The University of Delaware Endowment

Annual Report 2016

Investments Office Celebrates 20 Years

The fiscal year ended on June 30, 2016 marks the twentieth anniversary since the University of Delaware adopted the endowment model popularized by David Swenson at Yale University. The endowment model stresses the importance of broad asset class diversification, a comfort with illiquidity and an emphasis on equity-oriented investments to maximize the return potential on the University’s most important financial asset. A brief history of the Investments Office can be found in the timeline below with several important milestones, the development of the endowment’s assets under management and the annual distribution to the University.

The endowment has almost tripled in size during this time due to strong performance from the financial markets and the ongoing contributions of our generous alumni and friends. The growth in endowment assets has improved the overall health of the University and is an important component of the AA+ rating from Standard & Poor’s. Over the last twenty years, the endowment’s annual contribution to the University has grown from $21 million to $51 million. That is an additional $30 million each year to help support the University’s educational goals!

The adoption of the endowment model allows the University to benefit from a broader array of investment options, profit from the additional premium associated with illiquid alternative investments and allocate funds in keeping with that of a long-term investor. We look forward to the next twenty years as we continue our mission to help strengthen the University of Delaware’s financial position and maximize the return on contributions from our generous alumni and friends.

<table>
<thead>
<tr>
<th>Event</th>
<th>Year</th>
<th>Assets ($mn)</th>
<th>Distribution ($mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UD adopts Endowment Model &amp; Hires Outside Managers</td>
<td>1996</td>
<td>579</td>
<td>20.3</td>
</tr>
<tr>
<td>UD Hires First CIO &amp; First Private Equity Fund</td>
<td>2000</td>
<td>832</td>
<td>30.4</td>
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<tr>
<td>First Venture Capital Fund &amp; First Real Estate Fund</td>
<td>2004</td>
<td>936</td>
<td>40.3</td>
</tr>
<tr>
<td>First Natural Resources Fund &amp; First Distressed Fund</td>
<td>2008</td>
<td>1,278</td>
<td>49.4</td>
</tr>
<tr>
<td>Keith Walter named new CIO &amp; New Governance Model</td>
<td>2012</td>
<td>1,156</td>
<td>44.6</td>
</tr>
<tr>
<td>20 Year Anniversary on Endowment Model</td>
<td>2016</td>
<td>1,422</td>
<td>50.8</td>
</tr>
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</table>
The fiscal year that ended on June 30, 2016 saw the global equity markets decline -3.73% on increased market volatility and a -15% drop in global company earnings. It was a year where investors looking for performance outside of the U.S. were disappointed as international stock markets were -10.16% and emerging market stocks were -12.05%. Meanwhile, safe-haven investments benefitted from the uncertainty as gold jumped +12.09% and investment-grade bonds rose +6.00%.

Against this backdrop, the return on the University of Delaware endowment for the fiscal year ended June 30, 2016 was -2.34% net of management fees and expenses. The equity market decline and weak returns from hedge funds were the main contributors to the drop in market value last year. However, this return ranks in the top 38th percentile among University Endowments monitored by Cambridge Associates with assets between $1 and $3 billion. The Investments Office was able to limit the negative impact of the declining markets on the endowment assets due to strong alpha generation from global equities and steady absolute performance from private investments. In addition, asset allocation played an important role in the strong relative returns due to overweights in outperforming U.S. stocks and bonds.

The performance last year is an example of our focus on the preservation of capital and the stability of endowment distributions. Despite the recent decline in the public markets, the endowment was still comfortably able to provide the University with an annual payout that exceeded the prior fiscal year. While we hate to lose money in any given year, we take comfort that we were able to limit the impact of the down markets better than the majority of our endowment peers. We are very proud of the fact that while returns have been stronger than both benchmark and endowment peers over the last twenty years, we have taken less risk than our benchmark and peers in achieving these market beating results.
The Endowment Mission

The endowment provides perpetual funding to support the University’s educational goals while preserving real value for future generations. To that end, the University’s Board of Trustees, Investment Visiting Committee, and Administration have a shared mission to maximize the endowment’s total return consistent with the University’s prudent investment risk constraints. This mission requires an expected long-term return that exceeds the inflation-adjusted annual spending rate. In order to pursue that goal, the University maintains an equity-biased portfolio and seeks to partner with best-in-class management firms across diverse asset categories while also managing some endowment assets in-house. The Investments Office manages the endowment under the guidance of and within the policies authorized by the Investment Visiting Committee of the University.

The target spending rate for the endowment is 4% to 5% of the three-year average market value as determined annually by the University’s trustees. In Fiscal 2016, the spending distribution to the University was $51 million, providing financial support and flexibility to the University’s operating budget. In recent years, the endowment’s role in supporting the University has become more meaningful as funding from the State of Delaware has declined. This support is likely to become even more important in the coming years given the challenges facing higher education today. The blue line in the chart below shows the decline in operating appropriations from the State of Delaware as a percentage of total operating revenue at the University, while the red line shows the increase in endowment payout to the University over time. The ongoing generosity of our alumni and friends has helped to ensure the long-term financial health of the University through the establishment of endowed gifts. A strong endowment allows the University to fund initiatives that will have a lasting impact on the student experience and the overall institution.

Historical State Operating Appropriations as a Percentage of Operating Revenue

State Operating Appropriations/Operating Revenue (LHS, percent)  
Endowment Spending Payout (RHS, $thousands)
The Endowment Purpose

The endowment supports a variety of aspects of University life. There are more than 1,000 endowment accounts that make up the overall University endowment that have been established by our generous alumni and friends. The majority of these endowment accounts were established for the support of our students so that young people of every background can attend the University of Delaware. Diversity is a core educational value and a guiding principle of the 2015 Delaware Will Shine Strategic Plan. Research shows that campus communities with meaningful diversity practices significantly increase the quality and value of education for all students. These transformative learning experiences enhance critical thinking, promote civic responsibility, enrich formal and informal exchanges amongst students from various backgrounds, and prepare our students to navigate in an increasingly diverse and global world. Other endowments have been created for instruction and department research as well as the general ongoing operational needs of the University.

Number of Endowment Accounts by Purpose as of 6/30/16

- Student Aid, 62%
- Instruction & Research, 28%
- General Support, 4%
- Other, 6%
Compounding Growth Over the Long Term

Due to the perpetual nature of the investment program, the long-term performance results are a true reflection of the endowment’s long-term investment horizon. Longer term performance has been strong on both an absolute and relative basis despite challenging market conditions. The endowment recorded an annual return of +7.5% in the twenty years ended June 30, 2016, exceeding the +6.8% annual return for the benchmark and the +5.7% annual return for a portfolio index of 60% global stocks and 40% global bonds. The significant annual outperformance over the last twenty years shows that the endowment model’s long-term investment approach has worked well for the University of Delaware.

The chart below illustrates that the compounding of excess returns can have a significant impact on the University over time. An endowment of $1 million established twenty years ago in 1996 would have grown to a value of $4.3 million compared to a value of only $3 million invested in a global portfolio of 60% stocks and 40% bonds. The $1.3 million in excess investment gains is more than the original gift amount and would contribute an additional $62,000 annually toward the endowment’s purpose. That is enough to make life changing investments in the education and development of many more University of Delaware students.
Asset Allocation

The University has developed asset allocation guidelines based on its total return objectives, income requirements, and capital market expectations. These guidelines are long-term oriented and are consistent with the endowment’s risk posture and investment objectives. Over the last twelve years, the University has dramatically reduced the endowment’s investments in domestic stocks and bonds by reallocating to international and nontraditional asset classes. In 2000, more than 80% of endowment assets were invested in US stocks and bonds with 20% in international assets and 0% invested in hedge funds and private investments. Today, only 40% of assets are invested in U.S. stocks and bonds while 20% are invested in international stocks, 19% in hedge funds and 21% in private investments. As a result, the endowment is now more diversified across asset classes. The broader opportunity set should not only provide higher returns in a greater variety of investment environments but also help to control risk. The University has increased the Private Investments target allocation to 25% to take advantage of the superior risk-adjusted returns generated by this asset class. It will take some time to achieve this target because of the long investment periods associated with this asset class. The source of funds for these investments is currently invested in fixed income and cash.

Endowment Asset Allocation vs. Target Allocation as of 6/30/16

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Current Allocation</th>
<th>Target Allocation</th>
<th>Peers &gt; $1bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Equity</td>
<td>45.5%</td>
<td>45.0%</td>
<td>40.6%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>19.2%</td>
<td>23.3%</td>
<td>20.7%</td>
</tr>
<tr>
<td>Private Investments</td>
<td>20.7%</td>
<td>25.0%</td>
<td>26.9%</td>
</tr>
<tr>
<td>Bonds &amp; Cash</td>
<td>14.7%</td>
<td>12.5%</td>
<td>10.2%</td>
</tr>
</tbody>
</table>

The source of funds for these investments is currently invested in fixed income and cash.
Blue Hen Investment Club

The Blue Hen Investment Club (BHIC) also reached its twenty-year milestone in the latest fiscal year. One of the benefits of working in the Investments Office at the University of Delaware is that we are the administrative advisor for the BHIC which gives us the opportunity to work with the talented students in the College of Business and Economics. The BHIC is a student-run investment fund that invests University money in the stock market and provides a valuable experience to its members by allowing them to manage a real world investment portfolio. The BHIC was founded in 1996 when the University’s Board of Trustees entrusted the club with $500,000 to learn how to manage a real investment portfolio, making it one of the oldest and largest student-run investment clubs in the country. Twenty years later, I am pleased to report that the club is stronger than ever as members learn about the most important aspects of finance and investing, while developing strong teamwork, public speaking and analytical skills. The fund balance as of the end of June 2016 was $1.64 million invested in 31 individual stocks across multiple countries and eight economic sectors. The Executive Committee of the BHIC presents its results annually to the Investment Visiting Committee of the University of Delaware. I am always amazed at the professionalism with which the club is run and the sophisticated investment tools that the students use to manage the portfolio. These students are getting a leg-up on the competition as they leave the University to interview for sought-after positions in the investment management industry because they are already developing the skills that they will need to be successful in the future. The Investments Office has a former BHIC member on staff in the analyst role and we offer a paid internship opportunity to juniors looking to learn more about the investment management industry and further develop their investing skills.

Photo by Lane McLaughlin
New Initiatives

The Investments Office is currently working on a number of initiatives that will seek to both improve performance and reduce costs over the next ten years. The largest cost reductions will come from eliminating fund-of-funds investments in alternative assets, the use of index funds for core equity and bringing some reporting and due diligence functions in-house. These initiatives should lead to a 57 basis point reduction in overall costs which would add $180 million in additional endowment assets over a ten year period. To improve performance, the endowment has been repositioned to become more streamlined with a reduction in the number of mandates and a focus on high conviction portfolios. A continual rise in the number of holdings historically led to an over- diversification of our portfolio. Over-diversification occurs when the number of individual investments in a portfolio exceeds the point at which adding an investment asset does not reduce the overall risk of the portfolio. The greater concentration should help us to achieve better returns over the long term by adding some unsystematic risk back into the program. The reduction of our portfolio holdings will also improve our monitoring capabilities making us better stewards of the endowment.
Looking Ahead

The endowment is designed to provide the University with greater independence, increased financial stability and the means to become a center for academic excellence. Understanding this fundamental purpose is important to understanding the long-term nature of the endowment’s investment process. This global multi-asset class investment framework has proven to be able to exceed public benchmarks over the long term, despite the occasional short-term underperformance. As we forecasted in last year’s annual letter, the capital markets were weaker last year after several strong years coming out of the global financial crisis. We expect that the markets will continue to rise at a mid-single digit pace over the next five years as interest rates start to rise globally and economic growth rates stabilize at a lower rate. As a result of this outlook for positive, but muted returns in the years ahead we are continuing to manage the endowment with a positive bias toward equity investments. Given the challenges facing higher education today, we will pursue long-term investment returns that will enable the University to continue to achieve its goals and maintain its excellence far into the future.

Sincerely,

Keith Walter
Chief Investment Officer

Anthony Bartocci – UD class of 2002
Investment Analyst

Christopher LeRoy – UD class of 2013
Investment Analyst

Stephanie Steenkamer – UD class of 1979
Administrative Assistant

Dr. Dennis Assanis
University President

Alan Brangman
EVP and University Treasurer

Greg Oler
Vice President, Finance