

A Review of Difficult Investment Policy Issues

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This article looks at the many challenging issues the advisor needs to address in developing an investment policy statement for a client. There is no one right way to look at any of these issues, so the authors seek to raise questions rather than provide the “right answer.” The issues discussed that the authors believe should be included in an IPS are investor goals, client cash flow needs, what to do when a client needs or desires inappropriate rates of return, identifying the investors’ time horizon and risk tolerance, handling concentrated or low-basis positions, tax considerations, portfolio optimization, outside investment accounts, and rebalancing and monitoring activities.

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While investment policy statements have for years been a required part of ERISA (Employee Retirement Income Security Act) plans and many trusts, foundations and endowments, they have recently become an accepted “best practice” in working with individual clients as well. The purpose of this article is to highlight some of the more difficult issues that arise for the advisor as the investment policy statement is being written.

The investment policy statement (IPS) should be the basic building block in an intentional investment process. In creating an IPS, the advisor and the client agree upon all of the essential issues surrounding how and why the money is to be managed. The IPS development process provides crucial education for the client and is a key communication step, helping each party to understand the other’s perspective and goals. The IPS is the document that guides the advisor as future decisions are made; it serves as a guidepost against which the reality of what has happened can be measured against the rules and procedures and benchmarks that were agreed to. Finally, it serves to create a purposeful decision-making process in rational times, to guide clients through the inevitable rough periods when emotions may cause them to make less than optimal decisions.

As a compendium of decisions made by the advisor and client about how the money is to be managed, the IPS has many critical and difficult issues. It is the goal of this article to identify and discuss many of these topics and to challenge you to build a more complete, relevant and personalized IPS for your client.

Overview

The investment policy statement serves four basic purposes:

1. **Identifying objectives**—to establish clear, reasonable and definable expectations, risk and return objectives, and guidelines for the investment of the assets.
2. **Defining the asset allocation policy**—to set forth a structure and identify the investment asset classes that will achieve a diversified portfolio, as well as to determine how those assets are to be best allocated to help achieve the investor’s objectives.
3. **Establishing management procedures**—to provide a guide for selecting, monitoring and evaluating the performance of those charged with managing and investing the assets, and making changes as appropriate.
4. **Determining communication procedures**—to provide a concise method of communicating the process and objectives among all parties involved with the investments and to assign responsibility for implementation.

When managing trust assets, qualified plan assets and other similar accounts where a fiduciary responsibility exists, it is a legal imperative to have a written investment policy statement.

Our experience is that the process of developing the IPS provides such a valuable discipline for us and is such an important educational opportunity for the client that we recommend that advisors create an IPS for each and every client.

Two caveats are worth repeating: (1) if you are going to create an investment policy statement, it is only useful if it is in writing; and (2) if you have an IPS, it is essential that you follow it. Worse than not having an investment policy statement is to have one and ignore it.

Components of an IPS

There is no one right way to construct an IPS, although advisors who use a consistent structure each time will find the process of writing an IPS much less arduous and time-consuming. Our approach is to categorize the common components of a complete investment policy statement into seven parts:

1. Introduction—purpose of the IPS and an explanation of why the investments are being structured as suggested
2. Key factual and account information and summary of investor circumstances
3. Investment objectives, time horizon and risk attitudes
4. Permissible asset classes, constraints and restrictions
5. The asset allocation
6. Selection, monitoring and control procedures
7. Signatures

Each advisor will approach each of these parts differently and each client’s IPS will require a certain degree of individualization. At the same time, having a template to provide consistency in structure from one client to the next can help save time as well as improve the output.

The Nine Steps of a Proper Investment Process

A thorough and proper investment process has nine steps. Each step relies on many different inputs and will be uniquely determined based on the advisor’s sophistication, his or her biases and preferences. Figure 1 summarizes the nine steps.



Each of these steps involves challenging issues that the advisor needs to consider. Each requires extensive consideration on the part of the advisor and often the client’s input as well.

We use a questionnaire that not only asks the client about investment objectives and risk tolerance, but also what they think about each of the policy issues to be addressed. All of these are discussed with the client before we write the IPS. Having a system that identifies and addresses each critical issue helps the advisor create a more thoughtful and intentional investment process. It also raises the client’s confidence in the advisor. What are these

issues?

Step 1: Identify Goals

The depth of understanding. It is critical for the advisor to understand what the client wants and needs. Different advisors use different questions and look for different information from their clients. At one end of the continuum, some advisors may only wish to know if the client wants to be aggressive, moderate or conservative, or whether they desire growth, income or a balance between the two. At the other end of the continuum is the financial planning model in which we seek to know about a client's values and life goals and wishes, and how the rest of the client's financial and personal life supports or doesn't support these desires. Where do you fit on this continuum? We believe that the best investment policy statements are developed after a more in-depth investigation of the client's goals than to merely fit them into one of a small set of predetermined and simplistic "boxes."

Cash flow issues. What kind of requirements does the client have for current cash flow and what implications will this have for portfolio construction? Each conclusion represents a policy choice that should be documented in the IPS. For example,

- If the client's personal income is unsteady or uncertain (such as income derived from periodic commissions or bonuses), that client may need to set aside more in cash reserves than a salaried client.
- If the client has periodic opportunities to make investments outside of their portfolio, such as real estate or private business ventures, larger reserves are probably desirable.
- If the client needs to make regular withdrawals, there are several ways to address this issue. For example, an advisor could periodically draw down from the portfolio in regular increments, either from the dividends and interest the portfolio generates, or from the sale of appreciated assets or principal as appropriate to provide the cash needed. A second approach would be to set aside a reservoir of cash in a money market account, draw down a predetermined monthly amount, and periodically replenish the money market account with portfolio interest, dividends, and capital gain distributions and investment sales to keep the account at the desired level. The determination of how much to set aside as a "reservoir" should be discussed with the client, as well as issues such as whether it should be in a separate account and if so, whether management fees will be charged for this account.

Cash balances. How much cash (money market asset class) should you design in the portfolio? How will the cash be used? Clients need cash (checking or money market accounts) to pay for normal living expenses. The operational aspect of managing a portfolio (such as ease of trading or having cash available to pay the management fee) requires having some cash in the portfolio. Clients may also need an emergency reserve. Decisions about the amount of cash will be influenced, not only by the topics addressed above, but will depend on a variety of factors having to do with such factors as size, consistency and future dependability of their income, other liquidity available and borrowing resources. Each of these questions and circumstances requires a policy decision.

Step 2: Identify the Target Rate of Return

The required rate of return that a client will need in order to attain his or her financial goals should drive much of the design process. Determination of the target rate of return can be done *only* after you have performed what is commonly referred to as a "capital needs analysis." In effect, you need to measure the projected inflows and outflows of the client's financial existence, (based on their goals), through an extended life expectancy, such as to age 100.

Some policy issues here involve your methodology for determining this number. Have you developed your own spreadsheets, or do you use a prepackaged program? Do you use the additional aid of Monte Carlo simulation and if so, what are the variables in those sets of calculations (such as standard deviations)? The advisor's answers to these questions will, in part, determine the answer to what rate of return is to be targeted.

What the client tells you should not suffice in identifying a return objective. You have a professional obligation to ensure that the expected investment returns will satisfy the client's goals and that the accompanying portfolio volatility is within the client's tolerance for risk. Meeting this obligation requires you to do some analysis. If the returns and risk are not aligned with an ability to satisfy the goals, then something has to give. The advisor has to spend some time educating the client about the conflict and the implications and perhaps in finding necessary compromises.

If you determine that the investment plan will be inadequate for the client's long-term needs and yet you implement the plan as is, then you will be doing the client a disservice and may have failed to satisfy your professional obligations. Who knows—in this litigious environment, you may also face negligence issues in court when your plan inevitably fails. The question is, What do you do when the client's goals or risk tolerances are unrealistic?

Step 3: Knowing the Time Horizon

Some of the policy issues pertaining to time horizon include how to handle short-term and longer-term liquidity needs. For example, if a portion of the investment portfolio will be used for college expenses for undergraduate and graduate years, at what point do you begin moving the annual tuition expenses into cash? Would it make a difference if an adequate line of credit were available to the client?

How do you estimate your client's life expectancy? To measure lifetime capital needs sufficiently, you need to estimate a mortality age. How do you choose a mortality age? Keep in mind that Internal Revenue Service and life insurance tables generally use a median age of death for the addressed group. Using those tables, therefore, means that there is roughly a 50 percent chance of outliving the identified mortality. By themselves, these tables may not be good guides for choosing the mortality to be used in a capital needs analysis.

Often a client believes that their investment allocation should be significantly altered when they reach retirement age. How will you handle this? If they retire at age 65 and live until 95, there is still a 30-year time horizon at retirement. How conservative can the client afford to be?

If the investment portfolio being considered under the IPS is a qualified retirement plan and the owner-client is planning to retire within two to five years, the portfolio might have to be liquidated. Will you have a systematic approach to selling and moving into cash, or will you "roll the dice" and stay fully invested until the last minute? If there are employees participating in the plan, how do you take their potential cash distribution needs into consideration?

Step 4: Understanding Your Client's Risk Tolerance

Getting a sense of a client's willingness to tolerate risk is critical to finding the right portfolio design so that the client will stay true to the course during both good and difficult times. How you make this determination and how you use that information in designing the portfolio need to be recorded as part of the investment policy statement. The client owns (and will be living emotionally) with his or her own investment policy. Therefore, the more clearly you describe what the client was thinking at the time and how that was used to establish the investment approach could be important as a historical record should there be a later disagreement.

For institutional clients, the degree of risk deemed acceptable will be a primary driver for what level of returns can be obtained and how the portfolio will be structured. For individual clients, we think risk tolerance is more of an education issue, because if they need to achieve a high return to attain their goals, they are probably going to need to accept the risk that comes with it (or adjust their goals).

What instrument or questionnaire was used to arrive at your conclusion about the client's tolerance for risk? Is it thorough? Well thought out? Does it have any basis in scientific research?

If the client can emotionally tolerate substantial volatility, but for fiscal reasons they should be more conservative, how will you deal with that? We think measuring risk capacity is often as important as identifying the client's risk tolerance. According to Rick Adkins of The Arkansas Financial Group,¹ "Risk tolerance' is the emotional and intellectual ability to withstand volatility and a given degree of loss. 'Risk capacity' is the financial ability to withstand volatility or loss."

There is a big difference in these concepts, as we have learned in the current bear market. We recommend that both of these risk components should be discussed with the client as the final IPS is drafted to make sure that it is attainable and consistent with the client's goals.

Step 5: Identification of Asset Classes and Investment Vehicles

Addressing concentrated positions. Besides the basic identification of the asset classes, how do you handle a portfolio with a concentration of a single stock, or investment sector? Possibly your client has one or more securities that they don't want to sell for tax or purely emotional or non-logical reasons. Maybe they have 60 percent of their assets in one stock. You need to develop policies for how you are going to deal with these situations. Maybe you dollar-cost-average out of these positions, and if so, over what time frame? How often? Will there be triggers to cause you to do more or less? Maybe you simply hold these positions and work around them. Do you treat the rest of the portfolio as though those positions didn't exist, or do you let them affect what you do with the rest of the portfolio?

For example, let's say a client comes to you with an outsized position (50 percent of their investment wealth) in General Electric stock. If they want to continue to hold GE, what are the implications for the rest of the portfolio?

- Do you assume that GE is a proxy for the U.S. stock market, which might mean it would be the only U.S. stock you hold?
- Perhaps you think it is a good proxy, but only for large U.S. stocks, so you might include small U.S. stocks as an asset class in the other half of the portfolio, as well as foreign stocks, real estate, cash or bonds.
- Perhaps you think that it is not a good proxy, but it does certainly represent an important part of the Dow Jones Industrial Average and the Standard & Poor's 500 Stock Index.

With that in mind, you might choose to divide the remaining half of the portfolio not only with small U.S. stocks, foreign stocks, real estate, cash and bonds, but with some other large U.S. stocks.

- Or you might consider the GE stock to be so concentrated, and therefore so non-representative that you build a portfolio design for half of the portfolio as though the GE stock didn't exist.

There's not a right or wrong way to approach these kinds of issues. It is important to acknowledge the many ways to deal with it, present your philosophy about the issues, seek the client's guidance and concurrence, and then come up with an approach that works for each of you and is operationally practical.

Investment style. Are you a proponent of passively managed vehicles such as index funds or exchange-traded index funds (ETFs), and if so, for all or only a few asset classes? Do you have a bias toward value over growth? What if the client refuses to own a particular asset class that you believe is imperative to include? How is this documented? Does the client wish to invest only in "socially conscious" investments, and if so, what is their definition of socially conscious?

Designating asset classes. When designing a portfolio, it is important to get agreement first on which asset classes are to be included, and then in what proportion, before entering into discussions of what specific security or mutual fund you are going to use in a particular way. It is also critical to agree on what asset classes will not be used. If you help the client understand the conceptual framework first, then which investments will be used is almost an afterthought, requiring little discussion.

That, of course, begs the question, "What asset classes do I use?" At which of the following levels do you prefer

to construct a portfolio?

- This portfolio will have 70 percent equities.
- This portfolio will have 40 percent of the total in U.S. equities.
- This portfolio will have 28 percent of the total in *large company* U.S. equities.
- This portfolio will have 15 percent of the total in large company *value* U.S. equities.
- This portfolio will have two percent of the total in U.S. *auto* stocks.

One of the problems you can often run into is “asset class spillover.” In other words, a small-cap mutual fund may carry real estate as part of its holdings, or an international fund may hold companies from emerging market countries, or a U.S. equity fund may hold some non-U.S. companies. Does this mean that you should not create separate asset classes in your portfolio for real estate, emerging markets or international? Does it mean that you decrease the specific allocation, and if you choose this approach, how do you track the changes the manager may make? The critical point here is that the advisor should discuss the approach to be used, get the client’s agreement and then document the approach in the IPS.

Step 6: Design the Asset Allocation

Tax considerations. The client’s portfolio must be designed with the client’s tax status in mind.

One of the important questions is choosing where to put different assets and the format the assets will take. For taxable accounts, it may be desirable to minimize both current income and turnover (thus lowering annual taxable capital gains). For tax-deferred accounts, it may be an attractive option to try to do the opposite—place the income-producing investments here and give more credit to maximizing pre-tax returns. Is the investor better off if the faster-growing assets are placed in the tax-deferred accounts to take fullest advantage of the compounding opportunities, or in the taxable account to take advantage of lower capital gains rates?

Will you attempt to regularly harvest tax losses or leave those decisions to another professional such as the client’s accountant?

Low basis securities. If a client is quite elderly and has many low basis investments in his or her portfolio, the advisor should take into consideration that selling at the start of the management relationship or any time thereafter simply to reallocate a portfolio may deny the heirs a step-up in basis. If this is an issue, how you plan to address it? These types of discussions are what add value to your client relationship.

Portfolio organization. Some advisors believe in a “core and satellite” approach to investing to help save taxes. Whether you use this or your own approach, it is appropriate to describe the situation and the issues and any policies that will be followed as a result.

Optimization. How do you know if you have developed an optimal asset allocation if you don’t use an optimizer? It is imperative if you present an asset allocation that you identify the source and the variables used in developing the recommendation. If you have obtained an asset allocation from your broker/dealer or insurance company or bank, we strongly suggest that you find out how it was developed and the assumptions used in its development.

Are you going to identify a specific and static percentage for each asset class in the portfolio, or are you going to identify an acceptable range of percentages for that asset class? For example, if your allocation has U.S. large cap with 40 percent of the total portfolio, will it be allowed to fluctuate between 30 percent and 50 percent, or do you want to try to keep it more consistent? This policy decision will have further ramifications for the rebalancing process.

Optimizer difficulties. We think that optimization is a good process for the advisor to go through in designing portfolios and asset allocations, but it is critical that the advisor recognize the limitations and the policy questions that get raised. Optimization is probably appropriate to help you or your client understand how increasing,

decreasing, adding or deleting an asset class might affect the overall risk and return of a portfolio. That can help in making intelligent design choices, but the “answer” that comes out of the computer is not necessarily “right” or even appropriate. The input provided to the computer software and the context in which it is placed need to be appropriate themselves. The adage “garbage in, garbage out” truly applies here. Use these programs with caution. Use them as a guide, but don’t rely on them for the answer.

Dealing with other accounts. Often, clients like to have their own “play account” in which they invest on the basis of their own whims or “helpful hints” from others. They may have other brokerage accounts, a UTMA (Uniform Transfers to Minors Act) or other specific-purpose accounts. To what extent will the existence of these assets affect the decisions made for this portfolio?

How will other assets owned by the client be handled vis-à-vis the decisions being made about this portfolio? Sometimes the client has other advisors working with parts of the total portfolio and it may be important to be aware of what decisions are being made or what assets are being held by those advisors. That being said, we caution against agreeing to mold your portfolio around some other advisor’s ideas. Doing so could subject your managed portfolio to periods of substantially greater volatility or relative underperformance, thus putting you at a possible competitive disadvantage. The client’s overall wealth could be adversely affected by its being managed in an information vacuum or without a unifying Big Picture.

Do you have the identical asset allocation for each spouse’s assets if they both have the same risk tolerance but all of the husband’s assets are in a retirement plan? What if one client has a different risk tolerance than the co-client? Do you develop a separate IPS for each one? What if that retirement plan doesn’t offer the complete range of investment choices you recommend in your investment policy? Are you going to recommend an asset allocation specifically for the retirement plan? If so, what responsibilities do you have to monitor changes in managers and values?

Step 7: Write the Investment Policy Statement

The final two steps in the investment process—selecting the investments and then managing the portfolio—necessarily arise after the IPS is written. These are the implementation steps and by definition should be directed by the investment policy statement.

Step 8: Select the Investments

You have already identified the asset classes and types of investment vehicles to be included in the portfolio. The next step is what the client normally believes is the most important part of the process—investment selection. As most of us have come to believe, selection of specific securities is relatively less important than the asset allocation decision, but the IPS still should have documented your selection process.

The most important policy decision in this part of the process is whether you are going to delegate the selection of the specific managers, mutual funds or stocks to a third party, or select the individual securities yourself. If you are delegating the selection of specific funds or managers to a third party, how have you selected this third party? If you are selecting the investments yourself, what are your criteria? The client has a right to understand your process methodology.

If you have decided to employ a passive approach to investment management, will you use mutual funds, exchange traded funds or some other approach? Why?

If you are selecting funds, should you use those that have no commissions or transaction fees assessed by the custodian, or does that make a difference? We might suggest that if a client is systematically depositing or withdrawing funds, then “no transaction fee” investments may be most cost effective and appropriate. If transactions are seldom anticipated, then paying a small transaction charge for a low expense fund may be better for the client.

Amount of discretion. Part of the understanding between the advisor and the client involves the extent to which the advisor makes all the decisions (“full discretion”) or to which the client has rights to be consulted and change the recommended tactic before the recommendation is executed. There’s no right or wrong way to do things, but the client has a right to know your procedure.

Other advisors or decision-influencers. Accountants, attorneys, trust officers, trustees and others may have an interest in, and influence over, some or much of what goes into the investment policy development. Where this situation exists, it may be helpful to identify who they are and what their role might be. For example, who gets a copy of the IPS? Do they need to be informed about investment changes or recommendations? Before the fact or just as a courtesy?

Step 9: Monitoring, Managing and Reporting

Rebalancing. Do you intend to rebalance the portfolio or will a buy-and-hold strategy be employed? If you plan to rebalance, will you choose an absolute or conditional rebalancing approach?

- An absolute approach could include a fixed percentage variance around the policy target. For example, if the variance percentage is 5 percent and if a particular asset class’ policy target is 40 percent of the portfolio, rebalancing would occur should the actual percentage fall below 35 percent or rise above 45 percent of the total.
- A conditional rebalancing approach might occur when the asset class moved 25 percent from its target. Using the 40 percent policy target, the rebalancing would occur if this asset class dropped below 30 percent or rose above 50 percent.

Will you employ a different rebalancing approach in taxable accounts than in tax-deferred accounts? Will you treat extremely volatile asset classes any differently than more stable ones? What market or economic forces could cause a change in the rebalancing policies, if any?

How frequently will the portfolio be reviewed for rebalancing? Will it be done on time-based frequency such as monthly, quarterly or semi-annually? Or whenever the portfolio moves out of policy ranges? Unfortunately, many portfolio management reporting systems do not have the capability of notifying you when a portfolio is out of acceptable range.

Benchmarks. Which benchmarks are you going to use—pure indices that have no management or transaction fees or category returns for managed asset classes that will reflect these costs? If you select indices, will they be capitalization and style specific? Which of the well-known indices (such as Barra, S&P, Russell or Wilshire) will be selected? Will your international index be in local currency or dollar denominated?

Monitoring issues. How often do you review the client’s portfolio? What does such a review consist of? How do you communicate that with the client? What is the process you use in the monitoring—that is, what do you monitor for? How often do you do it? How do you get the information for which you are monitoring?

Both the advisor and the client benefit from the regular use of investment policy statements. The best investment policy statements are those in which the issues described in this article have been discussed and jointly agreed to by the advisor and the client.

Endnote

1. *Measuring Risk & Managing Client Expectations*. Practitioners Publishing Company, (800) 323-8724.

Web Sites of Interest

- Re Draft of the Statement of Ethical Investment Policy
Statement of Ethical Investment Policy and Ethical Investment Policy Statement. www.churchinwales.org.uk/gb/EthicalInvestmentgb902.htm
- Fiduciary Investment Compliance Checklist: The objective of the checklist is to assist investment fiduciaries who are subject to ERISA or the Uniform Prudent Investor Act. www.chartwellusa.com/FiduciaryChecklist.pdf
- “Common Mistakes of Fiduciaries Responsible for Investments” by Lynn Hopewell http://www.monitor-inc.com/Articles/Lynn_Hopewell/Mistakes.pdf
- The Management of Investment Decisions, by Donald B. Trone, et al. www.booksforinvestors.com/abooks1/0786303921AMUS14663.html
- Investment Policy Statement Guidebook, version 2.1 by Norman M. Boone, CFP®, and Linda S. Lubitz, CFP® http://www.ibbotson.com/content/product_lvl4.asp?catalog=Products&category=Products&ib_id=IBPR4520021
- For more detailed background if you are not familiar with investment policy statements, we suggest you read our previous article “Developing the Investment Policy Statement,” which can be found on the past issues section of FPA’s Journal Web site: www.fpanet.org/journal/articles/1992_Issues/jfp0492-art5.cfm