DATE: October 15, 2004  
FROM: Gary C. Schultz  
TO: Members of the Board of Trustees  
Re: Penn State Endowment

Below is the preliminary third 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 September 30, 2004.

During 2004’s third quarter, Penn State’s Endowment earned 1.1% – due to investment value changes (excluding the impact of new gifts and spending). Given its broad diversification (discussed in detail three paragraphs below), the Endowment’s return for the quarter fell midway between the Standard & Poor’s 500 Index (-1.9%) and the Lehman Aggregate Bond Index (3.2%), as shown below:

<table>
<thead>
<tr>
<th></th>
<th>3Q04</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>-1.9%</td>
<td>13.9%</td>
<td>-1.3%</td>
<td>11.1%</td>
</tr>
<tr>
<td>Lehman Agg. Bonds</td>
<td>3.2</td>
<td>3.7</td>
<td>7.5</td>
<td>7.7</td>
</tr>
<tr>
<td>Endowment (prelim.)</td>
<td>1.1</td>
<td>13.2</td>
<td>4.5</td>
<td>9.4</td>
</tr>
</tbody>
</table>

Domestic equity markets experienced their first negative quarter in 1.5 years, bringing the S&P’s calendar year-to-date return to 1.5%. Meanwhile, weakening economic statistics caused longer-term bonds to rally, even as the Federal Reserve continued to boost short-term interest rates. For the 9 months ending September 30, 2004, Lehman Aggregate Bonds gained 3.4%. Penn State’s Endowment returned approximately 6.1% for the year to date.

For the 12 months ending September 30, 2004, the S&P gained 13.9% while the Aggregate Bond Index gained 3.7%. For the same period, the Penn State Endowment Pool returned 13.2%. 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 September 30, 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% in hedge funds, and 27% in fixed income (primarily short and intermediate bonds).

The Penn State Investment Council (PSIC) met on September 10, 2004 and approved:

- A $15 million investment in CF Absolute Return Fund, a non-directional hedge fund managed by the Commonfund located in Wilton, CT.
- Investments of $5 million in each of the following partnerships: Code Hennessy & Simmons Private Equity V, Apax Europe VI (private equity), Berwind Property Group VII (real estate).