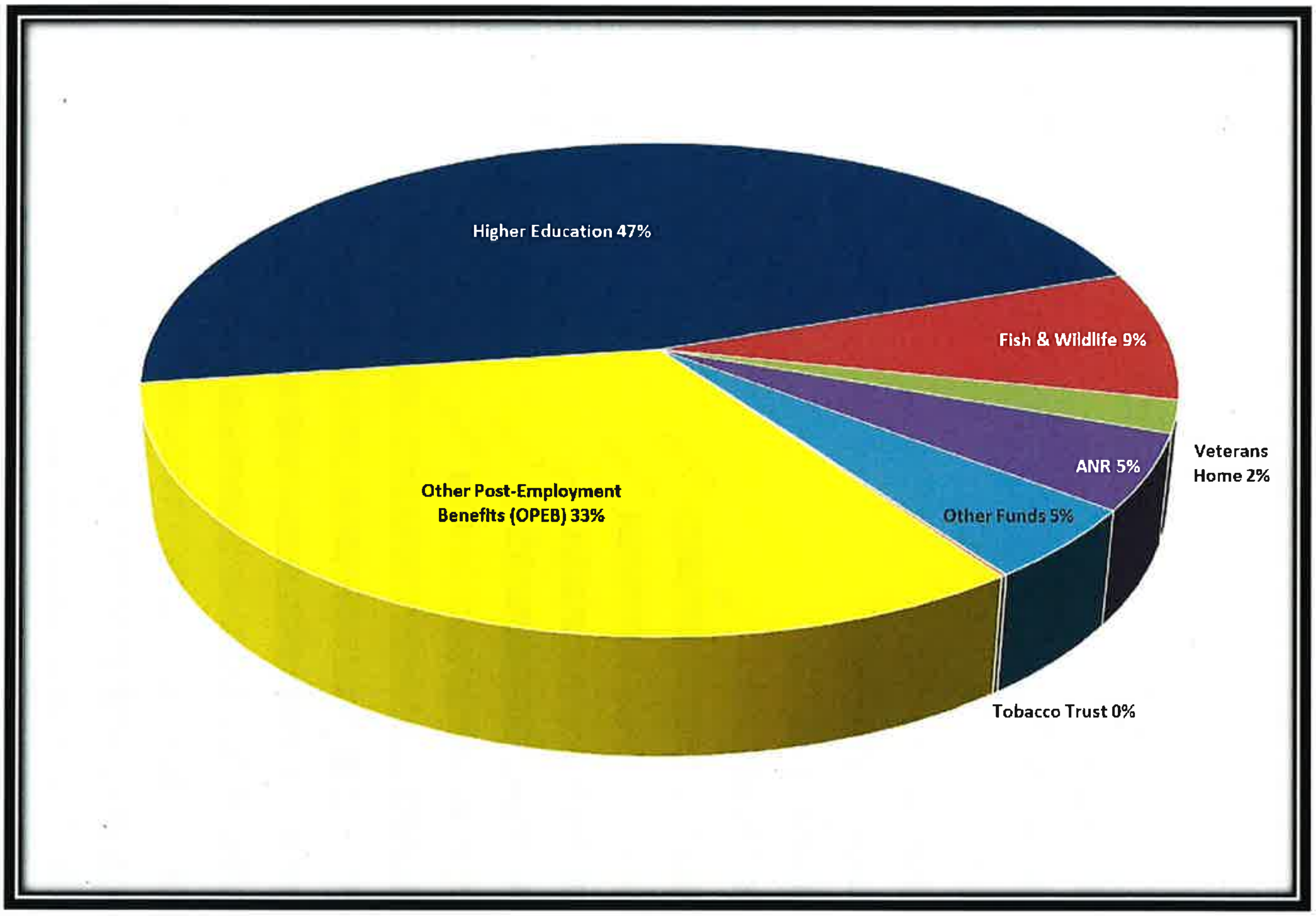


[1] In 2008, the 2% distribution was reduced by $12,737 to the amount listed to maintain the principal balance above the total contributions.

[2] Due to the expected low market return environment, in years 2014 – 2018 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

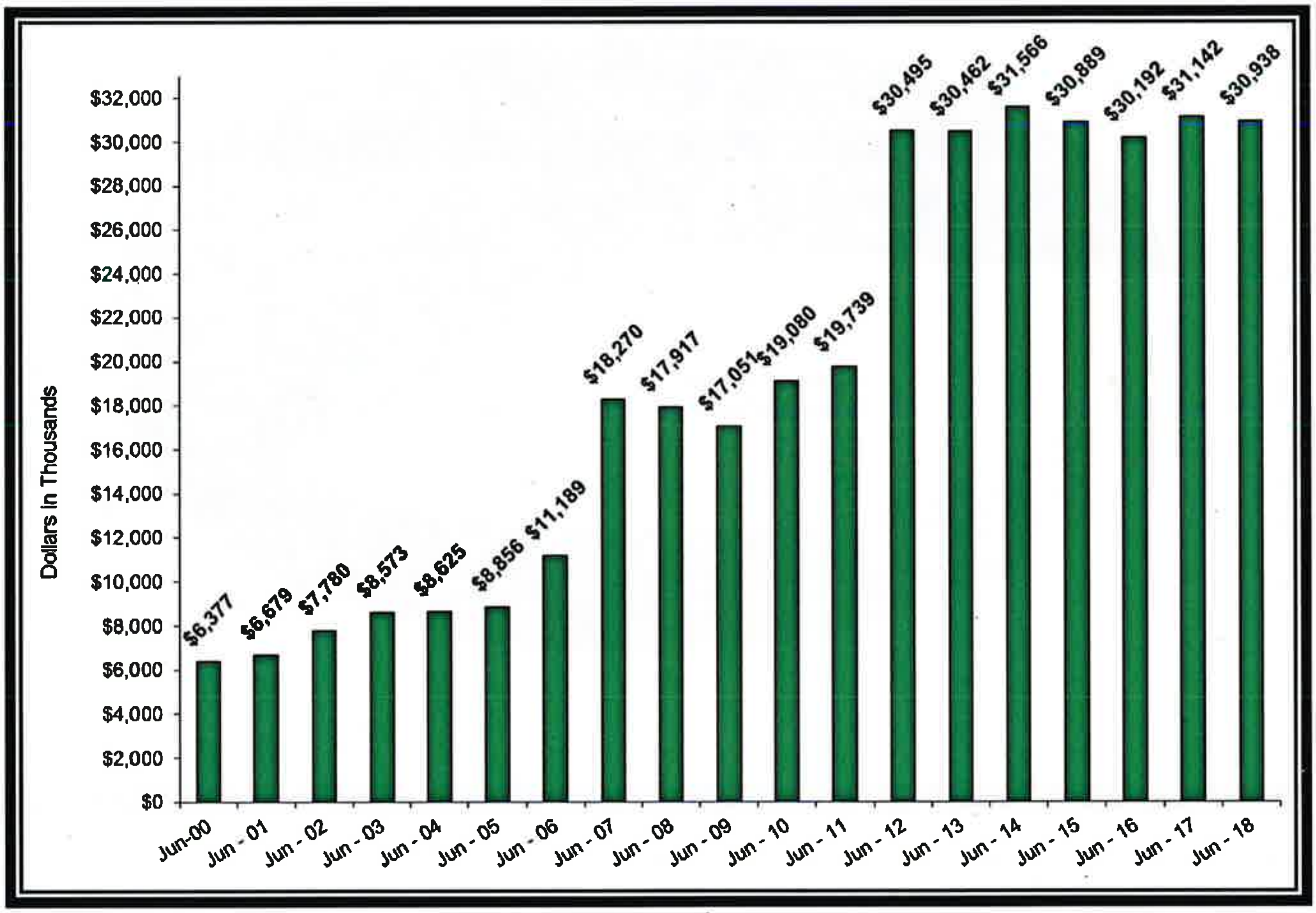
Trust Investment Account Fund Compositions
As of June 30, 2018



Please note that chart totals may not sum to 100% due to rounding.

Chart #4

Higher Education Endowment Trust Fund Asset Level
6/30/2000 to 6/30/2018
(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 2017	2016	2015	2014	2013
Fund Return	30,937,547		-0.1%	4.1%	4.4%	5.1%	4.9%	5.6%	6.7%	2.5%	2.4%	9.9%	5.3%
Vanguard Institutional Index Fund (VINIX)	6,866,782	22%	3.4%	14.3%	11.9%	13.4%	13.2%	10.2%	17.9%	4.0%	7.4%	24.5%	20.6%
Vanguard Developed Markets Index Fund (VTMNX)	4,777,379	15%	-1.6%	7.3%	5.1%	7.4%	5.6%	3.5%	18.0%	-8.5%	-0.2%	23.5%	18.5%
Vanguard Emerging Markets Stock Index Fund (VEMAX)	1,580,934	5%	-9.1%	6.3%	3.6%	4.3%	0.8%	1.8%	18.9%	-12.1%	-2.4%	14.1%	1.5%
Vanguard Total Bond Market Index Fund (VBTIX)	17,711,070	57%	-0.2%	-0.5%	1.7%	2.2%	2.5%	3.7%	-0.4%	6.1%	1.7%	4.3%	-0.9%

* *As of 06/30/2018*