

The Importance of Investment Policy Statements

Whether you are the fiduciary of a pension plan or an individual investor, one of the most important steps you can take in your investment planning process is the creation of an Investment Policy Statement (IPS). An IPS defines your goals and sets the guidelines for your investment activity, and some even consider it their business plan for making critical decisions. Most importantly, it provides discipline.

Donald Trone of the Foundation for Fiduciary Studies says "The preparation and maintenance of the Investment Policy Statement is the most critical function a fiduciary performs, for a well-written IPS becomes the narrative that defines how all of the investment-related responsibilities will be prudently managed." Few individuals or advisors, however, take the time to construct a comprehensive statement.

The IPS can be broken down into eight sections,

- Definition of goals and objectives
- Statement of parties' responsibilities
- Risk and return parameters
- Asset Allocation detail
- Screening criteria (if applicable)
- Investment due diligence and monitoring procedures
- Account review and rebalancing guidelines
- Fee and expense considerations

Start by defining why you are investing. Is the money earmarked for a specific goal, and what is the time frame for that goal? What do you hope to achieve with this investment? You should have an individual IPS for each goal, for example one for retirement monies and one for college savings.

If you are working with a financial advisor, you should define each of your responsibilities. The duty of the advisor may be to create the asset allocation, implement the plan, be in contact quarterly and monitor the investments. The client may have the responsibility to keep the advisor informed if their situation changes, follow the advisor's



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recommendations, and meet to review the account on a regular basis.

Next, you should state the return percentage that is expected, and how much risk will be taken to meet this goal.

Which benchmarks, such as the S&P 500, will you use to measure your returns? How much (or how little) volatility would you like to see in the portfolio? Defining these quantifiable goals will help you to create an asset allocation strategy.

Modern portfolio theory, simply stated, aims to maximize return while minimizing risk by mixing different kinds of investments. The IPS should specifically list how you are going to distribute those different investments, also known as your asset allocation. Be sure to list your overall percentages of stocks, bonds and cash. You should then take it a step further and break down your stock allocation into small/mid/large companies, growth and value styles, and your bond allocation by duration and quality. Be very specific.

Are there any companies or industries that you do not want to own? If you would like to screen the portfolio for tobacco companies, for instance, it should be listed here. Many people are employing social screens to their portfolios to align their values with their investments.

How will you choose who manages each investment style? Some important factors include the manager's tenure, their long-term performance record, the portfolio's volatility, the fees they charge, and how well they limit their investments to their particular style (style purity.) Defining your

process of selecting investment managers also gives you a basis on which to review them.

You should establish a schedule for account review. Review items such as manager performance and style purity, progress toward your goals, and the IPS itself. Make any changes that you deem necessary. Also keep an eye out for investment managers who leave their companies. Most times they are critical to an investment company's performance.

In addition, include a provision detailing when you will rebalance the portfolio. Rebalancing consists of reworking the portfolio to your original asset allocation, and most believe that it should be done on a yearly basis. Basically, you're taking some money off the table from your winners and "rebalancing" it back into the year's losers. This is the step which requires the most discipline, so be aware when you implement your IPS of the importance of rebalancing.

Provide parameters on the amount of fees you expect to pay. Is your account commission or fee-based? How much are the investment managers charging you and are there any account fees? It is important to work with your advisor to determine which fee structure works best for you, and gets you the service you require.

There is obviously a lot of time that goes into creating an Investment Policy Statement. When constructed and followed properly, however, it provides the discipline that many investors lack. Take the time to talk with your advisor about formulating an IPS. The results you yield will not only show on your statements, but in the relationship you have with your advisor.

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