RBC Global Asset Management
PH&N Institutional

Selecting a Delegated Services Provider

Delegated Investment Services Part 2

Implications of delegation

In Part I of this series we discussed the origins of the delegated service model and its principal features. For Part II, we will describe who the primary service providers are and how to select the right one to meet specific plan objectives and requirements.

While the act of delegating key governance and investment decision-making and execution to a third party results in a greater sharing of fiduciary responsibility and risk, it is important to recognize that it does not absolve the fiduciaries of their accountability for overall outcomes, or the governance of the delegated activities. Fiduciaries are ultimately responsible for their choice of delegated service provider and for taking remedial action if inadequate service fulfilment is compromising, or could potentially compromise, investment objectives.

As a result, a robust decision framework and criteria for selecting the appropriate provider is of critical importance when deciding to move to a delegated service model. This is especially true as the number of delegated service providers targeting the institutional space grows, along with the variety and scope of their offerings. Every provider's background and experience level will be different, as are the service model, fee structure, and operational infrastructure they offer, some of which may be more (or less) suitable for fulfilling the fiduciary's needs. It is therefore important to objectively evaluate the value propositions of each potential provider before engaging their services.

Overview of prevalent service providers

There are three primary types of providers in the delegated services space that have the ability to service institutional investors: 1) investment consultants; 2) asset managers; and 3) independents. Some of these providers will focus on offering delegated services that are directly aligned with their core business, as illustrated in the graphic below. However, others have built a complete delegated service offering that spans all matters of governance, investment management and administration.

Provider	Core business
Investment consultant	▪ Advisory services ▪ Third party monitoring ▪ Investment policy due diligence
Asset manager	▪ Trading in public and private capital markets ▪ Manufacturing and delivering investment strategies ▪ Portfolio management and compliance
Independents	▪ Insurers, record-keepers, fund of fund managers, etc. ▪ Account administration and reporting ▪ Investment fund platforms

Regardless of the desired scope of delegated services or the provider's background, the offering and value proposition of the retained model should be the one that best supports the fiduciaries' objectives and governance framework. To that end, some service models may be better suited than others.

Selection criteria and key considerations

The execution of the outsourced tasks will be pivotal to the long-term success and sustainability of an institutional asset base. As such, it is imperative to establish a robust and methodical framework for selecting a delegated service provider whose offering aligns with the fiduciaries' objectives, philosophy, and governance requirements.

First and foremost, the provider must act as a trusted partner whose primary mandate is to work with the fiduciaries to design and implement a model that is uniquely suited to their situation and needs. In support of this, providers must possess:

1. Strong governance framework that underpins all of the delegated activities
2. Rigorous risk management and compliance infrastructure
3. Robust operational structure to minimize incidence and impact of execution errors

Furthermore, the execution and reporting of the delegated activities need to be outcome-oriented rather than theoretical. The provider should have established systems in place to track and measure their progress and, in turn, demonstrate their ability to report tangible results and deliver on the stated objectives. Conversely, incomplete reporting procedures and an undefined method of performance tracking are signs of an inadequate service infrastructure that increases the risk of suboptimal results.

Depending on the scale of delegation, there are other important factors to take into consideration as well when choosing a service provider.

Depth & quality of advisory services	▪ Sufficient ability and resources to tailor the service model and level of delegation according to specific needs and preferences ▪ Knowledge and extensive experience in building strategic asset allocation decisions in area of specialization ▪ Rigor of quantitative analytics and technical know-how ▪ Commitment to providing ongoing support and contribution of best ideas in a proactive manner
Depth & performance of investment capabilities	▪ Deep platform of investment solutions with strong performance track records that meet industry and regulatory reporting standards ▪ Sufficient investment capabilities across asset classes, strategies, and management styles with capacity to provide global servicing if necessary ▪ Unbiased assessment of, and well-supported rationale behind using an open (external sourcing of investment products) or closed (internal manufacturing of investment products) platform ▪ Strong foundation of risk management and governance ▪ Continuous evolution of platform to maintain delivery of value-added
Client service & reporting	▪ Dedication to client service and timely communication ▪ Clear and comprehensive reporting that illustrates all aspects of delegated activities and allows fiduciaries to easily assess the provider's fulfillment of services ▪ Accessible and useful data
Fees	▪ Transparent and competitive fees that are commensurate with the value proposition of services ▪ No opaque fee bundling

Conflicts of interest

Throughout the selection process, it is important to consider potential conflicts of interest that providers may encounter in the fulfilment of their delegated duties, as well as how they manage them. Conflicts of interest can arise from multiple sources, such as lack of independence, imprudent governance, and third party affiliations.

Of particular importance to the delegated model is the difference between an "open architecture" and a "closed architecture" investment platform. Providers with limited investment capabilities and capital market presence must source all of their funds externally via an open structure. In contrast, credible closed architecture providers are experienced capital market participants with an established and extensive platform of internally manufactured strategies and resources.

Proponents of the open structure argue that it allows for best-in-class manager selection and a more diverse array of substitutes; conversely, a concern associated with closed structures can be that they narrow the investment universe to what's offered by one asset manager and their affiliates, which could result in sub-optimal diversification and performance. While this is theoretically valid, there is evidence suggesting that the probability of consistently selecting top-performing managers over the long term is relatively low[1].

Consequently, there is no guarantee that an open architecture platform will lead to better overall fund performance in a given asset class.

Another potential issue with an open architecture platform directly relates to conflicts of interest. The pricing model associated with an open offering tends to carry two layers of fees, one for the third-party investment managers and the other for the delegated provider. While clients might only see the all-in pricing of the delegated offering, there are in fact two separate groups earning fees in an open architecture service model. Conflicts of interest can arise if the delegated provider decides to source investment capabilities from subadvisors that charge lower fees so that the total cost of a delegated service arrangement remains competitive or supports their desired margins. This situation is susceptible to producing subpar performance as top-tier, third-party managers who are unwilling to adjust their fees may be excluded from the delegated provider's investment line-up. Consequently, an open architecture platform may not always lead to the combination of managers and funds with the best value-add.

Conversely, closed providers will typically charge for investment management services only so there is only one party collecting fees. With that said, a closed provider could be incentivized to include higher-fee strategies with sub-optimal track records when exercising discretion over fund allocations. Thus, conflicts of interest can exist with both types of platforms, and assessing the extent to which the provider balances and mitigates that conflict is a critical consideration when selecting a delegated investment services provider.

Lastly, the capacity to perform key governance and monitoring activities to maintain a high-quality, top-performing solution set differs between an open and closed structure as well. For instance, whether the provider has direct access to investment management teams will greatly influence their ability to identify issues, adopt corrective measures, and adapt the fund line-up to changing conditions in a timely fashion. A delegated provider who manufactures all of the platform's investment strategies (i.e. closed) will typically have instant and unfettered access to the various management teams and fund data, allowing for timely identification of issues and intervention. Furthermore, there is a high likelihood that the compensation of individuals who oversee the manufacturing teams (in most cases, the CIO) will be directly tied to fund performance, resulting in an alignment of interests. When funds are sourced externally (i.e. open), oversight will tend to be more limited due to delayed reporting and a lack of direct access to fund managers.

There are advantages and disadvantages to both models, but most importantly, a thorough assessment of potential sources of conflict and how they can be mitigated should be undertaken before hiring a provider.

[1]Source: University of Oxford, "Picking winners? Investment consultants' recommendations of fund managers" (2013); UK Financial Conduct Authority and University of Oxford, "Investment Consultants' Claims about Their Own Performance: What Lies Beneath?" (2018)

Maintaining good governance

While the decision to delegate can simplify many operational and governance elements of managing a pool of institutional assets, it does introduce its own set of challenges. The selected delegated provider can have a significant impact on overall outcomes, both positive and negative, while the process of establishing the right partner can contain nuances that for many represent uncharted territory.

The essence of conducting due diligence on a potential delegated model is no different from that of any service provider, such as a consultant, fund manager or custodian, with similar applicable screening processes and standards:

- Develop a system to document and properly articulate rationale to demonstrate responsible decision-making
- Objectively scrutinize selection criteria and consider a wide range of options from different providers and models
- If needed, solicit advice and RFP assistance from an independent third party advisor who does not offer delegated services

The bottom line

Delegating some or all of the investment and governance activities associated with a pool of institutional assets can greatly simplify operations and potentially lead to superior outcomes. However, it can also introduce new challenges and represent a daunting shift from the dynamics to which fiduciaries are accustomed, especially for those with little to no prior exposure to this evolving area of the investment management industry. To be sure, the number and complexity of delegated service providers are rising fast, and there is a dearth of information in the public forum that is sometimes contradictory or confusing.

Disregarding the promotional noise, the overriding considerations are straightforward and familiar. The ideal provider should regard the business relationship as a partnership in which they share in the fiduciary responsibilities, and be able to provide concrete, evidence-based reporting of service fulfilment that's supported by strict risk management, governance, and compliance controls.

A smooth and successful transition into a delegated model can only be achieved through the objective and comprehensive evaluation of all available offerings, along with an open mindset to modify and potentially transform the existing approach. Once implemented, it is the duty of fiduciaries to continuously evaluate the performance and service quality of their provider, and initiate corrective measures if necessary. We will discuss the ongoing governance of a delegated service model in Part III.

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