HEALTH WEALTH CAREER

BUILDING THE RIGHT INVESTMENT GOVERNANCE STRUCTURE FOR YOUR ADVISORY FIRM

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Strong governance is essential for growing financial advisory firms — it not only improves investment outcomes but also can prevent operational failures. With various delegated solutions on the market, good governance can be cost-effective and allow financial advisors to focus on client service and development.

Increasingly, financial advisory firms are dividing duties between relationship management and investment oversight. This structure maximizes economies of scale, enabling firms to increase growth and profitability. As firms move in this direction, however, they run the risk of further detaching investment decisions from client objectives. To counter this risk, firms need to optimize their investment governance processes to achieve better outcomes for their clients. Investor delays in making decisions and the effects of their behavioral biases can significantly impact results. One study found annual end-investor returns were 1.9% lower than fund returns.[1] Although retail investors account for a good portion of the return drag, institutional investors are not immune. In addition to the impact on returns, inadequate governance infrastructure can be the Achilles' heel for rapidly expanding firms, potentially resulting in operational failures.

Good governance should be viewed as a journey, constantly improving and changing as the firm evolves.

Below are a few suggestions for good governance:

- Get the right people — ensure decision-makers have the strength and skills to facilitate successful portfolio construction.
- Allow sufficient time for the management and oversight of the investment program.
- Ensure a sensible balance between asset allocation and manager evaluations.
- Build a framework to ensure speed of investment execution and to avoid behavioral biases.
- Schedule regular governance system oversight, with a commitment to identify and implement improvements.

[1] Hsu J, Myers BW and Whitby R. "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies," *The Journal of Portfolio Management*, Volume 42, Number 2 (2016).

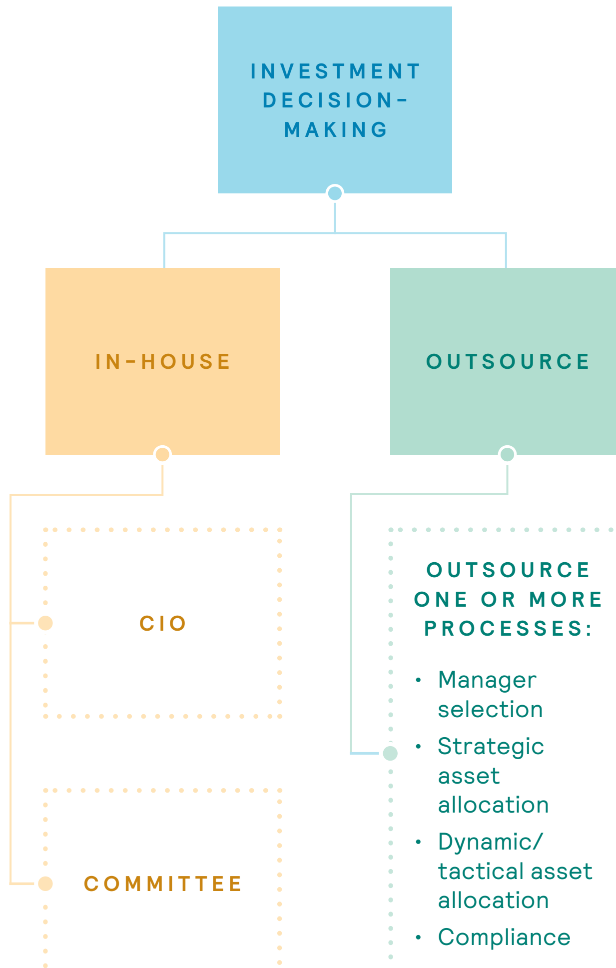
GOVERNANCE MODELS

Historically, financial advisory firms have relied on two in-house governance models: **strong-form CIO** and **committee-driven**. Each has its benefits and drawbacks, but the optimal solution is largely dependent on firm culture and client preferences.

A **strong-form CIO** has the benefit of being accountable for investment results across the business, is generally fully dedicated to the investment process and is typically able to make quicker decisions. However, by relying on the CIO, the firm may be vulnerable to significant key person risk if the CIO departs with the intellectual capital that has been driving decision-making. In addition, as a dedicated managerial staff member, the CIO may be less-connected to client objectives.

A **committee-driven** structure has the benefit of being closer to the client base, with the potential to provide more diversity in thought. However, when the committee is made up of professionals with revenue-generating duties, committee responsibilities will end up taking a back seat. Decisions can often be slower to make and implement. Finally, accountability may be harder to manage.

As outsourced solutions have become more prevalent, delegation has become a growing trend among advisory firms that seek to devote more internal resources to tax, financial and estate planning, relationship management and client development while leveraging the scale and experience of third parties to manage the investment program. Options can range from supplementing a well-resourced in-house investment function with technology solutions to fully delegating the investment process to an outside provider.



Delegation may be partial to fill in gaps where internal human or technological resources are unavailable or where firms find it more efficient to dedicate internal resources to activities that generate greater value, such as client servicing and client development. Outsourcing solutions may include responsibility for decision-making or implementation.

Pros and cons of models:

	COMMITTEE	CIO	DELEGATION
ACCOUNTABILITY	–	✓	✓
SPEED	–	✓	✓
KEY PERSON RISK	✓	–	✓
CONNECTION TO CLIENT	✓	–	–
COST (resource intensity)	–	✓	✓

DOCUMENTATION

Documentation of the governance process — from establishing governance to recording decisions made over time — is critical for ensuring good decisions are made as well as protecting firms from legal or regulatory review. If a firm is outsourcing any part of its governance duties, it should review the outsourcer's process and documentation to be certain there are no gaps. It is important to remember that although a firm can outsource responsibility, it still has the fiduciary obligation to select a strong third-party provider and conduct oversight to ensure the selected provider is fulfilling its obligations over time.

Charter

Once the firm has determined the appropriate governance approach, it will need to document the roles and responsibilities of the decision-makers within a charter. The charter should be a living document that is flexible enough to adapt to changes and also provide firm guidance to decision-makers. Topics the charter should cover include:

- **Committee membership:**
  - Are there ex officio members, such as the CEO, chief compliance officer and chief risk officer, etc.?
  - How many members should be on the committee?
  - How are committee members appointed?
  - What constitutes a quorum?
  - What are the reporting lines to firm governance/board of directors?
  - Are there any subcommittees?
- **Decision-making:**
  - Are there any members who have veto powers, and, if so, how are those vetoes handled?
  - How much latitude is given to the CIO, portfolio managers, advisors and outsourced providers without committee involvement?
- **Meetings:**
  - How frequently should the committee meet?
  - How are issues handled between regularly scheduled committee meetings?
- **Documentation of policies and procedures as well as meeting minutes**

Investment Policy Statement (IPS)

The charter determines who makes the decisions; the IPS outlines how. Firms should also consider the development of a firm-level investment policy statement (IPS) to govern investment platform decisions. The IPS should dictate requirements for investment product inclusion on a firm's recommended list and procedures to remove and add investments.

For firms managing model portfolios, the IPS should be aligned with their clients' objectives and constraints — allocation targets, ranges, rebalancing requirements, performance objectives, etc. The policy should outline guidance on implementation of dynamic asset allocation changes and how opportunistic investment opportunities can be pursued. If opportunistic investment asset classes arise, the IPS should define the process by which the asset class is approved for investment or otherwise considered within the current model portfolio. Further, the IPS should define how much latitude is provided to individual portfolio managers. The IPS should also contain clear guidelines on legacy investments brought over by new advisors or clients and how best to bring these portfolios into alignment with the IPS over time — or how advisors should document exceptions in which their clients' best interests are not well-served by trading into IPS-aligning investments.

As the saying goes, "what gets measured gets managed," and Mercer believes it is important to have well-defined metrics for measuring performance and risk within the IPS. This ensures decision-makers are bound to well-thought-out policies and thus do not succumb to behavioral biases when making investment decisions. Frequent meetings to review performance results can lead to short-term decisions. Therefore, to drive long-term results, we recommend performance be evaluated within the context of longer time periods and that quarterly meetings have varied agendas. Indeed, it is rare for Mercer to lose confidence in a manager due to performance results. Instead, primary drivers of changes in confidence are deterioration in idea generation, portfolio construction, implementation or business management. To that end, we suggest structuring manager reviews to focus on such factors.

INVESTMENT COMMITTEE REVIEW CALENDAR

Similarly, Mercer recommends that the committee establish a review calendar that provides for a systematic review of committee topics. Establishing the calendar can provide more structure and ensure that a comprehensive review of relevant topics happens regularly. Firms should also consider maintaining minutes of committee meetings. We've included a sample calendar below:

Regular Meeting Topics

- IPS compliance
- Review of investment manager news items
- Performance exceptions (positive or negative)
- Limited access/timeframe opportunities
- Dynamic asset allocation

Sample Quarterly Agendas

Quarter	Special topics
Q1	Total Portfolio Review Asset Class Review — Domestic Equity
Q2	Charter Review Asset Class Review — International Equity
Q3	Self-Operational Review Asset Class Review — Fixed Income
Q4	Strategic Asset Allocation/ IPS Review Asset Class Review — Alternatives

CONCLUSION

Running an investment program can be a significant cost to a firm, but a strong program is a key differentiator for advisors and clients. Finding ways to cost-effectively implement a program with a strong governance structure via outsourcing solutions can free up resources to focus on revenue-generating activities, such as client servicing and development. However a firm structures its investment decision-making process, it's vital that it be well-documented, with clear accountabilities. This ensures a consistent message is provided to regulators, advisors and clients and also prevents decision-makers from yielding to behavioral biases. A good governance structure will enable firms to act expeditiously and, over time, improve investment outcomes for clients.

ABOUT US

Mercer's Wealth Manager Solutions practice is dedicated to advancing investment management capabilities of financial advisory firms. Mercer leverages its global infrastructure, which has been fortified from providing advice to large institutional clients for over four decades, to provide innovative solutions for firms serving individual investors. Our expertise in delegated solutions, manager research, alternative investments and portfolio construction allows the flexibility for a customized approach.

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