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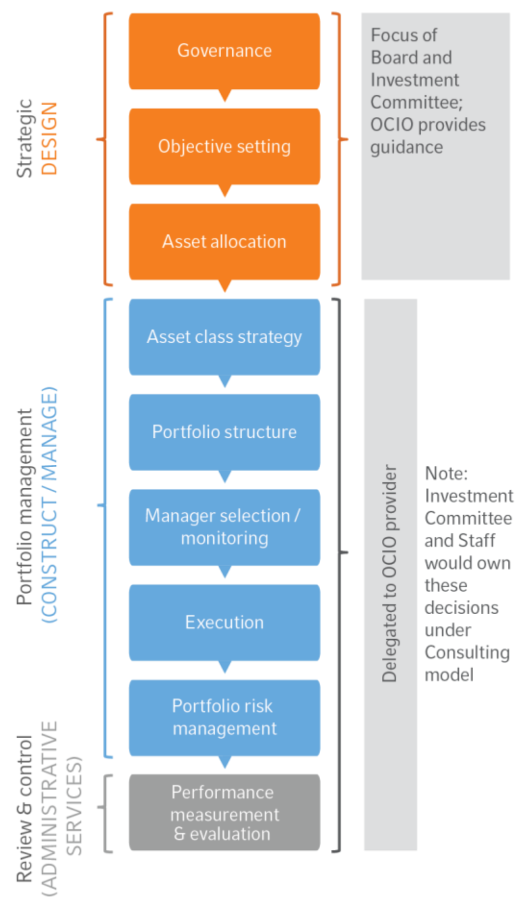
The fiduciary roadmap for non-profit organizations

Steps in a well-managed investment program

The fiduciary roadmap, shown in Exhibit 1, lays out the steps a prudent investor should take—and delegate—in running their portfolio. This includes everything from identifying governance structure and objectives, to executing investment ideas and managing enterprise risk. What can make or break an organization's investment success is its ability to execute all of the steps on the fiduciary roadmap well. This has led many fiduciaries to delegate aspects of their investment programs to an outsourced chief investment officer (OCIO) provider.

Russell Investments has written about the fiduciary roadmap for decades, and we have seen it evolve significantly over time. In this article, we revisit the roadmap from a non-profit investor's perspective and share how, in partnership with an OCIO, fiduciaries can successfully manage their investment programs in a volatile, ever-changing market environment. What sets the OCIO model apart from other investment models is the delegation of the steps outlined in the roadmap: it is the fiduciary who establishes the strategic decisions—with strategic advice, analytics, and guidance from the OCIO—and the OCIO who implements them. We believe it is critical for non-profit fiduciaries to understand what goes into each step so they can appropriately oversee their provider and better position their portfolios for success.

Exhibit 1: The fiduciary roadmap



To illustrate how the stages of the roadmap work together, we outline each of the decision-making levels in detail below.

Strategic design

All the steps and decisions made in the strategic design stage are the responsibility of the fiduciary. The decisions made here are those which tend to have the greatest impact on the organization's long-term success. The fiduciary's role is to enable good governance, set investment objectives that align with the organization's goals, and, with their provider's guidance, design the strategic asset allocation (SAA) for their investment program—and capture these decisions in their investment policy statement (IPS). The SAA is based on the non-profit organization's unique goals and objectives, spending policy, risk / return profile, liquidity needs, and desire for perpetuity. The IPS is the guiding document for the organization's investment program, recording beliefs and expectations.

Governance

Good governance is about seeing that the investment program is run properly, identifying potential shortcomings, and delegating decision-making authority to the most appropriate person or group where needed. These individuals may be either internal to the organization or external fiduciaries associated with the OCIO provider. Non-profit fiduciaries must identify how decisions are made, who is most qualified to make them, and how those decisions will be monitored.

Non-profit organizations face an interesting challenge in that many of the governing committees—such as the board, the investment committee, and the finance committee—are composed of volunteers. Because of this, clearly defining decision-making authority is key. Most non-profit fiduciaries face time, resource, and budget constraints—regardless, they bear fiduciary responsibility and retain decision-making authority for the organization. Part of effective governance is ensuring that decisions are made in a timely manner and reflect the non-profit organization's interests first and foremost.

Good governance also involves establishing effective systems for ensuring compliance with legal and regulatory requirements, and with the non-profit organization's stated guidelines. It is important for fiduciaries to be cognizant of any regulatory developments and the most current investment topics, and to ask their OCIO to provide regular updates on both items.

Objective-setting

Objective-setting entails making decisions about four primary, organization-specific inputs:

- Spending policy: setting the pattern of distributions from the investment program over a specified period of time
- Liquidity needs: managing liquid and illiquid assets to ensure they align with broader organizational goals
- Risk tolerance**:** determining the organization's ability and willingness to bear risk
- Desire for perpetuity**:** deciding how long the organization wishes to exist and aligning the spending, liquidity, and risk needs accordingly

These inputs drive the design of the SAA and ultimately determine how the fiduciary and the OCIO manage the investment program. Each of these inputs is closely intertwined with the others, which means that decisions made about one will influence decisions made about the others. For example, whether or not the organization wishes to exist in perpetuity will impact how much the organization should spend, and over what time horizon. Accordingly, the amount of liquidity needed to meet those spending goals will also shift.

One thing to note is that these are dynamic decisions; they can, and should, be revisited and adjusted based on changing market environments and the organization's evolving situation and goals.

Strategic asset allocation (SAA)

While the previous steps in this stage are fiduciary-driven decisions, the final step involves close collaboration between the fiduciary and the OCIO provider. In the most basic terms, the SAA determines the proportion of total assets that will be allocated to each broadly defined class of assets (e.g., equities, fixed income, real assets, private capital, etc.). At Russell Investments, we go one step further and envision the SAA in a roles-based framework, identifying the role a particular investment strategy plays in a portfolio. We refer to three broad role buckets when helping fiduciaries design their SAAs: growth, return enhancement, and risk reduction or diversification.

The growth bucket serves as the growth engine and return driver of the portfolio and would encompass, for example, global equities and directional hedge funds. Conversely, the return enhancement bucket includes illiquid assets that can potentially generate higher returns, but are also higher risk—such as private capital. Lastly, the risk reduction or diversification bucket provides diversification to the other two categories—non-directional hedge funds and core fixed income would fall into place here. Looking at asset roles when building the SAA can provide a more accurate picture of how each asset is positioned to help achieve total portfolio outcomes.

Driving the SAA decision are the objectives and constraints that the fiduciary will have defined in the previous decision step, as well as the OCIO provider's capital markets forecasts for the asset classes and roles being considered.[1]

It is important to have a discussion about, and model the impact of, any trade-offs which the organization might need to take in the investment program. If there are competing sub-objectives, they must be reconciled by defining suitable trade-offs (e.g., balancing spending requirements with the need for growth in perpetuity), and by distinguishing between the overall objective and various constraints (e.g., for the targeted level of return, how much risk is acceptable?).

It is also important to capture these broad decisions and record who handles what in the organization's IPS. In addition to investment beliefs, the IPS documents the roles and responsibilities of the various individuals associated with the investment program. This means setting specific guidelines and expectations for each person's role.

At this stage, fiduciaries should also decide whether to pursue a dynamic management strategy, as that will drive the types of asset classes and roles which are incorporated into the SAA. Any decisions made around the approach to dynamic management should also be updated broadly in the IPS. We'll delve into this a bit more in the following section.

Another key shift we have observed in recent years is the need for more frequent reviews of the SAA itself due to evolving goals and markets. Fiduciaries should consider reviewing their SAA annually, or when there is a significant shift in the market or organizational priorities, to ensure that the strategy remains aligned with the organization's goals and objectives.

Construct / Manage

At this stage, the OCIO provider takes the reigns and implements the decisions made by the fiduciary in the previous three steps. This stage includes the construction of the portfolio as well as the monitoring and daily dynamic management of each underlying investment strategy. The outsourced provider's approach should involve a total-portfolio view that looks across equity, fixed income, alternatives, and other arenas to make the best possible risk / return trade-offs. The following steps will be delegated to the OCIO provider—but it is important for an effective fiduciary to understand what the OCIO provider is doing on their behalf and to oversee those decisions appropriately.

Asset class strategy

Asset class strategy delves more deeply into a given asset class and / or asset role, and defines in detail how the allocation will be invested across sectors within the strategy. The steps involved include:

- Analyzing the appropriateness of investment styles, biases, and tilts versus benchmarks
- Determining active versus passive management allocations
- Establishing specific benchmarks and targets for asset and sub-asset classes (e.g., U.S. equity and style allocations)

As we mentioned in the previous section, dynamic management is a strategy which needs to be discussed by the organization's fiduciaries, and one we recommend to investors. The globalization of markets has led to a changing dynamic of increased correlation of risks and returns across regions, and the need for flexible navigation among these markets is one reason that dynamic management is beneficial. Another reason for incorporating a dynamic management strategy is the volatile market environment. In this type of environment, every basis point counts, making the ability to successfully capitalize on fleeting opportunities critical for non-profit organizations to meet their spending needs. Investors should weigh the benefits of a dynamic management strategy at this stage so that it will be easier for the OCIO to execute later on.

Portfolio structure

Portfolio structuring describes how to implement the strategies, bringing the SAA to life. In a total-portfolio, roles-based framework, strategies that the OCIO provider may include are illustrated in Exhibit 2:

Exhibit 2: Roles-based approach

Designed to get you to CPI + X%

GROWTH ASSETS *55 - 70 % of your total portfolio* Dynamically managed return driver of your portfolio	**Global equity** › Global equities › Regional large cap › Regional small cap › Emerging markets equity **Real assets** › Global listed real estate › Global listed infrastructure › Global commodities › Private core real estate **Return-seeking fixed income** › Global high yield › Emerging markets debt › Bank loans **Directional hedge funds**
RETURN ENHANCEMENT *5 - 15 % of your total portfolio* Longer-term, illiquid allocation to drive additional return.	**Private capital** › Private debt › Private equity › Private non-core real estate
RISK REDUCING / DIVERSIFYING *20 - 35 % of your total portfolio* Volatility management and return-smoothing allocations.	› Non-directional hedge funds › Core fixed income › Absolute return fixed income

The portfolio should be designed to hit a specific return target, such as CPI+5%.

Manager selection and monitoring

Manager selection and monitoring involves researching to identify the best possible managers for the investment program, and then determining which candidates are appropriate hires, given the portfolio's specific SAA and desired structure. This step is easier said than done—with a significant number of potential investment managers and strategies, and the complexity of evaluating, selecting, and monitoring managers, it is vital to work with an OCIO who has significant organizational resources focused on this area. It should be a critical part of their business and one of their competitive advantages.

Execution

Execution focuses on the actual implementation of the investment program. This includes developing investment manager guidelines and implementing changes across and within asset classes (portfolio transitions, asset class rebalancing, manager changes, etc.). Efficiently managing portfolios also entails being cognizant of and responsive to near-term risks and opportunities in an ever-changing marketplace. The goal of this stage is to improve the risk-adjusted return, as well as enhance the probability of achieving stated portfolio objectives by proactively addressing risk exposures and taking advantage of market opportunities.

In today's volatile market environment, investors must incorporate investment strategies that may offer incremental return opportunities, avoid risks for which they don't expect to be compensated, and better ensure that their portfolios are implemented efficiently. A dynamically managed portfolio includes actively managed strategies, and also entails actively tilting the portfolio and managing targeted exposures on the basis of both short- and long-term views of the market. The OCIO provider will set trading bands around the target SAA for each asset class, and execute those dynamic decisions in real time.

We believe combining dynamic management with a roles-based approach can increase your organization's ability to capture unique opportunities while continuing to manage risk.

Portfolio risk management

Measuring and managing risk at the total portfolio level, as well as within each segment of the portfolio, is essential to a successful investment program. It is vital that the outsourced provider has a team of highly skilled IT personnel, portfolio managers, and risk specialists with access to the latest tools and technologies. They should be able to evaluate entire portfolios under many different scenarios, stress tests, and market environments to understand what is likely to happen if a new investment were to be added or removed, and to identify any gaps relative to the portfolio's policy. In today's volatile markets, the right tools and technologies are part and parcel of effective risk management.

Administrative services

Last, but not least, is the administrative services stage. Here, the fiduciary reviews and supervises key administrative functions performed by the OCIO.

Performance management and evaluation

Performance measurement generally involves a comprehensive analysis of the total investment program, asset class / role, and manager performance versus benchmarks and peer groups. This ongoing evaluation process tests results against the objectives initially set (for example, was the 7% return goal met?) as well as against the actual outcomes (for example, were the organization's spending needs in a particular time period met?).

Conclusion

Our hope is that the fiduciary roadmap serves as a useful guide to help fiduciaries effectively and efficiently manage and oversee their investment programs.

For more details on the roles and responsibilities of an effective fiduciary, please refer to our new Non-profit Fiduciaries' Handbook, available at Russellinvestments.com/nphandbook.

[1] It is important to note that many non-profit organizations manage multiple pools of capital with different objectives, and that doing so usually requires different SAAs.

FOR MORE INFORMATION:

Call Russell Investments at **866-739-7979** or visit **russellinvestments.com/nonprofits**

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