UTIMCO Endowment Funds

Growth in Endowment Funds Net Asset Value

Endowment Funds

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Endowment Funds Overview

As of August 31, 2000, the UT Board was the fiduciary for four major endowment fund groups with a combined value equal to $12,805.2 million. The UT System and other institutional beneficiaries of the endowment funds managed by UTIMCO provide educational and health care services for the State of Texas. The ability of these institutions to provide quality services throughout the next century will depend on the maintenance of long-term financial equilibrium by these institutions. Maintenance of such equilibrium requires, among other financial objectives, the preservation of endowment purchasing power. Endowment funds are permanent funds by their nature with the result that endowment purchasing power must be preserved in perpetuity. The endowment must provide future generations the same level of economic support for scholarships, teaching, research, and other educational programs as it provides today.

Investment Objectives

Measured quantitatively, the preservation of endowment purchasing power requires the simultaneous achievement of two contradictory objectives:

- increase the amount of the annual distribution to endowment beneficiaries at a rate at least equal to the rate of inflation, and

- increase the market value of the endowment fund (after the annual distribution) at a rate at least equal to the rate of inflation.

These objectives are contradictory because higher rates of annual distributions require larger annual withdrawals from the endowment fund. Larger withdrawals reduce the endowment fund's ability to grow over time.

Factors Affecting an Endowment Fund's Purchasing Power

The maintenance of endowment purchasing power is affected by four major factors: a) fund investment return, b) fund expenses, c) the rate of inflation, and d) fund distributions. UTIMCO attempts to preserve endowment purchasing power by distributing from the endowment no more than the *average* expected annual investment return after expenses and inflation.

a) Fund Investment Return

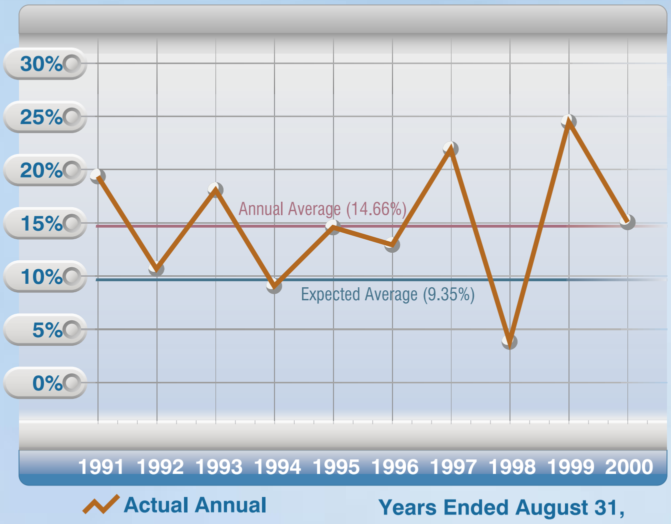
The investment returns and accompanying risk generated by the endowment funds are determined largely by the allocation of fund assets to different classes of investments. The Endowment Policy Portfolio is an efficient optimized mix of the multiple asset classes that produces the highest return with the lowest risk profile. The Endowment Policy Portfolio return is the index or benchmark return for endowment funds. This return is the sum of the weighted benchmark return for each asset class comprising the endowment policy portfolio. For the fiscal year 2000 this return was 14.8%. The expected average annual return of the Endowment Policy Portfolio is 9.35% with an associated expected risk of 10.44% (as measured by standard deviation). This is interpreted by stating that 66.7% of the time the endowment return in any given year is expected to be within a range of (1.09)% to 19.79%.

The neutral asset allocation underlying the Endowment Policy Portfolio as of August 31, 2000, was the following:

Asset Class	Neutral Weight	Range	Return Index
Cash and Equivalents	0.0%	0%-5%	ML 90 Day T-Bill Ave. Yield
U.S. Equities: Med/Large Capitalization	25.0%	10%-40%	S&P 500 Index
U.S. Equities: Small Capitalization	7.5%	5%-15%	Russell 2000 Index
Non-U.S. Equities: Established Markets	12.0%	5%-20%	FT Actuaries World (ex-U.S.) Index
Non-U.S. Equities: Emerging Markets	3.0%	0%-10%	MSCI-Emerging Mkts. Free
Alternative Assets: Marketable	10.0%	5%-15%	ML 90 Day T-Bills + 7%
Alternative Assets: NonMarketable	15.0%	5%-20%	17%
Inflation Hedging	7.5%	5%-15%	33% (GSCI - 100bps)/67% NCREIF
U.S. Fixed Income	15.0%	10%-25%	Lehman Brothers Aggregate Index
Non-U.S. Fixed Income	5.0%	0%-7%	Salomon Non-U.S. WGBI Unhedged
Total Fund Assets	**100%**		**Policy Portfolio Index**

The actual average annual return of the Endowment Policy Portfolio over the last 10 fiscal years was 14.66% and was quite volatile as presented below:

Endowment Policy Portfolio Returns



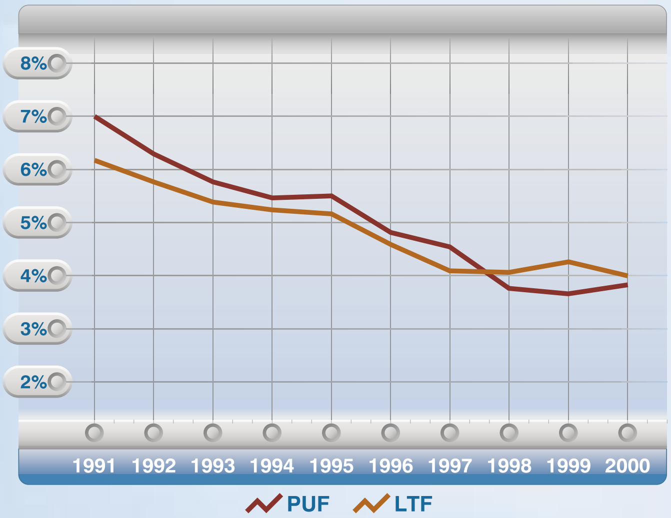
b) Fund Expenses
UTIMCO incurs expenses associated with strategy and analysis, portfolio management, custody and safekeeping, accounting, and other investment related functions. These expenses are allocated to the endowment funds in proportion to their asset values and certain activity levels. Fund expenses are paid from fund assets and are not netted against the distributions.

c) Rate of Inflation
Inflation erodes the value of endowment funds by reducing fund purchasing power over time. Investors have no control over the rate of inflation. UTIMCO must invest fund assets so as to maximize the risk adjusted real return on investment. Inflation is cyclical resulting in periods of increasing and decreasing fund purchasing power. The long-term average annual rate of inflation since 1926 is approximately 3.2% with a range of (10.3)% to 18.1%.

d) Fund Distributions (Spending)
Annual distribution, or spending, from endowment funds (except for the SIFs) is controlled by a spending policy (as approved by the UT Board). The key to preservation of endowment purchasing power over the long-term is control of spending through a target distribution rate. This target rate should not exceed the endowment's average annual investment return after fund expenses and inflation. The target distribution rate for endowments managed to the Endowment Policy Portfolio is currently 4.5% of the fund's asset value. The LTF and PHF distributions are increased annually at the rate of inflation provided that the distribution rate remains within a range of 3.5% to 5.5% of fund asset value. With the passage of Proposition 17, PUF distributions will be made from the total return on PUF Investments. Annual PUF distributions to the AUF are now based on 4.5% of the PUF's average net investment value.

Actual investment returns for any given year may vary significantly from the expected average annual investment return. Therefore, the endowment distribution policies use a smoothing formula to reduce annual volatility in spending and to maintain spending on a sustainable basis. The historical distribution rates for the PUF and LTF are presented below:

Historical Distribution Rates



Combining these four factors, the higher the fund investment return and the lower the rates of fund expenses, inflation, and spending, the greater the ability to increase the purchasing power of the endowment assets and the spending stream over time. Preservation of endowment purchasing power over the long run is currently targeted by UTIMCO using the following expected long-term annual rates for the Endowment Policy Portfolio:

	Expected Annual Average
Rate of Investment Return	9.35%
Less:	
Expense Rate	0.35%
Inflation Rate	3.50%
Distribution Rate	4.50%
Increase in Purchasing Power	**1.00%**