

# Asset Allocation Review and Recommendations

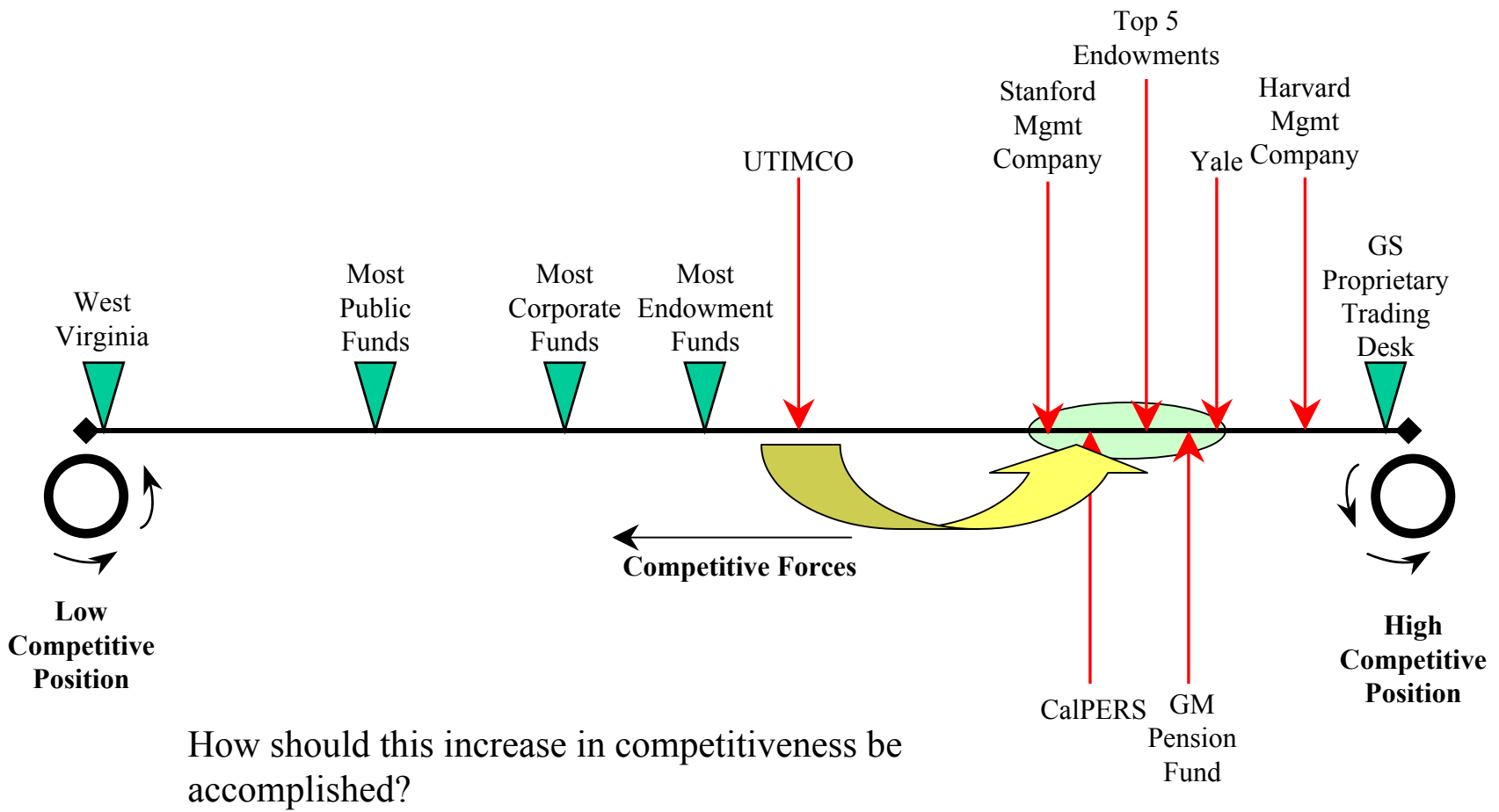
Presentation to the Board of Regents  
University of Texas System



THE UNIVERSITY OF TEXAS  
INVESTMENT MANAGEMENT COMPANY

November 2002

# Target Competitiveness Level for UTIMCO



## The Best Option for UTIMCO

- ◆ The most appropriate approach for UTIMCO is to:
  - Focus on those asset classes and markets where we can add value,
  - Find and retain the best external managers to invest the bulk of UTIMCO assets,
  - Supplement external managers with internal management in specific niches with specific objectives,
  - Create a very solid risk management and risk budgeting platform as the backbone for the entire investment process,
  - Use creative strategies to overcome the disadvantages of size,
  - Create a specialist organizational structure to implement the strategy.
  
- ◆ The foundation of the approach is value-added ....



## Focus on High PVA Opportunities

- ◆ Potential Value-Added (PVA) is the opportunity to increase returns beyond those generally available in an asset class through active management,
- ◆ PVA takes two forms:
  - PVA by an active manager is the result of effective security selection usually based on extensive research and analysis skills,
  - PVA by staff can result from a wide range of sources including skill in manager selection, term negotiations, manager monitoring, responses to periodic special opportunities in the markets, and risk control.
- ◆ Our objective at UTIMCO will be to focus on high PVA opportunities, developing the skills necessary to earn attractive returns.



# Comparisons of PVA Across Asset Categories

## Low PVA:

Annual Returns (%)	US Equity	International Equity	US Fixed Income
<b>First Quartile</b>	16.60	16.10	12.40
<b>Median</b>	15.50	14.90	11.30
<b>Third Quartile</b>	14.90	14.00	10.30
<b>Selection Advantage&gt;</b>	1.10	1.20	1.10
<b>Selection Mistake&gt;</b>	(0.60)	(0.90)	(1.00)
<b>Time Period</b>	1980-1997	1980-1997	1980-1997
<b>Sources&gt;</b>	PIPER	PIPER	PIPER

## Medium PVA:

Annual Returns (%)	International Fixed Income	Real Estate
<b>First Quartile</b>	N/A	9.90
<b>Median</b>	N/A	7.80
<b>Third Quartile</b>	N/A	5.90
<b>Selection Advantage&gt;</b>	2.90	2.10
<b>Selection Mistake&gt;</b>	(1.90)	(1.90)
<b>Time Period</b>	1980-1997	1980-1997
<b>Sources&gt;</b>	Cambridge Associates	Institutional Property Consultants (IPC)

## High PVA:

Annual Returns (%)	Small Cap US Equity	Leveraged Buyouts	Venture Capital	Mezzanine Finance	Hedge Funds
<b>First Quartile</b>	19.98	23.80	17.10	17.1	N/A
<b>Median</b>	14.35	13.20	8.10	11.7	N/A
<b>Third Quartile</b>	8.25	1.10	0.60	7.4	N/A
<b>Selection Advantage&gt;</b>	5.63	10.60	9.00	5.40	9.50
<b>Selection Mistake&gt;</b>	(6.10)	(12.10)	(7.50)	(4.30)	(8.90)
<b>Time Period</b>	1980-1997	1980-1997	1980-1997	1980-1997	1980-1997
<b>Sources&gt;</b>	PIPER	Venture Economics	Venture Economics	Venture Economics	Cambridge Associates

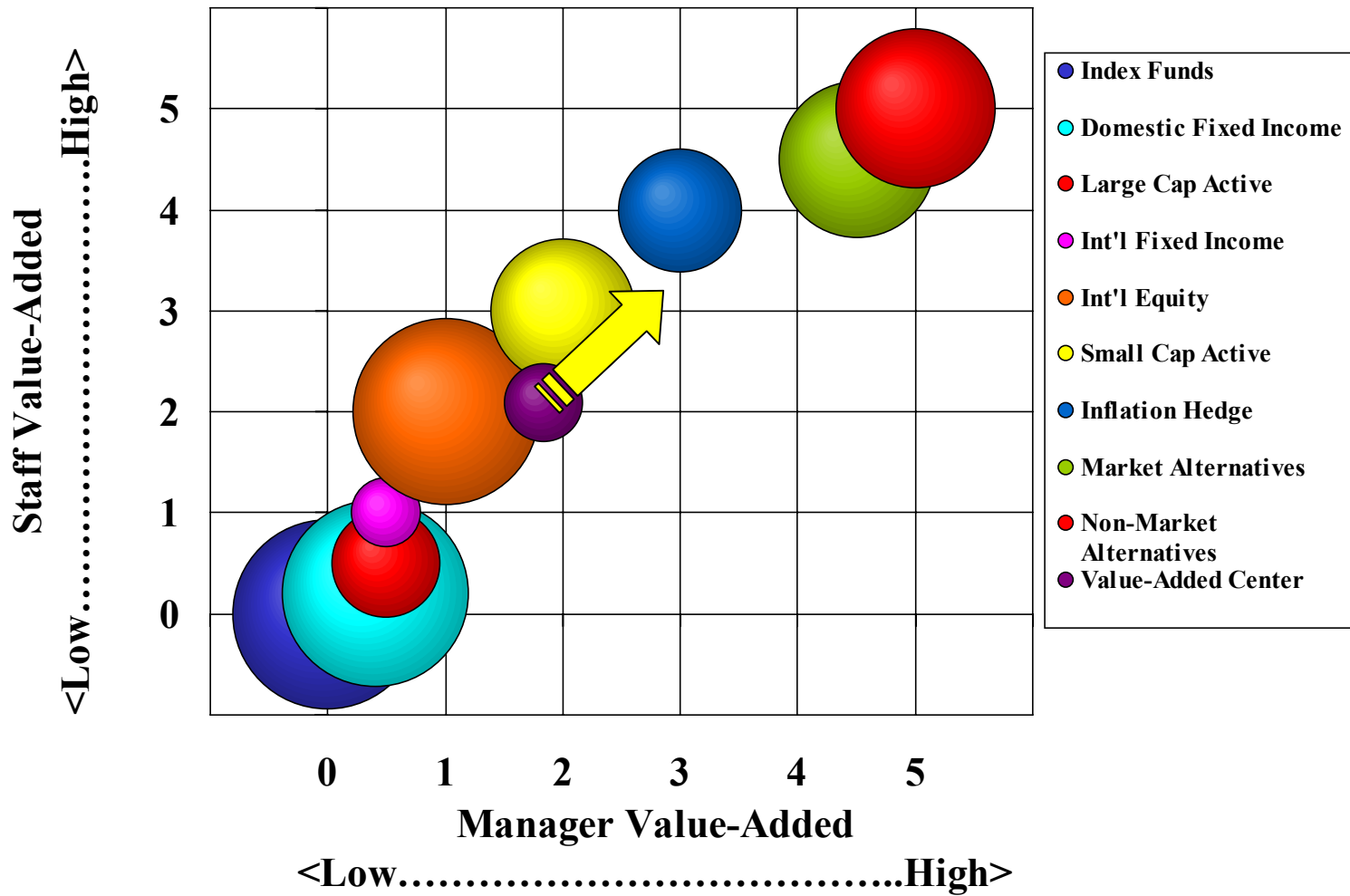


## Effective Organizations Focus on PVA

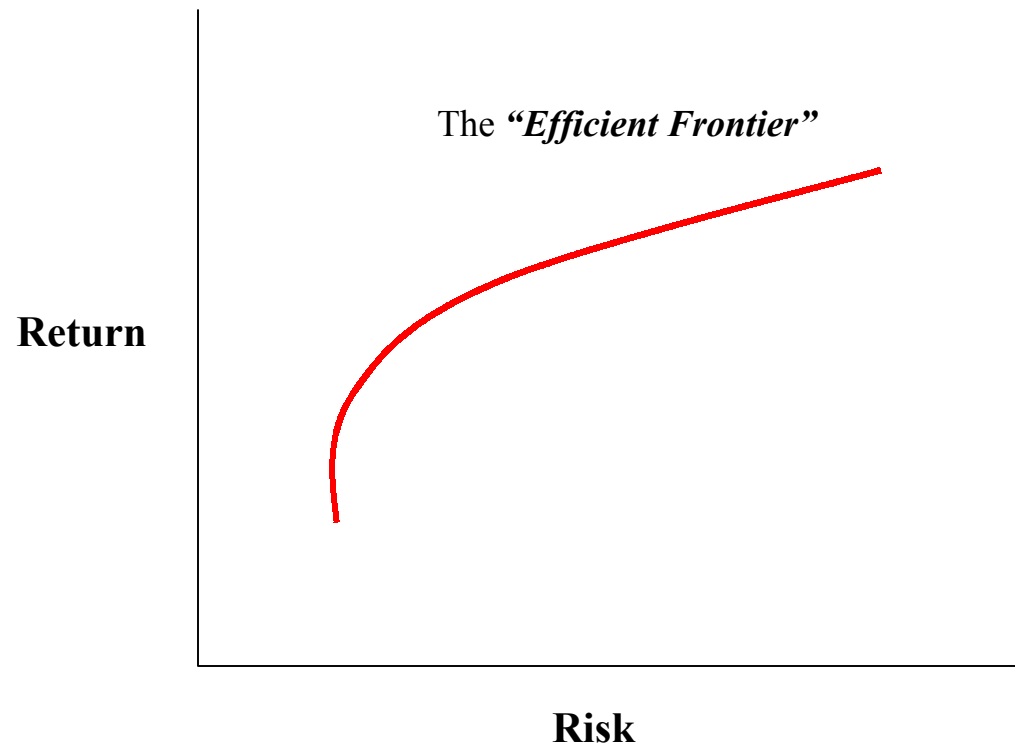
- ◆ Effective organizations focus limited resources on those activities most likely to add value, asset allocation and high PVA asset classes, while minimizing allocations and activities in low PVA categories,
- ◆ The important point is that even highly effective organizations will have some exposure to low PVA asset categories for diversification purposes, but the focus of the organization will be on adding value in higher PVA categories.



# PVA in the Current UTIMCO Portfolio Structure



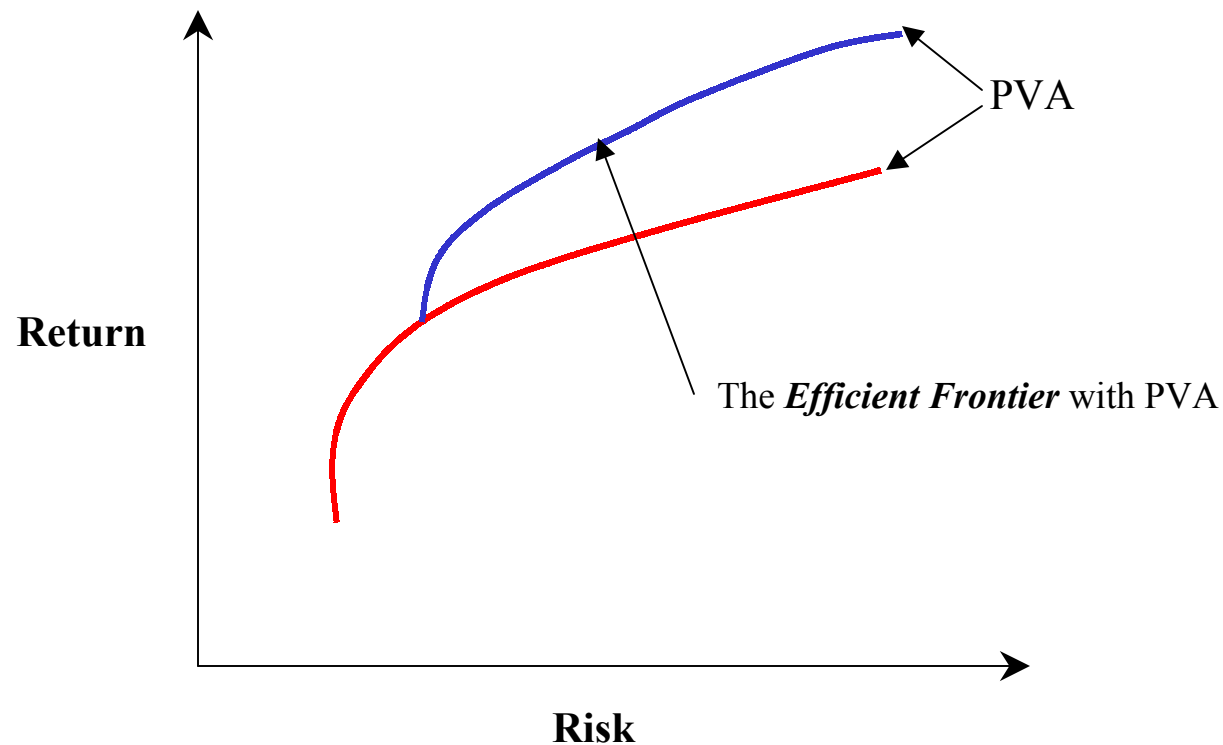
# Return Opportunities in Financial Markets





## Enhanced Opportunities with PVA

- ◆ By considering both traditional risk and return measures and PVA in making asset allocation decisions, a highly competitive organization can improve the efficiency of the set of assets available for strategic allocation decisions



## Return and Risk Assumptions

	Nominal Compound Annual Return (%)		Expected Risk (% Standard Deviation)
	Long Term 30 Year Horizon	Next 5 to 7 Years	
US Equity	9.00	7.50	16.50
Global non US Equity	9.25	7.50	19.00
Emerging Markets Equity	10.50	9.50	27.00
Absolute Return Hedge Funds	8.25	7.00	8.25
Equity Hedge Funds	8.50	7.50	12.50
Venture Capital	14.00	10.50	26.25
Private Equity	12.00	9.00	22.25
REITs	8.50	7.00	15.00
Private Real Estate	8.00	7.00	13.25
Commodities	7.00	6.00	19.25
US Bonds	6.00	5.50	9.25
TIPS	5.00	4.50	5.75
Cash	3.00	2.50	3.50
Inflation	3.00	2.50	N/A

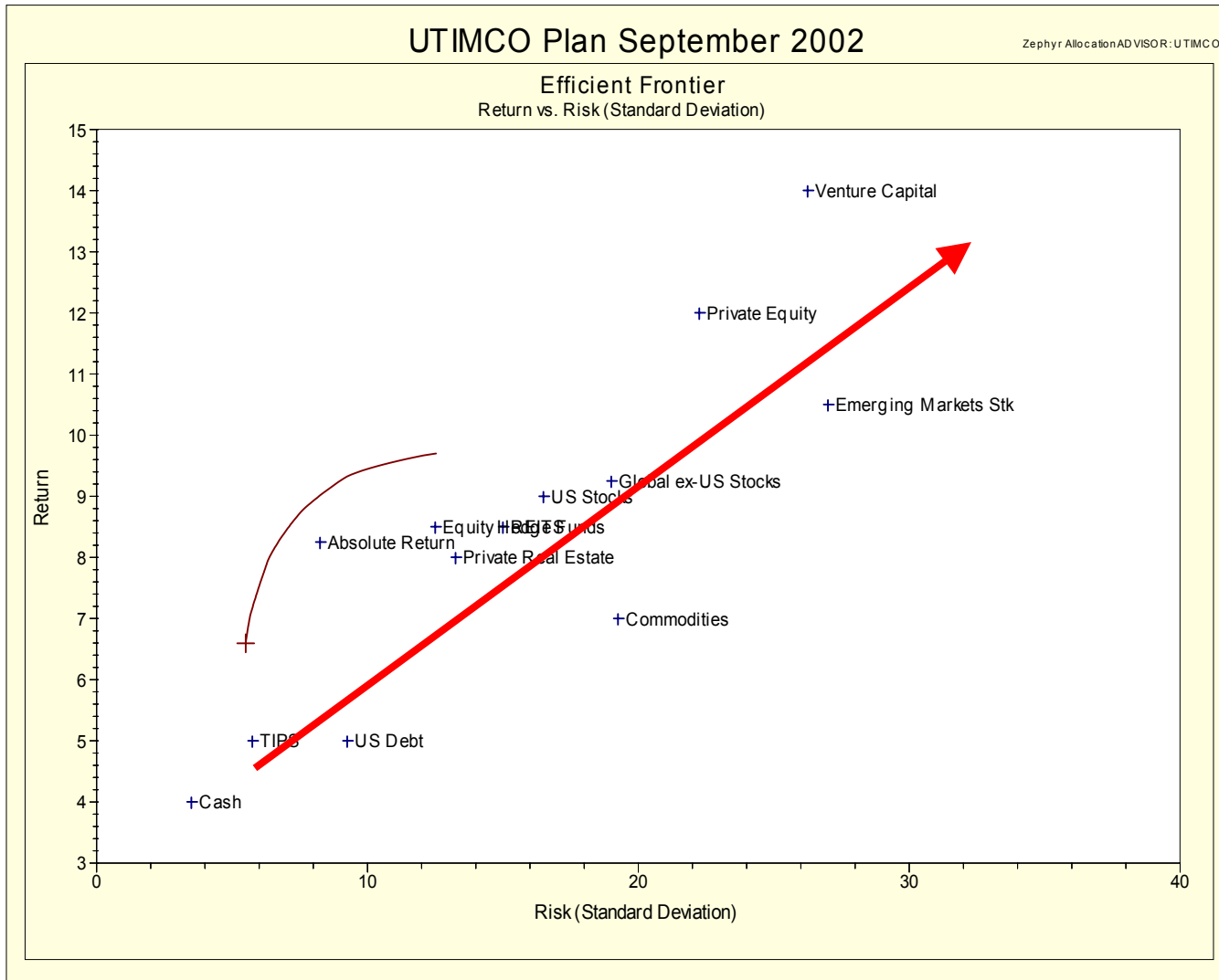


# Correlation Assumptions

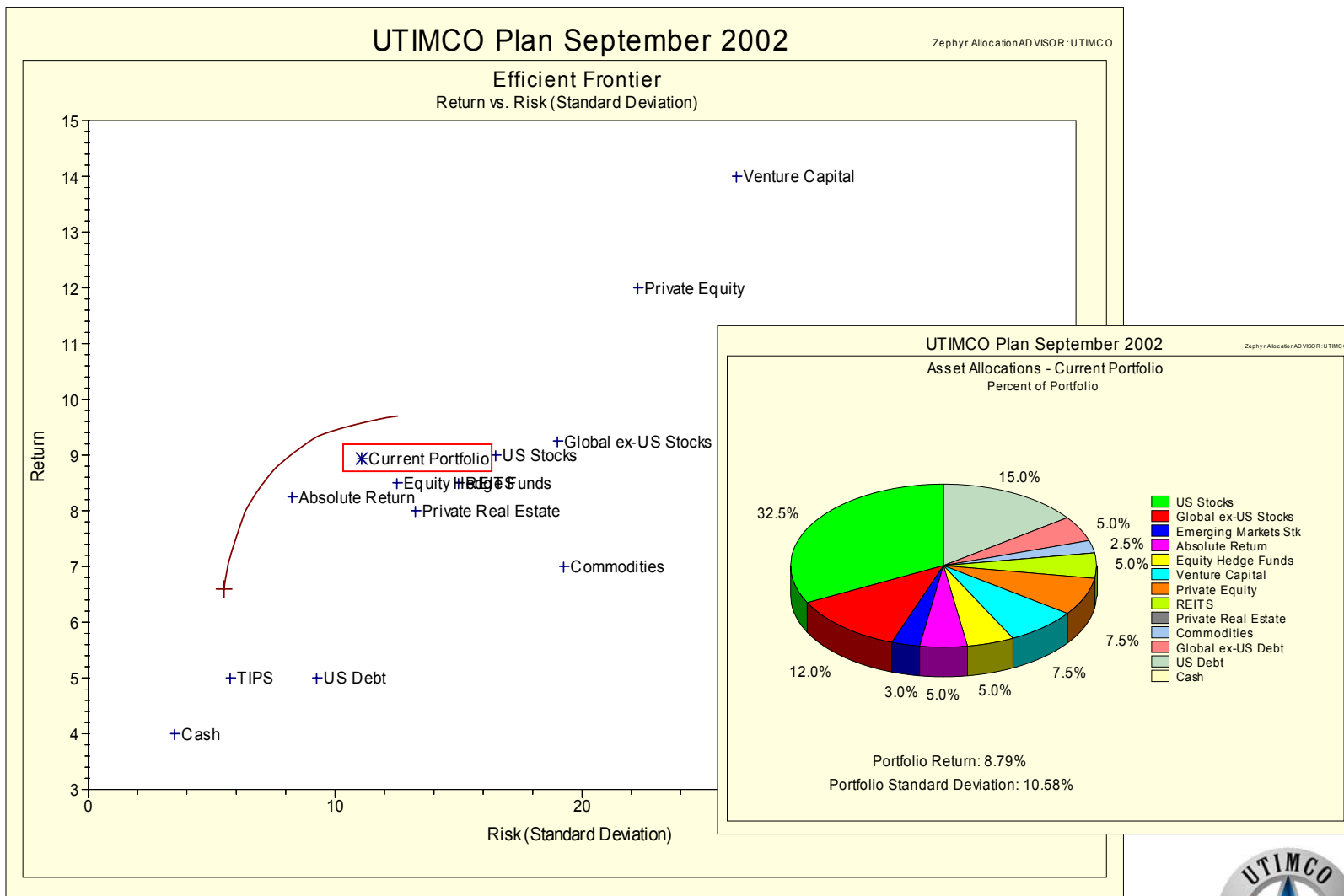
	US Equity	Global non US Equity	Emerging Markets Equity	Absolute Return Hedge Funds	Equity Hedge Funds	Venture Capital	Private Equity	REITs	Private Real Estate	Commodities	US Bonds	TIPS	Cash
US Equity	1.00												
Global non US Equity	0.52	1.00											
Emerging Markets Equity	0.08	0.28	1.00										
Absolute Return Hedge Funds	0.25	0.20	0.15	1.00									
Equity Hedge Funds	0.30	0.27	0.30	0.25	1.00								
Venture Capital	0.54	-0.03	-0.13	0.15	0.25	1.00							
Private Equity	0.40	0.10	0.06	0.20	0.25	0.84	1.00						
REITs	0.59	0.35	0.46	0.20	0.25	0.52	0.72	1.00					
Private Real Estate	0.29	0.33	-0.47	0.06	0.07	-0.02	0.19	0.10	1.00				
Commodities	-0.35	-0.22	0.09	-0.11	-0.31	0.12	-0.02	-0.32	0.10	1.00			
US Bonds	0.57	0.22	0.26	0.50	0.40	0.02	0.23	0.27	-0.01	-0.20	1.00		
TIPS	0.12	0.12	-0.13	0.54	0.02	-0.31	-0.04	0.20	0.38	0.35	0.30	1.00	
Cash	0.12	0.12	-0.13	0.54	0.02	-0.31	-0.04	0.20	0.38	0.35	0.30	1.00	1.00



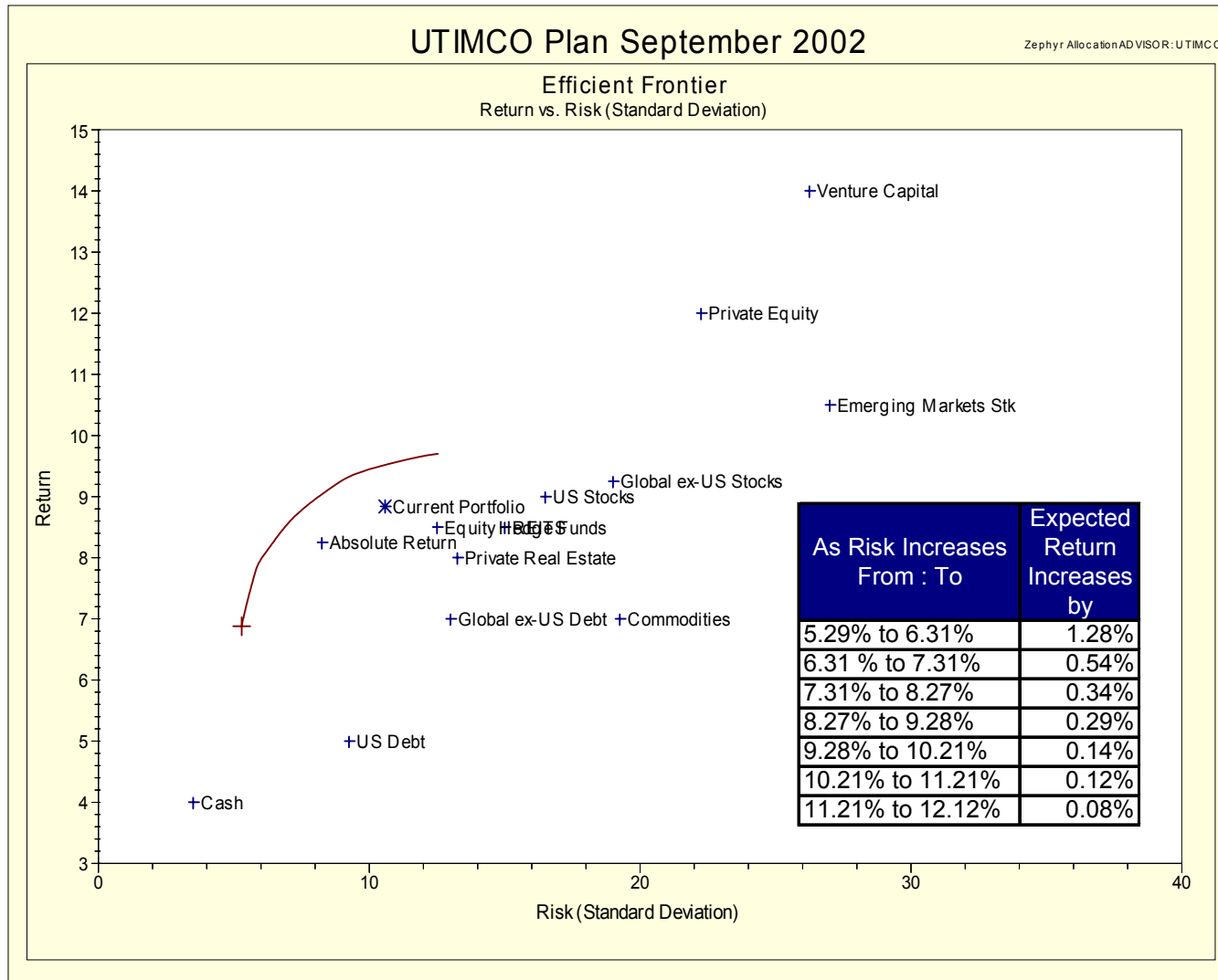
# The Risk Return Tradeoff



# The Current Allocation Policy



# Flat Efficient Frontier at Higher Risk Levels

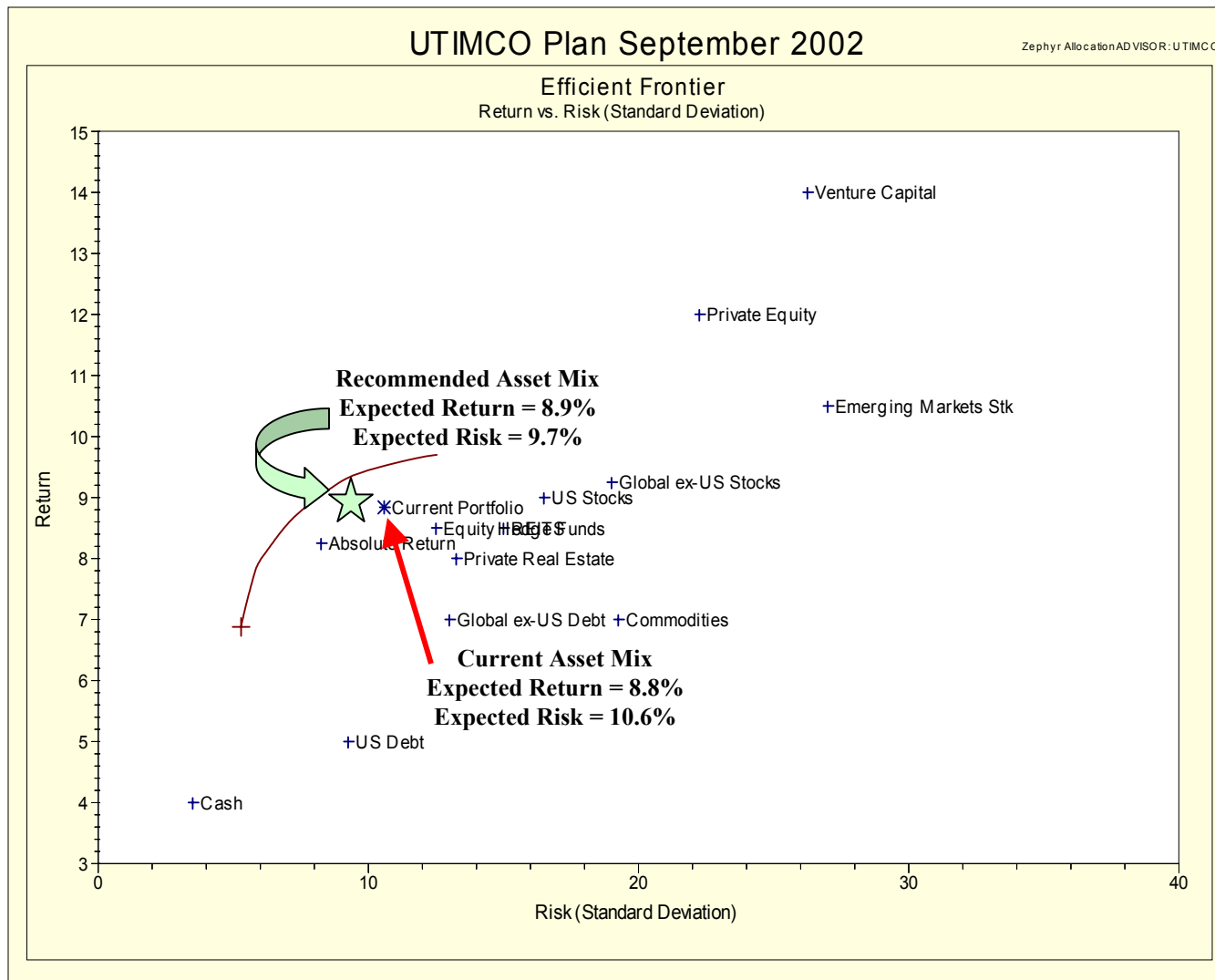


## Factors Affecting Allocation Decisions

Asset Category	Tactical View	PVA	Recommended Change
US Equity	Negative	Low	Reduce
Global non US Equity	Neutral	High	Maintain
Emerging Markets	Positive	Very High	Increase
Absolute Return	Neutral	Very High	Increase
Equity Hedge Funds	Neutral	Very High	Increase
Venture Capital	Neutral / Negative	Very High	Maintain
Private Equity	Neutral	Very High	Maintain
REIT's	Neutral / Positive	High	Reduce
Private Real Estate	Neutral/Positive	High	Increase
Commodities	Neutral / Positive	Low	Maintain
US Bonds	Neutral / Negative	Very Low	Maintain, change emphasis
Global ex US Bonds	Neutral / Positive	Low	Opportunistic



# Improving the Policy Allocation





# Functional View Of Recommended Allocation Policy

Function	Asset Category	Implementation Strategies	Current Target	Recommended Target	
Drivers of Return	Domestic Public Equity		32.50%	31.00%	
		Passive Management			
		Active Management			
	International Public Equity	Hedge and Alpha Transport			
			15.00%	19.00%	
		Passive Developed and Emerging			
		Active Developed and Emerging			
	Private Capital	Hedge and Alpha Transport			
			15.00%	15.00%	
		Venture Capital			
Private Equity					
Private Debt					
		Opportunistic Special Situations			
<b>Subtotal for Drivers of Return:</b>			<b>62.50%</b>	<b>65.00%</b>	
Risk Reduction	Absolute Return		10.00%	10.00%	
		Market Neutral Hedge Funds			
	Inflation Hedge		7.50%	10.00%	
		Financial Exposure to Commodities (GSCI futures)			
		Oil & Gas, Timber and other Physical Commodities			
		Public Real Estate (REITs)			
		Private Real Estate			
	Deflation Hedge	TIPS			
			0.00%	10.00%	
	Opportunistic Fixed Income	US Government Bonds and Agencies			
			20.00%	5.00%	
	Cash & Equivalents	Domestic Public Debt (Investment Grade)			
		High Yield Bonds (Below Investment Grade)			
		International Developed Markets Public Debt			
		Emerging Markets Public Debt			
Hedge and Alpha Transport					
		0.00%	0.00%		
		Money Markets			
<b>Subtotal for Risk Reducers:</b>			<b>37.50%</b>	<b>35.00%</b>	
<b>Total:</b>			<b>100.00%</b>	<b>100.00%</b>	



# Expected Returns, Risks, and Policy Ranges

Function	Asset Category	Implementation Strategies	New Recommended Policy		Prior Policy	
			Target Allocation	Range	Target Allocation	Range
Drivers of Return	Domestic Public Equity		31.00%	25% to 45%	32.50%	25% to 45%
		Passive Management	11.00%	10% to 40%	20.00%	10% to 35%
		Active Management	10.00%	5% to 15%	12.50%	5% to 20%
		Hedge and Alpha Transport	10.00%	5% to 15%		
	International Public Equity		19.00%	10% to 30%	15.00%	10% to 30%
		Passive Developed and Emerging	6.50%	5% to 15%	6.00%	5% to 15%
		Active Developed and Emerging	7.50%	5% to 15%	9.00%	5% to 15%
		Hedge and Alpha Transport	5.00%	0% to 10%		
	Private Capital		15.00%	10% to 20%	15.00%	10% to 20%
		Venture Capital	4.00%	2.5% to 10%	7.50%	2.5% to 10%
Private Equity		7.50%	5% to 10%	7.50%	2.5% to 15%	
Private Debt		0.00%	0% to 2.5%			
	Opportunistic Special Situations	3.50%	0% to 7.5%			
<b>Subtotal for Drivers of Return:</b>			<b>65.00%</b>	<b>50% to 80%</b>	<b>62.50%</b>	<b>50% to 80%</b>
Risk Reduction	Absolute Return		10.00%	5% to 15%	10.00%	5% to 25%
		Market Neutral Hedge Funds (Total Hedge Funds in Prior Policy)				
	Inflation Hedge		10.00%	5% to 15%	7.50%	5% to 15%
		Financial Exposure to Commodities (GSCI futures)	2.50%	0% to 10%	2.50%	0% to 10%
		Oil & Gas, Timber and other Physical Commodities	0.00%	0% to 10%	0.00%	0% to 10%
		Public Real Estate (REITs)	2.50%	0% to 10%	5.00%	0% to 10%
		Private Real Estate	2.50%	0% to 10%		
		TIPS	2.50%	0% to 10%		
	Deflation Hedge		10.00%	5% to 15%	0.00%	0.00%
		US Government Bonds and Agencies				
	Opportunistic Fixed Income		5.00%	2.5% to 15%	20.00%	10% to 39%
		Domestic Public Debt (Investment Grade)		2.5% to 15%	15.00%	10% to 25%
		High Yield Bonds (Below Investment Grade)		0% to 5%	0.00%	0% to 7%
		International Developed Markets Public Debt		0% to 5%	5.00%	0% to 7%
		Emerging Markets Public Debt		0% to 1%		
Cash & Equivalents	Hedge and Alpha Transport		0% to 5%			
	Money Markets	0.00%	0% to 5%	0.00%	0% to 5%	
<b>Subtotal for Risk Reducers:</b>			<b>35.00%</b>	<b>20% to 50%</b>	<b>37.50%</b>	<b>20% to 50%</b>
<b>Total:</b>			<b>100.00%</b>		<b>100.00%</b>	



# Potential Shortfall Over the Next 5 to 7 Years

Function	Asset Category	Implementation Strategies	Expected Annual Return over 30 Year Horizon	Expected Annual Return over 5 to 7 Year Horizon	
Drivers of Return	Domestic Public Equity	Passive Management	9.00%	7.50%	
		Active Management			
		Hedge and Alpha Transport			
	International Public Equity			9.75%	7.50%
		Passive Developed and Emerging			
		Active Developed and Emerging			
	Private Capital			13.00%	9.75%
		Venture Capital			
		Private Equity			
		Private Debt			
		Opportunistic Special Situations			
Risk Reduction	Absolute Return		8.25%	7.00%	
		Market Neutral Hedge Funds			
	Inflation Hedge			7.15%	6.15%
		Financial Exposure to Commodities (GSCI futures)			
		Oil & Gas, Timber and other Physical Commodities			
		Public Real Estate (REITs)			
		Private Real Estate			
	Deflation Hedge			5.50%	5.50%
		US Government Bonds and Agencies			
	Opportunistic Fixed Income			6.50%	7.00%
		Domestic Public Debt (Investment Grade)			
		High Yield Bonds (Below Investment Grade)			
		International Developed Markets Public Debt			
Emerging Markets Public Debt					
Cash & Equivalents			3.00%	2.50%	
	Money Markets				
<b>Total:</b>			8.90%	7.40%	
<b>Target Return to Maintain Payout Objectives:</b>			7.85%	7.35%	



## Razor Thin Margin Over Next 5 to 7 Years

	Long Term Horizon	5 to 7 Year Horizon
Investment Return	8.90%	7.40%
Less:		
Expense Rate	(0.35)	(0.35)
Inflation Rate	(3.00)	(2.50)
Payout Rate	(4.50)	(4.50)
Equals:		
Change in Real Purchasing Power	<b>1.05%</b>	<b>0.05%</b>



## The Payoff to High PVA

- ◆ The value-added through a highly competitive approach might be able to offset the effects of a more difficult future investment environment ....

For PUF at 4.75% Payout			
Decision Variables	Prior UTIMCO Assumptions	New 5 to 7 Year Assumptions	New Assumptions with High PVA
Probability of a Decline in Real Value of PUF (%)			
Any 5 Year Period	36	56	36
Probability of 20% or Greater Decline in Real Value of PUF (%)			
Any 5 Year Period	9	21	9
Probability of a Decline in Real Spending (%)			
Any 1 Year Period	46	70	48
Probability of a 10% or Greater Decline in Real Spending (%)			
Any 3 Year Period	13	23	13
Probability of a Decline in Nominal Spending (%)			
Any 1 Year Period	8	10	9
Median Total Payout over 10 Years (\$ millions)>	4,589	4,159	4,558



## Advantages of the Recommended Allocation

- ◆ Maintains expected return while lowering risk levels slightly,
- ◆ Offers greater chance for value added by staff and managers through the expected challenges of the intermediate term,
- ◆ The enhanced PVA of the recommended mix and the flexibility of the ranges around the targets are likely to provide the necessary return margin to enable us to reach return targets over the next 5 to 7 years.



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# PUF and GEF Discussion on Derivative Investments

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Presentation to the Board of Regents  
November 12, 2002



THE UNIVERSITY OF TEXAS  
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# Objective of Derivative Investments

- Implement investment strategies in a low cost and efficient manner
- Alter the Funds market exposure without trading the underlying securities
- Construct portfolios with risk and return characteristics that could not be created with cash market securities
- Hedge and control risks
- Facilitate transition trading





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## Purpose of Derivative Policy

- More clearly defines the documentation, control and review process for Derivatives
- Derivative policy complements the Investment Policy Statement heightening the focus on derivative investments
- Delegation provided within the approved guidelines allows for greater efficiencies in the implementation of strategies
- Requires UTIMCO Board approval for amendments to the Policy



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## Definition of Derivatives

- Derivatives are financial instruments whose value is derived, in whole or part, from the value of any one or more underlying assets, or index of assets (such as a bonds, stocks, commodities, interest rates, and currencies)
- Common types - Futures, Forwards, Swaps, Options



## Common Derivative Use

- **Replication** - Futures can be used to **replicate** equity indexes more efficiently and economically when coupled with a short term cash investment.
- **Derivative Application** - Investor wishes to replicate exposure to the S&P 500 index by utilizing the S&P 500 exchange traded futures contract coupled with a short term cash investment.
- **S&P 500 Futures Contract** - A standardized contract for the financial settlement derived from the change in market price of the S&P 500 index during the term of the contract.
- **Derivative Application Risk** - Minimal application risk in **replicating** the S&P 500 cash index. S&P 500 futures contracts are very liquid, and freely tradable on a recognized exchange. The difference in the cash (spot) price and futures price is the implied financing cost.



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# Replicate S&P 500 Index Exposure

## The Mechanics

- Contribute cash to the account = index exposure desired
- Post required margin (collateral) with broker
- Purchase the number of futures contracts = S&P index exposure desired
- Cash remaining in the account will increase (decrease) daily through settlement with the clearinghouse; the process of marking the account to market
- Interest will be earned on the cash balances in the account and on the collateral posted as margin with broker
- Contract is closed out at contract expiration



# Replicate S&P 500 Index Exposure

## The Mechanics

	Cash & Equivalents	Margin with broker	Long Value of Contract (S&P 500 Exposure)
Deposit cash to account	\$100		
Post margin	-\$10	\$10	
Purchase contract (difference in cash price and futures price is the implied financing cost. At expiration of contract futures price and cash price are equal. Interest earned on cash and margin deposit offsets the implied financing cost)			\$100
Daily settlement	+\$10		\$110
<b>End of Period (Cash + Margin = Value of Contract)</b>	<b>\$100</b>	<b>\$10</b>	<b>\$110</b>

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# Enhancing Index Returns

## (Alpha transport)

- Alpha transport takes advantage of the fact that equity strategies can be de-composed into two parts with the “market factor” replicated with index derivatives
- The cash component is replaced with fixed income securities, market neutral or long-short portfolios
- Determining and monitoring application risk is important



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# Enhancing Index Returns

(Alpha transport)

- Fixed income securities that have somewhat longer maturities may be coupled with futures thereby increasing the return
- Interest income on fixed income securities will exceed interest earnings on cash equivalent
- Have more application specific risk



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# Enhancing Index Returns

(Alpha transport)

- Market Neutral Strategy - Hedge Funds utilizing a market neutral or long-short portfolio construction may be coupled with futures thereby increasing return
- The right combination of the market neutral portfolio and cash needs to be determined
- Have more application specific risk





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## Enhancing Index Returns

- Shift Asset or Market Exposure – Swaps and futures can be used to temporarily shift asset exposure from one asset class to another without having to purchase or sell the underlying securities in the manager portfolios



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## Modify Market Exposure

- Futures may be used to modify exposure of a portfolio without trading the underlying stocks and incurring the associated commission and market impact cost



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## Increase Flexibility

- International – Country exposure can be adjusted easily without disrupting underlying portfolio investments
- Currency Exposure – Can be managed independently
- Facilitate Transition Trading – Maintain market exposure during periods of manager termination and manager selection



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## Current Derivative Applications

- S&P 500 index exposure is obtained in the PUF and GEF by using exchange traded futures coupled with cash investment
- Goldman Sachs Commodity Index exposure is obtained in the PUF and GEF by using exchanged traded futures coupled with cash investment



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## Current Derivative Applications

- Goldman Sachs – a global manager for the PUF and GEF utilizes derivatives to shift market exposure, hedge currency and country exposure and to manage interest rate risk within prescribed guidelines
- PIMCO – a domestic and international fixed income manager for the PUF and GEF utilizes derivatives to shift fixed income exposure, manage currency and interest rate risk within prescribed guidelines



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## Primary Risks to Control and Monitor

- Application Specific Risk
- Leverage inherent in derivative securities requires that appropriate risk management and control processes focus on the total risk assumed in the derivative application which must be documented and monitored
- Financial risks associated with derivative applications will be limited by minimizing counterparty risk for non-standard agreements



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# PUF and GEF Investments in Alternative Marketable Assets

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# Objectives of Alternative Marketable Investments

- Can offer investment opportunities not found in traditional long only investment strategies
- Can be used to profit from volatile market environments
- Have lower correlations to traditional securities and therefore provide additional diversification to the endowment funds' asset mix
- May be used in alpha transport strategies to construct portfolios with risk/return characteristics that could not be created with cash market securities





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# Objectives of Alternative Marketable Investments

- The risk/return profile of the investment determines its classification within the endowment funds' asset mix (return driver, or risk reducer)
- Used to implement strategies within the endowment funds' asset mix
- Return objective:
  - is absolute (isolated and driven by the manager's skill), not the asset class and benchmark
  - earn a return based on security selection characteristics, market risk is hedged



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# Alternative Marketable Investments

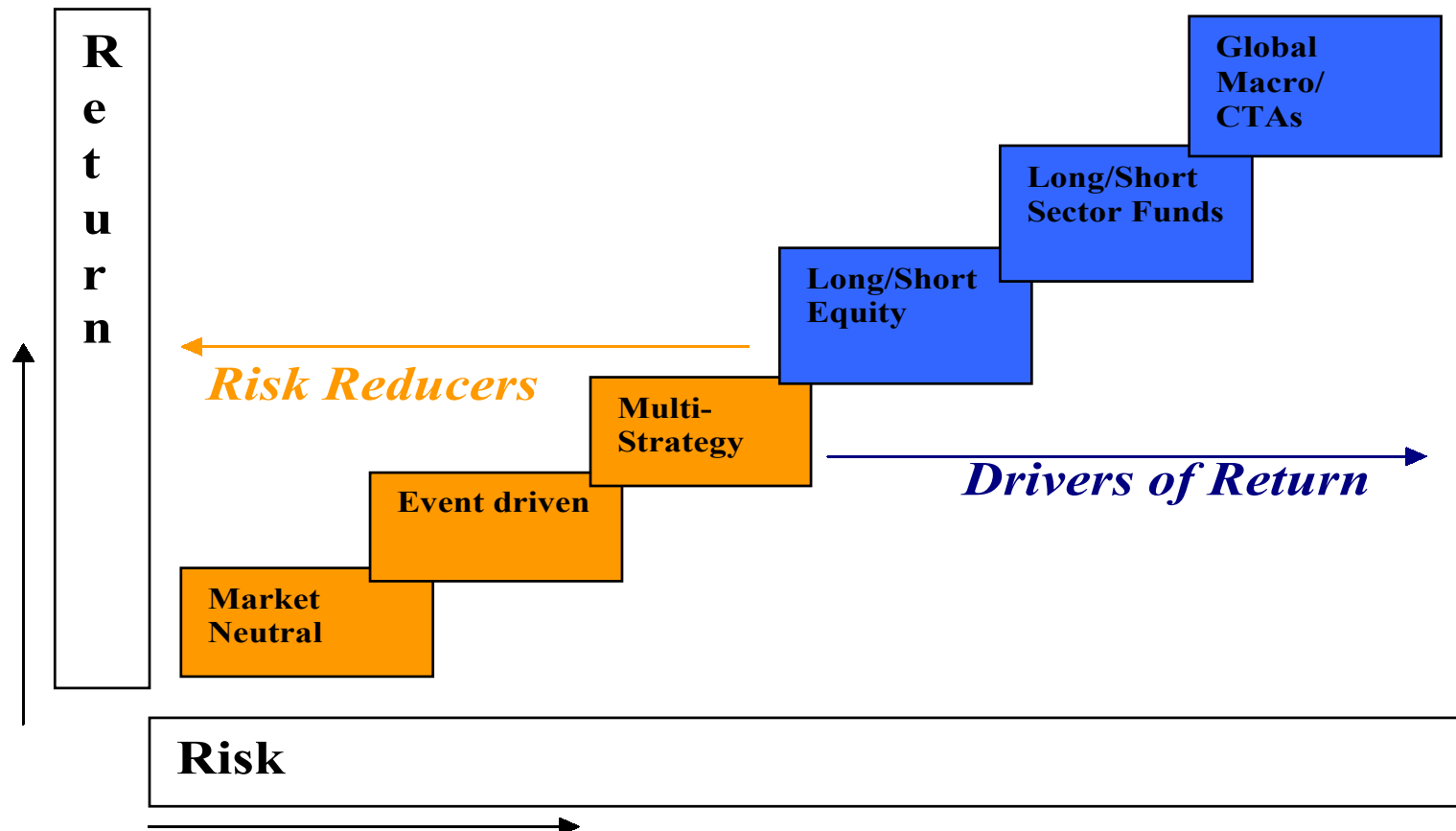
## Functional Characteristics

- Alternative Marketable Investments take on many forms and will be classified in the endowment funds' asset mix based on **functional** characteristics:
  - Return drivers - equities
  - Risk reducers - absolute return
  - Return drivers or risk reducers – used to construct alpha transport portfolios
- Common Types – Equity Market Neutral Strategies, Event Driven Strategies, Multi-Strategy Managers, Long/Short Equity, Long/Short Sector Funds and Global Macro



# Alternative Marketable Investments

## Functional Characteristics



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# The Risk Reducers

## Equity Market Neutral Strategies

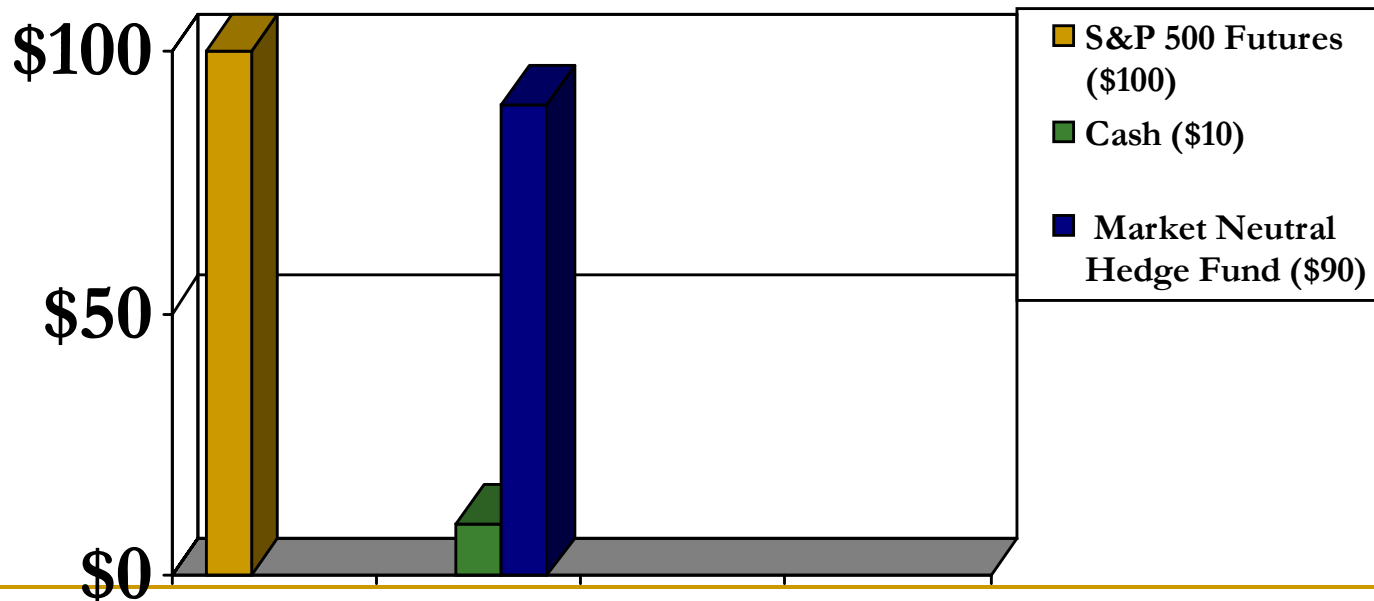
- Non directional in nature and serve to reduce market risk
- Investments are balanced between long and short equity securities
  - Purchase undervalued equities on the long side and overvalued equities on the short side
  - In rising markets the out-performance of the long portfolio should exceed losses on the short portfolio
  - In declining markets the relative out-performance of the short portfolio should exceed the underperformance of the long portfolio
- Equity market neutral strategies are very effective as the return source in alpha transport strategies



# The Risk Reducers

## Equity Market Neutral Strategies

- Alpha transport portfolio – Consists of S&P 500 futures, cash and market neutral portfolio
- Expected return of the alpha transport portfolio = (S&P 500 futures return + return of the market neutral portfolio + cash return)



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# The Risk Reducers

## Event Driven Strategies

- Source of return is driven by the value inherent in the strategy
- Usually 2 sided strategies involving the purchase and sale of related securities that are mispriced when compared to each other
- Strategies may invest in equities, convertible securities debt instruments
- Expected return is derived from:
  - an active reorganization, refinancing, and restructuring of companies experiencing cash flow/operating difficulties
  - through appreciation of discounted securities or through direct lending



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# The Drivers of Return

## Long/Short Equity Strategies

- Return source is directional in nature
- Focuses on long/short equity positions
- Sector strategies focus on specific industries such as technology, health care, financials
- Type of strategy dictates return:
  - Sector, country, market direction, security selection
  - Short alpha strategies derive most of their profits from short positions



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# The Drivers of Return

## Long/Short Equity Strategies

- Long/Short equity strategies can take many forms:
  - Low hedge strategies (Jones model )
  - Strategies may favor growth over value
  - Strategies may range their net long to net short positions based on their views
  - Strategies may take sector views
  - Trading oriented strategies make money when volatility is high





# Drivers of Return

## Macro and CTA's (unlikely investment candidates)

- Directional trading in global equity, bond, currency and commodity markets
- Return is derived from macro economics events such as:
  - anticipated central bank actions, shifts in economic policy regimes, or other changes in economic structure
- CTA's are primarily systematic (computerized) trend following utilizing:
  - financial and commodity futures



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## Important Factors

- Understand risk/return profile of strategy
- Assessing manager skills and integrity
- Leverage embedded in strategy
- Risk factors are transparent
- Size of fund complements strategy
- Appropriate risk management and internal controls
- Manager's interests are aligned with investor



Alternative Marketable Assets					Manager Performance August 31, 2002			
Function & Asset Category	Implementation Strategies	Manager	Allocation August 31, 2002 (in millions)	PUF and GEF Combined	One Year	Two Years	Three Years	Four Years
Drivers of Return:	Long/Short Equity	Maverick Capital	\$452.1	4.5%	(1.0)%	12.4%	16.7%	17.7%
		OCM Emerging	\$53.4	.5%	-----	-----	-----	-----
<b>Subtotal</b>			<b>\$505.5</b>	<b>5.0%</b>				
Risk Reducers:	Absolute Return Multistrategy Event Driven	Farallon Capital	\$268.7	2.7%	3.4%	8.4%	11.0%	12.9%
		Perry Partners	\$304.9	3.0%	3.3%	10.1%	12.9%	14.7%
		Satellite	\$170.5	1.7%	(22.4)%	(5.5)%	-----	-----
<b>Subtotal</b>			<b>\$744.1</b>	<b>7.4%</b>				
<b>Grand total</b>			<b>\$1,249.6</b>	<b>12.4%</b>				
Index Returns:								
S&P 500 (Equities)					(18.0)%	(21.2)%	(10.3)%	.2%
Lehman Brothers Aggregate (Fixed Income)					8.1%	10.2%	9.3%	7.1%

U. T. Board of Regents: Request for Approval to Amend the Permanent University Fund (PUF) and General Endowment Fund (GEF) Investment Policy Statements

BACKGROUND INFORMATION

Section 3 (a) of the Investment Management Services Agreement dated March 1, 1996, 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 amendments to the PUF and GEF Investment Policy Statements are proposed following a review of asset allocation for the PUF and the GEF by Cambridge Associates and UTIMCO, in addition to other amendments clarifying provisions in the investment policies. The proposed amendments are summarized below:

**(Reference - Page 3 for PUF)**

- For the PUF only, eliminating the word “person” in reference to the prudent person investment standard. The standard is defined as prudent investors.

**(Reference - Page 3 for PUF and Page 1 for GEF)**

- Replacement of the language for hiring unaffiliated investment managers to language referring to the UTIMCO Board of Directors’ approved Delegation of Authority Guidelines for the selection and termination of managers. These guidelines were approved by the UTIMCO Board of Directors in September 2000. **(Approved Delegation of Authority Guidelines included as an Exhibit for reference purposes)**

**(Reference - Page 4 for PUF and Page 3 for GEF)**

- Amendment to clarify the definition of alternative marketable investments and their use in implementing the asset allocation policy.

**(Reference - Page 5 for PUF and Page 4 for GEF)**

- Inclusion of language to provide clarification to Exhibit A (Specific Asset Allocation Expected Return and Risk, Neutral Allocations, Ranges and Performance Objectives).

**(Reference - Page 6 for PUF and Page 4 for GEF)**

- Amendment of range for broadly defined equity from 68% - 90% to 65% - 90%.

**(Reference - Page 6 for PUF and Page 4 for GEF)**

- Amendment of the provision for the allocation to deflation hedging and other fixed income to not exceed 35% of the Fund instead of 32% of the Fund.

**(Reference - Page 6 for PUF and Page 4 for GEF)**

- Amendment of performance measurement to clarify that investment performance is routinely measured by the Fund's custodian, who is an unaffiliated organization.

**(Reference - Page 7 for PUF and Page 5 for GEF)**

- Modification of derivatives language to reference the Derivatives Policy due to be approved by the UTIMCO Board of Directors on October 31, 2002.

**(Derivative Investment Policy included as an Exhibit for reference purposes)**

**(Reference - Page 11 for PUF and Page 9 for GEF)**

- Amendment eliminating the descriptive language for investments in alternative and inflation hedging assets since it is addressed in the Delegation of Authority Guidelines for the selection and termination of managers approved by the UTIMCO Board of Directors.

**(Approved Delegation of Authority Guidelines included as an Exhibit for reference purposes)**

The UTIMCO Board of Directors approved the proposed amendments to the Investment Policy Statements for the PUF and GEF on September 18, 2002. No changes are proposed for the Investment Policy Statements of the Long Term Fund, the Permanent Health Fund, the Short Term Fund, the Short Intermediate Term Fund, or the Separately Invested Funds.

# THE UNIVERSITY OF TEXAS SYSTEM PERMANENT UNIVERSITY FUND INVESTMENT POLICY STATEMENT

## **Purpose**

The Permanent University Fund (the "Fund") is a public endowment contributing to the support of institutions of The University of Texas System (other than The University of Texas-Pan American and The University of Texas at Brownsville) and institutions of The Texas A&M University System (other than Texas A&M University-Corpus Christi, Texas A&M International University, Texas A&M University-Kingsville, West Texas A&M University, Texas A&M University-Commerce, Texas A&M University-Texarkana, and Baylor College of Dentistry).

## **Fund Organization**

The Permanent University Fund was established in the Texas Constitution of 1876 through the appropriation of land grants previously given to The University of Texas at Austin plus one million acres. The land grants to the Permanent University Fund were completed in 1883 with the contribution of an additional one million acres of land. Today, the Permanent University Fund contains 2,109,190 acres of land (the "PUF Lands") located in 24 counties primarily in West Texas.

The 2.1 million acres comprising the PUF Lands produce two streams of income: a) mineral income, primarily in the form of oil and gas royalties and b) surface income, in the form of surface leases and easements. Under the Texas Constitution, mineral income, as a non-renewable source of income, remains a non-distributable part of PUF corpus, and is invested in securities. Surface income, as a renewable source of income, is distributed to the Available University Fund (the "AUF"), as received.

The Constitution prohibits the distribution and expenditure of mineral income contributed to the Fund. The Constitution also requires that all surface income and investment distributions paid to the AUF be expended for certain authorized purposes.

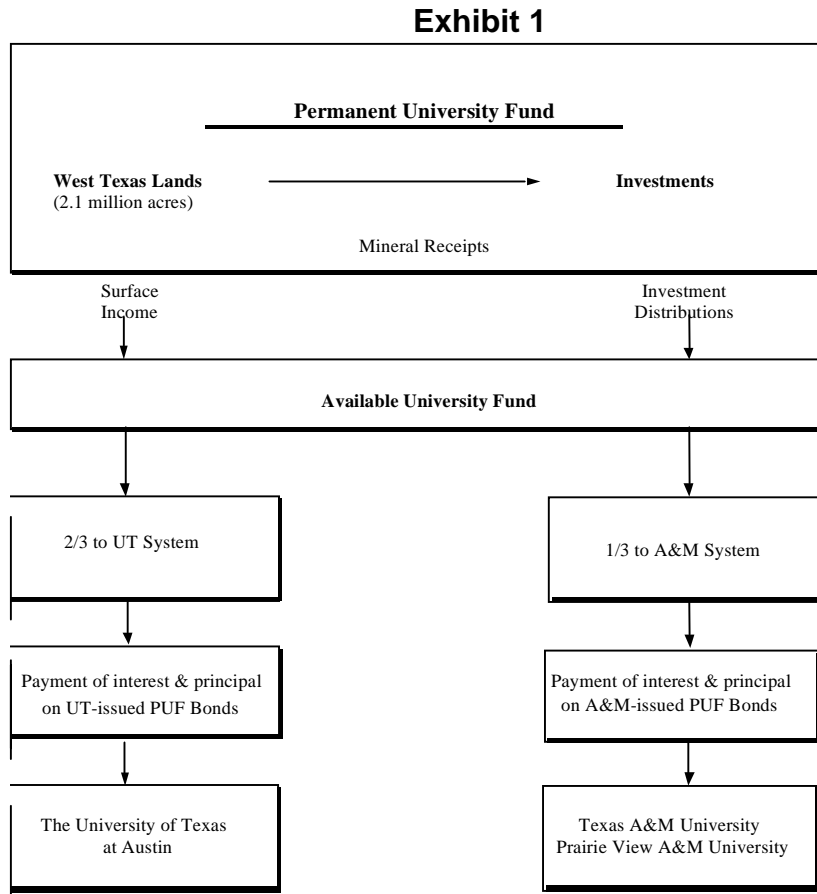
The expenditure of the AUF is subject to a prescribed order of priority:

First, following a 2/3rds and 1/3rd allocation of AUF receipts to the U. T. System and Texas A&M University System, respectively, expenditures for debt service on PUF bonds. Article VII of the Texas Constitution authorizes the U. T. Board and the Texas A&M University System Board (the "TAMUS Board") to issue bonds payable

from their respective interests in AUF receipts to finance permanent improvements and to refinance outstanding PUF obligations. The Constitution limits the amount of bonds and notes secured by each System's interest in divisible PUF income to 20% and 10% of the book value of PUF investment securities, respectively. Bond resolutions adopted by both Boards also prohibit the issuance of additional PUF parity obligations unless the projected interest in AUF receipts for each System covers projected debt service at least 1.5 times.

Second, expenditures to fund a) excellence programs specifically at U. T. Austin, Texas A&M University and Prairie View A&M University and b) the administration of the university systems.

The payment of surface income and investment distributions from the PUF to the AUF and the associated expenditures is depicted below in Exhibit 1:



## Fund Management

Article VII of the Texas Constitution assigns fiduciary responsibility for managing and investing the Fund to the U. T. Board. Article VII authorizes the U. T. Board, subject to procedures and restrictions it establishes, to invest the Fund in any kind of investments and in amounts it considers appropriate, provided that it adheres to the prudent [person] investment standard. This standard provides that the U. T. Board, in making investments, may acquire, exchange sell, supervise, manage, or retain, through procedures and subject to restrictions it establishes and in amounts it considers appropriate, any kind of investment that prudent investors, exercising reasonable care, skill, and caution, would acquire or retain in light of the purposes, terms, distribution requirements, and other circumstances of the fund then prevailing, taking into consideration the investment of all the assets of the fund rather than a single investment.

Ultimate fiduciary responsibility for the Fund rests with the Board. Section 66.08 of the Texas Education Code authorizes the U. T. Board to delegate to its committees, officers or employees of the U. T. System and other agents the authority to act for the U. T. Board in investment of the PUF. The Fund shall be managed through The University of Texas Investment Management Company ("UTIMCO") which shall a) recommend investment policy for the Fund, b) determine specific asset allocation targets, ranges and performance benchmarks consistent with Fund objectives, and c) monitor Fund performance against Fund objectives. UTIMCO shall invest the Fund's assets in conformity with investment policy.

UTIMCO may select and terminate unaffiliated investment managers subject to Delegation of Authority Guidelines approved by the UTIMCO Board. These guidelines are intended to ensure that the appropriate managers are retained to pursue a defined investment strategy within the Fund's portfolio structure and to define the general conditions under which a portfolio manager may be placed on a watch list or terminated. Such managers shall have complete investment discretion unless restricted by the terms of their management contracts. [Unaffiliated investment managers may be hired by UTIMCO to improve the Fund's return and risk characteristics. Such managers shall have complete investment discretion unless restricted by the terms of their management contracts.] Managers shall be monitored for performance and adherence to investment disciplines.

## Fund Administration

UTIMCO shall employ an administrative staff to ensure that all transaction and accounting records are complete and prepared on a timely basis. Internal controls shall be emphasized so as to provide for responsible separation of duties and adequacy of an audit trail. Custody of Fund assets shall comply with applicable law and be structured so as to provide essential safekeeping and trading efficiency.



## Fund Investment Objectives

The primary investment objective shall be to preserve the purchasing power of Fund assets and annual distributions by earning an average annual total return after inflation of 5.5% over rolling ten-year periods or longer. The Fund's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objective is to generate a fund return in excess of the Policy Portfolio benchmark over rolling five-year periods or longer. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect Fund asset allocation policy targets.

## Asset Allocation

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

Fund assets shall be allocated among the following broad asset classes based upon their individual return/risk characteristics and relationships to other asset classes:

- A. Cash Equivalents - are highly reliable in protecting the purchasing power of current income streams but historically have not provided a reliable return in excess of inflation. Cash equivalents provide good liquidity under both deflation and inflation conditions.
- B. Fixed Income Investments - Intermediate to long-term investment grade bonds offer the best protection for hedging against the threat of deflation by providing a dependable and predictable source of Fund income. Below investment grade bonds including high yield bonds usually behave more like equities than high-quality bonds such as Treasuries. In the recovery phase of the market such bonds frequently outperform high-quality bonds.
- C. Equities - provide both current income and growth of income, but their principal purpose is to provide appreciation of the Fund. Historically, returns for equities have been higher than for bonds over all extended periods. As such, equities represent the best chance of preserving the purchasing power of the Fund.
- D. ~~Alternative Investments - generally consist of alternative marketable investments and alternative nonmarketable investments.]~~

[ - ] Alternative Marketable Investments - These investments are broadly defined to include hedge funds, arbitrage and special situation funds, distressed debt, market neutral, and other nontraditional investment strategies whereby the majority of the [whose] underlying securities are traded on public exchanges or are otherwise readily marketable. These investments shall be used as implementation strategies within the Absolute Return, Opportunistic Fixed Income, Domestic and International Public Equity asset types. Alternative marketable investments may be made directly by UTIMCO or through investments in partnerships or corporate vehicles. ~~[If these investments are made through partnerships they offer faster drawdown of committed capital and earlier realization potential than alternative nonmarketable investments.]~~ Alternative marketable investments made through partnerships or corporate vehicles have various redemption options [will generally provide investors with liquidity at least annually].

E.[ - ] Alternative Non-marketable Investments - Alternative Non-marketable investments shall be expected to earn superior equity type returns over extended periods. The advantages of alternative non-marketable investments are that they enhance long-term returns through investment in inefficient, complex markets. They offer reduced volatility of Fund asset values through their characteristics of low correlation with listed equities and fixed income instruments. The disadvantages of this asset class are that they may be illiquid, require higher and more complex fees, and are frequently dependent on the quality of external managers. In addition, they possess a limited return history versus traditional stocks and bonds. The risk of alternative non-marketable investments shall be controlled with extensive due diligence and diversification. These investments are held either through limited partnership or as direct ownership interests. They include special equity, mezzanine venture capital, and other investments that are privately held and which are not registered for sale on public exchanges. In partnership form, these investments require a commitment of capital for extended periods of time with no liquidity.

E [E]. Inflation Hedging Assets - generally consist of assets with a higher correlation of returns with inflation than other eligible asset classes. They include direct real estate, REITs, oil and gas interests, commodities, inflation-linked bonds, timberland and other hard assets. These investments may be held through limited partnership, other commingled funds or as direct ownership interests.

## **Asset Allocation Policy**

The asset allocation policy and ranges herein recognize that the Fund's return/risk profile can be enhanced by diversifying the Fund's investments across different types of assets whose returns are not closely correlated. Asset allocation policies have become increasingly complex requiring the need to disclose the function or purpose of an asset type within the Fund's investment portfolio, in addition to disclosing the underlying implementation strategies within each asset type. The targets and ranges seek to protect the Fund against both routine illiquidity in normal markets and extraordinary illiquidity during a period of extended deflation.

The long-term asset allocation policy for the Fund must recognize that the 5.5% real return objective requires a high allocation to broadly defined equities, including domestic, international stocks, alternative [equity] investments, and inflation hedging assets of 65[8]% to 90%. The allocation to deflation hedging and other f[F]ixed i[i]ncome investments should therefore not exceed 35[2]% of the Fund.

The Board delegates authority to UTIMCO to establish specific neutral asset allocations and ranges within the broad policy guidelines described above. UTIMCO may establish specific asset allocation targets and ranges for large and small capitalization U. S. stocks, established and emerging market international stocks, marketable and non-marketable alternative equity investments, and other asset classes as well as the specific performance objectives for each asset class. Specific asset allocation policies shall be decided by UTIMCO and reported to the U. T. Board.

### **Performance Measurement**

The investment performance of the Fund will be measured by the Fund's custodian, an unaffiliated organization, with recognized expertise in this field and reporting responsibility to the UTIMCO Board, and compared against the stated investment benchmarks of the Fund. Such measurement will occur at least annually, and evaluate the results of the total Fund, major classes of investment assets, and individual portfolios.

### **Investment Guidelines**

The Fund must be invested at all times in strict compliance with applicable law. Investment guidelines include the following:

#### General

- Investment guidelines for index and other commingled funds managed externally shall be governed by the terms and conditions of the Investment Management Contract.

- All investments will be U. S. dollar denominated assets unless held by an internal or external portfolio manager with discretion to invest in foreign currency denominated securities.
- Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of Fund assets in such liquid investment fund.
- No securities may be purchased or held which would jeopardize the Fund's tax-exempt status.
- No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board.
- No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board.
- The Fund's investments in warrants shall not exceed more than 5% of the Fund's net assets or 2% with respect to warrants not listed on the New York or American Stock Exchanges.
- The Fund may utilize Derivative Securities ~~[with the approval of the UTIMCO Board]~~ to: a) simulate the purchase or sale of an underlying market index while retaining a cash balance for fund management purposes; b) facilitate trading; c) reduce transaction costs; d) seek higher investment returns when a Derivative Security is priced more attractively than the underlying security; e) index or to hedge risks associated with Fund investments; or f) adjust the market exposure of the asset allocation, including long and short strategies and other strategies provided that the Fund's use of derivatives complies with the Derivatives Policy approved by the UTIMCO Board. The Derivatives Policy shall serve the purpose of defining the permitted applications under which derivative securities can be used, which applications are prohibited, and the requirements for the reporting and oversight of their use. The objective of the Derivatives Policy is to facilitate risk management and provide efficiency in the implementation of the investment strategies using derivatives. ~~;~~ provided that leverage is not employed in the implementation of such Derivative purchases or sales. Leverage occurs when the notional value of the futures contracts exceeds the value of cash assets allocated to those contracts by more than 2%. The cash assets allocated to futures contracts is the sum of the value of the initial margin deposit, the daily variation margin and dedicated cash balances. This prohibition against leverage shall not apply where cash is received within 1 business day following the day the leverage occurs. UTIMCO's Derivative Guidelines shall be used to monitor compliance with this policy. Notwithstanding the above, leverage strategies are permissible within the alternative equities investment class with the approval of the UTIMCO Board, if the investment strategy is

~~uncorrelated to the Fund as a whole, the manager has demonstrated skill in the strategy, and the strategy implements systematic risk control techniques, value at risk measures, and pre-defined risk parameters.~~

- ~~Such Derivative Securities shall be defined to be those instruments whose value is derived, in whole or part, from the value of any one or more underlying assets, or index of assets (such as stocks, bonds, commodities, interest rates, and currencies) and evidenced by forward, futures, swap, option, and other applicable contracts.~~

~~UTIMCO shall attempt to minimize the risk of an imperfect correlation between the change in market value of the securities held by the Fund and the prices of Derivative Security investments by investing in only those contracts whose behavior is expected to resemble that of the Fund's underlying securities. UTIMCO also shall attempt to minimize the risk of an illiquid secondary market for a Derivative Security contract and the resulting inability to close a position prior to its maturity date by entering into such transactions on an exchange with an active and liquid secondary market. The net market value of exposure of Derivative Securities purchased or sold over the counter may not represent more than 15% of the net assets of the Fund.~~

~~In the event that there are no Derivative Securities traded on a particular market index such as MSCI EAFE, the Fund may utilize a composite of other Derivative Security contracts to simulate the performance of such index. UTIMCO shall attempt to reduce any tracking error from the low correlation of the selected Derivative Securities with its index by investing in contracts whose behavior is expected to resemble that of the underlying securities.~~

~~UTIMCO shall minimize the risk that a party will default on its payment obligation under a Derivative Security agreement by entering into agreements that mark to market no less frequently than monthly and where the counterparty is an investment grade credit. UTIMCO also shall attempt to mitigate the risk that the Fund will not be able to meet its obligation to the counterparty by investing the Fund in the specific asset for which it is obligated to pay a return or by holding adequate short-term investments.~~

~~The Fund may be invested in foreign currency forward and foreign currency futures contracts in order to maintain the same currency exposure as its respective index or to protect against anticipated adverse changes in exchange rates among foreign currencies and between foreign currencies and the U. S. dollar.]~~

### Cash and Cash Equivalents

- Holdings of cash and cash equivalents may include internal short term pooled investment funds managed by UTIMCO.
- Unaffiliated liquid investment funds as approved by the chief investment officer.
- Deposits of the Texas State Treasury.
- The Fund's custodian late deposit interest bearing liquid investment fund.
- Commercial paper must be rated in the two highest quality classes by Moody's Investors Service, Inc. (P1 or P2) or Standard & Poor's Corporation (A1 or A2).
- Negotiable certificates of deposit must be with a bank that is associated with a holding company meeting the commercial paper rating criteria specified above or that has a certificate of deposit rating of 1 or better by Duff & Phelps.
- Bankers' Acceptances must be guaranteed by an accepting bank with a minimum certificate of deposit rating of 1 by Duff & Phelps.
- Repurchase Agreements and Reverse Repurchase Agreements must be transacted with a dealer that is approved by UTIMCO and selected by the Federal Reserve Bank as a Primary Dealer in U. S. Treasury securities and rated A-1 or P-1 or the equivalent.
  - Each approved counterparty shall execute the Standard Public Securities Association (PSA) Master Repurchase Agreement with UTIMCO.
  - Eligible Collateral Securities for Repurchase Agreements are limited to U. S. Treasury securities and U. S. Government Agency securities with a maturity of not more than 10 years.
  - The maturity for a Repurchase Agreement may be from one day to two weeks.
  - The value of all collateral shall be maintained at 102% of the notional value of the Repurchase Agreement, valued daily.
  - All collateral shall be delivered to the PUF custodian bank. Tri-party collateral arrangements are not permitted.

- The aggregate amount of Repurchase Agreements with maturities greater than seven calendar days may not exceed 10% of the Fund's fixed income assets.
- Overnight Repurchase Agreements may not exceed 25% of the Fund's fixed income assets.
- Mortgage Backed Securities (MBS) Dollar Rolls shall be executed as matched book transactions in the same manner as Reverse Repurchase Agreements above. As above, the rules for trading MBS Dollar Rolls shall follow the Public Securities Association standard industry terms.

## Fixed Income

### Domestic Fixed Income

Holdings of domestic fixed income securities shall be limited to those securities a) issued by or fully guaranteed by the U. S. Treasury, U. S. Government-Sponsored Enterprises, or U. S. Government Agencies, and b) issued by corporations and municipalities. Within this overall limitation:

- Permissible securities for investment include the components of the Lehman Brothers Aggregate Bond Index (LBAGG): investment grade government and corporate securities, agency mortgage pass-through securities, and asset-backed securities. These sectors are divided into more specific subindices 1) Government: Treasury and Agency; 2) Corporate: Industrial, Finance, Utility, and Yankee; 3) Mortgage-backed securities: GNMA, FHLMC, and FNMA; and 4) Asset-backed securities. In addition to the permissible securities listed above, the following securities shall be permissible: a) floating rate securities with periodic coupon changes in market rates issued by the same entities that are included in the LBAGG as issuers of fixed rate securities; b) medium term notes issued by investment grade corporations; c) zero coupon bonds and stripped Treasury and Agency securities created from coupon securities; and d) structured notes issued by LBAGG qualified entities.
- U. S. Domestic Bonds must be rated investment grade, Baa3 or better by Moody's Investors Services, BBB- by Standard & Poor's Corporation, or an equivalent rating by a nationally recognized rating agency at the time of acquisition. This provision does not apply to an investment manager that is authorized by the terms of an investment advisory agreement to invest in below investment grade bonds.
- Not more than 5% of the market value of domestic fixed income securities may be invested in corporate and municipal bonds of a single issuer provided that such bonds, at the time of purchase, are rated, not less than Baa3 or

BBB-, or the equivalent, by any two nationally-recognized rating services, such as Moody's Investors Service, Standard & Poor's Corporation, or Fitch Investors Service.

#### Non-U. S. Fixed Income

- Not more than 35% of the Fund's fixed income portfolio may be invested in non-U. S. dollar bonds. Not more than 15% of the Fund's fixed income portfolio may be invested in bonds denominated in any one currency.
- Non-dollar bond investments shall be restricted to bonds rated equivalent to the same credit standard as the U. S. Fixed Income Portfolio.
- Not more than 7.5% of the Fund's fixed income portfolio may be invested in Emerging Market debt.
- International currency exposure may be hedged or unhedged at UTIMCO's discretion or delegated by UTIMCO to an external investment manager.

#### Equities

The Fund shall:

- A. hold no more than 25% of its equity securities in any one industry or industries (as defined by the standard industry classification code and supplemented by other reliable data sources) at market
- B. hold no more than 5% of its equity securities in the securities of one corporation at cost unless authorized by the chief investment officer.

#### Alternative Investments and Inflation Hedging Assets

Investments in alternative assets and inflation hedging assets may be made through management contracts with unaffiliated organizations (including but not limited to limited partnerships, trusts, and joint ventures), ~~[so long as such organizations:~~

- ~~A. possess specialized investment skills~~
- ~~B. possess full investment discretion subject to the management agreement~~
- ~~C. are managed by principals with a demonstrated record of accomplishment and performance in the investment strategy being undertaken~~



~~D. align the interests of the investor group with the management as closely as possible~~

~~E. charge fees and performance compensation which do not exceed prevailing industry norms at the time the terms are negotiated.~~

~~Investments in alternative nonmarketable assets and inflation hedging assets also may be made directly by UTIMCO in co-investment transactions sponsored by and invested in by a management firm or partnership in which the Fund has invested prior to the co-investment or in transactions sponsored by investment firms well known to UTIMCO management, provided that such direct investments shall not exceed 25% of the market value of the alternative nonmarketable assets portfolio or the inflation hedging assets portfolio at the time of the direct investment.]~~

Members of UTIMCO management, with the approval of the UTIMCO Board, may serve as directors of companies in which UTIMCO has directly invested Fund assets. In such event, any and all compensation paid to UTIMCO management for their services as directors shall be endorsed over to UTIMCO and applied against UTIMCO management fees. Furthermore, UTIMCO Board approval of UTIMCO management's service as a director of an investee company shall be conditioned upon the extension of UTIMCO's Directors and Officers Insurance Policy coverage to UTIMCO management's service as a director of an investee company.

### **Fund Distributions**

The Fund shall balance the needs and interests of present beneficiaries with those of the future. Fund spending policy objectives shall be to:

- A. provide a predictable, stable stream of distributions over time
- B. ensure that the inflation adjusted value of distributions is maintained over the long term
- C. ensure that the inflation adjusted value of Fund assets after distributions is maintained over the long term.

The goal is for the Fund's average spending rate over time not to exceed the Fund's average annual investment return after inflation and expenses in order to preserve the purchasing power of Fund distributions and underlying assets.

The Texas Constitution states that "The amount of any distributions to the available university fund shall be determined by the board of regents of The University of Texas System in a manner intended to provide the available university fund with a

stable and predictable stream of annual distributions and to maintain over time the purchasing power of permanent university fund investments and annual distributions to the available university fund. The amount distributed to the available university fund in a fiscal year must be not less than the amount needed to pay the principal and interest due and owing in that fiscal year on bonds and notes issued under this section. If the purchasing power of permanent university fund investments for any rolling 10-year period is not preserved, the board may not increase annual distributions to the available university fund until the purchasing power of the permanent university fund investments is restored, except as necessary to pay the principal and interest due and owing on bonds and notes issued under this section. An annual distribution made by the board to the available university fund during any fiscal year may not exceed an amount equal to seven percent of the average net fair market value of permanent university fund investment assets as determined by the board, except as necessary to pay any principal and interest due and owing on bonds issued under this section. The expenses of managing permanent university fund land and investments shall be paid by the permanent university fund.”

Annually, the U. T. Board of Regents will approve a distribution amount to the AUF.

In conjunction with the annual U. T. System budget process, UTIMCO shall recommend to the U. T. Board in May of each year an amount to be distributed to the AUF during the next fiscal year. UTIMCO's recommendation on the annual distribution shall be an amount equal to 4.75% of the trailing twelve quarter average of the net asset value of the Fund for the quarter ending February of each year.

Following approval of the distribution amount, distributions from the Fund to the AUF may be quarterly or annually at the discretion of UTIMCO Management.

### **Fund Accounting**

The fiscal year of the Fund shall begin on September 1st and end on August 31st. Market value of the Fund shall be maintained on an accrual basis in compliance with Financial Accounting Standards Board Statements, Government Accounting Standards Board Statements, industry guidelines, and state statutes, whichever is applicable. Significant asset write-offs or write-downs shall be approved by the chief investment officer and reported to the UTIMCO Board of Directors. The Fund's financial statements shall be audited each year by an independent accounting firm selected by UTIMCO's Board.

### **Valuation of Assets**

As of the close of business on the last business day of each month, UTIMCO shall determine the fair market value of all Fund net assets. Valuation of Fund assets shall be based on the books and records of the custodian for the valuation date. Valuation of alternative assets shall be determined in accordance with the UTIMCO Valuation Criteria for Alternative Assets.

The fair market value of the Fund's net assets shall include all related receivables and payables of the Fund on the valuation. Such valuation shall be final and conclusive.

### **Securities Lending**

The Fund may participate in a securities lending contract with a bank or nonbank security lending agent for either short-term or long-term purposes of realizing additional income. Loans of securities by the Fund shall be collateralized by cash, letters of credit or securities issued or guaranteed by the U. S. Government or its agencies. The collateral will equal at least 100% of the current market value of the loaned securities. The contract shall state acceptable collateral for securities loaned, duties of the borrower, delivery of loaned securities and collateral, acceptable investment of collateral and indemnification provisions. The contract may include other provisions as appropriate. The securities lending program will be evaluated from time to time as deemed necessary by the UTIMCO Board. Monthly reports issued by the agent shall be reviewed by UTIMCO to insure compliance with contract provisions.

### **Investor Responsibility**

As a shareholder, the Fund has the right to a voice in corporate affairs consistent with those of any shareholder. These include the right and obligation to vote proxies in a manner consistent with the unique role and mission of higher education as well as for the economic benefit of the Fund. Notwithstanding the above, the UTIMCO Board shall discharge its fiduciary duties with respect to the Fund solely in the interest of Fund unitholders and shall not invest the Fund so as to achieve temporal benefits for any purpose including use of its economic power to advance social or political purposes.

### **Amendment of Policy Statement**

The Board of Regents reserves the right to amend the Investment Policy Statement as it deems necessary or advisable.

### **Effective Date**

The effective date of this policy shall be \_\_\_\_\_ [~~September 1, 2004~~].

**ENDOWMENT FUNDS  
(5 to 7 Year Time Horizon)  
EXPECTED RETURN AND RISK, NEUTRAL ALLOCATIONS,  
RANGES AND PERFORMANCE OBJECTIVES**

Function	Asset Category	Implementation Strategies	Expected Nominal Return	Expected Risk	Target Allocation	Range	Investment Policy Benchmark Return
<b>Drivers of Return:</b>							
	Domestic Public Equity	Passive Management Active Management Hedge and Alpha Transport	7.50%	16.50%	31.00%	25%-45%	Wilshire 5000
	International Public Equity	Passive Developed and Emerging Active Developed and Emerging Hedge and Alpha Transport	7.50%	21.00%	19.00%	10%-30%	Morgan Stanley Capital International- All Country World Free ex U.S.
	Private Capital	Venture Capital Private Equity Private Debt Opportunistic Special Situations	9.75%	24.50%	15.00%	10% -20%	Wilshire 5000 + 4%
	<b>Subtotal Drivers of Return</b>					<u>65.00%</u> <u>50%-80%</u>	(Sum of Target Weighted Benchmarks)
<b>Risk Reducing Assets:</b>							
	Absolute Return	Market Neutral Hedge Funds	7.00%	8.25%	10.00%	5%-15%	91 day T-Bills Average Yield + 4%
	Inflation Hedging	Financial Exposure to Commodities (GSCI futures) Oil and Gas, Timber and Other Physical Commodities Public Real Estate (REITS) Private Real Estate Trenary Inflation Protected Securities (TIPS)	6.15%	9.25%	10.00%	5%-15%	(25% Goldman Sachs Commodity Index minus 100 basis points) +(25% Treasury Inflation Protected Securities) +(25% National Commercial Real Estate Index Fund) + (25% Wilshire Associates Real Estate Securities Index)
	Opportunistic Fixed Income	Domestic Public Debt (Investment Grade) High Yield Bonds (Below Investment Grade) International Developed Markets Public Debt Emerging Markets Public Debt Hedge and Alpha Transport	7.00%	11.75%	5.00%	2.5%-15%	Lehman Brothers Aggregate Bond Index (ex- U.S. Governments)
	Deflation Hedging	U.S. Government Bonds and Agencies	5.50%	9.25%	10.00%	5.0%-15%	Lehman Brothers Government Bond Index
	Cash and Equivalents	Money Markets	3.50%	3.50%	0.00%	0%-5%	91 day T-Bills Average Yield
	<b>Subtotal Risk Reducing Assets</b>					<u>35.00%</u> <u>20%-50%</u>	(Sum of Target Weighted Benchmarks)
	<b>Total</b>					<u>100.00%</u> <u>7.40%</u> 9.70%	(Sum of Target Weighted Benchmarks)
						0.76	

Risk is defined in annualized standard deviation terms.  
The neutral policy portfolio is the sum of the neutrally weighted benchmark returns.

Function	Asset Category	Implementation Strategies	New Recommended Policy		Prior Policy	
			Target Allocation	Range	Target Allocation	Range
Drivers of Return	Domestic Public Equity	Passive Management	31.00%	25% to 45%	32.50%	25% to 45%
		Active Management	11.00%	10% to 40%	20.00%	10% to 35%
	International Public Equity	Hedge and Alpha Transport	10.00%	5% to 15%	12.50%	5% to 20%
			10.00%	5% to 15%		
		Passive Developed and Emerging	19.00%	10% to 30%	15.00%	10% to 30%
		Active Developed and Emerging	6.50%	5% to 15%	6.00%	5% to 15%
	Private Capital	Hedge and Alpha Transport	7.50%	5% to 15%	9.00%	5% to 15%
			5.00%	0% to 10%		
		Venture Capital	15.00%	10% to 20%	15.00%	10% to 20%
		Private Equity	4.00%	2.5% to 10%	7.50%	2.5% to 10%
	Private Debt	7.50%	5% to 10%	7.50%	2.5% to 15%	
	Opportunistic Special Situations	0.00%	0% to 2.5%			
		3.50%	0% to 7.5%			
	<b>Subtotal for Drivers of Return:</b>		65.00%	50% to 80%	62.50%	50% to 80%
Risk Reduction	Absolute Return	Market Neutral Hedge Funds (Total Hedge Funds in Prior Policy)	10.00%	5% to 15%	10.00%	5% to 25%
			10.00%	5% to 15%	7.50%	5% to 15%
	Inflation Hedge	Financial Exposure to Commodities (GSCI futures)	2.50%	0% to 10%	2.50%	0% to 10%
		Oil & Gas, Timber and other Physical Commodities	0.00%	0% to 10%	0.00%	0% to 10%
		Public Real Estate (REITs)	2.50%	0% to 10%	5.00%	0% to 10%
		Private Real Estate	2.50%	0% to 10%		
		TIPS	2.50%	0% to 10%		
	Deflation Hedge	US Government Bonds and Agencies	10.00%	5% to 15%	0.00%	0.00%
			5.00%	2.5% to 15%	20.00%	10% to 39%
		Domestic Public Debt (Investment Grade)	2.5%	2.5% to 15%	15.00%	10% to 25%
	Opportunistic Fixed Income	High Yield Bonds (Below Investment Grade)	0.00%	0% to 5%	0.00%	0% to 7%
		International Developed Markets Public Debt	0.00%	0% to 5%	5.00%	0% to 7%
		Emerging Markets Public Debt	0.00%	0% to 1%		
		Hedge and Alpha Transport	0.00%	0% to 5%	0.00%	0% to 5%
	Cash & Equivalents	Money Markets	0.00%	0% to 5%	0.00%	0% to 5%
	<b>Subtotal for Risk Reducers:</b>		35.00%	20% to 50%	37.50%	20% to 50%
	<b>Total:</b>		100.00%		100.00%	

**THE UNIVERSITY OF TEXAS SYSTEM  
GENERAL ENDOWMENT FUND  
INVESTMENT POLICY STATEMENT**

**Purpose**

The General Endowment Fund (the "Fund"), established by the Board of Regents of The University of Texas System (the "Board") to be effective on March 1, 2001, is a pooled fund for the collective investment of long-term funds under the control and management of the Board. The Fund provides for greater diversification of investments than would be possible if each account were managed separately.

**Fund Organization**

The Fund is organized as a mutual fund in which each eligible account purchases and redeems Fund units as provided herein. The ownership of Fund assets shall at all times be vested in the Board. Such assets shall be deemed to be held by the Board, as a fiduciary, regardless of the name in which the assets may be registered.

**Fund Management**

Ultimate fiduciary responsibility for the Fund rests with the Board. Section 66.08, Texas Education Code, as amended, authorizes the U. T. Board, subject to certain conditions, to enter into a contract with a nonprofit Corporation to invest funds under the control and management of the U. T. Board.

The Fund shall be governed through The University of Texas Investment Management Company ("UTIMCO"), a nonprofit Corporation organized for the express purpose of investing funds under the control and management of the Board. UTIMCO shall a) recommend investment policy for the Fund, b) determine specific asset allocation targets, ranges, and performance benchmarks consistent with Fund objectives, and c) monitor Fund performance against Fund objectives. UTIMCO shall invest the Fund assets in conformity with investment policy.

UTIMCO may select and terminate unaffiliated investment managers subject to Delegation of Authority Guidelines approved by the UTIMCO Board. These guidelines are intended to ensure that the appropriate managers are retained to pursue a defined investment strategy within the Fund's portfolio structure and to define the general conditions under which a portfolio manager may be placed on a watch list or terminated. Such managers shall have complete investment discretion unless restricted by the terms of their management contracts. ~~[Unaffiliated investment managers may be hired by UTIMCO to improve the Fund's return and risk characteristics. Such managers shall have complete investment discretion~~

~~unless restricted by the terms of their management contracts.]~~ Managers shall be monitored for performance and adherence to investment disciplines.

### **Fund Administration**

UTIMCO shall employ an administrative staff to ensure that all transaction and accounting records are complete and prepared on a timely basis. Internal controls shall be emphasized so as to provide for responsible separation of duties and adequacy of an audit trail. Custody of Fund assets shall comply with applicable law and be structured so as to provide essential safekeeping and trading efficiency.

### **Funds Eligible to Purchase Fund Units**

No fund shall be eligible to purchase units of the Fund unless it is under the sole control, with full discretion as to investments, by the Board and/or UTIMCO.

Any fund whose governing instrument contains provisions which conflict with this Policy Statement, whether initially or as a result of amendments to either document, shall not be eligible to purchase or hold units of the Fund.

### **Fund Investment Objectives**

The primary investment objective shall be to preserve the purchasing power of Fund assets by earning an average annual total return after inflation of 5.5% over rolling ten-year periods or longer. The Fund's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objectives are to generate a fund return in excess of the Policy Portfolio benchmark and the average median return of the universe of the college and university endowments as reported annually by Cambridge Associates and NACUBO over rolling five-year periods or longer. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect Fund's asset allocation policy targets.

### **Asset Allocation**

Asset allocation is the primary determinant of the volatility of investment return and, subject to the asset allocation ranges specified herein, is the responsibility of UTIMCO. Specific asset allocation targets may be changed from time to time based on the economic and investment outlook. Fund assets shall be allocated among the following broad asset classes based upon their individual return/risk characteristics and relationships to other asset classes:

- A. Cash Equivalents - are highly reliable in protecting the purchasing power of current income streams but historically have not provided a reliable return in excess of inflation. Cash equivalents provide good liquidity under both deflation and inflation conditions.
- B. Fixed Income Investments - Intermediate to long-term investment grade bonds offer the best protection for hedging against the threat of deflation by providing a dependable and predictable source of Fund income. Below investment grade bonds including high yield bonds usually behave more like equities than high-quality bonds such as Treasuries. In the recovery phase of the market such bonds frequently outperform high-quality bonds.
- C. Equities - provide both current income and growth of income, but their principal purpose is to provide appreciation of the Fund. Historically, returns for equities have been higher than for bonds over all extended periods. Therefore, equities represent the best chance of preserving the purchasing power of the Fund.
- D. ~~[Alternative Investments—generally consist of alternative marketable investments and alternative nonmarketable investments.]~~
- [•] Alternative Marketable Investments - These investments are broadly defined to include hedge funds, arbitrage and special situation funds, distressed debt, market neutral, and other nontraditional investment strategies whereby the majority of the [whose] underlying securities are traded on public exchanges or are otherwise readily marketable. These investments shall be used as implementation strategies within the Absolute Return, Opportunistic Fixed Income, Domestic and International Public Equity asset types. Alternative marketable investments may be made directly by UTIMCO or through investments in partnerships or corporate vehicles. ~~[If these investments are made through partnerships they offer faster drawdown of committed capital and earlier realization potential than alternative nonmarketable investments.]~~ Alternative marketable investments made through partnerships or corporate vehicles have various redemption options [will generally provide investors with liquidity at least annually].
- E.[•] Alternative Non-marketable Investments - Alternative Non-marketable investments shall be expected to earn superior equity type returns over extended periods. The advantages of alternative non-marketable investments are that they enhance long-term returns through investment in inefficient, complex markets. They offer reduced volatility of Fund asset values through their characteristics of low correlation with listed equities and fixed income instruments. The disadvantages of this asset class are that they may be illiquid, require higher and more complex fees, and are frequently dependent on the quality of external managers. In addition, they possess a



limited return history versus traditional stocks and bonds. The risk of alternative non-marketable investments shall be controlled with extensive due diligence and diversification. These investments are held through either limited partnership or as direct ownership interests. They include special equity, mezzanine venture capital, oil and gas, real estate and other investments that are privately held and which are not registered for sale on public exchanges. In partnership form, these investments require a commitment of capital for extended periods of time with no liquidity. They also generally require an extended period of time to achieve targeted investment levels.

F[E]. Inflation Hedging Assets - generally consist of assets with a higher correlation of returns with inflation than other eligible asset classes. They include direct real estate, REITs, oil and gas interests, commodities, inflation-linked bonds, timberland and other hard assets. These investments may be held through limited partnership, other commingled funds or as direct ownership interests.

### **Asset Allocation Policy**

The asset allocation policy and ranges herein recognize that the Fund's return/risk profile can be enhanced by diversifying the Fund's investments across different types of assets whose returns are not closely correlated. Asset allocation policies have become increasingly complex requiring the need to disclose the function or purpose of an asset type within the Fund's investment portfolio, in addition to disclosing the underlying implementation strategies within each asset type. The targets and ranges seek to protect the Fund against both routine illiquidity in normal markets and extraordinary illiquidity during a period of extended deflation.

The long-term asset allocation policy for the Fund must recognize that the 5.5% real return objective requires a high allocation to broadly defined equities, including domestic, international stocks, alternative [equity] investments, and inflation hedging assets of 65[8]% to 90%. The allocation to deflation hedging and other f[F]ixed i[+]income investments should therefore not exceed 35[2]% of the Fund.

The Board delegates authority to UTIMCO to establish specific neutral asset allocations and ranges within the broad policy guidelines described above. UTIMCO may establish specific asset allocation targets and ranges for large and small capitalization U. S. stocks, established and emerging market international stocks, marketable and non-marketable alternative equity investments, and other asset classes as well as the specific performance objectives for each asset class. Specific asset allocation policies shall be decided by UTIMCO and reported to the U. T. Board.

### **Performance Measurement**

The investment performance of the Fund will be measured by the Fund's custodian, an unaffiliated organization, with recognized expertise in this field and reporting responsibility to the UTIMCO Board, and compared against the stated investment benchmarks of the Fund. Such measurement will occur at least annually, and evaluate the results of the total Fund, major classes of investment assets, and individual portfolios.

### **Investment Guidelines**

The Fund must be invested at all times in strict compliance with applicable law.

Investment guidelines include the following:

#### General

- Investment guidelines for index and other commingled funds managed externally shall be governed by the terms and conditions of the Investment Management Contract.
- All investments will be U. S. dollar denominated assets unless held by an internal or external portfolio manager with discretion to invest in foreign currency denominated securities.
- Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of Fund assets in such liquid investment fund.
- No securities may be purchased or held which jeopardize the Fund's tax exempt status.
- No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board.
- No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board.
- The Fund's investments in warrants shall not exceed more than 5% of the Fund's net assets or 2% with respect to warrants not listed on the New York or American Stock Exchanges.
- The Fund may utilize Derivative Securities [~~with the approval of the UTIMCO Board~~] to: a) simulate the purchase or sale of an underlying market index while retaining a cash balance for fund management purposes; b) facilitate trading; c) reduce transaction costs; d) seek higher investment returns when a Derivative Security is priced more attractively than the underlying security; e) index or to hedge risks associated with Fund investments; or f) adjust the

market exposure of the asset allocation, including long and short strategies and other strategies provided that the Fund's use of derivatives complies with the Derivatives Policy approved by the UTIMCO Board. The Derivatives Policy shall serve the purpose of defining the permitted applications under which derivative securities can be used, which applications are prohibited, and the requirements for the reporting and oversight of their use. The objective of the Derivatives Policy is to facilitate risk management and provide efficiency in the implementation of the investment strategies using derivatives.]; provided that leverage is not employed in the implementation of such Derivative purchases or sales. Leverage occurs when the notional value of the futures contracts exceeds the value of cash assets allocated to those contracts by more than 2%. The cash assets allocated to futures contracts is the sum of the value of the initial margin deposit, the daily variation margin and dedicated cash balances. This prohibition against leverage shall not apply where cash is received within 1 business day following the day the leverage occurs. UTIMCO's Derivatives Guidelines shall be used to monitor compliance with this policy. Notwithstanding the above, leverage strategies are permissible within the alternative equities investment class with the approval of the UTIMCO Board, if the investment strategy is uncorrelated to the Fund as a whole, the manager has demonstrated skill in the strategy, and the strategy implements systematic risk control techniques, value at risk measures, and predefined risk parameters.

- ~~Such Derivative Securities shall be defined to be those instruments whose value is derived, in whole or part, from the value of any one or more underlying assets, or index of assets (such as stocks, bonds, commodities, interest rates, and currencies) and evidenced by forward, futures, swap, option, and other applicable contracts.~~

~~UTIMCO shall attempt to minimize the risk of an imperfect correlation between the change in market value of the securities held by the Fund and the prices of Derivative Security investments by investing in only those contracts whose behavior is expected to resemble that of the Fund's underlying securities. UTIMCO also shall attempt to minimize the risk of an illiquid secondary market for a Derivative Security contract and the resulting inability to close a position prior to its maturity date by entering into such transactions on an exchange with an active and liquid secondary market. The net market value of exposure of Derivative Securities purchased or sold over the counter may not represent more than 15% of the net assets of the Fund.~~

~~In the event that there are no Derivative Securities traded on a particular market index such as MSCI EAFE, the Fund may utilize a composite of other Derivative Security contracts to simulate the performance of such index.~~

~~UTIMCO shall attempt to reduce any tracking error from the low correlation of the selected Derivative Securities with its index by investing in contracts whose behavior is expected to resemble that of the underlying securities.~~

~~UTIMCO shall minimize the risk that a party will default on its payment obligation under a Derivative Security agreement by entering into agreements that mark to market no less frequently than monthly and where the counterparty is an investment grade credit. UTIMCO also shall attempt to mitigate the risk that the Fund will not be able to meet its obligation to the counterparty by investing the Fund in the specific asset for which it is obligated to pay a return or by holding adequate short-term investments.~~

~~The Fund may be invested in foreign currency forward and foreign currency futures contracts in order to maintain the same currency exposure as its respective index or to protect against anticipated adverse changes in exchange rates among foreign currencies and between foreign currencies and the U. S. dollar.]~~

#### Cash and Cash Equivalents

- Holdings of cash and cash equivalents may include internal short-term pooled investment funds managed by UTIMCO.
- Unaffiliated liquid investment funds as approved by the chief investment officer.
- The Fund's custodian late deposit interest bearing liquid investment fund.
- Commercial paper must be rated in the two highest quality classes by Moody's Investors Service, Inc. (P1 or P2) or Standard & Poor's Corporation (A1 or A2).
- Negotiable certificates of deposit must be with a bank that is associated with a holding company meeting the commercial paper rating criteria specified above or that has a certificate of deposit rating of 1 or better by Duff & Phelps.
- Bankers' Acceptances must be guaranteed by an accepting bank with a minimum certificate of deposit rating of 1 by Duff & Phelps.
- Repurchase Agreements and Reverse Repurchase Agreements must be transacted with a dealer that is approved by UTIMCO and selected by the Federal Reserve Bank as a Primary Dealer in U. S. Treasury securities and rated A-1 or P-1 or the equivalent.

- Each approved counterparty shall execute the Standard Public Securities Association (PSA) Master Repurchase Agreement with UTIMCO.
  - Eligible Collateral Securities for Repurchase Agreements are limited to U. S. Treasury securities and U. S. Government Agency securities with a maturity of not more than 10 years.
  - The maturity for a Repurchase Agreement may be from one day to two weeks.
  - The value of all collateral shall be maintained at 102% of the notional value of the Repurchase Agreement, valued daily.
  - All collateral shall be delivered to the GEF custodian bank. Tri-party collateral arrangements are not permitted.
- The aggregate amount of repurchase agreements with maturities greater than seven calendar days may not exceed 10% of the Fund's fixed income assets.
  - Overnight Repurchase Agreements may not exceed 25% of the Fund's fixed income assets.
  - Mortgage Backed Securities (MBS) Dollar Rolls shall be executed as matched book transactions in the same manner as Reverse Repurchase Agreements above. As above, the rules for trading MBS Dollar Rolls shall follow the Public Securities Association standard industry terms.

### Fixed Income

#### Domestic Fixed Income

Holdings of domestic fixed income securities shall be limited to those securities a) issued by or fully guaranteed by the U. S. Treasury, U. S. Government-Sponsored Enterprises, or U. S. Government Agencies, and b) issued by corporations and municipalities. Within this overall limitation:

- Permissible securities for investment include the components of the Lehman Brothers Aggregate Bond Index (LBAGG): investment grade government and corporate securities, agency mortgage pass-through securities, and asset-backed securities. These sectors are divided into more specific subindices 1) Government: Treasury and Agency; 2) Corporate: Industrial, Finance, Utility, and Yankee; 3) Mortgage-backed securities: GNMA, FHLMC, and FNMA; and 4) Asset-backed securities. In addition to the permissible securities listed above, the following securities shall be

permissible: a) floating rate securities with periodic coupon changes in market rates issued by the same entities that are included in the LBAGG as issuers of fixed rate securities; b) medium term notes issued by investment grade corporations; c) zero coupon bonds and stripped Treasury and Agency securities created from coupon securities; and d) structured notes issued by LBAGG qualified entities.

- U. S. Domestic Bonds must be rated investment grade, Baa3 or better by Moody's Investors Services, BBB- by Standard & Poor's Corporation, or an equivalent rating by a nationally recognized rating agency at the time of acquisition. This provision does not apply to an investment manager that is authorized by the terms of an investment advisory agreement to invest in below investment grade bonds.
- Not more than 5% of the market value of domestic fixed income securities may be invested in corporate and municipal bonds of a single issuer provided that such bonds, at the time of purchase, are rated, not less than Baa3 or BBB-, or the equivalent, by any two nationally-recognized rating services, such as Moody's Investors Service, Standard & Poor's Corporation, or Fitch Investors Service.

#### Non-U. S. Fixed Income

- Not more than 35% of the Fund's fixed income portfolio may be invested in non-U. S. dollar bonds. Not more than 15% of the Fund's fixed income portfolio may be invested in bonds denominated in any one currency.
- Non-dollar bond investments shall be restricted to bonds rated equivalent to the same credit standard as the U. S. Fixed Income Portfolio.
- Not more than 7.5% of the Fund's fixed income portfolio may be invested in Emerging Market debt.
- International currency exposure may be hedged or unhedged at UTIMCO's discretion or delegated by UTIMCO to an external investment manager.

#### Equities

The Fund shall:

- A. hold no more than 25% of its equity securities in any one industry or industries (as defined by the standard industry classification code and supplemented by other reliable data sources) at market
- B. hold no more than 5% of its equity securities in the securities of one corporation at cost unless authorized by the chief investment officer.

## Alternative Investments and Inflation Hedging Assets

Investments in alternative assets and inflation hedging assets may be made through management contracts with unaffiliated organizations (including but not limited to limited partnerships, trusts, and joint ventures). ~~[so long as such organizations:~~

- ~~A. possess specialized investment skills~~
- ~~B. possess full investment discretion subject to the management agreement~~
- ~~C. are managed by principals with a demonstrated record of accomplishment and performance in the investment strategy being undertaken~~
- ~~D. align the interests of the investor group with the management as closely as possible~~
- ~~E. charge fees and performance compensation which do not exceed prevailing industry norms at the time the terms are negotiated.~~

~~Investments in alternative nonmarketable assets and inflation hedging assets also may be made directly by UTIMCO in co-investment transactions sponsored by and invested in by a management firm or partnership in which the Fund has invested prior to the co-investment or in transactions sponsored by investment firms well known to UTIMCO management, provided that such direct investments shall not exceed 25% of the market value of the alternative nonmarketable assets portfolio or the inflation hedging assets portfolio at the time of the direct investment.]~~

Members of UTIMCO management, with the approval of the UTIMCO Board, may serve as directors of companies in which UTIMCO has directly invested Fund assets. In such event, any and all compensation paid to UTIMCO management for their services as directors shall be endorsed over to UTIMCO and applied against UTIMCO management fees. Furthermore, UTIMCO Board approval of UTIMCO management's service as a director of an investee company shall be conditioned upon the extension of UTIMCO's Directors and Officers Insurance Policy coverage to UTIMCO management's service as a director of an investee company.

### **Fund Accounting**

The fiscal year of the Fund shall begin on September 1st and end on August 31st. Market value of the Fund shall be maintained on an accrual basis in compliance with Financial Accounting Standards Board Statements, Government Accounting Standards Board Statements, or industry guidelines, whichever is applicable. Significant asset write-offs or write-downs shall be approved by the chief investment

officer and reported to the UTIMCO Board of Directors. The Fund's financial statements shall be audited each year by an independent accounting firm selected by UTIMCO's Board.

### **Valuation of Assets**

As of the close of business on the last business day of each month, UTIMCO shall determine the fair market value of all Fund net assets and the net asset value per unit of the Fund. Valuation of Fund assets shall be based on the books and records of the custodian for the valuation date. Valuation of alternative assets shall be determined in accordance with the UTIMCO Valuation Criteria for Alternative Assets.

The fair market value of the Fund's net assets shall include all related receivables and payables of the Fund on the valuation date and the value of each unit thereof shall be its proportionate part of such net value. Such valuation shall be final and conclusive.

### **Purchase of Fund Units**

Purchase of Fund units may be made on any quarterly purchase date (September 1, December 1, March 1, and June 1 of each fiscal year or the first business day subsequent thereto) upon payment of cash to the Fund or contribution of assets approved by the chief investment officer, at the net asset value per unit of the Fund as of the most recent quarterly valuation date. Each fund whose monies are invested in the Fund shall own an undivided interest in the Fund in the proportion that the number of units invested therein bears to the total number of all units comprising the Fund.

### **Redemption of Fund Units**

Redemption of Units shall be paid in cash as soon as practicable after the quarterly valuation date of the Fund. Withdrawals from the Fund shall be at the market value price per unit determined for the period of the withdrawal.

### **Securities Lending**

The Fund may participate in a securities lending contract with a bank or nonbank security lending agent for either short-term or long-term purposes of realizing additional income. Loans of securities by the Fund shall be collateralized by cash, letters of credit, or securities issued or guaranteed by the U. S. Government or its agencies. The collateral will equal at least 100% of the current market value of the loaned securities. The contract shall state acceptable collateral for securities loaned, duties of the borrower, delivery of loaned securities and collateral, acceptable investment of collateral and indemnification provisions. The contract may include other provisions as appropriate.



The securities lending program will be evaluated from time-to-time as deemed necessary by the UTIMCO Board. Monthly reports issued by the agent shall be reviewed by UTIMCO to insure compliance with contract provisions.

### **Investor Responsibility**

As a shareholder, the Fund has the right to a voice in corporate affairs consistent with those of any shareholder. These include the right and obligation to vote proxies in a manner consistent with the unique role and mission of higher education as well as for the economic benefit of the Fund. Notwithstanding the above, the UTIMCO Board shall discharge its fiduciary duties with respect to the Fund solely in the interest of Fund unitholders and shall not invest the Fund so as to achieve temporal benefits for any purpose including use of its economic power to advance social or political purposes.

### **Amendment of Policy Statement**

The Board of Regents reserves the right to amend the Investment Policy Statement as it deems necessary or advisable.

### **Effective Date**

The effective date of this policy shall be \_\_\_\_\_ [~~March 1, 2001~~].

**ENDOWMENT FUNDS  
(5 to 7 Year Time Horizon)  
EXPECTED RETURN AND RISK, NEUTRAL ALLOCATIONS,  
RANGES AND PERFORMANCE OBJECTIVES**

Function	Asset Category	Implementation Strategies	Expected Nominal Return	Expected Risk	Target Allocation	Range	Investment Policy Benchmark Return	
Drivers of Return:	Domestic Public Equity	Passive Management Active Management Hedge and Alpha Transport	7.50%	16.50%	31.00%	25%-45%	Wilshire 5000	
	International Public Equity	Passive Developed and Emerging Active Developed and Emerging Hedge and Alpha Transport	7.50%	21.00%	19.00%	10%-30%	Morgan Stanley Capital International- All Country World Free ex U.S.	
	Private Capital	Venture Capital Private Equity Private Debt Opportunistic Special Situations	9.75%	24.50%	15.00%	10% -20%	Wilshire 5000 + 4%	
<b>Subtotal Drivers of Return</b>								
						<u>65.00%</u>	(Sum of Target Weighted Benchmarks)	
Risk Reducing Assets:	Absolute Return	Market Neutral Hedge Funds	7.00%	8.25%	10.00%	5%-15%	91 day T-Bills Average Yield + 4%	
	Inflation Hedging	Financial Exposure to Commodities (GSCI futures) Oil and Gas, Timber and Other Physical Commodities Public Real Estate (REITS) Private Real Estate Treasury Inflation Protected Securities (TIPS)	6.15%	9.25%	10.00%	5%-15%	(25% Goldman Sachs Commodity Index minus 100 basis points) +25% Treasury Inflation Protected Securities) +(25% National Commercial Real Estate Index Fund) + (25% Wilshire Associates Real Estate Securities Index)	
	Opportunistic Fixed Income	Domestic Public Debt (Investment Grade) High Yield Bonds (Below Investment Grade) International Developed Markets Public Debt Emerging Markets Public Debt Hedge and Alpha Transport	7.00%	11.75%	5.00%	2.5%-15%	Lehman Brothers Aggregate Bond Index (ex- U.S. Governments)	
	Deflation Hedging	U.S. Government Bonds and Agencies	5.50%	9.25%	10.00%	5.0%-15%	Lehman Brothers Government Bond Index	
	Cash and Equivalents	Money Markets	3.50%	3.50%	0.00%	0%-5%	91 day T-Bills Average Yield	
	<b>Subtotal Risk Reducing Assets</b>							
							<u>35.00%</u>	(Sum of Target Weighted Benchmarks)
	<b>Total</b>							
							<u>100.00%</u>	(Sum of Target Weighted Benchmarks)
							7.40%	
						9.70%		
						0.76		

Risk is defined in annualized standard deviation terms.  
The neutral policy portfolio is the sum of the neutrally weighted benchmark returns.

Function	Asset Category	Implementation Strategies	New Recommended Policy		Prior Policy		
			Target Allocation	Range	Target Allocation	Range	
Drivers of Return	Domestic Public Equity	Passive Management	31.00%	25% to 45%	32.50%	25% to 45%	
		Active Management	11.00%	10% to 40%	20.00%	10% to 35%	
		Hedge and Alpha Transport	10.00%	5% to 15%	12.50%	5% to 20%	
	International Public Equity	Hedge and Alpha Transport	10.00%	5% to 15%			
		Passive Developed and Emerging	19.00%	10% to 30%	15.00%	10% to 30%	
		Active Developed and Emerging	6.50%	5% to 15%	6.00%	5% to 15%	
	Private Capital	Hedge and Alpha Transport	7.50%	5% to 15%	9.00%	5% to 15%	
		Venture Capital	5.00%	0% to 10%			
		Private Equity	15.00%	10% to 20%	15.00%	10% to 20%	
		Private Debt	4.00%	2.5% to 10%	7.50%	2.5% to 10%	
	<b>Subtotal for Drivers of Return:</b>			65.00%	50% to 80%	62.50%	50% to 80%
	Risk Reduction	Absolute Return	Market Neutral Hedge Funds (Total Hedge Funds in Prior Policy)	10.00%	5% to 15%	10.00%	5% to 25%
			Financial Exposure to Commodities (GSCI futures)	10.00%	5% to 15%	7.50%	5% to 15%
Inflation Hedge		Oil & Gas, Timber and other Physical Commodities	2.50%	0% to 10%	2.50%	0% to 10%	
		Public Real Estate (REITs)	0.00%	0% to 10%	0.00%	0% to 10%	
		Private Real Estate	2.50%	0% to 10%	5.00%	0% to 10%	
		TIPS	2.50%	0% to 10%			
Deflation Hedge		US Government Bonds and Agencies	2.50%	0% to 10%	0.00%	0.00%	
		Domestic Public Debt (Investment Grade)	10.00%	5% to 15%	0.00%	0.00%	
		High Yield Bonds (Below Investment Grade)	5.00%	2.5% to 15%	20.00%	10% to 39%	
Opportunistic Fixed Income		International Developed Markets Public Debt		2.5% to 15%	15.00%	10% to 25%	
		Emerging Markets Public Debt		0% to 5%	0.00%	0% to 7%	
		Hedge and Alpha Transport		0% to 1%	5.00%	0% to 7%	
Cash & Equivalents		Money Markets		0% to 5%	0.00%	0% to 5%	
	<b>Subtotal for Risk Reducers:</b>	35.00%	20% to 50%	37.50%	20% to 50%		
<b>Total:</b>			<b>100.00%</b>		<b>100.00%</b>		

# Approval of Delegation of Authority to Corporations President and CEO

**(Approved by UTIMCO Board on 9/26/00)**

Delegation of Authority to UTIMCO management and approved by the CEO as listed below are a means to:

- to improve operational efficiency by institutionalizing the investment process and thereby insulating it from employee turnover
- to define and concentrate accountability for investment performance and policy compliance on UTIMCO management
- to ensure a transparent policy and investment decision making process.
- **Continue board decision making at the policy level**
  - Appointment/evaluation/compensation/termination of chief executive officer
  - Approval of investment policy (investment objectives, asset allocation, manager selection/termination policy, performance objectives, use of derivatives, etc.)
  - Evaluate compliance with investment policies
  - Evaluate investment results against performance objectives
- **Delegate authority to UTIMCO management for:**
  - **tactical asset allocation (within approved policy ranges)**
  - **manager selection/termination subject to the following limits:**

Manager Type	Manager Exposure	(\$Millions) UTIMCO Management Authority Limit (1)	Authority Limit as % of Total Assets (2)
Public - Passive	Portfolio value + New commitment	\$ 563	5.00%
Public - Active	Portfolio value + New commitment	\$ 281	2.50%
Private - Partnership	New commitment	\$ 28	0.25%
Private - Direct	Portfolio value + New commitment	\$ -	0.00%
Private - Relationship Total	Sum of portfolio values + Undrawn capital + New commitment	\$ 112	1.00%

(1) At time of award based on 8/31/01 endowment values

(2) \$11,264,060,427 endowment asset base (PUF and GEF\*) as of 8/31/01 (adjusted annually).

\*LTF and PHF transferred investments to GEF in exchange for GEF units

(3) Subject to concurring recommendation from private equity advisor

- Management's written notification to UTIMCO Board of an its intent to award a mandate under its delegation of authority
  - Management's approval shall become effective within 5 business days of notice provided that:
    - Executed certificates of compliance have been received from each Board member, and,
    - No Board member asserts his or her right of veto to the CEO
- Management's adherence to Board-approved Investment Manager Selection And Termination Guidelines (see Exhibit A)
- a concurring recommendation from non-discretionary advisor on selection of private equity managers (see Exhibit B)
- verification of compliance with the Investment Manager Selection and Termination Guidelines by UTIMCO Compliance Officer and Audit and Ethics Committee (see Exhibit A).
- Presentations by existing portfolio managers (including general partners) at each Board meeting
  - Managers with higher dollar exposures and potential for higher excess returns shall be reviewed more frequently

## EXHIBIT A

### INVESTMENT MANAGER SELECTION AND TERMINATION GUIDELINES

UTIMCO Management shall be responsible for the selection and termination of internal and external portfolio managers entrusted to invest U.T. System, TAMU System and other funds. While this delegation of authority recognizes that the manager selection and termination process is inherently subjective, it is subject to compliance with the guidelines below. These guidelines are intended to:

- ensure that the appropriate managers are retained to pursue a defined investment strategy within each fund's portfolio structure, and,
- define the general conditions under which a portfolio manager may be placed on a watch list or be terminated.

These guidelines shall be reviewed at least annually by the UTIMCO Board to ensure their continued relevance.

#### MANAGER SELECTION

The selection of portfolio managers shall be based upon an evaluation of the following due diligence factors:

- **General Overview of Firm**
  - History: date of formation, historical focus of firm, etc.
  - Ownership: identify the distribution of ownership, capital adequacy, use of firm capital as management incentive tool, etc.
  - Number of portfolio products/growth in number of products: identify firm resources that are dedicated to portfolio product under review
  - Assets Under Management: what is historical growth pattern, what are firm's plans to manage growth, percentage of firm's assets represented by UTIMCO portfolio.
  - Client profile: distribution and size of accounts, high net worth individuals vs. institutional.
  - Stability of Client Base: recent history of client additions and losses, reasons for losses
  - Participation of Manager's Capital in the Firm's Portfolios
  - Compensation of Firm's Investment Professionals
- **Personnel**

- Interviews: meet with key decision makers on-site, check references
- Evaluation of Experience: verify that portfolio managers have a meaningful and proven historical record of success with their current or prior firms.
- Approach to Staffing: Portfolio management by single manager or multi-manager, years staff has worked together, identify relationship manager for account, determine compatibility with UTIMCO staff and process
- Dedication of Firm's Resources: compatibility of firm's organizational size with portfolio management
- Education and Background of Investment Professionals: appropriateness for level of responsibility required by the mandate.
- Turnover of Investment Professionals: historical record, reasons for departures, succession plans.
- Client Service: through marketing representative vs. portfolio manager, firm interest in establishing relationship
  
- **Investment Philosophy and Process**
  - Competitive Advantage/Sustainability of Advantage
  - Style Discipline
  - Interaction of Macro Research with Security Level Research
  - Quantitative vs. Fundamental Investment Approach: reliance on quantitative screens
  - Country vs. Security Selection/Use of Hedging: (non-U.S. managers)
  - Use of Cash
  - Decision Making Process within Firm
  - Research and Due Diligence: idea generation, depth of research
  - Portfolio Construction/Diversification: by sector, industry, position size, country, value vs. equal weighting
  - Buy/sell Discipline: definition and consistency of process
  - Monitoring/Controls: evidence of effective compliance programs to monitor, control and administer the portfolio account.
  - Operations: adequacy of administrative, operating and trading capacities relative to the number and complexity of accounts under management.
  - Portfolio Risk: analyze historical and expected volatility of the portfolio vs. its benchmark, review firm's written policies concerning risk management
  - Liquidity: daily volume of portfolio securities, can the account be liquidated without a large market impact
  
- **Historical Investment Performance**
  - Comparison Against Relevant Passive Benchmarks:
  - Comparison Against Relevant Universe Benchmarks:
  - Cyclicality of Excess Returns; Information Ratio
  
- **Fees**

- Reasonableness Given the Portfolio Mandate
- Asset Based vs. Performance Based

In addition to the factors listed above, the selection of managers for alternative asset partnerships shall include the following considerations:

- **Marketable Alternative Assets:**
  - Investment Strategy: identify the unique strategy and pattern of expected returns that is not achievable with traditional strategies at a lower cost. Identify the source of expected value added – stock selection, shorting, leverage, event drivers, distressed investing, etc.
  - Net Exposure: identify the manager’s process for determining the portfolio’s net exposure (long positions less short positions); determine the historical range of net exposure.
  - Fees: determine the carried interest and whether it is subject to a preferred return or high water mark/loss carry forward provision.
  - Use of Leverage: determine the firm’s use of leverage at the partnership level; determine the historical range of leverage used.
  - Tax Status: determine the potential that the partnership’s activities will create UBTI, representation from firm re: best efforts avoidance of UBTI
  - Liquidity: determine the redemption and notice provisions governing the withdrawal of capital
  - Transparency: determine the availability of individual portfolio transactions, i.e., ability to see through the partnership.
- **Non - Marketable Alternative Assets:**
  - Deal Flow: identify the proprietary nature of the firm’s deal flow and distribution of deal generation among partners.
  - Key Man Provisions: determine the meaningfulness of provisions allowing for dissolution of the partnership in the event of the departure of certain key individuals from the firm.
  - Fees: determine the carried interest and whether it is subject to a preferred return and a clawback.



- Use of Leverage: determine the firm's use of leverage at the partnership level (assumed to be zero and limited to 5% for transaction friction), determine use of leverage at the portfolio company level.
- Tax Status: determine the potential that the partnership's activities will create UBTI, representation from firm re: best efforts avoidance of UBTI
- Valuation Policy: determine the firm's methodology for valuing illiquid investments and the method's reasonableness.
- Realization Strategies: determine the expected strategies to be employed by the firm in realizing its investments and the degree of the firm's experience in executing such strategies.

## **TERMINATION OF MANAGERS**

Portfolio managers (with the exception of index managers) shall be selected with the expectation of generating returns in excess of the returns for a relevant index or universe of peer managers. Managers whose performance is below expectations shall be placed on a watch list to determine whether termination is advisable. Portfolio managers shall be notified when they have been placed on a watch list. Reasons for portfolio managers to be placed on a watch list include:

- Under performance against its benchmark return or universe median return
- Significant change in portfolio composition or style
- Tracking error in excess of designated limits
- Significant changes in the manager's organization
- turnover of personnel
- ownership structure
- Growth of firm's assets under management to a level believed to inhibit effective implementation of portfolio strategy
- Unpredictable performance

If performance does not improve in a manner sufficient to justify manager retention, manager termination shall be considered. Termination of portfolio managers is expected to be infrequent but may be necessitated by the following factors:

- Fraud
- Violation of Investment Policy or Other Terms of Advisory Agreement
- Sustained Under Performance vs. Benchmarks
- Unethical Acts
- Turnover of Key Investment Professionals
- Significant Change in Ownership Structure or Control
- Assumption of Imprudent Risks
- Non Adherence to Assigned Portfolio Strategy
- Restructuring of Portfolio Mandates

# The University of Texas Investment Management Company

## Derivative Investment Policy

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Effective Date of Policy: February \_\_, 2003

Date Approved by UTIMCO Board:

### **Purpose:**

The purpose of the Derivative Investment Policy is to enumerate the applications, documentation and limitations for investment in derivative securities in the Permanent University Fund (PUF) and the General Endowment Fund (GEF), hereinafter referred to as the Funds. The Board of Regents approved investment policy guidelines for the Funds allow for investment in derivative securities provided that their use is in compliance with UTIMCO's Board approved Derivative Investment Policy. The Derivative Investment Policy supplements the Investment Policy Statement for the Funds.

### **Objective:**

The objective of investing in derivative securities is to facilitate risk management and provide efficiency in the implementation of various investment strategies for the Funds. Through the use of derivatives, the complex risks that are bound together in traditional cash market investments can be separated and managed independently. Derivatives provide the Funds with the most economical means to improve the Funds risk/return profile.

### **Scope:**

This Policy applies to internal management of derivatives at UTIMCO only. Derivatives policies for external managers are established on a case by case basis with each external manager. This Policy Statement applies to both exchange traded and over the counter derivative instruments. This Policy shall not be construed to apply to index or other common or commingled funds in which the Funds typically invest. These commingled investment vehicles are governed by separate investment policy statements.

### **Definition of Derivatives:**

Derivatives are financial instruments whose value is derived, in whole or part, from the value of any one or more underlying securities or assets, or index of securities or assets (such as a bonds, stocks, commodities, and currencies). For the purposes of this Policy derivatives shall include futures, forwards, swaps and all forms of options, but shall not include a broader range of securities including mortgage backed securities, structured notes and convertible bonds. (Refer to attached exhibit for glossary of terms)

### **Permitted Derivative Applications:**

Derivatives may be used:

- To implement investment strategies in a low cost and efficient manner,
- To alter the Funds market (systematic) exposure without trading the underlying cash market securities,
- To construct portfolios with risk and return characteristics that could not be created with cash market securities,
- To hedge and control risks so that the Funds' risk/return profile is more closely aligned with the Funds' targeted risk/return profile,
- To facilitate transition trading,
- By managers of public markets investments employed by UTIMCO. An external investment manager may engage in derivative security transactions only if the transactions are consistent with the overall investment objectives of the account. Derivative applications shall be approved only with investment managers that demonstrate investment expertise in their use, and have appropriate risk management policies and procedures to effectively monitor and control their use. Disclosure of permitted derivative applications with external investment managers shall be made to UTIMCO's Board prior to investment.

# The University of Texas Investment Management Company

## Derivative Investment Policy

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- By managers of alternative marketable equities employed by UTIMCO. The due diligence process in the selection of these managers requires a clear understanding of the managers use of derivatives, particularly as it relates to various risk controls and leverage. UTIMCO will invest in such strategies exclusively through limited partnership agreements, offshore corporations or other legal entities that limit the Funds' exposure to its investment in the strategy. Disclosure of derivative applications with alternative marketable equity managers shall be made to UTIMCO's Board prior to investment.

The primary intent of derivative security transactions should be to hedge risk in portfolios or to implement investment strategies more effectively and at a lower cost than would be possible in the cash market.

### **Derivative Applications Not Permitted:**

Derivative Applications shall not be used to invest in asset classes that are not consistent with the Funds policy asset categories, implementation strategies and risk/return characteristics. Only the above derivative applications are permitted until such time as this policy is amended and approved by UTIMCO's Board.

### **Documentation and Controls:**

Prior to the implementation of a new derivative application, UTIMCO shall document the purpose, justification, baseline portfolio, derivative application portfolio, risks (including at a minimum modeling, pricing, liquidity and legal risks), the expected increase or reduction in systematic and specific risk resulting from the application, the acceptable criteria for counterparties in over the counter derivative applications, and the procedures in place to monitor and manage the derivative exposure. Internal control procedures to properly account and value the Funds' exposure to the derivative application shall be fully documented. The Chief Investment Officer shall approve any new derivative applications prior to implementation after fully considering the permissibility, merits, and compliance with all documentation and controls requirements of the application. UTIMCO shall establish an appropriate risk management procedure to monitor compliance and will take corrective action if necessary. UTIMCO shall make a comprehensive report of all derivative applications to the UTIMCO Board on an annual basis.

### **Limitations:**

Leverage is inherent in derivative securities since only a small cash deposit is required to establish a much larger economic impact position. Thus, relative to the cash markets, where in most cases the cash outlay is equal to the asset acquired, derivatives applications offer the possibility of establishing substantially larger market risk exposures with the same amount of cash as a traditional cash market portfolio. Therefore risk management and control processes must focus on the total risk assumed in a derivatives application, which is the sum of the application-specific risk and the market (systematic) risk established by the derivative application. In order to control and limit the leverage risk, each derivative application must specify a baseline portfolio, and risk measures such as Value at Risk (VAR) will be employed to assure that the total economic impact risk of the derivative application portfolio relative to the baseline portfolio will not exceed 20% of the underlying value of the baseline portfolio. The total relative economic impact risk of each derivative application will be monitored on a daily basis by the most appropriate risk management tools for the particular derivatives application.

As an additional global limitation, the total gross value (without netting counter positions) of all derivatives positions, including both internal and external managers, in the Funds shall not exceed 50% of the net asset value of the Funds.

In order to limit the financial risks associated with derivative applications, rigorous counterparty selection criteria and netting agreements shall be required to minimize counterparty risk for over the counter derivatives. The counterparty must be an investment grade credit and the agreement must be marked to market no less frequently than monthly.

**The University of Texas Investment Management Company**  
**Derivative Investment Policy**

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**Derivative Investment Policy Exhibit**  
**Glossary of Terms**

**Application Specific Risk** – The portion of total risk in a derivatives application which is due to factors unique to the application as opposed to more systematic, market-related factors. For example, in an option on a specific stock, the risk associated with the specific business results of the company which issued the stock underlying the option would be Application Specific Risk, as opposed to the overall risk of the stock market which would be Systematic Risk.

**Baseline Portfolio** – The cash-market based portfolio which will serve as the basis for calculating the relative risk level of an equivalent derivatives application.

**Cash Equivalents** – Includes cash, short term fixed income instruments, accruals, variation margin and one day deposits in transit to the account.

**Cash Market** - The physical market for a commodity or financial instrument.

**Counterparty** - The offsetting party in an exchange agreement.

**Derivative Application** – A definition of the intended use of a derivative-based position such as replication or enhancing index returns, asset allocation or completion fund strategies, and various alpha transport strategies.

**Derivative Application Portfolio** – The portfolio including derivative instruments, cash equivalents, and other cash market assets established to replicate a specified baseline portfolio.

**Economic Exposure** - The total effective exposure of a derivative position. The economic exposure is the product of the dollar value of the exposure and the market or systematic risk level of the exposure. A common method of measuring economic exposure is with risk management tools such as “value at risk.”

**Exchange Traded Derivatives** - Derivative instruments traded on an established national or international exchange. These instruments “settle” daily in that cash exchanges are made between the exchange and parties to the contracts consistent with the change in price of the instrument. Fulfillment of the contract is guaranteed by the exchange on which the instruments are traded. Examples include S&P 500 futures contracts and Goldman Sachs Commodities Index futures contracts.

**Forward Contract** - A non-standardized contract for the physical or electronic (through a bookkeeping entry) delivery of a commodity or financial instrument at a specified price at some point in the future.

**Futures Contract** - A standardized contract for either the physical delivery of a commodity or instrument at a specified price at some point in the future, or a financial settlement derived from the change in market price of the commodity or financial instrument during the term of the contract.

**Option** - An instrument that conveys the right but not the obligation to buy or deliver the subject financial instrument at a specified price, at a specified future date.

**Over the Counter Derivatives** - Derivative instruments which result from direct negotiation between a buyer and a counterparty. The terms of such instruments are non-standard and are the result of specific negotiations. Settlement occurs at the negotiated termination date, although the terms may include interim

## The University of Texas Investment Management Company Derivative Investment Policy

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cash payments under certain conditions. Examples include currency swaps and forward contracts, interest rate swaps, and collars.

**Swap** - A contract whereby the parties agree to exchange cash flows of defined investment assets in amounts and times specified by the contract.

**Systematic Risk** – The non-diversifiable risks associated with an investment in a particular asset market. For example the financial, political, and other risks associated with a portfolio of common stocks are known as “market” or systematic risks.

**Value at Risk (VAR)** – An established method of measuring economic exposure risk. The measure conveys the maximum potential loss (in dollars or percent of total assets) for a particular investment position, for a particular period of time, for a particular level of confidence.