Dear Friends:

The construction, adoption and implementation of a workable and effective investment policy and/or investment policy statement for any organization can be a rather daunting and difficult task. However, like any attempt to eat an elephant, the best approach may be to break the project into "bite-size" pieces. Following, for your consideration and use, are a number of items to be considered in the process.

1. *Recognize that there is a certain tension between withdrawals to support the ongoing purpose of the organization, the expectation of funding requirements for capital-type purchases or non-routine projects, and the ever-present desire to simply grow the portfolio to support the organization in the future.*

Prospective approaches to assist the *ongoing spending needs* of the organization include:

- A policy of withdrawing a certain (sometimes inflation adjusted) dollar amount each year (or relevant period).
- A policy of withdrawing a certain percentage of the portfolio each year or period based on the period ending balance.
- A policy of withdrawing a certain percentage of the portfolio each year or period based on a calculation that includes the percentage withdrawal and some rolling average of several prior period ending balances (e.g. 5% of a rolling average of the prior 3 year-end balances).
- A policy of adding to the "corpus" of the portfolio each period at a pre-determined percentage rate and/or an inflation index, and if the portfolio's actual returns exceed the required corpus addition, making that excess available for withdrawal.
- A policy that combines elements of any or all of the above.

Prospective approaches and issues involved with *funding capital-type expenditures and non-routine expenditures* include:

- Specific identification and accounting for special or restricted gifts designated to fund certain capital or non-routine expenditures.
- Recognition of these planned expenditures in the total portfolio and/or specific accounts or investment vehicles consistent with the plans for the expenditures.

Prospective approaches and issues involved with the *desire to grow the portfolio over time* include:

- Recognizing that there is a relationship between risk and return in a portfolio and that the risk element can be managed and best tolerated by –
    - Intentionally funding cash needs through short-term low volatility holdings and bond and/or cd maturities scheduled to coincide with the expected cash needs.

5100 Poplar Avenue · Clark Tower 30th Floor · Memphis, TN 38137 · Phone (901) 681-0021 · Fax (901) 842-2824
www.tdcapitalmanagement.com

This funding should be done based on a minimum prospective time horizon of five years. In other words, funding all known or expected cash needs for a rolling forward five-year period. This approach will require periodic efforts to keep the five-year time horizon current and to adjust for changing cash need expectations.

- After funding the known or expected needs, maintaining the remaining or residual portfolio in a diversified manner to "diversify away" much of the systematic risk – leaving the predominant risk exposures as misidentified or unidentified cash needs resulting in shorter than expected holding periods, and market risk which cannot be diversified away, but is mitigated by the diversification and fairly long-term holding period.

2. *Consider selection of investment consultants or portfolio managers as an integral component of the investment policy or statement. Significant criteria for consideration in the consultant or manager selection process include:*

- Can the organization develop a comfort that the deployment of the managers' investment methodology will be consistent with the letter and spirit of the investment policy or statement?
- What are the preferred investment vehicles involved in the consultant or managers' investment methodology? – e.g. individual equities, mutual funds (active or passive management), individual bonds, certificates of deposit, exchange-traded funds, and so on.
- Are there conflict of interest issues that need to be addressed in the manager selection process?
- Are there legal or compliance related issues that need to be addressed in the manager selection process?
- Who will be the "custodian" of the organizations investment holdings?
- Consideration of fees and costs. There are a number of fees and costs that may be involved in the management of a portfolio. These fees include – commissions for equity trades; loads paid for mutual fund purchases; exposure to "back-end" loads if it is necessary or desirable to sell a fund before a designated deferral period; internal mutual fund fees or expenses; brokerage soft-dollar arrangements; solicitor or "finder's" fees; costs involved with transferring assets; direct, contractual fees to be paid to the manager or consultant; "mark-ups" on bonds and other security purchases; "wrap" or similar fees. Note - it is often advisable to receive a written analysis of all fees that are expected to be incurred in the relationship with the manager or consultant.
- There should be some consideration of the amount and frequency of analysis in the methodology to be employed by any prospective manager or consultant. How often will the portfolio be analyzed? What will be the extent of that analysis? If the results of the analyses suggest changes to the portfolio, how will those changes be implemented? How frequently and in what fashion will there be communication between the manager and the organization? What contingency plans are in place within the managers' organization? At what level within the managers' organization will service be provided to the portfolio? What are the experience and qualifications of the service providers?

3. *Other issues to be considered in the investment policy or statement process include:*

- Are there absolute or target minimum or maximum asset class allocations or percentages that the organization would like imposed on the portfolio?
- Are there certain securities or categories that the organization would like included or excluded from the portfolio? – e.g. minimum bond ratings, exclusion of certain categories of equities, or inclusion of "socially responsible" security selection.
- If the organization is subject to taxation – consideration of tax-efficiency and tax effects in the portfolio process.
- Are there asset classes, security types, or trading methodologies to be encouraged or discouraged? – e.g. precious metals, venture capital, short sales, private placements, leveraged transactions, commodities transactions, puts, calls, straddles, other options strategies, real estate, etc.

The thoughts above are merely designed to provide a framework for discussion and consideration. There are likely other issues that will need to be addressed prior to the final construction and implementation of an appropriate investment policy. Many of the additional considerations should become part of the dialog as the issues and points above are addressed. Others will be unique to the situation and organization of question.

We hope these thoughts are useful in your particular organizations plans and deliberations.

Sincerely,

Doug

Douglas Smith, CPA/PFS
Member, Chief Investment Officer

5100 Poplar Avenue · Clark Tower 30th Floor · Memphis, TN 38137 · Phone (901) 681-0021 · Fax (901) 842-2824
www.tdcapitalmanagement.com
a Registered Investment Advisor