UNIVERSITY OF HOUSTON SYSTEM ENDOWMENT FUND

STATEMENT OF INVESTMENT OBJECTIVES AND POLICIES
Approved by the Board of Regents November 15, 2001

PREFACE

The University of Houston System Board of Regents is charged with the fiduciary responsibility for preserving and augmenting the value of the endowment, thereby sustaining its ability to generate support for both current and future generations of students. As part of a commitment to long-range financial equilibrium, the Regents have adopted the broad objective of investing endowment assets so as to preserve both their real value and the long-range purchasing power of endowment income so as to keep pace with inflation and evolving university needs, while generally performing above the average of the markets in which the assets are invested.

To achieve its investment objectives the University of Houston System retains independent investment managers each of whom pursues a specific portfolio management strategy to maximize the total return (income and appreciation) over a variety of capital market cycles. The Administration and Finance Committee and Treasurer oversee the results of the independent managers and report periodically to the Board of Regents and the university community.

FORWARD

This policy is intended to be ongoing until the next review is completed. Comprehensive reviews are to be completed every five years.

It is the general practice of the University of Houston System to pool endowment resources. For investment purposes however, the assets are managed in separate endowment fund accounts. The following statement sets out explicit policies for the pooled endowment but would apply to non-pooled holdings as well. The Regents seek superior investment returns through professional management but not by assuming imprudent risks.

FINANCIAL OBJECTIVES

The primary long-term financial objective for the University endowment is to preserve the real (inflation-adjusted) purchasing power of endowment assets and income after accounting for endowment spending, inflation, and costs of portfolio management. Performance of the overall endowment against this objective is measured over rolling periods of at least ten years which should encompass several market cycles.

INVESTMENT OBJECTIVES

The primary long-term investment objective of the endowment is to earn a total rate of return that exceeds the "spending rate" plus long-term inflation (as measured by the

Consumer Price Index) plus the costs of managing the investment fund. Thus, if the spending rate averages 4 to 5%, the rate of inflation averages 5.5%, and investment management expense averages 0.5%, then nominal total return should equal or exceed 10 to 11% per year. Performance against this objective should be measured over rolling periods of at least five years.

The medium-term objective for the endowment is to outperform each of the capital markets in which assets are invested, measured over rolling periods of three to five years or complete market cycles, with emphasis on whichever measure is longer. In addition, the performance of the overall endowment is expected to be in the top quarter of the NACUBO Annual Comparative Performance Survey of all educational endowments. Thus, the Administration and Finance Committee is responsible for allocating assets to segments of the market and to managers who will provide superior performance when compared with both managers of other educational endowments and with capital markets generally.

Finally, the total return of the University's investment portfolio should be evaluated against the return of a composite index consisting of the Standard & Poor's 500 Index, the Russell 2000 Index, the Morgan Stanley Capital International EAFE Index and the Lehman Brothers Intermediate Government / Corporate Bond Index and weighted according to the Administration and Finance Committee's asset allocation targets.

INVESTMENT MANAGERS

In accordance with Board policy, hiring of investment managers and investment advisors requires approval of the Board. Managers of equities will be expected to produce a cumulative annualized total return net of fees and commissions that exceeds the indices listed above over moving three to five-year periods, and should be above a median for active investment managers using similar investment philosophies over the same time periods. At their discretion, managers of equities may hold cash reserves and fixed income securities up to 25% of portfolio market value with the understanding that performance will be measured against the common stock indices listed above. Managers who wish to exceed these limits should secure prior approval from the Treasurer.

Managers of fixed income securities will be expected to produce a cumulative annualized total return net of fees and commissions that exceeds the Lehman Brothers Intermediate Government / Corporate Bond Index by at least 100 basis points per year over moving three to five-year periods, and should be above a median of active fixed income managers over the same time periods.

ENDOWMENT PAYOUT POLICY

The Regents of the University of Houston have established an endowment payout policy which attempts to balance the long-term objective of maintaining the purchasing power of the endowment with the goal of providing a reasonable, predictable, stable, and sustainable level of income to support current needs. Payout is derived from interest, dividends and realized gains, net of portfolio management fees. The historical rate of

payout has been 4 to 5 percent. Going forward, the endowment will maintain a payout rate of approximately 4% to 5%, to be approved by the Board. The payout rate will be based as a percentage of the fiscal year end market value averaged over rolling three year periods. If an endowment has been in existence less than three years, the average will be based on the number of years in existence.

UNIVERSITY ADVANCEMENT ASSESSMENT

The system will annually assess a reasonable fee against the earnings of specified endowment funds to offset expenses associated with gift acquisition and fundraising at the component universities.

ASSET SELECTION AND ALLOCATION

The portfolio may be invested in readily-marketable securities such as domestic or international common stocks, domestic bonds, and cash equivalents. Convertible and preferred securities shall be included with common stocks for purposes of asset allocation.

The total endowment shall be diversified both by asset class and, within asset classes, by economic sector, industry, and market capitalization (size). The purpose of diversification is to limit the specific risk associated with any single security or class of securities. The Administration and Finance Committee shall periodically review overall asset allocation to ensure appropriate diversification is maintained.

Equities represent ownership of a corporation. Included in the domestic equities category are publicly traded common and preferred stocks, rights, warrants, convertible securities and American Depository Receipts. Large capitalization is defined as securities with a capitalization (number of shares outstanding times price per share) greater than $5 billion. Small capitalization is defined as capitalization of less than $1 billion. International equities represent ownership of a corporation domiciled outside the United States and whose shares are traded on a stock exchange outside the United States. Securities are usually purchased in the currency of the country in which the stock exchange is domiciled. The purpose of investments in equities is to earn high real and total rates of return, to provide both long-term capital appreciation and growth in current income that exceed the rate of inflation.

Bonds are debt instruments of corporations, government or governmental agencies, characterized by a fixed interest rate and stated maturity date. Intermediate bonds have a maturity between 3 and 10 years. The purpose of investment in bonds is to provide a hedge against deflation or stock market downturn, a relatively high level of current income, a stable source of revenue, and diversification of endowment assets.

Special investments include private placements, venture capital and other investments which fall outside the parameters of usual investment. The purpose of special investments is to provide significantly higher rates of return than can be achieved on other segments of the portfolio.

Cash equivalents are fixed income securities having maturities of less than one year from the date of purchase. This category may include Treasury Bills, repurchase agreements, certificates of deposit, demand notes, commercial paper, and bank pooled trust funds which invest in maturities of less than one year. The purpose of investments in cash equivalents is to provide adequate liquidity for investment reserves and from time-to-time to serve as equity or bond substitutes for defensive purposes in adverse investment conditions.

For the total endowment pool the market value of investments in various assets shall remain within the following ranges except for minor deviations due to fluctuations in market value or current spending:

ASSET ALLOCATION FOR THE FUND

	Allowable Ranges
Equities	50% - 85%
Fixed Income	15% - 50%

The allowable ranges for equities are established with the provision that no more than 15% of the total portfolio will be allocated to a manager or managers who invest primarily in international equities and no more than 10% to a manager or managers who invest primarily in small cap equities. A range of 0% - 10% at cost may be allocated to special investments. At least 15% of the endowment shall be invested in bonds as a deflation hedge. Such bonds shall have an average maturity consistent with intermediate maturity bond management and should be rated investment grade (Baa or BBB) or higher by a recognized rating agency and reinforced by independent in-house credit analysis. Furthermore, the average quality of each investment manager's bond portfolio should be rated A or higher. In the event that any fixed income security is downgraded below investment grade, the Board should be notified by the investment manager in writing, along with the course of action taken.

The Administration and Finance Committee may set asset allocation targets within these ranges, and the actual allocation of assets will be adjusted through additions and withdrawals of funds among managers and investment media to conform to these targets insofar as practical.

The Vice Chancellor of Administration and Finance may set asset allocation targets that deviate from these ranges in unusual circumstances, or in cases where market appreciation of equities cause the equity allocation to rise above the approved range or fixed income allocation to drop below the approved range. If the deviations remain for more than one quarter, the Vice Chancellor will seek approval of the Endowment Advisory Committee.

The endowment managers shall not sell securities short, buy securities on margin, borrow money or pledge assets, nor buy or sell uncovered options, commodities, or currencies, nor buy private placements of any kind including direct mortgages without consultation with the Treasurer. However, with prior approval of the Administration and Finance

Committee, the endowment managers may take short or long index futures positions to adjust their effective asset allocation, provided that the full exposure of such positions is covered by endowment assets.

Under normal circumstances the international investment managers are expected to invest substantially all of the assets in international equities. The limitations above notwithstanding, it is understood that the international investment manager may invest up to 35% in U.S. and non-U.S. government debt instruments or debt instruments of U.S. or non-U.S. companies. The international investment manager may enter into forward currency exchange contracts and currency and stock index futures contracts and related options, purchase and sell options on currencies and stock indexes, purchase put options on stocks, purchase and sell call options on stocks and enter into repurchase agreements, and may purchase foreign currencies in the form of bank deposits.

INVESTMENT MANAGEMENT

The endowment of the System will be managed primarily by external investment management organizations. Investment managers have discretion to manage the assets in each portfolio to best achieve the investment objectives, within the policies and requirements set forth in this statement, the investment manager agreement with the System including the guidelines for each investment manager, and subject to the usual standards of fiduciary prudence.

Each investment manager will be provided with written statements of investment objectives and guidelines as part of the investment management contract that will govern his or her portfolio. These objectives shall describe the role the investment manager is expected to play within the manager structure, the objectives and comparative benchmarks that will be used to evaluate performance, and the allowable securities that can be used to achieve these objectives. Each manager will report performance quarterly consistent with these objectives and also indicate current annualized income and yield. These statements will be consistent with the Statement of Investment Objectives and Policies for the overall endowment as set forth herein. Investment managers will be provided with a copy of the Statement of Investment Objectives and Policies.

Investment Performance Standards

A. Large Capitalization Equity Managers

Over the course of a fair market cycle of three to five years, a large cap equity manager is expected to:

1. Achieve an annualized rate of return that exceeds the Consumer Price Index by 6.0% or more per year over several market cycles.

2. Achieve a compound time-weighted rate of return in excess of the return of the S&P 500 Index.

3. Rank in the top half of a universe of other actively managed equity funds with similar objectives.

B. Small Capitalization Equity Managers

Over the course of a fair market cycle of three to five years, a small cap equity manager is expected to:

1. Achieve an annualized rate of return that exceeds the Consumer Price Index by 7.0% or more per year over several market cycles.

2. Achieve a compound time-weighted rate of return in excess of the return of the Russell 2000 Index.

3. Rank in the top half of a universe of other actively managed equity funds with similar objectives.

C. Value Equity Managers

Over the course of a fair market cycle of three to five years, a value equity manager is expected to:

1. Achieve an annualized rate of return that exceeds the Consumer Price Index by 6.0% or more per year over several market cycles.

2. Achieve a compound time-weighted rate of return in excess of the return of the Russell 1000 Value Index.

3. Rank in the top half of a universe of other actively managed equity funds with similar objectives.

D. International Equity Managers

Over the course of a fair market cycle of three to five years, an international equity manager is expected to:

1. Achieve an annualized rate of return that exceeds the Consumer Price Index by 6.0% or more per year over several market cycles.

2. Achieve a compound time-weighted rate of return in excess of the return of the Morgan Stanley Capital International EAFE Index.

3. Rank in the top half of a universe of other actively managed international equity funds with similar objectives.

E. Fixed Income Managers

Over the course of a fair market cycle of three to five years, a fixed income manager is expected to:

1. Achieve an annualized rate of return that exceeds the Consumer Price Index by 3.0% or more per year over several market cycles.

2. Achieve a compound time-weighted rate of return in excess of the return of the Lehman Brothers Intermediate Government / Corporate Bond Index.

3. Rank in the top half of a universe of other actively managed fixed income funds with similar objectives.

F. Special Investments

Over the course of a fair market cycle of three to five years, special investments are expected to:

1. Achieve an annualized rate of return that exceeds the Consumer Price Index by 7.0% or more per year.

SECURITIES LENDING

Managers may not enter into securities lending agreements. Securities owned by the endowment but held in custody by the endowment custodian may be lent to other parties through a contract between the University of Houston System and the custodian pursuant to a written agreement approved by the Board of Regents.

PROXY VOTING

Investment managers are responsible for voting proxies on behalf of the University of Houston System. When the manager is analyzing a proxy voting issue for the endowment and deciding how to vote, they should take into consideration the general positions of the Board of Regents as described in guidelines provided to each manager.

SPECIAL INVESTMENTS

Although the endowment will be managed primarily by external investment management organizations, investment opportunities of exceptional promise may from time to time be brought to the attention of management. These may include private placements, venture capital pools, limited partnerships and similar assets. The purpose of such investments is to provide very high long term capital growth sufficient to compensate for associated additional risk and possibly an absence of annual cash return. In the aggregate the maximum allocation to such investments shall be no more than 10% of the total market value of all endowment funds combined.

The Treasurer will monitor special investments and provide annual reports to the Board on their performance.

Optimally the gain from a special investment should be realized in five years or less, but in no event longer than ten years. In size, a special investment should range from 5 percent to 10 percent of the maximum portfolio allocation to special investments and participation in any special investment should not constitute a majority interest in the undertaking. Optimally a special investment will entail no expectation of a future obligation for an additional investment of an indeterminate amount and specific

information on the management and nature of the operations of an enterprise should be available and subject to analysis prior to investing.

ADVISORY COMMITTEES

The Administration and Finance Committee may establish advisory groups, such as the System Endowment Advisory Committee, to provide general investment advice, as well as advice on special investments, to the Administration and Finance Committee and the staff of the Vice Chancellor of Administration and Finance.

SPECIAL ADVISORS

The Chairman of the Administration and Finance Committee, the Vice Chancellor for Administration and Finance, and the System Treasurer may designate two or more Special Advisors to assist and provide guidance on each special investment transaction. These Advisors shall generally be selected from members of any established advisory committee. Their role shall be to provide experienced input to the decision process and transaction structuring. .

SPECIAL INVESTMENT APPROVAL AND MANAGEMENT

Proposals for special investments shall be presented to the Treasurer, who is responsible for coordinating the investigation of each special investment. When a proposal of exceptional promise is identified by the Treasurer and Vice Chancellor for Administration and Finance the following three step review process will be undertaken:

1. The Vice Chancellor for Administration and Finance, the Treasurer and the appointed Special Advisors shall conduct a thorough evaluation of specific investment proposals. Relevant information about the business or partnership, lead investor (if any), management, proposed terms, and expected returns shall be evaluated. Risk elements and exit strategies shall also be evaluated to the extent known.

2. If one or more of the four persons evaluating the investment believe that it should be pursued, the proposal will be discussed with the Chairman of the Administration and Finance Committee.

3. The Chairman shall consult with other members of the Administration and Finance Committee to determine whether the investment opportunity is deemed worthy of further consideration, fully recognizing the input from the committee. Approval of the Administration and Finance Committee shall be a prerequisite to recommending any special investment for approval by the Board of Regents.

The approval process is designed to assure the adequacy of experienced input to the decision process, a timely response capability, and the sufficiency of information for the Board of Regents. For logistical reasons, any meeting or information exchange may occur in person or via telephone or other available means of communication.

REVIEW PROCEDURES

A. Performance Measurement

The Administration and Finance Committee intends to review at least quarterly the performance of the endowment and each investment manager's portfolio relative to the objectives and guidelines described herein. The investment performance review will include comparisons with unmanaged market indices and the Consumer Price Index. A time-weighted return formula (that minimizes the effect of contributions and withdrawals) will be utilized.

B. Review and Modification of Policy

The Administration and Finance Committee shall review this Policy at least once a year to determine if modifications are necessary or desirable. If modifications are made, they shall be promptly communicated to the Investment Managers and other responsible parties.