The test of any long-term strategic plan is its performance in the face of a difficult environment. Fiscal year 2000–2001 provided Stanford Management Company (SMC) the opportunity to test our diversified allocation policy. Following a decade of tremendous gains in the U.S. economy and capital markets, growth slowed significantly and the global economy moved toward recession, causing a substantial decline in broad public market stock indices. This environment presented a challenge to endowments. After a decade of outstanding returns, 16 of the largest 20 university endowments showed negative returns for the period ended June 30, 2001. Stanford ranked eighth among this group of 20, reporting a –2.1% return. A difficult market environment in July and August caused further deterioration in Stanford's results, and the return for the fiscal year ended August 31, 2001, was –7.2%. Although Stanford's 2001 returns are disappointing when compared to recent historical results, our diversified portfolio substantially outperformed broad market indices such as the S&P 500, which declined approximately 25% for the year ended August 31, 2001.

Given the perpetual nature of the University, Stanford's strategic investment horizon must be long-term. Our objective is to develop and execute an investment strategy that generates optimal total return (income plus price appreciation) relative to the risk taken. To meet this goal, SMC was established in 1991 to manage Stanford's financial and real estate investment assets. SMC is a division of the University with oversight by a Board of Directors appointed by the University Board of Trustees. The SMC board consists of at least three trustees, several investment and real estate professionals, and University representatives. SMC directs in excess of $10 billion of endowment and trust assets, working capital, temporarily invested expendable funds, and commercial real estate investments including the Stanford Research Park.

SMC's primary endowment management responsibilities involve establishing asset allocation policy and implementing that policy through manager selection. Performance is measured relative to real return objectives, as well as market benchmarks.

Endowment Asset Allocation > Most of Stanford's $8.2 billion of endowment assets are invested in a diversified portfolio, referred to as the Merged Endowment Pool (MEP). Results discussed in this report reflect the performance of this $7.8 billion portfolio. During fiscal year 2000–01, asset allocation targets shifted significantly from the prior year. Fifteen percent of MEP assets were moved from domestic and international public stocks to alternatives in private equity, absolute return, and real estate. SMC also redefined the category of Alternative Investments into its component sectors—Private Equity, Absolute Return, and Natural Resources—to illustrate their relative weights and different risk/return characteristics.

The asset classes of the Merged Endowment Pool and their target allocations as of August 31, 2001 follow:

Asset Class	Strategic Allocation
Domestic Stocks	15%
International Stocks	17%
Private Equity	17%
Absolute Return	12%
Natural Resources	7%
Real Estate	20%
Domestic Fixed Income	12%
	100%

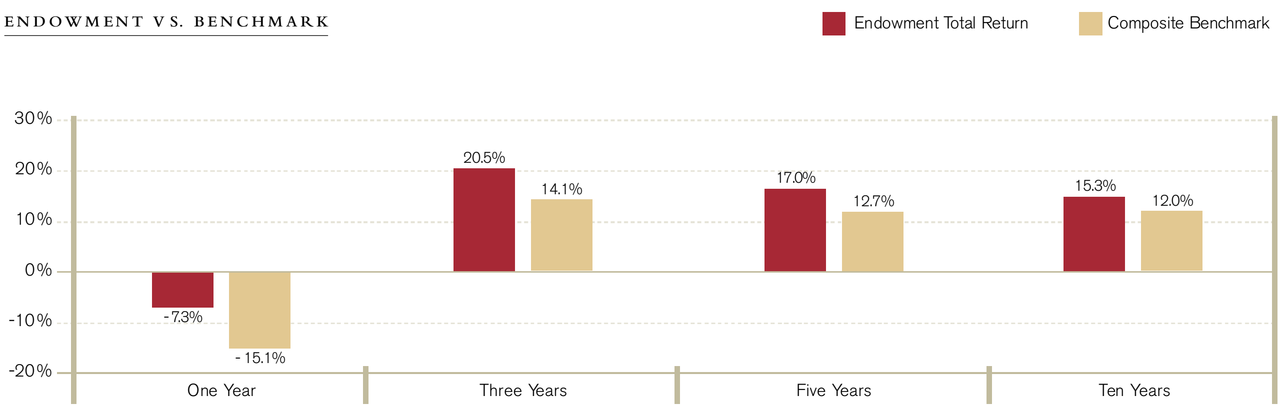
Endowment Performance Compared to Inflation > The table below illustrates annualized returns for various periods ending August 31, 2001 and shows the performance of Stanford's multi-asset strategy in a long-term context. Stanford's objective is to return a minimum of 6.25% over the rate of inflation. If this real return target is achieved over time, the value of the endowment will be maintained net of annual payouts to support endowed activities. Over the past three-, five-, and 10-year periods, Stanford's annualized real return has substantially exceeded the 6.25% target.

	One Year	Three Years	Five Years	Ten Years
Nominal Endowment Return	- 7.3%	20.5%	17.0%	15.3%
GDP Deflator [1]	2.3%	2.0%	1.9%	2.0%
Real Endowment Return	- 9.6%	18.5%	15.1%	13.3%

[1] The Gross Domestic Price (GDP) deflator, a measure of inflation, is through the quarter ended June 30, 2001.

Endowment Performance Compared to Benchmarks > SMC evaluates the performance of investment managers by comparing their returns to benchmarks that are appropriate for each individual asset class. For example, the benchmark for the Domestic Stocks asset class is the Russell 3000 Index. SMC evaluates overall portfolio performance by comparison to a composite benchmark, which represents a blending of the benchmark returns for each asset class weighted by the strategic allocations above. Actual performance, net of management fees, is compared to the composite benchmark for periods ended August 31, 2001:

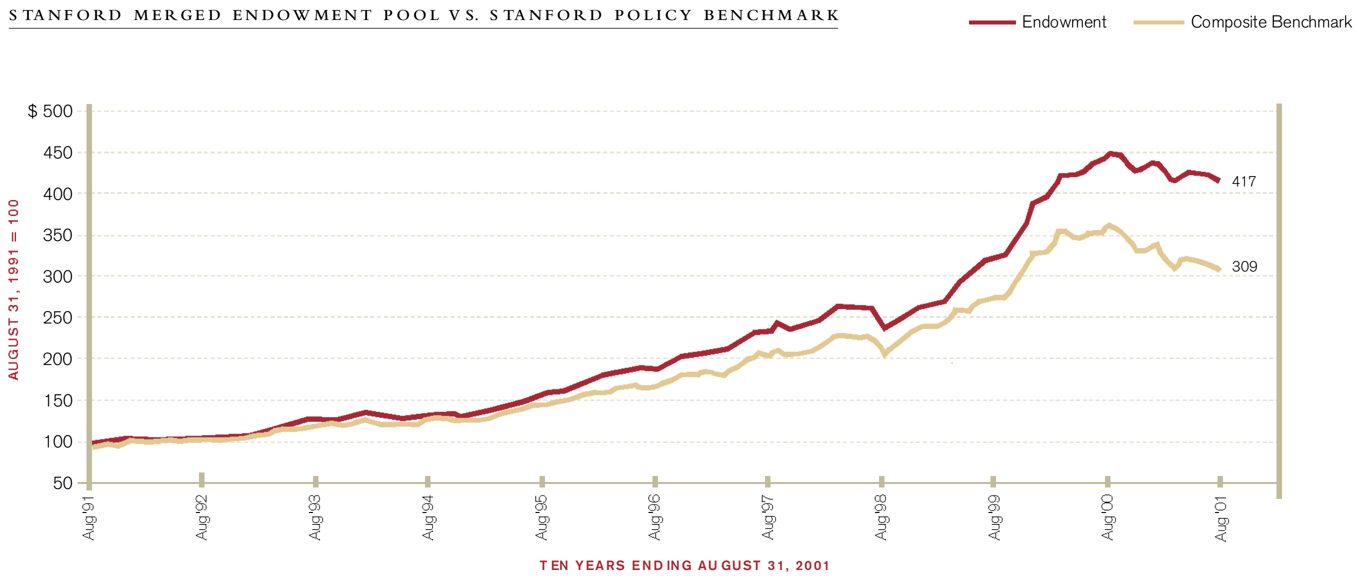
ENDOWMENT VS. BENCHMARK



SMC's effectiveness in implementing the multi-asset class approach, through superior manager selection, has resulted in a consistent and long-term performance advantage over the composite benchmark.

The cumulative return chart below compares the growth of $100 in Stanford's endowment with that of the composite benchmark over the past 10 years:

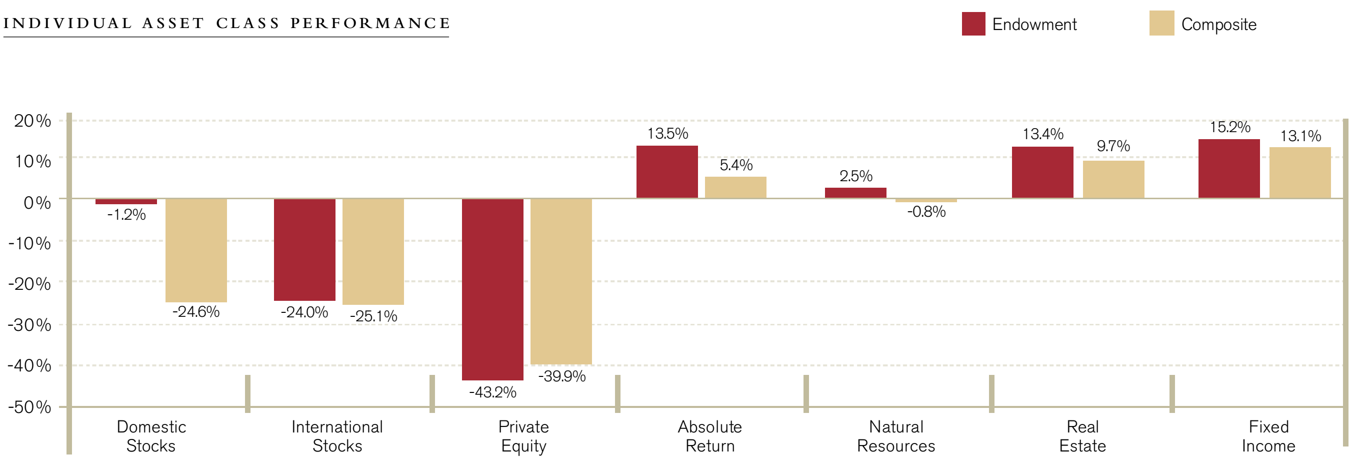
STANFORD MERGED ENDOWMENT POOL VS. STANFORD POLICY BENCHMARK



The performance advantage during this 10-year period relative to benchmark returns has added in excess of $1 billion to the value of the endowment.

Individual Asset Class Performance > The performance of the individual asset classes for the year ended August 31, 2001 gives more insight into the difficult environment and illustrates the benefits of diversification. The graph below shows individual class returns relative to each benchmark:

INDIVIDUAL ASSET CLASS PERFORMANCE



One year ended August 31, 2001

Stanford's Domestic Stock portfolio has been deliberately over-weighted in value stocks to offset the growth stock-oriented characteristics of venture capital partnerships held in Private Equity. This value orientation in Domestic Stocks resulted in a year of strong performance relative to benchmark as value stocks significantly outperformed the broader market. International equity, while slightly outperforming the benchmark, suffered a market correction similar to that of the broad domestic stock market in an environment of global economic uncertainty.

Private Equity represented the most challenging asset sector for SMC, when measured on a one-year return basis. Negative returns in this asset sector are due substantially to reversal of unrealized gains reported in prior periods. Despite this recent reversal, Private Equity has been a very successful asset class when evaluated long term, with investment gains that have added more than $2 billion to the value of the endowment over the last five years.

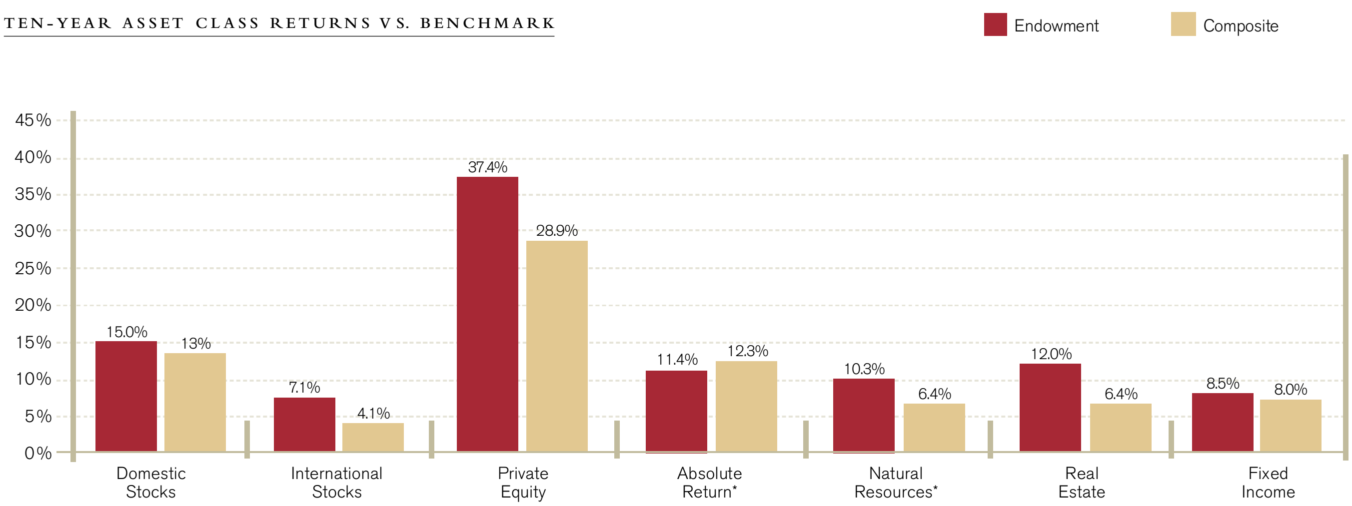
The Absolute Return portfolio is constructed to provide returns that are substantially uncorrelated to the broader equity markets. Absolute Return results for the last 12 months demonstrated successful execution of this strategy. The portfolio provided robust returns in several hedge fund categories including distressed debt, fixed income relative value, and multi-strategy arbitrage funds.

Stanford's endowment has a substantially larger commitment to Real Estate than peer institutions. The strategy of over-weighting real estate investments is based on SMC's extensive experience in real estate development and management of University lands. SMC's core competency in these areas provides a significant advantage when evaluating real estate investments. The Real Estate portfolio performed well in fiscal 2001, contributing returns through asset appreciation and high current cash yield.

Fixed Income was the highest returning asset class over the last 12 months as a result of open market actions by the Federal Reserve designed to reduce interest rates and investors' flight to U.S. Government securities during a time of global uncertainty. Fixed Income demonstrated a negative correlation to the equity markets, illustrating the advantage of a broadly diversified portfolio of assets.

Over a 10-year period, the total endowment return of 15.3% outperformed the benchmark's 12.0% as a result of individual asset class returns as outlined:

TEN-YEAR ASSET CLASS RETURNS VS. BENCHMARK



* Natural Resources and Absolute Return are for an eight-year period.

During the last few years, investment returns have been impacted by extreme volatility in global financial markets, substantial variability in U.S. economic growth, and ongoing change to U.S. Federal Reserve policy. SMC expects this challenging investment environment to continue. We are confident that our long-term investment strategy and manager selection process will preserve endowment capital and provide excellent returns during this uncertain period.

MICHAEL G. McCAFFERY
CEO, Stanford Management Company