portfolio construction forum

A Guide to forming an Investment Policy Framework

Andrew Fairweather & Jerome Lander | 17 July 2017

The primary purpose of this Guide is to assist practitioners develop their own investment policy framework by providing a helpful checklist of issues to consider, along with publicly available examples from financial institutions in Australia and globally. It is aimed at those practitioners who are considering offering a standalone, multi-asset portfolio service using a unit trust or Managed Discretionary Authority (MDA) on a managed account platform.

This Guide covers examples of key issues that should generally be considered. The specificity required means the written policies and their details are best tailored for the needs of the business in question. If required, numerous consultants and research houses can play a useful role in helping complete this important task to a high standard.

BACKDROP

Over the past decade, numerous investment portfolio construction practitioners have taken the investment management function in-house, effectively setting up multi-asset portfolios to better manage clients' wealth and create better alignment with clients' objectives. This trend has been well documented, and has contributed to the strong share price performance of most listed managed accounts providers, who are the key enablers that make it possible for:

1. The rise of nimble/hungry managed account provider advisers to offer their portfolios to the public without the need for statements or records of advice. Four factors have converged to make the move to bring investment management in-house possible, including providing the necessary technology, regulatory oversight, and administration solutions that together make it possible for practitioners to launch their own public offer, multi-asset portfolio services for very low capex.
2. The need for independent financial advisers to remain financially viable by offering a standalone and separately priced investment offering, considering changes to conflicted remuneration because of FoFA legislation, when competing with cross subsidising institutional wealth managers.
3. The desire to lower total investment management costs in a competitive environment, which has led to an increased use of direct assets, including direct shares, LICs, ETPs, ETFs, REITs, bonds/TDs, etc., which managed accounts often favour over managed funds.

4. The rise of boutique, yet highly experienced and capable investment consultants (as well as the traditional research houses), that have deep domain experience in assisting practitioners with tailored asset allocation, portfolio management and investment selection services.

Together, these four factors have made it possible for smaller practitioners to vertically integrate to the benefit of both their businesses and their clients' wealth, without requiring a large capital expenditure. It is likely that this trend will continue apace, and may even see some large practices leave institutional wealth managers (or stay, as bank-owned AFSLs respond to the external threat by offering similar functionality for their practitioners), as they seek to take more control over various aspects of their business.

But where do practitioners go to learn how to set up an investment policy framework to take this function in-house?

The transition from using balanced/sector funds under a traditional financial planning model (e.g. Statements of Advice/Records of Advice), to one where the practitioner is fully accountable for an implemented/real time investment solution is not a trivial one. There are many decisions to be made that, if done poorly, could have serious implications for both the busines and clients' wealth.

Most critical is the need to adopt a robust Investment Policy Framework (IPF) that clearly enunciates the investment strategy that the firm will adopt to achieve the mandate objectives. In our experience, there are very few "off the shelf" guides to walk practitioners through the detailed process of setting up an IPF.

As such, we intend that the information set out in this Guide will provide useful assistance to those who are about to embark on the journey.

INVESTMENT POLICY FRAMEWORK - OVERVIEW

An IPF is a set of governance standards that sets out how a mandate will be managed. The framework seeks to provide policies (Figure 1) across a range of important portfolio functions, including the firm's philosophy and beliefs, which will guide the Investment Committee's (IC) day-to-day portfolio decision making.

Figure 1: Each policy forms part of the overall IPF and must align with the other policies

Various Policies	Examples
1. Mandate(s) Objective(s) and Purpose	– Provide adequate retirement income – Outperform Cash + 2% with no loss of capital over 3 year time frame
2. Philosophy and Beliefs	– Markets are inefficient
3. Asset Allocation Framework	– Strategic asset allocation – Dynamic asset allocation
4. Allowable Investments	– Direct equities – Retail managed Funds – Private equity
5. Investment Selection and Monitoring	– Criteria, process and timeframes
6. Performance Measurement	– Linked to the mandate objectives
7. Risk Management and Governance	– Types of risks – How they will be managed

Importantly, the IPF aims to align each of the above components into a coherent set of policies that support each element of the investment management function. It is likely that any underperformance against mandate objectives will be linked to a weakness in the design (or the fit) of any of the sub- policies, excluding major external market shocks. Having the IPF framework will allow for an evidence-based assessment of performance against each of these policies, should any sustained underperformance continue.

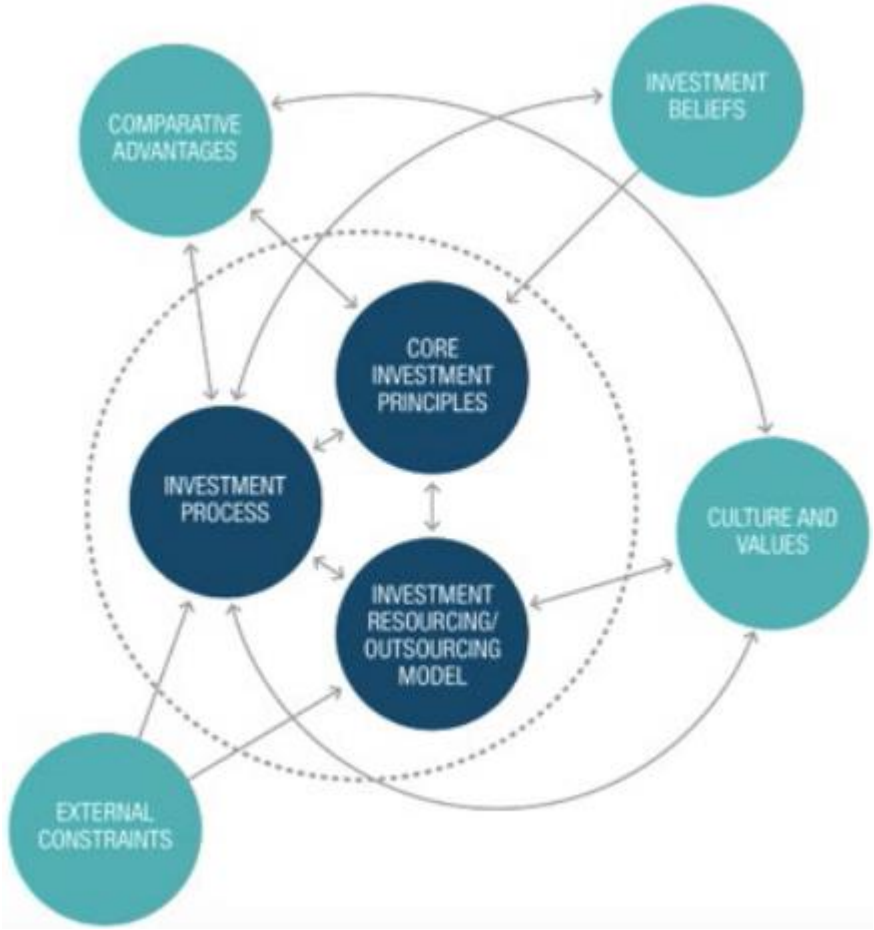
WHY IS AN IPF CRITICAL?

The IPF is more than just a set of policies designed to ensure compliance against what has been agreed. In addition to this, it should set out the practitioner's competitive advantage in providing such an important service. This advantage will probably be multi- dimensional in nature and include the ability to design a portfolio targeting the needs of the specific client base. Advantages might also come from the ability to invest in illiquid assets or in the length of time frame in managing the portfolio assets. Advantages may be hard to replicate by those attempting to offer a similar service.

It should also form the basis by which prospective clients can assess whether the practitioner has a robust framework and set of professional standards when managing client monies.

Figures 2 and 3 below seek to highlight the holistic nature of the IPF of two leading institutions – one, a wholesale investor with essentially one customer (e.g. the Australian government), and the other being Atrium Investment Management, which offers multi-asset portfolios to retail investors.

Figure 2: Future Fund Investment model[1]

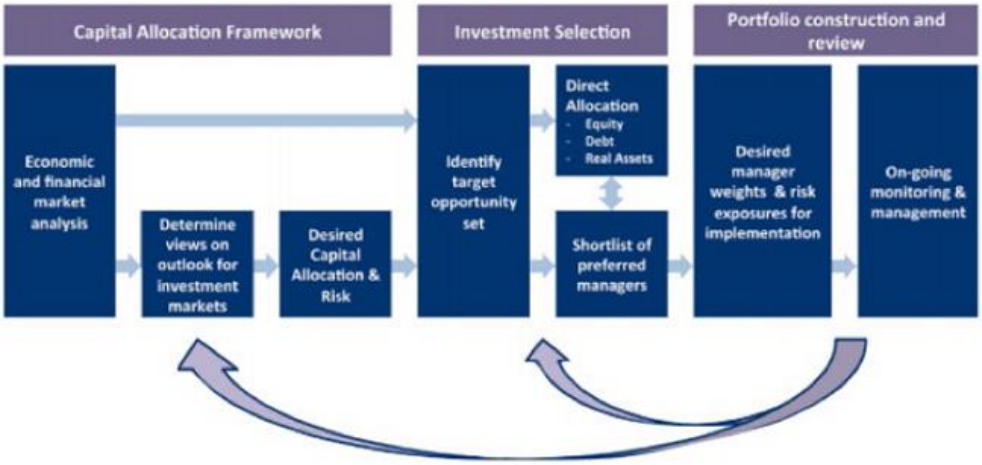


Source: 1. Future Fund – How we invest

The Future Fund sums up the need for a tight fit between each policy.

> "As (Figure 2 above) illustrates, these factors are all highly interdependent, such that changing one will have an impact on a number of others."

Figure 3: Atrium Investment Management Framework[2]
This firm highlights its IPF within its PDS. It shows the firm's system operating in a linear function for simplicity purposes. However, it too is a nonlinear system operating in real time.



Source: 2. Atrium Evolution Series Diversified Fund PDS

Section 1: Investment Mandate

Agreeing on the Investment Mandate (IM) is the most important step in developing an IPF. When articulated well, it sets the objectives that are to be achieved, the timeframes over which to judge performance, the levels of acceptable risk (multi-dimensional) and the types of risks the mandate will tolerate, etc. Two examples of the propose, objectives and strategy are provided below in Figure 4 in very clear and succinct terms.

Figure 4: A simple purpose statement provides an overarching goal that articulates the mandate's primary role

	Future Fund of Australia[3]	Harvard Endowment Fund[4]
Purpose	– To meet the government's future liabilities for the payment of superannuation to retired civil servants of the Australian Public Service	– Dedicated and permanent source of funding that maintains the teaching and research mission of the University
Objectives summary snapshot	– Maximise long term returns – Achieve CPI + 4.5 to 5.5% p.a. – To not take excessive risk – Positioned to maximise the possibility of meeting the CPI + 4.5% target	– Targets 5 to 5.5% payout of market value each year
Time frame	– Rolling 10-year periods	10-year periods
Strategy	– Absolute Return – Multi Asset – Forward looking – Hybrid model of partnering with specialist fund managers, and managing assets in-house – Long term	– Absolute return – Multi Asset – Hybrid model of partnering with specialist fund managers, and managing assets in-house – Long term

Source: 3. Future Fund. 4. Harvard Management Co, Inc.

Importantly, the IM objectives will change depending on the segment a practitioner is serving. However, the philosophy and beliefs and other polices will not change in support of those objectives. The level of risk (e.g. volatility, loss of capital, drawdowns) that is acceptable and the actions that may be required during any market shock or event will also differ between segments.

For example, if the primary purpose of a mandate is to preserve capital (e.g. older retirees), then in any market sell off, the IM might instruct the practitioner to sell riskier assets. An IM to maximise returns over the long term might be a net buyer in the same market event. These are 'ex-ante' decisions that should be agreed in advance through the governance rules.

Section 2: Investment philosophy and beliefs

As discussed above, the primary goal of the IM is to set risk and return objectives that are to be achieved over various time horizons. The role of the investment philosophy is to enunciate, in large part, what set of beliefs will guide the Investment Committee to achieve the objectives, in designing the asset allocating framework (Section 3) and the allowable investments, etc. Figure 5 shows an example, being US-based roboadviser Betterment's investment philosophy, as well as the Future Fund's investment beliefs.

Combined, the philosophy and beliefs provide an overarching set of principles that make it possible for the Investment Committee to act coherently, while communicating to investors how and why the objectives will be met. Typically, these beliefs can be expressed in the following terms.

Examples of Investment beliefs:

1. We believe that all markets are efficient and that forecasting the future is impossible, etc...
2. We believe that markets are mostly efficient but at times, short-term market behaviours cause prices to deviate from fundamental value, etc...
3. We believe that markets are inefficient and that active management can add a great deal of value across all asset classes, etc...

Other beliefs that are important to articulate can include:

1. Beliefs about costs and value for money;
2. Liquidity requirements and attitude towards this;
3. The timeframe over which performance should be judged; and,
4. Whether assets will be managed internally or externally (or both).

Figure 5: Examples of an Investment Philosophy and Set of Beliefs

Betterment Investment Philosophy[5]	Future Fund Beliefs – excerpt[6]
– At Betterment for Advisors we seek to achieve higher expected take-home returns for clients. Take-home returns are defined as returns net of fees, taxes, and risk-borne and behavioral mistakes. – Betterment for Advisors' clients are typically invested in our core globally diversified, index-tracking portfolio. Our investment team does not seek to add any form of market alpha by stock picking, sector weighting, or market timing. Our allocations are strategic, not tactical. We aim to deliver the higher expected risk-adjusted returns by diversifying client portfolios, using low-cost indextracking ETFs. – Our team does seek individual investor alpha – to help clients improve their performance on a risk-adjusted, after-tax, and after-fee basis. To achieve this, we manage client portfolios on an individual level, systematising optimal behaviors such as rebalancing, tax loss harvesting, and goal tracking with minimal effort on the clients' part.	– Risk management – The assessment and management of risk should emphasise qualitative considerations, through a deep understanding of the investment environment and its potential impact on the portfolio. Quantitative measurement is considered an important tool to both support and test this process – Dynamic management – Prospective returns and risks vary materially over time in a way that is at least partially observable and hence exploitable. The amount of risk taken should therefore be managed dynamically as conditions change. – Diversification – A higher expected return per unit of risk (investment efficiency) can be obtained from a broadly diversified allocation across different return drivers. In addition, the long time horizon supports a tolerance for illiquid assets – Inefficient Markets and adding value – Markets can be inefficient, albeit that the degree of inefficiency varies across markets and over time. Skillful management can add value after fees, and such added value can be uncorrelated to market returns over time and can therefore be highly beneficial to the total portfolio investment characteristics. Capturing skill-based returns requires an appropriately resourced and disciplined process

Source: 5. Betterment for Advisors. 6. Future Fund – how we invest

With such clear principles, every action (or inaction) made within a given mandate should be consistent with the philosophy and beliefs. For example, a set of beliefs that states that markets are efficient (e.g. Betterment or Vanguard), should have a very different portfolio design result (e.g. strategic asset allocation (SAA) and largely passive holdings) versus a set

of beliefs that states that markets are inefficient (e.g. dynamic asset allocation (DAA) and active management). Figure 5 showed two very different philosophies and beliefs in how they expect to achieve their mandate objectives. One set of philosophies and beliefs is not necessarily superior to the other. A key point is to ensure that the belief set reflects your own, and is justifiable (e.g. you can back the philosophy and beliefs with evidence as to why a certain path has been chosen).

A mandate's timeframe can also form part of the beliefs. In its literature, the Future Fund highlights that a form of its comparative advantage comes from taking a long-term view, made possible because of the nature of its purpose, and because of the semi-permanent nature of the asset base. Because of this belief (or ability to act long term), the Future Fund can (and does) invest in illiquid investments, takes on more (but not excessive) levels of market risk, or simply holds more in cash if there are no opportunities that meet the internal hurdle requirements. When viewing the Future Fund's portfolio (Figure 6), there is a strong fit between its beliefs, its absolute return strategy and the actual portfolio, especially when viewing the changes it has made through time.

Figure 6: The Future Fund's asset allocation highlights a strong fit between the mandate objectives and its philosophy and beliefs

Asset Class	% of Fund - Sep 2016	% of Fund - Sep 2012
Australian Equities	6.5%	10.7%
Developed Market Equities	15.3%	17.7%
Emerging Market Equities	7.6%	5.1%
Private Equity	10%	6.3%
Property	6.5%	6.4%
Infrastructure and Timberland	6.6%	5.9%
Debt Securities	11.8%	18.7%
Alternative Assets	13.6%	17.7%
Cash	22.1%	11.4%

Developing an asset allocation framework is described below in Section 3, with examples of how both the philosophy and beliefs align to asset allocation design.

Section 3: Asset allocation framework

Once the IM has been agreed, the asset allocation framework should align to the objectives, philosophy and beliefs. For most retail clients, liquidity is very important, and there are limitations in terms of what a platform or managed account will allow investments in, while endowments with long time horizons may be more willing to use illiquid investments (as Figure 5shows).

The asset allocation policy sets out the rules by which asset allocation decisions will be made. Again, these decisions must logically align with the objectives, the time frames, the levels of risk and the beliefs. It talks to the capital market assumptions being made (or not) and the way that risk and return objectives will be balanced against each other.

For example, "each CBus investment option is structured in a way that (they) believe has the greatest likelihood of achieving the option's return (and risk) objective." As Figure 7 shows, Cbus makes a clear statement about its long-term strategic asset allocation framework (20 years), which is supported by a shorter target portfolio asset allocation timeframe (five years) which is reviewed more regularly. In essence, Cbus is attempting to balance long-term asset class assumptions and forecasts, against medium-term market valuation considerations when allocating to the various asset classes within its various portfolios.

Table 5 – The Cbus asset allocation framework balances long-term asset class return assumptions with medium-term valuations

Long-term strategic asset allocation (LTSAA)	Target portfolio
Asset allocation over the long term (20 years or more) without taking into account what we think will happen in investment markets over the medium term (next 5 years).	Asset allocation that reflects our view of how investment market may perform over the medium term (5 years). The target portfolio is reviewed at least quarterly for all investment options. However, amendments to the Target Portfolio for all options other than the default options may be made only in the event of a material level of change.

As stated above, the asset allocation framework should align to the philosophy and beliefs, while giving the practitioner the best possible chance of achieving the mandate objectives. Below are some ideas on how a practitioner might think about implementing a framework.

High level ideas to consider when designing an asset allocation framework include:

1. If you believe that markets are efficient, an SAA framework with regular rebalancing might be the best method of designing the asset allocation framework e.g. Betterment and Vanguard.
2. If you believe that markets are inefficient, it is more likely that a DAA process with greater flexibility will be most suitable.
3. More recently, some practitioners are managing asset allocation based on maintaining a constant level of risk at the portfolio level. This should, in theory, provide more certainty in the range of possible outcomes, with an emphasis on goal achievement (or not achieving the goal) being the primary risk being managed. Having constant risk budgets removes some of the emotion from investing by selling assets when they exceed their risk allocation and vice versa.

Below is an overview of the Harvard Management Company's (HMC) asset allocation framework, ranges, and actual allocation for the 2015 year.

The Harvard Management Company (HMC) Strategic Asset Allocation Process

"Strategic Asset Allocation Process – HMC's strategic asset allocation process seeks to identify appropriate asset class allocations that best suit the long-term risk and return objectives of the University. This framework is designed to expose the endowment to primary drivers of long-term market returns and risk premia, while ensuring proper diversification of our investment strategies. In our factor-based approach, we first select a set of macro factors and measure our asset class exposure to these factors. This analysis produces an allocation range for each asset class. With these ranges determined, HMC chooses an optimal portfolio and a corresponding target allocation for each asset class, while also considering liquidity considerations.

"The resulting asset class target allocations form the strategic asset allocation, which aims to balance the long-term objectives of return generation, risk management, and liquidity provision. The actual asset allocation at a particular point in time may deviate from the strategic asset allocation, within the defined ranges."

Figure 8: HMC provides for wide asset allocation ranges to give it the flexibility required to meet its absolute return targets – there is a strong fit between the statement above, its ranges, and actual portfolio as at the end of 2015.

Asset Class	FY2016 Ranges (%)		2015 Actual (%)
US Equity	6	16	11
Foreign Equity	6	11	11
Emerging Market Equity	4	17	11
Private Equity	13	23	18
Absolute Return	11	21	16
Natural Resources and Commodities	6	16	11
Real Estate	10	17	12
Domestic Bonds	5	9	10
High Yield	0	3	
Foreign Bonds	0	4	
Inflation-Linked Bonds	0	6	
High Yield	0	3	

If we compare HMC's design with the Vanguard Balanced Index Fund, we see that Vanguard has a narrower focus and the target and actual portfolios being in the midpoint of that tight range. Why? Because Vanguard has a different philosophy and set of beliefs. It also serves retail clients whose need for liquidity is possibly higher.

Figure 9: Vanguard Balanced Index Fund has narrow ranges with little flexibility, consistent with their beliefs of SAA and passive investing.

	Asset Ranges	Target	Actual
Australian Shares	20%-24%	22	21.7
Global Shares	15%-19%	17	17.2
Australian Property	1%-5%	3	3
Global Property	1%-5%	3	3
Emerging Market Equities	0.5%-4.5%	2.5	2.5
Global Small Cap	0.5%-4.5%	2.5	2.5
Australian Fixed Income	18%-20%	20	20
Global Fixed Income	17%-20%	19	19.3
Global Credit	9%-13%	11	10.8

Providing the two examples is not to say one is superior to the other. It is about showing that the ranges and actual allocations fit with each firms' philosophy and beliefs – both are in strong alignment, which is what we would expect to see.

Evans and Partners also provides a very detailed overview of its asset allocation framework, its beliefs and its ranges, etc. It can be found by clicking the hyperlink in the footer.

To finalise, any changes to asset allocation within any mandate should make sense relative to the philosophy and beliefs, the outlook for asset classes (when using DAA), the asset allocation framework and guidelines, etc. Every decision should be justifiable against one of these criteria – it should be logical, consistent and fit with the mandate objectives. This applies to any tactical changes as well as any changes to the strategic asset mix.

Research houses and specialist consultants can play a vital role in helping design a suitable framework and in helping make any required changes.

Section 4: Allowable Investments

In achieving the IM objectives, an important consideration is what investments are allowed. Recognising that there will be differences for each mandate (e.g. a retiree versus an accumulator), as well as the beliefs (e.g. Betterment only invests in ETFs), it can be advantageous to make the list as broad as possible, accounting for any regulatory, cost or

liquidity constraints, and other limitations in terms of allowable investment universe. The goal here is not to sacrifice the IM objectives by reducing flexibility.

The allowable investments should also align to the beliefs. For example, Figure 5 shows that the Future Fund believes that markets can be inefficient and that partnering with skilful managers can add value. Betterment, on the other hand, believes that ETFs are the only underlying investment required to meet its objectives, but it diversifies by asset class, markets and ETF provider.

Figure 10: Both the Future Fund and Atrium provider a broad list of allowable investments

Future Fund	Atrium Evolution Series
Listed equities - Australian, Global and EM	- Cash, or its equivalent, and short term fixed interest
Private equity - Venture capital, buyout, distressed debt,	- Australian and international longer term fixed interest
Tangible assets - Real estate, timber, utilities, agriculture etc	- Australian and international developed market equities
Debt - High yield credit mortgages, nongovt fixed,	- Emerging market equities
Alternative assets -Skill-based absolute return and other risk premia	- Australian and international corporate or high yield debt (including listed hybrid securities)
Cash - Treasury bills, bank bills and deposits	- Australian and international listed real estate trusts
Portfolio overlays -Currency, interest rates, etc	- Australian and international listed infrastructure trusts
	- Unlisted assets including but not limited to real property and infrastructure
	- Liquid derivatives traded on the major listed exchanges around the world
	- Exchange traded funds (ETFs)

As stated throughout this Guide, the allowable investments should be consistent with the IM, philosophy and beliefs, while accounting for platform, liquidity, cost and regulatory constraints, where they exist.

Section 5: Investment selection and monitoring

It is critical for any practitioner is to have a set of governance standards when selecting and monitoring investments. Every investment should be explainable in the context of the current asset allocation views, while also being consistent with the philosophy and beliefs.

This section has been divided into two parts.

1. Investment Selection

Again, the Future Fund provides an excellent summary of how it selects and monitors its investments, which is very consistent with its core belief of:

> "Inefficient Markets and adding value – Markets can be inefficient, albeit that the degree of inefficiency varies across markets and over time. Skillful management can add value after fees, and such added value can be uncorrelated to market returns over time and can therefore be highly beneficial to the total portfolio investment characteristics. Capturing skill-based returns requires an appropriately resourced and disciplined process."

Fkgure 11: Future Fund manager selection is about identifying managers that can add value at a fair price, consistent with the belief in inefficient markets

Past Performance	We favour a strong, proven track record in the relevant investment strategy.
Business	We favour a strong, stable corporate structure with a long-term focus on investment management, clear alignment of interests with its clients and a reputable standing in the industry.
People	We favour a deep, experienced and stable team with integrity and with an effective performance oriented culture.
Process	We favour a clearly articulated and consistently applied investment process, portfolio construction that is aligned with our investment philosophy and efficient execution of transactions.
Fees and terms	We seek the best commercial terms available and favour those that are appropriately structured.

The above is similar to how most research firms and boutique consultants in Australia approach their manager research effort, and it is here (as well in forming an asset allocation framework), that they can play a vital role on an Investment Committee. It is simply not possible to cover the opportunity set effectively without such help. However, subject to the investment beliefs, the universe of allowable investments might be narrowed down considerably (e.g. ETFs only or genuinely active boutique fund managers), meaning that a large team is not required.

Many practitioners also use a minimum rating threshold, requiring only that "investment grade or above" investments are considered in any one asset class. This can also serve to reduce the workload to a smaller universe of fund managers available for selection. Whatever the process, it needs to be consistently applied, with all exceptions being carefully considered.

2. Monitoring investments

From the Future Fund again:

> "Once an investment transaction is completed, the relevant investment sector team undertakes a rigorous ongoing monitoring process. This monitoring applies to both the Investment Manager and, where relevant, the specific Asset."

Prior to making any investment, a set of risk and return assumptions should be put in place to monitor the expected behaviour of each investment, to ensure each is operating within expected boundaries. For example, if selecting a value manager, one should know how they will perform in a range of different investment environments. The same applies for a managed futures allocation, for example. Any deviation from expected behaviour should be a cause to review the investment because of the possibility of style drift, etc. The same goes for all assets. Once the expected return profile is understook, monitoring can occur in real time, using the platform to assist in monitoring performance.

The discipline to monitor underlying investments must also apply to the asset allocation framework e.g. current positioning against asset class and underlying portfolio limits. Generally, these ranges and limits, alongside the allowable investments, are "hard coded" into the offer document. Any breach of any limits could have severe legal consequences. That aside, the reason for establishing such a comprehensive IPF is not to simply ensure mandate rules are not breached, but systems need to be put in place to monitor these risks.

Here, platforms play a key role. Given that platforms issue the offer documents, they must provide the reporting function to the Investment Committee. The platform has the most to lose in any material breach and, as such, they do invest a lot of effort and IT infrastructure to aligning the mandate rules to reporting systems.

Of course, outside of investment monitoring, the obligation is to regularly meet with managers (where using external specialists) to monitor for changes in personnel, discuss capacity, negotiate fees and to access market insights, which can better inform the internal staff where an asset class is being internally managed. If doing asset class management in-house, then benchmarks for performance measurement must also be applied as rigorously as for any external manager. There is no point in-sourcing to save on costs, if the level of underperformance swamps that cost saving. Moving in-house, therefore, must stack up on investment grounds and must by monitored and reported on accordingly.

Monitoring of investments should consider a range of factors including:

1. The asset allocation and investment philosophy approach;
2. Asset class review schedule;
3. External manager changes and their materiality e.g. personnel changes;
4. Outlier performance (good and bad) that is not in line with expected behavior of the manager's strategy;
5. Style drift; and,
6. Business changes.

Critically, the monitoring of investments should be a standard item on every Investment Committee's meeting agenda.

Section 6: Performance measurement

HMC sets out its performance measures and objectives well.

> **HMC - Investment Objectives**
>
> In fiscal year 2015, HMC set forth three investment objectives that we believe are essential to delivering superior long-term risk-adjusted returns. These investment objectives, which measure our performance against real, relative, and peer returns, are ambitious goals set to serve the University over the long-term. As such, we will measure our performance relative to these objectives over five- and 10-year market cycles. In any given year, we may not achieve each of the stated objectives, as was the case in fiscal year 2016.

Not only must the Investment Committee monitor individual investments, it must monitor its own performance against the mandate objectives (risk and return) and an appropriate peer group (if relevant), using the appropriate time periods. The requirement to have detailed

attribution (easier with SAA than DAA) for asset allocation and investment selection is paramount. Without it, the Investment Committee may not be able to explain/communicate where its performance is coming from. This requirement for complete transparency is paramount in an age where investors have the ability to move.

Some practitioners use platforms to provide these important measurement services, while others use external services providers such as FE Analytics and Morningstar to provide the necessary data at the underlying investment and portfolio levels.

Section 7: Risk management and governance

A common theme throughout this Guide is to ensure that there is a strong alignment (fit) between each component of an IPF. Risk management and governance (RM&G) is no different. A well-framed RM&G should deal with a multitude of risks, including those set out in Figure 12 (again sourced from the Future Fund).

Each risk is associated with how the fund and mandate results might be impacted and ways to help manage the risk.

Figure 12: RM&G must account for a wide variety of risks – anything that has the potential to impact on achieving the mandate objectives should be dealt with.

Type of Risk	Examples	Way to address in managing the portfolio
Macro	Changes to macroeconomic variables (growth, real interest rates, inflation and risk premia Geopolitical risks Regulatory risks	Balanced exposure to unanticipated changes in macro factors
Market	equity credit currency interest rates prices changes in supply constrained resources	Target allocation that is expected to maximise long term returns. Dynamic management Diversification (combining not perfectly correlated assets). Diversifying investment must be accretive to risk adjusted returns

Liquidity	Inability to meet short term cashflows Loss of control over the strategic direction of the portfolio	Short-term cash test to ensure all immediate cashflows can be met. Monitor portfolio illiquidity having regard for time to divest, currency, and the level of undrawn commitments.
Specific	Related to individual investments	Monitoring and reporting asset allocation will 'vastly overshadow' individual issuer or counterparty exposure. Exposure limits.
Investment manager risk	Deliver results materially below expectations	Selection, Monitoring and Reporting Policy. Manager diversification controls. Alignment of interests.
Counterparty risk	Counterparty fails to deliver on their obligations resulting in a loss to the fund	Reporting and control procedures.
Peer group risk	The portfolio being exposed in some way by being different to a group of peer funds	Focus solely on the objectives of the mandate. Long-term focus - happy to deviate over short term periods.

Stress testing and simulating various scenarios may provide useful information on risks.

THE ROLE OF THE INVESTMENT COMMITTEE

While this does not necessarily fit neatly as a policy, there are some broad principles that define the role of the Investment Committee.

The primary role is to ensure that portfolio management is consistent with the IM objectives and the rules and guidelines agreed, while also monitoring the people who oversee the day-to-day management of the mandates.

Healthy debate, experience and independent thought is a core requirement of the Investment Committee and, as a result, who you choose to sit on your Investment Committee matters.

Typically, an Investment Charter is established to guide the Investment Committee.

The delegation of the day-to-day management of the IMs requires some flexibility to allow for actions during extreme market events when getting the Investment Committee together is not practical.

These events should be agreed in advance. For example:

1. If the market falls by XX%, the Investment Committee delegates that the management team can move by YY% in response.
2. The Investment Committee will allow the management team to move by 1% within each range without sign off between any Investment Committee meeting.

Things that may always require sign off include:

1. Changes to the asset allocation range or mandate objectives;
2. Material changes to the target portfolio;
3. Changes to key service providers; and,
4. Appointment of any investment staff.

The critical function is to ensure that there are no surprises and that communication is open at all times.

INVESTMENT CHARTER

An Investment Charter assists in setting out the rules by which decisions will be made by the Investment Committee. The Charter is made far simpler when:

a. the mandate is agreed;
b. the philosophy and beliefs are clearly articulated;
c. the asset allocation and allowable investment limits are documented; and,
d. the monitoring systems are in place.

The Investment Charter should also spell out how time will be allocated at each meeting (e.g. between governance, asset allocation, investment ideas and risk).

What should the Investment Charter include?

1. The roles of each Investment Committee member;
2. The standards by which the members will work;

3. Clearly defined roles and responsibilities for the day-to-day management of the portfolios;
4. Meeting schedules and details of how they are to be convened, and who should attend;
5. Voting and decision processes (e.g. whether unanimous decisions are required or a majority);
6. Portfolio manager discretion rules;
7. Record keeping of all decisions; and,
8. Conflicts and dispute resolution procedures.

SUMMARY

The above Guide is not intended to be an exhaustive list of everything a practitioner might need in order to implement a best practice IPF, but rather a useful starting position to help with the process of forming an IPF.

Below is a checklist of questions that that should be considered when designing an IPF.

Figure 13: A checklist to form a robust Investment Policy Framework

Checklist Item	Questions that should be addressed (non-exhaustive)
Investment Mandate	Clarify each mandates' purpose and objectives Is your mandate clear for each client segment? Are the mandate objectives justifiable and easy to communicate to clients and staff? Have you covered both risk and return objectives and on what basis?
Investment Philosophy & Beliefs	What is your investment philosophy? Is your philosophy clearly articulated? Does it match your own beliefs? On what basis has the philosophy and set of beliefs been based? Is it appropriate for the nature of your clients, and the extent and quality of the resources you can afford and have access to?

Asset Allocation Framework	What is the primary asset allocation framework, and does it align to the mandate, philosophy and beliefs? Does the asset allocation range make it possible for the mandates to be met e.g. risk to be properly managed? How often will the ranges and target portfolios be developed and assessed? On what basis have you set you asset allocation framework?
Allowable Investments	Are the allowable investment instruments well understood? On what basis have you made the decision to allow certain investments, whilst excluding others? Have you accounted for liquidity requirements? Do they fit with the client base and investor segment? Can they be appropriately administered e.g. can my managed account platform report on them?
Investment Selection and Monitoring	How will investments be selected? (and on what basis will they be redeemed?) What expected risk and return behaviours will each investment be monitored against? How will actual asset allocation be regularly monitored? How will managers and securities be monitored? How often will investments be reviewed and reassessed? How will results be assessed against peers and mandate objectives?
Investment Committee	Have you documented the specific role and responsibilities of the investment committee and included these in contracts with these parties? Have you suitably qualified and experienced people including independent proactive thinkers on your investment committee? How and when will IC member performance be measured?
Portfolio Management	Who will be the primary driver of portfolio positions? Who will ensure appropriate implementation of investment decisions? Are these captured in the Charter?
Operations and Compliance Framework	How will investment compliance be assured? How will counterparties be selected and assessed? Who is primarily responsible for operations management and implementation?
Conflicts of Interest Policy	This should be a written document which emphasises transparency and appropriate management of potential conflicts and issues

Risk Management & Governance	This should document all the known potential risks How will these risks be managed and mitigated? What risks are being addressed? What will your response be if any of the risks eventuate?
Investment Charter	This document clarifies the main processes and responsibilities Clarify scope and range of required roles Clarify decision making responsibilities, such as the member responsibilities of those on the investment committee. How will good governance be assured? What resources – including external and internal parties – will be needed to get results and be credible?
Overall	Do you have a process in place for regularly reviewing the policies? Do you have appropriate resources in place to implement your policies effectively? Appropriately document your policies and make all involved people party to them and their review

As stated at the very outset, this Guide has been designed to assist practitioners to think about the important aspects required to develop a robust Investment Policy Framework, using examples from the public domain. In doing so, we intend it to, in part, serve as a great starting point for practitioners as they move to become professional investment managers.

We welcome feedback

We recognise that this Guide is of a general nature and improvements are always welcome. If you would like to contribute to the Guide for future updates, please contact the authors. We intend to update the Guide regularly, taking ideas from other contributors – all of whom will be acknowledged.

DISCLAIMER

Andrew Fairweather is Founder & Managing Partner of Winston Capital Partners and Jerome Lander is Managing Director at ProCapital.