

The value of having an Investment Policy Statement

An Investment Policy Statement (IPS) outlines the rules around where and how you intend to invest your portfolio. By giving you a roadmap and a set of constraints around how you invest, an IPS makes it a lot easier to deal with challenging markets.

An IPS: Saving us from ourselves

A good IPS is succinct and clear, but detailed enough to be meaningful. The Statements we have for our Kiwisaver funds are very detailed and go over many pages, but I have seen others that are a little more than one page and they work perfectly well for the investors concerned.

How can an IPS help you deal with volatile markets? Although we don't like to openly admit it, the real role of an IPS is to save us from ourselves.

Humans are not wired to be investors. We are emotional beings; when we sense danger we flee and when we see others doing well we want to jump in too. Unfortunately, markets work in reverse, what looks dangerous is very often an opportunity, and what looks like opportunity can be a disaster waiting to happen.

By setting ground rules for how we invest, an IPS helps take the emotion out of investing. Markets swing between fear and greed; an IPS helps us avoid falling into the same trap with our portfolio.

Footnote: a measure of emotion is a good thing. One's abdomen, heart and head should all be part of any investment decision, but these emotional inputs work best when constrained by the guidelines that can be provided by an IPS.

Example Investment Policy Statement

Below we provide an example set of policies and guidelines that could be incorporated into an IPS. However, we recognise that one set of rules will never fit every investor. The first rule of an IPS is that it must be customised to suit each investor's circumstances, investment objectives, risk tolerance, values and income requirements.

1. Asset Allocation

The first component of an IPS should be the asset allocation, as how the portfolio is allocated across the various asset classes will be the key determinant of its potential returns and its risk profile.

Along with a benchmark allocation to each sector, an IPS should also allow some tolerance around these levels. This provides some flexibility and avoids having to constantly buy and sell investments to keep to the benchmark.

As an example, the asset allocation rules we have for our Balanced Kiwisaver Fund are:

Table 1: Asset allocation guidelines

Asset class	Benchmark	Allowable ranges	
	Portfolio (%)	Min. (%)	Max. (%)
NZ Equities	16.0	10.0	20.0
Australian Equities	16.0	10.0	20.0
Global Equities	18.0	10.0	25.0
Listed Property	10.0	5.0	15.0
Total Growth Assets	60.0	35.0	75.0
NZ Fixed Interest	35.0	25.0	50.0
Cash	5.0	0.0	20.0
Total Income Assets	40.0	25.0	65.0

Source: Craigs Investment Partners

2. Rebalancing

Linked to the asset allocation guidelines should be a policy that the portfolio is rebalanced regularly to keep the portfolio at the allocations originally chosen. In practice it means trimming sectors that have grown strongly and become 'overweight', and redirecting the proceeds to sectors that are below the intended weighting.

Implement a limit of tolerance, perhaps rebalancing when any of your target allocation weightings become 15% out of line. And do it automatically, without trying to double-guess the market, or pondering if maybe 'its different this time'.

Rebalancing is vital. It ensures the portfolio does not become excessively exposed to any particular asset class; in effect it keeps the portfolio diversified.

Note: rebalancing is hard to do. Nobody likes to sell stocks when they're going up and buy those that have lagged. But, as the boom and bust experiences of 1987, 1990, 1994, 1997, 1999, 2002 and 2008, show, rebalancing is the most important step in portfolio management. If you do nothing else, do this.

3. Investment guidelines for each asset class

The investment guidelines section of the IPS provide the parameters around the sort of investments you will own in each asset class, how many individual holdings you will hold and how you will manage risk. An example of the sort of rules that can be incorporated are detailed below.

Example investment guidelines

Fixed income

Overview

The primary role of the fixed income portfolio is to provide security of income and capital. A key intention of these guidelines is to minimise credit risk by constraining the core of the portfolio to investment grade securities and limiting exposures to any individual issuer and/or security. Mitigating interest rate risk should also be achieved by the maintenance of a

laddered portfolio. Fixed income securities should generally be held to maturity to minimise costs.

Guidelines

1. No single entity should represent more than 15% of the portfolio (across all asset classes - equities, bonds and property).
2. The fixed income portfolio will be laddered across a range of securities with varying maturity dates to minimise interest rate risk. The portfolio's duration should average 2.5-3.0 years and never fall below 1.0 year or exceed 4.0 years.
3. No one security/entity should represent more than 10% of the total bond portfolio.
4. The portfolio will only invest in issues from Government, Local Authorities, Major Trading Banks and Leading Corporates.
5. The portfolio will be diversified across sectors as much as possible.
6. At least 75% of the portfolio should be invested in Investment Grade bonds (BBB- and above).
7. At least 40% of the portfolio should be invested in A rated or better securities - including unrated Local Authority issues.
8. Capital notes and bonds (quasi-equity) securities should represent no more than 20% of the fixed income portfolio.
9. Perpetual securities should represent no more than 20% of the fixed income portfolio.
10. Fixed income securities will only be considered when they provide a fair rate of return relative to their associated risk, maturity, terms and subordination.

Property

Overview

Property is regarded as a separate asset class, although it is closely correlated with equities. It provides higher income and generally displays a lower level of volatility than equities.

Guidelines

1. The portfolio will hold listed property vehicles to provide a higher level of liquidity.
2. At least seven property securities will be held, with 2-3 from outside New Zealand.
3. Internally managed vehicles will be preferred.
4. Investment will be limited to those vehicles with PIE status (does not apply to global property).

New Zealand and Australian equities

Overview

The primary goal of the equity portfolio is to provide capital growth and growth in income. To this end we will favour high quality stocks with characteristics that include:

- § Defensive business and earnings
- § Astute management and governance
- § Attractive cash flow return on invested capital
- § Operate in a favourable sector
- § The potential for earnings growth
- § A track record of earnings and dividend per share growth
- § Sound financial position
- § A reasonable valuation and dividend yield

Guidelines

1. A portfolio of a minimum of 20 stocks, split more or less evenly across New Zealand and Australia.
2. 75% of the portfolio should be held in large cap stocks.
3. The portfolio will be diversified across sectors.
4. Stocks are bought with the intention of being held for the long-term (5 years+).
5. Stocks will be sold when the dividend is cut or under threat, or when any of the buy characteristics (listed above) are no longer present.
6. Up to 10% of the equity portfolio will be available to invest in higher risk investments, new issues or special situations.

Global equities

Overview

Global equities provide diversification away from New Zealand and access to the world's developing and emerging economies and markets

Guidelines

1. The global portfolio should be broadly diversified with reference to the regional contribution to global GDP as a benchmark, rather than the traditional reference benchmark of market capitalisation, which can result in excessive exposure to the most highly priced markets. See Table 2 below.

2. The portfolio will be constructed of a range of either 1) low-cost Listed Index Funds, or 2) Listed Investment Trusts and other managed funds with low fees, or 3) a diversified portfolio of overseas stocks (a minimum of 20 names).
3. A combination of each vehicle can also be utilised, as long as the portfolio is diversified by sector and geography.

Table 2: Global geographic weightings

	% of portfolio	MSCI Wgt (%)
North America	35.0	50.0
UK and Europe	30.0	29.0
Japan and Asia	25.0	14.0
Emerging Markets	10.0	7.0

Source: Craigs Investment Partners

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