2004

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. SMC oversees approximately $12.0 billion of endowment and trust assets, temporarily invested expendable funds, and commercial real estate investments.

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 approximately $10.0 billion as of June 30, 2004. MEP performance measurements are calculated on the 12 months ended June 30, 2004 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 an 18.0% investment return for the 12 months ended June 30, 2004. Over the past 10 years, the MEP achieved an annualized rate of return of 15.1%, growing from $2.6 billion to $10.0 billion. This investment performance places Stanford in the top 5% of all reporting university and college endowments during this period, according to the consulting firm of Cambridge Associates.

SMC, with assistance from its board, actively manages the endowment, while remaining committed to a consistent 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 for the 12 months ended June 30, 2004 was relatively calm and upward trending across most of the MEP's major asset classes. After three consecutive years of extremely volatile and generally punitive market conditions, investors' risk aversion changed abruptly. Investors, frustrated by the lowest interest rates in modern financial history, aggressively went in search of return. Almost all risky assets rebounded from their market lows of April 2003 – the riskier the assets, the greater the rebound. Investors, fatigued after months of earning only 1% on their money market funds, went in search of yield, bidding up the prices of high yield bonds and sending REIT prices to all-time highs. Although we are happy to collect an 18% return for the past year, as we look forward, we take more caution than comfort from recent performance.

As a perpetual pool of capital, the MEP's investment strategies are commensurately long-term in nature and meaningful performance can only be gauged over longer measurement periods. SMC endeavors to invest thoughtfully without being burdened by considerations of short-term performance or volatile market sentiment. The MEP's three-year annualized performance of 7.8% since June 30, 2001 should be regarded as the minimum period upon which a meaningful review of recent endowment results can be conducted. This three-year investment return places Stanford in the top 6% of all reporting university and college endowments during this period, according to Cambridge Associates. 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. In addition, SMC 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 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 conditions.

One SMC investment strategy that bears mention came on the heels of the corporate accounting scandals of late 2001 and early 2002, which created significant turmoil in the financial markets. In particular, many corporate debt instruments were downgraded, and the 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, SMC 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, such as performing high-yield bonds and negotiated purchases of nonperforming corporate bank loans. The markets for corporate credit investments have steadily improved since the summer of 2003, easing - and ultimately resolving - this credit crunch. As a result, we have reduced this overweight to corporate credit investments.

The market's current appetite for yield has compelled us to de-emphasize most forms of high yielding investments: REITs, stabilized private real estate, high yield bonds, and fixed income more broadly. To us, many of these assets now feel more like momentum plays than value plays. The nominal and real interest rate on capital is low and the market is projecting a low-return and stable inflation rate environment going forward. Risk premia, as thin as they may have seemed in the spring of 2003, have clearly compressed with the ensuing dramatic appreciation in financial asset pricing. Many of the U.S. based alternative investment strategies that were so productive for the endowment in the 1990's appear to be over-supplied with new capital. At the same time, the U.S. economy is running the largest current account deficit in its history. In the face of this set of issues, SMC has been focusing its marginal time and endowment capital on international opportunities. Although the MEP remains a heavily U.S. weighted portfolio, we are more internationally tilted than at any previous point in our history.

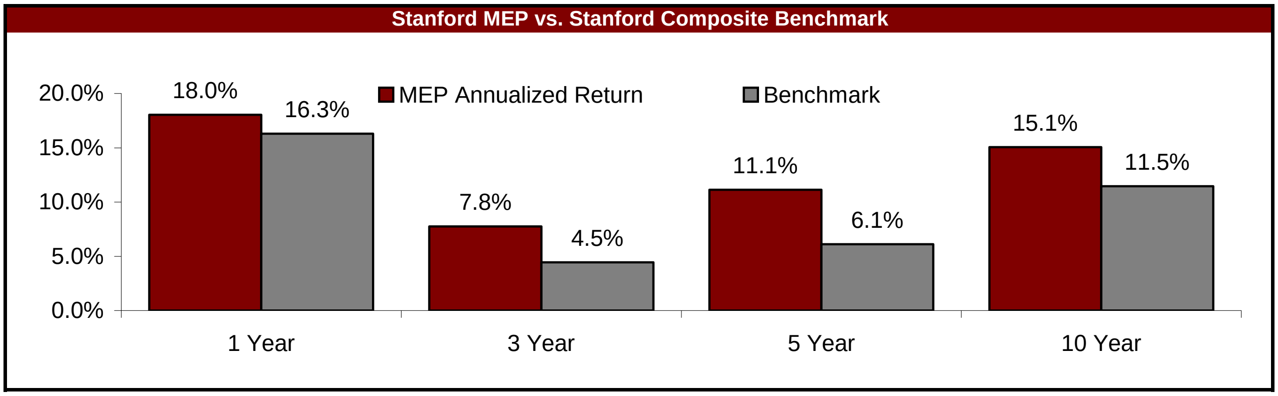
The strategic asset allocation targets for the MEP as of June 30, 2004 are listed below:

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%

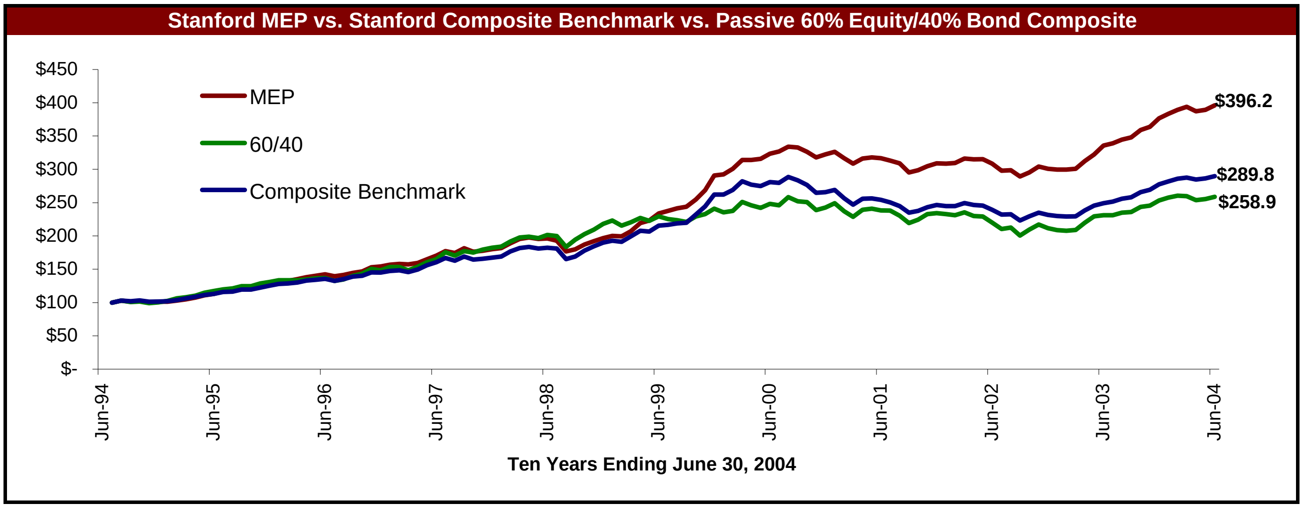
Stanford MEP Performance Compared to Inflation > The table below outlines annualized returns for various periods ending June 30, 2004 and illustrates the performance of the MEP in a long-term context. Stanford's objective is to return a minimum of 6.25% over the rate of inflation. If this real return 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	18.0%	7.8%	11.1%	15.1%
GDP Deflator	2.6%	1.9%	2.0%	1.9%
Real Endowment Return	15.4%	5.9%	9.1%	13.2%

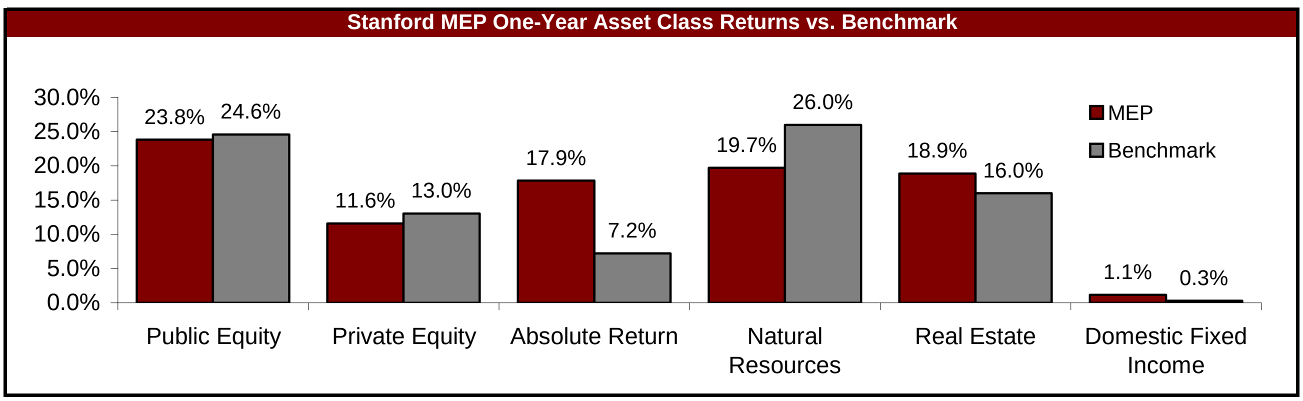
Stanford MEP Performance Compared to Benchmarks > SMC evaluates the performance of investment managers by comparing their returns to benchmarks that are appropriate for each individual asset class. SMC may alter an asset class benchmark to allow for a change in investment style, a shift in mix within 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 MEP 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, 2004.



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 MEP performance advantage (relative to benchmark returns) attributable to superior active manager selection has added in excess of $2 billion to the value of the endowment over this 10-year period. The chart also compares the growth of this $100 against a "60/40 portfolio" (a portfolio consisting of 60% stocks and 40% bonds), which 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 1994 through 1999. Beginning in the early 1990s, SMC shifted the MEP's asset allocation away from a dominant dependence on public stocks toward a much more diversified set of financial and real estate assets in a strategic move to mitigate risk in the portfolio. During the late 1990s this was, at times, an unpopular investment strategy as the stock market was rising in excess of 20% per year. The benefits of this diversification strategy did not become readily apparent until the last four years. During the four years since the market peak in June of 2000 ending in June of 2004, the U.S. stock market was down more than 16% cumulatively while the MEP's investment performance was up 22.5% 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, 2004 relative to each asset class benchmark is illustrated in the graph below:



Relative performance of the MEP versus its benchmark was strong for the one-year period with an overall portfolio alpha (return over benchmark) of 1.7%. The alpha was driven primarily by outperformance in the Absolute Return asset class. Total return in almost every asset class also improved from one year ago, with the exception of Fixed Income. However, we have not seen, and do not expect to see, a return of the broad-based bull market of 1982-2000. The last four 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 bottomed out. The view at SMC is that the tailwinds of the bull market have become the headwinds of today's challenging investment environment.

Stanford's Public Equity portfolio benefited from its substantial exposure to international equity markets. In particular, emerging market equities performed the strongest during the last 12 months. The equity portfolio is also tilted toward "quality" stocks – companies with lower leverage, lower interest rate sensitivity, and generally more consistent history of delivering high return on equity to shareholders. Currently, we believe there is better relative value in quality companies versus the broader market. Over the last 12 months, however, this quality tilt underperformed broader equity market benchmarks, as riskier stocks have demonstrated the best relative performance.

Private Equity, a combination of venture capital and leveraged buyout limited partnerships, had its best showing in recent years. We maintain 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, together with 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 long-term. In the past ten years, venture capital investment gains have added more than $2.5 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 investing in new funds.

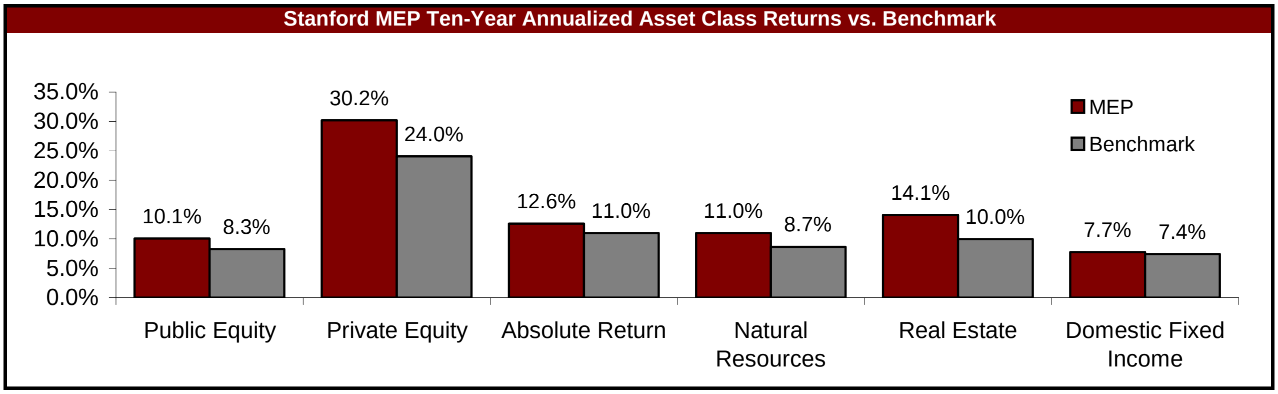
The Absolute Return portfolio is constructed to provide returns that are substantially uncorrelated to the equity and bond markets. The portfolio includes quantitative and fundamental equity hedge fund strategies, distressed debt, fixed income relative value, and multi-strategy arbitrage funds. One-year results for the period ended June 30, 2004 demonstrate the successful execution of all of these strategies, with a particular focus on distressed debt investing. The Absolute Return portfolio was deliberately overweighted to investment managers in the distressed debt sector for the past 30 months. Over the last 24 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 current 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 commodity 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 REITs. 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 over the past year as a result of a number of successful asset dispositions across the MEP's global Real Estate portfolio.

The Fixed Income asset class is facing a challenging, low-interest rate environment. With the yield on 10-year Treasury bonds hovering at recent historic lows, it is hard to be sanguine about the total return opportunity available in bonds.

The results of 10-year asset class returns, relative to benchmark, illustrate the value of SMC's ability to shift investment style/strategies and identify outstanding managers in each asset class as outlined below:



While we are pleased with the portfolio's 18.0% return for the 12 months ending June 30, 2004, we are more focused upon, and encouraged by, the MEP's three-year annualized return of 7.8%. This three-year period was characterized by repeated challenges to the global financial markets, including a significant recession, the terrorist attacks of September 11th, the unwinding of the dot-com and telecom bubbles, corporate malfeasance, and a war in the Middle East. Each of these unexpected crises represented 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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