

Board Oversight of Investment Performance

Session 3 of
Core Responsibilities of Fund Directors
June 4, 2014

Panelists

- **Julie Allecta, Moderator**
Independent Trustee
Forward Funds
- **Jane Freeman**
Lead Independent Director
Harding Loevner Funds
- **Norman Mains**
Managing Director, Chief Administrative & Risk Officer
Forward Funds
- **Christopher E. Palmer**
Partner
Goodwin Procter LLP

Agenda

- Board Oversight Responsibilities Regarding Performance
- Board Governance Structure and Oversight Processes
- Understanding the Characteristics and Performance Expectations of the Fund
- Board Oversight of Alternative Strategy Funds
- Understanding the Adviser's Investment Processes and Organization
- Addressing Underperformance

Board Oversight Responsibilities Regarding Performance

- Investment performance oversight is a key Board responsibility
 - General fiduciary duty
 - Important factor in annual Section 15(c) contract renewal process
- To oversee investment performance, it is important to understand fund objectives and strategies and the adviser's organization and processes
- Investment performance oversight relates to other oversight responsibilities, such as risk and compliance
- As the fund industry continues to evolve and become more complex, Boards should continue to enhance their understanding of investment management concepts and the objectives and strategies of the funds they oversee

Board Governance Structure and Processes

Board/Committee Structure

- Governance structure and processes may vary depending on a variety of factors, including
 - Range of funds and asset classes the Board oversees
 - Number of funds overseen
 - Board size and composition
 - Board structure (e.g., unitary or cluster)
- Some, but not all, Boards have investment committees
 - May have two or more committees meeting concurrently, based on asset class (e.g., equity and fixed income) or other characteristics (e.g., sub-advised and internally managed)
 - May have a “committee of the whole,” with all directors or independent directors as members

Board Governance Structure and Processes

Presentations

- Form and style of performance presentations during meetings vary
- Structure and process should be designed to enhance effectiveness and efficiency
 - Who reports to the Board?
 - Adviser CIO only? Individual portfolio managers?
 - For a manager-subadvised fund, are presentations provided by the manager and the sub-adviser(s)? How often do the sub-advisers present, and what are the roles of the presenters (e.g., PM, relationship manager)?
 - How long are the presentations? How much time is reserved for Q&A?
 - Is there a rotation approach? Does the Board or committee focus on a different asset or strategy sub-category at each meeting?

Board Governance Structure and Processes

Reporting

- Board reports may be presented in a variety of forms, based on investment objective, strategies or other characteristics
 - Traditional strategies and asset classes
 - Alternative strategy funds
- Board reports on fund performance should include key information to support the Board in fulfilling its responsibilities
 - Portfolio attribution and drivers of performance (e.g., leverage or risk)
 - Allocations and security selection (e.g., sector or geographic allocation)
 - Key market developments or other significant events
 - Reasons for any over- or under-performance

Characteristics and Performance Expectations

■ Overview

- Expectations of investment performance linked to disclosure
 - Investment objective (e.g., capital growth, capital preservation, current income)
 - Investment strategy
 - Investment policies and restrictions (e.g., concentration in industry/sector or geographic region)
- Fund management structure
 - Manager-of-managers arrangements
 - Fund-of-funds and master-feeder funds

Characteristics and Performance Expectations

- Investment performance is a function of investment objectives, strategies and risk parameters
 - Policies and restrictions regarding types and levels of investment exposure and sources of investment risk
 - Considerations particular to index funds, target date funds and alternative funds
- Understanding permissible asset classes and investments
 - Equities and fixed income securities
 - Market capitalizations
 - Derivatives, commodities and currencies

Characteristics and Performance Expectations

- Evaluating fund performance
 - Understand the rationale for selecting benchmark(s)
 - Broad-based market index disclosed in prospectus (e.g., S&P 500[®] Index)
 - Narrowly based indices (e.g., S&P[®] Global BMI Gold Capped Index)
 - Custom indices (i.e., selecting and combining benchmark indices)
 - Peer universe
 - Peer groups based on characteristics, such as holdings, strategies or objectives
 - Certain strategies make identifying and constructing peer universes more challenging
 - Third party or adviser-constructed universes
 - Time period

Characteristics and Performance Expectations

- Investment guidelines
 - Limit concentration, sectors or other ranges
- Understand impact of turnover and transaction costs
- Understand liquidity needs of fund based on investment strategies and shareholder base
- Recognize favorable and unfavorable market conditions
 - Market conditions in which fund would be expected to outperform verses underperform

Board Oversight of Alternative Strategy Funds

- Alternative investment funds are investment companies that employ strategies and instruments that are broader than traditional funds that limit their investments to equities, fixed income or cash
- Alternative funds may engage in strategies that are broadly classified as equity long/short, global macro, event driven, relative value and others
- Alternative fund strategies may use derivative instruments, currency exposures, leverage and other techniques in executing long, short or hedged positions
- The oversight role of the Board is the same as traditional funds but alternative funds present unique oversight challenges
- Effective oversight of alternative funds require an understanding of the strategy and financial instruments that the fund will employ
- A clear understanding of the strategy, investment risks and operational risks is essential

Board Oversight of Alternative Strategy Funds

- Similar oversight considerations as traditional funds, including performance and risk, but with additional challenges
 - Use of sub-advisers that may not be familiar with applicable regulatory requirements and limitations
 - Adviser must have resources and expertise to manage fund and oversee sub-adviser
 - Identification of peer universes
 - Assessing performance and expenses using peer groups
 - Adequate disclosure of complex investment strategies and products
- Use of internal and external resources

Board Oversight of Alternative Strategy Funds

- Investment and operational risk
 - Monitoring leverage and liquidity
 - Concentration and “names rule” compliance with derivative and short positions
 - Valuation
- Compliance and legal monitoring infrastructure
 - Adviser
 - Sub-adviser
 - Service providers

Adviser's Investment Processes and Organization

- Understand active vs. passive management
 - Active – seek long-term returns above benchmark
 - Passive – seek to track structure, returns and risk of benchmark
 - Active risk vs. tracking error
- Investment process
 - Top-down, bottom-up or other qualitative assessments
 - Quantitative or model-driven evaluation and allocation
 - Components of investment process may include, among others, identification of investable universe and/or focus list that is implemented by allocating assets on the basis of various market factors (e.g., political, market or individual company analysis)

Adviser's Investment Processes and Organization

- Adviser's responsibilities include monitoring risks and compliance with regulatory requirements and prospectus and SAI disclosure
 - Risk oversight process and analytics
 - Investment risks
 - Counterparties
 - Stress tests
 - Compliance with regulations and disclosure
 - Investment policies and adviser's guidelines
 - Leverage or borrowing
 - Style drift
 - Resolving issues of concern

Adviser's Investment Processes and Organization

- Selection and responsibilities of portfolio managers and investment personnel
 - Specific qualifications, experience and performance record with comparable investment strategies
 - Experience in investing in specific instrument types
- Investment team turnover and succession plans
- Allocation of portfolio manager's time to management of fund
- Internal reporting lines and access of investment personnel to senior management
- Portfolio manager compensation
 - Portfolio manager interests and incentives aligned with shareholders

Addressing Underperformance

- At times, the Board may determine that enhanced monitoring of a fund is warranted (temporary or persistent performance issues)
- Understand detractors from performance
 - Asset class or strategy
 - Management
- Maintain open dialogue with the adviser
- Boards utilize various approaches, including “watch lists,” based on
 - Repeated underperformance relative to benchmarks
 - Risk outside of target range or negative risk-adjusted returns
 - Increased portfolio turnover or transaction costs
 - Changes to investment management team

Addressing Underperformance

- Remediation steps generally escalate if performance concerns are not addressed
- Board should understand adviser's specific remediation plans, anticipated outcomes and timeframe
- Adviser's remediation may include
 - Adjusting investment process, portfolio structure or risk
 - Dedicating additional resources
 - Long-term structural changes, such as changes to asset classes
 - Restructuring of portfolio managers or investment team

Conclusion

- Oversight of investment performance is an ongoing responsibility
- Effective oversight processes may depend on a fund's investment objective and investment strategies
- Certain strategies (e.g., alternative strategy funds) may require more customized performance reviews and additional oversight on risk and operational matters
- Directors should work with management and counsel to ensure that Board reports include clear information regarding fund performance that addresses directors' need for information
- No one way to deal with underperformance

Resources

- IDC website
 - www.idc.org
 - Fundamentals for Newer Directors, <http://fundamentals.idc.org>
- IDC papers
 - Considerations for Board Composition: From Recruitment Through Retirement
 - Investment Performance Oversight by Fund Boards
 - Overview of Fund Governance Practices, 1994-2012
 - Board Oversight of Exchange-Traded Funds
 - Board Oversight of Target Retirement Date Funds
 - Fund Board Oversight of Risk Management

Resources

- IDC papers cont'd.
 - Board Oversight of Subadvisers
 - Board Oversight of Fund Compliance
 - Board Oversight of Derivatives
 - Board Oversight of Certain Service Providers
 - Board Consideration of Fund Mergers
 - Director Oversight of Multiple Funds
 - Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness
 - Implementing the Independent Chairperson Requirement

Resources

- SEC website
 - www.sec.gov
- ABA Fund Directors' Guidebook
 - www.abanet.org
- ICI Investment Company Fact Book
 - www.icifactbook.org
- Matt Fink, “The Rise of Mutual Funds” (Oxford Press, 2008)
- Robert Pozen & Theresa Hamacher, “The Fund Industry: How Your Money is Managed” (Wiley Finance, 2011)
- Norman Mains, “Winning with Liquid Alternatives” (McGraw Hill, 2014)

Future Webinars

- Oversight of the Fund's Service Providers – September 2014
- Specific Regulatory Responsibilities – December 2014

Panelist Biographies

- **Julie Allecta** is an Independent Trustee of the Forward Funds and the Masters Select Funds and serves as the Audit Chair for the Forward Funds. Ms. Allecta practiced law as a securities attorney for 31 years specializing in investment company and investment management matters before retiring in 2009.

Ms. Allecta studied for her undergraduate degree at Barnard College, Columbia University and later received MBA and JD degrees at the University of New Mexico. Before entering private law practice, Ms. Allecta spent several years with the Securities & Exchange Commission in Washington D.C.

- **Jane A. Freeman** is Lead Independent Director and a member of the Audit Committee of the Harding Loevner Funds. She served as the Chair of the Audit Committee for the Russell Exchange Traded Funds Trust. Most recently, she has served as Chief Financial Officer of Scientific Learning and as an independent consultant. Prior to that she served on the Management Committee of Rockefeller and Co. and co Chaired the Asset Allocation Committee. While there, she was instrumental in launching an absolute return fund of funds. She was a Principal at Scudder, Stevens and Clark where she managed the Scudder Development Fund, a small cap mutual fund. Jane earned her Chartered Financial Analyst charter. She holds a BA in Mathematics and Chemistry and an MBA from Cornell University and a License from the University of Louvain in Belgium.

Panelist Biographies

- **Norman E. Mains** is Managing Director of Forward Management. He has held leadership roles in the areas of research, product development and administration. His newest book *Winning With Liquid Alternatives* is available now on Amazon. He was formerly Executive Director and Chief Investment Officer for Morgan Stanley's Graystone Research—a team focused on creating customized solutions using hedge funds and other alternative investments for high-net-worth individuals, family offices, institutions and foundations. Prior to Morgan Stanley, Mr. Mains ran a fund of hedge fund group at Carr Global Advisors. Previously, he was the Executive Director of Product Development for Dow Jones Indexes, a position he accepted after being the Director of Research and Chief Economist at the Chicago Mercantile Exchange. Mr. Mains has been widely quoted in leading financial publications, appeared regularly on television to discuss financial markets and has co-authored and contributed to several other books on financial topics. He holds a BA and MA from the University of Colorado and has earned a PhD in Economics from the University of Warwick in the United Kingdom.
- **Christopher E. Palmer** is a partner and leader of the business law department in Goodwin Procter's Washington, D.C. office, and is a member of the financial services group. He represents mutual funds, investment advisers, insurance companies and broker-dealers on the development, regulatory approval, sale and administration of a variety of investment products, including mutual funds and variable and fixed life insurance and annuity contracts. He also represents mutual fund independent directors. Mr. Palmer advises companies on securities law matters, including reporting and corporate governance matters. He also represents companies in financial services litigation, SEC inspections and enforcement actions, and before state insurance departments. Mr. Palmer earned his BA, *egregia cum laude*, from St. John's University and JD, *magna cum laude*, from Georgetown University Law Center.