Meeting Minutes of the Investment Committee
University of Kentucky
Friday, September 16, 2022

The Investment Committee of the University of Kentucky Board of Trustees met on Friday, September 16, 2022, in the Gatton Student Center Harris Ballroom.

A. Meeting Opened

Investment Committee Acting Chair, Robert Vance, called the meeting to order at 8:15 a.m. and requested a roll call.

B. Roll Call

The following members of the Investment Committee were in attendance: Robert Vance, E. Britt Brockman, Todd Case, Ron Geoghegan and Hollie Swanson.

The following Community Advisory members were in attendance: William C. Britton, James F. Hardymon and Quint Tatro.

The University Investment Staff was represented by Chief Investment Officer Todd D. Shupp.

Cambridge Associates was represented by Eric Thornton and Celia Dallas.

C. Approval of Minutes for April 28, 2022

Chair Vance called for a motion to approve the minutes from the Committee meeting on April 28, 2022. The motion was moved by Trustee Brockman and seconded by Trustee Swanson. The motion passed without dissent.

D. UK Endowment Overview

Mr. Shupp outlined the day's agenda, which started with an overview of the UK Endowment. He began the presentation with a thirty-year lookback to 1992, when the Endowment was established in a consolidated format. Mr. Shupp next discussed the student impact of the UK Endowment which has provided real-world investment experience to hundreds of students. The Investment Internship Program has had 10 undergraduate student interns since the program launch in 2016, with two positions each academic year. The experience has helped students obtain competitive roles at top-tier organizations upon graduation.

Additionally, the Student Managed Investment Funds program which began in 2013 and has had 423 participants to date including 172 undergraduate and 251 graduate students in Finance. He stated that since inception the Endowment's cumulative spending distribution was $886 million, with $97 million distributed for scholarships. There have been 703 chair, professorship, and fellowship positions established, and $969 million dollars gained by investments.

Mr. Shupp then discussed the university's investment philosophy. He stated that diversification is the university's best strategy for achieving long-term objectives. The focus must be on long-term results, which require both patience and diligence. Markets are cyclical and valuation matters over the long term. Humility is important, and a blend of passive, active and less-liquid strategies is needed to reach UK's long-term goals. Mr. Shupp next addressed what the university avoids in managing the Endowment, including trying to time the market, making hasty decisions or extreme moves, being complacent and allowing past results to anchor expectations for the future.

Next, Mr. Shupp provided a review of staff activity from Fiscal Year 2022. He highlighted the transition to a new investment consultant, Cambridge Associates, and the related addition of 16 new managers within the approved asset allocation ranges. Additionally, onsite visits resumed, including an inaugural visit to Cambridge's offices, and visits to several manager offices. Finally, the Investment Office researched and supported the launch of a Responsible Investing Student Managed Investment Fund (SMIF). He concluded with the fiscal year 2023 initiatives including the distribution of the Investment Strategy Survey to the Investment Committee, providing educational presentations to UK students, continuing to closely monitor and manage service provider fees, and conducting ongoing capital markets research and onsite due diligence with endowment investment managers and consultant.

Given the 30-year lookback of Mr. Shupp's presentation, Trustee Swanson asked what inflation was like in 1992. Ms. Dallas replied that it was certainly lower than it is now. Around that time, Cambridge Associates was using an assumption for inflation of about 3%.

E. <u>Cambridge Associates Education Session and Asset Allocation Study</u>

Mr. Thornton began the Education and Asset Allocation Study with a brief overview of the two primary ways that Cambridge believes long-term results can be improved in the Portfolio: 1) adopting a higher-return asset allocation policy, and 2) improving implementation. The day's presentation was focused on the former, asset allocation policy.

Mr. Thornton set the stage by outlining Cambridge's investment philosophy. The goal is to maximize the odds of achieving primary objectives. To do so, Cambridge believes that an equity bias will enable higher long-term expected returns. However, consideration must also be given to protecting against the risk of catastrophe. Bonds typically provide protection during periods of macroeconomic contraction, while real assets can provide protection during periods of high and unexpected inflation. Finally, Cambridge believes in diversification as a core principle. Mr. Thornton next reviewed the roles of various asset classes for a portfolio, including growth (public and private equity), protection (diversifying strategies), and liquidity (real assets and fixed income).

Mr. Thornton next commented on how this philosophy can be applied to the University of Kentucky Endowment, ensuring alignment with the primary policy objectives stated in the Endowment Investment Policy. He indicated that there are no material operational constraints that should limit the Endowment's ability to accept risk. He further noted his opinion that UK has the capacity to accept equity risk, provided that other asset classes outlined earlier are also included that will allow the Portfolio to ride out storms in the equity markets. Mr. Thornton then reviewed the recommended target asset allocation, which proposes a modest reduction in diversifying strategies by 3%, shifting 2% to global public equity and 1% to private equity. In addition to the reduction in diversifying strategies, he recommended that the focus within the asset class shift more toward diversifying hedge fund strategies and away from strategies that move more with the equity and bond markets.

Trustee Shuffett asked how the UK Endowment was positioned in 2008, and how it compares to the recommendations being presented today. Mr. Shupp replied that going into the Great Financial Crisis, the Portfolio was very heavily allocated towards equities, roughly two-thirds of the Portfolio, and declined by quite a bit during that time. The Investment Committee at that time decided to diversify the Portfolio and reduce the weight of equities with implementation taking place in mid-2009. However, it can be fairly argued that the reduction in equities went too far, and risk was reduced too much. In more recent years, the Investment Committee has indicated a willingness and ability for a greater amount of risk to be taken. An additional key point is that the shifts that are being suggested today are strategic and moderate, not tactical bets on the direction of the market.

Mr. Hardymon commented that a 2.5% inflation assumption is being utilized in the calculations presented in the materials. While acknowledging the impossibility of accurately predicting inflation, if one assumed the more recent high inflation numbers were to continue for five years, he questioned if that would change the recommended asset allocation targets. Mr. Thornton replied that it would not change the long-term proposal. But if there was a high conviction view that inflation was going to remain a problem, and that the market was not anticipating that issue, it would change how the Portfolio was positioned today.

Mr. Tatro stated his observation that the Investment Committee has been reactive to markets in the past. To avoid that going forward, he pointed to the standard deviation forecast that Cambridge included in the materials as being just as important as the expected return for the Investment Committee to accept in the recommended asset allocation targets. He reminded the Committee that while the Portfolio is well-diversified and hedged, a large decline in the Portfolio will happen at some point, and there is opportunity in that. Mr. Tatro then asked Cambridge to speak to their expected rate of return for emerging markets. Mr. Thornton outlined Cambridge's intermediate-term nominal return expectations, which assume that valuations revert to their long-term mean and also assume reasonable long-term growth in earnings over a 10-year period. Key takeaways are that valuations are still pretty high, which will exert a downward pull on returns in the future. Over the next 10 years, they generally think returns will be below long-term averages.

Mr. Britton asked if this meant the Portfolio is tilted toward a value orientation as opposed to a growth orientation. Mr. Thornton confirmed that their intermediate-term nominal return expectations are rooted in a value philosophy but noted that this framework is intended to guide allocations at the major asset class level. It does not preclude allocating to growth stocks within those major asset classes if that is where the best opportunity appears. That said, Cambridge believes tilting a little more toward value in today's market does make sense.

Acting Chair Vance asked if Cambridge Associates is getting more comfortable with the credibility of financial statements from emerging markets, specifically China. Mr. Thornton replied that this is still a risk, but that they are getting better. Ultimately, Cambridge relies on managers to make those calls, believing that their proximity to and deep knowledge of the country and companies are helpful to avoid fraudulent and worrisome situations.

Next, Mr. Thornton introduced Ms. Celia Dallas, Head of Investment Strategy for Cambridge Associates, to present an education session on the current market environment. She began by stating that the current market environment is challenging, driven by inflationary risks, economic slowdown risks and geopolitical risks. She advised that in such uncertain and volatile times, it is best to lean into strategic plans and avoid trying to time the market bottom.

Ms. Dallas then provided a summary of global asset class performance focusing primarily on the calendar year-to-date period. Both equities and bonds were down substantially, which is not in line with historical norms whereby bonds typically provide ballast in periods when equities sharply decline. Real assets in the Portfolio have been more helpful this year, particularly within natural resources. Turning to economic indicators, growth slowed in the second quarter and the US suffered a technical recession as gross domestic product (GDP) growth declined substantially. The Composite Purchasing Managers' Index indicates that Europe, Japan and U.S. economies are all contracting. While inflation expectations have moderated, trailing inflation remains elevated.

On the inflation topic, Mr. Hardymon expressed his concern that the aggressive actions that were taken by the government and Federal Reserve in the 1970s could be repeated given the similarly high rate of inflation today.

Mr. Tatro stated that he has a strong opinion on inflation, and he disagrees with the frequent comparison made between today's inflation to that of the 1970s. In contrast to the 1970s, when the Federal Reserve was buying dollars and raising rates in order to support a weak U.S. dollar, the dollar is up strongly this year. He asked how an investor can rationalize what the Federal Reserve is doing to fight this inflation when it is not due to a dollar decline but instead due to outside forces such as the war in Ukraine, supply chain disruption, and government stimulus.

Ms. Dallas agreed that a lot of the inflation being seen today is related to supply chain disruption and that the dollar is not currently weak. She pointed out that a large part of the reason the dollar is strong is because the U.S. Federal Reserve was among the first central banks to tighten policy. Another reason the dollar is strong is because investors tend to run toward it in riskier environments given its safe-haven status. Turning back to the causes of today's inflation, she noted that they substantially broadened as the year continued and high inflation can no longer be attributed to only the demand-oriented after-effects of the Pandemic or the war in Ukraine. She stated her opinion that given this broadening, the Federal Reserve and other central banks do have the ability to address inflation.

Lastly, Ms. Dallas turned to suggestions on how to position the Portfolio given the current economic conditions and outlook. She first reiterated the importance of diversification. She next pointed to some upside risks in rates and inflation expectations and suggested that an overweight to the value style factor could be attractive as value stocks tend to do better in rising rate environments. She recommended an overweight to high-quality small-cap stocks given attractive relative growth rates, valuation discounts, strong profitability and desirable sector composition.

F. <u>Proposed Changes to Endowment Investment Policy</u>

Next, Mr. Shupp reviewed the proposed changes to the Endowment Investment Policy. As previously discussed by Cambridge, the updated policy reflects modest, incremental changes including an increase in the global equity allocation and a decrease in the diversifying strategies allocation. The diversifying strategies asset class description was also updated to adjust the beta profile, reducing the equity orientation to seek lower correlated returns. He also highlighted a minor update to the liquidity guidelines. Illiquid assets, categorized as being available only in two years or more, is moving from "no more than 40%" to "no more than 45%" of the Portfolio. Mr. Shupp noted that this proposed change does not reflect a desire to push less liquid holdings to the upper threshold, but instead is driven by a Cambridge recommendation to build in a slightly larger buffer for market fluctuations. Lastly, the proposals include minor changes to the benchmarks used for public equities and diversifying strategies. Mr. Thornton added brief comments surrounding the rationale for the benchmarks selected for each category, with the common theme being improved alignment with the investments held in these portfolios.

G. <u>Endowment Manager Presentation: Cordillera Investment Partners</u>

Mr. Chris Heller from Cordillera Investment Partners provided a firm overview, investment philosophy and process descriptions, and updates for Funds II and III in which UK is invested.

H. <u>Investment Staff Report</u>

Mr. Shupp presented the Investment Staff Report beginning with an overview of the Endowment asset allocation as of July 31, 2022. He stated that very little change had occurred since the March 31, 2022 allocation was presented at the last meeting, a very meaningful positive given the large market sell-off in the second quarter. Because the Portfolio was fully diversified, UK was able to take gains from the real assets portfolio and invest in equities to get back towards the approved targets. Mr. Shupp stated that the Portfolio remains well-diversified and well within the policy ranges both for liquidity and asset allocation.

Mr. Shupp then discussed recent manager appointments, terminations and due diligence for the period. On the appointments side, UK made new investments in or commitments to the following funds: Sheridan Square Offshore Fund, KSL Capital Partners VI, Telegraph Hill Partners V, ACL Alternative Fund, Palatine U.S. Real Estate and Verdane Capital XI. On the terminations side, UK redeemed in full from New Silk Road Asia Discovery Emerging Companies Fund, New Silk Road China Fund and Constellation Fund, all from the emerging markets portfolio. Lastly, he referenced manager due diligence and research during the period, highlighting that many meetings had returned to an in-person format rather than virtual.

I. Performance Review and Market Update

Mr. Thornton conducted a Fiscal Year 2022 performance review of the UK Portfolio. He stated that the Portfolio is currently estimated to have declined by 5% during this period, though this is expected to change somewhat after private investment returns are finalized. In the Fiscal Year 2022 period, major asset class performance was mixed in a volatile environment. The Portfolio underperformed the policy benchmark slightly for the fiscal year, driven largely by underperformance in diversifying strategies and public equity. Countering those areas of weakness, the Portfolio saw strong performance in real assets, and private equity and private credit delivered gains.

J. Other Business

Mr. Shupp reviewed the schedule of 2022 Investment Committee meetings and tentative agenda items. The remaining meeting of the year will take place on Monday, December 12. In addition to the regular meeting items, the proposal for Investment Policy changes will be brought for approval as well as an asset class strategy review. The February meeting will include an update on the mission-related investment program as well as an update from the Student Managed Investment Fund (SMIF).

K. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 11:04 a.m.

Respectfully submitted,

Kristina W. Goins
University Financial Services