University of Cincinnati
Report to the Board of Trustees
For Information

Date: March 7, 2012

Title: **UNIVERSITY OF CINCINNATI ANNUAL ENDOWMENT PERFORMANCE REPORT AT JUNE 30, 2011**

Synopsis: A summary of the annual performance of the UC endowment at June 30, 2011.

A copy of the report is attached.

Prepared by: ____________________
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Approved by: ____________________
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Attachment

FOR BOARD OFFICE USE ONLY:

Date of Board Acceptance: March 27, 2012 Submitted by: ____________________
President

The University of Cincinnati
Annual Endowment Performance Report at June 30, 2011

Fiscal 2011 Performance

For fiscal 2011, the University of Cincinnati Fund A ("Fund A") generated investment gains of +19.1%, which far exceed Fund A's primary goal[1], which was a +8.8% return for the period. During fiscal 2011, all of Fund A's major investment categories generated gains. The endowment value grew to $1.0 billion based on net investment gains of $148 million and distributions of $30 million. The endowment totaled $886 million on June 30, 2010.

Fund A excluding strategic assets such as Neighborhood Development Corporation Loans (hereafter, the "Investment Portfolio") generated gains of +21.1% in fiscal 2011, outperforming the NACUBO[2] national average, which gained +19.2%. The Investment Portfolio outperformed the Target Weighted Benchmark[3], which gained +20.6%, due primarily to outperformance in U.S. equities and fixed income. The Investment Portfolio underperformed the Broad Policy Benchmark[4], which was up +24.8%, due to the Broad Policy Benchmark's higher weighting to U.S. equities, which were among the highest returning investment categories in global financial markets for the period.

Market Commentary Fiscal 2011 witnessed very strong returns in virtually every asset category as it coincided with a period of increased risk-taking among investors simultaneous with falling interest rates due primarily to the announcement by the U.S. Federal Reserve of a second round of quantitative easing ("QE2")[5] in November 2010. In reaction to QE2 and other positive economic news, global public equities, real estate securities, commodities, and private equity investments all rose by 25% to 35% while at the same time U.S. bond markets[6] gained nearly +4%.

Trailing Three-Year Performance at June 30, 2011

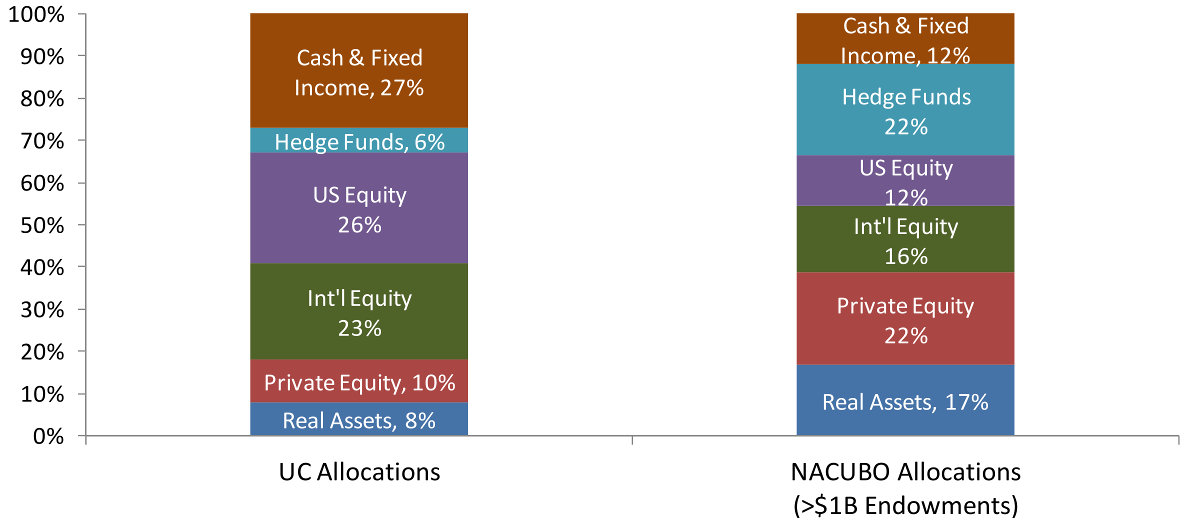
Over the past three years, which includes the 2008 market meltdown and subsequent recovery, Fund A generated modest gains (+2.5%) and underperformed its Primary Objective (+6.5%). In the type of climate experienced in the past three years, very few investment strategies produced gains that exceeded the Primary Objective. Even U.S. bond markets, among the best-performing markets in this period, generated the same returns as the Primary Objective (both +6.5%). The Investment Office remains focused on achieving the Primary Objective over long time horizons.

The Investment Portfolio generated +3.3% annualized gains in the trailing three years to June 30, 2011, outperforming the NACUBO average (+3.1%) due primarily to asset allocation (please see below). The Investment Portfolio underperformed its Target Weighted Benchmark (+4.5%) and Broad Policy Benchmark (also +4.5%) primarily due to major losses in a single large real estate investment. Most of the investment portfolio's investment categories outperformed their relevant benchmarks during the period, though collectively not enough to offset the underperformance of the collapsed real estate investment (for additional information, please refer to prior endowment performance reports).

The Investment Portfolio outperformed the NACUBO average over the past three years owing to the investment portfolio's higher allocations to fixed income and U.S. equities and lower allocations to

[1] Primary Objective: Spending Policy + Fees (Internal Administration, Custodian, and Consultant) + Consumer Price Index.
[2] Source: June 2011 NACUBO-Commonfund Study on Endowments. Please note that other universities may have different goals, liquidity, fundraising, and other factors that may render performance comparisons less relevant.
[3] The Target-Weighted Benchmark replicates the Investment Portfolio's strategic asset allocations with market indices to measure manager selection and tactical deviations from the strategic asset allocations.
[4] The Broad Policy Benchmark seeks to replicate Fund A's risk profile using only stock and bond indices.
[5] Quantitative Easing involves a central bank infusing the economy with newly-created money.
[6] U.S. bond markets are represented herein by the Barclays Capital U.S. Aggregate Bond Index.

real assets and private equity versus college endowments of comparable size. The most significant driver of the UC investment portfolio's outperformance during the past three years was the investment portfolio's dramatically higher weighting to fixed income securities, among the best-returning investment category during this period. The UC Investment Portfolio had 27% of its capital allocated to cash & fixed income versus 12% for NACUBO's endowments that exceed $1 billion.



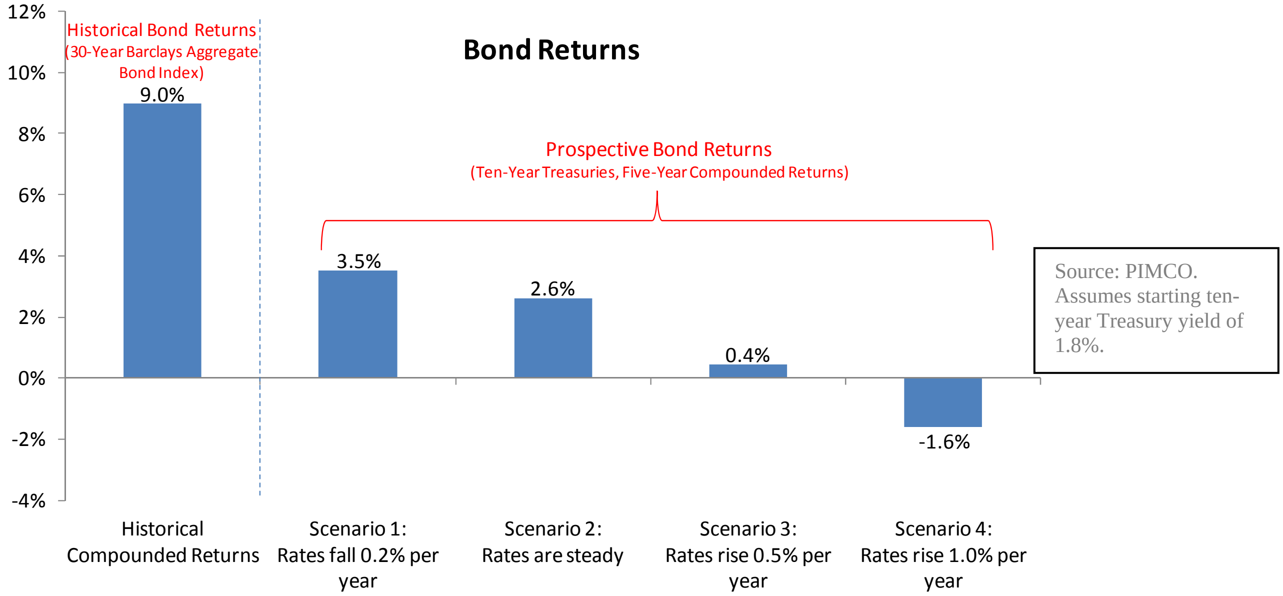
Market Outlook

The Investment Office is focused on maximizing the odds that the endowment will achieve its Primary Objective while remaining within the University's risk tolerance. The Investment Team believes the Primary Objective, which will likely exceed +8% or more per year, will be a difficult hurdle to clear in the current investment climate, given our outlook for poor stock and bond returns. The Investment Team's market outlook is driven by the following three major themes.

1. Historically Low Interest Rates Interest rates in the U.S. are nearing the natural limit of a 30-year secular decline from over 16% in the early 1980s to around 2% today.

Shaded areas represent recessions. Source: Board of Governors of the Federal Reserve System (research.stlouisfed.org).

When interest rates fall, bond prices rise, driving capital appreciation. High interest rates provide high current coupon payments to bond owners further boosting their returns. As such, falling interest rates in the past three decades were substantial tailwinds for fixed income returns and U.S. bond markets generated +9% annualized gains during this three-decade period. Looking forward with interest rates near 2%, the capacity for capital appreciation from falling rates is dramatically reduced and the current coupon payments are small. As such, we would expect Treasury bonds to generate returns in the range of +0.5% to +2.5% per year on an annualized basis for the next five years with a meaningful probability of interim periods of negative returns. The Investment Office is reducing the Investment Portfolio's allocation to fixed income by half from 30% to 15% gradually over the course of fiscal 2012 and reallocating this capital to investments that offer diversification benefits but have the potential to generate high returns that can help Fund A meet the Primary Objective.



2. Dual Speed World. For most of the twentieth century, the early leaders of the industrial revolution (the "Developed Market" countries), including the U.S., Western Europe, and Japan, have been the drivers of economic growth in the global economy while many of the largest and most populous countries in the world, including China, India, and Brazil experienced crippling political turmoil that severely hindered growth (the "Emerging Market" countries). Today, Developed Market countries face poor growth prospects due to aging demographics, high and growing debt loads, and challenging political dynamics. Meanwhile, Emerging Market countries have experienced dramatic turnarounds in their political situations that have enabled them to generate persistently strong economic growth that appears durable due to the depressed level of economic output from which they are starting, attractive demographics, low debt loads, and other factors.

This reversal in the fortunes of the world's largest economies presents the Investment Office with challenges and opportunities. Equity return potential from Developed Markets appears to echo the poor economic growth prospects of these countries while Emerging Market equities appear to offer compelling returns. Other assets, including Emerging Market bonds, Emerging Market currencies, and energy and other natural resources also appear poised to offer compelling returns driven by the changing dynamics of the global economy. Many of these investments are likely to carry higher volatility, but we expect their risk-adjusted returns will nevertheless be superior to Developed Market equities over the next five years. The Investment Office is reducing the Investment Portfolio's allocation to Developed Market equities and increasing the allocation to Emerging Market equities, debt, currencies, and natural resources investments.

3. Orphaned Assets and Investment Strategies. During the financial market meltdown of 2008, investment banks, highly leveraged hedge funds, and other highly leveraged investment entities were forced to deleverage, causing many to cease investing. When these entities exited the market, the pool of buyers for a number of assets and investment strategies shrank dramatically. In financial markets, when capital is scarce relative to opportunities, the investment returns available from those opportunities tend to rise.

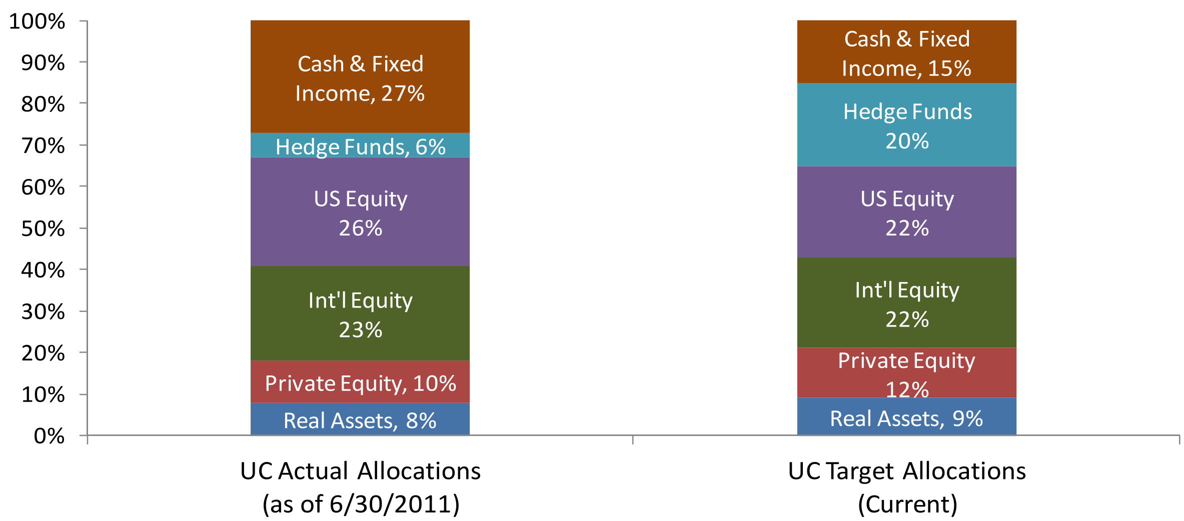
The assets that were orphaned in 2008 include a wide range of securities and hard assets of companies in the bankruptcy process, complex financial assets including structured products, and many others. Similarly, a wide range of strategies were orphaned including direct lending strategies, event-driven strategies that seek to benefit from merger and other corporate actions, and value-driven strategies that make hedged investments in out of favor assets.

Fund A is able to access these assets and strategies via Absolute Return managers, a diverse group of highly talented managers who have years or decades of experience investing in these assets and strategies, have the ability to shift their portfolios to reflect the most compelling investments in the marketplace, can hold large cash positions when they deem their opportunity set as unattractive, and utilize little if any leverage. The Investment Office has worked with a number of these fund managers in the past and possesses deep knowledge of their organizations, strategies, and skills.

Absolute Return managers, in seeking to exploit market inefficiencies in a wide range of markets, generate returns largely independent of broad equity and bond market moves. An equal-weighted portfolio of the managers in which Fund A currently invests would have produced a compound annualized return of +10.0% over the past ten years[7] (versus +2.9% for U.S. equities) with moderate (0.59) correlation to U.S. equities. Hence Absolute Return managers have offered solid diversification benefits and we expect them to continue to. Unlike the traditional diversifying assets (cash and fixed income), Absolute Return managers are positioned to simultaneously offer high returns that may help Fund A reach its Primary Objective. The Investment Office is increasing our allocation to Absolute Return investments from 6% to 20% over the course of fiscal 2012.

Portfolio Positioning

The Investment Portfolio strategic asset allocations reflect the market outlook above. Due to today's low interest rates and the compelling dynamics of orphaned asset and strategies, the allocation to fixed income is being reduced and the allocation to Absolute Return investments is being increased (within the Hedge Funds category below). Due to the implications of today's dual-speed world, the allocation to Developed Market equities is being reduced and the allocation to Emerging Market equity, debt, and currencies is being increased.



[7] As of November 30, 2011.

UC ENDOWMENT FUND A Summary Performance Data As of June 30, 2011	Annualized Performance 1-Year %	 3-Year %	 5-Year %	 10-Year %	Market Value $ Millions	 %
Total Fund	19.1%	2.5%	3.7%	5.4%	$740.6	
Neighborhood Development Corporation Loans	0.9%	1.2%	-4.4%	-	$61.0	
Investment Portfolio (Total Fund ex-NDCLs)[1]	21.1%	3.3%	4.8%	5.8%	$679.6	100%
Primary Objective[2]	*8.8%*	*6.5%*	*7.5%*	*7.7%*		
Broad Policy Benchmark[3]	*24.8%*	*4.5%*	*4.6%*	*5.0%*		
Target-Weighted Benchmark[4]	*20.6%*	*4.5%*	*5.4%*	*6.5%*		
NACUBO Average (Equal-Weighted)[5]	*19.2%*	*3.1%*	*4.7%*	*5.6%*		
U.S. Equity	33.5%	4.0%	3.7%	4.1%	$178.1	26%
U.S. Equity Benchmark	*32.4%*	*4.0%*	*3.3%*	*4.5%*		
Int'l Developed Markets Equity	30.4%	-0.8%	1.8%	5.7%	$102.7	15%
Int'l Developed Markets Equity Benchmark	*30.4%*	*-1.8%*	*1.5%*	*5.7%*		
Emerging Markets Equity	25.8%	4.5%	10.4%	-	$34.1	5%
Emerging Markets Equity Benchmark	*27.8%*	*4.2%*	*11.4%*	-		
Cash & Fixed Income	6.1%	9.0%	8.5%	6.8%	$197.5	29%
Fixed Income Benchmark	*5.1%*	*7.1%*	*7.2%*	*6.4%*		
Real Estate	32.1%	-15.0%	-7.6%	3.4%	$37.6	6%
Real Estate Benchmark	*23.1%*	*1.4%*	*2.4%*	*9.5%*		
Private Capital	23.6%	5.9%	9.4%	3.1%	$86.2	13%
Private Capital Benchmark	*24.2%*	*4.1%*	*9.5%*	*9.1%*		
Hedge Funds	10.3%	2.7%	5.4%	-	$43.5	6%
Hedge Funds Benchmark	*8.2%*	*-0.3%*	*3.0%*	-		

1 Total Fund performance excluding NDCLs beginning October 1, 2009. Total Fund performance adjusted by substituting Barclays Capital Aggregate Bond Index returns for NDCLs through September 30, 2009.

2. Primary Objective: Spending Policy + Fees (Internal Administration, Custodian, and Consultant) + Consumer Price Index.

3. Broad Policy Benchmark seeks to replicate Fund A's risk profile using only stock and bond indices.

4. The Target-Weighted Benchmark return is calculated by applying the target weightings of asset categories to their respective benchmark returns.

5. Source: June 2011 NACUBO-Commonfund Study on Endowments.