Minutes of the Meeting of the Investment Committee
University of Kentucky
Thursday, September 12, 2019

The Investment Committee met on Thursday, September 12, 2019, in Ballroom A of the Gatton Student Center.

A. Meeting Opened

Elizabeth McCoy, Chair of the Investment Committee, called the meeting to order at 10:00 a.m. and requested a roll call.

B. Roll Call

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

The following Community Advisory members answered the call of the roll: James F. Hardymon, William E. Seale, Quint Tatro, and Myra L. Tobin. The following Advisory member was not in attendance: William C. Britton.

The University Investment Staff was represented by Susan I. Krauss, Treasurer, Todd D. Shupp, Chief Investment Officer, and Nancy K. Rohde, Senior Investment Analyst.

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

C. Approval of Minutes for June 20, 2019

Chair McCoy called for a motion to approve the minutes from the Committee meeting on June 20, 2019. The motion was moved by Trustee Vance and seconded by Trustee Christian. The motion passed without dissent.

D. UK Endowment Overview

Ms. Krauss began the Endowment overview by defining an 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 in perpetuity to generate earnings for support of University programs. The Endowment provides stability because the principal is invested, and earnings are generated year after year. She discussed the breakdown on total Endowment assets by type, purpose, and entity and defined each type of Endowment. Next, Ms. Krauss discussed the historical Endowment values, flows, and returns chart. This illustrates the growth of the Endowment since 1992 when the consolidated investment pool was established. The three key components of Endowment growth are gifts/additions, investment earnings, and spending distributions and management fee withdrawals. She reviewed the historical target asset allocation and key governance milestones in UK's Endowment history. Until December 2016, a formal Request for Proposal (RFP) process was used to hire investment managers through the Purchasing Office. Beginning in 2017, staff was delegated the authority to hire investment managers via an alternative search process. Another key change that took place in March 2019 was the expansion of Investment Committee Advisory members to five. Prior to this, there were three.

Next, Ms. Krauss outlined the roles and responsibilities of the Investment Committee, Investment Staff, Investment Consultant (Fund Evaluation Group), Investment Managers, and Investment Custodian (Northern Trust). The roles of the Investment Committee include: 1) Formulate and review investment policies; 2) Appoint, monitor, and evaluate investment managers and consultants; 3) Review and approve plans for the general management of Endowment funds and; 4) Report to the Board after each Committee meeting on Endowment investment performance. The investment objectives outlined in the Investment Policy are to preserve purchasing power of Endowment assets and related revenue stream (intergenerational equity), and earn an average annual return, after expenses, of at least 7.5% over full-market cycles. This target is comprised of a 2.5% inflation assumption, a target spending rate of 4.0%, and a management fee of up to 1.0%. The management fee includes a standard fee of 0.5% and a temporary fee of up to 0.5%. Mr. Tatro asked if spending would be negatively impacted if inflation goes up. Ms. Krauss responded, "Inflation is evaluated annually, so if we anticipated inflation to increase, then this would need to be factored into our Asset Allocation Plan and the return and spending targets would be adjusted accordingly." Next, Ms. Krauss addressed the spending distribution policy. The Investment Committee has established a "hybrid" spending distribution policy which includes both the Endowment market value and inflation in determining spending distributions each year. This policy aligns well with Uniform Prudent Management of Institutional Funds Act (UPMIFA) spending guidelines.

Mr. Shupp then discussed the University's investment philosophy. He stated that, "Diversification is the University's best strategy for achieving long-term objectives. Focus must be on long-term results, which requires both patience and diligence. Secondly, markets are cyclical, and valuation matters over the long term. Finally, a blend of passive, active, and less liquid strategies are needed to reach the return target. Some issues to consider include that a diversified portfolio can cause regret, short-term performance dominates headlines, valuations can remain elevated for long periods, and behavioral biases can challenge a long-term strategy. Some common investor biases are chasing performance, over-emphasizing short-term results, and preference for familiar asset classes." Following this, Mr. Shupp discussed diversified portfolios by decade, illustrated in a series of graphs. Next, he shifted to a review of Fiscal Year 2019. "Key accomplishments included that consensus was built on risk tolerance and positioning, new asset allocation targets were implemented, portfolio diversification was expanded, and Environmental, Social, and Governance (ESG) research was continued. Enhancements were made to Endowment transparency, and investment office resources, systems, and processes were expanded." Following this, Mr. Shupp outlined some of the Investment Office's processes. "The Investment Office takes an active approach to managing the University Endowment. The Manager's due diligence consists of independent Manager research which includes meetings, conference calls, and webinars; collaboration with the FEG research team; and the ability to understand firms, teams, and strategies up front, then to monitor closely. Additionally, hasty reactions must be avoided, and thorough research must be conducted in order to frame decisions. A third piece of this process is service provider oversight. This includes an annual FEG due diligence questionnaire, as well as an onsite meeting. Additionally, the Investment Office conducts monthly calls, as well as an annual update meeting with Northern Trust." Next, Mr. Shupp discussed formal ongoing processes. "Monitoring of cash flows, transactions, and manager communications occur on a daily basis. Weekly internal meetings are conducted to review projects and the research pipeline. Occurring monthly or quarterly is an asset allocation review, manager letter and market reviews, and recurring FEG research calls. The external audit and onsite manager meetings are done on an annual or ad hoc basis." He also noted that the Dynamo database supports investment and operations management. Ms. Tobin asked, "How often do we have to change personnel within investment managers. In other words, do we ever have to ask for someone to be removed?" Mr. Shupp responded that the "Investment Office has never had to do this with an investment manager. However, UK went through a similar event with our custodian, where changing our point person resulted in a tremendous increase in the level of service." Wrapping up this discussion, Mr. Shupp addressed ongoing efforts for Fiscal Year 2020 initiatives including: implementing within approved asset allocation ranges, rebalancing, researching opportunities to improve long-term returns, closely monitoring investment managers and service providers, and prudently managing fees paid by the Endowment.

E. FEG Education Session and Asset Allocation Study

Ms. Wood began FEG's education session and asset allocation study by outlining the FEG and UK working relationship. She explained the various tasks and associated parties that relate to the Endowment's management. The governing fiduciaries are comprised of the Governor, Board of Trustees, and Investment Committee. The managing portion is made up of the Investment Staff and consultant FEG. Finally, the operating side consists of investment managers and the custodian. Ms. Wood also discussed the impact each role has on the Portfolio including the appointment of the Board of Trustees and Investment Committee, policy and asset allocation, rebalancing of asset allocation, hiring and firing of managers, security selection, and hiring and firing of custodians. She noted that UK's FEG consulting team works in close partnership with a 24-person research team, before turning the presentation over to Mr. Dowling, FEG's Chief Investment Officer and Head of Research.

Mr. Dowling discussed FEG's detailed manager research process. He opened his statements by emphasizing that FEG pursues managers with experienced personnel, sound investment philosophy, and demonstrated ability to outperform. The six tenets of manager research include: conviction, consistency, pragmatism, investment culture, risk control, and active return. He stated that FEG seeks out the following investment manager traits for the first tenet, conviction: strong belief in the investment philosophy, willingness to put investment decisions ahead of business decisions, investment alongside clients, and alignment of interests. He next discussed the second tenet, consistency, including: an evaluation of the stability of the organizational structure, composition of the investment professionals, the investment policy and process, and ensuring that performance is consistent with the stated strategy. With tenets three and four, pragmatism and investment culture, FEG looks for managers that understand and can articulate their core strengths and have the ability to capitalize and sustain their competitive edge. Next, Mr. Dowling addressed FEG's fifth tenet, risk control. "This includes an analysis that managers are not blind risk takers, but rather risk conscious, they acknowledge mistakes, have a robust and effective risk mitigation, and have proper counterparty management." Lastly, he highlighted the sixth tenet: active return. "This consists of the ability of managers to identify and profit from investment opportunities, feature strong risk-adjusted returns, and a successful track record."

Next, Mr. Dowling spoke about FEG's manager selection process. "The first step is to source managers. This is done through industry networking, direct solicitations, other managers, clients, and other limited partners, to name a few. Next, an introductory meeting or call is conducted to initially gauge the manager's fit within FEG's six tenet investment philosophy. Next in the process comes a review of the manager's due diligence questionnaire and other important documents. Performance is evaluated through a comprehensive statistical review, with a focus on performance versus objectives and market conditions, a comparison to the manager's relevant peer group, and track record verification. The next step includes reference checks and verification of key relationships. The final piece of this process is an onsite meeting to review investment policy and process with key decision makers, observe systems used in portfolio construction and overall management, discuss investment policies with a focus on risk management, discuss personnel involved in the process and specific roles, and observe and evaluate investment culture. Following this work, if the manager is still deemed to have merit, a research report is put together by an FEG analyst and submitted to the Investment Policy Committee (IPC) for vetting and potential approval."

Trustee Grossman asked how long this entire process takes. Mr. Dowling responded that it could take anywhere from three weeks to six months. Dr. Seale asked whether FEG is allowed to view all portfolios when vetting a hedge fund manager or only the portfolio under research consideration. Mr. Dowling replied that while FEG is normally focused on the main flagship fund, they may request detail on other funds in order to understand position overlap. Dr. Seale followed up by asking if they could also look at things such as transaction costs. For example, in a case of a manager having multiple funds, would they be paying a different transaction cost for each fund? Mr.

Dowling responded that FEG evaluates execution costs and soft dollars through audited financial statements. Dr. Seale then asked how it was determined whether or not a manager was getting a "kick back" from their broker. Mr. Dowling answered that an analysis of a manager's use of soft dollars is a part of FEG's compliance and trading review. He added, "This is very rare among institutional managers, and an abuse of soft dollars would result in FEG not investing with that particular manager." Ms. Wood remarked that the SEC has homed in on this issue as well. Mr. Tatro remarked that he is concerned that hedge fund managers are chasing alpha (excess return over a defined market index) by investing in the private equity space, and he asked if FEG works to verify the valuations that hedge fund managers place on their illiquid holdings, or if FEG simply takes the manager's word for these valuations. Mr. Dowling responded that it is a combination of both. "FEG gains comfort by the caliber and reputation of the auditors that evaluate managers' holdings. In each manager's audited financial statements, they are required to list the liquidity of their assets." He added that FEG also evaluates manager valuation policies and asks pointed questions around how various investments are valued. Mr. Tatro followed up by asking what the average lock up period was for these investments. Mr. Aluise replied that investments were made into these funds one-two years ago, so the lock up periods for many of the funds in the Portfolio has already expired. Finally, Mr. Tatro asked Mr. Dowling what was keeping him up at night as a CIO. Mr. Dowling responded, "The unintended consequences of current monetary policy, including the impact of quantitative easing on market price discovery in a lot of asset classes, especially fixed income."

Mr. Aluise then began a discussion of ongoing manager monitoring. He outlined FEG's monitoring process which includes monthly updates, quarterly conference calls, and an annual review. Mr. Aluise then took a deeper dive into hedge fund exposure for the University's Endowment. He highlighted and discussed the three largest strategy exposures: U.S. long/short equities, structured credit and credit distressed, and event-driven equity. In summary, FEG believes that effectively evaluating managers requires both qualitative and quantitative methodologies. Ongoing management is as important as initial due diligence.

Next, Mr. Aluise discussed asset allocation. He emphasized that allocation is the primary contributor to return variation, and whether or not UK meets the primary objective. He briefly noted graphs illustrating the expected real return of a hypothetical U.S. 60/40 stock/bond portfolio over time, and FEG's capital market assumptions across a broad array of asset classes. Mr. Aluise reminded the Committee of the asset allocation targets that were approved last year. "The broad allocation is 52% in global equity, 16% in global fixed income, 17% in real assets, and 15% in diversifying strategies." He remarked that by using a 10-Year Monte Carlo simulation, the expected return is slightly above the target, at 7.9%. (A Monte Carlo simulation is used to model the probability of different outcomes in a process that is largely unpredictable due to random variables. The statistical technique is used to understand the impact of risk and uncertainty in forecasting models).

F. Endowment Manager Presentation: HBK Capital Management

Next, Mr. Shupp introduced HBK Capital Management who presented an overview of their organization and fund as well as an update on multi-strategy hedge fund underlying strategy.

The Committee took a break for lunch and returned at 1:40 pm.

G. ESG Education Session

Ms. Rohde conducted a presentation on the topic of Environmental, Social, and Governance (ESG) investing. She began with a definition of ESG, which is using environmental, social, and governance factors to evaluate companies and other investments. She emphasized that ESG factors are considered alongside, not in place of, more traditional financial factors. She then briefly discussed a history and evolution of ESG investing and continued to present various ways that responsible investing can be implemented into a portfolio, from exclusionary approaches to ESG integration approaches.

Ms. Rohde continued, "ESG is growing in the U.S. and there is evidence that it is slowly gaining traction among Endowments." She then addressed some challenges that ESG faces including a lack of clarity and agreement on what ESG means, unclear government guidance, and varying degrees of ESG inclusion across various asset classes.

Ms. Krauss then briefly discussed the history of the University of Kentucky's divestment policies dating back to 1985. Following this, Mr. Shupp provided a brief recap of more recent discussions regarding divestment with a student group. While the University has not agreed to divest, he noted that significant strides have been made in the area of transparency, including a substantial overhaul of the Endowment website. He stated, "It is important that we continue our research and learn more about ESG and divestment before committing to action."

Ms. Rohde concluded the presentation with the following takeaways: ESG is not simply divestment; it is increasingly used with a goal of improving risk and return. ESG is growing slowly and steadily, and growth is expected to continue. Many challenges and questions remain around ESG, and time and additional research on ESG are warranted. Finally, the University of Kentucky Endowment has made strides in improving transparency through collaboration with students and has been clear and consistent.

H. Discuss Endowment Investment Policy

Ms. Krauss led a discussion of the Endowment Investment Policy. She noted that changes are not being proposed to the asset allocation this year. However, the Spending Distribution Policy is under review in consultation with the Endowment

Advisory Committee (EAC). She noted that the approved EAC Charter, which includes a listing of EAC members, is included in the Director's Desk materials following the Investment Policy. She continued by outlining the two primary goals of the EAC. The first is to evaluate the University's Endowment Spending Policy and compare it to alternative policies in order to determine the optimal future Spending Policy, which should accomplish the following: 1) Generate a reliable and steadily growing income stream to support Endowment beneficiaries; 2) Provide for long-term growth of the Endowment; and 3) Preserve the inflation-adjusted value of the Endowment. The second goal is to develop policies and/or incentives to ensure appropriate Endowment utilization (use of Endowment spending distributions). In order to accomplish the above, a benchmarking study of peer institution policies will be completed by UK Investment Staff and a Spending Policy forecasting analysis will be completed by FEG. The EAC will evaluate the benchmarking and forecasting analysis, and any other information deemed necessary, and make recommendations on future policies to executive leadership. Ms. Krauss continued, "As a result of the market value of the Endowment steadily growing, and a low inflation environment, our effective spending rate has remained lower than we would like to see. Since the current policy has been utilized for five years now, it is a good time to take a fresh look. The spending utilization across campus is also being taken into account by the EAC. Some areas are not taking full advantage of the spending distributions available to them. She also stated that if the EAC should choose to make a change within the Spending Policy, this would be shared with the Investment Committee prior to the December meeting. One-on-one meetings will be conducted with each Investment Committee member to fully review the Spending Policy and answer any questions that may remain before the Policy goes before the Committee for approval at December's meeting." Lastly, Ms. Krauss encouraged all Committee members to read the Endowment Investment Policy as well as the two attached appendices if they had not already done so.

Mr. Shupp then discussed the asset allocation portion of the Endowment Investment Policy. He noted that changes are not being recommended to the target asset allocation percentages, in contrast to last year. Mr. Tatro asked for confirmation that the domestic equity allocation target was increased over the last year. Mr. Shupp responded that the global equity allocation target was increased from 40% to 52% last year. He noted that the allocation to public equities is higher than the target as we wait for our private equity managers to call capital (draw down the University's capital commitment). Mr. Tatro followed up by confirming that subsequent tactical decisions could be made to take some risk off of the table if necessary. Mr. Shupp responded that this was the case, and that this was due to the flexibility in working targets and broad ranges approved by the Investment Committee. Dr. Seale asked if Investment Staff would consider continuing to increase global equity and decrease global fixed income given the National Association of College and University Business Officers (NACUBO) peer allocations. Mr. Shupp replied, "That is something we can think about, but there is concern that it is not a prudent time within the market cycle to scale up equities significantly." Next, Mr. Shupp discussed performance evaluation within the Endowment Investment Policy. "The total Endowment performance is measured against

1) the primary performance objective of achieving a total return, net of fees and expenses, of 7.5%; and 2) a Policy Benchmark consisting of market indexes reflecting the Endowment's strategic target asset allocation percentages."

I. Investment Staff Report

Mr. Shupp presented the Investment Staff Report, beginning with an overview of the Endowment asset allocation as of July 31, 2019. He stated that the Portfolio remains within the Policy ranges and is well-diversified across asset classes. He noted a couple of modest changes relative to the April 30th data, including a slight increase in private equity, which was funded from public equity. Additionally, pubic real assets were reduced in order to increase the private real asset allocation.

Dr. Seale asked if there was any interest among the Committee in increasing the amount of assets managed by the graduate and undergraduate students in the Student Managed Investment Fund (SMIF). Ms. Krauss responded that this can be considered and added, "At the time the program was approved, the initial allocation as a percentage of the overall Endowment was set at approximately 0.4-0.5% based on benchmarking and the amount that was considered appropriate. Another look can be taken at this, including updated benchmarking among peers." Dr. Seale then asked if the Endowment was able to invest in the Bluegrass Angel Fund. Ms. Krauss replied that this was allowed, but an investment was declined following due diligence because the Fund had a narrow regional focus. "As an alternative to this, an investment was made by the University via the Kentucky Technology, Inc., a subsidiary of the UK Research Foundation." At this time, Mr. Shupp addressed manager appointments, terminations, and due diligence. There were no appointments or terminations during the June 21st to September 12th time period. Due diligence for the period included meetings with new and existing managers, as well as updates on specific strategies with the FEG team and fund managers.

J. Performance Review & Market Update

Mr. Aluise began the performance review with a Fiscal Year 2019 summary, characterizing it as a year of two halves. "The portfolio's conservative positioning preserved capital well in the first half of the Fiscal Year but led to a relative lag in the second half's rally." He continued with a discussion on asset class 10-year performance. "A decade ago, the S&P (Standard & Poor's) 500 lagged nearly all other marketable assets for the 10-year period. This flipped in the most recent decade, with asset classes for the 10-year period. In regard to trailing five-year returns, the S&P 500 total return was 73%." Mr. Aluise next commented on the lack of market breadth over the past five years, specifically that a large portion of the S&P 500 index return has been driven by a handful of companies. He noted, "If Facebook, Amazon, Apple, Netflix, Microsoft, and Google are removed, the total index return is -12%, so this has been a very concentrated market." Mr. Aluise finalized his comments to frame the Portfolio's performance by stating that the U.S. equity large cap market, represented by the Russell 1000 Index, posted a 10% return during the Fiscal Year. In contrast, the U.S. equity small cap market, represented by the Russell 2000 Index, posted a decline of 3.3% for this same period. He highlighted that this 13-percentage point dispersion is the largest between the large cap and small cap markets since 1999.

Mr. Aluise turned to a performance summary of the Portfolio by asset class. He summarized this piece of the presentation with comments around Fiscal Year attribution and manager selection. He highlighted that, "Public equity has been the biggest laggard, while private natural resources was the major contributor in Fiscal Year 2019." Ms. Tobin asked Mr. Aluise to comment on asset allocation relative to the graph on page 205. Mr. Aluise replied that the asset allocation on this particular slide represents the performance contribution that is driven by overweights or underweights to the asset classes in the Portfolio. He concluded with a brief overview of the work FEG does regarding research and other processes including weekly research meetings and discussions around market expectations.

K. Other

Ms. Krauss reviewed the 2019 Investment Committee meeting schedule and tentative agenda items. She noted the upcoming December meeting will consist of regular agenda items as well as the Student Managed Investment Fund presentation. Also, the revised Endowment Investment Policy will be recommended for approval. Ms. Krauss also noted the inclusion of the Operating Cash and Investment reports as of June 30, 2019 and July 31, 2019 as supplemental information.

Mr. Aluise mentioned the upcoming FEG Investment Forum scheduled for September 23rd through 25th. Ms. Krauss also noted that the Investment Office will be planning agenda items for calendar year 2020 and reminded the Committee that input for topical items is welcome.

L. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 3:06 p.m.

Respectfully submitted,

Krista W. Goins

Kristina W. Goins
University Financial Services