Report from the Stanford Management Company

2006

The Stanford Management Company (SMC) was established in 1991 and manages Stanford's financial 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 $18.0 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 $15.3 billion as of June 30, 2006. MEP performance measurements are calculated on the 12 months ended June 30, 2006, to facilitate the comparison of returns with 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, 2006. Over the past 10 years, the MEP achieved an annualized rate of return of 14.8%, growing from $3.6 billion to $15.3 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, Cambridge Associates.

SMC, with assistance from its board, actively manages the MEP, 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. The portfolio is designed to optimize long-term returns, create consistent annual payouts to the University's operating budget and preserve purchasing power for future generations of Stanford faculty and students.

During the 12 months ended June 30, 2006, the S&P 500 Stock Index was up 8.6% and the Lehman Aggregate U.S. Bond Index was down 0.8%. The MEP's 19.5% return was driven by a diverse set of assets that performed well during this period, including International Equities, Private Equity and Natural Resources. Most pronounced over this period was the substantial movement in Natural Resources and International Equities. The year began with a barrel of oil costing $57, and it finished with a barrel of oil costing $74—an increase of 30%. The Natural Resources asset class within the MEP returned 61% for the year as the MEP realized gains on a number of investments made in prior years in an environment of substantially lower commodity prices. Despite the surge in commodity prices, the U.S. economy performed well and inflation expectations and interest rates remained in check, with market volatility near historic lows. Over this period, as the Federal Reserve moved its Federal Funds Target Rate from 3.25% to 5.25%, the yield on longer-duration fixed income instruments remained stable. This was, in part, due to the volume of international capital flowing into the United States.

During FY 2006, Stanford Management Company worked through significant organizational change, both at the senior management level and within the individual asset classes. The strong performance of the MEP is both a testimony to former CEO Mike McCaffery and CIO Mike Ross and their team, as well as an important reminder of the power of a patient, long-horizon investment model. For a perpetual pool of capital, three-year annualized performance should be regarded as the minimum period upon which a meaningful review of recent MEP results can be conducted. Since June 30, 2003, the MEP annualized performance of 19.0% places Stanford in the top 4% 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. We are excited to inherit a very strong portfolio, and motivated by the opportunity to make the investments in research, team, processes and risk management to continue the strong performance of the MEP.

STANFORD MEP ASSET ALLOCATION Given the perpetual nature of the University, SMC's investment horizon is 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.

In fact, this broad-based strength of performance came about in an extremely benign interest rate environment, and tight credit spreads supported continued economic expansion in the United States, even in the face of rising energy prices. Inexpensive credit supported the robust private equity industry and gains in domestic real estate. International markets continued to reflect slow recovery in Europe and rapid economic expansion in Asia, as China and India continued to grow their economies at a rapid rate. The common theme was that inexpensive credit lubricated the world's markets to an unusual degree. We expect to look back to this period as a rare period where positive returns were achieved across nearly every asset class.

The strategic asset allocation targets for the MEP as of June 30, 2006, 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%

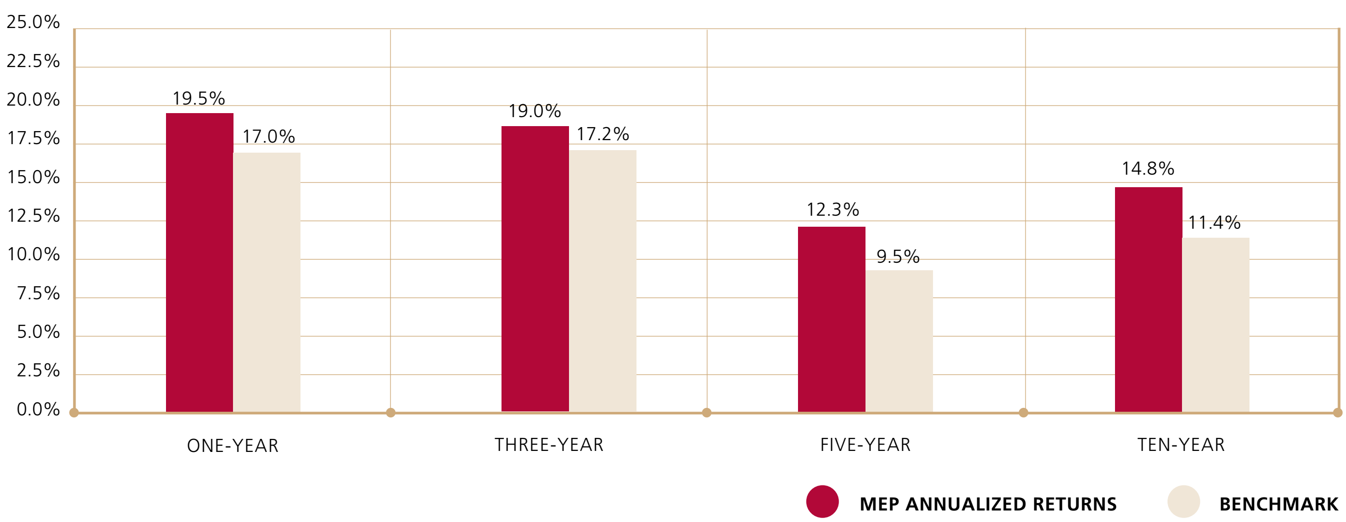
STANFORD MEP PERFORMANCE COMPARED TO INFLATION The table below outlines annualized returns for various periods ending June 30, 2006, and illustrates the performance of the MEP in a long-term context. Stanford's objective is to return a minimum of 6.25% over the rate of inflation. If this real return target is achieved over time, the value of the MEP will be maintained, net of annual payouts to support operating activities. Over the past one-, three-, 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	19.5%	19.0%	12.3%	14.8%
GDP Deflator	3.3%	3.0%	2.5%	2.1%
Real Endowment Return	16.2%	16.0%	9.8%	12.6%

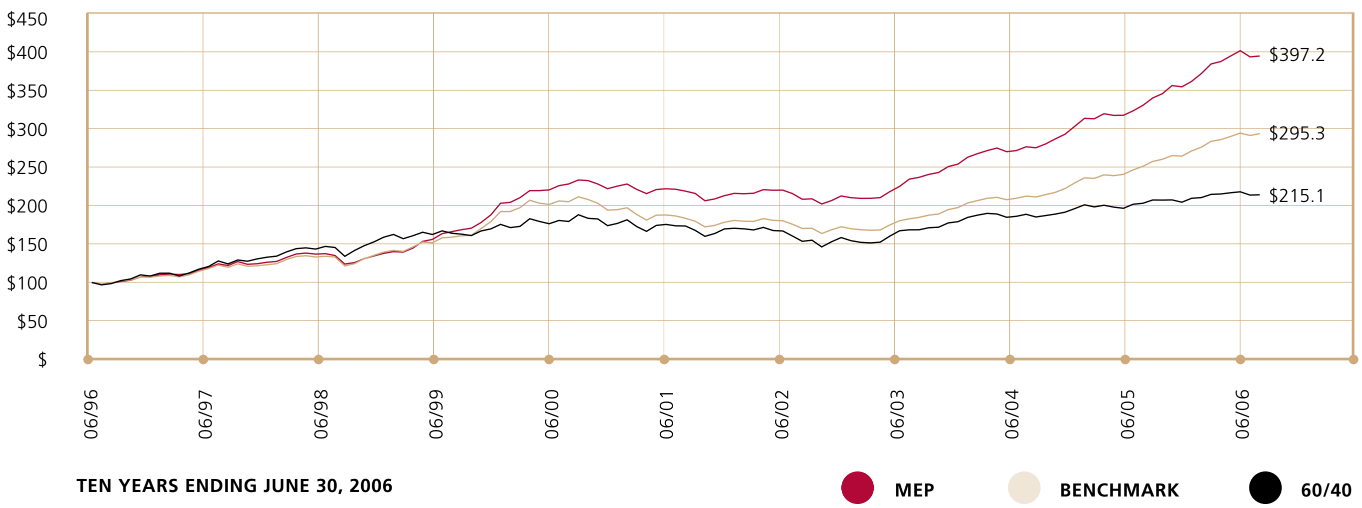
STANFORD MEP PERFORMANCE COMPARED TO BENCHMARKS SMC evaluates the performance of investment managers by comparing their returns to benchmarks that are appropriate for each individual asset class. SMC may alter an asset class benchmark to allow for a change in investment style, a shift in mix within an 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, 2006.

STANFORD MEP vs. STANFORD COMPOSITE BENCHMARK



SMC's effectiveness in implementing its investment strategies through top-level 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 MEP with that of the composite benchmark over the past 10 years. The MEP performance advantage (relative to benchmark returns) attributable to active manager selection has added in excess of $3.5 billion to the value of the MEP 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.

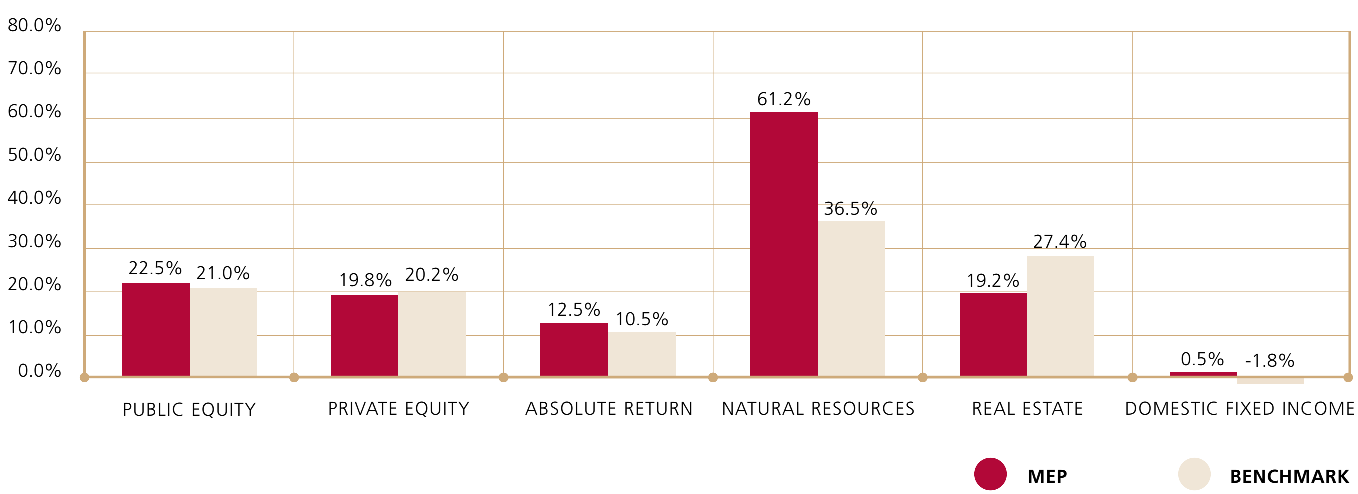
STANFORD MEP vs. STANFORD COMPOSITE BENCHMARK vs. PASSIVE 60% EQUITY/40% BOND COMPOSITE



Relative performance of the MEP versus its benchmark was strong for the one-year period with an overall portfolio alpha (return over benchmark) of 2.5%. The alpha was driven primarily by outperformance in the Natural Resources and Public Equity asset classes. Total return in most asset classes was strong for the year, as all asset classes, save fixed income, exhibited double-digit annual returns.

INDIVIDUAL ASSET CLASS PERFORMANCE The performance of individual asset classes for the 12 months ended June 30, 2006, relative to each asset class benchmark, is illustrated in the graph below:

STANFORD MEP ONE-YEAR ASSET CLASS RETURNS vs. BENCHMARK



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. We continue to 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 superior relative performance.

Private Equity performance was achieved primarily by returns generated by our buyout managers; the liquidity in the financing markets, coupled with the increasing amount of private equity capital available, drove strong exits in this asset class. Our increasing exposure to growth equity in emerging markets also contributed to the overall performance.

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 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 billion to the value of the MEP. 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, emerging markets, distressed debt, fixed income relative value and multi-strategy arbitrage funds. One-year results for the period ended June 30, 2006, demonstrate the successful execution of all of these strategies. As with the previous year ended June 30, 2005, we maintained a particular focus on distressed debt investing, which continued to perform well. SMC remains committed to a well-diversified Absolute Return portfolio, but is cautious about the current environment due to substantial increases in capital commitments from institutional investors into many hedge fund investment strategies.

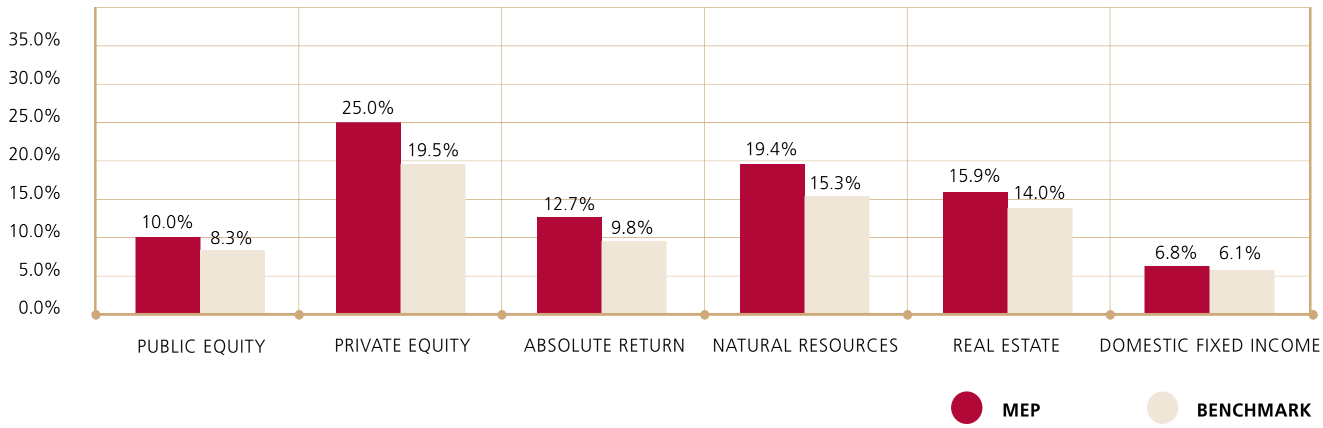
Driven by appreciating commodity prices, the Natural Resources portfolio continued to deliver extremely strong returns. SMC holds a diverse portfolio of outstanding managers in the oil, gas, energy and timber industries.

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 MEP's global Real Estate portfolio created strong returns through value-added activities and the continued demand for well-positioned assets.

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 4.0–5.0% range, low volatility and tight credit spreads, we see limited total return opportunities available in bonds. Ten-year Treasury yields rose about 120 bps, depressing returns associated with benchmark-oriented funds.

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



In closing, we are honored and excited by the opportunity to lead this organization and manage the University's investment assets. We are committed to maintaining the Management Company's long tradition of strong, risk-adjusted returns over long time horizons. The endowment is invested with a solid roster of diverse investment managers and measured portfolio tilts. We believe it is well-positioned to serve Stanford's long-term funding requirements and growth objectives, even as we begin to implement our vision of SMC's style and direction.

We are pleased with the portfolio's 12-month return of 19.5%, but remain more focused and satisfied with the portfolio's three-year and five-year annual returns of 19.0% and 12.3%, respectively. 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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