

UNIVERSITY OF HOUSTON SYSTEM ENDOWMENT FUND
STATEMENT OF INVESTMENT OBJECTIVES AND POLICIES
Approved by the Board of Regents May 15, 2008

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 plays a part in meeting the System's goals over a variety of capital market cycles. The Endowment Management Committee, Vice Chancellor for Administration and Finance (Vice Chancellor) or designee 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

In order to meet the financial objective stated above, the primary long-term investment objective of the endowment is to earn a total rate of return that exceeds the spending rate

plus the costs of managing the investment fund, and expressed in real (or inflation adjusted) terms. Given the current System spending rate of 7% (which includes 5% payout, 1.5% university advancement assessment, and 0.5% costs of managing the investment fund), the objective of this fund will be to earn a real (inflation adjusted) return of 7.0% when measured over rolling periods of at least five years. It is also understood that due to market conditions there may be five-year periods where this objective is exceeded and purchasing power is enhanced, as well as five-year periods where the objective is not met and purchasing power is diminished. 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 consistently in at least the second quartile of the NACUBO Annual Comparative Performance Survey of all educational endowments over rolling five-year time periods. Thus, the Endowment Management 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 appropriate benchmarks weighted according to the Endowment Management 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 marketable securities are expected to produce a cumulative annualized total return net of fees and commissions that exceeds an appropriate benchmark index 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 may hold cash reserves and fixed income securities up to 25% of portfolio market value with the understanding that their benchmark will not be adjusted to reflect cash holdings. Managers who wish to exceed these limits should secure prior approval from the Treasurer. The Treasurer, in turn, shall seek approval from the Vice Chancellor or designee.

ENDOWMENT PAYOUT POLICY

The Regents of the University of Houston System 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%, with any change to this range 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 plus a prorated amount for current fiscal year

gifts. 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. The Board shall annually review and approve the fee. The fee 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.

ASSET SELECTION AND ALLOCATION

It is understood that ownership assets (or equities) are to be the dominant asset class in the Endowment due to the superior long-term return offered by such assets. As such, equity assets may be thought of as the drivers of long-term Endowment return.

Although the long-term return from equity assets is superior, they have three primary drawbacks that must be addressed. The first is that periods of prolonged economic contraction (deflation) can be catastrophic. Although such periods are rare, the results of such periods are severe enough to warrant holding a portion of the Endowment in assets (primarily intermediate to long-term high quality, non-callable fixed income securities), which are likely to appreciate in value during such periods. In this context, high quality shall mean a portfolio with an average credit quality of AA or better, although active managers may choose to hold select investment grade securities with lower ratings. The goal of such holdings would be to provide sufficient liquidity to the Endowment to meet payout needs over a three to five-year period without having to sell a significant portion of the equities at “fire-sale” prices. Adherence to this policy will keep equity holdings intact and allow the Endowment to reap the rewards of a return to a more normal economic environment.

The second drawback to a reliance on equity ownership is the effects of an unexpected rise in the rate of inflation. Such rises have traditionally been problematic for most types of equity assets, and given the System’s stated goal of preserving purchasing power by achieving an attractive inflation adjusted return, some portion of the Endowment should be invested in assets that will appreciate in value during periods of unexpected inflation.

Lastly, equity assets are subject to greater degrees of risk. Risk takes many forms and is usually thought of in terms of volatility of investment returns. Volatile investment returns translate into a level of support for the System’s programs that (even with the smoothing effect of the rolling three-year average market value payout rule) is variable over time. In order to control this variability to a tolerable level, some allocation is warranted to assets that produce attractive returns, but in a more absolute (or less variable) pattern. It is understood that such absolute return assets will invariably return less than equity assets, given rational markets.

After providing for the three broad categories noted above, the remainder of the Endowment should be invested in equity assets, broadly defined and broadly diversified. Broad diversification is required not only to further smooth the pattern of returns, but to protect the endowment from the risks associated with undue concentration in any one type of equity asset. Although other forms of diversification may be considered, it is understood that the Endowment's equity assets will be diversified by style (growth versus value), geography (domestic versus foreign), and market capitalization (large-cap versus small).

Current policy targets and ranges for the Endowment are as follows:

	<u>Target</u>	<u>Range</u>
Risk Controlling Assets	32.5%	30 to 50%
Deflation Protection (high quality bonds)	15%	15 to 30%
Inflation Protection	10%	5 to 15%

Assets to be considered for inclusion in this category include: Real Estate/REITs, TIPS (Treasury Inflation Protected Securities), and Energy or Commodities.

Absolute Return	7.5%	5 to 10%
-----------------	------	----------

Assets to be considered for inclusion in this category would primarily include defensive arbitrage or absolute return funds. Bonds may also be held in some circumstances as absolute return vehicles, and in some circumstances a particular real estate manager may be viewed to qualify as such a holding as well.

Drivers of Return	67.5%	50 to 70%
Domestic Mid to Large Cap Equities	22.5%	20 to 40%
Domestic Small-cap Equities	2.5%	0 to 10%

Large and mid-cap equities are defined as the 1000 largest companies traded in the United States, while small cap equities are considered to be the next 2000 stocks in terms of size. This characterization is compatible with the constitution of the Russell 1000, Russell 2000 and Russell 3000 Indexes.

Non U.S. Equities	25%	10 to 30%
Long/Short Equity Managers	7.5%	5 to 10%
Non Marketable Equity Managers	10%	0 to 10%

Managers to be considered for inclusion in this category include private equity or venture capital managers, as well as real estate funds with comparable expected returns, and other funds subject to multi-year lock-ups.

The Endowment Management Committee sets the above asset allocation targets and 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.

REBALANCING

In addition to rebalancing through the deployment of cash flows, the Endowment Management Committee (“Committee”) should consider rebalancing whenever an exposure is meaningfully overweight or underweight its target, and must rebalance to the upper range of the asset class once an exposure is 5% or more beyond the range specified for that asset class as measured at the end of the month.

Between meetings of the Committee, should the exposure for any asset class reach a level of 5% or more beyond the uppermost limit of the specified range as measured at the end of the month, the Treasurer shall consult with the System’s Investment Consultant (if any) and make a recommendation to the Vice Chancellor or designee as to the appropriate rebalancing actions to take. By mutual agreement, those parties may then proceed either to take what rebalancing actions they deem to be reasonable and practical or, in the alternative, the Vice Chancellor may notify the Committee Chair who may call a special meeting of the Committee. Any rebalancing actions taken by the Treasurer, Vice Chancellor or designee, and Investment Consultant shall be communicated to the entire Committee by the Vice Chancellor in a timely matter but in any case, no later than the next Committee meeting.

Between meetings of the Committee, should the exposure of any asset class reach a level of 5% or more below the lower end of the specified range, as measured at the end of the month, or the System receives an inflow at any one time that is more than 3% of the total market value of the endowment, the Vice Chancellor shall notify the Committee Chair who shall convene a special meeting of the Committee to be held as soon as practical.

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 active investment manager with whom the System has a separate account 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.

Additionally, each manager will be expected to use best efforts to realize the best execution price when trading securities and the settlement of all transactions (except investment pool funds and mutual funds) shall be done on a delivery versus payment basis.

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.

ADVISORY COMMITTEES

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

REVIEW PROCEDURES

A. Performance Measurement

The Endowment Management Committee intends to review 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 for the overall endowment, although it is understood that individual managers may be evaluated using a dollar-weighted methodology, where appropriate.

B. Review and Modification of Policy

The Endowment Management 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.