Meeting Minutes of the Investment Committee
University of Kentucky
Thursday, June 18, 2020

The Investment Committee of the University of Kentucky Board of Trustees met on Thursday, June 18, 2020, via Zoom Webinar.

A. Meeting Opened

Elizabeth McCoy, Chair of the Investment Committee, called the meeting to order at 1:00 p.m. and requested a roll call.

B. Roll Call

The following members of the Investment Committee were in attendance: Elizabeth McCoy, Joe R. Bowen, Michael A. Christian, and Barbara Young. The following Committee member was not in attendance: Carol Martin "Bill" Gatton.

The following Community Advisory members were in attendance: James F. Hardymon, Quint Tatro, and Myra L. Tobin. The following Community Advisory member was not in attendance: William C. Britton.

The University Investment Staff was represented by Todd D. Shupp, Chief Investment Officer.

The Fund Evaluation Group (FEG) was represented by Michael J. Aluise, Greg Houser, and Rebecca S. Wood.

C. Approval of Minutes for May 4, 2020

Chair McCoy called for a motion to approve the minutes from the Committee meeting on May 4, 2020. The motion was moved by Trustee Christian and seconded by Trustee Young. The motion passed without dissent.

D. Portfolio Risk Review

Mr. Shupp introduced Mr. Greg Houser, Director of Research at Fund Evaluation Group. Mr. Houser's presentation was divided into three topics: risk measurement, risk tolerance, and risk monitoring. He began by distinguishing the difference between various measures of risk: absolute risk, relative risk, and risk-adjusted returns. He reviewed expected results for the total UK Target Allocation assuming a normal distribution. He also summarized FEG's capital market assumptions, comparing the expected return and standard deviation of each major asset class.

Next, Mr. Aluise discussed beta, which measures an investment's sensitivity to the market, which has a beta of 1.0. More volatile portfolios have a beta greater than 1.0 and demonstrate larger swings than the market, whereas portfolios that are less sensitive to the market have a beta lower than 1.0. He continued by stating that returns should not be viewed in isolation, and the risks taken to achieve a given level of return must be considered. Risk-adjusted measures create comparability across investments with widely differing risk levels. The Sharpe Ratio measures a portfolio's excess return (over the risk-free rate) per unit of total risk.

Mr. Houser then discussed behavioral risk. There are many non-market reasons investors have difficulty meeting their investment objectives. Becoming conscious, or simply reminding ourselves, of self-inflicted pitfalls is helpful in overcoming these difficulties. Investors intend to focus on the long-term but react to the short-term. Investors may allow greed and fear to influence or overwhelm their objectiveness. Additionally, investors may avoid asset classes that could provide risk-return benefits in portfolio construction.

Mr. Houser stated that liquidity risk has been a key focus for the investment office as well as for FEG. Liquidity risk is the inability to adjust portfolio positioning in response to changing market conditions, or to satisfy endowment spending needs. Monitoring and managing portfolio liquidity is critical. Based on the Investment Committee's last Investment Strategy Survey results, the consensus was that the liquidity profile of the endowment felt slightly too liquid. Mr. Houser outlined FEG's liquidity analysis with regard to the endowment portfolio, including a liquidity projection in a steady state environment over the next five years, and in the event of a major market disruption (modeled after the Great Financial Crisis in 2008). In the latter stress test, the portfolio's liquidity was found to potentially surpass illiquid targets, however not to drastic levels. In practice, capital commitments can be adjusted to compensate for material drawdowns in public market investments.

Next, Mr. Shupp discussed further liquidity stress testing of the UK Portfolio that was conducted by the investment office. Industry experts, including investment managers and other research providers, were consulted in the data preparation and assumptions utilized in this study. The first study stressed the most highly liquid assets in the portfolio, those that can be fully redeemed within one month. Applying very conservative performance assumptions to simulate what may occur in a severe downturn, the most liquid assets were found to cover nearly three years of annual spending and capital call needs. The second study included not only the most liquid assets, but also semi-liquid assets that can be liquidated within one year. Again applying conservative performance assumptions, the liquid and semi-liquid assets are estimated to cover 4.5 years of the portfolio's annual spending and capital call needs. Trustee Bowen asked to confirm his understanding that stress testing is best conducted in normal market environments so that proper decisions on opportunities and portfolio balance can be made once faced with a volatile market. Mr. Shupp confirmed that this is absolutely correct, this is a great way to avoid succumbing to some of the behavioral risks Mr. Houser previously mentioned.

Mr. Houser next discussed risk tolerance. He stated that there are two dominant and highly related risks to investors' portfolios: market risk and shortfall risk. Market risk is the risk of decline in portfolio value and income. Shortfall risk is the risk of failing to meet return requirements. Investors should seek to balance market risk and shortfall risk and therefore must recognize the need to take market risk, contemplate their maximum survivable drawdown, and diversify at the portfolio and manager level. Mr. Houser then discussed risk monitoring and provided a brief overview of FEG's proprietary risk management tool, Vigilance. This system provides risk forecasting, scenario analysis, and stress testing. He discussed the Portfolio's expected performance in various stress scenarios, with particular attention given to the early 1970s stagflation scenario given some similarities between that historical period and today.

Mr. Houser concluded with the following remarks: 1) risk measures should not be viewed in isolation; 2) risk-adjusted returns must also be considered; 3) these statistics are only tools and investors must understand what they measure and their limitations; and 4) diversification is key to managing risk without sacrificing return. Trustee Ramsay questioned how much cash is in the Portfolio, which could be used to invest in opportunities that become available during times of market stress. Mr. Shupp replied that the Portfolio has a significant allocation to high quality fixed income, which includes the Vanguard US Treasury Index Fund. That fund has daily liquidity and allows for necessary rebalancing transactions. Mr. Tatro made the comment that this presentation was very helpful to him in understanding the Portfolio's risks and asked Mr. Houser if FEG included drawdown estimates for illiquid investments in the scenario and liquidity analysis. Mr. Houser replied that the Vigilance software includes drawdowns for all of the Portfolio's asset classes, including illiquid funds. Chair McCoy referred back to the presentation's historical scenario analysis and made the comment that not all of those crisis periods are created equal. For instance, the Great Financial Crisis had much different underlying causes than the COVID-19 pandemic. She expressed her hope for a V-shaped economic recovery and shared observations from her professional banking experience through this period.

E. Investment Staff Report

Mr. Shupp presented the Investment Staff Report beginning with an overview of the Endowment asset allocation as of April 30, 2020. He stated that the Portfolio remains within the policy ranges and well-diversified across asset classes. Activity for the period included a rebalance within the credit portfolio as well as a transaction within public real assets. Next, he discussed the manager appointments, terminations, and due diligence for the period. Appointments included a temporary investment of $13.5 million in Vanguard FTSE Emerging Markets ETF within public equity and a $10 million investment in Sterling Group Partners within private equity. Terminations included a full redemption from Bienville Global Opportunities Offshore Fund. Proceeds were reinvested in diversifying strategies allocations. Due diligence for the period was conducted primarily in the areas of emerging markets equities and diversifying strategies.

F. Performance Review and Market Update

Mr. Aluise began the performance review and market update with a high-level overview of performance as of April 30, 2020. He stated that the Endowment's performance is in-line for the 3-year period with the Manager Weighted Index, which takes into account the various investment styles of each manager included in the Portfolio. Working well for the Portfolio during the calendar year-to-date period was hedged equity, high quality fixed income, and public credit fixed income. What did not work as well was an overweight to international equities, particularly value-oriented strategies, U.S. small cap equities having underperformed large cap, and diversifying strategies. He concluded his remarks by mentioning that the Portfolio has bounced back materially from the March 2020 lows, and the current allocation remains well within the ranges established in the Investment policy statement. Mr. Hardymon then echoed Mr. Tatro's comments regarding the value of the risk review presentation.

G. <u>Other Business</u>

Mr. Shupp reviewed the 2020 Investment Committee meeting schedule and tentative agenda items and highlighted the annual Investment Committee Retreat in September. He also noted the inclusion of the Supplemental Endowment Reports as of March 31, 2020 and the Operating Cash and Investments Report as of April 30, 2020. Chair McCoy concluded the meeting by reminding the Committee to complete the Investment Strategy Survey.

H. <u>Meeting Adjourned</u>

Hearing no further business, the meeting was adjourned at 1:59 p.m.

Respectfully submitted,

Krista W. Goins

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University Financial Services