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Personal investment policy is vital to strategy

A critical, yet often overlooked, component of a successful investment strategy for the individual investor is a personal investment policy.

Most large institutional investors, such as retirement plans, endowment funds and foundations operate under a formal, written investment policy. Many portfolio managers, stockbrokers, etc. establish general investment policies for individual clientele, but often only in the broadest of terms to comply with industry or regulatory expectations.

However, a detailed investment policy can be one of your most effective tools in managing portfolio risk, performance, and results.

What exactly is a personal investment policy?

Simply put, it outlines all the functional parameters of your investment portfolio. It serves as your guideline to successfully implementing and monitoring the investment strategy you've developed. It is not a financial plan as much as it is the result of proper financial planning.

A common ingredient of a basic investment policy is the desired ratio of equities and fixed income investments for your portfolio. For example, a policy for a balanced portfolio may define a target ratio of 50 percent stocks and 50 percent bonds.

A variation of this approach may use a range to define the ratio of equities to fixed income securities desired. For instance, a policy may state your overall exposure to stocks will be no more than 60 percent at any given time and no less than 40 percent. These limits prevent portfolio valuations from drifting beyond your predetermined level of comfort.

However, an effective investment policy needs to outline much more than your overall allocation among stocks and bonds. General areas such as risk tolerance, volatility constraints, time horizon, cash needs, tax considerations, and return expectations should be detailed.

When do you plan on spending what portion of your portfolio's assets? Do you view preservation of existing principal as your highest priority? Does this portfolio constitute the majority of your net worth?

The policy can further define your portfolio's exposure to various asset classes or management styles. Your circumstances may dictate that it is desirable to limit your bond portfolio's average maturity to less than 10 years with ratings no less than "BBB".

Or, your portfolio's exposure to a particular industry should not exceed 1.5 times that industry's weighting in the Standard & Poor's 500 Index.

Or, you desire no more than 20 percent of your portfolio invested in small cap growth stocks at any particular time.

All such parameters should be included in your personal investment policy.

How can a personal investment policy work for you?

I challenge my clients to continually ask the question, "Compared to what?"

"Am I getting good performance?" Compared to what? "Am I taking too much risk?" Compared to what? A personal investment policy provides your portfolio with a standard for comparison.

When used properly, your investment policy can help you limit risk, add discipline, and benchmark true performance. Your basic investment policy decisions should be based on your specific needs, circumstances, and expectations.

These decisions should not be based on current conditions in the investment markets. In fact, one of the main benefits of a personal investment policy is to helping you maintain an arms-length, objective perspective versus current market conditions, whether those conditions be good or bad.

As an example, suppose when establishing your personal investment policy you determine that a diversified portfolio with moderate risk and averaging a 10 percent annual return will assure your future needs are met and you then structure portfolio holdings accordingly. When a market frenzy inflates the valuation of Internet stocks to obscene levels or the bottom falls out of the Asian market, your predetermined investment policy will prevent you from either betting the farm or running for cover in a panic.

Absent those extremes, your investment policy is the tool that assures your planning and portfolio remains in sync. Any overexposure or underexposure to a particular asset type, industry sector or mutual fund becomes apparent when your policy serves as a point of reference and portfolio adjustments can be made accordingly.

Your portfolio's true performance can only be appropriately judged when comparative benchmarks are used that accurately reflect the parameters of your investment policy.

In essence, your investment policy provides a working framework that assures long term decisions and objectives won't be compromised by short term issues and events.

Contrary to the illusion presented by the nightly parade of "experts" on the media, investing is an inexact science at best. The number of possible variables, and combinations thereof, that can potentially impact the economy, the investment markets, and ultimately your portfolio are endless.

Defining, measuring, and controlling what you can is essential to meeting your investment goals and a personalized investment policy is one of your best tools for remaining focused and on track.

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