An Overview of Discretionary Management

By Matthew Karam CFA, CFP®, TEP, CIM®

Discretionary portfolio management is a form of investment management in which buy and sell decisions are made by a Portfolio Manager for a client account. The term "discretionary" refers to the fact that investment decisions are made at the Portfolio Managers discretion[1].

Discretionary investment management is tailored to high-net-worth individuals and institutional investors, such as pension funds, since discretionary accounts have higher minimum investment requirements[2].

A Portfolio Manager's strategy may involve purchasing a variety of securities as long as it falls in line with the client's risk profile and financial goals[3]. The primary benefits to utilizing discretionary investment management are:

- Enhanced educational requirements and due diligence screening of Portfolio Managers.
- The enhanced obligation of all Portfolio Managers to their clients.
- Ability to systematically implement and rebalance a portfolio.
- Ability to maintain portfolio flexibility and provide quality client communication.

Educational Requirements and Due Diligence Screening of Portfolio Managers

Financial advice in Canada is regulated in many forms. Education requirements vary depending on the type of investment products the advisor is looking to implement within an investment portfolio. Examples include stocks, bonds, mutual funds, exchange traded funds (ETF's), and options. An Investment Advisor may also continue their educational requirements to apply to become a Portfolio Manager.

Portfolio Manager's Obligations

In Canada, financial advisors must follow the suitability standard when making investment recommendations. The suitability standard generally means an advisor must collect the relevant client information prior to making investment recommendations, and take reasonable steps to ensure that the recommendation is suitable for the client[4]. In other words, it is an advisor's obligation to help determine whether an investment is appropriate for the client; the advisor must understand the investment product and know enough about the client to assess whether the product and the client are a match[5].

---

[1] https://www.investopedia.com/terms/d/discretionary-investment-management.asp
[2] https://www.investopedia.com/terms/d/discretionary-investment-management.asp
[3] https://www.investopedia.com/terms/d/discretionary-investment-management.asp
[4] https://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20121025_33-403_fiduciary-duty.pdf
[5] Re Daubney (2008), 31 O.S.C.B. 4817 at 4819, para. 16.

All Portfolio Managers are held to a higher standard of care over the suitability requirement. Portfolio Managers have the obligation to act with care, honesty and good faith, and must always put their clients' interests first. As a result, clients are able to place a higher level of trust in Portfolio Managers.

Systematic Portfolio Implementation and Rebalancing

Discretionary management offers the opportunity to implement portfolio changes on a timely and systematic basis. Accounts are assigned to an investment model to match the risk profile of the client. If a change is made to the model, it can be applied across all accounts using an automated process which aggregates the trades and sends them directly to the exchange/fund company.

For non-discretionary accounts, portfolio implementation and rebalancing must be done manually. Manually executing account changes can be detrimental to both the client and Portfolio Manager for a few reasons:

1) Manually rebalancing an account to its target asset allocation is complex and often inexact.
2) Manually rebalancing is more time consuming than using an automated trading process. The time can be more effectively used to create other value-added opportunities such as more in-depth investment research or tailored financial planning.
3) Non-discretionary accounts require prior trade approval before an investment recommendation can be implemented. The approval process can lead to costly price movements due to the time lag between the initial recommendation and final client approval.

Portfolio Flexibility

Discretionary portfolio management is not an all-or-nothing service. In some instances, investments that are not in the current model can still be 'locked' and excluded from being sold during the automated rebalancing. Examples of these exceptions may include investments with sentimental value, large capital gains, or even "play money" investments. These exceptions are topics to be addressed in the initial construction of a client's Investment Policy Statement, as well as in future portfolio reviews.

Client Communication

Although portfolio changes are automated with discretionary investment management, it is still a top priority for our clients to continue to receive quality communication regarding their entire wealth strategy. These communications come in many forms, including face-to-face meetings, model change updates, market updates, and financial planning reviews.

Transitioning to discretionary management allows for the opportunity to create more time for our team to focus on serving our clients.