The Investment Committee meeting was called to order at 9:00 a.m. Dr. Brockman asked for a motion to approve the September 15, 2009 minutes. Mr. Gatton made the motion to approve the minutes, Mr. Stuckert seconded the motion and all approved.

Dr. Brockman referred to a request for information on the real estate investment strategy made at the last meeting. Mr. Palmeri of R.V. Kuhns & Associates (RVK) noted that the investment policy included a 12% real estate allocation equally distributed among Core, Value-added and Opportunistic strategies. The implementation of the opportunistic investment strategy had been delayed until the financial markets stabilize. He stated that markets have improved somewhat, and the transition to value-added debt strategies has already been initiated. Mr. Palmeri introduced Mike Paolucci of RVK. Mr. Paolucci discussed the real estate investments and explained the differences between Open-Ended Funds and Closed-Ended Funds. With Open-Ended funds an investor typically has liquidity within 90-120 days. However, recently the Open-Ended funds have not had the liquidity that was anticipated. Value Added
and Opportunistic funds tend to be Closed-Ended funds, which require the commitment of capital for long periods, typically 7 – 12 years without the ability to redeem.

Mr. Paolucci pointed out that the UK Endowment Fund made two value-added real estate investments last year, one with Wrightwood Capital and another with TA Associates. Wrightwood Capital is a mezzanine real estate debt fund and TA Associates is a value-added real estate equity fund. He discussed two types of real estate investments: equity interest or debt interest. An equity interest involves the purchase of mortgages or portions of mortgages and origination of real estate debt. Mr. Paolucci emphasized the need to balance equity and debt investments and also the importance of income in real estate investments. Mr. Stuckert asked where opportunities for real estate investment were in the current market. Mr. Paolucci responded that opportunities existed on the west coast, the southwest coast along the southern US and to the southeast coast (the “smile” of the US) and a few spots in the mid-west including Chicago and Denver. Mr. Paolucci stated that while there are opportunities, the lending market is still quite frozen, thawing a little in selected strategies. Lenders are much more risk-averse, requiring much stronger debt covenants. RVK’s strategy will be to focus on first mortgage or mezzanine debt and strategies that generate current income. RVK and UK staff are currently looking at additional real estate opportunities for the UK Endowment fund through a Request for Proposal. They will report back to the committee when that review is complete.

Dr. Brockman moved to the next item on the agenda, discussion of the endowment spending and management fee policy. He asked for a motion to approve IC1, outlining changes to Section V of the Endowment Investment policy. Mr. Roberts made the motion to approve IC1, Mr. Stuckert seconded the motion.

Ms. Martin outlined the recommendations to change the total distribution from 5% to 4.5% and change the base period for calculation of market value from 36 months to 60 months. These changes would help preserve principal and smooth out spending over the long term. The spending rate would decrease from the current 4.5% to 4.375% in 2011 then to 4.25% in 2012. Fiscal year 2010 spending is estimated at $40.5 million. The change would result in an estimated $35.7 million in fiscal year 2011 and $33.2 million in fiscal year 2012. She stated that she had met with the college Deans to discuss the proposed changes and the consensus was that the primary objective should be to preserve principal. Mr. Wilcoxson asked about the change in spending from the current formula and Ms. Martin responded that if the spending formula is not changed, the estimated spending would be $36.4 million in fiscal year 2011 and $32.3 million in fiscal year 2012.

Ms. Martin then outlined the recommended decrease in the management fee from the current rate of .5% to .375% in fiscal year 2010 and to .25% in fiscal year 2012. She explained that the management fee provides general fund revenue and supports the overall management of the endowments including functions in the Treasurer’s Office. The changes in the management fee will result in a decrease in general fund revenue from approximately $3.4 million currently to $1.9 million over the next two years. Ms. Ball asked for clarification of the purpose of the management fee. Ms. Martin responded that it paid for the overall management of endowments across the University. She stated that it was originally tied to funding the Office of Development but this changed a few years ago to stabilize fiscal operations and to cover the total cost of endowment management. Mike Richey stated that the budget for the central development office was approximately $3.8 million.

Mr. Palmeri then summarized RVK’s analysis of the spending rate and management fee change. They utilized a Monte Carlo simulation, which is a statistical analysis using thousands of scenarios in which capital market returns vary for each trial to help estimate future patterns of capital market returns. The analysis utilized both the current asset allocation and the target policy asset allocation to determine the future ending wealth of the endowment and levels of spending under multiple potential spending policies.
He reported that reducing the overall spending rate to 4.5% would increase the probability that the real or inflation-adjusted value of the endowment fund will grow in the future, whereas a spending rate of 4.75% or higher could result in using principal for spending distributions.

Dr. Brockman reviewed the proposed resolution reducing the spending rate to 4.25% of the average market value over the preceding 60 months and reducing the management fee to .25% of the current market value, resulting in an overall spending rate of 4.5%. He clarified that this rate will support an average annual return, after inflation and expenses, of 4.5% over full market cycles. These adjustments will be phased in over a two year period.

Dr. Todd reported that the meeting with the Deans had gone well and that they were supportive of the change in order to preserve the endowments. IC1 was approved unanimously.

Dr. Brockman then introduced the next agenda item, the review of asset allocation and status of the transition plan. Ms. Krauss referred to the chart in the committee notebook that summarized the current asset allocation, the target allocation and the transition plan. The Phase 1 transition is complete and primarily involved the implementation of the new non-US equity strategies and Wellington’s real return strategy. During Phase 1 of the transition, from December 2008 through February 2009, the US Equity allocation was reduced by roughly $55 million and used to fund Non-US Equity. Also, Fixed Income was reduced by roughly $50 million and replaced with $35 million in non-US Equity, $12 million in Real Return and $3 million in Real Estate.

Ms. Krauss reported on Phase 2 of the transition. Upon completion, the Phase 2 transactions will reduce US Equity by roughly $39 million, Non-US Equity by roughly $28 million and Global Equity by roughly $54 million. The reductions in these asset classes will be used to fund Absolute and Real Return and rebalance Fixed Income. Ms. Krauss explained that except for the Wellington Real Return investment, funding of the Absolute and Real Return strategies had been delayed to allow the equity markets time to rebound. The Absolute Return strategies and PIMCO’s Real Return strategy are being funded in four quarterly installments, and approximately 50% of the funding is complete and the remainder should be complete by March 2010.

Ms. Krauss reported that Phase 3 implementation, which involves full implementation of the private equity and real estate allocations, will take approximately four to six years. This final phase will use US Equity (roughly $18 million) and Non-US Equity (roughly $14 million) to fund Private Equity. Additionally, Fixed Income (roughly $39 million) will be used to fund Real Estate.

Mr. Gatton asked how the private equity investments have performed. Ms. Krauss responded that the private equity investments had declined by approximately 20% in 2008 and capital calls had come to a halt. She stated that while capital call activity has picked up recently, it will probably take a few years to recover. Mr. Gatton stated that private equity at some ivy league institutions had declined by as much as 30%. Dr. Todd pointed out that although the ivys had experienced significant losses on private equity and other alternatives during this downturn, over the long term, the institutions had experienced great success with private equity and other alternative investments.

Dr. Brockman introduced the next item on the agenda, the performance review and market update by RVK. Mr. Palmeri reported total performance of 12.06%, net of fees, for the quarter ending September 30, 2009. The value added portion of fund performance (performance in excess of the policy benchmark) was 2.69%, with the current overweight allocation in equities helping performance over the quarter as the equity market were rebounding. Mr. Palmeri noted that the Committee’s patience in reallocating to the new target asset allocation had been rewarded. The strategy to dollar cost out of equities (and into the new alternative asset classes) to allow for a recovery in equities has worked out well. Manager performance contributed 0.08% of the outperformance. This is a value RVK would like to see improve
over time. The actual total fund performance exceeded the active benchmark by .13%, gross of fees, resulting in a rank of 31, which is in the top 1/3 of the Endowment peer group.

Mr. Palmeri then reviewed the returns in the various asset classes, using gross returns for proper comparison in the various manager universes. The domestic equity asset class slightly underperformed the benchmark by .17%, resulting in a rank of 48 for all funds. One manager that was noteworthy was the Wellington Emerging Companies fund, a small cap fund that has done extremely well year-to-date with a 39.69%, compared to the index performance of 22.43% over the same period. The global equity allocation, which will be separated into US and International in the future, performed well for the quarter and the year-to-date. Mr. Palmeri stated this will be a good time to take profits as the transition plan to the new asset allocation policy continues to be implemented.

Although the International Equity composite did very well on an absolute basis, on a relative basis it did not perform quite as well returning 17.76% compared to the benchmark of 19.69% for the quarter. These managers, which include Capital Guardian, Mondrian and Gartmore, will not invest in the lower quality, higher beta, higher risk stocks. These are the stocks that performed well over the past few quarters as the capital markets recovered, which is typical when an economy comes out of a recession. He noted that Capital Guardian has lost two of their portfolio managers and another is close to retirement. Capital Guardian has replaced one of the departing portfolio managers with a new manager that is a long-time investment professional at Capital’s sister organization, Capital Research and Management, where he managed two American Funds’ portfolios. The manager turnover at Capital Guardian should not be a problem due to Capital’s multiple portfolio manager system, whereby multiple managers run a sleeve of the total portfolio; however, RVK will continue to monitor the impact of these manager changes.

The Fixed Income composite returned 7.19% compared to the index of 3.74% for the quarter. Of the managers in this asset class, PIMCO Core Plus performed above the median and REAMS Core Plus was in the top quartile year-to-date. The Real Return composite returned 11.01% for the quarter and has done extremely well year-to-date, returning 30.98%, compared to the index of 15.69%. The Absolute Return composite returned 4.95% for the quarter compared to the index of 4.14%. Berens and Grosvenor outperformed the index while GAM underperformed slightly. The Real Estate Composite declined by 22.4% year-to-date, compared to a decline of 15.07% for the index. Mr. Palmeri explained that the underperformance is partly attributed to the timing of the valuation process, where UK fund managers are writing down losses quicker than the index.

The next item on the agenda was a review of the Cash, Overnight and Short-Term Investment Report. Ms. Counts noted that the format of the report has changed slightly as requested by Ms. Martin. The report has been reorganized to separate out cash and overnight investments from short term investment and moving the corresponding market indices to immediately follow the investment category they benchmark. Ms. Counts reported that as of October 31, 2009 the total portfolio subject to the overnight and short term investment policy was $373.3 million. Overnight investments totaled $153.7 million, and had a rate of return of 0.31%. This performance was led by the State Overnight funds with a return of 0.39% resulting from an agreement between the state and U.S. Bank. It is anticipated that these returns will decrease due to the expiration of that agreement. There was $38.8 million invested in the Fidelity Government Fund, with an annual return of 0.09%, and $83.8 thousand invested in the Dreyfus Governmental Fund, with an annual return of 0.03%. Ms. Counts reported that investment returns compared favorably to the market performance indices of the three month T-bill rate of 0.05%, the fed funds yield of 0.11%, and the Libor 3 month rate of 0.28%.

Short term investments totaled $219.6 million, of which $65.3 million was invested in the OFM short term investment pool with an annualized monthly loss of -2.71%. This loss was the result of the state selling investments at a loss in order to raise cash. Since UK is in the state pool, UK shared in the state loss. Mr. Butler stated that he had been in communication with Tom Howard with the Kentucky Office of
Financial Management and voiced his concerns that UK would suffer due to a state cash flow problem. Mr. Howard agreed and the state will be correcting this and will be establishing a separate account for state universities in the future.

Ms. Counts stated that $60.0 million was invested in the OFM intermediate pool with an annualized monthly return of 0.69%. Another $90.3 million was invested directly in federal agencies and instrumentalities with an annualized monthly return of 2.08%. The total short term average weighted return was 0.3%. This significantly underperformed the 2 year Treasury note rate of 0.89% as of October 31, 2009. This underperformance resulted from the state short-term pool loss.

With no further business the meeting adjourned at 10:30 a.m.

__________________________
Donna Counts
Office of the Treasurer