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**MINUTES OF THE FORTY-SECOND SENATE
OF THE ACADEMIC COUNCIL
May 27, 2010**

B. Provost's Budget Report (SenD#6341)

Chair Goldsmith referred Senate members to documents at their desks, noted that several guests were in attendance, and turned the floor over to the Provost to present the 2010/11 Stanford University Budget Plan. Provost Etchemendy began his PowerPoint presentation by expressing gratitude to the members of the University Budget Group and the Capital Planning Team for their commitment of time and their hard work.

“So let me start with some history. Back in 2003, in the midst of the dot-com implosion, I quoted that well-known piece of literature, ‘The Hitchhiker’s Guide to the Galaxy,’ and I enjoined the senators, ‘Don’t panic.’ In 2008 when things were very, very different, and Stanford seemed like it was the land of milk and honey, I, with uncharacteristic prescience, said, “Don’t get complacent.” And then last year, the piece of advice I gave you was, “Don’t be despondent.” So thinking about what lesson I wanted you to go away with this year, one injunction kept coming to mind. The budget situation this year is much, much better than it was last year. But as my mother always told me, ‘Don’t count your chickens [before they’re hatched].’ So I caution you that things can change at any moment, as we discovered in 2008.”

Etchemendy explained that he would first provide some context; then talk about the consolidated budget for the entire university (excluding only the hospital and construction expenditures); then about the general funds budget, which is the unrestricted funds portion of the consolidated budget about which central decisions are made; then about the capital budget; and finally discuss some lessons learned.

“In 2008/2009, as you know, we experienced the largest endowment drop in 50 years, very likely since the Depression. Ironically, in that same year, investment income had for the first time in the post-war period surpassed sponsored research as the largest single revenue source. However due to the investment decline, we anticipated a loss in endowment payout in excess of \$200 million. In preparing the budget for FY2010, we made several major decisions: to suspend the endowment ‘smoothing rule’ and reduce endowment payout by 25% in two years; not to cut our undergraduate financial aid program; to freeze salaries for 2009/10, as you all are painfully aware; to delay or cancel \$1.2 billion in capital projects; to lay off, as it turned out university-wide, 500 staff (by far, the hardest thing to do) and to freeze 50 faculty positions; and finally, we managed to close an anticipated \$130 million general funds deficit through a variety of cuts, savings, and revenue enhancements.”

Presenting an overview for 2011, the Provost stated that “the consolidated budget looks much better. We have a surplus of about \$85 million on \$3.8 billion in revenues. We have been able to include a

modest salary program for faculty and staff. And we see a continued increase in research funding due to the American Recovery and Reinvestment Act, the stimulus program. For the general funds budget we are projecting a \$26 million surplus on \$802 million in non-formula general funds, which includes \$20 million in endowment mitigation for the schools. My highest priority for the past two years has been to use general funds to help the schools whose endowments have dropped, since endowments are what pay many of the faculty salaries and most of the graduate aid for example. So that's a total of \$40 million (\$20 million for two years) flowing out to schools to help with the endowment drop. We've managed to allocate \$10 million in incremental funds for financial aid out of the general funds budget and another \$15 million in selected program support. Nonetheless, we still project a \$26 million surplus. So that looks very good."

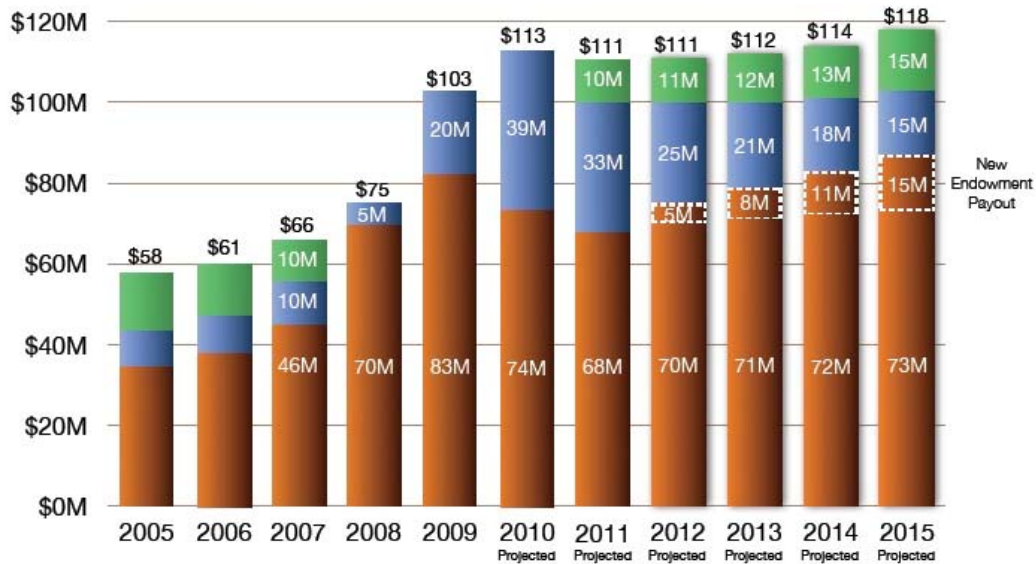
Etchemendy explained that the *capital plan* is a three-year window of projects that will be in some stage of planning or construction during that period, whereas the *capital budget* is what will be spent in 2010-11 on construction projects. He said that "the capital plan totals \$1.5 billion, down from \$1.8 billion in 2009-10, and almost \$3 billion the prior year. The drop from \$3 billion to \$1.8 billion was because we cancelled and delayed a lot of projects. The drop this year is because we're finishing projects, also causing the capital budget to decline from about \$650 million to \$368 million. We have reactivated some projects, very notably, the Bing Concert Hall, on which we broke ground a couple of weeks ago, and the Madera Grove Childcare Center, as I announced earlier this year."

The Provost then discussed the consolidated budget in more detail, starting with a table that showed two past years of revenues and expenses along with the 2010-11 budget plan, and both one-year and two-year percent changes. "Total revenues we project to be \$3.8 billion, total expenditures \$3.7 billion, and a surplus of \$84 million after \$107 million in transfers. You should be asking yourselves, well, where was the crisis? Even over the two years, revenues are up 2.6%, which doesn't keep up with inflation, but it certainly doesn't explain the turmoil that we went through. So what gives? What's happening here? As a first cut, the various revenue streams have different control points. And if you roughly divide them by the control point, then you find that the revenue streams controlled more centrally by the provost and the deans (which pay for most salaries and most of the operation of the university, other than the research enterprise), those revenues are down almost 5% over the course of the two years. On the other hand, revenues controlled by departments, faculty, or other separate units of the university are up by 12%, for example research direct costs are up very sharply. So the problem has been not in the overall revenue picture, but in the revenue that runs the university centrally." Noting that total undergraduate financial aid is budgeted at \$136 million, roughly half of what we will bring in from undergraduate tuition, and that total graduate support is \$285 million, which is actually more than we bring in for graduate tuition, the Provost joked, to laughter, that "the lesson you should take away from this is that we ought to get out of the student business."

Using a graph of ten years of undergraduate need-based financial aid costs, Etchemendy showed the effect in 2009 of the university's substantially more generous aid program, the cost of which jumped up in 2010 due to the economy and so many more students needing aid, but is expected to moderate in 2011. However, as the endowment payout for financial aid declines, there is a projected 2011 gap of \$43 million, \$33 million of which will be covered by President's funds, and \$10 million from the general funds budget. To solve this problem for the longer term, the financial aid goal in the Stanford Challenge campaign has been increased to \$300 million which by 2015 should bring in \$15 million in additional endowment payout to support financial aid. In addition, the general funds allocation will be

increased by about \$1 million a year and it is hoped that the Stanford Fund should be able to cover the remaining \$15 million. “So that is our plan going forward, and I think it’s a good plan. As long as we can raise the additional campaign money for financial aid, it is comfortably do-able by the university.”

Undergraduate Need-Based Aid



Does not include athletic scholarships or outside sources

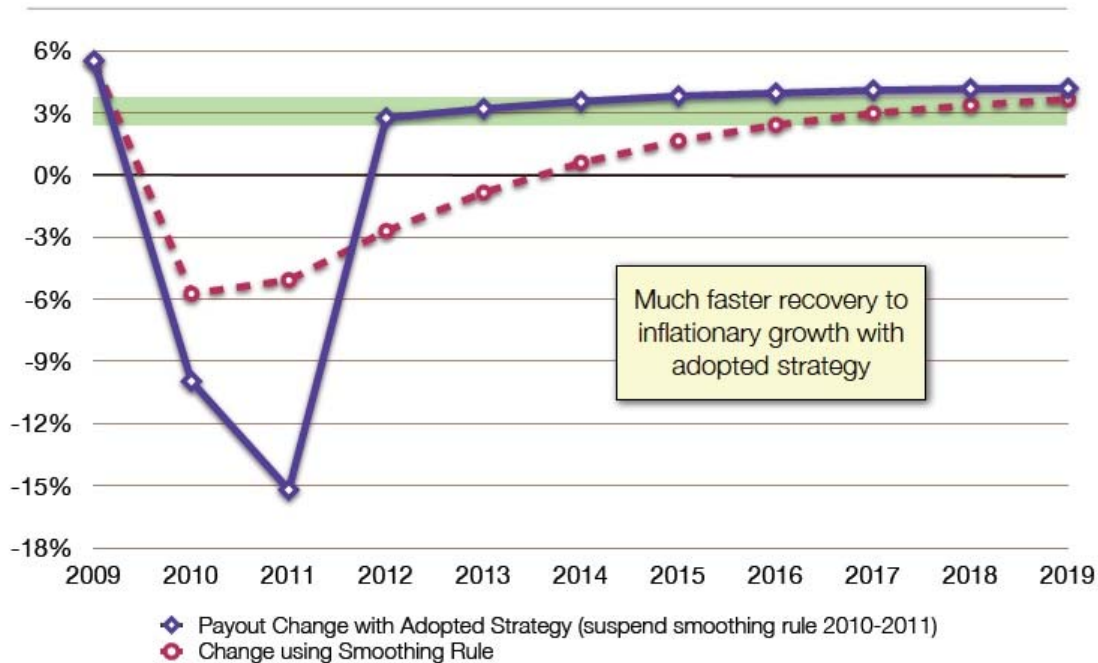
Legend: Red – Endowment Payout; Blue – President’s Funds (including The Stanford Fund);
Green – General Funds

The Provost then turned to sponsored research revenue, which has increased 15% over the two years, due to the stimulus funding. Showing graphs of total research funding (excluding SLAC) since 2001, he noted rapid growth through 2005 largely due to the doubling of the NIH budget, while non-NIH research funding did not grow much if at all.

Research funding then remained pretty flat until 2010 and 2011 when we’re seeing a large increase due to stimulus funding. Taking the stimulus funding out, research funding remains basically flat since 2005 in nominal dollars. “Adjusted for inflation, research funding has actually gone down significantly,” he said. “And what the future holds is anybody’s guess. But my guess is, the country is probably not going to be able to afford significant increases in research funding. I hope that’s wrong, but it’s a big worry going forward.”

After noting projected increases in revenues from health care services and expendable gifts, the Provost spoke at some length about investment income. “This should puzzle you,” he said, proceeding to explain why investment income is projected to grow 0.7% overall next year, with endowment income declining only 11% rather than 15% and other investment income up 209%. “I want to invest my money there!” he joked.

Year-Over-Year Change in Endowment Payout Adopted Strategy vs. Smoothing Rule



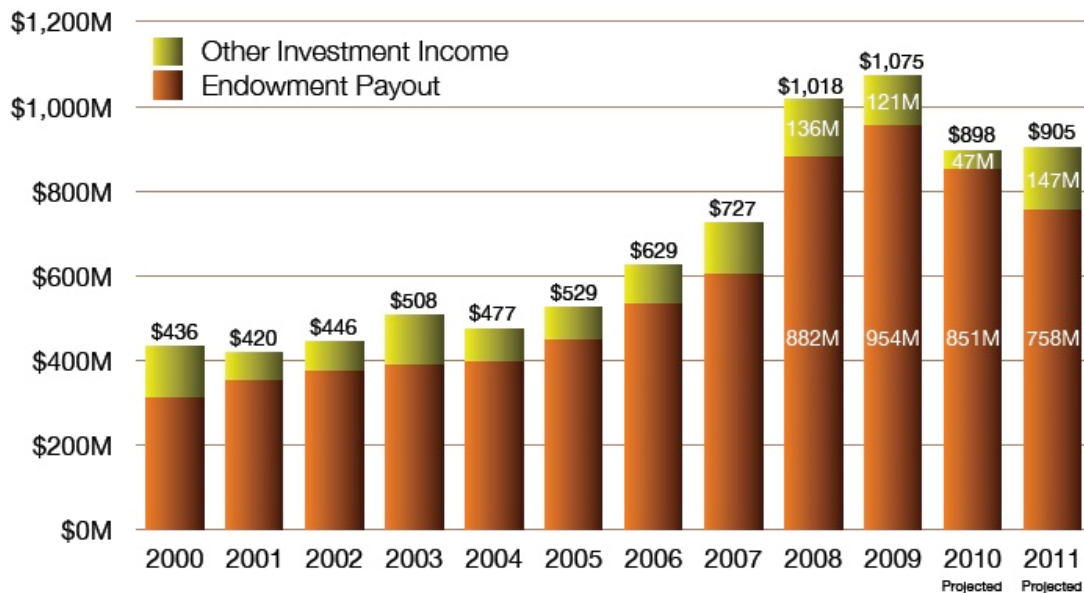
The Provost first reviewed the decision to bring down the payout faster than the smoothing rule would have dictated. “We brought down the payout this year 10%, and next year it will be coming down 15%. Our current projections – these are actually much better projections than we had last year – are that the payout on an individual endowment fund will go up by an inflationary amount, close to 3%, in 2012, and continue at that level if investments perform as they have historically. Now, compare that with what would have happened if we had used the smoothing rule. We have ended up with a much faster return to inflationary growth. If we had used the smoothing rule, we would not have returned to inflationary growth until about 2016 or 2017.”

Moving to the endowment income projection, he explained that the endowment also includes endowed lands, income from which has remained roughly the same. There will also be some payout on new endowment gifts, including a significant recovery in the Tier 1 Buffer which is funds functioning as endowment. This all nets out to a 10.9% decline even though payout on existing endowment will decline 15%.

The Other Investment Income is almost entirely investment returns on the expendable funds pool, the provost said. “The expendable funds pool (EFP) is all of the expendable money that is not being spent, but is sitting around the university in various accounts. That pool of funds is currently at about \$2 billion and it produces income from investment that then flows into the budget, and a very large portion of it flows into the general funds budget. By policy, the EFP payout is determined by the returns in the previous year, with a maximum payout of 5.5%, so this year the payout was zero. But in 2011 we anticipate a return of 7.5% and will pay out 5.5%. So the 200% increase in Other Investment

Income is from the EFP. And that's what really counters the drop in endowment income." Showing a decade of investment income, Etchemendy said the current projections are significantly better than those of a year earlier.

Total Investment Income



Moving on to the expense side of the budget, the provost spoke first about salaries and benefits. "This line should also puzzle you," he said. "We laid off 500 staff. We froze 50 faculty billets. So why do we have a 4.7% increase year over year and an 8.7% increase for two years in salaries and benefits? Well, the 4.7% is largely because we have a salary program going into this coming year. But why haven't projected costs gone down?" Using several graphs, he showed a one-year decrease in total staff headcount of about 200 (though not 500) and a straight-line projection indicating that by 2011 staff would probably have increased by about 800 if we had not had budget difficulties. Salaries funded by general funds stayed roughly flat, but there was 13% growth over two years in salaries funded by clinical revenue and by grants and contracts. Adjusting for salary inflation approximates the two-year change in head count, which grows more than 8% on the clinical and grants side, but drops 5% on the general funds side, he said.

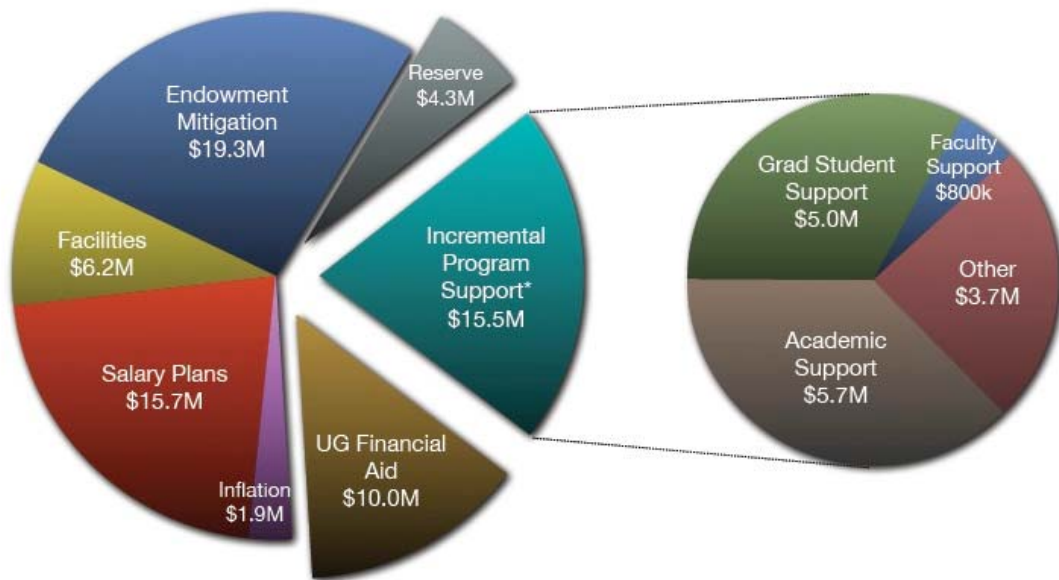
Pointing out that the consolidated budget is made up of 75% academic units and 25% administrative and auxiliaries, Etchemendy spoke next about the general funds budget.

He reminded Senate members that in 2009 he had forecast a \$40 million surplus this year in general funds, a balanced budget in 2011, and a \$15 million deficit in 2012, but, he advised, things had improved considerably since then, with increases in endowment market performance and decreases in utilities and O & M expenses, among other factors. This allowed an additional \$10 million allocation for financial aid, \$15 million for program allocations, and \$4 million to bring the university reserve back to its prior level of \$20 million. "This still leaves a \$26 million surplus. And we're projecting a

\$21 million surplus rather than a \$15 million deficit in 2012. So that's a good position to be in going into the next budget year."

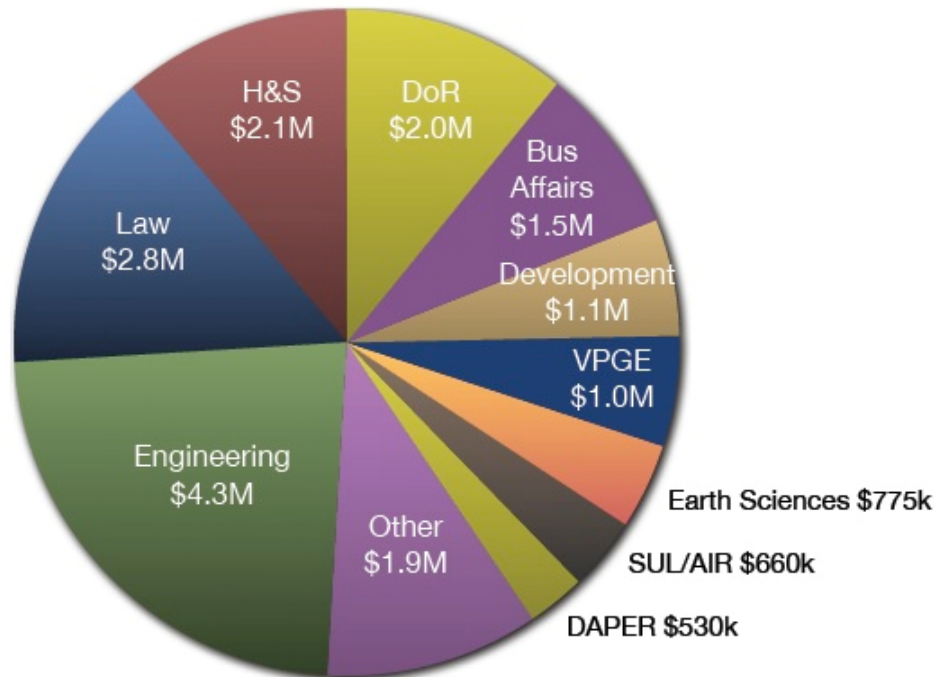
Straining against the clock, and a vigilant Senate chair, the Provost quickly showed pie charts of general funds additions and incremental program allocations by unit, noting that most incremental program support is largely additional endowment mitigation going to the schools.

General Funds Additions



* Includes additional endowment mitigation.

Incremental Program Allocations by Unit



Other is Admissions, Alumni, Central, Education, General Counsel, LBRE, VPSA & VPUE

Giving a brief two-year perspective on the general funds budget, he explained that most of what looks like an increase in general funds support of academic units is really compensating for the endowment payout declines in the schools. After factoring in endowment payout decline and adjusting for Bay Area inflation, “there’s been about a 10% decline in the schools, and about 12% in the administrative units. That is the problem we’ve been dealing with,” Etchemendy stated.

Skipping the Capital Plan, the Provost concluded by commenting on “lessons learned.”

Lesson 1: In good times, we need more discipline adding staff. “If you look at the growth in head count at the university, you’ll see that growth in faculty and in students has been very slow and relatively controlled over the last ten years (except in the School of Medicine clinical faculty). And in units funded through general funds, most staff growth has been relatively slow, because it’s limited by available funds. But staff growth out in the units with significant non-general funds revenue has been very fast and uncontrolled. We don’t billet or in any way restrict the hiring of staff. So one question is do we need a billeting system for staff, to control that more. I don’t know how that would work. And I suspect the answer is, no. But we really have to, as an institution, learn to be more cautious – when times are good, be more cautious in hiring additional staff, because those are the people you’re going to have to lay off when the budget gets tight.”

Lesson 2: In very bad times moving quickly is better than ‘smoothing.’ “Moving slowly would not have worked as well, for the reason that I already described, but also because moving quickly yields more strategic and thoughtful budget reductions.

Lesson 3: The expendable funds buffering policy needed to be changed.

Though the prior policy worked well for normal investment fluctuations (including the 2001-02 downturn), we found that with extreme investment losses, the policy left the general funds budget exposed to large and immediate drops, more than \$40 million in FY2010. The Provost credited CFO Randy Livingston with devising a much better policy. The new policy puts more buffering risk on sources of one-time funding, providing more protection for the base budget.

Lesson 4: In addition to the risk profile of our investment portfolio, more attention needs to be given to the liquidity of the portfolio.

“If you look at our investment returns compared to every major index, what you’ll see is that the only way to do better last year would have been to have the entire endowment in treasuries. The only way to do better for the three-year period would also have been to have the entire endowment in treasuries. But if you look at our five-, ten-, and 30-year results, you should be glad. The investment policy that we have is actually a very, very good policy and it stands the test of time,” Etchemendy concluded.

Goldsmith opened the floor for questions. Dean Pamela Matson asked “Are you worried about a double dip, having this happen again next year?” He replied, “We are still relying very heavily on endowment. So we are vulnerable. However, if there is a double-dip, the new policy is going to protect general funds much more than the old policy, so we should be in better shape. And I’d rather be going into a double-dip with a \$26 million projected surplus than with a deficit.”

Responding to a question about our peer institutions, Etchemendy said, “They will all weather the storm. They are a year or two behind us, so they’re all doing cuts for next year, and several of them will have to be doing cuts again the following year. They’re in cutting mode, where we no longer are. But they will all weather the storm.” Goldsmith commented that the graph showing the impact of the change to the smoothing formula is the strongest statement about the excellent leadership of the administration, since we are already in recovery mode after just a year.

Provost Etchemendy added that though he believes our peer private institutions will all weather the recent financial storm, he is very concerned about the U.C. system and whether they will weather the slightly different storm of decreased state funding. “This state and this institution, Stanford, will be a weaker place if Berkeley, UCSF, and UCLA are weaker. So we have to hope that they will manage to weather their storm as well.”

The Chair thanked the Provost for his report and the Senate applauded enthusiastically.