Glebe Administration Board

Diocesan Endowment
Report on September 2010 Quarter Performance

Introduction

1. The purpose of this paper is to report on the investment performance of the Diocesan Endowment for the September 2010 quarter.

Background

Investment Management of the Diocesan Endowment

2. At the end of 2009, GAB reconsidered the way in which investment management of the Diocesan Endowment should be undertaken. In undertaking this reconsideration, GAB sought investment management proposals from 4 of the main asset consultants to other endowments and foundations in Australia and obtained proposals from 3 of those consultants. Subsequently, GAB determined to appoint Mercer Australia Pty Limited ("Mercer") as its asset consultant under an implemented consulting arrangement. Under this arrangement the role of Mercer is –
   (a) to provide advice on high level strategic issues concerning the investment of the property of the Diocesan Endowment, including its investment objective, risk tolerance, strategic asset allocation, asset class investments and distribution policy, and
   (b) to provide advice on and assist with the implementation of the investment arrangements approved by GAB, and
   (c) to monitor and report on all aspects of investment performance.

3. Under clause 2 of the *Glebe Administration Ordinance 1930*, the principal objective of GAB in relation to the investment of the Diocesan Endowment is to maintain the real value of the Endowment and provide a reasonable income there from. Having regard to this principal objective, and with the assistance of Mercer, in early 2010 GAB reviewed the investment objective for the Diocesan Endowment, the risk tolerance, the nature of the asset classes in which the Diocesan Endowment should invest, and the strategic asset allocations and ranges for those asset classes.

4. The framework adopted by GAB for the investment of the property of the Diocesan Endowment is set out in its Investment Policy Statement, a copy of which can be found at http://www.sds.asn.au/Site/104303.asp?ph=cb

Investment Objective for the Diocesan Endowment

5. The investment objective of the Diocesan Endowment is as follows –

   > "To achieve a real rate of return over rolling 5 year periods of 5% per annum net of external investment management fees and adjusted for tax effects, subject to –
   > (a) preserving the real value of the Diocesan Endowment over rolling 10 year periods with a 70% probability, and
   > (b) the sum of the distributions from the Diocesan Endowment plus administrative and other costs (not including external investment management expenses) not exceeding, on average over rolling 5 years periods, 5% from 2013."

6. The investment objective includes not only a return objective, but also a statement as to risk tolerance and a distribution and costs policy. While each of these components is related, it is not necessarily appropriate to measure them over the same time periods.

7. The return objective is to achieve a real rate of return over rolling 5 year periods of 5% per annum, after external management fees and adjusted for tax effects. For this purpose, the real rate of return is the excess of the nominal return above the corresponding movement in the consumer price index (CPI). The reference to "tax effects" recognises that there are some tax characteristics of the Endowment which need to be taken into account in calculating the return (such as recognising that

imputation credits can be obtained on dividends paid by Australian companies, but withholding or other similar taxes on overseas investments cannot be reclaimed). Stated simply, the return objective for the Endowment is CPI plus 5% per annum over rolling 5 year periods.

8. Paragraph (a) of the investment objective sets out the statement as to risk tolerance, namely, that the real value of the investments be maintained over a rolling 10 year period with a 70% probability. This statement reflects that the achievement of the principal objective, being the maintenance of the real value of the Endowment and the provision of a reasonable income there from, requires risk to be incurred. For example, this objective could not be achieved if the property of the Diocesan Endowment was held only in capital guaranteed investments since the return on those investments would be insufficient to enable the real value of that property to be maintained, and provide a reasonable income to pay administration costs and make distributions. The statement of risk tolerance recognises that there is a 30% probability that the real value of the Endowment will not be achieved over a rolling 10 year period. After taking advice from the asset consultant, GAB considers that this level of risk tolerance is appropriate for the Endowment. However, the risk tolerance for the investment of the Endowment will be reviewed by GAB annually with the assistance of the asset consultant.

9. The distribution and costs policy is stated in paragraph (b) of the investment objective, namely, that the sum of the distributions from the Endowment and the administration costs (other than external investment management expenses) is not to exceed 5% per annum, on average, over rolling 5 year periods from 2013. This policy limits distributions and costs to no more than 5% per annum, so as to ensure that the real value of the Endowment can be maintained. 2013 is stated as the commencement for this policy since, under the *Diocesan Endowment (Special Distributions) Ordinance 2009*, distributions to the Synod for appropriation in 2010 (for spending in 2011) and 2011 (for spending in 2012) have been prescribed. Further comment about the distribution and costs policy is made later in this paper.

Asset Classes and Strategic Asset Allocation

10. Having regard to the return objective, the statement of risk tolerance and the distribution and costs policy, and after taking advice from its asset consultant, GAB has adopted the following asset classes, strategic asset allocations (SAA), asset class and rebalancing ranges for the investments of the Diocesan Endowment –

Asset Class	Min %	Rebalancing Min %	SAA %	Rebalancing Max %	Max %
Australian Shares	15	20	25	30	35
Overseas Shares – Developed	0	13	18	23	28
Overseas Shares – Emerging	0	1	2	3	5
St Andrew's House	20	n/a	25	n/a	30
Legacy Assets	0	n/a	0	n/a	3
Total Growth Assets	***50***	***65***	***70***	***75***	***80***
Australian Sovereign Bonds	0	7	10	13	20
Global Sovereign Bonds	0	3	7	10	20
Banking Services (net capital)	10	n/a	13	n/a	20
Other cash (not included in Banking Services)	0	n/a	0	n/a	30
Total Defensive Assets	***20***	***25***	***30***	***35***	***50***

11. Asset classes regarded as "growth" assets comprise 70% of the SAA of the portfolio, and asset classes regarded as "defensive" assets comprise the balance of 30%. There are minimum and maximum limits for investments in each asset class and, within those limits, is a rebalancing range.

12. GAB, as trustee of the Endowment, is a holder of a 50% interest in St Andrew's House (the other 50% stakeholder is Anglican Church Property Trust Diocese of Sydney as trustee of the Endowment of the See). GAB considers that the investment in St Andrew's House represents an unacceptable

concentration risk given the size of that investment compared with the total net assets of the Endowment. However, it accepts that there is little likelihood of realising the asset in the short term.

13. The strategic asset allocation for the banking services reflects the amount of capital of the Endowment allocated to the banking services (loans and mortgages, Glebe Income Accounts and treasury activities) undertaken by the Endowment.

14. The legacy assets comprise a range of illiquid assets currently held by GAB. The main legacy assets are 2 investments in unlisted property funds and a deposit with an authorised deposit taking institution. It is intended that these assets be liquidated in a commercially prudent manner, and the proceeds invested in the other approved asset classes. By April 2011, the value of the legacy assets is expected to be less than $50,000.

Invested Funds

15. Investments in the Australian shares, Overseas shares, Australian Sovereign bonds and Overseas Sovereign bonds asset classes are undertaken through multi-managed funds operated by Mercer Investment Nominees Limited and approved by GAB. Before the investments in these funds were approved due diligence was undertaken having regard to the investment policies of GAB referred to in the Investment Policy Statement.

16. The investment policies of GAB include the ethical investment policy, and the currency hedging policy. The ethical investment policy requires that a managed fund in which the property of the Endowment is invested, or an underlying pooled product, must not conduct as its main business, or one of its main businesses a “disapproved business”, and the fund or trust must not invest mainly in the securities of a corporation or scheme which conducts a “disapproved business” as its main business or one of its main businesses. A “disapproved business” is one of those businesses prescribed as disapproved by the Standing Committee from time to time.

17. In relation to currency hedging, the following policies apply –

(a) the exposure to Overseas Shares - Developed Markets asset class is to be 40% hedged (reflecting the view of the asset consultant that the Australian dollar is overvalued relative to foreign currencies), and
(b) the exposure to Overseas Shares - Emerging Markets asset class may be unhedged, since it is impracticable to hedge that asset class, and
(c) the exposure to other Overseas asset classes is to be hedged, wherever practicable.

18. The approved funds for each asset class are as follows –

Asset Class	Mercer Investment Product
Australian Shares	Mercer Socially Responsible (SR) Australian Shares Fund
Overseas Shares – Developed (hedged)	Mercer Hedged Overseas Shares Plus Fund
Overseas Shares – Developed (unhedged)	Mercer Overseas Shares Plus Fund
Overseas Shares – Emerging (unhedged)	Mercer Emerging Markets Fund
Australian – Sovereign Bonds	Mercer Australian Sovereign Bonds Fund
Overseas – Sovereign Bonds (hedged)	Mercer Overseas Sovereign Bonds Fund

19. The transition to investments in those funds in accordance with the strategic asset allocation was completed on 4 June 2010.

20. GAB considers that investing by way of multi-managed funds benefits the Endowment in several respects –
(a) the multi-managed funds give the Endowment exposure to a range of investment managers, thus reducing the risks associated with over-exposure to any one manager, and
(b) Mercer, rather than GAB, is responsible for monitoring and assessing the performance of each investment manager, and

(c) the use of such funds has enabled the simplification of the investment processes of GAB and reduced the overall costs of administering the Endowment (for example, the use of such funds enabled the winding up of the Glebe Equities Trust which was an internal structure through which investments in Australian shares were formerly undertaken).

Measurement of Performance

21. GAB has determined that performance of the market-linked investments in which the Endowment invests will be measured against the following indices –

Asset Class	**Index**
Australian Shares	S&P/ASX 300 Accumulation Index
Overseas Shares –Developed (hedged)	Morgan Stanley Capital International World Index (ex Aust) hedged into $A with net dividends reinvested
Overseas Shares – Developed (unhedged)	Morgan Stanley Capital International World Index (ex Aust) in $A with net dividends reinvested
Overseas Shares – Emerging (unhedged)	Morgan Stanley Capital International Emerging Markets Free Float Index
Australian Sovereign Bonds	UBSW Australian Treasury Bond Index (All Maturities)
Global Sovereign Bonds	JP Morgan Global Government Bond Index in $A (Hedged)

22. These indices are used by Mercer to benchmark the performance of the relevant Mercer investment products. GAB is satisfied that they are reasonable indices, although as noted later in this paper, consideration is to be given as to whether there is an Australian shares index for ethical and socially responsible funds which may be more appropriate for benchmarking the performance of the Australian Shares investment (which is undertaken via a Mercer socially responsible fund).

23. The performance of the St Andrew's House investment and the Legacy Assets is measured against the proxy index of CPI plus 5% per annum (which is the investment objective). The return on loans is measured against the benchmark of the 3 monthly bank bill mid index rate plus 0.75%. These indexes are considered by GAB to be appropriate for these asset classes.

Risk

24. GAB monitors the risk associated with the investment of the Endowment on an ongoing basis.

25. GAB manages the investment of the Endowment so that under adverse market conditions the expected loss (whether realized or unrealized) from investments and loans over rolling one year periods is not more than 20% of net assets with a 95% probability. This is monitored by GAB using a value at risk (VaR) methodology. Reports about Value at Risk are provided each month to the Asset and Liability Committee of GAB.

26. In addition, stress testing of the portfolio is now undertaken on an ongoing basis. This involves modelling the impact of extreme market conditions (such as those associated with the 1987 share market crash and the 2007–2009 Global Financial Crisis) to understand the impact on the Endowment if similar events were to occur in future, and the action GAB should take in response to such events.

27. The terms of engagement of the asset consultant require that it undertake an annual "health" check of the investment policy and investments of the Diocesan Endowment. This check will include an annual review of the risk associated with the investment of the property of the Endowment. The next check is to be undertaken in March 2011.

Distribution Policy

28. The distribution and costs policy stated in paragraph (b) of the investment objective is that the sum of the distributions from the Endowment and the costs of administering the Endowment (excluding external investment management expenses) is not to exceed 5% per annum, on average, over rolling 5 year periods from 2013. This policy limits distributions and costs to no more than 5% per annum, to enable the real value of the Endowment to be maintained.

29. GAB considers that the current level of distributions, together with the costs of administering the Endowment, are too high to enable the real value of the Endowment to be maintained on a rolling 5 year basis. GAB will recommend to the Standing Committee by the end of 2010 a new methodology to be applied in 2011 for determining the level of distributions from the Endowment having regard to the need to maintain the real value of the Endowment. In addition, GAB has taken steps to significantly reduce the costs of administering the Endowment and these cost reductions will be reflected in the budget for the Endowment in 2011.

Investments of the Diocesan Endowment – September 2010 Quarter

30. The following table sets out the investments of the Endowment as at 30 June 2010 and 30 September 2010 –

Assets	Policy Weighting	As at 30 June 2010		As at 30 September 2010	
	%	$'000s	% weight	$'000s	% weight
Growth Assets					
Australian Shares	25	25,499	24.6	26,924	25.6
Overseas Shares – Developed	18	16,109	15.6	16,828	16.0
Overseas Shares – Emerging	2	1,784	1.7	1,822	1.7
St Andrew's House	25	27,912	27.0	28,447	27.0
Legacy Assets	0	2,307	2.2	2,304	2.2
Total Growth	**70**	**73,611**	**71.1**	**76,325**	**72.5**
Defensive Assets					
Australian Sovereign Bonds	10	9,682	9.4	9,255	8.8
Overseas Sovereign Bonds	7	4,320	4.1	4,353	4.1
Investment Cash	0	2,125	2.1	1,515	1.4
Banking Services	13	13,806	13.3	13,852	13.2
Total Defensive	**30**	**29,933**	**28.9**	**28,975**	**27.5**
Total (Net Assets)	**100**	**103,544**	**100.0**	**105,300**	**100.0**

31. While the strategic asset allocation for Overseas Sovereign Bonds is 7.0%, the actual asset allocation is 4.1%. This reflects that this asset class is considered to be overvalued. In the medium term, on the advice of our asset consultant, GAB has determined that an amount be retained and invested as cash (Investment Cash).

Performance – September 2010 Quarter

32. The performance of the portfolio during the September 2010 quarter was as follows –

Assets	September Quarter %		
	Return (after fees)	Index	Variance
Growth Assets			
Australian Shares	6.8	8.3	(1.5)
Overseas Shares – Developed (hedged)	11.5	9.9	1.6
Overseas Shares – Developed (unhedged)	(0.3)	(1.1)	0.7

Assets	September Quarter %		
	Return (after fees)	Index	Variance
Overseas Shares – Emerging (unhedged)	4.0	3.0	1.0
St Andrew's House	1.9	1.9	0.0
Legacy Assets	2.1	1.9	0.3
Defensive Assets			
Australian Sovereign Bonds	0.8	1.0	(0.2)
Overseas Sovereign Bonds (hedged)	3.3	3.4	(0.1)
Loans	1.7	1.4	0.3
Cash	1.5	1.1	0.4
Total Return on Net Assets Vs Weighted Index	**3.3**	**2.2**	**1.1**

33. By reason of the significant changes to the SAA and method of investment management of the Endowment during June 2010, calendar year to date performance has not been included.

34. Mercer have reported in writing to GAB about the performance of the investments in Mercer multi-managed funds for the September quarter, and made a presentation to a meeting of GAB's Asset and Liability Committee. The comments in relation to each asset class can be summarised as follows.

Australian Shares

35. The investments of the Mercer SR Australian Shares Fund, in which the Endowment invests, are invested in ethical funds conducted by 3 underlying investment managers. The main reasons why the Australian shares asset class underperformed the market index during the September quarter were –
    (a) During the September quarter resource stocks performed strongly on the back of strong commodity prices. However, the Mercer Fund is significantly underweight (compared to index) in one major resource stock since that stock is excluded from the portfolio of one underlying investment manager due to uranium mining and environmental concerns. The underweight position detracted from performance compared to index.
    (b) Another underlying manager underperformed the index because it held an overweight position in a large company with an exposure to the United States, and the weak performance of the US dollar during the September quarter impacted the return on the shares in that company.

36. The underlying investment managers have collectively outperformed the index, after fees, over a longer period than 3 months.

37. The index by which the performance of the Mercer SR Australian Shares Fund is measured is the general market index, whereas the Fund is a socially responsible fund. Consideration is to be given as to whether there is a more appropriate index against which performance of the Fund should be measured.

Overseas Shares – Developed

38. The Overseas Shares – Developed Markets asset class performed strongly during the September quarter. However, the large rise in the Australian dollar during the September quarter detracted from the return for the unhedged portion of the Overseas Shares – Developed asset class.

Emerging Markets

39. Emerging markets performed solidly during the September quarter as the sector benefits from much stronger economic growth than developed markets. The portfolio outperformed the index by reason of strong stock selection and favourable country exposure, notwithstanding adverse currency movements.

Australian Sovereign Bonds

40. The Australian Sovereign Bond asset class modestly underperformed the index because of the active management strategy of one of the underlying investment managers.

Overseas Sovereign Bonds

41. The Overseas Sovereign Bond asset class modestly underperformed the index, after fees were taken into account.

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Chief Executive Officer

22 November 2010