

Honesty is the Best Policy

The importance of an Investment Policy Statement

August 2003

With the children back in school and summer activities drawing to a close, it's time to get your house back in order. While this could have literal meaning, we're figuratively speaking of your *financial* house. This month's *Fiscal Fitness* will define and explain the importance of an individual *Investment Policy Statement*. Consider how much time and energy you expend towards the ultimate goal of a comfortable (even early) retirement. Next, consider if you have a well-conceived plan for reaching your retirement goals. You're not alone if you don't.

An Investment Policy Statement (IPS) provides the guidelines and general framework to effectively allocate, supervise, monitor and evaluate the investment assets in your portfolio. In other words, the IPS is a written document of your return requirements, risk tolerance, income needs, liquidity concerns, investment time horizon, tax considerations and any other unique needs. We, the investment advisor, should encourage you, the client, to effectively communicate these parameters in a written document. It is not enough for an investor to instruct us to "make my money grow". Define "grow" and tell me how much risk you're willing to take and how long is your time horizon and...and....well, you get the message.

To assist with our probing, we utilize what is creatively dubbed an Investment Policy Statement Questionnaire. While this document may seem daunting, completing it is a very useful exercise for both of us. It's not a financial test and there are no wrong answers. Give us an honest assessment of what you're expecting and we'll give you an honest assessment of what you should expect. Once we reconcile your expectations with reality, we can use your investment policy as a "blue print" to build and manage your portfolio. Keep in mind that Investment Policy is fluid in nature – it is meant to evolve just as our needs evolve.

Though we've introduced some of these terms above, let's us define the primary considerations that form the spine of your Investment Policy:

- ‡ **Return Requirement** – Your expected return from the portfolio including income and capital appreciation, given the level of risk you perceive taking (see next point). We measure this from an inflation-adjusted viewpoint.
- ‡ **Risk Tolerance** – Any investment, other than cash, will expose the assets to some element of risk. Our job to maximize return for a client's given comfort level of risk. But finding and quantifying a person's level of risk is much more involved than saying "I'm conservative" or "I'm aggressive". We've found that we're never quite as aggressive in bear markets or as conservative in bull markets as we lead on. Nonetheless, investing too conservatively can be just as disastrous as being overly aggressive over time.
- ‡ **Income Needs** – Is income or capital appreciation, or a combination thereof, the goal? Investors have learned the meaning of capital *preservation* in recent years.
- ‡ **Time Horizon** – Consider when funds will be needed to meet future goals such as retirement, college education funding, and home purchases. The market has reminded us that stocks are not an appropriate short-term investment.
- ‡ **Taxes** – Minimizing taxes are certainly a key to attractive investment returns. Taxes are not assessed on income within retirement accounts such as an IRA or 401k. Tax efficient portfolios should always be an objective.
- ‡ **Unique Needs and Circumstances** – Consider yours and your family's unique needs and demands. Examples include future large cash outlays such as education funding, lifestyle changes or special medical needs family members.
- ‡ **Asset Allocation** – Based on all the above, this is how your money is invested among classes of assets to achieve your goals.

When investing, the real opportunity to achieve superior results is not by scrambling to outperform some market benchmark. Rather, it is establishing and adhering to appropriate investment policies over the long term through varying market cycles.

Unfortunately, too few investors have developed investment policies. In this case, the investment manager is left to manage their client's portfolio without truly knowing their real objectives. It's like traveling without a road map; Even though you don't know where you're going, you're still assured of ending up somewhere. It's unnecessary. You know where you want to go; the Investment Policy Statement helps us map the course to get you there.