



# Greenwich Roundtable

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2014

Principles of Governance

Case Studies of:

Excellence

Transition

Dysfunction

## BEST GOVERNANCE PRACTICES FOR INVESTMENT COMMITTEES



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*The Research Council enables the Greenwich Roundtable to host the broadest range of investigation that serves the interests of the limited partner and sophisticated investors. This group wishes to help investors document the allocation process. Their business activities serve as an example to all of their sincere desire to educate investors and of their belief in our mission. Members of the Research Council not only provide no-strings funding but they have also assisted the members of our Education Committee during the discovery process.*

## ABOUT THE GREENWICH ROUNDTABLE

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The Greenwich Roundtable, Inc. is a not-for-profit research and educational organization located in Greenwich, Connecticut, for investors who allocate capital to alternative investments. It is operated in the spirit of an intellectual cooperative for the alternative investment community. Mostly, its members are institutional and private investors, who collectively control \$2.6 trillion in assets.

The purpose of the Greenwich Roundtable is to discuss and provide current, cutting-edge information on non-traditional investing. Our mission is to reveal the essence of both trusted and new investing styles and to create a code of Best Practices for the sophisticated investor.

## EDUCATION COMMITTEE

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*The Education Committee has been working as a group of altruistic investors who contributed their time and worked to raise professional standards. The final result is intended to demystify the complexities of investing and to bring about greater understanding. Investing in alternatives is not well documented. The Education Committee is chartered to conduct original research and develop best practices from the investors' point of view.*



## BEST GOVERNANCE PRACTICES PRINCIPLES

Primary principles of best practices, consistent with the fiduciary duties of “care, loyalty, and obedience,”<sup>1</sup> include:

- Articulating the Organization’s long-term objectives and its unique needs.
- Evaluating realistically the Organization’s resources, both internal and external.
- Setting the Investment Governance and Operational Framework.
- Forming a strong Investment Committee.
- Establishing an Investment Policy Statement – including asset allocation, risk constraints, and performance metrics – that is consistent with furthering the Organization’s objectives and also realistic given its resources.
- Finding an appropriate person or organization, called the Fund’s Chief Investment Officer (CIO), to manage its investment portfolio and to be held accountable to the Committee.
- Defining a target for investment success that is both realistic and consistent with the Organization’s resources.
- Establishing a Payout Policy that is consistent with the Organization’s objectives and leads to a stable, durable Organization.
- Monitoring results and making changes as needed.

These are fundamental principles, regardless of the nature of the Organization or the size of the Fund. There are many ways to apply these basic principles, and the rest of this paper is devoted to discussing the many effective approaches in applying them.

“**E**fficiency is doing things right. Effectiveness is doing the right things.”

- Peter Drucker

<sup>1</sup> These three duties are “standards for a governing board’s stewardship of an institution,” per the Association of Governing Boards of Colleges and Universities. The duty of obedience refers to the obligation to advance the mission of the institution, to act in a manner that is consistent with its mission and goals. These standards are consistent with fiduciary responsibility under ERISA, which requires pension assets to be invested for the sole benefit of plan participants and defines prudence as how a prudent person would act “in the conduct of an enterprise of a like character and with like aims.”



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## LETTER FROM THE CHAIRMAN

The key to investment success for any Long-Term Investment Fund is a well-functioning Investment Committee. This white paper

- identifies the Best Practices that apply to the Investment Committees of Charitable Organizations, Pensions, Insurance Companies, Family Funds, and Sovereign Wealth Funds.
- provides timeless principles that apply to mega Funds as well as very small Funds, although their application may differ, depending on the size and nature of the Organization.
- suggests behavioral expectations for a Committee's Chair and its members.
- brings these principles to life by relating more than two dozen actual cases of effective Investment Committees, or Committees where Best Practices could have made them more effective.

*Best Governance Practices* breaks new ground in the breadth of its Best Practices. It benefits from many veteran Investment Committee members who shared their Committee experiences, and from the interdisciplinary contributions of the Greenwich Roundtable's Education Committee.

We are indebted to Rusty Olson, who has been able to weave together the knowledge and insight of all our contributors in a concise, usable form, along with his own insights from nearly 40 years as a student and practitioner in the industry. It is the fifth Best Practices white paper Rusty has edited for the Roundtable.

This and our other Best Practices papers have been made possible by our Research Council, which supports our efforts to educate investors about both the opportunities and challenges of investing in alternative assets. The Council believes that better informed investors create an industry composed of higher quality managers – an outcome that benefits everyone.

Lastly, we dedicate this Best Practices to Ed Barksdale, one of the founding members of the Greenwich Roundtable and a former Chair of the Education Committee. Always quick with wisdom and timely insight, he has been critical in making Best Practices a series of leading documents. We all thank you, Ed. We'll see you at the next symposium.

Mark Silverstein

## EDITOR'S PREFACE

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Ten years ago I wrote a book titled *The Handbook for Investment Committee Members*. I based it on what I had learned managing a Pension Plan for a large corporation and participating in half a dozen Investment Committees of relatively small local Organizations.

When the Greenwich Roundtable offered me the opportunity to incorporate the wisdom of many veteran Investment Committee members and edit a white paper on Best Practices, I jumped at the opportunity. I am proud of the good advice I gave in my book 10 years ago, but how much more valuable it would be if the advice were enriched by the learning of so many others!

I have profound respect for the members of the Roundtable who worked with me on this white paper. They are extremely busy people managing large amounts of money. Their dedicated work with me held no reward toward furthering their business interests. Their only reward is the satisfaction of knowing that everyone is better off if investors are more knowledgeable as they go about investing money that is so crucial to the Organizations they serve.

Investing an Organization's assets is the responsibility of the Board of Directors, but it is usually implemented by an Investment Committee. Who should these people be? What principles should they pursue? What experience has proved most fruitful? That is what this white paper is about.

This paper details the Best Practices that we have seen develop, and it adds a couple of dozen case studies in a wide variety of individual situations that illustrate how those principles have been successfully applied, or how some Committees might have accomplished more if they had followed Best Practices. I am greatly indebted to the many veteran investors (whom we are keeping anonymous) who took the time to review with me their experiences on some of the Investment Committees they have served on.

We hope this white paper will get you thinking about your own Investment Committee and asking questions about how many of these Best Practices your Committee currently pursues, and what steps your Committee might take to gain further benefit from them.

Russell Olson

“Periodically, an Investment Committee should ask itself: ‘Are we the right people tackling the right issues?’ If so, the Committee is more likely to make the right decisions.”

-Myra Drucker



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## ABOUT THIS WHITE PAPER

An effective Investment Committee is key to any Organization that has a Fund that is investing for the long-term – either a perpetual Fund, or one whose assets will not be needed for 10 years or more, typically with the purpose of maintaining the buying power of the corpus in perpetuity. Such Organizations include institutions that have Funds of every size, from \$1 million to \$100 billion – Endowments, Foundations, Pension Funds, Insurance Companies, Sovereign Wealth Funds, and Family Funds.

To encompass all of these Funds, we in this white paper use the term “Long-Term Fund”, or simply “Fund.” For all Organizations that establish a Fund, we use the term “Organization” – a term that denotes the owner or the sponsor of a Fund, including the owner of a Family Fund.

In the first part of this white paper, we review the practices and policies that the most successful Organizations have found to be Best Practices. Then we provide a range of case studies that illustrate the benefit of implementing these Best Practices.

The first three chapters – “Responsibility of the Board of Directors,” the “Investment Governance and Operational Framework,” and “The Investment Policy Statement” – list policies that should be formalized in writing. These policies are provided in normal black type, followed in many cases by discussion about them in **green type**.

Throughout this white paper, in referring to a person, we use the masculine pronoun. In all such cases, the “he” is used in the classical sense as shorthand to designate he or she. We prefer to avoid the imprecision of modern usage, such as each person does their own thing. And it is unwieldy to repeat each person does his or her own thing. That leaves us with only the classical approach.

\* \* \*

This paper is intended to provide overall guidance for fiduciaries. It should not be interpreted as legal advice. Many matters discussed in this paper are governed by laws and regulations applicable to different kinds of Organizations. These regulations often differ from state to state, and especially from country to country. Fiduciaries should consult with legal counsel to determine that their actions are in compliance with the regulatory structure that governs the Organizations they serve.

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## RESPONSIBILITY OF THE BOARD OF DIRECTORS

“The fiduciary buck stops with the Board of Directors.”

The Board of Directors<sup>2</sup> is ultimately responsible for everything the Organization does, including its investments. Most Boards choose to delegate investing of their Fund to an Investment Committee, but the Board still has the fiduciary responsibility for investment oversight and for establishing the policy governing distributions or payouts from the Fund.

The fiduciary buck stops with the Board of Directors. For Endowments and Foundations, the Board’s responsibilities are spelled out in the relevant state’s version of UPMIFA (the Uniform Prudent Management of Institutional Funds Act, which was approved in 2006 by the National Conference of Commissioners on Uniform State Laws.) In addition, Trustees might want to familiarize themselves with the five basic parameters of prudent delegation specified in the American Law Institute’s “Restatement (Third) of Trusts.”<sup>3</sup>

The Board should have a written charter for the Investment Committee, covering:

- How members of the Investment Committee are selected and who is to be Chair.

The Board, perhaps assisted by a nominating committee, appoints the Investment Committee Chair. Many believe that the Chair should always be a Board member. Some believe that the best choice for Chair may be someone who does not want to be burdened with Board responsibilities. In any case, the Board should ensure that at least one Board member is on the Investment Committee to keep the Committee sensitive to issues the Board is dealing with.

The Board or its Chair might authorize the Committee Chair to appoint members of the Committee, subject to confirmation, or the Board might want to select all members of the Committee and let the members elect a Chair. In each case the Board should be informed and retain the authority to override a decision.

As many Committee members as possible should have investment expertise, especially fiduciary investment experience with Long-Term Funds.

- Which decisions of the Investment Committee must be ratified by the Board.

Typically, the Board must ratify the Fund’s Statements of Governance and Investment Policy, any changes in or temporary departures from those policies, and any investments outside of the Policy Portfolio.<sup>4</sup> The Board should also ratify any service providers, such as a Custodian or Consultant to be hired by the Investment Committee. Board members generally retain liability for any decisions for which they retain ratifying authority, but they are protected by the business judgment rule as long as their conduct was reasonable. The Board should not override the Investment Committee, but if it sees a major or repeated problem, it should call a joint meeting.

- What reports the Board expects from the Investment Committee, and how often.

<sup>2</sup> Under ERISA the equivalent of “the Board” is the Named Fiduciary, which is usually a committee but may be a single individual. As with other Organizations, the Named Fiduciary usually appoints an Investment Committee.

<sup>3</sup> For an extensive discussion of this Restatement, see Von M. Hughes, “Understanding U.S. Public Pension Plan Delegation of Investment Decision-Making to Internal and External Investment Managers,” *The Hedge Fund Law Report*, Vol. 7, No. 3, January 23, 2014.

<sup>4</sup> The Policy Portfolio is described on page 19.



## RESPONSIBILITY OF THE BOARD OF DIRECTORS (CONT.)

The Board usually expects a written quarterly report from the Investment Committee plus an annual presentation by the Committee Chair.

There are times, if the investment program is dysfunctional, when the Board may want to hire an outside adviser to evaluate its organization, including costs, quality, and any conflict of interest, and report to the Board.

- Except in the case of a Pension Fund, where redemptions are determined by the Fund's liabilities, the Board should establish a policy – its Payout Policy – for making distributions from the Fund that meets the Organization's needs.

Following are examples of common approaches to such policies:

Many Endowment Fund Boards adopt a Payout Policy that is some form of Moving Average of prior years' market values of the Fund – such as withdrawing each year a set percentage of the Moving Average over the last three or five years (or the quarterly average over that interval). All market values are usually adjusted for contributions or any withdrawals in excess of Payout Policy.

The typical payout percentage of the Moving Average has been about 5%, which is considered about the maximum real return (net of inflation) that a diversified Fund can reasonably aspire to earn over the very long term. In a market that tends to rise over the years, a Payout Policy of 5% of the 5-year average will be more like 4½% of the latest yearend market value because of the market-driven year-to-

year increase in the value of the Fund. In recent years, many college Endowments have reduced their Payout percentage below 5% to acknowledge the fact that college expenses tend to rise faster than CPI.<sup>5</sup>

Some Funds find a valuable exercise is to simulate different Moving Average Payout percentages over the past 20 or 30 years, or use a probabilistic model to examine the distribution of probable results over a 20-year future period, to see what might work best for their particular Organization.

A few Funds, typically those whose operating budget is more dependent on their Endowment, use a weighted average of the Moving Average approach and of the prior year's actual payout. This reduces year-to-year changes and keeps payouts from going too high in a long bull market.

Payout Policy is a crucial policy, and the Board should seek input from the Finance Committee and the Investment Committee as well as from those responsible for the Organization's operations.

At times, a Board must make special withdrawals in excess of its established policy, although for the sake of maintaining the purchasing power of its Fund, it should avoid such withdrawals wherever possible.

In establishing and maintaining these policies and in overseeing decisions by the Investment Committee, the Board is legally required to act in good faith and with the care that an ordinary prudent person in a similar position would exercise under comparable circumstances. This

“The Board

should not override the

Investment Committee, but

if it sees a major or repeated

problem, it should call a

joint meeting.”

<sup>5</sup> “Higher Education Price Index”  
Commonfund Institute, 2014



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## RESPONSIBILITY OF THE BOARD OF DIRECTORS (CONT.)

standard is codified in the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in every state except Pennsylvania, which has its own statute mandating a similar standard.

“Changes to the Board or the Investment Committee should be like shaping a bonsai, bent slowly over time.”

“Governance is governance, management is management, and every Organization must clearly distinguish between them.”

- Kenneth Dayton

## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK

What is the difference between competent and incompetent Investment Committees? Perhaps this was best summarized by Keith Ambachtsheer and Don Ezra in their book, *Pension Fund Excellence*:<sup>6</sup>

*“Competent boards have a preponderance of people of character who are comfortable doing their organizational thinking in multi-year time frames. These people understand ambiguity and uncertainty, and are still prepared to go ahead and make the required judgments and decisions. They know what they don’t know. They are prepared to hire a competent Chief Investment Officer and delegate management and operational authority.”*

The final words bear repeating: “To hire a competent Chief Investment Officer and delegate management and operational authority.”

A strong Investment Committee begins with a statement about the Organization’s governance and operational framework. All of the following issues and policies should be addressed *in writing* either in the Board’s charter for the Committee or in a single Governing Policies document.

- The Investment Committee will consist of [number] members, appointed by [whom]. They will serve [staggered] terms of [number] years and may be reappointed for [number] terms.

**Size.** Five or six is often considered large enough to have diverse experience, expertise, and opinions, and small enough so everyone gets heard and understood. Three may be appropriate for a small organization. Nine is viewed

by some as the maximum. There is an inverse relationship between the size of a Committee and the magnitude of each member’s contribution. People pull less hard when in large groups. In smaller Organizations, an effective Investment Committee can be a single person with extensive experience in long-term investing.

A large Organization might want a large Investment Committee in order to give multiple constituent groups and major donors a feeling of ownership. Some Funds place major donors on an Advisory Committee to the Investment Committee, and some public Pension Funds use an Advisory Committee to provide recommendations to their Board of Governors.

Some Organizations with large Committees appoint a small Subcommittee of those with more investment experience to discuss some of the technical considerations with the Chief Investment Officer (CIO) and to approve the agenda for each meeting. Such a Subcommittee can be effective when the full Committee includes a major donor or other constituents who have limited investment experience.

While on rare occasions small task forces of the Committee can study a specific topic for the Committee, many believe that no Investment Committee should be divided into small groups, as it can lead Committee members to lose focus on the overall Fund.

If the Board Chair and CEO are not members of the Investment Committee, they still may want periodically to attend Committee meetings.

“A small Organization may be fortunate to find even a single person experienced enough to lead the Committee.”

<sup>6</sup> Keith P. Ambachtsheer and D. Don Ezra, *Pension Fund Excellence*, John Wiley & Sons, Inc., 1998, p. 90.

## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK (CONT.)

“A good Committee member begins with a flexible mind, willing and able to consider, weigh, and apply new concepts and ideas, to challenge previously held concepts, including one’s own, and to ask hard questions.”

Appointed by whom. In some cases the Board or a Governance Committee appoints remaining Committee members, and in others the Chair does so.

Length of terms. To be consistent with the long-term nature of a Fund, terms are often five to seven years, renewable once or even twice. If members come and go too quickly, the group will lose the stabilizing benefits of institutional memory. To keep a Committee from being dominated for too long by a single person, some Committees require at least a one-year hiatus after a member’s second term. On the other hand, a small Organization may be fortunate to find even a single person experienced enough to lead the Committee.

- As many Committee members as possible should have investment expertise.

Persons with experience investing a Long-Term Fund for an institution form the core of an Investment Committee. The more members with this experience, the stronger the Committee. Few brokers, bankers, and insurance executives have fiduciary experience with a Long-Term Fund, nor do most individual investors.

Persons who are networked with the investment world can sometimes suggest Investment Managers and open doors that might otherwise be closed. CIOs should benefit from their help, but CIOs need to do their own due diligence.

- All Committee members should have the following qualities:
  - Commitment to the Organization and a deep understanding of how the Fund relates to the Organization’s purpose and financial situation.
  - An ability and willingness to attend all Committee meetings, to review presentation materials before each meeting, to prepare their thoughts before a meeting, and to make sure they share what they know.
  - A willingness to accept a level of risk high enough to gain the investment return advantage of a long time horizon.
  - A flexible mind, willing and able to consider, weigh, and apply new concepts and ideas, to challenge previously held concepts, including one’s own, and to ask hard questions.
  - Ability to cooperate with others and put egos aside.
  - Diversity in experience, training, background, and education can be highly advantageous, providing different functional knowledge and ways of thinking. Social cohesion can be a drawback to diverse thinking.
  - Willingness to keep confidential the information given to Committee members.

## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK (CONT.)

In addition, it is helpful if members of the Investment Committee have overlapping membership with the Finance and Audit Committees.

- All Committee members are to sign the same Conflict of Interest statement and Code of Ethics required of Board members.

Committee members must disclose any actual or possible conflict of interest. This is even more important with members of the Investment Committee because of their power to influence investment choices. If an issue arises where a member has a conflict, he may make his comments but then must recuse himself from the discussion and the vote. The Committee should then attempt, with reasonable effort, to find an equally advantageous alternative that would not give rise to the conflict.

- A Staff member will prepare minutes of all actions decided by the Committee and will see that the Staff retains those minutes in a permanent file, together with any presentation materials supporting those actions.

Prudence is not a matter of what happened to an investment with 20/20 hindsight. It is the process and rationale that went into the decision and the subsequent monitoring. Because the prudence of an investment is not to be determined in isolation but in the context of the overall portfolio, good recordkeeping becomes very important as a way to demonstrate the manner in which decisions were reached. It

can provide a Committee's strongest defense of its prudence.

As stated in fi360's<sup>7</sup> *Prudent Practices for Investment Stewards*, "While even the most aggressive and unconventional investment can meet the standard if arrived at through a sound process, the most conservative and traditional product may be inappropriate if a sound process was not implemented."

Documenting how the Committee arrived at each decision also allows for post-decision audits by the Committee.

- The Committee is to meet at least [four] times a year and at any other time either the Committee Chairman, CIO, or any two Committee members request a meeting. There may be occasions, in order to complete specific Committee business, when the Committee may have to meet more frequently.

Although the Committee might not arrive at a major decision, such as the Policy Portfolio, at the first meeting at which the subject is discussed, the Committee should not take months to agree on such fundamental matters. In such cases the Committee might well meet multiple times within a matter of weeks.

If the Committee doesn't delegate the hiring and firing of Investment Managers to the CIO (internal or out-sourced), the Committee should be prepared on occasion to meet on short notice to approve an opportunity that has a short time line.

“Keep a thorough history of decisions.

Memories are (annoyingly) selective.”

- Arnold Wood

“For Investment

Committees created by a political process or those that are dysfunctional, try to introduce a skills matrix as a guide in selecting members.”

<sup>7</sup> fi360 is a company that provides training for persons to become an Accredited Investment Fiduciary.



## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK (CONT.)

“How many times have you seen a committee make a contrarian decision? This is very difficult because of behavioral issues.”

-Myra Drucker

- Committees should set meeting dates a year in advance.
- Committee members are to make every effort to attend all Committee meetings. If a member cannot attend in person, he should participate by conference call or, if possible, by videoconference.
- Committee members who participate in fewer than a given percentage of meetings over a rolling two-year interval are to be retired from the Committee.
- Decisions by the Committee are to be made by a majority of Committee members [or a majority of a quorum].

Generally, a majority is sufficient to ensure a good decision. Many Committees try to achieve a consensus of their members. The Chair, however, should be alert to the risk of “social loafing,” of members failing to raise a different point of view and all too quickly going along with more articulate members of the Committee.

- The Committee will often advise the Board on its Investment Governance and Operational Framework.
- The Committee will select<sup>8</sup> and annually evaluate the Organization’s Chief Investment Officer (CIO), who will be one of the following:
  - an internal CIO, who is typically hired by the CEO or CFO with Committee input. The CIO will then hire the rest of the investment Staff and perhaps a Consultant, and manage the entire investment program, subject to the oversight of the Committee.

or

- an Outsourced CIO (OCIO) to manage the portfolio, who will be selected by the Committee (or in some cases, the Board).

or

- a Consultant, to be selected by the Committee, who will advise the Committee on investment policy, asset allocation, and the hiring and monitoring of all Investment Managers.

Committees are ill-designed to make operational decisions. They should concentrate on governance and not attempt management. They do not have the time to do all the research required to bring well-thought-out investment recommendations to the Committee. The Committee must delegate this function.

Many large Funds have the resources to establish an internal CIO or investment Staff and prefer to do so in order to avoid the high costs associated with the use of Consultants or an OCIO. But that can be the wrong reason, because all too often, high-performing internal management tends to be more costly than expected. An alternative reason for internal management is greater control.

If the Committee can find an outstanding firm that can invest its Fund competently and in a way consistent with the needs of its Organization, then delegating the entire management of the Fund can be a highly prudent decision and one endorsed by UPMIFA if the Committee honors the standards for delegation

<sup>8</sup> Or approve, if the CIO was selected by the CFO, CEO, or Board.



## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK (CONT.)

What is the difference between an OCIO and a Consultant serving as CIO?

- We define the OCIO here as one, like an internal CIO, who has total discretion and accountability within the objectives set by the Investment Committee. But this is an evolving field, with a range of ways to divide authority between the Committee and the CIO. The OCIO may be a consulting firm or a well-diversified Investment Fund whose investment strategy is consistent with the Organization's objectives.
  - The OCIO can make and implement decisions in a more timely manner, without the extra work of gaining Committee approval for each decision.
  - The OCIO may have more investment expertise than members of the Committee.
  - The Committee can apply its objectives and risk parameters through its selection of a commingled Investment Fund, or through its management agreement with an OCIO, who will design a customized solution based on the Organization's particular objectives and risk tolerances.
- The Consultant brings recommendations to the Committee for asset allocation decisions and for the selection of Investment Managers.
  - The Committee retains continuous control of asset allocation and the selection of Managers, thereby retaining accountability for results.
  - Investment Committee members are more directly involved.
  - The Committee has the opportunity to question the Consultant on the due diligence underlying each recommendation.
  - A Committee member who is a seasoned long-term investor can often work with the Consultant to help source better Investment Managers.

We describe the difference between an OCIO and a Consultant as if it is an either/or decision. In practice, there is a continuum, depending on which particular decisions are delegated to the OCIO.

“The fundamental issue is getting value (rather than alpha) from good governance.”

- Keith Ambachtsheer

## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK (CONT.)

and supervision enumerated in the law. The Committee should ask itself: What value can we add?

The Committee, however, will still bear responsibility for the prudent selection of any OCIO or Consultant, and for reviewing at least annually its actions and performance in order to decide whether to continue retaining it.

Without an OCIO, the Committee can help to keep the Consultant accountable by requiring the Consultant in each case to make a single recommendation rather than giving the Committee a choice of asset allocations or Managers.

If the Chief Investment Officer is an OCIO or Consultant:

- It should acknowledge in writing that it is properly registered with the respective country's regulatory authority, such as the SEC in the US, and that it is a fiduciary of the Organization.
- It should make a written representation *annually* that either: (a) it receives no income, either directly or indirectly, other than consulting fees, or (b) if it does receive additional income, it should provide the names of all those from whom it has received payment, the amount of income and the services provided.
- It should update clients on the firm's ownership – how much is owned by its staff, and who else is an owner, and of what percentage of the firm's equity.

On accountability: An OCIO, like a Consultant, is accountable to the Investment Committee that hired it. But it also has a strong dotted line relationship with the Organization's CFO and CEO, with whom it must work hand-in-glove on cash flows, contracts, legal issues, and Committee communications.

- Prior to any Committee meeting, the Chair, upon recommendation of the CIO, will establish the agenda. Wherever possible, the CIO will send presentation materials to Committee members in time for them to receive the materials a week before the meeting. Committee members are expected to review these materials in preparation for the meeting.

Members should review the materials and perhaps develop specific questions, but they should not draw conclusive opinions until after the CIO's presentation and the subsequent discussion.

- All legal documents are to be reviewed by the Organization's attorney, including its Statements of Governance and Investment Policy.

The attorney should be competent in UPMIFA, UPIA, ERISA, and/or state law, as applicable.

- The Committee, at the recommendation of the CIO, will appoint a Custodian to hold all Fund assets. In some Funds the internal CIO has the authority to appoint the Custodian.

A competent Custodian is essential for any Fund.

“Committees should be in the business of optimizing their resources. Get into the business of thoughtfully evaluating those resources.”

- Myra Drucker



## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK (CONT.)

- A recommended Investment Policy Statement is to be submitted to the Committee by the CIO.
  - Either:
    - The Committee has authorized the CIO to appoint any Investment Manager or Investment Fund that is within the approved Policy Asset Allocation.<sup>9</sup>or
    - The Committee shall approve the selection of all Investment Managers and Investment Funds.
- Some feel strongly that the CIO should be authorized to select Investment Managers, and that the Committee is confusing governance with management if it decides to hire and fire Managers. If a Committee consists of unusually experienced investors, the CIO might find it helpful to informally communicate with members indicating his intention to hire a particular Manager in case any of the Committee members happens to know something negative about the Manager. But that is simply part of networking.
- Others believe the Committee should approve the hiring and firing of each Investment Manager or Investment Fund. The Committee, in its Governance Policies, should be specific in spelling out all actions that must be approved by the Committee.
- The CIO is authorized to make all decisions that are not reserved for the Committee.
- Every Committee needs a clearly specified mechanism for decisions that have to be made between regularly scheduled meetings. This mechanism can be a conference call between meetings, or authority delegated to a Subcommittee or to the Consultant.
  - The Committee should advise the Board of Directors on the Organization’s Payout Policy. The Committee will then implement whatever policy is established by the Board as best meeting the Organization’s needs.
  - In the case of an Endowment, the Staff’s CFO will keep track of all contributions that are donor-restricted to the Endowment Fund and will see that any restricted funds are invested and their proceeds applied in accordance with donor constraints.
  - The CIO will submit to the Committee and the Board of Directors a quarterly written report, including:
    - Recent performance (gross and net of fees) vs. benchmarks
    - Current asset allocation vs. Policy Asset Allocation
    - A portfolio liquidity schedule
    - Material actions implemented since the last quarterly report
    - Potential issues or actions for future meetings
- The Committee might request additional information, but these are the main items.

“The Committee is confusing governance with management if it decides to hire and fire managers.”

<sup>9</sup> See page 19.

## INVESTMENT GOVERNANCE AND OPERATIONAL FRAMEWORK (CONT.)

“Many forms of conduct permissible in a workaday world for those acting at arm’s length are forbidden to those bound by the fiduciary ties. A trustee is held to something stricter than the moral of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”

- Justice Benjamin  
N. Cardozo

- In an annual report to the Committee, the CIO will comment on the continued appropriateness of the Investment Policy and each of its Investment Managers and service providers.

By setting up an annual expectation that the CIO evaluate each Manager in the portfolio, the CIO will be obliged to articulate at least once each year why he expects a given Manager is the best choice in its investment role.

At least once each year the Committee will review the continued appropriateness of its Investment Policies and the continued retention of its CIO. If the CIO is internal, then the CFO should be part of that discussion.

- The Committee will prepare an annual report to the Board of Directors.

Its report typically includes:

- investment results vs. benchmarks
- year-end asset allocation vs Policy Asset Allocation
- additions and payouts during the year
- key actions during the year
- names of Committee members and key Staff members and Consultants
- total compensation paid to or accrued by Staff, Consultants, and any Committee members
- an appendix that includes the Statements of Governance and Investment Policy

## THE INVESTMENT POLICY STATEMENT

The Investment Policy Statement provides the foundation for the investment of any Fund. A typical statement includes sections on Purpose, Objectives, Fiduciary Responsibilities, Asset Allocation, and other common provisions. Discussion of each of these sections is provided below.

Some people believe the entire Investment Policy Statement should be brief and contain only essential provisions, for two reasons:

- A shorter Statement keeps the Committee members focused. They are more aware of all provisions in the Statement if it is shorter.
- Not having a Policy with respect to a particular matter may pose a risk, but having a Policy and not following it may be even riskier.<sup>10</sup>

### Purpose

Many Investment Policy Statements begin with a sentence such as: Investment policies and individual decisions are to be made for the exclusive benefit of the Organization and its mission.

### Objectives

A Committee's first question should be: What are we trying to accomplish for our Organization, and how can we harmonize the investment program with its real needs?

An objective that is appropriate for most Long-Term Funds is: To achieve the best possible Long-Term return

without exceeding the risk tolerance of the Organization, often represented by its Benchmark Portfolio.<sup>11</sup>

An objective of many Funds is to maintain the buying power of the Fund in perpetuity. Thus, many Funds aim to earn, over the long term, a *real* return of 5% and state that objective in their Investment Policy. That's an appropriate objective provided the Board and the Committee both understand that it is not a useful benchmark for the Fund's performance. The performance of virtually any long-term Fund has a high correlation with that of the stock market, and the S&P 500 once underperformed a 5% real return for nine rolling 20-year intervals, with one 20-year interval being as low as 1% real. The highest real return on the S&P 500 for a 20-year interval was 14%.<sup>12</sup>

Some people believe that an objective of 5% real in today's world is more difficult to achieve than it was in prior decades.

A further objective, especially for a Pension Fund, is: Without fail, to make every scheduled payment to or on behalf of the Organization on the date it is due.

Quite different objectives might be appropriate for Family Funds. Every Organization must determine its own objectives.

“What defines

success, and how do we

know we're successful?”

- Keith Ambachtsheer

<sup>10</sup> “A statement of investment policy . . . is a plan document that fiduciaries are required to follow. . . . Accordingly . . . fiduciaries violated their fiduciary duties when they failed to comply with the plan's own . . . investment policy statement.” – findings of a court of appeals in the case of *Tussey v. ABB Inc.* (from “Investment Policy Statements,” *Plan Sponsor*, July 2014).

<sup>11</sup> See page 20.

<sup>12</sup> Based on annual returns from 1961 to 2013 of the S&P 500 total return index and the US CPI.

## THE INVESTMENT POLICY STATEMENT (CONT.)

### Fiduciary Responsibility

At the very least, the Investment Policy of an Endowment Fund or Foundation, for example, should include a statement that the Fund will abide by the relevant state's version of UPMIFA (the Uniform Prudent Management of Institutional Funds Act) and include a paragraph such as the following quotation from Standards of Conduct:

*In the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.*

*The Investment Committee may delegate certain investment responsibility to an Investment Manager or to a Consultant, but in making and continuing that delegation the Committee is again held to the above fiduciary standards.*

*A person that has special skills or expertise, or is appointed in reliance upon that person's representation that he has special skills or expertise, has a duty to use those skills or that expertise in managing and investing the Fund.*

Some Endowment Fund attorneys recommend that all key sections of UPMIFA be included in the Investment Policy Statement, or that its key sections be appended as an exhibit.<sup>13</sup>

A fiduciary challenge arises when a donor or interested politician tries to influence appointments to or investment decisions of the Investment Committee. These are delicate situations to handle. The best defense is to remind the interested party of the requirements of UPMIFA or (for Pension Funds) ERISA.

Many public Pension Plans have Boards, largely politically appointed, that include representatives from varied stakeholder groups. Few if any of the members have any material investing experience. The most successful public Boards appoint Advisory Committees composed of professional investors, mainly those active in managing Long-Term Funds. More important, Board members *listen* to those Committees and heed their advice. Although public Pension Funds do not fall under ERISA legislation, successful ones follow ERISA's precept that all decisions must be made in the sole interest of plan participants.

Because some Committee members, such as political appointees, often lack investment experience, some Boards encourage members to obtain training in Investment Committee effectiveness.<sup>14</sup>

“If you have a long time horizon you ought to have an equity bias.”

- David Swenson

<sup>13</sup> Fiduciaries might want to pay special attention to Section 3 (investment considerations) and Section 4 (payout considerations) of UPMIFA.

<sup>14</sup> For example, programs such as the Rotman-ICPM Board Effectiveness Program for Pension and Other Long-Horizon Investment Institutions at the University of Toronto's Rotman School of Management and the Commonfund Endowment Institute held at the Yale School of Management. These 5-day courses are designed by recognized experts and feature leading faculty and speakers. Participants include Trustees, Committee members, and senior Staff from around the world.

## THE INVESTMENT POLICY STATEMENT (CONT.)

### Asset Allocation

Four terms that are important in relation to asset allocation are:

- The Policy Portfolio
- The Benchmark Portfolio
- The Actual Portfolio
- Benchmarking

The Policy Portfolio. The Policy Portfolio is the foundation of the Fund, as it designates the percentage of the portfolio that is intended to be devoted to each asset class.<sup>15</sup> It usually provides a range for each asset class that should not be exceeded by the Actual Portfolio.

After evaluating the historical performance of a range of possible Policy Portfolios over the past several decades, the Investment Committee should select one whose volatility, worst market declines, and other risk considerations would be appropriate for the Organization. It usually provides a range for each asset class that should not be exceeded by the Actual Portfolio. The range for each asset class should not be so broad that it fails to reflect the risk tolerances of the Organization. On the other hand it should not be a straitjacket. It should be broad enough to allow the Fund to be opportunistic in taking advantage of market anomalies.

The Policy Portfolio sets the risk constraint for the Fund's actual portfolio. A Fund's chief risk would be a loss of value that requires an unacceptably long time to recoup. The Organization will be in for painful surprises if the riskiness of the Policy Portfolio turns out to be greater than

the Organization can afford, or if it happens to be greater than the staying power of the Committee. Conversely, the Fund will incur opportunity costs if the risk constraint is too conservative, or if the Actual Portfolio is invested much more conservatively than the Policy Portfolio. An Organization cannot spend risk-adjusted returns.

Some Funds approach their Policy Portfolio differently. They start by deciding how much the Organization can afford to lose over a given time interval, then develop a portfolio whose historical returns would have fallen within that level of risk, and whose expected return would do likewise.

In any case, the challenge is to optimize the long-term expected risk/return of the Policy Portfolio. Based on mean-variance optimization, the higher the acceptable level of risk, the higher the expected return that is possible, and vice versa.

One of the most successful long-term investors has been the Yale Endowment, with its very high allocations to private investments and hedge funds. Many Long-Term Funds have tried to emulate Yale, but few have the exceptional resources and contacts to do so successfully. The Committee must first realistically assess: What are our resources, and what are we equipped to do?

The Investment Committee should review its Policy Portfolio (and also its Benchmark Portfolio) at least once a year, perhaps alter it only infrequently, but review it in the light of current market pricing relative to historic norms.

“The secret to governance is simple. Write down on a sheet of paper the guidelines that you expect your Committee to follow. Get approval of those guidelines and leave the room forever.”

- Charles Ellis

<sup>15</sup> Some Endowments and other investors have begun setting targets in their Policy Portfolios to an asset's role in the portfolio, such as growth, diversification, and hedging.

## THE INVESTMENT POLICY STATEMENT (CONT.)

“**T**he Actual Portfolio must be within the ranges established by the Policy Portfolio.”

The Benchmark Portfolio. A Fund’s Benchmark Portfolio is a broadly diversified portfolio of *liquid* asset classes whose index returns serve as a benchmark for the performance of the Fund.

The Benchmark Portfolio should mirror the Policy Portfolio as closely as possible while consisting solely of liquid asset classes. It can be as simple as X% MSCI All World All Country All Cap Index, Y% Barclays Aggregate Bond Index, with X and Y ranging between 60/40 and 90/10. A benchmark with eight or 10 liquid asset classes often serves as a better Benchmark for intervals shorter than five years.

The Benchmark Portfolio should have an expected long-term return that is as challenging as possible for the Fund to exceed. For example, many believe that cash should never be included in either a Policy Portfolio or a Benchmark Portfolio.

The Actual Portfolio. The Actual Portfolio will differ from the Policy Portfolio but must be within the ranges established by the Policy Portfolio. If at any time the allocation to an asset class exceeds its authorized range, the CIO should make the necessary transactions in a timely way to bring the allocation back within the authorized range.

Benchmarking. Investment performance should be compared with the Benchmark Portfolio to assess both asset allocation and Manager skills. For longer intervals, returns should be compared with those of the Organization’s peers. Peers are similar Organizations with similar resources and similar objectives for their Fund.

An estimate of the value added (or subtracted) during the latest quarter by the Fund’s deviations from the allocations of the Benchmark Portfolio is the difference in index returns between the Benchmark Portfolio and the Actual Portfolio’s asset allocation as of the beginning of that quarter. The value added (or subtracted) by the Fund’s Investment Managers during that quarter is the difference between the Fund’s return for the quarter and index returns on the Actual Portfolio’s asset allocation as of the beginning of that quarter.

These metrics are most useful if applied only to the liquid assets in the portfolio, those that have reasonably accurate market values. Inclusion of private illiquid investments muddies the comparisons. Performance of private illiquid investments is best evaluated separately, over long time intervals. This is often based on cash flow rates of returns.

But best practice for evaluating private investments is public market equivalents. This can be done in private real estate, for example, by maintaining a NAREIT phantom account in which every cash flow in the private investment is invested in, or redeemed from, the NAREIT index.

Pension Funds must also pay attention to the relationship of their market value to the present value of their liabilities – their funding ratio.

Ultimately, Committees want to compare their performance with peers. Peers are Funds with similar objectives that have the same range

## THE INVESTMENT POLICY STATEMENT (CONT.)

of assets. Committees should focus on intervals of five years or preferably longer, because over shorter intervals different investment strategies can drive a Fund's returns to be very different from those of its peers. For example, if a Fund had avoided the US stock market bubble in 1997-98 and the credit debacle in 2006-07, its long-term performance through those years might have been sharply lower than its peers, whereas its long-term performance through 2002 or 2008<sup>16</sup> might have been sharply higher than its peers. A Committee must understand why its results are meaningfully better or poorer than its peers. To the extent feasible, it can be helpful to compare results for various individual asset classes with those of peers.

The point is: Each Committee should decide for itself what it should do based on its own research, and it should not be afraid to take positions materially different from those of its Benchmark Portfolio or its peers.

### Other Provisions

Some Investment Policy Statements, but not all, include the following subjects:

#### Index Funds.

A good provision in any Policy Statement is: Unless the Committee can realistically expect active Investment Managers to achieve results in any particular asset class that, net of all costs, are materially better than their benchmarks, then those asset classes are to be invested in Index Funds.<sup>17</sup>

According to Charles Ellis, "An ideal investment Committee will have decided to invest in Index Funds because price discovery has already been worked out." This advice might be especially applicable for smaller Funds.

Consultants should be asked for a historical analysis of the performance of all their discretionary Manager recommendations for all clients over the last five years, compared with their respective benchmarks. Few if any Consultants have provided this kind of analysis, but all Consultants should develop such an analysis and make it available to clients.

#### Manager Criteria.

Some Statements include criteria for hiring Investment Managers, such as:

- Character. Integrity is a *sine qua non*.
- Continuity of Key People. *Future* performance is dependent on particular individuals, not on the name of the investment firm.
- Best in Class. Considering *expected* returns, volatility, and correlations, is the *expected* performance of the Manager as good as or better than any alternative Manager the Committee could access?
- Investment Approach. Do the assumptions and principles underlying the Manager's investment approach make sense to us?
- Liquidity. Will the liquidity of the Manager's investment strategy

“ A Fund should develop superb long-term working relationships with its best Managers, but that should not take the place of annual evaluations of them. ”

<sup>16</sup> Many Endowments monitor their performance on a fiscal year ending June 30, in which case fiscal year 2009 was the disastrous year.

<sup>17</sup> Committees should be aware, however, that exotic ETFs can introduce unintended risk to the portfolio.

## THE INVESTMENT POLICY STATEMENT (CONT.)

“The long run is a misleading guide to current affairs. In the long run we are all dead.”

- John Maynard Keynes

“Committees are ill-designed to make operational decisions. They should concentrate on governance and not attempt management.”

<sup>18</sup> Amit Goyal and Sunil Wahal, “The Selection and Termination of Investment Management Firms by Plan Sponsors,” *Journal of Finance*, Vol. 63, No. 4, August 2008, pp. 1805-1847.

create a potential problem for the liquidity of the Fund’s overall portfolio?

- Control. Can our Organization adequately monitor this Manager and its investment program?
- Legal. Has our attorney identified any legal concerns?

Investment Managers should be selected without regard to their geographic location, except as that may impact their investment capability.

All existing Investment Managers should be re-evaluated under these criteria at least once each year. Excessive turnover of Managers is a problem. While an average duration of relationships of less than 10 years may be acceptable, an average of five years or less is often considered not acceptable.

A classic mistake is the failure to recognize reversion to the mean. In a study<sup>18</sup> of 3,400 Funds over a decade, most newly hired Managers generated substantial excess returns over their benchmarks in the 24 months prior to being hired, and the fired Managers were behind their benchmarks. But in the next 24 months the fired Managers outperformed the hired Managers – a reversion to the mean.

A Fund should work rigorously to develop superb, long-term working relationships with its best Managers, but that should not take the place of annual evaluations of each Manager – sometimes in comparison with two or three benchmarks that might be relevant for a given Manager.

### Constraints.

Many Statements define the maximum percentage of assets the Fund may allocate to any Investment Manager or to any illiquid Investment Fund. Others prohibit the use of certain derivative investments, although many allow derivatives in their portfolio’s hedge funds. Still others set restrictions on bond ratings, although such restrictions limit the flexibility of the Fund’s fixed income investments.

A useful constraint is to preclude the use of any derivatives whose losses could impact the Fund’s assets beyond those in that particular Manager’s portfolio.

Some Organizations, such as religious organizations and environmental groups, have constraints against investments that violate their principles. This subject is examined separately under the heading of Responsible Investing (page 31).

### Rebalancing.

New contributions to the Fund should be applied to, and payments by the Fund withdrawn from, asset classes in such a way as to bring the Fund’s asset allocation toward its Policy Portfolio.

In order to maintain the Fund’s targeted risk and to gain the long-term benefit of reversions to the mean, a portfolio should be rebalanced to its intended allocation at least once a year.



## THE INVESTMENT POLICY STATEMENT (CONT.)

### The Fund's Liquidity.

The Fund is to maintain adequate liquidity to meet all obligations of the Fund and to meet all of its commitments to private investments without having to sell securities that may become costly to sell in times of extreme market stress.

Some Funds accumulate cash to provide for required payouts for the coming 3 to 12 months. This policy avoids the risk of having to sell volatile assets during a market decline. Funds that pursue this policy, however, should be aware of the long-term opportunity cost of not investing cash in a volatile asset such as a very liquid Index Fund, for example, and making redemptions just in time for payouts. Losses from sales at the bottom of a market are more than offset by greater returns over the longer term.

### Roles.

Some Statements define the roles of Consultants, Investment Managers, and Custodians, although many Funds find that unnecessary.

### Proxies.

The Fund should ensure that all proxies are voted, and the Manager that holds a stock in his account should be the one to vote it. He is in the best position to know what vote would most likely promote the value of that stock and be in the best interest of shareholders.

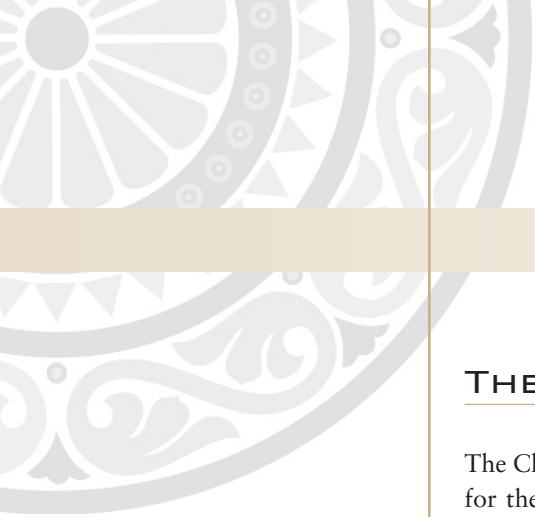
### Borrowing.

Some Statements provide that the Fund may not borrow money except for overnight emergencies, although the Committee may authorize specific Investment Managers to use leverage.

### Organization's Credit Line.

If some of the Fund's assets are pledged to a credit line of the Organization, then a portion of those assets may be constrained by the requirements of bond rating agencies for liquidity and underlying assets.

“ All proxies should be voted, and the manager who holds a stock should be the one to vote it. ”



“Have you ever sat on an investment committee with Dominant Donor Dan, Helicopter Harry or Self-interested Sam and everybody else just listened politely?”

- Myra Drucker

## THE INVESTMENT COMMITTEE AND ITS CHAIR

The Chair, working with the CIO, is responsible for the agenda and the time allocation to each item. He needs to remind members of the group’s objectives and keep members continuously on track.

A top priority of the Chair of an Investment Committee of experienced investors is to facilitate the collective contributions of *all* Committee members. He should generally not reveal his view until after the discussion is over. Groups of highly intelligent people often reach bad decisions that reflect the easy, prevailing consensus of what has worked recently. Dissenting views are often suppressed in order to move forward. This may appear to increase group harmony, but it ultimately undermines the effectiveness of decision-making. In turn, members are responsible for preparing their thoughts ahead of time and making sure they share what they know.

All too many meetings consist mainly of a myopic review of the markets during the last quarter and how each Manager performed. Performance summaries should be sent to Committee members in advance – and reviewed by them as part of their expected homework. *Relatively little Committee time should be devoted to the performance report.* Quarterly performance reporting all too often fosters short-term thinking.

Committees should spend the vast majority of their time on important topics that require them to think in terms of probabilities and outcomes. Meetings are an occasion for the Committee to review the portfolio in the context of its Investment Policies, and a chance for the CIO:

- to explain actions taken since the last meeting,

- to give an exception report covering only what, in a long-term context, has been working out better or less well than expected,
- to explore new opportunities, and
- to provide education in investment areas with which some members may be less familiar.

Ample time must be allotted, of course, to recommendations that the CIO is bringing to the Committee. If the Committee retains the decision to hire and fire Managers, those recommendations will be key items on the agenda. Committee members should ask hard questions about the CIO’s due diligence, such as:

- First and foremost, is the recommendation consistent with the Fund’s Policies? If not, the recommendation is inappropriate. Of course, at its next meeting providing the opportunity for broad consideration, the Committee might care to consider modifying its Policies.
- Has the CIO researched all of the right questions relative to things such as:
  - Character and integrity of the recommended Manager
  - Assessment of the *predictive value* of the Manager’s track record
  - Nature and relative pricing of the asset class itself
  - Credentials of the Manager’s key decision-makers
  - Depth of the Manager’s staff

## THE INVESTMENT COMMITTEE AND ITS CHAIR (CONT.)

- The Manager's decision-making processes and internal controls
- The range of risks and opportunities
- What alternatives did the CIO consider?
- Have adequate constraints and controls been established, especially with respect to liquidity and any derivatives that a Manager might be authorized to use?
- Do the fees and expenses seem reasonable relative to those of comparable funds?

Members must recall, however, that it is the CIO and his Staff who have performed due diligence on all prospective Managers, and if the Committee wants to hold the CIO accountable for results, it must be prepared to approve most of his recommendations – or else look for a new CIO.

Some Committees choose to meet recommended Investment Managers . . . and sometimes to meet several “finalist” Managers one after the other as in a “beauty contest.” The Committee can, at best, determine how articulate the Manager is. But articulateness has a low correlation with investment capability. In 20 to 30 minutes, a Committee's interview can be little more than superficial. Committee members cannot bring the perspective of having met with hundreds of Managers, as the CIO and his Staff have done, nor can they do the kind of analysis the CIO and

Staff should have done. In short, this is a poor and possibly dysfunctional use of Committee time.

Bringing an Investment Manager to a meeting might be a useful thing to do, but the purpose should be to help Committee members understand parts of the investment spectrum that many members may not be familiar with.

At least once a year the Committee should review its Investment Policies and its CIO, because the retention of both should be a conscious decision. That does not mean that either should be changed frequently, but a separate meeting might well be devoted to each. The Committee might profit also from periodically evaluating its own practices and operations. What have we been doing right? Where have we fallen down? As a Committee, do we possess the needed investment skills? How can we improve?

Another responsibility of the Chair is to provide one-on-one training for new Committee members. The Chair should review with each new member the Committee's Governance and Investment Policies, focusing on the why underlying those Policies.

Finally, serving on an Investment Committee should be interesting, enjoyable, and fulfilling for its members. The tone is set by the Chair.

## THE INVESTMENT COMMITTEE AND ITS CHAIR (CONT.)

“Use probabilistic odds for possible solutions. They help focus members on tangible arguments.”

- Arnold Wood

### Role of the Chair

- The Chair must be proactive in prioritizing issues, allocating time accordingly, confining members to relevance, encouraging members to speak out, ensuring that team members with dominant personalities are kept in check, and recognizing when a decision should be reached.
- All too often Committee members are quick to accept what is often considered common knowledge, or to support an opinion expressed by a leading member – a syndrome called “confirmation bias.” A Chair can act to empower others to prevent railroading or social pressure to push a decision through before careful Committee consideration.
- The goal is to draw out ideas and to keep personality ridicule in check. It is widely felt that a member who offers unique information or perspective is disruptive to the social balance of the Committee. Social loafing occurs when Committee members do not willingly speak up with their opinions or share their insights. The Chair should encourage alternative information, ideas, and solutions.
- The well-publicized technique of brainstorming should be done outside the Committee meetings, where members can compose thoughts independently.
- Feedback is a learning mechanism, but feedback from most decisions, when available, is often slow and generally inaccurate.

*Adapted from “Behavioral Finance and Investment Committee Decision Making” Arnold S. Wood, CFA Institute*

## THE CHIEF INVESTMENT OFFICER (CIO)

A key responsibility of the CIO is to provide continuing education to the Committee members, especially when some of the members are not investment professionals. Many members lack a broad grasp of the investment world, and it is up to the CIO to give them that understanding. He should provide such education - including the setting of realistic expectations for return and volatility - on a continuing basis. He should relate each decision opportunity to the Fund's Investment Policies.

What can the CIO do routinely for Committee education? The following may be helpful if done regularly, whether times are good or bad:

- Demonstrate the need for a long-term orientation and the futility of short-term thinking.
- Illustrate how the various security indexes have compared with one another at different times over the last 30 years, how each has periodically gone into devastating tailspins, and what degree of market debacles the Fund should expect to live through.
- Provide current market valuations, such as P/Es, dividend yields, and EPS growth rates compared with historical norms. Perhaps show a matrix of future total returns of the stock market as a factor of future P/Es and EPS growth rates.
- When analyzing a recommended or existing Manager, show how the Manager performed relative to his benchmark (or benchmarks) over a variety of different intervals, not just intervals to the latest date.

If possible, the CIO can help the Committee arrange an occasional off-site conference and bring a range of noted investment thinkers – not necessarily the Fund's Managers – to discuss in an informal and extemporaneous way the Fund's current investment strategy and other questions related to investment philosophy.

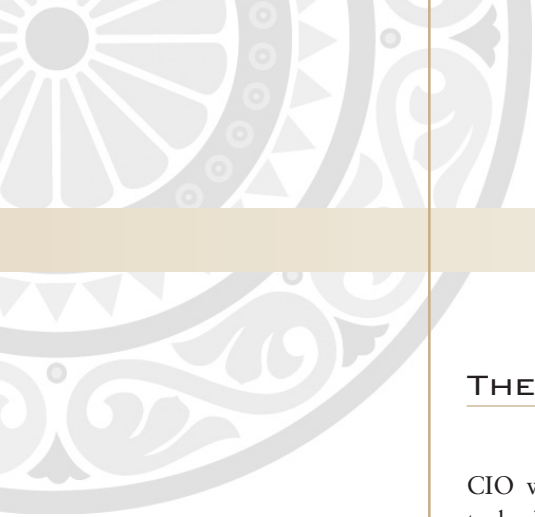
If the CIO is making a recommendation to the Committee, his recommendation should be comprehensive and incisive without constituting an information dump. When making a recommendation to the Committee, the CIO should go through his presentation – but not by reading it aloud. Every Committee member should already have read it. Instead, the CIO should discuss briefly the meaning – the “so what” – of each part of the presentation. This approach tends to elicit more and better questions and provides greater assurance that no key considerations have been glossed over.

At times a CIO may come upon a highly attractive but offbeat investment opportunity but hesitate to recommend it to the Committee for fear he would be laughed out of the room. To the extent this is true, it is a sorry reflection on the open-mindedness of the Committee, a reflection on the inadequate education given the Committee by the CIO, or both. Offbeat opportunities may require much greater due diligence and more careful explanation to Committees than traditional opportunities, but unconventional behavior is the only road to superior investment results.

Unusual or contrarian investments aren't for everyone. In addition to superior skill, successful investing requires the ability to look wrong for a while and survive some mistakes. The bottom line is not whether we dare to be wrong, but whether we dare to *look* wrong. A

“As a committee we need to be testing the quality of the thought process of the people who are making the decisions.”

- Myra Drucker



## THE CHIEF INVESTMENT OFFICER (CIO) (CONT.)

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CIO who is afraid to be different and afraid to look wrong is not likely to provide superior results. With hindsight, all CIOs will make mistakes. A Committee must expect this and must evaluate its CIO on overall results, on how often he was right, and on the reasoning and due diligence behind his recommendations.

Of course, if a given action potentially has bad consequences that are absolutely unacceptable to the Organization, the expected value of all of its consequences – both good and bad – can be irrelevant.

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An in-house CIO or an OCIO should manage internally only those asset classes in which it can excel and should use outside Managers whenever they can add value.

“Superior investing requires the ability to look wrong for a while and survive mistakes.”

## RISK

Risk is inherent in any portfolio and demands the Committee's continuous concern, beyond what is said in the Investment Policy Statement. Analyzing risk goes beyond analyzing an investment in isolation but rather in the context of the Fund's overall investment strategy. *How is the portfolio likely to behave under worst-case stress, and how might that affect the Organization?*

Volatility is an incomplete definition of risk. To an extent, Committees need to embrace volatility, as volatility is necessary to create opportunities for effective investing.

The chief risk is a loss that would require an unacceptably long time to recoup. By reviewing volatility and implosions of alternative benchmarks over the last 40 years – for example, benchmarks ranging from 60/40 to 90/10 stock/bonds – a Committee can attempt to quantify the risk of unacceptable loss, year-to-year declines, and recovery periods. Investment risk needs to be harmonized with the Organization's Payout Policy.

The words "fiduciary" and "prudence" have all too often been impediments to investment performance because of the scary emotional overtones those terms arouse. Such emotions lead to a mentality such as: "It's OK to lose money on IBM stock but don't dare lose money on some little known stock." Neither case should be more nor less OK than the other, assuming that the underlying research was sound.

Committees all too often look at what other Funds are doing and strive to do likewise on the assumption that that must be the way to go. As a fiduciary, a Committee should do its own independent thinking, apply its own good

sense of logic, and stay within its own realistic capabilities.

Complexity can be a risk that is hidden from both the CIO and, by extension, the Committee. During periods of stress, for example, embedded leverage and hidden triggers can amplify losses beyond their apparent risks. The CIO and Committee must continuously evaluate the appropriateness of both the amount and duration of leverage used by their alternative Managers, and should consider exiting Managers whose leverage they deem too risky.

Another risk besides leverage and unacceptable losses is *liquidity*. Investors can be rewarded for less liquidity or illiquidity, but only if they have first-class management. Even then, the liquidity of any portfolio must be monitored continuously. The CIO and Committee must ensure that the portfolio always has enough highly liquid assets that can, under extreme market stress, still be sold without undue transaction costs to fund commitments for the Organization or for private investments.

Some Funds maintain a continuing allocation to cash in order to meet near-term obligations. Cash, however, is a drag on long-term performance, and there are more rewarding investments which, though volatile, are almost equally liquid.

In periods of economic turmoil, the CIO and Committee need sufficient flexibility to adjust. But crucial investment decisions may be made in haste under pressure, and without adequate consideration of the long-term consequences. In such cases, the temptation to listen to urgent voices claiming that "this time it is different" has been very difficult to resist.

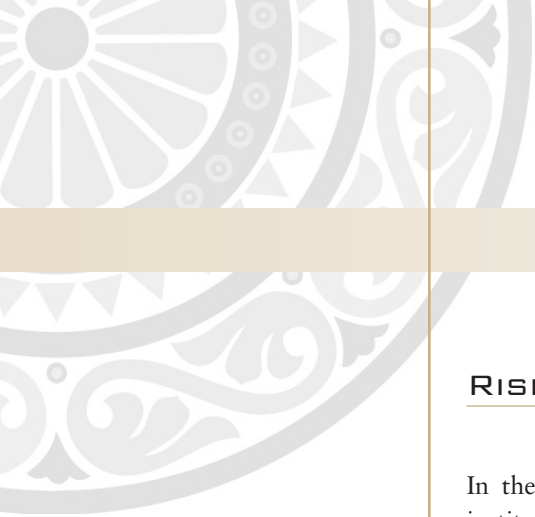
“Always ask,  
“What could go wrong?”

Committees have to  
consider the downside.”

- Arnold Wood

“One point of added  
volatility is meaningless,  
while one point of added  
return is priceless.”

- Jack Bogle



“If sellers know more about what they are selling than buyers know about what they are buying, buyers will pay too much for receiving too little value, and sellers will profit too much for providing too little. Committees can win the game by handing their money over to the game’s smartest player.”

- Keith Ambachtsheer

## RISK (CONT.)

In the 2008 crisis, for example, many major institutions panicked, sold at the bottom, and suffered permanent loss because they failed to get reinvested in time to benefit from the recovery in asset values. These were costly mistakes, suffered by many top institutions. Some Funds compounded their problem by selling their interests in private investments at a discount at the same time many private equity Managers were pounding the table for capital to buy private assets at distressed valuations.

The risk to the Fund of an unacceptable loss of purchasing power as a result of poor investment decisions is compounded by the potential for after-the-fact second-guessing and a possible legal challenge by the state’s attorney general or by donors or beneficiaries.



## RESPONSIBLE INVESTING

A number of Organizations – churches and others – have long overlaid their investment objectives with environmental, social, and governance standards known as socially-responsible investing (SRI). SRI avoids investing in the stocks and bonds of certain kinds of companies or industries. UPMIFA specifically states that “an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.” Private Pension Funds, however, are required by ERISA to take all actions for the sole benefit of retirees.

Social investing was most publicized in the 1980s, when many Funds avoided securities of companies that did business in South Africa. Other Organizations are sensitive to companies that do business in one or more other categories, such as cigarettes, alcoholic beverages, munitions, chemical fertilizers, and so on. Still other Funds consciously allocate a small part of their portfolios to minority-owned enterprises or other companies they view as performing a particular social good.

Overlaying our investment policies with social objectives is one way to “put our money where our mouth is,” and as such, is perfectly appropriate – provided the majority of constituents of the Organization agree with the social objectives and with the opportunity costs in terms of lower expected investment returns. Social investing probably does more to enable investing institutions to be consistent with their principles, and probably less from a practical standpoint to effect social change.

How can an Organization gain the consensus of its constituency as to what industries to avoid? Tobacco companies might be easy. And maybe munitions . . . but should we even avoid

companies for whom munitions are only 1% of their business? How about industries that pollute the environment? Which industries are they? Where should we draw the line?

If an Organization takes a social investing approach, everyone involved must be realistic about the fact that exercising social investing is likely to incur opportunity costs, for the following reasons:

- Any social constraints eliminate consideration of most mutual funds, hedge funds, and private investments. This leaves the Fund with a relatively small sector of the investment spectrum.
- Funds may find it difficult to consider a sufficiently wide range of strong Investment Managers to achieve the wide diversification that long-term investors should strive for.
- The best Investment Managers are competitive people and are driven to achieve the best they can. They tend to avoid clients who want them to observe any particular constraints.
- Very few mutual funds observe social investing constraints and become eligible for consideration. Those few mutual funds that do social investing have – over the long term – achieved performance that is average or below average.

In short, it is unrealistic to expect as good a long-term total investment return from a socially invested Fund as from one that has no such constraints.

“Overlaying our investment policies with social objectives is one way to ‘put our money where our mouth is.’”



## RESPONSIBLE INVESTING (CONT.)

“Two opposing needs are: the need for high returns, and the need to avoid capital impairment/cash flow shortfall. Committees must address these opposing needs head-on.”

- Keith Ambachtsheer

In addition:

- Members of the Organization must expend a lot of effort to maintain a complete, accurate, and timely list of companies to avoid or mandates to follow. Members must be willing to devote the time that’s necessary to do that.
- The Fund must consider whether the social objectives of any “social investment” mutual fund are the same as its Organization’s social objectives.

The Organization’s Board should recognize this reduced investment expectation and should buy into it explicitly by using a lower Payout Policy. And the Board has an obligation to inform the Organization’s constituents and make sure they agree. If everyone agrees, then of course the Board should go ahead with its plans for social investing.

Some Organizations try to pursue their social objectives through proxy voting. They have at times introduced and supported motions on a company’s proxy to effect some social or environmental change. Such efforts have often done more to sensitize companies to the issues than to effect change *directly* – and that has probably been the Organizations’ realistic expectations.

### ESG Investing

In recent years many investors have pursued a different approach, known as Environmental, Social and Governance (ESG) investing. This involves integrating ESG factors into fundamental investment analysis in making investment decisions. The idea is that companies that pursue relatively positive behavior in the areas of the environment and social justice, while adopting quality governance, are also companies that tend to perform better long term.

Today, some 1,200 institutions worldwide have signed onto the Principles for Responsible Investment (PRI), which encompass the above behaviors. Three-quarters of those that have signed are investment management firms. While preliminary studies suggest that while integrating ESG factors into fundamental investment analysis can improve investment performance, it is too early to draw comprehensive conclusions.

## Case Studies

Investment Committees apply best practices in different ways. We have assembled several case studies that illustrate how some Committees have benefited by applying these principles, and also how other Committees might have benefited if they had applied them.

The value of the case studies is not in the names of the Organizations, but in what they *did*. We have therefore substituted fictitious names for the Organizations. All names in the case studies

have been made up. Any similarities between them and of actual companies, organizations, and institutions is unintentional.

We hope that readers can find a case study or two that will let them say, “That’s about what we do,” or “That’s what we should be doing.”

We have arbitrarily organized the cases in order from the largest Fund size to the smallest.

## Case Studies: Effective Investment Committees

### Focusing on What Counts

The fiduciary of the \$50 billion Pension Fund of the State of South Carolina was a nine-person Board of Governors. The Board consisted of several experienced investors plus constituents such as teachers and firemen, and it appointed a nine-person Advisory Committee, many of whom were CIOs of Long-Term Funds. Board members conscientiously attended the quarterly Advisory Committee meetings. They listened intently and they learned.

Advisory Committee meetings devoted a short time to performance review, then focused on areas such as asset allocation and assumptions for 10-year relative returns. Each year the Committee carefully reviewed every asset class individually, and their suggestions were taken seriously by Staff.

The State had a very competent CIO and 40-person Staff with competitive compensation. The State

provided an excellent working environment, and many Staff members had long tenures there. A Consultant served simply as an extension of Staff.

The long-term performance of the State has been close to the range of larger university Endowments, which include some of the best managed Long-Term Funds in the country.

- ▶ *The Committee focused most of its attention to asset allocation and long-term assumptions.*
- ▶ *The willingness of Investment Committee members (Board members, in this case) to learn from the Advisory Committee is crucial.*
- ▶ *This case highlights how important it is for a large Fund to have – and retain – a highly experienced, competent Staff.*

### Effective Interaction Between Committee and Staff

The \$10 billion Endowment of Purningham University is governed by the Purningham Management Company, whose Board is appointed by the Trustees of the university. The 10-member Board is composed of 10 alumni who are all investment professionals, each active in particular sectors of the investment spectrum, plus the CEO, CFO, and university president as ex officio members. The Board delegates management to its experienced, highly competent, and well-motivated in-house Staff and views its own role as that of governing and providing advice.

The Board, which meets quarterly, must approve changes in asset allocation and commitments greater than \$300 million. The Board has a long-term Policy Portfolio that seldom changes, but the Staff reviews with the Board annual recommendations for changes in interim asset allocation. Frequent interaction between Staff and individual Board members results in no surprises. Upon request, Board members provide valuable contacts and background that can

help with due diligence efforts on new managers and strategies.

Sector heads are compensated on their performance relative to public and private sector indexes as well as on total Fund performance. The CIO's compensation is based on rolling 3-year results relative to benchmark and the median of the largest university Endowment Funds – up to a maximum of 100 basis points above median (to discourage excess risk). This has generally resulted in his being well-compensated.

- ▶ *The Board clearly delineates the line between governing and managing.*
- ▶ *A Board with such breadth of investment expertise among its members is consulted extensively by Staff for their advice.*
- ▶ *The frequent interaction of Staff and Board members makes for an effective team.*

“The Committee is focused on asset allocation and long-term assumptions.”

“The Board has a long-term Policy Portfolio that seldom changes, but the Staff reviews with the Board annual recommendations for changes in interim asset allocation.”

## A Committee That Governs

The Investment Committee for the \$8 billion Endowment Fund of Tarringwell University consists of eleven executives from a wide range of investment management firms. Management of the Fund is delegated to its internal CIO and Staff.

To establish its Policy Portfolio, the CIO presented to the Committee three risk profiles for the Committee to consider. The Committee chose one based on the university's financial needs, not for purposes of having a horse race with Yale.

At quarterly meetings, Committee members review performance but spend more time on the investment

outlook, a strategy update, and a review of the portfolio's risk profile. Most meetings also focus on one particular asset class, its current prospects, and the portfolio's current investment position in that asset class.

- ▶ *Performance has been very strong, both relatively and in absolute terms.*
- ▶ *This is a case of the right people focusing on the right issues.*
- ▶ *Effective delineation between governance and management*

## The Fruits of Education

In 1960 Jarkatronics established a Pension Fund to supplement the annuities it continued to buy from a life insurance company. The treasurer and his inexperienced Pension Fund manager reported to an Investment Committee consisting of five senior corporate executives, which had to approve every hiring or termination of Investment Managers.

Investment results during the 1970s were disappointing relative to market indexes, which was common among Pension Funds during that decade, and in 1978 the company hired a consulting firm to advise it. The Consultant advised terminating over half of the Fund's Managers and placing those assets in an Index Fund, and the Committee did just that. Then, over the next few years, the Consultant helped the Fund move indexed money to active Managers.

In 1982 the Consultant recommended that the Committee hold a two-day off-site conference with five diverse and nationally recognized investors, who described the many alternative kinds of assets that could be both productive and diversifying. The conference opened the minds of Committee members and Staff and led in subsequent years to the company's \$5 billion Pension Fund becoming the

most broadly diversified Pension Fund in the country.

The Fund's CIO, climbing a learning curve since the early 1970s, brought new and different kinds of investment recommendations to the Committee, including many unconventional opportunities. Committee members asked hard questions but generally approved the recommendations. The Committee's confidence strengthened over time, as every few years the CIO and Consultant arranged additional off-site conferences with five or six diverse but nationally prominent investors.

The CIO also helped Committee members to understand the lessons from historical market returns. The portfolio had an unusually high allocation to common stocks, and the CIO kept telling Committee members not to get too excited by the continuing high returns in the first half of the 1980s, because a repeat of the disastrous years of 1973-74 could occur at any time. Sure enough, in October 1987 the portfolio lost \$1 billion. At the Committee meeting at the end of that month when the CIO reported the loss, the Committee Chair said, "Thank you, are there any questions? If not, let's move on to new business."

“Investment

Committee members focus on the investment outlook, strategy update, and review of the portfolio's risk profile.”

“The CIO

helped Committee members to understand the lessons from historical market returns.”

## Case Studies: Effective Investment Committees (continued)

### The Fruits of Education (cont.)

As the CIO gained experience, he relied less on the Consultant for recommendations but used it instead as an extension of his Staff.

The pension portfolio was a high performer but with a very different asset allocation from the Pension Fund norm. Then in 1997 and 1998, the Fund's returns were bottom decile both years, and its 10-year returns fell well below median. The Fund had avoided the stampede into high-flying US growth stocks. Then, over the three years 2000-02 when the S&P 500 was down some 37%, the company's Pension Fund had a slightly positive return, and its 10-year results became top decile.

- ▶ *The Committee kept a long-term orientation, with realistic expectations about what that entailed.*
- ▶ *The CIO made Committee education his highest priority, which made it possible for him to bring many unconventional opportunities.*
- ▶ *The Committee members recognized that investing was not their area of expertise, so they had open minds to learn. By approving most of the CIO's recommendations and recognizing that not all of them would pan out, they allowed the CIO to grow.*
- ▶ *The Committee held the CIO accountable.*

### Benchmarking Against Liabilities

Nanvitech's Pension Fund of \$5 billion was one of the responsibilities of its Retirement Plans Committee (RPC), which consisted of the CFO, treasurer, general counsel, and senior vice president for human relations. The RPC met quarterly, and it delegated essentially all investment decisions to the Investment Committee, composed of the treasurer, the CIO, a senior corporate lawyer, and the senior investment team. That Committee met monthly.

The RPC retained approval authority on the Fund's high-level asset allocation, but it typically approved Investment Committee recommendations. The Committee had full authority to appoint Investment Managers, change benchmarks, rebalance, etc. For many years it invested at least half of its equity assets through Index Funds, which it managed internally.

Every quarter when the CIO and her senior Staff met with the RPC, they reported on the funding status of the Pension Plan – how the market value of the Pension Fund compared with the actuarial liabilities of the plan. In early 2007, by which time the Fund's

funding status had reached 110%, the CIO recommended a 10% move from equities to liability-driven investments – fixed income investments designed to offset the effect of changing discount rates on plan liabilities. The CIO emphasized that this recommendation was not a market timing call, as she and her staff weren't confident of their market timing ability. The recommendation was driven by asset-liability modeling and was a matter of prudence because, in the long run, one cannot easily access excess funding in a Pension Fund.

The RPC concurred, and they did the transaction in June 2007 – just in time, as it turned out.

- ▶ *The Retirement Plans Committee, which did not include experienced investors, was wise to effectively delegate the investment of its Pension Fund to its Investment Committee.*
- ▶ *The Investment Committee understood the Fund's long-term needs and linked its strategy to them.*

“The recommendation was driven by asset-liability modeling because, in the long run, one cannot easily access excess funding in a Pension Fund.”

## The Right People Focused on the Right Issues

Early on, Charton University established a subsidiary corporation, called Chartinvest, which was responsible for its investments, including the university's \$2 billion Endowment Fund. The president nominated half a dozen members to the Investment Committee. All were alumni or parents, and all held major positions in the investment world, although only one was a former CIO of a Long-Term Fund. Members could be appointed for two 3-year terms, and a person's term could be extended if he became an officer of Chartinvest.

The members were able to help the Staff get in on the ground floor of some of the best venture capital and hedge funds in the 1980s. Venture funds were in the midst of their J curves in the 1980s, and as a result, they sharply lagged the 20%-plus returns of the stock market. There was criticism of the Fund, but the Committee continued undaunted and earned great returns in the 1990s and has ever since.

The Investment Committee established a simple Investment Policy, and its charter required it to approve any commitment greater than \$15 million. Chartinvest had a strong CIO and Staff, largely home-grown. It offered students of the university's premier business school an opportunity to spend three years with Chartinvest, and it retained some of the best of them as permanent staff.

At times during Committee meetings, members suggested new Managers to be considered. The Staff then researched the Managers and either recommended that they be hired or got back to the Committee as to why not.

An executive committee of three members of the Investment Committee acted between the quarterly meetings to deal with new opportunities that had a short time fuse. It established the compensation of the CIO at a fully competitive level, nominated new Committee members, and reviewed Committee governance: What have we done well? What have we not done well? And should we change any of the ways we do things?

Performance of the university's Endowment Fund has been among the best in the business.

- ▶ *A deeply experienced Investment Committee was able to keep its focus on the long term.*
- ▶ *Veteran Committee members fed a strong CIO suggestions, often helpful - but the members intended that the CIO do his own due diligence and make his own decisions.*
- ▶ *The Investment Committee consisted of the right people, who focused on the right issues.*

“**I**nvestment Committee members were able to help the Staff get in on the ground floor of some of the best venture capital and hedge funds in the 1980's.”

## Case Studies: Effective Investment Committees (continued)

### The More Flexible One's Needs, The More Volatility One Can Accept

A well-to-do family established the \$1 billion Antlers Foundation to support educational and cultural causes. Its Investment Committee consisted of family members plus a few carefully selected people with deep experience managing Long-Term Funds.

The Committee, in establishing its Investment Policy, worked hard to understand the nature of the Foundation's annual grant recipients. Some recipients needed reliable amounts every year, but some could live with a large grant one year and perhaps nothing the next year. The Foundation decided to make redemptions on a year by year basis at a consistent 5% of assets, and it could accept a high level of volatility – so the Committee made an unusually high allocation to equities, almost 100%. During the 2008 market debacle, the flexibility of the Organization's grant process enabled it to continue meeting its mission while also pursuing its aggressive investment strategy.

Over the years the Committee has had great success investing the Fund's assets, without a CIO, using just three Managers – an Index Fund and two active Managers. The Fund has had a 20-year relationship with these Managers and expects to continue with them for many years to come. The Committee views investment policy and strategy as a joint responsibility of the Committee and its Investment Managers. It meets with each Manager twice a year to focus on the specific strengths they want to protect and build on, and to assure a close shared understanding, or partnership.

- ▶ *The Committee linked its strategy to the Organization's needs. It took advantage of the Organization's flexibility to establish an unusually aggressive Investment Policy.*
- ▶ *The Committee developed long-term relationships with a few superior Managers.*

### Transforming an In-Grown Committee

Prior to 2010 the \$1 billion Endowment of Perinson Institute was managed by its Investment Committee – 14 members, all of them highly experienced in alternative investments. Accordingly, nearly 75% of the portfolio was in hedge funds and private equity. Only 19% was in long equity – all U.S. stocks. A single Staff member executed the Committee's decisions.

Committee members had no term limits, and the same person had served as Chair for 25 years. The Committee met eight to 10 times a year, often with Investment Managers. Attendance at such frequent meetings was spotty, as – given the size of the Committee – individual members felt less sense of urgency.

The Fund survived the 2008 debacle better than most, but it largely missed out on the 2009 recovery. At yearend the institute hired Joyce, its first CIO, who

had previously managed a different Endowment. She, in turn, hired three investment professionals.

Joyce began by getting the Board to approve the reduction over time in the number of Committee members from 14 to 7 members, and they would serve no more than two 3-year terms. The Committee began to meet just four times a year.

Joyce wanted her relationship with the Committee to be collaborative, as many members were far more experienced than she. She recommended asset allocation and individual Managers. The Committee would discuss them and make the ultimate decision, thereby gaining ownership of the actions. The Committee never again met with Investment Managers, and in the end, it tended to approve all of Joyce's recommendations.

“The Organization could accept a high level of volatility - so the Committee made an unusually high allocation to equities.”

“She wanted her relationship with the Committee to be collaborative, as many members were far more experienced than she.”



## Transforming an In-Grown Committee (Cont.)

Initially, one of the Managers was a Committee member, and the Managers also included several sacred cows. They were not performing terribly well, but because of long relationships, the Committee had generally approved their new fund offerings without a great deal of rigor. Joyce compared their expected return streams with those of other Managers and asked which ones the Committee would choose to invest in today. Over time the Committee agreed to part company with all of their sacred cows. Some members were relieved that they did not have to be the ones to propose the changes.

When she became CIO, Joyce believed the Committee was not taking enough risk. Rather than shock the Committee, Joyce chose to increase equity exposure little by little until today the portfolio holds 40% in global equities, and alternatives are down to 50%. Joyce believes the portfolio now captures 58% of a market's upside, but only 32% of its downside.

- ▶ *The Committee has segued from managing to governing.*
- ▶ *Introducing term limits strengthened the Committee.*
- ▶ *A new CIO has led the Committee while giving due respect to its veteran members.*

## Outsourcing Was the Solution

When the CIO of a Long-Term Fund joined the Investment Committee of Quensius University in the late 90s, she joined a Committee that included three other institutional investors. For its \$950-million Endowment Fund, the selection of Managers was Committee-driven with the assistance of a Consultant. The Committee operated with asset class Subcommittees to vet Managers and make recommendations to the full Committee. Subsequently, the university hired a CIO, but the Committee retained authority to set asset allocation and to approve Manager selections.

The portfolio, which had a value discipline, performed poorly relative to the high-flying S&P 500 in the late 90s, and some Committee members wanted to move to growth Managers. But the experienced investors on the Committee held firm, and that decision saved the Fund considerable grief.

The Committee, however, was not satisfied with the Fund's long-term performance. In 2004 the Committee learned of Clyde, who had an outstanding record as CIO of a large university's Endowment Fund

but had just left to start his own OCIO firm. Quensius University became the firm's first client.

The Committee decided to turn over the Fund's investment responsibilities to Clyde's firm – asset allocation as well as Manager selection. It met with Clyde quarterly to understand what he was doing and to provide oversight. Experienced Committee members sometimes suggested specific Managers to Clyde, but decisions and accountability stayed with Clyde. Resulting performance has been very good.

- ▶ *Experienced investors who have had accountability for institutional performance, not just narrow dimensions of finance and Wall Street, can keep a Fund from going awry.*
- ▶ *Finding the right outsourced CIO can be a great solution, even for a large Fund.*

“E<sub>x</sub>perienced

Committee members

sometimes suggested specific

Managers, but decisions and

accountability stayed with

the OCIO.”

### The Transition from Managing to Governing

In the early 1990s the Investment Committee of Brownhurst College, with some help from a Consultant, was directly responsible for asset allocation and the selection of all Managers for its \$500 million Endowment Fund. An assistant treasurer implemented Committee decisions. Committee meetings, with 16 members and half a dozen staff, faculty, and students sitting in, were too large for useful discussions and timely decisions.

In 2000 the college decided to hire a first-rate CIO, who recommended asset allocation and Manager selection. While the Committee approved essentially all of the recommendations, it took several years for high-powered investment executives on the Committee to adjust to no longer being the ones calling the shots, despite commitment to a Staff-driven process.

Because of the Committee's large size, the college experimented with a structure in which Subcommittees were appointed for each of the main asset classes. This proved sub-optimal, because Committee members became balkanized and it was difficult for the CIO to manage the portfolio holistically.

A Chair recognized the need to reduce the size of the Committee and pared it to eight members, each of whom was a seasoned investment professional. This

reduction was very difficult, because a seat on the Investment Committee was considered a prized assignment. The smaller Committee, however, functioned far more effectively.

Dynamic Committee members continued to suggest alternative Managers to the CIO, and they opened doors to hard-to-get-into partnerships. The CIO and her staff always explored those suggestions, but they made their own determinations, and the Committee held them accountable.

The smaller Committee size, the elimination of Subcommittees, and the retention of the talented CIO resulted in strong and consistent performance for the following decade.

- ▶ *Managing by Committee is rarely effective, and it's particularly ineffective with a large Committee.*
- ▶ *The Chair successfully transitioned the Committee into a governance role.*
- ▶ *Veteran Committee members learned to support a strong CIO when they were no longer calling the shots.*

“The Chair pared the Committee to eight members. This reduction was very difficult, because a seat on the Investment Committee was considered a prized assignment.”

## A Simple Approach for an Aggressive Portfolio

The Caminella Institute made grants each year to a range of scientific projects, and it recognized that the projects it funded would require ever more expensive equipment. To accomplish its goals, the institute would want to make increasingly large awards from its \$450 million Endowment Fund.

The Investment Committee understood, and it told the Board of Directors that the most effective way to accomplish that was to invest in a portfolio that was essentially 100% equity – very diversified equity – but with no allocation to fixed income. That would mean living with above average volatility in market values.

The Board felt it could withstand the volatility if it adopted a long-term smoothing rule on payouts. It did this by establishing a Payout Policy consisting of 60% of the prior year's withdrawal and 40% of the 5-year Moving Average return of the Fund.

The nine-member Investment Committee was composed of people involved in investing. They decided to divide the investment of the Fund between Index Funds and a Fund that was strong in private equity and whose long-term investment record had been competitive with the largest university Endowments. The Fund took its lumps in 2008 without flinching, as the Organization's Payout Policy limited its pain.

- ▶ *The Board based its Payout Policy on its spending needs and established an Investment Policy appropriate for that Payout Policy.*
- ▶ *The Committee was comfortable about being different because it had thought carefully about what was best for the Organization and the importance of an unusually high risk tolerance.*
- ▶ *A Committee of experienced investors chose effectively to outsource the management of its Fund.*

“**T**he Board felt it could withstand the volatility if it adopted a long-term smoothing rule on payouts.”

### The Effectiveness of a Subcommittee

In the late 1990s John joined the Investment Committee of Hillmire Health Institute, which had co-invested Endowment Funds totaling \$400 million. The Investment Committee consisted mainly of representatives of co-invested department heads and affiliates. They kept constituents feeling informed and involved. John, the former CIO of a Long-Term Fund, was the only Committee member with significant experience with a Long-Term Fund.

At John's first meeting with the Committee, a newly hired Consultant made his first presentation, recommending a new asset allocation. The recommendation omitted a number of asset classes that John felt were important, so he convinced the Committee to table the decision until the Consultant revised its asset allocation recommendation. John then followed up separately, suggesting to the Consultant a Manager or two for those asset classes.

The Consultant's revised recommendation at the next meeting included the asset classes John suggested and one of the Managers he recommended. Over time, the Consultant and John established a highly productive relationship, whereby John felt welcome to make specific suggestions. The Consultant would study them seriously and then either adopt them or tell John why not. Over time the Consultant's recommendations steadily improved.

The Institute's finance officer and the Investment Committee Chair asked John to form a three-person Subcommittee with them to review the Consultant's proposals prior to each Committee meeting and to set the agenda. The give and take during these pre-meeting conference calls was very productive, as the Subcommittee could cut through complex recommendations and ask technical questions as additional due diligence. The Subcommittee made sure that proposals to the Committee were ones it could support.

Prior to each quarterly meeting, Committee members received several inches of information about

performance, plus a separate packet with new recommendations. That's an eye-glazing stack of information, especially for a lay person. All Committee members were encouraged to ask questions, and they did. But many recommendations might have had trouble gaining approval if many Committee members had not been aware of the Subcommittee's prior analysis and support.

In fact, the Consultant made recommendations to the institute that it didn't make to many other clients because it knew, through the Institute's Subcommittee, those recommendations would get an informed and open-minded hearing. At times, the Consultant would find an opportunity for a private fund with a very short time line, and the Subcommittee was authorized to approve such commitments.

The Subcommittee, however, made sure that the Consultant was accountable for all results. For any given recommendation of a new Manager, the Consultant and his staff are the ones who had done the extensive due diligence. The Subcommittee probed the due diligence, but ultimately the Committee felt it had to approve most such recommendations as long as it retained confidence in the Consultant.

The competence of the Consultant and its staff improved steadily, so that today the Funds' long-term investment performance has been one of the best among peers.

- ▶ *A small Subcommittee can provide the leadership for a large, more unwieldy, broadly representative Investment Committee.*
- ▶ *Challenging a Consultant can elicit the best the Consultant can do for a Fund.*
- ▶ *While probing the due diligence of its proposals, the Subcommittee still held the Consultant accountable.*

“The Subcommittee  
vetted Consultant  
recommendations before they  
were presented to the full  
Committee.”

## The Difference Between Eggs and Chickens

The Wynders Family Endowment (WFE) is a multi-generation family Endowment Fund intended to provide long-term stable payouts in inflation-adjusted dollars and thereby provide generally comparable benefits to present and future recipients.

During the 1970s WFE invited some of the best strategic thinkers with investment, finance, and legal backgrounds to join the governing Board for its \$150 million Fund. Then, after articulating the above objective, the Board adopted the following framework: it was in the egg farming business, with eggs representing income and chickens representing capital, so that the price of chickens was only of passing interest. The Payout Policy equaled 130% of the portfolio's dividend yield. To avoid impairment of its ability to make a stable payout in inflation-adjusted dollars, the Board established a "dividend continuation reserve" it believed would be big enough to cover the shortfall in dividend payments such as occurred in the 1930s. This reserve, equaling 15% of the portfolio, was invested in high-quality mid-term municipal bonds, with the balance of the portfolio invested in dividend-paying blue-chip stocks and REITs.

Finally, the Board hired an external master Investment Manager at a competitive fee to implement its "egg farming." That Manager, hired 20 years ago, remains in place today.

During the second half of the 1990s asset growth far outpaced payout growth. While some family members wanted an increase in payouts, the Board decided not to exceed its payout formula. Then in 2002 the Board was able to draw on its dividend continuation reserve to offset falling egg production. Through the next 10 years, including the travesties of 2008, the Board was able to navigate through with sustainable finances and no trauma. Over its 37 years, the principal value of its Fund has doubled in real terms, as have distributions from the Fund to its beneficiaries.

- ▶ *A disciplined Payout Policy was based on a deep and realistic understanding of investment markets.*
- ▶ *A portion of earnings in good years was used to fund a reserve for bad years.*
- ▶ *The Board developed a solid long-term relationship with a strong outsourced CIO.*

“**T**ying strategy to the needs of the Organization.”

## Case Studies: Effective Investment Committees (continued)

### The Synergy of Investment Committee and Consultant

“The synergy of the steering committee and the Consultant led to a sophisticated portfolio.”

Ravenville College, with a \$100 million Endowment Fund, had many distinguished alumni. Its nine-member Investment Committee was composed of alumni and parents who were all highly successful investors in managing hedge funds, private equity, or real estate. All were willing to devote as much time as it took to arrive at sound investment decisions. Despite their varied investment backgrounds, the Committee managed to be unanimous in all its decisions.

They met quarterly, plus a two-day meeting in New York City, where they met with a dozen Investment Managers. They also had a “steering committee” of four of their members, which served, in effect, as the Fund’s CIO. The four met between quarterly meetings to review Managers and make recommendations, and if a decision was needed between those meetings, it was accomplished via email. The college’s CFO handled administrative functions.

A dozen years ago the Committee replaced a large national consulting firm with a smaller one with whom the Committee developed an excellent relationship. The larger firm was not willing to consider Managers suggested by the steering committee without charging for the additional Manager search, but the smaller one was, and the Fund today includes a number of Managers suggested by the Committee members. The synergy of the steering committee and the Consultant led to a sophisticated portfolio that includes 20% of assets in a range of hedge funds, and another 10% in private equity and real estate. The long term performance has been top decile.

- ▶ *Diverse Committee members had a common sense of purpose and respected each other’s differences.*
- ▶ *A strong Consultant made the most of the deep experience of veteran Committee members.*

## An Effective Consultant

For years, Larchworth Society operated its \$100 million Endowment Fund without a CIO. The Investment Committee of seven was chaired by a large donor who was a principal in an investment firm, and he drove most decisions. The Committee included a couple of other members of investment management firms and several lay Board members.

The Committee members had trouble reaching decisions, since they felt they always needed to reach unanimous agreement, and several members had strong views. A result was that the Committee needed multiple quarterly meetings to establish asset allocation decisions or to change an Investment Manager, and the Committee couldn't respond promptly to changing situations. The Committee was not closely connected to the financial situation of the overall Organization, and performance was mediocre.

Problems came to a head in 2008, when market values and liquidity plummeted. The market value of some Endowment gifts actually dropped below cost, which prevented the society from making all of the withdrawals called for by its Endowment Payout Policy. In addition, the reduced market values breached loan covenants of the Society. Members of the Finance and Investment Committees got together and decided at the end of 2008 that the Society needed a Consultant.

The Consultant's first job was to understand the Organization, its sources of support, its reliance on the Endowment Fund, and its lines of credit. The Consultant then worked with the Committee to define the risks the Society could face in the years ahead – something the Committee had not done before.

Step one was to cover the Organization's bond covenants, so the Consultant led the Committee to focus on yield-oriented investments, such as high-yield bonds, senior bank debt, and higher-yielding stocks. By 2010-11, as the market recovered, bond covenants were again met, and the market value of donor-designated Endowment assets returned above cost, so the Committee moved to a more growth-oriented asset allocation and a Moving Average Payout Policy.

During these years, the Committee members most amenable to this sequence of actions were some of those without investment backgrounds. The Committee Chair changed to a person who managed a private investment fund, and he led the Committee to form a constructive partnership with the Consultant to tackle issues together. The Consultant would review recommendations with him and others before presenting them to the whole Committee, leading to a productive give and take.

The result has been improved performance and an Investment Committee that is now integrated with the overall organization.

- ▶ *Management by the Investment Committee was ineffective.*
- ▶ *The Consultant helped the Committee focus on the right issues. The new Committee Chair established a constructive partnership with the Consultant.*

“**T**he Consultant's first job was to understand the organization.”

## Case Studies: Effective Investment Committees (continued)

“The Chair convinced the Committee that it should focus on asset allocation and outsource the selection of Managers.”

“No Fund is too small to be invested effectively.”

### Learning To Govern

Lyell Academy, with \$75 million, had a five-member Investment Committee, chaired by a highly experienced institutional investor. Another Committee member was with a private real estate firm and a third with a private energy firm. These other two were big donors. At the time the Chair joined the Committee, the Fund had a plain vanilla portfolio with less than optimal diversification, and the Committee met regularly with its Managers.

The Chair convinced the Committee that it should focus on asset allocation and outsource the selection of Managers. That took a bit of convincing, especially with the two big donors. Ultimately, the Committee outsourced the portfolio to an Investment Fund that covered all asset class sectors except real estate. The Committee did its own real estate investing through REITs.

Once the Committee outsourced the selection of Managers, what would be the role of the Committee? That was never a problem. Quarterly meetings were far more effective talking about asset allocation, long-term risks, learning about new asset classes – and, of course, monitoring the outside Manager.

- ▶ *The Chair was a realistic leader who refocused the Committee on the right issues.*
- ▶ *Another example of where outsourcing the CIO proved effective.*
- ▶ *The Investment Committee discovered its proper role in governing.*

### A Mini Fund

In the 1980s Community Players, which sponsored amateur theatrical productions several times a year, received a gift of \$10,000, and its Board decided to use it to start an Endowment Fund. How should the Board invest it?

The Board fortunately included one member who was CIO of a Long-Term Fund. He agreed to become Chair and directed its investment into 10 well-diversified no-load mutual funds, allocating 80% to equity funds. When assets approached \$100,000, he established a custodial account with a local bank.<sup>19</sup> Over the next 15 years, with the help of new contributions, the Endowment Fund grew to exceed \$1 million.

For the full 25 years since inception, the same person remained Chair of the Organization’s three-person Investment Committee and continued to direct the Fund’s mutual fund investments. Over those 25 years, the Fund earned a satisfying annual rate of return of 10%. Analysis showed, however, that the total return and volatility would have been close to the same if the Fund had instead been invested entirely in Index Funds.

- ▶ *No Fund is too small to be invested effectively.*
- ▶ *The Board was fortunate to have a Chair who possessed extensive investment experience.*
- ▶ *Performance was very good, but indexed investments could have done almost as well, with less effort in mutual fund selection.*

<sup>19</sup> Alternatively, he could have established a trust account with a brokerage firm.



## Case Studies: Less Effective Investment Committees

### Bureaucracy at Work

The Investment Committee for the State of New Fancaria's \$50 billion Pension Fund appointed the CEO and CIO. It was responsible for evaluating the performance of these senior officers and, in most cases, also for approving the hiring and firing of Investment Managers. The Committee consisted of 13 members – six union members, three political appointees, and four ex-officio members. None had any direct investment management experience.

The Pension Fund was subject to statutory payroll laws, so it had to follow a long process to fire an Investment Manager. The payroll laws also limited Staff compensation. As a result, the Fund had a hard time attracting experienced talent. It had five CIOs between 2000 and 2012, and Staff turnover was 14%.

The Committee concerned itself with social, environmental, corporate governance, and local development issues, some of which became costly to the Pension Fund. The Fund invested in a number of private investment programs run by people who were major donors to local political campaigns. Unlike private Pension Funds under ERISA, public Pension Funds are not required to invest solely for the benefit of plan participants.

For the 10 years ended 2010, the Fund's average annual return was 3.0%, while states with more than \$1 billion in assets compounded 5.0%.

- ▶ *An advisory committee of experienced long-term investors, whose advice the Board heeded, would have benefited the State greatly.*
- ▶ *The State's government might also have benefited from a special adviser to help the Board develop best practices in its governance structure.*
- ▶ *Concerns about issues other than Fund performance degrade returns.*
- ▶ *Conflicts of interest are an anathema to an Investment Fund.*

“C

Concerns  
about issues other  
than Fund performance  
degrade returns.”

## Case Studies: Less Effective Investment Committees (continued)

### The Glamor of Alternatives

In 2008 the \$1 billion Foundation for Immunization Research established an Investment Committee consisting of five Board members, with little investment experience, and it contracted with three highly experienced long-term investors to join the Committee – Harry, Peter, and Martha. Harry, who managed private investments, recommended that the Committee either outsource the management of the Fund to a proven management firm or else index the portfolio.

Peter and Martha were dead set against indexing because they felt that would leave them nothing much to do. The Committee decided to hire as CIO an investment firm founded by someone who had been with a large university Endowment Fund for three years and then decided to open his own shop. He had not been CIO of a Long-Term Fund, and the Foundation was his first client.

Peter and Martha were very active in introducing the CIO to private equity and hedge funds that were

difficult to enter. That was a win-win-win in the sense that the Foundation was able to join a profitable club, the Manager was able to add to its client roster a prestigious name (the Foundation), and the Committee members' reputation was enhanced. Harry, who favored Index Funds, was quietly dropped from the Committee. Ultimately, the portfolio consisted almost entirely of alternative investments, about a third in private equity, half in equity-oriented hedge funds, and the rest largely in credit-oriented hedge funds.

As of the end of 2013, the portfolio had missed the major thrust of the five year bull market. Of course, that's a short-term view. With many private investments, long-term results won't be known for some years.

- ▶ *Managers of alternative investments may not have the same breadth of perspective as those who manage Long-Term Funds.*

“Harry, who favored Index Funds, was quietly dropped from the Committee.”

## A Committee Managing on Its Own

Ingrid, the veteran CIO of a Long-Term Fund, joined the Plansiton Historical Society as Chair of the Investment Committee for its \$1 billion Endowment Fund. The Committee of seven volunteers included one other professional investment manager. As Chair, Ingrid was challenged, because most quarterly meetings were attended by only four or five members, and subsequently those absent sometimes questioned actions that were taken.

The Chair dealt with this problem by initiating extensive communication with individual members between and before each meeting. She also assigned two-person teams to conduct research for the Committee – such as investigating social investing or evaluating a particular Investment Manager. In each case she asked one person to prepare a pro recommendation and the other a con.

The Committee had neither internal investment Staff nor a Consultant. It took full responsibility for both asset allocation and for the selection of Managers. Asset Allocation had been set before the Chair joined the Committee. The Committee reviewed asset allocation once each year and tweaked it tactically. The Committee subscribed to a Manager database service, from which it sourced Managers to

investigate. The members assigned to investigate a Manager were expected to visit the Manager and use a standard set of questions the Committee had developed for the purpose.

The Committee compared its results with those of a national environmental organization and with the NACUBO returns of college Endowment Funds. Not surprisingly, its portfolio underperformed the NACUBO results. The Committee had no ability to be opportunistic, and it held only a small exposure to alternative investments through funds-of-funds.

The Chair agreed that the Committee would have fared better if it had outsourced a CIO, because the Committee was managing instead of governing.

- ▶ *Portfolio management by a Committee without the resources to manage is generally destined to be suboptimal. The Committee was spending its time on the wrong issues.*
- ▶ *The Committee must learn to govern instead of managing, but at least – by comparing results with those of NACUBO – it targeted a measure of success.*

“**T**he Committee  
had no ability to be  
opportunistic.”

## Case Studies: Less Effective Investment Committees (continued)

### A Fund With No Written Objectives!

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Calindrome Institute set up a foundation to receive royalties for pharmaceuticals that it had patented. Royalties came in slowly, with most coming in by 2006-07, when the Fund reached some \$400 million. The Investment Committee consisted of seven founders of the institute, none of whom was experienced in long-term investing. For the previous 10 years the Committee relied largely on its regional Consultant, but the institute had no Investment Policy to articulate its investment objectives, and its investment returns were hardly mediocre. Payouts were decided on a year by year basis.

Janet joined the Committee in 2009 and found an asset allocation that included 40% in fixed income and about 20% in poorly performing private investments. She learned that few Committee members liked the Consultant very much, but they had no process to evaluate it and consider alternatives.

Janet, whose background was in helping manage a hedge fund, recruited a few more Committee

members with investment experience. She initiated a Consultant search that led to the hiring of a large national consultant. Together, they established an Investment Policy for a perpetual Fund, while the Institute's spending continued to be discretionary each year. The Committee today must approve asset allocation and Investment Manager appointments, but it relies heavily on its Consultant's recommendations. Performance has improved, as fixed income investments are now down to 6%, but prior private investments continue to be a drag.

- ▶ *An Investment Committee without any long-term investing experience is seriously handicapped.*
- ▶ *An organization without an Investment Policy is rudderless and likely to disappoint because it has no established direction.*
- ▶ *A policy of annually evaluating the Fund's Consultant would have gotten the institute onto the right track a lot sooner.*

## The Danger of Excessive Payouts

Mirkiston College had a \$150 million Endowment. The Board consisted mainly of alumni and parents, and it included only a few members with any investment experience. Its Finance Committee eventually added a member with hedge fund experience, but it basically relied on a large, well-known Consultant, who made asset allocation and Manager recommendations. Committee members were ill equipped to ask appropriate questions of the Consultant. As a result they basically rubber-stamped the Consultant's recommendations.

The eight-person Finance Committee met on campus three times a year on the same date that the Board met. It eventually found investment considerations too time-consuming to deal with, so it appointed a subset of its members to become an Investment Committee that reported directly to the Board. The Finance Committee was no longer responsible for Investment Policy decisions, and the Board became the body to ratify recommendations.

## Getting the Right Governance Structure

Carrigan Trust consisted of four entities, each with its own Endowment Fund, which together amounted to \$150 million. Each entity had its own Investment Committee, its own asset allocation, and its own set of Investment Managers. Each Committee acted as its own CIO, as none had a Consultant or Staff. The combined Committees totaled 20 members, including several investors who managed money for high-net-worth clients.

Chairs of the four Committees formed a fifth, overarching Committee, which had to approve each Manager selection. As a result, because each of the Committees met at different times, it took an extended time to effect a Manager change.

Tracy, the CIO of a Long-Term Fund, became Chair of the overarching Committee in 2004, and after a couple of years she convinced all the entities to hire a single Consultant to act as their CIO. Each

The two Committees, however, had conflicting objectives. The Investment Committee was seeking investment return from its 60/40 asset mix, while the Finance Committee was primarily concerned with balancing the school's short-term budget. The Payout Policy called for 5% of a Moving Average of market values, but in order to meet the needs of the college, the Finance Committee recommended payouts greater than 7% in the early 2000s. These payouts put great pressure on the Endowment, compounded further by the 2008 market debacle. Subsequently, the college had to sell some of its assets to shore up its Endowment.

- ▶ *A Committee without investment or tangible business experience is inadequate for the task.*
- ▶ *Investment Policy was not aligned with the needs of the Organization.*
- ▶ *Making redemptions from an Endowment in excess of normal Payout Policy – especially over multiple years – can be a road to disaster.*

Committee retained the authority to approve both asset allocation and Managers, and for the most part, they followed the Consultant's recommendations. But they did not hold the Consultant accountable.

Investment returns improved but could have been much better.

- ▶ *Management by Committee – especially by multiple Committees – can be a dysfunctional structure.*
- ▶ *The Chair began to steer the Committee toward the right issues.*
- ▶ *Who is accountable? Steps in the right direction have still not clarified that.*

“**I**nvestment Policy was not aligned with the needs of the Organization.”

“**T**oo many cooks spoil the broth.”

### The Dysfunction of Management by Committee

Bob, the former CIO of a Long-Term Fund, joined the nine-person Investment Committee of the Faulkner Art Museum, which had been established 20 years before. Bob was the only investment professional on the Committee. The \$100 million Fund had an Investment Policy Statement, but it had rarely been looked at.

For 10 years the museum had used a large national consulting firm as CIO, but the Consultant's approach was what Bob called "cookie cutter" – not tailored to the individual client. Bob began by asking for an updated Investment Policy Statement and received an off-the-shelf version. The Consultant had a standard asset allocation for most clients and a set group of Investment Managers it recommended. Bob asked about alternative approaches and some different Managers, but he initially received push-back from the Consultant. Perseverance paid off, however, and after a few years, the push-back subsided.

The Committee met directly with its Investment Managers and averaged a dozen such meetings a year. Bob found himself in the uncomfortable

position of asking most of the questions, and then other Committee members looked to him when it came time for a decision. Attendance at Committee meetings was not great. Between quarterly meetings there were occasional conference calls relating to the hiring and firing of Managers.

Over the years the Committee recruited members with substantial investment background, and as they worked together with the Consultant, the Fund's performance improved, although it still didn't equal that of its peers.

- ▶ *The beauty contest left an ill-equipped Committee accountable for managing the portfolio instead of the Consultant.*
- ▶ *A key Committee member moved a large consulting firm to focus more closely on the needs of that particular Organization.*
- ▶ *Finding a Consultant CIO in whom the Committee could have confidently given greater authority would have been a better solution.*

“The Committee met directly with its Investment Managers and averaged a dozen such meetings a year.”

## Conflicting Priorities

The Metropolitan Foundation, devoted to the support and development of its immediate metropolitan area, had assets of about \$100 million. The Foundation's 12-member Investment Committee was composed of investment professionals from local banks, brokerage firms, universities, and corporate Pension Funds, as well as a couple of local attorneys. The Foundation's Staff competently carried out administrative responsibilities, but it was not otherwise a contributor to investment decisions.

The Foundation's Investment Policies included a conservative asset allocation, and its Investment Managers were predominantly local banks and other local investment firms. The Foundation's executive director felt that substantial allocations to those local institutions were important in their support of the Foundation's annual fund drive.

At each quarterly meeting the members reviewed recent performance, and Investment Managers often made presentations. Various Committee members might initiate investment proposals, and the Committee would then discuss them and vote on

them. No benchmark was set for the total Fund, but the local Custodian's report showed each Manager's results compared with its own benchmark. Results were relatively disappointing, especially for the local Managers, and eventually, over a period of 20 years, the pressure to use local Managers eased. Finally the Committee hired a Consultant.

The Committee discussed the Consultant's recommendations at its quarterly meetings, and it adopted many, but not all, of them. It continued to be reluctant to place a material allocation of the portfolio into alternative investments. Performance improved but was not outstanding. Because the Committee did not follow some of the Consultant's key recommendations, the Committee could not hold the Consultant fully accountable for results.

- ▶ *Any criteria other than investment capability weakens investment results.*
- ▶ *Management entirely by a Committee – especially a large one that meets quarterly – was destined for mediocre performance.*

## Unnecessarily Cautious

The Investment Committee for the Wallingsworth Museum's \$30 million Endowment Fund was composed of seven members – all of whom managed sizable amounts of money professionally. The Committee managed the Fund without the help of a Consultant.

When Charles became Chair, he found that the Fund had an extremely conservative Investment Policy, resulting in substandard investment returns. All eight of its stock and bond Managers were benchmarked against U.S. security indexes, and the retention of cash was excessively large. This was astonishing because each of the Committee members took vastly more risk with the money he himself managed than he would approve for the museum's portfolio.

Charles worked hard to convince fellow Committee members that the museum had a long time horizon for its Endowment Fund, could withstand more volatility, and that the Fund should take advantage of that long time horizon. Charles was able to stay for only a couple of years, but during that time he was able to get the Committee to hire its first Manager of a global portfolio and its first hedge fund.

- ▶ *Committee members must be willing to accept a level of risk high enough to gain the investment return advantage of a long time horizon.*
- ▶ *A Consultant who took a sufficient interest in the \$30 million fund would have reminded Committee members of this fact.*

“The Foundation's executive director felt that substantial allocations to those local institutions were important in their support of the Foundation's annual fund drive.”

“Because the museum had a long time horizon, it could withstand more volatility in its Endowment Fund, and it should have taken advantage of that long time horizon.”

## Case Studies: Less Effective Investment Committees (continued)

“Committee meetings with Investment Managers generally reveal only who is the most articulate.”

### Going Through the Motions

The Investment Committee of Iverson Memorial Hospital was responsible for a \$10 million Endowment Fund. The Committee, including several experienced investors, relied on an internal CIO who, in turn, relied on a Consultant to build a 30-Manager portfolio. The CIO and the Consultant were both new in the past two years, during which time most of the Managers were hired.

The CIO was charming and articulate, and he had the confidence of most Committee members at its quarterly meetings. Any new Investment Manager he recommended made a presentation to the Committee and was available for questions until time for lunch.

The Committee members found the presentations interesting and enjoyable, but some worried that the knowledge of the 30 different Managers by the CIO and Consultant was not as strong as that of their peers. Performance was about average, but some members thought that it could have been a lot better with fewer, stronger Managers.

- ▶ *Meetings with Investment Managers, especially short meetings, generally reveal only who is most articulate, not who is the best investor.*
- ▶ *30 Managers is a lot for a \$10 million Fund.*



## POSTSCRIPT

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These cases illustrate, perhaps more effectively than anything else, the difference an Investment Committee can make if it follows Best Practices. Each situation is different, depending on the sophistication of the sponsoring Organization, the size of the Fund, and the resources available to it. But the same underlying principles apply essentially to all.

We are greatly indebted to the many veteran members of Investment Committees (whom we are keeping anonymous) who shared their experiences for this white paper.



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