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Writing Your Investment Policy Statement

Publication title: **Writing Your Investment Policy Statement**

For the last few months I've been admonishing readers about the mistakes we make as investors and offering vague homilies regarding what can be done about them. This month I'm offering a primer on a concrete and constructive practice every investor can adopt in their investment process to counteract these mistakes: writing an investment policy statement or IPS

Investment policy is the articulation of the link between your circumstances and the financial markets. An IPS describes in detail your long-term financial goals and the strategy you have embraced in the design and management of your portfolio to achieve them. Writing one is the single most effective technique available to investors in overcoming the influence of our emotions in reaction to short-term gyrations in the markets.

Analogous to a business plan for the conception and operation of a business, an IPS provides a blue print or a road map. After all, particularly for retirees, your portfolio is very much a business that is supporting you, the owner, in achieving your financial dreams.

A comprehensive IPS might run from a few to a dozen pages. To illustrate, let's outline essential elements of an IPS for a sample retirement portfolio. Of course, all figures are hypothetical and should not be used as the basis for creating your IPS.

- **Background: Assess your starting point.** $1,000,000 portfolio of a retired couple with $60,000 in pension and social security income.

Summary: Writing Your Investment Policy Statement

Creation of an IPS effectively documents an individuals long-term financial goals and strategy and can be used as a roadmap for an investor to reference when confronted with concerns with short-term market flucuations.

> If you don't know where you're going, you'll wind up somewhere else.
>
> —Yogi Berra

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Your Way to Prosperity

- **Goals: Define what you want to do with your money.** Goals in your IPS should mirror the goals established in—and be supportable by—your financial plan.
  - Provide $45,000 initial annual income (increasing by 3% inflation rate);
  - Fund possible health emergencies; and
  - Leave at least $600,000 estate to family and charities.
- **Time Horizon: Determine how long to you need or want to do these things (goals).** 35 year retirement.
- **Modeled Return: Define an anticipated target return.** 7.5% annually (4.5% above inflation).

Notice the modeled return is in both nominal and inflation adjusted terms. Return estimating is a combination of art and science reflecting projections for each of the asset classes chosen for the portfolio based upon history and current economic circumstances.

- **Risk Tolerance and Modeled Loss: Decide what your stomach and portfolio can take while still achieving your goals.** Moderate Risk Tolerance (-10% worst case annual loss).

Determining or establishing your risk tolerance is of fundamental importance in your investment policy.

- **Investment Philosophy: Describe what you believe about investing.** No investment strategy can be complete without a consistent underlying philosophy to guide the process. In this section you would describe the basic tenets of your philosophy. For example, you may believe markets are generally efficient and asset allocation—not stock picking or market timing—will be the major determinant of portfolio performance. On the other hand, you may believe that you or your chosen managers should be able to "beat the market."
- **Asset Allocation and Rebalancing Guidelines: Identify where you want to keep your money.** Decide what you need to own to achieve your modeled return. Assign each asset class a target and an upper or lower limit in terms of the percentage of your overall portfolio that class represents; rebalancing would occur when those limits are reached.

	Lower Limit (%)	Target (%)	Upper Limit (%)
U.S. Large-Cap	25	30	35
U.S. Small-Cap	5	10	15
International Stocks	5	10	15
Real Estate	5	10	15
Bonds	30	35	40
Cash	5	5	10

- **Duties and Responsibilities: Assign duties to your team members.** Describe the relative responsibilities of the investor, the advisor, the fund managers and the custodian.
- **Investment Manager Selection, Due Diligence and Monitoring: Stay on top of your progress.** Generally, mutual funds are utilized to implement the asset allocation strategy. In this section of the IPS, you describe the various criteria to select and evaluate the mutual funds chosen to execute your strategy. Here are some examples:
  - Performance benchmarks
  - Degree of correlation and performance relative to peer group
  - Minimum size and track record
  - Maximum expense ratios and fees

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As Charles Ellis explained in *Winning the Losers Game*, (McGraw Hill, 2002), investment policy is the antidote to panic. By engaging in this practice you will have established in advance, under calm conditions, decision-making criteria enabling you—in the words of Warren Buffet—"to keep your head while others are losing theirs."

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