

**Minutes  
Investment Committee  
January 28, 2013**

IN ATTENDANCE:

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

Mr. Gatton called the meeting to order at 1:00 p.m. Ms. Martin introduced Eric Monday, the new Executive Vice President for Finance and Administration, who joined University at the end of December and came from Louisiana State University. The committee members welcomed Mr. Monday to UK. Mr. Gatton then asked for a motion to approve the December 10, 2012 minutes. Mr. Stuckert made the motion to approve, Mr. Britton seconded the motion and all approved.

Mr. Gatton introduced the next agenda item, a review of the asset allocation and rebalancing activity. Ms. Krauss reported that at the end of December the endowment pool market value topped one billion dollars for the first time in the endowment's history. She pointed out that the endowment is reported based on net asset value, which is market value less liabilities, in the Investment Committee Report. Endowment related liabilities include medical malpractice and retiree health benefits and totaled \$80 million so the net asset value of the endowment as of the end of December was \$925 million. In terms of asset allocation, the fund is very close to the target and is comprised of 42% equities, 14% fixed income and 44% in various alternatives. There has been no rebalancing activity in recent months, other than a small liquidation of equity and fixed income to fund capital calls, and there are no plans for any significant future rebalancing activity.

Ms. Krauss then reported that the limited partnership originally set up in 2004 for regional investments and managed by Fort Washington was dissolved in December. Net of fees the fund was not performing well and the partnership was dissolved to reduce expenses. The separate securities formerly held in the fund will continue to be managed by Fort Washington until the company shares are liquidated.

Ms. Krauss also reported the fund is slightly under target on non-core real estate and Mr. Dan Krivinskas from RVK will discuss real estate investing later in the meeting. Ms. Krauss concluded by saying she would be traveling to Boston and New York next week to perform on-site due diligence visits with Wellington, Prisma and Berens.

Mr. Britton said he had heard that bond prices may be declining soon and asked Mr. Palmeri if the committee should think about changing fixed income allocations. Mr. Palmeri responded that some steps had already been taken to mitigate the potential effects of a rise in interest rates including investing in PIMCO's unconstrained bond strategy, Ream's low duration strategy and the sizing of the various mandates. Additionally, one of the new strategies under consideration, global tactical asset allocation, will allow managers to adjust their portfolio to respond to a potential rise in interest rates. The members of the committee discussed the possibility of interest rate increases and declines in bond prices and how these possibilities are taken into account in the investment process. Mr. Klotter stated that there is much risk analysis done in the portfolio asset allocation analysis to position the fund for these possibilities. Mr. Palmeri pointed out that it wasn't just the question of when rates are going to increase, but also the rate of the change which will affect the managers' ability to respond appropriately.

Mr. Gatton moved to the next agenda item, the performance review by Mr. Palmeri. Mr. Palmeri reported that last year was a very good year and the total fund composite was up 12.1% net of fees and outperformed the target allocation by 2.0% and the spending policy by 7.6% last year. For the last three years, the return of the endowment was 7.0%. He noted that the performance results for five, seven and ten years is not as good, but the asset allocations adjustments initiated after RVK was hired as the consultant should help to reduce volatility and enhance longer run returns. Mr. Palmeri then stated that since inception in 1992 the fund's total return has been 7.3%.

Mr. Palmeri reported that four out of five of the asset classes had outperformed their benchmarks. The best performing asset class last year was international equity with a 19.5% rate of return compared to the benchmark of 16.8%. Mr. Palmeri pointed out that the Domestic Equity asset class had underperformed its benchmark and that within this asset class Wellington Emerging Companies Fund had underperformed significantly and explained that RVK was watching this situation closely. Fixed income was up 8.7% compared to the index of 4.2% and every manager in the asset class did extremely well. The absolute return strategy was up 8.4%, above the benchmark of 4.8%. In concluding, Mr. Palmeri referred to a report in the notebook outlining a fee reduction RVK negotiated for the University for the Grosvenor See Blue portfolio that will save approximately \$32,000 per year going forward.

Mr. Gatton moved to the performance review for operating fund investments and asked Ms. Counts to proceed. Ms. Counts reported that as of the end of December, the Office of the Treasurer was managing \$398.2 million of operating funds and that \$303.9 million was in very liquid overnight and short-term investments. In addition, the University had \$94.3 million in other investments with \$60.0 million in the state intermediate pool. Ms. Counts reported that cash held at and managed by the state totaled \$140.3 million, and that UK had a total of \$538.5 million in operating funds as of the end of December. She reported that interest rates are low with an average return of 0.17% on overnight funds, which compared favorably to the three month T-bill rate of .04%. Other investments which are of intermediate maturity averaged 0.58% return compared to 0.25% for the two year Treasury note.

Mr. Gatton moved to the next agenda item, an overview of illiquid investments by Mr. Klotter. Mr. Klotter defined illiquid investments very broadly as investments you cannot sell or are not easily convertible to cash. UK's portfolio has about 66% that can be liquidated today, another 20% that are hedge funds that could be accessed in a year, and the remaining 14% of the portfolio is illiquid, which is private equity and real estate. UK's asset allocation and liquidity profile is similar to other institutions as reported in the 2011 NACUBO-Commonfund Study of Endowments. He noted that endowments tend to be the leader in holding illiquid investments, compared to other investment funds such as retirement funds, in part because they have less liquidity needs than other fund types. Also, endowments are perpetual and generally know their liquidity needs in advance, which allows them to invest in illiquid investments.

Mr. Klotter stated that the benefits to investing in the illiquid markets include enhanced long run returns. Private equity offers higher long-term return potential and exposure to less efficient markets such as new businesses and technologies. For real estate the benefits differ based on the sector: Core offers income and diversification; Value-Added offers income, appreciation and diversification; and Opportunistic offers capital appreciation and diversification. He said the disadvantages of illiquid investments include the potential to lose a lot of money, higher fees, higher maintenance in terms of capital calls, the “J Curve”, which means the early returns are usually negative as funds are invested, and valuation challenges as well as inability to access cash.

Mr. Klotter explained that the “J Curve” results at the beginning of an investment in a private equity fund because fees are taken out upfront from the capital raised creating a disproportionate ratio of fees to committed capital. Consequently, reported returns for early years are typically negative. The positive cash flow and corresponding returns result in later years. Since UK’s private equity program was started in earnest only a few years ago, it has been a drag on overall performance. This performance drag will decrease and eventually be eliminated over time. Mr. Klotter described the importance of effective manager selection in illiquid markets and said that over time the difference between top and bottom quartile performing private equity funds is 16.2%, whereas in contrast, the difference between top and bottom quartile managers of U.S “public” equity managers is 2.1%. Thus, the point is that manager selection for private equity is critical. Mr. Klotter further explained that valuation challenges of illiquid investments are a result of the investment timeline and cash flows. Instead of using a time weighted rate of return as is used for liquid investments, illiquid investment rates of return are measured by using the internal rate of return. Mr. Klotter commented that long-term performance of larger endowments that have invested in alternative strategies have exceeded the performance of smaller endowments that have not invested as heavily in alternative investments. He noted that the optimal structure of the illiquid investment strategy depends on the size of the investment, size of staff, level of investment expertise and the technology and reporting requirements.

Mr. Klotter introduced Steve Hahn of RVK to discuss the status of the UK Endowment Private Equity program. Mr. Hahn began by stating that UK’s private equity program is still immature and in the midst of the J Curve. Currently UK is about 40% invested in its private equity fund allocation. He said it was important to understand the market background. The private equity environment was very active from 2006 to 2008 and this was the same time UK began to invest in this asset class. Fundraising and investing in this asset class slowed substantially after 2008, which resulted in a slower than average drawdown of committed funds, and a corresponding delay in distributions. He compared UK Private Equity fund performance to peers and said that while some of UK’s fund of funds performance is currently in lower quartiles, the highest performing private equity returns were direct fund managers rather than fund of fund managers. The UK funds are still early in the life cycle and he expects performance to improve over time. He then reviewed UK’s private equity investments and distributions. He said that vintages between 2007 and 2009 are 80% invested, while vintages after 2009 are less than 50% invested. Distributions have been delayed due to the economic crisis, but more normalized valuation is expected going forward. The total private equity portfolio is experiencing positive returns as indicated by the 1.12 TVPI (total value to paid in capital) and he expects to see improved distribution activity and returns over time.

He then described the effect of comparing private equity manager performance based on the Internal Rate of Return (IRR) method versus the Time Weighted Return (TWR) methods. He noted that based on IRR most of the private equity funds have had positive returns whereas if you measured it by the TWR method, it would incorrectly indicate that the majority of funds had experienced negative returns. The reason is that under the TWR method, the early negative returns due to the cash outflows, the irregular pattern of those flows and associated fees weigh heavily in the return calculation. However, the IRR measures performance over the total period in proportion to the actual cash invested.

Ms. Krauss then gave background on the decision to hire a private equity separate account manager and the selection of Neuberger Berman through a Request for Proposal process. She said they currently manage the NB Wildcats Fund for UK. Ms. Krauss then introduced Neuberger Berman representatives Drew Fox, Brien Smith and Kaci Boyer. Mr. Fox and Mr. Smith gave background of NB investment management experience and process. Mr. Smith said the Wildcats Fund was a \$100 million commitment to private equity, of which \$50 million was committed to the Crossroads 2010 Fund and \$50 million will consist of various direct investments within the separate fund. Ms. Boyer reported that the fund is 46% committed and said there are nearly 600 companies in the portfolio and noted that \$2.3 million of the capital had been recycled to the fund. The Wildcats Fund had a total value of \$16.2 million as of September 2012. Of this, \$13.3 million was in private holdings and the gross performance was at 1.12X. Mr. Smith gave an overview of the private equity investment types of Primaries, Funded Primaries and Secondaries; and the four asset class types of Large-cap Buyout, Venture/Growth Capital, Mid-cap Buyout and Special Situations. He said that recycled distributions, secondary investments and the special situation asset class helped the early growth of the portfolio and funded primaries helped to reduce risk of the portfolio and increase the rate of capital deployment. In the long run they expect bigger total returns from the investment. He said the Wildcats Fund geographical diversification is predominantly focused on North America and is appropriately diversified across various industries. Mr. Smith then highlighted specific investments in the portfolio.

Mr. Krivinskis then began to review the UK Endowment Real Estate Portfolio. He gave an overview of the institutional real estate investment market and said UK began to invest in real estate in 2005 targeting 8% of the asset allocation and focusing on core real estate funds. In 2008 RVK was hired as the consultant and advised the University to increase the real estate investment allocation to 12%, with 4% to Core, 4% to Value-Added and 4% to Opportunistic strategies. In 2010 the target was reduced to 8%, with 4% Core and 4% Non-Core, which combined the former Value-added and Opportunistic strategies.

Mr. Krivinskis noted that the UK Real Estate Portfolio has performed well and outperformed the benchmarks over the past three years and performed in the top 20% to 40% over five years. The portfolio has 86.9% fixed rate debt utilization, which is very good. Geographically the portfolio is well diversified and international exposure will likely increase as non-core real estate investments increase. Mr. Krivinskis then discussed investment pacing reporting that currently 6.3% of total assets are invested in real estate. That is expected to increase to 7.1% next year and then increase to 8% thereafter. He then outlined opportunities in non-core real estate and RVK's recommendation to increase investment in non-core funds. A new RFP is planned for 2013 to add an additional non-core real estate manager.

Ms. Krauss then introduced Ron Lanier, Bill Hughes and Steve Olstein, representatives from UBS Trumbull Property Fund, a core real estate manager. Mr. Lanier recapped the history of UBS-TPF investing for UK since 2004 and reported a total current market value of \$43.1 million, and a 6.75% return since inception. Mr. Hughes discussed the market outlook and said that while real estate took a big hit in 2008 it is improving fundamentally and the market is starting to see income growth driving appreciation and not just changes in valuation. He said this is indicative of a more sustainable and normal real estate market. He commented on particularly favorable trends in the apartment sector and noted slower improvement for the hotel and office sectors, all trends UBS takes that into consideration when underwriting those activities.

Mr. Olstein provided background on the UBS-TPF fund and outlined the core strategy of quality, growth of income, diversification of risk for both geographic area and property type, and limited use of leverage. Additionally, individual assets are limited to no more than 5% of the fund. He said that while they are guided by the core strategy they are also able to act tactically if opportunities arise. He reported performance of the UBS-TPF relative to the benchmark ODCE, noting that the ODCE has twice the leverage of the UBS-TPF and a more highly leveraged fund would tend to perform better in times of

appreciation. Because of the leverage difference, on a short term basis the fund underperformed the benchmark, but over the five to ten year time frame they outperformed the benchmark. Over ten years the TPF return was 7.8% compared to the ODCE performance of 6.7%. He concluded his remarks.

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

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Donna Counts  
Office of the Treasurer