NORTHERN TRUST

BUILD A SUCCESSFUL INVESTMENT POLICY STATEMENT FOR YOUR NONPROFIT

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An investment policy statement (IPS) provides a roadmap for managing your organization's investments and spending over time. When carefully crafted, an IPS can help you define your investment philosophy and process.

WHY DO I NEED AN IPS?

The overriding reason for having an IPS is that it is a plan that can be followed in all market environments. The IPS is essentially a blueprint for portfolio management. This document promotes investment strategy continuity over time even as board members may rotate on and off. A well designed IPS will include the fundamental objectives of your organization's portfolio. This should include guidelines to help ensure your organization's investments are managed consistently with your short- and long-term goals and objectives.

By memorializing a portfolio management framework, the IPS enables your board members and investment advisors to carry out their duties with confidence. For example, it will help board members fulfill their fiduciary responsibilities such as the "duty of care" provision of the Uniform Prudent Management of Institutional Funds Act.

Another great reason for having an IPS is that it demonstrates to donors that the funds they contribute are being prudently managed.

WHAT ARE KEY ELEMENTS OF AN IPS?

Every IPS should include a few important components. **A Statement of Purpose** is often the first section of the statement. It should be a clear and concise description of your organization and its mission, and how the portfolio supports that mission. This overview can set the tone for the specifics within the body of the document.

A section covering **Delegation of Authority** should describe the roles and responsibilities of board members, committees, staff, custodian and outside advisors. The board of directors typically has final authority but may delegate all or part of its responsibility. The IPS should provide accountability for decision making at all levels, including approval of changes to the IPS itself.

The IPS should also communicate the **Investment Philosophy** of your organization. You may have a specific, written philosophy, or it may be that the overall IPS conveys the collective attitude of board members toward investment management issues.

Clear and realistic investment objectives are an essential part of the IPS. Nonprofits should describe the short- and long-term goals of the portfolio. A realistic understanding of the return and risk potential of major asset classes is essential to avoid disappointment later. The investment goal of the portfolio is an important question that should be answered. The goal may include an emphasis on capital preservation, consistency of payout, real return, maximum long-term growth, etc.

Risk Tolerance should be outlined in your IPS. Many organizations spend significant time on determining the return target for a portfolio, however the other side of that coin is the risk that is being assumed for a given return target. The ability of an organization to tolerate investment volatility and illiquidity should be carefully considered. In addition to volatility and illiquidity, other metrics to measure risk may also be considered such as beta, value at risk, tracking error, maximum drawdown, etc. An organization may have specific requirements or limits on illiquid investment strategies and these should be included. Any specific investment restrictions desired by the organization may be included. You may wish to enumerate diversification requirements, and also any prohibited investments. Of course it is important to assign responsibility for monitoring risks and reporting any violations of risk parameters.

If your organization has a **Spending Policy**, it is helpful to include this or a reference to it in your IPS. The two policies should work hand in hand as spending goals are an important consideration for the return target and risk tolerance of the investment portfolio. Carefully balance spending policy and the portfolio's ability to generate the required return with an acceptable level of risk.

One of the most important components of an IPS is a **Framework for Asset Allocation**. Traditionally a table is used with a list of major asset classes (US Equity, International Equity, Fixed Income, Real Estate, etc.) and the target allocation, as well as an allowable range for each asset class. There should also be a discussion of rebalancing procedures around the targets. The document should provide guidelines within which the portfolio will operate along with flexibility to manage within a wide range of investment environments. These targets are meant to be long-term oriented and therefore shouldn't be changed frequently. However, they should be reviewed annually to ensure continued alignment with organizational goals and the current capital market environment.

The IPS should provide guidelines within which the portfolio will operate along with flexibility to manage within a wide range of investment environments.

A discussion about how portfolio performance will be measured (Benchmarking) should be included. The total portfolio's benchmark should be based on the target asset allocation to create an objective way to evaluate relative performance during any type of market environment. Specific benchmarks should be used to evaluate asset classes and individual investment solutions. Asset managers and advisors should be given a good understanding of monitoring and reporting requirements.

There should be language in the IPS covering how and when third party advisors and money managers will be engaged. This section includes the criteria for hiring and terminating an advisor, consultant or manager and the details need to be tied to the specific type of advice being sought.

ADDITIONAL CONSIDERATIONS AND RECOMMENDATIONS

You may wish to prohibit certain investment strategies or security types. Caution should be used when broadly excluding investment strategies. Don't corner your organization by being specific unless that is exactly what you intend. You may inadvertently rule out strategies that your external managers/fund employ routinely. Examples often include securities lending, the use of derivatives, the use of leverage or the use of commodity contracts. It is common for the prospectuses of mutual funds to specifically allow such strategies and securities.

Many nonprofits will include a discussion of strategies or unique investment restrictions based on the charitable mission targeted by the organization. This generally will fall under the umbrella of sustainable investing or **Environmental, Social and Governance (ESG)**. ESG is rapidly growing in popularity, and there has also been an expansion of the definition and an increase in the potential implementation methods. Years ago, the most common approach was to exclude certain sectors (such as tobacco or firearms) from a portfolio based on an organization's values. There is now a wide spectrum of ESG investing strategies such as exclusion, integration, thematic and impact investing. Organizations that wish to include ESG criteria in an IPS should carefully evaluate ESG investing approaches in light of organizational values. Then select an approach or combination of approaches that aligns with those values.

Once an IPS is established, there should also be a plan to review the policy regularly. Organizational circumstances change and the investment environment is constantly evolving. Therefore, it is important to ensure that the policy remains relevant and effective with periodic updates. As a "living breathing" document, your Investment Policy Statement will remain a valuable governance tool for your board of directors and will help ensure that your investment portfolio helps advance your organizational goals.

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