Minutes of the Meeting of the Investment Committee
University of Kentucky
Monday, December 10, 2018

The Investment Committee met on Monday, December 10, 2018, in Ballroom A of the Gatton Student Center.

A. Meeting Opened

Elizabeth McCoy, Chair of the Investment Committee, called the meeting to order at 1:30 p.m. and requested a roll call.

B. Roll Call

The following members of the Investment Committee answered the call of the roll: Elizabeth McCoy, James H. Booth, Michael A. Christian, 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.

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 Christina N. Drake.

C. Approval of Minutes for September 13, 2018

Chair McCoy called for a motion to approve the minutes from the Committee meeting on September 13, 2018. The motion was moved by Trustee Christian, seconded by Trustee Vance, and approved by all.

D. Student Managed Investment Fund Presentation

Ms. Susan Krauss began by introducing the undergraduate faculty advisor, Quint Tatro, student presenter, Michael Zhu, as well as the graduate faculty advisor, Jon Chait from the Student Managed Investment Fund (SMIF) program. She then provided a brief background of this program. Following this, Mr. Zhu gave a stock pitch for Dollar Tree and shared his rationale for the selection of this stock, as follows: 1) the stock is trading at a significant discount to peers; 2) the stock is trading near an all-time-low compared to historical multiples for both Dollar Tree and Dollar General (before it was acquired); 3) the market has overreacted to Family Dollar’s struggles, and is ascribing very little value to that segment; 4) superior operational efficiency at Dollar Tree will soon translate to increased growth and strong margins at Family Dollar; and 5) management has an excellent reputation of capital allocation and has consistently achieved high returns on equity. Mr. Zhu reviewed some risks and considerations of the recommended investment and concluded the presentation by taking some questions from Investment Committee members.

E. Philanthropy Update

Next, Mr. Mike Richey provided an update on the *Kentucky Can* Campaign. He began by stating that the $2.1 billion Campaign is an ambitious, audacious undertaking due to the importance of the mission and vision for the state we serve. He went on to address why this Campaign is vital and highlighted some of the key Campaign goals: 1) to add 2,100 more Leveraging Economic Affordability for Developing Success (LEADS) scholarships to reduce nearly $60 million of unmet financial aid needs; 2) to provide more physicians to eliminate the doctor shortage in the state; 3) to provide 350 scholarships for student-athletes; and 4) to build endowment support for faculty who exemplify excellence in the classroom, in research, and in service. He reviewed strategies to grow the endowment to $2.1 billion and discussed some challenges facing the Campaign. Trustee Blonder asked whether or not there was an effort to fund the Graduate School and graduate students. Mr. Richey answered that most loyalty and identity gifts are at the Undergraduate level, but that strategies are being analyzed and put into place for the Graduate School. Mr. Britton asked a question regarding how the increased management fee has helped the Campaign. Mr. Richey answered that the fee has aided in filling several front line gift officer positions, as well as funding some Campaign related events.

F. Revised Endowment Investment Policy

Mr. Todd Shupp presented a recommendation that the Investment Committee approve the revised Endowment Investment Policy. The primary changes reflected in the modified policy include: 1) adoption of new asset allocation targets intended to enhance the portfolio's expected return while maintaining prudent diversification; and 2) other minor changes including adoption of revised liquidity guidelines and policy benchmark weights that correspond with the asset allocation targets. The motion to approve the revised Endowment Investment Policy was moved by Trustee Christian, seconded by Trustee Young, and approved by all.

G. Investment Staff Report

Next, Mr. Shupp presented the Investment Staff Report, beginning with an overview of the endowment asset allocation as of October 31, 2018, stating that the portfolio remains within the policy ranges and well diversified across asset classes. He highlighted the annual Other Post-Employment Benefits (OPEB) quasi endowment inflow of $7,973,007, which was received on September 20, 2018. These proceeds were allocated across the Endowment's public equity portfolio, in both U.S. and non-U.S. equity strategies. Mr. Shupp then presented a report on manager additions, terminations, and due diligence for the period of September 14 through December 10, 2018. In early November, two smart beta international equity strategies were added to the portfolio: FEG Select Structured Emerging Markets Equity Series, and FEG Select Structured International Equity Series, as well as a new $10 million commitment to existing manager Real Estate Capital Asia Partners (RECAP). Terminations included a full redemption from Vanguard Financial Times Stock Exchange (FTSE) Emerging Markets Exchange-Traded Fund (ETF). These proceeds were allocated to the previously mentioned smart beta strategy, FEG Structured Emerging Markets Equity. Mr. Shupp then transitioned to manager due diligence for the period, which included routine updates with existing managers, researching new potential managers within private credit, as well as two SMIF update meetings. In addition to these updates, a new monthly call with FEG was instated, primarily to review the firm's private equity pipeline. Dr. Seale then asked a question regarding private equity fees and performance, and Mr. Bean responded that for private equity, fees typically include a 2% management fee and a 20% incentive fee, over an 8% hurdle. Mr. Shupp and Mr. Bean followed up by stating that private equity investments have been a strong contributor to portfolio performance, both on an absolute basis and relative to public equity markets. Ms. Tobin then asked a question regarding the calculation of active and passive strategy exposure listed in the asset allocation file, and Mr. Shupp provided an explanation.

H. Performance Review & Market Update

Next, Mr. Nolan Bean presented the endowment performance overview. Volatility reappeared in most major asset classes in the month of October and persisted in a smaller fashion throughout November. The U.S. dollar had a negative impact on international equities, and mid-term elections introduced additional volatility, as well. He continued by stating that for the month of October, the Endowment portfolio posted a return of approximately -3%, resulting in an estimated decline of 1.7% for the year-to-date period. This compares to declines of 4.8% and 3.3%, respectively, for a global 60/40 portfolio, and losses of 7.5% and 4.0%, respectively, for global equities. He emphasized that October's volatility serves as a reminder that diversification can be helpful. This discussion concluded with a review of current portfolio themes across major asset classes.

Mr. Bean then shifted the discussion to Third Quarter market performance. Public real asset and domestic equities allocations performed well for this period, while international equity and core fixed income were areas of relative weakness. Mr. Britton asked whether our year-to-date performance relative to the benchmark would improve if October's returns were included. Mr. Bean stated that the portfolio's October performance was roughly in-line with the benchmark, and therefore did not have much of an impact. Overall, a more diversified asset allocation helped the portfolio preserve capital better than a traditional stock and bond portfolio would have in the volatile month of October. With the exception of emerging markets, where UK benefitted from strong active manager performance, the Endowment generally did not see gains from active management during the month. Mr. Bean acknowledged that he is not happy with the relative performance of some of the active managers in the portfolio over the shorter-term, but that he retains confidence in the managers over the long-run. Mr. Bean concluded this section of his presentation by summarizing the primary drivers of 2018 performance through the Third Quarter. The public equity portfolio has a tactical overweight to international equities, which was a headwind thus far in 2018. The global fixed income portfolio has a tactical underweight to high quality/core securities, with a tilt towards credit sensitive investments, which was additive thus far in 2018. Real assets were also positive contributors so far in 2018, and the focus continues to be on asset classes where the Endowment is being properly compensated for the risk being taken.

Next, Mr. Bean highlighted a manager memo providing the details surrounding the recent commitment to RECAP Fund V in private real estate and investments in international developed and emerging market equity strategies managed by Pacific Investment Management Company

(PIMCO) and Research Affiliates, via the FEG Select platform. Dr. Seale asked a question regarding the fees on these funds, and Mr. Bean provided details on the performance fee structure, noting that the incentive fee is paid only if the strategy outperforms its benchmark. FEG highlighted the fact that they are not managing these strategies and do not receive management fees, but structured the funds to provide a service to clients such as the University of Kentucky.

Lastly, Mr. Bean discussed performance for both September and October. He noted that fees had been driven down in efficient markets, where it is difficult to add value. Active fee dollars are instead being deployed in less-efficient areas such as private and semi-liquid markets. Mr. Aluise then provided some commentary on October performance. He reviewed each major asset class beginning with U.S. equities, which were down -7.5%. Non-U.S. equities did slightly better for the period, yielding a -7.3% return. He noted that global fixed income preserved capital, with a loss of only 0.2%, outperformed the benchmark. Additionally, diversifying strategies did a good job of preserving capital, relative to equities. In closing, he reinforced that diversification was additive in the month of October. Mr. Britton commented that he is skeptical about Diversifying Strategies and is waiting to see hedge funds make money, not just lose less than other asset classes. Mr. Bean responded that this is a common investor sentiment, and these strategies need to perform in choppy and down markets, otherwise it is valid to ask if there's been a structural change in the markets. Mr. Shupp added that we did see some hedge funds deliver positive returns in October and, since UK first invested in 2009, this portfolio has made money and outperformed its index. Trustee Young asked whether fees are being negotiated with our managers, and Mr. Bean stated that this was being done wherever possible.

I. <u>Other</u>

Ms. Krauss reviewed the 2019 Investment Committee meeting schedule and tentative agenda items. Additionally, she noted the inclusion of the endowment supplemental materials and operating cash and investment report as of October 31, 2018.

J. <u>Meeting Adjourned</u>

Hearing no further business, the meeting was adjourned at 3:00 p.m.

Respectfully submitted,

Krista W. Goins

Kristina W. Goins
University Financial Services