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Revisiting Your Investment Policy

Recent economic and financial turmoil has drastically changed the investment landscape. Investors face decisions about new securities, unfamiliar asset classes, different financial relationships, and an altered regulatory framework. This backdrop of change provides a timely reminder to revisit and evaluate existing investment policies, and perhaps adopt needed modifications.

A thoughtfully considered, and well-drafted investment policy statement, forms the foundation of a comprehensive investment program. The very process of creating, or even reviewing, an investment policy compels an entity to carefully consider its situation, including its objectives, constraints, abilities, and resources. Involving management and staff, at least for an initial draft is a chance to get a rounded perspective. The investment policy can serve as a checklist that organizes and structures an entity's investment program.

Starting Out

Internal Changes. A good place to start is to consider what changes have taken place internally since the last review of your investment policy; especially in light of the major economic and financial turmoil, has your entity's tolerance for risk changed? Has the size of your portfolio changed? How have your revenues, expenses weathered the economy? Has the predictability of your cash flows changed? Have any of these caused your objectives to change? Are your staffing and other resources for the investment process the same? Have they changed in such a way to alter what you can do with your investment program? Take inventory of these internal changes and evaluate how they affect your investment policy. Plan to make changes and modifications accordingly.

Your Financial Relationships. The period since 2008 has wreaked havoc on financial firms. The way they are structured and regulated has changed. Firms formerly considered appropriate have either disappeared or been acquired. Rethink your selection criteria for approved depositories. Regulation continues in a state of flux.

New Securities and Asset Classes. Government sponsored enterprise (GSE) securities have historically been popular among investors with primary objectives of safety, liquidity and yield because of their perceived safety and strong liquidity. The effects of GSE troubles have been two-fold: on the one hand, the federal government is rethinking the future of these issuers. This has implications for safety, liquidity and supply, if not for current securities, then for future ones. As well, many investors have reconsidered the place of such securities in their portfolios. Ultimately, other securities and/or asset classes will take their place. Evaluate the role of these securities, new securities, or potential future securities in your portfolio, and how you will handle such changes in your investment policy over time. For example, consider whether you would like to expand or alter the role of certain municipal securities in your policy.

Reviewing the Investment Policy Itself

Introductory Background Section. In addition to being an internal document, an investment policy is an external document. That is, it can provide valuable information to an entity's partners—whether financial institutions or other interested stakeholders such as ratings agencies, investors in the entity's own debt or others. Accordingly, starting with an introductory overview of the entity might provide useful context.

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Scope. The scope describes which funds the investment policy covers. Some entities explicitly state funds that are excluded from the policy. If an entity pools its funds to benefit from economies of scale or to simplify the process, such pooling should be identified in the scope.

If changes in the entity have changed the scope of funds covered—either increased or decreased—these should be noted here.

Investment Objectives. An investment policy should succinctly identify its objectives: safety of principal, liquidity for both anticipated and unexpected obligations, and appropriate return. The return objective can be further clarified by identifying a benchmark or a target that an investor deems appropriate.

Prudence, Indemnification and Ethical Standards. This section should clearly state that investments will be made with prudence and that staff will follow a prudent standard of conduct. Such a statement of prudence communicates internally and externally an entity's commitment to following a high standard in investing.

A statement of indemnification relieves an entity's officers or staff from personal responsibility so long as they act in accordance with written procedures and the investment policy and exercise due diligence, as long as deviations are reported within a given period and appropriate action is taken to control adverse developments. As part of the investment policy, consider whether indemnification language adequately protects staff.

This section often includes a statement on ethical conduct and prohibiting conflicts of interest. Consider whether your investment policy appropriately promotes ethical conduct and discourages conflicts.

Delegation of Authority. In this section of the investment policy, an entity can include a provision that the Finance Director or Treasurer establish written procedures for the operation of the cash management/investment program, consistent with this investment policy, and also a system of internal control to regulate the activities of subordinate employees.

Ending this section with a paragraph or a few sentences about the use of external investment advisers provides flexibility for the entity. Whether or not an entity currently uses an investment adviser, having a section that allows for the delegation of authority for the management of an entity's investment portfolio in a manner consistent with the entity's investment policy is prudent. The section should require that any investment adviser be registered with the SEC under the Investment Advisers Act of 1940 and adhere to the ***prudent expert*** standard.

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AUTHORIZED FINANCIAL INSTITUTIONS

An entity depends on relationships with financial institutions to transact investments. Establishing and maintaining relationships with financially sound and trust-worthy partners is of paramount importance. Having a list that defines with which institutions an entity can transact investments or deposits and having a due diligence process for their selection are key to the objective of safety.

Broker-Dealers. In this section of the investment policy, an entity can state that authorized broker-dealers are selected through a diligence process that the entity describes in the *Investment Procedures Manual* that all investors are encouraged to create.

Depository Relationships. This section of the investment policy should identify the process by which depository relationships are established.

Delivery and Safekeeping. One of the most important protections and a control against fraud is the separation of the safekeeping and custody function from the investment function. Investment policies should include a section regarding independent third-party safekeeping or custody of securities. By arranging to have securities held by a third party, an entity can effectively minimize safekeeping or custodial risk in an investment transaction.

Another topic that should be covered in this area is delivery-versus payment. This practice requires that no funds be released until securities are delivered. Having it in the investment policy formalizes this requirement for the entity and ensures that it is followed.

Authorized Investments. Entities should use caution in drafting and evaluating this section. Make sure the investments listed are appropriate for the entity's specific situation. When starting with a template or model investment policy, pay close attention to this section.

In light of the recent financial crisis, certain new investments emerged such as the government backed corporate notes. Investors' interest has been heightened in investments such as municipal bonds. Other securities such as commercial paper might have lost some investors' interest. Reviewing the list of authorized investments makes sense given the meaningful change that has taken place.

Portfolio Risk Management. An investment policy can include a section that addresses how an entity manages the risk in the portfolio. Use this as an opportunity to evaluate whether your risk control parameters are sufficient.

Prohibited Transactions. In this section, an entity can specifically identify investments that are prohibited or not allowed.

Mitigating Credit Risk. In this section, an entity can discuss techniques it uses to protect against credit risk. This can include diversification, placing absolute limits on percentage of portfolio that can be invested in any one issuer (except US treasuries), allowing for the sale of a security prior to its maturity and recording a capital gain or loss in the interest of improving the quality, liquidity or yield of the portfolio in response to market conditions or the entity's risk preferences; and having a policy for dealing with downgraded securities.

Confirm your investment policy is reflecting and guiding your current investment program.

Mitigating Market Risk. An entity can include a subsection in portfolio risk management that addresses market risk, the risk that the portfolio value will fluctuate due to changes in the general level of interest rates. The investment policy can include several techniques that address market risk, such as providing adequate liquidity for short-term cash needs, and making longer-term investments only with funds that are not needed for current cash flow purposes. Limits can be placed on callable securities, and final maturity of securities can be constrained to a specified maturity.

Performance Standards and Evaluation. A separate section of the investment policy can address how your investment portfolio will be measured and evaluated. Have you identified how you will select and use benchmarks to measure and evaluate your performance? Do you identify a benchmark? Is it still appropriate? Do changes need to be made in this area?

Procedures and Internal Control. In this section, the investment policy should state that an *investment procedures manual* is required. The procedures manual should cover daily treasury operations, name the entity's financial partners (e.g., advisers, brokers, bankers and custodians), and describe internal controls designed to protect an entity's assets from loss, theft or misuse. Having these in a separate document allows for changes without governing board approval.

Reporting, Disclosure and Program Evaluation. This component of the investment policy is crucial in maintaining transparency and accountability. Reports are effective means to track investment activity, assess how investment activity conforms to adopted guidelines and policies and to evaluate how the portfolio is performing relative to its objectives. The section should address the format and content of reports, frequency and who should prepare and who should receive and review the reports. Specified frequency might be monthly, quarterly, and annually.

Conclusions

It is prudent to review your investment policy periodically. Ideally, such review would take place annually. In normal circumstances, it is a good opportunity to review your investment program, using the investment policy as a checklist. Given the unprecedented changes that have taken place in investing, it is timely to take inventory of your program and confirm your investment policy is reflecting and guiding your current investment program.