Minutes
Investment Committee
Board of Trustees
September 11, 2012

IN ATTENDANCE:

Investment Committee Members:	Carol Martin Gatton, Chair William C. Britton 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 8:05 a.m. and asked for a motion to approve the June 18, 2012 minutes. Mr. Stuckert made the motion to approve, Mr. Britton seconded the motion and all approved.

Mr. Gatton asked Ms. Martin to address the first agenda item, an update on the spending policy review. Ms. Martin stated that the Endowment Investment Policy had two main components, one that addressed investments and asset allocation and another that addressed spending policy. She noted that the asset allocation was discussed at the June meeting and today the committee would begin discussing endowment spending. Ms. Martin discussed the issue of underwater endowments, spending distributions and discussions with the Council on Postsecondary Education (CPE) regarding spending on underwater RCTF endowments. She reported that the Governor had recently confirmed UK's position that the Board of Trustees has sole responsibility for the management of the University's endowments. Therefore, UK will no longer limit spending to actual income on the RCTF underwater endowments, which she also noted is not consistent with the investment asset allocation. Ms. Martin also said the University still needed to carefully consider how to manage spending on endowment funds in the future. She indicated that different spending policy options would be discussed today and staff would make a recommendation to the committee in December. Ms. Martin then introduced Mr. Palmeri and Mr. Klotter with R.V. Kuhns (RVK).

Mr. Klotter gave an overview of the current policy environment for spending policies. He said the discussion of spending policies and asset allocation is becoming much more integrated than in the past due to the market conditions and the regulatory environment. He said that spending policies are a high profile topic now due in part to UPMIFA, but the main reason people are focusing on spending policy is the performance of capital markets and pointed out that if all portfolios were up 20% a year for the past ten years there would not be as much concern about spending. Mr. Klotter said that since equity markets have been so challenging institutions needed to examine other factors affecting endowments that can be managed and controlled. Mr. Klotter said the primary variables affecting endowments are the total portfolio return, the rate of inflation, spending and expenses and if one variable changes, it affects the others. When the market crisis hit in late 2008 many institutions realized they had to make adjustments to spending policy. Mr. Klotter stated that RVK is recommending that clients establish spending policy parameters that should work in nearly all market conditions.

Mr. Klotter then summarized UPMIFA, which replaced UMIFA, and has been adopted in all 50 states. UPMIFA gave needed clarity regarding management of endowments. He referenced the prior discussion on CPE and underwater endowments and stated that UPMIFA clearly outlines that institutions can spend from funds with a market value below the original value of contributions. Mr. Klotter then outlined the seven factors that must be considered with developing a spending policy according to UPMIFA: duration and preservation of the fund; purpose of the institution and the fund; the general economic conditions; the possible effect of inflation and deflation; the total return on investments; the institution's other resources; and, the institution's investment policy. Mr. Klotter said the duration and preservation factor indicated that that if the fund is managed over the long term you do not need to worry about short term value fluctuations in setting spending policies. He also noted that if the endowment fund spending distribution is covering a high percentage of the operating budget generally the institution has less flexibility to adjust spending. He then stated that an institution should also consider inflation, investment returns and asset allocation in determining spending policies.

Next Mr. Klotter referred to a graph of effective spending rates from 2002 to 2011 for UK and peer institutions and said the charts were developed from data reported in the NACUBO-Commonfund Study. He pointed out that UK's effective spending rate is very much in line with its peers. Mr. Klotter then began discussing spending policy methodologies used by endowments as reported in the study. Seventy percent of institutions use percent of trailing market value, which is the method used by UK. Four percent spend income only, which is what endowments used to do prior to UMIFA. Eleven percent of institutions decide each year, which means they have no spending policy. Two other methodologies that are increasingly used are the inflation based and the hybrid methods. He said that these are two methods he wanted to focus on today. The inflation-linked method is used by 5% of institutions, and trending up. The weighted average method or hybrid method is used by 6% and also trending up.

Mr. Klotter stated the primary components of the percentage of weighted average market value calculation are defining the percentage of market value and defining the period for averaging the market value. For example, the average market value over three years to five years. The disadvantage of this type of policy is volatility. Spending varies more with this policy because if the market goes up, the spending goes up; if the market goes down, the spending goes down. Also, with this method spending tends to fall the most when the need may be the highest.

Mr. Klotter described the inflation linked spending method. Spending is essentially what you spent last year plus the increase in inflation or by inflation plus a certain amount, for example the rate of increase in CPI plus 1 or 2%. Advantages of this approach are that spending increases each year, unless there is deflation, and the volatility of spending is lower than a market based policy. It is also easy to calculate. The disadvantages are that you have the potential to overspend in times of stagflation, periods of stagnant or declining markets and high inflation. Another possible disadvantage is that spending will not keep up with large market increases.

Mr. Klotter then went on to describe the hybrid spending policy, which combines the weighted average market value and the inflation-linked approaches. Mr. Klotter then reviewed an example hybrid policy with a 70% of inflation-linked component and a 30% weighted market value component. He stated these percentages may vary based on the circumstances of the institution and other examples would be 60% inflation-linked and 40% weighted market value or 80% inflation-linked and 20%weighted market value. Mr. Klotter said the blended hybrid approaches are less volatile than a market based approach and avoids some of the problems of an inflation based approach. The main disadvantage of the hybrid approach is that it is complicated and more difficult to communicate to all the constituents. He said that regardless of policy used RVK recommends upper and lower spending bands, which is a policy that states your effective spending rate for a year must fall within the spending band.

Ms. Krauss then discussed the UK spending policy history. From 1993 to 2005, UK spent 5% over a 36 month averaging period, and in 1999 implemented a 1% management fee. In 2006 the spending rate was reduced to 4.75% and the management fee was reduced to 0.75% as a result of a market downturn. The spending rate was reduced again in 2007 to 4.5% and the management fee was reduced to 0.5%. In 2011 the rate was reduced to 4.25% and smoothed over a 60 month period and the management fee was reduced to 0.25%.

Mr. Gatton then asked for questions from the committee. Mr. Stuckert commented that he had no comments or questions but would await the recommendations made by staff at the next meeting. Mr. Hardymon asked RVK representatives if UK was unique in having so many different funds. Mr. Klotter responded that UK was not unique in having so many different funds but was one of the few they had worked with who was still dealing with underwater spending questions. Mr. Gatton then stated that UK would proceed with the current policy for the rest of this fiscal year and make a decision on the spending policy for the next fiscal year in December.

Mr. Gatton then moved on to the second item on the agenda, a review of asset allocation and rebalancing activity by Ms. Krauss. Mr. Gatton noted that the asset allocation review was one of the primary purposes of the investment committee. Ms. Krauss then referred to the asset allocation summary as of July 31, 2012 in the committee notebooks. At the end of July the endowment had a market value of $950 million and was made up of about 41% equities, 15% fixed income and 44% alternatives. She said a review of the allocation within the subcategories shows that UK is on target for all asset classes with the exception of real estate and that allocation is building slowly over several years in order to have appropriate vintage year diversification. She noted that the undertarget real estate allocation is currently invested in the equity allocations. Ms. Krauss then summarized activity since the last meeting. Within the equity category UK transitioned out of the State Street Russell 1000 Index fund to the Northern Trust Russell Index 1000 fund in July. In August there was a $10.1 million addition to the Other Post Employment Benefits quasi endowment, which was invested in ACWexUS ETFs;Wellington's Real Return Fund; Grosvenor's and Berens' absolute return funds and real estate capital calls. In the fixed income asset class UK adjusted between the Reams strategies by taking $4 million from the low duration strategy and moving it to the core plus strategy. Ms. Krauss said that the low duration strategy was set up a few years ago in anticipation of higher inflation and since that has not materialized and it was believed there would be better returns in the core plus strategy.

Mr. Gatton then moved to the next item on the agenda, the performance review and market update and asked Mr. Palmeri to proceed. Mr. Palmeri began by outlining the capital markets and the tumultuous events of the past year including the debt ceiling debate and downgrade of US government securities last fall; the poor economic performance for both the US and abroad; fiscal and monetary uncertainty resulting from the election and the European debt crisis. Finally, he said that the emerging markets are starting to see deceleration of growth (although still higher than developed market growth), which had been a big component of global market growth over the past decade. Mr. Palmeri reported that the S&P 500 was up 5.45% for the year, but that did not reflect the market volatility throughout the year. Small cap stocks were down 2.08% and international equities indexes had double digit negative losses throughout the year. He said there had been a flight to quality and fixed income indexes were up 7% to 12% for the year. The real estate asset class was one of the best performing asset classes last year, up 12% to 13% while commodities were down 14%. Mr. Palmeri noted that UK's asset allocation was in compliance with the investment policy and said he would be back in December with some recommendations of potential changes and some new asset classes.

Mr. Palmeri then moved on to discuss the University's endowment performance for the fiscal year ended June 30, 2012. He reported the total portfolio was down on a net basis 85 basis points versus the target allocation index which was down 11 basis points, so investments underperformed the target by 74 basis points. The total fund composite peer group ranking indicates UK performance was just below the median. Mr. Palmeri explained part of the reason for this underperformance is that UK is not fully invested in real estate and private equity because they are new programs and thus are not reaping the benefits of growth in those asset classes just yet. Mr. Hardymon asked what contributed to the negative performance of the target allocation index and Mr. Palmeri responded that the international equities contributed to the negative performance. Mr. Palmeri then moved on to discuss the performance by asset class. Domestic equity was up 3.34%, which was slightly below the equity composite, but in the peer group was in the top third of performance. Domestic equity did well in large part due to the passive equity allocations. The international equity components were down 12.39%, but the international market index was down 14.56%, so the international active managers performed better than the index.

Mr. Gatton asked if the international market conditions should have been predicted and if UK should have reduced the international equity holdings. Mr. Palmeri responded that it was very difficult to predict or time markets and quickly adjust asset allocation based on short term market fluctuations. Mr. Owen asked about the current allocation between domestic and international equities. Mr. Palmeri responded that RVK is still comfortable with the current allocation. Mr. Klotter added that some of the large European multinational equities are actually relatively cheap and look like good investments. He also stated that the tactical asset allocation adjustments take place in the hedge fund portfolios and portfolios like the Pimco All Asset All Authority fund. Mr. Bryant asked about the impact of the upcoming election on the financial markets. Mr. Klotter responded the market generally reacts more to congressional elections than the presidential elections. The factor that can affect markets is if there is an expectation that there could be a major shift in policy as a result of the elections, and the markets are not really expecting this as a result of this election. He noted that the worst election scenario that managers mention is lack of clarity of policy. Mr. Stuckert stated that while the Investment Committee wants the endowment investments to be in the best performing asset allocation every year, no one knows which area is going to be best at any one time. He stated that if the fund continues to do well compared to the average over time, then that should be considered good performance.

Mr. Palmeri moved on to review fixed income, which was up 6.42% over the last year and up 6.65% over the past ten years. In response to a question from Mr. Stuckert on the returns in real estate Mr. Palmeri noted that the real estate composite was up 11.33% over the last year. Mr. Britton asked about the real return asset class and the underperformance of Wellington. Mr. Palmeri stated that Wellington was down 11.4% in part due to their significant exposure to energy and agriculture. He noted that long term the fund was up 13.76% and outperformed the index by 1.3%. He said the reason Wellington is in the portfolio is to hedge against inflation over the long run. In a deflationary environment the investments in this asset class will most likely not do as well as other asset classes.

Mr. Gatton then moved on to the next item on the agenda, the performance review for operating fund investments and asked Ms. Counts to proceed. Ms. Counts referred to the report in the committee notebooks and pointed out that this was a report on the University's operating funds, not endowments funds. She said that as of July 31, 2012 cash subject to the operating fund investment policy totaled of $425.7 million. Of that $343.2 was invested in overnight and short term investments. The annualized monthly return on the overnight and short term investments was 0.15%, which was in line with the yield on the three month treasury of 0.08%. 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 1.63%. Ms. Counts stated that because rates are so low the only way to get any significant yield above the overnight rate is to commit funds for three years or more. She indicated concern that future rate increases would then result in decreases in the market value of the investments being below the purchase amount. As a result operating funds are being managed with very short duration and keeping in mind that safety of principal is the first priority. Ms. Counts moved on to report that cash held at the state totaled $60.4 million and that total cash available to fund operations was $486.1 million.

Mr. Gatton then asked RVK representatives for a summary of the private equity and alternative managers and asked if RVK had any knowledge of the Carlyle Group as a manager. Mr. Klotter referred to the performance report which included a list of the private equity managers on page 17. He explained that the private equity funds in the UK portfolio that have a large percent of paid in capital had nice returns. The challenge in evaluating returns for this asset class was that the returns are not realized all at once, but are realized over time as there are distributions from the funds. Because the P/E program is new, there very limited distributions, or in other words, very limited total return. He said the Carlyle Group is a direct fund and the UK private equity investments are fund of funds; but that Carlyle is a good manager and could bea holding in some of the fund of funds in the UK portfolio.

Mr. Gatton asked if there were any further questions. Being none, the meeting adjourned at 9:00 a.m.

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Donna Counts
Office of the Treasurer