DIOCESE OF New York
INVESTMENT GUIDELINES

Preamble

By whatever title, individuals who serve on boards are fiduciaries. They act in trust. As such, they are charged with being stewards. Their purview is not just day-to-day but also the long-term well being of the institution.

For a long time fiduciaries have been faithful to the idea that income at least equals expenses. In a world where inflation is zero, they would be good stewards of the institution's financial affairs solely by balancing the annual operating statement. Since they would not be drawing down capital funds to cover expenses and since inflation was zero, the real purchasing power of capital would be preserved from one year to the next and from one generation to the next.

From the earliest days of this country until the onset of World War I, there was no long-term inflation. Under that condition, life for fiduciaries was relatively easy. Just match revenue with expenses. Beginning with World War I, something new occurred — chronic inflation. After World War II, the inflationary pattern accelerated. Fiduciaries at first were slow to understand what the implications of inflation were for not-for-profit institutions. In the last 25 years, however, they have come to see what can happen to the purchasing power of capital (and, as a consequence, income generated by those resources) in the face of inflation.

Today, fiduciaries, to be good stewards of the financial resources, need to assure both the short term necessities of a balanced operating statement annually <u>and</u> the long term health of the institution's capital resources. The dual task is: funding programs, while preserving the real purchasing power of the capital. Failure to do the latter will, over time, threaten the former. Otherwise, fiduciaries are — knowingly or unknowingly — turning over to successors a financially weakened institution.

Because of the ravages of inflation and its impact on how one must invest in such an environment, most states (including New York) have amended the laws governing how not-for-profits may invest and how they may treat accounting for endowments.

Investment thinking has shifted also. Historically, investment return was defined as income divided by principal. That has changed. Now one talks about total return, which is dividends and/or interest plus appreciation (or minus depreciation) of principal. The new approach is necessary even for bonds because part of "income" is in reality a payment to offset the depreciation of the value of principal over time caused by inflation. Thus, not all income ought to be treated as truly spendable income. Some ought to be viewed as an adjustment attributable to principal. A similar blurring occurs with many common stocks, particularly in companies where the dividend is modest or non-existent. Most of the earnings are not paid out currently to shareholders but are retained in the company for reinvestment. In those cases, the large portion of the investment return shows up in the shares' market price. As a result, what might have been paid out as income is reflected instead as increased principal value.

All this background is presented to put into context the rationale for establishing an appropriate percentage of capital that can be expended each year. The amount may be earned as dividends or interest, or it may be supplemented in part by adding some principal. The combination variously has been referred to as drawdown, take- down, or spending rate. Usually, the amount is expressed as a percentage of capital.

There are two ways of determining what an appropriate or prudent spending rate is.

The most logical way is to start with a reasonable expectation of the long term total return on capital and then subtract a projected long term inflation rate. (Properly, the appropriate inflation figure ought to be the institution’s own inflation rate, which might be greater or less than the one for the economy as a whole.) What is left can be referred to as the real rate of return. If one wants to preserve the real purchasing power of the income stream over time, one must first preserve it for the capital funds. Thus, at most only what remains can wisely be used annually to fund program.

Since 1926, an all equity portfolio would have realized a total return of about 8% after inflation. (It should be noted that due to the sharp rise in the equity markets over the five years 1995-1999, the long-term return has risen by two percentage points. In light of that rise, it may be prudent to exercise caution when designing the appropriate spending rate.) Bonds, meanwhile, would have had a real rate of return of about 2%. An assumed portfolio of 50% equities and 50% bonds would, consequently, have returned 5% after inflation. If one had less than a 50% equity exposure, the returns would have been less than 5% in real terms. Should one choose to be extremely cautious, thereby having a portfolio that is 100% in bonds, the maximum that could be used prudently would be 2%. (Maximum spending based on the historical data and based on various equity/bond percentages is shown at the end of these guidelines.)

The alternative approach works from the bottom up, rather than from the top down. One determines the spending rate, adds inflation and then establishes what must be earned from investing. The very real risk is that the number derived may exceed what prudently can be achieved.

In conclusion, not-for-profits expect to have a perpetual life. As such, their investing posture and the amount they expend from their capital must be placed in that perspective. Fiduciaries, therefore, in order to be good stewards, must balance what they prudently can afford to spend today with the amount that they must allow for capital growth. History indicates that, to achieve long term goals and at the same time meet current needs, capital funds, including endowments, must be significantly invested in equities and that no more than 5% of those funds should be expended annually. To smooth out fluctuations of market prices, a three-year (or thirteen-quarter) moving average is a wise approach.

Investment Strategy

The Investment Committee is charged with overseeing the wise investment of the Diocese's capital. The primary goal of the Committee is to maintain and enhance the real purchasing power of those assets over the long term, while providing at least an inflation adjusted stream of income.

In carrying out the plan, the Committee will determine actively the allocation of assets between various investment categories. A key element of the overall approach will be the expending of no more than 5% of a three-year moving average of the value of the assets. To achieve that target, there must be a substantial emphasis on equities, which, except in extraordinary circumstances, will represent 50% to 80% of total assets. That degree of reliance on equities is necessary if the real purchasing power of principal is to be preserved, given the 5% utilization rate.

The Diocese acknowledges with gratitude the generosity of the many benefactors who have made possible the capital with which the Diocese is now endowed. The Investment Committee sees as its basic responsibility the wise management of the funds entrusted to the Diocese so that the assets may fruitfully benefit future generations. If the Committee is successful in its long-term goal, it will provide amply for the needs of today.

Investment Objectives

I. Achievement of a total return, measured over a complete investment cycle, at least equal to the spending rate (as determined from time to time by the Investment Committee) plus the inflation rate (calculated on a consistent basis by Federal Government sources).

II. Within the total return objective, stability and growth of income consistent with the need for long term capital appreciation is desired.

Definitions

a. Investment portfolio is all monies for which the Investment Committee exercises oversight, including stocks, bonds, cash, cash equivalents, and community-based investments but excluding loan guarantees and the Revolving Loan Fund.

b. Asset classes are investment categories such as domestic and international equities, bonds, cash, real estate, etc.

c. Total annual return equals the sum, each year, of dividends, interest, and other current income plus the change in the value of the assets, time-adjusted for capital additions and withdrawals, and after all transaction costs and management fees divided by the value of assets at the beginning of the year.

d. The spending rate is equivalent to the amount that is distributed annually from the various funds and is calculated as a percentage of the average market value at the end of each of the prior three years fiscal years. Predicated on the asset allocation that has been adopted, the spending rate has been set at 5% by the Investment Committee. Depending on circumstances, the Investment Committee may, in the future, unequally weight the three-year average.

e. The inflation rate is the Consumer Price Index (CPI) as calculated and reported by the U.S. Department of Commerce. The Investment Committee may wish to consider the inflation rate of the Diocese itself instead of the CPI. While less easily measured, the diocesan inflation rate is the more pertinent and most likely is greater.

f. Community-based investments are programs organized by non-profit entities with investment funds (sometimes characterized as “endowment” or “trust” funds) to use some part of these funds to accomplish, through investments, social purposes in addition to economic return. Investment assets are normally used solely to generate income, which is expended to support the program purposes of the investing entity. With alternative investments, the goal is to use investment funds not only to generate income but also to directly further, through investments within appropriate limits, the organization's social purposes. Although alternative investments might perhaps be used to further almost any purpose of a non-profit organization, they have been used principally to further purposes relating to economic and community development, particularly by investment in housing. Thus, for example, in addition to making grants to support the provision of affordable housing, an organization might make available construction loans for such housing.

Foundations refer to alternative investments as "program-related" investments. A church or church-related organization might refer to them as "mission-related" investments.

An organization considering making alternative investments may give greater or lesser weight to the use of investments to achieve program purposes. Some organizations, perhaps with specific goals to improve housing or the economic well being of those living in poverty, may give considerable emphasis to alternative investments. Other organizations, with purposes perhaps focused elsewhere but not restricted by their purposes (or otherwise) from making such investments, may use alternative investments as an addition to or an extension of criteria otherwise used in making investments. Either emphasis may be appropriate.

What sets alternative investments apart from program (grant) expenditures are precisely that they are investments. They earn income, and it is expected that the principal invested will be paid back. When paid back, the principal is again available for reinvestment by the organization. Grant monies, in contrast, once expended, are gone.

Asset Allocation

Equities shall be no less than 50% nor more than 80% of the investment portfolio, the specific percentage to be determined from time to time by the Investment Committee. The equity component currently comprises investments in the Diocesan Investment Trust Equity Fund, JP Morgan U.S. Equity Fund, three mutual funds that specialize in international equities and a private investment partnership that focuses on event-driven investing. In the future, as the assets of the diocese become significantly larger, other equity managers will be considered, in order to diversify investment styles and philosophies.

Fixed Income shall be no less than 20% nor more than 50% of the investment funds. The specific percentage is to be determined from time to time by the Committee. The fixed income component is presently invested in the D.I.T.'s Income Fund and, in order to achieve exposure to bonds of a longer maturity than is usually utilized by the manager of the D.I.T. Income Fund, in a portfolio of individual U.S. Treasury bonds that have a maturity of approximately ten years.

Cash, as an asset class, may be utilized when the Investment Committee wishes, for whatever reason, to reduce investments in the other classes.

Real estate adds to portfolio diversification. The Diocese has exposure to this asset class as a result of a 1998 gift of an income-producing building in Manhattan. Because of its illiquidity, under normal circumstances real estate ought not represent more than 10% of total invested assets.

Loans typically have much less favorable investment characteristics than qualified publicly traded equity and debt securities and therefore should be used only sparingly.

Some of the structural disadvantages of loans that are difficult and sometimes impossible to mitigate include: (a) illiquidity — the inability to sell loans prior to maturity; (b) the need to negotiate documentation and covenants when the loans are made, which, if done properly, involves legal representation and expenses; (c) the necessity to monitor and administer loans on an ongoing basis and to be prepared to renegotiate, modify and enforce the lender's rights at any time as long as loans are outstanding; (d) the concentration or lack of diversification inherent in a loan, since the Diocese would typically own all, and not a small percentage, of a loan; (e) the fact that private borrowers are generally less creditworthy than publicly traded corporations whose debt securities are qualified for investment; and (f) the fact that loans are frequently made or expected to be made at rates less than they would carry in the public market and therefore threaten the investment objective of earning a total return necessary to fund spending and to hedge inflation.

Solely as a matter of investment philosophy, loans are not considered appropriate investment assets, given the illiquidity and the terms generally associated with them. Moreover, since loans will be substituted for bonds, if the spending rate is not lowered, the greater the percentage of the portfolio in loans, the less that is available for bonds that can act as a deflation protection. Nonetheless, the Committee acknowledges the decision of Convention regarding community-based investments and will develop its strategy to conform to those wishes.

If the Investment Committee chooses to make exceptions to this policy pursuant to this or other non-investment considerations, it should attempt to mitigate as many of the disadvantages as possible. In particular, loans should be made for a fixed term, generally should not be renewable, should have the proper credit support, guarantees and/or mortgages, and should carry an interest rate that is appropriate for the risk inherent in the loan and is therefore more than the rate on U.S. Treasury securities of comparable maturity. Loans made at below market rates will be subsidized to reach market rates by an entity other than the investment portfolio. For risk and return considerations, the total of all loans ought not constitute more than 10% of the investment portfolio, or 25% of the fixed income portfolio, whichever is lower.

The Revolving Loan Fund is separate and distinct from and not a part of the investable portfolio. Equally, the financing of loan guarantees will not constitute an obligation of the investment portfolio.

Guidelines

Within each asset class — equities and fixed income (including loans) — investments will be diversified to reduce risk.

Equity investments in the securities of any single issuer may not exceed 5% of the portfolio.

With the exception of securities of the U.S. Government and its agencies, fixed income investments in the securities of any single issuer may not exceed 5% of the total portfolio.

Loans to any single borrower or organization may not exceed 2% of the total portfolio.

Performance Measurements

The performance figures of the portfolios will be reviewed quarterly, annually, and over a full investment cycle.

The Committee will select the most appropriate market index against which each manager is to be evaluated.

For the D.I.T. Equity Fund and the JP Morgan U.S. Equity Fund the measurement comparison will be with Standard & Poor's 500 Index. The international mutual funds will be measured against Morgan Stanley World ex-U.S. Index. Because the event-driven investment partnership is not expected to be correlated with any generally available index, it will be measured against an absolute return of 15% a year. For the D.I.T. Income Fund, it will be compared with the Lehman U.S./Corporate Bond Index. The portfolio of individual U.S. Treasury bonds is considered a defensive investment and, accordingly, will not be measured against any benchmark.

Assumptions and Caveats

The above asset allocation ought to be able to protect portfolio value and spending under conditions ranging from inflation to disinflation. It will not, however, protect portfolio value, nor spending, under conditions of deflation. Therefore, the Committee may need to consider setting aside a portion of the fixed income portfolio in long duration, non-callable U.S. Treasury bonds, which under deflationary conditions would be liquidated as necessary to provide monies to sustain the spending rate for some period of time and to forestall the need to liquidate depressed equities and other securities during the deflationary period.

Further, history proves that, under conditions of accelerating inflation, the ability of this or any other asset allocation to achieve the desired returns is impaired. Consequently, an on-going fund raising effort to add to corpus is important in order to raise the probability of achieving the portfolio’s objectives. The above asset allocation importantly assumes that contributions will be made annually in an amount equal to at least 1% of principal.

The Committee also wishes to note that undergirding its thinking is the belief that there is an interlocking relationship between balancing the spending rate and preserving the real purchasing power of principal. Varying investment returns from bonds, equities or other types of investments must influence one of three elements: either (a) revenue (or expenses) in the operating statement, (b) risk or (c) the ability to protect real purchasing power of investment assets on the balance sheet.

Finally, in applying the concept of a prudent spending rate, the Investment Committee, and the Diocese will be mindful of any donor restrictions. In those cases where a donor may have directed that a gift be held as an endowment, the spending rate contemplated by these guidelines will be applied to that gift only to the extent that the net appreciation in the fair market value of the assets representing the gift exceeds its historic dollar value, as provided for in Section 513 of the Not-for-Profit Corporation Law of New York State. Furthermore, to the extent the appreciation is "unrealized," the appreciation will be taken into consideration only with respect to readily marketable assets.

The Investment Committee will review these guidelines and the allocation policy from time to time, as the Committee believes necessary.

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NOTE:

MAXIMUM SPENDING BASED ON INFLATION-ADJUSTED INVESTMENT RETURNS
(1926-1998)

ASSUMED RATE FOR:	BONDS	5%
	EQUITIES	11%
	INFLATION	3%

	IF THE EQUITY TO BOND RATIO IS			
	0%-100%	25%-75%	50%50%	75%-25%
TAKE-OUT* SHOULD BE <u>NO MORE THAN</u>	2.0%	3.5%	5.0%	6.5%

* Before deducting investment expenses

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