

Investment Policy Statement

INTRODUCTION

This sample Investment Policy Statement (IPS) and accompanying Guidance is provided by the UK Practice Committee to assist practitioners in complying with the requirements under the *Trustee Act 2000*, applicable in England and Wales, and other legislation such as the *Trustee Act (Northern Ireland) 2001* where similar obligations are required.

The sample statement has been drafted with the trustees of private family trusts in mind, although trustees of charities should also consider the requirement for an IPS. It is good practice to have a written statement in place from the outset of any delegation of investment powers to professional qualified advisors.

There is no prescribed format in the legislation for such a statement. The following statement has been developed to include the common issues experienced by practitioners. It should be noted that the statement is a template, so practitioners will need to tailor it to meet their particular circumstances and requirements.

In the modern regulated world of investment management, setting up an account will involve recording in the paperwork many of the points in the statement. Nonetheless, we would still recommend issuing an IPS that is the creation of the trustees. It is prudent to ensure in dialogue with the investment manager that their papers and the trustees' IPS are complementary from the start of the delegation and throughout.

The statement should be amended as necessary as part of the regular review process between trustees and their delegates required by the *Trustee Act 2000*. If the IPS remains unchanged, it would be prudent for that to be noted accordingly, so that files record the fact that the trustees considered the matter. When any beneficiary disappointed by the investment function questions their trustees, it is a useful defence to have file notes and minutes that demonstrate a sensible and careful relationship between trustees and their investment managers.

Kevin Custis TEP on behalf of the STEP UK Practice Committee

SAMPLE INVESTMENT POLICY STATEMENT

Entity: XYZ Trust

Date: [Day, Month, Year]

Entity Value: [£, US\$, €]

Trust Purpose:

The Trustees of [] ("the Trust") have agreed to delegate and appoint the investment management responsibility of the funds to [] ("the Investment Manager").

It is the responsibility of the Investment Manager to ensure that the portfolio is invested and remains appropriate to meet the requirements as set out by this Investment Policy Statement or as discussed and agreed in writing during the life of the Trust.

In order to ensure the return and risk guidelines are adhered to, the Trustees have appointed independent specialists; Investment Reporting Limited (IRL) to conduct periodic investment reviews.

1. Investment Performance Objectives

The Trust is a [] Trust. The Trustees have a duty to preserve the purchasing power of the capital of the funds [and to provide for income generation if applicable]. The Trustees also have [the power/do not have the power] to accumulate income and [have the discretion / though do not have the discretion] as to whom and how much is paid.

Thus, by delegating the investment management activities to the Investment Manager, the Trustees wish the Investment Manager to protect and enhance the value of the assets in order to maintain the purchasing power of the funds when taking into account the effects of inflation using the published UK CPI rate, [tax] and trustee fees.

To ensure the performance target is measured and defined, the Trustees wish the Investment Manager to generate a total return of [] on a net of fees basis [of which X% has to be generated from income *if applicable*].

The performance of the investment manager will be judged over a rolling three year period.

2. Investment Risk Objectives

The Trustees understand that in order to generate returns in excess of inflation, [tax] and fees as stipulated above, it will be necessary to expose the portfolio to a [low/medium/high] degree of risk. Please see section B, under 'Level of Risk' of the IPS guidance notes for the Trustee Managed Portfolio Indices (TMPI) definitions of risk factors.

To ensure that the understanding of [low/medium/high] degree of risk is defined, the trustees would look to re-consider the investment strategy if the value of the portfolio was to decline or increase by more than [10%] [20%] [20% +] in a rolling 12 month period. The Trustees would also expect the volatility in each year to be [<6%] [between 6% and 10%] [>10%].

In the event of the portfolio falling outside these measurements over a rolling 12 month period, the investment manager must engage in a dialogue with the trustees to assess the continued appropriateness of the strategy and whether any capital preservation measures should be applied to the portfolio.

3. Investment Performance and Risk Monitoring

In order to ensure the return and risk guidelines are adhered to, the Trustees have appointed independent specialists; Investment Reporting Limited (IRL) to conduct monthly / quarterly / semi-annual / annual investment reviews.

For performance measurement purposes, the investment manager will use the [IRL agreed] benchmark.

The composition of the benchmark should not in any way dictate the Investment Manager's asset strategy in relation to the management of this portfolio subject to any restrictions detailed below. The Investment Manager is permitted to pursue any asset and geographical allocation which he/she consider appropriate, having given consideration to any tax and/or other restrictions outlined below. Performance and volatility will be measured against this composite benchmark although the asset composition of the portfolio may differ substantially.

For peer group comparison, IRL will include TMPI GBP [Low/Medium/High] Risk Indices.

4. Income requirements

As noted above, the Trust is/is not a Life Interest Settlement and as such the life tenant has an entitlement to the income arising from the portfolio.

To ensure the life tenant income entitlements are met but without compromising the capital beneficiaries longer term entitlement to inflation protected capital, the Trustees have agreed an income target of [either an actual amount net of taxes or a percentage] to be appropriate which [can be made from a combination of income and capital / must only be generated from income]. [Please also specify if the income requirements are due on specific dates, *if applicable*].

The trustees have delegated to the investment manager the necessary discretion to generate the income requirement from a combination of cash, bonds and equity and near liquid instruments as is considered appropriate.

The Trustees have applied a restriction on the quality of instruments which may be considered for yield generation purpose. These restrictions are outlined below.

This should ensure the investment manager has appropriate flexibility to manage the portfolio to meet both income requirements and target return expectations of The Trustees.

5. Ability to distribute capital in place of income

Capital and income should be segregated at all times [*if applicable*].

The investment manager should ensure that all investments in managed funds are made into the income share class or the reporting status vehicle, where offshore funds are being used.

6. The residence and tax status of the entity and beneficiaries for tax purposes (where relevant)

List the settlor/beneficiary names, age, residence and domicile.

List any other tax or legal considerations.

7. Investment restrictions

See guidance notes for examples of possible restrictions.

8. Transition Period

The Trustees acknowledge the existing portfolio may not be structured in accordance with the parameters detailed within this Investment Policy Statement. To ensure the Investment Manager has been given an appropriate opportunity to restructure the portfolio to accord with the revised guidelines, transition period of [6 / 12] months from the date of signing the Investment Policy Statement will apply. The Investment Manager should consider any potential CGT versus risk of retention on restructuring the portfolio and discuss this with the trustees accordingly.

The impact which this legacy portfolio and strategy may have on relative performance and risk, when compared with the IRL benchmark, will be fully taken into consideration by both the Trustees and IRL, during this transition period.

9. Capital and Liquidity Requirements

There is an / are no anticipated capital requirement/s of [if known] in the next [12] months. Therefore / however no investment should have lock-up period of greater than [3] months without the prior written permission of the Trustees.

10. The base currency of the entity

[GBP/Euro/US\$] is used for accounting / bookkeeping purposes.

11. Reporting Requirements

For the purpose of facilitating the trustees with the process of monitoring the portfolio the Investment Manager will be required to provide IRL with performance, asset allocation and currency allocation data together with copy valuations in accordance with the Trustees' instructions.

12. Review of Investment Policy Statement

This Investment Policy Statement can be reviewed and amended at any time should there be any change in the circumstances.

For and on behalf of: [] Trust

.....

Trustees

.....

Date

We hereby agree to comply with the guidelines of this Investment Policy Statement as detailed above and with any revision to which may be notified to us by the Trustees.

For and on behalf of: [] (Investment Manager)

.....

Director

.....

Date

GUIDANCE NOTES

What is an IPS?

The IPS is a document that is drawn up by the trustee to provide the portfolio manager with the key considerations for the effective management of the assets for which they have been appointed to manage.

The IPS is a powerful tool for any investor who appoints an investment manager.

It can contain a considerable amount of detail or can be highly effective in a concise form.

Why have an IPS when the investment management company has an effective investment management agreement?

Certain investment management agreements (IMAs) are comprehensive and include much of the information that is included in an IPS. The IMA will cover all of the issues that the regulated investment manager is required to include but these may not be entirely consistent with the requirements of the investor. The IMA is generally designed to protect the investment management company as well inform the investor of their rights, put simply the 'investments can go down as well as up and you may lose all of your money in certain instances'.

What is the benefit to the investor of an IPS?

No surprises and peace of mind.

What is the benefit to the investment manager of an IPS?

A clear summary of what is expected.

What is the legislation?

The *Trustee Act 2000* for trusts governed by English and Welsh law, Part IV Section 15, under 2a:

'The Trustee may not authorise a person to exercise any of their asset management functions as their agent unless –

- a) They have prepared a statement that gives guidance as to how the functions should be exercised (a policy statement), and*
- b) The agreement under which the agent is to act includes a term to the effect that they will secure compliance with –*
 - i) The policy statement, or*
 - ii) If the policy statement is revised or replaced , the revised or replaced statement'*

In other jurisdictions, having an effective IPS would tend to be considered as best practice.

What should an IPS include?

An IPS can be detailed however the main headings should be as follows:

1. Base currency

The base currency is a key consideration as beneficiaries should not be made to suffer unnecessary currency risk and would normally expect the trustees to give consideration to their future, known spending and liabilities.

Note: While a portfolio will typically have a reporting or accounting base currency, this does not preclude the investment manager from including other currencies within a portfolio. In fact if an investment manager can produce a better return without exceeding the risk tolerance then it could be an opportunity.

Often there will be situations where beneficiaries are based/living in different currency regions and it may be appropriate to have a currency strategy that caters for each of the beneficiaries. An example would be a structure with a UK- and a Europe-resident beneficiary and the trust may be split between the two.

2. Initial investment amount

The initial investment amount and also any known future additions or withdrawals, as this may influence how the assets are invested and the level of liquidity that is maintained.

3. Level of expected return

Actual amounts or percentage returns are clearer than 'balanced' or 'growth', which are highly subjective terms (possibly producing negative as well as positive returns).

Many trusts will have specific objectives to, say, 'pay away £50,000 per annum' and this can be stated as a target.

Generally, investors are investing to out-perform cash in the bank and to try and protect against the impact of inflation so an aspirational target of UK Consumer Price Index plus 2% may be appropriate.

Note: This is an aspirational target and there will be years when returns are above and below but having the target means that there is a reference point.

Another level of expected return for trustees may simply be 5%. In years where the 5% target is met, say 2.5% may be distributed with the balance reinvested.

The level of expected return is very useful as an agreed measure of 'what success looks like' and can be measured over an agreed period of time. Considering expected outcomes is also useful and fits with 'no surprises', 'peace of mind' and 'what success looks like'.

For example, if the equity markets are up 15% and the target is to produce an absolute return of 5% and the portfolio is up 6%, then that is a successful outcome. If however the portfolio is down -5% but equity markets are down -40%, while the target has not been met, there can be a useful discussion around the reason for the results.

4. Level of risk

TMPI has defined the following the risk factors:

- **Drawdown** – the worst peak to trough decline in value the portfolio suffers
- **Volatility** – a statistical measure of the dispersion of returns. This is calculated using 'Standard Deviation'.

5. TMPI risk definition

- **Low risk** – Suitable for risk-averse and short-term investment objectives. Aim is to exhibit a volatility of <6% with a maximum drawdown of <10% over a rolling 12-month period.
- **Medium risk** – Investment horizon of between three and ten years. Would exhibit a volatility of between 6-10% with a maximum drawdown of <20% over a rolling 12-month period.
- **Higher risk** – Ten-years-plus investment horizon, volatility 10% plus and potential drawdowns of 20% plus, which may result in larger losses over a rolling 12-month period.

As with the required level of return there is a strong case to use objective measures. One typical measure that an investor can readily understand is how much can the portfolio fall in value in a defined period before it causes real concern (as detailed above it can be very useful to consider percentage declines such as less than 10% over 12 rolling months or -10% to -20% or at the higher end, over -20%).

Such objective measures can be more useful than subjective terms such as lower risk, which not only means different things to different investors but different investment managers will also have varying interpretations. For example, some investors believe that investing in blue chip equities is low risk whilst others believe that equities are generally a high-risk investment.

6. Restrictions or ethical screening

There can be any number of reasons for investment managers being restricted from holding assets. Avoiding sectors such as tobacco or armaments are obvious examples of negative screening and there may be a preference for certain sectors such as medical research or animal welfare (e.g. positive screening). However there may also be tax or other considerations.

Examples may include:

- There should be no direct investments in [US/UK/other] situs assets.
- The investment manager may only invest in investment grade bonds.
- No hedge funds/derivatives/structured products.
- Ethical restriction screening should be applied to eliminate exposure to tobacco, armaments and fossil fuels.
- No more than 5% in any single equity position.
- No leverage permitted at a portfolio level and that leverage at a sub-fund/investment level should be restricted, i.e. no investment in funds that are more than 100% leveraged.
- Positive screening: there is a desire to consider positive screening for social and environmental impact.
- Investments in high yielding equities may only be made if it mutually benefits both the income and longer term capital growth and the investment managers ensure that level of risk is consistent within the specifies risk profile indicated in section 2 of the IPS.

7. Income requirements

The requirement for income can be as an actual amount for example \$20,000 per annum, or alternatively a percentage such as 3%.

8. Tax considerations

This is one of the most important sections as if there are tax considerations that are not adhered to then the result could be very costly.

9. Time horizon

The time horizon is important as it will influence how the investment manager positions the portfolio. Typically the shorter the time horizon the less volatile the investment strategy should be.

10. Benchmark

The benchmark is a useful measure to understand how successful the investment manager has been relative to the relevant markets into which they invest. For a

discretionary portfolio manager a benchmark should be a reference point for risk and return but should not drive the strategy. The investment manager should always first and foremost be trying to deliver the most return for the agreed risk.

11. Peer group

An appropriate 'peer group' can help the investor to understand if the selected investment manager is producing reasonable results relative to the other providers. The STEP Member Service, the Trustee Managed Portfolio Indices (TMPI) have been designed specifically for this purpose.

12. Investment monitoring

Confirmation of the frequency of portfolio reviews and what analysis will be undertaken should be included. There are different expectations across jurisdictions, though a recent BVI judgment identified that had quarterly monitoring been conducted then the performance issue could have been identified and addressed in a timely manner.

Conclusion

In order to draft an effective IPS it is of course essential to ask the correct questions and make sure that the requirements are reasonable and achievable. When done properly, the IPS will provide a detailed and concise instruction of what is expected and should unite the Trustees and the Investment Managers to help ensure a successful investment outcome.