Expanding the Fiduciary Scorecard

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Investment research and due diligence have been passions of mine for a very long time. My background is in investment management, and more specifically in building fully diversified portfolio models for individual investors. As I started to do more work in the retirement plan market, I noticed differences of investment processes between those advisors serving individual client families and those serving retirement plan clients.

Most advisors that manage portfolios for individual investors do not have a tool that quantifies the investment due diligence process and can be delivered to the investor. However, the retirement plan market places a large emphasis on the process used by investment fiduciaries to demonstrate the quality of investment options and, therefore has historically demanded more documentation from advisors. Out of this came a number of fiduciary score cards that attempt to rate and rank investment alternatives. These score cards are beneficial because they provide an intuitive framework and act as an executive summary for plan sponsors and advisors to review their retirement plans. This documented process is important for all clients, individual client families and retirement plans. And, an increasing number of individual client families would appreciate some output that documents their advisor's investment due diligence process.

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In analyzing how asset managers construct and manage individual client portfolios, security evaluation (investment due diligence) is just one stage of a greater process. As I evaluated the score cards used in the retirement plan market, I found that they are all centered on this one stage of the investment process. And, as an investment fiduciary, I was troubled by the fact that there are more components to a successful investment strategy. No two clients are the same, but those that are looking for a comprehensive investment fiduciary require a comprehensive score card.

There are a number of components that advisors implement when constructing and managing the investments used by individual client families and retirement plan clients. It would be powerful to develop a scorecard system that quantifies the performance of these various investment processes with respect to a broader group of categories. This would better position clients to more effectively monitor and understand their financial condition. There are four key components that would need to be assessed which are portable to a wide variety of clients seeking a holistic, comprehensive investment fiduciary.

Investment Policy

An increasing number of clients are implementing Investment Policy Statements (IPS), though it is still much more common in the higher net worth and institutional markets. Regardless, it is a critical tool that should be considered for all investors regardless of net worth. A proper IPS should articulate a number of issues:

- *Investor Objectives*: Each investor will have different goals but it is critical to outline the risk and return objectives as well as any investment constraints to help ensure the investment strategy is a match for the client situation.
- *Purpose & Limitations:* The overall objectives and limitations of the policy should be outlined and updated on a periodic basis to remain relevant to each client's changing circumstances.
- *Roles & Responsibilities:* Unfortunately, assumptions and misunderstandings among the various parties involved with the client account occur all too often and cause inaccuracies in the investment process. These roles and responsibilities should be clearly defined to keep the focus on the client's goals.
- *Investment Process:* The investment approach and philosophy should be detailed and fully transparent so that all parties have appropriate expectations and a proper understanding.

Asset Class Coverage

Most investment professionals agree that performance is driven primarily by asset allocation, yet the majority of advisors don't have a process in place to define the various asset classes or continually monitor the investment landscape. This is problematic because there is no standardized list of the available asset classes and there are a number of different methodologies used to classify investments. For example, some advisors consider US Large Cap Stocks as one asset class. Others treat Large Value, Blend and Growth style stocks as three distinct assets classes, and still others define each industry sector within the US Large Cap space as separate asset classes. Regardless, it is critical to define and outline the classification methodology so that investors have an appropriate understanding. All available asset classes do not need to be used for each investor but they should be considered and analyzed by the investment professional to help investors most effectively meet their unique objectives. Furthermore, there are a number of alternative investments that should be considered in this highly correlated environment, helping to increase portfolio efficiency. Especially in the case of retirement plans, there is tremendous value in having a complete lineup of asset class options for plan participants.

Security Evaluation

Advisors should employ a systematic evaluation process to analyze, select and monitor each client's investment options. There are various evaluation criteria that can be included in this process, but the goal should be to achieve higher and more consistent returns for investors. Many of these metrics are quantified by comparing the results of each investment option to that of an appropriate benchmark. This can be difficult at times because there are a number of alternative asset classes that do not have benchmark data available. Many of these rating systems will disregard these asset classes for this reason alone which puts restrictions on the asset class options and can limit long-term risk adjusted returns. Another difficulty is the misclassification of investment options. Again, because benchmark data is limited and style drift is alive and well, misclassifications are common causing skewed ratings. Although there are potential limitations, a well defined, rigorous evaluation process is essential to the ongoing monitoring of each client's investment options.

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Steve is the Chief Investment Officer for Advisory Alpha, an SEC Registered Investment Advisor. He and his team have developed a series of industry leading investment solutions that are distributed through select investment advisors across the country. Steve leads the investment team and manages a diverse group of fee-only portfolio strategies in addition to providing investment fiduciary services to retirement plans. He also conducts advisor training and education designed to make advisors as effective as possible in helping their clients meet their financial goals.

Portfolio Management Process

The portfolio management process employed is essential to maintain discipline for investors. Numerous individual client families have no portfolio management process in place and many retirement plan clients have no portfolio models even available to plan participants. Portfolio models are the next logical progression for plan participants; there have been severe shortcomings of participants selecting their own allocations as well as the vast limitations of target date funds. There are a number of steps needed for a successful portfolio management process.

- *Selection of Asset Classes:* The asset allocation of the various portfolio models must be consistent with the investment mandates. And, true diversification of traditional and alternative asset classes should be employed to maximize returns at each risk level.
- *Asset Allocation Process:* There is a wide variety of methods used to construct the portfolio asset allocation. Regardless of the specific approach used by the investment manager, the process should be clearly specified and followed.
- *Selection of Portfolio Holdings:* Depending on the investment vehicles used by the investment manager, the selection process may vary. However, it is important that the criteria and process is outlined to ensure consistency.
- *Rebalancing Process:* The client account allocation will slowly deviate away from the portfolio model allocation. Therefore, a disciplined rebalancing process is needed to maintain the integrity of the intended allocation. There are two common approaches that are widely used in the industry: Calendar Rebalancing where the entire portfolio is rebalanced according to a predetermined time schedule, and Percentage of Portfolio Rebalancing where individual portfolio holdings are rebalanced when they fall outside of a prescribed tolerance band. Regardless of the specific approach, the strategy should be clearly articulated and followed.
- *Benchmarking/Monitoring:* It is important to select appropriate benchmarks based on the risk tolerance, management style and investment approach for each portfolio model. If an incorrect benchmark is selected, it becomes difficult to properly monitor the portfolio model. Therefore, the criteria used to select the benchmarks should be accurate and documented by the investment manager.

The Security Evaluation stage is typically the sole purpose of many of the fiduciary scorecard systems available in the retirement plan community. Although extremely beneficial for clients desiring fiduciary guidance for this specific function, these scorecards do not address all components of the investment process. Ultimately, many clients do not want to manage this comprehensive investment review process yet still need to have an awareness of the process and results. There are a number of powerful fiduciary tools available to advisors and clients, which can be very effective as a part of the overall fiduciary process. A broader, comprehensive scorecard system built with this purpose can provide clients with a n intuitive, executive summary of their total investment position giving them peace of mind thus helping advisors provide more effective investment fiduciary services.