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 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: <u>the defect is in forcing the sale of the appreciating asset</u>, 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,

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Dear Stan,

After the discussion at the last meeting of the Commission I began to think about 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 yield 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.

Sincerely,

Jonathan Brown
Vice President

A Comparison of Investment Returns under UMIFA

Under UMIFA as enacted in 28 States	Year One	Year Two	Year Three	Year Four	Year Five
Growth Stock A	$10,000	$12,000	$14,400	$17,280	$20,736
Growth Stock B	$10,000	$7,500	$10,000	$11,500	$13,150
Cash Equivalent Portfolio	$10,000	$9,238	$6,182	$4,897	$3,325
Plus Appreciation (Loss) on Stock A During Year	$2,000	$2,400	$2,880	$3,456	$4,147
Plus Appreciation (Loss) on Stock B During Year	-$2,500	$0	$1,500	$1,650	$1,815
Transaction Costs for Sale of Stock A		$0	$0	$0	$0
Transaction Costs for Sale of Stock B		-$188	$0	$0	$0
Proceeds from Stock Sales		$7,500	$0	$0	$0
Plus Interest on Cash Equivalent Portfolio	$750	$1,241	$464	$367	$249
Portfolio Value at End of Year	$30,250	$32,191	$34,962	$38,783	$43,174
Spendable Income	$1,513	$1,610	$1,748	$1,939	$2,159

Assumes constant fee of 2.5% per transaction

Assumes constant 7.5%

Assumptions For Both Models
1) Endowment has two stocks ; one with consistent growth and one with erratic growth, plus a cash fund with a return of 7.5%

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
Growth Stock B	$10,000	$7,500	$10,000	$11,500	$13,150
Cash Equivalent Portfolio	$10,000	$9,238	$7,826	$6,373	$4,560
Plus Appreciation (Loss) on Stock A During Year	$2,000	$2,400	$2,880	$3,456	$4,147
Plus Appreciation (Loss) on Stock B During Year	-$2,500	$0	$1,500	$1,650	$1,815
Transaction Costs for Sale of Stock A		-$600	-$720	-$864	-$1,037
Transaction Costs for Sale of Stock B		$0	$0	-$575	-$658
Proceeds from Stock Sales		$12,000	$14,400	$28,780	$33,886
Plus Interest on Cash Equivalent Portfolio	$750	$648	$533	$370	$215
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

Additional California Assumption:
In order to realize gains stocks must be sold and then re-purchased