

Setting Investment Guidelines

Before jumping headfirst into a pool, first check to see that it is filled with water.

It might sound a bit simplistic, but before we attempt to find and analyze any investment managers, we should first have a very clear idea of what we are trying to achieve by hiring the manager. This way we will be able to put each investment product in its proper perspective. A value manager can be reviewed in the context of the value style and can be properly compared to a universe of other value managers. Likewise, a short-term domestic fixed-income portfolio can be compared to the appropriate benchmark and peer group. This practice will save time and make the process much more efficient.

Investment guidelines come in two primary stages: (1) the investment policy statement (IPS) and (2) the investment portfolio guidelines. The former concerns the overall portfolio or fund (such as a pension plan), while the latter is targeted toward each manager hired to fulfill specific objectives within the overall portfolio/fund (see Chapter 13). As common sense dictates, all investment guidelines should be well thought out and should cover every aspect of the investment process, from risk/return expectations to manager selection to portfolio monitoring. In addition, manager guidelines should leave nothing open to interpretation. Fiduciaries charged with hiring investment managers as well as the investment managers themselves should understand the guidelines and willingly agree to them. This avoids potential headaches down the road.

INVESTMENT POLICY STATEMENT

An investment policy statement sets the framework for all of the investment decisions that follow. When well written, the IPS helps to ensure that the

decision-making process with respect to the management of the total portfolio will be consistent and will serve as a beacon to aid navigation through unexpected market fluctuations and sometimes tumultuous economic conditions, enabling all parties to concentrate on what they were hired to do (or what they do best). A well-written investment policy statement typically addresses, but is not limited to, the following issues:

- Philosophy or purpose.
- Return/risk objectives, including thresholds.
- Time horizon.
- Type of plan or portfolio.
- Status of plan funding.
- Actuarial assumptions, including clearly stated reasoning behind the return/risk objectives.
- Cash flow needs or liquidity.
- Strategy being employed to meet the investment objectives.
- Permissible investments (financial instruments and asset classes).
- Restricted investments (instruments and asset classes).
- Asset allocation ranges.
- Benchmark(s) for total portfolio.
- Benchmarks for each individual component of the total portfolio (asset classes, individual managers, styles, etc.).
- Plan/portfolio responsibilities (board, investment committee, consultants, etc.).
- Policies regarding external hires, such as consultants and investment managers (including language on fees, use of competitive bidding process, due diligence process, hiring/firing policies, placement of external hires on the watch list).
- Portfolio and performance evaluations (standards and procedures).
- Benchmarks and rebalancing policies.
- Diversification (by manager, portfolio size, geography, investment characteristics, asset classes, etc.).
- Portfolio execution and trading strategy.
- Operational issues (custodial, administrative, spending policy).

However, the investment policy statement should not be written in a vacuum. Economic and market conditions evolve. As they do, it is imperative that the investment policy statement be reviewed at least yearly on a strategic level and perhaps more often on a tactical level so that the portfolio has a chance to evolve along with the market.

Many pension plans currently conducting searches for alternative

investment managers, such as hedge funds, only recently changed their investment policy statements to allow investments in this segment of the market. These adjustments reflect the ever-changing nature of the investment industry. Just keep in mind that all change is not necessarily good. What might be a beneficial change for some might be detrimental to others.

Because the focus of this book is investment manager analysis (not overall investment policy), this chapter should serve as a general guide or outline for the development of a new or the evaluation of an existing investment policy statement. The remainder of this chapter will highlight each of the significant sections that good investment policy statements typically contain.

Investment Objectives

This section is a critical element in the IPS document because it sets the tone for everything that follows. It is here where the portfolio's return and risk expectations are listed. Whenever the investment policy statement is reviewed, the ultimate goal is to ensure that the return and risk objectives have been achieved. As you can imagine, the objectives should be realistic and based on long-term assumptions. Many corporate pension plans got caught up in the bull market of the late 1990s and increased their pension plans' return expectations far beyond what they could reasonably expect to achieve. This resulted in faulty pension assumptions that have had a detrimental impact on many companies' financial statements and, in the case of some publicly traded companies, the prices of their underlying stocks.

For pension plans, return and risk objectives may be stated in absolute terms (example: the portfolio should return a minimum of 8% annually with a standard deviation no greater than 10% annually) or relative terms (example: the portfolio should have an annual return in excess of 200 basis points above the S&P 500 index with a standard deviation no greater than the S&P 500 index). A basis point represents $1/100$ th of a percent.

Funds of funds may also state their return and risk objectives in absolute or relative terms. However, because funds of funds are, in effect, individual investment products themselves, they tend to have a much more narrow investment focus (example: small-cap, large-cap, etc.). A fund of funds' investment policy statement is typically called a "prospectus" or "offering memorandum." Because there are legal requirements, investment policy statements and prospectuses tend to have different formats, but still contain all of the points listed earlier in this chapter.

Example of Investment Objective

The financial objectives of the plan are based on a comprehensive evaluation of the capital markets in the context of modern portfolio theory and have been measured against the plan's current and projected financial needs. Based on this evaluation, the plan will be measured against a customized benchmark consisting of the following indexes in the proportions listed:

- 50% S&P 500 index
- 10% Russell 2000 index
- 10% MSCI EAFE index
- 30% Lehman Aggregate index

The investment objectives for the plan are:

- *To achieve a nominal rate of return for the total portfolio equal to or greater than the return of the customized benchmark.*
- *To achieve a real rate of return in excess of 550 basis points above inflation, measured by the consumer price index (CPI).*
- *To keep the total portfolio's level of risk, defined as annualized standard deviation, equal to or less than that of the customized benchmark.*

Responsibilities

Once the objectives have been decided upon, it is important to clearly state who will be responsible for making sure that all the goals are accomplished. This is an important section because it specifies who is responsible for every aspect of the portfolio's management. This includes boards, trustees, internal employees, external investment managers, consultants, legal advisers, and others.

This section offers guidance not only to outsiders looking to establish contact, but also among co-workers who share portfolio analysis and management responsibilities. It is basically a detailed organizational chart that sets the pecking order within an organization.

Asset Allocation

Asset allocation is the subject of entire books, so I will simply state here that it comes in several levels. First, there is strategic asset allocation. This form of asset allocation is long-term in nature and is seldom changed or altered. Changes to asset allocation that occur due to short-term shifts in economic or market conditions are most often referred to as tactical asset allocation. For a pension plan, the strategic asset allocation decision is

most often arrived at by conducting an asset/liability study, where the fund's liability characteristics are considered when developing the fund's asset allocation policy.

This typically leads to a list of what asset classes and financial instruments are permitted for purchase. In addition, the list typically states the minimum and maximum weights according to asset class, market capitalization, investment style, and so on. Exhibit 1.1 depicts sample asset allocation guidelines that are broad, while the asset allocation guidelines depicted in Exhibit 1.2 break the main asset classes down into a variety of

EXHIBIT 1.1 Sample of Broad Asset Allocation Guidelines

Asset Allocation	Average %
Equity	50
Fixed income	40
Alternative asset classes	5
Cash and equivalents	5

EXHIBIT 1.2 Sample of Detailed Asset Allocation Guidelines

Asset Allocation	Minimum %	Average %	Maximum %
Traditional Asset Classes	80	90	100
Equity	40	47	60
U.S.	32	35	44
Small-cap	6	7	9
Mid-cap	7	8	10
Large-cap	19	20	25
Non-U.S.	8	12	16
EAFE	6	9	12
Emerging markets	2	3	4
Fixed Income	20	30	40
U.S.	16	25	33
Investment grade	12	20	26
Non-investment grade	4	5	7
Non-U.S.	4	5	7
Developed markets	2	3	4
Emerging markets	2	2	3
Alternative Asset Classes	0	10	20
Hedge Funds	0	5	10
Private Equity	0	5	10
Cash and Equivalents	1	3	5

subcategories. The more detailed the asset allocation, the more efficient the overall process will be. For example, it would be easier to perform attribution analysis when the asset classes have been defined in greater detail. Also, to create detailed asset allocation guidelines, you need to really think through the entire process and, ultimately, hold the investment committee or lead investment professionals responsible for the portfolio's outperformance or underperformance.

In addition to breaking out the underlying asset classes further, the detailed asset allocation guidelines set minimum, maximum, and average weights for each asset class. When setting the guidelines it is critically important to set asset allocation guidelines that parallel the return/risk parameters set in the investment objectives section of the investment policy statement. For example, it would be nearly impossible to achieve a long-term return in excess of 8 percent if the asset allocation guidelines emphasized short-term fixed income securities and prohibited equity investments and other asset classes that appear on the higher end of standard return/risk profile charts. An example of a standard risk/return profile based on long-term historical performance for various asset classes is depicted in Exhibit 1.3.

Short-term bonds appear in the low risk/low return quadrant. In order to achieve a long-term return of roughly 8%, it would be necessary to invest in some of the asset classes that appear higher up on the risk/return

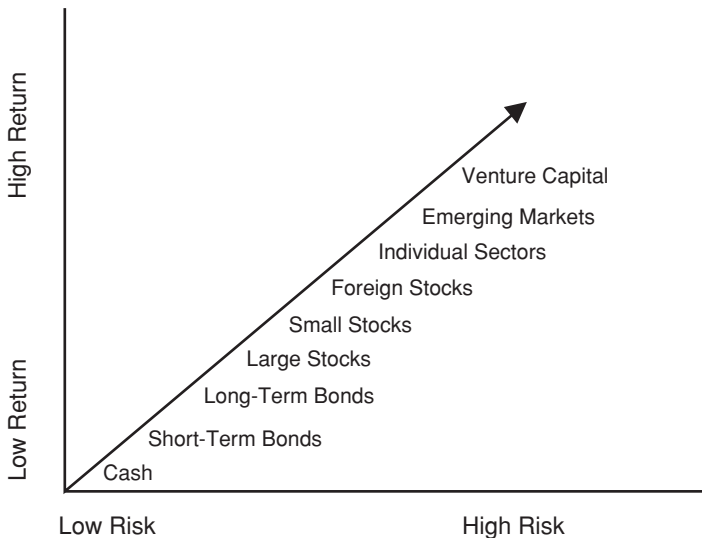


EXHIBIT 1.3 Risk/Return Profiles by Asset Class

line. A well-thought-out and well-written IPS will contain risk and return objectives that match the asset allocation ranges set within the document.

Investment Restrictions

This list is a compilation of any financial instruments (e.g., options) or investment strategies (e.g., currency hedging) that are not allowed. Restrictions can cover entire asset classes, specific transactions, countries, or exchanges, or can be taken to the individual company or organization level. Other examples include restrictions based on social, political, or religious reasons. A Catholic foundation, for example, may wish to avoid investing in “sin” stocks (typically defined as companies that are involved in the manufacture, sale, or distribution of alcohol, tobacco, and firearms). Once a process done largely by hand, the ability to flag any restricted purchases can now be achieved relatively easily at the custodial level or through various software packages. These restrictions should carry over verbatim to the investment manager guidelines (see Chapter 13) as well.

Portfolio/Performance Evaluation

Assuming you have a portfolio or fund that is up and running, it is imperative that periodic evaluations take place. As mentioned previously, the investment policy statement should be evaluated at least yearly. Questions to answer include the following:

- Has the portfolio achieved its goals?
- If not, where did we go wrong and, more importantly, how do we fix it?
- How have each of the underlying managers performed?
- Have all the underlying managers stayed within their stated investment guidelines?

These and many other questions should be asked and answered on a consistent basis. This section typically states what will be evaluated, how it will be evaluated, and who will evaluate it, and sets very specific time frames. For example, an investment policy statement or prospectus may state that the underlying investment managers will be informally reviewed quarterly and formally reviewed annually (naturally the terms *informally* and *formally* must be defined). Some of the issues that are typically addressed in this section include:

- Timing, frequency, and format of evaluations.
- Format to place investment managers on warning.
- Absolute performance.

- Relative performance (benchmark and peer group).
- Fundamental characteristics.
- Attribution analysis.
- Style analysis.
- Risk analysis.
- Minimum portfolio standards.
- Fees.
- Reporting standards and issues.

Operational Issues

Any number of things can be placed in this section, such as legal, accounting, custodial, administrative, and other issues. In addition, this section can also contain language that addresses the issue of proxy voting. Some organizations place that decision entirely with the underlying investment managers, while others place specific restrictions on particular issues that may arise. For example, a pension plan may specify that all proxy votes are to be voted as the company management sees fit, with the exception of issues relating to movement of labor from the United States to countries overseas.

CONCLUSION

The investment policy statement is a critical element in the ongoing management of any pension plan or investment fund. The guidelines set the tone for all the underlying investment manager searches and play a key role in the actual due diligence performed on any investment managers under review. The more explicit the investment policy statement, the easier it will be to actually manage the underlying pension plan or investment fund. In addition, because the risk/return objectives should be clearly stated in the investment policy statement, it is easier to evaluate the success or failure of the underlying pension plan or investment fund. As we learn in Chapter 9 (“Attribution Analysis”), we can conduct relative attribution analysis only when we have something concrete (a single index or a combination of indexes) to which to compare allocations and performance.

As we work our way through the investment manager analysis process, we will create a detailed set of risk and return objectives for the sample manager we select for the case study and build the underlying analysis one step at a time. This chapter has laid out a brief outline for developing an effective investment policy statement; Chapter 2 introduces a means of finding a broad list of potential investment managers and then demonstrates how to cull the broad list down to a few highly attractive candidates.