TFIR Statement on UC Liquidity and Working Capital Option Study, 05.03.13

Recently, the Office of the UC Chief Financial Officer (CFO) performed a study of UC Liquidity and Working Capital Options. TFIR's understanding is that the CFO study will be completed around May 15 and will be presented to the Regents Committee on Investments on May 21; however, TFIR has not seen a draft of the study. This TFIR statement is based on the limited information shared with the task force, so it is likely to be an incomplete and preliminary response. However, this issue is sufficiently important, urgent, and our concerns are sufficiently great, that we offer this initial response based on partial information. We are very concerned that TFIR - a task force specifically charged to advise UCFW and ultimately, the Academic Council, on matters of investment and retirement - has to date been excluded from full consultation.

The CFO's study of the balances in the Short Term Investment Pool (STIP) identified liquidity of approximately $2B in excess of the UC's working capital needs. The methodology used to determine this amount has not yet been shared with the Academic Senate, as noted above. TFIR continues to seek a full review of the determination of excess liquidity, but for the purpose of this statement, accepts the figure of $2B. The CFO's study concludes that higher investment returns could be earned, and recommends reallocating $2B from STIP to other investments.

To date, our understanding is that the proposed options for investment reallocation have involved transferring these funds from STIP to less liquid alternatives: either the Total Return Investment Pool (TRIP), or a new instrument, Long Total Return Investment Pool (LTRIP). Modeling has indicated that a $2B transfer to TRIP could provide approximately $45M in increased net revenues, and that a $2B transfer to LTRIP could provide approximately $67M in increased net revenues annually. Although these increased returns — on the order of 2 to 3% above the STIP rate — may initially appear attractive, TFIR urges that UCFW recommends that this plan be opposed. TFIR's position is based on the lack of transparency noted above, along with the following serious concerns:

> (1) The higher investment returns from TRIP and LTRIP, with public equity allocations of 35% and 64% respectively, are inherently volatile, and subject to considerable annual variation, including the possibility of substantial losses. There is no free lunch here: increased expected return entails increased risk, and there is no way to guarantee a rate of return that is substantially higher than the one from STIP, without taking on additional risk. Some of the funds invested in STIP involve commitments which must be met regardless of the investment outcomes, such as obligations to perform the work obliged by contracts and grants. Campus units that rely on STIP funds that do not have external obligations could end up bearing a disproportionate share of the impact of investment losses. It is unknown how this would affect support for teaching, research, and service on the campuses, but it is unrealistic to assume that there would be no impact.
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> Moreover, instability in campus revenues will be increased, because the same forces that drive decreases in investment returns simultaneously drive decreases in State revenue and resulting cuts in State funding to the University. Therefore, if the putative increased revenues derived from transfers to TRIP or LTRIP are intended to fund campus operating expenses, campuses are likely to experience abrupt decreases in revenue at the same time that they experience State budget cuts, further compromising their ability to carry out their mission.
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> TFIR recommends that this proposal receive no further consideration until contingency plans are developed and reviewed system-wide, and asks that the Office of the President and the campuses explain how shortfalls in anticipated investment returns would be dealt with.

(2) TFIR is concerned that we have seen no plan to deal with the consequences of market downturns, including campuses' likely responses. Our best guess is that the CFO proposal envisions treating TRIP/LTRIP investments essentially as an endowment. We agree that a stable rate of return can be successfully paid out to the campuses, with a high probability that the funds will be there to make these payments, if these TRIP/LTRIP funds are managed as endowment funds. This requires limits on campus withdrawals, and that the Office of the Treasurer be able to retain a portion of higher than anticipated returns, when times are good, to help weather the storm when times are bad. Although it is understood in general terms with respect to TRIP that "University Financial Management may establish limitations on Campus investments to maintain sufficient short term liquidity for University cash needs, and restrictions on withdrawals as is appropriate for the investment of longer-term assets", we have not yet seen an explicit statement that campuses will by necessity give up the right to withdraw funds from TRIP/LTRIP whenever they wish, nor an indication that campuses have agreed to such a limitation.

As currently proposed, therefore, campuses could withdraw funds whenever they chose, despite the long-term commitments inherent to certain types of investment. The documents governing TRIP provide that campuses have the right to withdraw from TRIP on a periodic basis, and withdrawals are always at net asset value. If net asset value is $1.20 per dollar of principal, for instance (as will happen following a good year), then a campus that withdrew $100M in principal would get an additional $20M that it could spend the same year. When upside gains are anticipated, a campus could remain invested and ride the tide, but when downside risk is expected, a campus could withdraw funds – leaving the others to "hold the baby". As a result, the proposed scheme is inherently susceptible to "gaming", disadvantaging the campuses which do not engage in such strategic behavior.

(3) The proposal, as we understand it, is fundamentally flawed, in that it does not recognize the fact that the campuses and the Office of the Treasurer have competing and incompatible aims. The campuses will inevitably seek short-term revenues to fund their day-to-day operating expenses, while the Office of the Treasurer seeks to stabilize and maximize long term returns. In effect, the proposal creates an investment vehicle aimed at providing greater returns over a longer-term, similar to an endowment, but without any of the provisions used by such funds to discourage the short-term strategies that seem more attractive to the campuses. As the plan is currently portrayed, it simply cannot provide a risk-free payout that is greater than the STIP rate.

Therefore, for the above reasons, TFIR strongly recommends that decisions on the proposed reinvestment scenarios, within TRIP or LTRIP, be postponed until such time as we have reviewed a plan to deal with downturns. We cannot support moving forward without seeing a plan to deal with downturns, including provisions that prevent campuses from simply withdrawing their funds at the bottom of the market.

TFIR's Alternative Proposal

An obvious alternative exists, should excess liquidity be verified, and we request that this alternative be analyzed at the same time that plans to ensure the stability of TRIP/LTRIP during downturns are developed. An internal loan to UCRP, of the type performed in 2010/11, has a number of advantages over the TRIP/LTRIP proposal. Although the University has continued to make progress toward fully funding the Annual Required Contribution (ARC), under the Regents funding policy, the unfunded liability in UCRP still continues to grow. If $2B can be invested to earn 4%, it can be invested in UCRP to earn 7.5%, and if the campuses are truly willing to make long-term investments, this is the best long-term investment available. The unfunded liability grows at 7.5% per year; to invest funds elsewhere, for a lower rate of return, is equivalent to using a credit card to make investments that earn less than the interest on the credit card. If the campuses instead make the same kind of internal loan to UCRP made in 2010/11, they can be paid the same 4% return, with funding coming from the eventual 18% employer contributions required to contribute full ARC. By putting that funding into UCRP now, and not later, it remains possible to stay on the current path for ARC, instead of requiring contributions even greater than 20% in the future, to make up for the shortfalls we continue to create, by not fully funding ARC.

Such a loan would therefore (i) maintain the same cash flow to the campuses; (ii) provide fiscal stability and predictability; (iii) provide a higher overall average rate of return to the University as a whole, 7.5%; (iv) reduce the University's large UCRP liability, while improving factors associated with credit ratings; and (v) greatly decrease the long-term cost of restoring UCRP to fully funded status. The administration's own projections for necessary employer contributions to UCRP demonstrate that TFIR's alternative recommendation would provide the same annual cash flows to the campuses, while simultaneously reducing their future costs related to the unfunded UCRP liability.

Recommendations

TFIR requests that, before making a decision, the Office of the CFO update the liquidity study to include not only the contingency plans we have requested above, but also a full analysis of our alternative proposal, showing the effects on the path for ARC, the funded status of UCRP, and the employer contribution percentages required with and without the internal loans we propose.