Session #3: Investment Policy Statement
Writing, Review, Amendment

Speakers: Fay DeBellis and Bryant Waller
Date: Saturday, Jan. 10
Time: 9:45 – 10:45 a.m.
Fay M. DeBellis, CFP®, SIMC
Senior Vice President

Fay graduated from St. Olaf College in 1986 with a double major in Economics and American Studies. Today, Fay is a Senior Investment Management Consultant with Morgan Stanley and leads the Northern Lights Group based in Minneapolis.

Fay has been recognized as a President’s Council Award winner since 1993 for exemplary performance within the firm and has been named Mentor of the Year. Fay & her team focus on consulting to families and small to medium sized local nonprofit organizations. Fay has been named to the Barron’s Top Women Wealth Advisors every year since 2007 and was recognized as one of 10 “Advisors who Care” by Registered Rep magazine for her service and dedication to philanthropy.

Currently, Fay is serving a three-year term as one of 12 members of the Morgan Stanley Diversity Council. She co-chairs the Association of Professional Investment Consultant’s (APIC) Professional Development Committee. APIC is a community of leading Morgan Stanley consultants, staff and firm employees who believe in fostering professionalism through a culture of consulting excellence.

Along with her 28+ years of professional investment experience, Fay is an active community volunteer. Fay has strong relationships with numerous non-profit organizations. Currently, Fay serves on the Board of Directors at Gillette Children’s Specialty Healthcare, as Chair of the Fundraising committee, a member of the investment committee & Annual Gala Committee. Fay also serves on the annual fund raising committee at Mounds Park Academy. Fay sits on the Alumni Board of the Humane Society for Companion Animals.
Bryant J. Waller, CFP®
Financial Advisor
Financial Planning Specialist

In 2002, Bryant graduated from St. Thomas Academy in Mendota Heights, MN. He then attended the University of St. Thomas where he earned a B.A. in Business Law in 2006. Bryant began his career with Morgan Stanley in 2007 when he joined Fay DeBellis and the Northern Lights Group.

Bryant is responsible for conducting investment research, assisting with Investment and Spending Policy development, allocation construction/modification and investment selection for client portfolios. He is charged with monitoring client portfolios ensuring they stay within investment parameters, executing allocation/investment changes and managing client cash flow needs.

Outside of work Bryant is an active volunteer. Currently, he serves as an alumni mentor for the undergraduate mentoring program at the University of St. Thomas and also volunteers with an animal welfare organization called Leech Lake Legacy.
The Importance of a Well Written Investment Policy Statement

The Northern Lights Group at Morgan Stanley

Fay DeBellis, CFP®, SIMC
Senior Vice President
Wealth Advisor

Bryant Waller, CFP®
Financial Planning Specialist
Financial Advisor

Agenda

1. Why Investment Policy matters
2. UPMIFA
3. Fundamentals of an Investment Policy Statement
4. IPS: Spending Policy and Allocation Constraints
5. Investment Policy Statement Addendums
6. Audits
**Why Investment Policy Matters**
*
*Charles Ellis*

**How to Win the Loser’s Game, Dow Jones-Irwin**

“The principal reason for articulating investment policy explicitly and in writing is to enable the client and portfolio managers to protect the fund from ad hoc revisions of sound long-term policy when short-term exigencies are most distressing and the policy is in doubt.” *Charles Ellis*

» It is important for directors/trustees and Investment Committees to declare accountability in an environment where sound investment principals are understood and seem reasonable.

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**Why Investment Policy Matters**
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*No Policy? A look at History*

The lack of Investment Policy can lead to:

» **William Aramony and United Way (A Violation of Trust)**
  - Found guilty of looting $1.2 million / sentenced to 7 years without parole.

» **New Era For Philanthropy (A Violation of Common Sense)**
  - Pitch: give us your donations for six months – we will double your money.
  - 250 charities involved — 160 lost more than $107 million to date.

» **Orange County and Derivatives (A Violation of Prudent Process)**
  - County Treasurer used borrowed funds to buy “inverse floaters”.
  - A substantial interest rate bet.
  - Estimated loss to date: $1.7 billion of public moneys.
Why Investment Policy Matters
The Landscape Today

» Increased fiduciary oversight, and requirements for disclosure and accountability.

» Nonprofit & ERISA audits now requesting IPS evaluations.
  • Risk analysis at the securities level, fixed income by ratings, equities by beta ratings.
  • Connecting asset allocation to portfolio construction and spending

» Increased difficulty meeting objectives in a lower return economic environment.

» Market trends toward alternative investment programs (Hedge Funds, Private Equity, Real Assets, etc.)
  • Greater due-diligence requirements.
  • Less transparency

» Market trends toward more dynamic asset allocation. (O-CIO)

UPMIFA
The Uniform Prudent Management of Institutional Funds Act

» UPMIFA is the revised law that changes the rules that govern the management of most Non-Profit Corporations. It does apply in Minnesota.

» Merges Two State Laws:
  • The Uniform Management of Institutional Funds Act (UMIFA) 1972 – Endowment Funds of Non Profit Corporations
  • The Uniform Prudent Investor Act (UPIA) 1994 - Trust Law

» Key Provisions
  • Allows Delegation of Investment Management Authority
  • Defines the Standard of Care for Making Investment Decisions with 13 factors (to follow)
  • Release of restrictions that may become outdated, unworkable
### Fundamentals of an Investment Policy Statement
#### A Prudently Written Investment Policy Statement

- Clarifies a Statement of Purpose
- Defines Roles and Responsibilities for Fiduciaries
- Identifies & Documents any Legal, Regulatory and Ethical issues.
- Determines Investment Goals, Objectives and Risk Parameters.
- Outlines Cash Flow considerations; (Actuarial Liabilities, Spending Policy, etc.)
- Documents Policy Constraints & Restrictions.
- Outlines Investment Manager due-diligence process.
- Defines Performance Reporting Criteria and Standards.
- Outlines Communication for Review and Evaluation.
- Documents asset allocation parameters and risk measurement (Addendum)
- Documents fee disclosure (Addendum)

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### Fundamentals of an Investment Policy Statement
#### Who are the players in writing a policy?

- All Fiduciaries
- Board of Directors/Trustees
- Chair of Investment Committee
- Investment/Finance Committee
- Chief Financial Officer of the Institution
- Legal Council
- Accountant/CPA’s
- Auditor
- Investment Consultant
The Northern Lights Group at Morgan Stanley:
The Importance of a Well Written Investment Policy Statement

Fundamentals of an Investment Policy Statement
Critical Sections

» Investment Objectives
» Spending Policy
» Asset Allocation Guidelines
» Portfolio Restrictions
» Alternative Investments

Fundamentals of an Investment Policy
Investment Objectives

» Set reasonable return objectives.
» Use full economic / market cycles for time horizon.
» Use relative return targets = Spending plus inflation.
» If you use absolute returns, be able to support a reasonable probability of achieving the return.
**Fundamentals of an Investment Policy**

**Investment Objectives: Example**

**Type of Fund:** Endowment

**Strategy:** Total Return

**Time Horizon:** Perpetuity

**Investment Horizon(s):** Long Term: 7+ years and/or a full economic business cycle

**Investment Objectives:** Preservation of purchasing power. Achieve a total return sufficient to support level of current spending that will be constant as a percent of investable assets and, in absolute terms, grows at least as rapidly as inflation.

**Real Return Target:** CPI +3%

**Spending Policy:** 4% Spending +1% Administration = 5%

**Benchmark:** The composite return represents a blended benchmark that is closely aligned with the investment policy target asset allocation. The composite benchmark is a blend of passive indices that best represent that target allocation and changes with investment policy amendments. The objective of the composite benchmark is to evaluate the value added from active management, rebalancing and tactical adjustments to the long-term target asset allocation.

**Illiquidity:** Maximum of 20% illiquid.

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**IPS: Spending Policy and Allocation Constraints**

**Developing a Spending & Investment Policy**

- Establish a reasonable and prudent spending level
- Determine how much to spend on current programs, and how much to invest to preserve future spending
- Spending at excessive rates creates long-term problems
- Rates in excess of 5% are high by modern standards
- A well-defined spending policy leads to a better defined investment policy, which improves long term results
- A fund’s spending rate plus projected inflation and expenses is the starting point for a target rate of return
IPS: Spending Policy and Allocation Constraints

Spending Policy Examples

» Dollar Amount Grown by Inflation: Under the dollar amount grown by inflation policy, a dollar amount of spending is calculated in the initial year on the basis of need or other criteria. (The amount is usually expressed as a percentage of the initial portfolio value.) The spending amount for each subsequent year is then determined by multiplying the prior year’s spending by an inflation factor—typically the change in the Consumer Price Index (CPI) or another cost inflation index.

» Spending Policy Rate with Smoothing: The amount available for appropriation during each fiscal year shall be calculated by applying the policy spending rate, <X>%, to the rolling <3 or 5>-year moving average of the quarterly market values on Fund assets.

» Banded Inflation Spending Policy: Apply a spending rate <X> to an initial year’s portfolio value. In forward years apply that dollar amount times the appropriate inflation rate <I>%, (Consumer Price Index (CPI) or Higher Education Price Index (HEPI) to be added to the prior year’s spending. The amount is banded between or equal to X% (Example: 3%) and X% (Example 6%) times the beginning period endowment value for current year. This will provide inflation adjusted spending policy, but not account for downturns in the capital markets.

» Hybrid Method: The level of annual spending is determined by combining a fixed percentage adjusted for inflation annually, plus a fixed percentage applied to a moving average formula of either 3-year of 5-years. The amount applied to the inflation versus the moving average portion of the formula may vary (60/40, 70/30, 80/20, etc).

Spending Policy

» Spending Policy is typically built from determining a “spending rule”, adding a benchmark for inflation, administrative expenses, and some percentage for real growth.

» For example: Spending Policy with Growth:

<table>
<thead>
<tr>
<th>Spending Policy with Growth Target</th>
<th>Spending Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Programs and/or Grants</td>
<td>5.0%</td>
</tr>
<tr>
<td>Expected Inflation Rate</td>
<td>2.5%</td>
</tr>
<tr>
<td>Administrative Expenses</td>
<td>0.5%</td>
</tr>
<tr>
<td>Allocation for Real-Growth</td>
<td>1.0%</td>
</tr>
<tr>
<td><strong>Required Target Rate of Return</strong></td>
<td><strong>9.0%</strong></td>
</tr>
</tbody>
</table>

» All spending policy assumes “Net Investment Returns”.

» Methodology in calculating the Spending Rule may vary dramatically, depending upon the institution and their needs.
The Northern Lights Group at Morgan Stanley:
The Importance of a Well Written Investment Policy Statement

» Return Expectation, Cash Flows, Liability and Spending, Asset Class Constraints, Restrictions, Risk Tolerance and Asset Mix Decisions are all inter-related decision models.

» A Well Defined Investment Policy leads to better investment process and improved long-term investment results.

Fundamentals of an Investment Policy Statement
Inter-Related Decisions

- Investment Objectives & Return Expectations
- Asset Allocation & Portfolio Structure
- Risk Assessment: Return vs. Preservation of Capital
- Cash Flow & Spending Policy

Inter-Related Decisions

Historic capital market returns can provide a starting point in determining the appropriate asset mix.

Board must make sure asset mix is based on a target that exceeds spending policy + expenses + inflation.

Asset allocation sets targets for stocks vs. bonds and for more specific classes: large value stocks, small growth stocks, intermediate bonds, etc.

Can “Stress Test” Portfolios for different scenarios, i.e., Rising Interest Rates, Stock Market Correction, Slow GDP Growth, Lehman Brothers Bankruptcy, etc. Defines the target return and the risk that an organization is willing to take to achieve the return.

Re-balancing asset classes back to their original allocations can reduce risk and may improve returns.

Reduced volatility will smooth out spending.
**Asset Allocation and Constraints**

**Rebalancing Guidelines**

» Investment management of the assets of the XYZ Foundation shall be in accordance with the following asset allocation guidelines:

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Totals</td>
<td>65%</td>
<td>75%</td>
<td>70%</td>
</tr>
<tr>
<td>Large Cap US Equity</td>
<td>35%</td>
<td>45%</td>
<td>40%</td>
</tr>
<tr>
<td>Small Cap US Equity</td>
<td>5%</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>International Equity</td>
<td>15%</td>
<td>25%</td>
<td>20%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>25%</td>
<td>35%</td>
<td>30%</td>
</tr>
<tr>
<td>Cash and Equivalents</td>
<td>0%</td>
<td>10%</td>
<td>0-5%</td>
</tr>
</tbody>
</table>

» The Investment Committee will periodically review these guidelines to determine if the fund is in compliance. When guidelines are outside the minimum and or maximum allocation limits the portfolio will be rebalanced back to the target allocation.

» What’s wrong with this typical Asset Allocation policy section?

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**IPS: Spending Policy and Allocation Constraints**

**Portfolio Re-Balancing**

» Consider the following:

**Large Cap Domestic Equity**

- Large Cap Domestic Equity
- Standard Deviation of Asset Class: 13.1%
- Maximum Limit: 45%
- Allowable change: 5%
- Maximum Limit for Target: 5% = 12.5% Change from Target
- Target Allocation: 40%

**Small Cap Domestic Equity**

- Small Cap Domestic Equity
- Standard Deviation of Asset Class: 16.5%
- Maximum Limit: 15%
- Allowable change: 5%
- Maximum Limit for Target: 5% = 50% Change from Target
- Target Allocation: 10%
IPS: Spending Policy and Allocation Constraints

Asset Allocation in a Challenging Environment

» Traditional methods of asset allocation have been challenged in recent years due to low returns in the fixed income space

» *The 30 year rate of return of the S&P 500 through November 2014 is 11.32%

<table>
<thead>
<tr>
<th>Total Return Objective</th>
<th>Required Equity Return</th>
<th>60/40 Equity to Fixed Income</th>
<th>Fixed Income Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.0%</td>
<td>15.4%</td>
<td>2.0%</td>
<td></td>
</tr>
</tbody>
</table>

Achieving this target rate of return would require outperforming the 30 year returns of the S&P 500

» Endowment Target: 12.0% 2.0%

*Source: Case Schiller

IPS: Spending Policy and Allocation Constraints

Incorporating Alternatives

Critical Issues regarding Alternatives:

» Restrictions: Alternatives may be in conflict with many restrictions written in other sections of traditional policy statements.

» Offering Docs: When investing in alternatives, review the offering memorandums to ensure they do not violate the Investment Policy.

» Transparency: Alternatives are less transparent and will cause delays in reporting and performance monitoring.

» Liquidity: Alternative investments may be limited to specific time periods and cause adjustments to re-balancing policy.

» Offering memorandums: become the investment manager policy addendums.
IPS: Spending Policy and Allocation Constraints
Alternatives Continued

» A separate section in the main body of the Investment Policy Statement should address Alternative Investments if included as a part of the investment structure.

» Restrictions - Investment Policy should acknowledge that the policy restrictions for traditional assets classes do not apply for the allocation to Alternatives.

» Due Diligence - Investment Policy should focus on the due-diligence process for fund selection and evaluation.

» Reporting and Transparency - Methods for monitoring the performance must consider the time lag for alternative investments.

» Restrictions - Asset allocation limits/restrictions and liquidity should be addressed.

IPS: Spending Policy and Allocation Constraints
Socially Responsible Investing

» General Characteristics:
  • Covers a wide range of Social Issues.
  • Not all directors/trustees think alike on Social Issues.

» Avoidance or Restrictive Policy
  • Typical issues: Alcohol, Tobacco, Pornography, Gambling, Weapons, Environmental.
  • Restriction can be tied to percentage of gross revenue. Requires detailed research.
  • Manager will easily comply to security list if provided.

» Supportive Policy:
  • Requires specific research skills and specialized investment managers.
  • Examples: Environmental problems and innovation type solutions.
  • Human rights and workforce diversity, etc.

» Investment Policy
  • Social issues must be specific and definitive for managers to execute.
  • Consultant must be able to monitor managers ability within the Policy Guidelines.
  • More restrictive and limiting
The Northern Lights Group at Morgan Stanley:
The Importance of a Well Written Investment Policy Statement

Addendums can be structured so the investment committee can amend and approve changes to addendums without a full vote of the board of directors/trustees.

Types of Policy Addendums:
- Investment Manager Addendum
- Asset Allocation Addendum
- Fees & Compensation Disclosure Addendum
- Gift Policy Addendum

Audit tests may review the Policy Statement and Addendums for dates and signatures documenting changes over time.

<table>
<thead>
<tr>
<th>Policy Title:</th>
<th>Foundation XYZ – IPS</th>
<th>Approved By:</th>
<th>CFO/Board of Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Version Number:</td>
<td>1.2</td>
<td>Approved Date:</td>
<td>July 20th, 2014</td>
</tr>
<tr>
<td>Replaced:</td>
<td>1.1</td>
<td>Effective Date:</td>
<td>August 1st, 2014</td>
</tr>
<tr>
<td>Audience:</td>
<td>Board of Directors</td>
<td>Last Review Date:</td>
<td>July 2014</td>
</tr>
<tr>
<td>Author:</td>
<td>Finance Committee</td>
<td>Next Review Date:</td>
<td>July 2015</td>
</tr>
</tbody>
</table>

Audit
Selected Elements of an Audit

- The organization’s Investment Policy Statement
- Investment objectives and goals of the organization
- Roles and responsibilities
- Delegation of authority
- Investment constraints and guidelines
- Reporting Requirements and documentation

Does the Policy collectively guide the Investment Committee, the Investment Consultant, the Investment Managers and all other responsible parties to meeting the Goals and Objectives of the fund?
Audits
Investment Policy Statement Audits

» CPA firms are now introducing audits on the Investment Policy Statements for fiduciary related accounts. The audit process evaluates the Investment Policy statement and then audits the financial statements and portfolio construction in compliance to the stated goals, objectives, portfolio construction guidelines and restrictions of that policy.

» The American Institute of Certified Public Accounts (AICPA) issued Audit Section AU 9328 on Auditing Fair Value Measurements and Disclosure and AU 9332 on Auditing Derivative Instruments, Hedging Activities and Investments in Securities, where readily determinable fair value does not exist. Auditors are suggesting several key recommendations:
  - Receiving confirmation from the Foundation’s money manager on the valuation of the manager’s fund is insufficient evidence for the certification of a funds value.
  - The Foundation is responsible for making the fair value measurement and disclosures included in financial statements.
  - The auditor must understand the Foundation’s valuation methodology, make sure it is in accordance with GAAP and test the entity’s fair value measurements and disclosures.

Summary

» Does Policy document Prudent Process?

» Are Responsibilities clearly defined?

» Does Policy meet the governing standards of applicable Law?

» Is the Investment Structure Appropriate?

» Does the Investment Structure increase the probability of achieving the investment objectives?

» Are objectives reasonable?

» Does it guide fiduciaries to make a better and more informed decisions?

Does the Policy collectively guide the Investment Committee, the Investment Consultant, the Investment Managers and all other responsible parties to meeting the Goals and Objectives of the fund?
Thank You!

Important Disclosures

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