MINUTES
UNIVERSITY OF HOUSTON SYSTEM
BOARD OF REGENTS
ENDOWMENT MANAGEMENT COMMITTEE

Friday, November 14, 2014 - The members of Endowment Management Committee of the University of Houston System convened at 9:04 a.m. on Friday, November 14, 2014, at the University of Houston, Athletics/Alumni Center, Melcher Board Room, 100B, Houston, Texas, with the following members participating:

ATTENDANCE –

Present
Jarvis V. Hollingsworth, Chair
Roger F. Welder, Vice Chair
Spencer D. Armour, III, Member
Beth Madison, Member
Tilman J. Fertitta, Ex Officio

Member(s) Absent
Durga D. Agrawal, Regent

Non-Member(s) Present
Paula M. Mendoza, Regent
Peter K. Taaffe, Regent
Welcome W. Wilson, Jr., Regent
Asit R. Shah, Student Regent, non-voting

In accordance with a notice being timely posted with the Secretary of State and there being a quorum present, the Chair of the Committee, Jarvis V. Hollingsworth, called the meeting to order and moved to the first item requiring committee action, the approval of the minutes from the Endowment Management Committee meeting held on August 19, 2014.

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AGENDA ITEMS

Action Items

1. Approval of Minutes – Item B

   On motion of Regent Armour, seconded by Regent Madison, and by a unanimous vote of the committee members in attendance, the following minutes from the meeting listed below was approved:

   - August 19, 2014, Endowment Management Committee Meeting

Regent Hollingsworth stated there were three (3) action items and three (3) informational items on the agenda for discussion. Four (4) representatives from Cambridge Associates were present at the meeting who presented several of the items listed on the agenda. It was also noted that after discussions and any recommendation(s) made from Cambridge Associates, a vote was called; and the recommendations from Cambridge Associates required committee approval only.

Following the approval of the minutes, Regent Hollingsworth moved to Item C on the agenda, a Management discussion regarding outsourcing and institutional support for Endowment Management – University of Houston System. Dr. Carl Carlucci, Executive Vice Chancellor for Administration and Finance introduced this item to the committee. Below is a summary of Dr. Carlucci's comments.

At the prior Endowment meeting held on August 19, 2014, Dr. Carlucci stated the board had requested a report on options for managing the Endowment portfolio. A document was prepared by Dr. Carlucci which was basically a compilation of current survey information showing outsourcing and institutional support. The information was compiled from several sources in order to develop a picture of how assets were managed by various owners. These studies did show some consistency of results across size and class of ownership, said Dr. Carlucci.

Dr. Carlucci began with a history of our institution. From 1927 to 1963, we were a private institution; and he believes this had an impact on how our policies had evolved. The Association of Governing Boards (AGB) recently did a survey and after looking at 143 public institutions and nine (9) systems of higher education, they stated there were three (3) types of foundations associated with universities:

1. Dependent
2. Interdependent
3. Independent

The University of Houston did not create an independent foundation; and then again, this was most likely due to the fact that as a private institution you can manage your endowment holdings as an asset on your balance sheet.

The National Association of College and University Business Officers (NACUBO) and the Commonfund conducted a survey of 835 college and university endowments and approximately 85% of the institutions reported using an investment consultant and 40% reported they had outsourced their investment management function. Only 18% of the institutions actually had their own Chief Investment Officer (CIO).

Outsourcing endowment management was reviewed. We got data on a larger universe, 191 including large global pension funds. This information was out of Chief Investment Officer (CIO) Magazine and it included both public and private endowments and foundations.

The results of their Outsourcing Survey found that approximately 40% of their endowments outsourced their investment management and had been doing so for seven (7) years or more. The length of time was an issue. When reviewing the charts, it showed that 43% were going to outsource, if they hadn't done so already – very consistent with what NACUBO had found. The type of outsourcing arrangements planned was addressed and in the $500MM-$1B category, everyone stated they would have a consultant recommend managers and they would approve them, which is exactly what the University of Houston System does here. Dr. Carlucci was a little surprised to see that some of the larger funds actually let the consultants select their managers. Then again, the difference in this study is that they show funds of >$15B and over. Unlike the NACUBO Study which has a much tighter range, this shows a very broad range of asset holders.

Regent Hollingsworth remarked he wanted to mention a little additional experience that he has had outside of the UHS Endowment here at UH. He served for several years on a large pension system with probably over 100 persons on the investment staff. Even at a staff that large, 80% of the recommendations with respect to doing diligence on deals, and then bringing them to the board, were being done by outside consultants. It is an extremely extensive process; entails significant work; and to have your own internal staff, especially at a university with the budget that we have, with the personnel that we have, would be incredibly difficult. He stated he would be concerned about our abilities internally to dedicate the resources necessary; and have the experience to really evaluate the deals; and make recommendations to our committee.

Regent Hollingsworth also commented on our structure. He stated the timing was perfect. Interestingly, Regent Hollingsworth stated that he had recently led a panel at Cambridge's conference in New York in the last week concerning structure. Where we are structure-wise as relation to asset management is interesting. Public universities are either typically on one extreme or the other with respect to how they manage their assets. Several public universities have all of their money in one entity. It might be raised from different colleges, different universities, but it is all managed under one entity. But then there are others on the other extreme, and fewer of them, where these independent organizations that then manage their money within their individual college or where their structure is. We are a hybrid and as Dr. Carlucci had indicated, probably as a result of the fact that we were a private institution for so long before we became public. UHS has their Endowment here; and then we have seven (7) other institutions, independent foundations (six within colleges – the Athletics Foundation being one of them); and then the independent UH Foundation, who independently manages their own assets. Of course, those assets that UH cannot manage based on legal restrictions, go to the UH Foundation. Therefore, you have the UHS Board, somewhat as a fiduciary entity. Regent Hollingsworth stated that we aren't exactly clear on what our fiduciary duty is with respect to the management of all of those assets across the system; but he thinks there is probably some responsibility that the board has (not exactly sure how much) but those assets are independently managed within those colleges, by the Athletic Foundation, and by the UH Foundation. It was interesting to hear some of the comments made by the other public institutions about how they are managing those dollars, some of the pros and cons of each, and some of the difficulties that it can present.

Dr. Carlucci stated that Regent Hollingsworth's comments had reinforced the data that was being presented. The staffing size of endowments and foundations were three (3); the staffing size for assets from the $500M-$1B+ range was three (3) to four (4); and the reasons for outsourcing were risk management and the lack of internal resources which has caused different organizations to look for consultants.

Dr. Carlucci addressed the cost of staffing which was drawn from data that was available online and for Houston, Texas in the job titles that he felt were appropriate. Investment managers are not cheap and neither is the support staff.

The five-year risk-adjusted returns (FY2008-2012) for public ivy endowments were discussed, as well as the Sharpe ratio which tells us whether a portfolio's returns are due to top smart investing decisions or a result of excessive risk. This ratio is calculated by subtracting the risk-free rate, usually 10-year T-note rates, from the return for the portfolio and dividing the result by the standard deviation of the portfolio's return. It was noted that the results of the table addressed were during the depth of the market downturn and should not be taken as normal or expected performance. The conclusion here, Dr. Carlucci stated, was that performance was not necessarily linked to what one might pay their CIO or how you would manage your endowment.

Dr. Carlucci stated, as a conclusion, he would go back to the AI-CIO Survey which concluded that large global pension funds go with in-house management. Endowments and foundations in corporate pensions are more split and the asset size determines which way they lean; although corporate priorities for corporate funds, because they get treated differently, can direct how they manage them. Dr. Carlucci stated that as Regent Hollingsworth had mentioned, asset size creates a real incentive to have an outsource of management that reduces the costs, but it also reduces the risk of making decisions that don't have access to the full range of information.

After reviewing the information again, Dr. Carlucci stated that the reason endowments and foundations went with outsourcing was because of the depth of the information, the coverage of the market, and the reliability of the history.

Regent Hollingsworth stated it had been a worthwhile exercise and an important decision for the committee and asked those members for any comments on this issue. Below is a brief summary of their remarks.

- Regent Welder felt that our current structure was appropriate for the size of our portfolio and our investment objectives. He stated that certainly someday we may graduate to a point where it may make sense to have some internal people on this, but personally, he was comfortable with what we were doing now and that the structure was appropriate.
- Regent Armour stated he felt that the university was managing the endowment fund appropriately at this point in time.

This item was for information only and required no committee action.

Dr. Carlucci introduced the Cambridge Associates' staff who were present at the meeting and who would be giving their report and recommendations to the committee. They are as follows:

- Ms. Shannon Thomas – is our local manager here in Dallas, Texas;
- Mr. Phil Fiske – is from Boston and he does private investments for everyone with Cambridge;
- Mr. Mark Dalton **–** is in their Dallas office, who recently returned from Singapore; and
- Ms. Katherine Chu – works with Mr. Fiske doing private investments.

Dr. Carlucci moved to Item D., the <u>Report from Cambridge Associates regarding the UH System endowment and non-endowed portfolios – University of Houston System</u> and asked Shannon Thomas to give her report.

Ms. Thomas presented a portfolio performance summary to the committee. The University returned -2.1% in the third quarter given the equity market pullback and was up +7.0% over the trailing one-year. The portfolio remains relatively in line with near-term targets, with an overweight to hedge funds and underweights to private investments and the marketable inflation hedge allocation. On a relative basis, developed international equity, developing markets and global bonds added +180, +130, and +90 basis points of value relative to their respective benchmarks. The declining rate environment and flight to safety positively impacted the U.S. bond portfolio, which gained +0.3% on an absolute basis and outperformed the benchmark by +20 basis points. Following a strong second quarter, the marketable inflation hedge portfolio returned -8.4% in the most recent quarter. U.S. equity (-0.7%) fared better than developed international equity and developing markets returning -4.1% and -2.1%, respectively.

Katherine Chu from Cambridge addressed private investments. Ms. Chu stated the University of Houston's private investments (P/I) program is still relatively immature. The net asset value of the University of Houston's P/I is $50.5 million which puts the UHS portfolio at approximately 8.0% of the total portfolio; and we are building to a 25.0% target. It is still early in the program but, of course, we are taking actions now to build the program in a prudent manner. The university has made $109 million of commitments to a total portfolio of which about half is unfunded so that is commitments that still have to be funded in the future. Distribution is about 65% of the capital that has been paid into the private program which has already been distributed; and the total exposure right now is an addition of the net asset value of the unfunded amount which ends up being approximately $100 million.

Ms. Chu addressed the implementation progress and for the year-to-date 2014, the University of Houston has committed $22.5 million to P/I. If the recommendation that Cambridge was bringing forward today is approved that would bring our commitment to $30.0 million for this year would be consistent with the pace that we have set previously for annual private investments commitments. At our last few meetings, it was discussed that we increase our P/I so in that we had discussed a 17.5% target before, we are now looking at increasing our target to 25.0% of total assets. In order to get to this 25.0% target within the next five-seven years, Cambridge would want to increase the commitment pace per year. This year the University was going for $25-$35 million per year and next year it is expected that it would increase to between $40-$50 million.

Near-term opportunities – managers who are under consideration were discussed. ArcLight Energy Partners VI is an energy manager that invests opportunistically in different areas of energy. Historically, they have invested a little more in power; and they are transitioning and shifting more towards focusing on mid-stream assets which Cambridge believes is appealing. This fund is currently getting raised but should be opened through the first half of next year. Another manager discussed was EnCap Energy Capital X. They are an excellent private equity manager. They provide growth capital to upstream oil and gas operating companies in the U.S. and Canada. EnCap is a great manager that adds a lot of value to the companies they are investing in; they are adding value by acquiring and exploiting undeveloped reserves, improving drilling in producing regions, and applying advanced drilling technology to conventional and unconventional reservoirs. The university has previously invested in EnCap Energy Fund VII as well as EnCap Flatrock Midstream Fund II and Fund III. A brief discussion followed.

Phil Fiske from Cambridge briefly discussed the various asset class groups. US Venture Capital has been overvalued since September 2014. The early stage review is fairly valued while later stage and expansion stage are overvalued. US private equity has been overvalued since June 2014. The overvaluation tends to be the middle market and the larger buyouts. Leverage is very easy to get right now; interest rates are low; covenants are light; prices are high; therefore, Cambridge is very cautious in the mid- and high-end of the market. The lower-end of the market is a less efficient market and there is less leverage that is used. The Real Estate they have is fairly valued. There are two aspects of real estate: (1) core properties in major metropolitan areas - very overvalued right now; (2) secondary markets are fairly valued, but Cambridge felt that, as a whole, they are very cautious about real estate at this time. Private Oil, Gas, and Other Energy are fairly valued. The negative on energy is that they have seen a lot of capital coming into the private market. Dedicated private equity energy managers are proliferating, which will increase competition for both oil and gas assets and experienced management teams.

Mr. Fiske stated that Cambridge recommended that the University of Houston approve an up to $7.5 million commitment to Francisco Partners IV, L.P. The manager is seeking to raise $2.0 billion in LP capital for its fourth private equity fund. The firm is based in San Francisco and employs 30 investment professionals and 8 operating professionals. A first close is scheduled for November 7, 2014, with a subsequent close in early December, and a likely final close in early 2015. Francisco Partners' (FP) barbell investment strategy allows it to canvass the technology landscape, pursuing growth when reasonable and value when on offer. FP's diversified portfolio, lower purchase price multiples, and moderate use of leverage has led to lower impairment ratios in Funds II and III compared to the average impairment of private equity funds. FP was founded in 1999 by Dipanjan Debt, Ball, Garfinkel, David Stanton, and Sanford Robertson, with Stanton as the original managing partner. At its inception, the firm had an exclusive relationship with Sequoia Capital, the preeminent Silicon Valley venture firm, leveraging Sequoia's networks and knowledge of technology markets. Sequoia remains a source of deal flow and networks for FP.

Mr. Fiske summarized Francisco Partners IV, L.P. terms as follows:

- Target Fund Size - $2.0 billion
- GP Commitment – $50,000,000
- Management Fee – During the investment period, 1.5% of commitments. Following the investment period, 1.25% of investment contributions less distributions and write offs. Raising of subsequent fund shall trigger the management fee step-down.
- Carried Interest – 20% subject to an 8% preferred return
- Partnership Life – 10 years from the effective date (subject to extension by the GP for two one-year extensions and by the LPAC for additional one-year extensions)

On motion of Regent Welder, seconded by Regent Madison, and by a unanimous vote of the regents in attendance, the request for the University of Houston to commit up to $7.5 million to Francisco Partners IV, L.P. was approved. This action requires committee approval only. No further board action is required.

Mark Dalton, from Cambridge Associates presented the committee with a hedge fund program update. Mr. Dalton stated that the University of Houston's hedge fund program was designed to provide a diversified "market-like" source of return at lower levels of risk over the long-term. The hedge fund allocation outpaced its HFRI benchmark by +50 basis points over the trailing one-year and has achieved 56% of the return of global equities with approximately 50% of the volatility over the same time period.

Mr. Dalton stated that Cambridge recommended the University of Houston invest $10.0 million in Proxima Capital Master Fund, an event-driven long-short manager that seeks to capitalize on securities that are mispriced by the market as a result of complex situations. Proxima invests across the capital structure, with the majority of its exposure in North American and Western European equities. Proxima Capital is located in New York City and was founded by Youlia Miteva in 2004. Ms. Miteva began her career in investment banking. She had prior hedge fund investing experience at Stonehill Investment Corp. and Third Point Management, where she specialized in special situations and risk arbitrage. She is highly regarded by industry references and boasts a strong proprietary network in the U.S. and in Western Europe. She brings diversification to the portfolio.

Proxima's typical investment time horizon is 6 months to 2-years for longs and 3 months to 1-year for shorts. The offshore fund charges a management fee of 1.5% of assets, plus 20% of net profits, subject to a loss carryforward provision. Exit is quarterly on the last business day of the quarter with 45 days' notice after a 1-year soft lock-up. Redemptions during lock-up are subject to a 4% redemption fee.

On motion of Regent Madison, seconded by Regent Welder, and by a unanimous vote of the regents in attendance, the request for the University of Houston to invest $10.0 million to Proxima Capital Master Fund was approved. This action requires committee approval only. No further board action is required.

The next item addressed from the agenda was Item E, <u>Approval is requested to modify the UH System Endowment Fund Statement of Investment Objectives and Policies – University of Houston System.</u> Dr. Carlucci asked Mr. Raymond Bartlett, Treasurer to present this item to the committee.

Mr. Bartlett stated that at the prior committee meeting held on November 14, 2014, he was asked to evaluate putting some risk controls around private investment exposure as we move towards building out this portfolio to the 25% target allocation. The university worked with Cambridge Associates to look at what would be an appropriate maximum exposure to private investments. The recommendation brought before the committee was for approval to amend the investment policy, in particular, in the Asset Selection and Allocation section that addresses this specific issue. It was recommended that the following statement be added to this section as follows: "***Unfunded commitments to private investments plus the NAV of private investments should not exceed 40% of the Endowment total market value as of the period measured. If this limit is reached, it will be evaluated by the Board to determine if the limit remains appropriate.***"

Regent Hollingsworth asked that if we were to hit this 40%, does the policy provide any short-term authority for the Endowment committee to discuss options, if it were a month or two before a board meeting, if immediate action were required. A discussion followed.

Following this discussion, Regent Hollingsworth recommended to the committee that they consider this item today and then asked the administration to bring back a policy revision for the February 19, 2015 meeting to consider delegating some interim authority to the chair of the Endowment committee and the chairman of the Board to make any interim decisions that may need to be made and then have those ratified at the next board meeting. Regent Welder recommended that this delegation of authority cover all asset allocations because the policy is specific to each asset class not just private investments.

On motion of Regent Armour, seconded by Regent Welder, and by a unanimous vote of the regents in attendance, the request to modify the UH System Endowment Fund Statement of Investment Objectives and Policies – University of Houston System was approved.

At the conclusion and approval of this item, Regent Hollinsgworth made the motion to place this action item unanimously approved by the committee and requiring the approval of the full board be placed on the Board of Regents' Consent Docket Agenda for final board approval.

On motion of Regent Armour, seconded by Regent Madison, and by a unanimous vote of the regents in attendance, the following item will be placed on the Board of Regents' Consent Docket Agenda for final board approval at the November 14, 2014 Board meeting as follows:

1. Approval is requested to modify the UH System Endowment Fund Statement of Investment Objective and Policies – UH System.

The final agenda item was addressed for information only, Item H, Report on the UH System's invested fund and bank deposits, and Mr. Raymond Bartlett, Treasurer for the UH System presented this item.

Mr. Bartlett stated this report was given to the committee each quarter which summarizes the UH System's invested funds and bank deposits. This report was for fiscal quarter ending August 31, 2014. There was $1.2 billion of investable funds and bank deposits as of this date. This information is also posted to the Treasurer's website within 60 days of the end of each fiscal quarter and submitted annually to the State Auditor's Office, Legislative Budget Board, Texas Comptroller of Public Accounts, and the Governor's Office of Budget, Planning and Policy.

Regent Hollingsworth requested that a more thorough report be given at the next meeting regarding the non-endowed funds and the investment policy and how we invest those dollars.

This item was presented as information only and requires no committee action.

There was no Executive Session held.

There being no further business to come before the Committee, the meeting adjourned at 10:30 a.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.

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Others Present:

Renu Khator
Carl Carlucci
Paula Myrick Short
Dona Cornell
Vic Morgan
Rathindra Bose
Richard Walker
Don Price
Branda Lumpkin
Marquette Hobbs
Mark Dalton
Katherine Chu
Raymond Bartlett
Don Guyton
Tom Ehardt
David Bradley
Erin O'Keefe
Frank Castro
Joe Brueggman
Brenda Robles
Phil Fiske
Shannon Thomas
Dan Maxwell
Dana Rooks
Jeffrey Cass
Sasha Ryder
Phil Booth
Brian Thomas
Jon Aldrich
Gerry Mathisen