BEST PRACTICE

Pension Investment Policies (2003)

Background. Most public sector pension systems have issued investment policies that govern how they will carry out their investment program, in order to strengthen both the financial condition of the pension plan and the promise to deliver retirement benefits to plan participants. Investment policies offer a number of advantages to pension systems:

- Investment policies are a clear demonstration of fiduciaries' due diligence;
- They are a communication tool for conveying investment goals and priorities to interested parties;
- They strengthen the internal controls of the pension system.

In addition, pension investment policies are often used to formally articulate the pension system's asset allocation strategy.

Like any financial policy, a pension investment policy is a governing document in which the governing board and other key stakeholders formally set broad policy parameters. Detailed guidance about implementation of the investment program may be contained in the investment policy or other documents, such as investment procedure manuals and agreements with third parties.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local entities establish a formal pension investment policy that is approved by the governing board or trustee(s) of the pension plan. A pension investment policy should be viewed as a long-term governing document. Because pension systems invest over an extended horizon, the policy statement should be designed with long-term issues in mind and not require frequent amendment.

The development of an investment policy must be made within the framework of the legal restrictions set forth in state and local statutes as well as those established by common law and fiduciary standards. Within this context, GFOA recommends that an investment policy contain the following elements:

- Statement of purpose – this statement would articulate the rationale for having the policy, as well as the investment goals (e.g., to meet or exceed a certain benchmark for the overall portfolio);
- Roles and responsibilities – this would identify the roles and responsibilities of key decision makers, including the governing board, the chief executive officer, the chief investment officer (if applicable), and external investment professionals;
- Standard of care – this would identify the standard of prudence that the decision makers are expected to meet in carrying out their investment responsibilities (e.g., prudent person or prudent expert);
- Asset allocation – this would summarize the long-term asset allocation strategy of the plan, typically expressed as percentage allocations to various asset classes such as stocks and bonds or subcategories thereof;
- Rebalancing – the need should be stated to periodically conform the portfolio to the asset allocation strategy;
- Investment guidelines – this element provides investment guidelines for external investment professionals to adhere to, in order to mitigate risk related to investment implementation (e.g., limits on holdings of individual securities). The scope of the guidelines should cover internal money managers if applicable;
- Reporting and monitoring – the frequency and manner in which external and internal parties report investment results are stipulated and the evaluation process defined;

- Corporate governance – as a matter of policy, pension systems should identify guidelines for proxy voting and other issues related to corporate governance.

Investment policies should be reviewed annually, with more exhaustive reviews occurring as needed (e.g., formal asset allocation studies).

References

- GFOA Best Practice, "Asset Allocation Guidance for Defined Benefit Plans," 2009.
- *Pension Investing: Fundamentals and Best Practices*, GFOA.
- The Legal Obligation of Pension Plan Governing Boards and Administrators.

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