Drawing the line

How to decide who does what in managing your organization’s investment program

THE FINAL PAPER IN A THREE-PART SERIES ON INVESTMENT OUTSOURCING

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In the first two papers of this series, I outlined the two primary models non-profit organizations most commonly use to manage their investment portfolios, as well as the skills and expertise non-profits should be looking for in their outsourcing provider (referred to here as an OCIO – outsourced chief investment officer). I also presented an outline for how to line up your organization’s skills and experience with those of your chosen provider. Once you have identified the skills you are looking for and selected someone to work with, the next step is to delegate responsibilities, which is the subject of this paper.

When it comes to outsourcing the activities associated with managing and servicing your investment program, there are two simple principles to keep in mind:

1. **Your fiduciary responsibility is non-transferable.** This means that no matter whom you choose, and no matter what types of skills and experience they bring to the table, your board and your investment committee are ultimately responsible for meeting your investment program’s goals. If your team is not able to adequately meet the responsibilities of managing and servicing your investment program, it is your fiduciary responsibility to find professionals who can.

2. **In order to effectively manage your investment program, you must have a good governance structure in place.** No OCIO will ever be able to replace your entire team, but with the right partner, you can ensure that you have the right people, with the right expertise, managing and implementing decisions which have the potential for the best possible outcome for your investment program. In order to do this, you need to clearly identify the roles and responsibilities of each of the groups engaged in the oversight and management of the program.

The fiduciary ladder: Steps in a well-managed program

One of the biggest questions facing organizations that choose to outsource aspects of the management of their investment programs is deciding which decisions to keep, and which to delegate. The ladder below, known as “the fiduciary ladder,” shows the key steps fiduciaries must take for a well-managed investment program. The decisions fall into three broad categories: strategic advice, portfolio management and review and control.

A significant result of the 2008–2009 Global Financial Crisis has been a shift in the understanding, and designation, of who is responsible for which rung on the ladder. There is increased recognition that portfolios are much more challenging to manage today, given the complexities of the markets, the regulatory regime, the dynamic nature of the markets, and the challenges investors face as they seek to meet their return targets. This has led to boards and investment committees transitioning more of the portfolio management responsibilities to OCIOs.
In the visual below, the blurring of the vertical bar on the right, which is color-keyed to “OCIO” and “Client” on the left, illustrates important facts to remember: there is flexibility as to what is outsourced and what is not, and customization is available.

The investment committee and staff should focus on what they do best, and delegate the rest. After going through the steps I’ve outlined in the two previous papers in this series, the governing fiduciaries: board, investment committee, and staff should have a firm idea of where on the ladder their respective areas of expertise reside. Today, a non-profit’s fiduciaries have the ability to delegate to an OCIO at their discretion, in keeping with their comfort level and the extent of their resources.

I use the fiduciary ladder frequently, to remind myself of the core steps in an effective investment management program. While the structure of the ladder has remained consistent for a number of years (Russell wrote extensively about the ladder in the 1990s), the nature of each step has changed significantly in the past decade. In addition, risk management as a distinct component of the process has really only been highlighted since the Global Financial Crisis.

In the fiduciary ladder, when a non-profit’s fiduciaries have delegated the management of total portfolio investment risk to an OCIO provider, responsibility for such management lies with the provider. It is the OCIO’s responsibility to stay within the risk budget determined by the non-profit’s board and investment committee – and to keep the entire team apprised of any strategic changes that need to take place in order to meet the risk target. By looking at the portfolio holistically, and by managing the assets in accordance with the roles they play within the portfolio, rather than only in light of their ability to beat a benchmark (for instance, in responding to inflation or reducing risk), the OCIO provider allows the underlying investment managers to focus their efforts on return potential rather than diversification. The OCIO diversifies the strategy at the total portfolio level, and the strategy is customized to the needs of the non-profit. This allows the board and investment committee to view the total portfolio and make decisions on that basis, rather than on the performance of a particular manager.

**Investment committees should focus on strategic, long-term decisions, not day-to-day management**

One challenge I frequently see with organizations is in making the distinction between what you *like* to do, and what you are *good* at doing. For example, many non-profit investment committees like to meet with and select investment managers. It’s interesting, it’s exciting and it gives you a feel for the nuances of the market. However, a short interview of a money manager during an annual investment committee meeting is not going to give committee members enough time to make a qualified decision as to whether that manager is appropriate for the portfolio. With the limited time that the average Investment Committee meets on an annual basis, there are many more crucial topics to discuss in that forum. When your organization works with an OCIO provider who has a deep bench of manager research analysts evaluating managers on an ongoing basis – and managing exposures daily – the OCIO is better positioned to adjust for market shifts and manager nuances than your investment committee can be, given the latter’s constraints on time and personnel resources.

When you are evaluating where to draw the governance line, part of that process involves having a long, frank, sometimes difficult conversation with your team to determine what you have the time and expertise to manage.
Pulling it all together

In this series I have outlined a framework to help you evaluate your current solution and give you the tools by which you can assess whether an OCIO solution is better for your needs. I have outlined the two most commonly used models, the skills and expertise needed to manage your investments, and the roles your team should play in the success of your investment program. Your organization’s ability to meet your spending requirements is often dependent upon the success of your investment program.

As I reflect on what I have heard from clients over the years, and on how they have approached working with an OCIO, I believe six key items make an OCIO provider stand out from the crowd.

1. **Dedicated business practice.** Ensure that your service provider is dedicated to the OCIO business – i.e., that it is one of their core capabilities.

2. **Nonprofit investment management expertise.** Ensure that your chosen OCIO has extensive experience in working with non-profit clients in the management of their investment portfolios.

3. **Custom-designed investment program solutions.** Because each non-profit is unique, you want to choose a provider who will custom-tailor your investment program to comply with your investment policy statement guidelines. They should create a program that meets your specific spending policy targets, risk and return profiles and liquidity needs, while thoughtfully employing a blended range of strategies, including active and passive and enhanced beta solutions, as appropriate.

4. **Open architecture.** Ensure that you have access to “best of breed” managers, not just your OCIO’s proprietary fund complex. Your provider should have experience in researching and monitoring investment managers and the ability to put those managers to work in a customized portfolio that is delivered with exceptional client service.

5. **Cost-efficient solution with benefits of scale and fee transparency.** Your OCIO should be able to give you the benefits of cost efficiency, fee transparency and timely performance reporting.

6. **No conflicts of interest.** Determine that your provider behaves with non-negotiable integrity. The organization should be structured in such a way that the OCIO provider is incentivized to manage potential conflicts of interest to the extent that even the appearance of conflicts does not occur, in order that their recommendations will not be compromised.

Russell has been helping non-profit organizations manage their investment programs for over 35 years. My hope is that this series of papers will help you determine the best approach to achieving your investment goals – and whether an OCIO relationship is right for your organization.
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