Minutes
Business and Finance Committee
Board of Regents of the University of Wisconsin System
February 10, 2005

The Business and Finance Committee met at 1:38 p.m. in room 1920 Van Hise Hall, UW-Madison. Present were Regents Bradley, Connolly-Keesler, Pruitt, Randall, and Rosenzweig.

a. Approval of Minutes of the December 9, 2004 meeting of the Business and Finance Committee

Upon the motion of Regent Randall, and the second of Regent Connolly-Keesler, the minutes of the December 9, 2004, meeting of the Business and Finance Committee were approved as presented.

b. Annual Financial Report

Doug Hendrix, Associate Vice President for Financial Administration, discussed the UW System Annual Financial Report. In explaining where the UW System's funding comes from, he noted that state appropriations are not considered operating revenue, so focusing on the total revenues give a more complete representation: 26.6% comes from state appropriations, 19.3% from tuition and 24.3% percent from grants and contracts, and 29.8% from other sources.

Mr. Hendrix reported on some trends that show the amount of revenue derived, in nominal and inflation adjusted dollars, respectively, from state appropriations, from tuition and fees, and from all other sources. When adjusted for inflation, state support has been relatively flat over most of the prior ten year period. Revenue from other sources has steadily increased.

Associate Vice President Hendrix described where the money is expended; stating that institutional support makes up 5.5%. When comparing against UW System peers, institutional support was 6.2% versus the peer average of 10.2%. The difference between 5.5% and 6.2% is due to the inclusion or exclusion of auxiliary operations from the base.

Regent Bradley asked if there has been progress in decreasing the gap between the method used in the Legislative Audit Bureau (LAB) audit to calculate administrative expenditures and the method utilized by peer institutions. Vice President Durcan told the Committee that she is continuing to meet with representatives from the Legislative Audit Bureau to determine the best options for reporting and classifying positions.

The Committee agreed that it will be important to agree upon a definition of administration with LAB and the Department of Administration (DOA), in light of the required reduction of the equivalent of 200 full-time positions in the 2005-07 biennial budget.

c. Office of Operations Review and Audit Update

Regent Bradley stated that, as Chair of the Committee, he and Regent Connolly-Keesler met with LAB last fall, and agreed that the Board should take a more active role in audit oversight. The Business and Finance Committee will begin hearing quarterly reports from the Director of Operations Review and Audit. Regent Connolly-Keesler has agreed to be the Committee's lead in this endeavor. The decision was endorsed by the Committee.

Ron Yates, Director, Office of Operations Review and Audit, described the current, ongoing program review projects being conducted by his office. These include examining the authority and responsibilities of campus police and public safety operations, how services are provided, and administrative areas such as staffing and equipment. The office is also analyzing the range of special course fees among UW institutions, reviewing the authorization process for these fees, and assessing the adequacy of fee collection and assessment procedures. Also, the office is focusing on initiatives that seek to return ill or injured employees to work as soon as medically feasible as a part of an Early-Return-to-Work Effort. For each of these projects, a report is being drafted.

Mr. Yates remarked that the office worked with UW institution auditors several years ago to identify six core audit areas: cash handling, payroll/personnel, property control, auxiliary operations, tuition and segregated fee revenues, and major systems. The frequency and scope of work performed in each of the core areas is based on the professional judgment of each UW institution auditor. For fiscal years 2003 and 2004, most of reported audit activity was in these core audit areas.

Regent Rosenzweig asked how other states' auditors compare to LAB in terms of the types of audits performed. Mr. Yates noted that other states' auditors focus much more on financial audits as opposed to program audits. Some states use external auditors; however, in general, those states pay higher fees for their audit services.

Director Yates explained that LAB has been conducting a number of UW System-related projects, including a review of UW Madison's Material Distribution Service (MDS) and Surplus with a Purpose (SWAP) programs. This review will analyze staffing levels, facilities, and the overall financial condition of the programs, with an anticipated completion date of summer 2005.

Mr. Yates expanded upon LAB's statewide projects. These include an evaluation of the state vehicle fleet, focused largely on the Department of Administration (DOA). LAB anticipates a spring 2005 completion date for this project. Also, a limited-scope review of cellular phone use in all state agencies is expected to be released no later than March 2005. The UW System currently has roughly 2,300 cellular phones. Finally, a review of the state's economic development programs is due to be completed by spring 2005.

Director Yates stated that the office reviewed UW institutions' procedures for removing sensitive data, such as social security numbers and medical information, from computers when the computers are no longer used. UW institutions did not report any instances in which confidential information had been inappropriately disclosed through discarded computer hard drives. However, with UW institutions replacing personal computers every three to four years, it is important that the data stored on the computers be securely removed.

Regent Connolly-Keesler asked whether all campuses have a policy regarding data removal from surplus computers. Director Yates noted that campuses already have policies in place, and the systemwide Regent Policy Document 97-2, "Policy on Use of University Information Technology Resources," could be amended to address the secure destruction of private and confidential records prior to computer disposal.

The Committee asked for a follow up report on this topic in six to nine months.

d. Business of the Committee

(1) Utilities Report to Joint Committee on Finance

Vice President Debbie Durcan indicated that the university has not had any reaction to the utilities report filed with the Joint Committee on Finance at the end of January.

Regent Rosenzweig suggested that UW System meet with the Joint Committee on Finance and communicate the importance of this matter. The state is currently dealing with a large Medicaid deficit, but need to be reminded of this problem. Committee members recommended that the UW System Administration meet with Legislators so that they better understand the utility shortfall.

Vice President Durcan stated that President Reilly has discussed this issue with the Co-chairs of Joint Finance; however it is a good suggestion to meet with other members of the Committee to make sure that they are fully aware of the problem.

(2) Quarterly Gifts, Grants and Contracts Report

Vice President Durcan summarized the gifts, grants and contracts awarded to the institutions of the UW System for the six-month period ending December 31, 2004. Total gifts, grants and contracts for this period were $660 million, an increase of $23.8 million from the comparable period of the previous fiscal year. Notable gifts included a $10 million gift to UW-Madison from the Inner City Asthma Consortium in the School of Medicine and a $12 million gift to the Wisconsin Center for Education Research on systemwide change for learners and educators. A report showing trend data from prior years for the comprehensive campuses will be submitted to the Committee at a future meeting.

e. Trust Funds

(1) Annual Trust Funds Report

Assistant Trust Officer Doug Hoerr presented the Trust Fund Annual Report. For the fiscal year ending June 30, 2004, gifts totaled $12.8 million compared to $10.8 million from the prior year. There were almost $22 million in disbursements. The Long-Term Fund rate of return was 17% compared to 16% for the benchmark. These strong returns made up for the difference between new gifts and disbursements. Total asset value was $346 million, an increase of about $30 million over the prior year. Finally, there have been strong returns since the fiscal year ended. The rate of return for the last quarter of calendar year 2004 was 10 percent.

(2) Introduction to Real Asset Classes

Assistant Trust Officer Hoerr stated that "real" asset classes are so named because they represent ownership in tangible, physical, or real assets, as opposed to financial assets such as stocks and bonds. These real assets are expected to provide real returns that effectively keep pace with and thereby hedge against inflation, while hopefully providing some excess or real return. Two such real asset classes are Treasury Inflation Protection Securities (TIPS) and timber.

Mr. Hoerr indicated that Treasury Inflation Protection Securities (TIPS) are a relatively new type of fixed income security in the U.S., having first been issued by the U.S. Treasury in early 1997. Today, the TIPS market, although much larger, liquid and efficiently priced, remains relatively small. Currently, there is roughly $200 billion in U.S. TIPS outstanding, representing some 10.5% of all U.S. Treasury long-term debt outstanding.

Assistant Trust Officer Hoerr explained how TIPS differ from conventional Treasury securities. A conventional Treasury provides a fixed nominal rate of return; it has a fixed nominal coupon rate, and at maturity, the par/face value is returned to the holder. A TIPS, however, provides a guaranteed real rate of return. Both the coupon interest payments and the principal repayment at maturity grow with inflation over the life of the bond.

Assistant Trust Officer Hoerr explained that TIPS are considered a distinct asset class principally due to the fact that they react quite differently to a major economic factor: inflation. Whereas unexpected increases in inflation cause stock and nominal bond prices to decline, the prices of TIPS will rise. Therefore, not only is the expected risk and return profile of TIPS unique, but the correlations of their returns to the returns of other asset classes are quite low.

Regent Connolly-Keesler asked whether Treasury Inflation Protection Securities are an alternative asset class. Mr. Hoerr noted that TIPS would be classified in the UW System endowment within the alternative asset class category or within an “inflation-hedging” category.

Mr. Hoerr noted that although investment management fees for a TIPS fund would likely be less than 0.25% of assets, it is doubtful that active management could be expected to add significant value. If the UW System were to make a fairly small allocation to TIPS (a 5% allocation would amount to only $15 million) it may be more effective to invest the money in-house or perhaps give this additional mandate to the Applied Securities Analysis Program (ASAP) at the UW-Madison Graduate School of Business. Regent Bradley remarked that this would be an additional educational opportunity for the ASAP program, and directed Mr. Hoerr to follow through with the ASAP program if TIPS are to be added to the asset allocation.

Mr. Hoerr noted that, since their 1997 inception date, TIPS real yields have ranged from over 4% to as low as 1.5%, and today are in the 2% range. If real yields on TIPS widen out to 4% or even 3% again, consideration should be given to increasing the Long Term Fund's allocation to them on an opportunistic basis.

Assistant Trust Officer Hoerr stated that timber is a real asset that consists of productive land of either natural forests or plantations. Institutional timberland investing has increased over the prior 10-15 years, and is a part of the endowment of many universities such as Harvard, Yale, and Stanford.

Mr. Hoerr indicated that, in theory, the primary source of return from timber investments should come from the actual biological growth of the trees during the holding period. Typical biological growth rates might range from 4% for hardwoods in the Eastern U.S. up to 10% for softwoods. Additional return can come from changes in timber or wood product prices, and changes in the value of the underlying land.

Assistant Trust Officer Hoerr commented on some potential sources of risk in investing in timber. Although risk of physical damage to trees is a significant concern, in fact, the overall physical risk to a diversified timber portfolio is minimal (less than one-half of one percent). The risk from physical loss in professionally managed properties is considered so low that insurance against such losses is normally never purchased. Regarding the market risk of changing prices for standing timber, it is important to note that prices have been volatile at times, although prices are offset by the constancy of biologic growth which smoothes investment returns. Liquidity risk, however, is a primary risk in direct timberland investing. Timberland properties are very illiquid. A seller forced in some way to sell a timber property quickly should therefore expect to make a significant price concession. Timberland needs to be viewed as a long-term investment and investors should rightfully expect to receive a liquidity premium for this tie-up of capital.

Assistant Trust Officer Hoerr noted that investment in timber is generally done through either public equities or private equities. The public equity route would entail investing in the equities of public companies in the business of timber and wood/paper products. The private equity route entails direct timberland investment via limited partnerships. Investors' committed capital is drawn down over a period of time, although this is usually a shorter period than with other private equity partnerships, such as venture capital funds. There is a long, contractual investment term or lockup, ten years is typical, with seven years of management and three years of liquidations. The fee structure involves both a management fee of 0.85% to 1.00% on called capital, and a profit share for the general partner of 10% to 20%, usually after limited partners have received a base preferred return.

Mr. Hoerr remarked that, given the likelihood that an allocation to timberland will improve the risk-adjusted returns of the Long Term Fund, tempered by the illiquidity concerns surrounding this asset class, the UW System anticipates that an allocation of up to 5% may be warranted.

Regent Bradley expressed concern that timber investments could be sold to companies that would harvest the timber in an environmentally unsound way. The Committee would need to be assured that companies apply due diligence to prevent this from occurring. Assistant Trust Officer Hoerr noted that GMO, one of UW System's current investment managers that also provides timber investing, could address the Committee and give details on the due diligence that they apply to investments in timber.

Regent Randall noted that tapping into the expertise of UW-Stevens Point should be considered when investing in timber. Mr. Hoerr responded that collaborating with UW-Stevens Point is a possibility.

f. Report of the Vice President

Vice President Durcan reported that there will be a meeting of Provosts and Chief Business Officers to develop guiding principles and review areas for further study in developing a systemwide administrative cost reduction plan. This topic is of immediate importance due to the $65 million in efficiency measures required in the Governor's budget.

Ms. Durcan noted that the College Savings Board is working on the transition from Strong Funds to Wells Fargo. An outreach subcommittee has been formed to look at ways to expand participation in the program by persons earning less than $40,000. Some of the ideas being considered include:

- Creating an endowment with the current contingency reserve;
- Targeting marketing efforts toward financial literacy, linking with pre-college programs, increasing awareness among school and agency professionals; and,
- Reviewing other states' programs for similar efforts.

Regent Randall suggested working with groups to communicate the Earned Income Tax credit, and the opportunity to set aside tax savings for their children's college education. Ms. Durcan remarked that the College Savings Board is looking into the possibility of an amendment to the state tax deduction to include a refundable income tax credit for low income individuals.

Vice President Durcan noted that Program Revenue Cash and Bonding will be discussed in the Physical Planning and Funding Committee. The UW System will be working with the Department of State Facilities to better align the types of projects that should be cash funded and those that should be bonded based upon the useful life of the project. The UW System does not expect that there will be a negative impact on the institutions or students.

Ms. Durcan reported on savings incurred in the purchase of the PeopleSoft Accounting Software Grants Module. The UW System negotiated reductions in maintenance contracts of $3 million over a 10 year period.

Vice President Durcan reported on the state's initiative to achieve savings by more targeted purchasing in selected areas. Regent Bradley asked what areas are targeted. Vice President Durcan responded that eight areas were identified for savings, including office and food supplies. Areas for possible savings will continue to be identified in the future.

Regent Randall commented that the UW System must be cognizant of small and minority businesses that have small margins when analyzing areas in the future. Vice President Durcan indicated that small and minority businesses are a big concern and will be kept in mind throughout the process.

Ms. Durcan remarked on a concern directed to Regent Gottschalk regarding beer commercials during radio broadcasts of university football games. The UW System has an advertising policy in place, and a committee reviews all advertisements. UW System staff will respond to the concern on Regent Gottschalk and the Business and Finance Committee's behalf.

g. Additional items which may be presented to the Committee with its approval

No additional items were presented to the Committee.

h. Closed session to consider trust fund matters as permitted by s.19.85(1)(e) *Wis. Stats.*

Upon the motion of Regent Pruitt, and the second of Regent Connolly-Keesler, the Business and Finance Committee adjourned to Closed Session at 3:21 p.m. Present were Regents Bradley, Connolly-Keesler, Pruitt, Randall and Rosenzweig.

The Business and Finance Committee adjourned at 3:40 p.m.

Eric Engbloom

Eric Engbloom, Recording Secretary