



Testimony of Christine Shaw, Office of the Treasurer
SUBMITTED TO THE COMMERCE COMMITTEE
MARCH 9, 2017

Good morning, Senator Hartley, Senator Frantz, Representative Simmons, and all of the members of the Commerce Committee. Thank you for the opportunity to submit testimony concerning House Bill 7226, *An Act Concerning Awards from the Connecticut Arts Endowment Fund*.

This bill, if enacted, would set a spending policy for the Arts Fund that could result in greater, more consistent income for arts organizations in Connecticut, but would also have the effect of allowing, for the first time, distributions from the corpus of the Fund. Given this change in policy, and the potential for deterioration over time of the assets of the Fund, the Treasury is sharing with this Committee its assessment of the implications of such a spending policy.

Background of the Arts Endowment Fund

The Arts Endowment Fund is one of fifteen (15) funds within the Connecticut Retirement Plans and Trust Funds ("CRPTF"). With assets of roughly \$19 million, it has a unique mandate that differs from that of the State's larger pension plans. It was established under the provisions of Public Act 88-355 in order to provide interest income from a principal amount that would last in perpetuity.

In an effort to maximize income to the beneficiaries that depend on the Fund, the investment strategy was last revised by the Treasurer and approved by the Investment Advisory Council in 2012. In light of the capital market forecasts at the time, as well as the Arts Fund's objectives and liquidity needs, the asset allocation was changed from 100% fixed income to 67% core fixed income, 30% equities and 3% cash to avoid the expected erosion of the value of its corpus. Equities were introduced to increase the overall returns of the Fund.

Since the 2012 allocation was put in place through December 31, 2016, the Arts Fund portfolio earned 4.15%, while the custom benchmark returned 4.32%. Comparatively speaking, the Barclays Aggregate, a core fixed income benchmark, increased by 1.69% for the same timeframe. This demonstrates that the allocation of a portion of the Arts Fund's assets to equities has positively contributed to portfolio appreciation due to an increase in realized and unrealized capital gains.

Trends in Distributions, Growth of Corpus

Over the past five fiscal years, the market value of the Arts Fund has increased from \$17.6 million to \$19.0 million (as of June 30, 2016) -- an increase of \$1.4 million or 8.0%. Cumulative distributions in the amount of \$2.35 million have been made during this

time. There has been a general decline in distributions by the Arts Fund since 2012 – from a high of \$620,700 to the most recent distribution of \$397,354. This decline has been largely driven by the historically unprecedented low interest rate environment due to falling inflation and actions by the Federal Reserve to fight deflation. These macroeconomic factors have hampered the Arts Fund’s ability to generate income.

Even with the muted interest rate environment, the Arts Fund has been able to generate a consistent stream of income while steadily growing its corpus as shown above. The tradeoff for long term growth of the corpus, through investment in equities, is the reduced allocation to interest income generating fixed income. While dividends from the equity positions are also paid out, they are lower than the interest payments associated with fixed income investments.

Impact of a Spending Policy

If a 4% spending policy is enacted, we can expect, in the short term, that there would be a sizeable bump in the annual distributions – assuming of course, no decline in the market value of the Fund. By sizeable, we mean that distributions could average in the \$700,000 range, a noteworthy increase over the 2016 distribution of \$397,000.

And while the 4% spending policy set forth in this bill is consistent with the best practices of many endowments and not-for-profits across the country, there is a chance that the principal of the Fund may deteriorate over the long term in real dollars (and adjusted for expected inflation).

The Treasury, along with the State’s independent Investment Advisory Council, plans to conduct, in the coming months, a comprehensive asset liability study for the Fund and other plans and trusts within the CRPTF. The primary objective of that study is to consider the merits of increased exposure to return-seeking assets such as U.S. Large and Small Cap equities, private equity and real estate. While the specifics of the right mix have yet to be worked out, we estimate that with a shift in equities from 30% to 60%, for example, the odds of preserving the corpus over a 30-year horizon with a 4% spending policy are roughly 50%. Simply put, this means that given current expectations for capital markets going forward – a somewhat inexact science, to be sure – there is a 1 in 2 chance that the corpus of the Fund will decline in real dollars. That said, there is also the same probability that the Fund could grow.

At the end of the day, it is for the Legislature to decide how the assets of the Fund are to be used. Should there be statutory approval of a spending policy, then the Treasury can fashion an appropriate investment strategy to maximize income with reasonable risk, while minimizing erosion of the Fund’s corpus.

Thank you for the opportunity to offer input on this bill.