The IPS is Your GPS

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Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"When it comes to investing, there is no such thing as a one-size-fits-all portfolio"

Barry Ritholtz, American author, newspaper columnist, blogger, and CIO of Ritholtz Wealth Management.

Most of us are familiar with a GPS (Global Positioning System). It's tough to imagine planning a cross-country road trip or figuring out directions to that new restaurant across town without one these days. Fortunately, advancements in technology over recent decades have allowed the GPS to be widely embraced and available to almost anyone at the tips of their fingers (smart phones, computers, in-car navigation systems, etc.). Widespread adoption over time has made travelling more efficient and has helped many people avoid wrong turns in their unique journeys.

On the other hand, not everyone is familiar with an IPS (Investment Policy Statement). An IPS is a formal document that identifies the specific investment objectives and constraints of an investor. It takes into account the unique circumstances of the investor and acts as a practical long term plan for achieving the outlined objectives. An IPS is a key element of portfolio management as it provides direction and structure that can help guide investment decisions and actions over time.

It is useful to think of the IPS as a GPS for investing. When planning a trip, the end destination is determined at the beginning of the journey, along with any specific stops or desired milestones along the way. A GPS will take those unique inputs and provide a number of possible routes one can take to arrive at the destination. The GPS is consulted during periods of uncertainty along the way and it can provide direction regardless of detours or inclement weather that threaten to interfere with the journey. No trip ever goes exactly as planned and it is likely that the GPS will need to be revisited at some points throughout the journey in order to re-evaluate or "re-calculate" the best route.

When creating an IPS, the end goals and objectives are determined at the beginning of the journey, just like a GPS. Desired milestones such as a home purchase, retirement, or charitable gifts can be planned for up front as well. This combination of objectives and constraints will determine how an investment portfolio will be designed (more on this later). During periods of uncertainty, the IPS will serve as a guidance tool to help investors remember exactly what it is they are trying to achieve and whether or not they are still on the right path. Of course, just like trips don't go exactly as planned, life also doesn't go exactly as planned. An effective IPS process provides long term structure with respect to an investment plan, but it is also dynamic and adaptable in light of changes to investor circumstances over time.

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There is no right or wrong way to craft an Investment Policy Statement. It can be as simple or as complex as needed, depending on the investor. Key elements to an IPS process:

- Objectives

  Often times the objective of an investment portfolio will be to maximize the return potential over the long term given the specific risk tolerance and constraints of an investor. Assessing these factors requires a deep understanding of both the financial circumstances and emotional temperament of the investor. While it is possible to take a do-it-yourself approach to this process, there is a benefit in working with an independent advisor that can offer an unbiased and objective evaluation on an ongoing basis.

- Time Horizon

  When it comes to investing, time is definitely an asset. A longer time horizon will give an investment portfolio the ability to tolerate greater short term volatility, which over time can be expected to yield a higher long term average return. A shorter time horizon typically necessitates a portfolio designed to display lower short term volatility and correspondingly lower expected returns.

- Income Requirements

  An investor may require regular withdrawals from their investment portfolio to fund ongoing expenditures. Depending upon the amount of regular withdrawal relative to the overall portfolio, it may be necessary to increase the proportion of fixed income securities in the investment portfolio.

- Liquidity / Cash Requirements

  Cash requirements are a direct function of an identified objective (purchase of a home or car or a future liability such as taxes or lump sum payments to a life insurance policy). By keeping a sufficient portion of investments in cash equivalent securities, a forced sale of investment assets at an inopportune time can be avoided.

- Risk Tolerance

  Risk tolerance is the degree of variability in investment returns that an investor is able and willing to withstand. It is influenced not only by financial goals and constraints (risk ability), but also by individual personality and behavioural psychology (risk willingness). Some investors can simply stomach volatility better than others, affording them the option of a portfolio with higher expected returns over the long term.

- Asset Mix

  A comfort level with investment risk and volatility of returns together with investment time horizon, requirements for regular income, and the main long term objectives for investments impact the overall design and asset mix of the portfolio. Subject to a material change in investor circumstances, their asset mix should be selected and adhered to with long term planning in mind and should not be influenced by day-to-day market fluctuations.

- <u>Rebalancing</u>

  Rebalancing is a critical factor of portfolio management. The individual assets in a portfolio will produce different returns at different times, causing the asset mix to vary from the intended targets. To maintain the intended risk and return characteristics, the portfolio needs to be regularly monitored and rebalanced as required. During periods of extreme market volatility, significant rebalancing actions may be necessary. Human nature often clouds the judgment of an investor during times like these as the cycle of fear and greed will try to take over decision making. It is natural to want to sell an asset that is declining in value and buy an asset that is appreciating in value, even though the rational decision is to buy the declining asset (cheap) and sell the appreciating asset (expensive). This is why a well-articulated and systematic rebalancing policy is extremely important as it removes emotion from the equation (removing emotion from portfolio management decisions is discussed further in the "Detachment" section of The 4 Ds of Portfolio Management).

The principal reason for developing an IPS is to protect an investment portfolio from ad hoc revisions to a sound long term investment strategy, especially during volatile markets. A deliberate and systematic IPS process offers a rules based approach to investing and ensures the plan is executed with the head and not the gut. During periods of uncertainty, the IPS can be relied upon to provide an unemotional and rational overview of an investor's individual circumstances and long term goals.

Unfortunately, the use of an IPS process has not received widespread adoption like the GPS, particularly for individual investors or families. At Quadrant Asset Management, a formal IPS process is a matter of routine for all clients. As professional advisors to our clients we cannot envision managing their portfolio without a current and comprehensive understanding of their unique circumstances and objectives.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.