

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## Creating an Investment Policy Statement

*Stephen C. Winks*

How do you differentiate yourself from thousands of financial advisors in today's highly competitive financial services business? When all financial advisors seem to be saying the same things, it is difficult for the consumer to discern one financial advisor from another. The creation of a statement of investment policy is perhaps the most powerful sales tool in the financial services business, as it differentiates the level of investment counsel and value the investment management consultant provides and facilitates the building of long-term relationships.

Without investment policy, it is not possible to add value or to provide a high level of investment counsel as there is no reference point to what values are important to the client and what the client hopes to accomplish. Thus, without the discipline of investment policy, almost any investment would seem to make sense. But with well delineated goals and objectives and a diagnostic evaluation of the investor, the consultant can determine the investment values (risk, return, tax efficiency, liquidity, cost structure and time horizon) necessary for the client to achieve their long-term goals and objectives. With these reference points, it is possible to add value in terms specifically meaningful to each client. In doing so, investment policy differentiates the high level of investment counsel provided by the consultant from other financial service professionals.

There is a wonderful opportunity to build relationships with the most highly desirable clients through the creation of a written statement of investment policy which would address the investment values most important for each individual client. Most investors have not quantified their goals and objectives as future unfunded liabilities. Most investors do not understand their sensitivity to risk, or income/estate taxation. Most investors do not have a clear investment time horizon or a sense of the cost structure or the liquidity of their assets. And yet, despite the absence of this crucial information, tens of thousands of financial advisors

stand ready to offer the most spectacular returns of the moment without any idea as to how it relates to the client's goals, objectives, unique needs and circumstances. These are the same financial advisors who say they add value. Yet, they cannot address the risk, return, tax efficiency, liquidity and cost structure implications of their investment recommendations in the context of the client's goals and objectives, or the client's assets as a whole. This is why written statements of investment policy are so important in differentiating you from your competitors and in initiating and building long-term client relationships. Investment policy raises all the soft value questions of accountability, suitability and objectivity around which long-term relationships are built. If one were accountable for their investment recommendations, they would not be chasing extraordinary short-term performance which, by definition, cannot be sustained. If one doesn't understand the client's sensitivity to risk, income and estate taxation, or their goals and objectives, it is not possible to make a suitable investment recommendation. Without detailed knowledge of the investor and their assets as a whole, how can one be

objective in their investment recommendation if the only information they have is the investment they are recommending and their compensation? Without knowledge of the investors, you have no understanding of the investment values that need to be addressed, and without knowledge of the client's assets as a whole, you cannot determine to what extent a particular investment recommendation actually adds value. In fact, with a SEC requirement (Section 405 of the Securities and Exchange Act of 1934), "to know your client" being the single, most significant source of litigation within the brokerage industry, accounting for hundreds of millions of dollars in the operating budgets of major firms, you would think that written statements of investment policy would be widely used by firms and at the least, widely used by enterprising financial consultants.

So why doesn't every client have a written statement of investment policy? Without automation, it very

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[ Graphic O m i t t e d ]

[ Graphics omitted ]

simply requires an incredible commitment after the client interview to create and evolve investment policy over years of quarterly performance updates. Investment policy is a living document. The client's needs and circumstances change over time as do market conditions. Thus, only in testing the client's behavior in actual market conditions does one gain a better understanding of the client's sensitivity to risk and other values that are initially developed in the abstract of a client interview and and diagnostic testing. Over a period of years of evaluating the client's actual reactions to real market conditions, are investment policy and investment strategy evolved to more accurately reflect the client's needs and circumstances. The challenge in providing a high level of investment counsel and value is to find a more efficient way to create and manage a written statement of investment policy.

Bob Rowe, a practicing consultant with a major brokerage firm, after more than 10 years in development, has created software that provides a means to produce a meaningful investment policy statement in a simple and efficient manner. Rowe Decision Analytics has substantially automated the creation and management of investment policy statements for retail investors, endowment funds and foundations, institutional level Taft Hartley plans, 401(k) plans and qualified plans (defined benefit, defined contribution, profit sharing, money purchase and target benefit). For consulting practitioners who have had to manually create investment policy for their clients, this is a significant breakthrough that will allow you to serve many more clients. For brokers and firms interested in providing a high level of investment counsel and value to their clients, this is a significant breakthrough that will allow investment policy to be more broadly used with clients. With Row Decision Analytics, it is now possible for every financial services professional who wants to provide a high level of investment counsel to create a custom statement of investment policy for clients. Importantly each individual statement of investment policy has a legal opinion of John Lohr, former counsel of Salomon Smith Barney's Consulting Group and general

counsel to Lockwood Financial Group, that the investment policy statement is in compliance with ERISA.

How Bob Rowe developed this investment policy technology is instructional in several ways, as it provides insight into how our industry is evolving and confirms that innovation continues to come from leading consulting practitioners, not their firms. For more than a decade, Rowe knew there had to be a better way to prepare and maintain written documentation of his client's goals and objectives, their return expectations, sensitivity to risk and taxation, and their liquidity needs. It was frustrating and time-consuming. Though Rowe's invest-

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ment policy statements always met his legal obligations and fiduciary duties, it rarely met its potential as a working document with the client. Rowe always felt the investment policy could become a powerful marketing tool that would differentiate the high level of investment counsel provided by the consultants.

In over a decade of research and development, Rowe went through six computer programming firms before finding one with superior understanding of financial issues. The software itself has been upgraded several times to account for the needs of the consulting practitioner, the needs of the clients and the evolution of regulations such as the Uniform Prudent Investor Act of Endowments, Foundations and Personal Trusts (UPIA). Initially there was an almost continual upgrading of the software that

can only come from its development by a practicing consultant.

First there were client-related issues. Investment policy approaches of the past overlooked the important differences and nuances of clients. When you have 23 different opinions on the investment committee for the foundation, how do you gather each trustee's opinion? Rowe always wondered why should the loudest voice in the trustee meeting reflect the majority? Will the client's intense dislike for tobacco be noted and remembered? How will you develop a majority consensus for the new 401(k) plan options your client seeks from you? How are you going to create investment policy for a Taft Hartley Fund when you have six very knowledgeable senior trustees and two new relatively inexperienced, yet very interested trustees? How do you create written investment goals for clients who like all investors, believe they know what they want, yet are uncertain how to get there? What about the medical clinic's 401(k) plan where you have mutual funds for most of the employees and you also have individually managed accounts for the more "financially astute" medical doctors who intend to become the next barons of Wall Street? The scenarios that Rowe encountered seemed almost endless.

Rowe also had to manage the cultural challenge of financial services firms understanding investment policy and their offering of policy substitutes or summaries which were of little help to the client and the consultant. It was only a few years ago that virtually no one within the major financial services firms knew what investment policy statements should accomplish. The few that did developed summaries of one or two pages or abbreviated statements that allowed practitioners to talk about investment policy in principle, but did not in practice facilitate the high level of investment counsel, which is the promise of investment policy. Even for the many consulting professionals willing to adhere to written investment policy statements, the situation was difficult. At firms which were committed to investment policy statement consistency, maintaining investment policy documentation was also a major challenge.

Clarity in interpretation was also a major issue. A poor investment policy statement could get 10 different interpretations from 10 different consultants. Cookie-cutter programs generated dismal results as too many of the policy statements read the same, thus not facilitating the in-depth client relationships that come with well prepared investment policy. Rewriting or customizing separate policy statements are costly, repetitive and very time-consuming. In the end, most mass produced statements served to keep the compliance department away but did little else. It was these challenges and questions and the desire to literally be of value for his clients that moved Bob Rowe to develop the software which is licensed by Rowe Decision Analytics as Investment Policy/Asset Allocation Model (IPAAM).

IPAAM is the first computerized software program that integrates the components of client-written investment goals and objectives with those of an asset allocation model. The technology can be customized to accommodate any investment values or packaging requirements of corporate users and is available to individual consulting practitioners. The software allows the investment management consultant or those who would like build a consulting practice to:

- Determine and manage each investor's goals and objectives through unique questionnaires developed for specific market segments to include retail high net worth investors, endowment funds and foundations, institutional level Taft Harley plans, 401(k) plans and transitional qualified plans. These market segment specific questionnaires simplify a very complex investment management burden that often entails fiduciary liability and provides a framework where their investment values, goals and objectives can be clarified.
- Organize all the trustee responses individually and collectively into one comprehensive statement of investment policy, creating one voice for the trustees.
- Create a customized investment policy for each participant in a 401(k) plan as well as

create investment policy for Taft Hartley plans, and endowment funds and foundations for high net worth individuals and for most forms of qualified plans.

- Test compliance of current proposed portfolio recommendations against investment policy.
- Develop a return-based "what if" analysis of the current portfolio against the proposed portfolio for expected income, return, expected appreciation and total return, current, minimum and maximum rates of return. IPAAM's asset allocation is not an optimizer or analytical model, but more of a client-decision making tool in looking at various hypothetical portfolio configurations or in looking at specific investment recommendations. Rowe recommends Ibbotson, Frontier or Investworks optimization models for portfolio construction.
- Integrate specific language on allowed and prohibited assets, the use of market magnifying derivatives, proxy voting, hypothecation of securities and many other relative and appropriate criteria.
- Provide a legal opinion that each statement of investment policy is in compliance with ERISA for qualified firms.

For investment professionals who want to provide the highest level of investment counsel and value for their clients, creating a statement of investment policy for each client is imperative. For firms who seek protection from litigation on investment suitability, lack of prudent diversification, inappropriate trading patterns, misrepresentation or appropriateness of investment strategy, these liabilities can be virtually eliminated with written reliable investment policy statements. Just as asset allocation is being more widely used and will eventually become an industry standard, investment policy will also become an industry standard. Thanks to the good work and perseverance of Bob Rowe and his vision of providing a high level of investment counsel and value to his clients, today it is possible for all clients to have a written statement or investment policy. ■

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## SENIOR CONSULTANT

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Co-Founder

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Co-Founder, Publisher & Editor-in-Chief

Sydney LeBlanc  
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Yanni Parnters

## SENIOR CONSULTANT

1457 Crystal Springs Lane  
Richmond, Virginia 23231

Ph 804-795-1642 ■ Fax 804-795-7703

[www.SrConsultant.com](http://www.SrConsultant.com)