Meeting Minutes of the Investment Committee
University of Kentucky
Thursday, June 15, 2023

The Investment Committee of the University of Kentucky Board of Trustees met on Thursday, June 15, 2023, in the Gatton Student Center Harris Ballroom.

A. Meeting Opened

Investment Committee Chair, Ray A. Daniels, 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 were in attendance: Ray A. Daniels, Todd Case, C. Frank Shoop and Hollie Swanson. E. Britt Brockman joined the meeting at 10:40 a.m.

The following Community Advisory members were in attendance: Tom Abell, M.D., William C. Britton, Elizabeth McCoy, Kathy McMullen and Quint Tatro.

The University Investment Staff was represented by Chief Investment Officer Todd D. Shupp and Investment Director Nancy Rohde.

Cambridge Associates was represented by Eric Thornton and Drew Landry.

C. Approval of Minutes for February 16, 2023

Chair Daniels called for a motion to approve the minutes from the Committee meeting on February 16, 2023. The motion was moved by Trustee Shoop and seconded by Trustee Case. The motion passed without dissent.

D. Cambridge Associates Education Session and Risk Review

Mr. Drew Landry, with Cambridge Associates (Cambridge), began the education session with a summary of the Investment Committee (IC) survey responses. The results were compiled from 16 participants, where more than half identified themselves as Investment Committee members. Mr. Landry reviewed aggregated responses to the survey questions covering the topics of investment objectives, risk tolerance, liquidity management and responsible investing.

Next, Mr. Eric Thornton presented the risk review. He noted that while UK conducts a formal review of portfolio risk annually, risk is constantly being scrutinized given that all investment decisions require an evaluation of risk versus return. Though there is no single definition of risk, Mr. Thornton discussed some of the more common types including: variability of returns (standard deviation), sensitivity to equity markets (beta), liquidity risk, behavioral risk, concentration risk, headline risk, peer risk and shortfall risk (risk of failing to meet the primary objective).

Macroeconomic extremes represent another risk, and he outlined two economic scenarios that investors should prepare for: 1) a prolonged economic contraction and, 2) an unexpected spike in inflation. Mr. Thornton stated that both extremes are very difficult to predict, pointing to the COVID pandemic and the war on Ukraine as recent examples. Given the unpredictability, he asserted that a portion of the portfolio should be held in assets that typically hold up in the two extreme scenarios, namely high-quality fixed income to protect against a deflationary event and real assets to protect in an inflationary environment.

He next pointed out that while the portfolio is structured to navigate unpredictability, the asset allocation is not static. Investment staff and Cambridge pay close attention to shifting risks and opportunities across asset classes, and he highlighted the management of the fixed income portfolio over the past two years as an example. Foreseeing a poorly skewed risk/return balance in March 2020 as rates were cut to zero by the Federal Reserve, a shift was made to shorten the duration of the Reams fixed income separate account. This decision, along with Reams' selection skill, resulted in strong downside protection over the next nearly three years.

Mr. Thornton then reviewed how the portfolio's target asset allocation has been constructed with various risk and return assumptions across the many asset classes. The overall risk level is roughly comparable to a simple blend of 75% stocks and 25% bonds. Various scenarios were then presented to provide some context for how the portfolio may perform in stressed scenarios. He also cautioned that starting valuations today compared to historical averages for many asset classes may make it more difficult for the portfolio to hit its 7.5% return target over the coming decade.

Trustee Swanson asked about two risks and how they are considered in risk modeling: 1) next year's presidential election and 2) the aging of the global population over the long term. Mr. Thornton addressed the first risk as short-term in nature, and he cautioned against making any portfolio moves on such events on the basis that it would be very difficult to know the outcome, and also very challenging to predict how the market would react. Turning to the risk regarding population decline, he described that situation as exerting a deflationary impulse and potentially lowering expected returns. He stated that not all regions face this risk, noting certain emerging markets where this trend is a tailwind. Mr. Britton asked for an update on Cambridge's conviction in emerging markets and confirmation of when, if ever, these assets outperformed U.S. equities. Mr. Thornton confirmed that the portfolio continues to have a slight overweight to emerging markets. His opinion is that the dollar looks pricey in today's market, and that could create a potential tailwind to emerging markets. He acknowledged that emerging markets have been extremely frustrating and have underperformed the domestic market for 12 years. He pointed to the cyclicality of these markets and highlighted that if you looked back at performance in 2008-09, emerging markets at that time had outperformed significantly.

The conversation continued with a focus on liquidity risk, specifically the results of liquidity stress tests on the UK Portfolio that were conducted by the investment office. Ms. Rohde presented the results of the first liquidity study that stressed the most highly liquid assets in the Portfolio, those that can be fully redeemed within one month. Applying very conservative performance assumptions to simulate what may occur in a severe downturn, the most liquid assets were found to cover three years of annual spending and capital call needs. Mr. Shupp provided the results of a second study that included assets that can be liquidated within one year. After applying the same conservative return assumptions, the liquid and semi-liquid assets are estimated to cover four years of the Portfolio's annual spending and capital call needs.

Mr. Thornton next turned the discussion toward a review of small-cap equity, defined as stocks with less than $2.5 billion in market capitalization. Outperformance of small-cap stocks has been established in financial theory, alongside the value factor, over long periods of time. In the near term, Cambridge recommends an overweight to small-cap equities given their valuation discount, strong profitability, and desirable sector composition. Mr. Thornton then briefly highlighted UK's small-cap exposure, which comes primarily from two complementary U.S. small-cap managers, Wellington Emerging Companies and Neumeier Poma.

E. <u>UK Staff Presentation</u>

Mr. Shupp and Ms. Rohde presented the UK Endowment Overview. Mr. Shupp began with some background including the growth in the endowment pool since its inception, noting significant milestones concerning returns and contributions. Ms. Rohde detailed a breakdown of total UK Endowment assets both by type and purpose. Mr. Shupp then reviewed a history of the people involved in managing the endowment pool, including investment office staff as well as consultant relationships. Ms. Rohde then discussed the university's investment philosophy, with a particular focus on discipline and diversification.

Mr. Shupp continued with some UK-specific examples of maintaining investment discipline. First, highlighting the importance of diversification, the Portfolio's downside protection in 2022 was notably better than it was in 2008. Second, Mr. Shupp highlighted the Portfolio's strong gains from private investments, noting that patience and consistency have been required in building out the private portfolio and have paid off. Ms. Rohde rounded out the discussion around discipline by outlining key elements of investment manager due diligence, highlighting Wellington Emerging Companies as an example of knowing a manager well and maintaining conviction through ups and downs by focusing on key process areas.

Mr. Shupp reviewed accomplishments for Fiscal Year 2023. Some of the most notable were ongoing investment due diligence (150 updates including meetings, calls, Zooms and on-site visits), beginning the staged shift towards new asset allocation targets following approval in December 2022, implementing 11 new fund investments within approved asset allocation ranges, continuing to strengthen UK's Investment Office team, adjusting defensive positioning in the fixed income portfolio and providing multiple educational presentations to UK students. He concluded with some initiatives for Fiscal Year 2024. Near-term focus items include developing and launching a Request for Proposals (RFP) for endowment custody services as well as training and assimilating the newly hired Investment Analyst. Ongoing efforts include continuing to closely monitor and manage service provider fees and conducting ongoing capital markets research and onsite due diligence with endowment investment managers and the UK consultant. Mr. Tatro stated his agreement with comments made earlier in the meeting regarding the attractiveness of emerging markets and small cap equities and asked if UK's current overweight to those areas is sized large enough to move the performance needle. Mr. Shupp replied that the current overweight to these areas has been carefully sized, with consideration given to balancing the higher return potential against the higher volatility and risk of these equity areas. He further noted that relative valuations, while persuasive over the long term, generally make for a poor short-term timing tool. For this reason, it is prudent to avoid exposing the portfolio to very large country or market capitalization bets against the index. Trustee Shoop asked about China being in the headlines and how such news affects asset allocation and risk decisions. Mr. Shupp replied that several types of risk have been considered in relation to the Portfolio's Chinese equity holdings, including geopolitical, headline, and contagion risk. Keeping those risks in mind, we still believe that an allocation makes sense given expected favorable characteristics such as stronger relative demographic growth.

F. Endowment Manager Presentation: Wellington Management

Mr. David DuBard from Wellington Management presented an overview of the Emerging Companies strategy, which is held in the Endowment.

G. Investment Staff Report

Mr. Shupp presented the Investment Staff Report beginning with an overview of the Endowment asset allocation as of April 30, 2023, compared to the December 31, 2022, asset allocation presented at the last meeting. He stated that the largest increase was to global equities, where public equities shifted upward due to a strong equity market and rebalancing that took place in order to reach the new policy targets. He continued that change was minimal within global fixed income. Real assets were slightly reduced to accommodate the increase in equity. There was also a notable reduction in diversifying strategies which represents ongoing redemption proceeds from this area of the Portfolio. Mr. Shupp briefly reviewed a new chart illustrating portfolio cash flows by asset category. He concluded by stating the Portfolio's liquidity profile is well within the policy ranges.

Ms. Rohde discussed recent manager appointments, terminations and due diligence for the period. On the appointments side, UK committed $20 million to Cortec Group Fund VIII-A, L.P., $20 million to Revelation Healthcare Fund IV, L.P., and $15 million to QED Fund VIII, L.P. On the terminations side, UK redeemed in full from LibreMax Offshore Fund and Kepos Alpha Fund. Lastly, Ms. Rohde referenced manager due diligence and research during the period. She highlighted a visit to Dallas in April with Neuberger Berman as well as two other managers.

H. Performance Review and Market Update

Mr. Thornton presented a performance review and market update for the calendar year-to-date period ending April 30, 2023. Markets were broadly positive during the period. The path was bumpy as investors faced the banking crisis in the first quarter and a very narrow equity market in which only five stocks contributed 60% of the S&P 500 return.

Mr. Landry then reported on UK's performance for the year-to-date period. While all major asset classes posted gains, relative outperformance in international equities, fixed income and public real assets were particularly additive to performance, as was the shift to a more neutral duration posture in the fixed income portfolio. Countering this, U.S. equities and diversifying strategies detracted from performance in relative terms, and regional emerging markets equity managers also detracted in the period.

I. Other Business

Mr. Shupp reviewed the schedule of remaining 2023 Investment Committee meetings and tentative agenda items. He highlighted that the next meeting would take place on September 14th and will include a review of proposed changes to the Endowment Investment Policy, as well as an education session. December's meeting will include the tentative approval of the Endowment Investment Policy and another education session to be determined, possibly an update on private investments.

Mr. Britton asked Cambridge how they look at asset allocation planning for the next ten years specifically in relation to the national deficit possibly reaching $10 trillion. Mr. Thornton replied that two things come to mind related to the deficit specifically: 1) the implications for inflation and; 2) the implications for the dollar. He acknowledged that both the deficit and spending are a concern, and a likely outcome would be that policymakers would have to tolerate a higher level of inflation to service this increased debt. Predicting timing on such things is so difficult that Cambridge advocates for a portion of the Portfolio to be invested in real assets.

J. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 11:54 a.m.

Respectfully submitted,

Kristina W. Goins
University Financial Services