Russell Investments

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Elements of a clearly defined investment policy statement for nonprofits

During the last few years, following the credit and liquidity crises of 2008, endowments and foundations have been reexamining a number of topics, such as asset allocation, portfolio liquidity, and best practices with regard to fiduciary governance standards. Risk management and good governance practices have taken center stage as many such nonprofits struggle with illiquid assets, falling donations, and the inability to meet desired spending levels without drawing from the corpus of the endowment. Central to the idea of good governance throughout a nonprofit's program is an investment policy statement (IPS). The purpose of this paper is to summarize what an IPS is, the elements it should include, and why it is important for a nonprofit to have a well-defined governing document.

An investment policy statement is a client-specific document designed to address the overall policies that govern investment-related activities of the nonprofit.

What is an investment policy statement?

An investment policy statement is a client-specific document designed to address the objectives, constraints, unique circumstances, and overall policies that govern investment-related activities of the nonprofit. The document should set forth clear responsibilities for all parties involved in the nonprofit's investment program – the board of trustees, investment committee, investment advisor/consultant, investment managers, and custodian. A well-constructed IPS will present the portfolio's financial objectives within the context of how much risk the trustees are willing to take on. The long-term strategic asset allocation of the portfolio should be detailed, to help ensure that the portfolio is invested in accordance with the nonprofit's long-term goals. The IPS should also set operational guidelines for constructing a portfolio to carry out the investment strategy. Lastly, the IPS should set forth rules for monitoring and reviewing all facets of the investment program.

Constructing an IPS should be a dynamic process. While changes should be infrequent, the document should be reviewed on a regular basis to ensure that it is current and that all of the language is still appropriate. During the design process or review, a nonprofit should seek input from trusted investment advisors. Working with an investment consultant or advisor can help identify additional risks and issues that may not be top of mind for committee and board members.

Drafting an IPS should be an educational process for the committee. Working through issues in the design process can help identify weaknesses in the committee's current risk management structure and refine the setting of objectives, potential investment strategies, and spending policies. The result should be a portable document that is easily understood by all interested parties. (For example, if the nonprofit retains a new investment manager or consultant, it should not require changes to the IPS solely because a new party is involved.) Finally, the document serves to protect all parties named in it. If a certain practice or investment strategy is subsequently questioned, the IPS can provide clarification.

Well-defined objectives are important to ensuring that the mission of the nonprofit can be carried out.

Why is an investment policy statement important?

A clear, well-defined investment policy statement is important to the success of a nonprofit's investment program, as it plays a vital role in the overall governance structure of the nonprofit. Well-defined objectives are important to ensuring that the mission of the nonprofit can be achieved. Clearly defined objectives set forth in the IPS can help in the determination of appropriate spending rates, to help ensure that future grant making is not impaired due to a drop in foundation assets. In addition, by identifying the potential risks the pool of assets may face, the investment committee will hopefully be in a better position to manage risks as they arise.

Another important facet of the IPS is that it helps define all associated parties and their responsibilities. When all parties have a clear understanding of their roles, time spent in committee meetings figuring out who is responsible for which action item can be minimized. The nonprofit can spend more time on other more productive activities, such as grant making.

Setting the target asset allocation, along with appropriate minimum and maximum allocations to individual asset classes, is vitally important in the IPS; doing so will help ensure that the portfolio is invested in accordance with the nonprofit's long-term objectives even during times of market uncertainty. The IPS should help to remove emotions from the investment process in times of market stress, when individuals are more likely to act irrationally. With the collapse of Lehman Brothers in September 2008 and the corresponding financial market downturn, some nonprofits concerned about a continued drop in portfolio values contemplated moving to 100% cash. While such a move may seem to be a good strategy during a market collapse, cash does not rally when the equity and bond markets turn around. If a committee had a poorly designed IPS, or none at all, it might have found it perfectly acceptable to move to cash despite straying significantly from its long-term strategic asset allocation. However, the committee with a well-defined IPS would not make such a move easily, as doing so would be a violation of its own guidelines.

The IPS should remove emotions from the investment process, especially in times of market stress.

Vital elements of an investment policy statement

Investment policy statements can range in length from a few pages to much longer documents, depending on the level of detail in the document. The contents of effective investment policy statements will differ, based on the specific needs of each nonprofit; however, all well-written investment policy statements should contain certain elements. They include: purpose and scope; definition of duties; objectives; investment strategy and asset allocation; spending and liquidity policy; unique circumstances; monitoring and review process; and an appendix with a strategy statement for each permissible asset class.

SECTION 1: PURPOSE AND SCOPE

Typically, the first section in an investment policy statement is "Purpose and Scope." This section is a broad overview of the material in the IPS. It should include the general objectives of the foundation or endowment and broadly state the scope of the document and which roles the investment policy covers. This section should also include some language on fiduciary duty. Generally, there will be some language stating that committee members should exercise prudent and appropriate care in accordance with the Prudent Investor Rule or the Uniform Prudent Management of Institutional Funds Act (UPMIFA), and that all actions taken by the committee should be in the best interests of the foundation.

SECTION 2: DEFINITION OF DUTIES

It is important for the IPS to clearly state the duties of all involved parties, so that each party may fulfill their duties effectively. At a minimum, the parties should be listed and their duties described. Provided below is an example of these duties:

- **Board of Trustees**: The board has the ultimate fiduciary responsibility for the foundation's investment portfolio. The board is responsible for ensuring that appropriate policies governing the management of the portfolio are in place and that they are implemented. Typically, the board sets and approves the IPS, and delegates responsibilities to the investment committee for implementation and ongoing monitoring.
- **Investment committee**: The investment committee is responsible for implementing the investment policy. Typically, the investment committee is responsible for approving investment strategy; hiring investment managers, the custodian and investment consultants; and monitoring portfolio performance on a regular basis (quarterly, at a minimum) to ensure compliance with investment policy.
- **Investment managers**: The duty of the investment manager is to implement the strategy for which they are retained. For example, a large cap growth manager would be responsible for investing in large cap growth-oriented stocks. It is the responsibility of the investment committee to ensure that investment managers remain in compliance with the investment policy.
- **Investment consultant**: An investment consultant is responsible for assisting the investment committee in all aspects of managing and overseeing the foundation's investment portfolio. At a minimum, consultants should provide asset allocation advice, provide spending studies, help with manager selection, provide portfolio level performance reports, review current managers, monitor the overall health of the portfolio and provide investment committee education.
- **Custodian**: A custodian is a financial institution responsible for safeguarding the assets of the portfolio. The custodian is also responsible for the settlement of securities bought and sold, collecting dividends and interest payments from the securities in the portfolio, and administering corporate actions on securities held, such as stock splits and dividends. The custodian also typically provides monthly and annual accounting reports and disburses funds for the nonprofit's operating budget.
- **Outsourced provider**: If a foundation feels that it does not have the staff for, or that it does not feel comfortable with, making day-to-day investment decisions, it may choose to use an outsourced provider. The outsourced provider assumes fiduciary responsibility and performs all of the duties of investment managers, consultants and the custodian.

SECTION 3: OBJECTIVES

All investment policy statements should clearly state the investment objectives of the portfolio. Clearly defined objectives will help set the investment strategy and strategic asset allocation. One of the key elements in these objectives is a statement of the rate of return the foundation would like to achieve over a market cycle. While it is client-specific, for many nonprofits this rate of return should be large enough to cover the annual spending rate; pay expenses incurred by investment managers, consultants, the custodians, and other professionals; and keep pace with inflation. Other items worth mentioning in the objectives include:

- Any portfolio liquidity requirements
- Time horizon of the pool of assets
- Spending rate
- Any additional constraints the endowment or foundation may face that could interfere with its mission

Clearly defined objectives will help set the investment strategy and strategic asset allocation.

SECTION 4: INVESTMENT STRATEGY AND ASSET ALLOCATION

Once the overall objectives of the foundation or endowment are clearly defined, the broad investment strategy can be broken down to more specific detail and the long-term strategic asset allocation can be defined. This is usually accompanied with language dictating that a comprehensive review of current and projected financial requirements will be considered in setting the investment strategy. It is important in this section of the investment policy to acknowledge that although investing is risky, the committee will create a strategic asset allocation that attempts to manage risk through asset class selection and diversification.

Once the strategy is detailed, it is important to define which asset classes will be used in the strategic asset allocation. These could include equities, fixed income, hedge funds, real estate, other alternatives, etc. In making asset allocation decisions, best practice is to include language declaring that while asset allocation should be monitored regularly, frequent changes in response to subtle changes in the financial markets are not expected.

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The investment committee is tasked with developing and adopting guidelines for broad allocation on a long-term basis. In setting the asset allocation, it is appropriate to develop ranges around asset classes so that minor tactical shifts can be made in response to market conditions. However, the IPS language should discourage committees from acting on pure emotion in times of market distress. A table is a common way to document the policy targets and ranges.

Exhibit 1: Strategic asset allocation

Asset class	Lower range	Target allocation	Upper range	Evaluation benchmark
U.S. equity	20%	30%	50%	Russell 3000® Index
Non-U.S. developed equity	10%	20%	30%	Russell Global ex-U.S. Index
Emerging markets equity	5%	10%	15%	Russell Emerging Markets Index
Fixed income	15%	20%	30%	BC U.S. Aggregate Bond Index
Hedge funds	0%	10%	20%	HFRI FOF Index
Real estate	0%	10%	20%	NFI-ODCE-EQ-EF

Sample provided for illustrative purposes only and is not representative of any actual portfolio.

Within the asset allocation section, it is appropriate to list all asset classes the foundation or endowment finds appropriate for investing. Equally important is to include investments that are prohibited from use within the portfolio.

Typically, the last item that is presented in the asset allocation section is the rebalancing policy. While the asset allocation ranges specified in the IPS can be very large, most foundations find it appropriate to rebalance when asset classes deviate from the target policy by more than 2% to 5%. Usually this is done on a specific date, such as month or quarter-end. It can also be useful to state that cash inflow and outflow will be used to bring the portfolio back closer to target.

SECTION 5: SPENDING AND LIQUIDITY POLICY

All investment policies should have a clearly defined spending and liquidity policy. All endowments and foundations should specifically state their expected spending policy on a yearly basis. Usually, it is the goal of the nonprofit to distribute in excess of the spending rate if it has the ability to do so. It should be specified in the IPS if a foundation has certain rules that it must follow in its spending policy, such as is the case for a private foundation required by the IRS to pay out 5% of the fair market value on an annual basis. The liquidity policy is something that many nonprofits are currently revisiting, given the high level of illiquidity that some experienced as a result of the 2008 to 2009 credit crises. Some foundations experienced difficulty meeting cash requirements as markets previously deemed liquid in nature disappeared. While nonprofits differ in their asset allocation and cash needs, it is advisable to clearly state the cash requirements needed on a monthly, quarterly, or annual basis. This should allow nonprofits greater flexibility to meet their cash needs during times of market distress.

SECTION 6: UNIQUE CIRCUMSTANCES

All investment policies should contain a section detailing any circumstances unique to the endowment or foundation such as a preference for socially responsible funds, green investing, or items specific to the endowment's or foundation's charter. The unique circumstances section is an opportunity to include items which the nonprofit would like to highlight that are not covered elsewhere else in the IPS.

SECTION 7: MONITORING AND REVIEW PROCESS

Once the asset allocation, investment strategy, and spending rate has been established, it is important to create a well-defined monitoring and review process to ensure that the objectives of the foundation or endowment are achieved. The review mechanisms should be centered on the investment objectives of the portfolio. Client-specific, common elements that might be found in this section include:

- The investment committee seeks to achieve or outperform the target return objective as defined in the asset allocation section over a full market cycle (five years or longer).
- The investment committee does not expect that this objective will be attained every year and recognizes that during various time periods, investment managers may produce significant underperformance and/or outperformance relative to the markets.
- The overall health of the portfolio will be monitored by comparing the value of the foundation's or endowment's assets against the expected spending rate plus inflation and fees, and tracking the changes of each to determine whether the spending rate requires adjustment. This exercise should be performed no less often than annually.
- Portfolio returns should be monitored quarterly to assist in evaluating the effectiveness of the investment strategy.

- Individual investment managers' guidelines will be reviewed as stated in each asset class strategy statement.
- The investment committee and/or board of trustees will undertake a detailed review and assessment of the program's overall strategy and investment structure at least every three years. Any changes to the policy should be communicated in writing to all appropriate parties.

SECTION 8: ACKNOWLEDGMENT

Typically, the last section in an investment policy statement is the acknowledgement section, which is signed by the foundation before copies are distributed to all parties. An example of an acknowledgment statement is as follows:

"We recognize the importance of adhering to the mission and strategies detailed in this policy and agree to work to fulfill the objectives stated herein, within the guidelines and restrictions, to the best of our ability."

SECTION 9: APPENDIX: ASSET CLASS STRATEGY STATEMENTS

Following the acknowledgement section of the IPS, many nonprofits include an appendix that provides more specific guidelines to investment managers. Generally, the foundation or endowment sets forth a specific set of guidelines for each asset class. This section provides elements such as strategic role in the portfolio, investment objectives, equity strategies, leverage guidelines and how the nonprofits will monitor and review the investment manager. It is appropriate for the nonprofits to list in this section any strategies they want their investment manager to avoid, such as short sales or the use of margin.

Conclusion

Having a well-defined and articulated investment policy statement is vital in today's challenging investment landscape. The investment policy statement should serve as the blueprint for nonprofits seeking to meet their objectives while minimizing portfolio risk. The investment policy statement fills a vital role in helping to complete the overall governance structure of an endowment or foundation.

Contact us for more information on how to improve your program's investment policy statement and tailor it to your organization's needs.

Call your client executive, consultant or another Russell representative at **800-426-8506.**
You can also find more information on **www.russell.com/institutional**

Important information

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