

**Minutes**  
**Special Informational Session**  
**Investment Committee**  
**Board of Trustees**  
**October 15, 2007**

IN ATTENDANCE:

Investment Committee Members:	Mr. Stephen P. Branscum Mr. James F. Hardymon Ms. Myra Leigh Tobin
Board of Trustees Members:	Ms. Mira S. Ball Dr. Charles R. Sachatello
Investment Staff & Consultants:	Mr. Henry Clay Owen Ms. Susan I. Krauss Mr. Steve Voss (Ennis, Knupp & Associates) Mr. Keith Black (Ennis, Knupp & Associates)
Others:	Dr. Lee T. Todd, Jr. Mr. Marc A. Mathews Mr. Sergio Melgar Mr. John Deans Mr. Dan Adkins

The meeting was called to order at 1:10 p.m.

Mr. Owen discussed the proposed timeline for the special informational session and investment consultant request for proposals, noting that the Investment Consultant RFP will be distributed on October 16<sup>th</sup>, with proposals due November 16<sup>th</sup>. The evaluation committee will review proposals and select finalists to make presentations to the Investment Committee in a special session to be held in January, 2008. The evaluation committee will consist of Mr. Owen, Ms. Krauss, Mr. Butler and Mr. Mathews. The proposed contract implementation date is April 1, 2008. Mr. Owen noted that January 21<sup>st</sup> was discussed previously as a possible date for the special session, however since January 21<sup>st</sup> is the Martin Luther King holiday, another date would need to be selected. Mr. Owen stated that Mr. Wilcoxson had suggested that the special session be held on January 23, 2008, which is the day after the January Board of Trustees meeting. All Committee members were in agreement with this date.

Ms. Krauss presented a table of returns from the 2006 NACUBO Endowment Study, displaying the fiscal year 2006 average returns of the participating institutions grouped by size of investment pool assets. The University's total return of 10.3% for the year ended June 30, 2006 slightly lagged the overall average return of 10.7% for all institutions participating in the survey, however the University significantly lagged the average return of 12.8% for endowments similar in size to UK (\$500 million to \$1 billion). The underperformance is attributable to UK's asset allocation, which consists of more exposure to traditional asset classes and less exposure to alternative asset classes. Alternative asset classes such as natural resources, private equity and real estate led returns in fiscal year 2006. Ms. Krauss pointed out that in all time periods (1, 3, 5 and 10 years) the average returns increased as the size of the investment pool increased. Ms. Krauss stated this is due to the fact that as investment pool assets increase, there is greater diversification and higher allocations to alternative asset classes, which have achieved higher returns over the last ten years. Ms. Krauss

reviewed a table summarizing the June 30, 2006 asset allocation of participating institutions, grouped by size, noting that the average allocation to alternative investments for all institutions was 18.8%. For endowments with assets in the \$500 million to \$1 billion range, the average allocation to alternatives was 31.5%, including an average hedge fund allocation of 17.4%. UK's allocation to alternatives as of June 30, 2006 was 7.4% (target allocation was 13%, comprised of 8% real estate and 5% private equity). Ms. Krauss reviewed other tables from the NACUBO study, including 2006 asset class return data and also a ten-year history of the average asset allocation.

Ms. Krauss reviewed 2006 return and asset allocation data of the University's nineteen benchmark institutions assigned by CPE. The average return of the nineteen benchmarks was 13.0% for the year ended June 30, 2006, compared to UK's return of 10.3%. UK also underperformed its benchmarks in the three, five and ten year periods. A review of the asset allocation at June 30, 2006 revealed that the benchmark institutions had an average allocation to alternatives of 33.9%, including an average hedge fund allocation of 18.6%. Ms. Krauss emphasized that while UK's historical returns are lower than our benchmark institutions, UK has met the primary objective of an endowment fund, which is generating returns equal to or greater than the sum of spending allocations, inflation, and the costs of managing the investments.

Mr. Black made a presentation titled "Introduction to Alternative Investments", discussing all aspects of alternative investments, which include hedge funds, venture capital, private equity, real estate, natural resources, among others. Investment in these asset classes has increased 30% since 2004 as these asset classes have low and/or negative correlations with stocks and bonds and offer reduced volatility of returns as compared to traditional stock/bond portfolios. Additionally, many alternatives can provide downside protection when stock and bond markets fall. However, there are issues that investors need to understand before investing in these asset classes, including illiquidity, high fee structures, lack of transparency, and changing correlations. Mr. Black also discussed the operational and market risks that should be considered when evaluating alternative investment strategies.

Mr. Black discussed the various types of hedge fund strategies, which fall into four broad categories as follows:

- 1) Relative Value – includes Equity Market Neutral, Fixed Income Arbitrage and Convertible Arbitrage;
- 2) Event Driven – includes Merger Arbitrage, Distressed Companies, and Other Events;
- 3) Directional – includes Equity Long/Short, Global Macro, and Tactical Asset Allocation;
- 4) Other – includes Multi Strategy, Real Asset, Emerging Markets, and Income Growth.

Mr. Black commented that there is great convergence in the industry right now as both institutional and asset management firms are introducing products that mimic hedge fund strategies, such as long/short equity and 130/30 equity. A 130/30 equity strategy involves shorting 30% of the portfolio and using the proceeds from the short sales to purchase additional long investments, resulting in 130% of the portfolio value being invested in long positions and 30% of the portfolio value being invested in short positions. Typically, these "institutional hedge fund-like" products are offered at much lower fee structures, with much more transparency than traditional hedge funds.

Mr. Black discussed investment strategies that fall into the real asset category, including real estate, commodities and timber. These types of investments provide real growth and a hedge in the event of high, unexpected inflation. Mr. Black reviewed return data for the period 1991 to 2007, which demonstrated that commodities outperformed stocks and bonds during weak market periods. Investing in commodities typically involves active management of commodities futures across a broad portfolio of different commodities. A manager attempts to add value by considering the supply and demand fundamentals in each market, actively rebalancing the weight between commodities, and focusing on contracts and roll strategies with the highest expected return. Mr. Black discussed infrastructure investing, which is the investment in infrastructure projects such as toll roads, bridges, utility networks, and other projects that have historically been financed

by government that are now being privatized. Infrastructure is appealing to institutional investors as it is a long duration, inflation-linked investment that provides a steady revenue stream and uncorrelated returns.

Mr. Black concluded that a reasonable alternative investment allocation would be 20% of assets. This allocation is less aggressive than the University's benchmark institutions, which had an average allocation of 34% to alternatives at June 30, 2006. Mr. Black recommended that the Investment Committee consider supplementing the current 8% real estate and 5% private equity allocations with a 7% allocation to hedge funds and other alternatives, including commodities and infrastructure.

Mr. Voss stated that the University has achieved investment success over the last ten years, with modest alternatives exposure, as the returns of the endowment pool have allowed for growth after spending and inflation. Meeting this primary objective in the future may be a greater challenge with lower return expectations for stocks and bonds. The University may also find it to be a continued challenge competing with peer institutions as they allocate an increasing portion of their assets to alternative investments. Mr. Voss reviewed a calculation showing the effect of enhanced returns to the University's endowment. Based on fiscal year 2006 return data, had the University been exposed to 20% alternatives (8% real estate, 5% private equity and 7% hedge funds and infrastructure) and earned peer-like returns in the alternative segment, the total fund return would have been 12.6%, versus the actual return of 10.3%. The 2.3% additional return would have resulted in additional growth to the endowment of \$12.6 million (based on the beginning FY06 endowment size of \$548 million), generating over \$500,000 of incremental spending. Mr. Voss concluded that a 20% alternatives allocation would reduce the University's reliance on equities, enhance returns over time and allow the University to be more competitive with peer institutions. Mr. Voss emphasized that increasing the allocation to alternatives is not required and added that it is important to continue with educational discussions and gain consensus as a group.

After some discussion by the Committee, Mr. Owen concluded by saying the purpose of the session was to provide information and share how other institutions are utilizing different types of alternative investments to enhance diversification and increase returns. Mr. Owen recommended that the Committee defer any decisions on asset allocation until the consultant RFP process is complete. At that time, a formal review of asset allocation will be initiated.

With no further business, Ms. Tobin made a motion that the meeting be adjourned, Mr. Hardyman seconded the motion and all approved. The meeting adjourned at 4:00 p.m.

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Susan I. Krauss  
Office of the Treasurer