2003

Report from the Stanford Management Company

The Stanford Management 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, Chairman 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 $10.0 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 $8.2 billion as of June 30, 2003. MEP performance measurements are calculated on the 12 months ended June 30, 2003 to be comparable to the results of other endowments and foundations (the following discussion of endowment performance relates solely to investments in the MEP). The MEP generated a +8.8% investment return for the 12 months ended June 30, 2003. The MEP's well-diversified mix of assets protected the portfolio in an extremely volatile period for world financial markets. During the same 12-month period, the S&P 500 Stock index cycled through six movements of up or down 20%. The 8.8% one-year return placed Stanford in the top quartile of university and college endowments reporting to the survey conducted by the consulting firm of Cambridge Associates. Over the past 10 years, the MEP has achieved an annualized rate of return of 14.0%, growing from $2.4 billion to $8.2 billion. This investment performance places Stanford in the top 5% of all reporting colleges and universities over the same period, according to Cambridge.

SMC, with assistance from its board, actively manages the endowment while remaining committed to a steady 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.

The environment during the past year was one of extreme volatility in virtually all asset classes. This short-term volatility serves as a cautionary note when reviewing short term performance, and brings into focus the longer-term view that underpins the management of a perpetual endowment. SMC endeavors to invest through this volatility, turning our long-term investment focus into a competitive advantage. Although the returns for the last year were +8.8%, the quarterly volatility behind this performance was substantial. The MEP's three-year annualized performance of +1.3% since June 30th, 2000 may represent a more meaningful review of recent endowment results. Over this three-year period, 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.

Endowment 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 reevaluates 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 Management Company entered into a long-term ground lease with a public REIT whereby the University sold 75% of its ownership interest in the Stanford Shopping Center (SSC). After half a century of spectacular success in developing and managing the growth of SSC, the University felt that it was prudent to investigate alternative ownership and management arrangements for what had become one of the top five regional malls in the country. In particular, the regional mall industry has undergone significant consolidation in the last decade, unlocking economies of scale in operating centers that Stanford, as a single-asset owner/operator, was unable to achieve. Our national search resulted in the University signing a 51-year ground lease partnership with the largest, and who we believe is the highest quality mall operator in the country. As a result of this and other transactions consummated during the year, the MEP's exposure to real estate has been reduced.

The corporate accounting scandals of late 2001 and early 2002 created significant turmoil in the financial markets. In particular, many corporate debt instruments were downgraded and pricing of these securities suffered. A number of corporations ultimately were forced to file Chapter 11 bankruptcy due to the combination of the operating stresses of a recession and acutely tight lending practices that followed these accounting problems. This "credit crunch" exacerbated the already weakening prices of many corporate credit instruments. Over the course of late 2001 and early 2002, the Management Company came to the conclusion that this credit crunch represented a contrarian buying opportunity. We engaged investment managers to overweight our exposure to corporate credit instruments; from performing high-yield bonds through negotiated purchases of non-performing corporate bank loans. The markets for corporate credit investments have steadily improved since the summer of 2003—the credit crunch has eased. Recently, we have moved to reduce this overweight to corporate credit investments.

The asset allocation targets for the MEP as of June 30, 2003 are listed below:

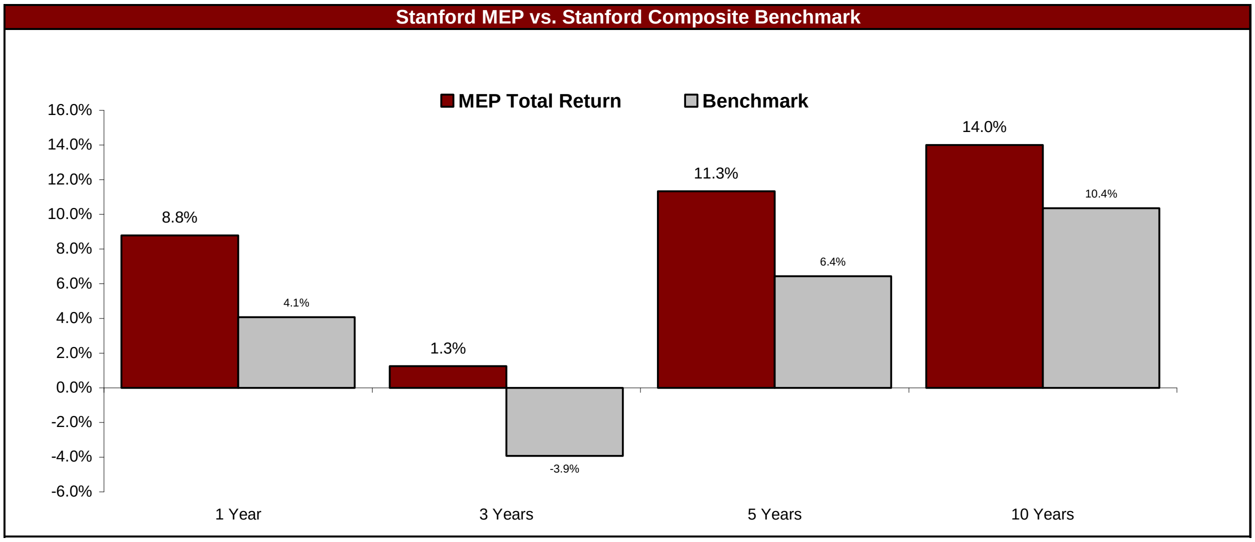
Long-Term Policy Targets	
Asset Class	Strategic Allocation
Public Equity	40%
Real Estate	16%
Private Equity	10%
Natural Resources	7%
Absolute Return	15%
Fixed Income	12%

Endowment Performance Compared to Inflation > The table below outlines annualized returns for various periods ending June 30, 2003 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 one-, five-, and 10-year periods, Stanford's annualized real return has substantially exceeded the 6.25% target.

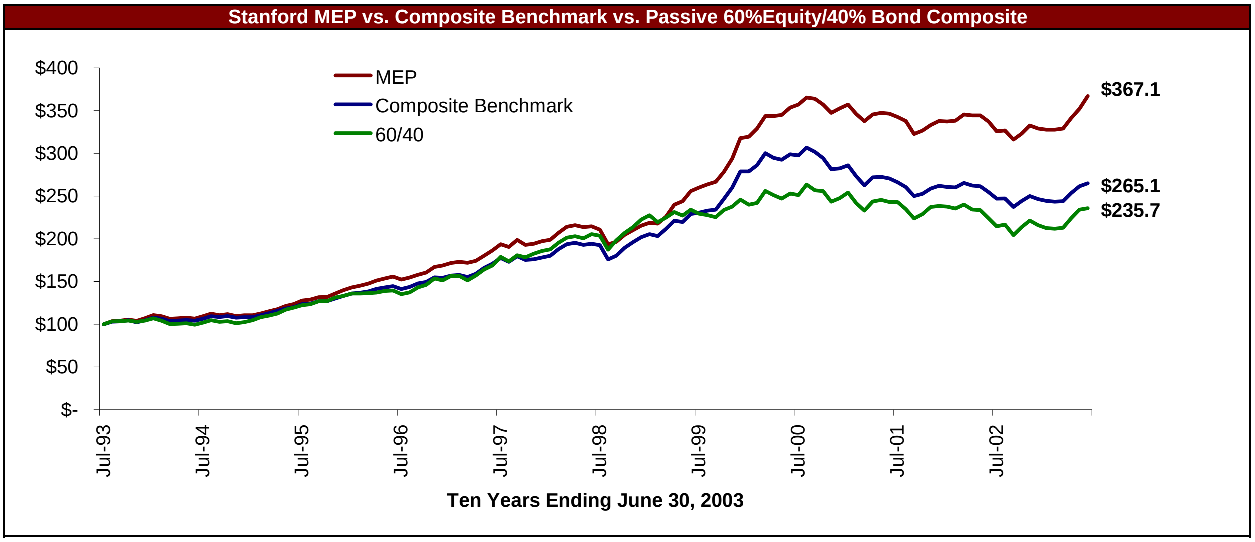
MEP Performance Compared to Inflation				
	One Year	Three Year	Five Year	Ten Year
Nominal Endowment Return	8.8%	1.3%	11.3%	14.0%
GDP Deflator	1.5%	1.6%	1.7%	1.8%
Real Endowment Return	7.2%	-0.4%	9.6%	12.2%

Note: Numbers may not add due to rounding.

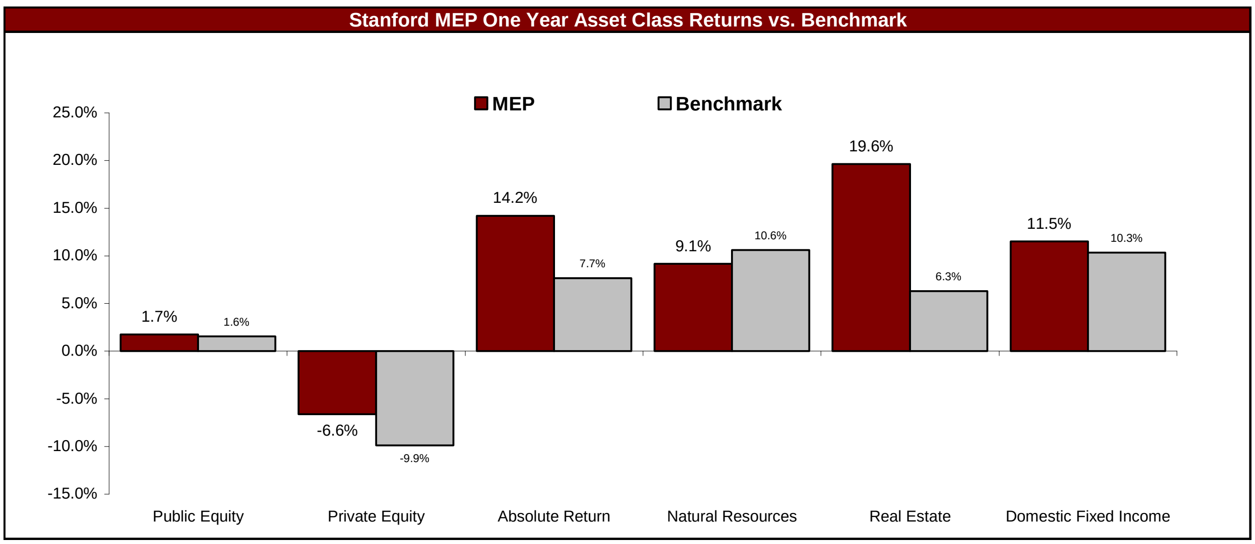
Endowment Performance Compared to Benchmarks > SMC evaluates the performance of investment managers by comparing their returns to benchmarks that are appropriate for each individual asset class. SMC may alter an asset class benchmark to allow for a change in investment style, a shift in mix within an 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, 2003.



SMC's effectiveness in implementing its investment strategies 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. The performance advantage attributable to superior active manager selection during this 10-year period (relative to benchmark returns) has added in excess of $2.0 billion to the value of the endowment. The chart also compares the growth of this $100 against a passive "60/40 portfolio" (benchmark returns for a portfolio consisting of 60% stocks and 40% bonds) which arguably represents a more traditional passive asset allocation. As one can observe from the chart, this passive 60/40 portfolio tracked the return of the MEP quite closely from 1993 through 1999. During that period, SMC operated under the belief that the MEP contained an unobserved and risk-mitigating diversification that was only exposed after the stock market peak in 2000. Beginning in the early 1990's, the endowment had moved away from a dominant dependence on public stocks toward a much more diversified set of financial and real estate assets. During the late 1990's this was, at times, an unpopular investment strategy as the stock market was rising in excess of 20% per year. Over the past three years, however, the U.S. stock market is down over 28% (June 30, 2000 - June 30, 2003) while endowment investment performance is up 4%, cumulatively. The recent returns to this multi-asset class diversification are also apparent relative to the benchmark 60/40 portfolio as seen in the chart below.



Individual Asset Class Performance > The performance of individual asset classes for the 12 months ended June 30, 2003 relative to each asset class benchmark is illustrated in the graph below:



Relative performance of asset classes versus benchmark was strong for the 12-month period with an overall portfolio alpha (return relative to benchmark) of 4.7%. Absolute returns of almost every asset class also improved from the year-ago period. However, we have not seen, and do not expect to see, a return of the broad-based bull market of 1982-2000. The last three years provide a stark contrast to the previous bull market period when substantially all financial assets exhibited double-digit annual returns. The bull market was a period of protracted interest rate declines, valuation expansion, and seemingly unsustainable economic over-expansion. The 20-year secular decline in interest rates appears to have continued through June of 2003, but SMC is not optimistic that this trend can continue. 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 three years, the markets have experienced an overall compression in financial and real estate asset returns which has caused investors to reexamine their investment strategies. For example, many institutions have reacted to today's environment by allocating substantial additional assets to alternative asset categories which are often limited in their investment opportunity and capacity to absorb additional capital. As a result of these trends, SMC has reviewed 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 had been deliberately over-weighted in value stocks for the last ten years. This value-tilt had been effective in offsetting the heavy growth stock concentration in the Venture Capital portfolio and provided substantial cushion during the decline in global equity markets in 2001 and 2002. However, during the past year SMC decided to unwind the value-tilt in that Public Equity portfolio. The Venture Capital portfolio no longer constitutes as significant a percentage of endowment assets, reducing its impact on the value/growth bias within the portfolio. The Public Equity portfolio experienced the greatest absolute volatility throughout the year, while its “alpha” (return relative to benchmark) was limited.

Private Equity, a combination of Venture Capital and Leveraged Buyout limited partnerships continued to struggle in the aftermath of the excesses of the late 1990’s. However, the rate of loss has slowed significantly in these partnerships giving hope that this market has neared its bottom. We are also beginning to see a return to positive alpha in the portfolio, renewing our expectation that the top private equity firms will once again deliver returns significantly greater than the private equity market as a whole. SMC remains cautious in the current venture capital environment due to the substantial "overhang" of capital raised by venture partnerships in 1999-2001, and the latent demand for the asset class found in the unfulfilled asset allocations of many new limited partner entrants to this marketplace.. Nonetheless, Venture Capital has been a very successful asset class for Stanford when evaluated over the longer-term. In the past nine 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 multi-strategy arbitrage funds. Results for the period ended June 30, 2003 demonstrate the successful execution of all of these strategies with a particular focus on distressed debt investing. The Absolute Return portfolio was deliberately overweight investment managers in the distressed debt sector for the last 18 months. Over the last 12 months, credit spreads have compressed causing these debt instruments to appreciate in value. With the steady appreciation of securities in the distressed debt market, the MEP has become a net seller, reducing our exposure to corporate credit securities of all varieties. 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 many hedge fund investment strategies.

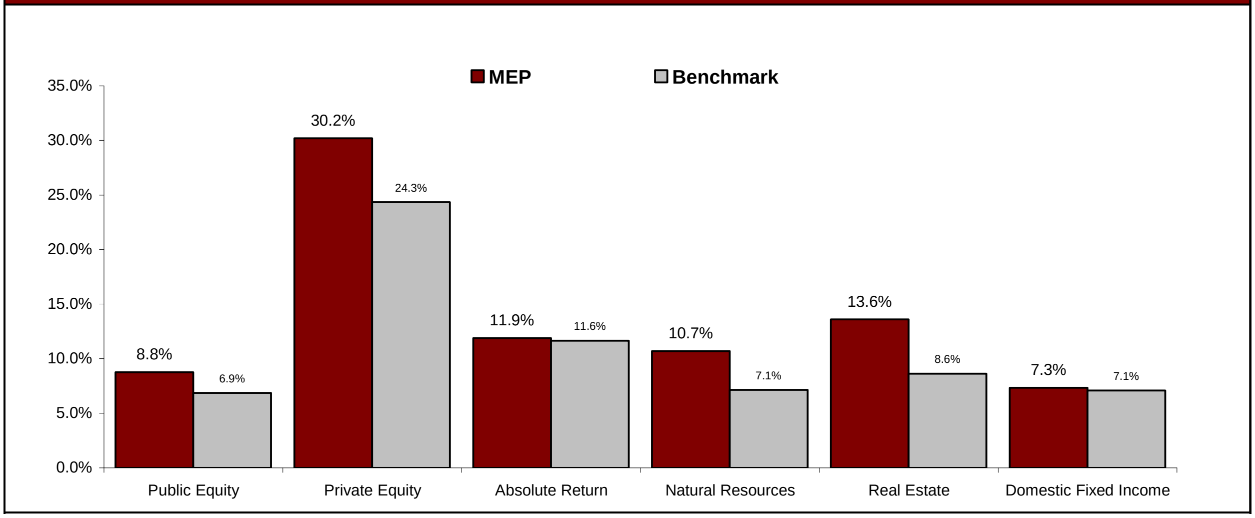
The Natural Resources portfolio is comprised of domestic and international investments in timber, direct oil and gas assets, and oil and gas private equity partnerships. The natural resources sector enjoyed generally strong performance over the last 12 months buoyed by higher commodities prices. SMC 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 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 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. 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 as a result of a number of successful asset dispositions across the MEP’s global real estate portfolio.

Fixed Income experienced strong relative and absolute return during the year. On June 30, 2003 the yield on the benchmark 10-year Treasury bond stood at 3.51%, approaching its lowest level in almost 50 years. This provided a tailwind for all fixed income investment managers. (Yields have since risen from these lows negatively impacting returns for all Fixed Income investors). The MEP's active managers in this space also created alpha through superior security selection.

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 Annualized Asset Class Returns vs. Benchmark



We are also pleased with the portfolio's 8.8% return for the 12 months ending June 30, 2003. However, we are more focused, and encouraged by the MEP's three year annualized return of 1.3%. A three-year period which has been characterized by repeated challenges to the U.S. financial markets, including a significant recession, the terrorist attacks of September 11th, the bursting of the dot-com and telecom bubbles, corporate malfeasance, and a war 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.

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