

Introduction

As of June 30, 2008, the assets that Princeton has traditionally described as “Endowment” stood at a record \$16.3 billion, approximately \$600 million more than the year before.¹ The vast majority of the Endowment, \$15.9 billion, is actively managed by the Princeton University Investment Company (“PRINCO”).² PRINCO is a University office, but maintains its own Board of Directors (the “Directors”), and operates under the final authority of the University’s Board of Trustees (the “Trustees”).

The purpose of the Endowment is to support the University’s current and future operating needs, while preserving intergenerational equity. This mission requires a long-term return that exceeds both the annual rate of spending and University inflation. In pursuit of this goal, PRINCO maintains an equity-biased portfolio and seeks to partner with best-in-class investment management firms across diverse asset categories.

Spending

The Endowment provided \$642 million in spending support to the University in fiscal year 2008.³

Each year the Trustees decide upon an amount to be spent from the Endowment for the following fiscal year. (Excluded from these decisions are funds that represent either capital reserves or assets devoted to strategic purposes, such as subsidizing faculty housing.) In their deliberations, the Trustees use a spending framework that is designed to enable sizable amounts to be spent in a reasonably stable fashion, while allowing for reinvestment sufficient to preserve purchasing power in perpetuity. Until recently, the framework targeted annual spending rates of between 4% and 5%. In 2006, the Trustees decided that based upon the strengthening of Princeton’s investment program, higher average spending rates could be supported going forward. As a result, the Trustees raised the upper boundary of the spending target range to 5.75%.

With long-term expectations of university inflation approximating 5% or more, the Endowment must seek

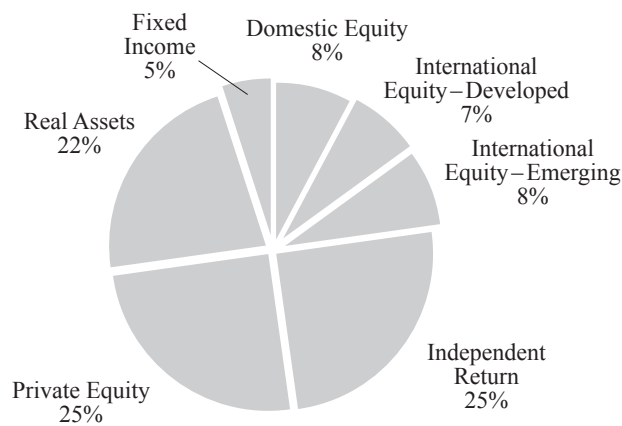
long-term investment returns approaching or exceeding 10% per year to maintain future purchasing power without a deterioration of corpus.

Asset Allocation

Asset allocation involves deciding what share of the portfolio should be placed in the various broad asset categories. The decisions attempt to balance the relative merits of equities *versus* fixed income, domestic *versus* foreign investments, and publicly traded *versus* non-marketable assets.

Princeton’s long-term asset allocation decisions are embodied in a Policy Portfolio, which describes the asset categories in which Princeton will invest, a set of target weights that indicate how the portfolio will be positioned in “normal” market conditions, and a range of weightings within which exposures can be adjusted in response to strategic (mid-term) opportunities arising from significant market disequilibria. The graph below (figure 1.) depicts the policy portfolio targets.

Figure 1. Princeton University Policy Portfolio, June 30, 2008



Clearly evident is PRINCO’s bias toward equities or equity-like assets—95% of the portfolio is allocated toward these investments. Also striking is the relatively small portion, 8%, of the portfolio dedicated directly to Domestic Equities. Large portions of the portfolio are allocated to other expected-return categories. Independent Return, Private Equity, and Real Assets bear further description. Independent Return is broadly defined as consisting of investment vehicles that seek high absolute returns that are typically independent of broad market trends. Private Equity and Real Assets include investments in private companies, venture capital opportunities, real estate, and natural resources. These areas have offered attractive opportunities for skilled, patient investors.

1. Excluded from “Endowment” are working capital, planned giving investments, bond proceeds awaiting drawdown, and certain student loans.

2. The remainder of the Endowment consists of University mortgages, loans, and other assets held for strategic purposes in addition to investment return.

3. Investment earnings distributed in fiscal year 2008 in the amount of \$663 million in the Statement of Activities is comprised of Endowment spending of \$642 million plus earnings from funds held in trust by others, working capital, planned giving investments, and other non-endowment investments.

The Policy Portfolio is diversified among asset categories for a number of reasons. Most importantly, PRINCO seeks return premia, in both risk-adjusted and absolute terms. In each equity asset category, Princeton has competitive advantages that make superior returns possible. A broader opportunity set means that the portfolio should be capable of producing high returns more often and in a greater variety of environments. The multi-asset class approach also offers diversification benefits that help to control risk.

PRINCO's directors, working closely with PRINCO staff, review the Policy Portfolio annually. Their fiscal 2008 Policy Portfolio review resulted in modifications of several long-term allocation targets—Private Equity's long-term target was increased by three points to 25% and Real Asset's long-term target was increased by two points to 22%. These changes were offset by a three-point reduction in Domestic Equity, a one-point reduction in Fixed Income, and half-point reductions in each of International Developed and Emerging Equity. The graph above incorporates these changes, which were motivated primarily by increased confidence in PRINCO's ability to expand its non-marketable investment programs without degradation in quality.

There has been in recent years a "Grand Unifying Theme" of PRINCO's activity, cutting across almost all asset categories. The theme has involved making it a priority to improve and expand our internationally based manager networks. While four years ago, PRINCO had just 12 relationships with "foreign local" managers, who managed \$1.1 billion of our assets, as of June 30 these relationships number 43, and collectively control \$4.5 billion of Princeton's assets (including unfunded commitments).

The following table (figure 2.) compares PRINCO's long-term Policy Portfolio asset allocation targets with the actual weights as of June 30, 2008. Within relatively small and pre-determined ranges, PRINCO's staff and directors will over or under weight relatively more or less compelling asset categories.

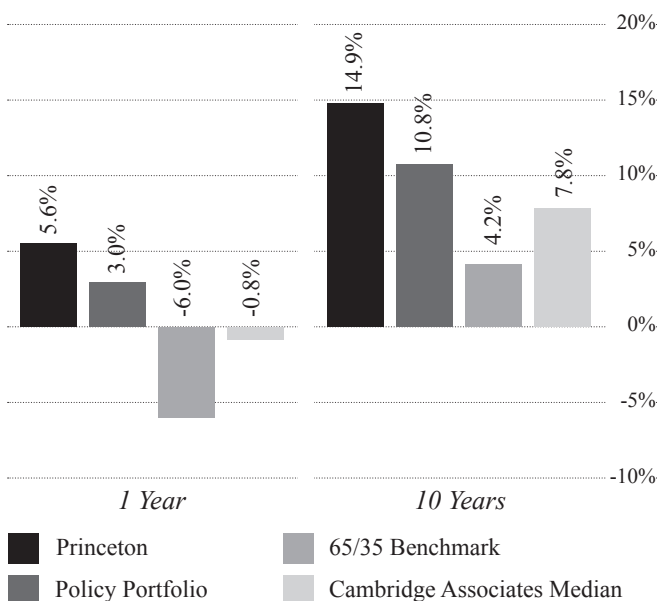
Figure 2. Asset Allocation, June 30, 2008

	<i>Policy Target</i>	<i>Actual Allocation</i>
Domestic Equity	8.0%	7.1%
International Equity—Developed	7.0%	4.8%
International Equity—Emerging	8.0%	7.4%
Independent Return	25.0%	24.2%
Private Equity	25.0%	29.4%
Real Assets	22.0%	23.1%
Fixed Income	5.0%	2.0%
Cash	0.0%	2.0%

Performance

For the fiscal year ending June 30, 2008, PRINCO produced a 5.6% return on invested assets, outperforming the Policy Portfolio benchmark by 2.6% and the median college and university endowment by 6.4%. This result was achieved against a backdrop of challenging market conditions. Over the 10 years ended June 30, 2008, Princeton's portfolio earned an annualized return of 14.9%, compared to a 10.8% return for the Policy Portfolio and 7.8% for the median college and university endowment.⁴ The managed investment portfolio delivered its greatest margin of excess performance relative to a passive blend of 65% S&P 500 and 35% Lehman (now known as Barclays Capital) U.S. Government/Credit Bond Index, which produced an annualized 10-year return of 4.2%.⁵ Princeton's excess performance relative to the Policy Portfolio, median college and university, and 65/35 benchmark has added

Figure 3. Endowment Performance vs. Benchmarks, Periods Ending June 30, 2008



Return to Policy Portfolio represents the weighted average of individual asset class benchmark returns.

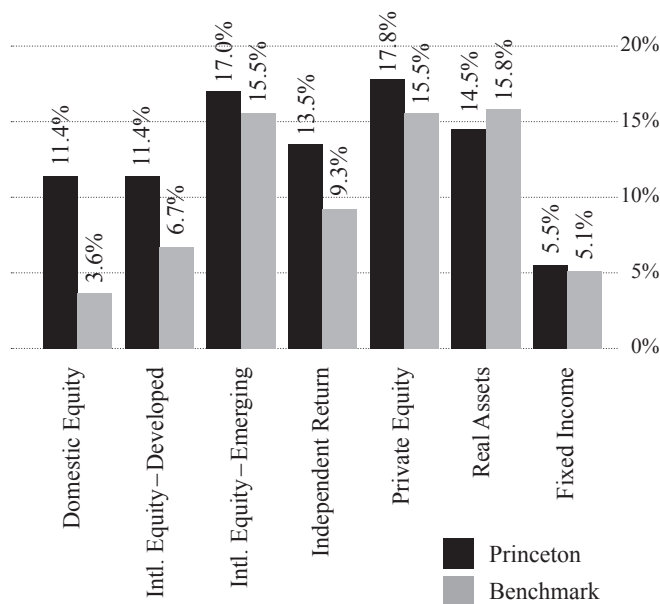
4. Policy Portfolio returns represent a weighted average of individual benchmark returns. The median college and university endowment returns are preliminary and represent data compiled by Cambridge Associates for 141 college and university endowments.

5. The 65% S&P 500/35% Lehman (now known as Barclays Capital) U.S. Government/Credit Bond Index portfolio represents what an investor would earn from a 65/35 investment in these equity and fixed income market indices, rebalanced annually.

approximately \$6, \$9, and \$12 billion, respectively, to the Endowment over the past 10 years. (figure 3.)

Over the past 10 years, Princeton outperformed within asset categories by an average annualized margin of 2.8%, with six of seven asset categories outperforming their respective benchmarks. The Real Assets portfolio produced strong absolute returns (the third highest across categories), but slightly underperformed its benchmark. A relative performance headwind has been created in Real Assets in recent years due to the substantial expansion of the program, which results in the portfolio's composition being relatively immature compared to that of the benchmark. (figure 4.)

Figure 4. Princeton Asset Class Returns vs. Benchmarks, 10 Years Ending June 30, 2008



Benchmarks used:

Domestic Equity: S&P 500 Index until 12/31/97; Wilshire 5000 Index thereafter.

International Equity – Developed: MSCI World ex-US Index.

International Equity – Emerging: MSCI Emerging Markets Index.

Independent Return: (40% Wilshire 5000 + 60% 91-day T-Bill) + 550 bps annualized.

Private Equity: Customized Cambridge Associates benchmark.

Real Assets: NCREIF Property Index until 6/30/00; Levered NCREIF Property Index until 6/30/03; thereafter blend of levered NCREIF Property and Timber Indices, Cambridge Associates Oil & Gas Universes and 6.5% Real Return.

Fixed Income: 2/3 Lehman (now known as Barclays Capital) U.S. Aggregate Bond Index + 1/3 Salomon Brothers Non-U.S. Dollar World Government Bond Index until 6/30/01; Lehman (now known as Barclays Capital) U.S. Government Bond Index thereafter.

Subsequent Events and Results

Post the close of the fiscal year, financial markets suffered steep declines of historic proportions. Through October, public equity market indices were down 25% to 50%. While Princeton's diversified asset allocation and risk-sensitive investment approach offered some protection, the Endowment has suffered significant losses in the 2009 fiscal year-to-date period.

PRINCO's standard internal, intra-year performance reporting protocols use best available information, which means that the results of non-marketable investments are lagged until the close of the fiscal year, when our books are kept open long enough to eliminate the lag. Given that more than half of the Endowment is invested in non-marketable asset categories, the lag of non-marketable performance reporting introduces significant imprecision to intra-year performance reports. This imprecision is a key reason why PRINCO does not typically publish intra-year results.

Nonetheless, the unusual declines in markets compel comment on intra-year results, as best as they can be estimated. Through October, the Endowment suffered a loss of approximately 11%, as estimated using PRINCO's standard protocols. However, this estimate probably understates losses. When more complete information is available regarding the status of non-marketable investments, the Endowment's losses may be materially worse, although the total performance is still likely to be better than that of public equity markets, broadly speaking.

Andrew Golden

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