

Fi360

Step 2 of the Fiduciary Process: Organizing the Client Engagement

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Topics

- Recognize what it means to be a fiduciary
- Identify the seven fiduciary precepts that comprise a fiduciary process
- Recognize the four-step Fiduciary Quality Management System
- Understand the importance of formalizing a client portfolio

Definition of “fiduciary”

When someone is managing the assets of another person and therefore stands in a special relationship of trust, confidence, and/or legal responsibility.



The Core Fiduciary Duties

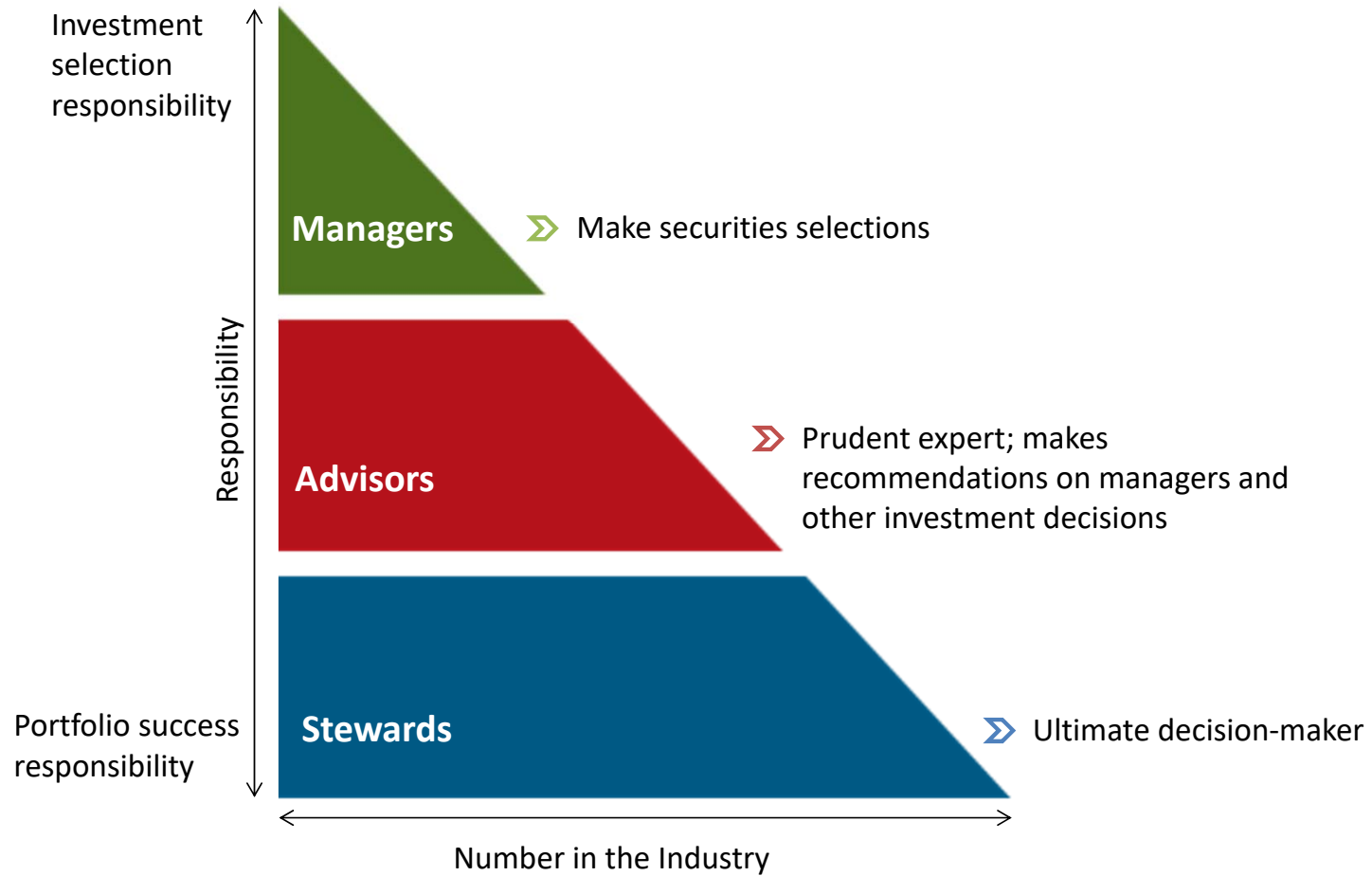
Duty of Loyalty:

- Best interest of client
- Acting in good faith
- Managing conflicts in accordance with client best interest

Duty of Care:

- Competence
- Demonstrating good judgment, knowledge and diligence
- Documentation

Roles and Responsibilities



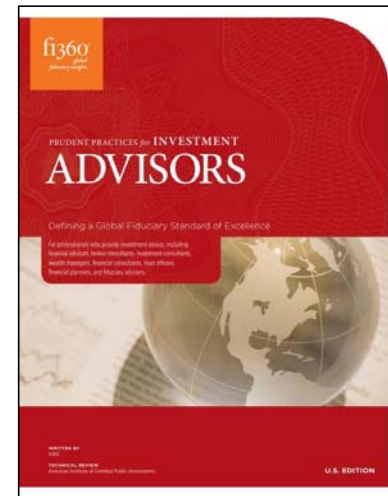
Process, Not Performance

- A fiduciary's conduct is measured by the process employed, not by the investment outcomes obtained.
- Fiduciary excellence is prudent processes, consistently applied.

Fi360's Prudent Practices

Legal Substantiation from:

- **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)
- **UMPERSA:** Uniform Management of Public Employees Retirement Systems Act (State, county, and municipal retirement plans)
- **IAA:** The Investment Advisers Act of 1940



Global Fiduciary Precepts

1. Know standards, laws, and trust provisions
2. Diversify assets
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



1. Rules



2. Diversify



3. IPS



4. Due Diligence



5. Expenses



6. Monitor



7. Conflicts

The Fiduciary Quality Management System (FQMS)



Step 2 - Formalize

- Analyze plan data
- Work through the hierarchy of investment decisions
- Document strategy in investment policy statement



Diversification

- Diversification is the mixing of a variety of investment types in order to reduce overall portfolio risk.
- ERISA requires diversification unless clearly prudent not to do so.
- Participant-directed plans must provide sufficient asset classes to enable participants to prudently diversify their individual portfolios.

Defining the Investment Profile

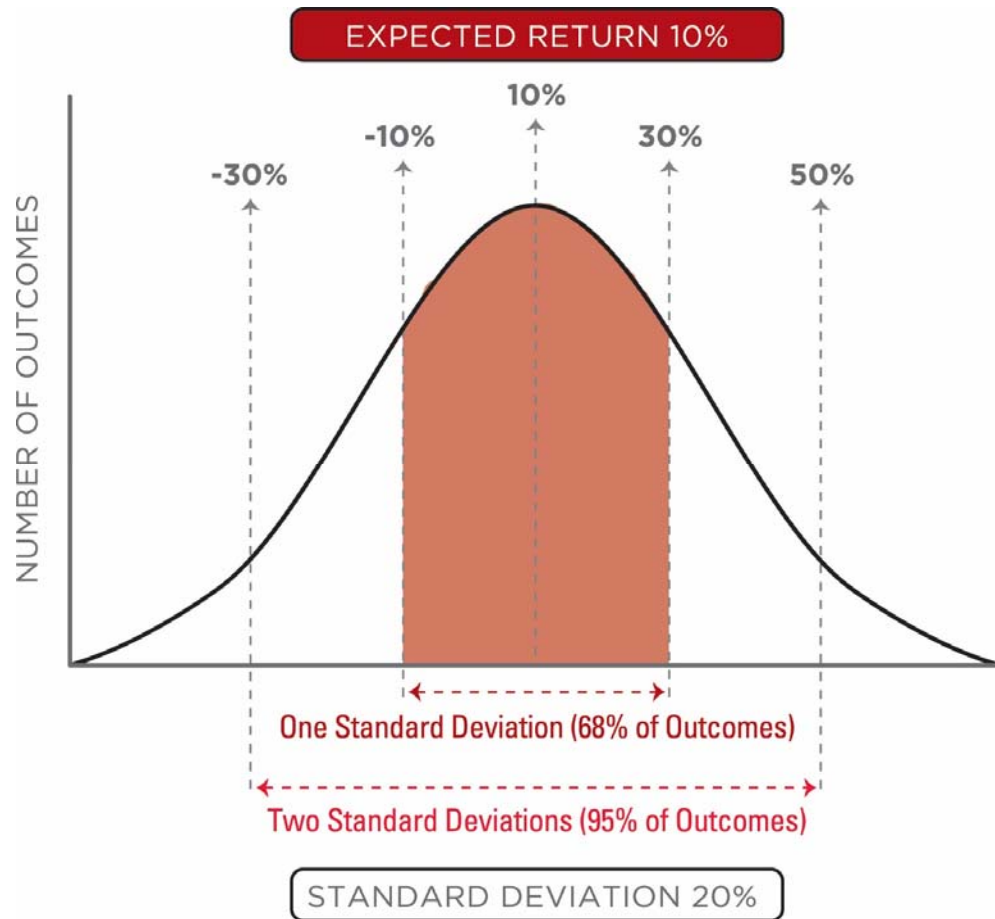
THE HIERARCHY OF DECISIONS



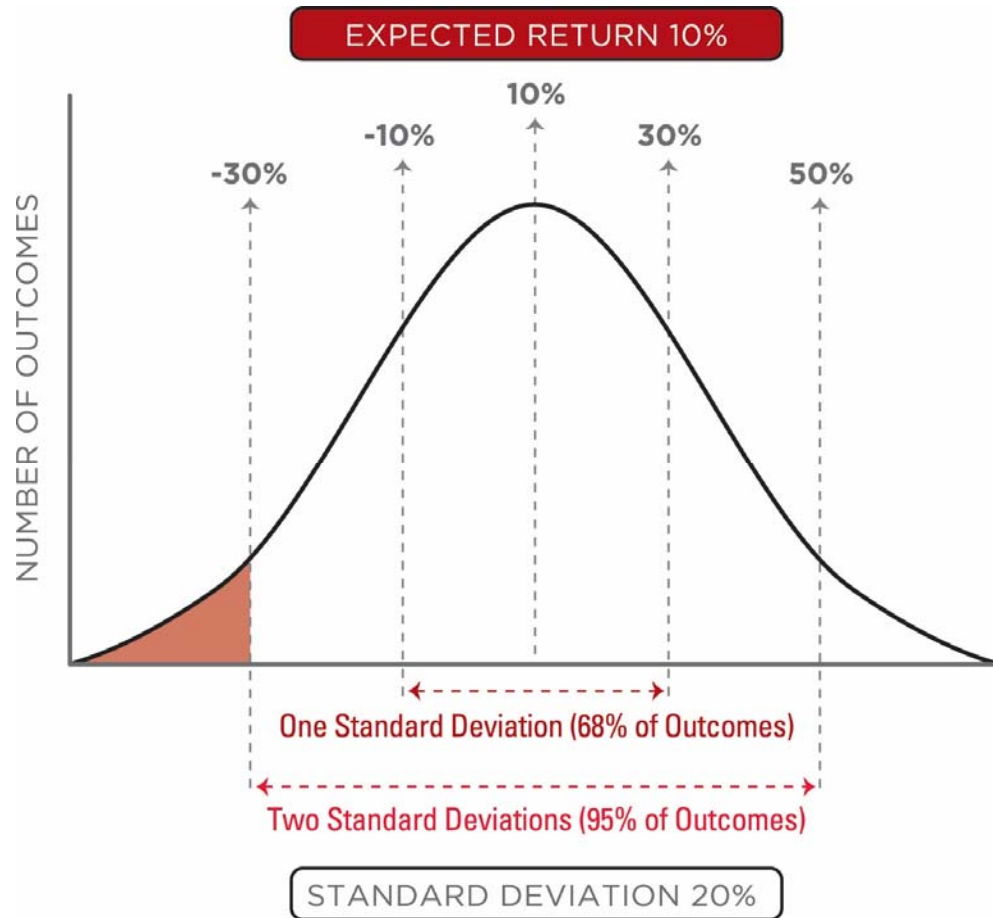
Risk

- 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.

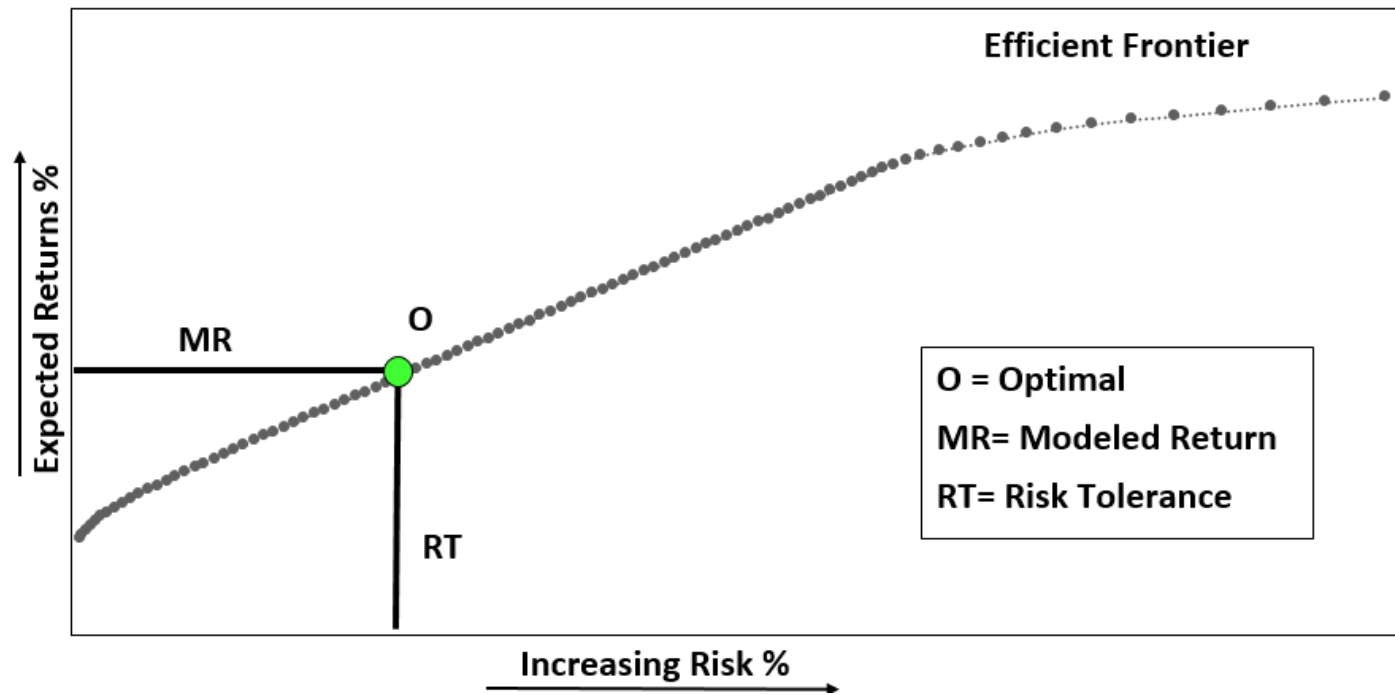
Probable Return Scenario



“Large Loss” Scenario



Modeled Return



Modeled Return Factors

- Ensure expected return assumptions are 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.

Asset Class Selection

Under ERISA, plan must offer a “broad range” of investment options that “in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk-and-return characteristics at any point within the range normally appropriate for the participant or beneficiary”

Allocation Issues in Participant-Directed Plans

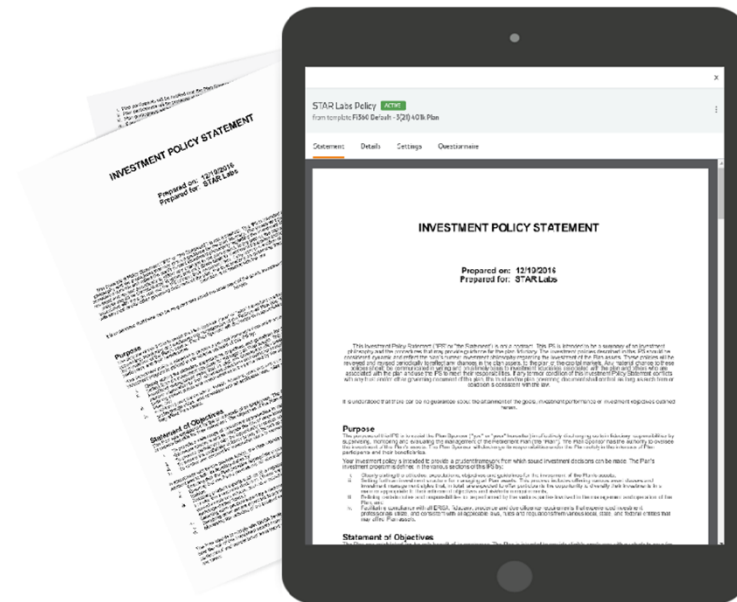
- “1/n” Phenomena
- Even more participants select only one option
- Age- or risk-based funds or models are generally desirable
- Money market or stable value funds are generally a poor default option

Suggested Sequence 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

The Investment Policy Statement (IPS)

- The critical management tool to direct the activities of the investment process.
- Preparing and following a well-crafted IPS facilitates consistent decision-making, clarifies roles and responsibilities, and documents all investment processes.



The Need for an Investment Policy Statement

- In finding a fiduciary breach for not establishing an IPS, one court stated:

“ERISA does not contain a specific requirement that a written investment policy be maintained by the trustee. I find, at least in this instance, that such a policy is necessary to insure that the plan investments are performing adequately and meeting the needs of the Funds.”

Liss v. Smith, 991 F.Supp. 278 (S.D.N.Y. 1998)

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
- Prudent practices, consistently applied, year after year

Building an IPS

- IPS Essential Elements:
 - Plan purpose including governing law
 - Duties and responsibilities
 - Risk, return, and time horizon parameters
 - Diversification and rebalancing guidelines
 - Due diligence criteria for selecting investment options
 - Procedures for controlling and accounting for investment expenses
 - Monitoring criteria for investment options and service vendors
 - Signatures

Using the IPS to Limit Liability

- Have it reviewed by an attorney
- Have it signed by all parties named in the document
- Implement the policy by following the written guidelines when selecting and monitoring plan investments and service providers
- Document that the IPS is being followed during annual reviews and update if necessary

Practical IPS Takeaways

- IPS critical to documenting plan fiduciary prudence.
- Most IPS documents could be improved.
- Understanding key IPS components can open doors and provide advisor opportunities.
- Be the educator and the expert.

When is SRI appropriate?

- Trust documents for an endowment or foundation specify that social screens will be applied.
- When a donor specifically identifies social screens in their gift.
- It is implied from the organization's mission that social screens will be applied.

Due Diligence for SRI

- Develop a level of expertise in SRI 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 SRI strategies employed

Methods of Implementing SRI Strategies

- Screening
- Shareholder advocacy
- Community investing

Application of ESG Factors in SRI Screening

- **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.

Questions, Answers and Discussion

Additional information on fiduciary trends can be found at Fi360 Fiduciary Talk Podcast www.fi360.com/fiduciarytalk (also available on iTunes)
and the Fi360 Blog www.fi360.com/blog