

Report of the UTIMCO Working Group

Preface

At its meeting on December 19, 2003, the Board of Regents (the "Board") of the University of Texas System (the "U.T. System") resolved to examine and evaluate the structure of, and services provided in connection with, the U.T. System's contractual relationship with the University of Texas Investment Management Company ("UTIMCO"), a Texas non-profit corporation established by the Board pursuant to authority expressly conferred by the Texas Legislature for the specific purpose of the management of investment of the Permanent University Fund and other endowment funds under the control of the Board (collectively, the "Delegated Funds"). The resolution of the Board noted ten specific areas to be evaluated, with the goal of defining and structurally improving the investment management function of the U.T. System (a copy of the resolutions is included herein at Tab 14). At the February 3, 2004 meeting of the Board, Board Chairman Charles Miller announced to the Board that he had designated a working group (the "Working Group") to undertake the review and prepare a written report to be delivered to the Board. The Working Group was charged with delivering its report to the Board for its review in advance of a special meeting of the Board now scheduled for April 29, 2004. Enclosed herewith is the report of the Working Group.

Membership of the Working Group

The Working Group initially included the following personnel named by the Chairman at the February 3 Board meeting:

U.T. System Staff

Philip R. Aldridge, Interim Vice Chancellor for Business Affairs
Charles Chaffin, Director of Audits
Cullen M. Godfrey, Vice Chancellor and General Counsel
Francie A. Frederick, Counsel and Secretary to the Board

Baker Botts L.L.P.

Charles Szalkowski
Christopher T. Brown

Ennis Knupp + Associates

Steve A. Voss
Michael D. Sebastian

McCombs School of Business, U.T. Austin

Laura T. Starks, Chair and Professor, Department of Finance
Keith C. Brown, Professor, Department of Finance

U.T. Austin Administration

Kevin P. Hegarty, Vice President and Chief Financial Officer

Professor Henry T. C. Hu, the Allan Shivers Chair in the Law of Banking and Finance at the School of Law at U.T. Austin was added to the Working Group at the request of the Chairman later in February.

Sandra Neidhart, Assistant Director of Audits and Shannon Brinkley, Executive Associate in the office of the Board staff, also participated in the meetings of the Working Group at the request of Mr. Chaffin and Ms. Frederick, respectively.

In addition, at the suggestion of the Chairman and various members of the Working Group, the following individuals were designated as liaisons to the Working Group:

Greg Anderson, Associate Vice Chancellor and Treasurer, Texas A&M University System

Bob Boldt, Chief Executive Officer, UTIMCO

Bruce Myers, Cambridge Associates

Messrs. Anderson, Boldt and Myers were available to serve as resource persons to members of the Working Group as needed.

Professors Starks and Brown terminated their participation in the Working Group on or about April 1 by telephone call from Professor Starks to Ms. Frederick, citing time constraints.

Scope of the Review

In undertaking its review, the Working Group endeavored to address the list of ten specific issues presented for consideration by the Board in its December 19 resolutions. In light of the diverse and far-reaching scope of those issues, and the very limited time available to complete the review, the Working Group elected to assign review of those issues it thought could be completed during the available time to particular members of the Working Group based on relative expertise in the underlying subject matter. Specific issues arising under the foregoing general categories were presented by Chairman Miller and U.T. System staff at the beginning of the Working Group's work. In addition, a number of additional specific issues were raised for consideration during the course of the Working Group's review.

The conduct of the review began with a review of the 2003 Report of Baker Botts and included numerous interviews conducted by members of the Working Group as determined appropriate by such members based on the issues to be analyzed and available time, review of a wide variety of source documents, including material provided by UTIMCO at the Working Group's request, and frequent meetings of the Working Group. A list of selected interviews and meetings is attached at Tab 15.

This effort resulted in the following components of the report:

- Tab 1. A list of improvements to the UTIMCO structure made since the delivery of the February 2003 Report of Baker Botts.
- Tab 2. U.T. System Staff Observations and Recommendations regarding UTIMCO, authored by Ms. Frederick, Mr. Aldridge, and Mr. Chaffin.
- Tab 3. A summary of recommendations of Ennis Knupp.
- Tab 4. An analysis of investment services provided by UTIMCO by Ennis Knupp and Mr. Aldridge.
- Tab 5. An analysis of administrative services provided by UTIMCO by Mr. Aldridge.
- Tab 6. An analysis of the cost-effectiveness of UTIMCO by Ennis Knupp.
- Tab 7. An analysis of investment policy-setting by Ennis Knupp.
- Tab 8. An analysis of consulting services by Ennis Knupp.
- Tab 9. An analysis of budgeting issues and UTIMCO's surplus reserve policy by Mr. Aldridge.
- Tab 10. An analysis of oversight and reporting issues by Ennis Knupp.
- Tab 11. An analysis of internal controls and procedures by Mr. Chaffin and Ms. Neidhart.
- Tab 12. An analysis of legal issues by Baker Botts.
- Tab 13. An analysis of the structural alternatives to the UTIMCO arrangement by Ennis Knupp.
- Tab 14. Board resolutions regarding the review.
- Tab 15. List of meetings and interviews conducted.

Except for the U.T. System staff observations and recommendations set forth at Tab 2, as to which there is general agreement among the members of the Working Group, the opinions expressed herein and therein are the opinions only of the respective authors of the relevant sections, and there are portions of this report as to which some members of the Working Group do not agree. Though substantially all of the material herein has been discussed by the Working Group prior to its inclusion, some material has not been reviewed by all members of the Working Group prior to its inclusion due to time constraints. In particular, the analysis by Ennis Knupp at Tab 13 was prepared by them as a separate project, without prior review or an opportunity to comment by the Working Group.

While each member of the Working Group has endeavored to conduct his or her portion of the review as independently as possible, we note that each member of the Working Group is affiliated with the U.T. System or with an institution that receives compensation from the U.T. System.

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TAB 1

Board of Regents – UTIMCO – Notable improvements since February 2003 Report

- The Board has accepted and reemphasized its role as the policy-setting authority in all matters related to investments, including issues with respect to public policy that might conflict with investment policy, such as the policy regarding disclosure of returns on private equity investments.
- The Board has better integrated UTIMCO's operations into the U.T. System, including through improved participation in and involvement by key members of the U.T. System staff in the affairs of UTIMCO, including the Chancellor, the Vice Chancellor for Business Affairs, the Vice Chancellor and General Counsel, and the Director of Audits.
- The Board has retained its own separate investment consultants, Ennis Knupp, to advise it independently on matters related to investment policy and oversight.
- The Board has made significant changes to its contract with UTIMCO implementing a number of recommendations from the 2003 Report and other improvements to the Board's arrangements with UTIMCO.
- The Board has made significant changes to its Rules and Regulations implementing a number of recommendations from the 2003 Report and clearly articulating the role of senior members of the U.T. System Staff with respect to the Board's oversight and management of UTIMCO.
- The auditors of the Delegated Funds are now clearly appointed by and reporting to the Board.
- The UTIMCO Board and the Board have approved substantial improvements to the UTIMCO Code of Ethics policy to better ensure conflicts of interest concerning related party transactions are avoided.
- The Board and UTIMCO are working to establish new enhanced disclosure requirements for outside service providers pursuant to the new disclosure laws enacted by the Texas Legislature in 2003.
- The Board has endeavored to implement new compliance measures modeled after those of the Sarbanes-Oxley Act of 2002, including certification of financial statements by the CEO and CFO of UTIMCO.
- The Board has developed new processes for the identification and selection of UTIMCO directors.

TAB 2

U. T. System Staff Observations and Recommendations on UTIMCO Review Issues

1. U. T. Board of Regents' Oversight of Investment

- 1.1 Board acts like a trustee for funds held in charitable trust for the unnamed beneficiaries of the funds (including students, faculty, staff).
- 1.2 Board has fiduciary responsibility as to the investments and the management of investments without regard to the use of external corporation for investment services.
- 1.3 Service by at least three members of the U. T. Board of Regents and Chancellor on UTIMCO Board is only a partial component of the discharge of fiduciary duties by the U. T. Board of Regents.
- 1.4 Best practice indicates a need for a team approach (Business Affairs, OGC, Audit, consultants, and UTIMCO staff) to verify accuracy and relevance of information related to investments.

2. Determination of Goals and Objectives for Funds

- 2.1 U. T. Board of Regents should set investment policies for all funds under management following i.) careful review of University's goals and objectives, including tolerance for risk, for the funds under management and ii.) input from representatives of income beneficiaries, consistent with Constitutional and statutory requirements, and iii.) an assessment of the overall financial condition of the System.
- 2.2 The agreement should be amended to address specifically the role of the U. T. Board of Regents regarding the approval of other significant policies such as the Liquidity Policy and the Derivatives Policy.
- 2.3 Asset allocation is the single most important factor in return on investments.
- 2.4 Asset allocations for all funds under management should be based on the objectives of the investment policies.

3. Relation of Goals and Objectives to Possible Structure for Investment Function

- 3.1 Current structure established in 1995-96 following review by Cambridge Associates.
- 3.2 As identified in the Legal Issues portion of the Working Group Report, there are alternate structural models.
- 3.3 Following discussion and identification of goals and objectives for the funds under management and after review of additional background provided in the UTIMCO Working Group Report, the U. T. Board of Regents should determine the optimal structure of the investment function.

4. Recommended Structure and Implementation

4.1 The Staff recommends continued agreement with separate corporation (UTIMCO) as Manager, with the following recommended enhancements to assure compliance with fiduciary responsibilities and to measure performance.

4.2 Education and Training

- a. Implement program of education for U. T. Board of Regents concerning legal and fiduciary responsibilities related to investment issues with more thorough orientation of new U. T. Board of Regents members.
- b. Work with members of U. T. Board of Regents who serve on UTIMCO Board and Chancellor to assure that all duties required of nonprofit corporate directors, such as oversight for hiring practices for personnel and corporate assets, are being discharged.
- c. Implement program of education for all UTIMCO directors concerning legal and fiduciary responsibilities related to Board duties and committee assignments.

4.3 Work with UTIMCO and U. T. Board of Regents' consultants on quarterly reports to the full U. T. Board of Regents from UTIMCO Chairman, UTIMCO staff, System staff, and U. T. Board of Regents' consultants, utilizing executive summaries that clearly and succinctly reflect performance and compliance with investment policies and risk criteria.

4.4 With an awareness of avoiding unneeded duplication or expense, provide staff support to the U. T. Board of Regents and the Chancellor, reporting through the Chancellor or his designee.

- Full-time employee, knowledgeable in investment matters
- Full-time assistant with auditing and accounting experience
- U. T. Lawyer experienced in investment and business issues, with this assignment as a priority
- Clerical support as needed
- Access to reporting/research services as needed

4.5 System staff and its consultants should be intricately involved in UTIMCO issues, such as

- Key role regarding creation of investment policies, review of UTIMCO budget, and review of implementing statute and agreement
- Work closely with UTIMCO staff to suggest needed changes to UTIMCO bylaws and internal policies
- Work with UTIMCO staff concerning compliance with Texas Open Meetings Act and Texas Public Information Act

4.6 Work with UTIMCO staff to assure that all UTIMCO policies, UTIMCO Board Minutes, and Committee Charters are accessible electronically through the UTIMCO Web site.

- 4.7 Hold joint annual meeting between U. T. Board of Regents and with UTIMCO Board to discuss issues regarding
 - Mission Statement for UTIMCO
 - Investment policies, implementation, and interpretation (including asset allocation)
 - Investment Management Services Agreement (contract)
 - Performance of contracted services
 - Proposed Budget for next fiscal year (For more detail regarding proposed review, see Budget Procedures Section of Working Group Report.)
- 4.8 Recommend that professionals providing consulting or legal advice to UTIMCO be hired by the UTIMCO Board and report directly to the UTIMCO Board.
- 4.9 Recommend that UTIMCO have staff and software support as needed to determine and report market, operational, liquidity, and other risk (in both normal and extreme event conditions).
- 4.10 Seek Attorney General's opinion concerning ability of U. T. Board of Regents to discuss performance of external UTIMCO Directors and the UTIMCO CEO in closed meeting under provisions of the Texas Open Meetings Act.
- 4.11 Review process for the U. T. Board of Regents' selection of UTIMCO directors to clarify that process begins with U. T. Board of Regents, utilizing nominations from UTIMCO Board members and others.
- 4.12 Work to assure that external UTIMCO directors possess varied investment backgrounds and risk management expertise.
- 4.13 Require that open session portions of UTIMCO Board meetings be recorded electronically to document actions taken and to assist in preparation of minutes.
- 4.14 Require better internal communications, including more formal communication from UTIMCO Board on recommended actions and from U. T. Board of Regents on policies approved, and more coordinated external communications.
- 4.15 Require UTIMCO Board meeting agenda to be established by UTIMCO Chairman in consultation with the Chancellor and in conjunction with UTIMCO staff.

TAB 3

SUMMARY OF RECOMMENDATIONS OF ENNIS KNUPP

The following is a brief summary of the strategic and tactical recommendations described in the next five sections.

Investment Services Provided

Endowments

- Recommend fully consistent investment objectives for the Permanent University Fund (PUF) and the General Endowment Fund (GEF)

- Recommend making rebalancing policy an explicit part of the endowments' Investment Policy Statements.

Operating Funds

- Recommend either
 1. Directing UTIMCO or another qualified party to formally provide policy-setting advice to the Chief Business Officers in regard to the management of the operating assets.

 2. Alternatively, centralizing all operating assets with UTIMCO, and let that organization recommend appropriate investment policy as it does with the endowment assets.

- The criterion for achievement of the investment objective of the Short Term Fund (outperforming the median manager) is not necessarily consistent with the primary investment objective. We recommend criteria for success that tie in directly with the investment objective.

- Recommend changing the benchmark of the Short Intermediate Term Fund (SITF) from a custom benchmark to a standard and publicly available benchmark, such as the Merrill Lynch 1-3 Year Treasury Index.

- Recommend setting a formal investment objective for the Institutional Index Funds of tracking the returns of the target indexes after fees and costs over a reasonable period of time.

- Recommend creating a separate Investment Policy Statement for the Institutional Index Funds. Currently they are covered by the Investment Policy Statement for the Separately Invested Funds.

- Recommend changing the index target of the Equity Index Fund to the Russell 3000 Index from the S&P 500 Index.

Investment Policy Setting

- Recommend requiring UTIMCO staff to provide full documentation and transparency into the development of capital markets return and risk assumptions.

- Recommend that any "decision factors" used in the asset allocation study process be set by the Board of Regents (not the UTIMCO Board) and be directly and solely linked to the investment objectives defined in the Investment Policy Statements.
- Recommend that the Investment Policy Statements unambiguously state the total fund performance benchmark, both on a current and historical basis.

Cost Effectiveness

- Review the difference between the 0.35% cost estimate embedded in the 5.1% required real return for the endowments, as it appears to be significantly higher than the actual costs incurred by UTIMCO in recent years.

Consulting Services Utilized

- Recommend that UTIMCO's consultant report directly to the Chairman of the UTIMCO Board of Directors and continue to function as an extension of UTIMCO staff.
- Recommend that all action items brought before the UTIMCO Board of Directors be vetted by Cambridge. Depending on the scope of the issue verbal commentary may be sufficient. In other cases a written analysis with a recommendation would be necessary.
- Recommend that "blue sheets" in UTIMCO Board books for items requiring UTIMCO Board of Directors approval include a line item titled "Consultant Recommendation".
- Review possible redundancy between private capital data provided by Cambridge and Venture Economics.
- Review need for Russell/Mellon performance reporting given possible redundancies with other reports.

Oversight and Reporting

- Recommend a more streamlined investment performance report focusing on compliance with investment policy and high-level performance measurement.
- Recommend that UTIMCO make Board books available to System staff at least two weeks prior to meetings of the UTIMCO Board of Directors.
- Recommend a more collaborative working relationship between UTIMCO management and System staff.
- Recommend review and consideration of UTIMCO proposed compensation policy.
- Recommend cost comparison study be performed on UTIMCO comparing total costs with those of other large funds.

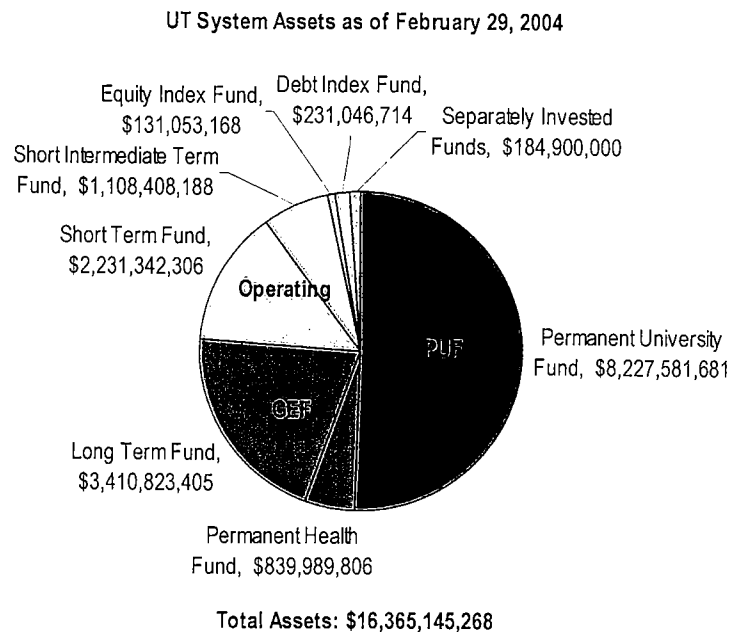
TAB 4

Investment Services Provided

Section Summary

In this section we will identify the users of UTIMCO's investment management services, what their particular needs are, how UTIMCO meets those needs and what, if any, gaps exist in services. We will start by understanding and documenting the spending requirements and objectives of the PUF and GEF and how UTIMCO uses this information to determine asset allocation for these funds. For the operating funds (STF, SITF and Index Funds) we will understand and document the broad needs of the various U.T. System operating entities that participate in the operating funds' investment pools. We will determine how asset mixes are determined for the operating funds' participants and determine if the choices and services available meet the unique needs of the participants. For the Separately Invested Funds, we will understand the available investment vehicles and determine if such choices are in keeping with the participants' needs. Our analysis will also make comparisons with the typical investment needs and practices of other large educational endowments.

Due to its complexity this section is presented in outline format.



1. Endowment Funds

1.1. Permanent University Fund

The Permanent University Fund (PUF) is a state endowment fund contributing to the support of 18 institutions and 6 agencies of the University of Texas System and the Texas A&M University System.¹ The Board of Regents has ultimate fiduciary responsibility for the management of the PUF.

¹ All fund descriptions from UTIMCO.

1.1.1. Investment Services Required (PUF)

The investment objective of the Permanent University Fund is defined in the Investment Policy Statement, which is proposed by UTIMCO and approved by the Board of Regents. The investment objective of the Permanent University Fund is described in its Investment Policy Statement as follows:

"The primary investment objective shall be to preserve the purchasing power of PUF assets and annual distributions by earning an average annual real return of 5.1% over rolling ten-year periods or longer. This 5.1% target was derived by adding the current target distribution rate of 4.75% plus an annual expected expense of .35%. The PUF's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objective is to generate a fund return in excess of the Policy Portfolio benchmark over rolling five-year periods or longer. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect PUF asset allocation policy targets."

1.1.2. Investment services provided by UTIMCO (PUF)

Studies have shown asset allocation policy to be the primary determinant of the long-term return of a fund. UTIMCO staff and the UTIMCO Board of Directors recommend a set of asset allocation targets designed to earn a required return of 5.1%¹ per year after inflation. See the section "Policy Setting" for more information on how asset allocation policy is developed.

Policy Targets and Return Expectations²

Asset Category	Policy Target	UTIMCO Expected Returns	
		Before Inflation	After Inflation
U.S. Equities	25%	8.5%	5.3%
Non-U.S. Developed Equity	10	8.5	5.3
Emerging Markets Equity	7	11.0	7.8
Equity Hedge Funds	10	8.0	4.8
Absolute Return Hedge Funds	15	7.0	3.9
Venture Capital	6	14.0	10.7
Private Equity	9	11.5	8.3
Commodities	3	5.0	1.9
Fixed Income	15	5.0	1.9
Cash	0	4.0	1.0
Total Fund	100%	8.37%	5.21%

¹ We note that the 0.35% expected cost component of the required return is substantially higher than actual costs incurred by UTIMCO. This observation is discussed in the Cost Effectiveness section.

² Asset categories are those defined in the Investment Policy Statement approved by the Board of Regents on December 19, 2003.

Based on the current asset allocation policy and the asset class return expectations developed by UTIMCO, the expected annual return on the PUF portfolio is 8.37%. Using UTIMCO's annual inflation expectation of 3% the PUF portfolio is expected to generate a 5.21% annual return after inflation and before expenses, which would exceed the return target.

UTIMCO uses a mixture of passively managed (indexed) investments and actively managed investments. The actively managed investments are employed with the objective of outperforming the policy portfolio benchmark and providing exposure to investments that are unavailable through passive management. UTIMCO's success in adding value through active management depends on its skill in selecting and structuring portfolios of managers with superior investment skill, and the subsequent ability of those managers to outperform their relevant benchmarks. As of February 29, 2004, 78% of the PUF is actively managed and 22% is passively managed. The percentage of assets actively managed has generally increased over time.

The Investment Policy Statement also specifies policy ranges for each asset category. Actual allocations are allowed to vary within these ranges, either due to market fluctuations or deliberate overweighting or underweighting by UTIMCO as a result of its investment outlook. Specifically, UTIMCO's responsibilities in this area are outlined in the Investment Policy Statements as excerpted below.

"Asset allocation is the primary determinant of the volatility of investment return and, subject to the asset allocation ranges specified in Exhibit A, is the responsibility of UTIMCO. Specific asset allocation positions may be changed from time to time, within the ranges specified in Exhibit A, based on the economic and investment outlook."¹

Policy Targets and Ranges

Asset Category	Policy Target	Policy Range
U.S. Equities	25%	15-45%
Non-U.S. Developed Equity	10	5-15
Emerging Markets Equity	7	0-10
Equity Hedge Funds	10	5-15
Absolute Return Hedge Funds	15	10-20
Venture Capital	6	0-10
Private Equity	9	5-15
Commodities	3	0-5
Fixed Income	15	10-30
Cash	0	0-5
Total Fund	100%	--

¹ Exhibit A in the Investment Policy Statements provides the asset allocation policy targets and ranges.

We note that policy ranges for some asset categories (particularly U.S. equities and fixed income) are wider than those adopted by the typical institutional investor. Ranges of this width are consistent with a desire to allow UTIMCO to make significant asset allocation deviations from the policy targets. We question whether such moves are contemplated by UTIMCO. We also note that a portfolio could be assembled by UTIMCO that complies with the ranges but has significantly different risk and return characteristics than those of the portfolio defined by the policy targets.

PUF Objective 1: Earn an average annual real return of 5.1% over rolling ten-year periods or longer

**Performance Since Inception of UTIMCO
March 1996-November 2003**

	Total Return	Total Return After Inflation
Permanent University Fund	8.2%	5.7%
Endowment Policy Portfolio	9.1	6.6
After-Inflation Return Target of 5.1%	7.5	5.1

Since the inception of UTIMCO in March 1996¹, both the PUF and its policy portfolio have generated real returns in excess of the 5.1% target.² It should be noted that although an asset allocation policy may be designed to meet a certain target return level, such returns cannot be guaranteed over any particular time period.

PUF Objective 2: Generate a fund return in excess of the Policy Portfolio benchmark over rolling five-year periods or longer

The PUF has underperformed the policy portfolio in each rolling five-year period since March 1996. We note that material changes in management structure have occurred in recent years, and that recent performance has been more favorable.

UTIMCO conducted a survey of stakeholder satisfaction with various aspects of its investment management services.³ Below we report the results of the survey regarding UTIMCO's skill in managing the endowment funds; these results are relevant for the PUF and GEF. As shown, all respondents rated UTIMCO's skill as average or above.

¹ Sufficient history does not yet exist to examine a rolling ten-year period for UTIMCO (the measurement period specified in the Investment Policy Statement).

² We recognize that the 5.1% real return target has not been in place for the entire period.

³ The survey was developed by UTIMCO staff with the aid of Key Survey, an online survey software company. Key Survey provided the software, online delivery mechanism, mapping of the questions and question tracking. UTIMCO staff, using question structure information and guidance from Key Survey, developed their own questions. According to UTIMCO, the responses were anonymous, and were compiled by Key Survey and presented to UTIMCO in consolidated format. There were 584 total survey participants (who received surveys) and 366 actual respondents.

Rating of UTIMCO Investment Skill in Managing Endowment Funds

Response Category	Percent of Respondents
Exceptional	23%
Above Average	53
Average	24
Below Average	0
Poor	0

1.2 General Endowment Fund

The General Endowment Fund (GEF) comprises the Permanent Health Fund (PHF) and the Long Term Fund (LTF). The PHF is an internal U.T. System mutual fund for the pooled investment of state endowment funds for health-related institutions of higher education, created with proceeds from state tobacco litigation. The LTF is an internal U.T. System mutual fund for the pooled investment of over 5,000 privately raised endowments and other long-term funds of the 15 component institutions of the U.T. System. The Board of Regents has ultimate fiduciary responsibility for the management of the GEF.

1.2.1 Investment Services Required (GEF)

The investment objective of the General Endowment Fund is defined in the Investment Policy Statement, which is proposed by UTIMCO and approved by the Board of Regents. The investment objective of the General Endowment Fund is described in its Investment Policy Statement as follows:

"The primary investment objective shall be to preserve the purchasing power of GEF assets by earning an average annual real return of 5.1 % over rolling ten-year periods or longer. This 5.1% target was derived by adding the current target distribution rate of 4.75% plus an annual expected expense of .35%.

The GEF's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objectives are to generate a fund return in excess of the Policy Portfolio benchmark and the average median return of the universe of the college and university endowments as reported annually by Cambridge Associates and NACUBO over rolling five-year periods or longer. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect GEF's asset allocation policy targets."

We note that the investment objectives of the PUF and the GEF are not entirely consistent, as the GEF's objectives include outperforming the median of a universe of peers while the PUF's do not. As the PUF and GEF have identical asset allocation policies, similar portfolio structure and otherwise identical investment objectives, we recommend setting consistent investment objectives in their Investment Policy Statements.

1.2.2 Investment services provided by UTIMCO (GEF)

Studies have shown asset allocation policy to be the primary determinant of the long-term return of a fund. UTIMCO staff and Board of Directors recommend a set of asset allocation targets designed to earn a required return of 5.1%¹ per year after inflation. See the section "Investment Policy Setting" for more information on how asset allocation policy is developed.

Policy Targets and Return Expectations²

Asset Category	Policy Target	UTIMCO Expected Returns	
		Before Inflation	After Inflation
U.S. Equities	25%	8.5%	5.3%
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Fixed Income	15	5.0	1.9
Cash	0	4.0	1.0
Total Fund	100%	8.37%	5.21%

Based on the current asset allocation policy and the asset class return expectations developed by UTIMCO, the expected annual return on the GEF portfolio is 8.37%. Using UTIMCO's annual inflation expectation of 3%, the GEF portfolio is expected to generate a 5.21% annual return after inflation, which would exceed the return target.

UTIMCO uses a mixture of passively managed (indexed) investments and actively managed investments. The actively managed investments are employed with the objective of outperforming the policy portfolio benchmark and providing exposure to investments that are unavailable through passive management. As of February 29, 2004, 79% of the GEF is actively managed and 21% is passively managed. The percentage of assets actively managed has generally increased over time.

The Investment Policy Statement also specifies policy ranges for each asset category. Actual allocations are allowed to vary within these ranges, either due to market fluctuations or deliberate overweighting or underweighting by UTIMCO as a result of its investment outlook. Specifically, UTIMCO's responsibilities in this area are outlined in the Investment Policy Statements as excerpted below.

¹ We note that the 0.35% expected cost component of the required return is substantially higher than actual costs incurred by UTIMCO. This observation is discussed in the Cost Effectiveness section.

² Asset categories are those defined in the Investment Policy Statements approved by the Board of Regents on December 19, 2003.

"Asset allocation is the primary determinant of the volatility of investment return and, subject to the asset allocation ranges specified in Exhibit A, is the responsibility of UTIMCO. Specific asset allocation positions may be changed from time to time, within the ranges specified in Exhibit A, based on the economic and investment outlook."¹

Policy Targets and Ranges

Asset Category	Policy Target	Policy Range
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Venture Capital	6	0-10
Private Equity	9	5-15
Commodities	3	0-5
Fixed Income	15	10-30
Cash	0	0-5
Total Fund	100%	--

We note that policy ranges for some asset categories (particularly U.S. equities and fixed income) are wider than those adopted by the typical institutional investor. Ranges of this width are consistent with a desire to allow UTIMCO to make significant asset allocation deviations from the policy targets. We question whether such moves are contemplated by UTIMCO. We also note that a portfolio could be assembled by UTIMCO that complies with the ranges but has significantly different risk and return characteristics than those of the portfolio defined by the policy targets.

GEF Objective 1: Earn an average annual real return of 5.1% over rolling ten-year periods or longer

Performance Since Inception of UTIMCO

March 1996 - November 2003

	Total Return	Total Return After Inflation
General Endowment Fund	9.1%	6.7%
Endowment Policy Portfolio	9.1	6.6
After-Inflation Return Target of 5.1%	7.5	5.1
Median Fund	n/a ²	n/a

¹ Exhibit A in the Investment Policy Statements provides the asset allocation policy targets and ranges.

² Per UTIMCO, median fund return data is not available for this time period.

Since the inception of UTIMCO in March 1996, both the GEF and its policy portfolio have generated returns in excess of the 5.1% target. It should be noted that although an asset allocation policy may be designed to meet a certain target return level, such returns cannot be guaranteed over any particular time period. The GEF has produced higher returns than the PUF over the period examined, due in part to the fact that the two funds historically had different investment objectives (the GEF was managed on a total return basis while the PUF was not.)

GEF Objective 2: Generate a fund return in excess of the Policy Portfolio benchmark over rolling five-year periods or longer

The GEF has outperformed the policy portfolio in 24 of 34 rolling five-year periods (using monthly data) since March 1996, and matched the policy return in the March 1996-November 2003 period. We note that material changes in management structure have occurred in recent years, and that recent performance has been more favorable.

GEF Objective 3: Generate a fund return in excess of the average median return of the universe of the college and university endowments as reported annually by Cambridge Associates and NACUBO over rolling five-year periods or longer

Universe data was not available for the March 1996-November 2003 period. However, UTIMCO provided with rolling 5-year comparisons on a quarterly basis for the Cambridge universe, and an annual basis for the NACUBO universe, for this time frame. The GEF outperformed the Cambridge median in 4 of 12 available 5-year periods, and the NACUBO universe in 3 of 3 available 5-year periods.

It is unclear what specific actions UTIMCO can take to meet a goal of outperforming the median endowment. Asset allocation, tactical allocation decisions, manager selection and structure will impact performance relative to peers. But asset allocation policy should be developed first and foremost to achieve the fund's long term investment goals, not to outperform other institutions with circumstances and investment goals that are no doubt different. And successful manager selection, tactical decisions and manager structure are already set as a goal in GEF Objective 2: to outperform the policy portfolio. We realize, however, that competitiveness is a goal of many of the relevant decision makers. A well designed investment policy and successful implementation of that policy should result in competitive returns over time. We support the outperformance of the median of a universe of peer funds as a secondary investment objective.

2. Operating Funds

The Operating Funds consist of the Short Term Fund (STF), the Short Intermediate Term Fund (SITF) and the Institutional Index Funds (IIFs), and are used to invest the operating funds of the 15 U.T. System institutions. The STF is a money market mutual fund (managed by Dreyfus) consisting of the working capital and other operating fund balances held by U.T. System institutions with an investment horizon of less than one year. The SITF is an internal U.T. System mutual fund for the pooled investment of the operating funds held by U.T. System institutions with an investment horizon between one and five years. The IIFs are indexed investments, examined in the next section (Separately Invested Funds). The Operating Funds serve the needs of the business officers of the individual U.T. System institutions. The Board of Regents has ultimate fiduciary responsibility for the management of the Operating Funds.

2.1 Investment Services Required (Operating Funds)

The investment objective of the Short Term Fund is described in its Investment Policy Statement as follows:

"The primary investment objective shall be to maximize current income consistent with the absolute preservation of capital and maintenance of adequate STF liquidity. The STF shall seek to maintain a net asset value of \$1.00.

Achievement of this objective shall be defined as a fund return in excess of the average gross return of the median manager of the Donoghue's universe of institutional only money market funds."

The investment objective of the Short Intermediate Term Fund is described in its Investment Policy Statement as follows:

"The primary investment objective shall be to provide both income through investment in high grade fixed income and floating rate obligations and capital appreciation when consistent with income generation, reasonable preservation of capital and maintenance of adequate SITF liquidity. In seeking to achieve its objectives, the SITF shall attempt to minimize the probability of a negative total return over a one-year period. Within the exposure limits contained herein, investments shall be diversified among authorized asset classes and issuers (excluding the U. S. Government) in order to minimize portfolio risk for a given level of expected return.

Achievement of this objective shall be defined by a fund return in excess of the Policy Portfolio benchmark and the average return of the median manager of the MorningStar universe of government bond funds restricted to an average maturity of less than or equal to three years. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect SITF asset allocation policy targets."

The investment objectives of the Institutional Index funds are provided in the Investment Policy Statement for the Separately Invested Funds.

2.2 Investment services provided by UTIMCO (Operating Funds)

UTIMCO maintains in-house investment staff to manage the SITF, and uses the Dreyfus Institutional Preferred Money Market Fund to manage the STF, in accordance with the investment objectives described above.

STF Objective: fund return in excess of the average gross return of the median manager of the Donoghue's universe of institutional only money market funds

We note that the criterion for achievement of the investment objective (outperforming the median manager) is not necessarily consistent with the primary investment objective. We recommend criteria for success that tie in directly with the investment objective.

SITF Objective 1: a fund return in excess of the Policy Portfolio benchmark

SITF Objective 2: a fund return in excess of the average return of the median manager of the MorningStar universe of government bond funds restricted to an average maturity of less than or equal to three years

Performance Since Inception of UTIMCO March 1996- November 2003

	Total Return
Short Term Fund	4.5%
Median Manager	4.1
Short Intermediate Term Fund	5.5%
SITF Benchmark	5.8
Median Manager	n/a ¹

Since the inception of UTIMCO the STF has outperformed its benchmark, while the SITF has underperformed its benchmark. Median manager data was not available for the March 1996- November 2003 period; however, we were provided with universe comparisons over other parts of this time frame. The SITF outperformed the median manager in each calendar year period from 1997 through 2000, and underperformed the median manager in the calendar years 2001 and 2002. We note that neither the SITF nor its benchmark has experienced a negative return in any one-year period.

¹ Per UTIMCO, median manager return data is not available for this time period.

EnnisKnupp examined the historical performance, objectives and benchmark of the SITF (see separate memorandum "Short Intermediate Term Fund Performance", dated March 17, 2004.) In this analysis, we noted that the SITF experienced pronounced underperformance of the benchmark in the last three fiscal years, in part due to a position taken by fund management to limit risk of loss of capital in what it believed to be a rising interest rate environment.

The custom benchmark of the SITF is a combination of six cash-like and short maturity government bond indexes. The investment characteristics of the benchmark are nearly identical to commonly used standard benchmarks, such as the Merrill Lynch 1-3 Year Treasury Bond Index. We recommend the use of a standard and publicly available benchmark.

3. Separately Invested Funds

The Separately Invested Funds (SIF) consist of endowments and charitable trusts where the nature of the underlying asset or donor restrictions preclude investment in the Long Term Fund. The SIF are established in the name of the Board of Regents as trustee, and the Board of Regents has ultimate fiduciary responsibility for their management. The Board of Regents delegates authority to UTIMCO to establish specific asset allocation targets and ranges for each trust or endowment account.

3.1 Investment Services Required (SIF)

The investment objective and asset allocation policies of the Separately Invested Funds are described in the Investment Policy Statement as follows:

"Investment Objectives

Endowment Accounts - The primary investment objective shall be to invest the Account in assets that comply with the terms of the applicable endowment agreement, taking into consideration the investment time horizon of the Account.

Trust Accounts - Trust Accounts are defined as either Foundation Accounts or Charitable Trusts (Charitable Remainder Unitrusts (CRUT), Charitable Remainder Annuity Trusts (CRAT), Pooled Income Funds (PIF), Charitable Trusts (CT), or Charitable Lead Trusts (CLT)). The Board of Regents recognizes that the investment objective of a trust is dependent on the terms and conditions as defined in the trust document of each trust. The conditions that will affect the investment strategy are a) the trust payout provisions; b) the ages of the income beneficiaries; c) the ability to sell the gifted assets that were contributed to the trust; and d) consideration to investment preferences of the income beneficiaries. Taking these conditions into consideration, the fundamental investment objectives of the trust will be to generate a low to moderate growth in trust principal and to provide adequate liquidity in order to meet the payout provisions of the trust.

Operating Accounts - These are separate operating accounts of the Component institutions which invest in an Equity Index Fund and U. S. Debt Index Fund as approved by the Chief Investment Officer. The amount of component operating funds invested in the index funds is governed by the U. T. System Financial Policy."

"Asset Allocation Policy

The asset allocation policy and ranges for each trust or endowment herein is dependent on the terms and conditions of the endowment or trust document. With respect to the operating accounts, the U. T. System financial policies shall govern. If possible, the Account's assets shall be diversified among different types of assets whose returns are not closely correlated in order to enhance the return/risk profile of the Account.

The Board of Regents delegates authority to UTIMCO to establish specific asset allocation targets and ranges for each trust or endowment Account."

3.2 Investment services provided by UTIMCO (SIF)

3.2.1 Separately Invested Funds: Endowment and Charitable Remainder Trusts

The U.T. System Separately Invested Funds (SIF) consist of privately raised endowments and over 40 charitable remainder trusts. The nature of the underlying asset or donor restrictions precludes the SIF's investment in the Long Term Fund.

Distributions from separately invested endowments support a variety of academic and health programs at U.T. System institutions.

The charitable remainder trusts are separate legal entities established according to statutory and regulatory requirements. The U.T. Board is trustee for these trusts, which have a combined market value of \$32.3 million as of August 31, 2001. UTIMCO provides investment management and all accounting and tax reporting services. Personnel of the Office of Estates and Trusts of U.T. System, acting as trust officers, provide all other services including review of trust instruments, coordination of gift receipts, and response to donor and beneficiary questions. Upon termination of a charitable remainder trust, the remaining value of the trust is distributed to the named institution in accordance with the terms of the trust instrument.

UTIMCO invests the trust assets in both fixed income securities and fixed income and equity mutual funds. The allocation between fixed income and equity depends on various factors including the type of trust, the payout percentage, and the age of the beneficiaries or term of the trust. The fixed income asset allocation for most trusts is between 40% and 60% and the remainder is allocated to equities. This allocation is intended to provide a balanced investment mix emphasizing reasonable growth of principal for the remainder beneficiaries.

Based on information gathered from UTIMCO staff regarding the management of the SIF, it appears to be difficult to make general statements about the objectives or performance of the underlying endowments and trusts, due to their numbers and disparate structure and objectives.

3.2.2 Institutional Index Funds

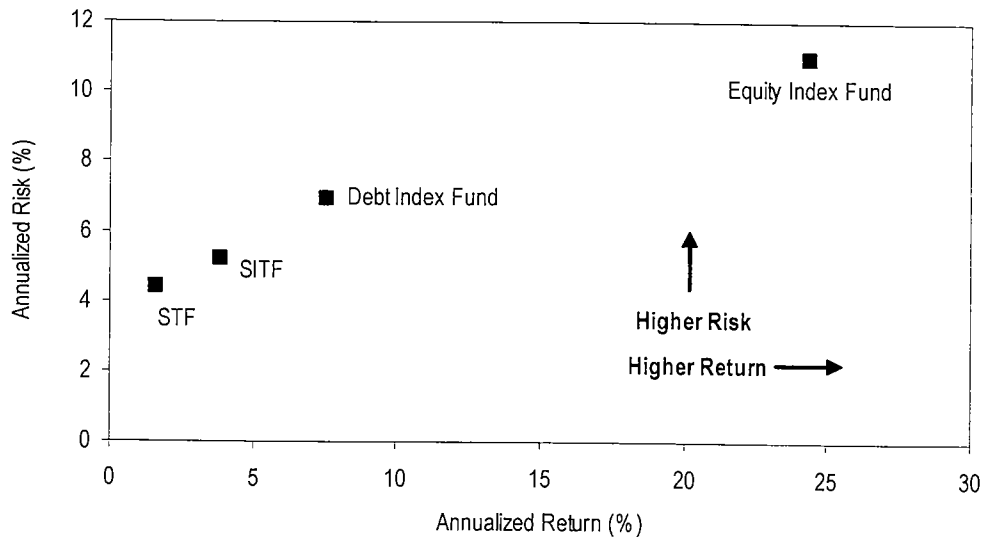
In addition, the Investment Policy Statement for the SIF covers the Institutional Index Funds, which are used to invest U.T. System institution operating funds that are longer term in nature. The IIFs are managed by Barclays Global Investors, a leading manager of indexed investments.

We note that there is no explicit performance objective for the Institutional Index Funds. Conformance with best practices would indicate the setting of a formal investment objective for these funds. Specifically, we recommend setting an investment objective for the IIFs of tracking the returns of the target indexes after fees and costs over a reasonable period of time.

In addition, the end users of the IIFs are different from those of the SIF endowment and trust accounts (though the ultimate fiduciary, the Board of Regents, is the same). For this reason we recommend maintaining a separate Investment Policy Statement for the IIFs, as with the STF and the SITF.

We show the historical risk and return of the operating fund options below. As shown, a broad range of risk and return levels are available with the existing options.

Risk and Return
March 1993 - January 2004



T

The Equity Index Fund is managed to track the returns of the S&P 500 Index, and the Debt Index Fund is managed to track the returns of the Lehman Brothers Aggregate Bond Index. We note that the U.S. equity components of the endowment funds are benchmarked against the broader Russell 3000 Index, which is a more complete representation of investment opportunities in the U.S. equity market. We recommend changing the index target of the Equity Index Fund to the Russell 3000 Index for the purposes of consistency with the endowment target and an improved investment opportunity set. The index target of the Debt Index Fund is consistent with the endowment target and a good representation of the fixed income opportunity set.

Characteristic	S&P 500 Stock Index	Russell 3000 Stock Index	Difference
Number of Securities	500	2,941	2,441
Weighted Average Market Capitalization	\$90.0 billion	\$75.5 billion	\$14.5 billion
Total Market Capitalization	\$10.3 trillion	\$11.6 trillion	\$1.3 trillion
Allocation to three largest sectors:			
Finance	21.3%	23.5%	2.2%
Consumer Non-Durables	22.5	21.4	1.1
Technology	17.0	14.5	2.5
Construction Methodology	Largest companies in 10 industries	Largest 3,000 U.S. companies	--
Rebalancing	Quarterly	Annually	--
Historical Rate of Return (25 years ending 12/31/2003)	13.6%	13.7%	0.1%

**Performance Since Inception of Institutional Index Funds
June 1999-November 2003**

	Total Return
Equity Index Fund	-3.1%
S&P 500 Index	-3.1
Debt Index Fund	7.5%
LB Aggregate Bond Index	7.4

The IIFs have closely tracked the returns of their target indexes since inception, which is a favorable outcome for indexed investments.

3.3 Operating Fund Options and Investment Policy

Issues: EnnisKnupp participated in phone interviews with several business officers regarding their participation in the Operating Funds (the STF, SITF, Equity Index Fund and Debt Index Fund.) A common theme that arose in these interviews was the seriousness with which business officers regard their responsibilities in properly managing the substantial assets invested in the Operating Funds. There is a desire in some areas for further guidance (from UTIMCO or another qualified organization) in setting asset allocation policy for these assets. Some component institutions have taken the step of forming investment advisory committees and drafting formal investment policy statements for the assets under their care. In general, we note that the assets seem to be invested materially more conservatively than the liquidity needs of the component institutions would suggest; that is, assets which could be perceived as long term in nature are invested in shorter-term fixed income vehicles, thus depriving the System of an opportunity for asset growth.

Solution: Business officers at the component institutions would benefit from more assistance from UTIMCO or another qualified organization in setting investment policy for these assets. One dramatic solution would be to centralize all operating assets with UTIMCO, and let that organization recommend appropriate investment policy as it does with the endowment assets. Alternatively, UTIMCO or another qualified party could formally provide policy-setting advice to the business officers in addition to UTIMCO's current reporting and informal advice-giving efforts.

4. Peer Analyses

In this section we compare the investment needs of U.T. System, as defined primarily by the Investment Policy Statements, with those of peer institutions.

4.1 Investment Policy Statements

The following table presents the results of a NACUBO survey of topics addressed in endowment investment policies.

Institutional Investment Policy Features¹ Endowments Greater Than \$1 Billion

Topic	Percentage of Endowments Addressing Topic Formally in Investment Policy	Topic addressed in U.T. System Endowment Fund Policies?
Asset allocation strategy followed	92%	Yes
Investment objectives of institution	92	Yes
How endowment earnings or returns relate to investment policy	87	Yes
Investment performance benchmarks	87	Yes
The degree of risk in investment pool	71	Yes, by way of asset allocation policy
Whether and how investment portfolio should be rebalanced to maintain an asset allocation	65	Partially
Considerations in hiring and retaining investment managers	61	Yes ²

Based on this survey, the investment policies of the endowments appear to be at least as comprehensive in formally addressing investment issues as that of the typical endowment. One possible area for improvement that we note is rebalancing. Studies have shown asset allocation policy to be the primary determinant of the long-term return of a fund. Rebalancing is a critical tool for controlling the risk characteristics of the endowments. Allowable ranges around the target allocations for each asset class are defined in the investment policies. However, specific language regarding when and how the funds should be rebalanced is absent. We recommend making rebalancing policy an explicit part of the Investment Policy Statements. We do note that the width of the allowable ranges suggests that the need for rebalancing due to market movements is likely to be infrequent.

¹ Source: NACUBO 2003.

² PUF and GEF Investment Policy Statements: "UTIMCO may select and terminate unaffiliated investment managers subject to the Delegation of Investment Approval Authority approved by the UTIMCO Board."

4.2 Spending Policy

The following table presents the results of a NACUBO survey of endowment spending policies.

Annual Spending Rule and Average Annual Calculated Spending Rate¹ Endowments Greater Than \$1 Billion

	Percentage of Endowments Addressing Topic Formally in Investment Policy	Rule Specified in UTIMCO Investment Policy Statements
Spend a pre-specified percentage of moving average of market values	73%	✓
Increase prior year's spending by a pre-specified percentage	12	
Decide on an appropriate rate each year	12	
Spend a pre-specified percentage of beginning market values	--	
Spend all current yield	--	
Spend a pre-specified percentage of current yield	--	
Increase prior year's spending by the inflation rate	3	
Spending Rate	5.4%	4.75%

The endowments' spending rule is consistent with that used by the clear majority of peer institutions. We note that the endowments' spending rate is lower than that of peer institutions.

¹ NACUBO 2003
::ODMA\PCDOCS\AUS01\345104\1

TAB 4 a

ENNISKNUPP

MEMORANDUM

To: Mr. Phillip Aldridge, Interim Vice Chancellor for Business Affairs
University of Texas System

From: Steve Voss
Michael Sebastian

Date: March 17, 2004

Re: Short-Intermediate Term Fund Performance

For the one-year period ending August 31, 2003 the UTIMCO-managed Short-Intermediate Term Fund (SITF) underperformed its internally-constructed benchmark by 0.9 percentage points. This followed a particularly difficult fiscal year 2002 in which the fund underperformed its benchmark by 2.8 percentage points.

This memorandum addresses several issues regarding the SITF. In particular, we:

- Examine the characteristics of the SITF and its current benchmark, and suggest an alternative benchmark
- Review past performance relative to the internally-constructed benchmark and a commonly used Merrill Lynch benchmark
- Illustrate performance of a universe of similarly managed funds
- Calculate the cost of the performance shortfall for the trailing fiscal three-year period
- Review of the objectives of the SITF
- Comment on our understanding of the explanation of the performance shortfall for the last three years

We begin with an analysis of the characteristics of the fund, its current benchmark and a viable alternative benchmark.

Characteristics of the SITF and Its Benchmark

	Short-Intermediate Fund	Custom Benchmark ¹	Merrill Lynch 1-3 Yr Treasury Index
Duration	1.61	1.77	1.71
Maturity (Years)	1.79	2.03	1.77
Yield to Maturity	1.97%	1.70%	1.68%

¹ 30% Merrill Lynch 1-3 Year Treasuries, 30% Merrill Lynch 1-3 Year Agency, 10% Merrill Lynch 3-5 Year Agency, 10% 3-5 Year Treasuries, 10 % Merrill Lynch 91 day T-Bill and 10% Merrill Lynch 182 day T-Bill

The Custom Benchmark is constructed using a combination of six cash-like and short maturity government bond indexes. Despite the intricacies of the Custom Benchmark, it exhibits characteristics nearly identical to those of the commonly used Merrill Lynch 1-3 Year Treasury Bond Index. Absent a compelling reason to the contrary, we recommend the use of a standard and publicly available benchmark such as those provided by Merrill Lynch (as shown here) or Lehman Brothers.

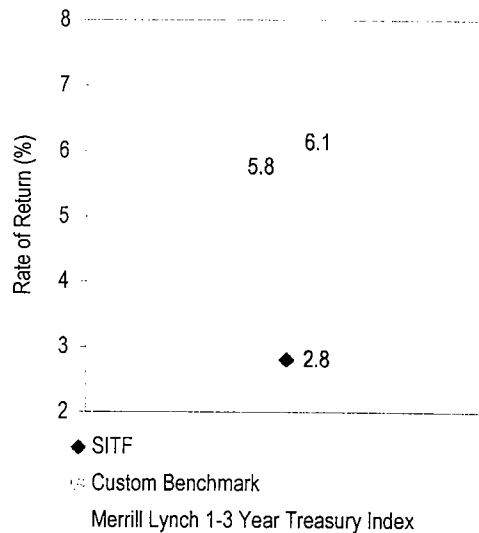
Performance

The table below shows the Short-Intermediate Term Fund's performance for each of the past ten fiscal years. We also summarize the annualized performance for the past three- and five-year periods ending August 31, 2003. For comparative purposes we show the performance results of the Custom Benchmark and the Merrill Lynch 1-3 Year Treasury Index.

Fiscal Year	Short-Intermediate Fund	Custom Benchmark	Merrill Lynch 1-3 Year Treasury Index
1994	2.0%	1.7%	1.7%
1995	6.7	7.6	7.5
1996	4.8	5.1	5.2
1997	8.1	7.0	7.0
1998	9.4	7.3	7.4
1999	2.9	3.8	3.9
2000	5.9	5.9	5.7
2001	9.0	9.4	9.4
2002	3.7	6.6	6.5
2003	1.6	2.5	2.5
Trailing 3-Year	4.7%	6.1%	6.1%
Trailing 5-Year	4.6	5.6	5.6

Underperformance was pronounced for the last three fiscal years. Performance for the year ended August 2002 was particularly disappointing. To further illustrate the magnitude of the performance shortfall, we compare the results of the SITF to that of a universe of similarly benchmarked products.

1-3 Year Fixed Income Funds
 One Year Ending 12/31/02
 (Net of Fees)¹



Impact of Underperformance

The Office of the Interim Vice Chancellor for Business Affairs performed a calculation quantifying the impact in dollars of the SIF’s underperformance. The impact of the fund underperforming by 1.4 percentage points per year over the trailing three-year period was calculated as \$65.5 million. We performed our own analysis and confirmed the magnitude of the underperformance. Our calculation produced a loss figure of \$65.7 million for the three-year period.

SITF Investment Objective

The Investment Policy Statement describes the objective of the Short-Intermediate Term Fund as follows:

“The primary investment objective shall be to provide both income through investment in high grade fixed income and floating rate obligations and capital appreciation when consistent with income generation, reasonable preservation of capital and maintenance of adequate SITF liquidity. In seeking to achieve its objectives, the SITF shall attempt to minimize the probability of a negative total return over a one-year period. Within the exposure limits contained herein, investments shall be diversified among authorized asset classes and issuers (excluding the U.S. Government) in order to minimize portfolio risk for a given level of expected return.”

¹ Source: Russell/Mellon Analytical Services. The universe includes 31 actively managed short/intermediate term bond funds benchmarked to a 1-3 year government bond index.

It is our understanding that management of the SITF made an effort to protect investor assets from what it believed to be a rising interest rate environment during the 2002-2003 period. We recognize that the guidelines call for "reasonable preservation of capital" and "minimization of the probability of a negative total return over a one-year period". As we understand the situation, these guidelines coupled with management's understanding of the System's Chief Business Officers' loss aversion led to the shorter-term interest rate position.

We question the appropriateness of this action. We note that the Business Officers have the option to invest assets under their care in the Short Term Fund, which is more suitable for investors whose primary objective is preservation of capital. Further, in the 28-year history of the Merrill Lynch 1-3 Year Treasury Bond Index there has never been a rolling one-year period (or calendar year period) in which the Index experienced a negative return. Granted, the likelihood of a modestly negative return in the current low yield environment is greater now than in the past if interest rates were to spike up dramatically.

Conclusion

The SITF experienced poor performance for the past three fiscal years. The shortfall can be explained by an interest rate bet made by the fund's management team. It is not common practice for commercially available short/intermediate funds to make such significant bets on the direction of interest rate movements. Instead, most funds manage interest rate sensitivity to be similar to that of the benchmark. Further, it strikes us as inappropriate to make investment management decisions based on input from the investors of the fund. Such input should help create and direct policy, not direct investment strategy. A clearly written set of investment guidelines that appropriately states objectives, risk tolerances and benchmarks should govern investment management.

We find the current guidelines too broad and overly complicated. We would be happy to work with the Board of Regents and UTIMCO's management team to revisit the guidelines of the SITF.

TAB 5

ADMINISTRATIVE SERVICES PROVIDED

I. Section Summary

In this section we will present background information regarding investment-related administrative services provided by UTIMCO. We will also define "administrative services", outline the current UTIMCO administrative services structure, identify the users of UTIMCO's administrative services, list what their particular needs are, and explain how UTIMCO meets those needs. Finally, we will document how UTIMCO's services overlap and/or complement services provided by System Administration, particularly the Office of Estates and Trusts.

II. Background of Administrative Services¹

Prior to 1984, investment management was performed by the Office of Investments and Trusts. Most non-investment functions such as investment accounting, cash management, etc., were performed by U.T. Austin on behalf of System Administration. From 1984 until the formation of UTIMCO in March 1996, the investment management and associated administrative services were performed by the Office of Asset Management (OAM). OAM was a department of System Administration that was primarily responsible for managing the System's investments. Within the OAM, administrative services functions were performed by the Office of Endowment Administration, which consisted of 29 employees prior to the creation of UTIMCO.

III. Definition of Administrative Services

The administrative services section of UTIMCO is comprised of 1) Accounting and Operations; 2) Finance and Administration; and, 3) Information Technology. These areas support UTIMCO's investment function by providing a comprehensive range of support services.

Accounting and Operations

This functional area is primarily responsible for the accuracy, timeliness, and efficiency of all accounting and security operation functions of all investments under UTIMCO's management. This area provides accounting and investment reporting for the Funds, individual endowments, and charitable trusts. Other duties include risk reporting, monitoring and reporting for investment compliance, maintaining effective internal controls, facilitating the settlement of all cash and security movements, and supporting internal managers as needed.

Finance and Administration

This functional area is responsible for monitoring UTIMCO's finances, enterprise risk management, compliance, administration, public and governmental relations, and client service. This area also provides administrative support to other functional areas within the organization.

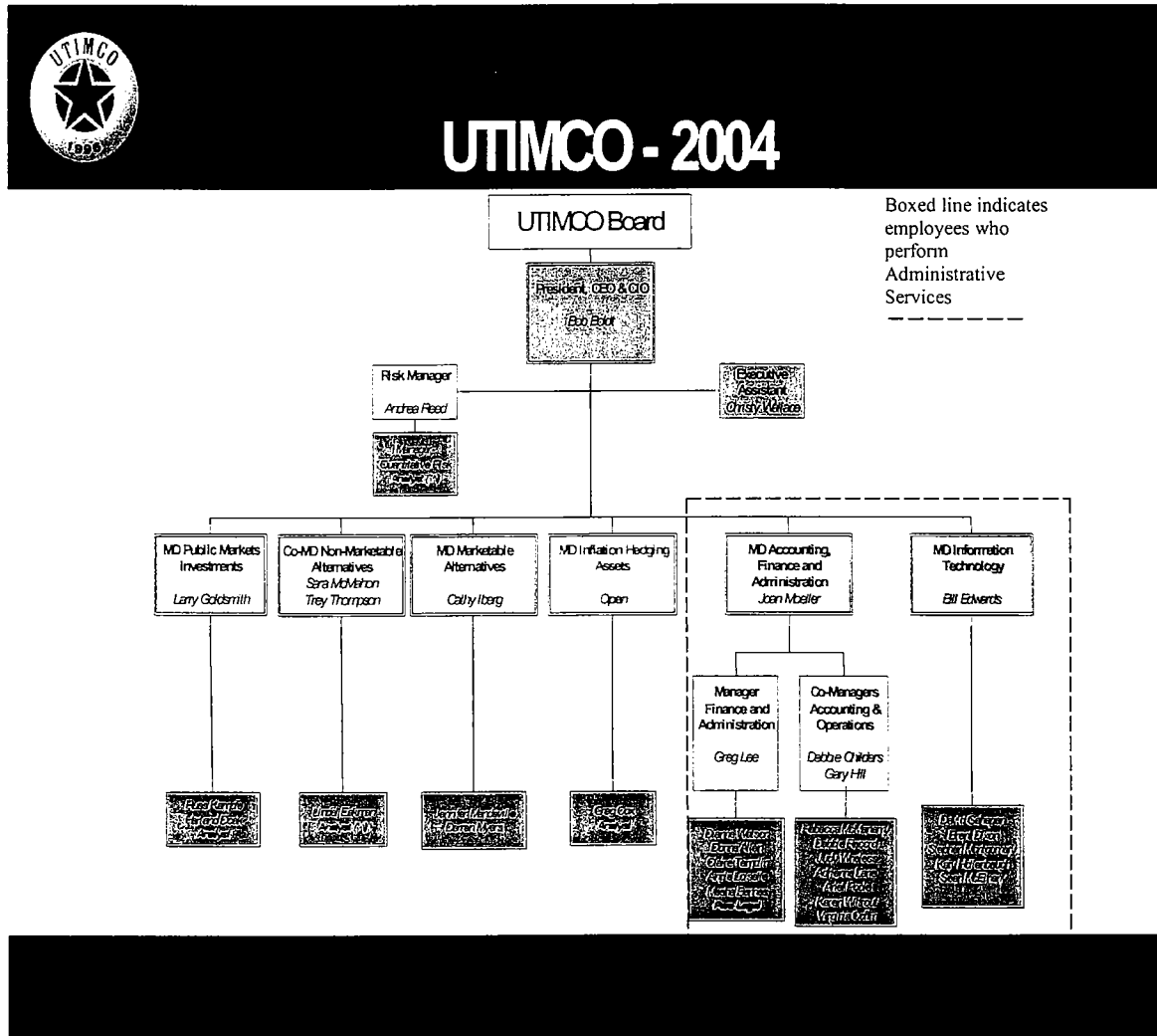
Information Technology

The purpose of the information technology group is to provide systems and system support for UTIMCO staff. The informational technology group is effectively divided into two areas, Network Management and Application Development. Network Management has responsibility for making recommendations for all devices to provide a safe and efficient working environment, and performs necessary maintenance routines to ensure all machines and software products are functioning properly and as expected. The Application Development group has the responsibility for Software development and software support.

¹ Source of data: University of Texas System Investment Management Organization Briefing Document, November 10, 1994

IV. Current UTIMCO Administrative Services Structure

The responsibility for administrative services at UTIMCO lies with the Managing Director of Accounting, Finance, and Administration and the Managing Director of Information Technology. There are 23 employees classified as administrative services personnel out of a total UTIMCO staff of 37. The individuals and higher-level position titles are listed on the UTIMCO organization chart on the next page.



V. Users of Administrative Services

In addition to the Board of Regents and the UTIMCO Board, there are a number of other users of UTIMCO's administrative services. These users include the financial, accounting, development, and academic personnel at the 15 U. T. System component institutions and System Administration (and the A&M institutions for PUF-related services). As part of its 2003 customer satisfaction survey, UTIMCO identified 584 individual customers (see chart below).

	Customer Count
Development Personnel	170
Finance Office Staff	109
University Deans	126
President's Office	20
Chief Business Officers	15
U. T. System Personnel	81
U. T. Board of Regents & UTIMCO Board	16
Other	47
Total	584

Many of the reports used by these customers are prepared by the administrative services staff. In addition to performance and other investment management reports, the administrative services staff is also responsible for designing and maintaining the web page and web reporting functions that many customers have come to rely on.

VI. Survey Results

UTIMCO distributed a "Client Satisfaction Survey" to obtain feedback from their customers, to serve as a benchmark for evaluation, and to help them provide their customers with the products, services, and information they need. While this survey covered both Investment and Administrative performance, it is a good barometer of overall customer satisfaction. A summary of the survey results are attached as an Exhibit to this section of the report. There were 584 surveys distributed and 366 were received (62.7% response rate). Some of the highlights include:

- 90% of respondents were satisfied with the service and information they receive from UTIMCO. Of these, 36% were very satisfied and 25% were extremely satisfied.
- 93% were satisfied with the responsiveness of the UTIMCO staff.
- 88% were satisfied with the level of UTIMCO availability and accessibility.
- 86% indicated that UTIMCO staff understood and acted on the specific needs of their organization.

UTIMCO Strengths (as cited in the survey results):

- Communication
- Customer Service
- Technical knowledge
- Reports and websites
- Responds quickly to inquiry
- Competent and skilled staff
- Helpful and professional staff
- Ease of information accessibility
- Investment and accounting expertise

UTIMCO Weaknesses (as cited in the survey results):

- Attitude
- Tough market conditions
- Lack of customer focus and communication

- Communication - can't always get a straight answer
- Interaction with donors – presentation on investment strategy
- Previously non-responsive, but this seems to have improved
- Needs to be more available for our donors
- Presenting technical knowledge in laymen's terms
- Communication with endowment families at a “plain English” level would help
- I don't always get the feeling that UTIMCO works for the UT System, but rather that the System works for UTIMCO

To augment the UTIMCO survey, the Office of Business Affairs conducted an informal survey focused on the administrative services part of the organization. Brief surveys were sent to Chief Business Officers and cash managers at all 15 U. T. System institutions. These include some of the individuals who interact most frequently with UTIMCO's administrative personnel and are heavier users of the administrative services UTIMCO provides. Of the 30 surveys sent out, there were 20 responses. None of the 20 cited specific negative issues with UTIMCO's performance of administrative services, and most were highly complementary of the administrative services staff.

VII. Office of Estates and Trusts²

The Office of Estates and Trusts was formed in 1989 to coordinate many of the functions involved with the management and review of gifts. The Office of Estates and Trusts is responsible for analysis, acceptance, processing, reporting, and administration of certain gifts and all bequests. In addition, the staff provides training for U.T. System institutions in the areas of estate, trust, and endowment administration, and estate and gift planning.

The administration of gifts involves ongoing, daily responsibilities required to ensure compliance with the terms of the approximately 6,450 endowments and 60 trusts held by the U. T. Board of Regents, as well as the 124 estates and 886 trusts that benefit U. T. The Office of Estates and Trusts establishes corpus and income accounts for all endowment gifts held by the Board of Regents. In addition, the staff verifies that endowment funds are received and deposited into the appropriate endowment account for investment in the U. T. System Long Term Fund. Periodically, these accounts are reviewed to ensure that the endowments are being administered appropriately at the U. T. System level.

The services provided by the Office of Estates and Trusts are complimentary to the services offered UTIMCO. We found no overlap of duties and the office expressed no lack of assistance or materials from the UTIMCO staff. The Office of Estates and Trusts has a strong working relationship with UTIMCO and was particularly complimentary of the various web sites UTIMCO has made available. It should be noted that these web sites have significantly reduced the time needed to perform many of their tasks.

VIII. Potential Overlap/Gaps

UTIMCO's Accounting and Operations personnel currently perform specific reporting functions that are not being provided by any System Administration office. As indicated above, these functions were the responsibility of the Office of Investments and Trusts until 1984, and the Office of Asset Management until UTIMCO was formed in 1996. Although there are several offices within System Administration (Controllers Office, Finance Office, Budget Office, etc.) with comparable skill sets, based on the specific nature and scope of the Administrative Services provided by UTIMCO, we do not view these tasks to be overlapping in any material way.

² Source of data: University of Texas System Administration Office of Estates and Trusts web page and an interview with the Executive Director of the office, Mr. Paul Youngdale.

The Finance and Administration segment of UTIMCO's Accounting, Finance and Administration Department performs many functions that various departments of System Administration also carry out. Below is a comparison chart of those services and the System Administration offices that perform similar functions.

UTIMCO's Administrative Services	System Administration Offices that Perform Similar Services
Payroll	U.T. Austin/Budget Office
Internal Controls	System Audit Office/Compliance Office
Legal (outside counsel)	General Counsel
Travel	Travel Office
Insurance	Employee Group Insurance
Human Resources	Human Resources
Employee Benefits Administration	Human Resources
Government Relations	Governmental Relations
Public Relations	Public Affairs
Enterprise Risk Management	Risk Management

Based on the table above, there are undoubtedly certain services at UTIMCO that could be performed by System Administration and/or U. T. Austin. These include payroll, travel, human resources, and benefits administration, among others. While there may be some redundancy of duties between UTIMCO staff and System staff, a more detailed study would have to be performed to determine if such a move would be cost efficient.

The chart below compares areas where services provided by the UTIMCO Information Technology section are similar to services provided by the System Administration Office of Technology and Information Services (OTIS).

UTIMCO	OTIS³
1. Network Services	1. Network Support
2. E-mail	2. Help Desk
3. Data Warehousing	3. Common Data Warehouse
4. Desktop Services	4. Desktop Support
5. Software selection, Recommendation and Maintenance	5. Software and Hardware Installation
6. Third Party Software Support/Consultation	6. Software and Hardware Installation
7. Telecommunication Services	7. Telecommunications Services
8. Web Design	8. Systems Development/Website Support
9. Internet/Intranet Applications	9. Network Support
10. Web Application Security	10. Security (Computer and Network)
11. ETL Services (Extract, Translate and Load)	11. Records Management/Document Management

³ Source of data: Mr. Lewis Watkins, Director of Information Resources, Office of Technology and Information Resources.

While we recognize that there are several areas of overlap between UTIMCO's Information Technology department and System Administration's Office of Technology and Information Services (OTIS), it is important to note that there are many applications not listed above that are unique to UTIMCO. These include the website applications (e.g., CRIS), Bloomberg, Telerate, TradeWeb, and Barra, among others. Given the small and efficient IT staff at UTIMCO and the specialized nature of many of UTIMCO's hardware and software applications, we do not believe that it would be advisable for System Administration staff (OTIS) to perform core IT functions for UTIMCO.

IX. Conclusions and Recommendations

The Administrative Services section of UTIMCO performs a wide variety of tasks and services in support of UTIMCO's investment management function. Due to the specialized nature of UTIMCO's services, we do not believe that significant opportunities exist to reduce costs by eliminating redundancies. Opportunities that do exist are in support services such as payroll, travel, human resources, and benefits administration.

1. Based on survey data collected by UTIMCO and System Administration, we have reason to believe that most of UTIMCO's customers are satisfied with the administrative services they receive.
2. While we have identified areas of overlap between UTIMCO and System Administration staff in administrative services, UTIMCO's unique investment management mission coupled with the high level of training and experience of the UTIMCO staff makes a compelling argument to keep this structure largely in place.
3. We were not able to obtain good comparative cost data to determine if these services are being provided in a cost effective manner in relation to UTIMCO's peers. Based on our experience and based on discussions with various consultants, it will be very difficult to find comparable cost data for peers in this industry. If desired, a cost comparison could be procured as a special study/survey.
4. Based on interviews and survey results, we have concluded that the Office of Estates and Trusts and UTIMCO have complimentary services and enjoy a good working relationship. There appears to be no overlap and we recommend this separation of duties continue in its current form.
5. Finally, we recommend that a customer satisfaction survey be sent annually to UTIMCO's customers. This would serve to keep open lines of communication, get valuable feedback, and provide a tool for new UTIMCO resources to be delivered.

TAB 5 a

Exhibit: Summary of UTIMCO Client Satisfaction Survey



2003 Client Satisfaction Survey

Who Participated?

- 584 Total Survey Participants
- 366 Completed Surveys
- 63% Participation

By Category:

	Completed Survey	Total Participants	Participation %
Development	114	170	67%
Finance	79	109	72%
Deans	60	126	47%
President's office	17	20	87%
Chief Business Officer	12	15	77%
UT System	58	81	71%
UT Board of Regents & UTIMCO Board	11	16	67%
Other	15	47	33%
Total	366	584	63%

By Component:

	Completed Survey	Total Participants	Participation %
Arlington	22	37	59%
Austin	79	141	55%
Brownsville	15	19	80%
Dallas	13	21	64%
El Paso	19	23	81%
Pan American	5	12	42%
Permian Basin	8	14	60%
San Antonio	15	28	54%
Tyler	10	16	63%
Tyler – HC	5	9	56%
Houston – HSC	15	31	49%
San Antonio – HSC	27	38	71%
Galveston	27	36	75%
MD Anderson	22	34	64%
Southwestern	12	20	59%
UT System	58	81	71%
UT Board of Regents & UTIMCO Board	11	16	67%
Total	366	584	63%

Exhibit: Summary of UTIMCO Client Satisfaction Survey

Overall Results

- 90% of respondent were satisfied with the service and information they receive from UTIMCO. Of these, 36% were very satisfied and 25% were extremely satisfied.
- 94% of the respondents agreed that UTIMCO has a skilled, experienced, and effective investment staff.
- 79% of the participants rated UTIMCO as an above average endowment manager.
- Rating of UTIMCO's Management of Endowment Funds:
 - 75% rated investment skill as above average
 - 70% rated innovation as above average
 - 64% rated communication and client service as above average
- Rating of UTIMCO's Management of Operating Funds:
 - 65% rated investment skill as above average
 - 66% rated innovation as above average
 - 64% rated communication and client service as above average

Rating of UTIMCO Personnel

- UTIMCO personnel received the following ratings:
 - 88% helpful
 - 88% knowledgeable
 - 91% professional
 - 88% courteous
 - 88% responsive
- Respondent ratings of UTIMCO staff in answering questions:
 - 91% timely
 - 94% accurately
 - 94% professionally
- 93% of the participants were satisfied with the responsiveness of UTIMCO staff.
- 88% of the participants were satisfied with the level of UTIMCO availability and accessibility.
- 86% of the participants indicated that UTIMCO staff understood and acted on the specific needs of their organization.

Exhibit: Summary of UTIMCO Client Satisfaction Survey
Satisfaction with Information, Reporting and Applications

- Participants rated UTIMCO the information they receive from UTIMCO as:
 - 100% accurate
 - 89% relevant
 - 96% timely
- Respondents rated the UTIMCO website:
 - 81% user friendly
 - 96% provides useful information
 - 94% contains timely information
- Participant satisfaction ratings for CRIS:
 - 98% providing useful information
 - 87% containing accurate information
 - 98% containing timely information
- Ratings of Endowment Reporting:
 - 97% providing useful information
 - 100% containing accurate information
 - 97% containing timely information
- Percentage of participants finding UTIMCO publications useful in answering questions:
 - Annual report: 42%
 - Endowment Funds Brochures: 23%
 - History of the Permanent University Fund: 19%
 - Long Term Fund Management Overview: 16%
- Participant ratings of the Annual Report:
 - easy to read: 79%
 - useful: 76%
 - complete: 92%
 - accurate: 95%
- Participant ratings of the Endowment Funds Brochure:
 - easy to read: 84%
 - useful: 87%
 - complete: 91%
 - accurate: 90%

UTIMCO Strengths

Participants listed these descriptors as strengths:

- Communication
- Customer Service
- Technical knowledge
- Reports and websites
- Responds quickly to inquiry
- Competent and skilled staff
- Helpful and professional staff
- Ease of information accessibility

Exhibit: Summary of UTIMCO Client Satisfaction Survey

- Investment and accounting expertise

Areas for Improvement

Negative terms describing UTIMCO:

<u>Term</u>	<u># of responses</u>
Remote	28
Secretive	10
Out of touch	3
Aloof	2
Arrogant	1
Follower	1
Outdated	1

UTIMCO Weaknesses:

- Attitude
- Tough market conditions
- Lack of customer focus and communication
- Communication - can't always get a straight answer
- Interaction with donors – presentation on investment strategy
- Previously non-responsive, but this seems to have improved
- Needs to be more available for our donors
- Presenting technical knowledge in laymen's terms
- Communication with endowment families at a "plain English" level would help
- I don't always get the feeling that UTIMCO works for the UT System, but rather that the System works for UTIMCO

What did we learn from the survey?

- Many of our clients are not aware of services we provide and many are not frequent users of the services:
 - 9% of the respondents didn't know we offered password protected applications on the UTIMCO website
 - 49% have not used Component Reports
 - 36% have not used CRIS
 - 46% have not used Endowment Reporting
 - 17% have not accessed the UTIMCO website
- Our clients do not interact with UTIMCO personnel very often, many with no contact at all:
 - 49% no personal visits
 - 37% no mail
 - 20% no e-mail
 - 30% no telephone

Exhibit: Summary of UTIMCO Client Satisfaction Survey
What did we learn from the survey? (cont.)

- 59% believed it was beneficial to regularly visit and provide updates on Investment Strategy and Performance.
- Participants provided specific suggestions that would help UTIMCO improve services:
 - More one on one contact with the investment managers
 - Better communication of the investment strategies
 - Comparison of performance to benchmarks
 - Better coordination with the office of finance
 - Advice on different investment options
 - Provide a clearer explanation of annual distributions to components
 - We need the Big Picture as well as all of the details
 - Thanks for the opportunity to give feedback...a sign you are moving in the right direction
- Participants recommended changes to the way UTIMCO manages the Operating and Endowment Funds:
 - More communication of the investment strategy and policies
 - Reactive to leading indicators
 - Avoid Enron and WorldCom holdings
 - Open disclosure of all holdings
 - More frequent information about my funds
 - More communication of the results, outlook, and expectations of the fund
- Participants request additional information on the website:
 - Economic commentaries
 - More investment news updates
 - Graphs of performance for overall and individual accounts
 - Performance comparisons with other investment companies
 - Pie charts showing breakdown of endowments by school
- Participants offer suggestions to improve the Endowment Reports:
 - Reports are hard to read and understand
 - Condense the information to one page
 - Reduce 5 year history to 3 years
 - Can they be done monthly?
 - Make the reports more donor friendly
 - Make reports less technical. Average reader is not a “wall street” type
- Participants request additional information on CRIS:
 - Information prior to 1993
 - Sort by academic purpose
 - Component account numbers
 - More summary information per component
 - Define the codes that can be exported to excel
 - On-line, clear documentation on how to generate reports
 - Name of the donor when viewing a specific endowment

Exhibit: Summary of UTIMCO Client Satisfaction Survey
Conclusions Reached from the Survey

The conclusion reached is that overall the results are positive. Our clients are satisfied with UTIMCO and the services provided. However, it was clear that communication requires improvement. Many of the negative remarks received were the result of a lack in communication. Many of our clients are using our services and reports although not to the fullest potential. However, too many of our clients are not even aware of the services we provide for their benefit.

Communication was the overriding theme:

- Improve communication in the investment area
- Improve dissemination of information
- Increase overall contact with our clients

TAB 6

Cost Effectiveness

Section Summary

Our goal in this section is to document the total costs associated with the UTIMCO organization. We will make a variety of comparisons based on the availability of data with other educational entities and other large public funds. We will identify the cost of outsourcing the entire pool of assets to one or two large index fund managers to establish a "minimum-cost structure" base for comparison. We will illustrate how the total costs associated with UTIMCO have changed since FY 1999 as assets and investment strategies have changed. We also show cost figures from the pre-UTIMCO structure.

Overview of Costs

The table below breaks down UTIMCO's costs into those related to external investment management, and other related costs. We note that costs associated with investments (either externally-managed or internally-managed) are explicit costs such as management fees and compensation. Any investment will also incur costs associated with making transactions (such as commissions and market impact). Such costs are not reflected in the table below.

These costs will typically be significantly greater for actively managed investments than for passive, indexed investments, due to the greater amount of transactions made in the typical active portfolio. The actual costs incurred by UTIMCO's investment managers will depend on the frequency and size of the trades they make, the asset type in which they invest, and the managers' trading efficiency. We do not have data necessary to calculate transaction costs. Estimates of factors described above can be made, but we do not believe such information will provide clarity of the true level of cost.

We recognize that these costs are important, but that the magnitude incurred depends heavily on the overall active/passive mix. UTIMCO's use of passive management has fluctuated over time. At present, passive management makes up 22% of the PUF and 21% of the GEF. Approximately 10% of the operating funds are passively managed in the Equity Index Fund and the Debt Index Fund. The appropriate mix of active and passive investments depends on a judgment of the relative merits of active management in a particular asset class. Such judgments are beyond the scope of this report.

As shown, UTIMCO's total costs as a percentage of assets have been fairly stable over the past five years. UTIMCO's external management fees are moderately higher than from a representative year of the pre-UTIMCO structure (when investments were handled by the Office of Asset Management (OAM)), while other costs are materially lower. We note that external management fees are likely to rise as a result of the greater allocation to higher-cost alternative investments specified in the investment policy approved on December 19, 2003.

	<u>Fiscal Year</u>					
	1994	1999	2000	2001	2002	2003
	OAM ¹			UTIMCO		
Total Managed Assets (\$ millions)	7,225	7,854	13,101	12,574	12,977	14,262
External Management Fees	0.07%	0.09%	0.12%	0.10%	0.11%	0.09%
All Costs ²	0.18	0.08	0.05	0.06	0.08	0.08
Total Costs	0.25%	0.17%	0.17%	0.17%	0.19%	0.17%

As described in the section "Investment Services Provided", the Investment Policy Statements define a required rate of return for the endowment funds that provides for annual distributions (spending) of 4.75% of assets, and costs of 0.35% of assets. We note that the 0.35% expected cost component is approximately double the costs incurred by UTIMCO in recent years. The cost estimate built into the required rate of return should reflect the best estimate of actual costs incurred; unless portfolio changes that would result in significant cost increases in the future are planned, the cost component of the required rate of return should be lowered. Building a higher cost estimate into the required rate of return could result in a policy target portfolio with a higher-than-necessary risk level being selected (though we note the margin is small.)

¹ Source of cost data: University of Texas System Investment Management Organization Briefing Document, November 10, 1994.

² Includes compensation, payroll taxes, benefits, lease expenses, professional fees, insurance, depreciation, custodial and analytical services, and other miscellaneous costs.

Comparison With Peer Institutions

Below we compare UTIMCO's costs with those of peer institutions. UTIMCO's cost level is notably lower than the typical large endowment in the Investment Management and Salaries/Administrative areas and comparable in other areas. Total costs are also lower compared with the typical large public fund.

	UTIMCO (FY 2003)	Endowments Over \$1 Billion ¹	Public Funds Over \$5 Billion ²
Investment Management	0.09%	0.26%	0.19%
Investment Consulting	0.01	0.01	<0.01
Trust and Custody	0.01	0.02	0.01
Accounting	<0.01	0.01	<0.01
Actuarial	--	0.01	<0.01
Legal	0.01	0.01	<0.01
Salaries/Administrative	0.05	0.09	0.03
Total	0.17%	0.40%	0.24%

Comparison With All-Indexed Strategy

An all-indexed investment strategy represents the lowest possible cost implementation of the policy portfolio, and can be considered baseline against which to compare other potential approaches.

A portfolio of index funds managed by one or more leading index fund managers would be expected to reliably track the returns of the policy portfolio; there would be no expectation of outperformance or underperformance. As a result, a change to an all-indexed strategy would require revision of the GEF Investment Policy Statement to reflect the fact that outperformance of the policy portfolio would not be an achievable goal.

Due to the inclusion of asset categories in the current investment policy that are difficult or impossible to obtain passive exposure to, the current investment policy cannot be fully indexed. Based on UTIMCO's capital market return expectations it is possible to achieve the expected rate of return associated with the current policy using low-cost index funds and an altered investment policy.³ In the table below we present two possible structures. The first, an all-indexed option using only very low cost index funds, requires a 96% equity exposure, compared with an 85% allocation to equity and equity-like assets in the current policy. The second, which allows exposure to more costly indexed investments in emerging markets and commodities, achieves a better risk/reward tradeoff at a lower overall equity allocation, but at a higher cost and a large commitment to emerging markets equity.

¹ Source: 2002 Greenwich Associates Market Dynamics Survey. This data was not available in the 2003 survey.

² Source: 2002 Greenwich Associates Market Dynamics Survey. This data was not available in the 2003 survey.

³ The allocations shown in the table were calculated using an optimizer that solved for the lowest risk portfolio possible that matched the expected return of the current policy portfolio. UTIMCO expected return, risk and correlation assumptions were used in all cases.

We present the details of the all-indexed strategy not as a suggestion that it should be followed, but simply as a lowest-cost scenario against which to compare the UTIMCO alternative.

Policy Allocations and Costs

	Current Policy	Match Current Return	Match Current Return – Expanded Asset Classes
U.S. Equities	25%	69%	30%
Non-U.S. Developed Equity	10	27	--
Emerging Markets Equity	7	--	39
Equity Hedge Funds	10	--	--
Absolute Return Hedge Funds	15	--	--
Venture Capital	6	--	--
Private Equity	9	--	--
Commodities	3	--	4
Fixed Income	15	4	28
Expected Return (Nominal)	8.4	8.4	8.4
Expected Return (Real)	5.2	5.2	5.2
Risk (Standard Deviation)	10.3	16.0	13.7
Sharpe Ratio ¹	0.40	0.27	0.31
Cost	0.17%	0.02%	0.05%
Potential to Meet PUF Objectives			
Earn 5.1% Real Return	Yes	Yes	Yes
Outperform Policy Portfolio	Yes	No	No
Potential to Meet GEF Objectives			
Earn 5.1% Real Return	Yes	Yes	Yes
Outperform Policy Portfolio	Yes	No	No
Outperform Median Fund	Yes	Yes	Yes

¹ A measure of return per unit of risk, or portfolio efficiency.

TAB 7

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Investment Policy Setting

Section Summary

In this section we describe the process by which asset allocation policy recommendations are made and approved. We describe our involvement in the process by which the current policy was developed, and provide recommendations for improvement of this process in the future.

Introduction

The responsibilities of the U.T. System and UTIMCO with regard to investment policy setting are outlined in Section 2 (Delegation of Investment Authority; Retention of Policy Setting Authority) of the Second Amended and Restated Investment Management Services Agreement between the U.T. System Board of Regents and UTIMCO.

"The U.T. Board, as ultimate fiduciary for the Accounts, retains policy setting authority.

[...]

The Board of UTIMCO and the President of UTIMCO shall be responsible for implementing the investment policy of the U.T. Board and performing those core investment duties delegated above."

Section 3 of the above-mentioned Agreement states:

"UTIMCO shall review current investment policies for each Account at least annually. Such review shall include distribution (spending) guidelines, long-term investment return expectations and expected risk levels, asset allocation targets and ranges for each eligible asset class, expected returns for each asset class and fund, and designated performance benchmarks for each asset class. After UTIMCO completes its assessment, it shall forward any recommended changes to U.T. System staff for review prior to being submitted to the U.T. Board for approval."

This section of the review focuses on the process of setting investment policy.

Given changes in management at UTIMCO, the asset allocation process appears to be a work in progress, with staff working to develop an optimal approach to each facet of a complicated process. Below we document the development of the current policy portfolio that occurred in the latter part of 2003. We have previously provided documentation and opinions on the process as it unfolded (see EnnisKnupp memoranda "Asset Allocation Review" dated September 19, 2003 and "Asset Allocation Issues" dated October 1, 2003.) In addition, the assumptions and much of the process are described in numerous UTIMCO documents. EnnisKnupp representatives attended each of the UTIMCO Board of Directors meetings referenced below.

Development of Return, Risk and Correlation Assumptions

UTIMCO staff developed assumptions for each of the asset classes to be potentially included in the policy portfolio. Inputs included historical data, a survey of consultants (including EnnisKnupp), and internal staff discussions. Overall, the process employed appeared to be thoughtful and thorough. However, the specific process used for developing individual assumptions (other than for broad U.S. equity) was opaque and did not appear to be fully documented. A process which incorporates full documentation and transparency into the development of assumptions would provide continuity and help the UTIMCO Board of Directors and the Board of Regents oversee the process. We note, however, that overall the assumptions used seem reasonable, supportable and consistent with EK's own assumptions.

The assumptions were presented to the UTIMCO Board at its September 12, 2003 meeting and approved with few changes.¹

Development of Modeling Framework

UTIMCO staff developed a process for identifying potential policy portfolios based on input assumptions and a modeling framework. Initial candidate portfolios were determined using a modified version of standard mean-variance optimization process. Primary modifications included a moderately different measure of risk (downside risk rather than variance) and non-normal distributions of asset returns.² Initially, premiums were added to asset class returns to account for the greater-than-benchmark returns UTIMCO projected that their active managers would earn—this was called Potential Value Added (PVA). Ultimately PVA was removed from the analysis due to concerns about building overly optimistic estimates of value added into expectations of asset class returns.

Identification of Candidate Portfolios

Using the above assumptions and modeling framework UTIMCO identified seven candidate portfolios with favorable risk and return characteristics. A number of constraints were applied in the process.

¹ At the meeting the Board decided to reduce the expected rate of return on broad fixed income investments from 6% to 5%.

² These modifications are explored in greater detail in our memo "Asset Allocation Review" dated September 19, 2003.

Candidate Portfolios

Asset Category	Candidate Policy Portfolios						
	1	2	3	4	5	6	7
U.S. Equities¹	22%	22%	20%	21%	20%	23%	39%
Global Ex-U.S. Equities	10	10	11	14	19	23	24
Developed	10	10	10	10	10	13	14
Emerging	0	0	1	4	9	10	10
Absolute Return Hedge Funds	15	16	19	19	15	10	3
Private Capital	13	16	17	18	20	20	20
Venture Capital	6	7	10	10	10	10	10
Private Equity	7	9	7	8	10	10	10
Inflation Hedge	20	21	19	17	15	14	4
REITs	0	2	5	5	1	4	0
Private Real Estate	5	5	5	5	5	5	3
Commodities	1	0	1	1	3	0	0
Timberland	4	5	3	2	1	0	0
Oil & Gas	4	5	5	4	5	5	1
TIPS	6	4	0	0	0	0	0
Fixed Income	20	15	14	11	11	10	10
Cash	0	0	0	0	0	0	0
Expected Annual Return	7.76	8.09	8.29	8.50	8.78	8.99	9.17
Downside Deviation	3.64	3.71	3.78	3.91	4.13	4.40	5.09
Annual Standard Deviation	8.28	8.89	9.32	9.87	10.74	11.66	13.48

A set of "decision factors" was identified and presented to the UTIMCO Board for rank ordering in terms of importance. These are listed below, along with the average importance assigned by Board members to each factor (higher weighted average score equates to greater perceived importance.) We also indicate whether each decision factor ties in directly with an investment objective as defined in the Investment Policy Statements. The most heavily weighted factors coincide directly with the investment objectives; some others do not. We would recommend that decision factors be directly and solely linked to the investment objectives defined in the Investment Policy Statements. Specifically, the decision factors listed below that do not coincide directly with the investment objectives could be removed, streamlining the process. Ultimately, the relevant decision factors should be defined by the Board of Regents, as the ultimate fiduciary of the assets.

¹ Including equity hedge funds (per UTIMCO classification.)

Decision Factors

Decision Factor	Weighted Average Score ¹	Directly Coincides With Regent-Approved Investment Objective?
Minimize possibility of real decline in PUF value	18.0	Yes
Maximize possibility of earning 5.5% real returns	17.6	Yes
Maximize possibility of being in top half of peer group performance	14.8	Yes
Minimize possibility of falling nominal distributions	11.1	No
Maximize possibility of earning 7.1% real returns	11.1	No
Minimize exposure to "illiquid" investment options	11.0	No
Minimize the possibility of a -20% return over three years	8.3	No
Maximize possibility of actual returns exceeding policy portfolio returns	8.2	PUF: No GEF: Yes

A Monte Carlo-type simulation process was devised that would simulate the outcomes of the various candidate portfolios in terms of the decision factors. As a result of this process, candidate portfolios 4 through 7 were identified by staff as the most attractive, for further consideration by the UTIMCO Board.

Proposed Portfolio Presented To and Approved By UTIMCO Board

UTIMCO staff presented the portfolios to the UTIMCO Board. Questions had been raised outside of the Board meetings regarding certain characteristics of the recommended portfolio, including its allocation to fixed income and to illiquid investments. An alternative to the recommended portfolios had been developed at the request of the Board of Regents and staff with analytical assistance from EnnisKnupp. At its November 20, 2003 meeting the UTIMCO Board worked to develop a compromise and ultimately approved a portfolio moderately different from the recommended portfolios.

Portfolio Approved By Board of Regents

At its December 19, 2003 meeting the Board of Regents approved the policy portfolio selected by the UTIMCO Board with one change (reduction of the maximum allowable allocation to commodities to 5% from 10%.)

¹ Ranks are for the PUF portfolio.

Board of Regents Approved Policy Portfolio

Asset Category	Policy Target	Policy Range	
U.S. Equities	25%	15-45%	Russell 3000 Index
Global Ex-U.S. Equities			MSCI All-Country World ex-U.S.
Non-U.S. Developed Equity	10	5-15	
Emerging Markets Equity	7	0-10	
Equity Hedge Funds	10	5-15	90-Day T-Bills +4%
Absolute Return Hedge Funds	15	10-20	90-Day T-Bills +3%
Venture Capital	6	0-10	Venture Economics Vintage Year Venture Capital Index
Private Equity	9	5-15	Venture Economics Vintage Year Private Equity Index
Commodities	3	0-5	GSCI minus 1%
Fixed Income	15	10-30	Lehman Brothers Aggregate Bond Index
Cash	0	0-5	90-Day T-Bills

Definition of Benchmarks

As shown in the table above, the Investment Policy Statements specify a benchmark for each asset class, but are silent on the benchmark for the total fund. This issue is made more substantial by the fact that the total fund benchmark proposed by UTIMCO is not simply the weighted sum of the asset class benchmarks (the proposed venture capital and private equity components of the total fund benchmark are different than the corresponding asset class benchmarks.) The current total fund benchmark should be unambiguously specified in the Investment Policy Statements. In addition, all benchmarks should be fully described on a historical basis, in the event that they have changed over time.

TAB 7 a

ENNISKNUPP

MEMORANDUM

To: Charles Miller, Chairman
University of Texas System Board of Regents

CC: Phillip Aldridge, Interim Vice Chancellor for Business Affairs
Jerry Modjeski, Senior Financial Analyst Office of Finance
Mark Yudof, Chancellor
Francie Frederick, Counsel and Board Secretary
University of Texas System

From: Steve Voss
Mike Sebastian

Date: September 19, 2003

Re: Asset Allocation Review

Subsequent to our September 17th conference call regarding EnnisKnupp's review of the UTIMCO asset allocation study, we thought it appropriate to document some of our preliminary thoughts to lay the foundation for our final analysis of UT System's asset allocation. This memorandum is intended to serve that purpose.

The text below follows the format used for discussion during our conference call. Specifically, we break our review down into four key components: 1) Post Modern Portfolio Theory; 2) Asset Classes; 3) Potential Value Added (PVA); and 4) Decision Factors. Lastly, we provide a timeline overviewing our work plan for the next month.

Post -Modern Portfolio Theory

Summary: A significant portion of UTIMCO's asset allocation work is being built on a variation of traditional Modern Portfolio Theory (MPT), which they refer to as Post-Modern Portfolio Theory.

EK Thoughts: PMPT differs from traditional MPT in two primary ways:

- Allows for non-normal distributions of asset class returns. Unlike in MPT, in which any asset class's distribution of returns is completely described by two parameters (expected return and standard deviation), PMPT allows for four descriptive statistics. The two additional parameters relate to the skew of the distribution toward positive or negative results (skewness), and the relative likeliness of extreme results (kurtosis).

- Measures risk as “downside risk” rather than volatility of returns. This involves a calculation of standard deviation in which observations greater than a pre-specified minimum acceptable return (MAR) are discarded, under the premise that investors would not consider such positive results to constitute “risk”.

The concept of PMPT is not inconsistent with accepted financial theory, yet it is not widely used in practice in the manner in which UTIMCO plans to employ the theory. We note, however, that certain elements are commonly used by institutional investors. Concepts such as MAR are often applied to asset/liability analysis and spending policy shortfall risk. As such, EnnisKnupp uses MARs in its asset allocation work for endowments and pension funds.

We found a limited base of financial literature covering the topic. We found no literature discounting the underlying precepts of PMPT.

Next Steps: We plan conduct a brief, informal survey of institutional investors to gain a better perspective of PMPT in practice.

Asset Classes and Assumptions

Summary: UTIMCO developed assumptions (expected return and risk) for fifteen asset classes, covering the broad spectrum of investment opportunities. External inputs to the development process included historical asset class experience and a survey of firms, including EnnisKnupp. The process appears to be based on a building-block approach to deriving a U.S. stock return from its components (inflation, income, capital appreciation and projected valuation change), and a reconciliation of each asset class's expected return with its risk (as measured by standard deviation).

EK Thoughts: UTIMCO's analysis was complete, in that it covered all the viable asset classes as defined by the world pie. UTIMCO's building block approach for estimating the expected return on U.S. stocks is consistent with general practice and EnnisKnupp's own methodology. The imposition of a direct relationship between asset class risk and expected return is also consistent with accepted financial theory and the general beliefs of most practitioners. We note, however, that the exact method used to derive assumptions is not clear to us for every asset class.

UTIMCO's asset class assumptions were generally reasonably close to those derived using EnnisKnupp's best thinking. There were a handful of exceptions that we would consider notable: private equity (UTIMCO's risk assumption is substantially lower than what we would assign to this asset class), commodities (we would assign a real return near zero to this asset class, while UTIMCO forecasts a positive real return) and TIPS. Regarding TIPS; during the September 17th UTIMCO board meeting, it was decided to reduce the expected return on broad fixed income investments by 100 basis points (from 6% to 5%). We would expect a corresponding decrease in the TIPS expected return assumption; it is not clear whether or not this adjustment is being made.

Next Steps: We plan to complete our understanding of how UTIMCO derived some of its capital market assumptions.

Potential Value Added (PVA)

Summary: As an extension of its asset class assumed returns, UTIMCO applies a value added figure to each asset class expected return, reflecting their expectation for excess returns generated by active manager skill and good manager selection/structuring.

EK Thoughts: The concept of applying PVA to capital market assumptions lacks conservatism and is inconsistent with theory and evidence collected over the decades regarding the efficacy of active management in most major asset classes.

UTIMCO uses as a starting point for its PVA assumptions the experience of funds in the PIPER, Cambridge, Venture Economics and Institutional Property Consultants databases. Fund databases are notorious for the presence of biases that cause them to overstate the actual historical performance of the products they purport to represent. Initial PVA assumptions are translated into an overall asset class value added assumption through the specification of "capture ratios" (such as 50%), which appear arbitrary and seem not to take into account the dilutive effect of indexing.

Additionally, the mechanism of the capture ratio appears to divide possible manager selection outcomes into two categories; "success" (in which the full margin of PVA is earned) and "failure" (in which a return *equal* to that of the asset class benchmark *net* of fees and costs is earned). The experience of institutional investors suggests that success is far from guaranteed, and that the cost of failure can be substantial. Our view is that UTIMCO's proposal does not reflect this reality.

Including assumptions for active manager value added in asset allocation studies is not common practice among institutional investors, though it is not unheard of. UTIMCO plans to do two versions of their work; one with PVA and one without.

Next Steps: Gain better understanding of UTIMCO's process for arriving at specific PVAs

Decision Factors

Summary: Once a shortlist of potential asset allocation mixes is identified in the first step of UTIMCO's process, each such mix will be run through a simulation analysis process. The output of this process includes the performance of each potential mix in terms of a number of "decision factors", which represent goals that are seen as desirable.

EK Thoughts: The concept of decision factors appears sound; essentially it represents a quantification of a decision process that would likely be followed in any event. The decision factors themselves also generally appear reasonable, though there does seem to be some overlap in the factors. One factor—the probability of a particular asset mix resulting in favorable rankings in a universe of endowments over a given period—seems to defy reliable modeling.

Next Steps: Gain understanding of relative weights (importance) applied to the various decision factors

Timeline

We anticipate holding a conference call with UTIMCO staff the week of September 22nd to complete our understanding of their assumption and approach. After that, we would like to hold another brief conference call with Chairman Miller and UT System staff to provide a final overview of our thoughts on the asset allocation study. Finally we anticipate drafting a report of our findings and will present this to the Board of Regents at the November meeting.

TAB 7 b

ENNISKNUPP

MEMORANDUM

To: Philip Aldridge, Interim Vice Chancellor for Business Affairs
University of Texas System

From: Steve Voss
Mike Sebastian

Date: October 1, 2003

Re: Asset Allocation Issues

Our capital markets modeling process relies on a theoretical, global capital asset pricing model (Global CAPM) methodology to obtain expected returns. Estimates of volatility and correlation are obtained directly from historical data. The cornerstones of our modeling process are the expected returns for U.S. stocks and cash (the risk-free rate). Once these figures are determined, the returns of all other asset classes are a function of their volatilities relative to the market portfolio, which is defined as the complete opportunity set of all global asset classes.

At this point we are unclear how UTIMCO derived many of their specific asset class return and risk assumptions. It is our understanding that UTIMCO derived many of its asset class assumptions based on study of historical data, analysis of the results of a survey of various consultants and investment managers, and UTIMCO's own judgments and market observations. As such, it is difficult to make direct comparisons of our methods with those used by UTIMCO.

We have a very good understanding of, and agree with, UTIMCO's approach to calculating the expected return for U.S. stocks. Detailed documentation for the other asset classes, however, either does not exist or has not been provided to us. We note that of the fifteen asset classes modeled by UTIMCO there are three that, in our opinion, require further analysis and reconciliation to better understand the assumptions.

Those asset classes include: 1) fixed income; 2) financial commodities; and 3) private equity. The remainder of this memorandum provides points for discussion we feel are relevant when reviewing the assumptions provided so far by UTIMCO. Lastly, we address the question regarding the existence of a liquidity premium often associated with private investments.

Fixed Income

During the September 12th UTIMCO Board meeting, the U.S. fixed income risk and return assumptions were each reduced by 100 basis points. The table below reflects EnnisKnupp's risk/return assumptions for U.S. fixed income (nominal bonds) and TIPS as well as UTIMCO's assumptions.

	EnnisKnupp Assumptions		UTIMCO Assumptions		Board Revised UTIMCO Assumptions	
	Return	Risk (Standard Deviation)	Return	Risk (Standard Deviation)	Return	Risk (Standard Deviation)
U.S. Fixed Income	4.5%	7.7%	6.0%	7.0%	5.0%	6.0%
TIPS	3.4	3.4	5.5	6.0	5.5	6.0

Prior to the September 12th UTIMCO Board meeting, UTIMCO maintained a 50 basis point return advantage for nominal bonds over TIPS. Each of the consultants and investment managers surveyed by UTIMCO also projected a return premium for nominal bonds relative to TIPS.

Absent more detailed information regarding UTIMCO Board's decision, we believe that an equal reduction in expected return and volatility in TIPS is warranted. The current relationship between nominal bonds and TIPS suggests assumptions of an increasing inflationary environment or a collapse of credit-related bonds. At this point, we are unsure that such assumptions are intended by UTIMCO.

Commodities

There exists no broad consensus on the best way to estimate future returns on commodities investments. As with other asset classes, we use a Global CAPM framework to derive an assumption for commodities. Our expected return (2.1%) is similar to our projected rate of inflation (2.5%). We believe that this expectation conforms with financial reality, in that it is reasonable to expect the prices of commodities to rise roughly in line with the general price level of goods and services. In addition, we would expect investors to require a relatively low rate of return on commodity investments given the diversification benefit they potentially bring, as a result of their low correlations with other asset classes.

Our assumption is conservative in comparison with historical experience. Over the January 1970-June 2003 period (the longest period for which we have data), commodities as represented by the Goldman Sachs Commodities Index (GSCI) have produced a 12.1% annualized total nominal return, compared with a 4.8% rate of inflation. Much of the return produced by commodities over this period can be attributed, however, to a relatively short interval—the early 1970s, in which high inflation and turmoil in the Middle East was reflected in large increases in the price of crude oil.

UTIMCO's proposed assumption of a 5.0% nominal rate of return for commodities—a 2.0% real rate of return over their 3.0% inflation expectation—strikes us as overly optimistic.

Private Equity Volatility

There are many definitions of private equity and numerous ways to derive expected returns and risk. Our approach, as with all other asset classes, utilizes a Global CAPM methodology. With such an approach we need a sufficiently long rate of return series from which to calculate standard deviation and correlation with other asset classes. We use a return series that consists of post venture capital investments. The data is marked to market and does not suffer from stagnant values as do many other private equity data series.

Our method for calculating return and risk assumptions for private equity leads to a volatility number of 31%. In contrast, UTIMCO's volatility number was 20%. After discussions with UTIMCO staff subsequent to earlier communications, we learned our perspective on private equity differs. The data series we use only includes venture capital. We do not break out buyouts and mezzanine investments as we are not aware of reliable historical return series for these segments of the market. Such investments historically have exhibited risk and return characteristics very different from those of venture capital. UTIMCO breaks out venture capital as a separate and distinct asset class and includes distressed debt, oil and gas, mezzanine and buyouts within its classification of private equity.

We no longer take exception to UTIMCO's volatility assumption in this area. It appears reasonable based on their definition of private equity and the current make-up of their private equity investments.

Private Equity Liquidity Premium

CAPM proposes that investment risk is completely defined by volatility (uncertainty) of returns. As such, the theory in its original form does not provide for compensation for non-market risks, including illiquidity. As with other fundamental theories, CAPM has been extended and revisited over the years by researchers who seek to improve it by adding complexity. Compensation for illiquidity is one of the additional variables that have been considered in this research. We are not aware of any consensus as to what a reasonable expectation for such a premium, if any, might be for a particular asset class.

Our return assumption for private equity investments, based as it is on traditional CAPM, does not take into account a liquidity premium. We do recognize that investors may require additional compensation for illiquidity (as well as leverage, difficulty in diversification, and other non-market risks traditionally associated with private equity investing). We make no attempt, however, to estimate the additional premium for private equity; rather, we simply postulate that any premium arises in the course of market transactions and that it constitutes appropriate compensation for the extra-risk characteristics of private equity investing.

It is our understanding that compensation for liquidity risk forms some component of the 3.0% margin of expected return UTIMCO projects for private equity over public equity. We would not recommend the explicit inclusion of a liquidity premium in the private equity return assumption.

TAB 8

Consulting Services Utilized

Section Summary

In this section we identify and review UTIMCO's use of outside consultants. We examine the services provided by the consultants and the costs of those services and examine if there are any redundancies. We also study the practices of other large institutional funds regarding the use of consultants and the fees paid to consultants. Finally, we review reporting channels between consultant, UTIMCO staff and the UTIMCO Board.

We note that UTIMCO uses a variety of consultants for issues ranging from software development, recruiting and employee compensation consulting to investment consulting and performance reporting and evaluation. In this section we focus on consulting services related to investments and performance evaluation.

Investment-related consultants used by UTIMCO are: Russell/Mellon Analytical Services and Cambridge Associates. We begin with a review of Russell/Mellon.

Russell/Mellon

Russell/Mellon Analytical Services (RM) was created as a result of the combination of Russell Investment Group and Mellon Financial Corporation. The firm provides a variety of analytical performance measurement and reporting tools. RM has offices around the world with a staff of over 400. The firm provides its services to investment consultants, investment managers and fund sponsors like UTIMCO. EnnisKnupp uses data provided by RM for the calculations of various universe statistics.

The RM relationship with UTIMCO is limited to performance reporting and various analytical services. RM prepares quarterly performance reports for UTIMCO's Board and management team covering total fund performance and attribution, asset class performance, manager performance and asset class and total fund universe rank data. Their reports also include a broad market summary for the quarter and longer periods. The summary provides return information on various stock and bond market sectors and historical data analysis of various economic factors.

The cost of RM's services fluctuates based on the complexity of reporting and the number of accounts for which they provide data. Costs for fiscal 2002 and 2003 were \$231,413 and \$261,625, respectively.

Cambridge Associates

Cambridge Associates is an independent investment consulting firm that has been in operation since 1973. The firm works with over 600 clients with aggregate assets of over \$700 billion. Clients include college and university endowments, private clients, foundations and other institutional funds. The firm has 117 consultants in five offices. Cambridge's primary office is located in Boston, MA. Bruce Myers serves as UTIMCO's consultant from Cambridge.

Cambridge first began working with The University of Texas System as its investment consultant in the early 1990s. Since then, Cambridge's role and responsibilities have changed several times; as UTIMCO was formed; as the management team at UTIMCO experienced significant turnover; and as the current UTIMCO management structure has taken shape. We briefly describe these three distinct periods below.

Pre-UTIMCO Era

There is little in terms of institutional memory available to recall the working relationship between the Office of Asset Management and Cambridge. It is our understanding that prior to the formation of UTIMCO, Cambridge was called upon to perform special projects like asset allocation reviews, structural reviews, and spending policy reviews. Cambridge also provided various surveys on endowment management practices.

Early days of UTIMCO

During the early days of UTIMCO, Cambridge Associates' activities were limited to project work and occasional presentations to the UTIMCO Board. The fees for the relationship were variable and depended on the scope of the projects. Typical projects included asset allocation and spending studies. Day-to-day management of U.T. System's investment funds was handled by UTIMCO management.

Late 1999 to November 2003

In the fall of 1999 members of the non-marketable alternatives team left the UTIMCO organization. This action was followed by the departure of the Managing Director of marketable investments and the departure of the Chief Executive Officer in late 2000. As a result of this turnover, UTIMCO began to rely heavily on Cambridge for day-to-day support. For the period November 2000 to November 2002 Cambridge essentially took over the management of UTIMCO's alternative investments. The fee for this increase in services was notable and is reflected in the Costs of Services section below.

Current Era

The current management team at UTIMCO began to take shape with the hiring of Bob Boldt, Trey Thompson and Sara McMahon in early 2002. In December of 2002 UTIMCO's Management Team restructured the working relationship with Cambridge. That agreement was updated in early 2003 and is outlined below.

Cambridge - Scope of Services

Under the current contractual relationship (contract date February 14, 2003 and renewal date December 11, 2003) between Cambridge and UTIMCO, Cambridge is to perform the following functions / provide the following services:

General Consulting Services

- "Access via the (Cambridge Associates) CA consulting team and in many instances CA's web site to proprietary databases on capital markets, investment managers and partnerships, and comparative peer performance; quarterly and annual surveys of investment and financial data.
- A variety of research reports and working papers on investment and financial issues.
- A comprehensive asset allocation review including a presentation to the Board.
- Attendance at up to eight investment advisory meetings per year to discuss investment strategy, asset allocation, performance, market environment and investment manager selections.
- Investment manager recommendations presented to the Board for final approval constitute an additional service and will be charged in accordance with the fee schedule shown in Exhibit I.¹

Non-Marketable Alternative Asset Consulting Services

- Upon request, a comprehensive review of Client's non-marketable alternative investment assets program including an analysis of existing fund performance.
- Preparation of quarterly forward calendars of non-marketable alternative investment opportunities.
- Each quarter CA will provide the Client with its proprietary US Venture Capital and Private Equity benchmark statistics to be used for individual manager evaluation.
- Up to twelve due diligence memos and recommendations providing summaries of references, highlights of competitive advantages, and other issues for consideration. The provision of more than twelve due diligence memos and/or recommendations during the contract year will be "Additional Services" and provided upon request at CA's standard fee.
- Attendance at up to twenty in-person meetings (time but not travel expenses) and/or participation in conference calls with Client to discuss non-marketable investment strategy, the market environment, and potential fund opportunities. Additionally, CA may be asked to address Client's concerns regarding potential reference calls or attendance at meetings with potential partners.
- Subject to the License terms and conditions in Exhibit II¹, access to CA's web-based software program Private Equity Benchmark Calculator for creating customized benchmarks specifying multiple filter criteria, such as asset sector, vintage year, and industry focus, region and stage.

Marketable Alternative Investment Consulting Services

- A comprehensive review of Client's marketable investment assets including an analysis of existing programs and funds, a program risk assessment, and recommended changes in program structure and allocation.
- Attendance at up to fourteen in-person meetings (time but not travel expenses) and/or participation in conference calls to discuss marketable alternative investment strategy, the market environment, and potential investment opportunities. Additionally, CA may be asked to address Client's concerns regarding potential marketable alternative investments. Such reasonable requirements may include additional reference calls or attendance at additional meetings with potential partners.
- Up to ten due diligence memos and recommendations that provide summaries of references, highlights the competitive advantages, and other issues for consideration. The provision of more than ten due diligence memos and/or recommendations during the contract year will be "Additional Services" and provided for upon request at CA's standard fee."

¹ Exhibits I and II provide detail pricing for additional services and lay out the terms and conditions of CA's web-based private equity benchmark calculator.

This agreement is consistent in scope with relationships that EnnisKnupp has with its large institutional funds with in-house management.

Use of Investment Consultant -- Industry Practices

Overseeing an institutional investment program is complex and challenging as a result of a proliferation of new investment managers, strategies, and financial instruments. Governing bodies that oversee such programs are most often busy professionals who are able to devote only a small portion of their time to oversight activities. Furthermore, many of the overseers may have limited knowledge of investment matters or knowledge related to only specific areas of the financial markets. For these reasons, many institutions have retained investment consulting firms.

According to the 2003 Greenwich Associates' Market Dynamic Survey, some 73% of all fund types (pensions and endowments) use investment consultants for a variety of services. Public pension funds tend to be the most prodigious user of consulting services as 82% reporting in the Greenwich Survey use a consultant. Large endowments use a consultant to a lesser extent – 61%.

The National Association of College and University Business Officers (NACUBO) also collects information on its members' use of consultants. According to the 2003 NACUBO Endowment Study 75% of educational endowments use a consultant. The table below provides a summary of the Greenwich Survey and the NACUBO Study for 2003:

Percentage of Funds that Use Investment Consultants

Endowment Size	Greenwich	NACUBO
Over \$1 billion	61%	45%
\$0.5 - \$1 billion	76	82
\$0.5 billion and less	77	NA
All Endowment Funds	73%	75%

The ideal working relationship between client and consultant is one where the consultant provides an independent and objective perspective on an investment program. Firms that have no ties or affiliations with investment management firms or other financial institutions can provide a client with unbiased advice on all investment issues. The consultant serves as a resource of knowledge that the client can access when making investment-related decisions. A consultant can also help clients stay abreast of trends in institutional investing, technical developments in the field and the increasingly varied types of investment management approaches.

An important question to ask is, "who is the consultant's ultimate client." We believe the ultimate client is the governing body overseeing the assets -- i.e. the board, investment committee, etc. At the same time, the consultant is often asked to serve as an extension of the fund's staff to help identify investment managers, serve as a sounding board and provide access to research and technology that are not available in-house. These roles can be conflicting at times and it is a challenge to accommodate them both.

We believe the most critical function a consultant can play is to help level the playing field between in-house staff and the governing body. Absent a skilled, independent investment consultant serving on its behalf, a governing body may be ill-equipped to oversee the in-house management function.

Possible Conflicts Associated with Investment Consultants

There has been much press lately describing possible conflicts of interest between investment consultants and their institutional clients. Late last year the Securities and Exchange Commission began an investigation of possible conflicts within the investment consulting industry. The SEC's primary interest was possible financial ties between investment consultants and the managers they recommend their clients hire. The Working Group believes UTIMCO should work with an investment consultant that is not jeopardized with either real or perceived conflicts of interest.

The table below identifies possible conflicts of interest between consultant and client and Cambridge's responses to the indicated questions.

Potential Conflict	Cambridge Associates' Position
1) Does CA employ registered broker dealers?	"No. Cambridge Associates does not employ registered broker dealers. Please refer to our conflict of interest policy located in our response to Question 5."
2) Does CA accept commissions as a form of payment?	"No. Cambridge Associates does not accept commissions as a form of payment. Cambridge Associates has never received any fees or other form of compensation from investment management firms and, at present, does not receive any compensation from broker-dealers."
3) Does CA buy or sell securities for itself that it also recommends to clients?	<p>"No. Cambridge Associates does not buy or sell securities that it recommends to clients, but our employees may do so in accordance with our Code of Ethics which states that:</p> <p>Co-investing: Except for personal trading that may be prohibited for other reasons (for example, insider trading policies), employees and other associated persons may purchase publicly-traded securities [For this purpose, "publicly-traded securities" is defined to include any security that is 1) traded on a national or regional securities exchange; 2) traded on an automated interdealer quotation system; 3) regularly traded in the national or a regional over-the-counter market; or is a share of an open-end investment company (i.e., a mutual fund).] that are owned by one or more of the firm's members.</p> <p>Employees may also purchase securities that are not publicly traded provided that investment by employees or other associated persons would not impede the ability of the firm's members to invest in the security to the extent that they desire to do so. Whenever an employee recommends a security in which he or she has invested or is contemplating making an investment, the employee must disclose this fact to the member institution or family to whom the recommendation has been given."</p>

4) Does CA receive any form of compensation from investment managers, banks, custodians, brokers, etc.?	"No. Cambridge Associates does not receive revenues or compensation in any form from investment managers. The firm generates all of its revenues through investment consulting services."
5) Does CA maintain a conflict of interest policy? Please describe the policy.	"Yes. We maintain a strict conflict of interest policy which follows. Cambridge Associates does not receive any fees from money management firms or other financial institutions. We believe that the financial structure of our business provides us with a form of economic and philosophical independence that is unusual among investment consultants. We are compensated only by our clients and have no compensatory relationships with investment management firms, investment banks, brokerage firms, or other financial advisory firms. Further, the diversity of our revenue base, which includes investment and financial consulting as well as financial advisory work, enhances our ability to provide unbiased advice. Our investment policy and investment manager recommendations for an individual institution reflect the structure, objectives, and conditions specific to the institution."
6) Do any of the firm's Principals or staff members currently sit on any investment company's board of directors? If yes, please list the entity and the Principals or staff member's role.	"Yes. A managing member of the firm sits on a REIT board by the name of Apartment Investment Management Company, Inc. Also, a few members of Cambridge Associate's advisory staff have non-voting observer status on the advisory boards of a few private equity/venture capital funds."
7) Do investment managers subsidize CA's client conferences?	"No. Investment managers do not subsidize Cambridge Associate's client conferences. Please refer to our conflict of interest policy located in our response to Question 5."
8) Do investment managers subsidize or otherwise defray CA's manager research costs?	"No. Investment managers do not subsidize Of otherwise defray Cambridge Associate's manager research costs. Please refer to our conflict of interest policy located in our response to Question 5."

Cambridge has been asked to assist in various investment consulting activities not directly related to its current service agreement with UTIMCO. It is fairly typical for a consulting arrangement that is "full service" (much like the Cambridge/UTIMCO relationship) to include items not directly referred to in the service agreement.

One item provided by Cambridge not directly included in the agreement was assistance in the development of UTIMCO's compensation plan. While such an arrangement does not necessarily present a conflict, it calls into question who Cambridge works for and what the appropriate reporting channel should be between Cambridge and UTIMCO. We discuss reporting channels in the next section.

Reporting Channels

UTIMCO's Delegation of Authority Policy (effective date April 25, 2003) defines the roles and responsibilities of UTIMCO Management and the UTIMCO Board. The document addresses a variety of management and operational issues, including the use of investment consultants. Appendix C of the Policy defines the authority provided to UTIMCO Management to recommend an investment consultant to the UTIMCO Board:

"UTIMCO Management shall be responsible for recommending, subject to UTIMCO Board approval, the selection of an external investment consultant and the scope of the work to be performed by the consultant. After approval by the UTIMCO Board, UTIMCO Management shall be responsible for negotiating the term and conditions of the consultant's contract, for determining the work schedule of the consultant, for evaluating the consultant's professional work product, and for recommending the extension or termination of the consultant's contract to the UTIMCO Board.

UTIMCO management shall present, on at least an annual basis, a comprehensive report to the UTIMCO Board on the current scope of work of the external consultant."

We are not aware of any other policy or governing language regarding UTIMCO's use of an investment consultant. We do not believe the reporting channels for Cambridge are as clearly defined as they should be and it is not readily evident whom Cambridge considers its primary client.

Since EnnisKnupp was engaged by the Board of Regents in August of last year, it participated in several regularly-scheduled UTIMCO Board meetings. EnnisKnupp has also been provided copies of the quarterly UTIMCO Board reports. And EnnisKnupp was recently given access to various work produced by Cambridge. This exposure to the working relationship between Cambridge and UTIMCO coupled with conversations with Bruce Myers at Cambridge yields several observations:

- The service agreement between Cambridge and UTIMCO historically has been addressed to UTIMCO's Management
- Cambridge's work product is often addressed to UTIMCO staff
- Cambridge is not required to provide a recommendation or express an opinion on all investment-related matters that require UTIMCO Board Approval

We recommend UTIMCO's consultant report directly to the Chairman of the Board at UTIMCO and continue to function as an extension of UTIMCO staff. Working in such a way would require only modest adjustments to the current Delegation of Authority Policy. We further believe that all action items brought before the UTIMCO Board should be vetted by Cambridge. Depending on the scope of the issue, verbal commentary may be sufficient. In other cases, a written analysis with a recommendation would be necessary. Lastly, UTIMCO agenda items are currently well summarized on a one-page document preceding the relevant background information. These are the "Blue Sheets" in the UTIMCO Board books. Items requiring Board approval should include a line-item titled "Consultant Recommendation."

Cost of Services

The annual fee for the services outlined in the current service agreement with Cambridge is about \$900,000. Below we compare the cost of Cambridge Associates and other analytical services received by UTIMCO.

	Fiscal 2002	Fiscal 2003	Fiscal 2004 (budgeted)
Cambridge Associates			
\$	\$2,797,487	\$1,477,800	\$901,170
Basis Points (bps) ²	2	1	1 (base)
Russell/Mellon			
\$	\$231,413	\$261,625	\$400,000 ³
Basis Points	<1	<1	<1
Total			
\$	\$3,028,900	\$1,739,425	\$1,301,170
Basis Points	3	1	1
Peer Comparison (bps) ⁴	1.1	1.0	NA

The comparative analysis for fiscal 2002 is less meaningful than the 2003 data. As stated earlier, the period from 2000 to 2002 was an anomalous time and Cambridge's scope of services increased dramatically. As shown for fiscal 2003, UTIMCO investment consulting fees expressed as a percent of total assets equal approximately one basis point. This is consistent with industry standards for large (greater than \$1 billion) funds.

Possible Redundant Services

Private Capital Benchmarking

It appears that there is little, if any, overlap between the services provided by Cambridge and the services provided by other entities. One area that warrants further examination is the data provided by Venture Economics for benchmarking the Private Equity and Private Capital asset classes. According to the current service agreement Cambridge "will provide the Client with its proprietary US Venture Capital and Private Equity benchmark statistics to be used for individual manager evaluation." We note that the Venture Economics data is for the aggregate asset class; not individual managers, yet there may be slight redundancies in services. Based on discussions with Bruce Myers, we understand that elimination of venture capital benchmark statistics from the existing Cambridge service agreement will likely not have a meaningful effect on the Cambridge's pricing for UTIMCO.

² 100 basis points equal 1%. The figure is calculated by dividing consulting costs by total U.T. System assets managed by UTIMCO. For fiscal year end 2002 and 2003 aggregate assets were \$12,976 million and \$14,262 million, respectively.

³ The increase in the RM annual fee for fiscal 2004 reflects additional services required by members of the UTIMCO management team. These services will actually be provided by different organizations, but for reporting purposes in this document we lump them in with RM.

⁴ Source: Greenwich Associates 2003 Market Dynamics Report. Includes 95 endowments and foundations with assets over \$1 billion.




Performance Reporting

UTIMCO staff prepares monthly and quarterly performance updates that are made available to the UTIMCO Board and other interested parties. The data used to create these reports are provided by UTIMCO's custodian – Mellon. Mellon calculates rates of returns earned by UTIMCO's investment managers, asset classes and total fund. UTIMCO then reviews these returns and reconciles any discrepancies between investment manager reported returns and Mellon-calculated returns. The same Mellon-calculated returns are used to populate the Russell/Mellon quarterly performance reports.

We question the usefulness of the RM performance reports. We recognize the reports provide a layer of comfort for the Board, given the data is organized and reported by a party independent of UTIMCO staff. At the same time the RM reports are shown on a calendar-quarter basis. This allows additional manager, asset class and total fund universe comparisons, but does not allow UTIMCO's Board members to compare the staff-prepared report to RM's report.

If obtaining comfort that UTIMCO staff is fairly and accurately reporting performance is important, a possible solution to the RM report would be to require certain audit procedures of the market values and returns data. This could be included in the scope of Ernst & Young's annual audit.

Our analysis did not find any other areas of redundancies.



TAB 9

PHILIP R. ALDRIDGE

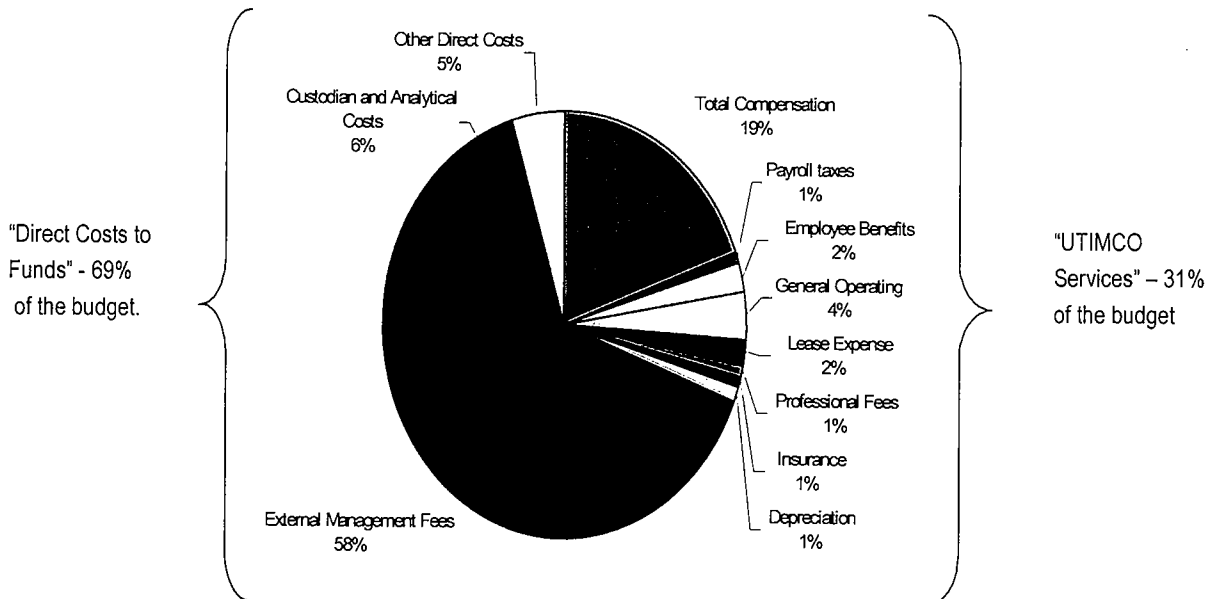
BUDGETING PROCEDURES

I. Budget Overview

Section 7(a) of the Second Amended and Restated Investment Management Services Agreement requires UTIMCO to "submit to the U. T. Board its proposed annual budget for the following fiscal year within the time frame specified by the Board." UTIMCO is also contractually committed to submit an allocation formula (fee schedule) to be charged to the funds to pay UTIMCO's budget. Both the budget and the fee schedule are required to be "approved or disapproved" by the Board of Regents.

In 2003 (the fiscal year 2004 budget), the Office of Finance performed a detailed budget review and prepared a summary report. The UTIMCO budget (attached to this report as Exhibit A) is made up of two sections, "Direct Costs to Funds" and "UTIMCO Services". The majority of the \$30.9 million budget, 69% for Fiscal Year 2004, is Direct Costs to Funds, consisting of External Management fees (58%), Custodial and Analytical Costs (6%), and Other Direct Costs (5%). The UTIMCO Services portion of the budget includes Compensation and Benefits (22%), General Operating expenses (4%), Lease Expenses (2%), Professional Fees, Insurance, and Depreciation (3%).

Representative UTIMCO Budget by Expenditure Category
(Based on Original FY 2004 Budget)



For the FY 2004 budget, UTIMCO utilized a new "zero-based" budgeting concept that required each Managing Director to build their respective budgets based on actual needs. Each Managing Director used cost information from actual receipts from the current year and a set of budget worksheets provided by the budget coordinator. The process was designed by UTIMCO to ensure accountability and responsibility for each component of the budget.

The FY 2004 budget process began in mid-April, 2003, and concluded with the approval of the budget and the associated fee schedule at the August, 2003, Board of Regents' meeting.

II. Current and Proposed UTIMCO Budget Review Process

To fulfill its contractual requirement, UTIMCO has followed a traditional budget cycle that begins in the spring and ends in August with the approval of the budget by the Board of Regents. This budget process is similar in nature, but more detailed than the process used for the creation of the System Administration budget. This additional detail is appropriate, given that UTIMCO's total budget is approaching the size of System Administration's entire AUF-funded budget and is necessary to determine the contract price for UTIMCO to manage the funds on behalf of the Board of Regents. The independent auditor for UTIMCO, Ernst & Young, performs a financial audit of UTIMCO's expenses by comparing items to appropriate supporting documents; however, they do not test those expenses for reasonableness. Until 2003, System Administration staff performed only a cursory review of UTIMCO's proposed budget prior to submittal to the Board of Regents. All of the work and most of the review was performed by UTIMCO staff and the UTIMCO Board. In 2003 the System Administration staff performed a more detailed review of the FY 2004 UTIMCO budget. This included several meetings with UTIMCO staff for explanations of large budget items and why some budget items changed significantly from the prior year. A comprehensive review of the budget was written by the Office of Finance; however, the report was not formally presented to the Board of Regents prior to approval. See Exhibit A for a summary of the UTIMCO budget for the fiscal years 2002 - 2004.

This budget report did not include a review of soft dollar arrangements. Soft dollar arrangements occur when an investment manager pays a higher brokerage commission than those that might be obtainable elsewhere in order to obtain research and other services provided by such brokers in the expectation to enhance the long-term value of the account. To our knowledge, UTIMCO requests that all orders for investment transactions be placed in such markets and through such brokers as shall offer the most favorable price, execution, and commission cost of each order (best execution). At the time of the FY 2003 budget report, UTIMCO did not have any soft dollar arrangements with any external managers. The working group has confirmed that UTIMCO continues to have no soft dollar arrangements.

It is the recommendation of the UTIMCO Working Group that System Administration staff conduct a detailed budget review on an annual basis, similar to what was done in 2003. The timing of this review should be consistent with the timing of the System Administration budget process, and a more open dialogue should be developed between UTIMCO and System Administration staff. In addition, the System Administration Audit Office should review UTIMCO's current and prior year accounts for reasonableness, as they do periodically for departments at System Administration. These departmental audits compare expenditures to supporting documents and U.T. policies, and test those expenditures for reasonableness. It is also recommended that System Administration staff be involved in the budget process at an earlier stage to ensure a full understanding of all significant budget items. The actual budget review process for FY 2004 and the proposed process for FY 2005 are shown in the table on the next page.

Table: Current and Proposed UTIMCO Budget Review Process

FY 2004 Budget Review Process		Proposed FY 2005 Budget Review Process	
		Early March	Survey UTIMCO for expected merit increases and prepare potential impact study.
		Late March	<ol style="list-style-type: none"> 1) Initial budget discussion between UTIMCO and System Administration Staff. 2) Prepare timeline for budget review
April	UTIMCO's February books closed and financial statements completed	April	<ol style="list-style-type: none"> 1) UTIMCO's February books closed and financial statements completed 2) System Administration staff performs review of current year actual expenses vs. budgeted expenses 3) System Audit staff and System Administration staff performs audit of UTIMCO accounts for reasonableness.
Early May	<u>UTIMCO Budget Process</u> UTIMCO budget packets distributed to CEO and Managing Directors; UTIMCO budget worksheets due from CEO and Managing Directors; present initial budget draft to CEO and Managing Directors; CEO budget review meetings with Managing Directors	Early May	UTIMCO budget process proceeds with involvement of System staff at an earlier stage including a review of budget worksheets and budget drafts.
Mid May	<ol style="list-style-type: none"> 1) Preliminary budget discussion held with System Staff 2) Draft budget due to System Staff 3) System budget review and discussions with UTIMCO 	Mid May	<ol style="list-style-type: none"> 1) Ongoing budget discussions held with System Staff 2) Draft budget due to System Staff 3) System budget review and discussions with UTIMCO
May 30	System Staff budget review and analysis completed	May 28	System staff review and analysis completed
June 26	Budget and Management Fee Schedule	June	Follow-up discussions with System staff

	slated for approval by UTIMCO Board		based on Board of Regents input
		July 15	Budget and Management Fee Schedule slated for approval by UTIMCO Board
August 7	Budget and Management Fee Schedule slated for approval by Board of Regents	July 16	Draft budget, management fee budget report reviewed with Board of Regents
		August 12	Budget and Management Fee Schedule slated for approval by Board of Regents

III. UTIMCO Operating Reserves

UTIMCO's budget is funded through the assessment of fees charged against the PUF, the LTF, the PHF, and the SITF. To the extent that its fee revenue (plus interest income) exceeds its total cash expenses, UTIMCO accumulates a budget surplus that it holds for cash management and emergency expenditure purposes. UTIMCO has established a target Cash Reserve¹ balance equal to one year's operating budget. That would imply a need for a Cash Reserve as of 3/1/04 of approximately \$9.6 million.

Based on a history of growing Cash Reserves, the flexible nature of UTIMCO's fee structure, and the lack of extraordinary, unplanned expenditures, the UTIMCO Working Group recommends a much lower Cash Reserve policy than the current 12 months' target. Specifically, we believe that a three-month Cash Reserve should be more than adequate. This policy would result in a Cash Reserve of approximately \$2.4 million for FY 2004.

Our recommendation is based on the following facts:

1. When adjusted for cash rebated to the investment funds, UTIMCO's Cash Reserve has never declined, on an annual basis. UTIMCO has consistently run a budget surplus and is projected to do so again in FY 2004.
2. The Board of Regents can assess an extraordinary one-time fee at any time. Unlike most businesses, UTIMCO manages a \$15 billion pool of assets that can be tapped to cover an extraordinary, unplanned expenditure. More than \$3 billion of these funds are invested on a short or intermediate basis.
3. UTIMCO's Cash Reserve calculation deducts accounts payable from the total. This means that the sum of UTIMCO's cash on hand plus investments is actually greater than the Cash Reserve. Assuming a 30-day payable balance on average, UTIMCO could have an additional \$750,000 or so of cash and/or investments in excess of its defined Cash Reserve.

Please see Exhibit B for a detailed analysis of UTIMCO's Cash Reserve.

¹ "Cash Reserve" equals cash on hand plus investments less accounts payable.

IV. Executive Summary and Recommendations

To fulfill its contractual requirement, UTIMCO has followed a budget cycle that begins in the spring and ends in August with the approval of the budget by the Board of Regents. Until 2003, System Administration staff performed only a cursory review of UTIMCO's proposed budget prior to submittal to the Board of Regents. All of the work and most of the review was performed by UTIMCO staff and the UTIMCO Board. In 2003, the System Administration staff performed a more detailed review of the FY 2004 UTIMCO budget. The staff report was not formally presented to the Board of Regents prior to approval.


In order for the Board of Regents to better fulfill its fiduciary duty, the UTIMCO Working Group is making the following recommendations:

1. System Administration staff should conduct a detailed budget review on an annual basis. While this would be similar to what was done in 2003, the review should begin during UTIMCO's budget process, not after, and should dovetail with the System Administration budget review process. This will help to ensure a more thorough understanding of the budget by System staff.
2. There should be an ongoing exchange of information throughout the budget process. Comments from System Administration staff should be responded to in writing by UTIMCO and addressed as necessary. Also, the Board of Regents should have an opportunity to review and comment on the proposed UTIMCO budget and System staff report prior to the submittal of the budget to the Board of Regents for approval.
3. The System Administration Audit Office should review UTIMCO's current and prior year accounts for reasonableness, as they do periodically with departments at System Administration.
4. UTIMCO's Cash Reserve policy should be revised to require a three month cash reserve target, rather than the 12 month reserve currently targeted. Excess funds, as defined by the Cash Reserve Policy, should be rebated to the funds on at least an annual basis. This could be codified in the Investment Management Services Agreement, if necessary.

TAB 9 a

ALDRIDGE – BUDGETING PROCEDURES

Exhibit A

	FY 2002 – FY 2004 UTIMCO Operating Budgets				
	8/31/02		8/31/03		8/31/04
	Budget	Actual	Budget	Actual	
UTIMCO Services					
Salaries and Wages	2,703,427	2,287,533	3,854,426	3,102,883	4,141,188
Bonus Compensation	1,086,879	239,416	2,100,684	1,088,344	1,867,266
Total Compensation	3,790,306	2,526,949	5,955,110	4,191,227	6,008,455
Total Payroll taxes	188,021	145,492	249,743	195,076	270,688
403(b) Contributions	200,051	156,515	291,841	219,898	320,423
Group Health, Dental, AD&D, Life, Group LTD	166,472	150,085	246,344	201,090	322,430
Employee Benefit Services	7,000	7,850	7,000	4,490	6,000
Employee Benefits	373,523	314,450	545,186	425,478	648,854
On-Line Data & Contract Services	522,500	304,635	512,500	399,556	558,800
Recruiting and Relocation Expenses	8,000	94,038	372,000	359,917	25,000
Travel	80,000	71,739	120,000	109,138	187,000
Phone Equipment and Charges	82,000	49,530	79,500	41,990	72,000
Computer & Office Supplies	71,600	51,344	79,100	50,412	85,650
Employee Education	20,000	13,034	72,000	58,128	56,500
Repairs/Maintenance	41,500	36,673	41,500	39,453	43,500
BOD Meetings	20,000	18,623	47,500	29,811	49,050
Other Operating Expenses	115,300	68,312	47,500	24,752	23,500
Total General Operating	960,900	620,092	1,371,600	1,113,157	1,101,000
Total Lease Expense	613,000	604,683	623,010	606,013	623,010
Investment Consultants	25,000	195	100,000	2,000	50,000
Legal Expenses	275,000	242,533	250,000	500,823	200,000
Compensation Consultant			0	45,200	25,000
Accounting fees	10,000	6,630	10,000	6,870	10,000
Total Professional Fees	310,000	249,358	360,000	554,893	285,000
Property/Liability Package	10,875	12,182	13,399	15,009	18,282
Umbrella Policy	5,000	5,691	6,412	6,756	7,812
Workers Compensation	7,300	10,910	11,543	14,109	16,722
Business Auto	160	162	172	175	200
Commercial Bonding Policy	38,000	36,659	35,614	39,138	46,926
Prof. and D&O Liability	119,600	131,931	144,513	158,881	190,582
Total Insurance	180,935	197,535	211,653	234,068	280,524

Depreciation of Equipment	281,592	271,692	286,200	286,176	294,243
otal UTIMCO Services	\$ 6,698,276	\$ 4,965,184	\$ 9,602,501	\$ 7,606,088	\$ 9,511,773
Direct Costs to Funds					
External Management Fees	12,788,316	10,968,493	13,344,491	9,216,481	9,525,099
External Mgt. Fees-Performance Fees	7,400,111	3,899,937	6,771,540	3,097,784	8,423,640
External Management Fees	20,188,427	14,868,430	20,116,031	12,314,265	17,948,739
Custodian Fees and other direct costs	1,244,906	1,179,267	1,262,700	1,044,689	1,156,630
Performance Measurement	321,338	231,413	268,163	261,625	400,000
Risk Measurement	286,000	361,460	353,000	308,750	403,000
Custodian and Analytical Costs	1,902,243	1,902,243	1,883,863	1,615,064	1,959,630
Cambridge Fees	2,799,844	2,797,487	968,607	1,477,800	901,170
Auditing	211,500	158,371	202,700	168,202	184,500
Consulting		51,387	100,000	0	0
Printing	101,757	91,246	94,900	99,880	87,700
Bank fees	4,000	7,289	9,000	7,605	9,000
Rating agency fees	22,800	21,876	22,000	21,508	22,000
Legal Fees	35,000	267,880	315,430	343,849	250,000
Other Directs Total	3,174,901	3,395,536	1,712,637	2,118,844	1,454,370
Total Direct Costs to Funds	\$ 25,265,571	\$ 20,102,705	\$ 23,712,531	\$ 16,048,173	\$ 21,362,739
Grand Total	\$ 31,963,847	\$ 25,067,889	\$ 33,315,032	\$ 23,654,261	\$ 30,874,512

TAB 9 b

Exhibit B

UTIMCO Reserve Analysis

I. Background

UTIMCO's budget is funded through the assessment of fees charged against the PUF, the LTF, the PHF, and the SITF. To the extent that its fee revenue (plus interest income) exceeds its total cash expenses, UTIMCO accumulates a budget surplus that it holds for cash management and emergency expenditure purposes. UTIMCO has established a target Cash Reserve² balance equal to one year's operating budget. That would imply a need for a Cash Reserve as of 9/1/04 of approximately \$ 9.6 million.

In 1996, UTIMCO was funded by the System with \$400,000 in cash plus certain office equipment. By the end of its first fiscal year, UTIMCO had a Cash Reserve balance of approximately \$1 million, of which, it rebated \$435,900 back to the investment funds on a pro rata basis. Table 1 shows that the Cash Reserve amount has increased each year since 1996 to a present balance of approximately \$10.5 million as of 2/28/04. You'll note that the Cash Reserve did not reach the target policy level (one year's annual operating budget) until FY 2001. Other than the 1996 rebate and a \$1.35 million rebate in FY 2001, all of the accumulated funds have been retained by UTIMCO.

Table 1 also highlights the fact that UTIMCO has consistently run a budget surplus, thereby adding to its Cash Reserve on an annual basis. Table 2 compares the Cash Reserve at the end of each fiscal year with the operating budget for the upcoming year. It then shows how many months of budgeted operating expenses are being held in Cash Reserve. As the numbers indicate, the Cash Reserve has been increasing every year when compared to the operating budget, except for FY 2001, which was impacted by the \$1.35 million distribution. Using UTIMCO's Cash Reserve estimate for FYE 2003, the Cash Reserve will actually exceed UTIMCO's FY 2004 budget.

The adequacy of the Cash Reserve was discussed with UTIMCO as part of the FY 2004 budget review. In those discussions, UTIMCO articulated several arguments in favor of maintaining a Cash Reserve equal to one year's operating budget:

1. UTIMCO's existing D&O insurance coverage was set, in part, based on the assumption that "additional reserves" would be available to cover actions against the Officers and Directors of UTIMCO.
2. A larger Cash Reserve reduces the likelihood that an unplanned withdrawal would need to be made from funds invested with a long-term allocation in mind.
3. Only 75% of performance bonuses are budgeted for FY 2004. If actual bonuses exceed the 75% level, the excess would need to be paid out of the Cash Reserve.

II. The Case for Reducing the Cash Reserve

While recognizing UTIMCO's concerns, there is still a strong case to be made that UTIMCO's Cash Reserve policy requires it to maintain cash and investments well in excess of what is necessary. Consider the following:

1. When adjusted for cash rebated to the investment funds, UTIMCO's Cash Reserve has never declined, on an annual basis. UTIMCO has consistently run a budget surplus and is expected to continue to do so in FY 2004. Based on eight years of history, it is hard to envision an extraordinary, unplanned expenditure of a

material nature that would be incurred by UTIMCO. Any actual D&O-related liability would necessarily have a lead-time of many months, if not years.

2. With Board of Regents' approval, UTIMCO can assess an extraordinary one-time fee at any time. Unlike most businesses, UTIMCO has a \$15 billion pool of assets that can be tapped at any time to cover an extraordinary, unplanned expenditure. More than \$3 billion of these funds are invested on a short or intermediate basis.
3. UTIMCO's Cash Reserve calculation deducts accounts payable from the total. This means that the sum of UTIMCO's cash on hand plus investments is actually greater than the Cash Reserve. Assuming a 30-day payable balance on average, UTIMCO could have an additional \$750,000 or so of cash and/or investments in excess of its defined Cash Reserve.
4. Unbudgeted performance compensation is relatively modest when compared to the total operating budget. A 100% (maximum) payout of UTIMCO's performance compensation for FY 2004 would add approximately 6% or \$600,000 to the operating budget – a sum that could be readily covered by a three-month reserve.

III. Conclusion

Based on a history of growing Cash Reserves, the flexible nature of UTIMCO's fee structure, and the lack of extraordinary, unplanned expenditures, we recommend a much lower Cash Reserve policy than the current 12 months' target. Specifically, we believe that a three-month Cash Reserve should be more than adequate. This policy would result in a Cash Reserve of approximately \$2.4 million for FY 2004. Of course, the actual cash and investments available to pay operating expenses would be greater by the amount of accounts payable outstanding at any point in time. We believe that this amount is more than adequate to manage UTIMCO's liquidity needs and to fund any unplanned or unbudgeted expenditures.

Table 1: UTIMCO Cash Reserve Analysis

	Cash Reserve**	Annual Operating Budget	Actual Operating Expenses	Budget Surplus (Deficit)
August 31, 1996	\$ 610,379			
Rebated to Funds	<u>\$ (435,900)</u>			
	\$ 1,046,279			
December 31, 1996	\$ 1,685,055	\$ 4,752,147		
December 31, 1997	\$ 2,229,534	\$ 5,635,811	\$ 4,671,095	\$ 81,052
August 31, 1998	\$ 2,634,418	\$ 5,713,932	\$ 2,929,793	\$ 2,706,018
August 31, 1999	\$ 3,606,195	\$ 5,730,297	\$ 5,079,734	\$ 634,198
August 31, 2000	\$ 5,117,129	\$ 6,569,921	\$ 4,656,180	\$ 1,074,117
August 31, 2001	\$ 4,463,550			
*Rebated to Funds	<u>\$ (1,350,000)</u>			
Net Reserves	\$ 5,813,550	\$ 6,698,276	\$ 4,508,611	\$ 2,061,310
August 31, 2002	\$ 7,806,894	\$ 9,602,501	\$ 4,966,657	\$ 1,731,619
August 31, 2003	\$ 10,110,253	\$ 9,511,773	\$ 7,606,088	\$ 1,996,413
Estimated 2003 – 2004 Budget Surplus to date				<u>\$ 254,000</u>
			Total Surplus	\$ 10,538,727

* Appears that Net Assets was used as the factor for calculating this rebate (rather than Cash Reserves).

** Cash on Hand + Investments - Accounts Payable

Table 2: UTIMCO Cash Reserve History

	Cash Reserve	Next Year's Operating Budget	Cash Reserves in Number of Months' Operating Budget
August 31, 1996	\$ 610,379		
December 31, 1996	\$ 1,685,055	\$ 4,752,147	4.3
December 31, 1997	\$ 2,229,534	\$ 5,635,811	4.7
August 31, 1998	\$ 2,634,418	\$ 5,713,932	5.5
August 31, 1999	\$ 3,606,195	\$ 5,730,297	7.6
August 31, 2000	\$ 5,117,129	\$ 6,569,921	9.3
August 31, 2001	\$ 4,463,550	\$ 6,698,276	8.0
August 31, 2002	\$ 7,806,894	\$ 9,602,501	9.8
August 31, 2003	\$ 10,110,253	\$ 9,511,773	12.8
August 31, 2004 (est.)	\$ 10,364,253		

TAB 10

Oversight and Reporting

Section Summary

In this section we review the oversight and reporting functions associated with UTIMCO. We cite the entities to which UTIMCO is required to report, cite critical functions carried out by UTIMCO and provide recommendations as to how these functions should be monitored by U.T. System staff and the Board of Regents.

Background

There are several entities, some governing and others not, to which UTIMCO is required to report. These entities include:

- **The Board of Regents:** As the ultimate fiduciary of the investment assets and UTIMCO's sole client, the Regents require regular reporting to ensure compliance with stated policies and that performance is meeting stated objectives. According to Section 66.08 of the Texas Education Code: UTIMCO is to "file quarterly reports with the [UTS] Board concerning matters required by the [UTS] Board."
- **U.T. System Staff:** System staff serves as an intermediary between UTIMCO's Board and staff and the Regents. System staff maintains nearly constant contact with UTIMCO, participates in its Board meetings and has access to all UTIMCO reporting.
- **State Auditor's Office and other Public Offices:** According to the General Appropriations Act "the governing board of each of the educational institutions named in this Article shall file with the State Auditor, Comptroller of Public Accounts, Legislative Budget Board and the Governor an annual report of all investment transactions involving endowment funds ... and all other securities transactions."
- **The Public:** Effective September 1, 2001, UTIMCO is officially subject to the Texas Open Meetings Act, with some exceptions. The UTIMCO Director's Manual provides a summary of the open meetings policy. In short, every regular, special or called meeting of the UTIMCO Board shall be open to the public, except as otherwise provided by Chapter 551, Sub-chapter D of Texas Government Code.

This section focuses on the reporting and oversight needs of the Board of Regents and U.T. System staff. To gain a better understanding of current reporting requirements, we reviewed the Second Amended and Restated Investment Management Service Agreement (IMSA). The agreement provides a description of various reporting requirements from UTIMCO. Key reporting requirements included in the IMSA are summarized below:

Investment Policies: "After UTIMCO completes its assessment, it shall forward any recommended changes to U.T. System staff for review prior to being submitted to the U.T. Board for approval."

Investment Performance: "UTIMCO shall monitor and report on investment performance for the PUF, PHF and U.T. Board accounts. Such responsibilities shall include the calculation and evaluation of performance of asset classes and individual portfolios, against established benchmarks over various periods of time, the periodic review of performance benchmarks, the reporting of investment performance of Separately Invested Assets and U.T. Board Trust Accounts as requested by the U.T. Board, and the reporting to regulatory agencies and others regarding investments under management to the extent required by applicable law."

Books and Records: "The books and records of the Accounts and all reports concerning UTIMCO's operations shall be available during normal business hours for inspection by an authorized representative of U.T. System. UTIMCO shall provide full audit access to auditors representing the U.T. Board or the State Auditor, including access to any and all information concerning the operations of UTIMCO."

Reporting: "...effective with the August 31, 2004 financial statements, the chief executive officer and the chief financial officer of UTIMCO shall provide certifications similar to those required by Section 302 of the Sarbanes-Oxley Act of 2002, Corporate Responsibility for Financial Reports. In addition, UTIMCO will begin following the U.T. System compliance guidelines as outlined in the Action Plan to Enhance Institutional Compliance, including providing the U.T. Board or its designee quarterly compliance reports."

Other Services: "UTIMCO shall perform other investment management services to include attending meetings of the U.T. Board and making reports as the U.T. Board may request from time to time..."

Annual Budget: "UTIMCO shall submit to the U.T. Board its proposed Annual Budget for the following fiscal year within the timeframe specified by the Board. ...The Annual Budget...shall be approved or disapproved by the U.T. Board. Any such Budget...that is disapproved shall be promptly revised by UTIMCO and resubmitted to the U.T. Board for approval."

In addition to the governing language above, we also note UTIMCO is to "file quarterly reports with the Board concerning matters required by the Board," per Section 66.08 of the Texas Education Code.

Current Reporting Structure

Currently U.T. System staff receives and has access to a variety of reports and documents from UTIMCO. Below is a representative list of specific items.

- UTIMCO Board meeting books
- Copies of certain memoranda to the UTIMCO Board
- UTIMCO monthly newsletter
- Various materials made available on UTIMCO's website

Once these items are reviewed by System staff, some issues are discussed with UTIMCO management to gain a better understanding of the material. From time to time EnnisKnupp has been asked to review specific UTIMCO Board agenda items and express a written opinion. Staff and EnnisKnupp have found it difficult to fulfill their oversight responsibilities and obligations to the Board of Regents as UTIMCO materials are received no sooner than one week in advance of the UTIMCO Board meeting.

We recommend UTIMCO make its Board books (or at least critical portions of it) available to System staff at least two weeks in advance of UTIMCO Board meetings. Additionally, issues that will require Board of Regents' approval should be provided to System Staff as soon as practicable. We recommend a more collaborative working relationship between System staff and UTIMCO so that issues can be properly addressed before they are presented to the Board of Regents.

Proposed Reporting Structure

The IMSA states that UTIMCO has:

"...complete authority to act for the Board in the investment of the Accounts, subject, however, to such limitations and restrictions as are set forth in the Investment Policies." The Agreement continues by stating:

"The U.T. Board, as ultimate fiduciary for the Accounts, retains policy setting authority." Such division of responsibilities and authority is typical of an investment manager / client relationship.

At one level we can see an environment with limited interaction between the investment manager (UTIMCO) and the client (Board of Regents) other than the establishment of asset allocation, routine monitoring of compliance with asset allocation policy and monitoring of investment performance relative to client-set objectives. Such a relationship between investment manager and board is not uncommon when there is an internal manager-of-managers structure in place and/or an external investment consultant. Under the Office of Asset Management structure, the Regents did not interact with individual external managers, but relied on OAM to carry out that function. The Regents did not spend time evaluating the external managers' derivatives policies, employee compensation plans or codes of ethics. These tasks were delegated to the OAM.

While by definition UTIMCO is separate and distinct from U.T. System, the two entities in many respects remain conjoined. As such, we believe that a level of oversight and policy development beyond that described above is required for the Board of Regents to be able to appropriately discharge its responsibilities as fiduciaries of U.T. System assets. We also believe that in the current environment, where governance is taking center stage everywhere from public companies to not-for-profit entities (and in particular at colleges and universities across the nation), a greater level of oversight by the Board of Regents is suggested.

In recognition of a need for greater oversight and reporting, we list critical functions performed by UTIMCO and what we believe to be the appropriate level of oversight for the Board of Regents and System staff for each function. The functions are broken down into two areas: investment-related and administrative. They can be further refined as functions that require recurring oversight and those that require oversight only when policy modifications are made.

Investment-Related Functions

Asset Allocation Compliance Monitoring

The overall asset allocation is the single most important feature of the System's investment program. The Board of Regents should continue to play a role in defining asset allocation (we discuss this in greater detail in the "Investment Policy Setting" section) and monitor the actual allocations relative to the policy targets. Currently this level of monitoring is done as part of EnnisKnupp's quarterly investment performance report.

- **Function and Format:** Monitoring of compliance with asset allocation policy should be performed monthly by System staff and the Regents' investment consultants. The results of the monthly reviews should be presented to the Board of Regents on a quarterly basis.

Performance Monitoring

In order to properly evaluate if its investment objectives, as set forth in the Investment Policy Statements, are being met, some form of performance monitoring is required at the Board of Regents level.

We understand through dialogue with various Regents that the current performance report provided by EnnisKnupp on a quarterly basis is viewed as overly complex and lengthy. While such an in-depth report is useful for those interested in a deeper understanding of investment results, EnnisKnupp can streamline it to make it more relevant to the Regents' needs.

- **Function and Format:** Performance monitoring should be performed by the Regents' investment consultants. In addition to the complete fund performance report, the consultant should prepare an executive summary that addresses high level issues such as compliance with asset allocation targets and performance relative to the performance objectives. In addition to the consultant's quarterly report to the Regents, the Regents should also have access to UTIMCO management for reports on performance and related issues of interest.

Administrative Functions

Code of Ethics

According to the Bylaws of UTIMCO as last approved on August 7, 2003, the Board of Regents must approve UTIMCO's Code of Ethics and approve future amendments.

- **Function and Format:** System staff should review any proposed changes to UTIMCO's Code of Ethics and report to the Board of Regents.

UTIMCO Compensation Policy

We are not aware of any formal governing language requiring approval of UTIMCO's compensation policy by the Board of Regents. That said, we do believe that the Regents should approve such a policy. Compensation practices of corporations and not-for-profits have come under scrutiny from various interested parties in recent times. It has become a best practice for governing boards to more thoughtfully evaluate compensation policies.

- **Function and Format:** UTIMCO management is currently operating under a compensation plan that was approved by the Board of Regents for fiscal year 2003. It is our understanding that a new plan has been proposed by UTIMCO staff and approved by the UTIMCO Board. This plan, however, has not been approved by the Regents. We believe the Regents should seek an assessment of the proposed policy from internal and external resources and take the matter under consideration. Going forward, as substantive changes are made to the compensation policy, System staff should review such changes and seek outside assistance (when necessary) and report to the Board of Regents.

Budget

Section 7 (a) of the Investment Management Service Agreement requires UTIMCO:

"...to submit to the Board its proposed annual budget for the following fiscal year..." We believe it is important for the Regents to be aware of the cost structure in place at UTIMCO. As stated earlier, although UTIMCO is a separate legal entity, it is tied to the University. UTIMCO's practices and budgeting procedures should be transparent.

- **Function and Format:** In a separate section titled "Budgeting Procedures", we advocate that System staff continue to conduct a detailed budget review on an annual basis. Such a review is similar to what staff does for other departments of U.T. System. In addition to the annual budgeting process and review, from time to time a cost comparison study should be performed. The purpose of such a study would be to compare UTIMCO's total costs with those of other large funds.

Needed Resources

We understand that current System staff resources are likely not adequate to provide the level of oversight that is suggested in this report. We also recognize that the function of oversight and reporting will likely vary from time to time based upon the composition of the Board of Regents and the working dynamics between the Board of Regents and UTIMCO. Today we are in an environment that calls for improvements in oversight and reporting. We believe the Regents should identify their needs and work with System staff to find the necessary resources. Flexibility in resources is critical, however, as reporting and oversight needs will continue to change over time.

TAB 11

The University of Texas Investment Management Company Overview of Controls

This section is a compilation of documents related to internal controls at UTIMCO.

Highlights of control activities are as follows:

- Financial Controls are divided into four areas: Control Environment and Structure; A Framework for Establishing Controls; UTIMCO Controls and Objectives; and UT Investment Funds - Key Business Processes.
- The Code of Ethics governs conflicts of interest and is included for review.
- An Audit and Ethics Committee of the UTIMCO Board of Directors was established on February 1996 for the primary purpose of assisting the Board in monitoring the financial and compliance functions of UTIMCO and the investment funds managed on behalf of The University of Texas System Board of Regents.
- UTIMCO has had independent audits performed since creation in 1996 for both UTIMCO and the UT Investment Funds (PUF, GEF, LTF, PHF, SITF) as applicable.
- UTIMCO is beginning its process to voluntarily implement the relevant provisions of The Sarbanes-Oxley Act of 2002. A project team has been assembled to provide the necessary technical and administrative oversight to ensure a successful project. The project team includes representatives from UTIMCO, the UT System Audit Office, and the external accounting firm of Ernst & Young. The majority of the teams work will center on two provisions:
 - * Section 302 Certification - The CEO and CFO shall prepare a statement to accompany the audit report to certify the appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the company.
 - * Section 404 Assessment - Requires the annual report to contain an "internal control report" which 1) states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and 2) contain an assessment, as of the company's year end, of the effectiveness of the internal control structure and procedures for financial reporting. The company's auditor shall attest to, and report on, the assessment made by the company's management.

Other documents and pertinent information are included for your review and analysis.



The University of Texas
Investment Management Company

Summary of Internal Controls

Updated March 2004



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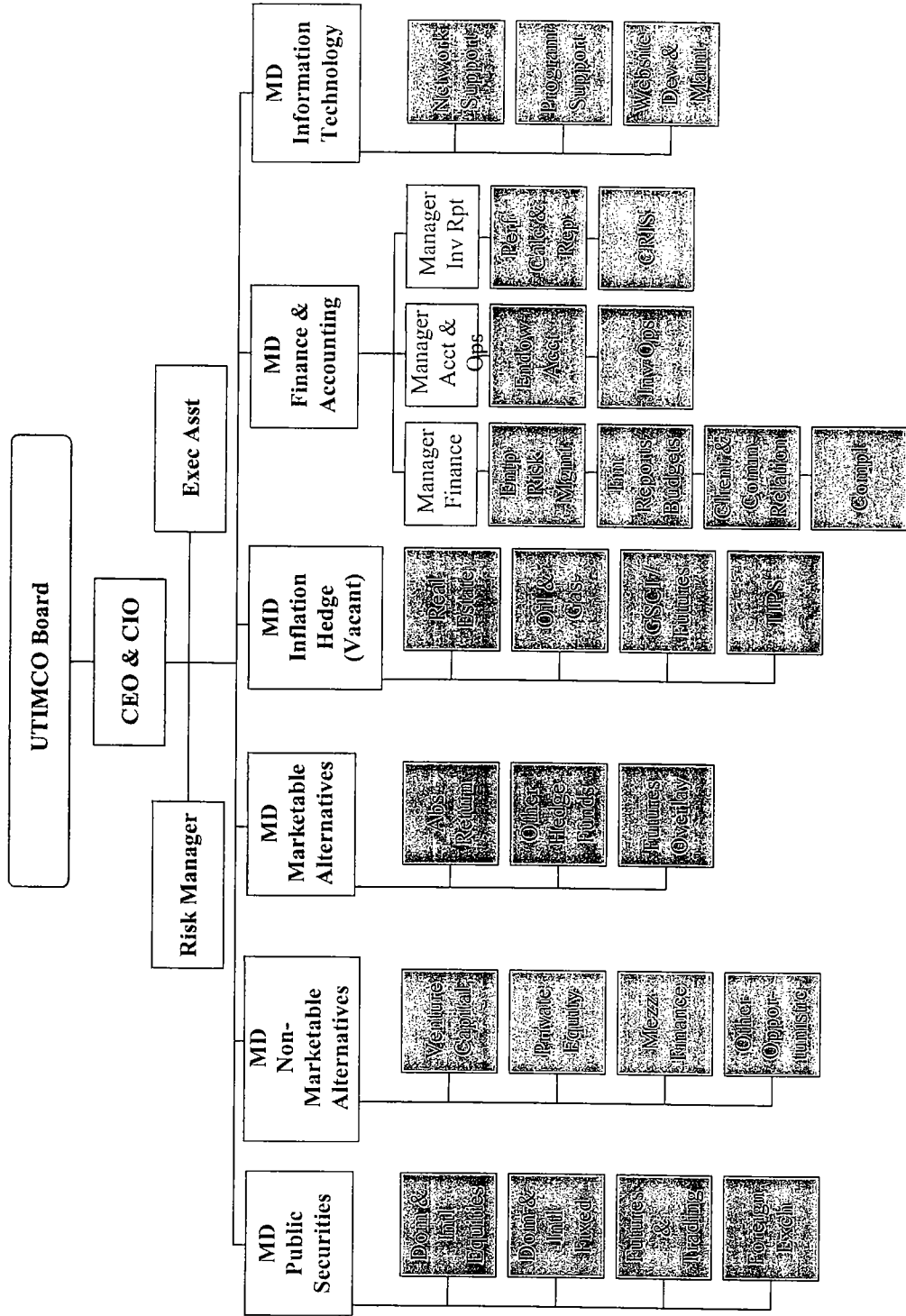
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UTIMCO Organization Chart



An Overview of Control Environment and Structure

Overview

A control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing disciplines and structure, and reflects the overall attitude, awareness and actions of the Board of Directors, management and others concerning all other components of internal controls and their emphasis within the organization. The control environment represents the collective effect of various factors, including:

- Integrity and ethical values
- Commitment to competence
- Board of Directors or Audit and Ethics Committee participation
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

Organizational Structure

UTIMCO's organizational structure provides an overall framework for planning, directing and controlling operations. Authority and responsibility is assigned within the organizational structure of UTIMCO to provide for adequate staffing, segregation of duties, efficiency of operation and adequate concentration of knowledge and skills.

UTIMCO is governed by a nine-member Board of Directors, consisting of three UT System Regents, the Chancellor of UT System, and five outside directors with experience in investment management. This structure is designed to preserve ultimate regental control of investments for fiduciary purposes and to increase the level of investment expertise in making investment decisions. Three members of the Board of Directors serve on the Audit and Ethics Committee. The committee is charged with responsibility for oversight of the financial procedures of the Corporation and Compliance with the Corporation's Code of Ethics. The Charter of the Audit and Ethics Committee further defines the committee's responsibilities.

The basic structure of the organization is laid out in the organizational chart found on the next page.



UTIMCO has the following departments:

President, Chief Executive Officer and Chief Investment Officer

The President and Chief Executive Officer is responsible for strategic and tactical business planning, administrative management including identifying and retaining senior staff members, financial management including budgeting and oversight, and operational management including compliance and enterprise risk management. The Chief Investment Officer has full responsibility for executing all investment decisions within the policy guidelines established by the UTIMCO Board of Directors including strategic and tactical asset allocation, external manager selection and termination, management of internal investment management, trading, and investment operations. The CEO provides leadership and communicates with a broad variety of key constituencies including the Board of Regents of the University of Texas System, Presidents and other leaders in the Component Institutions of The UT System, Alumna Associations, and Government leaders in Texas.

Risk Manager

The Risk Manager is responsible for all aspects of the investment risk management process at UTIMCO. The investment risk management process covers the selection and monitoring of external risk models, building risk models internally where necessary, creating and maintaining a complete risk budgeting process, designing and implementing the risk reporting process, and working with all UTIMCO MD's to successfully model risk exposures in all asset categories.

Functional Areas

Public Markets (Equity and Fixed Income)

This functional area is responsible for the investment of all "long-only" U.S. and non-U.S. equity and fixed income securities. Specific responsibilities include the research, selection, monitoring, and retention activities related to external institutional fund managers, as well as the direct active oversight and management of internal fixed income securities portfolios, cash, and select exchange-traded futures and funds (ETFs). In addition, peripheral responsibilities include the monitoring of trading activities and costs as well as the monitoring of proxy voting decisions by current investment managers.

Finally, as required, this area also provides investment and consultative support to constituencies of the University of Texas System as well as to direct UTIMCO clients.



Non-Marketable Alternatives

The Non-Marketable Alternatives (“NMA”) group manages the endowments’ private equity portfolio, which includes investments in venture capital, J.S. and European buyout, distressed debt, mezzanine, and secondary investment funds. The NMA team uses limited partnership structures for the majority of these investments, but the endowments



also own equity and debt securities of a number of private companies. As of 2/29/04, the endowments were invested with roughly 80 private equity managers through 130 different limited partnerships. In addition to monitoring these existing investments, the NMA staff proactively reviews in excess of 200 new investment opportunities each year to insure that the endowments will have access to the best private equity opportunities available.

Marketable Alternatives

Alternative Marketable Investments' mission is to select hedge fund managers of the first class by investing directly with selected hedge fund managers or by investing with a fund of hedge funds manager that offers investment opportunities to top tier emerging managers in addition to providing UTIMCO the ability to enhance internal staff skills. Based upon a hedge fund's risk return profile a hedge fund strategy shall be classified as a driver of return or a risk reducer in the endowment fund's investment policy mix. UTIMCO's dual goal in the investment implementation of hedge fund strategies is to maximize alpha within a risk controlled framework. Hedge fund investments must be analyzed and monitored appropriately to insure that the potential benefits outweigh the risk. The key to success is to follow a methodology in constructing, implementing and monitoring hedge fund investments within the Alternative Marketable Investment's program.

Inflation Hedging

The role of Inflation Hedging assets is the counterparty of Deflation Hedging assets, which at UTIMCO is made up of government and government agency fixed income securities. While fixed income securities provide a hedge against a weak economy, and lower prices or deflation, Inflation Hedging assets should provide protection to the portfolio, should higher prices and inflation occur. Higher inflation would not only have a negative effect on the value of fixed income securities, but also would hurt the values of public equity investments, as a dollar received in the future through higher dividends and stock prices would have to be discounted by higher prices.

Over longer periods of time the value of Inflation Hedging assets should move upward as inflation increases. There are several investment alternatives available to hedge against inflation. They include both public and private real estate, whose market values and rents should move with inflation over longer periods of time. Also included are investments in commodities such as oil, gas, and lumber, which can be achieved through direct private investment, or through the use of commodity indices such as the Goldman Sachs Commodity Index. Finally, inflation can be hedged by using Treasury Inflation Protected Securities (TIPS), which are fixed income securities whose value moves with the United States consumer price index (CPI).



Accounting and Operations

This functional area is responsible for the accuracy, timeliness, and efficiency of all accounting and security operation functions of all investments under UTIMCO's management. This area provides adequate and useful accounting and investment reporting (including performance) of the Funds, individual endowments, and charitable trusts to all external and internal parties. In addition the area provides performance measurement and risk reporting; monitors and reports investment compliance; supports the investment data needs of the organization; maintains an effective internal control for accounting and operations; facilitates the settlement of all cash and security movements; and assists the internal managers with portfolio maintenance and transaction processing.

Finance and Administration

This functional area is responsible for monitoring UTIMCO finances, enterprise risk management, compliance, administration, public and governmental relations, and client service. This area also provides administrative support to other functional areas within the organization.

Information Technology

Network and Desktop Support -- This area makes recommendations for all devices to provide a safe and efficient working environment, and performs necessary maintenance routines to ensure all machines and software products are functioning properly and as expected.

Software Development -- This area develops and maintains applications determined to be beneficial to UTIMCO and its objectives. Applications are designed to utilize the latest proven methods and resources for performance and maximization of delivery. Development will be constrained to avoid proprietary languages and processes to be able to utilize a broader range of resources.

Software Support -- Software Support analyzes and recommends third party software as the opportunity arises whether the request is initiated by a department within UTIMCO or through the area's own investigations, and also provides the necessary interfaces and hardware support, and maintains an IT contact with the appropriate vendor.

A Framework for Establishing Controls

The control structure at UTIMCO is modeled after the framework for evaluating internal controls that is contained in the report of The Committee of Sponsoring Organizations of the Treadway



Commission (COSO). This is most commonly used and understood framework; one that establishes a broad definition of internal control that extends to all objectives of an organization.

The COSO report, along with guidance received from Ernst & Young and the UT System Audit Office, serve as the framework for Internal Controls at UTIMCO. This framework consists of the following subject categories:

- Primary Objectives
- Accounting and Control Systems
- Characteristics of Reliable Control Systems
- Specific Components of an Effective Control System

Primary Objectives

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and Efficiency of Operations
- Reliability of Financial Reporting
- Compliance with applicable Laws and Regulations

Accounting and Control Systems

An entity's management is responsible for designing, installing, and operating an accounting system. Likewise, management is responsible for establishing and maintaining a system of internal control. Continuous supervision and modification, when necessary, are also elements of the management responsibility. The distinction between an accounting system and a control system will help clarify the frame of reference. An accounting system is a series of tasks by which transactions are processed and records and account balances are produced. It simply accounts, and it does not necessarily guarantee accuracy of the accounting. An internal accounting control system consists of a set of techniques, the overall purpose of which is to protect assets from theft of loss and to ensure the material accuracy and reliability of financial records.

Characteristics of Reliable Control Systems

The important characteristics of reliable systems are:



- Personnel of a quality commensurate with their responsibilities
- A plan of organization which provides appropriate segregation of functional responsibilities
- A system of authorization, objectives and techniques, and supervision adequate to provide accounting controls over assets, liabilities, revenue and expenses
- Control over access to assets and over access to important documents and blank forms
- Periodic comparison of records with actual assets and liabilities and action to correct differences.

Components of an Effective Control System

Internal control consists of five interrelated control components, which are:

- Control Environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing disciplines and structure.
- Risk Assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
- Control Activities* are the policies and procedures that help ensure that management's directives are carried out.
- Information and Communication* are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- Monitoring* is a process that assesses the quality of internal control performance over time.

The components of internal control, which are needed to achieve the objectives, have a direct relationship with objectives, which are what an entity strives to achieve.

Internal controls, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty and that any breakdowns in internal control can occur because of such human failures as simple error or mistake. Controls can be circumvented by the collusion of two or more people or management's override of internal control. Another limiting factor is that the cost of an entity's internal control should not exceed expected benefits.

Control Environment

Factors include:



- a) Integrity and ethical values
- b) Commitment to competence
- c) Board of Directors or Audit Committee participation
- d) Management's philosophy and operating style
- e) Organizational structure
- f) Assignment of authority and responsibility
- g) Human resource policies and practices

Risk Assessment

The purpose of an entity's risk assessment is to identify, analyze, and manage risks that affect entity objectives.

Control Activities

Control activities may be categorized as policies and procedures that pertain to the following:

- a) Performance revenue
- b) Information processing
- c) Physical controls
- d) Segregation of duties

Information and Communication

Management has written procedures and procedures. The company should have appropriate by-laws and Audit and Ethics Committee charters. Staff should understand the rules, regulations, and policies that govern the organization to ensure that they carry out their responsibilities. Proper documentation should be maintained in files so that staff can access, if necessary, to carry out their responsibilities.

Monitoring

Monitoring activities include:

- Documentation in files that procedures have been performed, including preparation and review sign-offs.
- Documentation outlining the controls and compliance issues of the organization, and a designated individual monitors the organization by following the documentation on a monthly basis, or other appropriate time frame.



Summary of Internal Controls

A Framework for Establishing Controls

- Individual discussions with personnel by designated individual to determine first hand the procedures being followed.
- External audit reviews.
- Internal audit reviews.

Attached in Appendix 1 and 2 are more details on the controls and key processes for both UTIMCO and the UT Investment Funds. Both sets of detailed business processes have been included to provide a comprehensive picture of the control structure at UTIMCO.



Overview

In an effort to ensure adequate controls, we have developed objectives and controls to guide each functional area within the finance operations spectrum. Specifically, objectives and controls have been prepared in the following areas:

- Expenditures
- Revenue Collection
- Human Resources
- Payroll
- Fixed Assets
- Accounting and Reporting

Staff Resources

The responsible staff performing these functions are:

- Joan Moeller, CPA Managing Director
- Greg D. Lee, CPA Manager, Finance & Administration
- Dianne Watson Office Manager
- Rebecca Jennings Administrative Assistant
- Mesha Barnes Office Associate
- Kim Burk Office Associate

Expenditures

UTIMCO's major expenditure is payroll and payroll related costs. Other significant expenditures are lease expense and fixed asset expenditures for computer and office equipment. The following objectives and controls have been established:

Objective – Controls should provide reasonable assurance that all expenditures are authorized and that all expenditures are for legitimate products, services, or assets benefiting UTIMCO.

Expenditures are reviewed and approved by authorized personnel. Authorization limits and personnel are designated in the UTIMCO Business Processes. Before invoices are paid, an individual authorized to review and approve the designated expenditure must sign and date the invoice, noting approval. Management and staff having any questions regarding the nature or legitimacy of an expenditure should immediately be directed to the Manager of Finance and Administration for appropriate action.



Objective – Controls should provide for proper segregation of duties, especially for invoice approval, vendor maintenance, and processing and preparation of checks.

The Office Manager prepares all the operating checks. This is performed by using the payment mechanisms in the Solomon accounting software currently used by the organization. The Office Manager does not have check signing authority on any of the bank accounts. When the Office Manager presents the check for signature, the approved invoices or other documentation must accompany the checks. The authorized check signers are responsible for comparing the checks to the appropriate documentation. After the checks are signed, the checks and invoices or other documentation are returned to Office Manager, who works with one of the Office Associates to prepare the checks for mail by stuffing the envelope with check and invoice. The sealed envelope is put in the "to be mailed" basket by the reception desk. The receptionist meters and mails the envelopes. Although the Office Manager has periodically trained other individuals to handle Accounts Payable, these individuals are no longer employed by UTIMCO so the Office Manager has remained in the Accounts Payable process. An Office Associate has been trained to code all invoices with correct general ledger accounts, separating invoices into batches by month for input into Solomon, entering invoices and printing edit reports for review by the Office Manager. This Office Associate also processes invoice batches. However, the Office Manager continues to write the checks. To help ensure a strong segregation of duties, the Manager of Finance and Administration opens and reviews all bank statements and related supporting documentation, specifically to include the review of all cancelled checks for tampering.

Objective – Controls should provide for safekeeping of blank check stock.

All checks are kept in a locked file cabinet in Office Manager's office. This office remains locked when she is away from the office.

Objective – Controls should provide for the monthly reconciliation of the UTIMCO bank accounts and reconciliation items should be researched and cleared on a timely basis.

The Manager of Finance and Administration opens the bank statement and performs his review. After his review, he forwards the statement(s) to the Office Manager. The Office Manager prepares the monthly bank reconciliations. The Office Manager researches and clears reconciliation items on a timely basis. The Manager of Finance and Administration reviews and approves the bank reconciliation during the monthly review of the monthly accounting and reporting package.



Revenue Collection

The main source of revenue is the management fee paid by the investment funds managed on behalf of the U.T. Board of Regents:

- The Permanent University Fund
- The University of Texas System Long Term Fund
- The Permanent Health Fund
- The University of Texas System Short Intermediate Term Fund

Other sources of income include interest and dividend income, directors' fees, service income, and open record fee income. The following objectives and controls have been established:

Objective – Controls should provide reasonable assurance that the approved amount for the quarterly management fee has been billed in a timely manner and wired into the UTIMCO money market account.

Administrative staff prepares the management fee invoice approximately two weeks before the due date. This invoice is reviewed by the Manager of Finance and Administration for accuracy against the amount of the approved budget. The UTIMCO Budget and Management Fee is approved by both the UTIMCO Board of Directors and U.T. System Board of Regents. The invoice is billed quarterly and is due on the first business day of the fiscal quarter. The invoice is sent to U.T. System as a reminder that the fees will be paid. The UTIMCO Manager of Finance and Administration signs the letter notifying the U.T. System of the payment request. Since UTIMCO has disbursement authority over the Fund accounts, the Manager of Portfolio Accounting and Operations initiates the wire transfer on the first business day of the quarter from each of the funds to the UTIMCO money market account.

Objective – Controls should provide for the reasonable assurance that UTIMCO is receiving the correct amount of interest on money market accounts and is deposited for credit to UTIMCO.

Interest is received on the Dreyfus Institutional Preferred Money Market Fund account and is credited at each month end. UTIMCO receives the daily rates on the Dreyfus account and is able to recalculate the interest received. Additionally, the Funds' money market accounts are invested in the same Dreyfus pool and the Funds receive information on the Dreyfus pool to monitor performance.



Objective – Controls should provide for the reasonable assurance that UTIMCO is receiving the correct amount of dividend income and realized/unrealized gains (losses) on its investment in the Short Intermediate Term Fund.

Earnings from UTIMCO's investment in the Short Intermediate Fund (both dividend income and realized/unrealized gains (losses)) is automatically reinvested in the fund. Monthly reports are generated and reviewed by the Manager of Finance and Administration. Necessary journal entries to post the monthly activity are provided to the Office Manager.

Objective – Controls should provide for reasonable assurance that all other income (checks and cash) should be properly safeguarded upon receipt and credited to UTIMCO's operating cash account on a timely basis.

UTIMCO's operations are such that limited amounts of checks and cash are received. UTIMCO may charge for open records request and the Office Manager prepares manual invoices when this occurs. The Office Associate prepares the deposit slip and deposits it. The Office Manager reconciles manual invoices with deposit slip and general ledger balance. Directors' fees represent fees to UTIMCO employees who serve on various boards of directors in investment advisory roles. Their appointments to the various boards coincide with UTIMCO's authority to act for the Board in the investment of the Funds. Employees assign all directors' fees to UTIMCO. UTIMCO may receive service fees from investment promoters or investee companies in consideration of the UTIMCO staff's private investment activities and/or investment origination activities. These service fees are considered additional revenue to UTIMCO. Historically, directors' fees and service fees have been very limited and sporadic. Upper management is involved and they're responsible for following the requirements of their job.

Human Resources

UTIMCO has approximately 40 employees whose sole purpose is the management of investment assets under the fiduciary care of the Board of Regents of The University of Texas System. UTIMCO has policies and procedures to help guide staff and provide relevant and timely training to help educate and assist all employees in their fiduciary responsibilities. This includes ethics and compliance training. UTIMCO also has developed procedures to help evaluate employee performance and assist them in their growth as an employee of UTIMCO. The following objectives and controls have been established for the Human Resources functional area:

Objective - Employees understand and follow UTIMCO's Code of Ethics



Annually, each employee is required to attend compliance training. Included in compliance training, is review of the Code of Ethics. The Chief Compliance Officer or designee reviews the document and highlights certain areas. Employees are required to read the document and sign a statement that they have received and read the Code of Ethics and have complied with the policies set forth. Each employee is required to return the signed acknowledgment to the Office Manager, or her designee, by January 31st of each year. New employees hired during the year are also required to read the Code of Ethics and abide by them. For the staff members hired during the year, the ethics compliance statement must be signed and returned within sixty days of employment.

Objective - Employee's duties and responsibilities are clearly defined.

Each employee has a job description that outlines the position's duties and responsibilities. Job descriptions are updated based on promotions and other changes in the employee's duties. Duties and responsibilities are evaluated annually at the time of the employee's evaluation.

Objective - Employees perform their job to the best of their abilities and are meeting management's expectations.

Employees are given annual written performance evaluations and compensation reviews in conjunction with the fiscal year for UTIMCO. Goals and objectives are reviewed during this process so the employee knows what is expected for the next year, as well as being evaluated on meeting their objectives for the previous year. Any deviation from the performance appraisals and compensation review cycle must be with the written approval of the President and CEO.

Objective – Employees are made aware of all UTIMCO Policies and Procedures.

New employees are provided a UTIMCO Employee Handbook on their first day with the organization. Current employees are provided an update to this handbook as often as necessary, but at least annually (usually during an annual compliance meeting held in January of each year). During a new employee's orientation and during UTIMCO's annual compliance training in January, important matters and changes are highlighted and discussed with all staff. Each employee is required to sign an acknowledgement that they have attended the training, received a copy of the updated handbook, and had an opportunity to address questions they may have.

Objective – Hiring practices reasonably ensure that qualified candidates are hired.

Resumes are collected and screened for all new job postings. They are reviewed by staff within the hiring department to determine the top candidates. Brief telephone interviews are conducted with the top candidates to help ensure the top candidates are selected and



also to ensure their continued interest in the available position. If this interview goes well, a personal interview time is set up. This interview may be with several employees of the specific department. Simultaneously, the Office Manager will check education credentials from the resume. Reference checks will be made on the top one or two candidates and a second interview may be necessary for them to meet with the appropriate managing director and/or president prior to a final selection being made.

Payroll

UTIMCO exempt employees are paid monthly on the last day of the month. Non-exempt employees are paid on a semi-monthly basis, usually on the 15th and the last day of the month. UTIMCO does not have a separate payroll department. Payroll functions are performed by the Office Manager and reviewed by the Manager of Finance and Administration.

Objective – Documentation supporting all employees hired or terminated are completed and forwarded to the Office Manager, who performs the payroll functions.

Department Managing Directors and department Managers notify the Office Manager of all new hires or terminations. Conditions of hire are documented by the manager and accepted by the new hire. This information is submitted to Office Manager who completes the appropriate information, ensures appropriate manager approval, and maintains personnel files for all staff. Normal terminations are handled in the same manner. Sensitive terminations are addressed by upper management with appropriate information and documentation submitted to Office Manager.

Managing Directors and department Managers submit appropriate documentation to the Office Manager for all new hires. For terminations, a payroll change form is prepared and submitted along with a separation date and any final payroll instructions for accrued vacation, etc.

Objective – All employees receiving payroll checks exist.

Due to small size of UTIMCO, the likelihood for fictitious employees is minimal. However, appropriate controls have still been put in place. The Office Manager reconciles employees' salaries to general ledger account balance. This is verified and reviewed by the Manager of Finance and Administration. Each employee's salary is documented on the payroll change form that is approved by the employee's manager. If an employee has been terminated, the Office Manager is included in the process to ensure appropriate steps are taken, regardless of whether the termination is voluntary or involuntary.

Objective – Employees are paid their approved salaries, overtime, and bonuses.



Time sheets are prepared and signed by employees and are reviewed, approved, and signed by their supervisor. The Office Manager enters the information into the ADP system and reviews final payroll reports prepared by ADP, the outside payroll processor. This information is reviewed by the Manager of Finance & Administration both before and after each payroll batch comes back from ADP. At year-end (August 31st), a schedule is prepared documenting the total salary paid to each employee and total of this schedule is confirmed to agree to the general ledger. The President/CEO approves all staff bonuses other than those for the Managing Directors and the President/CEO. The UTIMCO Compensation Committee is required to approve staff bonuses for the Managing Directors and the President/CEO. The President is authorized to approve individual salary increases (except his own, which must be approved by the Compensation Committee of the Board of Directors). The Compensation Committee activity is ratified by the UTIMCO Board of Directors.

Objective – Authorization for deductions are documented.

The Office Manager maintains the payroll and personnel files documenting any deductions, including the W9 for withholding. The employee completes appropriate forms to allow 403b and insurance deductions for family coverage, additional life insurance, etc.

Objective – Reasonable segregation of duties in the processing of payroll, handling of checks, signature of checks, and payroll bank reconciliations.

Due to the limited number of employees, only two individuals are involved with the payroll and reconciliation process: the Office Manager and the Manager of Finance & Administration. The Office Manager processes payroll through ADP and verifies the accuracy. The Manager of Finance and Administration reviews each payroll to ensure that the correct salary is paid and overtime is paid according to timesheets. Most employees are paid through direct deposit. The Office Manager distributes the nonnegotiable pay stubs to the employees. If a check is necessary due to employee not having direct deposit set up, two signatures are required for checks over \$1,000. The Manager of Finance & Administration opens and reviews the bank statements and initials to document the review and approval. The Office Manager reconciles the bank account. The Manager of Finance & Administration reviews the bank statement and reconciliation during the review of the monthly accounting package.

Fixed Assets



Objective – Fixed assets exist and are properly recorded

Detailed property records are kept by the Office Manager to support the general ledger balance. The detailed records are agreed to the general ledger on a monthly basis. Invoices support all fixed asset additions added to property records. Capitalization policy has been set at \$300 and greater. Deletions and/or disposals are forwarded from approved department managers. An annual inventory of fixed assets is taken and reconciled to the detailed property records. Exceptions are researched and appropriately documented.

Objective – Expenditures for fixed assets are authorized.

UTIMCO uses a two step process to authorize expenditures for fixed assets. Based on the limits outlined in Expenditures, prior approval is obtained from a Managing Director or the President and CEO. This written approval documents that the purchase is authorized. If the vendor requires a purchase order, the signed purchase order can also provide authorization. Once the actual invoice is received and is matched with the written approval documents, it is matched with the packing slip indicating receipt of merchandise. Packing slip (or invoice if not packing slip) is documented with date merchandise received and signature of employee receiving. The IT Managing Director or the Manager of Finance and Administration approves the payment of invoices with a signature and date.

Objective – Controls should provide for approved disposal of fixed assets and proper notification and recording of deletions in the detailed property records.

UTIMCO surpluses equipment at least annually. The IT Managing Director (computer and related equipment) and Office Manager (office equipment) each provide a list of surplus equipment to President/CEO for approval to discard. As outlined in the Business Process memorandum, the IT Manager and Office Manager follow certain guidelines to determine appropriateness of surplus. UTIMCO may sell the equipment through an employee lottery. The employee lottery allows all employees who participate in the lottery the option of purchasing the surplus equipment. The IT department will price the equipment based on third party sources. The lottery determines the order of employee selection of purchase. If items are not sold through the lottery, the equipment will be given to a 501(c) 3 organization. The equipment purchased by employees is not allowed to leave the premises without the Office Manager receiving payment for the items. Appropriate sales tax is collected at the time of sale.



Certain equipment may be used as trade-in, such as copiers. If trade-ins are allowed, the Office Manager appropriately records the transaction in the general ledger and fixed asset schedule.

Equipment that is deemed completely worthless (broken, not repairable, obsolescence has rendered useless, etc.) is discarded with Managing Director or Manager approval.

Objective – Controls should provide for proper depreciation of fixed assets

Fixed assets are depreciated over the estimated life of the asset using the straight-line method. Software and computer equipment is depreciated over three years. Other equipment and furniture is depreciated over five years. Leasehold improvements are depreciated over the term of the lease. The depreciation is maintained on the detailed property records kept by Office Manager and reviewed by the Manager of Finance and Administration.

Objective – Controls should provide for the safekeeping of assets against theft

Individuals may enter UTIMCO's office space by way of two entrances. The main entrance to UTIMCO (south side) always has an individual stationed at the reception desk. The other entrance (north side) remains closed and can be entered only by a staff member using a valid office access card. The UTIMCO main entrance is open from 8:00 to 5:00 during the work week. Since UTIMCO employs less than 40 people, outsiders are quickly noticed if someone did slip by the receptionist. Due to the nature of UTIMCO's fixed assets (furniture, office and computer equipment), most items would be quickly missed if stolen from the outside and it would be very obvious if an unauthorized person was removing fixed assets. If employee or other theft occurred over the weekend or outside of normal working hours, most items would be missed immediately. Surplus computer equipment would possibly not be detected until the physical inventory. However, this equipment has very little value since it is obsolete and is either being donated or is part of the employee inventory sale.

Objective – Fixed assets have adequate insurance coverage

The Office Manager and the Manager of Finance and Administration oversee the insurance renewal process each year. A part of that renewal process includes the analysis and valuation of fixed assets and a comparison to the amount of property and casualty insurance carried by the organization. The amount of this coverage is then approved by the Managing Director of Accounting, Finance, and Administration, with concurrence by the President and CEO.



Accounting and Reporting

Objective – All revenue, expense, assets and liabilities have been properly reported in UTIMCO's general ledger

UTIMCO utilizes the Solomon accounting system to maintain its general ledger. The Office Manager and assigned Office Associate enter invoices through the accounts payable system. The Office Manager posts payroll activity through an interface transaction. These transactions are automatically created in the general ledger. Other entries are made through general journal entries. These include depreciation, cash transfer between accounts, prepaid expense amortization, and revenue items. All balance sheet accounts must be supported by reconciliations or detailed account analysis. The Manager of Finance and Administration reviews and approves the monthly accounting package.

Objective – Monthly financial statements are prepared on a timely basis.

Financial statements are prepared by the 20th of each month unless additional time is requested by the Office Manager. The extension of time is approved by the Manager of Finance and Administration. The Manager of Finance and Administration, as the primary reviewer, is responsible for reviewing the monthly accounting package in a timely manner to not delay preparation of the monthly financial statements. Financial statements include footnote disclosures. A report is also run comparing actual to budget and actual to prior year actual. The Office Manager is responsible for documenting significant variances. Annual financial statements are audited by an external CPA firm. The Managing Director of Accounting, Finance, and Administration performs the final sign-off, review, and approval of the UTIMCO corporate financial statements.

Objective – Accounting ledgers and all reporting should be prepared in accordance with generally accepted accounting policies

The Office Manager is knowledgeable in the basic requirements. She consults with Manager of Finance and Administration with questions. The Manager of Finance and Administration has overall responsibility that generally accepted accounting policies are being followed in preparation of the financial statements. UTIMCO does not have any complicated accounting issues. However, the Manager of Finance and Administration will review any issues with the Managing Director of Accounting, Finance, and Administration and/or the external auditors to determine the proper accounting treatment of transactions.



UT Investment Funds – Key Business Processes

UTIMCO manages, pursuant to an Investment Management Services Agreement with the UT System Board of Regents, the Permanent University Fund, the Long Term Fund, the Permanent Health Fund, the General Endowment Fund, the Short Intermediate Term Fund, Short Term Fund, Separately Invested Assets, and the Institutional Index Funds. The day-to-day operational responsibilities of the Funds are delegated to UTIMCO. The fiduciary for the management of the Funds remains with the Board of Regents as designated by the Texas Constitution and various state statutes.

The key business processes are detailed on the following pages. A listing of these key processes is detailed below:

- **Investment Management**
 - Procedures for Private Investment Stock Distributions
 - Standard Procedures for UT Invest
 - DTC Confirm Procedures
 - External Manager Trade Processing
 - Securities Valuation
- **Pricing**
 - Price Sources
 - Price Sources and Frequencies
 - Methodologies
 - Price Exceptions
 - Indices Used
 - Month End Reconciliation and Price Overrides
- **Valuation Criteria for Alternative Assets**
 - Private Investment Valuation Procedure
 - Monthly Sign-Off Procedures
- **Internal and External Managers**
 - Internally Managed Fixed Income Guidelines and Restrictions



- External Manager Due Diligence Questionnaire

- **Monitoring and Compliance**
 - UT Investment Funds (PUF, LTF, GEF, PHF, SITF, STF)
 - Securities Lending
 - External Investment Manager Agreement
 - Miscellaneous Compliance Issues
 - Compliance Summary Report
 - Compliance with Investment Policies

- **Miscellaneous Key Processes**
 - Safekeeping and Reconciliation
 - Fund Expenditures
 - CRT Distributions
 - Beneficiary Disbursements
 - Income Collection
 - Controls with Custodian

More detailed information about each of these key business processes is contained in Appendix 2 attached to this report.



Code of Ethics and Conflicts of Interest

Policies

The policies governing conflicts of interest are included in the UTIMCO Code of Ethics. This document is reviewed annually by staff, outside legal counsel, and the UT System Office of General Counsel. It is then approved by the UTIMCO Audit and Ethics Committee, the UTIMCO Board of Directors, and the UT System Board of Regents.

Procedures

Ethics Compliance Statement - The UTIMCO Code of Ethics requires that all directors and employees, including acting or interim employees, execute an ethics compliance statement on or before January 31 of each year, and within sixty days of their appointment or employment. They are certifying that they:

- have received and read a copy of the Code;
- are in compliance with its provisions;
- have not violated the provisions of the Code, except as otherwise disclosed previously to the UTIMCO Ethics Committee or Audit and Ethics Committee of the Board;
- recognize it is their duty to report any acts by other directors or employees when they have knowledge of violations of the Code;
- recognize it is their duty to update this statement if a change in circumstances occurs which requires reporting under the Code.

Key employees are required to sign a separate Ethics Compliance Statement acknowledging that they are a Key Employee and subject to more stringent requirements. These statements are reviewed by the Chief Compliance Officer or designee.

Financial Disclosure Statement - All UTIMCO directors and employees shall a financial disclosure statement disclosing the following information regarding themselves, their spouses, and their dependent children:



- Names of corporations for which you or your spouse serve as a member of the governing body in the capacity of a director, advisor, trustee, or officer.
- Names of any partnership, limited partnership, or other business entity where you have a 5% or more interest, or receive income which represents more than 5% of your gross income.

These statements are reviewed by the Chief Compliance Officer or designee.

Texas Ethics Commission Filings – Those UTIMCO Board members who also serve on the UT Board of Regents are required to file detailed financial statements with the Texas Ethics Commission. Copies of that information are obtained each year directly from the Texas Ethics Commission. These statements are reviewed by the Chief Compliance Officer or designee.

Pre-Clearance of Trades – As required by the Code of Ethics, no employee may engage in a personal securities transaction without obtaining pre-clearance for each such transaction with the Chief Compliance Officer. The Chief Compliance Officer shall verify that no buy/sell order has been placed by a UTIMCO internal manager. If a buy/sell order has been placed, no employee may conduct a personal securities transaction until one trading day after the buy/sell order has been completed or canceled. Pre-clearances will be documented by the Chief Compliance Officer in a personal securities transaction log for each employee, which will provide a record of all requests and approvals or denials of pre-clearances for personal securities transactions. Pre-clearance for personal securities transactions is effective for one trading day only.

An employee who engages in personal securities transaction must also provide transactional disclosure for each such transaction. Transactional disclosure forms must be completed for all personal securities transactions and given to the Chief Compliance Officer within ten calendar days of the trade date. The transactional disclosure form must contain the following information: name and amount of the security involved, date and nature of the transaction, price at which the transaction was effected, and name of the broker through whom the transaction was effected.

The pre-clearance and transactional disclosure requirements for personal securities transactions apply only to equity or equity-related transactions, including stocks, convertibles, preferreds, options on securities, warrants, rights, etc., for domestic and foreign securities, whether publicly traded or privately placed. The pre-clearance and transactional disclosure requirements do not apply to bonds (with the exception of convertible bonds), mutual funds, co-mingled trust funds, financial futures, and options on futures.

Certificates of Compliance - When UTIMCO considers entering into an agreement or transaction with a general partner for a particular fund we have to notify the UTIMCO Board of Directors and the UTIMCO key employees of this intention. The Board of



Directors and the key employees will in turn notify us if they do or do not have a pecuniary interest in the transactions or business entity. These statements are reviewed by the Chief Compliance Officer or designee.

Disciplinary Action Disclosure - The UTIMCO Code of Ethics requires that all directors and key employees file a disciplinary action disclosure statement setting forth any proceedings, actions, or hearings by any professional organization or other entity involving the director or key employee. These statements must be submitted to the UTIMCO Chief Compliance Officer by January 31st of the first year of designation as a director or key employee, or for those persons already serving as a directors or key employees on the effective date of this Code on each January 31st following the effective date. These statements also must be updated promptly if any action occurs which would cause a director's or a key employee's answers to change.

Compliance Training – Governed by the UTIMCO Compliance Training Policy. Required to be completed by January 31st of each year. This training is conducted by the Chief Compliance Officer and includes:

- Review of the employee handbook in which written confirmation is requested from each employee attending the training acknowledging that they have read the employee handbook.
- Review of UTIMCO's Code of Ethics Policy requesting receipt by UTIMCO's Chief Compliance Officer for all required disclosure statements and documents.
- Review of UTIMCO's policy on the appropriate use of computers and software.
- Review of UTIMCO's Intranet site for information and related links.

**A Copy of the UTIMCO Code of Ethics is attached
As Appendix 3 of this report.**



Audit and Ethics Committee

Background

The UTIMCO Board of Directors established an Audit and Ethics Committee on February 22, 1996. On July 15, 1996 the Board adopted certain resolutions regarding, among other things, the Corporation's Audit and Ethics Committee Mandate. This Mandate was superseded by the Audit Charter adopted by the UTIMCO Board on June 29, 2000, and amended on June 26, 2003.

Purpose

The primary purpose of the Committee is to assist the Board in monitoring the financial and compliance functions of the Corporation and the investment funds managed on behalf of The University of Texas System Board of Regents.

Composition

The Committee is comprised of three members of the Board; with members being appointed by a majority of the UTIMCO Board and approved by the U.T. Board of Regents. Members of the Committee must be independent and financially literate.

Functions, Duties and Responsibilities

- Oversight and Review of Financial Statements,
- Monitor Internal Controls, and



- Selection of Independent Auditors, and
- Oversight of the Corporation's Code of Ethics

More Detailed Information about the role and responsibilities of the Audit and Ethics Committee can be found in the Charter of the committee that is included as Appendix 4 of this report.

Audited Financial Statements

Beginning with the creation of UTIMCO in 1996, independent audits have been performed each year, if applicable, for both UTIMCO and the UT Investment Funds (PUF, GEF, LTF, PHF, SITF).

The independent external auditor for the periods March 1996 through August 31, 2002 was the international accounting firm of Deloitte & Touche, LLP. The international accounting firm of Ernst & Young, LLP performed the audit for the year ending August 31, 2003 and has been engaged to perform the audit for the year ending August 31, 2004.

Audit Results and Communications

Auditing standards require that the external auditor to report on the Audit Results and Communications each year.

In each year since UTIMCO's creation in 1996, the audits received an unqualified opinion from the external auditors. This means that the financial statements present fairly, in all material respects, the financial position and results of operations in accordance with accounting principles generally accepted in the United States.

In addition, the external auditor is required to report on Internal Controls. Except for items listed below, the external auditors found no weaknesses in internal controls and offered no suggestions or improvements to the organizations control structure and processes.

1996 and 1997 Findings – During the creation of UTIMCO and the transition of custodians, there were three findings identified by auditors. These findings (implement an archive system for private equity investment documents, dividend income posted to



the wrong fund for one security, and pricing error of one fixed income security) were addressed and resolved in a timely manner.

Board Valuation Policy – In 1999 UTIMCO staff asked the external auditors to review the UTIMCO Board of Directors’ policy for valuing private equity investments. As a result of this review, it was recommended that UTIMCO adopt a policy change to update its private equity valuations at August 31st of each year for activities that may have taken place since the last valuations were received from the partnerships. UTIMCO agreed with this recommended policy change and subsequently implemented the new policy.

In each of the last 4 years (2000 through 2003), external auditors have conducted there review and audit; no control weaknesses have been identified.

Commitment to Sarbanes-Oxley

Overview

Congress passed the Sarbanes-Oxley Act of 2002 in response to a lapse in integrity in senior management in publicly held corporations. Its provisions include what is now considered best practices” in the area of effective stewardship and corporate accountability. Although not required to comply with this act, UTIMCO has chosen to voluntarily comply with applicable provisions in a continued effort to demonstrate its commitment to integrity in financial operations and reporting. The provisions applicable to UTIMCO fall into three categories:

- Auditor Independence
- Corporate Responsibility
- Enhanced Financial Disclosures

Project Plan Overview

Section 302 Certification – Consistent with the IMSA Agreement executed with the UT Board of Regents, UTIMCO will comply with this provision beginning with the year ending August 31, 2004.

Section 404 Evaluation and Attestation – Consistent with recent guidelines issued by the Securities and Exchange Commission (SEC), UTIMCO will formally comply with this provision beginning with the year ending August 31, 2005. However, in the meantime the Project Team is continuing its efforts to document internal controls and operating procedures, evaluate and assess key controls, and make process improvements. All of this designed to ease the transition to formal compliance with Sarbanes Oxley as we move into the next fiscal year.



Project Team

A project team has been assembled to review, evaluate, and implement the relevant provisions of this legislation. The team will be establishing ground rules for responsibilities, documentation, and timelines critical to the overall success of the project. The team consists of Project Sponsors and Team Members as detailed below.

- **Project Sponsors** – The role of project sponsors is to (1) emphasize the importance attached to the successful completion of the project, and (2) increase the likelihood that communications from the project team will be given a high priority throughout the company. UTIMCO project sponsors are:

Bob Boldt President, Chief Executive Officer, and Chief Investment Officer

Joan Moeller Managing Director of Accounting, Finance, and Administration

- **Project Team** – The function of the project team is to plan and supervise the development, staffing, and execution of the company's internal control evaluation. The team will design the evaluation and recommend who is to be involved, what allocation of company resources will be necessary, and how the evaluation is to be completed. The core project team consists of:

Greg Lee, CPA – Team Leader

Manager – Finance and Administration – UTIMCO

Sandra Neidhart, CPA

Assistant Director of Audits – UT System

Ricky Richter, CPA

Partner, Ernst and Young, LLP

Gary Hill, CPA

Manager of Investment Reporting – UTIMCO

Debbie Childers

Manager of Portfolio Accounting and Operations – UTIMCO

Rebecca McManamy, CPA

Senior Accountant and Business Analyst - UTIMCO

Michael Rackett, CIA

Security Operations Assistant and Audit Specialist – UTIMCO

Dana Malone

Assistant Controller – UT System Office of Finance



**The Project Team's detailed Implementation Plan
is included as Appendix 5 of this report.**



UTIMCO Risk Assessment Initiative

All entities, regardless of their size, structure, nature, or industry, encounter risks at all levels within their organization. Risks affect a company's ability to survive; successfully compete within its industry; maintain its financial strength and positive public image; and maintain the overall quality of its products, services, and people. There is no practical way to reduce risk to zero. In fact, just the decision to be in business creates risk. However, management must continually determine how much risk is to be prudently accepted, and strive to maintain risks within those levels.

The process of identifying, analyzing, and managing risks is a critical component of any effective management system. And, acknowledging that change is always present, identifying changed conditions, and taking actions as necessary to respond to those changes are fundamental to an effective risk assessment process.

A comprehensive risk assessment for the organization is performed annually. This process is coordinated by the Manager of Finance and Administration, who is charged with the responsibility of administering and monitoring the risk management plan for the organization. A primary component is the separate risk assessments prepared annually for each of the operating departments within the organization:

- Finance and Administration
- Accounting and Operations
- Information Technology
- Public Market Investments
- Marketable Alternative Investments
- Non-Marketable Alternative Investments
- Inflation Hedging Assets
- Investment Risk Management

Methodology

The periodic self-assessment of risk is critical in helping the organization ensure potential risks are identified, evaluated, and considered in the strategic development of organization objectives. This periodic review (at least annually) allows all staff throughout the organization an opportunity to both re-evaluate risks within their respective departments, but also take a step back and review risk from a broader, organizational level.



The self-assessment process at UTIMCO is coordinated by the Manager of Finance and Administration, who is charged with the responsibility of administering and monitoring the risk management plans for the organization.

The comprehensive self-assessment is one process, but results in several tools that can be used by staff to continually assess and monitor risk at varying levels within the organization. The specific steps and procedures may vary among successful risk assessment plans, but a few basic components serve as the foundation for any effective plan:

Identify Principal Activities



Determine the Risks



Assess their Impact and Probability



Focus Efforts on the Highest Risks



Identify Controls to Mitigate Risks



Monitor and Test Controls



These steps are performed for each individual operating department and again for the organization as a whole. Staff members from each operating department are involved in the development and review of their departmental self-assessment.

The Executive Team (consisting of the Managing Directors from each department, the President, and the Risk Manager) use the departmental self-assessments as a tool in helping them develop the “organization-wide” self-assessment.

Reporting

The Risk Assessment process results in the production of several reports useful in identifying departmental activities, summarizing department functions, ranking risks, and highlighting appropriate monitoring activities. Each of the commonly used reports is described in more detail below:

Principal Activities Report – This report summarizes the functions and activities for each department.

Activity Risk and Assessment Report – This report identifies and assesses the impact and probability of each risk associated with specific functions within a department.

Risk Footprint – This report provides a “snapshot” of the functions and related risks within each operating department.

Risk Controls Matrix – This matrix identifies the existing controls that help to manage and mitigate the identified risks for each department.

Optimization Matrix – This matrix identifies those controls that, when adequately reviewed and monitored, provide the most optimal management of risk.

Monitoring Plan – This plan provides both a summary and detailed view of the controls and risks required to be monitored. This plan also describes the specific evidence of controls to be monitored for each risk.

Monitoring

Periodic monitoring of established controls is an important function. The monitoring process consists of determining whether all relevant risks have been



identified, assessing the adequacy of existing controls, and evaluating their effectiveness.

In addition, monitoring is the process of assessing and ensuring the quality of established controls over a period of time. As such, it is also necessary to determine whether conditions have changed to warrant increases or decreases to control measures.

An annual monitoring plan is established to review and assess existing risks and the related controls. The results of planned reviews, evaluations, and testing will be documented and reported quarterly to the Executive Team and the Audit and Ethics Committee of the board. The monitoring report will contain the findings

and results of the testing performed and the related recommendations to improve or strengthen controls when appropriate.

Managers and staff review and assess the probability and impact of various risks within the organization. In determining their response to these risks, the organization has developed a matrix identifying the actions expected by managers. As depicted in the chart below, it is expected that managers will taken immediate action for high risk items. Medium risk items require both management and monitoring activities. Items of low risk will be monitored, but require no further action unless the risk increases.

PROBABILITY →		Medium	Low
IMPACT ↓			
	Extensive Risk Management Required	Considerable Risk Management Required	Manage & Monitor Risk
Medium	Manage & Monitor Risk	Manage & Monitor or only Monitor	Monitor
Low	Monitor	Monitor or Accept Risk	Accept Risk

Risk Rating Scale

Throughout the risk assessment process it is necessary to quantify and classify impacts and probabilities into various ranges. As a result, the rating scale below has been developed to help provide guidance to managers and staff as they quantify various categories of risk:



➔

IMPACT		Medium	Low
	Catastrophic Requires Significant Resources to Resolve	**Problematic** Requires Resources to Resolve	**Minor** Requires Little Effort to Resolve

➔

PROBABILITY		Medium	Low
	Likely to Occur without Controls	May Occur without Controls	Unlikely to Occur, Even without Controls

Forms and Templates

As is the case with the implementation of any standardized process, it is necessary to develop specific forms and templates to be used throughout the organization. A sample of each of these templates is included below.

- Principle Activities
- Activity Risk and Assessment
- Risk Footprint
- Risk Controls Matrix

Principal Activities – Sample Template

This template is used in helping to identify and summarize the functions and activities for each department.



Summary of Internal Controls

UTIMCO Risk Assessment Initiative

	Principal Activities	Consolidated Activities	Prioritized Consolidated Activities
1			1
2			2
3			3
4			4
5			5
6			6
7			7
8			8
9			9
10			10
11			
12			
13			
14			
15			
16			
17			
18			
19			
20			

Activity Risk and Assessment – Sample Template

This report identifies and assesses the impact and probability of each risk associated with specific functions within a department.

	Principal Activity	Impact	Probability	RANKING
1	List of Individual Risks Associated with the Activity	H	M	HM
2				
3				
4				
5				
6				
7				
8				
9				
10				



Risk Footprint – Sample Template

Provides a “snapshot” of the functions and related risks within each operating department.

#	ACTIVITIES	RISKS				
		1	2	3	4	5
1	Principal Activity #1	Risk #1 High	Risk #2 High	Risk #3 Medium	Risk #4 Medium Low	Risk #5 Low
2	Principal Activity #2	Risk #1 High	Risk #2 Medium	Risk #3 Medium	Risk #4 Medium Low	Risk #5 Low
3	Principal Activity #3	Risk #1 Medium	Risk #2 Medium Low	Risk #3 Medium Low	Risk #4 Low	
4	Principal Activity #4	Risk #1 Medium	Risk #2 Medium Low	Risk #3 Low		
5	Principal Activity #5	Risk #1 Medium Low	Risk #2 Low			

Risk Controls Matrix – Sample Template

Identifies the existing controls that help to manage and mitigate the risks identified for each department.

Control Activities	Risk				Extensive Risks	Moderate Risks	Manageable Risks	Low Risks
	Risk #1	Risk #2	Risk #3	Risk #4				
Control #1	✓	✓	✓	✓				
Control #2	✓	✓	✓	✓				
Control #3	✓	✓	✓					
Control #4	✓	✓						
Control #5	✓							

TAB 11 a



UTIMCO Corporate Detailed Business Processes

Expenditures

Expenditures are incurred for the purchases of professional services, supplies, fixed assets, payroll related costs, and lease operating costs. UTIMCO does not utilize purchase orders except for computer equipment orders from vendors that require a purchase order.

In instances that require purchase orders, an order form is approved by either the President/COE, a Managing Director, or the Manager of Finance and Administration. The approved order is given to an administrative assistant in the finance department where a purchase order number is assigned and placed on the order form. Appropriate personnel approve the expenditure as outlined in the purchasing policies and guidelines. All invoices are mailed to the UTIMCO Office Manager. The Office Manager or Office Associate matches the invoice with a shipping receipt and/or order form where applicable. The Office Manager reviews the invoice for correctness. The invoices are forwarded to the appropriate person for approval. The invoices are then entered into the accounts payable system. A properly approved invoice includes the signature or initials of the approval, date, and if applicable, receipt date of merchandise.

Services provided include attorneys, accountants, subscriptions (including on-line services such as Bloomberg and Barra), annual report designers, and membership dues. Depending on the service provided, a contract is signed engaging the company. Interim billing is approved based on services rendered. Other services, such as subscriptions, are billed annually or quarterly, and are renewed automatically.

Supplies include office and computer supplies. An Office Associate orders the office supplies and documents receipt of the supplies. With the exception of computer orders requiring purchase orders, the Office Associate orders computer equipment and supplies for the IT department. This is usually done through the Internet. An IT staff member, with approval of the Managing Director of IT, sets up an order request on the applicable Internet site and the Office Associate finalizes the purchase.

Fixed assets include office furniture, computer equipment, software, office equipment, and leasehold improvements.

Payroll related expenses consist of insurance premiums and retirement contributions, cafeteria deductions, medical and dependent care. The Office Manager prepares the retirement contribution requirement and the Manager of Finance and Administration reviews and approves it. An Office Associate prepares the premiums due and the Office Manager approves it.



Lease operating expenses include office and parking. The office lease is based on a 60-month lease agreement based on a set amount per foot plus utilities. Parking is based on number of parking places. The Office Manager approves monthly invoices.

Utilities include telephone expenses. In addition to the office phones, certain employees also are given an allowance for cell phone expenses which is added to an employee's monthly paycheck. UTIMCO has a cell phone policy that details specifics. Operating costs such as electricity, water, garbage, etc. is passed through by the building management company. These past-through costs are a part of UTIMCO's lease agreement.

Travel expenditures include transportation costs such as airline, car rental, taxi, and mileage reimbursement. Other travel expenditures are hotel, meals, and tips. Travel expenses for employees who travel for company business will be reimbursed by UTIMCO as long as the expense relates directly to UTIMCO's business and the amounts are not lavish or extravagant. All expenses except for airfare and car rental fees are paid by the employee and reimbursed by UTIMCO. Airfare and car rental fees are paid by UTIMCO directly. No cash advances are given. UTIMCO will not reimburse expenses incurred by a spouse, dependent or other individual that may be traveling with the employee. UTIMCO has a Travel Policy that details specifics. Business travel should be approved by the employee's immediate supervisor prior to requesting travel arrangements. Some seminars or conferences may require approval from the President or Chief Compliance Officer (in accordance with the UTIMCO Code of Ethics). Employees are required to prepare an expense report with purpose of trip, dates, and receipts documented. Employees sign and date the expense report. The expense report is approved by the employee's supervisor if the supervisor is listed as an authorizer above. Otherwise, the next management level signs the report. The Managing Director of Accounting, Finance, and Operations reviews the expense reports for all other Managing Directors. The Office Manager provides a final review that all receipts are attached and properly documented.

Cash Disbursements Procedures:

Operating Account

Invoices are normally paid twice a month, on the 5th and 20th. If a late fee is charged, an explanation of the late fee is documented. Due to the nature of UTIMCO's business, vendor discounts are not an issue. After the checks are written, the checks and the supporting invoices are forwarded to approved signers. Amounts under \$1,000 require one signature. Amounts over \$1,000 require two signatures. For checks under \$1,000, the approver of an invoice cannot also be the lone signer of the check. It is acceptable for one of the signers for amounts over \$1,000 to have approved the invoice. The checks are returned to the Office Manager and mailed. Checks are written through the Solomon accounting system. Manual checks are written if an invoice needs to be paid right away



or if the invoice's due date falls between the check writing cycle. All checks are kept in locked filing cabinet in the Office Manager's office.

Authorized check signers for the operating account are:

Bob Boldt – President, CEO and CIO

Cathy Iberg – Managing Director

Joan Moeller - Managing Director of Accounting, Finance and Administration

Christy Wallace - Executive Assistant

Debbie Childers – Manager of Portfolio Accounting and Operations

Payroll Account

Payroll checks are direct deposited to an employee's bank account. The bank automatically transfers the funds from the UTIMCO operating account to the payroll account. The payroll account is a zero balance account. The first paycheck to new employees is a manual check. ADP requires one payroll cycle to activate direct deposit. For employees who do not desire direct deposit, manual checks are written. Two signatures are required for checks over \$1,000.

Authorized check signers are:

Bob Boldt - President, CEO and CIO

Cathy Iberg - Managing Director of Alternative Marketable Investments

Joan Moeller - Managing Director of Accounting, Finance and Administration

Christy Wallace - Executive Assistant

Debbie Childers - Manager of Portfolio Accounting and Operations

Money Market Account:

Wiring instructions: Wires can only be wired to UTIMCO's operating account. Wires are prohibited to non-UTIMCO accounts. Dianne Watson notifies Dreyfus and requests redemption and wire transfer to be made. Dreyfus wires the money to Bank One operating account and Bank One issues credit receipt via mail.

Revenue Collection



UTIMCO has limited sources of income. UTIMCO's operations are such that limited amounts of checks and cash are received. The main source of revenue is received from the management of the major Funds: PUF, LTF, PHF, and SITF. Other sources include directors' fees, interest, and service fees. The management fees are billed quarterly based on the annual budget approved by the UTIMCO board of directors and presented to the U.T. System Board of Regents. UTIMCO sends an invoice to Business Affairs at U.T. System informing them of the quarterly payments. The funds are wired on the first business day of the quarter (September 1, December 1, March 1, and June 1) from each of the Funds directly to UTIMCO's money market account with Dreyfus. Debbie Childers, Portfolio Accounting Manager, directs Mellon Trust, the custodian bank, to wire the funds based on the amounts submitted in the office. The payment received for the quarter is deferred and prorated as revenue over the three months in the quarter.

The other sources of revenue are not budgeted. Directors' fees represent fees to UTIMCO employees who serve on various boards of directors in investment advisory roles. Their appointments to the various boards coincide with UTIMCO's authority to act for the Board in the investment of the Funds. Employees assign all directors' fees to UTIMCO. UTIMCO may receive service fees from investment promoters or investee companies in consideration of the UTIMCO staff's private investment activities and/or investment origination activities. These service fees are considered additional revenue to UTIMCO. The directors or service fees are not received on a consistent basis and may not be received at all.

If UTIMCO charges for open records request, the Office Manager prepares a manual invoice. An Office Associate makes out the deposit slip and deposits it. The Office Manager reconciles manual invoices with deposit slip and general ledger balance.

Interest is earned to UTIMCO's funds invested in a money market account. The amount collected is reviewed for reasonableness based on amount and interest rate. UTIMCO receives the daily rates on the money market account and is able to recalculate the interest received.

Human Resources



UTIMCO has policies and practices in place related to the hiring, training, evaluating, promoting and compensating of employees. UTIMCO hires employees to fill vacancies created by the termination of existing employees as well as based on the need for adding personnel to meet objectives of UTIMCO. When UTIMCO hires for a vacated slot, the department head (accounting and operations, information technology, fixed income, equity, private equity, or administration) informs next layer of management (managing director or president/CEO) of their plans to hire the replacement. When adding personnel (not filling vacated slot), the managing director and/or President/CEO will approve the need for an additional slot. UTIMCO budget will also be reviewed for adequacy.

UTIMCO solicits potential employees by posting ads on Internet site and various publications as well as through recommendations and consultants. The department head or someone he/she designates reviews the candidates' resumes and gives a brief phone interview to determine if the candidate seems viable. An interview is then arranged with several of the department personnel as well as the managing director or President/CEO. All involved in the interview process will discuss results of interview and decide if candidate should be made an offer for employment. At this time, references and education credentials are verified. Managing Director or President/CEO will approve final decision. Salary will be determined based on experience and qualification of applicant for position being hired. Employees must meet requirements of job description.

The Human Resources Head (UTIMCO's office manager) and all group heads maintain explicit job descriptions for all positions in an effort to clearly define job requirements and properly manage employee workload. The job descriptions are periodically reviewed and updated, normally during the annual employee evaluation process.

When an employee resigns, a meeting is held with the supervisor to turn over existing projects. An exit interview is conducted with the office manager and all UTIMCO identification and card passes are obtained. Cobra and other relevant issues are explained. When termination is involuntary, it is effective immediately and the employee leaves the premises immediately after the exit interview under the supervision of the manager or office manager. *Exit Interview Checklist*

Upon hire, a new employee is given a new employee packet that contains forms and policies including a copy of UTIMCO's Code of Ethics Policy, Policy for the Security of Information Resources, and Employee Handbook as well as a review of these policies and handouts by administrative personnel. A checklist is maintained by administrative personnel to make sure that all forms and statements are returned in a timely manner. *New Employee Checklist*

Annual training provides a broad overview of laws, regulations and polices that affect all employees. The Code of Ethics policy sets forth the basic principles and guidelines for directors and employees of UTIMCO. All employees must develop an awareness of and



respond to UTIMCO's obligations to the Board of Regents of The University of Texas System.

UTIMCO promotes educational advancement opportunities, both formal and informal, and encourages employees to take advantage of training opportunities. UTIMCO employees attend seminars and training programs offered by outside resources as well as in-house training seminars.

Employees are given annual job evaluations by their immediate supervisor although not required. These evaluations follow an established format and are part of each employee's personnel file. During evaluation period, raises and promotions are requested by department heads and approved by the President/CEO. Promotion consideration is documented in job evaluation.

Each year UTIMCO reviews all employee benefits as they relate to cost and confirming regulations. Legal counsel is consulted to insure conformity.

UTIMCO also provides an Employee Handbook to all employees. UTIMCO periodically (normally annually) reviews the handbook and revises if necessary. Employees are given an updated copy and are required to sign a statement that they have read the handbook. Included in the handbook are employment policies regarding equal employment opportunity, policy against harassment, alcohol and drugs, non-smoking, hours of work and attendance, proper dress, nepotism (Code of Ethics), employment of minors, outside business interests/conflicts of interest (Code of Ethics), confidential information (Code of Ethics), personnel records, safety, no weapons, guidelines for appropriate conduct, and termination of employee. The UTIMCO handbook also covers compensation program and policies, which explain philosophy, guidelines for starting compensation, performance appraisals and compensation review, change in employment status, pay period, accounting timesheets, and time reporting and overtime. The handbook also discloses benefits. The benefits described are holidays, vacation time, sick time, personal days, reinstatement of certain benefits, family/medical leave policy, bereavement leave, military leave, jury duty, dues to professional organizations, license fees, continuing professional education, 403 (b) retirement savings plan, physical fitness, group insurance, and other leaves. The handbook covers general policies regarding building security, information resources, solicitation and distribution, telephones, bulletin board, expense reports, facilities, and gratuities/gifts. An insurance summary is also provided covering health and dental insurance, life, accidental death and dismemberment and long-term disability insurance benefits, and continuation of medical benefits.

Payroll

Exempt employees are paid once a month on the last business day of the month. Nonexempt employees are paid twice a month; on the 15th (or preceding business day



before the 15th) and the last business day of the month. The Office Manager processes payroll through ADP. A new employee is required to complete a payroll information form. Pay schedules are set up at the beginning of each calendar year for the entire year. Department manager is required to complete and sign a Payroll Change Order Form. This form is used to document initial salary and changes in compensation. The Office Manager uses this form to enter salary amount into ADP. All documentation is gathered with appropriate approvals prior to transmittal including new hires, pay changes, change of deductions, and vacation/sick leave. ADP processes all payroll information including the direct deposit. Payrolls are transmitted to ADP electronically three business days prior to pay date in order for bank processing of direct deposits. ADP calculates social security taxes, federal income taxes, employee benefit plan contributions, and other salary deductions. Documents and paychecks (if not direct deposits) are delivered to UTIMCO by courier the day following transmittal. ADP prepares all required tax forms and makes tax deposits within required time period. ADP documents are checked for accuracy against file information by Office Manager. The general ledger interface file and payroll files are downloaded from ADP after payroll is verified. Cafeteria deductions and retirement contributions are calculated and verified. Vacation/sick leave balances printed on pay stubs are verified with UTIMCO records. If there are any manual checks, the manual checks are signed by authorized signers and checks and pay stubs are put in envelopes for distribution to employees on payday by Office Manager. All payroll is reviewed and approved by the Manager of Finance & Administration both before and after the transmission to ADP, the external payroll processor.

Fixed Assets

UTIMCO capitalizes fixed assets that have a cost of \$300 or above. Capitalized costs include the invoice price, plus incidental costs such as sales tax, insurance during transit, freight, duties, ownership searching, ownership registration, installation, and breaking-in costs. All available discounts, whether taken or not, are deducted from the invoice cost. Discounts not taken are recorded as discounts lost and treated as interest expense. UTIMCO maintains a detailed listing of fixed assets in the monthly accounting records. Included in this listing are cost, acquisition date, serial number (or other identifier) method and life of depreciation, and depreciation schedule. Total fixed assets, accumulated depreciation, and depreciation expense are agreed to general ledger.

An inventory system is also in place to track fixed assets. All new equipment and software purchases are entered into the inventory database by Office Manager. Information includes description, serial number, acquisition date, cost, number of months to depreciate and room location. IT staff is contacted when addition is completed and they are asked to print the bar code labels. Labels are then attached to items.

A physical inventory is conducted annually at year-end. The bar code scanner is used to scan each bar coded item when conducting inventories. The inventory database matches



scanned codes to the information in the database and prints a report of items that were not located. All the exceptions on this report are cleared before inventory is complete.

UTIMCO surpluses equipment at least annually. Most of UTIMCO's equipment that is designated as surplus is computer equipment. UTIMCO does not have a significant amount of other office equipment. The IT department determines a list of surplus computer equipment. IT makes the determination based on several guidelines. For example, is the equipment functional but not at the level needed to accomplish its purpose of use? Does the equipment need to be repaired and is the cost of the repair excessive? Is the equipment capable of handling upgraded software capabilities? Has the equipment become obsolete? Can the equipment be used as backup? The Office Manager will make the initial decision of an office item that should be added to surplus. Office equipment normally has broken or is not functioning as required. IT presents a list of surplus to the Managing Director for approval to discard the surplus equipment. The Office Manager discusses the office equipment with the Managing Director or President/CEO. Once computer and office equipment items are added to the surplus list, UTIMCO has an employee lottery. IT will price the equipment based on a third party source and each employee is allowed to participate in the lottery. The lottery randomly selects an order of participation that allows the first person selected to have first selection of the equipment, and so forth. The employee must pay for the purchased items before the items may leave the premises. If items are left over, UTIMCO will donate them to a 501(c) 3 not-for-profit organization. If UTIMCO cannot sale or give the item away (i.e., completely not repairable) UTIMCO will find an alternative to dispose of the equipment. All equipment that is no longer on UTIMCO's premises and has been discarded must have documentation authorizing disposal.

Accounting and Reporting

General ledger is maintained using the Solomon accounting system. The accounts payable system is also utilized. An Office Associate enters invoices through the accounts payable system, processes payroll interface transactions, and makes all general journal entries. The Office Manager prepares a monthly accounting package that contains support for all general ledger asset and liability balances. In addition, this package includes documentation to support major income and expense items including management fee revenue, interest income, salaries and lease expense. All general journal entries are also documented and supported. Financial statements with footnote disclosures are prepared monthly. Budget to actual is included as a supplemental schedule and includes the budget to actual on the Fund level expenses. The UTIMCO general ledger is used to track expenses related to the Funds. The expenses are recorded through general journal entries and are only included in the supplemental schedule. They are not a part of the basic financial statements. The Manager of Finance and Administration reviews and approves the monthly accounting package and the financial statements. The financial statements are audited annually by external auditors.



Insurance Coverage

UTIMCO is covered by commercial insurance policies. UTIMCO is insured for Directors and Officers, Commercial Package, Commercial Crime, Business Auto, Workers Compensation, and Commercial Umbrella. An Insurance Coverage Worksheet is available that outlines the current coverage.

Insurance is renewed annually. An independent insurance agent is used to review the coverage limits, determine adequacy, and assist with the renewal process. The Office Manager and Manager of Finance & Administration review the plans, processes, and recommendations of the outside insurance professional. Determination about coverage is made based on organizational changes, property and equipment acquired, assets at risk, necessity of coverage, and any other relevant information. After a final determination is completed, the insurance coverage is reviewed and approved by the President/CEO.

TAB 11 b



UT Investment Funds – Key Business Processes

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Investment Management

- **Securities Processing**

The Funds are invested with external and internal managers. The managers manage different types of portfolios, such as fixed income, small/medium cap equities, foreign equities etc.

External Managers

External managers are fully responsible for their processing of trades. Due diligence is performed before hiring a manager in order to understand the manager's back office procedures and determine if their standards are acceptable.

We rely on the custodian's internal control processes to settle trades. Trade information is provided to the custody system either through electronic transmissions from the DTC Institutional Delivery System (IDS), electronic data interface (EDI) or manually through preformatted trade input screens. Non-automated trade instructions are received via fax, telex or telephone from the authorized investment manager. Trade information entered into the custody system is automatically edit checked for valid account numbers, broker codes, and for sales, availability of units to be delivered.

Depositories for domestic securities include DTC, PTC, the Fed, the Options Clearing Corporation and select other custodians. Trade positions and activity for settlement with outside depositories are reconciled daily with the custody system. All transactions in foreign markets are processed through brokers local to, or registered in, the foreign market. The investment manager or designated broker must contact the local broker to execute the transaction in the local market. Sub-custodians are only authorized to settle transactions based on instructions from Mellon Trust. (You can review their SAS70 for more details on their procedures.)

Each external manager will establish a procedure with Mellon's Pittsburg office for transmitting daily trades. Most trades are entered into the Mellon system through an automated process rather than manually.

Internal Managers

We currently have 5 internal managers: 2 Fixed Income, 1 Equities (REIT's and distributed stock), and 2 Private Investment managers. The Fixed Income managers and Equity manager invest only in domestic securities. All international securities are managed by external managers (with the exception of Japan futures).

Fixed Income:



All trades will be entered into Bloomberg by the Investment Managers and are automatically fed to custodian.

Processing Trades

1. Entered trades will be in the Bloomberg (SCUS) queue awaiting release to Mellon. Operations will release all trades in the queue for the current day at:
 - 10:30 AM
 - 4:00 PM
2. For trades that are entered after 4:00 PM, operations will review and release them from the prior day SCUS queue at:
 - 10:30 AM
3. The Investment Managers will notify Operations if they need exceptions to the normal processing times.

Monitoring Trades

1. To ensure that released trades are received by Mellon, Operations will check the CUSQ acknowledgement at the following times:
 - 10:45 AM
 - 4:15 PM
2. To ensure that Mellon books the trades correctly, Operations will produce a report showing all of the trades that were *entered* (not necessarily processed) on the previous day as of 6:00 PM. This report will be reconciled to Mellon.
3. Investment Managers will notify Operations as soon as possible any time a trade is entered after 6:00 PM.

Monthly Reconciliation

1. Operations will download the Bloomberg portfolio on the 1st of every month using TSAPI. The net position will be reconciled to the month-end Mellon report. Discrepancies will be reported to the Investment Manager.

Separation of Duties

1. The login ID “UTIMCO” is the administrator account. This login has access to all functions of Bloomberg including modification of user rights and entering trade tickets. Debbie Childers is the only person with access to this login. She is responsible for supervising this area as well as entering any journal entries that the traders do not enter.
2. The login ID “UTEXAS” is the operational account. Operations personnel and Debbie Childers have access to this login. This log-in has view only access with special permissions that allow it to verify trades entered into the system by another login and send those trades to Mellon electronically. It also has permission to view the portfolio positions. Lastly, this login can set up DTC and FED clearing instructions for brokers so that trades can process electronically.
3. Operations personnel are responsible for reporting all trades done on the prior business day to both of the traders and to Debbie Record. Debbie Record



reconciles all of the trades reported by operations to Mellon activity reports. This ensures that no trades are entered at either UTIMCO or Mellon without proper authorization.

4. The last login ID “UTIMCOBO” is used for all other back office personnel. This login has view only access. It can not make any changes to any standing data. It also can not access any trade or portfolio data.
5. Key aspects that maintain the control structure for electronic trade processing with Mellon:
 - a. Personnel responsible for reviewing and reporting trade and portfolio activity are different from those that enter that activity.
 - b. IT restrictions prevent reviewing personnel from entering trades or journal entries.
 - c. Trades have to be completed through an external broker.
 - d. Only trade tickets can be executed electronically. Any other fund transfer leaving UTIMCO has to be completed with two authorized signatures.

The managers are only responsible for executing trades; Operations will work with brokers to get accounts set up, give them custodian information, and anything else necessary to settle the trade.

Futures:

Collect trade authorizations.

1. Any purchases or sales should be summarized and signed by the investment manager responsible for those trades. This summary should be provided the day of the activity. Compare the data on the summary to the data under the Confirmation section of the Goldman report the next day. Be aware that Goldman may not list out the decimals of a price, but it will have a Residual Adjustment to balance back to the correct price. Also, prices are often quoted at an average price for all contracts, but Goldman may not be able to use that average; they may have to have one average for the PUF contracts and one average for the GEF contracts if a non-Bloomberg broker executed the trades for us. Otherwise, if these prices do not agree, check with the investment manager to verify the order.

Obtain third-party data.

(All futures contracts are currently being held at Goldman Sachs. Each morning we retrieve statements from them showing what the daily mark-to-market is. Daily prices are verified by comparing them to outside sources.)

1. Go to http://www.cme.com/dta/hist/daily_settlement_prices.html?type=idx (Chicago Mercantile Exchange, Inc. - CME)
2. Select the futures column next each of these and print the resulting window:
 - GSCI
 - S&P 500 Index
 - Russell 2000 Index



- S&P 400 Mid-Cap
3. Now go to <http://www.cbot.com/cbot/pub/page/0,3181,1165,00.html> (Chicago Board of Trade – CBOT)
 4. This takes you to the most current information for Dow futures. If you need more historical prices select the Historical Prices tab.
 5. Now go to www.gs.com (Goldman Sachs).
 6. Click on Client Login → GS Financial Workbench. Use a Secure ID token to obtain the login and password.
 - Login = utimco/(plus the name on the token)
 - Password = Gold(plus the numbers on the token)
 7. Make sure that All Accounts is selected and click Display.
 8. After the document opens, print the statements and then exit.
 9. Now go to the Bloomberg and pull up the historical prices for the Topix and Nikkei. See Bloomberg procedures for help with this. (Hint: NKM4 Index HP, where NKM4 will change depending what month contracts they are.)

Overview of the methodology:

There are 7 types of index futures we currently invest in:

- S&P 500 Equity
- GSCI Commodity
- Russell 2000 Equity
- S&P 400 Mid-Cap Equity
- Dow Jones Industrial Average
- Nikkei (Japanese Index)
- Topix (Japanese Index)

Usually each of these futures has contracts that are a part of the PUF account and some that are part of the GEF account. The margin in each account must be calculated separately. One thing that makes this calculation more difficult is the buying and selling of these contracts. To facilitate this, all activity such as buying and selling is calculated on one spreadsheet and then the total margin is calculated on another.

Another thing to be aware of is that all of our S&P 500 Equities are held in one account at Goldman; however, they are split up between two accounts at Mellon: the S&P account and the Hedge Fund Futures account. Thus the sum of the S&P 500 account and the Hedge Fund account at Mellon should equal the margin found in Goldman's S&P 500 account.

Another thing to be aware of is that we calculate the change in margin on a day to day basis. Goldman Sachs calculates the margin from the day each contract was purchased/sold to current day and then subtracting out any cash we have paid in the past from what we owe in total each day. This difference in methodology will result in the same final margin call unless an exchange rate is involved. When calculating foreign margins, we use a slightly



different process. Also note that Goldman uses a First In, First Out inventory method for contracts being held, whether in a short or long position.

Finally, a note should be made about short positions. Since short positions involve a slightly different approach, you will see that the margin is calculated differently. The primary difference is that the sales price and the purchase price are in different locations due to the nature of a short position. Also, all contracts are listed as negative numbers as a reminder of the position being short and as a reminder that a decrease in price will result in a positive margin flow. As a result, each account (and thus spreadsheet) is set up for either long or short positions. Should an account switch from one position to another, the spreadsheets will have to be modified accordingly. No one spreadsheet can calculate the margin for short and long positions even for the same type of futures contract.

Calculate the margin on domestic futures:

1. Open the Excel workbook for the daily margin flows:
 - K:\Groups\Operations\Futures\Daily Margin Flows.xls
2. Open the GSCI Total Flow spreadsheet and update the date (changing this date automatically updates the dates in all the other spreadsheets).
3. Now open the GSCI Activity Flow spreadsheet.
4. If there was activity such as a buy, sell, split, etc., enter that data in the appropriate place. Notice that the Blue numbers are the variables that you want to change. (Some of these prices are linked to update automatically, but unless you use this spreadsheet daily, do not rely on those links to update the correct prices. When contracts roll, the cell references can become slightly confusing.)
 - Contracts = make sure you have the correct month and symbol

CME Printout:

- Opening Price = this is the *prior day* settlement price
- Closing Price = this is the settlement price
- NOTE: opening and closing prices are different for each month listed on the printout

CBOT Printout:

- Closing Price = this is the settlement price and opening price for the next day
- NOTE: the opening price is listed here is adjusted for overnight activity, so use the prior day closing price for the next day's opening price. Also, each table of prices is for only one type of contract month.

GOLDMAN Printout under Confirmation:

- Purchase/Sales Price = will be listed by the trade
- # of Contracts = also listed by the trade
- Commissions = always enter as a negative number



- Adjustments = usually made to adjust for a rounded off price
5. If there was no activity for those futures, then make sure the # of contracts, commissions, and adjustment columns are empty, because the net amounts on this spreadsheet automatically feed into the next spreadsheet.
 6. Go to the GSCI Total Flow spreadsheet.
 7. Update all of the blue fields: date, contract name, prices, and # of contracts.
 - *The # of contracts is only those contracts held the entire day. Those sold and purchased are accounted for already by the previous spreadsheet. Take the prior day total and subtract any contracts sold today from that amount. Also, any contracts bought yesterday have to be added to this total.*
 8. Repeat for the other futures.
 9. Reconcile the calculations to the Goldman report.
 - a. The Total PUF Margin Flow should equal the Goldman Commodity PUF Total Equity.
 - b. The Total GEF Margin Flow should equal the Goldman Commodity GEF Total Equity.
 - c. Print the spreadsheets if correct (don't print the Activity one if there is no activity).
 - d. Repeat for the other futures.

Calculate the margin on foreign futures:

1. The process starts the same for foreign futures. The Total and Activity Flow spreadsheets must be completed as described above. However, all of this is done in the foreign currency rather than U.S. dollars.
2. Then an additional spreadsheet is created called LTD (life to date) which replicates the method that Goldman uses to calculate the margin. Use this spreadsheet to calculate the margin for each type of contract from the day the contract was bought/sold to the day prior to the day that you are balancing. This means if on 1/16 you are balancing the margin that occurred on 1/15, you would calculate the margin as of 1/14 on the LTD spreadsheet.
3. Then you enter in the total margin on that contract type for 1/15 from the far right hand column on the Goldman statement. The spreadsheet will calculate the difference, which should match the one day margin difference calculated by the Total Flow spreadsheet. Notice you also have to take into account the different types of contracts in the account and any activity for that day.
4. Once you have verified the LTD margins for each contract in the foreign currency, enter in the exchange rate used by Goldman. This will allow you to make sure the foreign currency amount was converted into U.S. dollars correctly. Then verify that the only change in cash is from the amount you instructed Mellon to wire or receive the day before. If all of things are in balance, then you can assume the total equity line of the Goldman statement is correct.



5. Also notice that the LTD method can be used to troubleshoot domestic futures should there be problems in reconciling the amounts.

Prepare and distribute reports.

1. Attach all of the GSCI paperwork together with the Margin Flow spreadsheets on top.
2. Circle the direction of flow.
 - If the margin is positive, we instruct Mellon to receive funds from Goldman.
 - i. Requires one signature.
 - If the margin is negative, we instruct Mellon to send funds to Goldman.
 - i. Requires two signatures.
3. Give all futures to Debbie Childers for approval.
4. When you receive them back signed appropriately, fax all of the Margin Flow spreadsheets to Mellon.
5. File all hardcopies appropriately.

Equities:

For sale of restricted stocks (from distributed stock portfolio), the manager places the trade with a broker and forwards the spreadsheet trade information to Operations via e-mail. Operations is responsible for filling out all the paperwork for the brokers and SEC, such as the sellers rep letter, stock powers etc. Operations will keep in communication with the custodian to make sure the trade settles. For more information on the forms that are required, see procedures.

<K:\Files\Procedures\Operations\Private stock distribution.doc>

All equity trades are entered into an internally created database system called UTInvest. Since the manager only supplies the share price and commission per share, UTInvest will perform the calculation in determining the total cash settlement amount. The amount that UTInvest calculates is compared to the DTC confirmation and adjustments are made when necessary.

<K:\Files\Procedures\Operations\UTINVEST.DOC>

<K:\Files\Procedures\Operations\PrintDTCconfirm.doc>

Technology Transfer Stock:

On occasion, some of our component schools receive what we call Technology Transfer stock. These are usually received as a result of a patent or licensing agreement, etc. The Health institutions are mainly the ones who receive these, but UT Austin does have several also. These securities are not publicly traded securities, but the goal is that they become publicly traded so that they can generate some income for the component. The certificates are usually sent directly to the component and they are supposed to forward certificates to



UTIMCO for safekeeping. (UT Austin likes to go through Office of General Counsel, BethLynn Maxwell.) UTIMCO does not always get notified of Tech Stock and therefore can not be responsible for securities that we know nothing about.

Once a security goes public, UTIMCO sends the certificates to Mellon to make it easier if they are sold. Usually the component informs UTIMCO that a stock goes public. The security will usually become DTC eligible so UTIMCO will have Mellon convert shares to DTC. This makes trading the security very simple. The component decides if and when they want to sell. UTIMCO's Equity Manager, Greg Cox, handles these trades. MD Anderson will sometimes place a standing order (if the price reaches \$xx.xx, sell "y" shares). Debbie Childers, Manager of Portfolio Accounting and Operations, will usually facilitate these trades rather than Operations since she is the component's contact person (due to the complexity of these stocks). If Greg sells the stock, he will notify Operations (with cc: to Dchilders) the same way he does with all other equity trades. Operations will work with Mellon to make sure the trade settles. When proceeds are received, they are wired to the component via the weekly wire.

The Board of Regents Rules and Regulations were changed August 2003 to read as follows:

- 1.82 Intangible personal property consisting of securities, interests in businesses, and equity interests in technology transfer firms as set out in the Regents' Intellectual Property Policy shall be managed by the component institution president or by UTIMCO, as determined by the component institution president. UTIMCO shall hold all stock certificates of securities managed by, or held on behalf of, the component institution president and shall assign, transfer or sell such securities, as directed by the component institution president or his or her designees, in accordance with section 2 of this Chapter. Other intangible personal property shall be managed by the component institution president.
- 1.83 The component institution president may designate in writing one or more committees, employees, officers or other agents of the institution, or one or more outside managers to manage any or all such assets on behalf of the component institution president.

Gift Securities Processing:

UTIMCO helps UT System's Office of Estates & Trust (E&T) in selling securities that are received as gifts. The majority of gift securities are automatically transferred to the Board of Regents' Merrill Lynch account by the donor, but they can also be received in physical form. If a stock/bond certificate is received, E&T gives the certificate to Operations for safekeeping. E&T will call UTIMCO and ask them to sell certain securities at Merrill Lynch. (Greg Cox, Russ Kampfe, Joan Moeller and Debbie Childers are currently the people



authorized to trade in Merrill Lynch account.) Orders are placed strictly over the phone. Once Merrill Lynch has executed the trade(s), they will notify E&T of the specifics of the trade (i.e. settlement amounts and settlement date). E&T will then notify Operations that they need to pick up a check at Merrill Lynch on a certain date (settlement date). If Merrill Lynch already has the security in our account, then there is nothing else that needs to be done. However, if E&T receives the gift in physical form, they will give the certificate to UTIMCO for safekeeping in the BankOne vault. The certificate will be taken to Merrill Lynch with proper authorization forms (such as corporate resolutions) when Operations goes to pick up the check. Operations will deposit the check through the normal check processing process.

Procedures for Private Investment (Partnership) Stock Distributions

- Judy will usually be the first to be notified that a partnership is making a stock distribution. Judy gives Michael Rackett a copy of this notification letter and she keeps the original. Based on information from the distributing partnership, Michael notifies the Internal Equity Manager of the security name and symbol, number of shares for each fund, applicable restrictions, and the distributing broker's name and contact phone number for sales. The letter from the partnership makes the offer that the distributing broker can sell the shares for us, but usually we have them send the shares to Mellon and Greg sells the shares himself. This is the manager's (Greg) call. If Greg chooses to have the shares transferred to Mellon, call the distributing broker and inform them of this and send them delivery instructions.
- Enter the information for the distributed stock into the UTInvest System – name, symbol, CUSIP; add symbol to ILX pricing worksheet. Use the Misc Transaction/Receive function to enter the receipt of the stock, use a current trade & settle date (same day), and assign the Book Value as given by the partnership. Keep copies of these transactions for Ops records.
- Judy will make her entries to PrivateI. This paperwork will be used to notify Mellon of the new shares, and will show how the distribution needs to be recorded.
- **Contact distributing broker for information on any restrictions – find out EXACTLY what the restriction is (most likely the broker will contact you first anyway).** This paperwork is not always correct, **NEVER** take for granted what the paperwork notes for the restriction. The name and phone number of the distributing broker will be on the paperwork received from the partnership.
- S-3 restrictions mean all sales must be accompanied by a prospectus for that exact stock issue that is being distributed. This prospectus could come from the partnership or distributing broker. Jefferies is the most commonly used broker, and they usually handle this and furnish the prospectus. If stock is sold immediately, distributing broker would need this. If sold later, we would need to supply this to selling broker.



- SEC Rule 145 restriction required only a Seller's Rep Letter and Stock Power, which will be provided by the distributing broker.
- SEC Rule 144 restrictions require everything that Rule 145 sales do, PLUS a Form 144 must be completed and sent in triplicate to the SEC the same date that the sales are done (trade date). The original and 2 copies will go to SEC: Keep a file copy.

Send to:
Securities Exchange Commission
450 Fifth St. NW
Washington, DC 20549

(These forms are all set up in K:\files\privateinvestments\distributed stock\forms they can all be filled out on line, except for the w-9, tax information form, it will have to be printed and filled out on a manual typewriter or by hand)

- When sales are done, enter the information into UTInvest when it's available from the broker. You'll usually have to use an extended settlement date, and an estimate is OK. Notify Mellon of the # of shares sold, the details of the sales, and the net wire amount they should expect. If only a portion of the position was sold, also notify Mellon that the balance of the shares will be delivered to them, either in physical form or via DTC.
- You'll have to touch base with the broker several times, usually, to check on the status of the settlements. When the shares come out of the partnership, they are usually in one "master certificate", and have to be sent to the transfer agent to be split among all the partners. The transfer agent process can take several weeks. Once the individual certificates are back, the brokers can settle our trade and wire us the money, and deliver the balance shares (if any).
- Have Mellon send a copy of all certificates that are received. Check these certificates carefully, if they are registered incorrectly, have Mellon return them for correction. When all money/shares have settled at Mellon, note the date of the wire receipt and share receipt on the paperwork, file in file room, they are filed in alphabetical order by name. (If there are shares to be received as well as a wire, they will not come in at the same time.) Hold the paperwork in pending until all wires and shares have been received.
- **All information regarding the distribution** must be entered into the stock history spreadsheet located in K: \files\privateinvestments\distributedstock\distributed stock transaction history.xls

Standard Procedures for UT Invest

Overview



The following procedures define procedures regarding input of internal equity trades into the Portfolio Management System (UTInvest) for tracking, reporting and confirmation. UTInvest menu is located in K:\Files\Access\UTINVEST\UTINVEST.MDB

Procedures

- **In The Afternoon** – Transactions (trades) can be entered before or after the market closes. Transactions can be entered at any time of the day, but do not run any reports until after 3 p.m., when pricing has been updated.
- **To Add a New Security** – Go to the database, which is located “behind” the UTInvest menu. Click on Table and click on Assetmaster. Add the name, symbol and CUSIP of the new security to the bottom of the list. It will automatically be placed in the correct alpha listing. *Be sure this info is added to the ILX spreadsheet located in the UTInvest menu.*
- **To Add a New Broker** – Go to the database, click on Table and click on Broker. Enter the broker’s name at the bottom of the list.
- **To Enter Trades** -- Click on Enter Trades. Click and pick from down arrows for the desired portfolio name, transaction type (Buy or Sell), symbol, and broker. Tab and fill in the number of shares and price. There is a Misc. field – the system will automatically figure this field. If you are entering a Buy, remember to zero out the Misc. field, as it is for sales SEC fees only. After all trades have been entered, you must go back and click on the Approved button. Otherwise, it will not move them into the Process Transactions section. Once all trades have been entered and approved – Exit. Click on Processed Transactions icon. Click on Process Trades. Trades will then be automatically moved into the Affirm Trades section. *Do not forget to process all transactions. If they are not processed they will still appear on the Transactions Report and they will appear in the Confirm set, but will not sweep Cash!*
- **To Update Pricing** -- Minimize the UTInvest menu screen. Open ILX workstation. Click on Housekeeping. Minimize the screen. Go back to the UTInvest menu screen and open the Excel Pricing Worksheet. Yes, to update pricing. When prices have been updated, close the ILX workstation, and close the ILX spreadsheet. Yes, to save the spreadsheet. Click on the icon that says “Update Pricing”. That is it. Now run the reports.
- **To Run Reports** -- Click on the icon “Portfolio Transactions Report”. Use Trade Report #1 for cash and adjustment entries, and if the transactions are only going to be Buys *or* Sells (not both). Use Report #2 if there are both Buys *and* Sells. This report will break them down by transaction type so that Greg can see the total for each. Judy gets a copy of transactions done for the Private Equities. Greg gets copies of all transactions; two copies go to Operations (1 to use for DTC and 1 to use for the Daily



Cash Rec with Mellon). *Mellon is to receive these reports DAILY, even if there are no transactions.*

- **To Confirm Trades** -- After pulling the DTC Trade Confirmations, go to the UTInvest menu and click on “Confirm Trades”. Match up the confirms to the trades listed to be confirmed. Click on each entry block to Confirm.
- **If Confirms Do Not Match Entries** – If it is your entry error, click on reverse trade located on the right of the screen next to each trade entry. This will automatically bounced it back to the Enter Trades area. After Confirming Correct Trades, go back to the Enter Trades screen. Make you corrections, process and confirm. Rerun the reports and give copies to Greg, Judy or Debbie, and keep one for the file. If it was a broker error, call the broker and request a correction. Do not confirm the trade, until you get the corrected Confirm.

If you should need to correct a trade that has already been confirmed, go to the UTInvest menu and click on Trade Reversal. Fill out the appropriate entry request such as portfolio name and date. You will then get a list of trades done for that portfolio and that specific date. Find the one you are looking for and click on Reverse Trade. It will be put back in the Enter Trade area. Correct it, approve it, then process and confirm it.

- **Update Cash, Shares, Book Entry, etc.** -- There is also an icon called “Misc Transactions”. This is to update cash, shares or any other miscellaneous information as needed. Use the Down Arrows to select Portfolio Name, Symbol, and Transactions. Transactions listed are Distribution or Receive. (Distribution would be used for anything that is being withdrawn from the Portfolio). You do not need to use a minus sign when using Distribution. For Daily Income Transactions, run Report #1. When completed attach it to the copy of the email requesting UTInvest to Update for Income and file.
- **Daily Balance Update** -- On the UTInvest menu there is an icon called “Daily Balance Update”. Enter the previous work date, click on “Update Balance Records for the date above”. The SQL screen will come up and require you to logon to the SWL Server (This is your warehouse login ID). After you hit Enter, it will take anywhere from 5 to 8 minutes (maybe more) for the report to update. When the report is updated, click on Daily Report Menu. Click on UTInvest Comparison to Custodian Exceptions. Print report. Check the report for exceptions. If there are any, research and resolve. There should only be exceptions for trades executed the previous day, or trades that have not settled for various reasons.

Do not keep a copy of this report except at month end. This report (Comparison to Custodian Exceptions) does not need to be run daily, only at month end or when there is a problem to resolve with Mellon.



To select a previous day report, click on Daily Balance Report menu. Arrow down to the date you wish to select and Enter.

On the first working day of each month, update ILX (as early as possible before the market opens). Pull up the report “UT Invest to Custodian Report”. Print “UTInvest to Custodian Exceptions” only. This would be the report for the last working day of each month. Give these copies to Judy. Give Judy a copy of the updated holdings as well as the custodian’s reports and transactions for the month for Private Investments and the REIT accounts. Give her the transactions report run for both Trade Report #1 and #2. Keep a copy for our files.

- **Month End Reports** -- Greg does want month end reports. If the last day of the month falls on a holiday and we were not in the office on that day, update ILX as soon as possible on the first business day after the holiday and give Greg an updated Holdings report.

DTC Confirm Procedures

Overview

The procedures explained below enumerate the steps taken to send confirms to DTC.

Step 1

- Click IMT Tradesuite STD. Click on AT&T Global Network. Click on
- AT&T Global Network Dialer.
- Sign in (using passwords that were assigned to you by DTC)
- Screen will automatically minimize itself.

Step 2

- Click on IMT Tradesuite STD
- Click on Confirm. Your password must be ALL CAPS, must contain at least 8 characters, with at least four alpha characters and on non-alpha character. (Example: WPASSX123)

Step 3

- Return to IMT Tradesuite STD.
- Click on Confirm (Again). Once the screen has gone through its routine trade search, click File Retrieve in the top left of the screen. Retrieve your set up file for trades. The confirms should automatically start printing, after it goes through its downloading cycle. It will also automatically pull each trade and list them on a spreadsheet.



- Double click on each line to look at the transactions on line. If there is no problem and the trade is correct, click on Affirm (bottom left). If there is a problem that needs correction, do as we have in the past, skip that trade and call the broker later, after all correct trades have been affirmed.
- Click on Send to DTC in the top right corner of the screen. It will pull up another screen. Click on Affirm and send. *If you don't click on the box that has Affirmed you won't get a copy of your affirmation and won't be able to go back and get one.*
- When you call the broker to correct the trade, ask them to correct the trade as soon as possible so that you can go back on line within a short period of time and affirm the corrected trade. This means we no longer have a day's delay in affirming trades.

External Manager Trade Processing

- **DTC** – Brokers input their trades into the DTC Confirm/Affirm system and details of the transactions are electronically sent to Mellon and are then converted to CMS form—some brokers will affirm their own trades, but if any information is not completed in the trade detail it will not be affirmed and instead will require manual intervention at Mellon (in these instances we will affirm **ONLY** with signed trade tickets bearing authorized signatures). Obviously foreign trades as well as US Government Securities trades cannot be sent to us via DTC.
- **WILLIAM JAMES** – Trades are entered into William James (a specific data format) by the brokers and then sent to the Advisor Services Group (ASG) in Pittsburgh. ASG, also using William James, is able to view the trades on their computer screens and with minimal effort can then paste the information on to CMS to create the transaction on our custody system using the information the Advisor has provided (thereby eliminating the risk of keying errors).
- **SWIFT** – SWIFT is an internationally recognized means of sending trade/payment instructions between financial institutions. A number of brokers use SWIFT messages to instruct us on trades. SWIFT messages are received by Mellon and are then translated (automated process) into CMS format (Mellon's TSU handles any issues that may arise during the electronic receipt of & electronic translation of these transmissions).
- **FAXED TICKETS**
- **INTERNATIONAL TRADES** -- When global trades are entered on to CMS, it is procedure to have a 2nd person verify (affirm) this trade (trade instruction requirements



vary by country). The information is carefully reviewed and subsequently affirmed by a team member who did not initially input the transaction on to our custody system.

Security Valuation (Major Funds)

Pricing Processes

The custodian (Mellon) is responsible for pricing all publicly traded portfolios. For the internally managed REIT account, Mellon's pricing is compared to ILX prices through the UTInvest database. Internally managed fixed income accounts are compared to BondEdge. Any discrepancies must be resolved before closing end of month records.

Internal managers: For the Short Intermediate Term Fund portfolio, on the first business day, Operations gives a form letter to the manager requesting a review of the custodian's valuation of the portfolio and a "signoff" if he agrees with all prices. Operations is to be notified of any discrepancies by the second business day.

For the REIT portfolios and the internally managed Fixed Income portfolios, a similar letter is prepared by Operations and given to the managers on the third business day. The managers are asked to respond by the 4th business day so that the funds may be closed in a timely manner.

External managers are also required to make any pricing challenges to Mellon by the 4th business day. Differences should be resolved by the 4th business day.

The attached document prepared by Mellon describes their pricing sources, methodologies and pricing variance processes.

<K:\files\mellon\pricesources.doc>

Non-Marketable Alternative Investments pricing is supplied by UTIMCO based on valuation policy approved by the Board of Regents. For each fiscal quarter-end, pricing is determined by using most recent financial statements received from partnerships. Since most financial statements are prepared on a calendar basis, their capital account balances are adjusted for cash flows from financial statement as of date to valuation as of date. For interim month ends, fiscal quarter end valuations are adjusted for cash flows. Values are compared to previous quarter's value to determine material changes in market value (greater than 25%). Major differences are investigated and adjustments are made, if necessary. Some major differences may occur when a large cash or stock distribution was made with large capital gain/loss being recognized.

Portfolio Endowment Accountant prepares workpapers and an accounting manager reviews them. Once approved, Portfolio Endowment Accountant provides Mellon the prices in an excel spreadsheet via e-mail. UTIMCO verifies Mellon has recorded pricing correctly by downloading



from Mellon the portfolios into the same spreadsheet as was provided to Mellon, and performs a one-to-one comparison.

K:\Files\PrivateInvestments\BODmatters\ValuationPolicy2000.doc

K:\Files\Procedures\Accounting\PrivateInvValuationProcess.doc

Alternative Marketable Investment prices are also provided by UTIMCO. Estimated values or performance numbers are required to be provided by the managers to UTIMCO by the 4th business day. If an estimate has not been received, UTIMCO follows up with an e-mail. In most cases, an estimated performance number is provided. In an excel spreadsheet, UTIMCO applies this performance to the previous month's value to determine a current month estimate. A Portfolio Endowment Accountant calculates these estimates and an accounting manager reviews it. Once approved, the Portfolio Endowment Accountant will then forward spreadsheet to Mellon. On the next business day, the accountant will ensure that Mellon recorded the prices correctly by looking at a holdings report.

For other mutual fund investments, UTIMCO may also need to provide Mellon with a price. For instance, Capital Guardian faxes statements to UTIMCO reflecting income reinvesting, capital gain reinvesting, and end of month valuation. An accountant forwards these faxes to Mellon. The next business day, the accountant will review Mellon's holding report to ensure reinvesting was recorded correctly (correct number of units were bought) and pricing was posted correctly. However, some mutual fund prices are automatically picked up in Mellon's pricing process, for instance, Templeton and Goldman Sachs Emerging Market.

MBA Investment Fund. UTIMCO also provides Mellon with the valuation for the MBA Investment Fund. Usually on the first business day, an accounting manager receives an e-mail from MBA Investment Fund' accountant. The information contained in the e-mail is the detailed investments of the MBA Investment Fund, UT's percentage ownership, and the balance sheet. By applying the percentage ownership to the stockholder's equity amount, UT's estimated value in the investment is determined. This is forwarded to Mellon via an e-mail. Again, the next business day, an accountant verifies the valuation was updated correctly by Mellon either by looking at a holding report or the balance sheet of the MBA Investment Fund account.

Other Pricing. UTIMCO also verifies any other prices that Mellon has to manually post. For instance, BGI index funds. UTIMCO can get the pricing from the BGI website and then compare to a Mellon holdings report to ensure Mellon has valued the investments correctly.

Also attached is a spreadsheet showing when prices are usually available for the PUF and GEF.

K:\Files\Mellon\PricingTimeline.xls



For the prices that UTIMCO provides or verifies, a spreadsheet is maintained to keep track of when a price is received and when it is verified (other month-end closing processes are also tracked on this spreadsheet):

K:\Files\Procedures\Accounting\ProceduresSignoff\MONTHLY.XLS

Performance. All managers are required to send formal reconciliations of market value and accrued income to UTIMCO within 30 business days, as well as performance numbers. Since these values are used to calculate performance, UTIMCO is confident that Mellon values are good. Mellon performance numbers and manager's performance numbers are compared for material discrepancies.

UTIMCO also performs month-end reconciliations for index funds and mutual funds. Although the reconciliations are performed mainly to verify holdings balances and income is recorded correctly, market values are also verified. On some rare occasions, a market value can change from preliminary numbers provided to us to the final month-end statement, but it's never material enough to re-open a month. If a price were to change that dramatically, we should have already been notified.

When final month-end values are received from the alternative marketable managers, they are reviewed to see if there was any major change from the estimate. A change may not be material to the fund, but will be material to the performance of that asset class. In most cases, the accounting records would not be re-opened and an FYI e-mail is sent to Managing Director and President.

Price Sources

Concept of Official Price Source

The official price source is the preferred source chosen by Mellon Trust to value a security. However, we may receive prices from other sources. The price received from the official price source is used in clients' portfolio valuations, unless it is determined to be inaccurate.

Mellon Trust's Global Pricing System automatically assigns an official price source for every security held, immediately following the initial acquisition. The assignment of the official price source is based on asset type and the vendor products to which Mellon Trust currently subscribes.

Official Price Source

Mellon Trust's official pricing sources are listed below:

- Merrill Lynch
- Interactive Data Corp (IDC)
- J.J. Kenny
- Lehman Brothers



- Securities Valuation Co.
- FRI Corporation
- Reuters
- Street Software Technology, Inc.

Reasons to Change Official Source

Mellon Trust monitors prices supplied by official sources daily and may change the official price source of a given security if:

- The official price source was incorrectly assigned
- The official price source is not pricing a particular asset
- The pricing methodology used by the official source is not appropriate for a particular asset
- An alternate source has a more relevant price

Supplemental Price Sources

Supplemental price sources include:

- Bloomberg
- Wall Street Journal
- Financial Times
- Morgan Stanley
- Brokers
- Client-preferred sources
- Clients and investment managers

Source of Foreign Exchange Rates

Mellon Trust’s pricing source for Foreign Exchange Rates is World Markets Company (WM Co.) The WM FX Rates are intended to be “closing” rates and therefore are published once per day. The calculation time is as of 4:00 PM London/ 11:00 AM EST.

Price Sources and Frequencies

Security Type	Official Vendor	Frequency	Other Vendors*
Fixed Income Pricing - U.S. Corporates, Governments,	• Merrill Lynch	• Daily	IDC, Bloomberg, Lehman, Brokers.
Mortgage-Backed ARMS	• Merrill Lynch • Merrill Lynch	• Daily • Weekly & month-end	IDC, Bloomberg, Lehman IDC, Bloomberg
CMOs and Asset Backed	• IDC • Merrill • Street Software Technology, Inc.	• Weekly, the 15 th , & month-end • Daily • Weekly & month-end	Bloomberg, Brokers,



UT Investment Funds – Key Business Processes

Appendix 2

Municipals	• J.J. Kenny (via Merrill)	• Month-end	IDC, Bloomberg
Treasury/GNMA Options	• Bloomberg	• Month-end	
Private Placements	• Merrill Lynch	• Daily	
Equity Pricing - U.S.	• IDC (includes exchange traded equity options)	• Daily	Bloomberg, Reuters, Wall Street Journal, Brokers.
Futures/Options on Futures	• Reuters	• Daily	Bloomberg
Open Ended Funds	• IDC	• Daily	Reuters, Bloomberg
International Pricing	• IDC • FRI Corporation	• Daily • Daily	Morgan Stanley, Bloomberg, Financial Times
Intl Pricing –(Canada) Fixed Income Equities	• Securities Valuation Co • FRI Corporation	• Daily • Daily	FRI Corp, Reuters, Bloomberg, IDC, Morgan Stanley, Financial Times
Foreign Exchange Rates	• WM Company- 11:00 AM EST/4:00 PM London	• Daily	Reuters, Bloomberg

***Note:** Frequency for other vendors/sources is as required.

Weekly means prices are received each Friday. For U.S. Municipals, prices are received on the last business day of the month.

Methodologies

Introduction

Methodologies are discussed below for the following asset types:

- Insurance Contracts and Short Term Assets
- U.S. - Fixed Income, Equities, Closed-end Mutual Funds, Options
- Non-U.S. - Equities, Fixed Income, Options

New Issues

Newly issued Fixed Income assets for which a vendor price is not available are valued at 'cost' until vendor coverage begins or until a price is supplied from another source.

Insurance Contracts/Short-Term Assets

Insurance Contracts and Short-Term Assets are priced at book value.

Note: An asset is considered short-term if the number of days between issuance and maturity is less than one year.

Internally Generated Matrix Pricing

Internally generated matrix prices are available as an alternate to valuing Short-Term Assets at cost for Domestic and Eurodollar CDs, BAs, Commercial Paper, T-



Bills, FNMA/FHLMC maturing within a year of issuance, other U.S. Government Obligations, and Short-Term Municipals.

Matrix Pricing for U.S. Fixed Income Assets

Merrill Lynch evaluated prices (i.e. matrix prices) are derived using a benchmark security and a spread in basis points. The benchmarks (typically Treasuries or bellwether corporate issues) are updated real-time and reflect market conditions throughout the day. The spreads are assigned by Merrill traders and are adjusted as market conditions change. As benchmarks move, the assets assigned to these benchmarks also move.

U.S. Corporates

Merrill Lynch evaluated prices are used for most Fixed Income assets. Corporate bond evaluations typically reflect the market as of 2:30 PM Eastern Time. All other evaluations reflect the market as of 3:00 PM Eastern Time.

U.S. Governments

Prices for U.S. Treasuries reflect the market as of 3:00 PM Eastern Time and are supplied by Merrill Lynch.

U.S. Mortgage Backed

Mortgage Backed Assets' prices may be either Merrill Matrix or Merrill Seasoned Matrix prices.

Seasoning depends on several factors:

- Length of time since issue date
- Weighted average maturity
- Current market conditions

Commitments to Purchase GNMA, FNMA or FHLMC issues are priced generically by Merrill Lynch based on type, coupon and maturity date.

U.S. Private Placements

Private Placements require special handling in order to be priced by Merrill Lynch. Mellon Trust will obtain a copy of the certificate for private placements vaulted by Mellon Trust. If the necessary pricing-related information is not contained in the certificate, a copy of the prospectus or summary of provisions/covenants will be requested. Upon receipt Mellon Trust will review and submit to Merrill Lynch. Merrill will then set up a pricing model and begin to price the security. If this information is not provided, a Merrill price cannot be obtained.

U.S. CMOs and Asset Backed



CMOs and Asset Backed Securities are evaluated prices. Evaluation models consider factors such as underlying collateral characteristics, tranche payments specification, prepayment speed assumption, average life and benchmark spreads.

U.S. Municipals

Most municipal security prices are evaluations supplied by J.J. Kenny (via Merrill). The remaining is hand priced by Kenny. All Kenny prices reflect the market as of 3:00 PM Eastern Time on the pricing dates.



Listed U.S. Equities and Closed-End Funds

For Listed U.S. Equities and Closed-End Funds, the Composite close price is considered the official price.

For active listed assets that did not trade today, a mean of the current bid and asked prices is the official price.

Non-NASDAQ Over the Counter U.S. Equities

The current bid price is considered the official price for Non-NASDAQ Over the Counter Assets. If there is no current bid, the current asked price is considered the official price.

U.S. Options

For Options, a mark to market price is considered the official price if the option trades on a given day.

The price is the last trade, if the last trade price falls between the current bid and asked. If the trade price is less than the current bid, the bid is considered the official price. If it is higher than the current asked, the asked is the official price. If the security did not trade, the mean of the current bid and asked is the official price.

If only a bid or an asked price is available for an option, the price is reviewed by Mellon Trust, and compared to the last official price, the strike price and the price of the underlying security. After this review, the current bid or asked may be considered the official price

International Markets

Local Primary Exchange's reported price (usually the latest available trade price) is the official price.

United Kingdom

The last sale/trade price is the official price for securities trading on the SETS exchange.

The mid-price is the official price for securities trading on the London Stock Exchange (LSE).



Canada

Securities Valuation Company (SVC) is the primary official price source for Canadian bonds. SVC will deliver Scotia McLeod prices for all Canadian bonds, which are part of the Scotia Universe of fixed income indices. Any non-Scotia Indexed bonds will be priced using SVC's internal matrix price or other available contributor price. FRI's evaluated prices are available as a secondary source to supplement SVC's coverage.

The last available trade price or current bid from the Primary Local Exchange is the official price for Canadian equities. Inter-listed assets are priced based on volume (when the issue is traded on more than one exchange) or an exchange hierarchy (if no trading occurred).

Over the Counter International Assets

Over the Counter assets are priced by IDC, or FRI through their own pricing contacts in the local markets or through Reuters and Bloomberg Contributor pages.

Over the Counter Currency Options

Over the Counter Currency Options are priced using a Black-Scholes pricing model that takes into consideration the option strike price, expiration date, market risk free rates and applicable volatility.

Price Exceptions

Introduction

There are three price exception scenarios:

- There is no official price
- The official price is not current
- The price varies beyond tolerance

No Official Price

No official price occurs when an official price source does not supply a price. Examples of this are assets without an S&P CUSIP or a real SEDOL. These assets require special handling and may require an alternate source for pricing.

Official Price Not Current

Inactive issues (delisted, bankrupt, or suspended) are exceptions and are left as stale prices representing the last available trade or mean price unless a price can be obtained from a manual source. Examples of manual sources are the NQB Pink Sheets and broker quotes.

Prices from supplemental or alternate sources may be considered official prices in "exceptional" cases only if the official price was:



- Not received
- Not current
- Deemed inaccurate

Vendor Price Varies Beyond Tolerance

Vendor price variances are reported when an asset's price change is greater than the allowed tolerance beyond an assigned benchmark. (See page 10 for Indices)

Price variances are also reported when vendor supplied data varies between sources greater than 2%. At month end, this variance check also signals issues for which no month end value was provided for the month end date.

Variances exist for many reasons, including but not limited to a:

- Capital change or tender offer
- Rumor of acquisition or merger
- Security being delisted, suspended from trading on an exchange, or in bankruptcy proceedings
- Security either over or under performing relative to the index against which it is being compared

Manual Pricing

When pricing vendors are unable to provide prices for securities that do not actively trade through established exchange mechanisms or for securities for which there is limited information in the market place, broker quotes are sought or internal calculations are applied if feasible. If all the aforementioned sources have been exhausted, investment managers are contacted for a price as a last resort. Examples of these difficult to price securities include defaulted equity issues and privately placed debt issues.

The accounting teams from statements received from the fund, partnership, or investment manager price commingled funds, partnerships and real estate assets.

Vendor Manual Prices

Mellon Trust obtains some prices manually from some vendors. These prices need to be manually entered by the Pricing Specialist.

Examples of vendor manual prices include:

- Broker Contributor pages from Reuters Securities 3000 System
- Bloomberg Contributor prices.
- Broker bids from the National Quotation Bureau's "Pink Sheet" and "Yellow Sheet" listings



Indices Used in Price Variance Research

Introduction

The following categorizes the indices used as benchmarks for the identification of price variance exceptions.

Non-U.S. Equities

Morgan Stanley Capital International Country Indices are used to benchmark the following marketplaces:

Argentina	Hong Kong	Norway
Australia	Indonesia	Philippines
Austria	Italy	Portugal
Belgium	Ireland	Singapore
Brazil	Japan	Spain
Canada	Jordan	Sweden
Chile	Korea	Switzerland
Denmark	Malaysia	Thailand
Finland	Mexico	Taiwan
France	Netherlands	Turkey
Germany	New Zealand	U.K.
Greece		

U.S. Equities

The Wilshire 5000 Equity Index is used as a benchmark for Equities traded in the U.S.

U.S. Fixed Income Assets

The Salomon Broad Investment Grade Bond Principal Index is used as a benchmark for Fixed Income Assets traded in the U.S.

Other Assets

Because it is difficult to define a benchmark for emerging markets, a 10% tolerance is set for allowed price variances. All price variances beyond 10% of index movement are researched.

Notes:



- If the variance for a security is greater than the tolerance plus or minus the change in the associated index, the security is reported as an exception and requires further review.

Assigned Tolerances

- U.S. Equities 20%
- U.S. Fixed Income 5%
- Non-U.S. Securities 10%

- Due to their inherent volatility, the tolerance for options is currently set at 100%.

Month-end Reconciliation and Price Overrides

Month-end Reconciliation

The reconciliation process can be a rigorous and time-consuming task for both the investment manager and Mellon Trust due to many factors.

These factors include but are not limited to:

- Different sources
- Different price types (close, bid, ask, mean, evaluated price)
- Subjectivity factors (with respect to fixed income evaluations)

Ways to Minimize Variances

Below are ways to improve the reconciliation process or minimize price variances between Mellon Trust and the investment manager:

- Mellon Trust actively utilizes multiple vendor feeds for most asset types. This allows us to compare sources and to challenge the vendors when unacceptable variances occur.
- Establish client-preferred sources for specific investment strategies.

Vendor Overrides

Vendor price overrides are processed by Mellon Trust, if the vendor price is deemed inaccurate. Vendors supply Mellon Trust with corrections throughout the month. The vendors communicate corrections through fax notifications.

Client Overrides

Client price overrides are processed at the client holdings level. These usually represent exceptions where the investment manager's price and Mellon Trust's official price vary beyond a tolerance established by the client. Client price overrides are not processed unless the client has established rules for price



overrides and communicated to Mellon Trust through the Accounting Manager or the Client Service Manager.

Valuation Criteria for Alternative Assets

Determination of Market Value in Financial Reports

The methodology used to evaluate the alternative illiquid, alternative liquid, and inflation hedging assets portfolios shall be performed quarterly using the guidelines outlined below. These valuations shall be communicated to the Fund's custodian by the third business day following the quarterly valuation period.

Direct Investments

a. Publicly Traded Stocks and Bonds

Restricted Stock

- last bid price or market closing price available for the last day of the measurement period discounted by 20% of market value.

No Restrictions

- last bid price or market closing price available for the last day of the measurement period.

b. Non-Public Stocks and Bonds

- if held as a direct investment and also held in a partnership/trust, valuation is price used by the partnership/trust, subject to significant events not reflected by the partnership/trust including, but not limited to, consummated sales and significant market fluctuations, or
- if held only as a direct investment, last price paid in a new round of financing (in which at least one substantial outside investor participated), subject to significant events including, but not limited to, consummated sales and significant market fluctuations.

c. Oil and Gas - valuation determined by using FASB 69 methodology

d. Real Estate at last appraised value

Partnership/Trust Investments



The partnership's/trust's capital account balance at the closest available reporting period, as communicated by the general partner, adjusted for intra valuation date contributions and withdrawals, subject to significant events not reflected by the partnership/trust including, but not limited to, consummated sales and significant market fluctuations.

Other

If no ascertainable value is available for the above-listed types of investments, book value of the investment shall be used for the investment's market value. If the investment is stated in foreign currency, the book value for the market value determination shall be further adjusted for currency exchange gains or losses.

Write Down - Book & Market Value

Investments determined to be permanently impaired in value shall, after the written approval of the President, be written down to a \$1 or entirely written off, and ratified by the Corporation's board.

Private Investment Valuation Procedure

QUARTERLY:

- The Private Investment Valuations are due on the third business day after the close of a quarter. Numbers are manipulated and provided to Mellon Trust for pricing.
- Valuations are calculated quarterly at the end of the months of February, May, August & November based on their position for the previous calendar quarter (i.e. February valuation is based on position at 12/31).
- Exceptions to this are foreign investments. Their value is calculated using the two quarters prior because financial reporting is done semiannually (i.e. 2/28 valuation will be based on their position at 9/30). Data is gathered from quarterly financial statements provided by the various partnerships, custodian capital balances or other sources determined by the type of investment. This is obtained in the following manner for different types of investments:

Oil & Gas - valuation determined by using FASB 69 methodology at fiscal year-end adjusted for cash flows for subsequent quarters

Public Stocks

Market closing price for the last day of the quarter as provided by Mellon. Restricted non-marketable securities are discounted 20%.



- | | |
|----------------------|--|
| Non-Public Stocks | If held as a direct investment and also held in a partnership/trust, valuation is price used by the partnership/trust, or if held only as a direct investment, last price paid in a new round of financing (in which at least one substantial outside investor participated) |
| Partnerships | Capital Account balance obtained from partnership quarterly report where available. |
| Foreign Partnerships | Capital Account balance times rate of exchange at balance date for MV in US dollars adjusted for cash flows in US dollars to current quarter. |
- On or about the third working day of the fiscal quarter-end month, an e-mail request for latest available financial statements is sent to all active partnerships. A sample e-mail is kept in k:\files\privateinvestments\letters\QuarterlyValuations.msg. In the case of a partnership, when the quarterly report is not available in time for the valuation process and there is no response to the e-mail request for information, a telephone request will be made to obtain the capital balances. Notes will be maintained as to the source of the valuation data (i.e. party providing data, date and time of conversation, etc.) Ask for Capital Account Balances for quarter for both The Permanent University Fund of the State of Texas and The Board of Regents of the University of Texas System General Endowment Fund. If possible, ask the partnership to reply via return e-mail or facsimile. Contacts and telephone numbers are maintained in k:\Files\PrivateInvestments\Letters\Address.doc.
 - Partnership values based on information as obtained above are entered for the date of value. An Adjusted Ending Value Report is then run in Private I to adjust provided values for cash flows to the current quarter-end. The adjusted values are reviewed and other manual adjustments (i.e. cash flows that may have been already included in the partnerships consideration of value) are made to arrive at fair market value. This value is then provided to Mellon as a per unit price carried out to six decimals which is entered to their system.
 - A download of Mellon holdings is done after they have entered pricing to their system which is then compared to the prices provided by UTIMCO. After it has been determined that Mellon balances are correct, they are input into Private I as the closing market value for the quarter and will balance to Mellon's market value.
 - Book value adjustments are made based on information provided by partnerships at the time of distributions. If a distribution is stated to be the last distribution pending final liquidation of a partnership, the book value is written down to \$1 pending receipt of a final K-1.

MONTHLY:



- Non-quarter monthly partnership valuations are based on the previous quarter-end valuation adjusted for cash flows. Foreign partnership valuations are also adjusted to apply current exchange rates.
- An Adjusted Ending Value Report is run in Private I to adjust provided values for cash flows to the current month-end. The adjusted values are reviewed and other manual adjustments (i.e. adjustments for money market account values and current exchange rates) are made to arrive at fair market value. This value is then provided to Mellon as a per unit price carried out to six decimals which is entered to their system.
- A download of Mellon holdings is done after they have entered pricing to their system which is then compared to the prices provided by UTIMCO. After it has been determined that Mellon balances are correct, they are uploaded into Private I as the closing market value for the quarter and will balance to Mellon's market value.

Monthly Sign-Off Procedures

PROCEDURE

FOR MONTH ENDED 8/31/03

Before Mellon closes:

- 1 Provide Mellon with Alternative Asset pricing
 <<See separate Alternative Asset procedures>>
- 2 Verify Mellon's Alternative Asset pricing:
 Compare values to the values we sent them
 Compare values to prior month for dramatic changes
 Verify that 20% discount is not applied to non-Alt Eq accts
- 3 Check if there are any O/S trades on Alternative Asset--
 Have Acctg change trade & settle date to same month
- 4 Verify Mellon updates **Barclays Global** prices correctly
- 5 Review individual Statement of Changes and look for
 unusual general ledger entries
 This review needs to be done every day until closed
 This review needs to be done every day until closed
- 6 Make sure transfer in/out net to zero on consolidation
 This review needs to be done every day until closed
 This review needs to be done every day until closed
- 7 Review "Bills" spreadsheet to ensure expenses are being
 Recorded
- 8 Provide Mellon with **MBA Investment Fund** price (UGEF2142)
 Verify Mellon records pricing correctly
- 9 Verify **Cap Guardian SC** price has been received
 Verify Mellon records pricing correctly
- 10 Verify **GSAM Emerging** price has been received
 Verify Mellon records pricing correctly
- 11 Verify **GSAM High Yield** price has been received
 Verify Mellon records pricing correctly
- 12 Verify **GSAM Overlay** price has been received
 Verify Mellon records pricing correctly
- 13 **Cap Guard Emerging 4202** (1-800-325-3590 Fund 15) 999652639



- Verify Mellon records pricing correctly
- 14 Verify **Maverick** valuation (2401) has been received
Verify Mellon records correctly
- 15 Verify **Perry** valuation (2403) has been received
Verify Mellon records correctly
- 16 Verify **Farallon** valuation (2404) has been received
Verify Mellon records correctly
- 17 Provide price for **Satellite** (4301) (estd performance due 3rd BD)
Verify Mellon records correctly
- 18 Provide price for **OCM Emerging** (2406)
Verify Mellon records correctly
- 19 Provide price for **Standard Pacific** (2408)
Verify Mellon records correctly
- 20 Provide price for **Protégé** (2409)
Verify Mellon records correctly
- 21 Provide price for **Sirios** (2410)
Verify Mellon records correctly
- 22 Provide price for **Arrowstreet** (2411)
Verify Mellon records correctly
- 23 Provide price for **Eminence** (2412)
Verify Mellon records correctly
- 24 Provide price for **ValueAct** (2320)
Verify Mellon records correctly
- 25 Provide price for **SG Partners** (2413)
Verify Mellon records correctly
- 25 Provide Mellon with pricing exceptions for internal equity managers
Verify Mellon records changes correctly
- 26 Provide Mellon with pricing exceptions for internal fixed income managers
Verify Mellon records changes correctly
- 27 Ensure all PUF land receipts have been recorded
- 28 Review PUF cash rec-Mellon vs Treasury
- 29 Determine accrued expenses are accurate
- 30 Review unprocessed items in TARECP
- 31 Load preliminary bond portfolios into BondEdge or Barra
and compare market prices
- 32 Accrued income receivable process on SIA securities
Must wait until interest allocations have been made
Check if PUF or LTF earned interest in UTXF2062 and move money to major funds
- 33 Update Oil & Gas valuations
- 34 Update spreadsheet and forward to Karen Lidstone by 17th
- 35 Send GL to Steve Woodard cc: Debbie Frederick
- 36 Calculate LTF unit price
- 37 Calculate LTF/GEF unit price rollforward
Start of new quarter, check GEF unit price on LTF Total Fund Transaction Detail-unit of participation
- 38 purchase
- PROCEDURES FOR ACCOUNTS HOLDING FUTURES:**
- 36 Determine which accounts have futures:
(Add new accounts to this list as needed)
 - GSCI account
 - GSAM (All GSAM accounts could possibly hold futures)
 - Pimco Accounts
 - Equitization account
- 37 Make sure variation margin is recorded correctly
GSCI account



- GSAM accounts
 - Liquidity Reserve account
 - Pimco Accounts
 - Equitization account
- 38 Determine if account holds collateral for futures which needs to be reclassified:
- GSCI account
 - GSAM accounts
 - Pimco Accounts
 - Equitization account

After month-end closes:

- 1 Allocate S/ITF income to endowments (UTSF2000)
- 2 Test if a security has earned income each period
- 3 Prepare month-end reports
- 4 Put month-end reports on intranet
- 5 Prepare Liquidity Reserve analysis of activity report
- 6 Issue performance
- 7 Statement of Investment report for Comptroller
Via Kerry Kennedy
Also send copy to Marie Robinson at Texas A&M
- 8 Prepare rollforward and review reorgs
- 9 Reconcile UT Invest to Mellon
- 10 Determine that participant contributions agree to LTF
quarterly financial statement file
- 11 Various reconciliations to custodians i.e. Mellon, Moody, Barclays Global, Templeton, Paine Webber
See separate sign off sheet k:\users\lema\procedur\signoff\bkrec.xls
- 12 Asset Under Management report
- 13 Send Management fee documentation to Business Affairs
- 14 Expenses to Dianne Watson by the 15th of month

**Internally Managed Fixed Income Portfolio
INVESTMENT GUIDELINES AND RESTRICTIONS**

The following guidelines apply to both the U.S. Bond and Non-U.S. Bond portfolios:

Investment Guidelines

The Accounts must be invested at all times in strict compliance with applicable law. The primary and constant standard for making investment decisions is the "Prudent Investor Rule."

Investment guidelines include the following:

General

- No securities may be purchased or held which jeopardize the Account's tax exempt status.
- No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board.



- No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board.
- The Accounts may utilize Derivative Securities with the approval of the UTIMCO Board to; a) simulate the purchase or sale of an underlying market index while retaining a cash balance for fund management purposes; b) to facilitate trading; c) to reduce transaction costs; d) to seek higher investment returns when a Derivative Security is priced more attractively than the underlying security; e) to index or to hedge risks associated with Fund investments; or f) to adjust the market exposure of the asset allocation, including long and short strategies; provided that; i) no leverage is employed in the implementation of such Derivative purchases or sales; ii) no more than 5% of Account assets are required as an initial margin deposit for such contracts.
- Such Derivative Securities shall be defined to be those instruments whose value is derived, in whole or part, from the value of any one or more underlying assets, or index of assets (such as stocks, bonds, commodities, interest rates, and currencies) and evidenced by forward, futures, swap, cap, floor, option, and other applicable contracts.

UTIMCO internal fixed income managers shall attempt to minimize the risk of an illiquid secondary market for a Derivative Security contract and the resulting inability to close a position prior to its maturity date by entering into such transactions on an exchange with an active and liquid secondary market. The net market value of exposure of Derivative Securities purchased or sold over the counter may not represent more than 15% of the net assets of the Account.

In the event that there are no Derivative Securities traded on a particular market index such as MSCI EAFE, the Account may utilize a composite of other Derivative Security contracts to simulate the performance of such index.

PIMCO shall minimize the risk that a party will default on its payment obligation under a Derivative Security agreement by entering into agreements that mark to market no less frequently than monthly and where the counterparty is an investment grade credit. PIMCO also shall attempt to mitigate the risk that the Account will not be able to meet its obligation to the counterparty by investing the Account in the specific asset for which it is obligated to pay a return or by holding adequate short-term investments.

The Account may be invested in foreign currency forward and foreign currency futures contracts in order to maintain the same currency exposure as its respective index or to protect against anticipated adverse changes in exchange rates among foreign currencies and between foreign currencies and the U. S. dollar.

Cash and Cash Equivalents

- Any cash balance in the Accounts shall be invested in the short term investment fund as determined by UTIMCO.



- Commercial paper must be rated in the two highest quality classes by Moody's Investors Service, Inc. (P1 or P2) or Standard & Poor's Corporation (A1 or A2).
- Negotiable certificates of deposit must be with a bank that is associated with a holding company meeting the commercial paper rating criteria specified above or that has a certificate of deposit rating of 1 or better by Duff & Phelps.
- Bankers' Acceptances must be guaranteed by an accepting bank with a minimum certificate of deposit rating of 1 by Duff & Phelps.
- Repurchase Agreements and Reverse Repurchase Agreements must be with a domestic dealer selected by the Federal Reserve as a primary dealer in U. S. Treasury securities; or a bank that is associated with a holding company meeting the commercial paper rating criteria specified above or that has a certificate of deposit rating of 1 or better by Duff & Phelps.
- Repurchase Agreements shall be collateralized to 102% of their market value marked to market on a daily basis.
- Reverse Repurchase Agreements and their coincident re-investment will be entered into on a matched book basis. The re-investment vehicles for the matched book transactions shall be the same Cash and Cash Equivalent instruments listed above. The rules for trading Repurchase Agreements and Reverse Repurchase Agreements shall follow the Public Securities Association standard industry terms.
- Mortgage Backed Securities (MBS) Dollar shall be executed as matched book transactions in the same manner as Reverse Repurchase Agreements above. As above, the rules for trading MBS Dollar Rolls shall follow the Public Securities Association standard industry terms.

Fixed Income and Domestic Fixed Income

Holdings of domestic fixed income securities shall be limited to those securities a) issued by or fully guaranteed by the U. S. Treasury, U. S. Government-Sponsored Enterprises, or U. S. Government Agencies, and b) issued by corporations and municipalities. Within this overall limitation:

- Permissible securities for investment include the components of the Lehman Brothers Aggregate Bond Index (LBAGG): investment grade government and corporate securities, agency mortgage pass-through securities, and asset-backed securities. These sectors are divided into more specific sub-indices; 1) Government: Treasury and Agency; 2) Corporate: Industrial, Finance, Utility, and Yankee; 3) Mortgage-backed securities: GNMA, FHLMC, and FNMA; and 4) Asset-backed securities. In addition to the permissible securities listed above, the following securities shall be permissible: a) floating rate securities with periodic coupon changes in market rates issued by the same entities that are included in the LBAGG as issuers of fixed rate securities; b) medium term notes issued by investment grade corporations; c) zero coupon bonds and stripped Treasury and Agency securities created from coupon securities; and d) structured notes issued by LBAGG qualified entities.



- U.S. Domestic Bonds must be rated investment grade, Baa3 or better by Moody's Investors Services, BB+ by Standard & Poor's Corporation, or an equivalent rating by a nationally recognized rating agency at the time of acquisition.
- Not more than 5% of the market value of domestic fixed income securities may be invested in corporate and municipal bonds of a single issuer provided that such bonds, at the time of purchase, are rated, not less than Baa or BBB, or the equivalent, by any two nationally-recognized rating services, such as Moody's Investors Service, Standard & Poor's Corporation, or Fitch Investors Service.

Non-U.S. Fixed Income

- Non-dollar bond investments shall be restricted to bonds rated equivalent to the same credit standard as the U.S. Fixed Income Portfolio.
- Not more than 7.5% of the Account may be invested in Emerging Market debt.
- International currency exposure may be hedged or unhedged.

Hedging Non-U.S. bond exposure: PIMCO may elect to hedge or not hedge the Non-U.S. Bond portfolio on a discretionary basis. The portfolio will be compared to the Unhedged SWGBI Non-U.S. PIMCO may hedge using the currencies underlying the bonds in the index. PIMCO may cross-hedge -- i.e. substitute Swiss Francs for Deutschmarks -- when market conditions favor cross-hedging.



External Manager Due Diligence Questionnaire

I. General Organizational Information & Update

A. General Information	Date of Update:	_____
<i>Manager Name:</i>		
<i>Address:</i>		
<i>Phone:</i>	<i>Fax:</i>	
<i>Email Address</i>		
<i>Internet Address</i> <i>(if applicable)</i>		
<i>Marketing/Client Contact</i>		
<i>Phone</i>	<i>Email</i>	
<i>Firm Assets Under Management (AUM)</i>		
<i>UTIMCO Assets Under Management</i>		
<i>UTIMCO Assets as a % of Total AUM</i>		
<i>Breakeven AUM</i>		



Brief description of Fund Products: (For each, please provide: Name, Strategy, Structure/Legal Entity, Fund Assets, Portfolio Manager) Attach any info if available.

Estimated time to complete the form _____

Name of Person Filling in Due Diligence Questionnaire _____

Title of Person Filling in Due Diligence Questionnaire _____

Signature _____

B. Background Information

1. What is the ownership structure of the organization?
2. Please list all related entities and the location and role of each.
3. Please list the U.S. and international regulatory agencies (i.e. SEC, CFTC, IMRO, etc.) with which the organization and related entities are registered and date of registration. And, please indicate if your organization or related entities are registered as any of the following:

Commodity Pool Operator
Futures Commission Merchant
Broker Dealer
Investment Adviser
Commodity Trading Adviser

4. Name the key members of the organization and provide a "Bio".
5. Who will be the individuals responsible for the UTIMCO account? What is the backup procedure for these personnel? (Please include investment/back office/client service).
6. What portion of senior management time is devoted to the management and investment activities of the firm? If not 100%, describe involvement with other activities.
7. Does senior management invest their own personal capital in the firm's investments? What percentage of total firm assets are employee assets?
8. How many employees are currently employed at your organization? Please provide breakdown by functional area and include an organizational chart.



9. ***Please provide updated copies of the following organizational documents if they have changed within the last 12 months or if UTIMCO has not yet been provided with them:***

*Partnership Offering Memorandum
Subscription Documents
Partnership Agreement*

Or

*Dates of Manager Agreement, Amendments, or Side Agreements
Manager's written procedures for compliance with UTIMCO guidelines*

AND

*Audited Financial Statements, Auditor Reports, and Management Letters
Organizational Chart*

Firm or Organization Mission Statement

Directed commissions/soft dollar policy or procedures

*Written procedures related to trading, operations, and reporting
as well as related compliance*

*Written procedures for determining and monitoring
counterparties*

*Written response to the G-30 recommendation for good risk
management of derivatives if you use derivative instruments or employ
leverage*

Written policy for allocation of investments among accounts

Code of Conduct/Insider Trading/Conflict of Interest Policies

*Insurance (type, amount, and carrier) include fidelity and /or
errors and omissions bond coverage as well as D & O*

Business Continuity/Disaster Recovery Plan

Continuing Education program

FORM ADV (all parts)

Most recent SAS #70 internal controls review (if available)

Regulatory filings such as Schedules 13d, 13g, or CFTC Form

40

*List and notice of authorized individuals acting on behalf of
Manager*

Many of the above documents will answer many of the questions that follow. Also, if you have other prepared documents that answer the following questions, please provide them to us. Please indicate the appropriate document that responds to the following questions.

10. ***Related to our activity, please provide the Name and Location of organizations currently providing the following and the nature/extent of those activities:***

Custody or Prime Brokerage Services (if more than one firm, please indicate role of each):

Legal Services:



Auditing:

Administrative Services:

Accounting Services:

Research Services:

Consulting Services:

Other:

C. Client Profile

ASSETS UNDER MANAGEMENT
Market Value as of _____

	<u>Number of Accounts</u>	<u>Total Dollars</u>	<u>Total Equity</u>	<u>Total Fixed</u>	<u>Total Other</u>
Tax-Exempt		- \$ Millions -			
Foundation					
Endowment					
Employee Benefit					
- ERISA					
- Non-ERISA					
Other – Taxable					
- Limited Partnerships					
Total					

NUMBER OF ACCOUNTS BY SIZE

	<u>Equity Oriented</u>	<u>Fixed Oriented</u>	<u>Other</u>	<u>Total</u>
Under \$50 million				
\$50-\$100 million				
\$100-\$200 million				
Over \$200 million				
Total				
Account load per portfolio manager				

ACCOUNTS GAINED/LOST

	<u>YTD 2003</u>	<u>Prior Year 2002</u>
Accounts Gained*		
- Number		



- *Dollar Value (\$Mil)*

*Accounts Lost**

- *Number*

- *Dollar Value (\$Mil)*

Net

- *Number*

- *Dollar Value*

**Institutional separate accounts only*

Do you have limits on amount you manage for each account? (List if yes)

Please attach updated performance for each account.

Please provide a history your assets/year over the last five years. Please include separate lines for:

- *Total firm assets*
- *This specific asset class (eg. Equities)*
- *This specific mandate*

D. Recent Developments

1. **Have you had significant organizational change (merger, strategic alliance, internal reorganization/job redesigns) in the past year?**
2. *Have you changed your investment philosophy, investment process, geographic markets, or types of assets and financial instruments used over the past year?*
3. **What changes have occurred in your business or operating environment (e.g., competition, pricing structure, technological developments, legislative or regulatory activity, industry capacity, cost, etc.) that affect your business directly?**
4. *Have you experienced staff turnover during the past year?*

<i>Staff Turnover</i>					
	<i># of employees</i>				<i>Delineate position(s)</i>
	<i>Gain</i>		<i>Lost</i>		
	<i>YTD</i>	<i>2002</i>	<i>YTD</i>	<i>2002</i>	
Senior mgmt./portfolio mgmt.					
Analysts					
Client Service/Marketing					
Trading					
Operations					
Financial Reporting					



Risk Management					
------------------------	--	--	--	--	--

5. *What are your future expansion plans?*
6. *Is your firm experiencing any litigation or customer complaints at this time? If so, please describe.*

E. Fees

1. *Describe fee arrangements with existing clients including domestic, offshore, private, public and managed accounts. Including:*
Management Fees
Performance Fees
High Water Mark policy
Lock-up Period

2. *Are any clients presently being charged lower fees than stated above?*
3. *What is your investment minimum?*
4. *What is your withdrawal policy?*
5. *Are there any confidentiality provisions at your organization that would preclude the public dissemination of your results?*

F. Marketing/Client Service

1. *List all reports and correspondence usually sent to clients.*

Portfolio Statement: -holdings, transactions, and performance	
Market Letters:	
Other: (at client's discretion)	

2. *What risk information is available to clients on a regular basis?*

II. Investments



A. Investment Strategy & Style

Overview

1. ***Describe your investment strategy and its principles.***
2. ***Describe the instruments you are using in the portfolio and the markets in which you trade.***
3. ***Who are the key employees making investment decisions? Please include both educational and professional credentials. How are they compensated? If their compensation is performance-based, please elaborate.***
4. ***Are there external investment subadvisors involved with UTIMCO portfolio management? Please identify the external sub-advisor/provider and explain their responsibilities and how you monitor their performance of duties and compliance with guidelines.***

Process

5. ***Describe the development of your investment approach. Is this system proprietary? Is it quantitative and /or computer enhanced/generated? Please explain.***
6. ***Describe your investment process. How are investment ideas generated? What is your competitive edge? How do you handle security/sector/industry/cap/beta/duration within your portfolio construction regime?***
7. ***What is your trading philosophy?***
8. ***In general, are your trades primarily spread, arbitrage, outright, or other?***
9. ***What is your hedging policy?***
10. ***What types of diversification are in your fund?***
11. ***Do you generate Unrelated Business Taxable Income and do you expect to continue to generate unrelated Business Taxable Income? If so, how much last year?***
12. ***Do you employ derivatives or leverage? If so, to what extent, and, how are these activities controlled and monitored?***

Key Portfolio Attributes

13. ***How do you anticipate your strategy performing in:***

Bull markets



Bear markets

Flat trendless markets

High volatility markets

Low volatility markets

Variability of Investment Style & Strategy (if quantitative in nature, please explain your model)

14. *Describe subjective decisions that must be made. For example, size of order, timing of order entry, splitting orders, rolling positions forward, selecting contract months, selecting markets, reversing and liquidating positions.*
15. *What are the factors used in making timing decisions and other subjective decisions (e.g., exchange rate differences)?*
16. *Who makes the subjective decisions required by your approach? If that person is unavailable what happens?*
17. *Does your approach differ by market? If so, to what extent?*
18. *How frequently are changes made to your approach?*
19. *Are any changes planned for the future?*
20. *What is your process for engaging in new investments?*
21. *What are the limits of your strategy relative to the markets in which you trade?*

B. Investment Performance

1. *Please provide monthly performance history since inception, net of fees for the portfolio/fund in which UTIMCO invests or intends to invest.*
2. *Please indicate whether or not performance records reflect discretionary trading, and investment authority and control by a single portfolio manager, or does it reflect a group or department's performance subject to oversight of management direction, or control?*
3. *Does the fund's entire performance history reflect the performance of the fund with actual dollars invested? If no, explain.*
4. *Does the fund's performance history include a track record from a previous employer? Do you have access to supporting documentation to substantiate the performance?*



5. *List the best/worst dollar and percentage monthly profit/loss among all your funds/accounts with similar strategies?*
6. *What were the three largest withdrawals in these funds since inception?*
Date
% of equity
Reason
7. *What is the benchmark, and what is the acceptable tracking error to the benchmark? How is tracking error monitored and controlled?*
8. *Are analytical models used for portfolio and security selection on mainframe systems? Are analytics independently reviewed? By whom? How often? Have the systems which are utilized for analytics, trading and trade processing been independently reviewed? If so, when and by whom? What were the results?*
9. *Describe procedures for performance and composite calculations. Are statements reconciled with custodial records before monthly performance calculations are made? Please provide monthly performance calculations/methodology with the monthly statements you send, or will send, UTIMCO each month. Also, please provide an example of the monthly calculation of your investment benchmark.*
10. *Does your performance data comply with AIMR performance presentation standards?*
11. *If yes, please indicate whether verification is Level I or II? Who provides verification?*

C. Portfolio Construction

1. *How many positions do you normally maintain? Long? Short?*
2. *What is your average holding period/turnover?*
3. *What is the fund's concentration limit per single investment? Are there exceptions to this rule?*
4. *What is the maximum percentage of assets committed to one market? To each sub-market group?*

D. Valuation & Pricing

1. *Do you maintain written policies and procedures for the valuation of portfolio investments that detail the specific methodology, including the use of market or model based valuations, to be used by instrument type? If yes, please attach.*
2. *What is the frequency of valuation/pricing?*



3. *Does your pricing come from an independent source? Please indicate your source(s).*
4. *Describe how your securities and commodities are valued (i.e. bid, ask, 2-sided quotes, mean of bid/ask, model, etc.).*
5. *How do you value collateral for various transactions and what is the frequency of valuations?*
6. *What percentage of your portfolio must be marked to dealer prices?*
7. *Describe how the dealer priced portion of the portfolio is substantiated, by whom it is substantiated, and how the decision is made to price within a bid/ask spread.*
8. *Describe the average range, in basis points, or the bid/ask spread for a typical dealer market security in your portfolio. What is the maximum range?*
9. *For securities held which are not readily marketable, and therefore not easily priced, what procedures are in place to determine market value and “stress test” that value?*
10. *For unrated securities, what procedures are in place to determine equivalent ratings? What is the review process for these ratings? How often?*

III. Operations

A. General Operational Overview

1. *How many professionals are there in the back office staff? List key individuals along with relevant experience or qualifications.*
2. *Describe the degree of segregation of duties among trading, accounting, and settlement and custody?*
3. *How is trade information communicated to the custodian or prime broker?*
4. *What is your investment allocation policy among portfolios?*
5. *What are your policies in relation to brokerage? What is the current round trip brokerage rate paid?*
6. *Do you ever share in commissions (i.e., accept rebates)? What is your commission to equity ratio?*
7. *What is your arrangement with broker-dealers and futures commission merchants regarding soft dollars? Directed commissions?*
8. *What procedures are in place to assure soft dollars and directed commissions are properly allocated to UTIMCO?*



9. *What are your proxy voting policies and procedures?*
10. *Do you reconcile the cash balance in UTIMCO's account to the custodian's cash balance on a daily basis? If not, how often do you balance cash to the custodial records and how do you monitor cash to ensure there are no overdrafts or uninvested dollars. Has there ever been a cash overdraft in UTIMCO's account?*
11. *Describe procedures in place for performing reconciliations of security positions, interest, dividends, etc. with custodial records and counterparties. Include the following details:
How often are reconciliations performed?
How soon after the period are the reconciliations completed and reviewed?
What procedures are in place to follow up on unreconciled items?
Are unreconciled items aged?
Is there a materiality threshold for resolving unreconciled items?
Who performs the reconciliation review, provides trade information, oversees trade blotters, confirms trades with counterparties and imports data or trade systems?*
12. **Are broker statements reconciled with custodial records before monthly performance calculations are made?**
13. **Describe how cash and security movements are accomplished.**
14. **What records of order placement are maintained? For how long? Are orders time-stamped or recorded?**
15. *Have you had any errors in placing orders? If so, how are errors resolved? Please explain circumstances.*
16. *Do you have any systems or methods in place to make funds available for redemptions?*
17. *What procedures are in place to follow up on unreconciled items? Are unreconciled items aged?*

B. Trading

1. *What controls are in place so that no fund/account has preference?*
2. *When and how are investment orders placed? Who has primary responsibility for placing orders? If unavailable, who supervises placement of orders? Are orders kept confidential from employees? What type of information is maintained on each fund/account?*
3. *How are bulk orders placed? Large orders broken up? Are personal or proprietary orders included in bulk orders? In what sequence are orders placed with brokers? How are fills allocated among accounts with the same broker? How are partial fills or fills at different prices treated?*



4. Do principals or employees trade for their own accounts? Is this monitored and are records maintained? Are records of such proprietary/affiliated trading available for inspection by investors?
5. When are proprietary/house orders placed? Separately or with client orders? Do proprietary/affiliated accounts always receive less favorable executions? Who monitors? Do foregoing principles apply equally to the trading of securities, commodities, options, forwards, and cash instruments?
6. What types of orders are placed to initiate positions (e.g., market, limit, stops)? How long are orders good for?
7. Are trailing stops used on existing positions? How frequently are these adjusted?
8. Do you have a specific loss point at which you would stop trading or go to cash?
9. Discuss how best execution and trade allocation are monitored and reviewed within your organization. How often do such reviews take place? What documents are reviewed; who performs the review? Is your firm trading with any affiliates on behalf of UTIMCO? If yes, how is best execution monitored?
10. Please provide your annual commission breakdown

	Manager Name As of		
	Equity Funds	Fixed Income Funds	Other
Best Execution			
Directed Brokerage			
Research (including IPOs)			
Third Party Research			
OTC			
Total			

D. Systems & Services

Accounting/Portfolio Mgmt/Trading Systems

1. Do you rely upon an outside accounting firm or maintain your own accounting data? Are your accounting policies consistent with industry standards?



2. *Briefly describe the hardware and software systems that you rely upon to produce accounting information.*
3. *Are your accounting records kept on a cash basis (e.g., coupon securities, expenses, fees, etc.) or accrual basis?*
4. *Have you changed your accounting methodology over the past year? If so, why?*
5. *Do you use a portfolio management system? If yes, please indicate system.*
6. *Do you use trading system software? If yes, please indicate system.*

Administrator

7. *If you have an administrator, do they independently compute the Net Asset Value?*
8. *Describe the methodology the fund administrator uses to review position prices and to independently value positions.*

Auditors

9. *Please identify your outside independent auditors and their length of service to your firm. Please provide reasons for replacement of predecessor auditors, if applicable.*

Prime Broker and Banks

10. *What is the genesis of each of your Custodians (if other than that directed by UTIMCO), Prime Brokers and Banking relationships?*
11. *Please provide financials and fidelity insurance information Custodians, Prime Brokers and Bankers you retain.*
12. *What banks do you use? What credit does each bank extend? What bank credit facilities have been used in the past? What is anticipated?*
13. *Who are your clearing brokers?*
14. *How are securities held by the Custodian or Prime Broker? Who holds foreign securities and how? (Which custodian or prime broker has custody of which assets?)*

Computer Systems

15. *Is your investment approach maintained manually or on computer? If the approach is maintained on computer, who owns the computer? the software? the written documentation relating thereto? Is it maintained on a mainframe or personal computer?*



16. *Are the analytics for the investment approach independently reviewed? Are models independently verified?*
17. *What types of computer security and virus protection procedures do you have in place?*
18. *Describe your disaster recovery plan or other emergency procedures (including utilities, phones and computer systems).*

IV. Oversight

A. Compliance

1. *Who is responsible for regulatory compliance? Is this a full-time position? How many other people work in the compliance department? Are they also full-time?*
2. *What procedures are in-place to ensure regulatory compliance?*
3. *When was the last inspection by any federal, state, or self-regulatory agency or authority? Please provide a copy of the inspection reports and responses thereto.*
4. *Describe any past, threatened, or pending customer or other complaints, litigation, arbitration, reparations, or administrative (whether criminal, civil, or administrative) proceedings against your firm or anyone in the firm.*
5. *Have there been...*
 - ...Any investigations, private or public, by the SEC, NASD, CFTC, NFA, exchange, state authority, foreign authority, or other governmental or regulatory authority?*
 - ...Any correspondence with the SEC, NASD, CFTC, or NFA other than routine registration matters? Any audits?*
 - ...Any regulatory actions taken against the firm?*
 - ...Any insurance claims?*
6. *Have all filing requirements been met for Blue Sky purposes?*
7. *Who is responsible for UTIMCO guideline compliance? Are they also responsible for notifying UTIMCO if the guidelines are violated? If not, who is?*
8. *How are compliance violations, if they occur, handled within your firm? What kinds of compliance violations are brought to the attention of the head of compliance and/or senior management?*
9. *Do you have a system in place which analyzes transactions prior to trading to determine whether they are in accordance with UTIMCO Investment Guidelines?*



10. Do you have an internal audit staff? If yes, please provide names, title and background.

V. Risk Management

A. General Risk Information

- 1. Do you have a written risk management policy? If yes, please attach.*
- 2. Do you have a separate, independent, risk management area? If so, how long has this area been in place? And, how many employees are assigned to this area? What percentage of their time is devoted to risk management?*
- 3. What are your firm's general views on risk?*
- 4. What are the key specific risks of each fund?*
- 5. What tools do you use to control those risks?*
- 6. What operational systems do you use in the risk management area on a regular basis?*
- 7. Describe your due diligence process for new securities or new markets. How do you evaluate the ability to settle?*
- 8. Please describe the benchmark used for each UTIMCO account and limits and controls related to the acceptable amount of deviation from the benchmark.*
- 9. Please describe most restrictive and most lax guidelines and how the guidelines might be modified.*
- 10. What are the key current risk factors for the portfolio (i.e. interest rate movements, changes in the price level, etc.)?*
- 11. As of the most recent reporting period, what were the portfolio percentage concentrations for the top 10 investments?*
- 12. Do internal auditors and/or custodians periodically test compliance with investment guidelines as stated in UTIMCO documents?*
- 13. Are there any recommendations or improvements to your processes, which have come about as a part of this review? Please specify.*
- 14. Have recent examinations resulted in recommendations, which have not yet been addressed?*
- 15. As of this date, are you in compliance with UTIMCO's investment guidelines as stated in the UTIMCO agreement with your firm? If no, please explain.*
- 16. If you step outside the guidelines, do you have procedures in place to notify us?*



17. *Are all cash and security movements properly authorized by senior staff and separately executed by staff independent of the reconciling functions (i.e., capital call, cash distribution, and stock distribution)? If no, please explain.*

B. Risk Measures

1. *What is the basis risk of the UTIMCO portfolio versus its benchmark?*
2. *How do you calculate the risk of each trade/position?*
3. *What is your view toward liquidity as it relates to risk?*
4. *Do you use VAR analysis? If yes, please discuss. Do you stress test the portfolio? If yes, please discuss.*

C. Borrowing/Leverage

1. *Are you currently using margin for UTIMCO's account? Did you use margin over the past year? Will you use margin in the future?*
2. *What is the historical range of:*

Net exposure in the portfolio.
Gross long positions?
Gross short positions?
3. *What is your historical range for gross and net leverage positions? What is the average for the trailing 12 months?*
4. *What are the maximum allowable borrowings and gross exposures?*
5. *Who is the lender for margin? What is the lender's relationship to the firm?*

D. Counterparty Risks

1. *How do you identify and evaluate potential counterparties?*
2. *Do you have a list of approved counterparties? If yes, may we have a copy?*
3. *How do you monitor your counterparty risks?*
4. *How often do you review your counterparties?*
5. *Do your counterparties have trading limits?*



VI. Securities Lending

1. Do you use securities lending? If yes, please explain specifics.

2. Do you have a written securities lending policy? If yes, please provide a copy.

VII. Use of Derivative Products

1. Does your organization have a written derivatives policy statement? If yes, please attach.

2. Please indicate which of the following are employed:

<i>Privately Negotiated (OTC) Forwards</i>	<i>Privately Negotiated (OTC) Options</i>	<i>Structured Securities and Deposits</i>	<i>Stripped Securities</i>	<i>Securities with Option Characteristics</i>	<i>Exchange Traded Futures</i>	<i>Exchange Traded Options</i>

3. Please explain the purpose of the derivative instruments employed as they pertain to the overall investment strategy.

4. Are aggregate amounts of open interest in futures contracts monitored? Do you have limits as a percent of fund assets?

5. If derivatives are used, please summarize actions/processes/procedures in place to address each of the G-30's 20 recommendations for good risk management of derivatives.

VIII. Use of Private Securities

1. Do you invest in private (not traded on a listed exchange) securities?

2. If yes,... Please explain your private security investment strategy?

How are private securities priced?

Where are private securities held?

What is the average holding period of private securities?



Monitoring and Compliance

*The complete process checklist for each fund is included
as Appendix 2a to this report.*



Miscellaneous Key Processes

Safekeeping and Reconciliation

- All securities are custodied by Mellon Trust. Only a relatively small percentage of security certificates are physically held at a Mellon location. The majority of these securities are held at outside depositories and sub-custodians. With securities held at outside depositories, movement is handled through book entry reducing the risk of misappropriations resulting from physical movement of securities.
- Physical securities are held at Mellon Trust's New York vault, which has its own internal control procedures in place. The vault manager selects a sample of CUSIPs each week to count, and ensures that all CUSIPs are counted at least once a year. Additionally, the Audit and Risk Review Department performs a vault count annually.
- Locations of assets are maintained on Mellon's custody system. (This information can be viewed by UTIMCO through Client Reporting.) Reconciliations of cash and security positions on the custody system to custodians and sub-custodians are performed on a daily, semi-monthly or monthly basis.
- The custody system also provides real-time and batch updating for securities transactions to the accounting and valuation systems. Nightly, a computer program compares the



security positions of the custody system and the accounting and valuation systems and produces reports identifying the differences.

- The two systems in-house that maintain internally managed portfolios (UTInvest and Private I) are reconciled to Mellon every month by a UTIMCO accountant. Number of shares, cost basis and market values are reconciled. On a daily basis, the REIT accounts cash is reconciled to Mellon when the daily cash report is prepared by Operations.
- All external managers are contractually required to reconcile to Mellon's records every month and a copy sent to UTIMCO, usually within 30 days.
- Reconciliation of BGI, Templeton, Capital Guardian (small cap and emerging), GSAM Emerging and High Yield to Mellon are also prepared every month by a UTIMCO accountant. Number of shares, cost basis, market value and income received are reconciled. A log is maintained of when the reconciliation is prepared and when it is reviewed: K:\Files\Procedures\Accounting\ProceduresSignoff\BKRECS.XLS

Fund Expenditures

Overview

- Investment related expenditures paid by the Major Funds are external manager fees, custodian fees, legal fees, audit fees, fees for on-line services such as Barra and Wilshire, S&P rating fees, various consulting fees, and various other bills. The UTIMCO fee and PUF Lands Accounting reimbursement is also paid from the Major Funds quarterly.

Expenditure Procedures

- External manager bills, audit bills, bills from Barra and Wilshire, S&P rating bills, consulting bills, and various other bills go to Debbie Childers, who reviews the bills and insures they agree with the contract or agreement. Once a bill is approved, Debbie initials the invoice, notates from what account(s) the bill needs to be paid, and then gives bill to Operations to prepare letter to the custodian instructing them to make the payment via check or wire transfer. Debbie Childers will review and sign the instruction letter and pass it on to another authorized signor. Once the letter has been signed by two authorized signors, Operations will fax the letter to the custodian. Debbie will also "log" the bill into an excel spreadsheet (k:\files\expenses\billpaymentlog.xls) in order to track when the payment is made and to ensure the custodian recorded it correctly. Operations will keep a copy of the letter in their pending file until the check is received from the custodian (if applicable). They will attach a copy of the check(s) to the instruction letter and invoice and file appropriately. The check will be given to Administration for mailing.



- During accounting's normal month-end close, the bill payment log is reviewed to verify that all payments requested during the month were paid.
K:\Files\Expenses\BillPaymentLog.xls
- Legal fees paid by the Major Funds are usually related to Private Investments. Those bills related to Private Investments are approved by Sara McMahon or Trey Thompson and are then given to Judy Wheless to determine how the bill should be allocated to the Major Funds. Expenses related to individual investments are allocated between PUF and GEF based on their commitment percentages (for example, PUF 55% - GEF 45%) or the actual amount PUF and GEF invested. Expenses related to Private Investment as a whole are allocated to the Funds based on their portfolio sizes. Judy will prepare the instruction letter to the custodian to cut check(s) and Debbie Childers and another authorized signor will sign the letter(s). The letter(s) is then given to Operations for them to fax to the custodian. Again, a copy of the check will be attached to the letter and invoice when the check comes in. Operations and Judy will keep a copy of the paperwork in their files. The check will be given to Administration for mailing.

Legal fees related to Marketable Alternatives are also paid by the major funds. The Managing Director, Cathy Iberg, approves these fees. The expense is allocated between PUF and GEF according to their investment percentage (usually PUF 66% and GEF 34%). The same process is followed as with Private Investments, i.e. Judy Wheless prepares instruction letter, etc.

- The custodian automatically charges the Major Funds' accounts for custody and performance fees each month based on agreed-upon estimates. A true up is made every six months. The true ups are sent from Mellon to the Manager of Portfolio Accounting and Operations for review and approval. Once she has approved them, she notifies Mellon, via e-mail, that she agrees with these amounts and Mellon will charge the respective accounts.
- UTIMCO sends an invoice to Business Affairs at UT System informing them of the quarterly UTIMCO fees. The funds are wired on the first business day of the quarter (September 1, December 1, March 1, and June 1) from each of the Funds directly to UTIMCO's money market account with Dreyfus. An accounting manager directs the custodian bank to wire the funds based on the amounts submitted in the office.
- Every August, Randy Wallace from UT System's Budget Office will write a memo to Joan Moeller or Debbie Childers to request reimbursement from the PUF for payment of expenses related to the PUF West Texas Lands. The reimbursement amounts are based on the next fiscal year's budget and payment is requested the first business day of the quarter.
- All expenses are periodically compared to the budget by the Managing Director. Major discrepancies are investigated.



- Estimated external manager fees are calculated in a spreadsheet: K:\Files\Expenses\ExternalMgrFeeSchedule\FiscalYear2003Actual.xls
Individual manager fees are estimated based on contract terms with each manager and projected account values. All fees are based on the account value and currently a 2.5% quarterly growth rate is assumed to estimate fees in the future. Since fees are billed on a calendar quarter basis, in the month following each closed calendar quarter, estimated fees are updated to reflect the final calendar quarter-end value.
- Expense accrual entries are calculated by UTIMCO and are given to Mellon to record. The accruals are calculated by a staff accountant and reviewed by a manager before they are forwarded to Mellon. The staff accountant will also ensure that Mellon records the entries correctly. Currently, accruals are recorded for external manager fees, custody and performance fees, distributions, UTIMCO fees, subscription fees, and Cambridge consulting fees.
- In the month-end accounting files, all recorded expenses are documented, usually by copies of invoice, external manager fees spreadsheet or bank letters. The accounting files are prepared by a staff accountant and reviewed by a manager. Therefore, the expenses are seen and reviewed by multiple people.

Beneficiary Disbursements

Permanent University Fund (PUF)

According to the PUF's Investment Policy, "Annually, the U. T. Board of Regents will approve a distribution amount to the AUF. In conjunction with the annual U. T. System budget process, UTIMCO shall recommend to the U. T. Board in May of each year an amount to be distributed to the AUF during the next fiscal year. UTIMCO's recommendation on the annual distribution shall be an amount equal to 4.75% of the trailing twelve quarter average of the net asset value of the Fund for the quarter ending February of each year. Following approval of the distribution amount, distributions from the Fund to the AUF may be quarterly or annually at the discretion of UTIMCO Management "

Usually, at the May Board of Regents meeting, UTIMCO will submit an agenda item with the recommended annual distribution amount. If it is approved, UTIMCO usually decides to make the distribution all at one time. Therefore, on the first business day of September, UTIMCO will instruct the custodian to wire the whole amount to the Texas State Treasury. Since the wire is going to a non-UT account (Texas State Treasury), the bank instruction letter requires two authorized signatures. The approved agenda item is used as backup.

This distribution does not require approval from the UTIMCO board since the UTIMCO board approves the investment policy.



Long Term Fund (LTF)

According to the LTF's Investment Policy, "the annual unit distribution amount shall be adjusted annually based on the following formula:

- A. Increase the prior year's per unit distribution amount (cents per unit) by the average inflation rate (C.P.I.) for the previous twelve quarters. This will be the per unit distribution amount for the next fiscal year. This amount may be rounded to the nearest \$.0005 per unit.
- B. If the inflationary increase in Step A. results in a distribution rate below 3.5%, (computed by taking the proposed distribution amount per unit divided by the previous twelve quarter average market value price per unit) the UTIMCO Board, at its sole discretion, may grant an increase in the distribution amount as long as such increase does not result in a distribution rate of more than 5.5%.
- C. If the distribution rate exceeds 5.5%, (computed by taking the proposed distribution amount per unit divided by the previous twelve quarter average market value per unit) the UTIMCO Board at its sole discretion, may reduce the per unit distribution amount.

Notwithstanding any of the foregoing provisions, the Board of Regents may approve a per unit distribution amount that, in their judgment, would be more appropriate than the rate calculated by the policy provisions."

After the fiscal quarter end for November is finalized, an analysis is performed by UTIMCO personnel to determine whether a change in payout should be made. This proposal will first need to be approved by the UTIMCO Board. After the UTIMCO Board approves it, UTIMCO will submit an agenda item with the recommended distribution rate to the Board of Regents, usually at their May meeting. If approved, the distribution rate will go into effect for the first quarter of the next fiscal year. The advantage to having the payout approved at the May BOR meeting is that components will have a more accurate number to use in their budgets for the upcoming year. If issues do arise in the May meeting and the payout is not approved, changes and adjustments will be made for re-submission to the UTIMCO Board and then the Board of Regents at their August meeting.

The Investment Policy also states: "Distributions from the Fund to the unitholders shall be made quarterly as soon as practicable on or after the last business day of November, February, May, and August of each fiscal year." Since the LTF holds a negligible amount of cash, the LTF must sell GEF units to generate cash in order to make the distribution. This sale of units will occur on the last day of the quarter (same day as the distribution occurs).

Mainframe programs are run to determine the distribution amount each component should receive (and how much is reinvested). Spreadsheets are prepared by accountant containing detailed information provided to components regarding their distribution. After review by a manager, accountant will request Operations to e-mail spreadsheet to components. Operations



will also prepare bank instruction letter to have the custodian wire money to the correct account. The accountant will review the letter(s) and the letter(s) must be signed by one authorized signor.

See distribution portion of the attached procedures for more detail:

K:\Files\Procedures\Accounting\LTFBuyIn.doc

Permanent Health Fund (PHF)

According to the PHF Investment Policy, “the annual unit distribution amount shall be adjusted annually based on the following formula:

- A. Increase the prior year’s per unit distribution amount (cents per unit) by the average inflation rate (C.P.I.) for the previous twelve quarters. This will be the per unit distribution amount for the next fiscal year. This amount may be rounded to the nearest \$.0005 per unit.
- B. If the inflationary increase in Step A. results in a distribution rate below 3.5%, (computed by taking the proposed distribution amount per unit divided by the previous twelve quarter average market value per unit) the UTIMCO Board, at its sole discretion, may grant an increase in the distribution amount as long as such increase does not result in a distribution rate of more than 5.5%.
- C. If the distribution rate exceeds 5.5%, (computed by taking the proposed distribution amount per unit divided by the previous twelve quarter average market value per unit) the UTIMCO Board at its sole discretion, may reduce the per unit distribution amount.

Notwithstanding any of the foregoing provisions, the Board of Regents may approve a per unit distribution amount that, in their judgment, would be more appropriate than the rate calculated by the policy provisions.”

After the fiscal quarter end for November is finalized, an analysis is performed by UTIMCO personnel to determine whether a change in payout should be made. This proposal will first need to be approved by the UTIMCO Board. After the UTIMCO Board approves it, UTIMCO will submit an agenda item with the recommended distribution rate to the Board of Regents, usually at their May meeting. If approved, the distribution rate will go into effect for the first quarter of the next fiscal year. If issues do arise in the May meeting and the payout is not approved, changes and adjustments will be made for re-submission to the UTIMCO Board and then the Board of Regents at their August meeting.

The Investment Policy also states: “Distributions from the PHF to the unitholders shall be made quarterly as soon as practicable on or after the last business day of November, February, May, and August of each fiscal year.”



On the last business day of the quarter, UTIMCO will instruct the custodian to send 9 separate wires to the Texas State Comptroller (the Comptroller's office requires a separate wire for each account at the Treasury). See excel spreadsheet : K:\Files\Distributions\PHF\MellonInstructionLetter.xls This instruction letter is prepared by a staff accountant and then requires two authorized signatures.

Since the PHF holds a negligible amount of cash, the PHF must sell GEF units to generate cash in order to make the distribution. This sale of units will occur on the last day of the quarter (same day as the distribution occurs). On a rare occasion when the Treasury is not open on the last day of the quarter but the banks are, the actual distribution will occur on the following first business day, however, the sale of units will still occur on the last day of the quarter (to coincide with the sale of units for the LTF).

Short Intermediate Term Fund

According to the Investment Policy, "Distributions of income from the Fund to the unitholders shall be made as soon as practicable on or after the last day of each month." The distributions occur on the second business day on the month following the month income was earned.

Throughout the month, the custodian calculates income each valuation period and maintains a spreadsheet that allocates income to unitholders. This spreadsheet is forwarded to UTIMCO each valuation period. UTIMCO does some reasonableness testing and notifies the custodian if there are any problems. Components have the option of reinvesting their income or receiving it in cash once a month. After the last valuation period is approved by UTIMCO and the income allocation amounts are tested and approved, UTIMCO will notify the custodian, and they will wire money to the components (according to their standing instructions) who request to receive their income in cash. For those components who reinvest, the custodian will buy additional units in their accounts.

Separately Invested Endowment, Trust, And Other Accounts

According to the Investment Policy, "Distributions of income or amounts from the Accounts to the beneficiaries shall be made as soon as practicable, either: a) based on the terms of the trust instrument; b) following the fiscal quarter end for endowments; or c) on or after the last day of the month for operating Accounts."

Endowments:

A few days before the end of each fiscal quarter, UTIMCO will run a program to determine which endowments reinvest all or a portion of their income and will calculate the reinvestment amount based on the quarter's income received thus far. This program will create transactions to transfer the appropriate amount of cash from the income account to the sub 22 principal account so that it will invest in the LTF. After all income has been posted for the quarter (usually the 3rd



business day of the following month), another program is run to determine how much remaining income cash needs to be reinvested and how much needs to be distributed to components.

Accounting will prepare a spreadsheet that itemizes the amount of income, by endowment, that is being distributed to component. Operations will e-mail this spreadsheet to the components. Operations will prepare instruction letter to custodian requesting the custodian to wire determined amounts to each component's Dreyfus account. Some internal transfers might need to occur so that all wires will go out from the same custodian account (UTXF2062). Internal transfer instruction letters only require one signature.

K:\Files\Procedures\Accounting\SIADIST.DOC

Charitable Trusts:

Every month-end, distributions are made to CRT beneficiaries. The majority of the distributions are paid by check, but a couple of them are wired. An accountant prepares a spreadsheet showing the distribution amounts and a senior accountant reviews this. Once reviewed, payments are made.

The checks are prepared through the Solomon software package. The checks require two signatures. UTIMCO maintains a checking account with BankOne, which is kept at a zero balance. When checks are written, money is transferred from Mellon account UTXF2064 to cover the checks.

For distributions made by wire, the accountant requests Operations to prepare an instruction letter to Mellon requesting them to wire the money. Two signatures are required on this instruction letter (the accountant who calculates distributions, prepares report and prepares checks, is not an authorized signor).

K:\Files\Procedures\Accounting\CRTDISTR.DOC

If a Paine Webber sale is necessary to make a distribution, an accountant initiates a sale by phone. This is followed up with a written letter. UTIMCO requires that two signatures be put on this letter. Paine Webber will accept a faxed letter for their instructions, but their internal auditors require the originals be sent also. Periodically, if we do not send an original, Paine Webber will send us an unsigned copy of the letter and ask us to send a signed copy back to them.

Income Collection

Overview



UTIMCO mainly relies on Mellon's procedures for income collection (procedures outlined in their SAS 70).

- Mellon's income collections area involves the processing and reconciliation of income received from investments held in our accounts. Specifically, the income collections area collects dividends and interest due on payable date, processes income received, investigates underpayments and overpayments and prepares claims for income earned but not received on payment date. Interest income is generally recorded on an accrual basis. Dividend income is recorded on the ex-dividend date.
- Income accruals are processed in the Mellon custody system, which is updated for dividend announcements provided by an independent service organization or sub-custodian. Information regarding physical asset holdings is entered into the accounting and valuation systems through an automated interface with the custody system. The custody system updates the accounting and valuation systems in real-time as trade and other changes are made to custody holdings. A file of expected income collections or an "income map" is generated by CUSIP and SEDOL and by account on the custody system and is used subsequently to update the accounting and valuation systems.
- Income collections are subsequently reconciled to the income maps generated by the custody system. Differences between actual and expected receipts are identified by the custody system and an exception report is generated for investigation. Once differences are resolved, the income maps are adjusted, if necessary, and then released to the accounting and valuation systems. This release causes the collection to be reflected in the account.

Some extra UTIMCO procedures are done for internally managed accounts.

- For Fixed Income accounts, UTIMCO has created a database that projects expected income payments during the month for fixed income holdings, and this is compared to what Mellon records as actually being received. Differences are investigated and notated. End of month accrued income receivable is also calculated and is compared to Mellon's records. Usual differences are accrued interest bought or sold, short or long interest payment period due to issue date of the bond, and mortgage backed securities with greater than a month delay. A staff accountant generates and reviews report and investigates differences, and an accounting manager reviews it.
- External managers are required to reconcile their accrued income to Mellon in their normal month-end reconciliation process. These reconciliations ensure that Mellon is recording income correctly.

Controls with Custodian



- Instructions and information provided to Mellon Trust from customers should be in accordance with the provisions of the servicing agreement, trust agreement or other applicable governing agreements or documents between Mellon Trust and the customer.

UTIMCO has entered into a custody agreement with Mellon Trust, effective 7/1/2001, which expires in five years. In conjunction with the custody agreement, UTIMCO also provides an “authorization” letter which specifies whom is authorized to do what at Mellon, and if more than one approval is required. This letter contains sample signatures and is updated frequently.

Some controls in place are:

- Two signatures are required in some cases
- A call back is required for payments in cash in excess of \$100,000

K:\Groups\Operations\authorizations\MellonAUTHApril2002.DOC

- Sufficient controls over physical and logical access to Mellon Trust’s systems via terminals at customer locations should be established, monitored and maintained by the customer.

All UTIMCO employees are allowed to have access to the Mellon on-line system(s). All users only have view capabilities; no one has update capabilities. Each employee must obtain a unique user id and maintain their password. All user set ups go through the Manager of Portfolio Accounting and Operations. Special software is required to access their Client Reporting system and Measurisk. They also offer access via a protected website. Whenever an employee leaves UTIMCO, the Manager needs to notify Mellon to deactivate their user id.

- Timely written notification of changes to individuals authorized to effect activities on behalf of the customer should be adequately communicated to Mellon Trust.

The above referenced authorization letter is updated when an authorized employee leaves or an authorized employee is added either by new employment to UTIMCO or change in responsibility.

- Timely review of reports provided by Mellon Trust of account balances and related activity should be performed by appropriate customer personnel and written notice of discrepancies should be provided to Mellon Trust.

On line reports are reviewed by UTIMCO personnel throughout the month and problems are communicated to Mellon via e-mail.



- At month end, timely notification of changes in related parties for purposes of identifying party-in-interest transactions should be adequately communicated to Mellon Trust. (See discussion on authorization letter.)
- Customer investment managers should verify and reconcile securities and cash balances provided by Mellon Trust and communicate discrepancies on a timely basis.

Full reconciliation between an investment manager and Mellon is required every month; usually by the 30th. These reconciliations are performed by the investment manager. A copy is to be provided to UTIMCO.

- Timely review of reports provided by Mellon Trust of investment security and portfolio values should be performed by customers and investment managers and written notice of discrepancies should be provided to Mellon Trust.
- All managers are required to notify Mellon of any month-end pricing discrepancies by the fourth business day of each month.

APPENDIX 2a

COMPLIANCE REPORT FOR THE QUARTER ENDED FEBRUARY 28, 2003

Permanent University Fund Investment Policy

Fund Management

1. UTIMCO shall:
 - a) Recommend investment policy
Policy approved by UTIMCO board February 15, 2001; BOR approved an amendment to the Fund Distribution Section in August, 2001.
 - b) Determine specific asset allocation targets, ranges and performance benchmarks.
Policy approved by UTIMCO board February 15, 2001; BOR approved an amendment to the Fund Distribution Section in August, 2001.
 - c) Monitor fund performance against fund objectives
Performance reports prepared monthly to monitor performance.
 - d) Invest the Fund's assets in conformity with investment policy.
Fund assets are invested according to policy.
2. Unaffiliated investment managers shall be monitored for:
 - a) Performance
Evaluated periodically by Chief Executive Officer in the interim in place of Managing Director of Public Markets.
 - b) Adherence to investment disciplines
Evaluated periodically by Chief Executive Officer in the interim in place of Managing Director of Public Markets.

Asset Allocation Policy

1. The allocation of Fixed Income should not exceed 32% of the Fund and the allocation of Equities should be 68% to 90% of the Fund.
Fixed Income is 21.55% of the Fund and the allocation of Equities is 77.41%.

Performance Measurement

1. Investment performance will be measured by an unaffiliated organization at least annually.
Investment performance is provided monthly by Russell/Mellon. Russell/Mellon also prepares quarterly performance reports that incorporate performance universes, appropriate indexes and analytics to analyze Fund performance relative to other endowment funds and investment managers.

Investment Guidelines - General

1. Investment guidelines for index and commingled funds are being followed by the manager as determined by the terms and conditions of the Investment Management Contract.
All index and commingled fund managers are following investment guidelines.
2. All investments will be U. S. dollar denominated assets unless held by an internal or external portfolio manager with discretion to invest in foreign currency denominated securities.
All portfolios meet the requirement.
3. Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of Funds assets in such liquid investment fund.
All liquid investment funds have been approved.
4. No securities may be purchased or held which would jeopardize the Fund's tax-exempt status.
Securities held by the Fund do not jeopardize the tax-exempt status of the Fund.
5. No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board.
No managers are authorized to use margin or leverage.
6. No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board.
No short sales have been placed.
7. The Fund's investment in warrants shall not exceed more than 5% of the Fund's net assets.
The Fund's investment in warrants does not exceed 5% of the Fund's net asset value.

8. The Fund's investment in warrants not listed on the New York or American Stock Exchanges shall not exceed more than 2% of the Fund's net assets.
The Fund's investment in warrants does not exceed 2% of the Fund's net asset value.
9. The Fund may utilize Derivative Securities with the approval of the UTIMCO Board provided that:
 - a) No leverage, as defined in the Investment Policy, is employed in the implementation of such Derivative purchases or sales.
In determining leverage for PIMCO, cash assets allocated to futures contracts include cash equivalents securities defined as investment grade securities with a duration of one year or less.
 - b) The net market value of exposure of Derivatives Securities purchased or sold over the counter may not represent more than 15% of the net assets of the Fund.

Total exposure for the Fund as of 2/28/03 was \$536.7 million or 8.5%. The accounts holding futures were GSAM, PIMCO, GSCI and Cash Equalization (S&P 500 Future Contracts).

Investment Guidelines - Cash and Cash Equivalents

1. Unaffiliated liquid investment funds must be approved by the chief investment officer.
All liquid investment funds have been approved.
2. Commercial paper must be rated in the two highest quality classes by Moody's Investors Service, Inc. (P1 or P2) or Standard & Poor's Corporation (A1 or A2).
No C.P.'s held.
3. Negotiable C.D.'s must be with a bank that is associated with a holding company meeting the commercial paper criteria or has a C. D. rating of 1 by Duff & Phelps.
No C.D.'s held.
4. Bankers' Acceptances must be guaranteed by an accepting bank with a minimum C.D. rating of 1 by Duff & Phelps.
No Bankers' Acceptances held.
5. Repurchase Agreements and Reverse Repurchase Agreements must be transacted with a dealer that is approved by UTIMCO and selected by the Federal Reserve as a primary dealer in U. S. Treasury securities and rated A-1 or P-1 or the equivalent.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
6. Each approved counterparty shall execute the Standard Public Securities Association (PSA) Master Repurchase Agreement with UTIMCO.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
7. Eligible Collateral Securities for Repurchase Agreements are limited to U. S. Treasury securities and U. S. Government Agency securities with a maturity of not more than 10 years.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
The maturity for a Repurchase Agreement may be from one day to two weeks.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
9. The value of all collateral shall be maintained at 102% of the notional value of the Repurchase Agreement, valued daily.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
10. All collateral shall be delivered to the Fund's custodian bank. Tri-party collateral arrangements are not permitted.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
11. The aggregate amount of Repurchase Agreements with maturities greater than seven calendar days may not exceed 10% of the Fund's fixed income assets.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
12. Overnight Repurchase Agreements may not exceed 25% of the Fund's fixed income assets.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
13. Mortgage Backed Securities Dollar Rolls shall be executed as matched book transactions in the same manner as Reverse Repurchase Agreements above. As above, the rules for trading MBS Dollar Rolls shall follow the Public Securities Association standard industry terms.
No Mortgage Backed Securities Dollar Rolls have been executed.

Investment Guidelines - Domestic Fixed Income

1. Holdings of domestic fixed income securities shall be limited to those securities a) issued by or fully guaranteed by the U. S. Treasury, U. S. Government sponsored Enterprises, or U. S. Government Agencies, and b) issued by corporations and municipalities.

All securities held are permissible.

2. Permissible securities for investments include the components of the Lehman Brothers Aggregate Bond Index (LBAGG): Investment grade government and corporate securities, agency mortgage pass-through securities, and asset-backed securities. These sectors are divided into more specific sub-indices; 1) Government: Treasury and Agency; 2) Corporate: Industrial, Finance, Utility, and Yankee; 3) Mortgage-backed securities: GNMA, FHLMC, and FNMA; and 4) Asset-backed securities. In addition to the permissible securities listed above, the following securities shall be permissible: a) floating rate securities with periodic coupon changes in market rates issued by the same entities that are included in the LBAGG as issuers of fixed rate securities; b) medium term notes issued by investment grade corporations; c) zero coupon bonds and stripped Treasury and Agency securities created from coupon securities; and d) structured notes issued by LBAGG qualified entities.

All securities held are permissible.

3. U. S. Domestic Bonds must be rated investment grade: Baa3 or better by Moody's Investors Services, BBB- by Standard & Poor's Corporation, or an equivalent rating by a nationally recognized rating agency at the time of acquisition. This provision does not apply to an investment manager that is authorized by the terms of an investment advisory agreement to invest in below investment grade bonds.

All bonds purchased met or exceeded the rating requirement.

4. Not more than 5% of the market value of domestic fixed income securities may be invested in corporate and municipal bonds of a single issuer.

All single issuer holdings of corporate and municipal securities are less than 5% of the market value of the portfolio.

Investment Guidelines - Non-U. S. Fixed Income

1. Not more than 35% of the Fund's fixed income portfolio may be invested in non-U. S. dollar bonds.

21.4% of the fixed income portfolio is invested in international debt.

2. Not more than 15% of the Fund's fixed income portfolio may be invested in bonds denominated in any one currency.

The fixed income portfolio does not have 15% invested in bonds denominated in any one non-U. S. currency.

3. Non-dollar bond investments shall be restricted to bonds rated equivalent to the same credit standard as the U. S. Fixed Income Portfolio.

All bonds purchased met or exceeded the rating requirements.

4. Not more than 7.5% of the Fund's fixed income portfolio may be invested in Emerging Market debt.

The Fund does not hold more than 7.5% of the Fund's fixed income portfolio in Emerging Market debt.

Investment Guidelines - Equities

1. The Fund shall hold no more than 25% of its equity securities in any one industry at market.

The Fund does not hold 25% of its equity securities in any one industry at market.

2. The Fund shall hold no more than 5% of its equity securities in the securities of one corporation at cost unless authorized by the chief investment officer.

The Fund does not hold 5% of its equity securities in the securities of any one corporation.

Note: This does not include assets acquired through the Alternative Assets program nor individual securities held in the indexes.

Investment Guidelines - Alternative Investments

1. Investments in alternative assets may be made through management contracts with unaffiliated organizations as long as sufficient due diligence has been conducted and documented in due diligence memorandum. In the due diligence process,

it shall be verified that such organizations:

a) possess specialized investment skills

b) possess full investment discretion subject to the management agreement

c) are managed by principals with a demonstrated record of accomplishment and performance in the investment strategy being undertaken

d) align the interest of the investor group with the management as closely as possible

e) charge fees and performance compensation which do not exceed prevailing industry norms at the time the terms are negotiated.

All due diligence requirements have been performed and documented for the investments approved during the quarter.

2. Investments in direct investments in alternative non-marketable assets shall not exceed 25% of the market value of the alternative non-marketable assets portfolio at the time of the direct investment.
Direct investments did not exceed 25% of the total non-marketable portfolio at the time of the investment. At February 28, 2003, the Fund held 2.5% of its non-marketable portfolio in direct investments (excluding distributed stock).
3. Members of UTIMCO management may serve as directors of companies in which UTIMCO has directly invested Fund assets with approval of the UTIMCO Board.
No members of the UTIMCO management currently serve as directors.
4. All compensation paid to UTIMCO management of director services shall be endorsed over to UTIMCO and applied against UTIMCO management fees.
Compensation previously has been endorsed to UTIMCO. Currently, no members of the UTIMCO management serve as directors.
5. Service as a director shall be conditioned upon the extension of UTIMCO's Directors and Officers Insurance Policy coverage.
Coverage is extended through February 2003.

Fund Accounting

1. Significant asset write-offs or write-downs shall be approved by the chief investment officer and reported to the UTIMCO Board.
There have not been any significant asset write-offs or write-downs during this reporting period.
2. The Fund's financial statements shall be audited by an independent accounting firm selected by UTIMCO's Board.
The financial statements are audited annually by Deloitte & Touche LLP.
3. Market Value of the Fund shall be maintained on an accrual basis in compliance with Financial Standards Board Statements, Governmental Accounting Standards Board Statements, industry guidelines, and state statutes, whichever is applicable.
Market value is maintained on an accrual basis in compliance with applicable standards.

Valuation of Assets

1. UTIMCO shall determine the fair market value of all Fund net assets.
UTIMCO prepares accounting reports on a monthly basis based on the fair market value of net assets.
2. Valuation of Fund assets shall be based on the books and records of the custodian for the valuation date.
The valuation is based on the books and records of the custodian after review by UTIMCO accounting department.
3. Valuation of alternative assets shall be determined in accordance with the UTIMCO valuation criteria for alternative assets.
Alternative assets are valued based on UTIMCO valuation criteria.

Fund Distribution

1. Purchasing power of PUF investments for any 10-year period must be preserved. If not, the Board may not increase annual distributions to the AUF until purchasing power is restored except to pay principal and interest due and owing on bonds and notes.
Purchasing power of PUF investments has been maintained at 1.36% for 10 years ending February 28, 2003.
2. Annual distributions made to the AUF during any fiscal year may not exceed an amount equal to 7% of the average net fair market value of PUF investment assets.
The annual distribution for the year ending August 31, 2003 was \$363.0 million and was 4.75% of the prior twelve-quarter average net fair value calculated as of February 28, 2002.
3. The U. T. Board of Regents will approve a distribution amount to the AUF.
The Board approved the 2003 distribution in August of 2002.
4. UTIMCO recommends to the U. T. Board each year an amount to be distributed to the AUF during the next fiscal year.
UTIMCO recommended to the Board the 2003 distribution through an agenda item submitted and approved at the August 2002 meeting of the U. T. Board.
The 2003 distribution was made in one annual payment in September 2002.
5. Distributions from the Fund to the AUF may be quarterly or annual based on the discretion of UTIMCO's management.

Permanent University Fund Asset Allocation Guidelines

	Expected Return	Expected Risk	Neutral Allocation	Actual Allocation	Range
U. S. Equity Allocation			11.0%	13.1%	
Passive Large/Medium Cap					
Active Large/Medium Cap				3.2%	
Active Small Cap			10.0%	10.5%	
U. S. Equity Allocation			10.0%	6.6%	
Hedge/Alpha Transport Strategies			31.0%	30.2%	25% - 45%
Passive Developed Markets				5.4%	
Passive Emerging Markets			6.5%	6.3%	
Int'l Equity Allocation				4.9%	
Active Developed Markets				3.4%	
Active Emerging Markets			7.5%	8.3%	
Int'l Equity Allocation			5.0%	0.6%	
Hedge/Alpha Transport Strategies			19.0%	15.2%	10% - 30%
Private Capital				1.9%	
Venture Capital Partnerships				9.1%	
Private Equity Partnerships				0.4%	
Direct Investments				2.0%	
Private Debt Partnerships				0.3%	
Special Situation Partnerships			15.0%	13.7%	10% - 20%
Absolute Return			10.0%	8.6%	5% - 15%
Market Neutral Equity Hedge Funds				3.6%	
Commodities Futures				6.3%	
REITS			10.0%	9.9%	5% - 15%
Opportunistic Fixed Income				8.9%	
U.S. Investment Grade Debt			15.0%	21.4%	7.5% - 30%
U.S. Below Investment Grade Debt			0.0%	1.0%	0% - 5%
International Developed Markets			100.0%	100.0%	
Deflation Hedging Fixed Income				9.5%	
U.S. Govt. Bonds and Agencies					
Cash And Cash Equivalents					

Expected Nominal Return Expected Risk Return/Risk Ratio

The rebalancing of the Fund assets to achieve the neutral allocations shall be subject to the funding of alternative investments.
Risk is defined in annualized standard deviation terms.

The neutral policy portfolio is the sum of the neutrally weighted benchmark returns.

COMPLIANCE REPORT FOR THE QUARTER ENDED FEBRUARY 28, 2003

General Endowment Fund Investment Policy

Fund Management

1. UTIMCO shall:
 - a) Recommend investment policy
Policy approved by UTIMCO board February 15, 2001; policy effective March 1, 2001.
 - b) Determine specific asset allocation targets, ranges and performance benchmarks.
Policy approved by UTIMCO board February 15, 2001; policy effective March 1, 2001.
 - c) Monitor fund performance against fund objectives
Performance reports prepared monthly to monitor performance.
 - d) Invest the Fund's assets in conformity with investment policy.
Fund assets are invested according to policy.
2. Unaffiliated investment managers shall be monitored for:
 - a) Performance
Evaluated periodically by Chief Executive Officer in the interim in place of Managing Director of Public Markets.
 - b) Adherence to investment disciplines
Evaluated periodically by Chief Executive Officer in the interim in place of Managing Director of Public Markets.

Asset Allocation Policy

1. The allocation of Fixed Income should not exceed 32% of the Fund and the allocation of Equities should be 68% to 90% of the Fund.
Fixed Income is 20.72% of the Fund and the allocation of Equities is 79.28%.

Performance Measurement

1. Investment performance will be measured by an unaffiliated organization at least annually.
Investment performance is provided monthly by Russell/Mellon. Russell/Mellon also prepares quarterly performance reports that incorporate performance universes, appropriate indexes and analytics to analyze Fund performance relative to other endowment funds and investment managers.

Investment Guidelines - General

1. Investment guidelines for index and commingled funds are being followed by the manager as determined by the terms and conditions of the Investment Management Contract.
All index and commingled fund managers are following investment guidelines.
2. All investments will be U. S. dollar denominated assets unless held by an internal or external portfolio manager with discretion to invest in foreign currency denominated securities.
All portfolios meet the requirement.
3. Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of Funds assets in such liquid investment fund.
All liquid investment funds have been approved.
4. No securities may be purchased or held which would jeopardize the Fund's tax-exempt status.
Securities held by the Fund do not jeopardize the tax-exempt status of the Fund.
5. No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board.
No managers are authorized to use margin or leverage.
6. No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board.
No short sales have been placed.

7. The Fund's investment in warrants shall not exceed more than 5% of the Fund's net assets.
The Fund's investment in warrants does not exceed 5% of the Fund's net asset value.
8. The Fund's investment in warrants not listed on the New York or American Stock Exchanges shall not exceed more than 2% of the Fund's net assets.
The Fund's investment in warrants does not exceed 2% of the Fund's net asset value.
9. The Fund may utilize Derivative Securities with the approval of the UTIMCO Board provided that:
 - a) No leverage, as defined in the Investment Policy, is employed in the implementation of such Derivative purchases or sales.
In determining leverage for PIMCO, cash assets allocated to futures contracts include cash equivalents securities defined as investment grade securities with a duration of one year or less.
 - b) The net market value of exposure of Derivatives Securities purchased or sold over the counter may not represent more than 15% of the net assets of the Fund.

Total exposure as of 2/28/03 was \$223.1 million or 6.95%. The accounts holding futures were GSAM, PIMCO, GSCI and Cash Equalization (S&P 500 Future Contracts).

Investment Guidelines - Cash and Cash Equivalents

1. Unaffiliated liquid investment funds must be approved by the chief investment officer.
All liquid investment funds have been approved.
2. Commercial paper must be rated in the two highest quality classes by Moody's Investors Service, Inc. (P1 or P2) or Standard & Poor's Corporation (A1 or A2).
All commercial paper purchased met or exceeded the rating requirement.
3. Negotiable C.D.'s must be with a bank that is associated with a holding company meeting the commercial paper criteria or has a C. D. rating of 1 by Duff & Phelps.
No C.D.'s held.
4. Bankers' Acceptances must be guaranteed by an accepting bank with a minimum C.D. rating of 1 by Duff & Phelps.
No Bankers' Acceptances held.
5. Repurchase Agreements and Reverse Repurchase Agreements must be transacted with a dealer that is approved by UTIMCO and selected by the Federal Reserve as a primary dealer in U. S. Treasury securities and rated A-1 or P-1 or the equivalent.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
6. Each approved counterparty shall execute the Standard Public Securities Association (PSA) Master Repurchase Agreement with UTIMCO.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
7. Eligible Collateral Securities for Repurchase Agreements are limited to U. S. Treasury securities and U. S. Government Agency securities with a maturity of not more than 10 years.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
8. The maturity for a Repurchase Agreement may be from one day to two weeks.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
9. The value of all collateral shall be maintained at 102% of the notional value of the Repurchase Agreement, valued daily.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
10. All collateral shall be delivered to the GEF custodian bank. Tri-party collateral arrangements are not permitted.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
11. The aggregate amount of Repurchase Agreements with maturities greater than seven calendar days may not exceed 10% of the Fund's fixed income assets.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

12. Overnight Repurchase Agreements may not exceed 25% of the Fund's fixed income assets.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

13. Mortgage Backed Securities Dollar Rolls shall be executed as matched book transactions in the same manner as Reverse Repurchase Agreements above. As above, the rules for trading MBS Dollar Rolls shall follow the Public Securities Association standard industry terms.

No Mortgage Backed Securities Dollar Rolls have been executed.

Investment Guidelines - Domestic Fixed Income

1. Holdings of domestic fixed income securities shall be limited to those securities a) issued by or fully guaranteed by the U. S. Treasury, U. S. Government sponsored Enterprises, or U. S. Government Agencies, and b) issued by corporations and municipalities.

All securities held are permissible.

2. Permissible securities for investments include the components of the Lehman Brothers Aggregate Bond Index (LBAGG): Investment grade government and corporate securities, agency mortgage pass-through securities, and asset-backed securities. These sectors are divided into more specific sub-indices: 1) Government: Treasury and Agency; 2) Corporate: Industrial, Finance, Utility, and Yankee; 3) Mortgage-backed securities: GNMA, FHLMC, and FNMA; and 4) Asset-backed securities. In addition to the permissible securities listed above, the following securities shall be permissible: a) floating rate securities with periodic coupon changes in market rates issued by the same entities that are included in the LBAGG as issuers of fixed rate securities; b) medium term notes issued by investment grade corporations; c) zero coupon bonds and stripped Treasury and Agency securities created from coupon securities; and d) structured notes issued by LBAGG qualified entities.

All securities held are permissible.

3. U. S. Domestic Bonds must be rated investment grade: Baa3 or better by Moody's Investors Services, BBB- by Standard & Poor's Corporation, or an equivalent rating by a nationally recognized rating agency at the time of acquisition. This provision does not apply to an investment manager that is authorized by the terms of an investment advisory agreement to invest in below investment grade bonds.

All bonds purchased met or exceeded the rating requirement.

4. Not more than 5% of the market value of domestic fixed income securities may be invested in corporate and municipal bonds of a single issuer.

All single issuer holdings of corporate and municipal securities are less than 5% of the market value of the portfolio.

Investment Guidelines - Non-U. S. Fixed Income

1. Not more than 35% of the Fund's fixed income portfolio may be invested in non-U. S. dollar bonds.

24.6% of the fixed income portfolio is invested in international debt.

2. Not more than 15% of the Fund's fixed income portfolio may be invested in bonds denominated in any one currency.

The fixed income portfolio does not have 15% invested in bonds denominated in any one non-U. S. currency.

3. Non-dollar bond investments shall be restricted to bonds rated equivalent to the same credit standard as the U. S. Fixed Income Portfolio. All bonds purchased met or exceeded the rating requirements.

4. Not more than 7.5% of the Fund's fixed income portfolio may be invested in Emerging Market debt.

The Fund does not hold more than 7.5% of the Fund's fixed income portfolio in Emerging Market debt.

Investment Guidelines - Equities

1. The Fund shall hold no more than 25% of its equity securities in any one industry at market.

The Fund does not hold 25% of its equity securities in any one industry at market.

2. The Fund shall hold no more than 5% of its equity securities in the securities of one corporation at cost unless authorized by the chief investment officer.

The Fund does not hold 5% of its equity securities in the securities of any one corporation.

Note: This does not include assets acquired through the Alternative Assets program nor individual securities held in the indexes.

Investment Guidelines - Alternative Investments

1. Investments in alternative assets may be made through management contracts with unaffiliated organizations as long as sufficient due diligence has been conducted and documented in due diligence memorandum. In the due diligence process, it shall be verified that such organizations:
 - a) possess specialized investment skills
 - b) possess full investment discretion subject to the management agreement
 - c) are managed by principals with a demonstrated record of accomplishment and performance in the investment strategy being undertaken
 - d) align the interest of the investor group with the management as closely as possible
 - e) charge fees and performance compensation which do not exceed prevailing industry norms at the time the terms are negotiated.All due diligence requirements have been performed and documented for the investments approved during the quarter.
2. Investments in direct investments in alternative non-marketable assets shall not exceed 25% of the market value of the alternative non-marketable assets portfolio at the time of the direct investment.
Direct investments did not exceed 25% of the total non-marketable portfolio at the time of the investment. At February 28, 2003, the Fund held 3.1% of its non-marketable portfolio in direct investments (excluding distributed stock).
3. Members of UTIMCO management may serve as directors of companies in which UTIMCO has directly invested Fund assets with approval of the UTIMCO Board.
No members of the UTIMCO management currently serve as directors.
4. All compensation paid to UTIMCO management of director services shall be endorsed over to UTIMCO and applied against UTIMCO management fees.
5. Compensation previously has been endorsed to UTIMCO. Currently, no members of the UTIMCO management serve as directors.
Service as a director shall be conditioned upon the extension of UTIMCO's Directors and Officers Insurance Policy coverage.
Coverage is extended through February 2003.

Fund Accounting

1. Significant asset write-offs or write-downs shall be approved by the chief investment officer and reported to the UTIMCO Board.
There have not been any significant asset write-offs or write-downs during this reporting period.
2. The Fund's financial statements shall be audited by an independent accounting firm selected by UTIMCO's Board.
The financial statements are audited annually by Deloitte & Touche LLP.
3. Market Value of the Fund shall be maintained on an accrual basis in compliance with Financial Standards Board Statements, Governmental Accounting Standards Board Statements, and industry guidelines, whichever is applicable.
Market value is maintained on an accrual basis in compliance with applicable standards.

Valuation of Assets

1. UTIMCO shall determine the fair market value of all Fund net assets.
UTIMCO prepares accounting reports on a monthly basis based on the fair market value of net assets.
2. Valuation of Fund assets shall be based on the books and records of the custodian for the valuation date.
The valuation is based on the books and records of the custodian after review by UTIMCO accounting department.
3. Valuation of alternative assets shall be determined in accordance with the UTIMCO valuation criteria for alternative assets.
Alternative assets are valued based on UTIMCO valuation criteria.

Purchase and Redemption of Fund Units

1. Purchase of Fund units may be made on any quarterly purchase date. (9/1, 12/1, 3/1, or 6/1 of each fiscal year or the first business day subsequent thereto)
Purchase of units occurred on December 2, 2002.
2. Redemption of units shall be paid in cash as soon as practicable after the quarterly valuation date of the Fund.
Units were redeemed on February 28, 2003.

General Endowment Fund Asset Allocation Guidelines

	<u>Expected Return</u>	<u>Expected Risk</u>	<u>Neutral Allocation</u>	<u>Actual Allocation</u>	<u>Range</u>
U. S. Equity Allocation			11.0%	14.0%	
Passive Large/Medium Cap				3.2%	
Active Large/Medium Cap				8.0%	
Active Small Cap			10.0%	11.2%	
U. S. Equity Allocation			10.0%	7.1%	
Hedge/Alpha Transport Strategies			31.0%	32.3%	25% - 45%
Int'l Equity Allocation				6.0%	
Int'l Equity Allocation				1.0%	
Int'l Equity Allocation			6.5%	7.0%	
Int'l Equity Allocation				4.8%	
Int'l Equity Allocation				3.6%	
Int'l Equity Allocation			7.5%	8.4%	
Int'l Equity Allocation			5.0%	0.6%	
Int'l Equity Allocation			19.0%	16.0%	10% - 30%
Private Capital				1.8%	
Private Capital				6.7%	
Private Capital				0.4%	
Private Capital				2.0%	
Private Capital				0.5%	
Private Capital			15.0%	11.4%	10% - 20%
Absolute Return			10.0%	9.3%	5% - 15%
Inflation Hedging				3.8%	
Inflation Hedging				6.5%	
Inflation Hedging			10.0%	10.3%	5% - 15%
Opportunistic Fixed Income				7.5%	
Opportunistic Fixed Income				0.3%	
Opportunistic Fixed Income				2.9%	
Deflation Hedging Fixed Income			15.0%	20.7%	7.5% - 30%
U. S. Govt. Bonds and Agencies			0.0%	0.0%	0% - 5%
Cash And Cash Equivalents			100.0%	100.0%	

Expected Nominal Return Expected Risk Return/Risk Ratio

The rebalancing of the Fund assets to achieve the neutral allocations shall be subject to the funding of alternative investments.
Risk is defined in annualized standard deviation terms.

The neutral policy portfolio is the sum of the neutrally weighted benchmark returns.

COMPLIANCE REPORT FOR THE QUARTER ENDED FEBRUARY 28, 2003

Permanent Health Fund Investment Policy

Fund Management

1. Chapter 63 of the Texas Education Code designates the Board of Regents as the administrator for the PHFHE and for its own PFHRI fund. The Board, therefore,
 - a) manages and invests the Fund in the same manner as the Board manages and invests other permanent endowments UTIMCO has been given authority to invest the Funds. The Fund is invested in the General Endowment Fund and is therefore managed and invested in the same manner as other permanent endowments.
 - b) invest the funds in a manner that preserves the purchasing power of the Fund's assets and distribution
2. Fund shall be governed through UTIMCO and UTIMCO shall:
 - a) Recommend investment policy
 - b) Policy approved by UTIMCO board February 15, 2001; policy effective March 1, 2001.
 - c) Determine specific asset allocation targets, ranges and performance benchmarks.
 - d) Policy approved by UTIMCO board February 15, 2001; policy effective March 1, 2001.
 - e) Monitor fund performance against fund objectives

Performance reports prepared monthly to monitor performance.

Funds Eligible to Purchase Units

1. Only funds eligible to purchase units are permanent health funds established pursuant to Chapter 63 of the Texas Education Code, under the control of the Board.

Only eligible Funds have purchased units.

Asset Allocation Policy

1. The allocation of Cash should not exceed 5% of the Fund and the allocation of GEF Commingled Fund should be 95% to 100% of the Fund. The Fund is 100% invested in the GEF.

Performance Measurement

1. Investment performance will be measured by an unaffiliated organization at least annually. Investment performance is provided monthly by Russell/Mellon.

Investment Guidelines - General

1. Investment guidelines for the U. T. System GEF shall be as stated in the GEF Investment Policy Statement. The Fund is invested in the GEF. The Fund, therefore, follows the GEF guidelines.
2. All investments will be reported in U. S. dollars.
3. Only investments are GEF units and a negligible amount of cash and are reported in US Dollars. Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of PHF assets in such liquid investment fund. All liquid investments have been approved.
4. No securities may be purchased or held which would jeopardize the Fund's tax-exempt status. Securities held by the Fund do not jeopardize the tax-exempt status of the Fund.
5. No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board. No securities held by the Fund were purchased on margin or use leverage.
6. No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board. No short sales have been placed.

Investment Guidelines - Cash and Cash Equivalents

1. Unaffiliated liquid investment funds must be approved by the chief investment officer.
All liquid investments have been approved.

Fund Distributions

1. UTIMCO shall be responsible for establishing the Fund's distribution and determining the equivalent per unit rate.
Rate is approved by the Board of Directors.
2. Increase the prior year's per unit distribution amount by the average inflation rate for the previous twelve quarters.
Distribution rate for 2002-2003 remained the same at \$.047/unit.
3. UTIMCO Board may increase or decrease rate if the distribution rate falls outside of the perimeters of 3.5% to 5.5%.
Distribution rate fell within perimeters.
4. Board of Regents may approve a per unit distribution amount that, in their judgment, would be more appropriate than the rate calculated by the policy provisions.
The Board approved that the distribution rate remain at \$.047/unit.
5. Distributions from the Fund to the unitholders shall be made quarterly as soon as practicable on or after the last business day of November, February, May and August of each fiscal year.
Distribution was made December 2, 2002 for the first quarter and February 28, 2003 for this fiscal quarter.

Fund Accounting

1. Significant asset write-offs or write-downs shall be approved by the chief investment officer and reported to the UTIMCO Board.
No significant write-downs occurred during the reporting period.
2. The Fund's financial statements shall be audited by an independent accounting firm selected by UTIMCO's Board.
The financial statements are audited annually by Deloitte & Touche LLP.
3. Market Value of the Fund shall be maintained on an accrual basis in compliance with Financial Standards Board Statements, Governmental Accounting Standards Board Statements, industry guidelines, and state statutes, whichever is applicable.
Market value is maintained on an accrual basis in compliance with applicable standards.

Valuation of Assets

1. UTIMCO shall determine the fair market value of all Fund net assets.
UTIMCO prepares accounting reports on a monthly basis based on the fair market value of net assets.
 2. Valuation of Fund assets shall be based on the books and records of the custodian for the valuation date.
The valuation is based on the books and records of the custodian after review by UTIMCO accounting department.
- Purchase and Redemption of Fund Units**
1. Purchase of Fund units may be made on any quarterly purchase date. (9/1, 12/1, 3/1, or 6/1 of each fiscal year or the first business day subsequent thereto).
No units were purchased.
 2. Redemption of units shall be paid in cash as soon as practicable after the quarterly valuation date of the Fund, subject to certain requirements specified in the policy.
Units were redeemed on February 28, 2003.

Permanent Health Fund Asset Allocation Guidelines

	<u>Expected Return</u>	<u>Expected Risk</u>	<u>Neutral Allocation</u>	<u>Actual Allocation</u>	<u>Range</u>
GEF Commingled Fund	9.35%	10.44%	100.0%	100.0%	95% - 100%
Cash	3.75%	3.50%	0.0%	0.0%	0% - 5%
Expected Nominal Return	9.35%				
Expected Risk		10.44%			
Return/Risk Ratio		0.90%			

Risk is defined in annualized standard deviation terms.
 The endowment policy portfolio is the sum of the neutrally weighted benchmark returns for the GEF.

COMPLIANCE REPORT FOR THE QUARTER ENDED FEBRUARY 28, 2003

Long Term Fund Investment Policy

Fund Management

1. Fund shall be governed through UTIMCO and UTIMCO shall:
 - a) Recommend investment policy
 - b) Policy approved by UTIMCO board February 15, 2001; policy effective March 1, 2001.
 - c) Determine specific asset allocation targets, ranges and performance benchmarks.
 - d) Policy approved by UTIMCO board February 15, 2001; policy effective March 1, 2001.
 - e) Monitor fund performance against fund objectives
- Performance reports prepared monthly to monitor performance.

Funds Eligible to Purchase Units

1. Only funds eligible to purchase units are those under the sole control by the Board. Any fund whose governing instrument contains provisions which conflict with policy, whether initially or as a result of amendments to either document, shall not be eligible to purchase or hold units of the Fund.

Only eligible Funds have purchased units.

Asset Allocation Policy

1. The allocation of Cash should not exceed 5% of the Fund and the allocation of GEF Commingled Fund should be 95% to 100% of the Fund. The Fund is 100% invested in the GEF.

Performance Measurement

1. Investment performance will be measured by an unaffiliated organization at least annually. Investment performance is provided monthly by Russell/Mellon.

Investment Guidelines - General

1. Investment guidelines for the U. T. System GEF shall be as stated in the GEF Investment Policy Statement. The Fund is invested in the GEF. The Fund, therefore, follows the GEF guidelines.
2. All investments will be reported in U. S. dollars. Only investments are GEF units and a negligible amount of cash and are reported in US Dollars.
3. Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of Fund assets in such liquid investment fund. All liquid investments have been approved.
4. No securities may be purchased or held which would jeopardize the Fund's tax-exempt status. Securities held by the Fund do not jeopardize the tax-exempt status of the Fund.
5. No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board. No securities held by the Fund were purchased on margin or use leverage.
6. No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board. No short sales have been placed.

Investment Guidelines - Cash and Cash Equivalents

1. Unaffiliated liquid investment funds must be approved by the chief investment officer.

All liquid investments have been approved.

Fund Distributions

1. UTIMCO shall be responsible for establishing the Fund's distribution and determining the equivalent per unit rate. Rate is approved by the Board of Directors.

2. Increase the prior year's per unit distribution amount by the average inflation rate for the previous twelve quarters. The current distribution rate of \$.258 per unit for 2002-2003 was increased by 2.8% from \$.251 per unit. The increase was determined in November 2001, was approved by the UTIMCO Board in February 2002 and the Board of Regent in August 2002.
3. UTIMCO Board may increase or decrease rate if the distribution rate falls outside of the perimeters of 3.5% to 5.5%. Distribution rate fell within parameters.
4. Board of Regents may approve a per unit distribution amount that, in their judgment, would be more appropriate than the rate calculated by the policy provisions. The Board approved the increase of 2.8%. The consumer price index for the prior three years as of November 30, 2001, was 2.7%. The increase of 2.8% above results from rounding the per unit rate as provided in the investment policy.
5. Distributions from the Fund to the unitholders shall be made quarterly as soon as practicable on or after the last business day of November, February, May and August of each fiscal year. Distribution was made February 28, 2003 for this fiscal quarter.

Fund Accounting

1. Significant asset write-offs or write-downs shall be approved by the chief investment officer and reported to the UTIMCO Board. No significant write-downs occurred during the reporting period.
2. The Fund's financial statements shall be audited by an independent accounting firm selected by UTIMCO's Board. The financial statements are audited annually by Deloitte & Touche LLP.
3. Market Value of the Fund shall be maintained on an accrual basis in compliance with Financial Standards Board Statements, Governmental Accounting Standards Board Statements, industry guidelines, whichever is applicable. Market value is maintained on an accrual basis in compliance with applicable standards.

Valuation of Assets

1. UTIMCO shall determine the fair market value of all Fund net assets. UTIMCO prepares accounting reports on a monthly basis based on the fair market value of net assets.
2. Valuation of Fund assets shall be based on the books and records of the custodian for the valuation date. The valuation is based on the books and records of the custodian after review by UTIMCO accounting department.

Purchase and Redemption of Fund Units

1. Purchase of Fund units may be made on any quarterly purchase date. (9/1, 12/1, 3/1, or 6/1 of each fiscal year or the first business day subsequent thereto). Purchase of units occurred on December 2, 2002.
2. Redemption of units shall be paid in cash as soon as practicable after the quarterly valuation date of the Fund, subject to certain requirements specified in the policy. Units were redeemed on February 28, 2003.

Long Term Fund Asset Allocation Guidelines

	Expected Return	Expected Risk	Neutral Allocation	Actual Allocation	Range
GEF Commingled Fund	9.35%	10.44%	100.0%	100.0%	95% - 100%
Cash	3.75%	3.50%	0.0%	0.0%	0% -5%
Expected Nominal Return				9.35%	
Expected Risk				10.44%	
Return/Risk Ratio				0.90%	

Risk is defined in annualized standard deviation terms. The endowment policy portfolio is the sum of the neutrally weighted benchmark returns for the GEF.

COMPLIANCE REPORT FOR THE QUARTER ENDED FEBRUARY 28, 2003

Short Term Fund Investment Policy

1. Unaffiliated liquid (Money Market Funds) investment funds rated AAA_m by Standard & Poor's Corporation. All liquid investment funds have been approved.

The Short Term Fund is 100% invested in the Dreyfus Institutional Preferred Money Market Fund that is rated AAA by Standard & Poor's Corporation.

Short Intermediate Term Fund Investment Policy

Fund Management

1. UTIMCO shall:
 - a) Recommend investment policy
Policy approved by UTIMCO board February 11, 1999.
 - b) Determine specific asset allocation targets, ranges and performance benchmarks.
Policy approved by UTIMCO board February 11, 1999.
 - c) Monitor fund performance against fund objectives
Performance reports prepared monthly to monitor performance.
 - d) Invest the SITF's assets in conformity with investment policy.
SITF assets are invested according to policy.
2. Unaffiliated investment managers shall be monitored for:
Managed internally.

Performance Measurement

1. Investment performance will be measured by an unaffiliated organization at least annually.
Investment performance is provided monthly by Russell/Mellon. Russell/Mellon also prepares quarterly performance reports that incorporate performance universes, appropriate indexes and analytics to analyze Fund performance.

Funds Eligible to Purchase Fund Units

1. Only funds eligible to purchase units are those under the sole control by the Board. Any fund whose governing instrument contains provisions which conflict with policy, whether initially or as a result of amendments to either document, shall not be eligible to purchase or hold units of the Fund.
Only eligible funds have purchased units.

Investment Guidelines - General

1. All investments will be U. S. dollar denominated assets unless held by an internal or external portfolio manager with discretion to invest in foreign currency denominated securities.
All portfolios meet the requirement.
2. Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of Fund assets in such liquid investment fund.
All liquid investment funds have been approved.
3. No securities may be purchased or held which would jeopardize the Fund's tax-exempt status.
Securities held by the Fund do not jeopardize the tax-exempt status of the Fund.

4. No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board.
No securities have been purchased on margin or leverage.
5. No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board.
No short sales have been implemented during the period.
6. The Fund may utilize Derivative Securities with the approval of the UTIMCO Board provided that:
 - a) No leverage is employed in the implementation of such Derivative purchases or sales.
No derivatives have been implemented during the period.
 - b) No more than 5% of the Fund assets are required as an initial margin deposit for such contracts.
No margin deposits have been required during the period.
 - c) The Fund's investment in warrants shall not exceed more than 5% of the Fund's net assets.
The Fund's investment in warrants does not exceed 5% of the Fund's net assets.
 - d) The Fund's investment in warrants not listed on the New York or American Stock Exchanges shall not exceed more than 2% of the Fund's net assets.
 - e) No warrants held at the end of the period.
The net market value of exposure of Derivative Securities purchased or sold over the counter may not represent more than 15% of the net assets of the Fund.
No derivatives have been implemented during the period.
7. The duration of any eligible investment shall not exceed 10 years.
No investment exceeds 10 years.

Investment Guidelines - Risk Management

1. Interest rate risk shall be controlled by limiting the option-adjusted duration of the portfolio between one-half year and four years unless approved in advance by the UTIMCO Board.
The option-adjusted duration of the Fund is .67 years.
2. Not more than 5% of the total value of the securities in the Fund shall be placed with any one issuer other than the U. S. Treasury, U. S. Agency, or Government sponsored entities.
No corporate securities are held.
3. Counterparty exposure in the area of Repurchase Agreements and Reverse Repurchase Agreements shall be not more than 5% of the total value of the securities in the Fund placed with any one counter party.

Investment Guidelines - Eligible Investments

1. Unaffiliated liquid (Money Market Funds) investment funds rated AAA by Standard & Poor's corporation.
All liquid investment funds have been approved.
2. Commercial Paper must be rated at least A-1 by Standard & Poor's and P-1 by Moody's Investors Service, Inc.
No commercial paper held.
3. Negotiable C. D.'s must be rated at least A-1 by Standard & Poor's and P-1 by Moody's Investors Service, Inc.
No certificate of deposit held.
4. Bankers' Acceptances must be rated at least A-1 by Standard & Poor's and P-1 by Moody's Investors Service, Inc.
No bankers' acceptances held.
5. Floating rate securities, if they meet the single security duration criteria and are based on a spread over or under a well-know index such as LIBOR or a Constant Maturity Treasury index. No internally leveraged floating rate securities are permitted. The following types of floating rate securities are not eligible for investment; inverse floaters, non-money market based floaters, interest only or principal only floaters, non-dollar based floaters, and range note floaters.
No floating rate securities held.
6. Repurchase Agreements and Reverse Repurchase Agreements must be transacted with a dealer that is approved by UTIMCO and selected by the Federal Reserve as a primary dealer in U. S. Treasury securities and rated A-1 or P-1 or the equivalent.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

7. Each approved counterparty shall execute the Standard Public Securities Association (PSA) Master Repurchase Agreement with UTIMCO.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
8. Eligible Collateral Securities for Repurchase Agreements are limited to U. S. Treasury securities and U. S. Government Agency securities with a maturity of not more than 10 years.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
9. The maturity for a Repurchase agreement may be from one day to two weeks.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
10. The value of all collateral shall be maintained at 102% of the notional value of the Repurchase Agreement, valued daily.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
11. All collateral shall be delivered to the Fund's custodian bank. Tri-party collateral arrangements are not permitted.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
12. The aggregate amount of Repurchase Agreements with maturities greater than seven calendar days may not exceed 10% of the Fund's fixed income assets.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.
13. Overnight Repurchase Agreements may not exceed 25% of the Fund's fixed income assets.
Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

Investment Guidelines - Domestic Fixed Income

1. Securities issued by or fully guaranteed by the U. S. Treasury, U. S. Government-Sponsored Enterprises, or U. S. Government Agencies. The latter two categories include U. S. Government Agency Mortgage Backed Securities ("MBS").
All securities held are permissible.
2. With prior written approval of the UTIMCO Board, the Portfolio Manager may enter into derivative transactions utilizing exchange traded fixed income futures contracts or options on fixed income futures contracts; provided that such derivatives transactions are designed to control duration or manage risk. Such derivatives transactions shall be established on a case by case basis. These contracts shall include, but not limited to, Ten-Year Treasury Futures, Eurodollar Futures, provided that the futures exchanges are rated AAA or the equivalent values or in the case of options in delta or percentage of equivalent futures contracts. For the purpose of this policy, Collateralized Mortgage Obligations are considered to be MBS, not derivatives.
No derivative securities are held by the Fund.

Purchase and Redemption of Units

1. Purchase of units may be made no less than once a week and on the first business day of each month.
Purchases are made on Wednesday (or the first business day after) of each week and the first business day of the month.
2. Redemption of units shall be paid in cash as soon as practicable after the most recent weekly or end of month valuation date.
Redemptions are made on Wednesday (or the first business day after) of each week and the first business day of the month.

Fund Accounting

1. Significant asset write-offs or write-downs shall be approved by the chief investment officer and reported to the UTIMCO Board.
There have not been any significant asset write-offs or write-downs during this reporting period.
2. Market value of the Fund shall be maintained on an accrual basis in compliance with Financial Accounting Standards Board Statements, Government Accounting Standards Board Statements, or industry guidelines, whichever is applicable.
Market value is maintained on an accrual basis in compliance with applicable standards.

Valuation of Assets

1. UTIMCO shall determine the fair market value of all Fund net assets.
UTIMCO prepares accounting reports on a monthly basis based on the fair market value of net assets.
2. Valuation of Fund assets shall be based on the books and records of the custodian for the valuation date.
The valuation is based on the books and records of the custodian after review by UTIMCO accounting department.

Short Intermediate Term Fund Asset Allocation Guidelines

	<u>Minimum</u>	<u>Maximum</u>	<u>Actual</u>
U. S. Treasuries	0.00%	100.00%	45.88%
U. S. Government Agencies	0.00%	80.00%	16.06%
Mortgage Backed Securities	0.00%	60.00%	4.34%
STIF	0.00%	40.00%	33.72%
Corporate Cash Equivalents	0.00%	40.00%	0.00%
Repurchase Agreements	0.00%	33.00%	0.00%

Separately Invested Endowment, Trust and Other Accounts Investment Policy

Performance Measurement

- The investment performance of the actively managed Accounts, where cost effective, will be calculated and evaluated annually. Investment performance is calculated quarterly by the internal staff.

Investment Guidelines - General

- All investments will be U. S. dollar denominated assets unless held by an internal or external portfolio manager with discretion to invest in foreign currency denominated securities.
 - No members of the UTIMCO management currently serve as directors.
- Investment policies of any unaffiliated liquid investment fund must be reviewed and approved by the chief investment officer prior to investment of Fund assets in such liquid investment fund.
 - All liquid investment funds have been approved.
- No securities may be purchased or held which would jeopardize the Fund's tax-exempt status.
 - Securities held by the Fund do not jeopardize the tax-exempt status of the Fund.
- No investment strategy or program may purchase securities on margin or use leverage unless specifically authorized by the UTIMCO Board.
 - No securities have been purchased on margin or leverage.
- No investment strategy or program employing short sales may be made unless specifically authorized by the UTIMCO Board.
 - No short sales have been placed during the period.
- The Fund may utilize Derivative Securities with the approval of the UTIMCO Board provided that:
 - No leverage is employed in the implementation of such Derivative purchases or sales.
 - No derivative transactions have been executed during the reporting period.
 - No more than 5% of the Fund assets are required as an initial margin deposit for such contracts.
 - There are no margin deposits.
 - The Fund's investment in warrants shall not exceed more than 5% of the Fund's net assets.
 - The Fund's investment in warrants does not exceed 5% of the Fund's net assets.
 - The Fund's investment in warrants not listed on the New York or American Stock Exchanges shall not exceed more than 2% of the Fund's net assets.
 - The Fund's investment in warrants does not exceed 2% of the Fund's net assets.

Investment Guidelines - Risk Management

- Counterparty exposure in the area of Repurchase Agreements and Reverse Repurchase Agreements shall not be more than 5% of the total value of the securities in the Account placed with any one counterparty.
 - Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

Investment Guidelines - Eligible Investments

1. Unaffiliated liquid (Money Market Funds) investment funds rated AAA by Standard & Poor's Corporation or approved Tax Exempt fund. SEI Money Market is not a rated fund. This was based on donor preferences and is immaterial to the total account value. All other funds are either rated or tax-exempt.

2. Commercial paper must be rated in the two highest quality classes by Moody's Investor Service, Inc. (P1 or P2) or Standard & Poor's Corporation (A1 or A2).

All commercial paper purchased met or exceeded the rating requirement.

3. Floating rate securities, if they are based on a spread over or under a well-know index such as LIBOR or a Constant Maturity Treasury index. No internally leveraged floating rate securities are permitted. The following types of floating rate securities are not eligible for investment; inverse floaters, non-money market based floaters, interest only or principal only floaters, non-dollar based floaters, and range note floaters.

Floating Rate securities are not held.

4. Repurchase Agreements and Reverse Repurchase Agreements must be transacted with a dealer that is approved by UTIMCO and selected by the Federal Reserve as a primary dealer in U. S. Treasury securities and rated A-1 Or P-1 or the equivalent.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

5. Each approved counterparty shall execute the Standard Public Securities Association (PSA) Master Repurchase Agreement with UTIMCO. Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

6. Eligible Collateral Securities for Repurchase Agreements are limited to U. S. Treasury securities and U. S. Government Agency securities with a maturity of not more than 10 years.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

7. The maturity for a Repurchase Agreement may be from one day to two weeks.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

8. The value of all collateral shall be maintained at 102% of the notional value of the Repurchase Agreement, valued daily.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

9. All collateral shall be delivered to the Account's custodian bank. Tri-party collateral arrangements are not permitted.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

10. The aggregate amount of Repurchase Agreements with maturities greater than seven calendar days may not exceed 10% of the Fund's fixed income assets.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

11. Overnight Repurchase Agreements may not exceed 25% of the Fund's fixed income assets.

Repurchase Agreements and Reverse Repurchase Agreements are not held by the Fund.

12. Mortgage Backed Securities Dollar Rolls shall be executed as matched book transactions in the same manner as Reverse Repurchase Agreements above. As above, the rules for trading MBS Dollar Rolls shall follow the Public Securities Association standard industry terms.

Mortgage Backed Securities Dollar Rolls are not held by the Fund.

Investment Guidelines - Fixed Income

1. U. S. Domestic Bonds must be rated investment grade: Baa3 or better by Moody's Investor Services, BBB- by Standard & Poor's Corporation, or an equivalent rating at or above the minimum requirements.

All securities held are permissible.

2. Not more than 35% of the Account's fixed income portfolio may be invested in non-U. S dollar bonds.

All investments are U. S. dollar denominated.

3. Non-dollar bond investments shall be restricted to bonds rated equivalent to the same credit standard as the U. S. fixed income portfolio.

All investments are U. S. dollar denominated.

4. Not more than 7.5% of the Account's fixed income portfolio may be invested in Emerging Market debt.

No Emerging Market debt held.

Investment Guidelines - Equities

1. The Account shall hold no more than 25% of its equity securities in any one industry at market. Three accounts exceed the limit. One account holds 71.6% in Clubcorp International, another account holds 97.4% in Etex Banco, and another account holds 77.1% of General Growth Properties as required by donors. This does not include gifts targeted for immediate sale nor holdings in mutual funds.
2. The Account shall hold no more than 5% of its equity securities in the securities of one corporation at cost unless authorized by the chief investment officer. Three accounts exceed the limit. One account holds 71.6% in Clubcorp International, another account holds 97.4% in Etex Banco, and another account holds 77.1% of General Growth Properties as required by donors. This does not include gifts targeted for immediate sale nor holdings in mutual funds. These provisions do not apply to an endowment in which the agreement prohibits the sale of an equity security.

Fund Accounting

1. Significant asset write-offs or write-downs shall be approved by the chief investment office and reported to the UTIMCO Board. There have not been any significant asset write-offs or write-downs during this reporting period.

Securities Lending

Securities Lending Standards

1. All security loans must be with borrowers approved by UTIMCO.
All loans were with approved borrowers.
 2. The market value of the collateral shall be maintained at a minimum of 100% of the market value of the loaned securities for U. S. issuers and a minimum of 105% of the market value of the loaned securities for non-U. S. issuers.
The collateral market value is maintained at a minimum of 100% for U. S. loans and 105% for non-U. S. loans.
- Collateral Investment Pool Policy and Guidelines**
1. Allowable Instruments and Credit Quality
 - a) Obligations issued or fully guaranteed by the U. S. Government or agencies or sponsored agencies or sponsored corporations.
 - b) Obligations of domestic banks, including Certificates of Deposits, Bankers' Acceptances, Notes and other Debt Instruments, provided such banks are rated Aa3 or AA- or better by Moody's Investors Service, Inc. or Standard & Poor's Corporation. (This excludes Commercial Paper which is identified in d.)
 - c) Instruments issued by sovereigns, sovereign supported credits, and instruments of foreign banks and corporations. U. S. banks offshore are subject to the quality restriction of their parent company outlined in b. The foreign banks or corporations must be rated Aa3 or AA- or better by Moody's Investor Service, Inc or Standard & Poor's Corporation.
 - d) Commercial paper of U. S. Corporations and other eligible issuers described in a b, c, provided such commercial paper is rated PI by Moody's Investor Service, Inc. or A1 by Standard & Poor's Corporation.
 - e) Corporate notes and bonds rated Aa3 or AA- or better by Moody's Investor Service, Inc. or Standard & Poor's Corporation.
 - f) The following types of Euro issues: Euro C. D.'s, B.A.'s T. D.'s, and bonds. A minimum Aa3 or AA- rating is required from either Moody's Investors Service or Standard & Poor's Corporation.
 - g) Yankee Securities subject to the quality constraints outlined in e.
 - h) SEC registered domestic money market funds rated Aaa or AAA by Moody's Investors Service, Inc. or Standard & Poor's Corporation. as defined under SEC Rule 2a-7, including money market mutual funds of an affiliate of the Lending Agent, and approved in writing by the President of UTIMCO.
 - i) Repurchase Agreements with a domestic dealer selected by the Federal Reserve as a primary dealer in U. S. Treasury securities or a bank that is associated with a holding company whose commercial paper is rated A1 or better by Standard & Poor's. The maximum length of any repurchase transaction shall be three months. Such repurchase agreements must be secured by securities issued or guaranteed by the United States Government or it agencies or instrumentalities of government sponsored enterprises. The market value of such securities must be no less than 102% of the amount invested by the buyer of the repurchase transaction. The security for repurchase agreements (excluding overnight repurchase transactions) must be marked-to-market every business day and the market value of the security must be maintained at a value not less than 102% of the amount invested by the buyer of the repurchase transaction.
 - j) Asset backed securities must have a minimum rating of AAA by Standard & Poor's Corporation or an equivalent nationally recognized bond rating agency.
 - k) Floating rate notes must reprice at least quarterly and use a standard repricing index such as LIBOR, Federal Funds, Treasury Bills or commercial paper.
 - l) All credit ratings set forth herein shall be applicable at time of purchase.

2. Non-Allowable Instruments and Credit Quality
 - a) Unsecured broker/dealer obligations.
 - b) Pass through mortgage-backed securities and interest only and principal only (IO, PO) stripped mortgages.
 - c) Complex derivative or structured securities, including, but not limited to: swaps, futures, options, inverse floating rate notes, defined range floating rate notes, trigger notes and set-up notes.
 - d) No individual investment which can acquire a negative coupon or whose return of principal is linked to any set methodology may be made for any reason. However, zero coupon securities such as commercial paper, short term discount notes, original issue discount (OID) notes, and Treasury bills which are purchased at prevailing market yields will be deemed to be acceptable for purchases.

All securities purchased for the Collateral Pool meet the above investment guidelines.

3. The dollar weighted average maturity shall not exceed 60 days without prior written consent of the client.
The average maturity is 7 days.
4. Diversification
 - a) The account cash collateral must maintain a minimum overnight (next business day) liquidity level of 20%.
The next day liquidity is 83.4% of the portfolio.
 - b) The combined holdings of securities from one issuer should not constitute more than 5% of the fund, except for repurchase agreements by the U. S. Government or agencies or sponsored agencies or sponsored corporations.
The portfolio holdings meet the requirements.
 - c) No more than 15% will be invested in any one sector, except for the finance sector which will be limited to 30%, and except for repurchase agreements which will not be limited. This restriction shall not apply to obligations issued or fully guaranteed by the U. S. Government or agencies or sponsored agencies or sponsored corporations.
The portfolio holdings meet the requirements.

External Investment Management Agreements

Portfolio Transactions

External investment managers have several restrictions regarding trades. Types of investments, commissions, quality requirements and international trades are addressed throughout the various agreements.

All managers are in compliance with their respective contracts.

Portfolio Composition

All portfolios have limits set to control exposure to a single company, industry, country and/or asset type plus overall requirements mandating quality.

All managers are in compliance with their respective contracts.

Reports

External investment managers are required to provide several reports throughout the quarter. Reports include preliminary and final performance, custodian reconciliations, proxy voting results, ADV filings and an annual statement of compliance.

All managers are in compliance with their respective contracts.

Miscellaneous Compliance Issues

The University of Texas Investment Management Company Financial Disclosure Statement

All UTIMCO directors and employees shall file annually with the Chief Compliance Officer of UTIMCO a financial disclosure statement disclosing specified information regarding themselves, their spouses, and their dependent children; provided that directors who file disclosure statements with the Texas Ethics Commission need not also file this financial disclosure statement. This filing must be completed by January 31st of each year or within 60 days of appointment or employment.

All directors and employees have completed and signed the statement as of January 31, 2003 or within 60 days of appointment or employment.

The University of Texas Investment Management Company Ethics Disclosure Statement

All directors and employees, including acting or interim employees, shall execute an ethics compliance statement on or before January 31st of the year, or within sixty days of their appointment or employment.

All directors and employees have completed and signed the statement as of January 31, 2003 or within 60 days of appointment or employment.

The University of Texas Investment Management Company Disciplinary Action Disclosure Statement

All directors and key employees shall file a disciplinary action disclosure statement setting forth any proceedings, actions, or hearings by any professional organization or other entity involving the director or key employee.

All directors and key employees have completed and signed the statement as of January 31, 2003 indicating no violations.

The Permanent University Fund Variable Rate Notes, Series A Liquidity Agreement

The Board shall give the Administrative Agent written notice of any change in the investment policies of the PUF not later than ten days after the effective date of the change, commencing June 1, 1997.

Changes to the policies were made effective February, 2001 and submitted to U. T. System.

Note Purchase Agreement between UTS Revenue Financing System and UTS Short Intermediate Term Fund

1) A "Purchase Commitment" is for up to \$350,000,000 and shall remain unless the STIF shall decline to an amount less than \$1,225,000,000 and be expected to remain below that amount for a period of 30 days.

The net asset value of the Short Intermediate Term Fund is \$1,594.7 million.

2) A "Purchase Commitment" for the series 2001A Revenue bonds, with a maximum commitment of \$83,175,243.

Amount of commitment decreases annually based on principal and interest payments on the 2001A Revenue bonds.

Legislative Budget Board Reporting

Rider 5, page III-231, the General Appropriations Act (77th Legislature) require institutions to report certain information regarding their investments. Rider 5 and the Act require the State Auditor's Office to prescribe the method and manner for reporting this information.

Beginning in fiscal year 2003, the State Auditor's Office will ask institutions to prepare investment reports using their own formats (which they currently use to communicate investment information to their boards). Rather than require institutions to submit this information by mail, the State Auditor's Office will ask each institution to publish its quarterly information on its Web site.

The Quarterly Investment Report package will be submitted to the UTIMCO Board and the Board of Regents.

The investment summaries (agenda items) approved by the Board of Regents will be posted on UT System's Web site.

Institutions should also submit standard annual investment reports to the State Auditor's Office, the Comptroller of Public Accounts, the Governor's Office, and the Legislative Budget Board.

Annual report was completed and submitted to U.T. System.

Investment policies shall be submitted to the Legislative Budget Board by December 31st of each year.

State Auditor's Office recommended that each institution post its investment policy on its Web site. All investment policies are posted on www.utssystem.edu/cont/ReportTemplate.htm

Higher Education Code Permanent University Fund 66.05

The code requires a report to be prepared and distributed to the governor, state comptroller, state auditor, attorney general, commissioner of higher education, and to the members of the legislature by the 1st day of January each year. The report is to include a statement of assets, schedule of changes in book value, summary of gains and losses and income from investments of the Permanent University Fund during the year ending August 31 preceding the publication of the report.

The PUF Annual Report has been completed and distributed in accordance with the terms of the code prior to January 1, 2003.

Valuation Policy for Alternative Assets

Investments determined to be permanently impaired in value, after the written approval of the President, be written down to a \$1, or entirely written off and approved by the UTIMCO's Board.

There have not been any significant asset write-offs or write-downs during this reporting period.

The preceding information has been prepared by Debbie Childers and to the best of my knowledge all information is true and accurate.

Debbie Childers
Manager of Portfolio Accounting and Operations

Date

Compliance Summary Report for the Quarter Ended February 28, 2003

UTIMCO's compliance process encompasses the following:

- (1) Verification of compliance with the Board of Regents investment policies and guidelines.
- (2) Verification of custodian compliance with security lending guidelines.
- (3) Verification of external investment manager compliance with investment manager contracts.
- (4) Verification of miscellaneous compliance matters encompassing ethics, special reports, regental and statutory provisions.

There were no non-compliant issues noted for the quarter ended February 28, 2003.

Note: A detail report will be provided upon request.

TAB 11 c



THE UNIVERSITY OF TEXAS INVESTMENT MANAGEMENT COMPANY

CODE OF ETHICS

THE UNIVERSITY OF TEXAS INVESTMENT MANAGEMENT COMPANY

CODE OF ETHICS

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Adopted: January 5, 2000
Amended: June 26, 2003
Approved by the Board of Regents August 7, 2003

THE UNIVERSITY OF TEXAS INVESTMENT MANAGEMENT COMPANY

CODE OF ETHICS

General Principles

This Code of Ethics sets forth the basic principles and guidelines for directors and employees of The University of Texas Investment Management Company ("UTIMCO"). In addition to strict compliance with legal requirements, all directors and employees are expected to be guided by the basic principles of honesty and fairness in the conduct of UTIMCO's affairs and to comply with the policies contained in this Code. It is the policy of UTIMCO that a director or employee may not have a direct or indirect interest, including financial and other interests, or engage in a business transaction or professional activity, or incur any obligation of any nature that is in conflict with the proper discharge of the director's or employee's duties in the interests of UTIMCO.

Pursuant to an Investment Management Services Agreement (as amended, the "Agreement"), between the Board of Regents of The University of Texas System and UTIMCO, the Board of Regents has appointed UTIMCO as its investment manager with respect to those funds for which the Board of Regents has investment responsibility (the "Accounts"). Pursuant to the Agreement, UTIMCO has acknowledged that it will be acting as a fiduciary with respect to managing the investment of the Accounts. Accordingly, all directors and employees must develop an awareness of and respond to UTIMCO's obligations to the Board of Regents of The University of Texas System.

Specific Policy Statement

Although the general principles outlined above shall apply in the conduct of all UTIMCO activities, UTIMCO's directors and employees are also bound by the following specific policies.

Definitions

In this Code the following definitions apply unless the context requires otherwise:

- (1) "Audit and Ethics Committee of the Board" means a standing committee of the Board under the UTIMCO bylaws.
- (2) "Board" means the Board of Directors of UTIMCO.
- (3) "Chief Compliance Officer" means the person designated from time to time as the Chairman of the Employee Ethics and Compliance Committee.

- (4) "Code" means this Code of Ethics.
- (5) "Director" means a member of the Board of UTIMCO. For purposes of Article III.B hereof, "director" includes the spouse, minor children and other dependent relatives of a member of the Board of UTIMCO.
- (6) "Director entity" means an investment fund or other entity controlled by a director of UTIMCO. For purposes of the foregoing, a director shall be deemed to control an investment fund or other entity if his or her management role with or investment in such fund or entity enables the director to direct the operating or financial decisions of such fund or entity. In the absence of any management role for the director, where the terms of his or her investment did not give the director the legal right to direct the operating or financial decisions of such fund or entity and where the director does not attempt to direct such decisions, the fund or entity shall be presumed not to be a "director entity."
- (7) "Employee" means a person working for UTIMCO in an employer-employee relationship. For purposes of Article III.D (2) and (3) hereof, "employee" includes the spouse, minor children and other dependent relatives of an employee of UTIMCO.
- (8) "Employee entity" means an investment fund or other entity controlled by an employee of UTIMCO. For purposes of the foregoing, an employee shall be deemed to control an investment fund or other entity if his or her management role with or investment in such fund or entity enables the employee to direct the operating or financial decisions of such fund or entity. In the absence of any management role for the employee, where the terms of his or her investment did not give the employee the legal right to direct the operating or financial decisions of such fund or entity and where the employee does not attempt to direct such decisions, the fund or entity shall be presumed not to be an "employee entity."
- (9) "General Counsel" means the lawyer or firm of lawyers designated from time to time as the General Counsel of UTIMCO; provided that when the General Counsel is a firm of lawyers, one principal within that firm shall be identified to receive all written and oral communications hereunder.
- (10) "Key employee" means an employee who has been designated by the Board as one who exercises significant decision-making authority by virtue of the position he or she holds with UTIMCO.
- (11) "Personal securities transactions" means (1) transactions for a director's or employee's own account, including IRA's, and (2) transactions for an account in which a director or employee has indirect beneficial ownership, unless the director or employee has no direct or indirect influence or control over the account.

A director or employee has "indirect beneficial ownership" of an account if (i) the director or employee has a beneficial interest (such as a trust of which he or she is an income or principal beneficiary) or (ii) the director's or employee's family (including husband, wife, minor children or other dependent relatives) has a beneficial interest. A person has a "beneficial interest" in an account if the person: (i) is an income or principal

beneficiary or other equity owner of the account or (ii) receives compensation for managing the account for the benefit of people other than such person or his or her family.

- (12) "Private investment" means any debt obligation or equity interest that is not a publicly traded security, including a "private investment" in a publicly traded company.
- (13) "Publicly traded company" means a business entity with a class of securities that consists of publicly traded securities.
- (14) "Publicly traded securities" means securities of a class that is listed on a national securities exchange or quoted on the NASDAQ national market system in the United States or that is publicly traded on any foreign stock exchange or other foreign market.
- (15) "Relative" means a person related in the third degree by consanguinity (blood relative) or the second degree by affinity (marriage) determined in accordance with Texas Government Code Sections 573.021-025. Examples of relatives within the third degree by consanguinity are a child, grandchild, great-grandchild, parent, grandparent, great-grandparent, brother, sister, uncle, aunt, niece or nephew. A person adopted into a family is considered a relative on the same basis as a natural born family member.

Examples of a relative within the second degree by affinity are a spouse, any person related to the spouse within the second degree by consanguinity, or any spouse of such person. A person is considered a spouse even if the marriage has been dissolved by death or divorce if there are surviving children of that marriage.

- (16) "UTIMCO" means The University of Texas Investment Management Company.
- (17) "UTIMCO entity" means an investment fund or other entity controlled by UTIMCO. For purposes of the foregoing, UTIMCO shall be deemed to control an investment fund or other entity if UTIMCO's management role (which may be exercised through agents, directors, or employees) with or investment in such fund or entity enables UTIMCO to direct the operating or financial decisions of such fund or entity. In the absence of any management role for UTIMCO, where the terms of its investment did not give UTIMCO the legal right to direct the operating or financial decisions of such fund or entity and where UTIMCO does not attempt to direct such decisions, the fund or entity shall be presumed not to be a "UTIMCO entity."
- (18) "U. T. Board" means the Board of Regents of The University of Texas System.

I. General Standards

The following general ethical principles apply to directors and employees:

- A. Directors and employees may not:

- (1) accept or solicit any gift, favor, or service that might reasonably tend to influence the director or employee in the discharge of his or her duties for UTIMCO or that the director or employee knows or should know is being offered with the intent to influence the director's or employee's conduct on behalf of UTIMCO;
 - (2) accept other employment or engage in a business or professional activity that the director or employee might reasonably expect would require or induce the director or employee to disclose confidential information acquired by reason of his or her position with UTIMCO;
 - (3) accept other employment or compensation that could reasonably be expected to impair the director's or employee's independence of judgment in the performance of his or her duties for UTIMCO;
 - (4) make personal investments that could reasonably be expected to create a substantial conflict between the director's or employee's private interest and the interests of UTIMCO; or
 - (5) intentionally or knowingly solicit, accept, or agree to accept any benefit for having exercised the director's or employee's authority or performed the director's or employee's duties at UTIMCO in favor of another.
- B. Directors and employees must also comply with all applicable laws. They should specifically be knowledgeable of Texas Education Code Section 66.08 (Permanent University Fund - Composition, Investment, and Use - Investment Management).
- C. Directors and employees must be honest in the exercise of their duties and must not take actions which will discredit UTIMCO.
- D. Directors and employees should be loyal to the interests of UTIMCO to the extent that such loyalty is not in conflict with other duties which legally have priority. Directors and employees should avoid personal, employment, or business relationships that create conflicts of interest. Should directors or employees become aware of any conflict of interest, they have an affirmative duty to disclose and to cure the conflict in a manner provided for in this Code.
- E. Directors and employees may not use their relationship with UTIMCO to seek or obtain personal gain beyond agreed compensation and/or any properly authorized expense reimbursement. This should not be interpreted to forbid the use of UTIMCO as a reference or the communication to others of the fact that a relationship with UTIMCO exists, provided that no misrepresentation is involved.

II. Conflict of Interest

- A. *Definition:* A conflict of interest exists for a director or employee whenever the director or employee has a personal or private commercial or business relationship that could reasonably be expected to diminish the director's or employee's independence of judgment in the performance of the director's or employee's responsibilities to UTIMCO. For example, a person's independence of judgment is diminished when the person is in a position to take action or not take action with respect to UTIMCO or its business and such act or failure to act is or reasonably appears to be influenced by considerations of personal gain or benefit rather than motivated by the interests of UTIMCO.

It shall not be considered a conflict solely because a director or employee has an investment in the stock of a publicly traded company which is owned, purchased, sold, or otherwise dealt with by UTIMCO; provided that the affected person's interest in the stock of the publicly traded company is not more than 5% of any class and the person is not a director or officer of the publicly traded company.

- B. *Duty to Cure:* Directors and employees who become aware, or reasonably should have become aware, of a conflict of interest have a duty to cure it. A person normally cures a conflict of interest by promptly eliminating it. If a director or employee may prudently withdraw from action on a particular matter in which a conflict exists, he or she may cure the conflict in that manner provided that:

- (1) the person may be and is effectively separated from influencing the action taken;
- (2) the action may properly be taken by others;
- (3) the nature of the conflict is not such that the person must regularly and consistently withdraw from decisions which are normally his or her responsibility with respect to UTIMCO; and
- (4) the conflict is not a prohibited transaction resulting from a director having a pecuniary interest in a business entity as described in III. (A) below.

Directors must disclose any conflicts of interest regarding matters which are before the Board, absent themselves from any relevant deliberations, and not vote on the matter. Employees must disclose any conflicts of interest and refrain from giving advice or making decisions about matters affected by the conflict unless the Board, after consultation with the General Counsel, expressly waives this prohibition. The Board will decide whether to waive any disclosed conflict of interest at an official meeting. To assist it in deciding whether to grant waivers, the Board may develop criteria for determining the kinds of relationships that do not constitute material conflicts. Any waiver of a conflict of interest, including the reasons supporting the waiver, must be included in the minutes of the meeting. Records of all waivers granted with the supporting reasons will be maintained by the Chief Compliance Officer.

A person who cannot or does not wish to eliminate or cure the conflict of interest must terminate his or her relationship with UTIMCO as quickly as responsibly and legally possible.

- C. *Duty to Disclose:* Directors must disclose conflicts of interest in writing to the General Counsel prior to the Board meeting. If disclosure is made at a Board meeting, the minutes of the meeting must include the disclosure of the conflict.

Employees must promptly disclose conflicts of interest in writing to the Chief Compliance Officer through the UTIMCO conflict of interest disclosure statement. The Chief Compliance Officer will report to the Audit and Ethics Committee of the Board regarding the conflict of interest disclosure statements which he or she receives. Should a person with a duty to disclose conflicts have reasonable cause to believe disclosure to the Chief Compliance Officer will be ineffective, the person should disclose the conflict to the Audit and Ethics Committee of the Board. Disclosure to the Audit and Ethics Committee of the Board is accomplished through written disclosure to the Chairman of the Committee, whose address may be obtained from the UTIMCO Office Manager. Whether disclosure is to the Chief Compliance Officer or the Audit and Ethics Committee of the Board, a copy of the disclosure statement should be provided to the employee's supervisor unless the person with the conflict of interest believes that such disclosure would be detrimental to the resolution of the conflict.

III. Prohibited Transactions and Interests

- A. *UTIMCO:* Agreements or Transactions. UTIMCO and UTIMCO entities may not enter into an agreement or transaction with:
- (1) a director or employee acting in other than an official capacity on behalf of UTIMCO;
 - (2) a director entity, employee entity or other business entity (including an investment fund) in which a director or employee has any pecuniary interest;
 - (3) a former director or employee, an investment fund or other entity controlled by a former director or employee (with control being determined in the manner specified in the definition of "director entity" above), or a business entity in which a former director or employee has a pecuniary interest, on or before the first anniversary of the date the person ceased to be a director or employee; or
 - (4) an investment fund or account (other than the Accounts) managed by a director, director entity, employee or employee entity as a fiduciary or agent for compensation.

Except as provided below, a person shall be deemed to have a pecuniary interest in a business entity if the person:

- (i) owns five percent or more of the voting stock or shares of the business entity; or
- (ii) owns five percent or more of the fair market value of the business entity; or
- (iii) received more than five percent of his or her gross income for the preceding calendar year from the business entity;

provided that any private investment by a person in a business entity (including an investment fund) controlled by such person shall constitute a pecuniary interest in that business entity. For purposes of the foregoing, control of a business entity shall be determined in the manner specified in the definition of "director entity" above.

Investments. Without limiting the foregoing, UTIMCO and UTIMCO entities will implement procedures and safeguards to insure that none of the Accounts is invested in the publicly traded securities of a publicly traded company in which a director, director entity, employee or employee entity has any pecuniary interest (as described above). Further, UTIMCO and UTIMCO entities may not (i) invest in the private investments of a business entity if a director, director entity, employee or employee entity then owns a private investment in the same business entity or (ii) co-invest with a director, director entity, employee or employee entity in the private investments of the same business entity.

Prior to consideration by the Board of an agreement or transaction with a business entity or investment in a business entity, each director and key employee shall certify that he or she does not have any pecuniary interest in the associated business entity.

- B. *Directors:* Directors and director entities may buy or sell a publicly traded security of an issuer which is held by UTIMCO but may not engage in a personal securities transaction when the directors have actual knowledge that UTIMCO is trading such securities. UTIMCO is trading securities of an issuer when a buy/sell order has been placed by a UTIMCO internal portfolio manager for execution. Further, directors and director entities may not (i) invest in the private investments of a business entity if UTIMCO, a UTIMCO entity, an employee or an employee entity then owns a private investment in the same business entity or (ii) co-invest with UTIMCO, a UTIMCO entity, an employee or an employee entity in the private investments of the same business entity.
- C. *Directors and Employees:* No director or employee may:

- (1) participate in a matter before UTIMCO which involves a business, contract, property or investment held by such person if it is reasonably foreseeable that UTIMCO action on the matter would confer a benefit to such person by or through the business, contract, property or investment;
- (2) have stock or other ownership or profit sharing interest in any brokerage firms or consultants selected by such director or employee for UTIMCO business if such director or employee (i) has the discretion to direct trading, and therefore the discretion to select brokerage firms, or (ii) the discretion to select consultants; provided that directors shall not direct trades or exercise discretion over the selection of brokerage firms;

[This restriction applies to stock or other ownership or profit sharing interests held by a director's or employee's spouse. This restriction also applies to stock held for a director's or employee's own account or an account in which he or she has a beneficial interest (unless the director or employee has no direct or indirect influence or control over the account). For this purpose, a director's or employee's own account or an account over which he or she has a beneficial interest includes accounts involving immediate family members (spouse, minor children, or other dependent relatives). However, this restriction shall not prohibit the ownership of stock in a company that may own stock in such entities, provided such entities are not the dominant or primary business of the parent company.]

- (3) recommend or cause discretionary UTIMCO business to be transacted with or for the benefit of a relative;
- (4) under any circumstances accept offers by reason of their position with UTIMCO to trade in any security or other investment on terms more favorable than available to the general investing public;
- (5) borrow from investment managers, outside service providers, professional advisors or consultants, banks or other financial institutions with which UTIMCO has a business relationship, unless such entities are normally engaged in such lending in the usual course of their business, and then only on customary terms offered to others under similar circumstances to finance proper and usual activities;
- (6) represent any person in any action or proceeding before or involving the interests of UTIMCO except as a duly authorized representative or agent of UTIMCO;
- (7) use UTIMCO information, resources, or facilities, nor use information or resources paid for by UTIMCO, for personal gain or the gain of anyone other than UTIMCO. This prohibition means that directors and employees may not use information paid for by UTIMCO to assist or benefit private clients of the directors or employees; or

- (8) take action personally or on behalf of UTIMCO which will result in a reasonably foreseeable conflict of interest. Should there be action which a director or employee believes to be in the best interest of UTIMCO but which could foreseeably result in a conflict of interest, the director or employee must disclose such fact to the Chief Compliance Officer prior to taking such action.

D. *Employees:* No employee or employee entity may:

- (1) engage in outside employment, business, or other activities which detract from the ability to fulfill the full-time responsibilities to UTIMCO;

(Key employees must obtain advance written approval from the President for any outside employment or business, including service as director, officer, or investment consultant or manager for another person or entity. Any outside employment by the President must be approved in advance by the Board.

Employees, with the prior approval of the Board, may serve as directors of companies in which UTIMCO has directly invested Account assets. In such event, any and all compensation paid to employees for their services as directors shall be endorsed to UTIMCO and applied against UTIMCO's fees. Furthermore, Board approval of any employee's service as a director of an investee company shall be conditioned upon the extension of UTIMCO's Directors and Officers Insurance Policy coverage to the employee's service as a director of the investee company.)

- (2) engage in a personal securities transaction without obtaining preclearance for each such transaction with the Chief Compliance Officer; or

[The Chief Compliance Officer shall verify that no buy/sell order has been placed by a UTIMCO internal manager for securities of the same class. If such a buy/sell order has been placed, no employee may conduct a personal securities transaction for such securities until one trading day after the buy/sell order has been completed or canceled. Preclearances will be documented by the Chief Compliance Officer in a personal securities transaction log for each employee, which will provide a record of all requests and approvals or denials of preclearances for personal securities transactions. Preclearance for personal securities transactions is effective for one trading day only.

An employee who engages in personal securities transaction must also provide transactional disclosure for each such transaction. Transactional disclosure forms must be completed for all personal securities transactions and given to the Chief Compliance Officer within ten calendar days of the trade date. The transactional disclosure form must contain the following

information: name and amount of the security involved, date and nature of the transaction, price at which the transaction was effected, and name of the broker through whom the transaction was effected.

The preclearance and transactional disclosure requirements for personal securities transactions apply only to equity or equity-related transactions, including stocks, convertibles, preferreds, options on securities, warrants, rights, etc., for domestic and foreign securities, whether publicly traded or privately placed. The preclearance and transactional disclosure requirements do not apply to bonds (with the exception of convertible bonds), mutual funds, co-mingled trust funds, financial futures, and options on futures.]

- (3) (a) invest in the private investments of a business entity if UTIMCO, a UTIMCO entity, a director or a director entity then owns a private investment in the same business entity or (b) a co-invest with UTIMCO, a UTIMCO entity, a director or director entity in the private investments of the same business entity.

- E. *Former Directors and Employees:* A former director or employee may not make any communication to or appearance before a present director or employee before the first anniversary, in the case of former employees, and the second anniversary, in the case of former directors, of the date the former director or employee ceased to be a director or employee if the communication is made (a) with the intent to influence and (b) on behalf of any person in connection with any matter on which the former director or employee seeks action by UTIMCO.

If a director or employee knowingly communicates with a former director or employee in violation of this prohibition, the director or employee will be subject to disciplinary action including, with respect to a director, removal from serving as a director of UTIMCO.

IV. Confidential Information

- A. Directors and employees may not disclose confidential information, except when duly authorized personnel determine such disclosure is either permitted or required by law. Confidential information must be used by directors and employees for UTIMCO purposes and not for their own personal gain or for the gain of third parties.
- B. Information derived from a relationship with UTIMCO which might reflect favorably or adversely upon the value of any investment or contemplated investment may not be used by directors and employees in any manner for the purpose of personal advantage or to provide advantage to others.

V. Nepotism

- A. UTIMCO may not employ a person who is a relative of a director. This does not prevent the continued employment of a person who has already been working for UTIMCO for thirty consecutive days prior to the date of the related director's appointment.
- B. UTIMCO may not employ a person who is a relative of (1) a key employee, (2) a consultant, or (3) any owners, directors, or officers of consultants. This does not prohibit the continued employment of a person who has already been working for UTIMCO for thirty consecutive days at the time of the selection of a new key employee or consultant. Nor does this prevent the continued employment of persons who have been working for UTIMCO for thirty days prior to becoming relatives.
- C. No employee may exercise discretionary authority to hire, evaluate or promote a relative. No employee may supervise a relative, either directly or indirectly. As used herein, "supervise" means to oversee with the powers of direction and decision-making the implementation of one's own or another's intentions. Supervision normally involves assigning duties, overseeing and evaluating work, and approving leave.

VI. Decision-Making Based on Merit

UTIMCO business transactions are to be based on professional integrity and competence, financial merit and benefit to UTIMCO and, whenever required or prudent, on a competitive basis. Directors and employees may not base any UTIMCO business decisions on family or personal relationships.

VII. Observance of UTIMCO Controls and Policies

Directors and employees will observe the accounting and operating controls established by law and UTIMCO policies, including restrictions and prohibitions on the use of UTIMCO property for personal or other non-UTIMCO purposes.

VIII. Gifts and Entertainment

- A. A director or employee is prohibited from soliciting or accepting a gift because of or through use of the employee's or director's position with UTIMCO if the gift is from a person other than an employee or a director and the employee or director knows or should have known that the gift would not have been solicited, offered, or given had the employee or director not held his or her position as an employee or director. This prohibition applies not only to gifts solicited or given for the personal benefit of the director or employee but also to gifts to third parties.
- B. The prohibitions in this article do not apply to the following gifts, provided that acceptance of such gifts violates no law:

- (1) gifts given on special occasions between employees and/or directors;
- (2) books, pamphlets, articles or other such materials which contain information directly related to the job duties of an employee or director and are accepted by the employee or director on behalf of UTIMCO for use in performing his or her job duties;
- (3) gifts from relatives of employees or directors which are based solely on a personal relationship between the director or employee and his or her relative;
- (4) business meals and receptions when the donor or a representative of the donor is present;
- (5) ground transportation in connection with business meetings, meals, or receptions;
- (6) seminar or conference fees when the seminar relates to the director's or employee's job duties and is sponsored by UTIMCO's consultants or agents, prospective consultants or agents, or persons or entities whose interests may be affected by UTIMCO;
- (7) items with a value of less than \$50, excluding cash or negotiable instruments, and other gifts of nominal value. Examples of gifts of nominal value are (a) modest items of food and refreshments on infrequent occasions and (b) unsolicited advertising or promotional material such as plaques, certificates, trophies, paperweights, calendars, note pads, pencils, and other items of nominal intrinsic value.

- C. Attendance by directors or employees at seminars or conferences sponsored and paid for by UTIMCO's consultants or agents, prospective consultants or agents, or persons or entities whose interests may be affected by UTIMCO that involve entertainment or recreation may in some cases be in the best interest of UTIMCO.

Employees must obtain specific written approval of their attendance at such events from the President or Chief Compliance Officer. Approval may be withheld for elaborate entertainment events such as ski trips, hunting trips, or stays at expensive resorts.

- D. Under no circumstances may directors or employees accept a gift if the source of the gift is not identified or if the director or employee knows or has reason to know that the gift is being offered through an intermediary.
- E. If a prohibited gift is received by a director or employee, he or she should return the gift to its source. If that is not possible or feasible, the gift should be donated to charity.

IX. Compliance with Professional Standards

UTIMCO representatives who are members of professional organizations which promulgate standards of conduct, such as the Association for Investment Management and Research, must comply with those standards.

X. Financial Disclosure

- A. Directors and employees must file financial disclosure statements with the Chief Compliance Officer, and for directors who file disclosure statements with the Texas Ethics Commission, in the form prescribed by law for such disclosure statements.
- B. Directors and employees must file their financial disclosure statements within 30 days of their date of appointment or employment and by January 31st of each year. The President may postpone a filing deadline for not more than 60 days on written request or for an additional period for good cause, as determined by the Chairman of the Board. A financial disclosure statement must be maintained by UTIMCO for at least five years after the date of its filing.

XI. Key Employees

- A. The Board shall designate by position with UTIMCO the employees who exercise significant decision-making authority. By virtue of their position with UTIMCO, these persons are “key employees”.
- B. Employees designated as key employees must acknowledge their key employee status in writing through the annual ethics compliance statement.
- C. Requirements of this Code which are specifically applicable to key employees are the following:
 - (1) disciplinary action disclosure; and
 - (2) advance approval of outside employment, including service as a director, officer, investment consultant, or manager for another person or entity.

XII. Ethics Training and Advice

- A. The President will appoint an Employee Ethics Committee composed of UTIMCO personnel which will have responsibility for:
 - (1) providing ethics training for UTIMCO personnel; and
 - (2) issuing opinions on the proper interpretation of this Code.

- B. Employees may file a written request with the Employee Ethics and Compliance Committee for an opinion on the proper interpretation of this Code and may rely upon that opinion with respect to compliance with the Code.
- C. The Chairman of the Employee Ethics and Compliance Committee will be the Chief Compliance Officer.

XIII. Compliance and Enforcement

- A. The Board will enforce this Code with respect to employees through the President, who is responsible for its implementation with respect to employees.
- B. The full range of disciplinary options under UTIMCO personnel policies and practices may be used with respect to employees who violate this Code, up to and including termination.
- C. The Board is responsible for the enforcement of this Code with respect to violations by individual directors through resolutions of reprimand, censure, or other appropriate parliamentary measures, including requests for resignation.
- D. Directors with knowledge of a violation of this Code must report such violation to the General Counsel. Employees with knowledge of a violation of this Code must report such violation to the Chief Compliance Officer or to a member of the Audit and Ethics Committee of the Board. No retaliatory action will be taken against the reporting person for any such report involving another person made in good faith.
- E. Within sixty days of their employment or appointment, employees and directors must sign and date financial disclosure and ethics compliance statements that they have received and read this Code, that they will comply with its provisions, that it is their duty to report any acts by other directors or employees when they have knowledge of violations of this Code, and, for employees, that adherence to this Code is a condition of their employment. The statement will also include a disclosure of any conflicts of interest or violations of the Code of which they are aware and a reminder that they are required to update their statements if a change in circumstances occurs which would require reporting under this Code. Persons employed by UTIMCO on the date of adoption of this Code must sign and date the statement within thirty days of the adoption of this Code. The signed statements will be maintained in the employee's personnel file. Persons serving as directors on the date of the adoption of this Code must also sign the financial disclosure and ethics compliance statement within forty-five days of the adoption of this Code.
- F. Directors and employees, including acting or interim employees, must sign and date financial disclosure and ethics compliance statements as described above each year. The annual financial disclosure and ethics compliance statements must be submitted to the Chief Compliance Officer by January 31. Any person who is

a director or employee on December 31 of any year must file an annual financial disclosure and ethics compliance statement for that year. Directors' financial disclosure and ethics compliance statements will be maintained by the Chief Compliance Officer.

- G. Directors and key employees must also file disciplinary action disclosure statements setting forth any proceedings, actions, or hearings by any professional organization or other entity involving the director or key employee. Disciplinary action disclosure statements must be submitted to the Chief Compliance Officer by January 31 of the first year of designation as a director or key employee or, for those persons already serving as directors or designated as key employees on the effective date of this Code, on January 31 following the effective date. Disciplinary action disclosure statements must be promptly updated if any action occurs which would cause a director's or a key employee's answers to change.
- H. The custodian for open records purposes of the disclosure statements required under this Code is the Chief Compliance Officer.
- I. The President will notify the Audit and Ethics Committee of the Board in writing by February 15 of each year of the following:
 - (1) any approval given for outside employment by key employees, including the nature of the employment; and
 - (2) any disciplinary action disclosed by directors or key employees.

UTIMCO

Employee
Ethics and Compliance Committee

Bob L. Boldt
Bill Edwards
Larry Goldsmith
Cathy A. Iberg
Greg Lee
Sara McMahon
Joan Moeller
Andrea Reed
Trey Thompson
Christy Wallace

UTIMCO

List of Key Employees

Bob Boldt
Greg Cox
Harland Doak
Bill Edwards
Larry Goldsmith
Russ Kampfe
Cathy Iberg
Greg Lee
Sara McMahan
Joan Moeller
Andrea Reed
Trey Thompson
Christy Wallace

TAB 11 d

UTIMCO
AUDIT CHARTER
OF THE
AUDIT AND ETHICS COMMITTEE

Background

The Board of Directors (the "Board") of UTIMCO (the "Corporation") established an Audit and Ethics Committee (the "Committee") on February 22, 1996. On July 15, 1996 the Board adopted certain resolutions regarding, among other things, the Corporation's Audit and Ethics Committee Mandate (the "Mandate"). The Mandate was superceded by this Audit Charter adopted by the UTIMCO Board on June 29, 2000, as amended on June 26, 2003.

Purpose

The primary purpose of the Committee is to assist the Board in monitoring the financial and compliance functions of the Corporation and the investment funds managed on behalf of The University of Texas System Board of Regents (the U.T. Board"). Specifically, the Committee is to assist the Board in monitoring:

- the integrity of the financial reporting process, the system of internal controls, the audit process, and the process for monitoring compliance with laws and regulations;
- the independence and performance of the Corporation's independent auditors;
- the independence and performance of the independent auditors selected by the U.T. Board to audit the investment funds managed by UTIMCO on their behalf;
- for the purposes of review, any internal audit functions performed by the U. T. System Audit Office;
- the Corporation's audit and ethics policies; and
- the Corporation's compliance processes associated with investment policies and risk management.

Scope

In addition to the Corporation, this Audit Charter shall encompass the investment funds subject to the Investment Management Services Agreement by and between the U. T. Board and the Corporation effective March 1, 1996, and any subsequent amendments or restatements. As such, the role and purpose of the Committee

includes monitoring the functions and processes for both the Corporation and the investment assets managed on behalf of the U.T. Board.

Composition

The Committee shall be composed of three members of the Board; such members to be appointed from time to time by a majority of the Board and approved by the U. T. Board as required by Section 66.08 (c)(3) of the Texas Education Code. Members of the Committee must meet the independence and financial literacy requirements as defined below. A member may be removed with or without cause at any time by a vote of a majority of the Board.

Independence Requirements

The Board shall determine that all members of the Committee have no relationship with the Corporation, which would interfere with their exercise of independence from management.

Financial Literacy

The Board, based on its business judgment, shall determine that each member of the Committee is financially literate.

Financial Management Expertise

The Board, based on its business judgment, shall determine that at least one member of the Committee possesses accounting or related financial management expertise.

Meetings; Quorum; Etc.

The Corporation's Bylaws state that any committee created by the Board shall (i) have a chairman designated by the Board, (ii) fix its own rules or procedures, (iii) meet at such times and at such place or places as may be provided by such rules or by resolution of such committee or resolution of the Board, and (iv) keep regular minutes of its meetings and cause such minutes to be recorded in books kept for that purpose in the principal office of the Corporation, and report the same to the Board at its next succeeding meeting. At every meeting of any such committee, the presence of a majority of all the members thereof shall constitute a quorum, and the affirmative vote of a majority of the members present shall be necessary for the adoption by it of any action, unless otherwise expressly provided in the committee's rules or procedures or the Bylaws of the Corporation or by the Board. The Board may designate one or more Directors as alternate members of any committee, who may replace any absent or disqualified member

of such committee. In the absence or disqualification of a member of a committee, the member or members present at any meeting of the committee and not disqualified from voting, whether or not constituting a quorum, may unanimously appoint the designated alternate Director to act at the meeting in the place of the absent or disqualified member.

Functions, Duties and Responsibilities

Review of Financial Statements. The Committee has the following duties and responsibilities with respect to the financial statements of the Corporation and the investment funds managed on behalf of the U.T. Board:

- review the annual audited financial statements with management and the independent auditor, including significant issues regarding adequacy of internal controls and accounting principles and practices;
- review an analysis prepared by management and the independent auditor of significant financial reporting issues and judgments made in connection with the preparation of the financial statements;
- discuss with the independent auditor the matters required to be discussed by Statement on Auditing Standards No. 61 relating to the conduct of an audit; and
- receive and review periodic reports from the independent auditor regarding the auditor's independence and discuss such reports with the auditor.

Internal Controls. The Committee has the following duties and responsibilities with respect to its monitoring of the integrity of the financial reporting process and internal controls of the Corporation and the investment funds managed on behalf of the U.T. Board:

- review with the independent auditor any problems or difficulties the auditor may have encountered during its audit and any management letter provided by the auditor and the Corporation's response to that letter, such review to include:
 - any restrictions on the scope of activities or access to required information; and
 - any changes required in the planned scope of the audit;
- obtain reports from management, the independent auditor and any appropriate U. T. System internal auditor with respect to the Corporation's

policies and procedures regarding compliance with applicable laws and regulations;

- meet at least annually with the independent auditor and the senior personnel of the U. T. System Audit Office without management participation;
- meet periodically with management to review the major financial risk exposures and the steps management has taken to monitor and control such exposures;
- review significant changes to internal controls and accounting principles and practices as suggested by the independent auditor, internal auditors or management;
- review the significant reports to management prepared by the U. T. System Audit Office and management's responses; and
- review with the Corporation's legal counsel or other appropriate persons legal matters that may have a material impact on the financial statements, the Corporation's compliance policies and any material reports or inquiries received from regulators or governmental agencies.

Auditors. The external auditors for the Permanent University Fund are selected by the U.T. Board. These auditors have a dual reporting responsibility, reporting to both the Audit, Compliance, and Management Review Committee of the U.T. Board and to the Committee. The external auditors for the Corporation are selected by, and report to, the Board. By agreement between the U.T. Board and the Board, the external auditors for the other investment funds managed by the Corporation on behalf of the U.T. Board will be selected by the U.T. Board and will have a dual reporting responsibility, reporting to both the Audit, Compliance, and Management Review Committee of the U.T. Board and to the Committee.

The Committee has the following specific duties and responsibilities with respect to the Corporation's independent auditors:

- recommend to the Board the appointment of the independent auditor, which firm is ultimately accountable to the Committee and the Board.
- approve the fee arrangement of the independent auditor;
- after interviewing members of the Corporation's staff evaluate together with the Board the performance of the independent auditor and, if so determined by the Committee, recommend that the Board replace the independent auditor; and

- if determined by the Committee to be necessary or advisable, recommend that the Board take appropriate action to satisfy itself of the independence of the auditor.

Other Duties. The Committee has the following additional duties and responsibilities:

- make regular reports (at least twice each calendar year) to the Board regarding the Committee's activities and such other reports as may be requested by the Board;
- review and reassess the adequacy of this Audit Charter annually and recommend any proposed changes to the Board for approval;
- perform such additional special functions, duties or responsibilities as may from time to time be designated by the Board;
- review the Code of Ethics policy of the Corporation annually and recommend any proposed changes to the Board for approval;
- annually evaluate and review the Corporation's compliance process; and follow the U.T. System compliance guideline as outlined in the Action Plan to Enhance Institutional Compliance; and
- monitor and review the certification of financial statements by the Corporation's Chief Executive Officer and Chief Financial Officer, as required by Section 302 of the Sarbanes – Oxley Act of 2002, Corporate Responsibility for Financial Reports, effective with the August 31, 2004 financial statements.

Powers and Limitations

The Committee shall have the authority to retain special legal, accounting or other consultants to advise the Committee. The Committee may request any officer or employee of the Corporation or the Corporation's outside legal counsel or the U. T. System Audit Office to attend any meeting of the Committee or to meet with any members of, or consultants to, the Committee.

Approved by the Board of Directors on June 26, 2003.

TAB 11 e

UTIMCO Implementation Plan The Sarbanes-Oxley Act of 2002



Provision	Summary	UTIMCO Status	Action Required
Auditor Independence			
Section 201	Requires Audit of Financial Statements by and Independent Auditor.	Already Comply	No action required by UTIMCO.
Section 201	Does not allow the public accounting firm to provide non-audit service contemporaneously with the audit.	Already Comply	<ul style="list-style-type: none"> • Include in Sarbanes-Oxley compliance checklist. • Consider adding language to the Audit Charter of the Audit and Ethics Committee. • Consider adding to the engagement letter for audit services.
Section 203	The lead audit partner and reviewing partner must rotate off of the audit every 5 years.	Already Comply	<ul style="list-style-type: none"> • Include in Sarbanes-Oxley compliance checklist. • Consider adding language to the Audit Charter of the Audit and Ethics Committee. • Consider adding to the engagement letter for audit services.
Section 204	Confirms that the public accounting firm reports to the audit committee and requires the reporting of all "critical accounting policies and practices to be used....all alternative treatments of financial information (within GAAP) that have been discussed with management....the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the public accounting firm.	Already Comply	<ul style="list-style-type: none"> • Include in Sarbanes-Oxley compliance checklist. • Consider adding language to the Audit Charter of the Audit and Ethics Committee. • Consider adding to the engagement letter for audit services. • Consider requiring independent auditor to prepare and submit required information in writing to the Audit and Ethics Committee.

UTIMCO Implementation Plan The Sarbanes-Oxley Act of 2002



Provision	Summary	UTIMCO Status	Action Required
Auditor Independence (Continued)			
Section 206	The CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the public accounting firm during the 1 year period preceding the audit.	Already Comply	<ul style="list-style-type: none"> • Include in Sarbanes-Oxley compliance checklist. • Consider adding language to the Audit Charter of the Audit and Ethics Committee. • Consider adding to the engagement letter for audit services.
Corporate Responsibility			
Section 301	Each member of the audit committee shall be a member of the board of directors, and shall otherwise be independent.	Already Comply Included in Audit Charter	No Action Required by UTIMCO.
Section 301	The audit committee shall directly be responsible for the appointment, compensation, and oversight of the work by the auditor.	Already Comply Included in Audit Charter	No Action Required by UTIMCO.
Section 301	The audit committee shall establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal controls, and auditing.	Already Comply UTIMCO is participating in a Hot Line Program as a part of our participation in the UT Institutional Compliance Program. The committee will routinely receive updates and reports on the complaints received.	<ul style="list-style-type: none"> • Consider adding language to the Audit Charter of the Audit and Ethics Committee requiring the Hot Line program and periodic reports to the committee.

UTIMCO Implementation Plan The Sarbanes-Oxley Act of 2002



Provision	Summary	UTIMCO Status	Action Required
Corporate Responsibility (Continued)			
Section 301	The audit committee shall have the authority to engage independent counsel, or other advisors, as it determines necessary to carry out its duties.	Action Required	<ul style="list-style-type: none"> Add specific language to the Audit Charter of the Audit and Ethics Committee. Include in Sarbanes-Oxley compliance checklist.
Section 302	The CEO and CFO shall prepare a statement to accompany the audit report to certify the appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the company.	Action Required Implementation Scheduled for 8/31/2004 Financials	<ul style="list-style-type: none"> Sarbanes-Oxley Project Team has identified detailed procedures to ensure the CEO and CFO can certify the appropriateness of the financial statements and disclosures, effective with the August 31, 2004 financial statements.
Section 305	The Chief Executive Officer and the Chief Financial Officer shall reimburse the organization for any bonus or other incentive-based compensation received during the 12 month period following the issuance of false or non-compliant financial statements.	Action Required	<ul style="list-style-type: none"> Recommend specific language to be included in the Performance Compensation Plan of the organization. Include in Sarbanes-Oxley compliance checklist.
Enhanced Financial Disclosures			
Section 404	Requires the annual report to contain an "internal control report" which 1) states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and 2) contain an assessment, as of the company's year end, of the effectiveness of the internal control structure and procedures for financial reporting.	Action Required Implementation Scheduled for 8/31/2005 Financials	<ul style="list-style-type: none"> The Sarbanes-Oxley Project Team recommends voluntary implementation beginning with the August 31, 2005 year end. Consider adding specific language to the Audit Charter of the Audit and Ethics Committee.

UTIMCO Implementation Plan The Sarbanes-Oxley Act of 2002



Provision	Summary	UTIMCO Status	Action Required
Enhanced Financial Disclosures (Continued)			
Section 404	The company's auditor shall attest to, and report on, the assessment made by the company's management. An attestation made under this section shall be in accordance with standards adopted by the Public Company Accounting Oversight Board (PCAOB). This attestation should not be the subject of a separate agreement.	Action Required Implementation Scheduled for 8/31/2005 Financials	<ul style="list-style-type: none"> The Sarbanes-Oxley Project Team recommends voluntary implementation beginning with the August 31, 2005 year end. Consider adding specific language to the Audit Charter of the Audit and Ethics Committee.
Section 406	Requires the company to disclose whether it has adopted a code of ethics for its senior financial officers and the content of that code.	Limited Action Required	<ul style="list-style-type: none"> Although the company has adopted a code of ethics for its senior financial officers, the organization needs to specifically disclose this fact, while also disclosing the content. The Code of Ethics should be modified to specifically require disclosure for its senior financial officers.
Section 406	Requires immediate reporting of any change in, or waiver of the code of ethics.	Limited Action Required	<ul style="list-style-type: none"> Procedures will be enhanced to ensure immediate reporting of any changes or waivers. The Code of Ethics should be modified to require immediate reporting of any changes or waivers to appropriate oversight committees.
Section 407	Requires the company to disclose whether at least 1 member of its audit committee is a "financial expert" who has 1) an understanding of generally accepted accounting principles and financial statements, 2) experience in preparing audited financial statements and the application of such principles in connection with the accounting for estimates, accruals, and reserves, 3) experience with internal accounting controls, and 4) an understanding of audit committee functions.	Action Required	<ul style="list-style-type: none"> The Sarbanes-Oxley Project Team will identify and recommend procedures to assess and disclose the "financial expert" serving on the Audit and Ethics Committee. The Sarbanes-Oxley Project Team will recommend attributes that should be considered by the board when evaluating candidates with financial expertise. Consider adding specific language to the Audit Charter of the Audit and Ethics Committee.

UTIMCO Implementation Plan
The Sarbanes-Oxley Act of 2002



Provision	Summary	UTIMCO Status	Action Required
Enhanced Financial Disclosures (Continued)			
Section 409	Requires the company to disclose information on material changes in the financial condition or operations on a rapid and current basis.	Action Required	<ul style="list-style-type: none"> The Sarbanes-Oxley Project Team will recommend procedures for rapid and current disclosure of changes in the company's financial condition or operations.

Processes Being Mapped and Reviewed by the Sarbanes Oxley Project Team

UTIMCO

Revenue Recognition
 Expenditure Process
 Payroll
 Accounting and Reporting
 Investments
 Fixed Assets
 Budget Process
 IT Systems

UT Investment Funds

Investment Purchases
 Investment Sales
 Derivatives
 Commingled -- Trading
 Commingled -- Valuation
 Stock Distributions Received
 Valuations -- Marketable
 Valuations -- ALT MKT
 Non marketable Valuations
 Financial Highlights--footnt.
 Investment Income Process -- Int/Div
 Investment Income Process -- NMA
 Securities Lending
 Expenditures -- Asset Based
 Expenditures -- Non-Asset Based
 Contributions
 Distributions
 Accounting Close and Reporting
 Performance Reporting
 Investment Compliance
 Allocation of Income/Gains and Losses
 NAV per unit calculation

TAB 11 f



Methodology

The periodic self-assessment of risk is critical in helping the organization ensure potential risks are identified, evaluated, and considered in the strategic development of organization objectives. This periodic review (at least annually) allows all staff throughout the organization an opportunity to both re-evaluate risks within their respective departments, but also take a step back and review risk from a broader, organizational level.

The self-assessment process at UTIMCO is coordinated by the Manager of Finance and Administration, whose is charged with the responsibility of administering and monitoring the risk management plans for the organization.

The comprehensive self-assessment is one continuous process, but consists of 10 very specific steps that help determine, document, assess, and monitor risk at varying levels within the organization. Now for the details....

Step 1 Identify Principal Activities

In order to determine the risks associated with a particular department or function, it is important to first determine the principal activities that are being performed. Although this could be performed by a department manager or supervisor, it is best to involve all staff and personnel within the department. The main goal is to identify the tasks being performed, and who better to help identify these tasks than the staff actually performing them.

A template has been developed principle idea is to aid the process and help ensure consistency among departments.

Principal Activities	Consolidated Activities	Prioritized Consolidated Activities
1		1
2		2
3		3
4		4
5		5
6		6
7		7
8		8
9		9
10		10
11		
12		
13		
14		
15		
16		
17		
18		
19		
20		



Using this template, staff “brainstorming” is used to develop the list of activities. This simple process is begun by one staff member in the room identifying an activity or task. The process continues from person to person, around the room, until no one is able to identify any additional tasks. During this process it is important to allow the free flow of information and comment among the group. This will help ensure a list that reflects all of the activities performed by the group.

**Step 2
Group Related Activities**

Once the individual tasks or activities have been listed, the group’s next task is to summarize those tasks into related categories. It is normal for these categories to be the major functions of the group. The number of major functions or categories will normally vary with the size and number of functions performed by the group. There is no magic number of categories, but it would be normal to have 4-5 major functions for small departments, while 8-10 major functions would not be abnormal for larger departments.

**Step 3
Prioritize Major Functions by Importance**

These functions should then be prioritized by the group, denoting the “most important”, followed by the “2nd most important”, etc. This is simply an opportunity for the group to provide their opinion, so it is not important that the group spend a lot of time in ranking the importance of these major functions. The “Risk Footprint” template that will be used later automatically ranks the importance of each major function based upon the impact and probabilities of the individual risks within that department.

**Step 4
Identify Relevant Risks**

The next step in the process is to identify the risks associated with each of the principal activities or major functions. The “brainstorming” technique described in Step 1 above is also helpful in ensuring that a complete list of the risks for each function is produced.

Risks should be in the form of outcomes or consequences. Although it is common for groups to initially propose risks that are in other forms, they fail to provide the outcome or consequence. An example may better illustrate this. For



example, a common risk noted by groups is “failure to follow a company policy or procedure”. Although this might be a valid cause or source of a problem, it shouldn’t be labeled a risk. The risk should be the result or consequence if the policy or procedure weren’t followed.....(equipment stolen, unauthorized purchases, funds misappropriated, etc.).

A template has been prepared to help the group list the associated risks and maintain documentation of their process. This sample template is shown below:

	Principal Activity	Impact	Probability	RANKING
1	List of Individual Risks Associated with the Activity	H	M	HM
2				
3				
4				
5				
6				
7				
8				
9				
10				

Step 5
Determine the Impact & Probability

Using this same template, the next step is to look at each risk from two perspectives: impact and probability. Probability is a measure of the likelihood that the event will occur, while impact represents the effect should it actually occur. In addition, the probability should be calculated as the likelihood of a single occurrence with no management review or oversight controls in place.

For our purposes, both of these attributes should be categorized using a scale ranging from High to Low. Rating scales for each of these attributes are found below:



➔

PROBABILITY	High	Medium	Low
	Likely to Occur without Controls	May Occur without Controls	Unlikely to Occur, Even without Controls

➔

IMPACT	Catastrophic	Medium	Low
	Catastrophic Requires Significant Resources to Resolve	**Problematic** Requires Resources to Resolve	**Minor** Requires Little Effort to Resolve

Step 6 Create and Review the Risk Footprint

The templates being used throughout this process create a “Risk Footprint” from the data entered at various stages. This matrix is created automatically and provides a “snapshot” of the Key Functions and Risks for each department. A sample is included below:

		RISKS ➔				
#	ACTIVITIES	1	2	3	4	5
1	Principal Activity #1	Risk #1 High	Risk #2 High	Risk #3 Medium	Risk #4 Medium Low	Risk #5 Low
2	Principal Activity #2	Risk #1 High	Risk #2 Medium	Risk #3 Medium	Risk #4 Medium Low	Risk #5 Low
3	Principal Activity #3	Risk #1 Medium	Risk #2 Medium Low	Risk #3 Medium Low	Risk #4 Low	
4	Principal Activity #4	Risk #1 Medium	Risk #2 Medium Low	Risk #3 Low		
5	Principal Activity #5	Risk #1 Medium Low	Risk #2 Low			

This Risk Footprint provides a Desktop Reference Tool for managers to use in continually monitoring the risks within their respective departments. Ready access also provides the manager an opportunity to use this tool in evaluating changes in procedures and the impact of possible changes in department strategy.



Step 7 Identify Controls that Mitigate Risks

Identifying the relevant risks is only one component of an effective risk assessment process. It is critical to follow this with documenting the existing controls that are in place to help mitigate the risks that have been identified. Initially, this is a lengthy and cumbersome process, but once established is easy to maintain on a “going-forward” basis.

As with other steps in the risk assessment process, a template has been developed to aid in the process and ensure consistency throughout the organization. A sample template is included below:

Control Activities	Risk				Extensive Risks	Moderate Risks	Manageable Risks	Low Risks
	Risk #1	Risk #2	Risk #3	Risk #4				
Control #1	✓	✓	✓	✓				
Control #2	✓	✓	✓	✓				
Control #3	✓	✓	✓					
Control #4	✓	✓						
Control #5	✓							

The risks associated with a specific department function are listed across the top of the template and are color coded to represent their risk ranking. Control activities are listed down the left hand side of the template. Checkmarks are placed in columns where controls currently exist to mitigate the specific risk.

Step 8 Monitor and Test Controls

An effective risk assessment process is not complete without proper monitoring. Monitoring serves to assess and confirm both the presence and functioning of control systems over time. There are several goals inherent in monitoring activities:

- Ensure Relevant Risks have been Identified
- Assess the Adequacy of Existing Controls
- Ensure Existing Controls are Operating as Designed

Ensure Relevant Risks have been Identified



One of the three most important components of an effective monitoring process is ensuring that all relevant risks have been identified. Recognizing that this is difficult to achieve or know that you have achieved, additional steps have been built into the process. The specific control measures are summarized below:

- Involve All Managers and Staff in the Risk Identification Process
- Managing Director Review of Identified Risks
- Independent Review by Risk Assessment Coordinator
- Oversight Review by Chief Compliance Officer

Assess the Adequacy of Existing Controls

The second component necessary to an effective monitoring process is a periodic review and assessment of the adequacy of existing controls. Because conditions change, this review and assessment should be performed annually. This review should be performed at four levels:

Level I – a self review should be performed by the Managing Director with responsibility for the function.

Level II – an independent review should be conducted by a qualified individual outside of the respective department. Currently this review is to be performed by the Security Operations Assistant (who is a Certified Internal Auditor) and possesses the appropriate knowledge, skills, and abilities to conduct this independent review and assessment.

Level III – an independent review of detailed analysis, documentation, support, and rationale for the Level I and Level II reviews. This review will result in the preparation of recommendations to be forwarded to the Chief Compliance Officer for review and action. This independent review will be conducted by the Manager of Finance and Administration, who is charged with the responsibility of administering and monitoring the risk management plan for the organization

Level IV – an oversight review is to be conducted by the Chief Compliance Officer, with particular emphasis on areas with proposed changes.

The Risk Control Matrix should be used by all staff conducting periodic reviews. This matrix shows both the detail sufficient to assess the adequacy of controls and also provides a big picture view reflecting either inadequate or an overabundance of controls. The micro version of the Risk Control Matrix (depicted in the chart below) reflects the detailed controls for each risk that has been identified:



Control Activities ↓	Risk				Extensive Risks	Moderate Risks	Manageable Risks	Low Risks
	Risk #1	Risk #2	Risk #3	Risk #4				
Control #1	✓	✓	✓	✓				
Control #2	✓	✓	✓	✓				
Control #3	✓	✓	✓					
Control #4	✓	✓						
Control #5	✓							

This next chart depicts the macro view of the Risk Control Matrix.....note particular areas where controls may appear inadequate....and other areas where controls appear to be over abundant.

Control Activities ↓	Risk						
	ERM	Communications	Corporate Finance	Human Resources	Administrative Support	Building Management	
Written Policies & Procedures approved by Management Team	✓	✓	✓	✓	✓	✓	Not Enough Controls?
Proper Segregation of Duties	✓		✓			✓	
Manager Review & Approval of Transactions	✓		✓	✓		✓	Too Many Controls?
Periodic System and Controls Review by Manager of Finance & Administration	✓		✓		✓	✓	
Annual System and Controls Review by Managing Director	✓		✓		✓	✓	
Annual Review and Testing by UT System Internal Auditors	✓		✓	✓	✓	✓	
Annual Review and Testing by External Auditors	✓		✓	✓	✓	✓	
Involvement of UTIMCO Board Members and Chief Compliance Officer	✓					✓	
Individual Managing Director Review of Department Activities	✓					✓	
Independent Review by Outside Legal Counsel	✓			✓	✓		
Deadline posted to Outlook Calendar	✓		✓		✓		
Staff Accountability	✓	✓	✓	✓	✓	✓	
Centralized Duties and Responsibilities	✓		✓	✓	✓	✓	
Check Stock maintained in a secure location	✓		✓			✓	
Two signatures required for checks >\$1,000	✓		✓			✓	
Checks are signed by somebody other than the person who approves the invoice.	✓		✓			✓	
Annual Fixed Asset Inventory	✓		✓			✓	
Maintenance of Appropriate Control Environment	✓		✓			✓	
Electronic door locks. After hours access only by authorized staff.	✓		✓			✓	



Ensure Existing Controls are Operating as Designed

The process of ensuring that existing controls are operating as designed requires a more traditional approach of monitoring. It involves the testing of specific control attributes for a sample of transactions or events. Modern audit sampling techniques are used to ensure adequate sample sizes. Exceptions are noted, causes determined, and corrective measures are implemented.

Reporting

The sharing of relevant information throughout the risk assessment process is critical. The reporting component consists of specific information generated and distributed to various audiences:

Operational Managers – a number of specific reports are provided to help department managers identify departmental activities, summarize department functions, rank risks identified by the department, and view a high level perspective of the risks within a department. Each of these reports is described in more detail below:

- Principal Activities Report – This report summarizes the functions and activities for each department.
- Activity Risk and Assessment Report – This report identifies and assesses the impact and probability of each risk associated with specific functions within a department.
- Risk Footprint – This report provides a “snapshot” of the functions and related risks within each operating department.

Compliance Managers and Staff – The managers and staff involved in administering and monitoring the risk assessment plan have a need for additional information. Accordingly, additional reports are available in addition to those used by operational managers:

- Risk Controls Matrix – This matrix identifies the existing controls that help to manage and mitigate the identified risks for each department.



- Optimization Matrix – This matrix identifies those controls that, when adequately reviewed and monitored, provide the most optimal management of risk.
- Monitoring Plan – This plan provides both a summary and detailed view of the controls and risks required to be monitored. This plan also describes the specific evidence of controls to be monitored for each risk.

Executive Team and Oversight Bodies – These groups require specialized reports that require a higher level perspective. The following reports have been developed to provide information from this unique perspective:

- Risk Assessment Overview – This document provides an overview of the risk assessment process for the organization, highlighting both the purpose and process for assessing and monitoring risk within the organization.
- Annual Assessment of Risk – This annual report summarizes the annual risk assessment conducted for each department, and specifically highlights actions in high risk areas.
- Annual Risk Controls Assessment Report – This annual report summarizes the results of monitoring reviews conducted to ensure all relevant risks are identified, assess the adequacy of existing controls, and ensure controls are operating as designed.

TAB 11 g



Monitoring Plan

Overview

Periodic monitoring of established controls is an important function. The monitoring process consists of determining whether all relevant risks have been identified, assessing the adequacy of existing controls, and evaluating their effectiveness.

In addition, monitoring is the process of assessing and ensuring the quality of established controls over a period of time. As such, it is also necessary to determine whether conditions have changed to warrant increases or decreases to control measures.

An annual monitoring plan is established to review and assess existing risks and the related controls. The results of planned reviews, evaluations, and testing will be documented and reported quarterly to the Executive Team and the Audit and Ethics Committee of the board. Monitoring reports will contain the findings and results of the testing performed and the related recommendations to improve or strengthen controls when appropriate.

Objectives

The Self Assessment phase of an Enterprise Risk Management Plan identifies the population of risks and controls for an organization. Once completed, it is important to monitor these risks and controls. With that objective in mind, a Monitoring Plan has been developed with the following goals:

- Review the sufficiency and efficiency of the organization's control environment,
- Evaluate the adequacy and effectiveness of key controls,
- Identify risks that may not have been identified by the department self assessment processes,
- Document the results of the monitoring process, and
- Report the condition of the control environment to management, the Audit Committee, and the Board of Directors; while providing recommendations to management where appropriate.



Scope

The Monitoring Plan will focus on the activities, risks, and controls identified by each department's self assessment process. The fulcrum for this analysis will be the Risk and Controls Matrix developed by each department. The review of each department's risks and controls should allow for broad conclusions to be drawn about the overall control environment. It will also allow monitoring efforts to be focused on higher risks and important "key" controls.

Time Frame

The target date for the initial phase of the monitoring plan is February 28, 2004. An estimated 250 employee hours will be required at the execution level; additional supervisory and oversight hours will be required.

Methodology

The following framework has been developed to assist in organizing the various monitoring activities:

Validate Each Department's Risk and Control Matrix

The first step of the Monitoring Plan involves validating each department's risk and control matrix. This involves reviewing the identified risks to help ensure that all relevant risks have been included. Then, since the identification of risks occurred in departmental segments, the analysis will include a process of prioritizing the risk levels relative to the company as a whole.

Analyze Risk and Control Matrix

This step analyzes the risk matrix and draws conclusions about the control environment based upon the mix of risks and controls that are present. In order to accomplish this, the risk analysis assumes that all of the controls identified actually exist and are operating as intended, relying upon the self assessment process to have accurately depicted the risk and controls for each department.

With this foundation, an analysis of the controls in place in relation to the amount of risk present will ensure that each individual risk has



been mitigated sufficiently and efficiently. The following describes this process:

Sufficiency Analysis - Determine if the controls in place are sufficient to mitigate the risk. For example, if there are only a few controls that may not mitigate a risk on their own, we should determine whether they create a synergistic effect that sufficiently mitigates the risk when combined.

Efficiency Analysis - Identify opportunities to increase efficiency by ensuring that the controls are cost-effective in relation to the amount of risk present.

Control Characteristics - Identify control characteristics that will assist in these determinations:

- **Detective and Preventive Controls** - A detective control detects an event after it occurs, while a preventive control prevents an event from occurring.
- **Execution, Supervisory, and Oversight Controls** - An execution control is an action taken to monitor the event, such as performing reconciliations. A supervisory control involves some type of independent review/validation of the execution control. An oversight control involves some type of managerial oversight of both the execution and supervisory controls.
- **Primary and Secondary Controls** - A primary control can mitigate the risk on its own, while a secondary control mitigates part of the risk or mitigates the risk when it is used in conjunction with other controls.

Testing Controls

The next step is to select controls and test them to ensure they are working as intended. Several factors need to be considered in deciding which controls to test:

Critical Risks - Using the prioritization process described in the Risk Matrix Validation section, the most critical risks of the company can be identified. Testing efforts will focus on these critical risks and will decrease proportionately as risks become less critical. Due to time



budget constraints, many areas that have a medium level of risk may be tested on a rotational basis.

Sufficiency Results - The results of the sufficiency analysis will also be considered in the selection of controls to test. If a specific risk is deemed to have an insufficient level of control to mitigate the risk, testing for effectiveness yields little benefit to achieving the already failed goal of mitigating the risk.

Key Controls - Once a critical risk is identified, it may not be necessary to test all of the controls associated with it. By analyzing the mix of controls and their characteristics, some controls may be identified as key controls. A key control is usually the one primary control for a risk, or out of several primary controls, it is the one management relies upon the most. When appropriate, testing may be limited to key controls rather than testing all controls related to a specific risk.

Coordination with Enterprise Risk Management Plan – All specific testing will be coordinated with testing that may be performed in conjunction with the organization's risk management plan. This will help reduce the likelihood of duplicate testing.

Testing Process

Once the controls have been selected, the testing process should include the following:

Test Objectives - The objectives to be accomplished should be clearly established before the testing begins.

Scope Definition - The population set, sample size, sampling method, and the specific controls being tested should be identified.

Test Methodology - Testing procedures will vary for each control and will be selected appropriately by considering the level of risk present, the format of the data to be tested, and time budget constraints. Procedures will be founded on the practices and standards of the auditing industry.



After reviewing the control process and how it relates to that risk, there are two types of testing that can occur.

Adequacy Test - Adequacy is a determination that the control process was designed correctly. For example, if the risk is that transactions may not be processed, then the control objective is to ensure the completeness of the data. However, if the control process involved a review of the transaction report listing all of the activity for the day, then the control is inadequate because it is only verifying the accuracy of the data.

If a control is deemed to be inadequate, there is no additional benefit to testing it for effectiveness; however, it may be beneficial to test for the scope of errors that occurred with a lack of control in place.

Effectiveness Test - Effectiveness is a determination that the risky event being controlled is not occurring. If the control in the example above had been adequate, it would have compared documentation of the events that trigger transactions to the number of transactions that occurred. Effectiveness testing would then sample these events and trace them forward to processed transactions.

Test Results - Test results should clearly demonstrate the objectives of the test. If they do not, either further testing or a modification of the objectives may need to occur.

Documentation - Documentation requirements will vary for each control, but should be able to demonstrate the efforts taken for and the results of each process described in this plan. Retention requirements should at a minimum coincide with audit work paper retention requirements.

Reporting

The results of planned reviews, evaluations, and testing will be documented and reported quarterly to the Executive Team and the Audit and Ethics Committee of the board. Monitoring reports will contain the findings and results of the testing performed and the related recommendations to improve or strengthen controls when appropriate.

TAB 12

**UTIMCO Working Group
Analysis of Legal Issues**

BAKER BOTTS  **LLP**

April 23, 2004

PRIVILEGED AND CONFIDENTIAL ATTORNEY-CLIENT COMMUNICATION

**UTIMCO Working Group
Outline of Legal Issues
Baker Botts L.L.P.**

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April 23, 2004

UTIMCO Working Group Analysis of Legal Issues Baker Botts L.L.P.¹

This portion of the report of the UTIMCO Working Group endeavors to address certain legal issues raised by the Board of Regents in connection with its oversight of UTIMCO and investment management activities generally. To a significant extent, many of these issues were discussed in the 2003 Baker Botts Report (the "2003 Report"), and as such we have tried to emphasize those portions of our analysis that are new, and the following material should be read in conjunction with the 2003 Report. The opinions expressed herein are those of the authors.

Summary of Recommendations

Among the recommendations discussed in more detail below are the following. We note that most of these recommendations are not our opinions on matters of law, but rather our opinions on matters of policy informed by the legal analysis we have undertaken in connection with this report and the 2003 Report, provided at the request of the Board of Regents for their consideration.

- Retain the current UTIMCO structure as contemplated by the UTIMCO Enabling Statute, with improvements to the structure and associated oversight processes designed to improve the implementation of Regental policy by UTIMCO and achievement of the Board's investment management goals and fiduciary duties, as detailed in this and the other sections of the report.
- At the Board level, review and work to achieve Regental consensus on the purpose and role of UTIMCO.
- Improve the quality of information, reporting, and decision-making regarding investment management matters by adopting as appropriate the specific information and reporting-related recommendations contained in this report and better educating the Regents regarding matters related to investment policy.

¹ The principal authors of this document are Charles Szalkowski and Christopher T. Brown, partners resident in the Houston and Austin offices, respectively, of Baker Botts L.L.P.

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- Conduct a formal annual review of the UTIMCO relationship and investment management implementation, as a component of the annual UTIMCO budget and contract review.
- Enhance the Board's structural control over investment management, primarily through increased attention by the Board to the selection and oversight of UTIMCO's directors.
- Improve communication between the Board of Regents and the UTIMCO Board, including by providing for periodic reports by the UTIMCO directors to the Board of Regents.
- Evaluate the reliance on UTIMCO for performance of certain record-keeping functions to determine whether they would be better or more efficiently provided within the U.T. System.
- Evaluate the management of commercial and corporate aspects of operational functions by UTIMCO to determine whether they would be better or more efficiently provided within the U.T. System.
- Improve communication between the UTIMCO CEO and the Board of Regents.
- Work to enhance the Board's confidence and trust in UTIMCO, including by more frequent interaction among the UTIMCO directors and the Regents.
- Heighten the standards for UTIMCO's internal controls and procedures as appropriate for more sophisticated investment vehicles.
- Collaborate with the U.T. System's peer institutions to develop, promulgate, and advance best practices for investment management by large public universities.

Overview

The Board of Regents (the "Board" or the "Regents") of the University of Texas System (the "U.T. System") is the steward of more than \$16 billion in public funds with which it has been entrusted. These funds include the Permanent University Fund (the "PUF"), set aside for the U.T. System and the Texas A&M System (the "A&M System") pursuant to the Texas Constitution; thousands of separate endowment funds resulting from gifts to the U.T. System by private benefactors; the Permanent Health Fund accounts allocated to the U.T. System as part of the Legislature's disposition of the state tobacco litigation proceeds, and the operating funds of the various U.T. System component institutions (collectively referred to herein as the "Delegated Funds"). Since 1996, pursuant to express authority conferred by Texas statute (Section 66.08 of the Education Code, referred to herein as the "UTIMCO Enabling Statute"), the Board has delegated its day-to-day investment management responsibilities to the University of Texas Investment Management Company ("UTIMCO"), a Texas non-profit corporation established for the sole purpose of performing investment management services for the Board. UTIMCO

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operates under the oversight of a volunteer board of directors (the "UTIMCO Board") selected by the Board, comprised of three Regents, the Chancellor of the U.T. System, a representative of the A&M System, and currently, independent investment professionals. The UTIMCO Board oversees a staff of salaried full-time managers ("UTIMCO Management"), who in turn oversee a network of for-profit money managers (as well as making some direct investments). A Second Amended and Restated Investment Management Services Agreement dated as of August 7, 2003 between UTIMCO and the Board (the "UTIMCO Agreement") sets forth the more detailed terms and conditions under which UTIMCO provides investment management services to the Board.

Duties of the Board of Regents

From a legal perspective, the overarching issue the Board must consider with regard to its management of the Delegated Funds under its control is the question of when the Board has fulfilled its duties with respect to such management. The answer to that question establishes the outer legal parameters for all of the Board's activities in this area – which is not to suggest that the Board should not aspire to an even higher standard for its management of investments in the best interests of the people of the State of Texas.

As noted in the 2003 Report, the Board properly views itself as the "ultimate fiduciary" of the Delegated Funds. The scope of its duties as a fiduciary is articulated in the diverse (and sometimes conflicting) sources of law governing the different categories of funds, including the Texas Constitution as to the PUF, the Uniform Management of Institutional Funds Act (and, in some respects, the law of trusts) as to the endowment funds, and the separate statute governing the Permanent Health Fund as to those funds. Distilled to its essence to the extent it can be, the Board's duty is to conform to a "prudent investor" standard of reasonable care, skill, caution, and prudence. Given the paucity of directly relevant precedent informing such standards, the Board must to a large extent rely on its own best judgment as to when it has acted with sufficient care and prudence in investment matters. This judgment may be aided by the more extensive legal analyses available concerning private law contexts in which fiduciaries manage the funds of others (and the ongoing private sector efforts to improve standards of governance and internal controls exemplified by Sarbanes-Oxley, efforts which the Board is already adapting to its own organization in this and other areas).

Delegation of Investment Management by the Board

As with all of the myriad functions of the U.T. System for which the Board is responsible, some level of delegation of its functions is inevitably necessary – nine people cannot operate an institution the size of the U.T. System alone. The Board's fiduciary duty with respect to the Delegated Funds can only be fulfilled by delegation to competent people who are adequately managed and controlled. There is a wide range of acceptable selection and oversight procedures that would fulfill the legal duty of the Board, but in the end, for both legal and public policy reasons, the Board must be satisfied with the selection, oversight and control of the persons to whom it has delegated the investment management responsibility. If the Board is not satisfied, then it has not fulfilled its responsibility.

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The possible scope and form of the delegation ranges from delegation to a committee of the Board to complete arms' length outsourcing of function to a private third party. We believe that, except as specifically circumscribed by law (as is the case with the PUF under the Texas Constitution and the UTIMCO Enabling Statute), it is likely that a court would find any delegation within that continuum to satisfy the standard of care provided that the delegation was structured to incorporate systems of checks and balances reasonably designed to ensure the actual implementation of investments was prudent – bearing in mind that the scope and form of the delegation, and the types of investments authorized, will likely compel different degrees of Board oversight and monitoring. And in any case, we believe the checks and balances should include at a minimum measures reasonably designed to achieve the following:

- Reservation of ultimate power and authority (and corresponding duty) regarding investment policy and related matters by the Board;
- The scope of the delegation to UTIMCO, and corresponding reserved powers, are articulated with sufficient clarity;
- The agents to whom authority of the Board is delegated (including the UTIMCO Board, UTIMCO Management, and the outside managers) are prudently selected, so that they may be reasonably relied upon;
- The Board is reasonably informed, by being provided with adequate information to assess the performance of UTIMCO;
- Such information is utilized as part of regular oversight discharged with sufficient frequency to provide reasonable assurance of performance, and, as appropriate, the Board makes reasonable further inquiries, and takes further action, based on that information;
- The Board has reasonable confidence in the adequacy of the systems of internal controls and compliance in place at all appropriate levels to ensure that investment management is implemented in accordance with the applicable standards of care; and
- There are measures in place to achieve accountability of the agents for their performance, such that the performance of UTIMCO is reviewed and judged both as to achievement of the nominative goals and by comparison to the comparative goals in each case established or approved by the Board, and those performance measures are in fact utilized as needed.

Stated simply, the Board may properly delegate implementation of its investment management to UTIMCO so long as the Board is reasonably satisfied, based upon continuing due inquiry and oversight, that UTIMCO is performing such investment management consistent with the directives of the Board – again recognizing that the ultimate responsibility remains the Board's, and that it has a duty to monitor its agent's performance and intervene when it has reason to believe the agent is not performing. As such, the Board's efforts to review carefully its arrangements with UTIMCO based on performance over the eight or so years since UTIMCO's inception and restructure them as may be deemed appropriate, is prudent, and arguably, compelled.

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In applying these principles to the Board's delegation to UTIMCO, careful consideration must also be given to the complicating factor that the delegation is layered, in that the governing board of the principal (the Board) is effectively delegating to an intervening governing board of the agent (the UTIMCO Board, which includes three Regents and the Chancellor), which in turn delegates some of its responsibilities (and most of the day-to-day investment management operational matters) to officers and employees of the agent (UTIMCO Management), who in turn make most of the investments through third-party fund managers, many of whom may offer highly complex and sophisticated financial products that are not easily understood by people who are not experts in such instruments. The attenuation of control and accountability up and down this chain of principals and agents, and the challenges involved in ensuring the adequacy an accuracy of information and reporting regarding performance, risk, and compliance at different levels, arguably calls for more detailed structural oversight and internal controls and procedures than might be the case in a delegation to a committee, on the one hand, or a complete arms' length outsourcing, on the other hand.

It is important to emphasize, when considering the unique structure of the UTIMCO arrangement, that while UTIMCO is a separate legal entity from the Board and the U. T. System, it is not independent of the Board. UTIMCO operates as a separate corporation under the structural (i.e., through designation of directors and other structural elements of Board control contemplated by the UTIMCO enabling statute and UTIMCO's charter documents) and contractual control of the Board.

While we conclude that the Board's management of investment of the Delegated Funds through UTIMCO appears to satisfy the applicable standards of care, we hasten to note that this report identifies a number of areas of concern about aspects of the Board's investment management that could be improved. The very fact that this report is being prepared demonstrates the Board's diligence in its continued oversight of the implementation of the Board's investment policy by UTIMCO. The enhanced oversight efforts exerted by the Board over the course of the past two years is not the only area of compliance improvement attended to by the Board during that period, but seems unique in terms of the extent of the review, the extent of reliance on outside professionals to assist in the review, and the range of basic and specific issues explored in those reviews. No doubt this reflects the relative novelty of the UTIMCO delegation vis a vis other institutional functions governed by the Board and the uniquely complex nature of the UTIMCO structure – the U.T. System, with the creation of the UTIMCO structure, has been a pioneer among its peers, particularly other public universities, and there are no easy precedents to follow in this area.

Determining the Role of UTIMCO

In conducting its review of these matters, it may be helpful for the Board first to establish a general consensus regarding its objectives with respect to investment management – in particular, the desired structural role of UTIMCO and the manner and type of investments to be made by UTIMCO on the Board's behalf. Toward that end, it may be useful to consider the Board's original intentions when it created UTIMCO.

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Original Intent Regarding the UTIMCO Delegation

When UTIMCO was created in 1996, the Board explained in connection with its enabling resolutions that UTIMCO was being created as the result of a review of the UT System investment governance and management structure that had been undertaken in recognition of the UT System's increasing reliance on private support and its endowment resources to fund its mission. The Board noted that the challenges to success in this area had increased, as the system faced an increasing competitive and complex investment environment marked by global markets, alternative investment classes, a proliferation of new, complicated financial instruments, and short windows of opportunity, and as the scale and complexity of the Board's investment responsibility had grown to a point where full-time oversight of the investment portfolios was required.

The U.T. System engaged Cambridge Associates to review the situation. In its 1995 report, Cambridge Associates identified numerous deficiencies in the then-existing governance structure that, in its opinion, inhibited the UT System's ability to compete effectively for investment returns. In particular, it noted the limited investment expertise among most Board members, a lack of "institutional memory" from frequent Board turnover, overlapping governance committees, and poor separation of policy formulation from operations. In light of these findings, Cambridge Associates recommended the structure now reflected in UTIMCO, with a hybrid board consisting of both Regents and investment professionals, delegating investment decisions to investment staff, subject to policy constraints.

In adopting these recommendations, the Board specifically cited as its purposes (a) the preservation of ultimate Board control of investments for fiduciary purposes, (b) the creation of a separate investment board with a high level of investment expertise for oversight purposes, (c) an emphasis on policy deliberation at the Board level, (d) streamlining decision-making by shortening reporting lines, and (e) focusing accountability for investment results. In other words, UTIMCO was designed to enable an exclusive focus on investment policy and performance within the investment policies established by the Board.

Dedicated Consideration of Investment Policy

From one perspective, the UTIMCO Board may be seen as like a special committee of the board of directors of a private corporation established to evaluate and make decisions and recommendations regarding the interests of a particular group of corporate stakeholders, except that in this case the discharge of the fiduciary duties of the "special committee" (the UTIMCO Board) focuses not on the interests of a particular group, but rather on one discreet subset of the whole panoply of interests and concerns of the Board (and of the U.T. System and the other beneficiaries of the Delegated Funds). By structure, by contract, and by the terms of the Investment Policy Statements, UTIMCO's job is to implement those investment policies in its best business judgment, without reference to any considerations other than what decisions will best achieve the Board's investment policies. While UTIMCO cannot, in any practical sense, have any interests adverse to those of the Board or the U.T. System, the structure is such that it may result in circumstances where the judgment of the UTIMCO Board or management as to a specific investment-related decision may need to be weighed against other policy considerations

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of the Board. A recent example is the deliberation over the Board and UTIMCO's policy regarding disclosure of returns of private equity investments. To the extent that UTIMCO's position was that such disclosure should not be made to the extent it might limit future investment opportunities, it may have been the best decision when viewed solely through the prism of the best interests of achievement of the Board's investment policies; the Board properly reserved for itself the power to determine whether its policies regarding full disclosure were more important than speculative opportunity cost.

This structure, which embodies the potential for opposition between different policies of the Board and the potential for increasing independence of the agent, presents the question whether, in the Board's view, the goals it cited in 1996 when creating UTIMCO still apply. Should the implementation of investment policy be delegated to a technically separate entity governed by a majority who may be non-Regents and managed by a team of investment professionals who primarily report to that board? On balance, the case for such a delegation remains strong, provided the Board has confidence in the adequacy of its investment policy directives, confidence in the system of checks and balances it establishes to ensure those policies are properly implemented and the goals of accountability and performance are met, confidence in the professional competence and integrity of the individuals to whom it has, indirectly through the UTIMCO Board, delegated day-to-day decision-making authority, and confidence that it has the ability to timely learn of incorrect implementation of its investment (or other) policies and to correctively intervene. This report contains a number of recommendations for specific measures that would better develop such confidence without fundamentally altering the current structure.

The Structural Role of UTIMCO

Assuming the Board believes the statutorily contemplated UTIMCO structure is the desired structure for its investment management, it must next determine the more specific structural role of UTIMCO. Is UTIMCO to be a money manager or a manager of money managers?

If UTIMCO is intended to be a direct money manager, that will likely argue for certain choices as to the type of employees needed at UTIMCO, the type of compensation scheme and the levels of competitive compensation that are needed to attract those individuals, and the type of oversight that is needed outside UTIMCO to oversee its work and to gauge its compliance with the directives laid down to it, and its success, risk levels, and costs compared to other alternatives. Of course, by comparison to a traditional selection process, there would seem to be a flaw here, because normally, one would not choose a particular money manager without some substantive track record of performance by that money manager in the very types of investments being expected of that manager, and UTIMCO cannot build a track record before the Board engages it because it can have only one client. Also, such an expectation means that there would need to be other alternatives open, a staff outside UTIMCO at the U.T. System ready, capable and willing to oversee and select from among those alternatives, and some reason to expect that a separate UTIMCO would be better at managing money than the myriad of commercial alternatives.

If UTIMCO is intended to be a manager of money managers, then it is essentially an outsourced department of the financial section of the U.T. System, and it would need a different

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set of attributes in the people it needs, a different compensation scheme to attract those individuals, and a different, and perhaps lesser, type of independent oversight – an oversight perhaps similar to that which oversees any other department within the U.T. System. By analogy, most large American business entities with any kind of retirement plan have a section within the treasury function that manages the retirement fund managers, often with a committee of interested overseers who have other full time jobs; most large endowments have a staff of managers of money managers to select and monitor the outside money managers, and a board of volunteer directors to oversee the staff.

Neither model seems to describe precisely UTIMCO as it has evolved. Perhaps UTIMCO can best be seen as a hybrid – it manages some money directly (at least short-term money market investments and REITs) and it oversees other money managers (including the private equity and hedge fund general partners of the limited partnerships in which it has invested). As discussed above, the original intent behind the creation of UTIMCO as a separate legal entity seems to have been, in part, to obtain the independent professional consideration of the best implementation of the investment policies of the Board. This notion of independence inherent in a separate legal entity becomes noteworthy because, by their very nature, organizations tend to work to preserve and strengthen their own existence and independence over time. As such, as an even more fundamental predicate matter, the Board needs an acknowledgement by all involved that the Board absolutely and irrevocably governs all matters related to investment policy, and that any delegation it may elect to make is premised on that principle.

Observations and Recommendations

Information and Reporting

The Board must reasonably be satisfied that the information that is delivered to it, as the ultimate fiduciary, is sufficient and useful for the Board to make informed decisions regarding investment management matters and exercise its oversight duties. Is it both thorough and succinct? Does it clearly indicate the extent to which the funds managed are within the numerous different policy guidelines and rules? Does it indicate how well the money managed by UTIMCO has performed compared to the universe of other money managers that might be chosen in those respects deemed important by the Board, such as net return, risk assumed, and cost or expense? How accurate is that information and who audits it? How reliable is that information and who has checked it? To what extent and with what frequency does the UTIMCO Board review these results, both to check the work of the employees, and also to assess the service to the (sole) customer? Do the UTIMCO Directors understand what they are looking at? What limited number of benchmarks and measuring statistics are most useful to the Board in performing its oversight role in the much more limited time it has available? Do the Regents understand what they are looking at? Who is looking at that information between meetings of the Board or between meetings of the UTIMCO Board?

Based on our review, it seems clear that the UTIMCO Directors are diligent in their effort to ensure that they have adequate information to discharge their duty, that they work to question

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appropriately the information to ensure its accuracy, completeness, and objectivity. The U.T. System Staff members assigned to UTIMCO oversight are similarly diligent. Whether the information received is satisfactory to provide the Board with complete confidence that its investment policies are being implemented to its satisfaction remains less clear. The Board may wish to consider the following improvements toward that end:

- Implementation of the recommendations regarding information, reporting, and internal controls provided in other sections of this report. In directing its staff and UTIMCO regarding such implementation, the Board should give care to demand that the quantity of information presented to the Board is sufficiently succinct to enable thorough review by time-constrained Regents of what is provided, while sufficiently complete for oversight to be satisfactory, and to demand that it obtain adequate information for the Board to adequately oversee UTIMCO without unduly duplicating the more detailed oversight performed by the UTIMCO Board.
- Improved communication between the UTIMCO Board and the Board, as discussed below.
- Improved education of the individual Regents regarding investment policy matters.

Accountability

In light of the complex, tiered structure of the UTIMCO delegation, the Board must have confidence that there are sufficient accountability measures at each level, both within and outside the U.T. System, and even down the chain from UTIMCO with the outside managers with whom UTIMCO invests the Delegated Funds (though such confidence may be obtained by virtue of reasonable confidence that UTIMCO has ensured such accountability). Is the compensation of the UTIMCO staff tied to the key performance indicators of importance to the Board? Is the compensation of the U.T. System oversight staff tied to the thoroughness and accuracy and faithfulness of their review? Is the compensation plan practical – do those who are working under it understand it? Do those who are overseeing the workers understand it? It would seem unreasonable to have a compensation system that the workers understand better than the overseers – that can be too readily gamed or played by those to whom it means more. Are the UTIMCO directors graded both on their own faithful performance and on the results provided by those whom they oversee? Is the Board graded on its performance (in this investments arena or in any arena)? Are there checks and balances within the system at UTIMCO, at its Board, at the U.T. System and at the Board so that deviations from policy are rapidly and firmly checked?

Periodic Review

The Board may wish to institute a formal annual renewal of the contract between UTIMCO and the Board, a process that would constitute an annual “vote of confidence” in the entire system and process of delegation. There is a nice balance here for, on the one hand, the Board can determine to terminate its delegation to UTIMCO virtually at any time upon 90 days’ notice, whereupon UTIMCO would wither and die, and, on the other hand, UTIMCO or its executives can commit institutional suicide if they do not like the terms and thereby leave the Board with no way, in the short run, to manage its funds.

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But, it must be recognized by all parties that, in the end, UTIMCO is the creature of the Board, and the Board can impose essentially any contract terms it desires on UTIMCO. (Of course, it cannot force the current UTIMCO employees and volunteer directors to continue to work under just any conditions, so, even at this stage, there is some check on potential arbitrary action of the Board of Regents.)

Nevertheless, when that annual contract renewal is approved, the Board would be voting on more than just the terms of the agreement. It would be voting on whether or not to continue the existing structure and voting to approve the existing controls and policies and procedures, as modified by that new year's contract.

Structural Control

As a legal structural matter, the Board has all the ultimate formal control over UTIMCO it needs. In addition to being able to impose the contract terms it desires, it appoints all of the UTIMCO directors, including the one who is from a list provided by the A&M System regents. The only other person who is statutorily automatically on the UTIMCO Board is the Chancellor, who, of course, is also chosen by the Board. The Board can put whatever conditions it wishes on the directors it appoints (and can remove by majority vote any directors who fail to abide by those conditions), including, for example, if the Board wishes, a condition that the UTIMCO directors prepare and certify periodic reports to the Board, a condition that the UTIMCO directors agree that the Board will need to approve the compensation of the UTIMCO executives, a condition that the UTIMCO directors prohibit investments in such-and-such kinds of securities, or (to use a silly example) even a condition that the UTIMCO directors permit only burnt orange carpet in the UTIMCO office.

The UTIMCO directors are the direct delegates of the Board, and as the current structure stands, they are responsible for the conduct and performance and compliance of the UTIMCO executives and employees.

Board-to-Board Communication

It appears that there has not been enough communication and discussion between the Board and its delegates, the UTIMCO directors.

Because there are three Regents on the UTIMCO Board, those three Regents are the first line of oversight. In effect, they constitute a committee of the Board. Those three Regents might be asked to present a UTIMCO report at each Board meeting, and in that report, give their views of the continuing efficacy of UTIMCO, including from time to time the qualifications and competence of the UTIMCO executives and employees (and of the outside UTIMCO directors), the UTIMCO staff's compliance with the policies and limitations imposed on them by the Board and the UTIMCO Board, and the adequacy of the internal control systems at UTIMCO. If the three Regents who have been chosen by their fellow Regents to be on the UTIMCO Board are asked to express how well they are satisfied with those matters entrusted to their responsibility, that could go a long way toward enhancing the confidence of the rest of the Regents.

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Similarly, as suggested in our 2003 Report, there ought to be more social, intellectual and personal interaction between the outside directors of UTIMCO and the Regents who are not on the UTIMCO Board. These outside UTIMCO directors are public-spirited volunteers, who commit substantial time and effort to their work, and who forgo the opportunity for their own firms to be engaged to invest Board funds as a result of their volunteer service. They should be acknowledged and applauded for their contributions, and, at the same time, quizzed by their principals, the Regents, about their comfort with the UTIMCO policies, procedures, employees and systems they are overseeing.

To repeat, the UTIMCO directors are elected by, and ought to be reporting to, the Board. Periodic reports from the UTIMCO directors to the Board would be a small process step to remind them whose delegates they are and for whom they work, to allow them to express their professional views to the Board, and no doubt, to engender a greater level of trust, confidence and understanding.

There are, it would seem, two primary ways that the Regents can become comfortable with the delegates it appoints and the persons to whom those delegates further delegate investment decision-making. One is to get to know them as individuals, watch them work, discuss the subject matter with them, and thus be better able to assess and develop confidence in them. The second is to develop confidence both in the array of internal controls and procedures, limitations and policies, that they have responsibility for overseeing, and in the functioning of those procedural structures.

We have noted that certain of the Regents have been attending the UTIMCO Board meetings as observers, and we applaud that and recommend that each Regent take the opportunity to attend at least one UTIMCO Board meeting, perhaps as often as annually.

More probably needs to be done in connection with recruiting, vetting, and electing new UTIMCO outside directors, although much has been improved since the 2003 Baker Botts Report. We note that long-time UTIMCO director Luther King's term is ending, and this is a timely opportunity for the Board to exercise its authority and to develop a robust process for recruiting and choosing new outside directors. But, the existing members of the UTIMCO Board also need to have a voice in making recommendations, both because of their experience in the investment profession, and also because the Board will want to know, in advance, of any interpersonal difficulties any particular nomination may imply.

Overall Structural Considerations

As to the question of whether the existence of UTIMCO as a separate legal entity is the "right" structure, here are the views of the authors of this section of the Report:

The authors of this section of the Report have concluded that the structure is not only the "right" structure for the U.T. System, but it is the structure we would likely recommend to other public universities similarly situated. There were a variety of different purposes articulated when UTIMCO was created, but we believe that, in the end, the primary and most important purpose fulfilled by having a separate legal entity is to insulate (without separating) investment decision-making from the political process.

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The historians among us can report on the history of the management of these funds and others like them over time, but virtually everyone would agree that it is not a good thing to have the investment decisions subject to direct political pressures. The existing structure reduces the chances of charges of cronyism where the implication is that the U.T. System funds are being invested to support the investment or commercial objectives of the Governor, key legislators, or other particular individual political appointees (including Regents). This structure reduces the chances that a particularly strong personality in the position of a Regent or Chancellor can influence investment decision-making directly. This structure gets the investment decision-making out of the hands of political appointees, who only through chance have any professional expertise in making investment decisions, and into the hands (bounded by the checks and balances of the policies, controls and procedures) of the professionals on the UTIMCO staff and on the UTIMCO Board. Finally, as noted above, it seems to help insulate the investment decision-makers from considerations other than what produces the best investment results consistent with the Board's investment policies, unless the political body charged with public policy oversight, the Board, affirmatively determines to insinuate other public policy considerations into the process.

The classic example is the 1980s issue of whether to participate in South African investments. In the UTIMCO structure, the UTIMCO employees and directors would be able to make what their professional judgment determined to be the best decisions for investment results. If the Board determined, for public policy reasons, that it was committed to a particular South African investment policy (no doubt after considering the UTIMCO staff's analysis of the anticipated cost of that policy), it is clear that the Board could formally intervene in the process and declare that UTIMCO would, or would not, invest in South Africa. But the UTIMCO structure can insulate the investment decision from that type of policy choice absent formal intervention by the Board, and the structure gives the Board a legitimate basis to protect its investment performance from temporal political considerations.

Business Operations

We have been speaking of investment decision-making. The goal, and one that seems to be working fairly well in the current structure, is to delegate the investment decision-making (to be sure within the investment objectives and policies adopted by the Board). Currently, however, it appears that two other types of matters are also delegated to UTIMCO:

The first is the back-office, "bank trust department" type of work that relates to record-keeping and to reports for donors whose donations are part of planned gifts that retain an income interest or some other interest. Another section of this report focuses on this work; although it appears to be working well, there does not seem to be any particular reason why this work is being done at UTIMCO rather than at the U.T. System, and no particular expertise is involved that is inherently more likely to be available at UTIMCO than at the U.T. System.

Second, the directors of UTIMCO have delegated to them currently not just the investment decision-making, but also the management of the non-profit corporation that is UTIMCO. While this is a natural outcome of the separate legal entity structure, this may not be necessary. It is probably true that the compensation and perquisites of the employees, especially

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incentive compensation, are very closely related to oversight of the investment management function (especially if the trust-department type work is removed from the mix), but it isn't clear that this extends to the other aspects of managing the operational aspects of UTIMCO, and as is being suggested in other parts of the report, the Board may well decide to retain within the U.T. System some management and oversight of the commercial and corporate aspects of managing the UTIMCO operations and entity. This is no doubt a distinction that cannot be as easily drawn in practice as in this paragraph, but the point is that the investment decision-making ought to be delegated, through the Board's appointment of UTIMCO directors, to UTIMCO, and whether running the UTIMCO entity ought to be delegated to those same people is a separate question. The Board could well decide to retain and operate the budgetary and commercial aspects of running UTIMCO within the U.T. System, subject to the same procedures and oversight process as any other component of the U.T. System, without losing much of the benefit of the insulation provided by the separateness that is mentioned above. It is interesting that the current contract includes both a total fee approval process such as there would be with an independent, profit-oriented investment management firm, and also a limited review of the detailed UTIMCO budget. Because the usual objective of setting a fixed fee and allowing the investment management firm to structure itself and manage its costs within the fee is the goal of making a profit, this model has perhaps inspired UTIMCO management to some efficiencies that have resulted in "profits" or retained surpluses. Those retained surpluses do properly belong to the Delegated Funds, since they constitute the results of charges against the funds that were greater than were required for UTIMCO to perform its functions during prior years.

Anecdotal evidence suggests that the UTIMCO Board currently focuses almost entirely on the investment decisions being made, and the controls of those decisions and their implementation, not on the office lease, bank operating accounts, and other commercial issues of UTIMCO. To the extent that UTIMCO's separate status as a non-profit corporation permits it to purchase goods and services on commercial terms rather than through Texas governmental procurement procedures, there may be both some benefits and some detriments. Sourcing certain services tied directly to investment decisions, such as from investment consultants and money managers, probably would have little or no added benefit if done through competitive bidding and other procurement policies. However, other goods and services purchased for the operation of UTIMCO, as for any other component institution, might well benefit from governmental procurement and purchasing policies and budgetary "reasonableness audits" and oversight, particularly where those procurement policies have political implications.

Similarly, the issue of the choice of counsel for UTIMCO could be, as suggested elsewhere, bifurcated between the work counsel does for UTIMCO the entity and work that counsel does for the funds at the direction of the UTIMCO delegates. It is clear that the Office of the General Counsel of the U.T. System does not have the expertise as currently structured to handle the investment transaction representation, and so it is likely that the General Counsel would engage the same law firm and lawyers anyway. But the approval of that selection could well be assigned to the General Counsel since the law firm's fees are directly charged to the funds. In the end, as currently structured and as suggested in portions of this Report, UTIMCO is and ought to be a separate legal entity and the decision as to whether a legal person needs separate counsel is one that, in contemplation of the law governing lawyers, can really only be made by that person.

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But these are details and none of these choices is necessarily clearly better than the others. The legal responsibilities of the Board do not mandate that the ultimate structure come out at any particular place in the wide spectrum referred to above.

UTIMCO Management

The role of the UTIMCO CEO is clearly crucial. Different CEOs will necessarily emphasize different aspects of the job, and will have different personalities. However, it seems that client service is one of the most important jobs of the CEO of an organization engaged in money management. Here, where there is only one "client", namely the Board in its fiduciary role, that aspect of the job ought to be fairly focused. The Board, through its delegates, the directors of UTIMCO, already has indirect control over the selection of the CEO, his or her performance, and compensation. It appears that the current incumbent has naturally focused primarily on dealing with his direct overseers, the UTIMCO board, and less on dealing with his ultimate clients, the Regents. Again, the answer seems to lie primarily in greater communication. The CEO needs to become more well known to the Regents who are not UTIMCO directors, and he needs to appreciate the informational and educational needs those Regents have in fulfilling their fiduciary duty. A closer working relationship ought to strengthen the confidence and comfort the Regents have individually in relying on the CEO and his team.

There are, of course, other "clients" as well, and we applaud the work recently being done by the UTIMCO staff to work more closely with the CBOs at the various component institutions, to understand their concerns, their requirements, and their informational needs, and to be responsive. The recently completed survey by UTIMCO surveyed several hundred people throughout the U.T. System and found that generally UTIMCO is doing a good job. We note that the survey may have weighted equally the replies of the Regents with those of the others surveyed, without adjusting for the differences in types of concerns and the ultimate authority of the Board.

Human nature suggests that it is possible for expert professionals to stray from their professionalism in either of two ways: first, by forgetting that their "clients" are not nearly so expert, and often are shy about asking for clarification, and thus perhaps by unintentionally obfuscating what could be made clearer; or second, by using their exalted expertise intentionally to confuse or pontificate, or condescendingly to minimize the needs of the audience to understand. Virtually every expert professional is guilty of straying one way or the other from time to time; in this situation with its political undertones and high public profile, there is even more need for the expert professionals to work to make sure the "clients" comprehend and are comfortable.

To sharpen the point a bit, the professionals at UTIMCO will not be doing a good job, regardless of their investment results, if they have not been able to make the Regents comfortable that the Regents have acted wisely and with prudence in delegating to them.

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Establishing Confidence and Trust

So, the Regents need to do a better job of working to get to know the UTIMCO directors and staff and to understand the work they do, how it is managed, and the internal checks and balances of how it is controlled; and the UTIMCO directors and staff need to do a better job of accepting the legitimacy of the concerns of the Regents and the U.T. System staff, and working to make sure they understand and are satisfied. Working to live up to these exhortations is essential even if everyone involved in the current arrangement is absolutely the smartest, most honest, hardest-working, most dedicated and public-spirited person of good will, if every investment decision is the best investment decision ever made, if every one of the internal controls, investment policies, and risk analyses is perfect for the situation, and if the investment results are the best of any investment management group anywhere for all eternity. Good investment results do not necessarily produce confidence and trust, but confidence and trust will permit forgiveness of the occasional, inevitable investment mistakes.

Heightened Standards for Internal Controls

Other sections of this report deal with possible improvements in the crafting and testing of compliance with investment objectives, investment policies, risk limitations, and the like. The internal checks and balances are crucial, and the external verification of the functioning of the checks and balances is just good form. One point, however, has concerned the authors of this section of the Report. In the olden days, investment portfolio management was simpler, with allocations between only a few asset classes, mostly utilizing long positions in publicly traded stocks and bonds. Modern portfolio management has many new tools for assessing and allocating risk in connection with diversification, many new investment products and asset classes, and many investment "rocket scientists" dreaming up new ways of separating types of risks and returns and permitting them to be sold to those with the appetite for just that kind of product. But, it is inevitable that the checks and balances, the audit techniques, have lagged the new investment tools and new asset classes and products. It would seem to be a dereliction of duty for the UTIMCO staff to recommend, or the UTIMCO Board to approve, investing in any category of investment for which there is not already in place both at UTIMCO and in the UT System the appropriate checks and balances, audit techniques and outside confirmation sources to permit less sophisticated compliance personnel (whether outsiders or insiders) and persons with supervisory responsibility, to confirm that the investment choices made are within the authority granted and actually have the purported aspects, features and risks they are supposed to have. This places an extra burden on the investment managers, of course, but in the post-Sarbanes-Oxley world, and especially when the money being invested belongs to the taxpayers, this is critical. Therefore, UTIMCO management ought to articulate the critical issues that should require internal controls and external auditing in connection with each new category or type of investment, and articulate whether and how they believe the existing systems need to be beefed up to keep track of those new categories or types of investment, and no one up the chain of authority ought to approve any new category or type of investment absent confirmation that those checks and balances are in place.

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Collaboration with Peer Institutions

The U.T. System Staff has learned that many of the U.T. System's peer institutions are struggling with issues similar to those addressed in this report, and that great interest has been expressed by members of that peer group regarding the Board's review of the pioneering structure it has implemented. The Board may wish to consider expanding its leadership role in this area by reaching out to its peers in an effort to share information about investment management structures and implementation, with a view to collectively identifying and establishing best practices.

Analysis of Specific Legal Issues

Following is a discussion in outline form of the specific legal issues presented for our review, accompanied as appropriate with commentary and recommendations.

I. Governance Matters.

A. UTIMCO Charter and Bylaws. The UTIMCO Enabling Statute requires at Sec. 66.08(c) that the Board must approve UTIMCO's Articles of Incorporation, bylaws, and any amendments, as well as the UTIMCO Code of Ethics. The UTIMCO Charter documents were reviewed and discussed in detail in the 2003 Report (see 2003 Report at Section IV(B), pp. 20-28). The UTIMCO Articles of Incorporation have not been amended since the entity's incorporation in 1995.

Commentary and Recommendations:

Any revisions to the UTIMCO Charter and Bylaws should be driven by the Board's consideration and conclusions regarding the other substantive recommendations and conclusions of this report. In particular, we note that some of the U.T. System Staff recommendations, such as those regarding UTIMCO Board issues, would likely be advanced by revisions to the UTIMCO Bylaws to codify those recommendations.

B. UTIMCO Board.

1. Nomination and election of directors.

a) UTIMCO Enabling Statute. The UTIMCO Enabling Statute requires that the UTIMCO Board be comprised of nine members, to include at least three members of the Board, the Chancellor, and one or more persons selected from a list of financial experts to be provided by the A&M System. All of the members of the UTIMCO Board are to be appointed, and may be removed, by the Board. See UTIMCO Enabling Statutes Secs. 66.08(d)-(e).

b) Board Rules. The Board Rules track the corresponding provisions of the UTIMCO Enabling Statute, except that they do not speak to the Board's removal power. Board Rules, Part One, Ch. I, Sec. 7.3.

c) UTIMCO Bylaws. The UTIMCO Bylaws, in Article III, provide as follows.

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- (1) Number. The number of members of the UTIMCO Board will be determined by the Board. (Article III, Sec. 2).
 - (2) Appointment and Term. As to appointment and term, to be appointed by the Board and Chancellor, with the three Board designees to serve two-year terms expiring April 12 of each odd-numbered year, and others to serve three-year staggered terms, up to a maximum of three three-year terms each. (Article III, Sec. 3).
 - (3) Removal. All members of the UTIMCO Board may be removed by the Board, with or without cause. (Article III, Sec. 4).
 - (4) Vacancies. Any vacancies are to be filled by the Board. (Article III, Sec. 5).
 - (5) Nominating Committee. The UTIMCO Board is to have a Nominating Committee comprised of three members of the UTIMCO Board. All candidates will be screened by the Nominating Committee, which will then deliver a list of nominees to the Chairman of the UTIMCO Board for submittal to the Board.
- d) Proposed Process. By memorandum on May 23, 2003, Counsel and Secretary to the Board Francie Frederick proposed a review of UTIMCO Board nominees modeled on that performed by the Governor's office with respect to nominees for the Board and the A&M System Board of Regents, comprised of the following:
- (1) Chairman Solicitation of Nominations. Chairman of UTIMCO Board solicits nominations from the Board, the A&M System Board of Regents, UTIMCO Board, and other interested institutions.
 - (2) UTIMCO Nominating Committee Review. Nominations are reviewed by UTIMCO Board Nominating Committee.
 - (3) UTIMCO Nominating Committee Recommendations. UTIMCO Board Nominating Committee forwards list of nominees and recommendations of candidates considered qualified by UTIMCO Board Chairman.
 - (4) UTIMCO Chairman Recommendations. UTIMCO Board Chairman reviews list and provides list with recommendations to Board Chairman.
 - (5) Candidate Questionnaire. At direction of Board Chairman, U.T. System Staff asks those considered as serious candidates to complete a questionnaire covering relevant lines of inquiry and apprises candidates of provisions of UTIMCO Code of Ethics and disqualifications from service.
 - (6) U.T. System Staff Investigation. Using information from questionnaires, U.T. System Staff:

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- (a) Confirms educational degrees and professional certifications.
 - (b) Assures that professional licensures and certifications are in good standing.
 - (c) Reviews business relationships, if any, with members of Board, UTIMCO Board, the U.T. System, or UTIMCO.
 - (d) Initiates the U.T. System Police Director's review of Texas conviction database and contacts local law enforcement.
- (7) Personal Interviews. Board Chairman or designee and UTIMCO Board Chairman conduct personal interviews, as needed, prior to submission of recommended appointment for consideration by Board.
- (8) Status of Proposal. According to U.T. System Staff, this proposal was utilized with respect to new directors of UTIMCO elected in 2003, but not formally adopted.

Commentary and Recommendations:

The selection of members of the UTIMCO Board is among the most important aspects of the Board's management of UTIMCO, comparable to the establishment of investment policy. The power is a plenary one without any real limitation other than such process as the Board may have endorsed by its approval of processes embodied in UTIMCO's Charter and Bylaws.

The primary issue for the Board to consider is the extent of initiative it should take in the UTIMCO Board identification, nomination, and election process – to what extent should the process be Board-driven, as opposed to the Board reacting to UTIMCO proposals.

Anecdotally, based on interviews and discussions, the actual process appears to be bifurcated, with the Board unilaterally selecting its designees to the UTIMCO Board without UTIMCO input, the Board relying largely on the A&M System for identification of the A&M System designee, and UTIMCO identifying and recommending independent financial experts to serve on the UTIMCO Board (we are advised by UTIMCO's CEO that UTIMCO Management plays a de minimis role in the identification of candidates).

The U.T. System Staff's proposed process appears to prescribe diligent procedures for compliance, but steps (1) (Board Chairman's solicitation of recommended candidates from interested institutions) and (2) (review of candidates by UTIMCO Board Nominating Committee) leave open many issues as to how candidates are identified. A key question is the composition of UTIMCO Board Nominating Committee – to what extent is there Board representation through Board members serving on the committee? To whom do the members of the UTIMCO Board Nominating Committee owe their duties? To what extent is the UTIMCO Board Nominating Committee effectively serving as an advisory committee to the Board, as opposed to the UTIMCO Board?

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One reason to maintain the UTIMCO Board Nominating Committee may be to ensure interpersonal compatibility of candidates. Moreover, the financial experts on the UTIMCO Board may be more qualified to assess the qualifications of other financial experts. An alternative approach might be to retain the services of a professional recruiter to identify candidates.

The UTIMCO Board Nominating Committee is, at least in the abstract, unnecessary given the Board's plenary right to appoint and remove UTIMCO Board members – the only statutorily compelled process is the provision of a list of financially expert candidates by the A&M System Board of Regents. The Board could propose revision of the UTIMCO Bylaws and ancillary nomination process to eliminate or minimize the role of the UTIMCO Board in the process, for example, limiting that role to step (1). Barring issues of process inefficiency, the U.T. System Staff's proposed structure seems prudent to ensure an inclusive process that inherently incorporates the input of relevant institutions and stakeholders in the process.

To enhance its discharge of its investment management duties, we recommend the Board consider taking a more active role in the identification of prospective directors of UTIMCO.

2. UTIMCO Board Committees. Following is a discussion of the three standing committees of the UTIMCO Board: the Audit and Ethics Committee, the Nominating Committee, and the Compensation Committee. Our review has not encompassed the ad hoc Liquidity Committee recently established, or the ad hoc Search Committee, whose activities are, we are advised, winding down.

a) Audit & Ethics Committee. The UTIMCO Board has an Audit and Ethics Committee. The Audit and Ethics Committee is governed by a charter. See discussion at pp. 27-28 of 2003 Report.

(1) UTIMCO Enabling Statute. Section 66.08(c)(3) requires that the Board approve the Audit and Ethics Committee of UTIMCO.

(2) UTIMCO Charter and Bylaws. The UTIMCO charter documents do not address the Audit and Ethics Committee, other than the provision in Article IV, Section 1 tracking the language of the UTIMCO Enabling Statute to require that the Board approve the Audit and Ethics Committee.

(3) Audit and Ethics Committee Charter. UTIMCO's Audit and Ethics Committee Charter (the "Audit Committee Charter") was adopted on July 15, 1996. The Audit Committee Charter purports to encompass all of the investment assets subject to the UTIMCO Agreement, and dedicates the Audit Committee to the purposes of assisting the UTIMCO Board in monitoring (a) the integrity of UTIMCO's financial reporting and internal controls, the audit process, and legal and regulatory compliance; (b) the independence and performance of UTIMCO's auditors; (c) for the purposes of review, any internal audit functions performed by the U.T. System Audit Office; (d) UTIMCO's audit and ethics policies; and (e) UTIMCO's compliance processes associated with Investment Policies and risk management. The

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Audit Committee Charter gives the committee the responsibility for selection of UTIMCO's auditor, which firm will be "ultimately accountable to the Committee and the [UTIMCO] Board." The Audit Committee Charter sets forth reasonably detailed functions, duties, and responsibilities, including review of financial statements, internal controls, auditor oversight, and regular review and reporting.

(4) Membership. The Audit Committee is composed of three members of the UTIMCO Board, each of whom must be independent as an absolute matter, each of whom the UTIMCO Board, in its business judgment, determines is "financially literate," and one of which must be determined by the UTIMCO Board, in its business judgment, to possess "accounting or related financial management expertise." The current members are R.H. (Steve) Stevens, Jr., the A&M System designee (Chair), Woody L. Hunt, and Susan M. Byrne.

Commentary and Recommendations:

The existing Audit Committee Charter, by virtue of the statutory requirement of its approval by the Board, already reflects the input of the Board and seems comprehensive, especially considered together with the UTIMCO Code of Ethics discussed in the 2003 Report, in the process it contemplates to ensure UTIMCO's compliance with respect to accounting and ethics matters. The issues related to the selection of auditors for UTIMCO and the Delegated Funds, as discussed below, have already been largely addressed by the Board as the result of the 2003 Report. As such, the Audit and Ethics Committee would not seem to require substantial revision at this time. Areas of revision the Board may wish to consider as part of its implementation of the recommendations of the UTIMCO Working Group include (i) as part of its effort to improve its oversight of UTIMCO and integration of UTIMCO into other the U.T. System processes for compliance, specific enumeration of participation of Board designees in Audit & Ethics Committee, perhaps including a more formal, regular participation of appropriate Board/the U.T. System staff member(s) as observer(s) in the Audit and Ethics Committee's deliberations (an obvious choice for such participation being the Director of System-Wide Compliance), and (ii) revisions as appropriate to reflect the already-implemented bifurcation of selection and oversight of independent auditors of UTIMCO and the Delegated Funds to provide for the Board to be responsible for selection and oversight of the auditors of the Delegated Funds, with the UTIMCO Board/Audit and Ethics Committee retaining responsibility for the auditors of UTIMCO.

- b) Nominating Committee. See discussion at (I)(B)(1) above.
- c) Compensation Committee.

(1) UTIMCO Enabling Statute and Charter Documents. The UTIMCO Enabling Statute and charter documents do not speak to the requirement or constitution of the UTIMCO Compensation Committee.

(2) Current Compensation Committee. UTIMCO does have a Compensation Committee, created by the UTIMCO Board on August 30, 1996. The current

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responsibilities of the Compensation Committee were enumerated and documented in the August 30, 1996 UTIMCO Board minutes. [Note: Minutes not provided.] As of the date of this outline, the Compensation Committee does not have a charter, however, a September 18, 2002 memorandum of Jerry Turner of Vinson & Elkins to the UTIMCO Board states that "Directors serving on the Compensation Committee are responsible for recommending the compensation of the President of UTIMCO to the full UTIMCO Board and approving the compensation of the other officers of UTIMCO," and states later in the same memorandum regarding the special responsibilities of the UTIMCO Board that the UTIMCO Directors retain authority over the "compensation of the President" of UTIMCO.

(3) Draft Compensation Committee Charter. According to materials provided to the UTIMCO Working Group by Vice Chairman Hunt, a draft charter of the UTIMCO Board Compensation Committee was presented to the UTIMCO Board at its September 12, 2003. The draft charter states that "[t]he primary purpose of the Committee is to provide oversight of the compensation system for officers and employees of [UTIMCO]." Specific enumerated duties and responsibilities are as follows:

(a) Recommend CEO Base and Incentive Compensation. Recommend to the UTIMCO Board the base salary and performance compensation award of the President and CEO of UTIMCO.

(b) Approve Officer Salaries. Approve the base salaries of all officers of UTIMCO other than the President and CEO.

(c) Recommend Incentive Compensation Plan. Recommend the Performance Compensation Plan (presumably tying to the definition of same in the plan documents) and any amendments thereto to the UTIMCO Board.

(d) Recommend Employees Eligible Under Incentive Plan. Recommend the "Eligible Employees" (again, presumably defined in the plan) who are to be granted performance awards under the Performance Compensation Plan.

(e) Approve Eligible Employee Incentive Awards. Approve the Performance Compensation Plan awards for all eligible employees except the President and CEO.

(f) UTIMCO Management Establishment of Other Employee Incentive Compensation. The draft charter further provides the determination of performance compensation for employees not included in the Performance Compensation Plan is delegated to UTIMCO management.

(g) Reservation to UTIMCO Board of CEO Incentive Compensation. By implication, the foregoing delineation of responsibilities appears to reserve

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for the full UTIMCO Board approval of performance compensation for the UTIMCO President and CEO. This reservation should probably be made express.

Commentary and Recommendations:

See discussion under Compensation Matters below.

3. General UTIMCO Board issues.

a) Status and Role.

(1) Hybrid model. As noted above, the UTIMCO Board is a unique institution, an intermediate governing body between the Board and the professional managers that comprise UTIMCO Management.

(2) Dual Fiduciary Duties. The UTIMCO Board is composed of designees of the principal (the Board/the U.T. System), who, in their capacity as members of Board, owe separate fiduciary duties as public officials (though, as discussed at length in 2003 Report, it is unclear whether there are any plausible circumstances in which those persons' duties as Regents and duties as UTIMCO directors could conflict); a designee from the list produced by the A&M System, a co-beneficiary of the PUF, historically and currently an A&M System Regent, with similar dual fiduciary duties; the U.T. System Chancellor, who has similar fiduciary duties as the Board designees and specific responsibilities to implement Board policy vis a vis UTIMCO pursuant to Board Rules and UTIMCO Agreement; and independent directors who by practice have had investment management expertise.

(3) Institutional Independence. While such a structure might be designed to provide for, in substance, an advisory committee to the Board with respect to investment management, the formal structural independence of the UTIMCO Board appears to result in a board that, while cognizant of its collective and individual duties to the Board and the U.T. System, is also (as required by law) focused on its duties as an independent board of directors of a separate corporation. Those duties are not limited to investment matters, but also include duties to implement and oversee all of the other responsibilities of the board of a non-profit corporation, including routine operational matters involving personnel, etc. In that regard, we note the U.T. System Staff's recommendations regarding such matters included at Tab 2.

(4) Duties of the UTIMCO Board. To whom does the UTIMCO Board owe duties? UTIMCO has no members, as is the case with many non-profits. It is a 501(c)(3) corporation for federal income tax purposes, its charitable and educational purposes being, presumably, ancillary to those of the U.T. System

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(and the A&M System).² Under the Texas Non-Profit Corporation Act, the directors of UTIMCO owe duties to UTIMCO. UTIMCO, as a contractual agent of the Board, has a fiduciary duty to the Board and the U.T. System. Thus, not unlike the directors of a business corporation acting as general partner of a limited partnership, the UTIMCO Board also has an indirect, but no less important, duty to its entity's beneficiaries – the Board in this case, or the limited partners in the analogous partnership circumstance. As such, it is difficult to see how there could be any fiduciary duty conflict in this context for the Regental UTIMCO directors, given that it is in the highest best interest of UTIMCO to perform as a fiduciary for the benefit of the Board.

In addition, the UTIMCO Board has some duties (not rising to the level of fiduciary duties) to UTIMCO's creditors and other third parties with whom UTIMCO has privity of contract, duties which would be heightened were UTIMCO (unlikely or impossible as it may seem in the current structure) to find itself in the vicinity of insolvency. And, as with the board of directors of any corporation, the UTIMCO Board has some responsibility to and for the employees and management of the corporation. At a minimum, the UTIMCO Board could have some personal liability for failure to make provision for the payment of wages and salaries to the corporation's employees under applicable federal and state wage and labor laws.

Commentary and Recommendations:

The UTIMCO Board structure has apparent advantages by providing a hybrid board comprised of members of the Board, a representative of the PUF co-beneficiary (the A&M System), and subject matter experts to oversee the professional managers. From the perspective of the interests of the U.T. System, these advantages would be offset to the extent that they also resulted in the consideration of interests other than those of the U.T. System (excluding the interests of PUF co-beneficiary the A&M System, whose interests the Board is Constitutionally compelled to represent as to investment of the PUF). Barring insolvency or other contextually implausible scenarios, there should be no such other interests to consider, as the duty of UTIMCO is to do the best job for the Board – acknowledging that, from the UTIMCO Board's perspective, a significant component its performance of its duties to its principal will result from its selection and oversight of UTIMCO Management, and the outside managers they select. As such, the overall structure seems well-designed to achieve the Board's stated original objectives behind the creation of UTIMCO.

As discussed above and elsewhere in this report, the relationship between the Board and UTIMCO would likely benefit from improved integration at both the governing board and staff levels, to ensure greater Board-level understanding of and confidence in the management of UTIMCO by the UTIMCO Board, and greater UTIMCO Board-level understanding of the Board's policy and other directives. In addition to the specific governing board level

² In preparing this report, we have not reviewed the IRS Determination Letter regarding UTIMCO's 501(c)(3) status, but would recommend it be reviewed in connection with the further review of these matters by the Board and its staff.

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improvements discussed in the overview above, the Board may also wish to consider specific improvements to U.T. System Staff-level integration, e.g.,

- *Formalizing the relationship between the U.T. System Chancellor (as Chancellor, and not necessarily as UTIMCO director and Vice Chairman for Policy) and the UTIMCO CEO to ensure common understanding of the day-to-day needs of UTIMCO's institutional principal, without undermining the structure wherein the UTIMCO CEO is selected by, compensated by, and answers to, the UTIMCO Board;*
- *Integrating the Director of System-Wide Compliance as a participant in the deliberations of UTIMCO's Audit and Ethics Committee;*
- *Further integrating the Vice Chancellor of Business Affairs as a participant in the deliberations of the UTIMCO Board, possibly as liaison with the UTIMCO Board Compensation Committee and CEO; and*
- *Further integrating the U.T. System General Counsel as counsel to the Delegated Funds interacting on a day-to-day basis with UTIMCO Management on legal issues that relate to the Delegated Funds.*

4. Allocation of authority as between UTIMCO Board and Management.

a) Delegation of Authority.

The UTIMCO Board has adopted a Delegation of Authority Policy, the most recent iteration of which was adopted and effective as of April 25, 2003. The Policy declares its purpose as the clear delineation of responsibilities of the UTIMCO Board and management, and provides as follows:

(1) Non-investment matters. All aspects of management, operational and financial authority related to administration, accounting and financial management, systems technology management, personnel management, compliance, client relations and reporting, and public relations that are not specifically reserved for the UTIMCO Board in the relevant charter documents (which include the UTIMCO Enabling Statute and the UTIMCO Agreement) are granted to management.

(2) Investment management. All investment management responsibilities not specifically reserved for the UTIMCO Board in the governing documents are delegated to management, including specifically the following:

(a) Tactical Asset Allocation. Tactical asset allocation within the ranges of the Investment Policies, including rebalancing portfolio weights to Policy Target Weights or actively deviating from Policy Weights as market conditions dictate.

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(b) Investment and Manager Selection. Investment vehicle and manager selection in accordance with a detailed Appendix to the Delegation of Authority Policy.

(c) Manager Oversight. Manager and partnership monitoring and termination in accordance with a detailed Appendix to the Delegation of Authority Policy.

(d) Investment Research and Internal Asset and Risk Management. Investment research and internal asset management, investment risk management.

(e) Proxy Voting. Proxy voting and monitoring.

(f) Selection and Oversight of Consultants. Selection and management of investment consultants in accordance with a detailed Appendix to the Delegation of Authority Policy.

(g) Performance Monitoring and Reporting. Performance monitoring and reporting.

(h) Strategic Asset Allocation Recommendations. Preparation of recommendations regarding strategic asset allocation and other policy issues for the UTIMCO Board.

(3) Chief Compliance Officer Monitoring. The Delegation of Authority further requires that all UTIMCO management decisions made thereunder will be monitored by UTIMCO's Chief Compliance Officer (i.e., the principal attorney serving as outside counsel to UTIMCO), who will report any exceptions to the CEO immediately, with the CEO responsible to develop a remedy to the execution, if possible, and promptly report same to the UTIMCO Board. It further requires that the Chief Compliance Officer provide a list of exceptions to the Audit and Ethics Committee at least annually.

Commentary and Recommendations:

The current overall structure of the UTIMCO delegation, as a general matter, gives the UTIMCO Board the discretion to determine the appropriate delegation to UTIMCO Management. That said, the Board would certainly have legitimate interests in providing for UTIMCO Board approval of specific categories of decisions and acts, including the assurance of approval of the Regental designees (indeed, the Board could reasonably require specific approval of selected items by the Regental designees or the full Board of Regents). As such, any revisions to the relative allocation of authority as between the UTIMCO Board and UTIMCO Management should be driven by the Board's conclusions with respect to specific subject matter areas.

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C. Public Policy and Other Non-Investment Policy Issues. Among the high-level issues under review is the process whereby issues that bubble up in the course of UTIMCO's performance of its contractual duties (i.e., issues that may implicate policies of the Board other than investment policy) and that may, in the view of the Board, require input from the Board, be identified and dispatched. Except for selected instances, as noted below, there is no uniform procedure for such matters prescribed, as might be expected given the challenges inherent in identifying other policy matters that may be implicated in the course of investment policy implementation.

1. UTIMCO Agreement.

The most recent amendment of the UTIMCO Agreement attempts to address policy matters by providing as follows in the new second paragraph of Section 2:

The U. T. Board, as ultimate fiduciary for the Accounts, retains policy setting authority. Unless otherwise provided in writing by the U. T. Board, UTIMCO is authorized to look to the Chancellor to provide primary oversight and management concerning matters other than the core investment duties delegated above, including relations with the media, legal issues (such as public disclosure of information), intergovernmental relations, and policy issues other than those associated with investment allocation and/or return. The Board of UTIMCO and the President of UTIMCO shall be responsible for implementing the investment policy of the U. T. Board and performing those core investment duties delegated above. It shall be the responsibility of the President of UTIMCO to inform the Chancellor of unresolved policy issues not governed by the Investment Policies immediately so that appropriate oversight and management can be provided by the Chancellor. UTIMCO hereby agrees to abide by such oversight and management decisions made by the Chancellor.

2. Board Rules.

The Board Rules were also amended to make the Chancellor responsible for such policy matters, by providing the following additional enumerated primary responsibility:

3.2(12) Serving on the Board of Directors of The University of Texas Investment Management Company (UTIMCO). Generally overseeing the operations of UTIMCO and coordinating interaction between the System and UTIMCO. Ensuring that UTIMCO implements the core investment functions delegated to it in conformance with these Rules and Regulations, the Investment Management Services Agreement, and the Investment Policy Statements adopted by the Board. Directing UTIMCO in areas other than core investment functions, such as relations with the media, intergovernmental relations, and public disclosure issues.

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3. Conflicts Issues.

One issue to consider in light of this expanded role for the Chancellor is the extent to which it compounds the already extant conflicts that may exist between the Chancellor's duties to the U.T. System and the Board, on the one hand, and his duties as a director of UTIMCO under the Texas Non-Profit Corporation Act, on the other hand. As discussed in the 2003 Report at pp. 50-51, it is difficult to imagine a realistic circumstance in which UTIMCO could have any interests adverse to the U.T. System or the Board, given the limitation of UTIMCO's purpose to discharging the interests of the Board. As to policy issues outside the scope of the investment policy matters delegated to UTIMCO, it would seem even less likely that there could be any interest other than the Board's implicated. Nonetheless, the Chancellor and the U.T. System Staff lawyers should be alert to the potential for conflicts as they may arise in the future.

4. Disclosure Policy.

Similarly, the most recent amendment to the UTIMCO Agreement endeavors to prescribe a policy regarding disclosure matters, and a process for addressing disclosure issues as they may arise. Section 3(g) of the UTIMCO Agreement provides as follows:

Disclosure of Information:

The U. T. Board is committed to a policy of full and fair disclosure to the public. As part of that commitment with respect to private investments in the Accounts, the following information shall be disclosed to the public with respect to such private investments ("private investment information"): the name and purpose of each private investment entity; the names of the individual principals managing such private investment; the amount invested by UTIMCO in such private investments; the investment returns for such private investment, including internal rates of return; and remaining value information. UTIMCO shall make no private investment with an entity unless the U. T. Board and UTIMCO has clear and unequivocal authority to disclose to the public the private investment information, described immediately above, relating to such investment.

Before UTIMCO declines to disclose any information it has collected, assembled or maintained in its role as investment manager for the U. T. Board that is requested under the Texas Public Information Act, the President of UTIMCO shall consult with the U. T. System Vice Chancellor and General Counsel. UTIMCO shall disclose the information unless the Vice Chancellor and General Counsel, after consultation with the Chancellor, approves a Public Information Act request to the Attorney General.

We gather from our discussions with the U.T. System Staff that this revision to the Agreement, and the Board policy dictates that preceded it, have been largely

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successful in ensuring consistent implementation of Board policy with respect to public disclosure matters.

5. Practice.

Per our discussions with the UTIMCO CEO, it appears there remains uncertainty as to how exactly UTIMCO Management is to identify issues that should properly be brought to the attention of the Chancellor in his capacity as Vice Chairman for Policy. As the appointment of the Chancellor as Vice Chairman for Policy recognizes, UTIMCO Management is properly selected for its expertise in investment matters, should not be looked to for exercise of political judgment, and should properly make its decisions based on its business judgment of which decisions will best achieve the investment policies established by the Board (which in turn preclude the consideration of temporal political concerns by UTIMCO). As such, frequent and regular interactions between the UTIMCO CEO and the Chancellor would seem prudent to ensure the Chancellor is able to timely identify issues that might require his attention as the Vice Chairman for Policy and/or the attention and political judgment of the Board.

Commentary and Recommendations:

As discussed at length in the 2003 Report, the Board must balance the tension between maximization of investment policy objectives and countervailing policy concerns. The formalization of the U.T. System Chancellor as UTIMCO Board Vice Chairman for Policy authorized and directed to provide direction to UTIMCO on the Board's and the U.T. System's behalf on such countervailing policy considerations seems an effective mechanism to help identify and, to some extent, resolve such issues, though query whether a more formal and/or more frequent interaction between the Chancellor and the UTIMCO CEO would be helpful to further the purpose of this structural enhancement. The principal challenges here, as in several other areas involving questions as to whether Board policy is being correctly interpreted and applied by UTIMCO, are (i) how to timely identify situations where UTIMCO's implementation may depart from Board policy or intention, and (ii) how to timely intervene to correct the situation without unduly disrupting the operations. Other recommendations in this report regarding improved board and staff-level integration should help advance the Board's efforts to address these challenges.

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D. Compensation matters – process and authorities.

1. UTIMCO Charter Documents. The UTIMCO Enabling Statute does not address compensation matters. The UTIMCO charter documents do not address compensation matters either, other than the provision in the Bylaws that directors will receive no compensation other than expense reimbursement.
2. Delegation of Authority. The prior Delegation of Authority policy (December 12, 2002) did speak to compensation matters, delegating to the UTIMCO CEO the following responsibility:

Subject to the concurrence of the Compensation Committee, establish a uniform performance compensation plan for UTIMCO management that recognizes:

- UTIMCO's compensation should be competitive with private endowments and foundations
- The lack of internal mobility in UTIMCO's organizational structure creates a significant retention risk
- Performance-based compensation cannot be limited on the upside
 - For example: cap at 100% of salary
- A significant portion of performance-based compensation should be tied to achievement of corporate wide objectives
- Commitment to the UTIMCO investment team is paramount.

This policy was superseded on April 25, 2003 with a new Delegation of Authority Policy that does not specifically address compensation matters. This omission may reflect expectation by the UTIMCO Board that compensation matters will be addressed in a separate Compensation Committee charter, as discussed above and below.

3. Compensation Committee Charter. As noted above, the draft Compensation Committee Charter contemplates the following allocation of responsibilities and authorities with respect to compensation matters.
 - a) UTIMCO Board.
 - (1) Approval of Incentive Compensation Plan. Approves UTIMCO Performance Compensation Plan based on recommendation of Compensation Committee.
 - (2) Approval of CEO Base and Incentive Compensation. Approves base salary and performance compensation award of the President and CEO of UTIMCO based on recommendation of Compensation Committee.

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b) UTIMCO Board Compensation Committee.

(1) Recommendation of CEO Base and Incentive Compensation. Recommends the base salary and performance compensation award of the President and CEO of UTIMCO to the UTIMCO Board.

(2) Approval of Other Officer Base Compensation. Approves the base salaries of all officers of UTIMCO other than the President and CEO.

(3) Recommendation of Incentive Compensation Plan. Recommends the Performance Compensation Plan and any amendments thereto to the UTIMCO Board.

(4) Recommendation of Eligible Employees. Recommends employees eligible to be granted performance awards under the Performance Compensation Plan.

(5) Approval of Other Officer Incentive Compensation Awards. Approves Performance Compensation Plan awards for all eligible employees except the President and CEO.

c) UTIMCO Management.

(1) Other Employee Incentive Compensation. Determination of performance compensation for employees not included in the Performance Compensation Plan.

(2) Non-Officer Base Compensation. Establishment of base compensation for non-officer UTIMCO employees (implied, not express, in draft Compensation Committee charter).

d) Board – Approval of Compensation as Component of UTIMCO Budget. Approve UTIMCO compensation arrangements as component of UTIMCO Annual Budget/Annual Fee. Not addressed anywhere other than UTIMCO Agreement.

(1) Section 7(a) of the UTIMCO Agreement provides as follows:

Annual Budget and Management Fee:

UTIMCO shall submit to the U. T. Board its proposed annual budget for the following fiscal year (an "Annual Budget") within the time frame specified by the Board. The Annual Budget shall include all estimated expenses associated with the management of the Accounts. The Annual Budget shall also include an annual UTIMCO management fee (an "Annual UTIMCO Management Fee") which shall include all operating expenses associated with the general management of the Accounts, including, without limitation, salaries, benefits, and performance

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compensation of portfolio management and support personnel, expenses for consulting services, office space lease expenses, office furniture and equipment expenses, professional, legal, payroll, and other general services expenses, travel, insurance, capital expenditures, and other miscellaneous expenses incurred by UTIMCO in connection with the performance of its obligations hereunder.

At the same time that UTIMCO submits its Annual Budget, it shall also submit to the U. T. Board an allocation formula for charging the Annual Budget to the Accounts. The Annual Budget and the allocation formula shall be approved or disapproved by the U. T. Board. Any such Budget or formula that is disapproved shall be promptly revised by UTIMCO and resubmitted to the U. T. Board for approval.

The UTIMCO Board has the responsibility of recommending the UTIMCO budget to the Board including the substantial list of specific items that make up the UTIMCO Annual Fee. While the UTIMCO Agreement only gives the Board the authority to approve or disapprove the UTIMCO budget as a whole, the Board's approval right inherently encompasses the power to defer approval of any UTIMCO budget until specific items are adjusted to the satisfaction of the Board. Implicit in the long list of items that make up the Annual UTIMCO Management Fee is the Board of Regents' interest in scrutinizing those items.³

Commentary and Recommendations:

By establishing UTIMCO as a separate non-profit corporation with its own board of directors, the Board under the authority conferred by the Legislature has created a structure wherein the responsibility for compensation matters is allocated, as is commonly the case, with the corporation's board of directors or compensation committee setting compensation of the CEO and other officers, and establishing incentive compensation arrangements that they deem appropriate in their business judgment, and delegating to management of the corporation the responsibility for setting compensation of non-officer employees of the corporation. The Board retains, however, ultimate authority (expressly or implicitly) to revise these arrangements as it deems appropriate based on the unique nature of the situation – which includes the fact that UTIMCO is effectively a captive agent of the Board, and the sole source of funds for such compensation is the Delegated Funds entrusted to the Board and in turn delegated to UTIMCO for the sole purpose of discharging the investment policies established by the Board. Among the tools available to the Board to refine the existing process are the possibilities that it ensure representation of its interests in the deliberations of the UTIMCO Board Compensation Committee, whether through Board designees' service on such committee or U.T. System Staff participation in the deliberations of such committee, and contractual provisions for separate consideration of compensation matters by the Board.

³ We have not evaluated any issues regarding possible constraints that might be imposed on the reasonableness of UTIMCO executive compensation under the Internal Revenue Code and related regulations due to UTIMCO's 501(c)(3) status, nor under the Texas Non-Profit Corporation Act.

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4. Selection of UTIMCO Management. While not specifically called out for our review, a similar issue the Board may wish to consider is whether it should have a more formal role in the selection of the UTIMCO Management, and in particular the CEO. As currently structured, the UTIMCO Board has the authority to fill any vacancy in any office of UTIMCO pursuant to the UTIMCO Bylaws, and there does not appear to be any formal mechanism contemplated for Board approval of such decisions, though in practice there may also be informal consultation and even approval. In light of the significant indirect delegation of authority to the UTIMCO CEO to implement Board policy, it would not be unreasonable for the Board to require some more explicit right of the Board to approve the selection of the UTIMCO CEO, whether by approval of the Regental designees serving on the UTIMCO Board (perhaps including the Chancellor), or by Board approval of the UTIMCO Board's decision.

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II. Outside Services.

A. Counsel to the Delegated Funds and UTIMCO.

1. General Considerations.

UTIMCO, as a Texas non-profit corporation that exists as a legal entity separate from the Board (and from the Delegated Funds), retains its own counsel. The U.T. System and the Board, the owner(s) of the Delegated Funds, have both internal and external counsel, including the Vice Chancellor and General Counsel and the State Attorney General. From our interviews, it appears that some concern has arisen in some quarters over the impression that UTIMCO's outside counsel provides UTIMCO advice that treats UTIMCO as independent of, and possibly adverse to, the Board and the U.T. System, rather than, as some believe should be the case, treating UTIMCO as a captive agent of the Board whose interests should be entirely aligned with the Board.

UTIMCO's ability and need to have its own legal counsel seems, upon consideration of the relevant rules of professional responsibility applicable to attorney-client relations, to inhere in a structure that provides for UTIMCO to exist as a separate, and technically private, legal entity. For that structure allows for at least the theoretical potential for instances in which confidential client information of UTIMCO could not lawfully be disclosed by its counsel to the Board or the U.T. System, instances in which conflicts exist between UTIMCO and the Board or the U.T. System that could not lawfully be waived, and instances in which UTIMCO's counsel could not operate with the professional independence required under the rules. It may be, however, that most of the work performed by counsel to UTIMCO is really representation of the Delegated Funds, which may properly be viewed as representation of the Board, in which case the Board could properly select and direct outside counsel. Moreover, as discussed above, there is a reasonable argument to be made that there are very few plausible situations, if any, in which UTIMCO could have interests adverse to the Board or the U.T. System, and that, as such, it may be appropriate to limit UTIMCO's use of independent counsel to those specific situations as they may arise (for example, in the review of the contract imposed on UTIMCO by the Board). At a minimum, it would seem that the UTIMCO Board could reasonably insist that it have separate counsel of its choosing to advise it in determining whether it needs separate counsel in any particular matter.

2. Board Rules.

The Board Rules enumerate as a responsibility of the U.T. System General Counsel the oversight of legal services provided to UTIMCO by outside legal counsel, consistent with the requirements of the Texas Disciplinary Rules of Professional Conduct, and providing counsel, advice, and legal interpretations to the Board, the Chancellor, and other the U.T. System officials concerning UTIMCO-related issues. By styling the General Counsel as a meta-client of

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UTIMCO's outside counsel, acknowledging the limits of the professional responsibility rules, and simultaneously identifying the General Counsel as the counselor to UTIMCO's contractual counter-party on UTIMCO-related matters, the Board Rules touch on most of the issues presented by the question of who should provide legal counsel to UTIMCO.

3. Professional Responsibility Considerations.

One specific proposal noted for consideration by the UTIMCO Working Group is the possibility of an amendment to the UTIMCO Agreement that would add a provision that (i) the General Counsel retain outside counsel ("Selected Counsel") on behalf of UTIMCO, (ii) UTIMCO pay for such Selected Counsel (from its budget, which in turn is funded from the Delegated Funds owned by the Board), and (iii) Selected Counsel report to the General Counsel. The proposal would provide that UTIMCO represent in advance that the interests of the U.T. System and UTIMCO are aligned and no conflict exists between the two parties. In addition, UTIMCO would be required to agree that, to the extent a conflict may arise, UTIMCO will waive such a conflict; if an unwaivable conflict arises, Selected Counsel would agree to work to resolve the conflict with the General Counsel. Moreover, if Selected Counsel were unable to reach a resolution with the U.T. System, UTIMCO would be authorized to retain the services of outside counsel not previously retained by the General Counsel.

Pursuant to the terms of the proposal, Selected Counsel's duty to report to the General Counsel would include that, to the extent that the General Counsel were not in attendance when Selected Counsel confers with UTIMCO, then Selected Counsel would be obligated to advise the General Counsel "with regard to all matters associated with such outside legal counsel's representation of UTIMCO on a periodic basis and as requested."

The proposal endeavors to address many of the issues under the Texas Disciplinary Rules of Professional Conduct (the "Rules") associated with such an arrangement, but it is not clear whether it eliminates such issues entirely. In particular, further consideration should be given to issues arising under the Rules related to (i) the use of confidential information, (ii) conflict of interest and (iii) professional independence of a lawyer.

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a) Use of Confidential Information – Rule 1.05. Under Rule 1.05, a lawyer may reveal confidential information (i) when he has been expressly authorized to do so in order to carry out the representation; (ii) when the client consents after consultation, (iii) when it is to the client, the client’s representatives, or the members, associates, and employees of the lawyers firm, except when otherwise instructed by the client; and (iv) in certain instances when it is necessary to comply with a court order, to prevent a crime, to rectify a fraud, or to enable the lawyer to establish his own defense. Confidential information includes both privileged information and unprivileged client information.

Under the proposal, as a general matter, UTIMCO would waive attorney-client privilege prospectively. In implementation of such a proposal, care would need to be given to UTIMCO’s “express authorization” of Selected Counsel to reveal confidential information, and to the possibility of situations in which the revealing of confidential information may not necessarily required to carry out representation of UTIMCO (but really merely to satisfy the curiosity of another party). More importantly, instances could arise in which such waiver would implicate other potential conflicts, in which case Selected Counsel might have a further duty to consult with UTIMCO regarding possible conflicts that may arise under the proposal.⁴

b) Conflict of Interest – Rule 1.06.

Rule 1.06 (Conflict of Interest) provides that a lawyer shall not represent a person if the representation of that person:

(1) involves a substantially related matter in which that persons interests are materially and directly adverse to the interests of another client of the lawyer or the lawyers firm; or

(2) reasonably appears to be or become adversely limited by the lawyers or law firm's responsibilities to another client or to a third person or by the lawyers or law firms own interests.

A lawyer may represent a client in the circumstances described above if:

⁴ In Attorney General Opinion 487, an employer enlisted an attorney to represent both the employer and an employee. After the lawyer consulted with both the employer and the employee, the parties each consented to waive any conflict that may arise between the parties pursuant to the dual representation. Each party acknowledged that there were no known conflicts at the time, but that it was understood there was a remote possibility of a future conflict and that confidential information may be revealed to both parties. In the course of the attorney’s representation he discovered, based upon confidential information, that the employee was not fit to do his job. The attorney then revealed the employee’s confidential information to the employer. After analyzing Rule 1.05, the Attorney General found that though under Rule 1.05 the information need not be revealed to carry out the representation of the employee (but rather the employer), the attorney properly revealed the information after consulting with the parties. *See Op. Tex. Att’y Gen. No. 487 (1992)*. Notably, it was immaterial to the decision that the specific subject of the confidential information was not known at the time the representation began. However, at the time the lawyer consulted with the parties, each knew the subject of the suit and the party suing them. In the instant case, UTIMCO would be granting a blanket waiver without knowing the subject matter of the suit or the opposing party.

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(3) the lawyer reasonably believes the representation of each client will not be materially affected; and

(4) each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any.

The proposal endeavors to address Rule 1.06, but in the implementation of such a proposal, care would need to be given to the question of whether UTIMCO received full disclosure of the possible consequences of the representation. Moreover, there should probably be some allowance for circumstances when a disinterested Selected Counsel would conclude that the client should not agree to the representation under the circumstances, in which case under the Rules the lawyer involved should not ask for such an agreement or provide representation on the basis of the client's consent. *See* Comment 7 to Rule 1.06.

Arguably, the U.T. System and UTIMCO may be considered part of the same organization or even one and the same given the unique relationship between these legally distinct organizations. If this is so, the situation is arguably much like that of an organization and its directors, officers or employees, or a parent corporation and its subsidiary. Under Rule 1.12 (Organization as a Client) a lawyer employed or retained to represent an organization represents the organization, as distinct from its directors, officers or employees. *See* Rule 1.12, Comment 1. Selected Counsel may then have a duty to proceed in the best interest of the organization and not the best interest of its constituent. If indeed Selected Counsel represents both the organization and the constituent, then Selected Counsel should proceed under Rule 1.06. Selected Counsel must believe the representation of each client will not be materially affected and he must fully disclose the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any.⁵ To the extent that the U.T. System is interfering with Selected Counsel representation of UTIMCO, the lawyer may not be able to properly represent UTIMCO under the Rules.

c) Professional Independence of a Lawyer – Rule 5.04.

Under Rule 5.04 (Professional Independence of a Lawyer), “a lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.” Comment 4 to Rule 5.04 provides as follows:

Because the lawyer-client relationship is a personal relationship in which the client generally must trust the lawyer to exercise appropriate

⁵ In Attorney General Opinion 476, a lawyer was hired by the organization to assist it and its members. This was not an impermissible conflict because the organization did not interfere with the judgment of the attorney in his representation of the members. *See* Op. Tex. Att’y Gen. No. 476 (1991).

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professional judgment on the clients behalf, Rule 5.04(c) provides that a lawyer shall not permit improper interference with the exercise of the lawyer's professional judgment solely on behalf of the client. The lawyer's professional judgment should be exercised only for the benefit of the client free of compromising influences and loyalties. Therefore, under Rule 5.04(c) a person who recommends, employs, or pays the lawyer to render legal services for another cannot be permitted to interfere with the lawyer's professional relationship with that client. . . .

Any proposal in which the General Counsel of the U.T. System would direct Selected Counsel to UTIMCO would clearly implicate Rule 5.04, particularly to the extent Selected Counsel might view a given directive from the General Counsel to be inconsistent with his professional judgment regarding the interests of UTIMCO. It would be incumbent upon Selected Counsel to have reasoned comfort that at no point in the course of the representation was his professional independence compromised, and any proposed arrangement for supervision of Selected Counsel by the General Counsel should allow for circumstances in which Selected Counsel would determine to that his independence required supervision by and consultation with UTIMCO representatives independent of the Board.

4. UTIMCO v. Delegated Funds – Separate Clients. The issue as addressed to date does not appear to sufficiently recognize the distinction inherent in the structure between counsel to UTIMCO, as a separate legal entity, and counsel to the Delegated Funds. The Delegated Funds have a separate legal existence – indeed, UTIMCO, as agent of the Board, signs contracts in the name of the PUF, the Long Term Fund, and the like. With respect to the provision of legal advice to those entities, the distinction seems critical. To the extent the work performed by UTIMCO's Selected Counsel is really representation of the Delegated Funds, it would seem to constitute representation of the Board as owner of the Delegated Funds, in which case it would seem the Board could properly select and direct such Selected Counsel without implicating the professional responsibility rules noted above. (By the same token, there would seem to be no reason why the Board could not authorize UTIMCO as its agent to direct such counsel on behalf of the Board as its principal, assuming no conflicts of interest and appropriate contractual or other arrangements regarding confidential information.)

Review of the information provided to the Working Group regarding the services performed by Selected Counsel during the past several years suggests a substantial portion of the work is representation of the Delegated Funds. For example, in 2002-2003, according to material provided to the Working Group by UTIMCO, the aggregate Selected Counsel fees of \$844,672.74 were allocated approximately 59% to UTIMCO and 41% to the Delegated Funds, and in 2001-2002 the percentages were 47% UTIMCO and 53% Delegated Funds. The UTIMCO percentages were higher in 2001-2001 (90%) and 1999-2000 (81%). According to the information provided, the work allocated to UTIMCO comprised representation in matters related to open records, corporate issues, personnel, and litigation. The work allocated to the Delegated Funds is not

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described, but we are advised it primarily involves representation in contractual matters.⁶

5. Overlapping Interests/Conflicts of Interest.

A more difficult question is the extent to which UTIMCO might have interests that are not aligned with the Board. UTIMCO, by statute, charter, and contract, exists only to discharge the investment policy of the Board. As a non-profit corporation, it has no shareholders. The fiduciary duty of the UTIMCO Board is owed to the general public by virtue of its charter, which interests presumably would be aligned with the interests of the Board as an agency of the state, which of course is the contractual principal to whom UTIMCO as an entity owes substantially identical duties. Perhaps the most obvious potential conflict would arise when UTIMCO is negotiating its contract with the Board, but even in that situation a credible contrary argument can be made that UTIMCO has no viable interests independent of the Board's, and that, because UTIMCO must submit to any contract imposed by the Board or disband, the Board could reasonably deprive UTIMCO of separate counsel in that circumstance, which is arguably analogous to the many precedential situations in which a parent does not allow for separate counsel to a putative spinoff entity. As such, a reasonable argument can be made that the only conflicts of interest between UTIMCO and the Board would be theoretical ones.

It may be that the real conflict is between the discrete set of interests of the Board for which UTIMCO is responsible – day-to-day implementation of the Board's investment policy – and other interests of the Board. As discussed in the overview, one might argue that the structure of the UTIMCO arrangement contemplates implementation of investment policy in a separate entity for the express purpose of insulating investment policy from other concerns (subject of course to the Board's plenary right to change the investment policies). If that is the case, an argument might be made that the objectives are advanced by UTIMCO interacting with Selected Counsel independently, and directing such Selected Counsel to render its advice through the prism of the best interests of investment policy.

Commentary and Recommendations:

In light of this analysis, one approach to consider would be to bifurcate the issue:

⁶ An ancillary question raised by this information is why the Delegated Funds work ramped up so significantly over the past two fiscal years – with a ten-fold increase from 2001 to 2002, and a 28% increase from 2002 to 2003. If the work primarily consists of representation on contractual matters, query whether this may be an indicator of a UTIMCO policy change in favor of more complex investments that require substantially more lawyer time to structure and document, e.g., private equity investments, investments in derivatives, and the like. At a minimum, the substantial increase in legal fees charged to the Delegated Funds would arguably seem to weigh in favor of a greater oversight role for the Board's in-house legal staff.

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- *The General Counsel serves as counsel to the Delegated Funds, selects and oversees outside counsel to the Delegated Funds, and the cost of such outside counsel is borne by the Delegated Funds (perhaps independently of the UTIMCO budget).*
- *UTIMCO selects and oversees its own counsel with respect to any legal issues specific to UTIMCO, and makes provision for payment of such counsel in its budget.*
- *Counsel to the Delegated Funds and counsel to UTIMCO could continue to be the same counsel, barring unwaivable conflicts.*
- *In addition, depending on its views of the potential conflicts of interests (or absence of such conflicts), the Board may wish to propose a more active role for the General Counsel as to the separate UTIMCO outside counsel, subject to necessary and appropriate provisions for the professional responsibility considerations outlined above.*

B. Selection, oversight, and reporting of independent accountants/auditors to Delegated Funds and UTIMCO.

1. **UTIMCO Enabling Statute.** Section 66.08(f) of the UTIMCO Enabling Statute provides that if the PUF is among the Delegated Funds, an annual audit must be performed by auditors of the U.T. System and the A&M System and presented to the Board.
2. **Historical Practice.** Prior to the 2003 Report, UTIMCO selected the auditor of both UTIMCO as an entity and the Delegated Funds. On July 7, 2003, the Board authorized the U.T. System staff to negotiate and enter into an auditing services contract with Ernst & Young for the fiscal year ending August 31, 2003. UTIMCO, through its Board's Audit and Ethics Committee, continues to select and oversee auditors of UTIMCO as an entity.
3. **UTIMCO Agreement.** The UTIMCO agreement requires, among other things, that UTIMCO maintain books and records with an August 31 fiscal year, with separate records of all transactions for each of the Delegated Funds. available to the U.T. System representatives for inspection during normal business hours, and with the requirement of full audit access provided to auditors representing the Board of the State Auditor, including access to any and all information concerning the operations of UTIMCO. (Section 3(e).)
4. **Certifications.** The most recent amendment to the UTIMCO Agreement added a new requirement that, effective with the August 31, 2004 financial statements, UTIMCO provide certifications "similar to those required by Section 302 of the Sarbanes-Oxley Act of 2002, Corporate Responsibility for Financial Reports." The agreement does not specify the scope or form of the certifications, nor to whom the certifications are to be provided (though we presume it would be to the Board). The agreement further requires that UTIMCO begin following the U.T. System compliance guidelines as outlined in the Action Plan to Enhance

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Institutional Compliance, including providing the Board or its designee quarterly compliance reports. (Section 3(f).)

5. Audit and Ethics Committee. UTIMCO has its own audit committee, the Audit and Ethics Committee. That committee's charter gives it primary responsibility with respect to review of UTIMCO's financial statements, oversight of auditors, review and oversight of internal controls. The committee has three members to be appointed by the UTIMCO Board and approved by the Board per Sec. 66.08(c)(3) of the UTIMCO Enabling Statute. The charter requires that the UTIMCO Board determine that (i) the members of the committee are independent in that they have no relationship with UTIMCO that would interfere with their independence from UTIMCO and its management, (ii) that each member is, in the business judgment of the UTIMCO Board, financially literate, and (iii) that at least one member, in the business judgment of the UTIMCO Board, possess accounting or related financial management expertise.
6. Membership. The current members of the committee are R.H. (Steve) Stevens, Jr. (Chair), the A&M System Regent who serves on the UTIMCO Board, Woody L. Hunt (a Board member and Chairman of the UTIMCO Board), and Susan M. Byrne, an investment management professional serving as an independent director of UTIMCO.
7. Auditor of UTIMCO v. Auditor of Delegated Funds. As with outside counsel, it is important to distinguish between the auditors of UTIMCO as an entity and the auditors of the Delegated Funds. Arrangements to that effect have, we are advised, been implemented as the result of the 2003 Report.

Commentary and Recommendations:

As a general matter, it is essential that the Board have confidence in the accuracy of the financial statements and other relevant financial information (including information about risk, performance, etc.) regarding the investment performance of the Delegated Funds. Toward that end, the Board should select and oversee the auditors of the Delegated Funds; indeed, the UTIMCO Enabling Statute contemplates that, at least as to the PUF. In addition, the Board and its staff should ensure they have adequate mechanisms in place to provide appropriate interim financial oversight as to the investment management of the Delegated Funds. It may be that the Board rightly views the interim oversight provided by the UTIMCO Audit and Ethics Committee (and the full UTIMCO Board) to be adequate, but specific consideration of the issue would seem in order.

With regard to UTIMCO as an entity, it seems appropriate for the UTIMCO Board to select and oversee the auditors.

The Board and its staff should review the role of the U.T. System Staff, the State Auditor, and others in the financial oversight process as well. As noted above, this perhaps should include consideration of a more regular role of the Director of System-Wide Compliance or other U.T. System Staff officer as an observer of the UTIMCO Audit and Ethics Committee's

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deliberations. Toward that end, we note the U.T. System Staff recommendations regarding such matters set forth elsewhere in this report.

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III. Contractual Matters.

A. Budgetary process and authorities.

1. UTIMCO Enabling Statute. The UTIMCO Enabling Statute is silent as to budgetary matters.
2. UTIMCO Agreement. The UTIMCO Agreement provides as follows:
 - a) UTIMCO is to prepare an Annual Budget within the time frame specified by the Board. The budget must include all estimated expenses, and include an annual UTIMCO management fee inclusive of all operating expenses of UTIMCO – salaries, benefits, performance compensation of portfolio management and support personnel, consulting fees, overhead, etc.
 - b) The allocation formula for charging the UTIMCO Annual Budget to the Delegated Funds “shall be approved or disapproved” by the Board. If disapproved, it will be promptly revised and resubmitted by UTIMCO.
 - c) On the first day of each fiscal quarter, UTIMCO can charge each of the Delegated Funds with its allocable share of $\frac{1}{4}$ of the Annual Management Fee. The fee can be revised during the fiscal year without Board approval.
 - d) UTIMCO can charge direct expenses of outside management to the Delegated Funds.

(UTIMCO Agreement Sec. 7(a)(a)-(d).)

Commentary and Recommendations:

To the extent it is not satisfied with the current process, the Board should revise the UTIMCO Agreement to reflect a UTIMCO budgetary process that better integrates with other similar the U.T. System processes, to include specific processes for individual components of the budget, such as performance compensation. This report includes specific recommendations by U.T. System Staff to that effect.

B. Indemnification provisions.

1. UTIMCO Agreement. The UTIMCO Agreement contains the following provisions regarding indemnification.

Section 20. Indemnification.

(a) Agreements to Indemnify:

To the fullest extent authorized by the Constitution and laws of the State of Texas, the U. T. Board shall indemnify and hold harmless each of the Indemnified Parties against any and all Losses, including Losses resulting from the negligence of the Indemnified Party claiming

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indemnification; provided, however, the U. T. Board shall not be obligated to indemnify an Indemnified Party against Losses to the extent such Losses are caused by (i) an act or omission that involves intentional misconduct or a knowing violation of law by the Indemnified Party claiming indemnification, (ii) a transaction from which the Indemnified Party claiming indemnification received an improper benefit, (iii) an act or omission for which the liability of the Indemnified Party claiming indemnification is expressly provided by an applicable statute, or (iv) an act or omission constituting gross negligence by the Indemnified Party claiming indemnification; provided further that indemnification payments by the U. T. Board shall be paid from the same sources as the Annual Fee pursuant to Section 7.

(b) Reimbursement:

Each Indemnified Party shall reimburse the U. T. Board for payments made by the U. T. Board pursuant to this Section to the extent of any proceeds, net of all expenses of collection, actually received by it from any insurance with respect to any Loss. At the request and expense of the U. T. Board, each Indemnified Party shall have the duty to claim any such insurance proceeds and such Indemnified Party shall assign its rights to such proceeds, to the extent of such required reimbursement, to the U. T. Board.

(c) Notice:

In case any Claim shall be brought or, to the knowledge of any Indemnified Party, threatened against any Indemnified Party in respect of which indemnity may be sought against the U. T. Board, such Indemnified Party shall promptly notify the U. T. Board in writing; provided, however, that any failure so to notify shall not relieve the U. T. Board of its obligations under this Section.

(d) Defense:

The U. T. Board shall have the right to assume the investigation and defense of all Claims, including the employment of counsel and the payment of all expenses. Each Indemnified Party shall have the right to employ separate counsel in any such action and participate in the investigation and defense thereof, but the fees and expenses of such counsel shall be paid by such Indemnified Party unless (i) the employment of such counsel has been specifically authorized by the U. T. Board, in writing, (ii) the U. T. Board has failed to assume the defense and to employ counsel, or (iii) the named parties to any such action (including any impleaded parties) include both an Indemnified Party and the U. T. Board, and such Indemnified Party shall have been advised by counsel that there may be one or more legal defenses available to it which are different from or additional to those available to the U. T. Board (in which case, if such Indemnified Party notifies the U. T. Board in writing that it elects to employ separate counsel at the U. T. Board's expense, the U. T. Board shall not have the right to assume the defense

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of the action on behalf of such Indemnified Party; provided, however, that the U. T. Board shall not, in connection with any one action or separate but substantially similar or related actions in the same jurisdiction arising out of the same general allegation or circumstances, be liable for the reasonable fees and expenses of more than one separate firm of attorneys for the Indemnified Parties, which firm shall be designated in writing by such Indemnified Parties).

(e) Cooperation; Settlement:

Each Indemnified Party shall use reasonable efforts to cooperate with the U. T. Board in the defense of any action or Claim. The U. T. Board shall not be liable for any settlement of any action or Claim without its consent but, if any such action or Claim is settled with the consent of the U. T. Board or there be final judgment for the plaintiff in any such action or with respect to any such Claim, the U. T. Board shall indemnify and hold harmless the Indemnified Parties from and against any Loss by reason of such settlement or judgment as provided in Subsection (a) of this Section.

(e) Survival; Right to Enforce:

The provisions of this Section shall survive the termination of this Agreement, and the obligations of the U. T. Board hereunder shall apply to Losses or Claims whether asserted prior to or after the termination of this Agreement. In the event of failure by the U. T. Board to observe the covenants, conditions and agreements contained in this Section, any Indemnified Party may take any action at law or in equity to collect amounts then due and thereafter to become due, or to enforce performance and observance of any obligation, agreement or covenant of the U. T. Board under this Section.

The UTIMCO Agreement defines "Losses" as

"...losses, costs, damages, expenses, judgments and liabilities of whatever nature (including, but not limited to, attorneys', accountants' and other professionals' fees, litigation and court costs and expenses, amounts paid in settlement, amounts paid to discharge judgments and amounts payable by an Indemnified Party to any other person under any arrangement providing for indemnification of that person) directly or indirectly resulting from, arising out of or relating to one or more Claims;" and "Claims" as "all claims, lawsuits, causes of action and other legal actions and proceedings of whatever nature brought against (whether by way of direct action, counter claim, cross action, or impleader) any Indemnified Party and all requests or demands for indemnification made by any third party upon any Indemnified Party, even if groundless, false or fraudulent, so long as the claim, lawsuit, cause of action, other legal action or proceeding, request or demand is alleged or determined, directly or indirectly, to arise out of, result from, relate to or be based upon, in whole or in part, the duties, activities, acts or omissions of any person arising under this Agreement."

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2. **Liability.** As discussed at length in the 2003 Report, it is unclear to what extent there might be “Losses” incurred by UTIMCO or its directors and officers within the scope of the UTIMCO Agreement. First, there is a strong argument that UTIMCO, as agent of the Board, is protected by the sovereign immunity of the Board. Second, the preponderance of liabilities incurred by UTIMCO are in fact liabilities it incurs on behalf of, and in the name of, the Board or specific Delegated Funds. As such, Losses of UTIMCO would seem most likely to arise in connection with the activities UTIMCO undertakes as a separate entity. Obvious possibilities would include labor and employment-related claims by its employees, contract claims by its vendors (e.g., providers of information technology or associated services, or consultants to UTIMCO such as Cambridge Associates). Given that all activities of UTIMCO inherently seem to relate to its performance of its obligations under the UTIMCO Agreement, the contractual indemnification would seem to encompass all such claims and liabilities.
3. **Insurance Arrangements.** UTIMCO maintains an Investment Management Insurance Policy, inclusive of claims made directors and officers liability insurance and investment adviser professional liability, in the aggregate amount of \$10 million; the 2003 premium amount on such insurance was \$165,000.
4. **Enforceability.** As discussed at length in the 2003 Report, the Texas Constitution places substantial limitations on the ability of any state agency such as the Board to enter into contracts for indemnification. Where, as here, there are funds available to satisfy such indemnification, there would seem to be a substantial likelihood that the indemnification provisions would be found to be enforceable.

Commentary/Analysis:

On its face, the indemnification section of the UTIMCO Agreement does not seem overly broad in the unique context of UTIMCO. It effectively adopts a standard that tracks the indemnification provisions of applicable corporate law (and the UTIMCO Charter and Bylaws) as to directors and officers, extending the availability of such protections to UTIMCO and its constituents as agents of the Board, though the express provision of indemnification for negligence in the UTIMCO Agreement does not appear in the charter documents. Absent such an indemnification, UTIMCO's sole source of funds for any Losses would likely be its directors and officers liability insurance and any surplus funds retained by the corporation.

C. Dispute resolution.

No dispute resolution procedures in UTIMCO Agreement. The implicit dispute resolution leverage lies in the plenary right of the Board to terminate the UTIMCO Agreement with or without cause. As such, it has been suggested that the Board may wish to amend the UTIMCO Agreement to provide for some explicit pre-termination dispute resolution mechanisms, such as alternative dispute resolution (“ADR”) provisions to the extent permissible for government bodies pursuant to the Texas government code.

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1. Government Dispute Resolution Act. The Texas Governmental Dispute Resolution Act⁷ provides governmental entities with significant discretion to adopt ADR procedures. The Board could therefore implement a negotiating requirement as discussed below, provide for mediation, make use of the Texas General Arbitration Act or the Federal Arbitration Act to the extent useful, or adopt other procedures best suited to its purposes and UTIMCO's unique structure.

The Governmental Dispute Resolution Act leaves much to the Governmental Entity's Discretion. It states a policy favoring ADR and provides for procedural, budgeting, confidentiality and other mechanisms and considerations by which governmental entities may adopt and implement ADR procedures. While Chapter 2009 provides mechanisms and some limitations, it does not prescribe specific ADR methods or procedure, instead giving governmental entities discretion to decide what will best meet the described policy given its unique operations.

2. Negotiating Requirement. The UTIMCO Agreement could contain a provision requiring the Board and the UTIMCO Board to each designate representatives, or perhaps some portion of their membership, to meet informally and negotiate in good faith any conflict prior to beginning any other ADR mechanism or litigation. The provisions could call for various procedural mechanisms designed to ensure success. Such measures could include a minimum number of negotiation sessions, a confidentiality requirement, a requirement of a signed summary of the proceedings summarizing an agreement if one is reached or a certification that despite good faith efforts a negotiation was not reached (and perhaps the basis for disagreement or points of contention) and an agreement that neither party will assert, utilized during, or make the basis of any ADR, litigation, or other proceeding discussions or any disclosures made in the negotiations provided that both sides negotiate in good faith.
3. Mediation. While used less often than other ADR methods in the commercial setting, mediation may prove a viable alternative in this context given the generally aligned interests of UTIMCO and the Board. Mediation functions similar to arbitration except that the parties speak directly to each other, the proceeding is usually not binding, and the mediator does not have power to compel the parties to act but rather functions as a neutral voice of reality that encourages both sides to seek agreement within the realm of realistic expectations.
4. Texas General Arbitration Act and Federal Arbitration Act. The UTIMCO Agreement could call for binding arbitration, where the arbitrator takes a more active role and can compel the parties to take certain actions. The provision inserted into the agreement could explicitly refer to the Texas General Arbitration Act, Texas Civil Practices and Remedies Code sections 171.001-171.098, or the Federal Arbitration Act, 9 USC sections 1-307, provided that such provisions

⁷ Texas Government Code, Chapter 2009.

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were tailored to UTIMCO's unique position and status. These statutes both contain certain procedural provisions and have significant bodies of case law construing the their respective natures and limits.

Commentary and Recommendations

- *The Board is right to explore possible avenues to resolves disputes with UTIMCO short of its contractual termination right. But the unique affiliation of the organizations, with overlapping boards and close staff-level interaction, would not seem to be a circumstance in which arbitration or other formal dispute resolution is a likely option. More likely, it seems, is that the adoption of other recommendations contained in this report designed to lead to better integration of the U.T. System and UTIMCO and the staff and governing board levels should lead to a situation in which UTIMCO's day-to-day policy decisions are more likely to reflect the input and direction of UTIMCO's principal, and any areas of potential difference are identified early enough that any potential dispute is corrected long before it ripens.*

D. Investment Policy matters.

1. Constitution, etc. As noted in 2003 Report, the Board retains ultimate responsibility for setting investment policy, and the Board's establishment of investment policy is one of its paramount duties in this area.
2. UTIMCO Agreement. The UTIMCO Agreement contemplates a process whereby UTIMCO periodically reviews investment policies and makes recommendations to the Board

Sec. 3(a). Investment Policies:

UTIMCO shall review current investment policies for each Account at least annually. Such review shall include distribution (spending) guidelines, long-term investment return expectations and expected risk levels, asset allocation targets and ranges for each eligible asset class, expected returns for each asset class and fund, and designated performance benchmarks for each asset class. After UTIMCO completes its assessment, it shall forward any recommended changes to U. T. System staff for review prior to being submitted to the U. T. Board for approval.

Commentary and Recommendations

As a predicate matter, the Board must ensure that the overall goals of the investment of the several Delegated Funds are clearly articulated, including risk levels, liquidity needs and distribution requirements, investment objectives, and derivatives policy. Based on our discussions in connection with this report, there appears to be some disagreement about those goals, and the goals may well vary as among the funds. Until those overall goals are articulated and agreed, it is hard to judge whether the investment policies are well developed, and what the benchmarks ought to be against which to measure risk, returns, liquidity, and the like.

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In developing those investment policy goals, the Board needs to ensure that it is not unduly reliant on UTIMCO, that its judgment is formed based on sufficiently diverse and independent sources of information. Toward that end, the Board's efforts to develop relationships with other independent investment consultants providing independent advice as to appropriate investment policy decisions seems prudent. It is important that use of such expert services include professionals with sufficient expertise to adequately assess risk. And as discussed in the overview, as more complex and sophisticated the investment products are involved, greater financial, risk management, and other internal controls are required.

E. UTIMCO ability to assert and prosecute causes of action of Delegated Funds.

Another question posed is the extent of the relative authority and standing of the Board and UTIMCO, respectively, to assert (or decline to assert) any causes of action that may accrue to the Delegated Funds. We assume, for purposes of this analysis, that any court would find UTIMCO to be the agent of the Board.

1. Ownership of Causes of Action. As discussed in the 2003 Report, the Board is considered the owner of the Delegated Funds. As such, it seems reasonable to assume that it would also be found to be the owner of any causes of action that may accrue to the Delegated Funds.
2. UTIMCO Agreement. The UTIMCO Agreement does not contain any provision allowing UTIMCO to prosecute causes of action of Delegated Funds.
3. Board Rules. The Board Rules provide in Part Two, Chapter IX, as follows.

2.5 Authority to Receive and Collect Money or Property (last amended 8/7/03) (editorially amended 11/03)

2.51 UTIMCO is authorized and empowered to seek, demand, collect, recover, and receive any and all sums of money, debts, dues, rights, property, effects, or demands due, payable, or belonging, or that may become due, payable, or belonging to the PUF or the Board from any person or persons as a result of any investment transaction and to execute any and all necessary or proper receipts, releases, and discharges therefor and any other instruments as may be necessary or appropriate from time to time relating to the handling, management, control, and disposition of any investment. The authority granted in this Subdivision does not include the authority to institute litigation on behalf of the Board or to settle contested claims or litigation that may result in UTIMCO receiving less than full value for the claim or the payment of damages or awards. The settlement of any contested claim or litigation for less than full value requires the prior approval of the U. T. System Vice Chancellor and General Counsel and appropriate System officials, as set out in Part Two, Chapter XI, Section 3 of these Rules and Regulations.

The 2003 amendments pared back the broader authority previously delegated to UTIMCO with regard to settlement authority that was noted in the 2003 Report.

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4. Analysis. Research of relevant authorities indicates that the Board can sue on any contract made with the Delegated Funds, even though the contract may have been made by UTIMCO as its agent. Settled law holds that a principal can sue on a contract made by his agent, even where the agent did not disclose his agency, *see e.g. Ford v. Williams*, 62 U.S. 287 (1858). Thus, the Board should be able to sue regardless of whether or not UTIMCO disclosed its agency.

Unsurprisingly, UTIMCO may assert a cause of action of the funds with the express permission of the Board, *see e.g. Fant v. Farrier Bros*, 253 S.W. 955 (Tex. app.—Texarkana, 1923) (holding that where an agent discloses the fact that he sues for the benefit of another and alleges that he is authorized to bring such a suit, his petition is not subject to a general demurrer). Generally an agent may not maintain a suit in its own name based on its principal's contract, but Texas law creates four exceptions: (1) where the agent contracts in his own name, (2) where the principal is undisclosed, (3) where the agent is authorized to act as owner of the property, and (4) where the agent has an interest in the subject matter of the contract. *See e.g. Perry v. Breland*, 16 SW3.d 182, 187 (Tex. app.—Wasteland 2000).

Commentary and Recommendations

The provisions of the Board Rule cited above appear to articulate the authority of UTIMCO in such matters with reasonable clarity. Where they may fall short is in the absence of an express obligation of UTIMCO to notify the Board of any causes of action the Board or the Delegated Funds may have, for it is likely that in many such instances only UTIMCO would be in a position to have such knowledge. Consider, for example, the situation in which the Board may have a claim against an entity in which some of the Delegated Funds may have been invested. The Board may wish to consider amending the UTIMCO Agreement to provide for such an express obligation, to be supplemented with routine involvement and oversight of U.T. System Staff in UTIMCO's observations to help increase the likelihood that any such claims would come to the Board's attention. In addition, consideration may wish to be given to whether the Board Rules provisions adequately encompass the issues that might arise to the extent that the Board or the Delegated Funds might be eligible to be members of a class in any class action that might be initiated against an investment by a third party. The improvements to organizational integration at the board and staff levels recommended in this report would likely advance the Board's ability to be informed of and act on any claims it may have regarding a particular investment.

F. UTIMCO Surplus.

1. Background. UTIMCO has historically been paid an Annual Fee under the UTIMCO Agreement that exceeds its actual expenses, and has retained those surplus amounts in a reserve that currently approximates \$10 million. Discussions with UTIMCO by various members of the Working Group indicates that the primary intended purpose of such surplus reserves is to fund unanticipated operational expenses of UTIMCO's discharge of its investment management

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functions; it may also be envisioned as a source of funds for UTIMCO's indemnification obligations with respect to its directors and officers.

2. Texas Nonprofit Corporation Act. The Texas Nonprofit Corporation Act (the "TNCA") defines a nonprofit as a corporation that does not distribute its income to its members, directors, or officers.⁸ The TNCA also prohibits payment of dividends or other distributions of income except for reasonable compensation, benefits in conformity with the corporation's purpose, and upon dissolution.

The foregoing limitations do not, as a general matter, prohibit the corporation from spending income for purposes within the scope and purpose of the nonprofit, so long as the earnings are not distributed or paid as dividends to members, directors, or officers.⁹

3. UTIMCO Agreement. The UTIMCO Agreement does not expressly address issues regarding any surplus generated as a result of UTIMCO's operations.

Commentary and Recommendations

UTIMCO's retention of surplus for operational purposes or potential indemnification liabilities would seem to be lawful under the TNCA, as such purposes seem related to UTIMCO's discharge of its purpose. Absent contractual or budgetary limitations on the retention of surplus, and subject to its duties to the Board as its contractual principal, the UTIMCO Board would appear to have the discretion to determine in good faith the appropriate amount of such surplus in its business judgment. To the extent the Board is of the view that the surplus amounts are excessive, it could address the issue in a number of ways, including the addition of a specific term to the UTIMCO Agreement or conditioning its approval of future Annual Fee proposals on a mechanism for disposing of any surplus in a different manner. For example, the Board could require that any surplus (or any surplus above a specific amount) be returned ratably to the Delegated Funds or be used to fund future approved UTIMCO budget needs. This report includes U.T. System Staff recommendations as to matters involving the UTIMCO surplus in the section regarding budgetary procedures at Tab 9.

⁸ Art. 1396-1.02(3) VATS.

⁹ See, e.g., Tarrant Appraisal Dist. v. Colonial Country Club, 767 S.W.2d 230 (Tex.App.-Fort Worth 1989).

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IV. General Review Issues.

A. Maintenance of UTIMCO as non-profit corporation.

1. PUF v. Other Endowments. With respect to this issue, the analysis is probably different as to the PUF and the other endowment funds.

- a) PUF.

- (1) Texas Constitution. As noted in the 2003 Report, the Texas Constitution governs the Board's management of the PUF. The relevant Constitutional provisions do not speak expressly to the Board's ability to delegate investment management, though one might argue their terms by allowing various categories of investments allow some level of delegation. This issue was the subject of significant research by the General Counsel's staff at the time of UTIMCO's creation.

- (2) UTIMCO Enabling Statute. Any such ambiguity is presumably resolved by the UTIMCO Enabling Statute, in which the Legislature expressly authorized the Board to:

- (a) at Section 66.08(a), "...delegate investment authority and contract for the investment of the [PUF] to the same extent as the governing board of an institution of higher education with respect to an institutional fund under [the Uniform Management of Institutional Funds Act ("UMIFA")]," which in turn at Section 163.006 of the Property Code allows the governing board of an institution of higher education to delegate investment authority to its staff and "other agents" and to "contract with independent investment advisors, investment counsel, investment managers, banks, or trust companies to act for the board in investment of institutional funds," and

- (b) at Section 66.08(b), "...enter into a contract with a nonprofit corporation for the corporation to invest funds under the control and management of the board, including the [PUF], as designated by the board..."

- b) Other Endowment Funds. Delegation of investment management with respect to the other endowment funds is primarily governed (and, it seems, permitted by) UMIFA, as well as, in some cases, the law of trusts (recent amendments to which appear to expand investment authority), and in other cases, specific statutes (e.g., those governing the Permanent Health Fund, which in turn reference UMIFA).

2. Analysis. There is a strong argument based on these provisions that the Board would have broad latitude under the UMIFA standard for a complete outsourcing of investment management. To the extent it wants more of a hybrid structure, the UTIMCO Enabling Statute arguably requires that the captive entity be a non-profit corporation. One might argue that the relevant language is permissive and

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not exclusive ("...the [Board] *may*...."), but it is not clear that a close review of the legislative history etc. would support such a position. It may be that further research would show that the proponents of the current UTIMCO structure merely solicited statutory language that would provide express authorization to do exactly what they had in mind by way of a structure, relying on the Legislature to resolve any ambiguity as to the Board's authority to implement such a structure, without limiting other possible options -- recognizing that prudent implementation of some alternate structure would likely involve similar legislative clarification of authority.

3. Tax Form. There is no express requirement that the non-profit corporation be a 501(c)(3) entity, but (without consulting thoroughly with tax counsel) it would seem that the only alternatives would be less tax-advantaged (i.e., less tax-exempt) entities. It is important to distinguish between the form of the entity from a corporate law standpoint and the tax status of the entity.

B. Alternate structural models.

As discussed in the overview to this section of the report, there is a wide range of structural alternatives to the UTIMCO arrangement that the Board could likely employ within the bounds of its fiduciary duties regarding management of the Delegated Funds. These could range from a reversion to in-house management, perhaps under the oversight of a committee of the Board, to a complete arms' length outsourcing of investment management to a private third party that also invested the funds of others.

In addition to our discussion of the policy issues associated with such alternatives set forth above, we note the recommendations of U.T. System Staff and Ennis Knupp elsewhere in this report regarding such high-level structural matters.

1. In-house management. In-house management clearly seems permissible under the Texas law governing the Board's investment responsibilities, subject to the Board being reasonably satisfied that the committee and staff to whom the investment responsibilities were delegated had sufficient expertise to competently implement the Board's investment policies. As noted in our overview, we believe the Board's interests are well served by the UTIMCO structure, but suggest that the Board may wish to at least evaluate whether some or all of the back office and non-investment related commercial operations of UTIMCO might be better or more efficiently handled in-house at the U.T. System.
2. Complete Outsourcing. The provisions of the Uniform Management of Institutional Funds Act governing the endowment funds would seem to permit a complete outsourcing, but it is not clear that the provisions of the Texas Constitution governing the PUF would. At a minimum, express statutory authority, presumably in the form of an amendment to the UTIMCO Enabling Statute, would be prudent to ensure such authority. Moreover, careful

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consideration would need to be given to the implications of such an outsourcing as to the potential dilution of Board control over investment matters involved in such an approach, implications regarding the sovereign immunity otherwise associated with the Board's investment, and many of the other issues discussed in this report and the 2003 Report as they might apply in such a circumstance.

V. Other issues.

A. New statutes.

1. Trust Law. Recent enactments related to law of trusts -- Uniform Prudent Investor Act and the Uniform Principal and Income Act.

In reviewing the previous UTIMCO report it appears that the change to the investment standard and the new delegation rule are the most relevant provisions under the Prudent Investor Act to address in the updated report.

The Principal and Income Act pertains primarily to the manner in which receipts and disbursements are categorized as principal or income, and therefore should not have much impact on the report. The trustee's power to adjust principal and income of a trust is a significant one, but I have difficulty seeing when it would apply since the board would only serve as trustee when the school is a beneficiary of the trust. A trustee may not exercise the power to adjust if the trustee is a beneficiary of that trust.

- a) Uniform Prudent Investor Act – Chapter 117 of the Texas Trust Code (the “Trust Code”)

- (1) Enacted in 2003 and effective January 1, 2004 - applies to trusts existing prior to January 1, 2004 and trusts created after January 1, 2004; provided the terms of the trust do not provide otherwise

- (2) Requires a trustee to invest as a prudent investor adopting a total return/modern portfolio approach of investing – former section 113.056 of the Trust Code prudent person standard has been repealed

- (3) Section 117.004 sets forth the standard of care:

- (a) Investment and management as prudent investor considering factors - purposes, terms, distribution requirements, and other circumstances of trust

- (b) Evaluation of trustee's investment and management decisions based upon conduct not performance

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- (c) There are various factors trustee is to consider relevant pursuant to Section 117.004(c) of the Trust Code
- (d) Professional trustees with special skills or expertise have a duty to use them
- (4) Duty to diversify unless trustee determines otherwise
- (5) Duty to review trust assets and make and implement decisions within reasonable time to comply with trust purposes and prudent investor rule
- (6) Departs from prior law with allowed retention of initial trust estate without diversification and without liability
- (7) Duty to invest and manage trust assets solely in interest of beneficiaries
- (8) Duty to act impartially investing and managing trust assets considering differing beneficial interests
- (9) Investment costs must be appropriate and reasonable in relation to assets
- (10) Delegation of Functions – Section 117.011 of the Trust Code
 - (a) Former Section 113.060 of the Trust Code has been repealed
 - (b) Allows delegation of functions as long as trustee exercises skill, reasonable care and caution in selecting agent, establishing terms and scope of delegation, and periodically reviews and monitors performance and compliance
 - (c) Trustee who complies is not liable to beneficiaries of trust for decisions or actions of agents unless agent is an affiliate of the trustee or terms of the delegation require arbitration or shorten the statute of limitations
 - (d) Affiliate is defined in Section 111.004 of the Trust Code
- b) Uniform Principal and Income Act - Chapter 116 of the Trust Code
 - (1) Enacted in 2003 and effective January 1, 2004 - applies to existing trusts and trusts created after that date unless the terms of the trust provide otherwise
 - (2) Subchapter D – Allocation of Principal and Income in former Sections 113.101 et seq. of the Trust Code have been repealed
 - (3) Intent of Act - coordinates trust accounting with total portfolio based investment decisions

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(4) Allows trustee to adjust principal and income of a trust in limited circumstances to meet prudent investor standard

(a) Unlikely to apply because no adjustments are allowed that would change the amount payable to a beneficiary as a fixed annuity or fixed fraction of the value of the trust assets, which would include charitable remainder unitrusts and charitable remainder annuity trusts

(b) A trustee may not exercise if the trustee is a beneficiary of the trust unless a cotrustee to whom the provision does not apply exercises the power

(5) UTIMCO would likely be considered an affiliate of the Board for purposes of the new statutes. Following is the definition from the Texas Trust Code.

c) "Affiliate" is defined in section 111.004 of the Trust Code as follows:

(1) "Affiliate" includes (A) a person who directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with another person; or (B) any officer, director, partner, employee, or relative of a person, and any corporation or partnership of which a person is an officer, director, or partner.

(10) "Person" means an individual, corporation, a partnership, an association, a joint-stock company, a business trust, an unincorporated organization, or two or more persons having a joint or common interest, including an individual or a corporation acting as a personal representative or in any other fiduciary capacity.

2. S.B. 1059 – New Ethics and Disclosure Requirements.

a) Summary. Senate Bill 1059, adopted by the Texas Legislature on June 1, 2003, establishes new ethics and disclosure requirements for outside financial advisors and service providers effective as of September 1, 2003. Specifically, the act requires as follows.

(1) Applicability. The act applies to any public retirement system, institution of higher education as defined in UMIFA (which would include the U.T. System), or "another entity that is part of state government and manages or invests state funds or for which state funds are managed or invested."

(2) Ethics. The governing body of the applicable state agency must adopt standards of conduct for financial advisors or service providers who are not employees of the agency, provide financial services to the agency, or advise the agency regarding the investment or management of state funds, and who may reasonably be expected to receive more than \$10,000 in compensation

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from the agency during a fiscal year or who render important investment or funds management advice to the agency, as determined by the governing body.

(3) Disclosure. Any such financial advisor or service provider must disclose in writing to the head of the agency and to the state auditor:

(a) any relationship it has with any party to a transaction with the agency, if a reasonable person could expect the relationship to diminish the financial advisor's independence of judgment in the performance of its responsibilities to the agency; and

(b) all direct or indirect pecuniary interests it has in any party to a transaction with the agency, if the transaction is connected with any financial advice or service it provides to the agency in connection with the investment or management of state funds.

The act requires an annual statement be filed regarding the foregoing.

b) UTIMCO Implementation Plan. We have not undertaken a detailed review of UTIMCO's proposed implementation plan. U.T. System Staff, and in particular the General Counsel, should (as we understand is already the case) review the implementation plan for compliance with the provisions of the statute, including the conclusion that the Board is the governing board under the statute, and that the conclusions as to which service providers to the Board and UTIMCO are included within the scope of the statute's reporting obligations.

TAB 13

ENNISKNUPP

MEMORANDUM

To: University of Texas System Board of Regents
From: Steve Voss
Mike Sebastian
Date: April 15, 2004

Re: The University of Texas System's Investment Management Function

Independent of our involvement with the UTIMCO Working Group, we were asked to evaluate the University of Texas System's asset management needs, and provide an opinion on structural options. This memorandum provides that opinion. In coming to our conclusions we relied upon our experiences regarding the best practices of fiduciaries charged with overseeing large pools of assets (public and private).

Conclusion: Structurally, we believe UTIMCO continues to be an appropriate platform for meeting the System's asset management needs. Reporting enhancements and improvements in the client/investment manager relationship are needed, however.

Background

We studied the work done by the Office of Asset Management, Cambridge Associates and others related to the need for enhanced investment returns, and the viable ways to achieve such returns under different asset management structures. This work was the foundation that led to the creation of UTIMCO.

The minutes from the April 10, 1995 Board of Regents' meeting provide the best details on how UTIMCO came to be. The minutes include Executive Committee Letter Number 95-15, drafted by then-Chancellor William Cunningham. The letter provides the following background information:

"The U.T. System is relying increasingly on private support and its endowment returns in order to fund its mission. Both of these critical sources of funding depend on the successful management by the Board of the \$7 billion of PUF and U.T. System investment assets under its fiduciary care. Success in investment management will present an increasingly formidable challenge for the Board in the coming years. Over the next decade, traditional securities markets are not expected to provide the superior returns of the past. In addition, the Board will be required to compete for returns in an increasingly complex investment environment marked by global markets, alternative investments, a proliferation of new, complicated financial instruments, and short windows of opportunity."

The Executive Committee Letter also identified "several weaknesses" and "certain prerequisites necessary to compete successfully for investment returns." The weaknesses of the Office of Asset Management structure were cited as follows:

- limited investment experience of the Board members;
- absence of institutional memory;
- an extended decision making process; and
- lack of an exclusive focus on investment policy and performance

The prerequisites necessary to compete for returns were described as:

- [the Board must] attract and retain high caliber investment professionals;
- provide a focused professional money management environment;
- streamline its decision making; and
- eliminate bureaucratic obstacles

The "weaknesses" identified in the Executive Committee Letter to some degree relate to the specific circumstances of the OAM, and as such some may not persist today. Others, however, are perennial and are as valid today as they were in 1995.

Some members of the Board of Regents have significant experience in investments while some have very little, as would be expected with any specialized area of knowledge. The limited terms of Regents and the learning curve for newly-appointed Regents serve as a limit on institutional memory. The Board's decision-making process lends itself well to the management of a large university system but not necessarily to the frequent and urgent decisions that arise in the active management of an investment portfolio. Perhaps most significantly, the nine members of the Board of Regents simply cannot focus exclusively on the investment policy and performance of the System's assets.

These challenges could be met either by a division of System staff or by a separate asset management entity such as UTIMCO.

The Internal Staff Solution

The System's investment needs could be met by internal staff devoted to managing the investment portfolios, as was the case with the Office of Asset Management. This structure could range from a minimum cost and oversight solution in which all assets are passively managed (indexed), to a complex collection of active and passive strategies similar to what exists in the UTIMCO-managed portfolio today.

Passive Implementation

A fully passive implementation of the System's investments has intuitive appeal. Requiring little oversight beyond the setting of asset allocation policy, this structure might appeal to a Board with a finite amount of time to spend on a broad and deep set of priorities involved in the management of the System as a whole. And investment theory and experience suggest that even skilled active management has met with limited success in its objective of beating the market.

The endowments have, as primary investment objectives, the goal of earning a return after inflation of at least 5.1%. In the current economic environment of low interest rates, reduced corporate profit growth expectations and elevated stock valuations, EnnisKnupp's capital market assumptions and those used by UTIMCO during its asset allocation review suggest expected investment returns lower than those experienced in recent decades. In such an environment, it will likely be difficult if not impossible to earn a 5.1% real return using passively-managed endowment portfolios with reasonable levels of investment risk (ones that are not nearly 100% equity). Accordingly, elements of active management and use of unconventional investments are likely needed to improve the odds of achieving the 5.1% real return objective.

We note that the current policy, unlike a passive alternative, requires a high level of confidence in UTIMCO and its managers. That is, the fact that the current policy is expected to achieve the 5.1% objective does not mean that it will. It may in fact produce a lower return than a passive alternative might, though neither may achieve the investment objective. This uncertainty is accounted for in the expected risk (standard deviation or downside risk) of the policy portfolio. The current policy is also more expensive than a passive alternative in terms of the higher management fees and transactions costs associated with active management (this is discussed further in the "Cost Effectiveness" section of the UTIMCO Review).

A More Complex Portfolio

Internal staff could manage any combination of traditional and unconventional strategies (as a manager of managers) to meet the System's needs, without limits imposed by the governance structure itself. Here we are referring to the structure in place pre-UTIMCO.

The passively managed solution provides a limited probability of meeting the investment objective based on the current economic environment. A more complex portfolio overseen by staff may improve the odds of meeting the objective, but continues to be hampered by the weaknesses outlined in the 1995 Executive Committee Letter referenced earlier in this memorandum.

A Separate Asset Management Group

A separate asset management group addresses these weaknesses. Specifically, separating the asset management function from other System activities allows it to flourish in an environment best suited to its nature. However, there is a potential associated cost in the form of more complicated oversight and loss of Board control over management activities. We list the arguments for and against a separate asset management group structure in the table on the following page.

Pros and Cons of Maintaining a Separate Asset Management Group

Pros	Cons
<ul style="list-style-type: none"> ▪ Ability to create an "asset management culture" with: <ul style="list-style-type: none"> – A focus on policy and performance – Reduced bureaucratic obstacles – A competitive pay structure – The ability to retain skilled and experienced investment professionals ▪ Asset management group is insulated, to some extent, from non-investment concerns 	<ul style="list-style-type: none"> ▪ Regents forego control of day-to-day activities and staff of investment management function ▪ Reporting structure may be more complicated, with multiple layers of principals and agents

We discuss each of these points below.

Pro: Importance of the "Asset Management Culture"

In our research paper, "Can Public Funds Compete?" we attempt to explain differences between the performance of public pension funds and that of endowments and corporate pension funds. The study finds that endowments on average outperform public funds by approximately 0.5% per year—a significant margin. Our analysis suggests that asset allocation and investment strategy explain part of the performance differential. Other, unquantifiable factors like staff compensation and governance and cultural factors also appear to account for some of the favorable performance of endowments. Below we provide selected excerpts from our paper.

Staff Compensation

"According to Greenwich Associates, there are significant differences in the average compensation of investment professionals for the three fund types. Corporate funds pay investment professionals 33% more than do public funds. Endowments pay 66% more, on average, than public funds. Although we cannot establish a linkage between the two, we cannot reject differences in compensation levels as a possible factor that explains differences in fund performance."

Governance and Cultural Factors

"One of the least studied aspects of institutional investment management is how various governance and cultural factors might influence investment outcomes. These are largely intangibles relating to (1) freedom of action, (2) board-level expertise, and (3) the extent to which fund investment could be characterized as enterprising. Unfortunately, these factors do not lend themselves readily to quantification at the individual fund level in a way that permits rigorous analysis. Nevertheless, we know from experience there are differences among fund types in their governance and culture. These are the factors we considered:

Restrictions. Public funds tend to be the most restricted in their investment activities. They face statutory as well as board-imposed restrictions. The most common form of restriction is precluding certain investments or investment activities; others are designed to encourage targeted (in-state) investments or affirmative action. That public funds are subject to freedom of information laws constitutes an additional restriction – a restriction on maintaining proprietary information. The latter is proving vexing to many public funds in their venture capital investing. Corporate funds are subject to party-in-interest restrictions under ERISA. Endowment funds operate largely free of investment restrictions.”

[...]

Trustee Investment Experience. This tends to be greatest for endowments, which have the luxury of selecting from among their alumni investment experts to sit on investment committees, even if they are not trustees. At the other end of the spectrum, the vast majority of public fund boards are made up of lay people with respect to investment.

Culture. In our experience, endowments are the most enterprising and results-oriented of the three fund types. Public funds, given their visibility and public accountability, are the most conservative, process-oriented, and politically sensitive.

It is tempting to speculate as to the potential effect of these differences in the less quantitative aspects of fund management. All of these factors suggest that endowments by their very nature may have greater performance potential than public funds. While these factors *may* have a bearing on the superior performance of endowments, much more work needs to be done before we can establish a critical link between governance and cultural factors and fund performance.”

These findings suggest that promoting a suitable culture in the System’s investment management organization can provide tangible benefits in terms of performance.

Pro: Insulation from Outside Concerns

The Board of Regents should ensure that policy properly reflects System circumstances, and investment staff should focus solely on meeting those policy objectives. We note the current UTIMCO structure is not immune from outside distractions. The current Working Group review is evidence of this. UTIMCO also devotes resources to responding to challenges from outside entities such as the press. To truly isolate investment staff from these concerns, System staff and the Board of Regents should deal with non-investment issues.

Con: Regents Forego Day-to-Day Control

Compared with the internal staff approach, the separate asset management group structure carries a greater risk of a divergence of interests of the investment group and the Board, or a deterioration of communications between the two groups. In many respects this describes the current situation. However, such risks can be mitigated through careful design of the oversight and reporting relationship between the two entities. We provide recommendations for improvements in this area in the "Oversight and Reporting" section of the UTIMCO Review. System staff also offers specific recommendations regarding oversight in its section.

Con: Increased Complexity of Reporting Structure

A separate asset management corporation is governed by its own Board of Directors. This adds another layer of management between the Board of Regents and the actual investment assets, which presents an additional risk of conflict between the two boards. These risks, too, can be controlled with appropriate oversight by the Board of Regents, and we believe that the Regents have sufficient tools at their disposal to address them.

Conclusion

In balance, we believe that the University of Texas System would be best served by using a separate corporate entity to manage its investment portfolios. Further, we believe (based on our experiences over the last several months as the Board of Regents' consultant and our participation in the UTIMCO Review) that the actual structure embodied in UTIMCO is the right one. The challenge in the future will be to ensure that the oversight and reporting functions operate smoothly. The UTIMCO Review contains specific recommendations for improvements in this area.

TAB 13 a

CAN PUBLIC FUNDS COMPETE?

Endowment funds and, to a lesser degree, corporate pension funds have had better risk-adjusted performance than public pension funds. This research examines factors that might explain this phenomenon. Differences in asset allocation and investment strategy appear to have played a role. Perhaps the more interesting result is the identification of factors such as staff compensation levels, governance, and investment culture that may also be a part of this performance.

We hear much of the differences in practice among investor types. We know, for example, endowments are heavier users of alternative investments than are pension funds, and public funds rely more heavily than others on passive management. Our literature is largely silent, however, on the question of whether particular fund types have outperformed others generally and whether particular practices have proven superior to others. Do endowments outperform pension funds after accounting for differences in risk? Do certain aspects of investment policy contribute to superior performance? And what about factors such as fund size, expense levels, staff size and compensation, and fund governance practices – do these factors have a systematic bearing on fund performance? The purpose of this research is to explore these issues to gain insight into best practices in institutional fund management.

Any empirical study is only as good as the data that underlies it. For the present purpose, the ideal dataset would include, in addition to return histories for a large sample of individual funds, detailed descriptions of their practices and circumstances over time. Unfortunately, the ideal dataset to make a comprehensive evaluation of inter-fund performance does not exist. Consequently, we have obtained data from several sources, integrating them as best we can. As a result, this study is far from definitive. Rather, it is at best a beginning: an attempt to frame the problem and identify factors that might reasonably be expected to have a bearing on fund performance.

The study begins with a comparison of the performance of three fund types – corporate pension funds, endowments (including foundation funds), and public funds. Table 1 shows the rates of return of the three fund types for two periods: 1987-2002 and 1995-2002. After analyzing the results for the longer period, we added the shorter one because doing so resulted in a materially larger sample while still encompassing major bull and bear markets.¹ Endowments produced the highest average rate of return during both periods and public funds the lowest. The annual return spread between endowments and public funds was approximately 0.5% (50 basis points) for both periods.

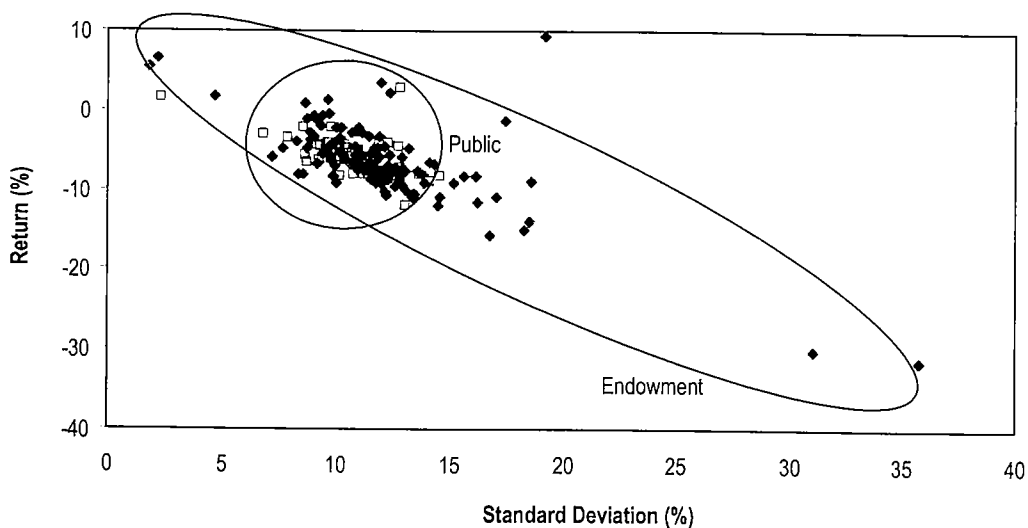
Table 1
Return and Risk for Fund Types

Fund Type	1987 – 2002 (16 years)		1995 – 2002 (8 years)	
	Annual Return	Standard Deviation	Annual Return	Standard Deviation
Endowment	9.17%	10.94%	8.91%	11.97%
Corporate	9.11	10.56	8.74	11.77
Public	8.63	10.14	8.38	11.20

Source: Russell/Mellon Analytical Services.

Table 1 reveals that while endowments earned the greatest returns, they also exhibited the greatest risk as measured by standard deviation of annual return. Figure 1, which focuses on performance during the bear market, illustrates that public funds not only operate at a lower risk level than endowments, their risk habitat is much smaller. Public funds generally clustered within a standard deviation range of 7% to 15%, while endowments ranged in standard deviation from less than 5% to more than 30%.

Figure 1
Public Funds Occupy a Smaller, More Conservative Risk Habitat than Endowments
April 2000–December 2002 (Bear Market)



What might account for public funds' more confined habitat? Some would say that, owing to greater public scrutiny, public funds are more concerned with peer practices and, consequently, have a tendency to herd. Another possible explanation has to do with the differing natures of public funds and endowment funds. Each public employee retirement system is a financial institution in its own right. And each has a common goal, which is to invest assets, plus future contributions, to fund pension obligations, which for large employee populations are relatively homogenous in their financial characteristics, e.g., duration and inflation sensitivity. On the other hand, resources of endowed institutions vary widely. For many colleges and universities, spending from endowment provides a small fraction – often less than 20% – of the institution's overall budget (other sources being tuition, fees, federal and/or state funding, etc.). For these institutions, there is also at work a diversification effect of income sources owing to imperfect correlation among them. For these reasons, the capacity of some educational endowments to bear investment risk is inherently great. For other institutions, such as foundations, the entire budget is usually funded by spending from the investment portfolio. It would be understandable if some of their investment policies were a good deal more conservative.

Whatever the explanation of differences in risk levels among fund types, it is important to take those differences into account in making performance comparisons. We did so using the Capital Asset Pricing Model, regressing an equal-weighted average of fund returns by type against a global market portfolio comprising all investable capital market assets.² The resulting risk-adjusted performance measure is the regression intercept or alpha. We cumulate the alphas for each fund type and plot the endowment and corporate series relative to the public series in Figure 2.

Figure 2 shows that endowment funds and, to a lesser degree, corporate pension funds outperformed public funds in the 1987-2002 period.

Figure 2
Cumulative Risk-Adjusted Return
1987-2002

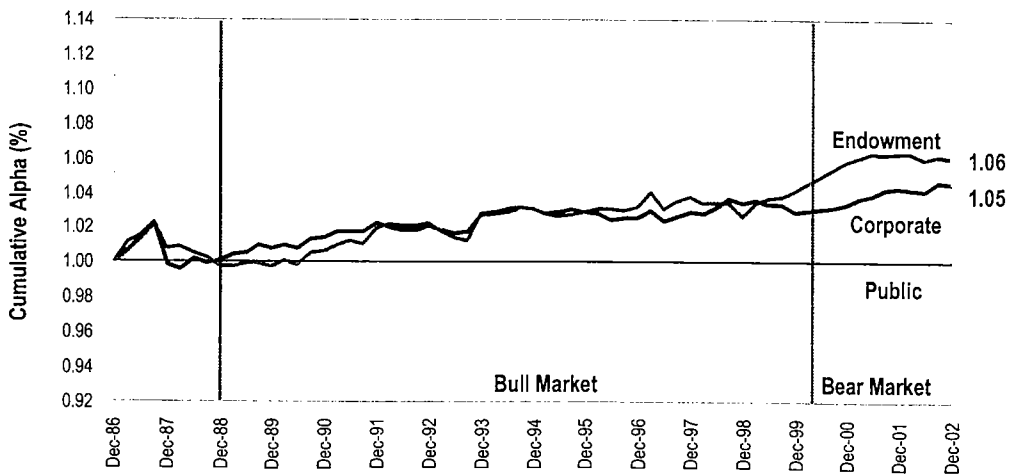


Table 2 provides similar results for 1995 through 2002 without using a market model. Here we have simply regressed the individual funds' returns on their standard deviations to develop an empirical return-risk relationship for each fund type. The average values indicated are the y values of the regressions at standard deviation of 12%, a reasonably central value for all three fund samples. Table 2 shows that endowments, especially, have outperformed public funds, earning an additional 55 basis points of risk-adjusted return per year over that eight-year period.

Table 2
Return Differentials by Fund Type
1995-2002

Average Return at Standard Deviation of 12%	Return Differentials
Public: 8.50%	Corporate over Public: 0.14 basis points
Corporate: 8.64%	Endowment over Corporate: 0.41 basis points*
Endowment: 9.05%	Endowment over Public: 0.55 basis points*

*Statistically significant differences.

ANALYZING DIFFERENCE IN RETURN

The data indicate that endowments have performed better than pension funds, and especially public funds, during the study period. The next step is to explore why this might have been the case. To this end, we have identified seven factors that could account for differences in return by fund type:

- *Asset Allocation.* This is the observed allocation across common asset classes. Asset allocation is well documented as the prime determinant of diversified portfolio performance.
- *Active versus Passive Management.* This is the average percentage of total fund assets that is managed actively.
- *Fund Size.* In some research, differentials in asset value among funds have explained differences in performance in some time periods.
- *Operating Expense.* This refers to overall cost structure. Funds with too high a cost of operation might be expected to underperform funds that are ostensibly more efficient.
- *Staff Compensation.* Funds that compensate their key investment professionals more highly arguably can attract the more capable staffs.

- **Staff Size.** Some funds might be better staffed to achieve positive risk-adjusted returns. Thus, staff size is considered a possible explanatory variable.
- **Governance and Culture.** Four elements of fund governance and management culture might have some impact. These include: (1) investment restrictions, (2) rigor of the fiduciary setting, (3) typical investment experience of board members, and (4) culture, meaning the extent to which fund investment could be characterized as *enterprising*.

Ideally, we would like to test each of these factors as an independent hypothesis, using statistical methods where possible. Some factors are statistically testable; most are not, owing to the absence of characteristic data at the individual fund level.

Discounted Factors

We find we can discount if not reject outright three of the seven factors in explaining performance differentials among fund types. These are fund size, operating expense, and staff size.

Fund Size. The average fund asset values are \$10.0 billion for public funds, \$1.4 billion for corporate funds, and \$900 million for endowment funds.³ We might expect alpha to be inversely related to fund size, recognizing the direct relationship of transaction cost and trade size. (See Beckers and Vaughn, 2001.) Under this theory, smaller funds are more nimble than larger ones because their trading costs are lower.

Figure 3 shows the relationship of alpha to fund asset size for all three types of fund. There is no statistical relationship between alpha and size. Separate regressions for each fund type produce the same result. Therefore, we reject fund size as an explanatory variable that would account for differences in alpha by fund type, at least for the period covered.

wrong. Overall, we tend to discount staff size as a factor in explaining differentials in fund performance, at least until a clearer picture emerges.

Table 4
Full-Time-Equivalent Investment Staff Members

	Number of FTE Staff Members	Number of FTE Staffers Per Billion Dollars
Public	13.0	1.3
Corporate	3.9	2.8
Endowment	3.5	3.9

Source: Greenwich Associates.

Factors We Cannot Discount

To test each remaining factor rigorously with statistical methods, we need good characterization of the factor parameters at the individual fund level. For example, to test rigorously for the effects of asset allocation differences, we would require fairly detailed asset allocation data for each fund over time. Likewise, without an adequate description of factors relating to governance at the fund level, we cannot test rigorously for the influence of governance factors. Unfortunately, good-quality data of this type do not exist at the individual fund level. As a result, we must work with average characteristic values for the three fund types in some cases; in other cases, we lack even that and must rely on basic observation and experience.

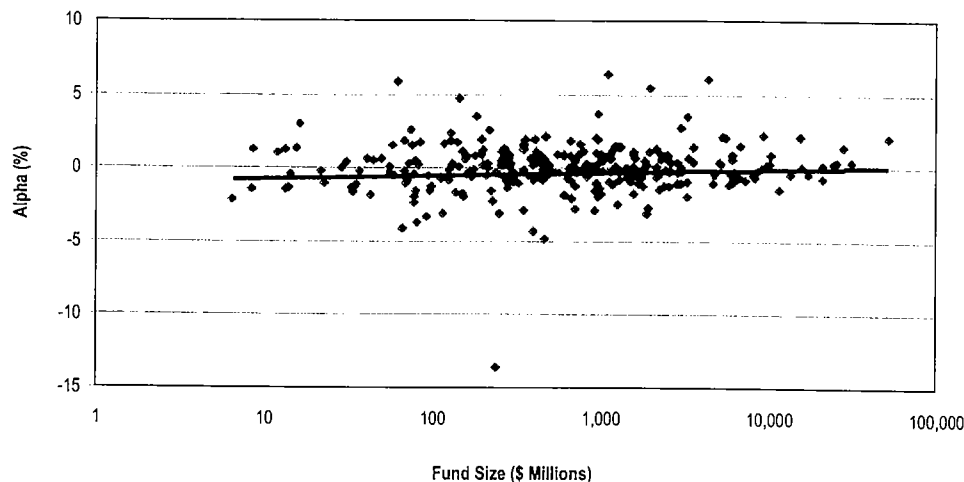
Asset Allocation. Table 5 presents typical asset allocation figures for the three fund types in the year 2002. We tend to discount differences in asset allocation between public and corporate funds when we account for differences in *risk-adjusted* performance. While public funds hold 6 percentage points more in bonds, the performance results, which are risk-adjusted, effectively take account of this difference. Otherwise, the differences in asset allocation between public and corporate funds are negligible.

Table 5
Typical Asset Allocation and Passive Management Percentages, 2002

Asset Class	Corporate	Public	Endowment
U.S. Stocks	48%	44%	36%
International Stocks	16	15	13
Real Estate	3	4	4
Private Equity	3	3	8
Hedge Funds	0	0	8
Fixed Income	29	35	30

Source: Greenwich Associates.

Figure 3
Risk-Adjusted Return by Fund Size, 1995-2002



Source: Russell/Mellon Analytical Services.

Operating Expense. Table 3 provides information on the cost of operation of the different fund types.

Table 3
Elements of Operating Expense

	Total Investment Expense (bps)	Salary and Administration (bps)
Public	34	5.1
Corporate	37	6.3
Endowment	53	9.7

Source: Greenwich Associates.

These results indicate that endowments, with the best performance, also have the highest level of operating expense and that public funds have the lowest expense level. Accordingly, we can discount, if not reject outright, the proposition that fund performance was adversely affected by higher levels of operating expense during this period.

Staff Size. Table 4 provides staffing information for the three fund types. More staff does not mean better returns. In fact, staff size is inversely related to alpha during this period. But the opposite picture emerges if we adjust staff size for asset size; here we see a direct relationship between staffing and class of performance. The latter interpretation, however, ignores entirely economies of scale in fund management, which strikes us as

There are significant differences between endowments and the other two fund types, notably in the areas of private equity and hedge funds. Table 6 indicates that a 5-percentage-point greater allocation to private equity could have had a very significant impact on the return of the typical endowment fund, especially if endowments were more heavily invested in venture capital. (Although solid data are lacking, casual observation suggests that endowments were indeed more heavily invested in venture capital than the other forms of private equity, such as buyouts, which have been the principal component of the private equity portfolios of public funds.) By way of a simple illustration, if we use the return data in Table 6, a five percentage point greater allocation to venture capital (at the expense of domestic equity) over the 1995-2002 period would have added 65 basis points of incremental return. (This figure is arrived at by multiplying the incremental annual return of venture capital over domestic equities of 1300 basis points by .05.) This approximates the roughly 50-basis-point difference in return between endowments and public funds reported earlier. This is a crude calculation, to be sure, but it serves to put into perspective the potential impact of venture capital investments during this period.

Table 6
Asset Class Returns, 1995-2002

Wilshire 5000	9.6%
Lehman Bonds	8.6
Venture Capital	22.6
All Private Equity (incl. buyouts)	14.1
Hedge Funds (funds of funds)	8.5

Sources: *Venture Economics, Hedge Fund Research.*

Caveats are in order regarding the potential impact of venture capital returns. Managed pricing plays a significant role in determining venture returns in the interim between cash flows. See Anson (2002). Managed pricing has the potential to distort venture returns, and we have no sure way of knowing the potential effect during this period. Mitigating the concern over managed pricing is anecdotal evidence that venture capital funds made extraordinarily large distributions during 2000. To the extent investors liquidated shares received rather than continuing to hold them, which most did, they realized their gains, ameliorating some of the concern with managed pricing.

Also noteworthy is the fact that the superior risk-adjusted return of endowments likely reflects a measurement bias in their favor. Managed-pricing conventions, which manifest themselves in positive autocorrelation of portfolio return, tend to dampen the observed volatility of private equity investments and hedge funds. To the extent this is true, it is fair to conclude that the observed volatility of endowments is understated, which means their risk-adjusted performance is overestimated. To correct for this we adjusted the Sharpe ratios of all funds in the sample for the presence of autocorrelation using the method described in Lo (2002). The results appear in Table 7. Adjusting standard deviations for autocorrelation does decrease endowments' Sharpe ratios more so than those of the other fund types. It does not, however, eliminate their advantage in risk-adjusted return.

Table 7
Sharpe Ratio Adjustment for Autocorrelation
1995-2002

Fund Type	Average Sharpe Ratio		
	Raw	Adjusted	Difference
Endowment	0.43	0.40	.03
Corporate	0.39	0.37	.02
Public	0.35	0.34	.01

We do not have good information regarding the timing of investors' hedge fund allocations during 1995-2002. The endowments' allocation obviously started smaller than 8% and grew to that level. This lack of knowledge, combined with the difficulty in generalizing about hedge fund performance, causes us to be reluctant to speculate on the effect of endowments' greater hedge fund investments.

Active versus Passive Management

Table 8 shows the median return of domestic equities by fund type (unadjusted for risk) and the percentage of *total* fund assets that were typically invested in one form of active management or another in 2002. Endowments' median return exceeded that of public funds by 0.85%. Endowments were also greater users of active management. And while the usage data for active management pertain to total fund, as opposed to domestic equities alone, we know that domestic equity is the asset class that accounts for the lion's share of passive investing for all fund types. Unfortunately, the 85-basis-point difference in return conflates two effects: systematic differences in the return of active and passive management during the period as well as differences in usage rates of active management. Nevertheless, these data tell the story that, during this period, active management appears to have systematically outperformed passive and, thus, more active management was better than less. Applying the same type of crude adjustment we applied above in gauging the potential impact of a greater allocation to venture capital, we see that an 85-basis-point return advantage in domestic equities translates to a typical return differential of 31 basis points at the total fund level. (This figure is arrived at by multiplying the incremental return of endowments' equities of 85 basis points by .36, the domestic equity percentage of endowments.) These admittedly rough calculations suggest that the use of active management, too, could account for a significant part of the difference in return between endowment and public funds.

Did endowments' greater use of active management contribute to the performance outcome? We cannot answer definitively; we can merely say that we cannot reject it as a factor.

Table 8
Domestic Equity Performance
1995-2002

	Median Return for Total Domestic Equities (Active and Passive Combined)	Percentage of Total Fund Assets Actively Managed
Endowment	10.61%	91%
Corporate	10.02	84
Public	9.76	74

Source: *Russell/Mellon Analytical Services, Greenwich Associates.*

It is possible that the recent bear market accounts, at least in part, for these results. The years 1995-2002 culminated in a three-year market decline. Active management generally does better in bear markets owing to the tendency of managers to hold some cash on average: In up markets cash is a drag, and in down markets it is a buffer. By way of illustration, in the six up-market years 1994-1999, an average of 77% of equity mutual funds underperformed the S&P 500, whereas in the three down-market years that followed, an average of 47% underperformed.⁴ For this reason, the positive performance advantage associated with active management may be, to some extent, an artifact of the 1995-2002 period, which ends in a major bear market. This inference is supported by Cost Effectiveness Measurement, Inc., whose recent studies indicate that more active management has generally been better. Their recent findings, however, differ from their findings in earlier years, when their data favored the opposite conclusion.⁵

Staff Compensation

According to Greenwich Associates, there are significant differences in the average compensation of investment professionals for the three fund types. Corporate funds pay investment professionals 33% more than do public funds. Endowments pay 66% more, on average, than public funds.⁶ Although we cannot establish a linkage between the two, we cannot reject differences in compensation levels as a possible factor that explains differences in fund performance.

Governance and Cultural Factors

One of the least studied aspects of institutional investment management is how various governance and cultural factors might influence investment outcomes. These are largely intangibles relating to (1) freedom of action, (2) board-level expertise, and (3) and the extent to which fund investment could be characterized as enterprising. Unfortunately, these factors do not lend themselves readily to quantification at the individual fund level in a way that permits rigorous analysis. Nevertheless, we know from experience there are differences among fund types in their governance and culture. These are the factors we considered:

- *Restrictions.* Public funds tend to be the most restricted in their investment activities. They face statutory as well as board-imposed restrictions. The most common form of restriction is precluding certain investments or investment activities; others are designed to encourage targeted (in-state) investments or affirmative action. That public funds are subject to freedom of information laws constitutes an additional restriction – a restriction on maintaining proprietary information. The latter is proving vexing to many public funds in their venture capital investing. Corporate funds are subject to party-in-interest restrictions under ERISA. Endowment funds operate largely free of investment restrictions.
- *Fiduciary Setting.* Public and corporate funds operate under strict fiduciary standards. Corporate funds are governed by ERISA and subject to its enforcement through the U.S. Department of Labor. While a formal enforcement apparatus does not exist in the public sector, increasingly the fiduciary standards there are identical to ERISA standards. Endowments operate in a comparatively relaxed fiduciary environment. A paucity of applicable case law is testimony to this observation.
- *Trustee Investment Experience.* This tends to be greatest for endowments, which have the luxury of selecting from among their alumni investment experts to sit on investment committees, even if they are not trustees. At the other end of the spectrum, the vast majority of public fund boards are made up of laypeople with respect to investment.
- *Culture.* In our experience, endowments are the most enterprising and results-oriented of the three fund types. Public funds, given their visibility and public accountability, are the most conservative, process-oriented, and politically sensitive.

It is tempting to speculate as to the potential effect of these differences in the less quantitative aspects of fund management. All of these factors suggest that endowments by their very nature may have greater performance potential than public funds. While these factors *may* have a bearing on the superior performance of endowments, much more work needs to be done before we can establish a critical link between governance and cultural factors and fund performance.

Summary

Public funds have underperformed corporate and endowment funds for more than a decade, even after adjusting for differences in risk. Endowments' greater allocation to private equity is a likely contributor to this outcome. Greater use of active management by corporate and endowment funds also appears to have helped during the period of this study. The effect of differences in staff compensation levels and governance/cultural factors is not currently testable, but observed variations for these factors are logically consistent with recent performance differences. These factors remain plausible contributors to performance differences.

ENHANCING COMPETITIVENESS

Fundamental differences exist among classes of institutional investors. These include differences in investment objective and risk tolerance, portfolio size, the application of fiduciary standards, and the realities of governance. In making performance comparisons, it is important to recognize that each investor type must operate within its own sphere, just as the leopard must live with its spots. That said, it behooves each investor to understand its inherent competitive advantages and disadvantages, and to tailor its investment approach accordingly. At the same time, each investor should seek to identify ways in which it can improve its competitiveness within the latitude available to it.

In this spirit, we offer public fund trustees several suggestions for building competitiveness:

1. *Continue to base asset allocation on intrinsic considerations.* This means that investment policy should be based on a rigorous evaluation of the needs of the plan. Of primary interest should be the nature of the underlying liability (its duration, growth rate, and inflation sensitivity), funded status, prospects for future funding, and liquidity requirements. Comparisons with the performance and practices of other investors are useful, but they should not be primary drivers of investment policy.
2. *Play to strengths.* Important competitive advantages and disadvantages of public funds derive from their relatively large size. As a result of economies of scale that are possible, they can operate at extremely low cost. Size also dictates that some asset classes are more suitable than others for public funds. In addition to all the publicly-traded areas of the market, real estate is a logical area for public funds. Large portfolio size facilitates diversification among large, "lumpy" properties as well as control over portfolio management functions; large size also permits a very competitive cost structure. Private equity, on the other hand, is an area of comparative disadvantage for public funds. Owing to their large size and the very small size of the private equity market, public funds tend to invest more heavily in buyout funds – and the large buyout funds, at that – than in venture capital funds. Moreover, their public nature can compromise their capacity for confidential dealing with some private equity managers, who do not want particulars of their portfolio companies and exit strategies falling into the public domain. Likewise, hedge funds, which are a form of hyper-active management, often in less liquid market sectors, are not a natural fit within the portfolios of mega-funds. The comparative advantage in all forms of active management is with the smaller portfolio, all else the same.
3. *Indexing remains a good way to get asset class returns and effect diversification.* Sharpe (1991) reminds us that, net of costs, the average actively managed dollar *must* underperform the average passively managed dollar, and for this reason index funds fairly consistently outperform more than half of the managers for a given class of active management. Malkiel (2003) provides empirical support for this observation. He reports that 60% to 90% of active managers underperformed their benchmarks in various domestic and international stock and bond categories for a recent ten-year period.

4. *Re-examine boundaries that exist within the portfolio.* Public funds can achieve satisfactory results using index funds only. Virtually all, however, attempt to achieve *superior* performance through various forms of active management. Our research (Ennis, 2001) indicates that most funds would benefit from lessening their reliance on narrow specialty management and broadening mandates in their active investing. Broader, more flexible mandates acknowledge that exploiting the lion's share of value-added opportunities necessitates moving funds among market sectors and capitalization ranges. Others have shown that the long-only constraint hurts portfolio efficiency. (See Brush, 1997, Grinold and Kahn, 2000, and Jacobs and Levy, 1993). In the same vein, other research indicates that *sector* factors are having a greater impact on stock pricing internationally than *country* factors, a sign of ongoing global market integration. (See Cavaglia, Brightman and Aked, 2000, and Hopkins and Miller, 2001). This, in turn, challenges us to consider *global* equity portfolio management as an alternative to partitioned domestic and international mandates. In short, successful efforts to earn alpha may necessitate crossing boundaries that have been built into most portfolios, and skillful, resourceful managers should be free to find value where it lies. The growing acceptance of hedge fund investing on the part of institutional investors is testimony to their warming to this view of the world of investment opportunity.

5. *De-emphasize strict organization of staff resources by asset class; shift budgetary resources up and to the center.* It has become customary for large public funds to organize the bulk of their professional resources along asset class lines. Strict adherence to this organizational approach contributes to rigidity in asset allocation: It is difficult for assets to cross boundaries when the people who manage them aren't in a position to do so.

6. *Strive to bring staff compensation in line with that of the private sector. Examine the trade-off between staff size and compensation.* A dollar of public pension fund assets is worth the same as a dollar of endowment assets. To the extent that compensation levels in the public sector lag those in the private sector, public funds will be at a competitive disadvantage in recruiting the most valuable investment professionals.

In this regard, funds are increasingly evaluating *incentive compensation* plans to bridge the compensation gap. While incentive compensation arrangements are fraught with agency issues, this may be the only way to approach anything like compensation parity.

Public funds should make a frank assessment of the trade-off between staff size, which does not appear to be a factor in value-added investing, and staff compensation, which may be a factor. This is a sensitive issue, to be sure. But it is possible that fully competitive compensation for key top-level positions could in many cases be realized without increasing overall staff expense through judicious reductions in intermediate and junior staff positions.

7. *Delegate greater manager selection authority to staff.* It will not be easy for public funds to fundamentally alter the nature of their governance process or their investment culture. That said, funds should re-examine every aspect of their operation to see if it is possible to free up and streamline decision-making.

One area for this is manager selection. Many funds still have a committee of trustees make manager hiring and firing decisions. Committees, especially committees of laypeople, are not equipped to distinguish skillful investment management from a good sales pitch. Indexing is almost certainly a better strategy than hiring and firing active managers by committee. Funds should strive to maximize the delegation of manager selection and retention to staff.

Comparisons with other public funds and other types of investment funds can furnish decision-makers with valuable perspective as they work to enhance their competitiveness. Through careful such analysis, while remaining true to their nature, public fund decision-makers can better understand their own strengths and weakness. And in the process, they may discover ways to enhance their fund's competitiveness.

The research described here only scratches the surface in identifying best practices through inter-fund comparisons. Much work remains ahead of us.

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ENDNOTES

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¹ The 1987-2002 sample includes 74 corporate, 27 endowment and 14 public funds. The 1995-2002 sample includes 178, 73, and 45 funds, respectively. The data source is Russell/Mellon Analytical Services, which reports only "gross" returns. Returns used in the analysis are net of average fees reported by Greenwich Associates for the respective fund types, viz., 37, 53, and 34 basis points.

² The world market portfolio series is maintained by Ennis, Knupp and Associates using data from UBS Asset Management and Venture Economics.

³ Greenwich Associates.

⁴ Lipper, The Vanguard Group.

⁵ The Cost Effectiveness Measurement, Inc., Toronto, ON, 2002 survey covers 137 U.S. funds with aggregate assets of \$1.4 trillion. See Section 2, Reserach.

⁶ Greenwich Associates.

TAB 14

**DECEMBER 19, 2003 RESOLUTIONS
OF THE BOARD OF REGENTS**

WHEREAS, The University of Texas System has been extensively engaged in the review of its organizational oversight and responsibility functions for the purpose of improving governance structures in the course of the Board's ongoing accountability activities; and

WHEREAS, The University of Texas Investment Management Company was formed in 1995 and has operated, under contract with the Board of Regents since 1996, through multiple market cycles and several changes in the management team.

THEREFORE, BE IT RESOLVED, That over the next several months, the U.T. Board of Regents will examine and evaluate The University of Texas Investment Management Company as to structure and services, including the following:

- Investment services provided;
- Administrative services provided;
- Cost effectiveness;
- Policy setting procedures;
- Consulting services utilized;
- Legal services utilized;
- Budgeting procedure;
- Oversight and reporting functions;
- Contract form and legal structure; and
- Other relevant and structural issues

with the goal of defining and structurally improving the investment management function of the U. T. System.

TAB 15

REPRESENTATIVE LIST OF ACTIVITIES RELATED TO UTIMCO WORKING GROUP

- December 8, 2003 Meeting with Chairman Miller (Szalkowski)
- December 8, 2003 Telephone meeting with Steve Voss and Michael Sebastian of Ennis Knupp (Chairman Miller, Aldridge, Frederick)
- December 23, 2003 Meeting with Chairman Miller (Szalkowski)
- January 8, 2004 Telephone meeting with Ennis Knupp (Chairman Miller, Aldridge, Frederick)
- January 14, 2004 Meeting (Frederick, Godfrey, Szalkowski, Chris Brown)
- January 21, 2004 Telephone meeting with Chairman Miller (Aldridge, Chaffin, Frederick)
- January 22, 2004 Planning meeting (Aldridge, Chaffin, Frederick)
- January 22, 2004 Meeting with Regent Caven (Szalkowski)
- January 23, 2004 Meeting with Chairman Miller and Regents Barnhill and Craven (Szalkowski)
- January 28, 2004 Meeting with Professor Starks (Chairman Miller, Frederick)
- January 29, 2004 Meeting with Professor Brown (Chairman Miller, Frederick)
- January 29, 2004 Meeting with Chancellor Yudof (Szalkowski, Chris Brown)
- January 29, 2004 Meeting with Regent Huffines (Szalkowski, Chris Brown)
- January 29, 2004 Meeting (Szalkowski, Chris Brown, Aldridge, Chaffin, Godfrey, and Frederick)
- February 3, 2004 Meeting with Vice-Chairman Hunt (Szalkowski, Chris Brown)
- February 3, 2004 Meetings with Regents (Frederick, Szalkowski, Chris Brown, Voss, Sebastian, Godfrey, Aldridge, Chaffin)
- February 10, 2004 First weekly telephone meeting of UTIMCO Working Group
- February 13, 2004 Meeting (Frederick, Aldridge, Godfrey, Chaffin, Szalkowski, Chris Brown, Starks, and Keith Brown)
- February 16, 2004 Telephone meeting with Vice-Chairman Clements (Szalkowski)
- February 17, 2004 Second weekly telephone meeting of UTIMCO Working Group (Chairman Miller makes remarks.)
- February 18, 2004 Telephone meeting with Ennis Knupp (Chairman Miller, Regent Caven, Chancellor Yudof, Aldridge, Chaffin, Frederick, Voss, and Sebastian)
- February 20, 2004 Meeting with Vice-Chairman Krier (Szalkowski, Chris Brown)

February 20, 2004 Meeting (Szalkowski, Aldridge, Chris Brown, and Frederick)

February 18, 2004 Meeting with Chancellor Yudof (Professor Hu)

February 22, 2004 Meeting with Chairman Miller (Professor Hu)

February 24, 2004 Third weekly telephone meeting of UTIMCO Working Group (Vice-Chairman Hunt and Mr. Boldt make remarks.)

February 25, 2004 Telephone meeting (Chairman Miller, Frederick, Aldridge, Szalkowski, and Chris Brown)

March 2, 2004 Fourth weekly telephone meeting of UTIMCO Working Group

March 9, 2004 Fifth weekly telephone meeting of UTIMCO Working Group

March 10, 2004 Meeting (Chairman Miller, Starks, Keith Brown, Aldridge, Chaffin, and Frederick)

March 10, 2004 Telephone meeting (Chairman Miller, Frederick, Aldridge, and Ennis Knupp)

March 10, 2004 Meeting with Chairman Miller, Vice-Chairman Krier, Regent Huffines and Chancellor Yudof (Professor Hu and Frederick)

March 11, 2004 Meeting with Regent Caven (Professor Hu)

March 16, 2004 Sixth weekly telephone meeting of UTIMCO Working Group

March 17, 2004 Telephone meeting with Regent Estrada (Szalkowski)

March 18, 2004 Meeting with Regent Estrada (Ennis Knupp)

March 19, 2004 Telephone meeting (Chairman Miller, Szalkowski, Frederick, Chaffin, and Sandra Neidhart)

March 22, 2004 Telephone meeting (Chairman Miller, Frederick, and Aldridge)

March 22, 2004 Meeting with Regent Craven (Ennis Knupp)

March 22, 2004 Meeting with Vice-Chairman Krier (Ennis Knupp)

March 22, 2004 Meeting with Vice-Chairman Clements (Ennis Knupp)

March 23, 2004 Seventh weekly telephone meeting of UTIMCO Working Group

March 23, 2004 Meeting with Cambridge Associates (Ennis Knupp)

March 24, 2004 Meeting with Vice-Chairman Hunt (Ennis Knupp)

March 24, 2004 Meeting with Regent Barnhill (Professor Hu)

March 25, 2004 Meeting with Regent Estrada (Professor Hu)

March 25, 2004 Meeting with Regent Barnhill (Chaffin)

March 26, 2004 Meeting with Regent Caven (Ennis Knupp)

March 26, 2004 Meeting with Regent Barnhill (Ennis Knupp)

March 26, 2004 Meeting with Vice-Chairman Hunt (Professor Hu)

April 1, 2004 Chaffin attends Investment Audit Practices Seminar regarding Endowment

April 2, 2004 Meeting with Regent Huffines (Ennis Knupp)

April 2, 2004 First Working Group Team Meeting

April 5, 2004 Meeting with Bob Boldt (Professor Hu)

April 6, 2004 Meeting with Andrea Reed of UTIMCO (Professor Hu)

April 6, 2004 Ninth weekly telephone meeting of UTIMCO Working Group

April 7, 2004 Meeting with Bob Boldt (Chris Brown, Szalkowski)

April 7, 2004 Meeting with Vice-Chairman Krier (Chaffin)

April 7, 2004 Meeting with Vice-Chairman Hunt (Professor Hu)

April 8, 2004 Meeting with Vice-Chairman Clements (Professor Hu)

April 8, 2004 Attendance of Szalkowski, Aldridge, Chaffin at UTIMCO Board meeting

April 12, 2004 Meeting with Chairman Miller and Regent Huffines (Frederick, Aldridge, and Chaffin)

April 13, 2004 Second Working Group Team Meeting

April 13, 2004 Meeting with Craig Hester (Chaffin)

April 14, 2004 Meeting with Chancellor Yudof (Frederick, Aldridge, and Chaffin)

April 14, 2004 Telephone meeting with Regent Caven (Frederick, Aldridge, and Chaffin)

April 15, 2004 Telephone meeting with Vice-Chairman Hunt (Frederick, Aldridge, and Chaffin)

April 16, 2004 Telephone meeting with Vice-Chairman Clements (Frederick, Aldridge, and Chaffin)

April 22, 2004 Telephone meeting of UTIMCO Working Group

April 22, 2004 Telephone Meeting with Regent Craven (Professor Hu)

April 28, 2004

Third Working Group Team Meeting