Minutes of the Meeting of the Investment Committee
University of Kentucky
Thursday, February 22, 2018

The Investment Committee met on Thursday, February 22, 2018, in Room 127 of the Charles T. Wethington Building.

A. Meeting Opened

Mark P. Bryant, Chair of the Investment Committee, called the meeting to order at 2:20 p.m. and requested a roll call.

B. Roll Call

The following members of the Investment Committee and Community Advisory Members answered the call of the roll: Mark P. Bryant, Claude A. Berry, III, James H. Booth, Elizabeth McCoy, Robert D. Vance, and Barbara S. Young. Trustees Mike A. Christian and Carol Martin "Bill" Gatton were 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 Consultant Nolan M. Bean.

C. Approval of Minutes for December 11, 2017

Chair Bryant called for a motion to approve the minutes from the Committee meeting on December 11, 2017. The motion was moved by Ms. Young, seconded by Mr. Vance, and approved by all.

D. 2017 NACUBO-Commonfund Study of Endowments

Mr. Bean presented the 2017 National Association of College and University Business Officers (NACUBO)-Commonfund Study of Endowments. He began by stating UK's absolute numbers were good, but behind peers due to a more conservative asset allocation. However, he also noted that while this is constructive information, not to get overly focused on peer performance. The University of Kentucky ranked 76 of 809 institutions in terms of market value, up from 83 last year. A total of 809 U.S. endowments and affiliated foundations participated in the study, representing $567 billion in combined endowment assets. He pointed out that all data is for the 2017 fiscal year (July 1, 2016 – June 30, 2017). Mr. Bean transitioned the conversation to risk, noting this was a driver of relative performance. UK had a lower risk posture vs peers (14.7%

vs. 16.9% expected standard deviation). The portfolio's source of risk is more diversified, and still managed to generate 80% of the return of peers in Fiscal Year 2017. Trustee Young asked a question regarding hedge fund performance during the 2008-2009 market downturn, specifically whether they helped mitigate risk during that time period. Mr. Bean indicated that hedge funds did decline less than the broad equity market, but some investors were disappointed with their performance. Trustee Young then asked if we still have confidence that hedge funds will be able to navigate the next market downturn, and Mr. Bean indicated that we do, given the types of funds held in the portfolio. Ms. Tobin then asked about the performance and timing of UK's investments in marketable alternative strategies, and inquired whether we should remain in these holdings. Mr. Shupp and Mr. Bean highlighted that UK would have benefitted from having these investments during the market crisis and emphasized the continued conviction in the portfolio's diversification. Mr. Britton commented that the losses experienced by UK during the market crisis led the Investment Committee to take a more conservative approach, and that the portfolio hasn't yet fully benefitted from commitments to private equity given the J-curve effect. Trustee Young asked when we will be out of the J-curve, and Mr. Bean responded by stating that while we are still making new commitments to private equity, the portfolio is achieving material return contributions from existing investments.

Mr. Bean continued his presentation by stating that over the long run, equity returns are driven by two things: dividends and real growth. Over the last seven years, returns have been driven by multiple and margin expansion. Addressing why the Endowment is diversified, Mr. Bean referenced the 2016 Investment Committee portfolio construction survey, in which 13% was the average maximum decline that would be tolerable in any one year. He stated that since inception, the portfolio has produced a return of 7.3% annualized and since 2008, the portfolio has produced an annualized return of 8.7%. He also highlighted that we are approaching the longest bull market in history. Reviewing NACUBO asset allocation data by fiscal year, survey results show that allocations to major asset classes were largely unchanged for the seventh straight year. The trend of decreasing allocations to fixed income while increasing allocation to international equity continued. The largest endowments allocated almost six times more to alternative strategies than the smallest endowments. The smallest endowments, meanwhile, allocated more than three times more to domestic equity and fixed income than the largest endowments. Mr. Bean reviewed effective spending data from the survey and concluded the presentation with a historical table reflecting the University's target asset allocation.

Mr. Shupp then conducted a presentation on performance benchmarking. He began with some background, stating that endowment performance is routinely evaluated across all time periods. The primary focus is achieving our long-term return target of 7.5%. This objective received seven of ten first place votes in the 2016 portfolio construction survey completed by the Investment Committee and key stakeholders. The policy benchmark is also a key metric used to evaluate returns. Peer benchmarking is an additional tool for performance comparisons, but he noted that there are important limitations. These include the fact that each institution has unique objectives and constraints that can drive major differences in risk tolerance, asset allocation, and returns. This, combined with incomplete data submitted in the survey, can lead to apples to oranges comparisons. In the 2016 Investment Committee survey ranking of the most important measures of performance, outperforming peers received only one of ten first place votes. Mr. Shupp then moved the discussion to custom peer benchmarking. In addition to reviewing National Council on Secondary Education (NCSE) average results, staff also prepares custom comparisons against four benchmark groups: public institutions with $1-$2 billion in assets, University Review Committee (URC) institutions, Southeastern Conference (SEC) Institutions, and Kentucky Institutions. The most important peer group in the 2016 Investment Committee survey, receiving six of ten first place votes, was the $1-$2 billion public institutions group. Mr. Shupp concluded his comments with a graph showing one, three, five, and ten-year trailing results for UK and the peer groups. Trustee McCoy asked a question regarding UK's results versus the NACUBO peer groups and whether we should attempt to respond more quickly to market movements. Mr. Shupp highlighted that the portfolio achieved its primary return objective in Fiscal Year 2017, and noted that our primary focus is not on assessing return opportunities over very short, one-year time periods. He commented that performance in Fiscal Year 17 made sense given the portfolio's asset allocation and noted there are a number of initiatives under way to improve performance. Mr. Bean also clarified that peer results are not UK's benchmark.

Ms. Tobin inquired if we would have been better off investing in index funds instead of actively managed funds. Mr. Shupp noted that a purely passive, domestic equity portfolio would have indeed outperformed post-crisis, but in his view, this would not have been a prudent strategy. Given current return forecasts, a shift towards a passive 60/40 or 70/30 stock/bond blend would also not be prudent given that exposure appears very unlikely to meet the 7.5% return objective. Trustee Young then asked whether there are discussions in the industry regarding whether we have entered a new era of investing, in which historical market data is less relevant. Trustee Britton highlighted the uncertainty by noting positive catalysts such as tax reform could be mitigated by expanding deficits and rising interest rates. Mr. Bean acknowledged the importance of considering many factors impacting markets and noted that we are not basing portfolio decisions solely on strategies that worked in the past. Trustee Berry then asked a question regarding how managers are thinking about overpriced stocks and the potential for three interest rate hikes. Mr. Bean stated that there is a great deal of focus on the impact of rising rates, and the portfolio has only limited exposure to interest rate risk. He also noted the possibility that rising rates could cause both bonds and stocks to lose value, which would reduce the diversification properties of these assets. Given this environment, the portfolio contains exposure to flexible strategies that can capitalize on rising rates as well as strategies designed to perform well in rising inflation. Mr. Britton noted that it was widely expected that inflation would rise between 2014 and 2016, and strategies positioned for this outcome were detractors from our return.

E. Investment Staff Report

Mr. Shupp presented the Investment Staff Report, beginning with an overview of the endowment asset allocation as of December 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 November 1, and December 31, 2017, noting there were very few changes at the asset allocation level. Within developed, non-U.S. equity, active strategies were exited, and proceeds shifted to passive strategies, and potential future allocations include smart beta. Within diversifying strategies, proceeds from our fund of funds manager, Grosvenor, continue to be reinvested on a direct basis as part of the previously discussed strategy. He highlighted that one benefit of this shift was a reduction in manager fees. Mr. Shupp then addressed new commitments, noting the University made a commitment in a new tranche within our existing Neuberger Berman fund. The portfolio's manager concentration continues to decrease, as diversification across asset classes increases. A major contributor to this reduction was the exit from the active non-US strategies during the period. Mr. Shupp then presented a report on manager appointments, terminations, and due diligence for the period of December 12, 2017, through February 22, 2018. He noted that over this period, there was one new commitment within international equity, Constellation, and one new commitment within diversifying strategies relative value, HBK Multi-Strategy Offshore Fund. Manager terminations included a full redemption from Coastland Relative Value Fund on January 22, where proceeds were reallocated to existing diversifying strategies managers, as previously mentioned. Lastly, Mr. Shupp summarized due diligence during the period. This included several updates with existing managers, a discussion with Fund Evaluation Group on the private implementation plan, as well as a call with Neuberger Berman to discuss portfolio structure, and the attendance of Aether's onsite annual meeting.

F. Performance Review & Market Update

Mr. Bean began by reviewing a memo providing the details surrounding investments within the public equity and diversifying strategies allocations of the endowment portfolio. Next, he shifted the discussion to performance as of December 31, 2017. For the calendar year, the portfolio returned 10.4%, which is expected to increase once final numbers are in from alternative managers. Mr. Bean then highlighted January performance, with UK's return of 1.8% slightly outperforming the benchmark return of 1.7%. The endowment market value as of calendar year-end was approximately $1.5 billion. U.S. equity had a fiscal year to date return of 16.5%, and international equity was slightly ahead of the benchmark at 18.4%. Fixed income was up 1.3% in the period. In diversifying strategies, the return for the month of January was 1.0%, and 2.9% for the fiscal year-to-date period. Return expectations here are in between bonds and stocks. Real assets showed modest gains with 0.4% in January and 3.4% fiscal year returns. Within public real assets, Mr. Bean called attention to the Harvest Master Limited Partnership (MLP) Income Fund, which was up 6.2% for the month, and 10.6% for the three-month period. He concluded by stating that a newer strategy, private natural resources, showed a gain of 19.3% for the fiscal year to date period ending January 31, 2018.

G. Operating Fund Cash & Investments

Ms. Krauss provided a report on the University's operating fund cash and investments as of December 31, 2017. She opened this discussion by stating that safety of principal and liquidity are the two primary goals for management of operating funds. Ms. Krauss then called attention to total cash and investments which was almost $2.4 billion as of calendar year end. This is comprised of both non-endowed and endowed investments which totaled $1.1 billion, and $1.3 billion, respectively. She highlighted that this total excludes $155 million for the Other Post-Employment Benefits (OPEB) quasi endowment that is invested within the endowment pool since those assets are legally restricted to support payment of retiree health benefits. Tiers I and II total $752 million, or 95 days cash on hand. As a reminder, Tier I represents cash, overnight and short-term investments, and Tier II represents cash on deposit with the Commonwealth. The total for the three non-endowed tiers is slightly over $977 million, or 124 days cash on hand, which is well within the approved target range established by the Debt Management Committee who meet regularly to monitor liquidity levels and establish appropriate targets. She noted that Tier IV are operating funds invested in the endowment pool, which totals $381 million. Of these operating funds, $304 million of this is the Hospital operating quasi endowment, and $77 million is the new University operating quasi endowment. She concluded her remarks by stating that the goals for these funds are to gain a modest return and preserve capital. Mr. Vance then shared his thoughts regarding the impact the corporate tax cut has had on equity markets, and the potentially offsetting factors of economic stimulus and rising interest rates, which could entice investors to allocate in fixed income assets. Taking these factors into account, he anticipates the market will be a bit steadier. Mr. Seale then shared his concern surrounding how future generations will be able to pay the expanding federal debt.

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.

I. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 3:31 p.m.

Respectfully submitted,

Krista W. Goins

Kristina W. Goins
University Financial Services