Improving Your Finances

How to Create an Investment Policy Statement

By Christine Benz | 06-08-17 | 05:00 AM | Email Article

Have you been ignoring my 2017 financial to-do list? No worries. Because if you only do one major portfolio-related task all year, you're just fine tackling June's to-do: the creation of an investment policy statement.

Financial advisors often prepare complicated investment policy statements for their clients, complete with appendixes, footnotes, and legal disclaimers. But your IPS needn't be overwrought.

Rather, at its most basic and useful, an IPS documents the parameters of your investment plan: the asset allocation framework, criteria for selecting securities, and the system to maintain those investments on an ongoing basis. Used in conjunction with a master directory (and a retirement policy statement, if you're retired or getting close) an IPS can be an invaluable tool for keeping tabs on your investments. Such documents will also aid your loved ones if, for whatever reason, they need to be able to obtain a quick and thorough overview of your investment plan.

If you've been an "investment collector," rather than an investment planner, up until now, it's not too late to think through your approach and commit it to writing.

We've created an investment policy statement template you can use to document your strategy, but you can also customize your own IPS in a Word document. If you're investing for multiple goals--retirement as well as college, for example--it will probably make sense to create a separate IPS for each goal.

While an IPS isn't likely to contain as much personally identifying information as a master directory, it's still valuable to protect these documents. Note that our IPS template is designed for users with access to Adobe Acrobat, which enables password-protection for documents. If you are opening this template with Adobe Reader (rather than Acrobat), print the document and write in the fields provided. Then store the document in a safe location, such as a locked file drawer or safe deposit box. Alternatively, if you’d like to customize your document, set up a file with similar fields in Microsoft Excel or Microsoft Word. Both programs enable password protection for your document.

No matter what format you use for your directory, be sure to follow these steps.

Step 1: Document your goals.
Documenting your goals might seem straightforward, but there's more to this section than meets the eye. If your goal is to fund retirement, for example, goal duration means forecasting your life expectancy (and that of your spouse, if you have one). Planning for a very long retirement is usually a good policy, but it doesn't make sense for everyone; this article can help you get closer to an answer on time horizon.

Quantifying how much you'll need for retirement is even more complex, requiring you to forecast not just unknowables such as your life expectancy and rate of investment return, but also to factor in your own variables, such as how your spending might change in retirement and whether you have nonportfolio sources of income such as a pension. Tools such as T. Rowe Price's Retirement Income Calculator can help you come up with a realistic estimate of your goal amount.

Step 2: Outline your investment strategy.
We've only left a few lines here, and that's by design: The idea is to be succinct. (If you went through our "investment approach on a note card" exercise, you already have the raw materials.)

An investment strategy for accumulators, for example, might be "To invest primarily in low-cost index funds, increasing contributions along with salary increases. Begin with an 80% equity/20% bond mix, transitioning to 60% equity/40% bond by retirement." An investment strategy for retirees might be "To invest in dividend-paying equities and bond mutual funds to deliver a baseline of income; regularly rebalance to provide additional living expenses. Target a 50% bond/50% stock mix."

Step 3: Document current investments.
Here you're documenting all of your accounts of a given type, as well as their most recent values. While our IPS template requires you to amalgamate all of your accounts of a given type--the IRAs for both you and your spouse, for example--you can append additional pages to create a more granular view of your holdings.

Step 4: Document target asset allocation.
If your first thought is, "But I don't have a target asset allocation!" let this section be your impetus to arrive at one. This article walks through the key variables to consider when setting your portfolio's asset allocation for retirement. This one tackles asset allocation for college, and this article discusses how to allocate assets for short-term goals (it also includes some sample short- and intermediate-term portfolios).

Because your portfolio's actual asset allocation is going to bump around a bit based on market performance (and, perhaps, active asset allocation decisions from you or your fund manager), it's sensible to express your target allocations to each asset class as a range rather than a specific target. If your range for equities is 65% to 75%, for example, that means you'll rebalance when your equities weighting goes below 65% or above 75%. For the major asset classes, a range of no fewer than 5 and no more than 10 percentage points is sensible.

Setting your allocations to U.S. stocks, foreign stocks, bond, and cash is the main job here. But for investors who would like to embed "tilts" into their portfolios--toward small-cap or emerging-markets equities, perhaps--we've also included lines for you to specify how much you'll dedicate to each of these sub-asset classes.

Step 5: Outline investment selection criteria.
Use this area to specify the characteristics that you'll look for in each investment type (and that you'll hold them to, on an ongoing basis). For example, you might specify that each of your equity holdings rate at least 3 stars, or that your mutual funds must all be rated Bronze or better. (Morningstar's analyst-driven ratings, whether star and moat ratings for equities or analyst ratings for mutual funds, are good variables to include among your monitoring criteria because they take into account multiple factors.)

You needn't specify parameters for each of these areas included on our template--for example, if you invest exclusively in index funds, you'd skip the sections related to management tenure and might instead specify that your holdings should each have expense ratios of less than 0.20% per year.

Step 6: Specify monitoring parameters.
Implicit in outlining all of the above policies--from asset allocation to investment-holding specifics--is that you'll periodically check in on your portfolio to ensure that it still passes muster.

In this section, you'll specify how often you'll check up on your portfolio. Less is more, in my view, which is why the maximum monitoring frequency included here is monthly. You'll also outline when you'll rebalance. Rather than rebalancing at specific time periods, I recommend rebalancing only when exposure to the major asset classes is 5 or 10 percentage points from the targets. (If you've set target ranges for your asset allocation in the section above, that will determine your response in this section.)

And because the best portfolio checkups are focused, it's best to specify what you'll look for as you review your portfolio. I like to start by focusing on the most important variables, like whether the portfolio is on track to meet its goals and whether its asset allocation is in line with the target range. Then, if time permits, you can focus on smaller-bore issues, such as your portfolio's performance relative to a benchmark with like-minded asset allocations. (This article discusses how to set up such a benchmark.)

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