

LETTER FROM THE CHIEF INVESTMENT  
OFFICER AND TREASURER

2010 ANNUAL PERFORMANCE REPORT

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## LETTER FROM THE CHIEF INVESTMENT OFFICER AND TREASURER

After a very difficult investment environment in 2008, Irvine's investment portfolio has now experienced two years of strong returns. While it is easy to attribute Irvine's strong performance in 2010 largely to the continued global rally that began in 2009, the ability and willingness to capitalize on this momentum were rooted in Irvine's investment discipline and long-term focus. This discipline left the Foundation with ample available capital to take advantage of irrationally low asset prices during the collapse in 2008. Similarly, the Foundation was better positioned to capitalize on the plethora of distressed sellers that surfaced across asset classes in the years since, as the global recovery failed to move quickly enough to accommodate many investors' liquidity needs. The fruits of these efforts showed themselves most prominently in Irvine's Special Situations portfolio, which returned 18 percent in 2010. The long-term focus, borne out of the Foundation's ultimate goal of serving the people of California in perpetuity, gave our investment staff the patience to stick with and continue to build out its Private Equity portfolio, which rebounded in 2010 to return 20.3 percent and remains well positioned for the future. In total, the endowment returned 14.4 percent for the year, beating the policy benchmark by more than 1.3 percentage points, and entered 2011 at \$1.6 billion according to our audited financial statements which follow.

While 2010 helped put 2008's collapse further in the rear-view mirror, Irvine's investment staff took the opportunity to revisit the crisis and contemplate policies that could have alleviated its effects. These internal discussions about what hurt or helped Irvine most during and since the downturn, supplemented by the experiences and lessons learned by some of our peer institutions, highlighted one portfolio management tenet above all else: the value of flexibility. In some cases, this meant the flexibility to act quickly to adapt to changing market conditions, while in others it meant the flexibility of having capital left to take advantage of opportunities when others had overcommitted their capital to illiquid investments. With this overarching theme in mind, we began to rethink how best to evaluate the role a potential investment would play in the portfolio and how subsequently to categorize that investment to help track the endowment's overall exposures.

After thorough discussion and extensive modeling to gain insight into how potential scenarios might play out in practice, staff, with our investment committee's concurrence, determined the investment landscape had changed sufficiently to warrant a new asset allocation approach. The crux of the change involved a shift from the traditional method of defining investments by asset classes to an approach focusing more on each investment's functional characteristics and expected role in the portfolio. Whereas traditionally investments were grouped based on the type of asset involved and the investment instruments or structure utilized, the new functional approach will group investments according to their expected risk, return, liquidity and diversification characteristics, with much less consideration of how those characteristics are attained. By paying less attention to how many stocks, bonds, buildings or other assets we own, and concentrating instead on how these assets are expected to perform in different market environments, we will be better able to understand the portfolio's true exposures, a critical component when weighing new opportunities.

In specific terms, this shift means moving from grouping investments according to the eight traditional asset classes, as listed below, to the four functional investment classes in the second list below.

### INVESTMENTS BY ASSET TYPE

- U.S. Equities
- International Equities
- Fixed Income
- Absolute Return
- Private Equity
- Real Estate
- Real Assets
- Special Situations

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#### INVESTMENTS BY FUNCTIONAL CLASS

- Global Public Equities
- Stable Value
- Private Investments
- Special Situations

Harking back to the value of flexibility, the new asset allocation framework provides us with the ability to avoid or materially underweight asset types facing unfavorable conditions given the current environment, and instead put that capital to work in better positioned areas. For instance, if real estate does not look attractive given current conditions, staff will not be forced to maintain an allocation to real estate based on a strategic asset allocation target to real estate. Instead, our investment staff can scour the investment landscape to find investment opportunities that meet the specific functional characteristics needed to remain within the established allocation range for the four new functional investment classes. While important constraints remain in place to ensure proper diversification, liquidity and risk budgeting, the new framework improves flexibility for Irvine to meet allocation goals while also targeting investments with the best risk-reward tradeoffs given the current investment environment.

The Foundation maintains a long-term view, with the objective of earning at least 5.5 percent on an annual basis after inflation and investment fees. In a world where meeting that objective is becoming increasingly difficult as the number of sophisticated investors continues to increase and investment products grow ever more complex, ensuring that Irvine is fully capitalizing on all of its relative advantages is critical. The new asset allocation approach, above all else, improves investment flexibility, the value of which was proven during 2008 and since. And we believe that this shift will better equip Irvine's investment staff to achieve its investment objectives over the long term.

Finally, we recognize that the rebound in the markets during 2009 and 2010 was not matched in the underlying economy. This reality is particularly true in California, where the unemployment rate is stuck at about 12 percent and many communities continue to struggle economically. In our minds, these ongoing challenges reinforce the broader meaning and importance of our investment work. As we seek to protect and maximize the Foundation's resources, we take pride in knowing that it is done in support of Irvine's mission of expanding opportunity for the people of California.



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