MINUTES OF THE
UNIVERSITY OF HOUSTON SYSTEM
BOARD OF REGENTS
ENDOWMENT MANAGEMENT COMMITTEE

October 23, 2008

The Chair, Carroll Robertson Ray, convened the Endowment Management Committee of the University of Houston System Board of Regents, in Room 128 E. Cullen Building, 4800 Calhoun, University of Houston, on Thursday, October 23, 2008, at 1:36 p.m., with the following members present: Jim P Wise, Vice Chair; Calvin W. Stephens; Welcome W. Wilson, Sr., Ex Officio; Michael J. Cemo and J. Christopher Jones, Advisory Members.

Regent Ray opened the meeting and stated that due to current market circumstances, finance and credit markets had reached historic proportions. There was a lot of pressure on fund managers to review asset formulas; and performance of managers would be addressed.

She then turned the meeting over to Dr. Carl Carlucci who introduced Bruce Myers and Hamilton Lee from Cambridge Associates for their report.

Mr. Myers stated that when a flood of liquidity recedes, the following events usually occur:

1. Profit margins contract and P/E multiples fall
2. Levered players suffer and heavily levered players fail
3. Forced selling can lead to periods of indiscriminant selling (i.e. all correlations go to one) and even outright panic
4. Ultimately, the markets overshoot, with prices reaching a level where investors return to by financial assets.

Regent Ray expressed her concern regarding the security of money market funds. Mr. Myers stated further erosion of these funds was likely.

Mr. Myers said the combination of economic stimulus, easy credit, and low interest rates created an environment that pushed financial asset prices to high levels and encouraged excessive risk taking. He said it is important to realize while leverage is coming down, liquidity is not improving, and the United States continues to borrow more.

Mr. Myers discussed the difference between a secular bear market and a cyclical bear market. He stated that secular bear markets last longer and are characterized by one or more "bear market rallies" which can be prolonged in duration, quick to materialize, and quick to collapse. They have historically ended when financial excesses have been cleansed from the system, and when markets have approached or exceeded the lows set in

previous bear markets. Mr. Myers said he is concerned about deflation today, and that we need to watch for inflation in the future.

Mr. Myers stated that with the exception of the 1930's, all recessionary periods in the U.S. over the last one hundred years have lasted 24 months or less. Cyclical bear markets in the U.S. since World War II have been 36 months or less. Secular bear markets can take a decade or more to play out, as in the U.S. in the 1970's or Japan in the 1990's. These secular bear markets are typically punctuated with several strong market rallies. Mr. Myers stated he believes the U.S. entered a secular bear market in March of 2000.

Mr. Myers spoke about the markets going forward and offered the following comments:

1. While there are signs of world equity markets being undersold, investor sentiment is fragile and the world banking system is still under stress, so the possibility of further losses cannot be dismissed.
2. Thus far, declines in equity valuations have occurred through falling share prices; earnings are likely to contract over the next 12-24 months, with further declines in equity valuations driven more by reduced earnings.
3. Given the degree of uncertainty and the fragility of investor sentiment, high levels of volatility in the public markets (i.e. strong rallies and abrupt downdrafts) would not be a surprise.

The danger of market timing was discussed. Mr. Myers stated that periods of extreme volatility increase the danger of magnifying losses through attempts of market timing. It is important to avoid market timing, but maintain one's rebalancing discipline. Mr. Myers stated that in periods of turmoil, like we are currently experiencing, it is helpful to be cognizant of a few fundamental aspects of the financial markets that have not and will not change. These fundamental aspects are:

1. Over long periods of time, investors make more money investing in equities versus fixed income ("being owners versus lenders").
2. While equities are the dominant asset class over long periods of time, they can be extremely volatile in the short run. Use diversification to manage volatility and disciplined rebalancing to take advantage of opportunities.
3. A high allocation to equities brings with it the need to offset "fat tail risk", which is the risk of extreme outcomes that have a low probability of occurring but are potentially catastrophic. The most pronounced of these risks is prolonged deflation or inflation.
4. Invest in various asset classes whose returns are not highly correlated. This is the basis of diversification, the purpose of which is to reduce the variability of returns without sacrificing performance.

The following strategy was recommended by Cambridge Associates:

1. Where current allocations to marketable equity are significantly above or below the targets, the Endowment Management Committee should consider rebalancing;
2. Steps should be taken to insure that cash and short-to-intermediate term fixed income is available to meet likely liquidity needs over the next 12 months;
3. Rallies should be used as an opportunity to trim asset classes that have outperformed and reallocate to underperforming asset classes where valuations are more attractive. They also provide an opportunity to raise cash for liquidity needs and to provide "dry powder" for opportunistic purchases; and
4. Maintain broad diversification and tilt toward quality (strong balance sheets, visible earnings, attractive valuations) wherever possible.

It was the consensus of the committee to meet more often, possibly once a month. The committee would use this opportunity to rebalance when needed. The committee also mentioned the prospect of holding 10 percent of the portfolio in cash. Mr. Cemo expressed the need to look at managers closely.

Regent Ray wanted to look at the benchmarks and make certain they were appropriate. Mr. Cemo also said that the 1-1/2% University Assessment fee should be reviewed. Dr. Carlucci said he thought we should also think about the assessment fee in terms of our return on this investment.

The following were Cambridge's recommended action items that the Committee considered:

1. Liquidate Federal Street Partners (To be notified by October 25, 2008) Balance is about $10.2 million.
    - Identify replacement for investment in early 2009; and
    - Pending identification of a replacement, hold proceeds in cash.
2. Rebalance portfolio, focusing on reducing overweight in Inflation Hedging assets (currently 15.2% vs. target of 10%) and modestly increasing allocations to U.S. and International Equities (currently underweight long-term targets).
    - Consider using Colchester Real Return Bond Fund as one potential source of cash ($5.4 million).

Regent Stephens moved committee approval to liquidate Federal Street Partners and Colchester; Regent Wise seconded the motion; and members of the committee concurred.

3. Consider adding exposure to sovereign, non-dollar bonds at the earliest opportunity; and
4. Stand firm on Wells Capital and Smith Graham investments.

Regent Ray asked Cambridge Associates if there were any funds managers who had been subject to litigation; and Mr. Myers stated there were none at this time. Regent Ray requested a report from Cambridge at the next meeting regarding securities lending and litigation related to our managers.

Regent Ray also inquired as to whether or not the committee should stay with Alliance Bernstein; Mr. Myers thought there was no need to move at this time.

At the next scheduled Endowment Management Committee meeting, it was requested that Mr. Rierson report on the use of the 1-1/2% University Advancement fee and show the comparison of this fee to other universities. Regent Wise stressed the importance to justify this fee to University of Advancement at the next committee meeting.

A copy of the material distributed at the Endowment Management Committee meeting was filed in the Board office.

There being no further business to come before the committee, the meeting adjourned at 3:30 p.m.

All documentation submitted to the Committee in support of the foregoing action items, including but not limited to "Passed" agenda items and supporting documentation presented to the Committee, is incorporated herein and made a part of these minutes for all purposes; however, this does not constitute a waiver of any privileges contained herein.

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Others Present:

Carl Carlucci
Dona Cornell
Dan Gardner
Tom Ehardt
Raymond Bartlett
Wynne Chin
Ed Hugetz
Bruce Myers
Hamilton Lee
Gerry Mathisen