Four considerations for strong investment policy statements

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AN INVESTMENT policy statement (IPS) can be one of the most important documents for individual and institutional investors alike. Four considerations can help determine how robust an IPS is. The overarching theme among them is thoroughness.

But before we address these four considerations, we need to level set the current IPS landscape. Simply put, the "bad" investment policy statements outnumber the "good". The IPS may be an investment programme's most important governance and oversight document and as such, should cover all details relevant to governing, executing, and monitoring the programme and its portfolios.

A thorough IPS should contain as many of the sections listed here as are relevant to the given investment programme. The IPS should document how that investment programme will be constructed to support the mission and tie back to the overall goal for the assets, whether it's to support a distribution, a budget, specific capital projects, etc.

The six key sections listed in the accompanying chart cover a wide range of governance, portfolio execution, and monitoring and oversight responsibilities. These are relevant to board or investment committee members serving in a fiduciary capacity.

In our experience, this is where organisations with a "bad" IPS fall short. In some cases, they leave sections out, in others, they include them but not with enough specificity to drive the intended behaviour, processes, and outcomes. These shortcomings tend to fall into one of the four consideration areas.

1. The definition of responsibilities

It may seem obvious, but the IPS should identify who does what. As an example, for board or investment committee members serving as fiduciaries for an institutional investor, there should be no ambiguity as to who is responsible for the various tasks associated with the investment programme. The following assignments need to be made:

- Who is responsible for governance, oversight, and maintenance of the IPS?
- Who will set the investment and distribution objectives for the fund?
- Who will make asset allocation, manager selection, and other portfolio management decisions?
- Who will evaluate how well the investment programme meets its objectives?

These responsibilities, among others, should be identified and assigned to specific owners, in writing, so that expectations are clear. These key owners may include the asset owners, board members, trustees, and investment committee members, in addition to financial service providers such as investment advisers and custodians.

Done right, this offers clarity on the responsibilities of each party, especially those with fiduciary duties, and accountability around the completion of those tasks.

2. Objectives and constraints

When creating an investment portfolio, you must consider return objectives, risk tolerance, time horizon, taxes, liquidity, legal/regulatory requirements, responsible investing, and unique circumstances.

Common IPS sections

I. GOVERNANCE	II. OBJECTIVES & CONSTRAINTS	III. PORTFOLIO PARAMETERS
Purpose & scope	Statement of goals	Asset allocation
Definition of duties	Spending rule	Benchmarks
Investment philosophy	Return objectives	Selection and retention
	Risk tolerance	Types of securities
	Time horizon	Portfolio rebalancing
	Liquidity requirements	
	Unique circumstances	
IV. RISK MANAGEMENT	**V. CLIENT SERVICE**	**VI. ACKNOWLEDGEMENT OF IPS**
Control procedures	Communications	
Performance objectives	Reporting	

Source: PNC

Spell out these factors and define and share them with the managers of the investment programme. When considering these principal objectives and constraints, ask the following questions:

- Return objective: What is the purpose of these funds? If the goal is to make a distribution while preserving purchasing power, does the return objective account for this?
- Risk tolerance: What is an appropriate level of risk for the portfolio?
- Time horizon: How long will these assets be invested? In perpetuity, or for a set period of time?
- Taxes: Are there any tax impacts or implications that should be considered as they relate to the investment portfolio?
- Liquidity: What are the portfolio's cash flow needs (for example, to fund distributions)?
- Legal or regulatory requirements: Are there any federal or state regulations that are applicable? What about other considerations?
- Responsible investing: Does the portfolio's construction and management require responsible investing factors be incorporated?
- Unique circumstances: Are there any specific policies, such as special rules around approving alternative investments, that need to be integrated into the management of the portfolio?

An investment programme should be built on these factors and should be designed to adapt as they evolve.

3. Benchmarking the plan

Measuring progress is essential to successful investment programme strategy. Specifically, gauging the performance of the investment programme against defined benchmarks can help determine if it is on track to meet its objectives or if strategy adjustments might be required. Two steps are integral to this process:

- Define "success" in specific terms, through a relative or absolute benchmark.
- Measure the investment programme's performance relative to the definition of success on a periodic basis.

A relative benchmark applies an index or blend of indices to compare the performance of the investment programme. An absolute benchmark or hurdle rate is an actual percentage return. Investment returns below this benchmark suggest the programme is not meeting its objective. Returns above it imply the objective is being achieved.

The second critical aspect of benchmarking is making sure that the benchmarks are actually used. Specifically, the performance of the investment programme relative to the established benchmarks must be calculated on a regular basis.

We recommend that benchmarks be reviewed annually and in response to material changes in the investment portfolio or investment programme objectives. This can help determine whether they remain appropriate for what the investment programme is trying to achieve.

4. Portability

Over time, the circumstances, decision-makers, and financial services vendors associated with a policy may change. When the team in charge of the long-term objectives experiences turnover, how do you keep the investment programme on track? An effective IPS can help.

With that in mind, will someone be able to pick up the IPS and understand the investment programme without any other guidance?

Some key factors to consider in answering this question include:

- Does the IPS include the common sections mentioned above?
- Have you defined responsibilities for key decision-makers?
- Have you defined the objectives and constraints?
- Have you defined what success looks like (for example, established benchmarking guidelines)?
- Have you defined how you are going to monitor the portfolio and with what frequency?

If the answer is "yes" to these questions, your IPS may be able to weather investing's inherent uncertainties.

A strong IPS can provide a solid foundation for an investment programme and give investors the discipline they need to persevere through challenging investment environments.

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