This cover page provides a summary overview of the Pennsylvania State University Endowment and Similar Funds for calendar year 2005. The next page summarizes Endowment-related data that is discussed on the remaining pages.

Executive Overview

Endowment Performance

Annualized net investment returns for the Penn State University Endowment Pool (adjusted for the impact of gifts and spending, and after external investment management expenses) are shown below for periods ending December 31, 2005:

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<thead>
<tr>
<th>Period</th>
<th>5 Years</th>
<th>10 Years</th>
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<tbody>
<tr>
<td>Cal '05</td>
<td>11.9%</td>
<td>9.2%</td>
</tr>
<tr>
<td>3 Years</td>
<td>14.3%</td>
<td></td>
</tr>
<tr>
<td>5 Years</td>
<td>4.6%</td>
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Endowment & Similar Funds Market Value (pg 3)

Penn State University’s Endowment and Similar Funds were valued at $1.32 billion as of December 31, 2005, including the Long-Term Investment Pool’s (LTIP) $1.23 billion in investment assets.

Review of Investment Markets (pg 4)

As shown in the graph below, public equities in the US (S&P 500 Index) edged bonds (Lehman Aggregate Bond Index) in the year ended December 31, 2005. Meanwhile, international equities and domestic real estate did significantly better. Also compared are the respective returns for 12-months ending December 31, 2004 and 2005 for the S&P 500, MSCI World ex-US, 91-day US Treasury Bills, Lehman Aggregate Bond, and publicly-traded Real Estate Investment Trusts (REITs).

Investment Diversification and Asset Mix (pg 5)

At calendar year end, 50% of pool assets were invested in public equities (domestic and foreign), 20% in fixed income, 23% in alternative investments (real estate, private capital, energy, distressed debt), and 7% in hedge funds. This was consistent with Penn State’s Policy Asset Allocation.

Comparative Fund Performance (pg 6)

Penn State’s Long-Term Investment Pool returned 11.9% net for the year ending December 31, 2005. The Endowment’s returns for longer periods have also compared favorably with the benchmark returns for Penn State’s Policy Portfolio.

Asset Class/Manager Performance (pg 7)

While the Endowment’s actively-managed portfolios generally performed in line with their benchmarks, there were exceptions as noted on page 7.

Long-Term Investment Pool and Spending (pg 8)

Penn State’s Long-Term Investment Pool has averaged 10.0% and 9.2% net per annum over the last 20 and 10 years, respectively, allowing total annual Endowment spending to maintain a steady pace.
5-Year Endowment Facts and Figures

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<tbody>
<tr>
<td>LTIP* (annualized net returns)</td>
<td>11.9%</td>
<td>14.4%</td>
<td>16.6%</td>
<td>-8.2%</td>
<td>-9.3%</td>
</tr>
</tbody>
</table>

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<th></th>
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</thead>
<tbody>
<tr>
<td>Long-Term Investment Pool*</td>
<td>1,225.2</td>
<td>1,090.2</td>
<td>957.4</td>
<td>807.9</td>
<td>870.1</td>
</tr>
<tr>
<td>Similar Funds**</td>
<td>98.0</td>
<td>95.9</td>
<td>89.9</td>
<td>82.6</td>
<td>87.1</td>
</tr>
<tr>
<td>Total Endowment</td>
<td>1,323.2</td>
<td>1,186.1</td>
<td>1,047.3</td>
<td>890.5</td>
<td>957.2</td>
</tr>
</tbody>
</table>

| Gifts & Other Additions ($ mils) | 51.2 | 56.0 | 69.1 | 69.5 | 52.1 |
| Current Spending ($ mils) | 54.3 | 52.3 | 51.4 | 48.6 | 43.7 |

* Long-Term Investment Pool (LTIP) — Endowment assets over which Penn State’s Office of Investment Management (OIM) has direct investment responsibility, as approved by the Penn State Investment Council (PSIC)

** Similar Funds — includes donor-restricted and deferred gifts, plus funds in transit to LTIP

Penn State Investment Council (PSIC) Quarterly Meetings

**December 16, 2005, met and approved:**
- Amending non-marketable alternative capital commitments to a calendar-year basis and targeting annual commitments for 2006 between $70 and $80 million
- Committing $10 million each to Rubenstein Properties Fund, Sigular Guff BRIC Opportunities Fund, and TA Associates Fund X; and $5 million to TA Subordinated Debt II

**September 16, 2005 met and approved:**
- Liquidating Commonfund Absolute Return Hedge Fund and dividing proceeds equally between incumbent hedge fund managers Aetos Capital and Federal Street Associates
- Committing $10 million each to Oaktree Capital Opportunities Fund VI, and Natural Gas Partners VIII

**June 17, 2005, met and approved:**
- Hiring Sands Capital Management of Arlington, VA as the Endowment’s large-cap growth equity manager, funded with $40 million
- Committing $10 million to Goldman Sachs New Partners Fund; $5 million each to Morgenthaler Partners VIII, and Vestar Capital Partners V

**March 11, 2005, met and approved:**
- Targeting prospective non-marketable private partnership commitments between $70 to $80 million for the 12-month period ending March 31, 2006
- Committing of $5 million each to the following limited partnerships: CF Natural Resources VI, CF Capital International Private Capital V, LBA Realty Fund II, JMI Equity Fund V, Welsh, Carson, Anderson, & Stowe X; and $10 million to CF Capital Venture Capital VII

Please note that commitments made to Limited Partnerships (LP) are not immediately invested and are called (paid) over a number of years until commitment level is satisfied.
Endowment and Similar Funds Market Value

As of the end of 2005, Endowment and Similar Funds were valued at $1,323.2 million, which includes $1,225.2 million in Long-Term Investment Pool (LTIP) assets. Non-pooled assets — charitable remainder trusts, charitable gift annuities, and other life income funds in addition to some donor restricted funds — accounted for an additional $98.0 million. The annual market values for the University’s Endowment Pool and Similar Funds for the last five calendar years are shown below:

From the graph above:

The Endowment and Similar Funds’ total value increased by $137.1 million during calendar 2005. As seen in the table on page 2, new gifts added to the Pool over the last 12 months totaled $51.2 million, while Endowment program support (spending) amounted to $54.3 million.

The total Endowment’s $366.0 million increase since 2001 reflects new gift contributions and reinvested investment earnings, after providing cumulative program support of $250.3 million.

Inflows of new gifts, along with positive investment returns, have resulted in a cumulative 38.2% increase in the Endowment’s value, net of spending, from December 31, 2001 to December 31, 2005.
Review of Investment Markets in Calendar 2005

Returns for US equity markets slowed considerably in 2005, lagging non-US equities for the second consecutive year. In addition, domestic bonds recorded mid-single-digit returns for the third consecutive year. The performance of investment markets that impact Penn State University’s Long-Term Investment Pool is discussed below.

U.S. Equities

The S&P 500 rose a modest 4.9% for the 12 months ending December 31, 2005, compared to 10.9% for calendar 2004. The Dow Jones Industrial Index lagged as well, gaining only 1.7% in 2005 and 5.3% in 2004. Small-capitalization stocks, as measured the Russell 2000 Index, also slowed their pace, returning 4.6% versus 18.3% last year. The technology-laden Nasdaq Index performed even worse, earning just 1.4%, versus 8.6% in 2004.

Foreign Equities

Equities outside the United States outperformed their US-counterparts, despite strength in the SUS. The Morgan Stanley World Index (MSCI) ex-US climbed 20.4% for the 12-month period ending December 31, 2005, following a 14.7% return in calendar 2004. Emerging market stocks in less developed countries jumped 34.5% over the last 12 months, outpacing their 25.9% return in 2004.

Fixed Income

Domestic bonds lagged US equities in 2005, as the Lehman Aggregate Bond Index (representing various maturities of US Government and corporate bonds) rose 2.4% compared to 4.3% in 2004. Long-Term Treasuries gained 6.5% in 2005 versus 7.7% in 2004. Meanwhile, 91-day Treasury Bills clearly reflected the rise in short-term interest rates, returning 3.1% in 2005 versus 1.3% in 2004. Treasury Inflation Protected Securities (TIPS) essentially matched the Lehman Aggregate Index, gaining 2.8% compared to 8.5% in calendar 2004.

Real Estate

Although interest rates rose somewhat in 2005, real estate stocks continued to benefit, as publicly-traded Real Estate Investment Trusts (REITs) rose 12.2% and 31.6% in 2005 and 2004, respectively. Privately-held real estate investment partnerships gained 19.2% in 2005 compared to 12.4% in 2004.

Alternatives

Private Equity and Venture Capital continued to rebound, posting returns of 35.1% and 12.5%, respectively, for the 12 months ending September 31, 2005 (private capital markets are typically reported on a 3-month delay). In the previous 12-month period, Venture Capital returned 10.0%, while Private equity gained 18.9%. By comparison, the Russell 2000 Index of small-capitalization stocks returned 18.0% for the 12 months ending September 30, 2005 and 18.8% for the year ending September 30, 2004.

Economic and Market Outlook

Calendar 2005 marked the third consecutive year that equity market returns were lower than the previous 12-month period. It was also the third consecutive year that equities outdistanced bonds, as rising interest rates held fixed income returns in check. Looking ahead, the continued growth of world economies has started to heighten inflation concerns, especially for natural resources such as oil and gas. With approximately 15% of its investments regarded as inflation-sensitive (real estate, energy, and TIPS), Penn State’s well-diversified endowment portfolio — consisting of public equities, bonds, private capital, and hedge funds in addition to the aforementioned “real assets” — continues to be the most appropriate investment approach for long-term growth and sustainable spending.
Investment Diversification and Asset Mix

Asset allocation is a primary determinant of investment performance and risk control. The strategic policy asset mix targets a combination of five major asset categories to maximize potential returns, while tempering volatility. Reflecting a desire to support generous spending and the need to preserve purchasing power in light of changing market conditions, the Penn State Investment Council (PSIC) regularly reviews the Endowment’s strategic policy asset mix as shown below on the far right, along with Penn State’s actual asset mix for calendar years 2005 and 2004:

As seen in the rightmost column above, the Endowment’s Strategic Policy Asset Mix indicates a 50% allocation to public equities — including US and non-US common stocks — plus another 23% to non-marketable alternative equities (real estate, venture capital, buyouts, and energy), in order to take advantage of superior asset growth and purchasing power protection offered by equity-type investments.

The 7% allocated to “marketable alternatives” is comprised of hedge fund investments, which include a variety of investment strategies employing multiple investment classes. Currently, $64 million of the $85 million in hedge funds is equity-biased (directional), while $21 million is allocated to absolute return “fund of hedge funds.”

More details about this category are discussed on the bottom of page 7 under Asset Class/Manager Performance. The remaining 20% of the Endowment is targeted to fixed income (primarily bonds) in order to stabilize returns and to provide current income.

As of December 31, 2005 (middle column above), 50% of pool assets were invested in public equities, 23% in non-marketable alternative investments and 7% in marketable alternatives. Fixed income securities comprised 20% of total assets, of which about 1% was invested in money markets.

In comparison to one year ago (far left column above), the most meaningful year-to-year reallocation was a decrease of 5% from fixed income and an increase of 5% in domestic equities. This resulted from shifting $40 million out of fixed income investments to fund a new domestic equity manager at the end of December, as well as moving another $10 million from money market investments into domestic equity index funds.

Penn State’s commitment to equities continues to be substantial because of expectations that ownership of assets will provide superior purchasing power protection and asset growth in the long run.
Long-Term Strategy and Endowment Performance Compared

The Endowment’s Long-Term Investment Pool (LTIP) is guided by its hypothetical Strategic Policy Portfolio, whose prescribed mix of assets serves as a unique composite benchmark against which the Endowment’s performance is monitored. In the table and graph below, the respective weightings of five major asset classes from one year ago are associated with corresponding market benchmarks to generate Strategic Policy Portfolio returns over 1-, 3-, and 5-year horizons:

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Benchmark</th>
<th>Weighting</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Equities</td>
<td>S&amp;P 500 Index</td>
<td>35%</td>
<td>4.9%</td>
<td>14.4%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Non-U.S. Equities</td>
<td>MSCI World ex US</td>
<td>10%</td>
<td>14.5%</td>
<td>24.3%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Marketable Alternatives</td>
<td>Custom Index</td>
<td>7%</td>
<td>10.7%</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Non-Marketable Alt’s</td>
<td>Custom Index</td>
<td>23%</td>
<td>18.4%</td>
<td>14.8%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Fixed Income/Cash</td>
<td>Lehman Total Bonds</td>
<td>25%</td>
<td>2.4%</td>
<td>3.5%</td>
<td>5.9%</td>
</tr>
<tr>
<td>Policy Portfolio (net)</td>
<td></td>
<td>100%</td>
<td>8.8%</td>
<td>12.7%</td>
<td>3.4%</td>
</tr>
</tbody>
</table>

(Note that the above static asset allocations are biased towards recent Strategic Policy Portfolio returns relative to the investment pool, whose actual mix varies from year to year, as discussed on the previous page.)

Penn State Endowment (LTIP) vs Policy Portfolio

Penn State’s Policy Portfolio returned 8.8% for 2005 versus 11.9% net for the Long-Term Investment Pool. The Pool’s 3.0-point advantage was due largely to the strong rebound in PSU’s non-marketable equity portfolio (alternative equities), which generated a 35.3% return versus the benchmark’s 18.4% return, as explained in more detail on the next page.

For the trailing 3- and 5-years, the Policy Portfolio would have generated annualized returns of 12.7% and 3.4%, respectively. The Endowment earned 14.3% net and 4.6% net, respectively, as its non-marketable investments experienced higher returns over these periods than the policy portfolio.

The Strategic Policy Portfolio provides a guidepost to help achieve long-term results that are consistent with the twin objectives of purchasing-power preservation, along with stable endowment spending. The Endowment’s performance varies from the static Policy Portfolio as a consequence of several factors, including but not limited to the following: timing of cash-flows into and out of the Endowment, tactical shifts in asset mix, and investment manager performance.
Asset Class/Manager Performance

Domestic Equity Managers

As of December 31, 2005, Domestic Equities represented approximately 40% of Endowment assets, structured as Core (25%) and Satellite (15%). The 25% “Core” is split 60%/40% between S&P 500 Index Growth and Value, respectively, while the remaining 15% is spread among four “Satellite” managers, each assigned to style/size disciplines whose performance in the short-run can vary from the S&P 500 Index. This impacted the relative performance of active managers, as noted below.

Within large capitalization equities, Institutional Capital’s value portfolio gained 10.9% for calendar 2005, to outperform the S&P 500’s 4.9% return by 6.0 percentage points. A new large-cap growth manager, Sands Capital, was funded as of July 1, 2005 and earned 13.0% since it was hired. Siphron Capital’s GARP (growth-at-a-reasonable-price) portfolio earned 0.2%, underperforming the S&P 500 by 4.7 points.

Within small capitalization stocks, Chartwell Partners’ growth portfolio (6.3%) outpaced the Russell 2000 Growth Index (4.2%). On the other hand, Reich & Tang’s small-cap value portfolio (-1.6%) trailed the Russell 2000 Value Index (4.7%).

Foreign Equity Managers

As of December 31, non-US Equities represented about 10% of Endowment assets, with 7.0% invested in “developed” economies and 3.0% in “emerging markets.” For the year, Commonfund’s International Equity portfolio (15.2%) edged the MSCI World ex-US Index (14.5%), while Commonfund’s Emerging Markets portfolio (33.5%) trailed the MSCI Emerging Market Index (34.5%) by 1.0 percentage point.

Fixed Income

Commonfund’s Multi-Strategy Bond Fund returned 3.3% in calendar 2005, to outperform the Lehman Aggregate Bond Index’s (LBAG) 2.4% return by 0.9 percentage points. Mellon-Standish earned 2.8%, while the Treasury Inflation Protected Securities (TIPS) portfolio earned 1.8%. As of December 31, 2005, the fixed income portfolio had an average maturity of 5.8 years, compared with 5.1 years for December 31, 2004.

Non-Marketable Alternatives

Penn State’s Private Equity and Venture Capital composite portfolios returned 22.5% and 23.2%, respectively, while the Real Estate private-equity sector gained 14.5%. Meanwhile, Penn State’s Energy sector benefited from the rise in crude and climbed 119.3%. Privately-held distressed/subordinated debt returned 15.7%. (All non-marketable returns represent September 30, 2005 Net Asset Values [NAVs] and include cash flows through December 31, 2005.)

 Marketable Alternatives

This category includes investment partnerships that employ hedged strategies (approaches not restricted to holding only long positions) to provide consistent investment returns, irrespective of underlying market trends. The Endowment’s hedge funds are separated into two strategies: directional (equity long/short) and absolute return (low volatility approaches).

Among the Endowment’s directional hedge funds, the Oaktree Capital Management (OCM) Emerging Markets portfolio seeks to generate positive returns, whether emerging market stocks are rising or falling. During the last 12 months, OCM returned 5.8% (after all expenses) while the Emerging Market (long only) Index rose 34.5%. But, over the last five calendar years, OCM has averaged 10.9% annualized, lagging the Emerging Market Index’s 19.4%. Over the last seven years, the OCM portfolio has returned 16.9% per year versus 15.9% for the Emerging Market Index. Federal Street Partners, a fund of hedge fund investing in global markets, was hired one year ago and returned 15.2% in 2005. Cumberland Associates, a long/short manager investing in domestic equities, was hired two years ago and declined 1.1% in 2005.

Aetos Capital is a fund of hedge funds that pursues less volatile, absolute returns by utilizing 25 to 35 individual hedge fund managers in a variety of hedge strategies. Aetos, who was hired 18 months ago, returned 6.7% in 2005.
Endowment Growth and Spending

The chart below illustrates the impact of compounded net investment return, program support (spending), and inflation (as measured by the Higher Education Price Index [HEPI]) on the long-term purchasing power (real growth) of Penn State’s Endowment Pool since December 31, 1985.

Over the last 20 years, the total Endowment Pool has returned an average of 10.0% per year, net of gifts and external investment management expenses. As seen in the graph above, approximately half of the Endowment’s appreciation has supported ever-increasing program spending. The remaining growth has buffered the corrosive effects of inflation and provided a cushion against market fluctuations. Accordingly, the Long-Term Investment Pool has met the twin (and somewhat conflicting) objectives of generating ample current spending, while maintaining real (inflation-adjusted) growth for future generations of students.

Two Different 10-year Periods

The table below bifurcates the last 20 years into two 10-year periods, whose returns differ appreciably. While both periods include portions of the bull markets of the 1980s and 1990s, the second half of the 10-year period ending 2005 includes the steep 2.5-year sell-off that began in early 2000. The bear market’s impact on long-term returns is illustrated by subtracting annualized returns for the most recent 10 years from those for the 10 years ending 1995:

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</thead>
<tbody>
<tr>
<td></td>
<td>1995 to 2005</td>
<td>9.1%</td>
<td>6.2%</td>
<td>9.2%</td>
<td>3.7%</td>
<td>5.4%</td>
<td>2.5%</td>
<td>5.5%</td>
</tr>
<tr>
<td></td>
<td>1985 to 1995</td>
<td>14.9</td>
<td>9.6</td>
<td>10.8</td>
<td>4.2</td>
<td>10.7</td>
<td>5.4</td>
<td>6.6</td>
</tr>
<tr>
<td>Diff (percentage points)</td>
<td>-5.8</td>
<td>-3.4</td>
<td>-1.6</td>
<td>-0.5</td>
<td>-5.3</td>
<td>-2.9</td>
<td>-1.1</td>
<td></td>
</tr>
</tbody>
</table>

As shown by the negative differentials in the last row above, investment returns for the most recent 10-years lagged those for the previous 10 years in every instance. Because of the severity of the 2000-2002 bear market, the S&P 500’s annualized nominal returns for the 10-year period ending December 31, 2005 trailed those of the 10-year period ending December 31, 1995 by 5.8 %p (percentage points), while the respective returns for bonds (Lehman Aggregate Bond Index) were 3.4 %p less. For the same periods, the Endowment’s net return was 1.6 %p lower.

On an inflation-adjusted basis relative to HEPI, the Endowment’s net real return (on the far right above) declined only 1.1 %p, compared to steeper real erosions of 5.3 %p for stocks and 2.9 %p for bonds. Broad portfolio diversification, including augmented allocations to inflation-sensitive strategies, is principally responsible for the Endowment’s considerably smaller diminution in real returns compared to the inflation-adjusted returns of equity and bond indexes.