Reported to the Board of Trustees

September 23, 2021

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**Office of Investments Annual Report**

**Fiscal Year Ending June 30, 2021**

**Table of Contents**

Introduction…………………………………………………………………………3

Invested Asset Overview………………………………………………...…………4

Endowment Funds...…………....………………………………………….….……5

Asset Allocation…………………………………………………..………..6

Spending Policy.…………………………………………………..........…..7

Performance Measurement……………………………………………...….7

Operating Pool………………………………………………………………......…10

Asset Allocation………………………………………………….…...........10

Performance Measurement……………………………...……….……........11

Financial Impact…...…………………………………………………….............…12

Income Distribution………………………………………….………......…12

Program Costs..…………………………………….……………………….12

Appendix A – Investment Fee Schedule……………...……..…….…….………….13

Appendix B – FY21 Fee Summary……….………………………………Separate attachment

Appendix C – FY21 Endowment Transaction Report…………………....Separate attachment

Appendix D – FY21 Security Listing………………………………….….Separate attachment

**Introduction**

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e are pleased to present the University of Illinois System Office of Investments Annual Report for the 2021 fiscal year. All data in the report is as of June 30, 2021, unless noted otherwise.

Fiscal year 2021 brought an economic recovery without historic parallel. The economic reopening combined with enormous policy support propelled the rebound but also triggered goods and labor shortages and a jump in inflation. The investment program maintained a strong liquidity profile while taking advantage of dislocations. Over the one-year period, the endowment pool returned 27.7%, while the operating pool returned 0.7%, both outperforming respective benchmarks. Collectively, the endowment and operating pools distributed $80 million in investment income to the University System.

The investment program proceeded with several projects and new investments throughout the year. Staff published a new website to the public to further increase transparency and highlight accomplishments. The financial sustainability program continued with great success as the endowment’s seed investment of $160 million in the BlackRock ESG Insights strategy grew to $252 million, returning 47% since inception and outperforming its benchmark by 1.2%. In the endowment pool, investments were made in the following partnerships/funds: Icon Partners I, II and IV (global equity), Clearlake Flagship Plus Partners (global equity), Tiger PIP XIV (global equity), Merit Capital Partners VII (global fixed income), Hudson Bay International (diversifying strategies), and Singerman Real Estate Opportunity Fund (real assets). In the operating pool, staff commenced a meaningful rebalancing to reduce duration and protect against rising rates. Furthermore, the plan to transfer $5 million per month in operating assets to the endowment pool concluded after reaching the 15% target allocation.

Enclosed is an overview of invested assets and key performance and asset allocation measures for the endowment and operating pools. A fee summary, security inventory and transaction report are included as separate reports in the Board materials.

**Office of Investments Overview**

Under supervision of the Comptroller, the Office of Investments manages the University System’s operating and endowment assets, including farmland donated to the University. Operating and endowment assets are invested through carefully selected external investment firms, while farmland is primarily managed internally by the Agricultural Property Services department.

The University of Illinois BOT establishes policies for managing University asset pools. The Investment Policy sets forth asset allocation ranges for the endowment and operating pools. The Audit, Budget, Finance, and Facilities (ABFF) Committee of the BOT reviews asset allocation and performance and makes recommendations to the BOT regarding investment policy. The BOT has delegated to the Comptroller management of the University’s assets within the BOT approved policies. The Comptroller has charged the Investment Office within Treasury Operations with the day-to-day management of the investment program. It is important to note that the assets managed by the Office of Investments are distinct from those managed by the University of Illinois Foundation (UIF). UIF is a university related organization with an independent board. **Invested Asset Overview**

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he Investment Office manages two distinct categories of funds, the endowment funds and the operating pool. The permanent coreis an investment of operating pool funds in the endowment pool. The distribution of the collective pools is displayed in Figure 1.

**Figure 1**

The sections that follow elaborate on the investment program for the endowment and operating assets of the University of Illinois System.

**Endowment Funds**

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he *Endowment Funds* (market value $1.07 billion) consist of two distinct sources of funding. The first source is comprised of gifts donated to the University System to support its mission (light blue, gray and gold segments in Figure 2). Some gifts are restricted to a specific purpose while others may be for unrestricted use. The distribution of endowment pool gifts by purpose is presented in Figure 3. The second source of funding consists of operating pool funds that are managed as part of the endowment pool—the *Permanent Core*. This comprises 49% of the endowment funds. The *Endowment Pool* (dark and light blue segments in Figure 2) is managed on a consolidated basis to permit a pooled total return investment approach with a long term investment horizon. Gifts associated with separately invested endowments and endowed farms (0.1% and 7.2% of the endowment funds, respectively) are managed outside of the pool.

**Figure 2**

**Figure 3**

**Asset Allocation**

The endowment poolis invested in a variety of asset classes in accordance with policy approved by the BOT. The current distribution of endowment pool funds across sub-asset classes is shown in Figure 4. Figure 5 compares the actual allocations to long term policy ranges. All asset classes remain in policy ranges.

**Figure 4**

**Figure 5**

The endowment pool is unique compared to peers in its relatively low allocation to alternative assets. Approximately 75% of the pool is comprised of traditional asset classes. This public market allocation allows for efficient rebalancing as redemptions and contributions can be made on relatively short notice. It also reduces expenses as traditional asset classes generally charge lower fees than alternative investment vehicles. Hedge funds and core real estate were augmented into the endowment pool asset allocation in 2010, and staff has largely transitioned the private equity program from the fund-of-fund structure that originated in 2004 to a model comprised of direct investments in limited partnerships. The inclusion of farmland as an asset class also distinguishes the endowment fundsfrom peers. Farmland includes agricultural land donated to the University, as well as an investment into a closed-end U.S. farmland partnership, which serves to increase our allocation and diversify the geographical exposure. Income from endowment farms supports student scholarship and research programs.

**Spending Policy**

The investment objective of the endowment poolis to preserve the purchasing power of pool assets and provide annual support for an infinite period. The endowment pool annual spending policy for fiscal year 2021 is based on a percentage of a six year moving average of the unit market value of the endowment pool. The spending rate—set by the Comptroller annually in consultation with the President—is 5.35%,inclusive of a 1.25% administrative fee. The endowment pool distributed approximately $26 million during the 2021 fiscal year (inclusive of the administrative fee and excluding income distributed from the permanent core allocation).

**Performance Measurement**

A variety of approaches, each with advantages and disadvantages, can be taken in measuring investment performance. Four methods—(1) total return relative to the combined rate of spending and inflation, (2) peer rankings, (3) total return relative to the performance benchmark, and (4) cash flow activity—are presented below to provide a holistic view of endowment pool performance.

Total Return Relative to Spending and Inflation Rates

Following a two-year period of underperformance, the endowment pool rebounded in FY21, outperforming its hurdle rate by a significant margin. Annualized five year returns for fiscal years 2017-2021 are presented relative to the effective spending rate and the consumer price index (CPI) in Figure 6. The effective spending rate is inclusive of the administrative fee and calculated as a percentage of the year end endowment market value. This comparison provides a medium-term assessment of whether endowment returns are sufficient to offset inflation and spending. If a period of sustained underperformance were to occur, consideration would be given to whether adjustments to the asset allocation or spending rate are warranted.

**Figure 6**

Peer Rankings

Figure 7 provides the most recent available comparison—as of June 30, 2020—of the University System endowment performance against peers. The University System endowment performed favorably over the 10-year period but lagged over shorter timeframes following negative performance in FY20. We expect improvement in this comparison once FY21 figures are available.

**Figure 7**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | | 1 Year | 3 Year | 5 Year | 10 Year |
| **University System Endowment Return** | | **-0.3%** | **4.2%** | **4.8%** | **8.6%** |
| *NACUBO Institutions $500 Million - $1 Billion* | 75th Percentile | 3.4% | 6.3% | 5.9% | 7.9% |
| Median | 1.6% | 4.9% | 5.0% | 7.3% |
| 25th Percentile | -0.1% | 3.9% | 4.4% | 6.7% |

Total Return Relative to Performance Benchmark

The endowment outperformed its performance benchmark over the one-year period but underperformed longer periods, which can largely be attributed to the fee drag of ~1% annually. Recent outperformance can be attributed to U.S. public equity, fixed income, real estate and farmland. The historical investment performance of the endowment has been provided in Figure 8.

**Figure 8**

Cash Flow Activity

The endowment pool balance is impacted by three factors—net additions, the spending distribution, and capital appreciation. The impact of these factors over a ten year period as of June 30, 2021, is summarized exclusive of the permanent core allocation in Figure 9.

**Figure 9**

|  |  |
| --- | --- |
| **Summary of Endowment Pool Activity FY12-FY21** | |
| All figures in millions | |
|  |  |
|  | **Ten Year Totals** |
|  |  |
| **Beginning Balance** | **211.0** |
|  |  |
| Net Additions | 141.5 |
|  |  |
| Distributions | -160.7 |
|  |  |
| Capital Appreciation | 273.3 |
|  |  |
| **Ending Balance** | **465.1** |

**Operating Pool**

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he *Operating Pool* (market value $2.82 billion) consists of funds available for current use by academic and administrative units within the System. The pool includes cash from state appropriations, tuition and fees, student loan funds, grants, self-insurance programs, and hospital and auxiliary services. The consolidated management of funds provides robust tracking and efficient investment management.

The investment objective for the operating poolis to preserve the value of the principal, maintain liquidity appropriate to the forecasted working capital requirements of the System, provide prudent diversification and maximize the rate of return on investment. Income from the pool is returned to units in proportion to their share of the assets. During fiscal year 2021, $52.8 million was distributed from the operating pool (including the permanent core allocation) after banking and investment management fees were paid.

**Asset Allocation**

Operating pool assets are invested in fixed income securities and cash equivalents. The assets are allocated by liquidity layer. Investment managers within a given liquidity layer follow fundamentally consistent investment guidelines that set forth restrictions on duration, credit quality, diversification, performance benchmarks and permissible security types, among others. Provided that state regulation does not allow the System to borrow for working capital, the operating poolhas ample liquidity and is of high quality with an average AA credit rating. Figure 10 demonstrates the operating pool’s asset allocation on June 30, 2021, within the policy ranges by liquidity layer.

**Figure 10**

\*Note: The total operating pool market value does not include the permanent core allocation. This allocation is included in the endowment pool market value.

**Performance Measurement**

Operating pool managers have consistently outperformed the performance benchmark. Historical performance relative to the performance benchmark is displayed in Figure 11.

**Figure 11**

**Financial Impact**

The investment program generates investment income, as well as investment management costs, to the University System. All costs are offset or paid directly from investment income. The Investment Office works diligently to maintain the cost structure at a reasonable level.

**Income Distribution**

During the 2021 fiscal year, the investment program distributed income of $80.2 million in total to units across the University System after paying investment management fees. The summary of the distribution by source is shown in Figure 12.

**Figure 12**

|  |  |
| --- | --- |
| **($ Millions)** | **Distribution** |
| Endowment Pool | 26.0 |
| Operating Pool | 52.8 |
| Endowment Farms | 1.4 |
| **Total Distribution** | **80.2** |

**Program Costs**

The most significant cost to the investment program is external counterparty (*i.e.,* investment manager, custody, investment consultant) fees. For fiscal year 2021, this comprised $15.5 million or 40 basis points of total assets. Investment manager fees are net against performance. The fee schedule is enclosed in the appendix, and the FY21 Fee Summary is included separately in the board materials. Internally, the Investment Office is comprised of three full time employees with an annual salary cost to the System of approximately $280k with a technology expense of $50k.

The FY21 Security Listing and FY21 Endowment Transaction Report have also been included as separate attachments in the board materials.

# University of Illinois System

# Investment Fee Schedule – Traditional Investments

**Firm**  **Terms**

Money Market Funds Management Fee

JP Morgan 0.18%

(U.S. Government Money Market Fund)

Northern Trust 0.20%

(Institutional Government Select Portfolio)

Illinois Funds 0.05% (plus administrative expenses)

(Local Government Investment Pool)

Fixed Income

Galliard Capital Management 0.18% - first $200 million

(Short Duration) 0.15% - balance

Income Research + Management 0.21% - first $100 million

(Short Duration and Intermediate) 0.18% - next $100 million

0.15% - balance

JP Morgan 0.15% - first $50 million

(Managed Reserves) 0.125% - next $50 million

0.10% - next $100 million

0.08% - next $100 million

Neuberger Berman 0.175% - first $50 million

(Enhanced Cash) 0.15% - next $50 million

0.12% - next $150 million

(10% rebate on total fee)

Neuberger Berman 0.20% - flat fee

(Intermediate) (10% rebate on total fee)

Northern Trust 0.20% - first $100 million

(Short Duration) 0.18% - balance

Wells Fargo Asset Management 0.09% - first $100 million

(Conservative Income and Short Duration) 0.07% - balance

Attucks Asset Management 0.35% flat fee

# University of Illinois System

# Investment Fee Schedule – Traditional Investments

**Firm**  **Terms**

Fixed Income (Continued Management Fee

Vanguard Total Bond Market Index 0.05% flat fee

Artisan Partners 0.55% - first $250 million

(High Yield Income Strategy) 0.50% - above $250 million

Equity

BlackRock 0.055% flat fee

(ESG U.S. All Cap Equity Fund)

Ariel Capital Management 1.00% - first $10 million

(Small Mid Cap Value) 0.75% - next $10 million

0.50% - balance

BlackRock 0.0975% flat fee

(MSCI ACWI ex-US IMI Index Fund B)

Real Estate Investment Trust

Vanguard 0.09% flat fee

(Real Estate Investment Trust Index Fund)

# University of Illinois System

# Investment Fee Schedule – Alternative Investments

**Firm**  **Terms**

Private Capital Management Fee Carried Interest

Adams Street Partners

ASP 2004 U.S. Fund 0.00% 10% on Secondary

ASP 2004 Non-U.S. Fund 0.00% 10% on Secondary

ASP 2006 U.S. Fund 0.10% 10% on Secondary

ASP 2006 Non-U.S. Fund 0.10% 10% on Secondary

ASP 2006 Direct Fund 0.00% 20%

ASP 2007 U.S. Fund 0.20% 10% on Secondary

ASP 2007 Non-U.S. Fund 0.20% 10% on Secondary

ASP 2007 Direct Fund 0.20% 20%

ASP 2008 U.S. Fund 0.30% 10% on Secondary

ASP 2008 Non-U.S. Fund 0.30% 10% on Secondary

ASP 2008 Direct Fund 0.39% 20%

ASP 2009 U.S. Fund 0.40% 10% on Secondary

ASP 2009 Non-U.S. Developed Fund 0.40% 10% on Secondary

ASP 2009 Non-U.S. Emerging Markets Fund 0.40% 10% on Secondary

ASP 2009 Direct Fund 0.59% 20%

ASP 2010 U.S. Fund 0.50% 10% on Secondary

ASP 2010 Non-U.S. Developed Fund 0.50% 10% on Secondary

ASP 2010 Non-U.S. Emerging Markets Fund 0.50% 10% on Secondary

ASP 2010 Direct Fund 0.79% 20%

ASP 2011 U.S. Fund 0.60% 10% on Secondary

ASP 2011 Non-U.S. Developed Fund 0.60% 10% on Secondary

ASP 2011 Non-U.S. Emerging Markets Fund 0.60% 10% on Secondary

ASP 2011 Direct Fund 0.99% 20%

ASP 2013 Global Fund 0.86% 10% - Secondary & Co- Investment, 20% Direct

ASP Co-Investment Fund III 0.83% 10%

* Fee Tail Down: Fees above reflect reduction to 90% of the management fee in year eight of a subscription, 80% in year nine, 70% in year ten, etc. The tail down begins in year seven for direct funds.

# University of Illinois System

# Investment Fee Schedule – Alternative Investments

**Firm**  **Terms**

Private Capital (continued) Management Fee Carried Interest

Clearlake Capital Partners IV 2.0% 20% (8% hurdle rate)

Clearlake Opportunities Fund 1.75% 20% (8% hurdle rate)

Clearlake Capital Partners V 1.75% 20% (8% hurdle rate)

Clearlake Capital Partners VI 1.75% 20% (8% hurdle rate)

Clearlake Flagship Plus 1.25% 20% (8% hurdle rate)

Clearlake ICON I 1.0% 20% (8% hurdle rate)

Homestead Capital USA Farmland Fund III, L.P. 1.5% 15% (6% hurdle rate)

Centana Growth Partners II 2.5% with scale down 20% (8% hurdle rate)

to 2.0% after 5th year

Illinois Ventures IETF III 2.5% 20%

Oaktree Opportunities Fund X 1.6% 20% (8% hurdle rate)

Oaktree Opportunities Fund X(b) 1.6% 20% (8% hurdle rate)

Oaktree XI 1.44% 20% (8% hurdle rate)

ParkerGale Capital II, L.P. 2.0% 20% (8% hurdle rate)

BlackRock Multi-Alternative Opportunities Fund 1.5% 20% (8% hurdle rate)

Merit Mezzanine Fund VI 1.75% 20% (8% hurdle rate)

Varsity Healthcare III 2.0% 20% (8% hurdle rate)

# University of Illinois System

# Investment Fee Schedule – Alternative Investments

**Firm Terms**

Private Capital (Continued) Management Fee Carried Interest

Tiger Global Private Investment Partners XIV 2.0% (0.07% average 20-25% step up

(FEG Select) FEG Select fee)

Hedge Funds

Davidson Kempner International 1.5% 20%

Elliott International 1.5% 20%

Hudson Bay 2.0% 20% with high water mark

Real Estate

Heitman HART 1.1% - first $10 million NA

1.0% - next $15 million

Prudential PRISA 1.0% - first $10million 3% Operating Cash Flow 0.95% - $10M to $25M 0.10% Cash Balance

(1.20% Maximum Annual Fee)

Farallon Real Estate Partners III 1.5% (reduced by 15% of 20% (6% hurdle rate)

commitments for reserve)