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WESPATH INVESTMENT MANAGEMENT

COUNTRY
US

TYPE OF FUND/ORGANISATION
Division of the General Board of Pension and Health Benefits of The United Methodist Church

TOTAL ASSETS
US$ 19 billion as at September 2013

"Wespath's investment programme to support affordable housing and community facilities has delivered a range of portfolio benefits such as lower investment volatility, higher yields and greater diversification."

INTRODUCTION

Wespath Investment Management serves the needs of institutional investors in a number of ways: offering a multi-manager platform of broadly diversified funds, socially themed investments through its 'positive social purpose' lending, and by integrating environmental, social and governance (ESG) factors into its investment strategy.

In 1990, Wespath established its Positive Social Purpose (PSP) Lending Program through which it funds affordable housing and community facilities. Roughly ten years ago, it extended the programme to fund charter schools[1] in the US and microfinance projects in emerging markets. By 30 September 2013 the PSP Lending Program had grown to over US$ 700 million – roughly 10% of its Fixed Income Fund.

This case study outlines how Wespath developed what has become, a highly successful programme and overcame the challenges it faced. It is one of a series of case studies produced by the PRI Initiative's Environmental and Social Themed Investing Work Stream.

KEY POINTS

- Wespath's investment programme to support affordable housing and community facilities has delivered a range of portfolio benefits. These include lower investment volatility, higher yields and greater diversification.
- Successfully operating the PSP Program took time and required up-front investment in knowledge and skills. However, the costs have been recovered as the programme has grown in scale.
- In creating unique programmes of this type, it is important to focus initially on a limited investment opportunity set to gain experience and scale in one area.
- Finding good pricing models and appropriate benchmarks to clearly measure financial performance against alternative opportunities have been, and continue to be, important parts of building the investment case among staff and the funds' leadership. Publishing financial results also helped to allay scepticism of the investment merits of this innovative approach.
- Using third-party providers to provide back-office functions such as valuation, accounting, legal support, and information technology enables Wespath to focus on developing expertise in investment due diligence and programme monitoring.

1 A charter school receives public funding and operates privately.

RATIONALE

Wespath believes that the inclusion of strong social values and good governance in investment decision-making can, and should, have a powerful positive impact on financial outcomes. It aims to deliver consistent, reliable investment returns while upholding the social principles of The United Methodist Church. The philosophy of the PSP Lending Program is to help people who lack ready access to capital by facilitating responsible, risk-adjusted investments in those communities. This strategy complements its traditional fixed-income investments and replaces the traditional mortgage-backed fixed income exposure in the Fixed Income Fund.

TYPE AND STRUCTURE OF INVESTMENTS

Wespath invests via a network of third-party loan originators that specialise in lending to organisations that build affordable housing and community facilities. A government programme to incentivise private investment in this sector – the Low Income Housing Tax Credit – underpins this type of lending.[2] Wespath acquires a senior position in mortgage loans from independent third parties, typically non-profit organisations. It benefits from various types of loan guarantee structures (provided, for example, by federal and local government guarantee schemes) that help to reduce the risks associated with these investments. PSP's loans have been used to fund the construction, rehabilitation or preservation of over 38,000 affordable housing units in all 50 US states. The programme has expanded to provide loans for community facilities that provide services to low- and moderate-income people, including homeless shelters, health care centres, community centres and charter schools.

The PSP has grown to around US$ 700 million – about 10% of Wespath's flagship Fixed Income Fund. Cumulatively, since 1990, Wespath has invested a total of US$ 1.6 billion of investment across a wide variety of projects throughout the US.[3] The programme has achieved an average annual compound growth rate of 5.8% over the past ten years (Figure 1).

In financial terms, the PSP has helped reduce investment return volatility – which is particularly important for Wespath's defined benefit annuity liabilities, for which these long-term mortgage products are proving an excellent match. During the 2008–09 financial crisis, PSP's investments performed relatively well, at a time when many of Wespath's more traditional real estate and mortgage-backed investments lost value. Wespath attributes this outperformance to the stability of demand for affordable housing and community services.

By investing in parts of the real estate market that are not widely traded, Wespath also provides diversification and access to real estate credit risk while receiving higher yields than from other mortgage sectors with a comparable risk profile.

APPROACH

Board-led: In 1990, at the request of its Board of Directors, Wespath created a taskforce to investigate how to invest US$ 25 million in affordable housing in light of its fiduciary obligations to pension plan beneficiaries. The recommendation was to create the PSP Program.

In-house capacity: Given the less traditional nature of these fixed income investments, Wespath built a team of in-house experts to run them over the course of several years. Deal structures, pricing, counterparty risk and public-

Figure 1: Wespath Investment Management PSP Lending Program annual compound rate of return, to 30 September 2013[4]

	Qtr	YTD	1 year	3 years	5 years	7 years	10 years
PSP Lending Program	2.04%	3.07%	3.35%	5.10%	7.03%	6.49%	5.80%
PSP Custom Benchmark[5]	0.42%	-3.82%	-3.12%	4.03%	7.51%	5.56%	5.11%

2 For further information on LIHTC see Positive Social Purpose Investing: Finding Uncommon Value, Wespath Investment Management, 2011. http://www.wespath.com/research_and_resources/institutional_insights/
3 http://www.gbophb.org/news/releases/pr20111019.asp
4 Rates of return reflect past performance and are no guarantee of comparable future results. The prices of Wespath investment funds will rise and fall with the value of the investments held in the funds. The units a participant owns may be worth more or less than their purchase price when redeemed. Investment results shown here are after all investment, administrative and custodial expenses.
5 PSP Custom Benchmark since 1/1/2010 is comprised of 60% Barclays Universal ex-MBS, 25% Barclays US Long Credit A, 15% Barclays Credit 1-5.

private sector interplay – all particular to these investments – require in-depth knowledge that is not readily available among traditional investment managers. Wespath also had to develop a deep understanding of the Low Income Housing Tax Credit system.

Focused team with senior leadership: Today, the three-person PSP team operates as a distinct division, on a par in Wespath's internal structure with its public equities, fixed income and private equities teams. Its investments have a separate internal approval structure, with senior leaders meeting every two weeks to review investment opportunities and performance. The PSP team is supported by Wespath's accounting and legal teams.

Smart outsourcing: Intermediaries source, underwrite and service investments, while a commercial mortgage servicer acts as Wespath's back office for record-keeping, document management and data analysis.

CHALLENGES

Up-front investment required: Building the knowledge and the in-house team involved significant up-front costs, but these were recovered as the programme grew in scale and maturity, and overall transaction costs have been reduced.

Finding appropriate investment opportunities: Initially, the investment process was lengthy, and finding investment opportunities that met Wespath's fiduciary and social requirements was challenging. Due diligence was also time-consuming due to inexperience and a lack of technical skills. But once Wespath became known for its involvement in this type of investing and for its expertise, it was able to scale the programme rapidly. It began to identify new investment opportunities, both through existing and new sources, more easily and to assess the risks and rewards of complex deals more quickly.

Designing a clear pricing methodology: Wespath also invested a considerable amount of time with a specialist third-party vendor to establish an appropriate pricing assessment methodology that could satisfy the investment committee's and auditors' questions about substantiating fair value assessments. Third-party vendors now manage the entire process, providing monthly pricing spreads and assumptions, modelling cash flows, and pricing individual loans daily. This specialist pricing expertise has been important because many of the underlying assets are illiquid, meaning that it is only possible to calculate fair values using estimates or risk-adjusted value ranges.

Appropriate benchmarking: Establishing an appropriate benchmark was as challenging as providing fair market values. As a unique investment niche, there is no exact match to the investment characteristics or assets held by the PSP Lending Program, so Wespath had to look at alternative approaches to choosing a benchmark. It first investigated the opportunity cost of PSP investments for each investment fund by comparing pricing and returns to the benchmark for the larger Wespath funds that hold PSP investments. The theory is that the alternative to investing in PSP assets is to invest in all of the other fixed income sectors in the relevant fund. Additionally, for PSP investments earmarked to match annuity liabilities, Wespath evaluates new allocations against the current annuity payout rate for annuities being written that month plus an additional spread for liquidity and credit risk. "This additional approach provides the added discipline that our new investment purchases should, at minimum, cover the costs of the annuities we write," says Mike Lohmeier, director of PSP. "Having long-term yardsticks for whether beneficiaries are getting a fair return helps retain internal and external stakeholders' support for the programme."