Morgan Stanley

Topics in Wealth Strategies:

Why an Investment Policy Statement Matters

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The Importance of Having an Investment Policy Statement

AN INVESTMENT POLICY STATEMENT (IPS):

- Memorializes an investment plan and its underlying assumptions
- Clearly identifies duties and responsibilities
- Reinforces trust, confidence and responsibility with regard to obligations to others
- Helps to withstand time and supersede changes resulting from changes in personnel stewarding the assets
- Maintains the integrity of the assets during periods of stress
- Encompasses the standard of care relevant to the parties/roles associated with the IPS and mitigates behavioral bias

Best Practices

Investment Decisions Based on the Entire Portfolio Rather Than Individual Securities:

THEN – PRUDENT MAN

- Restricted Investments
- Investment Guidelines
- Individual Managers

NOW – PRUDENT INVESTOR

- Diversification
- Investment Policy Statement
- Investment Management

"This approach … utilizes modern portfolio theory to guide investment decisions and requires risk vs. return analysis.

– FDIC

Behavioral Bias

The Importance of an Investment Policy Statement Being a Written Document Cannot be Underestimated.

ESSENTIAL ELEMENTS INCLUDE:

1. Legal Entity
2. Objective
3. Time Horizon
4. Liquidity
5. Taxability
6. Risk Profile
7. Special Circumstances
8. Strategic and Tactical Asset Allocation
9. Investment Management
10. Monitoring and Review (Roles and Responsibilities)

1 Legal Entity

CONSIDERATIONS:

- What is the value of the assets that fall under the purview of the IPS?
- How many and what types of legal entities exist?
- What is the market value for each?
- Have the existing legal documents been reviewed to confirm understanding?
- Is there any additional strategy to be completed?
- What is the intended purpose for the assets?
- Can any of the legal entities be grouped / aggregate by a common beneficiary?
- Who are the decision makers and how do they make decisions?

BEHAVIORAL BIAS:

- Compartmentalizing pools of assets

BEST PRACTICE:

- Identifying and aggregating the number of legal entities applicable to each beneficiary while simultaneously understanding the impact of shared assets in entities across beneficiaries

Types of Entities for Individuals

Personal Retirement (401K, IRAs)

Trust Split Interest Trust

Types of Entities for Institutions

Endowment (Operating, Investment, and Capital) Foundation

Pension (Benefit, Contribution) Profit Sharing

2 Objective

CONSIDERATIONS:

- What is the objective of each entity or may the objective apply to several aggregated entities?
- What are the goals of the assets in the context of the entity's mission?
- Are there multiple and potentially conflicting objectives?

BEHAVIORAL BIAS:

- Return Chasing – if a target return is specified, it may be reasonable over longer periods of time as the impact of inflation and market conditions average out, however, in the shorter term to the extent that market conditions continuously change, it may trigger substantive changes in asset allocation (and substantive changes in risk profile) in an attempt to generate additional total return
- Income Matching – if one matches income generated from fixed income to an annual dollar distribution, it may be reasonable over shorter periods of time, however, in the longer term it may trigger substantive changes in asset allocation (and substantive changes in risk profile) as interest rates change and potentially jeopardize the sustainability of the portfolio with a significant allocation to fixed income

BEST PRACTICE:

- Not setting a fixed return target so as to withstand variable market environments

Spending Rate (Specified) + Expense (Specified) + Inflation (Not Specified)

3 Time Horizon

CONSIDERATIONS:

- How long are the assets expected to be invested? (single life time, multiple life times, indefinitely)
- What are the legal specifications imposed by the legal entity?
- Do legal entities have common beneficiaries?
- If multiple entities have a shared beneficiary, what is the time sequence/relationship of the entities?

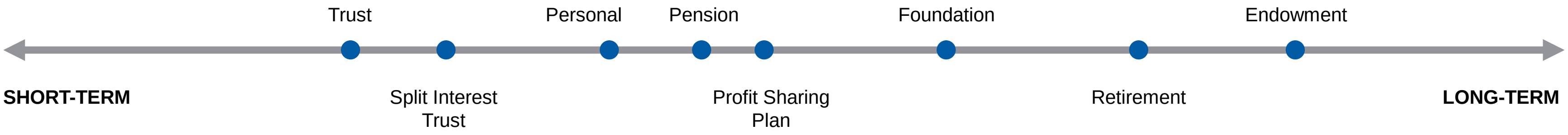
BEHAVIORAL BIAS:

- Compartmentalizing pools of assets

BEST PRACTICE:

- Understanding that different entities have different time horizons and utilizing the time sequencing/relationship among legal entities

TIME HORIZON



4 Liquidity

CONSIDERATIONS:

- Are there any cash flows into or out of each legal entity and if so what is the amount?
- Are these pre or post tax?
- Are they consistent each year or are there one-off flows expected and what is the timing of these flows?
- If there are any distribution requirements, may they be made “in kind” or only in cash?
- What is the illiquidity tolerance / budget?

BEHAVIORAL BIAS:

- Compartmentalizing pools of assets

BEST PRACTICE:

- Understanding the liquidity status of each legal structure in conjunction with the client’s liquidity needs and aggregating net flows

PERSONAL ACCOUNT		
Beginning Assets	**48,377,353**	**50,395,728**
Interest and Dividends	1,001,151	1,042,920
Capital Appreciation	1,515,961	1,579,209
Cash Inflows	2,392,200	407,097
Salary	270,600	0
Payment from Retirement Account	0	407,097
Payment from GRAT	2,121,600	0
Cash Outflows	(1,430,400)	(4,440,100)
Living Expenses	(1,082,400)	(1,104,100)
Home Upgrade	0	(3,000,000)
Portfolio Loan	(348,000)	(336,000)
Principal	(300,000)	(300,000)
Interest	(48,000)	(36,000)
Taxes	(1,460,536)	(2,087,848)
Ending Assets	**50,395,728**	**46,897,005**
RETIREMENT ACCOUNT		
Beginning Assets	**6,209,944**	**6,555,670**
Interest and Dividends	138,784	146,510
Capital Appreciation	206,943	218,464
Cash Inflows	0	0
Cash Outflows	0	(407,097)
Payment to Personal Account	0	(407,097)
Taxes	0	0
Ending Assets	**6,555,670**	**6,513,547**
GRAT		
Beginning Assets	**3,706,837**	**1,846,687**
Interest and Dividends	81,550	38,216
Capital Appreciation	179,900	57,868
Cash Inflows	0	0
Cash Outflows	(2,121,600)	0
Payment to Personal Account	(2,121,600)	0
Taxes	0	0
Ending Assets	**1,846,687**	**1,942,771**

5 Taxability

CONSIDERATIONS:

- Are the entities taxable, tax-deferred or tax-exempt?
- In the case of taxable entities, what is the tax rate?
- Are there tax penalties for certain types of investments?
- Have the tax returns been examined?

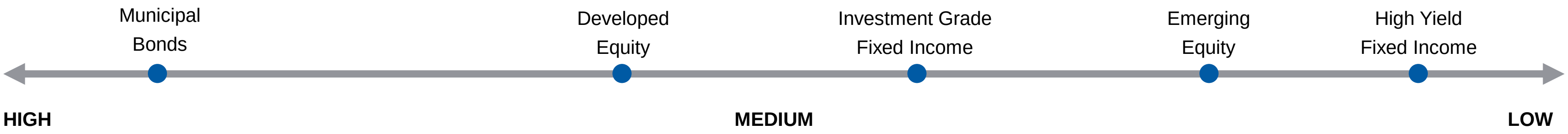
BEHAVIORAL BIAS:

- Compartmentalizing pools of assets

BEST PRACTICE:

- Considering the overall tax efficiency of asset classes (taxable, deferred, tax-exempt) so as to locate the asset classes within complimentary legal entities (tax-exempt, deferred, taxable) to properly asset locate

TAX EFFICIENCY



6 Risk Profile

CONSIDERATIONS:

- How does the investor define risk?
- What risk measures are appropriate?
- Is the investor more afraid of losing money or missing out on upside return?
- What is the risk profile/tolerance of each entity or may the profile apply to several aggregated entities?

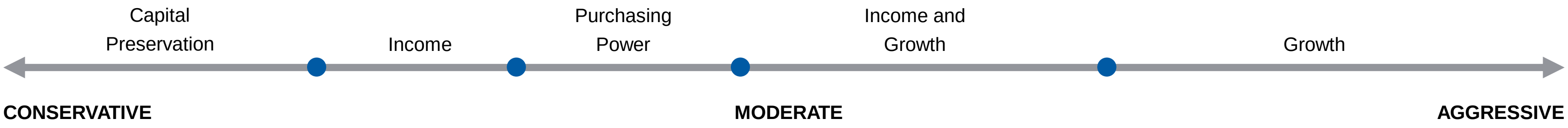
BEHAVIORAL BIAS:

- Compartmentalizing pools of assets

BEST PRACTICE:

- Determining the risk profile of a beneficiary in aggregate and then budgeting risk within and across legal entities

RISK SPECTRUM



7 Special Circumstances

CONSIDERATIONS:

- Are there any legacy assets with particular restrictions and / or preferences?
- Are there any illiquid assets and are they to be included / considered in the context of the IPS?
- Are there any historical tax implications that should be considered?
- What is the investor’s investment history?

8 Strategic and Tactical Asset Allocation

CONSIDERATIONS:

- Are my assets allocated strategically to reflect the investor's goals, risk tolerance, tax situation, cash needs and other circumstances?
- Should the investor make tactical adjustments to allocation in attempts to take advantage of current market conditions?
- Should the investor consider Tactical Asset Allocation within asset class ranges instead of traditional rebalancing?

BEHAVIORAL BIAS:

- Panicking or becoming greedy in times of market turmoil

BEST PRACTICE:

- Adhering to a policy portfolio within ranges
- Staying invested in bad market environments and rebalancing in good market environments

STRATEGIC	BENCHMARK	TACTICAL
60% global equity	ACWI	40% – 80%
25% global fixed income	Global Aggregate	15% – 35%
10% alternatives	Libor+300bps	5% – 15%
5% cash	3 Month T-Bill	0% – 10%

This is a hypothetical illustration. Actual performance for an account may be materially lower or higher than the allocation illustrated above. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment.

9 Investment Management

CONSIDERATIONS:

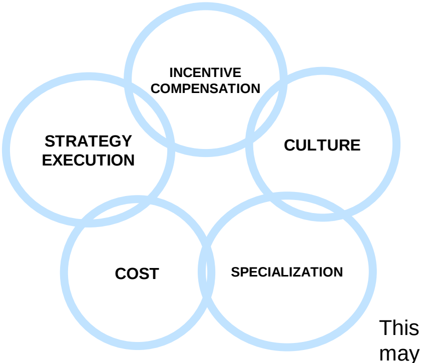
- What are the criteria for selecting investment advisers / managers?
- What are the duties and responsibilities of the advisers / managers?
- How will the investor monitor performance?

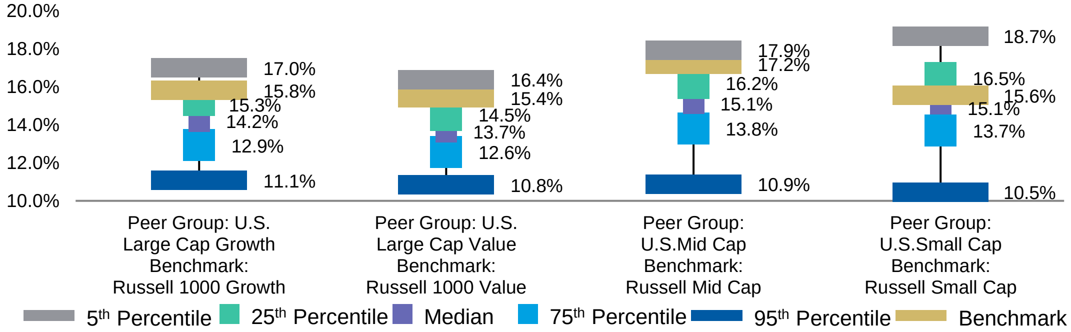
BEHAVIORAL BIAS:

- Chasing returns by favoring near term performance

BEST PRACTICE:

- Utilizing managers with consistent long-term risk adjusted returns





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Source: Morningstar

10 Monitoring and Review

CONSIDERATIONS:

- What are the duties and responsibilities of the investor and adviser?
- What is the frequency and means of communication between the investor and adviser?
- How will the investor and adviser monitor performance?

BEHAVIORAL BIAS:

- Neglecting to review portfolios in favorable return environments, and overreacting (making too many decisions) during less favorable environments

BEST PRACTICE:

- Re-examining your IPS at least once a year, or after any material change
  - Client (elements 1 – 7)
  - Adviser (elements 8 – 9)
  - Both (element 10)

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