Understanding Open Architecture Investment Programs

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Thinking about significant investment innovations of the last several decades, the introduction of "open architecture" programs has earned a place on the list. Today, open architecture is widely acknowledged as a fiduciary best practice by organizations including the Center for Fiduciary Excellence (CEFEX) and the Center for Board Certified Fiduciaries (CBCF).

Despite the advantages of open architecture, confusion remains about the benefits of an open vs. closed architecture investment program. For stewards of foundation assets, open vs. closed architecture is an important consideration.

The Power of Choice

Simply put, an **open architecture investment program** offers clients open access – the ability to invest in proprietary *and* external products and services. A **closed architecture investment program** offers clients closed access – the ability to invest only in proprietary products and services.

An example to think about is Costco. If Costco offered only their proprietary Kirkland products, it would be an example of closed architecture. However, Costco offers a wide variety of outside products and services, which means it utilizes an open architecture. The model works; Costco shoppers can select the products – Kirkland or otherwise – that best meet their needs.

It is estimated there are currently more than 10,000 investment managers in the U.S. As investment managers have become increasingly specialized, there are few firms that excel in every asset class. By including more investment managers – more choice – open architecture provides access to a wider variety of managers who may be deemed "best-in-class."

The Fiduciary Consideration

Another key consideration in open vs. closed architecture is the role of the financial advisor and how it impacts the fiduciary responsibilities of the board. We can start with a definition of the fiduciary role: **it is a legal and ethical mandate to act in the best interests of the client.**

In an open architecture program, the financial advisor is focused on providing an unbiased selection of best-in-class managers. In a closed architecture program, the financial advisor recommends only proprietary products which may or may not be the best choice for the clients. There is an inherent conflict of interest in a closed architecture program, as the financial advisor has a bias to recommend proprietary products.

By providing broader access to investment managers that are vetted through a due diligence process, open architecture also helps limit diversification risk by not placing assets in the hands of a single investment firm and its approach.

Transparency

In a closed architecture program, a single firm generally serves three roles – financial advisor, investment manager, and custodian. In an open architecture program, the financial advisor oversees the investment manager and custodian roles. Defined roles and oversight by the financial advisor enable transparency and accountability around portfolio holdings, trade execution, record-keeping, and fees. Transparency around portfolio holdings can be especially relevant for clients focused on mission alignment.

Considering these elements – choice, competition, flexibility, transparency – it is understandable why open architecture is considered a fiduciary best practice.

By James Lumberg, SouthCol Advisors LLC

About the author: James Lumberg is the founder of SouthCol Advisors, LLC, an independent Registered Investment Advisor that works with organizations to build customized portfolios that help achieve their mission.*

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