First Supplement to Memorandum 90-21

Subject: Study L-3012 - Uniform Management of Institutional Funds Act (Effect of Transaction Costs under California UMIFA)

Attached to this supplement is an analysis of the effect transaction costs can have under the existing California version of UMIFA which appears to require realization of appreciation before it may be taken into account in setting spending policy of a charitable institution. The analysis is provided by Jonathan Brown, Vice President of the Association of Independent California Colleges and Universities. As explained in Mr. Brown's letter, this exercise was spurred by the position taken by Yeoryios Apallas, Deputy Attorney General, to the effect that an institution would have to sell an appreciated stock to take advantage of its appreciation and then repurchase that stock if it wanted to keep it in the institution's portfolio.

Mr. Brown's model shows the effects over a five-year period of this type of policy if transaction charges average 2.5%. You should look at the figures in detail, but several point stand out:

• Transaction costs are significantly greater where the gain must be realized. Obviously such expenditures do not benefit the charitable purpose of the institution that incurs them.

• The model shows that 21% more spendable income would be generated under the UMIFA standard permitting budgeting based on both realized and unrealized net appreciation than under the California statute which is restricted to realized net appreciation.

• The model illustrates the effect of the California rule on the potential growth of the endowment. Under the stated assumptions, after five years the endowment would be worth \$43,174 under the UMIFA standard as against \$36,796 under the California rule.

We anticipate a possible objection to Mr. Brown's conclusions, since he assumes the sale and repurchase of the same stocks. The

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suggestion was made at the January meeting that even though the California statute would seem to require this behavior, it might not be prudent to do so under the applicable standard of care. Of course, this tells us several things, one being that the statute is internally inconsistent and ultimately unworkable. It also seems imprudent to force the institution to sell its best stocks -- those that have appreciated the most -- in order to realize the appreciation needed to meet budgetary needs. It is no answer to suggest that the sale is prudent so long as <u>different</u> stocks are purchased. This approach exalts form over substance: the defect is in forcing the sale of the appreciating asset, not in the repurchase of the same stocks. Whether the same or different stocks are purchased after the gain is realized is irrelevant to the issue of prudence, since the institution's governing board is required to sell to realize the gain and then is required to make the best investment under the circumstances; this may very well mean a portfolio including the same stock that was sold to satisfy the realization requirement. The realization of gain and the increase in the basis of the portfolio is the same, whether or not the same stock is purchased. The point is that the repurchase assumption made by Mr. Brown, following the lead of the Attorney General's representative, is not unrealistic, as it might first appear. It is, in fact, what is encouraged, even required, by a literal interpretation of the existing statute, and amply illustrates the folly of existing law.

Respectfully submitted,

Stan G. Ulrich Staff Counsel

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February 7,1990

Stan Ulrich Staff Counsel California Law Revision Commission 4000 Middlefield Rd., Suite D-2 Palo Alto, CA 94303-1335

Dear Stan.

After the discussion at the last meeting of the Commission I began to think about Director of Marketune and Research how a charitable institution would institute a spending policy according to the suggestion of the Deputy Attorney General. I constructed the attached spreadsheet to illustrate the alternatives between the Uniform Statute and the current California variation. I used a model portfolio with initial values of one third in a consistent performance stock, one third in a more variable security and one third in money market equivalents. Attached is the result of my effort. I should comment that there are at least four variables which would distort the order of magnitude of the investment performance postulated. Those variables include;

> Assume a different rate of investment return and the vield and need for trading would differ. I have chosen two stocks in this model. Obviously, most endowments would be considerably more diversified. The key data point which would not vary is the greater reliance in charitable endowments which the Uniform Statute would encourage for California endowments. The question of diversification of portfolio, and the associated effects of the California versus the Uniform Statute, was well demonstrated by Dan Wingerd in his presentation.

> The Model Assumes a Constant Commission Rate for Transactions. Many of our institutions assume a 2% transaction cost, some assume a 3% rate. Varying the transaction cost would modify the results. The fundamental fact here is that whatever the rate, the policy advocated by the Deputy Attorney General would significantly increase transaction costs.

> • The money equivalent yield is figured at a constant 7.5%. Most careful managers can produce a slightly higher yield under current conditions. In addition, most managers use modelling techniques to decide the proper allocation among alternative investment possibilities. The 7.5% is assumed to be a reasonable middle ground for this exercise.

> The endowment spending policy is assumed to be consistent between the two models. I have chosen a 5% spending policy. As was stated at the meeting some endowments establish a "real" spending rate which keys off the current rate of yield when

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compared to the current rate of inflation. The goal of all endowments is to hold a constant value for the endowment.

Putting the alternatives into a graphic form often helps me to understand the issues involved more clearly. I hope this sheet might do that for you.

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Sincerely, Johathan Brown Vice President

A Comparison of Investment Returns under UMIFA

linder limits as enacted in 28 States		Year One	Year Two	Year Three	Year Four	Vear Five	
Consth Stool A		\$10,000	\$12,000	\$14.400	\$17.990	400 796	Assumptions
Growth Stock B		\$10,000	\$7,500	\$10,000	\$11500	φ20,730 ¢12 160	For Both
Coch Fautralent Portfolio		\$10,000	\$0,000	\$6 189	\$4 807	φ13,100 ¢3 305	1) Endowment
Due Appreciation (Loss) on Stock A During Year		\$2,000	\$2,200	\$0,102 \$2,880	47,097 47,097	\$0,020 \$4 147	has two stocks :
Plus Appreciation (Loss) on Stock R During Tear		-\$2,000	φ2,400 ¢Ω	¢2,000 \$1,500	φ0,400 ¢1,650	Φ4,147 Φ1 Ο16	one with
Transaction Costs for Sole of Stock A		-42,000	¢0	φ1,000 ¢Ω	φ1,000 ¢Ω	φ1,010 ΔΦ	consistent
Transaction Costs for Sale of Stock B S Assumes		constant fee of	-¢199	φυ \$0	φ0 ¢0	ቀ0	growin and one
Proceeds from Stock Sales		transaction	\$7500	φυ \$Ω	φυ \$Ω	φ0 ¢0	growth, plus a
Phys Interest on Cash Emivalent Portfolio		\$750	\$1,000 \$1,241	\$464	\$367	φυ \$240	cash fund with
Portfolio Value at End of Year		\$30 250	\$32,191	\$34.962	\$38 783	ቁፈቱታ \$43 174	a return of
Spendable Income	Assumes	\$1.513	\$1 610	\$1 748	\$1 939	\$2 150	7.5%
	constant 7.5%	41,010	<i></i>	+1,7 10	Ψ1,505	φ2,105	
Under UMIFA as enacted in California		Year One	Year Two	Year Three	Year Four	Year Five	
Growth Stock A \$		\$10,000	\$12,000	\$14,400	\$17,280	\$20.736	Additional
Growth Stock B		\$10,000	\$7,500	\$10,000	\$11,500	\$13,150	California
Cash Equivalent Portfolio		\$10,000	\$9,238	\$7,826	\$6,373	\$4,560	Assumption;
Plus Appreciation (Loss) on Stock A During Year		\$2,000	\$2,400	\$2,880	\$3,456	\$4,147	realize gains
Plus Appreciation (Loss) on Stock B During Year		-\$2,500	\$ O	\$1,500	\$1,650	\$1,815	stocks must be
Transaction Costs for Sale of Stock A			-\$600	-\$720	-\$864	-\$1,037	sold and then
Transaction Costs for Sale of Stock B			\$0	\$ 0	-\$575	-\$658	re-purchased
Proceeds from Stock Sales			\$12,000	\$14,400	\$28,780	\$33,886	
Plus Interest on Cash Equivalent Portfolio		\$750	\$ 648	\$533	\$370	\$2 15	
Portfolio Value at End of Year		\$30,250	\$31,185	\$29,726	\$33,653	\$36,796	
Spendable Income		\$1,513	\$1,559	\$1,486	\$1,683	\$1,840	
\$3,000 \$2,000 \$1,000 \$0 \$0 Transaction Costs Norms Transaction Costs Califo	ai rnia	\$2500 \$2000 \$1500 \$1000 \$500 \$0 \$0		At the end UMIFA s more spe for charit: Spenda Spenda	l of five years (tandards prod ndable income able purposes. ble Income N ble Income C	he normal luce 21% available	
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