

Key Definition

New Board Member Tip: What To Ask About the IPS?

- What is our asset allocation strategy and how was it determined?
- What is our portfolio rebalancing policy?
- When was the policy most recently reviewed?

About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, works exclusively with nonprofit organizations to create the financial means to last the life of their missions.

Independence combined with specialized knowledge and experience enables us to optimize an organization's investment returns relative to its unique risk/return profile.

To find out more, contact William M. Courson, President (614) 224-8800
wcourson@lancasterpollard.com

The Importance of a Strong Investment Policy Statement

By Chris Moran

One of the major challenges that nonprofit boards face is turnover among investment committee members. Finding qualified, volunteer fiduciaries to oversee the investment portfolio can be difficult, posing a significant problem for the organization. Moreover, board turnover could lead to frequent changes in investment policy strategy and management tactics. The best way to combat this issue is to have a strong investment policy statement in place that will provide disciplined investment tenets for a consistent, strategic approach to managing the investment portfolio through successive generations of committee members.

Written properly, the investment policy statement (IPS) should outlast the current administration as well as multiple generations of committee members. While there will be adjustments along the way as new asset classes are introduced and asset allocation decisions are evaluated, the core of the document should remain consistent.

Components of a well written IPS should include, but are not limited to, the following:

- Purpose & Policy Review Clause
- Investment Objectives & Constraints
- Description of Responsibilities
- Fiduciary Duty & Conflicts of Interest
- Asset Allocation Definitions & Guidelines
- Monitoring Portfolio Investments & Performance
- Investment Manager Review

The sections that will be the most helpful in guiding the organization through committee member turnover are the Policy Review Clause and Asset Allocation Guidelines.

The annual review clause should state what elements of the IPS should be reviewed, in what context, how often, and by whom. Building an annual review clause into the IPS is considered a best practice for a number of reasons. Not only do market outlooks change from year to year, but the purpose of the portfolio may change as the organization changes. Of course, committee members change, as well. As a result, the annual review gives new members the opportunity to participate in a discussion about the investment portfolio in an open forum. New board members might raise questions that may not have concerned previous members, and planning for that annual review by having it scheduled as part of the IPS helps ensure that this key best practice is acted upon. A policy-driven review creates an environment where each member can voice concerns, reducing the chance of the "strongest voice" directing policy. The review will also provide an educational setting in which all members can be reminded of the portfolio structure and the rationales behind the inclusion of the various asset classes that make up the portfolio.

The IPS review should coincide with an annual asset allocation study. This will allow new members to familiarize themselves with the purpose of the portfolio, and how asset class assumptions (from both a risk and return standpoint) are incorporated into the asset allocation guidelines.

Asset Allocation Definitions & Guidelines begin with the strategic allocations, which are the target for each asset class determined through an asset allocation study that incorporates budgeted uses for the funds and/or return targets that are unique to the organization. Asset class constraints are outlined to ensure tactical allocations never stray too far from the strategic goals of the investment portfolio. Tactical allocation is a tool of active management that establishes short-term asset allocation in order to take advantage of valuation discrepancies in specific asset classes.

Another important component within the Asset Allocation Definitions & Guidelines is the rebalancing language. A traditional approach is to incorporate constraints or bands around the strategic asset allocation targets. For example, if a strategic allocation for a given asset class is 10%, the bands could be plus or minus 5%. The existence of bands will allow the asset classes' weightings to drift away from strategic targets as markets rise and fall while serving as a trigger for when to rebalance the portfolio. Incorporating bands is important for a few reasons: it will not only prevent excessive trading to get back to target, but allow for tactical underweighting and overweighting of certain asset classes. An organization that does not incorporate bands around the strategic allocation will likely find itself either constantly rebalancing the portfolio, or worse, adjusting the IPS as a reaction to changes in the markets. Research by Lancaster Pollard Investment Advisory Group shows that it is beneficial to incorporate into the policy an annual rebalance to the strategic targets, usually done in conjunction with an annual asset allocation study.

A well-defined portfolio rebalancing policy removes the emotional component of investment management and eliminates the tendency to practice market timing. New committee members should recognize the constraints intentionally set within the asset allocation guidelines as a well-thought-out approach to a disciplined investment strategy.

The third aspect of the Asset Allocation Definitions & Guidelines section is the specific definition of each asset class. For equity-like asset classes, the definition should include eligible securities, excluded investments, and a benchmark. Fixed income-like asset classes should also incorporate a diversification and duration component. Appropriate general guidelines may encompass excluded investments, de minimis rules, diversification, and marketability. Clearly defining each asset class simplifies investment policy compliance and serves to educate new investment committee members on portfolio structure and the purpose of each asset classes' inclusion in the portfolio.

Investment Policy Statement review is critical to the entire life cycle of board membership. It is intended to keep existing committee members engaged while educating those who are new. Moreover, the underlying purpose of the IPS is to ensure investment committee actions are policy-driven rather than emotional, mitigate the impact of strong personalities, and provide continuity when there is turnover, whether planned or unplanned.