Reproduced with permission from *Benefits Magazine,* Volume 55, No. 3, March 2018, pages 42-47, published by the International Foundation of Employee Benefit Plans (www.ifebp.org), Brookfield, Wis. All rights reserved. Statements or opinions expressed in this article are those of the author and do not necessarily represent the views or positions of the International Foundation, its officers, directors or staff. No further transmission or electronic distribution of this material is permitted.

pdf/218

Critical Questions to Ask

When Evaluating an Investment Manager

by | **Jennifer Mink**

Selecting an investment manager and providing oversight of that manager are part of the fiduciary responsibility of employee benefit fund trustees. This article, the second of a two-part series, addresses critical questions trustees should ask when monitoring an investment manager.

The first part of this series discussed the fiduciary standards of conduct for trustees governed by the Employee Retirement Income Security Act (ERISA). The article established that trustees have the authority under ERISA to share their fiduciary responsibility and delegate decision-making authority to investment managers; however, ERISA requires trustees to monitor and provide ongoing oversight of the investment managers they hire.

Part I provided a framework of the critical questions to ask when hiring an investment manager—firm, team, process, results and other (FiTPRO). This article emphasizes those principles in establishing the critical questions trustees should ask managers after they are hired.

The Ongoing Due Diligence Meeting

There is no statutory rule requiring trustees to routinely meet with their investment managers, but trustees typically meet with their managers periodically after the manager is hired. These meetings can occur on a regular basis (during a board of trustees meeting) or more infrequently (annual manager review meeting). Regardless of whether a trustee interacts with the manager in front of the entire board or has a one-on-one meeting, trustees should be prepared to ask the right questions during these encounters.

Trustees should again focus their questions on the elements of FitPRO during due diligence meetings.

Firm

- Were there any changes in ownership?
- Are there any regulatory inquiries or investigations?
- Has any litigation been brought against the firm or principals?

Team

- Were there any significant departures related to the investment team?
- Were there any new hires?

Process

- Did the manager follow its process?
- What investments helped or hurt during a particular time period?
- Were these investments consistent with the manager's buy-and-sell discipline?
- Does the manager anticipate any changes to the process in the current market environment?
- What is the manager's expectation for performance over the next 12 months?

Results

Since the manager has been hired to manage money for plan beneficiaries, investment results are essential to discuss:

- What are the actual investment returns?
- How do the returns compare with the manager's benchmark (over different time periods) net of fees?
- How does the manager rank in its peer universe?

Other

This category can include questions about the investment policy, such as whether the manager is in compliance with the fund's investment policy and if the manager has any requested changes to the investment policy. The investment landscape is constantly changing, and trustees and managers should have an open dialogue regarding what makes sense for plan management.

Trustees also should inquire about any changes in the level of errors and omissions (E&O) insurance. A reduction in E&O coverage could be troublesome. Another important question pertains to liquidity—Has the liquidity of the investment changed, or is it expected to change? (More information about the significance of liquidity is provided in the Watch List Meeting section).

ERISA addresses the consideration of plan expenses as a fiduciary duty; thus it always helps to ask about potential fee reductions. Trustees should look at whether the fund is still paying the most competitive fee based on its size and investment style. They may be surprised that simply asking that question can prompt a fee reduction or discussion of possible negotiation of fee breakpoints.

Ongoing due diligence meetings are usually routine in nature and are meant to hit the highlights, but problems can arise with investments, and even the best managers can stumble. When problems or issues arise with an investment manager, they are typically placed on "watch." A manager being placed on watch may lead to an in-person meeting to hopefully gain a better understanding of a problem and potential actions to take.

The Watch List Meeting

Watch list meetings—typically the most challenging meet-

ing for trustees—allow trustees to ask their managers pointed questions about a problem or issue. These meetings can be essential since they may determine whether trustees continue a relationship with an investment manager or ultimately terminate the manager. Trustees should revisit the files they created for the manager and read the answers to the initial FiTPRO questions. If the right questions were asked in the beginning, trustees will know if the answers they hear at the watch list meeting are a cause for action. The following are primary examples of investment issues prompting a manager to be placed on watch.

takeaways

- Trustees periodically hold due diligence meetings with fund investment managers, either regularly during board of trustees meetings or informally at a manager review meeting.
- Among the issues discussed during due diligence meetings are investment results and process and changes to the investment team or firm ownership.
- A watch list meeting occurs after an investment manager has been placed on "watch" because of a problem or issue such as poor investment performance, investment policy compliance violation or a change in firm ownership or portfolio management.
- Continual violations of the fund's investment policy may be grounds for termination of the investment manager.
- Asking the right questions up front and comparing the manager's answers throughout the relationship can help guide trustees in making prudent decisions about which managers to hire and which managers to fire.

Performance

All investment managers underperform at some point. In fact, most top-quartile investment managers have at least one bottom-quartile period in their track record. With that in mind, it is important to evaluate investment manager performance over a period of time and in context with the overall market environment. Three to five years is a typical time period for evaluation.

Did the manager stick to its discipline? If a manager is expected to provide downside protection, but the market has been on an upward trend, it is not unusual for these managers to lag the market on the upside.

Were there any changes to the investment process? If a firm's sell discipline includes selling securities that decline 20% or more, and you see securities in the portfolio that have fallen by a greater percentage, did something change? Has the manager requested any changes to the investment policy? Perhaps the policy limits the size of an individual security, yet that security represents a large portion of the index. This policy limit may prevent a manager from taking a strategic overweight.

Have there been any changes to the investment team, or are any anticipated? How are members of the team compensated? Often investment team bonuses can be tied to a manager's performance. If bonuses are being cut because of poor performance, it may prompt investment professionals to leave the firm. This is not to say people should get bonuses they do not deserve, but asking the question can provide some insight into what may lie ahead.

Additional items to inquire about include liquidity and fees. Trustees should ask about the number of clients that have terminated the manager in the last 12 months and the value of assets that have left the strategy. Depending on what the underlying investments are, the portfolio could suddenly become less liquid to remaining investors while the manager seeks to meet redemptions and pay investors who have requested a withdrawal. Also, if the situation is dire enough, the firm may begin to trim investment personnel, which may indicate a lack of continued commitment to the product.

If trustees are satisfied with the answers received from the manager and are willing to allocate additional time to turn things around, the watch list meeting could present an ideal time to discuss a fee reduction or consideration of a different fee schedule. Sometimes managers may offer a performance-based fee at this juncture. While there may be merits in considering such a change, trustees should request that a ceiling or cap be instituted on a performance-based fee structure to prevent overpayment.

Determining how long a manager should remain on the watch list can be tricky because the reason (or perceived reason) for the underperformance can be affected by a multitude of factors and take time to work itself out. While the length of time will vary, trustees willing to give a manager "more time" should do just that. Expecting a performance situation to correct itself in a short period of time (i.e., one quarter) is often unrealistic.

Change in Firm Ownership

Industry consolidation can occur at any time for multiple reasons. Buyers might be attracted to investment firms

learn more

Education

Certificate Series—Investment Basics
March 14-15, Las Vegas, Nevada
Visit *www.ifebp.org/certificateseries* for more details.

Investments Institute
April 9-11, Naples, Florida
Visit *www.ifebp.org/investments* for more information.

From the Bookstore

The Tools & Techniques of Investment Planning, Fourth Edition
Stephan R. Leimberg, Thomas R. Robinson and Robert R. Johnson. National Underwriter. 2017.
Visit *www.ifebp.org/books.asp?9099* for more details.

in good markets. Firms also look for strategic partnerships when markets are bad. Privately held firms may be looking to cash out, while publicly traded firms may be looking to grow or diversify their product offerings. When a change in ownership occurs, trustees need to ask about changes in key personnel:

- Has there been a change in the chief investment officer or any change to the investment team?
- Has the investment team/portfolio manager (PM) signed an employment contract with the new owner, and what is the term of that contract? Trustees should have assurances that the people they hired are still going to be there. (If the answer is "no" for employment contracts, see the Change in Portfolio Manager section.)
- Does the new ownership expand the firm into any new lines of business? This can be a positive or negative depending on the relevance of the other business lines.
- If, as the result of a purchase, the investment firm becomes part of a larger parent company, what involvement will the parent company have in operations?

Managers on the watch list for an ownership change typically remain on watch through the closing of the deal and for a period of time thereafter to ensure the transition is smooth and there are no surprise departures after the close.

Change in Portfolio Manager

This can be a tricky situation to navigate. A PM departure is significant. When the manager was interviewed, trustees likely were told how amazing the investment team was. Now that the PM has left the firm, his or her significance on the team may be suddenly downplayed. Trustees should ask why the PM left and whether it was because of a problem at the firm, such as lack of resources and support, or if the manager got a better opportunity or started his or her own firm. Perhaps the manager left for personal reasons or was terminated for poor performance.

Regardless of whether the full story about the departure is disclosed, trustees must evaluate the effectiveness of the manager's replacement. When the firm was initially interviewed, did the investment team consist of a single PM who made all of the decisions, or were there multiple PMs? The departure of a star PM who made all of the decisions is significantly different than the departure of one of three PMs with the remaining two running the portfolio. Trustees also should ask if any other staff left the firm or if more departures are expected. It also is beneficial to ask if the remaining investment professionals have contracts in place. Unless the analysts have been contractually bound to stay with the firm, they may follow a departing PM. If the PM was terminated because of poor performance (which trustees will likely be aware of from their own investment results), perhaps the new PM will be an improvement and catalyst for improved results.

If trustees understand the departure and are comfortable with the new PM, the manager typically remains on watch for a period of six months to a year. If trustees do not like what they hear or discover that other team members have departed, it may be time to make a change and possibly follow the team that left.

Compliance Violation

Every benefit plan should have an investment policy statement. This written document provides the framework for the investment program, defines roles and responsibilities of the trustees and professionals, and stipulates what investment managers are permitted to do (or prohibited from doing). Investment managers are expected to manage their (separate account) portfolios in accordance with the fund's investment policy and, under ERISA, trustees are expected to monitor a manager's compliance with the policy.

Preparing for an Investment Manager Meeting

Here are five tips for preparing for and conducting investment manager meetings:

- Request materials in advance (and read them).
- Prepare questions to ask the manager (depending on the type of meeting).
- Allow the manager sufficient time for the presentation (and for trustees to ask questions).
- Ask questions (do not be afraid to speak up).
- Take notes (document your process).

One of the questions asked at the initial manager interview addressed procedures to ensure compliance with the investment policy. A watch list meeting to discuss a compliance violation should begin by asking how the violation occurred and what changes have been made to avoid future violations. Depending on the nature of the violation, losses may have been incurred. Trustees should ask if any compensation is due to the fund as a result of the violation. Depending on the size of the reimbursement, the manager can repay the fund by putting the money back into the investment portfolio or reduce its investment manager fees invoiced to the fund.

It is prudent for trustees to ask the manager if the violation was an isolated incident (in one portfolio only) or across multiple portfolios. If the violation affected multiple investor accounts and the losses are significant, trustees should ask the manager if the firm's E&O carrier has been put on notice of a potential claim. Some violations may not be as simple as a manager buying a security that was not permissible. Questioning managers regarding their interpretation of the policy as the cause for the violation can sometimes help identify areas for improvement in policy language.

Depending on the nature of the violation, most managers seek to improve their process for monitoring and/or improving policy language to ensure that a violation does not happen again. However, continual violations of the policy may be grounds for termination or further action.

The resolution of many of the issues surrounding a watch list meeting can be traced back to asking the right questions at the interview meeting. If trustees think back to FiTPRO answers and remember why they hired the manager, they can effectively make decisions regarding a prudent course of action.

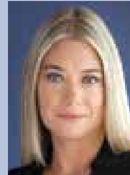
Non-ERISA Considerations

Not all benefit funds are governed by ERISA, but the standard of care in the questions to ask managers can apply to any investment fund for which a trustee serves as a fiduciary. In some cases, trustees can ask investment managers to apply an ERISA-like fiduciary standard to their management of non-ERISA assets. Furthermore, not all investment products are structured to accept ERISA fiduciary responsibility. In those instances, trustees can ask the investment manager to agree to ERISA fiduciary standards in a side letter (in consultation with fund counsel).

In Summary

While an investment consultant typically asks the questions detailed in this article, it is important for trustees, as fiduciaries, to understand the questions that consultants ask investment managers and why they ask them. Much of ERISA is process-driven, and trustees who participate in the process and ask the critical questions may have a deeper understanding of why investment managers are hired and fired, improve how time is allocated to manager interviews during a meeting and be empowered to make better decisions for their plan participants.

bio



Jennifer Mink is a partner and senior consultant at Investment Performance Services (IPS), LLC, in the Philadelphia metropolitan area. She has extensive experience conducting investment manager searches for defined benefit, defined contribution and welfare plans throughout the United States. In addition, she assists client funds with investment policy design, asset allocation strategies, performance reporting and compliance monitoring of managers. With over 20 years of investment experience, Mink is a member of the IPS Investment Committee helping to formulate strategic policy for the firm. She was a contributing author to the *Investment Policy Guidebook for Trustees* (Fifth Edition) published by the International Foundation and is a frequent speaker at educational conferences. She earned her B.S. degree from North Carolina State University and an M.B.A. degree from Rider University. She can be reached at jmink@ips-net.com.