ADDITIONAL AGENDA ITEM

FINANCE AND PLANNING COMMITTEE

MAY 12, 2004

8. **Approval to amend the Permanent University Fund and General Endowment Fund Investment Policy Statements**

RECOMMENDATION

The Board of Directors of The University of Texas Investment Management Company (UTIMCO) recommends that the U. T. Board of Regents approve the proposed amendments to the Asset Allocation and Policy section of the following Investment Policy Statements as set forth in congressional style on Pages 39e - 39g:

a. Permanent University Fund (PUF)

b. General Endowment Fund (GEF)

It is further recommended that the U. T. Board of Regents approve the revised Exhibit A of the PUF Investment Policy Statement and the GEF Investment Policy Statement as set forth in congressional style on Page 39h.

BACKGROUND INFORMATION

Section 3(a) of the Investment Management Services Agreement dated March 1, 1996, second amended and restated effective August 7, 2003, between the Board of Regents of The University of Texas System and UTIMCO provides that UTIMCO shall review the investment policies of the assets under its management and recommend any changes of such policies for approval by the U. T. Board of Regents. The Investment Policy Statements for the PUF and the GEF provide that UTIMCO "shall...determine specific asset allocation targets, ranges, and performance benchmarks consistent with PUF (and GEF) objectives...". The Board of Regents adopted amendments to the Investment Policy Statements for the PUF and GEF at its December 19, 2003 meeting which established new asset allocation targets for several asset categories. However, there were also changes made to performance benchmarks and asset category definitions in the revised Investment Policy Statements which the UTIMCO Board believes would have negative unintended consequences. In exercising its delegated responsibility to determine benchmarks, UTIMCO recommends the technical corrections to the PUF and GEF Investment Policy Statements set forth in this agenda item. There are no changes to any Regents-approved asset allocation targets recommended in this agenda item and there are no changes to the expected return or expected risk measures. The only recommended changes are technical corrections to benchmark categories and definitions.

The recommended changes to the PUF and GEF Investment Policy Statements segregate two individual asset categories which were grouped under broader asset classes, and provide asset definitions and benchmarks for the revised asset categories. The proposed definitional changes are reflected in Exhibit A of both the PUF and GEF Investment Policy Statements. In addition, a change in the benchmarks for Private Equity and Venture Capital asset categories as reported in Exhibit A is proposed.

During the construction of the new policy portfolio, it became apparent that two unintended consequences resulted from the movement of Real Estate Investment Trusts (REITS) and Treasury Inflation Protected Securities (TIPS) from the inflation hedge asset category to the U.S. Equities and Fixed Income categories, respectively. The benchmarks of the U.S. Equities and Fixed Income classes were not adjusted correspondingly to account for the asset allocation percentage weights of the asset categories added.

1. Under the asset classification scheme of the new Investment Policy Statement, the actual U.S. Equities portfolio for the PUF and GEF would consist of approximately 21.6% of REITS (REITS' value of $859.2 versus total U.S. Equities with REITS of $3,974.1 as of March 31, 2004) while the Benchmark for the asset class, the Russell 3000 Index, has a weight of approximately 2% in REITS. This difference in weights between the actual portfolios and the policy portfolios creates a substantial risk concentration requiring transactions totaling more than $1.5 billion to correct. In addition to the expenses associated with the transactions which would total several million dollars, there would be three additional negative effects:

    a. REITS have been an important part of the endowment funds' portfolios for more than 10 years. They are the endowments' only investment in real estate and substantially reducing this position would lower the diversification and increase the risk of the overall portfolios with no expected increase in returns.

    b. Because the proceeds of the sale of the existing REIT portfolio would be transferred from internal management to external active management, the total UTIMCO and Fund budgets would immediately increase by about 8.7% (approximately $2.7 million per year), reflecting the difference in costs between internal and external active management. In addition, total internally managed assets would be reduced by about one-third with no decrease in costs.

c. An important source of value added over the past two years, REITS managed internally by Mr. Greg Cox, Portfolio Manager - Equity Investments, would be reduced to about one-tenth of its previous weight, thus limiting UTIMCO's ability to add value in the future.

2. The second issue relates to TIPS. Although UTIMCO does not currently have a TIPS position in the endowment portfolios, the intention was to introduce TIPS as part of the portfolio allocation, and a 5% allocation was originally approved by the UTIMCO Board. However, moving TIPS to the Fixed Income category would make it unlikely that the intended 33.3% allocation to TIPS (5% for TIPS out of 15% total for fixed income) would occur since the Lehman Brothers Bond Index does not contain any TIPS in its construction. TIPS would be more appropriately measured against the Lehman Brothers US TIPS Index. Therefore, implementing the 5% allocation to TIPS intended by the Asset Allocation Policy would create a substantial risk concentration position relative to the Lehman Brothers Aggregate Bond benchmark, making it less likely that TIPS would actually be purchased under the risk budgeting procedure used by UTIMCO. This would be an unintended negative result because TIPS have unique and attractive strategic characteristics which would improve diversification and lower the overall risk of the portfolio. The Investment Policy should encourage, not discourage, a TIPS position. The changes recommended in this agenda item would encourage TIPS positions.

The changes to the Asset Allocation and Policy sections of the PUF and GEF Investment Policy Statements are proposed to correct the negative unintended consequences.

Clarification on the use of the Venture Economics Benchmark for the Private Capital asset category is also proposed. During the recently completed Asset Allocation Review process, a new benchmark based on Venture Economics data was approved. The UTIMCO Board approved the use of Venture Economics' Vintage Year Venture Capital Index for the benchmark of Venture Capital and the use of Venture Economics' Vintage year Private Equity Index for Private Equity. At the time of the approval, the UTIMCO Board noted that staff would have to determine the most appropriate way to incorporate the Venture Economics benchmark into the endowment policy portfolio benchmark. The incorporation of Private Capital returns into the overall policy portfolio presents technical challenges due to differences in the methodology used to calculate return.

The best solution to the technical challenges is to use the Venture Economics' Periodic IRR Index for the entire Private Capital asset category rather than separate indices for venture capital and private equity. Although still not a perfect solution to the benchmarking problems of private equity, the Venture Economics Index does have an important characteristic necessary in any good benchmark: high correlation with the actual portfolio segment for which it has been selected as the benchmark. The table below indicates the correlation of actual private equity returns in the endowment funds with the Venture Economics Index over individual 1, 3, and 5-year periods over the past 10 years:

Correlation Coefficients	UTIMCO and Venture Economics
1 Year	0.9229
3 Years	0.8931
5 Years	0.9520

Correlation coefficients are statistical measures of how closely two variables change as measured at different points in time. A correlation coefficient of 1.0 indicates the two variables are moving in exact lockstep; a correlation coefficient of 0.0 indicates the two variables are moving completely independently. The high correlation measures above for the historical returns of the private capital portfolios and the Venture Economics benchmark indicate that the Venture Economics benchmark should be an effective benchmark for the endowments' private capital investments.

The UTIMCO Board of Directors approved the proposed amendments to the Investment Policy Statements for the PUF and GEF, and the revised Exhibit A of these Investment Policy Statements, on May 6, 2004.

Asset Allocation and Policy

Asset allocation is the primary determinant of the volatility of investment return and, subject to the asset allocation ranges specified in Exhibit A, is the responsibility of UTIMCO. Specific asset allocation positions may be changed from time to time, within the ranges specified in Exhibit A, based on the economic and investment outlook.

PUF [GEF]* assets shall be allocated among the following broad asset classes based upon their individual return/risk characteristics and relationships to other asset classes:

A. U.S. Equities - U.S. equities represent ownership in U.S. companies that are traded in public markets~~.~~: ~~Equities include stocks that are further identified by size of the company and are classified as large capitalization, medium capitalization, and small capitalization. U.S. equities may further be delineated by style (growth or value). Warrants, rights, options, futures and hedge funds are also included if the underlying assets are equities. In addition, Derivative Applications approved by the UTIMCO Board that serve as a U.S. equity substitute will be classified as U.S. equities. Equities provide both current income and growth of income.~~

Traditional U.S. Equities – Traditional U.S. equities include common stocks and derivatives based on common stocks including warrants, rights, options, exchange traded funds, and futures. In addition, Derivative Applications approved by the UTIMCO Board that serve as a U.S. Equity substitute will be classified as traditional U.S. equity. Equities provide both current income and growth of income.

REITS – REITS are real estate investment trusts. REITS are companies which own, and in most cases operate, income producing real estate.

B. Global ex U.S. Equities – Global ex U.S. equities represent ownership in global companies that are traded in public markets. The global ex U.S. markets include established and emerging markets. ~~Equities include stocks that are further identified by size of the company and are classified as large capitalization, medium capitalization, and small capitalization. Global ex U.S. equities may further be delineated by style (growth or value) or region (Latin America, Asia etc.) or state of economic development (Emerging Markets).~~ Warrants, rights, options, exchange traded funds, and futures ~~and hedge funds~~ are also included if the underlying assets are equities. In addition, Derivative Applications approved by the UTIMCO Board that serve as a Global ex U.S. equity substitute will be classified as Global ex U.S. equities. Equities provide both current income and growth of income.

* Reference for GEF policy only

C. Hedge Funds – Hedge funds are broadly defined to include nontraditional investment strategies whereby the majority of the underlying securities are traded on public exchanges or are otherwise readily marketable.

Equity Hedge Funds – Equity hedge fund investments include U.S. and international long/short equity strategies. These strategies attempt to exploit profits from stock selection skills by taking long and short positions in various equity securities. These strategies may also include fund of hedge fund investments. Equity hedge fund investments are made through private placement agreements.

Absolute Return Hedge Funds – Absolute return hedge fund investments include arbitrage and event driven strategies. Arbitrage strategies attempt to exploit pricing discrepancies between closely related securities, utilizing a variety of different tactics primarily within equity, fixed income and convertible securities markets. Event driven strategies attempt to exploit discreet events such as bankruptcies, mergers, and takeovers. Absolute return hedge funds may include fund of hedge fund investments. Absolute return hedge fund investments are made through private placement agreements.

D. Private Capital - Private Capital investments include the illiquid debt and equity securities of private or publicly-traded companies. Private Capital investments consist of two sub-asset class categories: Venture Capital and Private Equity.

Venture Capital – Venture capital investments consist of investments in companies, both U.S. and non-U.S. that are in the early stages of development. Venture Capital investments are held either through limited partnership or as direct ownership interests.

Private Equity – Private Equity investments consist of investments in the equity securities of private businesses, both U.S. and non-U.S., that are considered to be in the post-start-up phase and that are profitable and generating income. Private Equity investments are held either through limited partnerships or as direct ownership interests. The classification of private equity also includes mezzanine and opportunistic investments. Mezzanine consists of investments in funds that make subordinated debt or minority equity investments in private companies. Opportunistic investments are limited to illiquid assets and may include distressed debt or secondary private equity partnerships.

E. Commodities – Natural resource investments which include oil and gas interests, commodities, and other hard assets.

F. Fixed Income – Fixed income investments include debt issued by the U.S. Treasury, various government agencies and domestic and foreign corporations.

Traditional Fixed Income - The principal securities include bonds, notes, bills and mortgage and asset-backed securities. ~~Fixed income investments also include hedge funds if the underlying assets are fixed income investments, and treasury inflation protected securities (TIPS) which are marketable securities with a return linked to the inflation rate.~~ In addition, Derivative Applications approved by the UTIMCO Board that serve as a fixed income substitute will be classified as traditional fixed income.

TIPS - TIPS are treasury inflation protected securities which are marketable securities with a return linked to the inflation rate.

EXHIBIT A

POLICY TARGETS, RANGES AND PERFORMANCE OBJECTIVES

	Percent of Portfolio (%)		
Asset Category	**Policy Targets**	**Policy Ranges**	**Benchmarks**
US Equities:	**25.0**	**15 to 45**	Combination benchmark: 80% Russell 3000 Index plus 20% Wilshire Associates Real Estate Securities Index ~~Russell 3000 Index~~
Traditional US Equities	20.0	15 to 45	Russell 3000 Index
REITS	5.0	0 to 10	Wilshire Associates Real Estate Securities Index
Global ex US Equities:			MSCI All Country World Index ex US
Non-US Developed Equity	10.0	5 to 15	
Emerging Markets Equity	7.0	0 to 10	
Total ~~Traditional~~ Equity	**42.0**	**20 to 60**	
Equity Hedge Funds	10.0	5 to 15	90 Day T-Bills + 4%
Absolute Return Hedge Funds	15.0	10 to 20	90 Day T-Bills + 3%
Total Hedge Funds	**25.0**	**15 to 25**	
Venture Capital	6.0	0 to 10	~~Venture Economics Vintage Year Venture Capital Index~~
Private Equity	9.0	5 to 15	~~Venture Economics Vintage Year Private Equity Index~~
Total Private Capital	**15.0**	**5 to 15**	Venture Economics' Periodic IRR Index
Commodities	**3.0**	**0 to 5**	GSCI minus 1%
Fixed Income:	**15.0**	**10 to 30**	Combination benchmark: 66.7% Lehman Brothers Aggregate Bond Index plus 33.3% Lehman Brothers US Tips Index ~~Lehman Brothers Aggregate Bond Index~~
Traditional Fixed Income	10.0	10 to 30	Lehman Brothers Aggregate Bond Index
TIPS	5.0	0 to 10	Lehman Brothers US Tips Index
Cash	**0.0**	**0 to 5**	90 Day T-Bills

Expected Annual Return (%)	**8.36**
Downside Deviation (%)	**4.22**
Standard Deviation (%)	**10.30**