A member of the Foundation’s senior team, Ellen J. Ellison has served as chief investment officer since January 2013. In response to the University’s strategic objective of increasing private giving and doubling the endowment, she was hired to staff and build the Foundation’s first independent investment team in a new Chicago-based investment office. Over the past two years, Ellison has recruited investment and operational talent as well as managed the Foundation’s $1.5 billion endowment.

Ellison has more than 30 years of experience in investment and endowment management and served most recently as the executive director of investments at the University of Miami. While at Miami, Ellison managed two multi-class asset investment pools, including university endowment and pension funds that totaled $1.5 billion. She also served as the chief investment officer at J.I.K. Investment Services, Inc., a family office in Miami, Florida and as a senior vice president at Fiduciary Trust Company International in both New York and Miami. Ellison holds the Charted Financial Analyst designation.
FROM THE CIO

It’s been a rewarding and productive year at the Chicago-based UIF Investment Office. In response to a strategic mandate from the Foundation’s Board, we have established a newly independent office with professional investment and operations staff, and have made significant progress in the transformation of the Foundation’s endowment portfolio.

Although much work remains in the initial build-out phase of the program, I am gratified by the results so far and the collective accomplishments of the Board and Investment Policy Committee, the Foundation, and the investment team over the past 12 months. We thank them all for their guidance, wisdom, and support.

One of the best parts of my job has been the opportunity to meet so many accomplished and dedicated individuals across our alumni, parent, student, and donor groups. As we move into the next stages of this new venture, I remain excited and committed as we build a world-class investment program to support the mission of the University of Illinois today and into the future.

Sincerely,

Ellen J. Ellison, CFA
The past year provides an excellent illustration of the often tenuous and mysterious link between macroeconomic/geopolitical headlines and global financial markets.
All major asset classes saw positive returns for the year with global equities up 23.6%, U.S. equities up 24.6%, and U.S. bonds rising 4.4%. This was stellar performance especially in light of the constant barrage of bad headlines.

It was challenging to keep track of all the headlines (mostly negative) in 2014 that included: a number of hotly contested elections, a U.S. government shut-down, military incursions and coups, popular protests, widespread unease in the Middle East, new terrorist threats, and global health scares. With each new adverse headline, investors would initially seek refuge in the safe havens provided by U.S. treasury bonds, the dollar and the Japanese yen.

This “flight to quality” would be accompanied by a temporary spike upward in volatility that was followed by a return to “normal” as investors regained confidence and sought higher risk/return assets. Despite these sharp, albeit brief, reversals in investor sentiment and behavior, and the challenging valuations of most asset classes, money continued to flow into equities and other risky assets in what could best be described as a market “melt-up.”

FOUR MAIN INVESTMENT THEMES OF THE YEAR (AND TO WATCH IN 2015):

• Outsized role of central bankers in global financial markets
• Long-term implications (and unintended consequences) of persistently low volatility
• Changing global energy landscape
• Large increase in global merger and acquisition activity led by the emergence of a strong group of hedge fund “activist” investors

Within the U.S. and much of the developed world, an unhealthy co-dependent relationship has developed between investors and their respective central bankers such that non-economic actors—like the U.S. Federal Reserve—have been the principal drivers of global investment returns. The world’s central bankers have provided the main lever of stability since the global financial crisis of 2007-2009.

As a result, all asset prices have grown increasingly sensitive to what is going on at either the U.S. Fed, the Bank of England, the European Central Bank, or the Bank of Japan. On the surface, the support provided has been positive, and most experts agree that central bankers’ actions were necessary during the darkest days of the banking and financial crisis.

The U.S. Fed has started to reverse its previous accommodative policies given our economy’s strength while, at the same time, its counterparts in Japan and Europe begin the same process of injecting liquidity into markets with the goal of stimulating real economic growth and staving off deflation.

Seven years post-crisis, the Fed’s consistent hand-holding has worked in the U.S., but has produced some unintended consequences. Interest rates and market volatility have been artificially suppressed for so long that investors have grown complacent about risk and motivated to make atypical investment decisions. We assume that this cozy scenario cannot last indefinitely.

As interest rates go up and volatility returns to both equity and debt markets, we are concerned about the possible negative reaction of investors who can no longer count on the Fed to intercede on their behalf. To paraphrase Nassim Taleb and Mark Blyth in their article, “The Black Swan of Cairo” (Foreign Affairs, June 2011), complex systems like the global financial market can appear calm on the surface for long
periods of time. This is an illusion of calm. In fact, systems that have not experienced any meaningful setbacks accumulate silent risks beneath the surface making them far more dangerous when a blowup eventually does occur.

We worry about these silent risks as we assess the investment outlook, and look for attractively-priced assets. We also appreciate the difficulty of predicting the source of any future crack. However, we consider the bond market in 2015 as one potential area of future vulnerability. It is important to note that bond market volatility can easily bleed into equities since, as long duration assets, equities are naturally sensitive to bond prices and to interest rates.

Volatility surged in commodity and energy markets in 2014. While a number of strategists predicted that commodities would continue to be weak into 2014—driven by the moderation in Chinese growth and lower demand for raw materials—few experts imagined a 50% collapse in the price of crude. The shale oil revolution has transformed the U.S. energy picture as daily production output exceeded 8 million barrels per day for the first time in a quarter century. This represents an increase of 3 million barrels of production per day over 2010.

Sharp moves in commodity prices are normal. However, this time the price drop wasn’t the result of a global economic collapse or other geopolitical unrest but rather the culmination of long-term efforts to improve drilling in the U.S. coupled with OPEC’s decision in July to maintain market share at the expense of prices. The implications are vast and complex with both winners and losers. We expect that oil prices will remain an important investment theme into 2015 as well as potential area for future investment.

Finally, merger and acquisition (M&A) activity exploded 47% in dollar terms to $3.3 trillion. This was the best year for takeovers since 2007 but was driven by just a few large transactions with limited participation from the small to middle-market corporate sector. Europe saw much of the action where many companies were driven to build cross-border exposures to extend their business footprint outside of their main markets. Three industry sectors—pharmaceutical, media, and technology—dominated.

Low interest rates, robust capital markets, and high equity prices all supported the resurgence in activity. Tax inversions, a technique that allows companies to arbitrage into another country’s lower corporate tax rate via acquisition, were also cited as a catalyst. Next year looks to be another good year for M&A especially in Europe and, it is hoped, with broader market participation.

Also of note is the prominent role hedge fund “activists” have played in advocating for investors. These funds run the gambit of style and approach and typically choose to work either very publicly in the media, or, quietly and behind the scenes in speaking and advising corporate managements. We tend to prefer the latter, more cooperative, approach of “quiet” activism as it has been, in our experience, far more effective and productive for the long-term investor.

On a final note, M&A activity in general kicks in and accelerates more towards the end and not the beginning of an economic cycle and should be monitored closely as a potential red flag.
This past fiscal year was another strong year for the University of Illinois, its Foundation, and the stewardship of endowment assets. This report focuses on the Foundation's $1.46 billion endowment assets and their management.
THE FOUNDATION’S TOTAL ACTIVE ENDOWMENT REACHED $1.46B

NEW CASH GIFTS = $79 MILLION

GROSS INVESTMENT GAINS $200M+
**ENDOWMENT PERFORMANCE: 2014**

<table>
<thead>
<tr>
<th>TIME PERIOD</th>
<th>POOL RETURNS</th>
<th>TOTAL PORTFOLIO BENCHMARK</th>
<th>RELATIVE +/-</th>
<th>PEER GROUP MEDIAN RETURN¹</th>
<th>ALL PUBLIC INSTITUTIONS MEDIAN RETURN</th>
<th>ANNUALIZED EFFECTIVE TOTAL SPENDING RATE²</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 YEAR</td>
<td>15.1%</td>
<td>17.6%</td>
<td>-2.5%</td>
<td>16.5%</td>
<td>15.7%</td>
<td>5.4%</td>
</tr>
<tr>
<td>3 YEAR</td>
<td>9.5%</td>
<td>10.6%</td>
<td>-1.1%</td>
<td>9.5%</td>
<td>9.0%</td>
<td>5.6%</td>
</tr>
<tr>
<td>5 YEAR</td>
<td>12.4%</td>
<td>13.6%</td>
<td>-1.2%</td>
<td>12.1%</td>
<td>11.6%</td>
<td>5.8%</td>
</tr>
<tr>
<td>10 YEAR</td>
<td>6.8%</td>
<td>8.1%</td>
<td>-1.3%</td>
<td>8.2%</td>
<td>7.0%</td>
<td>5.7%</td>
</tr>
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</table>

¹Based on the 2014 NACUBO-Commonfund Study of Endowments peer universe of all endowments > $1.0 billion in AUM.

²Includes Administrative Fee. Spending is pursuant to the Foundation’s policy and in consultation with the University. The Foundation currently distributes 4.0% of a six-year moving average of the corpus of most endowment accounts to the University. The policy is reviewed annually by the Foundation’s Board of Directors. For 2014, the 5.4% total spending consists of a 4.1% “effective” spending rate and a 1.3%, “effective” administrative fee.
The endowment strives to produce a long-term absolute return that will exceed the minimum required return (budgeted spending + inflation adjustment) such that excess earnings can continue to grow and compound over the long term. This constitutes the perpetual requirement of endowed assets.

Our ability to support the University’s mission and to stay ahead of inflation is a crucial long-term goal whose achievement is best evaluated over a long-time horizon of 10 to 20 years.

We are pleased to report that last year’s performance, +15.1%, exceeded the minimum required return by a substantial 7.5%. This was also true for the preceding three and five year time periods ending June 2014 when the portfolio return outpaced the minimum required return by 2.0% and 4.6% respectively.

It is also important to look at a portfolio’s relative return as compared to its own custom, or internal benchmark. This measure helps to judge program effectiveness over the intermediate term of successive five-year intervals. It is critical since it reflects how the investment team and process have added (or subtracted) value—in both good and bad markets—relative to a theoretical passive strategy.

Last year, the portfolio returned 15.1%, trailing the internal benchmark by 2.5%.

As educational institutions compete for the best and brightest students, faculty, grants, donations, and athletes, endowment performance has become yet another measurement by which schools are scored, ranked, and discussed—often with the same pride and intensity previously reserved for athletics and academics. Here too, the time frame should be at least 5 years if not longer to be meaningful.

Last year, all endowments with assets in excess of $1.0 billion realized a 16.5% median return, a result that exceeded the UIIF endowment’s return by 1.4%. The top 25% of this same peer group realized a total return of 18.6% (NACUBO-Commonfund Study of Endowments). We discuss the endowment’s performance attribution in greater detail on page 11.
There were two main reasons for the endowment’s relative underperformance during fiscal year 2014. First, the investment team began the process of carefully migrating the portfolio from its former, fund-of-hedge fund structure to a direct manager model. In the interim, we chose to maintain a strong liquidity profile throughout this period of significant change to gain flexibility as well as the ability to play offense should market volatility increase materially.

We forecasted that cash and short duration assets would accumulate, especially during the last six months of the fiscal year, and ended the year at 24% in short-term fixed income securities. Although this was a temporary factor, it did negatively affect relative performance since the policy benchmark against which we are compared holds no cash. We chose to bear the opportunity cost of having excess liquidity in a rising market than to face a permanent loss of capital.

In addition, last year proved an especially challenging environment during which to restructure the endowment. In our estimation, most assets were richly-valued given that the bull market, begun in March 2009, is looking a bit long in the tooth. We found the prospective opportunity set of strong investment ideas to be limited. This reticence to deploy cash quickly was not a reflection of market timing (we don’t believe in it) but rather an indication that we are valuation driven and hyper-sensitive to the opportunities we have before us.

In fact, valuation sensitivity serves as a primary guide to manager selection and portfolio construction and will result, in our opinion, in a lower risk portfolio. The built-in margin of safety afforded by buying out-of-favor or cheaply-valued assets is a fundamental underpinning of our philosophy and approach to the endowment. Last year, any amount of cash would have been a drag on performance given the uniformly robust equity and debt markets.
PRIVATE ASSETS: VENTURE CAPITAL & PRIVATE ENERGY LEAD ALTERNATIVE STRATEGIES

The second reason for the endowment’s relative underperformance relates to the fact that it is rebuilding and expanding its exposure to various illiquid and private asset strategies that include: private equity, venture capital, real estate, and other types of long-term real assets such as energy, timber, and agriculture.

After a decade of disappointing returns relative to public market investments, these asset classes made an amazing comeback in 2014 and boosted the performance of many larger endowments with mature private equity/venture capital programs. Of the various alternative strategies, venture capital produced the highest return at 23.3%, followed by a 16.5% return for private equity. Much of the top performance at the largest U.S. endowments and foundations for the year can be attributed to excellent private equity, venture capital, and real asset returns from seasoned private asset portfolios.

We note with some irony that after several years of criticism of the “Yale model,” its approach was fully vindicated this past year since Yale (along with several other top endowment investment programs such as Notre Dame, University of Michigan, Columbia, and Stanford University) all produced very strong returns.

The UIF endowment has a combined private equity and private real estate policy target of 22%. The current allocation of 12.2% is primarily made up of legacy fund-of-fund relationships from the 2006–2008 vintage years. New fund commitments were curtailed starting in vintage year 2008 when the entire program was in transition.

This lack of continuity hurt us in terms of relative performance in fiscal year 2014 despite the fact that our private equity return was 20.4% (vs. a 30.2% benchmark). The real estate funds fared better with a return of 17.3% (vs. a 9.8% benchmark) but only represent a small portion of the portfolio. Edward “Ned” Creedon, Director of Private Investments, and I are working diligently to reestablish our exposures in this area but note that it will take time for the benefits to accrue fully to the portfolio.

PUBLICLY-TRADED ASSETS: U.S. LEADS THE REST OF THE WORLD

The U.S public equities, at 22.6% of the portfolio, performed well beating the Wilshire 5000 Index by 70 basis points net of all fees with a 25.6% return. Although the majority of this part of the endowment is passively managed, Adage Capital continued to outperform the S&P 500 significantly.

Non-U.S. developed equities ended the year at 16.7% of the portfolio assets and realized a total return of 22.2% versus the MSCI EAFE benchmark return of 23.6%. In general, we maintain strong confidence in the active managers within this allocation and do not anticipate significant changes.

Emerging market equities were 6.8% of the portfolio allocation and delivered both strong absolute and relative performance beating the MSCI EM IMI benchmark by 200 basis points with a 16.7% return. In particular, Westwood Global Investments realized a strong return of 17.9%, or 360 basis points ahead of their benchmark.

Aggregate Bond Index. In particular, Return Fund. Both managers: Western Asset Management and the PIMCO Total Return Fund. Both managers outperformed the Barclays Aggregate Bond Index. In particular, Western Asset earned 6.7%, a result that is 230 basis points ahead of the benchmark. This performance differential is especially stellar for an active bond manager. We are in the process of restructuring this portion of the portfolio such that all corporate bond (credit) management will be housed within the newly-increased marketable alternatives allocation.

MARKETABLE ALTERNATIVES (MALTS): UIF “DIRECT” MODEL IS OFF TO A GOOD START

Our target Policy Portfolio has a 30% allocation to marketable alternatives, a significant increase from the previous target of 13%. During the past fiscal year, we have successfully migrated the externally-managed hedge fund-of-fund assets into the pool and are in the process of building out a diversified portfolio that will include a variety of different styles including global long/short equity, hedged credit, distressed credit, and multi-strategy mandates.

As of fiscal year end, five new managers had been added to this part of the portfolio that totaled approximately 10%. A 13.6% return was in line with the benchmark return and well in excess of the median NACUBO universe for hedge funds of 9.9%. Marketable alternatives are a strategic focus of the UIF investment team and will sit at the heart of the overall alternatives portfolio going forward as a compliment to the classical global equity holdings. We like the fact that MALTs are fairly liquid, flexible, and have the potential to capture the majority of the upside return of the underlying assets but with a lower degree of volatility.
POLICY PORTFOLIO

The Policy Portfolio is reviewed annually by the Foundation’s Investment Policy Committee based on input and recommendations from the Investment Team. It is the theoretical, dynamic, long-term mix of assets that will best support “intergenerational equity” (i.e. the fair balance between current spending distributions and future principal growth that supports spending in perpetuity). It also encompasses both expected returns and associated risks but should not change dramatically from year to year. We understand and expect that course corrections will be necessary along the way as markets and opportunities change in real time and that it is important to remain flexible as we navigate. The Policy Portfolio also provides Investment Policy Committee with a strategic outline that enhances group decisions, discussions, and discipline during difficult market cycles and helps us to avoid making reactive short-term changes under duress. Finally, as mentioned in the endowment primer, it serves as a benchmark against which our active management decisions and resulting performance are assessed.

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<tr>
<th>POLICY VS. ACTUAL PORTFOLIO</th>
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<tr>
<td>GLOBAL EQUITY</td>
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<td>U.S. Equity</td>
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<td>Non-U.S. Equity Developed</td>
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<td>Non-U.S. Equity Emerging 2</td>
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<tr>
<td>GLOBAL FIXED INCOME</td>
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<td>Credit</td>
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<td>Inflation-Protected Bonds</td>
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<td>Sovereign Bonds</td>
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<tr>
<td>ALTERNATIVES</td>
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<tr>
<td>Marketable Strategies</td>
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<tr>
<td>Credit/Absolute Return/Distressed</td>
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<td>Hedged Equity</td>
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<td>Private Assets</td>
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<td>Private Equity 3</td>
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<tr>
<td>Real Assets 4</td>
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<tr>
<td>LIQUIDITY/SHORT DURATION</td>
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</tbody>
</table>

1 As affirmed by the Investment Policy Committee in June 2014
2 Includes up to 2.5% in dedicated Frontier Market Equity strategies
3 Includes LBO, Mezzanine, M&A, Growth Equity, International PE, and Venture Capital
4 Includes private real estate (non-campus), energy, and natural resources (oil and gas, timber, and agriculture)
Although we have already made significant strides in the portfolio remodeling, these numbers indicate that much work remains.
It is important to emphasize that a complete portfolio overhaul such as the one currently in progress requires time, patience, and a great sensitivity to current market opportunities and challenges.

We have advised the Investment Policy Committee and the UIF board of directors that it is reasonable to estimate that it will take an additional 12-24 months until we reach what could be considered a steady state portfolio for all public assets and marketable alternatives.

As explained in this report, it will take several more years for the private equity and real assets allocations to be built, given our forecast implementation/pacing schedule as well as the fundraising outlook and opportunity set of the managers we hope to engage.

We look forward to providing quarterly updates during the next fiscal year.