Minutes of the Investment Committee
University of Kentucky Board of Trustees
1:30 p.m. on May 1, 2017
Room 327C, Charles T. Wethington Building

IN ATTENDANCE:

Investment Committee Members:	Mark P. Bryant, Chair Claude A. Berry, III James H. Booth William C. Britton Michael A. Christian Robert D. Vance Barbara S. Young
Community Advisory Members:	James F. Hardymon (participated via conference call) William E. Seale Myra L. Tobin
Investment Staff & Consultants:	Susan I. Krauss, Treasurer Todd D. Shupp, Chief Investment Officer Nolan M. Bean, Consultant, Fund Evaluation Group Michael J. Aluise, Consultant, Fund Evaluation Group Rebecca S. Wood, Consultant, Fund Evaluation Group

Chair Bryant called the meeting to order at 1:41 p.m. and requested a roll call. Chair Bryant then called for a motion to approve the minutes from the Committee meeting on February 16, 2017. The motion was moved by Mr. Booth, seconded by Mr. Britton, and approved by all.

Ms. Krauss introduced Eric Winkler, who serves as the current Endowment Investment Intern, as well as the Portfolio Manager of the Student Managed Investment Funds (SMIF). Mr. Winkler began a stock pitch presentation for his selected stock, Chipotle Mexican Grill (CMG) which was previously presented to the undergraduate SMIF class. He included a company overview indicating the unique opportunity created by poor investor sentiment due to an E. coli issue in late October 2015. He then presented company highlights which included a great return on equity and sales growth, as well as a strong balance sheet with no long- or short-term debt. Mr. Winkler also addressed Chipotle's change in management structure. In December 2016, Chipotle moved away from co-CEO (Monty Moran steps down from management position and board) and Steve Ells (founder) is now the sole CEO. Ells has run the company for twenty-three years, and plans to refocus on operations and employees. The catalysts used to drive this company to realize its valuation include an unexpected earnings report (cut cost faster than expected), another franchise success, and pursuing international franchising. Mr. Winkler concluded that Chipotle is a strong company with no debt, they offer a unique product, have low basis treasury stock, and were a strong company before the E. coli incident. The recommendation was to buy 5%, or the maximum position for the portfolio, which was accepted.

Ms. Krauss then discussed IC1, a recommendation that the Committee approve changes to the Student Managed Investment Funds (SMIF) Program. In December 2013, the Investment Committee approved establishment of a new SMIF Program for the management of up to $5.1 million in a large cap equity strategy. Approximately, $1,800,000 has been invested in the SMIF program to date, which is currently managed by undergraduate finance majors. The Gatton College of Business & Economics (Gatton College) now proposes allocating the remaining commitment of $3,300,000 by adding $750,000 to the undergraduate SMIF program and creating a new $2,550,000 SMIF account to be managed by graduate students in the Master of Science in Finance Program. The amended Investment Management Agreement (IMA) will have an initial term of two years (July 1, 2017 through June 30, 2019) and a new IMA will be renegotiated every two years thereafter. The materials included the December 2013 IC action and supporting materials, which included the investment management guidelines for the existing UK undergraduate SMIF portfolio sponsored by the TVA, performance summary from the TVA custodian, Mellon Bank, and portfolio holdings and position values as of 10/31/2013. Chair Bryant asked if it would be possible for the Committee members to obtain a copy of the current positions in each account. Both Ms. Krauss and Mr. Quint Tatro, faculty adviser for the SMIF program, affirmed that it would be. Dr. Seale inquired about the portfolio guidelines and suggested modification to allow investment in ETFs. Mr. Tatro commented ETF's would be useful for obtaining sector exposure on a temporary basis. Ms. Krauss stated the guidelines would be reviewed and updated with the contract amendment effective July 1st. Dr. David Blackwell, Dean of the Gatton College, and Mr. Tatro were then invited to make comments about the program, at which time they noted the immense value of the SMIF program in each of their experiences. The motion was moved by Mr. Britton, seconded by Mr. Christian, and approved by all.

Mr. Bean then presented the Portfolio Risk Review. This provides a snapshot of the portfolio's exposures within each of the four asset categories (equity, fixed income, real assets, and diversifying strategies). He discussed graphs showing current UK targets compared to NACUBO peers, as well as to both a 60/40 and 80/20 blended, stock/bond portfolio. The current asset allocation policy approved by the Committee shows less volatility than the average endowment, but a similar expected return. Historically, the blended 60/40 portfolio has produced a 5.3% real return. Based on current projections, the expected real return is 2.5%, less than half of the long-term average. Next, he discussed maximum drawdown considerations. In the 2016 portfolio construction survey, completed by Committee members, the average response was that 13% was the maximum acceptable decline. Next, Mr. Bean discussed the concept of contribution to risk, highlighting that a simple 60/40 portfolio of stocks and bonds is made up nearly all equity risk. The current asset allocation, diversified across a mix of equities, bonds, inflation hedging strategies, and diversifying strategies, is less reliant on equity risk to drive returns. The primary source of volatility in a portfolio is due to equities and the stock market.

Mr. Bean then reviewed each of the four main asset categories in the portfolio. He began with global equity which is comprised of public equity, private equity and long/short equity strategies. Reviewing geographic exposure relative to the MSCI All Country World Index (ACWI), the University's portfolio has slightly more exposure in Emerging Markets, less in Developed Asia, and slightly less in US Equities. Additionally, the University's global equity portfolio is currently positioned with more capital allocated to passive strategies than peers. (UK is 43% passive versus the NACUBO average of 24%). Regarding the global equity portfolio's sector exposure, Mr. Seale noted that the UK endowment mirrors the MSCI ACWI very closely, so why not buy the ETF, eliminating the need for active managers? Mr. Bean responded that since almost half of the portfolio is indexed, its exposures will look very similar to the market. Addressing the half of the portfolio that is actively managed, composed of small cap and international stock, expected value will be added primarily from stock selection, rather than geographic or sector tilts. Mr. Shupp added that the role of active and passive management continues to be evaluated with FEG, and the rationale for having active management in the global equity portfolio is that there is an opportunity to outperform indices in non-US equity markets. Mr. Bean added that the greatest benefit for active management lies in markets that cannot be indexed, such as private equity. He concluded with an overview of global fixed income, global real assets (primarily made up of real estate), and diversifying strategies.

Next, Mr. Shupp presented the Investment Staff Report. He began with an overview of the endowment asset allocation as of March 31, 2017, stating that the portfolio remains well within the policy ranges and well diversified across asset classes. In response to a request by Trustee Christian, some footnotes to denote passive exposure were added to this report as well as the FEG report. On the second page, staff added a section to break down the passive exposure contained in each of the four main asset categories of the portfolio. The biggest changes since the asset allocation report as of year-end include incremental reductions towards the hedged equity target and increased exposure in diversifying strategies, with capital shifting from fund of funds to direct managers. He then presented a report on manager appointments, terminations and due diligence for the period February 17, 2017 through May 1, 2017. On March 1st, an allocation was made to an active MLP manager, Harvest, as well as a number of managers within Wildcat Alpha. These included a $15 million commitment to a private credit fund, Merit Mezzanine, two hedged equity funds, Highfields and Firefly Value, as well as three diversifying strategies funds, Coastland Relative Value Fund, LibreMax Offshore Fund, and Kepos Alpha Fund. Mr. Shupp noted that FEG compiled two memos outlining the firms' strategies, as well as the rationale for investing in those strategies. For terminations, there were two redemptions from Wellington hedged equity funds related to the reduction of hedged equity exposure towards the new asset allocation target. Mr. Shupp also noted there had been an extensive amount of due diligence during the period. This included a number of meetings with existing managers as well as potential managers. He also noted there were a number of calls with FEG across a variety of subjects as well as a SMIF update meeting including students from the SMIF class.

Next, Mr. Bean provided a performance review for the period ending March 31, 2017. He began by noting two memos from FEG to the University. The first memo provided an overview of the rationale for manager additions to the University's diversifying strategies portfolio. The second memo provided the details surrounding the commitment to Merit Mezzanine VI in private credit, the investment in the Harvest MLP Income fund in public natural resources, and the investments in Highfields Capital and Firefly Value Partners in hedged equity. Ms. Wood began her comments with a review of first quarter 2017 market returns. She stated that the beginning of the year has been strong. US equities posted a positive return, 5.7%, during the quarter, as did MLPs at 3.9%. The energy sector trailed other sectors as commodity prices, most notably oil prices, declined. In International markets, the U.S. dollar has weakened, which has helped returns. Following this, Mr. Aluise went over UK Endowment performance. Looking at asset allocation targets, he noted the portfolio was slightly overweight in global equities currently, and slightly underweight in fixed income. Regarding performance, it was a strong quarter for the portfolio, with a return of 3.0%. Mr. Aluise noted that Global Equity, which includes public equity, long short equity, and private equity, lagged its benchmark. Fixed income delivered outperformance, as did real assets and diversifying strategies. Finally, Mr. Bean noted that active/passive labels were added to the performance report, as well as a one-page fee summary that will be included from this point forward.

Lastly, Ms. Krauss provided a report on the University's operating fund cash and investments as of March 31, 2017 which has been revised in accordance with a new policy adopted by the Treasury Investment Advisory Group. The primary goals of this group are 1) Safety of capital and 2) meeting liquidity needs. The new structure divides the management strategy into four tiers. Tier I (most liquid) representing cash, overnight & short term investments totaled about $278 billion. Tier II is cash on deposit with the Commonwealth, totaling around $547 million. Tier III totals $256 million and represents other operating investments, comprised mainly of restricted funds, which includes private gifts, grant money as well as cash for the affiliated corporations. The Days Cash on Hand column represents the number of days in cash the university has on hand based on fiscal year 2016 operating expense per day. Tiers I and II must total at least 60 days and Tiers I – III should be in the range of 125 to 175. Tier IV is the operating funds or long term reserves invested in the endowment pool. Currently this represents the hospital quasi-endowment, established by the Board of Trustees in 2006. With Board approval, these funds could be accessed. The right hand part of the revised report shows yield and return information for the current fiscal year relative to approved benchmarks. The next page shows supplemental information including current and historical operating funds per tier and bond proceeds on deposit with the Commonwealth. Ms. Krauss provided background on FCR 2, which is being recommended to establish a new University Operating quasi-endowment and allow the investment of operating cash and investments in the endowment pool subject to three constraints: 1) a maximum investment of $75 million annually; 2) liquidity targets approved by the Debt Management Committee must be maintained; and 3) an overall constraint of 35% of total operating cash and investments. Tier IV investments currently represent 21% of the total operating funds and would increase to 26% with a $75 million investment if the new University Operating Quasi is approved.

The meeting was adjourned at 3:17 p.m.

Respectfully submitted,
Kristina W. Goins
University Financial Services