

Minutes of the Meeting of the Investment Committee
University of Kentucky
Thursday, February 20, 2020

The Investment Committee met on Thursday, February 20, 2020, in the J. David Rosenberg College of Law.

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, Joe R. Bowen, A.C. Donahue, and Barbara Young. The following Committee members were not in attendance: Michael A. Christian and 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 University Investment Staff was represented by Todd D. Shupp, Chief Investment Officer.

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

C. Approval of Minutes for December 9, 2019

Chair McCoy called for a motion to approve the minutes from the Committee meeting on December 9, 2019. The motion was moved by Trustee Young and seconded by Trustee Donahue. The motion passed without dissent.

D. Fixed Income Strategy Review

Mr. Aluise introduced Mr. Keith Berlin, who conducted the fixed income strategy review. He began by stating that the primary roles of a global fixed income portfolio are deflation protection, volatility reduction, and total return. The UK global fixed income portfolio is divided into three sub-categories: high quality/rate sensitive, public credit sensitive, and private credit. Mr. Berlin highlighted three key recommendations from FEG's recent fixed income outlook: 1) consider a shorter duration profile because rates are low; 2) look for opportunities to reduce fees; and 3) continue to allocate to the private lending space.

Reviewing a graph of long-term U.S. interest rates over the past 150 years, he noted that today's rates are below the long-term historical average and represent a challenge for traditional fixed income investors. That said, allocations to traditional core bonds remain prudent for liquidity and diversification purposes. Next, he turned to public, high yield corporate credit and stated that the current opportunity set is limited. Investors' insatiable demand for income has pushed the yield on the Merrill Lynch High Yield Bond Index near historic lows. He then outlined the private credit opportunity set and began by describing a typical private company capital structure. Private lending consists of making loans to private companies, with higher coupons expected than available from public companies. Mezzanine loans have offered a consistent yield premium over traditional high yield markets historically. However, increased demand for these strategies could compress this spread going forward and make the asset class less attractive relative to public high yield.

Mr. Berlin discussed the endowment's investment in a private debt manager, Merit Capital Partners, which was founded in 2005 and makes mezzanine investments in private, lower middle-market transactions in the manufacturing, distribution, and services industries. He summarized his remarks by stating the importance of not reaching for yield through duration or unattractive credit risk. The University's fixed income portfolio is well diversified and has added value relative to its primary benchmark since inception.

Mr. Tatro asked Mr. Berlin what he expects in fixed income with regard to the economy. Mr. Berlin responded by providing expected returns for the various buckets within fixed income. In terms of the potential impact of an economic downturn to investments, Mr. Berlin stated that the biggest defense is investing with managers who have been around a long time, have good restructuring capabilities, and have shown that they can weather market cycles. It is also important to maintain diversification across vintage years in private credit investments given that it is unknown when the next downturn will occur.

E. ICR 1 – Extension of Endowment Investment Consultant Contract

Chair McCoy asked for a motion to approve ICR 1, the extension of the Endowment Investment Consultant Contract. The recommendation is that the Investment Committee authorize Investment Staff to extend the contract with Fund Evaluation Group (FEG) to provide investment consulting services for the University of Kentucky Endowment for the period June 1, 2020 through May 31, 2022, subject to the terms and conditions of the existing contract. The motion was moved by Trustee Donahue and seconded by Trustee Bowen. Mr. Shupp provided additional color on some of the key services provided by FEG. The motion passed without dissent.

F. Investment Staff Report

Mr. Shupp presented the Investment Staff Report beginning with an overview of

the Endowment asset allocation as of December 31, 2019. Overall, there were no significant changes for the period. Minor changes included a small rebalance between small cap U.S. equities and large cap U.S. equities as well as routine capital calls during the period. Mr. Shupp briefly discussed the portfolio's liquidity tiers among liquid, semi-liquid, and illiquid categories. This framework was established during the 2016 Investment Policy update to put more depth and breadth around liquidity considerations in the portfolio. Mr. Shupp emphasized the importance of thinking about the portfolio's liquidity proactively as the bull market is unlikely to continue unabated and UK wants to ensure it can withstand more volatility and adverse market conditions. Trustee Bowen asked how nimble UK can be when it comes to shifting asset allocation. Mr. Shupp replied that UK is able to be nimble within its asset class target ranges and deploy capital quickly as opportunities arise. Trustee Bowen followed up by asking for additional background on the process for making portfolio changes. Mr. Shupp responded that Investment Staff has the discretion to make investment decisions within the broad ranges approved by the Investment Committee. This governance structure was designed to allow Investment Staff to capitalize on investment opportunities in a timely manner. Trustee Blonder asked whether the threat of the COVID-19 outbreak has been discussed. Mr. Shupp stated that up to this point the market has seemed to move past this rather quickly, potentially undershooting the long-term consequences of the virus. The portfolio's diversification puts UK in a good place should a decline occur from here as it seems that the full impact is still to be determined.

Mr. Shupp continued by reporting on manager appointments, terminations, and due diligence for the period. A new allocation was made to Socorro Asset Management (Socorro) within the diversifying strategies space. Two manager terminations took place including Stone Milliner Asset Management and AQR Capital Management. Lastly, Mr. Shupp addressed due diligence which included an onsite meeting with Socorro as well as a number of meetings with current and prospective managers. In addition, Chair McCoy, Mr. Shupp, and Ms. Rohde traveled to Cincinnati for the annual FEG onsite meeting.

G. Performance Review and Market Update

Mr. Aluise began the performance review and market update with a graphical review of major asset category returns as of December 31, 2019. He highlighted the strong recovery that took place in late 2019, noting that nearly every asset class showed a positive return for the calendar year. Broad negative returns across equities in 2018 recovered in 2019, driven by the Federal Reserve's shift toward a more accommodative policy posture. Current equity valuations suggest international markets and value stocks represent long-term attractive opportunities and, over the long-term, being diversified globally has benefited investors. Next, Mr. Aluise discussed fixed income, pointing out that long-term Treasuries were an outlier in 2019 by posting gains of nearly 15 percent in a period when equity markets also rallied. Such performance by a defensive asset class shows the unique dynamic of the 2019 markets.

Mr. Aluise turned to the portfolio's performance over 2019 and highlighted positive contributors including U.S. equity and real assets, which had particularly strong Real Estate Investment Trust (REIT) performance. Hedged strategies, an overweight to international equities, and private equity were relative detractors. Mr. Aluise noted the inclusion of the manager memo for a new fund allocation, Socorro Dynamic Opportunity Fund.

In closing, Ms. Wood presented the results of the 2019 National Association of College Business Officers-Teachers Insurance and Annuity Association (NACUBO-TIAA) Study of Endowments. Beginning with average annual rates of return, the University was at 5.5 percent - above the median of 5.1 percent and average of 5.3 percent for the fiscal year 2019. She reminded the Committee that the defensive posturing of the portfolio was the main driver of lagging three-year and five-year returns relative to peers. Ms. Wood concluded that the equity market experienced a severe selloff during Fiscal Year 2019, leading to lower returns than those experienced in the "up-market" of Fiscal Year 2018. The portfolio's diversification provided downside protection during FY2019 market volatility, contributing to a better return than peers during this period.

H. Other Business

Mr. Shupp reviewed the 2020 Investment Committee meeting schedule and tentative agenda items. He stated that the next meeting will include the annual portfolio risk review. June's meeting will include an asset class strategy review, which will focus on the real assets portfolio, the Annual Investment Committee Retreat will be held in September. He also noted the inclusion of the cash and investment operating report updated through December 31, 2019. Trustee Bowen asked FEG for their thoughts regarding the potential for accelerated inflation. Mr. Aluise replied that this has been a concern of FEG's for years. Though there have been many factors suggesting that inflation would move higher, it has not budged. Still, it remains a concern that is factored into the portfolio.

I. Meeting Adjourned

Hearing no further business, the meeting was adjourned at 3:09 p.m.

Respectfully submitted,



Kristina W. Goins
University Financial Services