

**UNIFORM PRUDENT MANAGEMENT OF
INSTITUTIONAL FUNDS ACT**

drafted by the

**NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS**

and by it

**APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES**

at its

**ANNUAL CONFERENCE
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WITH PREFATORY NOTE AND COMMENTS

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By

**NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS**

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INSTITUTIONAL FUNDS ACT**

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UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

Prefatory Note

Reasons for Revision. The Uniform Prudent Management of Institutional Funds Act (UPMIFA) replaces the Uniform Management of Institutional Funds Act (UMIFA). The National Conference of Commissioners on Uniform State Laws approved UMIFA in 1972, and 47 jurisdictions have enacted the act. UMIFA provided guidance and authority to charitable organizations within its scope concerning the management and investment of funds held by those organizations, UMIFA provided endowment spending rules that did not depend on trust accounting principles of income and principal, and UMIFA permitted the release of restrictions on the use or management of funds under certain circumstances. The changes UMIFA made to the law permitted charitable organizations to use modern investment techniques such as total-return investing and to determine endowment fund spending based on spending rates rather than on determinations of “income” and “principal.”

UMIFA was drafted almost 35 years ago, and portions of it are now out of date. The prudence standards in UMIFA have provided useful guidance, but prudence norms evolve over time. The new Act provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending. The Uniform Prudent Investor Act (UPIA), an Act promulgated in 1994 and already enacted in 43 jurisdictions, served as a model for many of the revisions. UPIA updates rules on investment decision making for trusts, including charitable trusts, and imposes additional duties on trustees for the protection of beneficiaries. UPMIFA applies these rules and duties to charities organized as nonprofit corporations. UPMIFA does not apply to trusts managed by corporate and other fiduciaries that are not charities, because UPIA provides management and investment standards for those trusts.

In applying principles based on UPIA to charities organized as nonprofit corporations, UPMIFA combines the approaches taken by UPIA and by the Revised Model Nonprofit Corporation Act (RMNCA). UPMIFA reflects the fact that standards for managing and investing institutional funds are and should be the same regardless of whether a charitable organization is organized as a trust, a nonprofit corporation, or some other entity. *See* Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule 7* (1986) (stating “[t]he modern paradigm of prudence applies to all fiduciaries who are subject to some version of the prudent man rule, whether under ERISA, the private foundation provisions of the Code, UMIFA, other state statutes, or the common law.”); Harvey P. Dale, *Nonprofit Directors and Officers - Duties and Liabilities for Investment Decisions*, 1994 N.Y.U. Conf. Tax Plan. 501(c)(3) Org’s. Ch. 4.

UPMIFA provides guidance and authority to charitable organizations concerning the management and investment of funds held by those organizations, and UPMIFA imposes additional duties on those who manage and invest charitable funds. These duties provide additional protections for charities and also protect the interests of donors who want to see their contributions used wisely.

UPMIFA modernizes the rules governing expenditures from endowment funds, both to provide stricter guidelines on spending from endowment funds and to give institutions the ability to cope more easily with fluctuations in the value of the endowment.

Finally, UPMIFA updates the provisions governing the release and modification of restrictions on charitable funds to permit more efficient management of these funds. These provisions derive from the approach taken in the Uniform Trust Code (UTC) for modifying charitable trusts. Like the UTC provisions, UPMIFA's modification rules preserve the historic position of the attorneys general in most states as the overseers of charities.

As under UMIFA, the new Act applies to charities organized as charitable trusts, as nonprofit corporations, or in some other manner, but the rules do not apply to funds managed by trustees that are not charities. Thus, the Act does not apply to trusts managed by corporate or individual trustees, but the Act does apply to trusts managed by charities.

Prudent Management and Investment. UMIFA applied the 1972 prudence standard to investment decision making. In contrast, UPMIFA will give charities updated and more useful guidance by incorporating language from UPIA, modified to fit the special needs of charities. The revised Act spells out more of the factors a charity should consider in making investment decisions, thereby imposing a modern, well accepted, prudence standard based on UPIA.

Among the expressly enumerated prudence factors in UPMIFA is "the preservation of the endowment fund," a standard not articulated in UMIFA.

In addition to identifying factors that a charity must consider in making management and investment decisions, UPMIFA requires a charity and those who manage and invest its funds to:

1. Give primary consideration to donor intent as expressed in a gift instrument,
2. Act in good faith, with the care an ordinarily prudent person would exercise,
3. Incur only reasonable costs in investing and managing charitable funds,
4. Make a reasonable effort to verify relevant facts,
5. Make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy,
6. Diversify investments unless due to special circumstances, the purposes of the fund are better served without diversification,
7. Dispose of unsuitable assets, and
8. In general, develop an investment strategy appropriate for the fund and the charity.

UMIFA did not articulate these requirements.

Thus, UPMIFA strengthens the rules governing management and investment decision making by charities and provides more guidance for those who manage and invest the funds.

Donor Intent with Respect to Endowments. UPMIFA improves the protection of donor intent with respect to expenditures from endowments. When a donor expresses intent clearly in a written gift instrument, the Act requires that the charity follow the donor's instructions. When a donor's intent is not so expressed, UPMIFA directs the charity to spend an amount that is prudent, consistent with the purposes of the fund, relevant economic factors, and the donor's intent that the fund continue in perpetuity. This approach allows the charity to give effect to donor intent, protect its endowment, assure generational equity, and use the endowment to support the purposes for which the endowment was created.

Retroactivity. Like UMIFA, UPIA, the Uniform Principal and Income Act of 1961, and the Uniform Principal and Income Act of 1997, UPMIFA applies retroactively to institutional funds created before and prospectively to institutional funds created after enactment of the statute. Regarding the considerations motivating this treatment of the issues, see the comment to Section 4.

Endowment Spending. UPMIFA improves the endowment spending rule by eliminating the concept of historic dollar value and providing better guidance regarding the operation of the prudence standard. Under UMIFA a charity can spend amounts above historic dollar value that the charity determines to be prudent. The Act directs the charity to focus on the purposes and needs of the charity rather than on the purposes and perpetual nature of the fund. Amounts below historic dollar value cannot be spent. The Drafting Committee concluded that this endowment spending rule created numerous problems and that restructuring the rule would benefit charities, their donors, and the public. The problems include:

1. Historic dollar value fixes valuation at a moment in time, and that moment is arbitrary. If a donor provides for a gift in the donor's will, the date of valuation for the gift will likely be the donor's date of death. (UMIFA left uncertain what the appropriate date for valuing a testamentary gift was.) The determination of historic dollar value can vary significantly depending upon when in the market cycle the donor dies. In addition, the fund may be below historic dollar value at the time the charity receives the gift if the value of the asset declines between the date of the donor's death and the date the asset is actually distributed to the charity from the estate.

2. After a fund has been in existence for a number of years, historic dollar value may become meaningless. Assuming reasonable long term investment success, the value of the typical fund will be well above historic dollar value, and historic dollar value will no longer represent the purchasing power of the original gift. Without better guidance on spending the increase in value of the fund, historic dollar value does not provide adequate protection for the fund. If a charity views the restriction on spending

simply as a direction to preserve historic dollar value, the charity may spend more than it should.

3. The Act does not provide clear answers to questions a charity faces when the value of an endowment fund drops below historic dollar value. A fund that is so encumbered is commonly called an “underwater” fund. Conflicting advice regarding whether an organization could spend from an underwater fund has led to difficulties for those managing charities. If a charity concluded that it could continue to spend trust accounting income until a fund regained its historic dollar value, the charity might invest for income rather than on a total-return basis. Thus, the historic dollar value rule can cause inappropriate distortions in investment policy and can ultimately lead to a decline in a fund’s real value. If, instead, a charity with an underwater fund continues to invest for growth, the charity may be unable to spend anything from an underwater endowment fund for several years. The inability of a charity to spend anything from an endowment is likely to be contrary to donor intent, which is to provide current benefits to the charity.

The Drafting Committee concluded that providing clearly articulated guidance on the prudence rule for spending from an endowment fund, with emphasis on the permanent nature of the fund, would provide the best protection of the purchasing power of endowment funds.

Presumption of Imprudence. UPMIFA includes as an optional provision a presumption of imprudence if a charity spends more than seven percent of an endowment fund in any one year. The presumption is meant to protect against spending an endowment too quickly. Although the Drafting Committee believes that the prudence standard of UPMIFA provides appropriate and adequate protection for endowments, the Committee provided the option for states that want to include a mechanical guideline in the statute. A major drawback to any statutory percentage is that it is unresponsive to changes in the rate of inflation or deflation.

Modification of Restrictions on Charitable Funds. UPMIFA clarifies that the doctrines of cy pres and deviation apply to funds held by nonprofit corporations as well as to funds held by charitable trusts. Courts have applied trust law rules to nonprofit corporations in the past, but the Drafting Committee believed that statutory authority for applying these principles to nonprofit corporations would be helpful. UPMIFA permitted release of restrictions but left the application of cy pres uncertain. Under UPMIFA, as under trust law, the court will determine whether and how to apply cy pres or deviation and the attorney general will receive notice and have the opportunity to participate in the proceeding. The one addition to existing law is that UPMIFA gives a charity the authority to modify a restriction on a fund that is both old and small. For these funds, the expense of a trip to court will often be prohibitive. By permitting a charity to make an appropriate modification, money is saved for the charitable purposes of the charity. Even with respect to small, old funds, however, the charity must notify the attorney general of the charity’s intended action. Of course, if the attorney general has concerns, he or she can seek the agreement of the charity to change or abandon the modification, and if that fails, can commence a court action to enjoin it. Thus, in all types of modification the attorney general continues to be the protector both of the donor’s intent and of the public’s interest in charitable funds.

Other Organizational Law. For matters not governed by UPMIFA, a charitable organization will continue to be governed by rules applicable to charitable trusts, if it is organized as a trust, or rules applicable to nonprofit corporations, if it is organized as a nonprofit corporation.

Relation to Trust Law. Although UPMIFA applies a number of rules from trust law to institutions organized as nonprofit corporations, in two respects UPMIFA creates rules that do not exist under the common law applicable to trusts. The endowment spending rule of Section 4 and the provision for modifying a small, old fund in subsection (d) of Section 6 have no counterparts in the common law or the UTC. The Drafting Committee believes that these rules could be useful to charities organized as trusts, and the Committee recommends conforming amendments to the UTC and the Principal and Income Act to incorporate these changes into trust law.

UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

SECTION 1. SHORT TITLE. This [act] may be cited as the Uniform Prudent Management of Institutional Funds Act.

SECTION 2. DEFINITIONS. In this [act]:

(1) “Charitable purpose” means the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community.

(2) “Endowment fund” means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use.

(3) “Gift instrument” means a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund.

(4) “Institution” means:

(A) a person, other than an individual, organized and operated exclusively for charitable purposes;

(B) a government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; or

(C) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated.

(5) “Institutional fund” means a fund held by an institution exclusively for charitable purposes. The term does not include:

(A) program-related assets;

(B) a fund held for an institution by a trustee that is not an institution; or

(C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund.

(6) “Person” means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.

(7) “Program-related asset” means an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment.

(8) “Record” means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

Comment

Subsection (1). Charitable Purpose. The definition of charitable purpose follows that of UTC § 405 and Restatement (Third) of Trusts § 28 (2003). This long-familiar standard derives from the English Statute of Charitable Uses, enacted in 1601.

Some 17 states have created statutory definitions of charitable purpose for various purposes. *See, e.g.*, 10 PA. CONS. STAT. § 162.3 (2005) (defining charitable purpose within the Solicitation of Funds for Charitable Purposes Act to include “humane,” “patriotic,” social welfare and advocacy,” and “civic” purposes). The definition in subsection (1) applies for purposes of this Act and does not affect other definitions of charitable purpose.

Subsection (2). Endowment Fund. An endowment fund is an institutional fund or a part of an institutional fund that is not wholly expendable by the institution on a current basis. A restriction that makes a fund an endowment fund arises from the terms of a gift instrument. If an institution has more than one endowment fund, under Section 3 the institution can manage and invest some or all endowment funds together. Section 4 and Section 6 must be applied to

individual funds and cannot be applied to a group of funds that may be managed collectively for investment purposes.

Board-designated funds are institutional funds but not endowment funds. The rules on expenditures and modification of restrictions in this Act do not apply to restrictions that an institution places on an otherwise unrestricted fund that the institution holds for its own benefit. The institution may be able to change these restrictions itself, subject to internal rules and to the fiduciary duties that apply to those that manage the institution.

If an institution transfers assets to another institution, subject to the restriction that the other institution hold the assets as an endowment, then the second institution will hold the assets as an endowment fund.

Subsection (3). Gift Instrument. The term gift instrument refers to the records that establish the terms of a gift and may consist of more than one document. The definition clarifies that the only legally binding restrictions on a gift are the terms set forth in writing.

As used in this definition, “record” is an expansive concept and means a writing in any form, including electronic. The term includes a will, deed, grant, conveyance, agreement, or memorandum, and also includes writings that do not have a donative purpose. For example, under some circumstances the bylaws of the institution, minutes of the board of directors, or canceled checks could be a gift instrument or be one of several records constituting a gift instrument. Although the term can include any of these records, a record will only become a gift instrument if both the donor and the institution were or should have been aware of its terms when the donor made the gift. For example, if a donor sends a contribution to an institution for its general purposes, then the articles of incorporation may be used to clarify those purposes. If, in contrast, the donor sends a letter explaining that the institution should use the contribution for its “educational projects concerning teenage depression,” then any funds received in response must be used for that purpose and not for broader purposes otherwise permissible under the articles of incorporation.

Solicitation materials may constitute a gift instrument. For example, a solicitation that suggests in writing that any gifts received pursuant to the solicitation will be held as an endowment may be integrated with other writings and may be considered part of the gift instrument. Whether the terms of the solicitation become part of the gift instrument will depend upon the circumstances, including whether a subsequent writing superseded the terms of the solicitation. Each gift received in response to a solicitation will be subject to any restrictions indicated in the gift instrument pertaining to that gift. For example, if an initial gift establishes an endowment fund, and the charity then solicits additional gifts “to be held as part of the Charity X Endowment Fund,” those additional gifts will each be subject to the restriction that the gifts be held as part of that endowment fund.

The term gift instrument includes matching funds provided by an employer or some other person. Whether matching funds are treated as part of the endowment fund or otherwise will depend on the terms of the matching gift.

The term gift instrument also includes an appropriation by a legislature or other public or governmental body for the benefit of an institution.

Subsection (4). Institution. The Act applies generally to institutions organized and operated exclusively for charitable purposes. The term includes charitable organizations created as nonprofit corporations, unincorporated associations, governmental subdivisions or agencies, or any form of entity, however organized, that is organized and operated exclusively for charitable purposes. The term includes a trust organized and operated exclusively for charitable purposes, but only if a charity acts as trustee. This approach leaves unchanged the coverage of UMIFA. The exclusion of “individual” from the definition of institution is not intended to exclude a corporation sole.

Although UPMIFA does not apply to all charitable trusts, many of UPMIFA’s provisions derive from trust law. Prudent investor standards apply to trustees of charitable trusts in states that have adopted UPIA. Trustees of charitable trusts can use the doctrines of cy pres and deviation to modify trust provisions, and the UTC includes a number of modification provisions. The Uniform Principal and Income Act permits allocation between principal and income to facilitate total-return investing. Charitable trusts not included in UPMIFA, primarily those managed by corporate trustees and individuals, will lose the benefits of UPMIFA’s endowment spending rule and the provision permitting a charity to apply cy pres, without court supervision, for modifications to a small, old fund. Enacting jurisdictions may choose to incorporate these rules into existing trust statutes to provide the benefits to charitable funds managed by corporate trustees.

The definition of institution includes governmental organizations that hold funds exclusively for the purposes listed in the definition. A governmental entity created by state law may fall outside the definition on account of the form of organization under which the state created it. Because state arrangements are so varied, creating a definition that encompasses all charitable entities created by states is not feasible. States should consider applying the core principles of UPMIFA to such governmental institutions. For example, the control over a state university may be held by a State Board of Regents. In that situation, the state may have created a governing structure by statute or in the state constitution so that the university is, in effect, privately chartered. The Drafting Committee does not intend to exclude these universities from the definition of institution, but additional state legislation may be necessary to address particular situations.

Subsection (5). Institutional Fund. The term institutional fund includes any fund held by an institution for charitable purposes, whether the fund is expendable currently or subject to restrictions. The term does not include a fund held by a trustee that is not an institution.

Some institutions combine assets from multiple funds for investment purposes, and some institutions invest funds from different institutions in a common fund. Typically each fund is assigned units representing the share value of the individual fund. The assets are invested collectively, permitting more efficient investment and improved diversification of the overall

portfolio. The collective fund makes annual distributions to the individual funds based on the units held by each fund. For purposes of Section 3 [and Section 5], the collective fund is considered one institutional fund. Section 4 and Section 6 apply to each fund individually and not to the collective fund.

Assets held by an institution primarily for program-related purposes rather than exclusively for investment are not subject to UPMIFA. For example, a university may purchase land adjacent to its campus for future development. The purchase might not meet prudent investor standards for commercial real estate, but the purchase may be appropriate because the university needs to build a new dormitory. The classroom buildings, administration buildings, and dormitories held by the university all have value as property, but the university does not hold those buildings as financial assets for investment purposes. The Act excludes from the prudent investor norms those assets that a charity uses to conduct its charitable activities, but does not exclude assets that have a tangential tie to the charitable purpose of the institution but are held primarily for investment purposes.

A fund held by an institution is not an institutional fund if any beneficiary of the fund is not an institution. For example, a charitable remainder trust held by a charity as trustee for the benefit of the donor during the donor's lifetime, with the remainder interest held by the charity, is not an institutional fund. However, this subsection treats as an institution a charitable remainder trust that continues to operate for charitable purposes after the termination of the noncharitable interests. The Act will have only a limited effect on a charitable remainder trust that terminates after the noncharitable interest ends. During the period required to complete the distribution of the trust's property, the prudence norm will apply to the actions of the trustee, but the short timeframe will affect investment decision making.

Subsection (6). Person. The Act uses as the definition of person the definition approved by the National Conference of Commissioners on Uniform State Laws. The definition of institution uses the term person, but to be an institution a person must be organized and operated exclusively for charitable purposes. A person with a commercial purpose cannot be an institution. Thus, although the definition of person includes "business trust" and "any other . . . commercial entity," the Act does not apply to an entity organized for business purposes and not exclusively for charitable purposes. Further, the definition of person includes trusts, but only trusts managed by charities can be institutional funds. UPMIFA does not apply to trusts managed by corporate trustees or by individual trustees.

If a governing instrument provides that a fund will revert to the donor if, and only if, the institution ceases to exist or the purposes of the fund fail, then the fund will be considered an institutional fund until such contingency occurs.

Subsection (7). Program-Related Asset. Although UPMIFA does not apply to program-related assets, if program-related assets serve, in part, as investments for an institution, then the institution should identify categories for reporting those investments and should establish investment criteria for the investments that are reasonably related to achieving the institution's charitable purposes. For example, a program providing below-market loans to

inner-city businesses may be “primarily to accomplish a charitable purpose of the institution” but also can be considered, in part, an investment. The institution should create reasonable credit standards and other guidelines for the program to increase the likelihood that the loans will be repaid.

Subsection (8). Record. This definition was added to clarify that the definition of instrument includes electronic records as defined in Section 2(8) of the Uniform Electronic Transactions Act (1999).

SECTION 3. STANDARD OF CONDUCT IN MANAGING AND INVESTING INSTITUTIONAL FUND.

(a) Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.

(b) In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

(c) In managing and investing an institutional fund, an institution:

(1) may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution; and

(2) shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

(d) An institution may pool two or more institutional funds for purposes of management and investment.

(e) Except as otherwise provided by a gift instrument, the following rules apply:

(1) In managing and investing an institutional fund, the following factors, if relevant, must be considered:

- (A) general economic conditions;
- (B) the possible effect of inflation or deflation;
- (C) the expected tax consequences, if any, of investment decisions or strategies;
- (D) the role that each investment or course of action plays within the overall investment portfolio of the fund;
- (E) the expected total return from income and the appreciation of investments;
- (F) other resources of the institution;
- (G) the needs of the institution and the fund to make distributions and to preserve capital; and
- (H) an asset's special relationship or special value, if any, to the charitable purposes of the institution.

(2) Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.

(3) Except as otherwise provided by law other than this [act], an institution may invest in any kind of property or type of investment consistent with this section.

(4) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.

(5) Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of this [act].

(6) A person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

Comment

Purpose and Scope of Revisions. This section adopts the prudence standard for investment decision making. The section directs directors or others responsible for managing and investing the funds of an institution to act as a prudent investor would, using a portfolio approach in making investments and considering the risk and return objectives of the fund. The section lists the factors that commonly bear on decisions in fiduciary investing and incorporates the duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable. Thus, the section follows modern portfolio theory for investment decision making. Section 3 applies to all funds held by an institution, regardless of whether the institution obtained the funds by gift or otherwise and regardless of whether the funds are restricted.

The Drafting Committee discussed extensively the standard that should govern nonprofit managers. UMIFA states the standard as “ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision.” Since the decision in *Stern v. Lucy Webb Hayes National Training School for Deaconesses*, 381 F. Supp. 1003 (1974), the trend has been to hold directors of nonprofit corporations to a standard nominally similar to the corporate standard but with the recognition that the facts and circumstances considered include the fact that the entity is a charity and not a business corporation.

The language of the prudence standard adopted in UPMIFA is derived from the RMNCA and from the prudent investor rule of UPIA. The standard is consistent with the business

judgment standard under corporate law, *as applied to charitable institutions*. That is, a manager operating a charitable organization under the business judgment rule would look to the same factors as those identified by the prudent investor rule. The standard for prudent investment set forth in Section 3 first states the duty of care as articulated in the RMNCA, but provides more specific guidance for those managing and investing institutional funds by incorporating language from UPIA. The criteria derived from UPIA are consistent with good practice under current law applicable to nonprofit corporations.

Trust law norms already inform managers of nonprofit corporations. The Preamble to UPIA explains: “Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations.” *See also*, Restatement (Third) of Trusts: Prudent Investor Rule § 379, Comment b, at 190 (1992) (stating that “absent a contrary statute or other provision, the prudent investor rule applies to investment of funds held for charitable corporations.”). Trust precedents have routinely been found to be helpful but not binding authority in corporate cases.

The Drafting Committee decided that by adopting language from both the RMNCA and UPIA, UPMIFA could clarify that common standards of prudent investing apply to all charitable institutions. Although the principal trust authorities, UPIA § (2)(a), Restatement (Third) of Trusts §337, UTC § 804, and Restatement (Second) of Trusts § 174 (prudent administration) use the phrase “care, skill and caution,” the Drafting Committee decided to use the more familiar corporate formulation as found in RMNCA. The standard also appears in Sections 3, 4 and 5 of UPMIFA. The Drafting Committee does not intend any substantive change to the UPIA standard and believes that “reasonable care, skill, and caution” are implicit in the term “care” as used in the RMNCA. The Drafting Committee included the detailed provisions from UPIA, because the Committee believed that the greater precision of the prudence norms of the Restatement and UPIA, as compared with UMIFA, could helpfully inform managers of charitable institutions. For an explanation of the Prudent Investor Act, see John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. Rev. 641 (1996), and for a discussion of the effect UPIA has had on investment decision making, see Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J. L. & Econ. (forthcoming 2007).

Section 3 has incorporated the provisions of UPIA with only a few exceptions. UPIA applies to private trusts and is entirely default law. The settlor of a private trust has complete control over virtually all trust provisions. See UTC § 105. Because UPMIFA applies to charitable organizations, UPMIFA makes the duty of care, the duty to minimize costs, and the duty to investigate mandatory. The duty of loyalty is mandatory under applicable organization law, corporate or trust. Other than these duties, the provisions of Section 3 are default rules. A gift instrument or the governing instruments of an institution can modify these duties, but the charitable purpose doctrine limits the extent to which an institution or a donor can restrict these duties. In addition, subsection (a) of Section 3 reminds the decision maker that the intent of a donor expressed in a gift instrument will control decision making. Further, the decision maker must consider the charitable purposes of the institution and the purposes of the institutional fund

for which decisions are being made. These factors are specific to charitable organizations; UPIA § 2(a) states the duty to consider similar factors in the private trust context.

UPMIFA does not include the duty of impartiality, stated in UPIA § 6, because nonprofit corporations do not confront the multiple beneficiaries problem to which the duty is addressed. Under UPIA, a trustee must treat the current beneficiaries and the remainder beneficiaries with due regard to their respective interests, subject to alternative direction from the trust document. A nonprofit corporation typically creates one charity. The institution may serve multiple beneficiaries, but those beneficiaries do not have enforceable rights in the institution in the same way that beneficiaries of a private trust do. Of course, if a charitable trust is created to benefit more than one charity, rather than being created to carry out a charitable purpose, then UPIA will apply the duty of impartiality to that trust.

In other respects, the Drafting Committee made changes to language from UPIA only where necessary to adapt the language for charitable institutions. No material differences are intended. Subsection (e)(1)(D) of Section 3 of UPMIFA does not include a clause that appears at the end of UPIA § 2(c)(4) (“which may include financial assets, interest in closely held enterprises, tangible and intangible personal property, and real property.”). The Drafting Committee deemed this clause unnecessary for charitable institutions. The language of subsection (e)(1)(G) reflects a modification of the language of UPIA § (2)(c)(7). Other minor modifications to the UPIA provisions make the language more appropriate for charitable institutions.

The duties imposed by this section apply to those who govern an institution, including directors and trustees, and to those to whom the directors or managers delegate responsibility for investment and management of institutional funds. The standard applies to officers and employees of an institution and to agents who invest and manage institutional funds. Volunteers who work with an institution will be subject to the duties imposed here, but state and federal statutes may provide reduced liability for persons who act without compensation. UPMIFA does not affect the application of those shield statutes.

Subsection (a). Donor Intent and Charitable Purposes. Subsection (a) states the overarching duty to comply with donor intent as expressed in the terms of the gift instrument. The emphasis in the Act on giving effect to donor intent does not mean that the donor can or should control the management of the institution. The other fundamental duty is the duty to consider the charitable purposes of the institution and of the institutional fund in making management and investment decisions. UPIA § 2(a) states a similar duty to consider the purposes of a trust in investing and managing assets of a trust.

Subsection (b). Duty of Loyalty. Subsection (b) reminds those managing and investing institutional funds that the duty of loyalty will apply to their actions, but Section 3 does not state the loyalty standard that applies. The Drafting Committee was concerned, at least nominally, that different standards of loyalty may apply to directors of nonprofit corporations and to trustees of charitable trusts. The RMNCA provides that under the duty of loyalty a director of a nonprofit corporation should act “in a manner the director reasonably believes to be in the best

interests of the corporation.” RMNCA § 8.30. The trust law articulation of the loyalty standard uses “sole interests” rather than “best interests.” As the Restatement of Trusts explains, “[t]he trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary.” Restatement (Second) of Trusts § 170 (1). Although the standards for loyalty, like the standard of care, are merging, *see* Evelyn Brody, *Charitable Governance: What’s Trust Law Got to do With It?* Chi.-Kent L. Rev. (2005); John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest*, 114 Yale L.J. 929 (2005), the Drafting Committee concluded that formulating a duty of loyalty provision for UPMIFA was unnecessary. Thus the duty of loyalty under nonprofit corporation law will apply to charities organized as nonprofit corporations, and the duty of loyalty under trust law will apply to charitable trusts.

Subsection (b). Duty of Care. Subsection (b) also applies the duty of care to performance of investment duties. The language derives from § 8.30 of the RMNCA. This subsection states the duty to act in good faith, “with the care an ordinarily prudent person in a like position would exercise under similar circumstances.” Although the language in the RMNCA and in UPMIFA is similar to that of § 8.30 of the Model Business Corporation Act (3d ed. 2002), the standard as applied to persons making decisions for charities is informed by the fact that the institution is a charity and not a business corporation. Thus, in UPMIFA the references to “like position” and “similar circumstances” mean that the charitable nature of the institution affects the decision making of a prudent person acting under the standard set forth in subsection (b). The duty of care involves considering the factors set forth in subsection (e)(1).

Subsection (c)(1). Duty to Minimize Costs. Subsection (c)(1) tracks the language of UPIA § 7 and requires an institution to minimize costs. An institution may prudently incur costs by hiring an investment advisor, but the costs incurred should be appropriate under the circumstances. *See* UPIA § 7 cmt; Restatement (Third) of Trusts: Prudent Investor Rule § 227, cmt. M, at 58 (1992); Restatement (Second) of Trusts § 188 (1959). The duty is consistent with the duty to act prudently under § 8.30 of the RMNCA.

Subsection (c)(2). Duty to Investigate. This subsection incorporates the traditional fiduciary duty to investigate, using language from UPIA § 2(d). The subsection requires persons who make investment and management decisions to investigate the accuracy of the information used in making decisions.

Subsection (d). Pooling Funds. An institution holding more than one institutional fund may find that pooling its funds for investment and management purposes will be economically beneficial. The Act permits pooling for these purposes. The prohibition against commingling no longer prevents pooling funds for investment and management purposes. *See* UPIA § 3, cmt. (duty to diversify aided by pooling); UPIA § 7, cmt. (pooling to minimize costs); Restatement (Third) of Trusts: Duty to Segregate and Identify Trust Property § 84 (T.D. No. 4 2005). Funds will be considered individually for other purposes of the Act, including for the spending rule for endowment funds of Section 4 and the modification rules of Section 6.

Subsection (e)(1). Prudent Decision Making. Subsection (e)(1) takes much of its language from UPIA § 2(c). In making decisions about whether to acquire or retain an asset, the

institution should consider the institution's mission, its current programs, and the desire to cultivate additional donations from a donor, in addition to factors related more directly to the asset's potential as an investment.

Subsection (e)(1)(C) reflects the fact that some organizations will invest in taxable investments that may generate unrelated business taxable income for income tax purposes.

Assets held primarily for program-related purposes are not subject to UPMIFA. The management of those assets will continue to be governed by other laws applicable to the institution. Other assets may not be held primarily for program-related purposes but may have both investment purposes and program-related purposes. Subsections (a) and (e)(1)(H) indicate that a prudent decision maker can take into consideration the relationship between an investment and the purposes of the institution and of the institutional fund in making an investment that may have a program-related purpose but not be primarily program-related. The degree to which an institution uses an asset to accomplish a charitable purpose will affect the weight given that factor in a decision to acquire or retain the asset.

Subsection (e)(2). Portfolio Approach. This subsection reflects the use of portfolio theory in modern investment practice. The language comes from UPIA § 2(b), which follows the articulation of the prudent investor standard in Restatement (Third) of Trusts: Prudent Investor Rule § 227(a) (1992).

Subsection (e)(3). Broad Investment Authority. Consistent with the portfolio theory of investment, this subsection permits a broad range of investments. The language derives from UPIA § 2(e).

Section 4 of UMIFA indicated that an institution could invest "without restriction to investments a fiduciary may make." The committee removed this language from subsection (e)(3) as unnecessary, because states no longer have legal lists restricting fiduciary investing to the specific types of investments identified in statutory lists.

Subsection (e)(3) also provides that other law may limit the authority under this subsection. In addition, all of subsection (e) is subject to contrary provisions in a gift instrument, and a gift instrument may restrict the ability to invest in particular assets. For example, the gift instrument for a particular institutional fund might preclude the institution from investing the assets of the fund in companies that produce tobacco products.

In her book, *Governing Nonprofit Organizations: Federal and State Law and Regulation* 434 (Harv. Univ. Press 2004), Marion R. Fremont-Smith reports that some large charities pledge their endowment funds as security for loans. Subsection (e)(3) permits this sort of debt financing, subject to the guidelines of subsection (e)(1).

Subsection (e)(4). Duty to Diversify. This subsection assumes that prudence requires diversification but permits an institution to determine that nondiversification is appropriate under exceptional circumstances. A decision not to diversify must be based on the needs of the charity

and not solely for the benefit of a donor. A decision to retain property in the hope of obtaining additional contributions from the same donor may be considered made for the benefit of the charity, but the appropriateness of that decision will depend on the circumstances. This subsection derives its language from UPIA § 3. *See* UPIA § 3 cmt. (discussing the rationale for diversification); Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992).

Subsection (e)(5). Disposing of Unsuitable Assets. This subsection imposes a duty on an institution to review the suitability of retaining property contributed to the institution within a reasonable period of time after the institution receives the property. Subsection (e)(5) requires the institution to make a decision but does not require a particular outcome. The institution may consider a variety of factors in making its decision, and a decision to retain the property either for a period of time or indefinitely may be a prudent decision.

Section 4(2) of UMIFA specifically authorized an institution to retain property contributed by a donor. The comment explained that an institution might retain property in the hope of obtaining additional contributions from the donor. Under UPMIFA the potential for developing additional contributions by retaining property contributed to the institution would be among the “other circumstances” that the institution might consider in deciding whether to retain or dispose of the property. The institution must weigh the potential for obtaining additional contributions with all other factors that affect the suitability of retaining the property in the investment portfolio.

The language of subsection (e)(5) comes from UPIA § 4, which restates Restatement (Third) of Trusts: Prudent Investor Rule § 229 (1992), which adopted language from Restatement (Second) of Trusts § 231 (1959). *See* UPIA § 4 cmt.

Subsection (e)(6). Special Skills or Expertise. Subsection (e)(6) states the rule provided in UPIA § 2(f) requiring a trustee to use the trustee’s own skills and expertise in carrying out the trustee’s fiduciary duties. The comment to RMNCA § 8.30 describes the existence of a similar rule under the law of nonprofit corporations. Section 8.30(a)(2) provides that in discharging duties a director must act “with the care an ordinarily prudent person in a like position would exercise under similar circumstances. . . .” The comment explains that “[t]he concept of ‘under similar circumstances’ relates not only to the circumstances of the corporation but to the special background, qualifications, and management experience of the individual director and the role the director plays in the corporation.” After describing directors chosen for their ability to raise money, the comment notes that “[n]o special skill or expertise should be expected from such directors unless their background or knowledge evidences some special ability.”

The intent of subsection (e)(6) is that a person managing or investing institutional funds must use the person’s own judgment and experience, including any particular skills or expertise, in carrying out the management or investment duties. For example, if a charity names a person as a director in part because the person is a lawyer, the lawyer’s background may allow the lawyer to recognize legal issues in connection with funds held by the charity. The lawyer should identify the issues for the board, but the lawyer is not expected to provide legal advice. A lawyer is not expected to be able to recognize every legal issue, particularly issues outside the lawyer’s

area of expertise, simply because the board member is lawyer. *See* ALI Principles of the Law of Nonprofit Organizations, Preliminary Draft No. 3 (May 12, 2005) § 315 (Duty of Care), cmt. c.

UMIFA contained two provisions that authorized investments in pooled or common investment funds. UMIFA §§ 4(3), 4(4). The Drafting Committee concluded that Section 3(e)(3) of UPMIFA authorizes these investments. The decision not to include the two provisions in UPMIFA implies no disapproval of such investments.

SECTION 4. APPROPRIATION FOR EXPENDITURE OR ACCUMULATION OF ENDOWMENT FUND; RULES OF CONSTRUCTION.

(a) Subject to the intent of a donor expressed in the gift instrument [and to subsection (d)], an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- (1) the duration and preservation of the endowment fund;
- (2) the purposes of the institution and the endowment fund;
- (3) general economic conditions;
- (4) the possible effect of inflation or deflation;
- (5) the expected total return from income and the appreciation of investments;
- (6) other resources of the institution; and
- (7) the investment policy of the institution.

(b) To limit the authority to appropriate for expenditure or accumulate under subsection (a), a gift instrument must specifically state the limitation.

(c) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only “income”, “interest”, “dividends”, or “rents, issues, or profits”, or “to preserve the principal intact”, or words of similar import:

(1) create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund; and

(2) do not otherwise limit the authority to appropriate for expenditure or accumulate under subsection (a).

[(d) The appropriation for expenditure in any year of an amount greater than seven percent of the fair market value of an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation for expenditure is made, creates a rebuttable presumption of imprudence. For an endowment fund in existence for fewer than three years, the fair market value of the endowment fund must be calculated for the period the endowment fund has been in existence. This subsection does not:

(1) apply to an appropriation for expenditure permitted under law other than this [act] or by the gift instrument; or

(2) create a presumption of prudence for an appropriation for expenditure of an amount less than or equal to seven percent of the fair market value of the endowment fund.]

Comment

Purpose and Scope of Revisions. This section revises the provision in UMIFA that permitted the expenditure of appreciation of an endowment fund to the extent the fund had

appreciated in value above the fund's historic dollar value. UMIFA defined historic dollar value to mean all contributions to the fund, valued at the time of contribution. Instead of using historic dollar value as a limitation, UPMIFA applies a more carefully articulated prudence standard to the process of making decisions about expenditures from an endowment fund. The expenditure rule of Section 4 applies only to the extent that a donor and an institution have not reached some other agreement about spending from an endowment. If a gift instrument sets forth specific requirements for spending, then the charity must comply with those requirements. However, if the gift instrument uses more general language, for example directing the charity to "hold the fund as an endowment" or "retain principal and spend income," then Section 4 provides a rule of construction to guide the charity.

Prior to the promulgation of UMIFA, "income" for trust accounting purposes meant interest and dividends but not capital gains, whether or not realized. Many institutions assumed that trust accounting principles applied to charities organized as nonprofit corporations, and the rules limited the institutions' ability to invest their endowment funds effectively. UMIFA addressed this problem by construing "income" in gift instruments to include a prudent amount of capital gains, both realized and unrealized. Under UMIFA an institution could spend appreciation in addition to spending income determined under trust accounting rules. This rule of construction likely carried out the intent of the donor better than a rule limiting spending to trust accounting income, while permitting the charity to invest in a manner that could generate better returns for the fund.

UPMIFA also applies a rule of construction to terms like "income" or "endowment." The assumption in the Act is that a donor who uses one of these terms intends to create a fund that will generate sufficient gains to be able to make ongoing distributions from the fund while at the same time preserving the purchasing power of the fund. Because historic dollar value under UMIFA was a number fixed in time, the use of that approach may not have adequately captured the intent of a donor who wanted the endowment fund to continue to maintain its value in current dollars. UPMIFA takes a different approach, directing the institution to determine spending based on the total assets of the endowment fund rather than determining spending by adding a prudent amount of appreciation to trust accounting income.

UPMIFA requires the persons making spending decisions for an endowment fund to focus on the purposes of the endowment fund as opposed to the purposes of the institution more generally, as was the case under UMIFA. When the institution considers the purposes and duration of the fund, the institution will give priority to the donor's general intent that the fund be maintained permanently. Although the Act does not require that a specific amount be set aside as "principal," the Act assumes that the charity will act to preserve "principal" (i.e., to maintain the purchasing power of the amounts contributed to the fund) while spending "income" (i.e. making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions). Thus, an institution should monitor principal in an accounting sense, identifying the original value of the fund (the historic dollar value) and the increases in value necessary to maintain the purchasing power of the fund.

Subsection (a). Expenditure of Endowment Funds. Subsection (a) uses the RMNCA articulation of the standard of care for decision making under Section 4. The change in language does not reflect a substantive change. The comment to Section 3 more fully describes that standard of care.

Section 4 permits expenditures from an endowment fund to the extent the institution determines that the expenditures are prudent after considering the factors listed in subsection (a). These factors emphasize the importance of the intent of the donor, as expressed in a gift instrument. Section 4 looks to written documents as evidence of donor's intent and does not require an institution to rely on oral expressions of intent. By requiring written evidence of intent, the Act protects reliance by the donor and the institution on the written terms of a donative agreement. Informal conversations may be misremembered and may be subject to multiple interpretations. Of course, oral expressions of intent may guide an institution in further carrying out a donor's wishes and in understanding a donor's intent.

The factors in subsection (a) require attention to the purposes of the institution and the endowment fund, economic conditions, and present and reasonably anticipated resources of the institution. As under UMIFA, determinations under Section 4 do not depend on the characterization of assets as income or principal and are not limited to the amount of income and unrealized appreciation. The authority in Section 4 is permissive, however, and an institution organized as a trust may continue to make spending decisions under trust accounting principles so long as doing so is prudent.

Institutions have operated effectively under UMIFA and have operated more conservatively than the historic dollar value rule would have permitted. Institutions have little incentive to maximize allowable spending. Good practice has been to provide for modest expenditures while maintaining the purchasing power of a fund. Institutions have followed this practice even though UMIFA (1) does not require an institution to maintain a fund's purchasing power and (2) does allow an institution to spend any amounts in a fund above historic dollar value, subject to the prudence standard. The Drafting Committee concluded that eliminating historic dollar value and providing institutions with more discretion would not lead to depletion of endowment funds. Instead, UPMIFA should encourage institutions to establish a spending policy that will be responsive to short-term fluctuations in the value of the fund. Section 4 allows an institution to maintain appropriate levels of expenditures in times of economic downturn or economic strength. In some years, accumulation rather than spending will be prudent, and in other years an institution may appropriately make expenditures even if a fund has not generated investment return that year.

Several levels of safeguard exist to prevent an institution from depleting an endowment fund or diverting assets from the purposes for which the fund was created. In comparison with UMIFA, UPMIFA provides greater direction to the institution with respect to making a prudent determination about spending from an endowment. UMIFA told the decision maker to consider "long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions." UPMIFA

clarifies that in making spending decisions the institution should attempt to ensure that the value of the fund endures while still providing that some amounts be spent for the purposes of the endowment fund. In UPMIFA prudent decision making emphasizes the endowment aspect of the fund, rather than the overall purposes or needs of the institution.

In addition to the guidance provided by Section 4, other safeguards exist. Donors can restrict gifts and can provide specific instructions to donee institutions regarding appropriate uses for assets contributed. Within institutions, fiduciary duties govern the persons making decisions on expenditures. Those persons must operate both with the best interests of the institution in mind and in keeping with the intent of donors. If an institution diverts an institutional fund from the charitable purposes of the institution, the state attorney general can enforce the charitable interests of the public. By relying on these safeguards while providing institutions with adequate discretion to make appropriate expenditures, the Act creates a standard that takes into consideration the diversity of the charitable sector. The committee expects that accumulated experience with such spending formulas will continue to inform institutional practice under the Act.

Distinguishing Legal and Accounting Standards. Deleting historic dollar value does not transform any portion of an endowment fund into unrestricted assets from a legal standpoint. An endowment fund is restricted because of the donor's intent that the fund be restricted by the prudent spending rule, that the fund not be spent in the current year, and that the fund continue to maintain its value for a long time. Regardless of the treatment of endowment fund from an accounting standpoint, legally an endowment fund should not be considered unrestricted. Subsection (a) states that endowment funds will be legally restricted until the institution appropriates funds for expenditure. The UMIFA statutes in Utah and Maine contain similar language. 13 Me. Rev. Stat. Ann. tit. 13 § 4106 (West 2005); Utah Code Ann. 1953 § 13-29-3 (2005). *See, also*, advisory published by Mass. Attorney General, "The Attorney General's Position on FASB Statement of Financial Accounting Standards No. 117, ¶ 22 and Related G.L.C. 180A Issues" (January 2004) <http://www.ago.state.ma.us/filelibrary/fasb.pdf> (last visited May 22, 2006) (concerning the treatment of endowments as legally restricted assets).

The term "endowment fund" includes funds that may last in perpetuity but also funds that are created to last for a fixed term of years or until the institution achieves a specified objective. Section 4 requires the institution to consider the intended duration of the fund in making determinations about spending. For example, if a donor directs that a fund be spent over 20 years, Section 4 will guide the institution in making distribution decisions. The institution would amortize the fund over 20 years rather than try to maintain the fund in perpetuity. For an endowment fund of limited duration, spending at a rate higher than rates typically used for endowment spending will be both necessary and prudent.

Subsection (c). Rule of Construction. Donor's intent must be respected in the process of making decisions to expend endowment funds. Section 4 does not allow an institution to convert an endowment fund into a non-endowment fund nor does the section allow the institution to ignore a donor's intent that a fund be maintained as an endowment. Rather, subsection (c) provides rules of construction to assist institutions in interpreting donor's intent. Subsection (c)

assumes that if a donor wants an institution to spend “only the income” from a fund, the donor intends that the fund both support current expenditures and be preserved permanently. The donor is unlikely to be concerned about designation of particular returns as “income” or “principal” under accounting principles. Rather the donor is more likely to assume that the institution will use modern total-return investing techniques to generate enough funds to distribute while maintaining the long-term viability of the fund. Subsection (c) is an intent effectuating provision that provides default rules to construe donor’s intent.

As subsection (b) explains, a donor who wants to specify particular spending guidelines can do so. For example, a donor might require that a charity spend between three and five percent of an endowed gift each year, regardless of investment performance or other factors. Because the charity agrees to the restriction in accepting the gift, the restriction will govern spending decisions by the charity. Another donor might want to limit expenditures to trust accounting income and not want the institution to be able to expend appreciation. An instruction to “pay only the income” will not be specific enough, but an instruction to “pay only interest and dividend income earned by the fund and not to make other distributions of the kind authorized by Section 4 of UPMIFA” should be sufficient. If a donor indicates that the rules on investing or expenditures under Section 4 do not apply to a particular fund, then as a practical matter the institution will probably invest the fund separately. Thus, a decision by a donor to require fund specific expenditure rules will likely also have consequences in the way the institution invests the fund.

Retroactive Application of the Rule of Construction. A constructional rule resolves an ambiguity, in this case, because donors use words like endowment or income without specific directions regarding the intended meaning. Changing a statutory constructional rule does not change the underlying intent, and instead changes the way an ambiguity is resolved, in an attempt to increase the likelihood of giving effect to the intent of most donors.

If a donor has stated in a gift instrument specific directions as to spending, then the institution must respect those wishes, but many donors do not give precise instructions about how to spend endowment funds. In Section 4 UPMIFA provides guidance for giving effect to a donor’s intent when the donor has not been specific. Like Section 3 of UMIFA, Section 4 of UPMIFA is a rule of construction, so it does not violate either donor intent or the Constitution.

The issue of whether to apply a rule of construction retroactively was considered in connection with UMIFA. When the New Hampshire legislature considered UMIFA, the Senate asked the New Hampshire Supreme Court for an opinion regarding whether UMIFA, if adopted, would violate a provision of the state constitution prohibiting retrospective laws, and also whether the statute would encroach on the functions of the judicial branch. The opinion answered no to both questions. Opinion of the Justices, Request of the Senate No. 6667, 113 N.H. 287, 306 A.2d 55 (1973).

More recently the Colorado Supreme Court considered the retroactive application of another constructional statute, one that deems the designation of a spouse as the beneficiary of a life insurance policy to be revoked in a case in which the marriage was dissolved after the

naming of the spouse as beneficiary. In *re Estate of DeWitt*, 54 P. 3d 849 (Colo. 2002). In holding that retroactive application of the statute did not violate the Contracts Clause, the court cited approvingly from a statement prepared by the Joint Editorial Board for Uniform Trusts and Estates Acts (JEB). JEB Statement Regarding the Constitutionality of Changes in Default Rules as Applied to PreExisting Documents, 17 Am. Coll. Tr. & Est. Couns. Notes 184 app. II (1991).

The JEB Statement explains that the purpose of the anti-retroactivity norm is to protect a transferor who relies on existing rules of law. By definition, however, rules of construction apply only in situations in which a transferor did not spell out his or her intent and hence did not rely on the then-current rule of construction. *See also In re Gardner's Trust*, 266 Minn. 127, 132, 123 N.W. 2d 69, 73 (1963) (“[I]t is doubtful whether the testatrix had any clear intention in mind at the time the will was executed. It is equally plausible that if she had thought about it at all she would have desired to have the dividends go where the law required them to go at the time they were received by the trustee.”) (Uniform Principal and Income Act).

Non-retroactivity would produce serious practical problems: If the Act were not retroactive, a charity would need to keep two sets of books for each endowment fund created before the enactment of UPMIFA, if new funds were added after the enactment. The burden that such a rule would impose is out of proportion to the benefit sought.

Subsection (d). Rebuttable Presumption of Imprudence. The Drafting Committee debated at length whether to include a presumption of imprudence for spending above a fixed percentage of the value of the fund. The Drafting Committee decided to include a presumption in the Act in brackets, as an option for states to consider, and to include in these Comments a discussion of the advantages and disadvantages of including a presumption in the Act.

Some who commented on the Act viewed the presumption as linked to the retroactive application of the rule of construction of subsection (c). A donor who contributed to an endowment fund under UMIFA may have assumed that the historic dollar value of the gift would be subject to a no-spending rule under the statute. Because UPMIFA removes the concept of historic dollar value, the bracketed presumption of imprudence would assure the donor that spending from an endowment fund will be so limited.

Those in favor of the presumption of imprudence argued that the presumption would curb the temptation that a charity might have to spend endowment assets too rapidly. Although the presumption would be rebuttable, and spending above the identified percentage might, in some years and for some charities, be prudent, institutions would likely be reluctant to authorize spending above seven percent. In addition, the presumption would give the attorney general a benchmark of sorts.

A variety of considerations cut against including a presumption of imprudence in the statute. A fixed percentage in the statute might be perceived as a safe harbor that could lead institutions to spend more than is prudent. Although the provision should not be read to imply that spending below seven percent will be considered prudent, some charities might interpret the statute in that way. Decision makers might be pressured to spend up to the percentage, and in

doing so spend more than is prudent, without adequate review of the prudence factors as required under the Act.

Perhaps the biggest problem with including a presumption in the statute is the difficulty of picking a number that will be appropriate in view of the range of institutions and charitable purposes and the fact that economic conditions will change over time. Under recent economic conditions, a spending rate of seven percent is too high for most funds, but in a period of high inflation, seven percent might be too low. In making a prudent decision regarding how much to spend from an endowment fund, each institution must consider a variety of factors, including the particular purposes of the fund, the wishes of the donors, changing economic factors, and whether the fund will receive future donations.

Whether or not a statute includes the presumption, institutions must remember that prudence controls decision making. Each institution must make decisions on expenditures based on the circumstances of the particular charity.

Application of Presumption. For a state wishing to adopt a presumption of imprudence, subsection (d) provides language. Under subsection (d), a rebuttable presumption of imprudence will arise if expenditures in one year exceed seven percent of the assets of an endowment fund. The subsection applies a rolling average of three or more years in determining the value of the fund for purposes of calculating the seven-percent amount. An institution can rebut the presumption of imprudence if circumstances in a particular year make expenditures above that amount prudent. The concept and the language for the presumption of imprudence comes from Mass. Gen. L. ch. 180A, § 2 (2004). Massachusetts enacted this rule in 1975 as part of its UMIFA statute. New Mexico adopted the same presumption in 1978. N.M.S.A. § 46-9-2 (C) (2004). New Hampshire has a similar provision. N.H. Rev. Stat. § 292-B:6.

The period that a charity uses to calculate the presumption (three or more years) and the frequency of valuation (at least quarterly) will be binding in any determination of whether the presumption applies. For example, if a charity values an endowment fund on a quarterly basis and averages the quarterly values over three years to determine the fair market value of the fund for purposes calculating seven percent of the fund, the charity's choices of three years as a smoothing period and quarterly as a valuation period cannot be challenged. If the charity makes an appropriation that is less than seven percent of this value, then the presumption of imprudence does not arise even if the appropriation would exceed seven percent of the value of the fund calculated based on monthly valuations averaged over five years.

If sufficient evidence establishes, by the preponderance of the evidence, the facts necessary to raise the presumption of imprudence, then the institution will have to carry the burden of production of (i.e., the burden of going forward with) other evidence that would tend to demonstrate that its decision was prudent. The existence of the presumption does not shift the burden of persuasion to the charity.

Expenditures from an endowment fund may include distributions for charitable purposes and amounts used for the management and administration of the fund, including annual charges

for fundraising. The value of a fund, as calculated for purposes of determining the seven percent amount, will reflect increases due to contributions and investment gains and decreases due to distributions and investment losses. The seven percent figure includes charges for fundraising and administrative expenses other than investment management expenses. All costs or fees associated with an endowment fund are factors that prudent decision makers consider. High costs or fees of investment management could be considered imprudent regardless of whether spending exceeds seven percent of the fund's value.

The presumption of imprudence does not create an automatic safe harbor. Expenditures at six percent might well be imprudently high. See James P. Garland, *The Fecundity of Endowments and Long-Duration Trusts*, *The Journal of Portfolio Management* (2005). Evidence reviewed by the Drafting Committee suggests that at present few funds can sustain spending at a rate above five percent. See Roger G. Ibbotson & Rex A. Sinquefeld, *Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-1987)* (Research Foundation of the Institute of Chartered Financial Analysts, 1989). Indeed, under current conditions five percent can be too high. See Joel C. Dobris, *Why Five? The Strange, Magnetic, and Mesmerizing Affect of the Five Percent Unitrust and Spending Rate on Settlers, Their Advisers, and Retirees*, 40 *Real Prop. Prob. & Tr. J.* 39 (2005). Further, spending at a lower rate, particularly in the early years of an endowment, may result in greater distributions over time. See DeMarche Associates, Inc, *Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix* (Council on Foundations: 3d ed. 1999). A presumption of imprudence can serve as a reminder that spending at too high a rate will jeopardize the long-term nature of an endowment fund. If an endowment fund is intended to continue permanently, the institution should take special care to limit annual spending to a level that protects the purchasing power of the fund.

Subsection (d) provides that the terms of the gift instrument can provide additional spending authority. For example, if a gift instrument directs that an institution expend a fund over a ten-year period, exhausting the fund after ten years, spending at a rate higher than seven percent will be necessary.

Subsection (d) does not require an institution to spend a minimum amount each year. The prudence standard and the needs of the institution will supply sufficient guidance regarding whether to accumulate rather than to spend in a particular year.

Spending above seven percent in any one year will not necessarily be imprudent. For some endowment funds fluctuating spending rates may be appropriate. Although the Act does not apply the percentage for the presumption on a rolling basis (e.g., 21 percent over three years), some endowment funds may prudently spend little or nothing in some years and more than seven percent in other years. For example, a charity planning a construction project might decide to spend nothing from an endowment for three years and then in the fourth year might spend 20 percent of the value of the fund for construction costs. The decision to accumulate in years one through three and then to spend 20 percent in the fourth year might be prudent for the charity, depending on the other factors. The charity should maintain adequate records during the accumulation period and should document the decision-making process in the fourth year to be able to meet the burden of production associated with the presumption. Another charity might

prudently spend 20 percent in year one and nothing for the following three years. That charity would also need to document the decision-making process through which the decision to spend occurred and maintain records explaining why the decision was prudent under the circumstances.

A charity might establish a “capital replacement fund” designed to provide funds to the institution for repair or replacement of major items of equipment. Disbursements from such a fund will likely fluctuate, with limited expenditures in some years and big expenditures in others. The fund would not exhibit a uniform spending rate. Indeed, an advantage of a capital replacement fund is the ability to absorb a significant capital expenditure in a single year without a negative impact on the operating budget of the institution. Disbursements might average five percent per year but would vary, with spending in some years more and in some years less. Even if this fund is an endowment fund subject to Section 4, spending above seven percent in a particular year could well be prudent. Subsection (d) does not preclude spending above seven percent.

A charity creating a capital replacement fund or a building fund might choose to adopt spending rules for the fund that would not be subject to UPMIFA. Specific donor intent can supersede the rules of UPMIFA. If the charity creates a gift instrument that establishes appropriate rules on spending for the fund, and if donors agree to those restrictions, then the UPMIFA rules on spending, including the bracketed presumption, will not apply.

Institutions with Limited Investment and Spending Experience. Several attorneys general and other charity officials raised concerns about whether small institutions would be able to adjust to a spending rule based solely on prudence, without the bright-line guidance of historic dollar value. Some charity regulators who spoke with the Drafting Committee noted that large institutions have sophisticated investment strategies, access to good investment advisors, and experience with spending rules that maintain purchasing power for endowment funds. For these institutions, the rules of UPMIFA should work well. For smaller institutions, however, the state regulators thought that additional guidance could be helpful. After discussing strategies to address this concern, the Drafting Committee decided to include in these comments an additional optional provision that a state could choose to include in its UPMIFA statute.

The optional provision focuses on institutions with endowment funds valued, in the aggregate, at less than \$2,000,000. The number is in brackets to indicate that it could be set higher or lower. The number was chosen to address the concern of the state regulators that some small charities might be more likely to spend imprudently than large charities. The Drafting Committee selected \$2,000,000 as the value that might include most unsophisticated institutions but would not be overinclusive.

The optional provision creates a notification requirement for an institution with a small endowment that plans to spend below historic dollar value. If an institution subject to the provision decides to appropriate an amount that would cause the value of its endowment funds to drop below the aggregate historic dollar value for all of its endowment funds, then the institution will have to notify the attorney general before proceeding with the expenditure. The provision does not require that the institution obtain the approval of the attorney general before making the

distribution. Rather, the notification requirement gives the attorney general the opportunity to take a closer look at the institution and its spending decision, to educate the institution on prudent decision making for endowment funds, and to intervene if the attorney general determines that the spending would be imprudent for the institution. Although the Drafting Committee thinks that the prudence standard in UPMIFA provides adequate guidance to all institutions within the scope of the Act, if a state chooses to adopt a notification provision for institutions with small endowments, the Drafting Committee recommends the following language:

(-) If an institution has endowment funds with an aggregate value of less than [\$2,000,000], the institution shall notify the [Attorney General] at least [60 days] prior to an appropriation for expenditure of an amount that would cause the value of the institution's endowment funds to fall below the aggregate historic dollar value of the institution's endowment funds, unless the expenditure is permitted or required under law other than this [act] or in the gift instrument. For purposes of this subsection, "historic dollar value" means the aggregate value in dollars of (i) each endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time the donation is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund. The institution's determination of historic dollar value made in good faith is conclusive.

[SECTION 5. DELEGATION OF MANAGEMENT AND INVESTMENT

FUNCTIONS.

(a) Subject to any specific limitation set forth in a gift instrument or in law other than this [act], an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.

(c) An institution that complies with subsection (a) is not liable for the decisions or actions of an agent to which the function was delegated.

(d) By accepting delegation of a management or investment function from an institution that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state in all proceedings arising from or related to the delegation or the performance of the delegated function.

(e) An institution may delegate management and investment functions to its committees, officers, or employees as authorized by law of this state other than this [act].]

Comment

The prudent investor standard in Section 4 presupposes the power to delegate. For some types of investment, prudence requires diversification, and diversification may best be accomplished through the use of pooled investment vehicles that entail delegation. The Drafting Committee decided to put Section 5 in brackets because many states already provide sufficient authority to delegate authority through other statutes. If such authority exists, then an enacting state should enact UPMIFA without Section 5. Enacting delegation rules that duplicate existing rules could be confusing and might create conflicts. For charitable trusts, UPIA provides the same delegation rules as those in Section 5. For nonprofit corporations, nonprofit corporation statutes often provide comparable rules. A state enacting UPMIFA must be certain that its laws authorize delegation, either through other statutes or by enacting Section 5.

Section 5 incorporates the delegation rule found in UPIA § 9, updating the delegation rules in UMIFA § 5. Section 5 permits the decision makers in an institution to delegate management and investment functions to external agents if the decision makers exercise reasonable skill, care, and caution in selecting the agent, defining the scope of the delegation and reviewing the performance of the agent. In some circumstances, the scope of the delegation may include redelegation. For example, an institution may select an investment manager to assist with investment decisions. The delegation may include the authority to redelegate to investment managers with expertise in particular investment areas. All decisions to delegate require the exercise of reasonable care, skill, and caution in selecting, instructing, and monitoring agents. Further, decision makers cannot delegate the authority to make decisions concerning expenditures and can only delegate management and investment functions. Subsection (c)

protects decision makers who comply with the requirement for proper delegation from liability for actions or decisions of the agents. In making decisions concerning delegation, the institution must be mindful of Section 3(c)(1) of UPMIFA, the provision that directs the institution to incur only reasonable costs in managing and investing an institutional fund.

Section 5 does not address issues of internal delegation and potential liability for internal delegation, and subsection (c) does not affect laws that govern personal liability of directors or trustees for matters outside the scope of Section 5. Directors will look to nonprofit corporation laws for these rules, while trustees will look to trust law. *See, e.g.*, RMNCA, § 8.30(b) (permitting directors to rely on information prepared by an officer or employee of the institution if the director reasonably believes the officer or employee to be reliable and competent in the matters presented).

The language of subsection (c) is similar to that of UPIA § 9(c) and RMNCA § 8.30(d). The decision not to include the terms “beneficiaries” or “members” in subsection (c) does not indicate a decision that this section does not create immunity from claims brought by beneficiaries or members. Instead, a decision maker who complies with section 5 will be protected from any liability resulting from actions or decisions made by an external agent.

Subsection (d) creates personal jurisdiction over the agent. This subsection is not a choice of law rule.

Subsection (e) notes that law other than this Act governs internal delegation. Section 5 of UMIFA included internal delegation as well as external delegation, due to a concern at that time that trust law concepts might govern internal delegation in nonprofit corporations. With the widespread adoption of nonprofit corporation statutes, that concern no longer exists. The decision not to address internal delegation in UPMIFA does not suggest that a governing board of a nonprofit corporation cannot delegate to committees, officers, or employees. Rather, a nonprofit corporation must look to other law, typically a nonprofit corporation statute, for the rules governing internal delegation.

SECTION 6. RELEASE OR MODIFICATION OF RESTRICTIONS ON MANAGEMENT, INVESTMENT, OR PURPOSE.

(a) If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution.

(b) The court, upon application of an institution, may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. The institution shall notify the [Attorney General] of the application, and the [Attorney General] must be given an opportunity to be heard. To the extent practicable, any modification must be made in accordance with the donor's probable intention.

(c) If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court, upon application of an institution, may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purposes expressed in the gift instrument. The institution shall notify the [Attorney General] of the application, and the [Attorney General] must be given an opportunity to be heard.

(d) If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, [60 days] after notification to the [Attorney General], may release or modify the restriction, in whole or part, if:

(1) the institutional fund subject to the restriction has a total value of less than [\$25,000];

(2) more than [20] years have elapsed since the fund was established; and

(3) the institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

Comment

Section 6 expands the rules on releasing or modifying restrictions that are found in Section 7 of UMIFA. Subsection (a) restates the rule from UMIFA allowing the release of a restriction with donor consent. Subsections (b) and (c) make clear that an institution can always ask a court to apply equitable deviation or *cy pres* to modify or release a restriction, under appropriate circumstances. Subsection (d), a new provision, permits an institution to apply *cy pres* on its own for small funds that have existed for a substantial period of time, after giving notice to the state attorney general.

Although UMIFA stated that it did not “limit the application of the doctrine of *cy pres*”, UMIFA § 7(d), what that statement meant under the Act was unclear. UMIFA itself appeared to permit only a release of a restriction and not a modification. That all-or-nothing approach did not adequately protect donor intent. *See Yale Univ. v. Blumenthal*, 621 A.2d 1304 (Conn. 1993). By expressly including deviation and *cy pres*, UPMIFA requires an institution to seek modifications that are “in accordance with the donor’s probable intention” for deviation and “in a manner consistent with the charitable purposes expressed in the gift instrument” for *cy pres*.

Individual Funds. The rules on modification require that the institution, or a court applying a court-ordered doctrine, review each institutional fund separately. Although an institution may manage institutional funds collectively, for purposes of this Section each fund must be considered individually.

Subsection (a). Donor Release. Subsection (a) permits the release of a restriction if the donor consents. A release with donor consent cannot change the charitable beneficiary of the fund. Although the donor has the power to consent to a release of a restriction, this section does not create a power in the donor that will cause a federal tax problem for the donor. The gift to the institution is a completed gift for tax purposes, the property cannot be diverted from the charitable beneficiary, and the donor cannot redirect the property to another use by the charity. The donor has no retained interest in the fund.

Subsection (b). Equitable Deviation. Subsection (b) applies the rule of equitable deviation, adapting the language of UTC § 412 to this section. *See also* Restatement (Third) of Trusts § 66 (2003). Under the deviation doctrine, a court may modify restrictions on the way an institution manages or administers a fund in a manner that furthers the purposes of the fund. Deviation implements the donor’s intent. A donor commonly has a predominating purpose for a gift and, secondarily, an intent that the purpose be carried out in a particular manner. Deviation does not alter the purpose but rather modifies the means in order to carry out the purpose.

Sometimes deviation is needed on account of circumstances unanticipated when the donor created the restriction. In other situations the restriction may impair the management or investment of the fund. Modification of the restriction may permit the institution to carry out the donor’s purposes in a more effective manner. A court applying deviation should attempt to follow the donor’s probable intention in deciding how to modify the restriction. Consistent with the doctrine of equitable deviation in trust law, subsection (b) does not require an institution to

notify donors of the proposed modification. Good practice dictates notifying any donors who are alive and can be located with a reasonable expenditure of time and money. Consistent with the doctrine of deviation under trust law, the institution must notify the attorney general who may choose to participate in the court proceeding. The attorney general protects donor intent as well as the public's interest in charitable assets. Attorney general is in brackets in the Act because in some states another official enforces the law of charities.

Subsection (c). Cy Pres. Subsection (c) applies the rule of cy pres from trust law, authorizing the court to modify the purpose of an institutional fund. The term “modify” encompasses the release of a restriction as well as an alteration of a restriction and also permits a court to order that the fund be paid to another institution. A court can apply the doctrine of cy pres only if the restriction in question has become unlawful, impracticable, impossible to achieve, or wasteful. This standard, which comes from UTC § 413, updates the circumstances under which cy pres may be applied by adding “wasteful” to the usual common law articulation of the doctrine. Any change must be made in a manner consistent with the charitable purposes expressed in the gift instrument. *See also* Restatement (Third) of Trusts § 67 (2003). Consistent with the doctrine of cy pres, subsection (c) does not require an institution seeking cy pres to notify donors. Good practice will be to notify donors whenever possible. As with deviation, the institution must notify the attorney general who must have the opportunity to be heard in the proceeding.

Subsection (d). Modification of Small, Old Funds. Subsection (d) permits an institution to release or modify a restriction according to cy pres principles but without court approval if the amount of the institutional fund involved is small and if the institutional fund has been in existence for more than 20 years. The rationale is that under some circumstances a restriction may no longer make sense but the cost of a judicial cy pres proceeding will be too great to warrant a change in the restriction. The Drafting Committee discussed at length the parameters for allowing an institution to apply cy pres without court supervision. The Committee drafted subsection (d) to balance the needs of an institution to serve its charitable purposes efficiently with the policy of enforcing donor intent. The Committee concluded that an institutional fund with a value of \$25,000 or less is sufficiently small that the cost of a judicial proceeding will be out of proportion to its protective purpose. The Committee included a requirement that the institutional fund be in existence at least 20 years, as a further safeguard for fidelity to donor intent. The 20-year period begins to run from the date of inception of the fund and not from the date of each gift to the fund. The amount and the number of years have been placed in brackets to signal to an enacting jurisdiction that it may wish to designate a higher or lower figure. Because the amount should reflect the cost of a judicial proceeding to obtain a modification, the number may be higher in some states and lower in others.

As under judicial cy pres, an institution acting under subsection (d) must change the restriction in a manner that is in keeping with the intent of the donor and the purpose of the fund. For example, if the value of a fund is too small to justify the cost of administration of the fund as a separate fund, the term “wasteful” would allow the institution to combine the fund with another fund with similar purposes. If a fund has been created for nursing scholarships and the institution closes its nursing school, the institution might appropriately decide to use the fund for other

scholarships at the institution. In using the authority granted under subsection (d), the institution must determine which alternative use for the fund reasonably approximates the original intent of the donor. The institution cannot divert the fund to an entirely different use. For example, the fund for nursing scholarships could not be used to build a football stadium.

An institution seeking to modify a provision under subsection (d) must notify the attorney general of the planned modification. The institution must wait 60 days before proceeding; the attorney general may take action if the proposed modification appears inappropriate.

Notice to Donors. The Drafting Committee decided not to require notification of donors under subsections (b), (c), and (d). The trust law rules of equitable deviation and cy pres do not require donor notification and instead depend on the court and the attorney general to protect donor intent and the public's interest in charitable assets.

With regard to subsection (d), the Drafting Committee concluded that an institution should not be required to give notice to donors. Subsection (d) can only be used for an old and small fund. Locating a donor who contributed to the fund more than 20 years earlier may be difficult and expensive. If multiple donors each gave a small amount to create a fund 20 years earlier, the task of locating all of those donors would be harder still. The Drafting Committee concluded that an institution's concern for donor relations would serve as a sufficient incentive for notifying donors when donors can be located.

SECTION 7. REVIEWING COMPLIANCE. Compliance with this [act] is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight.

SECTION 8. APPLICATION TO EXISTING INSTITUTIONAL FUNDS. This [act] applies to institutional funds existing on or established after [the effective date of this act]. As applied to institutional funds existing on [the effective date of this act] this [act] governs only decisions made or actions taken on or after that date.

SECTION 9. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT. This [act] modifies, limits, and supersedes the federal Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001, et seq., but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. Section 7001(c), or

authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. Section 7003(b).

SECTION 10. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

SECTION 11. EFFECTIVE DATE. This [act] takes effect

SECTION 12. REPEAL. The following acts and parts of acts are repealed:

(a) [The Uniform Management of Institutional Funds Act]

Strive for the Best: Building and Maintaining an Excellent Board

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Strive for the Best: Building and Maintaining an Excellent Board

Excellent boards are made, not born. Achieving excellence in board governance requires success in four crucial areas: capable leadership, a sound organizational structure, attention to fiduciary duties and a culture that binds the board members to each other in a cohesive unit.

Introduction

The nature of trusteeship has changed markedly in the new century. In addition to the mission-related and financial issues with which fiduciaries have always dealt, trustees of nonprofit organizations are now regularly required to make decisions in response to media scrutiny, challenges from regulators, demands from stakeholders and constituents, the requirements of increasingly complex investment strategies, the priorities of donors, and reputational threats to board members and the organizations they serve.

In contrast with the past, boards are being held to an ever-higher standard in which “getting by,” “muddling through” or “preserving the status quo” no longer suffice. Board seats are no longer viewed as honorary rewards for service or financial contributions, nor can the trustee’s oversight role be viewed as one of passive observation. How well a board functions determines, in large measure, the fortunes of the organization it governs. Mediocre or middling performance may enable an organization to survive, but rarely to thrive, while weak or dysfunctional boards may jeopardize their

organization’s very existence. Governance may have been a subject of less prominence in the past, but the current era is one in which regulators, the media, whistleblowers and dissatisfied constituents are quick to bring potentially harmful issues into sharp focus, scrutinizing both activity and inactivity. Only a high level of board performance can create and sustain the energizing, inspiring and motivating environment in which the organization and its constituencies can excel.

All boards should, in principle, aspire to a place in this upper tier of governing bodies. But what does excellence mean for a nonprofit board, and how is it measured? More important, how does a board map a path to that goal?

This paper attempts to serve as a guide for trustees and boards that aspire to excel, with particular emphasis on the board’s fiduciary role. We identify the practices and policies of excellent boards and the steps that nonprofits can take to put them into practice. While reviewing the functions of a board and its members, we also attempt to show what boards look like when they are at the top of their game.

The Board's Purpose and Roles

Overview

What makes a board “excellent”? One answer lies in the crucial difference between governance and management.

The board's role is strategic, not tactical. Its primary responsibilities are to establish and clearly articulate the mission of the organization, to hire a management team to run the organization in accordance with policies and objectives that further that mission, and to monitor progress toward the mission's fulfillment.¹ The execution of ongoing operations and the development and implementation of institutional programs are the responsibility of management and staff, not the board. On an ongoing basis, the board's role is one of oversight, in which it reviews and assesses management's success in carrying out its job.

Indeed, once the mission of the organization has been defined in its charter and bylaws, fiduciary principles require that the board guard that mission as it has been defined. In particular, the chair and trustees need to beware of situations in which, perhaps because new trustees have a point of view at odds with the organization's traditional role, the organization is led to diverge from its original charter in impermissible ways.

While the board does not manage, it does not simply preside. The board engages in active supervision of management and staff: this means setting standards that are clear and objective, being sure that position descriptions are known and understood, and ensuring that the actual running of the organization is well supervised by senior staff members. The board needs to have confidence that management is effectively running the organization and that staff are competently executing those actions that advance the mission. It is in this role of defining the mission and monitoring progress that the board provides purpose and direction for the staff, while in its oversight duties it remains focused on governance and avoids becoming involved in operations.

Fiduciary Principles as Guides to Behavior

A brief review of fiduciary duty, an important part of the English common law tradition that has been incorporated into state law throughout the U.S., emphasizes the need to remain aware of these key

¹ This may include modifying or revising the mission statement under certain circumstances.

principles. The classic definition of a fiduciary is one who acts in a position of trust or confidence on behalf of another. Fiduciaries are expected to handle the affairs of others with the same care and prudence that they apply to their own affairs.

From a nonprofit board's point of view, fiduciary responsibility is traditionally expressed in terms of three fundamental duties: care, loyalty and responsibility.²

- The *duty of care* requires that trustees not treat their role casually, but instead attend meetings, take reasonable steps to become well acquainted with all of the information and pertinent facts under the board's purview and bring their best judgment to bear in the board's deliberations and decisions.
- The *duty of loyalty* requires that trustees place the interests of the organization above their own. Where conflicts of interest do occur – whether with trustees' own interests or with the interests of another organization with which they are involved – policies must be in place to ensure that the conflict is disclosed and neutralized. The practice of recusal, in which the conflicted trustee takes no part in the decision – to the extent of leaving the room while the matter that is the subject of the conflict is discussed and voted upon – has become standard practice in the nonprofit sector.³
- The *duty of responsibility* requires that trustees maintain the organization's adherence to the purposes described in its charter and by-laws, following its policies in a disciplined and consistent manner in addition to complying with relevant laws and regulations.

Fiduciary Duty Embodied in Law

At endowed nonprofits, these three duties come into play most prominently in relation to the policies and practices that govern the investment and spending of the organization's perpetual funds. Responsibility for these matters is frequently delegated to an investment committee, subject to oversight by the full board. The

² The duty of responsibility is sometimes also referred to as the duty of obedience.

³ For example, among the 835 colleges and universities participating in the 2013 NACUBO-Commonfund Study of Endowments, the 56 percent that permit trustees to conduct business with the institution also report that they have a process for resolving potential conflicts; of this group 44 percent, or more than three-quarters, use recusal and disclosure and a further three percent use recusal only. Use of these policies is observed in similar proportions in parallel Commonfund studies of foundations, operating charities and independent schools.

Uniform Prudent Management of Institutional Funds Act (UPMIFA), introduced in 2006 and now the law in nearly all states⁴ and the District of Columbia, provides guidance in the investment and spending of donor-restricted funds. UPMIFA's governance language not only addresses the standard of prudence, which lies at the core of the law, but also guides fiduciaries by providing concise lists of issues that must be considered in investing, spending and delegating authority to third-party agents with respect to donor-restricted funds. Fiduciaries are guided to give a thorough airing to these matters through discussion and evaluation, and to record the process in written minutes. UPMIFA thus aids fiduciaries in understanding what they should do in order to reasonably assure themselves that they are in compliance with the law and with prudent standards of good governance.

Changes in the Nature of Board Service

The increasing attention that has been paid to these fiduciary duties by courts, regulators, lawmakers, stakeholders and the general public in the last decade has meant that board service has become more demanding. The type of person recruited for board membership, and the nature of the board commitment itself, have also changed. While in the past it was acceptable for busy people to “lend their name” to an organization by agreeing to become trustees, today there is no longer room for such “decorative” members. Harder-working boards are the norm: those who do not have the time or desire to play a full part can seek recognition and a measure of satisfaction on other, non-fiduciary, advisory boards that the organization may establish. For their part, trustees who have made the commitment to be fully engaged in and be supportive of the organization's mission contribute effectively to the board's deliberations and decisions and derive satisfaction from knowing that their contribution is not a casual one.

Beyond these fundamental governance duties, board members are increasingly being called upon to fulfill other important roles. One is to be the public voice of advocacy, articulating the case for the institution and its mission. Closely linked to this is the task of bringing the full benefit of their personal and professional contacts to the fiduciary function. This is one important reason – though not the only one – that boards seek diversity of experience and talents in recruiting new members.

The institution's mission can be fulfilled at a higher level if board members are able to call upon a broad range of social and business connections, not just for fund-raising but to enable the institution to benefit from the efficiencies created through the best use of all its resources.

Fiscal Health and the Board

One of the most important functions of the board—though often overlooked—is the preservation of the fiscal health of the institution. This is often interpreted to mean donating to the organization and raising funds on its behalf, but more is involved.

Fund-raising is obviously an important part of fiscal stability. In that regard, some degree of financial contribution, proportional to a trustee's means, is usually required of board members. Not every donor, however, wants to become a fiduciary or has the time and skill to govern a nonprofit organization. For this reason, major donors should not automatically be invited to become board members.

The idea of a separate, nonfiduciary, advisory board has recently gained currency as a body that can benefit the organization by giving donors recognition and an opportunity to express their support for the organization while insulating them from fiduciary responsibilities and their attendant potential liability. Non-trustee advisory boards also present a useful way to respond to individuals who may promise gifts in expectation of an opportunity to influence the direction of the organization, and to allow the board to assess a potential board candidate's qualifications for future board membership.

Board Structure, Composition and Other Key Attributes

The structure of a board can help or harm its effectiveness, and consideration of these matters is important to improving a board's performance. In this section, we discuss the dynamics related to the structure and membership of effective boards.

⁴ Pennsylvania has its own law, which is similar in spirit.

Size

Until recently, boards were frequently quite large. Boards with 20 or more members were common, and those with upward of 30 trustees or more were not unheard of. The presence of honorary members – often substantial donors – was also customary. These practices have changed. According to BoardSource, the average size of a nonprofit board in the U.S. is now 16 members.⁵

While there is no “right” size for all organizations, the guiding principle has become that smaller boards are generally thought to function better, particularly with respect to efficient workflow and process management. In such bodies it can be easier to schedule meetings, secure a quorum and communicate among members. Smaller boards may also share a greater sense of camaraderie – a crucial characteristic of superior boards – and the costs related to board activities will likely be lower. In order for smaller boards to avoid becoming overburdened, the chair may establish ad hoc committees or working groups to deal with specific issues and make recommendations to the full board; the non-fiduciary advisory panels discussed in the previous section can also fulfill this function for specific issues within their area of expertise by assisting in the work of committees.

The Board Chair

The single most crucial factor in the success of this model is the selection of the individual who will serve as the board chair. The diligence, commitment and character of the chair determine the board’s agenda and the way committees are populated, and help to ensure that board and staff view the mission in the same way.

Leader, spokesperson, advocate, facilitator, source of authority: the role of the chair is the most important on the board, and the most demanding and time-consuming. The chair is a guarantor of board effectiveness, enabling individual board members to contribute meaningfully to its work. At the most basic level, the chair:

- Presides at board meetings
- Facilitates the work of the committees, often serving as an ex officio committee member

- Serves as the chief liaison with the president or executive director of the organization
- Works with the board’s executive committee and the president or executive director to prepare the agenda for board meetings
- Protects and defends the mission of the organization and maintains the integrity of the bylaws
- Inspires board members and senior staff to perform their work in pursuit of the mission of the organization
- Is a good listener, creating and maintaining a culture conducive to teamwork, collaboration and mutual respect
- Serves as mentor to new and experienced members of the board who may be confronted with a difficult task or decision
- Leads periodic board self-assessment exercises to build on board strengths and identify and strengthen deficiencies
- Advocates internally and externally for the organization before beneficiaries, regulators, legislators, donors, news media and the public, forging links with key constituencies

Board Recruitment and Diversity

If a board is to be successful, the board chair and trustees must be identified, nurtured and sustained. Successful boards thus begin with the recruitment process.

It is important that there be a strong nominating committee or board development committee to vet potential members. The central functions of such a committee include identifying and communicating candidly with potential trustees, explaining to them the role of the board and their own roles and responsibilities as prospective trustees, and probing to understand why the individual wants to serve. Beyond recruitment, however, the committee has a more strategic role in shaping the board as a strong, dynamic entity that understands its function and actively seeks to improve its performance.

To take one example, a board should ideally be composed of people with varying backgrounds, perspectives, experiences and expertise. A board that is too homogeneous will not benefit from the range of perspectives that leads to vigorous, well-

⁵ BoardSource Nonprofit Governance Index 2012, Data Report 1: CEO Survey of BoardSource Members, p. 10 (2012). <http://www.boardsource.org>.

rounded discussion and examination of key issues and decisions. There can be exceptions. Audit committees are frequently populated by CPAs, auditors and lawyers. Similarly, investment committees benefit from having members with specialized knowledge and relevant industry experience. Even then, however, it is not necessary for every member of the investment committee, whether a trustee or a non-trustee member, to be an investment professional. Laypeople may raise issues that provoke deeper discussion and prod the committee to take a second look at questions that may have been dismissed too easily.

Training and Ongoing Education

New board members who are thoughtfully recruited and carefully vetted are the lifeblood of the high-functioning board. It cannot be assumed, however, that new trustees coming from a business or professional background – no matter how successful they may have been – will automatically grasp the nuances of nonprofit governance, which may frequently seem foreign to them.

Board orientation is the first crucial step. In the weeks leading up to their first meeting as trustees, new board members should attend, as a class, a briefing led by the board chair or the nominating or board development committee along with the chief executive officer. The format may vary; a popular setting is a day-long or weekend-long retreat prior to a full board meeting, but there might instead be a series of shorter sessions focused on specific topics. It is beneficial if some or all incumbent board members attend in order for the new trustees to meet and begin the process of bonding with their colleagues. One highly useful practice is for an incumbent board member to be assigned to mentor an incoming trustee, thereby accelerating and smoothing the transition to a comfortable role on the board. This process of assimilating new trustees can also assist in increasing their retention for further terms of board service.

A range of materials should be provided to the new board member before and during formal orientation. These include fundamental organizational documents such as the organization's and board's policy manual or handbook, the bylaws, a copy of the most recent annual report, the strategic plan, the current budget, the investment policy statement, a history of the organization and its traditions, a calendar of board and

committee meetings, and a definition of the roles and responsibilities of fiduciaries. It may be helpful to request that the organization's legal counsel be made available to address the latter topic and, at the same time, to discuss rules and regulations and important but sensitive issues such as how the organization's policies on conflicts of interest apply to the board.

Committees of the Board

Much of the real work of effective boards is carried out at the committee level. Common types of standing committees include those overseeing the audit, investment and finance functions; also frequently found are committees devoted to strategic fund-raising (sometimes called development or institutional advancement), governance or board development, compensation and human resources, and strategic planning. Many boards also have an executive committee, which can be empowered to decide certain types of issues between meetings of the full board. According to BoardSource, nonprofit boards have an average of 5.5 committees.⁶

Governance Committee

This committee, to which we have referred previously, is sometimes also referred to as the board development or nominating committee and is charged with seeing to the long-term health of the board, evaluating the board's, and board members' current performance and anticipating future needs. This committee seeks to ensure that the mix of experience and skills of current and future trustees is matched with the evolving needs of the organization. It also addresses weaknesses or shortcomings in the current board and, importantly, seeks to identify individuals who may in the future serve as board chairs.

Development Committee

For organizations that seek to raise funds on an ongoing basis, the development or advancement committee leads efforts to enhance the organization's endowment, to support long-term strategic or programmatic initiatives and to fund capital projects. While fund-raising has traditionally been regarded as a comparatively tactical function, with episodic campaigns punctuating periods

⁶ BoardSource Nonprofit Governance Index 2012, Data Report 1: CEO Survey of BoardSource Members, p. 11 (2012). <http://www.boardsource.org>.

of relative inactivity, most organizations now recognize that the cultivation of donors at all levels (and especially of major donors) has become a strategic function and have increasingly taken steps to recruit and staff the development office at a level appropriate to the organization.⁷

Finance Committee

The finance committee assists the board with its fiscal responsibilities by overseeing the organization's ongoing financial operations, reviewing budgets and periodic financial reports, and forecasting future financial needs, usually in coordination with the organization's internal financial staff. At endowed organizations the need for close coordination between this committee and the investment committee is self-evident, and joint meetings once or twice a year, supported by regular ongoing communications, have become a feature of effective boards.

Investment Committee

The investment committee, found at organizations that possess endowments or other long-term pools, is charged with fulfilling the intentions of donors with respect to donor-restricted funds and of maintaining the endowment fund's purchasing power, ideally into perpetuity. Duties of this committee include creating and maintaining an investment policy, setting the investment portfolio's policy asset allocation, developing an appropriate spending policy, rebalancing the portfolio on a regular basis and providing an annual report to the board on the state of the endowment. As noted, the investment committee should work in close coordination with the finance committee and the organization's senior staff; at smaller nonprofits, the investment committee is often a subcommittee of the finance committee. Together, these two groups should determine and recommend to the board a sustainable spending practice for the endowment.

Audit Committee

The audit committee oversees the organization's external audit function, primarily through selecting and working

with an independent outside audit firm. Its role is broader, however, and encompasses the integrity of the organization's financial reporting process. In particular, since 2002 the influence of the federal Sarbanes-Oxley Act has meant that nonprofit organizations, like the for-profit public corporations for which the law was originally written, have tended to make the audit committee independent. Furthermore, in many organizations the audit committee has become the body authorized to deal with issues such as enforcement of the organization's policies regarding ethical conduct and whistle-blowing and ensuring that the organization is in compliance with all legal and regulatory requirements. For these reasons, recruitment of an individual of integrity and character to serve as audit committee chair has become a crucial matter.

Human Resources Committee

The human resources committee focuses on the policies and practices that support and govern the nonprofit's staff and employees. Special attention is paid by this committee in particular to the senior executives of the organization who are charged with implementing the board's mission and vision.

Strategic Planning Committee

The strategic planning committee reviews and assesses internal organizational strengths and weaknesses and external long-term opportunities and threats in the context of the environment in which the organization must function in the future. In carrying out its charter, this committee coordinates closely with other board committees and staff in recognition of the fact that effective strategic planning is a collaborative effort. The strategic planning process is discussed more fully below.

Documentation of Committee Structure

Documentation of committee responsibilities is an important part of a properly-functioning board. There should be written job descriptions for the main officers of the board—typically the chair, vice chair, treasurer and secretary—and for the chairs of standing committees.

These standing committees should be identified in the bylaws, and for each there should be a written charter or description of its function and responsibilities. Ad hoc committees, formed to accomplish specific projects or

⁷ See, e.g., J. Griswold and W. Jarvis, "Essential Not Optional: A Strategic Approach to Fund-Raising for Endowments", Commonfund Institute, 2012. <https://www.commonfund.org/InvestorResources/Publications/Pages/WhitePapers.aspx>.

tasks, should receive their charters in the form of board resolutions and their reports should be recorded in the minutes of the board meeting at which they occur.

The Executive Director or President

Perhaps the most critical task for the board is to select, hire, support, evaluate and, if necessary, replace the president or executive director of the organization. This individual has primary responsibility for carrying out the institutional priorities established by the board and for enabling the institution to achieve its strategic goals and objectives by staff members to execute specific plans and programs.

Paramount to the success of the ongoing relationship between the executive director and the board are a clear position description and agreed-upon goals and objectives. Without them, it is difficult to know if the executive is satisfying the board's expectations.

The likelihood of retaining an effective staff leader is enhanced when:

- There is a positive and trusting relationship with the board chair and individual trustees
- The board has confidence in the chief executive's ability to inspire and motivate staff, maintain focus on mission and objectives and use resources wisely
- Communications between the executive and the board are open, honest and frequent
- The parties work as partners, with each respecting the other's roles and responsibilities (an effective board will delegate rather than try to interfere in the work of the chief executive).
- A constructive annual evaluation of the chief executive, including a self-evaluation, is conducted

Strategic Planning

One of the board's central functions is strategic planning. While sometimes mistaken for an exercise in unconventional thinking and visionary thought, strategic planning is in fact nothing more than being able to see the organization clearly in its current environment, assess its strengths and weaknesses honestly, and calibrate what it will need to continue to thrive and fulfill its mission in the future.

A Word on Senior Staff Recruitment

Identifying, hiring and retaining a talented president or executive director are all critical tasks for the high-functioning board. A search committee, often assisted by an outside consultant, is usually formed to lead this recruitment process, but it should seek input from members of the standing board committees as it creates the position description and identifies the qualifications and personal qualities it wants in this person. Once that individual has been identified, an essential step prior to hiring should be a thorough background check including input from previous employers, a check of credit history and confirmation of the candidate's educational background and professional qualifications.

What is (and is not) a Strategic Plan?

Three important characteristics can help to define an organization's strategic plan:

- First, it is not a short-term operational plan. Operational plans are needed and can serve as stepping stones in implementing the long-term strategic plan, but they are usually part of the larger strategic plan, not a separate document.
- Second, a strategic plan is not to be placed on a shelf once the review process is completed. It is a living document that should be reviewed and refined every two or three years. Such a review need not involve complete or drastic change unless it is warranted, but the plan needs to evolve with the needs and capabilities of the organization.
- Third, a strategic plan should not be wordy, complex or convoluted. Here, simplicity is a virtue. Planners should avoid falling into the trap of creating a document that may not be well understood and which, therefore, may be less than enthusiastically supported by those responsible for implementing it.

A standing committee of five to eight people, made up of both board and senior staff members, should be responsible for creating and maintaining the strategic plan. This group may call upon consultants or other external resources (including, if required, an outside facilitator) and should also reach out to relevant internal and external constituencies to encourage a process that is both broad and deep.

The process should involve a review of the organization's long-term mission and position in its community, an attempt to define the critical issues confronting the organization and an examination of how changes in the external environment are expected to affect the organization in the future. The classic analysis of strengths, weaknesses, opportunities and threats (sometimes called a SWOT analysis) is a good place to start. Ultimately, the strategic plan should embody in writing the organization's mission statement, set goals for the future, articulate the strategies by which the organization intends to achieve those goals, and define appropriate measures of progress.

Putting it All Together

How does a board take the necessary steps toward improvement? Some measures are administrative – for example, reviewing the board's committee structure and decision-making process, creating charters and descriptions of roles for committee chairs and a position description for the chief executive. Perhaps the greatest positive impact, however, comes from cultural forces inside the board and organization. What are the elements of a culture that can support a first-rate governing board?

First and most important is trust among the board members, the chair and the senior staff. This binding together of the individuals on the board yields several specific beneficial outcomes. One is the elimination of functional silos and narrow mindsets that can result in turf battles or in refusal to become involved outside the well-defined limits of a particular committee or function. This climate of trust must be created from the

top, with the board chair serving as the role model and this behavior as the template for committee chairs and committee members.

According to Jeffrey Sonnenfeld of the Yale School of Management:

It's difficult to tease out the factors that make one group of people an effective team and another, equally talented group of people a dysfunctional one; well-functioning, successful teams usually have chemistry that can't be quantified. They seem to get into a virtuous circle in which in one good quality builds on another. Team members develop mutual respect; because they respect one another, they develop trust; because they trust one another, they share difficult information; because they all have the same, reasonably complete information, they can challenge one another's conclusions coherently; because a spirited give-and-take becomes the norm, they learn to adjust their own interpretations in response to intelligent questions.⁸

It follows, as we have noted, that recruitment remains crucial to the task of creating a board that can excel. Effective board members need not be heroic leaders or deep visionary thinkers, but they must be thoughtful and authentic individuals who can inspire by example and motivate others in a non-threatening way.

The experience of serving on a high-functioning board can be tremendously uplifting. The knowledge that one's fellow trustees are united in the pursuit of something that none could accomplish alone represents for many the peak of service, in which the whole is indeed greater than the sum of its individual parts. Conversely, without that spirit of cooperation and unity, many crucial goals and objectives can remain beyond reach.

8 "What Makes Great Boards Great," Harvard Business Review, September 2002.

On Transparency

- In the wake of corporate scandals such as Enron, Tyco and WorldCom in the early 2000s, there has been an increasing push for greater transparency among for-profit and not-for-profit organizations alike.
- Transparency is very often mistaken for its near-synonym, disclosure, but they are not the same. Disclosure – the communication of material information – is familiar as something required under law and many codes of ethics. Transparency, on the other hand, is one of the beneficial outcomes of a culture of trust. At its highest level, it nurtures in the organization a culture of inquiry in which appropriate communication and discussion of all topics is permitted and openly encouraged.
- Issues such as compensation or money matters, or the challenges of dealing with trustees or staff who may not be performing well, can be addressed by a strong board chair resolved to improve the environment in a constructive way. Such an individual can make it clear, politely but firmly, that there is an appropriate way to raise such matters within the board environment.
- One tool for increasing transparency is candor, a quality that is sometimes misunderstood as rudeness or pushiness but can, in cases involving governance, more often take the form of an honest expression of puzzlement or a request for more information. In this context, while not every member of the board needs to be an expert on every single agenda topic, the exercise of fiduciary duty requires trustees to balance deference to expertise with the ability to inquire, thereby fulfilling their responsibility for oversight.
- While transparency is central to good governance, the board must be discerning and cognizant of those times when the need for confidentiality is critical. For example, when legal counsel is advising a nonprofit's trustees or officers it is important that the advice not be shared with third parties in order to maintain the protection of the attorney-client privilege. In sum, transparency should prevail in the conduct of board affairs, with confidentiality being the exception when mandated by circumstances.

Finally, it is essential to create a measurement system for the board that is comprehensible, relatively simple and not susceptible to manipulation. While overall organizational success can be measured in relation to the organization's mission as well as in financial terms, boards need reasonably objective methods of assessing their own accomplishments, recognizing areas for improvement and developing appropriate action plans. Board self-assessment is a field that is still developing; despite its imperfections, however, a board should attempt on a regular basis to obtain a comparatively objective set of measurements by which it can judge its success against the goals it has set for the organization and itself.

Excellent boards are built on a clear understanding of their duties as fiduciary and governing bodies of nonprofit organizations. Rooted in that foundation, a board is positioned for maximum effectiveness when it can benefit from strong leadership by the chair, a properly structured committee system, engaged and committed members and a sound relationship with senior staff managers, most importantly the president or executive director. Cultural attributes such as leadership, trust, transparency and candor are an essential adhesive that binds the board together and constitutes the indispensable ingredient in the formula for success. As more boards work to improve their operations and those of the institutions they serve, these tangible and intangible characteristics of successful boards can serve as guideposts to measure their progress toward excellence.

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Asset Allocation and Governance Review
Idaho Board of Land Commissioners



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November 24, 2014

EXECUTIVE SUMMARY

I. Introduction and Background

Callan was retained by the Idaho Board of Land Commissioners (Land Board) in May 2014 to review the findings and recommendations of the Subcommittee on Endowment Governance and identify shortcomings and make recommendations for improvement; review the internal policies and procedures of the Idaho Department of Lands (IDL) regarding valuation and forecasting methodologies; and conduct an asset allocation study incorporating the IDL-managed land assets with the financial assets overseen by the Endowment Fund Investment Board (EFIB).

II. Governance Summary and Conclusions

In order to gain a better understanding of the issues and the opinions of those close to the process, Callan reviewed relevant current and historical documents and interviewed members of the Land Board, Land Board staff, the IDL director and staff and the Manager of Investments for the EFIB. As a result of our review, a number of issues were identified as weaknesses in the governance structure based on current best practices. Our recommended improvements to the governance structure are designed to mitigate the concerns as well as address the weaknesses. We prioritized the recommended governance improvements as follows:

Priority 1: Clearly Established Objectives

The mission statement as expressed in the Idaho Constitution is to manage the endowment lands “in such manner as will secure the maximum long term financial return to the institution to which granted”; however, there is little context around this objective. The Land Board must operate within the framework of Constitutional and statutory conditions which impact the current stated objective. Callan notes that these constitutional conditions may temper the objective of maximizing financial returns. The Land Board needs to determine what position, over the long-term, endowment lands play in the portfolio given legal constraints and authority.

A comprehensive Investment Policy Statement should be developed for the combined Trust that identifies the investment objectives, risk management processes, risk tolerance (including connecting the risk taken in the asset allocation with that expressed in the distribution policy), the adopted asset allocation and rebalancing ranges, decision-making and the roles of each party involved in the investment process, how performance will be monitored and measured for each asset type, and the establishment of appropriate metrics and peer groups where relevant for both the land and financial assets. Elements of this policy have been set forth in various documents already including in the State Trusts Lands Asset Management Plan and the EFIB Investment Policy Statement.

The Investment Policy Statement should be a separate document distinct from the State Trust Lands Asset Management Plan. The Asset Management Plan should be re-oriented to be a strategic plan which covers the combined Trust and focuses on the long-term implementation of the Policy. This strategic plan should be supplemented by an annual plan.

Priority 2 - Align Expertise, Authority and Responsibility

The role of the Land Board should be one of strategic planning and policy setting. To fulfill its duty as a fiduciary, the Board should retain outside expertise to assist in the setting of policy and strategy as well as provide review of transactions. Additionally, the Land Board should re-examine current delegation of decisions to IDL to ensure they align with their expertise. An expert should be utilized to assist the Land

Board in areas where it lacks expertise. All recommendations provided by this expert should be reviewed independently for adherence to institutional processes and procedures.

Priority 3 – Independent Verification

Checks and balances exist in the management of the financial assets with the use of an independent board (EFIB) and use of outside expertise (consultant). Outside expertise and independent verification is lacking in some of the work that IDL conducts. IDL has been identified as an operational expert for timberland, rangeland, and agriculture. Under the trust but verify principle, IDL's operational recommendations and procedures should be reviewed and verified by an independent expert, who reports to the Land Board and not IDL. The addition of an outside expert advisor with knowledge of those issues faced by the Land Board, including review, reporting and monitoring of IDL investment activities, would help to create a fiduciary structure similar to that in place for the financial assets. The addition of an outside expert advisor with knowledge of those issues faced by the Land Board, including review, reporting and monitoring of IDL investment activities, would help to create a fiduciary structure similar to that in place for the financial assets.

A comprehensive independent outside financial audit is not conducted on the land asset portfolio as is done for the financial assets. An independent audit is an important check and safeguard on an expert's internal financial controls and accounting procedures. Currently, the independent auditor of the financial assets performs a limited review and testing of IDL accounting procedures annually, but does not express an opinion on endowment land financials as a whole. The Legislative Auditor also performs an examination every three years, but their emphasis is on compliance and not disclosure.

Priority 4 - Transparency

Further developing the supporting documentation and infrastructure consistent with modern institutional investment practice for land-related investments will improve transparency. Policies should be reviewed to ensure they clearly document the process by which investment decisions are made and be codified in an Investment Policy Statement. The policies should be logical, defensible and clear to stakeholders and other interested parties and lay out a road map for achieving long term objectives. The policies should define the roles of all parties and the criteria used to make decisions.

Priority 5 - Accountability

Institute a process to fairly measure IDL progress towards the achievement of goals and objectives established by the Land Board. After further clarifying the role of Idaho commercial real estate¹ in the portfolio, a revised and approved strategic plan should clearly describe appropriate measurement methodologies and reasonable performance objectives by asset class. The current Asset Management Plan lays out expected peer returns on assets by land asset class but there is no comparable information for the financial assets in the Investment Policy Statement for the fund. Periodic reporting to the Land Board should measure current performance and progress towards achieving long-term objectives as stated in the Investment Policy and consistent with the Asset Management/Strategic Plan.

The Land Board and the IDL should expand their view of the appropriate peer set for governance and operations. The peer set goes beyond regulatory requirements and other state land trusts and includes institutional investors such as endowments and state pension plans. This would provide a way to measure whether IDL is achieving its stated vision of being a "premier organization for trust management".

¹ Commercial real estate here refers to ownership of offices, retail properties, operating business etc.

Review of Sub-Committee Proposed Governance Structures

A number of recommendations were proposed by the Sub-Committee on Endowment Investment Governance in regard to governance issues including the modification of the level of decision making authority on timber sales contracts, land investment decisions deemed to be routine and special land investment decisions. There were also recommendations for cash flow which included a proposed 90%/10% rule for splitting proceeds from land disposal between the Permanent Fund and the Land Bank. Callan's conclusions on the Endowment Investment Governance Sub-Committee's recommendations include:

Conclusion: Callan supports the delegation of authority to make decisions to IDL and the Director where appropriate. We defer to the Sub-Committee and Land Board on what the applicable levels for each should be.

Conclusion: Callan believes the 90%/10% rule of splitting proceeds from land disposals is too rigid and premature. The Land Board needs to determine whether maintaining and/or growing the land base is a priority given the objective of maximizing returns of the total trust at an appropriate level of risk. There may be strategic considerations that are difficult to quantify in a formula. Land Bank monies could be allocated periodically consistent with the long term strategic and annual plans, as they are developed, rather than according to prescribed rule.

III. Revenue Forecasting Conclusions

The revenue forecasting methodology could be improved for all asset types except forestland and residential cabin sites. In particular, the revenue forecast for land types that are subject to leases should be based on the amounts that will be generated under the terms of the lease in the forecast years. The documentation of the process and verification of the forecasts could be augmented and improved across the board.

IV. Land Asset Valuation Policy Conclusions

The current practice of having a complete mass land appraisal using a sales comparable approach for forestland, rangeland, and agriculture should be discontinued. This valuation method does not provide an independent valuation of the entire asset (e.g. land and resource growing on the land) nor does it contain information that could be used by the IDL for performance measurement, or to improve its management or valuation practices, and it does not consider the particular constraints on the sale of land. It is also inconsistent with best practices.

Independent values will need to be established for the commercial portfolio by an expert as there are no recent independent, third party opinions of value. Callan believes external valuations are important to develop a baseline until the direction of the portfolio is more fully developed and for performance measurement purposes. Additionally, if a specialist real estate investment manager/consultant is hired to provide assistance on the portfolio, they will need current values to give appropriate advice on the properties.

The Land Board will need to determine a valuation approach for forestland and rangeland. The report identifies various options that could be taken by the Land Board for forestland and rangeland. Callan supports a process that incorporates an independent expert opinion and a discounted cash flow/income approach. There is little benefit to be gained from valuing smaller components of the portfolio such as agriculture for ongoing performance measurement given the de minimis holdings.

The valuation policy should be updated if the Land Board makes any changes to the current methodology.

V. Performance Reporting Conclusions

Callan proposes a summary report similar to that currently produced for the Endowment Fund Investment Board that would include the addition of market values for the IDL portfolio to reflect the asset allocation of the total endowment fund. We would rely on IDL to provide the monthly cash flows for their portfolio. A return would be calculated quarterly which would reflect cashflows in/out of the portfolio but hold the market value constant. Once a year a new valuation for the IDL portfolio could be calculated based on the valuation policy and methodology approved by the Land Board.

VI. Asset Allocation Results

The asset allocation study did not include an assessment of the impact of differing asset allocations on the current distribution policy. Dollar distributions to beneficiaries are calculated as a percent of the rolling three-year average of the individual endowment permanent funds. The earnings reserves are set by evaluating the volatility of the returns of the financial assets and land revenues. If an asset allocation mix is selected that deviates from the risk and return in the current mix, the Land Board will need to assess the impact on the distribution policy and make changes as necessary.

Four sets of potential allocations were constructed:

1. Allocations with only the existing investment types (stocks, bonds and Idaho lands) assuming that Idaho timberland and grazing land could be bought and sold to reach the desired allocations;
2. Allocations with only the existing investment types assuming that timberland and grazing land would be maintained at their current allocations;
3. The same assumptions as set 1 but with possible allocations to US real estate and private equity; and,
4. The same assumptions as set 2 but with possible allocations to US real estate and private equity

Sets 1 and 3 assume that any lands acquired would have investment characteristics similar to existing lands and an expected return of at least that of the existing assets.

The study developed a value for grazing land at \$61 million and timberland of \$1.15 billion. The total portfolio, IDL lands and financial assets, has a value of approximately \$3 billion. The expected long-term compound return of the existing combined portfolio is projected to be 6.7% nominal, or 4.45% real after adjusting for a projected inflation of 2.25%.

The study reached several important conclusions:

- The current total endowment allocation is reasonable and efficient.
- Timberland is a desirable investment across the range of asset mixes reviewed. Timberland has an attractive forecast return for the anticipated level of risk and diversifies other asset classes well. Consequently, the unconstrained computer model specified an allocation to timberland at or above its current level for all asset mixes evaluated. The model suggests that timberland investment could be expanded if the acquired properties are expected to perform at least as well as the existing timberland.
- Grazing land was included by the computer model in more conservative (lower risk) asset mixes. The return for grazing land provides reasonable compensation for its risk and diversifies bonds well. However both a lower return and less attractive equity diversification relative to timberland reduce its allocation to zero in higher return and risk mixes. If the asset mix chosen results in a reduction or elimination of the allocation to grazing land, potential sales or exchanges should be prioritized according to their expected contributions to returns with transactions executed as limitations permit. It would be counterproductive to dispose of grazing land quickly at a discount for the sole purpose of bringing the actual allocation in line with the target.

- The model shows investments in U.S. diversified, institutional real estate to be modestly attractive and private equity to be only marginally attractive. As a general rule, an allocation below 5% to an asset class does not contribute enough return to make it a worthwhile investment. This is especially true for investments such as real estate and private equity which are more complex investments than stocks and bonds. The computer model allocated less than 5% to private equity in all asset mixes evaluated. U.S. real estate could be an attractive investment for mixes with rates of return at or above those currently forecast for the EFIB portfolio.
- The model finds that the combination of Idaho timberland and grazing land with the EFIB investments at their current levels has a similar expected return but a volatility that is anticipated to be materially lower than that of the existing allocation containing financial assets alone. While there is no compelling reason to adjust the current EFIB asset allocation, other allocations could be considered. Increasing the public equity allocation as a percentage of public assets from the current 70% to 85% would boost the return by almost 0.4% annually at the expense of increasing the expected risk from 9.41% to 10.77%. Conversely, decreasing the public equity component to just under 60% would reduce the return by the approximately the same 0.4% annually while decreasing the risk to 8.12%.

The decision to maintain the existing mix or move to one of the alternatives should be done in conjunction with an evaluation of the impact on the distribution policy.

VII. Idaho Commercial Real Estate Portfolio

Callan has been asked to specifically address the role of Idaho Commercial Real Estate in the portfolio. Most of the stakeholders with whom we spoke were hesitant, for a variety of reasons, to grow the current Idaho commercial property portfolio, unless there was a compelling investment reason to do so. In Callan's opinion, there is not. The asset allocation work implies an allocation to a broadly diversified portfolio of U.S. real estate could, at best, play only a modest role in improving the diversification of the portfolio and there is no investment reason for an allocation to consist primarily of a concentrated position in Idaho properties. Further, Callan does not recommend ownership of single properties for the endowment.

Currently, appropriate decision-making and oversight is not in place for the ongoing management, analysis, or prudent divestiture of the existing Idaho commercial portfolio. Our report details recommendations designed to put in place a decision-making framework, including the hiring of a specialist real estate manager/consultant, reporting to the board, to provide the analysis and management expertise on the retention, disposition and management of commercial properties.

The decision-making and management framework to properly oversee the current commercial portfolio will also prove useful as a model for the evaluation and management of other non-routine land investment decisions. For example, consideration of whether to execute a ground lease with a tenant on a vacant parcel of land or purchasing more timberland or farmland.

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I. Governance

A. Introduction

The mission of the Endowment is to prudently manage Idaho's endowment assets to maximize the long-term financial returns to the beneficiary institutions.

Callan was retained by the Idaho Board of Land Commissioners (Land Board) in May 2014 to review the findings and recommendations of the Subcommittee on Endowment Governance and identify shortcomings and make recommendations for improvement; review the internal policies and procedures of the Idaho Department of Lands (IDL) regarding valuation and forecasting methodologies; and conduct an asset allocation study incorporating the IDL-managed land assets with the financial assets.

B. Governance Environment

Management of the endowment trust lands is entrusted to the State Board of Land Commissioners who serves as the sole fiduciary of both the land and financial assets. Per the Idaho Constitution, the Land Board is charged with managing the Endowment in such a manner as will secure the maximum long-term financial return to the beneficiary institutions. The Board must invest trust assets in compliance with the Idaho Prudent Investor Act which requires decisions to be made in the sole interest of trust beneficiaries and "manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust."¹ The duty of prudence requires Trustees to bring the appropriate level of expertise to the administration of the Trust. An implied duty of Trustees is also to preserve and protect the assets with a long-term perspective sensitive to the needs of both current and future beneficiaries.

The Endowment Fund Investment Board (EFIB) was formed to provide expertise and professional oversight to the investment of the revenues from lands. The IDL administers the management of the land assets.

C. Governance Structure

Governance is a framework of policies and procedures by which an organization ensures fairness, accountability and transparency. The framework consists of an understanding of expectations between the organization and its stakeholders; processes that minimize conflicts of interest; procedures that provide supervision and serve as checks and balances; and continuous monitoring.

Priorities of a good governance structure include:

- Clearly established mission with supporting reasonable objectives
- Alignment of expertise, authority and responsibility
- Independent verification
- Transparency
- Accountability – Monitoring process including metrics for assessing achievement or progress towards agreed upon objectives

D. Information Gathering

In order to gain a better understanding of the issues as well as the thoughts and opinions of those close to the process, Callan reviewed current and historical documents and interviewed members of the Land Board, their respective staffs, the Manager of Investments for the EFIB, and the Director of the Department of Lands during July and August. Some common themes emerged from our conversations:

¹ Idaho Statutes, Title 68, Chapter 5, Section 68-502

- Monies currently in the Land Bank, as well as those to be received from the sale of cabin sites, should be deployed quickly given the current low level of return in the Treasurer's pool.
- IDL and the EFIB have been operating in separate silos.
- Interviewees generally agreed that if commercial real estate is determined to be an appropriate asset class for investment, it is best implemented in a national or globally-diversified manner through the EFIB.
- Many felt that the Land Board should have a policy level decision-making role and should not be approving every individual transaction proposed by IDL.
- There was consensus that the IDL is not an expert in commercial real estate. The lack of expertise was noted both for acquisition analysis and asset management including establishing a longer term plan, renovation, change of use, deciding when to sell, and executing dispositions.
- All expressed their satisfaction with the governance structure surrounding the management and monitoring of the financial assets – professional staff, independent board, use of outside expertise (consultant) and performance reporting and monitoring.
- There is a general sense of dissatisfaction with the current State Trust Lands Asset Management Plan especially in regards to commercial real estate and an immediate need to address the ongoing issue of deployment of proceeds generated by the sale of cabin sites.
- Looking at recent press, there appears to be a general misunderstanding of the performance objectives of IDL compared to the financial assets as well as a generally negative view of the Endowment owning operating businesses that compete with the private sector and remove property from tax rolls.

E. Weaknesses in the Current Governance Structure

Callan has identified the following weaknesses in the current governance structure:

- Insufficient context around the constitutionally defined Land Board objective of maximizing return.
- The current State Trust Lands Asset Management Plan is a combination of investment policy and strategic plan.
- There are meaningful differences in the structure of decision making, performance expectation setting, use of outside experts and reporting for the financial assets compared to the land assets.
 - In the management of the financial assets, both internal (EFIB staff) and external (consultant) expertise is used. Checks and balances exist in the form of oversight by a multi-member professional board and external as well as internal preparation and review of performance.
 - IDL is making some investment decisions with implications to the Trust without any independent verification. The Land Board often relies on the recommendation and analysis of IDL without the use of outside sources of information or expertise.
- An elected Board may be influenced by politics, have short-term motives and incentives, and lack expertise, all of which may present conflicts to its fiduciary duty to act in the sole interest of the beneficiaries of the Trust. Incorporating additional expertise and policies and procedures to provide checks and balances will help to mitigate any potential conflicts of interest.
- The Land Board should be focused on the setting of policy and strategy. Much of the Land Board's time is spent reviewing individual transactions.
- IDL performance measurement and reporting could be improved.

F. Recommended Improvements to Governance Structure

Priority #1 – Clearly Established Objectives

The mission statement as expressed in the Idaho Constitution is to manage the endowment lands “in such manner as will secure the maximum long term financial return to the institution to which granted”. As noted previously, there is little context around this objective. The Land Board must operate within a framework of Constitutional and statutory considerations:

- Requirement that asset sales are conducted exclusively through an oral auction process with a minimum price set at appraised value.
- Condition specifying maximum sales of 320 acres per person over their lifetime

Callan notes that these constitutional conditions may temper the objective of maximizing financial returns. The Land Board needs to determine the role, over the long-term, that endowment lands play in the portfolio given current legal constraints and authority.

A comprehensive Investment Policy Statement should be developed for the combined Trust that identifies the following:

- Investment objectives – clearly state investment objectives in the context of the desired distribution policy.
- Risk tolerance – connecting the risk taken in the asset allocation with that expressed in the distribution policy.
- Appropriate asset classes – real estate, agriculture, other?
- Target mix and rebalancing ranges where appropriate
- How investment decisions will be made (including decisions about how revenues from lands are reinvested).
- How performance will be monitored, establishing appropriate metrics and peer groups where relevant – land and financial assets.
- Elements of this policy have already been set forth in various documents including in the State Trusts Lands Asset Management Plan and the EFIB Investment Policy Statement.
- The Investment Policy Statement should be a separate document distinct from the State Trust Lands Asset Management Plan. The Asset Management Plan should be re-oriented to be a strategic plan which covers the combined Trust and focuses on the long-term implementation of the Policy. This strategic plan should be supplemented by an annual plan.

Priority #2 - Align Expertise, Authority and Responsibility

The role of the Land Board should be one of strategic planning and policy setting. To fulfill its duty as a fiduciary, the Board should retain outside expertise to assist in the setting of policy and strategy as well as provide review of transactions. A re-examination and determination should be made by the Land Board regarding the appropriate delegation of decisions to IDL that aligns with their expertise.

An expert should be utilized to assist the Land Board in areas where it lacks expertise. All recommendations provided by this expert should be reviewed independently for adherence to institutional processes and procedures. Retaining a specialist real estate manager/consultant for the commercial properties will solve a number of concerns identified elsewhere in this report including appraisal, management, maximizing value, producing what if scenarios, and revenue forecasting. IDL is the recognized operational expert for timberland, rangeland, and agriculture and a different set of decision-making delegations will apply to ensure the Land Board retains policy-setting responsibilities.

Priority #3 – Independent Verification

Checks and balances exist in the management of the financial assets with the use of an independent board (EFIB) and use of outside expertise (consultant). Outside expertise and independent verification is lacking in some of the work that IDL conducts. IDL has been identified as an operational expert for timberland, rangeland, and agriculture, and has established comprehensive internal review processes for many routine investments (e.g. road construction and reforestation) and employs outside expertise in many of those activities. Under the trust but verify principle, IDL's operational recommendations and procedures should be reviewed and verified by an independent expert who ultimately reports to the Land Board and not IDL. This is not a new idea. "An investment mentality would require an independent review

of the in-house management and a separate and independent performance and monitoring system to assure the Land Board that it has hired an “expert” when it has hired itself as the manager.”² The addition of an outside expert advisor with knowledge of those issues faced by the Land Board, including review, reporting and monitoring of IDL investment activities, would help to create a fiduciary structure similar to that in place for the financial assets.

Unlike the financial asset portfolio, a comprehensive independent outside financial audit is not conducted on the land portfolio. An independent audit is an important check and safeguard on an expert’s internal financial controls and accounting procedures. Currently, the independent auditor of the financial assets performs a limited review and testing of IDL accounting procedures, but does not express an opinion on endowment land financials as a whole. The Legislative Auditor also performs an examination every three years, but their emphasis is on compliance and not disclosure.

Priority #4 - Transparency

Develop the supporting documentation and infrastructure consistent with modern institutional investment practice for land-related investments. Policies should be established that document the process by which investment decisions are made and be codified in an Investment Policy Statement. The policies should be logical, defensible and clear to stakeholders and other interested parties and lay out a road map for achieving long term objectives. The policies should define the roles of all parties and the criteria used to make decisions.

An example of a decision making process that is transparent is the current EFIB Distribution Policy. The policy was established by the Land Board recognizing the importance of balancing the needs of current and future beneficiaries of the Trust. Those affected by the policy may not always agree with the results but the process is transparent and defensible.

Priority #5 - Accountability

Institute a process to fairly measure IDL progress towards the achievement of goals and objectives established by the Land Board.

The EFIB has established investment objectives for the management of the financial assets: maintain the purchasing power of the Fund, maximize total return over time at an acceptable level of risk and provide relatively smooth and predictable distributions to beneficiaries.³ There is also a clearly established performance review process requiring monthly performance; evaluation of the sufficiency of earnings reserves; summary of significant actions taken by the EFIB; and any compliance issues or areas of concern.⁴

A revised (after further investment consideration of commercial real estate⁵) and approved strategic plan should clearly describe appropriate measurement methodologies and reasonable performance objectives by asset class. The current Asset Management Plan lays out expected peer returns on assets by land asset class but there is no comparable information for the financial assets. Periodic reporting to the Land Board should measure current performance and progress towards achieving long-term objectives as stated in the Investment Policy and consistent with the Asset Management or Strategic Plan.

The Land Board and the IDL should expand their view of the appropriate peer set for governance and operations. The peer set goes beyond regulatory requirements and other state land trusts and includes

² Endowment Fund Reform Progress Report, Robert Maynard, December 6, 2013

³ Endowment Fund Investment Board Investment Policy Statement, February 2014.

⁴ Idaho State Board of Land Commissioners, State Trust Lands Asset Management Plan, (December 20, 2011).

⁵ Commercial real estate here refers to ownership of offices, retail properties, operating business etc.

institutional investors such as endowments and state pension plans. This would provide a way to measure whether IDL is achieving its stated vision of being a “premier organization for trust management”.

G. Sub-Committee Proposed Governance Structures

The recommendations of the Land Board Sub-Committee on Endowment Investment Governance Strategy were forwarded to Callan Associates on September 19.

A number of recommendations were proposed in regards to governance issues: the modification of the level of decision making authority on timber sales contracts, land investment decisions deemed to be routine and special land investment decisions.

Callan opinion: Callan supports the delegation of authority to make decisions to IDL and the Director where appropriate. We defer to the Sub-Committee and Land Board on what the applicable levels for each should be.

A number of recommendations were proposed by the Sub-Committee in regards to cash flow:

- Land Bank to only be used to facilitate consolidation of lands, acquire access or acquire land for Public Schools
- 90% of the proceeds from land disposals go to the Permanent Fund managed by the EFIB, other 10% stays in the Land Bank for potential reinvestment in lands
- Non-Public School land proceeds flow to the Permanent Fund managed by EFIB unless there is an identified need to acquire access
- Land Board conducts biennial review of the Land Bank to determine if funds should be retained or transferred to the permanent Fund

Callan opinion: We feel that the 90%/10% rule of splitting proceeds from land disposals is potentially too rigid and premature. The Land Board needs to determine whether increasing the land base is desirable from an investment perspective. If the Land Board were to engage an outside expert to assist in the development of a long term strategic as well as an annual plan, land bank monies could be allocated on a periodic basis consistent with the plans.

COLORADO STATE LAND BOARD

Portfolio Goals and Portfolio Analysis



COLORADO
State Land Board
Department of Natural Resources

Portfolio Presentation
October 2, 2014

Outline

1. Portfolio Analysis Summary
2. Portfolio Management
3. Ownership and Characteristics
4. School Trust Estimated Value and Return
 - a) Total
 - b) Land
 - c) Minerals
 - d) Permanent Fund
5. Next Steps



Portfolio Analysis Summary

- \$4.1 billion School Trust estimated value
 - \$2.5 billion land
 - \$880 million minerals
 - \$725 million cash (Perm Fund)
- Estimated School Trust return
 - 4.7% income (\$193 million FY 13-14)



Portfolio Management

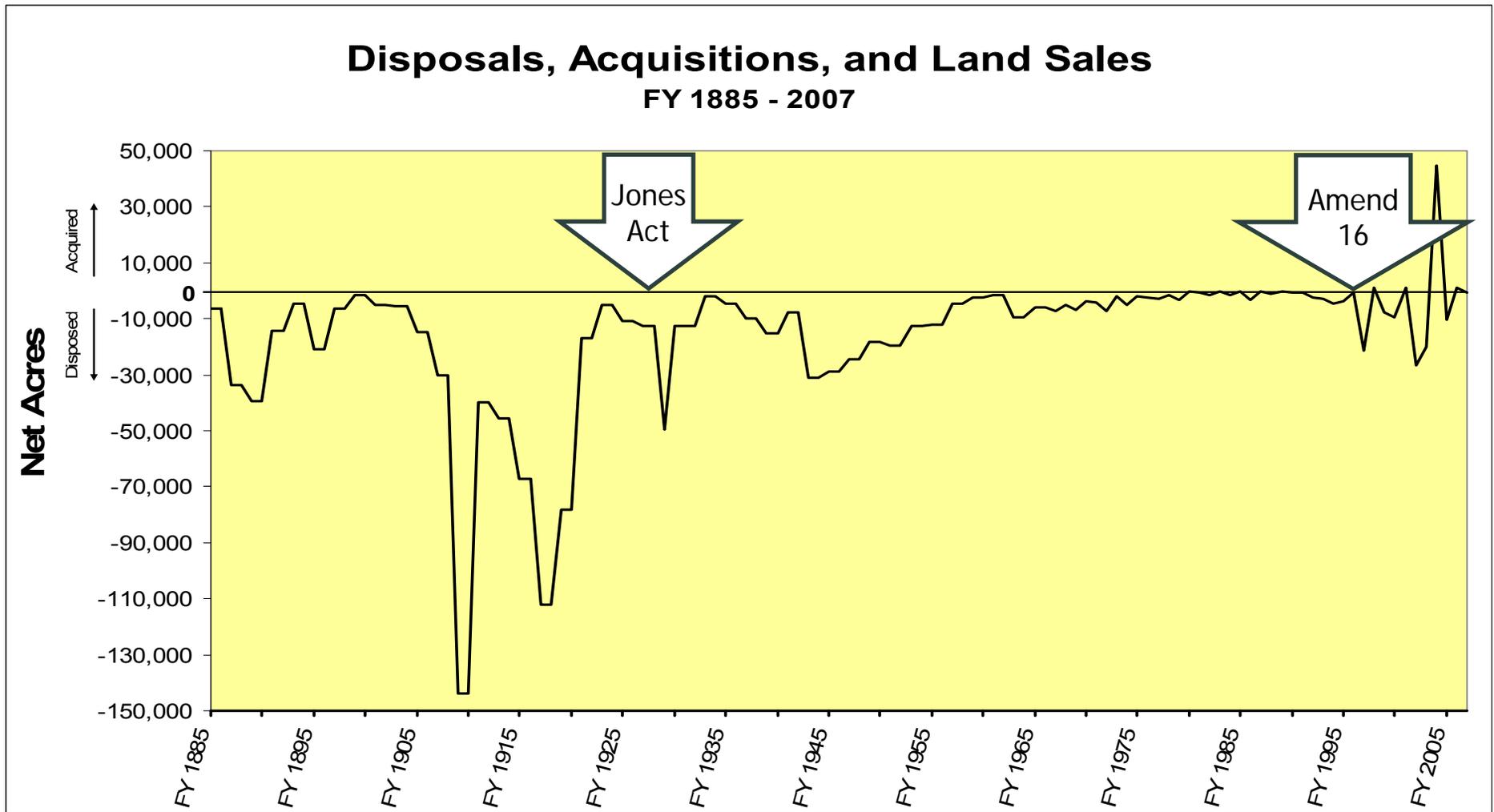
- Decrease Risk - Diversification
 - Investment Type
 - Investment Location

- Increase (Long-term) Returns
 - Income or Payout - 4% to 5%
 - Value Appreciation - 3% to 4%

- Strategies/Principals/Guidelines

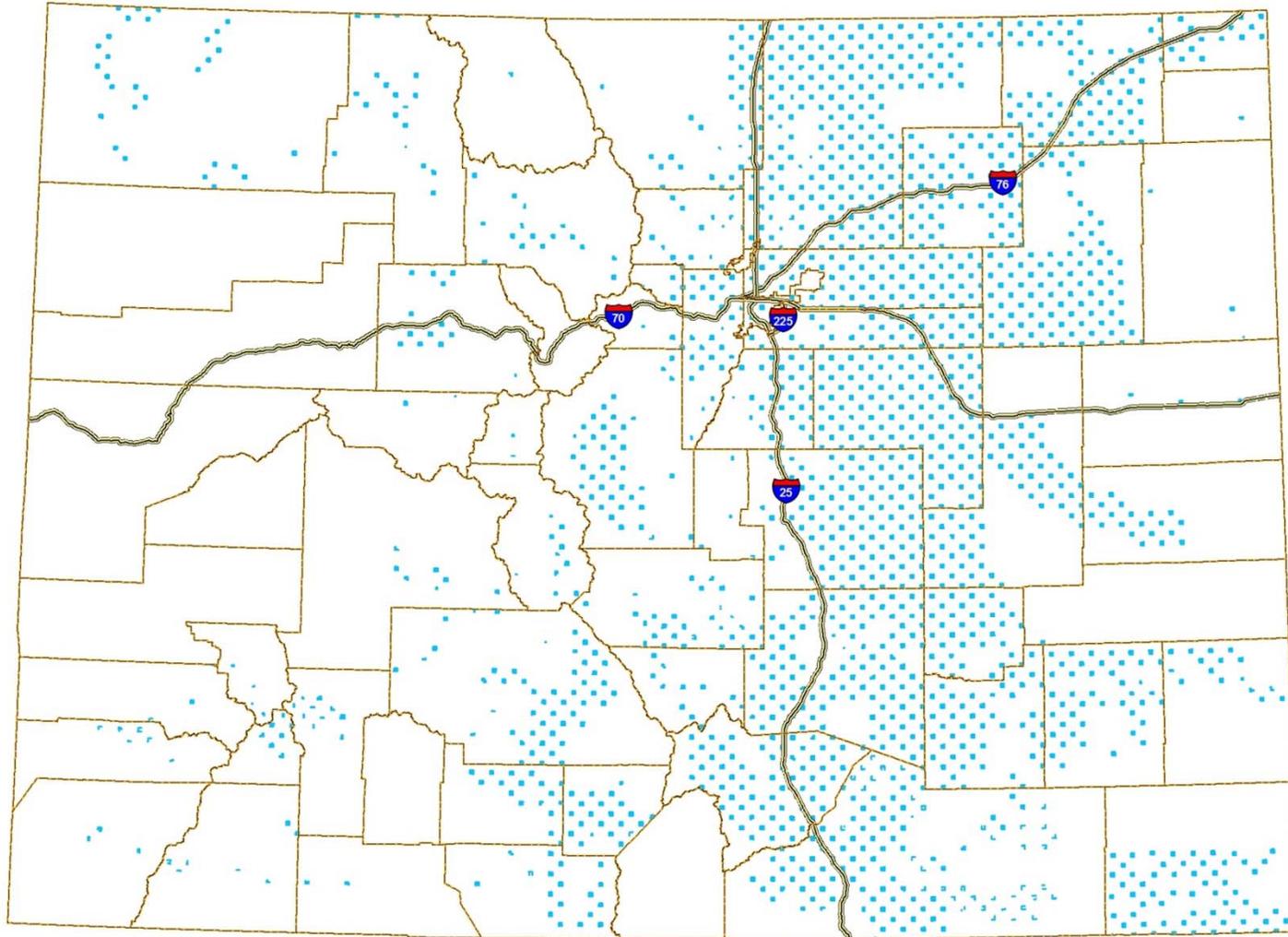


State Land Board Ownership



State Land Board Ownership

1876

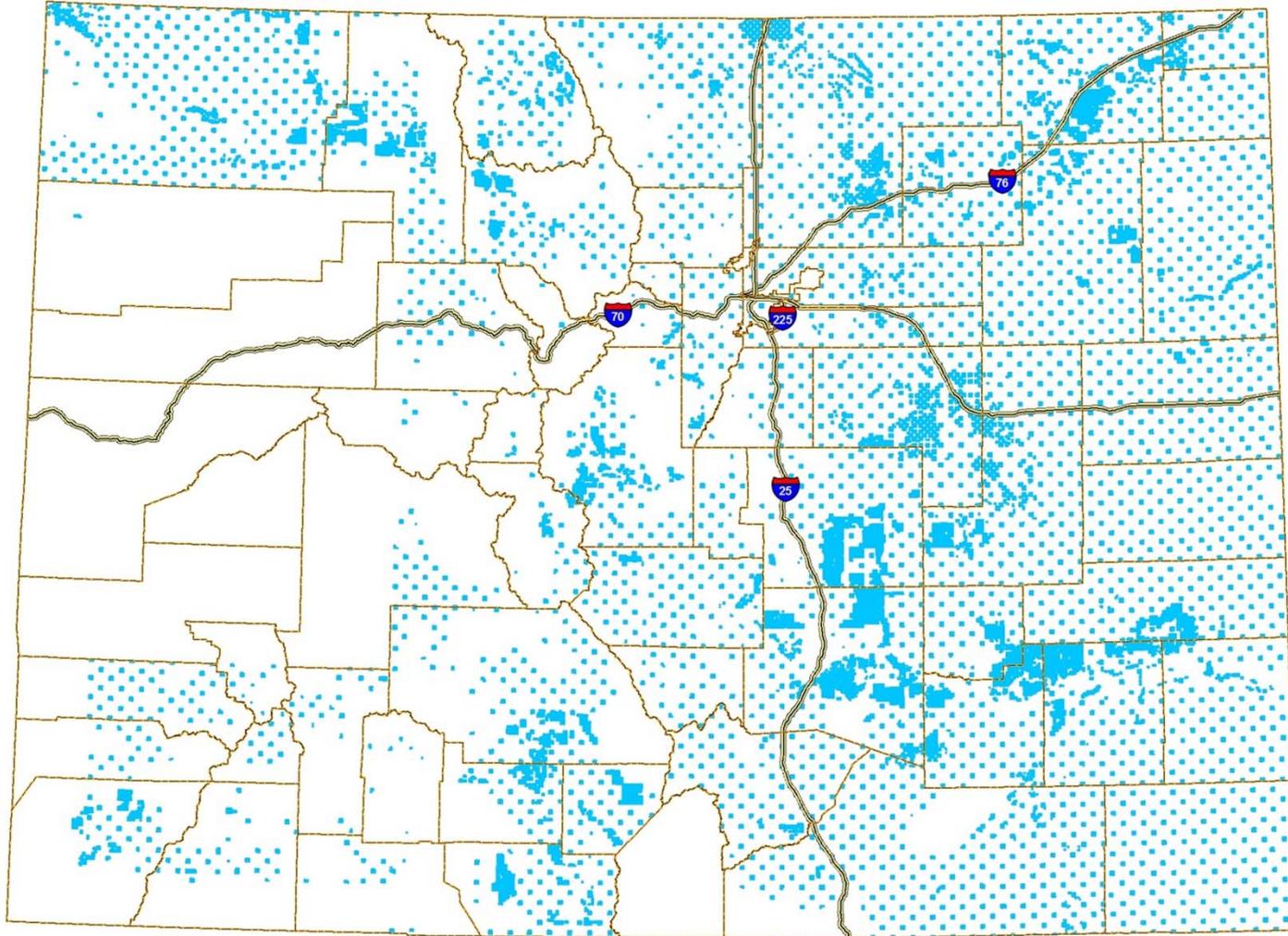


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State Land Board Ownership

All Other Federal Grants

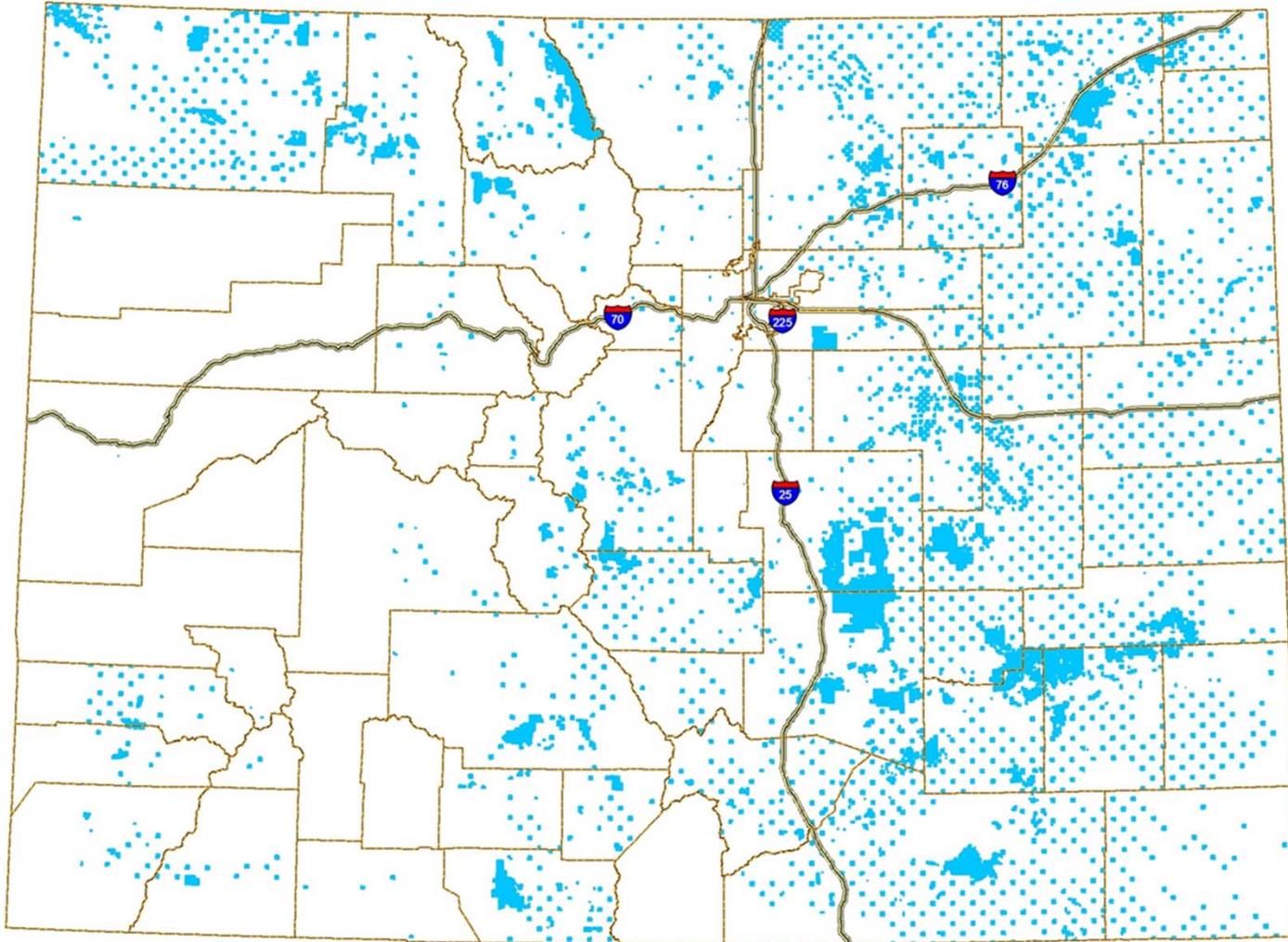


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State Land Board Ownership

Current Ownership



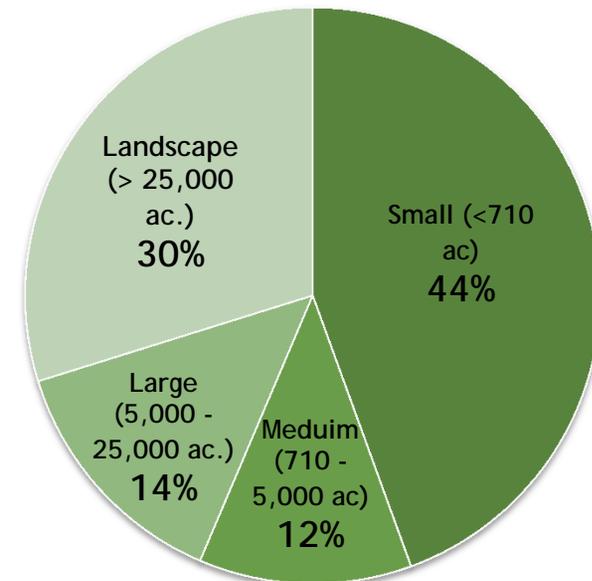
COLORADO
State Land Board
Department of Natural Resources

Portfolio Presentation
October 2, 2014

Portfolio Characteristics

- Ownership Size
 - 44% isolated parcels
 - 30% landscape properties
 - 14% large
 - 12% medium
- Location
 - 70% Eastern Plains
- Access
 - 60% adjacent to public roads
- Minerals
 - 30% severed mineral estate

State Trust Land Asset Size



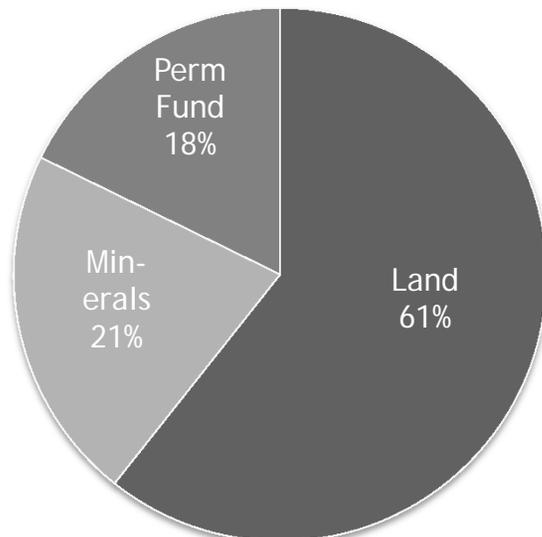
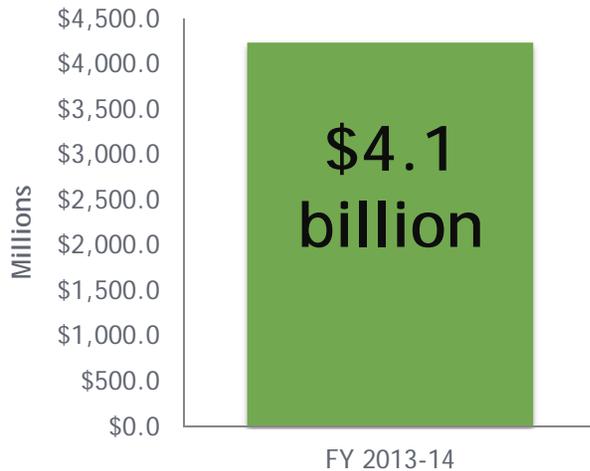
Portfolio Valuation Model

- Approximation, not precision
- Several valuation methodologies
- Repeatable
- Explainable
- Reasonable



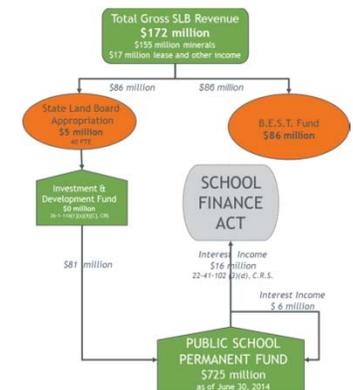
TOTAL SCHOOL TRUST

VALUATION 2014



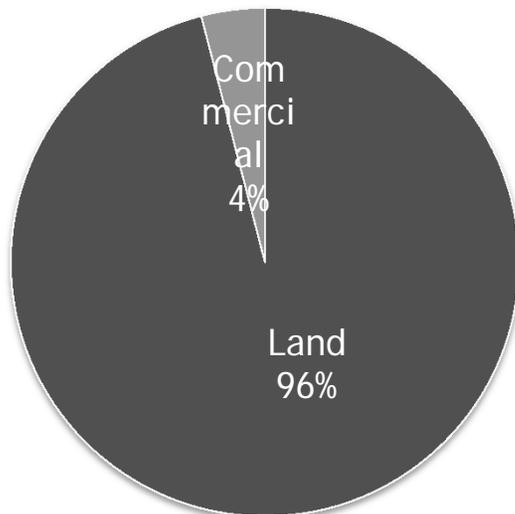
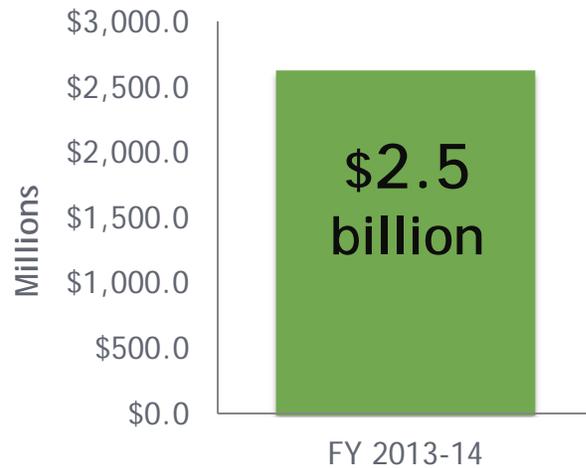
VALUATION SUMMARY

- 4.7% income return (\$193 million)
- Valuation
 - \$2.5 billion land (comp sales)
 - \$880 million minerals (income)
 - \$725 million cash (face value)
- \$107 million "distributed " (2.6% of value)
 - \$86 million BEST
 - \$16 million School Finance
 - \$5 million SLB operating
 - \$0 million I&D Fund



LAND

VALUATION 2014

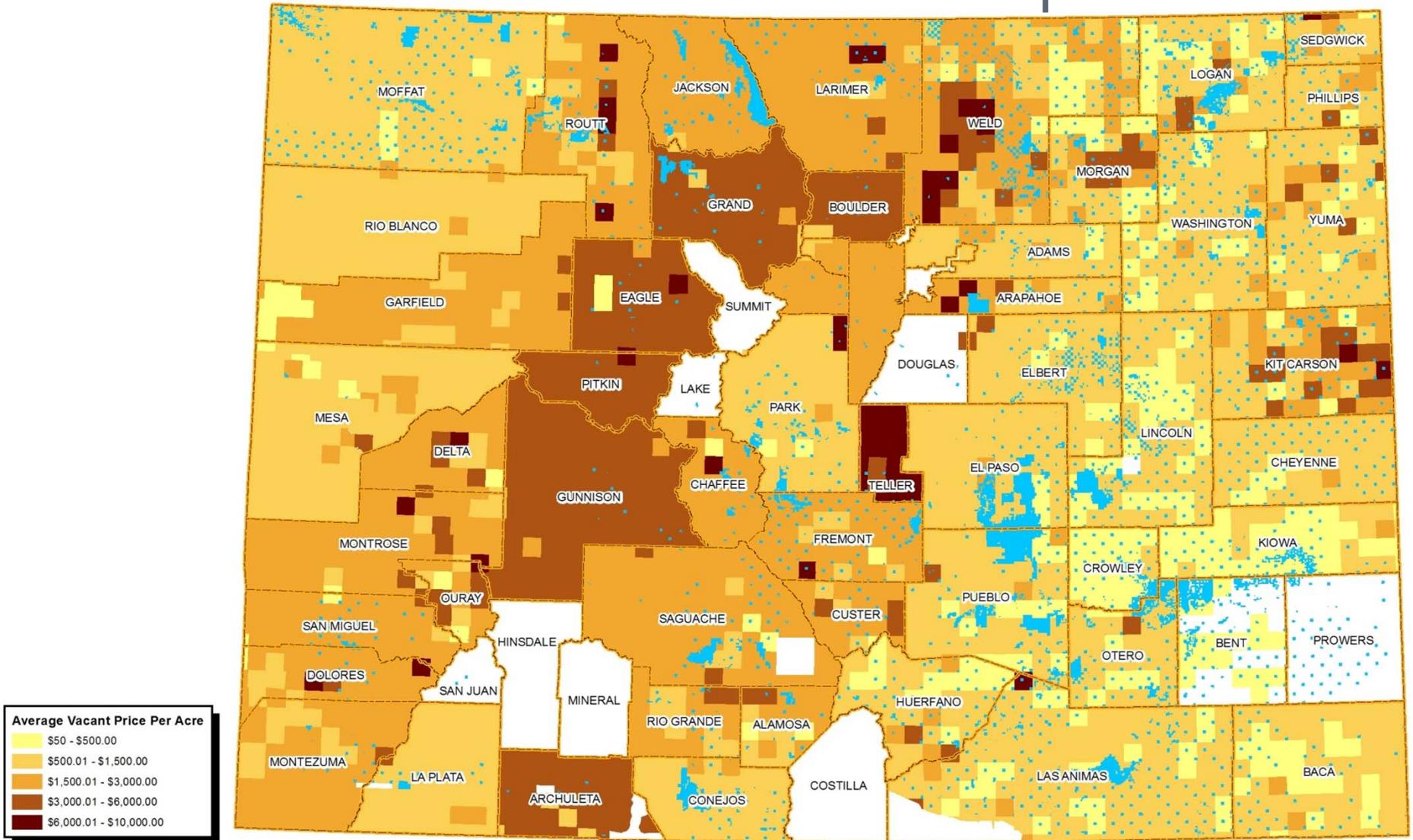


VALUATION SUMMARY

- 0.7% income return (\$17 million)
- Valuation per acre by township
- Assumptions
 - Land Sales -3 year
 - Vacant Land
 - \$50- \$10,00/acre
 - >100 acres
 - Township or County average
 - \$250/ac for >25,00 acre properties



Land Valuation Map

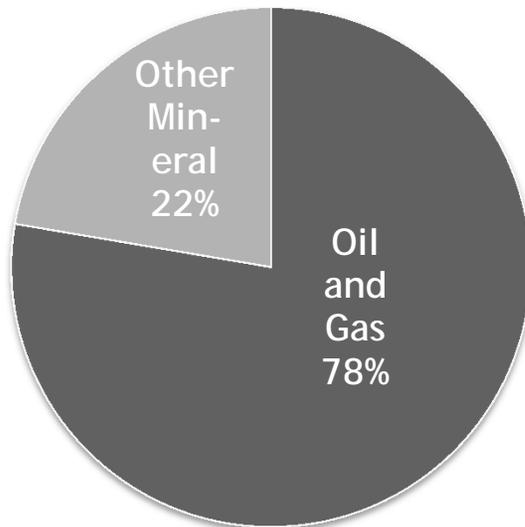
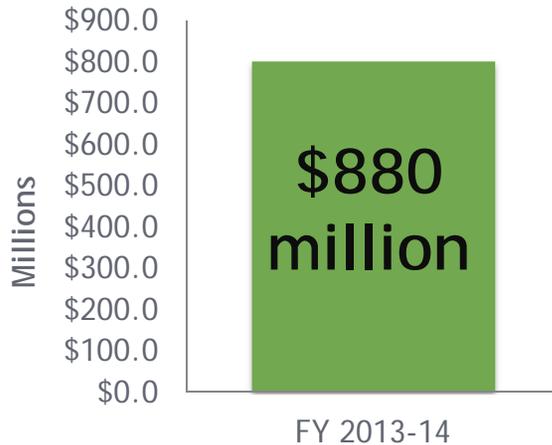


COLORADO
State Land Board
Department of Natural Resources

Portfolio Presentation
October 2, 2014

MINERALS

VALUATION 2014



VALUATION SUMMARY

- 12% income return (\$155 million)
- Valuation based on future income from producing reserves
- Assumptions
 - Standard decline curve
 - New wells of 200 to 250 per year
 - \$85 per barrel oil
 - Normalized revenue history
 - Discount rates 9% to 15%
 - 10 year DCF
 - Perpetuity Value



Minerals

Scenario Analysis - Oil Value

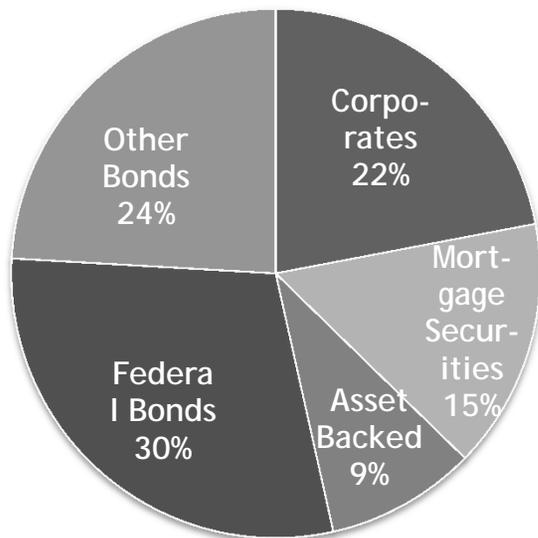
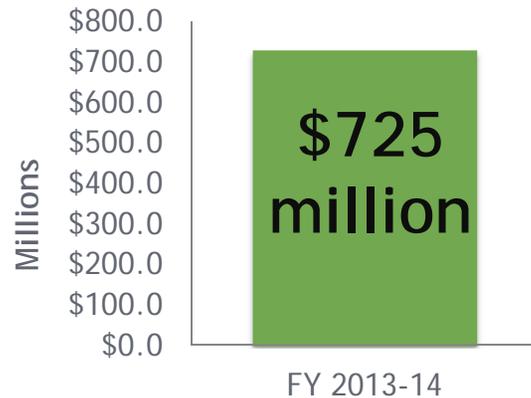
Table 2		OIL VALUE				
		Average Initial Monthly Production				
		8,000	8,500	9,000	9,500	10,000
	\$70.00	\$392,844,812	\$403,635,289	\$414,425,766	\$425,216,243	\$436,006,720
	\$75.00	\$420,905,161	\$432,466,387	\$444,027,612	\$455,588,837	\$467,150,063
	\$80.00	\$448,965,510	\$461,297,484	\$473,629,458	\$485,961,432	\$498,293,405
	\$85.00	\$477,025,859	\$490,128,581	\$503,231,304	\$516,334,026	\$529,436,748
<u>Oil Price</u>	\$90.00	\$505,086,208	\$518,959,679	\$532,833,149	\$546,706,620	\$560,580,090
	\$95.00	\$533,146,557	\$547,790,776	\$562,434,995	\$577,079,214	\$591,723,433
	\$100.00	\$561,206,907	\$576,621,874	\$592,036,841	\$607,451,808	\$622,866,775
	\$105.00	\$589,267,256	\$605,452,971	\$621,638,687	\$637,824,402	\$654,010,118
	\$110.00	\$617,327,605	\$634,284,069	\$651,240,533	\$668,196,997	\$685,153,461

- Oil is 57% of total mineral value
- Valuation Range ≈ \$400 million to \$700 million
- \$5/bbl oil (6% change) ≈ \$30 million in value
- 50 wells (25% change) ≈ \$70 million in value



CASH (Permanent Fund)

VALUATION 2014



VALUATION SUMMARY

- 3.0% return
- Valuation based on bond value
- Fund invested entirely in bonds (AA or higher)
- Fund balance growth due to SLB revenues:
 - \$38 million in FY 2011-12
 - \$22 million in FY 2012-13
 - \$86 million in FY 2013-14



CASH

Colorado State Treasury Permeant Fund Investment Policy adopted 2010

Security	Min	Max	Notes
Treasury/Agency	20%	100%	
Misc. Government Guaranteed	0%	50%	
Mortgage	0%	50%	Must be Federal Issued
Domestic Corporate	0%	20%	At lease 'A' rated
Asset-Backed	0%	30%	Must be US domiciled
Municipal	0%	15%	At lease 'AA' rated
Repurchase Agreements	0%	50%	Fed approved vendor
TPool	0%	20%	Colorado Gov't Fund
Bank Agreements and Bank Notes	0%	20%	Must be US domiciled & FDIC



Next Steps

1. Refine the models
2. Build a three year total return
3. Develop portfolio-level strategies or guidelines
4. Develop scenario planning model
5. Develop portfolio-level opportunity analysis
6. Other thoughts?



COLORADO STATE LAND BOARD



COLORADO
State Land Board

Department of Natural Resources

Portfolio Presentation
October 2, 2014



MEMO

To: Colorado State Board of Land Commissioners
From: Tobin Follenweider, Deputy Director
William Martin, GIS Planner
Bill Gaertner, Inventory Manager
Mike McAninch, Investment Officer
Date: 10.2.2014
Re: Portfolio Analysis

SUMMARY

This memo concerns the Portfolio Analysis as anticipated by the Strategic Plan. The following summarizes our analysis:

- Portfolio Valuation and Return - 2014
 - \$4.1 billion School Trust estimated value
 - \$2.5 billion land
 - \$880 million minerals
 - \$725 million cash (Perm Fund)
 - Estimated School Trust return
 - 4.7% income

- Portfolio Characteristics
 - Landscape parcels and small isolated parcels
 - Located on Eastern Plains
 - Generally adjacent to public roads
 - 4.8 million acres trust land granted
 - 36% disposed in first 100 years
 - 8% disposed in last 40 years



BACKGROUND

The portfolio analysis project is intended to meet several of the Board's Strategic Plan objectives and builds on past portfolio presentations and initiatives.

Strategic Plan

Strategic Plan objectives (see below) include the development of portfolio management tools and the establishment of portfolio goals. Over the past 3 years, we built and improved the portfolio analysis tools and sought to identify appropriate portfolio goals.

Goal 1. Develop creative and responsible ways to deliver enhanced financial outcomes for our eight public trusts, with special emphasis on our largest trust, the School Trust.

Strategic Objective #1.1: Develop a robust approach to and appropriate tools for portfolio management that create diversification and reasonable and consistent revenues over time.

Strategic Objective #1.2: Set goals for portfolio performance that will guide all portfolio recommendations brought forward by the staff for board decisions.

Strategic Objective #1.3: Set revenue performance goals by asset class on an annual and five-year basis.

DISCUSSION

Portfolio Goals

Effective portfolio management stems from understanding and establishing clear portfolio goals. Portfolio goals help overcome the inherent limitations of portfolio valuation models. The following discussion focuses on investment fundamentals and admittedly lacks full consideration of governance, fiduciary responsibility, and other important elements¹ for state trust portfolio management.

As outlined by the Common Fund Institute, the primary portfolio management goals for long-term investors (e.g. endowments, foundations, sovereign wealth funds, etc.) are reducing risk and producing consistent returns

¹ The Western State's Land Commissioner's Association (WSLCA) is developing a set of trust portfolio management principals/guidelines and, with the assistance of investment professionals, intends to generate an investment management guidance document for state trust fiduciaries.



Diversification

Diversification is generally seen as one of the best ways to reduce risk. Diversification includes diversifying investment use (grazing, commercial, recreation, etc.), type (e.g. bonds, equities, real property, etc.) and location (e.g. Denver, Grand Junction, New York, Hong Kong, Paris, etc.).

Some investors use specific hedging strategies and/or asset allocation models. Common Fund employs a “Monte Carlo simulation” that models future economic uncertainty and builds a range of probable investment outcomes based on particular investment types and locations.

Ultimately, investment planning models and diversification strategies intend to provide information and analysis to fiduciaries that make independent decisions as to what is in the best interest of the trust.

Total Return

Total return incorporates both annual income and long term value appreciation. Total return is often measured using a three-year moving average to smooth out the highs and lows (see *Endowment Asset Management*, Acharya and Dimson 2007).

Based on our current research, long-term investors tend to target a total return of around 8 percent. This is often made up of 4 percent to 5 percent income and 3 percent to 4 percent long term value appreciation. The percentage targets for income and appreciation are usually driven by the individual investor’s annual revenue goals or specific funding obligations (e.g. tuition grants). The Common Fund Institute, as well as others, commented that annual income output of more than 5 percent are generally not considered sustainable for long-term investors.

Portfolio Analysis

For this analysis, we looked at portfolio characteristics and portfolio valuation and return

Portfolio Characteristics

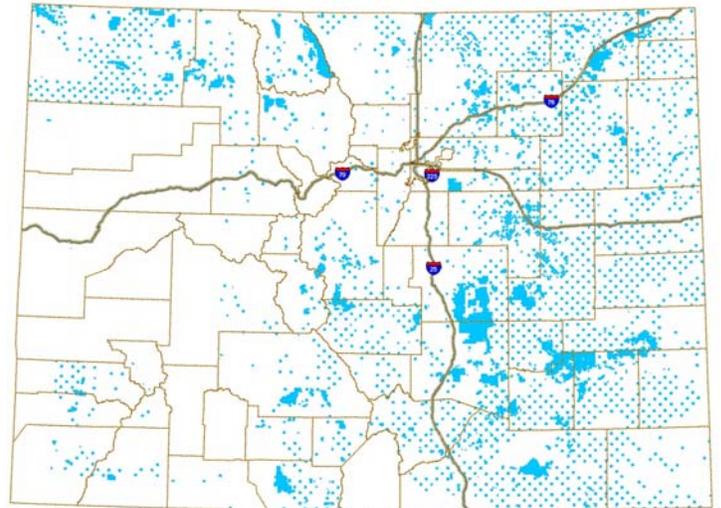
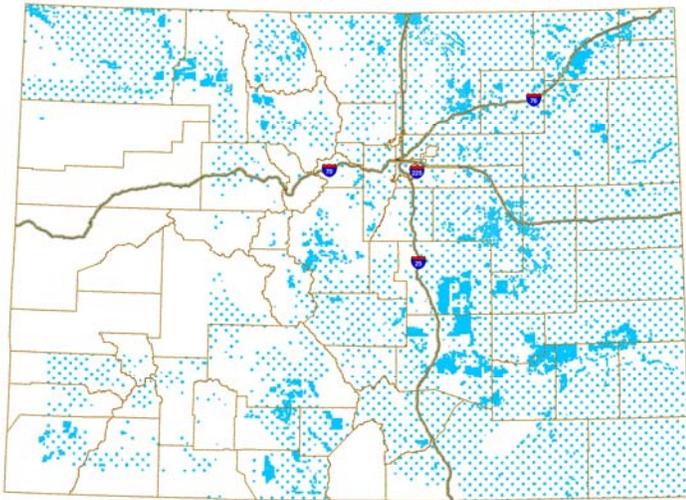
While the state land board has a relatively good understanding of what it owns today, we have never had a complete picture of when and how we received these assets. Generating this picture is important for both operational needs and portfolio analysis. We learned through several Lean evaluations during FY 2012-13, that staff did not have a single source to validate and in some cases even identify exactly what we owned.



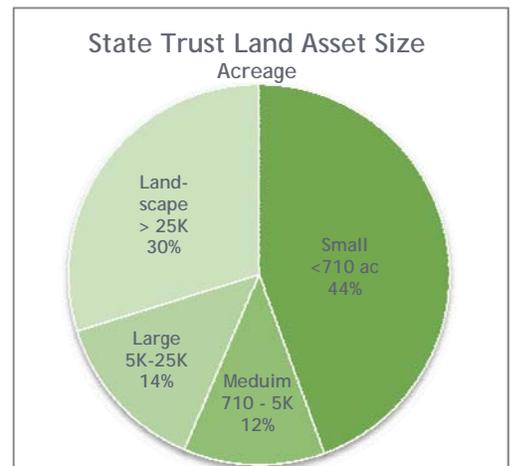
We have spent the last year developing a GIS map that holds all essential information about ownership including all the original granted land. We learned that over a third of the granted acreage was sold during the State Land Board's first 100 years and that less than ten percent has been sold since 1976.

Original Federal Grants Lands

Current Trust Lands



As has been reported in other presentations, the current state trust land portfolio has a number of notable characteristics. The chart to the left shows that state trust land is weighted towards two ends of the ownership spectrum. About three-fourths of the ownership is concentrated in either small parcels (<710 acres) or very large or "landscape" parcels (>25,000 acres). Large and medium acreage properties account for only a quarter of the trust property. State Land Board field staff believe that it takes between 5,000 acres and 10,000 acres to support a family grazing operation on the Eastern Plains.



Other significant characteristics of the state trust portfolio include:

- Over 70 percent of trust land is on the Eastern Plains
- About 60 percent of trust land is adjacent to public roads
- About 30 percent (approximately 1.2 million acres) of the mineral estate is severed
- Annual trust revenues are primarily from oil and gas (85 percent in FY 2013-14)

Current Market Valuation and Return

Our past valuation attempts did not include Minerals and were simplistic (e.g. county level valuation) or overly complex (e.g. econometric-based hedonic model). Therefore, one of our goals was to build a repeatable, reasonable, and easily explainable valuation.

The 2014 baseline value estimate for state trust assets is \$4.1 billion. Land (including buildings) is the largest component at \$2.5 billion or 61% of total trust value. School Trust mineral value is estimated at \$880 million or 21% of total trust value. The Permanent Fund at \$725 million accounts for the remaining 18% of total trust value.

School Trust Estimated Value and Returns 2014

Category	Valuation	Revenue	Return (1yr)
Land (include buildings)	\$2.6 billion	\$17.1 million	0.7%
Minerals	\$880 million	\$154.7 million	12.0%
Cash (Perm Fund)	\$725 million	\$21.6 million	3.0%
TOTAL SCHOOL TRUST	\$4.1 billion	\$193.4 million	4.7%

Valuation Methodology

We identified six asset classes for portfolio valuation; land, oil, gas, bonus, other mineral, and commercial. While there are numerous methodologies for asset valuation, we focused on three:

1. *Market/Comparable Sales*: Estimating value of an asset compared to similar assets that have been sold. This was used for the land valuation.
2. *Intrinsic Valuation*: Estimating value of an asset based on the present value of expected future cash flows. The most common intrinsic valuation approach is discounted cash flow (DCF). This was used for the mineral valuation.
3. *Income (Capitalization) Approach*: Estimating value of an asset based on "capitalizing" the current year's net operating income (gross revenue minus operating expenses). The Cap Rate serves as a proxy for risk and reasonable return. This was the approach used for commercial asset valuation.



Land Valuation

The School Trust land valuation is based on market sales comparable approach. The land valuation model utilizes the Ranchland sales database and GIS. The Ranchland sales database contains more than 30,000 property sales transactions (some dating back 15 years) for most Colorado counties. The transactions are gathered from county assessors, cleaned and when appropriate, aggregated.

The sales transactions were mapped using each transaction's legal description or some other mappable data (e.g. GIS layer, physical address, etc.) and we created a township-based average per acre sale price (see below). The township per acre value was used to establish the value of the trust land within the township. We believe that this improved on the county average per acre valuation we have used in the past.

The following assumptions were used for the land valuation model:

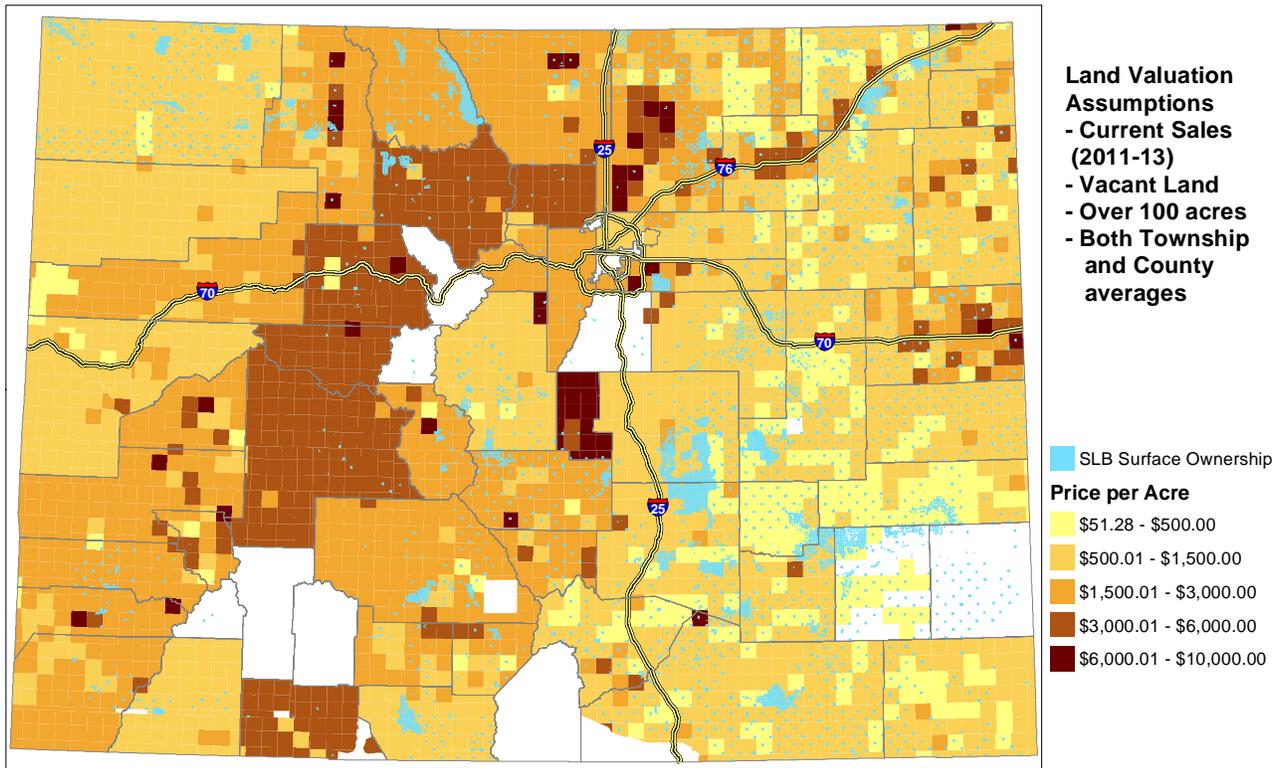
- All sales of vacant land that have occurred between January 2011-December 2013
- Sales over 100 acres
- Price per acre for transactions are between \$50-\$10,000/acre
- Average price per acre for township-range
 - If no sales exist within a specific township-range, used county average
 - If no sales exist within a specific township-range and county, developed estimate
- All landscape parcels (>25,000 acre) were valued at \$250 per acre

Based on the assumptions listed above, the 2014 land valuation is based on about 1,800 "comparable" sales as well as the \$250/acre limit on the landscape parcels. These sales occurred across the state. However, there are certain areas where there were no sales or has limited sales during the past three years. The number of comparable sales and their location is certainly a limitation of this model.

Estimated land value ≈ \$2.4 billion



Township Valuation Estimate 2014

Mineral Valuation

The School Trust mineral valuation was based on the discounted value of future cash flows from producing or “proven” reserves. Except for the lease bonus value, the valuation model does not attempt to capture unproven reserves or resource potential. The mineral valuation includes four different subclasses: oil, gas, bonus, and other mineral.

1. Oil Valuation

We utilized the discounted cash flow (DCF) valuation method for the oil valuation, which included both vertical oil production and horizontal oil production. Vertical production uses a 10 year DCF model and the horizontal production valuation utilized data from existing horizontal wells to determine initial production figures and build an average decline curve for new wells.



The following assumptions were used in the vertical oil valuation model:

- 158,000 barrels of oil from vertical production
- 3% decline each year
- Oil price = \$85
- 8% discount rate
- 10 Year cash flow
- Terminal value = Year 11 cash flow/ discount rate (perpetuity formula)
- Vertical Estimated Value ≈ \$140 million

The following assumptions were used in the horizontal oil valuation model:

- Initial production 9,000 bbls.
- Decline curve - Based on historical average monthly well production
- Oil price - \$85
- 8.0 % decimal interest
- 8% discount rate
- Well starts:
 - 2013 - 173
 - 2014 - 200
 - 2015 - 200
 - 2016 - 250
- 3 year decline curve
- Terminal value is 150 bbls. monthly production
- Horizontal Production Estimate ≈ \$360 million

Attachment 1 illustrates the sensitivity of the oil valuation model based on the range of likely assumptions. Depending on the assumption, the oil valuation can vary from \$400 million to \$700 million. The most significant variation comes from the price of the oil. Even relatively small changes in the price of oil can lead to significant changes in the overall valuation.

Estimated oil value ≈ \$500 million

2. Gas Valuation

Valuing gas is more complex than oil because gas contains a number of individual marketable products (e.g. reservoir gas, liquids, etc) with individual production amounts. Moreover, the State Land Board only began regularly tracking this information on July 1st. 2014.

Until there is sufficient data, the gas valuation model uses an approach that includes 10 year DCF model, gas income valuation multiple, and a comparison to oil valuation in order to arrive at estimated value.



The following assumptions were used in the gas valuation model:

- Normalized 5 year historic gas cash flow
- 9.0% discount rate
- 10 year DCF model
- Perpetuity formula at terminal value

Estimated gas value ≈ \$180 million

3. Bonus Valuation

The bonus valuation is based on projected bonus revenue after July 1, 2014. The bonus valuation is comprised of the bonus revenue received from quarterly auctions as well as the bonus received from both Lowry Ranch and 70 Ranch.

The following assumptions were used in the standard bonus valuation model:

- Terminal Value forecasted based on FY 2014-15 projected revenue
- Discount rate is 15% due to highly volatile revenue stream
- Perpetuity formula for terminal value
- Auction Bonus ≈ \$63 million

The following assumptions were used in the Lowry/70 Ranch Bonus valuation model:

- Actual bonus revenue anticipated
- Discount Rate = 3.0%
- Lowry/70 Ranch ≈ \$87 million

Estimated bonus value ≈ \$150 million

4. Other Minerals

The valuation of other mineral revenues is based on a 10 DCF year model.

The following important assumptions were used in the other mineral valuation model:

- Normalized 5 year historic cash flow
- 10 year DCF model
- 10% discount rate
- Perpetuity formula at terminal value
- Coal valued independently at \$8 million

Estimated other mineral value ≈ \$47 million



Commercial Valuation

The value of a commercial real estate investment is directly related to the investment's ability to produce an "acceptable return." While there are a variety of ways to determine the acceptable return, one of the most common methods for valuing investments in real estate is the income (capitalization) approach.

There are three ways in which capitalization rates are generally established. One is to use the average capitalization rate of similar properties that have sold recently. The second is to use surveys to obtain an estimate of the cap rates used by other real estate investors. The third is to estimate the cap rate from a discounted cash flow model. We used an industry-average cap rate to estimate the value of the State Land Board commercial assets.

The following assumptions were used in the commercial real estate valuation model:

- Cap Rate of 8.0%
- Next year's forecasted operating earnings
- Market square foot value for commercial properties that are not producing income

Estimated commercial value ≈ \$100 million

Attachments:

Scenario Analysis - Oil Value



Scenario Analysis - Oil Value

- Table 1 represents a constant \$85 oil price but with changing initial production and/or the discount rate.
- Table 2 represents a constant 8% discount rate but with changing oil price and/or initial production.
- Table 3 represents a constant 8% discount rate and constant \$85 oil but with changing new well production and initial production.

Table 1		OIL VALUE				
		Average Initial Monthly Production				
		8,000	8,500	9,000	9,500	10,000
	5.00%	\$646,848,496	\$660,639,077	\$674,429,658	\$688,220,239	\$702,010,821
	6.00%	\$572,335,953	\$585,889,822	\$599,443,691	\$612,997,560	\$626,551,429
	7.00%	\$518,276,787	\$531,601,478	\$544,926,170	\$558,250,861	\$571,575,553
Discount Rate	8.00%	\$477,025,859	\$490,128,581	\$503,231,304	\$516,334,026	\$529,436,748
	9.00%	\$444,335,836	\$457,223,487	\$470,111,139	\$482,998,791	\$495,886,442
	10.00%	\$417,658,125	\$430,337,313	\$443,016,500	\$455,695,688	\$468,374,875
	11.00%	\$395,370,613	\$407,847,666	\$420,324,718	\$432,801,771	\$445,278,823

Table 2		OIL VALUE				
		Average Initial Monthly Production				
		8,000	8,500	9,000	9,500	10,000
	\$70.00	\$392,844,812	\$403,635,289	\$414,425,766	\$425,216,243	\$436,006,720
	\$75.00	\$420,905,161	\$432,466,387	\$444,027,612	\$455,588,837	\$467,150,063
	\$80.00	\$448,965,510	\$461,297,484	\$473,629,458	\$485,961,432	\$498,293,405
	\$85.00	\$477,025,859	\$490,128,581	\$503,231,304	\$516,334,026	\$529,436,748
Oil Price	\$90.00	\$505,086,208	\$518,959,679	\$532,833,149	\$546,706,620	\$560,580,090
	\$95.00	\$533,146,557	\$547,790,776	\$562,434,995	\$577,079,214	\$591,723,433
	\$100.00	\$561,206,907	\$576,621,874	\$592,036,841	\$607,451,808	\$622,866,775
	\$105.00	\$589,267,256	\$605,452,971	\$621,638,687	\$637,824,402	\$654,010,118
	\$110.00	\$617,327,605	\$634,284,069	\$651,240,533	\$668,196,997	\$685,153,461

Table 3		OIL VALUE				
		Average Initial Monthly Production				
		8,000	8,500	9,000	9,500	10,000
	150	\$389,620,083	\$398,659,558	\$407,699,033	\$416,738,508	\$425,777,982
	175	\$422,205,577	\$432,751,631	\$443,297,685	\$453,843,739	\$464,389,793
	200	\$454,791,071	\$466,843,704	\$478,896,337	\$490,948,970	\$503,001,604
Number of Wells	250	\$519,962,059	\$535,027,851	\$550,093,642	\$565,159,433	\$580,225,225
	275	\$552,547,553	\$569,119,924	\$585,692,294	\$602,264,665	\$618,837,035
	300	\$585,133,047	\$603,211,997	\$621,290,947	\$639,369,896	\$657,448,846
	325	\$617,718,541	\$637,304,070	\$656,889,599	\$676,475,128	\$696,060,657
	350	\$650,304,035	\$671,396,143	\$692,488,251	\$713,580,359	\$734,672,467
	375	\$682,889,529	\$705,488,217	\$728,086,904	\$750,685,591	\$773,284,278



Endowment Asset Management

Investment Strategies in
Oxford and Cambridge

Shanta Acharya and Elroy Dimson

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To our parents

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The rebound in the value of endowments was not just the result of market gains over the past year, but was helped by the flow of gifts and donations. Institutions in Oxford and Cambridge might find the prospect of raising such large gifts challenging, but developing a tradition of 'asking' may involve a different approach altogether. US institutions have been engaged in cultivating their alumni and friends with a view to 'asking' for annual gifts and donations for several decades now. Significant investment of time and funds are typically made at the initial stages of development activity. It cannot be said that Oxbridge institutions have missed out on such benefactions; they have done well under the circumstances. As income from gifts and donations among Oxford and Cambridge institutions is currently rather low, compared with the sums raised by their peer group in the United States, it may nevertheless be easier to enhance that intake without excessive additional cost.

To sustain a long-term fund-raising strategy, Colleges have to refocus their marketing strategies, invest in building relationships, both with Alumni and Friends. As institutions of higher education in the UK become focused on fund-raising as a means of building a diversified, more secure income base, they also have to compete with other philanthropic organizations for funds. Amounts raised by Oxford and Cambridge may look respectable today in terms of what other universities in the UK are able to garner, in the new era of philanthropy where giving is becoming more business-like, these institutions have to compete for funds like any other institutions in the philanthropic sector.

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Concluding observations

Introduction

Unlike pension funds whose investment objectives may be interpreted as being similar, endowment purposes vary considerably. One philanthropic institution might choose to spend its entire endowment within a defined period while another has the fiduciary obligation to ensure that spending today does not prejudice future generations of beneficiaries. Even within the educational sector, where endowment purposes are ostensibly similar, differences in approaches to investments and fund-raising play a crucial role. In this sector, the indeterminate nature of liabilities means that a successful investment policy sustains the flow of funds to the operating budget and assists in fulfilling institutional goals. A clearly defined objective, on which investment policy is based, therefore acquires greater significance.

Oxford and Cambridge endowments comprise funds generally regarded as for the long term, and which fundamentally underpin and sustain the operation of the institutions at their desired level of activity. This definition of an endowment was historically interpreted differently among Colleges in Oxford and Cambridge resulting in the free transfer of funds between endowment and reserves, between operational and non-operational assets. Removal of internal tax incentives to increase or decrease the value of the endowment will help in curbing such transfers, which have proven to be detrimental to the long-term preservation of its capital. The process of reform has begun; going forward it is anticipated that institutions will fully recognize them as essentially inefficient in securing their long-term objectives.

Oxbridge institutions have collectively embraced major change over the last few years by implementing total return investment strategies. They simultaneously made the shift from spending policies that encouraged income-generating investments towards establishing sensible spending rules that freed up asset allocation decisions. Such changes in investment approaches have consequences in terms of determining appropriate governance, choice of assets, identifying skilled managers, monitoring their performance,

understanding the sources of value-addition and cost analysis, and setting many other aspects of endowment policy. As such transitions take a long time to implement many of the institutions are in the process of managing that change.

The practice of borrowing from the endowment at nil rates of interest not only depleted endowment capital, but inhibited investment policy. While borrowing from the endowment is relatively uncommon today, such a method of financing capital expenditure was fairly common in the recent past among Colleges. As a consequence, investment policy decisions were secondary to operational considerations, which effectively dictated endowment asset allocation leading to lower investment returns for the endowment. Under such constraints, it is impressive that endowment income in Oxford and Cambridge today contributes over a third of total income of the Colleges and thus plays a critical role in sustaining operations.

Lack of endowment independence resulting in weak implementation of appropriate investment and spending policies, not to mention capital outflows from the endowment and the lack of a tradition of fund-raising, all contributed to eroding long-term endowment growth. While Ivy League institutions built up substantial endowments over the past few decades, Oxbridge institutions suffered. Comparisons with the size of endowment assets of top universities in the United States are typically made to illustrate the lack of resources available to UK institutions. Size of assets under management is material, as it influences some aspects of decision-making. For example, an endowment's size may restrain its ability to invest in alternative assets and strategies, which tend to be illiquid in nature and carry a higher element of risk. Income requirements have a far greater influence on asset allocation decisions of a smaller endowment than a larger one. An endowment's ability to afford independent investment advice and performance analysis may also be a limiting factor. An institution with less than £10 million of assets under management simply cannot afford to replicate the sort of investment strategies pursued by institutions with assets above £500 million under management.

Universities in the UK have also had to deal with real cuts in higher education funding over the past decades. A significant factor influencing overall quality of output is the difference in spending between Oxford and Cambridge and their counterparts in America. The British government and the academic institutions fully recognize the challenges of globalization; new partnerships, methods of funding, assessment are all part of the way forward in establishing greater plurality of funding support. From 2006–7, for example, universities have the power to vary the fees they charge directly to students, up to a maximum of £3,000 per year in the UK. Changes in the funding of research in meeting new economic and social challenges, including investing in physical infrastructure, issuing debt, among other initiatives, are afoot.

In spite of significant funding gaps between the top US and UK institutions, it is encouraging that the combined endowment assets per FTE student in Oxford and Cambridge are considerably higher today than those at wealthier public universities in the United States. In round numbers, the 2004–5 endowment assets per FTE student in Oxford were \$269,000. At Cambridge, the aggregation of the different endowments into a centralized fund meant that endowment assets per FTE student rose to \$296,000, resulting in Cambridge and Oxford trailing behind Princeton (\$1.6 million), Yale (\$1.4 million), Harvard (\$1.3 million), Stanford (\$0.8 million), and MIT (\$0.7 million). In reality, endowment assets per student vary considerably among the Colleges; for example, a student in Trinity College (Cambridge) would be significantly well off, having access to superior facilities compared with a student from a less well-off College in the same University.

Oxford and Cambridge currently receive a large percentage of their income from public sources; the government will continue to be the major source of funding for universities. This should be seen as an opportunity for institutions when determining asset allocation and in leveraging the stability of their diverse sources of funding. What Oxford and Cambridge need is not to forgo income from public sources, but to increase their private income substantially. To do so they must be able to demonstrate not just their pre-eminence as academic institutions but that their endowments are performing efficiently. Donors like to be assured that their gifts are well spent—either in directly supporting academic purposes of the Colleges today and/or in the future. Thus, to attract gifts and donations, Oxford and Cambridge must maintain their status as among the best educational institutions in the world.

Endowment governance and management structure

The collegiate structure of Oxford and Cambridge is unique, its tutorial system unparalleled in terms of delivering excellence in teaching. The Colleges, independent and self-governing institutions, form a core element of each University, to which they are related in a federal system. Students at Oxbridge are members of their College and the University; such an arrangement has proven to be beneficial in fulfilling the primary objective of these institutions—that is the pursuit of education.

The focus on the primary purpose of Colleges is reflected in their annual account and report, which makes no specific reference to 'investment objectives'. Investment performance too is typically described without reference to any stated investment objective. Institutions could benefit from clearer enunciation of the investment objective. As in the United States, they could address how endowment return relates to spending policy, performance benchmark, risk analysis, and issues relating to portfolio rebalancing to maintain the

asset allocation target; they could also comment on considerations in hiring and retaining investment managers and consultants. Such information is not uniformly supplied in the United States; nor are these topics always defined quantitatively. But the level of disclosure by educational endowments in the UK, in the form of annual reports or accounts, is lower, there being no requirement on their part to do so.

The primacy of educational objectives should not deter these world-class institutions from investing their endowment portfolios efficiently. In the final analysis, asset allocation involves the appropriate allocation of risk. While bursars acknowledge that risk management remains an area of concern, and the definition of risk associated with individual Colleges inevitably vary, there is no agreement on how to examine these issues formally; none, at least, that we were able to assess during the course of our study. Broadly speaking, risk for these institutions is the inability of the endowment to generate a certain level of income to support their primary educational objective. Therefore, investment objectives need to be clearly defined by these institutions and their endowments allowed the freedom to prosper.

It is worth noting that while the Colleges are independent, self-governing institutions, their endowments are not. Oxbridge investment committees serve largely in an advisory capacity. Investment policy is recommended by the Investment Committee, either via the Finance Committee or directly to the Governing Body of the College. The Investment Committee acts as an adviser to the Governing Body in determining appropriate policies for the management of the endowment assets. Lack of independence of the Endowment has long-term consequences, critically for the institutions if they lose out in terms of superior investment returns. Thus, government and management structures matter, if they can improve asset allocation decisions resulting in superior long-term performance.

This is not to suggest that the universities of Harvard and Yale, for example, do not oversee their investments; they do. But the HMC is responsible for managing the Endowment. Harvard Management Company is a wholly-owned subsidiary of Harvard University; it was founded in 1974 to manage the University's endowment, pension assets, working capital, and deferred giving accounts. Harvard Management Company is governed by a Board of Directors appointed by the President and Fellows of the University. The Yale Investment Office is likewise responsible for investing the Yale Endowment. The collegiate structures of Oxford and Cambridge make it difficult to emulate, for example, the Harvard or Yale management structure. The individual size of the endowment within Colleges is too small to have an impact. The size and contribution of the two Oxbridge University endowments also do not measure up. The establishment of an Investment Office in 2006, with a CIO, for the management of Cambridge University's endowment and the investments of its related bodies therefore marks a new direction. As the Colleges are not part

of this University's Investment Office initiative, it illustrates how governance and management considerations influence investment applications.

Similarly, a few Oxford Colleges established a collective investment partnership, OXIP, to meet the specific requirements of educational endowments. Investing 10 per cent of the endowment in such a fund does not lighten the asset allocation burden on the Investment Committees of Colleges. Other existing partnerships for investments in private equity and hedge funds were set up to secure greater economies of scale. While fees paid to external managers currently do not appear to be onerous, it is not clear that the investment performance justifies those costs. If higher cost-adjusted returns could be achieved, then Colleges and Universities should seriously consider amalgamating their resources. Analysis of investment performance is perhaps the greatest weakness in the overall investment process. A centralized fund would help in assessing costs versus performance.

If improved performance can be achieved by investment decisions that emanate from new ways of structuring the governance of some of Oxbridge institutions, such as the question of the independence of the endowment, it is worth scrutiny and implementation. While long-term performance of endowment investments in Oxford and Cambridge is not available, there is a consensus that it does not compare favourably with that consistently achieved by Yale and Harvard over the past 20 years. While combined endowment assets in Oxford or Cambridge are small by comparison with Ivy League institutions, an improvement of even 1 per cent in Oxbridge annual return would boost endowment wealth and assist in the fund-raising effort. Streamlining management arrangements will ensure that the Investment Committee is responsible for determining the strategic investment decisions, which include asset allocation, manager selection, risk, and performance analysis. Currently, Oxbridge institutions are not rigorous in assessing the latter aspects of their endowment asset management.

The recent trend towards finance and investment professionals joining the UK endowment sector is encouraging; today, an increasing proportion of Colleges have professional investment bursars. Only time will tell what their real contribution will be to the collective endowment asset management process. Compared with their US counterparts, Oxbridge institutions appear to have smaller investment committees. But, taking into account the size of assets under management and investment strategies employed, the number of individuals involved in the process is high. Greater effort at pooling assets and strengthening investment expertise could help in efficient management of costs and performance. While the use of investment consultants remains patchy, and several of these hires were limited to advice on manager selection or entry to private equity and absolute return strategies, the use of consultants in performance measurement would complement the effort on making good asset allocation decisions.

While in aggregate there are a large number of people in the investment committees, our study shows that several Colleges are managing with limited professional and support staff, with the Bursar often being the only person responsible for a varied number of investment and non-investment related tasks. The challenge of managing the available resources in support of the College's overall objectives cannot be emphasized enough. Greater independence of the Endowment would benefit the Investment Committees in Oxford and Cambridge in appointing members with greater investment expertise. The Investment Committee's role in determining and being responsible for prudent endowment management needs bolstering. As the contribution of the endowment in sustaining long-term institutional objective is widely acknowledged, investing judiciously in the management structure remains critical.

Spending policy

The concept of a spending policy, prevalent among major endowments and foundations in the United States, is relatively new to Oxford and Cambridge institutions. The link between investment objective, rate of spending, investment return target, and asset allocation is also in the early stages of development. Until recently, Oxford and Cambridge institutions were able to spend only income; not unlike Yale and Harvard in the 1960s when those universities also limited their endowment's annual contribution to the operating budget to investment yield: interest, dividend, and rental income.

Today, determining a sustainable spending rate is among the key decisions that the Governing Body of an Oxbridge College is responsible for. An average 4 per cent spending rate among Oxbridge institutions is a more conservative strategy than at corresponding US institutions, which have spent on average 5 per cent over the past decade. Under a quarter of institutions in Oxford and Cambridge spend more than 5 per cent of the previous year's endowment value, the range of spending varying from less than 2 per cent to a high of 13 per cent. Rates of spending higher than 5 per cent are difficult to sustain in the long-term as generating real returns of more than 5 per cent is not achievable, unless the College is comfortable with taking on significant risk exposure.

A target spending-rate serves as a guide in determining an endowment's ability to maintain intergenerational equity, with higher rates indicating a bias towards the current generation of students and faculty, and lower rates favouring future generations. While some foundations can opt to favour current beneficiaries, educational institutions have a fiduciary responsibility towards protecting the future as much as the present. If an institution places emphasis on its current academic operations alone, then distributions from the endowment may not be adjusted for fluctuations in the market value of investments. At the other extreme, focusing on endowment preservation may

mean that funds over and above the rate of inflation alone would be made available for current spending. Setting a sustainable spending rule assists in greater fiscal discipline.

In determining spending policy among educational institutions, it is important to consider not only the needs of current beneficiaries but also those of future generations. The per cent of annual drawdown from the endowment is as important as the need to maximize investment returns at any given level of risk. The methodology used in making such withdrawal is therefore critical. Using a fixed annual withdrawal formula simply transmits the market volatility into the operating budget assumptions. Most US institutions use, for example, a rolling 3-year average market value approach resulting in the spending of 5 per cent of the endowment value. About half the institutions in Oxbridge also apply a rolling 3-year average market value criterion.

The move towards adopting 'total return' investment policies in Oxford and Cambridge is a welcome development as Colleges implement asset allocation strategies that focus on long-term returns rather than income. Total return strategies offer opportunities as well as challenges; inappropriate allocation of assets can prove equally detrimental to preserving the real value of the endowment while providing a stable source of income. It is worth noting that the transition to a total return policy among several Oxbridge Colleges was facilitated by their high weighting in property assets that provide the necessary source of income during this period of transition. Real estate not only provided the necessary diversification but also generated a stable source of income. This was something that several bursars pointed out—that without the stable revenue from property, the path to implementing total return investment policies would have been challenging. Also, the property market cycle assisted in this reconfiguration; if the property market had been in a reverse, correctional cycle, the responses would not have been so tilted in favour of the asset class.

Asset allocation

One of the challenges for endowment managers is how to maximize spending today while preserving the purchasing power of the endowment for posterity. Higher expected returns may resolve the conflict between providing for operations today while preserving real value. At the same time, vulnerability to inflation directs investments away from fixed income towards equity. Institutional portfolios with very long-term investment horizons, such as endowments, are therefore best invested in assets capable of generating equity-like returns, including public and private equity, and strategies that aim to deliver absolute returns. To mitigate equity risks, portfolios may incorporate fixed income, real estate, and other assets such as commodities or natural

resources. Non-traditional assets are not only strong diversifiers; they can also serve to enhance returns. Alternative assets tend to be less efficiently priced than traditional marketable securities, providing an opportunity to enhance returns through active management.

While Yale and Harvard have been exploiting illiquid, less efficient markets such as venture capital, leveraged buyouts, oil and gas, timber, and hedged strategies for some time, the salient feature of Oxford and Cambridge endowment portfolios is their investment in property assets, which at an average of over 30 per cent, is among the highest among any group of professional institutional investors, apart from specialist property investors. Property investments span a range of assets from equity to debt as well as assets combining debt and equity-like characteristics. Property can also be privately owned with infrequent valuations or be publicly quoted as any other marketable security. If one were looking for an Oxbridge consensus with regard to asset allocation, it can be suggested that the Colleges (not the Universities) regard real estate as a core investment.

According to the accounts of the Oxford Colleges, the aggregate average allocation to property in 2004–5 had risen to 45 per cent compared with 31 per cent in 2003; this was the result of appreciation in the value of property as well as new investments in the asset class. Cambridge Colleges, for which data are unavailable, would also have benefited from their high allocation to the asset class. The average property holding in Oxbridge today is more likely to be over one-third of endowment assets. By comparison, the educational endowment sector in the United States invested 2.7 per cent in real estate assets while the not-for-profit sector in the UK held 3.4 per cent in the asset class. Oxbridge property allocation is similar to ownership of fixed-income assets among US college endowments. The fixed-income-like characteristics of property were cited as a determining factor among Oxford and Cambridge institutions when investing in the asset class. Oxbridge Colleges with smaller-sized endowments were the least likely to hold property assets in their endowments. About one quarter of Colleges reported not owning any property assets in the endowment. The wealthier Colleges invested less in domestic (UK) equity, fixed income, and cash; richer Colleges were significantly overweight in property, but less so in alternative assets when compared with their peer group in the United States.

Less wealthy institutions in Oxbridge invested significantly more in domestic equity assets compared with the richer Colleges. Poorer Colleges also invested less in absolute return strategies; but they did not necessarily use passive strategies such as indexed products. One of the advantages of indexing, apart from reducing diversifiable risk, is avoiding the risk of poor manager selection. In general, those less well-endowed Colleges in Oxford and Cambridge that did not invest in property, or in absolute return strategies,

also reported lower investment returns. Many of them employed a single balanced manager, and were overweight in domestic equity assets. There was under-diversification across asset classes, investment strategies, and specialist managers. However, exposure to property, unlisted securities, or hedge funds does not automatically guarantee superior returns. Non-traditional assets offer opportunities for those who know how to exploit them; equally, they pose a challenge to those who do not have the expertise. Manager selection is therefore a greater risk in active strategies than in passive ones, while market inefficiency is what passive investors have to contend with.

The need to support the operating budget provides the key to understanding asset allocation decisions among Oxbridge institutions. Colleges seek a certain level of income from their endowments. Generating efficient portfolios did not appear to be the primary focus for those managing the endowment; generating a certain level of income was. At the same time, it would be unfair to suggest that investment bursars were not vexed by the concept; they did not know what an efficient portfolio meant. It was the single most important issue raised among Oxbridge bursars: 'Is there an ideal asset allocation for long-term investors such as educational endowments?' For Colleges with a reasonable contribution of income from property assets, it was relatively easier to generate more efficient portfolios or more diversified ones. Property is seen as a relatively low-risk investment among institutions that have owned such assets for centuries. From the standpoint of some Colleges, even indexed equity investments are not as safe as property in yielding the desired level of income.

Oxford and Cambridge institutions are not averse to investing in absolute return strategies; a major deterrent in expanding such exposure was finding appropriate fund-of-funds managers. The risk of getting the manager selection wrong in hedge funds and private equity partnerships is higher than in ordinary active equity managers, the average return of a manager in the upper quartiles being significantly higher than in the lower quartiles where returns can be negative. The ability to identify such managers early enough in their investment cycle is crucial, and there is concern about the specific risk arising from high exposure to a few managers.

Over one-third of Colleges in Oxford and Cambridge did not invest in alternative strategies at all, particularly hedge funds, as this was perceived as being too risky. The aggregate exposure to alternative strategies is unavailable, but there is evidence to suggest it has increased significantly over this period, albeit from a low base. The increasing professionalism evident in investment approaches among Oxbridge institutions, by way of superior diversification strategies embracing assets and investment styles and leading to a rise in the appointment of specialist managers, illustrates what can be achieved within a relatively short time frame.

Approaches to risk

For experienced investors, a central aspect of asset management is risk control. Thus, understanding the risk profile of the overall portfolio lies at the heart of any assessment of investment alternatives. At the same time, risk is defined individually by every investor, and it is difficult to generalize, except in absolute terms. Though individual perceptions of risk may vary, better diversification can improve the risk-return profile of a portfolio by enabling investors to achieve higher returns for their preferred level of risk or lower risk for a target level of return.

The concept of risk among Oxford and Cambridge investment professionals is interesting because a theoretical definition of risk is often of little use to these individuals; what they are more comfortable with is the range of outcomes that may be experienced in their own institutions. For example, many investors within this sector believe that market volatility is of little consequence to the portfolio as long as income is unaffected. The major risk for them is the failure to secure the required income from the endowment. In an ideal world, these investors would like a sustainable source of income, inflation protected, and not have to worry about how exactly to secure that. This way of conceptualizing risk is also the reason why Colleges frequently think of property as a core asset. It can be argued that Oxbridge's diversity in approaches to asset allocation is largely attributable to their property holdings. Their policies may not be based on quantitative analytical models, but over the centuries, income from property has provided these institutions with an insight into the importance of income diversification.

There is also great diversity in approaches towards risk; investment policies appear to have a more qualitative basis, rarely being driven quantitatively. However, some institutions may have taken inappropriate, ill-informed risk exposures, and may not have been appropriately compensated for that risk. While it is assumed they evaluated investment alternatives, rarely was such analysis conducted systematically and at the level of the whole portfolio. It is quite likely that the level of inadvertent or unintended risks inherent in some College portfolios could drown the potential gains from superior investment skill, thereby leaving the endowment with a higher than intended volatility and a negative contribution to return. This is not to suggest that quantitatively driven investment decisions are superior. Investment decisions are in many organizations more qualitative in nature, but they need to be backed by rigorous quantitative analysis. Risk analysis and risk-adjusted performance were not apparent in more than a small handful of Oxford and Cambridge institutions. Bursars are deeply conscious of such a deficit and wish to address the problem; the question that engages them most is how best to do so.

As the major risks to the Colleges are those that would prevent them from carrying out their charitable objectives permanently, sustaining (if not

increasing) the contribution of the endowment to the Colleges' total operating budget is critical. Focusing on endowment asset management should therefore be a major objective of the Colleges in their overall risk management. None of the institutions formally covers issues relating to the degree of risk in their investment pool. At best, risk is managed through diversification—in terms of asset classes, though not always through investment strategies and fund managers. Diversification is perhaps the least expensive way for institutions with relatively small-sized endowments to manage portfolio risk, and it is encouraging that many bursars have expressed a strong interest in how best to diversify their holdings. Nevertheless, for an endowed institution, there is more to risk management than simply ensuring a spread of assets in the portfolio.

Performance measurement

The lack of transparency in measuring investment performance and associated costs remains the Achilles heel of endowment asset management in Oxford and Cambridge. These institutions need a deeper understanding of their sources of risk-adjusted performance ('alpha') as well as the risks involved in attaining that performance. They need to comprehend both asset allocation decisions (typically guided by the Investment Committee) and stock selection (generally made by the asset managers). They also need to infer whether investment returns were achieved as a result of superior decision-making or were random and non-replicable outcomes—that is, they need to seek evidence of skill. Needless to say, costs and fees feature in this analysis; when we refer to performance, it is after-costs performance that matters.

One way to secure comprehensive performance analysis is to employ an independent performance measurement firm. Outsourcing to an external firm would secure economies of scale as well as consistency in the choice of analytical method. Currently, performance analysis is fraught with limitations. Efficient asset allocation decisions cannot realistically be taken without adequate information on the investment portfolios' aggregate profile on a range of subjects, such as the asset mix, risk profile, costs, and performance attribution. It is essential that these institutions address these issues urgently.

Analysis of the annual accounts of the Colleges in Oxford and Cambridge that do disclose information on investment performance raises an array of issues. For a start, there is no common standard for reporting investment performance; no consistent basis for the measurement of performance, comparable analysis of benchmarks, or asset allocation. Long-term analysis of asset allocation versus investment performance is not possible as neither set of data is in the public domain. Some Colleges report investment performance without any actual reference to returns as illustrated in the following examples:

- The continued recovery in stock markets is reflected in the growth in the value of the College portfolio. Cash balances invested in the University Deposit Pool continued to earn a competitive interest rate (Linacre College, Oxford).
- The College's Investment Advisory Group (IAG) actively monitors the performance of the professional investment advisers retained by the College, and ensures that an appropriate allocation of asset types is maintained and monitored to pre-agreed benchmarks. The objective of the College is to maximize investment returns over the medium to long-term, taking into account such risk and liquidity factors as appropriate. The current structure is principally a mix of equity, bond and property holdings, while cash investments provide the College's working capital and assist in the management of operational cash flow.

The College is fortunate in having a high quality commercial property and real estate base to its investment portfolio. In addition, the recovery in investment returns from equities and gilt-edged securities has been beneficial to the College's overall financial position over the course of the year (Corpus Christi College, Cambridge).

Others expressed investment performance in the following terms:

- College investments at the year end were valued at £32.34 million. They included investment properties valued at £4.75 million and non-marketable investments. The College's investment securities portfolio rose in value over the year from £22.63 million to £27.23 million. The increase mainly reflected the improvements in stock market values, but included new gifts that were added to the College's trust and special funds portfolio in the course of the year (Sidney Sussex College, Cambridge).
- The College's investments performed well for a second consecutive year. Outside the operational buildings of the College, which make up 66.1 per cent of its fixed assets, the College has commercial properties valued at £6,240,000 and yielding £540,386 in income, together with a number of equity and fixed interest holdings yielding income amounting to £717,033. These showed a total return (income and capital gain) of 16.51 per cent (Churchill College, Cambridge).
- The Investment Subcommittee manages the College's investment portfolio for total return and it should be noted that the actual endowment income receivable in any particular year as shown on the Income and Expenditure Account is only one component of the endowment return, and may fluctuate significantly from year to year. The benchmark for investment performance since 1 July 2003 has been set at a long term real return of 4.5 per cent. Investment performance is measured by calendar quarters and the total return on quoted endowment securities and cash

was 13.2 per cent in the year to 30 June compared with 7.4 per cent for the benchmark. The College's trailing three year investment performance is 23.6 per cent which compares with 18.7 per cent for the benchmark. The total return on the FTSE All Share index over the three years was 25.3 per cent. The Subcommittee's general direction from the Governing Body and its Finance Committee is to provide for a prudent and sustainable percentage of the expected long run return on endowment to fund the College's objectives while at the same time aiming for some growth in real endowment capital. The Subcommittee believes that its sustainable spending target should range between 3 per cent and 4 per cent (St Catherine's College, Oxford).

There are about as many formats for reporting investment performance as there are Colleges. Lincoln College in Oxford, for example, under the heading 'Investment Performance' provided the following information in its financial statements for the year ended 31 July 2005:

The College's investments are under the direction of the Governing Body which acts on the recommendations of the Finance Committee. The Finance Committee is chaired by the Rector and benefits from the advice of two Committee members who are alumni of the College and who have special experience in investment and general financial matters. The College has continued to follow the investment plan formulated initially in October 2001. Investment strategy for financial assets is based on the maintenance of a core portfolio (UK and international equities and cash) supplemented by selected additional investments in specialist areas (private equity, hedge funds etc). During the latest year the College increased its private equity exposure by becoming a founding participant in the Oxford University Fund LP; and reinforced the 'core specialist' strategy by taking an exposure to global commodities, via Goldman Sachs Commodities Index certificates. The core financial asset portfolio is managed by JP Morgan Fleming Asset Management and the specialist investments by a variety of investment managers. The College's portfolio of commercial, agricultural and (non-student) residential properties is overseen by Laws and Fiennes of Broughton, Banbury.

For the purposes of operational budgeting a yield of 3% is assumed to be drawn down on a sustainable basis from the College's endowment assets. The actual yield on the College's investment portfolio was in excess of 3% in 2003-4.

Lincoln College has actually provided a significant amount of information relating to its endowment asset management arrangements, but not much on its actual asset allocation or investment performance.

Even Colleges that are relatively transparent may not disclose total return information in their annual account. All Souls College in Oxford, for example, for the year ending July 2005, reported its asset distribution: 22 per cent in UK-listed equities, 17 per cent in international equities, 3 per cent in private equity, 6 per cent in absolute return investments, 5 per cent in bonds and cash,

and the remainder (47 per cent) in a diversified property portfolio. But, total return or individual asset class returns were not available for its endowment, valued at £182.8 million.

St John's College, in Oxford, on the other hand, does not give a detailed breakdown of its endowment asset allocation, except an indication of its broad allocation: listed equities (33.6 per cent), unlisted equities (4.2 per cent), listed fixed income stock (29.8 per cent), cash (3.3 per cent), and property (29.1 per cent). The College generated a return of 28.8 per cent from its UK equities portfolio, 37.6 per cent from its overseas equities holdings; overseas bonds returned 24 per cent; domestic Index-Linked bonds returned 13.9 per cent and property returns were 33 per cent. Each asset category comfortably outperformed its respective benchmark. While a total return figure for the endowment portfolio, worth £257.4 million, is not available, estimates suggest they were higher than the 22.3 per cent achieved by the Yale endowment in 2004–5 during which period the decline of the US dollar over the previous 3 years was reversed, albeit by a narrow margin.¹ Like the Yale endowment, St John's endowment benefited from its broad diversification, though the asset distributions were very dissimilar. Unlike Yale, we do not have access to long-term data to compare the merits of investment strategies pursued by these institutions.

To provide another example of higher returns achieved by a College with a high equity orientation is Somerville College in Oxford, which secured a return of 25 per cent in 2004–5 by holding 66 per cent of its endowment portfolio in equities, 28 per cent in bonds and cash, 4 per cent in unlisted securities, and 2 per cent in property. Somerville's endowment was valued at £32.6 million. Somerville endowment's performance benefited from its high equity allocation. Thus, property was not always the performance driver over the last few years, though Colleges with a high allocation to both property and equities generally did well.

As listed equity investments performed well in 2004–5, it is difficult to understand why Colleges such as Wolfson and St Anne's, in Oxford, with 67 per cent and 70 per cent respectively in listed equities, reported returns of 7.5 per cent and 16.25 per cent respectively when the FTSE All Share rose 24.7 per cent over that period. Wolfson's endowment included 15 per cent in property, 11 per cent in unlisted securities and 7 per cent in bonds and cash in addition to the 67 per cent in equity assets. Wolfson's endowment was worth £22.2 million; but there is no clear explanation for its poor return. St Anne's endowment (70 per cent in public equities, 14 per cent in bonds and cash, and 15 per cent in an internal loan to the College) had a similar allocation to equity assets, and it reported returns twice those reported by Wolfson. Without standardized portfolio reporting, it is hard to establish how and why different Colleges' endowments (some with similar allocations) performed differently.

Even Downing College in Cambridge that provided comprehensive information on its endowment asset allocation, its total, and benchmark return for 2004–5, failed to account fully for its rather lacklustre performance of 13.3 per cent total return for the year. We were informed the College portfolio was being restructured but that was not a serious analysis of well below median returns. Similarly, Gonville and Caius's total return of 20 per cent for the 'eleven months' of 2004–5 was better, but we were not given the underlying asset allocation or benchmark for analysing such performance. One of the poorest returns in Oxbridge was reported by Peterhouse; 10.9 per cent in 2004–5 compared with 2.3 per cent in 2003–4. Its endowment asset distribution was 84 per cent in property, 11 per cent in listed equity, and the remaining assets in subsidiary companies, cash and unlisted securities. The accounts provide no comparable benchmark returns or explanation for its paltry returns. The IPD index return was 18 per cent for the year, the FTSE All Share return was 24.7 per cent and overseas equities returned 23.8 per cent. So, it is difficult to understand the sources of Peterhouse's 11 per cent return.

Each of the Colleges cited above followed investment strategies resulting in differing asset profiles. That by itself is not surprising; what is worth noting is the dispersion of returns arising and tolerated within a single collegiate family. The Colleges, though related in a federal system, operate independently implementing asset allocation policies that make sense to each individual institution. But the range of investment returns among these closely knit institutions raises several issues and potential solutions. There is clearly little herding, which can be a good thing as long as it reflects greater independence of decision-making among these institutions resulting in greater competition.

However, performance should be rigorously analysed. There is no evidence to suggest such a process is in place. There could be better pooling of resources in terms of sharing information on returns, managers, costs, asset mix, and investment approach. There is an informal network of course, but individual investment strategies are not scrutinized among the peer group. Apart from providing networking opportunities, without relevant analytical material available to these institutions, the contribution to the decision-making process from peer consultation can be limited.

Colleges in Oxford and Cambridge are often constrained in what they can afford to do in terms of acquiring and using investment related information. As long as they are truly independent in seeking out individual solutions, it may be appropriate for some Colleges to increase their indexed allocation; for others, it could be investing more in alternative assets and absolute return strategies, including property. Blind replication of what the peer group is doing is not an option for a cohort of investors whose investment policies are highly individualized. But there is clearly scope for more pooling of resources. Knowing the peer group asset allocation could be advantageous in terms of

overall decision-making, and benefits could be gained initially from a system of internal benchmarking.

As a third of Oxbridge endowments were invested in property, both the cost and performance of this asset class need to be assessed carefully. The cost of managing property is among the highest in total costs of endowment management. While a detailed cost breakdown between property and non-property investments is not available, overall cost analysis suggests that the Colleges are not paying too much for their endowment management. Nevertheless, the size of the opportunity for gaining good value for money may be gauged by considering that, for example, the £2 billion currently under fragmented management in Oxford is costing the collegiate University around £10 million per annum, which might be put to greater advantage.

Institutions within the endowment world have adopted an increasingly professionalized approach to asset management, as witnessed by the rise in employment of ex-investment bankers and finance specialists in the sector. These individuals are, in turn, more likely to hire investment consultants and to exploit new concepts in asset management, and the collective impact on future practices within endowments is set to rise. Future generations are likely to judge today's endowments by their long-term improvement in risk control and investment performance.

Conclusion

If asset allocation decisions, based on careful assessment of individual objectives, are interpreted as being more efficient, then these institutions in behaving independently could be regarded as being on the right path. From defining investment policy to risk management, though they agree broadly on investment issues and are aware of one another's general approaches, there is little herding among them. What they forego is the scope for economies of scale, not to mention greater centralization in decision-making. Such scale economies are hard to achieve because the Cambridge and Oxford Colleges are truly independent bodies, and are not simply departments of a single institution. However, increased transparency can have a similar effect, in that it is likely to support informed decision-making and to mitigate unnecessary risk-taking. The concern that Colleges compete with other endowments is not an argument for opacity. After all, despite considerable public disclosure, the investment strategies of Yale and Harvard are not easily copied.

The limited role of investment consultants in Oxford and Cambridge asset management may also have contributed to the lack of herding among the Colleges. The level of diversity manifest in all aspects of Oxbridge endowment

management, except in the alternative assets area where Cambridge Associates and Fauchier Partners have facilitated greater cohesion and pooling of investments, is something that the Colleges value and seek to retain. As one external observer commented to us, 'Cambridge Associates seems to be making a killing advising colleges separately; pooling of endowments will generate considerable economies of scale.'

If consultants were to have a strategic role in asset allocation among institutions in Oxford and Cambridge, they would doubtless move towards more similar portfolios. While there is no hard evidence to suggest that the Colleges today possess a clear investment edge, apart from their expertise in property and their high allocation to the sector, it can be assumed that the substantial dispersion in their current asset allocation policies would be eroded. We do not know how many Colleges might be persuaded that, by following more homogenous strategies (at least for non-property assets), higher risk-adjusted returns could be achieved. But if that conviction were shared among Colleges, there would be increased pressures to pool endowment assets.

The extent to which investment consultants might make a difference to the asset management process among these institutions also depends on the degree to which consultants are willing to invest in researching the specific needs of the sector. The common perception among the bursars today is that the interests of the Colleges and their consultants are far from aligned. Differences in interest exist between an endowment and their external managers as well as their advisers. Problems surrounding investment horizon, intergenerational equity, tax matters, and various forms of risk, for example, concern endowments more intimately than other investors.

Diversity makes for more efficient portfolios and markets. Whether such a high level of diversity in investment approaches is necessary or desirable, taking into account the overall size of endowment assets in Oxford and Cambridge, is an interesting question. While the Colleges clearly value their independence, one of the questions that engaged all the Colleges was: 'Is there an ideal asset allocation for truly long-term investors such as educational endowments?' The asset allocation strategies of Ivy League institutions are examined regularly but not emulated. There exists a degree of scepticism about such strategies, primarily because access to similar investment opportunities remains limited for Oxbridge institutions.

Unlike pension funds in the 1980s and early 1990s, when balanced mandates based on peer group benchmarks were the norm, Oxbridge institutions remain refreshingly original in their investment approach. Such conviction-driven investing may disappear for a host of reasons, including the rise of 'professional' investment bursars and the increasing influence of investment consultants in strategic decision-making. The low penetration of consultants, coupled with an absence of specialized education for foundation and

Concluding observations

endowment asset managers, has driven a wedge between the endowment practices in Europe and North America. There is now greater awareness of peer group activity, increased impact from a new breed of professional investors in the sector, and a widening range of professional education activities targeted at endowments. For better or worse, it is likely that the current level of individualism revealed by these institutions will gradually disappear.

Notes

Acknowledgements

1. Note that in our tables, entries are rounded and hence may not sum to 100 per cent.

Chapter 1: Endowment definition

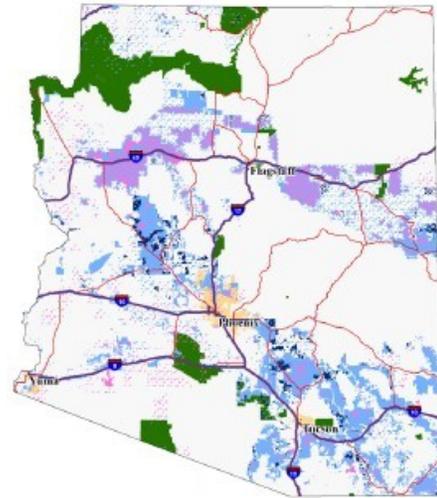
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5. *Ibid.*, p. 32.
6. *Higher Education Financial Yearbook 2005/6*, p. 2.III.
7. 'Costing, Funding and Sustaining Higher Education: A Case Study of Oxford University', Oxford Centre for Higher Education Policy Studies (OxCHEPS) and The Ulanov Partnership (February 2004), p. 2.
8. *Cambridge University Reporter, Accounts of the Colleges and Approved Foundations in the University of Cambridge*, Vol CXXXV, 18 March 2005, p. 159. According to a news item by Bloomberg, 'Cambridge and Oxford Adopt U.S. Methods to Win Alumni Donations', on 1 December 2005: 'At Cambridge it cost £13,500 to educate an undergraduate each year. The University receives £7,500 in state support and student tuition fees, which the government caps at £1,150. That leaves a £6,000 deficit per student per year.'
9. 'Costing... Oxford University', OxCHEPS, p. 12.
10. *Ibid.*, p. 25.
11. *Ibid.*, p. 28.
12. *Higher Education Financial Yearbook, 2005/6*.
13. 'Costing... Oxford University', OxCHEPS, p. 6.
14. Comparable data were not available for Cambridge as five Cambridge Colleges, including Trinity, opted not to report their accounts in the newly recommended SORP format. The published *Accounts of the Colleges* in the University of Cambridge for the year ending 2004 therefore does not include comparable data for all the Colleges. Total income for the 25 Cambridge Colleges reporting in the SORP format for the year ending 2004 was £139 million compared to Oxford's £210.6 million.

Arizona Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are approximately 9.3 million surface acres and 9 million mineral acres of trust land in Arizona.¹ Surface acres include land that is managed for commercial and residential development uses, agricultural uses and grazing. The mineral acres contain deposits of precious minerals, oil, gas, and minerals used as aggregate or fill.² There are trust lands throughout the state, but unlike many western states, many trust lands in Arizona are held in large, contiguous blocks. Approximately one million acres of trust land occur within a 60 minute or less drive of the Phoenix and Tucson metro areas.

State Trust Lands in Arizona



Light blue designates state trust land.

Due to sale activities for given trust lands, maps may not reflect the most current holdings of a given state trust land agency.

Map: Sonoran Institute

How are trust lands in Arizona managed?



Photo: Diana Rhoades

Trust lands in Arizona are managed by the Arizona State Land Department (ASLD), which is directed by the State Land Commissioner. The State Land Commissioner is appointed by the Governor. The Board of Appeals, a five-member board appointed by the Governor for six-year terms, acts as a review and approval entity with decision-making authority when decisions of the Commissioner are contested.³ The Arizona Revised Statutes require that the ASLD “hold the public lands of this state in trust for the benefit of the people of this state and shall manage them in an orderly and beneficial manner consistent with the public policy declared in subsection B.”⁴

The ASLD is responsible for the management, lease and sale of trust lands, the receipt of revenues from trust land activities, and the subsequent transfer of these funds to the State Treasurer. Their mission is “To manage State Trust lands and resources to enhance value and optimize economic return for the trust beneficiaries, consistent with sound stewardship, conservation, and business management principles supporting socioeconomic goals for citizens here today and generations to come. To manage and provide support for resource conservation programs for the well-being of the public and the State’s natural environment.”⁵

Who are the beneficiaries of trust lands in Arizona?

Revenues generated from Arizona's trust lands are deposited into fourteen separate trust funds that support eleven beneficiary groups. A specific acreage of trust lands was granted to each beneficiary, and the revenue generated from those lands is deposited into the corresponding fund.

Public schools are the designee of 87.5% of the trust land in Arizona and receive the majority of the revenue generated by trust land in the state.

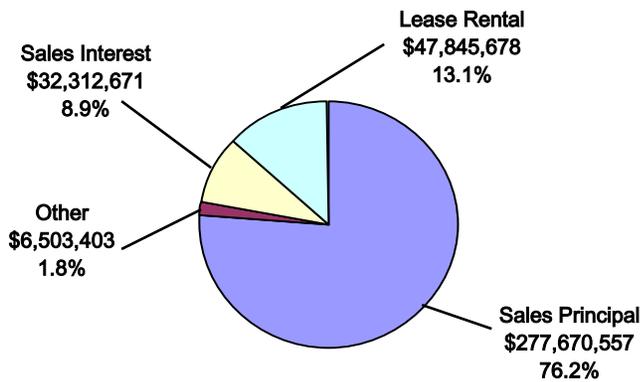
Arizona Trust Land Beneficiary Funds and Acreage Dedicated to Each⁶

Fund	Beneficiary	Surfaces Acres in Fund	% Acres
Agricultural and Mechanical Colleges	Engineering Programs at University of Arizona (UA) Arizona State University (ASU) Northern Arizona University (NAU)*	124,944	1.3%
Common Schools (K-12)	Public Schools	8,105,550	87.5%
Legislative, Executive and Judicial Buildings	Department of Administration for Bonds **	64,257	0.7%
Military Institutes	ROTC Programs at ASU, NAU, and UA *	80,168	0.9%
Miners' Hospital (2 Grants)	Pioneers' Home	95,431	1.0%
Normal Schools (teacher colleges)	ASU, NAU, and UA *	174,798	1.9%
Penitentiary	Penitentiary	76,111	0.8%
School for the Deaf and Blind	School for the Deaf and Blind	82,560	0.9%
School of Mines	University of Arizona	123,254	1.3%
State Charitable, Penal and Reformatory	Juvenile Corrections – 25% Department Of Corrections – 25% Pioneers' Home – 50%	76,930	0.8%
State Hospital	Arizona State Hospital	71,248	0.8%
University Land Code	ASU, NAU, and UA *	137,908	1.5%
University of Arizona 1881	UA	54,218	0.6%
Total		9,267,377	100.0%

* Distribution determined by enrollment

** For financing public buildings

How are revenues generated from trust lands?



Revenue Streams from Arizona Trust Lands for All Beneficiaries Combined, FY 2006⁷

Arizona trust land managers generate revenue from these lands in a number of ways, including land sales, residential and commercial leases, agriculture, grazing and right-of-way leases. The three largest sources of revenues from trust lands in fiscal year 2006 were from land sale principal and interest and lease rental revenue.

Over the last five years, the biggest source of income for the public schools has come from land sales principal, with lease rentals generally being second. Beginning in fiscal year 2004, sales interest became third, overtaking royalties.

How does the revenue get to the beneficiaries?

Each year, revenues generated from trust land uses are deposited into the given beneficiary group's Permanent Fund or distributed directly to the beneficiaries depending on the source of the revenue. Permanent Funds receive revenues from non-renewable sources, such as land sales and mineral royalties.⁸ Revenues from renewable sources, such as lease rental revenues, permits and interest from the deferred payments associated with land sales, are distributed directly to the beneficiaries. By the end of FY 2006, the market value of the Permanent Common School Fund totaled \$1.9 billion.⁹ In fiscal year 2006, Arizona school trust lands generated approximately \$363 million, of which \$264 million was deposited into the Permanent Common School Fund and \$99 million distributed to the Department of Education.¹⁰

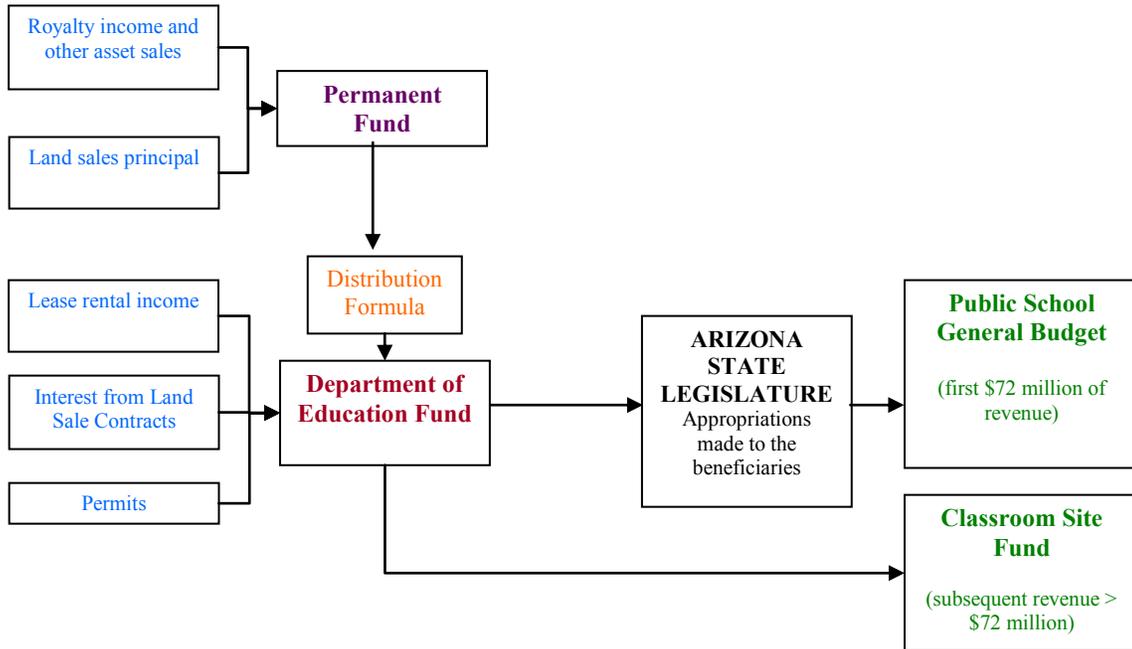
Permanent Land Funds are managed and invested by the State Treasurer.¹¹ The State Treasurer distributes funds to the beneficiaries from the permanent fund according to a constitutional formula. The formula distributes the preceding five-year net return (accounting for inflation) multiplied by the average monthly market value of the preceding five years. This ensures the fund will grow with inflation.

All trust land revenues that are distributed to the beneficiaries, both from the State Treasurer as well as from the Arizona State Legislature, with the exception of the public schools, are used by the beneficiary. In the case of public schools, the first \$72 million of revenue are combined with general fund revenue and distributed to the schools. Any amount over \$72 million is distributed to the Classroom Site Fund.

Revenue in the Classroom Site Fund is allocated to each school district on a per-pupil basis and is not subject to legislative appropriation; instead there are statutory requirements on how the districts can allocate the revenue.¹² Sixty percent is allocated for teaching compensation, twenty percent of which is to increase teachers' base pay and forty percent compensates teacher performance. The remaining forty percent is termed menu monies and can be spent on a number of other needs including student performance interventions, class size reduction, dropout prevention, additional teacher compensation, professional development, and teacher liability insurance.¹³ The Arizona Revised Statutes require that "Monies designated by law as special state funds shall not be considered a part of the general fund" and that "School districts and charter schools may not supplant existing school site funding with revenues from the fund."¹⁴

District Steering committees comprised mostly of teachers help determine how the districts will allocate the money. The largest portion of the Classroom Site Fund, about 93% in FY 2004, was spent for teacher base pay increases and performance compensation, followed by professional development.

Public School Funding Chart¹⁵



Public schools in Arizona receive funding from a combination of federal, state and local funds. State funding provides 45% of total education funding, and of the state’s portion, trust land revenues make up approximately 3.5% of that amount.

FY 2003 Public School Funding Source Diagram¹⁶

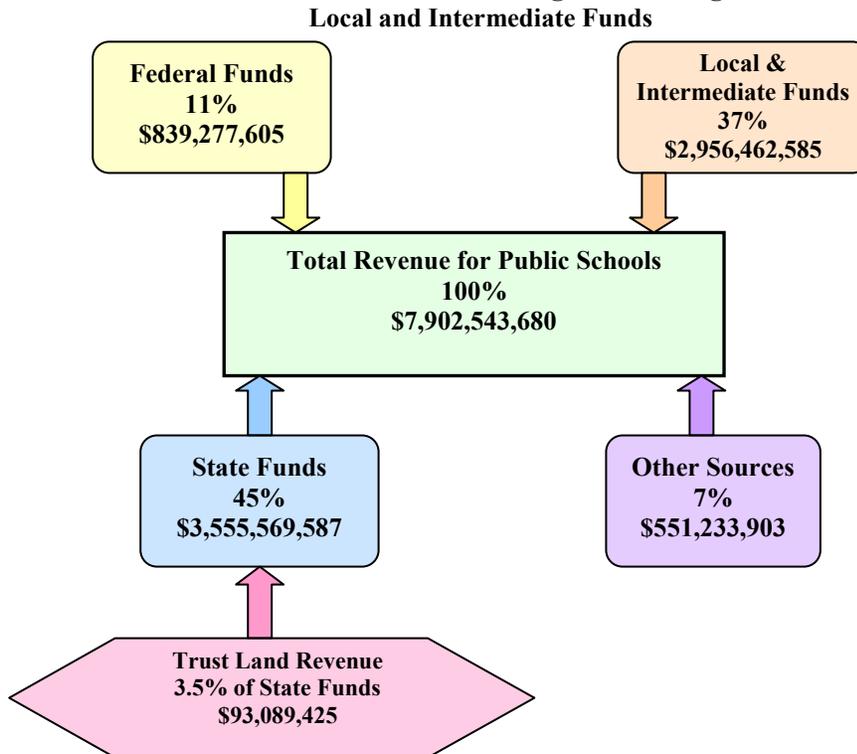




Photo: The Nature Conservancy

Sources:

¹Arizona State Land Department, Annual Report 2003-2004.

²Telephone Interview with Sharon Gulden, Chief Accountant at the Arizona State Land Department (2005).

³Arizona Revised Statutes § 37-132 and § 37-213.

⁴Arizona Revised Statutes § 37-902.

⁵Arizona State Land Department webpage http://www.land.state.az.us/support/mission_goals.htm. (March 11, 2007).

⁶Arizona State Land Department, Annual Report 2005-2006.

⁷Arizona State Land Department, Keith Fallstrom, Budget and Accounting Manager, Personal Communication (July 2007).

⁸Telephone Interview with Sharon Gulden, Chief Accountant at the Arizona State Land Department (2005).

⁹Arizona State Land Department, Annual Report 2005-2006.

¹⁰Ibid.

¹¹Arizona Revised Statutes §§ 37-521 through 37-526.

¹²Arizona Revised Statutes § 15-943.

¹³Arizona Revised Statutes § 15-977.

¹⁴Arizona Revised Statutes § 35-142 and § 15-977.

¹⁵Arizona Revised Statutes §§ 37-521 through 37-526.

¹⁶ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data, which comes from the Arizona State Land Department *Annual Report 2003*. “Other Sources” is defined as “Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets.” NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.

This report was prepared by the Sonoran Institute/Lincoln Institute of Land Policy Joint Venture and Children’s Land Alliance Supporting Schools (CLASS). Thanks to Wendine Thompson-Dawson and Alden Boetsch for their research and writing efforts.

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Colorado Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are approximately 2.8 million surface acres and 4 million mineral acres of trust land in Colorado.¹ Surface acres include land that is managed for agriculture, grazing, commercial and right-of-way uses.² The mineral acres include underground areas that contain deposits of oil, gas and coal.³ Trust lands in Colorado are mostly concentrated in a checkerboard pattern in the eastern grasslands, although there are a few large, consolidated parcels, including areas near more urban parts of the state such as Denver, Colorado Springs and Pueblo.

State Trust Lands in Colorado



Light blue designates state trust land.

Due to sale activities for given trust lands, maps may not reflect the most current holdings of a given state trust land agency.

Map: Sonoran Institute

How are trust lands in Colorado managed?



Photo: Colorado SBLC

The management of Colorado's trust lands is overseen by the Colorado State Land Board (SLB), comprised of five volunteer Commissioners who are appointed by the Governor and approved by the Colorado State Senate for a four-year term.⁴ The SLB is one of eight divisions within the Colorado Department of Natural Resources. The members of the SLB appoint a Director to administer Colorado's trust lands under the SLB's oversight and approval.⁵ The SLB is responsible for generating a "reasonable and consistent income over time" for trust beneficiaries.⁶ The agency is funded from proceeds from the trust lands, not from tax dollars.

The SLB is responsible for the management, lease and sale of state trust lands, the receipt of revenues from trust land activities, and the subsequent transfer of these funds to the State Treasurer. The Colorado Constitution requires that the SLB hold trust assets in a "perpetual, inter-generational public trust for the support of public schools," managed to protect the value of the trust under principles of sound stewardship.⁷

Who are the beneficiaries of trust lands in Colorado?

Revenues generated from Colorado’s trust lands are deposited into eight separate trust funds that support seven beneficiary groups. A specific acreage of trust lands belongs to each beneficiary, and the revenue generated from those lands is deposited into the corresponding beneficiary’s funds.

Colorado Trust Land Beneficiary Funds and Acreage Dedicated to Each⁸

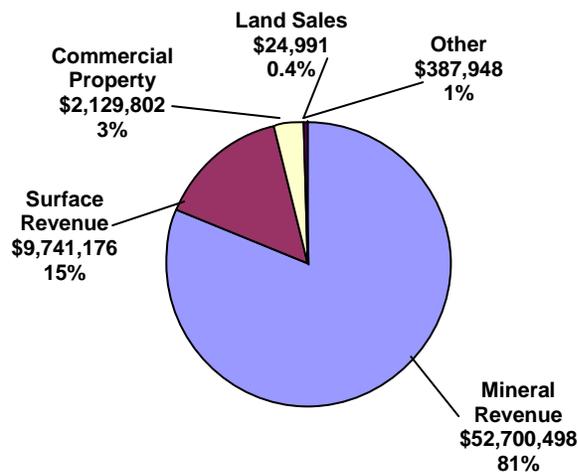
Fund	Beneficiary	Surface Acres in Fund	% Acres
Colorado State University	Colorado State University	19,949	0.7%
Hesperus	Fort Lewis College	6,279	0.2%
Internal Improvements	State Parks	67,406	2.4%
Penitentiary	Penitentiary	6,847	0.2%
Public Buildings	Public Buildings	530	0.0%
Saline	State Parks	11,358	0.4%
School	Public Schools	2,663,238	93.5%
State Forest	State Forest	70,201	2.5%
University of Colorado	University of Colorado	3,521	0.1%
	Total	2,849,329	100.0%

Public schools are the beneficiary of 93% of the trust land in Colorado and receive the majority of the revenue generated by state trust land in the state.⁹



Photo: Colorado SBLC

How are revenues generated from trust lands?



Revenue Streams from Colorado Trust Lands for All Beneficiaries Combined, FY 2006¹¹

Colorado's trust land managers generate revenue from these lands through resource extraction, grazing leases, and real estate sales and leases. The three largest sources of revenues from trust lands in FY2006¹⁰ were from mineral revenue, surface uses such as grazing leases and rights-of-way, and commercial property.

Over the last five years, the biggest source of income for the public schools has come from mineral development.¹² It is anticipated that the property that once was the Lowry Bombing Range, when developed, will provide significant revenue because of its proximity to the Denver metropolitan area.

How does the revenue get to the beneficiaries?

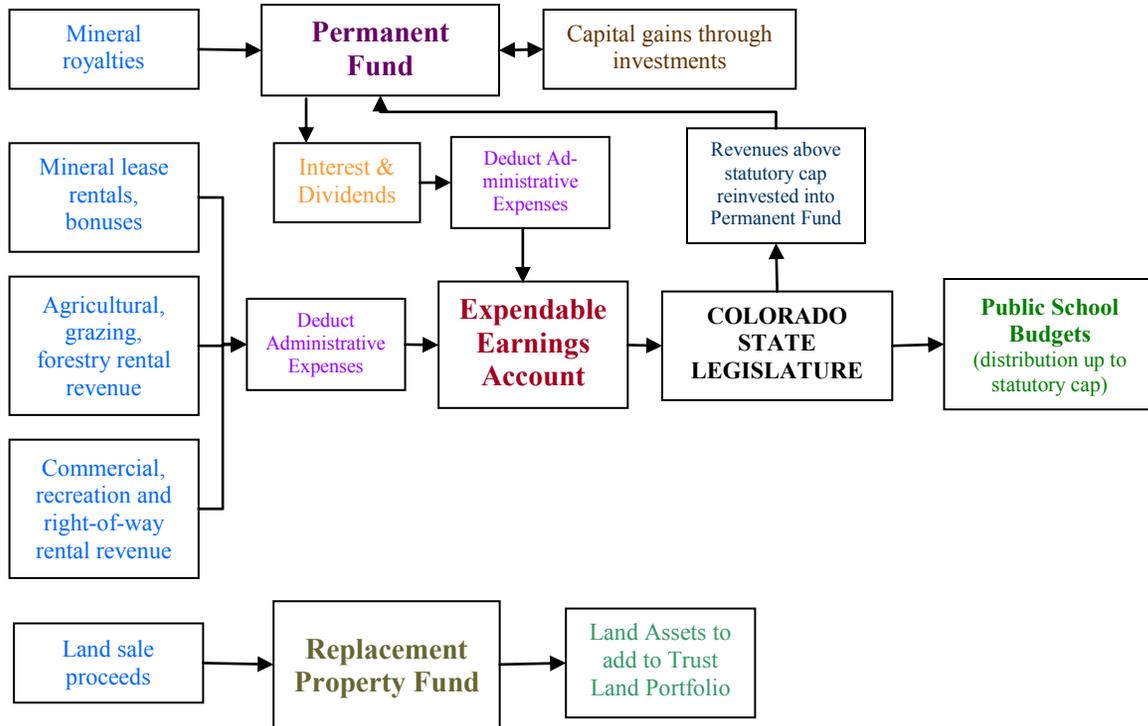
Revenues generated from trust land uses are deposited into the given beneficiary group's Permanent Fund or Expendable Earnings Account. Permanent Funds receive revenues from non-renewable sources, such as mineral royalties. Revenues from renewable sources, such as commercial leasing, grazing, agricultural, recreation and right-of-way rentals are deposited into Expendable Earnings Accounts. Proceeds from the sale of school trust land are deposited into a Replacement Property Fund that can be used to acquire new parcels of school trust land.¹³ However, if the proceeds are not used to buy new land within two years, these funds are transferred to the School Permanent Fund. In FY2006, Colorado trust lands generated almost \$65 million, of which \$48 million was deposited into the Public School Permanent Fund.¹⁴

Twelve million dollars from lease revenue was deposited in the Expendable Earnings Account for legislative appropriations along with some interest from the Permanent Fund. These revenues supported overall education funding despite a Colorado constitutional provision that "Distributions of interest and other income for the benefit of public schools...shall be in addition to and not a substitute for other moneys appropriated by the general assembly for such purposes,"¹⁵ a supplement to, not a substitute for, general fund appropriations.

Permanent Funds are managed and invested by the State Treasurer. At the end of FY 2006, the market value of the Public School Permanent Fund was \$454 million, and the interest income generated from investing the fund was \$22 million. The State Treasurer is funded out of the state's general fund and the Public School Permanent Fund can only be invested in bonds, time deposits, savings and loan associations, and bonds issued by school districts.¹⁶ Any capital losses from investments must be offset with gains in the Permanent Fund within three years; otherwise appropriations from the state general fund are required to make up the loss.¹⁷

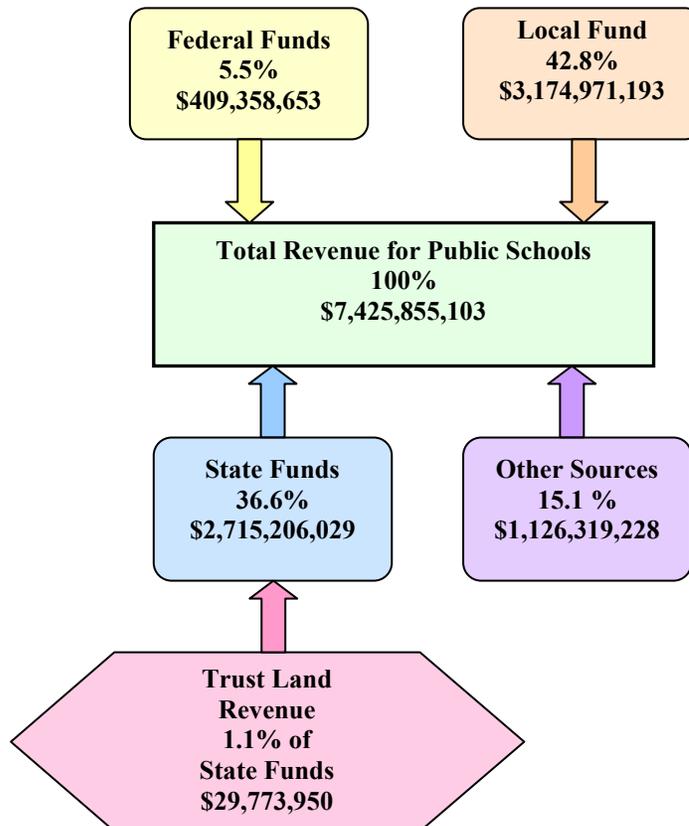
Only interest from the Permanent Funds is available for distribution to the beneficiaries, while the corpus of the Fund remains untouched. The entire balance of Expendable Earnings Account is made available for legislative appropriation and distribution to the beneficiaries up to the statutory cap. The Colorado State Legislature appropriates the Expendable Earnings Account including investment income from the Permanent Funds as part of the general operating budget of each of the beneficiaries up to a cap established by the Legislature. Money above the cap is reinvested in the respective Permanent Fund. The cap is high for all funds except the Public School Permanent Fund.

Public School Trust Funding Flow Chart¹⁸



Public schools in Colorado receive funding from a combination of federal, state and local funds. State funding provides 36.6% of total education funding, and of the state’s portion, trust land revenues make up 1.1% of that amount.

FY 2003 Public School Funding Source Diagram¹⁹ Local and Intermediate Funds



Since trust land revenue is included in the general fund appropriations for each of the beneficiaries, the dollars generated from trust lands can only be traced from the land to the beneficiary's operating budget. However, the Colorado Constitution states that this money should be a supplement to, and not a substitute for, general fund appropriations.²⁰



Photo: Colorado SBLC

Sources:

- ¹ Colorado State Land Board webpage <http://www.trustlands.state.co.us/Information/AboutUs.asp> .
- ² Colorado State Board of Land commissioners FY 2004 Annual Report.
- ³ Colorado State Board of Land Commissioners webpage <http://www.trustlands.state.co.us/Documents/Questions/General.pdf>.
- ⁴ Colorado Revised Statutes § 36-1-101.5.
- ⁵ Colorado Revised Statutes § 36-1-102.
- ⁶ Colorado Department of Natural Resources Budget Request “Detail by Program” FY 2005-2006, page 106.
- ⁷ Colorado Constitution Article IX § 10.
- ⁸ Colorado State Land Board Fiscal Year 2004 Annual Report and the Colorado State Land Board webpage <http://www.trustlands.state.co.us/Information/AboutUs.asp>.
- ⁹ Colorado State Land Board FY 2005 Annual Report.
- ¹⁰ Colorado State Land Board FY 2005-2006 Year End Revenues Report.
- ¹¹ Ibid.
- ¹² Ibid.
- ¹³ Colorado Revised Statutes, § 36-1-124.5.
- ¹⁴ Colorado State Land Board FY 2005-2006 Year End Revenues Report.
- ¹⁵ Colorado Constitution Article IX, Section 3.
- ¹⁶ Colorado Revised Statutes § 22-41-104, 24-36-109, 24-36-112, and 24-36-113.
- ¹⁷ Mike Coffman, Colorado State Treasurer, Personal Communication 2004.
- ¹⁸ Based on chart from Colorado State Land Board FY 2004 Annual Report.
- ¹⁹ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data which comes from the Colorado State Land Board *FY 03 Year-End Revenues Report*. “Other Sources” is defined as “Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets.” NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.
- ²⁰ Mike Coffman, State Treasurer, Personal Communication (2004).

This report was prepared by the Sonoran Institute/Lincoln Institute of Land Policy Joint Venture and Children's Land Alliance Supporting Schools (CLASS). Thanks to Wendine Thompson-Dawson and Alden Boetsch for their research and writing efforts.

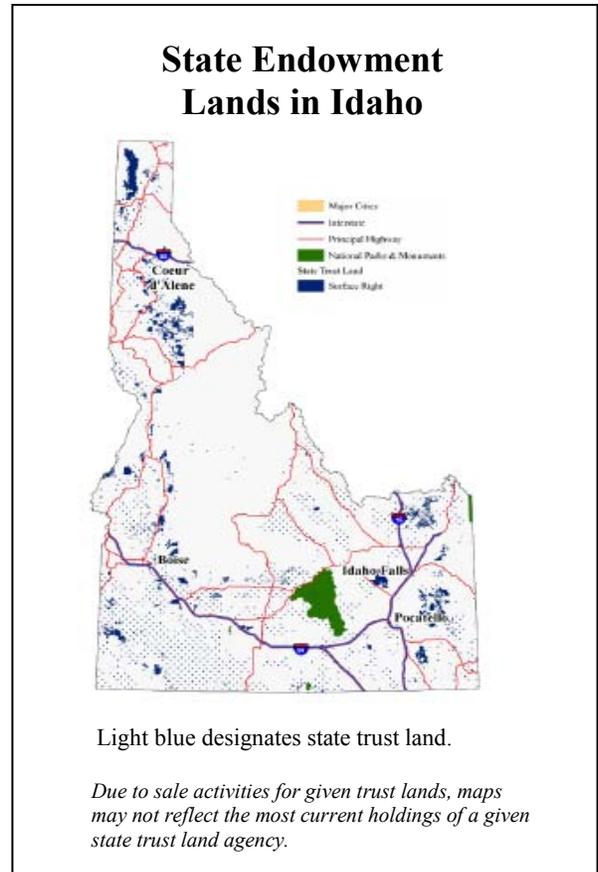
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Idaho Endowment Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands, or endowment lands as they are referred to in Idaho, are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are almost 2.5 million surface acres and approximately 3 million mineral acres of endowment land in Idaho.¹ Surface acres include land that is managed for timber, cottage sites, grazing, and residential and commercial real estate leasing uses. The mineral acres include underground areas that are managed for the extraction of minerals and other materials like sand, gravel and rock.² While most of these lands are distributed in a checkerboard pattern in the central and southern parts of the state, there are also a number of large, consolidated parcels of endowment land.³



Map: Sonoran Institute

How are endowment lands in Idaho managed?



Photo: Idaho Department of Lands

Endowment lands in Idaho are managed by the State Board of Land Commissioners that determines the policies, rules, and strategic plans for the agency, the Idaho Department of Lands (IDL). The Land Board is comprised of five statewide elected officials: the Governor, Secretary of State, Attorney General, State Controller, and the Superintendent of Public Instruction.⁴ The Land Board hires the Director of the Idaho Department of Lands.⁵ The Idaho Constitution requires the Land Board to manage the land “in such a manner as will secure the maximum long-term financial return to the institution to which granted.”⁶ The Land Board is also responsible for oversight of the Endowment Fund Investment Board.⁷ The IDL has many other responsibilities relating to the many other lands held by the state in addition to the endowment lands.⁸

The IDL is responsible for the management, lease and sale of Idaho's endowment land.⁹ Revenue generated from the management of endowment land is deposited into either an Earnings Reserve Account or a Permanent Endowment Fund, both of which are invested by the Endowment Fund Investment Board.¹⁰ Earnings are also used to pay the trust expenses of the agency which is not dependent on tax dollars for its trusts operations. The IDL's mission is to “manage endowment trust lands to maximize long-term financial returns to the beneficiary institutions and provide protection to Idaho's natural resources.”¹¹

Who are the beneficiaries of endowment lands in Idaho?

Revenues generated from Idaho’s endowment lands are deposited into nine different trust funds that support 14 beneficiary groups. Trust funds that benefit multiple beneficiaries are split, with a certain proportion of distributed revenue going to each beneficiary for that trust fund. Those amounts are noted in the chart below.

Idaho Endowment Land Beneficiary Funds and Acreage Dedicated to Each¹²

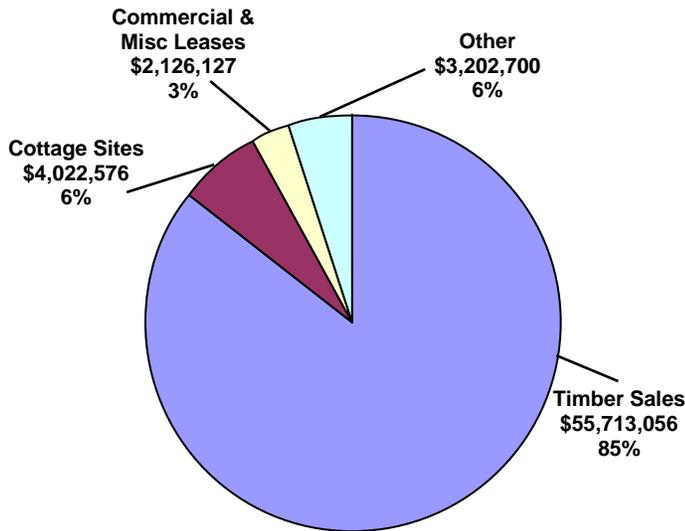
Fund	Beneficiary	Surfaces Acres in Fund	% Acres
Agricultural College	University of Idaho	33,464	1.3%
Charitable Institutions	Idaho State University (4/15) Industrial Training School (4/15) State Hospital North (4/15) Soldiers' Home (5/30) School for the Deaf and Blind (1/30)	77,807	3.2%
Public Schools	Public Schools (K-12)	2,090,904	85.0%
Normal School	Idaho State University (1/2) Lewis-Clark State College (1/2)	59,693	2.4%
Penitentiary	Penitentiary	28,904	1.2%
Capitol	Capitol Building Improvements	7,222	0.3%
School of Science	University of Idaho	75,397	3.0%
State Hospital South	State Hospital South	31,009	1.3%
University	University of Idaho	55,861	2.3%
	Total	2,460,261	100%

Public schools are the designee of 85% of the endowment land in Idaho and receive the majority of the revenue generated by endowment lands in the state.¹³



Photo: Idaho Department of Lands

How are revenues generated from endowment lands?



Revenue Streams from Idaho Endowment Lands for All Beneficiaries Combined, FY 2005 ¹⁶

Idaho endowment land managers generate revenue from these lands in a number of ways including timber sales, cottage site leases, and grazing, mineral and real estate leases.¹⁴ The three largest sources of revenue for the trusts from endowment lands in fiscal year 2005 were timber sales, cottage site leases (for residential cabins), and commercial leases.¹⁵

The biggest source of income for the beneficiaries comes from timber sales.¹⁷ Rather than leasing timberlands outright, the IDL sells timber at auction to the highest bidder at a thousand-board-foot rate which varies depending on the timber type harvested. The auction grants the highest bidder the right to harvest the designated trees, and the winner of the auction is mailed a monthly invoice for the value of the thousand-board-feet that were attained and harvested.

How does the revenue get to the beneficiaries?

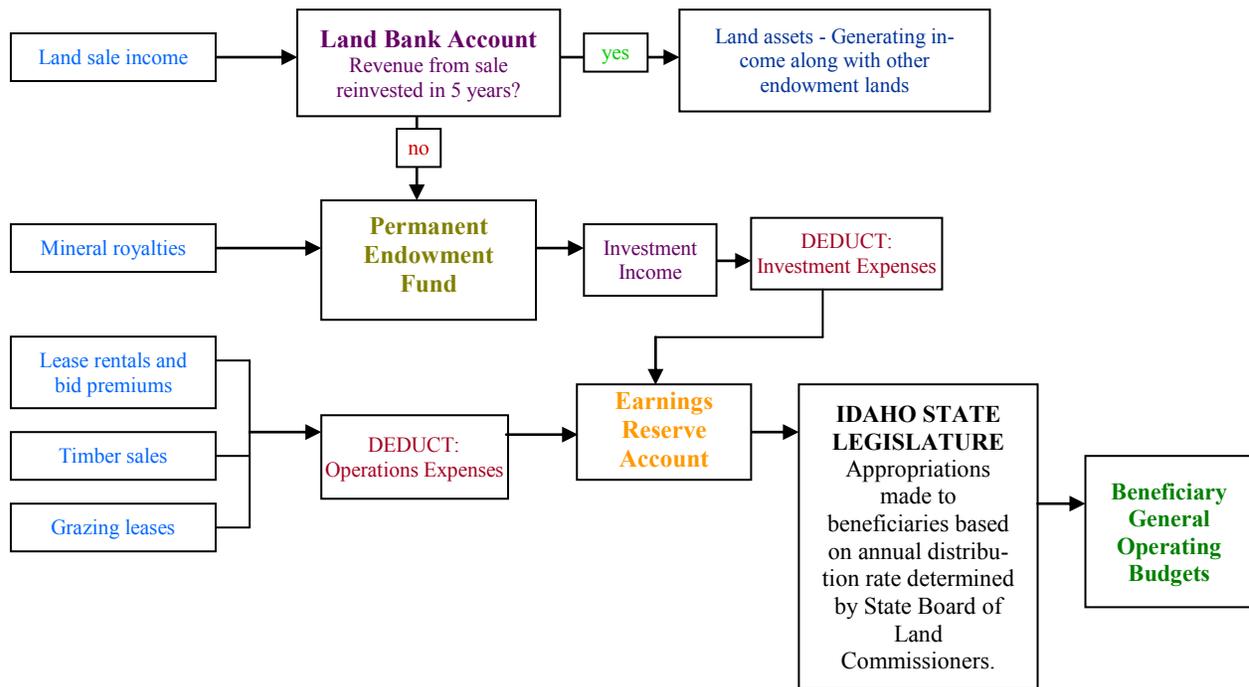
Each year, revenues generated from endowment land uses are deposited into the given beneficiary group's Permanent Endowment Fund or Earnings Reserve Account. Permanent Endowment Funds receive revenues from non-renewable resources like mineral royalties, excepting land sale revenue. Revenues from renewable sources such as timber, grazing, cottage site leases, other lease revenues and lease bid premiums are deposited into the Earnings Reserve Account. Revenue from the sale of endowment land is deposited in the Land Bank Account where it can be used to purchase replacement endowment lands to continue generating revenue for the trust. However, if the revenue from a land sale in the Land Bank Account is not used to purchase replacement lands within five years, it is transferred to the Permanent Endowment Fund.¹⁸ In fiscal year 2006, Idaho endowment lands generated \$66 million for all beneficiaries.¹⁹ After management expenses, approximately \$35 million was deposited into the public schools' Endowment Funds.²⁰

The Endowment Fund Investment Board (EFIB) manages and invests the Permanent Fund and the Earnings Reserve Fund as a single pool of assets for each of the beneficiaries, and is required to show prudence, diversification, loyalty and impartiality in their investments.²¹ Only the interest and dividend income from the Permanent Fund is distributed to beneficiaries, while the corpus of the Permanent Fund remains untouched. Permanent Fund interest and dividends in excess of inflation are deposited into the Earning Reserve Fund for the given trust, which is available for legislative appropriation and distribution to beneficiaries.²² The EFIB uses the Permanent Endowment Funds to generate investment income for the trusts. The Earnings Reserve fund serves as a buffer and stabilizer, muting the volatility of the financial investments and earnings from endowment lands in order to make the distributions to the beneficiaries more stable and predictable.

The State Board of Land Commissioners sets an annual distribution rate for each of the beneficiaries based on a three-year moving average of the market value of the Permanent Fund and proportion of the Permanent Fund attributed to each beneficiary.²³ This allows the Board to respond to changing returns from the land and

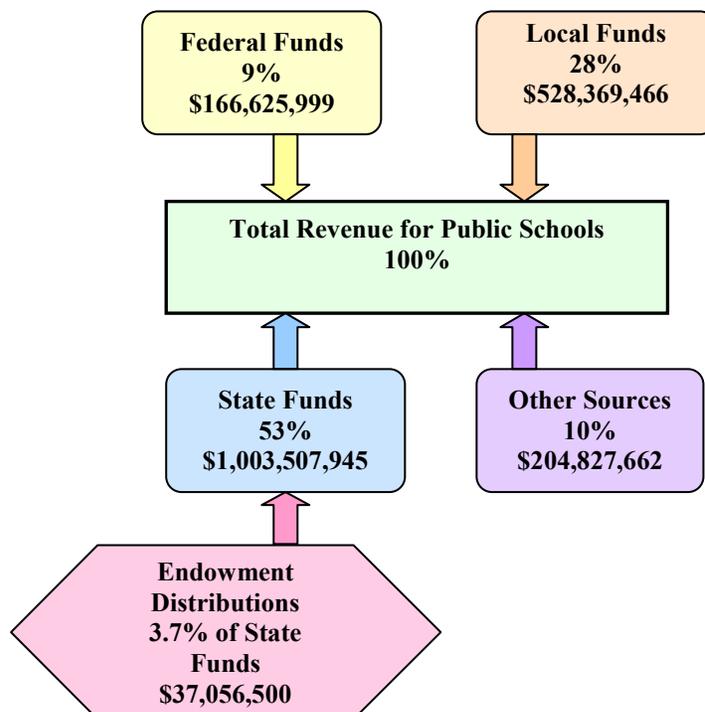
investment assets. Since the assets of the Permanent Fund are never distributed, payments are made from the beneficiaries' Earnings Reserve Accounts. However, to protect the corpus of the trust, if the Earnings Reserve Account falls to zero due to decline in the market value of the Permanent Fund, distributions to the beneficiaries cease. The State Legislature appropriates the money from the Earnings Reserve Account into the general operating budget for each of the beneficiaries.²⁴

Public School Trust Funding Flow Chart²⁵



Public schools in Idaho receive funding from a combination of federal, state and local funds. State funding provides 53% of total education funding, and of the state's portion, endowment land revenues make up nearly 4%.

FY 2003 Public School Funding Source Diagram²⁶ Local and Intermediate Funds





Trust land revenues and endowment fund earnings play a consistent role in the funding of public schools in Idaho. In FY2006, revenues to public schools from land and investment activities were \$53.5 million dollars.²⁷

Photo: Idaho Department of Lands

Sources:

- ¹ Idaho Annual Report FY 2006 (covering July 1, 2005 June 30, 2006).
- ² Idaho Annual Report FY 2006 (covering July 1, 2005 June 30, 2006), page 13.
- ³ Telephone interview with Winston Wiggins, Director of the Idaho Department of Lands, September 29, 2005.
- ⁴ Idaho Constitution Article IX § 7.
- ⁵ Idaho Code § 58-104.
- ⁶ Idaho Constitution Article IX § 8.
- ⁷ Idaho Code § 58-104.
- ⁸ Idaho Department of Lands webpage <http://www.idl.idaho.gov/overview.htm>.
- ⁹ Ibid.
- ¹⁰ Idaho Department of Lands Annual Report FY 2006, page 9.
- ¹¹ Idaho Department of Lands webpage <http://www.idl.idaho.gov/overview.htm>.
- ¹² Idaho Department of Lands Annual Report FY 2005 and Endowment Fund Investment Board FY 2004 Financial Statement.
- ¹³ Data from Idaho Endowment Fund Investment Board Financial Statements for FY 1999-2004.
- ¹⁴ Idaho Annual Report FY2006.
- ¹⁵ Kathy Opp, Support Services Division Administrator, Personal Communication, November 4, 2005.
- ¹⁶ Ibid.
- ¹⁷ Idaho Department of Lands Annual Reports FY 1999- FY 2006.
- ¹⁸ Idaho Code Titles 57 and 58 and §§ 20-102A, 33-902A, 33-2909A, 33-2911A, 33-2913A, 33-3301A, 66-1101A, and 66-1104.
- ¹⁹ Idaho Endowment Fund Investment Board FY2006 Financial Statement.
- ²⁰ Ibid.
- ²¹ Idaho Code § 58-104.
- ²² Idaho Endowment Fund Investment Board Financial Statements for FY 1999-2004.
- ²³ Telephone interview with Winston Wiggins, Director, Idaho Department of Lands, September 29, 2005.
- ²⁴ Ibid.
- ²⁵ Information generated from Idaho Codes and Endowment Fund Investment Board Financial Statements.
- ²⁶ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data which comes from the Idaho EFIB *Financial Statement 2003*. "Other Sources" is defined as "Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets." NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.
- ²⁷ State of Idaho Endowment Fund Investment Board. Financial Statement for Fiscal Years 1999-2005.

This report was prepared by the Sonoran Institute/Lincoln Institute of Land Policy Joint Venture and Children's Land Alliance Supporting Schools (CLASS). Thanks to Wendine Thompson-Dawson and Alden Boetsch for their research and writing efforts.

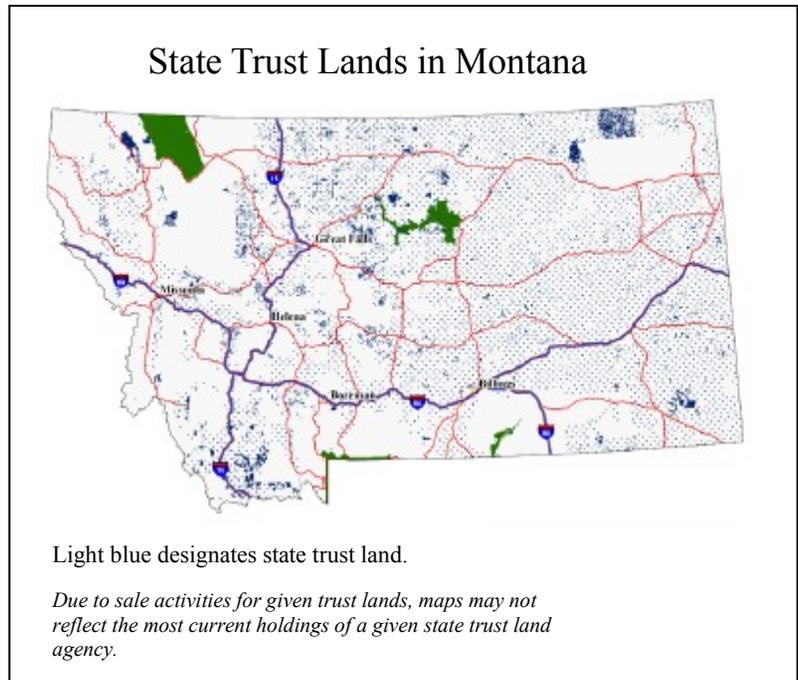
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Montana Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are approximately 5 million surface acres and 6.2 million mineral acres of trust land in Montana.¹ Surface acres include land that is managed for agriculture, grazing, timber and commercial uses. The mineral acres include underground areas that contain deposits of oil, gas, coal and other minerals.² Most of the trust lands in Montana are scattered throughout the state in a checkerboard pattern, with only a few consolidated parcels.



Map: Sonoran Institute



Photo: Montana Department of Natural Resources and Conservation

How are trust lands in Montana managed?

Trust lands in Montana are managed by the Montana Trust Land Management Division (TLMD) of the Department of Natural Resources and Conservation (DNRC). The TLMD operates with direction from the State Legislature and a Board of Land Commissioners composed of Montana's top five elected officials: the Governor, the Secretary of State, the Attorney General, the State Auditor and the Superintendent of Public Instruction.³ The Montana Code requires that the Board of Land Commissioners manage the land in order to “secure the largest measure of legitimate and reasonable advantage to the state” and “provide for the long-term financial support of education.”⁴ The Board sets policy and must approve permanent disposal of land and transactions over \$50,000.⁵ The Director of the DNRC is chosen by and serves at the pleasure of the Governor.⁶ The Administrator of the TLMD is hired by the Director and is the executive of the TLMD.⁷

The TLMD is responsible for the management, lease and sale of state trust lands. Their mission is to “manage the State of Montana's trust land resources to produce revenue for the trust beneficiaries while considering environmental factors and protecting the future income-generating capacity of the land.”⁸

Who are the beneficiaries of trust lands in Montana?

Revenues generated from Montana’s trust lands are deposited into 10 separate trust funds that support nine beneficiary groups. A specific acreage of trust lands belongs to each beneficiary, and the revenue generated from those lands is deposited into the corresponding fund.

Public schools are the designee of almost 90% of the trust land in Montana and receive the majority of the revenue generated by state trust land in the state.

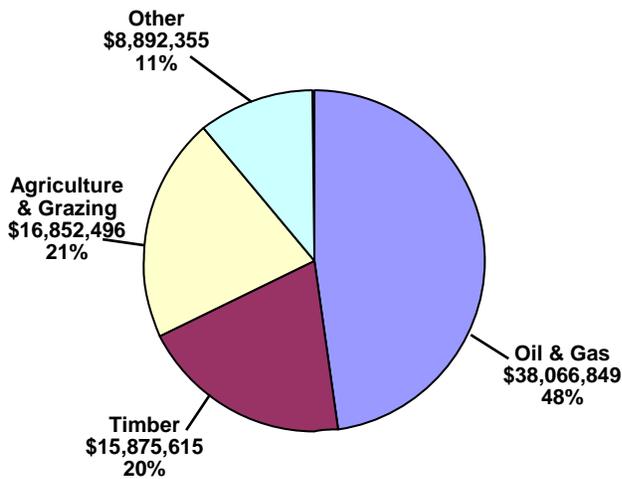
Montana Trust Land Beneficiary Funds and Acreage Dedicated to Each⁹

Fund	Beneficiary	Surface Acres in Fund	% Acres
Common School	Public Schools (K-12)	4,622,195	89.8%
University of Montana	University of Montana	17,973	0.4%
Montana State University - Morrill	Montana State University	63,456	1.2%
Montana State University – 2nd Grant	Montana State University	31,424	0.6%
Montana Tech of the University of Montana	Montana Tech	59,440	1.2%
State Normal School	MSU - Billings and Western MT college	63,455	1.2%
School for the Deaf and Blind	School for the Deaf and Blind	36,461	0.7%
State Reform School	Pine Hills Youth Correctional Center	67,855	1.3%
Veterans Home	Veterans Home	1,276	0.0%
Public Buildings	Public Buildings	186,991	3.6%
	TOTAL	5,150,526	100%



Photo: Montana Department of Natural Resources

How are revenues generated from trust lands?



Revenue Streams from Montana Trust Lands
for All Beneficiaries Combined, FY2006¹⁰

Montana trust land managers generate revenue from these lands in a number of ways, including oil, gas and mineral extraction, timber sales, grazing leases and agricultural uses.

For FY 2006, the three largest sources of gross revenue for the trust funds managed by Montana TLMD were oil and gas royalties, rentals and bonus payments; timber sales; and agricultural and grazing leases.¹¹ However, over the prior ten years agricultural and grazing leases have generated the majority of the income.

How does the revenue get to the beneficiaries?

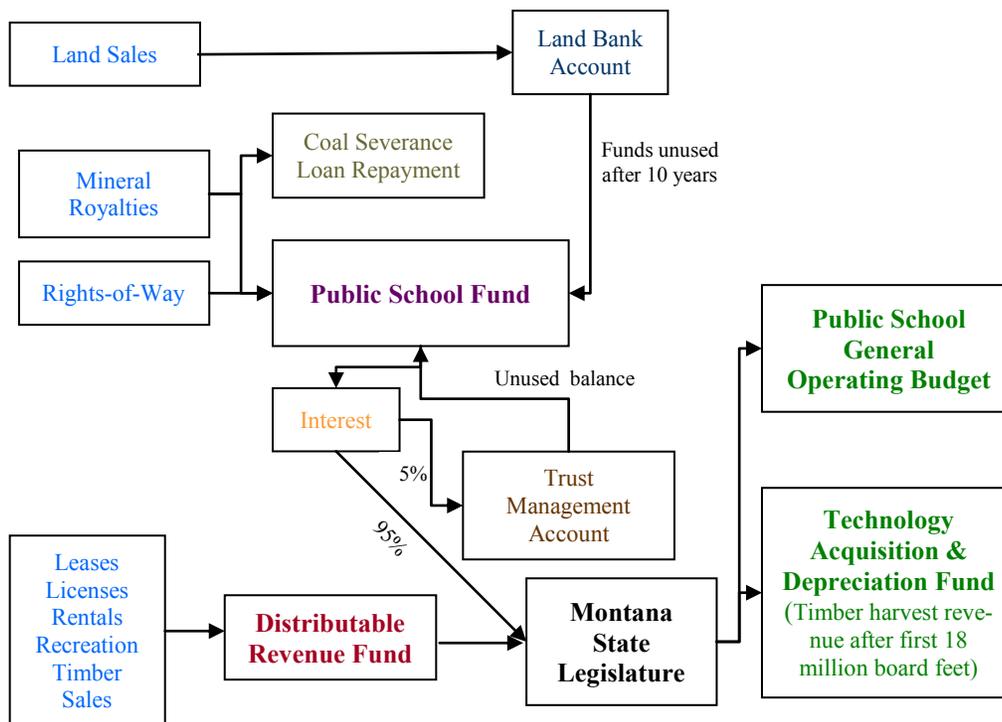
Each year, revenues generated from trust land uses are deposited into the given beneficiary's Permanent Fund or are distributed on an annual basis to the trust beneficiaries. Permanent Funds receive revenues from permanent asset dispositions, such as land sales, rights-of-way and mineral royalties. Revenues from timber sales (for public school beneficiaries only), leases and licenses, rentals, and recreational use are considered distributable revenue for the beneficiaries. Proceeds from trust land sales are deposited into a Land Bank Account where they can be used to purchase replacement land. If Land Bank Account funds are not used within ten years, they are transferred to the Permanent Fund for the given beneficiary. In FY 2006, Montana trust lands generated approximately \$80 million in net revenues including interest for the combined trust beneficiaries. The Common School Trust received \$65 million in net revenues, with \$4.6 million for the Technology Acquisition & Depreciation Fund and \$3.4 million deposited to the Public School Fund (Permanent Fund).¹² The estimated asset value of the lands in the Common Schools Trust in FY 2006 is \$3.9 billion.

Permanent Funds are managed and invested by the Montana Board of Investments, whose members are appointed by the Governor.¹³ The Board invests all the permanent funds as a single pool and then divides the interest income according to the trusts' initial contribution to the investment. The Montana Public School Fund was \$397 million in FY 2006.¹⁴ The Montana Constitution directs ninety-five percent of the interest from the Public School Fund to be distributed to the schools each year, in addition to 95% of the distributable revenues generated during the year. These funds are appropriated by the Montana State Legislature for the public schools' general operating budget. The remaining 5%, minus TLMD operating expenses, is credited to the Public School Fund.¹⁵ Funds for all other beneficiaries are made available for appropriation and distribution.

As a note, in FY 2002 the State Legislature borrowed \$46.4 million from the coal severance tax trust and deposited it into the Public School Fund in lieu of \$138.9 million in future mineral royalties. Since FY 2002, a portion of the mineral royalties generated from the Common School Trust have gone to repay this loan.¹⁶

Although the trust revenues appropriated to the public schools are directed to the schools' general operating budgets, revenue from timber harvests from common school trust lands, excluding the value of the first eighteen million board-feet, is directed to the Technology Acquisition and Depreciation Fund.¹⁷ This Fund is used for the purchase, rental or repair of technological equipment for public schools.¹⁸

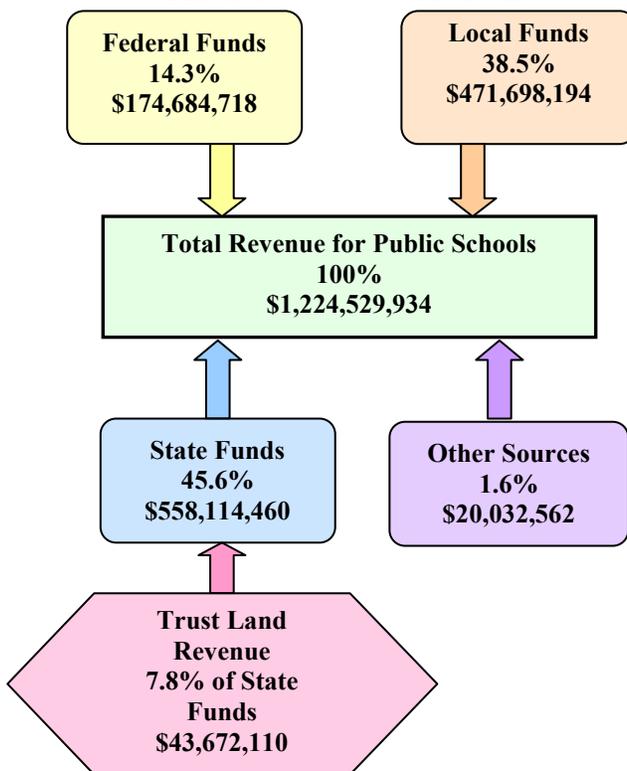
Public School Funding Chart¹⁹



Public schools in Montana receive funding from a combination of federal, state and local funds. In FY2003, state funding provided nearly half, or 45.6%, of total education funding, and of the state's portion, trust land revenues made up approximately 7.8% of that amount.

FY 2003 Public School Funding Source Diagram²⁰

Local and Intermediate Funds



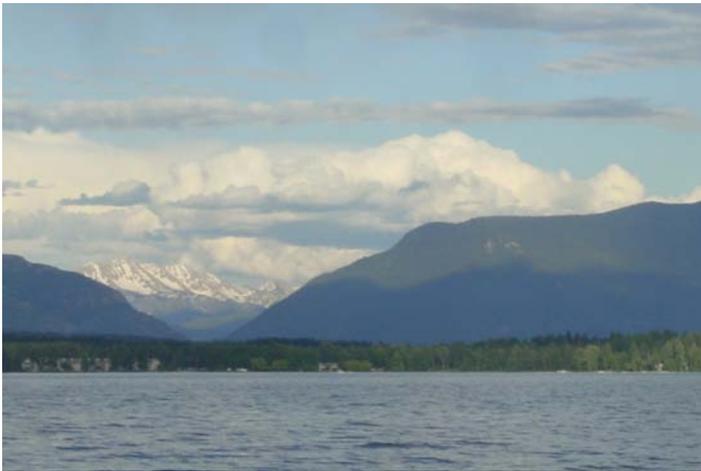


Photo: Montana Department of Natural Resources and Conservation

In FY 2006, over \$73 million was distributed to the public schools from the management of the Common School Trust.²¹ The contribution to public school funding, by percentage has also increased to 10.8% of state funding for public schools. Trust land revenues play a significant role in the funding of public schools in Montana. Though much of this distribution is combined with and may supplant general fund revenue, the portion of revenue that is distributed directly to the Technology Acquisition and Depreciation Fund allows schools to address pressing technology needs as the Office of Public Instruction deems necessary.

Sources:

- ¹ Montana Trust Land Management Division webpage <http://www.dnrc.state.mt.us/trust/tlmdhome.htm>.
- ² Tom Schultz, Administrator, Montana Trust Land Management Division, Personal Communication, 2005.
- ³ Constitution of the State of Montana Article X § 4.
- ⁴ Montana Code Annotated § 77-1-202.
- ⁵ Tom Schultz, Administrator, Montana Trust Land Management Division, Personal Communication, 2005.
- ⁶ Montana Code Annotated § 2-15-3301.
- ⁷ Montana Code Annotated § 2-15-111.
- ⁸ Montana Trust Land Management Division webpage <http://www.dnrc.state.mt.us/trust/tlmdhome.htm>.
- ⁹ Montana Trust Land Management Division webpage, Land Banking, available at http://www.dnrc.state.mt.us/trust/Land_Banking/default.htm.
- ¹⁰ Montana DNRC FY2006 Annual Report.
- ¹¹ Ibid.
- ¹² Ibid.
- ¹³ Montana Code Annotated §§ 52-7-105 and 77-1-202.
- ¹⁴ Montana DNRC FY2006 Annual Report.
- ¹⁵ Montana Code Annotated § 20-9-341.
- ¹⁶ Montana Trust Land Management Division, Annual Report for FY 2005, page 17.
- ¹⁷ Montana Code Annotated § 20-9-343.
- ¹⁸ Montana Code Annotated § 20-9-533.
- ¹⁹ Generated from information contained in Montana DNRC FY2006 Annual Report, Constitution and Statutes.
- ²⁰ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data which comes from the Montana DNRC *Annual Report Fiscal Year 2003*. The “State Funds” category includes state general funds and other state sources. The “Other Sources” category is defined as “Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets. NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.”
- ²¹ Montana DNRC FY2006 Annual Report.

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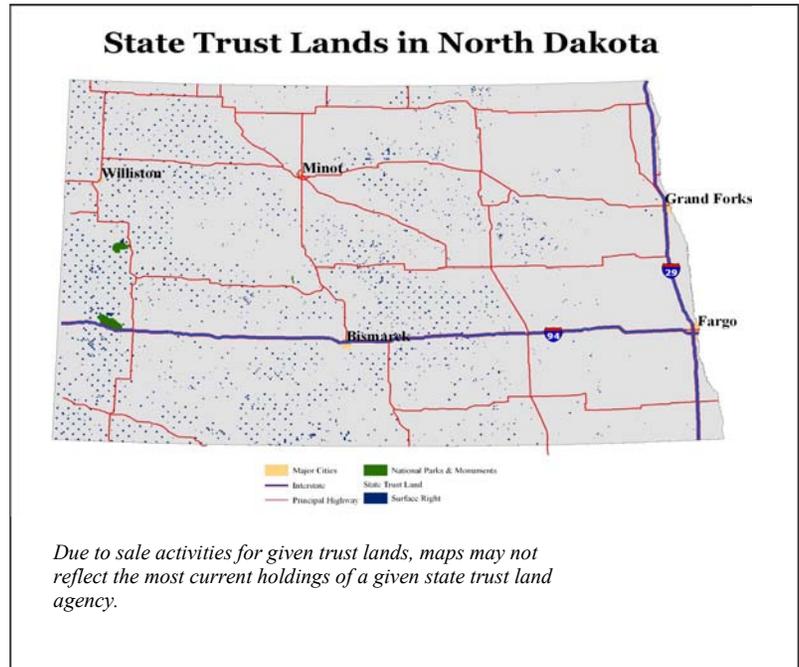
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North Dakota Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are approximately 700,000 surface acres and 1.8 million mineral acres of trust land in North Dakota.¹ Surface acres include land that is managed for agriculture, grazing, and right-of-way uses.² The mineral acres contain deposits of oil, gas and coal.³



Map: Sonoran Institute

How are trust lands in North Dakota managed?



Photo: Tim Kiser

The management of North Dakota's trust lands is overseen by the Board of University and School Lands (Board), whose members include the top five statewide elected officials: the Governor, Attorney General, Secretary of State, State Treasurer, and Superintendent of Public Instruction. The members of the Board appoint a Commissioner to administer North Dakota's trust lands and to direct the North Dakota State Land Department (NDSLDD) with the Board's oversight and approval.⁴ The Board was granted control of appraisal, sale, rental, and disposal of North Dakota's trust lands, with a constitutional direction to invest the proceeds of the trust lands.⁵ The North Dakota Constitution limits the surface use of trust lands to leasing for grazing and meadow purposes.

The mission statement of NDSLDD is consistent with the State Constitution, and is to "serve as a trustee for the benefit of the common schools (public grades K-12), various institutions of higher education, and certain other state institutions."⁶ The goal of the NDSLDD, as set in statute, is to "maximize distributable income and trust growth" given the laws and policies governing the department and is subject to the "prudent investor rule."⁷

Who are the beneficiaries of trust lands in North Dakota?

Revenues generated from North Dakota’s trust lands are deposited into thirteen separate trust funds that provide revenues for fifteen beneficiary groups. A specific acreage of trust lands was granted to each beneficiary, and the revenue generated from those lands is deposited into the corresponding beneficiary’s fund.

Public schools are the designee of over 91% of the trust land in North Dakota and receive the majority of the revenue generated by trust land in the state.⁸

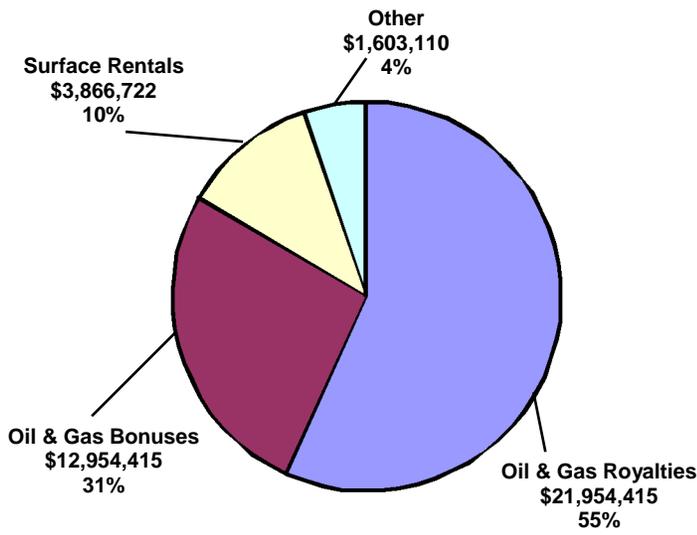
North Dakota Trust Land Beneficiary Funds and Acreage Dedicated to Each⁹

Fund	Beneficiary	Surface Acres in Fund	% Acres
Common Schools	Public Schools	636,099	91.1%
N.D. State University	N.D. State University	15,306	2.2%
State Hospital	N.D. State Hospital	2,242	0.3%
Ellendale State College	Dickinson State University Minot State University MSU-Bottineau Veterans Home School for the Blind State Hospital State College of Science	5,033	0.7%
Valley City State University	Valley City State University	4,961	0.7%
Mayville State University	Mayville State University	3,229	0.5%
N.D. School for the Blind	N.D. School for the Blind	3,522	0.5%
N.D. School for the Deaf	N.D. School for the Deaf	4,895	0.7%
Industrial School	Youth Correctional Center	3,800	0.6%
State College of Science	N.D. State College of Science	3,774	0.5%
Schools of Mines	University of North Dakota	3,450	0.5%
Veterans Home	N.D. Veterans Home (A Soldier’s Home)	2,800	0.4%
University of North Dakota	University of North Dakota	9,104	1.3%
	Total	698,215	100%



Photo:Hephaestos GFDL

How are revenues generated from trust lands?



Revenue Streams from North Dakota Trust Lands for All Beneficiaries Combined, FY 2006 ¹¹

North Dakota's trust land managers generate revenue from these lands through resource extraction (including oil and gas royalties and bonus revenues), grazing and hay farming leases, and land sales. The three largest sources of revenues from trust lands in FY2006 ¹⁰ were from oil and gas royalties, surface rentals, and oil and gas bonus revenues.

Over the last five years, the biggest source of income for the public schools has come from oil and gas royalties.¹²

How does the revenue get to the beneficiaries?

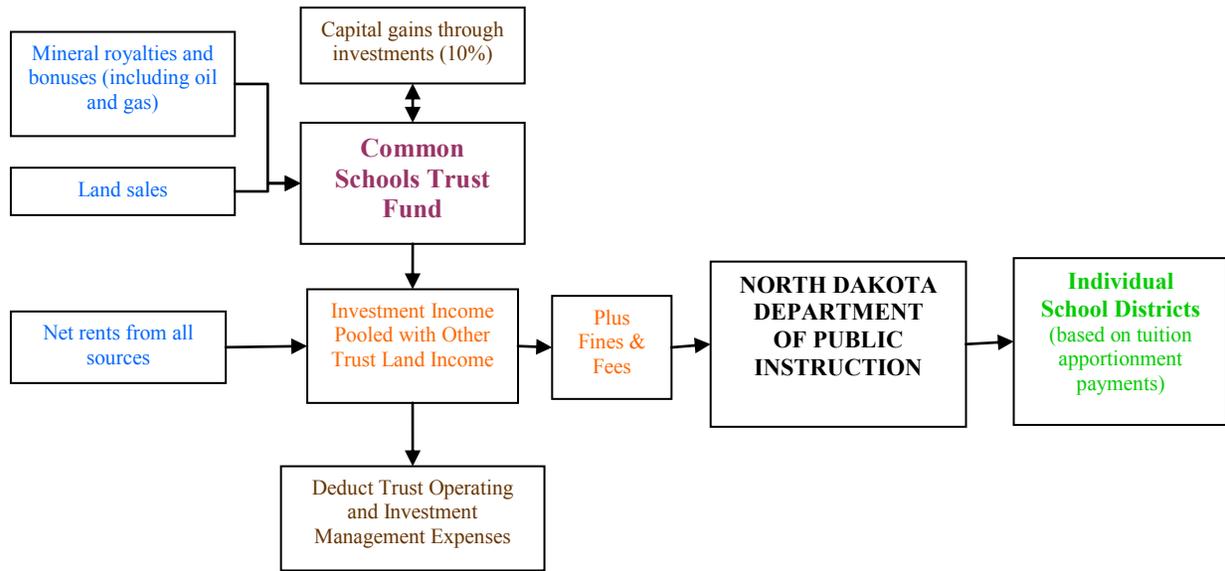
Revenues generated from trust land uses are deposited into the given beneficiary group's Trust Fund or to their expendable income account, depending on the source of the land revenues. The Common Schools Trust Fund receives revenues from non-renewable sources, such as land sales and mineral royalties and bonuses. The Common Schools Trust Fund also receives 45% of the state's tobacco lawsuit settlement proceeds, plus the net proceeds from unclaimed property and 10% of the state's oil extraction tax collections. Revenues from renewable sources, such as surface rentals for grazing or agricultural purposes or mineral rentals, are combined with investment income and realized capital gains from the Common Schools Trust Fund and made available for distribution to the beneficiaries, less operating and investment management expenses. For FY 2006, North Dakota's trust lands generated \$5.5 million in land revenue for the beneficiaries and investment income of \$31.5 million from the investment of the Permanent Funds.¹³ The market value of all of the Permanent Funds combined was \$817 million at the end of FY 2006.¹⁴ The trust beneficiaries received a total of over \$33 million in distributions from trust lands and funds during FY 2006.¹⁵

In 2006, voters approved Constitutional Measure No. 1, which would allow for a distribution method for trust land revenues based on a 5-year average of the value of the trust funds.¹⁶ However, implementation of this measure still awaits federal legislation to amend the 1889 Enabling Act for North Dakota. If this change is made, the distribution to the beneficiaries will change beginning with the 2009-2011 biennium. If Congress does not approve the Enabling Act change, distributions to the beneficiaries will continue according to current methods.¹⁷

The Board of University and School Lands is responsible for the investment of the trust funds and are required to apply the prudent investor rule as they manage trust funds, which states that the Board must invest as would an "institutional investor of ordinary prudence, discretion and intelligence."¹⁸ Only interest from the trust funds is available for distribution to the beneficiaries, while the corpus of the fund remains untouched.

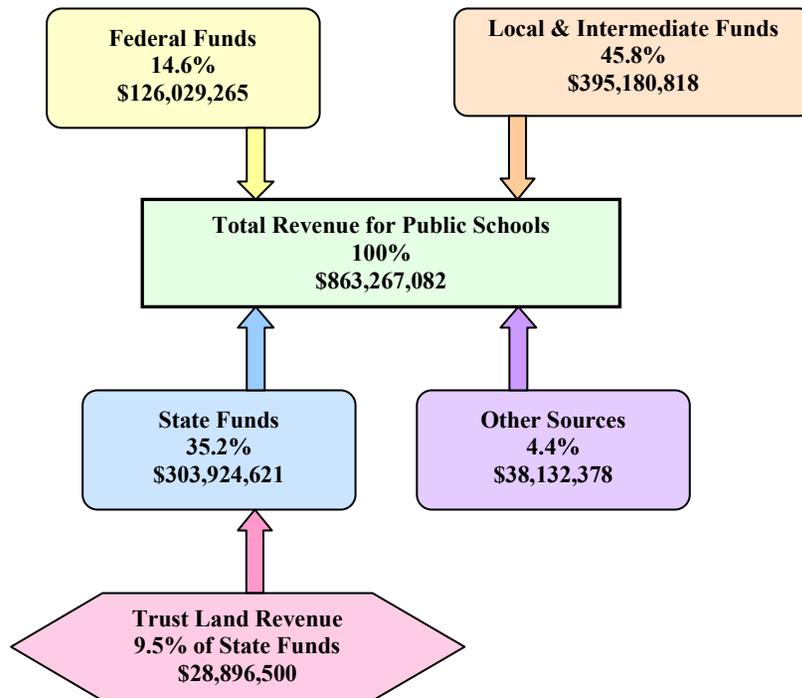
The total amount of trust land revenues provided to the public schools in FY 2006 was \$31.1 million, and was derived from the combined investment, capital gains, and rental income from the Common Schools Trust Fund.¹⁹ These revenues are pooled with fines and fees and are subsequently distributed to the school districts directly as a part of the tuition apportionment payments made by the Department of Public Instruction.

Public School Funding Flow Chart ²⁰



Public schools in North Dakota receive funding from a combination of federal, state and local funds. State funding provides 35.2% of total education funding, and of the state’s portion, trust land revenues make up 9.5% of that amount.

FY 2003 Public School Funding Source Diagram ²¹ Local and Intermediate Funds





Trust lands in North Dakota make up nearly 10% of state funding for education, giving them a significant role in overall funding for public schools. Commissioner Preszler notes that trust land funding is a “meaningful” source of revenue, especially as other sources of revenue languish due to tax revenues losses from a declining and aging population within the state.²²

Photo: Hephaestos GFDL

Sources:

- ¹ North Dakota State Land Department 2003-2005 Biennial Report. Mineral acreage provided by Jeff Engelson, Director of the Investment Division, North Dakota State Land Department, Personal Communication (2006).
- ² Ibid.
- ³ Ibid.
- ⁴ North Dakota Century Code § 15-02-01.
- ⁵ North Dakota State Constitution, Article IX § 3.
- ⁶ Jeff Engelson, Director of the Investment Division, North Dakota State Land Department, Personal Communication (2006).
- ⁷ Ibid.
- ⁸ North Dakota State Land Department 2003-2005 Biennial Report.
- ⁹ Ibid.
- ¹⁰ Ibid.
- ¹¹ Ibid.
- ¹² Ibid.
- ¹³ Ibid.
- ¹⁴ Ibid.
- ¹⁵ Ibid.
- ¹⁶ North Dakota State Land Department Fact Sheet “Frequently Asked Questions About Constitutional Amendment #1” Rev 03-06.
- ¹⁷ Ibid.
- ¹⁸ North Dakota Century Code § 15-3-04.
- ¹⁹ Gary Preszler, Commissioner, North Dakota State Land Department, Personal Communication (2007).
- ²⁰ Data provided by Keith Bayley, Account Budget Specialist, and Jeff Engelson, Director of Investment Division, Personal Communication (2006).
- ²¹ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data, which comes from the North Dakota State Land Department 2003 *Biennial Report*. “Other Sources” is defined as “Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets.” NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.
- ²² Gary Preszler, Commissioner, North Dakota State Land Department. Personal Communication (2006).

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Nebraska Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are approximately 1.4 million surface acres and 2.9 million mineral acres of educational trust land in Nebraska.¹

Educational trust lands in Nebraska comprise mainly grasslands, croplands and mineral lands.



Map: Sonoran Institute

How are trust lands in Nebraska managed?



Photo: Visitnebraska.org

Nebraska's trust lands are managed by the Nebraska Board of Educational Lands and Funds (NBELF). The Board is comprised of five members, four from Nebraska's congressional districts as established in 1961 and one at large member. Board members are appointed by the Governor and approved by the Nebraska State Senate.² This Board is responsible for the selection of a Deputy Director, who is the NBELF Chief Operating Officer and is responsible for administering Nebraska's educational trust lands under the NBELF's oversight and approval.³ The NBELF is "required to manage and conduct all School Trust operations and activities with mandatory fiduciary duty."⁴

The NBELF is responsible for the management, lease and sale of trust lands, the receipt of revenues from state trust land activities, and the subsequent transfer of these funds to the State Treasurer. According to NBELF's stated goals, the "Board and its staff are firmly committed to maximizing the income and preserving the assets of the School Trust for the benefit of Nebraska and its citizens. In pursuit of these goals, every effort is made to manage and conduct the Board's business operations on the profit motive patterned as closely as possible on business operations conducted by the most efficient enterprises in the private sector."⁵

Who are the beneficiaries of trust lands in Nebraska?

Revenues generated from Nebraska’s educational trust lands are deposited into four trust funds that provide revenue for public schools, the University of Nebraska, University of Nebraska Agricultural College, and the state colleges. A specific acreage of trust lands was granted to each beneficiary, and the revenue generated from those lands is deposited into the corresponding fund.

Nebraska Educational Trust Land Beneficiary Funds and Acreage Dedicated to Each⁶

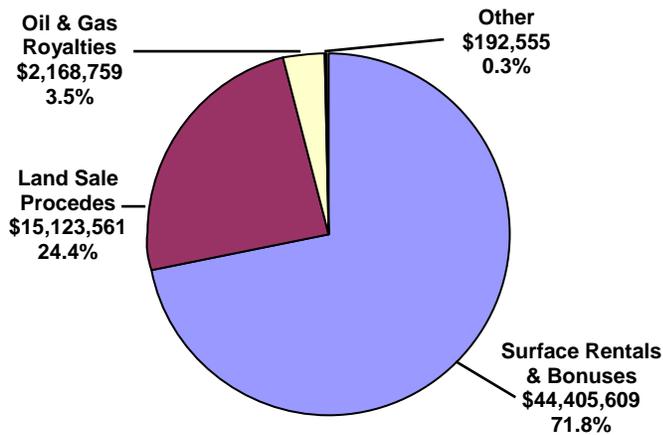
Fund	Beneficiary	Surface Acres in Fund	% Acres
Common Schools (K-12) (including saline lands)	Public Schools	1,340,183	99.3%
University	University of Nebraska	6,173	0.4%
University Agricultural College	University of Nebraska Agricultural College	3,814	0.3%
State College (Normal)	Nebraska State Colleges	75	0.0%
	Total	1,350,245	100.0%

Public schools are the designee of over 99% of the educational trust land in Nebraska and receive the majority of the revenue generated by trust land in the state.⁷



Photo: Visitnebraska.org

How are revenues generated from educational trust lands?



Revenue Streams from Nebraska Educational Trust Lands for All Beneficiaries Combined, Biennium 2006⁹

Nebraska's trust land managers generate revenue from these lands through a combination of agricultural leases and rentals, mineral leases, oil and gas royalties, land and timber sales, and other leases and rentals. The three largest sources of revenues from trust lands in Biennium 2006,⁸ were from surface rentals and bonuses, land sale proceeds, and oil, gas and mineral royalties.

Over the last five years, the largest source of income for the public schools has come from surface rentals and bonuses through agricultural leasing.¹⁰ The Board voluntarily pays the real estate taxes for their lessees, who repay the board, rather than making in-lieu-of-tax payments.

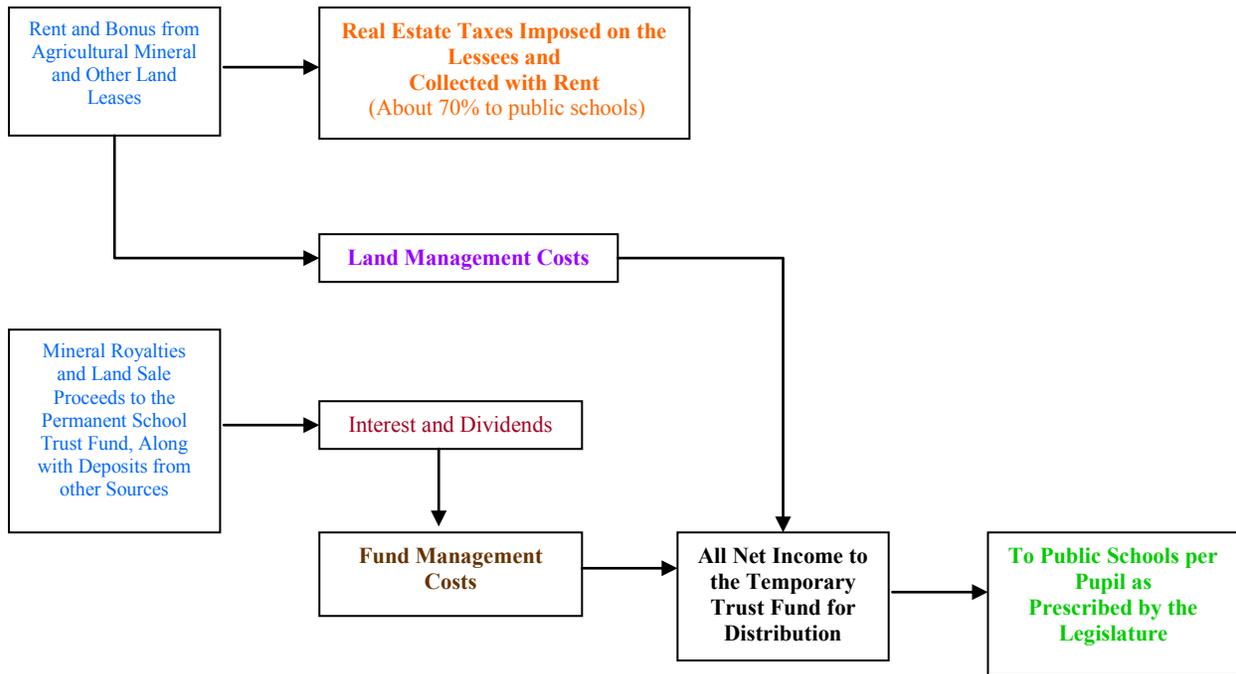
How does the revenue get to the beneficiaries?

Revenues generated from the public schools' educational trust lands are deposited into the Permanent School Trust Fund or into the Temporary School Trust Fund. The Permanent School Trust Fund receives revenues from non-renewable, or long-term renewable sources, such as land sales, mineral royalties, and timber. Revenues from renewable sources, such as lease rentals, bonuses, and interest on all leases, are transferred to the State Treasurer, where no more than 20% is deducted by legislative appropriation for land management costs and directed back to NBELF to fund day-to-day operations.¹¹ The land office typically uses about 10% to fund its operations.¹² The remaining renewable resource revenues are combined with interest and dividends from the Permanent School Trust Fund and deposited into the Temporary School Trust Fund.¹³ In Biennium 2006, Nebraska educational trust lands generated \$36.3 million for the Permanent School Trust Fund.¹⁴ In Nebraska, oil and gas severance taxes, federal mineral deposits, unclaimed property, escheats, and certain other licenses and fees also contribute to the principal of the Public School Permanent Trust Fund.

Permanent Funds are managed and invested according to the prudent person rule by the State Investment Officer under the direction of the Nebraska Investment Council.¹⁵ The Nebraska Investment Council is funded out of the earnings of the state funds it manages, where each fund contributes its relative share of the investment.¹⁶ The balance of interest and dividends are distributed to the beneficiaries, while capital gains are held in the Permanent Funds.¹⁷ All net income to the Temporary School Trust Fund, including the interest and dividends from the Permanent School Trust Fund, is made available for legislative appropriation and distribution to the schools on a per pupil basis as prescribed by the legislature.¹⁸ The market value of all permanent funds at the end of Biennium 2006 was \$400.5 million, of which \$397 million was the Permanent School Trust Fund. The market value of the land and fund for schools for biennium 2006 was \$914.5 million.¹⁹

The Nebraska State Legislature appropriates the Temporary School Trust Fund in two phases to county treasurers. In the first phase, the school districts containing non-taxable public land are reimbursed for the foregone property tax revenue. In the second phase, the remaining balance goes to all county treasurers for distribution to each school district on a per pupil basis.²⁰ The total distribution to schools in Biennium 2006 was \$59 million.²¹

Public School Trust Funding Flow Chart²²



Public schools in Nebraska receive funding from a combination of federal, state and local funds. State funding provides 32.5% of total education funding, and of the state’s portion, trust land revenues make up 3.3% of that amount.

FY 2003 Public School Funding Source Diagram²³ Local and Intermediate Funds

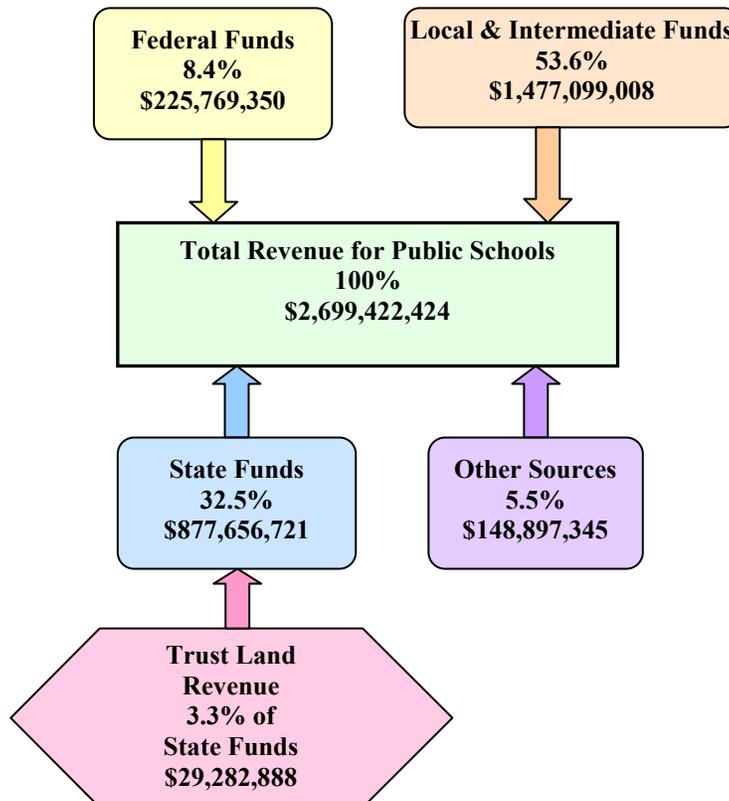




Photo: Matthew Trump

Educational trust lands revenues generally play a consistent role in the overall funding of public schools in Nebraska, but have been making a declining contribution relative to the general fund contribution. However, since total revenues from trust lands have been increasing over time, this indicates that general fund contributions to education have increased faster than that of trust land contributions. Deputy Director Gildersleeve says that the NBELF works hard to ensure that the beneficiaries receive the same rate as comparably rented or sold land that is held privately.²⁴

Sources:

- ¹Nebraska Board of Educational Lands and Funds, 65th Biennial Report, 2004-2006, and personal communication with L. Jay Gildersleeve, General Counsel and Deputy Director for the Board of Educational Lands and Funds (2007).
- ²Nebraska Constitution, Article VII § 6.
- ³Revised Statutes of Nebraska § 72-201 (5).
- ⁴Nebraska Board of Educational Lands and Funds web page, <http://www.belf.state.ne.us/index.htm>.
- ⁵Nebraska Board of Educational Lands and Funds web page, <http://www.belf.state.ne.us/history.htm>.
- ⁶Nebraska Board of Educational Lands and Funds, 65th Biennial Report, 2004-2006.
- ⁷Ibid.
- ⁸Cindy Kehling, Executive Assistant, Nebraska Board of Educational Lands and Funds, Personal Communication, 2006.
- ⁹Ibid.
- ¹⁰Nebraska Board of Educational Lands and Funds, 65th Biennial Report, 2004-2006 and Nebraska Board of Educational Lands and Funds website <http://www.belf.state.ne.us/history.htm>.
- ¹¹Revised Statutes of Nebraska § 72-232-07.
- ¹²Cindy Kehling, Executive Assistant, Nebraska Board of Educational Lands and Funds, Personal Communication, 2006.
- ¹³Revised Statutes of Nebraska § 79-1035.02.
- ¹⁴Cindy Kehling, Executive Assistant, Nebraska Board of Educational Lands and Funds, Personal Communication, 2006.
- ¹⁵Revised Statutes of Nebraska § 72-232.02.
- ¹⁶Revised Statutes of Nebraska § 72-1249.02.
- ¹⁷Revised Statutes of Nebraska § 79-103.5.01.
- ¹⁸Cindy Kehling, Executive Assistant, Nebraska Board of Educational Lands and Funds, Personal Communication, 2006.
- ¹⁹Based on information contained in the Nebraska Board of Education Lands and Funds 65th Biennial Report, 2004-2006 and Cindy Kehling, Executive Assistant, NBELF.
- ²⁰Revised Statutes of Nebraska § 79-1035 through § 79-1037.
- ²¹Based on information contained in the Nebraska Board of Education Lands and Funds 65th Biennial Report, 2004-2006 and Cindy Kehling, Executive Assistant, NBELF.
- ²²Ibid.
- ²³FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data, which comes from the Nebraska Board of Educational Lands and Funds 64th Biennial Report, page 11. "Other Sources" is defined as "Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets." NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.
- ²⁴L. Jay Gildersleeve, General Counsel and Deputy Director for the Board of Educational Lands and Funds (2004).

This report was prepared by the Sonoran Institute/Lincoln Institute of Land Policy Joint Venture and Children's Land Alliance Supporting Schools (CLASS). Thanks to Wendine Thompson-Dawson her research and writing efforts.

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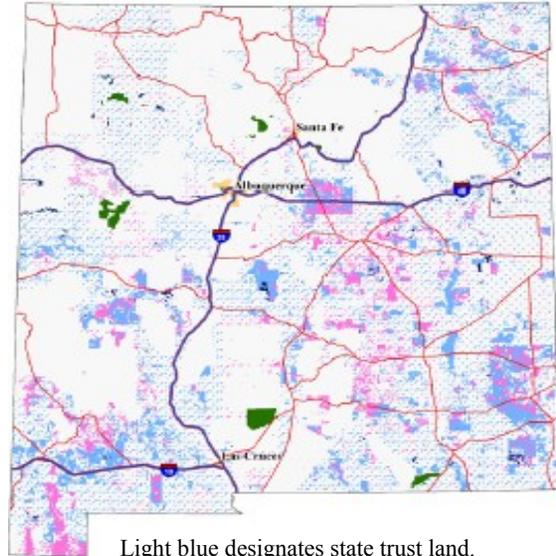


New Mexico Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are approximately 9 million surface acres and 13 million mineral acres of trust land in New Mexico.¹ Surface acres include land that is managed for grazing, agricultural, open space, and commercial and residential development uses. The mineral acres include underground areas that contain large deposits of oil, natural gas, and minerals. Most of the trust lands in New Mexico are scattered throughout the state in a checkerboard pattern, however, there are a few, large contiguous parcels.

State Trust Lands in New Mexico



Light blue designates state trust land.

Due to sale activities for given trust lands, maps may not reflect the most current holdings of a given state trust land agency.

Map: Sonoran Institute

How are trust lands in New Mexico managed?



Photo: Emily Kelly

Trust lands in New Mexico are managed by the Commissioner of Public Lands, who is one of the statewide elected officials, and directs the New Mexico State Land Office.

The mission of the New Mexico State Land Office is:

Recognizing that education is the key to prosperity and that it provides opportunity for an improved quality of life, we are dedicated to generating sustainable revenues from state trust lands to support our public education institutions. We strive to build partnerships with all New Mexicans to conserve, protect and maintain the highest level of stewardship for state trust lands, an ever-lasting legacy for generations to come.²

The New Mexico State Land Office's management principles, or "ABC's," include a requirement that the agency:

- A** Administer state trust lands to generate the highest possible level of sustainable revenue for New Mexico's public schools, public institutions of higher learning, and other public institutions so that all New Mexicans can enjoy a higher quality of life.
- B** Benefit the trust and its natural resources through responsible stewardship which creates a strong economic environment that will contribute to healthy rural and urban communities so that future generations will continue to benefit from their endowment.
- C** Conduct the operations of the State Land Office with the highest level of fiscal accountability, efficiency, customer service and employee relations."³

The SLO is responsible for the management, lease and sale of trust lands, the receipt of revenues from trust land activities, and the subsequent transfer of these funds to the State Treasurer.⁴

Who are the beneficiaries of trust lands in New Mexico?

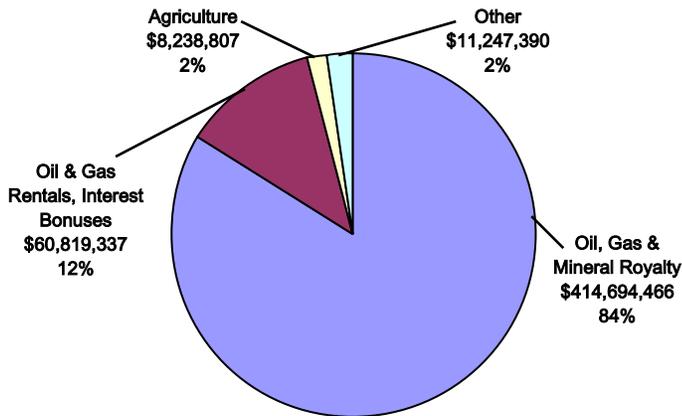
Revenues generated from New Mexico's trust lands are deposited into 21 trust accounts that provide support for the respective beneficiary. Each acre is designated to a specific beneficiary and the revenue generated from each acre is paid to the corresponding beneficiary.

Public schools are the designee of just over 73% of the trust land in New Mexico and receive 83% of the revenue generated by state trust land in the state.

New Mexico Trust Land Beneficiary Funds and Acreage Dedicated to Each⁵

Fund	Beneficiary	Surface Acres in Fund	% Acres
Capitol Buildings	Capitol Buildings	88,701	0.9%
Charitable, Penal and Reform Institutions (fund is divided equally between the beneficiaries)	Carrie Tingley Hospital Las Vegas Medical Center Los Lunas Hospital Miners' Colfax Medical Center Penitentiary of New Mexico New Mexico Boys' School Youth Diagnostic and Development Center	79,148	0.8%
Carrie Tingley Hospital	Carrie Tingley Hospital (children's hospital)	7,940	0.1%
Common Schools	Public Schools (K-12)	7,042,767	73.1%
Eastern New Mexico	Eastern NM University in Portales	88,979	0.9%
Water Reservoirs	Irrigation Works Construction Fund	346,029	3.6%
New Mexico State Hospital	Las Vegas Medical Center (State psychiatric hospital)	122,607	1.3%
Miners' Hospital of New Mexico	Miners' Colfax Medical Center	100,931	1.1%
New Mexico Boy's School	New Mexico Boys' School	50,935	0.5%
New Mexico Highlands University	New Mexico Highlands University	190,993	2.0%
New Mexico Military Institute	New Mexico Military Institute	140,099	1.5%
New Mexico School for the Deaf	New Mexico School for the Deaf	129,626	1.3%
New Mexico State University	New Mexico State University	200,696	2.1%
New Mexico School for the Visually Handicapped	New Mexico School for the Visually Handicapped	143,870	1.5%
New Mexico Tech	New Mexico Institute of Mining and Technology	163,641	1.7%
Northern New Mexico Community College	Northern New Mexico Community College	96,162	1.0%
Penitentiary of New Mexico	Penitentiary Fund	126,194	1.3%
Rio Grande Improvement	Rio Grande Improvement	58,261	0.6%
Saline Lands	University of New Mexico	1,044	0.0%
University of New Mexico	University of New Mexico	260,814	2.7%
Western New Mexico University	Western New Mexico University	190,993	2.0%
	Total	9,630,589	100.0%

How are revenues generated from trust lands?



New Mexico trust land managers generate revenue from these lands in a number of ways, primarily from oil and gas but also including grazing leases, and real estate leases. The three largest sources of revenues from trust lands in fiscal year 2006 were from oil and gas royalties, rentals, interest and bonuses; agricultural leases; and commercial, industrial and residential development.⁶

The largest source of income for the beneficiaries comes from oil and gas royalties.⁸

Revenue Streams from New Mexico Trust Lands for All Beneficiaries Combined, FY 2006⁷

How does the revenue get to the beneficiaries?

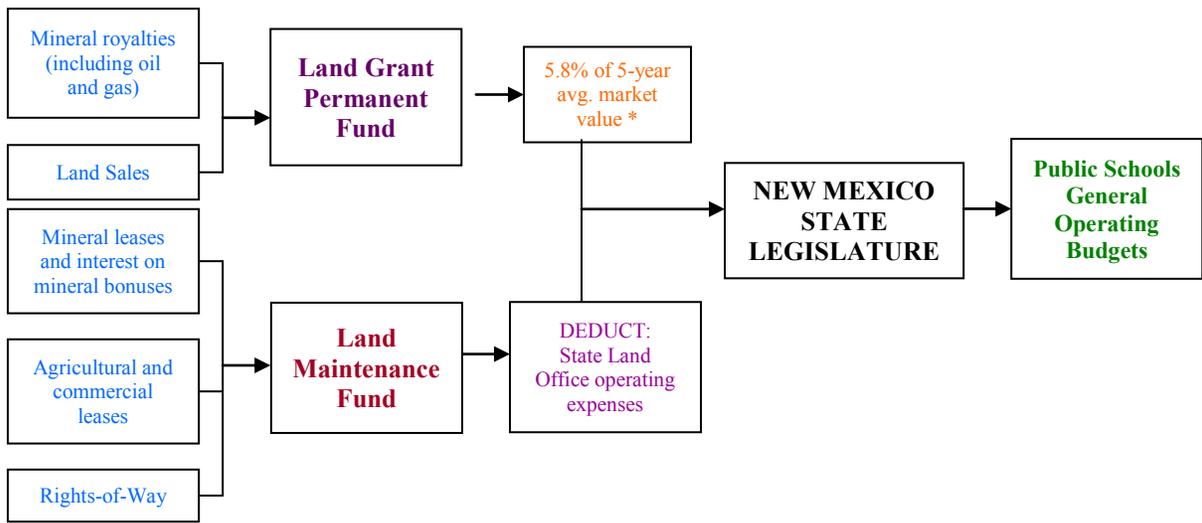
Each year, revenues generated from trust land uses are deposited into the given beneficiary group's Land Grant Permanent Fund or Land Maintenance Fund. Revenues from non-renewable sources, such as land sales and oil and gas royalties are deposited in the Land Grant Permanent Fund. Revenues from renewable sources, such as agricultural leases, commercial leases, oil and gas rentals, rights-of-way, and the interest on earnings and bonuses are deposited into the Land Office's Land Maintenance Fund. In FY 2006, New Mexico trust lands generated approximately \$495 million.⁹

Land Office earnings are deposited with the State Treasurer. The State Investment Officer invests the money under the supervision of the State Investment Council.¹⁰ All trust land beneficiaries in New Mexico receive a fixed distribution of 5.8 percent of the five-year average market value of the Land Grant Permanent Fund. The FY 2006 distribution to public schools was \$407 million, most of which was derived from investment income from the \$10 billion School Land Grant Permanent Fund.¹¹

However, as a result of a change in the New Mexico Constitution, beneficiaries receive an additional 0.8% of the five-year average market value of the Land Grant Permanent Fund from fiscal years 2005 through 2012, and an additional 0.05% for fiscal years 2013 through 2016. For public schools, the increased distribution was intended to provide funding for school reform. The increase is only allowed as long as the five-year average value of the Land Grant Permanent Fund stays above \$5.8 billion.¹² This increased distribution above 5% tipped the balance between the benefits for current and future beneficiaries.

The balance of the Land Maintenance Fund, minus the State Land Office's operating expenses, is also available for legislative appropriation and distribution to the beneficiaries.¹³ The State Treasurer distributes Land Grant Permanent Fund and Land Maintenance Fund contributions to the general operating budgets of individual beneficiaries according to legislative appropriation.

Common School Trust Funding Chart (2004-2012)¹⁴

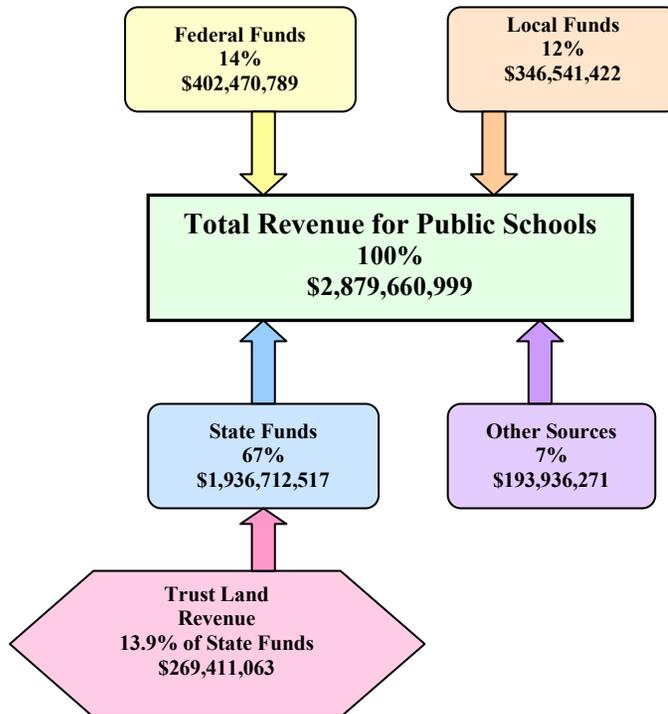


* This amount will increase by 0.8% from FY 2005- FY 2012 and then 0.05% from FY 2013 – FY 2016.

Public schools in New Mexico receive funding from a combination of federal, state and local funds. State funding provides more than half (67%) of total education funding, and of the state’s portion, trust land revenues make up approximately 13.9% of that amount, making it a significant source of state funding for public schools.

FY 2003 Public School Funding Source Diagram¹⁵

Local and Intermediate Funds



In FY 2006, over \$493 million from the trust went to support the beneficiaries, with public schools receiving nearly \$407 million.¹⁶ The New Mexico State Legislature uses trust land investment income and renewable resource revenue to offset the revenue that the state must provide for the beneficiaries, including public schools. The distribution from the Permanent Fund is relatively consistent due to the five-year moving average rule. The fairly constant nature of the distributions allows the legislature and the beneficiaries the ability to plan their budgets fairly accurately and to avoid years of large shortfalls in the budgets.



Photo: Emily Kelly

Sources:

¹ New Mexico State Land Office webpage, <http://www.nmstatelands.org/GetPage.aspx?sectionID=18&PagID=97>.

² New Mexico State Land Office Annual Report 2004.

³ Ibid.

⁴ New Mexico Statutes Annotated § 19-1-6 and 19-1-2.

⁵ New Mexico State Land Office webpage, <http://www.nmstatelands.org/GetPage.aspx?sectionID=18&PagID=97>.

⁶ New Mexico State Land Office Annual Report FY2006.

⁷ Ibid.

⁸ New Mexico State Land Office Annual Reports for FY 1999-2006.

⁹ New Mexico State Land Office Annual Report FY2006.

¹⁰ New Mexico Constitution, Article XII § 7, and New Mexico Statutes Annotated §19-1-18 and §19-1-2.

¹¹ New Mexico State Land Office Annual Report FY2006.

¹² New Mexico Constitution, Article XII § 7, and New Mexico Statutes Annotated §19-1-18 and §19-1-2.

¹³ In FY2004, the New Mexico State Land Office's operating expenses were 4% of the Land Maintenance Fund.

¹⁴ New Mexico State Land Office Annual Report 2004.

¹⁵ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data which comes from the New Mexico State Land Office FY 2003 Annual Report. "Other Sources" is defined as "Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets." NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.

¹⁶ New Mexico State Land Office Annual Report FY2006.

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Oklahoma Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.



Map: Sonoran Institute

Due to sale activities for given trust lands, maps may not reflect the most current holdings of a given state trust land agency.

There are approximately 745,000 surface acres and 1.1 million mineral acres of trust land in Oklahoma.¹ Surface acres include land that is managed for agriculture, grazing, commercial leases, and rights-of-way.² The mineral acres contain deposits of oil, gas and coal.³

How are trust lands in Oklahoma managed?



Photo: Pat Sheldon

Oklahoma's trust lands are managed by the Oklahoma Commissioners of the Land Office (OCLO), whose members include the top four statewide elected officials and one appointed official: the Governor, Lieutenant Governor, the State Auditor and Inspector, the President of the Board of Agriculture (appointed by the Governor), and the Superintendent of Public Instruction.⁴ The Governor, as President of the OCLO, is responsible for appointing a Secretary to administer the OCLO. The OCLO Secretary is responsible for hiring required staff for OCLO with the exception of attorneys and appraisers, who are selected by the Commissioners themselves.⁵ The OCLO is also responsible for the management and investment of trust land revenues.

The mission of the Oklahoma Commissioners of the Land Office states that the OCLO is to “grow the permanent Trust and to generate maximum earnings for distribution to trust beneficiaries.”⁶ This mission is aligned with the statutory requirements laid out by the Oklahoma Statutes, which charge the OCLO with preserving and increasing the value of the trust for maximum return.⁷

Who are the beneficiaries of trust lands in Oklahoma?

Revenues generated from Oklahoma’s trust lands are deposited into nine separate trust funds that provide revenues for nine beneficiary groups. All of Oklahoma’s trust lands provide revenue to either education or building funds. A specific acreage of trust lands was granted to each beneficiary, and the revenue generated from those lands is deposited into the corresponding beneficiary’s fund.

Oklahoma Trust Land Beneficiary Funds and Acreage Dedicated to Each⁸

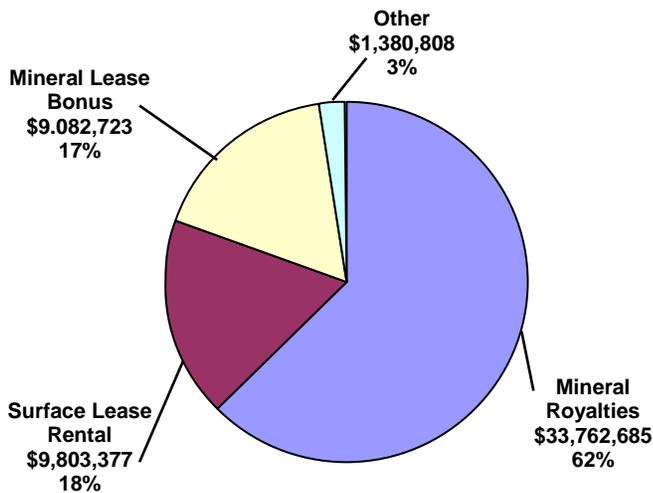
Fund	Beneficiary	Surface Acres in Fund	% Acres
Common Schools (K-12)	Public Schools	367,320	49.3%
Educational Institution	State 4 year colleges	82,489	11.1%
University Fund	Oklahoma University	63,604	8.5%
Agricultural and Mechanical College	Oklahoma State University	76,686	10.3%
University Preparatory Fund	Northern Oklahoma College	21,481	2.9%
Langston Fund	Langston University	18,995	2.6%
Normal School	Normal Schools (teachers’ colleges)	74,630	10.0%
Public Buildings	Public Buildings	36,261	4.9%
Greer	Greer Public Buildings	3,239	0.4%
	Total Acres	744,705	100.0%

Public schools are the designee of nearly 50% of the trust land in Oklahoma and thus receive roughly half the revenue generated by trust land in the state.⁹



Photo: Randy Schreiner

How are revenues generated from trust lands?



Revenue Streams from Oklahoma Trust Lands for All Beneficiaries Combined, FY 2004¹¹

Oklahoma's trust beneficiaries receive most of their annual support from the investment of the Permanent Funds derived from their lands, and not from the lands themselves; however, the lands continue to build their Permanent Funds. Oklahoma's trust land managers generate revenue from the trust lands primarily through resource extraction (oil and gas royalties and bonus revenues) and surface leases. Surface lease rental includes rentals, easements and surface damage revenue derived from mineral extraction disturbances. OCLO does not often engage in outright sale of trust lands. The three largest sources of revenues from trust lands in FY2004 were from mineral royalties, surface rentals, and mineral lease bonuses.¹⁰

Over the last five years, the largest source of income for the public schools has come from mineral revenues, including oil and gas royalties.¹²

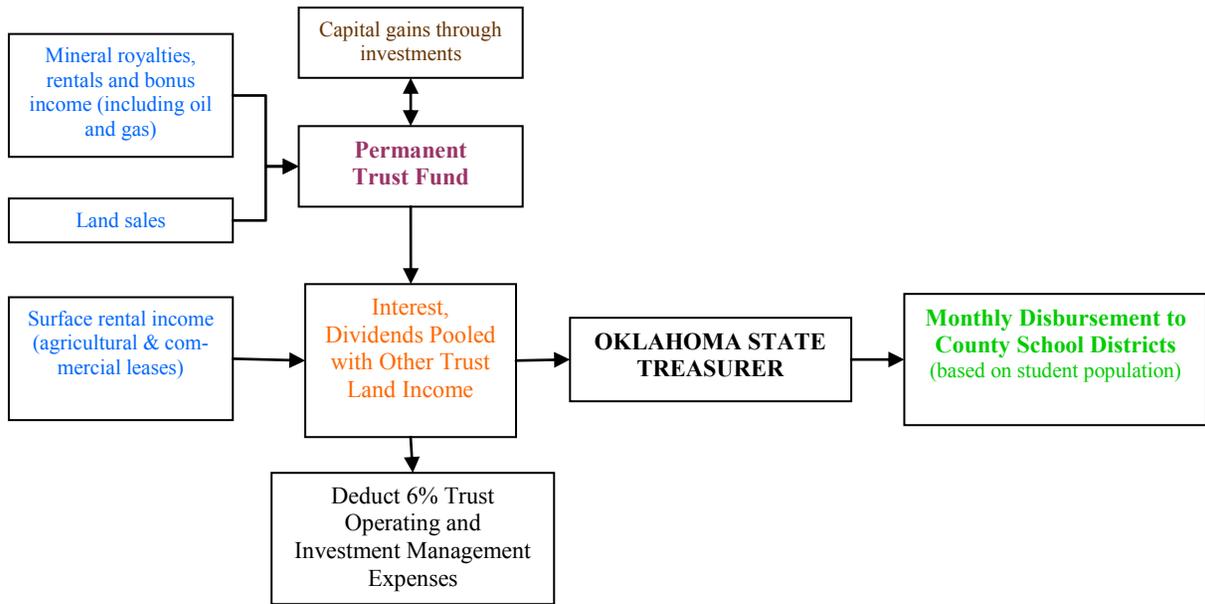
How does the revenue get to the beneficiaries?

Revenues generated from trust land uses are deposited into the given beneficiary's Permanent Fund. The Permanent Fund receives revenues from non-renewable sources, such as land sales and mineral royalties and bonuses as well as investment income from capital gains. Revenues from renewable sources, such as surface rentals for grazing or agricultural purposes, are combined with investment income from the Permanent Fund and made available for distribution to the beneficiaries after 6% of the earnings are deducted to cover the agency's operating expenses.¹³ In FY2004, Oklahoma trust lands generated \$202 million for the beneficiaries, of which over \$135 million was deposited into the Permanent Funds and \$64 million was distributed.¹⁴

The OCLO is responsible for the investment of the Permanent Funds for the beneficiaries, and appoints a three-member committee responsible for developing an annual investment plan to provide maximum benefit to the current and future beneficiaries. This committee is required to invest "with care, skill, prudence and diligence under the circumstances then prevailing to a prudent person acting in a like enterprise of a like character and like aim would use," however, it is a lower standard than that of the prudent investor rule.¹⁵ Only dividends and interest income from the Permanent Funds is available for distribution to the beneficiaries, while the corpus of the Fund and capital gains remain untouched. There are numerous statutory restrictions on their investments.

The Oklahoma Permanent Funds had a market value in excess of \$1.1 billion in FY 2004.¹⁶ Investment income totaled \$148 million that year, but capital gains were retained in the funds.¹⁷ The total amount of trust land revenues distributed to the public schools in FY2004 was over \$46 million, and was derived from the combined investment income from the Permanent Fund and surface rental income.¹⁸ After OCLO operating expenses have been deducted, these revenues are directed to the Oklahoma State Treasurer who then aggregates them with general fund appropriations for the beneficiaries and distributes the total to school districts by county on a monthly basis according to student population.

Public School Trust Funding Flow Chart¹⁹



Public schools in Oklahoma receive funding from a combination of federal, state and local funds. State funding provides 51.7% of total education funding, and of the state’s portion, trust land revenues make up 2.1% of that amount.

FY 2003 Public School Funding Flowchart²⁰ Local and Intermediate Funds

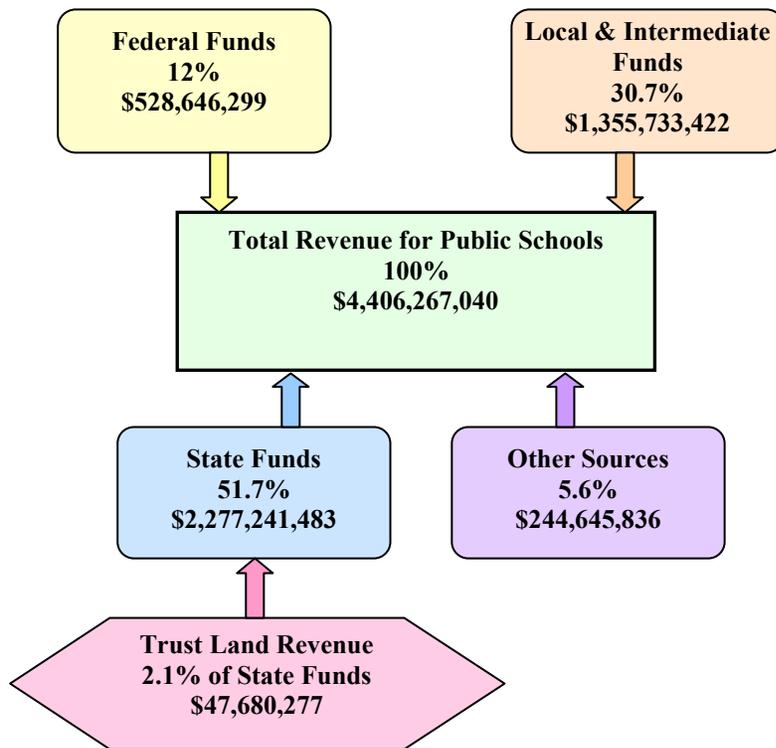




Photo: Oklahoma Commissioners of the Land Office

Trust land revenues in Oklahoma are applied to the beneficiaries overall legislative appropriation before the state contributes general fund revenues. The higher the trust land revenue, the lower the general fund appropriation must be to maintain the public school system at the status quo level. The legislature is then able to direct general fund appropriations to other government sponsored programs or decrease taxes. In Oklahoma, where trust revenues are considered the first component of base budgets for education and not dedicated to a specific purpose, an additional \$163,515,632 trust distribution for all trusts went to support education funding along with the \$47,680,227 distributed to public schools in FY2004.²¹

Sources:

¹ Oklahoma Commissioners of the Land Office, FY2004 Annual Report.

² Ibid.

³ Ibid.

⁴ Oklahoma Statutes § 64-1.

⁵ Oklahoma Statutes § 64-2-3.

⁶ Oklahoma Commissioners of the Land Office, FY2004 Annual Report.

⁷ Oklahoma Statutes § 64-1.1.

⁸ Oklahoma Commissioners of the Land Office, FY2004 Annual Report.

⁹ Ibid.

¹⁰ Ibid.

¹¹ Ibid.

¹² Oklahoma Commissioners of the Land Office Annual Reports for FY1995-2004 as provided by Tom McCreary, Director of Accounting, Oklahoma Commissioners of the Land Office.

¹³ Oklahoma Constitution Article XI § 3, and Oklahoma Statutes § 64-15.

¹⁴ Oklahoma Commissioners of the Land Office Annual Reports for FY1995-2004 as provided by Tom McCreary, Director of Accounting, Oklahoma Commissioners of the Land Office.

¹⁵ Oklahoma Constitution Article XI § 6.

¹⁶ Oklahoma Commissioners of the Land Office Annual Reports for FY1995-2004 as provided by Tom McCreary, Director of Accounting, Oklahoma Commissioners of the Land Office.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ Generated using information from Oklahoma Constitution Article XI and Oklahoma Statutes Titles § 64 and 70.

²⁰ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data which came from Tom McCreary, Director of Accounting for the Oklahoma Commissioners of the Land Office. "Other Sources" is defined as "Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets. NCES Database, Glossary, http://nces.ed.gov/ccd/bat/Glossary_Asp?letter=O.

²¹ Oklahoma Commissioners of the Land Office Annual Reports for FY 1995-2004.

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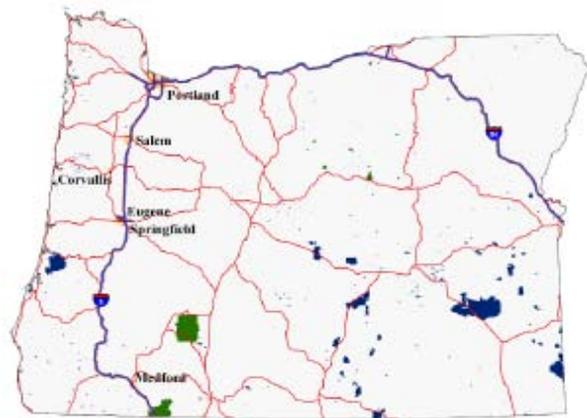


Oregon Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.

There are approximately 760,000 surface acres and 1.2 million mineral acres of trust land in Oregon.¹ Surface acres include land that is managed for timber and grazing. The mineral acres include underground areas that could be managed for resource extraction. Most of the trust lands in Oregon are concentrated in the southeastern part of the state. There is also a large consolidated block of trust land in the southwestern part of the state known as the Elliott State Forest. The remainder of the land is scattered throughout the state.²

State Trust Lands in Oregon



Light blue designates state trust land.

**Due to sale activities for given trust lands, maps may not reflect the most current holdings of a given state trust land agency.*

Map: Sonoran Institute

How are trust lands in Oregon managed?



Photo: Oregon Department of State Lands

Trust lands in Oregon are managed by the Oregon Department of State Lands (ODSL) under the direction of the State Land Board (Board).³ The Board is composed of Oregon's top three elected officials: the Governor, Secretary of State, and the State Treasurer.⁴ The Board appoints the Director of the Oregon Department of State Lands who acts as chief executive officer.⁵ The Board is required by the constitution to manage these trust lands "with the object of obtaining the greatest benefit for the people of this state, consistent with conservation of this resource under sound techniques of land management."⁶

The ODSL is required to "manage, control and protect" the trust land in order to obtain the highest "permanent value of the lands."⁷ The agency is responsible for the management, lease and sale of trust lands, the receipt of revenues from trust land activities, and the subsequent transfer of these funds to the State Treasurer. ODSL's mission is "To ensure the legacy for Oregonians and their public schools through sound stewardship of trust lands, wetlands, waterways, unclaimed property, estates and the Common School Fund."⁸ The agency's Land Management Division is funded out of the income generated by trust resources.⁹

Who are the beneficiaries of trust lands in Oregon?

Revenues generated from Oregon’s trust lands are deposited into one trust fund although Oregon’s original trust land grants included six beneficiaries. The legislature consolidated all original trusts into the Common School Fund, and an 1887 law directed all future sales income from internal improvement lands to be deposited into the Common School Fund.

Oregon Trust Land Beneficiary Funds and Surface Acreage Dedicated to Each¹⁰

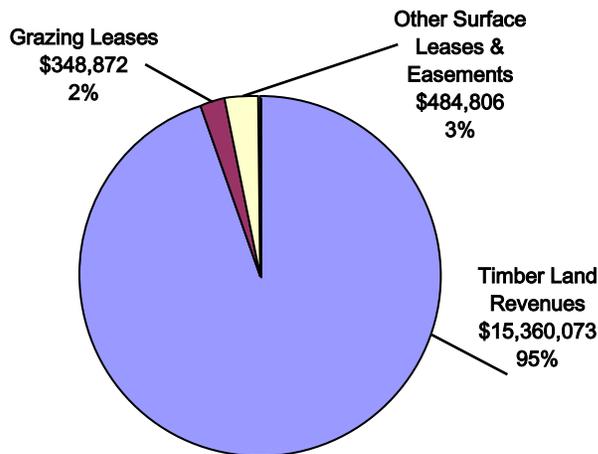
Fund	Beneficiary	Surface Acres in Fund	% Acres
Common Schools	Public Schools (K-12)	758,585	100.0%
Capital Buildings	To construct public buildings	0	0.0%
Internal Improvements	Public Schools (K-12)	518	0.0%
Agricultural College Land	Oregon State University	0	0.0%
Salt Springs Fund	To protect salt springs for public use	0	0.0%
University Fund	University of Oregon	0	0.0%
	Total	759,103	100.0%

Public schools are the designee of essentially all remaining trust land in Oregon and receive 100% of the net revenue generated by trust land in the state.



Photo: Oregon Department of State Lands

How are revenues generated from trust lands?



Revenue Streams from Oregon Trust Lands for Public Schools, FY 2004¹²

The largest source of trust land revenue for the Common School Fund is from timber harvests from of the Elliott State Forest. Leases on the agency's headquarters building; grazing leases; agricultural, industrial, and commercial leases; waterway leases; fees; and easement revenue make up all other revenue generated in FY2004.¹¹ A significant amount of revenue is generated from the management of non-trust lands such as the beds and banks of state-owned waterways, including the Territorial Sea. The revenues from leasing, easements and mining - known as statutory revenues - are used to fund other ODSL programs. The unused balance is deposited into the CSF along with trust-land funds.

How does the revenue get to the beneficiaries?

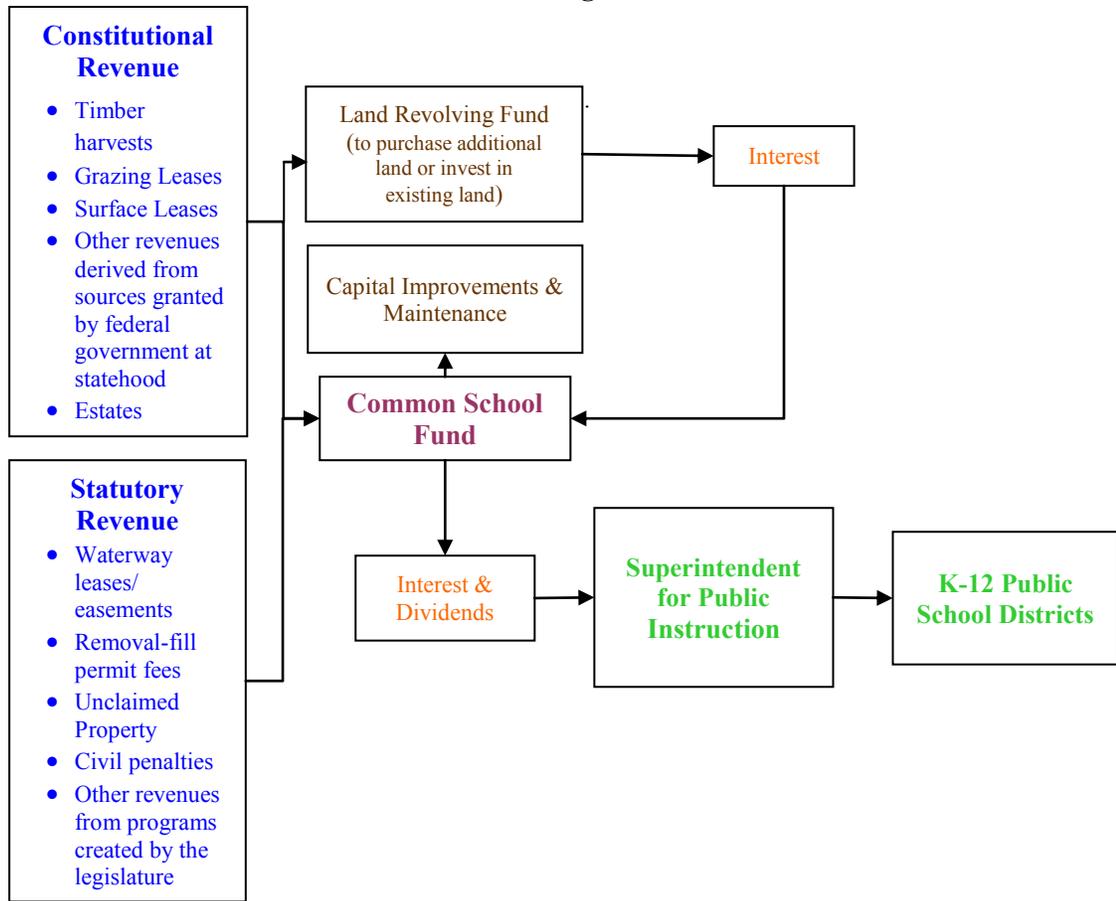
Each year, revenues generated from trust and non-trust land uses are deposited into the Common School Fund, and include all sources of land management income, from timber harvests and grazing leases (known as constitutional revenue) to waterway leases and easements (known as statutory revenue). Additionally, unclaimed property receipts and revenue from escheated estates are deposited into the Common School Fund. The ODSL has the power to place land revenue into a land bank, an account invested in short-term investments while replacement lands are considered.¹³ The earnings from the short-term investment of the land bank are deposited into the Common School Fund.¹⁴ During the biennium ending June 30, 2005, Oregon trust lands generated approximately \$37.3 million.¹⁵ The market value of the common School Fund was \$911 million by the end of 2004; the current market value is over \$1 billion.

The Common School Fund is managed and invested according to the prudent investor rule by the State Treasurer and the Oregon Investment Council under the direction of the State Land Board. The Investment Council is comprised of the Director of Public Employees Retirement Services (non-voting member), the State Treasurer, and five investment professionals appointed by the Governor.¹⁶ The interest from the Common School Fund is distributed on a semiannual basis to the Superintendent of Public Instruction according to a formula established by the State Land Board.¹⁷ The formula is a sliding-scale based on a three-year rolling average change in the value of the fund. The Board distributes a minimum of 2% of the Fund if there are sufficient earnings, and up to 5% of the Fund if the Fund value increases 11% or more in a year.¹⁸ The net return for FY 2005, including capital gains and losses for the Common School Fund was 9.21%.¹⁹

The Superintendent of Public Instruction distributes the funds on a semi-annual basis according to a formula established by the State Land Board.²⁰ These funds are distributed to all of Oregon's K-12 public school districts on a per pupil basis directly by the Oregon Department of Education, per legislation passed in 2005.²¹

The Common School Fund is primarily an endowment fund for Oregon Public Schools, but the principal has been used to construct and maintain the ODSL headquarters building, improve existing land, and restore land damaged by fire.²²

Public School Funding Chart²³



Public schools in Oregon receive funding from a combination of federal, state, local and other funds. State funding provides 34.4% of total education funding, and of the state’s portion, trust land revenues make up approximately 1.4% of that amount.

Public School Funding Source Diagram²⁴

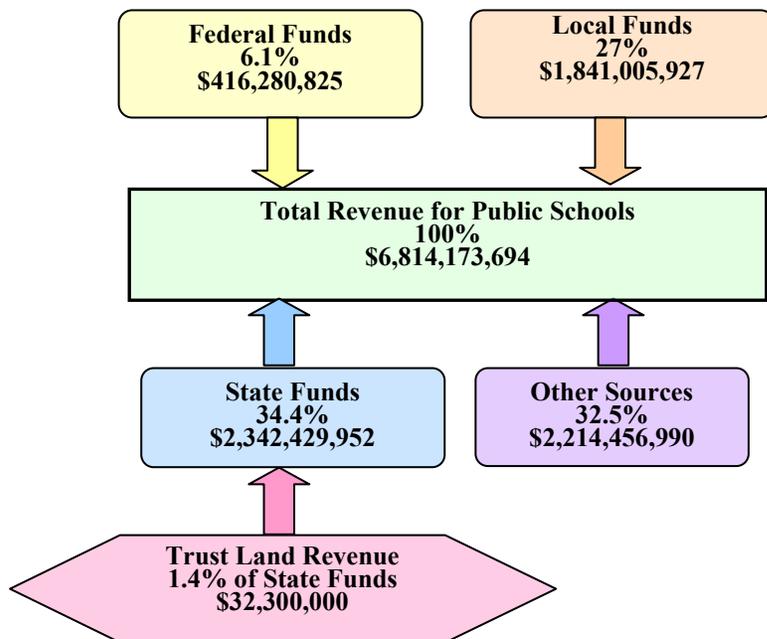




Photo: Oregon Department of State Lands

Representatives of the public school beneficiaries are actively involved in trust land and fund management. One way the beneficiaries are involved is through a Common School Fund Advisory Committee, which consists of representatives from the School Boards Association, the School Administrators' Association, the Parent Teacher Association and the Education Association. As the value of the Common School Fund increases, so will the semi-annual distribution to each of the public school districts in Oregon”

Sources:

- ¹ Data provided by Julie Curtis, Communications Manager, Oregon Department of State Lands, Personal Communication, 2006.
- ² Ann Hanus, Director, Oregon Department of State Lands, Telephone Interview, 2006.
- ³ Oregon Constitution Article VIII § 5 and Oregon Revised Statutes § 273.041.
- ⁴ Ibid.
- ⁵ Oregon Revised Statutes § 273.171.
- ⁶ Oregon Constitution Article VIII § 5 (2).
- ⁷ Oregon Revised Statutes § 273.051.
- ⁸ Oregon Department of State Lands, “Protecting Oregon’s Natural and Fiscal Resources,” Pamphlet, 2005.
- ⁹ Oregon Revised Statutes § 273.105.
- ¹⁰ Data provided by Julie Curtis, Communications Manager, Oregon Department of State Lands, Personal Communication, 2006.
- ¹¹ John Lilly, Asset Manager, Oregon Department of State Lands, Personal Communication, 2006.
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- ¹³ Oregon Revised Statutes § 273.413 – Land Revolving Account.
- ¹⁴ Ann Hanus, Director, Oregon Department of State Lands, Telephone Interview, 2006.
- ¹⁵ John Lilly, Asset Manager, Oregon Department of State Lands, Personal Communication, 2006.
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- ¹⁷ Oregon Revised Statutes § 327.410.
- ¹⁸ Oregon Department of State Lands, Oregon’s Common School Fund, Pamphlet, 2005.
- ¹⁹ Inga Deckert, Director of Legislative and Public Affairs, Oregon State Treasury, Personal Communication, 2006.
- ²⁰ Oregon Revised Statutes § 327.410.
- ²¹ Oregon Department of State Lands webpage, www.oregon.gov/DSL/DO/aboutcsf.shtml.
- ²² Oregon Revised Statutes § 273.115.
- ²³ Generated from information from the Oregon Department of State Lands web site.
- ²⁴ FY 2003 data from National Center for Education Statistics with the exception of the Trust Land Revenue data, which comes from the Oregon Department of State Lands *Common School Fund Pamphlet 2003*. Other Sources is defined as “Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets.” NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.

This report was prepared by the Sonoran Institute/Lincoln Institute of Land Policy Joint Venture and Children’s Land Alliance Supporting Schools (CLASS). Thanks to Wendine Thompson-Dawson and Alden Boetsch for their research and writing efforts.

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South Dakota Trust Lands & Education Funding

As new states entered the union, Congress made land grants to those states to provide support for a variety of public institutions, principally public schools. These lands were accepted through ratification of state constitutions that contained provisions guiding the state's management of these lands. Unlike public lands, state trust lands are held in trust by the state for designated beneficiaries. As trustees, state land managers have a fiduciary duty to manage the lands for the benefit of the beneficiaries of the trust grant. They lease and sell these lands for a diverse range of uses to meet that responsibility – generating revenue for the designated beneficiaries, today and for future generations.



Map: Sonoran Institute

Due to sale activities for given trust lands, maps may not reflect the most current holdings of a given state trust land agency.

There are approximately 760,000 surface acres and 5.2 million mineral acres of trust land in South Dakota.¹ Surface acres include land that is managed for agricultural and grazing uses. The mineral acres contain deposits of oil, gas and minerals. Trust lands in South Dakota are mostly concentrated in a checkerboard pattern throughout the state, with larger, more consolidated parcels in the western portion of the state.²

How are trust lands in South Dakota managed?



Photo: SXC

South Dakota's trust lands are managed by the South Dakota Office of School and Public Lands (SDOSPL) headed by the Commissioner of School and Public Lands, who is a statewide elected official.³ The Commissioner is responsible for administering South Dakota's trust lands, including setting lease rates, conducting land sales and exchanges, and collecting and distributing revenues.⁴ The Commissioner and the State Auditor act as a Board of Appraisal, determining which tracts should be sold when the Commissioner wants to sell trust lands in any given county.⁵ The SDOSPL is also responsible for approximately 100 state-owned dams, controlling noxious weeds on trust lands, and acting as the real estate agent for other state agencies and the legislature.⁶

The mission of SDOSPL is to “ensure efficient and superior management of school and endowment lands and trust funds owned and administered by the State of South Dakota.”⁷ Additionally, the South Dakota State Constitution requires that all federally granted lands be held in trust with the principal remaining inviolate and that each trust parcel be classified and managed to its “highest and best use.”⁸

Who are the beneficiaries of trust lands in South Dakota?

Revenues generated from South Dakota’s trust lands are deposited into thirteen separate trust funds that support twelve beneficiary groups. A specific acreage of trust lands was granted to each beneficiary, and the revenue generated from those lands is deposited into the corresponding beneficiary’s fund.

South Dakota Trust Land Beneficiary Funds and Acreage Dedicated to Each⁹

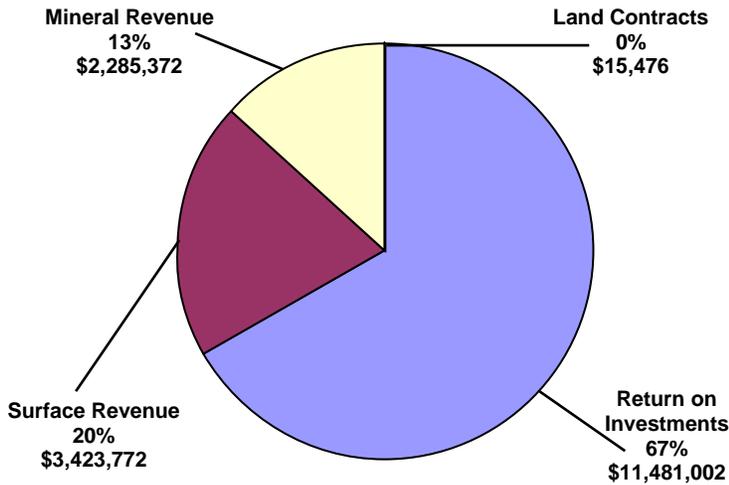
Fund	Beneficiary	Surface Acres in Fund	% Acres
Common Schools	Public Schools	608,539	80.3%
SD State University	SD State University	36,617	4.8%
SDSU Experiment Station	SDSU Experiment Station	10,135	1.3%
University of SD	University of SD	7,950	1.0%
Northern State University	Northern State University	8,011	1.1%
Normal Schools	Black Hills State University Dakota State University	17,933	2.5%
SD School for the Visually Handicapped	SD Schools for the Deaf and Visually Handicapped	6,146	0.8%
SD School for the Deaf	SD Schools for the Deaf and Visually Handicapped	7,093	0.9%
SD Development Center	Redfield Development Center	18,550	2.4%
SD Juvenile Corrections Facilities	Juvenile Corrections	4,676	0.6%
School of Mines	School of Mines	7,639	1.0%
Springfield	Northern State University Black Hills State University Dakota State University	10,487	1.4%
Public Buildings	Public Buildings	14,488	1.9%
	Total	758,264	100.0%

Public schools are the beneficiary of approximately 80% of the trust land in South Dakota and receive the majority of the revenue generated by state trust land.



Photo: Wikipedia

How are revenues generated from trust lands?



South Dakota's trust lands generate revenue primarily through interest gained from the Permanent Fund and leases of surface and mineral acres. The three largest sources of revenues from trust lands in FY2006¹⁰ were return on investments, surface leasing and mineral receipts.

Revenue Streams from South Dakota Educational Trust Lands for All Beneficiaries Combined, FY 2006¹¹

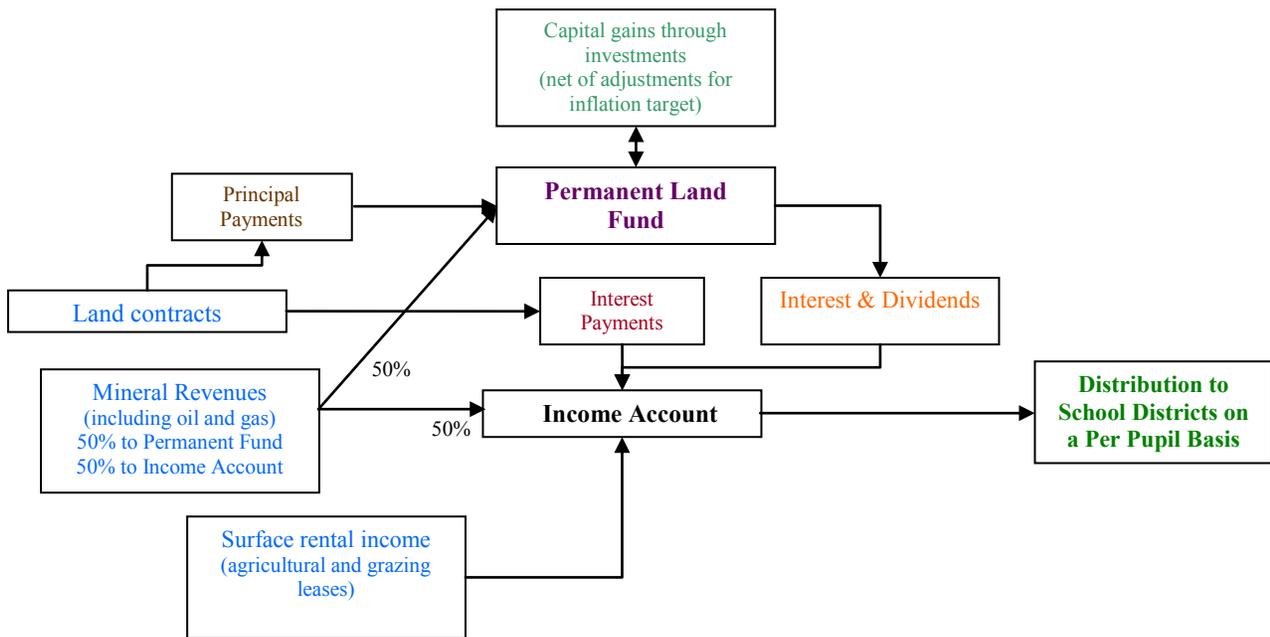
How does the revenue get to the beneficiaries?

Revenues generated from trust land uses are deposited into either the given beneficiary group's Permanent Fund or Income Account. Permanent Funds receive all revenues from land sales, and half of the revenues from mineral revenues, including oil and gas. Revenues from rentals, interest on deferred payments, and the remaining half of mineral revenues are deposited into the Income Account, along with interest and dividends from the Permanent Fund.

Permanent Funds are managed and invested by the State Investment Council, an eight member body composed of both elected and appointed officials which appoints a State Investment Officer to perform the day to day management of the trust funds.¹² Each member of the Council must be a trained investor.¹³ The interest and dividends from the Permanent Funds are available for distribution to the beneficiaries after the State Investment Officer has ensured that the principal of each Permanent Fund has increased at least as much as the inflation rate. If a Fund did not increase in value at the rate of inflation, the dividends and interest income are then used to make up the difference, while the remainder is distributed to the Income Account.¹⁴

The balance of interest and dividends from the Permanent Fund after covering inflation is combined with surface rental revenues, half of the mineral revenues and the interest from land contracts into the Income Account. The Income Account comprises the distributable revenue to the beneficiaries. For the last several years, the State Legislature has directed the SDOSPL to maintain a fixed payment of revenue in the Income Account to the public schools on a per pupil basis. This revenue is distributed to the school districts directly and separate from the general fund appropriation for public schools.¹⁵

Public School Trust Funding Flow Chart ¹⁶



Public schools in South Dakota receive funding from a combination of federal, state and local funds. State funding provides 30.8% of total education funding, and of the state's portion, trust land revenues make up 3% of that amount.

FY 2003 Public School Funding Source Diagram ¹⁷ Local and Intermediate Funds

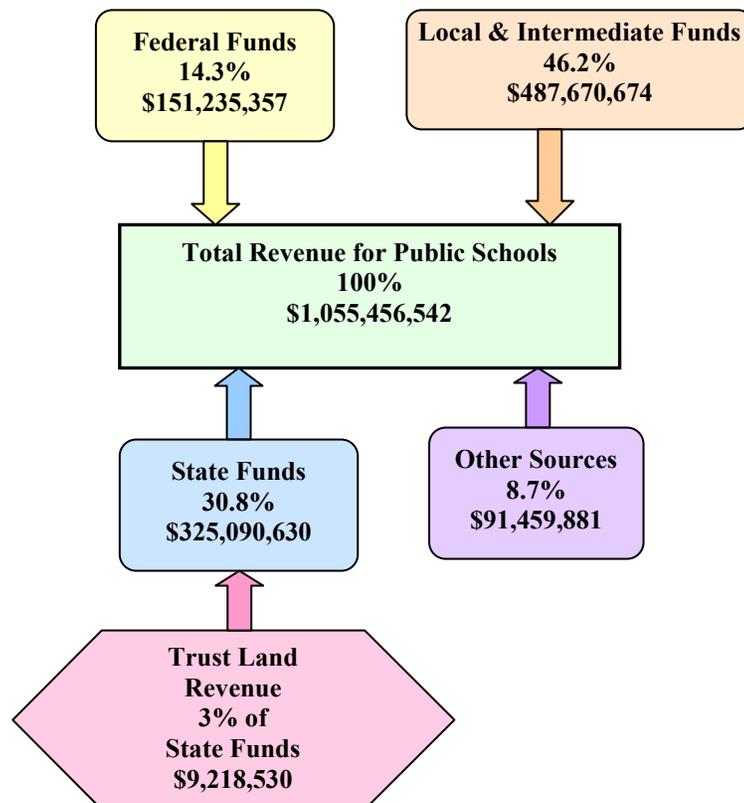




Photo: Scott Catron

Since trust land revenue is distributed directly from the Income Fund to the school districts on a per pupil basis, it does not supplant other legislative appropriations. Thus, it provides South Dakota school districts with valuable discretionary funding to address issues unique to their particular school free of the restrictions placed on legislative appropriations.

Sources:

- ¹ South Dakota Office of School and Public Lands website Facts page, <http://www.sdpubliclands.com/facts/index.htm>.
- ² Mike Cornelison, Land Agent, South Dakota Office of School & Public Lands, personal communication (2007).
- ³ South Dakota Constitution Article IV § 7 and South Dakota Codified Laws § 5-1-7.
- ⁴ South Dakota Codified Laws §§ 5-5-6.1, 5-9-8, and 5-10-4.
- ⁵ South Dakota Codified Laws § 5-9-3.
- ⁶ South Dakota Office of School and Public Lands Annual Report 2005-2006, page 6.
- ⁷ South Dakota Office of School and Public Lands website homepage, <http://www.sdpubliclands.com/index.htm>.
- ⁸ South Dakota Codified Laws § 5-3-11.
- ⁹ South Dakota Office of School and Public Lands, Annual Report 2005-2006.
- ¹⁰ Ibid.
- ¹¹ Ibid.
- ¹² South Dakota Codified Laws §§ 4-5-19 and 4-5-20.
- ¹³ South Dakota Codified Laws §§ 4-5-13 and 4-5-14.
- ¹⁴ South Dakota Constitution Article VIII § 3 and South Dakota Codified Laws § 5-10-18.3.
- ¹⁵ South Dakota Constitution Article VIII § 3 and Office of School and Public Lands, Annual Report 2005-2006.
- ¹⁶ Sandra Waltman, Communications Specialist, South Dakota Office of School and Public Lands, personal communication (2006).
- ¹⁷ FY 2003 data from National Center for Education Statistics (NCES) with the exception of the Trust Land Revenue data, which comes from the South Dakota Office of School and Public Lands *Annual Report 2003*. “Other Sources” is defined as “Revenue from bond principal and premiums, sale of school property, or compensation from loss of fixed assets. NCES Database, Glossary, <http://nces.ed.gov/ccd/bat/Glossary.Asp?letter=O>.”

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