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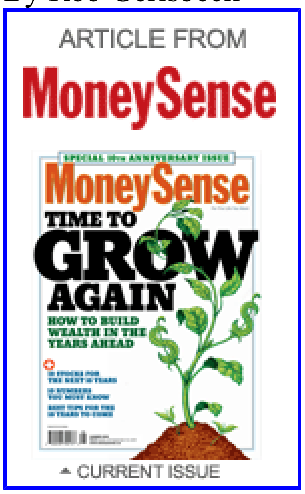
Investing

Investing sober

Ensure your portfolio gets home safely no matter what.

By Rob Gerlsbeck



If you were building a new home, you would hope that your architect would put the plans down on paper before construction started. Otherwise, you might end up with two bedrooms instead of three. Or no bathroom. Or a construction bill that's twice what you expected.

Oddly enough, though, most of us build our investment portfolio without any plan on paper. Stephen Horan, head of private wealth for CFA Institute, a global association of investment professionals, says the typical investor throws money into the market and hopes there will be a big pile waiting when he or she needs it. In other words, we build a house without blueprints.

There is a better way. It's called an Investment Policy Statement. Most advisers to wealthy clients put one together as a matter of course. But you don't need a Porsche in your driveway to benefit from an IPS. The biggest benefit of an IPS is that it forces your adviser to talk—to really talk—to you. "Up until that point he might not even know how many kids you have," says Horan.

An IPS should run between four and 15 pages. It should lay out everything about your financial strategy. When I say everything, I mean everything: how much money you can stand to lose in a market downturn, your long-term objectives, your investment philosophy, your tax and estate situations, how you want your money split between stocks and bonds, how much you'll need to put aside each month to meet your goals.

Don't confuse an IPS with one of those flimsy questionnaires the bank hands you before selling you a mutual fund. An IPS is far more detailed. It might stipulate, for instance, that you want to hold only investment-grade bonds or blue-chip stocks. It could note that you have a moral objection to investing in cigarette companies. It may outline your need to set aside extra money to provide care for an autistic child or to pay for the weddings of your three toddlers a couple of decades from now. An IPS should be so detailed and specific that it would allow someone who has never met you to invest your money exactly as you would like.Drawing up an IPS forces you and your adviser to crunch numbers and think through what you need to make your dreams a reality. And that can prevent you from taking foolish gambles with your money. If you discover that a 5% return on your investments is sufficient for you to enjoy a great retirement, an IPS stops you from taking unnecessary flyers on junior mining shares and Ecuadorian bonds.

Once your IPS is written, it provides a steady point of reference. You and your adviser should go over it once a year to see if you're on track. Just like visiting a house under construction, you'll be able to see how well your financial goals are coming together—or not.

An IPS is particularly valuable in a crisis, when it can act like a loyal friend, reminding you of your long-term goals, says Tom McCullough, president of Northwood Family Office, a Toronto-based adviser to wealthy clients. McCullough says every financial adviser has seen clients who react to a crash by demanding that their adviser pull their money out of the market. McCullough's response to such clients: sure, but first you have to rewrite your IPS to reflect your new investing philosophy. The curious thing, he says, is once people re-read their documents,they nearly always decide to stick to their original plan. "They realize their investment strategy is quite sound in the first place."

McCullough calls this investing sober versus investing drunk. When there's a crash (or bubble for that matter), we make rash decisions, as if we were drunk. An IPS, however, is written during a moment of sobriety. And sober decisions are usually better than sloshed ones.

Don't be surprised if your adviser is reluctant to write an IPS. It can take a day or more to put one together. Some advisers simply won't think it's worth their time if your investments are less than $100,000. If so, you have several options. The first is to write one yourself. Start by downloading this worksheet. If you still need help, consider hiring a fee-only planner. Such planners charge by the hour. Since they're not earning money selling you products, they can concentrate on giving you good advice. The other option: fire your adviser and find one who's less judgemental of the size of your piggy bank. Just make sure he knows a little something about architecture.