

Structuring effective performance oversight: A toolkit for fund directors

Steps board members can take if an adviser fails to deliver

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Board oversight of performance is one of a fund director's core oversight responsibilities, but what can a director really do if an adviser fails to deliver?

Before continuing, consider reading Dianne's previous [piece](#) on performance oversight.

Persistent underperformance demands a solution, and directors must step in to address the issues without stepping into the shoes of management. Unexpected outperformance can also be a cause for alarm, as it could indicate a misalignment with a fund's investment strategy or excessive assumption of risk.

The independent director community should be commended for undertaking its performance oversight responsibility with diligence and conscientiousness. They may want to look at their available options and develop a structured approach to working with the adviser to course correct if appropriate.

Generally, aberrant fund performance should be closely monitored, and independent directors should be regularly updated on the adviser's strategies to address it. As a first step, the fund's adviser may analyze the appropriateness of the fund's benchmarks and peer groups.

Portfolio managers may share how a fund's investment strategy is designed to perform differently in various market conditions or compared to particular indices. That can support a finding that a fund is performing as expected – just not well in a particular market environment or as compared to an index that might not serve as the best option for performance comparison.

In evaluating performance, boards should understand how the adviser determines when and what action it should take or recommend if performance issues arise. The adviser is responsible for managing fund assets and taking steps to address performance issues. Directors, on the other hand, have an oversight role with respect to performance. Any action to address unexpected performance typically would reflect dialogue between the board and the adviser (or subadviser) over a period of time.

If a true performance issue exists, directors should consider what information would be most useful to effectively assess its potential impact. They may request robust attribution analysis – including factor, sector or security-selection attribution – to determine whether results reflect market exposures, principal strategy concerns and/or investment implementation issues. Trustees may also request enhanced performance reporting and/or interim updates.

Once the board has sufficient information to assess the fund's performance, directors can work with the adviser to develop a plan to address the issue. Independent directors may request portfolio managers provide a detailed plan (in person during a board meeting) to address unexpected performance within a certain timeframe. Potential solutions may include the adviser providing additional resources or adjusting a fund's portfolio management team.

If the plan developed by the adviser fails to improve performance, boards may consider oversight escalation options. For example, directors may request that more senior personnel at the adviser be more actively involved or present remediation plans to the board.

Directors may also consider whether third-party experts – such as independent consultants that review an adviser's investment process, portfolio construction and attribution factors – could offer a more in-depth explanation about what caused the unexpected performance.

At this stage, counsel is generally closely involved with the board and the adviser in monitoring and providing guidance related to performance improvement plans. Options may include changes to a fund's mandate, investment restrictions or applicable benchmarks – or the adviser's staffing and execution of portfolio management responsibilities.

Boards may consider requesting more formalized structural solutions, such as asking the adviser to implement its performance improvement plan and present results in six months. A board could also conditionally approve the related advisory agreement based on the plan's results.

Directors may weigh whether to leverage their contractual authority under Section 15(c) by requesting a renegotiation of fee structures or changes to portfolio managers. Other options could include the merger or liquidation of the fund. Although generally considered to be a last resort, boards have the authority to terminate the adviser or not approve the advisory agreement renewal if that is believed to be in the fund's best interest.

A sample oversight methodology chart for the aforementioned performance oversight options is below:

Board Oversight of Fund Performance Process

Stage 1: Targeted Information Requests

- Request information regarding consistency of fund investments with investment objective and strategy
 - For example, to what extent do holdings overlap with the benchmark? What are the fund's largest performance detractors, and is this driven by the fund's strategy? What is the adviser's sell discipline for underperforming holdings?
- Request robust attribution analysis (e.g., sector vs. security selection attribution, factor exposures, performance in up/down markets)
- Request more frequent performance reporting (e.g., monthly top contributors/detractors)
- Request enhanced performance reporting (e.g., volatility compared to peers, evaluation of concentration risk)
- Review peer/index comparisons and suitability analysis from the adviser, if applicable, to assess whether appropriate. How does the fund compare to funds with sufficiently similar strategy and concentration?

Stage 2: Enhanced Engagement with Management

- Request performance improvement plan with deadlines for progress and board reporting (e.g., portfolio repositioning plan, capacity adjustments)
- Inquire about appropriateness of adviser resources and staffing (e.g., analyst coverage and research depth)
- Request in-person presentations from portfolio managers to explain largest detractors

Stage 3: Oversight Escalation Options

- Engage third-party experts or increase involvement of counsel (e.g., independent consultant review of portfolio construction, benchmarks or attribution analysis)
- Request additional resources or portfolio manager additions or responsibility changes
- Escalate discussions to senior management
- Require interim performance updates
- Request information about potential investment mandate or restriction changes

Stage 4: Leveraging Contractual and Structural Options

- Conditionally approve advisory or sub-advisory agreement; approve for period less than one year (e.g., renewal could be contingent on demonstration of performance improvement at next review)
- Request negotiation for lower management fees (e.g., temporary fee waiver, reduction of management fee or imposition of new/additional breakpoints)
- Request evaluation of portfolio manager or sub-adviser changes
- Consider whether a fund merger or reorganization would be appropriate
- Terminate or elect to not renew advisory agreement

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