2002

REPORT FROM THE STANFORD MANAGEMENT COMPANY

STANFORD UNIVERSITY > 2002

The Stanford Managment Company (SMC) was established in 1991 to manage Stanford's financial and real estate 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 investment and real estate professionals, the University President, Chief Financial Officer, Chair of the Board of Trustees, and the CEO of SMC. The board approves SMC asset allocation targets, oversees the hiring of external asset managers, and evaluates the performance of SMC investments and professionals. The Management Company oversees approximately $9.7 billion of endowment and trust assets, temporarily invested expendable funds, and commercial real estate investments, including the Stanford Research Park and the Stanford Shopping Center.

The majority of the University's endowment assets are invested through the Merged Endowment Pool (MEP), which is a diversified portfolio of actively managed financial and real estate assets valued at $7.6 billion as of June 30, 2002. The following discussion of investment returns and assets refers to the MEP only. MEP performance measurements are calculated on the 12 months ended June 30, 2002 to be comparable to the results of other endowments and foundations. The MEP generated a -2.6% investment return for the 12 months ended June 30, 2002. The MEP's well-diversified mix of assets protected the portfolio in an extremely difficult period for world financial markets. During the same 12-month period, the S&P U.S. stock index fell 18%, and the NASDAQ U.S. stock index fell 32%. The -2.6% one-year return placed Stanford in the top quartile of university and college endowments reporting to the survey conducted by consulting firm Cambridge Associates. Over the past 10 years, the MEP has achieved an annualized rate of return of 14.6%. This investment performance places Stanford in the top 5% of all reporting colleges and universities over the same period, according to Cambridge.

The environment during the past year was one of extreme volatility in virtually all asset classes. Sharp declines in asset values resulted from broad-based market movements, as well as highly specific events. SMC, with assistance from the board, actively managed the endowment through this environment while remaining committed to a long-term investment strategy. The MEP portfolio is constructed on a foundation of modern portfolio theory and strategic asset allocation and is continuously tested through the rigors of state-of-the-art risk management techniques. The portfolio is designed to optimize long-term returns, create consistent annual payout to the University's operating budget, and preserve purchasing power for future generations of Stanford faculty and students.

Since March of 2000, the financial markets have created challenges for all investors. SMC has responded to this environment by remaining committed to our managers, who have demonstrated consistent strategies and excellent returns over a long period of time. The Management Company has invested substantially in increased risk management by hiring additional professionals and implementing new information technology systems. The investment decision process at SMC involves an ongoing review of all portfolio assumptions, a detailed analysis of interim returns, and an in-depth dialogue with the board.

Stanford MEP Asset Allocation > Given the perpetual nature of the University, SMC's investment horizon is very long-term. Our objective is to generate optimal total return relative to an appropriate level of risk for Stanford. SMC re-evaluates portfolio asset allocation each June, reviewing with the SMC board expected risk, return, and correlation among asset classes in the process of confirming current strategic asset allocation targets or setting new targets. The process takes into consideration an analysis of the historical characteristics of asset classes, as well as a review of current market trends. Recently, the process has become complicated by the highly volatile performance of several asset classes, particularly alternative asset categories such as Private Equity. In previous years, allocations to Domestic Public Equity and International Public Equity were reported as two separate asset classes. SMC has moved toward a more global view of the public equity markets and now treats all public equities as components of a single Public Equity asset class. The most significant changes in MEP targets in the June 2000 period include a decrease in Private Equity and increases in Absolute Return and Public Equity. The adjustment in exposure to Public Equity is of particular note. In June of 2000, the portfolio allocation to Public Equity stood at 47%. However, after reviewing various measures of long-term, risk-adjusted returns relative to investment alternatives, SMC decided to lower the allocation to Public Equity to 32% as presented in the 2001 annual report. This represented a significant decrease in Public Equity exposure at a point when SMC perceived increased risk and reversion to mean returns for the asset sector. Since that time, dramatic revaluations have occurred in the public markets, and SMC has moved aggressively to bring the Public Equity allocation up to its current 40% target.

The asset allocation targets for the MEP as of June 30, 2002 are listed below:

STANFORD MEP LONG-TERM POLICY TARGETS

Asset Class	Strategic Allocation
Public Equity	40%
Real Estate	16%
Private Equity	10%
Natural Resources	7%
Absolute Return	15%
Fixed Income	12%
	100%

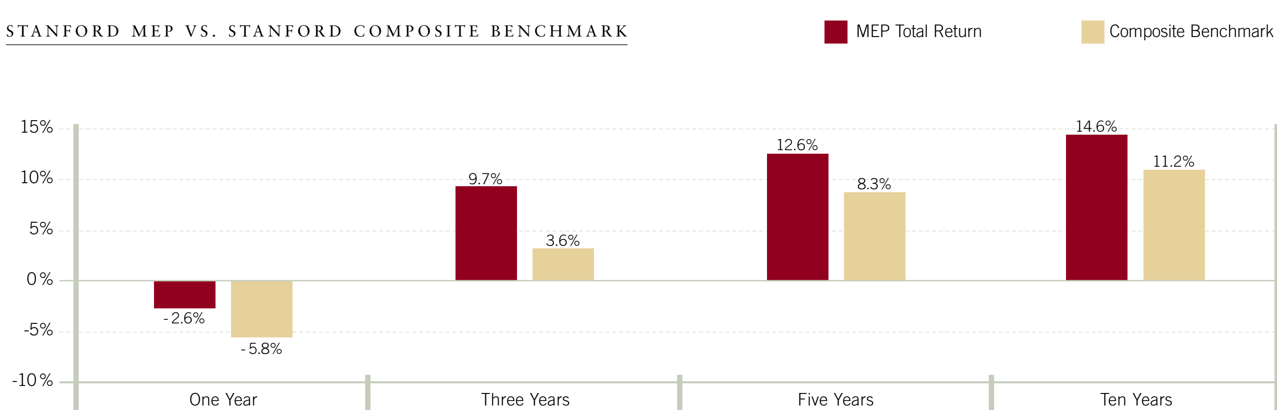
Stanford MEP Performance Compared to Inflation > The table below outlines annualized returns for various periods ending June 30, 2002 and illustrates the performance of the MEP in a long-term context. Stanford's objective is to return a minimum of 6.25% over the rate of inflation. If this real return 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.

STANFORD MEP PERFORMANCE COMPARED TO INFLATION

	One Year	Three Years	Five Years	Ten Years
Nominal MEP Return	- 2.6%	9.7%	12.6%	14.6%
GDP Deflator	1.1%	1.9%	1.7%	1.9%
Real MEP Return	- 3.7%	7.8%	10.9%	12.7%

Stanford MEP 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. SMC may alter an asset class benchmark to allow for a change in investment style, a shift in mix within an asset category, or to account for the impact of leverage. The SMC board reviews asset class benchmarks on an annual basis to ensure comparability. 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. In the table below, actual performance, net of management fees, is compared to the composite benchmark for periods ended June 30, 2002.

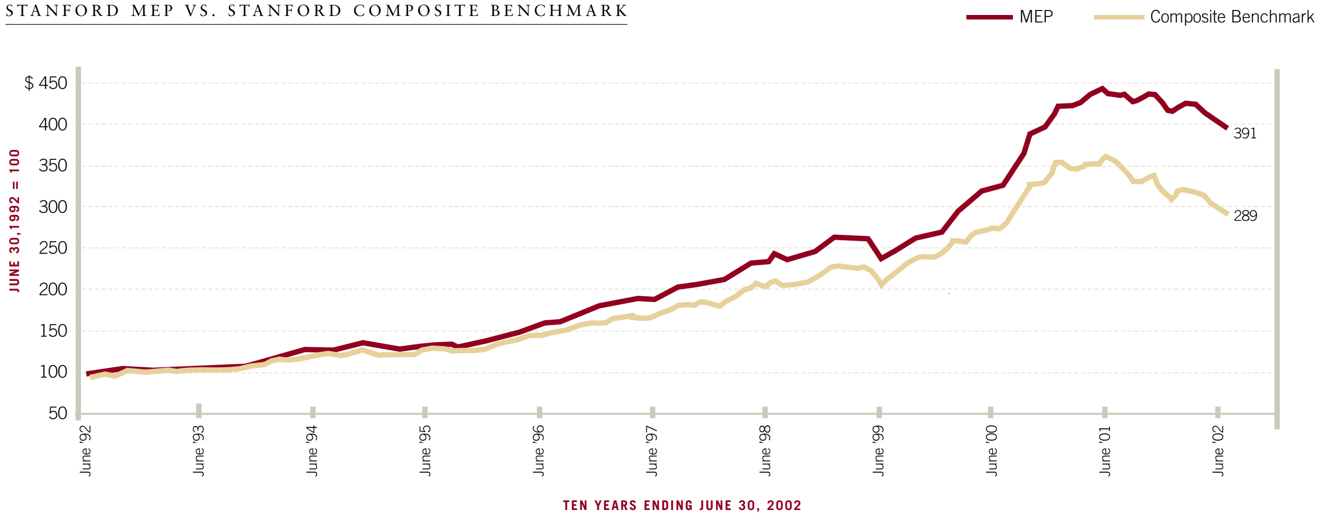
STANFORD MEP VS. STANFORD COMPOSITE BENCHMARK



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:

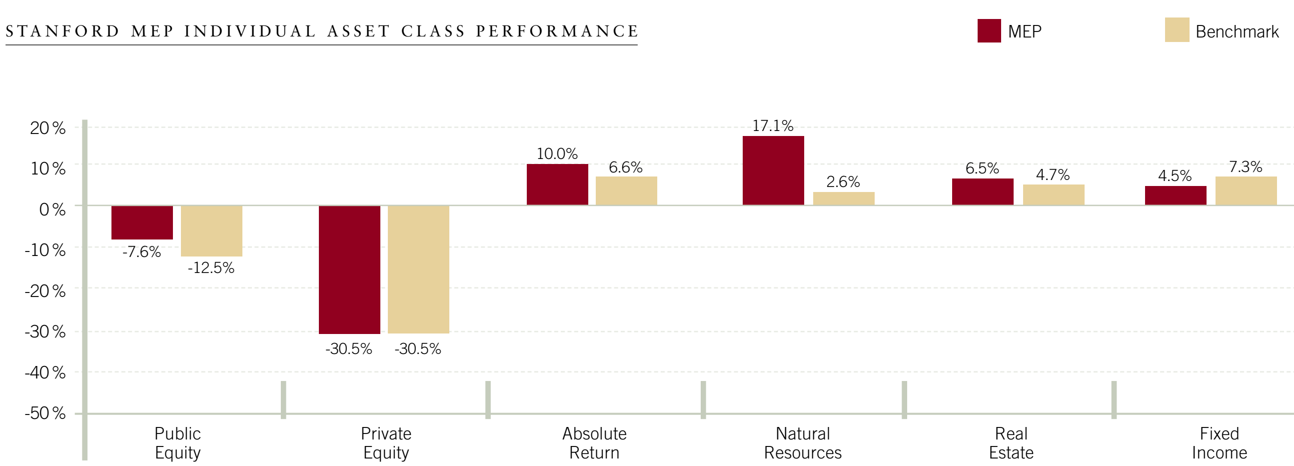
STANFORD MEP VS. STANFORD COMPOSITE BENCHMARK



The performance advantage during this 10-year period relative to benchmark returns has added in excess of $1.5 billion to the value of the endowment.

Stanford MEP Individual Asset Class Performance > The performance of individual asset classes for the 12 months ended June 30, 2002 relative to each asset class benchmark is illustrated in the graph below:

STANFORD MEP INDIVIDUAL ASSET CLASS PERFORMANCE



Although relative performance of asset classes versus benchmarks continues to be positive, the portfolio has exhibited negative absolute returns in more than one asset category for two consecutive years. This is a marked contrast to the late 1990s, when substantially all asset classes contributed positive returns. This volatility in the global market environment places renewed emphasis on the importance of diversification within the portfolio.

The last two years of negative investment performance provide a stark contrast to the previous bull market period from 1982 to 2000, when substantially all financial assets exhibited double-digit annual investment returns. The bull market was a period of protracted interest rate declines, valuation expansion, and seemingly unsustainable economic over-expansion. The view at SMC is that the tailwinds of the bull market have become the headwinds of today's challenging investment environment. Over the past two years, the markets have experienced an overall compression in financial and real estate asset returns that has caused investors to re-examine their investment strategies. For example, many institutions have reacted to today's environment by allocating substantial additional assets to alternative asset categories that are often limited in their investment opportunity and capacity to absorb additional capital. As a result of these trends, SMC has re-examined our assumptions for relative risk-adjusted returns among asset classes and the impact of manager fees on net returns in alternative asset classes.

Stanford's Public Equity portfolio has been deliberately overweighted in value stocks for the last nine years. This value tilt has been effective in offsetting the heavy growth stock concentration in the Venture Capital portfolio and has provided substantial cushion to the dramatic decline in global equity markets. The portfolio also benefited from a substantial weighting to smaller market capitalization stocks. Finally, the Public Equity performance benefited from the introduction of specialist strategies and high-yield bonds into the portfolio, particularly during the later part of the June 30, 2002 period. The impact of these factors, combined with strong performance by managers, accounted for the out-performance in the Public Equity asset class.

Private Equity, a combination of venture capital and leveraged buyout limited partnerships, accounted for the largest negative contribution to portfolio return. Continuing a trend that started in the fall of 2000, venture capital partnerships marked down private investments (reversed accounting gains) which were valued during the NASDAQ bubble environment of the late 1990s. We anticipate venture partnerships may incur further write-downs in the next 12 months. Additionally, SMC is cautious in the current venture capital environment due to the substantial "overhang" of capital raised by venture partnerships in 1999–2001. However, Venture Capital has been a very successful asset class for Stanford when evaluated over the longer term. Over the past eight years, venture capital investment gains have added more than $2 billion to the value of the endowment. SMC will continue to allocate capital to this asset sector by maintaining relationships with proven private equity funds and by selectively establishing investment positions in new funds.

The Absolute Return portfolio is constructed to provide returns that are substantially uncorrelated to the equity markets. The portfolio includes qualitative and fundamental equity hedge fund strategies, distressed debt, fixed income relative value, and multistrategy arbitrage funds. Results for the period ended June 30, 2002 demonstrate the successful execution of these strategies as the portfolio showed substantial positive returns amidst a bearish market climate. SMC remains committed to a well-diversified Absolute Return portfolio, but cautious about the environment due to substantial increases in cash flows from institutional investors into some investment strategies.

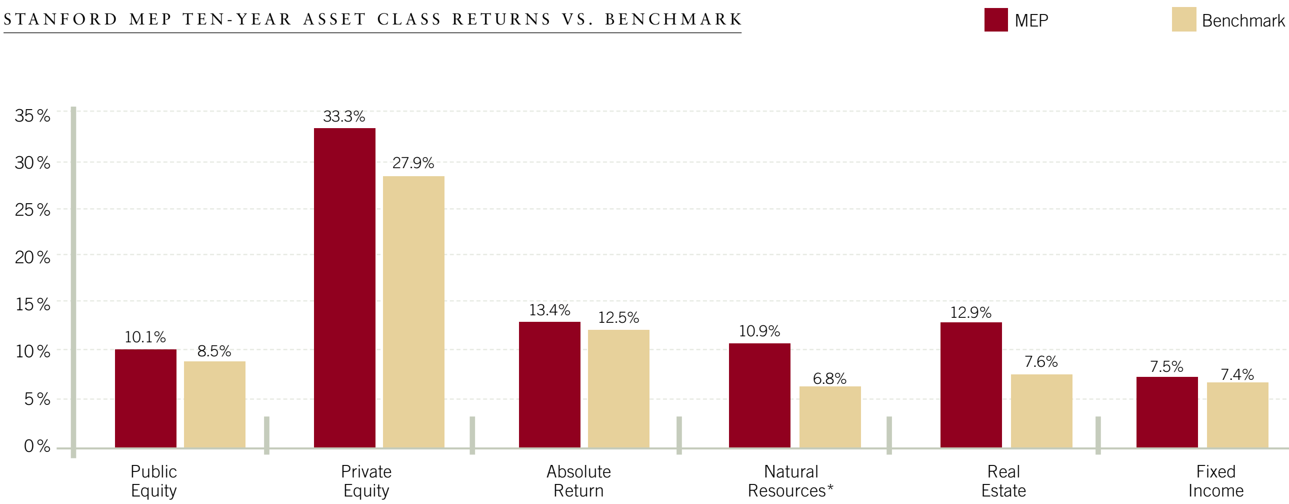
The Natural Resources portfolio comprises domestic and international investments in timber, direct oil and gas assets, and oil and gas private equity partnerships. The portfolio's strong relative returns this period reflect excellent manager performance in combination with strong oil and gas prices. SMC continues to build a diverse portfolio of outstanding managers in the oil, gas, energy, and timber industries.

Stanford's endowment has a substantially larger commitment to Real Estate than our peer institutions. The strategy of overweighting 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 portfolio includes direct investments in commercial and residential real estate development, limited partnership positions in real estate opportunity funds, and publicly traded real estate investment trusts. The MEP also includes the Stanford Shopping Center and a portion of the Stanford Research Park. SMC strives to invest in real estate assets outside of the San Francisco Bay Area and Santa Clara County to provide economic diversification and seismic risk mitigation. The Real Estate portfolio demonstrated strong returns relative to benchmark for the period.

Stanford's Fixed Income portfolio was the only asset class to demonstrate returns less than benchmark. This weak relative performance resulted from losses associated with corporate bonds in the aftermath of corporate malfeasance such as the Enron and WorldCom cases. Total losses attributed to these events were minimal on an overall MEP portfolio basis, but had a material impact within the fixed income asset class. As a result of this experience and increased volatility in the fixed income markets, SMC has outsourced management of the Fixed Income portfolio.

Ten-year asset class returns relative to benchmark illustrate the value of SMC's ability to both shift investment style/strategies and identify outstanding managers in each asset class as outlined below:

STANFORD MEP TEN-YEAR ASSET CLASS RETURNS VS. BENCHMARK



* Natural Resources since inception (nine-year return).

Although SMC is disappointed to show negative investment performance under any circumstances, it is during difficult periods such as the past two years when we most acutely appreciate the positive impact of our diversified investment strategy. Over the past 10 years, the endowment has moved away from a dominant dependence on public stocks to a much more diversified set of financial and real estate assets. During the late 1990s this was, at times, an unpopular investment strategy as the stock market was rising in excess of 20% per year. Over the past two years, however, the U.S. stock market is down more than 30% (June 30, 2000–June 30, 2002) while the endowment is down less than 5%. We are also pleased with the portfolio's performance during a two-year period that has been characterized by repeated challenges to the U.S. financial markets, including a significant recession, the terrorist attacks of September 11, the bursting of the dot-com and telecom bubbles, corporate malfeasance, and political turmoil in the Middle East. Each of these unexpected crises represents another stress test to a portfolio built to withstand the unexpected. While we remain vigilant for the next crisis, as long-term investors we endeavor to turn short-term challenges into successful investment strategies. As an integral component of one of the world's great universities, the Stanford Management Company remains energetically committed to our mission: the pursuit of optimized risk-adjusted investment strategies that preserve the long-term purchasing power of the endowment for future generations.

MICHAEL G. McCAFFERY
President and Chief Executive Officer
Stanford Management Company

MICHAEL L. ROSS
Chief Investment Officer
Stanford Management Company