Minutes of the Meeting of the Investment Committee
University of Kentucky
Thursday, September 13, 2018

The Investment Committee met on Thursday, September 13, 2018, in Woodward Hall of the Gatton Business and Economics Building.

A. Meeting Opened

Britt Brockman, Acting Chair of the Investment Committee, called the meeting to order at 9:00 a.m. and requested a roll call.

B. Roll Call

The following members of the Investment Committee answered the call of the roll: Britt Brockman, Claude A. Berry, III, James H. Booth, Michael A. Christian, Elizabeth McCoy, Robert D. Vance, and Barbara S. Young. Carol Martin "Bill" Gatton was not in attendance.

The following Community Advisory Members answered the call of the roll: William C. Britton and Myra L. Tobin. William Seale was not in attendance.

Kristina Goins announced that a quorum was present.

The University Investment Staff was represented by Susan I. Krauss, Treasurer, and Todd D. Shupp, Chief Investment Officer.

Fund Evaluation Group was represented by Nolan M. Bean, Michael J. Aluise, and Rebecca S. Wood.

C. Approval of Minutes for June 21, 2018

Chair Brockman called for a motion to approve the minutes from the Committee meeting on June 21, 2018. The motion was moved by Trustee Vance, seconded by Trustee Christian, and approved by all.

D. Overview of UK Endowment

Ms. Krauss began the overview of the UK endowment with an outline of what would be covered in the discussion. She defined the endowment as a pool of gifts provided by donors and other funds set aside by the Board of Trustees with the requirement that they be held and invested in perpetuity to generate earnings for support of University programs. Additionally, the Endowment provides stability since the principal is invested and earnings are generated year after year. Ms. Krauss then presented a breakdown of total endowment assets by type, purpose, and entity as well as brief definitions of each. She then reviewed the roles and responsibilities of the Investment Committee (IC), investment staff, investment consultant, and the investment managers and custodian. The IC responsibilities are set forth in the governing regulations and include formulating and reviewing investment policies, appointing, monitoring, and evaluating investment managers and consultants, reviewing and approving plans for the general management of the endowment fund, and reporting to the Board on endowment investment performance after each Committee meeting.

Trustee Vance asked about the duration of the temporary management fee for the endowment Capital Campaign and Ms. Krauss answered that this would likely conclude at the end of the Capital Campaign. She continued by reviewing the investment objectives which are to preserve the purchasing power of endowment assets and related revenue stream (intergenerational equity) and to earn an average annual return, after expenses, of at least 7.5% over full market cycles. This encompasses a 2.5% inflation estimation, a target spending rate of 4.0%, and an annual management fee of up to 1.0%. Mr. Britton suggested that Ms. Krauss explain the management fee to new members, and she explained that this is an internal management fee including fundraising expenses and internal management expenses.

Ms. Krauss then provided background on the Uniform Prudent Management of Institutional Funds Act (UPMIFA), a statute that applies to charitable organizations, including non-profit corporations, governmental agencies, and any entity operated exclusivity for charitable purposes. The two main principals of UPMIFA are: 1) investment: assets are to be invested prudently in diversified investments that seek growth as well as income; and 2) spending: allows for expenditures deemed prudent for endowment program purposes. Among the key principles to guide investment decisions are: the prudent person standard of care, a special skills standard of performance, total portfolio focus, diversification, rebalancing, and cost management. Ms. Krauss commented on the explicit diversification requirement set forth in UPMIFA. Trustee Blonder asked whether there is an external agency that monitors these guidelines and Ms. Krauss answered that there is not, but investment staff and the investment consultant work to ensure UK adheres to UMPIFA. She continued by reviewing the seven UPMIFA principles to guide spending decisions which included a brief discussion on underwater endowment funds.

Next, Ms. Krauss provided comments on the University's spending distribution policy. The Investment Committee has established a "hybrid" spending distribution policy which includes both endowment market value and the level of inflation in determining the spending distribution each year. She discussed the spending distribution formula and why this is utilized. She then reviewed the historical endowment values, flows, and returns graph as of Fiscal Year 2018. Chair Brockman asked a question regarding donor gifts and whether or not those are included in the graph as part of the endowment. Ms. Krauss answered that many gifts received by the University are not endowed, such as current operating and capital gifts, thus they are not reflected in the historical graph. She briefly discussed the historical target asset allocation chart, which reflects how the targets have changed since 2000. She then transitioned into the UK endowment history, including some important governance milestones, noting the importance of shifting from an RFP structure for manager searches to delegating the hiring and termination of managers to the staff in consultation with the consultant. Trustee Grossman asked what the difference was between a custodian and a manager and Ms. Krauss replied that the custodian is responsible for the safekeeping and recordkeeping of assets, while the manager is responsible for making investment decisions according to their defined mandate.

Mr. Shupp then discussed the growth of Investment Office staff over time, including the development of an internship program, and then introduced Nancy Rohde, who recently joined as Investment Analyst. He then began a discussion concerning investment philosophy. Key beliefs include: 1) diversification is our best strategy for achieving objectives; 2) focus on the long-term; be patient; remain diligent; 3) markets are cyclical, and valuation matters in the long-term; and 4) a blend of passive, active, and less liquid strategies is needed to reach our return target. Issues to consider are that diversified portfolios underperform in certain markets, short-term performance dominates headlines, valuations can remain elevated for long periods of time, and behavioral biases can challenge a long-term strategy. Next, he reviewed Fiscal Year 2018. Key accomplishments included expanded portfolio diversification, continued fee reduction initiatives, the recruitment of an experienced Investment Analyst, and onboarding of research and portfolio management software. Mr. Shupp then outlined some ongoing efforts and near-term focus items for Fiscal Year 2019. He concluded his discussion with a seven-year lookback at endowment performance and some investment staff observations. These include reasons for optimism, reasons for caution, and the need to manage carefully through the current environment. In summary, it is extremely difficult to predict future returns; however, our focus remains on what we can control. Trustee Grossman then asked if UK considers ways to protect from the long-term dangers associated with climate change. Mr. Shupp responded that we've discussed climate change in meetings with a student group advocating for fossil fuel divestment and we are continuing to research ways to approach environmental, social, and governance issues within an investment context.

E. <u>FEG Education Session & Asset Allocation Study</u>

Mr. Aluise and Ms. Wood began FEG's education session with the Investment Committee survey results. In alignment with survey results, the proposed asset allocation will target a slightly higher risk profile, aiming to increase the expected return through a few modest changes: an increase of equity exposure, a reduction of hedge funds, and a reduction of core fixed income. As background, survey participants included seven Investment Committee members, two staff members, and one other stakeholder. Survey benchmark groups included Kentucky institutions, public institutions ($1 – 2 billion endowment value), Southeastern Conference (SEC) institutions, and University Review Committee Institutions (URC). Ms. Wood reviewed aggregate responses to each of the survey questions covering the topics of investment objectives, asset allocation, risk tolerance, liquidity management, and responsible investing. Mr. Aluise then shifted the discussion to liquidity and private capital pacing. Cash flows will be negative in the early years due to the time necessary for investments to mature. Distributions from earlier commitments should fund capital calls by approximately 2020 when net cash flow becomes positive. A policy is in place to ensure the portfolio maintains sufficient liquidity, while capitalizing on illiquid markets. In a steady market environment, the portfolio is expected to reach the liquidity targets in the next five years. He continued by stating that capital commitments will be adjusted to compensate for any material drawdowns in public market investments. Responses show the Committee believes the portfolio can accept more illiquidity, given its long term nature. They also believe the portfolio is positioned conservatively. Survey respondents also believed that active management and asset allocation can add value. Trustee Blonder asked whether there would be additional discussions with IC members and other Board members to further review the survey and provide education. Ms. Krauss stated that she and Mr. Shupp will be setting up one-on-one meetings with each

Committee member to address any questions related to the survey or concerns with the proposed asset allocation changes.

Mr. Aluise resumed with a discussion on asset allocation and strategy. He outlined several advantages of the University of Kentucky Endowment, such as the fact that the University is the sole client of the endowment, and there is a long time horizon, as well as minimal liquidity constraints. As a reminder, the 7.5% primary return objective is made up of 4% spending, up to 1% fees, and 2.5% inflation. He stated that asset allocation is expected to be the primary contributor to return variation and will determine whether UK meets the primary objective. He continued by stating that increasing the portfolio's expected return over the long-term can be achieved in one of two ways: increase volatility (equity market risk) or increase illiquidity (private capital). The goal is to increase the risk profile of the portfolio moderately, doing so at a measured pace. He then noted a graph showing a historical view of public equity markets and the current prolonged bull market. The new asset allocation targets propose an increase in the equity allocation, a decrease in core fixed income exposure, and a decrease in hedge funds (diversifying strategies). Mr. Bean and Mr. Shupp commented that a great deal of research and analysis went into the proposed asset allocation figures. Mr. Britton then commented that he was surprised fixed income was not reduced even further on the proposal given the rich set of opportunities in more growth-oriented asset classes. Mr. Shupp and Mr. Bean responded that a modest allocation to fixed income is necessary to provide defense to the portfolio in the event of an equity market downturn. They further elaborated that the fixed income allocation comprises many different types of fixed income strategies, with a range of risk/return profiles, and this bucket does not contain only traditional, core fixed income. Trustee Christian then mentioned concern regarding the probability of reaching the 7.5% target return, and Mr. Bean agreed it would be challenging to achieve, but the proposed asset allocations are expected to help reach this goal. Trustee Christian added that he was very pleased to see the survey results reflected an alignment of investment philosophy and that risk was being incrementally increased by utilizing the portfolio's illiquidity budget. Trustee McCoy asked FEG to define what types of assets they consider liquid, as there may be a distinction between our classification and a personal investor's. Mr. Bean replied that this included anything where a redemption notice could be submitted within one week such as public equities, mutual funds, and ETF's.

F. Neuberger Berman Education Session

Next, Neuberger Berman presented a private equity update as well as a discussion on asset allocation and diversification.

The Committee took a break for lunch and to attend the Senate Chamber dedication at noon and returned at 2:00 pm.

G. Proposed Changes to Endowment Investment Policy

Mr. Shupp presented the proposed changes for the Endowment Investment Policy, citing only two material changes to the policy. The primary change to the policy is a proposed shift to a new target asset allocation, discussed previously by FEG. The proposed changes include an increase in global equity (40% to 52%), a decrease in global fixed income (20% to 16%), a decrease in real assets (20% to 17%), and a decrease in diversifying strategies (20% to 15%). He noted the broad ranges approved by the Committee within each asset category allow for greater flexibility within the portfolio. The other change noted was due to these shifts, there also would be corresponding changes to the weights of the policy benchmarks.

H. Investment Staff Report

Next, Mr. Shupp presented the Investment Staff Report, beginning with an overview of the endowment asset allocation as of July 31, 2018, stating that the portfolio remains within the policy ranges and well diversified across asset classes. Addressing rebalancing activity, he noted that the final redemption proceeds from a fund of hedged equity funds manager were received, reflecting continued progress in the transition out of these funds with the goal of reducing fees as a primary driver. Additionally, he briefly discussed portfolio liquidity, stating that only approximately 53% of the portfolio is represented by the two less liquid categories (semi-liquid and illiquid). Mr. Shupp then presented a report on manager additions, terminations, and due diligence for the period of June 22 through September 13, 2018. There were no new manager hires or manager terminations during this time. Manager due diligence focused on routine updates with existing managers, sourcing new potential managers, as well as several conversations with FEG concerning asset allocation. He concluded his remarks mentioning that there were some additional decisions to be made within the private real assets portion of the portfolio before calendar year-end.

I. Performance Review & Market Update

Next, Mr. Nolan Bean, FEG, began with a performance overview presentation. Among the asset classes that worked well in the second quarter were public real assets and domestic equities, while international equity and core fixed income were negative. Mr. Bean continued with a brief discussion of one-year performance for the period ended June 30, 2018. The Fund underperformed the benchmark, with key detractors being an overweight to non-US equities, the J-curve effect for privates, and active manager performance.

Turning to an overview of current asset class views, Mr. Bean stated that while the U.S. economy is doing well, FEG believes that U.S. equity valuations are stretched and there are better opportunities in the non-U.S. equity area. Within private equity, they see long-term opportunity but are less enthused with the short-term opportunity given the high dollar amounts chasing returns in this space. FEG is not positive on the outlook for traditional fixed income, and they are recommending less in real estate, following a strong run compared to other real asset sectors. Trustee Young asked about equity's upward cycle and whether we are making an assumption that the upward trend is going to level off. Mr. Bean replied he thinks global equity markets will continue to go up in the long-term, which is why we want to have a bias towards equities; but that the magnitude of gains will likely be more muted in the coming ten years than they have been over the past decade. Mr. Britton commented on the fixed income portfolio and its recent performance, and then asked how long it will take to reallocate some of this capital towards assets with higher expected returns. Mr. Bean acknowledged that lower risk, high quality fixed income is expected to deliver lower returns and said this is being addressed in two phases. First, the portfolio's proposed asset allocation targets include a reduction in high quality bonds. Second, private credit exposure, which has a higher expected return, will increase over time as managers call capital. He estimated that process will take three years.

Mr. Bean then reviewed a presentation on Fiscal Year 2018 performance. Beginning with equities, the U.S. equity large cap market, represented by the Russell 1000 index, posted a 14.5% return during the Fiscal Year due in part to strong earnings growth. Value stocks (+7.3%) continued their weakness against growth stocks (+22.5%) as measured by the Russell 1000 style indices. Domestic equities led the charge in Fiscal Year 2018, with trade tensions and currency volatility putting a damper on international developed and emerging equity returns. High yield securities produced positive results in Fiscal Year 2018, and are now trading near the tightest spread in history. Next, he addressed real assets, noting that International Real Estate Investments Trusts (REITs) were the strongest performers over the trailing one year, despite a strengthening U.S. dollar. MLPs experienced volatility (especially in 2018) but have recently rebounded and experienced strengthening momentum. Specific to the UK portfolio, one key takeaway is that the U.S. equity portfolio modestly underperformed the benchmark in Fiscal Year 2018, due to underperformance from an active small/micro-cap manager. The international composite lagged the index due to an overweight to emerging markets, which experienced downward pressure in the back half of Fiscal Year 2018. The private equity portfolio underperformed peers in Fiscal Year 2018, although the portfolio is still awaiting the quarterly valuations for the final quarter of the Fiscal Year. While absolute, estimated performance was strong (+10.7%), a relative drag was caused by the portfolio's exposure to legacy funds of funds and the J-curve effect for new investments. In his concluding remarks, Mr. Bean mentioned that MLPs had been the biggest headwind for the portfolio in 2017 and early 2018, but rebounded strongly in the final quarter of the Fiscal Year.

J. Operating Fund Cash & Investments

Ms. Krauss provided a presentation on the Operating Fund program. She began with a background on policy, stating that the Operating Fund Investment Policy applies to the investment of non-endowed funds while also excluding bond proceeds. Authority for this policy falls under administrative regulations and the custody, investment, and disbursement of operating funds has been delegated to the Treasurer. The formal policy has been established to provide a framework for the prudent management of operating funds and requires establishment of an Operating Funds Investment Committee to provide oversight for the operating investment program. The Committee's responsibilities include reviewing and approving the Operating Funds Investment Policy, reviewing operating fund investments, and advising Treasury staff on investment allocations. Unlike the objectives of the endowment, which are focused on long-term growth, the investment objectives here are focused on the short-term and include safety of capital and liquidity. The Debt Management Committee establishes days cash on hand target ranges for tiers I – III as well as the maximum number of days cash on hand to be allocated to Tier V for internal loans. Next, Ms. Krauss briefly summarized the tiered investment structure and performance evaluation process. She concluded with a discussion of recent policy changes. This included an update of the Operating Fund Investment Committee and Treasury Staff to align with the University Financial Services reorganization. Additionally, the benchmark was revised for the short/intermediate-term investments to better align with the liquidity needs of the underlying funds and the list of permitted investments was expanded to allow greater flexibility.

Next, Ms. Krauss reported on the University's operating fund cash and investments as of June 30, 2018. For the Fiscal Year, tiers I- III totaled approximately $982 million. Tiers I and II days cash on hand was 94, while this was 124 days for tiers I – III, or the midpoint of the range. Ms. Krauss transitioned to the July 31, 2018 report, noting the change in benchmark for Tier III effective July 1, 2018, which changed to an equal blend of the 3-month Treasury Bill and the Barclays 1-5 Government Credit Index.

K. Other

Ms. Krauss reviewed the 2018 Investment Committee meeting schedule and tentative agenda items, highlighting the upcoming December meeting. In additional to regular business, the Student Managed Investment Fund (SMIF) class will present an update to the Committee, and the Revised Investment Policy will be considered for approval.

L. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 3:25 p.m.

Respectfully submitted,

Krista W. Goins

Kristina W. Goins
University Financial Services