PART 1

Understanding Managed Accounts

Investment Policy and Governance Framework

STATE STREET GLOBAL ADVISORS®

The wealth management industry is going through a disruptive phase with regulation and managed accounts functionality among the main catalysts for change. As many practices embark on revisiting their client value proposition, a well-articulated Investment Policy Statement is a critical roadmap to managing client's assets and client expectations.

An Investment policy statement articulates how your practice invests. Formalised Investment Policy Statements (IPS) have been standard in the institutional Superannuation Market and one of the best examples can be seen from looking at the Future Fund where they outline their investment model. They define their investment parameters with regard to their beliefs, culture and constraints. See example: **www.futurefund.gov.au/investment/how-we-invest/investment-policy-and-position-papers.**

An IPS also provides a roadmap for how your practice will navigate different investment markets. This is particularly important given that we are in the late stages of the second longest equity bull market in history[1]. A rise in volatility is likely to be sooner rather than later.

Whether you're looking to adopt a managed account structure, improve your governance framework or simplify the way you communicate with clients, a well documented IPS is a critical part of the journey. A well-developed IPS should align to your client objectives, promotes adherence to these objectives and provide a disciplined process for your investment decisions. Further to this, your IPS can become integrated into your client value proposition and how you interact with your clients to help communicate how you invest, why and the benefits.

In this paper, we share 5 key areas to address in your Investment Policy Statement:

1. **Investment Philosophy**
2. **Strategy & Process**
3. **Implementation**
4. **Team Governance**
5. **Monitoring & Review**

An IPS is your investment manual. It provides a structured and systematic approach to avoid the behavioral biases and emotional behaviors that often lead to suboptimal decisions (see appendix). A structured framework is likely to lead to more successful decision making and consistent outcomes. **As new regulation, technology and products become available your Investment Policy Statement may evolve.**

Your Investment Philosophy
Your North Star

An investment philosophy is a statement (or series of statements) that articulates your purpose when investing. *Your Investment Philosophy addresses the "Why" of your investment decisions* and the benefits of your approach to help meet your client's objectives.

Questions you should consider are:

- What unique value does your firm offer?
- Why do you do what you do?
- What are your strong held and fundamental beliefs about Investment markets?
- How do you prioritize risk and return?
- How much is cost a consideration?
- What are you client's objectives?

An example of an Investment Philosophy is:

The world is not a static environment and markets are ever changing. We believe that:

- *Strategic Asset Allocation (SAA) is the main driver of returns*
- *Active management can add value — both the use of Active Management within an asset class as well as active dynamic asset allocation decisions*
- *Because of this, investors can be opportunistic. There are periods of short, medium and long term market dislocations that you can take advantage of around the SAA.*

Ask yourself: Are there longer term characteristics that you believe will be rewarded over time? A few examples are:

- The long term outperformance of equity markets
- Risk vs return
- Active vs passive (market efficiency)
- Long term strategic vs active asset allocation
- The value premium
- Whether companies that are well run on ESG metrics perform better
- Consideration of fees

Investment Strategy and Process
Your GPS Navigation Tool

The Investment Strategy articulates the layers in your investment approach — how you make the investment decisions based on your defined philosophy.

The Investment Policy Statement should also address Team Governance. Who sits on the investment committee and what are the triggers for decision making? Having a disciplined approach that articulates pre-set triggers and actionable outcomes will facilitate decision making. It's essential to establish regular Investment Committee meetings and document who the "right people" are to seek agreement from to proceed with investment decisions so that action can be taken quickly (and opportunities are not lost).

When defining your Investment Strategy, it can be helpful to break it down into three different components:

1. **Return Objectives**
   - What's the total real return required and how much of this should be income vs capital growth given a client's spending rate?
   - What's your expectation regarding inflation?
2. **Risk Objectives**
   - What's your clients appetite to take risk?
   - What are your clients financial goals (short term and long term)?
   - How large an investment shortfall can occur before jeopardizing the portfolio's ability to meet major short term and long term goals?
   - What does the psychological profiling tell you?
3. **What are the portfolio constraints?**
   - Have consideration for the clients' liquidity needs
     - Ongoing expenses
     - Emergency Reserves
     - Consider transaction costs and portfolio volatility
   - What's the investment time horizon and are there "life-event-stages" such as retirement that the portfolio will support?
   - Are there regulatory or legal constraints?
   - Do unique circumstances or self-imposed limits on certain types of investments?

Some questions to consider are:

- What is your asset allocation approach? Is it purely Strategic, Dynamic or Opportunistic?
- What are your benchmarks for returns? Is a composite of your SAA, Cash or CPI?
- What are your benchmarks for risk: Do you employ asset allocation ranges, probability of loss, risk measured by standard deviation, risk measured by drawdowns?
- What are your inputs? Are they based on quantitative insights or fundamental oversight? Do you have involvement from an external consultant, a series of Fund Manager partners? What is your experience and the experience of the Investment committee?

Asset Allocation

If we think of the destination as your client's objectives, then the flight path is your Strategic Asset Allocation. As in any journey, the weather conditions can change. You may need to fly higher to avoid turbulence and Dynamic Asset Allocation (DAA) may be warranted to create a smoother journey and ensure you get to your destination (retirement) on time.

Some of the client portfolio objectives that you may need to factor when establishing your Asset Allocation are listed below:

PORTFOLIO OBJECTIVES

Spending Policy
- Spending rate
- Funding for living
- Funding for specific projects
- How much is needed versus what can be afforded?

Return Requirements
- Cover spending rate
- Inflation
- Real growth
- Fees

Time Horizon
- When will the money be needed?
- Cash and Liquidity needs

Sensitivity to Risk
- Volatility
- Near-term or long-term losses
- Inflation risk
- Risk that future funding will be less

Strategic Asset Allocation — Your Flight Path

One of the best ways to manage portfolio risk and return outcomes is long term Strategic Asset Allocation (SAA). To state the industry standard disclosure though, *past performance is no guarantee of future returns* and past returns should not be the starting point for a forward looking SAA design.

To meet client needs and understand the asset class opportunity we believe that you need to assess the expected returns and expected risks from each asset class and constraints. Any forecasts (whether shorter or longer) should be aligned with not only the investment horizon but also the review frequency.

Some of the inputs that you may need to consider include; the cash rate, inflation, GDP deflators, broader Marco signals, real economic growth and productivity gains to forecast asset class returns over a 10–20 year period to understand the asset class opportunity set. The diagram on the next page summarises this.

Investment markets are dynamic and central forecasts can change so SAA should be reviewed periodically to ensure that your clients are able to achieve their long term objectives.

When constructing your SAA some key considerations are:

- What is the asset mix that can provide a balance between your clients expected risk and return for the long term?
- Are the weights and choice of asset classes/strategies fit for purpose?
- How important is liquidity and what is your view on the use of alternatives?

Dynamic Asset Allocation (DAA)

When faced with turbulence, do you continue on the same flight path, does your cruise control auto adjust or do you need to make manual changes?

Whilst SAA can be long term diversifier of risk, over shorter time frames, market dislocation can cause higher levels of volatility and opportunity[2]. Studies have shown that over 90% of the variability in return is based on the asset allocation selected.[2]

Equally, NOT making changes to asset allocation can lead to another risk — the risk of asset class drift and a shortfall to meeting your client objectives. So how will you approach these changing conditions?

How is your practice structured to make these dynamic decisions? Do you have a framework and is the implementation of your decisions manual or automatic? Do you work with a Research House or Consultant/ Investment manager to make these decisions?

When constructing your DAA parameters, some key considerations are

- Why are you making DAA decisions? Is it to reduce risk and/or improve returns? What is more critical to meet your client objectives?
- Do you utilize Investment Funds/Strategies that employ a flexible mandate to help shift portfolio allocations seamlessly?
- What are the dynamic bands and rebalancing rules?
- How do you think about policy and political events in your process?

In a typical Balanced 60/40 portfolio, 90.5%[2] of portfolio risk is typically attributed to equities. When thinking about managing total include portfolio risk, how will you assess the direction of volatility? Some inputs that you may want to consider include VIX measures and implied volatility to gauge whether markets are expressing an aversion to risk.

Further to this, if the market is moving to a risk off phase, what strategies will you employ? Will you:

- Reduce your total exposure to equities
- Reduce your beta market cap equities and increase your exposure to strategies that are risk aware
- Utilise strategies that employ derivatives and DAA to help manage these environments; or
- How do you think about the use of alternatives as a diversifier?

Portfolio Implementation and Manager Selection

Once the goals are determined and the portfolio structure is identified, the plan is put to work through the implementation phase. Executing the plan is just as important as how the plan has developed.

Care must be given to the choice of investment strategies that will fill the various asset class buckets. Determining the use of active investment versus index, or styles such as growth versus value and the rules for rebalancing the portfolio are all considerations that must be reviewed.

For many practices, manager selection is done with the assistance of a research house or asset consultant. In Australian equities alone there are over 300 broad cap funds[3] to choose from, so identifying the strategy that best meets your client's objectives requires a detailed qualitative and quantitative assessment. Then additional consideration must be applied to how the strategies that you combine work together in up markets and down markets.

Active or index? The optimal solution can often be reached through a blend of the two to manage the amount of total risk taken at the portfolio level, and compensated for, to create more efficient portfolios.

Qualitative Assessment

- **Quality people:** Assessing people involves understanding their education, experience, motivation, passion, integrity, objectivity, insight, leadership, stability and teamwork.
- **Well-defined philosophy:** 'Manager Philosophy' is a set of principles that a Fund Manager follows and it's essential it aligns with your practices. *Is the Investment Philosophy built on deep insight of capital markets? Is it consistent and clearly articulated? Is it differentiated from peers?*
- **Disciplined process:** The investment process defines how the portfolio will be managed. It's a reflection of the investment decision life cycle, from idea generation to trade execution. A disciplined process should incorporate such things as: efficient decision making (including buy/sell decisions, rebalancing, risk management and trading), valuation discipline, logical/unique research process and enhancement history. You should seek consistency between a firm's 'stated' philosophy, process and 'actual' practices.
- **Strong business culture:** What is the corporate governance approach; consideration for operational risk management and controls?
- **Other considerations:** What investments have been made in technology? How effective is the trading function?

Quantitative Assessment

- **A superior return history:** While past performance is no guarantee of future performance, a longer and persistent history of outperformance can point to a skilled Fund Manager as opposed to a lucky one that rose from idiosyncratic events. Rolling periods that match a manager's investment horizon will help you understand performance and how the strategy behaves in different market environments.
- **Choice of benchmark**: Investors should be aware of the manager's chosen benchmark and its appropriateness. Benchmark selection can impact stock selection and portfolio biases.
- **Portfolio consistency with portfolio risk and philosophy:** Provided a long enough history, risk adjusted performance measures such as Sharpe Ratio (funds with absolute return objectives) and Information Ratio (funds with benchmark relative objectives) should be used to assess consistency of performance against stated objectives. You can expect shorter-term performance to deviate from stated objective / fund benchmark from time to time.
- **Portfolio risk:** Measures such as standard deviation, tracking error, drawdown capture are useful but should not be used in isolation. These are more meaningful when used alongside returns. The choice of rolling windows can also help to understand how much risk to expect over different investment horizons.
- **Fees:** While lower fees appear attractive in isolation we encourage investors to consider the net-of-fees outcome. Are the fees being charge appropriate and competitive? Are there performance fees? Some investors believe that performance fees aligns with investor objectives however a performance fees can also result in outsized risk-taking if not structured appropriately.

Team Governance, Portfolio Monitoring and Review

Investment markets are dynamic and portfolios need to be monitored and reviewed periodically. For this reason it is recommended that Investment Committee meetings are structured monthly/quarterly with 'review triggers' set **in advance**.

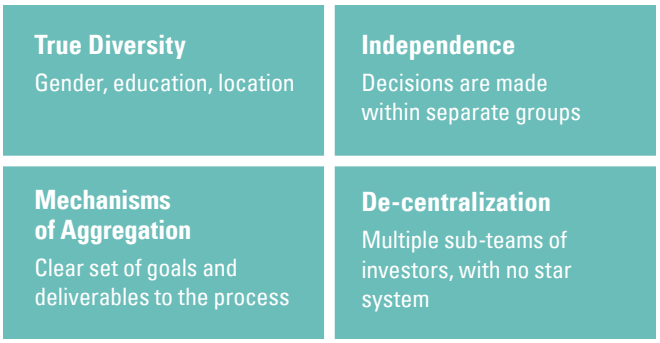
Another key element of your IPS is to define how your team is structured to make these investment decisions. Who has responsibility for each aspect of the investment research and decision-making?

James Surowiecki's *"The Wisdom of Crowds"*, provides a philosophy around decision making that outlines why a "Group of Experts" i.e. a team, is better than just one expert. It would be wrong to assume that an individual expert can accurately provide a balanced view. A group of experts however can influence the organization of ideas, accountability, and filtering out behavioral biases such as phantastic bias, regret aversion, herding bias or value attribution (see appendix for more behavioral biases).

From this, we can deduce that all investment decisions need to be recorded with rationale for the change (whether at the strategy level or asset allocation level) to avoid any bias. It also serves as a useful audit trail given the fiduciary role of a financial advisor.

Why do we believe in "Groups of Experts"?

"The Wisdom of Crowds" published in 2004, written by James Surowiecki.



Source: SSGA, Investment Solutions Group (ISG).

Based on the above diagram summarising the value of a group of experts in "The Wisdom of Crowds", we can attribute the key aspects of an effective manager or portfolio oversight program:

- Ongoing maintenance of key due diligence documentation such as an Financial Services Council (FSC) document
- Periodic performance reviews — both return-based and holding-based performance, risk and attribution analysis per portfolio and per investment
- Holding-based reviews — as needed
- Documented meeting and interactions with Fund Managers or formal investment reviews that are conducted
- Documented meetings with the internal investment team, industry experts, or third party independent consultants.

There are several considerations when establishing roles and responsibilities:

- Is there a clear set of goals and deliverables for each member to bring to the process?
- Is it a diverse group of experts?
- Is there an opportunity to debate ideas openly to avoid consensus thinking?
- Who will play the devil's advocate to challenge ideas to promote debate?

Checklist

Investment Philosophy

- Preface each with, "We believe that …"
- Does it provide a clear rationale for consistent performance?
- Does it answer the question, "Why?"
- Does it bridge decisively to the investment process — i.e., flows from Why to How?
- Is it stated in terms that are simple and concise?

Investment Strategy and Process

- Have you articulated your asset allocation method?
- Is it purely Strategic, Dynamic or Opportunistic?
- What are your benchmarks for returns? Is a composite of your SAA, Cash or CPI?
- What are your benchmarks for risk: Asset allocation ranges, probability of loss, risk measured by standard deviation?
- What are your inputs? Are they driven by quantitative insight or fundamental oversight. Do you have involvement from an external consultant, a series of Fund Manager partners, your experience, the Investment committee?
- Who are the members of the IC, what are the triggers for investment decisions?

SAA Considerations

- What is the asset mix that can provide a balance between your clients expected risk and return for the long term?
- Are the weights and choice of asset classes/ strategies fit for purpose?
- What is your view on the use of alternatives?

DAA Considerations

- Why are you making DAA decisions? Is it to reduce risk and/or improve returns? What is more critical to meet your client objectives?
- Do you utilize Investment Funds/Strategies that employ a flexible mandate to help shift portfolio allocations seamlessly?
- What are the dynamic bands and rebalancing rules/constraints?
- How do you think about Policy and political events in your process?

Portfolio Implementation and Manager Selection

- Quantitative Assessment: How will you monitor performance and the role of the strategy in a multi manager multi asset portfolio?
- Qualitative assessment: Is the philosophy and process true to label?

Team Governance and Portfolio review

- Is there a clear set of goals and deliverables for each member to bring to the process?
- Is the IC made up of a diverse group of experts?
- Is there an opportunity to debate ideas openly to avoid consensus thinking?
- Who will play the devil's advocate to challenge ideas to promote debates?

Next Steps
Applying this to your business

ACTION	FINANCIAL ADVISOR	YOUR STATE STREET REPRESENTATIVE
1 **Build your Investment Philosophy**	• Review your answers to each of the questions • Highlight words and phrases • Articulate your investment philosophy in a manner that your clients can repeat	• Provides support in helping you to define your investment philosophy
2 **Build the rest of your Investment Policy**	• Review your answers to the other 4 sections of the investment policy framework with the rest of the team • Is there a visual way to demonstrate your policy to your clients?	• Provides support in helping you to define other areas of your investment policy & model portfolio construction
3 **Apply it**	• Share the policy with other members of the firm. • Is it consistent with how you've done business or want to do business in the future? • Create a roll out plan	• Partners with you to refine your policy • Assists in providing an Asset Allocation framework and share proprietary investment ideas
4 **Execute and monitor results**	• Introduce to client advocates to assess impact • Share with Centres of Influence to gather their feedback • Enhance and refine • Commence roll out	• Provides ongoing feedback & partnership

The information outlined above is intended for illustrative purposes only.

Appendix

Behavioural Biases that can impact outcomes when making investment decisions

State Street: The Folklore of Finance: How Beliefs and Behaviours Sabotage Success in the Investment Management Industry, Centre for Applied Research Study 2014

Anchoring Bias: beginning an analysis with a default number in mind and adjusting up or down from that number. The "anchor" number often unduly influences the ultimate conclusion. (Bunn 1975)

Availability Bias: giving a great weight to easily recalled and recent information over information that is less recallable or harder to understand. (Taylor 1982)

Career Risk: occurs when the remuneration and decisions to replace or retain an investment manager depends directly on the managers performance, driving the manager to short-termism and irrational behaviour. (Dasgupta 2006)

Cognitive Dissonance: mental discomfort that results when confronted by new information that conflicts with existing beliefs or ideas. (Festinger 1962)

Confirmation Bias: seeking out, overvaluing or misinterpreting information that confirms prior beliefs and ignoring contradictory information. (Nickerson 1998)

Conservatism Bias: maintaining prior views or forecasts by inadequately incorporating new information. This causes individuals to overweight initial beliefs and underreact to new information. (Ritter 2003)

Decision Fatigue: deteriorating quality in decisions made by an individual after making a series of decisions. Results in inadequate consideration of information and rushed judgement. (Tierney 2011)

Dispositions Effect: hastily selling assets whose price has increased while retaining for too long assets that have dropped in value. (Shefrin 1985)

Endowment Effect: valuing an asset more (greater than its objective value) when it is held. (Kahneman 1991)

Emotional Quotient: the level of ones' ability to understand other people, what motivates them and how to work cooperatively with them. (Gardner 1983)

Framing Bias: arriving at a different decision based on how the options are worded. (Tversky 1981)

Gambler's Fallacy: believing that the probability of an event is lowered when the event recently occurred, even though the probability of the event is objectively known to be independent from one trial to the next. (Clotfelter 1993)

Herding Bias: trading on the same side of the Market in the same securities, ignoring conflicting information in favour of acting as other investors do, often for reassurance and comfort. (Grinblatt 1995)

Heurisitics: simple rules used in forming judgements to make decisions, consisting of "mental shortcuts" that focus on certain aspects of a decision and ignoring others. (Nielsen 1994)

Hindsight Bias: seeing past events as having been predictable and reasonable to expect before they occurred. (Fischhoff 1975)

Home Bias: maintaining a high proportion of investments in securities listed in one's own country as opposed to internationally diversifying. (Coval 1999)

Illusions of Control Bias: believing one can control and influence outcomes that one actually has no control over. (Langer 1975)

Loss Aversion: permitting losses and disadvantage to shape preference differently than gains or advantages. The utility derived from a gain is much lower than the utility given up by an equivalent loss. (Tversky 1991)

Mental Accounting Bias: treating one sum of money differently than another equal-sized sum based on how the money is categorised. People mentally group their assets into non-interchangeable mental accounts, when reality money is inherently interchangeable. (Thaler 1980)

Overconfidence Bias: demonstrating underserved faith or confidence in one's own judgements, to a higher degree than the judgement's objective accuracy warrants. (Gerry 2002)

Phantasic Object: A mental representation in which an imagined scene fulfils a person's desire to have exactly what they want. The imagination drives investors to see what they want to see in an investment. (Tuckett 2008)

Regret Aversion: avoiding an action for fear of making a poor choice. (Humphery 2004)

Representativeness Bias: classifying new conformation based on past experience and classifications; especially using those classifications even tin the new information does not necessarily fit. (Kahneman 1972)

Self-Control Bias: failing to act in pursuit of long-term goals because of a lack of self-discipline. Short-term satisfactions interferes with the achievement of long-term objectives. (Pompian 2006)

Self-Serving (Self-Attribution) Bias: people's tendency to attribute positive events to their own character but attribute negative events to external factors. (Boyes 2013)

Short-Termism: avoiding investments that are necessary for the future but require a sacrifice of short-term benefits. (Laverty 1996)

Status Quo Boas: doing nothing or maintaining a previous decision when instead a change should be made. (Kahmenan 1991)

Value Attribution: imbuing someone or something with certain qualities based on perceived value, rather than objective data. (Brafman 2008)

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*AUM reflects approx. US$36B (as of March 31, 2018) with respect to which State Street Global Advisors Funds Distributors, LLC serves as marketing agent; SSGA FD, LLC and State Street Global Advisors are affiliated

[1] S&P 500, as at 30 June 2018.

[2] SSGA December 31, 1975–December 31, 2015, for illustrative purposes only. The index returns are unmanaged and do not reflect the deduction of any fees or expenses. The index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. Past performance is not a guarantee of future results. Rolling 5yr Risk Allocation of a 60% Equity/40% Bond Portfolio US Agg. 9.5% S&P 500 90.5%.

[3] Morningstar. As of 30 June 2018.

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