Assisting Investment Stewards with Investment Governance

By Robert Burns, CFA®, AIF®

Fiduciary obligations have been increasingly top of mind for investment stewards, those individuals who are trustees, investment committee members, attorneys, accountants, institutional investors, and anyone else who is involved in managing investment decision making. Fiduciary obligations weigh heavily on some investment stewards, yet for others the concerns continue to fade the longer the current bull market lasts. Conversations with these investment stewards reveal a strong desire to ensure that they are making smart decisions about their portfolios, including hiring the right managers, being in the right asset classes, and to what degree. However, these conversations too rarely center on the portfolio management process and its supporting procedures, i.e., the investment governance structure. Investment stewards have a desire to know that their actions are prudent and appropriate because as fiduciaries they have a duty of loyalty and care.

The investment advice industry has been inundated with news stories about fiduciary breaches, legislation—new and proposed—as well as updates from internal and regulatory compliance. The debate about various fiduciary standards that do or may apply to brokers in the future continues, but the matter has been decided for registered investment advisors (RIAs) and their representatives. RIAs are governed by a fiduciary standard as defined in the Investment Advisers Act of 1940, as amended. The SEC Staff Study of January 2011 explained: "An investment advisor is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Included in the fiduciary standard are the duties of loyalty and care."

Adding to the frustration surrounding this issue for both investment stewards and investment advisors is the lack of a complete understanding of what the fiduciary standards require. Most investment stewards have never received any training on the responsibilities of a fiduciary, and many of those providing investment advice don't have a working knowledge of how the duties they provide do or don't meet a fiduciary standard.

The Role of Advice Providers

Those providing investment advice to investment stewards play a critical role in helping them deliver on their fiduciary obligations by ensuring assets are well-managed. As the investment experts, those acting as investment advisors can—and should—assist investment stewards with best practices and the form of the investment management process and the governance surrounding it. Both stewards and advice providers need a source of information that could provide the following:

- A comprehensive listing of fiduciary standards
- Procedures that support those standards
- Objective substantiation that these standards can fulfill what is required of fiduciaries
- A listing of documents that evidence all of the above

Leveraging Synergies

Why should advisors focus on this added value? Because it's in their best interest.

In helping your clients deliver on their fiduciary responsibility and providing them with the documentation required, you often are meeting your fiduciary obligations as well. For example, a couple of these synergies are the following:

- Create an asset allocation study in support of your recommendation and walk your client through the process of how it was created and why it is right for them. This allows clients to understand why assets are allocated as they are and how this meets their organizations' needs. By doing this you have created a substantiated basis for your asset allocation recommendation.
- Create a schedule of what your clients should review throughout the year and document that reviews took place and their results. The resulting schedule and checklist serve to document, for both parties, the governance process employed for the investment management process.

A Resource for Fiduciary Clarity

Prudent Practices for Investment Advisors & Stewards, handbooks created by fi360, a leading fiduciary training and resources organization, is one source of fiduciary clarity.[1] Such fiduciary resources, supported by the Center for Fiduciary Studies, define seven Global Fiduciary Precepts that require fiduciaries to understand and deliver on the following:

1. Know standards, laws, and/or trust provisions
2. Diversify assets to the specific risk and return of client
3. Prepare an investment policy statement
4. Use prudent experts (professional money managers) and document due diligence
5. Control and account for investment expenses

6. Monitor the activities of prudent experts
7. Avoid conflicts of interest and prohibited transactions

Benefits to Investment Stewards of Better Investment Governance

The many potential benefits of implementing good governance around your investment management process include the following:

Systematic method of documenting delivery on fiduciary obligations: Investment stewards should be able to demonstrate fiduciary skills, knowledge and investment awareness, and a fundamental understanding of the law to effectively delegate and share responsibility with other fiduciaries while providing effective oversight to serve their beneficiaries.

Better risk management and mitigation: Good governance helps with risk management and mitigation from investment and legal perspectives, because most investment litigation involves the alleged omission of certain fiduciary practices and/or prudent investment procedures, as opposed to the commission of certain acts.

Increased efficiency and effectiveness: By implementing a comprehensive process to fulfill fiduciary obligations, investment stewards can create a rigorous business-like structure that ensures efficient and effective review and decision making by investment committees and boards.

Institutional reputation: Donors today are much more demanding of their charities and often are seeking evidence that the dollars they are supplying are being prudently managed. Investment stewards who can communicate clearly how they provide responsible oversight of the management of investment advisors and investment decisions to a defined fiduciary standard of excellence may enjoy an advantage over competing entities in gathering donations and asset management.

The Investment Policy Statement

Investment management process governance includes the documented policies controlling and guiding the investment portfolio, known as the investment policy statement. The major areas this policy should include are the following:

- The governing law applicable to the portfolio
- Responsibilities of all parties associated with the portfolio and its investment management
- Risk, return, time horizon, liquidity, and cash flow needs of the portfolio
- Portfolio diversification and rebalancing
- Due diligence criteria for selecting investment options
- The process for controlling and accounting for investment expenses
- Monitoring criteria for portfolio investments and service providers

This document should be reviewed on an annual basis to ensure it continues to reflect the needs of the organization. Other important governance documents include investment committee or board by-laws and spending policies.

Asset Allocation

Analysis of the current portfolio should be conducted on a periodic basis to ensure that the asset classes, asset allocation, and their characteristics continue to align and comply with the parameters set out in the investment policy statement.

Manager Search and Monitoring

Reports that display investment performance relative to appropriate indexes, peer groups, and the portfolio's performance and compared to the investment policy statement objectives should be reviewed periodically.

Other Periodic Reviews

Periodic reviews of the fees, compensation, and expenses related to the investment management process should be conducted to ensure that they are reasonable and fair in light of the services being provided.

Just as there should be a process for organizations to periodically review the board's effectiveness as part of its overall governance efforts, investment committees should employ a process to evaluate the effectiveness in meeting their fiduciary responsibilities.

Evidence of Investment Stewardship

The final step in the governance process should include the documentation of all of the steps in the process. The investment reviews and analysis conducted in all meetings should be documented in the minutes and corresponding analysis documents attached to the permanent records of the organization.

Final Thoughts

A well-thought-out and structured governance plan can go a long way toward ensuring that investment stewards are meeting their responsibilities and obligations as fiduciaries. The fiduciary standard is a process standard and is primarily focused on procedural prudence. How fiduciaries gather, analyze, and implement appropriate information in accordance with generally accepted investment theories and analyzing how the strategy meets portfolio objectives provides the basis for determining procedural prudence.

Investment advisors can play an instrumental part in assisting their investment steward clients—especially smaller not-for-profit organizations—by implementing good governance. Because of the shared fiduciary responsibilities, helping clients focus on delivering their fiduciary obligations by assisting with their governance plan helps you, too.

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Endnote

1. See "Prudent Practices for Investment Advisors," http://www.fi360.com/prudent-investment-process/advisors-practices and "Prudent Practices for Investment Stewards," http://www.fi360.com/prudent-investment-process/stewards-practices.

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