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Consultants are responsible for providing many services to the trustees they serve. The services that receive most of the attention are related to writing investment policy statements, conducting asset allocation studies, and providing investment manager due diligence. Although all these are important, arguably the most important service the consultant can provide is trustee education throughout the entire consulting process. Experience has shown that the more educated the trustee, the better the investment results. In this discussion, the predominant focus will be on the education of trustees tasked with oversight on investment plans such as pension plans, foundations, and individual trusts.

TRUSTEE AS FIDUCIARY

The education of the trustee begins with the understanding of what it means to be a fiduciary. The term fiduciary has been interpreted in many ways depending on the entity, which is why fiduciary responsibilities have been such a focal point of legislation in recent years. At the most basic level, the fiduciary has the duty to act in an ethical manner on behalf of another, based on an expectation of putting the interest of the beneficiary (or beneficiaries) first.

For pension plans, under the Employee Retirement Income Security Act of 1974 (ERISA) and most state pension laws, a fiduciary is responsible for protecting the plan and its participants and is subject to the highest standard of care known under the law. Persons are considered as fiduciaries if they exercise any discretionary authority or control regarding the management of the investment plan assets, render investment advice for a fee or other compensation, or have any discretionary authority or responsibility in the administration of the plan.

For nonprofit boards, according to the Midwest Center for Nonprofit Leadership, the board of trustees has a fiduciary duty of care that requires active participation and attendance at board meetings; a fiduciary duty of loyalty, requiring the member to not use the position on the board for personal gain; and the fiduciary duty of obedience, requiring the board to comprehend applicable state and federal regulations relating to their responsibilities to the nonprofit.

For individual trusts, the trustee is considered to have a fiduciary responsibility to the beneficiary of the trust. In this type of relationship, the beneficiary has no legal title to the trust, only a beneficial interest, yet the trustee must act only in the best interest of the beneficiary and can act in no way to serve his or her own best interest.

TRUSTEES AND THE DELEGATION OF DUTIES

Trustees should understand the roles and responsibilities that each fiduciary and advisor to the fund is expected to fulfill. The trustees, as named fiduciaries, have the ultimate responsibility for directing and monitoring the investment management of plan assets. As such, the trustees are authorized to delegate certain responsibilities to professional experts, which include, but are not limited to:

Investment management consultant: The consultant may act in a non-discretionary or a discretionary capacity. This distinction is important in determining the accountability of the consultant. In either capacity, the consultant will advise the trustees in establishing the fund's investment policy, objectives, and guidelines; selecting investment managers and investment vehicles, reviewing such managers and investment vehicles over time; and measuring and evaluating investment performance.

Investment managers: The investment managers have discretion to purchase, sell, or hold the specific securities that will be used to meet the fund's investment objectives, within the limits of each manager's specific investment mandate.

Custodian: The custodian will physically (or through agreement with a sub-custodian) maintain possession of securities and investment assets owned by the fund, collect dividend and interest payments, monitor and process class action claims, redeem maturing securities, and affect receipt and delivery following purchases and sales. The custodian may also perform regular accounting of all assets owned, purchased, or sold, as well as movement of assets into and out of the fund accounts.

Additional specialists such as attorneys, auditors, actuaries, and others may be needed to assist the trustees in the execution of their responsibilities to administer the funds in a prudent manner.

The importance of the decision and ability to delegate authority to professional experts often is overlooked. Without the delegation of authority, the responsibility of drafting an investment policy statement, implementing an investment strategy, and monitoring the plan results would fall solely on the shoulders of the trustees. This does not, however, mean that the ability to delegate authority should be used without oversight. Proper selection of professional advisors can be completed through documents that solicit a proposal for cost and services to allow the trustees to find professional advisors they think align best with the overall strategy of the plan.

SETTING OBJECTIVES AND GOALS

Trustees must set objectives and goals for the fund in order to execute an appropriate investment strategy. Educating trustees about the factors affecting the objectives and goals allows the trustee to make prudent decisions regarding investment strategy. The predominant factor for most institutions is the liability to be managed. The structure of the liability varies and may be based on an actuarial study of a pension plan, a spending policy of an endowment, the distribution schedule of a foundation, or the health, education, maintenance, and support needs of an irrevocable trust. Educating trustees about the current liability, future liability, and current funding of the future liability helps establish a common goal for trustees.

Explaining how liabilities will react under different economic scenarios is where the education process can help manage trustee expectations. An asset allocation study (or optimization study) that provides different ranges of outcomes, along with a most-likely outcome based on historical data, can be helpful in educating trustees about the risk-reward characteristics and probability of success of the investment strategy that will be put in place to manage the liability. A liability-driven investment strategy may be sufficient to manage the future liability in certain cases. The importance, however, of the trustee understanding the liability-to-asset structure is that assets and liabilities likely will diverge in certain environments, such as in times of economic stress. It is for the trustees to decide what level of risk to funding the future liability is acceptable. This concept forms the basis of a larger and more in-depth conversation on the risk-reward relationship inherent in financial markets. The right allocation is one where trustees understand the risks taken to justify the expected returns. Understanding this is crucial to maintaining discipline in times of economic or financial uncertainty.

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Although an optimization study can be extremely useful in trustee education, trustees often mistake these studies, which are based off of historical results, as a guarantee of a future outcome. Trustees also may anchor on the stated investment return objective in a down year, forgetting that the objective is long-term and results are not linear. Educating trustees on the purpose of an optimization study, the limitations of using capital markets assumptions, and the importance of discussing the range of possible outcomes is critical for establishing both the risk-reward relationship of the portfolio and future expectations of the trustees. It is important to communicate to trustees that the historical analyses used to establish the basis for an optimization study may differ from actual results. Illustrating an expected range of outcomes and a most-likely result based on the historical data allows the trustees to gain more confidence that the allocation chosen can provide enough risk exposure to offset the future liability.

KNOW YOUR AUDIENCE

Part of knowing how much detail is needed in educating a board is understanding the investment sophistication of the group of trustees. In many cases, trustees need a detailed but simple, relatable, and investment jargon-free education on the nature of investment management. It is dangerous to assume that trustees understand the basics of portfolio construction. Starting out with a confidential survey of each trustee's level of sophistication may help the consultant understand where to direct the education effort. At times, an Investing 101 presentation that discusses the high-level topics of investing, capital markets, asset allocation, and risk versus reward is a good way to get the trustees more comfortable for a deeper dive.

As the conversation transitions from asset allocation to investment strategy, trustee education becomes very specific to the individual portfolio. Whether an existing allocation is being reviewed or a new allocation is being constructed, the importance of the trustees' understanding of the role each asset class and class segment is expected to provide within the total portfolio is key. A thorough overview of the asset classes and class segments that can make up a portfolio is a good starting point in the discussion on diversification. Although the historical benefits of diversification over long periods of time may be conceptually easy to grasp, previous market cycles that highlight short-term deviances in specific classes or segments provide context around the importance of ongoing education.

Trustees also may need education about the different investment vehicles that can be used to achieve the stated objective. Providing an overview of both liquid investment vehicles (i.e., mutual funds, exchange-traded products, interval mutual funds, and separately managed accounts) and illiquid investment vehicles (i.e., limited partnership funds to access real estate, private equity, venture capital, and alternatives) is important to help the trustees feel comfortable understanding the benefits and limitations of such vehicles in gaining access to a specific asset class or class segment.

ACTIVE VS. PASSIVE MANAGEMENT

Once the asset allocation is decided, the focus can shift to determining which investment managers should be utilized. A large part of this discussion is educating the board on the differences in philosophy between active and passive investment vehicles. Discussing the differences between active's approach of aiming to add value above an appropriate benchmark over the long term, and getting benchmark-like returns via passive vehicles, is an important part of the education process. Additional dialogue should revolve around the differences, limitations, and preference of owning underlying securities versus a comingled vehicle or a fund structure. Typically, a blend of active and passive management strategies is a reasonable approach.

If active management is utilized, it is important to teach the board that the objective of active management is to outperform a set benchmark, and that to outperform means the manager will have to be different from that benchmark. Setting acceptable guidelines and timeframes for monitoring the manager's results is important from an accountability standpoint. Typically, an initial review in identifying a preferred manager will start with a quantitative analysis examining historical performance, risk-adjusted performance (e.g., alpha, Sharpe, Sortino, etc.), appropriateness of the benchmark (e.g., R-squared), and expectations for periods of underperformance (e.g., up/down capture). After a level of comfort has been established with a group of managers, a qualitative analysis of each manager that looks into such aspects as the structure of the firm, investment philosophy, tenure and experience of management, and future business plans will take place. After both the quantitative and qualitative reviews have taken place, a preferred manager will be selected for their respective asset class or class segment. Ongoing monitoring of the selected manager is important to ensure that the investment philosophy does not shift from when the manager was first hired. Rolling three-year and five-year periods should be analyzed to remind trustees that exposure to active management with the goal of outperforming a benchmark will bring periods of short-term underperformance. In the ongoing monitoring of the manager's results, if it is determined that the manager is no longer suitable, the consultant may recommend that the current manager be terminated and to start the manager search process again to find a replacement. While infrequent, the process of finding a new manager does happen. This can be due to reasons such as portfolio manager turnover, fund company changes, or adverse disclosures discovered in the manager's Form ADV.

STAYING ON TRACK

Throughout the investment process, trustees may entertain ideas based on successes they have had investing personally or professionally that they may be inclined to bring up as ideas for the plan portfolio. Consultants and trustees should periodically review the historical short-term deviances that have occurred, and that will occur again in the future, in performance and correlations between different asset classes and class segments. Specific class or segment bull markets (e.g., emerging markets in late 1980s, tech stocks in early 2000s, and large-cap stocks post-2008) could cause trustees to want to deviate from the long-term investment policy, in favor of making up for the short-term underperformance of a diversified portfolio. A disciplined rebalancing strategy that keeps the asset allocation close to target levels is one way to avoid emotional and cognitive biases that, collectively for the board, can be damaging to long-term results. Although it is extremely important, behavioral education can be difficult to address with a group of successful people who are coming together for a common cause. Individual trustees bring their own biases to specific situations, but a group of individuals who typically live in close geographic proximity and share similar values may form group biases that can be dangerous to the long-term policy. Periodically spending time to review and educate the trustees about behavioral biases and heuristics that may, if acted upon, cause damage to the long-term plan would be worthwhile, depending on the trustees' comfort in discussing this topic.

SUMMARY

Consultants bear the responsibility of educating trustees. The education process culminates in the creation of a sound investment policy statement. Collaboration between consultants and trustees in the drafting of the policy statement will help to maintain a disciplined board and facilitate a smooth transition to the next generation of trustees.

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CONTINUING EDUCATION

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