INVESTMENT POLICY STATEMENT
SAMPLE

CREATING YOUR PERSONAL INVESTMENT POLICY

A keystone of our holistic wealth management process is the personal Investment Policy Statement (IPS). A tool used by billion-dollar institutional fund managers, an IPS is a vital component to our mission of helping you plan, build, and preserve your wealth.

WHAT IS AN INVESTMENT POLICY STATEMENT?

An Investment Policy Statement documents your specific, long-term portfolio goals and parameters. These include your risk tolerance, return goals, investment timeline, tax picture, investment constraints, and other personal considerations.

We create your IPS in conjunction with your personal Financial Plan. In doing so, we match your portfolio return goals to the income you need now and in the future, as projected by your Financial Plan. This helps us carry an appropriate amount of investment risk that matches your real-life income needs.

To ensure your IPS remains a working document, we update it annually and/or any time there is a major change in your life.

HOW AN INVESMENT POLICY STATEMENT CAN HELP YOU

Once established, your IPS helps ensure we're both on the same page, and it serves as a roadmap for ongoing investment decisions about your portfolio. We buy or sell investments from your accounts based upon your IPS. For example, before making an investment change, we take into account the effect on your taxes.

Investing with your IPS helps us:

- Achieve your target return with the least possible risk
- Ensure your investment taxes are minimized
- Avoid overexposing you to stocks and/or asset classes you already own, such as employer stock
- Personalize investments or asset classes you wish not to be invested in

Developing a thorough, personalized Investment Policy Statement is a critical first step in long-term financial planning, and it will help us maintain our long-term focus during short-term market movements or life changes. As markets swing, your documented goals will keep us both focused on the end game.

Kelly Crane, CFP®, CLU, CFA, MBA
President and Chief Investment Officer
Napa Valley Wealth Management

Napa Valley Wealth Management was one of the first independent investment advisory firms to bring billion-dollar, institutional money-management techniques to individual investors.

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INVESTMENT POLICY STATEMENT

Congratulations on developing a very thorough, personalized Investment Policy Statement for you and your family. This is a critical first step in long-term financial planning, and it will help us maintain our long-term focus during short-term market movements or life changes. This page is an overview of the objectives you have established during this process. The following pages explain each section in further detail.

STATEMENT OF YOUR FINANCIAL OBJECTIVES

Our goal is to establish a managed portfolio that achieves real growth, after inflation, with a level of risk that is appropriate for your return. Following are the objectives for your portfolio:

- To earn a reasonable return net of inflation while minimizing exposure to the stock market fluctuations.
- To generate a significant amount of portfolio income.

Based upon our conversations and the information you provided, and given the long-term nature of your objectives, following is an overview of your investment policy.

		SEE PAGE
PORTFOLIO DESCRIPTION	Together, we selected Sample Portfolio B/Balanced Income as the most appropriate investment portfolio for you now.	6
PORTFOLIO RATE OF RETURN	This portfolio recommendation is designed to generate an average, expected rate of return of 2.5-3.5% above inflation, net of fees and costs. Based on current projections, this equates to a current nominal return of 5.5-6.5%.	6
YOUR CASH REQUIREMENTS	Currently you are not taking a monthly distribution.	2
INVESTMENT PERIOD	Your investment period is over 10+ years.	2
YOUR RISK TOLERANCE	Your risk tolerance is a maximum, aggregate loss of 5% over a one-year time frame.	3
PORTFOLIO TAX STRATEGIES	Your portfolio is to be managed as a taxable & tax deferred account, and your combined federal and state tax bracket is to be the marginal tax bracket of 32%.	3

NAME SIGNATURE DATE

NAME SIGNATURE DATE

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WHY ESTABLISH AN INVESTMENT POLICY STATEMENT?

The principal reason for explicitly articulating and writing a long-term investment policy is to enable you and your Financial Advisor to protect the portfolio from emotional and arbitrary revisions of sound long-term policy. This written investment policy statement will help maintain our long-term focus when short-term market movements may be distressing and the policy guidelines are being sorely tested.

The very process of creating an investment policy statement embodies the essence of financial planning: assessing your current financial situation, setting goals, developing a strategy to meet the goals, implementing the strategy and regularly reviewing the results.

By linking your goals to the investment strategy necessary to achieve them, you create useful investment guidelines and reasonable expectations of portfolio performance. Although your Financial Advisor can help you in this process, you must shoulder the responsibility of determining your overall investment policy. Your Financial Advisor can capably and efficiently handle implementation, ongoing management and general portfolio operations.

YOUR CASH REQUIREMENTS

Currently you are not taking a monthly distribution. The cash needed to generate this distribution may be taken from income or from capital, as we will be pursuing a total return objective for the portfolio. In order to preserve the integrity of the investment portfolio, the distribution may also, for non-retirement accounts, be made through a margin loan. In this case, you would be temporarily borrowing against the assets of the account and incurring the “broker call rate” of interest (as more completely described in the brokerage account application).

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INVESTMENT PERIOD

The expected, minimum investment period for any securities portfolio containing equities is five years. Otherwise, the portfolio’s assets should be invested primarily in fixed-income securities. You should view all variable return investments, including stocks, as long term. Keep in mind, by lengthening the investment period, the investment portfolio volatility is greatly reduced.

We established your investment period is over 10+ years (long term), to coincide with your lifetime. Should you require the funds in the portfolio *prior* to this time, please recognize that you would likely be exposed to a higher loss at the time of early withdrawal.

TAX STRATEGIES FOR YOUR PORTFOLIO

Our investment strategy and recommended investments depend in part on whether or not the managed portfolio is subject to current tax. Profit-sharing plans, IRA Rollovers, and other "qualified" portfolios enjoy a "tax-free" environment: So long as the assets remain *inside* the tax-deferred vehicle, we need not concern ourselves with the recognition of income or capital gains in the portfolio. You are only taxed at the time of distribution from the account.

A taxable portfolio, however, must be managed with tax consequences firmly in mind. We are committed to helping you realize the best *after-tax* rate of return possible, which means that the investment strategy, selection of investments, and the timing and selection of sales must take into account the tax consequences to your overall situation. **Together, we decided your portfolio is to be managed as a taxable & tax deferred account. Your combined federal and state tax bracket is to be the marginal tax bracket of 32%.**

YOUR RISK TOLERANCE

We asked you to identify the risk level that would cause you serious discomfort or concern. "Risk," in this context, is defined in terms of the maximum annual loss you could absorb without abandoning your investment program (as defined by this investment policy statement). Nothing is certain, so we are forced to analyze the *probability* of a loss exceeding your maximum. Though we are not 100% certain, we can reasonably assert a 90% confidence level (based on our best assumptions) that your portfolio will not generate a loss in excess of your maximum.

Your risk tolerance is a maximum aggregate loss of 5% over a one-year time frame.

OUR INVESTMENT METHODOLOGY: ASSET ALLOCATION

Napa Valley Wealth Management (NVWM) is one of the first independent investment advisors to bring billion-dollar, institutional money management techniques to individual investors and smaller pension plans.

Your portfolio will be managed with a primary focus on asset allocation, using Modern Portfolio Theory principles (see the last few pages of this IPS for more information). Simply stated, asset allocation is the process of selecting a mix of asset classes and efficiently allocating capital to those assets by matching rates of return to a specific and quantifiable risk tolerance.

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The tools used in asset allocation have become a very useful means for advisors to express *quantitatively* their views regarding risk and their relationship to investment return. It focuses attention on the overall composition of the portfolio rather than the traditional method of analyzing and evaluating the individual components, such as specific stock selection. A consequence of this focus is that individual investment positions within your portfolio may exhibit considerable volatility and relative risk. Taken out of context, such individual positions may appear to be excessively risky to your personal situation and risk tolerance; however, Modern Portfolio Theory is based on the benefits of including such investments in an attempt to maintain or increase returns, while the diversification benefits keep the risk of the overall portfolio in the desired range.

Index funds are used in those markets in which we believe active management cannot add value—markets that appear to be truly efficient and the costs associated with active management do not appear justified. In certain situations, however, we may utilize active managers or closed-end funds to exploit those segments of the market that appear to exhibit some inefficiency.

Successful investing requires the development of long-term plans arrived at objectively and dispassionately. Too often, investment decisions are based upon isolated, short-term considerations (in the heat of the moment), without regard to the portfolio as a whole or the interrelationships of the assets used. Since 90+% of future portfolio performance results are determined by the *asset allocation* policies, it should be at the asset allocation and investment policy level that the Financial Advisor and client spend the majority of their time.

PERFORMANCE EXPECTATIONS

The portfolio will be managed to minimize principal fluctuations, consistent with the stated return objectives. Using the precepts of Modern Portfolio Theory, as described in this statement, we attempt to generate the desired rate of return at the minimum level of risk.

The attached Statement of Policies and Objectives provides our best estimates of the portfolio's future performance. This information is based on historical returns for these asset classes and an educated estimate of their future performance. Specifically, we compute and identify a range of possible returns for the entire portfolio over one, two, three, four and five years. You should note in particular the downside estimates, or the returns at the lowest part of the range. At the "90% certainty level," your returns should not fall below these estimates; they are, however, only estimates—reflections of our best, educated assumptions.

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Of course, no guarantee can be given about future performance and this policy statement shall not be construed as offering such a guarantee. For illustrative purposes only, we show the historical performance of your recommended portfolio. Historical performance is not a guarantee, nor is it necessarily an indication, of the results you will experience in the future. Finally, you should recognize that investments in actively managed mutual funds are used to represent asset class allocations, and as a result, actual returns may be higher or lower than those presented in the attached Statement of Policies and Objectives.

HOW WE IMPLEMENT YOUR INVESTMENTS

Each investor typically establishes his or her own individual account at Schwab/brokerage. Many clients have several accounts (e.g., a joint tenancy account, a trust account, several IRA accounts, etc.). After you have approved and accepted your portfolio, we implement the investment plan and effect the transactions in your accounts. In doing so, we attempt to arrange your investments among multiple accounts to take advantage of any tax-sheltered accounts being used (such as Rollover IRAs or profit-sharing plans).

You should also note that NVWM passes along our reduced transaction costs to our clients. Commissions in excess of 3.0% are applied to offset fees on a current invoice.

No-load and closed-end mutual funds are the primary investment vehicles used in your portfolio. After each transaction, a confirmation is mailed to you from Schwab/brokerage detailing the trade date, price per share and other important information. You receive monthly account reports from Schwab/brokerage and quarterly performance reports from NVWM. The quarterly report provides important performance information over the last quarter and for trailing periods. Schwab/brokerage highlights the transactions in your accounts, while NVWM gives you a quarterly picture of "how you're doing." Additionally, year-end tax reporting is provided to the investor by Schwab/brokerage and, in some cases, NVWM.

YOUR ACCOUNT REVIEW

Each quarter your portfolio is reviewed to ensure compliance with the Statement of Policies and Objectives, and to confirm the best available investment vehicles are being used to achieve your objectives. If this review determines the portfolio exceeds your risk tolerance or does not meet your return requirements, transactions are implemented in accordance with this Investment Policy Statement. The asset constraints section of the Statement of Policies and Objectives provides the guidelines we need to ensure that these transactions are in compliance with your investment goals.

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YOUR PORTFOLIO DESCRIPTION

Based upon our conversations, and the information you have provided, and your stated objectives, we have selected Sample Portfolio B as the most appropriate investment portfolio for you now.

Sample Portfolio B's investment strategy is designed for _balanced income_. It is particularly well suited for investors who seek higher returns than a capital preservation portfolio, but are uncomfortable with stock market volatility. More than half of the portfolio is invested in fixed-income securities, e.g., government bonds and money market funds. Its volatility is about 50% of the S&P 500 and its expected return is 2.5-3.5% over inflation. Income-producing assets lessen capital loss over all but short time periods, but at the certain cost of a reduction in long-term returns.

OTHER PORTFOLIO DESCRIPTIONS

Sample Portfolio A's investment strategy is designed for _capital preservation_. Its focus is minimizing capital losses while earning a total return in excess of certificates of deposit. Investors who may need access to their funds in the near-term (one to three years) may also find this portfolio to be appropriate. Almost two-thirds of the portfolio is invested in short-term debt obligations, including government-backed bonds and short-term, high quality corporate bonds. The volatility of the portfolio is approximately 25% of the volatility of the stock market (as measured by the standard deviation of the S&P 500 index), with an expected long-term return of 1-2% over inflation. This portfolio limits volatility, but at the certain cost of a significant reduction in long-term returns.

Sample Portfolio C's investment strategy is designed for _balanced growth_. It strikes a balance between stocks and bonds, using income to reduce risk while still seeking capital appreciation from stock investments. This portfolio is appropriate for most long-term investors who cannot tolerate significant losses in a single year. At least two-thirds of the portfolio is invested in common stocks. Its volatility is 75% of the S&P 500 and should provide an expected return of 3.5-4.5% over inflation. In unfavorable markets this portfolio can show losses over one- to three-year periods; however, cumulative negative total returns are unlikely over longer periods of four to five years.

Sample Portfolio D's investment strategy is designed for _growth_. It is for investors who are comfortable with stock market risk and who seek higher returns than the S&P 500. These investors recognize that in order to build wealth over time they must invest in assets that potentially can, in unfavorable markets, show a capital loss over significant time periods—two to five years. The portfolio is almost completely invested in common stocks

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and has a risk factor approximately equal to that of the S&P 500. On a long-term basis, this portfolio should exceed the return of the S&P 500 by 1-2%, with an expected return of 4.5-7% over inflation.

No guarantee can be made that these investment objectives can be met or that your investment will not have incurred a loss at the time of withdrawal.

A LITTLE BACKGROUND ON MODERN PORTFOLIO THEORY

Modern Portfolio Theory is, at its essence, a mathematical means of selecting a mix of asset classes and allocating capital among those assets efficiently, based on quantifiable risk tolerance and return objectives. Risk tolerance is essentially the level of risk an investor is willing to accept in order to achieve a specific rate of return over time. It is no longer a one-dimensional process of selecting the right stock, bond or property to place in portfolios heavily weighted by equities, fixed income or real estate. The scientific community has established that the efficient allocation of capital to specific asset classes will be far more important than the process of selecting the "right" components of that asset class.

The process of capital asset allocation originated in the mid-1950s with work done by Professor Harry M. Markowitz and the University of Chicago in a body of work now referred to as Modern Portfolio Theory. More recently Professor William Sharpe has expanded this field at Stanford University using his capital asset pricing models or "efficient frontier" analysis, as has Professor George Chou at the University of Portland using computer models. The premise for all of this work is that for any level of risk that one is willing to accept, there is a rate of return that should be achieved. Any return that is less than the maximum that should be achieved, implies that the portfolio is inefficient and should be modified accordingly.

Modern Portfolio Theory and asset allocation methods have as their foundation four basic premises:

1. *Investors are inherently risk-averse.* Investors should be unwilling to accept risk except where the level of returns generated will fairly compensate for that risk. In our experience, more investors call for reassurance when investments *go down in value* than when the market is going up. In other words, volatility doesn't bother them—only volatility involving a loss! Therefore, it is reasonable to assume that investors are more concerned with the risk of losing their capital than they are with returns on their capital.

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2. *Markets are essentially efficient.* Most academic and industry research supports the idea that markets, at least in the broadest sense, are efficient. The nature of an efficient market is such that all participants have the same information regarding the market in general and specific issues in particular, at the same time. Often, however, they come to opposite conclusions as to the appropriate price of individual securities.

3. *Shifting focus from individual securities analysis to consideration of portfolios as a whole, predicated on explicit risk-reward parameters and on the identification and quantification of portfolio objectives.* Along with other academic work, a study by Merrill Lynch in 1979 showed that in a typical diversified investment portfolio, diversification eliminates so much of the "specific risk" (the risk that a specific company's stock will decline in value) that roughly 90% of all the risk in the portfolio is reduced to "market" risk (the irreducible risk of being "in the market") and only 5-10% is specific risk. In another study, three leading financial analysts found that, on average, nearly 94% of the variability of a portfolio's return can be explained by the asset allocation policy followed—not the manager's timing or security selection.

4. *Creating an "optimal" portfolio will generate the highest return for a given level of risk.* In other words, for any level of risk an investor chooses to take, there is an optimal rate of return that should be achieved. Quantitative methods are used for measuring risk and diversification, making it possible to create efficient and theoretically optimal portfolios. Portfolio diversification is not so much a function of *how many* assets are involved as it is a function of the *relationship of each asset to the other assets*, and the proportionality of those assets to the overall portfolio.

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A critical concept involved in developing optimal portfolios under Modern Portfolio Theory is "correlation." This is the measure of one asset's return and price behavior compared to another asset class over the same period. Do the asset classes move in the same direction or in the opposite direction at the same time? If they move in the same direction at the same time, they are said to have a positive correlation. No benefits of diversification are achieved by investing in asset classes that are highly positively correlated. This is sometimes described as *random diversification*. Clients sometimes develop portfolios that are randomly diversified, having been constructed haphazardly

over a long period of time. *Efficient diversification*, on the other hand, matches asset classes that have *dis*similar price movements over the same market cycle. You can see that the number of assets in a portfolio is less important than the price movement relationship of those assets.

It is a misconception, albeit a widely held one, that investors must accept a higher level of risk (than currently exists in their portfolio) to achieve higher returns. By using efficient asset allocation methodologies, investors can oftentimes achieve higher returns with *less* risk. The key factor in making this goal achievable is the diversification of the investor's current portfolio. If it is already efficiently diversified, then higher returns will only come with higher levels of risk. However, if the investor's portfolio is randomly diversified, then higher returns may be attained without increasing risk.

This is the appeal and reward of the proper application of Modern Portfolio Theory to your investment portfolio.

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