RBC Global Asset Management
PH&N Institutional

Introduction to Delegated Service Models

Delegated Investment Services Part 1

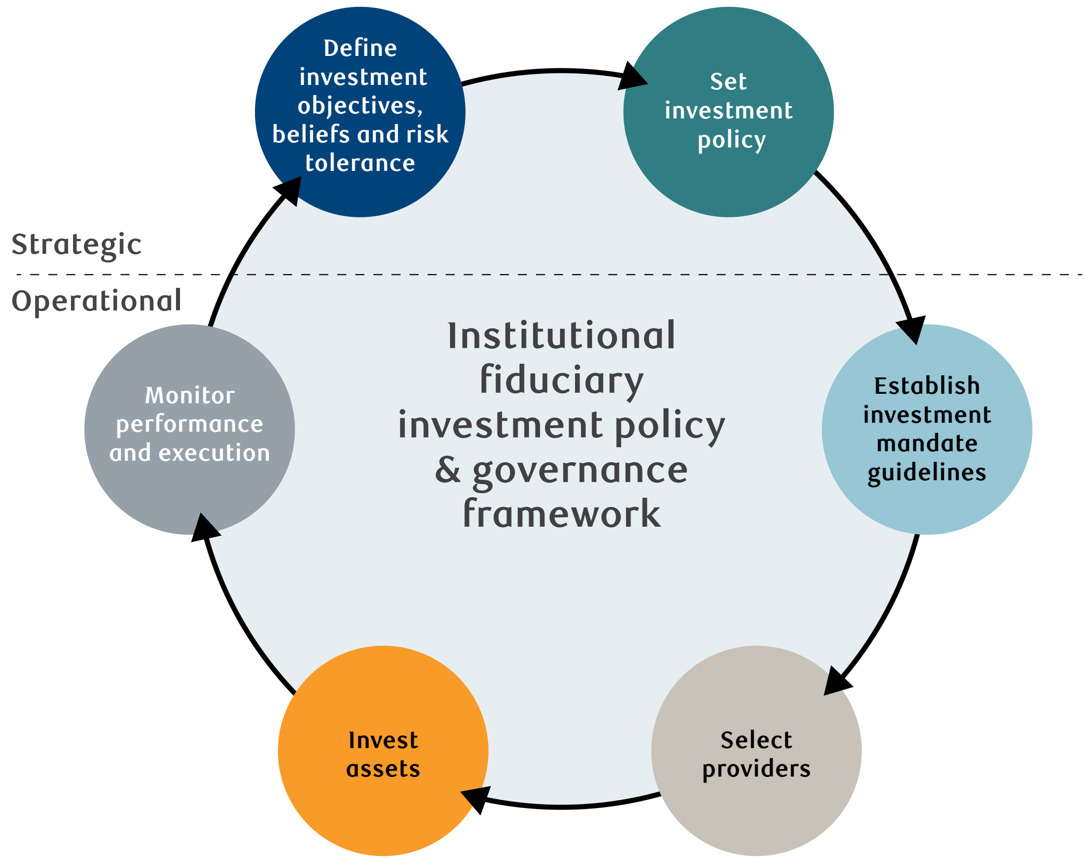
In Part I of this three-part series, we will discuss the origins of the delegated service model and examine the driving forces behind this trend, the different forms the service model can assume, and the potential benefits to both fiduciaries and stakeholders.

Introduction to the Delegated Investment Service Model

An institutional investment fund typically represents a large pool of assets that exists to support a specific outcome; for example, the payment of pensions to a retirement plan's members or the disbursement of donor capital to fund charitable endeavors. The management and administration of the assets will invariably involve many different individuals, some of whom will ultimately bear the designation of fiduciary. A fiduciary is an individual to whom a pool of assets may not belong, but who is empowered to make decisions with respect to those assets that will affect outcomes. As such, a fiduciary will have a moral and legal obligation to act in the best interest of the beneficiaries of the assets; accordingly, they will operate under a formal governance structure to fulfill this obligation.

While the exact governance structure of each institutional investment fund will vary, we typically observe a broadly similar decision and governance framework when it comes to institutional assets' investment policy. This is illustrated in the diagram below.

Under the traditional application of this governance framework, fiduciaries are responsible for the selection, evaluation, monitoring, and adjustment (if needed) of all components. Meanwhile, retained third parties – such as consultants and asset managers – often act in an advisory capacity or at the explicit direction of the governing fiduciaries. While these third parties are subject to a fiduciary obligation from an operational standpoint, their responsibility to asset beneficiaries is typically indirect and more limited, because they are not empowered to make discretionary decisions within the investment policy cycle.



The preceding paragraph described the traditional approach to investment policy construction and execution, but more recently an alternative service model has emerged that has been gaining popularity and has lately become a mainstream consideration. Simply put, this new service model allows fiduciaries to formally delegate decision-making and the associated fiduciary accountability to third-party service providers. While this type of arrangement is known by different names in the market – for example, **outsourced chief investment officer** (OCIO) or **fiduciary management services** – the generalized term for such arrangements is **delegated investment services**. The following section will examine the forces that have led to the emergence of these types of offerings.

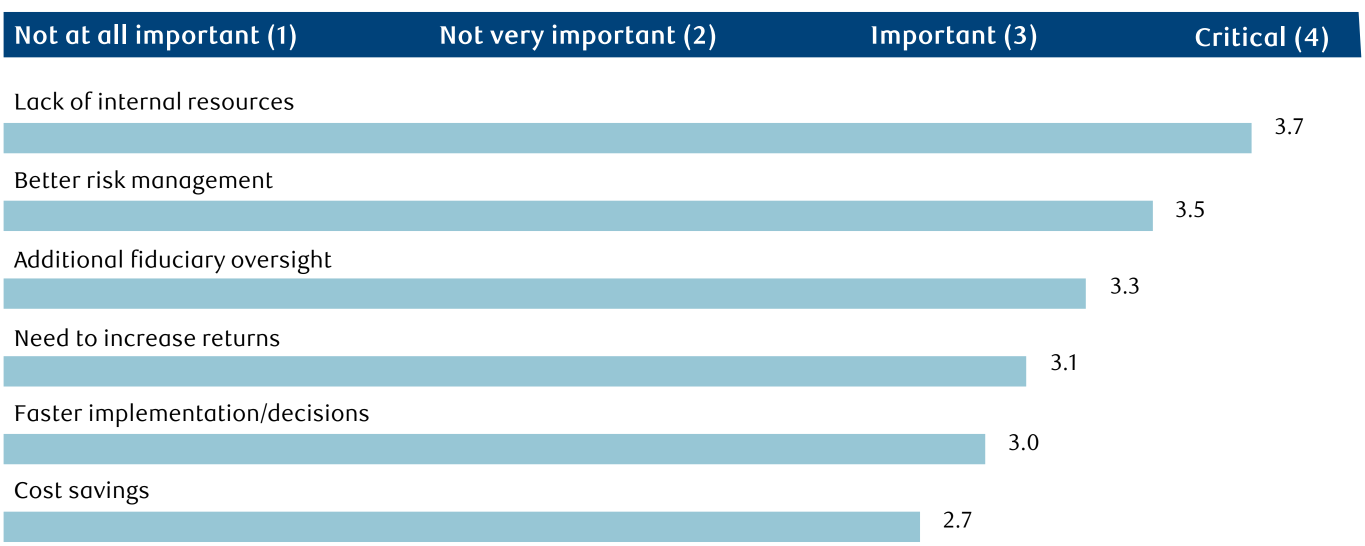
Factors driving demand for Delegated Investment Services

A number of developments have created an environment that presents considerable challenges to fiduciaries' ability to fulfill their governance responsibilities and make decisions that best support successful outcomes for beneficiaries. This is largely attributable to the following factors:

- a limited or declining base of internal resources (staff, budget, and time) to support fiduciaries;
- a challenging market environment characterized by low return expectations across major asset classes;
- a growing breadth of asset classes and investment strategies that are increasingly complex and require more time and knowledge to analyze, implement, and monitor;
- an increased desire for customized, holistic investment solutions that leverage various fields of expertise in one highly responsive, interconnected framework; and
- the evolution of regulatory structures that lead to more stringent governance standards.

According to **Chief Investment Officer Magazine**'s 2018 Outsourced-Chief Investment Officer Survey, the top reasons cited by respondents driving the demand for delegated service offerings were insufficient internal resources, improved risk management, and additional fiduciary oversight. A more comprehensive list of factors and their ranking by importance is presented in the following figure:

Factors driving demand for delegated investment service models



Source: Chief Investment Officer Magazine: 2018 Outsourced-Chief Investment Officer Survey

Under a delegated investment services model, most of these challenges are addressed by leveraging the expertise and resources of the delegated provider. This party will assume a greater degree of discretionary decision-making otherwise conferred upon the fiduciaries, in addition to sharing the fiduciary accountability associated with those activities. By doing so, fiduciaries aim to achieve better outcomes for beneficiaries by potentially benefitting from the following factors inherent to a delegated service arrangement:

- access to an array of different professionals with specialized expertise;
- access to a greater range of strategies and tools;
- increased accountability from providers for outcomes;
- access to a more extensive monitoring and governance infrastructure; and
- ability to respond more quickly to market developments.

The principles of delegation

As previously illustrated, the governance framework and decision cycle for fiduciaries involves a multitude of steps that can vary in scope and complexity depending on the investor. It is important to note that adopting a delegated investment services arrangement does not fundamentally alter any of these steps, or change the framework – it merely entails a different service arrangement with respect to execution and accountability.

That said, it is equally important to note that there are certain decisions and fiduciary responsibilities in the governance framework that cannot be delegated to a third-party's discretion – we've illustrated these in the table that follows. The fiduciary line represents the threshold of responsibility, and accountability for those components that lie above it – defined here as the **Strategic** elements – must remain with the governing fiduciaries. Those services categorized as Operational, however, can be fully outsourced as part of a delegated investment services arrangement.

		Traditional Service Model		Delegated Service Model	
		Trustees	**3rd Party**	**Trustees**	**Delegated Service Provider**
Strategic	**Overall plan governance**	✔		✔	Support
Strategic	**Solution design** ▪ Define investment objectives ▪ Establish strategic investment policy ▪ On-going revision and strategy evolution	✔	Advice from Consultants & Asset Managers	✔	Advice
FIDUCIARY LINE					
Operational	**Implementation** ▪ Portfolio construction ▪ Manager selection ▪ Asset allocation management – Rebalancing – Glide paths – Tactical ▪ Cash flow management and trade execution ▪ Risk management ▪ Oversight of underlying mandates ▪ On-going research and innovation	✔	Advice from Consultants Asset Managers execute with direction from Trustees	Delegated	✔
Operational	**Total plan monitoring & compliance** ▪ Total portfolio performance & compliance	✔		Delegated	✔
Operational	**Total plan reporting** ▪ Written and in-person reporting of results ▪ Economic and capital market research ▪ Thought leadership and education	✔		Delegated	✔

One way to characterize the distinction between what can and cannot be delegated is to consider the various functions as they relate to the establishment of a Statement of Investment Policies and Procedures (SIPP).

The **Strategic** components – the articulation of fund objectives, investor beliefs, and risk tolerance, as well as the determination of the long-term asset mix and other investment policy items – lay the groundwork for what the investor hopes to achieve and for the establishment of the SIPP. While fiduciaries benefit from the advisory support of their delegated service provider, the ultimate decision-making authority for these components invariably remains with the governing fiduciaries themselves. **Operational** services, on the other hand, follow the establishment of the SIPP and comprise the implementation of the established objectives and processes with the goal of achieving the desired outcome. The fiduciary line lies between the two stages and effectively involves the establishment of the SIPP itself.

What this means is that while fiduciaries can delegate the key design, decision-making, and execution responsibilities that go into developing a robust governance structure, the ownership of the SIPP remains under their sole fiduciary purview. As a result, the delegation of implementation and execution does not absolve fiduciaries of the ultimate accountability for overall outcomes.

Determining whether a delegated service model is right for you

As an institutional investor, a few of the tell-tale signs that moving towards a delegated service model could be an appropriate and ultimately beneficial course of action include:

- too much time spent on operational elements of investment policy rather than strategic elements;
- long delays in implementing changes to the investment structure;
- inability to explore different avenues or consider new sources of information that could lead to beneficial changes to the investment program; and
- concerns or evidence of lapses in certain governance activities due to lack of time, resources, or expertise.

Just as each institutional investor has a unique set of obligations and challenges, the type and extent of delegated services they require will likewise be unique. Whether looking for a turnkey solution that comprises the full spectrum of delegated services or seeking focused support in specialized areas, it is important that fiduciaries precisely identify the functions in their governance structure that would benefit from delegation to a third party. This in turn will provide clarity for all stakeholders and influence the process for identifying the right provider.

Conclusion

The role of the plan fiduciary has become increasingly complex as the breadth and sophistication of investment strategies has grown and the regulatory framework has evolved; meanwhile, the standard of good governance has continued to rise. The resulting challenge is all the more pronounced in cases where the resources available to them are declining. In response to this changing role and environment, the external service offerings available to meet the needs of fiduciaries have likewise evolved. This paper has discussed the emergence of the delegated investment services model and its principal features and potential benefits; next in this three-part series, we will describe the primary service providers in this arena and offer helpful criteria to assist fiduciaries in selecting the right partner to help them meet specific plan objectives and requirements.

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