Opening Remarks

January 2006

It is our pleasure to share with you the 2004-05 annual endowment report. As you know, Puget Sound’s endowment is vitally important to its financial health. Generations of students and faculty have benefited from the thoughtfulness of alumni, parents, friends, corporations, and foundations that have made gifts in support of this permanent resource.

As of June 30, 2005, Puget Sound’s endowment totaled $201.8 million. During the past decade, fiscal years 1995-96 through 2004-05, the endowment distributed $77.6 million to the university’s operating budget. These dollars were expended to support large and vitally important budget components such as student financial aid, faculty compensation, library resources, the academic program, and Puget Sound’s remarkable campus.

We are pleased to report that Puget Sound’s pooled endowment again exceeded the university’s performance benchmark by generating returns of 9.6% against a benchmark of 9.5%. Each asset class in the portfolio produced positive returns for the year. In addition, thanks to the generosity of many individuals and organizations, the university also received $1.08 million in new gifts to endowment during the course of the fiscal year.

The university is grateful to donors who have supported its mission by contributing to its endowment. Through their farsightedness and planning, Puget Sound is a stronger institution that is well-positioned to provide a nationally recognized liberal arts education to future generations of talented students. Thank you for supporting Puget Sound’s mission and for all you do, in so many ways, for this wonderful university.

Sincerely,

Sherry B. Mondou
Vice President
for Finance and Administration

David R. Beers
Vice President
for University Relations
Background

Purpose of this Report
We prepare this report annually on the university’s endowment to inform donors, their advisors, and other interested parties about the objectives, management, and performance of the university’s pooled endowment fund. In addition to providing this general report, the university periodically updates donors on the status of their named fund(s), which are maintained separately within the pooled endowment fund.

Overview of the University of Puget Sound’s Endowment
The purpose of the endowment is to provide ongoing financial support for operations that will remain stable (or grow) in real or inflation-adjusted terms, as adjusted for new additions to the endowment. Endowment is an important funding source for Puget Sound, as it is for virtually all colleges and universities.

As of June 30, 2005, the University of Puget Sound endowment consisted of 473 separate funds totaling nearly $202 million. According to the National Association of College and University Business Officer (NACUBO) Endowment Study, Puget Sound’s endowment value (as of June 30, 2005) ranked 216, in terms of size, out of the 746 colleges and universities participating in the study.

Puget Sound’s endowment was created by donors who have stipulated that their gifts be invested in perpetuity to provide investment earnings that help pay the costs of fulfilling the university’s mission. Individual endowed funds may carry and honor the name of the donor or others designated by the donor, or donors may add new gifts to general endowments already established.

The university manages its endowment through policies established by the Board of Trustees. Earnings from endowment investments support university programs in accordance with donor-imposed restrictions. In addition to the restricted-use endowment gifts the university receives, unrestricted endowment gifts provide maximum flexibility in their use and are particularly helpful to the university as circumstances change over time. Between 1996 and 2005, Puget Sound’s total endowment distributed nearly $78 million in program support for student financial aid, professorships, academic support, research, and other purposes.

Programs Supported by the Endowment

1 This report is based on fiscal year-end unless otherwise indicated.
What is the Pooled Endowment Fund?
The university’s endowment is made up of pooled and non-pooled funds. To the fullest extent possible, individual endowments are pooled for investment purposes, creating a vehicle similar to a mutual fund, which enables both diversification and economies of scale. This pooling enables broad diversification of investments among asset classes that are not similarly affected by economic, political, or social developments, thereby providing an appropriate balance between risks, returns, and volatility. In addition, pooling permits economies in oversight, investment management, and accounting costs. Even though endowment assets are invested as a pool, the university separately maintains the identity of each endowed fund in its accounting records. Individual accounts of the principal and accumulated earnings of each fund in the investment pool are maintained and periodically reported.

In the rare cases when the university has accepted an endowment gift that cannot be pooled for investment purposes, the principal is held and invested separately from all other university investments. At times, the university also temporarily holds donated assets in the non-pooled endowment until they can be liquidated and transferred to the pooled endowment fund. Fourteen separately held and managed individual endowment funds made up the university’s non-pooled endowment at June 30, 2005.

The university’s pooled endowment also includes both term endowments and quasi-endowed funds. Term endowments are funds for which the donor stipulates the principal may be expended after a stated period of time or upon the occurrence of a certain event. Quasi-endowed funds are not restricted to the endowment by the donor but have been designated by the Board of Trustees to be held in the endowment and administered in a similar fashion to true endowment funds.

Endowment Market Value
Like other colleges and universities, Puget Sound’s endowment experienced declines in market value during 2001 and 2002 because of overall declines in investment markets during those years. Investment performance has continued to improve since 2003, with the pooled endowment returning 17.6% against a benchmark return of 17.2% in 2004, and 9.6% against a benchmark return of 9.5% in 2005.

Puget Sound’s investment policies recognize the importance of using a long-term time horizon when measuring performance. In fact, the pooled endowment fund has more than doubled over the past ten years. This success is largely due to strong investment returns during the prior decade and to the generous support of our donors. The following graph shows the market value of the university’s pooled, non-pooled, and total endowment for the past ten years.

Because the majority of Puget Sound’s endowment consists of pooled funds, the remainder of this report will concentrate on the policies and performance of the pooled endowment fund.
Pooled Endowment Fund Investment Policies and Objectives

What is the Primary Objective of the Pooled Endowment Fund?
Well-reasoned, sound investment policies and objectives are a crucial part of the University of Puget Sound’s comprehensive investment plan. The university’s investment policies are recommended by the Investment Subcommittee of the Board of Trustees, approved by the Finance and Facilities Committee, and annually distributed to the full Board. These policies recognize that the primary investment purpose is to provide a sustainable maximum level of return consistent with prudent risk levels. The specific investment objective is to attain an annualized total real return (net of fees and expenses) of at least 5% plus the rate of inflation, through appreciation and income.

Puget Sound’s investment policies recognize support for current operations must be consistent with the long-term growth of the endowment. While shorter-term investment results will be monitored, adherence to a sound long-term investment policy, which balances short-term spending needs with preservation of the real (inflation-adjusted) value of assets, is crucial to the long-term success of the endowment.

What is Puget Sound’s Endowment Spending Policy?
Determining an appropriate endowment spending policy is one of the Board of Trustees’ most important responsibilities. The university has a moral and legal obligation to donors, many long deceased, who intended their gifts to support not just today’s students and faculty but also succeeding generations long into the future. To do this, the university must strike a balance between distribution and reinvestment of earnings. Excessively high spending rates deteriorate long-term spending power, while reinvesting too large a portion of total return could cause significant disruptions in the programs our donors support. The university’s spending policy aims to balance the need for current earnings with the need to preserve the purchasing power of the endowment.

Like other colleges and universities, Puget Sound distributes earnings from the pooled endowment fund using a formula that has a smoothing effect when the market is volatile. This is important because the earnings provide annual support for ongoing programs that are important to the mission of the university. This smoothing is accomplished by distributing earnings based on a moving average of the pooled endowment fund market value; an approach used by a majority of university endowment funds. The use of a moving average asset base moderates the impact of market fluctuations on annual spending, thereby making it easier for the institution to formulate and adhere to annual budgets.

The effect of this spending rule is demonstrated in the following graph. Even though endowment spending declined in fiscal years 2002–2005, the increased levels of annual spending over most of the prior decade were made possible because, in accordance with policy, some of the gains earned in the prior periods were reinvested rather than distributed.
In 1998, the Board of Trustees adopted a plan to gradually decrease the approved spending rate from 6.0% to 5.0% over a ten-year period. In October 2002, in response to significant downturns in financial markets, the Board accelerated their plan and reduced the approved spending rate to 5.0% for 2003. For 2003, the impact of lower market value, the reduced spending rate, and short fiscal year\(^2\) resulted in a reduction in the total endowment distribution, as reflected in the preceding graph. Since 2003 was a ten-month period due to a change in fiscal year, we have shown for comparison purposes, in both the preceding and following graphs, what a full-year distribution would have been.

The Board-approved spending rate has remained constant at 5.0% since 2003. The lower spending rate is important for the long-term health of the endowment. The most significant impact of lower revenue from endowment spending is a reduction in funding specifically for financial aid.

The following graph shows endowment distribution per student for the years 1996–2005, with both short- and full-year amounts for 2003. During this period of time, enrollment at the University of Puget Sound had been relatively stable. By the end of this ten-year period the university’s pooled endowment had doubled in value, resulting in more resources available to fund the educational needs of each student. Even with this doubling, the resources have not kept pace with rising education costs.

---

\(^2\) In October 2001, the Board of Trustees approved a change in the university’s fiscal year end from August 31 to June 30, effective for the fiscal period beginning September 1, 2002, and ending June 30, 2003.
Recent Declines in Pooled Endowment Fund Distributions
The university’s endowment distribution and resulting endowment distribution per student has decreased in 2002–2005, when considering what the distribution would have been for a full year in 2003. The decrease in the year ended August 31, 2002, was due to decreases in the pooled endowment fund’s moving average market value combined with a planned decrease in the Board-approved spending rate from 5.85% in 2001 to 5.75% in 2002.

Several reasons contributed to the decrease in the university’s endowment distribution and resulting distribution per student for the ten-month period ended June 30, 2003. The pooled endowment fund’s 36-month moving average market value continued to decline, as a result of overall market declines in 2001 and 2002. The Board of Trustees approved a decrease in the spending rate from 5.75% to 5.0% for the reasons described in the previous section. The endowment distribution for the ten-month period ended June 30, 2003, was prorated for many individual endowment funds to the fullest extent possible because of the short fiscal year. This caused the actual ten-month distribution to be approximately 10% less than what a full 12-month distribution would have been. The endowment distribution and endowment distribution per student graphs in the preceding section show a comparison of the actual ten-month distributions versus what a 12-month distribution for 2003 would have been.

The 2004 and 2005 endowment distribution and endowment distribution per student continued to decline (from the full 12-month 2003 level) because, although the approved spending rate was held constant at 5.0%, the pooled endowment fund’s 36-month moving average market value continued to decline as a result of the residual effects of lower average monthly market values in 2001, 2002, and 2003.

Underwater Endowment Funds
As a result of general market declines between 2001 and 2003, endowments of colleges and universities and other not-for-profit organizations experienced negative investment returns and overall reductions in the value of their investment portfolios. Because investment portfolios are directly linked to endowment funds in a manner similar to how a mutual fund is linked to (owned by) individual investors, a decline in the value of an investment portfolio causes a similar decline in the value of individual endowment funds. A decline in the value of an institution’s endowment funds naturally causes a reduction in the amount of the overall funds the organization has available to distribute in accordance with its internal spending policy. Individual endowment funds were established at different times over the life of an institution and therefore, the impact of a decrease in market value of an investment portfolio on a particular endowment fund will vary.

Of particular concern in declining and recovering markets is an individual endowment fund that has a market value that has declined below its “historic dollar value” (typically the fair market value at the time of the gift). When this occurs, it is referred to as an “underwater endowment fund.” In down markets, the market values of recently established endowment funds generally have a greater chance of falling below their historic dollar values. As a result, institutions that initiated significant fundraising efforts in the recent past to increase their overall endowment may have a greater number of underwater funds.

In 2002–2005, Puget Sound had individual, named endowment funds that were “underwater.” The gifts funding these underwater endowments were largely received during the university’s successful comprehensive fundraising campaign that concluded in 2000, which was also the beginning of a bear market. Positive investment returns earned by the end of 2003 through 2005 significantly reduced the number of underwater endowment funds. As of June 30, 2005, there were nine underwater endowment funds with a market value of approximately $157,000 less than the historic dollar values. This is compared to just a year earlier when there were 32 underwater endowment funds with a market value of
approximately $906,000 less than the historic dollar values. Until the market values of these endowments are again equal to their historic dollar values, the university, in compliance with state law, must limit the annual endowment distribution from these endowments to current income, such as interest and dividends. This legally mandated limit on the endowment distribution contributed to the overall decrease in the endowment distribution in 2002–2005.

How are Endowed Gifts Invested and Managed?
The university’s comprehensive investment plan and policies provide appropriate restraints and opportunities. These policies guide the university’s governing board as they perform their fiduciary duties, which include determining asset allocation and investment strategy, selecting investment vehicles and managers, and monitoring performance. Like most colleges and universities with an endowment the size of Puget Sound’s, the university uses an investment consultant to advise the university in all aspects of managing and overseeing the endowment.

In 2005, the university’s Finance & Facilities Committee approved, upon recommendation by the Investment Subcommittee, a new target asset allocation for the pooled endowment fund of 32% domestic equity, 15% international equity, 18% fixed income, and 35% to hedge fund, private equity, real estate, and natural resources. The following graph shows the actual and committed asset allocations of the pooled endowment fund at December 31, 2005, as compared to the new target allocation.

**Pooled Endowment Asset Allocation**

*December 31, 2005*

![Graph showing asset allocation comparison]

- **Target**
  - U.S. Equity – Large Cap: 20%
  - U.S. Equity – Small Cap: 12%
  - International Equity: 15%
  - Fixed Income & Cash Equivalents: 18%
  - Hedge Funds, Private Equity, Real Estate, and Natural Resources: 35%

- **Pro Forma Committed**
  - U.S. Equity – Large Cap: 22%
  - U.S. Equity – Small Cap: 13%
  - International Equity: 17%
  - Fixed Income & Cash Equivalents: 20%
  - Hedge Funds, Private Equity, Real Estate, and Natural Resources: 28%

- **Actual**
  - U.S. Equity – Large Cap: 26%
  - U.S. Equity – Small Cap: 18%
  - International Equity: 20%
  - Fixed Income & Cash Equivalents: 20%
  - Hedge Funds, Private Equity, Real Estate, and Natural Resources: 16%
Pooled Endowment Fund Management
(as of September 30, 2005)

Investment Consultant
Fund Evaluation Group, Cincinnati, OH

Custodial Bank
Victory Capital Management, Inc., a division of KeyBank N.A., Cleveland, OH

Equity Managers
Dimensional Fund Advisors, Inc., Santa Monica, CA
Geewax, Terker & Company, Chadds Ford, PA
Lord Abbett & Co., Kansas City, MO
PIMCO, Newport Beach, CA
Quellos Capital Management LP, Seattle, WA
State Street Global Advisors, Boston, MA
The Commonfund, Wilton, CT

Fixed Income Manager
PIMCO, Newport Beach, CA

Hedge Fund, Private Equity, Real Estate, and Natural Resources Managers
Acacia Capital Corporation, Phoenix, AZ
BlackRock Financial Management, Inc., New York, NY
Blackstone Alternative Asset Management L.P., New York, NY
Endowment Realty Investors, Inc., Wilton, CT
FIA Timber Partners, L.P., Atlanta, GA
Frazier & Company, Seattle, WA
Kelso & Company, New York, NY
Venture Capital Fund of America, New York, NY

Pooled Endowment Fund Investment Performance

What is Total Return?
Total return is the accepted method of measuring the performance of equity, fixed income, and alternative investments. For purposes of this report, total return is the combination of income, dividends, gains, and losses for a specific period of time, net of investment expenses such as investment management, custodial, and consulting fees.

Performance of the pooled endowment fund is measured by comparing the total return on invested assets by individual investment managers, asset classes, and the pooled endowment fund as a whole to appropriate benchmark returns. The Investment Subcommittee of the Board of Trustees regularly reviews the pooled endowment fund performance measures. The university also compares the performance of the pooled endowment fund to that of other college and university endowment funds of similar size.
How Well Did the Pooled Endowment Fund Perform Over the Past Five Years?
The following graphs compare the total return on the pooled endowment fund to the benchmark return\(^1\) for a period of one, three, and five years\(^4\). The total, five-year, annualized return for the pooled endowment fund was 2.1%, as compared to the benchmark return of 2.1% for the same time period. As was noted previously in this report, the return on the pooled endowment exceeded the benchmark in both 2004 and 2005.

Annualized Total Returns for the Periods Ended June 30, 2005

How Well Did the Pooled Endowment Fund Perform Over the Past Ten Years Compared to Other Colleges and Universities?
The following graph compares the total return on the pooled endowment fund to other selected universities' endowment funds for periods of one and ten years. The total, one-year return for the pooled endowment fund in 2004\(^5\) was 17.6% and exceeded the average return of other colleges and universities. The total, ten-year, annualized return for the pooled endowment fund was 8.7%, as compared to other colleges and universities for the same time period, as illustrated below. Ten years ago, Puget Sound had more of its assets allocated to fixed income and less to alternative investments than its peers, whereas today the pooled endowment asset allocation more closely tracks the asset allocation of peer institutions. For many colleges, alternative investments have been the best performing asset class during this time period.

Annualized Total Returns for the Periods Ended June 30, 2004\(^5\)

---

\(^1\) Benchmark return is comprised of: 30% S&P 500, 15.0% Russell 2000 Index, 15.0% MSCI ACWorld Free ex-US, 27.0% LB Aggregate Bond Index, 5.0% NCREIF Property Index, 5.0% Russell 3000 Index +5%, and 3.0% US T-Bill + 5%.

\(^4\) The comparative return reported is for the period ended June 30, 2005.

\(^5\) The most current available comparative returns on university endowments are for the period ending June 30, 2004.
How Much in Endowed Gifts has Puget Sound Received?

Puget Sound received $85.8 million in total gift income over the past ten years. Of this total, $27.5 million in gifts were added to the university’s endowment fund. The graph below shows contributions received (on a cash basis, excluding unpaid pledges) during fiscal years 1996 through 2005.

As this endowment report illustrates, colleges, universities, and the individuals who sustain them have shared the trauma of September 11, 2001, the slowing economy, and a volatile stock market. The impact on Puget Sound’s total gift income was magnified by the slowdown of major gifts that can immediately follow a major campaign. (The Campaign for Puget Sound: Charting the Future, the most successful campaign in our history, closed December 31, 2000, with most major pledges paid.) Throughout this transition period, Puget Sound has celebrated and strengthened its relationships with the people who are committed to its success.
Closing Remarks

As you have seen in these pages, the Board of Trustees and the administrators of the University of Puget Sound are committed to the prudent management of the university’s endowment. Generations of alumni, parents, and friends, as well as corporations, foundations, and other organizations have thoughtfully provided for the future of the university through their contributions to the endowment. Puget Sound recognizes its responsibility to manage these resources wisely for the benefit of current and future generations of students and faculty.

One of the key challenges in higher education is the issue of affordability. Colleges and universities like Puget Sound derive the vast majority of their revenue from three sources: tuition and fees, endowment distributions, and annual gifts made in support of the operating budget. By growing the endowment through charitable gifts and careful management, as well as by increasing annual contributions to the Puget Sound Fund, the university can, over time, lessen its reliance on tuition and fees. As Puget Sound seeks to ensure access to all qualified students, regardless of their ability to pay for all of the costs associated with their education, the importance of sources of revenue other than tuition and fees and, especially, the importance of the endowment, cannot be overemphasized.

As a donor or potential donor to the endowment, you make a tremendous difference to the students and faculty of this university. Puget Sound is most grateful for your vision, thoughtfulness, interest, and, of course, for your generosity. On behalf of the students and faculty, thank you.

For More Information

If you have questions or comments about the University of Puget Sound’s endowment funds or would like to receive information on how you can support the University of Puget Sound, please contact:

David R. Beers
Vice President for University Relations
253.879.3902
drbeers@ups.edu

or

Stephen McGlone
Senior Director of Gift Planning
253.879.3482
smcggone@ups.edu
University of Puget Sound
Board of Trustees and Officers

Trustee Officers

Deanna W. Oppenheimer '80
Chair, Chair of the Executive Committee
Peter K. Wallerich P'77
Vice Chair
Ronald R. Thomas
President
Michael J. Corliss '82
Treasurer

Trustees

Carl G. Behnke
President, REB Enterprises, Inc., Seattle, Washington
Richard M. Brooks '82
CEO/Director, Zumiez Incorporated, Everett, Washington
William M. Canfield '76
President, Genzyme Glycobiology Research Institute, Oklahoma City, Oklahoma
Marvin H. Caruthers P'02
Professor, University of Colorado, Boulder, Colorado
Bradbury F. Cheney '82
Executive Director, Ben B. Cheney Foundation, Tacoma, Washington
Michael J. Corliss '82
Owner/President/CEO, Investco Financial Corporation, Sumner, Washington
Lowell Daun '68
Senior Vice President, Delta Dental Plan of California, Rancho Cordova, California
Hollis S. Dillon '84, J.D. '88
Owner and Co-President, HeidiSays.com, Mercer Island, Washington
Randolph C. Foster '74
President, Triad Development, Seattle, Washington
Frederick W. Grimm '78
Teacher/Coordinator (retired), Tacoma Public Schools, Tacoma, Washington
Nancy R. Hoff '51
Senior Vice President (retired), Corporate Affairs,
Mack L. Hogans
Weyerhaeuser Company, Tacoma, Washington
Justin L. Jaschke '80
CEO (retired), Verio, Inc., Englewood, Colorado
Haruo Kazama '66
President/CEO, Genesis International, Ltd., Kyoto, Japan
Matthew M. Kelleher '79
Senior Vice President, Smith Barney, Seattle, Washington
George E. Matelich '78
Managing Director, Kelso & Company, New York, New York
Janeen Solie McAninch '77, P'06
President/CEO, Becker Capital Management, Portland, Oregon
William D. McCormick P'97
Professor of Physics Emeritus, University of Texas, Austin, Texas
William H. Neukom P'94
Chair, Preston Gates & Ellis, LLP, Seattle, Washington
Marc A. Olson '87
Group Program Manager–Microsoft Office,
Deanna W. Oppenheimer '80
Microsoft Corporation, Redmond, Washington
Edward W. Paup
Chief Executive, UK Retail Banking, Barclays PLC, London
John C. Pierce '65, P'94, '97
Bishop, Pacific Northwest Conference, The United Methodist Church,
Robert C. Pohlad P'07
Seattle, Washington
Nathalie B. Simsak
Executive Director, Oregon Historical Society, Portland, Oregon
Elaine J. W. Stanovsky '76
Chair/CEO, PepsiAmericas, Minneapolis, Minnesota
Kiseko Miki Takahashi
Chairman of the Board (retired), Lanoga Corporation, Bainbridge Island, Washington
Ronald R. Thomas
Council Director/Assistant to the Bishop, Pacific Northwest Conference,
Peter K. Wallerich
The United Methodist Church, Everett, Washington
William T. Weyerhaeuser
Former Member of the Diet, Tokyo, Japan
John A. Whalley '64
President, University of Puget Sound, Tacoma, Washington
Private Investor, Tacoma, Washington

Non-Trustee Officers

Kristine M. Bartanen
Academic Vice President and Dean of the University
David R. Beers
Vice President for University Relations
Mary Elizabeth Collins '81
Executive Assistant to the President and Secretary of the Board
Janet S. Hallman '84
Interim Controller
Jean Kim
Vice President for Student Affairs and Dean of Students
George H. Mills, Jr. '68, M.S. '72
Vice President for Enrollment
Sherry B. Mondou
Vice President for Finance and Administration