

Memorandum 90-21

Subject: Study L-3012 - Uniform Management of Institutional Funds Act
(Approval of Revised Recommendation)

At the January meeting, the Commission approved introduction of a bill in this session of the Legislature to implement the recommendation to conform California law to the Uniform Management of Institutional Funds Act (UMIFA) with respect to the authority of eleemosynary institutions to take net appreciation, both realized and unrealized, into account in making budgetary appropriations. In addition, the bill would continue the existing law governing release of restrictions on endowments. A bill has been prepared, and the staff is seeking an author. Attached to this memorandum is a staff draft of a revised recommendation explaining the changes that the bill would make in existing law. This recommendation is submitted to be approved for printing.

In other developments, we note that two more states -- Indiana and Texas -- enacted UMIFA in 1989, including the provision relating to net appreciation, which by definition means both realized and unrealized appreciation. Only California and Kansas, of the 30 states that have enacted this provision, have omitted the reference to "unrealized" appreciation. The Texas Legislature made the following finding when it enacted UMIFA last year:

Texas Property Code § 163.002. Legislative findings and purpose

- (a) The legislature finds that:
- (1) privately supported educational, religious, and charitable organizations perform essential and needed services in the state;
 - (2) uncertainty regarding legal restrictions on the management, investment, and expenditure of endowment funds of the organizations has in many instances precluded obtaining the highest available return on endowment funds; and
 - (3) the organizations, their officers, directors, and trustees, and the citizens of this state will benefit from removal of the uncertainty and by permitting endowment funds to be invested for the long-term goals of achieving growth

and maintaining purchasing power without adversely affecting availability of funds for current expenditure.

(b) The purpose of this chapter is to provide guidelines for the management, investment, and expenditure of endowment funds of privately supported educational, religious, and charitable organizations in order to eliminate the uncertainty regarding legal restrictions on the management, investment, and expenditure of the funds and to enable the organizations to maximize their resources.

(Section 163.004 provides for appropriation of "net appreciation, realized and unrealized." The vote on this bill was 31-0 in the Texas Senate and 121-0 in the Texas House.)

Also attached, as Exhibit 1, is a copy of a letter from Daniel A. Wingerd, Associate Vice President of The Common Fund, amplifying on his remarks at the January meeting. This letter provides interesting background information on the management of educational endowments and is directly relevant to the need to revise California law.

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

**The Common Fund**

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Mr. Yeoryios Apallas
Deputy Attorney General
Charitable Trust Division
California Department of Justice
350 McAllister Street
San Francisco, CA. 94102

January 20, 1990

Dear Mr. Apallas,

As you may recall, I appeared with you at the meeting of the C.L.R.C. at which we discussed possible changes to the California code with respect to UMIFA and unrealized appreciation for non-profit educational endowments. While I appreciate the process which the CLRC makes possible, I found much of our discussion in that meeting somewhat distasteful. It would be far better, it seems to me, if the two of us could sit down over coffee and examine these matters in a somewhat less confrontational manner. It is my desire and hope that we can do just that. Though the Commission members have already voted in favor of recommending a change to the existing code (1978 Calif. Statute, Chapter 802, Section 2), "winning" is not my ambition. Rather I would like to understand your concerns as a representative of the A.G., and would appreciate similar consideration from your office.

The purpose of this letter and accompanying documentation is to explain and illustrate the position taken by myself and Mr. Jonathon Brown of the C.A.I.C.U. during our meeting in Los Angeles. In the course of this, I will present the best data I possess, along with sufficient explanation of the data I can muster to make our case clear. After you have considered this material, I would welcome both the opportunity to meet with you personally to discuss the issues, as well as your inquiries or requests for any further documentation or clarification required by your office. If my treatment below is labored, please forgive. In my desire for thoroughness, I may be guilty of telling more than you wish to know.

The Common Fund

First, I would clarify our corporate interest in this matter. As a non-profit investment management service serving exclusively non-profit educational institutions nationwide, we have no monetary interest in the outcome of this matter. We serve nearly 1100 client institutions nationwide, including around 120 in my western region. We invest money from these institutions in a wide range

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investment vehicles from short term cash to long-term investments in international stocks, real estate and venture capital. We do not have a financial interest in how these schools invest their funds. I do not receive any commissions on business with them nor with anyone; I receive a salary which is unaffected by the volume of my accounts. Rather, we appear before state agencies on this matter because of our genuine concern for the well-being of educational endowments in the state of California. We have taken a similar role in many other states, including most recently with the State of Oregon.

THE CASE FOR REFORM

I. The Nature of Equity & Fixed Income Markets

Among the comments which you made at the meeting was that our recommendation assumed "an upward moving stock market." In a sense, that is true. That is, our counsel and recommendation to schools that they invest significantly in equity (common stock) assets is based upon the reality of long-term performance in those markets. As I explain in the next section, however, our case does not assume that markets always rise. Rather, our case depends heavily on the observation that on average, equities return more than fixed-income instruments. Both have volatility (up and down years) and both offer income (dividends or interest), but on average the investor demands and receives a higher return for ownership (equity) than for debt (fixed-income securities).

Below are some figures representing overall gross returns for about the last fifteen years. It may be argued that this is not a sufficiently long time for deriving average market performance, and indeed the Wilshire Simulation Model (discussed below) takes data from a much longer period of time. But the results are not substantially different, and it could as easily be argued that it is more reliable to base average performance on the more recent experience in our rapidly-changing world. For instance, the U.S. share of global capital markets has shrunk dramatically in the last 15 years (from around 65% to around or under 40%), and foreign investments in the U.S. market has increased almost as dramatically. Hence, we believe the last 15 years to be a good measure of contemporary market performance.

The numbers on the following page include (1) average annual returns, annualized (annual compound average) returns, and gross total cumulative returns for both the S&P 500 Stock Index and the Shearson-Lehman Gov/Corp Bond Index for 15 years; (2) average asset class returns for stocks, bonds and cash for the 80, 60, 40, 20 and 10-year periods ending 1988, compiled by SEI, Corp.; and (3) the average annualized compound returns and gross cumulative returns for The Common Fund's Stock and Bond Funds for 15 years.

A. Index and Common Fund Returns

	S&P 500 Stock Index <u>'75-'89</u>	TCF Equity Fund <u>'75-'89</u>	SHEARSON/LEHMAN Gov/Corporate Bond Index <u>1975 - 1989</u>	TCF Bond Fund <u>'77-'89*</u>
Low Return	-7.26%	-3.95	1.18%	-.97%
High Return	37.30%	37.77	31.10%	31.52%
Average Annual	17.37%	19.09	10.65%	10.82%
Annualized (Com- pound Av. Ann.)	16.60%	18.42	10.36%	10.44%
Gross Cumulative	1001.45%	1262.21%	439.16%	N/A*
*TCF Bond Fund 13 Years; Inception mid-'76, data from 1/77				

B. SEI Corp. Asset Class Returns, 1908-1988
(Overlapping 10-80yr periods Ending Dec. '88)
Total Return, Not Adjusted for Inflation

	80 Yrs <u>'08-'88</u>	60 Yrs <u>'28-'88</u>	40 Yrs <u>'48-'88</u>	20 Yrs <u>'68-'88</u>	10 Yrs <u>'78-'88</u>
Common Stock	9.5	9.0	12.1	9.4	16.2
Domestic Bonds	5.0	5.0	5.1	8.3	10.9
Cash (90-Day T)	3.9	3.7	5.1	7.5	9.0

Here, we are not so much interested in the absolute values as in the spreads between asset classes, which remain fairly constant over time. Stocks tend to provide around 4% per year higher returns than bonds, and bonds about 1-2% per year higher than cash, on average.

In conclusion, The Common Fund has joined hundreds of other independent consultants who advise non-profit institutions (particularly endowments and pension funds) that over the long run, equity investments will add value over fixed-income, and that portfolios should include widely diversified equity as well as fixed-income assets, with some preference in weighting to equities.

II. The Wilshire Company's Simulation Model

During our session, you began your remarks by stating that "it is possible to arrange data so as to prove any point." Granting the truth to that, The Common Fund has turned to an independent consulting organization based in Los Angeles for a simulation model which factors in the average market returns and volatility for the last 40-50 years (weighted more heavily to the post-war economy) and inflation for the last 20 years (6% straight-line) and demonstrates to client institutions the potential growth of endowment given changes in two variables: asset exposure and spending rate. On the basis of these simulations, The Common Fund has persuaded hundreds of institutions nationwide to include equity investments in their portfolios and to forego high rates of spending in favor of more modest rates in the range of 5%.

The simulation model makes some capital market assumptions which are constant; the advisor then selects the asset mix desired and the spending rate variables to be included, and the computer produces a simulated 20-year growth of endowment based upon whatever initial principal value is chosen, usually \$10 million.

The capital market assumptions are explicit (stated at the top of each simulation). Average returns and volatility are assumed as:

	<u>Median Annual Return</u>	<u>Average Volatility</u>
Domestic Stock	12.5%	18%
Internatl. Stk	13.5%	20%
Real Estate	10%	13%
Venture Capital	20%	30%
Domestic Bonds	8.5%	11%
Global Bonds	9.0%	12%
Domestic Cash	7.0%	3%

Based upon leading indexes of returns for each asset class, this simulation model conservatively states the median return for a large number of annual returns from each class. Additionally, the model states the expected range of variability of return for each asset class (expressed as "risk" or "standard deviation of return"). Hence, it is found that over a very long period of time, the median return for stocks is around 12.5%, while the standard deviation (variability) of return is about 18%. This means that for any given year, stocks might be expected to return an annual average of 12.5%, but could be as low as -5.5% (12.5 - 18.0) or as high as 30.5 (12.5 + 18.0). Bonds, on the other hand, can be expected to average 8.5%, with an expected high of 19.5% or a low of -2.5%. This is not a "trick" performed with smoke and mirrors; it represents at least one firm's best estimate of likely market

performance within one standard deviation of return.

At the meeting we attended, I presented Commission members with five of these simulations. Please note that the format I chose for this meeting, and which I use for my clients, is very simplified. The actual simulations received from Wilshire Co. are about 38 pages in length; I have reduced the median numbers and their results down to one page for each asset mix, and have included two possible spending rates, always 5% and 7%. I have attached one of the full simulations for your review in order for you and your staff to see how the simplified version recapitulates data from the larger version.

This model is more sophisticated than it appears. For instance, it not only factors in the median returns of each asset class, but also takes account of each class's correlation with respect to every other class. Correlation is that statistical measure which, in the investment field, measures the relative direction of each asset class compared to all others. So, for example, while Domestic Bond and Global Bond returns are very close, they do not always move in the same direction; that is, global markets often move in an opposing direction to domestic bonds. The same is true of the relationship between stocks and real estate; the returns are nearly identical, but often when stocks are high, real estate is low. That is because inflation drives real estate prices up, but often adversely affects stocks, and vice versa.

This simulation, then, presents the results of difference asset allocations and spending rates upon endowment growth, in terms of both principal and spending. It presents those results in both nominal and real (inflation-adjusted) terms.

The results are dramatic and have also proven over the years to be highly reliable. Endowments that have a high spending rate and most of their assets invested in short-term money-market vehicles (such as CD's, a familiar event in California) earn very little compared to those more informed institutions who invest a significant portion of their assets in stocks and maintain a low spending rate. As I stated in my original letter to the Commission, the irony is that even with the same asset mix, schools with a lower spending rate soon can spend more money because their principal grows faster. But the arithmetic is most dramatic in those cases where schools include sizable investments in stocks.

Of the five simulations which I presented, the asset mix options included are:

	<u>Sim.1</u>	<u>Sim.2</u>	<u>Sim.3</u>	<u>Sim.4</u>	<u>Sim.5</u>	
Stocks	0%	25%	50%	60%	70%*	*This
Bonds	0%	25%	25%	40%	30%	includes
Cash	100%	50%	25%	0%	0%	RE/VenCap

One final word before looking at results. This is a guide to median market performance, not a prediction of what the market will do over the next twenty years. Needless to say, much of our lives (investments included) are based on quasi-scientific observations of our environment which "average" the results we see and upon which we base future action. It's not perfect, but it's the best we've got. Failing that, we are bound to repeat those mistakes of history which we have yet to learn. Endowments are learning fast. Across the nation, schools are learning from the largest and most experienced endowments (Harvard, Yale, Princeton, Stanford, Univ. of Texas, etc.) that fixed-income weighted portfolios do not grow sufficiently to keep up with spending plus inflation. In other words, a good investment policy is to target annual growth of endowment principal sufficient to account for spending plus inflation. If an endowment plans to spend 5% of their principal value each year while inflation is at 6%, their endowment must grow at an annual rate of at least 11% to maintain a constant, level purchasing power. The simulations we use for educating endowments and which I shared in this meeting demonstrate that portfolios which are too heavily weighted in favor of cash or bonds cannot accomplish this.

Let's look at the simulations' projections of growth in principal and spending of a \$10 million endowment over a 20-year period. In other words, for a \$10 million endowment that, in 1990 would spend \$700,000 (7%) per year, what would the principal and spending values be in the 20th year given the following asset mixes:

<u>Sim #</u>	<u>Nominal Value of Principal</u>	<u>Real Value of Principal</u>	<u>Nominal Value of Spending</u>	<u>Real Value of Spending</u>
#1	9.53 mill	2.97 mill	\$667,100	\$207,900
#2	13.33 mill	4.15 mill	\$934,000	\$291,000
#3	17.3 mill	5.39 mill	\$1,221,000	\$377,000
#4	20.01 mill	6.24 mill	\$1,400,000	\$436,800
#5	18.94 mill	7.90 mill	\$1,330,000	\$553,000

Now, what happens to values resulting at the end of 20 years from the same asset mixes when we reduce spending to 5% (\$500,000 in 1990) ?

#1	14.37 mill	4.48 mill	\$718,500	\$224,000
#2	20.03 mill	6.25 mill	\$1,000,000	\$312,000
#3	25.92 mill	8.08 mill	\$1,296,000	\$404,000
#4	29.93 mill	9.33 mill	\$1,497,000	\$466,000
#5	25.59 mill	10.68 mill	\$1,260,000	\$534,000

As you can see, only with a low spending rate and a large portion of the endowment invested in equity holdings can the school even

hope to have the same inflation-adjusted dollars in the year 2010 that they started with in 1990, in both principal and spending. If one only considers the nominal growth of the endowment, almost any asset mix looks fine. But when inflation is taken into account, only those policies which allow for substantial growth of principal will enable the endowment to purchase the same services 20 years from now that they are able to purchase presently.

III. College and University Endowments' Asset Allocation

Now the question becomes one of comparing the recent California experience with other schools across the nation. Numbers do vary according to the time and scope of each survey, but the record is fairly clear that California stands out from the national average. Here are the results of what we now know, both from the National Association of College and University Business Officers (NACUBO) and from Common Fund surveys and actual management experience:

	<u>Stocks</u>	<u>Bonds</u>	<u>Other</u>	<u>Cash</u>
1987 NACUBO Survey	57.1%	28.1%	3.6%	11.2%
1987 Common Fund Survey	63.0%	24.0%	5.0%	8.0%
1988 NACUBO Survey	58.6%	28.0%	3.6%	10.8%
1989 NACUBO Survey*	52.5%	29.7%	5.8%	11.6%
*Preliminary June 30, 1989 figures; survey not yet complete				
1989 Actual California				
Common Fund Accts.*	37.8%	47.2%	2.0%	13.0%

*There is no systematic survey of California institution's investments. Hence, these figures represent 12/31/89 allocations among 97 Common Fund accounts in California (NACUBO Survey = approx. 240 institutions) involving just over \$400 million of endowment, and exclude Stanford University and U.C., System endowments.

The numbers for California require some interpretation. First of all, these numbers differ from those submitted to the Commission, to a very small degree. Because they were calculated in a rush, minutes prior to the meeting, several records were inadvertently omitted. For this, I apologize, though the overall picture remains the same. Secondly, these numbers exclude Stanford University and the University of California, System. Both of these endowments are in excess of \$1 billion and would seriously impair the validity of any comparative average. Finally, we believe these figures are actually an improvement over what the picture would be in a total survey of every California school's endowment. The reason for this is simple: only those schools who are persuaded

of the need for long-term equity growth of the endowment utilize The Common Fund. Many others, including a large number with whom I have had multiple conversations over the years, resort almost exclusively to short-term, fixed-income investments such as CD's and Treasury bills. In addition, many smaller schools resort to the same type of investments because they do not believe their endowments are sufficiently large to bother with professional management. This is particularly true of the small independent colleges and community colleges. In other words, the California picture which emerges from a survey of Common Fund members in the state is no doubt a great deal more positive than the full average of all California institutions.

At minimum, it appears that California schools include 15-20% less equity investments in their portfolios than schools across the nation. If California allocations were isolated from the NACUBO averages and simply compared strictly with those of other states, the disparity would be even greater.

The bottom line is this: California institutions are enjoying smaller returns on their endowments. Moreover, because of their propensity for fixed-income investments and the slow rate of growth of their endowments, they also tend to have higher-than-average spending rates. This is the same deadly combination which is illustrated in Simulations #2 and #3 above, with the 7% spending.

IV. Why Are California Colleges Losing Money?

In case after case, college and university business officers have complained that they are prohibited from investing more substantially in stocks because of California's peculiar law which bars the taking into account of unrealized capital appreciation in determining spending.

Let's examine the problem they really face. In the ordinary situation, amply illustrated by the simulations above, schools will simply designate a fixed spending rate of 5-7% which is applied to the rolling average net asset value of their endowment over a 3-5 year period. The arithmetic would look like this:

<u>Year</u>	<u>Net Principal Value, End of Year</u>	<u>Rolling 5-yr Av.</u>
1980	\$10,000,000	
1981	\$10,987,000	
1982	\$12,439,000	
1983	\$11,758,000	
1984	\$12,101,000	\$11,457,000
1985	\$12,957,000	\$12,048,000
1986	\$14,245,000	\$12,700,000
1987	\$11,003,000	\$12,412,800
1988	\$12,239,000	\$12,509,000

This is a very realistic scenario, one so typical that it has been repeated scores of times across the country within The Common Fund. Notice that there are two years, 1983 and 1987, with significant declines in the asset value of the endowment. This is roughly the normal experience of the market; in about 2 or 3 years out of ten, there will be sufficient declines in stock prices to result in a negative return (capital depreciation) for the endowment. We have allowed losses of about 5% in 1983 and about 22% in 1987 above in order to illustrate that capital losses do not threaten endowment spending when rolling averages are utilized for spending purposes. In actuality, no endowment fell to that extent in 1987 because they would not have had 100% of their assets in stocks.

Now, notice that we refer at the top of the column to "Net Principal Value..." That annual number is the total valuation of the endowment's portfolio at year end, inclusive of any UNREALIZED capital appreciation/depreciation. It simply includes any value added to the endowment from either capital gain or income (interest or dividends) and does not assume the sale of any asset in order to "realize the appreciation."

Let's look at spending for the typical school with a spending rate of 6%.

	<u>Rolling 5-Year Average</u>	<u>Spending at 6%</u>
1984	\$11,457,000	\$687,420
1985	\$12,048,000	\$722,880
1986	\$12,700,000	\$762,000
1987	\$12,412,000	\$744,720
1988	\$12,509,000	\$750,540

As we can see, the changes in actual spending are very small. Why? Because all of the gains and losses are averaged over time. In this way, even major fluctuations in principal values have very limited effect upon spending.

Now, what happens to some schools in California confronted by the rule which disallows unrealized appreciation to be taken into account for spending purposes?

1. Many California institutions do not hire staff nor enjoy the presence of trustees who understand investing. The prohibition against using unrealized appreciation leaves them confused, and they avoid the issue by avoiding assets that appreciate.
2. Even in instances where institutions understand the issue, the arithmetic and process is complicated. Either they
 - a. Do not calculate any appreciation into their

spending, relying instead upon yield (dividends and interest income), or

- b. They sell off their best appreciating assets in order to realize the gain; then, they either reinvest the unused portion of the appreciation in the same asset or else in some other.
3. Both of these (2.a and b) options generally wear the institution down over time, resulting in more and more resort to fixed-income securities where they don't have to bother with realizing the appreciation and paying the additional transaction costs.
4. If an institution wishes not to sell an asset in order to realize the capital appreciation, it simply must sell securities that have suffered a capital loss, realizing the loss in order to have liquid assets for spending. This in spite of the fact that some would prefer to keep the asset until the loss is recovered, should such be deemed possible.

V. SUMMARY & CONCLUSION

We believe we have demonstrated that:

- a. Equities outperform fixed-income over time;
- b. Equity-weighted portfolios are generally better for endowments from a total-return standpoint;
- c. California institutions are generally prevented from a total-return approach to investment management because of the prohibition against spending on the basis of unrealized capital appreciation;
- d. Because of this under-investment in equities, California institutions are earning less return at a time when reduced per-capita State aid makes endowment returns critical for scholarships;
- e. The rule is unnecessary and counter-productive:
 1. There is no evidence that Schools operating in a total-return environment invade principal for the purpose of spending.
 2. Schools operating under the California rule can still keep the rule, invest solely in fixed-

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income securities, spend only yield and still lose principal (see Simulation #1), thus frustrating the very intent of the rule.

3. Nothing whatsoever is gained by forcing schools to sell a security in order to "realize" the capital appreciation. If they like the security, all they have to do is repurchase it; if they don't like it, they would have sold it anyway.

We read in the daily press of the State's budgetary difficulties. Our contact with colleges and universities all around the state indicate the growing importance which they attach to gift revenues directed to endowment for providing chairs and scholarships. The President of the United States has asked that each citizen become one of the "1,000 Points of Light" in finding means to solve social issues without government intervention and expense.

Here is a situation where government intervention has proven a negative influence on the private (as well as public) sector. All that needs to be done in order for schools to better achieve their aims and purposes is to return to the original language of the Uniform Management of Institutional Funds Act and, like most other states in the union, grant schools the opportunity to spend based upon a total valuation of their investment portfolios, including unrealized appreciation.

Sincerely,

Daniel A. Wingerd
Associate Vice President

DAW:mw

Enclosures: (1) Five Simulations (Simplified Version)
(2) Wilshire Co. Simulation (Full Version)

cc: George Keane, President
David Storrs, Senior Vice President
Jonathon Brown, Vice President, C.A.I.C.U.
✓ Stan Uhlrich, Staff Counsel, C.L.R.C.

**Simulated Effects Of
Asset Allocation & Spending Rate
on
The 20-Year Growth of Endowment Spending & Principal**

SIMULATION
EFFECT ON GROWTH OF ENDOWMENT FROM
VARIABLE SPENDING RATES & 100% CASH MIX
 (No Contributions Added)

Spending Rate Variables

Policy A: Spending 7%
 Policy B: Spending 5%

Asset Mix for Both Policies

100% Cash-Equivalents

Inflation Assumption

Straight-Line 6%

Capital Market Assumptions

<u>Asset</u>	<u>Med.Ret.</u>	<u>Stand.Dev.</u>
Cash	7.0%	3.0%

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SIMULATION OF RETURNS

Policy A: 7% Spending Rate

(Mkt. Values in Millions)

Policy B: 5% Spending Rate

<u>YEAR</u>	<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>		<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>	
	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>
1990	10.0	700,000	10.0	700,000	10.0	500,000	10.0	500,000
1991	9.98	698,600	9.41	658,700	10.18	510,000	9.61	480,000
1992	9.95	696,500	8.86	620,200	10.37	518,500	9.23	461,500
1993	9.93	695,100	8.34	583,800	10.56	528,000	8.86	443,000
1994	9.90	693,000	7.84	548,800	10.75	537,500	8.52	426,000
1995	9.88	691,600	7.38	516,600	10.95	547,500	8.18	409,000
1996	9.86	690,200	6.95	486,500	11.15	557,500	7.86	393,000
1997	9.83	688,100	6.54	457,800	11.35	567,500	7.55	377,500
1998	9.81	686,700	6.15	430,500	11.56	578,000	7.25	362,500
1999	9.78	684,600	5.79	405,800	11.77	588,500	6.97	348,500
2000	9.76	683,200	5.45	381,500	11.99	599,500	6.69	334,500
2005	9.64	674,800	4.02	281,400	13.12	656,000	5.47	273,500
2010	9.53	667,100	2.97	207,900	14.37	718,500	4.48	224,000



SIMULATION
EFFECT ON GROWTH OF ENDOWMENT FROM
VARIABLE SPENDING RATES & 25/75 ASSET MIX
 (No Contributions Added)

Spending Rate Variables

Policy A: Spending 7%
 Policy B: Spending 5%

Inflation Assumption

Straight-line 6%

Asset Mix for Both Policies

25% Domestic Equities
 25% Domestic Bonds
 50% 90-Day Treas.Bills

Capital Market Assumptions

<u>Asset</u>	<u>Med.Ret.</u>	<u>Stand.Dev.</u>
Stock	12.5%	18%
Bond	8.5%	11%
Cash	7.0%	3%

Total Portfolio Return 7 Risk

8.75% 6.64%

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SIMULATION OF RETURNS

Policy A: 7% Spending Rate

(Values in \$000)

Policy B: 5% Spending Rate

<u>YEAR</u>	<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>		<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>	
	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>
1989	10,000	700	10,000	700	10,000	500	10,000	500
1990	10,138	710	9,571	670	10,346	517	9,763	488
1991	10,288	720	9,155	641	10,712	536	9,538	477
1992	10,437	731	8,786	613	11,096	555	9,313	466
1993	10,587	741	8,388	587	11,487	574	9,096	455
1994	10,746	752	8,030	562	11,895	595	8,888	444
1995	10,896	763	7,680	538	12,312	616	8,680	434
1996	11,054	774	7,355	515	12,745	637	8,480	424
1997	11,221	785	7,039	493	13,203	660	8,280	414
1998	11,379	797	6,739	472	13,670	684	8,088	404
1999	11,545	808	6,447	451	14,153	707	7,905	395
2004	12,403	868	5,173	362	16,835	842	7,022	351
2009	13,336	934	4,157	291	20,034	1,000	6,248	312



SIMULATION
EFFECT ON GROWTH OF ENDOWMENT FROM
VARIABLE SPENDING RATES & 50/50 ASSET MIX
(No Contributions Added)

Spending Rate Variables

Policy A: 7%
Policy B: 5%

Inflation Assumption

Straight-line 6%

Asset Mix for Both Policies

50% Domestic Equities
25% Domestic Bonds
25% 90-Day Treasury Bills

Capital Market Assumptions

<u>Asset</u>	<u>Med.Ret.</u>	<u>Stand.Dev.</u>
Stock	12.5%	18%
Bond	8.5%	11%
Cash	7.0%	3%

Total Portfolio Return & Risk

10.1% 10.6%

.....
SIMULATION OF RETURNS
.....

Policy A: 7% Spending Rate

(Values in \$000)

Policy B: 5% Spending Rate

<u>YEAR</u>	<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>		<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>	
	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>	<u>MKT.VAL</u>	<u>SPEND</u>
1989	10,000	700	10,000	700	10,000	500	10,000	500
1990	10,271	719	9,696	679	10,487	524	9,888	494
1991	10,562	739	9,396	658	10,996	550	9,788	489
1992	10,854	760	9,113	638	11,529	576	9,679	484
1993	11,154	781	8,838	619	12,095	605	9,580	479
1994	11,462	802	8,563	599	12,687	634	9,480	474
1995	11,787	825	8,305	581	13,303	665	9,380	469
1996	12,112	848	8,055	564	13,953	698	9,280	464
1997	12,445	871	7,814	547	14,636	732	9,180	459
1998	12,795	896	7,572	530	15,344	767	9,080	454
1999	13,153	921	7,339	514	16,094	805	8,988	449
2004	15,086	1,056	6,289	440	20,425	1,021	8,522	426
2009	17,301	1,221	5,390	377	25,915	1,296	8,080	404



SIMULATION
EFFECT ON GROWTH OF ENDOWMENT FROM
VARIABLE SPENDING RATES & 60/40 ASSET MIX
 (No Contributions Added)

Spending Rate Variables

Policy A: Spending 7%
 Policy B: Spending 5%

Inflation Assumption

Straight-line 6%

Asset Mix for Both Policies

60% Domestic Equities
 40% Domestic Bonds

Capital Market Assumptions

<u>Asset</u>	<u>Med.Ret.</u>	<u>Stand.Dev.</u>
Stock	12.5%	18%
Bond	8.5%	11%

Total Portfolio Return & Risk

10.9% 13.2%

.....
SIMULATION OF RETURNS

Policy A: 7% Spending Rate

Policy B: 5% Spending Rate

<u>DOLLARS YEAR</u>	<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>		<u>NOMINAL DOLLARS</u>		<u>REAL</u>	
	<u>MKT.VAL.</u>	<u>SPEND</u>	<u>MKT.VAL.</u>	<u>SPEND</u>	<u>MKT.VAL.</u>	<u>SPEND</u>	<u>MKT.VAL.</u>	<u>SPEND</u>
1989	10 mil	700,000	10 mil	700,000	10 mil	500,000	10 mil	500,000
1990	10.35 mil	724,500	9.77 mil	683,900	10.56 mil	528,000	9.97 mil	498,500
1991	10.72 mil	750,000	9.54 mil	667,800	11.16 mil	558,000	9.93 mil	496,500
1992	11.10 mil	777,000	9.32 mil	652,400	11.79 mil	589,500	9.90 mil	495,000
1993	11.49 mil	804,300	9.10 mil	637,000	12.45 mil	622,500	9.86 mil	493,000
1994	11.89 mil	832,300	8.89 mil	622,300	13.15 mil	657,500	9.83 mil	491,500
1995	12.31 mil	861,700	8.68 mil	607,600	13.89 mil	694,500	9.79 mil	489,500
1996	12.75 mil	892,500	8.48 mil	593,600	14.68 mil	734,000	9.76 mil	488,000
1997	13.20 mil	924,000	8.28 mil	579,600	15.50 mil	775,000	9.73 mil	486,500
1998	13.66 mil	956,200	8.09 mil	566,300	16.38 mil	819,000	9.69 mil	484,500
1999	14.14 MIL	989,000	7.90 mil	553,000	17.30 mil	865,000	9.66 mil	483,000
2004 (15)	16.82 mil	1.177mil	7.02 mil	491,400	22.76 mil	1.138mil	9.50 mil	475,000
2009 (20)	20.01 mil	1.401mil	6.24 mil	436,800	29.93 mil	1.497mil	9.33 mil	466,500



SIMULATION
EFFECT ON GROWTH OF ENDOWMENT FROM
VARIABLE SPENDING RATES & 70/30 ASSET MIX
(No Contributions Added)

Spending Rate Variables

Policy A: Spending 7%
Policy B: Spending 5%

Inflation Assumption

Straight-line 6%

Asset Mix, Both Policies

Domestic Stock = 45%
Domestic Bonds = 25%
Internatl Stock = 10%
Global Bonds = 5%
Real Estate = 10%
Vent.Capital = 5%

Capital Market Assumptions

<u>Asset</u>	<u>Med.Ret.</u>	<u>Stand.Dev.</u>
Stock	12.5%	18%
Bond	8.5%	11%
Int.Stock	13.5%	20%
Glob.Bnds	9.0%	12%
Real Est.	12.0%	13%
Vent.Cap.	20.0%	30%

TOTAL PORTFOLIO RETURN & RISK: Med.Ret. = 11.75%; Stand.Dev. = 11.97%

.....
SIMULATION OF RETURNS
.....

Policy A: Spending Rate 7%

Policy B: Spending Rate 5%

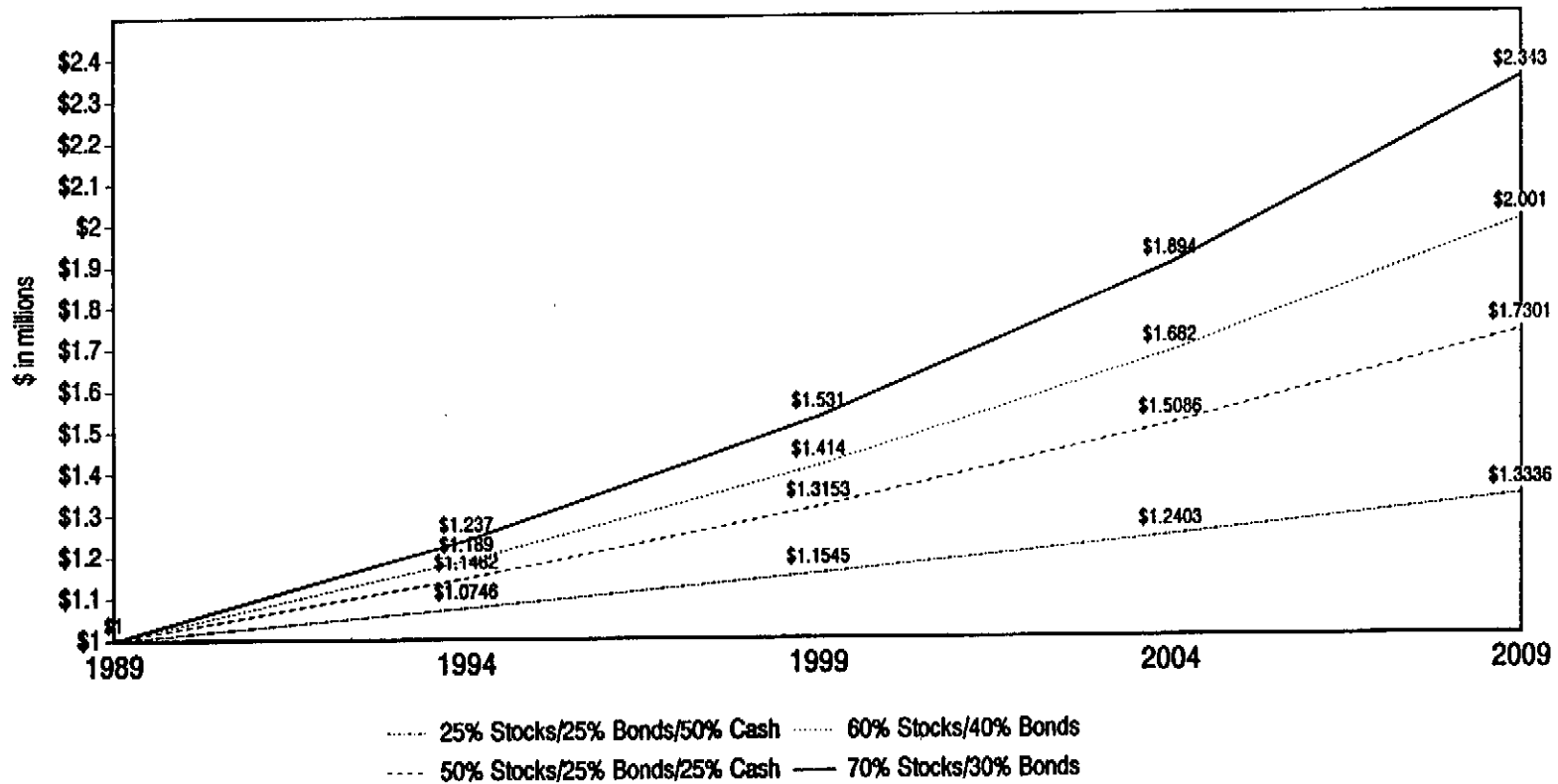
<u>YEAR</u>	<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>		<u>NOMINAL DOLLARS</u>		<u>REAL DOLLARS</u>	
	<u>MKT.VAL.</u>	<u>SPEND</u>	<u>MKT.VAL.</u>	<u>SPEND</u>	<u>MKT.VAL.</u>	<u>SPEND</u>	<u>MKT.VAL.</u>	<u>SPEND</u>
1989	10 mil	700,000	10 mil	700,000	10 mil	500,000	10 mil	500,000
1990	10.43 mil	730,000	9.84 mil	688,000	10.65 mil	532,500	10.04 mil	502,000
1991	10.89 mil	762,000	9.69 mil	678,000	11.33 mil	566,500	10.09 mil	504,500
1992	11.36 mil	795,000	9.54 mil	668,000	12.07 mil	603,500	10.13 mil	506,500
1993	11.86 mil	830,000	9.39 mil	657,000	12.85 mil	642,500	10.18 mil	509,000
1994	12.37 mil	866,000	9.24 mil	647,000	13.68 mil	684,000	10.22 mil	511,000
1995	12.91 mil	903,000	9.10 mil	637,000	14.56 mil	728,000	10.26 mil	513,000
1996	13.47 mil	943,000	8.96 mil	627,000	15.50 mil	775,000	10.31 mil	515,500
1997	14.06 mil	984,000	8.82 mil	617,000	16.50 mil	825,000	10.35 mil	517,500
1998	14.67 mil	1.02 mil	8.68 mil	607,000	17.57 mil	878,500	10.40 mil	520,000
1999	15.31 mil	1.07 mil	8.55 mil	598,000	18.71 mil	935,500	10.45 mil	522,500
2004 (15)	18.94 mil	1.33 mil	7.90 mil	553,000	25.59 mil	1.26 mil	10.68 mil	534,000

7/7/89



Simulated Nominal Growth of \$1 million Endowment

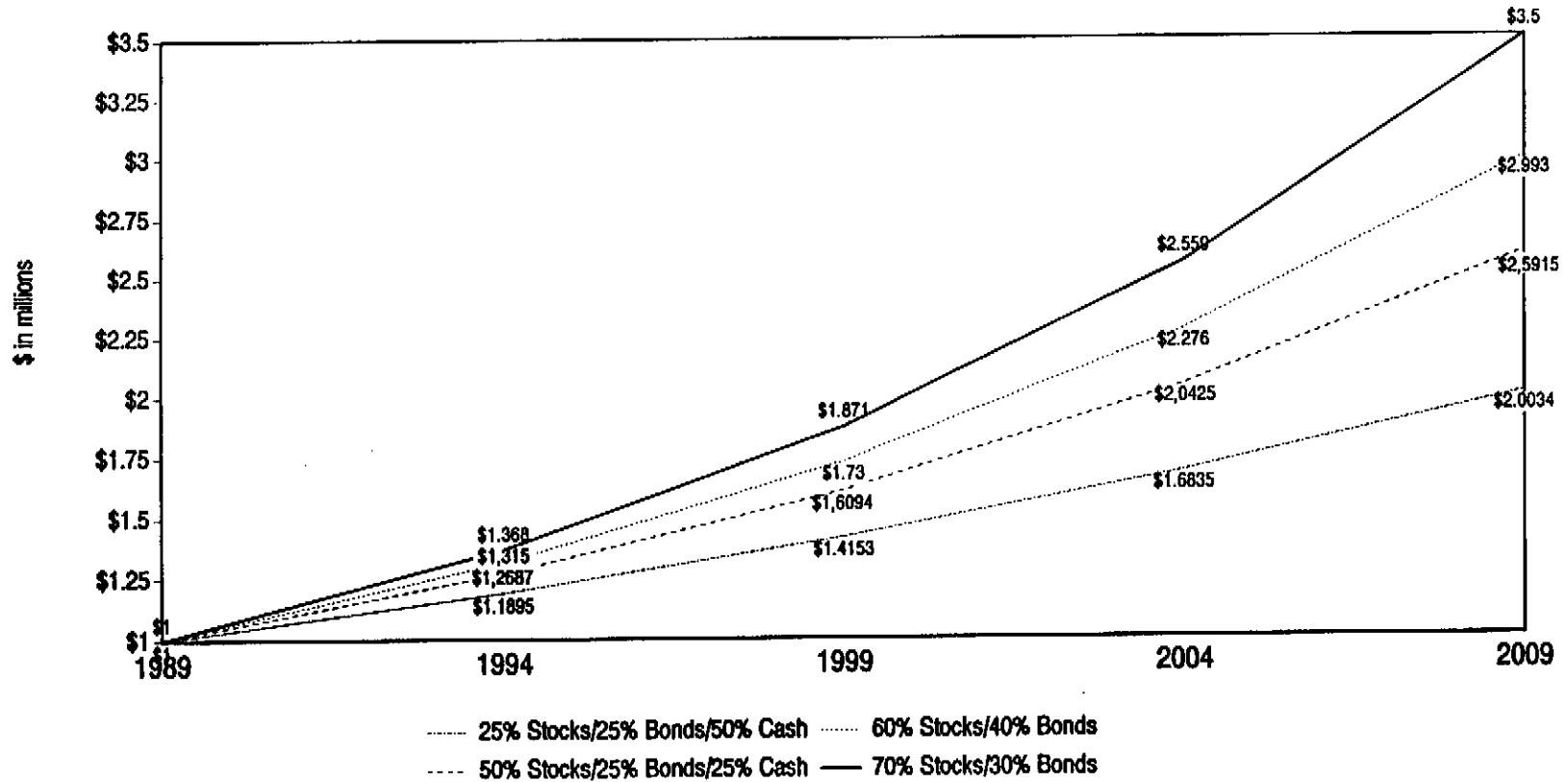
4 Asset Mix Alternatives
7% Spending Rate



Simulated Nominal Growth of \$1 million Endowment

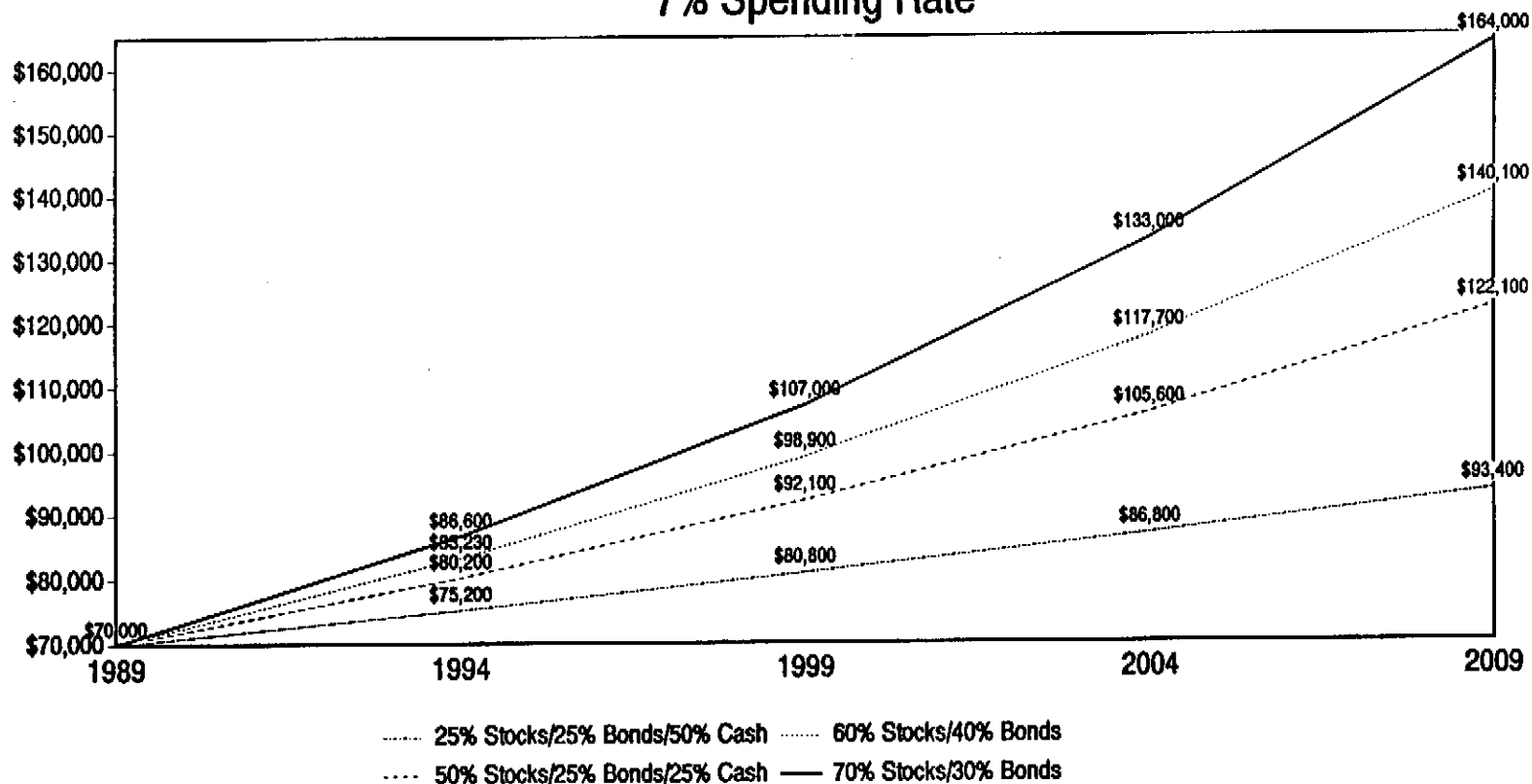
4 Asset Mix Alternatives

5% Spending Rate



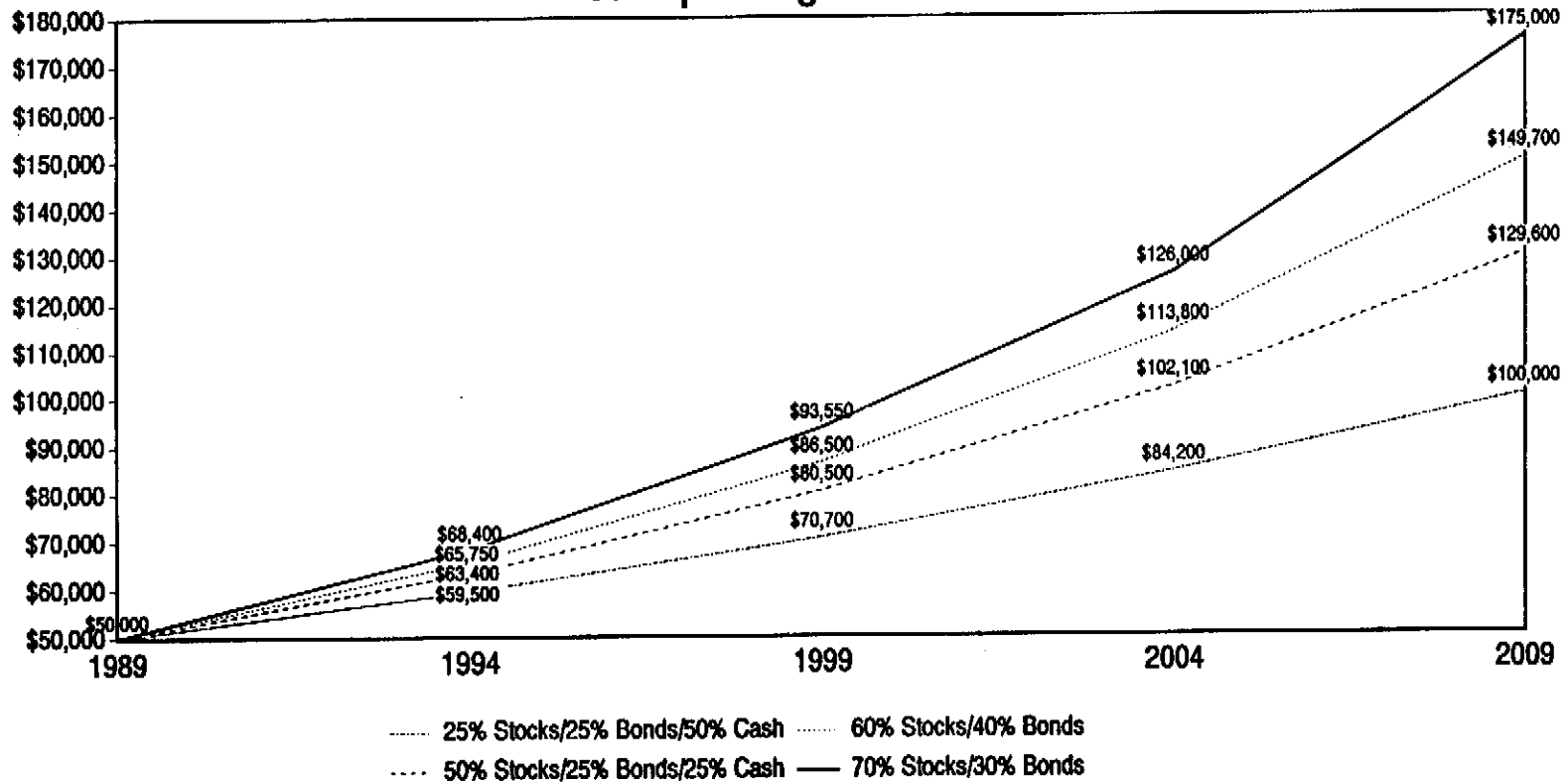
Simulated Growth of Endowment Spending

For a \$1 million Endowment
4 Asset Mix Alternatives
7% Spending Rate



Simulated Growth of Endowment Spending

For a \$1 million Endowment
4 Asset Mix Alternatives
5% Spending Rate



RECOMMENDATION

relating to

UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT

California enacted the Uniform Management of Institutional Funds Act¹ in 1973 as a pilot study, subject to a five-year sunset provision and restricted to certain accredited private colleges and universities.² The official text of the Uniform Management of Institutional Funds Act³ has a much broader scope, applying to private educational, religious, charitable, and eleemosynary institutions and to governmental organizations holding funds for such purposes.⁴ Apparently, the pilot study was successful, since the sunset provision was repealed in 1978.⁵ However, the restricted scope of the act was retained and the authority to use net appreciation, including both

1. Hereinafter cited as UMIFA.
2. See 1973 Cal. Stat. ch. 950, § 1 (enacting Civ. Code §§ 2290.1-2290.12). The California version of the act applies only to private incorporated or unincorporated educational institutions accredited by the Association of Western Colleges and Universities. The sunset clause was enacted by 1973 Cal. Stat. ch. 950, § 3. The act was moved to Education Code Sections 94600-94610 when the Civil Code trust provisions were generally repealed in connection with enactment of the new Trust Law. See 1986 Cal. Stat. ch. 820, §§ 7, 24.
3. See UMIFA, 7A U.L.A. 714-27 (1985 & Supp. 1990).
4. See UMIFA § 1(1) (1972).
5. 1978 Cal. Stat. ch. 806, § 1.

realized and unrealized gains and losses, was amended to refer only to "net appreciation, realized, in the fair value" of the institutional funds.⁶

Expansion of Scope of UMIFA

The Commission recommends that the California version of UMIFA be revised to apply to the same organizations covered by the original uniform act. No persuasive reasons have been given for continuing the restrictions that applied under the original pilot study. None of the other 31 jurisdictions that have enacted UMIFA has so drastically restricted its scope.⁷ The problems faced by charitable organizations that are treated by UMIFA are not unique to private colleges and universities.⁸ The effect of this recommendation would be to extend the benefits of UMIFA to all unincorporated educational, religious, charitable, and eleemosynary institutions in California.⁹

This extension of UMIFA provides more guidance and authority to institutions that are not currently governed by UMIFA. Specifically, these institutions would be able (1) to use net appreciation of endowment funds, subject to a fiduciary duty of care, (2) to delegate day-to-day investment management to committees and employees and to hire investment advisory and management services, and (3) to seek the release of obsolete or impracticable restrictions on the use of endowment funds by obtaining the donor's consent or on petition to a

6. 1978 Cal. Stat. ch. 806, § 2.

7. See annotations at 7A U.L.A. 714-27 (1985) & Supp. at 177-78 (1989). Indiana limits the uniform act to institutions of higher education. See Ind. Code Ann. § 30-2-12-5 (West Supp. 1989).

8. In addition, the Commission recommends that UMIFA be moved to the Probate Code. The Education Code is not an ideal location if the act's coverage is expanded beyond private colleges and universities. It is appropriate to place the expanded act with the Trust Law, since the Trust Law also applies to charitable trusts. See Prob. Code § 15004.

9. The act would not supplant the statutes governing the conduct of charitable corporations.

court with notice to the Attorney General.¹⁰ Extending the application of UMIFA would also provide guidance as to an institutional board's power to invest and manage property and would clarify the standard of care governing the exercise of a board's powers¹¹ where the board is not governed by some other statute.¹²

Appropriations Based on Net Appreciation

The Commission recommends that the provision relating to appropriation of net appreciation in the budgeting process of the institutions covered by UMIFA be revised for consistency with the official text of the Uniform Act. A major purpose of UMIFA was to authorize the prudent use of the net appreciation of endowment funds over their historical dollar value in determining the budgets of tax-exempt institutions. As explained in the Prefatory Note of UMIFA:

The Act authorizes the appropriation of net appreciation. "Realization" of gains and losses is an artificial, meaningless concept in the context of a nontaxable eleemosynary institution. If gains and losses had to be realized before being taken into account, a major objective of the Act, to avoid distortion of sound investment policies, would be frustrated. If only realized capital gains could be taken into account, trustees or managers might be forced to sell their best assets, appreciated property, in order to produce spendable gains and conceivably might spend realized gains even when, because of unrealized losses, the fund has no net appreciation.

10. For the existing provisions that would apply under a broadened statute, see Educ. Code §§ 94602 (use of appreciation), 94605 (delegation of authority), 94607 (release of restrictions). See generally UMIFA Prefatory Note, 7A U.L.A. 706-09 (1985). The standard for releasing restrictions is similar to but distinct from the *cy pres* rule. See UMIFA § 7(d).

11. For the existing provisions that would apply under a broadened statute, see Educ. Code §§ 94604 (investment authority), 94606 (standard of care).

12. The proposed law includes a provision that UMIFA does not alter the duties and liabilities of governing boards under other laws. See, e.g., Corp. Code §§ 5231-5231.5 (directors of nonprofit public benefit corporations), 7231-7231.5 (directors of nonprofit mutual benefit corporations), 9240-9241 (directors of nonprofit religious corporations). Similarly, the proposed law would not displace any limitations on the expenditure of public funds by governmental organizations.

Thirty jurisdictions have enacted Section 2 of UMIFA authorizing appropriation of net appreciation, both realized and unrealized; only California and Kansas omit the reference to unrealized appreciation.¹³ The California provision is outmoded. It is inconsistent with the portfolio approach to investments applicable under modern trust law.¹⁴ It leads institutions to underutilize their assets by relying too heavily on fixed-income investments (e.g., bonds and certificates of deposit) instead of a more balanced portfolio that would include more equity investments (stocks). An overly cautious investment strategy both impairs the ability of the institution to spend in furtherance of its goals, thereby impeding the very purpose for which the endowment exists, and restricts the growth of the endowment and thus the future ability to spend to achieve the institution's purposes. Institutions with portfolios leaning more heavily on yield-oriented, fixed-income investments tend to spend a greater percentage of their income to meet their annual needs than

13. See Cal. Educ. Code § 94602; Kan. Stat. Ann. § 58-3602 (1983). Authority to use net appreciation, both realized and unrealized, is provided in the following 28 jurisdictions: Colo. Rev. Stat. § 15-1-1104 (1987); Conn. Gen. Stat. Ann. § 45-100j (West 1981); Del. Code Ann. tit. 12, § 4702 (1987); D.C. Code Ann. § 32-402 (1988); Ill. Ann. Stat. ch. 32, ¶ 1103 (Smith-Hurd Supp. 1989); Ind. Code Ann. § 30-2-12-8 (West Supp. 1989); Ky. Rev. Stat. § 273.520 (19__); La. Rev. Stat. Ann. § 9:2337.2 (West Supp. 1989); Md. Est. & Trusts Code Ann. § 15-402 (1974); Mass. Ann. Laws ch. 180A, § 2 (Michie/Law. Co-op. 1987); Mich. Stat. Ann. § 26.1199(3) (Callaghan 1982); Minn. Stat. Ann. § 309.63 (West Supp. 1990); Mo. Ann. Stat. § 402.015 (Vernon 1979); Mont. Code Ann. § 72-30-201 (Supp. 1985); N.H. Rev. Stat. Ann. § 292-B:2 (1987); N.J. Rev. Stat. Ann. § 15:18-16 (West 1984); N.C. Gen. Stat. § 36B-2 (1989); N.D. Cent. Code § 15-67-02 (1981); Ohio Rev. Code Ann. § 1715.52 (Page 1985); Or. Rev. Stat. § 128.320 (1989); R.I. Gen. Laws Ann. § 18-12-2 (1988); Tenn. Code Ann. § 35-10-103 (1984); Tex. Prop. Code Ann. § 163.004 (Vernon Supp. 1990); Vt. Stat. Ann. tit. 14, § 3402 (1974); Va. Code § 55-268.2 (1986); Wash. Rev. Code Ann. § 24.44.020 (Supp. 1989); W. Va. Code § 44-6A-3 (1982); Wis. Stat. Ann. § 112.10(2) (West 1988). Georgia law does not refer to appreciation, providing instead for authority to accumulate net annual income and add it to principal. See Ga. Code Ann. § 44-15-2 (Supp. 1989). New York did not adopt Section 2 of UMIFA.

14. See Prob. Code § 16040 and its Comment; see also *Recommendation Proposing the Trust Law*, 18 Cal. L. Revision Comm'n Reports 501, 539 (1986).

institutions whose portfolios contain a better balance between equity and income.¹⁵

The existing California statute, if applied literally, encourages imprudence by requiring the sale of assets to "realize" appreciation and by skewing portfolios toward yield-oriented, fixed-income investments. The statute ignores the need to keep pace with inflation by prudent equity investments.¹⁶ Focusing only on realized net appreciation, the existing statute also ignores the fact that the assets retained may have depreciated, thereby leaving the institution in an even more perilous situation after sale of the appreciating asset.

The experience in other jurisdictions over the last 15 years should have disclosed any problems that might have arisen under Section 2 of UMIFA. Research has not revealed any problems with this feature of UMIFA in other jurisdictions. Not only have those states authorizing use of net appreciation continued their statutes without enacting new restrictions, other states have added their names to the list of jurisdictions adopting the official text of the uniform act, Texas being the most recent.¹⁷

15. See letter from Daniel A. Wingerd, Associate Vice President, The Common Fund, to Yeoryios Apallas, Deputy Attorney General (Jan. 20, 1990), reproduced as Exhibit 1 to Commission Memorandum 90-21.

16. See also W. Cary & C. Bright, *The Law and the Lore of Endowment Funds* 5-6 (1969).

17. Tex. Prop. Code §§ 163.001-163.009 (Vernon Supp. 1990), enacted by 1989 Tex. Gen. Laws ch. 213, § 1. The Texas Legislature made the following finding in Section 163.002(a):

(1) privately supported educational, religious, and charitable organizations perform essential and needed services in the state;

(2) uncertainty regarding legal restrictions on the management, investment, and expenditure of endowment funds of the organizations has in many instances precluded obtaining the highest available return on endowment funds; and

(3) the organizations, their officers, directors, and trustees, and the citizens of this state will benefit from removal of the uncertainty and by permitting endowment funds to be invested for the long-term goals of achieving growth and maintaining purchasing power without adversely affecting availability of funds for current expenditure.

(b) The purpose of this chapter is to provide guidelines for the management, investment, and expenditure of endowment funds of privately supported educational, religious, and charitable organizations in order to eliminate the uncertainty regarding

Finally, it should be noted that UMIFA does not force an institution to adopt an investment strategy that it might consider imprudent. In fact, prudence is still the standard by which the investment decisions are judged.¹⁸ The proposed law would simply remove an artificial limitation on the prudent use of endowment funds in furtherance of the institutions' purposes. However, if a donor wishes to prevent the institution's use of net appreciation of an endowment gift, the donor can so provide in the gift instrument.¹⁹ The intent of the donor, as expressed in the gift instrument, should be the guide to the use of net appreciation, not a blanket statutory restriction like that provided in existing California law.

legal restrictions on the management, investment, and expenditure of the funds and to enable the organizations to maximize their resources.

The Rhode Island statute prefaces the authority to use net realized and unrealized appreciation with the proviso that it is "[i]n order to permit investments which do not have a high annual cash return while preserving the institution's right to a prudent amount of annual income" R.I. Gen. Laws Ann. § 18-12-2 (1988).

18. Education Code Section 18506, providing the standard of care which is based on the standard applicable to trustees generally under the Trust Law, would be continued without substantive change in the proposed law.

19. Educ. Code § 94603; UMIFA § 3.

PROPOSED LEGISLATION

The Commission's recommendation would be effectuated by enactment of the following measure:

An act to amend Section 5240 of the Corporations Code, to add Part 7 (commencing with Section 18500) to Division 9 of the Probate Code, and to repeal Chapter 6 (commencing with Section 94600) of Part 59 of Division 10 of Title 3 of the Education Code, relating to the Uniform Management of Institutional Funds Act.

The people of the State of California do enact as follows:

Corporations Code § 5240 (amended). Investments under Nonprofit Public Benefit Corporations Law

SECTION 1. Section 5240 of the Corporations Code is amended to read:

5240. (a) This section applies to all assets held by the corporation for investment. Assets which are directly related to the corporation's public or charitable programs are not subject to this section.

(b) Except as provided in subdivision (c), in investing, reinvesting, purchasing, acquiring, exchanging, selling and managing the corporation's investment, the board shall do the following:

(1) Avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital.

(2) Comply with additional standards, if any, imposed by the articles, bylaws or express terms of an instrument or agreement pursuant to which the assets were contributed to the corporation.

(c) No investment violates this section where it conforms to provisions authorizing such investment contained in an instrument or agreement pursuant to which the assets were contributed to the corporation. No investment violates this section or Section 5231 where it conforms to provisions requiring such investment contained in an instrument or agreement pursuant to which the assets were contributed to the corporation.

(d) In carrying out duties under this section, each director shall act as required by subdivision (a) of Section 5231, may rely upon others as permitted by subdivision (b) of Section 5231, and shall have the benefit of subdivision (c) of Section 5231, and the board may delegate its investment powers as permitted by Section 5210.

(e) Nothing in this section shall be construed to preclude the application of the Uniform Management of Institutional Funds Act, ~~Chapter 3 Part 7~~ (commencing with Section ~~2290+1~~ 18500) of ~~Title 3 of~~ ~~Part 4 of~~ Division 3 9 of the Civil Probate Code, if that act would otherwise be applicable, but nothing in the Uniform Management of Institutional Funds Act alters the status of governing boards, or the duties and liabilities of directors, under this part.

Comment. Subdivision (e) of Section 5240 is revised to correct a cross-reference and to add language consistent with Probate Code Section 18508.

Education Code §§ 94600-94610 (repealed), Uniform Management of Institutional Funds Act

SEC. 2. Chapter 6 (commencing with Section 94600) of Part 59 of Division 10 of Title 3 of the Education Code is repealed.

Education Code § 94600 (repealed), Short title

Comment. Former Section 94600 is continued in Probate Code Section 18500 without change. The Uniform Management of Institutional Funds Act has been moved from the Education Code since it has been expanded to apply to religious, charitable, and other eleemosynary institutions.

Education Code § 94601 (repealed), Definitions

Comment. Former Section 94601 is restated in Probate Code Section 18501 without substantive change, except that the definition of "institution" in subdivision (a) has been substantially expanded in the new provision. Additional technical changes have been made. See Prob. Code § 18501 and its Comment.

Education Code § 94602 (repealed), Expenditure of asset net appreciation for current use

Comment. The first sentences of former Section 94602 is superseded by Probate Code Section 18502. See the Comment to Prob. Code § 18502. The second sentence is omitted. See the Comment to Prob. Code § 18502. The third sentence is continued in the second sentence of Probate Code Section 18502 without change.

Education Code § 94603 (repealed). Construction of gift instrument

Comment. Former Section 94603 is restated in Probate Code Section 18503 without substantive change. See the Comment to Prob. Code § 18503.

Education Code § 94604 (repealed). Authority of board to invest and reinvest

Comment. Former Section 94604 is continued in Probate Code Section 18504 without change, except that the comma following the word "associations" in subdivision (a) is omitted.

Education Code § 94605 (repealed). Delegation of authority

Comment. Former Section 94605 is continued in Probate Code Section 18505 without change.

Education Code § 94606 (repealed). Standard of care

Comment. Former Section 94606 is restated in Probate Code Section 18506 without substantive change, except as noted in the Comment to Probate Code Section 18506.

Education Code § 94607 (repealed). Release of restriction in gift instrument

Comment. Former Section 94607 is restated in Probate Code Section 18507 without substantive change. See the Comment to Prob. Code § 18507.

Education Code § 94608 (repealed). Severability

Comment. Former Section 94608 is omitted because it is unnecessary. See Prob. Code § 11 (severability).

Education Code § 94609 (repealed). Application and construction

Comment. Former Section 94609 is omitted because it is unnecessary. See Prob. Code § 2(b) (interpretation of uniform acts).

Education Code § 94610 (repealed). Status of governing boards

Comment. Former Section 94610 is restated in Probate Code Section 18508 without substantive change. See the Comment to Prob. Code § 18507.

Probate Code §§ 18500-18509 (added). Uniform Management of Institutional Funds Act

SEC. 3. Part 7 (commencing with Section 18500) is added to Division 9 of the Probate Code, to read:

PART 7. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT

§ 18500. Short title

18500. This part may be cited as the Uniform Management of Institutional Funds Act.

Comment. Section 18500 continues Education Code Section 94600 without change. The Uniform Management of Institutional Funds Act has been relocated from the Education Code, where it applied only to certain private institutions of higher education. See Section 18501(e) and its Comment. As to the construction of provisions drawn from uniform acts, see Section 2. See also Section 11 (severability).

§ 18501. Definitions

18501. As used in this part:

(a) "Endowment fund" means an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument.

(b) "Gift instrument" means a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitations from which an institutional fund resulted) under which property is transferred to or held by an institution as an institutional fund.

(c) "Governing board" means the body responsible for the management of an institution or of an institutional fund.

(d) "Historic dollar value" means the aggregate fair value in dollars of (1) an endowment fund at the time it became an endowment fund, (2) each subsequent donation to the endowment fund at the time it is made, and (3) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the endowment fund.

(e) "Institution" means an incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a governmental organization to the extent that it holds funds exclusively for any of these purposes.

(f) "Institutional fund" means a fund held by an institution for its exclusive use, benefit, or purposes, but does not include (1) a fund held for an institution by a trustee that is not an institution or (2) a fund in which a beneficiary that is not an institution has an

interest, other than possible rights that could arise upon violation or failure of the purposes of the fund.

Comment. Section 18501 restates former Education Code Section 94601 without substantive change, except that the definition of "institution" has been substantially expanded. As revised, the definition of "institution" is the same as that provided in Section 1(1) of the Uniform Management of Institutional Funds Act (1972). Former Education Code Section 94601(a) defined "institution" as a "private incorporated or unincorporated organization organized and operated exclusively for educational purposes and accredited by the Association of Western Colleges and Universities to the extent that it holds funds exclusively for any of such purposes."

Section 18501 lists the definitions in alphabetical order, unlike former Education Code Section 94601. The definition of "historic dollar value" in subdivision (d) has been revised by adding "endowment" preceding "fund" in the second and third clauses.

Section 18501 is the same in substance as Section 1 of the Uniform Management of Institutional Funds Act (1972), except for the omission of the provision in Section 2(5) of the uniform act making conclusive a good faith determination of historic dollar value. As to the construction of provisions drawn from uniform acts, see Section 2.

§ 18502. Expenditure of asset net appreciation for current use

18502. The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by Section 18506. This section does not limit the authority of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument, or the charter of the institution.

Comment. Section 18502 is the same in substance as Section 2 of the Uniform Management of Institutional Funds Act (1972). As to the construction of provisions drawn from uniform acts, see Probate Code Section 2. The provision in the first sentence permitting the appropriation of net appreciation, whether realized or unrealized, supersedes the first sentence of former Education Code Section 94602. The second sentence of Section 18502 continues the third sentence of former Education Code Section 94602 without change. The second sentence of former Education Code Section 94602, which provided a rolling five-year averaging rule, is not continued.

§ 18503. Construction of gift instrument

18503. (a) Section 18502 does not apply if the applicable gift instrument indicates the donor's intention that net appreciation shall not be expended.

(b) If the gift instrument includes a designation of the gift as an endowment or a direction or authorization to use only "income," "interest," "dividends," or "rents, issues, or profits," or "to preserve the principal intact," or a direction or authorization that contains other words of similar meaning:

(1) A restriction on the expenditure of net appreciation need not be implied solely from the designation, direction, or authorization, if the gift instrument became effective before the Uniform Management of Institutional Funds Act became applicable to the institution.

(2) A restriction on the expenditure of net appreciation may not be implied solely from the designation, direction, or authorization, if the gift instrument becomes effective after the Uniform Management of Institutional Funds Act became applicable to the institution.

(c) The effective dates of the Uniform Management of Institutional Funds Act are the following:

(1) January 1, 1974, with respect to a private incorporated or unincorporated organization organized and operated exclusively for educational purposes and accredited by the Association of Western Colleges and Universities.

(2) January 1, 1991, with respect to an institution not described in paragraph (1).

Comment. Subdivision (a) of Section 18503 restates former Education Code Section 94603(a) without substantive change. Subdivisions (b) and (c)(1) restate former Education Code Section 94603(b) without substantive change. Subdivision (c)(2) applies a consistent rule of construction to institutions (as defined in Section 18501(e)) that were not covered by the former law. See the Comment to Section 18501.

Subdivisions (a) and (b) are the same in substance as the first two sentences of Section 3 of the Uniform Management of Institutional Funds Act (1972). As to the construction of provisions drawn from uniform acts, see Section 2.

§ 18504. Investment authority

18504. In addition to an investment otherwise authorized by law or by the applicable gift instrument, the governing board, subject to any specific limitations set forth in the applicable gift instrument, may do any or all of the following:

(a) Invest and reinvest an institutional fund in any real or personal property deemed advisable by the governing board, whether or

not it produces a current return, including mortgages, deeds of trust, stocks, bonds, debentures, and other securities of profit or nonprofit corporations, shares in or obligations of associations or partnerships, and obligations of any government or subdivision or instrumentality thereof.

(b) Retain property contributed by a donor to an institutional fund for as long as the governing board deems advisable.

(c) Include all or any part of an institutional fund in any pooled or common fund maintained by the institution.

(d) Invest all or any part of an institutional fund in any other pooled or common fund available for investment, including shares or interests in regulated investment companies, mutual funds, common trust funds, investment partnerships, real estate investment trusts, or similar organizations in which funds are commingled and investment determinations are made by persons other than the governing board.

Comment. Section 18504 continues former Education Code Section 94604 without change, except that in subdivision (a) a reference to deeds of trust has been added and an unnecessary comma following the word "associations" has been omitted. The forms of investment listed in subdivisions (a) and (d) following the word "including" are illustrations and not limitations on the general authority provided in these subdivisions. As to the construction of provisions drawn from uniform acts, see Section 2.

§ 18505. Delegation of investment management

18505. Except as otherwise provided by the applicable gift instrument or by applicable law relating to governmental institutions or funds, the governing board may do the following:

(a) Delegate to its committees, officers, or employees of the institution or the fund, or agents, including investment counsel, the authority to act in place of the board in investment and reinvestment of institutional funds.

(b) Contract with independent investment advisers, investment counsel or managers, banks, or trust companies, so to act.

(c) Authorize the payment of compensation for investment advisory or management services.

Comment. Section 18505 continues former Education Code Section 94605 without change. This section is the same in substance as Section 5 of the Uniform Management of Institutional Funds Act (1972). As to the construction of provisions drawn from uniform acts, see Section 2.

§ 18506. Standard of care

18506. (a) When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property, appropriating appreciation, and delegating investment management for the benefit of an institution, the members of the governing board shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. In the course of administering the fund pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

(b) In exercising judgment under this section, the members of the governing board shall consider the 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, general economic conditions, the appropriateness of a reasonable proportion of higher risk investment with respect to institutional funds as a whole, income, growth, and long-term net appreciation, as well as the probable safety of funds.

Comment. Section 18506 restates former Education Code Section 94606 without substantive change. See the Comment to Section 18500. The standard of care in subdivision (a) is consistent with the general standard of care provided by Section 16040.

§ 18507. Release of restriction in gift instrument

18507. (a) With the written consent of the donor, the governing board may release, in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund.

(b) If written consent of the donor cannot be obtained by reason of the donor's death, disability, unavailability, or impossibility of identification, the governing board may apply in the name of the institution to the superior court of the county in which the principal activities of the institution are conducted, or other court of competent jurisdiction, for release of a restriction imposed by the applicable gift instrument on the use or investment of an institutional

fund. No court has jurisdiction to release a restriction on an institutional fund under this part unless the Attorney General is a party to the proceedings. If the court finds that the restriction is obsolete or impracticable, it may by order release the restriction in whole or in part. A release under this subdivision may not change an endowment fund to a fund that is not an endowment fund.

(c) A release under this section may not allow a fund to be used for purposes other than the educational, religious, charitable, or other eleemosynary purposes of the institution affected.

(d) This section does not limit the application of the doctrine of cy pres.

Comment. Section 18507 restates former Education Code Section 94607 without substantive change. In the second sentence of subdivision (b), the phrase "release a restriction on" has been substituted for the phrase "modify any use of" in former Education Code Section 94607(b) for consistency with the remainder of this section. Section 18507 is the same in substance as Section 7 of the Uniform Management of Institutional Funds Act (1972), except for some variations in subdivision (b). As to the construction of provisions drawn from uniform acts, see Section 2.

§ 18508. Status of governing boards

18508. Nothing in this part alters the status of governing boards, or the duties and liabilities of directors, under other laws of this state.

Comment. Section 18508 continues former Education Code Section 94610 without change, except that the language relating to duties and liabilities of directors is new. The purpose of the new language is to make clear that the duties and liabilities of directors of incorporated institutions are governed by the relevant statute and not by this part. See, e.g., Corp. Code §§ 5231-5231.5 (directors of nonprofit public benefit corporations), 7231-7231.5 (directors of nonprofit mutual benefit corporations), 9240-9241 (directors of nonprofit religious corporations).

§ 18509. Laws relating to expenditure of public funds

18509. Nothing in this part limits the application of any law relating to the expenditure of public funds.

Comment. Section 18509 is a new provision that makes clear the relation of the Uniform Management of Institutional Funds Act to any other law concerning expenditure of public funds. See, e.g., Gov't Code § 53601. Thus, under Section 18509, if other law provides greater limitations on the expenditure of public funds, that law prevails over any provision of this part that might otherwise have been applicable.