CFA Society
United Kingdom

STEWARDSHIP

Position paper

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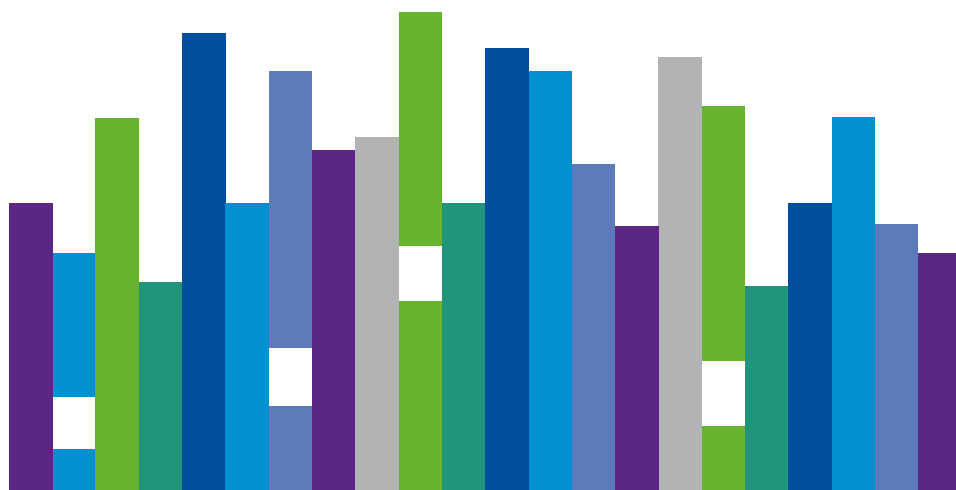

STEWARDSHIP

This paper describes CFA UK's views on investment professionals' obligations to their clients – it describes the behaviour that investment professionals should follow to act as good stewards of client assets.

» Be clear about the principal

» Understand your responsibilities to the client and to the profession and operate in such a way that you can meet those responsibilities

» Understand your client, help them to establish sensible and appropriate expectations and meet those expectations

The purpose of the paper is to give members guidance on how best to practice good stewardship of client assets; to help clients and consultants learn how investment professionals understand stewardship; and to encourage high ethical and professional standards in relation to stewardship.

The paper is relevant where the investment professional acts as an agent (on behalf of the client – the principal) and is particularly applicable where the investment professional has a direct relationship with the client (whether retail directly, retail represented by a fund's directors or institutional).

PREFACE

Investment professionals have a duty to earn and hold the trust of those for whom they act. While investment professionals are contracted as agents, the profession should set a higher standard for the discharge of their duties; stewardship. Stewardship is a succinct expression of the duty of care experienced by investment professionals. This paper summarises the nature of stewardship and makes recommendations that investment professionals seeking to act as good stewards are advised to follow.

'I believe that the next generation of leaders in finance will be defined...by the stewardship they exercise as fiduciaries and the responsibility they demonstrate to their communities.'

John Rogers, CFA, Chief Executive, CFA Institute

Stewardship and fiduciary duty are not synonymous. A fiduciary is legally required not to place itself in a position where its interests conflict with its client's interests or to profit from its own position at its client's expense. A fiduciary also must not take on another client whose interests might conflict with those of its existing client. The fiduciary has a duty of undivided loyalty.

These fiduciary duties are suitably burdensome for the circumstances in which they are required, but good stewardship is a more realistic objective for investment professionals, carries a lower cost and is a more appropriate standard for clients to impose and expect.

INTRODUCTION

Investing involves clear responsibilities and a duty of care to clients. The understanding that the clients' interests must always come before our own is a fundamental tenet for CFA Institute and CFA society members. This shared belief is clearly expressed in CFA Institute's Code of Ethics and Standards of Professional Conduct which all members annually commit to abide by. These standards are required of investment professionals precisely because investment is a profession, not a business.

A profession[1] is characterised by the existence of a body of individuals:

» identifiable by reference to some register or record;

- recognised as skilled in a field in which the public needs protection against incompetence (the standards and learning being prescribed by the profession itself);
- holding themselves out as serving the public;
- voluntarily submitting themselves to standards of ethical conduct beyond those required of the ordinary citizen by law; and
- undertaking to accept responsibility to their clients and to their profession.

The investment profession's service to the public comes in two forms: service to society (the public in its collective form) and service to the public as a set of clients (the public individually). The investment profession serves society by assisting in intermediation of savings and the efficient allocation of capital. The investment profession serves individual clients (retail or institutional) by helping them to invest their assets so as to meet their current and projected liabilities[2] or such other objectives as the client may have set. This paper does not dispute that there are societal issues related to the allocation of capital (such as are dealt with in the FRC's Stewardship Code[3]), but this note is concerned with the profession's service to the public as clients.

SERVING CLIENTS THROUGH STEWARDSHIP

Stewardship implies a willingness to do the right thing without expecting immediate reward. The key concept is that doing a good job comes first and will lead to reward, rather than the first priority being to grow profits or assets. We cannot ignore the reality that investment management firms need to be durable (and, therefore, economically successful) if they are to serve clients well over time, but the pursuit of business success should not be placed ahead of the pursuit of excellent work on our clients' behalf. 'Business success should be a consequence of excellent client service'[4].

Alongside investing client assets and ensuring the careful and appropriate management of those assets, stewardship of client assets involves various other duties of care. One of these is delivering on the commitments that we make in relation to our advice and actions. We need to be clear about what is achievable and the risks that will be taken in pursuing returns. We also need to be clear about the additional risks – besides investment risk – which asset management involves, such as liquidity risk or counterparty risk. Where the concept of stewardship is properly embedded within an investment management organisation, the firm is aware of the importance of clear, relevant and frequent communication between them and their clients.

Wrapped up in the concept of stewardship is an expectation that the obligation is sustainable over time. There is also an associated set of ideas along the lines that stewardship of assets implies obligations to other stakeholders (such as responsibilities to investee companies – through attention to governance issues – and social obligations such as environmental stewardship), but as stated earlier, this aspect of stewardship is not addressed in this paper.

There are five key elements in a stewardship approach that we should expect of investment professionals:

- Clarity about the principal
- Understanding your responsibilities to your client and to the profession
- Understanding your client
- Establishing client expectations
- Meeting expectations

These elements are applicable to investment professionals working across the entire value chain. For example, investment analysts need to understand the requirements of the investment managers for whom they generate research and know well their professional responsibility to provide objective, independent, rigorous analysis. Investment advisers must take care to assess their clients' needs, then to establish suitable expectations and to meet them. Product developers should ensure that their work will serve clients' needs and will do so with sufficient transparency and disclosures to be properly assessed.

While the characteristics of good stewardship apply broadly to all investment professionals, their most obvious representation is in the relationship between the investment manager and the investing client.

[1] Law Society evidence to the Royal Commission on Legal Services, 1978.
[2] Ethics and the investment profession, Ethics in Practice by Philip Lawton, CFA ©2005 by CFA Institute
[3] http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf
[4] The Winner' Game, Charley Ellis, CFA Financial Analysts Journal July/August 2011.

The Financial Reporting Council introduced the UK Stewardship Code in 2010. The code is designed to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. CFA UK supports the Stewardship Code as we agree with the code's seven principles and appreciate the 'comply or explain' basis for the code's application.

However, while appreciating that investment managers should comply with (or explain non-compliance with the FRC's code), CFA UK believes that investment managers' primary responsibility is to act as stewards of the assets entrusted to them by clients. It may be possible that this primary responsibility is met through active engagement with investee companies, but it is also possible that it is not. Engagement with companies is intended to improve value creation, but investment managers' responsibility is to generate the risk-adjusted returns that their clients expect. Return generation is closely related to value creation, but the two may not be proportionate or contemporaneous.

CLARITY ABOUT THE PRINCIPAL

Irrespective of whether an investment professional works on behalf of institutional or retail clients, they must always be clear in whose interests they are acting in order that they may then take appropriate steps to develop suitable investment policies and supporting communication[5]. In a similar vein, remuneration and reward structures should be designed to recognise the primacy of the clients' interests.

UNDERSTANDING YOUR RESPONSIBILITIES TO YOUR CLIENT AND TO THE PROFESSION

All members of CFA Institute and CFA UK agree to adhere to and abide by CFA Institute's Code of Ethics and Standards of Professional Conduct*[6]. The code and standards describe the behaviour and practices that investment professionals should maintain and make clear the duties that investment professionals have to their clients as well as those to the market and to their employers.

The following is a précis of parts of the code and standards.

Investment professionals must always act professionally. They must:

» be knowledgeable about applicable laws and regulations;

» use reasonable care and judgment to achieve and maintain independence and objectivity;

» not knowingly make any misrepresentation;

» not engage in any professional conduct involving dishonesty, fraud or deceit, or commit any act that reflects adversely on their professional reputation, integrity or competence;

» ensure that, if they are in a management position, that they embed stewardship principles in their subordinates' objectives and that reward structures encourage best practice in the stewardship of client assets; and

» maintain and improve their professional competence and encourage others to do the same.

With respect to the duties owed to clients, investment professionals must bear in mind that they:

» have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment;

» must act for the benefit of their clients and place their clients' interests before their employer's or their own interests;

» must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities;

» must understand their clients' circumstances and objectives and make only suitable recommendations and investments;

» must present performance information fairly, accurately and completely; and

» must maintain client confidentiality[7].

[5] Investment professionals acting not as agents, but as principals (on behalf of an employer or alongside a partner or a co-investor) also have stewardship obligations, but that there may be less need to communicate or explain as the employer or partner is likely to have an equivalent level of knowledge and expertise.
[6] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1.
* CFA UK members who are not members of CFA Institute or candidates in the CFA Program commit to adhere to and abide by the code and standards (except for Standard VII which relates to responsibilities as a CFA Institute member or CFA Program candidate in terms of references to CFA Institute, the CFA designation and the CFA Program).

All CFA Institute members must complete a professional conduct statement annually to retain active membership. That statement requires members to state whether or not they have been the subject of any complaint, investigation, ban or other legal process in the prior two years. The statement is a critical step in permitting the operation of CFA Institute's professional conduct programme and is an important mechanism for reminding members about their ethical and professional responsibilities.

Investment professionals who wish to reinforce that revision might undertake a self-audit against the code and standards, highlighting areas in which they feel that their performance could be improved. Local CFA member societies should provide opportunities for members to raise their concerns and receive mentoring or guidance from experienced investment professionals across different areas of the code and standards.

OPERATING AS A GOOD STEWARD

Stewardship requires the right framework to function well. Fundamentally, investment firms need to be adequately resourced to ensure that client assets will be safeguarded. Policies and procedures should be in place that will allow firms to have the human, financial, IT and administrative resources in place to serve clients well.

Individual investment professionals (other than those acting in senior management or director roles) may feel that they are unable to influence firms' ability to operate effectively on clients' behalf. However, all investment professionals will have some experience of one or more of their firms' investment policies and processes; their recruitment, retention and compensation policies; and their policies and processes for valuation, performance reporting and client communication.

The principles of business that the FSA sets down in its handbook and which then govern the specific Conduct of Business obligations for investment firms make it clear that firms must:

» conduct their business with integrity and with due skill, care and diligence;

» take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems;

» maintain adequate financial resources, observe proper standards of market conduct and deal with their regulators in an open and cooperative way;

» arrange adequate protection for client assets, pay due regard to the interests and information needs of their clients and communicate information to them in a way which is clear, fair and not misleading; and

» manage conflicts of interest fairly and must take reasonable care to ensure the suitability of its advice and discretionary decisions.

Investment professionals acting as good stewards will help their firms meet these obligations by participating in reviews of the systems and controls that their firms operate and by working within appropriate sets of systems and controls.

UNDERSTANDING YOUR CLIENT

The Financial Services Authority (FSA) January 2011 guidance consultation on Assessing Suitability[8] observed 'the high number of unsuitable investment selections we see in the pensions and investment markets is still a significant concern.' The FSA report noted that the primary fault was the 'failure to collect and properly account for all the information relevant to assessing the risk a customer is willing and able to take'. Typically, there were failures to take account of the capacity for loss and in operating risk profiling tools. Even where risk was properly assessed, there were then failures to select products matching the correctly assessed level of risk.

CFA Institute's code and standards make it clear that in relation to suitability, when members and candidates are in an advisory relationship with a client, they must:

» make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly;

» determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action;

[7] This is a précis of the code and standards. To read the full code and standards visit http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1.
[8] The Financial Services Authority (FSA) January 2011 guidance consultation on Assessing Suitability http://www.fsa.gov.uk/pubs/guidance/gc11_01.pdf
[9] Managing Individual Investor Portfolios by James Bronson, CFA, Matthew Scanlan, CFA, and Jan Squires, CFA in Managing Investment Portfolios © 2007 by CFA Institute

- judge the suitability of investments in the context of the client's overall assets, liabilities, income and expenditure; and
- when managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

A good first step towards meeting these requirements is to prepare an investment policy statement for clients. As stated in CFA Institute's reading on *Managing Individual Investor Portfolios*[9], 'the investment policy statement is a client-specific summation of the circumstances, objectives, constraints and policies that govern the relationship between adviser and investor.'

In constructing a statement, the client and the adviser need to reconcile investment objectives, risk tolerance and portfolio constraints. Calculation of a client's required return involves multiple assumptions (about, for example, the future value of current assets, the sustainability of income, the rate of inflation, interest rates and the client's time horizon). These assumptions should be reviewed, tested and (if necessary) amended regularly in order for an investment professional to continue to serve a client effectively as a steward of their assets.

It is also important to make sure that clients understand the sensitivity of the assumptions that are being used. For example, a 0.5% difference in the growth estimate for an asset with a 50-year time horizon is much more significant than one with a five-year term. It is important that clients understand the likely relative impact of the various assumptions on the potential outcomes. Alongside the need to review the assumptions used in developing the statement, the client's willingness or ability to take on risk is also likely to change over time and must be regularly reviewed.

A client's ability to take on risk depends on their time horizon, the relative critical importance of their goals and their ability to bear loss. A longer time horizon allows a client to take on potentially more volatile investments as there is greater opportunity for the client's performance to recover from periods of investment shortfall. The client's ability to bear losses – not just a failure to achieve the hoped for returns – will also be a key determinant of the appropriate level of risk for an investment professional to recommend.

A client's willingness to take on risk can be more difficult to assess. An investment firm might consider undertaking risk profiling so as to ensure a consistency of advice relative to understood risk. However, where risk profiling tools are employed, firms should review their output carefully to assess whether or not the results are consistent with ultimate client behaviour[10]. Finalised FSA guidance from March 2011[11] noted that some firms using questionnaires arrived at inappropriate interpretations due to poor question construction and inappropriate weighting of responses. Of the 11 risk-profiling tools that the FSA reviewed, nine were found to have weaknesses that could lead to flawed outputs. Where firms use risk profiling they should understand its limitations and complement it with other suitability assessment and 'know your customer' processes.

As stated earlier, the suitability of an investment (based on its anticipated risk/return profile and that of the client) must be judged on the basis of the client's total assets, liabilities, income and expenditure and should take account of other criteria such as the client's liquidity requirements, their tax status, their time horizon, their legal and regulatory environment and any unique circumstances that apply.

A good steward will also understand that clients want more than just a time horizon appropriate targeted risk-adjusted return. They also require high standards of communication and reporting so that they can understand the investment process and can observe the outcomes of that process. They want regular, clear communication about performance and about fees.

They may also want the unexpected. As Meir Statman pointed out in his August 2004 paper *What do investors want?*[12] 'Diners want more than the utilitarian benefits of low cost and high nutrition when they choose restaurants'. Investors may enjoy the status that is conferred by their choice of investment manager or investments, or they may want to express their social views by having a preference for socially responsible investments. In short, investors' utility functions may be unexpectedly complex and a good steward of their client's assets will bear that in mind.

[10] *http://www.fsa.gov.uk/pubs/guidance/gc11_01.pdf*
[11] *FSA Final Guidance on Assessing Suitability, March 2011, fg11_05.*
[12] *Statman, Meir, What Do Investors Want? (August 2004). Available at SSRN: http://ssrn.com/abstract=603683 or http://dx.doi.org/10.2139/ssrn.603683*

This paper comments primarily on the relationship between fund manager and client that necessitates an advisory aspect. Some clients appoint a third party adviser who is responsible for assisting them with the articulation of their investment objectives and, in such instances, there is a more limited or no advisory role for the fund manager. For example:

A fund manger may be given a specialist mandate that would not be suitable for the entirety of the client portfolio, but has been deemed an appropriate constituent within a broader portfolio.

A fund manager may solely be responsible for the management of a collective investment scheme into which an investor has invested based on separately received advice.

In these circumstances, good stewardship is delivered through adherence to the fund's stated investment restrictions, objectives and processes and through clear, accurate and frequent communication with the investor(s). Where the fund in question is a pooled vehicle, good governance requires the fair treatment of all parties within the vehicle. (This is likely to require the publication of pre-stated redemption practices).

ESTABLISHING CLIENT EXPECTATIONS

As good stewards, investment professionals take care to understand their client's requirements, risk appetite and constraints, to develop and deliver appropriate investment policies and to execute these in a responsible and sustainable manner within an appropriate framework of policies and processes.

But, stewardship also entails taking care to explain the limitations of the services that will be provided to the client so that expectations of both client services and performance can be set at the right level and so that the client understands well what they are paying for and what they are paying.

Investment professionals' clients need to be aware of how they will be served, the actions that will be taken in their interest and how they will be charged. They also need to be aware of the risks to which their capital will be exposed. Just as in medicine, investment professionals need to secure informed consent for their actions. While investment professionals do not hold their clients' lives in their hands, they are entrusted with their clients' capital and have an ethical obligation to ensure that their clients understand how they will manage that capital (both in terms of the investment approach and administratively) and the risks that are entailed. The concept of informed consent and practical advice on how it might be secured is covered in a separate CFA UK position paper.

A primary requirement of stewardship is that the client is clear about the extent of the services that will be provided.

All clients should expect asset allocation appropriate to the investor as described by an investment policy statement or clear mandate guidelines, careful security selection (taking account of any pre-established constraints), performance measurement against an appropriate benchmark and the regular review of their requirements. Dealing, settlement, custody and reporting arrangements also need to be explicitly discussed and the purpose and value of client dealing commission should be made clear. Similarly, the arrangements under which the client's assets will be maintained in a ring-fenced manner so that they are easily identifiable (and any circumstances where this might not be the case) need to be documented and communicated to the client with firms also providing transparency about outsourcing arrangements (and their contingency plans in case of the failure of those arrangements). Last, any conflicts to which the investment manager or adviser might be exposed should also be disclosed in full and the appropriate policies for managing such conflicts should be shared with the client.

Section VI of CFA Institute's Code of Ethics and Standards of Professional Conduct addresses conflicts of interest directly and requires their full and fair disclosure. CFA UK's paper on conflicts of interest considers how good stewards may best manage conflicts and, where avoidance is impossible, can implement full and fair disclosure.

But not only do clients need clear information about the services that will be offered, they also require a reasonable understanding of the outcomes those

services will generate and the risks that will be borne through the operation of the services. Most obviously, clients need to be aware of the risk that they may not achieve their risk-adjusted return objective over their targeted time horizon. Beyond that, though, they also need to be notified about the risks that they face in addition to market and, where appropriate, active management risk – notably counterparty risk, liquidity risk and operational risk. Clients need to be informed of the measures in place to mitigate these risks.

Managers and advisers may be able to do more to control these risks than they can to mitigate market risk, but clients still need to be aware of the potential impact of such risks. They also need to be reminded (if appropriate) that many of the most important risks that they face relate not to their assets, but to their liabilities. As stated before, the potential risks to client income and to their liability profile need to be carefully considered and regularly reviewed.

Market returns and market risk are not the only determinants of client outcomes. Costs also have an impact and need to be fully and clearly communicated. Fees and charges should be transparent and should be aligned with clients' interests. Annual management charges should be sufficient to meet the investment firm's costs and to provide a competitive margin. Performance fees might be applied where there is evidence of a reasonable likelihood that they will be exceeded by the additional manager performance that they are designed to encourage. Investment firms should work hard to ensure performance structures closely align the client and investment manager's utility functions. Last, clients and potential clients should consider providing worked examples of the likely level of fees and charges under different performance scenarios.

Not only should fees and charges be transparent and aligned with clients' interests, it is also important that investment professional's compensation structures are linked to client outcome and not just to outcomes for the firm. So, bonuses might be linked to the achievement of client objectives (as well as or instead of firm objectives) and a portion of bonus payments should be deferred over several years to encourage the maintenance of performance on clients' behalf over that period. In addition, bonus payments might be made in the form of co-investments in the funds in which the client is invested.

Considerations that stewards should take into account when implementing and communicating fees, charges and compensation structures are described in a separate CFA UK position paper.

MEETING EXPECTATIONS

It is critically important then that investment professionals do what they say they will do – provide appropriate, informed advice; develop suitable investment policies; execute those policies accurately and carefully; ensure the safe custody of client assets and the appropriate management of client monies; communicate effectively and return regularly to review the client's needs in the context of their total portfolio.

Whenever possible, investment professionals will also deliver the risk-adjusted return that the client seeks. That will not always be possible. Where it is possible, it may involve greater variability than anticipated in the pattern of returns and/or periods of under- or overperformance. Where managers and advisers have established an expectation that returns may be volatile (and may disappoint on occasion) and then deliver clear reporting on the causes of poor (or better than expected) performance, clients are more likely to maintain their trust in the manager as a steward of their assets. Maintaining that trust should be in the client's best interests as it should permit the application of an investment approach that matches their time horizon and should also reduce the likelihood that the client may chase returns and enter a disappointing pattern of selling low and buying high.

Finally, it is also important to note that clients and ultimate beneficiaries are not alone in having expectations of investment professionals. Fellow professionals, too, will expect their counterparts and colleagues to maintain high standards of professional behaviour and to respect their responsibilities to their clients and to the profession.

Good stewards of their clients' assets will take care to understand their clients, to establish reasonable expectations and will endeavour to meet or surpass those expectations. By doing so, they will earn

their clients' trust. It is also important that investment professionals should demonstrate their role as trusted stewards by charging appropriate fees for their services.

CONCLUSION

The society's members are competent investment professionals that abide by high ethical and professional standards and have demonstrated their commitment to the profession. Their education, experience and the obligations in CFA Institute's Code and Standards to which they subscribe mark them out as committed investment professionals. Summarised below are measures that members might use in order to practice the highest levels of stewardship on clients' behalf.

- Clarity about the principal
  - Remind yourself regularly that you act for the benefit of your clients and must place your clients' interests before your employer's or your own
  - Encourage your fellow investment professionals to do the same and challenge those who you believe have forgotten this core principle
- Understanding your responsibilities to your client and to the profession and operate professionally
  - Abide by CFA Institute's Code of Ethics and Standards of Professional Conduct
  - As well as signing the annual Professional Conduct Statement, undertake an annual self-audit against the code and standards and seek to improve your behaviour in areas where your performance is less strong
  - Where you have oversight and the ability to review and inform processes, participate in reviews of your firm's policies relating to investment, trading, settlement and custody, performance calculation and reporting
- Understanding your client
  - Ensure that your client understands their own ability and willingness to bear risk and their capacity for loss
  - Ensure that you know your clients' ability and willingness to bear risk, their capacity for loss and that you properly understand their time horizon
  - Use investment policy statements and review these, and the assumptions on which they are based, regularly
  - Make sure that your clients understand the key sensitivities in the assumptions and inform them as these factors change
  - Secure your clients' informed consent
- Establishing client expectations
  - Share conservative estimates of risk and return with your clients
  - Be clear about the impact of fees and charges and consider providing worked examples
  - Disclose and describe risks beyond market risk such as liquidity risk, counterparty risk and operational risks – and the measures used to mitigate these risks
  - Manage and disclose conflicts
- Meeting expectations
  - Do what you say you will do and do not surprise your clients. Communicate often, clearly and honestly
  - Act in accordance with the code and standards
  - Apply appropriate fees and charges that are transparent and aligned with clients' interests and employ compensation structures that are linked to client outcomes, not the firm's alone

Despite their best endeavours, investment professionals will not always be able to meet their clients' expectations. However, if they have provided informed, objective and appropriate advice about what can be achieved for a client based on their risk profile and time horizon, if they have communicated fairly and clearly and have carefully safeguarded the client's assets, the investment professional will have acted as a good steward and will have earned an opportunity to win or maintain their clients' trust.