MyFiduciary
Governance & Investment Support

A Guide on how to Prepare Content for an Investment Policy Statement

An Investment Policy Statement (IPS) is the key governance document for an Investment Steward. It should reflect an investment entity's unique situation, objectives, tolerances, requirements and preferences. The purpose of this document is to provide a guide on how to formulate an IPS and the content it might include.

The basis of the guide is a defined global fiduciary standard, as set by fi360 Pacific's '*Prudent Practices for Investment Stewards*' Handbook. The Formalise step of the *Prudent Practices,* specifically Practice 2.6, outlines preparation and maintenance of an IPS. Practice 2.6. states that 'The investment policy should contain sufficient detail to define, implement and monitor the portfolio investment strategy'. In this guide for each component of the IPS we reference the specific criteria in Practice 2.6.

We also provide a mind-map over page which summaries key elements required for an IPS to meet the fiduciary standard. This can help you organise your IPS content and may also be used as a check list once the IPS is finalised.

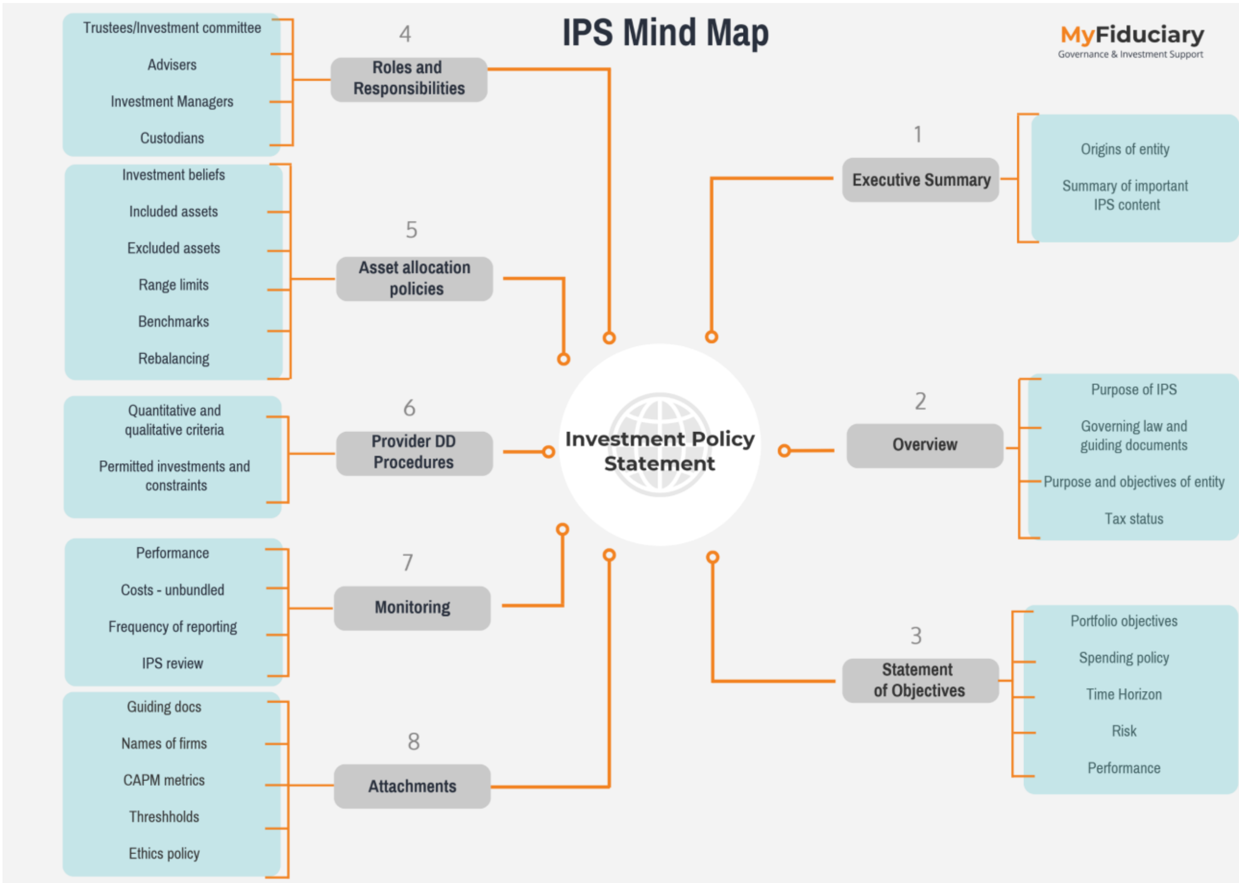
The elements included in this guide are general and will need to be adapted for each investment entity's specific situation. Additional components may also be needed for some investors' circumstances, for example, due diligence criteria for direct investments.

As an overall check, three conditions for a sound Investment Policy Statement are that there is:

1. *enough detail for any competent third party to implement the investment strategy;*
2. *enough flexibility that it can be implemented in a complex and dynamic environment, and;*
3. *not so much detail that it requires constant revisions and updates.*

This guide may also be read in conjunction to the articles below:

- *The Importance and Common Pitfalls of Preparing a Governance-focussed Investment Policy Statement*, and
- *Practical Advice for Preparing an Investment Policy Statement*.


IPS Mind Map
MyFiduciary
Governance & Investment Support
Investment Policy Statement
1
Executive Summary
Origins of entity
Summary of important IPS content
2
Overview
Purpose of IPS
Governing law and guiding documents
Purpose and objectives of entity
Tax status
3
Statement of Objectives
Portfolio objectives
Spending policy
Time Horizon
Risk
Performance
4
Roles and Responsibilities
Trustees/Investment committee
Advisers
Investment Managers
Custodians
5
Asset allocation policies
Investment beliefs
Included assets
Excluded assets
Range limits
Benchmarks
Rebalancing
6
Provider DD Procedures
Quantitative and qualitative criteria
Permitted investments and constraints
7
Monitoring
Performance
Costs - unbundled
Frequency of reporting
IPS review
8
Attachments
Guiding docs
Names of firms
CAPM metrics
Threshholds
Ethics policy

Contents

Executive Summary

This is an optional section from the perspective of the *Prudent Practices*. Details could include:

- Entity type and origin
- Vision and Purpose of Entity
- Assets held
- Assets not included in the policy
- Location of entity
- Modelled return and volatility
- Strategic asset allocations

Governing Legislation

2.6.1 The investment policy statement identifies the bodies of law governing the portfolio.

Identify and list legislation relevant to the establishment and governance of the Entity. For example, in New Zealand this could be:

- Charities Act 2005
- Charitable Trusts Act 1957
- Trustee Act 1956
- Relevant trust deeds

Background

Need to provide details on the background of the entity/organisation and governance of the fund (or any other relevant background information). For example, this could include how it was initially established, strategic plans, and vision and values of the entity.

Statement of Objectives

Entity Investment Objectives

Outline the principle objectives of investment activities and ensure these align with any establishment or constitutional documents.

For example, objectives might include some combination of:

1. To maximise returns for the level of risk taken.
2. To provide for current and future beneficiaries.
3. To meet operational spending requirements.
4. To follow sound and prudent investment practices.
5. To diversify the investment portfolio
6. To foster greater self-determination
7. To develop our endowments
8. To invest according to SRI principles.

   etc

2.7.1 The goals and objectives established for the portfolio are evaluated to determine whether socially responsible investing is appropriate and/or desirable.

2.7.2 If a socially responsible investment strategy is elected, the investment policy statement documents the strategy, including appropriate implementation and monitoring procedures.

Time Horizon

2.6.3 The investment policy statement specifies risk, return and time horizon parameters.

This is established by carefully considering asset base, cash flows and liabilities that must be met.

Example:

An investment horizon of at least 10 years is required for the investment strategy. This takes account of the volatility of financial markets and the fact that it can take many years to recover from a major downturn. If there is a change is circumstances, and more significant withdrawals are needed (greater than xx% of the portfolio), then the policy may be reviewed with a focus on greater liquidity and lower volatility.

Investment Beliefs

It is considered good practice for entities charged with oversight of a pool of assets to anchor their investment activities by an investment philosophy, as represented by a set of beliefs around markets and investing. Some examples of investment beliefs are outlined on the table below:

Investment Decision	Core Facts	Core Beliefs
Investment objectives and governance	It is critical to be clear about the investment purpose(s), risk tolerances, benchmarks, and the timeframes over which results should be assessed.	Clear investment governance and decision-making structures add value.
Asset allocation	Risk and return are strongly related. Diversification across and within asset classes increases the risk-adjusted return of a portfolio. Risk premiums are less risky (have less volatility) over longer time periods than over the short run.	Asset allocation is the key investment decision. Investors with a disciplined, long-term approach to investing will out-perform more short-term focused investors. Transparency across objectives, implementation and reporting builds confidence and enables a long-term approach to be pursued.
Asset class structure and strategy	The risk premium on an asset class or investment is compensation for underlying sources of risk (such as market, size and illiquidity risk). The varying sources of risk on an asset class can be unbundled and used to formulate sub-asset classes for listed markets and investment hurdles for direct investment opportunities.	Allocations to sub-asset classes or risk factors can add value compared to an allocation to a market-cap weighted exposure.
Direct investing	Direct investing involves taking on asset specific risks and may have higher costs than what is usually incurred investing into a broadly diversified listed portfolio.	Direct investing can earn a higher risk-adjusted return (net of all costs) than investing into public markets given market 'inefficiencies' and alignment of investment capabilities to the direct opportunities.

Responsible investment	Some investors prefer an investment approach that takes into consideration environmental, social and governance (ESG) factors.	An investment process that integrates aspects of ESG can reduce risks and add value to diversified portfolios and will be progressively adopted as appropriate options arise.
Manager selection	Capital markets rapidly and efficiently incorporate new information into security prices. The more efficient a market is, the more difficult it will be for a manager to add value ('alpha') over a benchmark return net of fees.	A manager's ability to persistently add value is both rare and difficult to identify ex-ante in relatively efficient capital markets. Some markets are less efficient and hence conducive to active management, including direct investing.
Portfolio execution	An investment process that regularly monitors and manages supply relationships and execution costs can help prevent unnecessary costs.	A disciplined approach to portfolio rebalancing which takes into account transaction costs and long-run expected returns, adds value.

Risk Tolerances

In establishing the risk tolerances for the IPS, the entity's ability to withstand short and intermediate-term variability need to be assessed and agreed upon. This should include discussion of:

- Necessary risk to meet objectives,
- Tolerable risks, and
- Consideration of large losses.

Performance Expectations

The long-term expectation for the return of the portfolio should be outlined. This includes the gross expected return, the return net of costs, and the return net of costs and tax obligations. Investment costs should cover all costs associated with the strategy, including portfolio administration and staff costs, custody costs, and fund and investment management fees.

Detailed capital market assumptions used in modelling the overall expected return should be included in an Appendix to the IPS. This includes performance expectations (both risk and return) of each asset class selected or significant single investments. Note that these can be subject to revision which is why we do not recommend including it in the body of the IPS.

Asset Class Guidelines

2.6.4 The investment policy statement defines diversification and rebalancing guidelines consistent with risk, return, and time horizon parameters.

The asset classes in the portfolio need to be specified. This section should also cover:

- Asset classes that were considered but excluded in the portfolio.
- Other assets that may exist outside of a listed portfolio and how these were considered when formulating the overall asset allocation (e.g. commercial property).
- Prudential limits such as exposure limits to any single investment that can in principle be sold, illiquidity limits, single manager limits, and tracking error limits (if applicable).

Rebalancing of the portfolio

Rebalancing is important to maintain diversification and ensure that the portfolio does not deviate from its target levels of risk and return. Rebalancing the portfolio back to the Asset Allocation can add significant value because it is a systematic way of selling asset classes that become more expensive (and become a bigger part of the portfolio) and buying asset classes that have become cheaper (and have shrunk as a share of the portfolio).

Once the target allocation is established, periodic rebalancing is necessary to maintain the intended risk-return profile of the portfolio. The IPS needs to state how frequently rebalancing should occur and the re-balancing process (how it is done and who decides). Any rebalancing decisions need to carefully consider the gains to be made by maintaining the target asset allocation versus the transaction costs and cash flows needs.

Roles and Responsibilities

2.6.2 The investment policy statement defines the duties and responsibilities of all parties involved.

The IPS needs to set out clearly the roles and responsibilities of the parties involved and whether they have a fiduciary duty. For example, these typically include:

- Entity (e.g. Organisation, Board, Committee)
- Fiduciary Consultant
- Other Investment Advisers
- Portfolio Administrators
- Investment Managers
- Custodial Services

Investment Due Diligence

2.6.5 The investment policy statement defines due diligence criteria for selecting investment options.

The due diligence guidelines relating to the selection of investments, or in monitoring the selections made by advisers, need to be included in the IPS. The due diligence guidelines should cover all the types of investments the entity will make as part of executing its investment strategy. Below we provide the due diligence criteria for managed funds from the *Prudent Practices.* Other types of due diligence screens and criteria are required for direct investments, impact investments, and 'alternative' assets in general.

3.2 Decisions regarding investment strategies and types of investments are documented and made in accordance with fiduciary obligations of care.

Example fund manager due diligence criteria:

1. *Regulatory oversight:* Each investment manager should be a regulated bank, an insurance company, a mutual fund organisation, or a registered financial adviser.
2. *Minimum track record:* The product's inception date should be greater than three years.
3. *Stability of the organisation:* There should be no perceived organisational problems – the same portfolio management team should be in place for at least two years.
4. *Assets under management:* The product should have at least $75 million under management. (Note: to be determined separately for international and Australian and New Zealand asset holdings.)
5. *Holdings consistent with style:* The screened product should have no more than 20% of the portfolio invested in 'unrelated' asset class securities. For example, a Large Growth product should not hold more than 20% in cash or fixed income.
6. *Correlation to style or peer group:* The product should be highly correlated to the asset class of the investment option. This is one of the most critical parts of the analysis since most of the remaining due diligence involves comparisons of the manager to the appropriate peer group.
7. *Expense ratios/fees:* The product's fees should not be in the bottom quartile (most expensive) of their peer group.
8. *Performance relative to assumed risk:* The product's risk-adjusted performance (Alpha and/or Sharpe Ratio) should be evaluated against the peer group's median manager's risk-adjusted performance.

9. *Performance relative to a peer group:* The product's performance should be evaluated against the peer group's median manager return, for 1-, 3- and 5-year cumulative periods.

Control Procedures

2.6.7 The investment policy statement defines monitoring criteria for investment options and service providers.

Performance Objectives

It is necessary to mention the ongoing review and analysis of investments, managers and providers. This is equally important as the due diligence implemented during the selection process of investments and investment managers. The fiduciary duty to monitor the performance of investments and other service providers is inherent in the obligations of Stewards to act prudently and professionally in carrying out their duties.

Example:

On a timely basis, but not less than six monthly, the Entity/Client will meet to review whether each manager or provider continues to conform to the search criteria outlined in the previous section; specifically:

1. The adherence to the Portfolio's investment guidelines;
2. Material changes in the provider's organisation, investment philosophy and/or personnel; and
3. Any legal or other regulatory agency proceedings affecting the provider.

It is at the entity's discretion to take corrective action by replacing a manager or provider if they deem it appropriate at any time. Control procedure should also be specified for any direct investments.

Measuring Costs

2.6.6 The investment policy statement defines monitoring criteria for controlling and accounting for investment expenses.

The IPS needs to establish procedures for controlling and accounting for investment expenses to fulfil the obligation to manage investment decisions with the requisite level of care, skill and prudence. It is important that fiduciaries have these procedures in place so that they only pay reasonable and necessary expenses.

Example:

The entity will review at least annually all costs associated with the management of the Portfolio investment program, including:

- Any investment provider fees.
- Expense ratios of each investment option against the appropriate peer group.
- Custody fees: The holding of the assets, collection of the income and disbursement of payments.
- Investment Management Entity – cost of management (if appropriate)

Investment Policy Review

It is good practice to review the IPS on an annual basis, and this information should be included in the IPS.

Example:

The Client will review this IPS at least annually to determine whether stated investment objectives are still relevant and the continued feasibility of achieving the same. It is not expected that the IPS will change frequently.

Approved:

_________________ _________________ _________________

For Entity or Client

Date:

Appendix I:

Summary of Capital Markets Inputs

Risk and return assumptions made for each asset class and significant single investments (e.g. investments that are more than 2.5% of the total asset base of the entity) when considering projected portfolio outcomes.

Appendix II:

Named Fiduciaries

Client, Board or Investment Committee members