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ENDOWMENT & FOUNDATION GOVERNANCE: FIDUCIARY OVERSIGHT AND IMPLEMENTATION

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MARSH & McLENNAN COMPANIES

WHAT IS FIDUCIARY GOVERNANCE AND WHY IS IT IMPORTANT?

Fulfillment of fiduciary responsibilities requires more than understanding a portfolio's components. To achieve consistent results and protect assets there must be a common understanding among all stakeholders of the objectives of the funds, the role and responsibility of each relevant party and the parameters within which the management of the funds will occur. Governance is the structure and process established to ensure this common understanding and provide oversight of implementation, asset management and distribution decisions.

Governance is the top priority for boards of directors and investment committees. It begins long before portfolio structuring and investment decisions. Good governance can enable sound and efficient decision-making; it promotes accountability and sustained focus on achieving desired goals. In addition, a comprehensive understanding of the challenges facing an organization and an investment portfolio can enable fiduciaries to appropriately balance the organization's risk tolerance with its return objectives.

Broadly speaking, governance focuses on five important areas:

1) Priorities, scope and objectives
2) Constraints and prohibitions
3) Roles and responsibilities
4) Delegation of authority
5) Ongoing oversight

A strong governance process will define these areas and will outline the processes and controls required to ensure accountability.

At the most fundamental level, there are two reasons why governance is critical for those with fiduciary responsibilities:

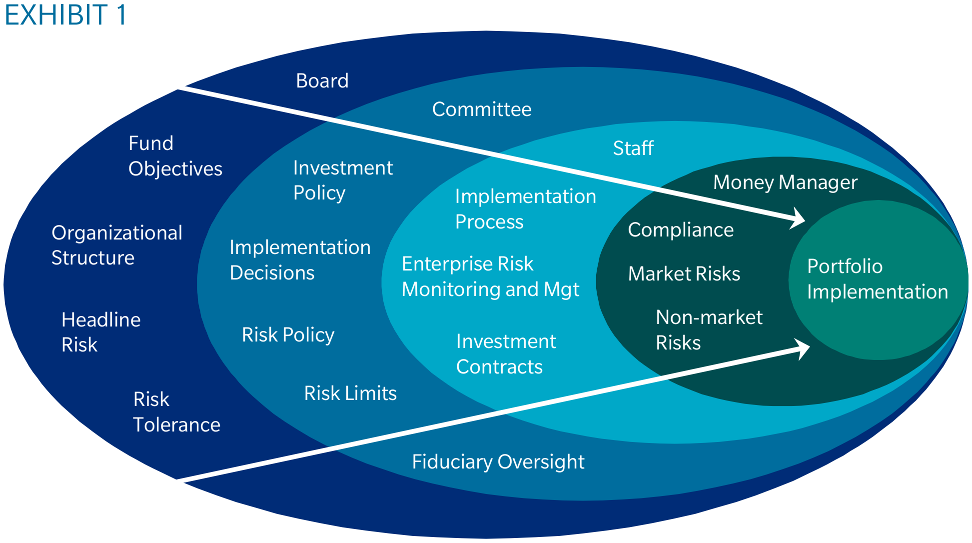
1) Fiduciaries are entrusted with and responsible for the care and protection of assets; and
2) Fiduciaries bear a legal responsibility for prudently fulfilling this duty.

WHAT DOES GOOD GOVERNANCE LOOK LIKE?

Mercer believes that comprehensive governance starts with the highest governing body of the organization and flows through to the person charged with accomplishing the tasks required to implement the program. Consequently, we work directly with boards of directors, the investment or pension committees to which authority has been delegated and the staff members charged with implementing the committee's decisions to assist them in the fulfillment of their fiduciary duties.

Industry best practices suggest that governance be considered in two pieces, policy and implementation, both of which must consider the objectives of, and the risks facing, the organization broadly and the portfolio specifically. Within this theory, policy makers provide objectives, delegate necessary authority and set risk tolerances. In general, those who set the policy do not outline or perform the tasks needed to accomplish the goals. Instead, the implementers determine and initiate the best methods for achieving the stated objectives.

EXHIBIT 1

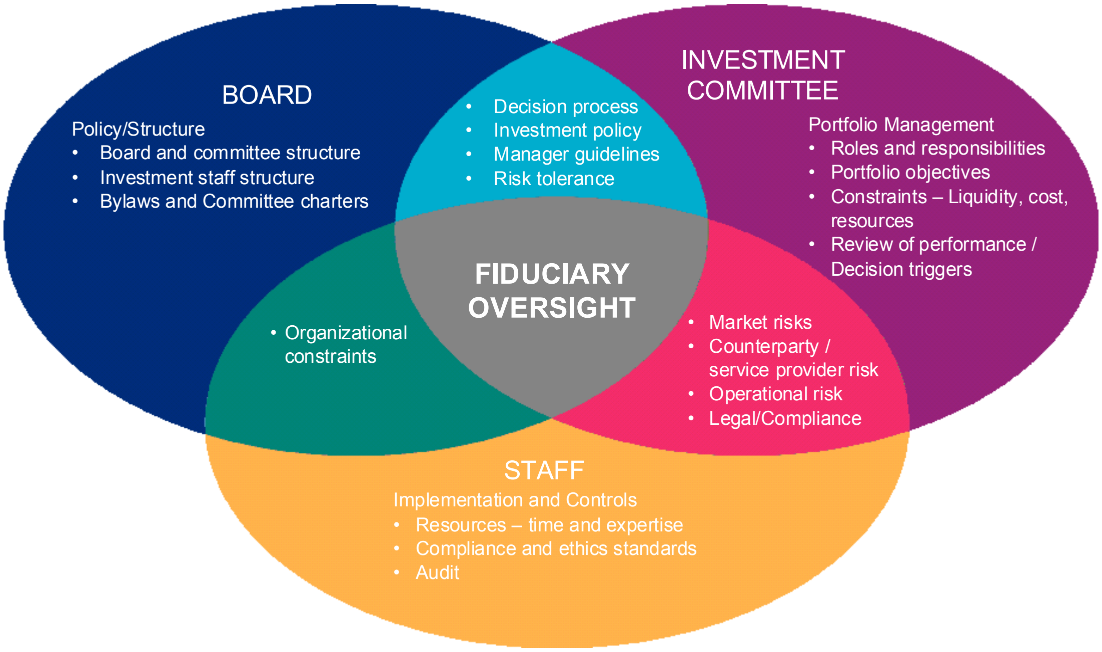


As Exhibit 1 shows, each level sets boundaries for the next as authority is delegated towards implementation. Risks are present at each level and should be considered by the entity with the best opportunity to address the specific issue. Each level is subject to all of the parameters set by the levels above it. Within those limits, the entity in question can determine appropriate tasks and act, or implement, within its authority. Although each level must abide by the boundaries of the higher level, the expectation is that once delegated, responsibility for implementation rests with the lower level.

Each level below the board is either a policy maker or an implementer depending on the specific interaction. In all cases, however, policy work involves creating a framework and implementation involves determining and executing the tasks necessary to achieve the policy goals without violating the policy boundaries.

Within the investment context, the board addresses the issues highlighted in the upper left circle of Exhibit 2 and typically delegates authority to implement and monitor the investment portfolio to a committee and, through the committee, to staff. Bylaws and a charter establish the investment committee and outline broad parameters for operation such as "achieve a return sufficient to support the budgetary requirements of the organization with risk consistent with the regular withdrawal requirements of the Fund".

EXHIBIT 2



Board members must consider the resources available to the organization including access to investment expertise and sensitivity of the organization to challenges to the investment structure. Budget constraints, politically or socially charged issues and structural requirements should all be addressed at the board level.

The investment committee articulates the decision process, determines investment policy, negotiates manager guidelines and grants authority to each of these subcontractors to perform various elements of fund management. The investment committee also further defines the return objective, liquidity provisions and roles and responsibilities of relevant parties such as money managers, custodians and consultants.

WHAT MAKES A GOOD INVESTMENT POLICY STATEMENT?

The investment policy statement (IPS) is the investment committee's opportunity to set the framework within which it will manage money. A prudently constructed IPS will address the issues highlighted in Exhibit 2. Specifically, the IPS should reiterate the objectives of the funds, outline the fund's risk tolerance, define the investment time horizon and clarify any liquidity constraints. Roles and responsibilities for the broad classes of players (e.g. money managers, custodian, consultant, etc.) should be outlined with reference to specific guidelines or contracts that may be changed without a revision of the policy document. Likewise the parameters of asset allocation should be attached as an appendix.

As it considers the management of the portfolio, the investment committee must consider and address two types of risks: 1) market risks including risk of loss, inflation and illiquidity; and 2) the risks inherent in portfolio management such as counterparty and service provider risk, transactional risks and costs, and legal and compliance requirements. Due diligence must be performed to understand, mitigate and appropriately address each of these within the organization's specific context. To the extent that the committee performs this due diligence, it becomes the implementer to the board's policy maker role.

HOW IS THE GOVERNANCE PROCESS REFLECTED IN THE PORTFOLIO?

Staff is often assigned the task of implementing the committee's decisions. These actions must be taken within the frameworks created by the board and the committee and will therefore reflect the objectives and constraints established for the Fund. Generally, it is the staff who interact with money managers, set up the necessary paperwork and compile relevant data for the committee. Proper implementation requires sufficient resources, in terms of both time and expertise, to handle the necessary tasks. Where these resources are not available in-house, some or all of the implementation can be outsourced. Often, outsourcing can provide stronger governance by enlisting independent and highly-trained resources. Audits provide objective verification that the funds have been managed in accordance with generally accepted practices.

Most authority to implement specific investment strategies is delegated by the investment committee to professional money managers. These firms establish parameters for their unique strategies and delegate the implementation authority to portfolio managers and other staff members charged with achieving the strategy's goals.

CONCLUSION

Governance and fiduciary responsibility are complex and multi-layered issues. As described above, there are many different roles, various paths to reach the desired return and a broad array of risks to be considered in the investment management process. Governance is not a prescriptive list of tasks to be accomplished by the board, investment committee, staff or money managers. Rather it is an ongoing process of definition and oversight that enables and organization to affirmatively answer the question, "Are we managing the portfolio the way we said we would?"

The governance structure described allows for flexibility and innovation while still maintaining prudent oversight.

ABOUT THE AUTHORS

Laura Kunkemueller is a Principal at Mercer. Prior to her current position, she served as a senior consultant at Evaluation Associates from September 2007 to June, 2011. Laura works on investment policy development, asset allocation modeling, manager due diligence and search preparation, portfolio structure analysis and special projects. Before joining Evaluation Associates, Laura was an Associate Director at Rogerscasey, where she provided investment consulting to corporate defined benefit plans and foundations. Prior to that, she was the principal consultant of Kunkemueller Consulting, specializing in the creation of for-profit enterprises to fund not-for-profit organizations. Laura began her career in the insurance industry, spending more than 13 years in both underwriting and management capacities working for national property and casualty insurers, as well as for regional brokers.

Laura graduated with a BA from Princeton University and received an MBA, specializing in not-for-profit management, from Yale University. In 2012, she received a masters degree in change management from Oxford University/HEC Paris. She holds a Series 65 license. She is currently a member of the board of trustees of the Boston Conservatory, and on the board of directors of USRowing. Laura is an internationally credentialed rowing referee.

Freeman Wood is a Principal and Director of the Americas team within the Mercer Sentinel® Group in Mercer's investment consulting business.

Freeman joined Mercer in 2009 has a broad background and significant expertise in risk management. Freeman has led quantitative market and credit risk management teams within large banks, corporate treasury functions, and regulators, and has experience in derivatives trading and alternative investment portfolios. Immediately prior to joining Mercer he worked in the hedge fund industry, primarily as head of investments and risk management for a fund of hedge funds. Freeman was with Ford Motor Company for 8 years in a variety of roles including head of enterprise risk management and head of international Treasury. Freeman's other experiences include 4 years with BNP Paribas as head of market risk for proprietary trading in New York, 6 years with the Federal Reserve in banking supervision, and 3 years equity options trading on the floor of the CBOE.

Freeman holds a Bachelor of Science degree from Allegheny College and an MBA from Northwestern's J L Kellogg Graduate School of Management.

CONTACT US

Let us help you meet your governance challenges.

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