

**Minutes  
Investment Committee  
Board of Trustees  
February 21, 2012**

IN ATTENDANCE:

Investment Committee Members:	Carol Martin Gatton, Chair William Britton William S. Farish, Jr. Erwin Roberts
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)

Mr. Gatton called the meeting to order at 8:00 a.m. and asked for a motion to approve the October 25, 2011 minutes. Mr. Farish 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 IC1. Ms. Krauss stated that IC1 is a recommendation to extend the contract with R.V. Kuhns & Associates (“RVK”) for the period April 1, 2012 through June 30, 2013. The University hired RVK in early 2008 as a result of a Request for Proposals. The initial four-year term of the contract expires on March 31, 2012 and the contract allows up to four one-year renewals. The fifteen month extension simply aligns the contractual term with UK’s fiscal year. Ms. Krauss commented that the staff and Committee will reevaluate in December of this year whether or not to extend the contract for another year. If it’s decided not to extend again, there will be six months to issue an RFP for a new consultant and execute the related contract before July 1, 2013. Ms. Krauss reported on the fee terms of the contract and described the diversification efforts of the last fours. Based on RVK’s recommendations, UK has implemented new absolute and real return allocations and expanded the private equity and real estate allocations. The changes have been made with the objective to enhance total return and reduce the volatility of returns over the long-term. At this point, it’s too early to evaluate the success of the changes made since we have implemented the changes in phases and the private equity and real estate programs are in the early stage of investment. However, 2012 should be a good test for how the endowment pool performs since we are close to the approved target allocation. After some discussion by the Committee, Mr. Britton made the motion to approve IC1, Mr. Roberts seconded the motion and all approved.

Mr. Rob Palmeri of RVK joined the meeting. He was not present during the discussion and vote on IC1.

Angie Martin provided an update on the Endowment Advisory Group, which is an internal group of senior faculty and staff members formed in November 2010 to address issues on individual endowment funds. One issue addressed by the group since its formation has been spending from underwater endowment funds. As background on the underwater issue, Ms. Martin reviewed a new summary in the Committee notebooks which details the market value and contributed value of the endowment by quarter since December 31, 2010. As of December 31, 2011, 895 of the 2,029 individual endowment funds were underwater. About half of the 895 funds were underwater less than 10% and the other half were underwater between 10 and 25%. Only 15 funds were underwater by more than 25%. Ms. Martin explained that the funds, most of which were created in the last ten years and matched by RCTF state funds, are underwater due to the two market hits during that timeframe. The Endowment Advisory Group recently reviewed the underwater status by college to determine the appropriate level of spending in the context of UPMIFA, the Uniform Prudent Management of Institutional Funds Act, passed by the General Assembly in 2010. UPMIFA calls for prudence when making spending decisions from underwater endowment funds and consideration of other fund sources. In light of the expected state budget cut for fiscal year 2012-13, the Endowment Advisory Group has recommended that underwater funds receive the standard spending policy distribution. Further cuts to the programs at this time would be too draconian. The group's recommendation will be considered as part of the full budget process.

Next on the agenda was a discussion by Ms. Krauss of the 2011 NACUBO–Commonfund Study of Endowments. Ms. Krauss reported that the UK ranked 81<sup>st</sup> in size out of 839 participating institutions, with a reported market value of \$916 million as of June 30, 2011. UK returned 18.7% for the year versus the average survey return of 19.2% due to a lower allocation to equities. UK returned 4.2% for the ten years ended June 30<sup>th</sup> compared to the average return of 5.6%, due to a higher allocation to equities over the ten-year period. Ms. Krauss pointed out that larger institutions performed better than smaller institutions over the ten year period due to higher allocations to alternative investments. Ms. Krauss then reviewed the asset allocations as of June 30, 2011 reported in the survey, noting that the overall average allocation to alternative investments was 27%. Smaller institutions, or those with endowments less than \$25 million, had an allocation of 10% to alternatives while larger institutions, or those with endowments greater than \$1 billion, had an allocation of 60% to alternatives at June 30, 2011. UK's allocation to alternatives was 40% at June 30, 2011. Ms. Krauss also reviewed returns and asset allocations of the top-quartile and top-decile performers, asset class returns for fiscal year 2011 and a summary of the survey results for the University's benchmark institutions.

Mr. Gatton introduced the next agenda item which was a review of the asset allocation and rebalancing activity by Ms. Krauss. Ms. Krauss reported that the total market value of the endowment pool was \$924.8 million as of January 31<sup>st</sup>, with 42% in equities, 42% in alternatives and 16% in fixed income. She reviewed the recent and planned rebalancing adjustments. Recent adjustments completed include reducing fixed income by \$21 million, adding \$10 million to non-US equity in an ETF strategy and funding the initial capital calls for the NB Wildcats Fund and the Real Estate Capital Asia Partners III Fund. She reported that the new Prisma absolute return strategy will be funded at the end of February with proceeds from the GAM redemption,

withdrawals from the fixed income managers and cash on hand. The GAM proceeds were received on February 6<sup>th</sup> and temporarily invested in a low duration ETF. Ms. Krauss reported that RVK and staff decided to slightly overweight Prisma at \$50 million (versus \$46.2 million at target) in order to obtain a reduced fee schedule. Additionally, it was decided to underweight Reams' low duration strategy and overweight Reams' core-plus strategy as interest rates are not expected to rise for some time. Ms. Krauss commented that 1% will be maintained in the low duration strategy for liquidity purposes.

Mr. Gatton introduced the next agenda item which was the performance review by Rob Palmeri. Mr. Palmeri reported that endowment ended the year with a strong fourth quarter, returning 3.95% versus the policy benchmark return of 4.09%. The fourth quarter underperformance against the policy benchmark was due mainly to the overweight position to the fixed income asset class. For the calendar year, the endowment pool lost 1.98% versus the policy benchmark loss of 0.37%. The 2011 underperformance against the policy benchmark was due mainly to PIMCO, which experienced significant losses in the third quarter due to Bill Gross' decision to take the treasury position of the Total Return Fund to zero; after which there was a flight to safety and spike in ten-year treasury yields. Mr. Palmeri commented that PIMCO appears to be back on track, evidenced by strong fourth quarter performance. He reviewed the quarterly and annual results of the various asset classes, noting that RVK continues to monitor Capital Guardian, which has experienced performance difficulties over the last three years.

Mr. Palmeri reported RVK has recently updated their forward-looking capital market assumptions and will be performing the annual asset allocation study and risk review. As a result, there may be some tweaks to the recommended policy allocation, which will be discussed with the Committee in June. Mr. Britton inquired if RVK was considering an allocation to commodities, energy or natural resources. Mr. Palmeri reported that UK currently has exposure to these strategies in the real return products managed by PIMCO and Wellington, which are "bundled" inflation-hedging strategies designed to lower the volatility of investing separately in commodities and other real assets. One idea being considered in the asset allocation review is "unbundling" some of the 10% real return allocation and investing a portion in illiquid strategies. Many energy and natural resource investments are structured as limited partnerships with a term of 10 to 12 years.

The next item on the agenda was a review of the Cash, Overnight and Short-Term Investment Report by Donna Counts. Ms. Counts reported that as of January 31, 2012, there was \$296.2 million in overnight and short term investments. Ms. Counts also reported that cash held at and managed by the state as of January 31<sup>st</sup> totaled \$233.9 million, resulting in total cash and operating investments of \$530.0 million. Total return on overnight funds for January was 0.10% and the return on short term investments was 0.78%, in line with the market indices for January. She also compared the January report to the same report as of December 31, 2011, noting that the total cash and operating investments increased from \$404.0 million at the end of December to \$530.0 million at the end of January mainly due to tuition and housing receipts during the month.

Ms. Counts reported that the Office of the Treasurer ("OT") has recently developed a new Operating Fund Investment Policy that expands the allowable investments in which the OT can invest to include all investments currently allowable by state law. The new policy also explicitly

allows the OT to hire an outside investment manager for operating funds. The objectives for the new policy are to diversify the operating fund investments, enhance returns, and to achieve greater flexibility and liquidity. The current policy, approved in early 2008, limits investment to funds managed by the Office of Financial Management, government securities and agencies, and government money market funds. The new policy will allow the OT to invest in a variety of fixed income securities (allowable by state law), including AAA-rated prime money market funds that include non-government securities. These prime money market funds have cut-offs late in the day which will be a significant advantage over the State investment pools, which require us to communicate our investment by 9:00am each day. In addition to providing us with greater flexibility, investment in non-State funds will enhance our liquidity management by reducing our investment concentration with the State, which has been a concern at times. The OT will explore hiring an external fixed income money manager to invest a core amount of operating funds that would be invested in an intermediate term strategy (i.e. three to seven years). Ms. Counts stated that the OT will continue to review results of the operating fund investments with the Investment Committee.

With no further business, the meeting adjourned at 9:30 a.m.

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Susan I. Krauss  
Office of the Treasurer

# IC 1

Office of the Treasurer  
February 21, 2012

Members, Investment Committee

## EXTENSION OF ENDOWMENT INVESTMENT CONSULTANT CONTRACT

Recommendation: that the Investment Committee approve extension of the contract with R.V. Kuhns & Associates to provide consulting and performance measurement services for the University of Kentucky Endowment for the period April 1, 2012 through June 30, 2013, subject to the terms and conditions of the existing contract.

Background: The Investment Committee conducted a national search for an Endowment investment consultant in fiscal year 2007-2008. Requests for Proposals (RFP) were solicited from qualified firms and R. V. Kuhns & Associates was selected based on their qualifications and evaluation criteria established by the Investment Committee. The term of the initial contract was April 1, 2008 through March 31, 2012, and provided for four one-year extensions at the option of both parties under the same terms and conditions. The University retains the right in this contract to cancel without cause with 30 days written notice.

This action will extend the one-year renewal period to fifteen months in order to convert to a fiscal year contractual period. After this extension, there will be three one-year extensions through June 30, 2016 at the option of both parties under the same terms and conditions.

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Action Taken:     Approved         Disapproved         Other \_\_\_\_\_