

MINUTES OF THE
UNIVERSITY OF HOUSTON SYSTEM
BOARD OF REGENTS
ENDOWMENT MANAGEMENT COMMITTEE

December 3, 2008

The Chair, Carroll Robertson Ray, convened the Endowment Management Committee of the University of Houston System Board of Regents, in Room 128 E. Cullen Building, 4800 Calhoun, University of Houston, on Wednesday, December 3, 2008, at 10:38 a.m., with the following members present: Jim P. Wise, Vice Chair; Calvin W. Stephens; Welcome W. Wilson, Sr., Ex Officio; Michael J. Cemo and J. Christopher Jones, Advisory Members.

Regent Ray welcomed everyone to the meeting and turned the meeting over to Mr. Hamilton Lee, who presented the committee with the report from Cambridge Associates.

Mr. Lee gave an update on the October 2008 Flash Report. The portfolio declined 13.9% for the month ending October 31, 2008. Performance was negative across all asset classes for periods measured out to 1 year, with the exception of cash. Hedge fund managers did preserve capital relative to the US and international equity markets. In aggregate, hedged equity and absolute return managers declined 6.5% and 4.9%, respectively, compared to a 17.5% decline in U.S. equities and 25.5% in international stocks for the month ending October 2008.

Regent Wise asked the consultants for their opinion on the current reactions of the investment managers due to the current market conditions. Mr. Bruce Myers stated that some of the managers were clearly shaken by the recent events, but Cambridge had looked over their portfolios, and felt in the long term, they would be fine with what they had done. Mr. Myers voiced that there may be a few managers to place on the watch list depending on future developments, which they were monitoring.

Regent Stephens questioned the source of capital should we be forced to sell investments for spending or rebalancing. Cambridge recommended sourcing approximately \$39 million to cover the FY08 payout, FY09 capital calls and manager fees. In addition, a 2.5% allocation to cash was recommended as a defensive measure. Cambridge said it was important to have some immediately accessible liquidity given the current market conditions.

Regent Ray recommended the Board consider lowering the payout rate to preserve the endowment fund for future generations as well. Dr. Carl Carlucci favored this action, and he stressed that conversations would need to take place with the deans so they would have a better understanding on how the money was being spent and the impact of a reduction in the payout. Dr. Carlucci also said he would take a look at what impact a payout rate reduction might have on scholarships. Regent Ray stressed that a one percent decrease in spending might be necessary and emphasized the importance of “balancing” current needs and the need to look towards the future. Regent Ray asked Dr. Carlucci to bring a FY09 payout rate recommendation to the next committee meeting.

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The Cambridge consultants reiterated their belief in a long-term approach to asset allocation. They stressed the importance to know that over long periods of time, investors make more as an owner than as a lender; and even though the market was volatile, equities should be expected to generate almost twice the return of bonds over extended periods. Therefore, equities were the only way to maintain spending in excess of 5% while growing the purchasing power of the portfolio.

Mr. Lee stated that during periods of deflation, equity prices fall while the prices of high-quality, non-callable, long-duration bonds tend to rise or maintain their value. Bonds can be used for spending or rebalancing the portfolio without having to liquidate depressed equities. Mr. Lee stated that during periods of unexpected inflation, the prices of both stocks and bonds can fall suddenly, while the prices of real assets like commodities, natural resources, and real estate tend to rise, providing a source of cash without having to sell depressed assets.

Cambridge Associates emphasized that the committee should consider how to rebalance the portfolio or where to source funds for spending. Cambridge recommended to the committee to continue to position the portfolio defensively. Several recommendations were given:

- Avoid Leveraged Investments;
- Overweight quality across the equity and bond portfolio
 - Tilt towards mega-and large-cap steady growth companies and slightly away from small-cap and large-cap and even value stocks
 - Tilt towards bonds backed by the full faith and credit of the US government or at least those bonds in the investment grade category
- Avoid overextended sectors of the economy where possible
- Look for unusual opportunities among the turmoil; and
- Be prudent in Implementing Inflation and Deflation Hedges.

There were two recommendations made by the committee:

1. Source the \$38.7 million cash needs as recommended by Cambridge:
 - (a) \$4.9 million from liquidation of Colchester (previously approved and completed);
 - (b) \$1 million each from Moncrief Willingham and Absolute Plus Management;
 - (c) \$1.3 million from Wellington Management Diversified Inflation Hedge;
 - (d) \$10.5 million from liquidation of Federal Street; and
 - (e) \$10 million each from Smith Graham and Wells Capital Management

Regent Ray made the motion to accept this source of cash, and Regent Jim Wise and Regent Calvin Stephens seconded the motion, which passed unanimously.

2. Cambridge recommended liquidating Wells Capital. Two reasons for this liquidation were given:
 - (a) The uncertainty surrounding the outcome of pending and potential future litigation against Wells Capital; and

- (b) To use the proceeds of the Wells investment to restructure the bond portfolio more defensively. Cambridge recommended rebalancing the 15% total allocation target to fixed income as follows:
- (i) 5% comprised of high-quality (government-backed), non-callable, intermediate-to-long-duration bonds;
 - (ii) 5% to remain benchmarked to the Lehman Aggregate Bond Index; and
 - (iii) 5% to sovereign, non-dollar bonds

After the committee discussed in detail Cambridge's suggestions, they recommended the termination of Wells Capital and the funds used for the bond portfolio. The committee agreed to invest \$20 million of the funds from the Wells Capital liquidation in a laddered US Treasuries portfolio. The committee authorized staff and Cambridge to work with our endowment fund custodian to purchase the laddered US Treasuries provided Cambridge and staff were satisfied the custodian could execute this laddered securities program at a cost commensurate with an index fund cost structure.

The Lehman Brothers Aggregate mandate would be maintained with Smith Graham. Smith Graham's performance would be monitored carefully over the next few quarters and an assessment would be made whether or not a replacement for this manager would be made before mid-year.

Two global bond managers were included in Cambridge's review (Colchester Global Investors and Mondrian Investment Partners) with a more formal review taking place after the first of the year which would include interviewing potential managers.

Regent Ray made a motion to approve these recommendations and Regent Wise and Regent Stephens seconded the motion, which passed unanimously by the committee.

There being no further business to come before the committee, the meeting was adjourned at 12:30 p.m.

All documentation submitted to the Committee in support of the foregoing action items, including but not limited to "Passed" agenda items and supporting documentation presented to the Committee, is incorporated herein and made a part of these minutes for all purposes; however, this does not constitute a waiver of any privileges contained herein.

Others Present:

Carl P. Carlucci
Dona H. Cornell
Dan Gardner
Bruce Myers

Grover Campbell
Michael Rierson
Raymond Bartlett
Hamilton Lee

Tom Ehardt
Ed Hugetz
Eli Cipriano
Gerry Mathisen

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