

VII. STANDING COMMITTEES

B. Finance, Audit and Facilities

Investment Program Update

For information only.

Attachment

Investment Program Update



Investment Program Update

*A Report to the Board of Regents
May 12, 2011*

Treasury Office
University of Washington

Investment Program Update

A Report to the Board of Regents

May 12, 2011

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Executive Summary

- The Board of Regents approved significant policy revisions in 2010. An anticipated lower return environment compelled a reduction in spending. Asset allocation changes simplified the portfolio structure enabling an integrated management process and improving the risk profile.
- UWINCO thoroughly examined roles and responsibilities of the committee, CIO and staff in 2010. Furthermore, UWINCO performed an in-depth review of managers in both the Consolidated Endowment Fund (CEF) and Invested Funds (IF).
- UW distinguishes itself by a globally integrated investment team and management style highlighted by significant exposure to emerging markets. Since UW has a small endowment, execution of this global strategy requires thoughtful management of human resources.
- The CEF is conservatively positioned and includes the following characteristics:
 - Enhanced liquidity
 - Reduced probability of impairment risk
 - Underperformance in equity bull markets
- The IF are managed to stabilize campus support and enhance long term performance through a combination of:
 - High quality fixed income
 - Diversified CEF exposure

Roles and Responsibilities

Roles & Responsibilities: Investment Program Overview

The Board of Regents of the University of Washington is vested by statute with responsibility for the management of the properties of the University, including the Consolidated Endowment Fund and other University funds.

Investment program oversight resides with the Finance, Audit and Facilities Committee (FAF), a subcommittee of the Board of Regents. In May 2001, the Board approved the establishment of an advisory committee, the University of Washington Investment Committee (UWINCO), consisting of Board members and external investment professionals. In 2004, the Board approved the appointment of the University's first Chief Investment Officer (CIO) to manage the day to day activities of the investment portfolios.

From the "Statement of Investment Objectives and Policy for the Consolidated Endowment Fund"

Roles & Responsibilities: Governance

Board of Regents

Sets investment policy

- Spending rate
- Strategic asset allocation
- Delegations

Appoints investment officer/advisors

- Chief Investment Officer (CIO)
- UWINCO members
- Investment consultants

Program review

- Program oversight/accountability

UWINCO

Advises CIO

- Investment planning
- Asset allocation
- Manager identification
- Market trends

Advises the Board of Regents

- Investment program oversight
- CIO oversight

Chief Investment Officer (CIO)

Implements investment program

- Day-to-day management
- Tactical asset allocation
- Manager appointments
- Manager terminations
- Risk management
- Research

Monitors results

- Performance reporting

Governance of the investment program is defined around clearly established roles and responsibilities.
In 2010, UWINCO focused on clarifying actions required to meet those roles.

Roles & Responsibilities: 2010 Policy Changes

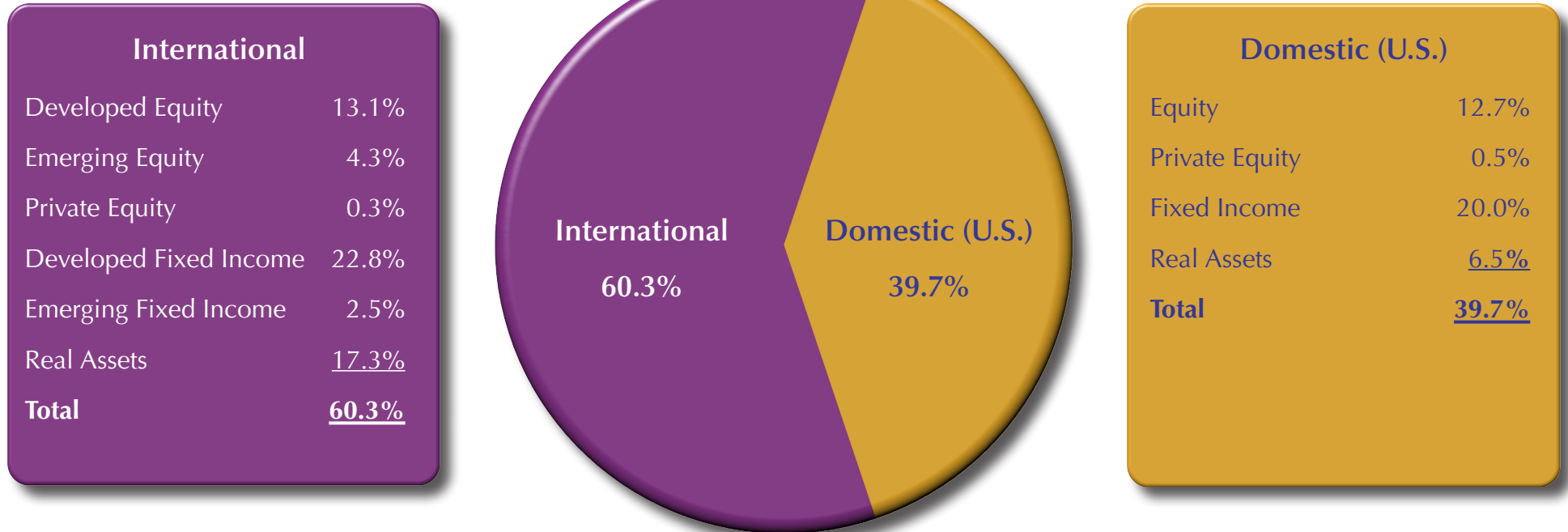
The Board of Regents approved significant policy revisions in 2010. The changes outlined below simplified the portfolio structure enabling an integrated management process and improving the risk profile.

- Revised spending policy – 5% of a five-year rolling average
- Simplified categories of investments – Capital Appreciation & Capital Preservation
- Enhanced liquidity and monitoring controls

Capital Markets

Capital Markets: Global Composition

\$113t as of December 31, 2010



Data compiled from multiple sources as of 12/31/10. Balances do not include currency or derivatives.

Over the last 6 years the CEF's exposure to emerging markets has increased from 4% to 17%.

Capital Markets: Equity Indices Movements

The Real (Inflation-Adjusted) Mega-Bears

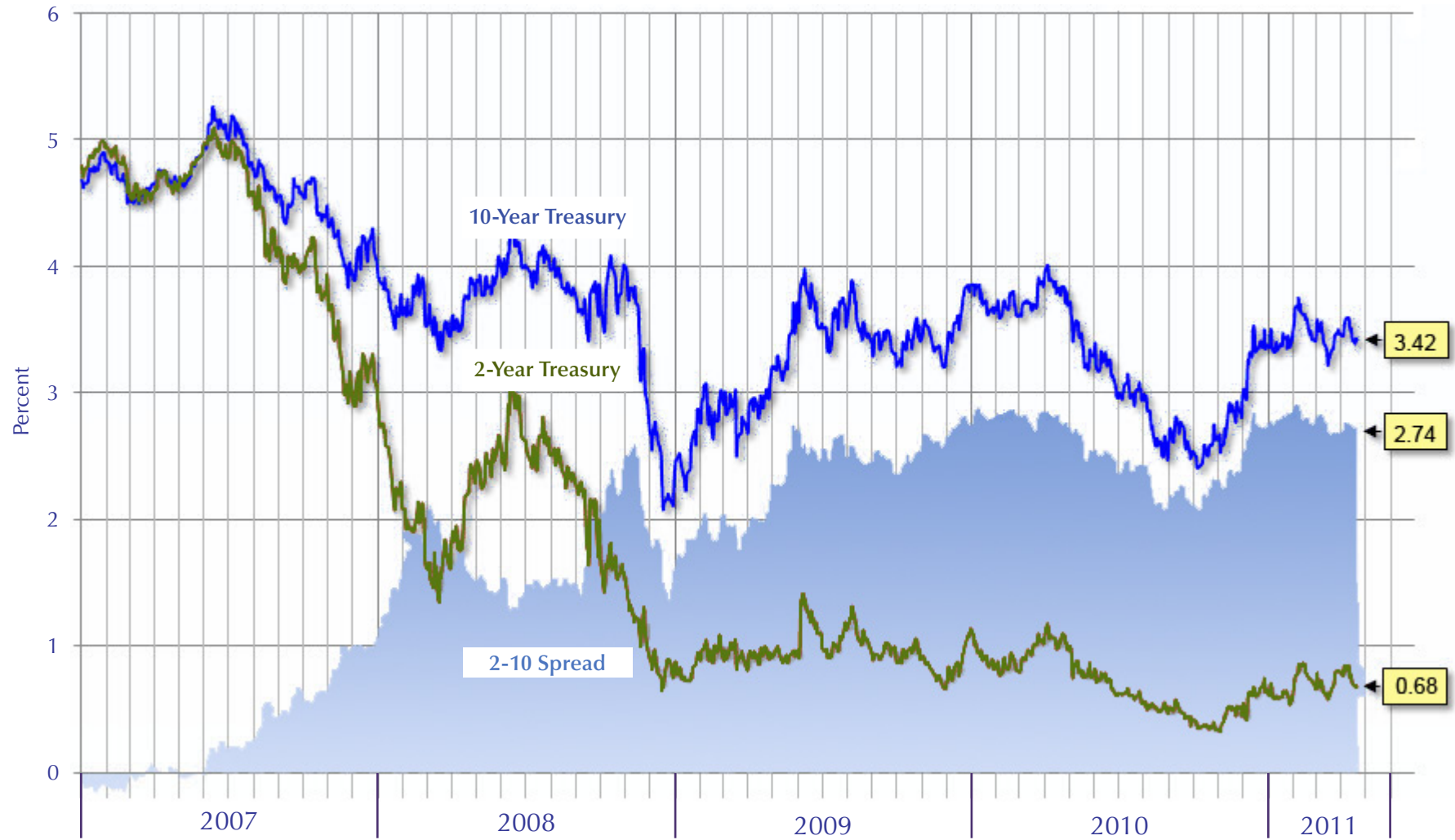


Source: dshort.com

The Mega-Bear comparison starts the current bear in 2000. Why? In real terms, the S&P 500 hits its all-time high in March of that year. The nominal high in 2007, when adjusted for inflation, was actually 16% below the 2000 real high.

Capital Markets: Treasury Yields

2- and 10- Year Treasury Yields* since 2007 (w/2-10 spread in background)



*As of April 21

Source: dshort.com

Consolidated Endowment Fund

Profile: Consolidated Endowment Fund (CEF)

Description: A permanent fund established through private gift funds to support the program specified by the donor.

Size: \$2.1 billion at December 31, 2010 including \$0.4 billion of operating funds.

Composition: Over 3,200 individual endowments which are comingled for investment purposes similar to a mutual fund.

Primary Objective: To preserve the purchasing power of each endowed gift over time. This objective drives the discussion on spending policy, return requirements, long-term asset allocation and risk tolerance.

Secondary Objective: To provide a steady stream of income to support individual programs. This objective influences the spending formula used in calculating the income distributions.

Profile: CEF Characteristics

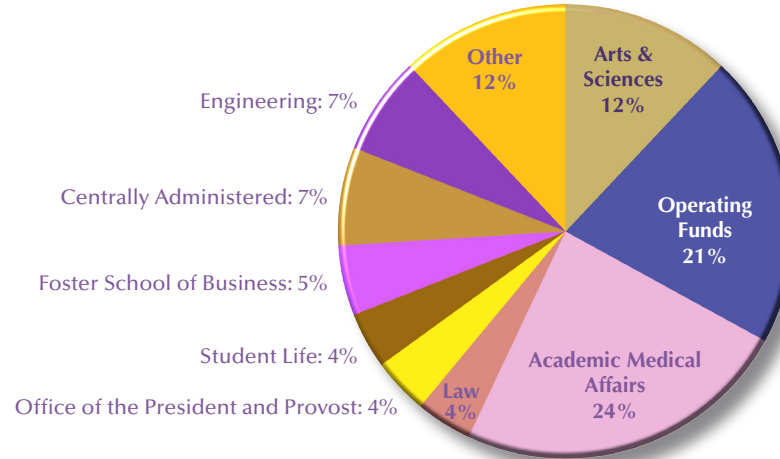
as of December, 31 2010 (\$=m)

Endowed Program Support¹

Principal by Purpose

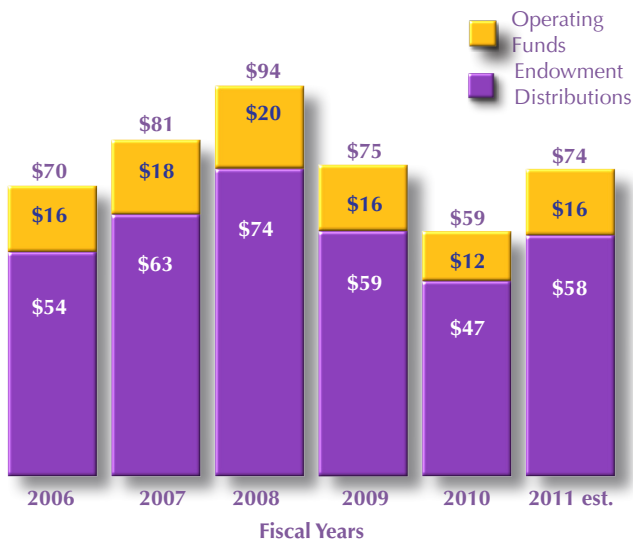


Principal by School and College



¹ Includes operating funds invested in the CEF.

Endowed Dollars Distributed

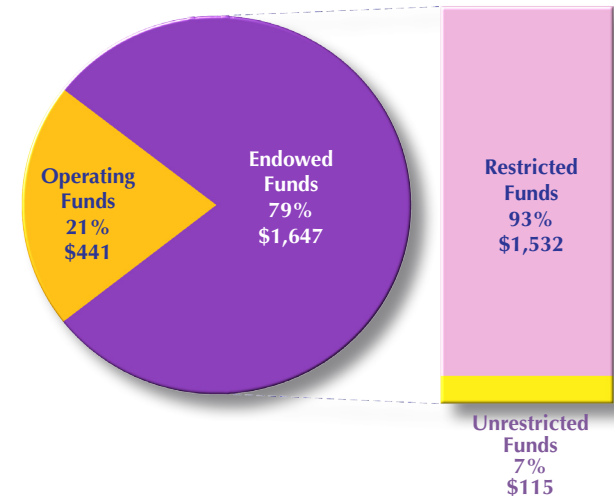


Endowment Distributions as a % of UW Revenues

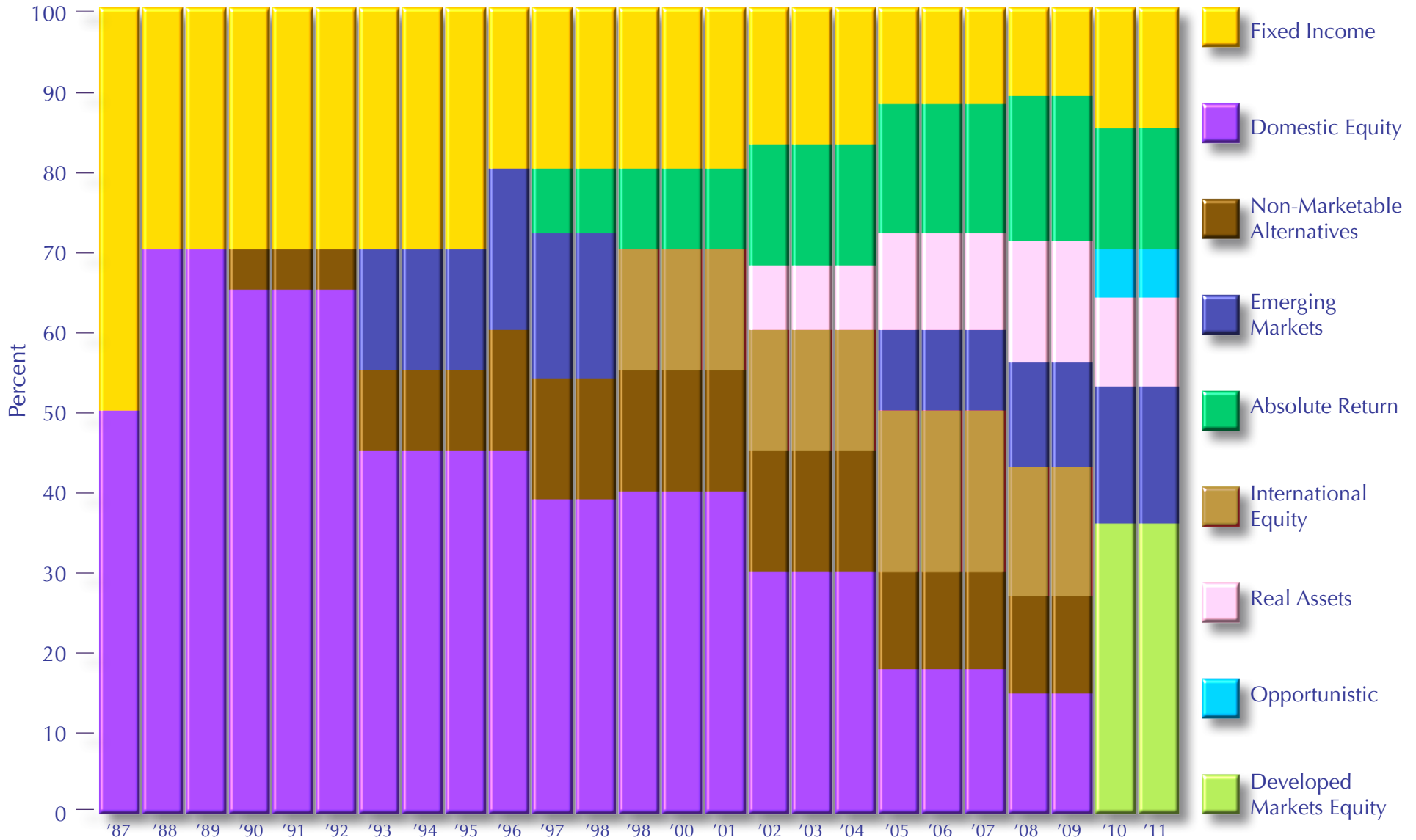
Fiscal Years	Annual UW Revenues	Endowment Distributions	%
2006	\$3,455	\$70	2.0%
2007	\$3,666	\$81	2.2%
2008	\$3,427	\$94	2.7%
2009	\$3,054	\$75	2.5%
2010	\$3,923	\$59	1.5%
2011*	\$3,500	\$74	2.1%

* estimated

Endowment Composition \$2,088



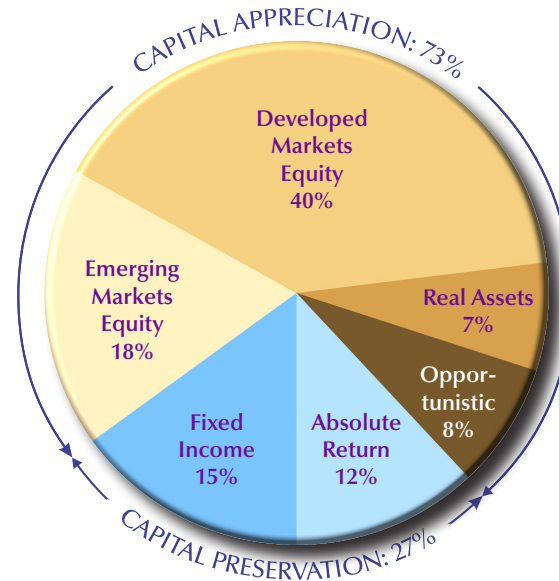
Profile: CEF Policy Asset Allocation



Over the past twenty-five years, the CEF has grown significantly in size and complexity. The portfolio today is diversified across many dimensions: asset classes, countries, sectors, investment styles and managers.

Positioning: CEF Portfolio

Asset Allocation as of December 31, 2010 (\$=m)

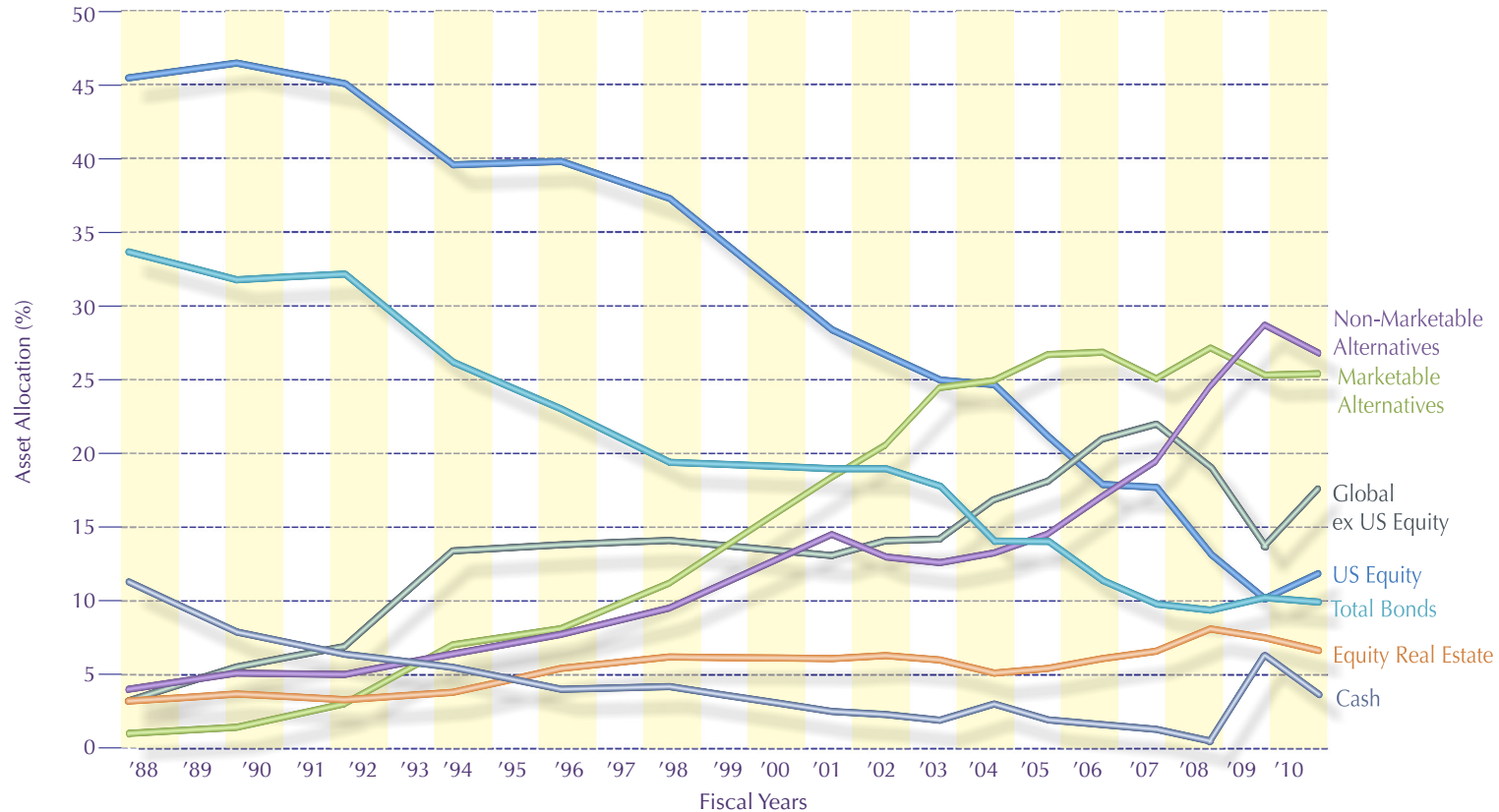


	Current Allocation (\$m)		Target	Policy Range
Emerging Markets Equity	\$369	18%	17%	
Developed Markets Equity	\$840	40%	36%	
Real Assets	\$143	7%	11%	
Opportunistic	\$166	8%	6%	
Capital Appreciation	\$1,518	73%	70%	55%–85%
Absolute Return	\$248	12%	15%	
Fixed Income	\$323	15%	15%	
Capital Preservation	\$571	27%	30%	15%–45%
Total CEF	\$2,088	100%		

Current positioning favors Capital Appreciation led by public equities.

Positioning: Asset Allocation Trends at Other Universities

June 1988–June 2010



	'88	'90	'92	'94	'96	'98	'00	'02	'04	'06	'08	'10	UW '10
US Equity	45.3	46.3	44.9	39.4	39.6	37.1	31.2	26.5	24.5	17.7	13.0	11.6	11.2
Global ex US Equity	2.9	5.2	6.6	13.1	13.5	13.8	13.1	13.8	16.6	20.7	18.8	17.3	29.8
Marketable Alternatives	0.7	1.1	2.7	6.7	7.8	10.9	15.7	20.3	24.7	26.6	26.9	25.1	20.6
Non-Marketable Alternatives	3.7	4.8	4.7	6.1	7.4	9.2	12.5	12.7	13.0	16.8	24.3	26.5	15.7
Total Bonds	33.4	31.5	31.9	25.9	22.7	19.1	18.8	18.7	13.8	11.1	9.1	9.6	6.3
Equity Real Estate	2.9	3.4	3.0	3.5	5.1	5.9	5.8	6.0	4.8	5.8	7.8	6.3	9.6
Cash	11.0	7.6	6.1	5.2	3.7	3.9	2.8	2.0	2.7	1.3	0.2	3.3	6.9

Source: Cambridge Associates

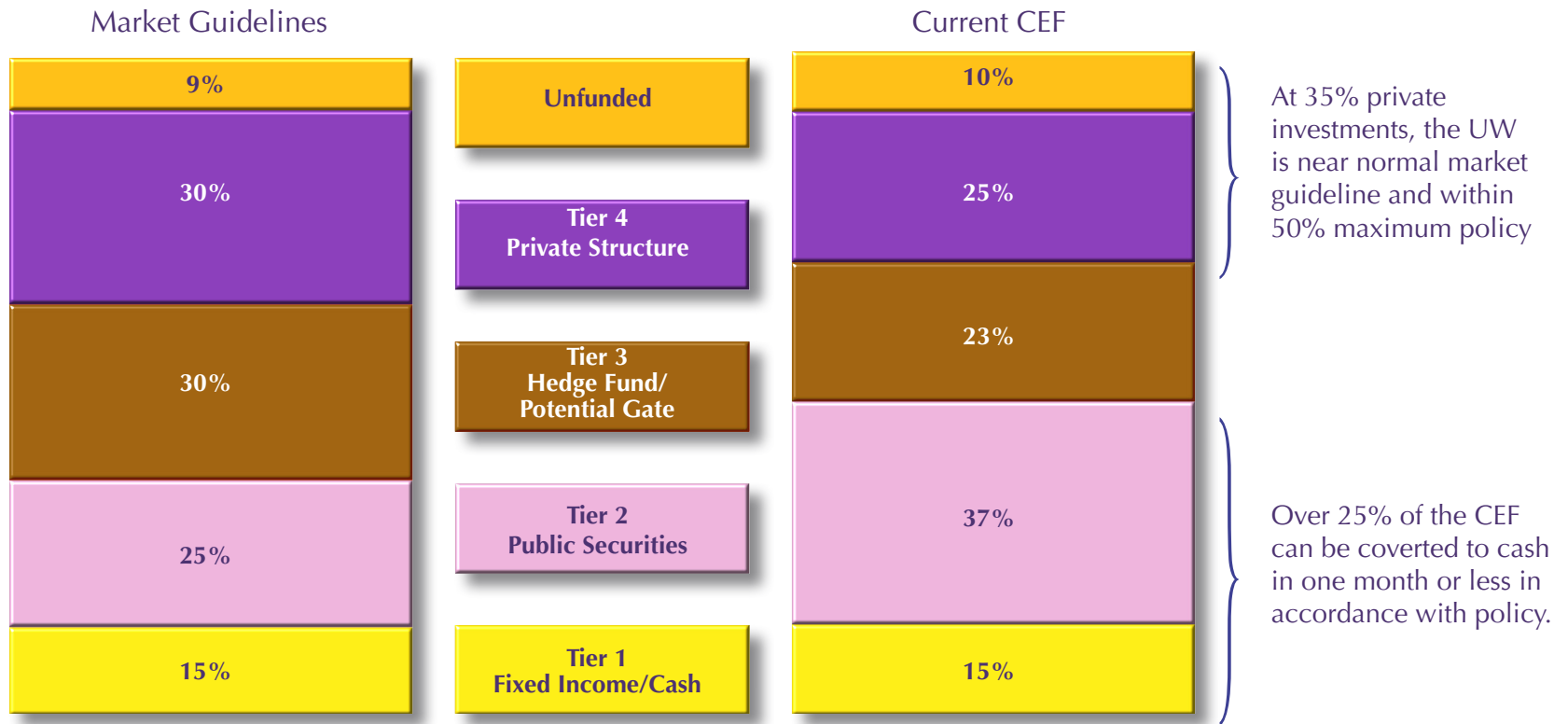
Asset allocation trends among large endowments mirror the UW's experience. However, the UW has a lower allocation to private investment (non-marketable alternatives) and a higher allocation to international equities.

Liquidity: Philosophy, Guidelines and Implications

- Our **philosophy** is to manage liquidity to a conservative case:
 - Ensure solvency represents the only downside risk
 - Accommodate lack of a borrowing policy
 - Avoid UW being forced sellers of distressed assets
 - Provide UW flexibility to capitalize on market dislocations
- Our **guideline** is to maintain sufficient liquidity to meet 2+ years of liabilities:
 - Project distributions to campus
 - Forecast capital calls to private equity funds
- The **implications** for our portfolio:
 - Limit exposure to private funds where UW does not control liquidity
 - Continue high exposure to fixed income with limited downside and excellent liquidity

Liquidity: Current CEF versus Guidelines

As of December 31, 2010



The efficient management of liquidity suggests a level that provides for two years of endowed program distributions along with sufficient capital to meet contractual commitments to private investment managers. Heightened sensitivity to illiquidity risk since 2008 financial crisis led to enhance liquidity monitoring and controls.

Spending and Inflation: Required CEF Returns

Total Nominal Return* Required to Meet the Long Term Spending Target

Endowment Distributions	4.0%	Long Term Policy Rate
Advancement Office	0.8%	} Administrative Fee
Investment Office	0.2%	
Expected Inflation	3.0%	Consumer Price Index
Total Return Required	8.0%	

* Return is assumed net of investment fees (manager, consulting, custodial and legal) of approximately 50 basis points.

Required Nominal Return Matrix

Distribution Rate plus Administrative Fees

	3.0%	4.0%	5.0%	6.0%	7.0%
1.0%	4.0%	5.0%	6.0%	7.0%	8.0%
2.0%	5.0%	6.0%	7.0%	8.0%	9.0%
3.0%	6.0%	7.0%	8.0%	9.0%	10.0%
4.0%	7.0%	8.0%	9.0%	10.0%	11.0%
5.0%	8.0%	9.0%	10.0%	11.0%	12.0%
6.0%	9.0%	10.0%	11.0%	12.0%	13.0%
7.0%	10.0%	11.0%	12.0%	13.0%	14.0%
8.0%	11.0%	12.0%	13.0%	14.0%	15.0%

Inflation

Long Term spending plus inflation rate estimate.

Program distributions, administrative fees and inflation are critical factors in defining a sustainable level of program support.

Spending: Impairment Risk

	Spending Level	Impairment Risk	
	6.5%	64.0%	
	6.0%	53.0%	
	5.5%	41.0%	
The spending level includes distributions to endowed programs and administrative fees.	5.0%	28.0%	Impairment risk is the probability of a real drop in endowment value over a fifty year period.
	4.5%	19.0%	
	4.0%	11.0%	
	3.5%	7.0%	
	3.0%	3.0%	

An endowed institution balances the competing demands of current and future generations. 2010 policy changes to spending and asset allocation reduced the probability of impairment risk by nearly 50%.

Performance and Risk: CEF

As of December 31, 2010

		<u>1 Year</u>	<u>5 Year</u>	<u>10 Year</u>	<u>15 Year</u>	<u>20 Year</u>
RETURN	Total CEF Return	11.6%	5.1%	6.0%	9.2%	10.2%
	Policy Benchmark ¹	10.9%	5.9%	5.6%	8.7%	10.1%
	70/30 Market Benchmark ²	12.6%	3.6%	3.0%	6.8%	8.7%
	Peer Quartile Ranking ³	2nd	2nd	3rd	NA	NA
	Return Contribution (m)	\$219	\$451	\$868	\$1,398	\$1,683
RISK	CEF Sharpe Ratio⁴	1.51	0.27	0.41	0.60	0.72
	Policy Benchmark Sharpe Ratio	1.08	0.34	0.35	0.52	0.67

¹ Policy Benchmark is a blend of market indices weighted to reflect the strategic asset allocation of the CEF.

² 70% S&P 500 plus 30% Government Bonds.

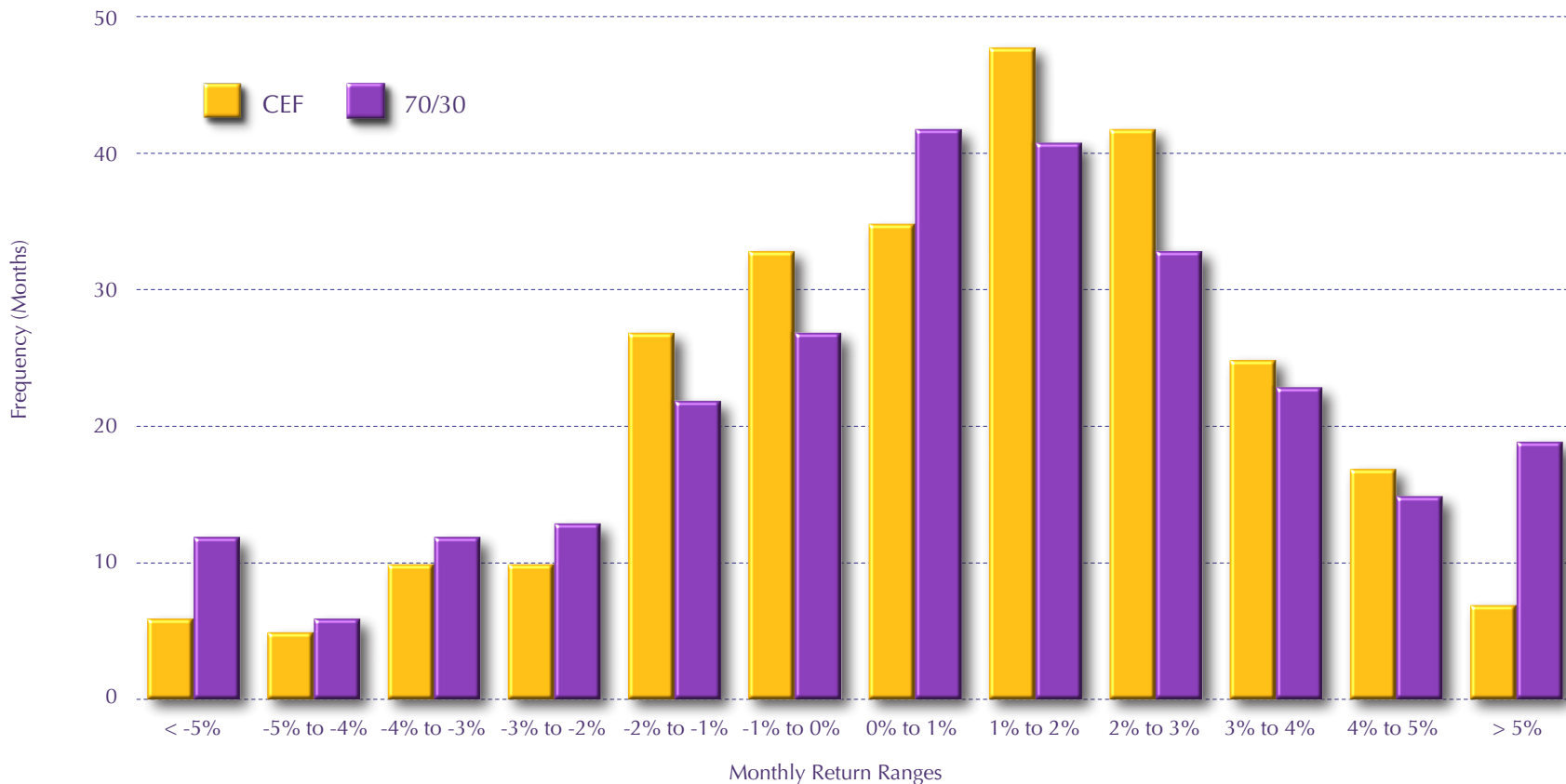
³ Cambridge Associates Top 50 Colleges & Universities.

⁴ The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance. The Sharpe ratio is calculated using standard deviation and excess return over the risk-free rate to determine reward per unit of risk.

The CEF outperformed the policy benchmark over most periods with a better risk profile.

Performance and Risk: CEF Distribution of Returns

CEF Return Histogram Versus 70% S&P500 and 30% Government Bonds Inception through December 31, 2010

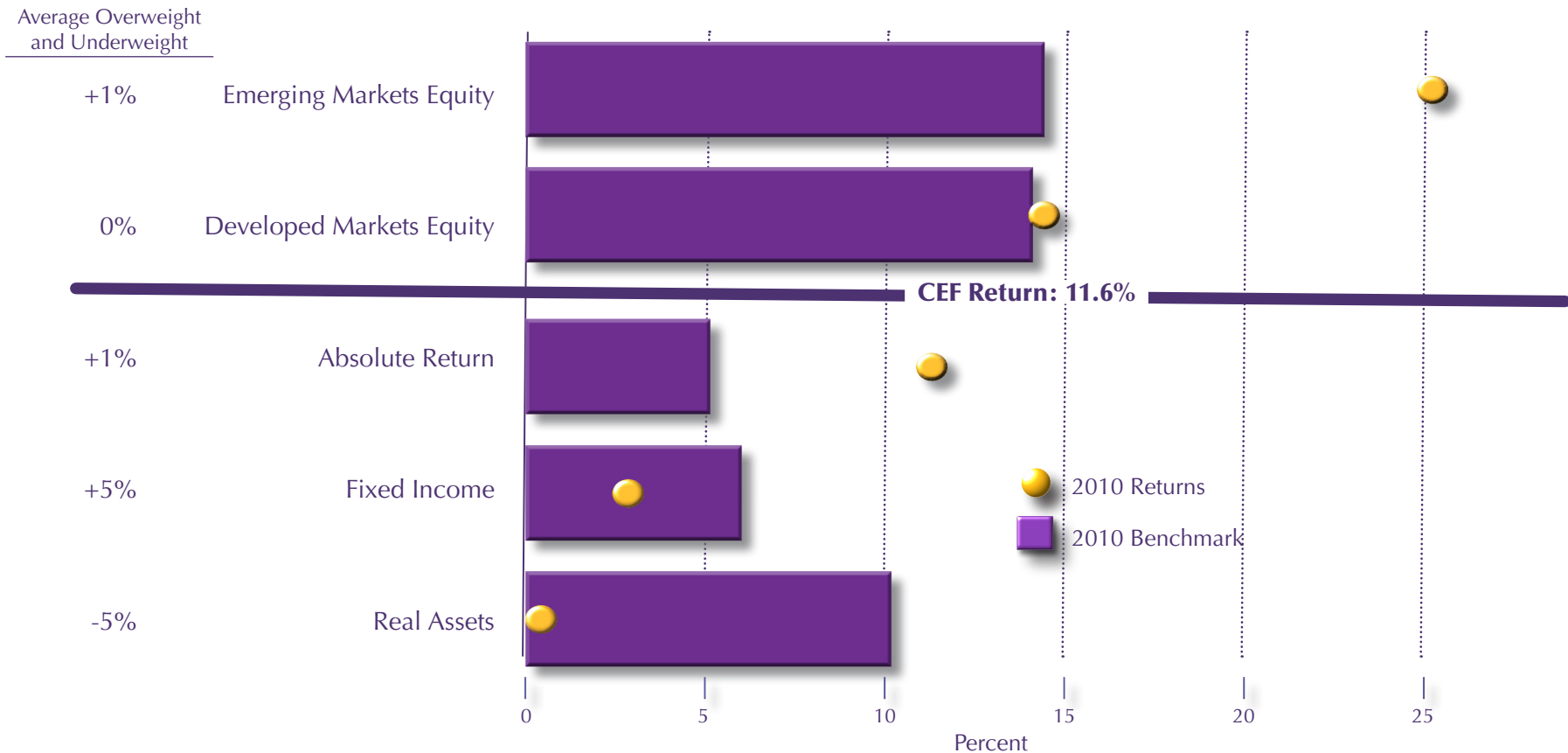


CEF Performance Recap through December 31, 2010

	<u>1 Year</u>	<u>5 Year</u>	<u>10 Year</u>	<u>15 Year</u>	<u>20 Year</u>	<u>ITD (11/88)</u>
Total CEF Return	11.6%	5.1%	6.0%	9.2%	10.2%	10.2%
70/30 Benchmark	12.6%	3.6%	3.0%	6.8%	8.7%	7.4%

The CEF has more stable returns relative to a passive portfolio.

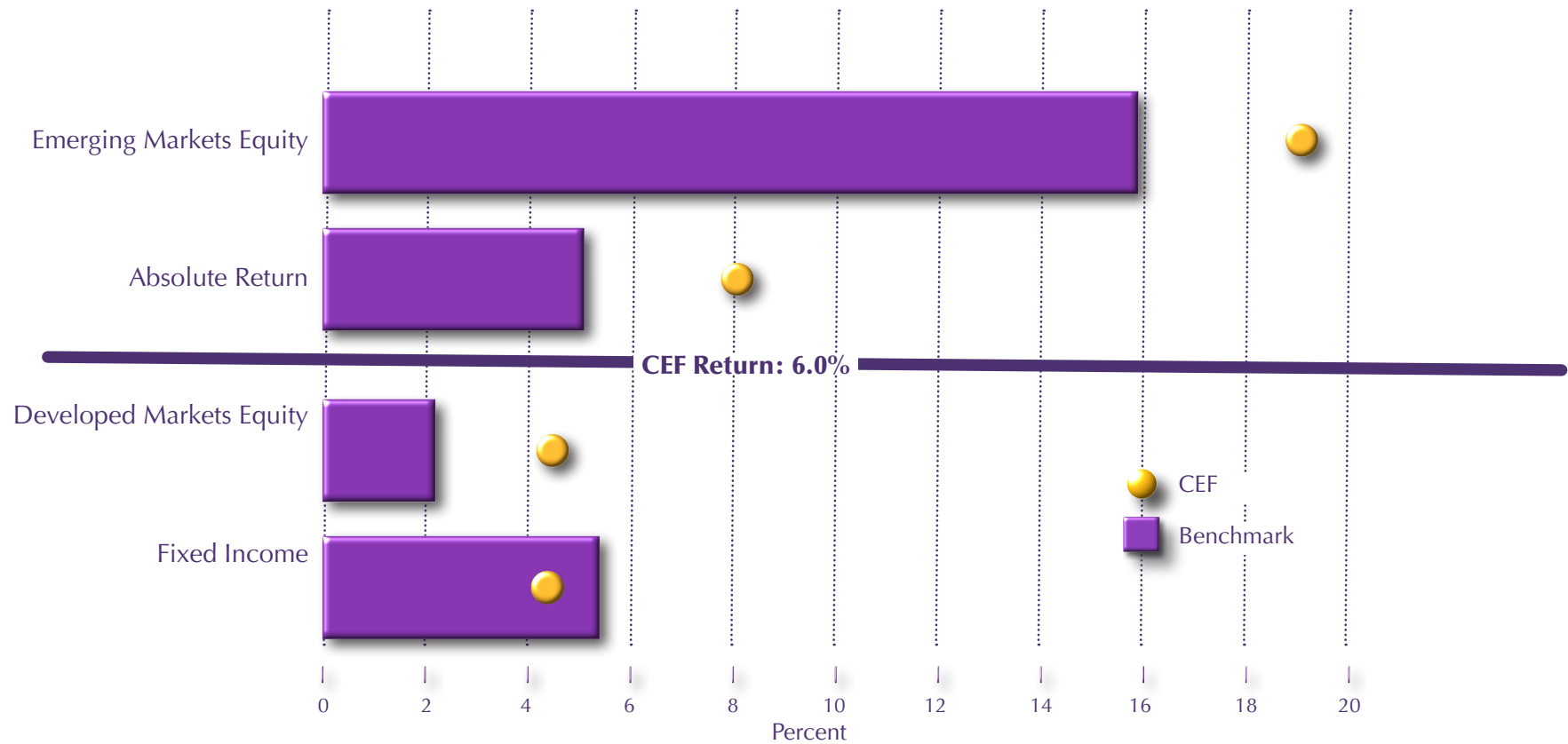
Performance: 2010 by Asset Class



Note: Opportunistic strategy commenced 7/1/2010. Six month return of 6.2% is not presented on annual return chart but is included in the overall CEF return.

All strategies had positive returns for the year led by developed and emerging markets.

Performance: Ten-Year Returns by Asset Class



Note: Opportunistic Strategy commenced 7/1/2010 and has a six month return of 6.2%. Real Assets Strategy commenced 1/1/2004 and has a seven year return of 4.0%. The strategies are not presented on the ten-year return chart, but their returns are included in the overall CEF return.

All strategies had positive returns for the ten-year period led by emerging markets and absolute return.

Invested Funds

Profile: Invested Funds (IF)

Description: The operating funds of the University.

Size: \$1.2 billion at December 31, 2010 plus \$0.4 billion invested in CEF units.

Composition: Institutional funds (35%) and funds on deposit by campus departments (65%).

Financial Objective: To meet the day-to-day financial obligations of the University as they come due. To support University initiatives and programs.

Investment Objective: To achieve investment returns above those of money market instruments.

Depositor Time Frame: Short to limited term.

University Guarantees: Access to funds on demand. Principal guaranteed.

Profile: IF Depositors

Average Cost Basis for the fiscal year ended June 30, 2010 (\$ 000's)

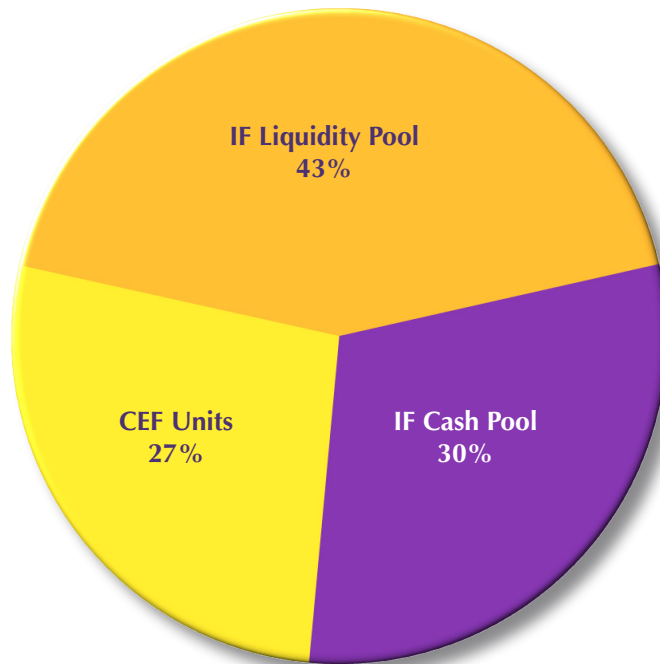
Campus Depositors Funds ¹			Institutional Funds		
UW Medicine	\$345,801	25.0%	General Institutional Funds	\$399,924	28.9%
Insurance Funds	77,403	5.6%	Reserves	79,457	5.7%
Grants	53,222	3.8%			
Office of Research	51,679	3.7%			
Auxiliary Services	45,297	3.3%			
College of Arts & Sciences	38,132	2.8%			
College of Engineering	36,401	2.6%			
Foster School of Business	22,431	1.6%			
Student Facilities & Fees	13,544	1.0%			
All Others	219,934	15.9%			
Total	\$903,844	65.3%	Total	\$479,381	34.7%

¹ Includes gifts, private grants, royalty funds and auxiliary reserves.

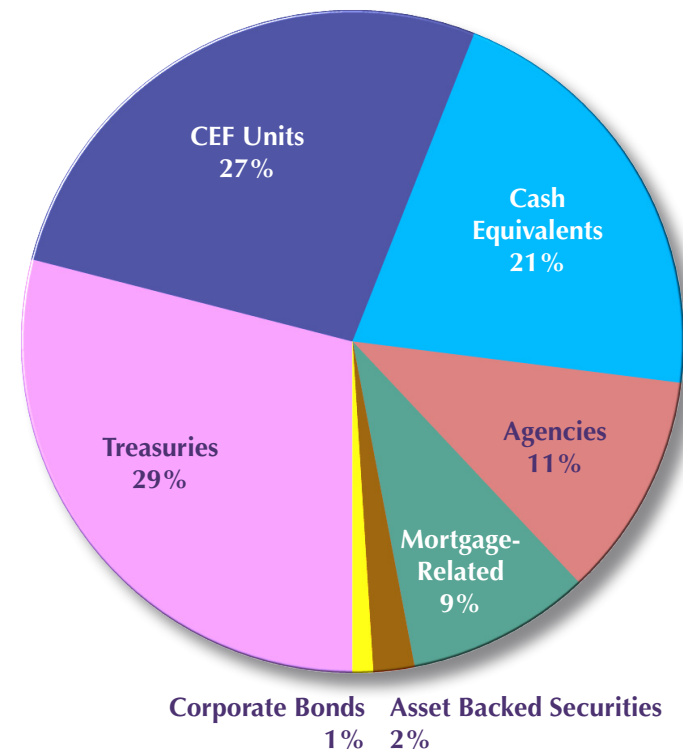
Positioning: IF Asset Allocation

As of December 31, 2010

By Pool



By Asset Type



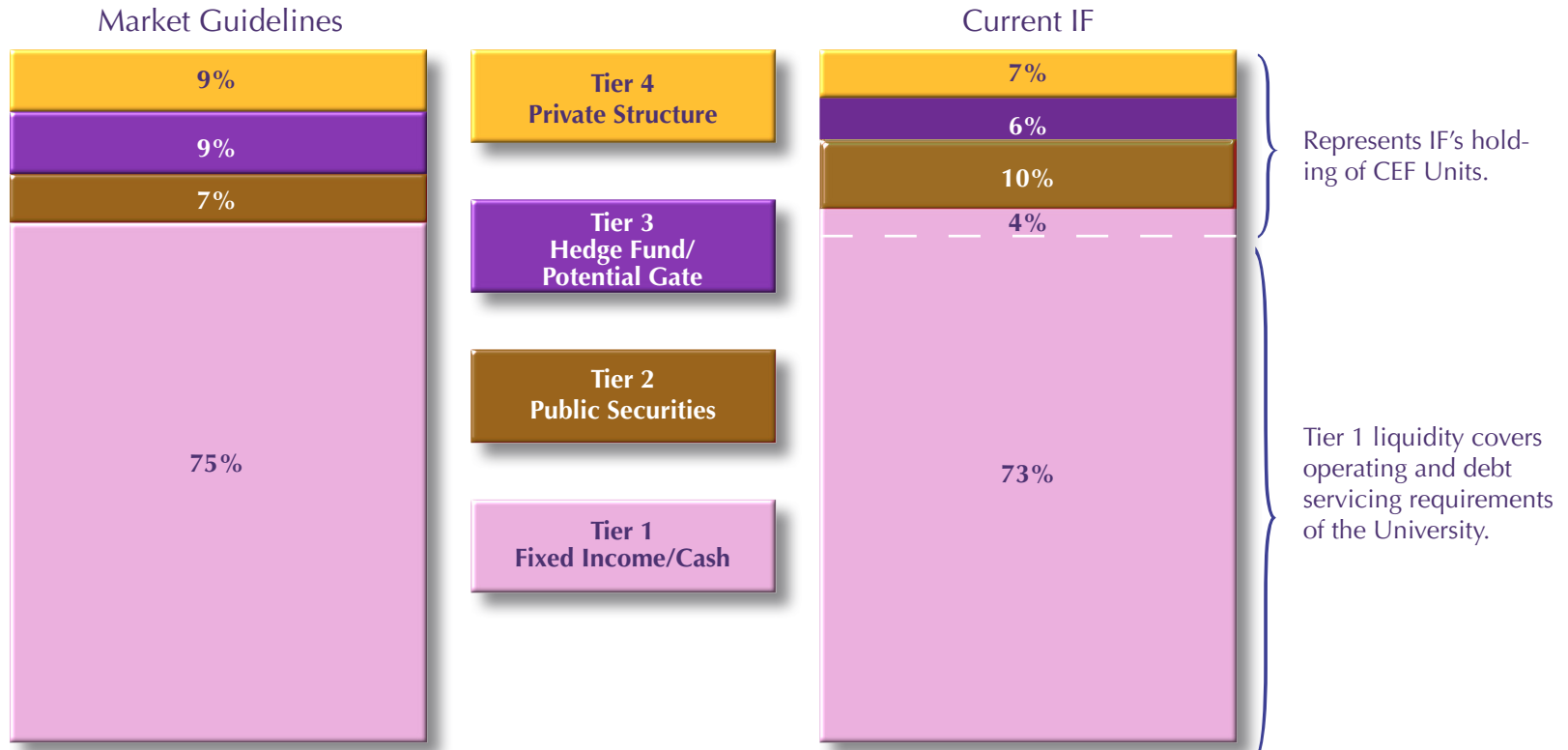
	Fund Allocation (\$m)		Range	Duration in Years		Guidelines
	Actual	Maximum		Actual	Maximum	
Cash Pool	\$480	30%	10%–40%	0.4	3.0	Average quality of "AA"
Liquidity Pool	\$697	43%	30%–60%	3.5	4.2	Average quality of "AA" ¹
Total Cash & Liquidity Pool	\$1,177	73%				
CEF Units held by IF	\$441	27%	15%–40%			
Total Invested Funds	\$1,618	100%				

¹ At least 25% in US Gov't and its agencies

Invested Funds are highly liquid with CEF units providing enhanced returns.

Positioning: Current IF versus Guidelines

As of December 31, 2010



Invested Funds are managed to protect the principal and meet the liquidity requirements of the University.

Performance and Risk: IF

As of December 31, 2010

		<u>1 Year</u>	<u>5 Year</u>	<u>10 Year</u>	<u>15 Year</u>	<u>20 Year</u>
RETURN	Total IF Return including CEF units	5.8%	4.5%	5.0%	6.4%	7.1%
	Policy Benchmark ¹	5.4%	5.2%	4.8%	6.4%	7.0%
	Total IF Return excluding CEF units	3.7%	4.4%	4.6%	5.2%	5.8%
	Policy Benchmark ¹	3.2%	4.7%	4.6%	5.1%	5.6%
MARKET	Three Month T-Bill	0.1%	2.3%	2.3%	3.2%	3.6%
RISK	IF Sharpe Ratio²	3.5	0.7	1.0	1.3	1.5
	Policy Benchmark Sharpe Ratio	2.6	1.0	0.9	1.3	1.5

¹ Policy Benchmark is a blend of market indices weighted to reflect the strategic asset allocation of the IF.

² The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance. The Sharpe ratio is calculated using standard deviation and excess return over the risk-free rate to determine reward per unit of risk.

**The inclusion of CEF exposure in the IF portfolio enhanced performance in 2010.
Over the long term, CEF exposure has improved the performance of IF by over 1% per annum.**