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(Excerpted from the Minutes of the Faculty Senate Report)

SenD#6256

MINUTES OF THE FORTY-SECOND SENATE
OF THE ACADEMIC COUNCIL
October 8, 2009

I. Other Reports

A. Report on Budget Issues

Chair Goldsmith invited the Provost to give an update on the budget.

With the aid of slides, the Provost began his presentation by listing the topics to be covered:

Endowment Performance
Other Revenue
General Funds Budget
Financial Aid
Lessons Learned

Endowment Performance

The Provost devoted most of his presentation to this topic. As of June 30, 2009, the investment returns on the endowment were minus 25.9%. Among the 20 largest university endowments, Stanford's had the third worst performance, Harvard's being the worst (minus 27.3%), then Cornell, then Stanford. The institution with the best one-year return was Penn, with minus 15.7%. This has led many people to question the model of investment adopted by Stanford, Harvard and other major endowments.

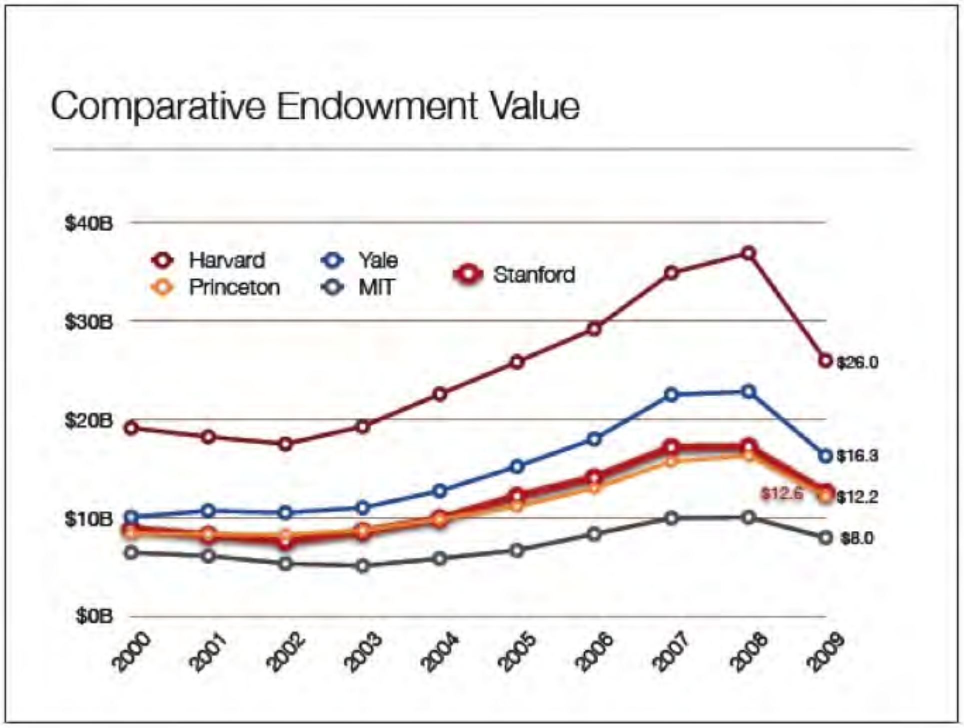
He asked the senators to focus on the bottom six endowments and the top six endowments for this past year, and went on to illustrate larger windows of performance. First, he presented a chart showing the endowment performance of the same 20 institutions over the past three years. The annualized returns for the three years were all very similar: between +2% and -2%. Stanford's and Harvard's were -1%, while Yale's was +0.3%.

Next, he displayed the performance of the institutions over the past 10 years. Yale led with 11.8% annual returns, followed by Duke (10.1%) and Princeton (9.7%); Harvard and Stanford (both 8.9%) were tied for 7^{th}.

The Provost noted, "[The strong 10-year returns] are a consequence of exactly the same investment strategy that did not play out well in this past year. The difference between bringing in 9% per year for ten years and bringing, say, Penn's ten-year annualized return of 4.2%, is a very, very big difference. And so it's not clear that we would want to change our investment model."

The Provost acknowledged, “David Swenson, who runs the Yale endowment is an acknowledged genius, and he does a wonderful job for Yale. I am very happy for them.”

[Laughter]



The Provost noted that Stanford still has the third largest endowment at $12.6 billion, essentially the same as Princeton’s. Harvard’s is $26 billion, down from $37 billion; Yale’s is $16.3 billion, down from $22 billion.

The next slide illustrated the endowment per student. Princeton ($1,631,000), Yale ($1,434,000), and Harvard ($1,286,000) figures were considerably higher than Stanford ($832,000) and MIT ($777,000). (Includes both undergraduate and graduate students.)

How did we move from $17.2 billion down to $12.6 billion? The Provost went into detail: “We lost $3.64 billion—investment loss. We took nearly one billion dollars of endowment payout…to pay for operating expenses. There’s not a person in this room whose salary was not partly paid for out of that money…Just in case people ever say, well, why don’t we spend down the endowment—we do spend down the endowment!”

Nearly $0.5 billion dollars was removed from the Tier 1 buffer, “…which are funds functioning as endowment, that we use to buffer something called the expendable funds pool.”

"Gifts to the endowment were about +$142 million and funds invested into the endowment were +$162 million. What [the latter means is that] schools may have expendable funds that they want to put into the endowment to create funds functioning as endowments. If you have, for example, a payout on a chair that has grown larger and larger and you haven't spent it and you decide you want to turn that into a second chair, you then invest it in the endowment and it becomes a fund functioning as endowment. $162 million of such expendable funds were put back into the endowment.

"If you take all the additions and subtractions, that's how we got down to the $12.6 billion.

"When will our endowment funds get back to the point where they are growing at roughly an inflationary rate? (This is not a question of how long will it take for us to get an endowment that is as large as it was last year. That's going to be a long time.)"

The next slide was a table estimating payout growth and payout rate over the next 3 fiscal years (FY) assuming a 10% annual investment return on endowment.

"If we have a 10% annual investment return for the next couple of years, we will not be there until probably about FY13 or FY14. We will have <u>minus</u> 10% payout growth (FY10), <u>minus</u> 15% (FY11) and reach 0% in FY12 at this rate. In order to get to a 3.5% increase in FY12, we would have to make almost 20% investment returns for the next two years on the endowment. And that's probably not in the cards.

"So it will probably not be until FY 13, that we will see some growth. It will be a couple of percent. In FY 14 we will be back to the point where the endowment payout is growing at the rate of inflation."

<u>Other Revenue</u>
The next slide was a graph of sponsored research over the past 11 years. Each column was divided into 3 segments, Federal, SLAC and Non-Federal funds. In the last three years, the total amount of sponsored research was:

2007: $1.049 billion ($132M in Non-Federal; $349M, SLAC and $568M, Federal).

2008: $1.049 billion ($150M in Non-Federal; $354M, SLAC and $544M, Federal).

2009: $1.030 billion ($218M in Non-Federal; $297M, SLAC and $515M, Federal).

The Provost noted that these are nominal dollars, so the total is a significant decline in inflation-adjusted terms.

“Nonfederal research grants went up from $150 million to $218 million in FY09, and that’s primarily the California Institute for Regenerative Medicine—stem cell dollars from the state of California. About $50 million [was] to help us build SIM I (Stanford Institutes of Medicine 1). And that is a one-time event.

“We had a significant drop in the SLAC funding, but again, this turns out to be something that is not particularly worrisome. This reflects the completion of construction of LCLS, the Linac Coherent Light Source. So it’s really not a worrisome drop. SLAC has already received — or will be receiving — $90 million of stimulus funding moving forward. So they will be in great shape for the next few years.

“But here is a very worrisome development. We have dropped 5.3% in federal sponsored research. We know that we’re doing quite well receiving Stimulus Package grants, and we expect that will give us a boost in FY10 and it will probably help in FY11, but it is hard to predict what the Federal Government will do in the future with research funding.”

The Provost explained that in the category of Development, we track two different numbers. One is called new activity and the other is called cash. Cash is actual cash being received from new gifts and pledge payments. New activity is a combination of new pledges plus new cash gifts that we just found out about — that is, cash that is not a payment on a previous pledge.

The next slide showed a chart of cash and new activity superimposed. There were two peaks in new activity—the CUE (Campaign for Undergraduate Education) Launch of $1.048B in 2000 and the TSC (The Stanford Challenge) Launch of $1.143B in 2006. “The peaks represent the time where our major, most generous, donors make pledges right at the very beginning in order to kick off the campaign.”

“It is expected that in the course of the campaign you see a decline in cash and new activity after you have your major donors making the initial, very large pledges. You then have to go out and talk to people who are not capable of giving $100 million but maybe are giving $25 or a thousand dollars and so forth. So the total amount, of course, tails off.”

In the last three years there has been a decline in both cash and new activity. “What we have had is a tail off here, and this [FY09] is a little bit more of a drop than we had originally hoped for before the decline in the economy. I think it’s actually quite a good performance given the economic circumstance. There’s only one other university that has ever received over $600 million in cash in a single year, and that’s Harvard (three times), and its best year was $650 million in 2008. From a development standpoint, we have raised more money consistently for several years, I don’t remember how many…”

President Hennessy interjected: “Five.”

Clinical Revenue
The next slide was a bar chart showing the steady growth in clinical revenue from Stanford and Lucile Packard Children's Hospital from $94 million in 1999 to $429 million in 2009.

"Clinical revenue is, in some sense, our most consistently growing revenue, and that flows mainly into the medical school. It does not flow into the university at large for the most part…The big unknown here is what is going to be the effect of the health care bill, assuming a health care bill is passed…Depending on how it's written, it could have a very significant effect, positive or negative, on medical schools and teaching hospitals."

General Funds Budget.
The next slide was as follows:

General Funds: The Problem to Be Solved
June 2008 General Funds budget forecast:

- 2009/10: $2.4M
- 2010/11: -$5.7M
- 2011/12: -$10.1M

December 2008 revised forecast, i.e., total problem to be solved:

- 2009/10: -$78.2M
- 2010/11: -$129M
- 2011/12: -$153.5M

The Provost commented, "We had a moving target last year, as time went on. When we start the process, in June of the preceding year, we come up with a forecast of what the year is going to look like and what the budget process will look like the following year. [The upper panel] was our June General Funds Budget forecast in June of '08.

"We thought that in FY10, we would have a $2.4 million surplus, and then a few small deficits we would have to handle as time goes on.

"In December after the economic downturn hit — our revised forecast [lower panel] was that in FY10, we would have a deficit of $78 million, growing in FY12, to a deficit of $153 million...In recent memory, this is the worst deficit that we have ever faced.

Solving the problem.

"We decided to try to solve the problem to the extent possible in a single year—to make the decisions last year that would carry us through the foreseeable future with a roughly balanced budget."

The next slide illustrated the deficit that existed in the General Funds Budget and the actions taken to reduce it for the next three fiscal years: FY 2009, FY 2010 and FY

2011. The actions were divided into two categories, central (administration) and unit (school) actions.

“Last year, we took $40 million in central budget cuts and general funds reductions in the units of about $80 million, for a total of about $120 million; which was intentional—we were overshooting the deficit. That should give us, this year, a general funds *surplus* of about $40 million. That is one-time money we will use to help units bridge [their gaps], as they reduce their base budgets.

“In FY11, we project a balanced budget. [A $129.8M deficit will be offset by $44.8M in central and $85.0M in unit general funds reductions.]

“In FY12 we project about a… $15 million budget deficit, but the projections out that far are not accurate enough for us to be worried about that relatively small deficit...Knowing about it in advance, this will be fairly easy to adjust to and we will end up going into that year, I think, with a balanced budget.”

The Provost then described the central actions that were taken to reduce the deficit.

- Reduced reserves for facilities, housing and operations
- Froze salaries
- Delayed or suspended capital projects
- Initiated a campus health service fee
- Incremental tuition

The delay or suspension of capital projects saves money directly and indirectly in the form of anticipated operations and maintenance costs for the buildings that will not have to be spent and interest payments on debt not incurred.

Incremental tuition was the consequence of slightly more students in certain law school programs. Also, the number of undergraduates admitted was reduced by 50, rather than a planned reduction of 100.

The provost then turned to the staff layoffs and faculty positions. “…The hardest part, by far, was the [staff] layoffs. By the end of this year, we will have laid off 470 staff members. That was very hard for all of the units—but necessary. We also froze about 50 faculty positions.”

Without going into detail, the Provost stated that there were many other actions, such as program reductions, staff reorganizations, salary reductions and funding shifts that contributed to the budget reductions.

<u>Budget outlook.</u>
For FY 2010, staff reductions will occur only through attrition. Faculty retirements are predicted to double. And there will be some hiring in every school, though at a reduced level.

Beyond 2010, normal faculty hiring should be restored by 2011 or 2012.

Financial Aid

The Provost acknowledged that, "Financial aid is, to be blunt, in a difficult situation. Last year we introduced generous new enhancements to the financial aid program…We knew we did not have all of the endowment to cover the anticipated increased cost in our undergraduate financial aid budget. Our projections showed…a $20 million shortfall not covered by the endowment. But we knew we could cover that shortfall temporarily using The Stanford Fund [annual gifts from undergraduate alumni] and the President's funds while we raised additional financial aid endowment.

"But then we were hit by the dual impact of the drop in the endowment and our students' families being hit by the bad economy. Many have lost their jobs or have reduced income, and many more students are applying for financial aid than had before. The combination of these two turned a $20 million shortfall into to a $40+ million dollar shortfall.

"We decided last year to maintain the program [and] to cover this shortfall with one-time funding—and then figure out what to do longer term…But we did not cut other programs in order to finance the financial aid shortfall. We are funding this out of one-time sources of funds—President's funds and The Stanford Fund.

"Our long-term plan is to increase the fundraising goal of the Stanford Challenge for financial aid to $300 million, which would give us an annual payout of $15 million. That's a very large goal. Obviously, we will raise more if we can, but that in itself is a very ambitious target. [In addition, we will] continue partially funding it through The Stanford Fund ($10-$15M), and over time, move some financial aid back into the General Funds budget ($10-$15M). Assuming successful fundraising and an improved economy, this should close the gap."

Lessons Learned

Budget Lessons.

The Provost said the first lesson was that, "In good times, we have got to figure out how to be more disciplined in adding staff. The staff growth has been really remarkable…That's mainly in units that have significant non-general funds revenue. One question I have is: Do we need a billeting system for staff like we have for faculty?"

Second, "In very bad times, acting quickly is better than smoothing. So we did that right and I think we are in good shape because of that."

Expendable Funds Buffering Policy Lessons.

Third, "Our buffering policy worked well for normal investment fluctuations. With extreme investment losses, this policy left the General Funds budget exposed to large and immediate drops. Therefore this policy needed revision—and we have done that. Randy Livingston [Vice President for Business Affairs] redesigned the policy, and came up with a great new system. The bottom line is that more buffering risk is taken on by sources of one-time funding, funds for capital projects and so forth, while providing more protection for the base budget."

Endowment Lessons.
Since John Powers of the Stanford Management Company is scheduled to speak about the endowment in an upcoming Senate meeting, the Provost deferred that discussion to him.

That ended the Provost's presentation. Chair Goldsmith opened the floor for questions.

Professor Gordon Brown asked, "What assumptions have you made about the continuing growth of the stock market and, therefore, the endowment fund?"

The Provost replied, "We are making relatively conservative assumptions. We are assuming that the endowment can initially earn about 8%. The long-term assumption is generally between 9 ½ and 10%. Remember, if you have a payout of 5½%, with inflation of 3½%, you have to make at least 9% in order to keep up with inflation."

Professor Kenneth Taylor: "You said retirement has picked up…Is the [net number of] faculty decreasing or increasing? And are billets being reallocated? Or are the hirings happening where the retirements are happening?"

The Provost replied, "…The faculty retirement incentive program has generated about 70 retirements university-wide. There will be a net reduction until those people are replaced. But we're not replacing at that rate right now…the schools continue to have open billets and their deans are out looking for endowed chairs to allow them to fill those [slots]. So there will be a short-term decrease in faculty. But there will be no shifting of billets between schools."

At this point the Chair Goldsmith ended the question period.

[Applause]

Chair Goldsmith commented, "We will have more time for in-depth discussion on this topic at the executive session. I want to thank the President and the Provost for being very open with the Senate about this whole process…Talking to colleagues at peer institutions, it is truly remarkable where we stand today given where we were a year ago. Many other universities are looking at extended cuts over many years, and we're in recovery mode after one year. I think that's a remarkable achievement by the President and Provost and all the people behind them."

"So thank you from the Faculty Senate."