Investing for Endowments and Foundations

Wespath Investment Management (Wespath) understands the unique needs of endowments and foundations affiliated with The United Methodist Church (UMC), and has a strong history of managing assets on behalf of these entities.

Endowments and foundations exist in perpetuity, and must address the challenge of finding the correct balance of risk and rewards in the management of their assets to support their ability to fulfill their mission for generations into the future.

Wespath's mission is to enable clients to meet their investment objectives while honoring the values of the UMC. We aim to do this through:

- Investing in a diversified mix of asset classes containing strategic biases
- Limiting investments in high-cost, less-liquid alternative strategies
- Implementing sustainable investment strategies

Unique needs

The investment returns generated by endowments and foundations support mission-aligned programs identified by the sponsoring institutions. Typically, because of their perpetual nature, these organizations will have a higher tolerance for risk than other institutional investors, such as pension funds with a defined benefit obligation.

Endowments and foundations design investment policies that seek to maximize investment returns, which will enable greater support of their missions. However, these institutions will also consider the predictability of the annual funds they need to disburse, and may lower their risk tolerance accordingly.

When making investments, many endowments and foundations follow two key objectives:

- To generate a high enough real return to fulfill their annual funding objectives without withdrawing principal
- To preserve the real value of their principal, which means a portion of the return attempts to protect against loss of value due to inflation

Many of these investors will target returns of roughly 6-8% in order to fund a 4-5% spending policy, plus an inflation forecast of 2-3%.

Dave Zellner
Chief Investment Officer

Dave has been with Wespath since 1997 and is responsible for the entire Investments Division, comprised of Investment Management, Investment Services and Sustainable Investment Strategies. Former employers include Shell Oil Company, where he managed equity portfolios for Shell's retirement plans and Investment Research Company (an investment management firm) where he was a portfolio manager and responsible for managing the firm's investment operations. As CIO, Dave is responsible for executing and administering Wespath's investment program as directed by its Investment Strategy Statement and Statement of Administrative Investment Policy. Dave received a bachelor's degree in Finance from Louisiana State University and his MBA from the University of Houston.

Investing for Endowments and Foundations *(continued)*

Wespath understands that prudent investing for endowments and foundations is different from prudent investing for retirement plans, and it has the flexibility to execute a strategy customized to meet the unique needs of each client.

Investing in diverse asset classes

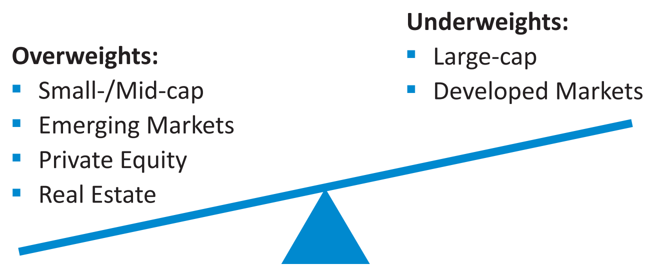
Wespath works with each endowment and foundation client to understand its funding objectives and tolerance for risk. We believe that the risk/return profile for the investments selected by Wespath's clients generally aligns with the risk/return profile of most endowment and foundation portfolios.

For example, many of our clients have chosen to invest in Wespath's Multiple Asset Fund (MAF), our flagship fund, which represents our model balanced investment fund. It allocates assets to four of Wespath's funds:

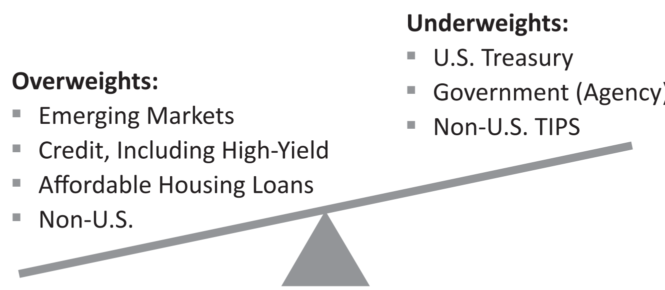
U.S. Equity Fund	35%
International Equity Fund	30%
Fixed Income Fund	25%
Inflation Protection Fund	10%

Each of MAF's component funds contains strategic biases—overweights and underweights to certain asset classes—which aim to add value that recognizes Wespath's long-term investment worldview regarding global growth and markets.

Strategic Biases—Stocks



Strategic Biases—Bonds



For example, one of Wespath's long-term investment theses is that the world will continue to see modest and sustainable growth driven by the emerging economies of Asia, Latin America, Africa and Eastern Europe. We therefore implemented a meaningful strategic allocation to emerging market stocks within our International Equity Fund, and a similar allocation to emerging market debt within our Fixed Income Fund.

We also overweight small- and mid-cap stocks within our U.S. and international equity funds compared to other institutional investors. We believe the return potential associated with the active management of small- and mid-cap stocks is greater over the long-term than what can be achieved through active management in the large-cap sector.

Also within our equity funds, we include modest allocations to private equity and private real estate. Although we believe in limiting the use of illiquid alternative assets (for reasons outlined below), we believe the strategic use of these asset classes within certain funds has the potential to add value and reduce risk through diversification.

> "The strategic use of (illiquid alternative) asset classes within certain funds has the potential to add value and reduce risk through diversification."

Wespath's performance assumption estimates an average 7% long-term rate of return for MAF[1], which aligns with a typical spending policy of 4-5% and a long-term inflation forecast of 2-3%.

Limiting investments in less-liquid alternatives

While Wespath invests a portion of its assets in less-liquid alternative investments, we do so sparingly and will invest in an alternative investment strategy only after we have conducted comprehensive due diligence on the investment and its sponsor.

Our reasons for limiting investing in less liquid alternative investments include:

- **High fees:** Most managers of alternative investment strategies charge a fee that ranges from 1% to 2% of the funds invested, and many begin charging fees at the time the investor has made the commitment (meaning that the investor will pay fees before the capital is actually deployed). In addition, most managers of alternative investment strategies will share the gains earned from the strategy. Typically, the manager will keep 20% of the gains, though many will do so only after the investor has achieved a minimum rate of return, usually 8%.
- **Limited access to the best opportunities:** The best managers of alternative investments will typically only accept capital from clients that have a long history of investing with the manager.
- **Complex legal structures:** Investors must navigate complex legal documentation before committing capital to alternative investments. This includes a comprehensive private placement memorandum, a subscription agreement and “side-letter” agreements (i.e., documents prepared by each investor that specifies the unique requirements of the investor). In addition, tax-exempt (non-profit) investors may confront potential tax implications and need to use so-called “offshore structures” to avoid a taxable event. This adds another layer of complexity to the investment.
- **Unpredictability for return of capital:** Many alternative investment structures inherently preclude access to capital when the investor may require it. Some structures do not return all capital until 15-20 years after the investor’s commitment.

Investors with high allocations to illiquid alternative investments (such as private equity, private real estate, infrastructure, etc.) often believe that doing so significantly increases future investment return potential while reducing the volatility of their overall investment mix.

However, this perceived benefit can be a mirage due to the accounting vagaries associated with fair market valuations for many alternative investments. Estimates of fair value typically trail the performance of public markets during bull markets, but also trail the performance of public markets during bear markets.

Notable is what many observed during the Great Recession. Many investors with high allocations to alternative investments were challenged by insufficient liquidity when they recognized significant declines in the value of their public securities. Attempting to raise cash to fund their operations, distribute funds to beneficiaries, and fulfill capital calls resulting from their alternative investment commitments, asset reallocation, etc., investors sought to sell their alternative investment interests through a private secondary market transaction. However, many discovered that secondary market buyers were only willing to purchase their interests at substantial discounts (as high as 50%) to the investment’s net asset value. Were these investors required to mark the value of their alternative investments based on what the secondary market was willing to pay, they would have clearly discovered that the underlying value of their assets would have suffered consistent with investors with a predominantly publicly-traded investment portfolio.

[1] Wespath’s Investment Fund Return Assumptions are developed by Wespath’s Chief Investment Officer and updated on a calendar quarter basis. They represent Wespath’s expected compounded rates of return for its funds and are developed for long-term forecasting purposes (30 years and greater).

The forecasted return for each fund is based on the projected return of the fund’s designated benchmark, which Wespath believes to be generally representative of each underlying fund’s investments. The return assumptions also include Wespath’s expected value added from active strategies including, as applicable, alternative investment strategies. In addition, the projected returns reflect the expected impact of management, administrative and custodial fees, transaction costs and other relevant expenses.

Wespath does not forecast changes in interest rates, nor does it predict near-term market returns for its funds. Wespath fully expects that the near-term performance of its funds will significantly differ, either positively or negatively, from its long-term assumptions. There are numerous investment-specific assumptions that factor into the long-term investment fund return assumptions that may not be consistent with future market conditions and that may be significantly different than the actual investment results achieved by the funds. The return assumptions for the investment funds set forth above are not a prediction or projection of actual investment results and there can be no assurance that any will be achieved, or that losses, lower yields or higher risk levels will be avoided.

The assumptions contained herein do not constitute investment recommendations and are not a promise of future performance.

Investing for Endowments and Foundations *(continued)*

Table 1

**Hedge Funds Massively Outperformed Stocks—
5 Years Ending 12/31/02**

Asset Class	Returns	Risk
Bonds	7.5%	3.3%
Stocks	-0.6%	18.8%
Hedge Funds	13.2%	7.1%

Table 2

**Hedge Funds Have Trailed Badly Since—
12/31/2002 to 9/30/18**

Asset Class	Returns	Risk
Bonds	3.8%	3.3%
Stocks	10.1%	13.1%
Hedge Funds	1.6%	5.2%

Bonds	Bloomberg Barclays U.S. Aggregate Bond Index
Stocks	S&P 500 Index
Hedge Funds	HFRX Global Hedge Fund Index
Returns	Compounded annual returns
Risk	Annualized standard deviation of monthly returns

Source (Tables 1 and 2): Hedge Fund Research[2], Wilshire Compass, Wespath

Liquid alternative investment strategies typically include so-called "absolute return" and hedge fund strategies. These strategies aim to produce positive long-term investment returns under all markets. Wespath intentionally and successfully avoids hedge fund investing for the reasons cited in the Wespath paper: "Wespath's Hedge Fund Strategy—The Path Not Followed" available here: **wespath.org/HedgeFundStrategy**.

Clearly, as illustrated in Table 1 above, hedge funds delivered outstanding results during the five years ending December 31, 2002. The few institutional investors with hedge fund allocations reported enviable absolute and relative returns. The success of hedge funds, along with a belief that they would continue to deliver meaningful diversified returns, fueled the rapid growth of hedge fund investments. According to historical data from Statista, assets invested in hedge funds totaled roughly $500 billion at the end 2002. By the third quarter of 2018, that number had grown to over $3.2 trillion according to recent data from hedge fund research provider HFR.

However, hedge fund performance subsequent to 2002 has been lackluster. As illustrated in Table 2 above, the average hedge fund actually produced an average compounded return of slightly less than 2% for the past 15 years.

While Wespath does not offer a prediction of future performance of hedge funds compared to the broad bond and stock indexes, we remain skeptical that hedge funds will ever be able to deliver the results that many hedge fund investors expect.

Implementing sustainable investment strategies

Endowments and foundations—including those affiliated with the UMC—often seek to align their investments with their missions. Wespath seeks to invest in a way that upholds the values of the UMC.

Wespath invests in a sustainable and responsible manner, creating long-term value for its retirement plan participants and institutional clients while honoring UMC values. This means we incorporate the consideration of environmental, social and governance (ESG) factors into investments across asset classes and in the selection of external asset managers. We do this because we believe these efforts support long-term value creation while having a positive impact on the environment and society.

[2] Source: Hedge Fund Research—The HFRX Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry. Hedge Fund Research, Inc. (HFR) utilizes a UCITSIII compliant methodology to construct the HFRX Hedge Fund Indices. The methodology is based on defined and predetermined rules and objective criteria to select and rebalance components to maximize representation of the Hedge Fund Universe. HFRX Indices utilize state-of-the-art quantitative techniques and analysis; multi-level screening, cluster analysis, Monte-Carlo simulations and optimization techniques ensure that each Index is a pure representation of its corresponding investment focus.

It is our duty as fiduciaries to help promote sustainable practices and policies—88% of global sustainability studies demonstrate that companies with solid ESG practices achieve stronger operational performance; 80% of studies show good sustainability practices positively influence stock price[3].

The UMC also instructs us to "make a conscious effort to invest in institutions, companies, corporations, or funds with policies and practices that are socially responsible, consistent with the goals outlined in the Social Principles." (*The Book of Discipline of The United Methodist Church 2016*, ¶717) Wespath's wide-ranging sustainable investment activities are described as *Avoid—Engage—Invest (see box below).*

Conclusion

Wespath understands that its endowment and foundation clients have unique goals and concerns compared to other institutional investors. We closely consult with our clients to develop an asset allocation strategy that addresses these unique requirements. While Wespath prefers to allocate fewer assets to alternative investment strategies compared to some endowments and foundations, its investment strategy—with a focus on diversification, limiting less liquid alternatives, and sustainable investing, aligned with UMC values—has stood the test of time.

- **Avoid**—Based on long-standing United Methodist social concerns, Wespath avoids investing in companies that relate to the ethical exclusions set by the United Methodist Church, or because of the sustainability-related financial risk they pose to the funds we manage.
- **Engage**—Wespath engages dozens of companies on issues linked to corporate performance and value, such as climate change, human rights and board diversity. Most engagement efforts occur behind the scenes through in-person meetings (or conference calls) with company executives. Other efforts are more public, like letters to public policymakers or filing shareholder resolutions, on which investors vote at companies' annual general meetings. Engagement is our opportunity to enter into constructive, and persuasive, dialogue with companies and policymakers, expressing concerns, offering suggestions and working together to encourage sustainable policies and practices.
- **Invest**—We seek to invest in companies that will generate a market-rate return and demonstrable social and environmental impact.

[3] "*From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Performance*" (March 2015); University of Oxford and Arabesque Partners

Updated December 2018 with revised hedge fund asset data.

Wespath

BENEFITS | INVESTMENTS

Caring For Those Who Serve

1901 Chestnut Ave.
Glenview, IL 60025-1604
847-869-4550
wespath.org

About Wespath Investment Management

Wespath Investment Management (Wespath) is a division of Wespath Benefits and Investments, a general agency of The United Methodist Church. Wespath provides investment solutions for the endowment and retirement plan (defined contribution and defined benefit) portfolios of United Methodist-affiliated institutional investors, including foundations, higher education institutions, health care organizations and churches through a broadly diversified family of daily-priced funds. Wespath's investment process proactively incorporates the consideration of environmental, social and governance (ESG) factors into investments across asset classes and in the selection of external asset managers. Wespath's activities promoting sustainability include proxy voting, corporate and public policy engagement, and positive impact investing. As of September 30, 2017, total assets under management were approximately $23 billion.