

# 2017

The University of Texas/Texas A&M Investment Management Company

## ANNUAL REPORT



THE UNIVERSITY OF TEXAS/TEXAS A&M  
INVESTMENT MANAGEMENT COMPANY

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## UTIMCO AT A GLANCE

- Created March 1996
- Manages the investment assets under the fiduciary care of the UT System Board of Regents
- \$41 billion under management
- Governed by a nine-member board consisting of at least three members of the U. T. System Board of Regents, four members appointed by the U. T. System Board of Regents, three of which must have substantial background and expertise in investments, and two members appointed by the Texas A&M System Board of Regents, one of which must have a substantial background and expertise in investments
- Day-to-day management responsibility for the investment assets is delegated to UTIMCO staff
- Diversified portfolio includes US and global equities, fixed income investments, real estate, private equity, venture capital, and hedge funds



## OUR MISSION

We generate superior long-term investment returns to support the University of Texas and Texas A&M University systems as they provide world-class teaching, push the boundaries of discovery, and achieve excellence in patient healthcare for the people of Texas and beyond.



## TOTAL ENDOWMENT RESULTS

For the year ended August 31, 2017, the Permanent University Fund (PUF) returned +12.2% and the General Endowment Fund (GEF) returned +12.7%, resulting in a combined Total Endowments performance of +12.3%. The value added by the active management decisions of the UTIMCO team was +1.8% over the Endowments' Benchmark Policy Portfolio returns of +10.5%.

Over this same period, the total value of the Endowments grew from \$26.4 billion to \$29.3 billion, an increase of \$2.9 billion. Total assets managed by UTIMCO grew by \$4.5 billion to end the year at \$41.3 billion. For the one year period ending June 30th, the Endowments earned a return that exceeded each of the nation's four largest private endowments. At present, the Total Endowment assets managed by UTIMCO rank second in size relative to all other endowments in America.

## MARKET CONDITIONS

This period marked the eighth consecutive year of an equity market expansion, and is now the second longest bull market period without a significant downward correction in equity market history. The US stock market bottomed on March 9, 2009 and has since gone up a cumulative 265%, leading to total returns of 337% including dividends. Despite relatively slow GDP growth and limited productivity advances in the US, stock markets have moved steadily upwards, supported initially by low valuations and accommodative monetary policy.

Following the "Great Financial Crisis" central banks globally, led by the US Federal Reserve, drew short term interest rates down to near zero and went on to use previously untested monetary policies designed to avoid a potential depression. The intended impact of these policies was to spread out the potential negative implications over a longer period of time. To date, the policy has worked and is just now being carefully reversed as economic and financial market conditions have improved.



Figure 1

### Economic and Financial Condition Indicators<sup>1</sup>

	Then	Now	Total Change	Annualized
<b>S&amp;P 500</b>				
Price	676.5	2,471.7	+265.3%	11.1%
Price/Earnings Ratio (Forward/Trailing)	11.2/11.1	18.9/21.1	+7.7/+10.0	
Volatility	38.5	9.5	-29.0%	
US UNEMPLOYMENT (%)	8.3	4.4	-3.9%	
10-YEAR TREASURY-NOTE YIELD (%)	2.9	2.1	-0.7%	
GROSS DOMESTIC PRODUCT GROWTH YEAR OVER YEAR(%) <sup>2</sup>	-3.5	2.3	+6.1%	
INFLATION YEAR OVER YEAR (%)	0.2	1.9	+1.7%	
FEDERAL FUNDS RATE (%)	0.25	1.25	+1.0%	
SIZE of FEDERAL BALANCE SHEETS (\$, TRILLIONS)	\$1.9	\$4.4	+\$2.6	

<sup>1</sup> Source: Bloomberg  
Then refers to 3/31/09, now refers to 9/30/17

<sup>2</sup> Real Terms



## ASSET ALLOCATION

The Endowments' goals are to produce attractive long-term returns within a sound and well diversified asset allocation structure, professionally and prudently implemented at all times. In order to achieve these goals over time, three complementary investment portfolios are simultaneously maintained.

- A Global Equity portfolio, designed to capture the long-term advantages of the Endowments' time horizon
- A Stable Value portfolio intended to provide diversification against deflationary conditions (e.g., typical recessions)
- A Real Return portfolio intended to provide diversification against unexpected inflation

Set out in Figure 2 on the next page is the Endowments' current asset allocation to the various components of each of the three strategies.

Figure 2

### Endowments Asset Allocation

as of August 31, 2017 (\$ in millions)

	2017		2016	
<b>GLOBAL EQUITY</b>				
<b>TOTAL US PUBLIC EQUITY</b>	<b>\$2,306.7</b>	<b>7.9%</b>	<b>\$2,073.0</b>	<b>7.9%</b>
<b>NON-US PUBLIC EQUITY</b>				
EAFE + Canada	1,928.1	6.6%	1,545.5	5.9%
Emerging Markets	3,122.5	10.7%	2,145.3	8.1%
<b>TOTAL NON-US PUBLIC EQUITY</b>	<b>5,050.6</b>	<b>17.3%</b>	<b>3,690.8</b>	<b>14.0%</b>
<b>DIRECTIONAL HEDGE FUNDS</b>	<b>4,761.8</b>	<b>16.3%</b>	<b>5,779.9</b>	<b>21.9%</b>
<b>PRIVATE EQUITY</b>				
Private Equity	2,166.0	7.4%	1,984.9	7.5%
Venture Capital	1,419.6	4.8%	1,196.4	4.5%
Emerging Markets	1,470.8	5.0%	1,152.5	4.4%
Credit	859.4	2.9%	960.9	3.6%
<b>TOTAL PRIVATE EQUITY</b>	<b>5,915.8</b>	<b>20.1%</b>	<b>5,294.7</b>	<b>20.0%</b>
<b>TOTAL GLOBAL EQUITY</b>	<b>18,034.9</b>	<b>61.6%</b>	<b>16,838.4</b>	<b>63.8%</b>
<b>STABLE VALUE</b>				
US Fixed Income (Investment Grade)	763.9	2.6%	492.5	1.9%
Non-US Fixed Income	784.1	2.7%	661.4	2.5%
Emerging Markets Sovereign Debt	492.4	1.7%	371.4	1.4%
Non-Directional Hedge Funds	1,422.3	4.9%	1,145.8	4.3%
Cash	1,041.9	3.5%	1,140.1	4.4%
<b>TOTAL STABLE VALUE</b>	<b>4,504.6</b>	<b>15.4%</b>	<b>3,811.2</b>	<b>14.5%</b>
<b>REAL RETURN</b>				
Inflation Linked Bonds	14.4	0.0%	12.0	0.0%
Real Estate	2,133.3	7.3%	1,706.8	6.5%
Natural Resources	3,899.2	13.3%	3,430.2	13.0%
Gold	695.5	2.4%	581.8	2.2%
<b>TOTAL REAL RETURN</b>	<b>6,742.4</b>	<b>23.0%</b>	<b>5,730.8</b>	<b>21.7%</b>
<b>TOTAL ENDOWMENTS</b>	<b>\$29,281.9</b>	<b>100.0%</b>	<b>\$26,380.4</b>	<b>100.0%</b>

## INVESTMENT PHILOSOPHY- CREATING LONG-TERM RETURNS

The Endowments are managed as long-term investment funds with a time horizon exceeding that of most other investors. They have consistent sources of funding with relatively low and reasonably predictable short-term funding requirements. As a result, the Endowments are able to assume significant equity risk as well as higher levels of illiquidity than the typical investor. These two factors alone should typically produce higher long-term returns relative to most other funds. When combined with effective risk systems and risk management, attractive and consistent results have been achieved.



Figure 3

### Annualized Returns

(Periods Ending August 31, 2017)

	SINCE MARCH 1996		SINCE MARCH 2009	
	Endowments	Policy Benchmark	Endowments	Policy Benchmark
<b>Return</b>	<b>7.82%</b>	<b>7.09%</b>	<b>10.51%</b>	<b>8.96%</b>
<b>Volatility</b>	<b>8.13%</b>	<b>8.52%</b>	<b>5.90%</b>	<b>6.74%</b>
<b>Sharpe Ratio<sup>1</sup></b>	<b>0.67</b>	<b>0.56</b>	<b>1.75</b>	<b>1.30</b>

<sup>1</sup>Sharpe Ratio is the average return earned in excess of the risk free rate per unit of volatility or total risk.

In addition, other factors are key to creating superior risk-adjusted long-term returns.

#### The Risk-Free Rate

The returns available to an investor without taking incremental risk have declined meaningfully over the past 20+ years. Using the 10 Year U.S. Treasury Bond as a proxy, this rate has fallen from 6.9% in 1996 to 2.1% in 2017. When taking inflation into account the deterioration is even more pronounced. Assuming that most investors are trying to earn returns of 5% in excess of inflation, risk-free government bonds are simply no longer helpful in achieving an investor's return goals.

#### Creating "Alpha" (Returns that Exceed Passive Benchmarks)

To achieve this consistently requires both skill and the assumption that markets are not completely efficient, or that their efficiency varies over time and across market cycles. Over the past one and five year periods UTIMCO's portfolios have produced the results shown in Figure 4 versus passive or competing benchmarks.

#### Aligning Costs

To achieve cost alignment, UTIMCO seeks to negotiate fees with external managers that are below market and where the manager's incentives are aligned with our own. Recently, UTIMCO has been collaborating with its key investor relationships to assure that the Endowments receive either a high return or a substantial portion of any excess return over a properly constructed passive benchmark. Attractive co-investment opportunities are also developed with key investment relationships which add to returns and lower costs. Co-Investments currently represent 8.0% of the Endowments' assets and have generated returns of 16.1% since the inception of the program.

Figure 4

### Investment Returns by Portfolio

	ONE YEAR			FIVE YEARS		
	Return	Benchmark	Over/Under	Return	Benchmark	Over/Under
<b>EQUITY</b>						
Developed Country	10.8%	10.8%	0.0%	11.2%	8.2%	3.0%
Emerging Markets	16.9%	18.6%	(1.7%)	7.2%	6.7%	0.5%
<b>FIXED INCOME</b>						
Investment Grade	2.9%	1.7%	1.2%	1.1%	1.7%	(0.6%)
Credit	12.3%	8.2%	4.1%	9.6%	7.2%	2.4%
<b>OTHER</b>						
Natural Resources	17.4%	9.0%	8.4%	0.7%	3.5%	(2.8%)
Real Estate	14.5%	7.8%	6.7%	11.8%	10.1%	1.7%
<b>TOTAL</b>	<b>12.3%</b>	<b>10.5%</b>	<b>1.8%</b>	<b>8.0%</b>	<b>6.8%</b>	<b>1.2%</b>



## INVESTMENT PHILOSOPHY- RISK MANAGEMENT

Managing risk is central to the execution of any investment process, and is a priority for the UTIMCO team. This is done primarily by focusing on longer-term outcomes rather than short-term results; prudent and effective diversification; a series of risk systems that monitor economic and market conditions; and professional collaboration with both the UTIMCO Board of Directors and a global network of investment organizations. Most importantly, UTIMCO maintains an organization of high character and professional investment personnel dedicated to integrity and transparency. The objective of our risk management processes is not to avoid any and all risk, but rather to manage through various environments effectively by assuring that UTIMCO is always the “strong hand” in the market. This allows us to not only weather the inevitable and unpredictable financial storms, but also to take advantage of the unique investment opportunities that those “bad times” often produce.

Markets gyrate through repeating but difficult to anticipate patterns as they work their way through both short and longer-term cycles. Short-term

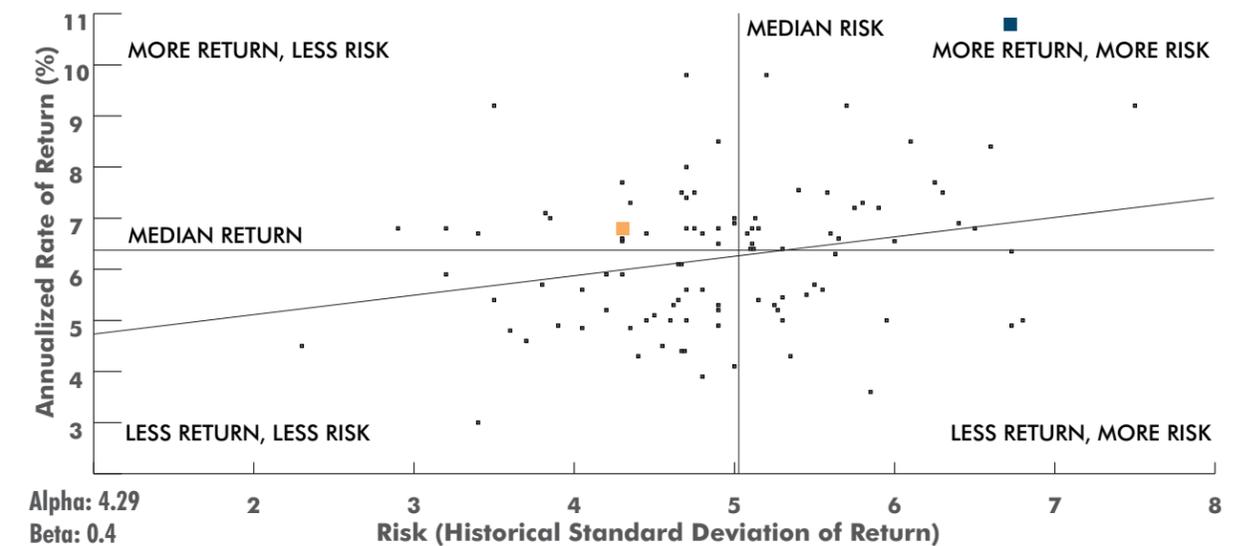
cycles are driven primarily by business conditions and are comprised of corrections, recoveries and expansions. At this time, equity markets are generally in expansion having reclaimed their previous peaks. Longer-term cycles are generally driven by debt levels. The amount of debt in the economy has risen substantially over the past several decades and is likely to be less of a stimulus to economic activity going forward. In fact, at some point, deleveraging is likely although the pace has, so far, been slow. Should interest rates rise meaningfully, deleveraging would likely be accelerated and economic conditions would likely deteriorate.

Bear markets are generally the result of one of the following five factors: recessions, commodity disruptions, Federal Reserve policies, global geopolitical events and/or excessive valuations. At the present time, valuations are above historical norms while other conditions remain generally benign. Whenever the next cyclical “bear market” occurs, the Endowments will likely decline in a range between -16% and -36%, with a baseline outcome of approximately -23%.

Over the past three years, UTIMCO has taken less risk than 81% of other similar funds while producing a three year return exceeding the peer average and a passive benchmark.

Figure 5

### Trust Universe Comparison Service Risk vs Total Returns of Master Trusts - Foundation & Endowment 3 Years Ending September 30, 2017



	Risk Value	Risk Rank	Return Value	Return Rank
■ GEF TOTAL FUND	4.30	81	6.85	34
■ S&P 500	6.72	3	10.81	1
MEDIAN	5.06		6.40	

## FUTURE OUTLOOK

Short-term investment returns are largely driven by variations in economic conditions relative to what markets are currently pricing in. Today economic and financial market conditions are strong but valuations are also relatively high across most markets. This combination means that future endowment returns are likely lower and that results in the 4% to 7% range are most likely until better valuations are ultimately restored. This will likely occur either through a typical bear market decline, or an extended period of lower than normal market returns. Whatever the future holds, UTIMCO will manage through the process using sound investment practices and with experienced,

dedicated and high character investors. And as better investment opportunities arise, UTIMCO will be prepared to participate in them.

Thank you for your continued dedication to the important work that these endowments support.

Sincerely Yours,

**Britt Harris**  
President, CEO and Chief Investment Officer



## UTIMCO BOARD OF DIRECTORS



**Jeffery D. Hildebrand**  
Chairman



**Ray Rothrock**  
Vice Chairman



**R. Steven Hicks**  
Vice Chairman for Policy



**Phil Adams**



**J. Kyle Bass**



**Robert Gauntt**



**Janet Handley**



**Ray Nixon**



**James C. "Rad" Weaver**

**Jeffery D. Hildebrand Vice Chairman:** Board of Regents, The University of Texas System **Chairman:** Board of Regents, The University of Texas System - Finance and Planning Committee **Member:** Board of Regents, The University of Texas System - Facilities Planning and Construction Committee; Board of Regents, The University of Texas System - Health Affairs Committee; University Lands Advisory Board **Founder, Chairman and Chief Executive Officer:** Hilcorp Energy Company **Recipient:** 2005 Distinguished Engineering Graduate Award, The University of Texas at Austin; 2013 Petroleum & Geosystems Engineering Distinguished Alumnus Award, The University of Texas at Austin **Board Member:** Central Houston, Inc.; Houston Livestock Show and Rodeo; Houston Police Foundation; The Hildebrand Foundation

**Ray Rothrock Chair:** UTIMCO Compensation Committee **Member:** UTIMCO Risk Committee; Forbes Midas List; Corporation for the Massachusetts Institute of Technology **CEO:** RedSeal, Inc. **Partner Emeritus:** Venrock **Chairman:** Transatomic Power **Recipient:** 2016 Texas A&M University Distinguished Alumnus Award **Past Chairman:** National Venture Capital Association **Board Member:** Check Point Software Technology (NASDAQ: CHKP); Several Private Companies including Roku, Team8, Shape Security, Appthority, CTERA, Dyadic, and Tri Alpha Energy; Nuclear Innovation Alliance **Speaker:** Nuclear energy, climate change and energy policy in general **Co-Executive Producer:** Documentary, Pandora's Promise; **Advisor:** BreakThrough Institute

**R. Steven Hicks Chair:** UTIMCO Policy Committee **Member:** Board of Regents, The University of Texas System; Board of Regents, The University of Texas System - Academic Affairs Committee; Board of Regents, The University of Texas System - Audit, Compliance, and Risk Management Committee; Board of Regents, The University of Texas System - Health Affairs Committee **Former Vice Chairman:** Board of Regents, The University of Texas System **Chairman:** Board of Regents, The University of Texas System - Facilities Planning and Construction Committee **Executive Chairman:** Capstar Partners, LLC

**Phil Adams Member:** UTIMCO Audit and Ethics Committee; UTIMCO Policy Committee **Member, Past Chairman and Vice Chairman:** Board of Regents, The Texas A&M University System **Owner and President:** Phil Adams Company **Member:** National Association of Insurance and Financial Advisors; Philosophical Society of Texas **Board Member:** American Momentum Bank; Texas A&M Mays Business School Development Council; Scott & White Health Plan **Former Board Member:** First American Bank

**J. Kyle Bass Chair:** UTIMCO Risk Committee **Member:** UTIMCO Compensation Committee; Advisory Group for the Center of Asset Management at the Darden School of Business at the University of Virginia **Principal:** Hayman Capital Management, L.P. **Board Member:** Troops First Foundation; Texas Department of Public Safety Foundation **Expert Witness:** U.S. House of Representatives, U.S. Senate and Financial Crisis Inquiry Commission **Former Managing Director:** Legg Mason, Inc. **Former Senior Managing Director:** Bear Stearns & Co.

**Robert Gauntt Member:** UTIMCO Compensation Committee; UTIMCO Risk Committee; The University of Texas Chancellor's Council Executive Committee; Pro-Vision Charter School; Hope for Africa Advisory Group **Founding Partner:** Avalon Advisors, LLC **Former Chairman:** Investment Committee and Risk Management Committee of the Teacher Retirement System of Texas Board of Trustees **Former Member:** McCombs School of Business Advisory Council; Texas Growth Fund Board; Endowment Committee at River Oaks Baptist School; **Letterman:** The University of Texas at Austin - 1983 NCAA Division I National Championship Baseball Team

**Janet Handley Chair:** UTIMCO Audit and Ethics Committee **Member:** UTIMCO Policy Committee; A&M Legacy Society; Texas Wall Street Women **Former Vice President for Investments:** Texas A&M Foundation **Investment Committee Advisor:** Society of Petroleum Engineers **Former Member:** Venture Capital Advisory Council - Commonfund Capital

**Ray Nixon Member:** UTIMCO Compensation Committee; UTIMCO Policy Committee; McCombs School of Business Advisory Council **Executive Director and Portfolio Manager:** Barrow, Hanley, Mewhinney & Strauss **Trustee:** UT Southwestern Foundation **Inductee:** The University of Texas McCombs School of Business Hall of Fame **Board Member:** East West Ministries; Salvation Army; Dallas Seminary Foundation **Chairman:** Texas Health Resources Endowment Investment Committee **Former Board Member:** CFA Society of Dallas-Fort Worth; CFA Society of DFW Strategic Advisory Board

**James C. "Rad" Weaver Member:** UTIMCO Audit and Ethics Committee; UTIMCO Risk Committee; Board of Regents, The University of Texas System - Academic Affairs Committee; Board of Regents, The University of Texas System - Audit, Compliance, and Risk Management Committee; Board of Regents, The University of Texas System - Facilities Planning and Construction Committee; Board of Regents, The University of Texas System - Finance and Planning Committee **CEO:** McCombs Partners **Chair:** San Antonio Chamber of Commerce **Chair Pro Tem:** Dallas Federal Reserve Board San Antonio **Board Member:** Cox Enterprises; Southern Towing Company; Circuit of the Americas; Allegiance Ambulance; General LED

## UTIMCO SENIOR MANAGEMENT



**Britt Harris**

President, CEO and Chief Investment Officer

**Uche Abalogu**, Chief Technology Officer

**Susan Chen**, Managing Director – Public Markets, Technology and Deal Legal

**Anna Cecilia Gonzalez**, Corporate Counsel and Chief Compliance Officer

**J. Russell Kampfe**, Managing Director – Fixed Income

**Edward Lewis**, Managing Director – Real Estate

**Joan Moeller**, Senior Managing Director – Accounting, Finance and Administration

**Ryan Ruebsahm**, Managing Director – Hedge Funds and Credit

**Melynda Shepherd**, Manager – Human Resources

**Ken Standley**, Chief of Staff

**Sharon Toolson**, Executive Assistant

**Mark Warner**, Senior Managing Director – Natural Resources and Emerging Markets

**Uziel Yoeli**, Managing Director – Risk Management

**Fiduciary Counsel**, Andrews Kurth Kenyon LLP, Austin, Texas

**Independent Auditors**, Deloitte & Touche LLP



**Uche Abalogu**



**Susan Chen**



**Anna Cecilia Gonzalez**



**J. Russell Kampfe**



**Edward Lewis**



**Joan Moeller**



**Ryan Ruebsahm**



**Melynda Shepherd**



**Ken Standley**



**Sharon Toolson**



**Mark Warner**



**Uziel Yoeli**