

Investment policy gap ups risk, cuts return

One-third of mid-size firms have no policy for short-term investments; those that do don't even look at them

By Megan Johnston

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Under the Employee Retirement Income Security Act of 1974 (ERISA), the Labor Department mandates that companies must set up an investment policy statement for their employee retirement plans. But for a company's own investments—even those as safe or liquid as cash—CFOs should consider setting up a policy statement as well.

According to a study by consultancy Treasury Strategies, 33% of middle-market companies do not have an investment policy statement for short-term investments. Moreover, for all companies that do have such policy statements, 20% haven't reviewed them in more than three years.

That could pose a problem, according to Jeff Avers, Treasury Strategies' managing director, because CFOs who neglect to review policies, even for short-term investments, may be missing investment opportunities and incurring undue risk.

In general terms, an investment policy statement is a written document that serves as a blueprint for the building of an investment portfolio and becomes a business plan for the ongoing management of investments, according to Robert Rowe, president of Rowe Decision Analytics, a consultancy that designs investment policy statements for companies, endowments, foundations and high-net-worth individual investors.

Mr. Rowe, who has been preparing such policy statements for 20 years, founded his firm because of a lack of consensus on policies in the marketplace. "There's not a real standard, and so much of it is interpretation," he said. Today he offers 42 types of investment policy statements.

For corporate cash management, the policy statement should include components like the purpose and objective of the portfolio, including the minimum return required on the portfolio in relation to its investment benchmark, and the types of risk that the portfolio can stomach, including duration and liquidity. Other components include a list of acceptable and prohibited instruments, the minimum credit rating and maximum maturity of investment vehicles, and target benchmarks.

The Treasury Strategies study found that companies that compare their investment performance against external benchmarks tend to have a higher average annualized yield on investments with maturities longer than 180 days. For example, for investments with maturities of one to two years, companies that used benchmarks had an average annualized yield of 3.7%. Companies that did not benchmark had an average annualized yield of 3.37%. The dominant benchmarks include Libor, the Federal funds rate and Treasury securities.

Firms should also set separate objectives for their core and non-core liquidity policies. A non-core liquidity policy would include those securities with maturities of up to a year, like money-market mutual funds and commercial paper. A core liquidity policy would include investments with longer maturities, like corporate notes and bonds, and asset-backed securities.

There are other types of policy statements that CFOs should consider, said Mr. Rowe. For example, many CFOs

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today are overseeing endowments in foundations. Those sorts of investments aren't covered under ERISA, but similar requirements are expected under the Uniform Management of Institutional Funds Act, he said. In addition, there are various umbrella investment policies for 401(k) plans. For example, a company employee who is also an investment professional may decide to forgo the company's available 401(k) fund options in order to set up his own portfolio of stocks and bonds. The investment policy statement could absolve the plan sponsor of the fiduciary responsibility for that individual's investment decisions.

And Mr. Rowe said such statements are important given today's investment climate.

"As the euphoria in the equity market rises, investment discipline pretty much goes right out the window," he said. "And when the markets adjust, as they always do, the lesson will be learned again." FW

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