

# Four Considerations for Creating a Strong IPS

An investment policy statement (IPS) can be one of the most important documents for institutional investors. Despite this, not all IPSs are of the same quality. Which of these statements better describes your organization?

- A. Our IPS is the backbone of our successful investment program; or
- B. I know someone has an IPS around here somewhere...

If your answer is B, you're not alone. But, you're likely out on the benefits that a well-documented IPS can create for your investment program. A strong IPS can provide a solid foundation for an investment program and can give organizations the discipline to face the uncertainties of challenging investment environments. If you were to run your IPS through a stress test, would your IPS be strong enough to withstand the pressure?

In this paper we describe four considerations to use in helping determine if an IPS is strong. The overarching theme of these four considerations is thoroughness as it relates to documenting the governance, oversight, investment management and monitoring/evaluation functions of the investment program.

## Current Landscape

Before we discuss the four considerations, it is important to level set regarding the current landscape of IPSs. Simply put there are more "bad" IPSs than there are "good" IPSs. The IPS is perhaps the most important governance and oversight document regarding an investment program and should cover all details relevant to governing, executing and monitoring the program and its portfolio(s). Implicit in this, in our opinion, is one key difference between a "good" IPS and a "bad" IPS: thoroughness.

Figure 1  
Common IPS Sections

<b>I. Governance</b> <ul style="list-style-type: none"> <li>a. Purpose &amp; Scope</li> <li>b. Definition of Duties</li> <li>c. Investment Philosophy</li> </ul>	<b>II. Objectives &amp; Constraints</b> <ul style="list-style-type: none"> <li>a. Statement of Goals</li> <li>b. Spending Rule</li> <li>c. Return Objectives</li> <li>d. Risk Tolerance</li> <li>e. Time Horizon</li> <li>f. Liquidity Requirements</li> <li>g. Unique Circumstances</li> </ul>	<b>III. Portfolio Parameters</b> <ul style="list-style-type: none"> <li>a. Asset Allocation</li> <li>b. Benchmarks</li> <li>c. Selection and Retention</li> <li>d. Types of Securities</li> <li>e. Portfolio Rebalancing</li> </ul>
<b>IV. Risk Management</b> <ul style="list-style-type: none"> <li>a. Control Procedures</li> <li>b. Performance Objectives</li> </ul>	<b>V. Client Service</b> <ul style="list-style-type: none"> <li>a. Communications</li> <li>b. Reporting</li> </ul>	<b>VI. Acknowledgement of IPS</b>



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We believe a thorough IPS should contain as many of the sections in Figure 1 as are relevant to the given investment program. The investment program is a key tool used to sustain the mission of nonprofit organizations. The IPS should document how the investment program will be constructed in support of this mission and tie back to the overall goal for the assets (e.g., to support a distribution, budget support, specific capital projects, etc.). The six key sections identified cover a wide range of governance, portfolio execution and monitoring/oversight responsibilities relevant to the board members or investment committee members serving in a fiduciary capacity.

In our experience, this is where organizations with a “bad” IPS fall short: in some cases, sections are left out; in other cases, where they are included, they lack the specificity to drive the intended behavior, processes and/or outcomes. In this paper, we address four problem areas commonly encountered when creating an IPS.

### Definition of Responsibilities

It may seem obvious, but it's important to define who does what. For board members and/or investment committee members serving in a fiduciary capacity, there should not be any ambiguity regarding who is responsible for the tasks and responsibilities associated with the investment program. The list below outlines some of the assignments that need to be made:

- Who is responsible for governance and oversight of the program, including maintaining the IPS?
- Who will set the investment and distribution objectives for the fund?
- Who is responsible for making asset allocation manager selection and other portfolio management decisions?
- Who will be responsible for evaluating the success of the investment program with meeting its objectives?

These responsibilities, to name a few, should be identified and assigned to specific owners, in writing, so the expectations are clear as to who is responsible for what. These key owners may include board members, trustees, investment committee members,

investment advisor(s) and custodian(s), among others. Done right, this provides clarity regarding the responsibilities of each party, especially those with fiduciary duties, and can provide accountability around the completion of those tasks.

### Objectives and Constraints

When creating an investment portfolio, it is important to consider key objectives and constraints: return objective, risk tolerance, time horizon, taxes, liquidity, legal, responsible investing and unique circumstances. These objectives and constraints need to be defined and shared with those responsible for managing the investment program. Some questions to ask when considering the eight key objectives and constraints include the following:

1. *Return Objective*: What is the purpose for these funds? If the goal is to make a distribution while preserving purchasing power, does the return objective take this into account?
2. *Risk Tolerance*: Have you determined what an appropriate level of risk is for your portfolio?
3. *Time Horizon*: How long will you invest these assets? In perpetuity, or for a set period of time?
4. *Taxes*: Are there any tax impacts or implications that should be considered as they relate to the investment portfolio?
5. *Liquidity*: What are the cash flow needs (e.g., to fund distributions) of your organization?
6. *Legal/Regulatory Requirements*: Are there any federal/state regulatory requirements that are applicable? Donor restrictions? Other considerations?
7. *Responsible Investing*: Are there any responsible investing considerations that your organization wants to incorporate into the portfolio?
8. *Unique Circumstances*: Are there any specific policies that your organization wants to incorporate into the portfolio?

An investment program should be built upon these factors and should adapt as these factors evolve for your organization. Documenting these factors in the IPS can help those in charge to make investment decisions with these factors in mind.



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### Benchmarking the Plan

Measuring progress toward goals is an integral component of a successful investment program strategy. Specifically, measuring the performance of the investment program against defined benchmarks can allow an organization to determine if it is on track to meet its objectives or if strategy adjustments are needed. Critical to this process are two steps:

- 1) defining “success” in specific terms, through a relative benchmark and/or an absolute benchmark; and
- 2) measuring the performance of the investment program against your definition of success on a periodic basis.

Two commonly used ways to define success for an investment program involve relative benchmarks and absolute benchmarks:

- 1) A relative benchmark utilizes an index or blend of indices to make a comparison against the performance of the investment program. As an example, a relative benchmark might involve comparing the performance of your investment portfolio against the performance of a 60%-40% blend of the S&P 500® and the Bloomberg Barclays Aggregate Bond Index.
- 2) An absolute benchmark, or hurdle rate, is an actual percentage return. For example, if your objective is to retain the principal and purchasing power of your portfolio against a 4% annual distribution, 2% inflation, and 0.5% in fees, a back-of-the-envelope calculation would require a 6.5% return. Investment returns below this benchmark would imply the program is failing to meet its objective; returns above this number would imply that it is meeting its objective.

The second important part of benchmarking, as mentioned above, is to make sure that the benchmarks are actually used. Specifically, it is important to measure the performance of the investment program against the established benchmarks on a regular basis. As a final note, we recommend that the benchmarks be reviewed annually and as a response to material changes in

your investment portfolio or investment program objectives. This can help determine that they remain appropriate for what you are trying to accomplish with your investment program.

### Portability

Over time, your board, your decision-makers and your vendors may change. When the people in charge of your long-term objectives experience turn over, how do you keep your investment program on track? To this end, an effective IPS can help the investment program maintain continuity. You can test this with a simple question: Can someone pick up this IPS and understand the investment program without any other guidance? Some key questions to consider in answering this question include:

- 1) Does it include the common sections mentioned above?
- 2) Have you defined responsibilities for key decision makers?
- 3) Have you defined the objectives and constraints?
- 4) Have you defined what success looks like (i.e., established benchmarking guidelines)?
- 5) Have you defined how you are going to monitor the portfolio and with what frequency?

If you can answer “yes” to these questions, there may be a higher likelihood that your IPS will be able to reduce the difficulties inherent to personnel changing over time.

### Conclusion

A strong IPS can provide a solid foundation for an investment program and gives organizations the discipline to face the uncertainties of challenging investment environments. With the key considerations discussed in this article in mind, we recommend working with your decision makers, legal services firm and investment manager(s) to determine if your IPS is thorough or if improvements can be made.

**For more information on investment policy statements, we recommend our white paper, *Discipline to Succeed*. Please reach out to your PNC Investment Advisor for more information.**

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