

The University of Houston System Endowment Fund



FISCAL YEAR 2008

AUGUST 31, 2008

Market Overview

Domestic equity markets reported positive performance for the month of August. For the year, however, the DJIA and S&P 500 Index remain down over 11%. The recent news of continued woes in the financial sector and concerns about government bailouts has pushed the Dow down 6.2% so far in September. More downward pressure on the stock market is expected as financial markets are weaker than the current market discount suggests. Corporate earnings contraction is expected to continue, and currency volatility will persist especially with the U.S. dollar.

Small Cap vs. Large Cap & Growth vs. Value

Large cap equities continued to lag smaller caps largely due to the significant deterioration within the financial sector. Small cap stocks have outperformed large cap stocks for all periods measured. From a style standpoint, both large cap and small cap value stocks outperformed its counterpart for the month of August by 62 and 227 basis points, respectively.

Global Market Overview

Global equity markets remained negative for U.S.-based investors in August. International equities, as measured by the MSCI EAFE Index, returned -4.1% for August. Similar to the U.S. equity markets, the MSCI EAFE value outperformed growth on a relative basis by 142 basis points for the month of August. Over longer time horizons, growth has outperformed value by a significant margin for the past 1 year and 3 year period.

Valuation

The market value at the end of August was \$530 million, including \$54 million of non-endowed funds invested in the endowment.

Performance

As indicated in table 1 below, the endowment's performance lagged the dynamic portfolio benchmark for the month, quarter, calendar-year-to-date and 1-year ending August 31, 2008. International equities, hedged equities and inflation hedges, particularly Wellington DIH, were the major contributors to the underperformance of the endowment for the periods measured. The endowment's asset allocation has protected some capital in this difficult market as the broader U.S. and international equity markets are down more than the endowment for the calendar-year-to-date and 1-year periods.

Table 1	One Month	Three Months	Calendar YTD	One Year
UHS Endowment	-1.23%	-8.36%	-9.20%	-5.39%
Dynamic Portfolio Benchmark	-0.38%	-5.16%	-5.74%	-3.51%
DJIA	+1.81%	-8.02%	-11.43%	-11.35%
S&P 500 Index	+1.45%	-7.89%	-11.39%	-11.14%
Russell 1000 Index	+1.38%	-8.12%	-11.02%	-10.60%
Russell 2000 Index	+3.61%	-0.82%	-2.62%	-5.48%
NAREIT Equity	+2.21%	-5.74%	+1.95%	-7.05%
MSCI EAFE Index	-4.05%	-14.73%	-17.31%	-14.41%
Lehman Agg. Index	+0.95%	+0.79%	+2.00%	+5.86%
CPI-U	-0.40%	+1.13%	+4.31%	+5.37%

Asset Allocation

The portfolio's asset allocation is in compliance with the investment policy as indicated in table 2.

Table 2	Asset Allocation	Asset Allocation	FY 2008 Target	Long-term Target	Policy
Asset Class	08/31/08	08/31/08	Allocation	Allocation	Range
	\$000s	%	%	%	%
Equities					
US Equity	137,089	25.9	29.0	25.0	20 - 50
International	123,266	23.2	25.0	25.0	10 - 30
Total Equities	260,355	49.1	54.0	50.0	30 - 80
Fixed Income	84,230	15.9	15.0	15.0	15 - 30
Absolute Return	30,593	5.8	7.5	7.5	5 - 10
Hedged Equities	62,089	11.7	12.5	7.5	5 - 10
Inflation Hedge	74,498	14.0	10.0	10.0	5 - 15
Alternatives	4,604	0.9	1.0	10.0	0 - 10
Cash	13,860	2.6	0.0	0.0	
Total	530,229	100%	100%	100%	

Exposure to Financial Sector Companies of Interest

While our large cap domestic equity managers have exposure to the financial sector, their exposure to Lehman Brothers is de minimus. None of the endowment's hedged equity and absolute return managers has direct investment or prime brokerage exposure to Lehman Brothers, and their counterparty risk is de minimus.

Asset Allocation in Light of Market Turbulence

Cambridge is recommending its clients be defensive with their asset allocation, specifically:

- Make sure fixed income is high quality – UHS' policy focuses on investment grade bonds with a bias towards higher quality.
- Focus on large cap and mega cap equities with high emphasis on high quality earnings and consistency of those earnings - \$114 million or 83% of the total \$137 million in domestic equity investment is allocated to large cap and mega cap equities.
- Maintain a neutral weighting between domestic and international equities – UHS has approximately an equal allocation (25%) to domestic and international equities.
- Maintain some cash reserves and avoid the temptation to try and time the market with existing reserves; instead allocate cash over time – UHS has \$14 million in cash (2.6%).
- Maintain a reasonable level of access to fairly liquid investments to meet capital calls and endowment payout – Cash reserves and high quality fixed income provide this liquidity (totaling \$98 million).
- Protect against deflation through high quality bonds and inflation through a diversified portfolio of hard assets (e.g. commodities and real estate) – UHS has \$84 million (15%) allocated to bonds with an emphasis on investment grade bonds; more specifically to higher quality investment grade bonds. We have \$75 million (14%) in inflation hedging assets such as commodities and real estate.

Hurricane Ike Impact to UHS' Real Asset Investments

We spoke to our real estate managers, Berwind Property Group and Newlin Realty, and they both said their multi-family property investments in Houston fared well with most damage limited to shingles or minor structural damage to roofs, broken windows and uprooted trees. None of the properties experienced damage from rising water just blown rain. They said the power is on for most properties and there is not expected to be any significant financial impairment to the properties or the investment due to Hurricane Ike. Our timber investment manager, Sustainable Woodlands Fund, benefited from the rain from the storm. These timber properties are primarily located in the southeastern United States.