

## The Associated Investments Fund: A History of a Pennsylvania "First"

by Wm. Richard Gordon

*On his approaching retirement, the president of Franklin Investment Company (the University subsidiary that manages the Associated Investments Fund) tells how the nation's first such integrated fund came into being, and how it has changed to adjust to new circumstances over the past forty-five years. Mr. Gordon is a 1936 alumnus of the Wharton School, who taught there in addition to holding high-level administrative posts including treasurer of the University. He was honored this year with an Alumni Award of Merit. As he retires June 30, Franklin Investment Company Vice President Scott Lederman is acting as head of the operation. Next week, Mr. Lederman will present an update of the University's performance in the management of its endowment funds in recent years.*

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Forty-five years ago, on January 1, 1937, the University of Pennsylvania created what is believed to be the first charitable, "discretionary, diversified, commingled, open-ended, unitized" fund of its kind: The Associated Investments Fund (A.I.F.).

As early as 1928 the University had commingled in several Associated Trusts the assets of certain endowment funds grouped according to their similar purposes, namely University Associated Fellowship and Scholarship Trusts, General Trusts, Library Trusts, Prize Trusts, Professorship, Lectureship and Salary Trusts, as well as University Hospital Associated General Trusts and Free Bed Trusts.

These Associated Trusts were not unitized, but shared consolidated assets; distributed income was based on the ratio that the book value (principal) of each individual participating fund bore to the aggregate book value of the assets and income, respectively, of the Associated Trusts.

But when the Commonwealth of Pennsylvania Act of May 5, 1933, ("An Act Relating to Non-Profit Corporations") was passed, it restricted investments to those designated "legal investments" for trust funds under the laws of the Commonwealth. This meant that after that date any new participations in our pool might have been contrary to the Act's provisions. Fortunately, an amendment was made on July 17, 1935, that restored our discretion.

Accordingly, the University's original plan for a "trust investment pool," or pooled fund, drawn up in 1928 and revised in 1931, was reviewed in 1935. In the spring of 1936, it was resubmitted to the University's independent auditors, Lybrand, Ross Brothers & Montgomery. Their approval on May 27, 1936, resolved some questions about amortization of bond premiums, disposition of debit and credit accretions, issuance of shares based on book or market value, creation of a reserve or insurance fund, distribution and accumulation of income.

With those elements in place, the Investment Committee on October 27, 1936, approved the proposal of the Treasurer and Comptroller for the establishment of what was initially called the Associated Endowments Fund (A.E.F.). On November 10, 1936, the Committee approved a carefully screened list of investments deemed appropriate for transfer to the A.I.F., constituting its initial portfolio.

Three days later, on December 11, the Board ratified the list of endowment funds specifically authorized by Drinker Biddle & Reath, counsel for the University, for admission to the proposed Fund.

In his report to the Executive Board on March 12, 1937, the Treasurer noted that the A.E.F. had been set up on the books of the University as of January 1, 1937.

After further consideration of providing for the amortization of premiums on investments, the Investment Committee resolved on March 30, 1937, that "such amounts as this Committee shall determine from time to time to be suitable appropriations from the income of the Associated Endowments Fund in order to make provision for writing down the premium on investment, when held to maturity or call when such investments are purchased at a more than the par or call value thereof, shall be added to the Reserve Fund, which shall be carried upon the books of the University as the Associated Endowments Reserve and Amortization Fund, any such appropriation from income to be subject

to re-transfer to the income account of the Associated Endowments Fund at the discretion of the Committee."\*

By action of the Investment Committee at its meeting of June 15, 1937, the concept of the Associated Endowments Fund was then broadened to include not only endowment funds, "the principal of which is to be invested and kept inviolate and only the income used"—but also, "as the Treasurer shall deem appropriate, all other University trust funds, including general funds, current expense funds, plant and equipment funds, and funds not currently applicable."

Accordingly, on July 1, 1937, the Associated Endowments Fund was restyled as the Associated Investments Fund (A.I.F.).

## The A.I.F. ... and Undistributed Principal

Admissions to and withdrawals from the A.I.F. were made at the semiannual appraisal dates of July 1 and January 1 until 1965, when all of these semiannual processes became quarterly.

As funds are admitted to the A.I.F., the book value of securities and cash transferred is carried over to and incorporated with the book value of the A.I.F. The admitted funds, however, receive participating shares in the A.I.F. based on the market value of such shares divided into the market value of securities and cash which such funds are transferring to the common pool at the time. Thus, book values remain on the books intact, as memoranda records of cost and acquisition values only.

The Undistributed Principal Accretions Fund (see note above) is not separately invested, nor are its participations, as such, issued to the pooled funds. Each pooled fund, having its certain number of participating shares in the A.I.F., commands its *pro rata* share of the total market value of all investments and cash, of the entire A.I.F. (the Fund proper plus Undistributed Principal Accretions Fund)

When a fund is withdrawn in whole or in part, the original book value of that fund becomes the basis for comparison with the market value of its total participating shares in the A.I.F. in calculating its profit (the excess of market value of participating shares over such book value of the withdrawing fund). Thus, a profit is a credit accretion increasing the principal of the withdrawing fund. A loss (excess of book value of the withdrawing fund over the market value of its participating shares) is charged to that fund's principal, thereby decreasing the fund.

The Undistributed Principal Accretions Fund of the A.I.F. is not affected by the admission of participating funds but only by their withdrawal at a profit or loss to those funds. Thus, a credit accretion (profit) to a withdrawing fund is reflected in a charge to the Undistributed Principal Accretions Fund. Conversely, a debit accretion (loss) to a withdrawing fund is reflected in a credit to the Undistributed Principal Accretions Fund.

In summary, the Undistributed Principal Accretions Fund functions as the cumulative repository of all debit and credit accretions realized

\* Note. On October 13, 1947, the Executive Committee of the Executive Board took the following action: RESOLVED: That the change in name of Associated Investments Fund/ Reserve and Amortization Fund to (that of) Associated Investments Fund/ Undistributed Principal Accretions be approved

from: (1) withdrawal of funds at market values in excess of, or less than, their respective book value of investments and cash; (2) sale, call, or maturity of investments held by the Associated Investments Fund; (3) amortization of premiums, and (4) over and under distributions of income.

The Associated Investments Fund/Undistributed Principal Accretions is separately shown in the Annual Financial Report of the University "Endowment and Other Funds" as a Fund Functioning as Endowment (Or "Quasi-Endowment"). This figure is the balance offsetting the total debits to all pooled funds (consisting of cash and investment), with credits consisting of (1) non-expendable principal, ("basic book value") and (2) non-expendable principal—Undistributed Principal Accretions Fund, the latter representing the undistributed principal resulting from accretions.

### From Depression to Post-War Years

The *modus operandi* of the A.I.F. has remained unchanged since its inception. In 1938, the University loaned securities held by the A.I.F. for the first time. In 1940 we entered into our first Agency and Custodian Agreement with The Fidelity Bank, after which all negotiable securities were delivered and, to the extent appropriate, registered in the Bank's "street" name. The latest revision in this longstanding agreement was made in 1982.

With the economic collapse of 1938 and new pressures caused by World War II, income earned and distributed through A.I.F. units declined as dividend on common stocks was often reduced. In view of the fact that during this period the percentage of common stocks to the total January 1 market value portfolios was rising (from 11.4 percent in 1938, to 19.47 percent in 1942, and 42.02 percent in 1947), the Executive Committee of the Executive Board on March 31, 1947, authorized the creation of the "Associated Investments Fund/Income Stabilization Fund," renamed on June 8, 1950, the Associated Investments Fund/Income Stabilization Reserve. To this were credited dollar amounts of income to be held in reserve, subject to distribution in the event of future contingencies. The Reserve was invested in the A.I.F., with each participating fund taking a *pro rata* share. Because the Hospital of the University of Pennsylvania urgently required all of its then-current and accumulated investment income, the Reserve was later liquidated in its entirety and distributed *pro rata* to all participating trusts. This Income Stabilization Reserve has never been reactivated.

On January 29, 1946, the University purchased for \$387,500 cash—subject to a mortgage of \$3,800,000 held by Metropolitan Life Insurance Company, on which the University was not liable—the real estate located on the northeast corner of 8th and Market Streets, Philadelphia, leasing it together with certain renewal options to Lit Brothers for an annual rental of \$275,000 with the net lease guaranteed by City Stores Company. This investment was held in the Cyrus H. K. Curtis Fund, an unrestricted (general) fund expendable as to principal and income at the discretion of the Trustees.

The total investment in the Lit Brothers property amounted to \$4,256,971.11 as shown below:

|   |                     |                  |
|---|---------------------|------------------|
| Consideration—                            |                     |                  |
| Cash paid to Lit Brothers                 | \$ 387,500 00       |                  |
| Subject to existing mortgage              | <u>3,800,000.00</u> | \$4,187,500 00   |
| Settlement Charges—                       |                     |                  |
| Title Insurance Premium                   | 2,000 00            |                  |
| Miscellaneous                             | <u>55.00</u>        | 2,055 00         |
| Other Charges—                            |                     |                  |
| University Counsel                        | 7,507 50            |                  |
| Recording Lease                           | <u>15.25</u>        | 7,522 75         |
| Mortgage Prepayment Penalty April 1, 1952 |                     | <u>59,893.36</u> |
| Total Investment                          |                     | \$4,256,971.11   |

The Revenue Act of 1950 (as amended) subjected the net rentals received from sale/lease-back investments of this character to Federal corporate income tax—a tax to apply on that percentage of the net rentals equal to the percentage of the purchase price represented by borrowed money.

Studies made jointly by University Counsel Henry S. Drinker, Esq., and the engineering firm of Day & Zimmerman, Inc., showed that as a result of this tax, the average return on the University's original investment (\$387,500) would be reduced from 7.05 percent to approximately 1 percent, and that the taxes which would have to be paid over the term of the lease, based on the present rate, would come close to \$400,000.

Accordingly, the Investment Committee on March 24, 1952, directed that the Lit Brothers property, subject to its mortgage (reduced on April 1 of that year to \$2,994,668.11) be allocated to the A.I.F. as an investment property, and that cash and securities equal to the book value of the real estate be allocated from the A.I.F. to the Cyrus H. K. Curtis Fund. The Committee further ordered (1) that the existing mortgage be paid off in full on April 1, 1952, together with prepayment of 2 percent (the total amounting to \$3,054,561.47) to be made with funds provided by sales and allocations of securities held for investment in the A.I.F., and (2) that there be allocated to the Cyrus H. K. Curtis Fund from the A.I.F. cash and securities with a market value at March 31, 1952, of \$1,202,409.64, equivalent to the book value as of April 1, 1952, of the equity held by the Curtis Fund in the Lit Brothers property.

The Investment Committee thereupon adopted the following resolutions:

RESOLVED: That the Committee approve of the proposal to withdraw from the Associated Investments Fund all participating shares now owned by agency funds and funds which, in the opinion of Counsel, should be withdrawn in order to leave within the A.I.F. only funds the principal of which must be devoted to producing an income; and be it further

RESOLVED: That the present A.I.F. be designated as A.I.F. #1, and that a new Associated Investments Fund #2 be created, to be organized and managed precisely as the A.I.F. has heretofore been organized and managed; and be it further

RESOLVED: That there shall be included in A.I.F. #2 the assets of cash and securities resulting from the withdrawal of shares owned by the agency and other funds specified above, to be withdrawn from the present A.I.F., together with such additional funds or portions thereof as may from time to time be approved by the Investment Committee for inclusion in the A.I.F. #2; and be it further

RESOLVED: That the assets of cash and securities received from the withdrawal of the above-mentioned shares shall be placed in the new A.I.F. #2, evidenced by participating shares representing proportionate interests in the assets of A.I.F. #2 as of March 19, 1952, appraisal; and be it further

RESOLVED: That the Chairman and the Secretary be authorized to determine, in their discretion, what cash and securities are to be allocated from A.I.F. #1 to A.I.F. #2, representing the shares so withdrawn from the A.I.F. #1, such securities to be valued on the basis of the appraisal of the assets of the A.I.F. #1 made March 19, 1952

The Executive Committee of the Executive Board at its meeting of April 14, 1952, expressed itself as follows:

WHEREAS, at its meeting on March 27, 1952, this Committee approved the proposal made by the Investment Committee to withdraw from the Associated Investments Fund all participating shares now owned by agency funds and funds which, in the opinion of Counsel, should be withdrawn in order to leave within the Associated Investments Fund only funds the principal of which must be devoted to producing an income,

AND WHEREAS all such participating shares having been withdrawn from the Associated Investments Fund, with the result that the participating shares remaining in the Associated Investments Fund are held only by funds devoted to producing an income, now, therefore, be

RESOLVED: That the name of the Associated Investments Fund be changed to ASSOCIATED ENDOWMENTS FUND; and be it further

RESOLVED: That the new fund established as the result of withdrawal of certain participating shares from the old Associated Investments Fund, be known as the GENERAL INVESTMENTS FUND

The Associated Investments Fund #2, therefore, was redesignated the General Investments Fund (G.I.F.).

The Executive Board on October 9, 1953, took the following actions:

RESOLVED: That, the approval of Henry S. Drinker, Esq., counsel for the University and of Lybrand, Ross Bros. & Montgomery, the University's independent auditors, having been obtained, the appropriate officers of the University be authorized to transfer the assets of the Associated Endowments Fund (except for the real estate and improvements at the northeast corner of Eighth and Market Streets, Philadelphia, and the lease thereof to Lit Brothers) into the General Investments Fund of January 1, 1954; and be it further

RESOLVED: That the Associated Endowments Fund, after such transfer, retain only the real estate and improvements at the northeast corner of Eighth and Market Streets, Philadelphia, and the lease thereof to Lit Brothers; and be it further

RESOLVED: That the General Investments Fund, after such transfer, be entitled the Associated Investments Fund

The Executive Board on December 11, 1964, authorized the sale of the Lit Brothers property.

On September 15, 1965, the Lit Brothers property was purchased by the Eighth & Market Corp., a subsidiary of City Stores Company, lessee, for a total consideration of \$4,225,000 consisting of cash of \$700,000 and a 5 percent purchase money Mortgage and Note of the Eighth & Market Corp. in the original amount of \$3,525,000, dated September 15, 1965, maturing September 15, 1990, subject to a "balloon" of 50 percent.

Such cash and the above Mortgage and Note were then transferred to the A.I.F. and the A.E.F., established April 27, 1952, thereupon was dissolved.

The A.I.F. continues to hold this investment, now reduced to \$2,937,000, classified as a "residual Asset."

The Executive Committee of the Executive Board on April 24, 1952, directed that the A.I.F. (then A.E.F. and G.I.F.) be charged annually with a certain portion of salaries, wages, and charges of the budgets of the Financial Vice-President; Treasurer, including custodian charges and publications; Comptroller, "Trust Administrative Charges" were expanded subsequently to include proportionate elements of legal, auditing, and other costs directly ascribable to the management of the A.I.F.

Effective July 1, 1972, the Trustees directed that the income of the A.I.F. be assessed with an appropriate charge to cover indirect expenses attributable to supported activities, subject to the approval of Counsel, and verification by the University's independent auditors. This additional "overhead" charge reflects therefore an agreed-upon portion of such costs as heating, lighting, maintenance, insurance, and other general University services deemed appropriate in this context.

### The 1970s: The Franklin Investment Company

Since 1972 the A.I.F. has been maintained in accordance with Section 7581 of the Commonwealth of Pennsylvania Non-Profit Corporation Law of 1972.

Thus, on July 10, 1972, Franklin Investment Company (F.I.C.) was organized as a Pennsylvania business corporation of which The Trustees of the University of Pennsylvania was the sole shareholder.

On August 15, 1972, Franklin Capital Investors (F.C.I.), a partnership, was formed to advise the University with respect to investments held in the A.I.F. other than mortgages and sale/leasebacks (thereafter classified as its "Residual Assets") By means of its investment in Franklin Investment Company the University maintained a limited partnership interest in F.C.I.

On October 25, 1974, the University and Franklin Capital Investors terminated their Investment Advisory Agreement of August 1972.

On May 19, 1975, F.I.C. was converted to a nonprofit corporation under the Pennsylvania Non-Profit Corporation Law of 1972 to promote and further the investment interests of the Trustees of the University of Pennsylvania. F.I.C.'s outstanding shares of common stocks were thereupon cancelled.

Following the Pennsylvania Revised Non-Profit Corporation Law of 1972, The Trustees of the University of Pennsylvania created the Investment Board as its "other body" on June 6, 1975, when investment management was transferred from the Investment Committee to the Investment Board.

On the same date, the Investment Board and the Trustees of the University designated Franklin Investment Company as the agent and instrumentality of the University through which decisions and actions of the Investment Board were to be made.

The first meeting of the Investment Board in joint meeting with Franklin Investment Company was also held June 6.

In the capacity of its operating Company, Franklin Investment Company has since that date acted as the "amanuensis" of the Investment Board.

As the Pennsylvania Non-Profit Corporation Law of 1972 provides, the Trustees of the University of Pennsylvania are authorized, by resolution enacted within 120 days of the close of the University's fiscal year (June 30), to allocate from net realized capital gains accumulated in the A.I.F. to income, an amount which, when added to all other income received from the A.I.F. during such year, will not exceed 9 percent of the market value of the A.I.F. after deducting the amount so allocated. This transaction, however, depends upon how much the market value exceeds the aggregate "basic book" value or, principal of participating funds.\*

\* "Total Return" equals "Gain" + "Yield" or, stated another way, "Price Change" + "Income." not annualized, as percent of starting value before reinvestment.

The University, therefore, declared a Realized Capital Gains as of June 30, 1973, 1974, and 1975.

Although the University continues to administer the A.I.F. on a Total Return basis, it has made no distributions of Realized Capital Gains since June 30, 1975.

Having carefully reviewed all aspects of the matter, the University on March 30, 1979, granted The Fidelity Bank, its agent and custodian, authority to arrange for the deposit of the University's eligible securities held thereby with The Depository Trust Company (DTC), a "limited purpose trust company," New York, New York. This made the receipt and delivery of securities easier, providing for one day receipt and delivery of security loans.

On March 24, 1976, the Investment Board adopted in written form certain Long-Term Objectives and Investment Restrictions, a copy of which, revised through October 23, 1981, is available on request.

The A.I.F. is appraised weekly, monthly, and quarterly; copies of the statements are distributed to the members of the Investment Board, to Trustees on request, and to certain officers of the University. Summaries of the A.I.F. portfolio, estimated income, and performance data are submitted monthly to the Executive Board of The Trustees of the University of Pennsylvania, and to the full Board at its stated meetings.

The A.I.F. is audited on a quarterly basis.

The Investment Board meets in conjunction with the Stated Meetings of The Trustees of the University of Pennsylvania.

On April 23, 1980, the Chairman of the Investment board created an Executive Committee of the Investment Board. The Executive Committee meets three times yearly, or more frequently at the call of the Chair. Its purpose is:

- 1 To establish investment policy guidelines deemed appropriate for the respective categories of invested funds administered by the University of Pennsylvania.
- 2 To develop and periodically review an approved list of investments.
- 3 To direct Franklin Investment Company to take emergency or other investment action as necessary.

Beginning in 1981, with the approval of the Trustees, spending of endowment income earned by A.I.F. investments has been limited to a percentage of a multiyear moving average of year-end values of the shares invested in the A.I.F. with a one-year budget lead time. The spending rate will be reconsidered each year. Excess amounts of investment income will be reinvested in the principal of companion reinvestment funds, and, thereby will earn spendable income in future years. The effect of this policy, in the long term, will be to help protect the purchasing power of the endowment and, ultimately, that of the endowment income. In fiscal year 1981, this concept yielded approximately \$3,140,000 of income which has been reinvested.

In 1981 the University embarked on a program of selling covered calls (options) on selected stocks held in the A.I.F.

Chairmen of the Investment Committee and of the Investment Board for the period under review are listed below:

| <i>Investment Committee</i> | <i>Served</i>  |
|-----------------------------|----------------|
| Edward Hopkinson, Jr., Esq. | 1937 - 1966    |
| Howard Butcher III          | 1936 - 1972    |
| James M. Skinner, Jr.       | 1972 - 1974    |
| <i>Investment Board</i>     | <i>Served</i>  |
| Wesley A. Stanger, Jr.      | 1974 - 1979    |
| Julian S. Bers              | 1979 - 1980    |
| John B. Neff                | 1980 - Present |

The present membership of the Investment Board is:

#### *Trustee Members*

- Henry M. Chance II
- H. Samuel Greenawalt, Jr.
- Paul F. Miller, Jr.
- F. Stanton Moyer
- John B. Neff, *Chairman*
- Julian S. Bers (Emeritus)
- Wesley A. Stanger, Jr. (Emeritus)

#### *Non-Trustee Members*

- Wm. Richard Gordon
- Samuel M. V. Hamilton
- Adolph B. Kurz
- Richard B. Worley
- Edward G. Jordan, *Administrative Liaison*