

How an Investment Policy Statement Can Help Take You to the Next Level Article for AICPA publication

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The investment world is changing. The “Prudent Man Rule” came out in the early 19th Century and applied directly to the management of trust assets. Modern Portfolio Theory was developed in the 1950’s and became the underpinning for 1974’s ERISA and the Prudent Investor Act adopted by most states in the 1990’s.

Today, we have Elliot Spitzer reminding us that all the “i’s” need to be dotted and the “t’s” need to be crossed. The NASD and the SEC are ever more closely scrutinizing the appropriateness of investment choices and how well they fit with the client’s circumstances. Disclosure is the concern. Ultimately, the fair test is: “Was the client told what was going to be happening and was the client given enough information to be able to make an informed decision?”

As we have suggested in our book “Creating an Investment Policy Statement: Guidelines and Templates,” there is no better way to make sure these concerns are well addressed than using an investment policy statement (“IPS”) as part of your investment process. Investment policy statements are legally required today in virtually all situations where there is a trustee or fiduciary relationship. While having an IPS is not yet required for individual clients, since the vast majority of most investment clients are individuals, offering such clients the same high-level process is the next frontier.

It is time for every financial advisor who manages money directly or helps clients implement recommended investments to develop an investment policy statement with every client. Doing so will help make the process and the relationship transparent between the client and the advisor. This investment governance document makes it clear to everyone what is going to happen, under what circumstances and why. When the advisor has reviewed each of the policy issues with the client and helped the client understand the choices and documented the decisions, the trust and the understanding is significantly enhanced. Isn’t that the kind of client relationship we are all after?

To get there, a process is needed. Consider it like your audit checklist, except for the investment side of your business. We think of it as a Nine Step Investment Process, of which the critical step is not choosing the investments, but rather deciding with the client what you will be doing, why and how. Working with the client to address those issues takes a little longer, but it creates a much better understanding between you and your client and it builds trust.

The Nine Step Investment Process



Step 1: IDENTIFY CLIENT GOALS

Does the client need income or growth? How much? Do they need a certain amount of liquidity or cash available? What questions will you ask to elicit this information so that it is complete and accurate?

Step 2: IDENTIFY THE TARGET RATE OF RETURN

Need differs from want. For individual clients, they usually know what returns they would like, but not what they need. It's therefore important to be able to quantify the need, which we do through monte carlo simulations of projected cashflow needs. Ultimately, as the advisor, you need to be confident that the returns you are designing into the recommended portfolio has a good probability of achieving the goals, including not running out of money before the client dies.

Step 3: KNOW THE TIME HORIZON

Individual clients generally have a time horizon that ends only with their death. Sometimes, when the investing is really done for the kids or grandkids, it goes beyond death. On the other hand, if the main purpose is to have money available for college or a new home, that time limit dictates what investments are appropriate. Institutional clients will often have a more defined time horizon, which also impacts on decisions.

Step 4: UNDERSTAND RISK TOLERANCE

Should a client's fear of volatility or their need for returns drive the investment decisions if the two are incompatible? If a client needs high returns, they will either have to live with the necessary volatility or they need to adjust their goals so the targeted returns (and the accompanying risk) can be lowered.

Step 5: IDENTIFY ASSET CLASSES and INVESTMENT VEHICLES

What kinds of investments will you be recommending to the client? What are they willing to accept? What won't they consider? Will you include things like emerging markets, high yield bonds or commodities? How will you deal with Concentrated Positions? Will you be more focused on growth or value opportunities and why?

Step 6: DESIGN THE ASSET ALLOCATION

With steps 1-5 in mind, we can now tackle the single most important of the investment decisions you will make with your client—the asset allocation. What are the tax considerations in making these choices? Will different kinds of assets be located in different accounts? If you have low basis securities or non-managed accounts, how will they be worked into the asset allocation, if at all? Will the allocation be optimized for maximum risk-return opportunities?

Step 7: WRITE THE INVESTMENT POLICY STATEMENT

This is where you document the decisions we've listed above that you have discussed with the client. This becomes your investment governance document.

Step 8: SELECT THE INVESTMENTS

Will you have full discretion to choose the specific investments or will you just be making recommendations? By what criteria will the investment choices be made?

Step 9: MONITOR, MANAGE AND REPORT

Once the investments have been selected, they will need to be monitored, evaluated and periodically adjusted. What benchmarks or other criteria will you use to make such evaluations? How and how often will the portfolio be re-balanced? After you have made the investments, what will your sell discipline be?

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 as it will be. The IPS development process provides a crucial education process for the client and is a key communication step, helping each party to understand the others' perspective and goals. The IPS is the document that guides the advisor as future decisions are made, and 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 cause us all to make less than optimal decisions.

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, which are:

1. Introduction: purpose of the IPS and an overview explanation about 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. With that in mind, we have built our web-based IPSAdvisorPro.com to permit an advisor to modify the verbiage and structure to reflect his or her own practice, and yet quickly construct an IPS that is totally customized for each client.

Writing an IPS for each client takes time. But keep in mind that the IPS simply documents the discussions you should already be having with your clients anyway. Once you have a standardized process, you can make sure that each necessary topic is covered and then writing the IPS itself can be done reasonably efficiently. Most importantly, in doing so you will have built a good understanding between you and the client and communicated a clear approach to how the investments will be handled. Clients appreciate the clarity. Clarity builds trust. Trust is the foundation for a long-lasting relationship. Using an IPS in your process helps it all happen.

Linda S. Lubitz, CFP and Norman M. Boone, CFP are co-authors of the forthcoming book "Creating an Investment Policy Statement—Guidelines & Templates." They also are the creators of the web-based software www.IPSAdvisorPro.com designed to help advisors create investment policy statements. They have their respective financial planning firms in Miami and San Francisco.