Prudent Practices for Hiring and Monitoring Investment Advisors

Greg Headrick, AIFA®
Northwest Asset Management
Grend@nwasset.com
nwasset.com

AGENDA

› Hiring and Investment Advisor
› Foundation for Fiduciary Studies
› Creation of 22 step process
› How to use the Process
› Questions

UPIA - SECTION 9. DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.
**Hire an Advisor – RFP**

1. Send RFP to 10 Advisors
2. Interview 5 over the Phone
3. Interview 2 in person – Hire one of them

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**Foundation for Fiduciary Studies**

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**Fi360**

Mission: “To promote a culture of fiduciary responsibility and improve the decision making processes of investment fiduciaries.”
The Foundation for Fiduciary Studies

Established in the Fall of 2000 by Don Trone. Mission was to develop standards of care for investment fiduciaries. Practices define a complete process for investment fiduciaries. Dedicated to providing the most complete and up-to-date information regarding fiduciary responsibility. The Foundation is committed to advancing this knowledge to the public. FI360.COM

The Center for Fiduciary Studies

The Center for Fiduciary Studies (Center) is the first full-time training and research organization focused exclusively on fiduciary responsibility. Offers both classroom and online education based upon the practice standards of care. In Association with University of Pittsburgh Joseph M. Katz Graduate School of Business, Center for Executive Education The Center awards two professional designations. Accredited Investment Fiduciary® (AIF®) Accredited Investment Fiduciary Analyst™ (AIFA®)

The Center for Fiduciary Studies

The Accredited Investment Fiduciary® (AIF®) mark signifies the designee has acquired the knowledge to apply Global Fiduciary Standards of Excellence. The Accredited Investment Fiduciary Analyst™ (AIFA®) mark signifies the designee has demonstrated the knowledge to assess whether an investment fiduciary conforms to a Global Fiduciary Standard of Excellence.
Fiduciary Analytics

Fiduciary Analytics provides sophisticated Web-based tools and reporting, including the innovative Fiduciary Score™ and the Fund Family Fiduciary Rankings™.

Fi360

Mission: “To promote a culture of fiduciary responsibility and improve the decision making processes of investment fiduciaries.”

Creation of the 22 Practices
Objectives of the Practices

1. Define prudent processes for investment fiduciaries that are comprehensive, but not cumbersome.
2. Provide a checklist approach to guide any investment fiduciary in the pursuit of fiduciary excellence.
3. Enable any organization to assess its fiduciary activities to determine conformity to Global Fiduciary Standards of Excellence.

Process for creating the Practices

Compiled the data from Legislation, Case Law & Regulatory opinion letters
Was open to public comment on Web for two years 9,000 comments
AICPA served as technical editor
Fred Reish offered legal substantiation

Investment Fiduciaries

Stewards – Manage the investment decision making process (trustees, investment committee members, plan sponsors)
Advisors – Provide comprehensive and continuous investment advice (wealth managers, financial advisors, trust officers, financial consultants, investment consultants, financial planners)
Managers – Make investment decisions, and selects the individual securities to implement a specific investment mandate (such as large cap growth).
The Investment Steward

More than 5 million men and women who serve as:

- Members of investment committees of retirement plans, foundations, and endowments
- Trustees of private trusts

Stewards manage more than 80% of the nation’s liquid investable wealth, yet few have received formal training for their role.

The Investment Advisor

Most Stewards share their fiduciary responsibilities with Investment Advisors.

Even so, Investment Advisors:

- Are governed by a fragmented and outdated regulatory structure,
- Often have a limited understanding of the fiduciary code of conduct, and
- Have no uniform advanced education requirements.

Therefore, effective due diligence in selecting Investment Advisors is critical.

The Investment Manager

Investment Managers make investment decisions. They select the individual securities to implement a specific investment mandate (such as large cap growth).

There are 12,000+ Investment Managers in the U.S.¹

Examples include money managers who are responsible for separate accounts, mutual funds, commingled trusts, and unit trusts.

The Steward and Advisor have a fiduciary duty to demonstrate that Investment Managers have been prudently selected and monitored

¹ "Manager Statistics at a glance," Pensions & Investments, May 28, 2007
Responsibility vs. Liability

Fiduciary responsibilities can be shared but not abdicated.

Liability exposures exist where there are unfulfilled responsibilities.

Fiduciaries can reduce liability by identifying and filling gaps in their practices.
Assessment Levels

Legal Status

U.S. Legislation

ERISA - Employee Retirement Income Security Act (Qualified retirement plans)

UPIA - Uniform Prudent Investor Act (Private trusts, the default standard if nothing else “fits”)

UPMIFA - Uniform Prudent Management of Institutional Funds Act (Foundations, endowments, and government sponsored charitable institutions)

MPERS - Uniform Management of Public Employees Retirement Systems Act (State, county, and municipal retirement plans)
Legislation, Regulation and Professional Self-governance

- SEC Pension Study (2005)
- Pension Protection Act (2006)
- DOL disclosure initiatives (2008)
  - Changes to Form 5500
  - Section 408(b)(2) Rule Change
  - Disclosures to participants
- CFP Rules of Conduct

Global Fiduciary Precepts

1. Know standards, laws, and trust provisions
2. Diversify assets to specific risk/return profile of client
3. Prepare investment policy statement
4. Use “prudent experts” 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

Fiduciary Quality Management Series

Analogous to the ISO 9000 QMS Continual Improvement Process:

- Organize
- Formalize
- Monitor
- Implement
Components of a Standard

The 22 Practices
A Process
Substantiated in:
Legislation
Case Law
Regulatory Opinion Letters

Fiduciary Quality Management Series
Analogous to the ISO 9000 QMS Continual Improvement Process
Investment Steward and Advisor Practices

Step 1 - Organize

Practice SA-1.1: Managing investments in accordance with applicable laws, trust documents and written IPS
Practice SA-1.2: Roles and Responsibilities
Practice SA-1.3: Avoiding self-dealing
Practice SA-1.4: Service agreements and contracts in writing
Practice SA-1.5: Jurisdiction over assets

Practice SA-1.1

Investments are managed in accordance with all applicable laws, trust documents, and written investment policy statements.

- 1.1.1 Investments are managed in accordance with all applicable laws.
- 1.1.2 Investments held in trust are managed in accordance with trust documents.
- 1.1.3 Investments are managed in accordance with the written IPS.
- 1.1.4 Documents pertaining to the investment management process are filed in a centralized location.
Practice SA-1.2

The roles and responsibilities of all involved parties (fiduciaries and non-fiduciaries) are defined, documented, and acknowledged.

- 1.2.1 The roles and responsibilities of all parties are documented in the IPS.
- 1.2.2 All parties demonstrate an awareness of their duties and responsibilities.
- 1.2.3 All parties have acknowledged their status in writing.
- 1.2.4 Investment committees have and follow a defined set of by-laws.

Practice SA-1.3

Fiduciaries and parties in interest are not involved in self-dealing.

- 1.3.1 Policies and procedures for overseeing and managing potential conflicts of interests are defined.
- 1.3.2 All fiduciaries annually acknowledge the organization's ethics policies and agree to disclose any potential conflicts of interest.

Practice SA-1.4

Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

- 1.4.1 Service providers fully disclose, in writing, compensation arrangements and affiliations involved in each engagement, as well as their fiduciary status.
- 1.4.2 Agreements and contracts are periodically reviewed to ensure consistency with the needs of the managed assets.
- 1.4.3 Agreements and contracts are periodically reviewed by legal counsel.
- 1.4.4 Consideration is given to putting vendor contracts back out for bid every three years.
Step 2 - Formalize

Practice SA-2.1: Time horizon
Practice SA-2.2: Risk level and tolerance
Practice SA-2.3: Expected return
Practice SA-2.4: Asset class selection
Practice SA-2.5: Asset class implementation and monitoring
Practice SA-2.6: The IPS as the business plan
Practice SA-2.7: Optional SRI screens

An investment time horizon has been identified.
- 2.1.1 Sources, timing, distribution, and uses of cash flows are documented.
- 2.1.2 In the case of a defined benefit retirement plan, the appropriate asset/liability study has been factored into the time horizon.
- 2.1.3 In the case of a defined contribution retirement plan, the investment options must address the range of investment time horizons.
- 2.1.4 In the case of a foundation or endowment, the receipt and disbursement of gifts and grants has been factored into the time horizon.
- 2.1.5 In the case of a retail investor, the appropriate needs-based analysis has been factored into the time horizon.
- 2.1.6 Sufficient liquid assets for contingency plans are maintained.
Practice SA-2.2

A risk level has been identified for each client.

- **2.2.1** The level of risk the portfolio is exposed to is understood, and the quantitative and qualitative factors that were considered are documented.

- **2.2.2** A "worst case" scenario has been considered, and it has been determined that the portfolio has sufficient liquidity to meet short-term (less than five years) obligations.

Practice SA-2.3

An expected, modeled return to meet investment objectives has been identified

- **2.3.1** The "expected" or "modeled" return is consistent with the portfolio's goals and objectives.

- **2.3.2** The "expected" or "modeled" return assumptions for each asset class are based on risk-premium assumptions, as opposed to recent short-term performance.

- **2.3.3** For Defined Benefit plans, the expected return values being used for actuarial calculations are reasonable.

Practice SA-2.4

Selected asset classes are consistent with the risk, return, and time horizon.

- **2.4.1** Assets are efficiently diversified to conform to the specified time horizon and risk/return profile.

- **2.4.2** For participant directed plans, selected asset classes provide each participant the ability to diversify their portfolio appropriately given their time horizon and risk/return profile.

- **2.4.3** The methodology and tools used to establish appropriate portfolio diversification are effective and consistently applied.
Practice SA-2.5

Selected asset classes are consistent with implementation and monitoring constraints.

- 2.5.1 Individuals responsible for implementing and monitoring investment decisions have the time, inclination, and knowledge to do so effectively.
- 2.5.2 The process and tools used to implement and monitor investments in the selected asset classes are effective.
- 2.5.3 The ability to access suitable investment products within all selected asset classes has been considered.

Practice SA-2.6

There is an IPS which contains the detail to define, implement, and monitor the client’s investment strategy.

- 2.6.1 The IPS defines the duties and responsibilities of all parties involved.
- 2.6.2 The IPS defines diversification and rebalancing guidelines consistent with specified risk, return, time horizon, and cash flow parameters.
- 2.6.3 The IPS defines due diligence criteria for selecting investment options.
- 2.6.4 The IPS defines monitoring criteria for investment options and service vendors.
- 2.6.5 The IPS defines procedures for controlling and accounting for investment expenses.

Investment Steward and Advisor Practices

Step 3 - Implement
Step 3 - Implement

Practice SA-3.1: Investment due diligence
Practice SA-3.2: Safe harbors
Practice SA-3.3: Appropriate investment vehicles
Practice SA-3.4: Service providers selection

Practice SA – 3.1

3.1 The investment strategy is implemented in compliance with the required level of prudence

- 3.1.1 A due diligence procedure for selecting investment options exists.
- 3.1.2 The due diligence process is consistently applied.

Practice SA-3.3

Investment vehicles are appropriate for the portfolio size.

- 3.3.1 Decisions regarding passive and active investment strategies are documented and appropriately implemented.
- 3.3.2 Decisions regarding the use of separately managed and commingled accounts, such as mutual funds and unit trusts, are documented and appropriately implemented.
- 3.3.3 Regulated investment options are selected over unregulated options when comparable risk and return characteristics are projected.
- 3.3.4 Investment options that are covered by readily available data sources are selected over similar alternatives for which limited coverage is available.
Practice SA-3.4

A due diligence process is followed in selecting service providers, including the custodian.

• 3.4.1 A documented due diligence process is applied to select service providers.
• 3.4.2 The custodian has sufficient insurance to cover the portfolio amount.
• 3.4.3 The sweep money market fund selected is the custodian’s lowest cost share class available.

Investment Steward and Advisor Practices

Step 4 - Monitor

Practice SA-4.1: Quantitative Reviews
Practice SA-4.2: Qualitative Reviews
Practice SA-4.3: Control Procedures
Practice SA-4.4: Investment Management Fees
Practice SA-4.5: Asset Placement Fees
Practice SA-4.6: Periodic Review Process in Place
Practice SA-4.1

Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives

- 4.1.1 The performance of each investment option is periodically compared against an appropriate index, peer group, and due diligence procedures defined in the IPS.
- 4.1.2 The information that is provided in performance reports is evaluated and actions considered are documented.
- 4.1.3 "Watch list" procedures for underperforming Investment Managers are followed.
- 4.1.4 Rebalancing procedures are followed.

Practice SA-4.2

Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers.

- 4.2.1 Periodic evaluations of the qualitative factors which may impact Investment Managers and Investment Advisors are performed.
- 4.2.2 Unsatisfactory news regarding an Investment Manager and/or Investment Advisor is documented and acted upon.

Practice SA-4.3

Control procedures are in place to periodically review policies for best execution, “soft dollars,” and proxy voting

- 4.3.1 Control procedures are in place to periodically review policies for best execution.
- 4.3.2 Control procedures are in place to periodically review policies for “soft dollars.”
- 4.3.3 Control procedures are in place to periodically review policies for proxy voting.
Practice SA-4.4
Fees for investment management are consistent with agreements and with all applicable laws

• 4.4.1 A summary of all parties that have been compensated from portfolio assets has been documented, and the fee has been determined to be reasonable in light of the services rendered.

• 4.4.2 The fees paid to each party are periodically examined to determine whether they are consistent with services agreements.

• 4.4.3 The fees being paid for various services are periodically evaluated for reasonableness.

Practice SA-4.5
“Finder’s fees” or other forms of compensation that may have been paid for asset placement are appropriately applied, utilized, and documented.

• 4.5.1 All parties compensated from portfolio assets have been identified, along with the amount (or schedule) of their compensation.

• 4.5.2 Compensation paid from portfolio assets has been determined to be fair and reasonable for the services rendered.

Practice SA-4.6
There is a process to periodically review the organization’s effectiveness in meeting its fiduciary responsibilities.

• 4.6.1 Effectiveness of fiduciary Practices is periodically reviewed in order to foster continued improvement.

• 4.6.2 Assessments are conducted at planned intervals to determine whether (a) appropriate policies and procedures are in place to address all fiduciary obligations, (b) such policies and procedures are effectively implemented and maintained, and (c) the IPS is up-to-date.

• 4.6.3 Assessments are documented, conducted in a manner that ensures objectivity and impartiality, and results are reviewed for reasonableness.
GOOD INVESTMENTSENSE

The twenty-two Practices are intended to assist fiduciaries in understanding the breadth and scope of their investment duties and responsibilities.

Practices also make good investment sense. Superior investment returns result from developing a prudent investment process, and then sticking with it.

Practices provide the foundation and framework for an investment process, and will help prevent making ad hoc investment decisions influenced by emotions and/or market noise.

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Review sample IPS
Thank You!

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Greg@nwasset.com

QUESTIONS?