

# Development of an Investment Policy

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# Agenda



- I. What is the purpose of an investment policy?
- II. A detailed look at the components of a policy
- III. The discussions that help create an effective policy

# The Purpose of an Investment Policy



1. Investment Objectives
2. Investment principles of risk, prudence, & ethics
3. Responsibilities of the various parties
4. Appropriate investment instruments
5. Limits on particular assets
6. A basis for review of the portfolios and the overall outlook for the pool

# The Purpose of an Investment Policy

The Investment Policy Statement (IPS) should be a tool for the pool, the pool's board, and the various vendors to use as a guide for implementation.

The Balancing Act: Building in the “letter” of the guidelines as well as the “spirit.”



# The Components of an IPS

## 1. Investment Objective

- State the objective and the goals
- It doesn't have to be complex

### Examples of Objectives:

“Primary objective is preservation of principal, secondary objective is investment income”

“Produce consistent and reliable interest income, minimize the risk of realizing significant capital losses, comply at all times with state laws governing investment by public entities”

“Preserve capital, maximize return on investments subject to guideline constraints, provide sufficient liquidity to meet anticipated cash needs”

# The Components of an IPS

## 1. Investment Objective and Goals

- Each pool is unique, structure goals accordingly
- Goals tend to vary

### Examples:

“Ensure adequate liquidity/capital is maintained to meet fiduciary responsibilities to policyholders, provide a solid capital foundation for long-term stability, provide a stable cashflow stream while managing risk.”

“Generate steady, reliable income over long periods”

“Maintain public confidence in the pool”

# The Components of an IPS

## 2. Investment Principles of Risk, Prudence, & Ethics

- What is your pool's risk tolerance?
- Do you have flexibility (i.e., statutes allow you to purchase equities), or are you restricted?
- Can your risk tolerance change?
  - In the context of asset/liability matches
  - In the context of business operations
  - The concept of a risk questionnaire

# The Components of an IPS

## 2. Investment Principles of Risk, Prudence, & Ethics

### Sample Risk Questions

#### 1. Risk

The basic principle of investing: *the higher return you seek, the more risk you face*. Based on your feelings about risk and potential returns, your goal is to:

- A. Potentially increase my portfolio's value as quickly as possible while accepting higher levels of risk.
- B. Potentially increase my portfolios' value at a moderate pace while accepting moderate to high levels of risk.
- C. Income is of primary concern while capital appreciation is secondary.
- D. The safety of my investment principal.

# The Components of an IPS

## 2. Investment Principles of Risk, Prudence, & Ethics

### Sample Risk Questions

#### 2. Investment Approach

Which of the following statements best describes your overall approach to investing as a means of achieving your goals?

- A. Having a relative level of stability in my overall investment portfolio.
- B. Moderately increasing my investment value while minimizing potential for loss of principal.
- C. Pursue investment growth, accepting moderate to high levels of risk and principal fluctuation.
- D. Seek maximum long-term returns, accepting maximum risk with principal fluctuation.

# The Components of an IPS

## 2. Investment Principles of Risk, Prudence, & Ethics

### Sample Risk Questions

#### 3. Volatility

The value of most investments fluctuates from year to year as well as over the short term. How would you feel if an investment you had committed to for ten years lost 20% of its value during the first year?

- A. I would be extremely concerned and would sell my investment.
- B. I would be concerned and may consider selling my investment.
- C. I would be concerned, but I would not consider selling my investment.
- D. I would not be overly concerned given my long-term investment philosophy.

# The Components of an IPS

## 2. Investment Principles of Risk, Prudence, & Ethics

### Sample Risk Questions

#### 4. Variation

Realizing that any market-based investments may move up or down in value over time, with which of the hypothetical portfolios below would you feel most comfortable?

	Year 1	Year 2	Year 3	Year 4	Year 5	Avg. Annual Return
<input type="checkbox"/>	3%	3%	3%	3%	3%	3%
<input type="checkbox"/>	2%	5%	6%	0%	7%	4%
<input type="checkbox"/>	-6%	7%	21%	2%	8%	6%
<input type="checkbox"/>	9%	-11%	26%	3%	18%	9%
<input type="checkbox"/>	14%	-21%	40%	-4%	31%	12%

# The Components of an IPS

## 2. Investment Principles of Risk, Prudence, & Ethics

### Sample Risk Questions

#### 5. Future Earnings

In the next five years, you expect that the investment income of the portfolio will probably:

- A. Decrease
- B. Stay about the same
- C. Increase modestly
- D. Increase significantly

# The Components of an IPS

## 2. Investment Principles of Risk, Prudence, & Ethics

- Does your risk profile determine returns or does your need for returns determine your risk?

# The Components of an IPS

## 3. Responsibilities of the Various Parties

- What are the various roles?
  - Investment Managers
  - Custodian
  - Consultant
  - Board & Staff
- Tailor the duties to the roles
  - Helps to reduce the potential of inadvertently missed tasks
- Common to see reporting requirements

# The Components of an IPS

## 4. Appropriate Investments & 5. Limits on Assets

- Define or be ready for interpretation of differences
- Set the boundaries so your investment partners (brokers, investment managers) can offer guidance on what to expect from the portfolio mix
- Do your investment guidelines work with your risk tolerance?

# The Components of an IPS

## 4. Appropriate Investments & 5. Limits on Assets

- What is permitted versus what is not – which way is better?
  - Need to intersect statutes/regulations/legislation with additional constraints by pool
- A manager's perspective – important to set guides but don't dictate implementation, if possible

# The Components of an IPS

## 4. Appropriate Investments & 5. Limits on Assets

- Key Items(*continued*):
  - What asset classes are eligible
  - How much in each class
  - Are there other issues of concern
    - Do structured securities need to pass a cashflow test?
    - Do you care if the credit quality rating is different if there is no bond insurance?

# The Components of an IPS

## 4. Appropriate Investments & 5. Limits on Assets

- Key Items(*continued*):
  - Are there limits by issuer?
    - Do these limits vary by the type (i.e., no more than 30% with any one Gov't Agency, no more than 2% with any other issuer, no more than 5% in any structured product issue, etc.)
  - Are there limits by vehicle?
    - Can you use mutual funds?
    - Other asset classes – can you have hard assets, commodities
    - What is the pool's stance on derivative usage

# The Components of an IPS

## Example #1

Asset Class	Risk Tolerance	Attributes
Cash/ Short Term Funds	Low	<ul style="list-style-type: none"><li>- Very liquid money market securities</li><li>- High quality commercial paper</li><li>- U.S. Governments and Agency securities</li><li>- Maximum duration 2 years</li><li>- Maximum 50% of the portfolio with maturity in excess of 1 year</li><li>- Mutual funds with adjustable rate mortgage securities and average duration of less than one year</li><li>- Benchmarked against a comparable maturity Treasury Index</li></ul>
Core Investment Grade Bonds	Low/Medium	<ul style="list-style-type: none"><li>- Actively or passively managed</li><li>- Managed on a pre-tax basis</li><li>- Controlled duration around the benchmark</li><li>- Sector and security diversification</li><li>- Maximum 25% of the portfolio with a credit rating of BBB</li><li>- Average credit rating of AA</li><li>- Benchmarked against the Barclays Intermediate Aggregate Bond Index</li></ul>

# The Components of an IPS

Asset Class	Risk Tolerance	Attributes
Non-Investment Grade Bonds	Medium/High	<ul style="list-style-type: none"> <li>- Actively or passively managed</li> <li>- Managed on a pre-tax basis</li> <li>- Controlled duration around the benchmark</li> <li>- Sector and security diversification</li> <li>- Maximum of 20% of the portfolio with credit rating of single B</li> <li>- No securities with a credit rating below single B</li> <li>- Benchmarked against the Barclays BB Corporate Bond Index</li> </ul>
U.S. Equities	Medium/High	<ul style="list-style-type: none"> <li>- Actively or passively managed</li> <li>- Managed on a pre-tax basis</li> <li>- Tilted towards low turnover, high dividend strategies</li> <li>- Maximum of 20% of the portfolio in small-cap equities</li> <li>- Benchmarked against the S&amp;P 500 and/or Russell 1000 Indices and the fund's mandated benchmark target</li> </ul>
International Equities	Medium/High	<ul style="list-style-type: none"> <li>- Actively or passively managed</li> <li>- Managed on a pre-tax basis</li> <li>- Maximum of 25% of the total equity portfolio               <ol style="list-style-type: none"> <li>1. Maximum of 10% of the total equity portfolio international across emerging market exposure</li> </ol> </li> <li>- Benchmarked against the fund's mandated benchmark target</li> </ul>

# The Components of an IPS

## Example #2

Security	Max. Allocation	Additional Constraints
U.S. Treasury Obligations (including Strips)	Unlimited	- None
Federal Agencies, not including FNMA or FHLMC	Unlimited	- No more than 20% in securities of any single agency
FNMA (Fannie Mae) and FHLMC (Freddie Mac)	Up to 40%	- No more than 25% in securities of either issuer - Limits apply to all securities, including both debentures and mortgage securities
Mortgage Securities	Up to 70%	- Limit applies to all mortgage-backed, mortgage pass-through, or other mortgage-related securities, regardless of issuer.

# The Components of an IPS

Security	Max. Allocation	Additional Constraints
CMOs, including tranches such as PACS, Sequential Payers, VADM	Up to 50%	<ul style="list-style-type: none"><li>- No residual tranches</li><li>- No more than 2% in any single CMO tranche</li><li>- Limit applies to all CMOs, regardless of issuer</li></ul>
State or Local Government Obligations	Up to 30%	<ul style="list-style-type: none"><li>- No more than 2% in securities of any single issuer</li><li>- A security may not be purchased if the issuer would not meet the statutory minimum rating requirements without bond insurance</li></ul>
Commercial Paper (maturity 270 days or less)	Up to 25%	<ul style="list-style-type: none"><li>- No more than 2% in securities of any single issuer.</li><li>- No more than 25% in one industry</li><li>- No asset-backed commercial paper</li><li>- No commercial paper issued by foreign corporations through "co-issue" or similar arrangements</li></ul>

# The Components of an IPS

Security	Max. Allocation	Additional Constraints
Interest bearing deposits, including certificates of deposit	Up to 25%	- Maximum in any single institution is the lesser of \$250,000 or the amount insured by FDIC
Money market mutual funds	Up to 25%	
Banks acceptances	Up to 25%	- No more than 10% with any single issuer - Limit to banks that carry A1/A+ or better rating
Repurchase agreements	Up to 25%	

# The Components of an IPS

## 4. Appropriate Investments & 5. Limits on Assets

- Also need to think about overall portfolio guidance
  - What is the allowable duration?
    - Are there different strategies needing different guides?
  - What is the benchmark for the portfolio(s)?
  - What is the procedure in the event of a violation of guidelines?
    - For fixed income managers, how should they handle credit rating downgrades?
  - Are there other statutory requirements the pool needs to monitor? (i.e., “high risk” mortgages)

# The Components of an IPS


## 6. Review of the portfolios, the IPS, and the strategy

- Setting expectations
  - What are the performance assumptions
  - What are the factors that the pool will use to review vendors
- Providing a framework for updates
  - How often will the reviews happen
  - Who is responsible for review
- Applying the review
  - Are the guidelines functional – get feedback from the vendors
  - What has changed in the markets
  - Are there compliance issues that need to be addressed

# The Components of an IPS

Some final thoughts to keep in mind...

- Actuary – friend or foe?
- Your vendors are a good resource
- Risk vs. Return – it's not a static target
- Set your sights to the appropriate time horizon



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