

**Minutes  
Investment Committee  
May 13, 2013**

IN ATTENDANCE:

Investment Committee Members:	James W. Stuckert, Acting Chair William C. Britton William S. Farish, Jr.
Community Advisory Members:	James F. Hardymon Henry Clay Owen Bill B. Wilcoxson
Investment Staff & Consultants:	Eric N. Monday Angela S. Martin Susan I. Krauss Donna A. Counts Rob Palmeri (R.V. Kuhns & Associates)

Mr. Stuckert opened the meeting and explained that Mr. Gatton could not attend and requested that he serve as chair. He then called the meeting to order at 2:00 p.m. and asked for a motion to approve the March 18, 2013 minutes. Mr. Farish made the motion to approve, Mr. Britton seconded and all approved.

Mr. Stuckert introduced the first agenda item and Ms. Krauss explained that each year RVK conducts an asset allocation study and portfolio risk review for the formal asset allocation review required by the investment policy. She said Mr. Palmeri would review the risk review and asset allocation study and outline some proposed changes that should enable the fund to achieve a 7.5% long-term rate of return. She said the two most important policy decisions that the investment committee can make are the asset allocation and the spending policy and that these two decisions will determine the success or failure of the endowment. She said that the last ten years have not been a success story for UK's endowment because the endowment was not fully diversified going into the 2008 recession. As a result, the endowment lost 40% during the market downturn. She said that much progress has been made over the past five years but there was still room for improvement. With regard to the spending policy, she said that in December the committee had approved a new hybrid spending policy that should smooth out distributions and protect the corpus of the endowment over the long term. The committee also approved restorative and protective measures for underwater and newly established endowment funds.

Ms. Krauss said the current asset allocation target was approved September 2010. Since that time expected returns have decreased and expected volatility has increased, which results in lower expected compound returns going forward. The changes to be discussed were first introduced last June and include a new allocation to Global Tactical Asset Allocation ("GTAA"), a new allocation to Long-Biased Long/Short Equity, and increasing the allocations to private equity and private real estate. Over the past year the committee has had several informational sessions on these strategies.

Mr. Palmeri then discussed the study findings. He noted that the portfolio risk study is a backward looking review of what actually happened by looking at absolute and relative returns, risk adjusted returns, tracking error and other metrics as compared to market indices. The asset allocation study is forward looking and uses a mean variance optimization model to look at various asset classes and optimizes the portfolio to maximize expected return for a given level of expected risk. In terms of liquidity risk, Mr. Palmeri said that currently 30% of the portfolio is considered "less liquid", or would take one to six month to access, and 14% is considered illiquid (assets that are locked up for years).

Fourteen percent in illiquid assets is very low compared to peer groups. In terms of volatility risk, the public equity allocation is 40% of the fund, but contributes to 75% of the volatility of the portfolio. He further noted risks associated with fixed income discussed in detail at the last committee meeting.

He reported that the asset allocation study indicates that adding GTAA and Long-Biased Long/Short Equity strategies, increasing the allocations to private equity and private real estate and decreasing traditional equity and fixed income allocations improves the expected long term returns of the portfolio without increasing risk. He referred to table 6 in the study and reviewed the allocation for portfolio “8” that resulted in an expected arithmetic return of 7.71% with a standard deviation of 12.49% and said that compared to the current allocation we would improve the portfolio’s expected long term return with essentially the same risk. He noted the expected compounded return of 6.99% with the portfolio “8” allocation compared to the expected compounded return of 6.66% with the current portfolio allocation. Mr. Hardymon asked why portfolio “8” was selected and Mr. Palmeri responded that portfolio “8” is expected to generate a higher return and a slightly lower level of risk than the current portfolio. Mr. Britton asked about allocation for portfolio “5” that had a 6.86% expected compound rate of return with only 11.31% of expected risk. Mr. Palmeri responded that the additional 13 basis points of expected return to be produced by portfolio “8” could be significant over time and the additional potential return is important to help meet the endowments’ long term spending objective.

Ms. Krauss stated the long-term return objective for the endowment is 7.5% and that portfolio “8” is expected to achieve a 6.99% or roughly 7.0% rate of return based on expected returns at this asset class level, or what we expect the market indices to return. She then distributed a draft report, “Analysis of Nominal & Real Return Objectives”, to outline the investment return objective and look at how much manager alpha, or additional return, can be provided through manager performance over and above the asset class level over the long term. She said that RVK completed a separate analysis of expected manager alpha and based on that analysis, which contained fairly conservative assumptions, we can reasonably expect the manager value-add to be approximately 46 basis points over the long term. Therefore a long-term return objective of 7.5% is reasonable with the proposed changes to the asset allocation. However, the current asset allocation’s expected compound rate of return is 6.66% and would require manager alpha of 84 basis points to meet the 7.5% long-term return target, which she said was unrealistic. Ms. Krauss stated that a 7.5% return is needed to cover inflation, expected to be 3.0% over the long-term, a 4.0% spending rate, a 0.25% management fee and provide for a cushion of 0.25%. Without changes to the asset allocation, the endowment pool is expected to produce an average annual return of 7.0%, including manager alpha, which is not sufficient to cover spending and inflation over the long-term. Ms. Krauss concluded that the proposed asset allocation changes are necessary to increase the long-term return to 7.5% so we can at least maintain, or possibly grow the inflation-adjusted value of the endowment, which is our fiduciary responsibility under UPMIFA.

Mr. Stuckert asked about the actual manager alpha over the past three years. Mr. Palmeri responded that the domestic equity manager would not show alpha because they manage a low cost, passive strategy that is expected to mirror the index and generate no alpha. International managers generated 82 basis points of alpha, fixed income generated 67 basis points of alpha, real return generated 7 basis points, and absolute return generated 168 basis points of alpha. Mr. Stuckert noted that if the real return exactly equaled spending, then the endowment fund would not increase over time. Mr. Stuckert then reviewed Table 2 in the Asset Allocation study that highlighted historical performance of different asset classes from 1980 to 2012 and commented on the volatility of the different asset classes over time. Mr. Stuckert also noted that the Committee and RVK not only need to review asset allocation but also to monitor execution of the asset allocation by ensuring managers manage per the asset class parameters and have good performance within the asset class. Mr. Palmeri concurred and added that the GTAA and the Long-Biased Long/Short Equity allocations would help to reduce the overall volatility of the endowment pool. Mr. Palmeri noted that it is possible to have excellent managers that produce alpha, but still not achieve the absolute return objective of the endowment.

Ms. Krauss then presented a summary of the current portfolio, the proposed changes and a look through to the underlying investments. She said the recommended allocation changes do not change the underlying asset class exposures materially, but instead, changes the strategies employed and allows the managers to be more tactical. Mr. Palmeri said currently public equities account for 46.2% of total equity exposure, while long/short equity accounts for 5.31% and private equity accounts for 7.47%. Total equity exposure is roughly 59%. The allocation based on the proposed strategy has public equity at 30.46%, the long/short equity of 16.19% and private equity of 12.0%, for total equity exposure of roughly 58%. He said that over the long term equities give you higher return, but the increase in long/short and private equities helps to reduce the equity volatility.

Ms. Krauss then referred to a summary of the asset class changes under consideration. Within US equity, the allocation would decrease from 20% to 12%, reducing the Russell 1000 Index Fund and the Wellington Emerging Companies Fund. She said staff and RVK are considering allocating part of the US equity strategy to a return-enhancing strategy such as the Northern Trust Quality Dividend Focus Strategy, a strategy that invests in high quality companies that generate high dividends. Another product being considered is the PIMCO Stocks-Plus Product that gets the equity exposure through futures and invests the underlying collateral in fixed income. For non-US equities, it is proposed to eliminate Capital Guardian and split the allocation between Mondrian and William Blair. Other considerations include establishing dedicated emerging market and small cap exposures with Mondrian and William Blair. Fixed income would be reduced to 10%, and the Reams allocation split between a core-plus strategy and an unconstrained strategy to allow them greater investment flexibility to enhance returns. Ms. Krauss indicated that private equity would be increased to 12% and would take some time to implement. Several alternatives are being considered including increasing the commitment to Neuberger Berman, hiring a second separate account manager or making some direct investments. Regarding real estate, the endowment pool is under the current target of 8%, so an RFP will be issued to hire one or more non-core real estate managers regardless of what changes are approved for the asset allocation. The proposed recommendation will be to increase the real estate target to 12%. It is proposed that the Absolute Return asset class be reduced to 10%, which will leave one manager, Grosvenor, as the sole Absolute Return Manager. Real Return would become Diversified Inflation Strategies (“DIS”) and the PIMCO All Asset All Authority reclassified to the GTAA asset class, with Wellington remaining as the lead manager in the DIS asset class. With the proposed asset allocation, an RFP would be issued for managers of the illiquid portion of about 3% to invest in illiquid strategies including energy, timber or other similar real asset funds. Long-Biased Long/Short Equity would be 14% with existing managers used to manage the assets (Wellington, Berens, Prisma and Grosvenor). With the proposed asset allocation, an RFP would be issued for GTAA to hire a manager to complement PIMCO’s All Asset All Authority GTAA strategy.

Ms. Krauss then discussed manager concentrations. Before the changes PIMCO is the lead manager with 16% of total target followed by Grosvenor and Capital Guardian. If we move forward with the proposed asset allocation and manager structure, then Wellington will be the lead manager with 12% followed by Grosvenor then PIMCO. She commented she was comfortable with those concentrations as these are excellent managers. She also said they would return to the committee at some point in the future with a presentation on concentration risk and safety of assets.

Mr. Hardymon commented on the significant change in the asset allocation and asked how long the changes would take and Ms. Krauss responded that the liquid strategies could be implemented by January 1<sup>st</sup>, but that private equity and real estate will take some time. Ms. Krauss stated that she would prepare an implementation summary for the next meeting and discuss the timeframe in greater detail.

Mr. Stuckert commented that the third agenda item, review of asset allocation, had been part of previous discussions.

Ms. Krauss stated that staff and RVK plan to make a formal recommendation on the asset allocation at the June meeting and asked if the committee members had additional questions or concerns. She indicated that the proposed changes have been discussed with Mr. Gatton and he is supportive of the changes. She added that she would reach out to Mr. Bryant to discuss the proposed changes since he was unable to be at today's meeting. Mr. Stuckert asked about the RFP process for hiring new managers and Ms. Krauss said that RVK typically provides a short list of five to ten firms, which are invited to respond to the RFP upon release. The RFP is posted on Purchasing's website and we typically receive 20-30 proposals. She and RVK will then review the proposals and select three to five managers to interview then based on that process would select a manager to recommend to the committee.

Mr. Stuckert asked Mr. Palmeri to discuss the next agenda item, the performance review and market update. Mr. Palmeri noted that it had been a very good quarter for equity markets. Total fund composite return was up 4.14%, driven by equities and absolute return strategies, and up 11.67% fiscal year to date. Returns exceeded the index by 1.7%, an indication of manager alpha. Domestic equity was up 11.06% for the quarter, equal to the index and as expected since the funds are passively managed to the index. He noted that the Wellington Emerging Companies Fund performed below the market but that recent changes in the portfolio should help to improve future performance. He said international equities were up 4.6% and all managers added value on a relative basis and noted that the ishares index fund underperformed the active managers. The fixed income composite continued to do well for the quarter, up 64 basis points, while the index was down 12 basis points, indicating manager alpha in a down market. Real return was the worst performing exposure for the quarter due mainly to the PIMCO All Asset All Authority Fund. Absolute return strategies continue to do very well and were up 4.6% for the quarter, above the index by almost 1%. He noted that real estate and private equity quarter returns were not yet available. He noted that the committee had done an extensive review of managers in these classes earlier in the year. The committee members discussed various aspects of real estate and private equity return measurement and currency market effects. Mr. Palmeri recommended the Committee consider implementing an annual performance review, separate from the quarterly and monthly flash review, for Private Equity and Real Estate, given their unique attributes, and added that an internal rate of return calculation and review would be more meaningful.

Mr. Stuckert then moved to the next item, the Operating Fund Cash and Investment Report. Ms. Counts reported that total cash and investments subject to the investment policy was \$343.5 million, and of this \$239.3 million is invested in overnight and short term funds. Annualized monthly return was 14 basis points which compared favorably to the indices. There was \$104.3 million invested in the intermediate pool and agencies, with a yield of 0.86%. Funds held at the state total \$233.4 million with total operating funds of \$576.9 million. She said this is an improvement over one year ago. Mr. Britton requested a summary and trends of the operating funds over a twelve month period. Ms. Counts responded that she would provide that information. There was discussion as to the relative cash balances and Mr. Monday responded that the amount of cash on hand needs to be considered in relation to the overall \$2.6 billion budget inclusive of a \$1 billion hospital enterprise. He commented that other SEC institutions have similar cash balances as the University of Kentucky and this was an area currently under review. Mr. Britton then asked about the source of funds for hospital cash flow and inquired what cash would be used first. Ms. Counts responded that daily cash needs are covered by current revenues and the state overnight repo. On a monthly basis revenues are transferred to the state and then drawn from those accounts as needed. Mr. Owen asked how much was in the UKHC reserve that was quasi endowed and Ms. Krauss responded that amount was approximately \$240 million. Mr. Owen commented that this would be available to cover hospital cash shortages. Mr. Stuckert then noted that recently UKHC had borrowed cash from UK rather than use the Quasi funds, but that had been paid back and the hospital was in a positive cash position now.

Ms. Krauss then distributed a page from the University of Louisville Foundation report as requested by Mr. Britton. Mr. Britton commented that he found it interesting to review and compare to UK. Ms.

Krauss commented that based on the proposed allocations UK allocations would line up similar to U of L. Mr. Stuckert said that U of L had a different structure in that it had a foundation. Mr. Britton commented on the investment performance and Ms. Krauss added that their returns had been outstanding. Mr. Owen said that they had been able to diversify investments much earlier than UK. Ms. Krauss added that they had much more flexibility due to their governance structure.

Mr. Stuckert asked if there were any further items for discussion. Being none, the meeting adjourned at 3:20 p.m.

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Donna Counts  
Office of the Treasurer