BROWN UNIVERSITY

ENDOWMENT REPORT 2018

BROWN

Introduction

During the fiscal year from July 1, 2017, to June 30, 2018, Brown University's endowment and other managed assets appreciated by 13.2 percent. This return represents $450 million in investment gains, the second-largest total in the endowment's history.

Brown's endowment provided $163 million to the University during the year. This contribution comprises 15 percent of the annual operating budget and represents approximately $17,000 per student. In a record year for giving to Brown, net additions to the endowment totaled $93 million. Net of investment gains, expenses, gifts and spending, the endowment increased by 10.6 percent over the prior year. At the conclusion of Fiscal Year 2018, the endowment and other managed assets stand at $3.8 billion.

Supporting the University

The endowment is an aggregation of more than 3,000 accounts, the majority of which have specific mandates for their spending. This capital is pooled for the purposes of investment and management, and the spending requirements that govern the endowment govern each of these accounts. So while the pooling of these accounts makes it difficult to appreciate the broad diversity of their purposes, the collective result is to serve as a financial resource to the University, and to provide stability and support by contributing a percentage of the endowment's value to the operating budget each year. For FY18, the endowment contributed 5.1 percent of its value (the aforementioned $163 million) to the University. The value of the endowment is determined for the purpose of this calculation by computing the rolling average value of the prior 12 quarters. This has the desired effect of reducing the impact of the volatility of financial markets on the University, thereby improving the accuracy of forecasted capital outlays.

Although the endowment has grown in value each of the last two years, the contribution of the endowment to the operating budget in dollar terms actually declined year over year, and stands slightly below the contribution made in FY16. This is the result of a strategic decision by the Corporation of Brown University in 2017 to reduce the endowment payout, effectively conserving funds in order to compound their value and eventual impact on future Brown scholars.

Endowment Income Distribution by Purpose

32% Scholarships, Fellowships and Prizes

21% Professorships

16% Unrestricted

9% Programmatic and Student Support

6% Instruction & Lectures

6% Other

4% Libraries

4% Centers

2% Athletics

Performance

While the investment performance of the endowment is evaluated on an annualized basis, it is important to emphasize that the investment program itself is not implemented with a view toward achieving a return in a single year. Rather, the endowment is invested with the goal of achieving returns across considerably longer terms. More appropriate units of measurement for the endowment's investment program might include entire business cycles, decades or perhaps even generations.

Nonetheless, each time Brown's Van Wickle Gates have swung both inward and outward marking the passage of a year, it is time to evaluate the endowment's progress, which can be examined through three lenses.

The endowment's chief mandate is to preserve both value and purchasing power after spending. The preservation of purchasing power implies that inflation will not reduce the real impact of the endowment's spending on the endeavors of future Brown students and faculty. The most appropriate measure of inflation for this purpose is the Higher Education Price Index (HEPI), which for the last five years has averaged approximately 2 percent. The endowment's single-year investment return of 13.2 percent in FY18 far exceeds the sum of spending and inflation, as do the trailing 3-, 5- and 20-year annualized returns. The 10-year trailing return is the exception, which continues to bear the weight of FY09.

Fiscal Year Annualized Returns	FY 2018	Annualized Returns as of June 30, 2018			
	****	3 Year	5 Year	10 Year	20 Year
Brown Endowment	**13.2%**	**8.3%**	**9.2%**	**5.9%**	**8.3%**
Aggregate Benchmark	9.7%	6.1%	7.2%	4.5%	N/A
70/30 MSCI ACWI/Barclays Global Aggregate	7.9%	6.6%	7.1%	5.1%	N/A
MSCI All-Country World (ACWI)	10.7%	8.2%	9.4%	5.8%	N/A
MSCI All-Country World (ACWI) ex-U.S.	7.3%	5.1%	6.0%	2.5%	N/A
S&P 500 Index	14.4%	11.9%	13.4%	10.2%	6.5%

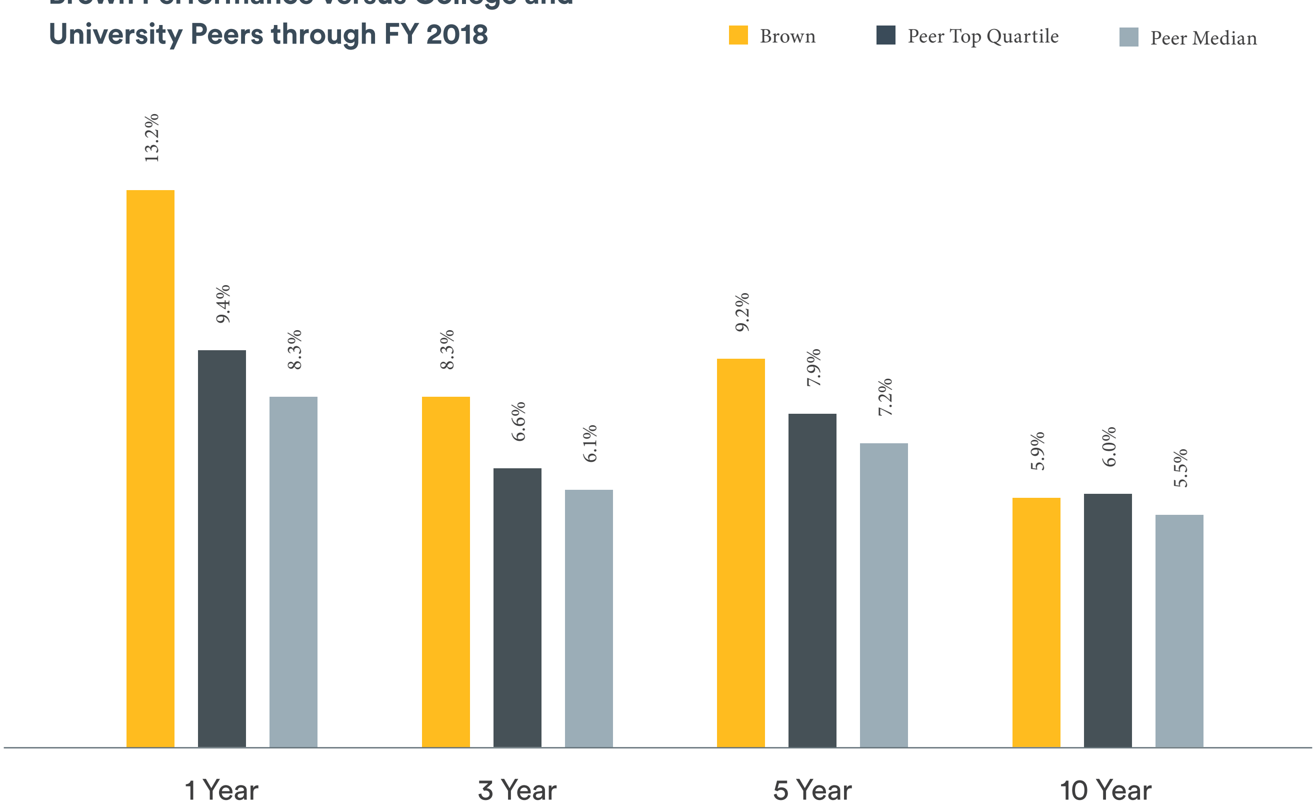
Performance (cont.)

The second consideration relates to whether the endowment's returns are exceeding the benchmarks provided by the capital markets. Put another way, is the endowment's return beating what could be achieved with a simple rules-based approach utilizing low-cost index funds? The most appropriate measure in this case is a 70/30 blend of global stock markets and fixed income markets. For this purpose, the MSCI All-Country World Index and the Barclays Global Aggregate Bond Index comprise the blended index. The endowment's return surpassed the 70/30 stock/bond blend in FY18 and has surpassed this benchmark for each of the 3-, 5- and 10-year trailing periods.

The third consideration is that peer educational institutions are undertaking similar decisions, with broadly similar missions, resources and time horizons. In order to examine Brown's investment performance relative to peers, we refer to a database of investment returns maintained by Cambridge Associates. For FY18, Brown's return of 13.2 percent places it comfortably ahead of the mean (8.5 percent) and median (8.3 percent) returns of 139 colleges and universities. Brown's compounded annual returns over 3-, 5- and 10-year periods each surpass the mean and median return, and the 1-, 3- and 5-year numbers are each in the first quartile of peer results.

In summary, by all three measures — exceeding spending plus inflation, surpassing market benchmarks and remaining competitive with peers — Brown's endowment continues to achieve satisfactory results.

Brown Performance versus College and University Peers through FY 2018



Source: Cambridge Associates data as of September 28, 2018 (n=139)

“THE ENDOWMENT IS INVESTED WITH THE GOAL OF ACHIEVING RETURNS ACROSS TERMS CONSIDERABLY LONGER THAN A SINGLE YEAR.”

Asset Allocation Review

For the purposes of investment decision-making, measurement and reporting, the Brown Investment Office breaks the endowment down into asset classes. This is a necessary and helpful framework that provides valuable insights but is not a precise classification system. Certain investments bear the characteristics of more than one asset class, yet must ultimately be assigned to a single one for reporting purposes. Another aspect of asset allocation addresses liquidity: Investments may be held in a liquid investment structure — that is, one that allows Brown discretion regarding when to ask for the return of its capital — and yet the underlying securities or assets may encounter periods when the availability of liquidity is diminished. An important consideration, therefore, is whether those investments are better described as liquid or illiquid. A successful asset allocation framework requires the practitioner to organize discretely that which is frequently ambiguous.

The endowment manages this ambiguity in several ways. One is by setting relatively broad ranges for asset allocation guidelines. A more conventional approach sets target allocations and thus encourages rebalancing, a merited technique that involves selling what has been recently successful and rotating capital into asset classes that have recently been less so. Brown's Investment Committee, rather than setting target allocations, sets intentionally broad ranges. While both approaches recognize and therefore require the benefits of diversification, Brown's approach incrementally values flexibility over the discipline of rebalancing.

Endowment Asset Allocation June 30, 2018

Asset Class	Market Value (in Millions)	% of Endowment
Public Equity	$1,030	27%
Absolute Return Strategies	$1,251	32%
Private Equity	$904	23%
Real Assets	$174	5%
Total Risk Assets	**$3,359**	**87%**
Fixed Income	$165	4%
Tail Hedges	$1	0%
Cash	$324	8%
Total Endowment	**$3,849**	**100%**

Asset Allocation Review (cont.)

Another approach to managing ambiguity is to employ a generalist model in the Brown Investment Office, rather than a specialist model. The combination of a target asset allocation with a specialist model — one in which individuals or teams of staff members focus exclusively on a single asset class — would create a problematic decision-making dynamic. Asset class specialists have a tendency to view available capital through the lens of a budget, that is, to be spent fully but not exceeded. The generalist model allows for more flexibility of thought. It allows the Brown investment team the freedom to conclude that an entire asset class appears unattractive, rather than feel subtly compelled to make an investment in order to achieve a target portfolio weighting.

Brown's size, resources, governance structure and other factors are critical inputs into the preference of these approaches, which are only a selection of the decisions that affect a successful asset allocation practice. Other investment organizations will make investment decisions differently. Each organization's requirements are unique, and while commonalities outnumber differences, there are many successful implementations that look very different from Brown's.

Public Equities: Fiscal Year 2018 witnessed continued strong global equity market performance. The U.S. equity markets re-asserted their leadership over global stocks, briefly relinquished during FY17, with the S&P 500 gaining 14.4 percent during the year while overseas markets gained 7.3 percent, as measured by the MSCI All-Country World ex-U.S. index. U.S. markets were helped along by corporate profits that exceeded expectations, due in part to the significant corporate tax cut arising from the Tax Cuts and Jobs Act passed by Congress in late 2017. Emerging Markets built on the strong gains of the prior year, climbing 8.2 percent. That number masks marked volatility, however, as Emerging Markets stocks led the way in the first half of the year, only to stumble and give back a bulky portion of gains during a spring marked by sovereign crises in Argentina and Turkey, with accompanying fears of contagion.

Brown's domestic equity portfolio slightly trailed benchmarks, while the global equity portfolio outperformed. The Emerging Markets portfolio, while modest in size, outperformed significantly, driven primarily by strategies focused on China. The combined result was a substantial outperformance of the MSCI All-Country World Index, the most comprehensive measure of the global equity market opportunity set. Although the Brown endowment employs low-cost index funds to achieve some of the desired exposure, the outperformance is largely attributable to the prowess of our investment managers.

"THE ENDOWMENT INVESTS WITH PARTNERS WHO ARE EXCEPTIONAL AT THEIR CHOSEN PURSUIT, WHOSE INCENTIVES ARE ALIGNED WITH BROWN'S AND WHO CONSIDER THEIR INVESTORS TO BE PARTNERS RATHER THAN CUSTOMERS."

Asset Allocation Review (cont.)

Absolute Return Strategies: Brown's portfolio of absolute return strategies encompasses a significant diversity of approaches to investing Brown's capital prudently and productively. Within our absolute return portfolio, the endowment grants some investment managers broad discretion to determine how much market exposure to employ, while others are strictly mandated to employ little or no market exposure. Brown's partners in this asset class utilize a mix of underlying securities, including equities, debt securities, currencies and derivative instruments. The portfolio includes managers who are aggressive about employing risk, balanced with managers who are extremely risk averse. Mandates range from broad to narrow. The notable common thread is that the endowment invests with partners who are exceptional at their chosen pursuit, whose incentives are aligned with Brown's, and who consider their investors to be partners rather than customers.

The results of this group of strategies for FY18 were exceptionally strong. The asset class generated a return approximately in line with the S&P 500, despite employing significantly lower market exposure. Generating an equity-like return in a strong year for the stock markets while employing a fraction of the risk is a genuinely excellent outcome. Caveats are appropriate here: Risk is not strictly defined by market exposure, and one year's results alone do not validate what is designed to be a long-term strategy. Nonetheless, the absolute return asset class is working precisely as intended.

Private Equity: One of the endowment's competitive advantages relates to time horizon. The advantages that accrue to investors who are able to take the long view are evident in some form in virtually all asset classes. However, in the endowment's private equity strategies, a long time horizon is a requirement. The Investment Office continues to make progress on a steady and methodical effort to build a superior private equity investment program. The primary focus is on finding partners with ability and integrity who are focused on opportunity sets where observable competitive advantages exist.

While the work is not done, the results from FY18 are encouraging. In a strong year for the asset class, Brown's private equity portfolio outperformed comparable benchmarks. Each of the Venture and Buyout/Growth sub-asset classes contributed returns nearly double their weight in the portfolio. Brown's portfolio of real estate and other real assets — considerably smaller — also generated solid results.

Leadership Structure

At the conclusion of FY18, the Investment Committee of the Corporation of Brown University ratified a change to the leadership structure of the Investment Office. Jane Dietze, a member of the investment team since 2013, became vice president and chief investment officer (CIO). Joseph L. Dowling III, university vice president and chief investment officer since 2013, assumed the newly created role of chief executive officer of the Investment Office.

The role of CIO, while ostensibly a pure investment role, has come to encompass a broad set of responsibilities. Managing a diverse portfolio of investments can be a consuming vocation, but a CIO must manage much in addition to this: an office and a team; the relationships of investment and administrative partners; the Investment Committee members' access to timely information; and more. The endowment's current leadership already shared many of these functions in a complementary fashion, with support from a deep and flexible team. Among the Investment Committee's core responsibilities is a mandate to hire and retain capable leadership. The change in leadership structure is fundamentally a recognition that Brown already had two strong leaders in place, as well as a deep and committed bench.

Among a leader's most critical tasks in any organization is to establish and maintain culture. Since 2013, the endowment leadership has made deliberate choices about the prevailing culture of the Investment Office. Today, it is a culture of teamwork and shared responsibility. It emphasizes the pursuit of continuous learning and data-driven empiricism. It stresses service to Brown's educational mission, through engagement with the University and its community, highlighted by scores of undergraduate interns and the several Brown alumni who work full time on the investment team today.

Brown's Competitive Advantages

The endowment's competitive advantages stem from the character of Brown University itself. The permanent nature of the institution allows for long investment horizons. The mission and values of the University make the endowment an attractive partner for our investment managers, conferring admittance to investment opportunities of limited capacity.

Nowhere is Brown's character more evident, however, than in the advantage that accrues to the endowment from the efforts of alumni and friends of the University. It was a wonderful year in this regard. The endowment utilized the generous efforts of alumni and parents assisting in due diligence, providing references and generating referrals to potential investment opportunities. These efforts are put forth with no motivation other than a love for Brown, and we are grateful.

Some institutions are unfortunately exposed to the inverse of this positive externality. That is, a disadvantage accrues as a result of the presumed privilege of being a member of a club. Associates may seek to extract rather than contribute value. Instead of experiencing a cumulative effect, these efforts are ultimately depletive to the institution. We are fortunate that Brown's values tend to inoculate the endowment from this dynamic. Brown's network is synergistic, and we anticipate that its effects will compound over time.

Taxing Endowments

During FY18, Congress passed the Tax Cuts and Jobs Act of 2017, legislation that holds diverse implications for the endowment's investments. Of particular note is that for the first time, the act established a 1.4 percent excise tax on the net investment income of the endowments of private colleges and universities that meet specific criteria. For the purposes of this report, we will set aside considerations of whether or not it is appropriate for Congress to tax the proceeds of endowed gifts to educational institutions. The practical reality for the immediate future is that Brown's endowment does not appear to reach a threshold set by the law, which is that the tax applies only to endowments with greater than $500,000 in endowment funds per full-time student. Clarification on how the law will be applied is still pending from the Internal Revenue Service, but for this year, and in all likelihood for a few years to come, it appears that the excise tax will not apply to Brown until we have made more progress in growing the endowment.

In Closing

Guided by the Investment Committee, and actively supported by alumni, the endowment's investment program is implemented and monitored by a dedicated team of professionals. The result is a diversified portfolio of investments overseen by practitioners selected for their skill and integrity. The endowment's liquidity is balanced, allowing for long-term investments while remaining consistently prepared to meet the University's financial needs. All the while, Brown's benefactors generously continue to build the strength of this core financial resource. The stewardship of the endowment is imbued in every sense with the permanence of Brown University and the timelessness of its mission and values.

Produced by the Investment Office with the Office of University Communications

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