

COMMUNITY OF CHRIST WORLD CHURCH AFFILIATE INVESTMENT POOL

Selected Investment Topics

This paper provides additional information about the Affiliate Investment Pool and investing in general. The topics are Diversification, Market Timing, Investment Time Horizon, and Budgetary Support From Investments. It is our hope you will find this information helpful as you provide leadership in exercising stewardship over the funds in the Affiliate Investment Pool.

DIVERSIFICATION

One of the benefits you receive by investing in the Affiliate Investment Pool is diversification of your portfolio. Diversification of a portfolio is one of the principles of sound institutional investing. This includes diversification among asset classes and diversification among different asset managers. The size of the overall church investment portfolio allows us to provide a significant amount of diversification that would probably not be available otherwise to participants in the Affiliate Investment Pool. The table at the bottom of the page titled “Report on Investment Returns and Asset Allocation” (available on the website as “Historical Returns & Asset Allocation”) shows the asset allocation diversification among asset classes for the Affiliate Investment Pool. Our manager diversification is accomplished by having nine equity managers, four fixed income managers and one real estate manager for Pool A-Balanced.

A benefit of having a diversified portfolio is the ability to reduce the volatility in returns that would occur if the assets were invested in only one type of security. By using asset allocation techniques provided by our investment consulting firm, we are able to minimize the volatility in our portfolio while maintaining the average return we expect. Chart 1 (below) provides an example of how diversification reduces volatility of returns and results in an increase in portfolio returns over a period of time. Chart 2 (below) shows returns for the twelve months ended June 30, 2012, 2011 and 2010 for Pool A and a number of different market indexes.

MARKET TIMING

A review of returns like those in Chart 2 would lead to a conclusion that a portfolio would have been better to have been invested only in high-yield fixed income securities for the twelve month period ending June 30, 2010, then moved to be invested only in small-cap equity securities for the twelve month period ending June 30, 2011, and then moved to be invested only in investment grade fixed income securities for the twelve month period ending June 30, 2012. While that is certainly true, it doesn't do much good to know that after the period has ended. Does that mean an investor should try to predict which asset class will perform better in an upcoming period?

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Studies have shown that trying to be a market timer will not be a successful strategy over the long term. For example, during the period from March 1992 to March 2002, 40% of the total gain in the S&P 500 index occurred in just six individual months. If a portfolio had missed just one of those months, the return would have been significantly reduced for the ten-year period. The church's investment strategy does not include market timing. We believe the best way to capture returns is to make sure our asset allocation is set to provide the expected rate of return we desire based on historical averages.

INVESTMENT TIME HORIZON

Just as the World Church does not try to do market timing, we would suggest that you not do it by moving back and forth between Pool A and Pool B to attempt to capture the highest return between the two each year. How then should you determine whether to invest in Pool A or Pool B?

The primary decision factor for choosing Pool A or Pool B is your investment time horizon. This is an evaluation of how long the money is expected to be invested and how much may need to be withdrawn at any one time. If your time horizon is five years or less, you should probably be invested in Pool B. A time horizon of more than five years would suggest you should be in Pool A.

Here's an example. If your funds are a building fund and you expect to use them for a building project within the next five years, you should probably be in Pool B. While the expected annual return of Pool A is higher than that of Pool B over the long term, Pool A will experience more fluctuation in returns from year to year than Pool B. In a period as short as five years, you may not have enough time for higher return years to offset lower or negative return years such that the average return would exceed that of Pool B.

Here's another example. If your funds are reserve funds and you plan to use the earnings from the fund to supplement the operating budget or another activity for an extended time, you should probably be in Pool A. Even though you will want to withdraw from the fund every year to support the budget or activity, you will not be withdrawing all of the funds at one time and therefore, your time horizon will be more than five years. In this case, the fluctuation in returns from year to year should not adversely affect your ability to withdraw funds for support on an annual basis. The next section of this paper will talk about this more.

The analysis of your investment time horizon needs to be done on a regular basis. A fund that began with a long horizon could switch to a short one at some point. For example, if a building project is many years off you may want to start with Pool A and move to Pool B when you get within five years. Also, you do not need to put all of your funds in only one option. You can put part of a fund in Pool A and part in Pool B. This could be appropriate if a large amount will need to be withdrawn within five years while the rest of it is expected to not be needed for a longer period.

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BUDGETARY SUPPORT FROM INVESTMENTS

The whole purpose for investing funds is to provide earnings that can be used to support your mission. This means that at some point funds will need to be withdrawn. The question then becomes, "How do I know when to withdraw funds and how do I know how much to withdraw?"

The answer depends, again, on the purpose of the funds. If it is for a project that will occur at a given time, you will probably let the funds accumulate until they are needed for the project and then make a one-time withdrawal. As noted in the previous section, if the funds can accumulate for more than five years you should probably be in Pool A. Otherwise, Pool B would seem more appropriate.

If the funds are reserve funds, as described in the previous section, then the issue is one of how to most appropriately budget for the use of these funds and make withdrawals accordingly. One approach would be to budget each year based on the previous year's earnings and use that full amount. One disadvantage to the entire earnings method is that the earnings can fluctuate significantly from year to year making the sustainability of the support difficult. Programs may be started when the earnings are high and then have to be cut back when earnings are low. Also, if all of the earnings are used each year, the base value of the account will never grow and the effect of inflation will reduce the value of the earnings even if the nominal dollar amount of earnings remains the same. In addition, negative return years will reduce the base value of the account. An example of this method is shown in Chart 3 (below). The graph in Chart 4 (below) includes a line titled "Entire Earnings Balance" that shows how the base amount never increases and decreases in years when the return is negative.

Another approach would be to use a spending rate method. This method allows an average return rate to be used in calculating the amount to be spent, thus smoothing out large fluctuations in available income from your investment. An example is shown in Chart 3. This method works by multiplying a set percentage (spending rate) times the base value of the account to determine the expendable amount that will support the budget or activity each year. In years in which the earnings are higher than the expendable amount, the excess remains in the account and the base amount increases. When the earnings are less than the expendable amount, the base amount decreases. If the spending rate is set properly, the expected long-term rate of return will exceed the spending rate and allow the base amount to increase in approximately the same amount as inflation over the long term. This will allow increasing amounts for the expendable amount over the long term to offset the effects of inflation on the support provided.

Another principle used in this method is to apply the spending rate to the average of the base amount for the five previous years rather than just the last year. This tends to smooth changes in the expendable amount even when the investment returns are fluctuating. The example in Chart 3 shows how this would have been applied over a ten year period using actual returns. The graph in Chart 4 includes a line titled "Spending Rate Balance" that shows how the base amount would have grown during this time.

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If the purpose of your account is to provide on-going support to a budget or activity, the Presiding Bishopric recommends using the spending rate method. If you need additional information to apply this method, we would be pleased to provide such assistance.

Chart 1

Asset Diversification Example

	<u>Asset X</u>		<u>Asset Y</u>		<u>Portfolio *</u>	
	<u>Return</u>	<u>Balance</u>	<u>Return</u>	<u>Balance</u>	<u>Return</u>	<u>Balance</u>
Beg Balance		\$ 1,000		\$ 1,000		\$ 1,000
Year 1	3.0%	\$ 1,030	36.0%	\$ 1,360	19.5%	\$ 1,195
Year 2	9.0%	\$ 1,123	6.0%	\$ 1,442	7.5%	\$ 1,285
Year 3	30.0%	\$ 1,460	0.0%	\$ 1,442	15.0%	\$ 1,478
Arithmetic avg.	14.0%		14.0%		14.0%	
Geometric avg.	13.4%		13.0%		13.9%	

* Portfolio is created by investing 1/2 in Asset X and 1/2 in Asset Y.

By diversifying from an investment in only Asset X or Asset Y to a portfolio invested one-half in each asset, the balance at the end of Year 3 is greater than it would be for an investment in either asset alone. This occurs even though the arithmetic average of returns for both assets and the portfolio are the same. The diversification causes the geometric average to be higher than the arithmetic average by reducing the volatility of returns.

The geometric average is the return that, if achieved each of the 3 years, would produce the ending balance at the end of Year 3.

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Chart 2

**Affiliate Investment Pool A Return Compared to Market Indexes
For the Twelve Months Ended June 30, 2012, 2011 and 2010**

	<u>6/30/12</u>	<u>6/30/11</u>	<u>6/30/10</u>
Balanced Portfolio			
Affiliate Investment Pool A	1.2%	19.2%	12.0%
Stock Market Indexes			
S&P 500 Index (large cap)	5.4%	30.7%	14.4%
Russell 2000 (small cap)	-2.1%	37.4%	21.5%
MSCI AC World Ex-US (Int'l)	-14.6%	29.7%	10.4%
MSCI Emerging Markets	-16.0%	27.8%	23.1%
Bond Market Indexes			
Barclays Aggregate	7.5%	3.9%	9.5%
Barclays US Corp High Yield	7.3%	15.6%	26.8%

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Chart 3

Affiliate Investment Pool A - Balanced Pool
Returns for ten years showing Entire Earnings example and Spending Rate example

Year	Annual Return	ENTIRE EARNINGS EXAMPLE			SPENDING RATE EXAMPLE		
		Balance end of yr	Earnings Spent	Annual Earnings	Balance end of yr	Expendable Amount	Annual Earnings
0		10,000			10,000		
1	15.28%	10,000	1,528	1,528	10,928	600	1,528
2	26.60%	10,000	2,660	2,660	13,207	628	2,907
3	2.98%	10,000	298	298	12,918	683	394
4	16.19%	10,000	1,619	1,619	14,303	706	2,091
5	10.19%	10,000	1,019	1,019	15,024	736	1,457
6	-5.00%	9,500	-	(500)	13,476	797	(751)
7	-4.95%	9,030	-	(470)	11,982	827	(667)
8	1.24%	9,030	112	112	11,319	812	149
9	18.71%	9,030	1,690	1,690	12,644	793	2,118
10	9.64%	9,030	870	870	13,090	773	1,219

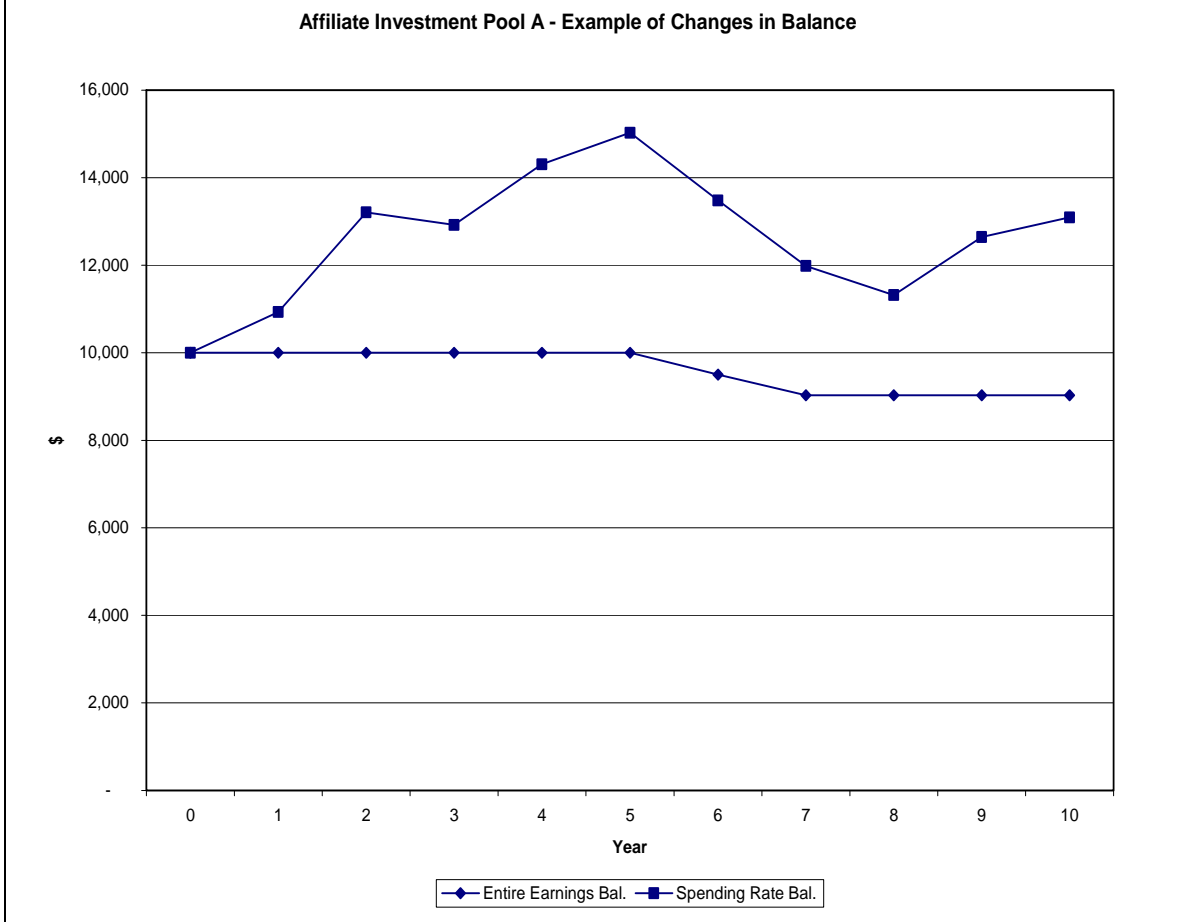
Spending rate: 6.0%

Notes:

1. Amounts are based on a deposit of \$10,000 at the beginning of Year 1.
2. These returns are those actually received in Pool A for a representative 10 year period.
3. The Entire Earnings Balance column shows no change when the return is positive since all earnings are spent. The balance decreases when the return is negative.
4. The Spending Rate Balance column shows the balance at the end of the year calculated by adding the earnings and subtracting the expendable amount from the previous year's balance.
5. The Expendable Amount column shows the amount withdrawn annually based on a spending rate of 6% times the average of the balance of the previous five years (or as many as are available).
6. The Annual Earnings amount columns show the annual earnings based on that year's return times the balance at the end of the previous year.

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Chart 4



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