IN ATTENDANCE:

Investment Committee Members: Carol Martin Gatton, Chair  
William C. Britton  
Mark P. Bryant  
William S. Farish, Jr.  
James W. Stuckert

Community Advisory Members: James F. Hardymon  
Henry Clay Owen

Investment Staff & Consultants: Susan I. Krauss  
Kimberly C. Lush  
Becky Gratsinger (R.V. Kuhns & Associates)

Mr. Gatton called the meeting to order at 5:00 p.m. He began by introducing Becky Gratsinger, CEO of R.V. Kuhns. Mr. Gatton then made a motion to approve the minutes from the Committee meeting on May 8, 2014. The motion was seconded and all approved.

Ms. Krauss echoed Chair Gatton’s introduction of Becky Gratsinger and stated that Ms. Gratsinger has been assigned to the University’s account as co-lead along with Rob Palmeri, replacing Ron Klotter, who recently departed R.V. Kuhns. Ms. Krauss then began a review of the Endowment Asset Allocation and Transition Plan dated April 30, 2014. She noted that at the end of April 2014 the endowment pool had a market value of $1.17 billion, comprised of 33% equities, 9% fixed income and 58% in various alternative strategies. She stated that there were no Phase I transition adjustments that took place during the month of April 2014. Ms. Krauss then discussed future transition activity. She stated that the majority of the liquid strategies were implemented in late December 2013 to early January 2014, adding that the remaining significant investment to be implemented for Phase I is the direct hedge fund program with Grosvenor. In order to gain exposure in the long/short equity allocation effective January 1, 2014, the University is currently in Grosvenor’s co-mingled fund, the Grosvenor Enhanced Long/Short Fund. Over the course of the next few months there will be a transition from the co-mingled fund into a portfolio of direct investments. Direct hedge fund managers are currently being considered for the portfolio. After manager selections are made, implementation is planned to occur in four monthly installments from September 1, 2014 through December 1, 2014. Ms. Krauss stated that the goal of the program is to reduce costs. An estimated annual fee savings of $350,000 is expected upon full implementation of the direct portfolio versus investing in the co-mingled product. Ms. Krauss also discussed implementation of the University’s second SMIF account, which should occur in the fall of 2014 and will be for graduate level students. This account is in addition to the SMIF account currently in place for undergraduate level students. Also, three additional SMIF accounts are planned to be implemented in the fall of 2015. Ms. Krauss then discussed the Phase II transition, covering the illiquid strategies, and the process of working towards the targets in private equity and real estate. Regarding private equity, the University is currently in negotiations with Neuberger Berman to commit an additional allocation. Next, Ms. Krauss reviewed the Report on Manager Appointments, Terminations and Due Diligence for the period of May 9, 2014 through June 9, 2014. There were no appointments or terminations during that timeframe. However, there have been conference calls with prospective long/short equity managers that are being considered for the Grosvenor See Blue B Fund, with on-site visits scheduled in July.
The next item on the agenda was the Performance Review and Market Update from R.V. Kuhns. Chair Gatton called on Ms. Gratsinger to provide reporting. Ms. Gratsinger began with an introduction of herself. She stated that she has been with R.V. Kuhns for twenty years and has held the CEO position since 2008. She then began a review of the University’s portfolio for the quarter ended March 31, 2014. A Manager Compliance Summary and related addendum was provided that categorized and described organizational and performance issues for the University’s managers. Ms. Gratsinger then addressed issues relating to two specific managers. First, she reviewed a memorandum from R.V. Kuhns to the University of Kentucky dated May 21, 2014 with a subject line of GMO Asset Allocation Team – Departure of Nick Nanda. The memo stated R.V. Kuhns’ opinion of the departure; they continue to maintain a strong level of confidence in the product, as well as in the remaining leadership. Next, she discussed another memorandum to the University from R.V. Kuhns, dated June 3, 2014 with a subject line of PIMCO Due Diligence Visit. R.V. Kuhns conducted an on-site visit with PIMCO on May 12, 2014. The visit was driven primarily by the recent sudden departure of Co-Chief Investment Officer and Chief Executive Officer Mohamed El-Erian, subsequent departure of portfolio managers, Marc Seidner and Chuck Laur, as well as recent poor performance for the flagship bond fund, PIMCO Total Return. On the visit R.V. Kuhns learned of new executive leadership appointments to support Bill Gross, with Jay Jacobs as the new President and six new deputy Chief Investment Officers. Also, the belief was formed that recent underperformance was not linked to Mr. El-Erian’s leaving, but rather a result of a positioning strategy that did not work well. R.V. Kuhns’ conclusion from the visit was that PIMCO remains a high conviction firm and their recommendation was that no action be taken for those strategies that were directly impacted by Mr. El-Erian’s departure. Additionally, assurance was provided that continued monitoring is planned.

Next, Ms. Gratsinger presented the University’s Investment Performance Analysis for the period ended March 31, 2014. The portfolio finished the quarter with total assets of $1.2 billion and a return of 11.89%. Asset allocation was compared to target allocation, and overweighting in domestic equity and international equity was noted, as well as underweighting in real estate. Ms. Gratsinger then provided an overview of how returns materialized for the quarter. Total value added of -0.21% was due to positive impact from asset allocation decisions and negative impact from manager value added, as well as some transactional drag in the portfolio. Total value added for the fiscal year to date ending March 31, 2014 was 0.56%, with asset allocation and manager value added both being positive for the period, primarily due to domestic equities doing well and international equities doing very well. Also, risk and return for the portfolio was analyzed for the prior five years, with findings indicating that the University has had higher returns and just marginally higher risk during the period. Additionally, for that period, it was determined that when the market has been going up, the University’s average return has gone up more. It was also noted that when the market has been down, the University’s average return has been fairly in line with the actual allocation index and down just a little more than the target allocation index. Ms. Gratsinger then began a review of the Asset Allocation and Performance – Net of Fees. For the quarter, the portfolio was up 1.41%. For the fiscal year to date, the portfolio was up 11.81%, and the long-term performance since inception in 1992 was 7.66%. For the quarter, domestic equity returned 2.05% and was very helpful in earning the overall return in the portfolio, beating the benchmark by 0.04%. Of note, Wellington Emerging Companies provided a strong return of 2.53%. Additionally, the international equity composite was well ahead of the benchmark with a return of 1.86%. The Mondrian ACW Ex US Equity Fund returned 2.92%, ahead of its benchmark of 0.71%. Mondrian International Small Cap, however, was at 2.55% and under its benchmark of 3.45%, but still additive to the portfolio by providing stronger returns than other portions of the international equity composite. William Blair All Cap Growth produced -0.51% for the quarter. Some of the factors affecting the negative performance were stock selection and financials, as well as the Pacific ex-Japan stock selection. William Blair’s Emerging Market Small Caps portfolio also added into absolute returns with 3.43%, just slightly below the benchmark of 3.54%. Regarding the Fixed Income Composite, there was a positive return of 0.84%, behind the benchmark of 1.84%. PIMCO Core Plus returned 1.45% and PIMCO’s unconstrained
portfolio returned 0.96%. Reams Core Plus provided a return of 1.51%, which was a greater return than PIMCO’s product, but below the benchmark of 1.84%. Reams unconstrained portfolio was short in its duration, returning -0.13%, behind the benchmark of 0.80%. The Diversified Inflation Strategy Composite returned 1.96% for the quarter, with Wellington Diversified Inflation Hedges returning 2.19% and Wellington Real Total Return yielding 1.80%. The Global Tactical Asset Allocation Composite returned 1.99%. In this category, PIMCO’s product outperformed GMO’s product with a return of 2.23% versus 1.75%, respectively. The Long/Short Equity Composite returned 0.96%, which was below the benchmark of 1.40%. Berens and Grosvenor were underperformers in the category. However, Wellington Custom Archipelago returned 2.44%. The Absolute Return Composite returned 1.21% with the Grosvenor See Blue product returning 1.24%, beating the benchmark of 0.75%. The Real Estate Composite returned 1.79%, trailing the benchmark of 2.55%, and the Private Equity Composite returned 0.08%.

Ms. Krauss concluded the meeting with a review of the Operating Fund Cash and Investment Report. Total operating fund cash and investments equaled $928 million for the period ended April 30, 2014. Bond proceeds were $237 million of the total. Therefore, the total operating fund cash and investments less 2014 bond proceeds were approximately $688.7 million. She noted that the bond proceeds were received in March 2014 and are invested in the state’s short-term pool. Funds will be drawn down as needed to fund the construction projects. She added that the $688.7 million total is approximately $60 million greater than at the same time last year. Also, she mentioned that the total cash and investments subject to the operating fund investment policy of the University totaled $391 million. Approximately half of that amount is invested in overnight and short-term investments, with the other half in intermediate term investments. She noted an effort has been made in the past six months to shift funds from overnight and short-term investments into intermediate investments as the University seeks opportunities to achieve greater returns.

As a closing reminder, Ms. Krauss stated the next meeting of the Investment Committee will be held on September 4, 2014.

The meeting was adjourned by Mr. Gatton at 6:01 p.m.

Respectfully submitted,
Kimberly C. Lush
Office of the Treasurer