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Investment Policy Statement – It’s not Just a Statement, It’s a Policy Matter!

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While it’s certainly no news to most trustees that failure to diligently follow an Investment Policy Statement (IPS) is considered a breach of fiduciary responsibility, their engagement with their IPSs at times makes it seem they are not alert to this principle.



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While almost every pension fund has one, not every fund is consistently and loyally abiding by the provisions of their Investment Policy Statement (IPS). It's certainly no news to most trustees that failure to diligently follow an investment policy statement is considered a breach of fiduciary responsibility, and yet their engagement with their IPSs at times makes it seem they are not alert to this principle.

The adoption of the IPS, although wide in our sector, has been largely in response to regulatory requirements. The culture of crafting and taking full ownership of an IPS was not there prior to the onslaught of the regulatory provisions mandating every fund to have one in place. The industry has tended to then treat this simply as a compliance tick-box exercise to “satisfy the needs of the regulator”. This is quite an unfortunate stance on what is globally otherwise considered a prudent standard good practice. The real challenge is that an IPS is worthless without the acknowledgement that its existence is necessary. Trustees need to believe in the reason for its creation to give it real value.

An All-Critical Governance Document

IPSs have become, for many global institutional investors, not just statements but matters of policy that they follow in letter and spirit. An IPS must serve as a critical governance document, one that should be carefully crafted, periodically reviewed and updated, and diligently followed. If we are to put it rather bluntly, the only thing worse than not having an IPS is having one that is not followed.

Ownership of an IPS is one of the most important fiduciary responsibilities of trustees. They need to have a clear sense of the need to deeply understand its provisions and closely follow its terms. An IPS is only as good as the trustees' execution of its provisions.

Where there is disgruntlement, an IPS can be used by suing members in validating a breach of fiduciary responsibility. It should, therefore, be firmly and intentionally applied. Failure to comply with IPS provisions, either

operational or substantive, can provide clear grounds for prosecution. Decisions inconsistent with provisions of the IPS could be the basis for claims against the trustees.

A Must-Have “Ulysses Contract”

An IPS provides a strong basis for consistent decision making over time. It also helps dilute the impact of sudden additions and departures of investment committee members, many of whom have vastly different understandings of fund composition and construction. It thus helps preserve institutional memory of a fund’s investment objectives, strategies and processes.

A well- and thoughtfully-crafted IPS will certainly require steps that the trustees may not wish to take in a given situation. The irony is, it is exactly for this reason that a fund has to have an IPS in the first place. Managing investments without an IPS means failing to acknowledge that investing is an emotional endeavor. An IPS is a type of a “Ulysses contract” – a guiding framework you craft during calmer times to anchor back to during harsh periods and ensure that chaos does not prevail. It is the embodiment of a calm, rational Board of Trustees who will need to remind a hysterical, irrational themselves what their priorities are at some point in the future, especially when markets are turbulent and emotions are high. Creating an IPS is essentially an act of admitting that “due to the vagaries of the markets, we are occasionally going to lose our minds at some point, and when that happens let’s be guided by the provisions of the policy we created while composed”. Simply recognizing that behavior is likely to be a huge component of future investment success.

Critical to mention here that, the mere creation of an IPS will not relieve trustees of liability; the IPS must be adhered to dutifully. Accordingly, keeping the policy up to date and documenting the trustees’ compliance with the established policy are as important as having the policy itself.

Created For, and Owned By Trustees

Of course, trustees are not necessarily expected to prepare the IPSs themselves. However, the IPS should be prepared through the lenses that they

look at investment markets, capturing their goals, aspirations and objectives. An IPS should reflect the collective investment beliefs of the trustees as this will guide the selection and monitoring criteria for assets and investment providers. Once crafted, an IPS is wholly owned, and is for total implementation, by the trustees.

Investment consultants' expertise and competence is very handy in the creation and crafting of an IPS. There is a skill and an art that's required in crafting an IPS. The language used, the comprehensiveness of scope, the clarity of objectives, the articulation of constraints, the clearness of roles, responsibilities and accountability, the precision of execution approach, the robustness of the monitoring mechanism, and the thoroughness of ongoing review and evaluation of the policy all require the dexterity of a competent investment management expert.

In turn, investment consultants also benefit from the exercise of leading in the crafting of a fund's IPS because in the process they get a deeper understating of the fund, its aspirations, fears, values, principles and risk tolerance as reflected through the trustees' choices and beliefs.

Drafting an IPS is quite an educational process too. Working through issues in the design process can help identify weaknesses in the fund's current risk management structure and refine the setting of objectives, potential investment strategies, and contribution and benefit policies.

Investment performance varies over time and should be evaluated frequently. Trustees, as fiduciaries, are charged with the all-important task of oversight. Of course, oversight does not mean to actively manage the investments, but to ensure that the policies are being followed diligently by those hired to manage them. An astute investment consultant will be sure to take care of this aspect of the trustees' demanding roles. With all that said, one clause that trustees should be certain not to leave out in the IPS is on monitoring and measuring the performance and value-add of its own trusted advisors, including and specifically so, the investment consultant.

Even where the trustees have investment management capabilities, or have a fully-fledged in-house investment management team, an independent investment consultant is critical to highlighting any blind spots that the trustees could not be alert to in their decision-making processes. It also significantly brings back logic and rationality where otherwise decisions would be made irrationally when emotions are high, for they certainly will be at times.

A Science and An Art

While the temptation is huge to load everything-investments into an IPS, trustees should steer away from producing a voluminous but incoherent policy document. A litmus test is that it should be detailed enough that it could be carried out by any competent third party such as a replacement investment consultant. It must also be flexible enough that it can be implemented in a complex and changing financial market and economic environment. Furthermore, it should be always up to date, consistent with industry best practices, reflective of the changing regulatory environment, and not so narrow as to unnecessarily constrain trustees from discharging their duties in a prudent and practical manner.

As much as an IPS is about the investment, it is also about governance. The IPS helps define all associated parties and their responsibilities. When all parties clearly understand their roles, they'll likely spend less time in committee meetings figuring out who is responsible for which action item. Trustees should therefore make sure that their IPS is focused on governance rather than regulatory compliance.

Stewardship Framework

Pension fund assets investing is a tremendous privilege, and one that comes with significant responsibility. It requires a fiduciary mindset, a willingness to thoroughly address all aspects of stewardship, and a robust investment governance framework.

In the words of the Oracle of Omaha:

“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What’s needed is a sound intellectual framework for decisions and the ability to keep emotions from corroding that framework” – **Warren Buffett**

One key requirement, even before an IPS is drafted, is that a fund must formally authorize the formation of an investment committee whose roles and responsibilities, together with those of other key stakeholders, are then captured in the IPS. Once the committee is set up, any failure to adhere to the provisions of the IPS in its operations is considered a breach of its duties. For instance, if the IPS states that the committee meets quarterly to review investments, it should not be meeting only semi-annually, else it will be in breach.

One of the key purposes that an IPS serves well is that of ensuring the investment committee actions are policy-driven rather than emotional. It also helps well in mitigating the impact of strong personalities within the committee membership.

Conclusion

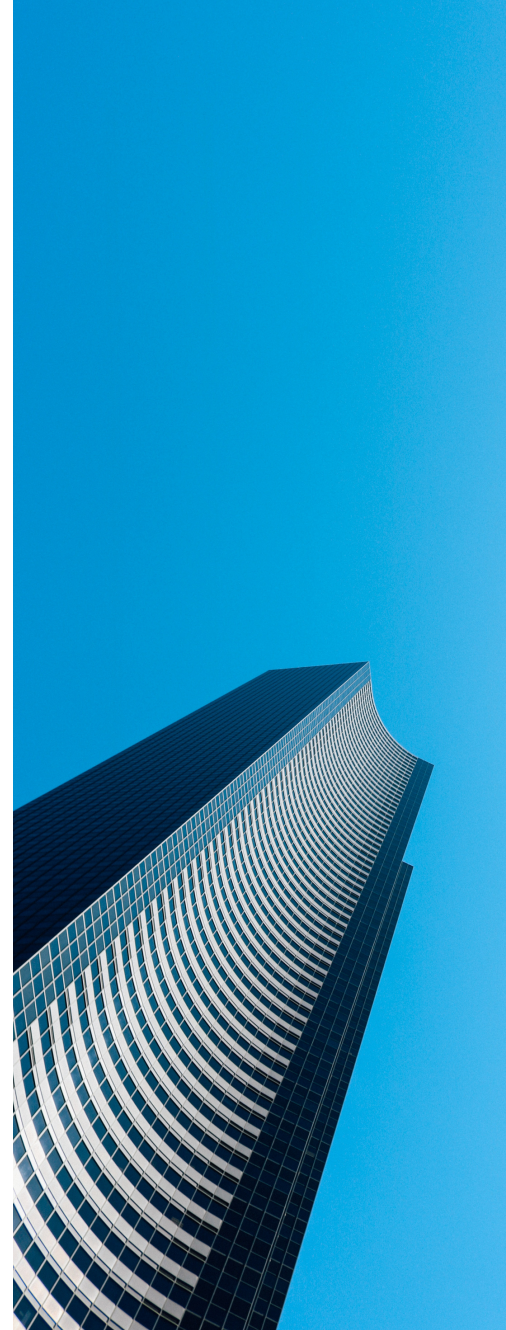
Arguably one of the most important policies in any fund’s governance artillery, one could even venture to say it is probably the one governance document that comes immediately below a fund’s set of rules in the order of importance – making it imperative that we all apply it devotedly. Its importance needs even more pronouncing in the current age of defined contribution schemes where the members directly carry the investment risk.



Our monthly publication is aimed at inviting conversations from like-minded individuals with a view to engaging in forward-thinking-led discussions on how we can collectively improve the state of our industry.

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