Flippin, Bruce & Porter
Investment Counsel

FaceValue℠
Building business through knowledge

Support your clients with a plan for success

Create a comprehensive Investment Policy Statement

Flippin, Bruce & Porter, Inc. employs a value-driven, bottom-up, large-cap, fundamental equity approach. We make investment decisions by looking beyond current investor emotion, discounting Wall Street expectations and then relating historical financial company characteristics to current price. We believe that by combining solid value and improving fundamentals, coupled with judging investment sentiment, our process can yield successful results.

Building an effective investment plan

All investors approach the capital markets aiming for success. All financial advisors intend to help their clients succeed. But without a clear, detailed, long-term strategy, even the best of intentions can fail to meet expectations — for both the investor and the advisor.

For these reasons, an Investment Policy Statement (IPS) — a carefully crafted written document that can guide advisors and their clients through the investment process — is an indispensable tool.

Simply put, an IPS is a plan that outlines the goals a client wishes to achieve and the strategies an advisor should employ to meet those goals. The IPS serves as the foundation for all investment decisions by carefully defining objectives, analyzing the suitability of investment opportunities, formulating asset allocation strategies, establishing benchmarks against which performance can be objectively measured, setting ongoing criteria for portfolio management and instituting procedures for consistent review and communication.

Perhaps most importantly, an IPS can keep clients focused on their goals and investment strategies for long periods of time and help advisors affirmatively answer the simple, but critical, question: Am I doing all I can to increase the possibility that my clients will achieve their financial objectives?

An IPS can be highly useful for both institutional investors responsible for sizable assets and individual investors with relatively modest portfolios. Properly constructed, an IPS can:

- Compel investors and their advisors to focus critically on, and respond to an investor's goals, time horizon, risk tolerance, and return and liquidity needs
- Identify appropriate investment options, asset classes and asset allocation parameters to meet an investor's objectives
- Establish roles, responsibilities and procedures for the investment, management, administration and monitoring of portfolio assets
- Raise key issues that might otherwise escape attention

Clearly, every client needs to have an IPS — whether it is a simple one-page plan or a long, complex strategy. As a written document, an IPS becomes the narrative that defines all management-related activities, and can serve to ensure that the client and advisor adhere to the intended investment plan.

A solid foundation for every client's investment strategy

As we mentioned earlier, a properly crafted IPS should serve as the foundation for a client's complete investment strategy. But for an IPS to be effective, that foundation must be constructed with the right tactical components. Although each client's IPS will require a certain amount of customization, there are a number of elements that should be included in virtually all such documents.

An Investment Policy Statement can help investors make well-informed decisions based on logical, prudent guiding principles, not on ill-founded emotion.

Purpose of investment

A key factor in building a productive, long-term relationship with a client is establishing mutual trust and agreeing to clear, definable and realistic expectations. When determining goals for an individual investor or institutional client, it is important for the advisor not only to listen to what the client wants, but also assist them in identifying their needs. A suitability profile may be an appropriate starting point for individual investors, but it is only a first step; multiple conversations with a client are essential, especially with institutional clients who are faced with complex challenges.

Roles, responsibilities and procedures

For an individual investor's IPS, establishing guidelines should be straightforward. The advisor will help establish asset allocation targets, implement the plan, contact the client on a regular basis and monitor investments. The client also will have responsibilities: to keep the advisor informed if his/her situation changes, follow the advisor's recommendations and meet to review the account. Guidelines for an institutional IPS typically are more complex. These often will include establishing the roles, responsibilities and procedures for the investment, management, administration and monitoring of portfolio assets among other advisors or decision-influencers — such as accountants, attorneys, trust officers and trustees.

Asset allocation and guidelines for investments

Based on an investor's profile, an initial asset allocation strategy is designed and put into action. Because studies indicate that asset allocation decisions play a fundamental role in determining portfolio performance, the IPS should be very specific about the asset classes chosen, the percentage of assets that should be invested in each class and the reasons for creating a particular mix. Only after the asset allocation formula is determined, should individual securities or funds be chosen. For more complex plans (especially institutional), subsequent allocation considerations, along with specific instructions regarding various investments, often are appropriate.

Specific investments

The advisor sets parameters for selecting and monitoring individual investment managers. Such parameters may include a manager's demonstrated adherence to stated investment objectives, and the competitiveness of fees and expenses relative to similar investments. In turn, the managers establish criteria for choosing specific investment opportunities, such as an investment option's volatility and performance related to selected benchmarks. The IPS also should list any investment alternatives that the client does not want to own or can't own due to specific policies or restrictions. Further, the advisor should fit investment managers to the client, not the other way around.

Time frame of investment

How long the savings/accumulation phase will last, when assets will be needed, and how long the distribution phase will need to continue are key factors in most every investment plan. In this area, the differences between the needs of an individual investor and those of an institutional investor can be striking. Individuals normally have relatively straightforward objectives (e.g. retirement) with clear-cut, if estimated, time frames (e.g. 20 years to accumulate assets for retirement and 30 years of spending in retirement). On the institutional side, client entities (such as defined benefit plans) often present indeterminate "life spans." Further, a retirement plan sponsor would have to take into account the age of its work force and incorporate into its IPS the likely retirement dates of current (generally older) and future (generally younger) employees/plan participants. Thus, for many institutional investors, time-frame management can require planning for an indefinite accumulation phase while attending to short- and long-term liquidity needs.

Withdrawals or income needed (liquidity needs)

The IPS should clearly define when, how much, and how often, income will be needed by the client — at present and future dates. Individual investors who have not yet arrived at the spending phase of their plans likely will require little or no current liquidity, though a complete IPS will estimate future liquidity needs and establish a schedule for converting existing assets into cash. Institutional investors, who normally have ongoing liquidity needs, will specify present and future allocations for cash equivalents necessary to meet their obligations. In all such instances, the IPS will identify which investments will be used to meet specific goals.

Tax issues

Relevant issues include the investor's current tax bracket and anticipated tax bracket at the conclusion of the accumulation phase. Other factors include the potential benefits of tax-favored securities, choosing between taxable and tax-deferred investment vehicles, and the impact of exchanging growth investments for income securities as the investor ends the accumulation phase. Further, the IPS should provide a tax-sensitive strategy if the client will need to liquidate highly appreciated low-basis assets to meet present or future income needs.

Expected return

It is essential that the financial advisor adequately educate clients on rates of returns that can reasonably be anticipated (though not guaranteed) from various types of asset classes and securities. Expectations should be managed and agreements reached, to avoid disappointments down the road. Based on such factors as the client's investment goal, time horizon and current assets, the IPS should establish a target rate of return and discuss the types of investments most likely to produce the target return. Similar factors dictate expected return for institutional investors, with the additional consideration of fiduciary responsibilities and how these responsibilities may be met through asset allocation and spending policy guidelines.

Expected risk

As important as expected return is an investor's expected risk. This involves evaluating the client's investment time frame and risk tolerance, analyzing anticipated risk vs. reward profiles of various investment options, and establishing a plan for reducing risk as the date of the client's goal approaches. However, the advisor also should consider the relationship between the client's "risk tolerance" (how much risk an investor says he/she is capable of handling) and "risk capacity" (the amount of risk an investor's complete financial profile indicates the investor should actually assume). An appropriate level of risk should be based on what the advisor deems necessary to achieve the client's goals — incorporating the rate of return a portfolio will need to generate over the relevant period of time. Where applicable, it is the advisor's responsibility to help the investor understand that their desired goal drives the level of risk that must be assumed.

Proposed benchmarks

Employing multiple asset classes means that a single index benchmark, or even several benchmarks, will be an inadequate measure of a portfolio's performance and risk characteristics. In most cases, the diverse nature of a portfolio's holdings could require the construction of a personalized benchmark to measure performance and volatility. Benchmark returns should be appropriate, unambiguous and readily measurable, and specified before the start of any evaluation period.

Performance reporting and plan monitoring

The IPS should note the frequency and method of reporting from the advisor. The advisor should plan to monitor the client's investment strategy (performance and risk factors) on a regular basis, using the IPS as an overall benchmark. The IPS should be revised, or a new IPS created, when there are significant changes to the client's financial or lifestyle circumstances, asset allocation or investment objectives, risk profile, liquidity needs or risk-and-return parameters. With regard to institutional clients, a change in company management or an organizational takeover could precipitate an IPS review.

Communication expectations

The financial markets are exceedingly fluid, as can be the case with an advisor's clients. Regular and informed communication between advisor and client is crucial to maintain a constructive, long-term relationship. The IPS will establish the frequency with which the advisor will communicate/meet with the client.

The unique demands of an institutional IPS

While an IPS written for an individual investor generally will be relatively short and straightforward, an institutional IPS will be longer and more detailed, and must address a number of additional complex issues.

Spending Policy Statement. This may be a separate document developed to detail the institution's spending requirements and limitations, presently and in the future. An IPS and a Spending Policy Statement can work together to meet the cash flow needs of the client. Over time, the IPS needs to provide sufficient flexibility to meet the cash flow needs laid out in the Spending Policy Statement.

Spending policy guidelines. Based on a client's needs and obligations, particularly when dealing with defined benefit plans or endowments, the IPS should state the percentage of a portfolio's assets to be distributed on a regular basis (usually annually) to fund expenditures.

Investment options. For defined contribution plans, ERISA requires plan sponsors to provide participants with at least three investment options, such as stable value, balanced and equity. These options must enable participants to construct portfolios that are appropriately diversified. The IPS will determine how broad the options to employees are. The point of using an IPS is not to overwhelm employees but satisfy participants and support their unique financial circumstances.

For complex strategies — such as an institutional portfolio spanning a broad range of asset classes and managed by multiple investment advisors — a separate Investment Policy Statement may be created for each portfolio segment.

Purpose of investment. When dealing with endowments, an IPS may need to define the three types of endowments: true endowments, term endowments and quasi-endowments. Because endowments can be complex arrangements between donors and nonprofits, the IPS may need to outline specific guidelines and limitations for each of these categories separately.

Financial advisors should stress to each client the importance of having a workable Investment Policy Statement — whether that IPS is a relatively simple single-page plan or an extensive, complex document coordinating the work of multiple investment managers.

Target return objectives. The IPS will establish a target rate of return. (Often, the IPS will state the expectation that target returns will be exceeded.) The IPS should note the actuarial assumptions that could affect future plan funding rates and liabilities.

Maximum risk tolerance. An appropriate level of risk should be based on the client's financial ability to accept risk and the level of risk the advisor deems necessary to achieve the client's goals. It is the advisor's responsibility to establish risk guidelines in the IPS and then identify a manager who can adhere to the guidelines. At the institutional level, more sophisticated risk measures may be employed to monitor and manage risk — such as standard deviation, alpha, beta, duration, Sharpe ratio and R-squared, along with portfolio probability simulations.

Tax issues. The Internal Revenue Service requires that independent and corporate foundations 1) pay out at least five percent of the year-end fair market value of their assets, 2) pay an excise tax of one or two percent on their earnings and 3) give money only to other 501(c)(3) organizations, with a few rare exceptions. These obligations should be described in the IPS.

Security restrictions. Managers should not invest in securities, or engage in actions, that are not expressly allowed by the client (per the IPS).

Execution guidelines. The IPS should specify how investment managers and custodians must execute trades. Managers, in particular, are directed to monitor trading costs and seek the best execution possible.

Proxy voting concerns. A client who is a plan sponsor has a fiduciary responsibility to spell out a proxy voting policy. Such a policy should compel investment managers to vote proxy ballots in a manner consistent with shareholder interest.

As an investor's financial strategy changes, so should their IPS

An effective IPS can serve as a catalyst to a long-term investment plan, and is an important tool in periodically assessing and recalibrating a client's financial strategy. As a flexible, dynamic document, the IPS should be reviewed by the advisor and client on a periodic basis, as well as whenever the client's circumstances change appreciably.

A key feature of an IPS is that it is not a static document, but an adaptable plan capable of evolving if an investor's specific goals and circumstances change over time. Because a client's investment strategy can be, in effect, a work in progress, so should the IPS that guides that strategy.

For example, an individual investor nearing retirement may need to reduce the level of risk in their portfolio, necessitating a change in the existing asset allocation strategy. Or perhaps a corporation with a defined benefit plan undergoes a change in senior management and new executives determine the company's IPS needs to assume more risk.

In these and other situations, an IPS can offer the clarity of a well-defined strategic approach, and a mechanism for keeping investors and their advisors in sync and on track.

Some brokerage firms do not permit their Financial Advisors to create Investment Policy Statements for clients, but may allow them to assist in the process. Please check with your firm's compliance department for further guidance.

FLIPPIN, BRUCE & PORTER
Investment Counsel

P.O. Box 6138
Lynchburg, VA 24505-6138
1-800-851-3804 | www.fbpinc.com