

**Minutes
Investment Committee
Board of Trustees
December 10, 2012**

IN ATTENDANCE:

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|---------------------------------|---|
| Investment Committee Members: | Carol Martin Gatton, Chair William C. Britton Mark P. Bryant William S. Farish, Jr. James W. Stuckert |
| Community Advisory Members: | James F. Hardymon Henry Clay Owen |
| Investment Staff & Consultants: | Angela S. Martin Susan I. Krauss Donna A. Counts Rob Palmeri (R.V. Kuhns & Associates) Ron Klotter (R. V. Kuhns & Associates) |

Mr. Gatton called the meeting to order at 1:00 p.m. and asked for a motion to approve the September 11, 2012 minutes. Mr. Stuckert made the motion to approve, Mr. Britton seconded the motion and all approved.

Mr. Gatton introduced the first item on the agenda by introducing Susan Krauss to discuss IC 1. Ms. Krauss stated that IC 1 is a recommendation to extend the contract with R.V. Kuhns & Associates (“RVK”) to provide consulting and performance measurement services for the University of Kentucky Endowment for the period July 1, 2013 through June 30, 2014, subject to the terms and conditions of the existing contract. Mr. Krauss explained that the University hired RVK in early 2008 as a result of a Request for Proposal (RFP) process and the term of the original contract was April 1, 2008 through March 31, 2012. On February 21, 2012 the Investment Committee approved the first extension for the period April 1, 2012 through June 30, 2013.

Ms. Krauss stated that approval of the action does not bind UK for the entire next fiscal year as we have a 30-day cancellation clause. She indicated that staff will be doing a benchmarking study over the next few months to evaluate how UK’s endowment investment function is structured compared to our peer institutions; evaluating both internal staffing levels and the use of consultants or other service providers, such as an outsourced chief investment officer. The outcome of this benchmarking study may influence future consulting contracts and may result in acceleration of an RFP process and cancellation of the existing contract with RVK. Mr. Stuckert made a motion to approve. Mr. Britton seconded the motion. The motion was approved unanimously.

Mr. Gatton introduced the next agenda item, approval of the Endowment Investment Policy and asked Ms. Krauss to proceed. Ms. Krauss explained that the policy calls for a formal annual review. As a result of this year’s review two major issues have been discussed including changes to the asset allocation and changes to the spending policy. Ms. Krauss noted in June RVK reported on the asset allocation study and recommended adopting new allocations of Global Tactical Asset Allocation and Global Long-Biased Long/Short Equity, as well as increasing the private equity and private real estate allocations. The new global strategies would be funded by reducing U.S. and non-U.S. Equity and also Fixed Income. It was

decided to put the asset allocation recommendations on hold in order to provide educational sessions on the new strategies.

Ms. Krauss stated the recommended policy changes relate primarily to the spending policy. At the last meeting RVK presented a detailed analysis of different types of spending policies: a rolling market value approach, an inflation adjusted approach and a hybrid approach which is a blend of the market value and inflation approaches. After modeling different hybrid blends it is recommended that a 60/40 blend be approved. The hybrid formula will be 60% based on of last year's spending, adjusted for inflation, and 40% based on 4% of the trailing 36 month average market value. The recommended spending policy also includes an annual spending band of 3.0% to 6.0% so that the calculated spending rate cannot result in spending below 3.0% or above 6.0% of the current endowment market value. She said fiscal year 2013-14 will serve as a transition year to the new policy and spending will be based on 4.0% of the trailing 60 month average market value. The new hybrid policy will be fully implemented in fiscal year 2014-15.

Mr. Stuckert asked a question about the management fee and Ms. Krauss responded that the management fee would stay the same at 0.25% and would be in addition to the hybrid spending policy. She noted that while the stated management fee is 25 basis points, the effective fee is less since some endowments are exempt from the fee. Additionally, she stated that she expects the effective hybrid spending policy rate to be lower than 3.75% in the foreseeable future so long as inflation stays below 3%, since only 40% of the formula is subject to the 4% spending rate calculation. The long-term target return of the endowment is 7.5%; however due to lower capital market returns, RVK's most recent asset allocation study reflected an estimated 10-year return of 7.0% based on the current asset allocation. The 7.0% rate of return should be sufficient to support both the spending policy distributions and the management fee withdrawals. However, Ms. Krauss noted that staff and RVK would be more comfortable with establishing a 7.25% target rate of return in order to provide a safer margin, which is why changes to the asset allocation will be recommended soon.

Ms. Krauss said another policy change was related to spending on underwater endowments. The proposed policy requires suspension of spending and management fee withdrawals from any endowment underwater by more than 20%. Endowments underwater between 10% and 20% will undergo a formal review by the Treasurer and the appropriate college dean or department head to determine the appropriate level of spending in accordance the seven factors set forth in UPMIFA (Uniform Prudent Management Institutional Funds Act). As of September 30, 2012, UK had 2,048 endowment funds including 703 underwater funds. This was an improvement over the prior quarter when 798 funds were underwater. For this quarter, 18 endowment funds were underwater by more than 20%, and about 250 funds were between 10% to 20% underwater. These underwater funds would need to be reviewed with the respective deans and department heads.

Ms. Krauss said another proposed change is a provision to delay spending distributions on new endowments gifts for at least one year to build a spending reserve. Ms. Martin commented that the Endowment Advisory Group was supportive of the various spending policy changes. Mr. Britton made a motion to approve the investment policy and Mr. Stuckert seconded the motion. The motion passed unanimously.

Mr. Gatton introduced the next agenda item, a review of the asset allocation and rebalancing activity. Ms. Krauss stated that the market value of the endowment at the end of October was \$989 million, comprised of 41% equities, 15% fixed income and 44% in various alternatives. She noted that the various asset classes were in line with their targets, with the exception of being slightly underfunded in real estate. Ms. Krauss reviewed the private equity and real estate commitments, noting that 39% of the private equity commitments had been called and 56% of the real estate commitments had been called.

Mr. Gatton moved to the next agenda item, the performance review by Mr. Palmeri. Mr. Palmeri reported the total fund composite was up 4.62% gross of fees and outperformed the target allocation by 50 basis points. For the last three years, return of the endowment was 7.91%, and inflation during that period was 2.3%, so the real return was 5.58%, compared to the total spending policy objective of less than 5%. Thus, he pointed out the Endowment had exceeded the Endowment's stated spending objective over this period, which coincided with RVK's tenure in working with the Investment Committee. These results were accomplished in spite of creating/building out a much larger private equity and real estate equity program. He said the ten year return was 6.5%, and that time period included two significant market downturns and, consequently, because of the Endowment's high exposure to equities the Fund experienced a permanent impairment. When RVK was first hired, their initial recommendation was to lower the high exposure to equities and diversify the Endowment more broadly to reduce the probability of a similar downturn in the future. He noted soon after the last downturn in 2008, a new more diversified investment policy was adopted to reduce the negative impact of market downturns and reduce volatility. However, instead of diversifying immediately, RVK recommended UK wait until there had been some recovery of the equity investments and then dollar cost average the transition of the investments to the new asset allocations. Mr. Palmeri passed out a summary of the total fund composite against a peer group of endowments and foundations that are over a billion dollars or more. UK's endowment is approaching this level. Year to date the UK endowment fund performance is in the top quartile of this peer group. He also pointed out that the Endowment had done very well in three of the last four years RVK had worked with the UK investment Committee.

Mr. Palmeri moved on to discuss manager structure. In the domestic equity category, UK moved from an active manager to a passive manager three years ago. Since then the equity portfolio was up 12.96%. While this underperformed the index by .48%, it slightly exceeded the median US Equity performance for endowments. He stated that Wellington's small-cap strategy was down and underperformed by 46 basis points and noted that the strategy had undergone a recent change in the portfolio manager. As a result RVK will be recommending that the Emerging Companies strategy be closely monitored. Ms. Krauss added that Wellington has been an excellent manager over the long-term and has experienced other periods of short-term underperformance. She agreed that the strategy does need to be reviewed due to recent change in portfolio manager. Mr. Palmeri reported that the international equity composite was up 16.62% for the year, above the index by 2.13%. For the quarter, international equities were up 7.41% and outperformed domestic equities. He noted that Capital Guardian is the core manager and had done very well recently; while Mondrian, the value manager, has underperformed and William Blair, the growth manager, has performed well. The underperformance by Mondrian is as expected due to their value-orientation.

Mr. Owen asked if RVK remained comfortable with the international equity allocation. Mr. Palmeri responded that they were comfortable and pointed out the recent superior performance of the international sector. Ms. Krauss stated that the relative performance between domestic and international equity markets was one reason the committee was considering the global tactical asset allocation strategy, which would give the manager discretion to move between the domestic and international investments.

Mr. Palmeri reported that fixed income had fabulous performance. Calendar year-to-date fixed income was up 8.13%, exceeding the aggregate index by 4.14%. Over three years, the fixed income return has been 7.42%, in spite of a very poor year from PIMCO Core Plus fund in 2011, and outperformed the market by 1.23%. Mr. Palmeri said that real return had done well also with returns exceeding the index in all time periods, indicating good manager structure and performance. He noted that the PIMCO real return fund had also done particularly well in recent periods. Mr. Palmeri reviewed the status of the private equity and real estate investments with \$233 million in commitments, \$96 million in paid in capital and \$14 million in distributions. He said that while typical for a portfolio of this maturity, the slow distributions were a drag on the overall portfolio performance and would be until the distributions accelerate.

Mr. Gatton moved to the performance review for operating fund investments and asked Ms. Counts to proceed. Ms. Counts referred to the report in the committee notebook and noted that the report was presented in two sections, the table on top of the page summarized cash managed by the Office of the Treasurer and the table at the bottom of the page summarized University cash held and managed by the state. University managed cash is invested per the Operating Fund Investment Policy, which was recently reviewed by the Committee. Ms. Counts reported that as a result of changes to the policy, operating funds were now invested in the Federated Prime Fund and the Morgan Stanley Prime Fund. Those funds were selected after a detailed review by staff, the Treasury Investment Advisory Committee and RVK. Ms. Counts said that as of October 31st, \$267.1 was invested in overnight and short term investments. The annualized monthly return on the overnight and short term investments was 0.18%, which exceeded the yield on the three month treasury of 0.11%. She said the other investments, which are either direct investments in federal agencies or the Office of Financial Management Intermediate pool, totaled \$82.6 million and had an annualized yield of 0.64%. Ms. Counts stated that because rates are so low operating funds are being managed with very short duration keeping in mind that safety of principal is the first priority. Ms. Counts reported that cash held at the state totaled \$147.9 million and that total cash available to fund operations was \$497.5 million.

Mr. Gatton asked Mr. Palmeri to introduce the discussion of possible new investment strategies. Mr. Palmeri said that each year RVK does an asset allocation study to evaluate the investment portfolio and determine if there are any changes that could be made to help UK meet or enhance the target investment return. This year RVK recommended that UK consider new investment allocations to Global Tactical Asset Allocation (GTAA”) and Global Long-Biased Long/Short Equity. Mr. Palmeri indicated that PIMCO representatives had been asked to discuss global tactical asset allocation investing and Wellington Management representatives had been asked to discuss long/short equity investing.

Ms. Krauss reported that John West of Research Affiliates, the subadvisor on a PIMCO GTAA strategy, had planned to attend the committee meeting in person but was at the O’Hare International Airport due to flight mechanical problems. Consequently, he presented and discussed the strategy via conference call. Also joining the conference call was Sarah Blank and Caleb Pitters from PIMCO’s New York office.

Mr. West indicated that his comments were meant to be largely educational and he planned to explain why Research Affiliates believes it is prudent to invest using a Global Tactical Asset Allocation strategy. Mr. West began by stating it is important to outline market return expectations for the future. He reviewed trends in interest rates from 1976 to the September 2012 and noted the current yield of less than 2%. He indicated an expectation that future bond market yields would be in the 2% range. He noted equity returns over the last 30 years of 12%, and identified the components of that return as valuation expansion, real earnings growth, dividends and inflation. He expects to see little to no valuation expansion and much lower real earnings growth, slower economic growth, and lower productivity growth. Therefore he expects future stock market returns of 5% to 6%. He noted that alternative investments provide another investment option that offer better returns but also have higher fees and are more illiquid. Mr. West noted there are three options to improve returns: consider other asset classes that may offer risk premiums; seek alpha; and actively manage the asset mix by seeking assets that are out of favor and priced for better returns and adjusting the investment strategy based on the risk-reward premiums in different market environments. He noted these are the characteristics of global tactical asset allocation.

Mr. West discussed the PIMCO All Asset All Authority Fund (AAAAF) and returns over the past ten years. Over the ten year period the fund had a return of 8.4%, compared to the broad market return of close to 6%. In 2008 the fund declined by 6.93% when most endowment funds were down 25% or more. The fund was able to take advantage of the market declines of 2008 by buying when the market was down and experienced a 19.6% gain in 2009. Mr. West stated that global tactical asset allocation provides opportunities to shift investments as relative values and markets change.

Ms. Krauss introduced Lee Cohen and Chris Kirk from Wellington Management to discuss long/short equity investing. She explained that Mr. Cohen is UK's relationship manager and Mr. Kirk is the director of investment relations for the hedge fund group. Mr. Cohen provided a brief background on Wellington Management's ownership structure, business model, investment platform and firm culture.

Mr. Kirk discussed long/short equity investing and said Wellington had been managing hedge fund strategies since the early 1990's. He defined long/short investing as a more flexible strategy that allows active management of stocks by buying stocks they think will increase and selling (or shorting) stocks they think are too expensive and will decrease in value based on market conditions. Other tools to improve risk-adjusted returns include adding leverage through margin borrowing to purchase stocks and using derivative instruments to mitigate risk in volatile markets. He said another long/short tool is dynamic management of equity market exposure, which allows the manager to take a defensive position and cut market exposure by reducing long positions and adding short positions. He gave an example of a manager uncertain about a particular sector but with strong views on two particular companies within the sector. He said the manager may execute a "pair trade" within the sector and buy shares in one company they consider to be very strong and undervalued and sell shares, or short, a competitor that they feel is over-valued. This allows management to try to reduce sector volatility. Finally, he noted that long/short managers at Wellington have broad latitude across markets, geographies and sectors to find the best investments in a point in time.

Mr. Kirk said that historically the average long/short equity fund has outperformed average equity markets with less volatility. From 1990 to 2012, the average equity hedge fund had annualized returns of 12.7% compared to annualized volatility of 9%. This compares to 8.7% return for the S&P 500, with 15% annualized volatility. Mr. Kirk said one reason why hedge funds have been able to outperform broader equity markets over time is by protecting capital during down markets.

Mr. Kirk discussed Wellington's particular approach to long/short investing in the Archipelago Long/Short Equity Fund of Funds. He said each Wellington hedge fund is managed by the most experience managers at Wellington who are experts in the market sectors in which they are investing. The independently managed sector funds are combined to provide a diversified group of Wellington-managed long/short equity hedge funds, known as the Archipelago Fund. As of October 2012 the gross long position of the fund was 124% while the gross short position was -67%, for a net position of 57%. He said this indicated the Archipelago Fund had half the amount of market exposure as the traditional long only investment approach. Mr. Klotter of RVK pointed out this net position has been fairly consistent over time, which is not typical of all long/short hedge funds. Mr. Kirk noted that within the Archipelago Fund, there are ten underlying funds. He said year-to-date the Archipelago was up 8.5% compared to 12.8% for the MSCI World index, and 5.7% for the average equity long/short fund (the HFRI Equity hedge index). Since its inception in April 2001, the Archipelago Fund has returned 8.1%, compared to 4.3% for the MSCI World index and 4.6% for the average long/short equity hedge fund. The risk measures indicate lower volatility than the overall equity markets and better up market and down market performance than the average long/short hedge fund. Mr. Palmeri noted that the fee structure of the Archipelago Fund is lower than other comparable long/short equity fund-of-funds. Fees are assessed at the underlying fund level on a 1 and 20 basis, meaning there is a 1% management fee and a 20% fee on the profits. Typical hedge funds fees are 2 and 20.

Mr. Gatton asked if there were any further comments or questions. Being none, the meeting adjourned at 3:55 p.m.

Donna Counts
Office of the Treasurer

- the purposes of the institution and the endowment fund;
 - general economic conditions;
 - the possible effect of inflation or deflation;
 - the expected total return from income and the appreciation of investments;
 - other resources of the institution;
 - the investment policy of the institution.
- A new requirement to delay spending distributions on new endowment gifts for at least one year in order to build a spending reserve (effective for fiscal year 2013-14 and thereafter).
- Other minor changes as noted throughout the attached policy.

Action taken: Approved Disapproved Other _____

REDLINED DRAFT

UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS

ENDOWMENT INVESTMENT POLICY

Amended December 10, 2012~~June 14, 2011~~

University of Kentucky
University of Kentucky Research Foundation
~~University of Kentucky Athletic Association~~
The Fund for Advancement of Education and Research in the UK Medical Center
University of Kentucky Mining Engineering Foundation, Inc.
University of Kentucky Gluck Equine Research Foundation, Inc.
University of Kentucky Humanities Foundation, Inc.
University of Kentucky Center on Aging Foundation, Inc.

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I. General

The University of Kentucky Endowment ("Endowment") is an aggregation of funds comprised of gifts from donors and grants from the Commonwealth of Kentucky with the requirement they be invested held in perpetuity to generate a reliable and steadily growing revenue income stream to support the mission of the University now and in the future. The revenue stream, or total return spending distributions, income supports scholarships, chairs, professorships, basic research, as well as academic and public service programs, as defined by the individual endowment agreements. The Endowment is expected to provide fiscal stability since the principal is invested for long-term growth and total return spending distributions are income is generated year after year.

The University of Kentucky has a fiduciary responsibility to prudently manage and preserve the long-term purchasing power of the Endowment, as well as the individual endowment funds, in order to evenly support present and future beneficiaries. This fiduciary responsibility constitutes both a legal and moral obligation to donors and the Commonwealth of Kentucky who intend that their gifts and grants provide support for the University in perpetuity.

The Endowment also includes other funds set aside by the Board of Trustees with the expectation that they be invested on a long-term basis.

II. Purpose of the Investment Policy

In general, the purpose of this policy is to outline a philosophy and attitude which will guide the management of the investment assets toward the desired results. It is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical.

This investment policy is set forth by the Investment Committee ("Committee") of the University of Kentucky Board of Trustees in order to:

- a. Define and assign the responsibilities.
- b. Establish a clear understanding of the investment goals and objectives of the Endowment assets.
- c. Offer guidance and limitations regarding the investment of Endowment assets.
- d. Establish a basis of evaluating investment results.
- e. Manage the Endowment's assets according to industry best practices and applicable laws.

The investment policy will be formally reviewed at least annually by the Committee and investment staff.

III. Roles and Responsibilities

Responsibilities of the Investment Committee

The Board of Trustees has established the Investment Committee with members appointed annually by the Chair of the Board of Trustees. The Committee is responsible for the review and oversight of the Endowment investments of the University of Kentucky and its affiliated corporations.

Governing Regulation II, E, (2) (e) II, A (6) (f) of the University of Kentucky sets forth the specific responsibilities of the Investment Committee as follows:

Under delegation from the Board of Trustees, and consistent with KRS 164A.550 through 164A.630, the Investment Committee is responsible for review and oversight of the endowment investment programs of the University and its affiliated corporations. These responsibilities include: formulating and reviewing investment policies; appointing, monitoring and evaluating investment managers and consultants; and reviewing and approving plans for the general management of the endowment funds of the University.

~~The membership of the Committee shall include five members from the Board of Trustees. Each member shall be appointed by the Chair of the Board of Trustees. A quorum of the Committee members must be present in order to conduct business.~~

In addition to the Trustee voting members, the Investment Committee may, from time to time, have the Chair of the Board of Trustees appoint, upon recommendation of the University President, non-voting Community Advisory Members to assist it in its functions by providing specialized advice and support. Said Community Advisory Members shall be selected on the basis of their expertise in such areas as investment management and finance. The appointments of Community Advisory Members to the Investment Committee shall be for three years and may be reappointed for an unlimited number of three year terms. The maximum number of Community Advisory Members authorized at any one time shall be three (3).

The Investment Committee Chair reports to the Board of Trustees after each meeting of the Committee on the performance results of endowment investments. Policies of the Committee are implemented by the Office of the Treasurer in carrying out the day-to-day operations of the University's endowment funds.

Responsibilities of Investment Staff and Endowment Advisory Group

Investment Staff

Investment staff ("Staff") will consist of the University's Vice President for Financial Operations and Treasurer and the Assistant Treasurer for Investments. Staff is responsible for executing the policies and decisions enacted by the Committee and the general daily activities and administration of the Endowment assets. The Staff will prepare analysis and recommendations for the Committee on development of policies and guidelines, selection of an appropriate long-term asset allocation, and

selecting an appropriate manager structure. The Staff will issue requests for proposals and provide recommendations to the Committee as to the managers most appropriate for managing the Endowment's assets. The Staff will maintain summaries of the investment guidelines for the various investment managers and periodically provide to the Committee.

Endowment Advisory Group

An Endowment Advisory Group of senior University administrators and faculty will be established by the President to advise the Vice President for Financial Operations and Treasurer on various matters pertaining to the prudent management of individual endowment funds.

Responsibilities of Investment Consultant

The Committee may engage an independent Investment Consultant ("Consultant") to assist the Committee and Staff in developing policies and guidelines, selecting an appropriate long-term asset allocation, selecting an appropriate manager structure, identifying investment managers, evaluating investment performance, and offering other services as requested. The Consultant will prepare quarterly and annual assessments of investment performance that include results for the total endowment and each individual investment manager compared to appropriate market indices and manager universes. The Consultant will also periodically provide in-depth and detailed analysis of each manager's portfolio.

IV. Delegation of Authority

The Committee may delegate the following investment related activities to qualified industry experts, but will be responsible for the selection and oversight of the vendors. Staff will assist the Committee with selection and oversight of the vendors and execute required contracts and applicable renewals.

Investment Custodian

The Committee will hire a Custodian for the University's endowment investments to establish and maintain direct account relationships with each investment manager and perform standard custodial functions, including security safekeeping, collection of income, settlement of trades, collection of proceeds of maturing securities, distribution of income, and daily investment of cash. The Custodian will provide monthly account statements and other reports as requested by the Staff.

Investment Managers

The Committee will delegate the selection, buying and selling of individual securities or assets to qualified industry experts. Each individual investment manager will exercise discretion over the securities or assets in accordance with specified investment guidelines.

Investment managers that utilize separate accounts to manage Endowment assets will adhere to specific investment manager guidelines established by Staff with the assistance of the Consultant. Each investment manager using a separate account is required to summarize its holdings and

transactions on a monthly basis.

Investment managers that utilize a mutual fund investment structure, a commingled trust fund structure or a limited partnership structure will have discretion to manage the assets in accordance with the policies and guidelines outlined in the respective mutual fund's ~~prospectus, prospectus~~; the commingled trust fund's offering memorandum or limited partnership's private placement memorandum.

A summary of the investment manager structure and benchmarks is provided in Appendix 2.

V. Financial and Investment Objectives

The Investment Committee has established the following financial and investment objectives for the Endowment:

1. To preserve the long-term purchasing power of the endowment assets and the related revenue stream over time to evenly allocate support between current and future beneficiaries (intergenerational equity).
2. To earn an average annual real return, after inflation and expenses, of at least ~~4.0%~~ 4.5% per year over full economic market cycles.

Kentucky Uniform Prudent Management of Institutional Funds Act (KRS 273.600 to 273.645)

Endowment assets will be managed by the Investment Committee in accordance with the provisions of the Kentucky Uniform Prudent Management of Institutional Funds Act (KRS 273.600 to 273.645), included in Appendix 1.

Spending Policy Rate and Management Fee

The Investment Committee has established a "hybrid" spending policy, which includes both the market value of the endowment and the current level of inflation in determining spending each year. Annual spending will be calculated by taking a weighted average comprising 60 percent of the prior year's spending, adjusted for inflation¹, and 40% of the amount that results when the target annual spending rate of ~~4.0%~~ 4.25% of is applied to the average market value of the Endowment over the preceding ~~3660~~ months. The spending amount determined by the formula will be constrained so that the calculated rate is at least 3%, and not more than 6%, of the current Endowment market value. ~~to establish financial equilibrium for the Endowment by creating a balance between annual spending and the expected real (after inflation) return on assets. As described below, the Endowment will be assessed an annual management fee of .25% of the current market value (assessed monthly) to support administrative costs. The target spending rate and management fee in concert with the target asset allocation policy are intended to support current and future program needs and allow the~~

¹ Inflation will be measured by the U.S. Department of Labor Bureau of Labor Statistics Consumer Price Index for All Urban Consumers (CPI-U).

~~Endowment value to grow at a rate at least equal to annual inflation.~~

~~The hybrid spending formula is depicted below:~~

$$\frac{60\% * (\text{Prior Year Spending} * [1 + \text{Annual Percent Change in CPI-U}])}{+ 40\% * (4\% * \text{Average Market Value for Preceding 36 Months})}$$

~~Note: the calculated spending rate must fall between 3% and 6% of the current market value of the Endowment.~~

The ~~hybrid spending policy above target spending rate and management fee policies~~ will be phased in as follows:

- ~~o Fiscal year 2013-14 will serve as a transition year to the new policy and spending will be based on 4.0% of the average market value for the preceding 60 months.~~
- ~~o The new hybrid policy will be fully implemented in fiscal year 2014-15.~~
- ~~• In FY 2010-11, the spending rate and management fee will be reduced from 4.5% and .5% to 4.375% and .375%, respectively.~~
- ~~• In FY 2011-12, the spending rate and management fee will be reduced to 4.25% and .25%, respectively.~~

~~The target spending rate and management fee established by the Investment Committee represent maximum amounts that can be withdrawn annually from individual endowment funds. The Vice President for Financial Operations and Treasurer may reduce or suspend withdrawals from individual endowment funds that are underwater.~~

Management Fee

~~Eligible endowments will be assessed an annual management fee of .25% of the current market value (assessed monthly) to support administrative costs.~~

Underwater Endowment Funds²

~~The target spending rate and management fee established by the Investment Committee represent maximum amounts that can be withdrawn annually from individual endowment funds. The Vice President for Financial Operations and Treasurer may reduce or suspend withdrawals from individual endowment funds that are underwater.~~

² ~~Underwater endowments are those in which the market value is less than the contributed value.~~

Effective for FY 2013-14 and thereafter, spending and management fee withdrawals will be suspended on all endowments underwater by more than 20%. Endowments underwater more than 10% will undergo a formal review by the Office of the Treasurer and appropriate College Dean to determine the appropriate level of spending in accordance the following factors set forth in the Kentucky Uniform Prudent Management of Institutional Funds Act:

- the duration and preservation of the endowment fund;
- the purposes of the institution and the endowment fund;
- general economic conditions;
- the possible effect of inflation or deflation;
- the expected total return from income and the appreciation of investments;
- other resources of the institution;
- the investment policy of the institution.

New Endowment Funds

Effective for FY 2013-14 and thereafter, spending distributions on new endowment funds will be delayed for at least one year in order to build a spending reserve.

VI. Investment Policies

Diversification

The Committee will invest in different asset classes and engage multiple investment managers to ensure proper diversification of the Endowment. Investment diversification is essential to limit risks that include return volatility, the magnitude of potential losses, and manager underperformance. Equity investments will be diversified by market capitalization (company size), style (growth or value), industry, and country of domicile (as it will include non-U.S. based companies). Fixed Income investments will be diversified by market sector, maturity, credit quality, issuer and country of domicile. Private equity investments will be diversified by strategy, including multiple venture capital, leveraged buyout, and special situation funds; by geographical allocation including U.S. and non-U.S. investments; and by vintage year of investment. Real Return Investments will be diversified by asset class and strategy. Absolute Return investments will be diversified by manager, investment strategy, and geographic location including U.S. and non-U.S. managers. Real estate investments will be diversified by property type, geographic location and investment strategy.

In an effort to optimize and efficiently utilize due diligence research and diversification, a "fund of funds" ("FOF") investment structure will generally be used for Private Equity, Real Return and Absolute Return investments.

Asset Allocation

The Committee has established asset class targets and ranges as follows:

| Asset Class | Investment Policy | |
|---------------------------|-------------------|---------------|
| | Target | Range |
| Broad U.S. Equities | 20% | 15-25% |
| Broad Non-U.S. Equities | 20% | 15-25% |
| Total Equities | 40% | 35-45% |
| Private Equity | 7% | 5-9% |
| Real Return | 10% | 8-12% |
| Absolute Return | 20% | 15-25% |
| Real Estate | 8% | 6-10% |
| Total Alternatives | 45% | 35-50% |
| Fixed-Income | 15% | 12-18% |
| Total | 100% | |

Rebalancing

Rebalancing is the term that describes the periodic movement of funds from one asset or asset class to another for the purpose of realigning the assets with the asset allocation target. A rebalancing strategy is an important element of asset allocation policy. Systematic rebalancing will reduce portfolio volatility and increase portfolio return over the long term. However, excessively tight ranges and frequent rebalancing can lead to unnecessary transaction costs.

The Committee has chosen to adopt a rebalancing policy that is governed by allocation ranges rather than time periods. The ranges, specified in the table above, are a function of the volatility and liquidity of each asset class and the proportion of the total fund allocated to the asset class. While the allocation to all asset classes remains within these limits, Staff will first use cash flows, as available, to maintain the overall allocation as close as possible to the target. When an asset class violates the lower or upper limits, public market funds will be actively rebalanced back to the target.

When any one of the public market asset classes hits a trigger point, the entire fund may be rebalanced back to asset class target allocations with the understanding that it may be impractical to return the real estate and private equity classes precisely to target in the short term. Accordingly, qualitative considerations (e.g., transaction costs, liquidity needs, investment time horizons, etc.) will be considered in determining the potential timing and extent of rebalancing real estate and private equity portfolios.

Staff is responsible for developing and implementing a rebalancing plan that is appropriate for existing market conditions, with a primary objective of minimizing transaction costs and portfolio disruptions. Managers on the Watch List will not receive additional allocations without Committee approval. In the event an allocation trigger point is not reached, Staff may still make minor changes among asset classes and within individual asset classes, as needed, to more effectively implement

the program and to maintain proper exposure to the approved asset allocation and asset class portfolio structures. Staff will report the results of all rebalancing activity to the Investment Committee at the regular meetings.

~~The Committee intends to maintain the actual asset class allocations within the target ranges outlined above. Allocations relative to targets will be reviewed at least on a quarterly basis to determine if rebalancing transfers between asset classes are necessary. In general, Staff will direct new endowment gifts to undertarget asset classes.~~

Commitments to Private Equity and Real Estate

Staff, assisted by the Consultant, will complete annual forecasting and make appropriate commitments to successor funds of approved private equity and real estate managers to reach and maintain the approved policy allocation and ensure diversification across vintage year, strategy, geography, etc.

Liquidity

The Endowment is intended to provide a stream of annual income to the University in perpetuity. As a result, the Endowment has a long-term orientation. In addition, the withdrawal rate from the Endowment fund is well defined, predictable, and of modest size relative to the total assets. Staff, assisted by the Consultant, is responsible for managing the liquidity of the portfolio to fund spending distributions and capital calls while maintaining the appropriate market exposure.

Proxy Voting

The Committee delegates full authority for proxy voting to its investment managers for the securities under their discretionary authority and requires the investment managers to vote all proxies in the best interest of the Endowment. In addition, when requested, the managers will report to the Committee on their proxy-voting policies and activities on the Endowment's behalf.

Proxy voting related to governance issues regarding investment managers hired to manage Endowment assets, and their related investment legal structures, terms and conditions, will be voted on by the Staff in the best economic interest of the Endowment. The Staff may solicit assistance of the Consultant on governance issues.

Transaction Costs

The Committee requires the investment managers, in their capacity as fiduciaries, to manage the transactions costs they incur on the Endowment's behalf in the best interests of the University. When requested, the managers will report to the Committee on the transactions costs incurred and the brokers used on the Endowment's behalf.

Transition Management

Transitions between investment managers are an important and inevitable element of portfolio management, typically resulting from manager terminations or changes to the investment strategy of the portfolio. The optimal method to use in executing a transition may vary significantly from one transition to another based on the types of assets involved and the timeframe in question. Generally, the Endowment's objective in a manager transition is to implement the change in a cost-effective, timely manner while maintaining the appropriate market exposure. It is imperative to note that the cost of transition is not commissions alone, but also bid/ask spread, market impact and opportunity cost. The market impact cost is the effect trading will have on the market price of the shares being traded. The opportunity cost, sometimes referred to as implementation shortfall, is the cost of market movements over the time it takes to trade. Efforts should be made to minimize the total cost rather than any single cost component. Selecting a transition manager can be done at the Staff's discretion with the assistance of the Consultant. Use of futures contracts and exchange traded funds may be required in order to maintain appropriate market exposure during a transition.

VII. Performance Evaluation

Endowment performance will be monitored and reviewed over full market cycles, generally three to five years, at three levels; total Endowment, asset class and individual manager. All three levels will include a passive index and peer group measurement review. Performance will be reviewed on a gross and net return basis and will include risk and risk adjusted returns.

Performance Benchmarks

The total Endowment performance will be measured against:

1. CPI plus ~~4.0%~~4.5% real return
2. A Policy Benchmark consisting of passive indexes reflecting the Endowments "strategic target" asset allocation percentages. See Appendix 2 for the Summary of Endowment Investment Manager Structure & Benchmarks.
3. An Active Benchmark consisting of passive indexes reflecting the Endowments "actual" asset allocation percentages
4. A peer group universe of similar plans

The asset class performance will be measured against:

1. The asset class' core passive index. See Appendix 2 for the Summary of Endowment Investment Manager Structure & Benchmarks.
2. A peer group universe of similar asset classes

The individual managers' performance will be measured against:

1. The managers' specific passive indexes. See Appendix 2 for the Summary of Endowment Investment Manager Structure & Benchmarks.
2. A peer group universe of similar investment styles

Performance Expectations

It is expected within each level the Endowment, the asset class, and the individual managers should exceed the passive index return and should be above median against the appropriate peer group universes over full market cycles.

It is expected that risk (and risk adjusted returns) will be in line with the risk associated with the specific passive index benchmarks over full market cycles.

APPENDIX 1

Kentucky Uniform Prudent Management of Institutional Funds Act
(KRS 273.600 to KRS 273.645)

273.600 Definitions for KRS 273.600 to 273.645.

In KRS 273.600 to 273.645:

- (1) "Charitable purpose" means the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community;
- (2) "Endowment fund" means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use;
- (3) "Gift instrument" means a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund;
- (4) "Institution" means:
 - (a) A person, other than an individual, organized and operated exclusively for charitable purposes;
 - (b) A government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; or
 - (c) A trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated;
- (5) "Institutional fund" means a fund held by an institution exclusively for charitable purposes. The term does not include:
 - (a) Program-related assets;
 - (b) A fund held for an institution by a trustee that is not an institution; or
 - (c) A fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund;
- (6) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity;
- (7) "Program-related asset" means an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment; and
- (8) "Record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 1, effective July 15, 2010.

273.605 Standard of conduct in managing and investigating institutional fund.

- (1) Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.
- (2) In addition to complying with duty of loyalty imposed by law other than in KRS 273.600 to 273.645, each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
- (3) In managing and investing an institutional fund, an institution:
 - (a) May incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution; and

(b) Shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

(4) An institution may pool two (2) or more institutional funds for purposes of management and investment.

(5) Except as otherwise provided by a gift instrument, the following rules apply:

(a) In managing and investing an institutional fund, the following factors, if relevant, shall be considered:

1. General economic conditions;
2. The possible effect of inflation or deflation;
3. The expected tax consequences, if any, of investment decisions or strategies;
4. The role that each investment or course of action plays within the overall investment portfolio of the fund;
5. The expected total return from income and the appreciation of investments;
6. Other resources of the institution;
7. The needs of the institution and the fund to make distributions and to preserve capital; and
8. An asset's special relationship or special value, if any, to the charitable purposes of the institution;

(b) Management and investment decisions about an individual asset shall be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution;

(c) Except as otherwise provided by law other than KRS 273.600 to 273.645, an institution may invest in any kind of property or type of investment consistent with this section;

(d) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification;

(e) Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of KRS 273.600 to 273.645; and

(f) A person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 2, effective July 15, 2010.

273.610 Appropriation for expenditure or accumulation of endowment -- Rules of construction.

(1) Subject to the intent of a donor expressed in the gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- (a) The duration and preservation of the endowment fund;
 - (b) The purposes of the institution and the endowment fund;
 - (c) General economic conditions;
 - (d) The possible effect of inflation or deflation;
 - (e) The expected total return from income and the appreciation of investments;
 - (f) Other resources of the institution; and
 - (g) The investment policy of the institution.
- (2) To limit the authority to appropriate for expenditure or accumulate under subsection (1) of this section, a gift instrument must specifically state the limitation.
- (3) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only "income," "interest," "dividends," or "rents, issues, or profits," or "to preserve the principal intact," or words of similar import:
- (a) Create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund; and
 - (b) Do not otherwise limit the authority to appropriate for expenditure or accumulate under subsection (1) of this section.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 3, effective July 15, 2010.

273.615 Delegation of management and investment functions.

(1) Subject to any specific limitation set forth in a gift instrument or in law other than KRS 273.600 to 273.645, an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in:

- (a) Selecting an agent;
- (b) Establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and
- (c) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

(2) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.

(3) An institution that complies with subsection (1) of this section is not liable for the decisions or actions of an agent to which the function was delegated.

(4) By accepting delegation of a management or investment function from an institution that is subject to the laws of the Commonwealth, an agent submits to the jurisdiction of the courts of the Commonwealth in all proceedings arising from or related to the delegation or the performance of the delegated function.

(5) An institution may delegate management and investment functions to its committees, officers, or employees as authorized by law of the Commonwealth other than KRS 273.600 to 273.645.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 4, effective July 15, 2010.

273.620 Release or modification of restrictions on management, investment, or purpose.

(1) If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution.

(2) The court, upon application of an institution, may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. The institution shall notify the Attorney General of the application, and the Attorney General shall be given an opportunity to be heard. To the extent practicable, any modification shall be made in accordance with the donor's probable intention.

(3) If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court, upon application of an institution, may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purpose expressed in the gift instrument. The institution shall notify the Attorney General of the application, and the Attorney General shall be given an opportunity to be heard.

(4) If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, sixty (60) days after notification to the Attorney General, may release or modify the restriction, in whole or part, if:

(a) The institutional fund subject to the restriction has a total value of less than fifty thousand dollars (\$50,000);

(b) More than twenty (20) years have elapsed since the fund was established; and

(c) The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 5, effective July 15, 2010.

273.625 Reviewing compliance with KRS 273.600 to 273.645.

Compliance with KRS 273.600 to 273.645 is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 6, effective July 15, 2010.

273.630 Application of KRS 273.600 to 273.645 to existing institutional funds.

KRS 273.600 to 273.645 apply to an institutional fund existing on or established after July 15, 2010. As applied to institutional funds existing on July 15, 2010, KRS 273.600 to 273.645 govern only decisions made or actions taken on or after that date.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 7, effective July 15, 2010.

273.635 Relation of KRS 273.600 to 273.645 to the Electronic Signatures in Global and National Commerce Act.

KRS 273.600 to 273.645 modify, limit, and supersede the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. secs. 7001 et seq., but does not modify, limit, or supersede Section 101 of that act, 15 U.S.C. sec. 7001(a), or authorize electronic delivery of any of the notices described in Section 103 of that act, 15 U.S.C. sec. 7003(b).

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 8, effective July 15, 2010.

273.640 Uniformity of application and construction of the Kentucky Uniform Prudent Management of Institutional Funds Act.

In applying and construing this uniform act, consideration shall be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 9, effective July 15, 2010.

273.645 Short title for KRS 273.600 to 273.645.

KRS 273.600 to 273.645 may be cited as the Kentucky Uniform Prudent Management of Institutional Funds Act.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 10, effective July 15, 2010.

APPENDIX 2

Summary of Endowment Investment Manager Structure & Benchmarks

UNIVERSITY OF KENTUCKY
SUMMARY OF ENDOWMENT INVESTMENT MANAGER STRUCTURE AND BENCHMARKS

| MANAGER NAME | HEADQUARTERS | INVESTMENT STRATEGY¹ | POLICY TARGET | POLICY RANGE | BENCHMARK |
|---|---|--|----------------------|---------------------|--|
| <u>Broad U.S. Equity:</u> | | | | | |
| Northern Trust | Boston, MA | Passive Russell 1000 (Large-cap) | 18.4% | | Russell 1000 Index |
| Wellington | Boston, MA | Active Russell 2000 (Small-cap) | 1.6% | | Russell 2000 Index |
| | | Total Broad U.S. Equity | 20.0% | 15.0-25.0% | Dow Jones U.S. Total Stock Market Index |
| <u>Broad Non-U.S. Equity:</u> | | | | | |
| Capital Guardian | Los Angeles, CA | Active MSCI ACW ex-U.S. - Core | 10.0% | | MSCI All Country World ex-U.S. Index |
| Mondrian | London, ENG | Active MSCI ACW ex-U.S. - Value | 5.0% | | MSCI All Country World ex-U.S. Value Index |
| William Blair | Chicago, IL | Active MSCI ACW ex-U.S. - Growth | 5.0% | | MSCI All Country World ex-U.S. Growth Index |
| | | Total Broad Non-U.S. Equity | 20.0% | 15.0-25.0% | MSCI All Country World ex-U.S. Index |
| | | TOTAL EQUITIES | 40.0% | 35.0-45.0% | N/A |
| <u>Private Equity:</u> | | | | | |
| Multiple Managers ² : Commonfund Capital Drum Capital NB Alternatives Pantheon Ventures Siguler Guff | Wilton, CT Stamford, CT Dallas, TX San Francisco, CA New York, NY | Private Equity Fund-of-Funds ("FOF") | 7.0% | 5.0-9.0% | Venture Economics All Private Equity Index Venture Economics All Private Equity Index Venture Economics All Private Equity Index Venture Economics All Private Equity Index Venture Economics All Private Equity Index |
| Chrysalis Ventures ³ | Louisville, KY | Regional Venture Capital | 0.0% | | Venture Economics All Private Equity Index |
| Fort Washington ³ | Cincinnati, OH | Regional Venture Capital | 0.0% | | Venture Economics All Private Equity Index |
| | | Total Private Equity | 7.0% | 5.0-9.0% | Venture Economics All Private Equity Index |
| <u>Real Return:</u> | | | | | |
| PIMCO | Newport Beach, CA | Real Return FOF (All Asset All Authority) | 6.0% | | All Asset Composite Index |
| Wellington | Boston, MA | Real Return FOF (Diversified Inflation Hedges) | 4.0% | | Wellington Diversified Inflation Hedges Composite Index |
| | | Total Real Return | 10.0% | 8.0-12.0% | 60%/All Asset Comp. Index/40% Wellington DIH Comp. Index |
| <u>Absolute Return:</u> | | | | | |
| Grosvenor | Chicago, IL | Core/Oppportunistic Absolute Return FOF | 12.0% | | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| Prisma | New York, NY | Core Absolute Return FOF | 5.0% | | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| Berens | New York, NY | Opportunistic Absolute Return FOF | 3.0% | | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| | | Total Absolute Return | 20.0% | 15.0-25.0% | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| <u>Real Estate:</u> | | | | | |
| UBS | Hartford, CT | Core Real Estate | 4.0% | 3.0-5.0% | National Council on Real Estate Investment Fiduciaries Index - 1% |
| Multiple Managers ² : Contrarian Capital SC Capital Partners TA Associates WestRiver Capital Wrightwood Capital | Greenwich, CT Singapore Boston, MA New York, NY Chicago, IL | Non-Core Real Estate | 4.0% | 3.0-5.0% | National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index |
| | | Total Real Estate | 8.0% | 6.0-10.0% | National Council on Real Estate Investment Fiduciaries Index |
| | | TOTAL ALTERNATIVES | 45.0% | 35.0-50.0% | N/A |
| <u>Fixed Income:</u> | | | | | |
| PIMCO | Newport Beach, CA | Core-Plus Fixed Income | 5.0% | | Barclays Capital Aggregate Bond Index |
| PIMCO | Newport Beach, CA | Unconstrained Fixed Income | 5.0% | | 3-Month LIBOR + 3% |
| Reams | Columbus, IN | Core-Plus Fixed Income | 3.0% | | Barclays Capital Aggregate Bond Index |
| Reams | Columbus, IN | Low Duration Fixed Income | 2.0% | | Barclays Capital 1-5 Year Government/Credit Index |
| | | TOTAL FIXED INCOME | 15.0% | 12.0-18.0% | Barclays Capital Aggregate Bond Index |
| | | TOTAL POOLED INVESTMENTS | 100.0% | | Policy Benchmark |

¹ Investment strategy definitions located in Appendix 3 of the Endowment Investment Policy.

² Multiple managers will be used to reach the target allocation for the investment strategy and target allocations for managers within this strategy will not be established.

³ The Committee has committed \$1 million and \$2 million to Chrysalis Ventures and Fort Washington, respectively, to enhance the total return for the Endowment and provide for leadership in economic development in the Commonwealth of Kentucky.

APPENDIX 3
Investment Strategy Definitions

INVESTMENT STRATEGY DEFINITIONS

Broad U.S. Equity Strategies

- **Passive Russell 1000 (Large-Cap):** Passive strategy that invests in the large-cap segment of the U.S. equity universe. The Russell 1000 index includes approximately 1,000 of the largest securities based on market capitalization and is a subset of the Russell 3000 index, which is a broad U.S. equity market index. The Russell 1000 represents approximately 92% of the U.S. equity market. The objective of a passive strategy is to match the return of the index.
- **Active Russell 2000 (Small-Cap):** Active strategy that invests in the small-cap segment of the U.S. equity universe. The Russell 2000 index includes approximately 2,000 of the smallest securities based on market capitalization and is a subset of the Russell 3000 index, which is a broad U.S. equity market index. The Russell 2000 represents approximately 8% of the U.S. equity market. The objective of an active strategy is to exceed the return of the index.

Broad Non-U.S. Equity Strategy

- **Active MSCI All Country World ex-U.S.:** Active strategy that invests in stocks in the broad non-U.S. equity universe (i.e. companies domiciled in countries other than the U.S.). The MSCI All Country World ex-U.S. index consists of approximately 2,000 securities across 47 markets, with emerging markets representing approximately 18%. MSCI attempts to capture approximately 85% of the market capitalization in each country. The objective of an active strategy is to exceed the return of the index.
 - Core: Strategy designed to have broad exposure to style (growth vs. value) and sector.
 - Growth: Strategy focusing on stocks that offer better-than-average expected earnings or growth potential. Common characteristics typically include a low dividend yield and high price to book/earnings ratios.
 - Value: Strategy focusing on stocks that are considered to be undervalued as they trade at a lower price relative to fundamentals (i.e. dividends, earnings, sales, etc.). Common characteristics typically include a high dividend yield and low price to book/earnings ratios.

Private Equity Strategy

- **Private Equity Fund-of-Funds:** Strategy that invests in various venture capital and leveraged buyout partnerships in the U.S. and non U.S. countries. The fund-of-funds approach provides access to top-tier private equity partnerships and enhanced diversification. Assets invested in the strategy are illiquid with a typical investment time horizon of seven or more years.
 - Core: Fully diversified fund by manager, strategy and geography.
 - Opportunistic: Non-core fund designed to capture excess returns due to current market opportunities, such as distressed/ special situation funds, emerging markets funds, or other specialized and/or geographically concentrated funds.

Real Return Strategy

- **Real Return Fund-of-Funds:** Strategy that typically invests in various real return assets including treasury inflation protected securities (TIPS), commodities, currency, REITS, timber, infrastructure and global natural resources. Strategy can also include equity and fixed income investments, and involve global tactical asset allocation among the various asset classes/strategies. The objective of real return investments is to provide a hedge against inflation. A real return strategy targets a return exceeding inflation by a premium, such as C.P.I. plus 5%. The fund-of-funds approach provides instant diversification among various real return assets.

Absolute Return Strategy

- **Absolute Return Fund-of-Funds:** Strategy that invests in a diversified range of hedge funds. Hedge funds are private, unregulated investment partnerships that execute a broad range of investment strategies across a broad range of securities. The objective of absolute return investments is to provide consistent positive returns with relatively low correlation to other asset classes. The fund-of-funds approach provides access to professional expertise in selecting and monitoring individual hedge funds, access to high quality, institutional hedge funds and instant diversification. Assets invested in the strategy typically have quarterly liquidity, however managers usually reserve the right to suspend liquidations under poor economic and market conditions.
 - Core: Fully diversified fund by manager, strategy and geography.
 - Opportunistic: Non-core fund designed to capture excess returns due to current market opportunities, such as currency trading funds, emerging markets funds, or other specialized and/or geographically concentrated funds.

Real Estate Strategies

- **Core Real Estate:** Strategy that invests in high quality, stabilized properties in economically diversified metropolitan areas. Properties are substantially leased and provide predictable income and cash flow, with limited potential for significant capital appreciation. Strategy includes four major property types as follows: office, retail, residential and industrial. Assets invested in the strategy typically have quarterly liquidity, however managers usually reserve the right to suspend liquidations under poor economic and market conditions.
- **Non-Core Real Estate:** Value added and opportunistic real estate strategies:
 - Value Added: Strategy that invests in existing properties that require redevelopment, releasing and/or repositioning. Strategy includes the four major property types (office, retail, residential and industrial) plus lodging. Investment return is derived from both rental income and property appreciation. Assets invested in the strategy are illiquid with a typical investment time horizon of seven or more years.
 - Opportunistic: Strategy that involves development properties and/or existing properties that require extensive redevelopment and releasing. Strategy involves all property types including

niche sectors such as healthcare, senior housing, etc., and can include investment in properties outside the U.S. Investment return is derived mainly from property appreciation. Assets invested in the strategy are illiquid with a typical investment time horizon of seven or more years.

Fixed Income Strategies

- **Core-Plus Fixed Income:** Strategy that invests the majority of the portfolio in high quality, U.S. dollar denominated, investment- grade fixed income securities similar to those in the Barclays Capital Aggregate Bond Index, including government/agency bonds, commercial and residential mortgage-backed bonds, asset-backed bonds and corporate bonds. Additionally, the strategy allows for investment in higher risk securities including non-investment grade, non-U.S. dollar denominated and emerging market bonds, but only to the extent allowed by the manager's guidelines.
- **Unconstrained Fixed Income:** Absolute return-oriented strategy that invests primarily in high quality, U.S. dollar denominated, and investment grade fixed income securities without sector or instrument limitations. The investment opportunity set includes government/agency bonds, commercial and residential mortgage-backed bonds, asset-backed bonds, corporate bonds (both investment grade and high yield), non-U.S. and emerging market bonds and currency. The strategy is designed to offer the traditional benefits of a core bond approach but with higher alpha potential and the opportunity to mitigate downside risk to a greater degree than what is reasonably possible from traditional active fixed income management approaches.
- **Low Duration Fixed Income:** Strategy that invests in a diverse set of short-term, high quality bonds which seeks to achieve low volatility and attractive returns relative to its benchmark (typically the Merrill Lynch 1-3 Year Treasury Index or Barclays Capital 1-5 Year Government/Credit Index). Investments include mortgage-backed securities, treasuries, corporates, and international fixed income. Additionally, the strategy allows for investment in higher risk, non-investment grade securities, but only to the extent allowed by the manager's guidelines. The strategy duration is typically less than three years.

CLEAN DRAFT

UNIVERSITY OF KENTUCKY AND AFFILIATED CORPORATIONS

ENDOWMENT INVESTMENT POLICY

Amended December 10, 2012

University of Kentucky
University of Kentucky Research Foundation
The Fund for Advancement of Education and Research in the UK Medical Center
University of Kentucky Mining Engineering Foundation, Inc.
University of Kentucky Gluck Equine Research Foundation, Inc.
University of Kentucky Humanities Foundation, Inc.
University of Kentucky Center on Aging Foundation, Inc.

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I. General

The University of Kentucky Endowment (“Endowment”) is an aggregation of funds comprised of gifts from donors and grants from the Commonwealth of Kentucky with the requirement they be invested in perpetuity to generate a reliable and steadily growing revenue stream to support the mission of the University now and in the future. The revenue stream, or total return spending distributions, supports scholarships, chairs, professorships, basic research, as well as academic and public service programs, as defined by the individual endowment agreements. The Endowment is expected to provide fiscal stability since the principal is invested for long-term growth and total return spending distributions are generated year after year.

The University of Kentucky has a fiduciary responsibility to prudently manage and preserve the long-term purchasing power of the Endowment, as well as the individual endowment funds, in order to evenly support present and future beneficiaries. This fiduciary responsibility constitutes both a legal and moral obligation to donors and the Commonwealth of Kentucky who intend that their gifts and grants provide support for the University in perpetuity.

The Endowment also includes other funds set aside by the Board of Trustees with the expectation that they be invested on a long-term basis.

II. Purpose of the Investment Policy

In general, the purpose of this policy is to outline a philosophy and attitude which will guide the management of the investment assets toward the desired results. It is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical.

This investment policy is set forth by the Investment Committee (“Committee”) of the University of Kentucky Board of Trustees in order to:

- a. Define and assign the responsibilities.
- b. Establish a clear understanding of the investment goals and objectives of the Endowment assets.
- c. Offer guidance and limitations regarding the investment of Endowment assets.
- d. Establish a basis of evaluating investment results.
- e. Manage the Endowment’s assets according to industry best practices and applicable laws.

The investment policy will be formally reviewed at least annually by the Committee and investment staff.

III. Roles and Responsibilities

Responsibilities of the Investment Committee

The Board of Trustees has established the Investment Committee with members appointed annually by the Chair of the Board of Trustees. The Committee is responsible for the review and oversight of the Endowment investments of the University of Kentucky and its affiliated corporations.

Governing Regulation II, E, (2) (e) of the University of Kentucky sets forth the specific responsibilities of the Investment Committee as follows:

Under delegation from the Board of Trustees, and consistent with KRS 164A.550 through 164A.630, the Investment Committee is responsible for review and oversight of the endowment investment programs of the University and its affiliated corporations. These responsibilities include: formulating and reviewing investment policies; appointing, monitoring and evaluating investment managers and consultants; and reviewing and approving plans for the general management of the endowment funds of the University.

In addition to the Trustee members, the Investment Committee may, from time to time, have the Chair of the Board of Trustees appoint, upon recommendation of the University President, non-voting Community Advisory Members to assist it in its functions by providing specialized advice and support. Said Community Advisory Members shall be selected on the basis of their expertise in such areas as investment management and finance. The appointments of Community Advisory Members to the Investment Committee shall be for three years and may be reappointed for an unlimited number of three year terms. The maximum number of Community Advisory Members authorized at any one time shall be three (3).

The Investment Committee Chair reports to the Board of Trustees after each meeting of the Committee on the performance results of endowment investments. Policies of the Committee are implemented by the Office of the Treasurer in carrying out the day-to-day operations of the University's endowment funds.

Responsibilities of Investment Staff and Endowment Advisory Group

Investment Staff

Investment staff ("Staff") will consist of the University's Vice President for Financial Operations and Treasurer and the Assistant Treasurer for Investments. Staff is responsible for executing the policies and decisions enacted by the Committee and the general daily activities and administration of the Endowment assets. The Staff will prepare analysis and recommendations for the Committee on development of policies and guidelines, selection of an appropriate long-term asset allocation, and selecting an appropriate manager structure. The Staff will issue requests for proposals and provide recommendations to the Committee as to the managers most appropriate for managing the Endowment's assets. The Staff will maintain summaries of the investment guidelines for the various

investment managers and periodically provide to the Committee.

Endowment Advisory Group

An Endowment Advisory Group of senior University administrators and faculty will be established by the President to advise the Vice President for Financial Operations and Treasurer on various matters pertaining to the prudent management of individual endowment funds.

Responsibilities of Investment Consultant

The Committee may engage an independent Investment Consultant ("Consultant") to assist the Committee and Staff in developing policies and guidelines, selecting an appropriate long-term asset allocation, selecting an appropriate manager structure, identifying investment managers, evaluating investment performance, and offering other services as requested. The Consultant will prepare quarterly and annual assessments of investment performance that include results for the total endowment and each individual investment manager compared to appropriate market indices and manager universes. The Consultant will also periodically provide in-depth and detailed analysis of each manager's portfolio.

IV. Delegation of Authority

The Committee may delegate the following investment related activities to qualified industry experts, but will be responsible for the selection and oversight of the vendors. Staff will assist the Committee with selection and oversight of the vendors and execute required contracts and applicable renewals.

Investment Custodian

The Committee will hire a Custodian for the University's endowment investments to establish and maintain direct account relationships with each investment manager and perform standard custodial functions, including security safekeeping, collection of income, settlement of trades, collection of proceeds of maturing securities, distribution of income, and daily investment of cash. The Custodian will provide monthly account statements and other reports as requested by the Staff.

Investment Managers

The Committee will delegate the selection, buying and selling of individual securities or assets to qualified industry experts. Each individual investment manager will exercise discretion over the securities or assets in accordance with specified investment guidelines.

Investment managers that utilize separate accounts to manage Endowment assets will adhere to specific investment manager guidelines established by Staff with the assistance of the Consultant. Each investment manager using a separate account is required to summarize its holdings and transactions on a monthly basis.

Investment managers that utilize a mutual fund investment structure, a commingled trust fund

structure or a limited partnership structure will have discretion to manage the assets in accordance with the policies and guidelines outlined in the respective mutual fund's prospectus; the commingled trust fund's offering memorandum or limited partnership's private placement memorandum.

A summary of the investment manager structure and benchmarks is provided in Appendix 2.

V. Financial and Investment Objectives

The Investment Committee has established the following financial and investment objectives for the Endowment:

1. To preserve the long-term purchasing power of the endowment assets and the related revenue stream over time to evenly allocate support between current and future beneficiaries (intergenerational equity).
2. To earn an average annual real return, after inflation and expenses, of at least 4.0% per year over full economic market cycles.

Kentucky Uniform Prudent Management of Institutional Funds Act (KRS 273.600 to 273.645)

Endowment assets will be managed by the Investment Committee in accordance with the provisions of the Kentucky Uniform Prudent Management of Institutional Funds Act (KRS 273.600 to 273.645), included in Appendix 1.

Spending Policy

The Investment Committee has established a "hybrid" spending policy, which includes both the market value of the endowment and the current level of inflation in determining spending each year. Annual spending will be calculated by taking a weighted average comprising 60 percent of the prior year's spending, adjusted for inflation¹, and 40% of the amount that results when the target annual spending rate of 4.0% is applied to the average market value of the Endowment over the preceding 36 months. The spending amount determined by the formula will be constrained so that the calculated rate is at least 3%, and not more than 6%, of the current Endowment market value.

The hybrid spending formula is depicted below:

$$60\% * (\text{Prior Year Spending} * [1 + \text{Annual Percent Change in CPI-U}]) \\ + 40\% * (4\% * \text{Average Market Value for Preceding 36 Months})$$

Note: the calculated spending rate must fall between 3% and 6% of the current market value of the Endowment.

¹ Inflation will be measured by the U.S. Department of Labor Bureau of Labor Statistics Consumer Price Index for All Urban Consumers (CPI-U).

The hybrid spending policy will be phased in as follows:

- Fiscal year 2013-14 will serve as a transition year to the new policy and spending will be based on 4.0% of the average market value for the preceding 60 months.
- The new hybrid policy will be fully implemented in fiscal year 2014-15.

Management Fee

Eligible endowments will be assessed an annual management fee of .25% of the current market value (assessed monthly) to support administrative costs.

Underwater Endowment Funds²

The target spending rate and management fee established by the Investment Committee represent maximum amounts that can be withdrawn annually from individual endowment funds. The Vice President for Financial Operations and Treasurer may reduce or suspend withdrawals from individual endowment funds that are underwater.

Effective for FY 2013-14 and thereafter, spending and management fee withdrawals will be suspended on all endowments underwater by more than 20%. Endowments underwater more than 10% will undergo a formal review by the Office of the Treasurer and appropriate College Dean to determine the appropriate level of spending in accordance the following factors set forth in the Kentucky Uniform Prudent Management of Institutional Funds Act:

- the duration and preservation of the endowment fund;
- the purposes of the institution and the endowment fund;
- general economic conditions;
- the possible effect of inflation or deflation;
- the expected total return from income and the appreciation of investments;
- other resources of the institution;
- the investment policy of the institution.

New Endowment Funds

Effective for FY 2013-14 and thereafter, spending distributions on new endowment funds will be delayed for at least one year in order to build a spending reserve.

² Underwater endowments are those in which the market value is less than the contributed value.

VI. Investment Policies

Diversification

The Committee will invest in different asset classes and engage multiple investment managers to ensure proper diversification of the Endowment. Investment diversification is essential to limit risks that include return volatility, the magnitude of potential losses, and manager underperformance. Equity investments will be diversified by market capitalization (company size), style (growth or value), industry, and country of domicile (as it will include non-U.S. based companies). Fixed Income investments will be diversified by market sector, maturity, credit quality, issuer and country of domicile. Private equity investments will be diversified by strategy, including multiple venture capital, leveraged buyout, and special situation funds; by geographical allocation including U.S. and non-U.S. investments; and by vintage year of investment. Real Return Investments will be diversified by asset class and strategy. Absolute Return investments will be diversified by manager, investment strategy, and geographic location including U.S. and non-U.S. managers. Real estate investments will be diversified by property type, geographic location and investment strategy.

In an effort to optimize and efficiently utilize due diligence research and diversification, a “fund of funds” (“FOF”) investment structure will generally be used for Private Equity, Real Return and Absolute Return investments.

Asset Allocation

The Committee has established asset class targets and ranges as follows:

| Asset Class | Investment Policy | |
|---------------------------|-------------------|---------------|
| | Target | Range |
| Broad U.S. Equities | 20% | 15-25% |
| Broad Non-U.S. Equities | 20% | 15-25% |
| Total Equities | 40% | 35-45% |
| Private Equity | 7% | 5-9% |
| Real Return | 10% | 8-12% |
| Absolute Return | 20% | 15-25% |
| Real Estate | 8% | 6-10% |
| Total Alternatives | 45% | 35-50% |
| Fixed-Income | 15% | 12-18% |
| Total | 100% | |

Rebalancing

Rebalancing is the term that describes the periodic movement of funds from one asset or asset class to another for the purpose of realigning the assets with the asset allocation target. A rebalancing strategy is an important element of asset allocation policy. Systematic rebalancing will reduce portfolio volatility and increase portfolio return over the long term. However, excessively tight ranges and frequent rebalancing can lead to unnecessary transaction costs.

The Committee has chosen to adopt a rebalancing policy that is governed by allocation ranges rather than time periods. The ranges, specified in the table above, are a function of the volatility and liquidity of each asset class and the proportion of the total fund allocated to the asset class. While the allocation to all asset classes remains within these limits, Staff will first use cash flows, as available, to maintain the overall allocation as close as possible to the target. When an asset class violates the lower or upper limits, public market funds will be actively rebalanced back to the target.

When any one of the public market asset classes hits a trigger point, the entire fund may be rebalanced back to asset class target allocations with the understanding that it may be impractical to return the real estate and private equity classes precisely to target in the short term. Accordingly, qualitative considerations (e.g., transaction costs, liquidity needs, investment time horizons, etc.) will be considered in determining the potential timing and extent of rebalancing real estate and private equity portfolios.

Staff is responsible for developing and implementing a rebalancing plan that is appropriate for existing market conditions, with a primary objective of minimizing transaction costs and portfolio disruptions. Managers on the Watch List will not receive additional allocations without Committee approval. In the event an allocation trigger point is not reached, Staff may still make minor changes among asset classes and within individual asset classes, as needed, to more effectively implement the program and to maintain proper exposure to the approved asset allocation and asset class portfolio structures. Staff will report the results of all rebalancing activity to the Investment Committee at the regular meetings.

Commitments to Private Equity and Real Estate

Staff, assisted by the Consultant, will complete annual forecasting and make appropriate commitments to successor funds of approved private equity and real estate managers to reach and maintain the approved policy allocation and ensure diversification across vintage year, strategy, geography, etc.

Liquidity

The Endowment is intended to provide a stream of annual income to the University in perpetuity. As a result, the Endowment has a long-term orientation. In addition, the withdrawal rate from the Endowment fund is well defined, predictable, and of modest size relative to the total assets. Staff, assisted by the Consultant, is responsible for managing the liquidity of the portfolio to fund spending distributions and capital calls while maintaining the appropriate market exposure.

Proxy Voting

The Committee delegates full authority for proxy voting to its investment managers for the securities under their discretionary authority and requires the investment managers to vote all proxies in the best interest of the Endowment. In addition, when requested, the managers will report to the Committee on their proxy-voting policies and activities on the Endowment's behalf.

Proxy voting related to governance issues regarding investment managers hired to manage Endowment assets, and their related investment legal structures, terms and conditions, will be voted on by the Staff in the best economic interest of the Endowment. The Staff may solicit assistance of the Consultant on governance issues.

Transaction Costs

The Committee requires the investment managers, in their capacity as fiduciaries, to manage the transactions costs they incur on the Endowment's behalf in the best interests of the University. When requested, the managers will report to the Committee on the transactions costs incurred and the brokers used on the Endowment's behalf.

Transition Management

Transitions between investment managers are an important and inevitable element of portfolio management, typically resulting from manager terminations or changes to the investment strategy of the portfolio. The optimal method to use in executing a transition may vary significantly from one transition to another based on the types of assets involved and the timeframe in question. Generally, the Endowment's objective in a manager transition is to implement the change in a cost-effective, timely manner while maintaining the appropriate market exposure. It is imperative to note that the cost of transition is not commissions alone, but also bid/ask spread, market impact and opportunity cost. The market impact cost is the effect trading will have on the market price of the shares being traded. The opportunity cost, sometimes referred to as implementation shortfall, is the cost of market movements over the time it takes to trade. Efforts should be made to minimize the total cost rather than any single cost component. Selecting a transition manager can be done at the Staff's discretion with the assistance of the Consultant. Use of futures contracts and exchange traded funds may be required in order to maintain appropriate market exposure during a transition.

VII. Performance Evaluation

Endowment performance will be monitored and reviewed over full market cycles, generally three to five years, at three levels; total Endowment, asset class and individual manager. All three levels will include a passive index and peer group measurement review. Performance will be reviewed on a gross and net return basis and will include risk and risk adjusted returns.

Performance Benchmarks

The total Endowment performance will be measured against:

1. CPI plus 4.0% real return
2. A Policy Benchmark consisting of passive indexes reflecting the Endowments “strategic target” asset allocation percentages. See Appendix 2 for the Summary of Endowment Investment Manager Structure & Benchmarks.
3. An Active Benchmark consisting of passive indexes reflecting the Endowments “actual” asset allocation percentages
4. A peer group universe of similar plans

The asset class performance will be measured against:

1. The asset class’ core passive index. See Appendix 2 for the Summary of Endowment Investment Manager Structure & Benchmarks.
2. A peer group universe of similar asset classes

The individual managers’ performance will be measured against:

1. The managers’ specific passive indexes. See Appendix 2 for the Summary of Endowment Investment Manager Structure & Benchmarks.
2. A peer group universe of similar investment styles

Performance Expectations

It is expected within each level the Endowment, the asset class, and the individual managers should exceed the passive index return and should be above median against the appropriate peer group universes over full market cycles.

It is expected that risk (and risk adjusted returns) will be in line with the risk associated with the specific passive index benchmarks over full market cycles.

APPENDIX 1

Kentucky Uniform Prudent Management of Institutional Funds Act
(KRS 273.600 to KRS 273.645)

273.600 Definitions for KRS 273.600 to 273.645.

In KRS 273.600 to 273.645:

- (1) "Charitable purpose" means the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community;
- (2) "Endowment fund" means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use;
- (3) "Gift instrument" means a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund;
- (4) "Institution" means:
 - (a) A person, other than an individual, organized and operated exclusively for charitable purposes;
 - (b) A government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; or
 - (c) A trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated;
- (5) "Institutional fund" means a fund held by an institution exclusively for charitable purposes. The term does not include:
 - (a) Program-related assets;
 - (b) A fund held for an institution by a trustee that is not an institution; or
 - (c) A fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund;
- (6) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity;
- (7) "Program-related asset" means an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment; and
- (8) "Record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 1, effective July 15, 2010.

273.605 Standard of conduct in managing and investigating institutional fund.

- (1) Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.
- (2) In addition to complying with duty of loyalty imposed by law other than in KRS 273.600 to 273.645, each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
- (3) In managing and investing an institutional fund, an institution:
 - (a) May incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution; and

(b) Shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

(4) An institution may pool two (2) or more institutional funds for purposes of management and investment.

(5) Except as otherwise provided by a gift instrument, the following rules apply:

(a) In managing and investing an institutional fund, the following factors, if relevant, shall be considered:

1. General economic conditions;
2. The possible effect of inflation or deflation;
3. The expected tax consequences, if any, of investment decisions or strategies;
4. The role that each investment or course of action plays within the overall investment portfolio of the fund;
5. The expected total return from income and the appreciation of investments;
6. Other resources of the institution;
7. The needs of the institution and the fund to make distributions and to preserve capital; and
8. An asset's special relationship or special value, if any, to the charitable purposes of the institution;

(b) Management and investment decisions about an individual asset shall be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution;

(c) Except as otherwise provided by law other than KRS 273.600 to 273.645, an institution may invest in any kind of property or type of investment consistent with this section;

(d) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification;

(e) Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of KRS 273.600 to 273.645; and

(f) A person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 2, effective July 15, 2010.

273.610 Appropriation for expenditure or accumulation of endowment -- Rules of construction.

(1) Subject to the intent of a donor expressed in the gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- (a) The duration and preservation of the endowment fund;
 - (b) The purposes of the institution and the endowment fund;
 - (c) General economic conditions;
 - (d) The possible effect of inflation or deflation;
 - (e) The expected total return from income and the appreciation of investments;
 - (f) Other resources of the institution; and
 - (g) The investment policy of the institution.
- (2) To limit the authority to appropriate for expenditure or accumulate under subsection (1) of this section, a gift instrument must specifically state the limitation.
- (3) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only "income," "interest," "dividends," or "rents, issues, or profits," or "to preserve the principal intact," or words of similar import:
- (a) Create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund; and
 - (b) Do not otherwise limit the authority to appropriate for expenditure or accumulate under subsection (1) of this section.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 3, effective July 15, 2010.

273.615 Delegation of management and investment functions.

(1) Subject to any specific limitation set forth in a gift instrument or in law other than KRS 273.600 to 273.645, an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in:

- (a) Selecting an agent;
- (b) Establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and
- (c) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

(2) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.

(3) An institution that complies with subsection (1) of this section is not liable for the decisions or actions of an agent to which the function was delegated.

(4) By accepting delegation of a management or investment function from an institution that is subject to the laws of the Commonwealth, an agent submits to the jurisdiction of the courts of the Commonwealth in all proceedings arising from or related to the delegation or the performance of the delegated function.

(5) An institution may delegate management and investment functions to its committees, officers, or employees as authorized by law of the Commonwealth other than KRS 273.600 to 273.645.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 4, effective July 15, 2010.

273.620 Release or modification of restrictions on management, investment, or purpose.

(1) If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution.

(2) The court, upon application of an institution, may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. The institution shall notify the Attorney General of the application, and the Attorney General shall be given an opportunity to be heard. To the extent practicable, any modification shall be made in accordance with the donor's probable intention.

(3) If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court, upon application of an institution, may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purpose expressed in the gift instrument. The institution shall notify the Attorney General of the application, and the Attorney General shall be given an opportunity to be heard.

(4) If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, sixty (60) days after notification to the Attorney General, may release or modify the restriction, in whole or part, if:

(a) The institutional fund subject to the restriction has a total value of less than fifty thousand dollars (\$50,000);

(b) More than twenty (20) years have elapsed since the fund was established; and

(c) The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 5, effective July 15, 2010.

273.625 Reviewing compliance with KRS 273.600 to 273.645.

Compliance with KRS 273.600 to 273.645 is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 6, effective July 15, 2010.

273.630 Application of KRS 273.600 to 273.645 to existing institutional funds.

KRS 273.600 to 273.645 apply to an institutional fund existing on or established after July 15, 2010. As applied to institutional funds existing on July 15, 2010, KRS 273.600 to 273.645 govern only decisions made or actions taken on or after that date.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 7, effective July 15, 2010.

273.635 Relation of KRS 273.600 to 273.645 to the Electronic Signatures in Global and National Commerce Act.

KRS 273.600 to 273.645 modify, limit, and supersede the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. secs. 7001 et seq., but does not modify, limit, or supersede Section 101 of that act, 15 U.S.C. sec. 7001(a), or authorize electronic delivery of any of the notices described in Section 103 of that act, 15 U.S.C. sec. 7003(b).

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 8, effective July 15, 2010.

273.640 Uniformity of application and construction of the Kentucky Uniform Prudent Management of Institutional Funds Act.

In applying and construing this uniform act, consideration shall be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 9, effective July 15, 2010.

273.645 Short title for KRS 273.600 to 273.645.

KRS 273.600 to 273.645 may be cited as the Kentucky Uniform Prudent Management of Institutional Funds Act.

Effective: July 15, 2010

History: Created 2010 Ky. Acts ch. 34, sec. 10, effective July 15, 2010.

APPENDIX 2

Summary of Endowment Investment Manager Structure & Benchmarks

UNIVERSITY OF KENTUCKY
SUMMARY OF ENDOWMENT INVESTMENT MANAGER STRUCTURE AND BENCHMARKS

| MANAGER NAME | HEADQUARTERS | INVESTMENT STRATEGY¹ | POLICY TARGET | POLICY RANGE | BENCHMARK |
|---|---|--|----------------------|---------------------|--|
| <u>Broad U.S. Equity:</u> | | | | | |
| Northern Trust | Boston, MA | Passive Russell 1000 (Large-cap) | 18.4% | | Russell 1000 Index |
| Wellington | Boston, MA | Active Russell 2000 (Small-cap) | 1.6% | | Russell 2000 Index |
| | | Total Broad U.S. Equity | 20.0% | 15.0-25.0% | Dow Jones U.S. Total Stock Market Index |
| <u>Broad Non-U.S. Equity:</u> | | | | | |
| Capital Guardian | Los Angeles, CA | Active MSCI ACW ex-U.S. - Core | 10.0% | | MSCI All Country World ex-U.S. Index |
| Mondrian | London, ENG | Active MSCI ACW ex-U.S. - Value | 5.0% | | MSCI All Country World ex-U.S. Value Index |
| William Blair | Chicago, IL | Active MSCI ACW ex-U.S. - Growth | 5.0% | | MSCI All Country World ex-U.S. Growth Index |
| | | Total Broad Non-U.S. Equity | 20.0% | 15.0-25.0% | MSCI All Country World ex-U.S. Index |
| | | TOTAL EQUITIES | 40.0% | 35.0-45.0% | N/A |
| <u>Private Equity:</u> | | | | | |
| Multiple Managers ² : Commonfund Capital Drum Capital NB Alternatives Pantheon Ventures Siguler Guff | Wilton, CT Stamford, CT Dallas, TX San Francisco, CA New York, NY | Private Equity Fund-of-Funds ("FOF") | 7.0% | 5.0-9.0% | Venture Economics All Private Equity Index Venture Economics All Private Equity Index Venture Economics All Private Equity Index Venture Economics All Private Equity Index Venture Economics All Private Equity Index |
| Chrysalis Ventures ³ | Louisville, KY | Regional Venture Capital | 0.0% | | Venture Economics All Private Equity Index |
| Fort Washington ³ | Cincinnati, OH | Regional Venture Capital | 0.0% | | Venture Economics All Private Equity Index |
| | | Total Private Equity | 7.0% | 5.0-9.0% | Venture Economics All Private Equity Index |
| <u>Real Return:</u> | | | | | |
| PIMCO | Newport Beach, CA | Real Return FOF (All Asset All Authority) | 6.0% | | All Asset Composite Index |
| Wellington | Boston, MA | Real Return FOF (Diversified Inflation Hedges) | 4.0% | | Wellington Diversified Inflation Hedges Composite Index |
| | | Total Real Return | 10.0% | 8.0-12.0% | 60%/All Asset Comp. Index/40% Wellington DIH Comp. Index |
| <u>Absolute Return:</u> | | | | | |
| Grosvenor | Chicago, IL | Core/Oppportunistic Absolute Return FOF | 12.0% | | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| Prisma | New York, NY | Core Absolute Return FOF | 5.0% | | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| Berens | New York, NY | Opportunistic Absolute Return FOF | 3.0% | | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| | | Total Absolute Return | 20.0% | 15.0-25.0% | Hedge Fund Net Fund-of-Funds Multi-Strategy Index |
| <u>Real Estate:</u> | | | | | |
| UBS | Hartford, CT | Core Real Estate | 4.0% | 3.0-5.0% | National Council on Real Estate Investment Fiduciaries Index - 1% |
| Multiple Managers ² : Contrarian Capital SC Capital Partners TA Associates WestRiver Capital Wrightwood Capital | Greenwich, CT Singapore Boston, MA New York, NY Chicago, IL | Non-Core Real Estate | 4.0% | 3.0-5.0% | National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index National Council on Real Estate Investment Fiduciaries Index |
| | | Total Real Estate | 8.0% | 6.0-10.0% | National Council on Real Estate Investment Fiduciaries Index |
| | | TOTAL ALTERNATIVES | 45.0% | 35.0-50.0% | N/A |
| <u>Fixed Income:</u> | | | | | |
| PIMCO | Newport Beach, CA | Core-Plus Fixed Income | 5.0% | | Barclays Capital Aggregate Bond Index |
| PIMCO | Newport Beach, CA | Unconstrained Fixed Income | 5.0% | | 3-Month LIBOR + 3% |
| Reams | Columbus, IN | Core-Plus Fixed Income | 3.0% | | Barclays Capital Aggregate Bond Index |
| Reams | Columbus, IN | Low Duration Fixed Income | 2.0% | | Barclays Capital 1-5 Year Government/Credit Index |
| | | TOTAL FIXED INCOME | 15.0% | 12.0-18.0% | Barclays Capital Aggregate Bond Index |
| | | TOTAL POOLED INVESTMENTS | 100.0% | | Policy Benchmark |

¹ Investment strategy definitions located in Appendix 3 of the Endowment Investment Policy.

² Multiple managers will be used to reach the target allocation for the investment strategy and target allocations for managers within this strategy will not be established.

³ The Committee has committed \$1 million and \$2 million to Chrysalis Ventures and Fort Washington, respectively, to enhance the total return for the Endowment and provide for leadership in economic development in the Commonwealth of Kentucky.

APPENDIX 3
Investment Strategy Definitions

INVESTMENT STRATEGY DEFINITIONS

Broad U.S. Equity Strategies

- **Passive Russell 1000 (Large-Cap):** Passive strategy that invests in the large-cap segment of the U.S. equity universe. The Russell 1000 index includes approximately 1,000 of the largest securities based on market capitalization and is a subset of the Russell 3000 index, which is a broad U.S. equity market index. The Russell 1000 represents approximately 92% of the U.S. equity market. The objective of a passive strategy is to match the return of the index.
- **Active Russell 2000 (Small-Cap):** Active strategy that invests in the small-cap segment of the U.S. equity universe. The Russell 2000 index includes approximately 2,000 of the smallest securities based on market capitalization and is a subset of the Russell 3000 index, which is a broad U.S. equity market index. The Russell 2000 represents approximately 8% of the U.S. equity market. The objective of an active strategy is to exceed the return of the index.

Broad Non-U.S. Equity Strategy

- **Active MSCI All Country World ex-U.S.:** Active strategy that invests in stocks in the broad non-U.S. equity universe (i.e. companies domiciled in countries other than the U.S.). The MSCI All Country World ex-U.S. index consists of approximately 2,000 securities across 47 markets, with emerging markets representing approximately 18%. MSCI attempts to capture approximately 85% of the market capitalization in each country. The objective of an active strategy is to exceed the return of the index.
 - Core: Strategy designed to have broad exposure to style (growth vs. value) and sector.
 - Growth: Strategy focusing on stocks that offer better-than-average expected earnings or growth potential. Common characteristics typically include a low dividend yield and high price to book/earnings ratios.
 - Value: Strategy focusing on stocks that are considered to be undervalued as they trade at a lower price relative to fundamentals (i.e. dividends, earnings, sales, etc.). Common characteristics typically include a high dividend yield and low price to book/earnings ratios.

Private Equity Strategy

- **Private Equity Fund-of-Funds:** Strategy that invests in various venture capital and leveraged buyout partnerships in the U.S. and non U.S. countries. The fund-of-funds approach provides access to top-tier private equity partnerships and enhanced diversification. Assets invested in the strategy are illiquid with a typical investment time horizon of seven or more years.
 - Core: Fully diversified fund by manager, strategy and geography.
 - Opportunistic: Non-core fund designed to capture excess returns due to current market opportunities, such as distressed/ special situation funds, emerging markets funds, or other specialized and/or geographically concentrated funds.

Real Return Strategy

- **Real Return Fund-of-Funds:** Strategy that typically invests in various real return assets including treasury inflation protected securities (TIPS), commodities, currency, REITS, timber, infrastructure and global natural resources. Strategy can also include equity and fixed income investments, and involve global tactical asset allocation among the various asset classes/strategies. The objective of real return investments is to provide a hedge against inflation. A real return strategy targets a return exceeding inflation by a premium, such as C.P.I. plus 5%. The fund-of-funds approach provides instant diversification among various real return assets.

Absolute Return Strategy

- **Absolute Return Fund-of-Funds:** Strategy that invests in a diversified range of hedge funds. Hedge funds are private, unregulated investment partnerships that execute a broad range of investment strategies across a broad range of securities. The objective of absolute return investments is to provide consistent positive returns with relatively low correlation to other asset classes. The fund-of-funds approach provides access to professional expertise in selecting and monitoring individual hedge funds, access to high quality, institutional hedge funds and instant diversification. Assets invested in the strategy typically have quarterly liquidity, however managers usually reserve the right to suspend liquidations under poor economic and market conditions.
 - Core: Fully diversified fund by manager, strategy and geography.
 - Opportunistic: Non-core fund designed to capture excess returns due to current market opportunities, such as currency trading funds, emerging markets funds, or other specialized and/or geographically concentrated funds.

Real Estate Strategies

- **Core Real Estate:** Strategy that invests in high quality, stabilized properties in economically diversified metropolitan areas. Properties are substantially leased and provide predictable income and cash flow, with limited potential for significant capital appreciation. Strategy includes four major property types as follows: office, retail, residential and industrial. Assets invested in the strategy typically have quarterly liquidity, however managers usually reserve the right to suspend liquidations under poor economic and market conditions.
- **Non-Core Real Estate:** Value added and opportunistic real estate strategies:
 - Value Added: Strategy that invests in existing properties that require redevelopment, releasing and/or repositioning. Strategy includes the four major property types (office, retail, residential and industrial) plus lodging. Investment return is derived from both rental income and property appreciation. Assets invested in the strategy are illiquid with a typical investment time horizon of seven or more years.
 - Opportunistic: Strategy that involves development properties and/or existing properties that require extensive redevelopment and releasing. Strategy involves all property types including

niche sectors such as healthcare, senior housing, etc., and can include investment in properties outside the U.S. Investment return is derived mainly from property appreciation. Assets invested in the strategy are illiquid with a typical investment time horizon of seven or more years.

Fixed Income Strategies

- **Core-Plus Fixed Income:** Strategy that invests the majority of the portfolio in high quality, U.S. dollar denominated, investment-grade fixed income securities similar to those in the Barclays Capital Aggregate Bond Index, including government/agency bonds, commercial and residential mortgage-backed bonds, asset-backed bonds and corporate bonds. Additionally, the strategy allows for investment in higher risk securities including non-investment grade, non-U.S. dollar denominated and emerging market bonds, but only to the extent allowed by the manager's guidelines.
- **Unconstrained Fixed Income:** Absolute return-oriented strategy that invests primarily in high quality, U.S. dollar denominated, and investment grade fixed income securities without sector or instrument limitations. The investment opportunity set includes government/agency bonds, commercial and residential mortgage-backed bonds, asset-backed bonds, corporate bonds (both investment grade and high yield), non-U.S. and emerging market bonds and currency. The strategy is designed to offer the traditional benefits of a core bond approach but with higher alpha potential and the opportunity to mitigate downside risk to a greater degree than what is reasonably possible from traditional active fixed income management approaches.
- **Low Duration Fixed Income:** Strategy that invests in a diverse set of short-term, high quality bonds which seeks to achieve low volatility and attractive returns relative to its benchmark (typically the Merrill Lynch 1-3 Year Treasury Index or Barclays Capital 1-5 Year Government/Credit Index). Investments include mortgage-backed securities, treasuries, corporates, and international fixed income. Additionally, the strategy allows for investment in higher risk, non-investment grade securities, but only to the extent allowed by the manager's guidelines. The strategy duration is typically less than three years.