Developing the Investment Policy Statement

S. KELLY RODGERS[1]
Chartered Financial Analyst and Investment Consultant, Toronto

Any organization that has investments needs an investment policy statement. It is the document that articulates the investment objectives and constraints of the organization and is equally valuable whether investments are handled internally or by an external manager.

An investment policy statement can be thought of as a job description for the investment manager. You wouldn't hire any employee without a job description and the same care should be applied to the organization's investments.

Some might think that only not-for-profits with very large endowments need policy statements but, in fact, a policy statement is needed no matter how small the investment portfolio. Whatever the size of the capital, such a statement should include money market instruments and guaranteed investment certificates as well as equities and bonds. Some organization may want to have two policy statements, one for the short-term investments and one for the long-term portfolio.

The first and most important issue an investment policy statement should address is the investment objectives. At times it seems as if we all have the same objectives: significant capital appreciation; high current income; and no risk. This is a case where the old cliché is correct: if it sounds too good to be true, it probably is. Determining investment objectives requires the balancing of these competing goals.

Simply put, it is the process of answering the question, "What is this money for?"

Once the organization begins to think about investment objectives in these terms, some of the answers will become evident. If the investments arise from excess operating funds that will only be available for a short period of time until they are needed for operations, then safety of principal and liquidity will be the most important objectives. If the investments are of a long-term or endowment nature then income or capital appreciation may be more important. Each organization must look to its own unique situation and needs when determining its investment objectives.

Some common objectives include the generation of additional income to offset operating deficits or the building of a capital base which will eventually generate income to fund special projects or new programs. Each organization will have a different answer. The more definitive the answer to the question of the purpose, the easier it will be to draft an appropriate investment policy

statement; vague objectives will lead to vague policies and it will be very difficult to see whether the objectives are being met.

An investment policy statement should address the following key areas: background and overview; objectives, risk and return; constraints and special circumstances, liquidity, time horizon, legal and regulatory requirements, organizational biases and preferences; and evaluation procedure.

Background and Overview

This section of the policy statement will serve to familiarize anyone reading it with the organization and its goals. It should outline very briefly the organization's reason for existence and identify the source of the capital. If an outside investment manager will be hired, the policy statement should also identify what type of firm will be hired to manage the assets. Organizations can hire financial institutions, usually banks or trusts, investment counsellors or brokerage firms. To determine which is which, note how each is registered. They can be registered with a provincial securities commission or with a stock exchange's self-regulatory organization. Be sure to weed out any possible conflicts of interest (such as brokerage commissions) which might affect the advice you receive.

Objectives

At first glance it would seem quite simple to state the return objectives: the best return possible. Unfortunately it is a bit more complicated than that because the rate of return must be matched to the risk that the organization is willing to assume. To some extent this will depend on factors that are unique to each organization. What is the total capital available for investment? What is the expertise of the board members in handling investments? Do board members understand their fiduciary obligations with regard to the organization's funds?

What level of risk, or volatility, can the organization afford to accept? For example, if the board decides to invest in marketable securities it must accept some capital risk in the short term. If it decides to invest only in guaranteed investments it must accept inflation risk. The board must assess the organization's needs with care and decide how much of each type of risk is appropriate. It is not possible to eliminate all investment risk but it is possible to balance different types of risk. Most boards want to preserve the capital of the organization and protect it against inflation so its purchasing power will be retained.

Constraints and Special Circumstances

This is where boards put the organization's personal stamp on the investment portfolio and members must ensure that this is done in a manner consistent with their responsibilities as board members rather than with their preferences as individuals.

Liquidity

The first constraint that must be addressed is the liquidity requirement. When will this money be needed? Will it be required to meet operating expenses or to fund a capital project at a specific time in the future or does the board anticipate that it will be held in perpetuity? It is useful to look at a worst-case scenario to help define the liquidity requirement. For example, would the liquidity requirement change if government funding were reduced or eliminated? How long would it take the organization to replace such funding and what would be the impact on capital during this period? By looking at possible scenarios the board will be able to determine how much of the capital should be kept in only the most liquid and safest investments.

Most not-for-profit organizations will have two distinctly different capital pools, one short-term and one long-term, and they should be dealt with separately since the objectives for each are completely different.

Time Horizon

The second constraint, time horizon, is closely aligned to liquidity. If the assets will be needed in two or even six months then no short-term capital risk can be assumed. If the capital will not be needed for a decade, if ever, then a moderate level of short-term risk or volatility can be accepted to gain better investment returns.

Legal and Regulatory Requirements

The third constraint boards must consider is regulatory or legal constraints. Many not-for-profits are required to make investments that comply with the *Trustee Act* of their particular provinces. This constraint may be imposed by law or by their own by-laws. Each province has very specific requirements in its *Trustee Act* that apply to both the type of assets and the type of individual securities in which not-for-profit boards are permitted to invest. In Ontario for example, mutual funds and other pooled vehicles are not eligible.

Biases and Preferences

The most difficult constraints to determine will be those that reflect the organization's own biases and preferences. These can be relatively simple such as maximum and minimum equity or fixed income weightings; maximum investments in investments such as corporate bonds which are not guaranteed by a government; or minimum credit quality ratings for fixed-income investments. They can also be as specific as forbidding investments in companies that make or sell tobacco or alcohol or are involved in gambling activities. Most organizations will at least require, as a general principle, that investments should not be made that are contrary to the aims and goals of the organizations, e.g., a cancer treatment centre will undoubtedly prohibit investments in tobacco companies.

Evaluation Procedures

Once the objectives and constraints have been determined a procedure must be developed to see if they are being honoured. This evaluation is the investment equivalent of the annual performance appraisal but it is usually conducted on a quarterly basis. The board must determine who will evaluate the investment performance—the full board, the finance committee or an investment committee. How will they determine if the performance has been acceptable? Most investment professionals will recommend that a benchmark portfolio be chosen against which the actual portfolio will be measured. For short-term investments this benchmark could be the rate paid on term deposits or it could be the 90-day Government of Canada Treasury Bill rate. For a long-term fixed income portfolio the benchmark might be the Scotia McLeod Bond Universe. A long-term Canadian equity portfolio might have as its benchmark the Toronto Stock Exchange 100 Index while a U.S. equity portfolio would probably use Standard & Poor's 500 Index.

A target rate of return is usually determined for the investments. Long-term investments must have long-term target rates. They should, for example, be expected to outperform the benchmark portfolio by one per cent on an annualized basis over a three- or five-year period. Or, depending on the objectives, the determined target might be a rate of return of three per cent over the rate of inflation or to outperform treasury bills in every year.

Evaluation must always be related back to the investment policy statement, not to what happened in the markets in the previous week.

If an outside investment counsellor is retained, then a reporting schedule should be determined. (Traditionally the investment industry reports to clients on a quarterly basis.) What are the written reporting requirements of the organization and the expectations for personal reporting? Who does the manager report to, a staff member or the board or both? These issues should be clarified so that all parties to the relationship have the same expectations.

The most difficult part of the investment process is getting the investment statement in place. Once this is done, maintenance and updating are not onerous tasks. While the statement should be reviewed annually, it will usually change only when the objectives or needs of the organization change.

FOOTNOTE

1. Kelly Rodgers is a chartered financial analyst and the author of *The Insider's Guide to Selecting the Best Money Manager*. She provides investment consulting services to organizations and individuals and is a regular contributor to *The Financial Post*. Her philanthropic activities include membership on the Finance Committee and the Portfolio Review Subcommittee of the Girl Guides of Canada National Council.