Investment Perspectives From An Endowment CIO

Presented by

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Ivey | Ben Graham Centre for Value Investing

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The views expressed in this presentation are those of Srini Pulavarti and do not necessarily reflect the views and opinions of UCLA or any other entity

Agenda

- **Endowment Investing Today**
- **What Has Happened**
- **What Is Happening**
- **What Should Change**
- **Investment Perspectives**

Endowment Characteristics

Reduced State Funding

Cost of Education Escalating at Unsustainable Rates

Increasing Dependency on Endowments for Funding

Volatile Asset Base, Fixed Liabilities

Balancing Unfunded Commitments and Portfolio Illiquidity

Higher Education Cost Inflation

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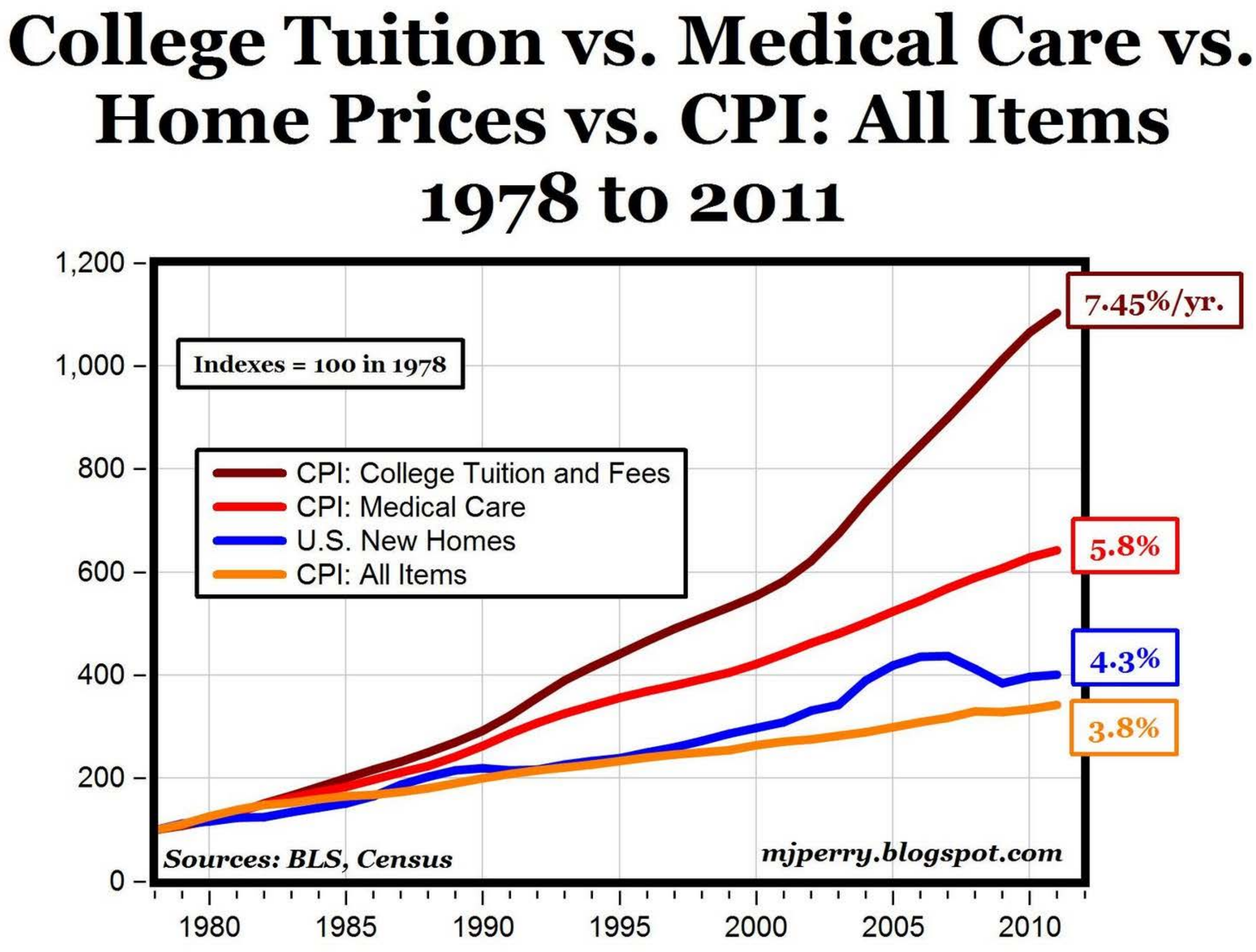

Interaction of Dependency & Risk

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Dependency Ratio = Payout / University's Operating Budget

FYE '12 UCLA Foundation Payout = $74M

FYE '12 UCLA Operating Budget = $5.5B

UCLA Dependency Ratio = ~1.3%

Other Premier Endowment Dependency Ratios:

- **Endowment #1 ($15B+ AUM): 46%**
- **Endowment #2 ($20B+ AUM): 36%**
- **Endowment #3 ($30B+ AUM): 33%**
- **Endowment #4 ($15B+ AUM): 23%**
- **Endowment #5 ($2.5B+ AUM): 15%**

An Endowment's Mission

Preserve corpus

Absolute returns vs. relative returns

Diversify by sector, asset class and geography

Be flexible, opportunistic and disciplined

Long-term horizon

Generate returns in excess of 8%

Required Rate of Return

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~8%+ Return Required Just To Cover Total Spending

Category	% of Endowment
Endowment Payout	6.00%
Inflation Estimate	2.00%
Break-Even Rate of Return	***8.00%***
Real Growth	0 - 1.00%
Target Rate of Return	***~8 - 9.00%***

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What Has Happened

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Portfolio Over-Diversification / Complexity:

- Asset Class Diversification
- Strategy Diversification
- Geographic Diversification
- Manager Diversification

Chasing Historical Returns

Overpaying for Beta

Most Managers Delivered Sub-par Returns

Transfer of Non-Profit/Tax-Exempt Wealth to Managers

Diversification and Sanity

"Wide diversification is only required when investors do not understand what they are doing." - Warren Buffett

"Frankly, I think the whole society is nuts — and the question is: What does a sane man do in an insane society?" - Joseph Heller

Shearing the Sheep

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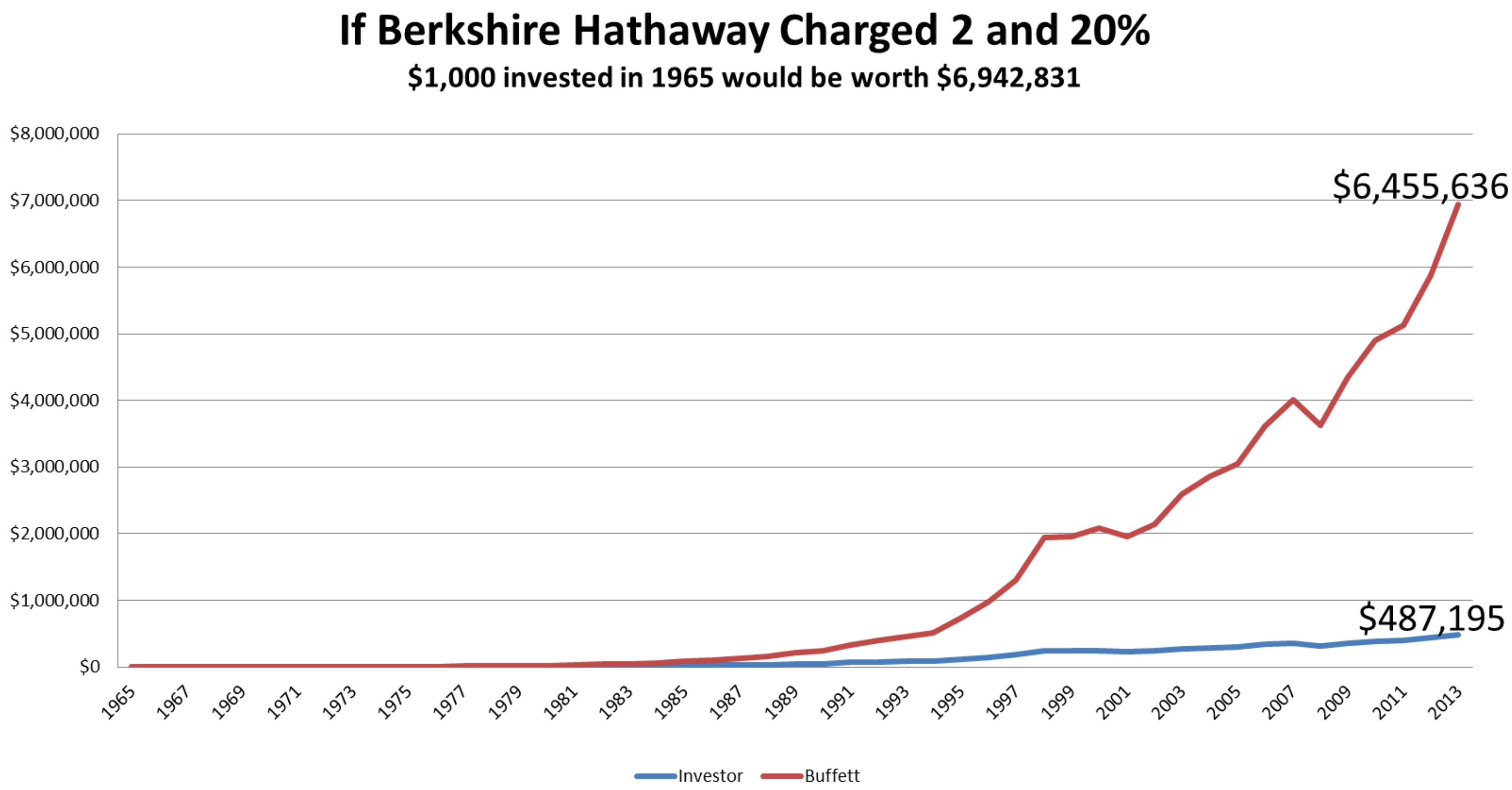

Note: Based on annual percentage change in per-share book value of Berkshire Hathaway. Assumes Warren reinvested all fees in Berkshire.
Source: Berkshire Hathaway 2013 Annual Report

Average Investor's Return Mirage

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1998 to 2010 Hedge Fund Investment Gains Resulted In:

- **$379 Billion in Manager Fees**
- **$70 Billion in Gains to Investors**
- **Investment Profit Spilt: Managers 84% / Investors 16%**

This is when markets were relatively flat

Source: Simon Lack, The Hedge Fund Mirage (2012)

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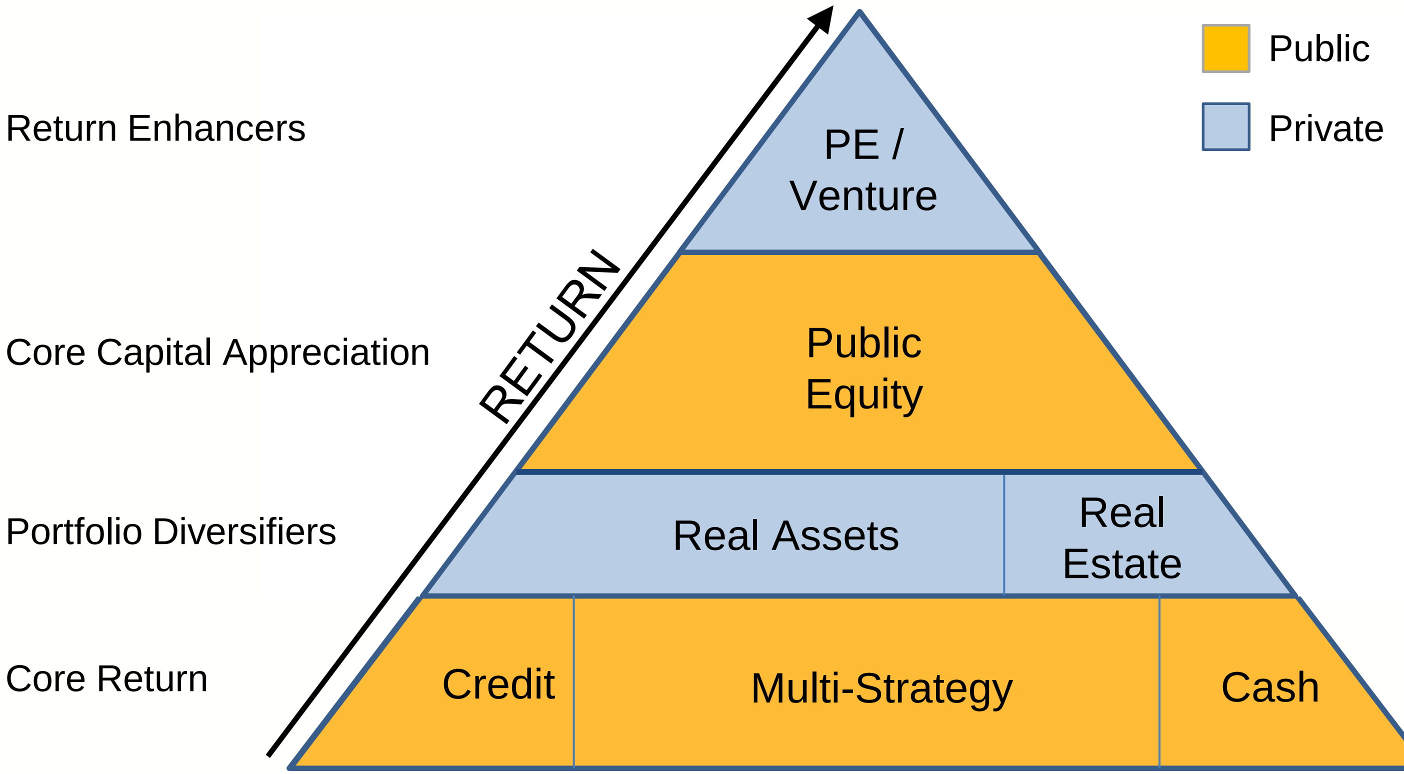
What Is Happening

Investors Are Questioning:

- **Source of Returns**
- **Sustainability of Returns**
- **Asset Allocation Frameworks**
- **Manager Fee Structures**
- **Commitment to Illiquid Asset Classes**
- **External Manager Model**

Rethinking Asset Allocation

Asset Allocation Frameworks Are Being Questioned



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What Should Change

Investors Should Focus More On:

- **Simplified Asset Allocation Framework**
- **Longer Term Asset/Liability Matching**
- **Absolute Measurement of Risk**
- **Manager Fees**
- **Alignment of Incentives with Managers**
- **Increased Involvement by Stakeholders**

Active Management

US Markets

- High Quality Markets
- 1/3 is Indexed

Non-US Developed Markets

- Medium Quality Markets
- Room for Active Management

Emerging Markets

- Low Quality Markets
- More Room for Active Management

Quality of Financial Markets

Factors that Impact the Quality of Financial Markets:

- **Financial Reporting Requirements**
- **Quality of Management**
- **Legal Structure and Process**
- **Rights of Property Owners**
- **Liquidity of Markets**
- **Sophistication of Market Participants**

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Markets Today

Bubbles

Distortions

Excess Liquidity

Excess Capital Chasing Few Good Investments

Creation Of New Bubbles

Markets Today

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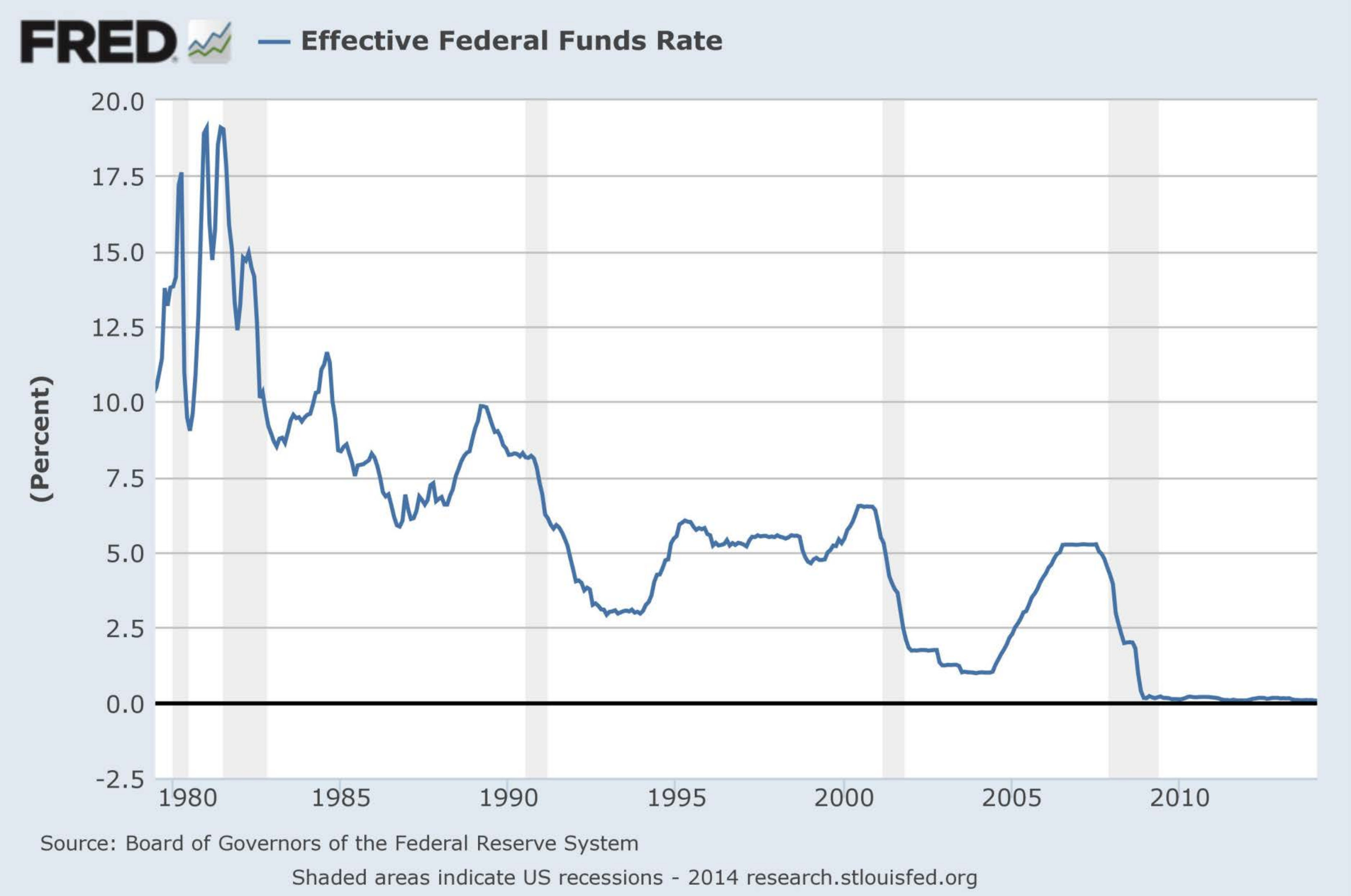

Big Are Getting Bigger

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	Top 10 S&P 500 Components (Million, USD $)					
	1980	1999	2000	2008	2009	2012
	$236,918	$3,126,121	$2,746,111	$1,866,092	$2,067,173	$2,554,412
1	IBM	Microsoft	GE	ExxonMobil	ExxonMobil	Apple
2	AT&T	GE	ExxonMobil	WAL*MART	Microsoft	ExxonMobil
3	EXXON	CISCO	Pfizer	P&G	WAL*MART	Microsoft
4	Standard Oil Company (Indiana)	WAL*MART	citigroup	Microsoft	Google	GE
5	Schlumberger	ExxonMobil	CISCO	AT&T	Apple	IBM
6	Shell	intel	WAL*MART	Johnson&Johnson	Johnson&Johnson	Chevron
7	Mobil	Lucent Technologies	Microsoft	GE	P&G	Johnson&Johnson
8	STANDARD	IBM	AIG	Chevron	IBM	AT&T
9	AtlanticRichfieldCompany	citigroup	MERCK	Pfizer	AT&T	P&G
10	GE	America Online	intel	JPMorgan	JPMorgan	Pfizer

Consolidation is Ubiquitous

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Source: Convergencealimetaire, 2012

Shrinking Credit Spreads

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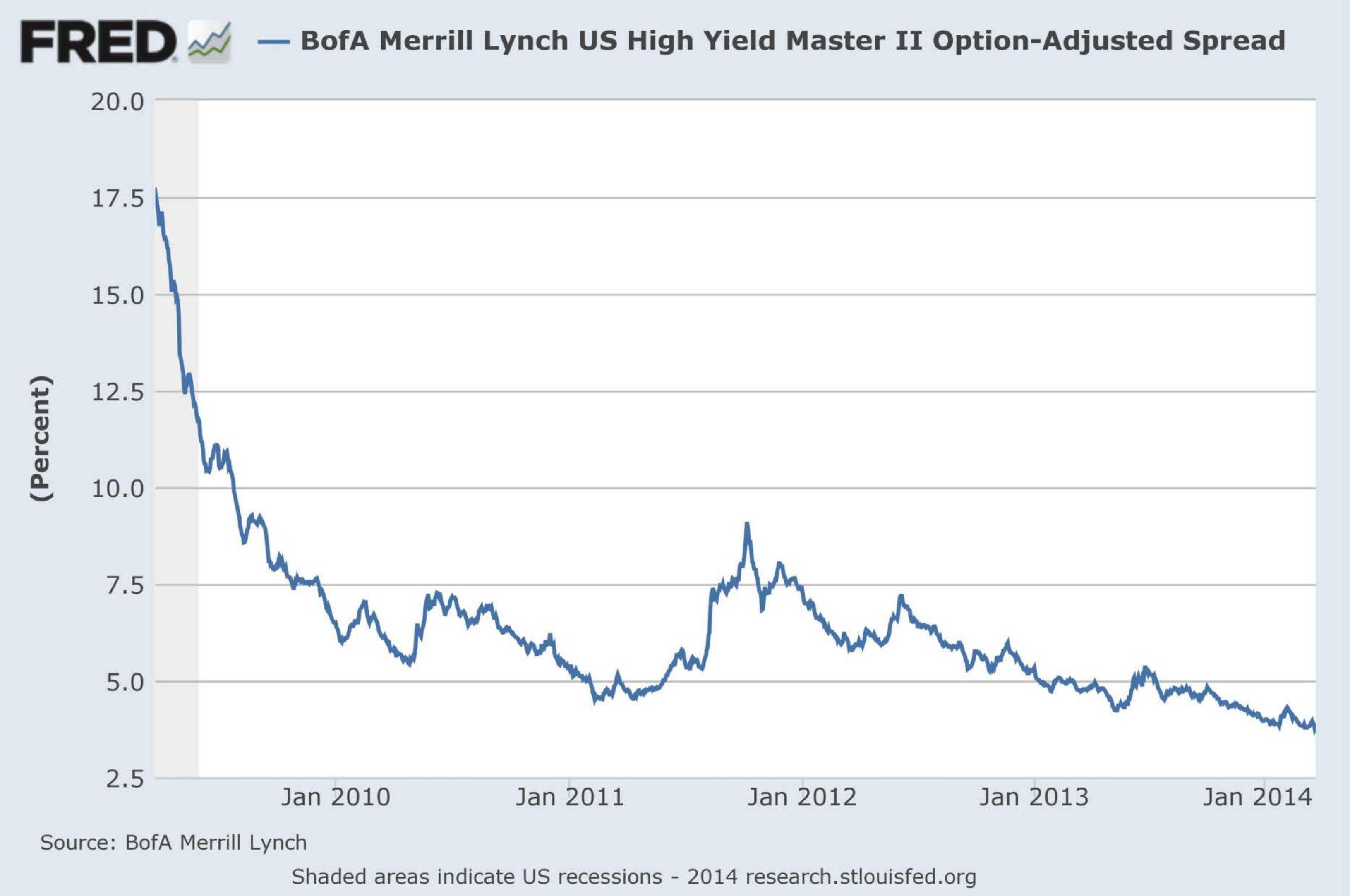

Understanding the Equity Risk Premium

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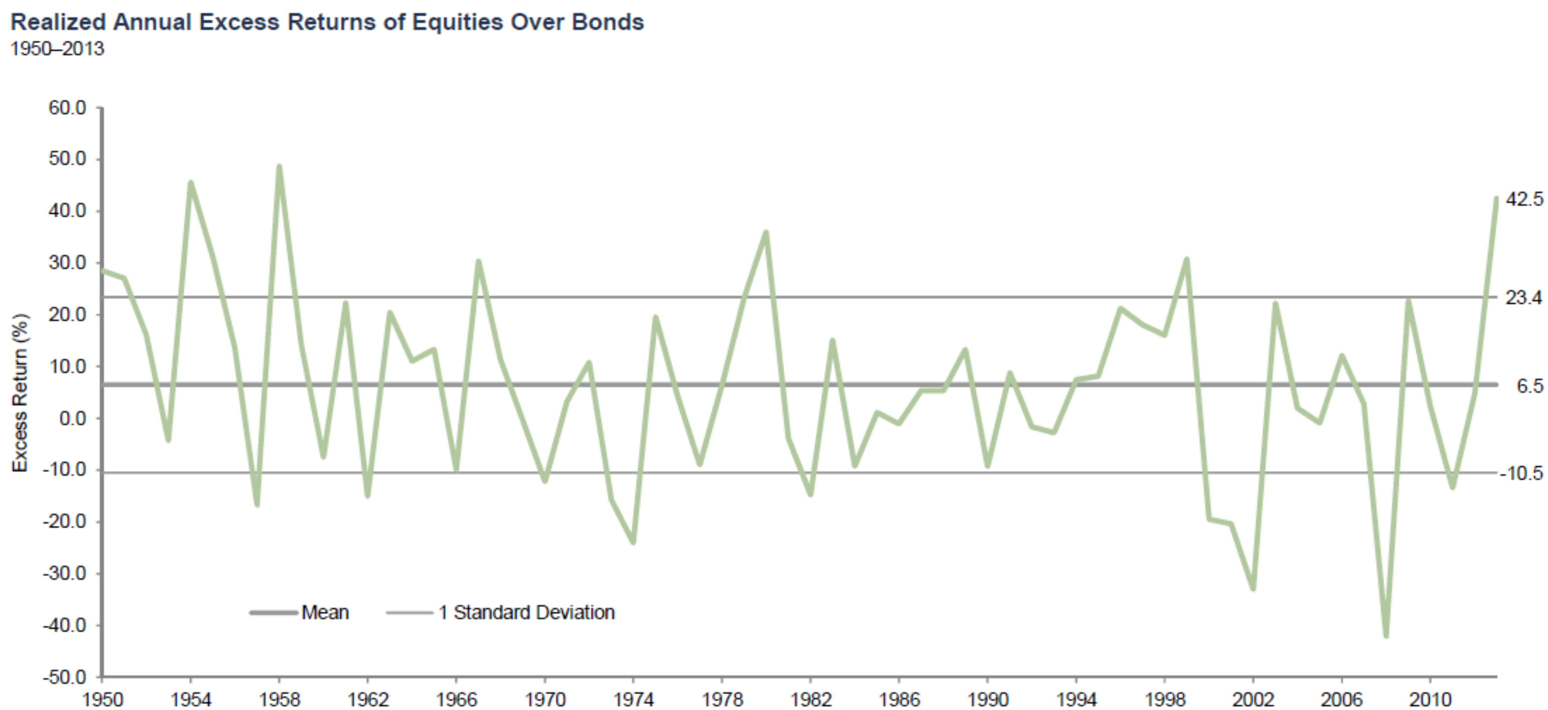
In 2013, the spread between equities and bonds was the highest it has been in 50 years



Sources: Citigroup Global Markets, Global Financial Data, Inc., Standard & Poor's, Thompson Reuters Datastream, and Cambridge Associates.
Note: Realized annual excess return in based on the geometric difference between equities and bonds.

QE Has Distorted Valuations

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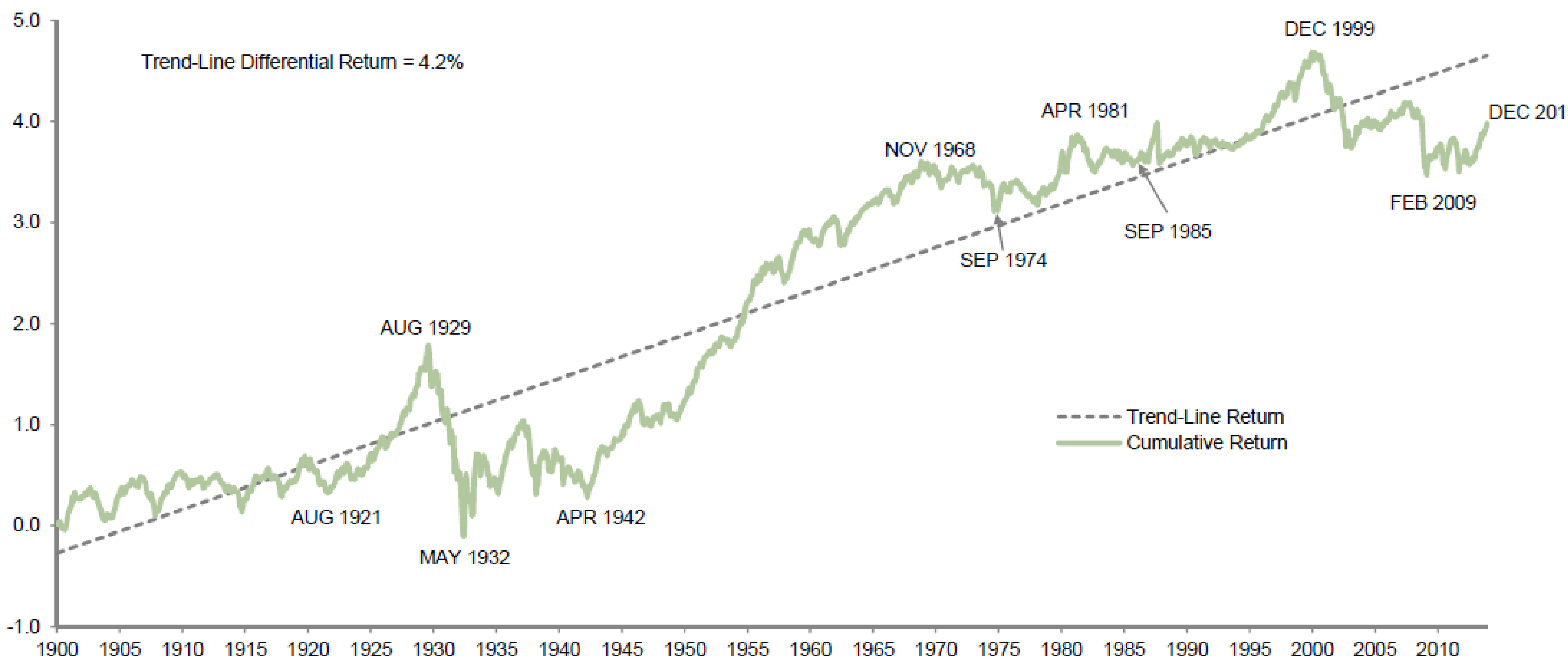
In the last 15 years, bonds have outperformed stocks

Cumulative Differential Between Equity and Bond Returns
1900–2013



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Dividends are Important

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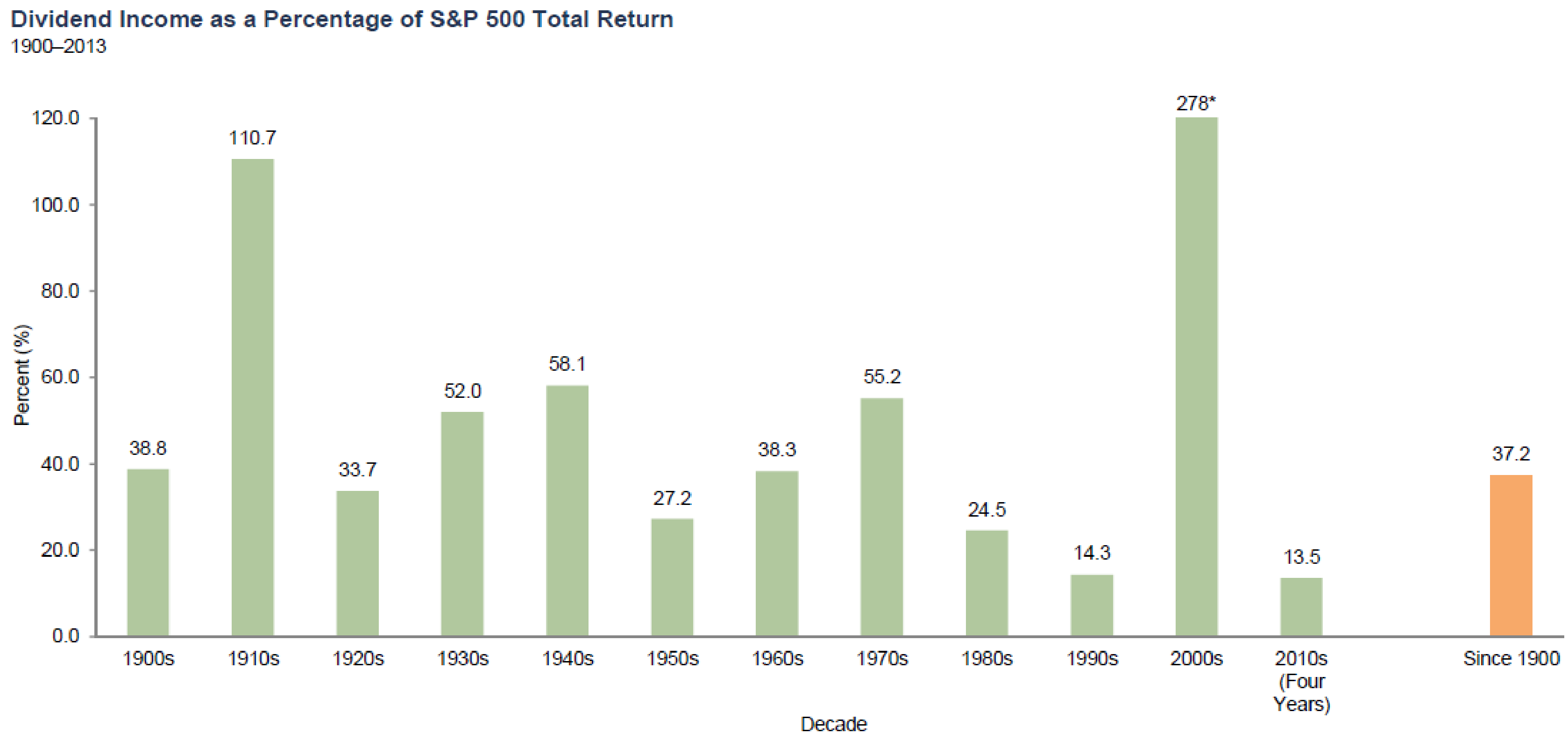

Sources: Global Financial Data, Inc., Standard & Poor's, Thompson Reuters Datastream, and Cambridge Associates.
* Scale capped at 120% for graphing purposes.

Our Current Asset Allocation

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70% - High Quality Global Equities

20% - Distressed / Opportunistic

10% - Cash

Keeping It Simple

Conclusion

- **The Current Model Is Broken**
- **Bubbles Create Opportunity**
- **Stay Opportunistic**
- **Seek Value Globally**
- **Invest For The Long Term (if you can)**