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Date: December 10, 1990

To: Fund Statement Recipients

From: Mario A. Pietrangelo, Funds Manager

Subject: 1990/91 Endowment Income for Pools A and B

In November, endowment income is allocated at the University Board of Trustees' authorized expenditure rate. This memo describes situations that may make it necessary at fiscal year end for us to pull back some of the income that now appears on your November statements.

The University Board of Trustees' authorized expenditure rate for 1990/91 is $1.73/share for Pool A and $1.82/share for Pool B. At the present time, we estimate that the 1990/91 yield (ordinary income) for both Pool A and Pool B for 1990/91 will be approximately $1.55, which is less than the expenditure rate.

Our endowment investment strategy is to maintain over time the real value of the endowment income available for support of our operations. To accomplish this, the expenditure rates are carefully set based on the market value of the endowment. The amount available for expenditure is most often paid from yield earned by the endowment pools. However, we expect that in some years increases in the market value and/or lower yields of the market place will produce an expenditure rate per share that is higher than the yield per share. This has occurred in Pool B every year beginning with fiscal year 1987/88. In 1989/90, the yield per share earned by Pool A was less than the expenditure rate for the first time.

When the yield is less than the expenditure rate, a small portion of the endowment income that was reinvested in earlier years is withdrawn from the endowment funds and added to what is actually earned to make up the difference. For example, in 1989/90, Pool A actually earned $1.55 per share. The expenditure rate was $1.59 per share. So, to make up the difference, $.04 per share was taken out of every Pool A endowment fund that had excess income reinvested in prior years. The result was that the funds invested in Pool A had income promised by the Board of Trustees available to spend even though Pool A really did not earn that much. This is done through the accounting system and perhaps may not even have been noticed.

However, when yield is lower than the expenditure rate, three things may happen:

1. The number of shares owned by each fund declines. Shares held by each fund are sold to come up with the money to supplement the earnings. In the case of Pool B, most funds have sold shares every year since 1987/88. When you are projecting your earnings for future years, please notice that you now have fewer Pool A or Pool B shares in each fund.

2. In the case of funds established in recent years, there may be little or no reinvested income to withdraw. For example, any fund invested in Pool B after 1987/88 has never had any excess income to reinvest. If the shares are worth more now than when they originally were bought, the increase in the market value can be used to cover the shortfall. This means, for example, that shares purchased for $30 might be sold for $35, thus realizing a gain of $5 per share. Then the $30 is used to buy new shares (albeit fewer shares). When this happens, you also end up having fewer shares to earn income in subsequent years. Gains generally cannot be withdrawn from funds invested in Pool A.

3. In the worst possible case, the value of shares owned by the fund may have declined. For example, shares purchased at $37 per share might now be worth only $35 per share. Obviously, since the share value has gone down, there is no gain to realize. When this happens, the fund involved does not get any money to supplement yield. To illustrate, if $1.59 per share is allocated as the Board approved expenditure rate and the yield for the pool is only $1.55, $.04 per share will be removed from the endowment income fund at the end of the fiscal year. If you have already spent $1.59 per share, you will have to come up with the difference (in this case $.04 per share) from another source. There is no way to know whether or not this will happen in 1990/91.

If you have any questions about how these transactions work, please contact Mary Morrison (5-1613, as.mkm) or Mario Pietrangelo (5-3863, as.map).