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Guidance for investment committees is overdue

By Stephen Mcmenamin

The need for guidance for investment committees is overdue. In the U.S. market alone, there are well over 100,000 asset pools of all sizes that have long-term investment objectives. Their assets total more than $14.6 trillion, counting only endowments of universities and colleges, foundations, and the 1,000 largest retirement funds. Perhaps half a million people sit on their boards of directors, and another half a million of people, who are not members of the boards, sit on their investment committees. While there are many investment committees that achieve the advantage of good governance, a great many have no clear understanding of how they should function.

In an effort to provide guidance, the Greenwich Roundtable's education committee has just published a white paper, Best Governance Practices for Investment Committees. The paper addresses the long-term investment needs — from megafunds to very small funds — of pension funds, sovereign wealth funds, foundations, endowments, insurance companies, charitable organizations and other asset owners. It includes 29 real-world case studies of committees that were particularly effective and committees that might have been more effective if they had applied best practices.

Govern, not manage

Principles deal with the structure and operation of the investment committee, the roles of its chairman and members — as well as roles of the organization's chief investment officer and other investment staff — and the development of a statement of investment policy.

An overriding theme is that the investment committee should govern, not manage. The investment committee must understand the particular needs of the sponsoring organization and tailor its investment policy to those needs. Its primary role is to:

- establish investment policy, including risk limits;
- review this policy periodically for continuing appropriateness; and
- ensure that the organization's investment program remains consistent with this policy.

The buck stops with the board of directors. But the board should hold the investment committee accountable and should specify which few of the committee's decisions must be ratified by the board. In turn, the investment committee should establish investment policy and hold its chief investment officer accountable — either an internal CIO if the organization is large enough, or an external CIO for most organizations.

Many organizations hire consultants to bring recommendations for the investment committee to decide. The committee is then managing, not governing. The investment consultant and staff perform the diligent research on investment managers and can judge which ones best meet hiring criteria. Committees are ill-equipped to select among candidates suggested by their consultant. Also, CIOs can make operational decisions on a timely basis. Committees need to understand what their CIO is doing, ask hard questions and occasionally make specific suggestions. A CIO needs to take advantage of a suggestion by a well-informed committee member, but the CIO must take accountability for making the ultimate decision.

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.

All too many committee 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.

Probabilities, outcomes

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

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.

Other key themes and behavioral insights in the paper include:

- The duty of loyalty and fiduciary responsibility. Actions that might benefit a committee member or any family member or friend should be avoided. (There are rare occasions when a decision might benefit a party-in-interest but is still in the best interest of the organization. For such a decision, the party-in-interest should leave the room for the final discussion and voting.) Committee members must adopt the mindset of the organization's long-term investment horizon, which is typically very different from a member's own personal investment horizon.
- The board, with the help of the finance and investment committees, should establish a payout policy for making distributions from the fund (except, of course, for a pension fund). That payout policy should reflect both realistic investment expectations and the particular needs of the organization.
- The core of an investment committee should consist of people with experience investing a long-term institutional fund. The more members with this experience, the stronger the committee. Few brokers, bankers and insurance executives have fiduciary experience with a long-term fund and can serve as core members. (But that doesn't necessarily make them unacceptable members.) Small organizations might be fortunate to have a single member with this experience.
- A five- or six-person committee is often considered large enough to have diverse experience, expertise and opinions, and small enough so everyone gets heard and understood. Three might 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 will take less ownership when in a large group.
- Diversity in experience, training, background and education can be highly advantageous, providing different functional knowledge and ways of thinking. Non-diverse committees often fall victim to group-think. Sound investing requires counterintuitive thinking and occasional willingness to go against the grain of generally perceived wisdom. A member who offers unique information or perspective can be disruptive to the social balance of the committee, but that can be a good thing. Committee members engaged in so-called social loafing — unwilling to speak up with their opinions or share their insights — add little to a committee. The committee chairman should encourage alternative information, ideas and solutions.

Asset owners should use these best practices to think about the structure and operations of their own investment committee, asking questions about what steps their committee might take to strengthen them. For investment committees formed by a political process, such as for public funds, "Best Governance Practices" can serve as a rational justification for operating without the dysfunctional influences that can accompany large pools of public money.

Stephen McMenamin is executive director of The Greenwich Roundtable, an interdisciplinary group of institutional investors who collaborate to identify the best investment practices in the rapidly changing world of non-traditional strategies, otherwise known as alternative investments, although many of its insights also apply to mainstream asset classes. The commentary is based on The Greenwich Roundtable's report, "Best governance Practices for Investment Committees."