Creating an Investment Policy Statement

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The Complexities in PWM

- Investors are heterogeneous—no two families or individuals are alike
- Risk preferences
- Life goals
- What level of aggressiveness is appropriate to my current financial circumstances?
- What are my expectations for returns and risks from available investments?
- PWM encompasses both taxable investment management and complex personal financial planning concerns
Why IPS Is Important

• Provides a linkage between the client, manager/advisor and the investment portfolio
• Serves as a structured decision-making process for clients and advisors and helps to balance return seeking and risk taking
• Offers clarity and generally helps to build a higher level of trust between client and advisor
• To satisfy regulatory requirements and fiduciary standards of care and client protection (suitability and fair dealing)
Timing the Market?
Psychology of Investing
Specify and quantify investor objectives and constraints.

Portfolio policies and strategies.

Specify capital market expectations.

1. Portfolio construction and revision.
2. Asset allocation, portfolio optimization, security selection, implementation and execution.

Monitor investor-related inputs.

Achieve objectives and measure performance.

Monitor economic and market related inputs.

The Portfolio Management Process

PLANNING  EXECUTION  FEEDBACK

Specify and quantify investor objectives and constraints.

Economic, social, political, sector, and security considerations.

Specify capital market expectations.

Portfolio policies and strategies.

Monitor investor-related inputs.

Achieve objectives and measure performance.

Monitor economic and market related inputs.
Planning

- There’s no ‘one’ perfect portfolio for every client. To create a portfolio that is right for an investor, we need to:
  - Establish portfolio’s **risk** and **return objectives** (RR)
  - Establish portfolio **constraints** (TTLLU)
  - Create an **Investment Policy Statement** (IPS) based on the above O&Cs.
  - Specify Capital Market expectations and determine the appropriate Strategic Asset Allocation
  - If you are investing your own money, know thyself
Execution

- Portfolio selection/composition
- Portfolio implementation
- Maximize: Speed of execution
- Minimize: Costs of execution (transaction costs and taxes)
Feedback

- Monitor and rebalance portfolio to restore the strategic asset allocation as asset prices change over time
- Recheck suitability of policy portfolio/investment strategy
- Performance/Manager evaluation and probability of achieving investor’s goals
  - Return measurement (out- or underperform?)
  - Attribution analysis (how is it achieved?)
  - Appraisal of managers (skill or luck?)
Investment Policy Statement

• A client description and mandate (KYC)
• An ‘autopilot’ setting in normal times and a stabilizer during stressful markets
• Duties of all participants in the investment process
• Client’s statement of objectives and constraints
• Any asset allocation and performance benchmark consideration relevant to the portfolio
• Specific guidelines for rebalancing the portfolio as client and market circumstances change
• Means of communication between investors and fiduciaries to ensure continuity and an objective test of compliance at periodic reviews
Risk Tolerance

You are playing blackjack in Las Vegas. You have lost $1,000! How much would you be prepared to lose to win $1,000 back?

- Nothing. You are heading for the bar.
- $200?
- $500?
- $1,000?
- >$1,000?
Risk Tolerance (2)

- How much risk is the investor willing and able to assume?
- **Willingness** to take risk: reckless chance taking (speculative) or accepting only calculated risk?
- Willingness depends on client’s psychological profile, methods of wealth acquisition and life experience
- **Ability** to take risk: Do you know your pain threshold and will you be able to respond to negative developments without overreacting?
- Ability depends on time horizon, portfolio size, level and stability of client’s wealth/income and overall financial situation (future liabilities and duration)
Risk Tolerance (3)

- The stock market offers hope of great rewards due to the risks that go with it and you can’t have one without the other
- The risk objective should be **specific, measurable** and **consistent** with the return objective and constraints of the portfolio
- If both ability and willingness are **high** (or low), then the overall risk objective will specify **high** (or low) risk tolerance. However, if they conflict, responsibility of manager to work with and educate the client to resolve the conflict
- Can be stated in absolute terms (e.g. max dollar loss) or as a level of decline/shortfall risk (e.g. underperform a target benchmark by no more than x%)
Measuring Your Sleep Quotient

Risk Assessment
Return Objective

- Risk and return objectives serve as a mandate for delegating decision making to the manager and evaluating the success of the manager.
- Specific and Measurable
  - Total return (income + growth)
  - Nominal or real (after inflation)
  - Absolute versus relative returns
  - Pretax or post tax
- Achievable and Realistic – balancing capital market expectations and investor’s risk objectives and constraints
- Time horizon needed to achieve the targeted returns
- Base currency
Time Horizon

- The period over which an investment objective is to be achieved.
- Investment time horizon shrinks as the investor ages (e.g. 90-age = estimated life expectancy) but could be extended in cases when investor bequeaths his wealth to future generations.
- A portfolio may have multiple objectives and multi-stage time horizons, generated every time by the investor’s change in circumstances (planned expense) within a life cycle.
- The longer the time horizon, the more concerned the investor should be with inflation adjusted (real) returns.
Liquidity Needs

- Defined as cash needed from the portfolio in excess of cash contribution into the portfolio or other savings by the client at a point in time
- Anticipated (planned expense/unfunded commitments) versus unanticipated (emergencies/liquidity squeeze)
- Recurring needs or a one-time (or for limited periods) distribution to meet an objective
- Constrain the ability of portfolio to take higher risks and the assets eligible to be selected for the portfolio
- Generally, when liquidity needs are high relative to the portfolio assets, they must be managed with lesser risk and focus on income generation assets
Legal and Tax Issues

- Plan sponsors, administrators, trustees and portfolio managers are obligated to comply with the relevant legal and regulatory requirements (e.g. ERISA and UMPERSA in the US)
- Public expectations of fiduciary duty, ethical conduct, professional competence and prudent investor rule
- For trusts, balance the interests of income beneficiary and remaindermen
- Consider effects of taxes on investment income, capital gains, property and wealth transfer (minimize, defer or avoid) and choice of jurisdiction
- If tax treatment is uncertain, include recommendation for legal counsel or professional tax advice
Fiduciary Duty
Unique Constraints/Preferences

- Each investor will have unique constraints that should be considered in managing the portfolio
- ESG (social responsibility investing, impact investing) or ethical preferences (shariah-compliant investments)
- Specific securities/markets to avoid or preferred
- Asset protection, philanthropic/legacy planning, health issues/special needs of the client
- Objectives stated in more than one currency (currency hedge overlay may be required)
- Any yet unresolved conflicts and inconsistencies would need investor education
• Having understood and been subjected to the risk preference and constraints of the investor, the portfolio manager must determine the policy asset mix – the long-run desired allocation of a fund to designated asset classes

• Asset allocation can be active or passive

• Active asset allocation is determined by market views and quantitative portfolio optimization tools may be used to maximize the return for the acceptable risk in the assets selected

• Portfolio implementation must be executed with timeliness and transaction costs to be monitored and minimized
Asset Class and Sub Class
How to Decide on the Blend

• Appraise your own financial and temperamental abilities to accept losses
• Making money is about disciplined portfolio management and ability to invest against the crowd
• Balance income and capital gain potential in portfolio
• Consider need to hedge interest rate and inflation risk
• Informed choice: Clients who choose a broadly diversified, multi-asset structure need to simultaneously adopt a broadly diversified frame of reference
A Sample IPS – Executive Summary

- Type of Plan
- Investment Assets
- Time Horizon
- Investment Objective
- Expected Return
- Risk Tolerance
- Fees
- Evaluation Benchmark

- Individual, Mr. Client
- $800,000
- Approx. 10 years
- Long-term capital appreciation
- Higher of 6% p.a. or 2% over inflation
- Moderate
- 1% of portfolio market value
- Total return to exceed the performance of individual indices of specific asset classes in the SAA of the Fund
# A Sample IPS – Executive Summary (2)

<table>
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<th>Asset Classes</th>
<th>Lower Limit</th>
<th>SAA</th>
<th>Upper Limit</th>
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<tr>
<td><strong>Equities</strong></td>
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<tr>
<td>Asia ex Japan</td>
<td>25.0%</td>
<td>35.0%</td>
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<tr>
<td>EMs ex Asia</td>
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<td>11.0%</td>
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<td><strong>Fixed Income</strong></td>
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<tr>
<td>Government</td>
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<td>5.0%</td>
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<tr>
<td>Investment Grade</td>
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<td>20.5%</td>
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<td>High Yield</td>
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<td>7.0%</td>
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<td><strong>Alternatives</strong></td>
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<tr>
<td>Cash &amp; Eqv</td>
<td>5.0%</td>
<td>8.0%</td>
<td>15.0%</td>
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</table>
Five Common Mistakes Made in IPS

- Miscalculating investor’s level of risk tolerance
- Underestimating investment time horizon
- Not determining or inaccurately determining investor’s specific financial goals
- Misjudging investor’s liquidity needs during their time horizon
- Not identifying investor’s unique circumstances or preferences
Portfolio Management Checklist

- Suitability – ALM focus
- Optimality – dynamic AA to meet changes
- Diversification – across risk factors and economic environments
- Illiquidity of assets – liquidity to meet liabilities and unfunded commitments
- Tax efficiency
Good Ethics = Good Business

- Flight to integrity will occur in the wake of every scandal.
- US mutual funds implicated in the market timing scandals some years ago lost some US$900b in client assets to rival firms.
- Surveys have shown that **Trust** is the no.1 priority people look for in a financial advisor or manager.
- Ethical culture has to be worked on, tended to and maintained constantly. If it’s ignored, it will start to breakdown.
- Active communication to manage clients’ expectations in the iterative process of money management is needed.
**Conclusion**

- Investment policy is an all encompassing term to describe an institutional or individual investor’s overall approach to the formulation of goals, asset mix, investment strategy, stock selections and disciplined management of the portfolio
- “Investment policy, wisely formulated by realistic and well-informed clients with a long term perspective and clearly defined objectives, is the foundation upon which portfolios should be constructed and managed over time and through market cycles.” – Charles Ellis, CFA
- “The best way to achieve long term success is not in stock picking and not in market timing, and not even in changing portfolio strategy. Sure, these approaches will have their current heroes and war stories, but few would last for long and not all war stories are entirely true. The great pathway to long term success comes via sound, sustained investment policy, setting the right asset mix and holding onto it.” – Charles Ellis, CFA