BUILDING A BETTER INVESTMENT COMMITTEE

Part 3 of a Series

Understanding Agency Costs & Minimizing Conflicts of Interest

INDEPENDENT.

INTELLECTUALLY HONEST.

EXPERIENCED.

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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.

UNDERSTANDING AGENCY COSTS & MINIMIZING CONFLICTS OF INTEREST

The third installment in the series reviews the principal-agent problem and critical steps institutional investors should take in:

1. Recognizing compensation-related conflicts of interest

2. Understanding client retention principal-agent problems

3. Implementing processes to mitigate principal-agent problems

PRINCIPAL-AGENT PROBLEMS: WHAT THEY ARE & WHY THEY MATTER

The principal-agent problem occurs when a principal (investor) hires an agent (investment advisor) to act on its behalf even when the agent's interests may diverge from those of the principal. In the investment industry, typically the investor's primary interest is realizing long-term growth in assets, while the investment advisor prefers a healthy and steady stream of fee income. This may not appear to be a problem, as investment advisors are hired to deliver long-term performance and should strive to satisfy their clients. Moreover, investors would not purposefully overpay or retain ineffective investment advisors. The problem, though, occurs when the investment advisor places its business interests ahead of the client's investment interests.

There are clear conflicts of interest pertaining to compensation, but also subtle principal-agent problems that neither investors nor investment advisors always truly appreciate. By better understanding the potential conflicts, investors can be more aware of their investment advisors' motives and able to question whether their actions and recommendations are truly in the investors' best interests.

The vast majority of investment advisors are ethical and seek to do what they believe is in their clients' best interest. Few seek to take advantage of their clients, but rather, work hard to help their clients achieve their investment objectives. Nevertheless, the principal-agent problem still exists. Although investors may not consciously contemplate these issues, most investors understand investment advisors are in business to earn money and therefore do not want to lose clients. Consequently, investors should be aware that investment advisors' business interests sometimes could conflict with investors' long-term investment interests.

This article reviews common compensation-related conflicts of interest, as well as less obvious client retention principal-agent problems. In all instances, the investor is the principal, and the agent assumes fiduciary responsibility. Fiduciaries are required to act in the client's best interest, disclose and reduce any conflicts of interest, and manage assets prudently.

Fiduciary agents can be categorized into two main groups:

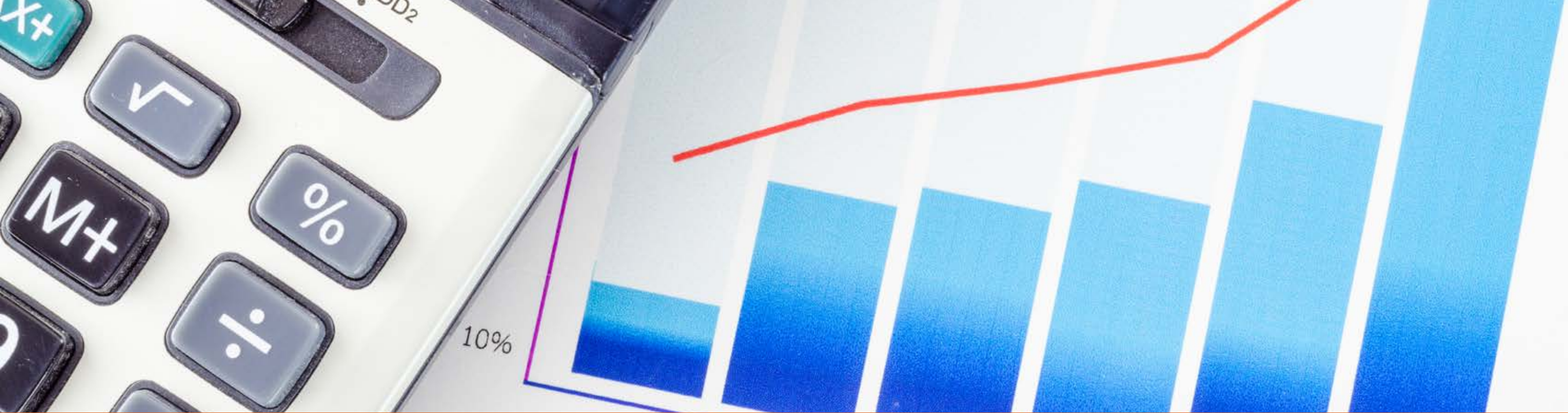
1. Investment managers, including separate account, commingled fund, and mutual fund managers

This group selects securities for a specific mandate (e.g., large cap value, international equity, core bonds) and typically manages only a portion of the overall portfolio.

2. Consultants, outsourced chief investment officers, and other advisors

This group is responsible for the overall portfolio and either has discretion over portfolio construction and manager selection/termination, or makes recommendations to the investor. In terms of fiduciary responsibility, there is little difference between those with discretion and those who make recommendations. In both cases, the advisor has a fiduciary responsibility to act in the client's best interest.

Although the principal-agent problem for staff members is not explored here, boards should be cognizant that staff members prefer to keep their jobs and can fall victim to some of the same influences as outside agents.



1. Recognizing Compensation-Related Conflicts of Interest

Despite a heightened sensitivity around fiduciary responsibility, many egregious conflicts of interest still exist. These conflicts pertain to compensation structures, where investment advisors are incentivized to act in ways that place their compensation ahead of their clients' best interests. For those focused on good governance, these practices are troubling, and the fact that some investors do not recognize these conflicts is disappointing. Below are notable compensation-related conflicts of interest that investors should avoid.

FEE-SHARING

Although not as common as in decades past, some investment advisors receive fees from the managers/funds they recommend or select for their clients. This fee-sharing compensation can be in the form of commissions, mutual fund loads, or 12b-1 fees. In all cases the advisor has an incentive to recommend or select certain funds over others because the compensation is greater. The advisor also may have an incentive to churn the portfolio (i.e., sell current holdings and purchase new holdings) to collect additional compensation.

AFFILIATED BROKERS

Some investment advisors and managers are affiliated with brokerage firms and trade on their platforms. They may argue that this affiliation helps them to achieve better trade execution, but the incentive to trade to generate more commission dollars is a definite conflict. Even if the advisor does not trade with the affiliate, they may favor investment managers who trade a great deal with the brokerage arm, presenting another conflict.

MANAGER-SPONSORED CONFERENCES

A few consulting firms host client conferences and solicit investment managers as sponsors. These conferences are educational and the clients benefit from the content and networking opportunities, but the sponsoring investment managers pay the consultant for the benefit to attend. Why do the investment managers sponsor these conferences? To spend a day or two trying to stand out among dozens of their competitors in front of potential clients or to gain favor with the consulting firm that may recommend them? When deciding who to recommend in a manager search, do the consultants favor the sponsoring managers over those who did not sponsor? Perhaps some consultants can remain impartial, but many fall prey to the human tendency to favor those who help them.

USING PROPRIETARY FUNDS/ AFFILIATED MANAGERS

Some investment advisors will recommend/ invest in proprietary funds or affiliated managers. In doing so, the advisor's objectivity may be compromised.

Consider an investment advisor working at a brokerage firm or bank (or even an independent registered investment advisor) that invests with both outside fund families and proprietary funds/affiliated managers.

A few questions immediately come to mind: Can the advisor truly be objective in evaluating the proprietary funds/affiliated managers? Are there additional incentives for the advisor to invest with the proprietary funds/affiliated managers? What other fee arrangements are involved? Even if there are fee rebates and concessions that do not change the overall compensation to the advisor, thereby providing a justification for the advisor to employ this approach, the advisor's firm still benefits from additional assets in these funds (or with these affiliated managers). Additional assets help to spread operational costs, thereby lowering the expense ratios on the proprietary funds. Lower expense ratios and larger asset bases can help in the marketing of these funds.

Similarly, consider a consultant who recommends their clients invest with the firm's proprietary private capital or hedge fund of funds. Often these fund of funds are designed to help smaller clients access the same private capital or hedge fund managers as their larger clients. The benefits to the investor are lower fees than other fund of funds and a consultant with keen knowledge of the underlying managers. The obvious conflict occurs when the consultant generates more revenue by recommending the proprietary fund of funds in place of external funds. Nevertheless, conflicts can occur even if management fees are rebated, as the consulting firm still benefits from the larger asset base and the spreading of operational costs across additional investors. When consultants recommend proprietary funds, can they still be objective in evaluating these funds? Even if the fund of funds is an appropriate

vehicle for investment, can the consultant be influenced in other areas? For example, will they be more likely to recommend higher allocations to private capital and hedge funds? Will their capital market assumptions (used in asset allocation studies) accurately reflect the expected returns, risks, and correlations inherent in these strategies? Or will they adjust the assumptions to favor higher allocations to these strategies? And will the investors who use the consultant's fund of funds recognize that they are more reliant on the consultant because they have a large part of their assets tied up in these funds?

DIFFERENT FEE SCHEDULES

Some investment advisors, such as those affiliated with banks and brokerage firms, may invest only with proprietary funds. Investing across multiple proprietary funds eliminates the conflicts between outside and proprietary managers, but introduces new conflicts if the funds have different expense ratios. For example, suppose the advisor invests in two funds, an equity fund and a fixed income fund. The equity fund's expense ratio is 0.75% and the fixed income fund's expense ratio is 0.40%. Because the firm collects higher fees with the equity fund than the fixed income fund, the advisor faces a conflict of interest when allocating between the two funds.

Another conflict arises when investment advisors and consultants charge higher fees for additional services. Because these additional services require increased resources, the higher fee may appear justified and not a conflict of interest, especially if the investor must agree to the new fee schedule. Nevertheless, the advisor still has an incentive to "up-sell" the client.

For example, a consultant may charge higher fees to advise on "alternative investments" such as private capital and hedge funds.

If the consultant's client does not currently invest in "alternative investments," the consultant has an incentive to increase its compensation by recommending the investor move to a higher level of service. The consultant may believe this is in the client's best interest, but the additional compensation introduces potential conflicts.

Similar to the example of the consultant who offers a fund of funds, investors must be aware that the consultant has an incentive to "sell" the benefits of "alternative investments," downplay the disadvantages, and adjust the firm's capital market assumptions to demonstrate the benefits of including "alternative investments" in the portfolio.

A better approach would be to have one fee schedule for all clients, thus eliminating this conflict.

2. Understanding Client Retention Principal-Agent Problems

Because investment advisors realize that poor short-term underperformance can lead to their termination, they have an incentive to minimize the risk of short-term underperformance, even if this detracts from long-term performance. Thus, the business interests (maintain the client and collect fees) of the agent (investment advisor) may not always align with the investment interests (long-term growth) of the principal (investor).

These subtle principal-agent problems are prevalent in the investment industry, but often unrecognized by investors and investment advisors. The investment advisors are not seeking to increase compensation through questionable tactics, but rather, simply maintain their clients. Advisors may structure portfolios that are over-diversified or too conservative and avoid long-term beneficial opportunities to mitigate short-term underperformance. Many investment advisors are unwilling to defend suitable, yet underperforming investment managers. Additionally, advisors may create activity and complexity to justify their worth. Some subtle principal-agent problems driven by a focus on client retention may not be entirely avoidable, but investors should be aware of these issues to better understand the motivations of their advisors.

OVER-DIVERSIFYING PORTFOLIOS

Investment managers who claim they are skillful stock selectors will nonetheless structure portfolios within certain constraints. These constraints include position sizes (e.g., no more than 5% in any one stock), sector weightings (e.g., +/- 20% vs. benchmark weighting), and portfolio optimization techniques designed to lower the tracking error (i.e., difference between the portfolio return and the benchmark return). Sometimes these managers are referred to as "closet indexers" because their portfolios are structured to perform in line with the benchmark. The problem is portfolios structured similarly to the benchmark generally perform in line with the benchmark return, but these managers charge active management fees, which are much higher than passive (indexing) management fees.

Why do so-called active managers structure portfolios so similarly to the benchmark? The answer is simple — despite investors claiming to focus on the long-term, managers rarely are terminated for generating benchmark-like returns, but are frequently terminated for significant short-term underperformance. Therefore, many managers structure portfolios not to generate the highest long-term returns, but to avoid meaningful short-term underperformance. Thus, their business interests (maintain the client) trump clients' interests (exceptional long-term performance).

Likewise, investment advisors and consultants also can design portfolios that are over-diversified. For example, an advisor may structure a portfolio that includes several actively managed equity mandates. Although each equity manager may construct fairly concentrated portfolios (and therefore are not "closet indexers"), the collective equity portfolio may resemble an index fund. Yet the investor is paying the higher active management fees. Although advisors and consultants claim they help their clients select top-performing investment managers, in this example, the advisor is mitigating the risk of not allowing any one manager to significantly impact the performance of the portfolio. Consequently, should one manager post disappointing short-term performance, the portfolio (and the advisor's reputation) will not take a huge hit. In other words, consciously or subconsciously, the advisor is focusing on business interests even if the added complexity and fees detract from the investor's long-term returns.

Similarly, a consultant may recommend investments in over a dozen asset categories, touting the diversification benefits of each investment. But does the 20% allocation to fixed income really need to be divvied into six different mandates? Do 2-3% positions, highly correlated to other positions, actually provide any substantial diversification benefits? While the consultant may truly believe in the recommendations and tout the marginal benefits, the consultant also benefits from not allowing any one investment to become too significant to the performance of the

portfolio. Furthermore, the added complexity also encourages the investor to become even more dependent on the consultant, who must oversee and monitor the increasing number of managers.

AVOIDING LONG-TERM BENEFICIAL OPPORTUNITIES

Just as investment advisors may over-diversify portfolios, they also can structure portfolios that are too conservative for their clients and fail to capture potential long-term beneficial opportunities. Research has demonstrated certain factors have historically earned return premia over time. There are reasonable rationales (mostly due to investor behavior and perceived risks) explaining why these return premia exist, and the evidence is persistent (i.e., long-term with in- and out-of-sample testing) and pervasive (i.e., consistent across regions and various asset groups).

Examples include:

- Size – smaller capitalization stocks outperform larger capitalization stocks
- Value – relatively inexpensive assets outperform relatively expensive assets
- Momentum – asset's recent relative performance tends to continue
- Carry – higher yielding assets outperform lower yielding assets

Despite considerable knowledge about these factors, many advisors shy away from implementing portfolios to exploit these premia, but rather, focus on minimizing the tracking error of the portfolio. Therefore, portfolios are not tilted toward small cap or value stocks, and do not incorporate momentum or carry strategies, even if over the long-term these tilts would increase returns. Instead, the advisors structure portfolios more in line with the market portfolio to ensure closer performance to the benchmark.

So why do investment advisors structure portfolios more in line with a benchmark instead of employing tilts that are expected to generate added return? Because they lack conviction, or believe their clients lack conviction, to maintain discipline when the factors underperform the market benchmark. These factors are expected to perform poorly at times, sometimes for several years, but over time, have proven to generate excess returns. Because investment advisors do not want to defend short-term underperformance and risk termination, they are reluctant to structure portfolios designed to provide better long-term performance. In other words, recommending a portfolio designed to perform better over the long run often has a greater probability of short-term underperformance, and therefore a greater probability of termination of the advisor.

FAILING TO DEFEND UNDERPERFORMING MANAGERS

Knowledgeable investment advisors understand that the managers they recommend or select will experience periods of underperformance, sometimes for several years. To realize the benefits of certain strategies, investors need to be patient, especially during difficult times. Investors cannot expect every strategy they own to outperform every year, or even every three- or five-year period. Rather, investors must understand the expected frequency and magnitude of manager underperformance. By recognizing how often, and by what extent their investment managers are expected to underperform, investors can better maintain discipline during inevitable rough patches.

Nevertheless, when these rough patches occur, investment advisors often fail to defend underperforming managers. Instead of recommending patience and reiterating all managers and strategies experience periods of underperformance, some investment advisors will recommend firing the investment manager. This occurs, despite a well-known study by Goyal and Wahal[1] that demonstrated, on average, terminated managers outperformed the newly hired managers over the ensuing three years. Therefore, in most situations, the investor would have fared better retaining the manager instead of hiring a replacement. So why do some advisors fail to defend underperforming managers? Mostly because they fear their clients will terminate them for recommending poor performing managers and compounding the problem by refusing to take action.

Rarely do investors follow up and ask investment advisors how the terminated managers performed after termination. Thus, the investment advisor no longer needs to defend the investment manager's poor performance and justify why the manager was hired in the first place. Even though terminating managers based on short-term performance usually results in lower portfolio performance, investment advisors who terminate managers based solely on short-term performance are placing their interests (maintaining their clients) ahead of the clients' long-term interests.

ADDING ACTIVITY AND COMPLEXITY TO JUSTIFY WORTH

Jeremy Grantham, co-founder of Boston-based investment manager GMO, stated, "Everyone in the institutional world over-manages money for very good career risk reasons. We want to be seen as busy and earning our keep." Investment professionals, like most people, believe more work justifies more pay. Hence, investment advisors can convince themselves they need to do more to justify their fees. Often this extra work has little impact on long-term returns, and in some instances, may detract from performance.

Manager portfolio turnover increased over the last several decades. The average managed U.S. stock mutual fund's annual turnover is nearly 100% today compared to 30% in the 1960s. Higher turnover leads to higher costs. Besides the observable commissions, there are hidden costs that are difficult to quantify, including bid/ask spreads and market impact.

John Bogle, in "The Arithmetic of 'All-In' Investment Expenses,"[2] estimates transaction costs average approximately 0.50% for actively managed U.S. equity mutual funds. Do the stocks investment managers buy outperform the stocks they sell? And if so, are the added gains enough to cover the transaction costs? On average the answer is no, because the investment managers are essentially trading among themselves. So why do managers trade so much more than they did a few decades ago, even if the additional trading reduces performance? Because managers must justify their existence and believe their clients would question why they are paying nearly 1% in annual fees for a buy-and-hold strategy.

Also, consider market timing. Some investment managers will hold large cash positions occasionally, thus, timing between stocks and cash. Some consultants will recommend overweighting or underweighting certain asset classes. Despite evidence that market timing is difficult to implement successfully, some managers and consultants will nevertheless seek to time the market.

Why? To appear sophisticated and justify their existence. Similarly, investment advisors will introduce new managers and asset classes to validate their worth. Often this added complexity does little to improve risk-adjusted performance, but does allow the investment advisor to appear busy and hardworking.

"To justify their existence or appear sophisticated, some investment managers seek to time the market, despite clear evidence that market timing is difficult to implement successfully."

3. Implementing Processes to Mitigate Principal-Agent Problems

ESTABLISHING ACCOUNTABILITY

How can investors (i.e., board and committee members) alleviate potential conflicts and ensure their interests take precedence? First, they must spend time understanding potential conflicts, especially related to compensation structures. Second, they should recognize how concerns over short-term outcomes can overwhelm adherence to long-term processes, for both investors and investment advisors.

Understanding how compensation structures and short-term concerns can influence investment advisors will assist investors in asking appropriate questions when conducting due diligence. Finally, investors should develop fundamental knowledge of the markets and investor behaviors, and with this knowledge, institute effective governance practices to ensure long-term investment growth is not sacrificed over concerns about short-term results.

UNDERSTANDING POTENTIAL CONFLICTS

Typical compensation structures for investment advisors are flat fee, hourly rate, asset-based fee, and commissions. Flat retainer fees may work fine and generally do not introduce any overt conflicts of interest. Hourly fees are generally acceptable for projects, but could incentivize the advisor to create more work to collect a higher fee. Asset-based fees are common and align interests to the extent the advisor suffers from market value losses and benefits from growth in assets. Commission-based fees should be avoided due to the incentive for the advisor to churn the portfolio to generate additional commissions.

When considering potential conflicts of interest, investors should understand the following about their current and potential advisors:

- **How is the firm compensated?**
- **Where does the firm receive other compensation?**
- **Are there relationships or affiliations with other firms?**
- **How are the advisor's team members compensated?**

Insight into other sources of compensation and other affiliations helps clarify if there are potential conflicts of interest. Does the firm have brokerage operations and receive commissions on advisor directed trades or favor investment managers who trade with them? Does the firm manage proprietary funds? Does the advisor host conferences sponsored by investment managers or provide services for managers and thereby have a bias to recommend those firms? Avoiding firms that answer yes to any of these questions reduces the chances the advisor will place compensation ahead of the investor's best interests.

Inquiring about how the advisor's team members are compensated helps investors to understand their advisor's motivations. For example, do the portfolio managers and research analysts receive a bonus based on calendar year returns? If so, they could become more conservative once they build a healthy excess return over the benchmark. On the other hand, they may take unnecessary risks late in the year if they are trailing the benchmark return. Bonuses based on rolling three- and five-year returns are preferable to calendar year returns and alleviate the incentive to focus on ultra short-term performance.

Some individual advisors (i.e., the lead client service representative) simply receive a salary and have no performance incentives. Other investment advisors are compensated based on their clients' revenues. Thus, they are incentivized to grow their business if they wish to increase their income, but are also incentivized to retain clients, lest their income decrease. Advisors usually find providing good service and retaining a client easier than gaining a new client. Therefore, this arrangement could lead to excellent client service if the advisor is well-compensated and manages a reasonable client load. If the advisor is not well-compensated and largely focuses on gaining new business to increase compensation, client service could suffer. Therefore, investors should understand their primary advisor's client load and potential capacity.

The investment industry is rife with conflicts of interest and even firms striving to be ethical can potentially face conflicts. Therefore, investors must understand where principal-agent problems can occur and seek to align incentives and compensation arrangements to minimize possible conflicts of interest.

HOW SHORT-TERM OUTCOMES OVERWHELM LONG-TERM PROCESSES

When considering how investment advisors may allow concerns over short-term outcomes to overwhelm adherence to long-term processes, investors should understand the following:

- **How concentrated are portfolios (number of positions, sector weights, and tracking error)?**
- **How many asset classes and managers are recommended?**
- **What are the firm's views on portfolio tilts and are these strategic or tactical?**
- **What methods are used to rebalance portfolios?**
- **How often are managers terminated and for what reasons?**

When hiring active investment managers, asking about the number of positions, views on sector weightings, and the historic and expected tracking error helps investors evaluate whether the manager is a "closet indexer" or a true active manager. Investors should not pay active management fees for index-like returns, and therefore, should avoid managers who place too many constraints on their ability to add value.

Likewise, understanding how many asset classes and managers an investment advisor expects to recommend helps investors determine whether their portfolios will be over-diversified. Over-diversified portfolios add unneeded complexity and costs, thereby lowering returns. For example, investing with several managers in one asset category (e.g., five U.S. large cap equity managers) could lead to an index-like exposure but active management fees. Additionally, some advisors may slice an asset class too finely and invest with each area (e.g., U.S. equity — large cap, mid cap, small/mid cap, small cap, and micro cap). These asset categories overlap and are highly correlated; therefore, most portfolios do not need dedicated mandates to each area.

Understanding where and how much an investment advisor is willing to tilt the portfolio to capture long-term return premia is informative. Because timing markets successfully is difficult, investors must be careful hiring advisors who employ tactical tilts. A better approach is to seek advisors who employ strategic tilts and have patience and discipline to maintain these tilts during underperforming periods.

One way to evaluate discipline is to understand the advisor's rebalancing philosophy. Advisors who rebalance portfolios when asset categories move out of acceptable ranges demonstrate conviction in a long-term process. By selling assets that performed well and purchasing assets that performed poorly, an advisor reveals a willingness to not let short-term market movements deter them from a long-term disciplined approach. Advisors who lack this discipline, however, often do the opposite and purchase more of what performed well and abandon strategies that performed poorly. Thus, the advisor avoids defending poor performing strategies to the client.

Questioning advisors on how often managers were terminated and for what reasons allows the investor to understand whether the advisor is willing to defend suitable, yet underperforming managers. Managers may have been terminated for justifiable reasons. Examples include: change in organizational structure, key personnel departures, legal issues, style drift, and significant increases or decreases in assets under management. More concerning, though, is if terminations were due to short-term underperformance, as this reflects a lack of confidence in the advisor's manager due diligence process.

Asking these questions, and other similar ones, can assist investors in better understanding the advisor's investment philosophy and motivations. The objective is to determine to what extent the advisor is willing to focus on long-term processes over short-term outcomes.

UNDERSTANDING MARKETS, BEHAVIORS, AND INSTITUTING EFFECTIVE GOVERNANCE PRACTICES

As discussed in Part 1 of this series, Establishing Effective Board and Committee Processes, devoting sufficient time to formulating a strategy and documenting the investment philosophy can help to ensure continuity and adherence to a long-term disciplined approach. The first step is encouraging investment committee members to develop a fundamental understanding of the markets and recognize how some investor behaviors can be unproductive. With that knowledge, the investment committee is less likely to allow an investment advisor to sacrifice long-term growth over concerns about client retention. Moreover, the investment committee will be prepared to focus on long-term processes and competently articulate an investment philosophy that meets the organization's objectives.

Why is a fundamental understanding of the markets important? Without it, investors are at risk of setting unrealistic expectations, at both the market and investment manager level. An appropriate asset allocation depends on realistic return assumptions. Retaining suitable fund managers during inevitable rough periods requires understanding the frequency and magnitude of manager underperformance. Additionally, when evaluating potential investments, often only the advantages are emphasized and investors are confounded when the results are less than advertised. By understanding not just the advantages, but also the disadvantages of different investment strategies, including the types of market environments in which the strategy is expected to perform poorly, investors are better prepared to focus on the long-term and not overreact to short-term outcomes.

Therefore, investment committees should strive to have members with knowledge of market history or take the necessary steps to obtain that knowledge. Committees with a fundamental comprehension of the markets are more likely to maintain long-term discipline when subpar short-term results ultimately occur. Also, well-informed committees can more effectively evaluate their investment advisors and foster collaboration and adherence to long-term disciplines.

Additionally, recognizing typical, yet unproductive, investor behaviors can prevent common mistakes, including allowing investment advisors to prioritize client retention over long-term growth. Typical investor behaviors (displayed by both investors and investment advisors) that can lead to unproductive decisions include reacting to recent events, herd mentality, displaying overconfidence, and valuing losses more than gains.

An example of reacting to recent events is reducing stock exposure after a market decline. Usually a better approach is to rebalance the portfolio (increase stock

exposure back to the target allocation) rather than lock in losses. Nevertheless, investors often are fearful and sell at inopportune times.

Following the herd is common among institutional investors, as many compare their performance and asset allocation to their peers. Too much emphasis on peers can lead investors to misallocate their portfolios and stray from what is appropriate for their institutions. Furthermore, jumping on the bandwagon and investing in the hottest new fad may not always be appropriate.

Some investors display overconfidence in their ability to allocate assets, select managers, and time markets. A more humble approach that acknowledges the difficulty in successfully executing investment decisions is preferable and likely to prevent irrational decisions due to overconfidence.

Loss aversion is common among investors and refers to the inclination to strongly prefer avoiding losses to realizing gains. By accepting loss aversion as a real concern, investors can take steps to remove emotion from their decisions and focus on long-term processes.

Committee members who clearly recognize unproductive investor behaviors are better positioned to avoid making common investing mistakes. They are also less likely to allow their investment advisors to veer from a long-term disciplined approach. Therefore, by spending time understanding common investor behaviors and ways to overcome these biases, investment committees can more effectively evaluate their investment advisors, as well as their own decision-making processes.

With a good understanding of market fundamentals and investor behaviors, investment committees will be better prepared to institute effective governance processes. By devoting sufficient time to strategic issues, including investment philosophy, and not simply focusing on the portfolio and current market environment, boards and investment committees will be more effective in developing appropriate investment policies. These policies must articulate the importance of focusing on the long-term, and by documenting this in an investment policy statement, investors will be less likely to stray from the stated discipline.

When developing the investment policy statement, investors should be sure to adopt long-term measurement periods. Three or five years is not long-term. Seven or ten years is preferable, but occasionally there will be ten-year periods where strategies may not work as planned. Nevertheless, adopting long-term measurement periods should minimize the temptation to react to recent events and short-term outcomes. Finally, the process of developing an investment philosophy and policy should assist in maintaining discipline and focus on the most important objective — ensuring long-term processes take precedence over short-term results.

INCENTIVES, CONFLICTS OF INTEREST, AND EFFECTIVE INVESTMENT POLICIES

Steven E. Landsburg, in The Armchair Economist: Economics and Everyday Life, wrote: "Most of economics can be summarized in four words: 'People respond to incentives.' The rest is commentary." Investment advisors may seek to justify why certain conflicts are not an issue and in the best interests of their clients. They may even believe this. Some will argue that disclosing a conflict of interest absolves them of the conflict.

Nevertheless, human beings respond to incentives, and no matter how ethical people think they are, when additional compensation is available, most will find remaining completely impartial difficult, even if this is at a subconscious level. Thus, investors would be wise to avoid investment advisors who share fees, trade through affiliate firms, ask managers to sponsor conferences, invest with proprietary funds, or have incentives to "up-sell" their clients.

Further, investment advisors prefer to retain clients, and therefore, are incentivized to structure portfolios to minimize the probability of being terminated. Some common practices, such as over-diversification, unwillingness to capture beneficial opportunities, failing to defend appropriate yet underperforming investment managers, and introducing added complexity, are prevalent, but not always well understood by investors. Being aware of these subtle principal-agent problems, as well as the motivations of investment advisors, should help investors recognize their own biases and mitigate concerns that short-term outcomes will outweigh adherence to long-term processes.

Boards and investment committees can combat these influences by developing practical knowledge of the markets, recognizing typical investor behaviors, and instituting effective governing processes. Better comprehension of the markets and human behaviors will bolster investors in their evaluation of investment advisors, as well as their own decisions. Furthermore, this knowledge will promote the development of effective investment policies designed to focus investors on long-term processes.

BACKGROUND ON SERIES

After serving as Managing Principal/Chief Investment Officer of a well-regarded investment consulting firm for 22 years, I have had time to reflect on the institutional investing industry and why investors frequently fall short of their benchmark returns. My conclusion is that persistently disappointing returns are due to the structure of boards and the behavior of investors.

Most of my clients were mid-sized endowments and foundations, typically between $50 million to $1 billion in assets. Moreover, I currently serve as investment committee chair for a $2 billion public retirement system with no investment staff, and as board chair of a $7 million educational foundation. Therefore, my observations relate to institutional investors that rely heavily on volunteer boards and investment committees and not to large institutions with dedicated investment offices.

I believe the vast majority of people involved in the management of institutional portfolios genuinely desire to do what is right. The obstacles to success are not due to a lack of sincerity or overt self-interest from the participants, but rather, due to a lack of understanding of how board structures and human behaviors negatively influence portfolios. Although I became increasingly aware of these issues during my years as a consultant and sought to address many of them, I likely contributed to others.

Now, though, I have the luxury of stepping back, learning from my experiences, and considering how the industry can improve. Many investors will agree with my thoughts and conclusions, but will be reticent to express these views publicly for fear of offending their clients or colleagues. My hope, however, is investors will recognize how certain behaviors restrain long-term performance and honestly assess where their structures and processes can be improved.

Footnotes:

[1] The Selection and Termination of Investment Management Firms by Plan Sponsors, Amit Goyal and Sunil Wahal, *The Journal of Finance*, Volume 63, Issue 4, August 2008.

[2] The Arithmetic of "All-In" Investment Expenses, John C. Bogle, *Financial Analysts Journal*, Volume 70, Number 1, January/February 2014.

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, on 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

Truepoint Institutional Advisors is a division of Truepoint Wealth Counsel, offering investment advisory services for endowments, foundations, nonprofits, trusts, retirement plans, and other institutional investors. Our mission is to help small and mid-sized organizations manage their investments more effectively and efficiently. We believe in accountability, transparency, and an intellectually honest approach to investing.

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