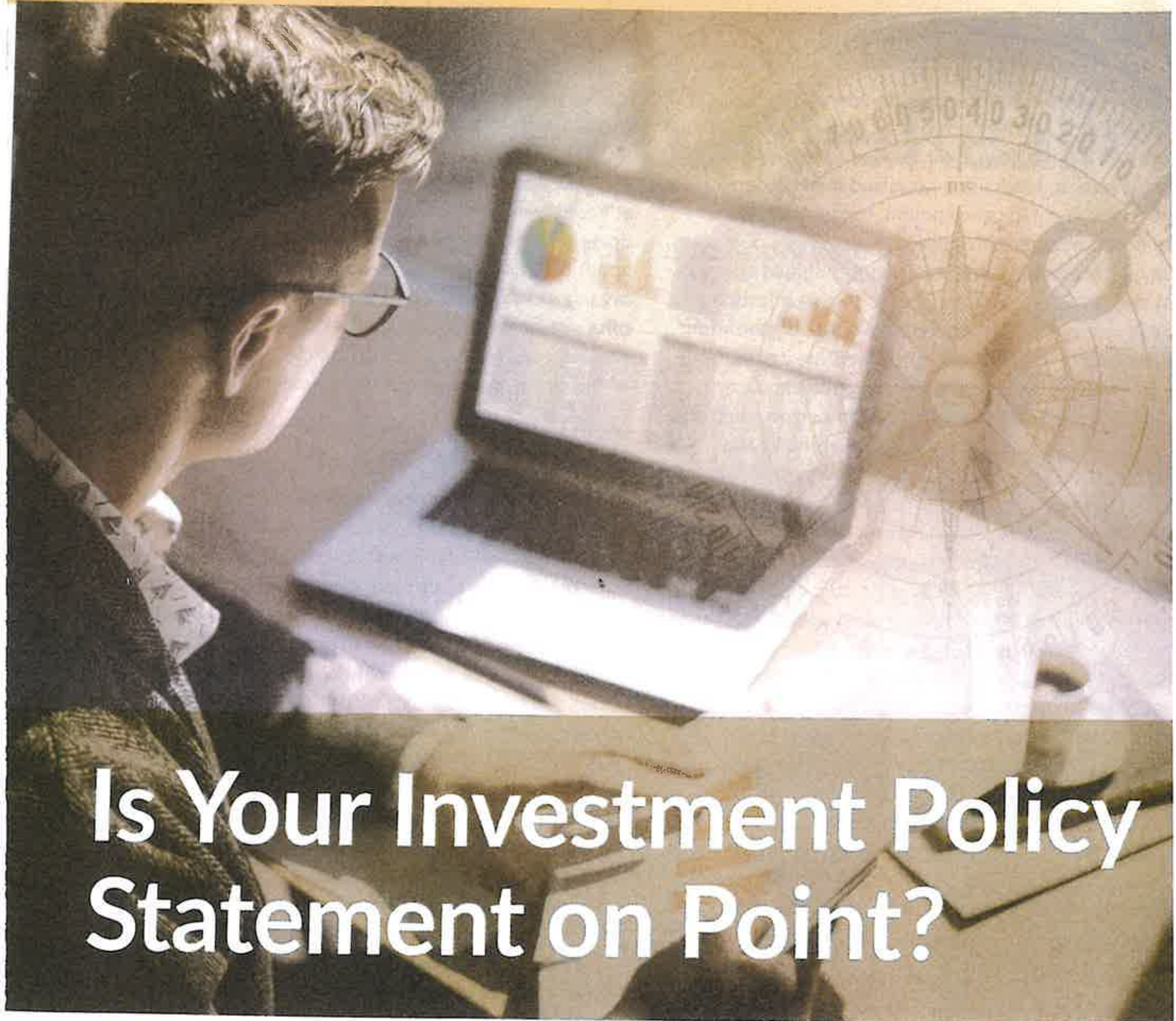

Is Your Investment Policy Statement on Point?

Managing your assets requires a compass

By Daniel Berkowitz, CFA, CIPM

Building an effective investment policy statement is critical for the successful management of any nonprofit organization's assets. A good IPS should help set clear alignment between an organization's mission and the assets used to support that mission. Just as no hiker should embark on a long trek without a compass, no nonprofit should be managing a pool of assets without an IPS. But the existence of a document in and of itself may not be enough.

Many nonprofit organizations adopt an IPS from various templates provided via investment management firms or found from internet resources. These are often a good start. But a template may not be customized enough to serve as a foundation for committee decision making through the ups and downs that market cycles most certainly will bring.

A well-crafted IPS supports a board's duty of care for the assets placed under their stewardship and helps ensure an organization's investment committee—and leadership team—are all rowing in the same direction. A well-crafted IPS will also clearly communicate an organization's investment goals, constraints, plan of execution, and importantly, measures of success.

Whether working with an outsourced adviser or managing assets in-house, these best practice considerations for nonprofits can help strengthen an IPS and lay the groundwork for creating a document that will serve as an effective guidepost well into the future.

DOCUMENT CLEAR AND MEANINGFUL INVESTMENT OBJECTIVES

Certainly, setting appropriate investment goals is no easy task. Two common pitfalls can undermine a set of investment objectives: Setting goals that are too ambiguous and setting goals that are unachievable.

Starting with the first, some nonprofit committees may intentionally set goals with less specificity to provide the team entrusted with managing the assets more flexibility through time. Though this is a thoughtful notion, the simplicity of less detail can actually create more confusion. For instance, a goal that states the organization would like to "earn a return above the rate of inflation" does not dictate what types of securities can be held and in what proportions—though these points may be addressed elsewhere in the IPS. Such details are important because without them, those responsible for managing assets could simply dial up the level of risk to meet return targets.

Similarly, setting unachievable investment objectives can cause a committee to make poor choices in pursuit of such objectives. One type of unachievable goal is a mismatch between a nonprofit's time horizon and investment strategy. For example, a foundation that must distribute assets under a relatively short, fixed horizon should generally be more focused on capital preservation—and should not pursue an aggressive growth objective, which may require multiple market cycles to reach fruition. Or, a nonprofit may set a return target that's too aggressive relative to their investment strategy and the types of investments it holds.

CREATE A THOUGHTFUL SPENDING POLICY WITH LIQUIDITY IN MIND

Most IPS documents have a section dedicated to spending policy—or at a minimum, a spending rule laid out. Crafting an appropriate spending policy warrants far more discussion in and of itself, but briefly, organizations should assess the nature of revenues and expenses first, rather than basing a spending rule purely on an expected return target.

Some nonprofits have diversified sources of unpredictable revenue streams from operations, while others are more dependent on a single source with greater predictability. Additionally, some nonprofits spend entirely from investment returns, whereas some spend minimal amounts from investment earnings and the majority from other sources. All these factors should be thoroughly assessed before deciding whether, for example, a hybrid spending policy or an inflation-based rule is more appropriate for a given organization.

With that said, to the extent spending is derived in some part from the portfolio, it is important to consider how the liquidity profile of the portfolio—or how easily various investments can be converted to cash—fits with the spending policy itself. This consideration has become even more important given the broad adoption of the endowment model for portfolio construction by many nonprofit organizations. Under this approach, many nonprofits hold significant allocations to private alternative investments and other active strategies that are generally more illiquid than investments in public markets.

Particularly during times of market duress, such as what we are experiencing now, it's important for an organization's investment committee to understand how liquid each sleeve of the portfolio is and which assets may be sold off first to meet required spending needs. Calibrating an investment strategy around a spending policy is an important exercise. Documenting the liquidity profile of various asset classes and any guidelines around drawdown in an IPS should be done in advance of inevitable periods of market volatility.

ENSURE UNIQUE CONSIDERATIONS ARE FORMALLY DOCUMENTED

Most nonprofits have some form of bespoke preferences or constraints. Sometimes they are more obvious, such as liquidity needs and unique reporting requirements. Other times they are more nuanced, like preferences for environment, social, governance (ESG) investing or restrictions related to the use of derivatives in portfolio management. Either way, these unique factors should be discussed and explicitly written out in the IPS for all relevant stakeholders to see.

Documenting these factors ensures those responsible for managing assets aren't surprised by unclear guidelines or expectations. Putting them in writing can also help new

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committee members bring themselves up to speed more quickly. Often, these unique considerations are woven throughout relevant sections of an IPS. To the extent a nonprofit is working from a shorter document with fewer sections, however, creating a "unique considerations" section is equally as effective as a catchall.

SET REASONABLE MEASURES OF SUCCESS

As with many endeavors in life, the definition of success is often subjective. With this in mind, nonprofit committees should be explicit and fair in defining what investment success looks like. Often, an IPS will lay out appropriate benchmarks against which an outsourced investment adviser or internal team will be evaluated. Being highly specific here is the right approach, but selecting the right benchmarks themselves can be challenging.

Some organizations prefer to compare investment performance to market indexes, while some prefer comparisons to peer institutions from providers such as The National Association of College and University Business Officers. Using multiple benchmarks or success metrics rather than one singular measure is often helpful in providing a committee with more context through which to assess performance. Ultimately though, what matters most is that if defined measures of success are met, the organization can achieve its mission.

For example, say an endowment uses a singular benchmark that incorporates market capitalization-weighted indexes covering global equity and fixed income. While this is a strong benchmark in that it is investable, transparent, easily measurable, and captures the impact of active management in excess return, it provides no information about peer-relative performance or the ability to meet spending needs. Hypothetically, this endowment could outperform such a benchmark by 50 basis points in a given calendar year (successful), while underperforming 75% of its peer group (unsuccessful) and earning less than a required payout percentage (unsuccessful).

Documenting time horizons for performance evaluation can be important as well. It's easy for nonprofit committee members to overly focus on short-term performance given various spending needs. However, many endowments and foundations are either indefinite-lived institutions or have extremely long investment horizons. If this is the case, assessing a portfolio that has a heavy allocation to private investments or other active strategies may require evaluation over five- and 10-year horizons instead.

Calibrating success across multiple measures is a reasonable approach. Still, use caution in ensuring the measures are not too numerous and are meaningfully linked back to the organization's objectives in some form.

UPDATE THE DOCUMENT OVER TIME

Building an IPS is not a singular event. Like any living document, it should be reviewed and updated on an ongoing basis. An IPS should most certainly be reassessed after any major changes, for example, to an organization's goals or spending needs. Even return targets may need updating in certain instances.

Absent major changes, an annual checkup is a reasonable frequency to use as a starting point. All investment committee members—and in some cases the full leadership team—should be involved in the review to ensure the process is collaborative. Outsourcing this exercise to a subset of the committee most familiar with the document as a starting point and then asking for full board sign-off may be an effective approach for larger committees or for committees that have seasoned investment professionals involved.

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