

# UNIVERSITY OF KENTUCKY

## ENDOWMENT INVESTMENT POLICY

Amended June 16, 2008

University of Kentucky  
University of Kentucky Research Foundation  
University of Kentucky Athletic Association  
The Fund for Advancement of Education and Research in the UK Medical Center  
University of Kentucky Business Partnership Foundation, Inc.  
University of Kentucky Mining Engineering Foundation, Inc.  
University of Kentucky Equine Research Foundation, Inc.  
University of Kentucky Humanities Foundation, Inc.  
University of Kentucky Center on Aging Foundation, Inc.

## Table of Contents

	Page
I. General	3
II. Purpose of the Investment Policy	3
III. Roles and Responsibilities	3
IV. Delegation of Authority	5
V. Financial and Investment Objectives	6
VI. Investment Policies	7
VII. Performance Evaluation	9
VIII. Investment Manager Structure	10

## **I. General**

The University of Kentucky Endowment (“Endowment”) is an aggregation of gifts provided by donors with the requirement they be held in perpetuity to generate earnings now and in future years to support the University's programs of instruction, research and public service. Earnings from endowment investments support scholarships, chairs, professorships, basic research, as well as academic and public service programs. The Endowment provides stability since the principal is invested and earnings are generated year after year.

The University of Kentucky has a fiduciary responsibility to manage the Endowment prudently and to preserve the purchasing power of the Endowment in order to evenly support present and future beneficiaries. This fiduciary responsibility constitutes both a legal and moral obligation to donors who intend that their gifts provide support for the University in perpetuity.

## **II. Purpose of the Investment Policy**

In general, the purpose of this policy is to outline a philosophy and attitude which will guide the management of the investment assets toward the desired results. It is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical.

This investment policy is set forth by the Investment Committee (“Committee”) of the University of Kentucky Board of Trustees in order to:

- a. Define and assign the responsibilities.
- b. Establish a clear understanding of the investment goals and objectives of the Endowment assets.
- c. Offer guidance and limitations regarding the investment of Endowment assets.
- d. Establish a basis of evaluating investment results.
- e. Manage the Endowment's assets according to industry best practices and applicable laws.

The investment policy will be reviewed annually by the Committee and investment staff.

## **III. Roles and Responsibilities**

### **Responsibilities of the Investment Committee**

The Board of Trustees has established the Committee with members appointed annually by the Chair of the Board of Trustees. The Committee is responsible for the review and oversight of endowment investments of the University of Kentucky and its affiliated corporations, consisting of the Research Foundation, Athletic Association, The Fund, Equine Research Foundation, Business Partnership Foundation, Humanities Foundation, Mining Engineering Foundation, and Center on Aging

Foundation.

Governing Regulation II, A (6) (f) of the University of Kentucky sets forth the specific responsibilities of the Investment Committee as follows:

Under delegation from the Board of Trustees, and consistent with KRS 164A.550 through 164A.630, the Investment Committee is responsible for review and oversight of the endowment investment programs of the University and its affiliated corporations. These responsibilities include: formulating and reviewing investment policies; appointing, monitoring and evaluating investment managers and consultants; and reviewing and approving plans for the general management of the endowment funds of the University.

The membership of the Committee shall include five members from the Board of Trustees. Each member shall be appointed by the Chair of the Board of Trustees. A quorum of the Committee members must be present in order to conduct business.

In addition to voting members, the Investment Committee may, from time to time, have the Chair of the Board of Trustees appoint, upon recommendation of the University President, Community Advisory Members to assist it in its functions by providing specialized advice and support. Said Community Advisory Members shall be selected on the basis of their expertise in such areas as investment management and finance. The appointments of Community Advisory Members to the Investment Committee shall be for three years and may be reappointed for an unlimited number of three year terms. The maximum number of Community Advisory Members authorized at any one time shall be three (3).

The Investment Committee Chair reports to the Board of Trustees after each meeting of the Committee on the performance results of endowment investments. Policies of the Committee are implemented by the Office of the Treasurer in carrying out the day-to-day operations of the University's endowment funds.

### **Responsibilities of Investment Staff**

Investment staff ("Staff") will consist of the University Treasurer and the Assistant Treasurer for Investments. 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 provide recommendations to the Committee as to the managers most appropriate for managing the Endowment's assets.

## **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 provide in-depth and detailed analysis of each manager's portfolio.

## **IV. Delegation of Authority**

The Committee may delegate the following investment related activities to qualified industry experts, but will be responsible for the selection and oversight of the vendors.

### **Investment Custodian**

The Committee will hire a Custodian for the University's endowment investments to establish and maintain direct account relationships with each investment manager and perform standard custodial functions, including security safekeeping, collection of income, settlement of trades, collection of proceeds of maturing securities, distribution of income, and daily investment of cash. The Custodian will provide monthly account statements and other reports as requested by the Staff.

### **Investment Managers**

The Committee will delegate the selection, buying and selling of individual securities to qualified industry experts. Each individual investment manager will exercise discretion over assets in accordance with specified investment guidelines.

Investment managers that utilize separate accounts to manage Endowment assets will adhere to specific investment manager guidelines established by Staff with the assistance of the Consultant. Each investment manager using a separate account is required to summarize its holdings and transactions on a monthly basis.

Investment managers that utilize a mutual fund investment structure, a commingled trust fund structure or a limited partnership structure will have discretion to manage the assets in accordance with the policies and guidelines outlined in the respective mutual fund's prospectus, the commingled trust fund's offering memorandum or limited partnership's private placement memorandum.

All investment managers' guidelines and policies are located in the addendum of the Policy.

## V. Financial and Investment Objectives

The Investment Committee has established the following financial and investment objectives for the Endowment:

1. To preserve the purchasing power of the endowment assets and the related revenue stream over time to evenly allocate support between current and future beneficiaries (intergenerational equity).
2. To manage the endowment assets in a single investment pool, employing multiple investment managers to gain specialization and diversification benefits of different investment asset classes and strategies.
3. To establish an annual spending rate policy of 4.5% of the average market value over the preceding 36 months.
4. To establish an annual management fee of .5% of the current market value.
5. To earn an average annual real return, after inflation and expenses, of at least 5% per year over full economic market cycles.

### **Uniform Management of Institutional Funds Act (KRS 273.520 to 273.590)**

Endowment assets will be managed effectively and prudently in accordance with the provisions of the Uniform Management of Institutional Funds Act (KRS 273.520 to 273.590), which specifically requires trustees to consider both the long-term and short-term needs of the University. The Committee has established policies intended to accomplish the primary goal to preserve or increase the purchasing power of the Endowment by maximizing real total return, subject to risk constraints.

### **Spending Rate and Management Fee**

The Investment Committee has established an annual spending rate policy of 4.5% of the average market value of the Endowment over the preceding 36 months to establish financial equilibrium for the Endowment by creating a balance between annual spending and the expected real (after inflation) return on assets. Additionally, the Endowment is assessed an annual management fee of .5% of the current market value to support administrative costs. The spending rate of 4.5% and the management fee of .5%, in concert with the target asset allocation policy is intended to support current and future program needs and allow the endowment value to grow at least equal to annual inflation.

## VI. Investment Policies

### Diversification

The Committee will invest in different asset classes and engage multiple investment managers to ensure proper diversification of the Endowment. Investment diversification is essential to limit risks that include return volatility, the magnitude of potential losses, and manager underperformance. Equity investments will be diversified by market capitalization (company size), style (growth or value), industry, and country of domicile (as it will include non-U.S. based companies). Fixed income investments will be diversified by market sector, maturity, credit quality and issuer. Real estate investments will be diversified by property type, geographic location and investment style. Private equity investments will be diversified by strategy, including multiple venture capital, leveraged buyout, and special situation funds, by geographical allocation including U.S. and non-US investments, and by vintage year of investment. Real Return strategies will be diversified by asset class and manager. Absolute Return Strategies will be diversified by manager, investment strategy, and geographic location including U.S. and non U.S. managers.

In an effort to optimize and efficiently utilize due diligence research and diversification within the alternative asset classes, which includes Private Equity, Real Return, Absolute Return and Real Estate, a “fund of funds” (“FOF”) investment structure will generally be used. Investing in an individual manager will need the approval of the Committee.

### Asset Allocation

The Committee has established asset class targets and ranges as follows:

Asset Class	Investment Policy	
	Target	Range
Broad U.S. Equities	26%	21-31%
Broad Non-U.S. Equities	20%	15-25%
<b>Total Equities</b>	<b>46%</b>	<b>41-51%</b>
Private Equity	7%	1-9%
Real Return	7%	5-9%
Absolute Return	10%	8-12%
Real Estate	12%	10-14%
<b>Total Alternatives</b>	<b>36%</b>	<b>31-41%</b>
<b>Fixed-Income</b>	<b>18%</b>	<b>15-20%</b>
<b>Total</b>	<b>100%</b>	

## **Rebalancing**

The Committee intends to maintain the actual asset class allocations within the target ranges outlined above. Allocations relative to targets will be reviewed at least on a quarterly basis to determine if rebalancing transfers between asset classes are necessary. In general, Staff will direct new endowment gifts to undertarget asset classes.

## **Liquidity**

The Endowment is intended to provide a stream of annual income to the University in perpetuity. As a result, the Endowment has a long-term orientation. In addition, the withdrawal rate from the Endowment fund is well defined, predictable, and of modest size relative to the total assets, so the Endowment's need for liquidity is significantly lower than other institutional investors.

## **Proxy Voting**

The Committee delegates full authority for proxy voting to its investment managers for the securities under their discretionary authority and requires the investment managers to vote all proxies in the best interest of the Endowment. In addition, when requested, the managers will report to the Committee on their proxy-voting policies and activities on the Endowment's behalf.

Proxy voting related to governance issues regarding investment managers hired to manage Endowment assets, and their related investment legal structures, terms and conditions, will be voted on by the Staff in the best economic interest of the Endowment. The Staff may solicit assistance of the Consultant on governance issues.

## **Transaction Costs**

The Committee requires the investment managers, in their capacity as fiduciaries, to manage the transactions costs they incur on the Endowment's behalf in the best interests of the University. When requested, the managers will report to the Committee on the transactions costs incurred and the brokers used on the Endowment's behalf.

## **Transition Management**

Transitions between investment managers are an important and inevitable element of portfolio management, typically resulting from manager terminations or changes to the investment strategy of the portfolio. The optimal method to use in executing a transition may vary significantly from one transition to another based on the types of assets involved and the timeframe in question. Generally, the Endowment's objective in a manager transition is to 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.

## **VII. Performance Evaluation**

Endowment performance will be monitored and reviewed over full market cycles, generally three to five years, at three levels; total Endowment, asset class and individual manager. All three levels will include a passive index and peer group measurement review. Performance will be reviewed on a gross and net return basis and will include risk and risk adjusted returns.

### **Performance Benchmarks**

The total Endowment performance will be measured against:

1. CPI plus 5% real return
2. A Policy Benchmark consisting of passive indexes reflecting the Endowments "strategic target" asset allocation percentages
3. An Active Benchmark consisting of passive indexes reflecting the Endowments "actual" asset allocation percentages
4. A peer group universe of similar plans

The asset class performance will be measured against:

1. The asset class' core passive index
2. A peer group universe of similar asset classes

The individual managers' performance will be measured against:

1. The managers' specific passive indexes identified in the investment manager guidelines located in the addendum of the Policy
2. A peer group universe of similar investment styles

### **Performance Expectations**

It is expected within each level the Endowment, the asset class, and the individual managers should exceed the passive index return and should be above median against the appropriate peer group universes.

It is expected that risk (and risk adjusted returns) will be in line with the risk associated with the specific passive index benchmarks.

## VIII. Investment Manager Structure

Below is the investment manager structure and corresponding target asset allocations as established by the Investment Committee:

<u>Manager</u>	<u>Investment Strategy</u>	<u>Target Allocation</u>
<b><i>Broad U.S. Equity:</i></b>		
Manager TBD	Passive Russell 1000 (Large-Cap)	23.95%
Manager TBD	Active Russell 2000 (Small-Cap)	2.05%
<b><i>Total Broad U.S. Equity</i></b>		<b>26.00%</b>
<b><i>Broad Non-U.S. Equity:</i></b>		
Manager TBD	Active MSCI ACW Ex U.S. (Core-Plus)	10.00%
Manager TBD	Active MSCI ACW Ex U.S. (Core-Plus)	10.00%
<b><i>Total Broad Non-U.S. Equity</i></b>		<b>20.00%</b>
<b><i>Private Equity:</i></b>		
Commonfund Capital, Wilton, CT	Private Equity Fund-of-Funds ("FOF")	2.94%
Pantheon Ventures, San Fran., CA	Private Equity FOF	2.94%
Manager TBD	Opportunistic Private Equity FOF	1.12%
Fort Washington, Cincinnati, OH	Regional Venture Capital	0.00% <sup>1</sup>
Chrysalis Ventures, Louisville, KY	Regional Venture Capital	0.00% <sup>1</sup>
<b><i>Total Private Equity</i></b>		<b>7.00%</b>
<b><i>Real Return:</i></b>		
Manager TBD	Real Return FOF	5.25%
Manager TBD	Real Return FOF	1.75%
<b><i>Total Real Return</i></b>		<b>7.00%</b>
<b><i>Absolute Return:</i></b>		
Manager TBD	Core Absolute Return FOF	4.00%
Manager TBD	Core Absolute Return FOF	4.00%
Manager TBD	Non-Core Absolute Return FOF	2.00%
<b><i>Total Absolute Return</i></b>		<b>10.00%</b>

---

<sup>1</sup> The Committee has committed \$2 million and \$1 million to Fort Washington and Chrysalis, respectively, to enhance the total return for the Endowment and provide leadership in economic development for the Commonwealth of Kentucky.

<u>Manager</u>	<u>Investment Strategy</u>	<u>Target Allocation</u>
<b><i>Real Estate:</i></b>		
UBS, Hartford, CT	Core Real Estate	
Manager TBD	Value Added Real Estate	4.00%
Manager TBD	Opportunistic Real Estate	4.00%
<b><i>Total Real Estate</i></b>		<b>12.00%</b>
<b><i>Fixed Income:</i></b>		
PIMCO, Newport Beach, CA	Core-Plus Fixed Income	9.00%
Reams, Columbus, IN	Core-Plus Fixed Income	9.00%
<b><i>Total Fixed Income</i></b>		<b>18.00%</b>

The target manager allocations shown above may be revised from time to time as a result of changes in the composition of the capital markets or the styles of individual managers. In addition, the allocations may be revised as a result of risk modeling analysis.

Definitions of the investment strategies are located in the addendum of the Policy.