Minutes of the Meeting of the Investment Committee
University of Kentucky
Monday, April 30, 2018

The Investment Committee met on Monday, April 30, 2018, in Woodward Hall of the Gatton Business and Economics Building.

A. Meeting Opened

Mark P. Bryant, Chair of the Investment Committee, called the meeting to order at 2:15 p.m. and requested a roll call.

B. Roll Call

The following members of the Investment Committee answered the call of the roll: Mark P. Bryant, Claude A. Berry, III, James H. Booth, Mike A. Christian, Elizabeth McCoy, Robert D. Vance, and Barbara S. Young. Carol Martin "Bill" Gatton was not in attendance.

The following Community Advisory Members answered the call of the roll: William C. Britton, William E. Seale, and Myra L. Tobin.

Kristina Goins announced that a quorum was present.

The University Investment Staff was represented by Susan I. Krauss, Treasurer, and Todd D. Shupp, Chief Investment Officer.

Fund Evaluation Group (FEG) was represented by Nolan M. Bean, Michael J. Aluise, and Rebecca S. Wood.

C. Approval of Minutes for February 22, 2018

Chair Bryant called for a motion to approve the minutes from the Committee meeting on February 22, 2018. The motion was moved by Mr. Vance, seconded by Dr. Christian, and approved by all.

D. Portfolio Risk Review

Mr. Nolan Bean, FEG, began the portfolio risk review by outlining two key questions: Do we have the right risk profile given our spending policy and the Committee's comfort level? Also, how should this risk best be taken? He stated that 2018 has been very different than 2017, and then reviewed some market statistics from that calendar year. Mr. Bryant raised a question regarding the increase in the number and value of private companies versus those that are public. Mr. Bean answered that there are certainly more in number, though not necessarily in value, citing Uber as an example. Shifting to a review of market performance for the first quarter of 2018, equities and bonds were down, -0.8% and -1.5% respectively, while diversifying strategies were up modestly. Next, Mr. Bean shared a reminder of the key tenets of the portfolio's current investment philosophy: 1) Focus on the long term; 2) Diversification works; 3) Valuation matters; and 4) Utilize a blend of active and passive management. Mr. Bryant asked a question regarding how to find information on the private companies, since they are not publicly traded. Mr. Bean replied that the UK portfolio has a 15% target allocation to private equity and, in our portfolio this sourcing and valuation is done by managers within their areas of focus. He then shifted the discussion to asset allocation, beginning with the Endowment's objective: to produce a return greater than the total of spending and expenses (5.0%) plus inflation (2.5%). The University's portfolio is broadly diversified and capable of going on the offensive when equity markets sell off. Mr. Bean next reviewed a graph showing current asset allocation versus targets in slightly more detail. Mr. Britton then asked a question regarding recent market volatility and what FEG's models show. In response, Mr. Bean commented on the performance of the portfolio during the first quarter, noting that having lower allocations to equities and bonds was helpful, while real assets were a detractor.

Next, Ms. Rebecca Wood shared comments regarding UK's risk return profile. She noted that compared to the National Association of College and University Business Officers (NACUBO) $1 billion or greater cohort, the University has less in equity, more in real assets, and more in diversifying strategies. The University's source of risk is more diversified than peers, with a lower risk posture (14.7% vs 16.9% expected standard deviation). Ms. Wood also called attention to the portfolio construction survey conducted in 2016, noting that the Investment Committee had participated in shaping the overall risk profile, liquidity budget, and investment strategy. She concluded her discussion by comparing the University's contribution to risk to the NACUBO $1 billion or larger group, highlighting the global equity category which was 62%, and 83% respectively.

Mr. Britton asked a question regarding a chart depicting the expected maximum drawdown of various blended stock and bond portfolios to confirm that a 100% stock portfolio could lose 40%. Mr. Bean confirmed that Mr. Britton's interpretation was correct. Dr. Christian inquired how often the Committee should update the portfolio construction survey and revisit items such as the maximum expected loss tolerance. Mr. Bean suggested that this be reviewed either every year, or every other year. Mr. Seale asked a question regarding a portfolio risk graph, and Mr. Aluise clarified that this was showing contribution to risk, rather than UK's asset allocation targets. He then reviewed a risk appetite graph illustrating the probability of achieving intergenerational equity, which in this case is the percent chance that a given asset allocation will achieve a 10 year return greater than 7.5%. He stated that the last three years have rewarded riskier allocations, but recent volatility highlights the case for diversified positioning. For example, between February and March, the S&P 500 posted a decline of 6.1%, while the UK diversifying strategies portfolio declined only 1.1%. UK performed well over the last several years when considering the risk profile of the portfolio. Mr. Bean interjected that the trailing five year Sharpe ratio of the S&P 500 Index (1.57) was the highest ever recorded. Mr. Aluise stated that liquidity is monitored to ensure the portfolio maintains an appropriate level of liquid assets for spending and opportunistic purposes before transitioning the discussion to a review of the main asset allocation categories making up the University's portfolio. He began with global equity, the primary driver of risk and return for the total portfolio. A more moderate allocation to equities is being pursued and is prudent given lower expected returns from the asset class due to current pricing. Mr. Aluise noted that the UK public equity portfolio is currently positioned with more capital allocated to passive strategies than peers. Based on Investment Committee input, passive exposure was significantly increased in 2017. The allocation to active strategies is isolated in less efficient markets such as emerging markets and small/micro cap in the U.S. Next, Mr. Aluise briefly discussed global fixed income, which provide diversification and lower expected volatility. Where appropriate, passive management is used to access market beta. Over 90% of the public fixed income portfolio is invested in the U.S., with remaining exposure divided between emerging markets and international developed regions. Mr. Britton asked whether there will be a point where we want to be more opportunistic, perhaps extending duration or increasing our allocation towards the target, given that Treasury yields hit 3% and are likely to go higher. Mr. Aluise responded by saying our current portfolio is somewhat insulated from price declines stemming from rising rates, given floating rate securities held in the public credit allocation. He stated that we can consider adding to the fixed income allocation in the event rates move towards 4%, but added that this is still not a historically high level. He then moved on to real assets, stating that allocations in this area are diversified across real estate, natural resources, and infrastructure. The portfolio will invest in active strategies in private markets, and a balance of active and passive strategies in public markets. Given that inflation is a primary component of the portfolio's return objective, allocating capital to inflation sensitive securities is prudent. Next, Mr. Aluise highlighted Master Limited Partnerships (MLPs), within real assets. MLPs currently trade at more attractive valuations than most other asset classes and have performed well in rising rate regimes. He wrapped up the discussion reviewing a graph showing that MLPs outperformed in prior rising rate cycles.

E. Investment Staff Report

Mr. Shupp presented the Investment Staff Report, starting with an overview of the endowment asset allocation as of March 31, 2018, stating that the portfolio remains within the policy ranges and well diversified across asset classes. He then reviewed asset flows for the period between January 1, 2018 and March 31, 2018 noting there were very few changes to the asset allocation since the last meeting. He highlighted that the final, planned near-term investment into international equity was completed during this time, within emerging markets. Progress was made in the ongoing shift from fund of fund hedge funds into direct investments, and this process is nearing completion. Mr. Shupp then noted that the portfolio's manager concentration continues to decrease, as diversification across asset classes increases, leaving only two firms with multiple mandates. He then presented a report on manager appointments, terminations, and due diligence for February 23 through April 30. He noted that in March, there was one new commitment within emerging markets equity and one addition in diversifying strategies. Additions were made in April in the areas of private capital as well as diversifying strategies. Lastly, Mr. Shupp summarized due diligence completed by investment staff during the period. This included several meetings and on-site visits with existing managers, as well as the semiannual portfolio update with the Student Managed Investment Fund (SMIF) class. Mr. Shupp highlighted that the students won a national stock pitch competition with the stock presentation given at the December Committee meeting.

F. Performance Review & Market Update

Mr. Bean began with an overview presentation for the Committee, including a review of market and portfolio returns, focusing on the trailing one-year period through March 31, 2018. The UK portfolio benefitted from being tactically overweight in international equities, and allocations to private real estate and natural resources were also additive. Detractors in the period included lower-risk positioning, hedged equity, and MLPs. Next, Mr. Bean noted that the Federal Reserve (Fed) led other central banks in providing the liquidity that supported the economy and equity markets post-crisis. Now that the Fed has ended quantitative easing and other banks are planning the same course, this support element is ending, and markets are adjusting while tax reform and tariffs are hitting the markets. In his concluding remarks, Mr. Bean reiterated that the portfolio has lower exposure to equity markets than peers, given current valuations and the outlook for future returns. The public equity portfolio has a tactical overweight to international equities, while the global fixed income portfolio has a tactical underweight to high quality, core securities, with a tilt towards credit sensitive investments. Finally, the private capital portfolio is adding long term, direct relationships, which should benefit the University over the long run. Mr. Bryant raised a question regarding the recent market volatility and heightened geopolitical risk, and how FEG evaluates this. Mr. Bean and Ms. Wood stressed that they follow facts, over predictions, in dealing with changing market environments.

G. Operating Fund Cash & Investments

Ms. Krauss provided a report on the University's operating fund cash and investments as of March 31, 2018. She called attention to total funds available for operations, which were $1.4 billion. The total cash and investments were approximately $2.6 billion, including the $1.3 billion endowment. She noted the breakdown was roughly 50% endowment investments and 50% operating, or non-endowment, investments and that unlike the endowment, whose primary goal is long-term growth, the goals for operating funds are stability or safety of principal, and liquidity. She then reviewed the components of Tier I, or the shortest-term capital. This tier is comprised of cash, overnight and short-term investments. The bulk of these funds, around 80%, are receipts required to be remitted to the Commonwealth. Ms. Krauss then highlighted two new categories comprising these funds. These include PNC commercial paper of $109 million, as well as newly-implemented short-term government securities, accounting for $35 million. These additions are a result of an effort to increase returns while, more importantly, still protecting the principal. Ms. Krauss concluded her comments by calling attention to the bond proceeds on deposit with the Commonwealth, noting a new line item for the January 2018 bond issue for the Hospital, Modernization and College of Law capital projects, contributing approximately $227 million to this group of funds invested in the OFM Limited Term Pool.

H. Other

Ms. Krauss reviewed items contained in the Other section, beginning with the 2018 meeting schedule and tentative agenda items, stating that no changes occurred since the last meeting. She noted that June's meeting would include a real assets strategy review and September's meeting will be an annual retreat at an off-site location to be determined. Additionally, she stated that the supplemental endowment materials as of 12/31/2017 were also included for informational purposes since the December 2017 interim financial statements are going to the Board for approval at the May 1 meeting.

Cameron Baller, of the student organization Divest UK, gave a brief presentation outlining the purpose and background of their campaign as well as near and long-term goals of the organization.

Ms. Tobin then asked when the next FEG portfolio construction survey would take place. Mr. Bean replied that this would be distributed at the June Investment Committee meeting, with results reviewed at the September meeting.

I. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 3:30 p.m.

Respectfully submitted,

Kristina W. Goins
University Financial Services