LANCASTER POLLARD

The Nonprofit Minute

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About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing *total* financial risk rather than just investment-associated risk. Lancaster Pollard Investment Advisory Group shares common ownership with Lancaster Pollard, a leading provider of investment banking and mortgage banking services for the senior living, health care, affordable housing and private education sectors.

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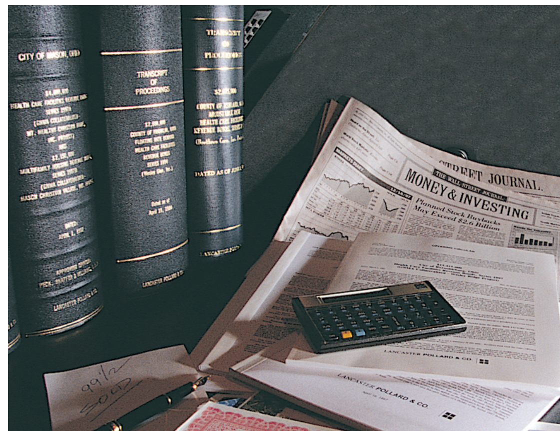
Investment Guidelines: Inside the Investment Policy Statement

An investment policy statement is an integral part of a well-disciplined, well-documented investment strategy. The investment policy statement (IPS) provides the "roadmap" for managing the organizations' assets. It establishes long-term objectives, assigns responsibility, promotes adherence to the objectives, and defines the management process while providing guidance through ever-changing market cycles.



While it is not necessarily the first step in creating or managing a portfolio, the statement provides the answers for investment questions and concerns that are presented over time regarding the assets entrusted to the mission. The board, administration and beneficiaries will certainly have an interest in the investment oversight function. Industry experts also have an interest in the content of the IPS. Increasingly, auditors and regulators also are interested. Indeed, ERISA measures compliance in terms of procedural prudence, not result.

While a significant portion of the investment policy statement targets procedure, many of the changes necessitating an IPS revision normally come from changes in the investment markets themselves. In order for the portfolio investments to remain relevant, the investment guidelines that make up the basis of the IPS must also be frequently addressed. Below, we discuss a four-stage process of creating or updating investment guidelines: evaluation, construction, implementation and review.

Evaluation

As with most endeavors, a complete situation analysis is paramount to success. Fiduciaries must become familiar with the sources and uses of the funds under their watch. Some sources may be regular and predictable; others may not, and proper cash flow planning will assist in the asset allocation process. Without proper planning, the cash flows may be inadvertently committed to a less liquid or a longer-term investment. This could result in the investment being liquidated at an inopportune time, possibly at a loss.

Accurately defining the use of the funds means more than identifying the "real" rate of return in a spending policy. Such analysis must also include a review of the applicable liabilities, assumptions used in the review, current obligations and the current funding status. If such analysis results in a "required return," the risk associated with that return can be

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budgeted by inputting such factors as expected return, inflation and fees. This analysis can and should be fairly comprehensive. The uses of the funds may also include emergency and other unforeseen expenditures, such as capital expenditures or contingent liabilities.

The identified uses must then be associated with an applicable time horizon over which the assets will be invested, which will help with risk analysis. While interest-rate-sensitive securities (bonds) are more volatile in longer maturities, total portfolio risk actually declines over time. That is to say, portfolios that have a longer time horizon can take on additional risk. The investment time horizon also includes other factors, such as donor restrictions or capital improvements. In such cases, specific policies may be developed for specific assets.

Construction

The information gathered during evaluation will lead to portfolio construction. An asset allocation model can be developed using the desired return assumptions and objectives. Studies have shown that over 90 percent of the variability of the return is based on asset allocation. The proper asset allocation model, then, can help mitigate extreme volatility in long-term portfolios. Historical analysis is a useful tool in providing an indication of how various asset classes have performed over time and offering a realistic expectation of returns. In addition to performance, volatility within each asset class also is a concern. Given such information, the potential of achieving the projected returns and investment goals can be reasonably assessed.

A well-diversified portfolio is the cornerstone of a enduring asset allocation strategy. While each asset class has a unique risk/return profile, adding asset classes reduces overall risk when they are properly introduced. Ideally, the asset allocation model will include correlation analysis, whereby the optimal portfolio consists of asset classes whose market movements are not highly correlated. While past performance (and volatility) is no guarantee of future results, empirical data forms a great deal of portfolio optimization modeling. This analysis depends upon history to prepare for the future. Other forecasting techniques, such as Monte Carlo analysis, can be used to estimate a probable outcome given certain risk assumptions. Other techniques can be particularly useful when stress-testing the portfolio or modeling best- or worst-case scenarios.

Implementation

Once the goals and portfolio structure are determined, implementation comes to the fore. Investment strategy now turns to the use of active versus passive management, value versus growth stocks, and when and how to rebalance an existing portfolio.

Passive management, or indexing, is most common amongst asset classes that are most efficient, such as high-quality fixed income or large-cap U.S. equities. Within efficient markets, over the long term, it is difficult for active managers to outperform popular indices. Should a portfolio be limited to just a few asset classes, passive management may be the right answer. Certainly, passive management may be allocated to a portion of the portfolio, while the balance is actively managed. Active management may take the form of enhanced indexing or individual security selection within a particular mandate. In either case, the active manager is held to performance standards not unlike the passive funds, with an eye toward outperforming the relevant benchmark, net of fees.

In addition to diversification amongst asset classes, style diversification is also considered. In larger portfolios, allocation to specific styles, such as small-cap value or mid-cap growth, increases diversification and lowers risk. As the portfolio should have undergone a significant analysis to determine the right asset mix, it is very important in actively-managed accounts to retain "style purity." If the asset allocation decision is intended to increase diversification, and a well-diversified portfolio mitigates over 90 percent of the variability of returns, managers must remain true to their mandate in order for diversification to perform its function. For example, a large-cap value equity manager who invests in large-cap growth instead can cause a portfolio that already has a large-cap growth manager to become less diversified, increasing the risk to the portfolio. Should large-cap growth stocks fall out of favor, this would have a greater negative impact on the performance of the portfolio.

Nearly all portfolios must be rebalanced periodically. Portfolio rebalancing is the reduction of an over-allocation to an asset class, probably due to good performance, and the increase in an asset class with a lower current allocation. Portfolios must be rebalanced to retain the risk parameters stated within the IPS. While there is no single favored method of rebalancing, a common strategy is to rebalance in a specific time period, either monthly or quarterly, back to the original asset allocation percentages. Rebalancing methodology and timing should be a distinct component of the IPS.

Review

As mentioned, the investment guidelines portion of the IPS is normally subject to more active review than other portions due to the ever-changing investment markets. The guidelines should also be subject to change whenever capital structure, funding status, cash flow or risk tolerance changes. Such changes should initiate a review of the full IPS. Even absent organizational or market changes, it is important to regularly reaffirm the suitability of the investment policy statement.

Creating an investment policy statement can be complex. A disciplined approach and continuous review will ensure that the policy addresses the organization's unique needs, especially through inevitable changes. A good IPS lets a nonprofit organization focus on more pressing matters: the mission.

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