

The Statement of Investment Guidelines

Provided by the General Council on Finance and
Administration of The United Methodist Church

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Disclaimer:

GCFA does not provide legal, accounting or investment advice, nor do we make recommendations on specific investments.

PREFACE

The General Conference has assigned responsibility for investment policy to the General Council on Finance and Administration. The assignment is presented in ¶ 806.12 of *The Book of Discipline of The United Methodist Church 2016* as follows:

“It shall develop general investment policies and guidelines for all agencies receiving general Church funds (see ¶ 810.2), following consultation with those agencies. The council, in its oversight capacity, shall review those agencies’ compliance with the general investment policies and guidelines. Upon their review, the council may recommend that an agency take certain actions to conform with these policies and guidelines. These guidelines are recommended for all Church organizations. If requested by an agency, the council shall provide consultation and assistance on the development of specific investment policies and the selection of investment counselors and managers. The council shall review, on at least an annual basis, the performance of all invested funds of all agencies receiving general Church funds. The council shall have complete authority to manage any portfolio of less than \$5,000,000 and may, upon request by the agency, manage larger portfolios. The council and general agencies are encouraged to invest in institutions, companies, corporations, or funds that make a positive contribution toward the realization of the goals outlined in the Social Principles of The United Methodist Church (¶¶ 160-166).”

As stated above “these guidelines are recommended for all Church organizations”. Specifically, these Investment Guidelines apply to all general agencies which receive general Church funds, as well as jurisdictions, annual conferences, local churches, and other agencies and institutions, all of whom are encouraged to use these guidelines in accordance with their basic understanding of Christian stewardship of assets and investments. These guidelines should also be used in conjunction with their own independent evaluations of their responsibilities and interests and the opportunities and risks involved in investing.

These guidelines do not prescribe specific solutions to issues or problems, but are an outline of the elements of a general investment policy. They outline a structure and process designed to facilitate broad participation in decision making based on a sound understanding of the elements of investing and full acceptance of the responsibilities for total stewardship of the assets and investments.

DOING GOOD WHILE DOING WELL

Individuals, agencies, and institutions are called by God to be faithful witnesses to the Gospel in the world and to express that faith in the way in which resources are used and invested. In the words of the “Preface to the Social Principles” we are called “to a prayerful, studied dialogue of faith and practice.”

Social Principles

The General Conference speaks to investment matters through the Social Principles in Part V of *The Book of Discipline 2016*. The Social Principles identify a number of issues to be considered when making investments decisions.

General Conference Resolutions

Many of the resolutions adopted by General Conference and presented in *The Book of Resolutions of The United Methodist Church* speak directly to matters that United Methodists should consider in making investment decisions.

Choices Among Conflicting Values

All humans are linked to God, each other and to the rest of creation. Human frailty and sinfulness so permeate life that there are no “pure” investments. Difficult choices must sometimes be made among conflicting values. For example, a decision to purchase United States government securities provides funding for space programs, education, aid to some oppressive foreign governments, medical research, nuclear weapons, a variety of businesses, food for hungry people, etc. In effect, investors “buy” the entire mix whenever they lend money to the federal government and they often deal with similarly complex “mixes” when making other investment choices. Recognizing this reality, investors may choose to establish specific prohibitions as part of their guidelines, such as “No investments in alcohol,” or “No investments in companies doing more than 10% of their business with the Department of Defense,” etc.

FIDUCIARY RESPONSIBILITY

Persons that are charged with investing funds have a fiduciary responsibility for those funds. Fiduciary responsibility requires those responsible for investments to fulfill the legally imposed duties of loyalty, care, and prudence.

The **Duty of Loyalty** prohibits self-dealing by persons who are fiduciaries. They are not permitted to take part in investment decisions that would create a conflict of interest. All investment decisions are to be made with a view to the interest of the beneficiaries rather than to the personal interests of the fiduciary. When conflicts do arise, they should be disclosed to the governing board immediately. Failure to do so will subject the fiduciary to potential liability for any losses suffered due to the breach of the duty of loyalty. Advance disclosure in writing will provide evidence of the disclosure in the event the issue of conflict of interest is raised. Any fiduciary with a conflict involving an investment decision should abstain from any participation in that decision and document the abstention in the minutes of the meeting.

The **Duty of Care** requires that a fiduciary act at all times in good faith and in a manner which is in the best interest of the beneficiaries. Fiduciaries are to be adequately informed about alternatives available at the time of decision. They are to act with the same care that responsible persons would exercise in the management of their own affairs. Where specific instructions are left with regard to legacies, they must be followed unless changed by court order.

The duty of care includes prudence in the investment context (including diligence in attending meetings), efforts to ascertain relevant information prior to decision making, balanced judgment, adequate assessment and balancing of potential investment risks and returns and adequate diversification of investments.

Fiduciary responsibility cannot be delegated. The decision of a board to engage investment adviser(s) will not absolve the board from its ultimate responsibility for the care of the funds. In order to discharge adequately the duties of care and loyalty, the fiduciary will need to demonstrate that appropriate procedures were used for selecting the adviser(s) and for

monitoring the results of the advice received. The adviser(s) should be trustworthy and competent to perform the work as outlined by the board. The loyalties of the adviser(s) must run to the beneficiaries, not to the individual members of the board.

Fiduciaries are permitted to accept the advice of an adviser where they can demonstrate that their initial decision to engage the adviser was well-founded and where subsequent developments do not give rise to a basis for suspending that reliance. A fiduciary that has knowledge that reliance on an adviser or other financial agent is no longer well-founded may become personally responsible for any loss sustained by the fund as a result of the inappropriate reliance.

Socially responsible investing can be consistent with fiduciary responsibility. Fiduciary responsibility for a portfolio requires informed choices that balance ethical considerations and financial risk and return. Fiduciaries will be judged by the reasonableness of the decisions they make, given the information available to them when a decision is made. Here are three examples illustrating that balance.

- Individuals investing their own money are free to combine ethics, risks and returns according to their own conscience.
- Trustees for a fund restricted to providing grants or loans for the construction of new church buildings need to make investment decisions which meet that purpose. They will be judged on how well they assist congregations. They will be expected to invest ethically and to avoid undue risk in seeking high returns on investments.
- Trustees for a defined contribution pension plan must prudently invest funds that they hold in trust for those who will eventually receive the pensions. These trustees have a legal obligation to invest solely in the interest of the beneficiaries. They will be judged by financial returns and they will also be expected to invest funds ethically.

“The Changing Standard of the Prudent Investor”

A seat on a charitable board carries with it serious legal responsibilities, even when, as in the majority of cases, the position is voluntary and unpaid. Trustees and directors operate under detailed rules that define their fiduciary obligations and the penalties that can be imposed on them for failing to meet those obligations.

These rules are especially important where management of not-for-profit organizations, trusts and endowments is involved. Trustees and directors need to use sound judgment when making investment decisions. They are expected to avoid reckless speculation while also obtaining an adequate return on the assets entrusted to their care. Inevitably, this means walking a line between excessive caution and excessive risk. Finding that line may not be easy.

Many of the rules governing charitable fiduciaries are rooted in common law – a body of legal precedents created through centuries of court cases. However, in recent years these principles have been revised to bring them in line with modern investment practice. More than 30 states have adopted the Uniform Prudent Investor Act (UPIA), a model law that clarifies the right of trustees to pursue effective portfolio strategies and allows them to hire independent portfolio managers to carry out those strategies. (Many states have also adopted

the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which applies the basic principles of the UPIA to charitable organizations.)

Greater flexibility brings greater accountability. Trustees and directors are expected to exercise due diligence in drafting an investment policy, selecting portfolio managers to carry out that policy and monitoring the performance of those managers over time. If found negligent, they may be held liable – not only for actual losses, but for the returns that *might* have been achieved if prudent judgment had been used.

Regardless of the size of the portfolio the UPIA states that the investment committee is held to the standard of the prudent investor. Committees are now encouraged to seek expert counsel, often in the form of an investment consultant and/or manager(s), to assist them in the process.

TYPES OF FUNDS

Unrestricted funds are those funds which can be used for any purpose allowed by the organization’s charter, articles of incorporation, bylaws or other documents.

Designated funds are unrestricted funds that the organization’s governing board has chosen to direct to a particular use.

Restricted funds are funds whose use has been limited by the donor, General Conference or another appropriate body. Such restrictions may limit the types of investments and the ability to use the principal and income to fund expenditures.

Endowment funds (also known as permanently restricted funds) are funds for which the corpus or principal is to be invested on a continuing basis. Depending on the wording of the instrument establishing the endowment fund, all or a portion of the income and capital gains may be available for expenditure.

Endowment fund restrictions often include phrases such as “the income (or income only) shall be distributed to...” Unless explicitly specified to the contrary or otherwise mandated by law, “income” in such phrases should be interpreted to mean that combination of interest, dividends and capital appreciation that can be withdrawn on a continuing basis without reducing the purchasing power of the original endowment principal. A determination of the appropriate amount of “sustainable income” will need to be made in administering such funds.

Note: These terms as legal descriptions may vary from state to state.

STEWARDSHIP

Tithes, offerings, gifts, bequests and the earnings from the investment process provide the assets to be invested. The General Board of Discipleship provides guidelines to sound stewardship. The Planned Giving Handbook prepared by the National Association of United Methodist Foundations provides many helpful suggestions on the development of a sound program of planned giving. Copies of this resource can be obtained through your annual conference United Methodist Foundation or Office of Development. Many annual

conferences have foundations which can be excellent resources for both stewardship and investment advice. The United Methodist Church Foundation in Nashville, Tennessee is also an excellent resource.

INVESTMENTS DEFINED

An investment is a commitment of funds, for a period of time, in order to derive an increased future flow of funds. It is intended that the investment will:

- return the invested principal;
- provide, through interest, dividends or capital appreciation, a real return to the investing unit for the time other funds are committed;
- provide compensation for inflation; and
- provide compensation for the business, market and liquidity risks involved in the investment.

The amount of the funds available and the need for liquidity define the investment opportunity. There are a variety of asset classes available for consideration. The broad types include cash and cash-equivalent securities; fixed-income securities (money market securities and capital market securities); equities (U.S. and foreign); mutual funds; derivative securities (futures and options); non-financial assets (precious metals, gems and art) and real property.

The type, maturity, rate of return, risk and liquidity available and the requirements for socially responsible investing determine the choice of investment instruments.

Financial securities should be given first preference because they are well defined and well supported with data about their features, their risks and the quality of the issuer.

They are readily purchased and sold through a broker/dealer and the securities exchanges. Special financial securities (e.g. derivatives, foreign currencies and foreign stocks and bonds) may be worthy of consideration if appropriate to the assets under management and if an experienced counselor is available.

Speculation is an investment based on the perception that a security is mispriced. It is not acquired for a certain rate of return as compensation for the assumption of risk. Speculation is not usually appropriate for the investments of The United Methodist Church.

Non-financial assets (art objects, precious metals and jewelry) and real property may be received by donation or bequest, so it may be necessary to manage some very unconventional investments – at least until they can be liquidated and the proceeds reinvested in other financial instruments. Except in very special cases, non-financial assets and investments should be promptly sold.

PRUDENT INVESTMENT MANAGEMENT A SEVEN STEP PROCESS

In response to the changes dictated by the Uniform Prudent Investment Act, a seven-step prudent investment management process was developed to ensure that the changes in UPIA were indeed implemented. By undertaking this process diligently, the investment committee may take comfort in knowing that they have begun to complete their fiduciary responsibilities.

1. Assess current position.
 - Review mission statement, vision statement and strategic plan.
 - Evaluate a statement of the entity's financial assets.
 - Review and document cash flow considerations.
 - Review current investment expenses.
2. Determine appropriate spending policy.
 - Spending policy determines how much will be spent currently versus how much will be invested to provide future spending.
 - Well defined spending policy leads to better investment policy and improved long term results.
 - Spending policy must consider "real return" after inflation.
3. Maintain written Statement of Investment Policy.
 - See section on Statement of Investment Policy for a detailed description.
4. Analyze asset allocation and design the optimal portfolio.
 - Asset allocation is one of the most important investment policy decisions. Over 90% of long term variance can be attributed to asset allocation.
 - What we know – capital market history.
 - What we decide – investment policy on return expectations, risk tolerance, asset class preferences and allocation constraints and restrictions, time horizon to meet objectives and economic forecast for capital markets.
 - What we conclude – Portfolio optimization, efficient frontier of optimal portfolios and expected returns given levels of expected risk.
5. Implement investment policy – investment manager research and evaluation.
 - Investment manager evaluation and due diligence.
 - Negotiate contracts and fee schedules for investment managers.
 - Coordinate custody and brokerage services.
 - Fund investment portfolios.
6. Monitor investment performance and activity.
 - Investment performance versus policy objectives.
 - Investment performance versus spending policy.
 - Risk adjusted performance analysis and market comparison.
 - Individual manager performance versus benchmarks and manager universe.
 - Investment activity must be within policy guidelines.
7. Complete a fiduciary audit (review the process).
 - Review steps 1-6 on a regular basis.
 - Prudent investment management is prudent process.
 - Re-balance the portfolio through changing market climate.

STATEMENT OF INVESTMENT POLICY

The Statement of Investment Policy and all supplemental details on goals, guidelines and procedures – both financial and social – shall be in writing and approved by the investment committee or other body responsible for supervising the investment of funds. A well-written

policy is an indispensable tool for investment management. Among the important benefits of producing and maintaining an investment policy are:

- The Statement of Investment Policy (SIP) documents policies, practices and procedures for investment decisions, ensuring continuity of the investment strategy when there is committee member turnover.
- The SIP reassures investors and donors of good stewardship.
- The SIP provides discipline during emotional or volatile markets.
- The SIP provides a yardstick by which to monitor and measure investment success. It provides for the review of investment managers and strategies for rebalancing the investment portfolio.

The National Conference of Commissioners of Uniform State Laws has recommended a revised version of the Uniform Prudent Investment Act (UPIA) that helps set the stage for the development and maintenance of investment policy. Courts have used UPIA as a basis for their rulings on fiduciary responsibility as it relates to investments. UPIA establishes a fiduciary standard for investments. It is considered the most comprehensive law on prudent investment management. The five fundamental considerations of UPIA are:

1. The standard of prudence is applied to any investment as part of the total portfolio (total return), rather than to individual investments.
2. The tradeoff in all investing between both risk and reward is identified as the fiduciary's central consideration.
3. All categoric restrictions on types of investments have been abrogated. The trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investment.
4. The requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investment.
5. The rule of trust law forbidding trustees from delegating investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.

These principles have also been applied to charitable organizations through the Uniform Prudent Management of Institutional Funds Act.

Each organization charged with responsibility for investments shall develop a specific and complete statement of investment policy.

Outline of a Statement of Investment Policy

1. Executive Summary:
A single page summary highlighting critical attributes of the entity's Statement of Investment Policy.
2. Introduction and Background:
 - General information on the entity, Board of Directors, Investment Committee and how the entity is organized and structured.
 - The policy statement is a tool to guide the communications and investment activity of the entity.
3. Purpose, Mission, and Vision Statements:
A description of the entity's overall purpose and function to serve as a tax-exempt entity. The mission statement comes from the head; a vision comes from the heart.

Vision is the beginning point for the journey, the instrument (the process) that tightly focuses all of our sight and actions on what we want to become tomorrow; it is not what we were in the past or what we are in the present. Continually focusing on a vision disciplines us to think strategically.

4. Investment Objectives and Guidelines: (Sections Include)
 - Time horizon – description of long-term goals and time period to achieve return objectives.
 - Risk tolerances – perspective on acceptable levels of risk to achieve returns.
 - Performance expectations – rate of return objectives, nominal and real returns above inflation.
 - Performance in relation to spending policy.
 - Asset allocation guidelines – this area should delineate the asset allocation constraints and restrictions, target allocation, and portfolio optimization to achieve the desired return.
 - Gift acceptance policies – establishes parameters for acceptable gifts; helps avoid the possibility of receiving problem gifts, i.e., property with environmental problems, trusts with unusual constraints.
5. Security Selection and Investment Managers:
Guidelines on the types of securities (stocks and bonds, domestic and international, etc.) authorized for investment. A detailed section on the due-diligence criteria for manager selection.
6. Performance Measurement and Monitoring:
Outlines the benchmarks for measurement of the entity’s overall performance and details the performance benchmarks for the various asset managers. The history of the capital markets, time horizons, market and economic conditions must be considered.
7. Summary and Conclusions:
A brief summary on the purpose of the policy statement and how it will be reviewed and updated to guide the entity’s investment activity.

ELEMENTS OF AN INVESTMENT POLICY

The following elements or themes of an investment policy are required for general agencies and are recommended for all organizations associated with The United Methodist Church:

- 1. Investment Strategy**
Define the investment objectives. Identify the assets under management, the expected receipts and disbursements and any obligations imposed by the donors; classify the assets as “current funds” or “non-current funds” and allocate them among asset classes as appropriate to the investment strategy.
- 2. Investment Management Consultant**
Select a qualified investment consultant from the staff of the agency, a United Methodist Foundation or from a licensed professional firm. Establish a specific agreement defining the terms and conditions of the relationship.

3. Spending Policy

- Spending policy, asset allocations, asset class optimization and written investment policy are all inter-related.
- Spending policy determines how much will be spent currently versus how much will be invested to provide future spending.
- Well-defined spending policy leads to better investment policy and improved long-term investment results. Spending policy must consider “real return” after inflation.

Sample Spending Policy Formula

		<u>Estimated Annual Rate</u>
	Estimated Portfolio Return	6.50%
Less	Inflation	1.50%
Less	Admin. Costs	0.50%
Less	Desired Portfolio Growth	<u>0.50%</u>
Equals	Spending or Distribution Level (Target)	4.00%

4. Asset Allocation

Asset allocation is the one most important decision of investment policy. Over 90% of long-term variance can be attributed to asset allocation. Once spending (distribution) targets are established we can consider capital markets history, tolerance for risk (the fiduciary’s most important decision), time horizon for the investments and then (only then) can we begin to construct the portfolio that will provide our target return with the lowest risk.

What We Know:

Capital market history

- Historical returns of asset classes.
- Historical variability of returns of asset classes (standard deviation).
- Historical correlation between asset classes.

What We Decide:

Investment policy

- Return expectations.
- Risk tolerance.
- Asset class preferences and allocation constraints and restrictions.
- Time horizon to meet objectives.
- Economic forecast of product and capital markets.

What We Conclude:

- Portfolio optimization.
- Efficient frontier of optimal portfolios.
- Expected returns at given levels of expected risk.

Well written asset allocation policies will include policies and parameters for periodic rebalancing of the asset allocation. Portfolios should be rebalanced first with cash inflows/outflows in a manner consistent with the strategic allocation of the fund. If there are no cash flows, policy should provide the committee with procedures for periodic (quarterly) review and rebalancing.

Established minimum and maximum exposure to the assets classes listed below:

Cash equivalent	_____ % to _____ %
Bonds	_____ % to _____ %
Equities	_____ % to _____ %
(other assets classes)	_____ % to _____ %

5. Investment Diversification

The diversification of investments is recognized as an important consideration in the control of risks associated with investing. Diversification of asset classes and diversification within an asset class are primary objectives in the structuring of the portfolio.

6. Security Selection

The stock portfolio is to be diversified so that the performance of one company does not significantly affect the performance of the portfolio.

The portfolio is to maintain a reasonable diversification across industry sectors, so that the performance of any one sector does not significantly affect the performance of the portfolio.

The bond ratings as rated by the Standard and Poor’s or Moody bond rating service or its equivalent for fixed-income investments (bonds and notes of the U.S. government and its agencies, U.S. corporate bond issues) must be considered. The portfolio shall be diversified to the extent that no one corporation’s bond issue will represent a significant portion of the total bond portfolio.

Cash equivalent investments (less than 1 year fixed income vehicles) will have a quality restriction. Commercial bank balances that exceed FDIC insurance levels should be considered to be of lower quality and subject to a cap.

Restrictions from engaging in dealing with security options, margin trading, short selling, of securities must be considered.

7. Monitoring

Monitor all portfolios on a periodic basis by both staff and the board of the agency. The board may appoint an investment committee to carry out this function for the board. This monitoring should include an evaluation of the performance of invested funds as well as the accomplishment of objectives within the policies and guidelines established.

Set criteria for the investment manager search and evaluation process. Interview candidates for the management of each specific asset class. Review the specific objectives and policy constraints for each manager. Set standards for communication, service and the performance benchmarks by which investment managers will be evaluated.

A. Investment Performance versus Policy Objectives:

- Performance measurements should be evaluated
- Net of all management fees, brokerage and custodial expenses.
- Annualized and time weighted considering all deposits and withdrawals.
- Within the policy constraints and guideline.

B. Investment Performance versus Spending Policy:

The total returns from investment activity must be evaluated net of all cost to the entity, including the entity's administrative expenses and payout to fund ministry.

C. Risk Adjusted Performance Analysis and Market Comparison:

Relative performance measurement compares the portfolio returns versus the financial market and the economic climate. Financial and economic benchmarks should be documented in the investment policy statement. Risk adjusted performance evaluates the volatility of portfolio returns around the mean performance over time. Several different statistical measurement tools should be used to evaluate performance behavior in this area. Examples include:

- Standard deviation or volatility of returns, (mean-variance) "scattergram charts".
- "Downside risk" or semi-variance returns.
- Manager beta, alpha, and correlation of returns to the benchmark index.
- Manager return correlations to asset class benchmarks.
- Many of those tools are used in portfolio optimization and asset allocation analysis to lower expected risk and maximize expected returns.

D. Individual Manager Performance versus Benchmarks and Manager Universe:

Evaluate the managers' performance versus specific benchmarks set forth in the investment policy statement. Managers should be evaluated versus appropriate "style" benchmarks over 3, 5 and 7 year periods.

E. Investment Activity must be within Policy Guidelines:

All investment activity should be within the constraints and guidelines of the investment policy document.

F. Social and Moral Goals

Assure that the elected membership, staff and consultants of an organization are aware of and sensitive to the religious, social, ethical, and moral aspects of investing and that investment judgments contribute to a positive social impact and to the correction of societal inequities. The use of divestment, selective investment, stockholders' actions, correspondence, visitation, or symbolic acts is encouraged when feasible, prudent, and proper in the accomplishment of moral and social goals established by the General Conference of The United Methodist Church.

G. Other Important Considerations

- Transaction Processing
Select a qualified broker/dealer or agent to execute all purchases and sales.

- Custody of securities
Establish a custodial agreement with a brokerage firm, bank, or regulated agency to provide for the physical safekeeping of the investments and to furnish periodic reports on the activity within the account.

When physical safekeeping of securities is not handled by a licensed, third party, establish a plan for periodic audits or verification of the securities.

SOCIAL GUIDELINES

Basic Philosophies

The organization, responding to the biblical challenge of responsible stewardship, calls for conscious investment decisions that further the principles of economic and social justice consistent with the goals outlined in the Social Principles of The United Methodist Church. Thus, the goals for the investment of the Fund are to influence corporate policy and public conscience in the promotion of peace, human rights, justice and the respect for and quality of life for all persons.

A basic tenet of the investment and capital formation and growth strategies undertaken by the Fund shall be to foster and advance business practices and activities which reflect the Social Principles of The United Methodist Church. All investment managers shall exercise their best efforts to place investments in ways that make a positive impact. Investment managers shall be guided by the following ethical norms according to the Social Principles of The United Methodist Church:

- An ecologically just world and a better quality of life for all creation;
- Social justice and the sacred worth of all persons;
- Sound fiscal policies that protect the economic life of all individuals;
- Political and governmental responsibility for protection of basic rights; and
- The unity of the world community

Any conflicts of values shall be resolved with discretion, fiduciary responsibility, and appropriate consultation.

With regard to socially responsible investing, the investment management of the Fund shall be a process of *avoidance*; that is, by avoiding investments in companies with policies or products that may harm society, either individually or corporately, in one or more ways. This investment process of avoidance primarily serves to reduce the universe of securities in which to invest by screening companies for socially undesirable characteristics. The committee may, from time to time, direct the investment managers as to specific investments or types of investments considered to be inappropriate for the Fund.

Although the socially responsible investment process implemented for the Fund is not anticipated to present a trade-off of risk or return as compared to the market, the organization and the committee remain committed to the imperative of the avoidance of investments that appear likely, directly or indirectly, to support any of the social ills listed herein. Every opportunity shall be taken to further shareholder advocacy to further the goals outlined in the Social Principles of The United Methodist Church, including advocacy of divestment.

Social Responsibility Guidelines

As an agency of The United Methodist Church, we are committed to implementation of The United Methodist 2016 *Book of Discipline* ¶ 717.

"Sustainable and Socially Responsible Investments – In the investment of money, it shall be the policy of The United Methodist Church that all general boards and agencies, including the General Board of Pension and Health Benefits, and all administrative agencies and institutions, including hospitals, homes, educational institutions, annual conferences, foundations, and local churches, 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. All United Methodist institutions shall endeavor to seek investments in institutions, companies, corporations, or funds that promote racial and gender justice, protect human rights, prevent the use of sweatshop or forced labor, avoid human suffering, and preserve the natural world, including mitigating the effects of climate change. In addition, United Methodist institutions shall endeavor to avoid investments in companies engaged in core business activities that are not aligned with the Social Principles through their direct or indirect involvement with the production of anti-personnel weapons and armaments (both nuclear and conventional weapons), alcoholic beverages or tobacco; or that are involved in privately operated correctional facilities, gambling, pornography or other forms of exploitative adult entertainment. The boards and agencies are to give careful consideration to environmental, social, and governance factors when making investment decisions and actively exercise their responsibility as owners of the companies in which they invest. This includes engaging with companies to create positive change and hold them accountable for their actions, while also considering exclusion if companies fail to act responsibly."

The 2016 *Book of Resolutions*, resolution 4071, provides additional guidelines about investment ethics, as well as sustainable and socially responsible investing.

INVESTMENT RETURNS

The Uniform Prudent Investment Act states that we are to view investments from a total return perspective, which includes interest, dividends, and capital appreciation.

Investment returns consist of three elements:

1. A risk-free return for the use of the capital over the short term. U.S. Treasury Bills (mature in one year or less) are considered risk-free and their yields represent a reasonable indicator of this risk-free return.
2. Compensation for the rate of inflation. The usual annual inflation rate varies from about 1% - 4%, although there have been some periods of double-digit inflation, as well as periods of deflation. Note that an expected rate of inflation is usually implied when the investment is undertaken. If the actual rate of inflation is higher

than the expected rate of inflation the real return is reduced and may become negative.

3. A risk premium. The risk premium depends on the degree of risk and the maturity of the security.

For currency investments (cash and near-cash) there is a modest interest return on U.S. bank deposits, certificates of deposit and money market funds; for foreign currencies the total return is dependent on the exchange rates relative to the U.S. dollar that prevail when the currency is bought or sold.

For debt investments (bonds) held to maturity, the nominal return is determined by the interest rate established when the investment was made. When a bond is called before maturity at a premium (discount) there is a capital gain (loss). When a bond is sold before its maturity, there is a capital gain (loss) if the current market interest rate is lower (higher) than the original interest rate.

The “Rule of 72” provides a quick means to understand the importance of the interaction between the rate of return and the duration of the investment. It is as important to assure a sustained investment program as it is to gain a good annual rate of return:

An investment in a typical:	at:	doubles in:
Interest-bearing Deposit	2%	$72/2 = 36$ years
U.S. Treasury Bill or CD	5%	$72/5 = 14.4$ years
High Quality Bond	7%	$72/7 = 10.3$ years
High Quality Stock	10%	$72/10 = 7.2$ years

INVESTMENT RISKS

Investment risk is simply the uncertainty of the future value of a security or a portfolio. The most common measure of risk is the standard deviation or dispersion of the actual past investment return from the expected average return.

The following concepts reflect the reality of risk and the practices that can be used to minimize and manage risk:

1. Long investment horizons involve greater uncertainty than short ones;
2. Different asset classes involve different levels of risk;
3. Diversification among securities in a single asset class and among different asset classes will reduce overall portfolio risk;
4. Investment risk can be managed by diversifying the asset allocation of a portfolio.

The conditions that generate uncertainty about the future value of a security are business risk (e.g. default of the issuer), financial risk (non-diversifiable risk and the maturity of the security), speculative risk, liquidity risk (due to the necessity to find a willing buyer) and more general investor outlook and confidence in the bond and equity markets.

Committees should also give careful consideration to an appropriate risk level. A high level of expected return (whether of income or capital growth) may mean that the investment manager will need to take some big chances which, in hindsight, the sponsors may regret.

Business Risk

The greatest risk associated with the debt security is the risk that the issuer may be unable to fulfill the obligation to make periodic payments of interest or be unable to repay the principal when due. The greatest risk associated with an equity security is that the issuer will be unable to pay dividends or to sustain and enhance the value of the stock.

The general perception of these risks is reflected in the price/earnings ratio for stock and in the ratings of bonds by Moody's and Standard and Poor's.

Bond rating	Description
Aaa or AAA	Highest quality, lowest default risk
Aa or AA	High quality
A	Upper medium grade
Baa or BBB	Medium grade
Ba or BB	Lower medium grade
B, C or D	Speculative, high default risks

The bonds in the four highest rating categories are known as “high-grade” or “investment-grade”, meaning that financial risk is relatively low and the probability of future payment relatively high. Lower rated bonds have speculative elements, and the repayment of principal and interest in accordance with the terms of the bond issue are not ensured. Note that bonds below medium grade are often called “junk” bonds.

Bonds issued by government or quasi-government entities offer reduced risk if they are issued with the “full faith and credit” of the issuer or are supported by a specific commitment of revenue.

Maturity Risk

An investment for a short period of time carries less risk than one for a long period. Thus short-term instruments generally carry a reduced risk premium and provide a reduced return.

Speculative Risk

The selection of a security on the perception that it is underpriced introduces additional uncertainty of future value because it assumes that the available data about the security is inaccurate or incomplete.

Liquidity Risk

Some assets and securities are not readily saleable. If there is not an established market and a known price range, a delay in the sale and reduction in selling price may be required to find a buyer.

Diversifiable and Non-diversifiable Risk

Each security involves some uncertainty about its future value apart from the risks inherent in the investment marketplace. The risk in a specific security is diversifiable and can be reduced by diversification. The uncertainty inherent in the investment marketplace is non-diversifiable.

Broad asset classes may be further divided. Each asset class – broad or narrow – is associated with a specific level of risk, so the allocation among classes generates a pattern of returns related to risk. Each security within a class also has a specific level of risk diversification.

The selection of securities with different features and characteristics - reduces the average risk within the class.

Market Risk

Economic conditions, international events and political conditions may induce both favorable and unfavorable changes in the security values apart from the merits of the individual issues and the issuer. Market risk is expressed by price changes and interest rate changes in stocks and bonds and exchange rate changes in currencies.

FINANCIAL INSTRUMENTS

Current funds may be held in a checking or savings account. Since they earn little or no interest the amount of such balances should be carefully adjusted to provide funds only for immediate and near-term needs. There are several ways of investing non-current funds. They can be invested in fixed-income short, medium, and long-term securities, in equity instruments or in any of the asset classes.

The advantage of using investment grade financial assets as vehicles of the investment (as compared with real estate or other tangible personal property) is that investment grade financial assets have a broad-based market for their evaluation, purchase and sale. The contents of a portfolio depend on the interaction of three elements: investment objectives or goals, the plan for meeting those objectives and the selection of specific securities that are permitted under the social stance of The United Methodist Church.

SHORT TERM INVESTMENTS

For the portion of funds that may be needed on short notice, investments should usually be limited to short term securities:

Cash. U.S. dollars offer high liquidity, low or zero risk but very low or zero returns.

Money Market Securities. Most short-term securities are fixed-income money-market securities (no equities) having a remaining maturity of up to one-year (including securities originally issued for longer periods) and are actively traded in financial markets.

U.S. Treasury Bills. Treasury Bills are United States government obligations issued in 90 day, 180 day, and 360-day maturities. They are issued at discounts, at \$10,000 face value and may be purchased by auction at Federal Reserve Banks or in the open market.

Commercial Paper. Commercial Paper is an unsecured promissory note issued by banks and corporations. It is generally issued on a discount basis with maturities of 270 days or less and backed by bank lines of credit to reduce the risk of default. Almost all commercial paper is rated with respect to credit risk by one or more of several rating services. Moody's, Standard and Poor's or Fitch Investors Service. Yields on commercial paper are often comparable to those on certificates of deposit and bankers' acceptances with similar maturities.

Certificates of Deposit. Certificates of Deposit (CDs) are deposits placed in banks and savings institutions at a stated rate of interest. CDs have an original maturity of 1 to 12 months but some are available for longer periods. CDs issued by a FDIC member are insured by the FDIC up to \$250,000 per depositor.

Negotiable Certificates of Deposit. Large deposits (\$100,000 or more), unlike regular CDs, qualify as money market instruments because they have short maturities, low default risk and are reasonably marketable.

Bankers' Acceptances. Bankers' Acceptances are short-term, non-interest-bearing time drafts (promissory notes) sold at discount and redeemed by the accepting bank at full face value. Bankers' Acceptances carry the issuer's pledge (the issuers are usually too small or too risky to use Commercial paper), are backed by the underlying goods being financed, and carry the guarantee of the accepting bank.

Short Term Investment Funds. A fund which holds short-term investments.

Repurchase Agreements. Agreement between a seller and a buyer, usually of U.S. Government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and usually at a stated time.

MEDIUM AND LONG – TERM INVESTMENTS

Medium-term securities have maturities of one to ten years and include securities originally issued for longer periods. Long-term securities have maturities up to 30 years. Securities are first sold in the Primary Market as Initial Public Offerings (IPOs) and then sold on the security exchanges in the Secondary Market.

FIXED INCOME CAPITAL MARKET SECURITIES

U.S. Treasury Issues. Treasury Notes are issued with maturities of one to ten years; Treasury Bonds are issued with maturities of up to thirty years.

STRIPS (Separate Trading of Registered Interest and Principal of Securities).

Under the U.S. Treasury STRIPS program, selected Treasury securities are available as separate interest and principal payments. Thus a long-term, default-free, non-callable zero coupon bond is available.

U.S. Agency Securities. All securities issued by the federal agencies have implied backing from the federal government. However, only those of a few agencies are explicitly backed by the full faith and credit of the United States government. There is slightly more risk involved with those federal agency securities not having the full backing of the United States government than with T-Bills. The maturities are normally longer than one year.

State and Local Government Obligations. Municipal issues are bonds sold by states, counties, cities and other political entities. Interest is excluded from federal income tax and state income tax in the state of issue. General obligations are backed by the full faith and credit of the issuer and repaid from taxes. Revenue obligations are sold to finance a particular project and are repaid from the income earned on the project. There is a wide range of risk, maturity and marketability in municipal obligations.

Corporate Issues. Corporate bonds are usually issued as term bonds with maturities of five years or more. They pay interest (either at a fixed rate or a floating rate referenced to an index rate) and principal at specified times. The corporation may have the right to call the bond and the bondholder may have the right to convert the bond into the corporation's common stock. They are riskier than government securities and offer a higher interest rate, which depends on the creditworthiness of the issuer.

Asset-Backed Securities and Pass-throughs. Asset-backed securities are created by combining many individual issues such as home mortgages into a new security. Mortgage-backed securities have low default risk but are very sensitive to interest rate changes. As payments of interest and principal are made by the lenders, the proceeds are “passed-through” to the security holders,

Collateralized Mortgage Obligations. Mortgage-backed bond that separates mortgage pools into different maturity classes, called tranches.

EQUITY SECURITIES

Preferred (or preference) stock. Preferred Stock pays a fixed annual dividend but only if corporate income is sufficient to do so. *Cumulative* preferred stock must pay any past unpaid dividends before any payments can be made to common stock.

Convertible Notes and Bonds. Notes and bonds which are convertible into common stock.

Convertible Preferred Stock. Preferred Stock which is convertible into common stock.

Common (or ordinary) Stock. Common Stock represents the ownership of a corporation. Shares of common stock give the right to any assets after all creditor, debt and preferred stock claims have been satisfied.

International Equities. International equity issues are foreign common stocks. They have similar features to U.S. issues but also some very special features in different countries.

Shares may be purchased in the home country or, if listed in two or more countries, may be purchased on U.S. exchanges. American Depository Receipts (ADRs) represent shares held by a U.S. bank and available for purchase in the secondary market.

COMMINGLED PORTFOLIOS

The fixed-income and equity securities discussed above provide a direct claim on the assets of the corporation. Commingled portfolios provide an indirect claim to a group of stocks or bonds. Commingled portfolios offer the advantages of economies of scale, diversification and professional management and are the preferred means of investing in both stocks and bonds for small portfolios that cannot attain sufficient diversification and for larger portfolios that seek professional management in a passive investment management style.

Open-Ended Investment Trusts. Mutual funds are available for single asset classes, both bonds and stocks, and in balanced funds that offer a mix of asset classes. Mutual fund shares are sold directly by the fund and trade at the Net Asset Value (NAV) of the fund.

Closed-End Investment Companies. Closed-end investment companies are similar to mutual funds except that they are traded on the secondary market exchanges and thus, their price does not match the net asset value.

DERIVATIVE SECURITIES

Derivative securities do not have a direct claim on any asset but rather a claim on a stock or bond at some future time. They provide a cost-efficient means of hedging asset and security price risk since they specify a price at some future date. They can also serve as a speculative investment vehicle.

Futures. A futures contract requires the buyer to purchase the underlying security at an agreed upon price at a specified time. The seller is obligated to deliver the security.

Futures contracts do not require payment until the maturity date. Futures are often used by farmers to assure a known price of a future crop and by corporations to fix the value of a future foreign payment or collection.

Hedge funds. A risky and unregulated investment partnership which often employs leverage to multiply gains from fluctuations or disparities in prices of various financial instruments such as futures and options.

Options. An option contract conveys the right but not an obligation to buy or sell the underlying security at the agreed price at the specified time.

Under a **Call Option** the call owner has the right but no obligation to purchase. If the call owner exercises that right the call seller is required to deliver the security.

Under a **Put Option**, the put owner has the right but no obligation to sell. If the put owner exercises that right the put seller is required to buy the security.

Swaps. Swaps are two party contracts to trade financial obligations. They were originally devised for trades of different currencies, different interest rates and different payment schedules. Now banks offer standardized swap contracts that reduce transaction costs, provide some liquidity, and trade in the secondary security markets.

INVESTMENT COMMITTEE DUTIES – AN OVERVIEW

Every general agency and organization that invests funds should have an investment committee to complete the seven-step prudent investment management process, which includes preparing the Statement of Investment Policy and recommending to the board goals, guidelines, and investment procedures that are attainable and understandable. These standards are to be set within the parameters established by the General Conferences, the General Council on Finance and Administration and the elected board of the agency.

Investments should meet both financial and social goals. If the investment meets the social criteria but fails the financial criteria, it is not a good investment. Likewise, when an investment meets the financial considerations but does not pass the social criteria, it is not a suitable choice either.

The committee should develop approved or prohibited lists of investments or establish standards for investment selection. The committee should also review transactions involving the purchase and sale of securities and monitor the performance of any staff or professional investment adviser given discretion to invest within specific guidelines.

The work of an investment committee is specialized. In selecting persons to serve on investment committees, in addition to the usual diversity considerations and commitments to the Church, attempts should be made to attract people representing a wide range of training, experiences and skills in the general areas of business, accounting, and investments. In addition, such persons must be willing to subordinate any personal investment biases that are inconsistent with the social criteria of an agency or organization.

Committee members should possess sufficient expertise to assure proper selection and evaluation of investment managers. The investment committee should include some individuals with professional experience in investment management or in evaluating investment management performance.

The committee should meet regularly to receive and act on recommendations of its investment counselor (if applicable) and to review and evaluate the performance of the investment portfolio.

Performance should be measured by the use of a clearly written, measurable goal or objective for the portfolio. The investment counselor, bank trust department, or financial staff of the agency can normally compute a portfolio's return on investment. The return should then be compared to the goals or objectives set for the portfolio to determine if the investment counselor has reached the goal.

Performance should be measured not only in absolute terms, but also in comparison with other portfolios of comparable size held by investors with a comparable degree of risk preference. Performance can also be compared to an appropriate index. Professional evaluation firms can be used to analyze the performance of a portfolio in comparison with portfolios composed of similar types of securities for both short and long-term performance evaluation.

This process allows the investment committee to see trends in its portfolio's performance and to compare it with the performance of other portfolios managed by other investment counselors, as well as an appropriate index.

The investment committee is also responsible for voting proxies and reviewing companies for their continued adherence to guidelines and policies previously approved by the investment committee or governing board.

INVESTMENT COUNSELOR

An agency or its investment committee may choose from three types of counselors for outside investment advice: (1) a United Methodist Foundation; (2) an independent investment consultant who receives a fee based on portfolio value; or (3) a bank trust department (not all bank trust departments can offer this service) whose fees may be based on portfolio value. The fees usually vary widely depending on the services needed and are based on a percentage of the managed assets, depending on the type of account, types of assets managed, and market value of the portfolio.

Whoever is selected as investment advisor, it is imperative that they are knowledgeable and experienced in the prudent investment process, so that they may assist you in reaching your investment goals effectively.

The United Methodist Church has several investment service options available to local churches and United Methodist groups. Most annual conferences are served by conference or area foundations that offer investment services. In addition, The United Methodist Church Foundation manages a large portfolio of funds for the benefit of the general agencies of The United Methodist Church and encourages certain other groups and institutions within the Church to participate in their investment offerings as well. Local church permanent endowment fund committees are encouraged to contact conference and/or area United

Methodist Foundations and development offices, the National Association of United Methodist Foundations, or the General Council on Finance and Administration as resources for investment services and options. See ¶2534 and ¶2535 of *The Book of Discipline of The United Methodist Church 2016* for additional guidance.

In order to broadly diversify a portfolio with separate portfolio managers in a cost effective manner, you may need approximately \$1,000,000 to invest. This is one reason why you may want to work with your area foundation, as they can invest funds so that you are broadly diversified for investments under \$1,000,000.

A reputable counselor is obligated to put the client's interest first, disclose all conflicts of interest and take into account the client's entire financial situation, along with any special investment restraints caused by the nature of the client organization. It is most prudent for an agency which will be using an independent investment counselor or a bank trust department that has its own discount brokerage house to make sure that the counselor or department is a Registered Investment Adviser under the terms of the Investment Adviser's Act.

There are several ways to find an appropriate investment counselor. A firm may be hired to conduct a search for an investment advisor whose profile would most satisfy the agency needs. Several candidates identified by the search company would then make written and oral presentations to the investment committee.

An agency should ask prospective counselors for written statements of their philosophy and policy. A reputable advisory firm or trust department usually has a highly developed investment philosophy, as well as an intellectual framework and discipline to guide its staff. Then the investment committee or other appropriate body chooses the one most able to execute the investment plan and reach the investment objectives.

Another way to find an investment counselor would be to investigate counselors used by other general agencies, annual conferences, foundations or churches.

The relationship with an investment counselor should be constantly under review. If a counselor does not demonstrate satisfactory investment performance after a reasonable time, the relationship should be severed. The client has everything to lose and nothing to gain when the counselor no longer reaches the goals set by the committee or governing board.

Attached is **Appendix A**, which is a sample Statement of Investment Policy, Objectives and Guidelines. This sample goes through each step in the investment policy process as outlined earlier in this guideline. It is very important that an investment consultant with the proper investment training assist in developing the Statement of Investment Policy. The most challenging and important portion of the Investment Policy is Addendum B – Asset Allocation Analysis. The investment consultant should have access to an asset allocation model, which has a database of historical returns and risks associated with the various asset classes. The consultant can then walk through the process with you, selecting the most optimal portfolio given your investment policy.

Also attached is **Appendix B**, which is a sample Gift Acceptance Policy for local churches to use in developing their own gift acceptance policies.

Disclaimer:

GCFE does not provide legal, accounting or investment advice, nor do we make recommendations on specific investments.