

VII. STANDING COMMITTEES

B. Finance, Audit and Facilities Committee

Investment Program Update

There will be an oral report for information only.

Attachment

Investment Program Update, a Report to the Board of Regents, June 7, 2012



Investment Program Update

*A Report to the Board of Regents
June 7, 2012*

Treasury Office
University of Washington

Investment Program Update

*A Report to the Board of Regents
June 7, 2012*

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Executive Summary

- 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 Consolidated Endowment Fund (CEF) reflects the following characteristics:
 - Large allocation to Emerging Markets
 - High quality exposure to Developed Markets
 - Portfolio stability provided by Fixed Income and Absolute Return
- Historical CEF performance has been mixed. Long-term returns remain solid despite disappointing short-term performance. Emerging Market strategy remains the primary driver of annual performance. Due to volatility of the sector, Emerging Markets requires both long-term conviction and staying power. This has been affirmed by University of Washington Investment Committee (UWINCO) and the UW investment team.
- The Invested Funds (IF) performance has been consistently positive. The IF are managed to stabilize campus support. Long term performance of the IF is enhanced through a combination of:
 - High quality fixed income
 - Diversified CEF exposure
- A Constitutional Amendment to permit the public portion of Invested Funds to be invested in corporate securities is scheduled for the November 2012 ballot.

Executive Summary: 2011–2012 Hits and Misses

Positives

- Absolute Return manager consistent performance
- Developed public markets positioning and manager performance
- Portfolio more concentrated in high conviction managers

Negatives

- Private market strategies trailed benchmark
- Emerging markets lagged developed markets
- Cash drag versus policy benchmark

Implications of Current Positioning

- Absolute Return and Opportunistic strategies will protect CEF in down markets but lag during market rallies
- Emerging Market relative performance will be magnified by differences in developed and emerging equity market returns
- Fixed Income allocation lowered thereby reducing impact of changes in interest rates

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 (CEF) and other University funds.

Investment program oversight resides with the Finance, Audit and Facilities Committee (FAF), a committee 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.

Source: 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

Reviews Program

- Program oversight/accountability

Investment Committee (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.

Capital Markets

Capital Markets: Historical 10-Year Treasury Yields



August 1971 to May 2012

Source: Federal Reserve - data since Aug. 1971, when U.S. terminated convertibility of US dollar to gold

Historically low interest rates present risk of owning longer maturity US Treasuries.

Capital Markets: Historical S&P 500 Price Levels

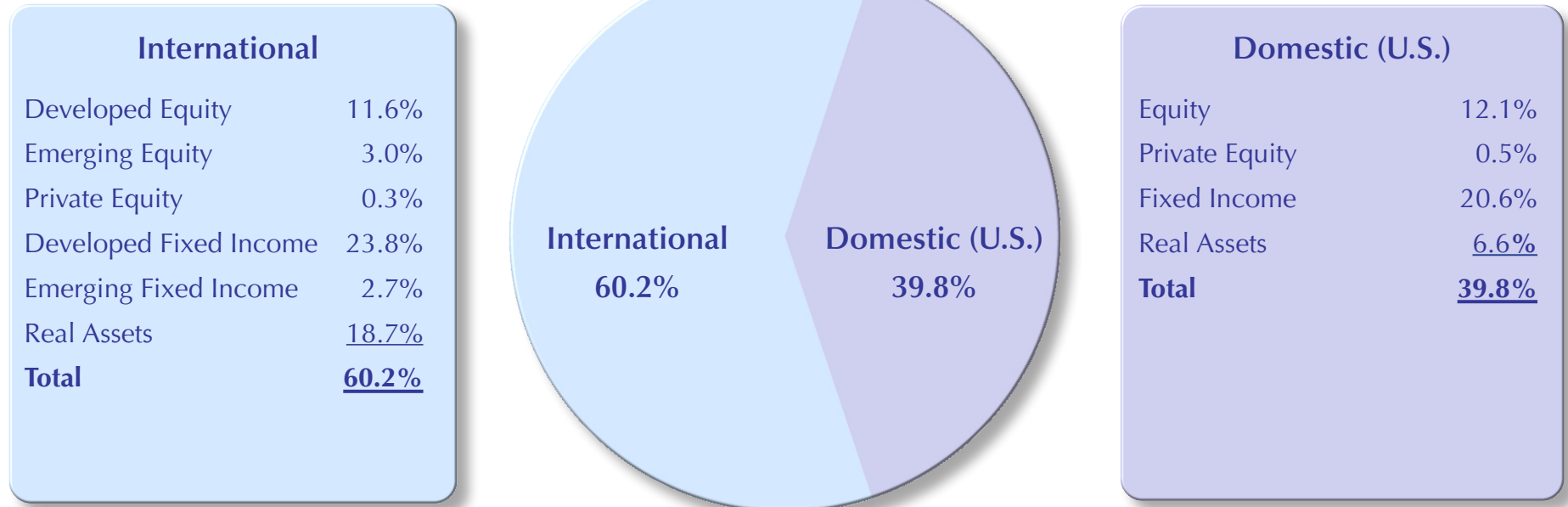
The S&P 500 and Federal Reserve Intervention



Financial markets have been heavily supported by Federal Reserve intervention.

Capital Markets: Global Composition

\$115t as of December 31, 2011



Data compiled from multiple sources as of 12/31/11. Balances do not include currency or derivatives.

Over the last 7 years, global capital markets have shifted from 62% domestic/38% international to nearly the reverse. The CEF's exposure to emerging markets has increased from 4% to 18%.

Capital Markets: Emerging vs. Developed Markets Fundamentals

	Gross Domestic Product/Capita (\$ at PPP ¹)		Current Accounts (\$b)		Foreign Currency Reserves (\$b)		Stock Market Capitalization (\$b)	
	1999	2011	1999	2011	1999	2011	1999	2011
China	\$2,164	\$8,603	\$28	\$201	\$161	\$3,213	\$331	\$581
India	\$1,446	\$3,741	(\$3)	-\$41	\$36	\$298	\$185	\$148
Brazil	\$6,864	\$11,852	(\$25)	\$3	\$36	\$352	\$228	\$226
Russia	\$6,847	\$16,746	\$24	\$101	\$12	\$499	\$72	\$39
Emerging Markets	<u>\$2,941</u>	<u>\$6,597</u>	<u>-\$10</u>	<u>\$592</u>	<u>\$548</u>	<u>\$5,633</u>	<u>\$1,491</u>	<u>\$1,573</u>
% Change		124%		6,023%		927%		6%
United States	\$42,797	\$48,182	-\$302	-\$480	\$136	\$148	\$16,635	\$15,104
Developed Markets	<u>\$26,220</u>	<u>\$39,217</u>	<u>-\$111</u>	<u>-\$131</u>	<u>\$1,485</u>	<u>\$5,017</u>	<u>\$34,147</u>	<u>\$30,238</u>
% Change		50%		18%		238%		-11%

Improvement
 Decline
 ¹ PPP = Purchasing Power Parity

Source: World Bank, IMF, EIU, Economist, City of London

Emerging market fundamentals have substantially improved over the past decade.

Capital Markets: Emerging vs. Developed Market Valuations

Metric	Emerging Markets	US	Developed Markets ex US
Price to Earnings	10.9x	14.7x	13.2x
Price to Book	1.6x	2.2x	1.3x
Dividend Yield	3.0%	2.1%	3.9%
Earnings Growth	13.2%	9.4%	12.9%

Source: Morgan Stanley Research, May 14, 2012

Many solid emerging market companies in UW portfolio are household names:

- Samsung (Korea)
- Esprit (HK/China)
- Nestle (India)
- Unilever (Indonesia)
- HSBC (HK/China)

Emerging market valuations are attractive. Recent difficult performance is due to capital flows seeking safety in US markets. The fundamental outlook for emerging markets remains positive.

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: \$2.2 billion at March 31, 2012 including \$0.4 billion of operating funds.

Composition: Over 3,700 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.

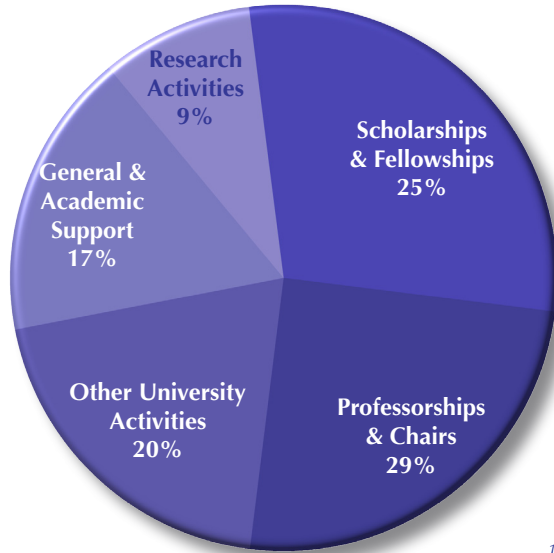
Secondary Objective: To provide a steady stream of income to support individual programs. This objective influences the spending formula used in calculating the income distributions.

Profile: CEF Characteristics

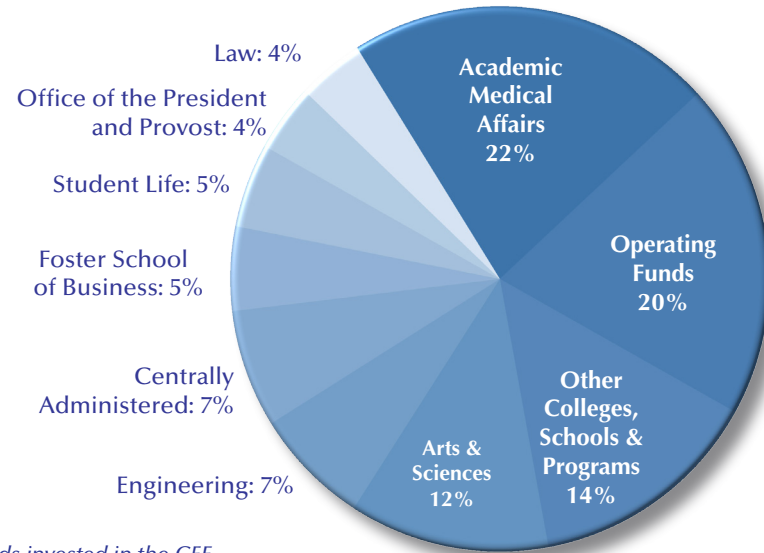
as of March 31, 2012 (\$=m)

Endowed Program Support¹

Principal by Purpose



Principal by School and College



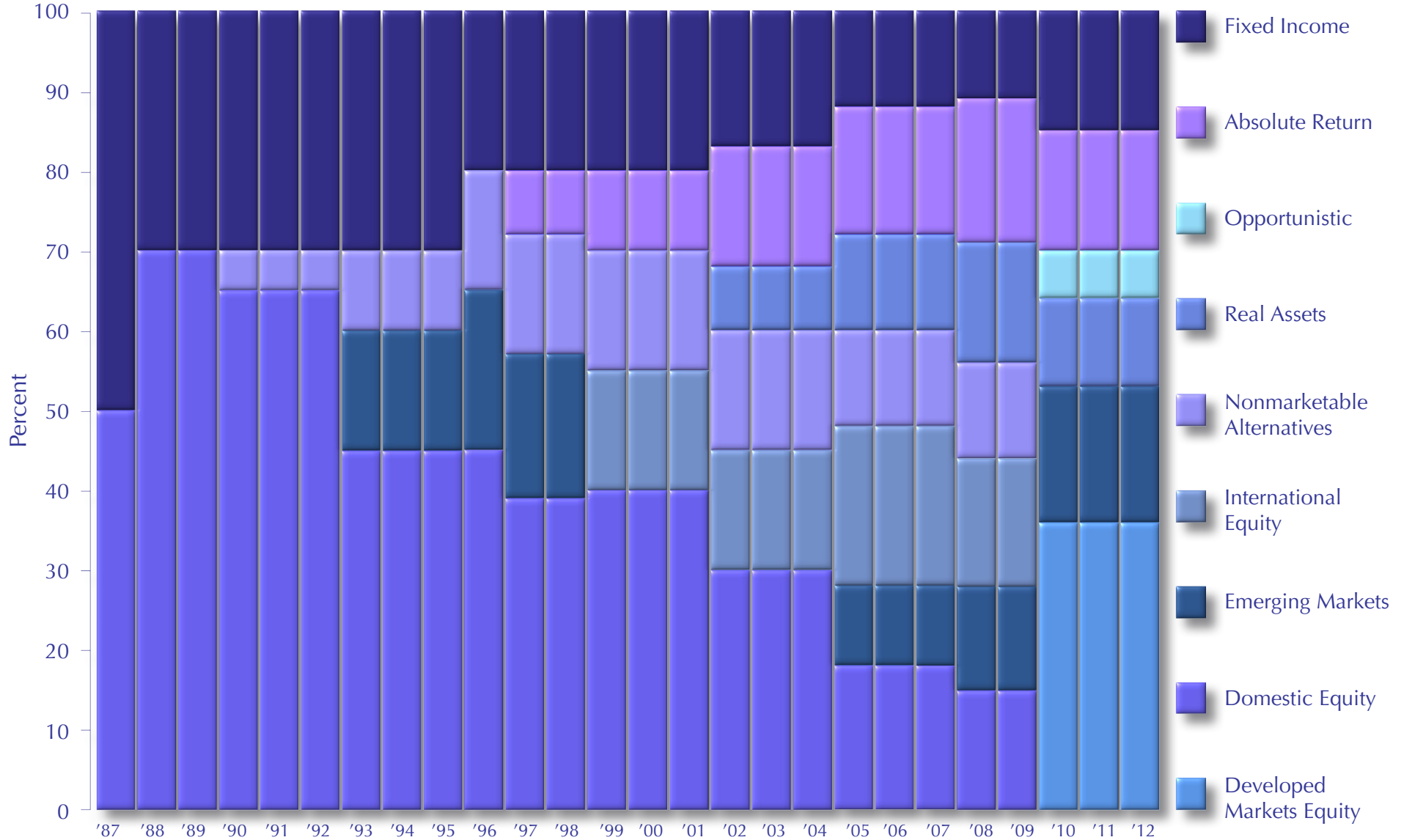
¹ Includes operating funds invested in the CEF.

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	\$3,099	\$75	2.4%
2010	\$3,966	\$59	1.5%
2011	\$4,360	\$74	1.7%
2012 Est.	\$4,500	\$85	1.9%

While representing nearly 2% of University revenues today, budget constraints elsewhere make the endowment more important for tomorrow.

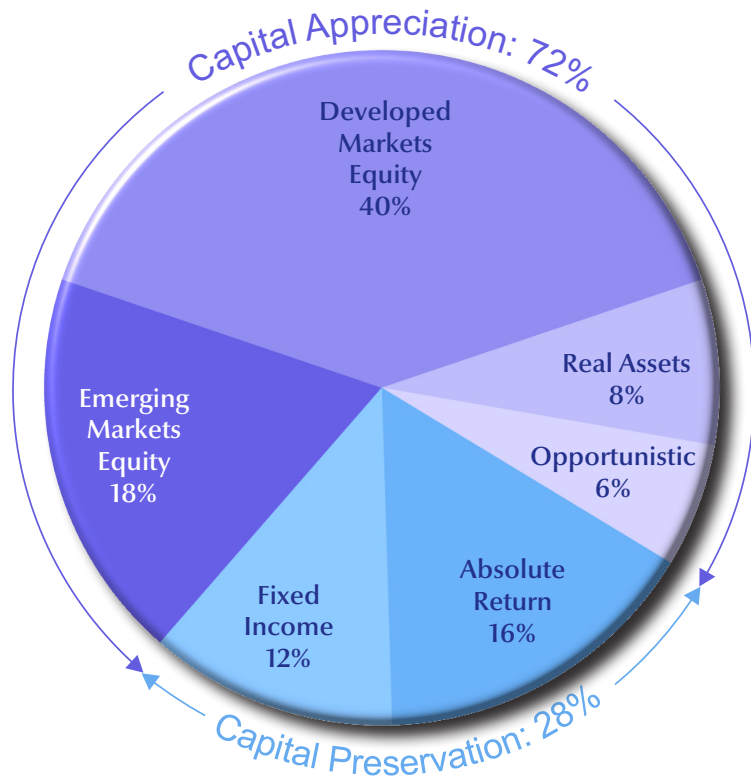
Profile: CEF Policy Asset Allocation



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 March 31, 2012 (\$=m)



CEF Asset Classes ¹	Current Allocation (\$ = millions)		Policy	
			Target	Range
Emerging Markets Equity	\$398	18%	17%	
Developed Markets Equity ²	\$860	40%	36%	
Real Assets	\$166	8%	11%	
Opportunistic	\$126	6%	6%	
Capital Appreciation ³	\$1,550	72%	70%	55%–85%
Absolute Return	\$353	16%	15%	
Fixed Income ⁴	\$258	12%	15%	
Capital Preservation	\$611	28%	30%	15%–45%
Total CEF	\$2,161	100%		

¹ Exposures at 3/31/12: International: 36%, Foreign Currency: 33%

² Includes US Equity of \$539

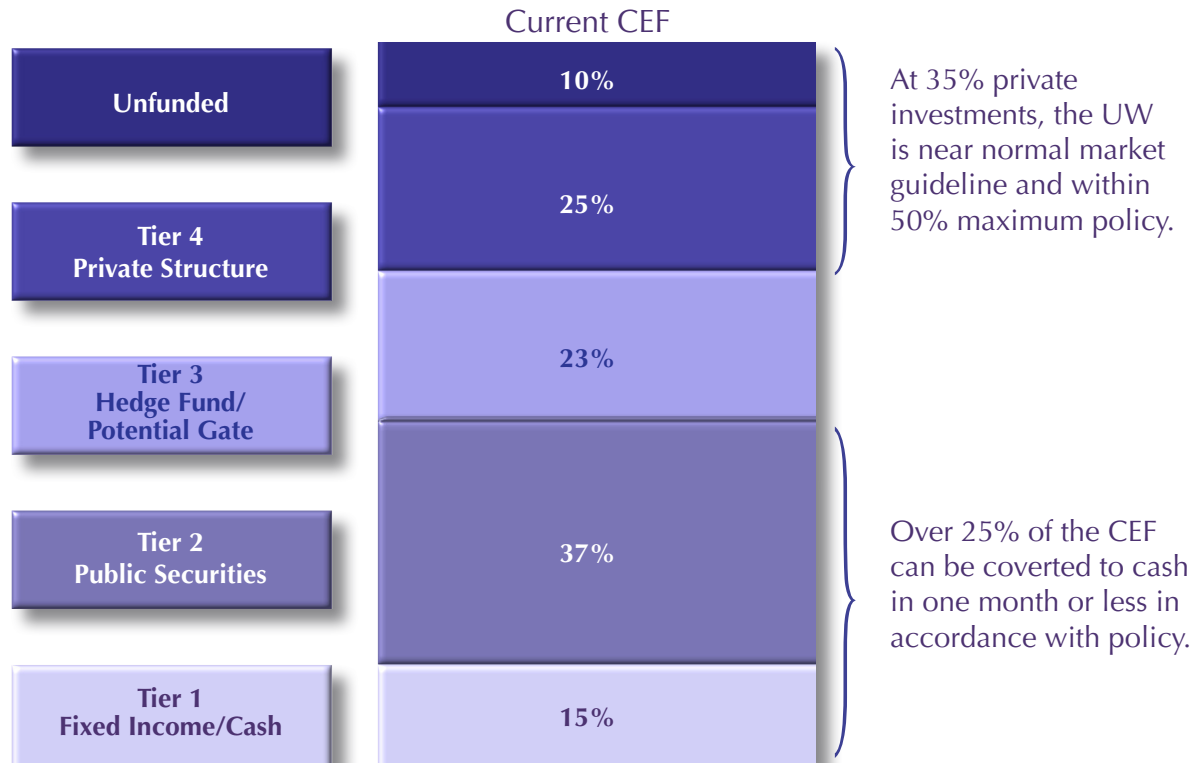
³ Includes 25% current exposure to private investments

⁴ Includes allocation to cash

Current positioning favors Capital Appreciation led by public equities.

Liquidity: Current CEF vs. Guidelines

Asset Allocation as of March 31, 2012 (\$=m)



Liquidity is managed to provide for endowed program distributions along with sufficient capital to meet contractual commitments to private investment managers.

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 Fees
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

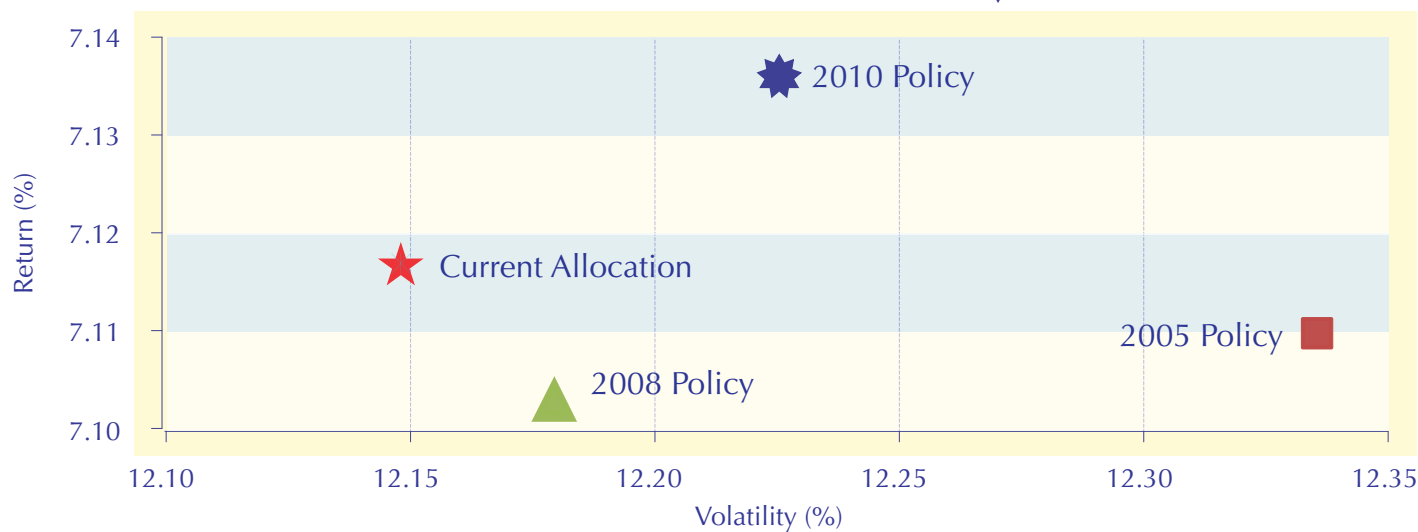
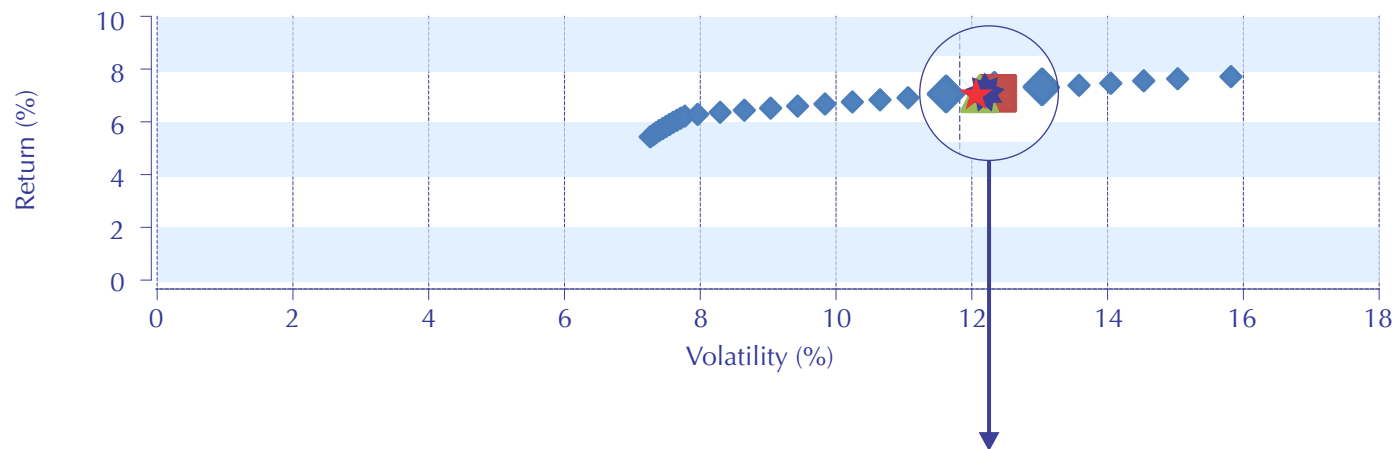
	3.0%	4.0%	5.0%	6.0%	7.0%
1.0%	4.0%	5.0%	6.0%	7.0%	8.0%
2.0%	5.0%	6.0%	7.0%	8.0%	9.0%
3.0%	6.0%	7.0%	8.0%	9.0%	10.0%
4.0%	7.0%	8.0%	9.0%	10.0%	11.0%
5.0%	8.0%	9.0%	10.0%	11.0%	12.0%
6.0%	9.0%	10.0%	11.0%	12.0%	13.0%
7.0%	10.0%	11.0%	12.0%	13.0%	14.0%
8.0%	11.0%	12.0%	13.0%	14.0%	15.0%

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: Projected Returns and Risk



UW asset allocation analysis projects returns of 7% per year over the long term. Increasing prospective returns would require taking significantly more equity risk.

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 March 31, 2012

		<u>1 Year</u>	<u>5 Year</u>	<u>10 Year</u>	<u>15 Year</u>	<u>20 Year</u>
RETURN	Total CEF Return	1.8%	1.8%	6.7%	8.4%	9.4%
	Policy Benchmark ¹	4.0%	3.6%	6.9%	7.9%	9.4%
	70/30 Market Benchmark ²	2.7%	2.6%	6.2%	6.2%	7.5%
	Peer Quartile Ranking ³	NA	NA	NA	NA	NA
	Return Contribution (\$m)	\$37	\$181	\$1,003	\$1,410	\$1,692
RISK	CEF Sharpe Ratio⁴	0.24	0.07	0.54	0.56	0.68
	Policy Benchmark Sharpe Ratio	0.47	0.23	0.55	0.50	0.64

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

² 70% MSCI ACWI plus 30% BC Government Bonds.

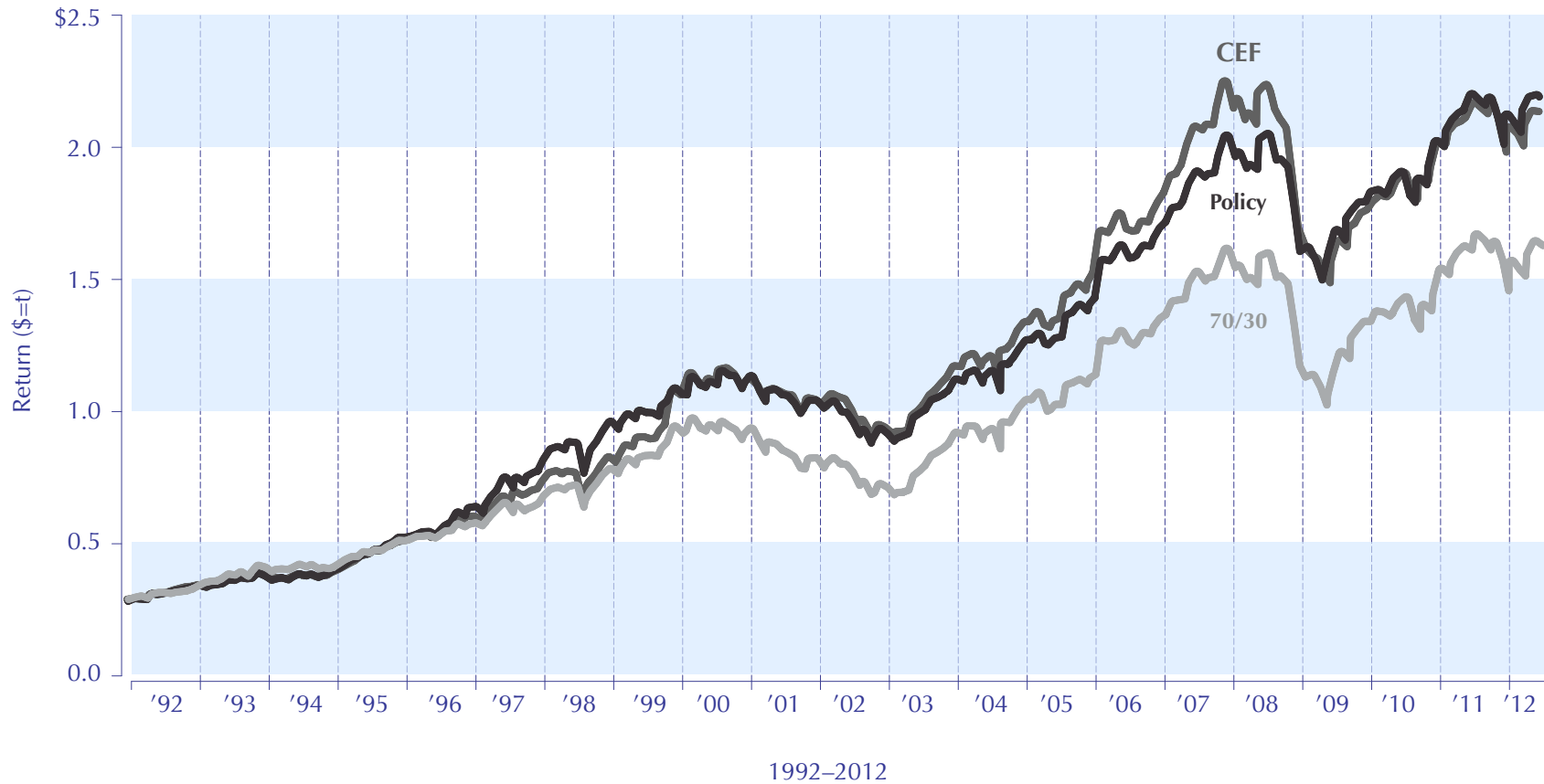
³ Cambridge Associates Top 50 Colleges & Universities (3/12 report not available at press time.)

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.

CEF performance has lagged over the short term. Longer term performance remains solid.

Performance and Risk: CEF Distribution of Returns

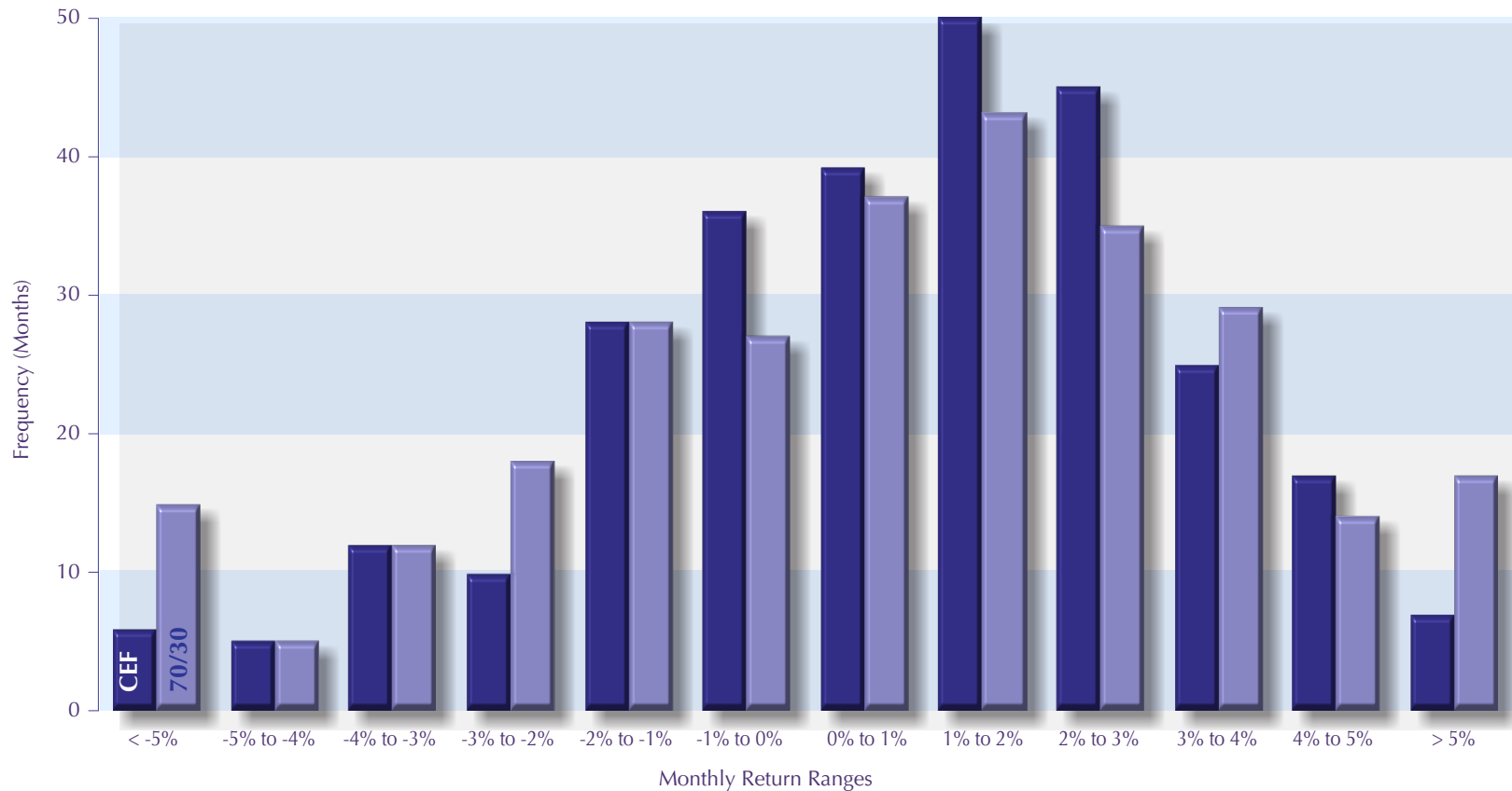
20 Year Comparative Growth of Endowment (including cash flows)



The CEF has added \$520 million of value above a passive portfolio over the last 20 years.

Performance and Risk: CEF Distribution of Returns

CEF Return Histogram Versus 70% MSCI ACWI and 30% BC Government Bonds Inception through March 31, 2012



CEF Performance Recap through March 31, 2012

	<u>1 Year</u>	<u>5 Year</u>	<u>10 Year</u>	<u>15 Year</u>	<u>20 Year</u>	<u>Since Inception (11/88)</u>
Total CEF Return	1.8%	1.8%	6.7%	8.4%	9.4%	9.8%
70/30 Benchmark	2.7%	2.6%	6.2%	6.2%	7.5%	7.2%
Over/Under 70/30	-0.8%	-0.8%	0.5%	2.2%	1.9%	2.6%

CEF has also generated more stable returns relative to a passive portfolio.

Performance: Annual Returns by CEF Asset Class

For Calendar Years Ending December 31

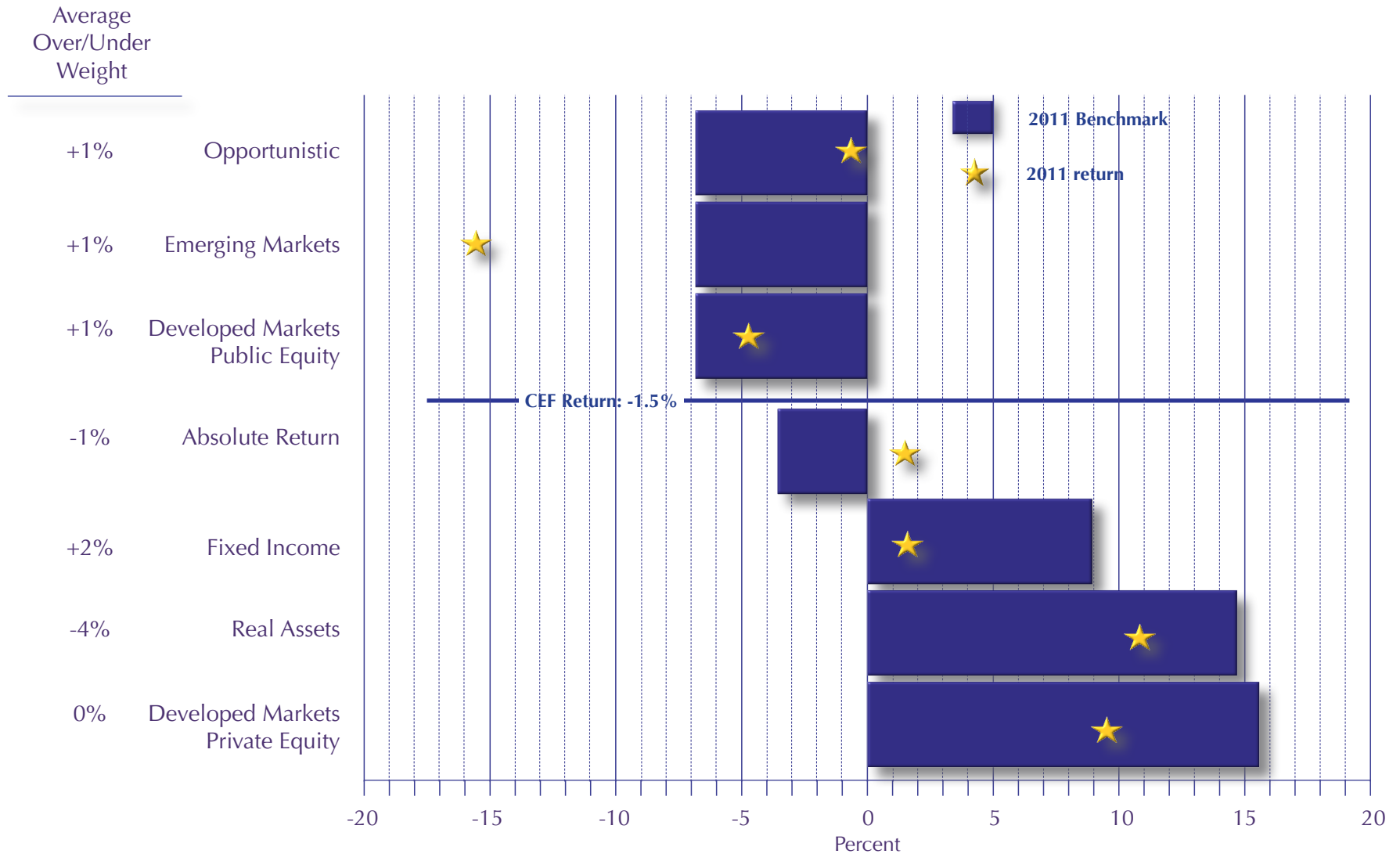
	2005	2006	2007	2008	2009	2010	2011	Seven Years 2005–2011
Best Performing	Emerging Markets 30.7%	Emerging Markets 36.0%	Emerging Markets 57.4%	Fixed Income -2.9%	Emerging Markets 71.4%	Emerging Markets 26.5%	Real Assets 10.7%	Emerging Markets 13.8%
	Developed Markets: Private Equity 26.0%	Developed Markets: Private Equity 17.4%	Developed Markets: Private Equity 28.8%	Developed Markets: Private Equity -4.4%	Developed Markets: Public Equity 25.9%	Developed Markets: Public Equity 12.9%	Developed Markets: Private Equity 9.4%	Developed Markets: Private Equity 10.7%
	Real Assets 21.4%	Developed Markets: Public Equity 16.0%	Real Assets 16.2%	Real Assets -22.9%	Absolute Return ² 24.2%	Absolute Return ² 10.7%	Fixed Income 1.6%	Absolute Return ² 6.7%
	Developed Markets: Public Equity 13.5%	Absolute Return ² 15.2%	Absolute Return ² 15.3%	Absolute Return ² -23.0%	Fixed Income 2.2%	Developed Markets: Private Equity 10.1%	Absolute Return ² 1.5%	Fixed Income 3.1%
	Absolute Return ² 10.0%	Real Assets 14.9%	Developed Markets: Public Equity 9.0%	Developed Markets: Public Equity -38.3%	Developed Markets: Private Equity -7.2%	Opportunistic ¹ 6.2%	Opportunistic ¹ -0.6%	Real Assets 2.7%
	Fixed Income 4.0%	Fixed Income 5.8%	Fixed Income 8.9%	Emerging Markets -52.0%	Real Assets -13.2%	Fixed Income 2.5%	Developed Markets: Public Equity -4.6%	Developed Markets: Public Equity 2.6%
						Real Assets 0.1%	Emerging Markets -15.3%	
Worst Performing								

¹ Opportunistic investment strategy added 7/1/2010

² Prior to 2008 absolute return included long / short equity investments

CEF performance has been driven by the Emerging Markets strategy.

Performance: 2011 by Asset Class



Performance of individual asset classes was mixed in calendar year 2011.

Invested Funds

Profile: Invested Funds (IF)

Description: The operating funds of the University.

Size: \$1.4 billion at March 31, 2012 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, 2011 (\$000's)

Campus Depositors Funds ¹			Institutional Funds		
UW Medicine	\$381,657	24.3%	General Institutional Funds	\$469,972	29.8%
Insurance Funds	81,122	5.2%	Reserves	81,046	5.3%
Office of Research (C4C)	63,328	4.0%			
Auxiliary Services	61,786	3.9%			
Private Grants	52,395	3.3%			
College of Arts & Sciences	44,953	2.9%			
College of Engineering	39,974	2.5%			
Student Facilities & Fees	13,565	0.9%			
Foster School of Business	12,933	0.8%			
Other Schools & Departments ²	266,949	17.0%			
Total	\$1,018,662	64.9%	Total	\$551,018	35.1%

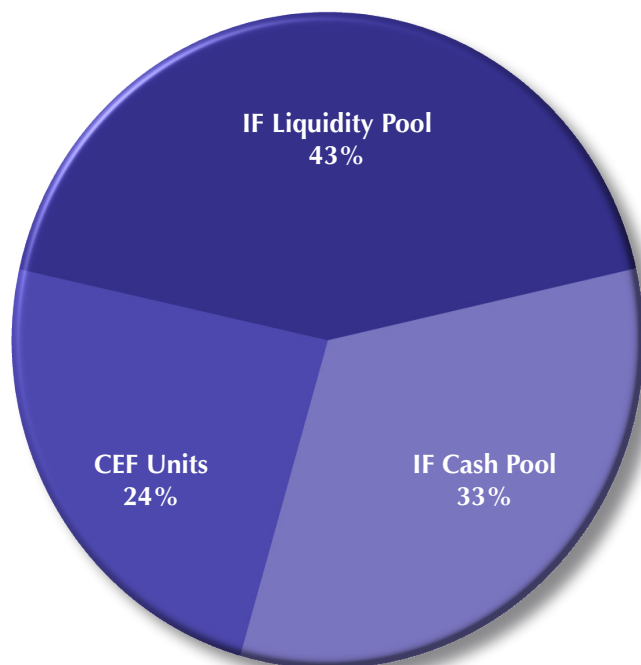
¹ Includes gifts, private grants, royalty funds and auxiliary reserves

² Includes other schools, colleges and departments with small operating and reserve balances

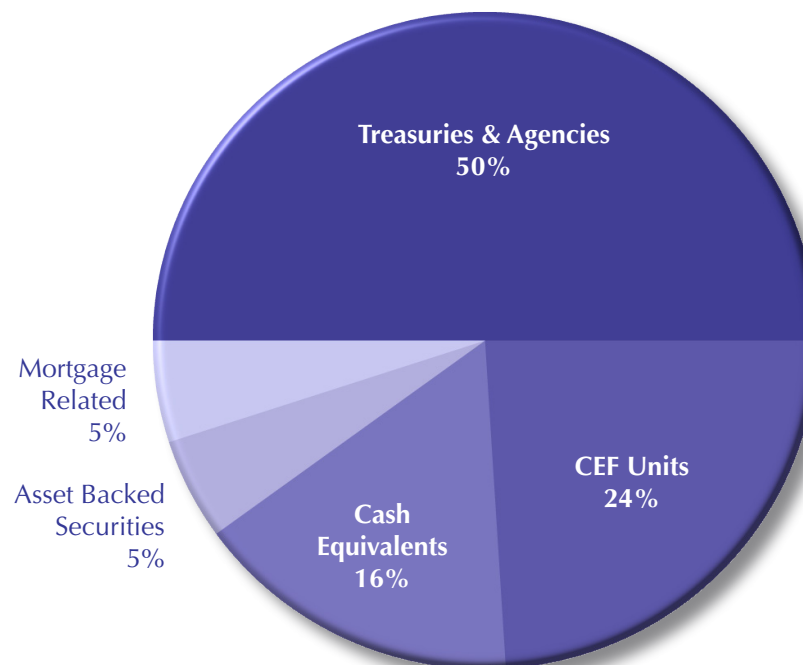
Positioning: IF Asset Allocation

As of March 31, 2012

By Pool



By Asset Type

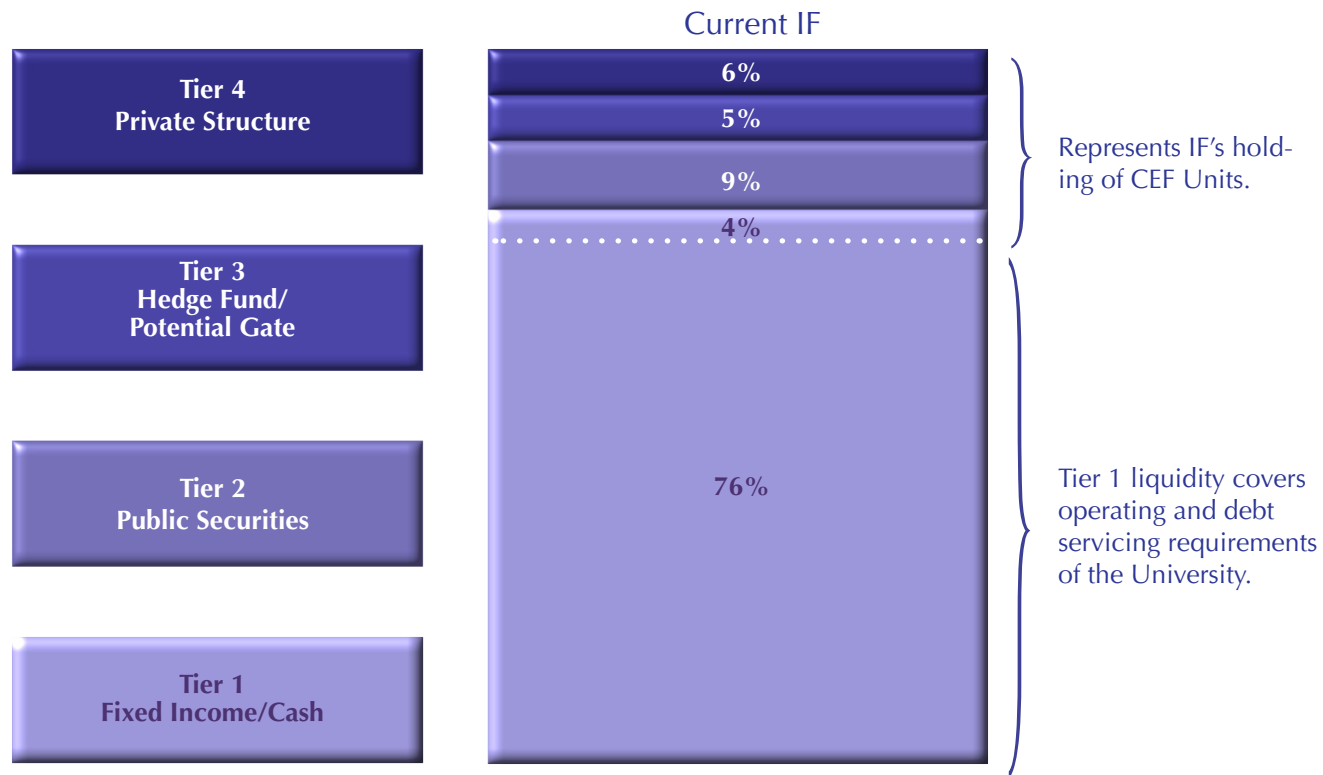


	Fund Allocation (\$m)		Range	Duration in Years		Guidelines
				Actual	Maximum	
Cash Pool	\$600	33%	10%–40%	0.5	3.0	Average quality of "AA"
Liquidity Pool	\$788	43%	30%–60%	3.6	4.5	Average quality of "A" ¹
Total Cash & Liquidity Pool	\$1,388	76%				
CEF Units held by IF	\$435	24%	15%–40%			¹ At least 25% in US Gov't and its agencies
Total Invested Funds	\$1,823	100%				

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

Positioning: Current IF vs. Guidelines

As of March 31, 2012



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

Performance and Risk: IF

As of March 31, 2012

		<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	2.7%	5.1%	4.8%	6.0%	6.5%
	Policy Benchmark ¹	3.5%	4.1%	5.1%	6.1%	6.5%
	Total IF Return excluding CEF units	3.4%	4.0%	4.1%	5.1%	5.4%
	Policy Benchmark ¹	3.5%	4.4%	4.2%	5.0%	5.2%
	Return Contribution of CEF (\$m)	\$7	\$35	\$222	\$325	\$405
MARKET	Three Month T-Bill	0.0%	1.1%	1.8%	2.8%	3.2%
RISK	IF Sharpe Ratio²	1.54	0.66	1.09	1.58	1.54
	Policy Benchmark Sharpe Ratio	1.93	1.03	1.25	1.58	1.52

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.

Over the long term, CEF exposure in the IF portfolio has improved the absolute performance of the IF by over 1% per annum.

Constitutional Amendment

Status

Constitutional amendment is scheduled for public vote in November 2012 to permit investment of UW and WSU operating funds in corporate securities. A simple majority is required for the amendment to become effective.

Implementation

- Accompanying legislation passed in March 2012 requires Washington State Investment Board (WSIB) implementation.
- If the proposed amendment is not approved and ratified by the voters, the accompanying legislation is void in its entirety.
- The UW investment team will work with UWINCO and the Board of Regents to determine how and when the authority is used, if approved.