Fiduciaries are no different than members of a company’s management team in that they both have resources under their direction that must be administered for the benefit of investors. To succeed in their roles, both depend on a defined strategy to guide their actions and must convey that plan to those who have entrusted assets to their care. Company managers commit their strategy to paper as a business plan; fiduciaries commit their plan to the investment policy statement (IPS).

The preparation and faithful execution of the IPS is the most important role of an investment fiduciary. Without a well-crafted IPS, fiduciaries managing a portfolio are like the crew of a ship that sets to sea without a navigation system and without a clear sense of the intended destination. Both the cargo and the crew are in jeopardy without adequate preparation and a well-charted course.

Policy Development
The major prerequisite for a well-crafted IPS is to have a well-reasoned strategy—the investment policy—developed before the drafting of the document begins. ERISA refers to the investment policy as “a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan” (ERISA Section 402(b)(1)).\(^1\) This reference is deceptively brief because it is quite comprehensive in scope. The focus on a funding policy points to the fact that the primary purpose of any investment portfolio is to use assets that are available and expected to be accumulated to meet expected distribution requirements (which are best thought of as future liabilities).

Equipped with adequate understanding of asset and liability streams, investment fiduciaries can focus upon formulating a methodology that reasonably can be expected to succeed, where success is defined as having sufficient available assets to meet expected liabilities. The methodology consists of prudent investment processes grounded in generally accepted investment principles that fiduciaries are obliged to follow in meeting the funding policy for the portfolio. The written document that captures the funding policy and methodology to meet that policy is the IPS.

It may seem obvious that the policy must be thought-out before it can be written down, but it is surprising how often an IPS document is adopted without adequate consideration of whether the IPS actually is aligned with what the investors want and need. This often happens when an investment product vendor supplies the IPS. The primary purpose of a vendor-provided document is to make sure the IPS conforms to the characteristics of the product; that is the tail wagging the dog. Investment products should conform to investor characteristics that are considered in advance and captured in a proper IPS.\(^2\)

An IPS supplied by a product vendor is generally better than no IPS at all, but the fiduciaries managing the portfolio should review and edit the vendor’s IPS as necessary to make sure it is consistent with their activities and with the best interests of the investors. The IPS belongs to, and is the responsibility of, the fiduciary that owns or has primary control of the assets, i.e., the steward. Therefore, plan sponsors, investment committees, trustees, and other stewards must pay particular attention to the quality of the IPS and whether its provisions are appropriate.

Statement Drafting
If the policy development process is thorough, it will cover all the elements that should be included in the IPS. Based upon legislative, regulatory, and case law substantiation, as well as industry best practices, there are six sections that should be included in most IPS documents.

1. Overview
The Overview should describe a) the purpose of the portfolio, b) governing law and guiding documents, and c) key aspects of the funding policy. The purpose of the portfolio is often closely associated with the account or client type. For example, the purpose of a retirement plan is to fund the retirement income needs of participants and beneficiaries; a foundation or endowment generally has a defined mission; and individual investors may have multiple objectives that should be reflected here.

Governing law also is closely associated with account or client type. Generally speaking, corporate retirement plans are governed by ERISA. Because ERISA is a federal law, it is consistent across all states. For example, investment policy statements for all defined benefit retirement plans should address accrued and projected benefit obligations, and the policy statements of all defined contribution plans should identify the safe harbors that are to be observed.

Contrast that to portfolios where state, rather than federal,
law applies. For those client types, there may or may not be consistency, depending on if uniform laws have been adopted. This is true for trusts, which generally, but not always, are governed by the Uniform Prudent Investors Act (UPIA), and charitable organizations, which typically are governed by the Uniform Prudent Management of Institutional Funds Act (UPMIFA). On the other hand, the law governing management of public employee retirement funds is not uniform, with most states adopting their own laws that frequently are drawn from the Management of Public Employee Retirement Systems (MPERS) model act. In these cases where state law governs, it is necessary to verify and document the governing law and any special IPS provisions that may impact how funds are to be invested or managed.

In addition to, or sometimes in lieu of, governing law, legal obligations as to how the portfolio must be managed may be established by guiding documents. Retirement plans generally are established by and must be managed in accordance with a plan document, in addition to ERISA rules. The same is true for trusts (the trust document). The point is that the fiduciaries responsible for managing the portfolio must know the rules, and the IPS should point to where to find them.

With respect to the funding policy, the overview should clearly state the investment time horizon, risk tolerance, and return expectations for the portfolio. The values provided here should align with the asset-liability considerations addressed in the policy development phase. Because these are forward-looking values, they must be treated as variables. Verbal descriptions are acceptable, such as short, intermediate, or long-term time frame, but they should be made clear by defining the terms when they are introduced. Some portfolios must use specific values that should be stated in the overview. For example, charitable organizations typically should state the assumed spending rate, and defined benefit pension plans require an actuarial return that will be used to determine the adequacy of contributions to fund future benefits.

For participant-directed plans, it is not possible to address aggregate time horizon, risk, and return expectations because this is under the control of the individual participants. Rather, the overview should briefly profile the demographics of the participants served and the terms of the plan, such as contribution matching, safe harbors used, automatic enrollment, etc.

2. Roles and Responsibilities

The steward, as the primary fiduciary for the portfolio, may (and generally does) delegate certain duties to service providers. To do so properly, the steward must decide the terms of delegation (or service expectations) and must select the service providers based upon reasonable due diligence processes. All service providers who are selected should be identified in this section, along with their roles and responsibilities and whether or not they are serving as a fiduciary.

Some of the service providers commonly engaged by the primary fiduciary are likely to be fiduciaries in their own right, such as investment advisors and managers. Others commonly engaged are typically not fiduciaries, such as custodians, record keepers, and brokers. All service providers should be called upon to disclose whether they accept fiduciary responsibility for the service they provide.

3. Asset Allocation Policies

The asset allocation policies section should reflect the asset classes that will be used in the portfolio and the strategic allocation to be maintained. A rebalancing protocol also should be specified with respect to whether it will be based on specific review schedules (e.g., quarterly) or anytime defined minimum or maximum range limits are crossed.

For participant-directed retirement plans, the asset classes made available to participants should be identified. The selection of asset classes for participant-directed plans should allow participants to adequately diversify their portfolios using the available options and should take into account how the age, income, and educational characteristics of the participant pool are likely to impact their likely risk, return, and time-horizon needs.

If the fiduciaries plan to use hedge funds or other types of investments that are not easily assigned to an asset class (i.e., they cannot be assigned reliable return, risk, and correlation statistics), a provision should be included in this section stating that the policy presumes certain inefficiencies in the market that can be exploited through the use of hedging techniques. The provision should place a clear limit to the amount of portfolio assets that may be devoted to such strategies.

Similarly, any restrictions on prohibited asset classes, prohibited security types, and requirements for socially responsible investing should be addressed in this section.

4. Due Diligence Procedures

Fiduciaries are obligated to select service providers carefully, giving consideration to the needs of the portfolio, the capabilities of various providers competing for the job, and cost. This is true with respect to the selection of investment managers and all other types of service providers. The due diligence procedures section of the IPS establishes the criteria that will be used.

Procedures to perform due diligence on investment managers have become well-established. The following are some of the more widely used due diligence criteria:

- Manager tenure
- Minimum assets held in the product
- Style consistency
- Expense ratio
- Risk-adjusted return
- Return relative to peer group and best-fit index
Occasionally the IPS will include threshold values for these criteria to be used to make the selections; however, it may be necessary to use different values for different asset classes in order to obtain sufficient investments from which to make selections. Additionally, the threshold values may change over time. Therefore, to maintain adequate flexibility, it is best to state that the criteria shown in the IPS are representative of those that will be used in the selection process and to avoid showing specific threshold values.

The selection of other service providers involves a more-customized approach. The roles and responsibilities identified earlier will need to be developed into more-detailed service requirements to target the search on appropriate providers. It is not necessary to list the service requirements in the IPS; rather, the language used in this section simply can describe the process to be applied.

Best practice is to use a formal request for proposals (RFP) process to select providers; however, it is acceptable to use a less-formal approach to gather and assess the service capabilities of service-provider candidates. Regardless of the level of formality, the fiduciaries responsible for delegating duties must be satisfied that the approach employed is effective in selecting providers that meet the service requirements at a fair and reasonable cost relative to alternatives available in the marketplace.

5. Monitoring Procedures

Fiduciaries must regularly monitor the activities of the investment managers and other service providers they have engaged to be sure they are meeting performance expectations. This section of the IPS normally will point back to the investment due diligence criteria and the service provider duties and responsibilities because decisions to retain service providers usually are based on the same factors that led to their selection.

The frequency of monitoring also should be addressed in this section. Best practice for most portfolios is to prepare and review performance reports at least quarterly and review service provider relationships approximately every three years. It is also best practice for the steward to review custodial statements monthly because this is one of the best places to detect errors or possible wrongdoing as early as possible. The IPS itself should be reviewed annually.

Because expenses often represent the largest constant drain on portfolio assets, this section of the IPS should require all service providers to fully disclose direct and indirect expenses incurred by the portfolio attributable to their services. Additionally, expenses should be highlighted here as a specific monitoring criteria. It is imprudent for fiduciaries to waste money; therefore, it is a clear fiduciary obligation to control and account for all expenses.

6. Attachments

Attachments can be used to provide information that is more detailed or changes more frequently than what is advisable to include in the main body of the IPS. The following are representative of documents that may be helpful for fiduciaries to have readily accessible as attachments to the IPS:

- Guiding documents referenced in the Overview
- The asset-liability study or pro-forma financial statements that reflect the basis for the funding policy
- A list of the persons or firms currently serving the plan in the capacities referenced under Roles and Responsibilities
- Current capital markets statistics (risk, return, and correlation estimates) for the asset classes referenced in Asset Allocation Procedures
- The specific thresholds being used for the criteria listed under Due Diligence Procedures
- A code of ethics policy for the stewards of an institutional portfolio

Summary and a Few Words of Caution

A well-crafted IPS positions investment fiduciaries for efficient and effective management of a portfolio. It helps mitigate the risks of regulatory action or litigation by demonstrating procedural prudence in this most important area of fiduciary responsibility. Moreover, it helps to align the expectations of the fiduciaries and the people who entrust their money to them by countering the inherent uncertainty of the economy and financial markets with the certainty of a professional investment management approach.

The benefits of the IPS will be realized only if its terms are faithfully followed. If the IPS is not adhered to, it can be worse than a pointless exercise, it can become the source of liability. This is especially true for ERISA accounts. Under ERISA, fiduciaries are explicitly obligated to adhere to plan documents, including the IPS. Therefore, failure to follow an IPS provision could be deemed a fiduciary breach. Similar exposure exists for other types of accounts.

The liability associated with failure to adhere to the terms of the IPS reinforces the importance of the fiduciary duty of due care; that is, the obligation to act with the skill, diligence, and good judgment of a professional. It also should remind fiduciaries to avoid being too detailed or rigid in drafting the terms of the IPS. The test of whether the IPS is well-drafted is whether it is sufficiently thorough to allow a competent third party, such as a new fiduciary, to follow it without significant additional research, yet not so detailed that it requires constant attention and frequent modifications for the responsible fiduciaries to remain in compliance.

Occasionally, the potential liability associated with negligence in meeting IPS terms will be used as an excuse to avoid preparing an IPS altogether. Given the fiduciary obligation to execute an appropriate investment policy, not committing the
policy to paper is irresponsible. It suggests that the fiduciaries are either unwilling or unable to follow a written plan (i.e., incompetent) and that the participants are not entitled to have their assets managed in a professional manner. These factors all involve potential liability exposures of their own.

The IPS structure outlined in this article can help assure that critical topics are addressed in a well-organized manner, but that is no guarantee of an effective IPS. The critical issues to keep in mind when you prepare or evaluate an IPS document are that the fiduciaries responsible for the portfolio must 1) have a sound investment policy and 2) faithfully carry it out. The IPS should provide adequate evidence of the first and effective guidance for the second. If it does, the document is ready and it is up to the investment fiduciaries to get on with the business of executing the plan.

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Endnotes

1. Reish Luftman Reicher & Cohen, Practice SA-1.1 in fi360’s Legal Memoranda.
2. Product providers can be a source of valuable assistance to investment advisors and their clients. For example, Jack Gardner (managing director of Thornburg Investment Management and president of Thornburg Securities Corporation) wrote a short book, How to Write an Investment Policy Statement (Marketplace Books, 2003) that the Thornburg fund company makes available to advisors and stewards. It is a well-written guide to prepare a process-driven, rather than product-driven, IPS.


5. The best in-depth training on investment policy and the preparation of investment policy statements is available in the context of fiduciary, investment management, or financial planning professional designation programs. These would include IMCA’s Certified Investment Management Analyst (CIMA®); the Accredited Investment Fiduciary® (AIF®) offered by Fiduciary360, the Chartered Financial Analyst® (CFA®) offered by the CFA Institute; and the Certified Financial Planner™ (CFP®) administered by the CFP Board. IPS-specific Webinars or workshops also are offered periodically by professional associations such as the Financial Planning Association (FPA), and by Fiduciary360. Finally, Norman Boone and Linda Lubitz are the authors of Creating an Investment Policy Statement, published by the FPA Press.

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