The University of Delaware Endowment
Annual Report 2017

Fiscal Year 2017 Performance

I am pleased to report a strong +12.5% return on the University’s Endowment assets in the fiscal year ended June 30, 2017. In an environment of low interest rates, sub-par economic growth and inflated equity valuations, the impressive performance results of the latest fiscal year have helped to strengthen the financial position of the University of Delaware. The pooled Endowment fund ended the fiscal year with a market value of $1.54 billion which represents an increase of nearly $120 million over the twelve month period.

Despite a significant number of geopolitical headwinds throughout the year, the global equity markets maintained their steady march higher in fiscal 2017. The year began with the UK vote to leave the European Union, saw the surprise election of President Donald Trump in November 2016 and a rising nuclear threat posed by North Korea. Against this backdrop, global stocks rose +18.78% led by technology and financial stocks while the CBOV Volatility Index dropped from 15.6 to 11.2. In contrast to the last several years when the U.S. equity markets posted the biggest gains, the fiscal year ended in June 2017 saw the best performance from stocks in the emerging markets and Europe. Meanwhile, safe-haven investments saw little interest from investors as gold slid -5.6% and investment-grade bonds lost -0.31%.

Leading the way last year were the Endowment’s investments in international stocks which posted a net return of +20.2%. The best performance relative to benchmark came from the Endowment’s investments in hedge funds. We were pleased that we were able to achieve a net return of +9.3% compared to a return of +6.3% for the HFRI hedge fund benchmark in our first full year investing directly in hedge funds instead of through a fund-of-funds vehicle. We are very proud of the fact that while overall returns have been stronger than both benchmark and Endowment peers over the last twenty-one years, we have taken less risk while achieving these market beating results, as seen in the chart, left.
The Endowment Mission

The Endowment provides perpetual funding to support the University’s educational goals while preserving real value for future generations. To that end, the University’s Board of Trustees, Investment Visiting Committee, and Administration have a shared mission to maximize the Endowment’s total return consistent with the University’s prudent investment risk constraints. This mission requires an expected long-term return that exceeds the inflation-adjusted annual spending rate. In order to pursue that goal, the University maintains an equity-biased portfolio and seeks to partner with best-in-class management firms across diverse asset categories while also managing some Endowment assets in-house. The Investments Office manages the Endowment under the guidance of and within the policies authorized by the Investment Visiting Committee of the University.

The target spending rate for the Endowment is 4% to 5% of the three-year average market value as determined annually by the University’s trustees. In Fiscal 2017, the spending distribution to the University was $51 million, providing financial support and flexibility to the University’s operating budget. In recent years, the Endowment’s role in supporting the University has become more meaningful as funding from the State of Delaware has declined. This support is likely to become even more important in the coming years given the challenges facing higher education today. The blue line in the chart below shows the decline in operating appropriations from the State of Delaware as a percentage of total operating revenue at the University, while the red line shows the increase in Endowment payout to the University over time. The ongoing generosity of our alumni and friends has helped to ensure the long-term financial health of the University through the establishment of endowed gifts. A strong Endowment allows the University to fund initiatives that will have a lasting impact on the student experience and the overall institution.
The Endowment Purpose

The Endowment supports a variety of aspects of University life. There are more than 1,000 Endowment accounts that make up the overall University Endowment that have been established by our generous alumni and friends. The majority of these Endowment accounts were established for the support of our students so that young people of every background can attend the University of Delaware. Diversity is a core educational value and a guiding principle of the 2015 Delaware Will Shine Strategic Plan. Research shows that campus communities with meaningful diversity practices significantly increase the quality and value of education for all students. These transformative learning experiences enhance critical thinking, promote civic responsibility, enrich formal and informal exchanges amongst students from various backgrounds, and prepare our students to navigate in an increasingly diverse and global world. Other Endowments have been created for instruction and department research as well as the general ongoing operational needs of the University.

Number of Endowment Accounts by Purpose as of 6/30/17

- Student Aid, 61%
- Instruction & Research, 28%
- General Support, 4%
- Other, 7%
Compounding Growth Over the Long Term

Due to the perpetual nature of the investment program, the long-term performance results are a true reflection of the Endowment’s long-term investment horizon. Longer term performance has been strong on both an absolute and relative basis despite challenging market conditions. The Endowment recorded an annual return of +7.8% in the twenty-one years ended June 30, 2017, exceeding the +7.1% annual return for the benchmark and the +5.9% annual return for a portfolio index of 60% global stocks and 40% global bonds. The significant annual outperformance over the last twenty-one years shows that the Endowment model’s long-term investment approach has worked well for the University of Delaware.

The chart below illustrates that the compounding of excess returns can have a significant impact on the University over time. An Endowment of $1 million established twenty-one years ago in 1996 would have grown to a value of $4.8 million compared to a value of only $3.3 million invested in a global portfolio of 60% stocks and 40% bonds. The $1.5 million in excess investment gains is more than the original gift amount and would contribute an additional $74,000 annually toward the Endowment’s purpose. That is enough to make life changing investments in the education and development of many more University of Delaware students.

Growth of $1 million invested in the UD endowment as of 6/30/17
Asset Allocation

The University has developed asset allocation guidelines based on its total return objectives, income requirements, and capital market expectations. These guidelines are long-term oriented and are consistent with the Endowment's risk posture and investment objectives. Over the last seventeen years, the University has dramatically reduced the Endowment’s investments in domestic stocks and bonds by reallocating to international and nontraditional asset classes. In 2000, more than 80% of Endowment assets were invested in US stocks and bonds with 20% in international assets and 0% invested in hedge funds and private investments. Today, only 40% of assets are invested in U.S. stocks and bonds while 20% are invested in international stocks, 19% in hedge funds and 21% in private investments. As a result, the Endowment is now more diversified across asset classes. The broader opportunity set should not only provide higher returns in a greater variety of investment environments but also help to control risk. The University has increased the Private Investments target allocation to 25% to take advantage of the superior risk-adjusted returns generated by this asset class. It will take some time to achieve this target because of the long investment periods associated with this asset class. The source of funds for these investments is currently invested in fixed income and cash.

Endowment Asset Allocation vs. Target Allocation as of 6/30/17

[Bar chart showing allocation of Endowment and Target Allocation]
Capital Market Expectations

Developing risk and return assumptions for the various asset classes offers a guide to the range of possible investment performance over a given period. These assumptions help the Investment Visiting Committee to guide the asset allocation and risk levels that are chosen to meet the University’s investment performance goals. In prior annual letters we have noted that we expect the capital markets to become more subdued over the next decade due to lower interest rates, lower economic growth, heavy debt loads, the unwinding of accommodative monetary policy and inflated market valuations. These same challenging conditions are still with us today as we look at the investment landscape for opportunities. We believe that setting realistic capital market expectations leads to good asset allocation decisions and a better performance outcome for the Endowment.

The chart below can provide some guidance as to where the University of Delaware’s Endowment will be looking in the future in order to achieve strong risk-adjusted returns. Fixed Income returns are expected to be quite low over the next decade due to a low starting yield, but given the important role this asset class plays in a diversified portfolio we will continue to have a small allocation to these investments. Hedge Funds should continue to provide strong risk-adjusted returns and their low correlation to traditional asset classes will make them a good place to invest over the next decade. Private Investments look to provide the strongest risk-adjusted returns over the next decade which is why the Investment Visiting Committee has raised this allocation target to 25%. Global Equities will likely see lower returns in the future and appear expensive compared to their history, but compared to fixed income they look attractive making a compelling case to continue to stay fully invested in this asset class.

Despite generally lower return forecasts across most asset classes, we maintain our positive view on the capital markets. In fact, our analysis suggests that the Endowment will produce a 6% real annual return over the next decade. Given that the Endowment has a perpetual time horizon, we will continue to invest for the long-term and make strategic adjustments based on changes to our capital market expectations.
Travel plays a key role in the research and portfolio management process in the Investments Office at the University of Delaware. The investment management industry is first and foremost a people business so getting out on the road and meeting our investment partners on their own turf provides us with a much deeper perspective into those individuals with whom we are entrusting the University’s Endowment assets. This takes on an even greater relevance in emerging market countries where we deal with a diverse range of economies and cultures. Recently we visited India, which is one of the most dynamic economies in the world today offering an unparalleled opportunity for investors. The Endowment has more than $50 million invested in India making it our largest single country allocation in the emerging markets. India is the world’s seventh largest economy and it is expected to grow by more than 7% next year, a faster rate of growth than any other major investable country in the world. However, the real story for India lies in its demographics since more than one-third of the population is between 15 and 34 years old making it one of the youngest populations on the planet. With a median population age of 27 years old, India’s economic growth will be fueled by first-time buyers of cars, motorcycles, homes and other large-ticket items for many years to come. Consider that there are already 400 million internet users in India today, more than the entire population of the United States. This number is expected to surge to 700 million users by 2020 which would put the internet adoption rate on par with that of China. With the IMF forecasting that per capita incomes in India will surge by 37% from 2016 to 2020, there will be an explosive amount of personal consumption in the years ahead. The Endowment has made strategic investments that will best harness the formidable power of the rising Indian consumer.

<table>
<thead>
<tr>
<th>Country</th>
<th>Allocation</th>
<th>MSCI EM Index</th>
</tr>
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<tbody>
<tr>
<td>India</td>
<td>33.36%</td>
<td>24.68%</td>
</tr>
<tr>
<td>ASEAN</td>
<td>20.94%</td>
<td>12.29%</td>
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<tr>
<td>China</td>
<td>14.51%</td>
<td>-7.68%</td>
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<tr>
<td>Brazil</td>
<td>5.25%</td>
<td>-13.16%</td>
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<td>Korea</td>
<td>6.79%</td>
<td>-8.70%</td>
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<tr>
<td>MEAF</td>
<td>7.73%</td>
<td>-3.84%</td>
</tr>
<tr>
<td>Mexico</td>
<td>6.79%</td>
<td>-1.51%</td>
</tr>
<tr>
<td>Brazil</td>
<td>5.25%</td>
<td>12.29%</td>
</tr>
<tr>
<td>Russia</td>
<td>5.25%</td>
<td>12.29%</td>
</tr>
<tr>
<td>MEAF</td>
<td>7.73%</td>
<td>12.29%</td>
</tr>
<tr>
<td>Other</td>
<td>11.44%</td>
<td>12.29%</td>
</tr>
</tbody>
</table>

Emerging Market Allocation as of 6/30/17 (Absolute and Relative to MSCI EM Index)
Blue Hen Investment Club (“BHIC”)

One of the benefits of working in the Investments Office at the University of Delaware is that we are the administrative advisor for the BHIC which gives us the opportunity to work with the talented students in the Lerner College of Business and Economics. The BHIC is a student-run investment fund that invests University money in the stock market and provides a valuable experience to its members by allowing them to manage a real world investment portfolio. The BHIC was founded in 1996 when the University’s Board of Trustees entrusted the club with $500,000 to learn how to manage a real investment portfolio, making it one of the oldest and largest student-run investment clubs in the country. Twenty-one years later, I am pleased to report that the club is stronger than ever with a fund balance of $1.89 million as of the end of June 2017. BHIC members learn about the most important aspects of finance and investing while developing strong teamwork, public speaking and analytical skills.

The Executive Committee of the BHIC presents its results annually to the Investment Visiting Committee of the University of Delaware. I am always amazed at the professionalism with which the club is run and the sophisticated investment tools that the students use to manage the portfolio. These students are getting a leg-up on the competition as they leave the University to interview for sought-after positions in the investment management industry because they are already developing the skills that they will need to be successful in the future. The Investments Office has a former BHIC member on staff in the analyst role and we offer a paid internship opportunity to juniors looking to learn more about the investment management industry and further develop their investing skills. A new development in the last year, the BHIC has established a charitable grant committee responsible for allocating a portion of the portfolio’s assets to philanthropic registered student organizations at the University of Delaware. I am proud to report that in addition to becoming better investors, the BHIC members are now also learning how to make a positive social impact in the University community.
New Initiatives

The Investments Office will continue to focus on the long-term initiatives outlined in prior annual reports that will seek to improve performance and reduce costs over the next ten years. We estimate that these initiatives will add more than $180 million in additional Endowment assets over a ten-year period. They include cost reductions from the elimination of fund-of-funds, the use of index funds for core equity allocations and bringing reporting and due diligence functions in-house. Performance improvements will mostly come from creating a more streamlined portfolio that has a focus on high conviction ideas. Greater concentration should help us to achieve better returns over the long-term by adding some unsystematic risk back into the program after years of over-diversification. This reduction of our portfolio holdings will also improve our monitoring capabilities making us better stewards of the Endowment.

A new initiative established in the last year is an emerging manager program at the University of Delaware. Using data from eVestment, we analyzed the returns of newly established long/short hedge funds and compared them to long/short hedge funds that have been around for at least five years and we found a significant performance difference between the two groups. The emerging long/short hedge funds produced an annual performance above the S&P 500 Index of +5.4% during the twelve year period from 2003–2014 while the mature long/short hedge funds produced an annual performance above the same benchmark of only +2.3%. We found that the emerging investment firms were able to generate superior performance because of the increased market flexibility associated with smaller asset bases and smaller investment teams. There is a better alignment of personal, professional and economic interests in these emerging managers that is attractive to an Endowment with a perpetual investing time horizon. Over time, we expect that these emerging managers will graduate to become full positions in the Endowment.

Emerging vs. Mature Annual Alpha from Long/Short Hedge Funds (2003–2014)
Looking Ahead

The Endowment is designed to provide the University with greater independence, increased financial stability and the means to become a center for academic excellence. Understanding this fundamental purpose is important to understanding the long-term nature of the Endowment’s investment process. This global multi-asset class investment framework has proven to be able to exceed public benchmarks over the long term, despite the occasional short-term underperformance. While we were very pleased with the strong performance results last year, we are prepared for a more challenging market environment in the years ahead. We expect that the markets will continue to rise at a mid-single digit pace over the next ten years as interest rates start to rise globally and economic growth rates stabilize at a lower rate. Given the challenges facing higher education today, we will continue to pursue long-term investment returns that will enable the University to achieve its goals and maintain its excellence far into the future.

Sincerely,

Keith Walter
Chief Investment Officer

Anthony Bartocci – UD class of 2002
Investment Officer

Christopher LeRoy – UD class of 2013
Investment Analyst

Dr. Dennis Assanis
University President

Alan Brangman
EVP and University Treasurer

Greg Oler
Vice President, Finance