Discretionary or Nondiscretionary Investment Management Approaches

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Today’s Topics

• What is discretionary investing?
• Why grant discretionary authority?
• What is the impact upon fiduciary responsibility?
• Are there different levels of discretion?
• Are there different discretionary models?
What Is Discretionary Investing?

Level 1
- Plan Design and Process
- Return Assumptions
- Actuarial Rates and Tables
- Benefits Levels
- Projected Cash Flows

Plan Sponsor

Level 2
- Asset Allocation—Strategic and Tactical
- Manager Selection
- Rebalancing

Consultant

Level 3
- Portfolio-level Buys and Sells

Manager
What Is Discretionary Investing?

Plan Sponsor

Investment Policy Statement

Investment Consultant

Investment Committee (optional)

Equity

Large Growth
Large Value
Mid Cap Blend
Small Cap Blend
Int'l Equity

Fixed Income

Core Fixed
High Yield
Int'l Bonds

Alternatives

Real Estate
GTAA
Hedge Funds
Commodities
Priv. Equity
What Is Discretionary Investing?

- There is discretionary authority
  - Level 1—Plan sponsor
  - Level 3—Manager buys and sells
- There is not discretionary authority
  - Level 2—Consultant asset allocation, manager selection and rebalancing
What Is Discretionary Investing?

- Discretionary investing defined: The granting to an investment professional the prior authorization to transact on behalf of the plan sponsor within written guidelines.
What Is Discretionary Investing?

• Granting discretionary authority to an investment consultant
  – Asset allocation
    • Strategic and tactical
  – Manager selection
  – Rebalancing

• Not unlimited
  – Investment policy statement (IPS)
  – Prudent fiduciary standards still apply
Why Grant Discretionary Authority?

- Better investment performance
- Investing is now “too complex”
  - Lack of trustee expertise
- Nimbleness/speed of execution
- Shorter meetings
- Fewer conflicts of interest
- Performance is now clearly “owned”
- More fiduciary liability insurance coverage
- Unanimity of decisions
What Is the Impact Upon Fiduciary Responsibility?

- Trustees are not “off the hook”
- Trustees must still monitor the investment consultant and investment managers
  - Consider hiring an independent monitor
- Trustees must still understand the investment process and strategy
- Because trustees are no longer directly involved in Level 2 decisions, greater emphasis on reporting is needed
What Is the Impact Upon Fiduciary Responsibility?

• Trustees must seek competitive/fair pricing for competent services
  – Consider RFP and search

• What is the fee difference?
  – Should OCIO cost more or less?
Are There Different Levels of Discretion?

- Not an all-or-nothing decision

<table>
<thead>
<tr>
<th>No Discretion</th>
<th>Rebalance</th>
<th>Tactical Asset Allocation</th>
<th>Manager Hire/Fire</th>
<th>Asset Allocation</th>
<th>IPS</th>
<th>Total Discretion</th>
</tr>
</thead>
</table>

- Short-term and Immediate
- Long-term and Steady

- Rebalance to strategic asset allocation
  - Broaden allowable ranges
- Tactical asset allocation with AUM% and goal
- Fire-then-index followed by traditional search
- Long-term strategy does not demand immediacy
  - Can it wait until the next meeting?
Are There Different Discretionary Models?

Plan Sponsor

Investment Policy Statement

OCIO

Equity

Large Growth
Large Value
Mid Cap Blend
Small Cap Blend
Int'l Equity

Fixed Income

Core Fixed
High Yield
Int'l Bonds

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Are There Different Discretionary Models?

“I was spreading some risk around, and apparently it all wound up in your portfolio.”
Are There Different Discretionary Models?

• Is it prudent putting all your big decision eggs in a single consultant’s basket?
  – No diversification of thought for:
    • Asset allocation
    • Tactical asset allocation
    • Manager selection
    • Rebalancing
    • Performance reporting

• Are there other discretionary models that diversify active consultant risk?
Are There Different Discretionary Models?

Plan Sponsor

Investment Policy Statement

OCIO

- Large Growth
- Large Value
- Core Fixed
- High Yield
- Real Estate
- GTAA
- Hedge Funds
- Commodities
- Priv. Equity
- Mid Cap Blend
- Small Cap Blend
- Int'l Equity
- Int'l Bonds
- Commodities

OCIO

- Large Growth
- Large Value
- Core Fixed
- Int'l Equity
- Int'l Bonds
- Commodities
- Priv. Equity
- Real Estate
- Mid Cap Blend
- Small Cap Blend
- Int'l Equity
- Int'l Bonds
- Commodities
- Priv. Equity
Are There Different Discretionary Models?

• Multiple OCIOs create many benefits
  – Diversify investment consultant risk
  – Eliminate monopoly of investment thought
  – Performance measurement improvement
  – Competitive forces
  – But more fees
    • Investment consultant
    • Manager fees

• How many OCIOs is optimal?
  – Trade-off between fees and diversification
Are There Different Discretionary Models?

- Why settle on multiple OCIOs?
- Why not multiple multi-asset class (MAC) managers?
  - Follow same broad investment guidelines
  - Real-time dynamism
  - Lower management fees
    - 20%-50% fee savings
  - Monitoring ease
  - Administrative/legal ease
Multiple Multi-Asset Class (MAC)

Plan Sponsor

Investment Consultant (optional or part-time)

Investment Policy Statement

- MAC-A
  - Large Cap
  - Mid Cap
  - Small Cap
  - International
  - Core Fixed
  - High Yield
  - International Fixed
  - Real Estate
  - Hedge Funds
  - Commodities
  - Private Equity
  - GTAA

- MAC-B
  - Large Cap
  - Mid Cap
  - Small Cap
  - International
  - Core Fixed
  - High Yield
  - International Fixed
  - Real Estate
  - Hedge Funds
  - Commodities
  - Private Equity
  - GTAA

- MAC-C
  - Large Cap
  - Mid Cap
  - Small Cap
  - International
  - Core Fixed
  - High Yield
  - International Fixed
  - Real Estate
  - Hedge Funds
  - Commodities
  - Private Equity
  - GTAA

- MAC-D
  - Large Cap
  - Mid Cap
  - Small Cap
  - International
  - Core Fixed
  - High Yield
  - International Fixed
  - Real Estate
  - Hedge Funds
  - Commodities
  - Private Equity
  - GTAA
Multiple Multi-Asset Class (MAC)

- Variations of “Multi-MAC” model
  - Active/Passive MAC managers
    - Diversify delegation of active vs. passive decision
  - Passive-only MAC managers
    - Rock bottom fees and diversify allocation function
  - OCIO can be a MAC manager
  - Illiquid alternatives consultant
## Model Comparison

<table>
<thead>
<tr>
<th></th>
<th>Balanced Manager</th>
<th>Non-Discretionary</th>
<th>OCIO</th>
<th>Multiple MACs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Managers</td>
<td>1</td>
<td>10+</td>
<td>10+</td>
<td>3 to 5</td>
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<tr>
<td>Administrative/Legal Demands</td>
<td>Low</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
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<tr>
<td>Meeting Length</td>
<td>Short</td>
<td>Long</td>
<td>Medium</td>
<td>Short</td>
</tr>
<tr>
<td>Manager Changes</td>
<td>Infrequent</td>
<td>Frequent</td>
<td>Frequent</td>
<td>Infrequent</td>
</tr>
<tr>
<td>Nimbleness in Markets</td>
<td>Medium-Fast</td>
<td>Slow</td>
<td>Medium</td>
<td>Fast</td>
</tr>
<tr>
<td>Management Fees</td>
<td>$</td>
<td>$$$</td>
<td>$$$</td>
<td>$</td>
</tr>
<tr>
<td>Consultant Fees</td>
<td>$$</td>
<td>$$$</td>
<td>$$$</td>
<td>$</td>
</tr>
<tr>
<td>Personnel Risk</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
<td>Low</td>
</tr>
<tr>
<td>Fiduciary Risk</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Monitoring/Transparency Risk</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Diversification w/in Asset Class</td>
<td>Low</td>
<td>Medium</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Diversification of Active Risk</td>
<td>Low</td>
<td>Medium</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Diversification of Allocation Risk</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
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<tr>
<td>Diversification of Selection Risk</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Diversification of Rebalancing Risk</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Session #I10

Discretionary or Nondiscretionary Investment Management Approaches

- Granting discretionary authority has many benefits and a few drawbacks
- Not an all-or-nothing decision
  - Which decisions require immediacy?
- Trustees are never “off the hook”
  - Increase monitoring and disclosure
  - Consider an independent monitor
- Consider diversified delegation model
  - More than one OCIO
  - Multiple multi-asset class (MAC) managers
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