

Developing and Implementing Investment Policy for Trusts, Sub- Trusts and Endowments

fi360 - global fiduciary insights
National Conference— May 4-6, 2011
San Antonio, Texas

Liza Horvath, CTFA, AIF®

Copyright © 2011 by Liza Horvath
All Rights Reserved

Outline

I. The Importance of the Investment Policy

- Why having an Investment Policy is Important to Clients
- Why having an Investment Policy is Important to Advisors

II. Investment Policy for Endowments

- You “should have known..”
- The Advisor – What you need to know before you commit
- Build Your Investment Policy
- What Works – What Does Not Work

III. Investment Policy for Trusts and Sub-Trusts

- What you need to Know Before You Commit
- Build Your Policy

IV. Your Business

V. Growing Your Business Using Investment Policy Knowledge

VI. References

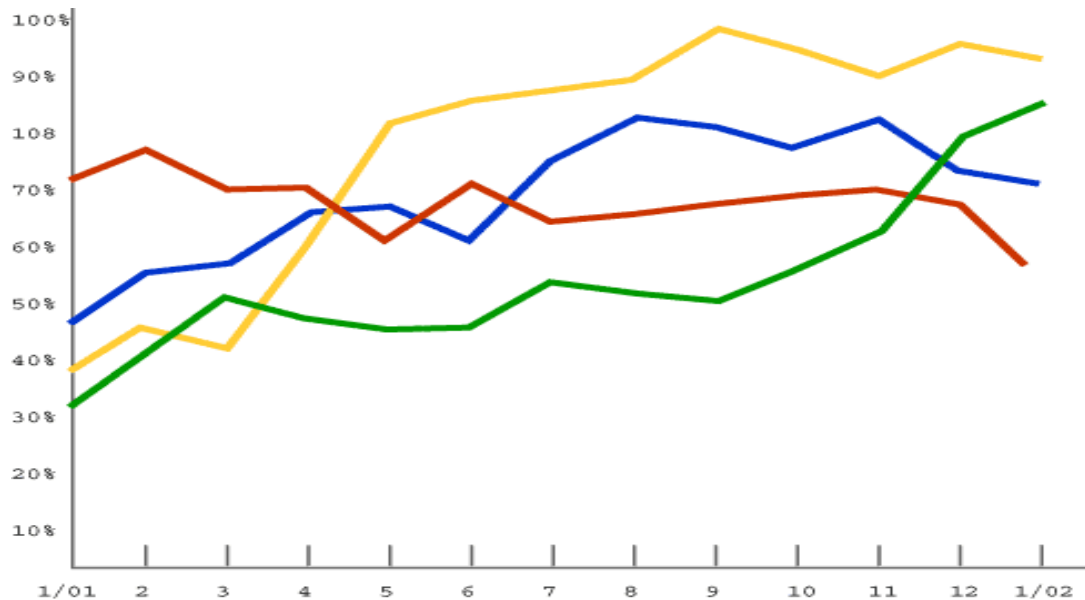
What This Session Is

- Overview of Policy Development, Implementation and Maintenance
- What Works and What Doesn't in an Investment Policy
- Using Your Investment Policy Knowledge to Grow Your Business
- Use of Experts and Documentation of Due Process in the Implementation of Investment Policy
- Setting and Managing Client Expectation with the Use of Investment Policy

What this Session Is Not

- How to Pick Stocks, Bonds or Mutual Funds
- Primer on ERISA Management
- Measuring Investment Performance and Selection of Appropriate Benchmarks
- Analysis of Historic Market Returns
- What is Acceptable Standard Deviation

The Importance of Having an Investment Policy



The Importance of Having an Investment Policy

- Overall - It's a Business Plan
- Supports a Well Thought Out Standard of Care
- Creates an (Auditable) Paper Trail
- Insulates the Advisor and the Client from "Market Noise"

The Importance of Having an Investment Policy – con't

- Why Investment Policy is Important to Your Clients:
 - Non-Profit Endowments
 - Trust Clients
 - Beneficiaries of Trust
- Why Investment Policy is Important to You:
 - Value Added
 - Set Expectations
 - Growing Your Business / Marketing
 - Because It's *Your Duty* as an AIF

Excerpt from the AIF[®] Code of Ethics

Client Commitment:

- Provide timely and understandable information that is accurate, complete and objective.
- Know the limits of my expertise.
- Proactively promote ..ethical behavior.
- Continue to improve my knowledge and skills.

Excerpt AIF[®] Code of Ethics - Copyright© 2002-2008. Reprinted with permission.
Full Copy of AIF[®] Code of Ethics reproduced as supplement in accompanying handout

Investment Professionals, Advisors Have Obligations

- Be Competent
- Place Clients' Interests above their own
- Be worthy of the trust placed in you
 - Stay Current with and diligently conform to
 - Best Investment Practices
 - Legal and Regulatory Requirements of Your Profession
 - Ongoing Professional Education is an Ethical Obligation
 - Benchmark Your Activities

Investment Policy for Endowments



Investment Policy for Endowments

- Boards have Fiduciary Duties and Responsibilities
- Restricted and Unrestricted Funds
- Duty to Prudently Manage Funds
- Bound by UPMIFA (in most states)
- Aware or “should have” been aware of Restrictions

“..should have known...”



On May 24, 2010, the California Attorney General filed a complaint against the Monterey County AIDS Project (MCAP) and several of its officers, directors, and key employees for, among other things, diversion and improper distribution of charitable assets, breach of fiduciary duty for failure to use assets for a restricted purpose, breach of fiduciary duty for failure to take actions to recover improperly diverted funds, and negligence.

According to the complaint, more than \$2.8 million of charitable assets was "misappropriated, misapplied or wasted."

Among Other Charges the Attorney General alleges that the Board
“Never adopted reasonable standards of **investment, invasion and use of the principal and income ...**”

The Advisor - What You Need to Know Before You Commit (*aka Your Pre-Nup*)

- Know the Client
 - The Organization
 - Their Mission
 - Standing in the Community and Legal Standing
 - Can you Ethically Represent Them?
- What are the Expectations
 - Long-Term Growth
 - Cash Flow Needs
 - Is the Expectation Reasonable

The Advisor - What You Need to Know Before You Commit – *con't*

– Collect, Review and Analyze Documentation

- Existing Investment Policy Statements
- Brokerage or Investment Manager Statements
- Relevant Custodial and Brokerage Agreements
- Service Agreements with Other Advisors
- Information on Retained Investment Managers; specifically ADV for each Separate Account Manager and Prospectus for each Mutual Fund
- Historical Investment Performance Reports

The Advisor – What You Need to Know Before You Commit – con't

- **Restrictions**

- What Funds are Investment Funds
- What funds are Restricted and the Terms
- Donor Restricted
- Board Restricted
- Does Restriction Affect Investment Decisions
- Can Restrictions be Modified or Released
 - California Probate Code Section 18507 (2011)
 - Uniform Probate Code

The Advisor – What You Need to Know Before You Commit – con't

Review of Restrictions – Endowment Funds

- “True” Endowments are classified as permanently restricted
- Funds subject to a restriction that the Board can satisfy – such as a timing restriction or purpose restriction – are classified as temporary restricted.
- Funds with no donor-imposed restrictions are classified as unrestricted.

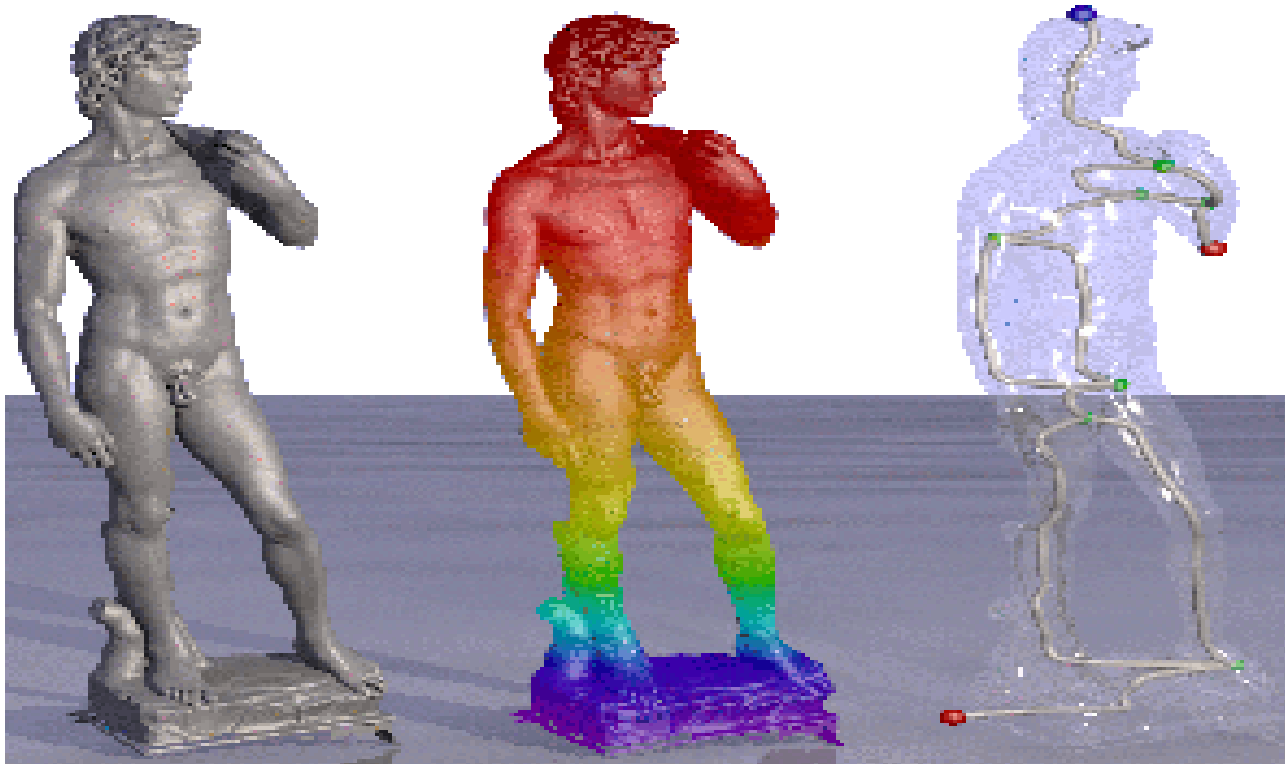


Practice
Tip

KEEP COPIES OF ALL DOCUMENTS REVIEWED AND
ANALYSIS IN YOUR PERMANENT FILE

Once You've Completed
Your Due Diligence

Build Your Endowment Investment Policy



Build Your Endowment Investment Policy

- **Purpose of Policy**

- Express expectations, objectives and guidelines
- Establish effective communication between Finance Committee, Board & Manager
- Agreement of formal criteria to select, monitor, and compare performance result

Build Your Endowment Investment Policy

- **Statement of Objectives**

- Mission of Endowment

- Long Term Appreciation
- Cash Flow Needs
- Maintain Purchasing Power

- Acceptable Risk

- Asset Allocation

Asset Classes

Risk

Correlation

Monte Carlo Simulations

Build Your Endowment Investment Policy

- **Statement of Objectives – con't**
 - “Safe Harbor” rules:
 - Use prudent experts
 - Due diligence process used to select prudent experts
 - Give the expert discretion – (off-load the risk)
 - Time Horizon
 - Long-Term Perspective v. Short-Term Liquidity Needs
 - Risk Tolerance
 - Performance Expectations
 - Benchmarks

Build Your Endowment Investment Policy

- **Duties and Responsibilities (More Below)**
 - Finance or Investment Committee
 - Custodian
 - Investment Advisor
- **Asset Class Guidelines**
 - Alternative Investments
 - Socially Responsible Criteria

Build Your Endowment Investment Policy

Delegation and Acceptance of Duties and Responsibilities

- Delegation and Acceptance can be Outlined in Investment Policy or an Ancillary Document
 - Responsibilities of client or investment committee
 - Role of Investment Advisor
 - Role of Custodian
 - Separate Account Managers, if any
 - Securities guidelines
 - Responsibility to seek best price and execution
 - Soft dollar accounting
 - Proxy voting

Build Your Endowment Investment Policy

- **Rebalancing Strategy**
 - Assets grow at differing rates
 - Rebalance to control intended risk
 - When to Rebalance?
 - Specific Dates
 - Asset Allocation Limits
 - Cash Flow
 - Abnormal Times = “flash reports” for allocation imbalances

Build Your Endowment Investment Policy

- **Monitoring**

- Performance
 - Frequency
- Using Benchmarks
- Watch List Criteria
- Measuring Costs

- **Investment Policy Review**

- Frequency
- Request for Proposal – Frequency

Build Your Endowment Investment Policy

Underpinnings of Every Endowment Investment Policy

General Economic Conditions

Tax Consequences

The Charity's Other Resources

Effects of Inflation and Deflation

Expected Total Return from Income and Appreciation

The Role of Each Investment in the Overall Portfolio

The Needs of the Charity to Make Distributions and Preserve Capital

What Works and What Does not in an Investment Policy Statement

- **Safety**

- “Preservation of Investment Capital is the Primary Concern...”

- Government securities, US Treasury Bills

- **The Obvious**

- FDIC

- Moody’s Ratings Services

- **Third Party Custodian**

- Can we say Madoff...

What Works and What Does Not in an Investment Policy Statement

- “Funds will be invested with several institutions..”
 - Effect on Fees
- “Next in importance to preservation of capital is liquidity..”
- “Investments shall be structured in such a manner that cash requirements will be met without necessity of liquidating investments..”
- Yield – “considered secondary to safety..”

What Works, What Doesn't Socially Responsible Investing

- **What Does Not Work**

“Endowments funds will not be invested in companies producing, supporting or contributing to the production, distribution or sale of firearms.”

- **Try Instead**

“The manager is instructed to evaluate all investment options according to objective economic criteria established by the manager and, if there are equally attractive investments, social factors may be considered.”

The Hierarchy of Decisions

Most
Important



Least
Important

What is the time horizon of the investment strategy?

What asset classes will be considered?

What will be the mix among asset classes?

What sub-asset classes will be considered?

Which managers/funds will be selected?

Investment Policy for Trusts and Sub-Trusts



What You Need to Know Before You Commit

- **Collect, Review and Analyze**
 - Trust documents & amendments
 - Trustees and named fiduciaries
 - Do documents allow for delegation of investment
 - Restrictions or prohibition (certain asset classes)
 - Existing Investment Policy Statements
 - Relevant Custodial and Brokerage Agreements
 - Service Agreements with Other Advisors

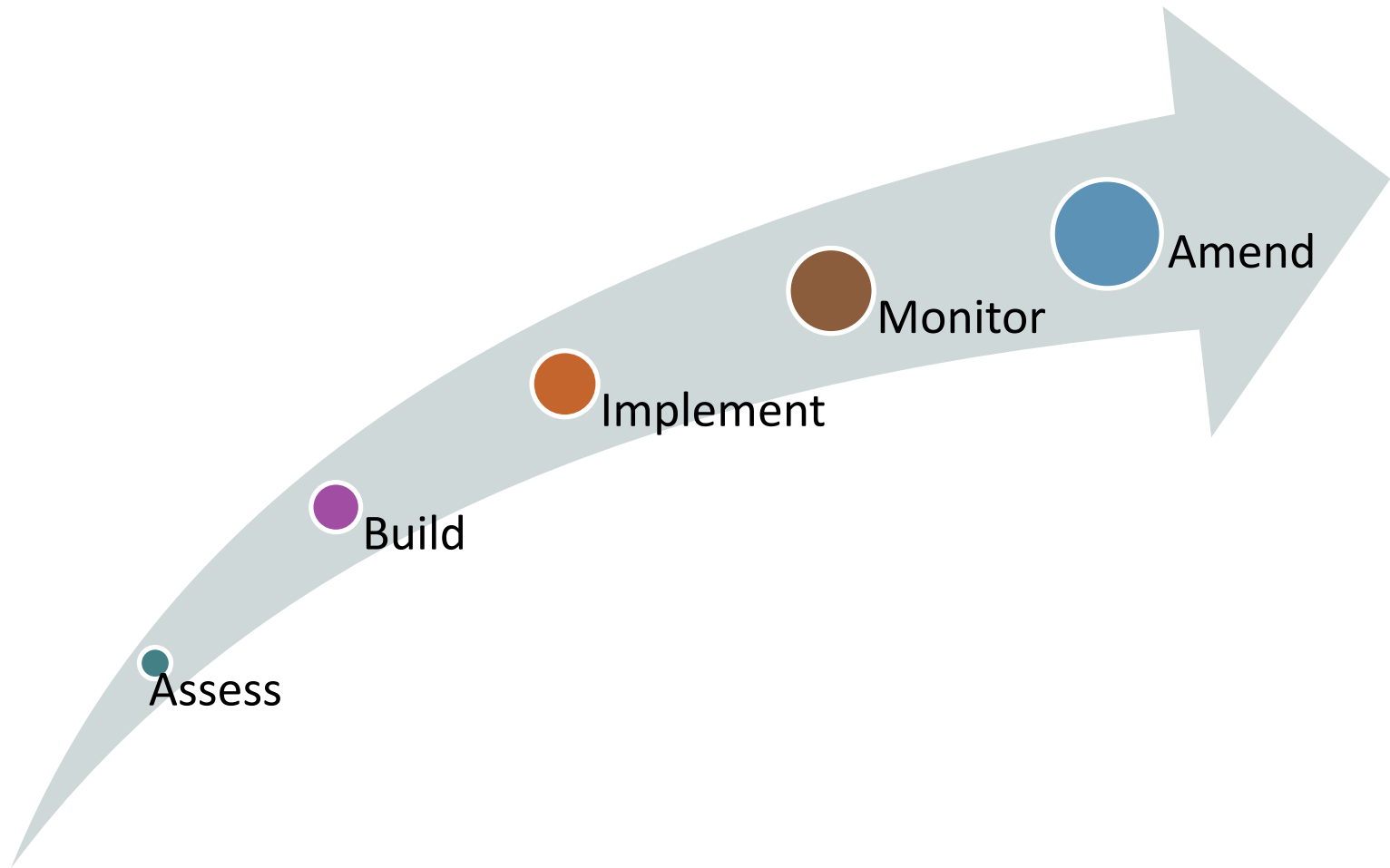
What You Need to Know Before You Commit – *con't*

- Information on Retained Investment Managers; specifically ADV for each Separate Account Manager and Prospectus for each Mutual Fund
- Historical Investment Performance Reports
- **Keep these Documents in Your Permanent File**

Elements of an Investment Policy for the Trusts and Sub-Trusts

First Assess ~ Then Build

The Flow of Investment Policies



Elements of an Investment Policy for the Trusts and Sub-Trusts

- **Assess**

- Read the Governing Documents

- Obtain counsel if needed

- Know the Law

- Know Your Beneficiary

- Income Needs
- Principal Needs
- Spendthrift?

- Know Your Remainder Beneficiaries



Elements of an Investment Policy for Trusts and Sub-Trusts

- **Assess - con't**
 - Avoid conflicts of interest
 - Avoid prohibited transactions
 - Discretionary Distributions
 - Process
 - History
 - Taxation
 - Trust v. Beneficiary

Elements of an Investment Policy for Trusts and Sub-Trusts

- **Build the Policy**

- Legal Criteria

- Tax Considerations

- Restrictions on Investments

- Liquidity Needs and Events

- Both Additions and Distributions

- Beneficiary Needs

- Both Current Beneficiary and Remaindermen

- Allocations to Stocks, Bonds, Cash, Etc.

Elements of an Investment Policy for Trusts and Sub-Trusts

- **Build the Policy**
 - Identify Benchmarks
 - Set Expectation
 - Frequency of Reviews
 - Expected Returns
- **Implement the Policy**
- **Monitor**
 - Your Usual Way of Money Management

Your Business

- Internal Policies
 - Why are consistent internal policies important?



**“Your Honor,
In our firm we *always* address this issue in this way.”**

Your Business

- Internal Policies
 - Procedures to Manage Potential Conflicts of Interest
 - Standard for Review of Policy (More Below)
 - Promoting a Culture of Fiduciary Responsibility
 - Business Acceptance Policy
 - Knowledge and Redress of Self-Dealing
 - Frequency of RFP
 - Review competitive management and vendor pricing
 - Review scope of services
 - Expanded services offered with no increase of fees

Your Business

- Standard of Review Policy
 - Diversifying portfolios
 - Evaluating management fees and expenses
 - Process for Termination of Non-Performing Managers
- Due Diligence in Selection of Managers
 - Select
 - Monitor
 - Seek New Managers if Style Drifts

Your Business

- Ongoing Education
 - Your Commitment is Evident – You are Here!



Growing Your Business with Investment Policy Knowledge

- Counseling Clients Who are Fiduciaries
 - The Successor Trustee
 - Surviving Spouse
 - Professional Trustees
- Who are Your Prospects?
 - Lay Trustees
 - Investment Committee Members
 - Retirement Plans
 - Foundations and Endowments
 - Personal Trusts (Committee)

Growing Your Business with Investment Policy Knowledge

– Knowledge of “Safe Harbor” Provisions

- Educate your Client
 - Delegation = Insulation from Liability
 - Safe Harbor is like Insurance
- Safe Harbor Requirements *
 - Investment decisions must be delegated to “prudent experts”
 - Investment Steward must demonstrate that the prudent expert was selected by following a due diligence process
 - The prudent expert must be given discretion over the assets
 - The prudent expert must acknowledge their fiduciary status in writing (mutual funds exempted from this requirement – prospectus serves as acknowledgement)

*Participant-directed plans have additional requirements

Conclusion

As an Accredited Investment Fiduciary ~ or as any
Fiduciary ~ we are held to the highest
Standards in our industry.

The services of our profession will be needed more
than ever in these times that are challenging both
from a world economic view and from a
demographic view.

Be confident, diligent and thoughtful in your practice
and success will follow.

References

- How to Write an Investment Policy Statement
 - Jack Gardner, Marketplace Books 2003
- Prudent Practices for Investment Advisors
 - Fiduciary360, First Published 2006
- Uniform Prudent Management of Institutional Funds Act (UPMIFA) ~ Adopted by California in July 2006 (enacted or introduced by 49 States).

*Thank You for Joining Me Today
and Enjoy the
Rest of the Conference!*