10 Most Important Things to Have In Your IPS

Investment Policy Statement

In partnership with:
Roger L. Levy, LLM, AIFA®, of Cambridge Fiduciary Services, LLC

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IPS... It's Pretty Simple

It's pretty simple when you think about it. You wouldn't start a business today without first having a written business plan. The same is true for managing an investment portfolio.

Whether the portfolio is owned by an individual, a trust, foundation, retirement plan, or other institution, a disciplined investment approach is required to achieve successful outcomes and a plan must be established to guide the investment process.

This plan, the Investment Policy Statement (IPS), must be carefully crafted to ensure that it reflects the client's intent and because the actions taken by those responsible for the investment process will be judged to some extent by the requirements stated in the IPS.

"Hell, there are no rules here. We're trying to accomplish something."

-Thomas Edison

Edison wasn't an investment advisor, but these words come to mind when reviewing how some investment portfolios are managed.

Take it from a pro.

Roger Levy, LLM, AIFA®
CEO of Cambridge Fiduciary Services, LLC

Roger is a friend of the **Blueleaf.com** team.

He has **25+ years experience** guiding fiduciaries, including investment advisors, with their fiduciary obligations and building due diligence records of their investment process. As a CEFEX Analyst, he offers fiduciary consulting and assessment services.

» **Questions** are welcomed at
rll@cambridgefiduciaryservices.com

"The IPS is particularly important to the investment advisor because it will set expectations governing investment performance and set the boundaries for permitted investments and strategies. This can be very helpful for resolving differences of opinion, for example, when an investment committee member is urging action outside the IPS guidelines. The IPS is also an opportunity to document that the investment process will be managed in accordance with the applicable fiduciary standard.

"Although the IPS must reflect the client's intent, you, as the advisor, should take the lead in preparing the IPS and in suggesting the topics to be included. The client's legal advisor should also be consulted. While there are no specific legal requirements for what an IPS should contain, it must be consistent with applicable laws, such as ERISA, UPIA, UPMIFA and UMPERSA[1], and with controlling documents, such as a trust agreement, foundation charter, or retirement plan. For a mature portfolio, also look at prior investment committee minutes (if applicable), service agreements, investment reports and other documents that reflect past decisions and how they were made and implemented.

"With those considerations in mind, the following[2] are the 10 most important things to include...

[1]The Employee Retirement Income Security Act of 1974 governing retirement plans; the Uniform Prudent Investor Act, a state law governing private trusts; the Uniform Prudent Management of Institutional Funds Act, a state law governing foundations, endowments and government sponsored charitable organizations; and the Uniform Management of Public Employee Retirement Systems Act, a state law applicable to state, county and municipal retirement systems, adopted in Maryland and Wyoming only.
[2]This Checklist has been partially derived from the handbook, Prudent Practices for Investment Advisors, published by fi360.

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10 Most Important Things to Have In Your IPS

1. Identify Those Involved In The Investment Process and Describe Their Roles

Start with a list all those who will play a role in the investment process and identify their responsibilities. In so doing, distinguish between parties who are fiduciaries and those who are non-fiduciaries. For example, you, as the investment advisor, are always a fiduciary. Your client, unless an individual, will likely be a fiduciary too, as in the case of the investment committee of a retirement plan, endowment of foundation. Record-keepers and third party administrators are generally not fiduciaries as their functions tend to be ministerial. Custodians are not generally fiduciaries either, unless they exercise some discretion or management over the assets entrusted to them, such as occurs when securities lending is permitted. Note that, where a party has a fiduciary role, it is good practice to obtain acknowledgment of that party's fiduciary status in writing. For service providers, this can be addressed in their contract.

Where an investment committee is authorized to make investment decisions, confirm the committee's authority by reference to the plan document or board resolution. The IPS should then identify the committee's composition and functions. Its meeting requirements and other operational guidelines should be included but a better practice would be for the committee to adopt bylaws governing the committee's operation.

With large portfolios there may be a need to engage separate account managers. If so, investment guidelines will be required for each manager upon engagement and care must be taken to ensure that such guidelines are consistent with the IPS. Further, contracts with separate account managers should require the managers to adhere to the IPS.

This raises the topic of "outsourcing" by which a client delegates to an investment advisor discretionary authority for all or part of the investment process. This has gained popularity today among some retirement plans, foundations and endowments as a means of making the investment process more nimble by removing the investment committee from the decision process. Accordingly, if your firm is to be granted discretionary authority over some aspect of the plan's investment process, such as asset allocation, and investment manager selection and replacement, the scope of that authority should be described in the IPS as well as in your service provider agreement.

2. Describe The Investment Objective

At the core of an investment objective lies an understanding of the client's time horizon and risk tolerance.

- The time horizon will vary based on the type of client and cash flow needs. For example, a client who is an individual will have a different time horizon and different cash flow requirements compared to a pension plan, which has long term needs and cash flow requirements based on actuarial assumptions. The IPS should describe the relevant considerations.

- Investment risk takes many forms but is typically measured in terms of volatility of returns or standard deviation. For many clients, identifying their tolerance for negative returns over a market cycle may be the best measure.

The investment objective articulated in the IPS will provide guidelines for portfolio construction and the benchmark for monitoring investment performance. The investment objective can be described in terms of maintaining purchasing power as measured by the Consumer Price Index. For pension plans, the actuarial investment and salary rate assumptions may be referenced. Foundations and endowments will take into account their particular spending rate.

In the case of defined contribution plans which are participant directed (an ERISA 401(k) plan for example), a plan level investment objective is inappropriate, since it is up to the plan participants to decide for themselves the levels of risk and return which they need to achieve retirement income security. Accordingly, the objective stated in the IPS should be to offer an array of investment choices that allow participants to construct portfolios meeting different risk and return objectives, while providing methodologies to minimize large losses.

Where custom portfolios are offered as investment choices, perhaps constructed of other core investment options, an investment objective should be stated for each such portfolio so that it can be clearly communicated to the participants. Investment objective guidelines should also be stated for target date funds (TDFs).

3. Identify Acceptable Asset Classes

From a fiduciary perspective, asset allocation should conform to generally accepted investment theories. Modern Portfolio Theory, despite recent criticism, has been validated by regulation and court decisions on the basis that it recognizes the relationship between risk and return, the historic return of different asset classes and the importance of diversification. Because of the complexity of asset allocation, it is important for you, as the investment advisor, to explain to the client the asset allocation strategy which you recommend. This will allow the client to gather appropriate information to evaluate and subsequently monitor your recommendation.

In terms of the IPS, permitted asset classes to be included in portfolio construction should be described. Traditional asset classes have consisted of cash equivalents, fixed income and equity securities. These are often sub-characterized: between large-cap, mid-cap and small-cap for equities, and government and corporate bonds, say, for fixed income. The use of non-US investment markets should also be described.

Today, it is common to add "alternative" assets to portfolio construction, such as real estate, hedge funds, private equity and commodities to increase diversification. However, not all asset classes are suitable for every client - alternative assets tend to be illiquid and to involve higher fees - and it is important for the client to understand why a particular asset class is to be included.

Asset class selection will also be impacted by the size of the portfolio, the sophistication of the client, investment costs, the desire for socially responsible investments, and the ability of the client to intelligently monitor performance.

Having identified permitted asset classes, the IPS should identify the percentage guidelines that may be allocated to each class. In order that the IPS does not require amendment when changes to asset allocation are made, a target allocation should be identified within a permitted range for each class.

Further, the IPS should address rebalancing procedures for when the investment environment causes an approved allocation to change.

4. Describe Permitted Investment Vehicles

The IPS should describe what vehicles may be used for portfolio investments. The most popular investment vehicles today consist of separate accounts, mutual funds, collective trusts, limited partnerships and exchange traded funds (ETFs). In describing permitted funds, mention should be made of the use of passive and/or active management.

For large portfolios, investment in individual equity and fixed income securities can be permitted, with management entrusted to an independent asset manager. The IPS should impose restrictions on the amount that may be invested in a single issuer and security, the minimum required market capitalization, and the minimum quality rating that would apply to bond purchases.

If the client contemplates the use of hedge funds or private equity funds, the IPS should describe the fund category to be considered. If consistent with the client's philosophy, the IPS should also impose guidelines and/or restrictions on the use of options, futures, leverage, contra parties and other derivatives and on the use of securities lending, noting that some of these strategies are inherent in some mutual funds and ETFs.

Note that for retirement plans, ERISA provides relief from fiduciary responsibility for investment decisions (not from oversight responsibility) made by an "investment manager" engaged by a plan under ERISA § 3(38). Such a manager must be appointed by the plan's "named fiduciary", typically the board of directors or investment committee. Additionally, the manager must be a bank, insurance company or registered investment advisor and acknowledge fiduciary responsibility in writing to the plan. There is a large universe of separate account managers who conform to these requirements but many have minimum investment requirements which put them beyond the reach of small plans.

Note also that ERISA places restrictions on the use of employer securities and employer real estate as plan investment options.

5. Identify Investment Selection and Monitoring Criteria

Selection Criteria

It is a fiduciary responsibility to perform due diligence when selecting an asset manager, whether a separate account manager, mutual fund, commingled trust or other investment vehicle. In order that ultimate selection fulfills the client's investment objective within the bounds of prudence, criteria must be established to guide the selection process. For the purposes of this Checklist, the term "manager" is broadly used to describe a separate account manager, mutual fund, collective trust or other vehicle.

Typically, selection criteria will focus on the following:

- Investment performance relatives to peers and benchmarks
- Consistency of style
- Investment Manager team tenure
- Minimum assets under management for liquidity
- Absence of regulatory issues or litigation affecting peer performance or management
- Timeliness and accuracy of investment reporting according to Global Investment Performance Standards
- Back office function substantiated by SSAE 16 or similar report
- Fair and reasonable investment costs
- Evidence of conformity with fiduciary best practices

For participant directed plans, special attentions should be paid to the selection of TDFs because of differences in their style, construction, performance, glidepath and cost. The US Department of Labor (DOL) has issued some guidance on this topic (Target Date Funds –Tips for ERISA Plan Fiduciaries – February 2013) and their comments should inform the selection criteria in the IPS. The following would be among the criteria on which to focus:

- TDFs' objective – long term growth/ capital appreciation
- Glidepath suitability – the role of equities and the pace of change in allocation
- Suitability of TDF series based on current and historic participant demographics and/or average risk tolerance assessment
- Investment strategy –strategic/tactical asset allocation and asset class selection
- Use of passive/active management
- Underlying funds structure – mutual funds/collective trusts
- Fees and expenses of TDF and underlying funds
- Proprietary versus nonproprietary funds
- Availability of custom portfolio
- Participant Communications strategy and available material

Monitoring Criteria

Equally important to a prudent investment process and meeting one's fiduciary duty is the periodic monitoring and documenting of investment performance. As with the selection process, establishing expectations in advance will aid you and the client in evaluating investment performance.

In the case of separate account managers, it is also good practice to explain to them in advance of engagement the monitoring criteria to which they will be subject. This will establish for the benefit of all involved confidence in the manager's ability to comply.

Monitoring criteria will include:

- Applicable benchmark indices
- Applicable peer groups
- Performance expectations compared to peers, benchmark and indices (on a risk adjusted basis, if desired)
- Investment performance comparison periods, e.g. one, three, five and ten year
- Absence of adverse changes in the manager's organization, staff or investment process, including acquisitions and divestitures
- Continued absence of regulatory and legal issues

If target date funds have been selected as investment options, additional monitoring criteria may be required in accordance with the DOL guidance previously mentioned. While the foregoing criteria cover most of the important TDF issues, particular attention should be paid to whether any significant changes have occurred in the TDFs' characteristics compared to when they were first selected.

6. Define Investment Watch List and Replacement Criteria

The IPS should define what action is to be taken if investment performance does not meet expectations. Clients need to know when it is time to replace a manager. This is not a simple matter but establishing "watch list" procedures will facilitate the process. Such procedures should reflect what level of negative performance will trigger watch list treatment and what period of time should elapse before negative performance triggers replacement.

Some advisors have created proprietary methodologies to perform this evaluation. If so, as a practice note, it is important for the client to understand how the methodology functions so that the client may make an informed and reasoned decision when you make a replacement recommendation. The IPS may also provide for automatic replacement searches in particular circumstances to counterbalance the glacial speed with which some investment committees deliberate.

7. Identify QDIA and Establish "Safe Harbor" Protection for ERISA Plans

ERISA imposes the highest fiduciary standard recognized by law. It also provides a number of mechanisms for plan fiduciaries to mitigate their fiduciary exposure. It is sound practice for plans to take advantage of these mechanisms, sometimes referred to as "safe harbors", and the plan's intentions should be reflected in the IPS. One mechanism has already been noted in relation to the appointment of an "investment manager". Principal among others that should be referenced in the IPS are the following:

A. Qualified Default Investment Alternative

Often, plan participants fail to make investment designations for their contributions. In the past, some plan sponsors directed such contributions into the plan's money market account as a "safe investment". Since such an investment, while "safe", is unlikely to yield a meaningful return, the DOL has adopted regulation under the Pension Protection Act of 2006 (PPA) to provide plan sponsors with relief from fiduciary responsibility when a default investment alternative selected by the plan sponsor meets certain requirements (29 CFR 2550.404c-5, October 24, 2007). Accordingly, if a 401(k) plan wishes to select a default investment alternative that qualifies for fiduciary relief under the PPA, that selection should be identified in the IPS with an explanation of how the alternative meets PPA requirements as either an aged-based life cycle or target date fund, a risk based balanced fund, or a professionally managed account.

B. Participant Fiduciary Advisor

Generally, under ERISA, a prohibited transaction arises when an investment advisor to a retirement plan provides investment advice to participants and charges a fee in addition to fees charged for advice to the plan. Under the PPA, exemption from a prohibited transaction is provided for participant advice arrangements if they meet the requirements of DOL regulation under the PPA (29 CFR 2550.408g-1, October 25, 2011). Accordingly, if a plan intends to offer an "Eligible Advice Arrangement", that intention should be reflected in the IPS together with a requirement that the arrangement shall conform to the PPA, including its audit requirement.

C. ERISA § 404(c) Relief

Generally, participants in a participant directed investment account plan are responsible for directing their own investments by making selections from the plan's investment alternatives and directing their contributions to the funds they have selected according to their own allocation strategy. ERISA § 404(c) regulation (29 CFR 2550.404c-1) affords plan fiduciaries relief from liability for losses incurred by plan participants by reason of their own investment decisions, provided that the plan meets a variety of administrative and investment requirements. One requirement is that participants should be informed that it is the plan's intention to seek this safe harbor protection. Accordingly, the intention to conform to ERISA § 404(c) should be stated in the IPS. Note that the information requirements of § 404(c) have been expanded by new ERISA § 404a-5 regulation (29 CFR 2550.404a-5) and that such disclosures are now required as a fiduciary responsibility.

8. Describe Criteria for Selecting & Monitoring Service Providers

A fiduciary's duty to perform selection due diligence and monitoring extends beyond investments. Fiduciaries must also exercise prudence when selecting service providers such as recordkeepers, administrators, consultants, actuaries (defined benefit plans) and custodians.

Accordingly, the IPS should identify the criteria that will apply to their selection, including:

- Years in business
- Staffing
- Reputation
- Ability to service the account in relation to client needs
- IT capability
- Availability of bundled/unbundled services
- Fees and expenses
- Industry accreditations
- Business interruption contingency plan
- Data breach prevention and response capabilities

In terms of monitoring, the IPS should state the frequency with which services and costs will be evaluated and how they will be benchmarked against those of other providers. The IPS should also address whether a RFP process is to be employed after an engagement has continued for a certain number of years.

9. Establish Procedure for Controlling and Accounting for Costs

It is an important fiduciary responsibility to pay only those costs which are necessary and reasonable. The IPS should establish procedures for accounting for all fees and expenses and provide for a cost review no less frequently than annually.

Typically, such costs include money manager fees and/or mutual fund expense ratios, consulting fees, administration costs, trading costs and custodian fees. Note that for ERISA plans with self-directed participant investment accounts regulation now requires detailed disclosures to plan participants of both administration costs as well as investment costs. Procedures should be in place to ensure timely disclosure.

10. Establish Procedure for Disclosing and Managing Conflicts of Interest

A common source of fiduciary breach involves self-dealing and conflicts of interest. A conflict may be viewed as an occurrence or circumstance that interferes with performance of a fiduciary duty. Clients who are individuals will want to be sure that you, as the investment advisor, are conflict free and that the same applies to other service providers. Clients who are foundations, endowments or retirement plans may encounter additional conflicts of interest, such as those that may arise between the organization and members of the investment committee.

The IPS or the investment committee's bylaws, if adopted, should require committee members to disclose conflicts of interest to the committee and abstain from voting on any matter where a conflict exists. If you, as the investment advisor, have any conflicts of interest, for example if variable compensation is earned, such conflicts will be disclosed in your service agreement and Form ADV Part 2.

The IPS should require that the issue of conflicts is to be considered before engaging any other service provider and that service agreements should disclose any conflict to which a service provider is subject.

"I have not failed. I have just found 10,000 ways that won't work."

-Thomas Edison

Avoid another 10,000 tries. Follow these 10 steps and just remember, IPS: It's Pretty Simple.

Conclusion

As we have seen, the IPS addresses a number of important issues that govern the investment process. There are more elements to consider for institutional clients than in the case of a client who is an individual, because of the fiduciary role played by the institutional client's investment committee, or trustee(s) in some cases. Irrespective, the IPS should be reviewed at least annually to confirm that the investment process is being managed in compliance with its terms and to test whether any change in circumstances requires a change in the IPS.

Finally, innovation in the investment world is a continuous process with new products and strategies constantly emerging. As an investment advisor, you undoubtedly keep abreast of new opportunities, like Blueleaf's easy-to-use account aggregation and client portal, and consider how they may benefit your clients.

It is important to keep the client's IPS in mind when bringing innovation to a client's portfolio. The IPS helps to keep the parties on course and to ensure that, when properly articulated in the IPS, the investment process conforms to an appropriate fiduciary standard of care.

For individual assistance **writing or reviewing your IPS**, contact Roger directly at:

rll@cambridgefiduciaryservices.com

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