



PORTFOLIO MANAGEMENT

The Evolving Investment Policy Statement

by Thomas J. Connelly, CFA, CFP

An investment policy statement (IPS) is a written road map for use through an uncertain future, hopefully leading to achievement of an individual investor's financial objectives. The starting point is the investor's circumstances, preferences and goals, which must be translated into measurable objectives. An investment strategy is then crafted that will have a high probability of meeting investor objectives at some level of risk, however risk may be defined, and with which the investor is comfortable. In some policy statements I have seen, investment strategy and guidelines are glossed over in broad brush strokes, while in others they are presented in excruciating detail.

The purpose of this column is to make some observations in light of current industry trends based on my personal experience using policy statements over the last seven years. Those readers interested in a meatier treatment of the subject are referred to an excellent article detailing the rationale behind, and the composition of, a quality IPS for a qualified plan which appeared in the *Journal of Financial Planning* in 1992.¹ More recent sources expand upon the earlier article and offer examples of policy statements for qualified plans, trusts and individuals,² as well as detailing the investment process for fiduciaries.³

The concept of the IPS has evolved over the last 20 years or so, primarily in the legal and regulatory environment surrounding defined benefit pension plans. In recent years, policy statements have increasingly been used for defined contribution pension plans and associated 401(k) plans in an effort to satisfy

fiduciary responsibilities and lower litigation risk. Modern investment theory, which emphasizes diversification and a portfolio perspective, has largely supplanted statutory "legal lists" and the quest for absolutely safe individual investments.

The "Trojan Horse" Financial Plan

In my opinion, investment policy statements are just crossing an important evolutionary threshold. In the past, an IPS was a response to regulatory forces by fiduciaries who did not want to become the guarantors of their client's securities. Now, investment policy statements are becoming proactive planning documents for many firms. Policy statements are used for individual, as well as institutional, clients. Asset management, for better or worse, is becoming such a large and growing part of many financial planning practices that the IPS just might be the next evolutionary step for financial plans. This may be especially true for planners who offer custom portfolio management and financial advisory services. Such planners should not consider raw investment returns, but how much money ends up in the pockets of the investor's family and designated beneficiaries after taxes at all levels, and after inflation.

An IPS cannot be constructed without detailing measurable investment objectives and the time frame required to realize these objectives. My firm sees many prospects who have had some estate planning completed and are not interested in a traditional financial plan. However, they are almost always inter-

ested in knowing whether they will outlive their sources of income and assets under conservative assumptions. Performing a detailed retirement analysis, in tandem with an IPS, can bring cash flow, retirement, tax and education planning goals into one process.

Although it is becoming fashionable to use life expectancies for investors or their beneficiaries to establish an investment time horizon, planners need to take into account the fact that time horizons may be "collapsed" by unexpected events. Some of these events, such as death, disability and infirmity, can be insured against, while others, such as an unplanned increase in an investor's standard of living, changes in tax laws or structural changes in the investment environment, cannot be insured against easily. In any case, these traditional financial planning issues should be addressed in the policy statement.

When these issues are presented as an integrated whole with the IPS as the focus, investors may see their relevance more clearly and be more willing to address them. Thus, financial planning professionals wishing to provide individualized service may find themselves providing traditional financial planning and annual reviews that revolve around the IPS rather than a traditional financial plan.

At my firm, the bulk of our assets under management have come in from financial planning clients. The work flow is reversing directions, however, with clients initially coming in for investment counsel but then asking for much-needed financial planning advice.

There are three potential fee sources to replace or augment financial planning fees: detailed retirement analyses, investment policy statements, and annual reviews of both documents.

Drawing up investment policy statements for institutional investors historically has been the turf of consultants and large investment firms that focus on these markets. It is no surprise that most of the current literature focuses on crafting policy statements for pension plans and institutional investors. These large players are now hungrily eyeing a smaller individual clientele that traditionally has been served by financial planners and bank trust departments. No professional with whom I have come in contact is more suited to offer the holistic investment and financial planning advice needed by individual investors than a Certified Financial Planner practitioner. In a number of cities, bank trust departments and money management firms have increased their hiring of CFP professionals to service wealthy clients. Financial planning firms might be wise to capitalize on their strengths in the individual investor marketplace rather than the hyper-competitive institutional marketplace. By using policy statements for their individual clients, planners can compete on their own turf and emerge victorious by virtue of their broad training, while providing more complete and individualized services to their clients.

Unexpected Benefits From Using an Investment Policy Statement

In addition to these benefits, I have discovered a few other benefits from our experiences of using an IPS as part of our firm's service arsenal. Effective use of an IPS also may yield benefits in the areas of marketing, business succession and practice management. Having an investment strategy codified in reasonable detail is a major selling point. Many investors would prefer to enjoy their retirement or travel abroad knowing that a written investment strategy in which they participated will be adhered to in their absence. An IPS also serves as a

useful tool for ongoing management of investor expectations and education, which can help avoid future misunderstandings and enhance client retention.

From the standpoint of business succession, a policy statement gives a firm the opportunity to continue servicing

existing clients, without missing a beat, should a principal or account representative leave for any reason. The IPS should have adequate detail on the investor's current financial situation, goals, objectives and investment strategy. From another perspective, an existing

financial planning practice that has a detailed IPS for each investor should command a higher selling price because there is a higher probability that the firm's clientele is more educated and strongly bound to the firm. In addition, the up-front time investment for a

potential purchaser to integrate the new clientele may be greatly reduced. I can speak firsthand on this subject, having purchased a practice this past summer.

Investment policy statements are initially time-consuming to compose. However, once the up-front time invest-

ment is made, they can provide a means of systematically maintaining ongoing individualized service while controlling internal growth and quality control. I have seen some financial planning firms create spreadsheet and database compliance programs that take quantified investment and tax planning objectives and investment guidelines from the IPS and import current investment positions from portfolio accounting software to automate IPS compliance reviews. This way, time can be leveraged tremendously. Detailed, custom portfolio design also can be monitored, reviewed and quickly adjusted, making this elevated level of service economical.

The investment policy statement is becoming an important part of the planner's service portfolio, making individualized service easier and providing a means for planners to apply their expertise for individual investors outside the realm of traditional financial plans. Their use can make the ongoing servicing of investors more efficient, increase client retention, and reduce litigation risk, thus adding value to the financial planning firm. ■

Endnotes

1. Norman M. Boone and Linda S. Lubitz, "Developing an Investment Policy Statement for the Qualified Plan," *Journal of Financial Planning*, Vol. 5, No. 2, April 1992, pp. 5-70.
2. Linda S. Lubitz and Norman M. Boone, *The Investment Policy Statement Guidebook*, (Ibbotson Associates, 1996).
3. Donald B. Trone, William R. Allbright and Philip R. Taylor, *The Management of Investment Decisions*, (Irwin Professional Publishing, 1996).

Thomas J. Connelly, CFA, CFP, is president of Keats, Connelly and Associates, a fee-only financial planning firm based in Phoenix, Arizona.