



### **Guidance for Developing Investment Policy Statements**

This guidance is intended to provide more in-depth descriptions of the high-level policies identified and recommended in the Guidelines for Investment Policy Statements. Some of the policies described below may not be necessary for all systems and are for unique situations, such as systems with specific governing laws or those with more complex investments. These types of policies are distinguished by the designation “(if appropriate).” Similar to the Guidelines for Investment Policy Statements, this guidance reflects accepted industry best practices established by the Chartered Financial Analyst Institute and the Government Finance Officers Association as well as investment expert reports analyzing retirement system investment practices and performance summarized in the PRB’s [2020 Investment Performance Report](#). Examples of these policies and a glossary of common terms can be found in the PRB Investment Policy Statement Example document.

#### **Description of each type of recommended policy:**

1. **Fund mission or goal:** This section states the foundational beliefs, purpose of the fund, and any laws that govern the fund.
  - a. State fund mission that acknowledges all relevant parties – This section at its core can appear obvious; however, a holistic view of the defined benefit fund is encouraged. A holistic view considers all parties involved including active members, retired members, and the system’s sponsor. It should also define the goals related to the benefits being provided, such as providing benefits that are both equitable and serve as an employer retention tool. This section should reference the system’s funding policy and recognize the sponsor as an integral part of meeting the fund’s mission to pay benefits.
  - b. State investment program purpose – This section should also focus on the specific purpose of the investment program.

#### **Fiduciary Responsibility**

In making and supervising investments of the reserve fund of a public retirement system, an investment manager or the governing body shall discharge its duties solely in the interest of the participants and beneficiaries:

- Providing benefits to participants and their beneficiaries; and
- Defraying reasonable expenses of administering the system

- c. (If appropriate) Reference relevant governing statutes.

2. **Roles and responsibilities:** This section specifies the parties involved in the investment program and describes each party’s responsibilities.

- a. Identify fiduciary standards and related requirements – Various roles will follow certain fiduciary responsibilities and prudent investor standards consistent with applicable statute, as described in the textbox.<sup>1</sup>
- b. List the important roles and define corresponding responsibilities – This policy should thoroughly cover the responsibilities of all major parties such as the board trustees, investment consultants, investment managers, custodians, and others. It should also define their levels of

<sup>1</sup> [Sec. 802.203, Texas Government Code](#)

authority and reporting requirements and include clear descriptions for monitoring and accountability of the assigned responsibilities. With these important roles clearly defined, the IPS helps provide continuity of the investment program by ensuring this important information can be passed on to future trustees.

- c. Describe how a role is reviewed – Role policies should include a description of how roles will be reviewed including what metrics will be used, how frequently they will be reviewed, and who is responsible for reviewing the results.

*Example:* “The consultant will use the IPS-specified performance metrics to review investment managers quarterly and present to the board for review.”

- d. Document the frequency of competitive procurement – For third-party consultants and other relevant service providers, the policy should provide for a regular competitive procurement process, typically every 3-5 years. Regular re-procurement helps ensure quality services for a competitive cost.

- 3. **Investment objective:** This policy defines the focus of the investment program using objective goals that can be measured and monitored. These objectives can be both short-term and long-term in nature and should be used to evaluate the overall success of the investment program. Examples of investment objectives are listed in the textbox, *Example Investment Objectives*.

- a. Document the investment objective – The goal or goals should be actionable, attainable, unambiguous, and specified in advance. See examples in the textbox.

- 4. **Liquidity:** Liquidity policies can influence different aspects of a pension fund depending on the specific funding situation. For example, mature plans will require more cash flow liquidity to make benefit payments. A liquidity policy can be a subsection to a larger policy—such as risk tolerance or investment assets—but may be a significant enough factor to merit a dedicated policy section.

- a. Liquidity as a standalone policy – This section should include procedures for staff or the system to notify investment managers of expected future distribution needs, fund liquidity level requirements, illiquid investment restrictions, and notification policies or actions that the fund will take in the case of insufficient liquid assets.
- b. Liquidity as a relevant subsection to another policy – Since the term liquidity can have different meanings in investments and in terms of pension funds, subsections can sometimes be a better option.

- 5. **Risk tolerance:** This policy defines the risks that the fund accepts in exchange for investment returns. Identifying acceptable risk can be done in several ways, which may include risk budgeting, statements accepting market volatility in exchange for believed higher returns over the long term, risk measures or metrics, and diversification goals. The goal of this section is to identify the risk factors that could impede success and how the system will ensure the risk is monitored and managed. This policy should:

- a. Identify risk factors – Examples can include market risk, economic risk, interest rate risk,

**Example Investment Objectives**

- Achieve a long-term rate of return that exceeds the assumed actuarial rate of return.
- The fund’s nominal net of fee return should meet or exceed the investment return assumption of 7 percent over a rolling five-year period.
- The actively managed investments performance should net return 1 percent alpha (excess return over a benchmark).

inflation risk, and credit risk.<sup>2</sup>

- b. Define risk metrics – Examples can include standard deviation, expected volatility, value-at-risk (VaR), and drawdown risk.
  - c. (If appropriate) Liquidity – Depending on the funding level or cashflow requirements to meet benefit payments, adequate liquidity levels might be a significant risk that requires detailed policies and monitoring.
6. **Investment assets:** This policy describes the asset classes considered investable by the fund and determines what percentage the fund will invest in each asset class, also known as the asset allocation. Refer to the example IPS document for more information and an example asset allocation. Assets can be grouped in different ways by various distinctions. However, the most common asset classes include equities, fixed income, real assets, alternatives, and cash. The policy should:
- a. Establish investable asset classes – Specify asset class allocation targets and rebalancing ranges.
  - b. Specify portfolio process – Establish portfolio asset allocation target determination process and frequency of review.
  - c. (If appropriate) Define expected volatility and risk levels, including expected volatility and risk levels in any asset allocation target tables.
  - d. (If appropriate) Specify how often an asset liability study is to be performed, with every three to five years as industry best practice.
  - e. (If appropriate) If investing in alternative assets, document additional policies, such as legal reviews, valuation methodologies, liquidity, and others.
  - f. (If appropriate) Document any cash flow or liquidity concerns or needs that would impact the investment options or allocation.
7. **Proxy voting:** Systems that have investment proxy voting rights should include this policy in the IPS. A proxy policy should state which party is responsible for voting, define guidelines or limitations that must be followed, and specify notification/reporting procedures to the board on votes placed. If a system chooses not to have investments with proxy voting rights and therefore has no related guidelines or procedures, the IPS should still include this section to state this fact.
8. **Performance evaluation:** This section describes how the system's board will assess the success of the investment program and use that information to improve future decision making. The evaluation of performance can be delegated to a third party such as an investment consultant, who can consolidate, validate, analyze, and present the findings to the system's board.
- a. Specify metrics – Time-weighted, or internal rate of returns (TWR, IRR). Net of fee returns should always be provided, and gross returns are optional.

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<sup>2</sup> PRB, *MET Investments Course*, accessed November 5, 2023, <https://education.prb.texas.gov/course/investments/>

b. Identify benchmarks – An acronym to use when identifying benchmarks is SAMURAI. See the textbox, *SAMURAI*, for a description of each aspect of benchmarks meeting this standard.

c. Cost management – This section can be written as a standalone section or as subsection to the performance evaluation policy. In any case, it should require that that both direct and indirect fees be monitored and specify frequency of review. The policy should include:

- i. Reporting requirements of investment expenses, both net and gross of fees.
- ii. Statutory reporting requirements – Texas retirement systems are required to report investment expenses in their annual financial reports. As a result, a fee policy should be tailored to capture and use the required information. This policy should require that both direct and indirect fees be evaluated and indicate the party responsible for providing this information.<sup>3</sup>

d. (If appropriate) Performance attribution – This policy would specify if performance attribution should be required with performance evaluations. These additional details can be extremely useful for a board to understand investment performance while making it easier to engage investment staff or consultants on potential actions.

e. (If appropriate) Performance appraisal and active vs. passive – This policy would focus on evaluating investment managers' ability to deliver alpha using metrics and excess return analysis. The policy could include procedures to review active managed investments vs. passive investment alternatives.

9. **Investment manager selection and monitoring:** Investment managers are those who manage a portion of the system's assets. As such, the IPS should include policies to specify the due diligence necessary to ensure those assets are invested in the best interest of fund. As conducting investment manager due diligence is a skilled practice, it is highly encouraged that systems that lack internal expertise rely on a third-party consultant with relevant expertise to create or provide policies and guidance to govern the process.<sup>4</sup>

a. Selection criteria – Include qualitative, quantitative, or other factors.

#### SAMURAI

- Specified in advance – The benchmark should be specified prior to evaluation.
- Appropriate – The benchmark should be a good proxy for the investment and its characteristics.
- Measurable – The benchmark should be easily calculable and available.
- Unambiguous – The benchmark should be clearly understood by all parties involved.
- Reflective of current investment opinion – The benchmark should match the investment style deployed by the fund.
- Accountable – The benchmark should be accepted as appropriate by the party who is ultimately accountable for the investment's performance.
- Investable – The benchmark should be purchasable or able to passively replicate.

<sup>3</sup> [Sec. 802.103, Texas Government Code, 40 TAC, §609.105\(9\)](#)

<sup>4</sup> [Secs. 802.204-802.207, Texas Government Code](#)

- b. Procedure and metrics used for monitoring – Use benchmarks established in the performance evaluation section. Performance should be reviewed at least quarterly.
  - c. Compliance – Review compliance with all applicable laws, fund guidelines, and monitoring policies.
  - d. Watch list policy – Include a watch list process in the policy as part of the monitoring process for investment managers. This type of policy allows a system to notify managers of their watch list status, which occurs when performance deficiencies or other issues arise that can lead to termination and withdrawal of assets. This process may include:
    - i. A notification to the investment manager of their placement on the watch list and the reason for the decision.
    - ii. A request for the manager to respond or provide any qualitative or quantitative analysis regarding the underlying issue.
    - iii. A contingency to research alternative investment opportunities if the investment manager is terminated.
    - iv. A requirement to review watch list managers every year to decide on removing, maintaining watch list status, or terminating.
10. **Ethics:** A section can be created to outline the core ethical principles that all parties should follow. Alternatively, this section may reference an additional document the system maintains, such as a code of conduct or broader ethics policy. These types of policies help clarify acceptable practices and document the core ethical beliefs trustees and other third parties will follow.