DFMS INVESTMENT COMMITTEE (IC) MEETING MINUTES

Final

Date: February 29, 2008
Location: The Episcopal Church Center - 815 Second Avenue, New York, NY 10017
Time: 9:00AM – 2:15 PM

Committee Members: James S. Clarke, *Chair*
Joel Motley, *Vice Chair*
The Rev. Maurice L. Goldsmith
Carol O'Neale
Dennis E. Stark
Robert C. Wilkins
Wesley Williams
Sally M. Zimmerman

Consultant & Staff: David Hyman, *Evaluation Associates Incorporated*
Reid W. Smith, *EAI, Director of Private Markets Research*
Margareth Crosnier de Bellaistre, *DFMS Staff*
Esther Fajo, *DFMS Staff*

Investment Managers: **AEW** (Matt Troxell & Renny Merritt)
European Investors (Kirsten McElroy & James Rehlaender)
Morgan Stanley (Christina Chiu & Amit Mukhadam)

Apologies: Arthur M. Bjontegard, Jr.
N. Kurt Barnes
Lloyd Mondal, *DFMS Staff*

1.0 General
1.1 Carole O'Neale opened the meeting with prayer.
1.2 The Chair expressed regrets from Art Bjontegard and Kurt Barnes who could not attend. Margareth Crosnier de Bellaistre mentioned that Lloyd Mondal was out sick.
1.3 The Chair reconfirmed upcoming meeting dates set for May 16th, August 15th & November 21, 2008.
1.4 **The minutes of the November 16, 2007 meeting were adopted as presented.**
1.5 The Chair commented on a general appreciation for the meeting books prepared by staff that he found very useful. However, he and others would like to have them mailed the week before the meeting.

2.0 Margareth CdeB presented the DFMS investment reports which included the year-end endowment performance, total annual fees and commission recapture results, as well as income from securities lending. David commented about the spread in the securities lending report, which showed a phenomenal increase over prior years. The Committee found that Edgewood's fees were high relative to those of the other managers. David reminded that Edgewood's stated fee is 1% on the first $25m and negotiable thereafter; however, Edgewood charges DFMS a flat 0.70%.

3.0 **Socially Responsible Investing (SRI) –**Sally Zimmerman stated that the Committee had not met since November 2007. However, she pointed out the SRI recommendations for the 2008 proxy voting shareholder resolutions included in the material.

4.0 **Economic Justice Loan Committee (EJLC) –** Rusty Goldsmith briefed on loans that were recently approved adding that no meeting took place recently. The EJLC was contemplating the adoption of CARS, a grading system of screening loan applicants. He mentioned that there were no accounts in arrears. However, the EJLC feels that its work is not visible throughout the Church.

5.0 **Unitrusts** - Margareth presented a report on the Unitrusts and Pooled Income funds noting nothing of concern. The Chair remarked that there has not been a response from Episcopal Church Foundation's President, Mr. Donald V. Romanik, to his letter of January 29, 2008. Margareth will follow up with ECF and report back to the Committee.

5.1 David gave a status report on the SSgA Bond Market mutual fund that is part of the charitable assets of ECF and contained subprime mortgage exposure. State Street liquidated this actively managed fund for all charitable asset accounts and moved the proceeds into an index fund, the Vanguard Bond Fund, last November. He reiterated that the 1-3 year government bond fund owned by the Society was not impacted by the subprime exposure. Bob Wilkins mentioned that ECF is also in discussion with SSgA about the bond fund performance.

6.0 **Portfolio Rebalancing –** Margareth stated that the practice followed by the staff was to rebalance the portfolio to the target ranges (the most recent were adopted in November 2007) at the end of each quarter. For instance, in October 2007 and in January 2008 the portfolio was rebalanced. The Chair understood that the Committee's instructions were not clear in November after the adoption of a resolution that limited all managers to 15% of the Society's endowment assets. Noting that one manager held 17% of the assets, the Chair opened discussions around what would work best in practice to lessen exposure. David Hyman observed that rebalancing is typically done quarterly, semi-annually or annually. A member remarked that by putting a cap at 15% limited exposure, there would be little additional benefit of rebalancing monthly. After discussion, it was agreed that rebalancing would continue quarterly but should be done within the quarter if it became clear that a manager exceeded the 15% limit.

7.0 **Treasurer's Report –** On behalf of Kurt Barnes, Margareth read the Treasurer's report, which included a status of the 2008 budget stressing the diocesan commitments and the slight reduction across all programs. She pointed out that the payout rate for 2008 reverted to 5.0% as per the 2006 resolution and that the endowment provided about $10,000,000 annually to the Society's budget. Margareth drew attention to the Treasurer's recommendation regarding liquidity (memo attached). The Chair took note of the recommendation but deferred discussion; he indicated that he would follow up with the Treasurer.

7.1 Margareth briefed on the status of the re-organization. Dennis Stark summarized the recent discussion at the Executive Council about the Archives. The land selected by the Task Force on the Archives has been sold. The Archives strategy Committee has contacted the current owner and continues its work in identifying a location in the preferred location; a new proposal might be presented before the IC later this year.

8.0 Real Estate–David reported on the meeting of the sub-Committee on real estate and introduced the three global real estate investment trust managers that were selected for presentation.

8.1 The Committee heard presentations from three firms: AEW, represented by Renny Merrit and Matt Troxell; European Investors, Inc. (EII) represented by Kirsten McElroy and James Rehlaender, the US Portfolio Manager with 24 years of investment experience; and Morgan Stanley – Christina Chiu & Amit Mukhadam.

8.2 The Chair thanked the sub-Committee for its excellent choice of all three real estate managers and opened the floor for debate. Reid weighed in that EII was unique in the sense that it thinks like a private equity investor and generated good performance over the years. The general feeling was that EII offered a superior presentation; James Rehlaender, EII's Managing Director and Portfolio Manager gave an impressive exposé on the firm's overview, global strategy, and investment approach.

8.3 This motion was proposed and adopted: **The IC decided to invest $10,000,000 with European Investors in two increments of $5,000,000, the first one in March 2008 and the second in June 2008, but will reconsider its investment should James Rehlaender leave the firm.** David will work on the mechanism of this investment with Margareth. The Chair asked Williams, Motley, and Hyman to continue the discussion on alternative investments. For diversification, lower risks, access to a different class of securities, David recommended that the Committee review the pros/cons of private equity first before considering distressed debt.

9.0 EAI Report – Endowment. David reported that all portfolios were in compliance with guidelines. He reviewed the 4Q2007 performance and indicated that, although large cap remained a compelling issue and DePrince (-4.1%) underperformed its benchmark Russell2000 (-3.1%), the Total Fund gained +2.3%. NewStar has shown improvement. The corpus continues to grow. Overall, the plan is well diversified in style, asset allocation and in manager quality. In comparison to peer groups, the portfolio presents very strong results, particularly over the last 5 years which shows higher returns and less risk.

9.1 David briefed on EAI's monitoring visit with Century Capital in January 2008. David held a telephone interview with Westwood. He added that Julius Baer announced that it would go public; it did not fit in the parent company USB. Overall there was nothing worrisome to report.

9.2 David spoke of e-mailing asset allocation information from the Commonfund Benchmarks Study, which has a universe of 155 nonprofit firms. When compared to the Commonfund universe, DFMS is overweight in equities (60% vs. 30%). The Chair pointed out that it was with this in mind that the Committee decided to invest 10% into alternatives, to which David remarked that Advent Capital Management fits between equities and fixed income.

9.3 Cost of hedging. In anticipation of a severe recession and its adverse impact on the market, the Chair suggested exploring "hedging" the entire portfolio as part of the fiduciary role of the IC. David, who had privately discussed this concern with the Chair, had contacted a couple of banks for pricing. He will keep the Chair informed on this issue.

9.4 The Chair asked David to talk about *"aggressive vs. defensive"* strategies at the next meeting.

9.5 Investment Guidelines. David will review to add real estate and to revise the target ranges.

10.0 The Chair drew attention to a resolution that acknowledged bequests to the Society. This resolution highlighted the absence of targeted efforts to increase the endowment of the Church. When compared to other churches or non profit organizations, the Chair stated that the Episcopal Church missed the boat by not actively seeking to increase its endowment.

11.0 Rusty invited the Committee to meet at his home in Florida. The Chair charged Margareth to estimate the costs of holding the meeting either in November or February. Although mindful of a memo received from the General Convention Office about a conscientious effort to control expenses, the general opinion was that it was necessary for the IC to hold physical meetings. Even though the costs of these meetings are allowable under the endowment, the IC wishes to keep them at a minimum. Margareth was asked to consult with the General Convention Office for an estimate of the costs of holding the meeting at Rusty's place.

12.0 To address a concern by a member of the Committee about the recognition of the work of the IC, the Chair asked Margareth to invite management (including Bishop Katharine if her schedule permits) to its May meeting.

13.0 The Chair adjourned the meeting at 2:15 PM. There was no executive session.

MEMORANDUM
DFMSPECUSA

TO: INVESTMENT COMMITTEE

FROM: NKBARNES

SUBJECT: FINANCE REPORT

DATE: 02/27/08

CC: MANAGEMENT

I am delivering the following written report because I will be unavoidably absent from the IC meeting on 2/29/08.

<u>2008 Budget</u>

- Unaudited results for 2007 as of 2/1/08 indicate savings versus budget of $1.8 million.
- 2008 budget reflects a $580,000 surplus as approved by General Convention 2006 in order to achieve a projected balanced budget for the entire 2007-2009 triennium
- Diocesan commitments for 2008: overall up 4% versus 2007 but remains $400K less than anticipated at GC2006; 36 signed commitments at 20% or higher
- A dividend payout at no more than 5.0% during 2008 and 2009. Endowment performance: an 11.6% return in 2007 permits an essentially unchanged dividend for 2008 despite using a lower payout rate of 5% versus 5 ½ % used in 2007. (Market weakness in 2008 will have an impact on the 2009 dividend, however.)
- Increased compensation costs effective 4/1/08 due to Reorganization (approx. $450K) are offset by program and operating cost reductions
- Many program and administrative expenditures have been reduced between 1% and 5% in order to accommodate lower income; higher legal expenses; and ongoing costs of Reorganization.

<u>Other Issues</u>

- Reorganization transition proceeding
- Possible agreement to recoup $1 million of the $3.2 million expended for a leasehold purchase in 2000 for St. John's School, Guam

<u>Asset Allocation</u>

- Investment markets and the economy remain very unsettled and unsettling. This will have an impact on both diocesan income and trust fund dividends.
- Dividends from the trust funds contribute between 20% and 25% (approximately $10 million annually) of the DFMS non-government-contract revenue. We produced a budget for 2008 that honored the IC's admonition to limit the dividend payout to 5%. We will endeavor to honor that again in 2009; endowment performance in 2008 will be incorporated in that calculation.
- In view of the endowment performance in these opening months of 2008, I would strongly encourage the Investment Committee to defer any additional allocations to investments that reduce the liquidity of the portfolio. We are akin to an operating foundation, dependent on income. We do not have the luxury of being "overfunded" like the Church Pension Fund.