

**Minutes  
Investment Committee  
September 9, 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 Billy B. Wilcoxson
Investment Staff & Consultants:	Susan I. Krauss Donna A. Counts Rob Palmeri (R.V. Kuhns & Associates) Ronald L. Klotter (R.V. Kuhns & Associates)

Mr. Gatton called the meeting to order at 1:30 p.m. He explained that the Investment Committee (the “Committee”) needed to go into closed session to hear reports on the evaluation of proposals for the Real Estate and Global Tactical Allocation (GTAA) manager searches. He said that the Committee would be interviewing the GTAA finalist and explained that the Committee must go into closed session because an open discussion of the firms and Committee deliberations could jeopardize the retention of the firm for the University. He explained that only those persons necessary to provide information to the Committee and appropriate staff may be present, that nothing else could be discussed in the closed session and that no votes would be taken. Finally he added that all presentation materials must be returned to John Deans of the UK Purchasing Division. Mr. Gatton then made a motion to go into closed session pursuant to KRS 61.180 (1) (g). Mr. Stuckert seconded the motion and all approved.

The closed session concluded at 2:30 pm. Mr. Gatton reported that no matter other than the announced matter was discussed, no final action was taken, and the Committee would proceed with the open session. Mr. Gatton then made a motion to approve the minutes from the meeting for June 10, 2013. Mr. Britton seconded and all approved.

Mr. Gatton introduced the next agenda item, IC 1, authorization for investment staff to perform an on-site due diligence visit of a GTAA manager finalist and enter contract negotiations with the manager if results of the on-site visit are satisfactory. Mr. Stuckert made a motion to approve IC1 and Mr. Britton seconded. The motion was approved.

Ms. Krauss then gave a review of asset allocation and the transition plan. She said the US Equity asset class will decrease to 12% and reported that staff and RVK had considered enhanced passive strategies, including PIMCO’s stocks-plus strategy, which uses futures to obtain equity exposure and invests the underlying collateral in a fixed income strategy. She said that while this has been a successful long-term strategy, UK has decided against implementing it at this time due to concern about increasing the fixed income beta of the total portfolio. Ms. Krauss reported that a dividend-focused strategy managed by Northern Trust was also reviewed but it was decided not to move forward with this strategy as this is a fairly crowded space. She stated since staff and RVK were unable to find attractive enhanced US equity strategies in the marketplace at this time, the US equity large-cap allocation will continue to be indexed at a cost of 2.5 basis points and UK will take active risk elsewhere in the portfolio.

Ms. Krauss reported that the Non-US Equity asset class will also be going from a target of 20% to 12%. Mondrian and William Blair will manage 6% each and the strategies of both managers will be expanded to include more emerging markets and small-cap exposure, for up to 50% of the managers' allocations. She stated that Capital Guardian will be terminated at the end of the year during the Phase I implementation.

Ms. Krauss reported the implementation of the new unconstrained fixed income strategy with Reams is underway. The total Fixed Income asset class is decreasing to 10% and PIMCO and Reams will each have 5%, to be managed in core-plus and unconstrained strategies. The Reams Low Duration portfolio of approximately \$5 million and approximately half of their Core-Plus portfolio were transitioned to the unconstrained strategy during August and the remaining funds will be transitioned in October.

Ms. Krauss then discussed the Long-Biased Long/Short Equity asset class. This allocation will be implemented with 5% each to Grosvenor and Wellington, and 4% to Berens, for a total of 14% allocated to this asset class. She said it was decided not to utilize Prisma because they do not offer a commingled long/short fund. Ms. Krauss explained that Grosvenor made an attractive offer that will enable UK to invest directly with their approved long/short managers at no added cost. To do this UK must keep at least \$100 million in the See Blue Fund, which has a management fee of approximately 87 bps. With approximately \$50 million in a long/short mandate at zero cost, the effective fee of the \$150 million will be approximately 58 basis points, which is very good for a fund-of-funds management fee. She said Wellington will develop a customized fund of their various in-house hedge funds. The balance of the Long-Biased Long/Short allocation will be invested in the Berens' Global Value Fund, which is a global long/short equity strategy.

Ms. Krauss reported that action on Private Equity will be deferred until early 2014 and consideration is being given to committing more to Neuberger Berman or doing a search for a second separate-account manager. Grosvenor will remain as the sole Absolute Return manager with a 10% allocation to the See Blue Fund. She said the Real Return asset class will be re-characterized as Diversified Inflation Strategies and Wellington will be the anchor in this asset class with a seven percent allocation. A three percent illiquid allocation will be added in early 2014 for a total of 10% in this asset class. In the interim, the three percent illiquid allocation will be invested in the Wellington Diversified Inflation Hedges strategy.

Ms. Krauss said that an RFP will be issued to hire non-core real estate managers and it is expected that a manager recommendation will be made in December. The core real estate allocation will increase from 4% to 5% through the reinvestment of dividends. Ms. Krauss concluded by noting that the Private Equity and Real Estate investments will take several years to fully implement and the under-target amount will be invested in the US and Non-US Equity asset classes until those allocations are fully implemented.

Mr. Britton asked how much in total Grosvenor would be managing. Ms. Krauss responded that Grosvenor would manage roughly \$150 million and that the current Grosvenor fund-of-funds allocation had outperformed the targets and added significant value for the fund. Mr. Palmeri responded that the concentration is something to track but not of concern at this time. Mr. Britton then asked about the \$374.5 million reported as not available for withdrawal in less than three months and asked which investments this included in addition to private equity and real estate. Ms. Krauss responded that it also includes the absolute return investments.

Mr. Palmeri provided the fiscal year performance review and market update and noted it was a very good year for equities with double digit returns for this asset class. While the US Aggregate Bond Index was down 69 basis points, the UK fixed income portfolio increased 172 basis points. High Yield bonds also had good returns while the commodity markets were down. The endowment fund had a total return, net

of fees, of 11.58% last fiscal year and exceeded the target allocation by 150 basis points. Fiscal year returns gross of fees was 11.96% compared to the All Endowment-Total Fund median of 12.19%, which puts UK at about the median. Mr. Palmeri noted that the ranking had improved over the past four years and should continue to as the asset allocation is fully implemented. The Committee members discussed ways to review historical returns and risk metrics related to long/short positions and international exposures for the portfolio. Mr. Palmeri and Mr. Klotter responded that they would work on a report.

Mr. Palmeri continued with the performance report and said that total value added of 1.50% above the fund benchmark was attributable to manager value added of 1.32% and asset allocation of 0.18%. He then discussed asset class performance. He reported Domestic Equity was up 20.84%, slightly under the benchmark with the underperformance due primarily to the Wellington Emerging Companies product. International Equity was up 17.21% and outperformed the market by 358 basis points, a turnaround from a few years ago.

Mr. Britton asked about Wellington's performance and Mr. Palmeri responded that Wellington had been on watch and he and Susan met with the Wellington team earlier this year regarding performance in the small cap equity strategy. Mr. Krauss added that there had been recent restructuring of the portfolio. Mr. Britton noted that they had underperformed in both strategies and asked why we were planning on increasing our exposure to Wellington in light of the underperformance. Mr. Palmeri noted that the proposed increase was in the Diversified Inflation Hedges (DIH) strategy, not the small cap strategy and that RVK believes the Wellington DIH managers were good long term performing managers that are having a difficult time in the current market and economic environment; he also noted that the active inflation hedges asset class has been struggling. Ms. Krauss added that DIH is a product that has significant volatility and that over time the strategy has performed very well. Ms. Krauss noted that she and RVK are visiting Wellington soon and that if they have concerns about DIH, they will recommend an alternative implementation plan.

Mr. Palmeri then reviewed the Absolute Return composite which returned 11.87% for the fiscal year, outperforming the index by 446 basis points. He said all three managers in this category performed well. Mr. Palmeri then referred to the Real Estate and Private Equity manager performance and noted that compared to the indexes the asset classes underperformed. However, he reminded the Committee of the complexities in measuring performance for these asset classes and that these managers are still in the funding process or in the early investment phase. He discussed the time weighted rate of return and internal rate of return analyses required for making a meaningful performance review of these asset classes. Mr. Palmeri concluded by noting that the outperformance of the total fund was attributed to an overweight in International Equity and strong performance within the Absolute Return Composite. The weakest results came from Real Return, while the strongest absolute performance came from the Domestic Equity Composite.

Mr. Palmeri then reviewed the real estate fund managers. The real estate commitments include Wrightwood Capital with a \$12.0 million commitment, paid in capital of \$11.49 million, distributions of \$6 million, a fund internal rate of return (IRR) of 3.84%, and a multiple of 1.06. He noted that the fund multiple compares how much was invested versus how much has been returned so far. The TA Realty fund multiple was above by 24 basis points and WestRiver was above by 13 basis points. The Contrarian Distressed Real Estate fund had a \$10 million commitment in 2011, with only \$4.7 million paid in, distributions of \$884 thousand, and a fund multiple of 1.08, or above by 8 basis points. The Real Estate Capital Asia fund commitment from 2011 was \$10.0 million, with only \$5.2 million paid in and \$3.2 million in distributions and already had a fund multiple of 1.3, which is an outstanding return. Mr. Palmeri noted that these real estate funds are still young. Ms. Krauss stated that staff and RVK would provide the annual review of the private equity and real estate funds early next year which will include a discussion of the time-weighted returns versus internal rate of returns.

Mr. Gatton moved to the next agenda item and Ms. Counts summarized the Operating Fund Cash and Investment Report as of July 31, 2013. She said the total operating funds were \$621.1 million and of that UK manages \$448.3 million. The overnight and short term investments totaled \$331.6 million. She commented that compared to last quarter, the overnight yield dropped about 10 basis points. Ms. Counts said the office had begun purchasing municipal investments in order improve returns. The currently-held municipal investments are state obligations which have maturities of four years or less. The state municipals have helped boost overall returns, with an average yield of 2.12% compared to the agencies and instrumentalities return of just under one percent.

Mr. Britton asked if we had considered hiring a professional manager for operating funds. Ms. Counts responded that there had been discussions about hiring a manager and Ms. Krauss reported that they are considering a contract amendment with Reams to manage a high-quality low duration strategy for the operating funds. She said Reams was one of the high-performing endowment fixed-income managers and they only charge a 20 basis point management fee. Ms. Krauss indicated other future enhancements to operating investment management may include issuing an RFP to hire an intermediate-term fund manager. Also, a Chief Investment Officer (CIO) will be hired soon to oversee endowment investments and this person will also review options to enhance operating fund returns, including potentially taking additional risk to improve returns for the longer-term working capital. Mr. Britton asked if we were looking at hiring a consultant to help identify the amount of cash available to invest more aggressively and still maintain sufficient liquidity. Mr. Owen commented that cash outflows total about \$200 million a month or more and UK needs to keep a couple of month's cash on hand to meet expenses. He also noted that the management fee charged by OFM was only 5 basis points and asked if Reams would be better in light of the higher management fee. Ms. Krauss responded that she believed that Reams could provide superior net of fees returns by taking additional credit risk.

Ms. Krauss reported on the 2013 endowment management benchmarking study she performed to compare UK to various peer institutions. Fifteen institutions responded to the survey and provided information in the following areas: investment office staffing and funding; use of performance incentives; systems use; consultant use; and outsourcing. She concluded that the survey results made it clear that UK is understaffed in the endowment management area and, as a result, a CIO search will be initiated soon. She stated the objective is to have the new person on board early next year.

Mr. Gatton asked if there were any further items for discussion. Being none, the meeting adjourned at 3:50 p.m.

Respectfully submitted,  
Donna A. Counts  
Office of the Treasurer