# Investment Fund Options

PO Box 2590
Pasadena, CA
91002-2590

626.568.7347
www.cpumf.org

# Background of the
# California-Pacific United Methodist Foundation
# Investments Funds

The California-Pacific United Methodist Foundation (the foundation) serves the needs of its investors through a disciplined investment process consistent with the principles of our congregations. We can meet those needs effectively by providing investment solutions that allow for closer alignment to the varying time horizons of our investors.

Some congregational initiatives have near-term horizons where a low risk appetite is appropriate. By contrast, other projects have a longer path to realization. This longer investment horizon may permit taking greater amounts of risk to achieve a higher level of return. In response to these diverse requirements, the foundation offers three investment solutions to address the needs of our clients.

# Summary of Solutions

The investment committee identified three areas of need for our investors that we can uniquely serve.
*Near-Term* – For projects and initiatives that have a time horizon of approximately 2-5 years, it may be prudent to invest much of the allocated capital with an emphasis on stability and limited risk. We created the Near-Term strategy for exactly this purpose. The goal of this strategy is to provide an incremental return over simple depository or checking accounts.

We seek to accomplish this by allocating approximately 80% the invested capital into short and intermediate maturity, investment grade fixed income securities such as US Treasuries and investment grade corporate debt. The remaining 20% allocation is to US and non-US equities and other diversifying assets.

As an important reminder, the Near-Term strategy is not a replacement for cash. We encourage investors who will be using specific funds within 6 to 12+ months to consider holding those dollars as actual cash deposits or equivalent.

*Growth* – This strategy represents the existing foundation portfolio with a few subtle adjustments that we will cover in detail later. Ideally, investors in the Growth strategy will have an investment horizon of approximately 5 years or more. The portfolio is designed to meet the needs of investors seeking a “moderate” allocation to risk and return.

The portfolio consists of 65% US and non-US equities, 30% fixed income securities and 5% in diversifying risk assets. We believe this allocation mix meets the baseline needs for many constituents seeking a moderate amount of market participation without being excessively conservative or overly risky.

*Growth+ (Plus)* – We developed the Growth+ portfolio for those members who are comfortable taking a higher risk, higher return stance relative to our other strategies. The intended investment horizon is no less than 7 years and ideally 10+ years. This additional time frame is in direct recognition of the potential for greater short-term volatility.

The strategy holds 80% of its allocation in US and non-US equities, 15% in fixed income securities and 5% in diversifying risk assets. Our intention with this portfolio is to better meet the needs of investors who believe their investment goals are better suited to an "aggressive" asset allocation.

## Asset Allocation

One approach to building an asset allocation is to think of the different components of our asset allocation individually and then combine them into an overall portfolio. The investment horizon time periods mentioned below are merely guidelines based upon historical results and should be considered as general recommendations.

*Cash* – As an asset, cash offers very little in the way of risk or return. Once we adjust for the effects of even modest inflation, we often see that cash has a negative real rate of return. Cash's greatest characteristic is instant liquidity. As mentioned earlier, cash is an ideal asset for use in projects that require spending in the next year or so.

*Short-term Bonds* – Short-term or short maturity bonds typically offer lower yields and are less sensitive to changes in interest rates. The multi-year returns for this type of bond is typically greater than cash and generally above the rate of inflation as well. An allocation to short-term bonds is consistent with a 1-3 year investment horizon.

*Intermediate Bonds* – Typically this is what investors are thinking when they invest in fixed income securities. Returns are often in the single digits and may trend lower over time in a sustained, low interest rate environment. Investors historically utilize this class of bonds to provide income and offset volatility in the equity markets given the asset class's role as a diversifier. Intermediate bonds have greater interest rate sensitivity than short-term bonds and may deliver a modest negative return in a brief period where interest rates increase significantly. An investor's time horizon should span 2-5 years depending on the type of intermediate bond and the investor's outlook on interest rates.

*US Large Cap Equities* – Stocks are certificates of partial ownership in a corporation. If the company grows and is successful, the value of the stock typically goes up. Stocks offer greater upside potential to bonds, but also greater risk in the potential for loss. US Large Cap Equities are often considered to be among the safer options among the equity asset classes due to the companies' larger size and market(s) of operation. Assets allocated into US Large Cap Equities should consider a minimum investment horizon of 5 years. Although historical returns indicate an average annualized return of ~10% per year, it is important to note that periods like the Dot-Com collapse and the Credit Crisis resulted in significant and prolonged losses for even less-aggressive large cap equity portfolios.

*US Small Cap Equities* – This asset class features even greater risk and reward potential compared to US Large Cap. The companies are smaller, more nimble and often faster growing. However, they are also more susceptible to economic uncertainty. When things are good, small caps tend to do well, but when things go bad, small caps can bear the brunt of a market downturn. Investment horizons to small cap often exceed 7-10 years given the greater potential for loss.

*Non-US Developed Market Equities* – It's a big planet and although the United States is the world's single largest economy, we often see significant sources of global growth generated abroad. Investments in developed markets outside the U.S. can offer both greater risk and reward potential compared to US large caps. An additional consideration is the role of currency exchange. A decline in the strength of the U.S. Dollar is beneficial for non-U.S. returns and a strengthening dollar can reduce the effective returns for this asset class. Investors should consider a time horizon like US Small Cap Equities of 7-10 years.

*Emerging Market Equities* –Among diversified groups of equites, emerging markets may be among the riskiest of asset allocations with a greater potential for positive and negative returns. The countries considered to be emerging markets are notably among the fastest growing markets in the world, but they are also the most sensitive to global macro-economic events. One amusing but surprisingly accurate anecdote to this effect is, "When the United States sneezes the world catches a cold." Like Non-US Developed Market Equities, fluctuations in the U.S. Dollar can have a meaningful impact on return. Investors in emerging markets should have a long-term investment perspective and be able to hold an allocation here for at least 10 years or more.

*Gold and other diversifying assets* – Several alternative investment options exist for investors seeking returns that don't correlate closely with stocks or bonds. We have found gold to be effective for this purpose. Gold behaves as a unique offset to volatility in both the stock and bond markets, and it also often serves as an effective tool for addressing surprises in inflation. Investors in gold should consider an investment horizon somewhere between U.S. large or small cap equities.

Table 1 summarizes the asset classes we have described so far:

*Table 1 - Asset Class Summary*

| Asset Class | Risk Potential | Reward Potential | Horizon |
|---|---|---|---|
| Cash | None – Inflation loss | Very little | Immediate |
| Short-term Bonds | Very little | Limited | 1-3 years |
| Intermediate Bonds | Modest | Modest | 2-5 years |
| US Large Cap Equities | High | High | 5+ years |
| US Small Cap Equities | Higher | Higher | 7+ years |
| Non-US Developed Mkts | Higher | Higher | 7+ years |
| Non-US Emerging Mkts | Highest | Highest | 10+ years |
| Gold | High | High | 5-7+ years |

## Strategy Allocations

Table 2 details some key breakdowns and characteristics of the target allocations, which is then followed by descriptive text for each strategy.

*Table 2 - Strategy Allocations and Characteristics*

| Asset Class | Near-Term | Growth | Growth+ |
|---|---|---|---|
| Cash | - | - | - |
| Short-term Bonds | 40% | - | - |
| Intermediate Bonds | 40% | 30% | 15% |
| US Large Cap Equities | 11% | 30% | 30% |
| US Small Cap Equities | - | 15% | 20% |
| Non-US Developed Mkts | 5% | 15% | 20% |
| Non-US Emerging Mkts | - | 5% | 10% |
| Gold | 4% | 5% | 5% |
| | | | |
| Approx. Annualized Return (15yrs) | 3.9% | 6.8% | 7.2% |
| Worst year | -3.7% (2008) | -26.3% (2008) | -33.3% (2008) |
| Best year | 9.1% (2009) | 24.6% (2009) | 30.8% (2009) |
| Worst 36 month period (Annualized) | 2% | -8% | -10% |
| Best 36 month period (Annualized) | 9% | 21% | 24% |

## Active vs. Passive

We pay active managers a fee under the premise they will outperform their given asset class benchmark over some reasonable period of time. History has shown that there are some very successful active managers who systemically create value over time, and by contrast there are many that do not. Unfortunately it seems almost impossible to predict whether an active manager will outperform in a given period. We can only focus on the dimensions of people, philosophy, process and performance (colloquially, the 4-P's) to assess if a manager has the requisite skills to create a long-term beneficial outcome.

Passive investing involves a much lower investment cost but we lose the potential to outperform a given asset class benchmark. If we deem a target benchmark for a given asset class to be sufficient for our needs, then a passive implementation for that asset class may be preferable. With active managers we focus on the 4-P's, but for passive solutions we need to look at the underlying index construction methodologies involved and understand how aligned our chosen investment vehicle is to our intended allocation target.
One final consideration ties to our next topic but we can touch on it here as well. With an actively managed separate account we own positions in the individual underlying securities. By contrast, mutual funds and ETF are pooled vehicles where we own a portion of the pool but not the individual securities. Currently we use actively managed separate account for the majority of our strategy implementation because we can exclude individual positions that do not align suitably to the social guidelines of the foundation

## Social Guidelines

Implementing social guidelines within the strategies entails a few considerations. It may make sense to review our option

**Negative Exclusion** – This is the approach we are currently using for much of our existing portfolio implementation. Negative exclusion simply restricts the portfolio managers from owning any of a number of non-permissible companies whose lines of business are deemed unacceptable. The residual, unallocated capital is then distributed pro-rata to the remaining, acceptable positions with the portfolio. Though very comprehensive and easy to implement, assuming the exclusion list is current and correct, there are a few unintended consequences with this approach.

First, many large companies engage in broadly diverse lines of business and sometimes the social challenges of one side are offset by the social good of another. A loose example would be European oil producers who indeed represent a large portion of energy exploration and exploitation but also represent nearly all of the new renewable energy capacity currently under development in Europe. Forgoing investment in Royal Dutch Shell on the basis of their oil business also forgoes them as the single largest European investor in renewables.

Second, the portfolio managers are not necessarily aware that a given set of holdings are excluded from the portfolio they provide to us and that can lead to unintended consequences with performance, either positively or negatively.

**Socially Aligned Strategies/Mutual Funds/ETFs** – These are portfolios that have taken into account their social guidelines from the onset of portfolio construction. Here we avoid the unintended consequences of a potentially imbalanced portfolio from the negative exclusion approach. However, the social priorities of these strategies may not align sufficiently with the priorities of our congregations. Also there is no guarantee that an undesirable sector is completely avoided, it may only be underweight a given allocation depending on construction methodology.

In addition some social strategies and funds are be more expensive from an investment fee basis than our existing separate account implementation. By contrast, some of the socially responsible, passive ETFs may be less expensive.
Lastly, the number and variety of different socially responsible strategies is still relatively small but growing every year. As this portion of the industry matures we may see more and more suitable options come to market.

## Foundation Policies Regarding Accounts

**Opening an Account**—A minimum deposit of $5,000 is required to open an account with the Foundation. The Foundation Staff will provide an agreement for your review. When the funds are received and account will be activated for the client. It is highly recommended that congregations/ministries will have adopted gift receipt as well as spending policies. This will be of great assistance to future volunteers responsible for the funds. If these policies exists, we request copies of them so that they may included in our files. Two signing agents will be required from your organization. It is recommended that you name specific "officers" as opposed to "specific persons" as volunteers change regularly. It is the client responsibility to update signatures with the Foundation Office.

**Adding to the Account**—Additional deposits of any amount may be made to your account at any time. These deposit can be accomplished through checks, stock transfers or wire transfers. For specific instructions please contact the Foundation Office

**Allocation of Funds**—Clients are given the opportunity, quarterly, to reallocate funds between the Near-Term, Growth, and Growth+ investment funds. Allocation changes must be received by the 25th of the month prior to the start of the next quarter (December, March, June, September). In order to be in more than one fund, there must be a minimum of $10,000 in each fund in which the client chooses to participate.

**Distribution of Funds**—Clients may set up automatic distributions or distributions upon request. Automatic Distributions should be arranged with the Foundation Administrator. Distribution happens the first of each month. Requests must be made, in writing, to the Foundation no later than the 25th of the previous month. A scan of the signed request is acceptable but should be followed with hard copy mailed to the Foundation Office. If a wire transfer is needed, you must speak with the Foundation Administrator.

**Fees**—the Foundation has a sliding fee scale. Fees shown are annualized and are deducted from accounts on a monthly basis.

*Foundation Fees as of 1/1/20*

| Account Size | Basis Points (on an annual basis) |
|---|---|
| **GROWTH, GROWTH+** | |
| $0—$1,000,000 | 148 basis points |
| $1,000,001— $5,000,000 | 123 basis points |
| $5,000,001 + | 113 basis points |
| **NEAR-TERM** | |
| All Accounts | 110 basis points |