MINUTES OF THE SPECIAL CALLED MEETING
UNIVERSITY OF HOUSTON SYSTEM
BOARD OF REGENTS
ENDOWMENT MANAGEMENT COMMITTEE
Monday
April 21, 2008

Members Present:

Jim P. Wise, Vice Chair
Carroll Robertson Ray
Calvin W. Stephens
Welcome W. Wilson, Sr.

Advisory Member Present:

Michael J. Cemo

****

The Endowment Management Committee of the University of Houston System Board of Regents convened in the Room 128 E. Cullen Building, 4800 Calhoun, University of Houston, on Monday, April 21, 2008. Noting the presence of a quorum, Vice Chair, Jim Wise called the meeting to order at 2:32 p.m.

Regent Wise welcomed the Committee members, staff and Cambridge Associates to the meeting. He then briefly introduced the topics to be discussed at the meeting. Regent Wise stated for perspective of a new member of the Committee, the purpose of the Endowment is to provide sustainable, perpetual support to the university and its current and future generations of students. Regent Wise also said, as stated in the Five-Year Review of Investment Policy Guidelines recently completed by Cambridge Associates at the request of the Committee, in order to carry out its educational mission, the University depends on a payout of 5% from the Endowment each year. On top of that, according to the Investment Policy, a University Advancement fee of 1.5% is assessed to offset fundraising costs. Finally, the cost of managing the Endowment is expected to be around 50 basis points per year. That means in order to help the University accomplish its financial objective, the investment objective of the Endowment must be to earn an average annual compound return of at least 7% in real terms (*after* inflation). In nominal terms, that likely means an average annual return of 9.5-11%.

Regent Wise stated that a question had risen as to whether or not the Endowment could be used or should be used to finance the acquisition of real estate contiguous to the University's campus should any such property become available for purchase. A memo dated March 27, 2008, from Cambridge Associates to the University on the subject of using the Endowment to fund real estate acquisitions (see Addendum A) was reviewed and discussed by the Committee. The overall consensus of the committee was that the acquisition of real estate along the University's perimeter may not represent the best investment opportunity for the Endowment at this time given the Endowment's size and its current distribution levels.

Regent Wise then turned the meeting over to Cambridge Associates representatives, Mr. Bruce Myers, who attended via conference call, and Mr. Hamilton Lee. Messrs. Lee and Myers provided the committee with an overview of the markets. Mr. Myers stated that the credit market conditions continued to deteriorate over the last quarter, even though the Federal Reserve had increased liquidity. He also stated that investment grade bonds rose, but major equity indices had negative returns for the quarter across the board, with international and emerging markets losing the most ground.

Mr. Lee reported on endowment asset allocation, investment manager allocation, investment manager performance, overall portfolio performance and peer comparison as it pertains to asset allocation and performance for endowments of similar size to the UHS endowment. Mr. Lee noted the strategy of allocating funds to alternative investments (venture capital and private equity) over a 6 to 8 year period to reach the 10% target allocation. Mr. Lee noted that the benchmark for Smith Graham was incorrect and should be the Lehman Brothers Aggregate Bond Index. Mr. Lee agreed to correct this in future performance reports.

Regent Ray inquired as to the reasons why the Committee might terminate a manager. Cambridge Associates stated there were various reasons why they may recommend to the Committee that a manager be terminated including, but not limited to, a manager's underperformance, as generally measured over a market cycle (typically defined as three years) relative to its established benchmark, change in investment manager investment philosophy or style, and turnover of the portfolio management team within the strategy. The Committee inquired about the performance by Smith Graham and asked Cambridge Associates to place them on watch and provide the Committee with a report on this manager at the next Committee meeting. In addition, the Committee asked Cambridge to include the 3-year return numbers in future performance reports and delete the fiscal year-to-date column.

Mr. Myers provided a 5-year comprehensive review of the endowment investment policy. A copy of this five-year review is attached as Addendum B. This review included an analysis of the asset allocation targets and ranges, risk controls, and governance provisions of the investment policy. There were three questions Mr. Myers felt the committee should consider when evaluating the Endowment Investment Policy:

- Does the investment policy provide for sufficient diversification to reduce short-term volatility and enhance long-term return?
- Does the investment policy ensure that the Endowment is sufficiently protected against economic disaster scenarios such as unexpected inflation and deflation?
- Does the investment policy effectively match the investment objectives of the Endowment to the financial objectives of the University?

The Committee inquired about the status of the 1.5% University Advancement fee and staff mentioned that this fee is reviewed and approved annually by the Board. Staff mentioned that the fee will be on the agenda for consideration at the August meeting.

Mr. Myers explained that since absolute return and hedged equity play a major role in diversifying the portfolio and reducing volatility, Cambridge recommends increasing the lower range for the absolute return and hedged equity asset classes at a level that ensures their inclusion in the portfolio at all times. After each question was analyzed and discussed by the Committee, the Committee agreed to modify the investment policy and to change the lower end of the allowable range for absolute return and hedged equity asset classes from 0% to 5%. The Endowment Management Committee approved this recommendation at the meeting and it will be brought forward for final board approval at the May 15, 2008, Board of Regents meeting.

The committee then reviewed the Non-Endowed Investment Policy Guidelines. The current policy was approved by the Board in the fourth quarter of 2007 with an effort to better reflect the actual liquidity needs of this pool, while attempting to generate higher overall returns at the same time. Changes, which involve dividing total assets into three "tiers" of liquidity, have been largely implemented by staff. Cambridge Associates recommended additional changes to the Non-Endowed Investment Policy as follows:

- A benchmark should be specified for each tier. The recommendations were:
  1. Cash Pool – 91-day T-bills for the most liquid tier of 40% allocated to cash;
  2. Liquidity Pool – Lehman Brothers Intermediate-Term Government Bond Index for this tier, representing 40% invested in highly liquid fixed income assets with a weighted average maturity of no more than five years;
  3. The Dynamic Portfolio Benchmark used by the Endowment for the final, least-liquid tier representing 20% of total assets.
  4. Total Portfolio Benchmark which would be simply a blend of the three above benchmarks weighted according to the target allocation of the three tiers in the portfolio (40%, 40%, and 20%, respectively).
- The need to define allowable ranges for each of the three tiers that emphasize the preservation of capital first, liquidity second, and yield last.
- The need to establish triggers for rebalancing to target when any pool exceeds its allowable range by at least 5%.

The committee approved the above recommendations from Cambridge Associates for the Non-Endowed Investment Policy Guidelines and these policy revisions will be brought forward to the Board of Regents meeting on May 15, 2008 for final board approval.

Mr. Lee discussed benchmarks for hedge fund and inflation hedging managers and mentioned the Committee had asked Cambridge to evaluate whether these benchmarks were the most appropriate for these asset classes. Mr. Lee advised the Committee that, given the limitations in finding a suitable investable benchmark for alternative assets, most institutions have devised custom benchmarks for their alternative programs that instead attempt to measure whether or not the investment has satisfied the role it was

intended to perform in the portfolio. Cambridge recommended that the existing benchmarks be retained. The Committee considered Cambridge's information and recommendation and agreed to retain the existing benchmarks for hedge fund and inflation hedging managers.

There being no further business to come before the committee, the meeting adjourned at 4:08 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:

Renu Khator
Dona Cornell
Jim McShan
Dan Gardner
Raymond Bartlett
Wynne Chin
Bruce Myers (via conference call)
Hamilton Lee
Gerry Mathisen