Northwestern University 2001 Financial Report

Northwestern University recently undertook a self-study to define — for ourselves and the world at large — precisely who we are and what sets us apart. In this day we are well aware of the advantages — indeed the necessity — of consistently projecting a strong identity that clearly communicates our aspirations as well as our core values and traditions.

Led by Thomas Z. Hayward, vice chairman of the Board of Trustees, the 18-month study consisted of two parts:

- How Northwestern is perceived by prospective students, current students, alumni, employers of our graduates, and other groups
- How the University represents itself through publications, stationery, the Web, and other communications

The results of the study are twofold: the creation of a "brand essence statement," which summarizes Northwestern's distinctive qualities, and a new visual identity program. Both are described in detail on pages 6–7.

As a first step toward its goal, the Hayward committee, composed of faculty and administrators, looked into how various audiences perceive Northwestern. They hired a firm that specializes in market research for colleges and universities to interview prospective students. Meanwhile, a group of graduate students in Medill's Integrated Marketing Communications program spoke with current students, and the Office of Administration and Planning surveyed employers of our graduates.

The committee, which met for more than a year, also reviewed data from previous surveys of alumni and undergraduates admitted to Northwestern.

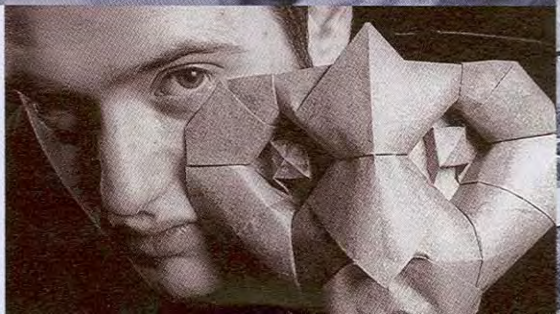
The information compiled from all of these sources helped committee members to determine which of Northwestern's strengths best match the interests of high-ability students and thus should be promoted. Those strengths were articulated in a "brand essence statement" (see page 6) defining who we are, what we aim to accomplish, and what makes us distinctive.

This statement — dubbed **"the four C's" for its focus on the University's strengths of choice, collaboration, communication, and Chicago** — is helping us all to think and talk about Northwestern more clearly and consistently, whether to prospective students, parents, donors, or the general public.

The Office of Undergraduate Admission is stressing the four C's in admission publications, video and oral presentations, and its Web site. I have asked other parts of the University to incorporate the points into their communications efforts so that a consistent message goes out about Northwestern.

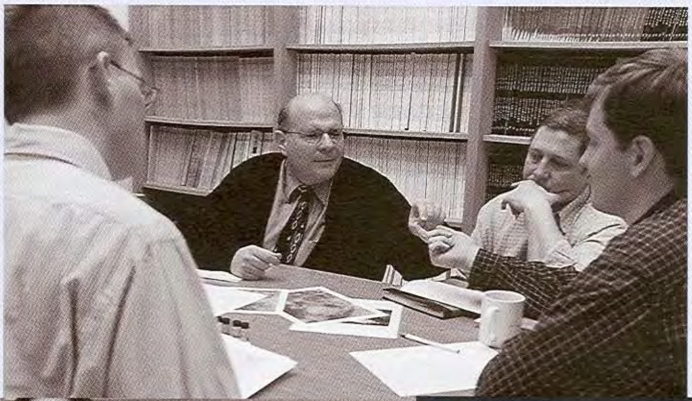
The recently introduced certificate in service learning (left), one of Northwestern's atypical academic offerings, allows students across the University to earn a certificate for a combination of volunteer experience and academic study. The University offers many other opportunities for enrichment and individualized study, from an archaeology field school (below right) to joint or accelerated degrees to music studies for nonmajors. The ultimate in choice — designing one's own major — allows students like Ethan Plaut (below left) to pursue unique interests. Plaut (Weinberg College '01) brought together his interests in origami and art, mathematics, science, music, literature, and linguistics in creating his major, "formal systems and the arts."

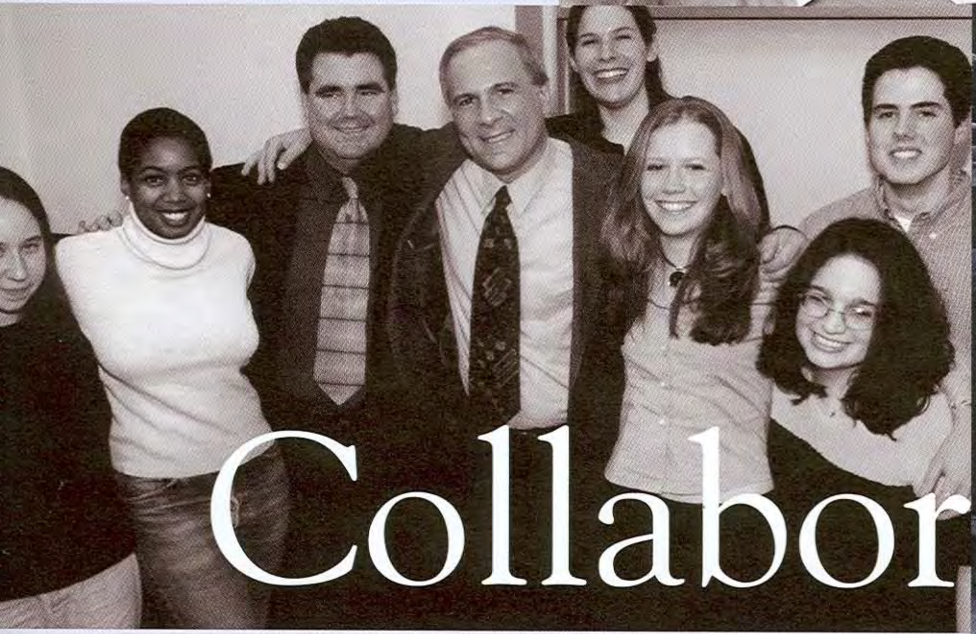
Choice

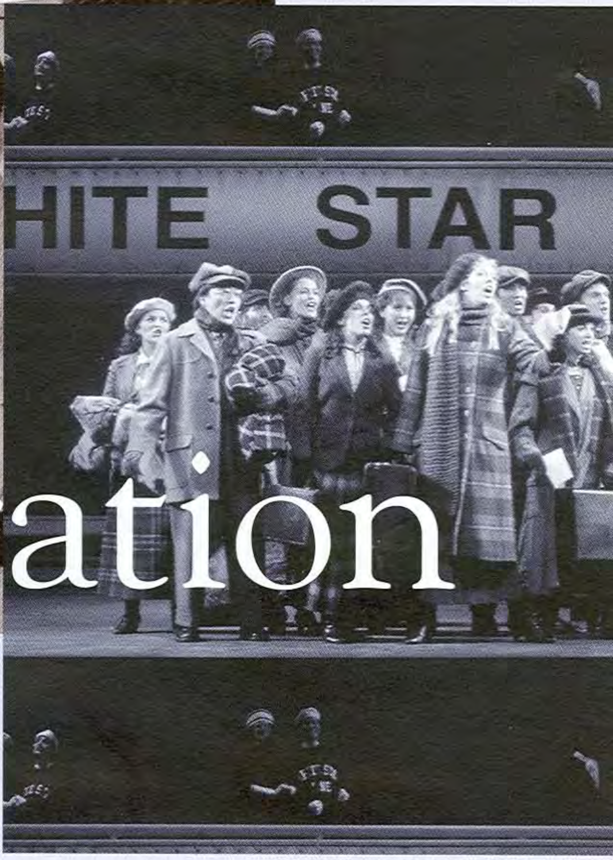


While the Hayward committee developed the verbal message, a second group was wrestling with how to develop a more consistent graphic identity for the University. An initial scan showed that more than 100 different stationery formats were in use. In some cases offices within the same department used completely different stationery. Business card styles varied widely. Northwestern's "official" color of purple as used by University offices ranged from lavender to nearly black.

Working with a Chicago design firm, this group considered dozens of possibilities for a new visual identity. Some were very traditional in appearance, others more contemporary. Potential choices were tested with different audiences, including current students, prospective students, and parents.



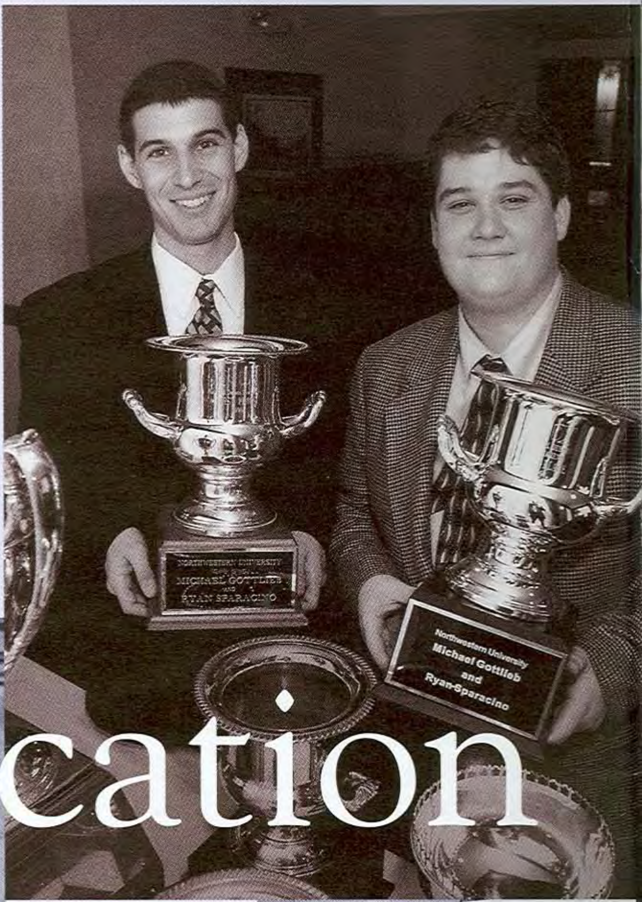




Collaboration

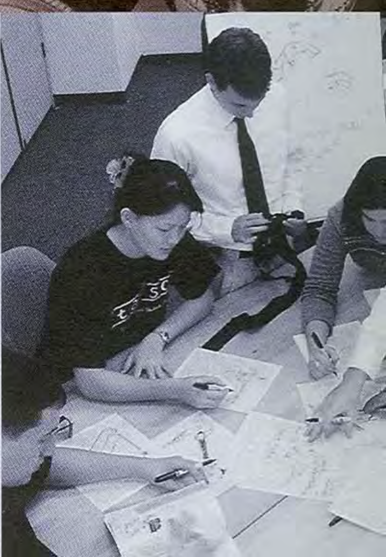
Northwestern is a community where faculty work with researchers in other disciplines and students have close contact with professors. With faculty appointments in materials science and engineering, chemistry, medicine, and biomedical engineering, Samuel Stupp (top, center) blurs the lines between normally autonomous disciplines. A team that's made headlines is that of Medill professor David Protess and investigative journalism students (above) who helped prove the innocence of several wrongfully convicted death row inmates. Among inter-school academic offerings, the Music Theatre Program (right) joins theatre and voice majors.

The traditional logo (see page 7) that was chosen combines a subtly refined version of our venerable seal in combination with the words "Northwestern University" in a customized typeface. A standard purple also was adopted. The new visual identity was approved by the Board of Trustees at its meeting last June and is already in use on University print publications, Web pages, and stationery. A powerful, effective, and immediate way to communicate our institutional identity, it will be used throughout the University.



Like students in all Northwestern schools, engineering majors are grounded in communication skills. The innovative Engineering Design and Communication course (below right) allows freshmen to tackle real-world problems for clients to whom they make oral and written presentations. One class designed an artificial hand for burn victim Iris Miller (below, left, with two students from the class). In a more traditional communication vein, Northwestern's debate team is the national leader; when Michael Gottlieb and Ryan Sparacino (right, left to right) won the National Debate Tournament in 1999, they gave Northwestern its 10th championship.

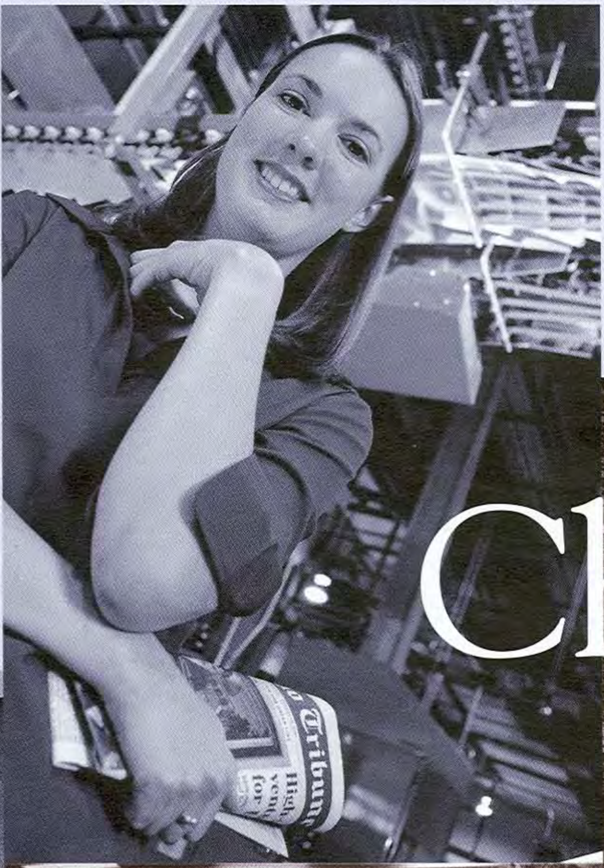
Communication



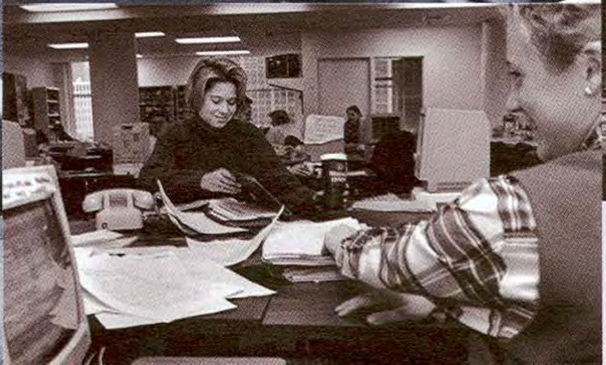
Northwestern has always valued independence and initiative within the University community. I believe, however, that the benefits of widely incorporating a standardized identity in communications produced by the University are self-evident. By better projecting Northwestern's personality and strengths, consistent implementation of the identity program will bring the University higher visibility and greater recognition.

Henry S. Bienen
President

With campuses in Chicago and nearby Evanston, Northwestern offers students a big city's internship and field studies possibilities along with its cultural advantages. Journalism students, for instance, cover the city's news for the Medill News Service (bottom right). Libby Lempereur (right), an engineering senior, is one of the many University students and alumni to take advantage of Chicago's job market; she found summer work in the *Chicago Tribune's* manufacturing and distribution division.



Chicago



Brand Essence Statement
Adopted June 2001

Northwestern University combines innovative teaching and pioneering research in a highly collaborative environment that transcends traditional academic boundaries. Northwestern provides students and faculty with exceptional opportunities for intellectual, personal, and professional growth in a setting enhanced by the richness of Chicago.

Northwestern University's distinctive qualities:

Broad program choice and flexibility
Northwestern University offers an unusually broad range of substantive academic opportunities for an institution of its size. The combination of close interschool cooperation and a distinctive academic calendar enables students and faculty to tailor their education and research individually in innovative ways.

A collaborative and engaged community
Northwestern University is a place where students at all levels learn from and do research with outstanding faculty and work with fellow students. It is an innovative and technologically sophisticated learning community in which students and faculty collaborate on academics and extracurricular activities.

Leadership through communication
Northwestern University's emphasis on effective communication, regardless of field of study, fosters the ability to think analytically and clearly and to speak persuasively. As a result, Northwestern graduates are exceptionally well prepared for academic and professional success and become leaders in their fields.

Chicago, one of the world's great cities
Northwestern University's locations on two beautiful campuses on Lake Michigan in Evanston and Chicago and in the Chicago metropolitan area provide students and faculty a wealth of outstanding intellectual, professional, social, and cultural opportunities.

Visual Identity
Adopted June 2001

NORTHWESTERN
UNIVERSITY

The seal
In 1856, the first year Northwestern held classes, trustees adopted an official seal to affix to formal University documents. Over the next 35 years new features were added, and by 1891 all of the familiar elements of the current seal were in place:

Northwestern University
The University's name had its origins in the founders' goal to create an educational institution serving the people of the former Northwest Territory — the region between the Ohio and the Mississippi Rivers, which would become the states of Illinois, Ohio, Indiana, Wisconsin, Michigan, and part of Minnesota.

Quaecumque sunt vera
This Latin phrase was adopted as the University's official motto in 1890. It translates as "Whatsoever things are true" and comes from the New Testament book of Philippians (4:8), in which St. Paul admonishes the Christians in the Greek city of Philippi: "Finally, brethren, whatsoever things are true, whatsoever things are honest, whatsoever things are just, whatsoever things are pure, whatsoever things are lovely, whatsoever things are of good report; if there be any virtue, and if there be any praise, think on these things."

Books and rays
The open book and the rays of light surrounding it symbolize learning and enlightenment. Inscribed on the pages is a Greek phrase transliterated as "ho logos pleres charitos kai aletheias," which means "the Word . . . full of grace and truth." This phrase was added to the seal with the Latin motto and comes from the Gospel of John (1:14): "And the Word was made flesh, and dwelt among us, and we beheld his glory, the glory as of the only begotten of the Father, full of grace and truth." Like the Latin motto, it expresses not only the ethical and moral values of the University's founders but also the religious roots of the University in the Methodist Church.

Laurel wreath
In Greek and Roman mythology, the laurel was sacred to Apollo, god of sunlight, prophecy, music, and poetry. It symbolized excellence when gathered into a wreath and placed on the brow of a poet, artist, or other luminary. A person so honored was known as a laureate, a word that continues to denote achievement today.

1851
The year of Northwestern's founding.

The signature
The words "Northwestern University" are set in Goudy, a classic typeface designed in the early 20th century by Frederic W. Goudy, a native Illinoisan who was one of the most important American type designers of the century. Emerging from the same historical and cultural milieu as the University, the Goudy typeface might be said to reflect Midwestern values: Its straightforward, self-assured, and unpretentious character makes it an appropriate choice for Northwestern.

Report of the Senior Vice President for Business and Finance

To the Board of Trustees of Northwestern University:

While external economic conditions declined in 2001, the University benefited from its long record of financial strength and stability. This foundation allows Northwestern to be flexible in managing assets and to carry out its mission of high-quality instruction and research even during recessionary periods.

Although assets as reported on the Consolidated Statements of Financial Position decreased in 2001 by 5.3 percent, largely as a result of the first negative investment return since 1988, the positive news is that the University's Long-Term Balanced Pool return of -7.8 percent outperformed the major benchmarks for many asset classes. As detailed in the investment report, the University's prudent strategy of investment diversification and risk management helped to buffer the portfolio against the drastic declines seen in certain classes such as domestic and international equities.

The University's net assets totaled more than $4.1 billion at August 31, 2001, a decline of 6.6 percent over 2000. While temporarily and permanently restricted net assets increased by 11.1 percent and 6.1 percent, respectively, unrestricted net assets declined by 9.9 percent because unrealized investment losses of $472.7 million were recognized as a nonoperating loss.

As Campaign Northwestern continues to raise contributions toward its $1.4 billion goal, gift revenue recognized across all net assets classes totaled $146.2 million in 2001. Grants and contracts revenue increased a robust 10.8 percent, to $248.3 million, signifying the University's continued success in growing the research base on both campuses.

The University's net tuition and fees revenue increased 4.8 percent, reflecting a policy of raising tuition modestly while assisting students with need.

As a result of a Board of Trustees' decision to increase the Long-Term Balanced Pool's per-unit payout amount by 17.3 percent, investment returns spent to support the operating revenue budget totaled $185.9 million in 2001.

Operating expenses increased in all functional categories in 2001. Their total of $871.9 million represented an increase of less than 6.4 percent over 2000. A $15.3 million decrease in depreciation expense helped keep total operating expenses in check. In 2000 a one-time charge of $20 million was incurred to depreciation as the University adjusted depreciation methods for buildings and equipment.

The excess of operating revenue over expense presented on the Consolidated Statements of Activities was $87.5 million, up from $55.7 million in 2000.

As detailed in Note 10 of the financial statements, the University completed its planned closure of the Dental School having recorded losses totaling $19.5 million over the last four years.

In sum, the University's sound financial bedrock enables it to react to both external forces and internal needs as necessary. Looking toward the future, Northwestern is well prepared to continue its important work of instruction and research regardless of economic peaks and valleys.

This report would not be complete without recognizing and thanking two senior officers: Mike Weston, vice president and general counsel, who recently retired, and Dave Wagner, vice president and chief investment officer, who is leaving the University. They contributed in so many ways to the financial success of Northwestern. The University is far better off as a result of their efforts.

Eugene S. Sunshine

Eugene S. Sunshine
Senior Vice President for Business and Finance

Investment Report

Over the past year investors have returned to the old tenets of reasonable valuations and expectations about revenue and profit growth, and the University's portfolio has been repriced downward, along with the rest of the market. As of August 31, 2001, the University's investment assets totaled $3.647 billion, including cash equivalents and intra-University investments. This total represents a decrease of approximately $409 million from August 31, 2000.

Although the Long-Term Balanced Pool was down 7.8 percent for the fiscal year, it outperformed the Investment Office's constructed benchmark, which was down 16.5 percent. The comparative outperformance is attributable to a number of factors: the overall diversification of the portfolio; the underweighting of equity assets relative to the target portfolio; the successful overweighting of value stocks during the first three quarters of the fiscal year; and the outperformance of the $530 million hedge fund portfolio, which was up 11.1 percent net for the 12 months ending August 31, 2001. Each of these items is discussed in greater detail below.

The University's Investment Pools

The University maintains investment pools as well as separately invested assets. Each pool has a specific set of objectives. The Annuity, Unitrust, and Life Income Bond Pool, the Charitable Remainder Trust Balanced Pool, and the Charitable Remainder Trust Tax-Exempt Bond Pool were liquidated in fiscal 2001. Their assets were transferred to Mellon Trust and classified as separately invested funds.

The Long-Term Balanced Pool is the University's principal endowment pool. It is managed with the objective of long-term total return.

The Short-Term Money Market Pool is a money market fund used for cash reserves. Its investment objective is to maximize current income consistent with preservation of principal and maintenance of liquidity.

The Intermediate-Term Bond Pool has two purposes. It is used to segregate for investment purposes money available for retirement of indebtedness. It is also used to maximize investment income available to defray annual debt service expenses.

Separately invested funds are donated funds, including restricted investments and some life-income plans, in addition to funds from the former Annuity, Unitrust, and Life Income Bond Pool and the Charitable Remainder Trust Balanced and Tax-Exempt Bond Pools.

Working capital funds held by the University are generated through the temporary differences between operating receipts and disbursements. These funds are not unitized. The income from investing them is used for general operating purposes. Working capital investments are held in a variety of money market instruments and guaranteed student loans.

The table on page 10 summarizes the net asset values and unitized information for the investment pools for the past five years.

History of the Merged Pools

	1997	1998	1999	2000	2001
Long-Term Balanced Pool					
Net asset value (in thousands of dollars)	$1,989,995	$2,024,494	$2,476,184	$3,337,660	$2,981,351
Number of units (in thousands)	16,433	17,156	17,442	18,413	19,091
Net asset value per unit	$121.10	$118.00	$141.97	$181.27	$156.17
Payout amount per unit					
Current earned income	$2.79	$1.98	$1.58	$1.05	$1.05
Previously reinvested realized gains withdrawn	0.94	2.19	2.62	4.25	5.17
Total payout per unit	$3.73	$4.17	$4.27	$5.30	$6.22
Annuity, Unitrust, and Life-Income Bond Pool (liquidated in fiscal 2001)					
Net asset value (in thousands of dollars)	$21,384	$13,418	$14,011	$6,758	
Number of units (in thousands)	2,782	1,687	1,863	905	
Net asset value per unit	$7.69	$7.95	$7.52	$7.47	
Payout amount per unit					
Current earned income	$0.56	$0.66	$0.51	$0.56	
Short-Term Money Market Pool					
Net asset value (in thousands of dollars)	$10,860	$15,027	$13,023	$30,959	$5,762
Number of units (in thousands)	1,085	1,502	1,301	3,093	576
Net asset value per unit	$10.01	$10.01	$10.01	$10.01	$10.00
Payout amount per unit					
Current earned income	$0.54	$0.53	$0.50	$0.61	$0.50
Intermediate-Term Bond Pool					
Net asset value (in thousands of dollars)	$126,557	$134,657	$188,788	$251,180	$249,536
Number of units (in thousands)	11,026	11,934	14,738	16,231	18,188
Net asset value per unit	$11.48	$11.28	$12.81	$15.48	$13.72
Payout amount per unit					
Current earned income	$0.54	$0.54	$0.48	$0.57	$0.62
Charitable Remainder Trust Balanced Pool (liquidated in fiscal 2001)					
Net asset value (in thousands of dollars)			$76,583	$80,886	
Number of units (in thousands)			524	487	
Net asset value per unit			$146.02	$166.26	
Payout amount per unit					
Current earned income			$0.63	$0.79	
Charitable Remainder Trust Tax-Exempt Pool (liquidated in fiscal 2001)					
Net asset value (in thousands of dollars)				$17,885	
Number of units (in thousands)				1,758	
Net asset value per unit				$10.18	
Payout amount per unit					
Current earned income				$0.11	
Summary of net asset values (in thousands of dollars)					
All pools	$2,148,796	$2,187,596	$2,768,589	$3,725,328	$3,236,649
Separately invested funds	37,051	95,537	101,076	92,879	172,461
Working capital	220,904	222,064	235,131	237,736	237,502
Total net asset value (in thousands of dollars)	**$2,406,751**	**$2,505,197**	**$3,104,796**	**$4,055,943**	**$3,646,612**

The Long-Term Balanced Pool

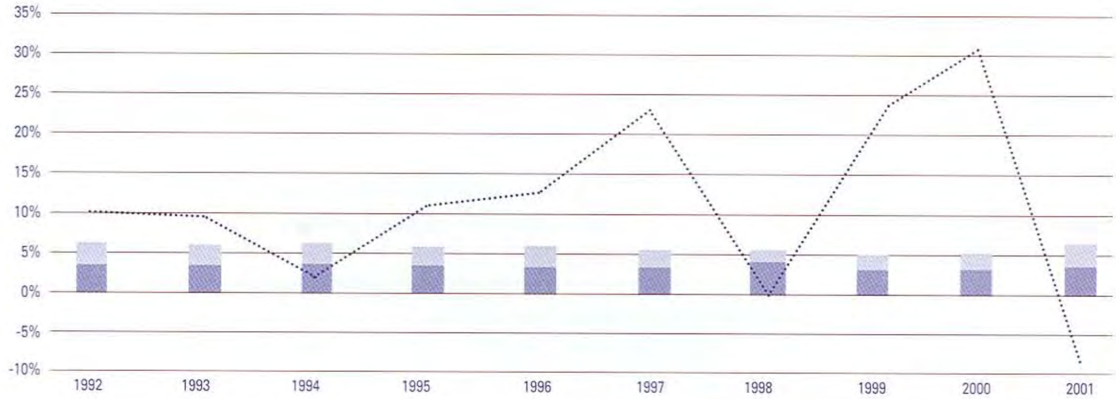
The market value of investment assets managed in the Long-Term Balanced Pool at August 31, 2001, was $3.21 billion, including $230 million of interpool loans. This was down approximately $356 million from the previous year. Because of its size and the importance of these assets to the University, the following sections refer only to this pool.

The principal objective for the University's Long-Term Balanced Pool is to preserve purchasing power and to provide a growing stream of income to fund University programs. The pool seeks to achieve on average an annual total rate of return (actual income plus appreciation) equal to inflation plus actual spending. The objective of preserving purchasing power emphasizes the need for a long-term perspective in formulating spending and investment policies. The University's investments historically have grown at a rate exceeding this objective. For the 12-month period ending August 31, 2001, the portfolio declined 14.9 percent below this objective. However, for the 5-, 10-, and 15-year periods ending August 31, 2001, the objective was exceeded by 7.2 percent, 4.9 percent, and 3.6 percent, respectively. A graphic review of the performance of the Long-Term Balanced Pool follows.

Long-Term Balanced Pool: Meeting Return Objectives

Investment objective: annual total return* ≥ spending + inflation

Spending ** Inflation ···· Total return (net)*

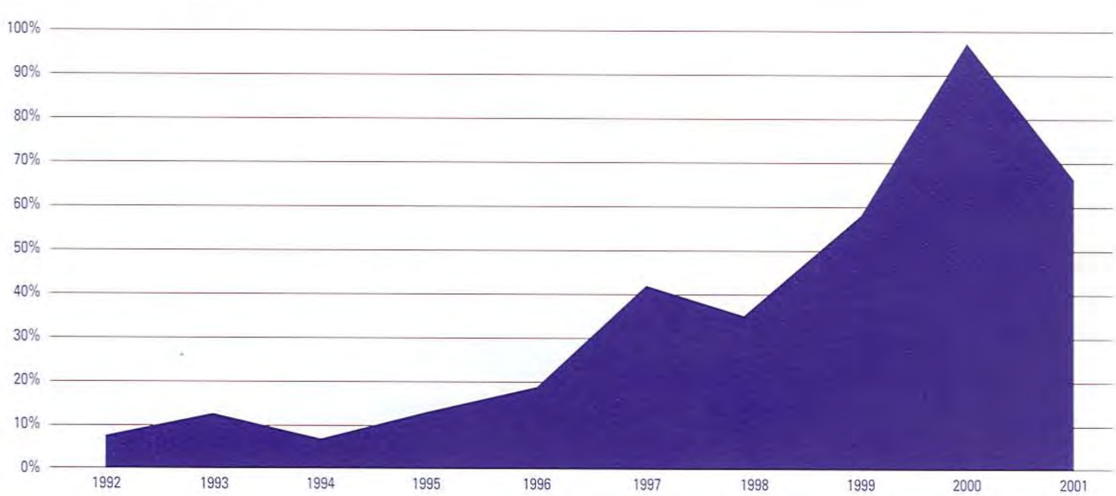


	Annualized			
	1-year	**5-year**	**10-year**	**15-year**
*Annual total return**	-8.47%	12.87%	11.10%	10.81%
– Spending	3.62%	3.36%	3.59%	3.95%
– Inflation	2.82%	2.35%	2.60%	3.22%
= Above (below) objective	**-14.91%**	**7.16%**	**4.91%**	**3.64%**

*Total returns are net of fees and are calculated on annual changes in net asset value. They may differ from payout distributions.

**New spending rule went into effect in fiscal year 1994.

Excessive Real Growth: Cumulative



Long-Term Balanced Pool Spending Rule

During fall 2000 an ad hoc committee of the Board of Trustees drawn from the Investment and the Budget Committees reviewed the University's spending rule. Following considerable deliberation, a new rule was recommended to the board, which approved it on February 10, 2001. The new rule blends two elements:

Market element adjusts annual endowment spending to the long-term sustainable target spending of 4.1 percent of the average actual market value of the endowment for the most recent two years. This component receives a 30 percent weighting in the spending rate calculation.

Spending element increases last year's spending rate by a factor for inflation (3.5 percent) plus budget growth (1.5 percent). This element of the spending rate receives a weight of 70 percent.

The actual spending rate per unit for fiscal 2001 was $6.22. For fiscal 2002 it will be $6.56. The payout rate for fiscal 2001 was 4.75 percent.

Spending Rule

	1997	*1998*	*1999*	*2000*	*2001*
Spending per unit	$3.73	$4.17	$4.27	$5.30	$6.22
Net asset value per unit	$121.10	$118.00	$141.97	$181.27	$156.17
Payout rates*	4.03%	4.30%	3.93%	4.52%	4.75%

*Through fiscal 2001, payout rate is calculated as spending per unit divided by the three-year average net asset value per unit, lagged one year.

Diversification

Over the past nine years the University's Long-Term Balanced Pool has been transformed from a two-asset-class portfolio of $1.3 billion to a highly diversified portfolio of $3.2 billion that at August 31, 2001, was more heavily invested in alternative strategies (venture capital, private equity, hedge funds, real estate, etc.) than in public equities. The University's strategy has evolved from planning for diversification to implementation to the current phase of reexamination of strategies and relationships, revisiting of assumptions, and strengthening of policies and procedures. As part of that evolution, the Investment Committee in July 2000 adopted a target portfolio broken down by major asset classes. The individual targets fall within the previous ranges and represent the University's best estimate of an appropriate asset allocation over a given market cycle. They provide a reference point for measuring success and for making tactical shifts. The target portfolio allocations are reviewed annually.

Throughout fiscal 2001 the Investment Office cautiously underweighted equity markets and overweighted the risk-hedging portion of the portfolio. These shifts contributed to the portfolio's outperformance relative to its benchmark. The target portfolio and the actual asset allocation at August 31, 2001, were as follows:

Target Portfolio and Diversification at Fiscal Year-End

	1997	*1998*	*1999*	*2000*	*Target*	*Target range*	*2001*
Equities							
Domestic	39%	32%	35%	30%	24%	22–26%	23%
International	15%	12%	11%	10%	13%	11–15%	10%
	54%	44%	46%	40%	37%		33%
Market hedged	6%	11%	12%	14%	17%	15–19%	19%
Private equity	11%	19%	20%	28%	26%	22–30%	25%
Equity focused	**71%**	**74%**	**78%**	**82%**	**80%**		**77%**
Fixed income	26%	23%	18%	13%	15%	14–16%	16%
Real assets	3%	3%	4%	5%	5%	2–8%	7%
Risk focused	**29%**	**26%**	**22%**	**18%**	**20%**		**23%**
Total	**100%**	**100%**	**100%**	**100%**	**100%**		**100%**

Domestic equities include equity-like asset classes such as high-yield bonds and REITs in addition to traditional large- and small-cap equities.

International equities include both emerging market equities and debt in addition to developed foreign country equities.

Market hedged includes all of the University's hedge, absolute return, and distressed strategies; these funds generally allow quarterly liquidity.

Private equity includes venture capital, private equity, opportunistic real estate, and other "equity-like" private investments.

Fixed income is limited to U.S. Treasury and highly rated agency and corporate bonds.

Real assets includes real asset investments such as timberland, producing oil and gas properties, "core" real estate, and U.S. Inflation-Protected Treasury bonds ("TIPs").

Use of Index Funds

The Long-Term Balanced Pool makes extensive use of passive strategies. Nearly 29 percent of the pool's $3.2 billion total is invested in 47 different index funds. The University owns funds that replicate benchmark indexes (e.g., S&P 500), markets of specific countries (e.g., the United Kingdom, Thailand), or market sectors (e.g., midsize utilities). These funds are employed in a range of strategies that start with straight passive index funds, where the costs are very low and little or no difference is expected from the benchmark. The University also employs a number of slightly active strategies, including tightly risk-controlled methodologies that seek to outperform the relevant benchmarks and modularized index funds that "tilt" away from the underlying benchmark — for instance, overweighting value as opposed to growth equities. One such tilt that was very successful divided the University's investments in S&P 500 indexes equally between a growth index and a value index in September 2000. When $120 million of the growth index was sold and the proceeds invested in the value index, the portfolio was given a value tilt. These value-tilted investments were then sold in spring 2001, and a $28 million improvement in performance resulted.

Alternative Assets

The Investment Committee in recent years has placed a special emphasis on diversification into private or alternative asset markets. These markets for the most part are illiquid and considered less efficient than public markets. Through due diligence the University seeks to select top-tier investment managers with demonstrated expertise and proprietory networks who have consistently generated returns above those of their peers. In addition, the Investment Office believes that alternative assets capture an illiquidity premium and provide an enhanced risk/reward profile for the pool.

Twenty-six alternative asset investments were made in fiscal 2001. Nineteen represent subsequent investments (add-on or follow-on) with managers with whom the University already has an established relationship. The greatest activity was among venture capital funds, where nine commitments totaling $160 million were made. Six of the investments were additions to existing hedge funds. The breakdown by type and fiscal year is in the chart that follows:

Long-Term Balanced Pool: Investment in Alternative Assets

					Number of new commitments					
	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*Total**
Distressed securities	2			1	1	2	1		1	8
Hedge funds		1	2		2	8	4	5	6	28
Natural resources			1		2	4	3			10
Venture capital	1		2		5	8	11	15	9	51
Private equity	1		4	3	6	11	4	6	8	43
Real estate		2	2	5	1	5	3	1	2	21
	4	3	11	9	17	38	26	27	26	161
New investments	4	3	10	9	13	29	13	4	7	92
Follow-on investments			1		4	9	13	23	19	69

*Total includes both active and inactive investments at August 31, 2001.

Commitments are called for investment at different rates for each strategy. Some of the investments have been funded immediately (e.g., hedge funds), while the capital for others (e.g., private real estate partnerships, venture capital, and private equities) will be called over a three- to five-year period. The market value of the funds called and actually invested totaled $1.591 billion as of August 31, 2001. As the various funds complete their investment periods, the University receives a return of principal and profit.

Private Equity and Venture Capital

Fiscal year 2001 was a difficult one for private equity and venture capital. Having enjoyed record returns under the "new economy" of the previous two years, these investments suffered significant setbacks as the NASDAQ fell precipitously, the initial public offering market collapsed, the economy stumbled, and the telecommunications and information technology industries were repriced to "old economy" metrics. In the second quarter of 2001 the Investment Office estimated that, over the course of the ensuing three or four quarters, the unrealized portions of these portfolios could lose up to 50 percent of their earlier market value. While this dire prediction had not come to pass as of September 30, 2001, the venture capital portfolio market value was down approximately 41 percent and private equity down 20 percent from December 31, 2000.

Through September 30, 2001, the University had committed $601 million to venture capital; $275 million was actually invested, $269 million was returned, and there was a remaining unrealized market value of $210 million. In the private equity category, $558 million had been committed, $327 million invested, and $104 million returned, and the remaining unrealized market value was $254 million.

While there may be further downward adjustments in these portfolios, the University remains committed to these investment classes. We have invested with top-tier partners and remain convinced that they have an edge over other investors in market and technical insights and greater access to top-tier talent and suitable financing. Not only are they currently working to rationalize existing investments, they are also investing the remaining commitments at the repriced valuations. Many investors feel this is as attractive an environment in which to be investing as any in the past 10 or 15 years. The Investment Office is confident that over a full cycle both private equity and venture capital will enjoy premium returns in line with historic expectations.

Hedge Funds

In recent years hedge funds have become an increasingly important component of many institutional portfolios. Like other alternative investments, they provide access to returns that are uncorrelated with traditional investments. The term "hedge fund" is used to cover a wide range of strategies including market neutral, merger arbitrage, and short-only.

The University's 16 hedge fund managers represent a range of these styles. Much like a fund of funds, the hedge funds are managed as a portfolio with a specific risk/reward objective: to provide, over a market cycle, equity-like returns with only about half the market volatility. The assumption is that the portfolio will underperform in up markets and outperform in down markets and, as a result of its superior risk-adjusted returns, will provide a higher ending value at the end of a market cycle. Northwestern's hedge funds portfolio has exceeded expectations, returning 11.1 percent and 22.8 percent annualized for the last one- and three-year periods, while the S&P 500 was down 24.4 percent and 6.2 percent for the same periods.

Long-Term Balanced Pool: Hedge Funds

Strategies	*Number of managers*	*Percentage of fund*
Domestic long/short	Five	35%
International long/short	Eight	42%
Event-driven	Two	17%
Absolute return	One	6%

Performance	*1 year*	*3 years*	*Since inception (9-1-94)*
Annualized rate of return			
Northwestern (net)	11.1%	22.8%	19.7%
S&P 500	-24.4%	-6.2%	15.2%
Volatility (annual standard deviation)			
Northwestern	4.2%	7.5%	7.2%
S&P 500	17.4%	17.7%	15.5%
Sharpe Ratio (risk/reward)			
Northwestern	1.49	2.22	1.94
S&P 500	-1.76	-0.52	0.72
Worst consecutive losing period			
Northwestern	-1.1% (1 month)	-1.1% (1 month)	-7.0% (2 months)
S&P 500	-14.9% (2 months)	14.9% (2 months)	-15.4% (2 months)
Best consecutive winning period			
Northwestern	5.4% (2 months)	22.1% (6 months)	38.1% (19 months)
S&P 500	8.5% (2 months)	14.9% (3 months)	34.5% (5 months)
Percentage of months profitable			
Northwestern	75%	79%	82%
S&P 500	33%	42%	66%

Performance

The performance of the entire Long-Term Balanced Pool for the 12-month period ending August 31, 2001, was -7.8 percent, gross of all expenses. This compares with Northwestern's composite benchmark's performance of -16.5 percent. The composite benchmark, which consists primarily of index returns weighted similarly to the University's market exposure, is reported gross of fees. In addition, since the University's fiscal year does not end on a calendar-year quarter, nearly half of the alternative assets reflect June 30 performance data.

Fiscal 2001 performance also can be understood by examining each of the underlying asset classes.

Long-Term Balanced Pool: Fiscal 2001 Gross Performance

	Northwestern		**Benchmark**	
Average asset mix	*Subasset class*	*12-month total return*	*Index/composite*	*12-month total return*
Equities				
24%	Domestic (both small and large capitalization)	-20.0%	Wilshire 5000 Index	-25.6%
8%	International	-24.6%	MSCI EAFE Free Unhedged Index	-24.3%
2%	Emerging markets	-20.6%	MSCI Emerging Markets Free	-27.9%
Fixed income				
16%	Domestic (both bonds and short-term investments)	11.2%	Lehman Government/Corporate Index	12.6%
Market hedged				
3%	Distressed securities	9.6%	Cambridge universe by vintage year	8.3%
14%	Hedge funds	16.2%	Cambridge manager mean	10.0%
Real assets				
7%	Natural resources, real estate, and treasury bonds	11.4%	Consumer price inflation plus 625 basis points	9.1%
Private equity				
9%	Private equity	10.8%	Cambridge universe by vintage year	15.0%
10%	Venture capital	60.7%	Cambridge universe by vintage year	60.8%
2%	Oil and gas	8.6%	Cambridge universe by vintage year	9.7%
3%	Real estate	11.6%	Cambridge universe by vintage year	11.2%
2%	Private equity international	-2.6%	Cambridge universe by vintage year	2.2%
100%		**-7.8%**		**-16.5%**

*Except alternative assets, for which net performance is shown.

Risk Management

As the University's portfolio has become more diversified, financial instruments have become more complex, global markets more integrated, and the Investment Office's risk management practices more important. The critical issue facing all investors is not whether to take risks but how to manage the risks that exist and how to maintain the balance between risk and reward.

The Investment Office believes that the first order of risk management is to understand the risk exposures for various strategies and managers and to construct a truly diversified portfolio. As part of this effort, the Investment Office has an extensive ongoing monitoring and annual reporting system. It uses quantitative risk measurement techniques to assess and control portfolio risks. "Stress tests" and simulations analyze portfolio performance under different adverse outcomes. The office scores each of its managers and varies its annual compliance review accordingly. It maintains standards for transaction reporting and has established backup and disaster recovery plans.

David L. Wagner

Vice President and Chief Investment Officer

Report of Independent Auditors

To the Board of Trustees of Northwestern University:

We have audited the accompanying Consolidated Statements of Financial Position of Northwestern University and subsidiaries (the "University") as of August 31, 2001, and 2000, and the related Consolidated Statements of Activities and Consolidated Statements of Cash Flows for the years then ended. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the University as of August 31, 2001, and 2000, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we also have issued a report, dated December 14, 2001, on our consideration of the University's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

Chicago, Illinois
December 14, 2001

Consolidated Statements of Financial Position

As of August 31, 2001, and August 31, 2000

(in thousands of dollars)	*2001*	*2000*
Assets		
Cash and cash equivalents	$243,182	$223,083
Accounts receivable	154,214	153,602
Notes receivable	52,176	55,132
Contributions receivable	202,041	181,003
Investments	3,421,655	3,743,404
Land, buildings, and equipment	753,589	714,189
Bonds proceeds held by trustees	70,623	100,504
Other assets	32,757	33,525
Total assets	**$4,930,237**	**$5,204,442**
Liabilities		
Accounts payable and accrued expenses	$76,365	$61,992
Deferred revenue	177,795	164,479
Actuarial liability of annuities payable and deposits payable	53,517	51,300
Reserves for self-insurance	39,934	34,124
Government advances for student loans	42,756	43,465
Bonds and notes payable	409,308	421,703
Reserve for Dental School closure	298	6,911
Total liabilities	**799,973**	**783,974**
Net assets		
Unrestricted	3,229,420	3,584,290
Temporarily restricted	297,448	267,803
Permanently restricted	603,396	568,375
Total net assets	**4,130,264**	**4,420,468**
Total liabilities and net assets	**$4,930,237**	**$5,204,442**

Detail of net assets	**Unrestricted**	**Temporarily restricted**	**Permanently restricted**	**2001**
Operating funds	$266,128	$94,294		$360,422
Invested in plant facilities	717,991	59,095		777,086
Annuity and life income funds	37,360	90,604	$33,177	161,141
Endowment and similar funds	2,207,941	53,455	570,219	2,831,615
Total net assets	**$3,229,420**	**$297,448**	**$603,396**	**$4,130,264**

Detail of net assets	**Unrestricted**	**Temporarily restricted**	**Permanently restricted**	**2000**
Operating funds	$245,044	$72,743		$317,787
Invested in plant facilities	656,065	43,484		699,549
Annuity and life income funds	38,044	89,778	$36,180	164,002
Endowment and similar funds	2,645,137	61,798	532,195	3,239,130
Total net assets	**$3,584,290**	**$267,803**	**$568,375**	**$4,420,468**

See Notes to the Consolidated Financial Statements, beginning on page 20.

Consolidated Statements of Activities

For the fiscal years ended August 31, 2001, and August 31, 2000

(in thousands of dollars)	*2001*		*2000*	
Changes in unrestricted net assets				
Operating revenues				
Tuition and fees	$411,513		$388,723	
(less scholarships and fellowships)	(114,516)		(105,457)	
Net tuition and fees	296,997		283,266	
Auxiliary services	57,394		59,559	
Grants and contracts	248,320		224,192	
Private gifts	53,647		43,347	
Investment return designated for operations	185,936		160,690	
Professional fees	29,818		25,783	
Sales and services	82,126		76,002	
Other income	5,161		2,475	
Total operating revenues		**$959,399**		**$875,314**
Operating expenses				
Instruction	321,513		300,438	
Research	211,486		196,474	
Academic support	107,588		97,018	
Student services	65,533		64,644	
Institutional support	76,557		72,312	
Auxiliary services	89,258		88,760	
Total operating expenses		**871,935**		**819,646**
Excess of operating revenues over expenses		**87,464**		**55,668**
Nonoperating				
Private gifts and grants for buildings and equipment	11,154		39,568	
Investment (losses uninvested) gains reinvested	(472,725)		728,006	
Gain on sale of plant assets	4,861		—	
Change in unrestricted net assets from nonoperating activities		**(456,710)**		**767,574**
Discontinued operations				
Loss on discontinuance of Dental School, including provision for operating losses during closing period		(1,496)		—
Net assets released from restrictions		**15,872**		**26,792**
Change in unrestricted net assets		**(354,870)**		**850,034**
Changes in temporarily restricted net assets				
Private gifts	43,023		15,181	
Net gain (loss) on annuity obligation	524		(260)	
Investment returns	1,970	45,517	1,397	16,318
Net assets released from restrictions		**(15,872)**		**(26,792)**
Change in temporarily restricted net assets		**29,645**		**(10,474)**
Changes in permanently restricted net assets				
Private gifts	38,344		59,466	
Net loss on annuity obligation	(3,323)	35,021	(1,473)	57,993
Change in permanently restricted net assets		**35,021**		**57,993**
Change in net assets		**(290,204)**		**897,553**
Beginning net assets		**$4,420,468**		**$3,522,915**
Ending net assets		**$4,130,264**		**$4,420,468**

See Notes to the Consolidated Financial Statements, beginning on page 20.

Consolidated Statements of Cash Flows

For the fiscal years ended August 31, 2001, and August 31, 2000

(in thousands of dollars)	*2001*	*2000*
Cash flows from operating activities		
Change in net assets	**($290,204)**	**$897,553**
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation	44,059	59,404
Loss on retirement of equipment	2,092	1,725
Net realized and unrealized losses (gains) on investments	369,721	(805,111)
Private gifts and grants restricted for long-term investment	(11,154)	(39,568)
Provision for loss on Dental School closure	1,496	—
Changes in assets and liabilities		
Accounts receivable	(612)	(41,710)
Contributions receivable	(21,038)	(2,680)
Other assets	768	258
Accounts payable and accrued expenses	14,373	12,551
Deferred revenue	13,316	17,593
Reserves for self-insurance	5,810	305
Government advances for student loans	(709)	(158)
Operating loss for Dental School closure	(8,109)	(5,494)
Net cash provided by operating activities	**119,809**	**94,668**
Cash flows from investing activities		
Purchases of investments	(3,480,036)	(1,583,343)
Proceeds from sales of investments	3,431,078	1,567,051
Decrease in trusts held by others	986	99
Acquisitions of land, buildings, and equipment	(90,665)	(58,696)
Proceeds from sales of plant assets	5,114	—
Student loans disbursed	(81,490)	(74,997)
Principal collected on student loans	84,446	74,395
Net cash used in investing activities	**(130,567)**	**(75,491)**
Cash flows from financing activities		
Net proceeds from issuance of notes payable and bonds payable	12,000	—
Net principal payments on notes and bonds payable	(24,490)	(2,375)
Amortization of discount on bonds payable	95	94
Decrease in bonds held by trustees	29,881	10,131
Proceeds from private gifts and grants restricted for long-term investment	11,154	39,568
Increase in annuity and deposits payable	2,217	4,129
Net cash provided by financing activities	**30,857**	**51,547**
Increase in cash and cash equivalents	**20,099**	**70,724**
Cash and cash equivalents at beginning of year	**223,083**	**152,359**
Cash and cash equivalents at end of year	**$243,182**	**$223,083**
Supplemental disclosure of cash flow information		
Cash paid for interest	$16,770	$17,000

See Notes to the Consolidated Financial Statements, beginning on page 20.

Notes to the Consolidated Financial Statements

For the fiscal years ended August 31, 2001, and August 31, 2000

1. Summary of Significant Accounting Policies

Operations

Northwestern University is a major private research university with more than 17,000 students enrolled in 11 academic divisions on two lakefront campuses.

Basis of Accounting

The University maintains its accounts and prepares its consolidated financial statements on the accrual basis of accounting. These statements include all wholly owned subsidiaries.

The University prepares its financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 116, "Accounting for Contributions Received and Contributions Made," and SFAS No. 117, "Financial Statements of Not-for-Profit Organizations." SFAS No. 116 requires that contributions received, including unconditional promises to give (pledges), be recognized as revenues at their fair values. SFAS No. 117 establishes standards for external financial reporting by not-for-profit organizations and requires that net assets and the flow of those assets be classified in three net asset categories according to the existence or absence of donor-imposed restrictions.

The category *Unrestricted Net Assets* describes funds that are legally available for any purpose and have no donor-imposed restrictions; all revenues, expenses, gains, and losses are classified as unrestricted net assets unless they are changes in temporarily or permanently restricted net assets.

The category *Temporarily Restricted Net Assets* includes gifts for which donor-imposed restrictions have not been met (these are primarily future capital projects) and trust activity and pledges receivable whose ultimate use is not permanently restricted.

The category *Permanently Restricted Net Assets* applies to gifts, trusts, and pledges whose donors required that the principal be held in perpetuity and that only the income be available for stipulated program operations. This category includes gifts stipulated for student loans.

Nonoperating activities primarily reflect transactions of a long-term investment or capital nature, including contributions to be invested for the support of future operations, contributions to be used for facilities and equipment, and certain unrealized gains or losses.

Income from temporarily restricted sources is reclassified as unrestricted income when the circumstances of the restriction have been fulfilled. Donor-restricted revenues whose restrictions are met within the same fiscal year are reported as unrestricted income. All expenditures are reported in the unrestricted class of net assets, since the use of restricted contributions in accordance with the donor's stipulations causes the release of the restriction.

Investments

Investments are generally recorded at fair value, determined on the following basis:

- Equity securities with readily determinable fair values and debt securities are valued at the last sale price (if quotations are readily available) or at the closing bid price in the principal market in which such securities are normally traded (if no sale price is available). Certain fixed-income securities are valued using dealer-supplied valuations.
- The fair values of equity securities that do not have readily determinable fair values and of other investments are estimated by external investment managers and are reviewed by management or, if an objective basis is unavailable, at cost. The aggregate carrying value of such investments was $1,696.6 million and $1,747.8 million at August 31, 2001, and 2000, respectively, of which $55.8 million and $106.5 million, respectively, were carried at cost. A range of possible values exists for these securities, and therefore the estimated values may differ from the values that would have been used had a ready market for these securities existed.

Investment income is recorded on the accrual basis, and purchases and sales of investment securities are reflected on a trade-date basis.

Derivative Financial Instruments

The University enters into equity options and equity-indexed options to hedge the risk of decline in fair value of certain equity securities. The options reduce the primary market risk exposure (e.g., equity price risk) of the hedged item in conjunction with the specific hedged strategy and, if applicable, have a reference index (e.g., S&P 500) that is the same, or highly correlated with, the reference index of the hedged item. Such equity options are recorded at fair value.

Fair Values of Financial Instruments Other than Investments

The fair values of financial instruments other than investments are based on a variety of factors. In some cases, fair values represent quoted market prices for identical or comparable instruments. In other cases, fair values have been estimated based on assumptions about the amount and timing of estimated future cash flows and assumed discount rates reflecting varying degrees of risk. Accordingly, the fair values may not represent actual values that could have been realized at year-end or that will be realized in the future. Fair values of the University's financial instruments other than investments approximate their carrying value in the accompanying consolidated financial statements.

Accounts and Notes Receivable

Accounts receivable arising from tuition and fees are carried net of an allowance for doubtful accounts of $510,000 and $824,000 as of August 31, 2001, and 2000, respectively. Notes receivable resulting from student loans are carried net of an allowance for doubtful accounts of $325,000 and $372,000 as of August 31, 2001, and 2000, respectively.

Land, Buildings, and Equipment

The value of land, buildings, and equipment is recorded at cost or, if received as gifts, at fair market value at the date of the gift. Significant renewals and replacements are capitalized. The cost of repairs and maintenance is expensed as incurred. Purchases of library books are also expensed.

Depreciation is calculated using the straight-line method over the useful lives of the buildings and equipment, which are estimated to be 3 to 20 years for equipment and a maximum of 40 years for buildings. If the carrying value of an asset exceeds the sum of estimated undiscounted future cash flows, an impairment loss is recognized for the difference between estimated fair value and carrying value.

Charitable Remainder Trusts

Charitable remainder trusts are classified as permanently restricted net assets if, upon termination of the trust, the donor permanently restricts the remaining trust assets. If the remainder is temporarily restricted or unrestricted by the donor, the charitable remainder trust assets are recorded as temporarily restricted net assets.

Annuities Payable

Annuities payable consist of annuity payments currently due and the actuarial amount of annuities payable. The actuarial amount of annuities payable is the present value of the aggregate liability for annuity payments over the expected lives of the beneficiaries (based on the mortality tables in the Internal Revenue Code as of January 1, 1997).

Revenue Recognition

Revenues from tuition and fees are reported in the fiscal year in which educational programs are predominantly conducted. Fall-quarter tuition and fees, billed in the prior fiscal year, are reported as deferred revenue.

Grants and contracts revenue is recognized as expenses are incurred on the project. Private gifts, including unconditional promises to give, are recognized as revenues in the period received. Conditional promises to give are not included in revenue until the conditions are substantially met. Pledges receivable due in more than one year are recorded at the present value of the estimated future cash flows. The expiration of a donor-imposed restriction on a contribution is recognized in the period in which the restriction expires, and the related resources then are classified as unrestricted net assets.

Income Taxes

The University is exempt from income taxes under Section 501(c)(3) of the U.S. Internal Revenue Code, except with regard to unrelated business income, which is taxed at corporate income tax rates.

Uses of Estimates in the Preparation of Financial Statements
The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities; the disclosure of contingent assets and liabilities at the date of the financial statements; and the reported amounts of revenues and expenses during the relevant period. Actual results could differ from those estimates.

At August 31, 2001, and 2000, reserves were established for uncollectible accounts, student loans, and pledges receivable. These reserves were estimated based on historical collection and allowance practices as well as on management's evaluation of current trends.

The reserves for self-insurance and postretirement medical and life insurance benefits were based on actuarial studies.

The University believes that the methods and assumptions used in computing these liabilities are appropriate.

Accounting Pronouncements
The Financial Accounting Standards Board issued two new accounting pronouncements related to derivative financial instruments for which implementation was required for fiscal 2001. The implementation of these new pronouncements did not have a significant impact on the University's financial statements or require a transition adjustment.

Reclassifications
Certain 2000 amounts have been reclassified to conform to the 2001 presentation.

2. Contributions Receivable

Contributions receivable consisted of the following:

(in thousands of dollars)	*August 31, 2001*	*August 31, 2000*
Unconditional promises expected to be collected in		
Less than one year	$111,104	$94,471
One year to five years	126,283	126,712
More than five years	11,529	3,078
Less discount to present value and other reserves		
Discount to present value	(33,536)	(27,863)
Other reserves	(13,339)	(15,395)
Total	**$202,041**	**$181,003**

3. Bonds and Notes Payable

The University had $82 million and $70 million placed in commercial paper at August 31, 2001, and 2000, respectively. The issues as of August 31, 2001, mature in fiscal 2002. Bonds payable are as follows:

(in thousands of dollars)	*August 31, 2001*	*August 31, 2000*
Mortgage bonds		
Illinois Educational Facilities Authority (IEFA)–Series 1974, 6.183%	$1,415	$1,835
Demand revenue bonds		
IEFA–Series 1985 varying adjustable interest rates	35,300	35,300
IEFA–Series 1985 University Pooled Financing Program, variable rate	14,000	16,000
IEFA–Series 1985 Cultural Pooled Financing Program, variable rate	10,028	10,040
IEFA–Series 1988, variable rate	46,000	46,200
IEFA–Series 1993, fixed rate	72,650	74,520
Less unamortized discount on IEFA–Series 1993	(2,155)	(2,262)
IEFA–Series 1996, fixed rate	—	20,000
IEFA–Series 1997, fixed rate	150,000	150,000
Total	**$327,238**	**$351,633**

Total obligations at August 31, 2001, are scheduled to mature through August 31 of each period as follows:

in thousands of dollars)	
2002	$4,722
2003	4,837
2004	4,952
2005	6,637
2006	11,722
2007–2011	81,161
2012–2016	103,185
2017–2021	35,215
2022–2026	67,162
Thereafter	9,800
Total	**$329,393**

Mortgage bonds, totaling $1.4 million at August 31, 2001, are collateralized by land and buildings with carrying values of $6.6 million at August 31, 2001. In addition, at August 31, 2001, the University had $1.8 million in assets held by trustees for debt service. The IEFA–Series 1974 bond issue is further collateralized by the first $475,000 of student tuition and fees collected in each calendar year.

At the option of the University and upon compliance with certain conditions, the IEFA–Series 1985 and 1988 bonds may operate in one of four variable-interest-rate modes or may be converted to a fixed rate until maturity or earlier redemption. At August 31, 2001, $35.3 million of the Series 1985 and all of the Series 1988 demand revenue bonds operated in the weekly variable modes, under which the interest rate is adjusted weekly based on prevailing market rates for similar securities. The weekly interest rate at August 31, 2001, was 2.1 percent.

Under the IEFA–Series 1985 Cultural Pooled Financing Program, the University assumed an additional liability representing its prorated share of underabsorbed financing costs that at August 31, 2001, amounted to $291,000. The University Pooled Financing Program and Cultural Pooled Financing Program may operate in the weekly variable-interest-rate mode or may be converted to a fixed rate until maturity. The fixed-rate conversion requires the consent of all participants in the pools. At August 31, 2001, the bonds operated in the weekly variable mode and bore interest at 2.1 percent. The bonds are collateralized by certificates of deposit held by the trustee in amounts equal to 1.67 percent of the bonds outstanding.

The IEFA–Series 1993 Revenue Refunding Bonds operate in a fixed mode until maturity, bearing interest at fixed rates ranging from 3 percent to 5.55 percent (weighted average rate at August 31, 2001, of 5.3 percent) and maturing from December 1, 2001, to December 1, 2021. Proceeds of the refunding bonds were invested in United States government securities with a cost of $75.4 million and placed in escrow to satisfy scheduled payments of $66.4 million of the IEFA–Series 1985 bonds and related interest until maturity. In 1993 this transaction was accounted for as an in-substance defeasance.

The IEFA–Series 1976 and 1977 demand revenue bonds were defeased on June 1 and July 1, 1996, respectively, through the issuance of commercial paper through the IEFA–Series 1995 Pooled Financing Program. Principal payment on the 1985 demand revenue bond is also included in the program. At August 31, 2001, the commercial paper issued under the program totaled $32 million, all maturing within a year.

The IEFA–Series 1996 demand revenue bonds matured in December 2000 and carried a fixed interest rate of 4.75 percent.

The IEFA–Series 1997 adjustable medium-term revenue bonds operate in a fixed mode until maturity, bearing interest at fixed rates ranging from 4.7 percent to 5.25 percent (weighted average rate at August 31, 2001, of 5.07 percent) and maturing from November 1, 2005, to November 1, 2015. The bonds are subject to mandatory tender at the stated dates and may be reissued in one of several permissible modes described in the agreements. The bonds will ultimately mature on November 1, 2032.

The lending agreements covering the IEFA demand revenue bond issues also provide that the bank may purchase bonds, at a rate not exceeding the bank's corporate base rate or prime rate (as defined), for which a demand has been made.

The lending agreements covering the demand revenue bond issues contain covenants that, among other things, require the University to maintain prescribed amounts of working capital (as defined). The covenants place certain limits on indebtedness and require holding investments in prescribed minimum amounts and maintaining certain financial ratios related to debt service, net assets to indebtedness, and assets to indebtedness. The University was in compliance with the covenants at August 31, 2001.

4. Investments

The University's investments are overseen by the Investment Committee of the Board of Trustees. Guided by the policies established by the Investment Committee, the University's Investment Office manages the investment of endowment and trust assets, certain working capital, temporarily invested expendable funds, and commercial real estate. These assets are managed by external equity investment managers, external and internal fixed-income and cash managers, and various limited partnership managers.

Substantially all these assets are merged into internally managed investment pools on a market-value basis; each holder subscribes to or disposes of units on the basis of the market value per unit at the beginning of each month.

Endowment Payout/Spending Rule

The University uses a total-return concept in determining allowable spending for endowment and quasi-endowment funds invested in its Long-Term Balanced Pool. The spending rule is that in each fiscal year, an amount between 3.5 percent and 6 percent of the market value of the pool (measured on a three-year moving average) be allocated to holders of units of the pool. The amount should equal the amount allocated in the previous fiscal year, adjusted by the net change in the projected Consumer Price Index (CPI). In 2001 the Investment and Budget Committees approved an adjustment to the payout in excess of the spending rule.

If endowment income received is not sufficient to support the total-return objective, the balance is provided from realized and unrealized gains. If income received is in excess of the objective, the balance is reinvested in the Long-Term Balanced Pool on behalf of the unit holders.

The University's policy is to allocate the current income of all other investment pools.

Investment Market Value

The following charts show the cost and estimated fair value of investments held by the University:

		August 31, 2001		*August 31, 2000*
(in thousands of dollars)	**Cost**	**Estimated fair value**	**Cost**	**Estimated fair value**
Equity securities				
Domestic	$799,847	$713,505	$767,491	$1,068,417
International	324,213	291,387	202,993	278,576
Debt securities				
Domestic — government	568,605	590,597	404,428	405,268
Domestic — corporate debt securities	113,854	109,637	154,826	146,462
International	13,357	19,917	65,357	96,624
Other investments				
Distressed securities	72,186	94,959	85,666	94,346
Hedge funds	306,542	533,023	247,032	428,714
Natural resources	108,305	130,229	91,824	100,858
Private equity	610,602	641,389	507,053	827,623
Real estate	175,190	226,350	170,930	210,286
Other	54,232	70,662	57,206	86,230
Total investments	**$3,146,933**	**$3,421,655**	**$2,754,806**	**$3,743,404**

The University is committed to making future capital contributions in other investments in the amount of $655 million, primarily in the next five years.

The carrying value of the University's investments (excluding intrauniversity investments, cash, and cash equivalents) is shown by investment pool in the following charts:

					August 31, 2001
(in thousands of dollars)	**Operations and plant**	**Quasi-endowment**	**Annuity and life-income**	**Permanent endowment**	**Total**
Long-Term Balanced Pool	$44,451	$1,013,835	$35,858	$1,668,011	$2,762,155
Intermediate-Term					
Bond Pool	243,615	5,922			249,537
Separately invested	4,879	14,820	147,370	5,392	172,461
Working capital	237,502				237,502
Total investments	**$530,447**	**$1,034,577**	**$183,228**	**$1,673,403**	**$3,421,655**

(in thousands of dollars)	Operations and plant	Quasi-endowment	Annuity and life-income	Permanent endowment	August 31, 2000 Total
Long-Term Balanced Pool	$49,156	$1,113,993	$44,018	$1,845,170	$3,052,337
Annuity and Life Income Bond Pool			6,390		6,390
Intermediate-Term Bond Pool	244,613	6,568			251,181
Charitable Remainder Trust Balanced Pool			85,378		85,378
Charitable Remainder Trust Tax-Exempt Pool			17,503		17,503
Separately invested	37	19,149	69,638	4,055	92,879
Working capital	237,736				237,736
Total investments	**$531,542**	**$1,139,710**	**$222,927**	**$1,849,225**	**$3,743,404**

Investment Return

The components of total investment return were as follows:

(in thousands of dollars)	August 31, 2001	August 31, 2000
Investment income	$86,106	$85,427
Net realized gains	343,169	413,975
Change in net unrealized (losses) gains on investments reported at fair value	(714,094)	390,691
Total investment return	**($284,819)**	**$890,093**

Investment return from operations is defined as the investment payout according to the spending rule for the Long-Term Balanced Pool and the actual investment income for all other investments. As reflected in the Consolidated Statements of Activities, investment return was as follows:

(in thousands of dollars)	August 31, 2001	August 31, 2000
Changes in unrestricted net assets		
Operating: investment return	$185,936	$160,690
Nonoperating: investment (losses uninvested) gains reinvested	(472,725)	728,006
Changes in temporarily restricted net assets		
Investment return	1,970	1,397
Total investment return	**($284,819)**	**$890,093**

Derivative Financial Instruments

The University uses derivative equity collars in the form of options to hedge equity exposure related to restricted assets held in trust. The value of the put and call options associated with the equity collars is inversely related to the market value of the underlying equity securities when outside of the range of the equity collars. The market value of the underlying equity assets hedged to the equity collars was $29.2 million at August 31, 2001.

Credit exposure represents the University's potential loss if all the counterparties fail to perform under the terms of the contracts, and if all collateral, if any, becomes worthless. This exposure is measured by the fair value of contracts with a positive fair value at the reporting date.

The University manages its exposure to credit risk by utilizing highly rated counterparties, establishing risk control limits, and obtaining collateral where appropriate. As a result, the University has limited credit risk. To date, the University has not incurred any losses on derivative financial instruments due to counterparty nonperformance.

The University regularly reviews the use of derivative financial instruments by each of the managers of alternative investment funds in which it participates. While these outside managers generally use such instruments for hedging purposes, derivative financial instruments are employed for trading purposes by five independent asset managers of funds totaling approximately $314 million and $254 million at August 31, 2001, and 2000, respectively.

5. Retirement Plans

The University maintains two contributory retirement plans for its eligible faculty and staff. The plans offer employees the choice of two investment company options, Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF), and the mutual funds offered by Fidelity Investments. Participating employee and University contributions are immediately vested. The University contributed $21.3 million and $22.7 million to the two plans in 2001 and 2000, respectively.

The University currently sponsors a health care plan permitting retirees to continue participation on a "pay-all" basis, which requires a retiree contribution based on the average per capita cost of coverage for the entire plan group of active employees and retirees rather than the per capita cost for retirees only. Retirees are also eligible to participate in certain tuition reimbursement plans and may receive a payment for sick days accumulated at retirement.

The University funds the benefit costs as they are incurred. The accumulated postretirement benefit obligation (APBO) was as follows:

(in thousands of dollars)	*August 31, 2001*	*August 31, 2000*
Active employees not yet eligible	$2,067	$1,600
Active employees eligible	2,514	1,920
Retirees	1,507	1,086
Unrecognized prior service cost	(1,148)	(1,257)
Unrealized loss	(1,909)	(739)
Total	**$3,031**	**$2,610**

The components of the net periodic postretirement benefit cost were as follows:

(in thousands of dollars)	*August 31, 2001*	*August 31, 2000*
Service cost (benefits attributed to employee service during the year)	$292	$212
Interest cost on accumulated postretirement benefit obligation	413	357
Amortization of prior service cost	109	109
Amortization of unrealized loss	117	24
Net periodic postretirement benefit cost	**$931**	**$702**

During fiscal 2001 postretirement benefit payments (net of retirees' contributions) were approximately $281,000.

The discount rate used in determining the APBO was 7 percent and 8 percent as of August 31, 2001, and 2000, respectively. The assumed health care cost trend rate used in measuring the APBO was 5 percent for 1999 and thereafter.

If the health care cost trend rate assumptions were increased by 1 percent, the APBO as of August 31, 2001, would have been increased by approximately 5.5 percent. The effect of this change on the sum of the service-cost and interest-cost components of the net periodic postretirement benefit cost for 2001 would have been an increase of 7.2 percent.

6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

(in thousands of dollars)	*August 31, 2001*	*August 31, 2000*
Land and improvements	$26,107	$26,246
Buildings	971,183	903,473
Equipment	156,776	154,130
Accumulated depreciation	(400,477)	(369,660)
Total	**$753,589**	**$714,189**

At August 31, 2001, the University had under construction buildings that will cost approximately $202.8 million. The estimated cost to complete this construction is $150.6 million. Costs incurred through August 31, 2001, of $52.2 million are included in land, buildings, and equipment. These buildings are being funded by loans, gifts (received or pledged), and grants.

7. Allocation of Expenses

The University allocated depreciation, plant maintenance expenditures, and interest on indebtedness to the various functional expense categories in the Consolidated Statements of Activities for the fiscal years ended August 31, 2001, and 2000. Those expenses have been distributed to the functional areas of the University as follows:

(in thousands of dollars)			*August 31, 2001*
	Depreciation	**Plant maintenance**	**Interest on indebtedness**
Instruction	$6,961	$14,157	$2,687
Research	8,151	16,576	3,146
Academic support	9,296	18,906	3,589
Student services	2,203	4.480	850
Institutional support	3,216	6,541	1,242
Auxiliary services	14,232	28,942	5,494
Total	**$44,059**	**$89,602**	**$17,008**

(in thousands of dollars)			*August 31, 2000*
	Depreciation	**Plant maintenance**	**Interest on indebtedness**
Instruction	$9,386	$11,409	$2,836
Research	10,990	13,358	3,321
Academic support	12,534	15,236	3,787
Student services	2,970	3,610	898
Institutional support	4,336	5,271	1,310
Auxiliary services	19,188	23,323	5,798
Total	**$59,404**	**$72,207**	**$17,950**

The allocations were based on the functional use of space on the University's campus.

8. Self-Insurance Reserves and Other Contingencies

The University maintains a self-insurance program for general liability, professional liability, and certain employee and student insurance coverages. This program is supplemented with commercial excess insurance above the University's self-insurance retention.

Reserves for losses under the University's self-insurance program, aggregating $39.9 million and $34.1 million at August 31, 2001, and 2000, respectively, include reserves for known losses and for losses incurred but not yet reported. A portion of the reserves pertaining to professional liability has been determined on a discounted present-value basis. Self-insurance reserves are necessarily based on estimates of historical loss experience, and while management believes that the reserves are adequate, the ultimate liabilities may be in excess of or less than the amounts provided.

Under an agreement between the University and Northwestern Medical Faculty Foundation (NMFF), a proportionate share of professional liability insurance costs is borne by NMFF.

The University has borrowed under an agreement whereby monies are advanced for the purpose of originating student loans. These loans, when fully disbursed, are sold to the lending agency, and proceeds are applied to retire the debt amount. Additionally, the University has contracted to service these loans, which totaled $154.5 million at August 31, 2001. Service revenues are the excess of the actual interest collected above a guaranteed rate of return on the serviced loans. The University guarantees these loans against default up to a defined percentage of the original loan amount. At August 31, 2001, and 2000, $418,000 and $460,000, respectively, were reserved in anticipation of future defaults.

From time to time, various claims and suits generally incident to the conduct of normal business are pending or may arise against the University. It is the opinion of management of the University, after taking into account insurance coverage, that any losses from the resolution of pending litigation should not have a material effect on the University's financial position or results of operations.

All funds expended in connection with government grants and contracts are subject to audit by government agencies. While any ultimate liability from audits of government grants and contracts by government agencies cannot be determined at present, management believes that it should not have a material effect on the University's financial position or results of operations.

9. Natural Classification of Expenses

Operating expenses incurred in the fiscal years ended August 31, 2001, and 2000, were as follows:

(in thousands of dollars)	*August 31, 2001*	*August 31, 2000*
Salaries, wages, and benefits	$465,302	$435,383
Services and professional fees	108,774	100,178
Supplies	47,671	41,636
Travel and promotion	45,438	41,083
Other expenses	48,056	38,142
Maintenance, utilities, and equipment	95,627	85,870
Interest on indebtedness	17,008	17,950
Depreciation	44,059	59,404
Total	**$871,935**	**$819,646**

10. Closure of the Dental School

In March 1998 the Board of Trustees voted to discontinue the Dental School programs effective August 31, 2001. The University recorded a loss of $20.8 million for the year ended August 31, 1998, which included the estimated cost to implement the closing plan and a provision for operating losses through August 31, 2001. For the year ended August 31, 1999, the University reduced the recorded loss by $2.8 million after reassessing the estimated cost to complete the closing plan. As of August 31, 2001, the University had completed its planned closing of the Dental School. Additional losses of $1.5 million were recorded in 2001, bringing the total closure costs to $19.5 million.

The Dental School had $2.1 million and $4.1 million in revenue in the years ended August 31, 2001, and 2000, respectively; expenditures for each year were $10.2 million and $9.6 million, respectively. Substantially all assets of the Dental School that were not fully depreciated as of August 31, 2001, will be used by other schools and departments of the University.

Administration and Trustees

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