

# Handling Difficult Investment Policy Issues

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# What would you like to learn today?

- How many of you are currently using an IPS for all of your clients – both institutional and individual?
- How many of you are using an IPS ONLY for institutional clients?
- Since you are an advanced audience, the topics we have prepared remarks about but we want your participation:
  - Review the IPS Process
  - Identify “policy” areas that may have different applications within each of your firms.
- We only have 50 minutes so this handout contains more information than we will have time to cover today so please use it a guideline for discussions within your own firm.

# Speakers Background

Linda Lubitz Boone, CFP® and Norm Boone, CFP® are practicing financial advisors. They have been recognized by all of the major financial publications as leading financial advisors and have served the profession as a members of the FPA National Board of Directors.

Together they have published and produced the following:

- Their first article: “Developing an Investment Policy Statement for the Qualified Plan”—April, 1992
- Their first software joint venture with Ibbotson “The Investment Policy Statement Guidebook”—1996 to 2001
- Their first book: “Creating an Investment Policy Statement: Guidelines and Templates”—FPA Press 2004
- IPS AdvisorPro® was released—April, 2006 and was named “Best Software Product of 2006” by Morningstar. Now part of the fi360 family

The usefulness of investment policy depends on the clarity and rigor with which investment objectives and the policy guidelines established to achieve those objectives, are stated.”

- Dr. Charles Ellis  
“The Investment Policy: Winning the Loser’s Game”

# CFA whitepaper *“Elements of an Investment Policy Statement for Individual Investors”*

- “Perhaps most importantly, the IPS serves as a policy guide that can offer an objective course of action to be followed during periods of market disruption when emotional or instinctive responses might otherwise motivate less prudent actions.”
- **“The IPS is a highly customized document that is uniquely tailored to the preferences, attitudes, and situation of each investor.** Templates that purport to offer convenience and ease in development of an IPS almost inevitably sacrifice consideration of factors that are highly relevant to the investor. The investment professional must thoroughly understand the investor’s objectives, restrictions, tolerances, and preferences to be able to develop a truly useful policy guide.”

# YOUR Investment Policy Statement?

## Your IPS

- Why do you write an IPS for your clients?
- How do you describe an IPS to your client

## Your IPS

- When do you use an IPS?
- When don't you?

# What is your IPS Process?

## Your Meetings

- How do you introduce the concept of an IPS?
- How many meetings? Steps involved?

## Client Involvement

- Is it a collaborative process or driven entirely by you?

## Questionnaire

- Do you use a questionnaire?
- How do you use it?
- When? Printed or online?

# 3 Steps for developing the IPS

## Questionnaire

- Circumstances/Investment Objectives/Risk Tolerance/Restrictions/Preferences
- Capital markets education presentation
- Review questionnaire responses

## Draft IPS

- Initial IPS version and asset allocation
- Address areas of concern
- Discuss any unreasonable expectations
- Make changes as needed

## Approval of Final IPS

- Review and approve final document
- Signatures
- Preliminary discussion of investment implementation

So, what goes in an IPS?

# Client Specific Issues – These change from client to client

- Goals—Return and Cash flow
- Downside Risk
- Asset Class Interest & Understanding
- Limits or Restrictions
- Asset Allocation
- Diversifying Concentrations
- Tax Concerns; Basis & Bracket
- Expected Additions or Withdrawals (Spending Policy)
- Time Horizon
  - To achieve goals
- Reserves or Liquidity Needs
- Educate on Investment Principles

# Your (Advisor or Firm's) Policies and Practices

## **These should be standardized for all your clients**

- Stocks, Funds or Separate Accounts
- Investment Strategies/Third Party Managers
- Passive vs Active
- Re-balancing Approach
- Timing or Tactical Moves
- Location of Assets by Account Type
- Client Play Accounts or Other Investments
- Tax Management Strategies
- Timing to review IPS with client/ evaluate investment managers
- Reporting
- Monitoring
- Disclosures
- Auditing of IPS Requirements

# Comparison of Key Issues between Individuals and Institutional clients

	Individuals	Institutions
Return needed to achieve goal	X	X
Risk Tolerance, Time Horizon, Cashflow needs	X	X
Emotional & Herd Instinct Motivations	X	X
Asset Allocation Considerations	X	X
Most recent performance impacts on current decisions	X	X
Tax Concerns (ST vs LT Gains/Losses)	X	
Stage of Life Issues	X	
Investment Committee Considerations		X
Needs of organization, plan, beneficiaries		X
Custodian, Administrator, Trustee, Actuarial considerations		X
Fiduciary Issues and Regulations		X

# Sample Table of Contents

- **Investment Policy Background**
- **Overview Commentary**
  - Assets included in this IPS
  - Investor Circumstances
- **Investment Philosophy**
- **Investment Objectives**
  - Rate of Return
  - Other Needs
- **Time Horizon**
  - Cashflow Needs
  - Spending/Withdrawal Policy
- **Acceptable Risk Level**
- **Asset Allocation**
  - Portfolio Risk & Return Statistics
  - Rebalancing Procedures
  - Investment Restrictions
  - Unique Portfolio Issues
- **Tax Policy**
- **Frequency of Review**
- **Liquidity**
- **Diversification**
- **Investment Criteria**
  - Selection
  - Retention or Sale
- **Monitoring and Control Procedures**
  - Reports
  - Audits
- **Meetings and Communication**
- **Duties and Responsibilities**
  - The Advisor
  - The Investor
- **Disclosures**
- ***Adoption signatures***

# Policy Issues for an IPS



Do you create an IPS for the whole family's wealth or do you create an IPS for each member?



Do you manage money on a “goals based” approach?

If so, do you create an IPS for each “goal pool”?

# Your Investment Policies

## Content

- What differs from client to client?
- How is that reflected in your IPS?

## Asset Allocation

- Do you use ranges or static target?
- How do you describe your asset classes?
  - Macro – Large US Stocks
  - Sub asset – Large U.S. Value Stocks
  - Fund names – Dodge & Cox Stock

# Your Investment Policies

## Liquidity

- How do you deal with cash needs for the future?
- How far ahead?

## Cash balances

- How do you deal with large cash balances?
  - For investing?
  - For billing?

# Your Investment Policies

## Rebalancing

- Trigger ?
- Frequency?
- Tactical vs. Strategic Changes

## Taxes

- How do you deal with taxes in your portfolios and your IPS?
- How do you deal with tax-efficient investing?

# How do you write your IPS's?

## Format

- Unique for each client
- Standard format without customization

## Tools

- Word document or excel template
- Software tool?
  - If so, which one? Hopefully IPS AdvisorPro
- Other

# Your Investment Policies

## Risk

- How do you measure risk?
- How is that reflected in your IPS?

## Outside Assets

- How do you deal with outside assets in your IPS?
  - Real estate
  - Other managed accounts
  - Other client-managed accounts
  - 529 Accounts and accounts owned by the kids

# Your Investment Policies

## Reviews and updates

- How often, when and why do you review and update an IPS?
- How often and when do you review the IPS with the client?

## Amendments

- How often, when and why do you amend an IPS?

# Your Investment Policies

## Compliance

- What are your compliance worries?
- How do you deal with them?

## Portfolios

- How do you ensure that portfolios are adhering to the IPS requirements?

# Resources for You

- Our Article: **Why Writing an Investment Policy Statement Should be Part of Your Investment Process** – give us your card for a copy
- IPS AdvisorPro.com – software to help you create totally customized IPS's. Now part of the fi360 family.
- Creating an Investment Policy Statement: Guidelines and Templates by Boone & Lubitz, FPA Press, 2004
- Investment Policy: Winning the Losers Game, Charles Ellis, Irwin Publishing, 1992
- The Management of Investment Decisions, Trone, Albright & Taylor, McGraw-Hill, Irwin Publishing
- fi360, Inc.
- CFA Institute
- Investment Management Consultants Association (IMCA)

# Thank you

The following slides are supplements to our presentation to share best practices for both individual and institutional IPS's.

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# Possible Content for an IPS

- Date
- Purpose—Reason for having an IPS
- Background of the client or client organization—
  - mission/purpose
  - Who they are; key factors in how they got to where they are, expectations and plans for future
  - Limitations or issues that are relevant
  - How does the fund/portfolio fit into the larger picture of the client
  - Other factors
    - Health
    - Expected or possible notable inflows or outflows
    - Beneficiaries and their needs
    - Currency issues (e.g. if based outside U.S.)

# Possible Content for an IPS

- Identifying who the decision-makers are
  - Couple—can they make decisions individually? For which accounts?
  - Committee—who are they (creating a record) and how decisions are formalized
- Relevant assets and/or accounts subject to the IPS
- Governance/contractual status
  - Any conflict between IPS and Engagement Agreement or Account paperwork (other?) to be decided in favor of the non-IPS documents
  - “Weasel words” that clarify
    - No guarantees of results
    - Limited by Market conditions

# Possible Content for an IPS

- Definition of terms
  - Fiduciary and who fits under it
  - Endowed vs non-endowed assets
  - Fund Accounting
  - Consultants, managers, board, finance committee
- Addressing conflict of interest—how the fund and the committee will avoid
- Risk Tolerance
  - Risk defined
  - Factors that influence risk
- Spending policy
  - How defined/calculated
  - Explicit Cash flow goals/expected inflows and outflow

# Possible Content for an IPS

- Allowance of and explanation of delegation of Authority—to whom and to what extent
  - Custodians
  - Consultants
  - Managers
  - Bank or other co-trustees
  - Other specialty experts (e.g. accountants, attorneys, auditors, actuaries)
  - Limitations on own committee's authority
- Responsibilities (matrix of parties and needs and involvement in each)
  - Consultant
  - Managers
  - Discretion—who? For what? Any limitations?

# Possible Content for an IPS

- Liquidity
  - Cashflow Needs Planning is required of finance committee (and communicated)
  - Minimum level of cash to be maintained
  - Client's responsibility to notify manager if needs change
- Specifically addressing Prohibited Assets and Prohibited Transactions
  - Specific policy about derivatives—defined, what is and is not allowed
  - List of specifically prohibited investments (e.g. venture capital, high yield bonds or directly owned real estate)
  - Prohibited transactions (e.g., short sales, margin investing)
- Socially Responsible Investment Practices
  - Definition
  - Implementation Considerations

# Possible Content for an IPS

- Taxes (for taxable clients)
  - Record tax considerations: marginal rates, tax loss carry-forwards, Alt Min, Other??
  - Process for minimizing taxes
- Method of Calculation of Spending Policy
  - Average of moving average of prior 12 quarters, measured annually
  - Limited to when there are Accumulated Earnings (no grant-making if no Accumulated Earnings)

# Possible Content for an IPS

- Investment Goals
  - Specified rate of return
  - Benchmarks to be measured against
    - Returns
    - Degree of risk taken
    - Performance relative to similar managers
      - For what period
      - What is acceptable minimum percentage within group
      - How long do you give them before they return to “respectability”?

# Possible Content for an IPS

- Asset Allocation
  - Targets are points, with rebalancing, or a range?
  - Interaction between rebalancing from target and the min/max limits???

Asset Class	Min. % Allocation	Target % Allocation	Max. % Allocation	Benchmark Index
Cash & Equivalents	0	0	10	30 day T-Bill
Fixed Income	20	40	60	BC Aggregate
Equity: Domestic	25	50	60	Russell 3000
Equity: International	5	10	25	MS EAFE

# Possible Content for an IPS

- Review and Evaluation—Consultant, Managers
  - Process
  - Criteria
  - Termination criteria
- Budget Process
  - How the board and committee determine the amount available for spending (on expenses, as well as grants)
- Gift Acceptance
  - Who is responsible
  - Process
  - Is this a proper IPS item? (should it be elsewhere?)

# Possible Content for an IPS

- Voting of Proxies
- Review of the IPS
  - Frequency
- Reports and Communication
  - Frequency
  - Content
  - Online access
  - Meetings
- Format ideas
  - One was a list of questions, with the offered answers and the selection noted
  - Do you include the Risk Tolerance questionnaire as part of the IPS, for the record?

# Common IPS Problems

- Too often missing or “off the shelf” and not customized
- It commits you to doing things you can’t be sure you will do
  - Rebalancing at certain triggers
  - Reviewing the IPS every \_\_\_ years
- It isn’t clear enough to be implemented by someone else (written in very general terms)
  - How is success or performance measured?
  - How and when will things be tested?
  - “5-10%, depending on Market Conditions”
- Poor definitions
  - “spending policy” without methodology for calculations
- Failure to clarify roles and responsibilities of all parties
- Forget to outline what CAN’T be done—restrictions

# Best Practices for Investment Committees

- Has a charter outlining roles and responsibilities of each party
  - Act as fiduciaries, not investment managers
  - Members should be chosen for their expertise
  - Avoid conflicts of interest (at minimum, acknowledge them)
  - Terms should be finite, but allow for valuable familiarity
  - Clarify and communicate committee member responsibilities and potential liabilities

# Best Practices for Investment Committees

- A clear investment strategy based on reasonable assumptions about risk and return
  - Committee's responsibility—to determine how to invest and who is to do it
  - Keep spending needs in consistent relationship to portfolio management
  - Base spending on actual returns, not expected returns

# Best Practices for Investment Committees

- Straightforward and clear process for hiring and firing managers to implement the strategy
  - Use consistent approach, which should be outlined in the IPS
  - Criteria for selection
    - Performance (should only be one part of criteria); focus on long-term
    - Nature of team and how they work
    - Philosophy
    - Investment Process
    - Fees
  - Make clear to managers the role their portfolio is expected to play—their assignment
  - In evaluation, speak to both current AND former clients

# Best Practices for Investment Committees

- Spending decisions are central to investment management process
  - How much?
  - Most frequent: % of assets (usually of moving market values)
  - Flat dollar, adjusted for inflation
  - Is volatility of spending amount an issue?
  - How reliant is organization on the funding provided?
- Common Sense and Discipline

# Best Practices for Investment Committees

- A recognition that investment theory often conflicts with behavioral tendencies (which requires investment committees to be disciplined and stay focused on investment goals)
- Willingness for committee members to challenge and debate issues at hand; use of facts and data rather than strong opinions to make decisions
- Continued effort to build constructive relationships with relevant parties and hold positive, helpful discussions among them