

Minutes of the Investment Committee
University of Kentucky Board of Trustees
4:30 p.m. on June 15, 2017
President's Room, Boone Center

IN ATTENDANCE:

Investment Committee
Members:

Mark P. Bryant, Chair
Claude A. Berry, III
James H. Booth
Michael A. Christian
Robert D. Vance
Barbara S. Young

Community Advisory
Members:

James F. Hardymon
William E. Seale (participated via conference call)
Myra L. Tobin

Investment Staff &
Consultants:

Susan I. Krauss, Treasurer
Todd D. Shupp, Chief Investment Officer

Nolan M. Bean, Consultant, Fund Evaluation Group
Michael J. Aluise, Consultant, Fund Evaluation Group
Keith M. Berlin, Head of Fixed Income, Fund Evaluation Group

Chair Bryant called the meeting to order at 4:30 p.m. and requested a roll call. Chair Bryant then called for a motion to approve the minutes from the Committee meeting on May 1, 2017. The motion was moved by Mr. Booth, seconded by Ms. Young, and approved by all.

Mr. Shupp introduced Mr. Keith Berlin, Senior Vice President and Head of Fixed Income at FEG. Mr. Berlin began a discussion on fixed income, highlighting that the portfolio's target allocation increased to 20% in the most recent update to the University's endowment investment policy. Mr. Berlin commented that FEG divides the fixed income market into two parts: rate sensitive securities and credit securities. The primary roles of a global fixed income portfolio are deflation protection, volatility reduction, and total return. In terms of portfolio construction, the UK target exposure is 10% high quality securities, 5% public credit and 5% private credit. High quality/rate sensitive investments are liquid and hedge against deflation and equity market declines. Mr. Berlin then went on to discuss public and private credit strategies. Public credit sensitive strategies managers understand capital structure and invest where risk-adjusted returns are attractive. FEG emphasizes active managers in this part of the fixed income market, which they consider a non-ideal universe for passive management. Within private credit/distressed strategies, FEG focuses on diversification across senior loans (least risk/return), mezzanine loans, and distressed debt (most risk/return). Moving on to a discussion of the opportunity set in high quality fixed income, Mr. Berlin stated that the value of the 10-year U.S. Treasury yield provides great insight into the subsequent 5-year return of the Barclays U.S. Aggregate Bond index, and the 2.5% 10-year yield as of March 31, 2017 is low by historical standards. Lower yields in core bonds make future returns less compelling. In contrast, however, credit opportunities have presented compelling risk/return characteristics historically. Opportunities are available in the private credit markets, through investments

with focused, long-standing managers. Key considerations supporting the case for private credit investments are that they are higher in the capital structure than common equity, mezzanine cash coupons and interest are in the range of 14%, and these investments may include additional upside through minority private equity interests. Mr. Berlin then provided an overview of a manager in the UK portfolio, Rimrock Capital Management. Rimrock was founded by a former rocket scientist, Dave Edington, who at one time was the second in command at PIMCO. One of the key features in Rimrock's strategies is a shorter duration profile. The current yield is 8.8% with a duration of 0.3 years. Mr. Berlin concluded by stating that the University's fixed income portfolio is well diversified and providing alpha, having outperformed over the last 10 years by 100 basis points. The focus looking forward is an ongoing evaluation of the appropriate mix of active/passive exposure and identifying private strategies with superior yield.

Mr. Shupp then presented the Investment Staff Report. He began with an overview of the endowment asset allocation as of April 30, 2017, stating that the portfolio remains well within the policy ranges and well diversified across asset classes. He then presented a report on manager appointments, terminations and due diligence for the period of May 2nd through June 15th. He stated that on May 10th, \$17.5M was invested in a Vanguard REIT ETF, related to the first tranche of the operating quasi inflow. In addition, on June 1st, \$18 million was invested in Indaba Capital Partners within the diversifying strategies asset category and \$15 million was invested in Pelham Long Short Fund, a hedged equity strategy. Terminated managers included full redemptions from three hedged equity funds within Grosvenor See Blue B on May 12th and 25th. These proceeds were used as the primary funding source for the new investments. Additionally, on June 7th, there was a full redemption from the Reams Unconstrained Bond strategy and proceeds were reallocated to the existing Reams Core Plus investment. Due diligence during the period included the annual onsite visit to FEG's headquarters to obtain updates on the firm and team, and to review all aspects of the portfolio, including a detailed update on the implementation plan. There were a number of meetings with existing managers as well as potential new managers as diversification continues to be built out across the portfolio.

Next, Mr. Bean provided a performance review for the period ending April 30, 2017. He began by referencing a memo providing background on and rationale for manager additions to the University's diversifying strategies and hedged equity portfolios. Following this, Mr. Bean reviewed endowment performance. The fiscal year to date return was 7.9%, which was ahead of the market-based target allocation index return. The international equity return was 2.5% for April, and 13.5% for fiscal year to date. The fiscal year to date return for the global fixed income asset category was 4.1%, with high quality/rate sensitive fixed income returning -0.3% while public and private credit returns were 5.3% and 11.5%, respectively, during the period. Ms. Krauss then asked Mr. Bean to review the pages of the report focused on private investments. Mr. Bean responded that since the managers of private investments control the timing of cash flows, such as capital being called, the internal rate of return (IRR) is used to capture the impact of these cash flows. Trustee Christian then asked if there were any planned changes in the Global Tactical Asset Allocations (GTAA) area. Mr. Bean replied that exposure will be reduced in this part of the portfolio. GTAA is a sub-component of diversifying strategies where the goal is to obtain strong returns, but the objective of this part of the portfolio is to have lower correlation with stock and bond markets.

Then, Ms. Krauss provided a report on the University's operating fund cash and investments as of April 30, 2017. Tier I is the most liquid and includes cash, as well as overnight and short term investments pending transfer to the state. Tier II is cash on deposit with the state. Tier III is other operating investments, a pool of assets managed internally by staff, primarily in agencies and municipalities. This tier also includes the Reams low duration account. The total for the three tiers is \$1.1 million, or 147 days cash on hand which is well within the approved target range. Tier IV is defined as operating funds invested in the endowment investment pool. At the May 1st meeting it was shared that a new University operating quasi endowment would be recommended for approval at the Finance Committee the following

day. This new operating quasi endowment was approved by the Finance Committee and Board of Trustees on May 2nd, and is in the process of being implemented. An initial investment was made on May 10th for \$56 million and an additional tranche will take place on June 19th for \$19 million. Over time, the expectation is that this will produce a higher return on long term reserves. Also highlighted in this report are comparisons to approved benchmarks as well as a section showing historical information of the various tiers and details on current bond proceeds on deposit with the State.

Lastly, Ms. Krauss reviewed the meeting schedule included in the Other section, noting that September's retreat will be held in Northern Kentucky and will include FEG's study on asset allocation and a detailed review of the investment policy. Also included in the Other section are various supplemental reports including the summary of endowment funds which highlights underwater endowments. Trustee Christian asked how the University's total number of underwater endowment funds compared with other institutions. Mr. Bean commented that this is a relatively small number in comparison to other universities he has worked with and, in one case, an institution was mirroring their new spending policy after the University of Kentucky's, which delays spending distributions on new endowment funds and limits spending on funds significantly underwater.

Following this discussion, Myra Tobin expressed concern regarding the distressed debt strategy that was mentioned in the fixed income presentation. Mr. Shupp acknowledged this concern and noted that, while distressed investments are an important component of return-generation in the fixed income portfolio, this strategy represents a small component of total UK endowment assets.

Chair Bryant concluded the meeting with comments of gratitude regarding a \$2.24 million pledge from the William Seale Family Foundation to establish and endow the "William E. Seale Endowed Chair in Business" in the Gatton College of Business and Economics. Prior gifts from the Seale Family Foundation include a \$10 million gift in 2014 to support the Gatton College Capital Campaign.

The meeting was adjourned at 5:47 p.m.

Respectfully submitted,
Kristina W. Goins
University Financial Services