

Endowment Management Review



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ENDOWMENT MANAGEMENT REVIEW

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Governance

TREASURY ASSETS¹ AS OF 12/31/07—\$3.4 BILLION

Dollars in Millions



Endowment & Similar Funds

| | |
|------------------------------------|-----------------------|
| Endowment Funds | \$1,760 |
| Operating Funds | <u>432</u> |
| Consolidated Endowment Fund | 2,192 |
| Life Income Trusts | 100 |
| Outside Trusts | 58 |
| Non-CEF Endowments | 24 |
| Permanent Fund ⁶ | <u>27</u> |
| | <u>\$2,401</u> |

Operating & Reserve Funds

| | |
|---|-----------------------|
| Invested Funds ^{2,3} | \$944 |
| Bond Retirement Fund ⁴ | 5 |
| Building Fund ⁴ | 26 |
| Debt Service Reserve Funds ⁵ | 9 |
| Bond Proceeds ⁷ | <u>39</u> |
| | <u>\$1,023</u> |

1. Includes assets whose management falls under the auspices of the Finance & Audit Committee of the Board of Regents. Excludes Metro Tract and Forest Trust Lands. All dollar amounts are expressed in millions and represent market values.
2. The Invested Funds holds Consolidated Endowment Fund units valued at \$432. To avoid double counting, the dollars are included only in the CEF totals.
3. In June 2002, the Board of Regents authorized the establishment of a captive insurance company, Portage Bay Insurance(PBI). The previous insurance vehicle, the Self Insurance Revolving Fund(SIRF), will close after existing claims are resolved. Current balances: PBI \$72.6 SIRF \$3.0.
4. General obligation bond reserve fund on deposit with the state of Washington.
5. Required reserve funds for locally issued bonds (2002 Housing & Dining \$1.6, 2004 Housing & Dining \$0.6, 2004 Parking \$1.6, Roosevelt 1 \$3.3 and Roosevelt 2 \$2.0).
6. Proceeds from sale of land grants and subsequent investment returns on deposit with the state of Washington.
7. Construction project funds which have not yet been disbursed (IMA \$7.9, Genome/R&T \$13.6, Parking \$6.1, Global Health Labs \$0.02 and 2007 General Revenue Bond \$11.8)

KEY INVESTMENT DECISIONS

INVESTMENT POLICY

Spending policy
Return requirements
Long-term asset allocation
Risk preference
Constraints

-
- *Established and approved by the **Board of Regents.***

STRATEGY

Active / passive
Internal/external management
Diversification
Portfolio structure
Market timing
Rebalancing
Derivative usage

-
- *Implemented by the **Chief Investment Officer.***
 - *Advised by **UWINCO.***

INVESTMENT MANAGEMENT

Manager identification
Manager due diligence
Manager appointment
Manager guidelines
Manager monitoring
Manager termination

-
- *Implemented by the **Chief Investment Officer.***

ASSESSMENT

Performance measurement
Risk management
Policy evaluation

-
- *Overseen by the **Finance, Audit and Facilities Committee of the Board of Regents.***
 - *Advised by **UWINCO.***
 - *Provided by the **Chief Investment Officer.***

KEY INVESTMENT ROLES

| BOARD OF REGENTS | UNIVERSITY OF WASHINGTON INVESTMENT COMMITTEE (UWINCO) | CHIEF INVESTMENT OFFICER (CIO) |
|--|---|--|
| <p>Sets investment policy</p> <ul style="list-style-type: none">• Spending rate• Strategic asset allocation• Delegations <p>Appoints investment officers/advisors</p> <ul style="list-style-type: none">• Chief Investment Officer• UWINCO Members• Investment Consultants (FAF) <p>Reviews results</p> <ul style="list-style-type: none">• Investment program oversight / accountability | <p>Advises the CIO</p> <ul style="list-style-type: none">• Investment planning• Asset allocation• Manager identification• Market trends <p>Advises the Board of Regents</p> <ul style="list-style-type: none">• Investment program oversight | <p>Implements investment program</p> <ul style="list-style-type: none">• Day to day investment program management• Tactical asset allocation• Manager appointments / terminations• Risk management• Research <p>Monitors results</p> <ul style="list-style-type: none">• Performance reporting |

UNIVERSITY OF WASHINGTON INVESTMENT COMMITTEE (UWINCO)

Role: Advisory committee established by the Board of Regents in 2001

Purpose: To advise the Board of Regents, the CIO and the administration on matters relating to the management of the University's investment portfolios. This includes but is not limited to overall asset allocation, performance goals, new investment strategies, strategy implementation, manager identification and due diligence.

Membership: Up to ten members of which two will be Regents.

Appointment: Individual members approved by the Board of Regents.

Term: Three years, renewable for two consecutive terms (nine years).

Criteria for Membership: Investment expertise in specialized markets (private equity, hedge funds, real assets, international markets); access to desirable managers/funds; strategic focus; commitment to the University of Washington.

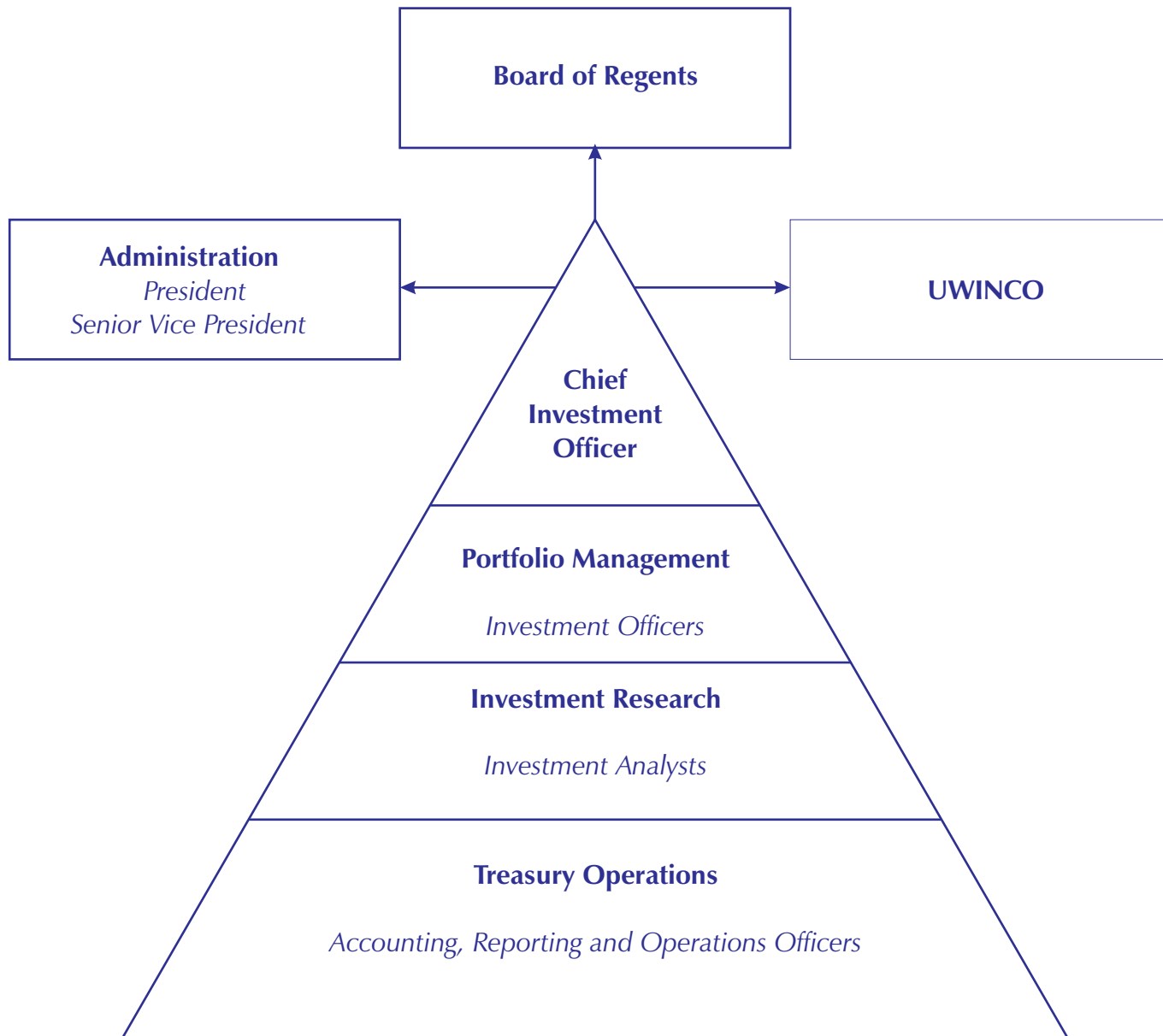
UWINCO Chair: Chair of the Finance, Audit and Facilities Committee or a Regent designee.

Meeting Frequency: Quarterly

Regent Members: Jeff Brotman (chair), Fred Kiga

Non-Regent Members: David Bonderman, Jeff Greenstein, Michael Larson, Mary Pugh

INVESTMENT DEPARTMENT ORGANIZATION

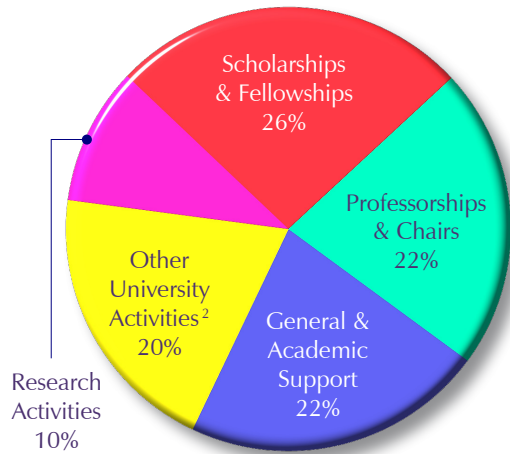


Endowment Goals

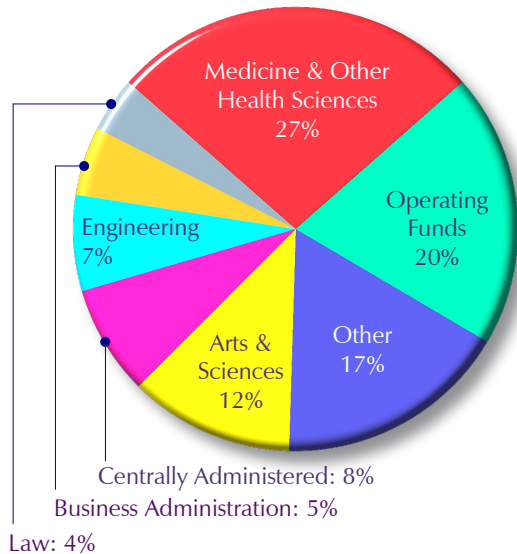
ENDOWMENT OVERVIEW

Endowed Program Support as of 6/30/07¹

By Purpose



By School & College

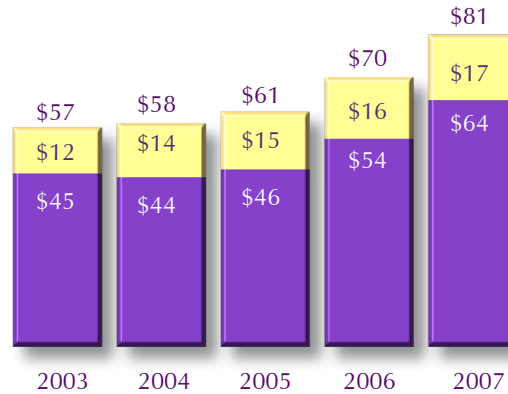


¹ Total number of endowments was 2,500 at 6/30/07.

² Includes operating funds invested in the CEF.

Endowed Distributions \$ = Millions

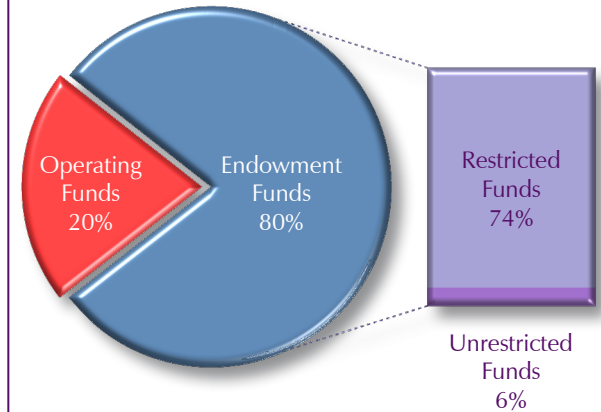
Dollars Distributed



| Fiscal Years | Annual UW Revenues | Endowment Distributions | Percent |
|--------------|--------------------|-------------------------|---------|
| 2003 | \$2,731 | \$45 | 1.6 |
| 2004 | \$2,841 | \$44 | 1.5 |
| 2005 | \$3,069 | \$46 | 1.5 |
| 2006 | \$3,308 | \$54 | 1.6 |
| 2007 | \$3,714 | \$64 | 1.7 |

Endowed Composition \$ = Millions

\$2,212 at 12/31/07



92% of the University's endowed funds are restricted. In restricted endowments, distributions may be used only for donor specified purposes. Unrestricted endowment funds may be used for any legitimate purpose of the institution, whether it be scholarships or building maintenance.

CEF SPENDING POLICY

Spending Policy: Set by the Board of Regents.

Spending Rate: Spend 5% of the average market value of the CEF for the previous three years*.

Frequency: Distributions are made on a quarterly basis.

Spending Changes: Changes to the spending rate are infrequent and require discussion and approval by the Board of Regents.

Fees: 1.0% annual administrative fee is charged against the endowment: 0.8% to the Office of Development, 0.2% to the Treasury Office.

* This is the most commonly used formula by colleges and universities

TOTAL RETURN REQUIRED AND SPENDING LEVEL

Total Nominal Return* Required to Meet Current Spending

| | | |
|------------------------------|-------------|-----------------------|
| Endowment Distributions | 5.0% | Policy Spending Level |
| Development Office | 0.8% | } Administrative Fees |
| Treasury Office | 0.2% | |
| Expected Inflation | 3.0% | Consumer Price Index |
| Total Return Required | 9.0% | |

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

Required Nominal Return Matrix

Spending Level and Administrative Fees

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

 Current spending and inflation rate estimate

PERFORMANCE GOALS

Return Requirement

To attain an average annual inflation-adjusted total rate of return of 6% (net of investment manager fees) over rolling five-year periods.

The 6% target provides for a 5% distribution to endowed programs and a 1% administration fee.

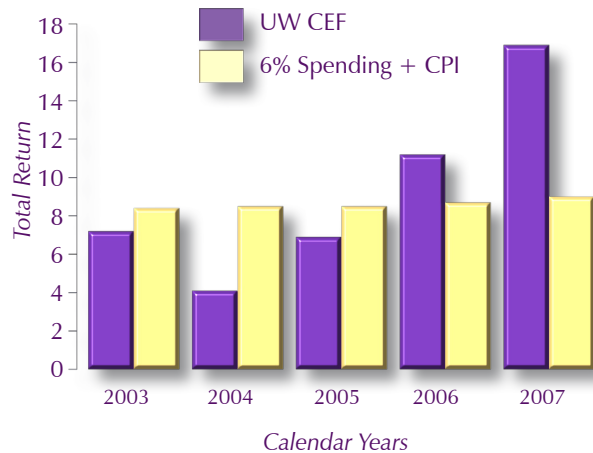
Policy Portfolio

To outperform, on a risk-adjusted basis, a representative blend of market indices which reflect the strategic asset allocation of the CEF over the long term (rolling five-year periods).

Peer Comparison

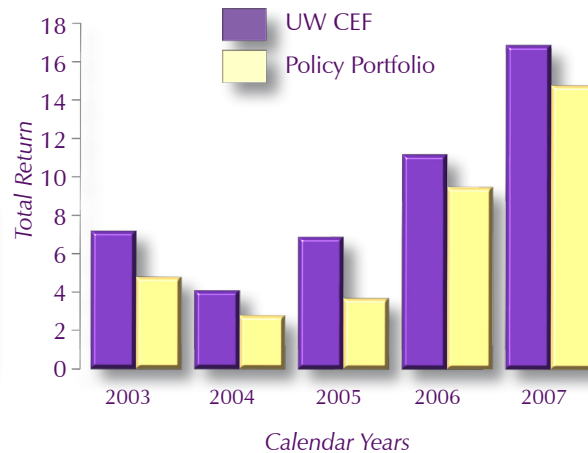
To exceed the median return of the 50 largest colleges and universities in the Cambridge Associates (CA) Universe over rolling five-year periods.

CEF vs. 6% Spending + CPI
Rolling 5 Year Annualized Returns



| | | | | |
|------|------|------|-------|-------|
| 7.2% | 4.1% | 6.9% | 11.2% | 16.9% |
| 8.4% | 8.5% | 8.5% | 8.7% | 9.0% |

CEF vs. the Policy Portfolio
Rolling 5 Year Annualized Returns

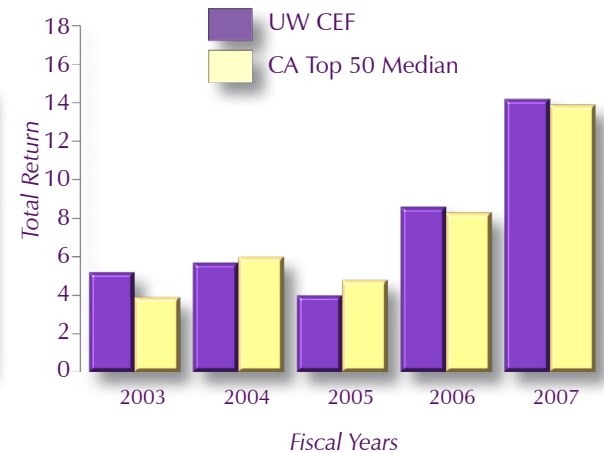


| | | | | |
|------|------|------|-------|-------|
| 7.2% | 4.1% | 6.9% | 11.2% | 16.9% |
| 4.8% | 2.8% | 3.7% | 9.5% | 14.8% |

5-Year Sharpe Ratio

| | | | | |
|-----|-----|-----|------|------|
| .35 | .16 | .62 | 1.24 | 2.07 |
| .12 | .00 | .17 | 1.03 | 2.03 |

CEF vs. CA Top 50 Colleges & Universities
Rolling 5 Year Annualized Returns



| | | | | |
|------|------|------|------|-------|
| 5.2% | 5.7% | 4.0% | 8.6% | 14.2% |
| 3.9% | 6.0% | 4.8% | 8.3% | 13.9% |

Did not meet performance goal

Capital Markets

GLOBAL CAPITAL MARKETS

Total Market Cap as of December 31, 2007—\$90.0 Trillion

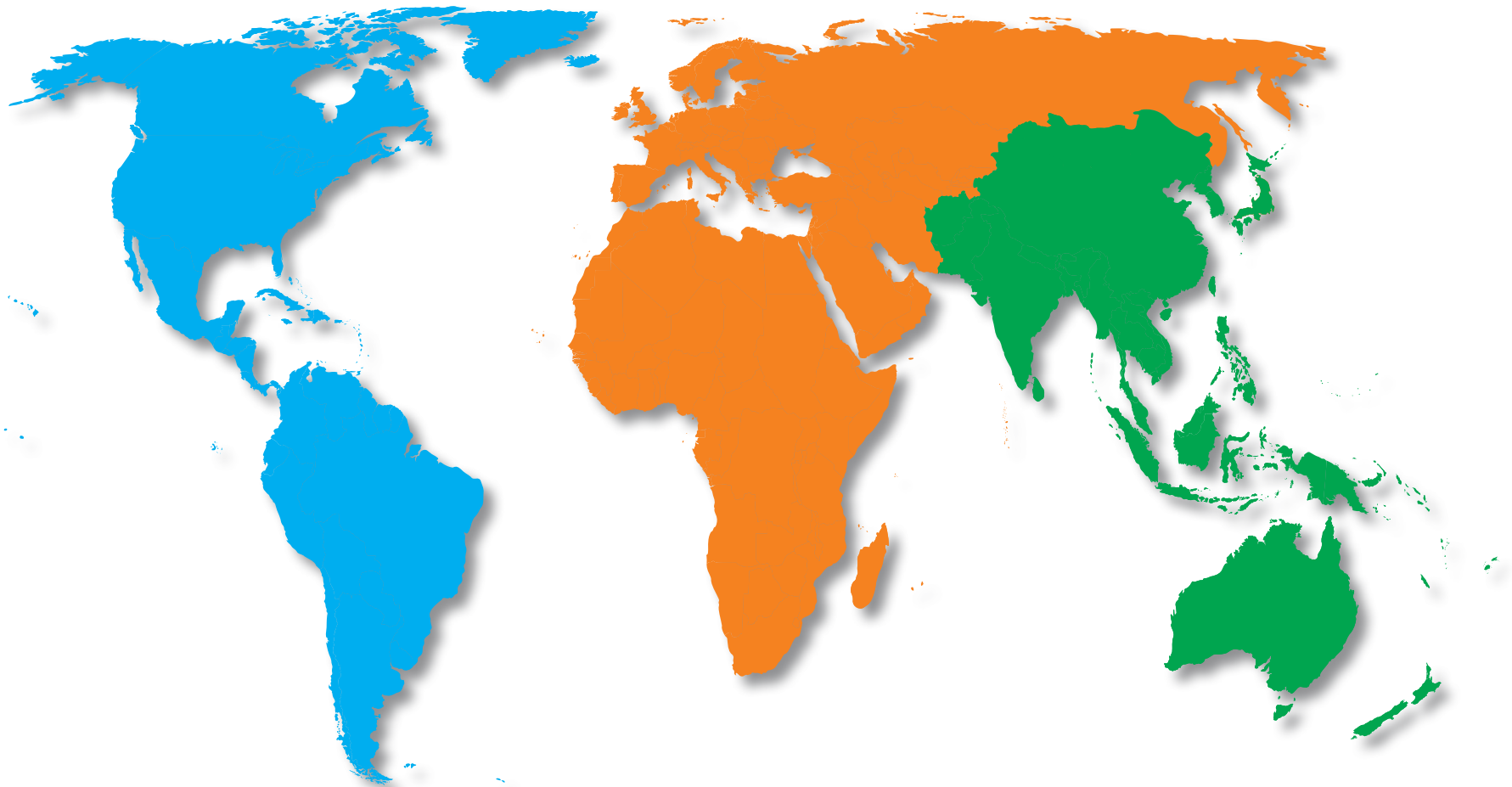
| Domestic | |
|--------------------------|---------------------|
| Equity | 15.9% |
| Private Equity | 0.3% |
| Fixed Income | 16.0% |
| Real Assets | 7.2% |
| Total | <u>39.5%</u> |



| International | |
|---|---------------------|
| Developed Equity | 18.5% |
| Emerging Markets Equity | 4.0% |
| Private Equity | 0.3% |
| Developed Fixed Income | 21.2% |
| Emerging Markets Fixed Income | 0.3% |
| Real Assets | 16.3% |
| Total | <u>60.5%</u> |

- International capital markets are larger than domestic markets.
- Higher growth rates in emerging markets should further increase the size of international markets.

THE WORLD IN THREE REGIONS



| | | | |
|---------------|--|--|--|
| |  Americas |  Europe/EMEA |  Asia |
| CEF Exposure: | 58% | 25% | 18% |

- The investment team is divided into groups to cover the three regions of the world.

THE WORLD IN THREE REGIONS

Regional Comparisons ¹

| | Americas | Europe/EMEA ² | Asia |
|------------------------------------|---|--|---|
| Developed Countries | Canada United States | Austria Belgium Denmark Finland France Germany Greece Ireland Italy Netherlands Norway Portugal Spain Sweden Switzerland United Kingdom | Australia Hong Kong Japan New Zealand Singapore |
| Emerging Countries | Argentina Brazil Chile Columbia Mexico Peru Venezuela | Czech Republic Egypt Hungary Israel Jordan Morocco Poland Russia South Africa Turkey | China India Indonesia Korea Malaysia Pakistan Philippines Sri Lanka Taiwan Thailand Vietnam |
| Population, total (mn) | 773 | 759/1,573 ² | 3,263 |
| GDP (tn US\$) | 16 | 15 | 10 |
| GDP (PPP) (tn) | 17 | 16 | 22 |
| MarketCap (tn) | 19 | 13 | 9 |
| Surface area (mn sq. km) | 37 | 23.7/52 ² | 26 |
| Foreign reserve (bn) | 352 | 955 | 2,756 |
| Current account (bn) | (765) | 104 | 359 |
| GDP growth (annual %) | 3.6 | 2.5 | 7.0 |
| Inflation, GDP deflator (annual %) | 7.9 | 3.0 | 4.5 |

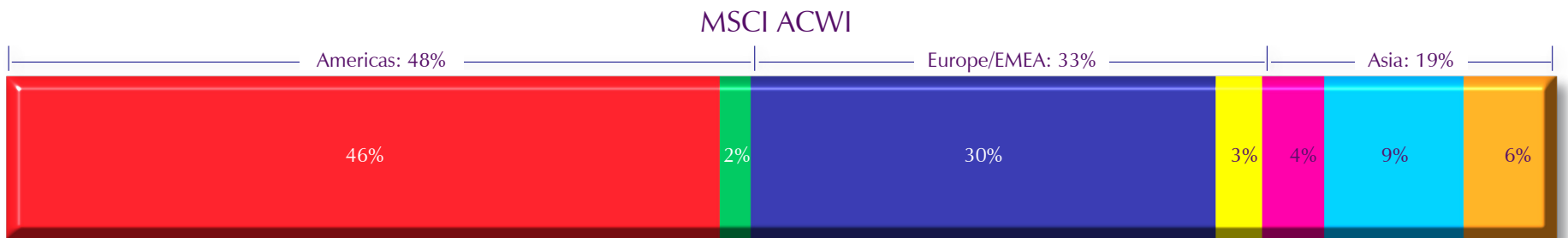
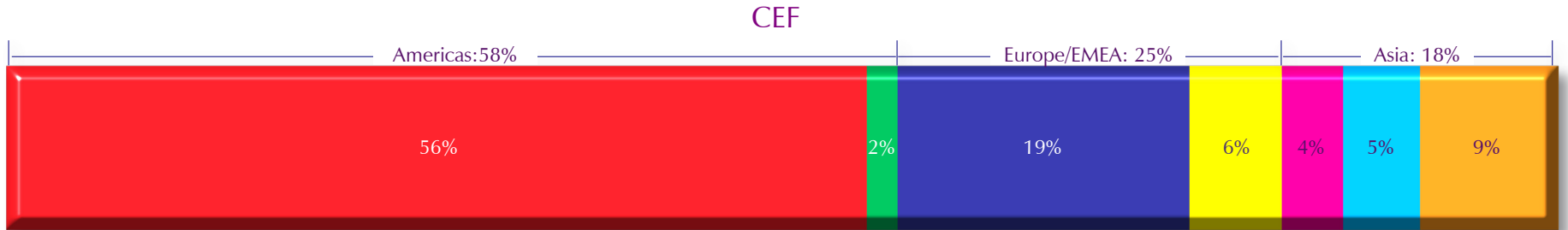
Source: World Bank, CIA World Factbook as of 2007

¹ The listed countries are those used in MSCI indexes.

² The right side entries for population and surface area for Europe/EMEA are adjusted for the African countries that are not listed in the detail above.

- Asia dominates other regions in terms of population and potential market capitalization growth.

CEF GLOBAL REGIONAL ALLOCATION AS OF 12/31/07



| Region | North America | Latin America | Dev. Europe | EMEA | Dev. Asia ex Japan | Japan | EM Asia |
|-----------|---------------|---------------|-------------|------|--------------------|-------|---------|
| CEF | 56% | 2% | 19% | 6% | 4% | 5% | 9% |
| MSCI ACWI | 46% | 2% | 30% | 3% | 4% | 9% | 6% |

- Compared to Global Equity market, the UW is underweight developed Europe and Japan and overweight emerging Asia.

Objective and Results

OBJECTIVE AND RESULTS

“Investment performance is our top priority, within the risk constraints of the University.”

Objective: Generate strong investment performance

- Outperform the CEF policy benchmark by 125 basis points per annum over rolling 3 year periods.
- Add \$15 million per annum above the policy benchmark or \$90 million over 5 years after compounding.
- Achieve performance that consistently ranks within the second quartile relative to the 50 largest colleges and universities.

Results

| | <u>2005</u> | <u>2006</u> | <u>2007</u> |
|-----------------------|-------------|-------------|-------------|
| CEF Return | 15.1% | 16.7% | 18.7% |
| Policy Benchmark | 13.3% | 16.6% | 13.9% |
| Excess Returns* | 180 bp | 11 bp | 480 bp |
| Contribution | \$26mm | \$2mm | \$91mm |
| Peer Quartile Ranking | 2nd | 2nd | 2nd |

*bp = basis points

Plan

- Expand global focus
- Increase exposure to diversifying strategies
- Enhance risk controls

HITS AND MISSES 2007–2008

Positives

- Overweight to emerging markets
- Overweight China and took profit in October, 2007
- Underweight to fixed income
- Strong private equity markets fueled by favorable financing environment

Negatives

- Overweight to international Financial and Consumer Discretionary sectors
- US small cap underperformance
- Hedge Fund tail event

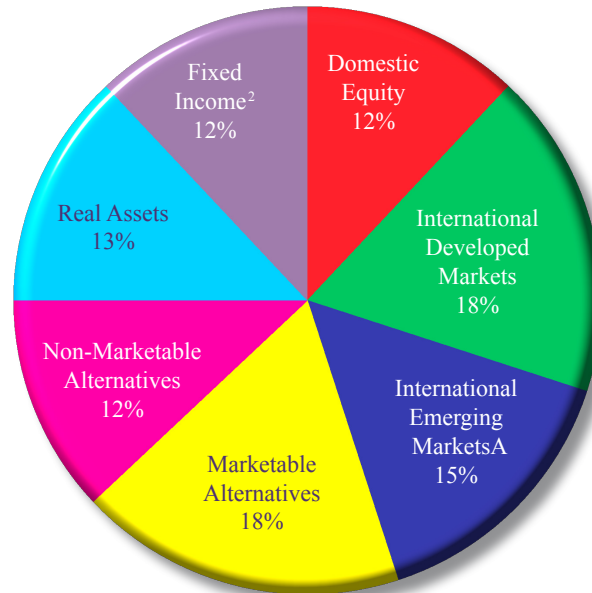
2007 PERFORMANCE BY ASSET CLASS



- Asset class exposures changed little in 2007.
- With the exception of international developed, all strategies outperformed their respective benchmarks.

ASSET ALLOCATION AS OF FEBRUARY 29, 2008

Consolidated Endowment Fund¹—\$2,137 MM



Dollars in Millions

| | Current Allocation | Policy Target | Policy Range |
|--|---------------------|---------------|---------------------|
| Domestic Equity | \$253 12% | 18% | 10%–40% |
| International Developed Markets | \$390 18% | 20% | 10%–35% |
| International Emerging Markets | \$314 15% | 10% | 5%–15% ³ |
| Marketable Alternatives | \$377 18% | 16% | 5%–25% |
| Non-Marketable Alternatives | \$266 12% | 12% | 5%–20% |
| Equity Fund | \$1,600 75% | 76% | 60%–90% |
| Real Assets Fund | \$288 13% | 12% | 5%–20% |
| Fixed Income Fund ² | \$249 12% | 12% | 5%–35% |
| Total Consolidated Endowment Fund | \$2,137 100% | | |

¹ At 12/31/07 international exposure: 47%, foreign currency exposure: 44%. ² Includes allocation to cash.

³ On 11/14/07 the Board of Regents approved expansion of the International Emerging Markets policy range to 5%–25%, through 6/30/08

Recommended Policy Changes

PROPOSED CHANGES

- Reorder asset strategies by risk (highest to lowest)
- Make policy asset allocation ranges consistent:
 - Public Market Strategies: 5%–35%
 - Alternative Strategies: 5%–25%
- Change policy asset allocation targets as follows:
 - Non-Marketable Alternatives. No change
 - Emerging Markets +3%
 - International Equity -4%
 - Domestic Equity -3%
 - Real Assets. +3%
 - Absolute Return +2%
 - Fixed Income. -1%
- Modify the policy benchmark:
 - Use MSCI All Country World Index for public market equity strategies
 - Simplify real assets and absolute return benchmarks

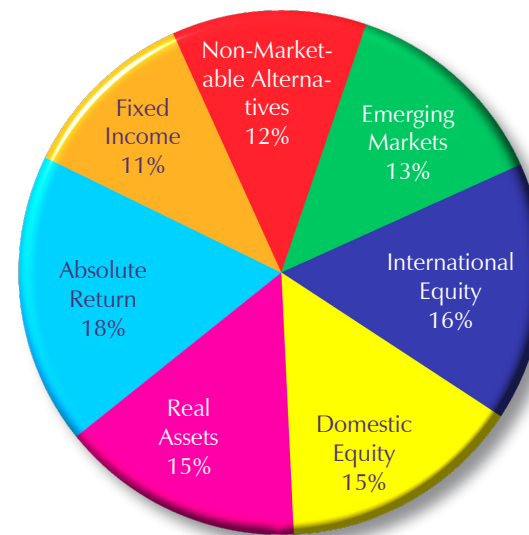
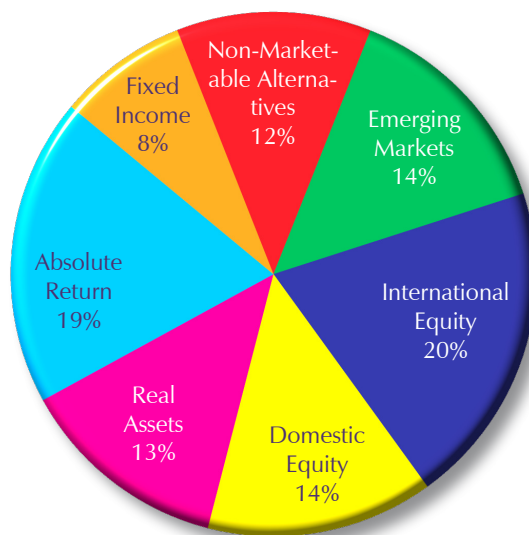
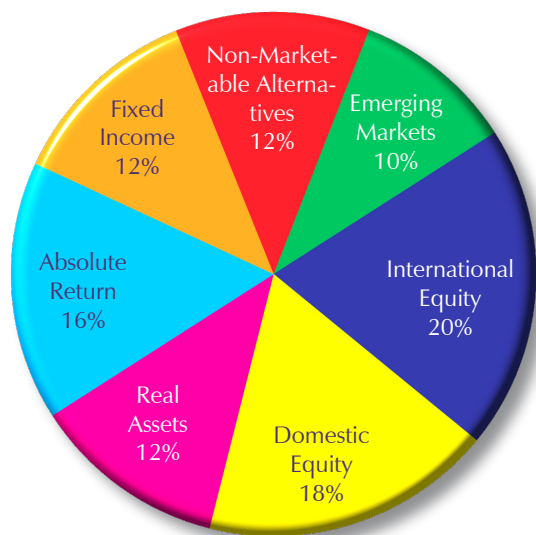
RECOMMENDED ASSET ALLOCATION








\$2.192 bn @ 12/31/07

Current CEF Policy

Actual CEF Exposure

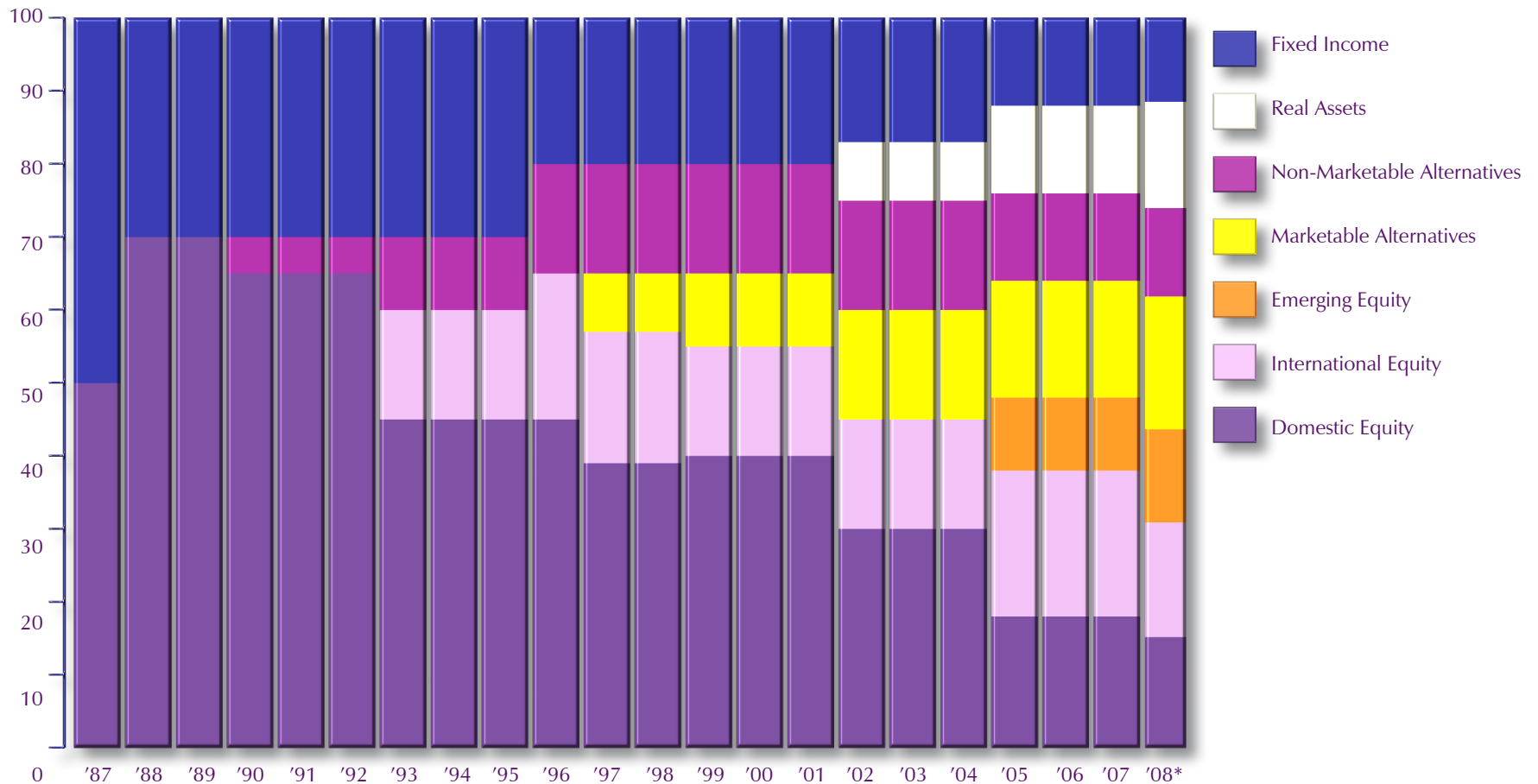
Proposed CEF Policy



| | Investment Strategies | Long-Term Target | Policy Range | 12/31/07 | Long-Term Target | Policy Range |
|---|-----------------------|------------------|--------------|----------|------------------|--------------|
|  | Non-Marketable Alt. | 12% | 5%–20% | 12% | 12% | 5%–25% |
|  | Emerging Markets | 10% | 5%–15% | 14% | 13% | 5%–35% |
|  | International Equity | 20% | 10%–35% | 20% | 16% | 5%–35% |
|  | Domestic Equity | 18% | 10%–40% | 14% | 15% | 5%–35% |
| | Total Equity | 60% | 70%–80% | 60% | 56% | 45%–75% |
|  | Real Assets | 12% | 5%–20% | 13% | 15% | 5%–25% |
|  | Absolute Return | 16% | 5%–25% | 19% | 18% | 5%–25% |
|  | Fixed Income | 12% | 5%–35% | 8% | 11% | 5%–35% |
| | Total CEF | 100% | | 100% | 100% | |

THE MOVE TOWARDS GREATER DIVERSIFICATION

Policy Asset Allocation FY 1987–2008



**Proposed*

- The trend has been towards greater diversification and a higher allocation to equities. Risk adjusted returns, as measured by the Sharpe ratio, increased over time as the CEF became more diversified.

ASSET CLASS STRUCTURE

Current

1. Equity Fund

Total
Equity

- Domestic Equity
- International Equity
- Emerging Markets Equity
- Marketable Alternatives
- Non-Marketable Equity

2. Real Assets Fund

3. Fixed Income Fund

Proposed (ranked by risk)

1. Equity Fund

- Non-Marketable Equity
- Emerging Markets Equity
- International Equity
- Domestic Equity

2. Real Assets Fund

3. Absolute Return Fund

4. Fixed Income Fund

ASSET STRATEGY ROLES (RANKED BY RISK)

| | |
|-----------------------------|------------------------------|
| Non-Marketable Alternatives | Enhanced Returns |
| Emerging Markets | High Returns |
| International Equity | High Returns |
| Domestic Equity | High Returns |
| Real Assets | High Returns/Inflation Hedge |
| Absolute Return | Downside Protection |
| Fixed Income | Deflation Protection |

PROPOSED POLICY BENCHMARK

| Investment Strategy | Proposed Long-Term Target | Current Policy Benchmark | Proposed Policy Benchmark |
|-----------------------------|---------------------------|--|--|
| Non-Marketable Alternatives | 12% | 50% CA Private Equity 50% CA Venture Capital | 60% CA Private Equity 40% CA Venture Capital |
| Emerging Markets | 13% | MSCI Emerging Markets | MSCI ACWI |
| International Equity | 16% | MSCI EAFE | MSCI ACWI |
| Domestic Equity | 15% | Russell 3000 | MSCI ACWI |
| Real Assets | 15% | Private: .65 NCREIF + .20 CA Oil & Gas + .15 NCREIF Timberland Public: .33 NAREIT + .33 GSCI Commodities Index + .33 Lehman US TIPS Index | 50% NCREIF + 30% CA Oil & Gas 10% NAREIT + 10% GSCI |
| Absolute Return | 18% | 60% Hedged Equity: 0.5 * 3-Month T-Bill + 0.5 * Russell 3000 + 2% 40% Absolute Return: 3-month T-Bill + 4% | 20% MSCI ACWI + 80% (3-Month T-Bill + 4%) |
| Fixed Income | 11% | Lehman Brothers Government Bond | Lehman Brothers Government Bond |

Portfolio Modeling

MODELING CONSTRAINTS

Proposed Policy Range Constraints

| | |
|-----------------------------|--------|
| Non-Marketable Alternatives | 5%–25% |
| Emerging Markets | 5%–35% |
| International Equity | 5%–35% |
| Domestic Equity | 5%–35% |
| Real Assets | 5%–25% |
| Absolute Return | 5%–25% |
| Fixed Income | 5%–35% |

Liquidity Constraint

$$ABS + RAS + NAS < 60\%$$

Rationale for Constraints

1. Ability to implement
2. Sufficient liquidity for spending
3. Forecasting error

- Policy ranges were widened in 2008 allowing more flexibility in the asset allocation, minimizing transaction costs and building a more efficient portfolio.

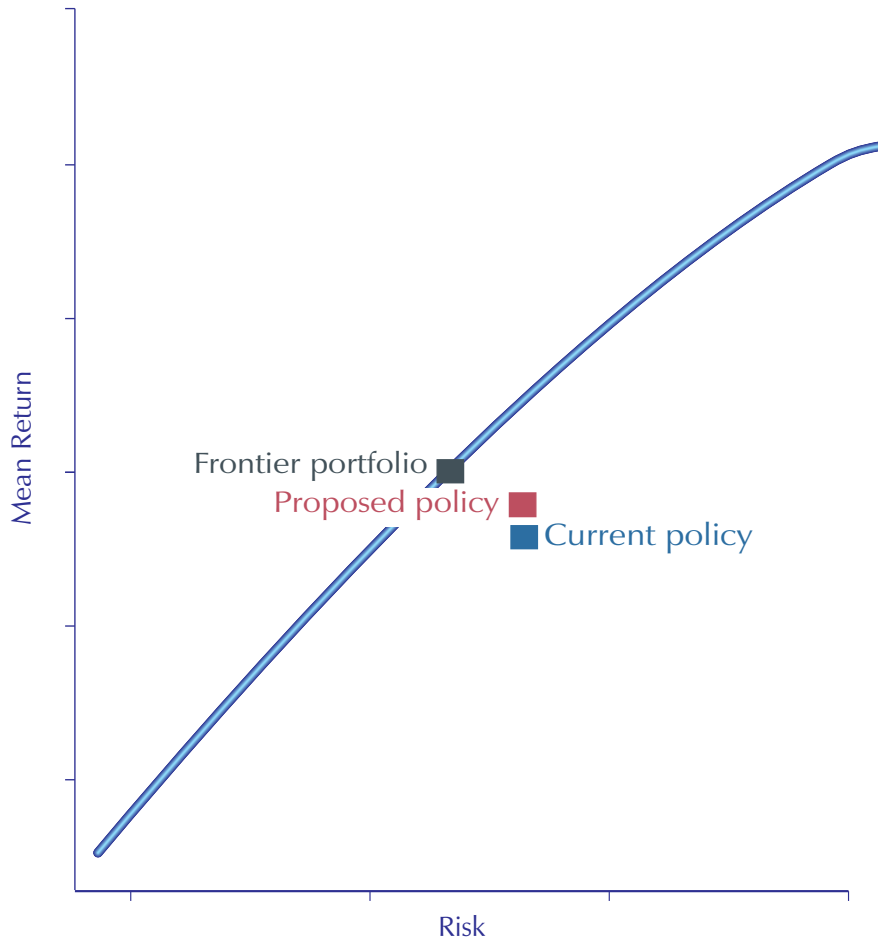
RISK/RETURN ANALYSIS



- Fixed Income, Absolute Return and Real Assets provide best diversification benefit.
- Marginal contribution to risk includes volatility in addition to correlation.

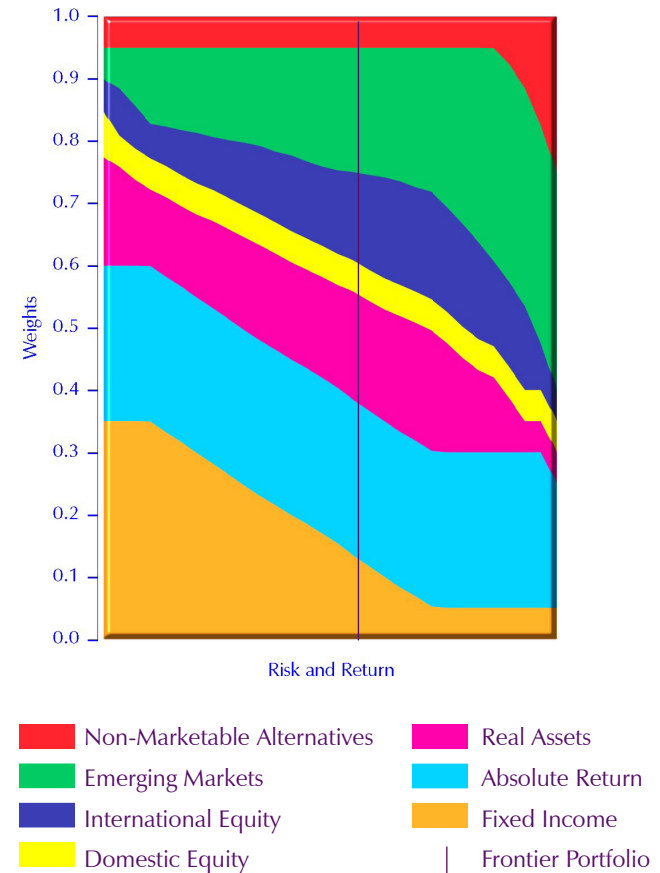
EFFICIENT FRONTIER

Efficient Frontier



Note: Risk is volatility of returns.

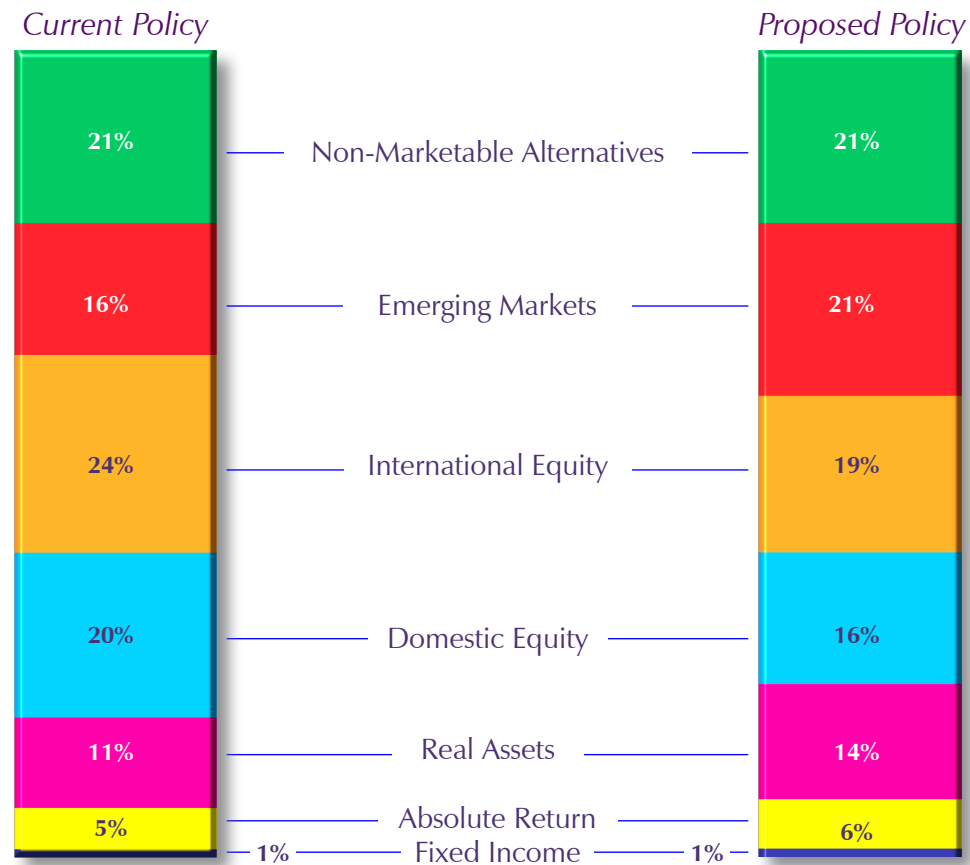
Efficient Portfolios



- Efficient frontier portfolio favors absolute return, real assets and emerging markets.

RISK ALLOCATION

Percentage Contribution to Risk



- Proposed portfolio creates more balanced risk profile
- This measure takes into account both volatility and correlations.

Investment Team

INVESTMENT TEAM PERFORMANCE OBJECTIVE

Objective: Generate Strong Investment Performance

- Outperform the CEF policy benchmark by 125 basis points per annum over rolling three year periods

“Investment performance is our top priority within the risk constraints of the University.”

INVESTMENT PROGRAM EVOLUTION

| | 7 Years Ago | Today |
|-------------------|--|--|
| GOVERNANCE | <ul style="list-style-type: none"> Decision-making committee of the Board of Regents with broad oversight of the University's finances | <ul style="list-style-type: none"> Advisory committee (UWINCO) focused solely on the invested programs of the University. |
| STRATEGY | <ul style="list-style-type: none"> Diverse range of asset classes—domestic focus | <ul style="list-style-type: none"> Diverse range of asset classes—global focus |
| | <ul style="list-style-type: none"> Active participation in alternative asset investments | <ul style="list-style-type: none"> Active participation in alternative asset investments |
| | <ul style="list-style-type: none"> Focus on asset allocation | <ul style="list-style-type: none"> Focus on market opportunity |
| | <ul style="list-style-type: none"> External investment managers | <ul style="list-style-type: none"> External investment managers |
| | <ul style="list-style-type: none"> Outsourced risk management and asset allocation modeling | <ul style="list-style-type: none"> Proprietary risk and asset allocation models (Partnership with UW's Computational Finance) |
| | <ul style="list-style-type: none"> Outsourced manager research and due diligence | <ul style="list-style-type: none"> Extensive internal manager research and due diligence—domestically and abroad |
| STAFFING | <ul style="list-style-type: none"> Treasurer with broad fiscal and administrative responsibilities | <ul style="list-style-type: none"> Dedicated Chief Investment Officer with delegated decision-making authority |
| | <ul style="list-style-type: none"> Small staff (3-4) of generalist finance professionals with responsibilities extending beyond investments | <ul style="list-style-type: none"> Moderate sized staff (8-9) of investment professionals focused solely on investments |
| | <ul style="list-style-type: none"> Compensation within the University's structure | <ul style="list-style-type: none"> Competitive performance based compensation |
| | <ul style="list-style-type: none"> Reliance on consultants as an extension of staff | <ul style="list-style-type: none"> Targeted use of consultants |

INVESTMENT TEAM FOCUS

Portfolio

- Focus on global opportunities
- Position portfolio defensively
- Address need to protect sensitive data

Risk

- Enhance portfolio construction and attribution
- Evaluate portfolio tools for managing risk
- Implement comprehensive risk monitoring

Research

- Expand proprietary research function
- Enhance systems for managing performance and research information
- Extend interaction with the academic / industry community

Organization

- Research best practices in endowment management
- Investigate alternative governance structures
- Initiate graduate internship program