Minutes of the Meeting of the Investment Committee
University of Kentucky
Monday, December 11, 2017

The Investment Committee met on Monday, December 11, 2017, in Room 327C of the Charles T. Wethington Building.

A. Meeting Opened

Mark P. Bryant, Chair of the Investment Committee, called the meeting to order at 2:16 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, Michael A. Christian, Elizabeth McCoy, Robert D. Vance, and Barbara S. Young. Trustee 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 Financial Services Investment Staff was represented by Susan I. Krauss, Treasurer, and Todd D. Shupp, Chief Investment Officer.

Fund Evaluation Group was represented by Consultants Nolan M. Bean, and Michael J. Aluise.

C. Approval of Minutes for September 14, 2017

Chair Bryant called for a motion to approve the minutes from the Committee meeting on September 14, 2017. The motion was moved by Mr. Vance, seconded by Mr. Christian, and approved by all.

D. Student Managed Investment Fund Presentation

Ms. Krauss introduced the Student Managed Investment Fund (SMIF) presentation and provided a brief background of the program. She then introduced Mark Liu, director of the Masters of Science in Finance Program, Matt Cochran, a student from the MSF Program and Joy Gilfillan representing the Undergraduate SMIF class. Dr. Liu and Mr. Cochran then provided a few remarks about the SMIF courses. Next, Ms. Gilfillan began a stock pitch presentation for her selected stock, CVS, which she had presented for the class. She provided a company background noting that the company operates in both the Pharmacy Retail/Long-term Care as well as Pharmacy Services segments. She also provided an investment thesis noting that the market's overreaction to negative news regarding Amazon as well as uncertainty surrounding the healthcare industry and further uncertainty about a potential CVS and Aetna merger has left CVS well undervalued. Ms. Gilfillan stated that some potential risks included tightening margins and consumer discretionary spending, Walgreen's acquisition of Rite Aid Stores, Amazon, and Healthcare Policy Change (ACA). She concluded her presentation with her recommendation which was a 4% stake in CVS.

E. IC1-Revised Endowment Investment Policy

Ms. Krauss presented IC1, a recommendation that the Investment Committee approve the revised Endowment Investment Policy. The revised policy reflects the following changes: 1) a temporary increase in the management fee by up to 50 basis points, for a maximum annual assessment of 1.00%, to support additional expenses related to the capital campaign, 2) a stated long-term nominal return objective of 7.5% versus the previous stated real return objective of 4.5%, and 3) other minor changes as noted in the policy provided to Committee members. In response to a question posed by Mr. Britton, who asked what would be done to help push increased contributions to the endowment, Ms. Krauss restated that the primary goal of the campaign is to increase the endowment to $2 billion or more. She added that this increase would provide support to student aid, as well as provide relief to the general fund. Mr. Richey, Vice President for Philanthropy, provided some additional comments related to this goal. Following additional discussion on the planned campaign, Dr. Seale suggested a slight change to the asset allocation target ranges to allow greater flexibility at the sub-asset category level. Senior investment staff responded that this would be evaluated and taken into consideration, however noted that staff currently have flexibility to adjust sub-asset class exposures as needed based on market conditions. Chair Bryant then called for a motion to approve the policy. The motion to approve the revised policy was moved by Mr. Vance, seconded by Ms. Young, and approved by all.

F. Investment Staff Report

Mr. Shupp presented the Investment Staff Report. He began with an overview of the endowment asset allocation as of October 31, 2017, stating that the portfolio remains within the policy ranges and well diversified across asset classes. He then reviewed asset flows for the period between August 1st and October 31, 2017, noting that within the US Equity portfolio, $3 million was added to the SMIF portfolios, as approved by the Investment Committee in May 2017. Mr. Shupp also highlighted progress on the restructuring within the non-US equity portfolio, including a shift from active to passive managers in non-US developed markets. He stated that a fifth hedged equity manager was added on September 1st, completing the planned transition from fund of funds to direct implementation in this part of the portfolio. A new commitment was added within private credit, an area currently underweight relative to the 5% target. Finally, he highlighted a net addition to the portfolio of approximately $7.4 million, representing an inflow to the OPEB quasi endowment that occurred on September 29th.

Mr. Shupp then presented a report on manager appointments, terminations, and due diligence for the period of September 15 through December 11, 2017. He noted that over this period, there was one new commitment in private real assets, one in private equity, six investments within international equity, and one new commitment within private credit. Manager terminations were related to the restructuring of the non-US equity portfolio and included withdrawals from William Blair, Mondrian, and a Northern Trust portfolio. Proceeds from these terminations were used primarily to fund the new international equity strategies. Lastly, Mr. Shupp summarized due diligence during the period. This included active dialogue with a number of international equity managers, a broad range of discussions with FEG including international equity restructuring, and the semi-annual SMIF portfolio update meeting. Dr. Seale then raised a question concerning what funds were included within the international equity portfolio, and whether the MSCI All Country World Index is the policy benchmark for the Global Equity asset category. Mr. Shupp described the new international equity portfolio structure, including the rationale for a combination of passive exposure in developed markets combined with active management in less-efficient, emerging markets. Mr. Bean also stated that the MSCI All Country World Index is not the policy benchmark for the Global Equity asset category.

G. Performance Review & Market Update

Mr. Bean provided a presentation to the Committee that began with a review of third quarter 2017 market returns. The university's one-year return as of September 30, 2017, was 8.9%, outperforming the market-based policy benchmark return of 8.6%. Trailing three- and five-year returns were 4.7% and 7.1% respectively. Mr. Bean reviewed what worked well during the one year period, highlighting the following: domestic equity outperformed the index, private equity outperformed peers, the global fixed income portfolio outperformed its composite index, and private real estate outperformed public real estate. Exposures that didn't perform as well included lower-risk diversifiers, international equity, and hedged equity. Next, Mr. Bean presented FEG's current views within each asset category, highlighting non-US equities, private equity, MLPs, and natural resources as areas with positive outlooks. Next, Mr. Bean provided updates on two asset categories, public equity and private credit. He stated that the public equity strategy is to utilize active management where the most value can be added, since developed markets are efficient. Implementation of this strategy emphasizes inexpensive, passive exposure in developed markets, combined with active allocations to regional specialists in emerging markets. Given current valuations, the portfolio's exposure is currently biased towards international equities. Private capital, which includes private equity, private credit, and private real assets, currently has a target of 30% of the endowment portfolio. Recent commitments to private capital include Primus VIII within private equity, Audax DLS within private credit, and Rivercrest within private real assets.

In his concluding remarks, Mr. Bean reiterated that steps have been taken to increase passive exposure and reduce the use of active management in efficient markets, and the public equity portfolio has a tactical overweight to international equities. The global fixed income portfolio has a tactical underweight to high quality/core securities, with a tilt towards credit sensitive investments. Long-term, direct relationships are being added within the private capital portfolio, which should benefit the University over the long run. Following this, Mr. Bean addressed questions from Committee members regarding Audax DLS, the new private credit manager commitment. Chair Bryant raised a question regarding the likelihood of reaching our 7.5% return goal, to which Mr. Bean replied that he was cautiously optimistic we could achieve it over the long-term.

H. Operating Fund Cash & Investments

Ms. Krauss provided a report on the University's operating fund cash and investments as of

October 31, 2017. She began by calling attention to Tiers I and II, which total $835 million, or 106 days cash on hand. The total for the three non-endowed tiers is slightly over $1 billion, or 134 days cash on hand which is well within the approved target range. She added that Tier IV are operating funds invested in the endowment pool, which totals $377 million. $301 million of this is the Hospital operating quasi endowment, and $76 million is the new University operating quasi-endowment. Total funds available for operations were $1.4 billion, or 182 days cash on hand as of October 31st. Ms. Krauss then reviewed a summary of the University's total cash and investments of $2.5 billion as of October 31st, noting endowment investments totaled $1.3 billion, or 53%, and the remaining $1.2 billion, or 47%, encompassing non-endowed investments, comprised of the Tiers I-III operating cash and investments of $1.1 billion and bond proceeds on deposit with the State of $0.1 billion. She concluded this discussion by stating that safety and liquidity are the two primary goals for management of operating funds.

I. <u>Other</u>

Ms. Krauss reviewed items contained in the Other section, beginning with the 2018 meeting schedule and tentative agenda items, including September's annual off-site retreat. She then highlighted the supplemental endowment reports for periods ending June 30, 2017, and September 30, 2017.

J. <u>Meeting Adjourned</u>

Hearing no further business, the meeting was adjourned at 3:36 p.m.

Respectfully submitted,

Kristina W. Goins
University Financial Services