The Investment Policy Statement (IPS)

Table of contents – Components of IPS

! NOTE !

The investment policy statement (IPS) is critical to the investment management process because it governs allocation of funds to various asset classes, the most important global investment decision

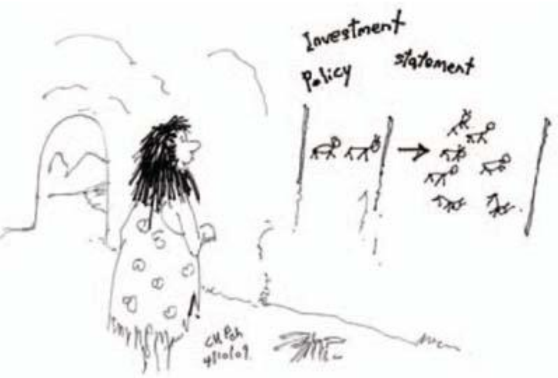
Client Description and Purpose

This section includes:

- Description of the client
- Purpose of the IPS
- It may also address the role of the various participants

! NOTE !

Every IPS must first describe the investor’s current situation which includes his financial status and requirements



Risk / Return Objectives

- This section establishes the **client risk tolerance** and **return goals**
- Some IPSs may specify level of risk and return
- The IPS generally indicates total return measures, but this may be specified differently
- **The IPS must specify whether the required returns are pre- or after-tax, real or nominal**
- The advisor should establish required return versus hoped-for return
- The advisor should **differentiate between client's willingness and ability to accept risk**

Risk Objective

5 steps to determine a risk objective

1) specify a risk measure (or measures) such as standard deviation
2) determine the investor's willingness to take risk
3) determine the investor's ability to take risk
4) synthesize the investor's willingness and ability into the investor's risk tolerance
5) specify an objective using the measure(s) in the first step above

Return Objective

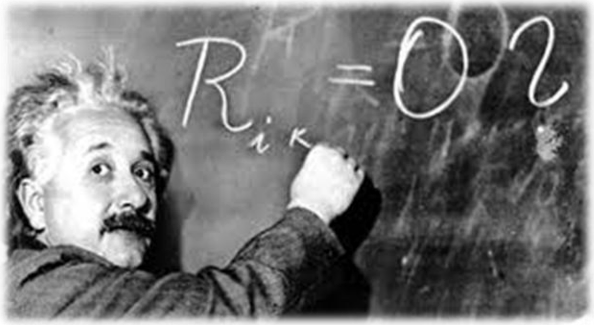
4 steps to determine a return objective

1) specify a return measure such as total nominal return

2) determine the investor’s stated return desire

3) determine the investor’s required rate of return

4) specify an objective in terms of the return measure in the first step above



Constraints

There are usually five categories of constraints:

1. Liquidity
2. Time horizon
3. Taxes
4. Legal and regulatory
5. Unique circumstances

Constraints

1. **Liquidity**

   The client's need for access to funds and the marketability of underlying securities require that cash balances be maintained

2. **Time horizon**

   - The client's time horizon for accumulation or withdrawals may determine the risk tolerance and therefore the allocation strategy
   - The time horizon constraint may be categorized as short term, intermediate term, or long term and as single stage or multistage
   - With sufficient assets and multigenerational estate planning, even older investors may retain a long-term investment perspective

3. **Taxes**

   The client's tax status may require defferentiation between capital gains (lower tax rate) and dividend or investment income (higher tax rate). After-tax return specification make this element of the IPS especially important

   ! NOTE !

   - A tax concern is any issue arising from a tax structure that reduces the amount of the total return that can be used for current needs or reinvested for future growth
   - If differences exist between the tax rates applying to investment income and capital gains, tax considerations will influence the choice of investment

Constraints

4. Legal and regulatory

Legal and regulatory factors are external considerations that may constrain investment decision making

EXAMPLES:

- Legal and regulatory cencerns may exclude the use of certain asset classes such as derivatives
- A government agency may limit the use of certain asset classes in retirement portfolios

5. Unique circumstances

- These are all the others contstraints, such as investors preference, knowledge, and capabilities that may limit the investment universe for the client
- Unique circumstances might include guidelines for social investing, trading restrictions, and privacy concerns.

Asset Allocation Consideration

The IPS may also set asset allocation constraints

1) Decisions on using a balanced or style – specific approach
2) What benchmark to use
3) Asset classes to be considered
4) Exposure limits for certain asset classes

Review and Monitoring

The IPS should include a feedback and control mechanism requiring review, monitoring and rebalancing

The IPS should specify:

The type and frequency of performance measurement	Performance attribution (the sources of the return)	Performance appraisal

To allow the client to judge whether the investement managers are living up to their standards

THANK YOU!