Minutes
Investment Committee
March 18, 2013

IN ATTENDANCE:

Investment Committee Members:	Carol Martin Gatton, Chair William C. Britton William S. Farish, Jr. James W. Stuckert
Community Advisory Members:	James F. Hardymon
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)

Mr. Gatton called the meeting to order at 2:05 p.m. and asked for a motion to approve the January 28, 2013 minutes. Mr. Stuckert made the motion to approve, Mr. Britton seconded and all approved.

Mr. Gatton introduced the next agenda item, a review of fixed income investments by Mr. Palmeri. Mr. Palmeri said that in the past two meetings members of the committee had asked questions about the fixed income investments due to concerns about a potential rise in interest rates. As a result, staff and RVK decided to present a detailed overview of the asset class. Fixed income is currently 15% of the total portfolio and there are two managers of four different strategies; PIMCO Core Plus, PIMCO Unconstrained Bond Fund (UBF), Reams Core Plus and Reams Low Duration.

Mr. Palmeri began by reviewing types of risks associated with the fixed income asset class. Beta is a measure of how sensitive a portfolio is to the volatility of the equity markets, and is measured in relationship with a benchmark such as the S&P 500. A beta of more than one indicates the portfolio is more volatile, a beta less than one indicates the portfolio is less volatile, and a beta of zero suggests a portfolio whose assets value is independent of equity market movements. He said that zero is the preferred beta for a fixed income portfolio. He referred to a chart illustrating beta exposure for each fixed income strategy from 2006 to 2012. The beta for each strategy had ranged from -0.15 for PIMCO Core Plus in 2008 to almost 0.5 for REAMS Core Plus in 2009. Mr. Palmeri said that all the strategies were converging to close to 0.0 in December of 2012 and stated that RVK is very comfortable with the beta exposure in the UK portfolio.

Next Mr. Palmeri discussed another risk measure, duration. He said that duration measures the sensitivity of a bond's value to changes in interest rates. For example, if a bond's duration is five years, a 1% point change in interest rates will result in a 5% change in price and if you buy this bond at 100, a 1% point increase in rates will result in a 5% decrease in the bond's value to 95. He said the duration of the UK portfolio has decreased in the past few years as the PIMCO UBF and the Reams Low Duration fund have been added. The average duration of the UK portfolio from March 2008 to December 2012 was about 3.75 years compared to the market, as measured by the Barclays US Aggregate Bond Index, of close to 5 years. Mr. Britton then asked what the effect would be of a decrease in interest rates on UK's portfolio. Mr. Palmeri referred to another page in the presentation illustrating the interest rate sensitivity of the UK fixed income portfolios, by manager and in aggregate. At the current duration and current effective yield of 2.4%, an increase in interest rates of 50 basis points is estimated to result in an increase in the fixed income portfolio of 0.8%. However, if rates go up 100 basis points, it is estimated that the portfolio would decline in value by 0.8%. Conversely, if rates go down 50 basis points the portfolio would go up 4.0%. Mr. Palmeri also noted that if rates rise slowly and steadily the fixed income managers can respond to those shifts in rates and reduce negative effects of the rate changes.

Mr. Palmeri then reported that as of January 31, 2013 the average maturity of the UK portfolio of 4.3 years compared to the Barclay US Aggregate Index of 7.1 years, and an effective duration of 3.2 years compared to the index duration of 5.2 years. The average quality in the UK portfolio is AA compared to the index average quality of AA1. He said the UK portfolio is high quality and lower in duration and noted the tradeoff is that the yield to maturity is slightly lower than the market, 1.7% compared to 1.9%.

Next Mr. Palmeri discussed the sector distribution by manager and in aggregate and stated that the portfolio is well diversified and that the PIMCO and Reams' strategies are complimentary. Reams Core Plus has 20.6% in Treasuries, and no other portfolio holds Treasuries. PIMCO Core Plus has 29.1% of government agencies, while Reams Core Plus has only 0.8% in agencies. He noted that fixed income performance last year was excellent with a total return of 7.0% compared to 2.6% for the market. Mr. Palmeri concluded by saying that if interest rates increase RVK believes the fixed income portfolio should do better than the broad market because of the portfolio characteristics and risk measures.

Ms. Krauss said that they are discussing the possibility of repositioning the Reams portfolio to an unconstrained strategy similar to the PIMCO strategy to allow them more flexibility to shorten duration further should rates move up to help improve future returns. She said this is being considered as part of the overall asset allocation analysis that will be brought back to the committee in May. Mr. Palmeri discussed the challenge of how to increase yield in fixed income investments in the current market, and the tradeoff between risk and yield. He noted that fixed income allocation and strategy is an issue all endowments are looking at in the current low interest rate environment and this will be discussed with the Committee more in May.

Mr. Gatton moved on to the next item on the agenda, a review of the 2012 NACUBO-Commonfund Study of Endowments. Ms. Krauss reported that the NACUBO-Commonfund study is released in late January is presented to the Committee every March. Mr. Klotter then began reporting and said 831 U.S. institutions participated in the survey and data was reported as of June 30, 2012. The results are reported by endowment size categories beginning for funds under $25 million and ending with funds over $1 billion. Mr. Hardymon commented on the data not being presented for more endowment categories over $1 billion. Mr. Klotter responded that due to the number and size of very large endowments this somewhat skews the results because the over $10 billion funds are very different from the $1 billion to $5 billion funds.

Mr. Klotter then reviewed overall performance and said that results were slightly negative with a loss of 0.3% on average. One year returns through June 30, 2012 favored institutions with large relative fixed income allocations and low alternative allocations. He said fixed income did better than equities, domestic equities did better than international equities, and hedge funds did not perform well. Within alternatives, the weakest performers were marketable alternatives and managed futures/commodities. Domestic equity was up 2.0%, fixed income was up 6.8%, international equities declined by 11.8%, alternatives were up 0.5% and cash was close to zero. Returns for the trailing 1, 5, and 10 year periods were below the average long-term target rate of 7.4%. He said the policy ramifications of returns less than the long term target include an increased focus on fundraising, cost containment, spending policies and an evaluation of asset allocation policies.

Mr. Klotter said equity and alternative asset allocation varies significantly by the size of the institution. For domestic equities, endowments over $1 billion had a 12% exposure while endowments under $25 million had a 39% exposure. Alternative strategies account for 61% for funds $1 billion and over and only 11% for funds under $25 million. He said there are cost economies that make it difficult for small endowments to invest in alternatives. UK's asset allocation is closer to the allocation for the $500 million to $1 billion and the over $1 billion funds and is more in line with our peer groups than it used to be. Mr. Klotter said the alternative strategies include many different types of investments and he anticipates a more refined breakdown of alternatives for future NACUBO reports. Mr. Palmeri added that while RVK looks at the NACUBO study, they do not try to mirror the allocations reported in the study.

Mr. Klotter noted UK's endowment provided 1.7% of the operating budget for fiscal year 2012 compared to 8.7% for all reporting institutions and 16.2% for institutions with endowments over $1 billion. He noted that this percentage varies greatly by institution size and whether it is public or private. Total amount of endowment spending for all institutions increased by over 20.8% for the period, but the effective spending rate fell to 4.2%. UK's endowment spending decreased by 13.2% in the same period and had an effective spending rate of 3.5%. He said that although UK's annual spending dropped, the market value has increased significantly from 2009 and the total portfolio benefited from the conservative spending and the strong market returns.

Ms. Krauss then compared the UK asset allocations and nominal returns to other benchmark institutions. The University Review Committee (URC) benchmark institutions include eleven institutions that are very similar to the UK. Most of these institutions manage very large endowments, with eight exceeding $1 billion. The benchmark group did very well compared to the NACUBO study group. The returns for the URC benchmarks over the past ten years averaged 6.8%, compared to the NACUBO study average return of 6.2% and UK's average return of 4.9%. She said UK's poor performance was due to the large equity exposure going into the downturn in 2008. The asset allocation comparison shows that as of June 30, 2012 the URC group has a higher allocation to alternatives, 48.4%, compared to compared to 54% for the NACUBO study average and 43.4% for UK. Within alternatives, UK's lower allocation to venture capital and private equity is the primary difference. UK's U.S. and Non-U.S. equity exposure was higher compared to the URC group, but like UK, the URC group's allocation to U.S. and Non-U.S. equity are equally weighted , which has become the standard for many institutional investors.

Ms. Krauss then compared UK to the other SEC institutions. The SEC group had a 10-year average return of 6.3%, slightly higher than the NACUBO study average return of 6.2%. She also reported that the SEC group had a 40.1% allocation to alternatives compared to 54% for the NACUBO study average and 43.4% for UK. Finally Ms. Krauss reviewed the results for Kentucky institutions participating in the study, noting the average ten year performance of 6.0% was below the average return of the NACUBO study, due to a much lower allocation to alternatives and a higher exposure to U.S. equities.

Mr. Gatton then moved to the next agenda item and Ms. Krauss reviewed the asset allocation and recent rebalancing activity. As of January 31, 2013 the fund totaled $1.035 billion, with 42% equities, 14% fixed income and 44% in various alternatives. She said there had been no rebalancing activity in recent months, and there were no plans for future rebalancing activity other than small withdrawals of equity or fixed income investments to fund capital calls. She noted that the portfolio is still slightly under-target in real estate, as expected, as the decision was made to move slowly towards the 8% real estate target.

Mr. Gatton moved to the next agenda item, the performance review by Mr. Palmeri. Mr. Hardymon asked about the status of the Wellington Emerging Companies Fund. Palmeri responded that RVK was continuing to watch their performance. Ms. Krauss responded that she had met on–site with Wellington representatives, including the new portfolio manager, and was reassured with their recent portfolio restructuring back to a more U.S. focused, high quality micro-cap strategy, which is the strategy that contributed to their longer-term success. In recent years, the strategy had added some non-U.S. and special situation investments that had not performed well versus the Russell 2000. Mr. Palmeri reviewed the manager asset allocations as of January 31, 2013 and noted that the Wellington Emerging Companies

Fund comprises only 1.62% of the portfolio. The Northern Trust Russell 1000 Index is the top position managing 18.63% of the fund assets, the Grosvenor See Blue fund accounts for 11.53% of the fund, and the Capital Guardian International fund accounts for 9.17% of the fund. He confirmed that the endowment fund asset allocation was within the policy target ranges. In terms of asset class performance, the quarterly return for international equity was the highest return at 6%, while domestic equity was flat. The other higher performing asset class was the absolute return category, and it was up 2.37%. The total fund composite for the quarter was up 2.09%, which compared favorably to the policy benchmark of 1.67%.

Mr. Britton asked about the concentration of investments with three managers controlling 40% of the portfolio. Mr. Klotter responded that the Grosvenor See Blue Fund was a fund-of-funds with 38 underlying investments. Also, Northern Trust is a passive index fund, and if Northern Trust were to have problems, UK would own the actual shares and not lose anything. Ms. Krauss pointed out she had asked similar questions about the PIMCO concentration and the reassurance provided by RVK was that those were mutual funds which have a very high degree of regulatory scrutiny. Mr. Gatton inquired about the controls in place to assure safety of the underlying hedge fund assets. Mr. Palmeri offered to make a presentation about manager concentration, asset safety and hedge fund risk management at a future meeting.

Mr. Palmeri then returned to reviewing investment performance. For the 12 months ending December 31, 2012 the total fund net of fees was up 12.28%, compared to the policy benchmark of 10.66%. Total value added was 1.63 percent, and that was primarily from manager value added in the absolute return and fixed income areas. Mr. Palmeri then reviewed the February returns. For the month the fund was up 15 basis points, outperforming the indices, and calendar year-to-date the fund was up 2.82%, again outperforming the indices. Fiscal year-to-date the fund is up almost 10%.

Mr. Gatton moved to the performance review for operating fund investments. Ms. Counts reported that as of the end of January operating cash and investments totaled $647.9 million. Of this, the Office of the Treasurer was managing $471.8 million and the rest is held at and managed by the state. Of funds managed by UK, there was $377.5 million invested in overnight and short-term investments. The fiscal year-to-date return was 18 basis points, which compared favorably to indices of .08% for the three month treasury and 0.16% for the fed funds rate. The University had $94.3 million in other investments with a fiscal year-to-date yield of 0.86%. She noted negative returns for the month in the state intermediate fund and said this is due to the recent increase in rates and the decline in the value of the underlying fund investments.

Mr. Gatton asked if there were any other issues or questions and Mr. Britton then asked about underwater endowments. Ms. Krauss referred to the summary of endowments in the committee notebooks and reported that of the 2,061 endowments, 637 were underwater as of December 31, 2012. She referred to the schedule of the distribution of underwater funds and referenced the revised spending policy approved in December. Per that policy FY 2014 spending will be suspended for the 12 endowment funds that are underwater more than 20%. Additionally staff will be meeting with the college deans and department heads to discuss spending distributions for the funds underwater between 10% and 20% to outline UPMIFA spending guidelines and encourage spending reductions. Ms. Krauss noted that the underwater situation improved significantly over the same period last year when 895 endowments were underwater.

Mr. Gatton asked if there were any further comments or questions. Being none, the meeting adjourned at 3:50 p.m.

Donna Counts
Office of the Treasurer