

**Minutes
Investment Committee
Board of Trustees
June 18, 2012**

IN ATTENDANCE:

Investment Committee	Carol Martin Gatton, Chair
Members:	William Britton William S. Farish, Jr. Erwin Roberts James W. Stuckert
Community Advisory	James F. Hardymon
Members:	Billy Wilcoxson
Investment Staff &	Angela S. Martin
Consultants:	Susan I. Krauss Rob Palmeri (R.V. Kuhns & Associates) Ron Klotter (R.V. Kuhns & Associates)

Mr. Gatton called the meeting to order at 3:30 p.m. and asked for a motion to approve the February 21, 2012 minutes. Mr. Britton made the motion to approve, Mr. Farish 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 approve termination of SSGA as the Russell 1000 index fund manager and authorize staff to execute a contract amendment with Northern Trust for management of the strategy. The change is necessary due to a recent operational change by State Street to discontinue its quarterly dividend distribution, which will decrease the actual income of UK's endowment pool by \$4 million annually. Northern Trust, the University's master custodian, offers a low cost Russell 1000 index fund that distributes income to investors on a monthly basis. Actual income for the endowment pool represents the interest and dividends distributed from the various investment managers to UK. The income must be distributed and reflected as income to be reported as income by the custodian. If the income is retained by a manager and not distributed as income, then it's included in the Net Asset Value, or NAV of the fund. Ms. Krauss explained that actual income is important at this time due to an agreement with the Council on Postsecondary Education ("CPE") that currently limits spending distributions on the state portion of underwater RCTF endowments to actual income. Effective July 1, 2012, spending distributions on both the state and private portion of underwater RCTF endowments will be limited to actual income. Angie Martin provided further background on the agreement

with CPE and reviewed the current status of underwater endowments. She also stated that staff is having discussions with CPE to revise the RCTF guidelines to incorporate UPMIFA (the Uniform Prudent Management of Institutional Funds Act), which was codified in KY in July 2010. Revision of the guidelines to incorporate UPMIFA would supersede the current agreement UK has with CPE that limits spending on underwater RCTF endowments to actual income.

Mr. Britton asked about the fees for the Northern Trust index fund. Ms. Krauss reported that the management fees will be slightly more for the Northern Trust fund, at approximately 2.4 basis points versus 1.2 basis points for the State Street fund. However, we will obtain reduced custodial fees from Northern Trust that will offset the additional management fees. Ms. Krauss stated that the assets between the two funds would be transferred in-kind in order to minimize transition costs. After some discussion by the Committee, Mr. Stuckert made the motion to approve IC1, Mr. Britton seconded the motion and all approved.

Mr. Gatton introduced the next agenda item which was a review of the asset allocation study and portfolio risk review by Rob Palmeri. Mr. Palmeri first presented the risk review and commented the analysis is performed annually to review different forms of risk including Thematic Risk, which evaluates portfolios broadly by themes of Capital Appreciation, Capital Preservation, Alpha and Inflation. Other risk issues analyzed included beta risk, risk budgeting and fixed income sensitivity. The review is intended to determine if the portfolio is well diversified. He noted that several years ago the beta risk of the portfolio was relatively high due to a high concentration in equities and Reams' credit-focused fixed income strategy. As a result, the Committee approved recommended changes to bring down the equity exposure and reduce Reams' allocation. Mr. Palmeri stated that this year's risk review did not contain any unusual or noteworthy risk exposures.

Mr. Palmeri then reviewed the asset allocation study, which is also performed annually using a model that includes forecasted long-term (10 years) assumptions for each asset class, including expected returns, standard deviations of returns and correlations of returns between the various asset classes. The output of the model is an "efficient frontier" or set of different asset allocations that provide the highest level of expected return for a given level of expected risk. The study reveals that in order to achieve the University's long-term return target of 7.5%, the University must look to other strategies besides traditional stocks and bonds. As such, RVK is suggesting that the Committee consider two new asset classes: Global Tactical Asset Allocation ("GTAA") and Global Long-Biased Long-Short Equity. GTAA managers seek to generate outperformance by exploiting long or short term inefficiencies in the global markets by investing in various asset classes and regions using stocks, bonds, derivatives, ETF's and investable indices. Long-biased long-short equity strategies are hedge funds or funds-of-hedge-funds that hold both long and short positions in equities but typically have a net long-exposure. Long-biased long-short managers will generally offer higher risk/return profiles than absolute return managers but with a lower beta, or active equity market exposure, than long-only equity managers.

Mr. Palmeri reviewed two different target portfolios RVK is suggesting the Committee consider in order to increase the total return of the endowment pool and decrease the volatility of returns, summarized as follows:

	Current <u>Target</u>	Proposed <u>Target A</u>	Proposed <u>Target B</u>
US Equity	20%	10%	11%
Non-US Equity	20%	10%	11%
Private Equity	7%	10%	10%
Diversified Inflation Strategies*	10%	10%	10%
Absolute Return	20%	16%	15%
Real Estate	8%	8%	8%
Fixed Income	15%	14%	10%
Long-Biased Long/Short Equity	--	10%	10%
Global Tactical Asset Allocation	<u>--</u>	<u>12%</u>	<u>15%</u>
Total	100%	100%	100%

*Note: current “Real Return” asset class renamed “Diversified Inflation Strategies”.

Mr. Farish commented that under the proposed target allocations, the amount invested in the US Equity asset class would be less than \$100 million, which seems low. Mr. Palmeri agreed that the amount allocated to US Equity sounds low, however pointed out that several other asset classes would have exposure to US equities including GTAA, Long-Biased Long/Short Equity, Absolute Return and Diversified Inflation Strategies. Mr. Farish commented that the University would have been better off investing more in US Equity than to have a 50/50 split between US and Non-US Equity. Mr. Palmeri responded that the 50/50 split is in line with the global equity market capitalization and that longer-term, non-US equities are expected to outperform US equities. Mr. Palmeri also stated that diversification is essential to reducing the volatility of the endowment portfolio, which will help grow the endowment over time due to the compounding effect.

Mr. Gatton inquired about the expected return for the private equity asset class. Mr. Palmeri responded that the return assumption for private equity was 11.75%. Mr. Palmeri then reviewed the various capital market assumptions used in the study.

Mr. Palmeri stated that the purpose of today’s discussion was simply to share the results of the asset allocation study and risk review in order to solicit feedback from the Committee. Staff and RVK expect to bring a formal recommendation on the asset allocation to the Committee at a future meeting after we have more clarity on whether UK will be subject to the actual income spending limitation for underwater RCTF endowments on a long-term basis. Staff and RVK expect to have additional discussions with the Committee on asset allocation prior to a formal recommendation.

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 \$959.9 million as of April 30th, with 43% in equities, 42% in alternatives and 15% in fixed income. She reviewed the recent and planned rebalancing adjustments, which consisted of liquidating \$4 million from the State Street index fund to fund various capital calls of the private equity and real estate managers. Ms. Krauss reported that the private equity managers have called \$65.0 million, or 34%, of the \$190.4 million total capital committed and the real estate managers have called \$22.8 million, or 52%, of the \$44.0 total capital committed. Ms. Krauss reminded the Committee that the new \$50 million Prisma investment was funded on March 1st with proceeds from the GAM redemption and withdrawals from PIMCO and Reams.

Mr. Gatton introduced the next agenda item which was the performance review by Mr. Palmeri. Mr. Palmeri reported that the endowment returned 6.88% for the quarter ended March 31, 2012 versus the policy benchmark return of 6.06%. Mr. Palmeri reviewed the fund attribution for the quarter noting the outperformance against the policy benchmark was due mainly to strong performance by the fixed income, real return and absolute return asset classes. Mr. Palmeri also reviewed the performance and other attributes of the fund versus RVK's peer universe of other endowments. Mr. Brockman asked about the composition of this peer universe and how UK's endowment performance compares to other similar universities. Mr. Palmeri responded that the universe consists of 150 endowments and added that the best source of benchmarking data is from the annual NACUBO-Commonfund Study of Endowments, which Ms. Krauss reviewed with the Committee in February. Mr. Brockman requested the benchmarking data from Ms. Krauss.

Mr. Palmeri called the Committee's attention to two memos in the meeting materials concerning existing manager issues. The first memo, dated March 16, 2012, reports the departure of a Grosvenor investment team member. The second memo, dated June 1, 2012, reports that the SEC has re-opened an investigation into specific trades made by Wellington, and the firm's practices regarding material, non-public information. Neither issue warrants termination at this time, however RVK will continue to monitor and inform the staff and Committee of significant developments.

Mr. Ron Klotter reviewed the May flash report distributed at the meeting. The endowment lost -4.28% during May versus the policy benchmark loss of -4.11%. Domestic equities were down -6.24% for the month and international equities were down -10.43%. The equity markets suffered due to concerns regarding Greece and the Eurozone. The real return asset class also performed poorly due to the deflationary environment, losing -5.84%. Absolute Return performed better, however still lost value during the month, losing -1.60%. The fixed income asset class provided deflation protection, returning 0.89%.

The next item on the agenda was a review of the Operating Fund Investment Report by Ms. Krauss. Ms. Krauss reported that as of April 30, 2012, there was \$350.3 million in overnight and short term investments. Ms. Krauss also reported that cash held at and managed by the state as of January 31st totaled \$119.9 million, resulting in total cash and operating fund investments of \$470.2 million. Total return on overnight funds for April was 0.16% and the return on short term investments was 0.76%, in line with the market indices. Ms. Krauss reported that of the \$350.3 million in overnight and short term investments, \$320.0 million is invested in various state investment pools. Ms. Donna Counts, Director of Treasury Operations, is currently reviewing various prime money market funds for possible investment in order to enhance returns and also improve diversification and liquidity.

Mr. Gatton asked if there was any further business to be discussed. Mike Richey stated how important it is for us to compare our performance results to other institutions since donors make comparisons on how the various endowments perform. Mr. Richey also shared with the Committee that Development is working to set up a donor advised fund program. Donor advised funds are becoming very popular as they allow donors more control over various decisions. With no further business, Mr. Gatton asked for a motion to adjourn the meeting. Mr. Britton made the motion to adjourn, Mr. Farish seconded the motion and all approved. The meeting adjourned at 5:10 p.m.

Susan I. Krauss
Office of the Treasurer

IC 1

Office of the Treasurer
June 18, 2012

Members, Investment Committee:

REPLACEMENT OF RUSSELL 1000 INDEX FUND MANAGER

Recommendation: that the Investment Committee approve termination of SSGA as the Russell 1000 index fund manager and authorize staff to execute a contract amendment with Northern Trust for management of the passive strategy.

Background: Spending distributions on the state portion of any Research Challenge Trust Fund (“RCTF”) underwater endowments are currently limited to actual income (i.e. interest and dividends received). Effective July 1, 2012, spending distributions on both the state and private portions of any RCTF underwater endowments will be limited to actual income.

In March 2012, SSGA announced discontinuation of their quarterly dividend distribution which is projected to reduce actual income of the endowment pool by \$4 million annually. As a result, UK needs to replace the loss of actual income from SSGA in order to preserve the level of spending distributions for RCTF underwater endowments.

Northern Trust, the University’s endowment custodian, offers a competitive Russell 1000 index fund that distributes income to investors. Investment staff and consultant, R.V. Kuhns & Associates, will negotiate a contract amendment and develop a transition plan to minimize the transaction costs of transitioning between the two index funds.

Action Taken: Approved Disapproved Other _____