Minutes of the Meeting of the Investment Committee
University of Kentucky
Thursday, June 20, 2019

The Investment Committee met on Thursday, June 20, 2019, in the Lewis Honors College Meeting Room.

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, James H. Booth, 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: William C. Britton, James F. Hardymon, Quint Tatro, and Myra L. Tobin. The following Advisory member attended by phone: William E. Seale.

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, Christina Drake, and Greg Dowling.

C. Approval of Minutes for April 29, 2019

Chair McCoy called for a motion to approve the minutes from the Committee meeting on April 29, 2019. The motion was moved by Trustee Booth and seconded by Trustee Vance. The motion passed without dissent.

D. Diversifying Strategies Review

Following a brief introduction by Mr. Aluise, Mr. Greg Dowling, CIO and Head of Research, FEG (Fund Evaluation Group) began a diversifying strategies review. He started with a definition of hedge funds. Hedge funds at their most basic are a structure, similar to a mutual fund or exchange traded fund. Most hedge funds are commingled vehicles that are not as liquid as mutual funds, which allows them a broad and flexible investment mandate with the ability to invest long and short, use derivatives, and incorporate leverage. Hedge funds also have a unique fee structure, including a flat management fee and a performance fee, which historically was incorporated in order to align incentives in keeping hedge fund asset sizes low enough to capitalize on niche opportunity sets that are not as scalable as those employed by traditional mutual funds. Most hedge funds focus on absolute return rather than benchmark-relative return, aiming to perform well in periods of distress and to offer consistent, positive returns in a low or steady volatility market. Most hedge funds are not structured to produce equity-like returns but rather to offer a risk/return profile between equity and fixed income. Basic categorizations of hedge fund strategies include: equity hedge, event driven, macro, and relative value. The presentation focused on the later three strategies. "Event driven" are strategies linked to events such as mergers and restructurings. "Macro" are strategies predicated on movements in underlying economic variables such as country currencies and rates. Lastly, "relative value" are strategies seeking to capitalize on price anomalies in different securities, sometimes within the same company's capital structure.

Next, Mr. Dowling addressed current negative perceptions surrounding hedge funds. The press regularly runs headlines about the looming collapse of the hedge fund industry when the reality is that assets in the space are near all-time highs. Still, Mr. Dowling acknowledged that the performance of hedge funds has been disappointing since 2009, and they have underperformed the S&P 500 in 13 of the last 20 years. However, it is important to take risk into consideration when evaluating performance and if one incorporates beta into the analysis, hedge fund performance looks more favorable with alpha (excess return over defined market index) generated over the S&P 500 in 14 of the last 20 years. As a reminder, Mr. Aluise defined beta as an investment or asset class's sensitivity to the market (the market has a beta of 1.0).

Mr. Dowling next addressed the argument for why allocations should be made to hedge funds. One primary reason is that the outlook for returns in fixed income is bleak based on the current low yield of the 10-Year U.S. Treasury bond, while the stock market's continued ascent may be approaching an end sooner rather than later. He highlighted that the portfolio's primary exposure to hedge funds lies within the diversifying strategies allocation, and the goal of that allocation is to provide positive expected returns that are uncorrelated to traditional markets. To accomplish this, the diversifying strategies allocation does not necessarily take less risk than the market, but rather takes different risks than other portions of the portfolio. Since 1990, hedge funds have demonstrated the ability to help mitigate downside risk by losing less than the MSCI ACWI (Morgan Stanley Capital International All Country World Index) in down months. While hedge funds have suffered a challenging decade, the potential for the asset class to avoid negative compounding provides justification for including an allocation.

Finally, Mr. Dowling discussed the University's current implementation and exposure to these funds. While traditional stocks and bonds comprise the majority of the portfolio, roughly 20% of the portfolio is targeted for hedge fund investments. The allocation to hedge funds is intended to improve the risk-adjusted return for the portfolio and, while not expected to outperform long-only equities, the objective for this allocation is to produce a return in excess of fixed income, with a similar level of risk.

Mr. Tatro raised a concern about continued lackluster hedge fund performance relative to the S&P 500 and asked if the underperformance over the past decade could be due to the dramatic increase in the number of hedge funds and competition over the same time period. Mr. Dowling answered that equity valuations are high and unlikely to continue to march endlessly higher, making traditional equity less attractive on a go-forward basis. In addition, the active management that hedge funds provide should come into greater favor as market volatility and dispersion increases. Finally, the low interest rates of the past decade have benefitted the traditional equity market but are unlikely to stay low forever. Mr. Dowling agreed that it is unlikely we will see a return to the stellar returns of hedge funds when the number of competitors in the space was lower, but he does believe returns will be attractive going forward as hedge funds have historically been the first to embrace new technologies and drive investment innovation. Mr. Aluise added that the expectation FEG has for this allocation is somewhere between a 4-6% annualized return. Mr. Tatro then commented that alpha within the hedge fund space stems from selecting the very best hedge fund managers and he suggests that it would be helpful to the Committee to understand FEG's hedge fund manager selection process. Mr. Dowling and Mr. Aluise affirmed that that this can be added to a future agenda item, possibly at the upcoming September Investment Committee retreat. Mr. Hardymon then asked FEG to comment on how they evaluate and manage the risk of fraud in the hedge fund area. Mr. Dowling described FEG's process to detect operational issues, including verifying fund auditors, meeting with teams through onsite visits, and evaluating investment and operational systems.

E. Investment Staff Report

Mr. Shupp presented the Investment Staff Report, beginning with an overview of the Endowment asset allocation as of April 30, 2019. He stated that the portfolio remains within the policy ranges and well-diversified across asset classes. He also noted that UK has essentially reached the new targets for each of the four main asset categories. This included incremental additions to public equities, private equities, and hedged equities. In order to accomplish this, public real assets and diversifying strategies were scaled down. Next, Mr. Shupp highlighted the manager appointments and terminations. Appointments included a new commitment of $12 million within the private real assets - private natural resources space to existing manager Scout Energy Partners. There were no terminations during this period. Due diligence included conversations with FEG regarding the diversifying strategies presentation and private capital pipeline, as well as several due diligence calls with new and existing managers. Finally, he highlighted an update call with PIMCO (Pacific Investment Management Company) on a variety of market-related topics.

F. Performance Review & Market Update

Ms. Drake began the performance review and market update with a high-level overview of market performance as of April 30, 2019. Showing a chart of equity market performance over 45 years, she noted that while U.S. equities have outperformed international and emerging markets equities in recent years, the opposite was true for many years prior to the current period. This demonstrates that equity market returns are cyclical, volatile, and recent outperformance tends not to persist. Nearly all asset classes started the year strong, with risky asset classes doing particularly well.

Mr. Aluise shifted the discussion to UK Endowment-specific performance. Working well for the period ending April 30, 2019 were real assets, high quality fixed income, and U.S. equity absolute performance. What did not work as well was the public equity portfolio's international tilt and having a value bias within the equity portfolio. Transitioning to asset allocation, Mr. Aluise stated that although the portfolio remains underweight to private asset classes, the current allocation is closely aligned with UK's broad targets. In conclusion, within public equity, maintaining a value bias along with an overweight to international markets has been a headwind over the last several quarters (and years). Since June 30, 2018, significant progress has been made on moving to the Committee-approved asset allocation: equity exposure has increased (45% to 52%) and diversifying strategies has decreased (19% to 15%). Attention is being given to private markets, where the portfolio is underweight relative to current targets. FEG and staff remain highly selective in their approach.

Next, Mr. Aluise discussed the manager memo for Scout Energy Partners. This firm possesses many qualities which make it attractive to the UK Endowment. One such quality is size - Scout is smaller and therefore operating in more inefficient markets. The Fund's terms create a prudent alignment with investors, and they have historically generated alpha. Scout is led by an experienced team with deep technical expertise in sourcing, underwriting, and acquiring upstream oil and gas assets.

He concluded his comments by calling attention to how active managers in the portfolio, specifically emerging markets equity managers, have demonstrated their value in more volatile and negative months such as May. These changes in value-add happen quickly and demonstrate the difficulty in timing the market. Mr. Shupp noted that changes in asset class performance can likewise shift quickly, highlighting the need for prudent portfolio diversification.

Mr. Britton asked for more information on the sub-strategies employed within the portfolio's overall hedge fund allocation. Ms. Krauss answered by stating that Investment Office staff will work with FEG to provide a look-through analysis of hedge funds to provide more information at the next meeting. Mr. Hardymon commented that it is important for the Committee to understand these investments in order to be properly prepared for what may happen to the portfolio's performance in the next downturn. Ms. Krauss commented that risk analysis has been done on the portfolio that predicts a smaller loss than was experienced in 2007-2008 in a future market selloff. Mr. Tatro stated that he finds it difficult to have confidence in scenario analysis that uses past performance data as an input because the hedge fund and private equity asset classes have changed over the past 10-20 years in such a way that their historical risk and return statistics are less useful in a predictive model. He continued by saying that while it is important to be aware of how the portfolio may perform in another down market, it is also important to consider how the portfolio may lag in the event that equity markets continue their march upward. Ms. Krauss agreed that portfolio risk modeling is not a perfect predictor and it is unlikely that the portfolio would lose exactly what the model suggests. However, it is a useful tool to help the Committee gauge portfolio-level risks, and strides have been made to diversify the portfolio and reduce overall risk levels such that the portfolio would not likely lose as much again as it did in the Great Financial Crisis.

G. <u>Other</u>

Ms. Krauss reviewed the 2019 Investment Committee meeting schedule and tentative agenda items, highlighting the upcoming September Annual Retreat. Agenda items for the Retreat include an endowment overview provided by investment staff, an educational session provided by FEG, a hedge fund manager presentation, as well as an ESG (Environmental, Social, and Governance) educational session. In addition to these items, a full review of the Endowment

Investment Policy will be conducted, and proposed changes discussed in detail. Lastly, she noted the inclusion of Supplemental Endowment reports as of March 31, 2019 and the Operating Cash and Investment reports as of March 31, 2019 and April 30, 2019.

H. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 3:14 p.m.

Respectfully submitted,

Kristina W. Goins
University Financial Services