CLIENT FOCUS

Governance checklist for today's fiduciaries

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Defined benefit plans, defined contribution plans, endowments and foundations are delegating more of their asset management responsibilities than ever. Tasks that were once the purview of an investment committee (e.g., manager selection and rebalancing) are increasingly delegated to investment staff or transferred to an outsourced chief investment officer (OCIO) partner. While much has been written about the specific functions being delegated, little has been written about changes to the governance process that should follow.

WHAT STAYS THE SAME?

For context, it is useful to start with the responsibilities that do not change.

First, the investment committee should retain responsibility for documenting the objectives, constraints and risk tolerance on behalf of the sponsoring organization. Examples of typical objectives include:

- Fully fund the pension plan within seven years with 95% confidence that required contributions will not exceed $100 million in any one calendar year.
- Support a 4% annual spending policy while preserving the absolute value of the corpus after accounting for inflation.

Constraints can include a fee budget, eligible asset classes/strategies and bands for rebalancing or tactical tilting. Risk tolerance is often a component of both objectives and constraints, but it is typically expressed via a strategic asset allocation (SAA) that the investment committee approves.

Second, the investment committee should define the measures of success against which the investment strategy will be assessed and then engage in a regular process of monitoring results relative to these measures.

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WHAT CHANGES?

The biggest change in the investment committee's responsibilities occurs with the activities that fall between defining the objectives and monitoring progress towards those objectives. Namely, the design and implementation of the investment strategy.

We think that best practice is to push decision-making to the level where the expertise resides. A practical application of this principle is that the investment staff or OCIO partner decides on which sub-advisor to hire. After all, what can an investment committee really discern about a sub-advisor based on a 45-minute marketing pitch?

The follow up question we sometimes get is, “How can the committee fulfill its fiduciary duty if it has delegated sub-advisor hire/fire decisions?”

The general answer to that question is to shift the committee’s focus from direct due diligence to ensuring that a proper due diligence process has been followed.

More specifically, the investment committee should be satisfied that a certain standard has been met in each of five categories: investment policy, investment thesis, risk, trust and process. The focus is slightly different depending on whether the delegation of investment strategy has been to internal investment staff or to an OCIO partner. Below we consider both scenarios.

DELEGATION TO INVESTMENT STAFF

Since the investment committee and investment staff are part of the same organization, the orientation of the oversight process tends to be more introspective and should include affirming that the following conditions have been met:

1. **INVESTMENT POLICY:**
   The proposed investment is consistent with the Investment Policy Statement.
   - ❑ What role does the investment play in the overall portfolio?
   - ❑ How is the investment consistent with stated investment beliefs and investing time horizon?
2. **INVESTMENT THESIS:**
   The underlying investment thesis is sound.
   - ❑ What is the underlying investment proposition and source of a positive expected return?
   - ❑ What is the information advantage that is being exploited to outperform the passive alternative, if there is one, net-of-fees, or the unique situation relative to another opportunity that makes the proposed investment attractive?
3. **RISK:**
   The risk associated with the investment is reasonably well understood and consistent with the risk tolerance of the stakeholders.
   - ❑ What does the distribution of possible outcomes look like and are the “left tail” outcomes acceptable on a standalone basis and in the context of the overall portfolio?
   - ❑ What environments would this investment be expected to struggle in?
   - ❑ What could go wrong and what is in place to mitigate these risks?
4. **TRUST:**
   The counterparties to the transaction are trustworthy.
   - ❑ How are incentives aligned between the investment sub-advisor, general partners, co-investors and/or other parties?
   - ❑ For private transactions, why has the other party decided to sell?
5. **PROCESS:**
   The investment staff followed a process that was appropriate for the investment.
   - ❑ Was sufficient time spent evaluating the investment opportunity?
   - ❑ Were appropriate resources (e.g., third-party experts, legal counsel) employed in the evaluation of the investment opportunity?

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DELEGATION TO OCIO PARTNER

In this case, the investment committee and OCIO partner are from two different organizations and the OCIO partner exercises unilateral discretion for certain decisions. Therefore, the orientation of the investment committee's oversight shifts somewhat. While the broad categories are the same, the focus is on whether the OCIO partner remains true to the qualities that led to their hiring in the first place and that they remain the right partner.

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1. **INVESTMENT POLICY:**
   The OCIO partner has a clear understanding of your objectives, constraints and risk tolerance (including time horizon).
   - ❑ How does the OCIO partner demonstrate progress toward the fund's primary objectives?
   - ❑ How does the OCIO partner give you confidence that it is operating within your investment policy parameters?
   - ❑ Is the OCIO partner appropriately proactive in helping the investment committee explore potential enhancements to the investment strategy?

2. **INVESTMENT THESIS:**
   Your overall investment philosophy remains aligned with that of the OCIO partner.
   - ❑ Do you have a clear understanding of how the OCIO partner intends to add value and how the portfolio is positioned as a result?
   - ❑ Are the results clearly attributed between strategic decisions, dynamic positioning and sub-advisor selection?

3. **RISK:**
   Your OCIO partner has a comprehensive process for managing total portfolio risk.
   - ❑ Does your OCIO partner have a robust risk platform that facilitates management of risk at the total portfolio level, including aggregated exposures across asset classes and investment sub-advisors?
   - ❑ Does your OCIO partner utilize a broad array of instruments and strategies beyond sub-advisor selection and allocation to construct and manage the portfolio?

4. **TRUST:**
   You are confident in the team assigned to your relationship.
   - ❑ Are you satisfied with the caliber of the investment professionals assigned to manage your assets and service your account?
   - ❑ Can your client service team effectively communicate all aspects of the strategy to the investment committee?

5. **PROCESS:**
   The OCIO partner follows a process that is appropriate given the complexity of the portfolio.
   - ❑ How does the OCIO partner ensure you have adequate diversification by strategy, investment style and process?
   - ❑ How are decisions made when choosing between active and passive implementation?
   - ❑ What is the OCIO partner's approach to identifying and hiring the best investment sub-advisors on your behalf?
   - ❑ Are you properly notified of the rationale for changes in sub-advisors?

CONCLUSION

The investment committee is rarely in the best position to evaluate specific investment opportunities – that should fall to the investment staff or OCIO partner. The investment committee does, however, play a vital role in ensuring that the objectives, constraints and risk tolerance are well defined; the investment strategy was arrived at following a sound process; and the results are monitored relative to clearly defined measures of success.

The items on the previous pages can serve as a checklist for ensuring that the due diligence process has been followed. As a result, the investment committee can more confidently delegate decisions to those with the expertise to make them.

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