A Guide for Establishing a Pension Investment Policy

By Nicholas Greifer

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Foreword

For almost all units of government, the development of an investment policy is fundamental to sound financial management. For a pension system that manages millions of dollars in assets, the importance of a policy cannot be overstated. Policies provide the prerequisite for strong internal controls, explain the rationale for a pension system's approach to investing, and demonstrate due diligence to external stakeholders who hold a keen interest in the outcome of the investment program. The goal of this monograph is to assist pension organizations in their efforts to develop and improve their investment policies.

A Guide for Establishing a Pension Investment Policy continues the Government Finance Officers Association (GFOA) "Documents on Disk" series. Like earlier monographs within the series, it is designed to provide concrete examples of outstanding investment practices, accompanied by documents contained in an electronic format. The book emphasizes a practical approach, based on the actual investment policy documents of GFOA member governments.

The GFOA wishes to thank Nicholas Greifer who authored the publication. His efforts build off the work of the GFOA Committee on Retirement and Benefits Administration (CORBA Committee), which in 2003 drafted the GFOA recommended practice, "Pension Investment Policies," as well as the pension investment policy checklist included in this publication. Stephen C. Edmonds, former Executive Director, Oklahoma Public Employees' Retirement System; Mary L. Tomanek, Senior Investment Management Consultant, Salomon Smith Barney; Terrance R. Stefanski, Executive Director, Municipal Employees Annuity and

Benefits Fund of Chicago were instrumental in the CORBA Committee developing this checklist. In addition, I thank Howard H. Pohl, Principal, Becker, Burke Associates for reviewing this publication, as well as Rowan Miranda and Rebecca Russum of the GFOA.

Jeffrey L. Esser
Executive Director
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Section 1
Introduction

What does it mean to be a prudent investor? The concept of prudent investing imposes special obligations upon pension trustees, their staff, and their investment advisors in carrying out the investment program of a pension system. Prudence begins with the establishment and maintenance of a sound investment policy. While certainly not the only component of a prudent investment program, the investment policy is the initial step in a long journey toward successful investment. Lacking a formal policy, letting it become outdated, or failing to enforce it creates the conditions for investment underperformance and economic loss to stakeholders.

Functions of Investment Policies

Government pension systems are long-term investors, seeking to meet financial obligations that extend over decades and generations. Indeed, because pension plans are rarely terminated, and because the plan sponsors rarely go out of business, these obligations are virtually perpetual in nature. Even so, pension trustees are often pressured to respond to short-term market fluctuations, to react to the daily noise of the capital markets, and to be seen as "doing something" by other stakeholders that have an interest in the plans. Given these conflicting pressures, the development of an investment policy is crucial to maintaining a long-term focus and serves a number of important functions:

- A concrete statement of investment goal(s) (e.g., to exceed a long-term target rate of return);
- A method for determining and expressing the pension board's investment philosophy and risk tolerance to both staff and third parties;
- A clear demonstration of "due diligence" (i.e., that the pension system follows a prudent set of procedures);
- A foundation for internal controls;
- Guidance to staff and third parties, to ensure both proper execution of the investment strategy as well as compliance with the law; and
- Risk management tool.

Regarding investment goals, the investment policy is the appropriate place for articulating specific goals, such as rate of return targets. By specifying these goals in writing, the board of trustees is able to formulate a coherent investment philosophy and style, one that is unique to its circumstances and tailored to its liabilities. The investment policy of a mature pension plan, for example, could be markedly different than that of a newer plan serving a younger population of plan participants. Similarly, the investment policy of a sharply underfunded plan may be different than one that is near full funding and may have a different investment philosophy and tolerance toward risk.

As mentioned, investment policies are a way to indicate to interested stakeholders that the system is exercising due diligence. Like any other financial policy, an investment policy is the foundation from which internal controls can be built. A strong internal control environment typically consists of policy and procedures to clarify what is expected of managers, segregation of duties to avoid conflicts of interest, and periodic testing of such controls (e.g., by auditors).

Investment policies are also a communication tool for educating and guiding staff and external parties. For example, a well-written policy will help investment managers understand the objectives of the pension plan, acceptable and unacceptable risk-taking, and specific constraints on transactions. To a great extent, a well-crafted policy should serve as a stand-alone document that any investment professional can understand and act on, without necessarily having to learn about the pension system's investment approach from other formal or informal sources.

Furthermore, the policy can serve as a way to educate and thereby insulate the pension system from inappropriate meddling by political actors. Indeed, the Association of Public Pension Fund Auditors (APPFA) notes that a key risk to the investment program is "sudden adverse legislative changes," and that a key risk management tool is the establishment of an investment policy. The APPFA report[1] states that "a well-organized and documented investment policy that has been approved by an appropriate governing body [e.g., board of trustees] is key to avoiding sudden and frequent overhauls of the investment program by various political bodies."

Lastly, investment policies serve as a tool for managing external and internal risks. Aside from managing political risk as cited above, investment policies are the place for expressing asset allocation strategy to manage external investment risks, with many pension systems including an asset allocation statement within the investment policy (discussed in the following section).[2] Internally, an issue for any pension system is the quality of governance, and whether the governing fiduciaries can competently oversee the investment program. In some jurisdictions, turnover among board members can be undesirably high, compounding governance problems and diminishing institutional knowledge and continuity. Written investment policies help maintain continuity and, as the APPFA report notes, "reduce the risk of poor governance."[3]

Organization of Monograph

This monograph is organized into four sections designed to prepare a new or experienced trustee or administrator who is developing or revising the pension system's investment policy. Section 2 summarizes the prevailing practice of pension systems in how they craft investment policies, as well as the GFOA recommended practice that spells out what such policies should contain. Section 3 provides the GFOA policy checklist, which can be used as a tool for plans to benchmark their existing policy against suggested guidelines developed by the GFOA Committee on Retirement and Benefits Administration. It is also included on the

CD-ROM that accompanies this book. Section 4 provides a synopsis of the three investment policies also included on the enclosed CD-ROM.

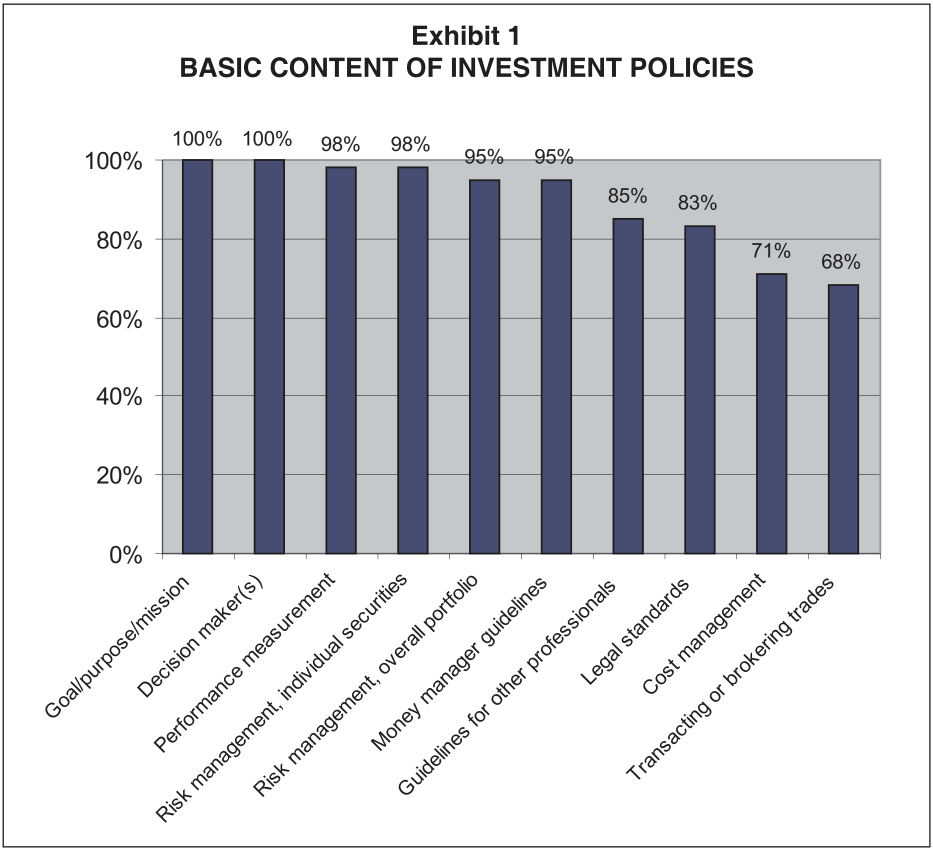
Section 2
Scope of an Investment Policy

What goes into an investment policy? This section presents research into the prevailing practices of Government Finance Officers Association (GFOA) members in order to ascertain how pension investment policies are typically formulated. In addition, Section 2 focuses on asset allocation strategy, which is usually contained in the investment policy statement and remains critical to any investment program. Also presented is the GFOA recommended practice on investment policies, which provides basic guidelines for determining what a pension system's investment policy should address.

Typical Provisions of an Investment Policy

What provisions do pension systems typically include in an investment policy? GFOA analyzed over 40 investment policies obtained from public pension systems to determine the state of the art in formulating such policies.[4] The analysis determined that most policies are comprehensive documents containing the following ten elements:

1. Statement of goal(s), purpose, or mission
2. Identification of decision maker(s)
3. Statement on performance measurement (benchmarking)
4. Statement on managing risks of individual securities
5. Statement on managing risk of overall portfolio
6. Money manager guidelines



7. Guidelines for other investment professionals
8. Legal standards
9. Cost management
10. Transacting or brokering trades.

Not surprisingly, the GFOA analysis found that each pension policy identified some kind of goal, mission statement, or purpose. Not all pension systems, however, articulated a *quantifiable* investment goal (e.g., "earning income to provide retirement benefits" is not the measurable investment goal that "earning the actuarial rate of return" is). Each policy also identified at least one decision maker, such as the pension board, for the investment program. A large majority of the policies also addressed the remaining eight categories, as shown in Exhibit 1.

Within the broad categories, the policies analyzed contained specific elements, as shown in Exhibit 2. In general, pension systems serving many employers had more detailed policies than smaller, single-employer systems, and they contained more of these specific elements.

Integrating Asset Allocation Strategy into the Investment Policy

As indicated in the preceding section, most policies analyzed by GFOA contained a statement on managing overall portfolio risk. In most cases, the asset allocation strategy is a principal risk management tool. For example, the Oklahoma PERS follows a common approach to conveying its asset allocation strategy, as shown in Exhibit 3.

In the past twenty years, asset allocation strategy has become widely accepted as the primary determinant of the variation in investment return. The GFOA recommended practice, "Asset Allocation—Guidance for Defined Benefit Plans (1999)," sums up the research as follows:

> Numerous studies have concluded that the single most important component determining overall performance of an investment portfolio is how that portfolio is allocated among different types of investments.

For example, a well-known study by Gary Brinson *et al* attributes 94 percent of the variation in investment return to asset allocation.[5] This conclusion is based on an examination of ten-year returns on investment portfolios consisting of the traditional asset classes (stocks, bonds, and cash). In contrast, market timing explained only 2 percent of return variations, with the remaining 4 percent attributable to securities selection. Whether or not one agrees on the exact percentage contribution to investment returns,[6] or the methodology of the Brinson study, consensus exists among practitioners that the asset allocation decision needs to be documented in an investment policy.

Ultimately, the asset allocation strategy is about managing portfolio-level risk. This kind of risk, known as systematic risk, cannot be "diversified away" but can only be mitigated through a multi-asset class portfolio. In contrast, pension systems can diver-

Exhibit 2
DETAILED ANALYSIS OF INVESTMENT POLICY ELEMENTS

Category/Element		Frequency
A. Statement of goal(s)/purpose/mission		
	A1. Statement of investment philosophy	20%
	A2. Prioritization of investment goals	44%
B. Identification of decision maker(s)		
	B1. Duties of the pension board	100%
	B2. Duties of staff (delegation)	66%
	B3. Duties of third parties (delegation)	98%
C. Statement on managing risk in the overall portfolio		
	C1. Asset allocation target (adds to 100%)	68%
	C2. Guidelines on alternative assets	37%
	C3. AA range	76%
	C4. Rebalancing guidelines	59%
D. Statement on managing the risks of individual securities		
	D1. Allowable investment types/strategies listed	76%
	D2. Prohibited investment types/strategies listed	66%
	D3. Limitation on derivatives	68%
	D4. Limitation on market timing	7%
	D5. Diversification within asset classes	88%
E. Statement of performance measurement (PM)		
	E1. Performance measures for portfolio	95%
	E2. Relative to inflation	63%
	E3. Relative to actuarial assumptions	51%
	E4. Relative to index	78%
	E5. Relative to DB pension universe	32%
	E6. PM for each asset class	66%
	E7. PM for each manager	85%
	E8. PM in relation to a group of managers	59%
	E9. PM in relation to index	78%
	E10. Net of fees	37%
F. Guidelines for money managers		
	F1. Selection criteria	44%
	F2. Manager "watch list"/term guidelines	49%
G. Guidelines for other professionals		
	G1. Custodians	63%
	G2. Investment consultants	71%

Exhibit 2 (cont.)		
Category/Element		**Frequency**
H. Legal standards		
	H1. Exclusive benefit principle	56%
	H2. "Collateral benefits"/ETI	27%
	H3. Prudent person	63%
	H4. Prudent expert	17%
	H5. Prudent investor	10%
I. Cost management		
	I1. Limits on transaction costs	56%
	I2. Index funds statement	41%
J. Transacting or brokering trades		
	J1. Securities lending guidelines	37%
	J2. Directed brokerage guidelines	37%
	J3. Best execution standard	41%
	J4. Soft dollars guidelines	24%

Exhibit 3
EXAMPLE OF AN ASSET ALLOCATION POLICY

	Range	Target
U.S. Equities	44%-50%	47%
International Equities	12%-16%	14%
Domestic Fixed Income	35%-43%	39%
Cash	0%-5%	0%

Source: Oklahoma PERS investment policy

sify away or eliminate unsystematic risk, which is the risk attributable to holding a single security. (See Exhibits 4 and 5.)

Investment policies faithfully executed can eliminate unsystematic risk by imposing diversification requirements. Such requirements demand that the pension system and its money managers hold a broad array of securities within each asset class.

Exhibit 4
SYSTEMATIC AND NON-SYSTEMATIC RISK

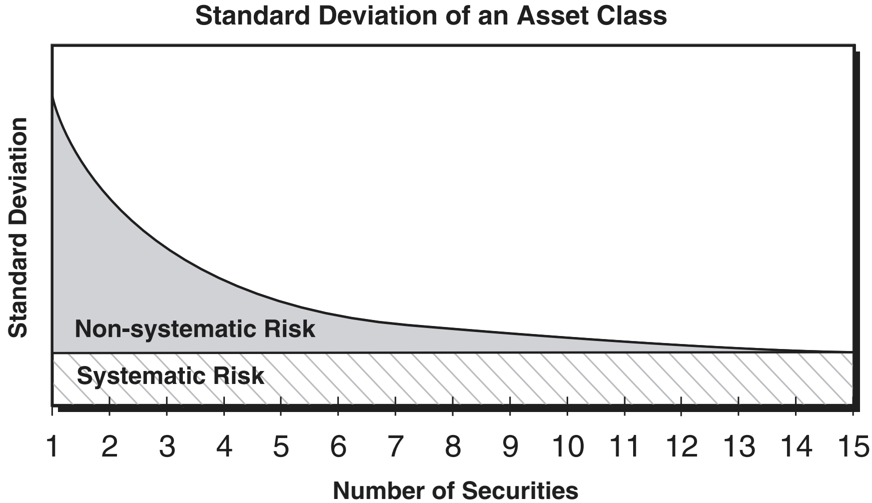


Exhibit 5 **RISK MANAGEMENT**				
Type of Risk	**Scope of Risk**	**Risk Management Tool**	**Effect**	**Reference**
Unsystematic	Single security	Diversification—hold multiple securities within an asset class (typically 30 or more)	Eliminates unsystematic risk	Checklist, p. 18
Systematic	Single asset class	Asset allocation—construct a portfolio of multiple asset classes (typically 3 or more)	Manages (but does not eliminate) systematic risk	Checklist, p. 17

Recommended Provisions of an Investment Policy

The foregoing discussion describes the prevailing practice among pension organizations. Is there a preferred way of formulating an investment policy? Although there is no "one size fits all approach," GFOA has developed a recommended practice, "Pen-

Exhibit 6
GFOA RECOMMENDED PRACTICE
PENSION INVESTMENT POLICIES

1. 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);
2. 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;
3. 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);
4. 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;
5. Rebalancing—the need should be stated to periodically conform the portfolio to the asset allocation strategy;
6. 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;
7. Reporting and monitoring—the frequency and manner in which external and internal parties report investment results are stipulated and the evaluation process defined;
8. Corporate governance—as a matter of policy, pension systems should identify guidelines for proxy voting and other issues related to corporate governance.

sion Investment Policies," to provide guidance to its members on this subject. The recommended practice provides an approach that sets minimum thresholds for what an investment policy should contain.

An investment policy must be developed 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 eight elements, identified in Exhibit 6.

GFOA notes that 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. Even so, investment policies should be reviewed annually, with more exhaustive reviews occurring on occasion (e.g., after conducting formal asset allocation studies).

Section 3
Investment Policy Checklist

In the preceding section, the prevailing practice and recommended practice for investment policies were discussed. The objective of Section 3 is to provide detailed guidance about how each section of an investment policy could be crafted. The GFOA Committee on Retirement and Benefits Administration (CORBA Committee) developed and approved these guidelines.

To develop the checklist, the CORBA Committee appointed a task force of experts who aligned the document with the existing GFOA recommended practice, "Pension Investment Policies;" analyzed existing policies, including those cited in Section 4; and reviewed the draft with the assistance of a chief investment officer of a state retirement plan. Lastly, the committee provided an additional review of the draft checklist prior to approval.

Guide to Using the Checklist

Although the investment policy checklist builds off of the GFOA recommended practice, it should not be viewed as mandatory. Rather, the checklist is a document that recommends items for *consideration* by pension fiduciaries who are commonly responsible for the investment policy document. It is suggested that pension plan trustees use this document in conjunction with advice received from investment advisors and other professionals who regularly provide input on a pension system's investment policy. As always, it should be reviewed for consistency with state and local law.

The checklist largely follows the structure of the GFOA recommended practice (see pages 10–11), with additional subjects for consideration contained in appendices. The policy is structured as follows:

I. Introduction
II. Statement of Purpose
III. Roles and Responsibilities
IV. Asset Allocation
V. Investment Guidelines
VI. Reporting / Performance Monitoring

Appendices
A. Cost Management
B. Securities Lending
C. Public Policy Issues Affecting the Investment Program
D. Corporate Governance
E. Guidelines for External Investment Professionals
F. Ethics and Conflicts of Interest
G. Alternative Investments
H. Common Investment Instruments

In addition, the electronic version contained in the enclosed CD-ROM contains a glossary of investment terms.

Checklist for a Pension Investment Policy

I. Introduction

Pension fund fiduciaries may consider the following items for inclusion in an introductory section of the investment policy (or similar section).

- ❑ Reference to state or local law creating plan;
- ❑ Intended beneficiaries of the plan (e.g., the plan is created for certain employees and their dependents); and
- ❑ Scope of policy (e.g., limited in application to pension fund assets).

II. Statement of Purpose

Pension fund fiduciaries may consider the following items for inclusion in the section of the investment policy that identifies the mission and purpose of the plan and its investment program (or similar section).

Mission statement.

- ❑ The fundamental mission of the Retirement System (e.g., to provide retirement and other benefits to plan participants); and
- ❑ Exclusive purpose – investment solely in the interests of plan participants and beneficiaries, for the exclusive purpose of providing retirement and other benefits to plan participants and beneficiaries.

Investment philosophy.

- ❑ Asset allocation – asset allocation is the key determinant of return and, therefore, commitments to asset allocation targets will be maintained through a disciplined rebalancing program;
- ❑ Diversification – diversification, both by and within asset classes, is a primary risk control element;
- ❑ Passive and active management – Active and passive fund portfolios are suitable investment strategies, with passive management especially suitable in highly efficient markets;
- ❑ Market timing – Market timing is precluded as an acceptable investment strategy;
- ❑ Liabilities – The investment program is ultimately for the purpose of meeting the pension system's obligations for benefit payments;
- ❑ Cash flow – The investment program must be cognizant of its cash flow obligations.

Goals and objectives. For total plan assets, the goals are as follows:

- ❑ To preserve the actuarial soundness of the plan in order to meet benefit obligations.
- ❑ To achieve a long-term (one to two market cycles) return of at least the actuarial earnings rate.
- ❑ To obtain a long-term (one to two market cycles) rate of return, net of fees, in excess of its policy benchmark by _____ basis points. The policy benchmark (see below) is a hypothetical portfolio of index funds weighted by asset allocation targets.[7]

Policy Benchmark		
Asset Class	**Index**	**Weight**
U.S. equities		%
Non-U.S. equities		%
U.S. bonds		%
Cash equivalents		%
(Other)		%
		100%

  - ➢ For the purposes of the investment policy, the System expects that domestic equities will provide a long-term return of _____%, non-U.S. equities _____%, U.S. bonds _____%, and cash equivalents _____ %. Long-term inflation is expected to be _____%.
- ❑ To prudently manage the inherent investment risks that are related to the achievement of investment goals.[8]

III. Roles and Responsibilities

Pension fund fiduciaries may consider the following items for inclusion in a section of the investment policy that defines the roles and responsibilities of internal staff and external professionals (or similar section).

Board of Trustees.

- ❑ General duties – The Board has the responsibility of establishing and maintaining broad policies and objectives for all aspects of the System's operation.
- ❑ Investment-related duties – The Board will review and approve the development or revision of the following documents:
  - ➢ The Investment Policy and Appendices
  - ➢ The Strategic Asset Allocation
  - ➢ Performance Benchmarks for the Strategic Asset Allocation
  - ➢ All other issues of investment policy not specifically enumerated here.
- ❑ Standard of care – The standard of prudence applied to the Board shall be the *prudent* ______[9] standard and shall be applied in the context of managing an overall portfolio.

Internal staff.

- ❑ General duties – A Chief Executive Officer (CEO) is appointed by, and serves at the pleasure of the Board. The CEO is responsible for planning, organizing, and administering the operations of the System under broad policy guidance and direction from the Board.
- ❑ Investment-related duties – The CEO, with the assistance of ________ (staff and/or investment consultants), monitors the performance of the investment portfolio; ensures that funds are invested in accordance with Board policies; studies, recommends, and implements policy and operational procedures that will enhance the investment program of the System; and ensures that proper internal controls are developed to safeguard the assets of the System.
- ❑ Standard of care – The standard of prudence applied to the Board shall be the *prudent* ______ standard and shall be applied in the context of managing an overall portfolio.

External investment consultant.

❑ Duties – The Consultant's duty is to work with the Board and Staff to manage the investment process. This can include:

  - ➢ Review of asset allocations and performance in conjunction with the Staff, and making recommendations to the Board as appropriate;
  - ➢ Assistance with external money manager selection; he or she will promptly inform the Board and discuss the impact of material changes taking place within any current manager's investment process; and
  - ➢ Meetings with the Board to provide an independent perspective on the Fund's goals, structure, performance, and managers.
- ❑ Standard of care – The standard of prudence applied to the external investment consultant shall be the *prudent* ______ standard and shall be applied in the context of managing an overall portfolio.
- ❑ Acknowledgement of fiduciary obligations – The external investment consultant will acknowledge in writing that he/she is a fiduciary of the pension plan.

- ❑ Communication – The investment consultant will provide the System with quarterly reporting and commentary on total portfolio performance, performance by asset class, and individual manager performance.

Money managers.

- ❑ Duties - Money managers will select, buy, sell, and loan specific securities pursuant to this investment policy and guidelines contained in the __________________ (contractual agreements). Discretion is delegated to the managers to carry out investment actions as directed by the System.
- ❑ Standard of care – The standard of prudence applied to money managers shall be the *prudent* ______ standard and shall be applied in the context of managing an overall portfolio.
- ❑ Acknowledgement of fiduciary obligations – Money managers will acknowledge in writing that they are a fiduciary of the pension plan.
- ❑ Communication – Money managers will provide the System with quarterly reporting and communicate any major changes in policy, economic outlook, or changes in the investment organization.

Other external providers. The System will retain custodians, attorneys, actuaries, accounting professionals, and a depository/financial institution(s) to implement its investment program.

- ❑ The custodian(s) will hold all cash and securities. The custodian will be responsible for providing a records maintenance system, fund accounting on a trade date basis, and other services as defined in the contract, such as performance reporting.
- ❑ A depository/financial institution will be utilized to accept and hold cash prior to allocating it to the investment managers, and to invest such cash in liquid, interest-bearing instruments.
- ❑ The System may retain an actuary to prepare actuarial valuations and periodically analyze the actuarial assumptions and experience of the System
- ❑ The System may retain accounting professionals to independently audit financial records and review internal controls.
- ❑ Standard of care – The standard of prudence applied to other external providers shall be the *prudent* ______ standard and shall be applied in the context of managing an overall portfolio.
- ❑ Acknowledgement of fiduciary obligations – The other external providers will acknowledge in writing that it is a fiduciary of the pension plan.

IV. Asset Allocation

Pension fund fiduciaries may consider the following items for inclusion in the section of the investment policy defining its asset allocation strategy or policy (or similar section). The purpose of Section IV guidelines is to manage risk associated with investment in an asset class (i.e., systematic risk). Risk associated with an investment in an individual security (non-systematic risk) is addressed in Section V.

Role and importance of asset allocation.

- ❑ Priority – The asset allocation decision is generally regarded as the most important decision to be made in the investment management process.
- ❑ Purpose - The purpose of a strategic asset allocation is to provide an optimal mix of investments that has the potential to produce the desired returns and meet current and future liabilities, with the least amount of fluctuation in the overall value of the investment portfolio. By spreading funds among several styles or investment types, there is an increased probability that if one investment type is decreasing in value, another is increasing in value.
- ❑ Scope – Most asset classes include a minimum of three broad categories of equities, bonds, and cash equivalents. In addition, within the scope of an asset allocation strategy other asset classes may be included, such as alternative investments (see Appendix G).

Asset allocation range. To further the long-term goals and objectives of the System set forth in Section II, the following asset allocation guidelines are established.

Asset Allocation Range			
Asset Class	**Minimum**	**Target**	**Maximum**
U.S. equities	%	A%	%
Non-U.S. equities	%	B%	%
U.S. bonds	%	C%	%
Cash equivalents	%	D%	%
(Other)	%	E%	%
		100%	

Rebalancing policy.

- ❑ Purpose – The primary purpose of rebalancing is to ensure that the System adheres to its strategic asset allocation, which is the System's explicit statement of its investment approach. Secondly, historical analysis of portfolio returns when rebalancing is used indicates that rebalancing reduces volatility and may add modest value, in comparison to a similar portfolio that is not rebalanced.
- ❑ Method of rebalancing – The System will carry out rebalancing in a cost-effective manner. If feasible, cash, as well as indexed investment strategies, will be used to maintain target allocations. Securities will be liquidated from the over-funded managers until the target allocations are met.
- ❑ The designated official will review the portfolio at least annually for rebalancing, based on:
  - ➢ Fixed Threshold: deviation of +/- __% from benchmark allocation, applied to each asset class, or
  - ➢ Proportional Threshold: deviation of +/-__% from benchmark allocation, applied in proportion to each asset class allocation.[10]

V. Investment Guidelines

Pension fund fiduciaries may consider the following items for inclusion in a section of the investment policy stipulating detailed investment guidelines. The purpose of Section V guidelines is to limit the risk associated with an investment in an individual security (e.g., non-systematic risk). The selection of investments will be guided by the prudent person and prudent expert standards.

Prohibited investments. Prohibited investments include, but are not limited to:

- ❑ Investments precluded by law or regulation;
- ❑ Securities purchased on margin;
- ❑ Short selling;
- ❑ Other ________________.[11]

Permissible investments. Permissible investments include those identified in the investment policy, subject to state statute and local ordinance. (Refer to Appendix H for common investment instruments.)

Diversification and credit quality. To limit the System's risk associated with holding individual securities (e.g., non-systematic risk), diversification requirements and other risk management requirements are set forth.

- ❑ Diversification relative to a single issuer – Any money manager operating within any asset class should not hold more than __% of the outstanding securities of any single issuer (for publicly traded securities).
- ❑ Diversification relative to System assets – For the following asset classes, no more than a certain percentage of System assets shall be invested in the securities of a single issuer.[12] This will be measured at the time of purchase and on a mark-to-market basis.
  - ➢ __% of System assets in U.S. stocks publicly traded

- ➢ __% of System assets in non-U.S. stocks publicly traded
- ➢ __% of System assets in U.S. bonds
- ➢ __% of System assets in non-U.S. bonds
- ➢ __% of System assets in cash-equivalent securities

- ❑ Diversification by economic sector – Within a given asset class, no more than __% of System assets should be in one economic sector or industry.
- ❑ Diversification by country – For the non-U.S. equity portfolio, the maximum limit in any single country shall not exceed a certain threshold (e.g., the greater of __ times the country's weighting in the appropriate benchmark or __% of the market value of the System's non-U.S. equity portfolio).
- ❑ Credit risk – Minimum quality rating for any fixed-income issue is an "investment grade" rating as determined by at least one nationally recognized credit rating agency. In the event that a credit is downgraded below this minimum, the investment manager shall immediately notify System staff and provide an evaluation and recommended course of action.

VI. Reporting / Performance Monitoring

Pension fund fiduciaries may consider the following items for inclusion in the section of the investment policy that addresses performance monitoring and reporting on investment results (or a similar section).

- ❑ Purpose – The purpose of monitoring and reporting on investment performance is for the Board to be able to (a) ensure compliance with System policy and applicable law, (b) manage the risk of the portfolio, and (c) assess the performance of money managers retained by the System.

Interim reporting by money manager. On an interim basis (e.g., quarterly) the Board of Trustees shall receive the following information:

- ❑ An outline of current strategy and investments;
- ❑ A statement of compliance with System policy for the period covered by the report signed by the portfolio manager and a principal of the firm.

Interim reporting by external investment professionals.[13] On an interim basis, the Board of Trustees shall receive the following information:

- ❑ Portfolio performance versus the assigned benchmark index and peer group;
- ❑ A summary of the largest holdings; and
- ❑ Portfolio composition relative to the asset allocation policy.

Annual reporting. In addition to the specified elements of a quarterly report, yearly reports should contain the following:

- ❑ A review of performance versus assigned benchmarks for the most recent quarter end, for one-, three-, and five-year periods ending with the most recent quarter, and for the most recent period if not a quarter end. Performance versus assigned benchmarks will be reported for the total portfolio, for each asset class, and for each money manager, net of fees.
- ❑ A summary of the portfolio's diversification and fundamental characteristics.
- ❑ An analysis of the portfolio by sector.

Appendix A

Cost Management

Pension fund fiduciaries may consider the following items for inclusion in a section or appendix of the investment policy that addresses cost management issues. Cost management is a critical component of the System's long-term investment performance. The defined benefit structure of this System provides potential economies of scale unavailable to individual investors. The following guidelines are designed to realize these potential scale economies.

Passive management. The System may allocate a portion of its total portfolio in passively managed investments.

- ❑ Pursuant to GFOA recommended practice, "Public Employee Retirement System Investments (1993, 1995 and 1997)," the system will evaluate formally and regularly the role or potential role of passive or indexed investment strategies applicable to the portfolio, and appropriate strategies to minimize the costs of transactions, portfolio management, and consultants.

Best execution standard.

- ❑ The System expects the purchase and sale of securities to be directed through brokerage firms offering the best price and best total execution cost (commission plus market impact).

Directed brokerage. The System may establish a directed brokerage program, whereby the broker(s) credits a portion of the commission directly back to the plan, either in the form of commission recapture or "soft dollars."

- ❑ If a directed brokerage program is established, the System or its designees will review credentials, procedures, and controls of brokerage firms offering commission recapture and/or soft dollar services pursuant to GFOA recommended practice, "Directed Brokerage Programs (1999)."
- ❑ All appropriate requests for proposals (RFPs) for services to the plan and its trustees will provide a comparison of soft-dollar services against hard-dollar costs if the plan were to instead direct that commissions be recaptured to the fund. Brokerage costs and arrangements will be reviewed formally on a periodic basis to assure that the net costs of transactions and services are as low as feasible.

Fee Disclosures.

- ❑ The system will periodically review plan fees and expenses, including but not limited to investment management, investment consulting, transactional, banking, and custodial.

Appendix B

Securities Lending

Pension fund fiduciaries may consider the following items for inclusion in a section or appendix of the investment policy that addresses securities lending.

Evaluation criteria. Prior to participating in a security lending program, the designated System official will evaluate:

- ❑ Indemnification provisions;
- ❑ Reinvestment guidelines and terms of the lending, including the maturity of loans as well as the securities purchased;
- ❑ Liquidity provisions and risks;
- ❑ Credit risks to be undertaken; and
- ❑ Resources required to monitor compliance with the agreement.

Collateral.

- ❑ Collateral will be set at a minimum of ___% of the daily market value of a domestic security, and __% of the market value of an international security. Securities of the System are not released until the custodian bank receives payment for the book-entry withdrawal of the loaned security.

Appendix C

Public Policy Issues Affecting the Investment Program

Pension fund fiduciaries may consider the following items for inclusion in a section or appendix of the investment policy that addresses public policy-related restrictions on the investment program.

Exclusive Benefit.

- ❑ As defined in Section II of this policy, the Board of Trustees will invest plan assets solely in the interests of plan participants and beneficiaries. This criterion applies to specific investments and to the entire investment policy established by the System.

Economically targeted investments. The System will consider economically targeted investments (e.g., investments providing collateral benefits) based solely upon the expected return and risk characteristics of an investment approach and its impact on the success of the program as a whole. Pursuant to GFOA recommended practice, "Public Employee Retirement System Investments (1993, 1995 and 1997)," such investment must meet three criteria:

- ❑ Investments designed with below-market rates of return or other concessionary terms are not acceptable because they compromise a plan's risk-return standard and conflict with trustee responsibilities. Investments must yield a rate of return commensurate with the recognized level of risk of the security;
- ❑ Investments must meet the diversification and credit standards established by the retirement system's investment policy; and
- ❑ Asset strategies should anticipate the cash needs of the system.

Socially responsible investments. The System will consider "socially responsible" investments based solely upon the expected return and risks of such an investment approach. Any investment(s) pursued under this approach must meet three criteria:

- ❑ Investments designed with below-market rates of return or other concessionary terms are not acceptable because they compromise a plan's risk-return standard and conflict with trustee responsibilities. Investments must yield a rate of return commensurate with the recognized level of risk of the security;
- ❑ Investments must meet the diversification and credit standards established by the retirement system's investment policy; and
- ❑ Asset strategies should anticipate the cash needs of the system.

Appendix D

Corporate Governance

Pension fund fiduciaries may consider the following items for inclusion in a section or appendix of the investment policy dealing with proxy voting and other issues affecting corporate governance.

Proxy Voting.

- ❑ Delegation – The Board of Trustees entrusts to its investment managers the responsibility to vote, in accordance with this guidance, proxies related to securities held by the managers in portfolios they manage on behalf of the System.
- ❑ Objective – Managers are to vote proxies in the best interests of the System's members and retirees as participants in a defined benefit pension plan and as the true shareholders of its invested assets. Managers are to vote proxies to maximize the value to shareholders of share ownership.
- ❑ Corporate boards – With respect to corporate governance, proxy votes should be *against* proposals to (a) limit/eliminate liability for violation of duty of care and (b) proposals to indemnify directors in instances of gross negligence. Proxy votes should be *for* proposals to indemnify board of directors, in which a director acted in good faith and reasonably believed action was in the best interest of the company.

Appendix E

Guidelines for Selection of External Investment Professionals

Pension fund fiduciaries may consider the following items for inclusion in a section or appendix of the investment policy that addresses selection of investment professionals.

General guidelines for external investment professionals. In order to select an external investment professional, the Board of Trustees will:

- ❑ Appoint a review committee to conduct the search process;
- ❑ Establish a competitive, merit-based procurement process for selection;
- ❑ State the expected responsibilities of the provider in writing; and
- ❑ Determine the criteria to be used by the review committee for the selection.

Considerations for structuring the selection process should include (a) the source of candidates to be considered (e.g., references from other pension systems), (b) due diligence on the candidates participating in the selection process, and (c) establishment of a formal agreement with the firm, pursuant to GFOA recommended practice, "Selection of Investment Advisers for Pension Fund Assets (2000)."

Selection criteria for investment consultants. The System will follow the general guidelines for external investment professionals hired either on full retainer or to carry out specific projects. In developing selection criteria, the review committee will consider, but is not limited to, the following criteria:

- ❑ Independence;
- ❑ Education and experience level of key personnel;
- ❑ Number of years the firm has been in business; and
- ❑ Number of clients and size of clients.

Independence refers to practices that ensure the consulting firm does not have other business relationships that could be construed as posing a conflict of interest.

Selection criteria for money managers. The System will follow the general guidelines for external investment professionals. In developing selection criteria, the review committee will consider, but is not limited to:

- ❑ Style parameters based on portfolio, including asset class and specialty focus as appropriate;
- ❑ The manager's decision-making process (e.g., whether the process is repeatable and is capable of adding value in the future);
- ❑ Manager experience with a portfolio comparable in size to the System's portfolio;
- ❑ Stability of key personnel;
- ❑ Number of years the firm has been in business;
- ❑ Dollar amount of other public pension assets under current management;
- ❑ Dollar amount of the total assets in the specific style being considered;
- ❑ Investment performance versus appropriate benchmarks; and
- ❑ Education and experience level of key personnel.

Termination of money managers. The System will develop a process for placing money managers on a "watch list" or terminating them. Termination may be necessitated by a change in asset allocation strategy, or by changes in the factors that had resulted in the selection of the money management firm.

A manager may be terminated for any reason, including the following criteria:

- ❑ Qualitative changes – personnel changes or other organizational issues of the money management firm;
- ❑ Quantitative changes – underperformance by a money manager relative to investment objectives over a full market cycle, and style deviations;
- ❑ Policy issues – violation of investment policies or legal issues; and
- ❑ Communication – failure to adhere to reporting requirements.

Appendix F

Ethics and Conflicts of Interest

Pension fund fiduciaries may consider the following items for inclusion in a section or appendix of the investment policy about ethical conduct.

Standard of conduct. Trustees and staff involved in the investment process shall refrain from personal business activity that could conflict with the proper execution and management of the investment program, or that could impair their ability to make impartial decisions.

- ❑ Trustees and investment staff shall disclose any material interests in financial institutions with which they conduct business.
- ❑ They shall further disclose any personal financial/investment positions that could be related to the performance of the investment portfolio.
- ❑ Trustees and staff shall refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the System.

Money manager oversight. In addition, the Board of Trustees or staff overseeing the money manager contract(s) should comply with the following ethical considerations:

- ❑ Adherence to all jurisdiction's and pension board's ethics laws, rules, and regulations related to procurement and involvement with contractors, including those related to political contributions;
- ❑ Disclosure to pension board of any inherent or potential conflicts of interest in dealing with specific investment advisers prior to taking any official action; and
- ❑ Adherence to the GFOA Code of Professional Ethics.

Appendix G

Alternative Investments

Pension fund fiduciaries may consider the following items for inclusion in a section/appendix of the investment policy addressing alternative investments (or similar section).

Definition. Alternative investments can be defined as investments that are generally not included in the traditional investment classes of stocks, bonds, and cash. There are two major types: those that are alternatives because of *how* they are traded or not traded (based on investment methods), and those that are alternatives because of *what* is traded (those where the assets are nontraditional).

Criteria. The Board of Trustees may elect to include alternative investments as part of the System's asset allocation strategy. In making this determination, it should consider the following factors, pursuant to the GFOA recommended practice, "Alternative Investments Policy for Public Employee Retirement Systems (PERS) (2000)":

- ❑ Additional policies and objectives that address the unique return and risk characteristics of alternatives, and limits in the strategic plan;
- ❑ Articulation of the investment's economic rationale and the overall importance of the specific investment in the marketplace as well as in the portfolio;
- ❑ The System's organizational resources in terms of staffing, culture and managerial discipline, and its ability to measure and monitor performance, risks, and costs;
- ❑ Expanded due diligence efforts by plan trustees, staff, and external providers;
- ❑ Development of appropriate benchmarks for comparison of returns and risk, and review of investment performance through industry cyclical downturns or bear markets;
- ❑ Review of the plan's liquidity needs with the actuary to determine if the investment cash flows are adequate, because many alternatives provide little or no cash flows prior to maturity;
- ❑ Selection of a manager or general partner whose experience and ability enables him or her to carry out the task of measuring and comparing returns on investments, this selection being as important as the returns themselves;
- ❑ Construction of alternative portfolios over time, with staggered start dates and/or investment periods to smooth the maturity, returns, and cash flows to further mitigate the risks.

Appendix H

Common Investment Instruments

Pension fund fiduciaries may consider the following items for inclusion in a section/appendix of the investment policy (or similar section) defining the types of securities utilized by the pension system.

Listed below are examples of investment vehicles commonly used by pension systems.

- ❑ Stocks
  - ➢ All equity investments publicly traded on an established exchange (including NASDAQ)
  - ➢ Common stock
  - ➢ Preferred stock
  - ➢ Convertible stocks and convertible bonds
  - ➢ Warrants
  - ➢ American Depository Receipts (ADRs)
  - ➢ Real Estate Investment Trusts (REITs)
  - ➢ Hedge funds
  - ➢ Country funds
- ❑ Bonds and Cash-equivalents
  - ➢ Obligations issued or guaranteed by the U.S. government, federal agencies, and government-sponsored corporations.
  - ➢ Obligations of domestic or foreign commercial banks and bank holding companies, including commercial paper, bankers acceptances, certificates of deposit, time deposits, notes, and bonds.
  - ➢ Obligations of domestic or foreign corporations, including commercial paper, notes, bonds, and debentures.
  - ➢ Repurchase agreements with major banks otherwise eligible for investment and “primary” government securities firms, fully secured by U.S. government or federal agency collateral.
  - ➢ Obligations collateralized by mortgages and receivable subject to overall quality ratings.
  - ➢ First tier money market funds as defined under SEC Rule 2a-7.
- ❑ Other asset classes – Permitted investments in alternative investments are defined in Appendix G.

Section 4
About the Electronic Documents

The enclosed CD-ROM contains four documents: the GFOA Investment Policy Checklist, as well as investment policies issued by the Missouri State Employees Retirement System (MOSERS), Kansas Public Employees Retirement System, and Sacramento Regional Transit District. The three policies all contain many of the attributes identified in the investment policy checklist (Section 3) and were scored highly in a GFOA study of investment policies (discussed in Section 2) in terms of exhibiting breadth and depth of coverage of investment policy issues.

Exhibit 7
MAJOR COMPONENTS OF INVESTMENT POLICIES

Categories	MOSERS	KPERS	Sacramento
Statement of purpose	Section I, II, V	Section 3, 5	Section I, VII
Roles and responsibilities	IV	4	Section II, VI, X, XI
Standard of care	II	1, 14	Section VIII
Asset allocation	V, VI	5	III
Rebalancing	Appendix I	5	IV
Investment guidelines	VII	6, 7, 8	VII, VIII; Appendix A-1, A-2, A-3, A-4
Reporting and monitoring	IX, X	8, 15	X, XI, XII
Corporate governance	IX; Appendix IV	12	IX

Notes

1. Association of Public Pension Fund Auditors, *Public Pension Systems: Statements of Key Risks and Common Practices to Address Those Risks* (Albany, New York: Association of Public Pension Fund Auditors, 2000), p. 11. The report has been endorsed by the Government Finance Officers Association and other associations representing the interests of public pension systems.
2. The asset allocation statement is often referred to as a *policy* asset allocation to distinguish it from the actual asset allocation, which fluctuates according to the market.
3. *Public Pension Systems: Statements of Key Risks,* p. 18.
4. Nicholas Greifer, "Pension Investment Policies: An Evaluation of the State of the Art," *Government Finance Review* (February 2002).
5. Gary Brinson et al., "Determinants of Portfolio Performance," *Financial Analyst Journal* (July/August 1986) and Gary Brinson et al., "Determinants of Portfolio Performance II," *Financial Analyst Journal* (May/June 1991).
6. Asset allocation is a smaller factor in explaining the return differences between funds. For research in this area see "The True Impact of Asset Allocation on Returns" by Roger G. Ibbotson, Ibbotson Associates. The article interprets research on the subject, including the Brinson et al. articles cited in the preceding note. See also Jeffrey Diermeier, "Economic Inputs and their Effect on Asset Allocation Decisions," *Applying Economic Analysis to Portfolio Management* (1985).
7. Specific objectives for sub-asset classes and individual money managers are set forth in other System documents.
8. There are variety of risks related to the pension investment program, including such risk measures as portfolio volatility (standard deviation), negative absolute return, negative relative return (relative to a benchmark), asset shortfall relative to liabilities, and actuarial surplus volatility. The fundamental risk is the failure to make pension benefit payments. For additional information, GFOA recommends review of the Association of Public Pension Fund Auditor's *Public Pension Systems: Statements of Key Investment Risk and Common Practices to Address those Risks*.
9. Prudent person or prudent expert. State or local laws may define these terms. In general, under the prudent *person* standard, investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived. Under the prudent *expert* standard, investment shall be made with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

10. Under a proportional threshold, the “collars” (the spread between the minimum and maximum thresholds) would be smaller for smaller asset classes.
11. This list of prohibited investments needs to be tailored to the individual pension system.
12. Fixed income securities issued by the U.S. Department of Treasury should be exempted from this diversification requirement.
13. Among some pension systems, this function is performed internally.