

Investment Policy Statements

An Overview for Board Members

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Introduction

In this Goldman Sachs Institutional Client Solutions white paper, we explore the issues boards of directors and investment committee members should consider in developing and maintaining an investment policy statement (IPS).

Goldman Sachs Institutional Client Solutions provides nonprofit institutions with ongoing market insights, expertise and client-specific solutions—from advice on individual asset class or strategy mandates to fully outsourced investment management.

We encourage you to contact us by e-mail at icsimd@gs.com if you are interested in learning more about investment policy statements or other investment management-related topics.

Why an Investment Policy Statement?

A thoughtful IPS acts as a critical governance and investment tool for any organization. It should provide a framework for making sound and deliberate decisions. It also offers:

A Well Articulated Investment Process: A written policy fosters deliberation and may diminish the emotional dimension of investing. An investment process reflecting careful deliberation and consensus will provide the board with greater “staying power” in volatile markets. A formal policy can also be useful in managing the outlying views of individual board members.

Compliance with Relevant Laws: An IPS can be useful in ensuring compliance with applicable rules and regulations, including diversification requirements. Organizations should review their existing IPS at least annually.

Good Governance Structures: An IPS may provide formal documentation regarding the exact roles and responsibilities of the various parties (e.g., the board, the investment committee, the staff, or the investment adviser). It also acts as a repository for the best practices that the organization has adopted over time.

Institutional Memory and Continuity: While the composition of the board may change, the permanence of an IPS provides a critical link and continuity between successive boards.

What Makes a Good Investment Policy Statement?

While each well-crafted IPS has many unique provisions, there are often a number of common characteristics:

Comprehensive but Flexible: An IPS should be comprehensive, but not so detailed that its contents are difficult to follow by the various constituents involved in the investment process. Investment managers should not be overly constrained by provisions such as directions on sub-asset class level targets, tight asset class ranges, lengthy investment restrictions and non-traditional benchmarking.

Compliant with Legal Standards: An IPS should ensure compliance with the legal standards governing the investment of the organization’s assets. We have included an overview of the key provisions of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) for your reference at the end of this document.

Key Governance and Investment Elements: An IPS should identify and address 1) the organization’s investment objectives and constraints, 2) investment strategy and parameters, and 3) governance issues.

Key Governance and Investment Elements

Organization’s Objectives and Constraints

An IPS should provide background on the organization, its mission and any constraints it might face. There should be enough information included in the IPS so that all of the relevant parties, including current and future board and investment committee members, staff and investment professionals, will be able to understand the investment strategy in the appropriate context. Topics to be addressed include:

Purpose of the Pool of Assets: What is the mission and purpose of the organization and which activities are the assets supporting?

Horizon: While some organizations expect to operate for a limited period of time, many organizations are designed to exist into perpetuity. An IPS should explicitly lay out the investment time horizon.

Spending Needs: An IPS should define the organization's expected spending needs as these needs, along with the organization's investment horizon, will have important implications for the investment strategy.

Constraints: An IPS should include any potential constraints, such as illiquid holdings that require consideration when setting the overall investment strategy.

Investment Strategy and Parameters

The investment portion of an IPS should balance the goals of the organization with the risk required to obtain the required target return. This deliberative process by the investment committee should include the use of various asset allocation models and simulation analysis, with a particular focus on "downside" risk.

Key points to include are:

Target Returns: The target return of the portfolio will be a function of the organization's spending needs, its investment horizon and risk tolerance. A common target return is 5% plus inflation, net of fees. This return would apply to an organization with a goal of spending 5% per annum while maintaining purchasing power over time.

Strategic Asset Allocation: Generally, the most important investment decision that any investor makes is the selection of a strategic asset allocation -- the portfolio's long-term weightings to various sectors over time. Strategic asset allocation models can quantify the expected risk and return of a given allocation. A board can use this output to gauge its comfort with any risk / return trade-off. The agreed-upon asset allocation should be expressed with percentage targets and permissible ranges.

Acknowledgement of Risk Tolerance: Once a strategic asset allocation is set, it can be helpful to incorporate into the IPS a formal acknowledgement that the board understands the potential risks associated with the selected allocation.

Tactical Asset Allocation: Managers often deviate from the long-term strategic asset allocation to take advantage of certain market dislocations (e.g., purchase more high-yield corporate bonds when yields are high). It is important for the IPS to not only recognize and explicitly permit this activity, but also place constraints on it.

Implementation: As the use of passive investment vehicles such as ETFs have become more popular, it is helpful to indicate whether the board has a bias towards active managers or passive managers, or prefers a mix.

Sample Asset Allocation with Percentage Targets and Permissible Ranges

Asset Class / Sub-asset Class	Lower Limit	Target Allocation	Upper Limit
Investment Grade Fixed Income	10.5%	25.5%	40.5%
Other Fixed Income	0.0%	7.0%	17.0%
US Equity	18.5%	28.5%	38.5%
Non-US Equity	4.5%	14.5%	24.5%
Hedge Funds	0.0%	6.0%	16.0%
Private Equity and Other Private Assets	3.5%	18.5%	33.5%

For illustrative purposes only.

Restrictions: An IPS should indicate any investment restrictions. The list of restrictions should be carefully evaluated to avoid unintended application of the restriction. For example, if the use of derivatives is prohibited, a carve-out exemption might be permitted in the case of certain commingled vehicles. This ensures that a hedge fund portfolio which uses derivatives would still be permissible.

Social Screens: Some organizations seek to avoid investments in certain types of securities, such as alcohol and tobacco stocks. Again, a carve-out exemption is often advisable since these screens prevent the use of commingled vehicles, including mutual funds, in the portfolio. This is because the underlying holdings of a mutual fund cannot be controlled by the restrictions desired by an individual investor.

Benchmarking / Monitoring of Portfolio and Investments: In order to evaluate the investment performance of the portfolio, an IPS should designate appropriate benchmarks that are consistent with the strategic asset allocation. These benchmark decisions can be made in conjunction with the investment adviser. Each individual manager should be assigned a benchmark as well.

Other Considerations: Any other unique and relevant considerations regarding the investment strategy should be highlighted in an IPS. These may include unique investment objectives such as income requirements, short-term and long-term liquidity needs, the existence of significant nonfinancial assets in the portfolio, the decision to maintain an undiversified portion of the portfolio, a desire for stability and other factors.

Governance Issues

It is important to include general guidance on how investment decisions should be made and implemented and the permissible scope of delegated authority for outside managers, advisers and internal staff. Since each organization assigns roles and responsibilities related to investment of assets in a unique way, it is helpful to be specific about each group's roles.

Board of Directors: The board of directors is charged with safeguarding assets of the organization. In performing this role, the board should adopt an IPS and may choose to delegate investment management responsibilities (if permitted by the bylaw) to an investment committee which in turn is responsible for implementing, monitoring and regularly reviewing the IPS.

"It is important to include general guidance on how investment decisions should be made and implemented and the permissible scope of delegated authority for outside managers, advisers and internal staff."

Investment Committee: When considering the composition of the investment committee, the board of directors should take into account the appropriate size of the investment committee, the requisite expertise of the members (both personal qualities and professional qualifications) and any conflicts of interest issues. All decisions should be documented. The investment committee needs to report to the board of directors regularly and continually monitor for conflicts of interest.

Outside Investment Adviser: Common duties of the investment adviser include making asset allocation recommendations, implementing the organization's asset allocation by placing the investments with managers, evaluating and monitoring manager performance, rebalancing, and attending meetings with the board and staff of the organization.

Staff: The ability of the organization's staff to execute those aspects of the investment process that have been assigned to them should be clearly enumerated in the IPS or the investment committee charter. Common tasks assigned to the organization's internal staff include executing documents and contracts; regular monitoring of investments, managers and advisers; and maintenance of summaries of investment activities.

Summary

A robust IPS can help ensure that an organization adheres to an investment decision-making process that is consistent and analytically rigorous. Organizations need to have a realistic understanding of the trade-off between risk and return. This should be clearly reflected in the IPS. An IPS should also appropriately address liquidity needs, spending requirements, inflation expectations and laws applicable to the investment management of the organization's assets. Finally, an IPS must provide the board with the ability to stay with their investment strategy during periods of market volatility. It should also allow the organization to make changes in a sound and measured manner when necessary.

Key Provisions of Uniform Prudent Management of Institutional Funds Act (UPMIFA)

All states (except Pennsylvania) have enacted the UPMIFA, a uniform statute that governs investing and spending practices of nonprofit organizations. It should be noted that many states have adopted versions of UPMIFA that differ to some extent from the uniform statute.

Under UPMIFA, the organization's *investment strategy* must consider the following factors, if relevant:

- General economic conditions
- Possible effects of inflation / deflation
- Expected tax consequences (if any) of investment decisions or strategies
- Role that each investment or course of action plays within the overall investment portfolio
- Expected total return of the portfolio
- Other resources of the organization
- Needs of the organization and particular investment funds to make distributions and preserve capital
- Special relationship or value (if any) of a particular asset to the organization's charitable purpose

Management decisions should be made in the context of the overall portfolio and within the overall risk management strategy of the organization, rather than in isolation. Diversification is *required*, unless the organization reasonably determines that its needs are better served without diversification. Retention or disposition decisions following the receipt of property need to be made in a reasonable period of time.

UPMIFA also provides guidelines on *spending from endowment funds* – endowment funds are funds that are not “wholly expendable by the institution on a current basis.” A board may spend or accumulate as much of an endowment fund as is prudent for the purposes of the fund, taking into consideration the following factors:

- Duration and preservation of the endowment fund
- Purposes of the organization and the endowment fund
- General economic conditions
- Possible effects of inflation / deflation
- Expected total return from income and the appreciation of investments
- Other resources of the organization
- Investment policy of the organization

Organizations may delegate management and investment functions to their committees, officers or employees. They may also delegate the management and investment of institutional funds to an external agent as long as the board of directors or the investment committee is acting in good faith. They must use the care that an ordinary prudent person in like circumstances would exercise in:

- Selecting an agent
- Establishing the scope and terms of the delegation
- Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation

If the directors properly delegate the investment function, they and the organization will not be liable for the decisions or actions of their agent.

Please note that Goldman Sachs & Co. LLC does not provide legal, tax or accounting advice.

Important Information

While we consult with those organizations in need of assistance in formally defining their investment needs and objectives, we do not draft Investment Policy Statements.

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