

UNIVERSITY OF ILLINOIS SYSTEM



Office of Investments Annual Report
Fiscal Year Ending June 30, 2022

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Introduction

We are pleased to present the University of Illinois System Office of Investments Annual Report for the 2022 fiscal year. All data in the report is as of June 30, 2022, unless noted otherwise.

Fiscal year 2022 was a tale of two halves. The first half of the year continued the remarkable recovery of fiscal year 2021. The tone changed as investors recognized that inflation was not only not transitory but also increasing at a rapid pace, notching the worst six months for public markets in 50 years. The fiscal year netted negative returns across public markets detracting 14% from US equity, 19% from international markets, and 10% from fixed income. The investment program fared relatively well in this challenging environment with the endowment losing 4.8% on the year and the operating pool down 1.9%. Both pools outperformed their respective benchmarks over the period. Collectively, the program distributed \$58.7 million in investment and farm income to the University System.

The investment program executed several new investments throughout the year. In the endowment pool, investments were made in the following partnerships/funds: Clearlake Capital Partners VII (global equity), Main Post Partners III (global equity), Varsity Healthcare Partners IV (global equity), Antares Senior Loan Fund II (global fixed income), Elliott International Ltd. 9th commitment (diversifying strategies), and Tembo Capital Mining Fund III (real assets). In the FY21 annual report, we shared a meaningful rebalancing in the operating pool to reduce duration and protect against rising rates. This rebalancing served the intended purpose and was reduced meaningfully in July 2022 as the risk/reward environment moderated.

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

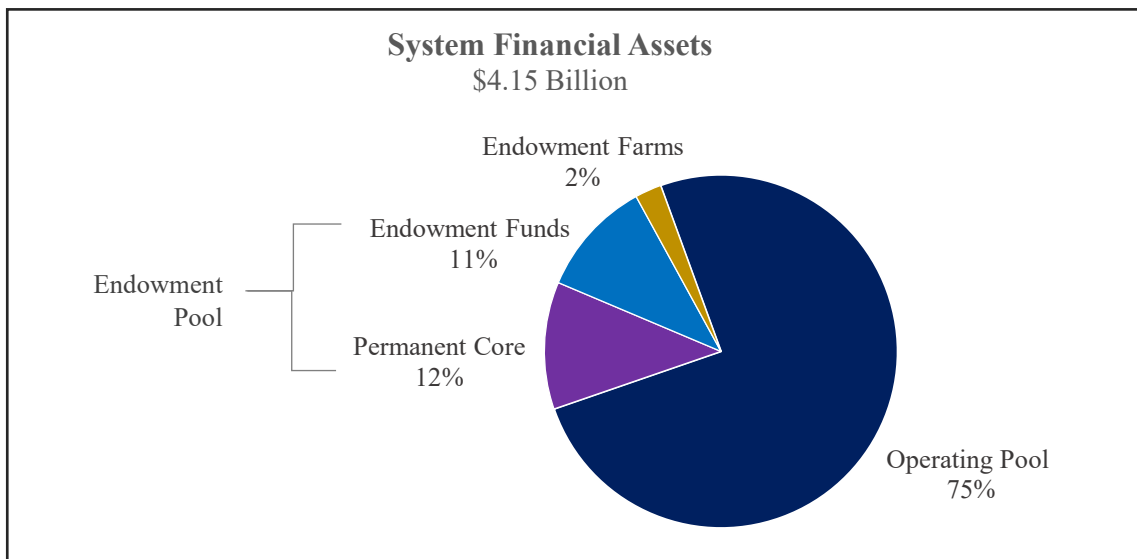
Under supervision of the CFO, the Office of Investments manages the University System's operating and endowment assets, including farmland donated to the University. Operating and endowment assets are invested through carefully selected external investment firms, while farmland is managed internally 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 CFO management of the University's assets within the BOT approved policies. The CFO has charged the Investment Office 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.

Financial Asset Overview

The Investment Office manages two investment portfolios—the endowment pool and the operating pool. The permanent core is an investment of operating pool funds that, combined with the endowment funds, forms the endowment pool. Endowment farms are managed by the Agricultural Property Services Office. The distribution of the collective pools is displayed in Figure 1.

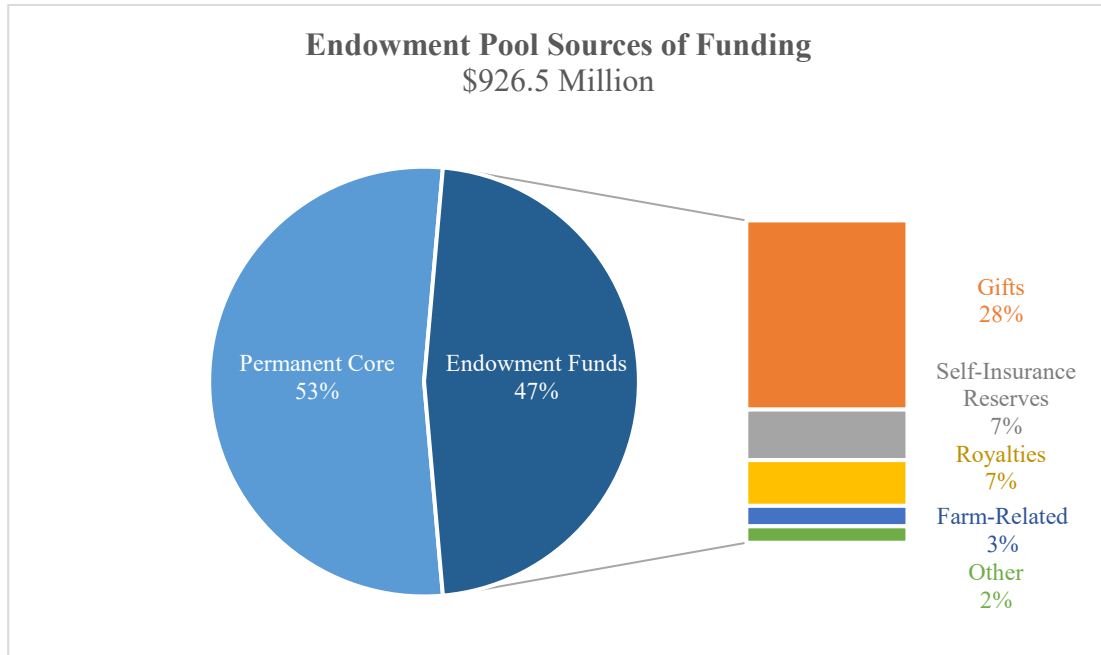
Figure 1



Endowment Pool

The *Endowment Pool* (market value \$926.5 million) consists of two categories of funding. The first source is *Endowment Funds*, defined as financial assets of the University System that have been deemed appropriate for long-term investment. Endowment funds comprise 47% of the endowment pool. The second source of funding consists of operating pool funds that are managed as part of the endowment pool—the *Permanent Core*. This comprises 53% of the endowment pool. The composition of the funding sources is summarized in Figure 2.

Figure 2



Asset Allocation

The endowment pool is invested across a variety of asset classes in accordance with policy approved by the BOT. The current distribution of endowment pool funds across primary and sub-asset classes is shown in Figure 3. Figure 4 compares the actual allocations to long term policy ranges. All asset classes remain within policy ranges.

Figure 3

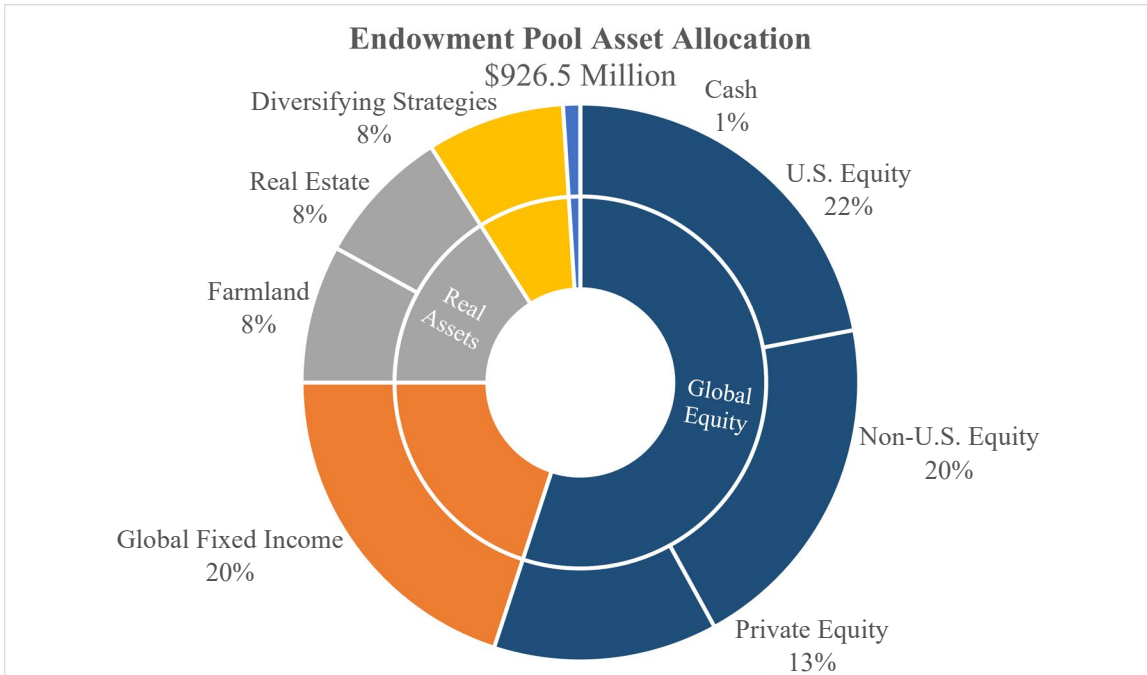
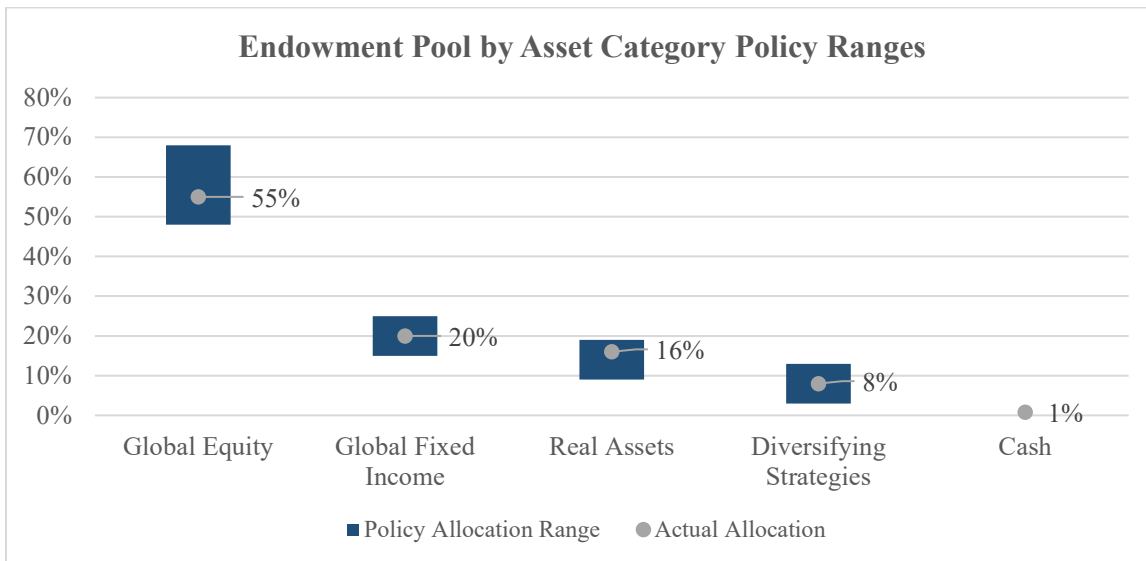


Figure 4



The endowment pool is relatively liquid compared to peers. Despite the recent divergence between private and public market valuations, 65% of the pool is subject to weekly (or more frequent) redemptions while 76% is subject to at least quarterly redemption provisions. This structure allows for efficient rebalancing and is well aligned with the liquidity profile of the underlying sources of funding. It also reduces expenses as liquid, public market allocations generally charge lower fees than alternative investment vehicles. Our preference for low-cost passive investments in public equity markets further reduces the fee burden. 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 pool from its 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 pool is 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 2022 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 2022 fiscal year (inclusive of the administrative fee and excluding income distributed from the permanent core allocation).

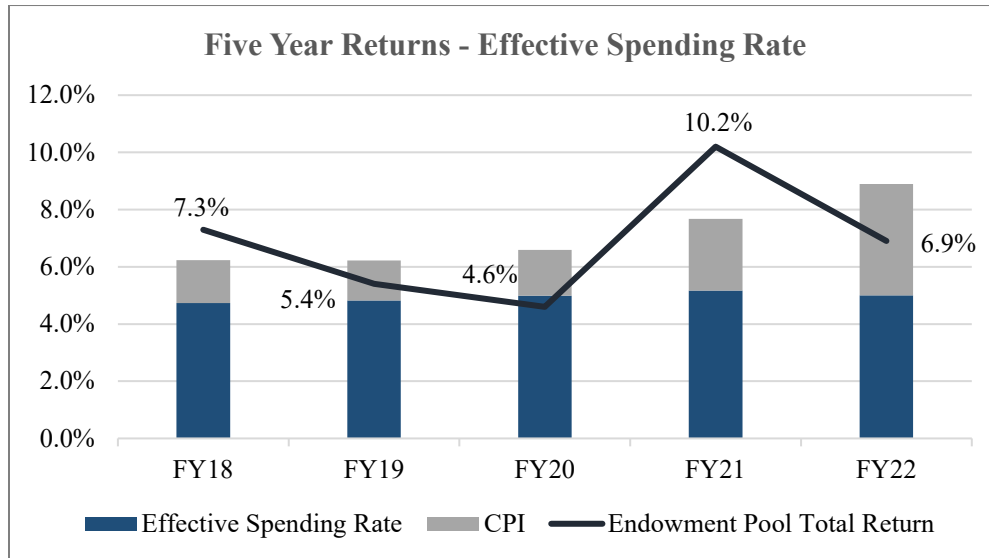
Performance Measurement

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

Total Return Relative to Spending and Inflation Rates

Annualized five year returns for fiscal years 2018-2022 are presented relative to the effective spending rate and the consumer price index (CPI) in Figure 5. 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. Endowment pool returns exceeded the hurdle rate for two of the five periods under consideration with the FY22 hurdle rate impacted by the drastic increase in inflation. Forward-looking inflationary expectations will be monitored to ensure that the endowment's asset allocation and spending rate remain appropriate.

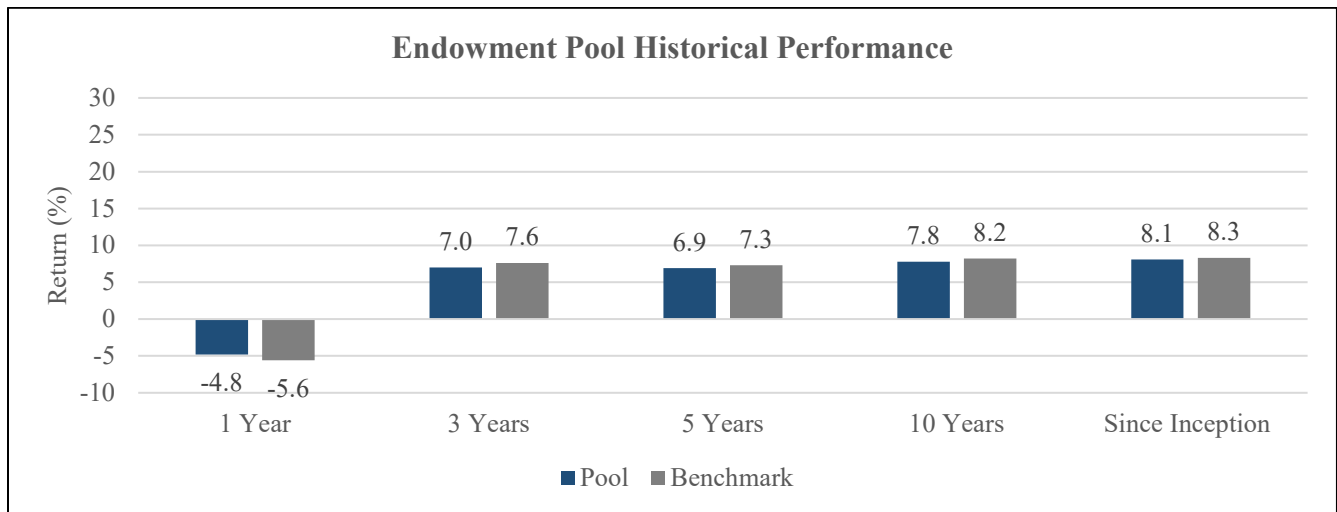
Figure 5



Total Return Relative to Performance Benchmark

The endowment outperformed its performance benchmark over the one-year period but marginally underperformed longer periods, which can be attributed to the fee drag of approximately 0.75% annually. Recent outperformance is credited to farmland, fixed income, private equity and diversifying strategies. The historical investment performance of the endowment has been provided in Figure 6.

Figure 6



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, 2022, is summarized exclusive of the permanent core allocation in Figure 7.

Figure 7

Summary of Endowment Pool Activity FY13-FY22	
All figures in millions	
	Ten Year Totals
Beginning Balance	223.1
Net Additions	145.9
Distributions	-170.5
Capital Appreciation	244.0
Ending Balance	442.4



Operating Pool

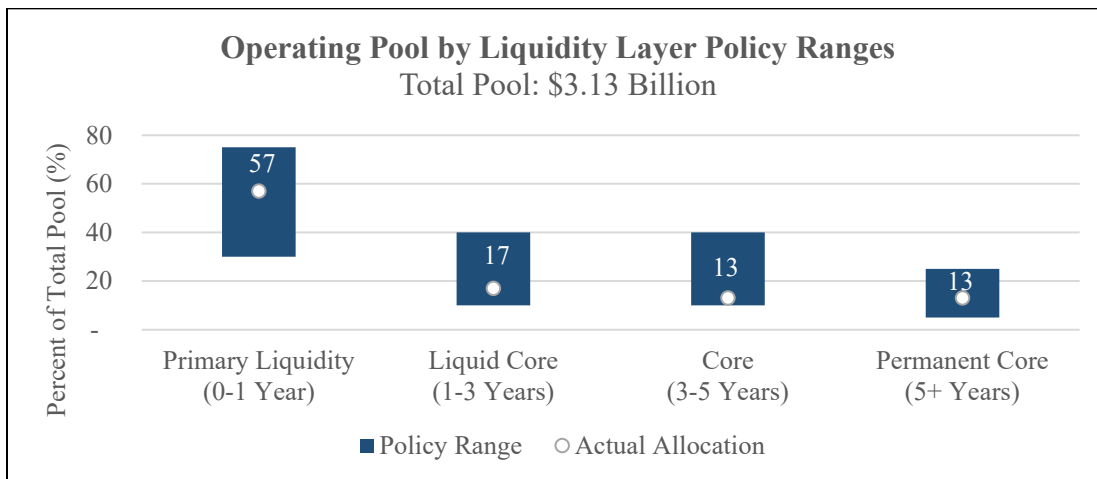
The *Operating Pool* (market value \$3.13 billion) consists of funds available for current use by academic and administrative units within the System. The pool includes cash from state appropriations, tuition and fees, student loan funds, grants, self-insurance programs, and hospital and auxiliary services. The consolidated management of funds provides robust tracking and efficient investment management.

The investment objective for the operating pool is 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 2022, \$30.5 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, amongst others. Provided that state regulation does not allow the System to borrow for working capital, the operating pool has ample liquidity and is of high quality with an average AA credit rating. Figure 8 demonstrates the operating pool’s asset allocation on June 30, 2022, within the policy ranges by liquidity layer.

Figure 8

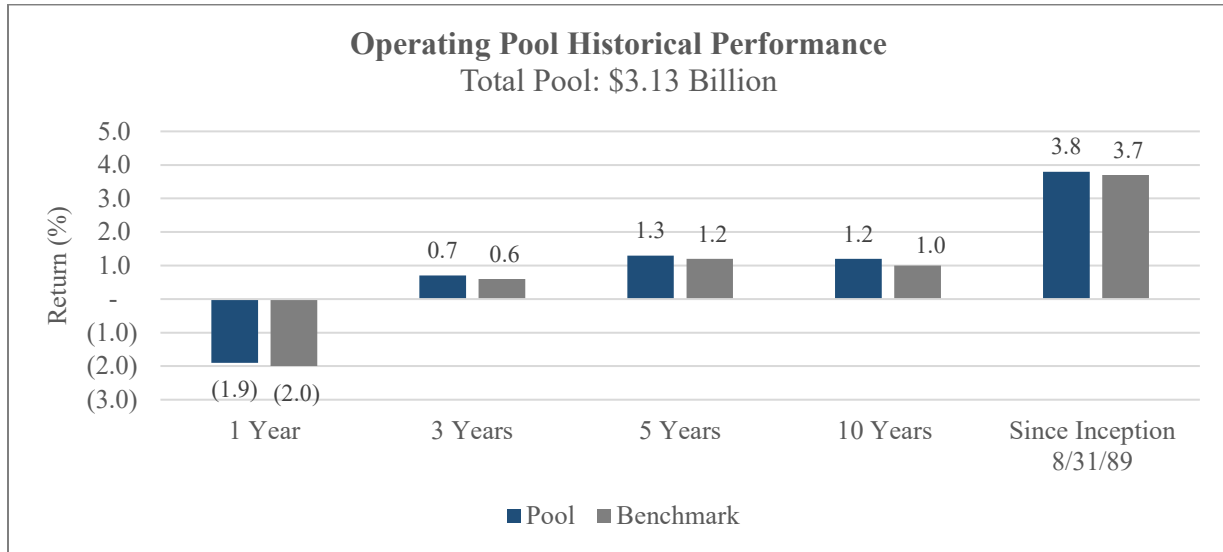


*Note: The total operating pool market value does not include the permanent core allocation. This allocation is included in the endowment pool market value.

Performance Measurement

Operating pool managers have consistently outperformed the performance benchmark. Historical performance relative to the performance benchmark is displayed in Figure 9.

Figure 9



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 2022 fiscal year, the investment program distributed income of \$58.7 million to units across the University System after paying investment management fees. The summary of the distribution by source is shown in Figure 10.

Figure 10

(\$ Millions)	Distribution
Endowment Pool	26.2
Operating Pool	30.5
Endowment Farms	2.0
Total Distribution	58.7

Program Costs

The most significant cost to the investment program is external counterparty (*i.e.*, investment manager, custody, investment consultant) fees. For fiscal year 2022, this comprised \$13.6 million or 33 basis points of total assets. Investment manager fees are net against performance. A fee schedule is enclosed in the appendix to this report, while the fiscal year 2022 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 \$350k with additional budgetary expenses (*i.e.*, travel, technology, training) totaling \$60k.

The fiscal year 2022 security listing and 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
<u>Money Market Funds</u>	
JP Morgan (U.S. Government Money Market Fund)	0.18%
Northern Trust (U.S. Government Select & Siebert Williams Shank Shares)	0.20%
Illinois Funds	0.05% (plus administrative expenses)
<u>Fixed Income</u>	
Galliard Capital Management (Short Duration)	0.18% - first \$200 million 0.15% - balance
Income Research + Management (Short Duration and Intermediate)	0.21% - first \$100 million 0.18% - next \$100 million 0.15% - balance
JP Morgan (Managed Reserves)	0.15% - first \$50 million 0.125% - next \$50 million 0.10% - next \$100 million 0.08% - next \$100 million
Neuberger Berman (Enhanced Cash)	0.175% - first \$50 million 0.15% - next \$50 million 0.12% - next \$150 million (10% rebate on total fee)
Neuberger Berman (Intermediate)	0.20% - flat fee (10% rebate on total fee)
Northern Trust (Short Duration)	0.20% - first \$100 million 0.18% - balance
Allspring Global Investments (Conservative Income and Short Duration)	0.09% - first \$100 million 0.07% - balance
Attucks Asset Management	0.35% flat fee

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Investment Fee Schedule – Traditional Investments

Firm	Terms
<u>Fixed Income (Continued)</u> Vanguard Total Bond Market Index	<u>Management Fee</u> 0.05% flat fee
<u>Equity</u>	
BlackRock (ESG U.S. All Cap Equity)	0.055% flat fee
BlackRock (MSCI ACWI ex-US IMI Index Fund B)	0.0975% flat fee
Ariel Capital Management (Small Mid Cap Value)	1.00% - first \$10 million 0.75% - next \$10 million 0.50% - balance
<u>Real Estate Investment Trust</u> Vanguard (Real Estate Investment Trust Index Fund)	0.09% flat fee

University of Illinois System

Investment Fee Schedule – Alternative Investments

Firm	Terms	
<u>Private Equity</u>	<u>Management Fee</u>	<u>Carried Interest</u>
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	0.00%	10% on Secondary
ASP 2006 Non-U.S. Fund	0.00%	10% on Secondary
ASP 2006 Direct Fund	0.00%	20%
ASP 2007 U.S. Fund	0.10%	10% on Secondary
ASP 2007 Non-U.S. Fund	0.10%	10% on Secondary
ASP 2007 Direct Fund	0.10%	20%
ASP 2008 U.S. Fund	0.20%	10% on Secondary
ASP 2008 Non-U.S. Fund	0.20%	10% on Secondary
ASP 2008 Direct Fund	0.19%	20%
ASP 2009 U.S. Fund	0.30%	10% on Secondary
ASP 2009 Non-U.S. Developed Fund	0.30%	10% on Secondary
ASP 2009 Non-U.S. Emerging Markets Fund	0.30%	10% on Secondary
ASP 2009 Direct Fund	0.39%	20%
ASP 2010 U.S. Fund	0.40%	10% on Secondary
ASP 2010 Non-U.S. Developed Fund	0.40%	10% on Secondary
ASP 2010 Non-U.S. Emerging Markets Fund	0.40%	10% on Secondary
ASP 2010 Direct Fund	0.59%	20%
ASP 2011 U.S. Fund	0.50%	10% on Secondary
ASP 2011 Non-U.S. Developed Fund	0.50%	10% on Secondary
ASP 2011 Non-U.S. Emerging Markets Fund	0.50%	10% on Secondary
ASP 2011 Direct Fund	0.79%	20%
ASP 2013 Global Fund	0.75%	10% - Secondary & Co-Investment, 20% Direct
ASP Co-Investment Fund III	0.73%	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.

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Investment Fee Schedule – Alternative Investments

Firm	Terms	
<u>Private Equity (continued)</u>	<u>Management Fee</u>	<u>Carried Interest</u>
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)
Clearlake ICON II	1.0%	15%-25% step up (8% hurdle rate)
Clearlake ICON IV	1.0%	15%-25% step up (8% hurdle rate)
Centana Growth Partners II	2.5% with scale down to 2.0% after 5 th year	20% (8% hurdle rate)
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)
ParkerGale Capital II, L.P.	2.0%	20% (8% hurdle rate)
Varsity Healthcare III	2.0%	20% (8% hurdle rate)
Tiger Global Private Investment Partners XIV (FEG Select)	2.0% (0.07% average FEG Select fee)	20-25% step up

University of Illinois System

Investment Fee Schedule – Alternative Investments

Firm	Terms	
	<u>Management Fee</u>	<u>Carried Interest</u>
<u>Private Credit</u>		
Oaktree XI	1.44%	20% (8% hurdle rate)
Merit Mezzanine Fund VI	1.75%	20% (8% hurdle rate)
<u>Diversifying Strategies</u>		
Davidson Kempner International	1.5%	20%
Elliott International	1.5%	20%
Hudson Bay	2.0%	20% with high water mark
BlackRock Multi-Alternative Opportunities Fund	1.5%	20% (8% hurdle rate)
<u>Real Assets</u>		
Heitman HART	1.1% - first \$10 million 1.0% - next \$15 million	NA
Prudential PRISA	1.0% - first \$10 million 0.95% - \$10M to \$25M (1.20% Maximum Annual Fee)	3% Operating Cash Flow 0.10% Cash Balance
Farallon Real Estate Partners III	1.5% (reduced by 15% of commitments for reserve)	20% (6% hurdle rate)
Singerman Real Estate Opportunity Fund IV	1.5% on commitments during investment period; 1.5% on unreturned contributions thereafter	20% (8% hurdle rate)
Homestead Capital USA Farmland Fund III, L.P.	1.5%	15% (6% hurdle rate)
Tembo Capital Mining Fund III	2.0%	15% (8% hurdle rate)