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Step 2 of the Fiduciary Process: Formalizing the Investment Strategy

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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)

MMPERSA:

Uniform Management of Public Employees Retirement Systems Act (State, county, and municipal retirement plans)

IAA:

The Investment Advisers Act of 1940

Global Fiduciary Precepts

01 Follow laws and governing documents

02 Diversify to manage risk and return

03 Prepare and follow an investment policy statement

04 Prudently select fiduciary and non-fiduciary service providers

05 Control and account for costs

06 Avoid or manage conflicts of interest

07 Monitor service providers

08 Monitor and assure conformity to fiduciary obligations

Job Task Analysis

Scope

Subject Matter Experts

Survey

Governance Approval

Periodic Table of Fiduciary Practices

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PRACTICE 1.1
The investment advisor demonstrates an awareness of fiduciary duties and responsibilities.

PRACTICE 2.1
An investment time horizon has been identified for each investment objective of the client.

PRACTICE 2.2
An appropriate risk level has been identified for the portfolio.

PRACTICE 1.2
Investments and investment services provided are consistent with governing documents.

PRACTICE 1.3
The roles and responsibilities of all involved parties, whether fiduciaries or non-fiduciaries, are defined and documented.

PRACTICE 2.3
The distribution of projected portfolio returns is evaluated in the context of the client's risk and return objectives.

PRACTICE 2.4
Selected asset classes are consistent with the portfolio's time horizon and risk and return objectives.

PRACTICE 1.4
The investment advisor identifies material conflicts of interest and avoids or manages conflicts in a manner consistent with the duty of loyalty.

PRACTICE 1.5
Agreements under the supervision of the investment advisor are in writing and do not contain provisions that conflict with fiduciary obligations.

PRACTICE 2.5
Selected asset classes are consistent with implementation and monitoring constraints.

PRACTICE 2.6
The investment policy statement contains sufficient detail to define, implement, and monitor the portfolio's investment strategy.

PRACTICE 1.6
Sensitive personal identifying information and assets of clients are prudently protected from theft, embezzlement, and business disruption risks.

PRACTICE 2.7
Investment due diligence using environmental, social, and governance (ESG) factors conforms to governing documents and the fiduciary obligations of investment decision-makers.

PRACTICE 4.1
Periodic reviews compare investment performance against appropriate market and peer group benchmarks and overall portfolio objectives.

PRACTICE 3.1
A prudent due diligence process is followed to select each service provider.

PRACTICE 4.2
Periodic reviews are made of qualitative and/or organizational changes of investment managers and other service providers.

PRACTICE 4.3
Procedures are in place to periodically review policies for trading practices and proxy voting.

PRACTICE 3.3
Decisions regarding investment strategies and types of investments are made in accordance with fiduciary obligations and are documented.

PRACTICE 3.2
Statutory or regulatory investment safe harbors that are elected are implemented in compliance with the applicable provisions.

PRACTICE 4.4
Periodic reviews are conducted to ensure that investment-related fees, compensation, and expenses are fair and reasonable for the services provided.

PRACTICE 4.5
There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

Step 2 - Formalize

- Analyze plan data
- Work through the hierarchy of investment decisions
- Document strategy in investment policy statement
- Environmental, social, and governance strategies

THE HIERARCHY OF DECISIONS

Most Important

Least Important

Time Horizon – Investment Strategy

Appropriate level of risk/return

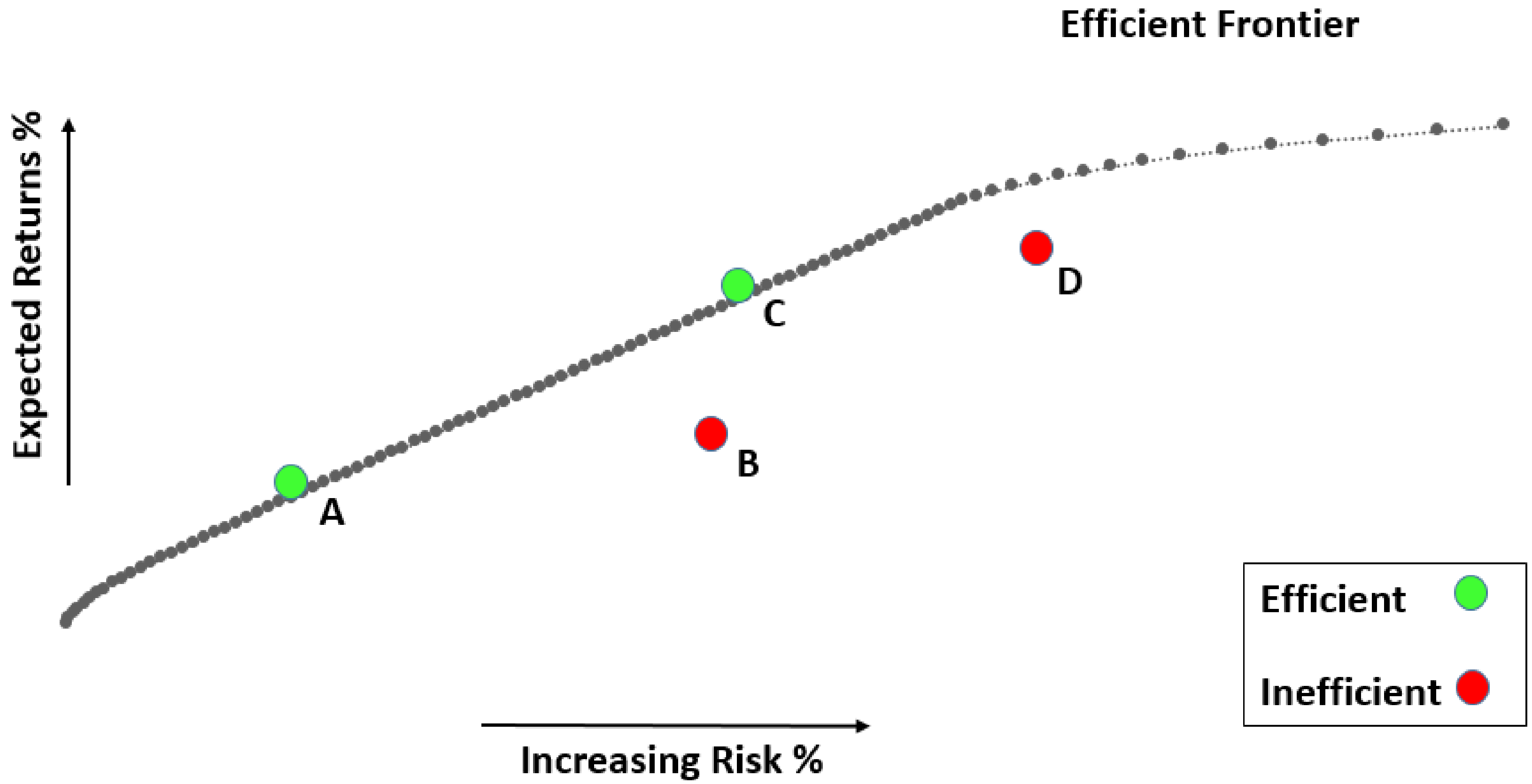
Asset Classes Considered

Mix among Asset Classes

Sub – Asset Classes

Managers/Funds

Efficient Frontier



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PRACTICE 2.1

An investment time horizon has been identified for each investment objective of the client.

CRITERIA

2.1.1 Sources, timing, distribution, and uses of cash flows are documented.

2.1.2 In the case of an individual investor, an appropriate needs-based analysis has been factored into the time horizon.

2.1.3 In the case of a defined benefit retirement plan, an appropriate asset/liability study has been factored into the time horizon.

2.1.4 In the case of a defined contribution retirement plan, the investment options provide for a reasonable range of participant time horizons.

2.1.5 In the case of a foundation or endowment, a schedule of expected receipts and disbursements of gifts and grants has been factored into the time horizon to the extent possible and an estimated equilibrium spending rate has been established..

Retail Investors

- Financial planning variables related to the time horizon:
  - Goals and objectives
  - Pro-forma financial statements
  - Investment “buckets”
  - Overlay management is required

Defined Benefit Plans

- Pooled portfolios with a long time horizon allow sophisticated management:
  - Asset/liability study is critical

Defined Contribution Plans

- Portfolios in trustee-directed DC plans can be managed in a manner similar to DB plans
- Participant directed DC plans must allow individuals to invest/diversify properly:
  - Individual options
  - Qualified Default Investment Alternative (QDIA)
  - Participant advice
  - Auto enroll & auto escalate deferral features

Foundations and Endowments

- Uniform Prudent Management of Institutional Funds Act (UPMIFA):
  - provides more flexibility in endowment spending than UMIFA
  - creates a presumption of imprudence if the spending rate is > 7%
- Private non-operating foundations have a 5% distribution requirement
- UPIA can apply to non-corporate charities and supports Modern Portfolio Theory

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PRACTICE 2.2

An appropriate risk level has been identified for the portfolio.

CRITERIA

2.2.1 The expected volatility of the portfolio is understood by the investment advisor and communicated to the client, and the quantitative and qualitative factors that were considered are documented.

2.2.2 “Large loss” scenarios have been identified and considered in establishing the portfolio’s risk level.

2.2.3 Expected disbursement obligations and contingency plans have been considered when establishing liquidity requirements for the portfolio and assessing the capacity to assume portfolio risk.

2.2.4 In the case of a defined contribution retirement plan, the investment options provide for a reasonable range of participant risk tolerance levels.

Risk

- A necessary level of risk is required to cover short- and long-term liabilities and/or objectives
- Fiduciaries can “fail” by being either too conservative or too aggressive.
- Consider worst, best, and most likely cases to better understand the consequences to participants.

Risk and Return

Disbursement Obligations

- For single portfolios (e.g., DB plans, endowments, and foundations), short-term disbursement obligations dictate allocations to fixed income asset classes.
- To avoid disruptive trading, consider a specific allocation to cash.

DC Plan Considerations

- Multiple portfolios or participant accounts
- Review employee demographics
- Plan investment options should address risk tolerance variations

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PRACTICE 2.3

The distribution of projected portfolio returns is evaluated in the context of the client's risk and return objectives.

CRITERIA

2.3.1 The projected portfolio return is consistent with the client's tolerance and capacity to assume volatility risk and investment goals and objectives.

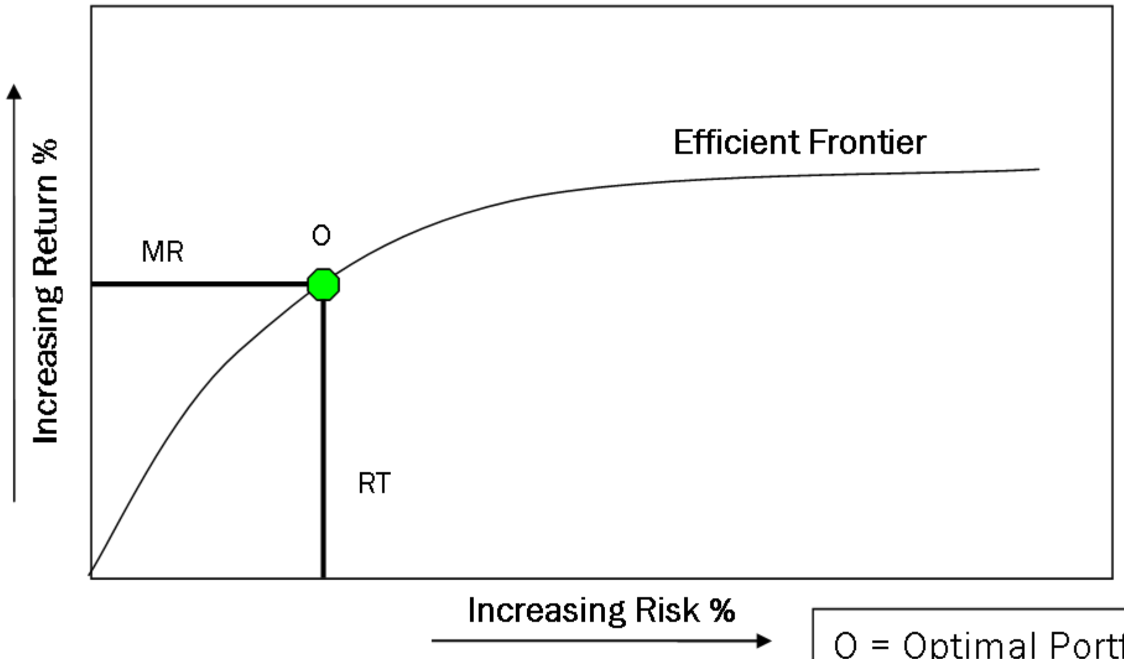
2.3.2 Projected return assumptions for each asset class are based on reasonable risk premium assumptions.

2.3.3 For defined benefit plans, the projected return values used for modeling are reasonable and are also used for actuarial calculations.

2.3.4 For defined contribution plans, the projected returns for pre-allocated options, such as target date funds or model portfolios, are based on reasonable risk premium assumptions.

2.3.5 For endowments and foundations, the projected return values used for modeling are reasonable and are consistent with distribution requirements or the projected equilibrium spending rate.

Projected Return



O = Optimal Portfolio

MR = Modeled Return

RT = Risk Tolerance

Reasonable Assumptions

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Asset Class (assigned Fi360 peer group)	10-Year Returns (2008-2017)	5-Year Returns (2013-2017)	3-Year Returns (2015-2017)	1-Year Returns (2017)	Annualized Modeled Returns (2018)
Large Cap Equity (Large Blend)	7.74	14.70	10.08	20.98	5.9
Mid-Cap Equity (Mid-cap Blend)	8.38	13.69	8.46	15.78	6.75
Small Cap Equity (Small Blend)	8.17	13.40	9.11	12.73	6.7
International Equity (Foreign Large Blend)	1.74	7.29	7.68	25.34	6.5
Emerging Market Equity (Diversified Emerging Mkts)	1.75	4.28	8.59	35.58	8.3
REITS (Real Estate)	6.93	8.51	4.89	5.20	5.9
International Bonds (World Bond)	3.80	1.08	2.02	7.05	2.2
High Yield Bonds (High Yield Bond)	6.60	4.77	5.08	6.64	4.7
Long Term Bonds (Long-Term Bond)	7.36	4.48	4.56	10.51	2.85
Intermediate Term Bonds (Intermediate-Term Bond)	4.17	2.05	2.20	3.77	2.85
Commodities - Gold (Commodities Precious Metals)	2.63	-7.60	1.59	10.80	3.75
T-Bills (Money Market Taxable)	0.23	0.10	0.16	0.47	2.7

* Data as of December 31, 2017. 1-,3-,5- and 10-year returns based of the median mutual fund return for the peer group assigned by Fi360. Annualized Modeled Returns based of the Capital Market Assumptions provided to Fi360 by MacroRisk Analytics

Return Factors in DB Plans

- Actuarial calculations determine current and future benefit obligations and funding status.
- Expected return figures used by the actuary should align with those determined by the investment advisor or consultant.

Return Factors in DC Plans

- Primary consideration when building/reviewing a DC plan menu:
  - Are expected return assumptions reasonable?
- For target date funds, understand the fund's investments, including:
  - Underlying asset classes
  - The fund's glide path

Source: DOL Guidance, "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries." February 2013.

Return Factors in Foundations and Endowments

- Regarding endowments and foundations:
  - Are expected return values used for modeling reasonable?
  - Are they consistent with ESR calculations?

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PRACTICE

2.4

Selected asset classes are consistent with the portfolio's time horizon and risk and return objectives.

CRITERIA

2.4.1 Asset classes are appropriately weighted to conform to the portfolio's specified time horizon and risk/return profile.

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

2.4.3 The methodology and tools used to establish appropriate portfolio allocation are prudent and consistently applied.

Diversification to Policy Portfolio

- **T** — **TIME HORIZON of the client** (Practice A-2.1)
- **R** — **RISK LEVEL of the client** (Practice A-2.2)
- **E** — **EXPECTED RETURN necessary to meet client's goals and objectives** (Practice A-2.3)
- **A** — **ASSET CLASS preferences of the client**
- **T** — **TAX STATUS of the client**

Aligning Allocation to Risk and Return

- RA = RFR + ßA (RM – RFR) + ε
- Policy portfolio:
  - Established by strategic asset allocation
  - Driven by BETA
  - Ideally used to hedge liabilities
- Pricing portfolio:
  - Relates to absolute returns in inefficient markets
  - Driven by ALPHA
  - Products usually bundle pricing and policy portfolios

Allocation Issues in Participant-Directed Plans

- "1/n" Phenomena
- Even more participants select only one option
- Age- or risk-based funds or models are generally desirable
- Money market or stable value funds are generally a poor default option

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PRACTICE

2.5

Selected asset classes are consistent with implementation and monitoring constraints.

CRITERIA

2.5.1 The investment advisor has the time, resources, knowledge, and skills to implement and monitor all selected asset classes.

2.5.2 The process and tools used to implement and monitor investments in the selected asset classes are appropriate.

2.5.3 Appropriate investment products are accessible within each selected asset class.

An Approach for Adding Asset Classes

# OF OPTIONS		ASSET and SUB-ASSET CLASSES
3		Large Blend, Multisector Fixed & Cash
4	Add	International Equity Blend
5	Add	Small Blend
6	Add	Intermediate Fixed
7	Add	Mid-Cap Blend
8	Add	Large Value, Large Growth
9	Add	Emerging Markets
10	Add	Real Estate
11	Add	High-Yield Fixed
12	Add	International Bond

Alternative Investments

- Alternative investments should be examined in light of policy versus pricing and must address:
  - Why are alternatives being considered?
  - What alternatives will be used?
  - Who will implement and who will monitor them?
  - Where (which asset classes) will the investments be made?
  - When will the investments be made and reviewed?
  - How will the investments be governed?
  - How much will be devoted to these investments?

Asset Allocation – Lessons Learned

1. Intuition is a good guide for the prudent expert.
2. Keep the big picture in mind when establishing capital markets inputs and using asset allocation tools.
3. Asset allocation is a social science – the optimal solution must reflect the needs of the client.
4. Professional liability increases exponentially with the number of places to the right of the decimal point.
5. What you allocate you must also implement and monitor.

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PRACTICE 2.6

The investment policy statement contains sufficient detail to define, implement, and monitor the portfolio's investment strategy.

CRITERIA

2.6.1 The investment policy statement identifies the bodies of law governing the portfolio.

2.6.2 The investment policy statement defines the duties and responsibilities of all parties involved.

2.6.3 The investment policy statement specifies risk, return, and time horizon parameters.

2.6.4 The investment policy statement defines asset weighting and rebalancing guidelines consistent with risk, return, and time horizon parameters.

2.6.5 The investment policy statement defines due diligence criteria for selecting investment options.

2.6.6 The investment policy statement defines procedures for controlling and accounting for investment expenses.

2.6.7 The investment policy statement defines monitoring criteria.

The Need for an IPS

- The business plan for the portfolio.
- Sufficient detail for a competent third party to implement.
- Not so detailed to require constant revisions and updates.

Benefits of an IPS

- Provides a paper trail to rely upon in the event of a legal challenge or dispute
- Prevents “Monday morning quarterbacking”
- Keeps investment process intact during market upheaval
- Provides implementation guidance in estate planning
- Reassures donors of investment stewardship

Outline for an IPS

- Executive Summary
- Roles and Responsibilities
- Asset Allocation and Rebalancing
- Due Diligence Procedures
- Monitoring
- Attachments

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PRACTICE 2.7

Investment due diligence using environmental, social, and governance (ESG) factors conforms to governing documents and the fiduciary obligations of investment decision-makers.

CRITERIA

2.7.1 The client's goals, objectives, and investment parameters are evaluated to determine whether ESG investing is necessary and/or desirable.

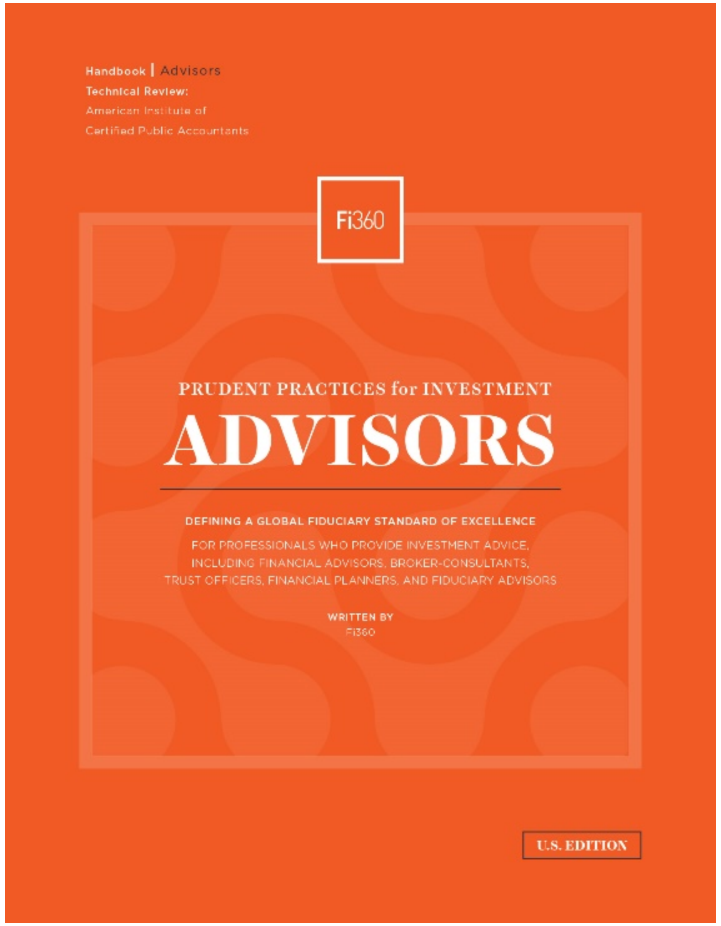
2.7.2 Provisions regarding ESG investing in governing documents are aligned with fiduciary obligations.

ESG Factors

- **Environment** – Legal and regulatory factors are likely to force analysts to consider the risk of investing in environmentally unfriendly companies.
- **Social Issues** – “Special value” can be assigned to avoiding financial support for moral outrages.
- **Governance** – Fiduciaries can influence business decisions, such as excessive executive compensation, by demanding seats on corporate boards of directors and voting proxies to foster corporate accountability. Good governance can also be a good indicator of a healthy organization that is positioned to succeed.

Due Diligence for ESG

- Develop a level of expertise in ESG sufficient to understand and properly structure an appropriate strategy
- Implement only strategies that are highly unlikely to damage – and preferably improve – long term risk adjusted performance
- Monitor the consistent application and effectiveness of the ESG strategies employed



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Q & A

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Additional questions can also be sent to support@fi360.com

THANK YOU