WHITE PAPER

Top 10 Components of an Institutional Investment Policy Statement

ANDREW D. BERG, CFA
PRINCIPAL

The establishment of a formal Investment Policy Statement ("IPS") is the most critical step for building a successful investment program. IPS guidelines capture the definition, purpose, and objectives for a single account or a consolidated pool of assets, and provide the investment roadmap for how those assets should be invested in order to achieve the documented goals. An institutional IPS is the foundational guide for both the investor and their outside investment advisor.

DIVERSIFIED TRUST
diversifiedtrust.com

1. DEFINITION AND PURPOSE OF ASSETS

What specific assets or accounts does the IPS actually cover? Some institutions have different combinations of long-term endowments, plant reserve funds, operating and short-term reserves, each of which can sometimes be segmented further by restricted/unrestricted status, time horizon, donor intent, etc. It's important that each asset pool with a unique set of objectives and restrictions has its own set of IPS guidelines, and that each IPS document is explicit about what pool it governs. And because of that potential complexity, it's also important that the IPS captures the core purpose of those assets.

2. GOVERNANCE ROLES AND RESPONSIBILITIES

This section answers the question of who does what and who is ultimately responsible. Depending on the organization and its structure, this should cover the Board of Directors or Trustees, Finance and/or Investment Committee, and outside investment advisor, with specific language around ownership and oversight responsibilities, what can be delegated to who, and what level of investment discretion the outside advisor can hold. Also, who is responsible for communicating and evaluating what and on what frequency of recurrence?

3. TIME HORIZON

What is the life expectancy of the assets, to the best of the institution's knowledge? Many foundations and endowments are expected to last in perpetuity, but that doesn't have to be the case. If there's a specific drawdown period planned for a pool of assets, what is the sunset date? Is it a situation where assets are going to be allowed to grow untouched for a particular period of time, or until they reach a specific dollar threshold, after which the time horizon and spending policy changes? It is important to capture all of those details. Time horizon plays a crucial role in asset allocations decisions, so whatever specifics are known should be part of the formal IPS guidelines.

So what exactly does an IPS contain? For institutions, we view the following as the ten most important components of a thorough, well-crafted set of IPS guidelines.

continued on next page ›

4. RETURN OBJECTIVES

What is the long-term investment goal (or goals) of the institution? This can be defined in a number of ways:

- An average annual return tied to the institution's spending rate (plus inflation, net of fees) to protect the corpus and preserve future purchasing power in real terms
- An expected average annual absolute return of X% (either in nominal or real terms)
- A relative return equal to or greater than the comparable return of a single index or specific blend of multiple indices over a particular rolling period of time
- A return that bests a specific peer institution or peer group over a particular timeframe
- An expected return relative to a reasonable level of risk, which can be defined a number of different ways

In many cases having more than one defined return objective may be appropriate. In all cases there is one essential point to keep in mind: each goal must match the purpose of the assets and be consistent with the defined time horizon and risk parameters. If any of those things are out of alignment, you may have a hard time achieving the goal, be disappointed in the end result (even if you technically achieve the goal), or encounter significant challenges along the way.

5. RISK PARAMETERS

Without risk, there can be no (or not much) return. But how much risk is the institution actually comfortable taking, and how much can the asset base truly withstand? Unfortunately risk is a much more ambiguous concept than return, which is why it is often the ignored component of the risk/return paradigm. It also often requires a deeper discussion than return objective because risk parameter definitions are sometimes more qualitative than quantitative. A sampling of ways risk can be approached and defined include:

- Portfolio value falling below corpus
- Maximum allowable absolute annual loss in dollar or percent terms
- Maximum allowable drawdown (i.e., maximum loss from peak to trough) in dollar or percent terms
- Maximum allowable annualized volatility of a given percent
- Maximum allowable annualized volatility relative to a single index or multi-index blend
- Maximum allowable level of illiquidity across the portfolio or within a particular sleeve

continued on next page ›

Diversified Trust

6. ASSET CLASSIFICATION STRUCTURE

What types of investment will be utilized in the management of the portfolio, and how are they to be categorized? Is a traditional classification structure of cash, fixed income, equity, and alternatives (or "other," or "non-traditional") being used? Or is a more sophisticated structure that groups investments according to like risk exposures (which drive return potential) appropriate, something along the lines of duration risk, credit risk, equity risk, inflation risk, and idiosyncratic risk (i.e., non-correlated)? Will large cap U.S. equities be discussed and assessed independently from small/mid cap U.S. equities, or should they be lumped together into a broad domestic equities bucket? Will developed market equities be kept distinct from emerging market equities, and are emerging market equities even allowable in the portfolio? This is the first set of guidelines that provides explicit instruction on what types of investments can and cannot be utilized in the investment management of the assets.

7. ALLOWABLE ALLOCATION RANGES

How much of each type of allowable investment can (or must) be held? Is there a minimum floor that must be maintained in a particular category in order to insure certain levels of preservation or appreciation exposure? Is there a maximum ceiling that may not be violated in order to protect the portfolio from significant drift away from the intended risk/return profile? Sometimes these allowable ranges are very broad and sometimes they are very tight (even to the point of specific target allocations formally approved by the Investment Committee). Sometimes they are defined at the broad asset class level only (e.g., fixed income, equity) and sometimes they are defined down to the sub-asset class level (e.g., domestic equity, international equity). As asset allocation is far and away the biggest driver of portfolio return, it is imperative that the investment categories available for use, and the allowable allocation ranges across those investment categories, be in sync with the return and risk objectives, or those objectives will be very difficult to meet.

continued on next page ›

Important Notes And Disclosures

This White Paper is being made available for educational purposes only and should not be used for any other purpose. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Diversified Trust Company, Inc. believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based. Opinions expressed in these materials are current only as of the date appearing herein and are subject to change without notice. The information herein is presented for illustration and discussion purposes only and is not intended to be, nor should it be construed as, investment advice or an offer to sell, or a solicitation of an offer to buy securities of any type of description. Nothing in these materials is intended to be tax or legal advice, and clients are urged to consult with their own legal advisors in this regard.

8. INVESTMENT AND TRADING RESTRICTIONS

Any specific restrictions around the individual investments that can be utilized (publicly traded or not, individual securities or commingled funds, allowance for options or derivatives), allowable aggregate exposures (to an industry or particular debt issuer, limiting bond allocations to certain credit ratings or maintaining a certain allowable average credit quality), total amount of illiquidity in the portfolio (and what the definition of “illiquid” is), or allowable types of trade activity (short selling), and whether these restrictions pertain to the investment advisor, only, or also individual commingled funds utilized within the portfolio.

9. REBALANCING POLICY

Are there specific, defined procedures for when and how the portfolio will be rebalanced, and what level of discretion will the investment advisor have in this area? Some institutions mechanically rebalance back to specific targets according to a calendar (e.g., every quarter end or every year end), regardless of what takes place in the capital markets in between those dates. Others rebalance only when actual portfolio allocations drift outside the allowable allocation ranges, or outside an allowable threshold from the specific target allocations. Still others use a combination of different approaches, including degrees of tactical rebalancing.

10. IPS REVIEW POLICY

How frequently are the IPS guidelines to be formally reviewed, and by whom? Typically a Finance or Investment Committee (with the help of their investment advisor) should review existing guidelines at least every two or three years to ensure that the IPS is in sync with any meaningful changes to the institution, the assets, or updated capital market expectations.

Of course there are other components that can be included in an IPS (e.g., documented spending policy, performance reporting requirements, benchmarking policy, policy for handling individual stock gifts and specific donor instructions, long-term neutral allocation targets, history of IPS guideline changes), some of which may be extremely important for a particular institution. But for most, we believe these ten are essential, and if your IPS thoroughly covers all these bases – and, importantly, they are consistent with one another – then chances are you have a very solid governing document.

ATLANTA
877.955.8266

CHARLESTON
866.619.1003

GREENSBORO
855.821.4999

MEMPHIS
800.264.7498

NASHVILLE
877.386.7332