Elements of a clearly defined investment policy statement for non-profits

An update

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Today's increasingly complex investment landscape places greater pressure on the fiduciaries overseeing the investment pools of endowments, foundations and healthcare organizations. Fiduciaries are not only reexamining their current investment decision-making practices, but also seeking to ensure that those practices allow for enough flexibility in implementation to maximize the likelihood of investment success. Recognizing the increasing importance of the investment portfolio to the needs of the broader organization, more fiduciaries are taking a holistic view, spending as much time on issues such as total enterprise risk management, good governance practices and spending policy as on asset allocation and investment strategy. Central to communicating the investment philosophy and decisions informed by this view is a clearly articulated investment policy statement (IPS), which serves as the foundation of an integrated and aligned oversight process.

In this paper, we summarize the key elements and discuss the ways by which "great" policy design can accommodate dynamic portfolio management and ultimately drive investing success.

What is an investment policy statement?

An investment policy statement is a client-specific document designed to address the objectives, constraints, unique circumstances and overall oversight procedures that govern the investment-related activities of a non-profit organization. A good IPS should clearly delineate the responsibilities of all parties involved in the non-profit's investment program – the board of trustees, the investment committee, the investment advisor, which may be an outsourced CIO provider, and the custodian. It will present the portfolio's financial objectives within the context of how much risk the trustees are willing and able to bear. The long-term strategic asset allocation of the portfolio should be specific, yet sufficiently broad (e.g. have asset allocation targets with broad ranges) to allow for flexibility in implementation as opportunities and risks evolve that can impact investment goals over predetermined time horizons. Lastly, the IPS should set forth operational guidelines and rules for monitoring and reviewing all facets of the investment program.

Constructing an IPS should be a dynamic process, just like the management of the non-profit's asset pool. While changes to the document should be infrequent, the IPS should be reviewed annually to ensure that all language and content reflect current fiduciary views and remain aligned with long-term objectives. During the initial design process or periodic review, a non-profit should seek input from trusted investment advisors who can help identify additional risks and issues that may not be top-of-mind for their committee and board members.

Drafting an IPS can also be an educational process for investment fiduciaries. Working through issues in the design process can help identify weaknesses and gaps between actual and best practices, and between expectations and reality. The result should be a document that can be easily understood and executed by all relevant parties and which provides clarity in the case of questions regarding investment strategy. (For example, an investment manager or strategy change should not automatically necessitate an IPS revision.) The IPS should be specific enough to provide guidance but not be overly restrictive which inhibits the ability to follow the IPS.

A good IPS that is well designed and well thought out is important to the success of a non-profit's investment program, as it plays a vital role in the overall governance structure of the non-profit. Well-defined objectives are important to ensuring that the mission of the non-profit can be achieved. Overall, a great IPS should position fiduciaries well to identify and mitigate potential risks to the asset pool(s).

Vital elements of a "great" investment policy statement

In addition to the core elements of a good IPS, we believe a "*great"* IPS should implicitly guide stakeholder alignment along the mission, objectives and policies of the organization. It should also outlast the longevity of the non-profit's current investment committee or board, unless fundamental or philosophical differences emerge and necessitate change. In this context, its role is to educate new board members on the thinking that has preceded them and the rationale for current practices. And as noted above, a "great" IPS should also allow for a degree of flexibility in implementation, to enable response to shorter-term opportunities and risks.

We believe a great IPS should implicitly create alignment among the mission, objectives and policies of an organization.

What embodies a "great" IPS? A well-written investment policy statement is typically organized in sections that address these subjects: 1) purpose and scope; 2) definition of duties; 3) objectives; 4) strategic asset allocation framework; and 5) rebalancing and spending policy.

Russell Investments advocates a discussion of asset allocation that focuses on asset roles, not just asset classes; liquidity policy; unique circumstances; and the monitoring and review processes, all of which will be discussed in greater depth below. We also suggest that for fiduciaries desiring clearer separation between policy and operational aspects, an addendum "implementation and procedures" document can supplement the main IPS that details the day-to-day monitoring, evaluation and review of investments, as well as the asset role statements that outline permissible investment strategies. This way, changes in the implementation process will not impact the core policy document, and frequent IPS revisions can be averted.

Section 1: Purpose and scope

Typically, the first section in an investment policy statement is "Purpose and Scope." It provides an overview and sets the tone for the specific guidelines within the body of the document. It should broadly state the scope of the IPS and its intended purpose, and set out the general objectives of the non-profit organization. If the organization has multiple asset pools with distinctly different objectives or time horizons, this is the section wherein to identify these distinctions.

This section should also include some language on fiduciary duty. Generally, there will be some language stating that committee members should exercise prudent and appropriate care in accordance with the appropriate law[1], and that committee members have a fiduciary responsibility to make investment decisions and take actions that are in the best interests of the organization.

Section 2: Definition of duties

It is important for the IPS to clearly state the duties of all involved parties, so that all may fulfill their duties effectively. At minimum, the parties should be listed and their duties described:

- Board of trustees: The board has the ultimate fiduciary responsibility for the foundation's investment portfolio. The board is responsible for ensuring that appropriate policies governing the management of the portfolio are in place, and that they are implemented. Typically, the board sets and approves the IPS and then delegates responsibilities to the investment committee for implementation and ongoing monitoring.
- Investment committee: The investment committee is responsible for implementing the investment policy. Typically, the investment committee is responsible for approving investment strategy; hiring investment managers or an outsourced CIO provider to implement the strategy; and monitoring portfolio performance on a regular basis (quarterly, at a minimum) to ensure compliance with the investment policy. In some cases, the investment committee and the board of trustees may be the same. If so, it is appropriate to detail the responsibilities in one section of the IPS.
- Outsourced CIO provider: Articulating the role of an outsourced CIO provider is critical. An OCIO provider assumes fiduciary responsibility and can perform a wide range of duties, depending on the level of discretion that has been delegated (e.g., determining asset allocation, selecting managers, actively managing the portfolio, etc.). Generally, there is an investment management

agreement between the non-profit and the OCIO provider that establishes the breadth and depth of the latter's investment management scope and level of fiduciary responsibility.

The OCIO should provide a comprehensive solution which includes assuming the fiduciary liability of the underlying investment managers and custodian. It is important to be clear on where the responsibility for those relationships lie. Depending on the scope of services and level of discretion accorded the outsourced provider and other parties, there may be additional roles to define.

- Investment managers (optional): The duty of investment managers is to implement the strategies for which their services have been retained. For example, a global equity manager would be responsible for investing in stocks across the breadth of the global opportunity set. Where the investment manager's scope of service covers multiple asset classes, such as the total liquid portfolio, "investment manager" may better be defined as an outsourced CIO provider.
- Custodian: The custodian is the financial institution responsible for safeguarding the assets of the portfolio. The custodian is also responsible for the settlement of securities bought and sold, collecting dividends and interest payments from the securities in the portfolio, and administering corporate actions on securities held, such as stock splits and dividends. The custodian also typically provides monthly and annual accounting reports and disburses funds for the non-profit's operating budget. Some OCIO solutions also provide custody services, so it may be possible to incorporate these responsibilities into the statement detailing the duties of the OCIO provider.

Section 3: Objectives

All investment policy statements should clearly articulate investment objectives with an outcome-oriented mindset. (For instance, the portfolio is required to spend 5% per annum in perpetuity.)This means evaluating an organization's current goals and constraints against the realities of market expectations to ensure that investment objectives reflect underlying return targets and risk tolerance, striking the right balance between return seeking and risk avoidance. Most non-profits aim to maintain purchasing power, which means that the long-term return objective should account for inflation, fees and annual spend, as appropriate. Other items worth mentioning in the Objectives section may include:

- Any portfolio liquidity requirements,
- Time horizon of the asset pools,
- Spending rate, and
- Any additional constraints the non-profit may face that could interfere with its mission

A well-defined set of objectives will not only help set the asset allocation and structure, but also reflect the non-profit's investment philosophy and the degree of linkage between investment success and the overall financial health of the organization. Objectives that vary across asset pools should be clearly specified.

Section 4: Strategic asset allocation framework

Strategic asset allocation will be the principal method via which a portfolio is designed and its assets invested to achieve the stated objectives over predetermined time horizon(s). It is imperative that non-profits spend whatever time it takes to clearly define those objectives and to determine which strategic allocation is most appropriate for the organization's needs. In accordance with the objectives statement, the allocation should be based on the applicable investment time horizon and should remain within the limits of acceptable risk. While investment committees usually acknowledge that assuming some risk[2] can help them achieve their long-term objectives, they should work to understand their true sentiments about risk, both rational and emotional, to limit the potential for regret in their responses to disappointing short-term returns or market volatility. Within the asset allocation framework, asset classes and investment strategies should be selected primarily for the roles they are to play in a total-portfolio context.

Clearly defined objectives will help set the investment strategy and strategic asset allocation.

Many organizations list out specific guidelines per individual asset class (e.g., large cap U.S. equity, emerging markets equity, intermediate-term bonds, etc.), as shown in Exhibit 1 below.

Exhibit 1: Example of a traditional asset class policy

ASSET CLASS	TARGET ALLOCATION	APPROVED RANGE
U.S. equity	22.0%	15% - 25%
International equity	23.0%	15% - 28%
Emerging markets equity	5.0%	0% - 10%
Fixed income	10.0%	5% - 15%
Real estate	11.5%	7% - 14%
Real assets ex–real estate	10.5%	7% - 14%
Marketable alternatives	15.0%	12% - 18%

As an organization moves toward a more dynamic asset allocation approach, adjustments should be made to the IPS, in order to incorporate a roles-based framework. Defining the strategic asset allocation in terms of the assets' respective roles (as listed in Exhibit 4 in the Appendix)[3] can give the organization the flexibility of a more nimble portfolio, as it works toward meeting its objectives while following stated implementation guidelines.

A roles-based framework lists asset-class allocations according to the manner in which they contribute to investment strategy outcomes. For non-profit organizations, this holistic approach classifies assets in three roles: growth, return enhancement, and risk reduction/diversification.

Exhibit 2: Example of a dynamic roles-based policy:

PORTFOLIO ROLE	TARGET ALLOCATION	APPROVED RANGE	LIQUIDITY PROFILE
Growth	65.5%	50% - 75%	Daily liquid
Return enhancement	5.0%	0% -10%	Moderately liquid to illiquid
Risk reducing/ diversifying	29.5%	15% - 35%	Daily to moderately liquid

When an organization shifts its asset allocation to a roles-based framework, there are some critical elements to be addressed. These include:

- Identifying the roles of the strategies used and permissible asset classes within each role,
- Allowing a tactical range for each role, as opposed to ranges restricted by individual asset-class buckets, and
- Clearly articulating who has fiduciary oversight of the target allocation and the extent of discretion accorded the outsourced provider.

The investment committee is tasked with developing and adopting guidelines for the strategic allocation on a long-term basis. In setting the target asset allocation, it is appropriate to develop ranges around portfolio roles to allow for tactical shifts in response to market risks or opportunities. The magnitude of ranges can imply the degree of risk tolerance for each. This approach provides guidelines for fiduciaries and their providers which will allow for dynamic management as well as discourage emotional decision making during times of market stress.

Lastly, since asset classes and strategies are broadly classified into roles, detailed strategy statements should be included that summarize the types of permitted assets and the objectives for each.[4]

Section 5: Rebalancing

In addition to describing the target asset allocation, language that articulates the rebalancing philosophy of the organization should be included. Periodic rebalancing of a portfolio is necessary to keep allocations from shifting too far from targets. Ranges are set at the portfolio role level; they can also be set at the asset-class level. Setting at the asset-class level may be specified in the investment management agreement or other outsourced provider documentation. This rebalancing may occur on a monthly or quarterly basis. If decision making and initiation of trades to accomplish rebalancing of the portfolio is delegated by the non-profit to an outsourced provider, that should be noted in the IPS and the governing agreement.

The language below provides an example of rebalancing policy:

> *The Committee recognizes that rapid unanticipated market shifts or changes in economic conditions may lead to wide deviations from the Target Allocation and approved ranges. Generally, these divergences should be of a short-term or tactical nature in response to fluctuating market environments. It is recognized that short-term deviations can also occur from periodic short-term impediments imposed by illiquidity of private market investments.*
>
> *The outsourced provider will review the Portfolio periodically and determine whether there is a variance between the Target Allocation and actual allocation that exceeds 2.0 percentage points (the "Maximum Tolerance") for each invested fund. This variance will be based on fund valuations generated by the outsourced provider for assets managed by the outsourced provider.*
>
> *If the Maximum Tolerance has been exceeded, the outsourced provider will rebalance the Account to the Target Allocation, or as close as reasonably possible, within ten business days; provided that if trading is not possible within ten business days, the outsourced provider will use best efforts to execute trades at the next available trade date.*

Section 6: Liquidity policy

While non-profits differ in their asset allocation and cash needs, liquidity is needed to: meet spend requirements; rebalance as needed/wanted; deploy capital opportunistically; and/or provide drawdown capital. The liquidity policy should state how necessary cash levels over various time horizons will be monitored to ensure that sufficient liquidity exists within the portfolio.

Mapping your investment portfolio's liquidity profile vis-à-vis its asset allocation and the roles of the asset classes can be helpful (as shown in Exhibit 5 in the Appendix). Ensuring that there are enough assets within each liquidity level (as outlined below) to meet your obligations should allow non-profits greater flexibility to meet their liquidity needs. This is especially important during times of market stress in order to minimize capital spend disruptions caused by inadequate liquidity. In addition, this exercise draws attention to the liquidity of the vehicles, as well as to the underlying instruments[5]:

CATEGORY	LIQUIDITY LEVEL
Highly Liquid	Daily
Liquid	Quarterly
Moderately liquid	> Quarterly to < 2 years
Illiquid	> 2 years to < 5 years
Highly Illiquid	More than 5 years

Section 7: Spending policy

Most asset pools, as appropriate, should have clearly defined spending policies that articulate how annual spend is determined. Ultimately, the board of trustees bears the responsibility for the proper management of the assets and the apportionment of those resources to current as well as future spending needs. The spending rate policy should be defined in such a way as to provide a relatively predictable stream of revenue to meet the desired goals of the organization, while preserving and/or increasing the value of assets for future use. This policy should be reviewed periodically and the organization should consider the impact of economic conditions as well as its other resources when determining whether or not to modify the spending policy.

Section 8: Risk management

The investment policy statement should set out guidelines around specific risk metrics so that the purpose of each metric can be known, measured and monitored in the portfolio. Vague statements around risk tolerance can make it difficult for an investment committee to gauge their true level of risk tolerance. This could lead to poor asset allocation decisions. Additional detail around risk can also provide guidance to the Outsourced CIO provider in managing risk in a manner consistent with the organization's objectives. A clearly articulated risk statement in the IPS should include the following[6]:

1. A definition of which risk measures are important to the organization such as beta, volatility, tracking error, active share, value at risk, maximum drawdown etc.
2. Time period over which risk will be measured (e.g. 1 Year, rolling 3 years etc.).
3. A definition of specific benchmarks and of how each will be used to evaluate absolute and relative investment risk
4. Quantification of the maximum acceptable level of risk for each risk measure, e.g.,
    a. Annual volatility 15%
    b. Annual tracking error, 2%
    c. Maximum drawdown is $X or Y% in any one year
    d. Losses greater than x% of the portfolio over Y time frame should be avoided.

Section 9: Sustainable investing

Sustainable investing[7] is an area that non-profit fiduciaries are addressing with increasing frequency. There are various approaches for incorporating sustainable investing within an IPS and we recommend non-profits go through a governance process[8] to determine a suitable approach for them. It is important to incorporate the motivation and the objectives, along with any constraints, in the investment policy statement. The language can vary based on the different approaches, but here's an example of text that can be incorporated in an IPS, for an organization that is pursuing a value based[9] ESG integration approach.

> *"XYZ Non-profit" believes that ESG integration into the investment process leads to better analysis of future financial performance and a deeper understanding of investment opportunities. Such analysis enhances our understanding of an investment and its ability to deliver long term value. In conducting ESG analysis, "XYZ non-profit" or its appointed external managers will typically source information from a range of sources including (but not limited to) proprietary research conducted by the investee itself, specialist research providers, brokers, academics, government agencies and non-government organizations. We will utilize internationally recognized benchmarks, codes and standards and participate in ongoing dialogue with industry participants to ensure our investment process is consistent with industry best practice.*

Section 10: Unique circumstances

The investment policy statement should contain a section detailing any circumstances specific to the organization.. For example, if your organization has a preference or a policy of avoiding unrealized business taxable income (UBTI), this is something that should be stated in this section. The "unique circumstances" section is an opportunity to include items that the non-profit would like to highlight and that are not covered elsewhere in the IPS.

Section 11: Monitoring and review process

Once the asset allocation, investment strategy, liquidity and spending policies have been established, it is important to create a well-defined monitoring and review process to help assure that the objectives of the foundation or endowment will be achieved. The review mechanisms should center on the investment objectives of the portfolio. Statements found in this section might include:

> *The investment committee recognizes that there are periods when objectives may not be attained, and that during various time periods, certain strategies may result in significant underperformance or outperformance relative to overall market performance.*
>
> *The overall health of the portfolio will be monitored by comparing the value of the non-profit's assets against the expected spending rate plus inflation and fees, and by tracking the changes of each to determine whether the spending rate requires adjustment. This exercise will be performed no less often than annually.*
>
> *Portfolio objectives will be monitored quarterly to assist in evaluation of the investment strategies' effectiveness.*

Asset role guidelines will be reviewed annually as stated in each asset role strategy statement.

The investment committee and/or board of trustees will conduct detailed reviews and assessments of the investment program's overall strategy, governance structure and investment policy at least every three years. Any changes to the policy will be communicated in writing to all appropriate parties.

Section 12: Acknowledgement

Typically, the last section in an investment policy statement is the acknowledgement section, which is signed by the non-profit before copies are distributed to all parties. An example of an acknowledgment statement is as follows:

We recognize the importance of adhering to the mission and strategies detailed in this policy and agree to work to fulfill the objectives stated herein, within the guidelines and restrictions, to the best of our ability.

Section 13: Appendix: Asset role strategy statements

Following the acknowledgement section of the IPS, many non-profits include an appendix or a separate implementation and procedures document that further defines the investment strategies and asset roles that make up each of the three broad portfolio roles (growth, return enhancement and risk reduction/diversification). These statements provide additional detail centered around four main categories:

- Strategic role – defines what sub-assets may be invested in each role (e.g., Growth can include Global Equities, High Yield Fixed Income)
- Strategies – outlines how market exposures may be attained (active/passive management) and how strategies are combined to meet the Investment objectives. If certain investments are not permitted, this would be an appropriate place to list out any prohibitions.
- Investment objective – spells out what each role is intended to accomplish. For example: Provide a total return greater than the designated benchmark.
- Monitoring and control – guidelines around how frequently the underlying investments will be monitored, and what should trigger a review of the investment manager or strategy

Conclusion

Having a well-defined and clearly articulated IPS is vital in today's challenging investment landscape. The IPS should serve as the blueprint for non-profit organizations seeking to meet their objectives while minimizing total portfolio risk. The investment policy statement fills a vital role in helping to lay the foundation of an organization's overall governance structure and ensuring that all fiduciaries are fulfilling their obligations. Writing a "great" IPS is often an iterative process; it demands engagement and thoughtfulness from each fiduciary. We strongly believe that such level of care will result in an oversight protocol that is more integrated and better aligned with the needs of the overall organization, and that can increase the probability for a non-profit to achieve investment success.

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[1] This can be either the Uniform Prudent Investor Act (UPIA) (where adopted) and trust law or more likely, the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

[2] Commonly measured by volatility and also includes many other risk types, such as credit and illiquidity. For a detailed look at portfolio risks, see Ruff and Schneider (2014), References section.

[3] For a detailed look at portfolio roles, see Ruff and Myers (2014), References section.

[4] See Appendix for an example of a Growth role strategy statement.

[5] For a detailed look at portfolio roles, see Kathuria and Myers (2013), References section.

[6] Ruff, M. (2015, September.) "Portfolio risk measures: that which is measured, is managed.) *Russell Investments Research*.

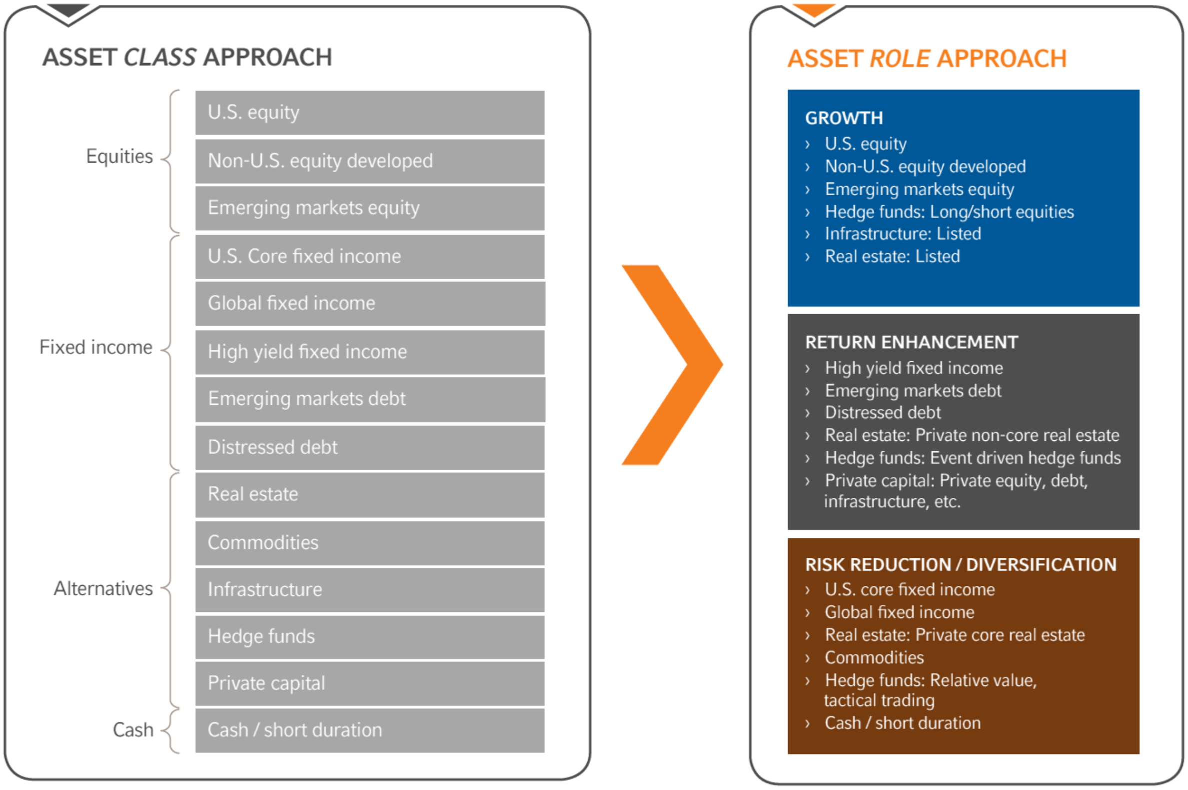
[7] While industry terminology continues to evolve, we use the term "sustainable investing" at Russell Investments to encapsulate a broad spectrum of strategies that seek to capture both financial and non-financial returns.

[8] Myers, H., Kathuria, M. (2014, June.) "Governance process for evaluating sustainable investing: A guide for non-profit fiduciaries." *Russell Investments Research*.

[9] Where ESG factors are considered financially material to the long-term performance of a company. Value based ESG integration focuses on identifying ESG risks that could adversely impact the investment outcome.

Appendix

Exhibit 4: Reframing your portfolio by asset roles



Source: Ruff, M., Myers, H. (2014.) "Drivers of investment management success for non-profit organizations." *Russell Investments Research*. Not an exhaustive list of strategies.

Exhibit 5: Sample liquidity profile

ALLOCATION	ASSET CLASS	LIQUIDITY LEVEL: HIGHLY LIQUID / LIQUID	SEMI-LIQUID / ILLIQUID	HIGHLY ILLIQUID
Equity				
20.0%	Global equity	100%	0%	0%
5.0%	Emerging markets equity	100%	0%	0%
Fixed income				
8.0%	Core fixed income	100%	0%	0%
2.0%	Global fixed income	100%	0%	0%
2.5%	Cash and cash equivalents	100%	0%	0%
5.0%	Global high yield debt	100%	0%	0%
5.0%	Emerging markets debt	100%	0%	0%
Alternatives				
5.0%	Long / short hedge funds	100%	0%	0%
15.0%	Non-directional hedge funds	50%	50%	0%
4.0%	Commodities	100%	0%	0%
3.0%	Global listed infrastructure	100%	0%	0%
3.0%	Global listed real estate	100%	0%	0%
7.5%	Private equity	0%	20%	80%
15.0%	Private real estate	0%	60%	40%
100%	**TOTAL WEIGHTED AVERAGE**	**70%**	**18%**	**12%**

Exhibit 6: Example of a growth role strategy statement

PORTFOLIO INVESTMENT ROLE STRATEGY STATEMENT – GROWTH

Strategic Role

- Invest in a diversified portfolio that may include, but is not limited to: Global Equities, including Domestic, International Developed, Emerging Markets, liquid real assets such as Listed Infrastructure and Real Estate Investment Trusts (REITs), and long/short equity strategies.
- Achieve returns in excess of passive indexes through the selective use of active investment strategies and investment managers, where the Manager deems active management appropriate.

Strategies

- Take an opportunistic approach to investing in "Growth" assets, which are dominated by equity market beta, by combining funds and/or separate accounts invested in a dynamic mix of asset classes and strategies for long-term asset growth, which may include making frequent or minor adjustments to the portfolio as appropriate investment opportunities related to current or projected changes in market environments may arise.
- Retain active management services for the purpose of achieving added value, with diversification provided through multiple investment managers/strategies; emphasize active management in areas where the market is deemed less efficient and passive management in areas where the market is deemed more efficient.

Investment Objectives

- The investment objectives are to provide a total return greater than that of the designated Growth composite benchmark and a risk level similar to that of the Growth composite benchmark.
- These investment objectives are expected to be achieved over the long term and are measured over a full market cycle.

Monitoring and Control

- The returns and portfolio characteristics of the strategy are reported quarterly to monitor progress toward meeting longer-term investment objectives.
- Due diligence meetings with the Manager will be held at least annually by the Committee, to review portfolio results and to discuss guidelines and expectations.

RELATED READING

Murray, S. (2012.) "Are 5% distributions an achievable hurdle for foundations? Were they ever?" *Russell Investments Research*.

Murray, S. (2011.) "Non-profit spending rules." *Russell Investments Research*.

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First used: June 2011 (Revised: April 2016; Disclosure revision: August 2016) USI-23912-04-19