Selecting and monitoring an investment manager is part of the fiduciary responsibility of employee benefit fund trustees. This article addresses critical questions trustees should ask when hiring an investment manager. A second article, in March, will highlight questions trustees should ask when monitoring an investment manager.

CRITICAL QUESTIONS
to Ask When Hiring an Investment Manager

by | **Jennifer Mink**

benefits MAGAZINE

Reproduced with permission from *Benefits Magazine,* Volume 55, No. 2, February 2018, pages 16-22, 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/118

Serving as an employee benefit fund trustee can be intimidating, especially when one considers that most trustees are expected to make decisions regarding investment accounts that can have asset values with as many digits as a telephone number. For many trustees, interviewing investment managers to assist with managing these accounts can feel like a daunting task, but it is an important and necessary part of fulfilling a trustee's fiduciary responsibility.

Fiduciary Responsibility

Employee benefit fund trustees are considered fiduciaries, but what exactly does that mean? The term *fiduciary* is generally understood as a person to whom property or power is entrusted for the benefit of another.[1] Fund trustees have fiduciary responsibility for someone else's money.

The Employee Retirement Income Security Act of 1974 (ERISA) has its own definition of who is a fiduciary. In general, it provides that anyone who exercises discretion over the administration, management and assets of a plan is a fiduciary.[2] Basically, ERISA considers who has discretionary control. ERISA also requires that plan documents identify a "named fiduciary." In the case of a multiemployer plan, the board of trustees is typically designated as the named fiduciary.

Under ERISA standards of conduct, as fiduciaries, trustees must (1) act solely in the interest of plan participants and their beneficiaries, (2) diversify plan investments, (3) pay reasonable plan expenses, (4) follow plan documents and (5) carry out duties prudently.[3] Acting *prudently* is generally understood as acting with care and thought for the future.[4] ERISA Section 404(a)(1)(B) provides that a fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." The ERISA prudence standard is a high standard of measure and is commonly referred to as the *prudent expert standard* or *prudent person rule*.

In the investment world, the prudent person rule helps guide fiduciaries when making investment decisions. In short, this rule means that a fiduciary entrusted with funds for investment may invest in securities that any reasonable individual interested in receiving a good return of income while preserving capital would purchase.[5] As fund fiduciaries, trustees need to be thoughtful and take action to ensure that money is available when a plan participant needs it.

Since most trustees do not have training, knowledge and expertise with investments, making investment decisions can be a challenge. Fortunately, ERISA allows fiduciaries to share their fiduciary responsibility with some service providers and permits trustees to delegate investment responsibility to investment managers (as defined in ERISA Section 3(38)).[6]

If trustees hire an investment manager that is a registered investment advisor and contractually agrees to be an ERISA fiduciary, the trustees are responsible for the selection of the manager but are not liable for the actions of the manager.[7] This delegated responsibility helps remove the burden of making investment decisions from the trustees, but they still have a responsibility to monitor the manager to ensure the investments are managed prudently and in accordance with the fund investment policy. While many trustees rely on an investment consultant (ERISA Section 3(21) "advice" fiduciary)[8] to conduct due diligence and make recommendations regarding investment managers, trustees

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 and 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.

Multiemployer Plans: A Guide for New Trustees, Third Edition, Revised

Joseph A. Brislin. International Foundation. 2016.

Visit *www.ifebp.org/books.asp?7754* for more information.

should know and understand the reasons behind the critical questions consultants ask investment managers. Learning to ask the right questions can help trustees gain a deeper understanding of the managers they hire, identify problems or issues more quickly, and respond accordingly with care and prudence.

There are typically three instances where trustees directly interact with their investment managers and have the opportunity to ask critical questions: (1) the initial interview, (2) an ongoing due diligence meeting and (3) a watch list meeting. This article covers questions to ask during the initial interview. A second article in March *Benefits Magazine* will discuss the ongoing due diligence and watch list meetings.

Initial Interview

The initial investment manager interview provides trustees with the opportunity to ask for information they need to select an investment manager and entrust that manager with plan assets; however, most trustees are unsure what is important. What questions should a trustee ask?

The five key areas to focus on are firm, team, process, results and other (easily remembered using the acronym FiT-PRO).

Firm

Asking if the firm is registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 as a registered investment advisor is the starting point.[9] Other regulatory areas to inquire about include any investigations, infractions or fines from a governing body such as SEC, Financial Industry Regulatory Authority (FINRA) or the Department of Labor (DOL). Trustees also should ask about any current or pending litigation against the firm or its principals and request a copy of the firm's Form ADV.[10]

Once the regulatory boxes are checked, trustees can ask about the firm's experience:

- How many years has the firm been in business?
- How long has the firm been managing the strategy being considered?
- What is the total market value of assets under management (AUM) by the firm as well as the strategy being considered?
- Who are the types of clients the firm manages money for, and how many clients/types are in the strategy being considered?

Information about AUM and number of clients provides insight into the firm's consistency. Trustees should look at whether the firm is supported by one or two very large clients or if the AUM is comprised of many clients and client types. If the answer is one or two large clients, a problem may arise if one or both clients terminate the manager. Losing a large investor can impact firm stability, the liquidity of the product and product performance. The length of time the firm has been executing the strategy helps demonstrate a track record and provides insight into how the firm supports the product. The type of investor (i.e., public, Taft-Hartley, endowment, high net worth) is an important consideration since guidelines governing different client types can vary (ERISA vs. non-ERISA), as can the time horizon (i.e., individuals such as retail/high net worth investors can have a shorter time horizon than pension investors).

Finally, asking about the ownership structure is imperative:

- Who owns the firm?
- Who are the key personnel with decision-making authority?
- Are any ownership changes anticipated?

The answers to these questions help provide assurance to the trustees regarding the overall stability of the firm both now and in the future.

Team

After gaining a comfort level with the firm, trustees should ask questions about the investment team:

- Who is/are the portfolio manager(s) (PMs), and what is their experience managing the strategy?
- What experience do the research analysts possess? Are they experts in their field of research (i.e., actual work experience in the health care or technology industry) or recent college graduates who crunch numbers?
- How long have the PMs and analysts been with the firm, and have any recently left? If so, why?

This information helps demonstrate the experience and depth of the investment team.

Having an understanding of who makes the investment decisions is valuable:

- Does the PM have ultimate decision-making authority?
- Do the analysts have ownership of their ideas and the

ability to decide what is ultimately purchased for the portfolio?

- Are the investment decisions regarding the portfolio delegated to an investment committee? If so, who is on the committee, and how are decisions made (e.g., by a majority, consensus, committee chairman)?
- Are the current team members responsible for the product's past track record?

Understanding how decisions are made helps define the process and ultimately determines who is responsible for the investment returns.

Process

Understanding the firm's investment process is the key to knowing what separates one investment firm from another and can often be the determining factor for selecting one manager over another.

Trustees should begin by asking about strategy:

- What is the manager's investment performance goal (i.e., returns that outperform the Standard & Poor's (S&P) 500 by 3%, absolute return of 8% net of fees, "not to lose money")?
- What is the buy philosophy (e.g., out-of-favor names (*fallen angels*), securities with 10% growth potential, a catalyst for positive change, the management team)?
- What is the sell philosophy (e.g., value declines by 20%+, replaced with a better investment option, target price reached)?
- Does the process involve fundamental research (actual research and consideration of a company's financial statements), or is the strategy systematic (technology-driven models)?

Many firms have a particular aspect of their process that can be considered the manager's "edge." Trustees should determine what is unique about the investment manager. For example, an equity manager may or may not allocate to a specific sector in the index (e.g., health care), or a fixed income manager may or may not consider the quality or duration[11] of the index when making investment decisions. Perhaps the differentiating characteristic of the strategy is simply the manager's willingness to focus on a single investment thesis, such as a high-yield bond manager buying only BB-rated bonds, a real estate manager investing in a specific geographic region or a private equity manager focusing on a single industry.

Finally, trustees should ask what aspects of a manager's process add value beyond price. Examples may include the ability to protect capital on the downside (when the market declines, the manager's decline is typically less than the overall market), the size of the manager (large firms can access large deals/positions while smaller firms can navigate areas that larger firms cannot and capture opportunities in a "less crowded" space) or the willingness of the manager to close the strategy to new investors. Some strategies such as small cap equity are capacity-constrained,[12] and closing the fund to new investors can protect the integrity of the investment and subsequent returns.

Returns (Results)

Investment results reveal how the team and process work together. Questions to ask include:

- What is the actual investment return, net of fees?
- How do the returns compare with the benchmark?
- How does the manager rank in the peer universe?

Peer universe rankings help provide insight into how a manager's returns compare with other investment managers that deploy assets in a similar investment style (i.e., large cap U.S. equities). To develop these rankings, investment management firms independently report their returns to various databases. The databases then sort the range of returns for a particular investment style into four quartiles. Managers with returns ranking between the 1st and 25th percentile for a given time period are considered "top quartile" managers during that period, or are the highest ranking managers.

Managers with returns between the 75th and 100th percentile are considered "bottom quartile" managers. A manager with returns around the 50th percentile would be considered "median" or average. Another way to consider universe rankings is if an investment manager's returns rank in the 25th percentile, it is "better" than 75% of the managers in the style universe for the time period under review. (Note: Not all investment strategies have comparable universes. Many alternative investments are too specialized to have enough commonality to populate a meaningful universe).

Investment returns, in conjunction with peer universe rankings, provide trustees with insight into their manager's performance. For example, a manager's 8% annual return might be considered good but would rank below median if the range of annual returns in the peer group is between 7% and 18%. The bottom quartile peer group ranking suddenly

puts an 8% return into a different perspective. Be mindful that it is unrealistic to expect managers to beat their benchmark over every time period and always rank in the top 10% of their universe. Even top quartile managers typically have at least one time period in which they fall in the bottom quartile. However, it is reasonable for trustees to expect their investment manager returns to rank above median over a *market cycle* (three- to five-year period). Managers with consistent top quartile returns, or higher, would be considered standouts . . . in a good way!

Finally, the Chartered Financial Analyst (CFA) Institute has developed best practice guidelines and standards that guide the investment industry. These standards help ensure all investment professionals place client interests first.[13] The guidelines and standards include Global Investment Performance Standards (GIPS®), which provide an ethical framework for the calculation and presentation of investment performance for investment management firms. Firms complying with GIPS provide investors with consistent and transparent presentations of the firm's performance.[14] While compliance with these standards is voluntary, it is important that trustees ask managers if returns are indeed GIPS-compliant.

Other

After asking about the firm, team, process and results, trustees need to ask about the "other stuff." This includes asking investment managers about their willingness to be an ERISA fiduciary in writing. ERISA allows trustees to share their fiduciary responsibility with an investment manager that agrees to be a fiduciary. Being registered with SEC does not guarantee that investment managers are willing to accept ERISA fiduciary responsibility. Trustees need to ask, confirm, and document the fiduciary status of the manager (in consultation with fund counsel).

Along with fiduciary confirmation, trustees should ask if the manager has errors and omissions (E&O) insurance and ERISA fiduciary bonding. E&O insurance protects professionals against claims arising from their actual or perceived negligence, errors and mistakes in the performance of service for others. In short, E&O coverage provides protection in the event that an error or omission has caused a financial loss.[15] Although the range of E&O coverage will vary among investment firms (based on size of AUM and other factors), the industry standard is typically at least $5 million in coverage.

In addition, ERISA Section 412 generally requires a fiduciary handling fund assets to be bonded. Bonding helps protect employee benefit plans from risk of loss due to fraud or dishonesty on the part of persons who "handle" plan assets or other property. In most instances, the maximum bond amount required under ERISA with respect to any fiduciary is $500,000. However, higher limits can be purchased.[16]

ERISA tasks trustees with the oversight of investment managers with regard to plan documents; therefore, trustees should ask what procedures are in place for managers to ensure they are in compliance with the fund investment policy statement.

In addition, ERISA has prohibited transaction rules. One that is of particular importance is the requirement that fiduciaries pay reasonable compensation (fees) to service providers, including investment managers. Therefore, making sure that investment managers are receiving reasonable compensation is required, both under the prudence standard and under the prohibited transaction provisions. Fee-related questions to ask include:

- What is the standard fee?
- Are there any reductions offered based on the size of the assignment?
- Is the manager willing to offer any discounts (perhaps the manager is

takeaways

- Under the Employee Retirement Income Security Act (ERISA), employee benefit fund trustees have a fiduciary responsibility for selecting an investment manager.
- While many funds rely on investment consultants to conduct due diligence and make recommendations regarding investment managers, it is important for trustees to understand the reasons behind the critical questions consultants ask investment managers.
- Learning to ask the right questions can help trustees gain a deeper understanding of the managers they hire, identify problems more quickly, and respond accordingly with care and prudence when issues arise.
- Areas to focus on when hiring an investment manager include experience of both the firm and the investment team, the investment process utilized by the manager, and the manager's performance results and peer universe rankings.
- Other areas to inquire about include the manager's willingness to be an ERISA fiduciary, errors and omissions insurance, ERISA fiduciary bonding and investment manager fees.

looking to build a presence in a certain geographic area or client type and the fund fits into those categories)?

- Does the manager have a most favored nation clause (MFN)? MFNs ensure that all clients or all clients of a similar size pay the same fee. If an MFN exists, managers may be reluctant to discount below the MFN. If a manager with an MFN offers a lower fee to one client, the manager must contractually offer the same lower fee to all other investors.

Furthermore, many alternative investments such as real estate, hedge funds, opportunistic strategies and private equity typically have a management fee as well as an incentive fee, so it is important to ask about different components of fees. If there are incentive fees, trustees should inquire about *hurdle rates* (minimum preferred returns to investors before incentive fees are charged) as well as a *high-water marks* (making up losses before manager participates in profits). Trustees also should ask about the liquidity terms of the product and inquire about what may cause the liquidity terms to change.

Asking the right questions and comparing the managers' answers can help guide trustees in making the ultimate decision of which investment manager to hire.

After trustees have successfully interviewed the manager, asked the right questions and made a selection, it is important to document the process. Creating a file that includes the answers to the questions will not only create a record of their work and process as trustees and fiduciaries, but also will serve as guidance during future encounters with the manager.

Watch for the second part of this article in the March issue of *Benefits Magazine* that will highlight critical questions to ask when monitoring an investment manager.

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 a 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.

Endnotes

1. See www.dictionary.com.
2. In addition to defining *fiduciaries* as those who exercise discretion, the ERISA definition of a fiduciary includes those who provide investment advice for a fee. Therefore, typically, investment consultants, even if they only provide advice, will be viewed as fiduciaries, in addition to those making the decisions.
3. See www.dol.gov/ebsa.
4. See www.oxforddictionaries.com.
5. See https://definitions.uslegal.com.
6. See www.nipa.org (National Institute of Pension Administration). ERISA Section 3(38) investment manager has full fiduciary responsibility for its investment decisions, subject to the terms of the plan documents and its investment policy statement. A 3(38) must be a registered investment advisor, bank or insurance company and must acknowledge its fiduciary status in writing.
7. See www.dol.gov/ebsa.
8. See www.nipa.org. ERISA Section 3(21) *investment fiduciary* is a paid professional who provides investment recommendations to the plan sponsor/trustee. The plan sponsor/trustee retains ultimate decision-making authority for the investments and may accept or reject the recommendations.
9. See www.sec.gov. Section 202(a)(11) of the Investment Advisers Act of 1940 defines an *investment adviser* as any person or firm that, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities. Investment advisers that manage more than $100 million must register with the Securities and Exchange Commission.
10. Form ADV consists of two parts. Part 1 contains information about the advisor's business and whether the advisor has had problems with regulators or clients. Part 2 outlines the advisor's services, fees and strategies.
11. *Duration* is an approximate measure of a bond's price sensitivity to changes in interest rates. The duration of a bond portfolio is measured in years. For example, if a bond has a duration of five years, its price will rise by 5% if interest rates fall by 1%; conversely, its price will decrease by 5% if interest rates rise by 1%.
12. A *constraint* is a limitation or restriction. Investment managers restrict the dollar capacity available for a given investment strategy. For various reasons, managers may implement self-imposed limits on the amount of assets they are willing to accept, thus making their investment product capacity-constrained. Managers often impose capacity constraints to help maintain and preserve the integrity of investment returns or liquidity of their products.
13. See www.cfainstitute.org.
14. See www.gipsstandards.org.
15. See www.insurancejournal.com.
16. See www.dol.gov. Each person handling funds must be bonded in an amount equal to at least 10% of the funds handled. The Department of Labor cannot require bonding for amounts greater than $500,000 or $1 million for plans that hold employer securities.