

May 16, 2006

MEMORANDUM

TO: The Finance Committee:

W. Heywood Fralin, Chair
A. Macdonald Caputo
Alan A. Diamonstein
Georgia Willis Fauber
Warren M. Thompson
John O. Wynne
Thomas F. Farrell, II, Ex Officio

and

The Remaining Members of the Board:

Daniel R. Abramson	Catherine S. Neale
Susan Y. Dorsey	Lewis F. Payne
G. Slaughter Fitz-Hugh, Jr.	Don R. Pippin
Glynn D. Key	Gordon F. Rainey, Jr.
Vincent J. Mastracco, Jr.	E. Darracott Vaughan, Jr., M.D.

FROM: Alexander G. Gilliam, Jr.

SUBJECT: Minutes of the Finance Committee Meeting on
May 16, 2006

The Finance Committee of the Board of Visitors of the University of Virginia met, in Open Session, at 10:40 a.m., Tuesday, May 16, 2006, in the Byrd Seminar Room at the Harrison Institute; W. Heywood Fralin, Chair, presided. A. Macdonald Caputo, Alan A. Diamonstein, Ms. Georgia Willis Fauber, Warren M. Thompson, and Thomas F. Farrell, II, Rector, were present.

Present as well were Daniel R. Abramson, G. Slaughter Fitz-Hugh, Jr., Ms. Glynn D. Key, Vincent J. Mastracco, Jr., Lewis F. Payne, and Don R. Pippin.

Also present were John T. Casteen, III, Leonard W. Sandridge, Alexander G. Gilliam, Jr., Paul J. Forch, Gene D. Block, Arthur Garson, Jr., M.D., R. Edward Howell, Ms. Yoke San L. Reynolds,

Ms. Colette Sheehy, William B. Harvey, Larry Fitzgerald, and Ms. Jeanne Flippo Bailes.

The Chair called the meeting to order and asked Mr. Sandridge, Executive Vice President and Chief Operating Officer, to present the Agenda.

2006-2007 BUDGET

Mr. Sandridge noted that the Medical Center Operating Board, meeting on May 11th, had approved the Medical Center budget, as the Wise Board has approved the budget for The University of Virginia's College at Wise.

The expenditure budget proposal for all three divisions of the University - the Academic Division, the Medical Center, and the College at Wise - totals \$1.97billion, which is an increase of 6.7%. This breaks down to \$1,069.9million, an increase of 6%, for the Academic Division; \$866million for the Medical Center, an increase of 7.4%; and \$30.4million for Wise, an increase of 11.7%.

Mr. Sandridge asked Ms. Sheehy, Vice President for Management and Budget, to present the budget.

Ms. Sheehy reviewed the budget making process. She noted, as had Mr. Sandridge previously, that because of the impasse on the state budget in the General Assembly, the University's budget proposals are conservative. Nonetheless, such Board initiatives as Access UVa, deferred maintenance, competitive compensation and research enhancement, have been met. The budget assumes the continued implementation of the Health System's Decade Plan, as well as the achievement of a 4.8% operating margin in the Medical Center - although as Mr. Sandridge had noted on this last point, a certain flexibility is to be allowed in order for the Hospital to meet its deficit in patient beds.

BUDGET - ACADEMIC DIVISION

Turning to the Academic Division, which has an expenditure budget proposal of \$1,069.9million, Ms. Sheehy said Tuition and Fees account for 28% of revenues, Grants and Contracts 25.8%, General Funds and Private Sources each 14.2%, Auxiliaries 13.2%, and 4.6% from Other. Instruction amounts to 25.9% of expenditures, Research and Publication Services 25.4%, Auxiliaries 13.2%, Academic 11%, Financial Aid 9.9%, and Other 14.6%.

Ms. Sheehy discussed in some detail a variety of new commitments and unavoidable increases included in the Academic Division budget.

BUDGET - PRATT FUND

Monies from the Pratt Fund, according to the terms of the bequest of Mr. Pratt, may be used for certain purposes in the School of Medicine and in the Departments of Biology, Mathematics, Physics and Chemistry. The budget proposes an allocation of \$1,300,000 for research and fellowships in the School of Medicine, and \$2,069,000 for the stated departments in Arts and Sciences.

BUDGET - THE UNIVERSITY OF VIRGINIA'S COLLEGE AT WISE

Continuing to the College at Wise, Ms. Sheehy noted that the College has 1,723 students, 141 faculty, and 123 support staff. The proposed expenditure budget is \$30.4million, of which 71.3% is designated for Educational and General, 21.1% for Auxiliaries, and 7.6% for Student Aid. Revenue sources include 50.4% from General Funds, 21.1% from Auxiliaries, 18% from Tuition and Fees, 5.7% from Grants and Contracts, and 4.8% from Other. The expenditure budget represents an 11.7% increase over the last budget, and assumes a state general fund increase of 20%. Tuition revenues will increase 10.6% and sponsored research and private support each will generate an additional 5%.

BUDGET - MEDICAL CENTER

Mr. Howell, Vice President and Chief Executive Officer of the Medical Center, gave an overview of the proposed Medical Center budget. He then asked Mr. Fitzgerald, Chief Financial Officer at the Medical Center, to present the budget in more detail.

Among the assumptions made in preparing the budget, Mr. Fitzgerald said, are expanding operating room and bed capacity, a rate increase in the range of 8 to 9.9%, provision for salary rises for employees and residents, and a capital budget of \$73.8million. Budgetary challenges facing the Medical Center include managing capacity, maintaining an adequate clinical workforce, controlling supply costs, and Medicaid and indigent care funding.

The proposed operating expenditure budget is set at \$866million, an increase of 7.6%. Projected operating expenses are \$804.5million, and the total operating margin is expected to be 4.8%, or \$60.4million.

The Chair called for resolutions approving the four elements of the University's budget: the Academic Division, The University of Virginia's College at Wise, the Medical Center, and the Pratt Fund Distribution for 2006-2007.

The Committee approved the resolutions and recommended them to the full Board for approval:

APPROVAL OF THE 2006-2007 OPERATING BUDGET FOR THE ACADEMIC DIVISION

RESOLVED that the 2006-2007 Operating Budget for the Academic Division is approved, as recommended by the President and the Chief Financial Officer.

APPROVAL OF THE 2006-2007 OPERATING BUDGET FOR THE UNIVERSITY OF VIRGINIA'S COLLEGE AT WISE

RESOLVED that the 2006-2007 Operating Budget for The University of Virginia's College at Wise is approved, as recommended by the President and the Chief Financial Officer.

APPROVAL OF THE 2006-2007 OPERATING AND CAPITAL BUDGET FOR THE UNIVERSITY OF VIRGINIA MEDICAL CENTER

RESOLVED that the 2006-2007 Operating and Capital Budget for the University of Virginia Medical Center is approved, as recommended by the President, the Chief Financial Officer, and the Medical Center Operating Board. In approving this budget, the Board of Visitors takes note that flexibility in the proposed Medical Center operating margin must be allowed in order to accommodate costs related to high occupancy and limited bed availability.

APPROVAL OF PRATT FUND DISTRIBUTION FOR 2006-2007

RESOLVED that the budget for the expenditure of funds from the Estate of John Lee Pratt be approved to supplement appropriations made by the Commonwealth of Virginia for the School of Medicine and Departments of Biology, Chemistry, Mathematics, and Physics in the College of Arts and Sciences. Departmental allocations, not to exceed \$3,368,652 for 2006-2007, are suggested by the department chairs and recommended by the dean of each school. To the extent the annual income from the endowment is not adequate to meet the recommended distribution, the principal of the endowment will be disinvested to provide funds for the approved budgets.

APPROVAL OF AUTHORIZATION FOR THE EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER

RESOLVED, as the budget for 2006-2007 for the Commonwealth has not yet been approved, the Executive Vice President and Chief Operating Officer is authorized to make whatever technical adjustments to the 2006-2007 University budget might be necessitated by the final State budget.

SPENDING POLICY

Mr. Sandridge explained that a new spending policy is not being brought to the Committee for approval. Because the return on the Endowment has been substantially above that projected when the payouts were established, and the current spending policy specifies that the Finance Committee may recommend changing the rate of increase, the Committee is being asked to adjust the spending rate. The new rate increases the payout for class A and class B shares, making the payment rates the same for both.

Ms. Reynolds, the Vice President for Finance, explained the proposal in some detail.

On motion, the Committee adopted the following resolution approving the change and recommended it to the full Board:

APPROVAL OF ENDOWMENT SPENDING POLICY

WHEREAS, the University's current endowment spending policy, approved by the Board of Visitors in March 2005, calls for a percentage increase in the annual distribution from the endowment, unless such increase causes the distribution to fall outside a range defined as 3.5 percent on the low end and 5.5 percent on the high end of the market value of the Pooled Endowment Fund;

WHEREAS, the policy specifies that if the distribution falls outside of this range, the Finance Committee may recommend either raising or lowering the rate; and

WHEREAS, the fiscal year 2006-2007 distribution as a percentage of March 31, 2006 market value will be below 3.5 percent of the market value for class A shares.

RESOLVED that for fiscal year 2006-2007, the spending rate for class A and class B shares will be adjusted to 4.0 percent of the market value at March 31, 2006, achieving the objective of the payment rate for class A shares that is equal to the payout rate for class B shares.

FINANCE COMMITTEE WORKPLAN

In the interest of saving time, Mr. Sandridge referred Members to the written progress report on the Finance Committee's Workplan, rather than giving an oral report. In sum, the Committee is "on target" in meeting its goals.

REPORT ON THE ENDOWMENT

The customary report on the Endowment was given to the Committee as a written report (see Attachment). Mr. Sandridge said he had just received April figures (the written report reflects market value and performance as of March 31st) which indicate that the rate of return for the current fiscal year, as of April 30th, is 17.1%.

On motion, the meeting was adjourned at 12:00 noon.

AGG:lah

These minutes have been posted to the University of Virginia's Board of Visitors website.

<http://www.virginia.edu/bov/financeminutes.html>

ATTACHMENT

UNIVERSITY OF VIRGINIA
BOARD OF VISITORS AGENDA ITEM SUMMARY

BOARD MEETING: May 16, 2006

COMMITTEE: Finance

AGENDA ITEM: II.B. Endowment Report - Market Value
and Performance as of March 31, 2006

ACTION REQUIRED: None

BACKGROUND: The University of Virginia Investment Management Company (UVIMCO) provides investment management to the Rector and Visitors of the University of Virginia and its related Foundations. Assets deposited in UVIMCO are held in the custody and control of UVIMCO in behalf of the University and Foundations within a long-term, co-mingled investment Pool.

UVIMCO's primary objective in managing the Pool is to maximize long-term real return commensurate with the risk tolerance of the University. To achieve this objective, UVIMCO actively manages the Pool in an attempt to achieve returns that consistently exceed the returns on a passively managed benchmark with similar asset allocation and risk. Recognizing that the University must attract outstanding students, faculty, and staff and provide them appropriate resources, UVIMCO attempts to manage Pool assets to provide long-term real returns that compare favorably with the returns of endowments of other outstanding schools. UVIMCO does not set spending rates. UVIMCO communicates the Pool's risk and return estimates to the University and Foundations for their consideration in setting spending rates.

DISCUSSION:

Performance Summary

Our return of 15 percent for the fiscal year-to-date more than doubled the seven percent return of a traditional 65 percent/35 percent blend of the Russell 3000 and Lehman Aggregate equity and bond market indices. Our 25 percent allocation to public equity provided a remarkable nine month return of 27 percent, largely as a function of our tilt toward emerging markets. Our over 50 percent allocation to hedge funds returned 12 percent for the nine months, keeping pace with the US equity market but lagging the soaring returns provided by foreign equities. The very strong market

returns over recent years and months for real estate and resources have contributed only modestly to our portfolio because of our small allocations and immature portfolios.

Despite its strong return, the Pool trailed its target benchmark by two percent fiscal year-to-date. Our portfolios of managers in the alternative asset classes all underperformed their benchmarks. Underperformance of our hedge fund managers during a period of strong equity market return is familiar and suggests that our hedge fund portfolio has more short exposure than its benchmark. As noted in previous commentary, underperformance of our private investments is a function of our immature portfolios and the J-curve effect.

Outlook and Strategy

At our upcoming annual review of investment policy in May, we will consider whether to lessen our heavy reliance on hedge funds and to increase our allocations to more traditional asset classes. We took a small step in that direction last year, which aided this year's returns, and we may take another step this year.

However, any such decision to increase traditional market exposure will be more difficult after the spectacular recent appreciation of risky assets around the world. While our hedge fund portfolio has provided a more than reasonable three-year compound return of 13 percent, it has dramatically lagged the 19 percent return of the U.S. equity market, the 32 percent return of developed non-US equity markets, the 47 percent return of emerging equity markets, and the three-year internal rates of return of 26 percent, 22 percent, and 27 percent that Cambridge reports for its universes of private equity, real estate, and resources managers, respectively. Undoubtedly many of our peers have larger allocations; and while we may suspect that we are underinvested in public equities, private equities, and real assets, we are loath to chase past returns.

Public Equity

The rapid ascent of global equity market prices continued during the first quarter of 2006. As has been the case for several years, emerging equity markets led the climb, up another 12 percent during the last quarter alone. Developed international markets followed close behind up nine percent, and the lagging US market still managed a five percent return for the quarter. Fiscal year to date, the ascent of global equity market prices was even higher and the performance differential among the regions wider,

with emerging markets up a dizzying 42 percent, developed international markets up 26 percent, and US equities up 12 percent. Within the US, small capitalization stocks dominated the broader market, up 14 percent for the quarter and 21 percent fiscal year-to-date.

Our long-held tilt toward emerging markets continued to pay off in both the first quarter and fiscal year-to-date. Our total public equity returns of nine percent for the quarter and 27 percent year-to-date exceeded our target blend of US, developed international, and emerging market equity indices by one percent and three percent, respectively. Individually, our US equity and developed international equity portfolios outperformed their benchmarks year-to-date but our emerging market portfolio lagged its benchmark largely because of our overweight to Asia.

Looking forward, we seek to reduce our tilt to small capitalization value in the US and our tilt toward emerging markets internationally. We made some changes during the quarter to accomplish these shifts. Within US equity we increased the large capitalization component of the portfolio by \$50 million, thus lessening our tilt to small value. We also reduced our emerging market portfolio by a net \$70 million, divesting \$100 million from a broad market fund while investing \$30 million in a specialized strategy in Korea.

Hedge Funds

Our hedge fund portfolio returned four percent for the quarter and 12 percent fiscal year-to-date, lagging the returns of our Tremont benchmark, which is up six percent and 14 percent for the quarter and fiscal year-to-date, respectively. The bulk of this underperformance can be attributed to underperformance of our large portfolio of long/short funds. We suspect that the main reason that our long/short managers have underperformed their benchmark is higher exposure on the short side, with much of that short position in small capitalization US stocks. The small capitalization rally in the US was likely more costly to our managers than to those that dominate the index. In the future, we believe this head wind will shift to a tail wind.

We continue to focus on finding great stock pickers organized as long/short hedge funds. We will also continue to diversify our hedge fund portfolio by strategy. We have added to our global macro allocation and are considering increasing our allocation to multi-strategy. Finally, we are looking to commit to opportunistic drawdown funds organized by experienced credit managers in anticipation of a coming credit crunch following the profusion of low

quality issuance of recent years.

Buyout Funds

Fiscal year-to-date our buyout portfolio returned 17 percent, due in part to the continued strong performance of our largest funds (over \$3 billion), which returned 33 percent for the fiscal year-to-date period. For the same period, the Cambridge benchmark returned 26 percent, with mega funds providing some of the strongest returns.

The overwhelming reason for our underperformance in buyout funds is our overweight in recent vintage years. As a result of our increase in commitments over the last few years, 28 percent of the market value of our buyout portfolio is from funds raised in 2004-2005, whereas the Cambridge benchmark has only six percent of its value in these vintages. As we would expect, these young funds are not yet providing returns. Cambridge reports a less than one percent fiscal year-to-date return for the universe of 2004-2005 vintage year funds.

The buyout sector continues to see record amounts of capital inflows, pushing entry valuations up and making the deal environment increasingly competitive. We are only committing to managers whom we believe will create value at the operating company level and are avoiding mega funds that rely more on financial engineering and are more subject to public market pricing.

Venture Capital

Our venture portfolio appreciated slightly in the quarter to three percent fiscal year-to-date, trailing the Cambridge benchmark return of ten percent. Industry-wide, late-stage funds that are more exposed to public equity market conditions continue to outperform early-stage funds by a large margin. Our venture capital portfolio is composed almost entirely of early stage funds because we believe that over the long run, early-stage funds will outperform late stage funds as they have over longer-term historical periods.

While the venture space is also experiencing increased inflows - the highest since 2001 - early-stage valuations for venture companies remain at what appear to be reasonable levels. We continue to commit as much as possible to the top tier of brand name firms (which is very little) and only very selectively add newer "emerging" managers.

Real Estate

The real estate portfolio returned 23 percent in the quarter, pushing the portfolio's fiscal year-to-date performance to 28 percent. This nine-month return still trails the Cambridge benchmark return of 32 percent but closed the gap substantially in the quarter. We attribute our lagging performance to our nearly five-year pause in real estate investing from early 1998 to late 2002, a time period that included many of the best vintage years for real estate funds. Approximately 43 percent of the Cambridge benchmark's market value is composed of funds from the 1999-2001 vintages, which had an average return of 46 percent for the fiscal year-to-date period. We have no exposure to these vintage year funds.

As noted last quarter, real estate capitalization rates remain at all time lows and experienced investors have been using this opportunity to sell real estate at what they perceive as extraordinarily high prices. Our investment activity is concentrated on value added managers who build rather than buy cash flow streams and so produce returns that are only incidentally exposed to market prices.

Resources

Our small and newly defined resources portfolio provided a nine-month return of 22 percent benefiting from the strong gains in our upstream oil and gas funds. Despite this strong return, our resources portfolio continues to trail its Cambridge benchmark.

Because of today's high energy and commodity prices, we consider new commitments with caution. Nonetheless, we continue to find some high quality managers with value added and/or hedged strategies that are appropriate for this point in the cycle, and we may make some additional commitments this year.

Fixed Income and Cash

Our small five percent allocation to short duration government bonds provided no return for the quarter and less than a two percent gain for the nine months fiscal year-to-date. The longer duration Lehman Aggregate bond index provided small negative returns over both periods as depreciation from rising interest rates more than offset income.

With cash rates rising to five percent, the cost of holding cash is reduced and the cost of borrowing increased. We still endeavor to fully invest our portfolio by targeting a zero cash balance and we continue to use leverage within many of our alternative investment funds and structures. We are, however, increasingly mindful that with global interest rates rising following a spectacular appreciation of financial assets, the risk as well as the cost of leverage is increasing.