Key Issues in Creating an Investment Policy Statement from an Advisor's Perspective

Estate Planning Council of Greater Miami

April 21, 2016

Presenter:

Linda Lubitz Boone, CFP®

President, The Lubitz Financial Group

Learning Goals for Tonight

- Many of you may serve as trustees for your client's trusts or serve on Investment Committees for Not-For-Profits. You will learn how to be better in these roles.

- To give you the tools to be able to examine an investment policy statement that has been given to you by your client's Investment Advisor and to know if it meets the Uniform Prudent Investor Act, if the IPS is for a Trust.

- To give you the tools as an **investor yourself**, to know if the IPS given to you by your Investment Advisor is truly transparent and appropriate to **your** situation. And it is my contention that if you are hiring someone to manage your personal investments and they do not manage and communicate with you through an Investment Policy Statement you are not being well served. If an IPS is required under UPIA and UPMIFA, why not for you as well?

Speaker's Background

Linda Lubitz Boone, CFP® is a practicing financial advisor for over 20 years. She has been recognized by numerous major financial publications as a leading financial advisor and has served the profession as a member of the FPA National Board of Directors.

She has published and produced the following:

- "Developing an Investment Policy Statement for the Qualified Plan"—April, 1992
- A software joint venture with Ibbotson "The Investment Policy Statement Guidebook"—1996 to 2001
- Her first book — Creating an Investment Policy Statement: Guidelines and Templates-- FPA Press 2004
- Leading edge software for professionals - IPS AdvisorPro® was released—April, 2006 and was named "Best Software Product of 2006" by Morningstar. Now part of the fi360 family.

The usefulness of an investment policy depends on the clarity and rigor with which investment objectives and the policy guidelines established to achieve those objectives, are stated."

- Dr. Charles Ellis
  "The Investment Policy: Winning the Loser's Game"

CFA whitepaper *"Elements of an Investment Policy Statement for Individual Investors"*

- "Perhaps most importantly, the IPS serves as a policy guide that can offer an <u>objective course of action to be followed during periods of market disruption when emotional or instinctive responses might otherwise motivate less prudent actions."</u>

- **"The IPS is a highly customized document that is uniquely tailored to the preferences, attitudes, and situation of each investor.** Templates that purport to offer convenience and ease in development of an IPS almost inevitably sacrifice consideration of factors that are highly relevant to the investor. The investment professional must thoroughly understand the investor's objectives, restrictions, tolerances, and preferences to be able to develop a truly useful policy guide."

Review:
What are the Principles of the Uniform Prudent Investor Act?

- The **fiduciary** has the duty to manage that investment assets considering the **purpose, terms, distribution requirements** and other circumstances of the Trust.
- The needs of the **current beneficiary and the remainder beneficiaries** must be considered as equal
  - This is often one of the biggest conflicts in the management relationship. I am sure we all have stories about this predicament.
- The **risk and return objectives** should be suitable for the trust
- There is a duty to have an investment strategy that **produces income and at the same time factors in safety of capital**
- The **delegation** of investment and management functions is permitted and encouraged

- The standard of prudence is applied to any investment as ***part*** of a total portfolio rather than to the individual investment alone

- Sound **diversification is fundamental** unless deemed to harm the investor/beneficiaries

- Factors such as inflation, tax consequences, expected total return, general economic environment and **attention to reasonable costs must be considered**

- The prudent investor rule is a test of *conduct* and **not** of resulting performance
  - **And I think that this is the most IMPORTANT role of the IPS. To keep investors from making big mistakes because they don't follow sound investment principles.**

A quick review – What is the purpose of an IPS?

- Establish a clear understanding of all involved parties in regard to the philosophies, policies, investment objectives and parameters that will guide the parties

- Establish an appropriate target asset allocation and rebalancing procedure, suitable to investor's risk tolerance and circumstances

- Define and assign responsibilities of all assigned parties

- Establish a relevant time horizon

- Establish a basis for evaluating results

- Establish a methodology for hiring/firing investment professionals

- Offer guidance and limitations to all investment managers regarding the assets to be managed

- Establish acceptable levels of communication and reporting

- **But the principal reason is to help you adhere to long term policy when "Mr. Market" makes current markets most distressing and your long-term policy suddenly seems in doubt**.
  - Why is it we don't want to buy stocks when they are "on sale" and wait until the price goes back up and then buy?
  - Jason Zweig "If we shopped for stocks the way we shop for socks, we'd be better off."

Client Specific Issues in an IPS – These change from client to client

- Goals—Return and Cash Flow
- Downside Risk – How do you measure risk?
- Asset Class Interest & Understanding
- Limits or Restrictions
- Asset Allocation
- Diversifying Concentrations
- Tax Concerns
- Expected Additions or Withdrawals (Spending Policy)
- Time Horizon
  - To achieve goals
- Reserves or Liquidity Needs

The Advisor/Firm's Policies and Practices

These are generally standardized for all clients

- Stocks, Mutual Funds/ETF's or Separate Accounts
- Investment Strategies/Third Party Managers
- Passive vs Active
- Re-balancing Approach
- Timing or Tactical Moves
- Location of Assets by Account Type – not an issue in Trusts, but VERY important in individual portfolios
- Client "Play" Accounts or Other Investments
- Tax Management Strategies
- Timing to review and evaluate investment managers
- Monitoring
- Reporting and Disclosures

Comparison of Key Issues between Individuals and Trusts/Institutional Clients

	Individuals	Institutions
Return needed to achieve goal	X	X
Risk Tolerance, Time Horizon, Cashflow needs	X	X
Emotional & Herd Instinct Motivations	X	X
Asset Allocation Considerations	X	X
Most recent performance impacts on current decisions	X	X
Tax Concerns (ST vs LT Gains/Losses)	X	
Stage of Life Issues	X	
Investment Committee Considerations		X
Needs of organization, plan, beneficiaries		X
Custodian, Administrator, Trustee, Actuarial considerations		X
Fiduciary Issues and Regulations		X

Sample Table of Contents

What are some of the additional issues to consider in IPS creation and Investment Management

Risk Tolerance

- What does risk mean to you?

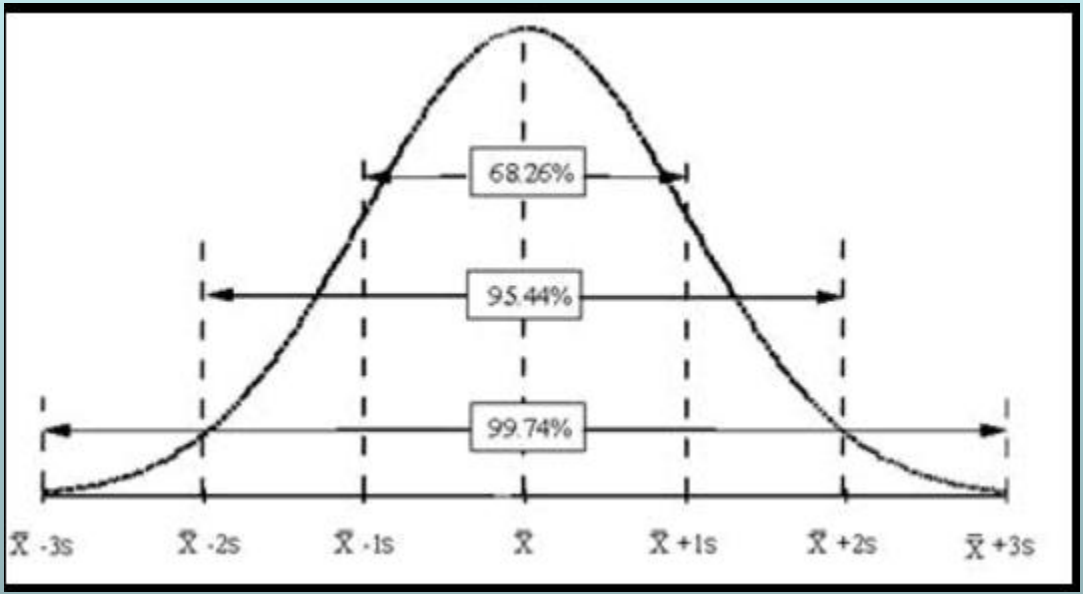
Price risk – price of the investment goes down
Interest rate risk – market value will change, income will be impacted
Inflation risk – loss of purchasing power robs your value
Business/default risk – Company goes bankrupt
Short term/long term risk – forced to sell when market is low/investment risk drives returns
Maalox moment risk – at what point will you lose confidence in the investment policy and sell out
REAL RISK – running out of money-not reaching your goals

Investment Goals

- Specified rate of return –
  - Use Nominal or Real Rate of Return?
    - Recommend have BOTH
  - Stated pre- and post-investment fees
- Returns to be measured against
  - Benchmarks appropriate to the portfolio
    - Not just the S&P or 60/40 allocation
  - Degree of risk taken:
    - Alpha, Beta, Standard Deviation, Sharp Ratio
  - Performance relative to similar managers
    - For what periods?
    - How long do you give them before they return to "respectability"?

Volatility range in the IPS?

- How much discretion are you giving your investment manager in determining the asset allocation?
  - Market timer (Tactical) or Capital Market Projections (Strategic)
- Look at portfolio volatility both as a % but also as dollars.
  - Fear of Black Swans (monthly decline of 20% or more)

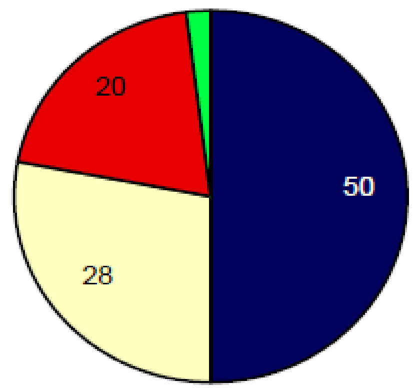


Asset Allocation

- Targets are points, with rebalancing or a range?
- How often should the Asset Allocation be changed?
- Why should it be changed?

Asset Allocation Table

Category	Holdings	%	% Range	Chart
Money Market/Cash		**2.00%**		
	Cash Equivalents	2.00%	1.00% - 3.00%	
Fixed Income		**28.00%**		
	U.S. Bonds	16.00%	13.00% - 19.00%	
	Multi Sector Bonds	10.00%	8.00% - 12.00%	
	Foreign Bonds	2.00%	2.00% - 2.00%	
Global Equity		**50.00%**		
	Foreign Equities- Developed Markets	14.60%	12.00% - 18.00%	
	U.S. Equities - Large Cap	13.50%	11.00% - 16.00%	
	U.S. Equities - Small Cap	9.00%	7.00% - 11.00%	
	Foreign Equities - Emerging Markets	7.90%	6.00% - 9.00%	
	Tactical	5.00%	4.00% - 6.00%	
Real Estate/Alternatives		**20.00%**		
	Real Estate/Alternatives	20.00%	16.00% - 24.00%	



Spending policy How defined/calculated?

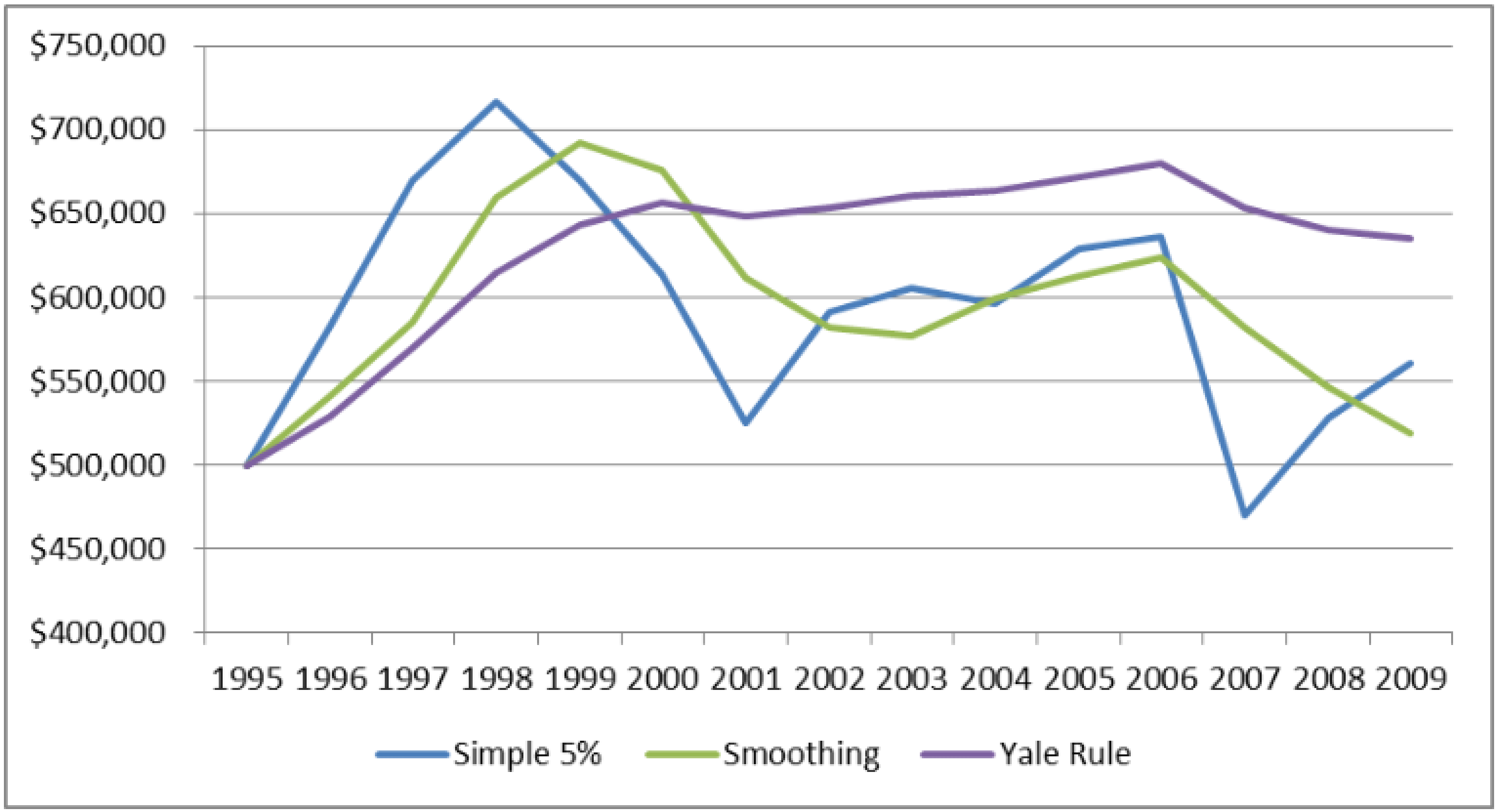
- There are many methods of Calculation of Spending Policy for beneficiaries
  - **Simple –** typically a flat amount of percentage applied to the market value of the portfolio.
    - **Pro:** good for preserving principal **Con:** highly volatile $$ distribution
  - **Inflation-based –** similar to Simple but apply an inflation adjustment
  - **Smoothing –** based on moving average; most commonly used are
    - Average of moving average of prior 12 quarters, measured annually
    - **Pro:** stability of cash distributions **Con:** tend to overspend in down markets and underspend in upward trending markets
  - **Hybrid –** called Tobin Rule
    - Distribution = 80% (Prior year distribution, increased by inflation) + 20% x [4.5% (Spend rate) x Market value of portfolio]
    - **Pro:** Combines 2 spending policy formats and allows for greater flexibility **Con:** more complex and committee must determine the optimal balance

REMEMBER MANAGEMENT FEES ARE PART OF THE DISTRIBUTION %, CLIENT GETS WHAT IS LEFT AFTER FEES ARE TAKEN.

Varying Results

Historic market data offers a method to evaluate spending policy performance. The chart below illustrates how various spending policies would have behaved over the past 15 years (1995–2009) if the portfolio assets were invested in a 60 percent S&P 500 Index and 40 percent Barclay's Capital US Government/Credit Intermediate Bond Index.

Comparison of Spending Policies from 1995–2009



For illustrative purposes only.

Liquidity

- Cash Flow Needs Planning is required by Trustee/Finance committee (and communicated to manager)
- Minimum level of cash to be maintained
  - “Salary account concept”
- Client’s responsibility to notify Trustee/Advisor if needs change

Specifically addressing Prohibited Assets and Prohibited Transactions

- Specific policy about derivatives—defined, what is and is not allowed
- List of specifically prohibited investments (e.g. venture capital, high yield bonds or directly owned real estate)
- Prohibited transactions (e.g., short sales, margin investing)

- Limitations or issues that are relevant to money management
  - Ultimate taxation in or out of estate
  - Concentrations
  - For taxable clients:
    - Unrealized Capital Gains
    - Marginal rates
    - Tax loss carry-forwards, Alt Min, Other??
  - Process for minimizing taxes
    - Tax loss harvesting
    - Efficient account placement – taxable, tax deferred, ROTH

- Socially Responsible Investment Practices
  - Definition

- Other factors
    - Health
    - Beneficiaries and their needs

Identifying who the decision-makers are

- Couple—can they make decisions individually? For which accounts?
- Committee—who are they (creating a record) and how decisions are formalized

Addressing conflict of interest

- What are conflicts of interest?
- How the Trustee/Committee will avoid

Governance/contractual status

- Any conflict between IPS and Engagement Agreement or Account paperwork (other?)

Allowance of and explanation of Delegation of Authority—to whom and to what extent

- Custodians
- Advisors and/or Consultants
- Bank or other Co-Trustees
- Other specialty experts (e.g. accountants, attorneys, auditors, actuaries)
- Limitations on own committee's authority

Acknowledgment of Fiduciary Status (New DOL Rule fyi)

Responsibilities (matrix of parties and needs and involvement in each)

- Advisor and/or Consultant
- Fund/Money Managers
- Discretion—who? For what? Any limitations?

Review and Evaluation—Consultant, Managers

- Process
  - Frequency; who is involved?
- Criteria
  - Use a standard Request for Proposal for consistency
- Termination criteria

Resources

- Creating an Investment Policy Statement: Guidelines and Templates by Boone & Lubitz, FPA Press, 2004
- Investment Policy: Winning the Losers Game, Charles Ellis, Irwin Publishing, 1992
- The Management of Investment Decisions, Trone, Albright & Taylor, McGraw-Hill, Irwin Publishing
- Foundation for Fiduciary Studies
- CFA Institute
- Investment Management Consultants Association (IMCA)

APPENDIX

- Investment Committee Best Practices
- Sample Investment Policy Statement for a Trust
- Questions you should ask when interviewing an Advisor and Fiduciary
- Family Foundation Article
  "Endowment and Foundation Committees and Investment Policy Statements: What Do You Need To Know?"
  by Linda Lubitz Boone, CFP® & Norman M. Boone®, CFP

Thank you for your interest. Please call us if we can be of service 305 670-4440

Linda Lubitz Boone, CFP®; Jorge Padilla, CFP®; Philip Herzberg, CFP®,CTFA,AEP®, MSF, Clint McCalla, CFP®, MS, and the Team at The Lubitz Financial Group

The Lubitz Financial Group Team (L-R): Jorge Padilla CFP®, Madeline Jusino, Philip Herzberg CFP®, CTFA, AEP®, MSF, Linda Lubitz Boone CFP®, Joshua Davison, Clint McCalla, Nancy Mele, Ellen Soto

Best Practices for Investment Committees

- Has a charter outlining roles and responsibilities of each party
  - Act as fiduciaries, not investment managers
  - Members should be chosen for their expertise
  - Avoid conflicts of interest (at minimum, acknowledge them)
  - Terms should be finite, but allow for valuable familiarity
  - Clarify and communicate committee member responsibilities and potential liabilities

Best Practices for Investment Committees

- A clear investment strategy based on reasonable assumptions about risk and return
  - Committee's responsibility—to determine how to invest and who is to do it
  - Keep spending needs in consistent relationship to portfolio management
  - Base spending on actual returns, not expected returns

Best Practices for Investment Committees

- Straightforward and clear process for hiring and firing managers to implement the strategy
  - Use consistent approach, which should be outlined in the IPS
  - Criteria for selection
    - Performance (should only be one part of criteria); focus on long-term
    - Nature of team and how they work
    - Philosophy
    - Investment Process
    - Fees
  - Make clear to managers the role their portfolio is expected to play—their assignment

Best Practices for Investment Committees

- Spending decisions are central to investment management process
  - How much?
  - Most frequent: % of assets (usually of moving market values)
  - Flat dollar, adjusted for inflation
  - Is volatility of spending amount an issue?
  - How reliant is organization on the funding provided?
- Common Sense and Discipline

Best Practices for Investment Committees

- A recognition that investment theory often conflicts with behavioral tendencies (which requires investment committees to be disciplined and stay focused on investment goals)
- Willingness for committee members to challenge and debate issues at hand; use of facts and data rather than strong opinions to make decisions
- Continued effort to build constructive relationships with relevant parties and hold positive, helpful discussions among them