BLOG

The investment policy statement – The linchpin of the portfolio management process

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'Devising an investment policy statement (IPS) is the most critical function of an investment advisor, for a well-written IPS defines how all investment-related activities will be managed effectively.'

The IPS is a document agreed on by an investor and financial advisor. It details the investment plan, consisting of an investor's return objectives, risk tolerance over a specific time period, liquidity requirements, tax considerations, regulatory needs and other requisites to manage the investor's money. It helps in decision making, overcoming potential market faults. It serves as a guide for undertaking financial transactions and safeguards the investor's interests when followed strictly. It does not need to be long, but needs to contain all the relevant details to guide investment behaviour.

The IPS is created taking many factors into consideration. First, the goals of and timelines for investment need to be decided on. More than one goal can be incorporated. For instance, buying a house and saving for retirement. However, the most important goal needs to be prioritised, so that the objectives can be framed accordingly. The objective/s need to be clearly defined and listed comprehensively with specific details, such as the period of investment, so that no instability in the market would lead to a deviation. The IPS can also include business rules, eliminating the process of rethinking when taking decisions; the financial advisor would just need to follow these business rules.

Once the investment goals are set, risk tolerance needs to be defined. It depends on the investor's risk-taking capacity and whether he leans towards profit making. The timeframe for achieving the goal/s and how best financial risk can be handled are also taken into account. When risk tolerance is clear, it is easy to make investment choices. Investing appears good when profits are made and bad in times of loss; hence, assets that are too risky, i.e., those above the tolerance level, should not be invested in. Furthermore, if the investor is too averse to risk, the IPS could include a plan to correct this and help grow wealth more effectively.

An integral part of compiling an IPS is selecting asset classes to invest in. An asset class can be defined as a group of securities with similar characteristics and correlations in the market, and governed by the same laws and taxes. Major classifications include stocks, bonds and cash. Real estate, commodities and precious metals options are also available. Investors have the liberty to further classify assets into US stocks and international stocks. An IPS contains the type of investment and the asset allocation chosen to reach the investment goals. When a specific asset allocation is decided on, it makes one follow the decision than falling prey to emotions during market fluctuations. For instance, if the IPS states that only 60% should be invested in equities and 40% in bonds, an investor cannot invest 45% in bonds just because he believes he will earn more profit that way. The percentages can be changed based on the objectives and risk tolerance level. An investor should also specify the assets he does not want to invest in.

These will be assets that would not help him meet his investment objectives. The IPS, therefore, serves as a roadmap in the investment process.

Investment portfolios tend to change over time. Hence, it is necessary to rebalance portfolios periodically. When a portfolio is small, each contribution could move assets away from their targets. Over time, the portfolio will grow and contributions would make up a smaller percentage of the portfolio, with each contribution having a smaller impact. Changes due to market fluctuations would, therefore, impact a smaller portfolio. Hence, a mix of stocks and bonds will reduce volatility and increase returns. A portfolio may be rebalanced at any time of the year, other than at the start and the end, when a significant amount of money comes to the market. It may also be rebalanced when it exceeds the pre-determined threshold.

An investor's objectives and risk-taking ability could change over time. Therefore, the IPS needs to be reviewed regularly to ensure it remains in line with these. Although objectives and goals would not change frequently, regular review of the IPS would emphasis its importance and help the investor avoid making emotional decisions. In the absence of an IPS, an investor could chase returns and invest in "hot" industries, instead of taking steps to achieve his goal.

Acuity Knowledge Partners' solution

The IPS is a tool that enhances client relationships and reduces compliance risk. At Acuity, we have experience in understanding IPSs and monitoring financial transactions accordingly. We review investment guidelines regularly to ensure they meet client requirements and objectives, and reach out to clients promptly in the event of a mismatch. We also check whether transactions are made in compliance with the set objectives, and work in collaboration with our clients.