

Minutes of the Meeting of the Investment Committee
University of Kentucky
Thursday, February 21, 2019

The Investment Committee met on Thursday, February 21, 2019, in Room 234 B of the Lee T. Todd Pharmacy Building.

A. Meeting Opened

Elizabeth McCoy, Chair of the Investment Committee, called the meeting to order at 2:00 p.m. and requested a roll call.

B. Roll Call

The following members of the Investment Committee answered the call of the roll: Elizabeth McCoy, Robert D. Vance, and Barbara S. Young. James H. Booth, Michael A. Christian, and Carol Martin “Bill” Gatton were not in attendance.

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

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

Fund Evaluation Group (FEG) was represented by Michael J. Aluise, Rebecca S. Wood, and Brian Hooper.

C. Approval of Minutes for December 10 , 2018

Chair McCoy called for a motion to approve the minutes from the Committee meeting on December 10, 2018. The motion was moved by Trustee Vance, and seconded by Trustee Young. The motion passed without dissent.

D. Public Equity Strategy Review

Mr. Aluise began the public equity strategy review stating that equity is the return engine of the total portfolio. He continued that the UK Endowment has a 52% target allocation to the global equity asset category, which includes public equity, hedged equity, and private equity. The focus for this discussion was public equity. Mr. Aluise then discussed the four main tenets in which the public equity portion of the Endowment portfolio was built: 1) embracing passive and smart beta in efficient areas; 2) taking a value philosophy – buying low and selling high; 3) allocating actively to emerging markets due to valuation opportunities; and 4) investing actively in small and micro-cap equities due to historical market inefficiencies. Mr. Aluise then turned the presentation over to Brian Hooper, Vice President – Global Equities, at Fund Evaluation Group (FEG). He began by reviewing the building blocks of the Endowment’s public equity portfolio. At the core of the portfolio is pure passive equity exposure, which provides market beta at a low

cost. Second are smart beta strategies which attempt to exploit selected factors that have historically outperformed over long periods. The third and final category is active exposure, where managers attempt to add alpha by creating portfolios of select stocks based on company specific attributes. Passive allocation strategies as a percentage of global assets under management have continued to grow. The University of Kentucky has been a part of this trend, and has increased passive and smart beta strategies. He noted UK has shifted much of its public equity allocation towards passive strategies, and active management within the UK portfolio is focused in the least efficient markets (small capitalization and emerging markets).

Following a breakdown of the global public equity universe, Mr. Hooper detailed the Endowment's core/satellite approach to that market. The core of the UK portfolio seeks broad, global equity market exposure through inexpensive and liquid passive and smart beta allocations. The remainder is in satellite allocations to active management within inefficient markets. Trustee Vance asked whether index funds are included in the satellite investments and Mr. Hooper answered that they are not.

Next, Mr. Hooper shifted to a more detailed discussion on domestic equity. He provided an overview of the Russell 1000 index, which is a good representation of a core allocation in domestic equity. The Russell 1000 index holds the largest 1,000 publicly traded companies in the U.S. and is weighted by market capitalization. Exposure to this portfolio index comes at a low cost of 0.03%. Mr. Hooper noted the increasing dominance of growth-oriented companies within the major benchmarks over the past 5-10 years, with technology and health care displacing financials as the larger sectors in the U.S. indexes. Trustee Young asked about the changes in index sector composition since the financial crisis, and Mr. Hooper replied that growth-oriented companies have become a much larger component as their stock prices have risen strongly. Conversely, many value-oriented stocks have become smaller parts of the indexes.

Moving to non-U.S. public equity, the UK portfolio has a tilt toward developed and emerging non-U.S. equity due to favorable valuations and growth prospects relative to the U.S. Low currency valuations were noted as another tailwind for emerging markets, with the expectation that a pause in U.S. interest rate increases may help emerging currencies to rally in comparison to the U.S. dollar. Emerging markets make up 12.2% of the MSCI All Country World Index but contribute 23.3% of worldwide Gross Domestic Product (GDP) and account for over 50% of the world's population. China alone produces 20% of global GDP and represents a growing portion of global equity indices, and presents a good opportunity for a stand-alone investment. Trustee Vance asked if we are investing in U.S. companies that do a lot of business with China, or investing directly in companies based in China. Mr. Hooper answered that the UK portfolio has exposures to both. Ms. Tobin asked how emerging market holdings are considered with regard to portfolio risk and a long-term holding period. Mr. Aluisse acknowledged that emerging markets have higher volatility and therefore our exposure is sized smaller. Trustee Young commented that political risk should also be considered, and Mr. Hooper acknowledged this risk potential and pointed out that active managers may add significant value here by carefully evaluating and sizing such risks.

E. Investment Staff Report

Next, Mr. Shupp presented the Investment Staff Report, beginning with an overview of the Endowment asset allocation as of December 31, 2018, stating that the portfolio remains within the policy ranges and well-diversified across asset classes. He highlighted the addition of a new chart showing the portfolio's actual vs. target asset allocation, intended to increase readability. Next, he addressed rebalancing for the periods of November and December which included the incremental increase of public equity exposure. International equity exposure was increased, and the planned shift was made to smart beta strategies, also in December. A decrease was made within fixed income exposure, using this capital for the recent public equity increase. This quarter, January and February in particular, an incremental reduction of public real asset exposure is being made, as well as a decrease in diversifying strategies. Mr. Shupp then highlighted four new investments that were made in the time period since the last meeting. Three out of four were in private markets: two in private equity and one in private real assets. The fourth was a hedged equity manager added to replace a manager previously in the portfolio. Due diligence for the period included the annual Fund Evaluation Group (FEG) onsite meeting to address a number of updates as well as an opportunity to meet additional members of the professional staff. Finally, there also were several routine calls and meetings with various existing and potential managers.

F. Performance Review & Market Update

Mr. Aluise began the performance review and market update with a high level overview of market performance as of December 31, 2018. Risk assets such as equities and real assets were vastly negative for the last quarter of 2018. However, the UK portfolio performed well on a relative basis with the Endowment down 4.8% versus a decline of 5.2% for the actual allocation index in the fourth quarter. Risk mitigating positions in high quality fixed income and diversifying strategies were among the strategies that worked well for this quarter. Holdings in higher risk assets such as domestic equity and Master Limited Partnerships (MLPs) did not work as well for the period. He continued that the portfolio's allocation is within policy ranges, and is moving closer to the target allocation approved by the Committee. Mr. Aluise noted that the portfolio preserved capital better than traditional stock/bond portfolios in the fourth quarter of 2018, and concluded by stating that greater volatility in 2019 should not come as a surprise (central bank policy, geopolitics, etc).

Next, Mr. Aluise noted the inclusion of the manager memo providing background on four new manager investments, previously mentioned by Mr. Shupp, which are held in the Wildcat Alpha Fund. He briefly highlighted MAP Renewable Energy, which is a fund solely invested in wind energy and energy storage.

Ms. Wood briefly covered the 2018 NACUBO-TIAA Study of Endowments. In the "up-market" of FY2018, the Endowment underperformed the NACUBO median university while maintaining a lower risk posture. While a headwind in FY18, the lower risk posture was a benefit in the first half of FY19 (6/30/18-12/31/2018). The Investment Committee recently approved a new asset allocation designed to enhance expected returns. Primary changes include a higher allocation to equities, reduced target allocation to lower risk assets (hedge funds and fixed income), and a greater allocation to private assets. These changes will increase the Endowment's ability to participate in up markets going forward, while maintaining prudent diversification. Markets

experienced volatility in the first six months of FY19, and the Endowment's lower risk posture aided performance relative to peers in that period.

Mr. Aluise concluded performance commentary by highlighting January 2019 performance. The total UK portfolio was up 3.5% in a month that marked a dramatic reversal from December for most asset classes. Equities, specifically small-capitalization, were the biggest drivers for performance, and Master Limited Partnerships were up 15% for the month. Trustee Ramsey asked how UK is positioned going into a possible recession in 2020, and what FEG is expecting. Mr. Aluise answered that we are positioned prudently, and the portfolio is broadly allocated not just across U.S. markets, but also abroad.

G. Other

Ms. Krauss reviewed the 2019 Investment Committee meeting schedule and tentative agenda items. She highlighted that the annual portfolio risk review will take place at the upcoming April 29th meeting and that the Annual Retreat will take place in September. Ms. Krauss also noted that December 2018 supplemental Endowment reports will be included in the April meeting materials to coincide with Board approval of the December 31, 2018 interim financial statements. Finally, she pointed out the inclusion of the operating cash and investment report as of December 31, 2018.

H. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 3:10 p.m.

Respectfully submitted,



Kristina W. Goins
University Financial Services