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We have completed an audit of investment policies and procedures at the University and Community College System of Nevada. This report represents one component of the audit required by Chapter 442, Statutes of Nevada, 2003 (A.B. 148). The purpose of legislative audits is to improve state government by providing the Legislature, state officials, and Nevada citizens with independent and reliable information about the operations of state agencies, programs, activities, and functions. The results of our audit, including findings, conclusions, recommendations, and the University and Community College System of Nevada's response, are presented in this report.

We wish to express our appreciation to the management and staff of the University and Community College System of Nevada for their assistance during this audit.

Respectfully presented,

Paul V. Townsend, CPA
Legislative Auditor

September 3, 2004
Carson City, Nevada

STATE OF NEVADA
UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF NEVADA
ANALYSIS OF INVESTMENT POLICIES AND PROCEDURES

AUDIT REPORT

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EXECUTIVE SUMMARY

UNIVERSITY AND COMMUNITY COLLEGE SYSTEM OF NEVADA
ANALYSIS OF INVESTMENT POLICIES AND PROCEDURES

Background

The Board of Regents is responsible for executive and administrative control of the University and Community College System of Nevada (UCCSN). To facilitate its management of the system, the Board has delegated various responsibilities to its standing and special committees, including one established to oversee UCCSN's investment program.

The Board of Regents' Investment Committee is charged with the responsibility to formulate and recommend to the Board appropriate investment policies, review and evaluate reports from external investment managers, and make appropriate recommendations regarding investment transactions. The Banking and Investments section of UCCSN's System Administration is responsible for cash and investment management, and the distribution of endowment and operating pool assets among UCCSN's institutions and System Administration. All investments are handled by external investment managers.

Purpose

The purpose of this audit was to assess the adequacy of policies and procedures over the generation and distribution of investment income. The audit included policies and procedures and corresponding investment activities for the fiscal year ended June 30, 2003, and activities for the fiscal year ended June 30, 2002, for certain audit issues.

Results in Brief

The Board of Regents has developed policies and procedures to provide guidance to staff and other parties involved in the generation and distribution of investment income. However, several areas of the Board's policies could be improved to provide better guidance on investment processes from pre-investment analysis to distribution of income. Specifically, policies should be complete, clear, and up to date. In addition, stronger policies and procedures are needed to correct internal control weaknesses in areas such as segregation of duties.

These issues are important, given the size of investment portfolios for the endowment and operating pools, and their importance as a source of income for UCCSN. According to UCCSN's investment advisor, as of June 30, 2003, the endowment pool was valued at almost $200 million, with the operating pool valued at over $210 million. During fiscal year 2003, the institutions and System Administration received distributions totaling $10 million from the endowment pool and $7 million from the operating pool.

Principal Findings

- The pre-investment analysis that underlies decisions on portfolio diversification, asset allocation, and portfolio rebalancing is not adequately addressed in UCCSN policy. Investment policies should include additional guidance in several areas, including cash forecasting, the investment time horizon, and risk tolerance. (page 12)

- The Board's policies, as written in its *Handbook,* do not provide any guidance on portfolio rebalancing for either the endowment or the operating pool. In addition, the policies do not address portfolio diversification for the operating pool. Not periodically rebalancing the portfolio may create an imbalance between levels of risk and return. The investment portfolio may assume greater risks than necessary or experience lower investment returns than needed to meet spending requirements. (page 14)

- Two specific investment issues were not addressed in the Board's policies. Those issues involved the control of investment costs and the legal jurisdiction of UCCSN's investments. Guidance is needed on these issues to help ensure UCCSN receives investment services at reasonable costs and its investments are adequately safeguarded. (page 17)

- The Board's policies do not clearly describe the practice for distributing assets from the operating pool. UCCSN distributes a percentage of the operating pool's assets to the institutions monthly. The percentage is established by the Investment Committee, in compliance with the Board's policy. However, the Board's policy also states that investment income is to be distributed, rather than a percentage of the operating pool's assets. Confusion could result if investment income does not equal the percentage of assets to be distributed, making it difficult for UCCSN staff to comply with both policy statements. (page 18)

- Oversight of the contracting process for the investments function needs to be improved. First, the Chancellor's signature was found on only one of five contracts requiring the Chancellor's signature. The Banking and Investments staff signed the contracts without having the authority to do so. In addition, the contract with UCCSN's investment advisor had not been revised or put out for bid since 1984. In April 2004, the Investment Committee discussed issuing a request for proposals for an investment consultant. (page 19)

- Allocation of the endowment's assets as of June 30, 2003, was not in compliance with the Board of Regents' policies. First, actual allocations to two asset classes differed significantly from their strategic targets. If there is a significant difference between the strategic target and the actual allocation, the asset allocation strategy may not work as intended. In addition, investment risks could be greater than expected, while returns could be lower. Second, one asset class exceeded the Board's permitted range. Permitted ranges represent upper and lower limits for asset classes and subclasses. By exceeding the permitted range, UCCSN may be increasing the risk in its portfolios beyond what was agreed to by the Board of Regents. (page 20)

- Segregation of duties over some investment transactions needs to be improved. The signature of just one staff person is needed to execute investment transactions such as establishing a contractual relationship with an investment manager or transferring the control of assets to a new investment manager. Individual investment transactions executed by the Banking and Investments staff can exceed $10 million. Allowing transactions of this size to be executed and approved by one person increases risk. (page 22)

Recommendations

This report contains six recommendations to UCCSN to improve its policies and procedures over the generation and distribution of investment income, and its compliance with existing policies and procedures. Specifically, UCCSN should conduct periodic comprehensive reviews of investment and income distribution policies. In addition, UCCSN should comply with existing procedures for contracting and allocating assets. Finally, policies and procedures should be strengthened to include adequate segregation of duties, and portfolio rebalancing. (page 35)

Agency Response

This agency, in its response to our report, accepted all six recommendations. (page 33)

Introduction

Background

The Board of Regents is responsible for executive and administrative control of the University and Community College System of Nevada (UCCSN). To facilitate its management of the system, the Board has delegated various responsibilities to its standing and special committees, including one established to oversee UCCSN's investment program.

The Board of Regents' Investment Committee is charged with the responsibility to formulate and recommend to the Board appropriate investment policies, review and evaluate reports from external investment managers, and make appropriate recommendations regarding investment transactions. While the Investment Committee provides guidance and oversight, Banking and Investments, a section of UCCSN's System Administration, performs the daily activities.

Banking and Investments Function

The Banking and Investments section is responsible for cash and investment management, and the distribution of endowment and operating pool assets among UCCSN's institutions and System Administration. It also determines the system's daily funding needs to maximize the amount available for investment. All investments are handled by external investment managers selected by the Investment Committee. An independent investment advisor provides additional guidance to the members of the Committee and UCCSN staff.

Others Involved in the Investment Process

In addition to UCCSN staff and the Board of Regent's Investment Committee, several other parties are involved in the investment process, including: the investment advisor, external investment managers, the provider of custodial services for investment securities, and the banking services provider.

Investment Advisor

The investment advisor provides advice on the selection of investment options and investment managers, and also assists in monitoring their performance. The investment advisor does not directly manage any investment assets for UCCSN. In theory, this enables the investment advisor to provide independent advice to UCCSN.

External Investment Managers

External investment managers typically represent specific investment disciplines and offer a variety of choices to UCCSN. Investment managers could focus on fixed income investments, domestic or international equity investments, investment securities, or limited partnerships.

Custodial Bank

The Board of Regents requires that all of its investments be held in the custody of one or more custodial banks. The custodial bank is responsible for the safekeeping of the physical documents that represent the various types of investment securities. When investment securities are held by a custodial bank, the external investment managers do not physically possess the investment securities. Instead, they provide instructions to the custodial bank on investing the portion of the portfolio they manage. The custodial bank then executes the order to buy or sell.

Banking Services Provider

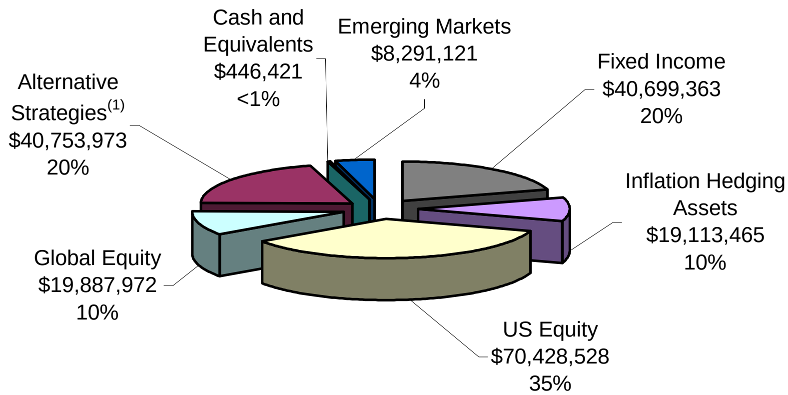
UCCSN has contracted with a bank for banking services. These services include the use of a zero balance account structure, and the use of wire transfers. UCCSN is also able to monitor its account balances using the bank's Internet website.

UCCSN's Investment Portfolios

UCCSN's investments are segregated into two distinct funds: the endowment pool and the operating pool. The endowment is a pool of assets created as the result of bequests or gifts. The operating pool represents UCCSN's cash and investments other than those in the endowment. According to UCCSN's investment advisor, the endowment was valued at $199,620,843 as of June 30, 2003. The value of the endowment has increased significantly since 1986, when its value was less than $40 million. Exhibit 1 shows the allocation of these assets to different types of investments.

Exhibit 1

Allocation of Endowment Assets
As of June 30, 2003

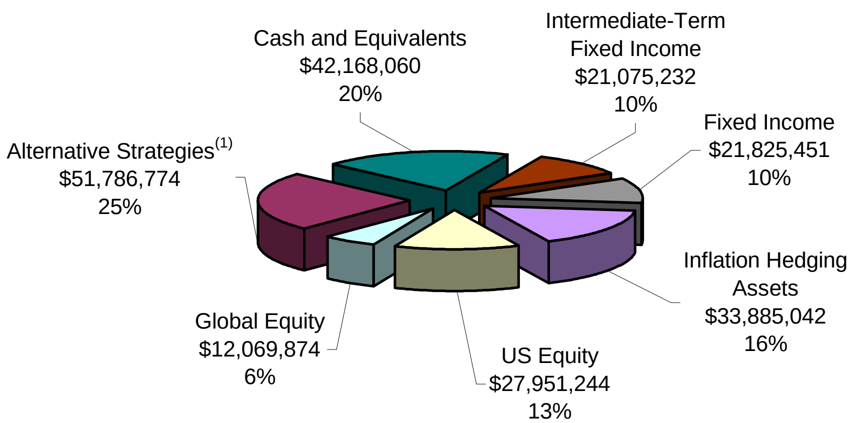


(1) Includes private equity and absolute return assets. Market value of private equity is as of March 31, 2003; portion of absolute return market value is preliminary.
Source: Investment performance report prepared by investment advisor for UCCSN.

According to UCCSN's investment advisor, the operating pool was valued at $210,761,677 as of June 30, 2003, an increase of over 300 percent since 1985, when its value was less than $50 million. Exhibit 2 shows the allocation of operating pool assets to different types of investments.

Exhibit 2

Allocation of Operating Pool Assets
As of June 30, 2003



(1) Includes absolute return assets. Portion of absolute return market value is preliminary.
Source: Investment performance report prepared by investment advisor for UCCSN.

Distribution of Assets

A portion of both the endowment and operating pools is distributed to UCCSN's institutions and System Administration. The endowment's assets are distributed on a quarterly basis, while the operating pool's assets are distributed on a monthly basis.

Distribution of the Endowment Pool's Assets

The Board of Regents has established a requirement that 4.5% of the endowment's average market value be distributed annually. This rate is then applied against each institution's portion of the endowment. Approximately $10 million in endowment assets was distributed to the institutions and System Administration in fiscal year 2003, which includes approximately $4 million from the estate tax portion of the endowment.

The federal estate tax is being phased out, gradually eliminating this source of revenue for state government. UCCSN'S share of the estate tax is deposited in a special account in UCCSN's permanent endowment fund. UCCSN reported estate tax receipts of $18.6 million in fiscal year 2003, and a balance of $70 million in its estate tax endowment account as of the end of that fiscal year.

Distribution of the Operating Pool's Assets

The Board of Regents has guaranteed UCCSN's institutions an annual distribution of 3.5% of the operating pool portfolio's average daily cash balance. A portion of this distribution is made each month, regardless of the actual amount of investment income earned. Monthly distributions are based on each institution's average daily cash balance in UCCSN's bank account for that particular month.

During fiscal year 2003, the institutions received 72.5% of the distribution, and 27.5% was divided between Board Administration, System Administration, and contingency accounts. In fiscal year 2003, $7 million was distributed in this manner.

In June 2003, the Board of Regents changed the allocation, eliminating System and Board Administration from the distribution. The Board replaced its share of the allocation with a quarterly assessment against all institutions. These assessments were expected to generate about $2.4 million in fiscal year 2004.

UCCSN has been spending the principal of its operating pool assets in recent years due to a decline in investment income. Since the 3.5% is guaranteed, when operating pool investment income falls below 3.5%, operating pool principal must be used to meet the guaranteed amount. UCCSN is tracking the amount of operating pool principal used to fulfill the guarantee. According to UCCSN, this amount reached a high of $19.6 million in October 2002, but declined to approximately $6 million as of June 2003.

Scope and Objective

This audit was required by Chapter 442, Statutes of Nevada, 2003 (A.B. 148) and was conducted pursuant to the provisions of NRS 218.737 to 218.893. The Legislative Auditor conducts audits as part of the Legislature's oversight responsibility for public programs. The purpose of legislative audits is to improve state government by providing the Legislature, state officials, and Nevada citizens with independent and reliable information about the operations of state agencies, programs, activities, and functions.

This audit included policies and procedures related to the generation and distribution of investment income, and corresponding investment activities for the fiscal year ended June 30, 2003, and activities for the fiscal year ended June 30, 2002, for certain audit issues. The objective of this audit was to assess the adequacy of policies and procedures over the generation and distribution of investment income.

Findings and Recommendations

The Board of Regents has developed policies and procedures to provide guidance to staff and other parties involved in the generation and distribution of investment income at the University and Community College System of Nevada (UCCSN). However, several areas of the Board's policies could be improved to provide better guidance on investment processes from pre-investment analysis to distribution of income. Specifically, policies should be complete, clear, and up to date. In addition, stronger policies and procedures are needed to correct internal control weaknesses in areas such as segregation of duties.

These issues are important, given the size of the investment portfolios for the endowment and operating pools, and their importance as a source of income for UCCSN. According to UCCSN's investment advisor, as of June 30, 2003, the endowment pool was valued at almost $200 million, with the operating pool valued at over $210 million. During fiscal year 2003, the institutions and System Administration received distributions totaling $10 million from the endowment pool and $7 million from the operating pool.

Guidance on Generation and Distribution of Investment Income Needs Improvement

The guidance provided to UCCSN's staff and others involved in the investment and income distribution processes needs to be expanded, updated, and clarified. The main source of guidance is the Board of Regents' *Handbook*. The *Handbook* contains the policies adopted by the Board for the governance of UCCSN. In addition, Banking and Investments has desk procedures covering some of the daily tasks related to the investment processes, and the Investment Committee has a handbook that was intended to provide an overview of the investment function.

There was no evidence in Investment Committee minutes of a thorough review of the Board's *Handbook*. Furthermore, the desk procedures and the Committee's handbook have not been updated for about 4 years.

Investment Policies Need Improvement

Several areas of the *Handbook* could be improved to provide better guidance on investment processes from pre-investment analysis to distribution of income. This guidance is needed to help ensure investment objectives are met and the Board of Regents' investment policies are clearly communicated to the Investment Committee and UCCSN staff.

Pre-Investment Activities

The pre-investment analysis that underlies decisions on portfolio diversification, asset allocation, and portfolio rebalancing is not adequately addressed in UCCSN policy. Investment policies should include additional guidance in several areas, including cash forecasting, the investment time horizon, and risk tolerance.

- The *Handbook* assigns the responsibility for cash forecasting to UCCSN staff. However, it is not specific about the timelines for forecasts.
- There are some references in the *Handbook* to "long-term" objectives, but there is no explicit statement regarding the investment time horizon for either the endowment or operating pools.
- There is no clear statement of investment risk tolerance, making it difficult to determine the level of risk UCCSN is willing to accept.

Prudent Investment Practices suggests a 5-year schedule of anticipated cash flows be prepared.[1] This is so the investment time horizon can be determined. The investment time horizon provides context for investment decisions, since asset allocations are partly based on it. For example, Smith College, with an endowment of over $800 million, includes a description of the investment time horizon used for its endowment in its policies.

[1] *Prudent Investment Practices: A Handbook for Investment Fiduciaries.* (Pittsburgh, PA. Foundation for Fiduciary Studies 2003). Edited by the American Institute of Certified Public Accountants.

> The investment guidelines are based upon an investment horizon greater than ten years, in accordance with the College's status as a perpetual entity. The endowment's target (or strategic) asset allocation is based on this long-term perspective….

Risk has different connotations to different fiduciaries, depending on their particular frame of reference, circumstances, and objectives. The Commonfund, formed by a Ford Foundation grant to develop excellence in endowment management, defines risk as:

> ….the *possibility of failing to meet objectives*—any of the objectives agreed upon by the Board and Investment Committee.[2]

A statement of risk tolerance should describe the level of risk the investor is willing to accept in the investment strategy. This includes tolerance of volatility in the financial markets.

Asset Allocation Policies Need Improvement

Additional detail needs to be added to UCCSN's policies and procedures to address asset allocation processes and decisions. Asset allocation policies are an important component of any investment policy. They should include the types of analyses required to support asset allocation decisions and an explanation of why allocations are made to specific asset classes.

First, policies should include the modeling of investment returns to determine the expected return a strategy is designed to produce. Assumptions used in the model should be identified. The *Handbook* includes a requirement that asset classes selected not be perfectly correlated. In other words, the returns of the asset classes do not always move in tandem. UCCSN's investment advisor did conduct some modeling of investment returns that could be used to support an asset allocation decision. However, the analysis was not required by the *Handbook* or described in the investment advisor's contract.

In addition, policies should include the reason for investing in each asset class and the role each asset class will play in the investment strategy. Factors to consider include: 1) the size of the portfolio, 2) investment expertise, 3) ability to monitor the

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[2] *Principles of Endowment Management*, (Wilton, CT; Commonfund Institute, 2001).

portfolio, and 4) sensitivity to investment expenses. The *Handbook* explains the purpose of the equity and fixed income asset classes for the endowment, but not the purpose of allocations made to sub-asset classes, such as real estate or international stocks. Much of the description for the operating pool focuses on fixed-income investments, even though a large portion of the pool's portfolio is allocated to domestic and international common stocks.

Finally, one of the key components of an investment policy is the identification of a specific and measurable return objective which is consistent with the spending rate policy.[3] The *Handbook* includes a statement of the return objective for the endowment pool, but not for the operating pool. Without a specific and measurable investment return objective, there is no goal against which to compare actual investment performance.

Rationale for Using Indexing Needs to Be Documented

The *Handbook* does not contain a policy on the use of indexed investment funds, although UCCSN does invest in them. The *Handbook* only refers to indexes in the context of their use as investment performance benchmarks. The purpose of an indexing policy is to avoid moving between a passive and an active investment strategy at the wrong point in the business cycle.

An article in the *Commonfund Quarterly,* states that investment policies should provide the rationale for or against the use of indexed investment funds as part of the description of the investment strategy.[4] A policy on indexing could assign a certain portion of the investment portfolio to index funds, with these funds passively managed over a long period of time.

Portfolio Diversification and Rebalancing Policies Need to Be Documented

The *Handbook* addresses portfolio diversification through the asset allocation strategy for the endowment pool. While the *Handbook* calls for the periodic review of the endowment's portfolio, it does not provide any guidance on portfolio rebalancing. Neither portfolio diversification nor rebalancing is addressed for the operating pool. UCCSN staff indicated at an Investment Committee meeting that portfolio rebalancing

[3] Jay Yoder, "Start on course, stay on course," *Commonfund Quarterly* (Winter 2001):p. 4.
[4] *Ibid*., p. 6.

occurred when monies were withdrawn from the investment portfolios for spending purposes.

Prudent Investment Practices maintains that rebalancing is an important element of an investment policy where the goal is to create a portfolio that balances appropriate levels of risk and return. That balance can only be maintained by periodically rebalancing the portfolio to maintain the appropriate diversification. Furthermore, rebalancing limits define the points when an investment portfolio should be reallocated to bring it back in line with established asset allocation targets. The discipline of rebalancing controls risk and forces the portfolio to move along a predetermined course.

Nevada PERS offers an example of a simply worded rebalancing policy with limits. "PERS' Fund Investment Objectives and Policies" states:

> Assets will be rebalanced as appropriate. Acceptable deviation from asset allocation targets is ± 3% of total fund.

Not periodically rebalancing the portfolio may create an imbalance between levels of risk and return. The investment portfolio may assume greater risks than necessary or experience lower investment returns than needed to meet spending requirements.

<u>Policies for Selection and Monitoring of Service Providers Could Be Improved</u>

The Board of Regents' policies regarding the selection of investment managers and other service providers need improvement. The Board's policies contain no explicit requirement that contracts and service agreements be in writing or that contracts clearly define the roles and responsibilities of all parties. Furthermore, the policies do not define the due diligence criteria and the process to be followed in the selection of either the custodial bank or the investment advisor. Finally, while the policies do call for the periodic review of services, including securities custody and consulting, it does not describe the due diligence to be performed in evaluating the performance of service providers. Due diligence is the attention and care exercised by a person to fulfill an obligation.

All service agreements and contracts involving external investment fund managers and investment consultants should be written and clearly define the scope of duties and responsibilities. In addition, investment policy should define the due diligence criteria and process to be used in the selection of investment managers. This requires fiduciaries to investigate the qualities, characteristics, and merits of each investment manager and identify the role each plays in the furtherance of the investment strategy. Furthermore, fiduciaries have an obligation to monitor the performance of service providers. The Institute of Internal Auditors suggests it is important that an annual review of the investment advisor be performed to ensure compliance with the investment objectives.[5] The Institute also calls for an annual due diligence review of the custodian covering financial condition, internal controls, and safekeeping.

Policies on Measurement of Investment Performance Could Be Improved

Accurate information on the performance of investments is critical in determining the success or failure of any investment program. To ensure accurate investment performance information is obtained, the performance reporting policies for the operating pool need to be clarified and performance presentation standards adopted. Unclear performance reporting requirements could result in the receipt of inaccurate or non-comparable information, hindering the ability of UCCSN to evaluate the performance of its investments.

The *Handbook* requires the preparation of a quarterly performance report. This report measures actual investment returns against objectives and various benchmarks. The requirement is better defined for the endowment than it is for the operating pool, however. In addition, the *Handbook* does not contain a policy addressing the use of performance presentation standards by either UCCSN's external investment managers or its investment advisor.

Prudent Investment Practices calls for the investment policy to require the preparation of periodic reports comparing actual investment performance against an appropriate index, peer group, and investment policy objectives. The Association for Investment Management Research (AIMR) has developed standards for use by investment managers, while the Investment Management Consultants Association (IMCA) has developed standards for use by investment advisors in their presentation of investment performance information.

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[5] Barbara Davidson, *Auditing Investments*, (Altamonte Springs, FL: Institute of Internal Auditors, 1999).

AIMR developed its standards to meet four goals:

- Achieve greater uniformity and comparability among performance presentations.
- Improve the service offered to investment management clients.
- Enhance the professionalism of the industry.
- Bolster the notion of self-regulation.

The standards set expectations and provide a yardstick for evaluating fairness and accuracy in performance presentation.

IMCA developed its standards to promote the development of accurate investment performance reports by its members. The standards cover the collection, analysis and reporting of performance data to clients.

Certain Investment Policy Issues Were Not Addressed

Two specific investment policy issues were not addressed in the Board of Regents' *Handbook*. Those policy issues involved the control of investment costs and the legal jurisdiction of UCCSN's investments. Guidance is needed on these issues to help ensure UCCSN receives investment services at reasonable costs and its investments are adequately safeguarded.

Investment Cost Control Needs to Be Addressed

Investment costs are not explicitly addressed in the *Handbook*. According to UCCSN staff, investment costs are considered when investment managers are hired. Fees charged by managers are verified to be in accordance with agreements through a review of invoices. UCCSN had written agreements with two investment account managers as of June 30, 2003. One of these agreements did not require best execution in trades, while both agreements allowed for soft dollar expenditures. Best execution is the difference between the price paid for a security and the fair market price. Soft dollar expenditures occur when an investor pays higher brokerage fees in exchange for receiving additional services such as research.

Prudent Investment Practices states that investment policies should define procedures for controlling investment expenses, including fees for asset placement. Expenses are required to be reasonable in relation to the value of the services provided, and chargeable to portfolio assets. In addition, the policies of external investment managers should be reviewed periodically to ensure they seek best execution on trades, and appropriately use soft dollar expenditures.

<u>Legal Jurisdiction of Investments Not Addressed</u>

The *Handbook* does not address legal jurisdiction for endowment and operating pool investments in foreign companies and countries. *Prudent Investment Practices* suggests that the investment policy acknowledge the importance of assets being within the jurisdiction of U.S. courts so that action can be taken in the event of a criminal act. Investing in companies and countries not fully under the rule of law or not subject to the jurisdiction of U.S. courts may result in the loss of investment monies with no avenue for redress.

<u>Distribution Policies Need Clarification</u>

The Board's policies do not clearly describe the practice for distributing assets from the operating pool. Approximately $7 million was distributed to UCCSN's institutions and System Administration in fiscal year 2003 from the operating pool. This makes it imperative the methodology used in determining the amount of each distribution is clear and understandable to all interested parties. The investment policy should clearly describe the formula for calculating distributions.

The *Handbook* contains two separate statements pertaining to distributions from the operating pool. One statement calls for investment income earned on operating pool assets to be distributed on a monthly basis to UCCSN institutions based on the institutions' respective average daily cash in bank balance. The other statement requires the Investment Committee to establish a spending rate on a bi-annual basis.

UCCSN distributes a percentage of the operating pool's assets to the institutions monthly, based on each institution's average daily cash in bank balance. The percentage is established by the Investment Committee, in compliance with the Board's policy. However, the Board's policy also states that investment income is to be distributed, rather than a percentage of the operating pool's assets. Confusion could result if investment income does not equal the percentage of assets to be distributed, making it difficult for UCCSN staff to comply with both policy statements.

Controls Over the Investment Function Could Be Strengthened

UCCSN's policies and procedures did not always establish controls, such as requiring segregation of duties or supervisory review for critical transactions. In addition, Banking and Investments staff did not always comply with policies and procedures. Improvements are needed in several areas, including contracting, asset allocation, and approval of investment transactions.

Contract Management and Monitoring Needs Improvement

Oversight of the contracting process for the investments function needs to be improved. Procedures were not followed, leading to problems with review and monitoring of contracts. For example, some contracts were not properly authorized, and one contract was still in effect, having been originally signed in 1984.

Contracting Procedures Not Followed

The Chancellor's signature was found on only one of five contracts requiring the Chancellor's signature. Banking and Investments staff signed the contracts without having the authority to do so. Further, only one contract showed evidence of General Counsel review. Finally, four contracts containing "hold harmless" language did not conform to the Chancellor's policy regarding the use of such clauses.

The Chancellor of UCCSN has promulgated guidelines for the contracting process. One provision requires the Chancellor sign contracts with an indefinite or open-ended term and contracts where total consideration is expected to exceed $400,000. There is also a requirement that the UCCSN's General Counsel review each contract that requires the Chancellor's signature. In addition, "hold harmless" provisions contained in contract language must conform to language contained in the Chancellor's guidelines. "Hold harmless" provisions protect contractors from claims and losses arising from contract performance.

Contracts obligate UCCSN to act in a certain way, and may increase risk. As a consequence of bypassing the Chancellor's contracting guidelines, accountability is lessened. The contracts signed by Banking and Investments staff represented over $145,000 in payments for custodial services and investment management services during fiscal year 2003.

Contract With Investment Advisor Not Timely Reviewed or Re-bid

UCCSN's contract with its investment advisor was signed in 1984 and has not been revised to reflect changes in services provided or re-bid since that time. This contract is open ended, with no fixed termination date. In April 2004, the Investment Committee discussed issuing a request for proposals for an investment consultant. A Chancellor's memorandum recommends that open ended or indefinite term contracts be periodically reviewed, but is not specific about frequency of review.

There are two principal problems with not periodically reviewing and re-bidding contracts: UCCSN may not be receiving the services it needs or getting the best value for its money. The investment advisor's contract cost UCCSN $113,329 in fiscal year 2003.

Asset Allocation Policy Not Followed

Allocation of the endowment's assets as of June 30, 2003, was not in compliance with the Board of Regents' policies. Exhibit 3 shows the actual asset allocations, the Board's permitted ranges, and the strategic targets.

Exhibit 3

**Endowment Pool Asset Allocation Compared
To Board of Regents' Policy
As of June 30, 2003**

Asset Class	Actual Allocation	Strategic Target	Permitted Range
Alternative Strategies	20.4%	15%	0-15%
Global Equity	10.0%	15%	5-25%

Sources: Board of Regents' *Handbook* and quarterly investment performance report prepared by UCCSN's investment advisor.
Note: Alternative Strategies is defined in the *Handbook* as absolute return strategies, venture capital, and private equity assets.

First, actual allocations to two asset classes differed significantly from their strategic targets. If there is a significant difference between the strategic target and the actual allocation, the asset allocation strategy may not work as intended. In addition, investment risks could be greater than expected, while returns could be lower.

Second, one asset class, alternative strategies, exceeded the Board's permitted range. The Board of Regents establishes the permitted ranges for endowment investments. These permitted ranges represent upper and lower limits for asset classes and subclasses. The asset allocation in the *Handbook* should reflect a well thought out asset allocation strategy for the investment portfolios. By exceeding the permitted range, UCCSN may be increasing the risk in the portfolio beyond what was agreed to by the Board of Regents. As fiduciaries, UCCSN staff and Investment Committee members have a responsibility and a need to ensure adherence to the permitted ranges.

Smith College's "Guidelines and Investment Policy" recognizes the need to adhere to permitted ranges.

> The Investment Committee believes that the constant changing of policy or strategy based on recent market conditions is another risk worthy of consideration. This risk will be managed by establishing and adhering to the Policy's asset allocation ranges.

The asset allocation policy is also designed to prevent a practice known as "chasing performance." This is a situation where investments are made in the latest hot stock or security, but after the point where good returns have been made or locked in. As a consequence of losing the "chase," investments are purchased that ultimately do not provide the return initially expected.

The Investment Committee establishes strategic targets within the ranges permitted by the Board of Regents. The theoretical goal is to match actual asset allocations to these target levels. To ensure the Committee's strategic targets are continually met, the portfolio must be periodically rebalanced. However, the Board of Regents has not adopted a portfolio rebalancing policy to guide staff. While there are several sources of guidance on this subject, we found that Smith College's investment policy succinctly addressed the practice of portfolio rebalancing. It states in part:

> Periodic rebalancing is necessary to keep the asset allocation from shifting too far from Policy guidelines….
>
> ….A rebalancing policy forces the sale of those investments that have recently performed very well (and thus have become a larger percentage of the portfolio than policy would dictate) and the purchase of those assets which may have recently performed poorly. It is often difficult to voluntarily execute such a policy in the absence of an explicit policy requirement.
>
> ….investors experience lower returns and higher risk when they do not regularly rebalance their portfolios back to their strategic mix. An asset allocation allowed to drift with market returns automatically ensures that the portfolio will be overweighted in an asset class at market peaks and underweighted at market lows….

Investment Approval Process Could Be Strengthened

Segregation of duties over some investment transactions need to be improved. Specifically, the signature of just one staff person is needed to execute investment transactions such as establishing a contractual relationship with an investment manager or transferring the control of assets to a new investment manager. Individual investment transactions executed by Banking and Investments staff sometimes exceed $10 million. Allowing transactions of this size to be executed and approved by one person increases risk.

Weber State University in Utah provides an example of a requirement for the approval of a second key staff person to execute critical investment transactions. Its investment policy states:

> The public treasurer must receive the approval of the Vice President for Administrative Services or the University President for individual investment transactions exceeding $1,000,000 in aggregate for one day, and for total transactions exceeding $10,000,000 during a calendar month, excluding repurchase agreements and transactions with the State treasurer’s investment pool.

Recommendations

1. Conduct periodic comprehensive reviews of investment and income distribution policies to ensure they follow best practices and provide adequate guidance to those involved in the investment and income distribution processes.
2. Comply with the contracting procedures prescribed by the Chancellor.
3. Develop a contract monitoring process, establishing timelines for contract review and re-bidding.
4. Comply with the Board of Regents’ asset allocation policy.
5. Adopt a portfolio rebalancing policy and adjust asset allocations as necessary.
6. Require a second signature on critical investment transactions.

Appendices

Appendix A
Audit Methodology

To gain an understanding of the University and Community College System of Nevada's (UCCSN) Banking and Investments function, we interviewed agency staff and reviewed constitutional provisions, statutes, and Board of Regents' policies significant to the generation and distribution of investment income. We also reviewed investment performance reports, and minutes from meetings of the Board of Regents and its Investment Committee. Further, we documented and assessed key processes and internal controls.

To accomplish our audit objective, we compared UCCSN's policies and procedures over the generation and distribution of investment income with industry best practices and standards. Industry best practices and standards were obtained from several sources, including: the Foundation for Fiduciary Studies, the National Association of College and University Business Officials, the Association of Governing Boards of Universities and Colleges, Commonfund Institute, the Government Finance Officers Association, the Institute of Internal Auditors, the Association for Investment Management Research, and the Investment Management Consultants Association.

To assess the reliability of the distribution of assets among UCCSN institutions, we determined if such distributions were accomplished in compliance with the Board of Regents' policies. In addition, we reviewed minutes of the Board of Regents' Investment Committee to determine if the Committee took actions required by the Board with regard to the distribution of endowment or operating pool assets.

To verify UCCSN's compliance with key investment policy provisions found in the Board of Regents' *Handbook*, we determined if actual asset allocations for the endowment and operating pools complied with Board policies. In addition, we verified whether external investment managers, UCCSN staff and the Investment Committee complied with Board policies.

Our audit work was conducted from July 2003 to April 2004, in accordance with generally accepted government auditing standards.

In accordance with NRS 218.821, we furnished a copy of our preliminary report to the Chancellor of UCCSN. On August 17, 2004, we met with UCCSN officials to discuss the results of the audit and requested a written response to the preliminary report. That response is contained in Appendix F, which begins on page 33.

Contributors to this report include:

Ian Allan Deputy Legislative Auditor	Jane Bailey Audit Supervisor
Stephen M. Wood, CPA Chief Deputy Legislative Auditor	

Appendix B

Prior Audit Recommendations

Our 1996 audit of the University and Community College System of Nevada contained 10 recommendations. However, none of these recommendations were related to the generation and distribution of investment income. Therefore, we did not assess UCCSN's implementation of the prior audit's recommendations.

Appendix C

Assembly Bill 148

Assembly Bill No. 148–Assemblymen Perkins, Leslie, Parks, Gibbons, Knecht, Anderson, Andonov, Angle, Arberry, Atkinson, Beers, Brown, Buckley, Carpenter, Chowning, Christensen, Claborn, Collins, Conklin, Geddes, Giunchigliani, Goicoechea, Goldwater, Grady, Griffin, Hardy, Hettrick, Horne, Koivisto, Mabey, Manendo, Marvel, McClain, McCleary, Mortenson, Oceguera, Ohrenschall, Pierce, Sherer, Weber and Williams

Joint Sponsors: Senators Care, Carlton, O'Connell, Amodei, Cegavske, Hardy, McGinness, Neal, Nolan, Rhoads, Schneider, Shaffer, Townsend, Washington and Wiener

CHAPTER.. 442

AN ACT relating to higher education; requiring the Legislative Auditor to conduct an audit of the University and Community College System of Nevada and the Board of Regents of the University of Nevada; and providing other matters properly relating thereto.

THE PEOPLE OF THE STATE OF NEVADA, REPRESENTED IN SENATE AND ASSEMBLY, DO ENACT AS FOLLOWS:

Section 1. 1. The Legislative Auditor shall conduct an audit of the University and Community College System of Nevada and the Board of Regents of the University of Nevada.

2. The audit must include, without limitation, an analysis of:

(a) Capital construction projects;

(b) The cost of athletic programs, including, without limitation, the sources and uses of money for such programs;

(c) The cost of administration, including, without limitation, personnel, travel and other associated costs;

(d) The utilization of host accounts;

(e) The validity and reliability of enrollment data;

(f) Policies and procedures for the generation and distribution of investment income;

(g) Contracting and bidding procedures, including, without limitation, construction, retrofit and repair projects and the use of "shared savings" programs to pay for utility costs and energy conservation projects; and

(h) Statewide programs, including, without limitation, program selection, funding and outcomes.

3. The Legislative Auditor shall present a final written report of the audit to the Audit Subcommittee of the Legislative Commission not later than February 7, 2005.

4. The provisions of NRS 218.737 to 218.890, inclusive, apply to the audit conducted pursuant to this section.

Sec. 2. 1. Upon the request of the Legislative Auditor, the University and Community College System of Nevada shall transfer from its budget to the Audit Division of the Legislative Counsel Bureau the sum of $90,000 to carry out the provisions of section 1 of this act.

2. Any remaining balance of the sum transferred pursuant to subsection 1 must not be committed for expenditure after February 7, 2005, and reverts to the University and Community College System of Nevada as soon as all payments of money committed have been made.

Sec. 3. This act becomes effective on July 1, 2003.

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Appendix D

Glossary of Terms

Absolute Return	A strategy where investment managers seek to earn a consistent rate of return without relying on the direction of traditional stock and bond markets. This strategy may include diverse investments, such as private equity, commodities, arbitrage, futures, or distressed debt.
Active Investment Management	An investment strategy that involves the active trading of securities in an attempt to earn above-average returns on a portfolio. Active investment management requires frequent monitoring of financial markets.
AIMR	Association for Investment Management Research.
AIMR-Performance Presentation Standards	These standards are designed to promote full disclosure and fair representation in the reporting of investment results in order to provide uniformity in comparing manager results. These standards include ethical principles, and apply to all organizations serving investment management functions.
Alternative Strategies	According to Board policy, alternative strategies includes asset classes that would be expected to increase the diversification of the total portfolio while also helping to improve the risk/return characteristics. These asset classes may include: absolute return strategies, venture capital, and private equity.
Asset Allocation	The process of deciding how to distribute an investor's wealth among different asset classes for investment purposes.
Asset Class	Securities that have similar characteristics, attributes, and risk/return relationships.
Benchmarks	A standard against which investment returns are measured. Benchmarks must correlate with the investment time horizon. Benchmarks might be the rate of return on a particular investment instrument or an index of stocks or bonds that correlates with a portion of an investment portfolio.
Best Execution	This is formally defined as the difference between the execution price (the price at which a security is actually bought or sold) and the "fair market price," which involves calculating opportunity costs by examining the security price immediately after the trade is placed. Best execution occurs when the trade involves no lost opportunity cost; for example, when there is no increase in the price of a security shortly after it is sold.
Broker	An agent who acts as an intermediary between buyer and seller in trading securities, commodities, or other property. A broker charges a commission for this service.
Cash Forecast	A cash forecast is a schedule of expected receipts and disbursements over a given period of time.
Commingled Investment Fund	An investment fund that is similar to a mutual fund in that investors purchase and redeem units that represent ownership in a pool of securities. Commingled funds are usually offered through a bank-administered plan allowing for broader and more efficient investing.
Common Stock	An equity investment that represents ownership of a firm, with full participation in its success or failure.
Concentration/Zero Balance Account	A bank account structure featuring a single account where balances are "concentrated" and one or more zero balance sub-accounts used for disbursements. Deposits are normally made into the concentration account, while disbursements are made from the zero balance accounts upon presentment of checks or other demands for payment. Monies are transferred from the concentration account to the zero balance account(s), as needed.

Glossary of Terms
(continued)

Correlation	Correlation measures the degree to which two variables are associated. Correlation is a commonly used tool for constructing a well-diversified portfolio. Traditionally, equities and fixed-income asset returns have not moved closely together. The asset returns are not closely correlated. A balanced fund with equities and fixed-income assets represents a diversified portfolio that attempts to take advantage of the low correlation between the two asset classes.
Custodian	A custodian is a financial institution that keeps custody and records of an organization's securities.
Dealer	An individual or firm in the securities industry who buys and sells stocks and bonds as a principal rather than as an agent. The dealer's profit or loss is the difference between the price paid and the price received for the same security.
Directed Brokerage	Circumstances in which a fiduciary requests that the investment manager direct trades to a particular broker so that the commissions generated can be used for specific services or resources.
Diversification	A process of investing assets among a range of security types by sector, maturity, and quality rating. The goal of diversification is to create a portfolio that balances appropriate levels of risk and return.
Due Diligence	The diligence reasonably expected from, and ordinarily exercised by a person who seeks to satisfy a legal requirement or to discharge an obligation, such as a prospective buyer's or broker's investigation and analysis of a target company, a piece of property, or a newly issued security. A failure to exercise due diligence may sometimes result in liability, as when a broker recommends a security without first investigating it adequately.
Endowment Pool	A pool of assets created as the result of bequests or gifts. Endowments serve a number of important purposes for educational institutions, including: allowing greater independence, providing operational stability, and facilitating educational excellence.
Fair Market Value	The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.
Fiduciary	Indicates the relationship of trust and confidence where one person (the Fiduciary) holds or controls property for the benefit of another person, for example, the relationship between a trustee and the beneficiaries of the trust. A fiduciary is any person who exercises any discretionary authority or control over the management of an endowment or disposition of its assets, renders investment advice for a fee or other compensation with respect to the funds or property of an endowment, or has the authority to do so, or has any discretionary authority or responsibility in the administration of an endowment.
Fixed-Income Investments	Loans with contractually mandated payment schedules from investors to firms or governments.
Hedging	The purchase or sale of a derivative security (such as options or futures) in order to reduce or neutralize all or some portion of the risk of holding another security.
IMCA	The Investment Management Consultants Association.
Indexing	A passive portfolio management strategy that seeks to match the composition, and therefore the performance, of a selected market index.
Investment Advisor	An entity that provides advice to individuals and institutional investors on structuring their portfolios and managing investment funds.

Glossary of Terms
(continued)

Investment Company	A company (corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities.
Investment Time Horizon	The time period used for planning and forecasting purposes or the future time at which the investor requires the invested funds.
Objectives	The investor's goals expressed in terms of risk and return and included in the policy statement.
Operating Pool	A pool of assets that represents all assets of UCCSN other than those in the endowment pool.
Permitted Ranges	Asset allocation limits adopted by the Board of Regents for its endowment pool. Upper and lower limits for each asset class have been established based on percentages of the total fair market value of the endowment pool.
Portfolio	A group of investments. Ideally, the investments should have different patterns of return over time.
Portfolio Rebalancing	Rebalancing limits define the points when a portfolio should be reallocated to bring it back in line with the established asset allocation target. The discipline of rebalancing controls risk and forces the portfolio to move along a predetermined course. It takes gains from stellar performers or favored asset classes, and reallocates them to lagging styles, without attempting to time the market.
Prudent Person Rule	An investment standard that outlines the fiduciary responsibilities of investors relating to investment practices.
Risk	The uncertainty that an investment will earn its expected rate of return.
Risk Tolerance	An investors' tolerance for the various types of risk connected with investing assets.
Safekeeping	Holding of assets (e.g., securities) by a financial institution.
Soft Dollars	A form of compensation to a money manager generated when the manager commits the investor to paying higher brokerage fees in exchange for the manager receiving additional services (e.g., stock research) from the broker.
Strategic Allocation Targets	Asset allocation targets established by the Board of Regent's Investment Committee for each asset class in the endowment pool. The targets are established as a percentage of the endowment pool's fair market value and must fall within the ranges permitted by the Board of Regents.
Systematic Risk	The variability of returns that is due to macroeconomic factors that affect all risky assets. Because it affects all risky assets, it cannot be eliminated by diversification.
Trading Costs	The costs associated with buying or selling an investment security. Trading costs are usually quoted in cents per share.
Unsystematic Risk	Risk that is unique to an asset, derived from its particular characteristics. It can be eliminated in a diversified portfolio.

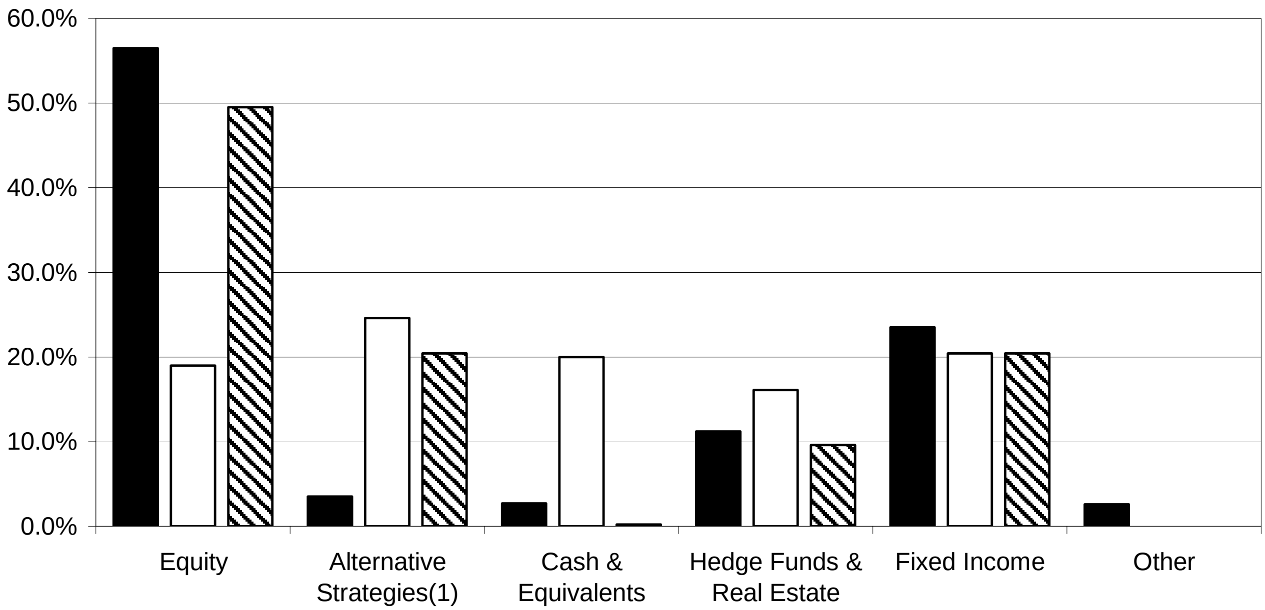
Glossary of Terms
(continued)

Variance	Variance is a statistical measure that indicates the spread of values within a set of outcomes around a calculated average. For example, the range of daily prices for a stock will have a variance over a period of time that reflects the amount that the stock price varies from the average, or mean price of the stock over the time period. Variance is useful as a risk statistic because it gives an indication of how much the value of a portfolio might fluctuate up or down from the average value over a given time.
Volatility	A degree of fluctuation in the price and valuation of securities.
Yield	The promised rate of return on an investment under certain assumptions.

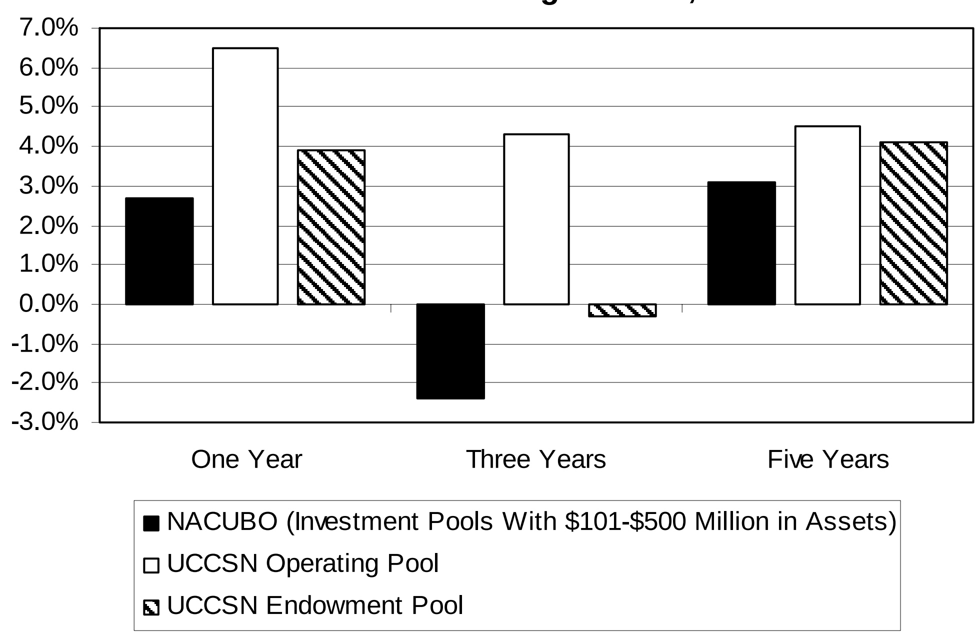
Appendix E

Statistical Information

Asset Allocation Comparison
Fiscal Year Ending June 30, 2003



Comparison of Annualized Total Returns
for 5-Year Period Ending June 30, 2003



(1) Includes private equity, absolute return, and venture capital assets. Market value of private equity is as of March 31, 2003; portion of absolute return market value is preliminary for operating and endowment pools.

Sources: National Association of College and University Business Officials (NACUBO) data obtained from the *2003 NACUBO Endowment Study*. UCCSN data obtained from quarterly investment performance reports prepared by UCCSN's investment advisor.

Statistical Information
(continued)

Fair Value of the Endowment Pool
By Institution
As of June 30, 2003

Institution	Fair Value Share of Endowment Pool	Percent of Total
Community College of Southern Nevada	$ 2,674,919	1.34%
Desert Research Institute	4,651,166	2.33%
Great Basin College	139,735	0.07%
Truckee Meadows Community College	5,269,990	2.64%
System Administration	78,251,371	39.20%
University of Nevada, Las Vegas	34,873,761	17.47%
University of Nevada, Reno	73,660,091	36.90%
Western Nevada Community College	99,810	0.05%
Total	**$ 199,620,843**	**100.00%**

Source: LCB Audit Division analysis of information obtained from UCCSN and UCCSN's investment advisor.
Note: Does not include Foundation funds.

Appendix F

University and Community College System of Nevada's Response

University and Community College System of Nevada

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Las Vegas, Nevada 89103
Tel: (702) 889-8426
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U C C S N
1968

2601 Enterprise Road
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September 1, 2004

State of Nevada
Legislative Counsel Bureau
Paul Townsend, Legislative Auditor
401 S. Carson St.
Carson City, Nevada 89701-4747

Dear Mr. Townsend:

Attached is the revised University and Community College System of Nevada response to the Investment Policies and Procedures Audit Report prepared by the Legislative Counsel Bureau audit staff.

We would like to thank the LCB staff for the courtesy extended to all UCCSN employees during this review.

Please contact me if you have any questions on the items provided.

Very truly yours,

Buster Neel by Ginny Criswell

Harry E. Neel, Jr.
Vice Chancellor for Finance and Administration

Attachment

Below is the UCCSN response to the Legislative Counsel Bureau (LCB) draft audit report of Investment Policies and Procedures.

Recommendation 1: *Conduct periodic comprehensive reviews of investment and income distribution policies to ensure they follow best practices and provide adequate guidance to those involved in the investment and income distribution processes.*

System Administration will review investment and income distribution policies at least every two years.

Recommendation 2: *Comply with the contracting procedures prescribed by the Chancellor.*

Chancellor's Memorandum #02-04, Policies and Procedures for the Preparation and Approval of UCCSN Contracts, will be followed in the future.

Recommendation 3: *Develop a contract monitoring process, establishing timeliness for contract review and re-bidding.*

All contracts except investment manager contracts have expiration dates and must be bid in accordance with the UCCSN Purchasing Policy. The investment managers are reviewed at each Investment Committee meeting.

Recommendation 4: *Comply with the Board of Regents' asset allocation policy.*

System Administration will review compliance with the asset allocation policy at least annually.

Recommendation 5: *Adopt a portfolio rebalancing policy and adjust asset allocations as necessary.*

The Investment Committee has the authority to rebalance the pools at any time as stated in the Board of Regents' Handbook, Title 4, Chapter 10, Sections 4.1.e, 4.5.b, 6.B.5 and 6.C.1. A recommendation will be made to the Investment Committee in February 2005 to adopt a formal rebalancing policy that will address adjusting asset allocation. Please note that we have a moratorium on changes to the Board of Regents' Handbook until February 2005.

Recommendation 6: *Require a second signature on critical investment transactions.*

Procedures will be put into place and the Office Procedures Manual will be updated by June 30, 2005 to ensure that two individuals are involved with transferring control of assets to a new investment manager.

UCCSN Response to Audit Recommendations

Recommendation Number		Accepted	Rejected
1	Conduct periodic comprehensive reviews of investment and income distribution policies to ensure they follow best practices and provide adequate guidance to those involved in the investment and income distribution processes	X	
2	Comply with the contracting procedures prescribed by the Chancellor	X	
3	Develop a contract monitoring process, establishing timelines for contract review and re-bidding	X	
4	Comply with the Board of Regents' asset allocation policy	X	
5	Adopt a portfolio rebalancing policy and adjust asset allocations as necessary	X	
6	Require a second signature on critical investment transactions	X	
	TOTALS	6	0