

Minutes
Investment Committee
May 8, 2014

IN ATTENDANCE:

Investment Committee	Carol Martin Gatton, Chair
Members:	William C. Britton
	Mark P. Bryant
	William S. Farish, Jr.
	James W. Stuckert

Community Advisory	
Members:	N/A - none present

Investment Staff &	Susan I. Krauss
Consultants:	Donna A. Counts
	Kimberly C. Lush
	Rob Palmeri (RVK)
	Dan Krivinskas (RVK)
	Scott Krouse (RVK)

Mr. Gatton called the meeting to order at 1:33 p.m. Mr. Gatton then made a motion to approve the minutes from the Committee meeting on March 31, 2014. The motion was seconded and all approved.

Ms. Krauss presented the Endowment Asset Allocation and Transition Plan as of March 31, 2014. The total market value of the endowment pool was \$1.17 billion, comprised of 33% equities, 10% fixed income, and 57% alternatives. There was no transaction activity related to Phase I, involving implementation of the liquid strategies, during the month of March 2014. She discussed the future transition / rebalancing activity needed in order to reach the asset allocation approved in June 2013. For the remainder of 2014, the most significant Phase I activity will be implementation of the direct hedge fund program with Grosvenor. Approximately \$19 million will be taken from the current See Blue Fund, the absolute return fund with Grosvenor, and transitioned into the long/short equity strategy. Currently, there is approximately \$39 million invested with Grosvenor in the long/short equity strategy in a co-mingled product. The \$39 million will be removed from the co-mingled fund and combined with the \$19 million from the current See Blue Fund, resulting in a total of \$58 million, or 5%, allocation in the portfolio of direct investments when fully implemented. A result of the movement of funds will be a significant decrease in the management fees paid to Grosvenor. Currently, the co-mingled fund is assessed a fee of 60 basis points. When fully transitioned to the portfolio of direct funds, there will be no fees assessed on See Blue B, cutting the effective fee of the total Grosvenor portfolios by approximately 20 basis points or \$350,000 on an annualized basis. She noted that Grosvenor recently proposed seven funds that are their highest conviction managers for the long/short equity strategy. Those seven funds are currently being reviewed, along with other potential candidates. On-site visits will be conducted for each manager and implementation will occur in four monthly installments from September 1, 2014 through December 1, 2014. Ms. Krauss then discussed Phase II, involving implementation of the illiquid strategies, including private equity, private real estate and private real assets. Regarding private equity, she mentioned that Neuberger Berman recently submitted a proposal for an additional commitment. They are nearly 98% committed in the current NB Wildcats Fund and a second allocation is being considered. She noted that the fee proposals submitted by Neuberger Berman are very attractive. Regarding real estate, Ms. Krauss stated that an RFP is anticipated to be issued later in 2014, committing additional dollars to that asset class. Additionally, an RFP will be issued for private real asset strategies within the

next year, potentially after the Chief Investment Officer position is filled. Private closed-end funds will be considered and funding will come from the Wellington liquid real asset funds. Ms. Krauss then reviewed the summary for Managers with Multiple Strategies, mentioning that Wellington and Grosvenor are two of the University's highest conviction managers, with 15.63% and 14.90%, respectively, and noting Northern Trust's index fund strategies at 19.84%. She concluded with a review of the Report on Manager Appointments, Terminations and Due Diligence. There were no new managers hired or terminated for the period of April 1, 2014 through May 8, 2014. A manager due diligence meeting was conducted with SC Capital Partners (General Partner for Real Estate Capital Asia Partners III, LP) on April 7, 2014 to perform a standard organizational and performance review. She noted that the fund is nearly 75% committed. Also, Ms. Krauss met with Mondrian on April 29, 2014 to review performance and obtain an organizational update. Mondrian manages two strategies for the University, an all country world ex-US value strategy and an international small cap strategy. Additionally, a conference call was conducted with Grosvenor on May 6, 2014 to discuss the objectives and implementation plan for the new long/short equity direct hedge fund program.

The next item on the agenda was the Asset Allocation Study and Portfolio Risk Analysis and Review presented by Mr. Palmeri. He reviewed a memo from R.V. Kuhns to the University of Kentucky dated May 8, 2014 that provides a summary of the risk review and asset allocation study. He noted that on an annual basis, a risk review and asset allocation study are conducted, looking at historical patterns and estimated future patterns to ensure the portfolio has been behaving in line with expectations and will continue to perform accordingly. He defined the Risk Analysis and Review as a purely historical analysis of how the endowment has behaved over time, whereas the Asset Allocation Study incorporates forward-looking capital market assumptions to generate conclusions. The four themes highlighted in the Portfolio Risk Analysis and Review include thematic investing, beta, risk budgeting, and fixed income duration. Relating to thematic investing, the University saw an increase of 12% to the alpha category with decreases in capital preservation (-5%), inflation (-1%), and capital appreciation (-6%). The change is reflected in the reduced target allocation to public equities and fixed income and the introduction of two new asset classes: global tactical asset allocation and long-biased long/short equity. Mr. Palmeri defined beta as the extent to which a portfolio behaves similar to equity market volatility. He noted that the University portfolio's beta has continued to trend downward from +0.8 in 2008 to +0.6 currently. In the category of risk budgeting, which looks at the sources of volatility and risk, it was noted that the Contribution to Volatility Risk is now much less concentrated with the reduction to public equities. In 2013, 75% of the portfolio's risk was driven by U.S. stocks & international stocks; that is now down to 54%. The final component, fixed income duration, showed that the portfolio's duration is currently 2.1 years, which is much lower than the duration of the Barclays Aggregate Bond Index duration of 5.6 years. The overall decrease in duration is due to the funding of Reams Unconstrained Bond fund, which has a negative duration (-1.2 years) and represents 32% of the UK Fixed Income composite as of February 28, 2014. Also, the portfolio has much less interest rate sensitivity now as compared to the previous year as a result of reallocating resources out of the Reams Low Duration portfolio and into the Reams Unconstrained Bond fund. Relating to the Asset Allocation Study, Mr. Palmeri provided a comparison of the previous target asset allocation to the current target asset allocation approved by the Committee in June 2013. He noted that the expected arithmetic return, or one-year return, increased from 7.24% to 7.58%, the expected risk (standard deviation) went from 12.05% to 12.27%, and the expected compound return, over a long-term period, went up from 6.57% to 6.89%. He noted that the study does not include expected manager alpha over and above the asset class returns, therefore UK's 7.5% long-term target return assumption is reasonable.

The next agenda item discussed was the performance review and market update as of March 31, 2014. Mr. Palmeri began by noting that the portfolio was doing very well, up 138 basis points calendar year to date, with a fiscal year to date return of 11.72%, outperforming actual allocation and target allocation. Significant performance worth noting included Wellington Emerging Companies' 30% one year return, which well outperformed the small cap market by 513 basis points and the University of Kentucky

Student Managed Investment Fund, which was one of the best performers of the month with a return of 2.09%. In the international equity composite, the return for the quarter was 1.86%. Small cap in the William Blair portfolio was up 3.43% for the quarter and up 13.47% since inception on October 1, 2013, almost tripling the index of 4.84%. Fixed income struggled for the quarter, only up 0.84%. One of the better performing asset classes for the quarter was diversified inflation strategies, which includes Wellington's Diversified Inflation Hedges, a volatile fund with a quarter to date return of only 2.23%, but a fiscal year to date return of 9.94%. Also noted was Wellington Custom Archipelago, with a return of 2.47% since inception on January 1, 2014. Lastly, absolute return strategies were reviewed. The Grosvenor See Blue fund continued to impress with a return of 1.17% for the quarter and 9.38% for the fiscal year to date, well ahead of the index by 332 basis points for the fiscal year.

Mr. Gatton noted that the order of the agenda items was being switched because Ms. Tongalson from Northwood Investors had not arrived yet. He then introduced Ms. Counts to present the Operating Fund Cash and Investment Report. She stated that the total of operating fund cash and investments for the month ending March 31, 2014 was \$904 million, which includes \$240 million of bond proceeds. She noted that the University had sold bonds earlier in the year and the proceeds from those bonds are currently on deposit in state construction accounts, which skews the total. Therefore, in order to do a relative comparison to normal operating cash, the bond proceeds were subtracted, leaving a total for operating fund cash and investments less 2014 bond proceeds of \$665 million. The cash and investment balance subject to the operating fund investment policy and managed by the University of Kentucky was \$376.4 million, slightly larger than the balance at the same time last year of \$343 million. The biggest difference from the prior year was in the allocation, with funds having been shifted from overnight investments to intermediate investments in an attempt to enhance interest income, which also contributes to the operating budget. Overnight rates were very low, yielding an average of eight basis points. Ms. Counts added that prime money market funds invested in by the University were recently reviewed. Two years ago those funds yielded twenty basis points whereas today the University receives approximately eight basis points on those funds. Because cash is not returning very well in the current market, more operating funds are being placed in intermediate investments, with the expectation that investment income will improve over the long term. She concluded by stating that a total of \$527.6 million was held at the state, with \$240 million of that from bond proceeds as mentioned earlier.

The next agenda item was the real estate portfolio update from R.V. Kuhns as of December 31, 2013. The update was provided by Dan Krivinskas, Director of Real Estate Consulting, and Scott Krouse, Consultant with the real estate team. Mr. Krouse provided an overview of the real estate portfolio performance, noting that the real estate portfolio was well-diversified across geographies and property types. He added that from 2008 to 2010, investments focused on attractive risk-return dynamics available in the U.S. real estate debt space, and that recent investments are anticipated to broaden geographic exposure and take advantage of the real estate market recovery in the U.S. and Europe and growth in Asia. He stated that the real estate portfolio continues to perform well, outperforming the NCREIF Property Index ("NPI") across quarter to date, one year and three year time periods. The target of 12% exposure to real estate is expected to be met by 2017. The core portfolio had a 3.5% internal rate of return, a 1.23 times equity multiple, and a 6.48% since-inception time-weighted return. The non-core portfolio had a 12.1% internal rate of return, a 1.22 times equity multiple, and an 8.31% since-inception time-weighted return. He mentioned that the portfolio is currently at 6.4% invested, with 5.4% of unfunded commitments, for a total market value plus unfunded commitments of 11.8%, moving towards the target of 12%. For the fourth quarter of 2013, the real estate portfolio returned 4.95% (gross of fees) / 3.97% (net of fees), outperforming the NPI's return of 2.53%. He mentioned that the portfolio had a very conservatively postured leverage rate of 20.25%, which is considered to be low risk. Although the leverage rate is expected to increase slightly over the next few years, it will still be considered to be at a low risk level. Regarding geographic portfolio diversification, the portfolio is slightly over-allocated to the Midwest region of the U.S. and significantly under-allocated to the West region relative to the NPI. Regarding real estate property type portfolio diversification, the portfolio is substantially over-allocated to

apartment and hotel investments while under-allocated to office, retail, and industrial relative to the NPI. Mr. Krivinskas reviewed some recent significant events for the real estate portfolio. UBS Trumbull Property Fund completed ten acquisitions and three dispositions during the quarter and is continuing to look at value-added investments, the Contrarian Distressed Real Estate Fund made four acquisitions during the quarter, Real Estate Capital Asia Partners made three acquisitions and generated an internal rate of return of 44.5%, and the TA Realty IX made two dispositions. WestRiver Real Estate Finance Fund made no acquisitions or dispositions, and Wrightwood Capital High Yield Partners II made seven dispositions. Regarding real estate investment pacing, the target allocation of 12% is expected to be met by 2017.

Mr. Krivinskas then introduced Vivian Tongalson, Managing Director from Northwood Investors. Ms. Tongalson provided a brief background of Northwood, which was founded in 2006 by John Kukral, formerly with Blackstone Real Estate Advisors. Northwood has raised more than \$3.5 billion of capital since inception and has invested or committed to invest approximately \$3.0 billion of equity across thirty-eight transactions of various asset types and investment structures, targeting investments in overleveraged, capital-deprived assets and repositioning opportunities. She stated that Northwood believes its unique approach to real estate investing and fund structure distinguishes it from competitors. Their approach focuses on principal preservation and long-term value creation with an emphasis on attractive unlevered returns and capital multiples (not IRR). Also, there is an intense hands-on asset management focus. The Northwood team of investors is made up of 107 professionals, with the team in Europe being comprised of seventeen professionals and expected to grow. Northwood has formed three operating companies to directly oversee leasing, operations and capital projects for the hotel, retail and multifamily investments. Currently, there are 82 investors with \$3.6 billion in total commitments. She commented that Northwood is optimistic that GDP will continue to grow, pointing out that growth accelerated to 4.1% and 2.6% in the third and fourth quarters of 2013, respectively, as a result of strong private domestic investment, which is a good sign for real estate. Additionally, Northwood believes there is a substantial opportunity to continue to invest in high quality assets in Europe due to the on-going deleveraging cycle. As an example, she profiled Northwood's French Industrial Portfolio, which includes ten office/industrial parks located in established commercial locations throughout France and comprising more than 300 units of varying ages with a total leasable area of approximately 2.8 million square feet. She concluded by remarking that Northwood plans to continue to use conservative financial structures, focusing on transformative properties, infill development, lease-up and repositioning of properties, under-loved / over-leveraged properties, distressed restructurings in Europe, over-leveraged portfolios in Europe and the U.S., and recapitalization of funds or advisors, adding that the University of Kentucky has committed \$20 million to Northwood.

The meeting was adjourned by Mr. Gatton at 3:45 p.m.

Respectfully submitted,
Kimberly C. Lush
Office of the Treasurer