CIO

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ON THE JOB

Due diligence is not just corporate wallpaper: it's your insurance policy when you have to defend your outsourcing picks.

Reported by Joanne Cleaver

What a mess. In 2009, New Mexico's State Investment Council discovered that more than a dozen politically connected "entities and individuals" had failed their fiduciary responsibilities or aided and abetted that breach, revealing a labyrinth of corruption at the fund, which then had assets of $11.46 billion, largely in permanent funds. Much of the problem was rooted in placement fees paid by external managers to a few politically-connected advisors.

Rebuilding started in 2010 with sweeping legislative changes that "removed critical investment decisions from the hands of one or two individuals, placing them more appropriately with the Council as a whole," according to the council's published reports.

It has taken several years of reforms and restructuring for the council to realign legacy investments and integrate a new, transparent, accountable culture that pivots on continual due diligence, ongoing audits, and a ‘trust and verify’ philosophy. The key, said Steven Moise, New Mexico’s state investment officer, is to “institutionalize best practices. If you don’t have the right systems in place, chances increase that things won’t go well in the future.” New Mexico now outsources all of its investment management to a spectrum of vetted firms and balances that with a staff compliance officer, regular internal audits, and a layered investment decision- making process with checks and balances at each step.

The public and stakeholders demand more transparency than ever. No aspect of management, from diversity to executive pay, escapes notice. Controversy can spark instantly about the decisions made by committees overseeing investment funds, all sorts of retirement funds, and other types of assets. CIOs and their staffs are raising their games with more stringent best practices for hiring consultants and asset managers.

No longer corporate wallpaper, due diligence is now an ongoing process, not a static ‘one and done’ step in the vetting process. It’s a way of managing ongoing relationships, because transparency builds trust. And when the inevitable questions come up and the CIO must explain why she picked a particular outsourcer, due diligence becomes her closest ally. That moment might come when a fund’s performance slides.

It might come when the firm trips up on a seemingly simple administrative tasks.

It might come when fees erode net returns, threatening to upend cash flow and benefit payments.

Fiduciary responsibility doesn’t come with a crystal ball, however. It’s more important to know how to respond to the unexpected than to try to predict every potential glitch. Partnering with the right firm to begin with means that the solutions emerge along with the problems.

Policies and Process

Adopting and implementing a clear investment policy is a nearly universal best practice. Still, some investment committees ignore their own policies, said Stephen McCaffrey, board chair of the Plan Sponsor Council of America (PSCA), a Chicago-based employer consortium that represents employers that offer defined contribution retirement plans. “The policy sets the investment philosophy and guidelines,” he said—“for instance, the proportion of the pension, say, that will be invested in private equity. Once you have the policy, you go out and select the funds.” But, he added, “if you have a policy and don’t follow it, you could have exposure. And you have to keep it up to date or it can actually work against you.”

	YES	NO	NOT SURE
2006	80.1%	11.1%	8.7%
2007	83.5%	9.1%	7.4%
2008	84.8%	7.9%	7.4%
2009	85.8%	7.6%	6.5%
2010	86.4%	7.5%	6.1%
2011	88.8%	7.1%	4.1%
2012	89.1%	7.0%	3.9%
2013	87.3%	8.2%	4.5%
2014	87.1%	8.6%	4.5%
2015	82.5%	7.7%	9.7%

Source: 59th Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America

Who sits on the investment committee makes a difference, too. Financially conversant professionals not privy to C-suite strategies and communications are ideal because they must make fiduciary decisions regardless of company growth strategies, says McCaffrey. ERISA regulations permit boards to delegate their fiduciary responsibilities to investment committees, which in turn can hire external consultants and asset managers.

Most do.

According to a survey last year by the PSCA, 82% of profit sharing and 401(k) plans have investment policy statements, although that's down from a peak of 89.1% in 2012, and two-thirds of companies work with an independent investment advisors 'to assist with fiduciary responsibilities.' The larger the plan, the more likely it is, overall, to hire external investment advisors to 'assist with fiduciary responsibility: 48.6% of the smallest plans (with one to 49 participants) hire such advisors, while 76.2% of the largest advisors (with more than 5,000 plan participants) do so, (see chart, on page 43) the survey found.

Guarding against outside influences nevertheless "is extremely difficult," said McCaffrey. One investment committee, he relates, had to fend off an overstepping patriot who wanted the committee to channel funds to what he thought was a patriotic investment.

"It comes down to process," said Lori Lucas, executive vice president and defined contribution practice leader at Callan Associates, a San Francisco-based investment advisory. "You have to have a sound process in place and you must document it. That investment policy statement—there are a lot of distractions [in the vetting process]. Everybody has the glossy brochures, but the investment policy statement streamlines decision-

making."
The tire-kicking can range "from the analytics to how the managers source ideas, how they analyze holdings going back in time, to the team responsible for the research," says Christopher E. Vella, CIO of Multi-Manager Solutions at Northern Trust Asset Management. "What's the experience of those managers? How many staff report to the leaders? Can they develop talent? How many research analysts support the managers? Can you spend time with the research team and understand the underlying analytics, and with the compliance team?"

From Best-in-Class to One-Stop Shopping

Do you want a collection of boutiques or a department store? That's the essence of one high-level decision that will define subsequent due diligence tactics: whether to engage multiple investment managers or a single large firm. Outsourcing the entire chief investment officer function is a decision on its own plane. But investment committees with staff CIOs also need to decide if and how to hand off discrete asset classes and functions to fund managers and consultants, respectively.

Ryan Lennie, managing director with Wilshire OCIO Solutions in Pittsburgh, said the decision pivots on your fund's internal resources for overseeing outsourcers—especially for ensuring compliance. It takes more time, money, effort, and, probably, consulting dollars to assemble a balanced market basket of specialty managers. Ongoing, it's also more tedious and expensive to reconcile all of their reports.

A firm offers a single point of contact; consistent reports; and, likely, the talent to ensure consistent operations. But a single OCIO may also manage primarily proprietary portfolios, requiring clients to buy additional services across the entire spectrum of the organization.

One way to create a more apples-to-apples comparison is to benchmark each asset class separately, said Lennie, forcing each unit segment within a large OCIO to win on its own merits. If the firm's individual managers can hold their own against specialty funds, efficiencies of scale might decide the issue.

"The key is to institutionalize best practices. If you don't have the right systems in place, chances increase that things won't go well in the future," says Steven Moise, New Mexico's state investment officer.

It's also simpler to communicate with a single firm as your fund's investment strategy evolves, rather than trying to keep a basket of specialty firms on the same ever-changing page, Lennie added. "It's easier when you have one firm overseeing the entire portfolio. They can understand from the top down your objectives and implement that all the way through," he said. Juggling communication and strategies among outsourcers can trigger trips among all, he said. "It becomes more complicated if we're talking about this strategy but I'm only managing 20% of your portfolio. At that point, the outsourcer is relying on the client" for clear and consistent communication and to ensure that all of the moving parts of the investment plan are in sync.

Rights and References

Every asset manager and consulting firm has a story to tell; it's up to the investment committee to sort hard facts from hyperbole. References, almost by definition, are cherrypicked. Seasoned CIOs, asset managers and consultants recommend these tactics for detecting the true narrative:

Fund Manager Checklist

With hundreds of new funds introduced each year, managers are selling themselves as much as they are their concepts, track records and teams. Ask these questions to quickly size up a fund manager's personal track record.

✔ How long have you been managing this fund?
✔ How long have you been managing this type of fund?
✔ If the fund is new, how long have you, yourself, been directly responsible for a fund?
✔ If your immediate past job was with a large firm, what were the results of

the funds that you, yourself, directly managed?
✔ Does your contract include fiduciary responsibility?
✔ What bonding, insurance and indemnifications are included in your contract?
✔ How do you ensure ongoing compliance?
✔ How do you handle client disputes?
✔ What is the compensation structure of your staff?
✔ What specific behaviors and results does your firm reward?

- Find clients with profiles similar to your organization: similar size, similar asset allocation, similar plan type. The more apples-toapples the comparison, the more relevant the client's experience is likely to be to yours.
- Get the firm's client retention rate.
- Confirm that the holdings that are supposed to be in the funds actually are in the funds.
- The more esoteric the asset class, the deeper the dive. Considering alternatives or international funds? Seek out managers with subject matter experts on their teams and interview those experts.
- For international investments, consider both economic trends and geopolitical volatility—and consider channeling your high-risk earmarks to that category.
- Ask for sample reports.
- Analyze the firm's capacity to grow along with the assets.
- Confirm the stability and security of the firm's trading and transaction platforms.
- Find out how the firm handles client disputes.
- Confirm the credentials of the firm's licensed professionals— their sign-offs are at the core of the firm's fiduciary responsibilities.

Spend time with the firm's managers and researchers to assess not only what they know, but how they think, Northern Trust's Vella said. "Talk with the specialists. If health care is growing, talk with the health care analysts to see what the manager is working from." When talking with fixed-income managers, "ask about strategies designed for particular types of funds, like liability-driven investments."

The more complicated the investment methodology, the more complicated the manager's business model, and this imposes a corresponding responsibility to unpack that methodology. Convergence Inc. has created analytics that profile the complexity of alternative investment managers—in essence, providing a window into the "black box" of risky, complicated assets that require expert, hands-on management. Extracting metrics that enable apples-to- apples comparisons of alternative returns equips managers with the details needed to decide if the complexity and risk are worth the effort, says John Phinney, president of the Norwalk, Connecticutbased firm. But complex business models are high-maintenance and require specialized oversight and monitoring, further driving up costs.

With a transparent process that lets the public view its investment process, New Mexico's investment officials are essentially crowd-sourcing their credibility. "It removes a layer of 'trust us,'" says Smith.

"To get better returns, CIOs might have to increase the complexity of their investment structure," Phinney said.

And if an investment team has a good track record, what are the chances that they can keep it up? Talent development is often overlooked as a key performance metric, said Salvatore Faia, president of Vigilant Compliance, LLC, a Chadds Ford, Pennsylvania, compliance consultancy, but it's essential for obtaining fresh observations that can drive results. "Do they encourage even junior people to offer input and participate in decisions?" That's doubly important when a team is led by a star whose celebrity can overshadow solid process and sustainable momentum, Faia added.

And be sure that the underlying legalities align with the committee's responsibilities. "Investment consultants typically try to avoid that fiduciary responsibility," McCaffrey said. "It's a big discussion point in the negotiations."

Bear in mind, too, that once the firm is engaged, final fiduciary responsibility still remains with you, the ultimate asset manager. "You are responsible for finding what fulfills the investment policy," McCaffrey said. That means that success also depends on your team's culture, willingness to challenge assumptions and each other, continual improvement of practices and oversight, and accountability to fund's other leaders and its beneficiaries.

Breaking Good

New Mexico's State Investment Council is rapidly rebuilding trust, thanks in no small part to its rehabilitated due diligence processes. Moise's annual letter, published at the council's website, summarizes the changes it has implemented since 2010. That's backed up by showing the work: the investment plan, strategy, and goals; ongoing education and operational improvements for the staff; and the fund's audits. Winning $38 million back through legal action has helped, too.

Among the best practices the council has adopted:

- An annual investment plan (http://www.sic.state.nm.us/annual-investment-plan-2016.aspx) published to the council's website. The plan outlines the council's perspective on economic conditions and dynamics affecting returns in the context of its mission and goals. It's written in plain English and includes detailed breakouts for the state's funds, investment categories, and beneficiaries. Prior to 2010, the council did not publish an investment plan, and published results sporadically.
- Publishing asset allocations, specific funds, and outsourcing firms retained (http://www.sic.state.nm.us/uploads/files/2016%20SIC%20Accomplishments%20and%20Goals.pdf).
- Following a stringent RFP process when considering new managers and vendors (http://www.sic.state.nm.us/investment-sourcing.pdf).

Any CIO can learn from New Mexico's hard-won insights, says Vince Smith, the council's CIO. His approach: filter options through the established investment plan and deploy asset class directors who "know what they're looking for." After the basic interviews and site visits are done, the team pushes beyond facts to "understand what those facts mean." That means analyzing trendlines to determine if the manager is likely to align with the fund's investment goals going forward. And it means discussing commitments to new firms while they are still on the drawing board - "understanding where the managers' businesses are progressing," Smith said. That converts due diligence from an occasional exercise to an ongoing point of view.

With a transparent profile that lets the public view its investment process, New Mexico's investment officials are essentially crowd-sourcing their credibility. "It removes a layer of 'trust us,' " Smith said. "I'm really seeing the value of other people independently reviewing the information." — *Joanne Cleaver*

DC Plans: A Fear of Fees

WHILE FEES are one key consideration in the due diligence equation, other factors—monitoring and compliance costs, especially – can affect net returns.

The Plan Sponsor Council of America (PSCA) reported that in 2015, 59.1% of defined contribution plan sponsors paid fixed fees to firms and 35.1% a percentage of plan assets, while 5% blended the two approaches.

The conversation about fees should be ongoing, not "one and done," said Stephen McCaffrey, board chair of the PSCA. Be sure that the negotiated rate is the institutional rate, not the retail one.

Fiduciaries must be ready to defend the fee structure as "reasonable;" that means annually polling managers about the current rationale for their fees and what would prevent them from lowering fees, McCaffrey said. “Ask them, ‘What has changed in your operation that would allow us to get lower fees?’ ” Sometimes, firms drop fees when the client account crosses a certain threshold – but they might not apply to your fund’s situation unless you ask.

Fees aren’t always straightforward, said Doug Neville, who heads the employee benefits group at St. Louis law firm Greensfelder, Hemker & Gale, P.C. Fee-for-service is clear enough, but some managers want to collect revenue shares both from corporate clients and from managers of individual funds, he noted.

“If you’re hiring someone to pick investments for you,” said Neville, “and they get three basis points from one fund as a revenue share and ten from another, which fund do you think they’ll recommend? There’s an inherent conflict there. The ultimate goal is to get enough information so you can agree to a fee structure that eliminates or minimizes the inherent conflict and ensures that the plan is paying reasonable fees. You have to keep asking questions until you get a full understanding of how much they’ll be making from your money.”