The 10 Essential Elements of Investing

Essential Element 8
Own the plan

Beaver Investing

The investment guide for Canadian foundations and charities
Third edition

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In Essential Elements 2-7, we covered the Invest phase: planning the investment program. We now proceed to the Govern & Lead phase with Essential Elements 8-10: owning the investment plan and building leadership capacity for long-term success.

Discern	Invest	Govern & Lead
1) Start with why	2) Set the mix	8) Own the plan
	3) Diversify	9) Build inside
	4) Simplify	10) Build outside
	5) Balance risk	
	6) Control cost	
	7) Use time	

In this paper, we bring together the elements we have outlined earlier in the guide and form them into a clear and concise investment plan.[1] The investment plan typically consists of three parts: a Governance Policy Statement, an Investment Policy Statement and a Spending Policy Statement. We will discuss each of these parts of the investment plan, before exploring how to develop and begin implementing the plan.

Governance Policy Statement

A governance framework outlines the responsibility, authority and accountability of the parties involved in the investment program. Below is an example of a Governance Policy Statement for small or medium Canadian foundations and charities.[2]

The organization's Board of Directors (the Board) has delegated to the Investment Committee (the Committee) the authority and responsibility for management and oversight of its investment assets (the Fund). The Committee recognizes that there are different types of fiduciary roles in the management and oversight of the Fund. The Committee is the governing fiduciary with the ultimate responsibility for the investment program. The Finance Director (or Executive Director) is the managing fiduciary of the investment program, charged with the day-to-day management responsibility for the Fund. In general, the Committee's responsibilities are focused on expressing the Fund's mission and choosing the investment policies most likely to achieve it. The Committee:

- Defines the Fund's mission.
- Establishes performance goals and investment objectives for the Fund and monitors actual performance versus these goals and objectives.
- Establishes the policy asset mix and acceptable asset allocation ranges.
- Approves asset allocation deviations from outside approved ranges.
- Determines the acceptable level of active management risk.
- Determines acceptable asset classes.
- Determines acceptable investment strategies.
- Approves asset class targets.
- Reviews governance procedures and makes recommendations to the Board.
- Approves custodian bank and audit relationships.
- Provides information and recommendations to the Board as required.

The Committee recognizes that its professional investment staff is best situated to make day-to-day investment decisions. The Committee has delegated authority to the Finance Director to implement key policy and operational decisions for the Fund. The Finance Director:

- Evaluates, retains, and terminates investment managers.
- Evaluates, retains, and terminates consultants and other service providers,
- Determines asset allocation deviations within approved ranges.
- Establishes performance benchmarks and investment guidelines for individual investment managers.
- Establishes and implements manager-monitoring procedures,
- Determines asset allocation within the parameters of the policy asset mix.
- Provides liquidity for payments to beneficiaries and to fund operations.
- Provides recommendations to the Committee as needed to aid in the decision-making process.
- Provides the Committee with adequate information and resources to make policy decisions and monitor fund performance.

The key point for small and medium institutions is to maintain a clear "separation of powers" between the governing fiduciary (Investment Committee) and the managing fiduciary (e.g. Finance Director). The Investment Committee's role will be undermined if a decision can be overruled on a whim by the Board Chair (e.g. the Committee sets a policy asset mix of 60% stocks and 40% bonds but is forced to change the mix because the Board Chair feels there is a lot of risk in world stock markets). Similarly, the Finance Director's role will be undermined if their decision can be set aside by the Investment Committee (e.g. the Finance Director selects an investment manager based on a thoughtful process but instead is encouraged to choose from a handful of investment managers known to the Chair of the Investment Committee). A clear and consistent "separation of powers" is a defining element of successful governance.

Investment Policy Statement

An Investment Policy Statement outlines the overall approach to investing. We provide an example below, highlighting three key themes. First, policy can be brief. Second, there is great value for institutions to explain not just what they invest in but why they invest the way they do. This enables them to teach their approach to new team members and share their approach with others outside the organization. Third, institutions should engage the investment committee and management team in developing the policy, which they can best achieve by linking it to their purpose or strategy. Although it is appropriate for an investment manager to propose or even facilitate a policy, the investment committee and management should have ample opportunity to understand the policy, explore how it would work in a wide range of situations and own the process of how it supports the strategy. Below is a sample investment policy statement, which draws on the principles outlined in the first seven parts of this investment guide.[3]

Organization's profile

For more details on the organization's profile, see Essential Element 1: Start with why.

- Purpose: Here we summarize the organization's purpose.
- Objectives: Here we summarize the organization's objectives.
- Time horizon: Here we state the organization's time horizon (e.g. expected to exist in perpetuity or will wind down in the next three years).

Investment objectives

- Growth: To maintain or grow the purchasing power of the endowment over the next 25 years and beyond.
- Spending: To distribute 3.5% of assets annually to programs that support the organization's purpose.

Return

- Required annual return (minimum acceptable annual return): To meet or exceed the disbursement quota in 100% of five-year periods.
- Target annual return, primary: To meet or exceed the disbursement quota plus inflation and investment costs in over 80% of five-year periods.
- Target annual return, secondary: To meet or exceed the market benchmark in over 60% of five-year periods.

Risk

Risk tolerance is comprised of ability, willingness and need to take risk (for more details on risk tolerance, see Essential Element 5: Balance risk):

- Ability to take risk: Consider the institution's time horizon, proportion of total income derived from investments and proportion of long-term assets spent each year, among other factors (see Essential Element 1: Start with why). Enter a stock-bond mix and the possible annual loss, based on the organization's ability to take risk
- Willingness to take risk: Consider the largest short-term loss that the institution is willing to accept without abandoning the investment plan. Enter a stock-bond mix and the possible annual loss, based on the organization's willingness to take risk.
- Need to take risk: Enter the required annual return or minimum acceptable annual return. This will normally be spending rate plus inflation and investment costs (see Essential Element 1: Start with why).

Institutions assess ability and willingness to take risk as a stock-bond mix, taking the lower of these two values. One hopes that the resulting value, when translated into an expected return, is higher than the institution's need to take risk – the minimum acceptable return required to meet long-term objectives.

Asset mix

For more details on the asset mix, see Essential Element 2: Set the mix.

- Stocks. We invest in stocks to provide long-term growth to the portfolio. We will typically invest 50-70% of our portfolio in stocks, divided between Canadian, US and international markets. Our exposure to each market will be within a stated range, based on the investment manager's advice. We will maintain full currency exposure to foreign stocks, since this can help to reduce the impact of short-term losses. Our bias is to own broadly diversified stock positions.
- Bonds. We invest in bonds to provide short-term stability to the portfolio. We will typically invest 30-50% of our portfolio in Canadian bonds, divided between short and medium maturities. Our exposure to these maturities will be within a stated range, based on the investment manager's advice. Our bias is to own broadly diversified bond positions.
- Cash. We will typically not hold cash in the investment portfolio. We will hold cash separately in a spending account for short-term needs.
- Rebalancing. We will rebalance the portfolio to its target asset mix annually, on or around the fifteenth day of January.

Below is a sample asset mix, based on 60% stocks and 40% bonds.

Asset	Average weight	Range
US stocks	20%	10-30%
International stocks	20%	10-30%
Canadian stocks	20%	10-30%
Canadian bonds	20%	0-40%
Canadian short-term bonds	20%	0-40%

Fees and costs

For more details on fees and costs, see Essential Element 6: Control cost.

- We recognize that fees and costs reduce our net returns. We will minimize these fees and costs where reasonably possible.
- We expect our investment management fees to be less than 0.75% of assets.
- We expect our holding costs (Management Expense Ratio) to be less than 0.25% of assets, unless for good reason.
- Other costs. We expect that other costs (e.g. transaction costs, account custody and foreign currency conversion) will be minimized in a prudent manner and charged at cost without any mark-up.

Restrictions

- Total restrictions. We will not use leverage, short selling or derivatives. We will not hold leveraged or inverse funds.
- Investment restrictions. We will only hold bonds that are rated investment-grade.
- Fund restrictions. Here we would note any restrictions on investing endowed funds. For example, donors sometimes restrict endowed funds so that only dividends or interest can be paid out, not capital gains.

- Ethical restrictions. Here we would note any restrictions on investing in assets or individual securities.

Monitoring, reporting and evaluation

- We will monitor performance quarterly, based on a report provided by the custodian.
- We will evaluate performance annually, based on risk and return over five-year periods, to avoid placing undue emphasis on recent performance.
- We will use the following market benchmarks in Canadian dollars (foreign stocks are currency-unhedged, with full exposure to their respective currencies):
    - US stocks: S&P 500.
    - International stocks: MSCI EAFE.
    - Canadian stocks: S&P TSX Capped Composite.
    - Canadian bonds: FTSE Canada Universe.

Spending Policy Statement

While most institutions pay careful attention to the Investment Policy Statement, sometimes the Spending Policy Statement can be neglected, especially by smaller organizations who wish to maintain flexibility for unexpected needs. In spending as in investment, however, a planned approach will generally work better than an ad hoc approach.

A Spending Policy Statement sets out how to manage spending and liquidity over the short term. Spending policies are typically a fixed percentage of assets, a smoothed percentage of assets or a hybrid of the two. With a fixed percentage of assets, we would spend say 4% of assets each and every year. Although this policy is simple to set, it is difficult to implement. Since the portfolio is invested in stocks, which are volatile, the level of our assets and spending can bob up and down quite a lot from one year to the next. With a smoothed percentage of assets, we calculate the average spending rate from say the last three years and apply this to the current year. The endowment of Yale University, widely considered to be one of the best-run endowments in the United States, uses a smoothed spending rule.[4] In this rule, the current year's spending sums to 80% of the previous year's spending and 20% of the target long-term spending rate applied to the year-end portfolio balance two years earlier (the latter is roughly equivalent to a three-year moving average). Institutions can apply a floor and ceiling to this method. If the calculated spending rate were 4% for a given year, then they might commit to a floor of say 3%, to maintain a minimum level of funding regardless of returns. Similarly, they might commit to a ceiling of say 6%, to prevent over-spending in good years. When thoughtfully designed, the spending policy can be a hidden gem of the investment plan, enabling institutions to pursue higher expected returns in the portfolio, without unduly transmitting volatility to the operating budget.

Developing the plan

We propose three guidelines to develop and begin implementing the investment plan.
First, develop the plan with as much engagement as possible from the investment committee and management team. Engagement means not just nodding and approving a plan that an

investment manager has provided but truly seeking to understand the essential elements of the investment program, questioning the assumptions behind them, asking what would happen in a wide range of situations and building confidence that the investment program will support and not impede the implementation of the organization's strategy. This is not easy to do but rewarding over the long term.

Second, outline in the plan not just the what of investing but also the why, including data, evidence or references to the literature. For example, as outlined in Essential Element 4: Simplify, if institutions do not explain the reasoning why full currency exposure to US stocks is desirable (that the US dollar can rise during stock market turmoil and help to reduce risk for Canadian investors), then the investment committee might be tempted to constantly revisit the currency hedging decision, reacting to the short-term fluctuations of the Canadian dollar. By explaining why they invest the way they do, organizations make it easier for investment committee members to focus their attention on the right things.

Third, keep it simple. Below is a simple but thoughtful agenda for an investment committee meeting:

1) Review investment and spending policy. The default is that no changes are required, so changes are by exception.
2) Review performance. Performance can be reported quarterly but should be evaluated only annually (preferably over rolling five-year periods), to maintain an appropriately long-term perspective.
3) Understand the process. For example, a committee decides over the course of four meetings to explore one of the stock investment strategies, to better understand its strengths and weaknesses over the long term.
4) Explore a learning theme. For example, a committee decides over the course of four meetings to explore the effect of inflation on long-term returns, learning how other organizations have addressed this in their investment policy.
5) Discuss other business. Address points raised by committee members, the executive director or the investment manager. Where possible, these points should be submitted in advance with a clear question, to encourage thoughtful reflection and discussion.

We suggest that the quarterly investment committee meeting should include extended learning and reflection on points 3-5 and only summary discussion of points 1-2, deferring evaluation of performance to the annual meeting. This replaces the usual focus on short-term performance with sustained reflection on the investment process. For institutions investing for the long term, process sets up performance.

Conclusion

It is difficult for any fiduciary investor to achieve long-term success without a strong investment plan. The investment plan consists of three parts. The Governance Policy Statement sets out the accountability and responsibility for the investment program; the Investment Policy Statement explains the approach to investing, including investment objectives, asset mix, risk tolerance and performance reporting; and the Spending Policy Statement shows how to manage spending and liquidity. As we will see in Essential Elements 9-10, foundations and charities can use the investment plan not just for investing but also to build leadership capacity, both inside and outside the organization.

[1] Key references for the process of developing, managing and governing an investment plan are Charles Ellis, *Winning the Loser's Game* (2017, seventh edition); David Swensen, *Pioneering Portfolio Management* (2009, second edition); and Ben Carlson, *Organizational Alpha: How to Add Value in Institutional Asset Management* (2017). Ellis was Chair of the Investment Committee at Yale University, during part of Swensen's tenure as Chief Investment Officer.

[2] The Governance Policy Statement is adapted from the example provided in *A Primer for Investment Trustees*, Research Foundation of the CFA Institute (2011).

[3] This is a sample investment policy statement (IPS), provided to outline some of the elements of an IPS for charitable institutions. An IPS should be developed based on the specific needs of an institution, including its time horizon, objectives and risk tolerance.

[4] Yale University, Endowment Update 2017.
http://investments.yale.edu/endowment-update