BUILDING A BETTER INVESTMENT COMMITTEE

Part 2 of a Series

Best Practices for Investment Committee Governance

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Renowned investment consultant and author Charles D. Ellis, CFA, published an article in the *Financial Analyst Journal* in the summer of 2012. Reminiscent of Agatha Christie's novel *Murder on the Orient Express*, Ellis investigates who is responsible for the underperformance of many institutional portfolios. He reviews the suspects — investment managers, fund executives, investment consultants, and investment committees — and concludes (as Hercule Poirot did in the novel) that all the suspects were guilty.

> "The same reality may explain the persistent failure of institutional investors to achieve their ubiquitous but evanescent investment goal of superior results or 'beat the market performance.' The results are persistently disappointing."

Charles D. Ellis, "Murder on the Orient Express: The Mystery of Underperformance," *Financial Analyst Journal*, July/August 2012

WHY DO INSTITUTIONAL INVESTORS OFTEN FAIL TO MEET THEIR STATED BENCHMARK RETURNS?

Persistently disappointing returns are often the result of ineffective board structures and misguided investor behavior. While these can be considered distinct concerns, they are also interrelated. An ineffective board structure can lead to misguided behaviors. Likewise, misguided behaviors can lead to ineffective structures and processes.

The structural and behavioral hurdles many institutional investors encounter include:

1. Absence of effective board and committee processes
2. Inadequate investment committee governance
3. Insufficient consideration of agency costs
4. Lack of patience and discipline
5. Misguided investment focus

This series examines how certain behaviors restrain long-term performance, and also offers suggestions on where structures and processes can be improved. Recognizing how board structures and investor behaviors impact performance is key to implementing an effective investment strategy.

BEST PRACTICES FOR INVESTMENT COMMITTEE GOVERNANCE

The second in the series reviews critical steps that institutional investors should take:

1. Recognizing the challenges confronting investment committees
2. Establishing effective oversight structures
3. Defining the rationale for outsourcing portfolio implementation

INTRODUCTION TO INVESTMENT COMMITTEE GOVERNANCE

Investment committees face more and increasingly complex challenges today than they did even a generation ago. Thirty years ago, for example, many institutional investors employed one or two balanced managers, which were often bank trust departments. The investment committee established an appropriate target asset allocation, such as 60% stocks (usually U.S. large cap) and 40% bonds (usually U.S. investment grade) and an appropriate range (e.g., + 10 percentage points) around these targets. The balanced managers were hired by the investment committee and given the responsibility of selecting the individual stocks and bonds. Although the investment committee established a target asset allocation, the balanced manager often had leeway to adjust the allocation within the stated ranges based on their views of the markets.

By the 1990s, institutional investors had diversified their portfolios, with most abandoning balanced managers and hiring specialist managers, such as large cap equity, small cap equity, international equity, and fixed income. In portfolios today, we see several additional mandates, such as emerging markets, real estate, high yield, private equity, and various hedge fund strategies. The specialist managers usually have little knowledge of the overall portfolio and simply focus on their particular mandate. Consequently, for institutions with no investment staff, the investment committee is responsible for establishing investment policies, including the target (i.e., strategic) allocation, employing any deviations (i.e., tactical allocation) from the target, as well as the selection and termination of the investment managers.

In this model, investment consultants usually are hired to assist in the process, but the investment committee has ultimate responsibility for hiring and firing managers. For portfolios large enough to hold separate accounts, investment committees often will conduct manager searches, interviewing the candidates before selecting the most appropriate manager for each particular mandate. Once the managers are hired, investment committees may perform their own additional due diligence by meeting periodically with the managers. For smaller mandates where mutual funds and other commingled funds are the preferred vehicles, investment committees will typically rely on

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the investment consultant to provide information on the managers. Ongoing due diligence may be provided by the investment consultant, but past performance is frequently a key factor in this process.

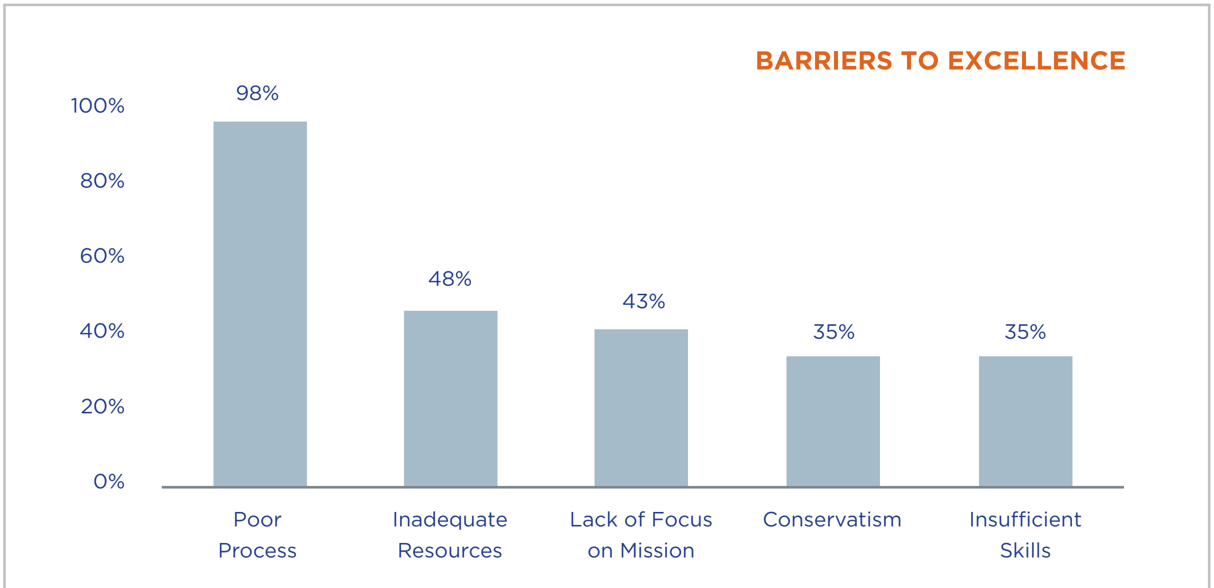
Furthermore, the investment committee is responsible for asset allocation and determining any deviations from the targets. These deviations could be intentional, overweighting (underweighting) of asset classes based on market views, or unintentional, simply due to a lack of rebalancing back to targets after market movements. In either case, the investment committee is responsible for reviewing the actual asset allocation versus the target allocation.

The increased complexity of institutional portfolios over the last few decades has changed how investment committees approach their roles. But is this the best governance structure for managing institutional portfolios? Should investment committees be responsible for selecting managers and allocating assets?

1. Recognizing the Challenges Confronting Investment Committees

BARRIERS TO EXCELLENCE

In their book *Pension Fund Excellence*, Keith Ambachtsheer and Don Ezra identified barriers to excellence for pension funds. In a survey of 50 senior pension executives, 98% cited poor process (decision structure, communication, and inertia) as a major hurdle to achieving investment goals. Other factors cited were inadequate resources (cited by 48%), lack of focus on mission (43%), conservatism (35%), and insufficient skills (35%). Although focused on pension funds, the survey's findings apply to other institutional investors. Many pension plan committees are staffed by employees who spend only a few days a year on investments, as they have other full-time responsibilities. This is not unlike endowment/foundation committee members, who are volunteers, typically meeting four times a year.



[1] *Pension Fund Excellence,* Keith P. Ambachtsheer and D. Don Ezra

In many cases the major hurdle to achieving superior performance is the committee structure, which leads to implementation shortfall.

COMMITTEE STRUCTURE AND PROCESS

Consider the typical investment committee. Do the members possess sufficient investment knowledge and skills? Do the structure and processes provide adequate resources for informed decisions?

Investment committees are often comprised of five to ten individuals with varying degrees of investment knowledge, who meet quarterly, seek consensus, and base their decisions on comfort. By meeting quarterly, committees may miss opportunities to act on investment opportunities, or on the other hand, believe they must act when action is not warranted.

Because the committee members either work together (pension plans) or are volunteers (endowments and foundations), they are usually collegial and avoid confrontations. Rarely are decisions reached in a contentious 5-4 vote. In fact, 8-1 votes are also unusual, as a general consensus is usually reached before acting. With varying degrees of investment knowledge, a large group, and a desire to become comfortable with an investment strategy before proceeding, **investment committees rarely are contrarian or invest in strategies before others**.

By investing with the "herd," committees seek to limit reputation risk. In order to achieve superior returns (if that is a goal), however, an investment committee must be willing to invest differently than its peers. Once an investment strategy has become "mainstream," the exceptional returns have been realized.

In many cases the major hurdle to achieving superior performance is the committee structure, which leads to implementation shortfall. Implementation shortfall includes delays in decisions due to lack of information, insufficient knowledge, failure to reach a consensus, inability to schedule a meeting, and lack of accountability (no one is solely accountable for performance).

Additionally, with the proliferation of managers and new investment strategies, investment committees have been unable to spend sufficient time interviewing and performing ongoing due diligence on the managers. Thus, they have had to rely more on staff, consultants, or fund of funds managers to perform this due diligence.

2. Establishing Effective Oversight Structures

LEVELS OF FIDUCIARY RESPONSIBILITY

In *Pension Fund Excellence*, Ambachtsheer and Ezra describe three levels of fiduciary responsibility:

1. Governing – mission and objectives
2. Managing – portfolio implementation
3. Operating – administration and execution

Understanding these responsibilities helps to define the roles of each fiduciary and ensure an effective governance structure.

	3-TIER CAPTIVE
Governing Fiduciaries	Investment Committee
Managing Fiduciaries	CIO and Staff
Operating Fiduciaries	Investment Managers Custodians Actuaries Other Vendors

THREE-TIER CAPTIVE

For many larger institutions (assets over $1 billion), the board or investment committee serves as the governing fiduciary. They establish the mission and objectives, define the liquidity and risk tolerances for the plan/fund, and set the asset allocation and investment policies.

The managing fiduciary is the chief investment officer, who determines the asset allocation within the policies established by the governing fiduciaries, selects the investment managers, and provides day-to-day supervision of the assets.

The operating fiduciaries include the investment managers, who select securities and manage the portfolios, the custodians, who hold the assets and collect dividends and interest payments, as well as actuaries, administrators, and other vendors.

TWO-TIER COMMITTEE DRIVEN

For institutions unable to hire investment staff, a common structure is to combine the governing and managing fiduciary roles, with the investment committee serving both roles. Thus, they set policy and also implement decisions by hiring managers, determining the asset allocation within the policy parameters, deciding when to rebalance, and when to terminate managers. This structure is fraught with difficulties, however, as the governing fiduciaries generally are unable to effectively evaluate themselves as managing fiduciaries.

	2-TIER COMMITTEE DRIVEN
Governing Fiduciaries Managing Fiduciaries	Investment Committee
Operating Fiduciaries	Investment Managers Custodians Actuaries Other Vendors

THREE-TIER OUTSOURCED

For institutions unable to hire investment staff, outsourcing the managing fiduciary role is preferable in order to overcome the challenges of the two-tier committee driven approach. The advantage to this approach, versus the two-tier committee driven structure, is:

- **Clear accountability for performance**
- **Increased oversight of the assets**
- **More disciplined decision making and efficient implementation**
- **Better allocation of the governing fiduciaries' time**

	3-TIER OUTSOURCED
Governing Fiduciaries	Investment Committee
Managing Fiduciaries	Outsourced CIO
Operating Fiduciaries	Investment Managers Custodians Actuaries Other Vendors

3. Defining the Rationale for Outsourcing Portfolio Implementation

CLEAR ACCOUNTABILITY

Under the two-tier approach, who is ultimately responsible for performance? The committee chair? The consultant? The entire committee? The committee chair runs the meetings and sets the agenda, but has only one vote. Consultants may provide recommendations, but they are not always accepted. **The entire committee ultimately is responsible, but as the governing fiduciaries, placed in the awkward position of assessing themselves as the managing fiduciaries. Thus, there is a lack of true accountability** with the two-tier structure. **Outsourced investment advisory firms, on the other hand, accept this responsibility** and are held accountable for performance.

INCREASED OVERSIGHT

Without a full-time investment department and boards/committees who meet only a few times per year, there is no one person responsible for the daily oversight of the assets. Outsourced advisory firms, on the other hand, employ investment and operational personnel, thus providing increased oversight while serving in the managing fiduciary role.

DISCIPLINED DECISION MAKING AND EFFICIENT IMPLEMENTATION

Coupled with the increased oversight and daily monitoring of the asset mix and investment managers, **outsourced advisory firms can provide disciplined decision making**. For example, suppose the stock market declines and bonds rally, thus moving the portfolio away from the target allocation. In this situation, the outsourced advisory firm can make the decision to rebalance the portfolio by selling bonds, which have performed well, and buying stocks, which have performed poorly. This approach can be difficult for committees to employ, as a few members may be unwilling to sell high and buy low in the midst of a difficult market environment. Additionally, the outsourced advisory firm, with a dedicated back-office staff, can provide efficient implementation of any portfolio decisions.

> In order to be successful, boards must recognize their limitations and focus more of their attention on governance, their fiduciary responsibilities, and the appropriate structure for their particular institutions.

BETTER ALLOCATION OF TIME

Finally, **outsourcing leads to better allocation of the governing fiduciaries' time.** By delegating the managing fiduciary role, the board/committee can spend more time on the governing fiduciary role. Too often committees are involved in the details of the investment portfolio, such as selecting specific managers and rebalancing, and are unable to spend the necessary time on the mission of the institution, defining the portfolio's risk tolerance and long-term strategy, and establishing the investment policies that ultimately will drive the long-term success of the portfolio.

DRIVING SUCCESS WITH EFFECTIVE GOVERNANCE

Today's fiduciaries oversee portfolios more complex than ever before. What may have worked years ago may not work as well today. With multiple specialist mandates, can committees still do an effective job in evaluating managers? Probably not. **Can a committee with limited resources that meets four times a year be effective in allocating a portfolio?** Probably not. Would a rational individual investor ever employ a structure where several friends were invited over to dinner every three months to select the individual's mutual funds and how the portfolio should be allocated? No. **So why do institutions employ this structure** and allow committees to spend so much time on manager selection/review and tactical asset allocation? Because they believe that is how they add value, and this is often the "fun" part of the job.

In order to be successful, boards must recognize their limitations and focus more of their attention on governance, their fiduciary responsibilities, and the appropriate structure for their particular institutions. Consequently, fiduciaries are assessing their governance structures and seeking to improve their processes. To avoid implementation shortfall and remove the barriers to excellence, **all fiduciary roles must be clearly defined**. The first step is to determine the appropriate oversight structure.

For institutions large enough to hire a chief investment officer and dedicated investment staff, the three-tier captive offers the best approach. The chief investment officer is full-time, understands the institution, and is clearly accountable for performance.

For those unable to hire investment staff, however, the outsourced chief investment officer approach is preferable to the two-tier approach of asking the board/investment committee to assume both the governing and managing fiduciary roles.

Christopher M. Meyer, CFA

As Managing Principal of Truepoint Institutional Advisors, Chris guides investment strategy and provides ongoing portfolio implementation and oversight for institutional clients.

He has more than 25 years of investment experience, previously serving as Managing Principal and Chief Investment Officer at Fund Evaluation Group. A member of the CFA Society of Cincinnati, Chris holds the Chartered Financial Analyst designation. He received his MBA in Finance from The Ohio State University and earned a B.S. degree in Statistics and Economics from the University of Akron. Prior to graduate school, Chris worked in the trust department of Fifth Third Bank.

Chris currently serves as the Investment Committee Chair for the Cincinnati Retirement System (previously served as Board Chair), Chairman of the Board of Directors for the Lambda Chi Alpha Educational Foundation (previously served as investment committee chairman), and as a member of the Finance Council at St. Antoninus Church.

He previously served as President of the Board of Trustees for the Cincinnati Reds Hall of Fame and Museum, on the Finance Advisory Board for the University of Cincinnati MSBA program, the board of the Madcap Productions Puppet Theatre, and as Chair of the Parish Council for St. Antoninus Church.

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About Truepoint Institutional Advisors

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