ICR 1

Office of the Executive Vice President for Finance and Administration
December 14, 2020

Members, Investment Committee of the Board of Trustees:

REVISED ENDOWMENT INVESTMENT POLICY

Recommendation: that the Investment Committee of the Board of Trustees approve the attached revisions to the Endowment Investment Policy.

Background: The revised policy reflects the following changes:

- Adoption of the following asset allocation targets intended to enhance the portfolio's expected return while maintaining prudent diversification:

	Current Target Allocation	Proposed Target Allocation	Change
GLOBAL EQUITY	**52%**	**53%**	**+1%**
Public	26%	33%	+7%
Private	20%	20%	--
Hedged (long/short)	6%	0%	-6%[1]
GLOBAL FIXED INCOME	**16%**	**13%**	**-3%**
High Quality/Rate Sensitive	7%	7%	--
Public Credit	4%	2%	-2%[1]
Private Credit	5%	4%	-1%
REAL ASSETS	**17%**	**14%**	**-3%**
Public	6%	3%	-3%
Private	11%	11%	--
DIVERSIFYING STRATEGIES	**15%**	**20%**	**+5%[1]**

[1]Long/short funds previously categorized within Global Equity (Hedged long/short) and Global Fixed Income (a portion of Public Credit) are shifted to Diversifying Strategies. The Proposed Target Allocation for Diversifying Strategies includes all long/short funds and is a 4% reduction from the current, aggregated total.

- Policy benchmark adjustments that correspond with the asset allocation targets and updates to accurately reflect current staff designations.

Action taken: ☑ Approved ❑ Disapproved ❑ Other ______________________

UNIVERSITY OF KENTUCKY
AND AFFILIATED CORPORATIONS

ENDOWMENT INVESTMENT POLICY

Amended December 14~~9~~, 2020~~19~~

University of Kentucky
University of Kentucky Research Foundation
University of Kentucky Gluck Equine Research Foundation, Inc.
University of Kentucky Humanities Foundation, Inc.
University of Kentucky Mining Engineering Foundation, Inc.

Responsibilities of Investment Staff and Endowment Advisory Group

Investment Staff

The senior Endowment investment staff ("Staff") will consist of the University's Executive Vice President for Finance and Administration, ~~Treasurer and~~ Chief Investment Officer, and Investment Officer ~~Senior Investment Analyst~~. Staff is responsible for executing the policies and decisions enacted by the Committee and the general daily activities and administration of the Endowment assets. The Staff will prepare analysis and recommendations for the Committee on development of policies and guidelines, selection of an appropriate long-term asset allocation, and selecting an appropriate manager structure. The Staff will perform other duties as delegated by the Committee. The Staff will maintain summaries of the investment guidelines for the various investment managers and periodically provide to the Committee.

Endowment Advisory Committee

An Endowment Advisory Committee of senior University administrators and faculty may be established by the President to advise the Executive Vice President for Finance and Administration and Staff on various matters pertaining to the prudent management of individual endowment funds.

Responsibilities of Investment Consultant

The Committee may engage an independent Investment Consultant ("Consultant") to assist the Committee and Staff in developing policies and guidelines, selecting an appropriate long-term asset allocation, selecting an appropriate manager structure, identifying investment managers, evaluating investment performance, and offering other services as requested. The Consultant will prepare quarterly and annual assessments of investment performance that include results for the total endowment and each individual investment manager compared to appropriate market indices and manager universes. The Consultant will also periodically provide in-depth and detailed analysis of each manager's portfolio.

Responsibilities of Investment Custodian

The Committee will engage an Investment Custodian ("Custodian") for the University's endowment investments. The Custodian will establish and maintain direct account relationships with each investment manager and perform core custodial functions, including security safekeeping, collection of income, processing and settlement of trades, collection of proceeds of maturing securities, distribution of income, and daily investment of cash. The Custodian will provide account statements and other reports as requested by the Staff.

IV. Delegation of Authority

Spending distributions and management fee withdrawals will be suspended on all endowments underwater by more than 20%. Endowments underwater more than 10% will undergo a formal review by the Office of the Treasurer and appropriate College Dean to determine the appropriate level of spending distributions in accordance with the following factors set forth in the Kentucky Uniform Prudent Management of Institutional Funds Act:

- the duration and preservation of the endowment fund;
- the purposes of the institution and the endowment fund;
- general economic conditions;
- the possible effect of inflation or deflation;
- the expected total return from income and the appreciation of investments;
- other resources of the institution;
- the investment policy of the institution.

The Treasurer has authority to approve exceptions of the policy to suspend spending distributions and management fee withdrawals on certain quasi and term endowments that are underwater by more than 20%.

New Endowment Funds

Spending distributions on new endowment funds will be delayed for at least one year in order to build a reserve for future spending distributions.

VI. Investment Policies

Diversification

Disciplined management of the asset allocation is necessary and desirable. Diversification of investments among assets that are not similarly affected by economic, political, or social developments is highly desirable. The general policy shall be to diversify investments so as to provide a balance that will enhance total return, while avoiding undue risk concentrations in any single asset or investment category.

Asset Allocation

To ensure broad diversification, the asset allocation will be set with the following target percentages and within the following ranges:

ASSET CATEGORY	TARGET	RANGE
GLOBAL EQUITY	**53~~2~~%**	**30 - 60%**
Public	*33~~26~~*	
Private	*20*	
~~*Hedged (long/short)*~~	~~*6*~~	
GLOBAL FIXED INCOME	**13~~6~~**	**5 - 25**
High Quality/ Rate Sensitive	*7*	

Public Credit	*2~~4~~*	
Private Credit	*4~~5~~*	
REAL ASSETS	**14~~7~~**	**5 - 25**
Public	*3~~6~~*	
Private	*11*	
DIVERSIFYING STRATEGIES	**20~~15~~**	**5 - 25**

Note: Sub-asset category (e.g., Public Equity) figures reflect working targets. Investment staff has flexibility to adjust sub-asset category exposures within broader, asset category (e.g., Global Equity) ranges, based on market conditions and ongoing research.

Global Equity – The allocation will consist of public and private equity-oriented funds managed by external investment firms. This is expected to be the highest risk, highest return asset category of the four. The allocation will be diversified by factors including security, sector, geography, market capitalization, and manager style.

Global Fixed Income – The allocation will consist of two broad categories: 1) high quality/rate sensitive and 2) credit/distressed. High quality bonds are defined as securities rated investment grade by S&P and Moody's (Baa/BBB and above). These bonds provide equity risk mitigation, deflation protection and liquidity to the portfolio. The credit / distressed allocation will include high yield bonds, bank loans, emerging market debt, structured or asset backed bonds, mezzanine loans and distressed debt. The credit / distressed allocation provides investment opportunities to generate a substantial real return.

Real Assets – the allocation will consist primarily of public and private assets. Public assets include Real Estate Investment Trusts (REITs), Master Limited Partnerships (MLPs) and commodities. Private assets include real estate, natural resources and infrastructure. Private assets may include real estate near the University campus which is deemed to have strategic value for the University. For diversification purposes not more than 2% of the portfolio will be invested in local real estate as opposed to external managers. The 2% maximum will be defined as the market value of the portfolio at the time of investment. All real assets are expected to provide inflation protection as well as generate positive real rates of return.

Diversifying Strategies – the allocation will consist of investments whose primary source of risk and return is differentiated from~~not a constant allocation to one of~~ the three asset categori~~lass~~es listed above. This includes, but is not limited to, hedge funds whose approach can be described as "absolute return," multi-strategy, event driven, relative value, hedged equity, or global macro~~, as well as Global Tactical Asset Allocation (GTAA)~~.

Rebalancing

Rebalancing is a term that describes the periodic movement of funds from one asset class or category to another for the purpose of realigning the assets with the asset allocation target. A implement the change in a cost-effective, timely manner while maintaining the appropriate market exposure. It is imperative to note that the cost of transition is not commissions alone, but also bid/ask spread, market impact and opportunity cost. The market impact cost is the effect trading will have on the market price of the shares being traded. The opportunity cost, sometimes referred to as implementation shortfall, is the cost of market movements over the time it takes to trade. Efforts should be made to minimize the total cost rather than any single cost component. Selecting a transition manager can be done at the Staff's discretion with the assistance of the Consultant. Use of futures contracts and exchange traded funds may be required in order to maintain appropriate market exposure during a transition.

VII. Performance Evaluation

Endowment performance will be monitored and reviewed over short and long-term time periods, with an emphasis on longer-term periods in order to include full market cycles and reflect the endowment's long-term investment strategy. Performance will be evaluated at three levels; total Endowment, asset class and individual manager. All three levels will include a market index and peer group measurement review. Performance will be reviewed on a gross and net return basis and will include risk metrics and risk-adjusted returns.

Performance Benchmarks

The total Endowment performance will be measured against:

1. The primary performance objective of achieving a total return, net of fees and expenses, of 7.5%

2. A Policy Benchmark consisting of market indexes reflecting the Endowment's "strategic target" asset allocation percentages. The current Policy Benchmark appears in the following table:

ASSET CATEGORY	TARGET	INDEX
GLOBAL EQUITY	**53~~2~~%**	
Public	33~~26~~	MSCI All Country World Index
Private	20	Thomson Private Equity
~~Hedged (long/short)~~	~~6~~	~~HFRI Equity Hedge~~
GLOBAL FIXED INCOME	**13~~6~~%**	
High Quality/ Rate Sensitive	7	Barclays Aggregate Bond Index
Public Credit	2~~4~~	50/50 ML High Yield/Bloomberg Barclays U.S. Credit Index~~HFRI RV: Asset Backed~~
Private Credit	4~~5~~	50/50 Thomson Mezzanine/Distressed Debt

REAL ASSETS	**14~~7~~%**	
Public	3~~6~~	1/3 each Bloomberg Barclays U.S. TIPS Index~~Commodities~~, NAREIT Index and Alerian MLP Index
Private	11	70/30 Thomson Natural Resources/Private Real Estate
DIVERSIFYING STRATEGIES	**20~~15~~%**	**HFRI Fund of ~~O~~Funds ~~:~~ Composite~~nservative~~**

3. A peer group universe of similar plans

The asset class performance will be measured against:

1. The asset class' index.

2. A peer group universe of similar asset classes

The individual manager performance will be measured against:

1. The manager's specific market indexes.

2. A peer group universe of similar investment styles

Long-Only Active Managers

Managers will be measured against their primary benchmark and their peer universe.

Long/Short Managers (Hedge Funds)

Most hedge funds do not have good benchmarks for performance measurement, especially over short time periods. Managers will be measured relative to peer benchmarks such as the various style indices tracked by HFRI. Secondary benchmarks will also be used, including relevant asset class benchmarks (such as the S&P 500 for ~~the~~ U.S. focused long/short equity funds) and absolute return measures (T-bills + X%).

Private Capital Managers

The majority of private equity, private real asset, and private credit funds will be invested with private partnerships. These partnerships typically range from 7-15 years in life, during which time the Fund may not be able to sell the investment. Additionally, the partnership may not produce meaningful returns for 3-5 years (depending on the strategy). New investments will create a drag on fund performance in the early years (3-5 years) until these investments begin to mature. This drag on performance is often referred to as the J-curve, due to the shape created by plotting a line graph with performance on the y-axis and time on the x-axis. Private, illiquid manager performance will be measured utilizing internal rate of return (IRR) calculations, and Multiple of Invested Capital (MOIC), and will be compared to an appropriate peer group. An IRR calculated from the inception of the partnership will be the primary performance measurement tool utilized for all private capital managers. Performance will be measured relative to the best available benchmark, understanding that some investments may not have entirely comparable indices.