What?

Investment policy is your guidelines with respect to your portfolio management. Think of it like driving. What is that destination? Do you feel comfortable driving on the highway? Do you prefer side roads? What type of gas stations do you prefer? What is your speed target? Do you allow driving above speed limit? How long do you feel comfortable driving? Do you allow driving more than four hours?

Now, think about your financial portfolio... What is your goal? What are your requirements for risk and return? Do you feel comfortable with junk bonds? Do you prefer treasury bonds? What type of securities do you prefer? What is your annual return target? What is your risk limit? Do you require portfolio insurance? Will you manage your own portfolio or will you hire someone to do it for you? How often will you assess performance?

Risk

We need to define our preferred and maximum risk levels. Standard deviation is a common risk measure. Implied volatility is also a common risk measure. While defining our risk preferences, it may be easier to have a point of reference. For many investors S&P-500 is the preferred benchmark. For instance, my risk preference is equal to S&P-500 index and my maximum risk level is three times the S&P-500 index. Effectively, whoever is managing my portfolio needs to obey with this investment policy. No financial security can have more risk than my defined maximum level. Also, it is not OK to lower the portfolio risk level unnecessarily. I prefer risk level of S&P-500 and not lower. Thus, let's not include too much treasury bonds into my portfolio.

Many portfolio managers charge management fees. It is usually not so pleasant to reveal a portfolio loss to a client. Thus, portfolio managers may opt investing in low risk and low return investments to avoid losses. But, this is at our expense because low risk earns low return.

Return

Once we define our investment policy with respect to risk, our return policy is pretty much done. It would be unrealistic to set a high return target for a low risk policy. Nonetheless, we need to set our return target as it has repercussions for the way our portfolio is managed.

For instance, if we set our return target as S&P-500 return then managing our portfolio is very easy: just buy S&P-500 index EFT (i.e. SPY) and be done with it. However, our return target can be fixed (i.e. 5% per year). With the fixed annual return target we can employ alternative income generating methods to maximize our profits while possibly lowering our risk.

It is therefore imperative to set our return expectation as part of our investment policy. For instance, my return target is 10% per year. I may not meet this target every year but I can write covered call options at 10% higher strike prices and realize alternative income for the portfolio.

Re-balancing

Many people check their portfolios regularly. Situations for companies change. Situations for bond issues change. While company ABC may be a good company last year, it may not meet our risk and return requirements this year. Markets change, economic conditions change, companies change and almost certainly investor preferences change. Thus, we need to re-evaluate our portfolio at a reasonable frequency.

It is important that we do not try to time the market as it is not part of portfolio management. Investors can speculate with financial securities but our job is to manage our portfolio. Thus, re-balancing too frequently may become speculation. For instance, I re-assess and re-balance semi-annually.

Safety

Depending on who is managing our financial portfolio and where we are keeping our assets, we need to maintain a safety protocol. Regular account controls should be part of our day-to-day lives.