INVESTMENT POLICY STATEMENT

(approved December 5, 2013)

Bring justice to our land, that all may dwell secure,
and finely build for days to come foundations that endure.

Hymn 600, verse 3 (The Hymnal 1982)

I. STATEMENT OF PURPOSE

Canon 5 declares "The Diocesan Council shall supervise the business and financial affairs of the Diocese", and Article 6 of the Diocesan Constitution states "The Treasurer shall be the chief financial officer of the Corporation". This investment policy statement serves to present in a single document guidance for the financial management of the investment funds of the Diocese in a way that upholds the values, beliefs, and mission of the Diocese.

Stewardship of financial resources calls for balance, thoughtful deliberation, and choices between competing alternative paths for carrying out the mission work of financial management. This document is intended to ensure that the ensuing process and outcome will faithfully serve the people and the congregations of the Diocese and the wider world they live in.

II. PRINCIPLES

This investment policy statement has as its foundation the following principles:

Timeless Abundance: The financial resources of the Diocese can, with proper stewardship, support the work and mission indefinitely.

Discipline and Reserve: Proper stewardship requires an attention to understanding, measuring, and managing risks; seeking an appropriate balance between risk and return; and maintaining buffers to absorb the shocks of adverse times and events.

Voice: Financial investments represent and are part of the wider world in which the Diocese lives, and our responsibility to respond to them is based on our call as disciples of Christ to engage the world outside our church doors.

Simplicity and Efficiency: The Bishop, Convention, Council, and Treasurer are ultimately responsible for financial stewardship, and any specific Diocesan investment policy and implementation must be accessible to them so that they can attest to its propriety and soundness and oversee its implementation.

III. ENDOWMENT AND RESERVE FUNDS

[Note: the accompanying appendix "Background and Financial Status" provides useful information based on circumstances as of the summer of 2013.]

This Investment Policy Statement considers two types of funds.

Endowment funds are dedicated to providing revenue each year to help fund the Diocesan operations. The goal of this investment policy and the associated spending draw policy is to provide a consistent and sustainable revenue stream to the annual budget process. Thus, the long-term investment performance of an endowment fund must provide growth that matches or exceeds the annual spending draw plus endowment expenses and inflation.

Reserve funds are held in anticipation of either capital spending needs or other extraordinary (ex-budget) spending that is predictable and for which Council or Convention have set aside funds in advance. It is standard policy that a reserve fund is spent only on those items intended and it is not available to contribute to the annual spending policy draw for the regular budget. As a reserve fund's time horizon is relatively short (typically three years), the investment objective of a reserve fund should preserve the value of the funds allocated to it; principal appreciation is secondary.

The Diocesan Council has responsibility for regularly assessing upcoming predictable expenses, such as capital improvements, and fully funding reserves for them. Particularly in light of the recent conclusion of the twenty million dollar comprehensive campaign, the importance of segregating sufficient funds from the somewhat riskier endowment pool to designated reserve funds is high.

IV. INVESTMENT OF ENDOWMENT FUNDS

Each year's Convention, through the adoption of a budget, adopts a spending draw for the year. Recent conventions have adopted draws between 4% and 5% of the three year trailing average of quarterly or monthly fund values. One interpretation of recent practices is that the value of 4% is the "usual" spending policy draw, and increases above that have been seen in response to "special" circumstances. A 4% draw is also the policy used by the TOD for its trust funds. This is known as a "total return" approach.

Thus, the **long-term target rate of return** for Diocesan endowment funds must exceed 4% plus endowment expenses and inflation in order to sustain indefinitely a spending draw of comparable spending power.

A second guideline is to **control the risk** of the endowment fund portfolio. Risk control is needed since a sharp drop in the value of an endowment fund will lead to both a drop in current revenue for the Diocesan budget under a constant spending draw policy and a reduction in future support for as long as it takes for the endowment's value to recover.

To quantify a risk control guideline consistent with recent Diocesan Council preferences, consider a guideline that standard deviation of the annual return on an endowment not exceed 15% per year. In this case, the expectation is that the chance the endowment portfolio could decline more than 30% in one year is about one in forty. (Given the current policy of basing draws on a three year average of portfolio values, a 30% decline would lead to a more palatable three-year decline in spending policy draws of 10% per year.)

History suggests that the targets of 4% plus endowment expenses and inflation and a 15% total portfolio return volatility imply a long-term stock-bond mix in the neighborhood of 60% stocks/ 40% bonds to 65% stocks/ 35% bonds.

A third guideline addresses **portfolio liquidity**. Public securities, like stocks and bonds, have the advantage of trading on secondary markets, allowing investors the chance to buy and sell with relatively low transaction costs for reasonably predictable prices. Direct investments, such as loans and equity investments in private enterprises, usually cannot be sold easily or quickly at fair value.

There will be situations where less liquid investments may be appropriate for an endowment fund. A mortgage loan to a bishop envisioned for HR purposes, for instance, could be an acceptable alternative to a bond investment. A direct investment in an enterprise deemed to have special attraction from an Environmental, Social, and Governance (ESG) perspective might be another example.

This investment policy statement cautions the Diocese to consider fully the ramifications of such illiquid investments. The guideline proposed here places limits on the total dollar amount placed in illiquid investments.

V. INVESTMENT GUIDELINES FOR ENDOWMENT FUNDS

<u>Asset allocation:</u> The overall endowment will be invested within a range of:

> **stock and equivalents: 50% to 70% of portfolio value; target 60%**
> **fixed income: 30% to 50% of portfolio value; target 40%.**

The Treasurer and Financial Advisory Committee will base tactical movement within the range on periodic assessment of the relative valuation of the different asset classes, along with the general economic outlook. The Executive Committee of Diocesan Council can authorize exceptional moves outside the range.

Benchmark:

The performance of the endowment fund portfolio will be measured regularly and reviewed against a performance benchmark composed of three parts:

50% CRSP US Total Market (a measure of US stock market performance)[1]
10% FTSE Global All Cap ex US (a measure of international stock performance)
40% Barclays Aggregate (a measure of US bond market performance)

Individual managers of Diocesan endowment funds will be measured separately against assignment-appropriate benchmarks.

All performance measurements should be made net of all fees.

Portfolio risk levels: An appropriate target measure of portfolio volatility is 15% per year. Portfolio volatility should be estimated on a regular basis using recent historical data.

Permitted securities: Individual and collective (mutual funds, ETFs, common trust funds, etc.) holdings of the following types are permitted:

- Large, mid, and small cap domestic equities
- Preferred equities
- Convertible securities
- ADRs and developed and emerging international equities (**emerging markets capped at 5% of overall portfolio, total international exposure capped at 20%**)
- Obligations of US Treasury and agencies
- Obligations of domestic and foreign corporations (all non-investment grade debt capped at **5% of the overall portfolio**)
- Municipal securities
- Commodities (capped at **5% of the overall portfolio**)
- Use of derivatives is permitted for overlays and as lower-cost alternatives. Use of leverage is not permitted.

Diversification: (a) For managers assigned to manage a stock portfolio on behalf of the

[1] The CRSP US Total Market benchmark is used here because it is both extremely broad (including more than 3,000 domestic stocks) and its publisher provides much more detailed information about the benchmark than other benchmark providers, including information about the position size of each constituent holding. In addition, as of June 2013, the world's largest mutual fund company, the Vanguard Group, has adopted the CRSP benchmarks for its mutual fund families.

Diocese, individual holdings of permitted common stock are capped at 5% of the manager's portfolio. Routine exceptions may be granted for holdings of diversified Exchange Traded Funds (ETFs). (b) For managers assigned to manage a bond portfolio on behalf of the Diocese, the total holdings of any one issuer's obligations are capped at 5%. This cap does not apply to holdings of US treasury and US agency obligations.

Direct investments: Direct investments for the furtherance of other objectives (such as human resource considerations or environmental, social, and governance concerns) are allowed with an **overall portfolio cap of 10%** and a **per-investment limit of 2.5%,** each direct investment and the amount thereof to be approved individually by vote of Diocesan Council.

VI. INVESTMENT OF RESERVE FUNDS

The purpose of a reserve fund is to set aside funds today for known spending needs in the immediate years ahead. When the Diocese places funds in a reserve fund, it does so with little tolerance for capital loss and to keep pace with inflation. Thus, the acceptable portfolio risk level for a reserve fund is significantly less than that for an endowment fund.

In addition, the liquidity requirements of a reserve fund are high. Reserve fund resources need to be available on relatively short notice (say 30 days at most). Direct investments and illiquid securities are not appropriate.

VII. INVESTMENT GUIDELINES FOR RESERVE FUNDS

- Funds should be invested in pooled or individual high quality fixed income obligations with a weighted average duration of less than three years. An allocation of **up to 10% of the portfolio in equities** is allowed.
- **Benchmark: Barclays Aggregate Intermediate Index**

VIII. SUSTAINABLE AND RESPONSIBLE INVESTING (SRI)

Sustainable and Responsible Investing (SRI), with its emphasis on environmental, social, and governance (ESG) factors, is an on-going concern and consideration for the entire Diocese. The investments of the Diocese should reflect the mission and ESG priorities of its congregations and their members.

The goal of this investment policy statement is to ensure that the Diocese is committed to a process that stays vibrant and accessible to all. The desired emphasis is on listening and learning, collaborative action, and expanding our network as committed investors.

Potential collaborators with the Diocese in SRI activities include the Trustees of Donations, the Episcopal City Mission, The Episcopal Church, the Church Pension Fund, and other faith-based investment organizations.

IX. SRI PRACTICES

Invest and engage: We, the Diocese, can work with other active shareholders throughout the market to coordinate our actions and engagement with corporations, and apply a variety of organizing strategies (e.g., proxy voting, dialogue with corporate managements, shareholder resolutions, public policy advocacy) to gain public support for our positions.

Divest (or offset) and protest: A different strategy is for the Diocese to sell all shares in the target corporation (sometimes called negative screening) and to publicly promote why the stake was sold, encouraging others to do the same. If the target corporation is held in a broadly diversified stock fund, the Diocese can offset the economic benefit through alternative selling strategies.

Dual purpose investing: The Diocese can also invest in companies or enterprises that have a specific, intentional social purpose, in addition to risk-adjusted return on investment.

X. SRI ACTIVITIES -- IDENTIFYING AND LISTENING TO DIOCESAN VOICES

Ensuring that the financial management of Diocesan funds reflects the values, beliefs, and mission of the Diocese won't be accomplished by this investment policy statement alone. In a spirit of collaboration, the Diocese will need to engage its parishes and members in the conversation.

It is anticipated that proposals regarding shareholder engagement, divestment, and alternative direct SRI opportunities will originate with individual members of, or in the congregations of, the Diocese; be faithfully debated there, at Convention, and by the Diocesan Council; and, if adopted, by virtue of Convention's and Council's actions become part of this investment policy statement.

The financial guidelines and targets noted above are primary; the impact on these of an SRI-driven proposal will be a factor in the decision-making.

XI. DIOCESAN SRI GUIDELINES

The Diocese will favor investment actions and activities that support long term economic development consistent with socially responsible outcomes. Five specific areas for consideration and action are: health impact of product and services; environmental impact; workplace policies; community engagement; and corporate governance. We aspire towards better than average practices and standards as measured globally.

Health and safety: We will discourage production and sale of products and services with a significant adverse impact on the health and safety of individuals or communities.

Environmental impact: We will promote above-average practices in the areas of conservation, pollution control, and waste reduction.

Workplace policies: We will expect entities to avoid unacceptable labor practices and violations of health and safety regulations, in their own facilities and organizations and in their supply chains.

Community engagement: We will encourage entities to uphold human rights and nurture positive relationships in the communities where they are located.

Corporate governance: We will seek to reform those entities whose governance practices are unethical or lack accountability to shareholders and other stakeholders.

XII. SELECTION AND MONITORING OF INVESTMENT MANAGERS AND ADVISORS

The Diocesan Council and the Treasurer are ultimately responsible for the investment of financial resources. From a practical perspective, the Council will ask a committee, such as its Financial Advisory Committee, to lead a process to include regular monitoring of investment results, periodic review of individual managers, and occasional recommendations as to manager additions or changes, as warranted. The Treasurer and the Chief Business Officer (or their designees) will take active advisory roles as they are able.

Investment performance will be evaluated over extended periods (preferably of more than a market cycle) in light of long-term objectives, with the understanding that there are likely to be short periods when performance of individual styles deviates from benchmarks.

Monitoring and resulting recommendations will focus on:

- Adherence to the guidelines in this document
- Fee-adjusted performance comparisons with appropriate benchmarks
- Changes within an investment manager’s organization

APPENDIX: BACKGROUND AND FINANCIAL STATUS

A. BACKGROUND

The Protestant Episcopal Diocese of Massachusetts ("Diocese") was established in 1784, incorporated in 1952, and is among the largest dioceses in the Episcopal Church in terms of baptized members. The head of the Diocese is the Diocesan Bishop, elected by a Convention of clergy and delegates from member parishes and missions. The Diocesan Council supervises the business and financial affairs of the Diocese between annual sessions of Diocesan Convention.

There are 183 congregations and these congregations identify more than 64,000 members among them. There are approximately 575 clergy canonically resident in the Diocese, of whom approximately 230 are retired.

The 2013 Diocesan budget totals approximately $8.1 million, and the Diocese employs about 38 individuals. The 2013 budget projects among its primary income sources revenues from congregation assessments of about $4.7 million and funds (primarily investment income) withdrawn from Diocesan financial assets of about $900,000. In addition, the budget includes revenue from trusts owned by the Trustees of Donations (TOD) for which the Diocese is the income beneficiary of about $1.3 million.

The financial and spiritual health of the Diocese is a reflection of the financial and spiritual health of its member congregations. The congregations provide most of the Diocese's revenue through their assessment payments. Income distributions from investments and trusts are an important supplement for the Diocese, but are not sufficient alone to sustain more than skeletal Diocesan operations.

The diocesan bishop heads several related organizations with significant financial assets and operations that complement the work of the Diocese. The largest of these related organizations are:

- Trustees of Donations to the Protestant Episcopal Church
- Episcopal City Mission
- Barbara C. Harris Camp and Conference Center
- Society for the Relief of Aged or Disabled Episcopal Clergy
- Society for the Relief of Widows, Widowers and Orphans of Clergy of the Episcopal Church
- Cathedral Chapter

For the most part, these entities control and oversee their own investment funds and thus are outside the scope of the accompanying investment policy statement.

In 2013, the Diocese is preparing for a transition in its episcopal leadership, with a new bishop to be elected in April 2014 to succeed the Rt. Rev. M. Thomas Shaw, SSJE. The election with take place April 5, 2014, and, pending a churchwide consent process, the bishop-elect will be consecrated on September 13, 2014, at which time Bishop Shaw will resign his office and the new bishop will assume episcopal authority.

B. FINANCIAL ASSETS AND INVESTMENT EXPOSURE OF THE DIOCESE

To understand more fully the financial profile of the Diocese, it helps to identify both the "Agency Funds" and the "Trust Funds".

Agency Funds are owned outright by the Diocese. The funds referenced here are invested in financial instruments, representing both endowment and reserve funds. Other assets owned by the Diocese, such as real estate, are not included here.

The June 30, 2013 internal (unaudited) statement of the Diocese includes the following assets:

Investments in the DIT funds	$ 28,518,921
Other stocks and bonds	$ 4,023,802
Mortgage notes	$ 419,577
TOTAL AGENCY FUNDS	$ 32,962,300 (representing both endowment and reserve funds)

The scope of this Diocesan investment policy statement is limited to the investment of these Agency Funds.

Trust Funds are owned by trusts that are legal entities distinct from the Diocese. The trustees manage the trusts according to conditions in the legal documents that created the trusts and identify the beneficiaries. The various legal trustees of these trusts control the investment of these funds.

Those trusts for which the Diocese's claim as a beneficiary is absolute and not subject to the discretion of the trustees, then the value of those trusts appears on the balance sheet of the diocese and the income from those funds is paid to the Diocese. The recent value of these trusts is:

Beneficial interest in perpetual trusts, supporting core budget	$ 13,971,425
Beneficial interest in perpetual trusts, supporting the BDFs	$ 15,503,079
TOTAL BENEFICIAL INTERESTS	$ 29,474,504

There are other trust funds that do not appear on the financial statements of the

Diocese (because the Diocese's claim as a beneficiary is not absolute).

Other trust funds (core budget)	$ 5,612,757
Other trust funds (BDFs)	$ 1,761,530
TOTAL OTHER TRUST FUNDS	$ 7,374,287

Virtually all of the trust funds considered here are owned by the Trustees of Donations (TOD), an entity distinct from but related to the Diocese. The TOD has its own investment policy statement (see www.trusteesofdonantions.org).

Recap

Agency funds (total)	$ 32,962,300	-- the subject of this policy
Trust funds (recorded as asset)	$ 29,474,504	-- owned and invested by others
Other trust funds	$ 7,374,287	-- owned and invested by others
TOTAL INVESTMENT EXPOSURE	$ 69,811,091	