Restructure of the investments of the Diocesan Endowment

(A report from the Glebe Administration Board.)

Key Points

- The Standing Committee passed the *St Andrew's House Trust (Variation of Trusts) Ordinance 2017* (the "Ordinance") on 31 July 2017. The Ordinance provided for the removal from the Diocesan Endowment ("DE") of its 50% interest in the St Andrew's House Trust ("SAHT").
- Under the Ordinance, the DE's 50% interest in the SAHT was removed on 1 September 2017 and reallocated for the general purposes of the Diocese. Distributions from this interest will become an additional source of income for the Synod separate from the DE.
- The principal reason for removing the DE's 50% interest in the SAHT was to restructure the investment of the DE to better reflect its status as a perpetual endowment through a more diversified portfolio.
- Modelling undertaken by GAB's investment asset consultant, Mercer, indicates that the restructured DE is likely to enhance the DE's investment returns.
- As a consequence, it is expected that total distributions to Synod (from the combination of the DE and the SAHT) will increase.

Purpose

1. To inform Synod about a significant restructure of the investments of the DE resulting in –
   (a) the removal from the DE of its 50% interest in the SAHT,
   (b) the realignment of the interest in the SAHT as an investment held for the general purposes of the Anglican Church in the Diocese of Sydney, and
   (c) the net income from the interest in the SAHT and any other amount realised from the capital of the interest being applied in accordance with the direction of the Synod.

Recommendation

2. That Synod receive this report.

Background

3. GAB is the trustee of the DE which is property held on trust for the purposes of the Diocese under the *Diocesan Endowment Trust Ordinance 2016*.

4. By clause 4 of the Diocesan Endowment Trust Ordinance 2016 –
   (a) the DE is held on trust for the purposes of the Anglican Church of Australia in the Diocese of Sydney, and
   (b) GAB, as trustee of the DE, is to act in a way which preserves the real value of the DE and, subject to this requirement, enables distributions to be paid to the Standing Committee each year to be applied in accordance with the determination or direction of the Synod.

5. This, in effect, defines a perpetual endowment.

6. In order to fulfil the purposes of the DE, the property of the DE is invested in a diversified range of asset classes in accordance with a strategic asset allocation. The reason for investing in a diversified range of assets is to ensure consistency of returns.

7. However, the DE's strategic asset allocation has not been able to achieve the level of diversification typical of a perpetual endowment. In particular, the holding of the historical investment in the St Andrew's House building (representing some 40% of the total portfolio of the DE as at 31 December 2016) meant that the DE was disproportionally invested in a large, illiquid asset whose investment performance is heavily tied to prevailing commercial property market conditions and the circumstances specific to the particular asset.

8. This disproportionate investment in the St Andrew's House building gave rise to a "concentration risk" which significantly impacted the investment performance of the entire DE portfolio for the following reasons –

(a) St Andrew's House is a large illiquid asset. The DE's interest in the SAHT represented about 40% of the net assets of the DE. This made it almost impossible to diversify the DE into a typical perpetual endowment portfolio.

(b) The illiquidity made making adjustments to the level of investment in the asset classes of the DE's portfolio (known as "rebalancing") more complex.

(c) The variability in the market revaluation of St Andrew's House each year caused other asset classes of the DE to be out of alignment with their strategic allocations.

(d) The volatility in the commercial property market added extra risk to the DE in the long term.

9. By way of comparison, the Long Term Pooling Fund ("LTPF") which is held on trust by the Anglican Church Property Trust is 100% liquid and invested as a typical diversified endowment portfolio. The combined net return of just the liquid asset classes (i.e. excluding the interest in SAHT) of the DE over 5 years as at 30 June 2017 was 9.03% pa compared to 11.21% pa for the LTPF. The LTPF's stronger return on the liquid assets is a direct result of the diversification within the LTPF.

10. Given the concentration risk, and the illiquid nature of the SAHT investment, GAB considered the best way to optimise the long-term returns of the DE as a perpetual endowment would be –

(a) to remove the SAHT investment from the DE's portfolio, and

(b) to implement a revised strategic asset allocation, based on the removal of this investment, to obtain the benefits of a diversified portfolio which reflects the DE's status as a perpetual endowment.

11. In order to achieve this outcome, the GAB promoted to the Standing Committee, and the Standing Committee passed the Ordinance at its meeting on 31 July 2017. Under clause 7 of the Ordinance, the Archbishop determined that the DE's 50% interest in the SAHT would be removed on 1 September 2017.

Consequences of the restructure

12. The removal of the SAHT investment from the DE portfolio means that the size of the DE was reduced from $163 million to $97 million (as at 1 September 2017). The restructured DE portfolio will be invested in a manner which better reflects its status as a perpetual endowment. GAB's obligation to maintain the real value of the DE and make distributions for spending by the Synod only applies to the restructured portfolio.

13. Following its removal from the DE, the 50% interest in the SAHT is held for the general purposes of the Diocese. The net income from the interest and any other amount realised from the capital of the interest will be paid or applied by the Standing Committee in accordance with the determination or direction of the Synod. The trustee of the SAHT, the St Andrew's House Corporation ("SAHC") will make distributions directly to the Standing Committee for this purpose as an additional source of investment income for the Synod. The SAHC is responsible to the Synod for the level of distributions from SAHT and any volatility in those distributions.

14. This means that while distributions from the restructured DE portfolio will be materially less than at present in dollar terms, a higher distribution rate from the DE is projected. Further, when the projection of enhanced distributions from the DE is taken together with the additional source of income from the SAHT, it is expected that the total amount available for spending by the Synod in future years will increase. The table in paragraph 21 seeks to illustrate the expected increases based on the modelling performed by Mercer, given standard market conditions and current estimates of distributions from the SAHT under its existing policies.

Results of the modelling – Restructured DE Portfolio

15. Mercer is the investment asset consultant for GAB. GAB engaged Mercer to undertake modelling of a restructured DE (without the 50% interest in the SAHT) to assist GAB better understand the investment objective, strategic asset allocation, expected return and the risk associated with the investment of a perpetual endowment, and its impact on projected distributions to the Synod.

16. At its meeting on 24 May 2017, GAB approved a revised strategic asset allocation for the DE based on the removal of its 50% interest in the SAHT, subject to the approval of Standing Committee. In order to obtain the benefit of a diversified portfolio which reflects the DE's status as a perpetual endowment, the GAB approved investments in 2 new asset classes as follows –

- Direct Property – Mercer Direct Property Fund
- Unlisted Infrastructure – Mercer Unlisted Infrastructure Fund

17. As full implementation of the revised strategic asset allocation will take up to 2 years (to gain relevant exposures in the Unlisted Infrastructure Fund), GAB will use a combination of the Mercer Direct Property Fund and the Mercer Listed Infrastructure Fund as a proxy in the interim.

18. These asset classes were chosen because they –

(a) reduce the volatility of returns,

(b) enable the DE to take advantage of the illiquidity premium within these asset classes (as the DE has a relatively low requirement for liquidity),

(c) provide extra protection against future inflation,

(d) when combined within the DE's portfolio, increase the probability of maintaining the real value of the DE while maintaining a 3.5% pa total spend rate,

(e) are expected to enhance the overall rate of return of the DE,

(f) provide greater exposure to the industrial property sector through the Direct Property Fund, and

(g) provide exposure to infrastructure assets globally which will help to further diversify the investment portfolio of the DE.

19. Modelling undertaken by Mercer indicates that the revised strategic asset allocation for the DE will have the following enhanced characteristics –

(a) The probability of meeting the investment objective of 3.5% + CPI over 20 years is 79.8%, compared to the current 70% probability.

(b) A greater probability of maintaining the real value of the DE without any reduction in spending.

(c) A long-term expected return of 7.2% pa (compared to the previous long term expected return of 6.3%)

(d) As a consequence of higher expected returns, a higher distribution rate to Synod is projected due to the extra expected capital growth of the DE.

Distributions for spending by the Synod

20. The removal of the 50% interest in the SAHT from the DE and its reallocation as an investment of the Synod will give rise to two direct sources of investment income for the Synod –

(a) Distributions from the restructured DE, in line with the current smoothing methodology.

(b) Distributions from the 50% interest in the SAHT. Currently the SAHC makes quarterly distributions to its stakeholders based on rolling forecasts of not less than 3 years of income.

21. The table below summarises the projected amounts available for spending by the Synod from the DE (with the 50% SAHT interest) for the period 2018 to 2026 and compares these amounts to corresponding projections for the DE (without the 50% SAHT interest) and the Synod's stand-alone 50% SAHT interest. The amounts shown in the table **should be treated as indicative only** and rely on a number of assumptions, including standard market conditions and an estimate of distributions from the SAHT based on its current policies. The amounts are also net of projected administration expenses (see further below).

	DE with 50% SAHT interest	**DE without 50% SAHT interest**		**Combined**	
Year	**DE distribution to Synod (with 50% SAHT interest)**	**DE distribution to Synod**	**SAHT distribution available to Synod from the previous year**	**Amount available to Synod for spending**	**Increase in amount available to Synod for spending**
2018	4,690,000	4,690,000	0	4,690,000	0
2019	4,820,000	2,560,000	2,456,000	5,016,000	196,000
2020	4,930,000	2,640,000	2,512,000	5,152,000	222,000
2021	5,050,000	2,710,000	2,568,000	5,278,000	228,000
2022	5,170,000	2,890,000	2,624,000	5,514,000	344,000
2023	5,290,000	2,960,000	2,679,000	5,639,000	349,000

	DE with 50% SAHT interest	DE without 50% SAHT interest		Combined	
2024	5,430,000	3,030,000	2,735,000	5,765,000	335,000
2025	5,570,000	3,210,000	2,800,000	6,010,000	440,000
2026	5,730,000	3,380,000	2,866,000	6,246,000	516,000
					2,630,000

22. In summary, the projections indicate an increase of $2.63 million in the total amount available to the Synod for spending over the period 2018 to 2026. In addition, the revised structure carries a much improved probability of maintaining the real value of the DE.

Transitional issues

23. In order to transition from a single source of funding for the Synod to two sources of funding, the Ordinance provides for the following arrangements –

(a) The amount distributed by the DE to the Synod for spending in 2017 will remain at $4.4 million. However as the $4.4 million was determined on the assumption that distributions from the 50% SAHT interest during 2017 would be paid in full to the DE, any remaining distributions from this interest in 2017 will be paid to the DE notwithstanding the date for removing the interest from the DE being 1 September 2017.

(b) The amount distributed by the DE to the Synod for spending in 2018 will remain $4.69 million. Again, this is notwithstanding the removal date of the 50% interest in the SAHT from the DE being 1 September 2017. Maintaining funding to the Synod at this level in 2018 is intended to provide certainty in the last year of the Synod's current funding triennium.

(c) Distributions from the SAHT during 2018 will be paid into a Synod "provisioning" fund. The Synod or the Standing Committee will pass an ordinance toward the end of 2018 to appropriate these funds for spending by the Synod in 2019 together with the relevant amount from the DE for 2019, as part of its normal appropriations and allocations processes. Distributions from the SAHT in subsequent years will be treated in the same way. This means, for example, that in 2019 the total projected amount available for spending by the Synod of $5,016,000 will be comprised of $2,560,000 from the DE and $2,456,000 from the SAHT (see shaded boxes in above table).

24. The arrangements referred to in (a) and (b) above are reflected in clause 6 of the Ordinance.

Administration Expenses

25. It will be necessary to revise the structure of fees and other administration expenses incurred in managing both the DE and the Synod's investment in the SAHT upon its removal from the DE.

26. The cost of administering the DE is an important factor to be managed if distributions are to be made to the Synod at levels which maintain the DE's real value. In November 2013, the GAB indicated to the Standing Committee that it would seek to ensure that administration costs for the DE (excluding external investment management fees and the costs of Financial Services) are less than 1.1% of the net assets of the DE.

27. The following is a table which sets out the administration costs of the DE as a percentage of the net value of the DE for the period 2010 to 2017.

Year	Admin expenses of the DE (% of average net assets over the year)	Average Net Asset value of the DE over the year ($000s)
2010	3.27%	113,604
2011	0.97%	112,400
2012	0.97%	118,498
2013	0.98%	128,832
2014	0.82%	139,487

Year	Admin expenses of the DE (% of average net assets over the year)	Average Net Asset value of the DE over the year ($000s)
2015	0.88%	147,747
2016	0.87%	156,827
2017	0.79%	162,592*

*using Mercer's forecast

28. Upon the removal of the DE's 50% interest in SAHT, the net value of the DE was reduced from $163 million (as at 1 September 2017) to $97 million. However as most of the administration costs of the DE are fixed, there will only be a modest reduction in those costs.

29. In order to recover the administration costs of the DE after the removal of its 50% interest in the SAHT, it is necessary to reset the rate at which the DE is charged in 2018. This will be sufficient to recover the projected administration costs of the DE in 2018. Assuming the projected administration costs of the DE in future years increase by CPI, the administration costs of the DE as a percentage of its net value are expected to decline in much the same way as they have declined during the period between 2010 and 2016.

30. There will be additional work involved in managing the Synod's 50% interest in the SAHT. The cost associated with this additional work still needs to be finalised. However, the projections shown in the table in paragraph 21 assume that this additional work can be undertaken within the existing cost structures in place immediately prior to the removal of the DE's 50% interest in the SAHT.

Potential disadvantages of the DE restructure

31. The removal from the DE of the 50% interest in the SAHT is intended to optimise the DE's performance as a perpetual endowment. As noted above, the modelling undertaken suggests that this is likely to result in the total amount available for spending by the Synod from the restructured DE combined with the Synod's stand-alone 50% interest in the SAHT being greater than the amount distributed from the DE in its previous form.

32. Synod's 50% interest in the SAHT is expected to continue to perform well for the following reasons.

(a) It has generated significant and increasing cash distributions in the past 4 years.

(b) Whether the market valuation of the SAHT goes up or down, this interest is expected to continue to distribute consistent cash to its stakeholders.

(c) The reserving policy undertaken by the SAHC accounts for future rental voids, maintenance costs and rental expenses. The policy seeks to ensure that distributions are stable year on year and increased by CPI.

(d) The distribution rate over the past 5 years from the SAHC has been about 1% greater on average than the distribution rate from the DE.

33. However, in making its decision to pass the Ordinance, the Standing Committee was made aware of the potential disadvantages in agreeing to remove the 50% SAHT interest from the DE and holding it as a stand-alone investment for the Synod. These are outlined below.

Concentration risk

34. There will be an increased concentration risk to the Synod in that a higher proportion of Synod's income in the future will be derived from commercial and retail property. Transferring the 50% SAHT interest from the DE will enable GAB to further diversify the DE portfolio by investing in the Mercer Direct Property Fund and Mercer Unlisted Infrastructure Fund. The result for the Synod will be an overall increase in the components of its income being derived from commercial and retail property assets.

Volatility

35. Although the SAHC has a reserving policy, the distributions from the 50% SAHT interest may be more volatile than distributions from the DE. At the moment the income from the 50% SAHT interest does not directly flow through the DE and then to the Synod. Any variation in the income from the 50% SAHT interest does not directly affect Synod. The smoothing effect of the DE's distribution formula ensures that total spending generally increases by CPI each year. An interruption to the cash distribution flow from the SAHT interest would have an impact on Synod and the ministries it funds in the following year. However the SAHT already employs significant smoothing strategies to mitigate the risk of fluctuating returns, and these strategies are not impacted by the proposed changes.

Illiquidity

36. The 50% SAHT interest is illiquid. As a standalone asset it is not readily sold and converted into cash.

Investment risk

37. The market value of the 50% SAHT interest is dependent on the commercial property market (among other factors). Synod may see significant valuation changes year on year. If a major tenancy is vacant for a prolonged period of time, this impacts the market value of the 50% SAHT interest and also cash distribution flows. However it should be noted that this does not equate to the Synod taking on any additional risk overall compared with the previous arrangements.

For and on behalf of the Glebe Administration Board.

ROSS SMITH
Chair, Glebe Administration Board

30 August 2017