BUCKNELL UNIVERSITY

Spring 2017 Semi-Annual Endowment Report

A MESSAGE FROM THE DIRECTOR OF INVESTMENTS

Hope Springs Eternal

Spring is traditionally a season of hope, and this year those sentiments appear apropos to describe the attitude of investors globally. The first six months of fiscal year 2017 began inauspiciously enough, with the unexpected outcome of Britain's vote to leave the European Union last June. Following this news, equity markets briefly declined and US interest rates bottomed before spending the remainder of 2016 on steady paths higher.

Investors have placed considerable hope on the new US presidential administration's ability to push through a stimulative fiscal agenda of infrastructure and defense spending, regulatory reforms and tax cuts. While we expect that the path to any changes in Washington will continue to be slow and challenged, these political changes in the US and abroad have arrived amid a backdrop of steadily improving global economic growth and earnings momentum.

The first six months of the fiscal year were busy for the University's Investment Office as we continued to evaluate changes across our global equity, fixed income and credit portfolios. In October, we undertook a substantial effort to optimize the endowment's asset allocation within the context of our long-term return goals as well as the risk considerations of the underlying asset classes and those of the University as a whole. This process included significant involvement from Commonfund, our strategic adviser; the Investment Committee of the Board of Trustees; and the University's senior finance administrators.

Global equities remain a significant allocation within the portfolio. This continued equity focus and strong relative performance of certain active managers led to a 6.8 percent return to the pooled endowment for the first six months of fiscal year 2017. We provide additional details on the performance drivers later in this report.

As we mark the ninth year of the current economic expansion, inexpensive asset classes are increasingly difficult to identify. We are mindful of this environment as we seek new investments, but we continue to find inefficient pockets of opportunity in areas of the equity, credit and real estate markets. Additionally, as investors we continually seek to identify a competitive edge in our evaluation tools and processes. Later in this report, we highlight the incorporation of environmental, social and governance (ESG) factors into our evaluation process and why we feel this approach will lead to positive outcomes.

Over the past year, we have also focused on negotiating fee structures that lower costs and better align interests with our active managers. Encouragingly, we have found the active management industry and our specific managers to be increasingly receptive to these changes. As stewards of the endowment, we will continue to focus on optimizing risk-adjusted net returns for the benefit of our University and its many constituents.

'ray Bucknell!

John Luthi '04
Director of Investments

ESG INVESTING

ESG: What and Why?
As awareness of issues such as climate change and social injustice increases, many individuals and institutions have explored the possibility of making an impact through socially responsible investing (SRI). While historically SRI has been implemented by avoiding investments in companies that do not align with the mission of the investor, many researchers, industry practitioners and institutions have reached the conclusion that this type of avoidance ("negative screening") of companies perceived as bad actors may not be the most effective method of influencing positive change. And in many instances, this approach may also conflict with an institution's fiduciary duty.

Many investors, including Bucknell, have instead chosen to adopt a policy of favoring investments that emphasize positive approaches to environmental, social and governance (ESG) considerations. While research has found that limiting a universe of stocks available for investment (e.g., by excluding a specific sector or industry) does impose costs such as constrained diversification and return potential, the consideration of ESG factors can actually provide benefits to an investment portfolio. More specifically, research has found that companies with lower ESG risks tend to provide stronger long-term equity returns and less volatility than those with higher ESG risks. Rather than imposing an opportunity cost for investors, incorporation of ESG factors can represent a meaningful tool for generating above-average, risk-adjusted returns.

Bucknell's Endowment: How?
The Bucknell Investment Office and Investment Committee have been tracking developments in socially responsible investment principals for many years. In 2013, we changed Bucknell's endowment policy to specify that ESG factors be considered for all new investments in the portfolio. When hiring investment managers for use within the endowment, the University considers a variety of quantitative and qualitative factors. Firms that incorporate ESG considerations as part of their investment process and philosophy are favored.

How does an equity manager incorporate ESG factors into their evaluation of companies? Examples of ESG factors include a company's energy use and waste management, how a company manages its labor force and supply chains, the independence of its board, and the alignment of incentives between management and shareholders. Companies that score low on these factors exhibit higher risks and are assigned a lower intrinsic value. In other words, ESG factors are incorporated mathematically within a valuation process, and thus companies with lower ESG risks are more likely candidates for investment.

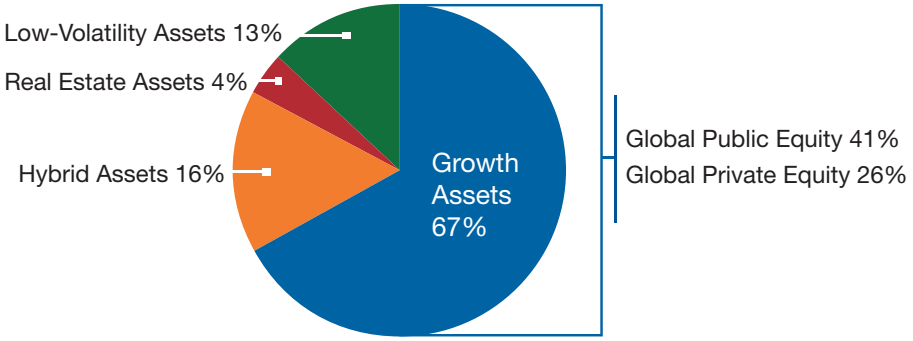
Additionally, an increasing portion of Bucknell's endowment is invested with managers who are signatories to the Principals for Responsible Investment (PRI) initiative. These principles seek to understand the implications of ESG factors with respect to investment and ownership decisions as well as to support and encourage best practices of those seeking to utilize an ESG investing framework. The University's endowment adviser, Commonfund, is also a signatory to the PRI. We expect the awareness of socially responsible investing principals and ESG factors to continue to grow, and we look forward to monitoring the evolution and development of the industry as we continue to seek approaches that will to add value to the endowment.

Commentary for the Six Months and One Year Ended December 31, 2016

Calendar year 2016 was a wild ride for public equity investors. The S&P 500, an index of the 500 largest public US companies, had one of its worst starts in history, losing 10 percent in just a few weeks through mid-February before spending much of the remainder of the year in an upward trajectory to earn 12 percent for calendar year 2016. Plummeting commodity prices and recessionary concerns were the primary culprits for the early-year sell-off, but commodity prices stabilized mid-year, buoying sentiment and prices. Thereafter, increased discussion of new infrastructure spending and reduced taxes helped equities end the year significantly higher. Much of the gains witnessed across public equity markets were experienced during the second half of 2016, which was meaningfully beneficial to endowment performance during the first six months of Bucknell's fiscal year, which began in July.

Our endowment is comprised of four broad asset groups: Growth, Hybrid, Real Estate and Low Volatility. Given the long-term focus of our endowed funds, Growth Assets, which is comprised of public and private equity investments, is the largest allocation in the portfolio today. This positioning benefited the endowment during the first six months of our fiscal year.

Asset Allocation Dec. 31, 2016



Growth Assets

The Growth portfolio is managed toward a global mandate, and so its benchmark (the MSCI All Country World index) is comprised of companies globally. Within public equities, US stocks were some of the strongest performers during the six months ended December 31, 2016, which benefitted the Bucknell Growth portfolio due to its purposeful tilt toward US companies. Additionally, strong manager performance across both public US and non-US equity managers and private natural resources added value. Overall, the Growth portfolio earned 8.9 percent during the period compared to 6.6 percent for the MSCI All Country World index.

Hybrid Assets

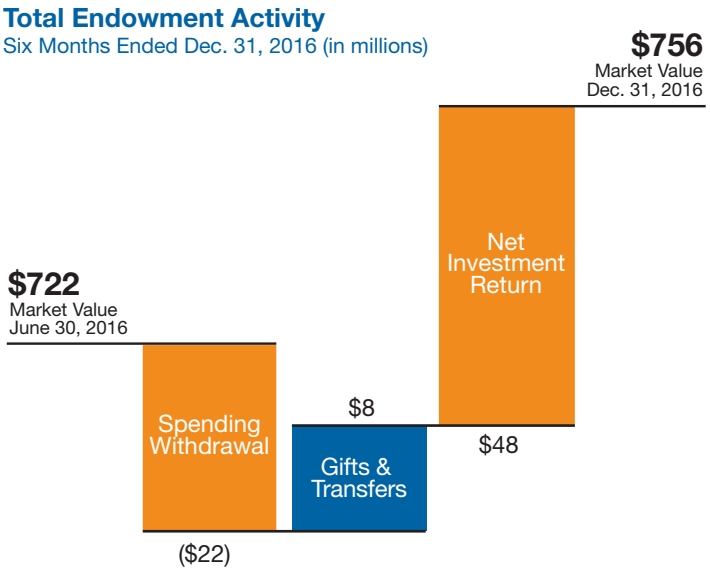
The Hybrid portfolio, by its very nature, is designed to seek investment opportunities that fall "in between the cracks" of traditional asset classes. The portfolio is opportunistic; it seeks new investment strategies or risk premiums that may not be captured by traditional long-only portfolios of stocks and bonds. Given its unique approach, we anticipate that the Hybrid portfolio should provide relative stability during periods of significant stress, thus potentially representing a source of opportunistic capital. The portfolio is primarily constructed of public and private credit investments as well as hedged/opportunistic strategies. The group produced a return of 4.6 percent over the six months ended December 31, 2016 driven by gains from private credit strategies.

Real Estate Assets

Real Estate was a strong performer during the first half of our current fiscal year, though its weight in the endowment is relatively small today given our market outlook as well as the current price environment for many property sectors. We have favored private real estate investments over publicly traded real estate investment trusts (REITs), primarily based on valuation concerns, as REITs seem to have become favored by investors seeking current income. Our partiality toward private real estate at the expense of public securities has benefitted the Real Estate portfolio significantly over the preceding six months. Our Real Estate portfolio earned 12.4 percent during the first half of the fiscal year, while the public market benchmark lost 4.4 percent.

Low Volatility

The Low Volatility portfolio is managed to provide the endowment with stability as well as current income and liquidity in order to fund ongoing support to the University. This portfolio may also be used as a source of capital to fund opportunistic investments during periods of market stress. The current low interest rate environment for most high-quality, fixed-income investments has presented challenges to generating meaningful returns while attempting to mitigate risks. The primary risk we seek to avoid today is interest rate risk stemming from increasing inflation and normalization of Federal Reserve policy. The Low Volatility portfolio returned just 1.2 percent during the period, but it significantly outperformed the Barclays Aggregate Bond index, which lost 2.5 percent (and 7-10 year US Treasury bonds, which lost 6.1 percent).



Bucknell UNIVERSITY

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