The Importance of the Investment Policy Statement

"If you don't know where you're going, you're liable to end up somewhere else." –Yogi Berra

Every well managed investment program is built on the foundation of a thoughtful investment policy statement. An investment policy is intended to convey what the portfolio is attempting to achieve as well as the risks that are willing to be assumed in the portfolio. Yet, an investment policy statement is worthless if it is not followed. Often, too short term of a focus or unrealistic return and risk assumptions can lead to inconsistent investment strategies and an investment program that lacks the appropriate focus.

Identify Objectives

Asset Allocation

Security Selection

Portfolio Rebalancing

Risk Management

An investment policy statement discusses the general investment objective of the portfolio, risk tolerance of the investor, eligible asset classes to be used and a general mix of those asset classes. In addition, the performance benchmarks and appropriate means of performance evaluation are outlined in the investment policy statement. Typically, the expected return of each asset class is done outside of the investment policy statement.

Asset Allocation and the Expected Return Assumptions

Ultimately, one of the fundamental aspects of a successful investment program is to select a mix of asset classes that produces a diversified portfolio and are designed to meet the objectives outlined in the investment policy statement. The allocation of the model portfolio (or the target portfolio) is based on the expected return assumptions for each asset class and is typically reviewed annually. As asset prices change, the portfolio will need to be rebalanced back to its intended policy mix. This rebalancing typically is done on a quarterly basis or at times of dramatic price movement in the markets.

The process of analyzing expected returns for the securities and the markets in which you invest is another important fundamental aspect of a successful investment program. Winthrop Capital Management publishes its Asset Allocation + Risk Management report annually which outlines our expected horizon returns for the major markets in which we invest.

The financial services industry has promulgated a buy and hold strategy for individual investors since the 1980's. The basis for a buy and hold strategy is rooted in the notion that the individual investor lacks the sophistication to consistently time the market and the naïve assumption that equity prices always rise over long time frames. Also, it allowed the financial advisor to scale his business since it takes less work to maintain a buy and hold portfolio. Up until 2007 a buy and hold strategy seemed to work for many investors as both equity and bond prices had appreciated over the prior two decades. However, given the changes in how our financial system and capital markets work, we maintain that a buy and hold strategy is the equivalent of a "buy and hope strategy" in today's market environment.

Getting Asset Allocation Right in your Portfolio

Nothing in life ever works out perfectly, and it should be assumed that the target asset allocation may not work to produce the investor's expected returns every year. Still, studies consistently show that the single largest determinant of the total return of a portfolio of investment securities is the asset allocation of the portfolio.

The general approach to a successful investment program is that when others get greedy and bid up the prices of certain asset classes, it is time to reallocate the portfolio and reduce the risk profile since the expected return profile for those asset classes may have declined. Conversely, when markets plunge and investors become fearful, the investor should move to increase exposure to those asset classes that are deteriorating in price since their expected returns going forward may have increased.

Our fundamental objective with asset allocation is to build a mix of assets that is diversified and non-correlated. In other words, as parts of the portfolio are moving up in value, there are other parts of the portfolio that remain stable or are moving lower.

Recognizing the Changes Taking Place in the Financial Markets

"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change." - Charles Darwin

As an informed investor, it is important to recognize that the financial system and the capital markets have changed over the past two decades. As a result of those changes, we maintain that the strategies and tactics of executing investment strategies have also changed. But, the fundamental principles of investing have not changed. We start with the premise that an investor should be adequately compensated for the risk they are inherently assuming. However, we do not believe that historic returns are the basis for predicting the future returns of a given market. For that reason, we believe in doing our own valuation analysis for each market in which we invest.

Some of the changes in the capital markets are very subtle, while others are more significant. For example, while the role of the Federal Reserve as our central bank remains the same, the tool kit that the Fed utilizes to implement monetary policy has changed. The result of the aggressive asset purchase programs and its zero interest rate policy is a distorted pricing of risk in our capital markets. In addition, with the repeal of the Glass-Steagall Act in 1999, the role of the major banks in our financial system has changed subtly. These changes include a more transactional approach to lending, a focus on growing noninterest income, egregious compensation practices, removal of mark-to-market pricing in the loan portfolio and an inconsistent regulatory regime. As a result of these changes, there has been a profound impact on how credit is extended in our economy. Without credit expansion, economic growth will be limited.

Structural problems in our economy and capital markets including high levels of debt and high unemployment, uncertain tax policy, and an uncertain financial regulatory environment will impede growth in financial assets at best. In its worst form, these structural problems could result in another shock to our financial markets causing another downturn in savings and portfolio valuations. Further, historic investment returns were earned in capital markets that operated in more of a free-market environment, which did not have the government intervention, rapid quantitative proprietary trading programs, and complex securities and transactions that exist in today's market. In addition, following the repeal of the Glass-Steagall Act, the laissez faire regulatory environment through much of the decade also had an impact in distorting returns and risk measures for publicly traded securities.

We believe it is critical to recognize these changes in the capital markets when developing and reviewing an investment policy statement and an asset allocation in these markets. Further, because of the structural problems in the capital markets and economy, we expect returns of financial assets to remain in the single digits over the near term.