3/10 Glebe Board Charter

(A report from the Standing Committee.)

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Introduction

1. On 11 October 2010, the Synod of the Diocese of Sydney resolved as follows (resolution 3/10) –

   "Synod requests the Standing Committee to produce a detailed report for the 2011 session of Synod regarding the operational application of the charter supplied to the GAB for its management of the Diocesan Endowment – as directed in the Glebe Administration Ordinance 1930 (section 2) and subsequent amending ordinances.

   The report to include (but not be limited to) the following areas –

   1. *The formula(s) actually applied and actions taken to 'preserve the real value of the DE' in each year from 1975 to 2009.*
   2. *The formula(s) and decisions applied in determining what constitutes 'a reasonable income from the DE' and how this was calculated in each year (or applicable budget triennium) from 1975 to 2009.*
   3. *The weighting and/or priority order applied to each of the two principles in each year from 1975 to 2009 and reasons as to why such a weighting and/or priority order was applied in each case.*
   4. *An examination of the ongoing appropriateness of both guiding principles for the future management of the DE including recommendations as to –*
      - *(a) future application of 'preserving the real value',*
      - *(b) future application of 'providing a reasonable income',*
      - *(c) future interaction (weighting and/or priority order) of the two principles in determining each future budget of Synod, and*
      - *(d) any additional principle statements that might be added to the two present guiding principles for GAB management of the DE."*

Executive Summary

2. The main matters addressed by this report can be summarised as follows –

   - Since 1984, the principal object of GAB in relation to the property known as the Diocesan Endowment has been to preserve the real value of that property and provide a reasonable income therefrom.
   - Consistent with the status of the Diocesan Endowment as a long term investment fund, the requirement to preserve the real value of the Endowment embodies the principle of "intergenerational equity", that is, the maintenance of the value of the capital for the benefit of both current and future generations.
   - The real value of the property of the Diocesan Endowment over the period 1984 to 2010 has not been maintained reflecting, particularly –
     - the impact of the significant declines in the investment markets in recent years,
     - the impact of bank gearing which resulted in realised losses when the gearing was repaid at a time when asset values were low, and
     - distributions from the Endowment for spending by the Synod have been too high.

- Since 1984 there have been various methodologies adopted for determining the amount to be distributed from the Endowment each year for spending by the Synod –
  - from 1984 to 2001, the amount of each distribution was calculated by reference to the "Operating Surplus" of the Diocesan Endowment, and
  - from 2001 to 2007, the amount of each distribution was calculated by reference to the "Net Asset Value" of the Diocesan Endowment, and
  - in 2008 the amount of the distribution was calculated by reference to a "Yale" type formula, the purpose of which was to minimise the impact of short term movements in investment markets on the amount of each distribution, and
  - in 2009 and 2010, as a consequence of the impact of the Global Financial Crisis, the amount of each distribution was specifically prescribed by the Standing Committee.
- Changes in the distribution methodologies applied from time to time were made following concerns that the then current distribution methodology allowed distributions to be made which were too high having regard to the need to maintain the real value of the Endowment.
- With the passage of time it is difficult to articulate specifically how, since 1984, GAB sought to balance the requirements to maintain the real value of the Endowment and maintain a reasonable income therefrom. GAB has regarded the requirement to maintain the real value to be a long term objective and has invested the property of the Endowment in asset classes which are expected to experience short term volatilities in returns.
- GAB has sought to meet the demands for income for spending by the Synod, so far as it was possible to do so. GAB has also sought to generate other sources of income but generally such other sources have not been sustainable.
- Since 2010 GAB has not sought to recommend that the Standing Committee review the terms of clause 2 of the 1930 Ordinance. Rather, it has reviewed the investment charter, the distribution policy and the expenses of the Endowment in light of the existing requirements to maintain the real value of the Endowment and provide a reasonable income therefrom.
- GAB has determined, as a matter of policy, that it will not borrow for investment purposes.

Background

3. The *Glebe Administration Ordinance 1930* (the "1930 Ordinance") provided for the establishment of the Glebe Administration Board to manage and control the properties then known as the St Philip's Sydney Glebe and the St James' Sydney Glebe. The ordinance specified the powers of the Board, and provided for the application of the rents and other income earned from the properties. Different provisions applied for the rents and other income of each property.

4. The provisions for the application of the rents and other income from the properties were varied subsequently, particularly those relating to the rents and other income received from the St Philip's Glebe. Until 1967, the Ordinance prescribed the specific purposes for which the rent and other income was to be applied, and the specific amounts of such applications.

5. During the 1960s, GAB also became trustee of the Bishopsthorpe Estate at Forest Lodge, the St Mark's Glebe at Randwick, and the St John's Glebe at Parramatta.

6. By the *Glebe Administration Ordinance 1930-1967 Further Amendment Ordinance 1968* new provisions were made for the application of the rents and other income from the glebes. Under those provisions –

- GAB had to prepare for the Standing Committee each year a statement as to the gross surplus of the rents and other income arising from the glebes, other than the Bishopsthorpe Estate; and
- the Standing Committee by resolution was to determine annually a sum, not exceeding ¾ of the gross surplus, which was to be applied by the Synod by ordinance.

7. These provisions were further amended by the *Glebe Administration Ordinance Further Amendment Ordinance 1970* to limit the distribution to an amount which was the greater of ¾ of the gross surplus, and the sum which GAB notified the Standing Committee was available for distribution.

8. The *Glebe Administration Ordinance 1930-1981 Amending Ordinance 1984* substantially amended the terms of the 1930 Ordinance. One amendment was to insert a new clause 2 into the 1930 Ordinance in the following terms –

> *"2. The object of the Board is to act as trustee of church trust property vested in it or in respect of which it may be appointed trustee and to do so in a way which both –*
>
> *a. preserves the real value of the property; and*
>
> *b. provides a reasonable income therefrom."*

9. Previously, there was no requirement in the 1930 Ordinance that GAB act to preserve the real value of the Diocesan Endowment. Clause 2 is still current.

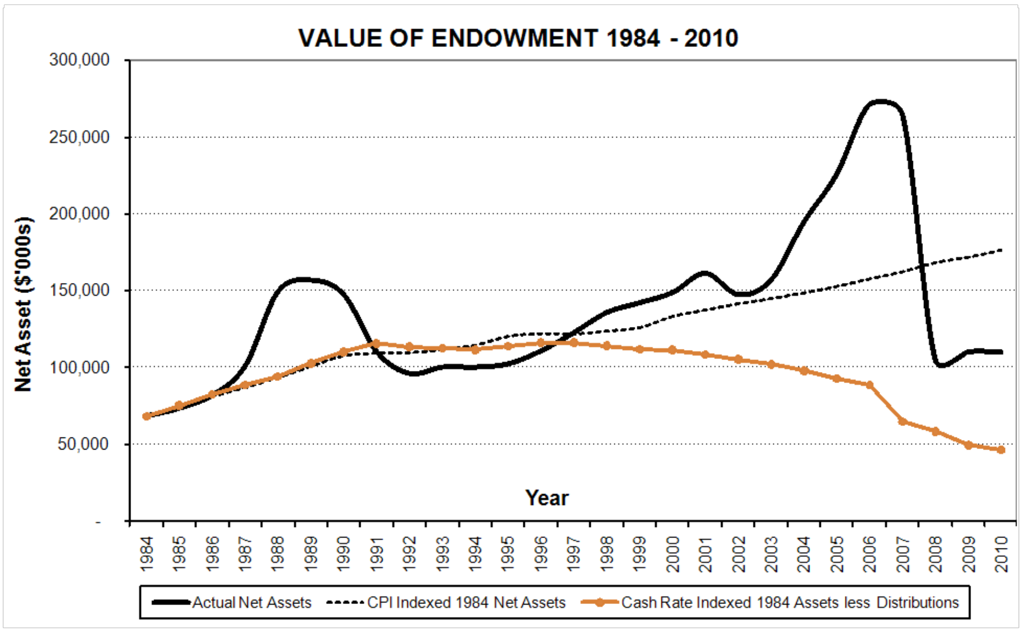
10. The Diocesan Endowment is a long term investment fund. The requirement in clause 2 to preserve the real value of the Endowment embodies the principle of "intergenerational equity", that is, the maintenance of the value of the capital of the Endowment in perpetuity, for the benefit of both current and future generations. The additional requirement to provide a reasonable income from the investment of the Endowment, such income to be enjoyed by the current generation, needs to be understood in light of the capital maintenance requirement. Generally, distributions of income are only considered to be "reasonable" to the extent that they allow the real value of the Endowment to be maintained.

11. The provisions for the application of the income of the property of the Endowment were removed from the 1930 Ordinance and re-enacted in the Diocesan Endowment Ordinance 1984 (the "1984 Ordinance"). Those provisions have been amended subsequently. A later section of this report considers the provisions for the application of income set out in the 1984 Ordinance, the changes which have been made to those provisions and the reasons why those changes were made.

12. Resolution 3/10 requests that information be provided about the formulas applied, actions taken and decisions made since 1975 in connection with the maintenance of the real value of the Endowment and the provision of a reasonable income therefrom. However, the resolution is in error in so far as it assumes that GAB has been required since 1975 to maintain the real value of the Endowment and provide a reasonable income therefrom. As has been indicated, this requirement was only inserted into the 1930 Ordinance in 1984. Accordingly, for the purposes of this report, 1984 has been taken as the year from which the information requested by the Synod is to be provided.

Maintenance of the real value of the Diocesan Endowment

13. The movement in the value of the Diocesan Endowment from 1984 to 2010 compared to the real value is illustrated on the following chart –



14. The dark line in the chart shows the movement in the actual value of the net assets of the Diocesan Endowment. In 1984, the net assets of the Endowment were about $60 million, and, in 2010, about $110 million. The dotted line is the value of the net assets of the Endowment in 1984, indexed each year by the changes in the Consumer Price Index. This represents the growth in the value of the Diocesan Endowment required to maintain the real value. In a year when the value of the actual net assets exceeds the value of the CPI Indexed 1984 Net Assets, the real value of the assets has increased. Conversely, if the actual net assets are less than the CPI Indexed 1984 Net Assets, the real value of the assets has declined.

15. The light line in the chart shows the value of the net assets in 1984 indexed annually according to the average cash rate each year over the period 1984 to 2010, less the distributions made from the Diocesan Endowment each year since 1984. Further comment about what this line shows is made later in this report.

16. Up until the end of the 1980s, the property of the Diocesan Endowment was mainly invested in commercial property assets. This led to a significant increase in the real value of that property during the favourable commercial property conditions of the late 1980s. This was followed by a major reduction in value in the early 1990s. Following that experience a more diversified investment portfolio was established.

17. The extent of the increase in the real value of the property of the Diocesan Endowment during 2002 to 2007 was attributable to very favourable investment markets accentuated by a gearing strategy by which borrowed money was used to boost the overall level of investments. While the Diocesan Endowment has taken deposits for many years, the level of gearing was boosted from 2002 onwards by borrowing money from banks.

18. The reduction in the net assets in 2007-2008 was a result of the large falls in investment markets, accentuated by the bank gearing in the balance sheet. The repayment of the bank gearing required the sale of a significant portion of the investment portfolio. This resulted in realised losses when the markets were low, and the repayment of the gearing precluded the Endowment from benefiting when investment markets subsequently improved. This outcome reflected a failure in risk management in relation to gearing. GAB has subsequently determined that it will not borrow for investment purposes (see paragraph 60 of this paper).

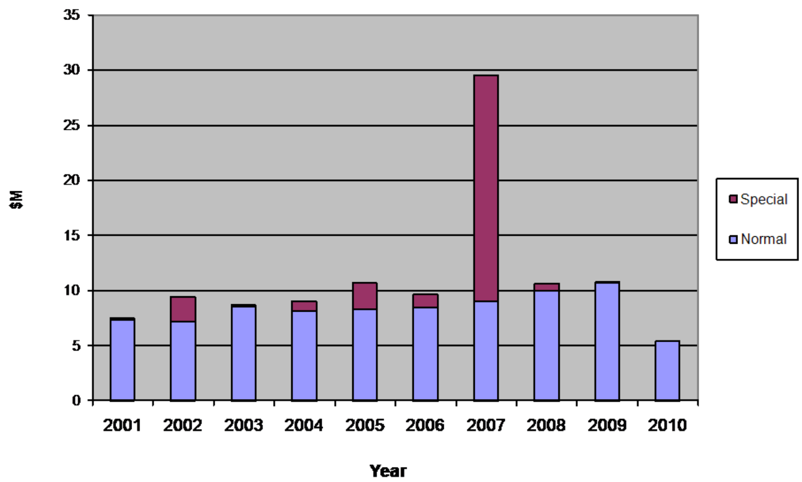
19. The chart shows that as at 31 December 2010, the actual value of the net assets of the Endowment was significantly less than the CPI indexed 1984 Net Assets. This indicates that over the period 1984 to 2007, the real value of the net assets was maintained, but the significant reduction in the value of the Endowment since 2007 means that over the period 1984 to 2010 the real value of the net assets has not been maintained. The reduction in the value of the Endowment since 2007 reflects the significant declines in the investment markets (which were exacerbated by bank gearing), and also that distributions from the fund for spending by the Synod have generally been too high. The following sections of this report consider the distributions from the fund, and the way in which those distributions have been calculated.

20. The light line showing the value of the 1984 assets indexed annually by the average cash rate each year, less actual distributions paid in that year, indicates that had the assets of the Diocesan Endowment been invested in cash investments only, the net assets of the Endowment would have been less that $50 million in 2010, given the actual distributions made between 1984 and 2009. This indicates that if the real value of the Diocesan Endowment is to be maintained, and a reasonable income earned, reasonable investment risk needs to be incurred – investing in cash investments only will not enable the real value of the Endowment to be maintained and a reasonable income earned. But the line also indicates that, historically, distributions from the fund for spending by the Synod have been too high to enable the real value of the Endowment to be maintained.

Distributions from the Diocesan Endowment

21. The following chart sets out the level of spending by the Synod from 2001 through to 2010 from distributions paid from the Diocesan Endowment –

Spending by the Synod



22. In each year, the first component is the normal distribution determined by the Standing Committee. The second component are the special additional distributions approved by the Standing Committee.

23. The most notable special distribution made in recent years was an amount of $20 million allocated to the Mission Property Committee in 2007. This money was used to fund the acquisition of land for future church construction in new growth corridors and also to assist in some construction projects on existing church sites. Other purposes for which special distributions were made include funding the new capital project and the mission executive. The Standing Committee has now determined that before consideration is given to any further proposal for a special distribution from the Diocesan Endowment, the Standing Committee will refer the proposal to GAB for its advice in light of all the circumstances available at that time.

24. Under the *Diocesan Endowment (Special Distribution) Ordinance 2009* the amount of the distribution provided for in 2009 and spent by the Synod in 2010 was $5.4 million. This is the amount reflected in the abovementioned chart for 2010. Under the same ordinance, the amount of the distribution to be provided for in 2010 for spending in 2011 is $5.25 million. Accordingly, a provision for distribution of $5.25 million was created in the financial accounts of the Diocesan Endowment as at 31 December 2010.

25. GAB considered that the level of distributions remained too high and, in December 2010, proposed a new methodology for calculating the amount of distributions. GAB's proposal is referred to later in this report. The proposal

has been accepted by the Standing Committee for the purpose of calculating the amount of the distribution to be provided for in 2011 for spending by the Synod in 2012.

Methodologies used for calculating distributions

26. The methodology originally adopted in the 1984 Ordinance for determining the distributions to be made from the Diocesan Endowment was based on the "Operating Surplus" of the Endowment. Subsequently, the methodology for determining distributions was changed to be based on the "Net Assets" of the Endowment. Later, by further modification, the methodology was based on the application of a "Yale" type formula. In 2009, the impact of the Global Financial Crisis resulted in the distribution methodology prescribed by the 1984 Ordinance being suspended.

Distributions by reference to "Operating Surplus"

27. When passed, the 1984 Ordinance provided that each year ("Year 2") the Standing Committee was to recommend to the Synod the amount to be distributed in the year after the year in which the recommendation was made ("Year 3"). The amount so recommended was to be that part of the "Operating Surplus" of the Endowment in the year before the recommendation was made ("Year 1") as did not exceed the aggregate of –

(a) ¾ of the amount of the Operating Surplus of the Endowment in Year 1, and

(b) the additional amount (if any) which GAB as trustee of the Endowment notified the Standing Committee as could be prudently distributed from the Endowment from the Operating Surplus of the Endowment in Year 1, or a prior year.

28. For these purposes, the "Operating Surplus" in a year was defined to be all revenue derived from the property of the Endowment during that year, and the realisation of such property, less –

(a) all expenses incurred in connection with that revenue or the property, and

(b) all losses (whether of a capital or revenue nature) so incurred.

29. The 1984 Ordinance also provided that the term "Operating Surplus" did not include –

(a) any gain or loss on the disposal of any part of the property more than 12 months after it was acquired or agreed to be acquired (whichever first occurred), or of any interest therein, or

(b) any extraordinary items, being items of revenue or expense or other gains or losses brought into account in the relevant year which were attributable to events or transactions outside the ordinary operations of GAB, or

(c) any gains arising from the repurchase by GAB of its own debentures, or

(d) any gains arising from the purchase of securities acquired to provide moneys to redeem debentures of GAB.

30. Otherwise, the "Operating Surplus" was to be determined in accordance with generally accepted accounting principles consistently applied.

31. In essence therefore, the distributions from the Endowment were determined having regard to the ordinary income of a revenue (as opposed to capital) nature.

32. From 1985 to 1995 distributions equal to 75% of the Operating Surplus in the relevant year were made on 7 occasions, distributions of 90% of the Operating Surplus were made twice, and a distribution equal to 61.8% of the Operating Surplus was made once.

33. In 1996, the Standing Committee asked that its Finance Committee consider and report about the level of distributions from the Endowment. The Finance Committee reviewed the capital of the Endowment from 1985 to 1995, and concluded that the real value of that capital had declined by an average of 1.5% per annum over that period. The Finance Committee considered that the main factor giving rise to a decline in the real value of the Endowment were the relatively high distribution rates from 1985 to 1995.

34. To protect the real value of the capital of the Endowment, and allow for modest growth, the Finance Committee recommended that the 1984 Ordinance be amended so that 70% (rather than 75%) of the amount of the Operating Surplus was the maximum amount which could be distributed. Subsequently, the Standing Committee passed the *Diocesan Endowment Ordinance 1984 Amendment Ordinance 1997* to amend the 1984 Ordinance to provide that the maximum amount of the Operating Surplus available to be distributed was 70% in 1997, reducing by 1% per annum until 2002 so that the maximum amount available for distribution would be 65%. The 1984 Ordinance retained the provision allowing for a greater amount to be distributed if GAB advised that a greater distribution could be prudently made.

35. However, the scheme for reducing the maximum amount of the Operating Surplus available for distribution was soon modified. By the *Diocesan Endowment Ordinance 1984 Amendment Ordinance 1999* the 1984 Ordinance was further amended so that the maximum amount able to be distributed in each of 1999, 2000 and 2001 was 75% of the Operating Surplus in the relevant year, with the maximum amount to be reduced to 65% in 2002.

Distributions by reference to "Net Asset Value"

36. In 2001 the Standing Committee received a report from GAB about its plans for the investment of the property of the Endowment from 2001 to 2005. The report dealt with a range of issues, including a proposal that the method for

calculating distributions from the Endowment be changed from one based on the Operating Surplus of the Endowment, to one based on the Net Asset Value of the Endowment.

37. In short, GAB proposed that in 2002 and subsequent years the amount to be provided for in any year for distribution be 5.4% of the average net asset value of the Endowment for the previous 3 years.

38. GAB considered that the determination of distributions by reference to the "Operating Surplus" of the Endowment inhibited sound investment decisions because the methodology limited the free flow of investment funds between asset classes and forced an inappropriate focus on income effects in investment decision making. The report contained the following example to illustrate the issue. If GAB wanted to convert part of its investment in equities to an investment in fixed interest, the realisation of the equities might give rise to a profit would form part of the "Operating Surplus", and become distributable. This meant that any large movement between asset classes could artificially inflate the Operating Surplus.

39. GAB indicated its intention to change its investment methodology from a focus on producing (or not producing) income for distribution purposes, to one which focussed on the total return of the portfolio and individual asset classes. GAB considered that the adoption of the proposed new distribution methodology would support this approach.

40. As mentioned, GAB proposed that the distribution from the Endowment in any year be 5.4% of the average net assets for the 3 preceding years. The rate of 5.4% was chosen because it resulted in the same projected distribution being available for the Synod in 2005 (being the end of the then planning period covered by GAB's report) as was projected to be available in 2005 if the then current methodology for determining distributions (based on the Operating Surplus) was continued. It was also said that the purpose of averaging net assets over 3 years was to minimise the impact of short term fluctuations in the investment markets on the amounts to be distributed to the Synod.

41. The Standing Committee appointed a subcommittee to consider and review a range of matters referred to in GAB's report, including the proposal for the change in methodology for determining the distributions to be paid from the Endowment. In relation to that proposal, the subcommittee raised the following issues, and was provided with the following responses –

(a) Why not simply redefine the concept of "Operating Surplus"? The subcommittee was advised that GAB had considered redefining the concept but no matter the redefinition the investment decision making process continued to be distorted. GAB preferred a total return methodology which the proposed new distribution formula supported.

(b) What about the distribution of unrealised gains? GAB said it recognised that under the "Operating Surplus" method of determining distributions, only realised gains could be distributed. GAB acknowledged that under the proposed distribution methodology based on net asset values unrealised gains may need to be distributed. The subcommittee was advised that GAB had undertaken cash flow forecasting, and was confident that cash holdings in the Endowment would be sufficient to enable distributions to be made without realising assets specifically for that purpose.

42. The subcommittee subsequently recommended the proposal and the Standing Committee made the *Diocesan Endowment Ordinance 1984 Amendment Ordinance 2002* to implement the new methodology for calculating distributions.

Distributions by reference to a "Yale" type formula

43. During late 2006 there was further consideration about the level of distributions from the Endowment having regard to GAB's objective in clause 2 the *Glebe Administration Ordinance 1930* to maintain the real value of the Endowment and earn a reasonable income therefrom.

44. In December 2006 the Standing Committee requested that GAB report by July 2007 about, among other things, the sustainability of the methodology adopted in 2002 for calculating distributions from the Endowment having regard to the objective of GAB to maintain the real value of the Endowment.

45. GAB's report was provided in August 2007. In addressing the level of distributions in light of the objective to maintain the real value of the Endowment, GAB considered the following matters –

(a) *Projected investment returns for the Endowment.*

On the basis of advice received, GAB advised that a projected future total return of about 9% per annum was considered reasonable for the Endowment. With an assumed inflation rate of 3% per annum, this meant that a real rate of return of 6% per annum could be allocated among retained earnings of the Endowment, the expenses of managing the Endowment, and the annual distributions to be made from the Endowment for the purposes of the Synod.`

(b) The need to retain earnings

Having regard to the volatility associated with the investment of the Endowment and the potential impact of that volatility on the distributions to the Synod, GAB advised that it was considered best practice to retain some of the expected return from the investment of the Endowment to preserve the real value of the Endowment between years, to protect the Synod fund against volatility from investment market returns and provide a steady and predictable flow of income to the Synod fund, and to protect the Synod fund against continued unfavourable market conditions across a number of years.

Based on advice received by GAB that it was appropriate to structure its investment strategy to have a 70% probability of meeting the objective of preserving the real value of the capital of the Endowment, GAB projected that the level of earnings to be retained to reach that probability would be in excess of 1% per annum.

(c) *The level of expenses for managing the Endowment.*

GAB noted that the management of the Endowment involved a number of aspects, including investment management, managing the "banking" services (treasury, deposit plan, and loans) and managing a range of legal and regulatory issues.

GAB also noted that in recent years the level of expenses of managing the Endowment (less those associated with the banking services) had averaged 1.5% of the assets of the Endowment, and that GAB had targeted an expense level of 0.8% of the assets of the Endowment. (An expense level of 0.8% was not subsequently achieved.)

(d) *Distributions to the Synod*

GAB noted that the formula for calculating distributions approved by the Standing Committee in 2002 provided for a distribution based on 5.4% of the net assets on the Endowment, averaged over 3 years.

GAB also noted that in the 10 years prior to the date of its report the actual "ordinary" distributions from the Endowment had averaged 5.2% per annum of the net tangible assets of the Endowment. If special distributions from the Endowment were taken into account, the average annual distribution rate had been about 6% of net assets.

46. GAB's report concluded that to enable the retention of an amount of 1% of net assets, an expense level of 1.5% of net assets, and a distribution to Synod of 5.2%, a real return of 7.7% was required to be earned from the investment of the Endowment. Allowing for an inflation rate of 3% per annum, this required a return of 10.7%, which was about 1.7% per annum more than the projected annual total return of 9% per annum for the Endowment. In GAB's view, this indicated that the distribution formula providing for a distribution of 5.2% per annum was unsustainable, and would not allow GAB to achieve its objective of maintaining the real value of the Endowment.

47. GAB considered several formulas which could be adopted for implementing a sustainable distribution formula, including methodologies which averaged net assets over 3 years, or 12 calendar quarters. But it recommended the adoption of a "Yale" type formula (so named because it is based on a formula used by the manager of the Yale University Endowment Fund in the United States to determine annual distributions from that fund) under which the amount to be available for distribution from the Endowment in any year was to be calculated as the sum of 2 parts, being –

(a) the prior year's distribution adjusted by inflation, weighted at 70%, and

(b) the average market value (over the previous 3 years) of the Endowment multiplied by a "predetermined percentage", weighted at 30%.

48. The weighting between the 2 parts (70% versus 30%) was suggested based on experience of other endowment funds researched by GAB at the time. GAB recommended that the "predetermined percentage" referred to in the second part of the formula be 4.2%. This was based upon an expected annual real return of 6% from the investment of the Endowment, less the amount proposed to be retained (being 1% per annum) and an amount on account of the costs of managing the Endowment (being 0.8% per annum, which was specified to be GAB's aspirational objective for the costs of managing the Endowment – the then current rate being 1.5% per annum).

49. GAB's recommendations in relation to the level of distributions from the Endowment were adopted by the Standing Committee and, by the *Diocesan Endowment Amendment Ordinance 2007*, the new methodology for determining annual distributions was enacted with effect from 2009. Under this new methodology on amount of $10.63 million was appropriated from the Endowment in 2008 for distribution in 2009.

Impact of the Global Financial Crisis

50. The Global Financial Crisis of 2008-2009 resulted in a substantial decline in the value of the net assets of the Endowment. As a consequence, the determination of the level of distribution by reference to the "Yale" formula was suspended and other arrangements substituted. By the *Diocesan Endowment (Special Distributions) Ordinance 2009*, as amended, the amount to be appropriated from the Endowment in 2009 (for spending in 2010) was specified to be $5.4 million, and in 2010 and 2011 a total of $10.5 million was to be appropriated for distribution (in 2011 and 2012). On the advice of GAB, the Standing Committee has subsequently agreed to appropriate a lesser amount in 2011 for spending in 2012.

Balancing the requirements to maintain the real value of the Endowment and provide a reasonable income therefrom

51. With the passage of time it is difficult to articulate specifically how, since 1984, GAB sought to balance the requirements of clause 2 of the 1930 Ordinance to maintain the real value of the Endowment and provide a reasonable income therefrom. The 1930 Ordinance appears to imply that the requirement to provide a reasonable income from the Endowment needs to be understood in light of the capital maintenance requirement and that, generally, distributions of income would only be "reasonable" to the extent that they allow the real value of the Endowment to be maintained.

52. GAB has regarded the requirement to maintain the real value of the Endowment as a long term objective, rather than a short term objective, and it has invested the property of the Endowment on the basis that short term fluctuations in the value of that property are to be expected. This reflects that the requirements of clause 2 to both maintain the real value of the property and generate a level of income consistent with the Synod's expectations requires that investment risk be assumed. However, in accepting risk (even within acceptable risk tolerances), there is no cast iron guarantee or assurance that expected returns will be achieved.

53. From 1984 the property of the Endowment has been invested in asset classes which are expected to experience short term volatilities in returns. For example, until the early 1990s the property of the Endowment was invested mainly in commercial and industrial real estate. During the late 1980s and early 1990s, the property market declined, and the value of the Endowment dropped significantly (as indicated in the graph in paragraph13).

54. To reduce the risk associated with the over exposure to the commercial and industrial property markets, in the early 1990s GAB diversified the investments of the Endowment into other asset classes, such as equities. The strategy of investing the property of the Endowment in a diversified range of asset classes has been maintained by GAB since then, although the nature of the asset classes and the allocations towards different asset classes have changed from time to time. Typically, those asset classes are subject to short term volatilities in returns. This approach is consistent with the approach taken by the trustees of other perpetual endowments, such as university endowments.

55. Alternatively, GAB could have invested the property of the Endowment into cash investments, or other investments where the capital value is better assured. However, as the graph in paragraph 13 indicates, had the investments of the Endowment been invested in this way, the value of the Endowment would have been significantly less than at present, given the distributions made for spending by the Synod over that period. Put another way, if the property of the Endowment had been invested in cash, the distributions to the Synod for spending would have needed to have been significantly reduced beyond the actual distributions made if the real value of the Endowment was to be maintained over the period from 1984.

56. Investment markets operate on the basis of cycles during which there will be periods during which markets will perform better than long terms averages, and periods where they will underperform. The failure to have due regard to the nature of the investment cycles may have contributed to some unwise practices in managing the Endowment.

57. For example, it is apparent that decisions about special distributions were made during the period when investment markets were performing strongly. As the graph in paragraph 13 shows during the period from 2002, the value of the Endowment grew significantly as investment returns exceeded long term averages. During that period the total amount distributed from the Endowment also grew significantly. In retrospect, it is apparent that decisions about distributions (particularly special distributions) may not have given due consideration to the investment cycle, and the need to ensure that a proportion of the above long term average returns should be retained to compensate for the period in the investment cycle when investment markets would weaken.

58. It is to be recognised that this period corresponded with a period where there were significant demands for income for spending by the Synod, and a desire by GAB to meet those demands so far as was possible.

59. The desire of GAB to meet the income needs of the Synod can be seen in the development of other initiatives by GAB, with a view to generating additional income. Since the mid 1990s, such other initiatives have included the launch of the Glebe Income Accounts and the operation of funds management and financial advisory businesses. The Glebe Income Accounts continue to be operated as part of GAB's banking services but the other initiatives were found not to be sustainable, and have been discontinued.

60. The bank gearing also contributed to the failure to maintain the real value of the Endowment. The gearing the amplified the impact of favourable markets 2002 until 2008: but it exacerbated the impact of declining markets during 2008 and 2009, and investment losses were crystallised when GAB decided to liquidate investments to repay the bank debt. Given the nature of the risks associated with gearing, GAB has subsequently determined as a matter of policy –

> "GAB will not borrow for investment purposes. The prohibition on borrowing does not apply to the Glebe Income Accounts … and does not prevent borrowing by way of overdraft or similar to meet short term cash flow needs."

Ongoing management of the Endowment

61. GAB has not sought to recommend that the Standing Committee review of the terms of clause 2 of the 1930 Ordinance. Given that the Endowment is a perpetual endowment, it is appropriate that the long term objective is to maintain the real value of the Endowment and, in the interim, to provide a reasonable income therefrom. Accordingly, since 2010, GAB has reviewed the investment charter, the distribution policy, and the expenses of the Endowment in light of those objectives.

Review of Investment Charter for the Endowment

62. In June 2010, after undertaking a review of the investment strategy of the Endowment, GAB adopted a new investment objective for the Endowment having regard to the requirements of clause 2 of the 1930 Ordinance. The investment objective was further reviewed in March 2011 and is now in the following terms –

> "To achieve a real rate of return over rolling 5 year periods of 5% per annum net of external investment management expenses and adjusted for tax effects, subject to –
>
> (a) preserving the real value of the DE over rolling 10 year periods with a 70% probability, and

(b) the sum of the distributions from the DE plus administrative and other costs (not including external investment management expenses) not exceeding 5%, on average, over rolling 5 year periods."

63. There are a number of points to be made about the investment objective.

64. First, the objective expressly envisages the maintenance of the real value of the Endowment, measured over a 10 year period. This is intended to reflect the period of the investment cycle – over a 10 year period, it would be expected that investment markets would run through the cycle of both out performing and underperforming long term average rates of return.

65. Secondly, the investment objective does not envisage a guarantee that the real value of the Endowment will be maintained over that period. It will be seen that the objective states that the probability of maintaining be 70%. This means that there is a 30% chance (or risk) that the real value will not be obtained over a 10 year period. This reflects that a certain level of risk needs to be undertaken if there are to be reasonable income distributions from the portfolio over the period. A probability of 70% is considered to be an appropriate level of risk to be assumed by a portfolio such as the Endowment. The Annexure sets out further information about the probability of achieving the investment objective, and provides a comparison with less aggressive and more aggressive investment objectives.

66. Thirdly, the investment objective includes both a return objective and a distribution policy. The return objective is that over rolling 5 year periods, it is expected that the return from the Endowment will be 5% per annum, over the inflation rate. If the real value of the Endowment is to be maintained then the amount available for distribution must be no more than 5% per annum measured over the same rolling 5 year period.

67. From the investment objective, a strategic asset allocation has been determined, and the property of the Endowment invested in different asset classes in accordance with that allocation. The strategic asset allocation has regard to the 3 distinct activities undertaken by GAB – the holding of investment assets, the undertaking of banking services, and the holding of an interest in the St Andrew's Houses fund.

68. Having regard to the Investment Objective, in December 2010 GAB recommended a different methodology for determining the distributions to be provided from the Diocesan Endowment for spending by the Synod. GAB recommended that distributions to the Synod from the Diocesan Endowment should be determined having regard to the 3 distinct activities of the Endowment. Each of these activities has different characteristics (particularly in relation to liquidity) which GAB considered must be taken into account in determining a distribution policy which is consistent with the objective of maintaining the real value of the Endowment.

69. In determining the amount of the distribution to be provided, the expenses of managing the Endowment must also be considered.

70. GAB proposed that this methodology apply to determine the amount of the distribution to be provided for in 2011 for spending by the Synod in 2012. The Standing Committee has adopted this proposal. It is also proposed that a similar methodology be adopted in future years for determining the amount to be distributed from the Diocesan Endowment.

Investment assets

71. In relation to the investment assets of the Endowment, GAB considers that a "Yale" type formula is the most appropriate method for determining the amount to be applied from the investment assets towards the calculation of the amount to be provided for distribution. Using such a formula, the amount to be applied from the investment assets in any year would be calculated as the sum of 2 parts, being –

(a) the amount applied from the investment assets in the prior year adjusted for inflation, weighted at 70%, and

(b) 5% of the average value (over the previous 3 years) of the investment assets, weighted at 30%.

72. In 2011 transitional provisions will apply so that the amount to be applied from the investment assets will be based upon the value of those assets as at 31 December 2010. It is considered inappropriate to use the value of the net assets from earlier years, given the substantial changes to the classes of assets which the Endowment now holds, and the value of its investments in recent years.

Banking services

73. GAB considers that the amount to be applied from the banking services activities towards the calculation of the amount to be provided for distribution should be a proportion of the surplus from those operations. The surplus from banking services is generally the net margin between the rates received from loans and treasury investments, and the rates paid on deposits, less the other costs of providing the banking services.

74. For the purposes of the calculation of the amount to be applied towards the calculation of the distribution to be provided for in 2011 for spending by the Synod in 2012, GAB considers that 75% of the surplus in 2010 is the appropriate proportion to be available for application having regard to the need to –

- maintain the real value of the capital of the Endowment allocated to banking services, and
- retain part of the surplus for the purposes of the costs of systems reviews and upgrades.

Interest in the St Andrew's House fund

75. GAB considers that the amount to be applied in relation to its interest in the St Andrew's House fund towards the amount to be provided for distribution should be a proportion of the cash distributions received by the Endowment from that fund.

76. For the purposes of the calculation of the amount to be applied towards the calculation of the distribution to be provided for in 2011 for spending by the Synod in 2012, GAB considers that 75% of the cash distribution received from the St Andrew's House fund in 2010 is the appropriate proportion.

Costs of administering the Diocesan Endowment

77. GAB expects that the total cost of administering the Endowment in 2011 will be $1.15 million, which is substantially less than the total cost of administering the Endowment in 2010 and earlier years. For this purpose, the total cost of administering the Endowment does not include the costs of providing the banking services since the costs of those services are taken into account in determining the surplus from banking services.

78. GAB's aim is to limit the total costs of administering the Endowment to an amount which is not more than 1.1% of the net assets of the Endowment. The previous objective of limiting the total cost to 0.8% of the net assets of the Endowment was determined when the net assets of the Endowment were significantly greater, and it is to be expected that the total cost expressed as a percentage of net assets will fall as the value of the net assets increases. The estimated total cost of administering the Endowment in 2011 (being $1.15 million) is 1.05% of the net assets of the Endowment as at 31 December 2010 (being $110 million).

Conclusion

79. Since 1984, GAB has been required to invest the property of the Endowment in a way which preserves the real value of the property, and provides a reasonable income therefrom. Since 1984 there have been a variety of methodologies adopted to calculate distributions from the Endowment. Changes in those methodologies have been made from time to time to address concerns that the real value of the Endowment has not been maintained. In hindsight, it can be seen that the real value of the Endowment has not been maintained. There are several factors which have contributed to this. First, the nature of investment methodology adopted by GAB since 1984 is such that risk cannot be avoided and in accepting risk (even within acceptable risk tolerances) there is no cast iron guarantee or assurance that expected returns will be achieved. Secondly, successive decisions about the level of distributions to be made to support the income needs of the Synod have impacted the ability to maintain the real value of the Endowment. Thirdly, other decisions such as the decision to gear the portfolio by way of bank debt and the crystallisation of losses to repay that debt have contributed to the failure to maintain the real value of the Endowment.

80. Since 2010 GAB has sought to respond to these issues by reviewing the investment objective of the Endowment, the distribution policy and the expenses of the Endowment with a view to ensuring, within acceptable risk tolerances, the maintenance of the real value of the Endowment measured over the long term, and the provision of a reasonable income therefrom.

Recommendation

81. The Synod receive this report.

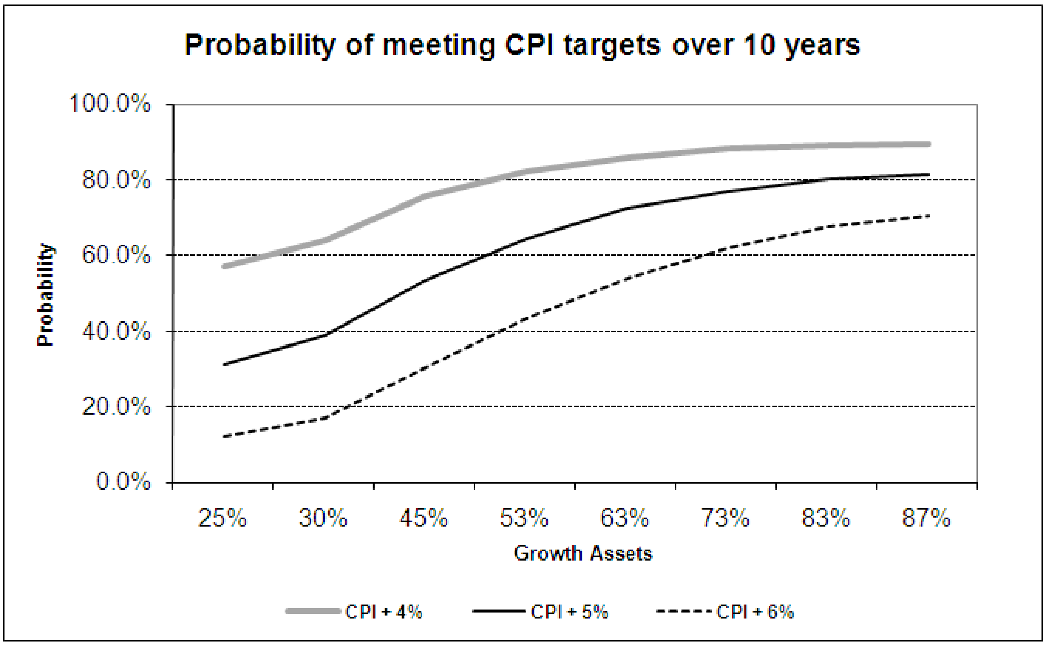
For and on behalf of the Standing Committee

ROBERT WICKS
Diocesan Secretary

22 August 2011

Annexure

1. The following graph has been prepared by GAB's Asset Consultant, Mercer, to indicate the probabilities of achieving 3 different investment objectives, having regard to different proportions of growth defensive assets within the portfolio. It is intended to illustrate that there is an inverse trade off between risk and return, and that a judgement needs to be made as to the best balance between risk and return for the Diocesan Endowment.



2. The 3 different 10 year investment objectives represented by the graph are –
   - CPI plus 4%. This is a less aggressive investment objective than that adopted for the investment of the Diocesan Endowment.
   - CPI plus 5%. This is the investment objective adopted for the Diocesan Endowment.
   - CPI plus 6%. This is a more aggressive investment objective than that adopted for the Diocesan Endowment.

3. The *x* axis on the graph indicates the portion of the investment portfolio invested in growth assets (such as shares and property). Historically, growth assets classes have the greatest volatility in terms of return. The model assumes that the balance of the investment portfolio is invested in defensive assets (such as bonds and cash). There is considerably less volatility in the returns for these asset classes compared to growth.

4. The *y* axis on the graph indicates the probability of achieving each investment objective over a 10 year term.

5. From the graph the following points can be made –
   - There is a greater probability that a less aggressive investment objective (CPI plus 4%) will be achieved over a 10 year term, given a particular mix of growth and defensive assets in the portfolio, compared to a more aggressive investment objective.
   - However, even with a less aggressive investment objective, a higher probability of achieving the objective requires that a greater proportion of the portfolio be invested in growth assets.
   - Generally, once the proportion of growth assets in an investment portfolio reaches 70-75% of the portfolio, adding further to the proportion of growth assets does not significantly increase the probability that the relevant investment objective will be achieved. In any event, because of the nature of some of the assets currently held in the Diocesan Endowment, it would be difficult to increase the proportion of the growth assets significantly beyond 70%.
   - Even with a less aggressive investment objective risk remains in the portfolio. There remains a probability that the investment objective will not be achieved.

6. While the probability of achieving a less aggressive investment objective might be higher, given a particular mix of growth and defensive assets, adopting a less aggressive objective has important implications for the level of the distribution which can be made from the Fund. A less aggressive investment objective would reduce the amount of the distribution available to the Synod for spending. The substantial cuts in the distribution to be made for spending by the Synod in 2012 are to make the amount of the distributions consistent with the current investment objective of CPI plus 5%. If a less aggressive return objective was adopted (say CPI plus 4%), the amount available for spending by the Synod would reduce further. While detailed modelling about the extent of the reduction has not been undertaken, preliminary analysis suggests that an investment objective of CPI plus 4% would reduce the amount of the distribution proposed to be made available for spending by the Synod in 2012 by about $600,000.

7. Accordingly, the determination of an appropriate investment objective requires a balance between risk and return.