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The University of Texas Investment Management Company

Presentation Materials Board of Directors Meeting

January 23, 2001

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UTIMCO

BOARD OF DIRECTORS MEETING

UTIMCO South Conference Room, 17th Floor, 221 W. 6th Street, Austin, TX

January 23, 2001

AGENDA

1:30 p.m.	**Call to Order**
1:30 p.m. - 1:50 p.m.	**Alternative Equities – Non Marketable** Approval of Commitment to Austin Ventures VIII, L.P. Approval of Commitment to American Securities Partners, III, L.P. Approval of Amendment to Delegation of Investment Approval Authority
1:50 p.m. - 2:00 p.m.	**U.S. Equities – Small Cap** Report of Award of Accounts to Pilgrim Baxter & Associates, Ltd. and Dalton, Greiner, Hartman, Maher & Co.
2:00 p.m. – 2:20 p.m.	**Presentation: Energy Outlook** Mr. Steve Strongin, Director of Commodity Research, Goldman Sachs & Co.
2:20 p.m.	**Adjourn**

Next Scheduled Meeting: Thursday, February 22, 2001

ALTERNATIVE EQUITIES - NON MARKETABLE
EXPOSURE TO ASSET CLASS
As of December 31, 2001
($ millions)

	PUF	PHF	LTF	Total	(GEF)
Alt. Equities: Non Marketabl	1,228.2	9.1	420.1	**1,657.4**	429.2
Total Endowment Assets	7,917.7	958.0	3,036.2	**11,911.9**	3,994.2
% of Total Endowment Asset	15.51%	0.95%	13.84%	**13.91%**	10.75%
Neutral Allocation	15.00%	15.00%	15.00%	**15.00%**	15.00%
Over (Under) Weight	**0.51%**	-14.05%	-1.16%	-1.09%	-4.25%

ALTERNATIVE EQUITIES - NON MARKETABLE
COMMITMENT ACTIVITY
($ millions)

Approval Date	Action	U.S. Venture Capital	U.S. Private Equity	Non U.S. Private Equity(1)	Opportunistic	Total
		43%	**36%**	**16%**	**5%**	**100%**
12/7/00	**7/1/00-6/30/01 Commitment Budget**	**200.0**	**170.0**	**75.0**	**25.0**	**470.0**
1/23/01	Austin Ventures VIII, L.P.	-30.0				**-30.0**
1/23/01	American Securities Partners III, L.P.		-30.0			**-30.0**
1/23/01	**Available Capital**	**170.0**	**140.0**	**75.0**	**25.0**	**410.0**

(1) includes non - U.S. venture capital

Resolution No. 1

WHEREAS, the Board has reviewed an Investment Recommendation prepared by the Corporation's private equity advisor, Cambridge Associates, Inc., recommending that the Corporation enter into a limited partnership agreement (the "Agreement") with AV Partners VIII, L.P. to invest up to $30 million of PUF, PHF and LTF assets in **Austin Ventures VIII, L.P.**;

WHEREAS, the Corporation has determined that the Agreement does not constitute an agreement or transaction entered into in violation of Subsection 66.08(i) of the Texas Education Code;

NOW, THEREFORE, BE IT RESOLVED, that the terms and provisions of the proposed investment as described in the Investment Recommendation dated January 17, 2001 for **Austin Ventures VIII, L.P.** be approved; and be it further

RESOLVED, that the President and CEO, and any Managing Director of this Corporation be, and each of them hereby is, authorized to make such further revisions to the terms and provisions as may be necessary or in the best interests of this Corporation, excluding an increase in the amount of the capital commitment to **Austin Ventures VIII, L.P.**; andbe it further

RESOLVED, that the President and CEO, any Managing Director, and the Secretary of this Corporation be, and each of them hereby is, authorized and empowered (any one of them acting alone) to do or cause to be done all such acts or things and to sign and deliver, or cause to be signed and delivered, all such documents, instruments and certificates (including, without limitation, all notices and certificates required or permitted to be given or made under the terms of the Agreement), in the name and on behalf of the Corporation, or otherwise, as such officer of this Corporation may deem necessary, advisable or appropriate to effectuate or carry out the purposes and intent of the foregoing resolutions and to perform the obligations of this Corporation under the Agreement and the instruments referred to therein.

AUSTIN VENTURES VIII, L.P.

Category: Venture Capital – U.S.

Fund Size: $1,500,000,000

Recommended UTIMCO Commitment: $30,000,000

Current UTIMCO Exposure: $113,300,000

Total Current and Proposed Exposure: $143,300,000

	Capital Account			
	Invested	Undrawn	Proposed	Total
AV IV	17.2	0.0	0.0	17.2
AV V	41.8	0.2	0.0	42.0
AV VI	30.1	2.6	0.0	32.7
AV VII	8.2	13.2	0.0	21.4
AV VIII	0.0	0.0	30.0	30.0
Total	97.3	16.0	30.0	143.3

Background
Austin Ventures has been investing in early stage technology companies located primarily in Texas and Southwest U.S since the formation of AV I in 1984. UT began reviewing AV funds in 1985. It declined to invest with Austin Ventures until AV IV in 1994 when Austin began to emerge as a technology center and AV Partners began to establish itself as a leading Texas based venture fund. While IRR performance for the pre 1994 funds (AV I-III) ranges from 12.6% to 26.3%, performance for AV IV – VI has been top quartile with IRRs ranging from 80% to 90% as of November 30, 2000.

Fund	Fund Size	UTIMCO Commitment	Invested	Distributed	Undistributed Value	IRR
AV IV (1994)	115.0	5.0	5.0	33.5	17.2	81.5%
AV V (1997)	170.0	15.0	14.8	12.8	41.8	92.0%
AV VI (1999)	320.0	20.0	17.4	6.3	30.1	93.8%
AV VII (2000)	825.0	20.0	6.8	0.0	8.2	39.6%

Austin Ventures' success is attributable in large part to its adeptness at responding to changing market conditions. While AV VIII will continue the firm's focus on communciations, semiconductors, software and services industries, it will dedicate a substantially larger part of the portfolio to opportunities in the Dallas Telecommunications corridor. This emphasis recognizes the arrival during the 1990s of established telecommunications companies such as Alcatel, Ericsson, Nortel Networks, Worldcom and Cisco and the emerging market for high speed telecommunications and optical fiber systems. AV believes that this market has evolved to the same point where the Austin market was in 1995 and that the technology being developed there will have an impact on worldwide markets. This strategy is not without risk as other venture firms also have recognized the Dallas telecommunications market. This could lead to exceesive early round valuations seen most recently in financing Internet start-ups. Nevertheless, Austin Ventures has invested over $350 million in 16 Dallas area companies since 1985. However, it has only recently established a physical presence in this market, placing a general partner in two offices in the Dallas telecom corridor (Dallas – Richardson). This strategy decision was under consideration since 1998 and reflects the careful planning historically employed by AV in developing its business model.

To continue its success, Austin ventures must also manage the rapid growth in assets under management and in the firm itself. The firm has come to market annually since 1999 and fund size has grown from $370

million in 1999 to the expected $1.5 billion for AV VIII. In addition, the number of investment professionals has soared to 19. At the same time, the firm has an outstanding if not obssesive focus on the execution of its business plan – a process UT/UTIMCO has followed closely from its position on the funds' advisory boards. The firm also has attracted a blue chip group of limited partners which will provide approximately 80% of the capital for AV VIII. Institutions committing capital to AV VIII for the first time are:

Fund of Funds:	Morgan Stanley, CSFB, Salomon Smith Barney, Tom Weisel partners,
Endowments:	Cornell University, Hamilton College
Foundations:	MacArthur Foundation, Meadows Foundation, Dupont Trust, Glenmeade Trust
Corporations:	Texas Instruments
Public Pension Funds:	Texas Teachers, State of Michigan, State of Pa.

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MEMORANDUM

TO:	Thomas G. Ricks University of Texas Investment Management Company
FROM:	Astrid M. Noltemy Jennifer Urdan
DATE:	January 17, 2001
RE:	Austin Ventures VIII

RECOMMENDATION

Cambridge Associates recommends that the University of Texas Investment Management Company ("UTIMCO") consider an investment of up to $30 million in Austin Ventures VIII, L.P. ("The Fund" or "Fund VIII"), subject to the negotiation and approval of final terms of the partnership. The Fund is seeking $1.25 billion in capital commitments. The Firm expects to hold a first and final closing at the end of January 2001. This Fund represents an opportunity for UTIMCO to continue its relationship with Austin Ventures ("The Firm" or "Austin"), a seasoned venture capital manager well positioned to continue its record of producing strong investment returns in both healthy and weak capital market environments.

SUMMARY

Austin Ventures is raising Austin Ventures VIII, L.P., a $1.25 billion private equity fund that will pursue a similar investment strategy as the Firm's prior funds. The Firm will make early-stage information technology investments with an emphasis on communications, semiconductors, and software and services. The Firm's geographical focus is Texas and the Southwest region. Austin typically sources its own deals through its extensive network, and it expects to be the lead investor in the majority of its deals. The individual members of the General Partner will be Joseph C. Aragona, J. Ross Cockrell, Kenneth P. DeAngelis, Edward E. Olkkola, Chris A. Pacitti, Stephen D. Straus, John D. Thornton, and Blaine F. Wesner.

Austin Ventures' strengths clearly lie in its deep and experienced management team, its historical dominance of the Texas market, and its ability to generate proprietary deal flow through its vast network. The recent addition of two offices in the Dallas metropolitan area will allow the Firm to further expand its proprietary network, and will allow Austin to move successfully into the growing communications market in Dallas.

ORGANIZATION AND MANAGEMENT

Austin Ventures' predecessor organization was founded by Jeff Garvey in 1979, and Kenneth DeAngelis and Joseph Aragona joined in 1981 and 1982, respectively, from the Merchant Banking Division of the Bank of Boston. Austin Ventures I, the group's first fund, was raised in 1984. Since 1979, the Austin principals have overseen the investment of approximately $2.9 billion.

Austin Ventures has grown extensively since its founding and now has 57 employees in total, nearly 30 of whom are investment professionals. In addition to Austin's eight general partners, it employs three partners, five associates, and six venture partners. The Firm has made a concerted effort to grow its staff to include large numbers of administrative, financial, research, marketing, and other support personnel. A large percentage of these employees assist in Austin's "hands-on approach" to its portfolio companies, helping the companies with issues such as recruiting, locating office space, and completing other administrative tasks.

The Firm is based in Austin, Texas, and it has recently opened two additional offices in metropolitan Dallas. The headquarters in Austin is currently staffed by five general partners, and eleven investment professionals. By the end of 2001, the Firm expects that the two Dallas offices will house three general partners, and ten investment professionals. Austin intends to remain focused on the Texas and Southwest markets, and as such, has no plans for additional offices. A table outlining the seniority and location of the general partners at Austin follows below.

Investment Professional	Title	Year Joined Austin	Office
Kenneth P. DeAngelis	General Partner	1981	Austin
Joseph C. Aragona	General Partner	1982	Austin
Blaine F. Wesner	General Partner	1990	Dallas
John D. Thornton	General Partner	1991	Austin
J. Ross Cockrell	General Partner	1995	Dallas
Stephen D. Strauss	General Partner	1996	Austin
Edward E. Olkkola	General Partner	1998	Dallas
Chris A. Pacitti	General Partner	1999	Austin

In addition to the investment professionals that are dedicated to the Firm, Austin utilizes an extensive network of venture partners, entrepreneurs-in-residence, and an incubator, AV Labs. With these additional resources, Austin's network for deal sourcing and for portfolio company management has expanded tremendously. Venture partners occupy board seats at portfolio companies and lend operational experience in each targeted category of investments. The entrepreneurs-in-residence provide new ideas and potential opportunities; AV Labs provides seed financing to prospective Austin portfolio companies. The use of venture partners in particular helps the Firm control the number of board seats to which each partner is assigned.

INVESTMENT STRATEGY

Austin VIII will make early-stage investments in information technology companies in Texas and in the Southwest. The Fund will focus its investments on communications, semiconductor, software and services companies. While no target allocations are set for investment in each area, the Fund is expected to be 50% allocated to communications and semiconductors, and 50% allocated to software and services. In its earliest funds, Austin's investment strategy was opportunistic, spanning across all sectors and industries, but since the beginning of the 1990s when Austin, Texas developed as a technology center, technology has become the core of the Firm's investment strategy. A similar pattern has evolved with regards to the Firm's geographical focus. The Firm's investments in Texas companies have grown from 46% of assets in Fund I to 93% of assets in Fund VII. Fund VIII will be the first fund offered by Austin that will have a significant

presence in Dallas. With the opening of two offices in the Dallas area, Austin hopes to play a significant role in that market.

In order to implement its early-stage investment process, Austin employs a number of external sources, such as the venture partners and the entrepreneurs-in-residence. Other elements of its strategy involve the use of incubators, AV Labs and STARTech. Fund VIII will invest $125 million in AV Labs II, more than two times the amount Fund VII invested in AV Labs I. AV Labs is a dedicated accelerator fund and is focused on Austin based companies. While STARTech serves a similar purpose to AV Labs, it works with a number of venture capital firms and is focussed on a larger geographical area.

Austin prefers to originate and lead its deals. In fact, in its prior funds, Austin originated approximately 71% of its investments, and it has led or co-led approximately 77% of the transactions. Additionally, the Firm intends to be an active board member of each portfolio company and holds board seats/attendance rights for 79% of its investee companies.

Austin's strategy is an extremely "high touch" one, which translates into significant involvement on the part of the Fund in all aspects of its portfolio companies. Much of Austin's value added comes in the strategic decision-making processes, for example during financing rounds, recruiting, and marketing. Because Austin is geographically located in close proximity to the bulk of its portfolio companies, its strategy is easily implemented through personal visits, board meeting attendance, and extensive communication.

PERFORMANCE

Fund	Date of Inception	Fund Size ($mm)	Contributed Capital ($mm)[1]	NAV ($mm)[1]	Distributed Capital ($mm)[1]	Net IRR[2]	Vintage Year Mean Benchmark[3]	Vintage Year Median Benchmark[3]	Vintage Year Top Quartile[3]
II	11/24/87	$60.0	$57.9	$1.1	$153.1	20.0%	18.3%	15.4%	21.9%
III	3/1/91	$75.0	$74.3	$68.8	$153.0	29.2%	36.9%	23.5%	36.5%
IV	7/29/94	$115.0	$113.9	$417.6	$735.7	82.1%	73.3%	35.1%	52.9%
V	12/23/96	$170.0	$160.4	$463.5	$143.9	99.0%	155.6%	78.9%	122.6%
VI	11/12/98	$320.0	$275.2	$489.8	$85.9	111.2%	132.2%	93.9%	139.9%
VII	10/29/99	$811.9	$242.6	$301.4	$0.0	60.1%	57.5%	27.6%	94.8%

Performance Notes:
1. Contributed capital, NAV, and distributed capital are to Limited Partners only, as of 9/30/00, as calculated by Cambridge Associates, LLC.
2. Returns are net of management fees and carried interest, as of 9/30/00, as calculated by Cambridge Associates, LLC.
3. Preliminary U.S. venture capital benchmarks are net to Limited Partners, as of 9/30/00, as calculated by Cambridge Associates, LLC.

Fund II: Fund II was raised in 1987 with $60.0 million in commitments. As of September 30, 2000, Fund II was fully invested in 26 companies and was producing a net internal rate of return ("Net IRR") of 20.0%, according to Cambridge Associates. Fund II had distributed $153.1 million to limited partners, according to Cambridge Associates. The Fund included three complete write-offs with the combined dollar-amount of these losses totaling $11.9 million. The Fund included three active investments as of September 30, 2000. Fund II's strongest performers included Matrix Environmental (210.7% gross IRR) and TIVOLI Systems, Inc. (118.8% gross IRR).

Fund III: Fund III was raised in early 1991 with $75.0 million in commitments. Through September 30, 2000, Fund III had called $74.3 million from its limited partners, had a remaining net asset value ("NAV")

of $68.8 million, and a net IRR of 29.2%; $153.0 million had been distributed to limited partners. As of September 30, 2000, Fund III was fully invested in 26 companies of which 20 investments are fully realized, four are partially realized, and two are unrealized. Of the 20 fully realized investments, two were write-offs. Among Fund III's strongest performers are EMC Corp. (166.7% gross IRR) and IntelliQuest Information Group, Inc. (113.0% gross IRR).

Fund IV: Fund IV was raised in mid-1994 with $115.0 million in commitments. Through September 30, 2000, Fund IV had called $113.9 million from its limited partners, had a NAV of $417.6 million, and had a net IRR of 82.1%; $735.7 million had been distributed to limited partners. The Fund's performance places it in the top quartile of venture capital funds raised in 1994. As of September 30, 2000, according to Cambridge Associates, Fund IV was fully invested in 25 companies of which eight investments had been fully realized, nine were partially realized, and eight were unrealized. Of the eight fully realized investments, three were write-offs. Among the strongest performers of Fund IV are Vignette Corporation (318.2% gross IRR), Crossroads Systems Inc. (301.9% gross IRR), and Active Power, Inc. (168.0% gross IRR).

Fund V: Fund V was raised in late 1996 with $170.0 million in commitments. Through September 30, 2000, Fund V had called $160.4 million from its limited partners, had a NAV of $463.5 million, and had a net IRR of 99.0%. As of September 30, 2000, according to Cambridge Associates, Fund V was invested in 30 companies of which three are fully realized, four are partially realized, and 23 are unrealized. Of the 27 partially realized or unrealized companies, four are held at cost, six are held below cost, and 17 are held above cost. Among Fund V's strongest performers are FacilityPro.com (646.4% gross IRR), TechRepublic, Inc. (382.4% gross IRR), and International Network Services, Inc. (302.7% gross IRR).

Fund VI: Fund VI was raised in late 1998 with $320.0 million in commitments. Through September 30, 2000, Fund VI had called $275.2 million from its limited partners, had a NAV of $489.8 million, and had a net IRR of 111.2%. As of September 30, 2000, according to Cambridge Associates, Fund VI was invested in 39 companies, of which five are partially realized and the rest are unrealized. Of the 34 unrealized investments, 15 are being held at cost, four are being held below cost, and 20 are being held above cost. Fund VI's strongest performers thus far include Agere, Inc. (acquired by Lucent Technologies, producing an 823.2% gross IRR), Ineto, Inc. (825.5% gross IRR), and iVita.com (598.2% gross IRR).

The Fund's main area of investment focus is on communications and software, which account for 45.2% and 30.0% of the Fund's invested capital, respectively. Smaller allocations have been made to consumer/retail services (7.5%), healthcare/biotech (7.1%), financial (5.6%), electronics (3.3%), and hardware (1.4%). Nearly 84% of Fund VI's investments have been made in the Southwest (predominately Texas) though opportunistic investments have been made in California and other regions. Approximately 61% (based on invested capital) of the Fund has been invested in either start-up or early-stage opportunities, though some investing has been made in the expansion-stage (18.8%), seed-stage (17.6%), and in public companies (3.0%).

Fund VII: Fund VII was raised in late 1999 with $811.9 million in commitments. Through September 30, 2000, Fund VII had called $242.6.6 million from its limited partners, had a NAV of $301.4 million, and had a net IRR of 60.1%. As of September 30, 2000, according to Cambridge Associates, Fund VII was invested in 28 companies, all of which are considered unrealized. Of these 28 investments, 21 are currently being held at cost and seven are being held above cost. Fund VII's strongest performers to date include AV Labs

(Austin Ventures' related incubator; gross IRR of 473.2%), Broadband Services, Inc. (380.7% gross IRR), and Pentasafe (242.2% gross IRR).

The Fund's main area of investment focus is similar to that of Fund VI's: communications and software, which account for 30.1% and 33.5% of the Fund's invested capital, respectively. Smaller allocations have also been made to hardware (17.1%), consumer/retail services (9.6%) and other investments (9.9%). Nearly 89% of Fund VII's investments have been made in the Southwest (predominately in Texas) though a very limited number of opportunistic investments have been made in other regions. Approximately 66% of the Fund's capital has been invested in start-up and early-stage company with smaller allocations made to seed-stage and expansion-stage opportunities. Additionally, Fund VII has to date invested 3.7% of its capital in oil and gas and 2.3% in the subordinated debt financing of a non-leveraged buyout situation.

COMPETITIVE ADVANTAGES

- *Exceptional reputation and deal flow in the Texas market.* Austin Ventures has dominated the Austin, Texas market since its founding nearly 20 years ago. As such, entrepreneurs regard the Firm as the first step for financing in Texas, insuring a strong, proprietary deal flow. With the opening of the two Dallas-based offices, the Firm expects to tap into the communications market there much in the same manner that it benefited from the semiconductor and software markets in Austin.

- *Strong, stable team.* The Firm's general partners each average over eight years of capital experience. In addition to the two founding partners, Kenneth DeAngelis and Joseph Aragona, the Firm has been adept at promoting from within to endure the continuation of the Austin culture and investment process. There has been no meaningful turnover within the partnership ranks.

- *Established venture partner network and resources.* The Firm has successfully established a core group of six Venture Partners who actively assist Austin to source deals; evaluate products, technologies and markets; and assist portfolio companies as board members or advisors.

ISSUES FOR CONSIDERATION

- *Fund size and assets under management.* As a result of the $800 million raised in 1999 and this fund's expected $1.25 to 1.5 billion, there is a significant amount of capital under management for investment, potentially impacting the team's capacity. The Firm has been able, however, to reasonably manage each partner's board responsibilities, take more advantage of its strong venture partner network, and increase the number of general partners and staff to meet the increased demands. Also of note, the Fund's strategy has shifted somewhat with its decision to invest in the more capital-intensive communications industry in Dallas. As such, the added dollars under management does not necessarily translate into an unmanageable number of portfolio companies.

- *Potential limitations of a regionally focused fund.* The Firm may be challenged to invest its increased amount of assets concentrated in the same geographical location.

CONCLUSION

Cambridge Associates considers Austin to be well positioned to continue its record of producing strong investment returns in both healthy and weak capital market environments as a result of several key drivers, including: its strong reputation as value-added investors; its exceptional deal flow in Texas; and the team's experience and stability. The depth and experience of the Firm coupled with its demonstrated ability to generate solid returns, make Austin Ventures VIII an attractive venture capital investment opportunity for UTIMCO.

SUMMARY OF KEY TERMS

Minimum Commitment:	$5 million.
General Partner's Commitment:	The General Partner will contribute 1% of the contributed capital to the Fund in cash.
Investment Period:	N/A.
Takedown:	Capital contributions will be made in minimum installments of $1 million, with at a minimum of 15 days' prior notice provided by the General Partner.
Distributions:	Net gains and losses will be allocated 75% to the Limited Partners and 25% to the General Partner.
Clawback:	N/A.
Fee:	During years one and two of the Fund, the fee will be 1.5% of total committed capital; during years three through six, the fee will be 2.5%; during years seven through ten (including any extensions to the life of the Fund), the fee will be 2.5% of the acquisition cost of the portfolio securities shown on the audited balance sheet as of the end of the immediately preceding fiscal year, other than portfolio securities that have been written-off. Based on the Firm's experience with other funds, the General Partner estimates that this fee schedule will result in an average annual fee of approximately 1.6% of committed capital over a ten year period.
Partnership Life:	Ten years. The General Partner may extend the term of the Partnership with the consent of a majority interest of the Limited Partners for up to three years.
Key Man Clause:	N/A.
Closing:	The Fund expects to hold a first and final closing at the end of January 2001.

KEY PERSONNEL

Joseph C. Aragona	**General Partner.** Joined Firm in 1982. Bank of Boston, Merchant Banking Division. M.B.A., Harvard Business School. B.A., Harvard University.
J. Ross Cockrell	**General Partner.** Joined Firm in 1995. Lomas Financial Corporation, Financial Analyst. M.B.A., University of Texas. B.A., Harvard University.
Kenneth P. DeAngelis	**General Partner.** Joined Firm in 1981. Bank of Boston, Merchant Banking Division. M.B.A., Wharton School of Finance. B.A., Harvard University.
John C. Dirvin	**Partner.** Joined Firm in 1997. Texas Instruments, Marketing and Finance. UNIX Computer, Marketing and Finance. M.B.A., Cornell University. M.S., Cornell University. B.A., Cornell University.

Peter J. Huff — **Partner.**

Joined Firm in 2000.

Whitney and Co., General Partner.
Triad Media Ventures, Co-Founder and General Partner.
McKinsey & Co.

M.B.A., Stanford Graduate School of Business.
B.A., Southern Methodist University.

Edward E. Olkkola — **General Partner.**

Joined Firm in 1998.

Compaq, Business Development and Strategy, Vice President.
Motorola, Business Development and Strategy.

M.B.A., Northeastern University.
B.A., University of Massachusetts.

Chris A. Pacitti — **General Partner.**

Joined Firm in 1999.

TL Ventures, Vice President.

B.A., Johns Hopkins University.

Venu R. Shamapant — **Partner.**

Joined Firm in 1999.

Telecom Technologies Inc., Business Development, Vice President.
McKinsey & Co., Engagement Manager.

M.B.A., Harvard Business School.
M.S., University of Texas, Austin.
B.S., Osmania University (India).

Stephen D. Straus | **General Partner.**

Joined Firm in 1996.

The Solutions Group, Founder and C.E.O.
LG Group Venture Capital, Associate.

M.B.A., Harvard Business School.
B.A., Colgate University.

John D. Thorton | **General Partner.**

Joined Firm in 1991.

McKinsey & Co.

M.B.A., Stanford Graduate School of Business.
B.A., Trinity University.

Blaine F. Wesner | **General Partner.**

Joined Firm in 1990.

Goldman, Sachs & Co.

M.B.A., Harvard Business School.
B.A., University of Oklahoma.

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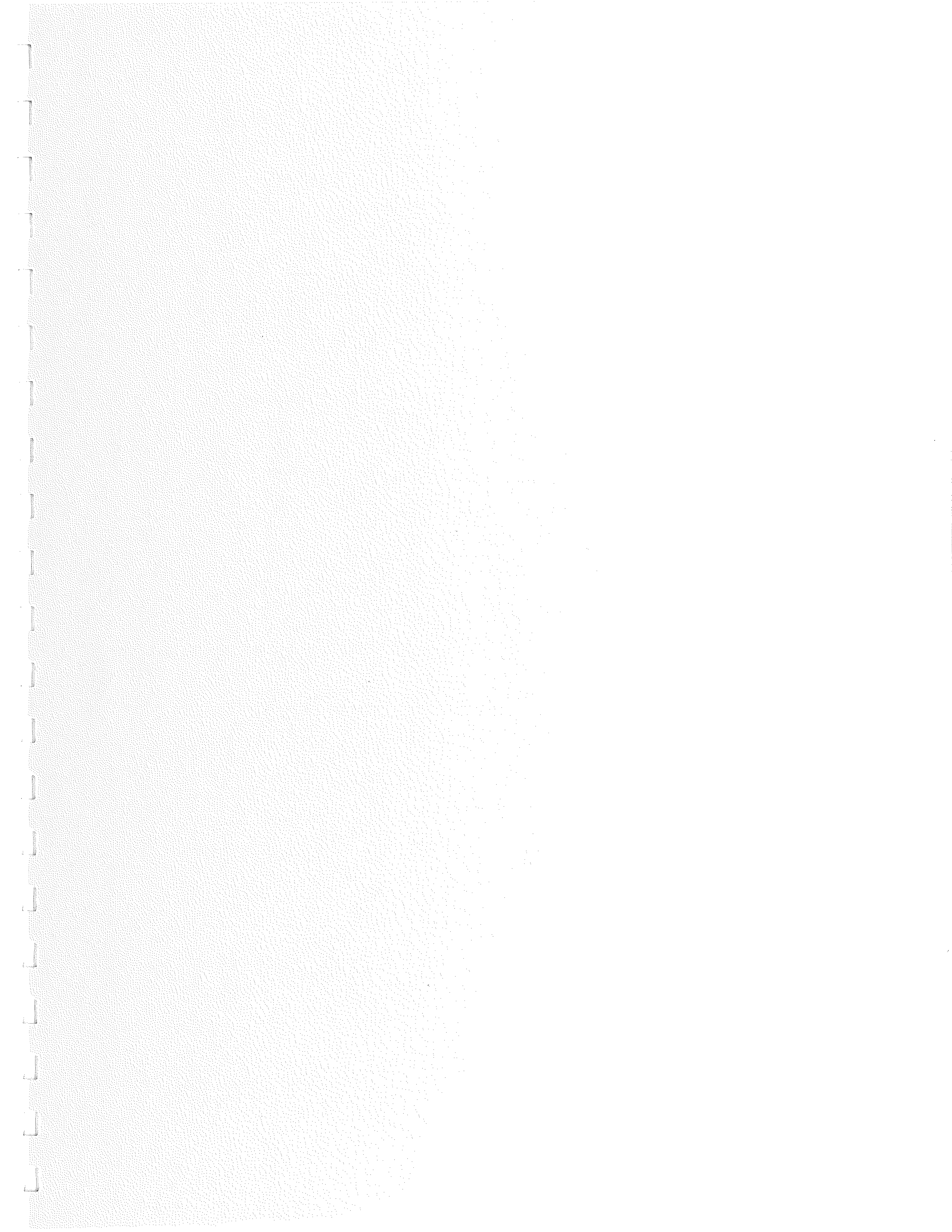


<u>Resolution No. 2</u>

WHEREAS, the Board has reviewed an Investment Recommendation prepared by the Corporation's private equity advisor, Cambridge Associates, Inc., recommending that the Corporation enter into a limited partnership agreement (the "Agreement") with American Securities Capital Partners, L.P. to invest up to $30 million of PUF, PHF and LTF assets in **American Securities Partners III, L.P.**;

WHEREAS, the Corporation has determined that the Agreement does not constitute an agreement or transaction entered into in violation of Subsection 66.08(i) of the <u>Texas Education Code</u>;NOW, THEREFORE, BE IT RESOLVED, that the terms and provisions of the proposed investment as described in the Investment Recommendation dated January 17, 2001 for **American Securities Partners III, L.P.** be approved; and be it further

RESOLVED, that the President and CEO, and any Managing Director of this Corporation be, and each of them hereby is, authorized to make such further revisions to the terms and provisions as may be necessary or in the best interests of this Corporation, excluding an increase in the amount of the capital commitment to **American Securities Partners III, L.P.**; andbe it further

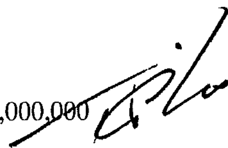
RESOLVED, that the President and CEO, any Managing Director, and the Secretary of this Corporation be, and each of them hereby is, authorized and empowered (any one of them acting alone) to do or cause to be done all such acts or things and to sign and deliver, or cause to be signed and delivered, all such documents, instruments and certificates (including, without limitation, all notices and certificates required or permitted to be given or made under the terms of the Agreement), in the name and on behalf of the Corporation, or otherwise, as such officer of this Corporation may deem necessary, advisable or appropriate to effectuate or carry out the purposes and intent of the foregoing resolutions and to perform the obligations of this Corporation under the Agreement and the instruments referred to therein.

AMERICAN SECURITIES PARTNERS III , L.P.

Category: Private Equity – U.S.

Fund Size: $750,000,000

Recommended UTIMCO Commitment: $30,000,000



Current UTIMCO Exposure: $29,600,000

Total Current and Proposed Exposure: $59,600,000

	Invested	Undrawn	Proposed	Total
ASP II	21.4	8.2	0.0	29.6
ASP III	0.0	0.0	30.0	30.0
Total	21.4	8.2	30.0	59.6

Background
American Securities was founded in 1947 as the New York based investment office of the William Rosenwald Family - heirs to the Sears Roebuck fortune. Today the firm manages $2 billion of equity capital through arbitrage, real estate and private equity strategies. It's private equity strategy is to invest $25 to $75 million in a limited number of middle-market companies with revenues ranging from $50 million to $300 million. ASP's strategy is intentionally designed to minimize operating and financial risk by investing in companies with a 50% to 70% market share, at roughly 6x trailing 12 months operating cash flow, with growth prospects to earn a 35% equity return over a 5-year holding period and strong management with a meaningful amount of its own capital invested. It dedicates two managing directors and a principal to each investment and plays a highly active role in its portfolio companies particularly with respect to strategy, management development and acquisitions.

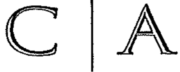
ASP organized its first fund, ASP I, in December 1994. It invested $118 million over a two year period. It has realized proceeds of $241 million and $45 million of unrealized value in the portfolio. Estimated gross IIR is 42.7% and 2.4x of cost. UTIMCO began a relationship with ASP in May 1998 when it committed $30 million to ASP II, a $350 million fund. As of September 30, 2000, it had invested $247 million in 6 companies. ASP II has had no realizations. However, ASP II portfolio companies have generated significant increases in operating earnings since investment. ASP II has generated a *gross* 67% IRR valuing each portfolio company at its original purchase multiple of last twelve months EBITDA as of September 30, 2000. ASP II's net IRR of –2.1% (including management fees and organizational expenses) is negative as expected with values held at book.

Fund	Fund Size	UTIMCO Commitment	Invested	Distributed	Undistributed Value	IRR
ASP II (1998)		30.0	20.0	0.0	19.5	-2.1%

ASP III is targeted at $500 million with a $750 million maximum capitalization. It had its first close on 12/27/00 receiving commitments of $201 million from existing investors. Committed limited partners include Suntrust ($25MM), DLJ Fund Investment Partners ($10MM), Disney Corp. ($10MM), Skidmore College($4MM) and a large contingent of high net worth families that also serve as a source of deal flow to ASP. The firm reports that it is in second or third round discussions with Yale, Goldman Sachs, Dupont, and Howard Hughes Medical Institute. It now projects that the final size of the fund will reach $750 million including a $40 million commitment from ASP itself.

Investment in ASP III represents a relatively low risk private equity strategy. The middle market sector contains the vast majority of U.S. companies but does not receive comparable amounts of private equity financing as the large capitalization market. In addition, many companies that relied on high yield sub-debt

and bank debt are being shut out and will be forced to offer equity at attractive valuations. On the other hand, certain sellers will also take their companies off the market in expectation of higher valuations in the future.



MEMORANDUM

TO: Thomas G. Ricks
University of Texas Investment Management Company

FROM: Astrid N. Noltemy
Jennifer Urdan

DATE: January 17, 2001

RE: American Securities Partners III

RECOMMENDATION

Cambridge Associates recommends that the University of Texas Investment Management Company ("UTIMCO") consider an investment of up to $30 million in American Securities Partners III, L.P. ("The Fund" or "ASP III"), subject to the negotiation and approval of final terms of the partnership. The Fund is seeking $500 million in capital commitments. The Fund will hold the next close at the end of January 2001. UTIMCO has previously invested in ASP II. The new Fund represents an opportunity for UTIMCO to continue a relationship with American Securities Capital Partners ("The Firm" or "ASCP"), an experienced mid-market buyout manager.

SUMMARY

American Securities, L.P., a parent company of ASCP, was founded in 1947 to manage the assets of William Rosenwald, a co-founder of Sears, Roebuck & Co. ASCP became one of the few investment firms in the family office marketplace known for its success and expertise in sponsoring private equity investments. This expertise has created proprietary deal flow for the Firm.

ASCP is led by a highly experienced and cohesive investment team. Charles D. Klein, Michael G. Fisch, David L. Horing and Paul Rossetti will have responsibility for the investing activities of the Fund and are supported by a team of experienced investment professionals. The General Partner will commit $40 million to Fund III.

Since December 1994, ASCP has invested in 12 private middle-market companies that collectively represent over $1.2 billion of enterprise value at acquisition. These investments have generated consistently positive returns. Fund I, raised in December 1994, made five investments and produced a net IRR of 39.0% on a cost basis of $118.7 million. Fund II, raised in July 1998, has invested over $250 million in seven companies to date.

ORGANIZATION AND MANAGEMENT

The ASCP investment team consists of four Managing Directors, three Principles and four Associates. Michael Fisch and Charles Klein have been partners since early 1993. Mr. Fisch formally was a management consultant at Bain & Company and an investment banker at Goldman Sachs. Prior to joining American Securities, he served as a Managing Director of First Atlantic Capital and a partner of its related private equity fund. Mr. Klein was an Institutional Investor all-star analyst working for Bear Stearns and

Lehman Brothers prior to serving as a senior financial advisor to the William Rosenwald family since 1978. David Horing joined ASCP in early 1995 at the beginning of Fund I. Prior to joining the Firm, he worked at Dyson-Kissner-Moran, a middle-market private equity investment firm. Mr. Horing previously worked at Salomon Brothers and The Boston Consulting Group. The fourth Managing Director, Mr. Paul Rossetti, joined the Firm in 1997 from Patricof & Co. Ventures, where he had been a partner since early 1996. Previously, Mr. Rossetti was also a senior officer at Dyson-Kissner-Moran, where he worked with Mr. Horing for 6 years. Mr. Rossetti's prior experience also includes working as Director of Acquisition for HMK Group, a middle-market private equity firm, and as a consultant for Bain & Company. The Managing Directors are supported by three Principals, four Associates, a CFO and an administrative staff. According to Mr. Fisch, all Principals are on partnership track. Glenn Kaufman, a Certified Public Accountant, joined the firm in 1997. His prior experience includes working as a consultant for Price Waterhouse and as an attorney for Cravath, Swaine & Moore where he focused on private equity and related transactions. Robert Klein (not related to Charles Klein) joined ASCP in 2000 following eight years at American Industrial Partners, where he was a Managing Director and served on both the Investment and Executive Committees. Mr. Klein's prior experience includes working as an associate and an analyst in the investment banking divisions of CS First Boston and Morgan Stanley, respectively. At these firms, he was involved in the M&A work focusing on media and telecommunications projects. Matthew LeBaron joined the team in 1999. His prior experience includes working as a consultant for The Boston Consulting Group and as an associate at Bain Capital. The four Associates supporting the Managing Directors and Principals have joined the Firm after completing analyst programs at major investment banks.

INVESTMENT STRATEGY

ASCP has established several criteria that are used to make investment decisions. The Firm invests only in companies with leading market positions and stable cash flow streams. The factors considered by the ASCP team include, but are not limited to, leading market share, proprietary technology, broad distributions networks, well-established brand name, and a diverse and stable customer and supplier base. For example, all seven investments made in Fund II were clear market share leaders in their niche. The Firm also seeks companies with substantially undervalued cash flow streams. In such situations, ASCP adds value by increasing asset utilization, improving operating efficiency, divesting non-core assets or capitalizing on changes in industry dynamics, regulatory environments or economic trends. When considering an investment, the partners of ASCP expect to work with proven managers and request the management of the potential investee company to hold a meaningful equity stake, thus aligning the interests of management and investors. ASCP prefers the management to own at least 10-12% of the company. The Firm is looking to make investments in its portfolio companies at attractive purchase multiples. Since inception of Fund I, the average purchase multiple for the Firm was six times the trailing 12-month operating cash flow. The Firm evaluates each investment based on existing cash flows, placing a premium on predictability and stability and discounting for cyclicality and volatility. By using strict valuation discipline and establishing a relatively conservative capital structure with low leverage, the Firm is able to mitigate somewhat the risks of private equity investing.

As within their previous funds, Fund III will have no specific geographic focus. The General Partners plan to make investments in the United States and, possibly, Canada. While the Fund will make no investments in foreign-domiciled companies, the portfolio companies do buy and will consider buying foreign entities to enhance their business operations.

The General Partners of American Securities believe that their established networks and industry expertise will enable them to source good investment opportunities. Throughout the Firm's history, the General Partners have gained significant deal flow access through their personal network of contacts and relationships established while managing the Rosenwald's family investment activities. Another source of deal flow for the Firm is created by targeted industry research. Several members of the team may spend up to several months researching and validating certain industry characteristics. Two of the Firm's investments, Community Pacific Broadcasting and DRL Holdings, have been sourced through such research. The Firm's Management Advisory Council also provides a source of deal flow. On occasions, the General Partner will also look at managed offerings led by investment banks, but the Firm prefers not to participate in the auctions (although one of its portfolio companies, El Pollo Loco, was bought through the auctioning process).

Historically, the Firm conducts full due diligence on less than 5% of the total reviewed opportunities. Once the most compelling opportunities are identified, the due diligence process begins, requiring two to four months to meet with industry experts, work with outside consulting firms, and collaborate with other sophisticated investors and buy-side analysts. The major factors considered during this process are target company's product and market strengths and weaknesses, management's ability to perform, long-term competitive viability of the business and industry, and the investment's overall balance of potential risk and return. All final investment decisions are made only with the unanimous approval of all four Managing Directors.

Once the investment is made, the Firm adds value through active management of the portfolio company. Two Managing Directors and one Principal are involved with each company. Typically, after closing the deal, ASCP organizes a multi-day off-site retreat with the management of the company. At these retreats, the investment team builds the relationship with the management, assigns responsibilities and directs management's focus on critical strategic goals. Usually, the outside consultants who participated in the due diligence present their findings. The Firm usually seeks to find outsiders to serve on the companies' boards of directors. These outside advisors are usually seasoned executives with relevant experiences.

Decisions regarding the exit usually depend on the specific characteristics of each investment, and to date the Firm has used three exit strategies – sale to strategic or financial buyers, recapitalization, and initial public offering.

PERFORMANCE

Fund	Date of Inception	Fund Size ($mm)	Contributed Capital ($mm)	NAV ($mm)	Distributed Capital ($mm)	Internal Rate of Return	Vintage Year Mean Benchmark[4]	Vintage Year Median Benchmark[4]
Fund I[1]	1994	$118.7	$118.7	$45.8	$240.6	39.0%	13.1%	15.8%
Fund II[2,3]	1998	$350.0	$222.5	$228.7	$0	1.9%	20.5%	3.1%

Performance Notes:

[1] Information on Fund I is as of 9/30/2000 as provided by the General Partner. The IRR is net of management fees and carried interest.

[2] Information on Fund II is as of 9/30/2000 as calculated by Cambridge Associates LLC. The IRR is net of management fees and carried interest.

[3] This fund is too young to have produced a meaningful return. Analysis and comparison of the partnership return to the benchmark statistic may be irrelevant.

[4] Cambridge Associates' benchmark statistics are internal rates of return, net of carried interest and fees as of September 30, 2000.

Fund I: This was the first fund raised by the current team (with the exception of Mr. Rossetti). The Fund invested $118.7 million in five platform companies. All investments in this fund are substantially realized with cash proceeds of $240.6 million. The unrealized value, held mostly in public securities of two companies (CTB International and Caribbean Restaurants), amounted to $45.8 million as of September 30, 2000. The Firm reports a net IRR of 39.0%. Based on the multiple of cost, Ketema, Inc. returned 2.6 times the investment for a gross IRR of 56.6%. The best performing investment made in Fund I, Caribbean Restaurants, has not been fully-realized , yet shows a 3.7x multiple of cost and a gross IRR of 87.1%. There were no write-downs or write-offs in this fund.

Fund II This fund was raised in 1998 with $350 million in capital commitments. As of September 30, 2000 the Fund had invested $222.5 million in six platform companies. Subsequent to that date, ASCP made an investment in the seventh platform company. Cambridge Associates calculates the IRR of the fund based on the audited financial statements provided by the fund manager. As is customary with the buyout industry, investments are held at cost until a significant valuation event occurs. Thus the IRR shown in the table above is 1.9% net to limited partners. However, if the calculations are based on the closing purchase multiples and trailing 12-month EBITDA, the gross IRR as of September 30, 2000 is 67.9%. Fund II portfolio companies have shown some excellent improvements. For example, DRL Holdings, a direct mail retailer, had more than 20% revenue growth since it was acquired by ASCP in July 1998. El Pollo Loco, a quick-service restaurant chain, showed a 49% change in EBITDA. VUTEk, the world's leading designer and manufacturer of super wide format digital printers, had its EBITDA grow by 75% since it was acquired in April 2000.

COMPETITIVE ADVANTAGES

- *Strong deal sourcing.* The general partners bring established networks and industry expertise to an already robust personal network of relationships established while managing the Rosenwald's family investment activities. As evidenced by their current portfolio, they have taken advantage of their deal flow sources and only occasionally participated in an auction.

- *Demonstrated track record.* Although it is a young record, the team has demonstrated its ability to execute its stated strategy and generate realizations for investors. At 9/30/2000, Fund I, raised in 1994, had returned $240.6 million to its limited partners on contributed capital of $118.7 million. As a result, the fund generated a net return of 39.0%, placing it in the first quartile of funds.

ISSUES FOR CONSIDERATION

- *Few realizations with Fund II.* Although encouraged by Fund I's performance, investors need to be aware that the 1998 Fund has yet to generate any realizations for investors. Because Fund I consisted of only five platform companies, there is not a long, established track record of a meaningful number of investments on which one can assess performance. That being said, however, it is still young in the life of Fund II and any comparison to benchmark statistics may not be relevant. It also is important to note that several Fund II investments have shown considerable revenue growth, poising them for potentially positive liquidity events.

CONCLUSION

American Securities Partners III represents a good opportunity for the Corporation to re-invest with an experienced mid-market buyout manager that has strong deal sourcing ability and investment discipline. The Firm's first fund is almost fully realized and has delivered high returns to its limited partners. Fund II is too young to have produced meaningful returns. While Fund II has not had any realizations to date, the portfolio contains solid investments with potential to yield above average returns. Given the strength of the team and its ability to execute the proven strategy, we recommend that UTIMCO consider committing up to $30 million to American Securities Partners III, L.P.

SUMMARY OF KEY TERMS

Minimum Commitment:	$5 million.
General Partner's Commitment:	$40 million.
Investment Period:	Six years.
Takedown:	Commitments will be drawn down as needed with not less than 10-business days' prior written notice.
Distributions:	Carried interest will be distributed 80% to limited partners and 20% to the General Partner based on funded commitments after a preferred return of 8% per annum.
General Partner Clawback:	Yes.
Fee:	The General Partner will receive an annual management fee equal to 2.00% of committed capital.
Life of Partnership:	10 years, subject to two one-year extensions at the discretion of the General Partner.
Projected Closing:	The Fund expects a final closing in the second quarter of 2001.

KEY PERSONNEL

Charles D. Klein	**Managing Director**
Year Joined Firm	1978 Advisor to William Rosenwald family
Prior Experience	Lehman Brothers, Analyst, 1974-1978 Bear Stearns, Analyst, 1971-1974
Education	B.A., Bard College LL.B., New York University Law School

David L. Horing	**Managing Director**
Year Joined Firm	1988
Prior Experience	The Boston Consulting Group, 1987-1987 Salomon Brothers, Investment Banking, 1984-1986
Education	B.S., University of Pennsylvania M.B.A., Harvard Business School
Michael G. Fisch	**Managing Director**
Year Joined Firm	1991
Prior Experience	Adler &Shaykin, Principal, 1987-1990 Bain & Company, Consultant, 1986-1986 Goldman, Sachs & Co., M&A, 1983-1985
Education	B.A., Dartmouth College M.B.A., Stanford University
Paul Rossetti	
Year Joined Firm	1996
Prior Experience	Greenwich Street Capital Partners, Managing Director, 1994-1996 Dyson-Kissner-Moran, Acquisitions, 1986-1994 HMK Group, Director of Acquisitions, 1984-1986
Education	B.S., US Air Force Academy M.S., Purdue University M.B.A., Harvard Business School

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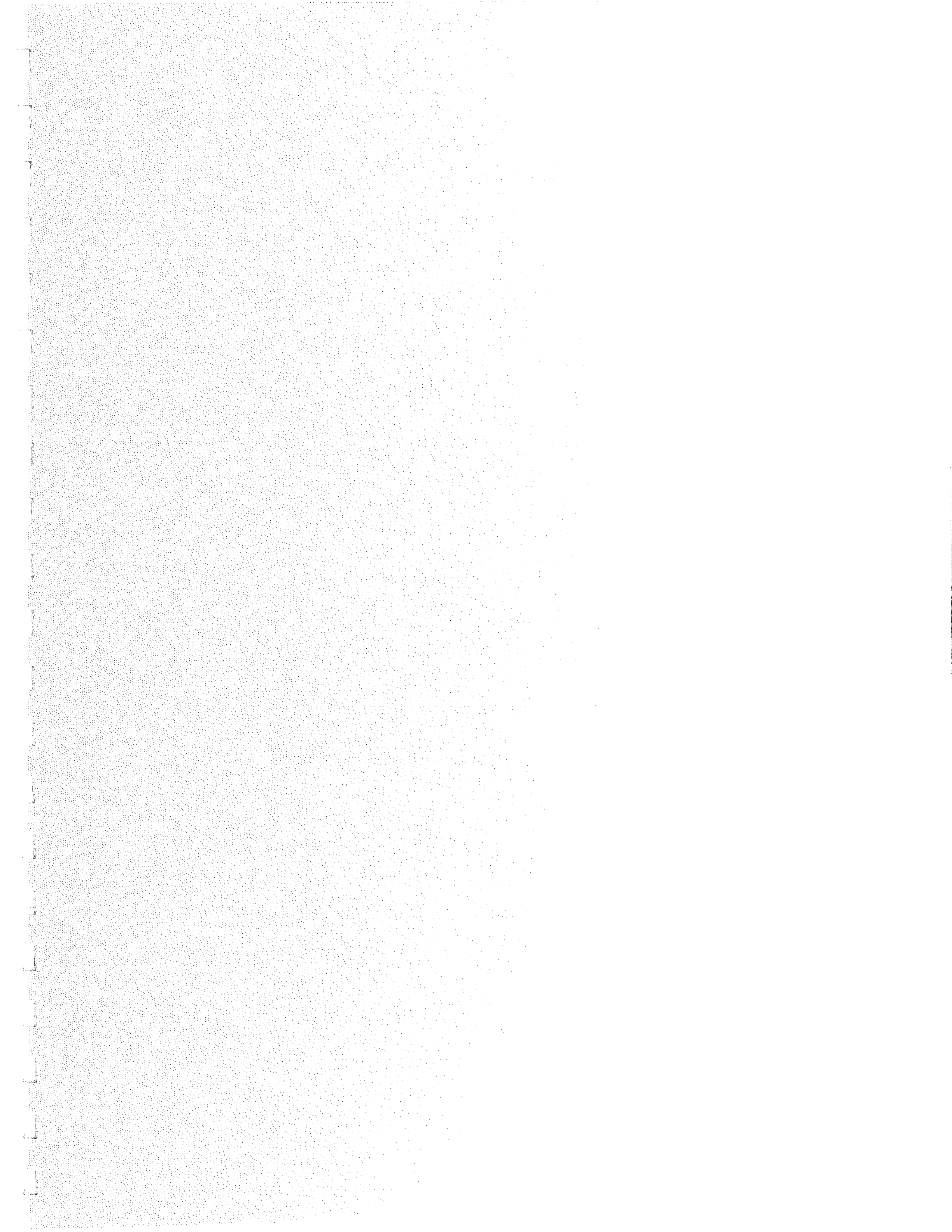


Resolution No. 3

WHEREAS the Board has heard a presentation recommending that the Corporation's CEO be authorized to approve follow-on capital commitments to private equity limited partnerships in amounts such that total exposure to such partnerships does not exceed 2.5% of the endowment asset base as defined in the Delegation of Investment Approval Authority adopted by the Board on September 26, 2000,

NOW, THEREFORE, BE IT RESOLVED, that the amendment to the Delegation of Investment Approval Authority, as presented, be and is hereby approved;

DELEGATION OF INVESTMENT APPROVAL AUTHORITY

AS APPROVED SEPTEMBER 26, 2000

Manager Type	Manager Exposure	Approval Limit as % of Total Assets(1)	(Millions) UTIMCO Management Approval Limit(2)
Public - Passive	portfolio value + new commitment	5.00%	$630
Public - Active	portfolio value + new commitment	2.50%	$315
Private - Partnership	undrawn capital+ portfolio value + new commitment	0.25%	$32
Private - Direct	portfolio value + new commitment	0.00%	$0

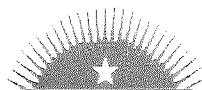
(1) at time of commitment
(2) $12,605 million endowment asset base (PUF+PHF+LTF) million as of 8/31/00 (adjusted annually).
(3) subject to receipt of recommendation from private equity advisor

PROPOSED

Manager Type	Manager Exposure	Approval Limit as % of Total Assets(1)	(Millions) UTIMCO Management Approval Limit(2)
Public - Passive	portfolio value + new commitment	5.00%	$630
Public - Active	portfolio value + new commitment	2.50%	$315
Private - Partnership (Follow-on)	undrawn capital+ portfolio value + new commitment	1.00%	$126
Private - Partnership (New)	undrawn capital+ portfolio value + new commitment	0.25%	$32
Private - Direct	portfolio value + new commitment	0.00%	$0

(1) at time of commitment
(2) $12,605 million endowment asset base (PUF+PHF+LTF) million as of 8/31/00 (adjusted annually).
(3) subject to receipt of recommendation from private equity advisor

New Small Cap Value Manager Search Update



January 23, 2000

Small Cap Equities (7.5% Neutral Allocation)

($ in millions)	LTF	PUF	PHF	Total	
Small Cap Equities:					
Growth Managers					
Cordillera	22	60	7	89	
Pilgrim Investment Advisors	53	143	18	214	
Fortaleza		58		58	
	75	**261**	**25**	**361**	**30%**
Value Managers					
Schroder	100	271	33	404	
GSAM	23	60	8	91	
	123	**331**	**41**	**495**	**41%**
BGI R 2000 Index	**98**	**207**	**46**	**351**	**29%**
Total Small Cap	**296**	**798**	**112**	**1207**	**100%**
Small Cap / Total Fund:	**10%**	**10%**	**12%**		

UTIMCO
The University of Texas Investment Management Company

Small Cap Value Search Process

Combination of Qualitative & Quantitative Analytics:
Cambridge & Associates (CA), Industry Contacts
Database search, BARRA Investworks; Russell Portfolio Universe

→ **US Small Cap Value** 80

Screen manager universe for:
- Consistently strong risk-adjusted returns
- Investment style consistency
- Sufficient product assets
- Acceptable level of portfolio turnover

→ **Potential Candidates** 37

Initial research:
- Final Screening, Contact CA

→ **Focus list** 5

Fundamental Research & Extensive Quantitative Analysis:
- Detailed review of organization, investment team, philosophy, and process
- Conference calls with portfolio managers
- Holdings-based & Returns-based Style Analysis
- Validate results, Coherence of Strategy
- Onsite visits, Q & A
- Portfolio risk and attribution analysis

→ **Final Candidates** 3

→ **Manager(s) Recommend** 1 to 2

UTIMCO
The University of Texas Investment Management Company

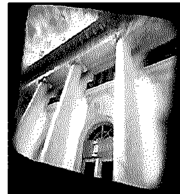
Small Cap Value Strategy

- Maintain Small Cap overweight of 10% v. 7.5% Policy (12% for PHF)
- Tilt to Small Cap Value 70% to Small Cap Growth 30%, relative to the neutral 50/50 mix.
- Engage two Small Cap value managers with $175 Million each, funded from existing exposure in the Russell 2000 Index.
  Essentially an internally funded rebalancing.
- Engage Dalton-Greiner and Pilgrim Baxter (Not affiliated with Pilgrim/Northstar) for new Small Cap Value mandates in accordance with the Strategic Plan

Small Cap Value Strategy

- Dalton Greiner is a pure play small cap manager
  - 8 CFAs dedicated to value investing. DG has several small cap value products including a recently launched deep value concentrated portfolio (inception date 8/99) known as Ultra value.
- Pilgrim Baxter focuses on long term earnings growth
  - Portfolio manager follows a disciplined value-oriented strategy to exploit inefficiencies in small cap market.
- Both Pilgrim Baxter and Dalton Greiner complement our existing manager roster. Very little overlap in security selection.
- Both are high value-added managers relative to the R 2000 Value index, with high information ratios and excellent risk-adjusted historic returns indicating top quartile performance.
- Final stages of fee negotiations.

Current + New Manager Allocations



($ in millions)	LTF	PUF	PHF	Total	
Small Cap Equities:					
Growth Managers					
Cordillera	22	60	7	89	
Pilgrim Investment Adviso	53	143	18	214	
Fortaleza		58		58	
	75	**261**	**25**	**361**	**30%**
Value Managers					
Schroder	100	271	33	404	
GSAM	23	60	8	91	
Dalton Greiner	49	103	23	175	
Pilgrim Baxter	49	103	23	175	
	221	**538**	**87**	**846**	**70%**
BGI R 2000 Index	**0**	**0**	**0**	**0**	**0%**
Total Small Cap	**296**	**798**	**112**	**1207**	**100%**
Small Cap / Total Fund:	**10%**	**10%**	**12%**		

Goldman Sachs

OIL VIEW SUMMARY – STRONGIN CONFERENCE CALL 1/4/01

SUMMARY: As weather warms, the normal seasonal drop-off in demand, combined with weakening fundamentals, will likely drive prices toward $20/bbl. Further, the recent tide of weakening economic statistics may signal a sustained downward shift in oil price trends unless central banks take significant action to reverse the current negative economic momentum. Yesterday's central bank action, while an important step in this direction, is unlikely by itself to sufficiently reverse the current economic momentum. In particular, it is important to remember that the Federal Reserve is responding to signals of immediate and near term weakness, but its policy actions will have their primary impact on economic activity 6 to 9 months from now. Thus, the shift in outlook that is occurring is that first half expectations are falling, while second half expectations are rising. The net is a weaker picture for physical demand near term with a better, but more uncertain bounce back in the second half.

The next 4 weeks: one more oil price spike?

- Over the next 4 weeks, limited excess production capacity and critically-low Atlantic Basin inventory levels have the potential to push prices back near the expected average realized price this winter of $32/bbl, especially should the weather remain cold.
- Crude fundamentals are likely much tighter than the statistics suggest, as the vast majority of the recent crude build has been centered in heavy crude, which has overwhelmed the refining capacity able to refine it.
- The cessation of Iraq exports, which is ongoing, has also deprived the market of approximately 60 million barrels of oil to date.

The next 6 months: significant price pullback expected after the winter weather warms

- Medium-term, on a 3 to 9 month horizon, prices may experience a significant pull back to near $20/bbl.
- While the recent shift in the underlying economic fundamentals is very real and serious, the full impact on the oil market will unlikely be felt until the weather begins to warm. Once oil demand begins to seasonally weaken with warmer weather, the market will become vulnerable to a sharp drop-off in prices, as the underlying economic fundamentals will unlikely provide much support to demand.
- Driving slower growth in 2001 has been the spike in North American natural gas and electricity prices and the slowdown in the U.S. manufacturing and technology sectors.

The 12 -month outlook and beyond: price path conditional on economic climate

- The longer-term outlook is highly conditional on the economic climate central banks create for the second half of 2001.
- A soft landing could push oil prices back into the high twenties by winter 2002 while a hard landing would likely turn seasonal weakness into a sustained downward price trend.
- Yesterday's central bank action, while an important step, is unlikely to sufficiently reverse the current negative economic momentum. We would view either "central bank over response and higher oil prices" or "insufficient central bank response and much lower prices" more likely than the middle path.
- However, the downside risk is much greater than the upside risk. Consequently, we believe current long-dated crude oil prices hold significant value for oil producers.

Goldman Sachs

GSCI VIEW SUMMARY – STRONGIN CONFERENCE CALL 1/11/01

SUMMARY: Our views have changed. We are downgrading the GSCI 12-month forward total return forecast to 7% from 20%, with the expected returns backloaded in the year and predicated on a monetary-policy-driven turnaround.

We are also lowering the 12-month total return forecasts for each of the subindices. The table at right lists the new forecasts.

Agricultural demand, which is conditioned more on demographic growth and weather than on income growth, is better insulated against the current deterioration in industrial conditions. The returns are also coming off a relatively weaker base given a string of record harvests.

GSCI Returns and Forecasts

	Weight (%)	Returns (%)				12-Month Forward Forecast
		1999	2000	2001 YTD	12-Month	
GSCI	100.0	40.9	49.7	0.3	50.3	7.0
Energy	66.9	92.4	87.5	0.6	89.5	7.0
Non-Energy	33.1	-1.7	0.6	-0.3	-0.3	6.2
Ind. Metals	6.4	30.7	-4.3	-0.5	-3.9	2.0
Prec. Metals	2.0	3.9	-1.2	-1.0	0.0	2.0
Agriculture	16.1	-18.9	-1.1	-0.2	-1.8	8.0
Livestock	8.6	14.4	8.6	-0.4	5.8	7.0

9-Jan-01 close

Source: GS Research

Key Points

- We are downgrading the GSCI 12-month forward total return forecast to 7% from 20%. We are also downgrading each of the subindices.
- The reason for the downgrade is swiftly deteriorating economic fundamentals, which are reducing the demand for industrial commodities.
- Two factors that are driving slower growth are the spike in North American natural gas and electricity prices and the slowdown in the U.S. manufacturing and technology sectors.
- Earlier this week, our U.S. economics team reduced their U.S. 1Q01 real GDP growth forecast to –0.3%yoy from 1.5%yoy, which pushed the 2001 number down to 2.0%yoy from 2.5%yoy previously. The GS forecast for U.S. industrial production growth now stands at –1%yoy in 4Q00 and –2.5%yoy in 1Q01, down from +2.5% and +1.9% as of mid-December.
- Price spikes may still occur in the near term as this transition unfolds, especially in crude oil and natural gas (winter cold snaps) and in aluminum (forced production curtailments). But demand will be materially weaker than prior expectations.
- Last week's central bank action, while a step in the right direction, is unlikely by itself to sufficiently reverse the current economic momentum. The Federal Reserve is responding to signs of near-term weakness, but its policy actions will have their primary impact on economic activity 6 to 9 months from now.