

LETTER FROM THE EXECUTIVE MANAGEMENT OF UTIMCO

Fiscal Year 2014 Returns
The Permanent University Fund (the “PUF”) and the General Endowment Fund (the “GEF”) – together the “Endowments” – had investment gains of 15.1% and 14.7%, respectively, for the fiscal year ended August 31, 2014 (“2014”).

PUF assets totaled $17.4 billion and GEF assets totaled $8.3 billion at fiscal year-end. This represents all-time peaks for the Endowments. Combined with the other funds managed by UTIMCO, namely the Intermediate Term Fund (“ITF”), and the Short Term and Debt Proceeds Funds, UTIMCO’s assets under management totaled $34.7 billion, also an all-time peak.

The Endowments’ actual returns exceeded the Policy Portfolio Benchmark by .92% for the PUF and .54% for the GEF. The ITF’s actual returns exceeded its Policy Portfolio Benchmark by .66%. As a reminder, the Policy Portfolio Benchmark represents the returns that would result without UTIMCO staff, or said precisely, the investment returns that would be realized if each asset class was at its Policy Portfolio target weight and generated that asset class’ average returns.

Over the past five years, the Funds actual returns have outperformed the Policy Portfolio Benchmark by an average of 1.8% per year for the Endowments and 2.4% for the ITF, resulting in $520 million per year of additional resources for the UT and A&M Systems. In 2014 alone, $219 million of additional resources were generated.

UTIMCO analyzes other top endowments in order to identify “best practices”. Over the last year, the Endowments’ investment returns have exceeded the average endowment and slightly lagged other large endowments, primarily due to the Endowments’ lower risk profile versus other large endowments.

UTIMCO staff (“Staff”), the UTIMCO Board (“Board”) and The University of Texas System Board of Regents (the “Regents”) have all concurred with having a less-risky portfolio, particularly given global economic uncertainties. While risk has been rewarded over the past few years, the goal of protecting principal supersedes the desire for higher investment returns. It is also the case that the Endowments’ risk profile has gradually and prudently increased over the past seven years, and it is planned that it will continue to do so.

Investment Strategy
Readers of previous Annual Report letters may observe that this part of the annual letter has remained consistent – and will again this year. This is because as a long-term investor our investment strategy remains relatively constant while our implementation is flexible in order to take advantage of capital market opportunities.

Our core investment principles, and therefore strategy, include beliefs that:

- A diversified portfolio produces the best risk-adjusted returns. Therefore we invest across all assets classes, capital structures, investment styles and geographies. One method of diversification is across investment styles, as manifested in our More Correlated and Constrained (“MCC”, or long-only), Less Correlated and Constrained (“LCC” or hedge fund) and Private Investment exposures.
- Skill matters when investing. Therefore, we continue to partner with the best investment managers around the globe. In fact, staff spends the majority of its time identifying, diligencing, structuring and monitoring external investment managers.
- A bias toward value is prudent, providing a margin of safety.
- Capital markets are subject to the same supply and demand imbalances at various times as other markets. Therefore, we look to take advantage of favorable imbalances in our investment decisions.
- Emerging market economies will continue to grow in the long term, albeit likely at lower rates than experienced over the past few decades. While economic growth creates demand for capital, we base our decision to provide capital on current asset pricing and expected returns. To be sure, emerging markets investments present additional risks such as political uncertainties, for which we must believe we will be compensated.
- Equity outperforms fixed income over the long term. Therefore we have an “equity orientation”. We also recognize that during certain periods, however, fixed income can present attractive risk-adjusted returns. We also retain a certain fixed income “cushion” to ensure liquidity to meet distribution and other short term obligations.
- Real assets – real estate and natural resources – may present attractive investment opportunities, particularly in an environment of monetary ease, as well as a “third leg” of diversification with stocks and bonds. With real estate investments, attractive returns may be generated in part due to the large amount of debt often used to acquire such assets. With natural resources investments, attractive returns may be generated due to its long term demand dynamics and the capital intensive nature of the value-add supply chain.
- As an “in-perpetuity” investor our long-term horizon enables us to prudently assume reasonable levels of illiquidity risk. We are mindful of the uncertainty of being rewarded for expending illiquidity risk, so we work to be thoughtful and deliberate in our private commitments.
Every year we engage in a thorough review of our Investment Policies ("Policy") with our Board and the Regents. And as we also do every few years, this year we updated our five year investment strategic plan, which calls for continued increased exposure to Real Assets and Private Investments.

**Portfolio Positioning and Tactical Allocations**

The portfolio is positioned as follows:

- Approximately 6% of the portfolio is invested in MCC Investment Grade Fixed Income. This part of the portfolio provides liquidity and diversification.

- The MCC Natural Resources portfolio includes the gold position, broad commodity trading strategies and natural resources-related public equities. MCC Real Estate brings core real estate exposure to the overall portfolio through investments with REIT investment managers. Each of the broad commodities, natural resources related public equity and REIT positions comprise approximately 2.5% of the overall Endowment portfolio.

- MCC Developed Country Public Equity exposure includes external managers focused on high-quality global companies as well as external managers who invest in mid and small capitalization companies. This exposure represents approximately 15% of the total Endowments.

- MCC Emerging Markets Public Equity contains external managers with global, regional or country-specific emerging markets investment mandates. These managers typically rely on a broad, disciplined investment approach and/or market-specific, local insight. The Endowment exposure in this portion of the portfolio is approximately 10%.

- The LCC book, at 30% of total assets, remains the largest allocation for the Endowments. UTIMCO has a diversified portfolio of approximately forty hedge fund managers employing a variety of investment strategies including long/short equity, event, opportunistic, credit and distressed securities, and global macro approaches. The LCC exposure generates “equity-like” returns with “bond-like” volatility risk. Our LCC external managers use modest levels of leverage, provide substantial position transparency, practice strong risk management, and generally approach investing with a value bias based on superior fundamental research.

- The Private Investments portfolio remained at approximately 28% of total assets and spans a broad range of asset classes including illiquid credit, real estate, natural resources, buy-out, growth and venture equity. One measure of the portfolio’s success is that in 2014, distributions of $1.548 billion almost kept pace with capital calls of $1.587 billion. During 2014, staff made $2.4 billion of new commitments to 46 external managers.
  - Illiquid credit exposure continues to recede as successful investments are monetized.
  - Real estate and natural resources-related private equity exposures continue to increase as staff pursues, identifies and partners with talented managers to exploit attractive market opportunities.
  - Buy-out and venture capital exposure remains steady as new investment opportunities in the lower middle market and certain venture capital market niches replace monetizations.
  - Emerging markets growth-oriented private equity again increased at a measured pace as staff continues to seek skilled partners to invest in this potentially rewarding area.

During 2014, although actual investment performance beat the Policy Portfolio by .92% in the PUF and .54% in the GEF, tactical allocation detracted .93%, or 93 basis points. Tactical allocation refers to staff’s positioning of investments in specific asset classes over or under Policy targets, but always within specified ranges.

The primary source of the tactical allocation performance detraction was the gold position. This position was added in September 2009 as a hedge against potential monetization coming out of the 2008 “Great Recession”. While central bank policy has been
extremely accommodative since late 2008 and the position enhanced returns in its first few years, the US dollar regained strength versus gold in the past few years and so the gold position has been mildly detrimental over the five year period. For the most part, the portfolio is invested close to target and undergoes only modest, incremental changes over the course of the year.

**Active Management**

Active management refers to the actual returns generated by our external investment managers relative to the passive or average returns in their respective markets. These efforts generated additional returns of 1.85% for the PUF and 1.47% for the GEF in 2014.

In fact, UTIMCO staff focuses the vast majority of its effort on partnering with “best in class” managers in order to deliver this level of value added returns. One set of metrics underscoring this is that staff participated in over 1,240 meetings with prospective investment managers and over 1,685 meetings with existing managers during the year. These meetings are in addition to the materials that were reviewed and analyzed on existing and new investments, as well as the basic market research that is conducted on an ongoing basis.

- **The MCC Investment Grade Fixed Income** portfolio, excluding the Liquidity Reserve, outperformed its benchmark by 2.0% as the market experienced an average gain of 6.2% and our portfolio was up 8.2%. This level of outperformance is stellar in this area of the capital markets and has been sustained over the past five years.
- **The MCC Real Estate** active managers produced an 18.8% return, slightly underperforming their benchmark by (.6)% in a very strong market.
- **The MCC Natural Resources** portfolio, excluding the gold position, was up 9.9% versus a benchmark gain of 8.3% as our commodity managers substantially outperformed their market averages.
- **The MCC Developed Country Public Equity** portfolio generated returns of 21.4%, slightly exceeding the market average 21.1% return. Over the past five years this portfolio has outperformed its benchmark by 3.6% annualized.
- **The MCC Emerging Markets Public Equity** portfolio was up 27.1%, substantially besting its benchmark return of 20.0%. Over the past five years, this portfolio has outperformed its benchmark by 2.8% annualized.
- **The LCC portfolio** posted a 10.6% return, exceeding the 7.7% average fund of fund benchmark. This portfolio continues to generate top decile returns, with a five year average annual outperformance of 5.8% versus its benchmark.

- **Private Investments** generated returns of 20.0%, outpacing the market average return of 18.61%. Venture Capital led the way with 34.2% returns, followed by Natural Resources (23.0% returns) and Real Estate (21.2% returns). In fact, all private investment asset classes posted at least 15% annual returns except for Emerging Markets.

Staff has embarked on a number of new initiatives aimed at producing above average returns, including, but not limited to:

- **Co-investments:** with the objective of increasing concentration with our highest conviction partners in their highest conviction ideas, and at lower fees, staff made 14 investments totaling $230 million during the year, and 34 investments totaling $778 million since the program was started a few years ago.
- **“Next Generation” hedge fund managers:** with the objective of sustaining top decile performance for years to come, staff has invested over $1.9 billion with 18 managers that are younger, have shorter standalone track records and have fewer assets under management than our average LCC partner.
- **Country-specific emerging markets managers:** with the objective of capturing higher returns, staff continues to shift the MCC emerging markets portfolio away from global emerging markets managers toward regional and country-specific managers including partners in India, Mexico, South Korea and Southeast Asia.
- **Creating “General Partners”:** with the objective of obtaining larger investments with smaller managers, staff has expanded its efforts to identify and partner with talented partners early in their efforts to create investment organizations, particularly in the Natural Resources, Real Estate and Lower-Middle Market Private Equity areas.

### 2014 Market Recap and 2015 Outlook

Central Banks continued an easy monetary stance, despite US tapering and in the presence of calls for the ECB to do even more, which resulted in strong returns for riskier assets.

Global bonds returned 6.2% for the twelve months ending August 31, 2014, as yields steadily fell and prices strengthened. High Yield bonds returned 11.2% over the same period.

Broad-based commodity indices fell -2.9% over the twelve-month period, showing strength during the first few months of 2014 but weakness in all other time periods. Gold was down -7.8% for the year. Oil spot prices were also down -10.9% for the twelve month period after see-sawing during the course of the year.

The S&P 500, Euro Stoxx and Topix indexes were all positive for the year, returning 25.2%, 16.1% and 9.1%, respectively. The MSCI Emerging Markets Index was...
up 20.0% for the year, led by India (57.3%) and Brazil (30.3%), with China flat (7.7%) and Russia down (-7.8%).

Our short term outlook remains strikingly similar to what we discussed last year, namely:

“Central banks and centrally planned economies continue to dominate global capital markets, skewing their purely economic functioning.

The United States Federal Reserve (“US Fed”) talked of tapering, although none has yet transpired, while the federal government lurches from crisis to crisis without a pragmatic, realistic focus on long term fiscal policy. Japan is easing, with structural reforms yet to be adequately enacted. Europe is not dead but may not be fully alive either.

China’s new regime is dealing with a legacy of non-market directed over-investments. India is, as usual, navigating volatility not altogether unrelated to the country’s governance. Russia remains resource rich and rule of law challenged. Brazil continues to combat inflation and debate the optimal level of government entitlements and redistribution.”

Of course, the US Fed did taper causing rates to go back up in the short term but only to have them recede to even lower levels by the end of August. Good news has come from India, but bad news has come from Russia. The Middle East has also become only more volatile and risky.

Capital markets appear to be “priced to perfection” although the general view is that bubbles are not obvious. It is also not obvious that there are any deep discounts in any asset class.

Therefore, our mantra continues to be cautious and selective, while maintaining a very diversified portfolio.

Our longer term view for the past few years remains our view for the next few years, summarized in the headline “Long Workout, Long March”. Again, as we wrote last year:

“Growth areas exist, even in a Long Workout: US energy and information technology’s global transformation are two examples. Certain austerity is part of the equation, which provides more investment warnings than opportunities. Good assets being sold by stressed sellers at compelling discounts is another example of a Long Workout investment opportunity. Given the public nature of the debt, monetization may also be a dynamic and therefore an investment consideration.

Long Marches are messy and hard and never linear. Growth requires capital, and if it is invested with the right partners in the right structures and at the right prices, then attractive risk-adjusted returns should be earned. Perhaps the biggest single variable in country selection is whether the government has some record of commitment to free capital markets, governed by consistent laws and adjudicated when necessary in independent courts – and will continue to do so into the future.

Importantly, UTIMCO takes a “bottom-up” approach with the objective of “making one good investment at a time”. Our comprehensive and consistent engagement with investors across global capital markets helps position us to take advantage of opportunities as they present themselves.”

**Board and Staff**

The Board and staff are the keys to UTIMCO’s investment success.

We are grateful for Charles Tate and Jim Wilson’s service on the UTIMCO Board. Jim chaired the Audit Committee, and Charles served on the UTIMCO Board for nine years and as Risk Committee Chair for much of his tenure. We welcome John White and Lee Hobson to our Board.

We are grateful for the open communications UTIMCO has with its colleagues at the UT and A&M Systems and their respective institutions. In addition, we appreciate the oversight, direction and support we receive from the UT and A&M Regents.

I cannot express enough gratitude to the UTIMCO staff, who has worked together now for a number of years to continuously enhance results. We mark with some sadness but great appreciation Cathy Iberg’s retirement. Cathy worked tirelessly for almost two decades to help make the organization what it is today.

Senior investment staff is fully in place, seasoned, and integrated. The six investment teams are more than ably led by tremendously talented investors, and each team is well-staffed, including along with the team leader at least one other very senior investor.

Staff held a strategic planning session this past year which sharpened our focus on efforts including attracting, training and retaining staff; emerging markets strategy and staffing; meeting processes and efficiencies; portfolio analytics; and future investment models.

The major enhancement to our information technology platform we began a few years ago is making good progress, and we continue to be blessed with very strong and devoted support and control colleagues.

We are pleased to have had a positive year of investment returns. We believe we are prepared for the vagaries, challenges and opportunities the markets will offer. And we are committed to doing our best, each and every day.

Bruce Zimmerman
Chief Executive Officer and
Chief Investment Officer
UTIMCO SENIOR MANAGEMENT As of August 31, 2014

BRUCE ZIMMERMAN – CEO and Chief Investment Officer
MARK WARNER – Senior Managing Director – Natural Resources Investments
LINDEL EAKMAN – Managing Director – Private Markets Investments
MARK SHOBERG – Managing Director – Real Estate Investments
SUSAN CHEN – Managing Director – Public Markets Investments
RYAN RUEBSAHM – Managing Director – Marketable Alternative Investments
UZIEL YOELI – Managing Director – Portfolio Risk Management

UTIMCO BOARD OF DIRECTORS As of August 31, 2014

MORRIS FOSTER (CHAIRMAN) – Member – Board of Regents, The Texas A&M University System; Past Chairman – Board of Regents, The Texas A&M University System; Chairman – Stagecoach Properties, Inc.; Director – First State Bank of Central Texas; Director – Tidewater, Inc.; Former President – ExxonMobil Production Company; Member – Board of Scott & White Medical Institute

ARDON E. MOORE (VICE CHAIRMAN) – Member – UTIMCO Compensation Committee; Member – UTIMCO Risk Committee; President and CEO – Lee M. Bass, Inc.; Member – The University of Texas Development Board; President – Fort Worth Zoological Association; Past President – All Saint’s Episcopal School of Fort Worth; Past Trustee – Texas Water Foundation; Past Trustee – Stanford Business School Trust; Past Trustee – Cook Children’s Hospital Foundation Board; Member – Advisory Council, The University of Texas McCombs School of Business

FRANCISCO G. CIGARROA, M.D. (VICE CHAIRMAN FOR POLICY) – Chancellor – The University of Texas System; Past President – The University of Texas Health Science Center at San Antonio; Member – Institute of Medicine of The National Academies; Fellow – American College of Surgery; Diplomate – American Board of Surgery; Member – American Medical Association; Member – Texas Medical Association; Alumni Fellow – Yale Corporation; Past President – Texas Academy of Medicine, Engineering, and Science of Texas (TAMEST); Member – Council of University Presidents and Chancellors; Member – President’s Advisory Commission on Educational Excellence for Hispanics

KYLE BASS – Chair – UTIMCO Risk Committee; Member – UTIMCO Compensation Committee; Principal – Hayman Capital Management, L.P.; Director – Troops First Foundation; Member – Advisory Group for the Center of Asset Management at the Darden School of Business at the University of Virginia; Board Member – 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.

R. STEVEN HICKS – Member – UTIMCO Audit and Ethics Committee; Member – UTIMCO Policy Committee; Vice Chairman – Board of Regents, The University of Texas System; Chairman – Capstar Partners, LLC; Member – Gentiva Health Services
JEFFERY D. HILDEBRAND – Chair – UTIMCO Policy Committee; Member – UTIMCO Compensation Committee; Member – Board of Regents, The University of Texas System; Founder, Chairman and Chief Executive Officer – Hilcorp Energy Company; 
Recipient – 2005 Distinguished Engineering Graduate Award, The University of Texas at Austin; Recipient – 2013 Petroleum & Geosystems Engineering Distinguished Alumnus Award, The University of Texas at Austin; 
Board Member – Catholic Charities of the Archdiocese of Galveston-Houston; Board Member – Central Houston, Inc.; Board Member – Houston Livestock Show and Rodeo; Board Member – Houston Police Foundation

H. LEE S. HOBSON – Chair – UTIMCO Compensation Committee; Member – UTIMCO Audit and Ethics Committee; Member – UTIMCO Risk Committee; Founder and Managing Partner – Highside Capital Management; Former Partner – Maverick Capital; 
Member – Council on Foreign Relations; Member – Dallas Committee on Foreign Relations; Member – Susan G. Komen for the Cure Foundation Investment Committee; Member – Children’s Medical Center Foundation, Executive and Investment Committees; 
Member – Virginia Theological Seminary Investment Committee; Member – Dallas Museum of Art Investment Committee; 
Member – Capital for Kids Advisory Board; Former Chairman – Investment Committee for the Episcopal High School in Alexandria, VA

ROBERT L. STILLWELL – Member – UTIMCO Audit and Ethics Committee; Member – UTIMCO Policy Committee; 
Member – Board of Regents, The University of Texas System; Past Member – Task Force on University Excellence and Productivity; 
Retired Partner – Baker Botts L.L.P.; Former Director – Mesa Petroleum Co.; Former Director – Pioneer Corporation; Former Principal – TBP Investments Management; Member – Board of Directors, EXCO Resources, Inc.; Member – Board of Directors, Warren Equipment Company; Trustee – T. Boone Pickens Foundation; Former Member – Longhorn Foundation Advisory Council Executive Committee at The University of Texas at Austin; Member – State Bar of Texas

JOHN D. WHITE – Chair – UTIMCO Audit and Ethics Committee; Member – UTIMCO Policy Committee; Member – UTIMCO Risk Committee; 
Member – Board of Regents, The Texas A&M University System; Principal – The Southern Funds Group, LLC; 
Co-founder, Chairman of the Board and CEO – Standard Renewable Energy Group, LLC; Former Managing Director – The Wind Alliance; Fellow – American, Texas and Houston Bar Foundations; Member – State Bar of Texas; Board Member – Houston Technology Center; Board Member – The Greater Houston Partnership; Board Member – The Association for Community Broadcasting; Former Chairman – Ed Rachal Foundation; Past President – Texas Aggie Bar Association; Past Member – Texas A&M Vision 2020 Project Faculty Committee; Past Member – Houston Livestock Show and Rodeo International Committee

JOAN MOELLER – Senior Managing Director – Accounting, Finance and Administration
ANNA CECILIA GONZALEZ – General Counsel and Chief Compliance Officer
UCHE ABALOGU – Chief Technology Officer

FIDUCIARY COUNSEL – Andrews Kurth, LLP, Austin, Texas

INDEPENDENT AUDITORS – Deloitte & Touche, LLP