
REPORT FROM THE STANFORD MANAGEMENT COMPANYSTANFORD UNIVERSITY 2005

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 \$14.3 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 \$12.4 billion as of June 30, 2005. MEP performance measurements are calculated on the 12 months ended June 30, 2005 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 19.5% investment return for the 12 months ended June 30, 2005. Over the past 10 years, the MEP achieved an annualized rate of return of 15.4%, growing from \$3.0 billion to \$12.4 billion. This investment performance places Stanford in the top 4% 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, 2005 was marked by a period of relatively modest returns for the U.S. stock and bond markets. Over this period, the S&P 500 Stock Index was up 6.3% and the Lehman Aggregate Bond Index was up 6.8%. The MEP's 19.5% return was driven by a diverse set of high returning assets, including International Equities, Private Equity and Natural Resources. Most pronounced over this period was the substantial run-up in commodity prices. The year began with a barrel of oil costing \$37, and it finished with a barrel of oil costing \$57—an increase of over 50%. The Natural Resources asset class within the MEP returned 71% for the year. Despite skyrocketing commodity prices, the performance of the U.S. economy and markets marched forward with relative calm; inflation expectations and interest rates remained in check. Over this period, as the Federal Reserve moved its Federal Funds Rate from 1.25% to 3.25%, the yield on longer-duration fixed income instruments remained stable. Rather than effecting a shift of the yield curve, the Fed only managed to flatten the yield curve. In large part, this was due to the volume of international capital flowing into U.S. treasuries. We are left to wonder how long the United States can continue to borrow from abroad at current volumes and at current interest rates.

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 15.3% since June 30, 2002 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 2% 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. At this point in the credit cycle, our concern is that the easing of the credit crunch may have gone too far, leading to excessive credit creation at unsustainably low spreads.

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 bond market is projecting a low-return and stable inflation rate environment going forward. Many forms of risk premia, in our view, remain thin, and in some cases negative. We have marginally reduced the total level of risk in the portfolio over the last 12 months. Many of the U.S.-based alternative investment strategies that were so productive for the endowment in the 1990s 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 much of its effort 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, 2005 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%

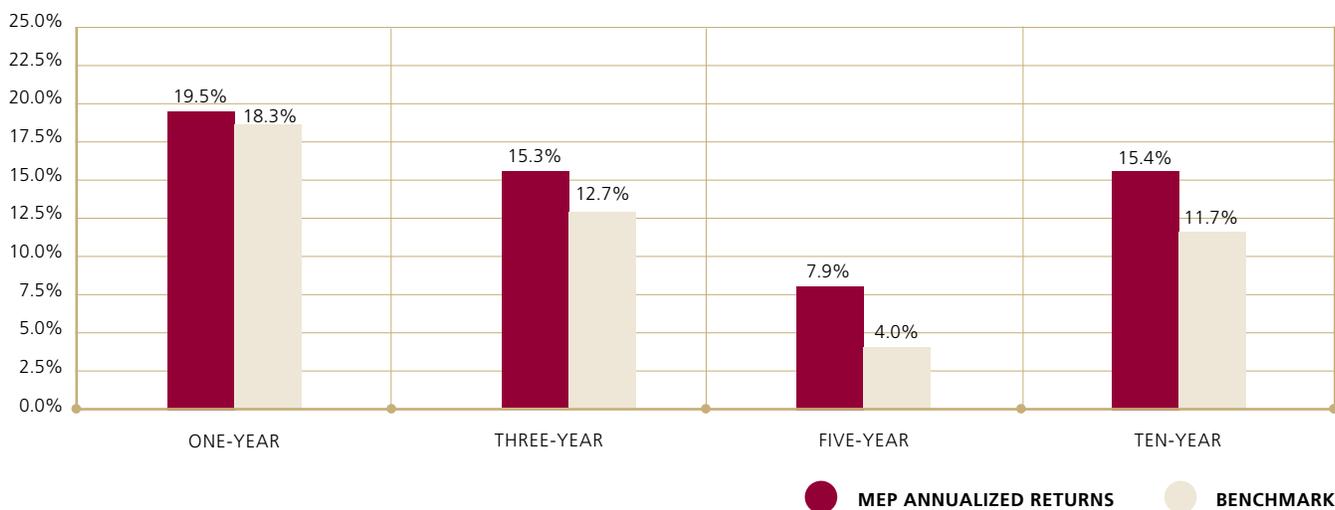
STANFORD MEP PERFORMANCE COMPARED TO INFLATION The table below outlines annualized returns for various periods ending June 30, 2005 and illustrates the performance of the MEP in a long-term context. Stanford's objective is to return a minimum of 6.25% over the rate of inflation. If this real return target is achieved over time, the value of the endowment will be maintained, net of annual payouts to support endowed activities. Over the past one-, three- 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	19.5%	15.3%	7.9%	15.4%
GDP Deflator	2.5%	2.2%	2.1%	1.9%
Real Endowment Return	17.0%	13.1%	5.8%	13.5%

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, 2005.

STANFORD MEP VS. STANFORD COMPOSITE BENCHMARK



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) has added in excess of \$3 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.

STANFORD MEP VS. STANFORD COMPOSITE BENCHMARK VS. PASSIVE 60% EQUITY / 40% BOND COMPOSITE

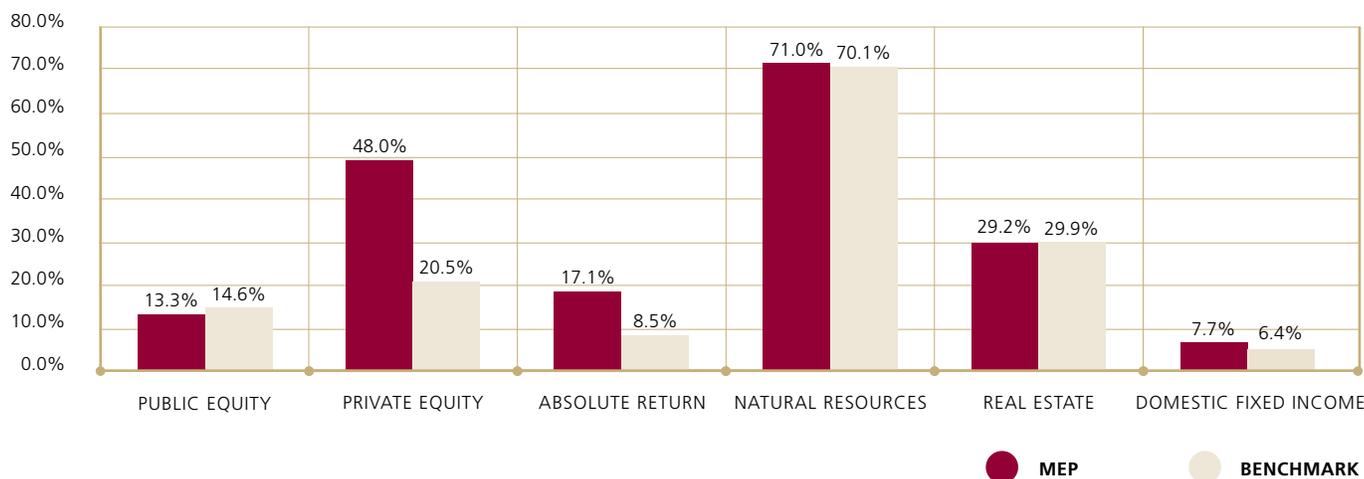


The current performance measurement date of June 30, 2005 affords a convenient end point to reflect back on long-term performance. The last 10 years can be succinctly broken down into the boom times of 1995-2000 and the down market of 2000-2005. A brief review of the MEP return history over these two periods provides an interesting perspective.

Prior to the peak of the market in early-2000, the Stanford portfolio kept pace with the bull market, primarily through the outstanding performance of its private equity portfolio. However, embedded in the background at the time was a highly diversified portfolio that was not overly dependent on the U.S. equity market. As can be seen in the chart above, this latent diversification became readily apparent after the U.S. equity market peaked in early-2000. Since that time, the Stanford portfolio has powered ahead of the U.S. stock market as a result of a variety of different successful return drivers: the overweight to credit described previously (that has since become an underweight), a strong tilt toward value stocks in the public equity portfolio (that has since been neutralized), strong performance in arbitrage hedge fund strategies, a significant shift in exposures out of the United States and into international stocks and currencies and a powerful surge in returns from our real estate assets that backfilled the equity market hole of 2001-2003. After having captured much of the upside of the bull market of the 1990s, the endowment preserved and grew capital during the bear market of the 2000s. While the S&P 500 sustained a peak-to-trough drawdown of 47% during this bear market, the Stanford portfolio only sustained a peak-to-trough drawdown of 13%. Preserving wealth, as investor Warren Buffett is keen to point out, is rule number one toward the goal of increasing wealth. Over the last five years, a dollar invested in the U.S. equity market would be worth only 89 cents, while a dollar invested in the Stanford portfolio would be worth \$1.46. The University has realized 64% more value in the actual endowment outcome than the U.S. equity market over this period. While the next five years are sure to bring a new set of challenges and opportunities, we remain focused on the same investment goal: to capture equity market-like returns while diversifying ourselves away from any single, dominant return driver.

INDIVIDUAL ASSET CLASS PERFORMANCE The performance of individual asset classes for the 12 months ended June 30, 2005 relative to each asset class benchmark is illustrated in the graph below:

STANFORD MEP ONE-YEAR ASSET CLASS RETURNS VS. BENCHMARK



Relative performance of the MEP versus its benchmark was strong for the one-year period with an overall portfolio alpha (return over benchmark) of 1.3%. The alpha was driven primarily by outperformance in the Absolute Return and Private Equity asset classes. Total return in most asset classes was strong for the year. However, we have not seen, and do not expect to see, a return of the broad-based bull market of 1982-2000. The last five 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 may eventually become the headwinds of tomorrow.

Stanford’s Public Equity portfolio benefited from its substantial exposure to the 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 a 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. This performance was predominantly driven by the exceptional financial performance of Google Inc. Google represents yet another proud link in the Stanford chain of entrepreneurial technology success that can date its roots back to Hewlett’s and Packard’s famous garage.

SMC remains cautious in the current venture capital environment due to the substantial 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. Since inception, venture capital investment gains have added more than \$2.0 billion to the value of the endowment. SMC intends to 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, 2005 demonstrate the successful execution of all of these strategies, with a particular focus on distressed debt investing. SMC remains committed to a well-diversified Absolute Return

portfolio but cautious about the current environment due to substantial increases in capital commitments from institutional investors into many hedge fund investment strategies.

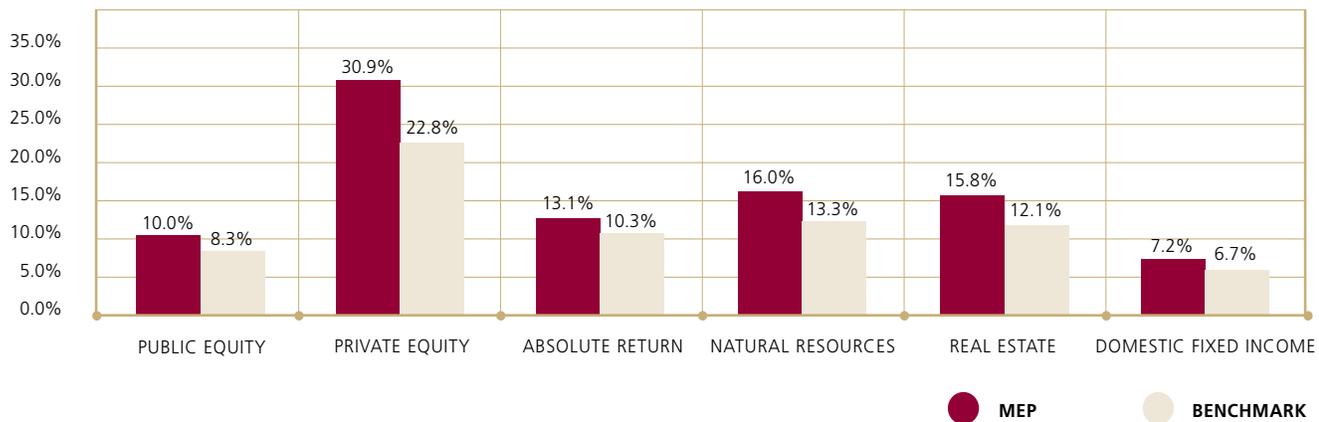
The Natural Resources portfolio is comprised of domestic and international investments in timber, direct oil and gas assets and oil and gas private equity partnerships. The natural resources sector enjoyed tremendous success over the last 12 months, buoyed by higher commodity prices. SMC continues to build a diverse portfolio of outstanding managers in the oil, gas, energy and timber industries.

Stanford's endowment historically has had 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 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 continued to face a challenging, low-interest rate environment. With the yield on 10-year Treasury bonds hovering in the 4.0-4.5% range, it is hard to be sanguine about the total return opportunity available in bonds. That said, 10-year Treasury yields fell about 70 bps, contributing greatly to the return on the portfolio.

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:

STANFORD MEP TEN-YEAR ANNUALIZED ASSET CLASS RETURNS VS. BENCHMARK



While we are pleased with the portfolio's 19.5% return for the 12 months ending June 30, 2005, we are more focused upon, and encouraged by, the MEP's three-year annualized return of 15.3%. This three-year period was characterized by repeated challenges to the global financial markets. Each new unexpected crisis 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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