

**Minutes  
Investment Committee  
Board of Trustees  
September 13, 2011**

IN ATTENDANCE:

Investment Committee Members:	Mr. Carol Martin Gatton, Chair Dr. Joe Peek Mr. Erwin Roberts Mr. James W. Stuckert
Community Advisory Members:	Mr. Billy B. Wilcoxson
Investment Staff & Consultants:	Ms. Angela S. Martin Ms. Susan I. Krauss Ms. Donna A. Counts Ms. Rebecca Gratsinger (R.V. Kuhns & Associates) Mr. Steve Hahn (R.V. Kuhns & Associates) Mr. Roman Nemtsov (R.V. Kuhns & Associates)
Others:	Dr. Britt Brockman* Ms. Shelia Brothers* Mr. Micah Fielden* Ms. Sandy Bugie Patterson* Dr. Charles R. Sachatello*

\*Attended the meeting prior to the closed session.

Mr. Gatton called the meeting to order at 8:30 a.m. and asked for a motion to approve the June 13, 2011 and June 14, 2011 minutes. Mr. Stuckert made the motion to approve, Mr. Roberts seconded the motion and all approved.

Mr. Gatton introduced the first agenda item by introducing Susan Krauss to discuss IC 1. Ms. Krauss stated that IC 1 is a recommendation to terminate the University's contract with GAM, absolute return fund-of-funds manager, due to departure of four senior investment team members in the last few months. Upon approval of the action, staff will request a full redemption request, effective for December 31, 2011. Ms. Krauss noted that GAM's required notification period is 95 calendar days prior to quarter-end and that redemption proceeds are expected to be received within 35 calendar days after December 31<sup>st</sup>. Ms. Krauss reported that an RFP for a new manager was issued on August 3<sup>rd</sup> and that staff and RVK were currently evaluating proposals and plan to bring a manager recommendation to the Committee on October 25<sup>th</sup>. The selected firm will be invited to make a presentation to the Committee on October 25<sup>th</sup> and staff and RVK will recommend that the Committee authorize staff and RVK to conduct an on-site due diligence visit of the manager and proceed with contract negotiations if the results of the on-site visit are satisfactory. The objective is to have the contract with the new manager executed by the end of the year so the redemption proceeds from GAM can be invested early next year. Ms Krauss commented that most absolute

return managers accept new subscriptions on a monthly basis, so it's likely that the redemption proceeds will need to be temporarily invested. Staff will work with RVK on a transition plan to maintain appropriate market exposure.

Mr. Peek moved to approve IC 1, Mr. Stuckert seconded the motion and the motion passed unanimously.

Mr. Gatton introduced the next agenda item which was a review of the asset allocation and rebalancing activity by Ms. Krauss. Ms. Krauss reported that the total market value of the endowment pool was \$942.2 million as of July 31<sup>st</sup>, with 42% in equities, 18% in fixed income and 40% in alternatives. She reviewed the actual asset allocations, the target allocations, and the over/under target positions for the managers. She stated that she will continue to monitor the positions and likely complete a formal rebalancing in the fourth quarter of 2011. She reported that a \$20,000,000 transfer of funds was made on July 1<sup>st</sup> between the two PIMCO fixed income strategies to implement the new target allocations approved by the Committee in June. The target allocation to the PIMCO Unconstrained Bond Fund was increased from 3% to 5% and the target for PIMCO's Core-Plus strategy was reduced from 7% to 5%. She noted the undertarget positions for private equity and real estate and the corresponding overtarget positions in public equities and fixed income. Ms. Krauss then reviewed a new summary of the private equity and real estate commitments and related capital calls. As of July 31, 2011, \$90.4 million has been committed to sixteen private equity funds and \$43.7 million or 48% has been called by the managers. For real estate, \$28.0 million has been committed to four funds and \$17.1 million or 61% has been called.

Mr. Gatton then moved on to the next item on the agenda, the investment performance review and market update, presented by Becky Gratsinger, CEO of R.V. Kuhns & Associates. Ms. Gratsinger stated she was delighted to attend today's meeting on Rob Palmeri's behalf. She noted that her performance review would focus mainly on the fiscal year results.

Ms. Gratsinger first provided a capital markets review for the fiscal year, noting that most asset classes had achieved strong returns, with equities delivering the strongest returns for the year, in the 30% range. Small caps achieved the highest returns, with the Russell 2000 and MSCI EAFE Small Cap indices returning 37.4% and 36.9%, respectively. The real estate asset class also achieved strong returns during the fiscal year, which was a welcome relief since this is the last asset class to come back after the market downturn that began in late 2007. The NCREIF ODCE Index returned 20.5% for the fiscal year and the Wilshire US REIT index returned 35.6%.

Ms. Gratsinger reviewed UK's asset allocation as of June 30, 2011 as compared to the target allocation and a peer group of other endowments, noting that the University has made good progress on its diversification efforts. Ms. Gratsinger then reviewed the attribution for the total fund noting that the endowment pool returned 18.71% net of fees, underperforming the target allocation index by 58 basis points. The underperformance was mainly due to underperformance by the international equity managers and an overweight position to fixed income during the period. Ms. Gratsinger commented that we are likely benefiting from the fixed income overweight at this time due to the volatility of the markets since the fiscal year-end. In the month of August alone, the S&P 500 index was down 5.4% and U.S. small caps were down 8.7%. Looking at calendar year-to-date returns through August, the S&P 500 is down 1.8%, U.S. small caps are down 6.5%, international developed market equities are down 5.7% and international emerging markets equities are down 8.3%. The fixed income market is up 5.9% year-to-date through August. Many factors are weighing on investors' minds at this time, including the sovereign debt crisis overseas, the banking sector

overseas, the U.S. debt ceiling crisis and continued concerns about the U.S. economy and real estate market. Ms. Gratsinger stated we can continue to expect volatility in the coming months and that RVK is happy about the University's diversification efforts as we have lessened our reliance on any one market and spread the investment strategy over many different markets and asset classes.

Ms. Gratsinger reviewed the total fund thematic and liquidity analysis. The four broad themes of the portfolio are capital appreciation, capital preservation, alpha and inflation. The endowment pool has a 51% target allocation to capital appreciation strategies, made up of equities and non-core real estate; a 15% allocation to capital preservation strategies, made of fixed income; a 20% allocation to alpha strategies, which includes the absolute return or hedge fund strategies; and a 14% allocation to inflation strategies, which includes the real return and core real estate strategies. Ms. Gratsinger reviewed the liquidity of the portfolio noting that 55% is in liquid strategies, 30% is in less liquid, absolute return-oriented strategies, and 15% is in illiquid or private strategies. So from a liquidity point-of-view, the portfolio is well-positioned.

Ms. Gratsinger reviewed the fiscal year attribution for each asset class and the transition adjustments made in the fourth quarter of 2010 in order to implement the new target allocation.

During the review of the real return asset class, Mr. Stuckert asked about PIMCO's real return strategy and whether that strategy follows Bill Gross' investment recommendations or the recommendations of an investment committee. Ms. Gratsinger commented that the PIMCO All Asset All Authority strategy was managed by Research Affiliates, a subadvisor, with Rob Arnott of Research Affiliates making the asset allocation decisions about which PIMCO funds to invest in. Bill Gross has an impact on the strategy of the underlying PIMCO funds. Mr. Stuckert asked whether asset allocation or investment decisions account for the fund's outperformance over the benchmark. Ms. Gratsinger responded that the outperformance is attributed to both the asset allocation decisions and the underlying fund performance, with more attributed to asset allocation. Mr. Peek commented that he doesn't understand the fear of inflation right now as it will not happen in the next 3 to 5 years. Ms. Gratsinger responded that the inflation position is a long-term statement in the asset allocation and the costs of running a University are typically greater than the urban CPI. Additionally, the real return and real estate allocations have additional benefits other than inflation protection. Historically, real estate has behaved differently than the equity markets so there is a correlation benefit. In the case of real return, both PIMCO and Wellington manage their portfolios with an absolute return goal and tactically allocate among various asset classes, providing a diversification benefit.

Ms. Gratsinger concluded her fiscal year review and congratulated the Investment Committee and staff in on completing the transition to the new asset allocation during the year.

The next item on the agenda was a review of the Cash, Overnight and Short-Term Investment Report by Donna Counts. Ms. Counts reported that as of July 31, 2011, there was \$421.9 million in overnight and short term investments. Ms. Counts also reported that cash held at and managed by the state as of July 31<sup>st</sup> totaled \$128.5 million, resulting in total cash and operating investments of \$550.4 million. Total return on overnight funds for July was 0.03% and the return on short term investments was 0.74%. The returns achieved are in line with the market indices for July. Attempts have been made to find better returns, but overnight and short term rates are extremely low. Ms. Counts stated that staff is considering some changes to the Overnight and Short Term Investment Policy that could allow for increased returns, however the University is still subject to State's investment restrictions which are fairly restrictive. She noted that the State's short term pool incurred a small mark-to-market adjustment due to uncertainly and turmoil in the markets in July, which

caused the value of governments securities to decrease at the end of July. The value of the short term investment pool has increased since July.

Mr. Peek stated that he needed to ask the same question that he has asked at prior meetings, which is why we need to keep \$500-600 million in short term investments on hand getting no return. He stated that he understands there are state regulations involved and would like to see the specific regulations and have them explained in detail as he doesn't think the private sector would hold this much cash.

Mr. Butler responded that after Mr. Peek questioned this issue at the June Investment Committee meeting, he conducted an email survey of SEC institutions' CFOs on how much cash/short term investments the schools keep on hand for working capital. Mississippi reported the lowest amount at \$400 million, Vanderbilt reported the highest figure at \$1 billion, and the mean or average reported was \$510 million. Based on this survey, Mr. Butler concluded that UK's liquidity or working capital cash and investments is in line with other SEC institutions.

Mr. Gatton then stated that the Investment Committee needs to go into closed session in order to hear reports on evaluation of proposals for the private equity and real estate manager searches and also to hear presentations from the finalists. He stated that the Committee will then recommend the firms with which the University should negotiate a contract. The Committee must go into closed session because an open discussion on the firms and the deliberations of the Committee could jeopardize the retention of a firm for the university.

Mr. Gatton outlined the guidelines for the closed session stating that only those persons necessary to provide information to the Committee, and appropriate staff, may be present with the Committee. Nothing else may be discussed in the closed session but information relating to the private equity and real estate manager searches. He stated that when the manager presentations and Committee discussion has been completed, no vote may be taken in closed session and all manager presentation materials must be returned to John Deans of UK's Purchasing Division.

Mr. Gatton then made a motion that the Committee go into closed session pursuant to KRS 61.810 (1) (g). The motion was seconded by Mr. Stuckert and was approved unanimously. The Committee went into closed session at 9:15 a.m.

At 11:10 a.m. Mr. Gatton announced that the closed session of the Investment Committee had concluded and no matters other than the announced matter were discussed and no final action was taken. He said the Committee is now back in open session and will proceed with votes on IC 2 and IC 3. Mr. Gatton asked for a motion to approve IC 2, which authorizes the Executive Vice President for Finance and Administration, or his designee, to enter into contract negotiations with a new private equity manager. Mr. Stuckert moved to approve IC 2, Mr. Roberts seconded the motion and the motion passed unanimously. Mr. Gatton then asked for a motion to approve IC 3, which authorizes the Executive Vice President for Finance and Administration, or his designee, to enter into contract negotiations with a new real estate manager. Mr. Stuckert moved to approve IC 3, Mr. Peek seconded the motion and the motion passed unanimously.

With no further business, the meeting adjourned at 11:12 a.m.

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Susan I. Krauss  
Office of the Treasurer