Transcript

Better conversations. Better outcomes.

Episode 80 – The do’s and don’ts of investment policy statements

Derek Sasveld - You can have an investment plan that you well understand as an investor, without an investment policy statement. But when bad things happen, or when you need to make adjustments, or when you need to have a discussion with your advisor or other people about whether you're making progress to your goal, it really helps to have. Because it's like going on a trip without a map or making a recipe without a recipe.

Emily Larsen - Welcome to *Better conversations. Better outcomes.* presented by BMO Global Asset Management. I'm Emily Larson.

Ben Jones - And I'm Ben Jones, and on this show, we're going to explore the world of wealth advising from every angle, providing you with actionable ideas designed to improve outcomes for advisors and their clients.

Disclosure - The views expressed here are those of the participants and not those of BMO Global Asset Management, its affiliates or subsidiaries.

Emily Larsen - Investment policy statements. What are they for? Do you actually need them? And what's the best way to go about creating one?

Ben Jones - It seems like there's a lot of questions that come up whenever you bring up the topic of investment policy statements, especially in the various segments of financial advice. Depending on who you talk with, an investment policy statement might mean different things to different people.

Emily Larsen - We're going to attempt to answer many questions that dispel some myths.

Derek Sasveld - I'm Derek Sasveld. I'm an investment strategist at BMO Global Asset Management.

Ben Jones - When you're out with friends, and you're having dinner or whatever, and they say what do you do for a living, how do you really describe your role?

Derek Sasveld - I basically say, because this is what I do, I help clients understand how we invest and I help our investors understand our clients. I work between our investment specialists and our clients to better understand each other.

Ben Jones - Wonderful. Where do we find ourselves today?

Derek Sasveld - We're in Hong Kong. Oh, no, we're in the Hong Kong room in the BMO Global Asset Management Chicago office.

Ben Jones - Let's start with some of the basics around investment policy statements as a whole, and why you should care about them.

Derek Sasveld - An investment policy statement is a formal document, and it's usually drafted between -- and I'll use these terms regularly during this discussion -- an advisor and a client. That client could be an individual investor, could be a pension fund. The advisor could be an investment manager or a consultant, or a financial advisor. It doesn't really matter, someone who's in an advisory capacity. The purpose of the document is to basically identify the investment goals of the client and the investment plan, or investment strategies that the advisor has chosen to get the client to the goals. At its base level, the investment policy statement really should just be about what the investment policy is. It could even -- I mean, you could make a contract on the back of a napkin in the restaurant. You could do the same thing, theoretically, with an investment policy statement. I think, actually, that the nature of what the investment policy statement is, is not by itself overkill, and I could understand how maybe someone might roll their eyes and say, do I have to write all of this down? But, it doesn't have to be overwhelming in that way, but it clearly can become overkill if there's too much information and someone uses the investment policy statement just to put every item that's relevant in the investment relationship into a document.

Ben Jones - Why is it important to have one?

Derek Sasveld - Well, I think there are probably three reasons why it's important to have one. One is, when there's uncertainty and stress, and in the investment environment there's almost always uncertainty and a lot of stress, it can help keep people on plan, right? That's true for individualists. It's also true for institutions. How do we make decisions when things go badly, right? And under what circumstances might we make decisions, and what governance is in place to do that? It keeps people on plan. Second, you wouldn't hire a babysitter to baby sit your kids, or a contractor to work on your house, without spelling out rules and responsibilities in advance, whether you were doing it verbally or with a document. So, you certainly would want to do this with your money. There's a certain due diligence component to it, I think, that makes that important. Then, as I mentioned earlier, it really helps especially individual investors, but even institutions, to really understand the investment program. It's kind of like, until you try to teach something to someone, you can't really say you know it that well, right? Until you have to write a document or participate in the writing of a document, laying out what the roles and responsibilities, and how the investment program works, it's not really yours until you do that. I think that's kind of cool.

Ben Jones - I think you really see the benefits with the group dynamics that occur at an institutional level of having everyone participate and be involved in the edits and rewrites of those investment policies.

Derek Sasveld - That's true. It's also -- there's plenty of turnover at the institutional level. For individuals, hey, it's my portfolio. Okay, fine, there may be some descendants at some point in time, but that's a very different situation. For a pension fund or for an endowment, there's going to be an investment committee whose membership rotates. Often, the investment policy statement outlives all of them.

Emily Larsen - Whether you're working with institutions or individuals, the IPS is an important way to document goals and the plans to achieve them. Let's dive into the key components of a well-written IPS.

Derek Sasveld - I think there are four components. There are at least especially three, but the fourth, I think, makes the IPS a little bit better. First, there has to be a statement of investment goals or the objective, right? This is the why. Why are we investing? Okay, what is the purpose around which we are investing? Second, the policy portfolio has to be described with performance in its risk characteristics. What are we investing in and what are the risk elements that are going to drive the decision? Third, there has to be a section on performance evaluation, i.e. how does the client and how responsible is the advisor to discuss performance and determine how we are on track? There's also a risk management component to that as well. Then finally, there should be a governance section, which describes who does what. The way I would look at it, that's the why are we investing, the why question. What is the investment approach? How are we actually evaluating performance? Then who does what? Those are the key elements.

Ben Jones - Now, let's break down each of these four components, the why, what, how, and who. We'll start first with why. Why are we investing? AKA, the statement of investment goals.

Derek Sasveld - In that section, usually what is included is some definition of what the accumulation is, and what the purpose of the investment objective would be with regard to purchasing power, providing for a certain amount of assets in over a period of time, providing for certain distribution characteristics, beginning in a certain period of time, and those types of broad parameters of what the long-term reward and what the purpose of using that reward would be.

Ben Jones - And how important is it to lay out context as far as some background, either on the investor or on the foundation, et cetera?

Derek Sasveld - Certainly. I think, actually, context is important. I wanted to keep the number of sections to the IPS that we were discussing at a minimum. Some people include a context section in the beginning as to who this is for, and why this is necessary, and so on. I mean, I could group that with the investment goals or the objective, but certainly some context is helpful.

Emily Larsen - The next component tackles the what. What is the investment approach?

Derek Sasveld - Yeah, I mean, I would call this the investment plan. Some people refer to it as the policy portfolio. Essentially, this is usually some kind of an asset allocation, often with percentage weights. I think it's good to do that in the body of the document and not necessary in an appendix, because it's that central to what we're trying to do. Also, there are descriptions. I think about the treatment of cash and other issues that will continue to come up that need to be described in full. The treatment of cash meaning, say for us since how do we accumulate cash for distribution, how do we deal with cash as it accumulates in the approach, and make sure it's fully invested, the treatment of illiquid assets, for instance, and how that allocation will be built, and then also harvested. Then, sometimes, re-balancing and how re-balancing should be done. Some people look at the investment policy statement and think there should be a dedicated risk management category. I would include those types of issues, like re-balancing and a few other of these issues, in the discussion of the investment plan and the policy portfolio in broad terms.

Ben Jones - The third component is the how. How will performance be evaluated?

Derek Sasveld - Performance evaluate is important. That's the how this is going to be implemented. That's, how do we evaluate active managers if they're chosen in the plan? How will the asset allocation that we've talked about or the investment plan be effected either through passive vehicles or active vehicles. How will we compare a performance to either whether we're on plan for the objective or performance of the vehicles that we've chosen and to determine whether we've made good choices? That's essentially the performance evaluation portion, and there could be a risk management portion to that.

Emily Larsen - The fourth and final component is the who. Who is responsible for which portions of the plan?

Derek Sasveld - The last section, governance, is basically who's responsible for what and who approves decisions on what timely basis. For institutions, it's extremely important because their decision-making is done in a very regimented framework usually by a committee, and it's important to set that out in a document like this.

Ben Jones - So, what can make a bad investment policy statement versus a good investment policy statement?

Derek Sasveld - One main message I have for people authoring investment policy statement is not to put too much information in them and not to get too specific, because the purpose is to describe in general terms what the investment plan is and how it's going to work.

Ben Jones - So, given kind of the constantly changing market dynamics, and the rest of the economic environment, how much flexibility or how specific should you build these statements?

Derek Sasveld - I think it's okay to actually have target weights. If you want a range for an asset allocation, I think that's probably a little bit better, where the midpoint of the range would be probably your target weight. It's important, I think, to specific that you probably should re-balance at the very least, or re-allocate when you have a certain amount of drift away from an identified weight. It's not that there shouldn't be a plan, or that as sort of an asset allocator or multi-asset person, I don't think it's important to express your discipline in a manner that restores the allocation that you thought was important in the first place. However, there are costs to doing all these things and it's good to have the objective in the investment policy statement to be on plan, but given that there are costs and there are implementation issues, there can be a best effort made to get closer to what that percentage might be without having to do extraordinary things to make that happen, okay. I also think that, just in generic terms, if you're making a description of how you are going to implement the investment plan by selecting managers, evaluating managers, and so on, it's entirely appropriate to have another document where that's done in a great deal of detail, but to describe how managers are selected as essentially a process that the advisor will undergo. I don't think it's necessary to engage in a great deal of blocking and tackling on every decision that might possibly be made in the investment relationship. That flexibility is of value to the advisor, and net of cost and other things, it's also a value to the client.

Ben Jones - I've often heard people say that it's better not to have an investment policy statement than to have one and not follow it. Are there bad IPSs, or are there pitfalls to IPSs that people should be aware of?

Derek Sasveld - There are pitfalls. I mean, I like the process of establishing an IPS. I think that's a good conversation to have, because it's a conversation about goals, and what the investment plan is, and so on. So, it's hard for me to think about an IPS necessarily as a bad thing, but there are certainly bad IPSs. I think investment policy statements that are not relevant to client investment objectives are bad. What do I mean? I worked with a family office and they had just hired a CIO who was a mortgage trader at Goldman Sachs, and they called me in to sort of take a look at the investment policy statement that he had written, and it was like -- it was a manifesto of his investment beliefs, okay. It was like 50 pages and highly detailed. It's like, that's fine, he wanted to demonstrate to his new employer that he was a very competent and detail-oriented investment professional, but it didn't have anything to do with the family.

Ben Jones - Got you. Great example.

Derek Sasveld - It's got to be relevant to the objectives, right? There may have been lots of nuggets of great stuff in there, right, but it wasn't an IPS built around objectives. It's not a statement of operational excellence by the advisor. It's not a statement of how to pick managers. It's a statement of the investment policy, and that's a broader type of a characteristic.

Ben Jones - Now, in general from what you've seen, how long is an ideal investment statement? Obviously for an individual, I could see this being less than a page. But for an institution, how long does this document end up generally being?

Derek Sasveld - For institutions, generally they end up being probably 10 pages or maybe a little more, because many of the details are a little bit more fleshed out, and there is just more governance to the governance portion. In other words, how decisions are made and in what timely fashion. One of the beautiful things about individual investors is that they're the decision-maker, right? So, yes, the governance portion has to be attributed to certain amounts of action, but the individual is empowered to do that, so you don't need to specify who does want in that, in an organizational sense. It also has to do with the complexity of the investment portfolio. If the investment plan, or the policy portfolio, has a lot of moving parts, it includes leverage, for instance, or other types of techniques and tools to manage, then you need a little bit longer period to do that, a longer statement to do that. But I think an individual could easily have a page or two to cover the essentials of what the IPS could be.

Emily Larsen - An IPS does not have to be long, complicated, or go through pain-staking revisions to get it right. In fact, the best investment policy statements are simple and effective tools that help create intentional outcomes for clients. Derek illustrated how simple these documents can be with four key components: Why, what, how, and who. What do you do with a finished IPS? How often should you review it? How does the completed IPS help a client succeed?

Ben Jones - Once an IPS is in place, is it done?

Derek Sasveld - To some extent, yes, it's done, because we have an updated version, we've distributed copies to people, we're happy with the result. It's good. It's not done for all time. When I worked at the outsource investment office and we did every one of these investment policy statements for all of our clients, we revisited the IPS every three years, and the investment policy formally every three years. You could do it more frequently, you could do it less frequently. I think one of the neat things about three years is that if you have at least a couple reviews, that would be within -- what I would consider to be an investment cycle for a bull market or a bear market to see itself through, so you'd have a variety of environments to address the investment policy statement, perhaps before or after a major crisis. It could be done more frequently, but also, the capabilities of the advisor and obviously the objectives of the client might change. It is endemic upon the client. The client is involved as a party in this, and is a partner in the IPS, and a truly motivated client may actually force a review of the IPS if something has changed in their circumstances. If they don't do that, the advisor certainly should.

Ben Jones - Okay. In general, things are running smooth. A good practice is every three years. There may be circumstances in which more often, or even randomly, that might need to be revisited. There probably are cases where these can stay in place for many three-year cycles.

Derek Sasveld - That's right. I mean, I once worked for an endowment that had, I think, virtually the same investment policy statement for a 20-year period.

Ben Jones - Wonderful. What should the committee consider if they're thinking they're going to make a change to the investment policy statement? Right, because I can't imagine that when you get six or seven people together, that everybody just says, yes, we should make a change and of course there's probably no implications of that change, right. So, how do they think through the implications and how do they think through a change itself?

Derek Sasveld - Well, this is a big deal. Sometimes institutionally, this requires a special session of an investment committee and is sort of beyond normal order. You generally hope that isn't triggered by investment market circumstances, because one of the purposes of the investment policy statement is to keep people on track and committees on track with something that they have chosen soberly in a period of low stress. If objectives have changed, clearly that's a trigger for changes to be made to the investment policy statement, and it makes sense if you're thinking of making a change to do it at that point. Obviously, the entire portfolio could be re-thought as a result. I think it's always a good question to ask, is is the level of risk that we've chosen appropriate for us? During the course of the experience, especially with individual investors, but also with the committees. People learn things about themselves, right? They learn what kind of risk they truly can tolerate once there's real money involved and they've embarked on an investment program. If they've learned something about that, they can revisit the investment policy for that reason. The scope of investments, I think, is always reasonable. Someone may learn, or the markets may offer a new opportunity for a certain type of investment that wasn't originally considered. The danger of that, of course, is that you could have a cocktail party effect where someone is comparing themselves to their neighbors or their peers, and that restlessness could be uncomfortable and could lead to a sub-optimal decision to include something in an investment policy that shouldn't be there, or was determined that was not appropriate, and still remains not so. But it's still good, I think, to have that discussion about scope. Then eventually what degree of active management do we want is an issue that comes up, I think, pretty regularly these days, and so that can be calibrated. Whether it's involved in manager selection or other decisions that get made within the investment policy that are active.

Ben Jones - How does a good investment policy statement actually help a client succeed?

Derek Sasveld - I think a good example comes from the period during the financial crisis, where a lot of clients who didn't have investment policy statements lost their way, and those that did benefited from some of that discipline. It's not that it's always a super happy ending, but during the financial crisis for instance it's not like everyone was able to take the liquidity they had and re-deploy it to make more money in the future, or enhance their -- to really take advantage of investment opportunities. But especially for defined benefit plans, they were able to pay their benefit because they had sufficient liquidity and we had had discussions about the role of illiquid investments in the total portfolio or we'd had a discussion about the horizon of the investment portfolio and the difference between the assets that they had and the horizon of the liabilities that they needed to meet. During the financial crisis, I think there were a lot of investors that I saw first-hand that benefited from an IPS because it gave them a certain discipline and security in an environment about which we had previously discussed.

Ben Jones - You know, I have to imagine using the financial crisis as an example. There were a lot of individuals who hit the panic button, even though they may have had a conversation with their advisor or had an investment policy statement in place. So, for advisors that are listening this to have investments policies in place with their individual investors, how do they help the client not emotionally blow through that investment policy statement?

Derek Sasveld - Well, there are no guarantees. So the investment policy statement is sort of another safety net, if you want to think of it that way, to keep people from falling through in an environment like that. I think it's important to discuss these things ahead of time, and when going through the construction of investment policy statement, it's not much different than going through a discussion about risk with a client, for instance, where you talk about what kinds of losses the client can absorb, and even occasionally, one thing I used to do in either the construction of an investment policy statement or once a year in client meetings, I would go over a few scenarios about what could happen in risky asset markets. Anyone who’s managing portfolios knows that the stock market can fall at least 10% a year for any reason in any given year. Generally, the stock market has fallen by almost 20% about half the years on record. So there are going to be times when people feel stressed. It helps to warn them ahead of time, and that's part of the process by which you can build an IPS, by talking about risk and talking about expectations, but the job of the advisor is always going to be navigating someone emotionally through a period where they're feeling enormous stress because investment markets have dealt them a blow that they didn't truly expect or hadn't really thought they would encounter. The IPS is not going to be a guarantee against that, but it can help with that discussion and it can help that discussion happen beforehand. I think it's always a mistake to ask a question about an actual event in the history of the advisor/client relationship specifically where there was special consternation. So, yes, the discussion has to be relevant to the circumstances of the advisor and the client, but I think sometimes there are scabs that shouldn't be picked, or if there are certain types of questions asked about certain types of scenarios, that will result in a longer and heavier discussion about issues that are not necessarily relevant to the investment question. So I think that's one. Another would be not to lead the witness right? Advisors have strong beliefs about how clients' portfolios should be constructed, but the best portfolio for the client is the one that the client understands and is comfortable describing. Even though sometimes as investment professionals we want people to have a certain type of structure that we think will lead best for an outcome, it's just best to get the clearest answers we can from them. So even though we want people to go in a certain direction intellectually, I think it's best to ask questions that are most neutral in trying to determine truly what their responses would be under certain circumstances.

Ben Jones - That makes a lot of sense. If you're an advisor, you're doing a lot of work here, how do you see that advisors generally charge for this? Do they charge a la carte? Is it just part of the job they were hired to do by the committee, part of their retainer fee? How do they generally charge for these services?

Derek Sasveld - Institutionally, it tends to be along with the price of service, but these things are changing. So, often an advisor will charge a single flat fee for a variety of things. Individually, I've seen it both ways. For financial advisors and individual investors, I've seen an extra charge for an investment policy statement and I've seen it also included in fees. I just think that although we've talked a lot about how in terms of processes, these should be done and these should be written, and I believe they are important, so some time is appropriate to put into them, this is the type of conversation that I think -- the investment policy statement essentially is a recording of a conversation of a result of a conversation that I think advisors should always have with their clients. In that sense, there may be a way to maybe not make it as intense of a time allocation for that reason.

Ben Jones - So now you put the effort to construct the investment policy statement and you've completed it. I asked Derek what it feels like for clients and advisors alike when this is done well.

Derek Sasveld - If you were to ask a client what that feels like, they'd say my advisor understands me and manages my investments as if they were her or his own.

Ben Jones - How does it feel if you're the advisor to a client and you've got this clear investment policy statement to follow?

Derek Sasveld - Yeah, I would look at it in a similar way, which is the advisor might think of it as if my client understands and appreciates what I do and why it matters for him or her.

Ben Jones - That's pretty rewarding.

Derek Sasveld - Yeah, it's like a wedding contract, kind of.

Ben Jones - Never heard it described that way, I might never use that, either.

Derek Sasveld - Sorry. Feel free to keep or delete.

Ben Jones - Okay, so if you were going to write your own surgeon general's warning for this episode, what does the warning label say?

Derek Sasveld - Properly developed, the investment policy statement can strengthen the client relationship, but it is no guarantee against unhappy or unsatisfied clients.

Ben Jones - How can our listeners follow your insights? You write a lot for BMO, you do a lot of speaking engagements on behalf of our entire team here at BMO GAM. So, how can listeners learn more about you and follow your thoughts?

Derek Sasveld - As a strategist, I'll be creating content, which is writing, video, maybe sometimes specific illustrations about what's happening in markets, describing investment ideas and market insights, and much of what I'm going to be doing is going to be posted on BMO GAM's website. Also, there will be some opportunities to see through my LinkedIn. And also, if anyone who is listening has a relationship with a BMO GAM representative, you can just mention to them that you have an inquiry or a question or a comment and I'll be happy to respond.

Ben Jones - I really sincerely enjoyed the conversation. I appreciate you coming and sharing some of your insights. If you wouldn't mind, we'd love to maybe have you back at a later date.

Derek Sasveld - Sure, Ben, it's been a pleasure.

Ben Jones - Thank you for listening to *Better Conversations. Better Outcomes.* This podcast is presented by BMO Global Asset Management. To access the resources discussed in today's show, please visit us at www.bmogam.com/betterconversations.

Emily Larsen - We love feedback, and would love to hear what you thought about today's episode. You can send an e-mail to betterconversations@bmo.com.

Ben Jones - And we really respond.

Emily Larsen - We do.

Ben Jones - If you thought of someone during today's episode, we would be flattered if you'd take a moment and share this podcast with them. You can listen and subscribe to our show on Apple Podcasts, or whatever your favorite podcast provider is. And, of course, we would very greatly appreciate if you'd take a moment to rate or review us on that app. This show and resources are supported by a very talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gipson, Matt Perry, Derek Devereaux. The show is edited and produced by Jonah Geil-Neufeld and Annie Fassler of Puddle Creative. And these are the real people that make this show happen, so thank you. Until next time, I'm Ben Jones.

Emily Larsen - And I'm Emily Larson. From all of us at BMO Global Asset Management hoping you have a productive and wonderful week.