DATE:    July 22, 2004

FROM:    Gary C. Schultz

TO:      Members of the Board of Trustees

Re:      Penn State Endowment

Below is the preliminary second quarter report on Penn State’s Endowment investments. These reviews are prepared for the Board of Trustees approximately two weeks following the end of each quarter, and are subject to possible revision.

The preliminary market value of Penn State’s Endowment, including similar funds, was approximately $1.1 billion as of June 30, 2004.

During 2004’s second quarter, Penn State’s Endowment earned 1.2% – due to investment value changes (excluding the impact of new gifts and spending). The equity bias (as described three paragraphs below) of the Endowment’s diversified asset mix positioned its second quarter return closer to that of the Standard & Poor’s 500 Index (1.7%) than the Lehman Aggregate Bond Index (-2.4%), as shown below:

<table>
<thead>
<tr>
<th></th>
<th>2Q04</th>
<th>1-Year</th>
<th>5-Years</th>
<th>10-Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Index</td>
<td>1.7%</td>
<td>19.1%</td>
<td>-2.2%</td>
<td>11.8%</td>
</tr>
<tr>
<td>Lehman Agg. Bonds</td>
<td>-2.4</td>
<td>0.3</td>
<td>6.9</td>
<td>7.4</td>
</tr>
<tr>
<td>Endowment (prelim.)</td>
<td><strong>1.2</strong></td>
<td><strong>15.5</strong></td>
<td><strong>4.1</strong></td>
<td><strong>9.5</strong></td>
</tr>
</tbody>
</table>

Equity markets continued to plod ahead, as the S&P 500’s 1.7% gain matched its first quarter return. Meanwhile, bonds drifted lower in anticipation of the Federal Reserve’s 0.25% fed funds increase announced on June 30th. The Lehman Aggregate Bond Index declined 2.4% in 2004’s second calendar quarter, essentially offsetting its first quarter gain.

For the 12 months ending June 30, 2004, the S&P gained 19.1%, while the Aggregate Bond Index was basically unchanged. We estimate the Penn State Endowment Pool returned 15.5%. Emphasizing our long-term focus, the table above also compares the Endowment’s 5- and 10-year annualized returns to the S&P 500 and Lehman Aggregate Bonds.

As of June 30, approximately 44% of the endowment portfolio was invested in public equities (both domestic and foreign), 23% in non-marketable equities (private capital, real estate, energy), 6.0% in hedge funds, and 27% in bonds (primarily short and intermediate maturities).

The Penn State Investment Council met on June 11, 2004 and approved a securities lending program through Mellon Bank, which serves as the Endowment’s custodian bank. Also, Ed Hintz was nominated to the Penn State Investment Council for approval by the Board of Trustees in September.

At its upcoming September 10th meeting, the Penn State Investment Council will review materials for the November seminar presentation to the Penn State Board of Trustees.

A formal announcement and details of the November seminar will be provided at a later time.