September 30, 2008

To: UUA Board of Trustees

From: UUA Investment Committee

Subject: Portfolio Diversification

On this the last day of one of the most remarkable months in US financial history it seems prudent to share a few thoughts about our portfolio diversification strategy for the UU Common Endowment Fund (UUCEF, formerly called the General Investment Fund). As a general rule we believe that we have been given a fiduciary obligation to try to balance three objectives in the management of this fund:

1) Return: to seek to achieve a reasonable financial return on the fund's assets consistent with prudent risk and our values as Unitarian Universalists. We have interpreted that charge historically as trying to achieve at least a 8.5% nominal return (assuming about a 3.5% average inflation rate) over an entire financial market cycle (ten years or more).
2) Risk: since a risk-free nominal return remains below 1% annually, we understand that we must and will own financial assets that involve a fair amount of risk (measured either by risk of loss and/or volatility of valuations over time). We have adopted as an internal guideline that we try to minimize assets with a greater than 30% annual volatility risk, and try to balance and diversify the risks within the overall portfolio such that annual volatility of the portfolio as a whole, at least as expressed in our consultant's portfolio modeling, stays under 10% annually.
3) Values: we express our UU values by determining those stocks or bonds, owning which would not be consistent with our UU values, and provide each of our managers with a "Do Not Buy" list of such financial assets. We also employ specific strategies where appropriate: such as our UU Values Index Fund (managed for us by Rhumbline) or activist investors (such as Relational), that can help to tilt the world in the direction of social justice while seeking to meet our risk and return objectives. We also have a small commitment to Community Investments (even though we recognize that we are subsidizing such investments through accepting a below market rate of return for the risks involved).

History

Up until the end of 2001 the UUCEF, like most comparable sized investment funds, was conservatively managed holding roughly 60% Large Cap. Equities (mostly domestic) and 40% bonds (mostly top rated and domestic fixed income). As it appeared that this portfolio strategy was no longer likely to achieve an endowment's return and risk targets going forward, most similar size endowments diversified their holdings into US small cap. equities, international equities, global bonds, high yield bonds, venture capital, private equity, hedge funds, real estate, and more recently emerging markets equities. Being relatively conservative and prudent as fiduciaries we have been slower than many of our

peers in adopting many newer financial instruments as part of our portfolio, but have with the advice of our consultant (NEPC) moved progressively in directions which we hope, and their financial modeling suggests, will allow us to continue to balance the return, risk and UU values criteria above. Our largest concerns about some of these newer financial assets revolve around transparency (do we know what we own?), liquidity (can we exit an investment in a timely manner?), higher fee structures (which relate both to expected net returns and also to fundamental issues of fairness), predictability of risk or volatility, and appropriateness of these holdings given our UU values.

As a committee we have been more comfortable initially adding diversification assets that were both transparent and liquid. Between 2002 and 2007 we have expanded our exposure to high yield and global bonds (reducing our domestic fixed income exposure accordingly) and also greatly expanded our exposure to international and US small cap. equities. In the last 24 months we have added substantial allocations to absolute return strategies (managers seeking equity and fixed income returns non-correlated with the broader market indices), structured our own UU large cap. index fund (which now manages about half of our remaining dedicated US large cap. equity allocation), and now have added two Global Asset allocation funds (which manage diverse and rapidly changing portfolios of stocks, bonds, currencies, and commodities on a global basis). These changes in portfolio strategy have resulted in a total return for the GIF of 9.2% annually with only 6.4% volatility over the last five years. This compares to a 7.1% total return that would have been received from a typical 60% US equity/40% US Bond portfolio over the same five year period with improved volatility as well. So we are quite happy with the changes we have made historically to diversify UUCEF's portfolio, however we appear to have recently entered into yet another very different environment for financial assets and our consultant is advising us that further changes will be necessary in order to continue to adequately balance our three criteria going forward.

Alternative Assets

Based upon available industry data, it appears that most endowment funds of our size have more aggressively embraced alternative assets (hedge funds, venture capital, private equity, commodities, and real estate) than we have historically, and as a result during times of turmoil in the US large cap. market have significantly outperformed our portfolio (particularly during 2002). While alternative financial assets represent 13% of our portfolio today they represent an average of 28% of the portfolios of our peers. Given the expected financial returns of various asset classes going forward, relying upon the financial models of our consultant for this analysis, we again find ourselves in a position where we cannot expect to adequately meet our three fiduciary criteria going forward unless we attempt to bring our portfolio more in line with our peers.

We have examined with the help of our consultant various portfolio allocations that might help us to achieve our return targets, but all that maintain our current liquidity levels achieve these expected financial returns with too much expected risk (well above 10% annually). We have examined the expected returns, transparency, volatility and expected correlation with our existing portfolio of each of the alternative asset classes

and have concluded that adding hedge funds to our asset allocation (most likely through investing in one or two hedge fund of funds) is the most prudent way to seek to achieve our targeted returns within our tolerance for risk. Given the recent turmoil in the public equity markets the timing for such a decision also appears to be reasonable. So we have asked our consultant to bring several hedge fund of fund managers forward for us to select from at our November 13, 2008 Investment Committee meeting. However we remain concerned about several aspects of this decision:

1) the costs of such investments are substantially higher than public equities or bonds so we expect our net costs to continue to rise as we invest in more complicated asset classes;
2) these investments will largely be illiquid at least in the short term;
3) these investments will potentially generate accounting and annual audit issues; and
4) there are likely to be some issues of perception both about the appropriateness of the UUCEF investing in hedge funds and any reduction in our ability to pursue socially responsible investments with that portion of our portfolio.

After consultation with our consultant and the UUA Committee on Socially Responsible Investing, we feel that the increased costs, illiquidity, and accounting issues are manageable, and well worth the improvement in expected returns and risk for the portfolio as a whole. We are exploring with CSRI how best to manage these perception issues, both real and perceived, in ways that still allow us to achieve our three criteria.

Our thoughts at the moment are that we could further diversify our portfolio in some manner that strengthens our SRI objectives without negating the benefits from our diversification into hedge funds altogether. We are currently exploring:

1) Expanding the US large cap. assets allocated to our UU Index Fund;
2) Investigating opportunities in international SRI funds;
3) Perhaps creating an allocation for investing in Green Energy Funds.

Based upon the financial modeling of our consultants, it appears that a 15% commitment of our portfolio to a Fund of Hedge Funds (primarily drawn from our US fixed income allocation) and up to a 5% additional allocation to one or more of the above, or comparable, SRI focused investments could yield a continued expected nominal return above 8.5% annually without increasing our expected volatility much above 10% annually, while continuing to expand our creative approaches to meeting our UU values while working to tilt the world in the direction of justice.

There is nothing that the Board of Trustees needs to do for us to continue to attempt to meet our fiduciary obligations through the above stated means. However we thought that you might find it useful to be provided a general overview of our thinking and approach as we continue to help the UUCEF navigate in these perilous times. While this is our work to do, we would appreciate any comments you wish to share with us prior to our meeting on November 13, 2008. I am also willing and available to meet with you if you so choose. In faith, Rev. Jim Sherblom, on behalf of the UUA Investment Committee.