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The Importance of an Investment Policy Statement: Putting Practice to Paper

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The past two decades saw three recessions and major market downturns, out of which arose a more complex institutional investment and regulatory landscape. Amid this increasingly challenging market environment, foundations, endowments and other nonprofit clients continue to demand higher standards from their fiduciaries. A comprehensive and coherent Investment Policy Statement (IPS) is key to meeting those demands and solidifying the relationship between clients and their advisors. In this piece, we provide an overview of an IPS, explaining the goals and importance of each of its components. We also illustrate the criticality of designing a living document that defines the wants and needs of a nonprofit client while providing job descriptions of its fiduciaries.

Key Takeaways

- The Investment Policy Statement defines the relationship between the client and its various fiduciaries. These include the client's Board of Directors or Investment Committee, as well as third parties such as the Outsourced Chief Investment Office (OCIO), investment managers, the custodian and the trust services provider.
- The IPS is the primary point of reference for the client and its OCIO. It captures knowledge gained and decisions informed by each stage of the investment process, including client discovery, asset allocation, portfolio construction, risk management and governance.
- The primary goal of the IPS is to establish guidelines within which the client can obtain its investment objectives. These guidelines should limit excessive risk taking while necessitating that the client assume sufficient risk to generate the targeted return.
- The guidelines should provide sufficient flexibility to invest throughout a market cycle. But while the IPS is a living document that evolves with the client's circumstances, it should not be altered frequently simply to respond to short-term market fluctuations.

What Is an IPS and Why Is It Important?

At its core, an IPS defines and describes the client and its financial goals, while documenting the roles and responsibilities of all parties managing the investment portfolios that are aligned with the client's investment objectives. These parties include but are not limited to the client's OCIO, its Board, its Investment Committee, its investment managers and the custodian.

The IPS ultimately serves as the cornerstone of a client's relationship with its OCIO. It is written by the OCIO in conjunction with the client to identify and establish goals and objectives, benchmarks, asset allocation guidelines, and any restrictions or idiosyncratic stipulations.

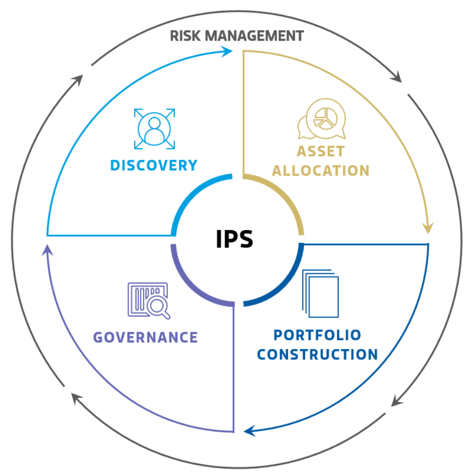
An IPS should provide a framework for the management of client assets, putting rails in place that enhance a client's ability to achieve its financial targets and to describe the fundamental intentions that are true to the spirit of the nonprofit. The process of developing an IPS should also be an opportunity for the OCIO to set and manage expectations around market outlook and the impact of that outlook on the client's short-term and long-term investment requirements.

Once formed, an IPS acts as a blueprint—providing context for the goals of the investment portfolios and helping to contextualize the client's spending outlook. The document enables OCIOs to provide a full suite of investment management, fiduciary oversight and operations/administrative services, allowing clients to focus on bigger-picture items.

Developing a Comprehensive IPS

The IPS is the central point of reference between the client and the OCIO through each stage of the ongoing investment lifecycle. While certain portions like the setup and structure are static and evergreen, the primary components of the IPS should be dynamic. (See Exhibit 1)

Exhibit 1: Our IPS Construction Process



Four pillars—client discovery, asset allocation, portfolio construction, and governance—support an ongoing process that is wrapped in risk management and should remain iterative.

This means that when establishing an IPS, both the client and the OCIO should do so with the understanding that certain aspects will evolve over time, given changing market environments and expectations as well as shifting client needs and constraints. These shifts may include changes in client cash flows and spending policies.

For example, a client may come to the OCIO with what it thinks are achievable goals. But the OCIO may find, and help the client realize, that to attain those goals, certain criteria—such as investment objectives, asset allocation guidelines, benchmarking and manager selection guidelines—may require adjustments at the onset of the IPS and throughout the length of the relationship.

In essence, an IPS is part art and part science, a document evolving along with the client's objectives, needs, and constraints. It helps preserve the relationship between institutions when there is turnover among the individuals involved. Consider a client's Board of Directors whose membership changes every few years. While the interests of all parties are naturally aligned as fiduciaries, the IPS provides a North Star to guide each stakeholder toward the client's ultimate objectives.

While the components of each IPS pillar may vary, depending on client type, an IPS should address the following:

	Client Discovery	
Investment Objectives	Assignment of Responsibility (including level of discretion)	Investment Philosophy
Time Horizon	Spending Policy	Liquidity
	Asset Allocation	
Benchmarking	Investment Horizon	Rebalancing Procedures
	Asset Allocation Parameters	
	Portfolio Construction	
Manager Selection and Retention Criteria		Asset Eligibility and Restrictions
	Governance	
Accountability	Performance Evaluation	Monitoring and Control
	Communication Periodicity	

An IPS in Action

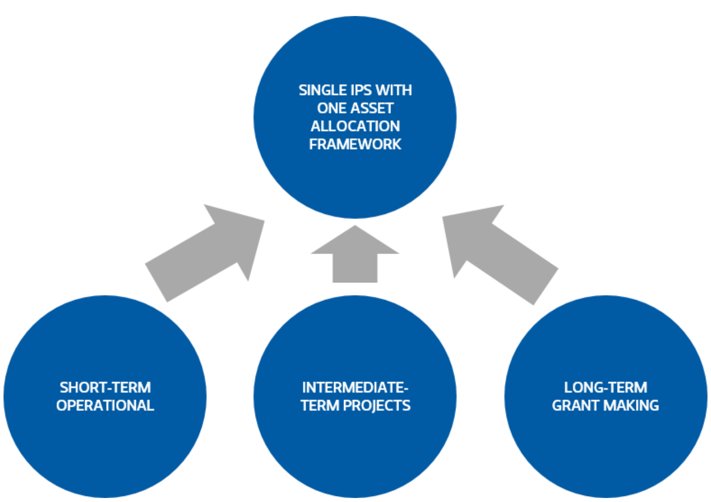
To illustrate some key components of an IPS and to demonstrate their values, we offer the following example.

Client Discovery Process

A $50 million community foundation hires Morgan Stanley's Custom Solutions OCIO as a fiduciary with discretionary authority over its investment portfolio. During the client discovery process, it becomes clear that the foundation had suffered from liquidity challenges and insufficient returns.

While the foundation has three asset pools—each used to fund distinct short- and long-term initiatives with different time horizons and liquidity needs—under its previous IPS, the three pools shared one asset-allocation framework. (See Exhibit 3)

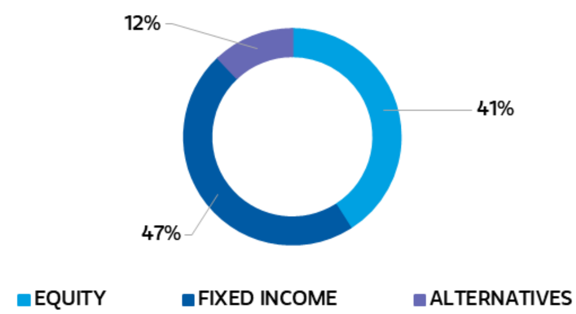
Exhibit 3: Previous IPS



With comingled objectives, there was no way to ensure that each pool was invested with the appropriate risk tolerance and return profile to meet its specific spending goals.

This scenario potentially puts the foundation at risk of failing to meet its overall objectives. For instance, if the asset pool earmarked for operational spending over the next one to three years is invested with the same aggressive-growth objective as the pool designated for long-term grant making, the client's spending needs could become significantly underfunded if the market experiences heightened volatility in the near term. (See Exhibit 4)

Exhibit 4: Previous Asset Allocation Framework



Initiatives of Asset Pools
Operational, Projects and Grant Making
Time Horizon Range of Asset Pools
1 to 12+ Years
Comingled Objectives
Preservation of Capital, Capital Appreciation, Liquidity, Growth
Expected Average Annual Return
4.60%
Expected Average Annual Volatility
6.50%

The new OCIO decides to take a more rigorous approach, developing a distinct plan for each pool of assets. Additionally, the OCIO team notices during the discovery process that the foundation has a preference for sustainable investments—a preference not previously documented in the client's previous IPS. With a better understanding and IPS documentation of the foundation's views toward environmental, sustainability and governance (ESG) issues, the OCIO is able to memorialize this preference within the client's investment philosophy and provide a level of accountability to ensure those views are adequately reflected in the portfolios.

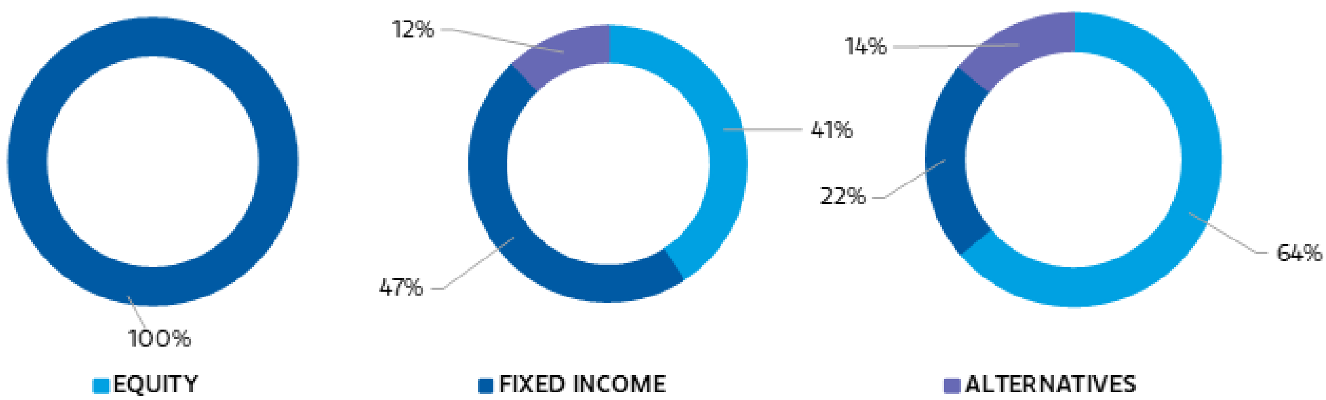
Asset Allocation and Portfolio Construction

The foundation's previous IPS called for investing the short-term operational asset pool as aggressively as the long-term grant-making pool. Had these assets been invested this way during the Great Financial Crisis ('08-'09), heightened levels of volatility and significant drawdowns would have made it nearly impossible to meet operational spending obligations. The risk and return characteristics provide further evidence of how different the investment objectives are for each asset pool.

By creating an IPS that addresses each unique pool with differentiated benchmarks, the OCIO ultimately is able to tailor asset allocation guidelines for each initiative—guidelines governing which asset classes to invest in and how much to invest in each. The asset-allocation guidelines highlight the recognizable differences in the pools' risk/return profiles. To further ground the concept of investing thoughtfully with needs and objectives in mind, the OCIO also determines a rebalancing schedule to ensure that investments do not stray beyond those stated in the IPS.

This process, which places rails around the way the OCIO can invest money earmarked for specific needs, can provide clear guidelines for the foundation. (See Exhibit 5)

Exhibit 5: New Asset Allocation Framework



	Initiatives of Asset Pools	
Short Term Operational	Intermediate-Term Projects	Long-Term Grant Making
	Time Horizons of Asset Pools	
1 - 3 Years	7 - 10 Years	12+ Years
	Objectives of Asset Pools	
Preservation of Capital and Liquidity	Capital Appreciation and Liquidity	Growth
	Benchmark	
95% - Barclays 1-5 Yr Gov/Credit 5% - FTSE Treasury Bill 3 Month	40% - MSCI AC World Net 48% - Barclays Aggregate 5% - HFRI FOF Comp 4% - MSCI REIT Net 3% - S&P GSCI	60% - MSCI AC World Net 20% - Barclays Aggregate 10% - HFRI FOF Comp 6% - NCREIF Property Idx 4% - S&P GSCI
	Expected Average Annual Return	
2.30%	4.60%	5.70%
	Expected Average Annual Volatility	
3.90%	6.50%	9.20%

Benchmarks: Custom Solutions OCIO 2020
Expected Average Annual Return and Volatility Assumptions from the Global Investment Committee

To offer the foundation a better understanding of the makeup of its portfolios, the new IPS also includes information about how the underlying investments are identified and evaluated. This process includes the OCIO's identifying criteria regarding manager selection and retention of investments within a portfolio. This, in turn, involves a consideration of the proposed investment manager's investment style and discipline and of the way in which each proposed investment complements the portfolio's other assets.

Lastly, because the foundation has specific ESG themes it wants reflected in its holdings, the OCIO makes note of any restrictions—in this case, prohibiting exposure to specific businesses— oil and gas companies, for example.

Governance

Partnering with this client, the new OCIO clearly outlines the roles and responsibilities of the client's Investment Committee, the OCIO team as the discretionary fiduciary, the Investment Managers that will be used in the portfolio, and the custodian. Having an IPS that clearly defines roles and responsibilities ensures that all parties are on the same page and adds another layer of accountability.

In contrast to the client's previous IPS, the new IPS created by the OCIO and the client develops performance benchmarks specific to each asset pool and clearly outlines the oversight standards that the OCIO and the foundation agree are appropriate to evaluate and monitor progress toward stated goals and objectives.

Memorializing a meeting cadence for the foundation and the OCIO to review and evaluate the IPS enables the OCIO to set expectations and helps to mitigate the emotional response arising in periods of heightened volatility. Additionally, documenting expectations around ongoing communications, including day-to-day connectivity and regular review of portfolio performance, keeps the foundation apprised of any material changes to the OCIO's investment outlook and tactics.

Conclusion

An IPS provides the foundation for the relationship between a nonprofit and its OCIO and other fiduciaries, a foundation that is increasingly critical for a strong base and ongoing peace of mind for clients in an environment marked by heightened market complexity.

This is even more essential today than in previous environments, given the anticipated lower investment returns over the next two decades. Stocks, as measured by the S&P 500 Index, compounded annually at 12.7% between March 2009 and February 2020. But over the next 20 years, U.S. equities are anticipated to return an average of 7.9% a year, according to Morgan Stanley Wealth Management's Global Investment Committee (GIC). (Source notes: March 31, 2021 Capital Markets Assumptions.)

Consider, too, the heightened volatility experienced since March 2020 and the GIC's expectations for "choppy" periods in the coming year. These highlight further the benefits of laying out the various responsibilities of each entity with fiduciary responsibilities, while establishing guidelines for a client's risk-taking comfort zone and ensuring that a client's objectives are realistic.

While the IPS is a living document, investment policies and guidelines should not change frequently. It is important to keep in mind that goals and objectives will be reviewed over varying periods of time and that short-term changes in the markets should not require an adjustment to their IPS.

Next Steps

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