

THE FIDUCIARY ASSESSMENT OF AN INVESTMENT ADVISOR



BY CARLOS PANKSEP

Much has been written about the importance of fiduciary assessments of plan sponsors and other types of investment fiduciaries such as foundations. Often, the service provider who has the biggest influence on a plan or foundation's fiduciary practices is the investment advisor. Under the Employee Retirement Income Security Act (ERISA), plan sponsors can hire investment advisors as co-fiduciaries to their plans, and are required to monitor them.

- What does a fiduciary assessment involve?
- Why is it important to investors?
- Can it improve investment performance?
- How does it help reputation management?
- What should advisors do?

Reprinted from the Spring 2012 issue of ASPPA's Plan Consultant. The American Society of Pension Professionals & Actuaries (ASPPA) is an organization of actuaries, consultants, administrators and other benefits professionals. For more information about ASPPA, call 703.516.9300 or visit the website at www.asppa.org.

Leading advisors undergo independent fiduciary assessments of their firms in order to convey to their clients that they're seriously committed to their fiduciary responsibilities. In an age of distrust and financial scandal, it's not sufficient to say that you're registered with the Securities and Exchange Commission (SEC). SEC registration is a legal minimum requirement. SEC auditors will perform random audits on firms or when they suspect fraud, but their workload has been more than they can handle. I know of at least one investment advisor who was able to indefinitely postpone an SEC audit by sending the auditor information on his firm's previous voluntary fiduciary assessment. After receiving the details of the fiduciary assessment, the SEC auditor seemed to lose interest.

An investment advisory firm that subjects itself to a third-party assessment is simultaneously confident, and desirous of continuous improvement. Its clients aren't demanding these assessments (yet), but they acknowledge that transparency and full disclosure are now client necessities in this industry.

HOW THE INVESTOR WINS

Generally speaking, advisors must strike a balance between their professional obligations to achieve the best investment returns for clients, and to make a profit for their firm's shareholders. According to Charles D. Ellis, ("The Winners' Game," *Financial Analysts Journal*, July/August 2011) "We're losing the struggle to put our professional values and responsibilities first and our business objectives second."

The struggle is being lost because many advisors aren't investing sufficient resources in effective investment counseling. Effective counseling isn't rocket science. It involves putting a plan in place with a prescribed asset mix, executing the plan in a consistent

way, preparing for downturns, and spending time with clients—particularly when markets and emotions are at extremes.

"The independent advisor's most important investment-related mission," says Bob Veres in his white paper, "The Future of the Financial Advisory Business: Opportunities, Challenges and Trends in the Second Decade of the 21st Century," "is to keep clients from self-destructing—an activity that, for many investors, is immensely more valuable than any portfolio management activity."

Fi360, a training organization in Bridgeville, Pa., publishes a handbook entitled "Prudent Practices for Investment Advisors," which describes 21 best fiduciary practices. This is a framework for effective counselling that's substantiated by regulation and case law, and is considered by many leading advisors to be the road map for generating the best investment performance for their clients.

It's been well documented that, in aggregate, investors suffer from a behavioral gap—their portfolios don't do as well as the funds and products they invest in. This is probably because they trade too much, chase past performance, and then stray from their plan. Also, investors differ in many ways according to assets, income, spending obligations, market skills and experience, time horizon, and risk tolerance. One thing is certain: Whether individual or institutional, they need help in designing and managing suitable investment programs.

THE FIDUCIARY ASSESSMENT

Excellent advisors use independent fiduciary assessments as a governance tool. Assessments help keep the advisor accountable to the assessor and the investor, thereby creating a firm reminder of the professional values of the firm. Regular assessments force the firm to maintain processes that are

Advisors must strike a balance between their professional obligations to achieve the best investment returns for clients, and to make a profit for their firm's shareholders.

sustainable, regardless of market conditions, thereby avoiding ad-hoc management decisions. The result is a systematic and effective investment management system resulting in higher investment returns over the long term.

An assessment should begin with a background check, including civil lawsuit databases and a review of public information such as the *AdvisorCheck* from the SEC and the Financial Industry Regulatory Authority's (FINRA) *BrokerCheck* if applicable. Since the assessment is likely to be used to increase client trust, the background check is a necessary starting point.

Next, a review of all of the firm's investment-related documents is necessary to ensure the fundamentals are sound. These documents include the investment policy statement (IPS) and the service agreement. As most know, the IPS is a foundational document for the investor. According to fi360's handbook ("Prudent Practices for Investment Advisors") the best IPS documents define:

- The duties and responsibilities of all parties involved
- Diversification and rebalancing guidelines with specified risk, return, time horizon and cash flow parameters

- Due diligence criteria for selecting investment options
- Monitoring criteria for investment options and service vendors
- Procedures for controlling and accounting for investment expenses.

The advisor's service agreement has emerged as a central document for the disclosure of fees and conflicts of interest. The U.S. Department of Labor has finalized Regulation § 2550.408b-2(c), which contains mandatory requirements for advisors serving ERISA plans. The regulation

is so prescriptive that it serves as a best practice for advisors to any client type. After all, an individual investor or foundation trustee should be equally sensitive to the disclosure of conflicts of interest.

The assessment should cover the advisor's procedure for asset allocation. What capital market information is used to formulate risk and return models? What assumptions and investment theory is used? Generally, advisors are expected to rely on either (1) widely available computer tools such as mean-variance optimizers and Monte Carlo simulation, or (2) model

portfolios that have been prepared using these same types of statistical programs. Models must be clearly articulated and a comparison to a standard model can help identify inconsistencies. For example, using a sample asset mix, how does the advisor's modeled return and standard deviation compare to a standard? Can the differences be explained? While there is no single preferred asset allocation methodology, the advisor must have a sound and documented approach.

Regarding the implementation of investment strategies, does the advisor apply appropriate watch list

The fi360 Fiduciary Score

The fi360 Fiduciary Score bar charts provide a visual representation of the investment's Score. The following thresholds provide the user with an easy to view assessment of the investment and a suggested course of action.

fi360 Fiduciary Score: 0

No fiduciary due diligence shortfalls.

fi360 Fiduciary Score: 1-25

The investment may be an appropriate choice for use in a fiduciary account.

fi360 Fiduciary Score: 26-50

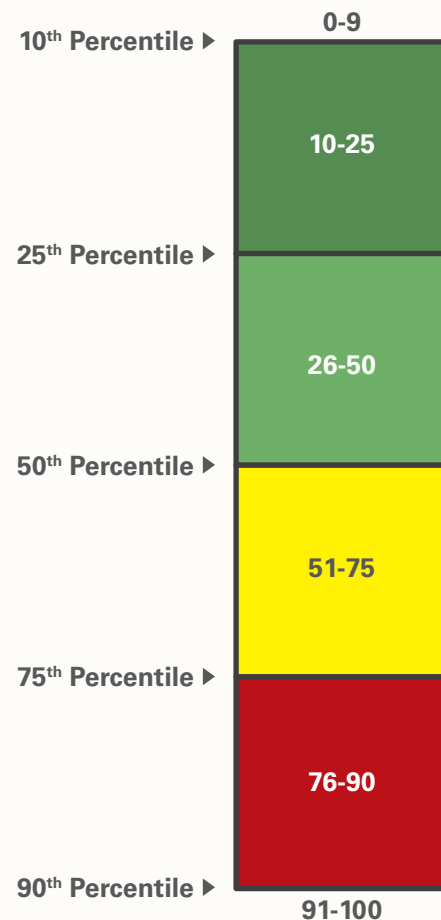
The investment has noteworthy shortfalls. It may not be an appropriate choice if being considered in a search. However, if already in use, the investment may not need to be replaced.

fi360 Fiduciary Score: 51-75

The investment has considerable shortfalls. It may not be an appropriate choice if being considered in a search. However, if already in use, the investment may not need to be replaced.

fi360 Fiduciary Score: 76-100

The investment has significant shortfalls and may not be appropriate for use in a fiduciary account. Strongly consider replacing the investment if already in use.



procedures for underperforming investment options? Are watch list procedures regularly applied? A fiduciary assessment verifies the existence of a procedure through the examination of the investments held in the advisor's client accounts. The examination should seek evidence of the advisor's application of due diligence criteria on each of the investments. Factors such as track record, assets, management tenure, style consistency, and, of course, cost should be considered in the due diligence screens. Fi360 offers a Fiduciary Scoring Tool that simplifies the screening for these factors.

Naturally, there is no single approach to this discipline. It must be well-documented, thorough, and acted upon.

An assessment will seek evidence of written communication with investment managers, particularly when one is hired or fired. Documentation is essential. It serves as the best protection for an investment advisor in the event of litigation. The paper trail, or more realistically the electronic trail, is an effective means of ensuring accountability in the advisor's team and evidence of adherence to an applied process for client management.

With the introduction of DOL regulation § 2550.404a-5 (known as "Participant Disclosure"), which is effective this spring, advisors to ERISA plans should also be assisting in the provision of investment-related fees, performance, and other information to plan participants and beneficiaries. While the ultimate responsibility falls to the plan sponsor, leading advisors will be knowledgeable of the regulatory requirements and able to help coordinate preparation of the disclosures.

The plan's record-keeper will likely provide the majority of the required plan-related and administrative expenses, but it may fall on the advisor to provide the investment-related information. A good fiduciary assessment will query the advisor

on this regulation. The regulation is intended to help ERISA plan participants, but many advisors will offer the same transparency to individuals as well as participants in non-qualified plans.

SAFE HARBOR PROTECTIONS

"Safe harbors" represent protections afforded to fiduciaries of employee benefit plans under ERISA. A rigorous fiduciary assessment of an investment advisor will query the specifics of the Act, serving as a checklist for compliance. The general safe harbor relates to the relief provided to fiduciaries from responsibilities as defined in Section 404(a) of ERISA. Similar relief is also provided in the Uniform Prudent Investor Act (UPIA) Section 9(a), Uniform Prudent Management of Institutional Funds Act (UPMIFA) Section 5(a), and Uniform Management of Public Employee Retirement Systems Act (MPERS) Section 6(d). Specific safe harbors in ERISA include:

- Section 3(38) of ERISA relates to the relief provided to fiduciaries from responsibility in connection with investment decisions made by an "investment manager."
- Section 404(c) relates to the defense afforded to fiduciaries of participant-directed retirement plans.
- Section 404(c)(5) guides the investment of funds in qualified default investment alternatives (QDIAs) when a participant fails to direct the investment of his account.
- Sections 408(b)(14) and 408(g) relate to the relief provided to fiduciaries from responsibility in connection with investment decisions made by a "fiduciary adviser," (as defined in the Pension Protection Act) who gives advice to participants.

Better to ask about the requirements of these safe harbors in an assessment

than in a courtroom! The assessment can be thought of as a plaintiff attorneys "discovery" in a potential litigation. An advisory firm that markets its own assessment can ward off plaintiff attorneys. Industry-leading insurance agencies such as the North American Professional Liability Insurance Association (NAPLIA) offer discounts on professional liability premiums to firms that are regularly assessed; they're lower-risk clients.

CLIENT FILE SAMPLING

The best test of an advisory firm's attention to its clients is a review of its actual files. I acknowledge that a client relationship is quite intangible and can't be precisely assessed. Individuals have different personalities and behaviors, while investment committees can have vastly diverse priorities. Client files, however, are excellent indicators of the state of the relationship, and of the advisor's organizational capabilities. Depending on the type of client, an excellent file should include:

- Client agreement (dated and signed)
- IPS (dated and signed)
- Documentation of the most recent account review
- Trust documents (if applicable)
- Investment Committee minutes
- Vendor Service Agreements
- Projected Cash Flow Analysis (for defined benefit plans)
- Documentation of the most recent rebalancing
- Documentation of due diligence for investment options
- Evidence of watch list procedures used

Some advisors say that their clients either refuse to meet, don't have time, or simply don't respond to meeting requests. The advisor's attempts to meet (either by email or date of attempted call) should be kept within the file.

BUILDING TRUSTWORTHINESS

Leading advisory firms, particularly new or independent ones, know the importance of establishing trust with clients. With volatile markets, a seemingly endless debate on the "fiduciary standards" among legislators and industry groups, and the occasional scandal or lawsuit for breach of fiduciary duty, investors have cause for heightened distrust.

"The pursuit of trustworthiness is not a purely altruistic practice," write Paul A. Argenti, James Lytton-Hitchins, and Richard Verity in "The

Good, the Bad, and the Trustworthy." (Strategy + Business, Winter 2010.) "It is a choice that some companies make to establish themselves in an age when corporate reputation matters. This doesn't mean that to be trustworthy a company must be flawless. But the company must at the very least admit mistakes and accept responsibility for them, gain the commitment of all employees to fix broken business practices that cause harm or that no longer reinforce the business strategy, and offer a realistic plan to deliver on its promises in the future."

The fiduciary assessment is rigorous and hence affects the culture of the organization. It's a useful tool for advisory firms to gain commitment and accountability from staff. From a marketing perspective, it's a tangible representation of that culture.

CONCLUSION

Regular fiduciary assessments of an investment advisor are rigorous activities that can lead to reduced risk and enhanced differentiation for the advisor, and improved investment performance for its clients. As the industry evolves over the next decade, plan sponsors, foundations, and individual investors will increasingly demand fiduciary assessments of their advisors. Those firms that voluntarily undertake these assessments will be industry leaders. **PC**



Carlos Panksep is general manager of the Centre for Fiduciary Excellence, LLC in Toronto, Ontario, Canada.



ASPPA RETIREMENT PLAN SERVICE PROVIDER CERTIFICATION

**Assessments are performed
by CEFEX, Centre for Fiduciary Excellence, LLC.**

The following firms are certified* within the prestigious **ASPPA Service Provider Certification** program. They have been independently assessed to the ASPPA Standard of Practice. These firms demonstrate adherence to the industry's best practices, are committed to continuous improvement and are well-prepared to serve the needs of investment fiduciaries.



For more information on the certification program, please visit: <http://asppa.org/home-page/rkcert.aspx> or call 416.693.9733.

Actuarial Consultants, Inc.
Alliance Benefit Group North Central States, Inc.
Alliance Benefit Group of Houston
Alliance Benefit Group of Illinois
American Pensions, Inc.
ASPIre Financial Services, LLC
Associated Benefit Planners, Ltd.
Atessa Benefits, Inc
Benefit Consultants, LLC
Benefit Plans, Inc.
Benefit Plans Plus, LLC
Benefits Administrators, LLC
Blue Ridge ESOP Associates
Creative Plan Designs Ltd.
DailyAccess Corporation
ExpertPlan, Inc.
First Allied Retirement Services/Associates
in Excellence
Ingham Retirement Group
Kidder Benefits Consultants, Inc.
Moran Knobel
North American KTRADE Alliance, Inc.
Pension Financial Services, Inc.
Pension Plan Professionals, Inc.
Pension Solutions, Inc.
Pinnacle Financial Services Inc.
Retirement Planning Services, Inc.
Rogers Wealth Group, Inc.
SI Group Certified Pension Consultants
SLAVIC401K.COM
Summit Benefit & Actuarial Services
Summit Retirement Plan Services Inc.
TIAA-CREF

*As of January 30, 2012