optimal investment committees

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Most institutional funds are governed by an investment or finance committee and many families choose to make decisions based on the consensus of a group of family members. Yet, while they outperform retail investors, there is considerable evidence that most institutional funds do not meet their performance objectives and our experience suggests that many families do not manage their money in a decisive, business-like manner.

Early in 2012, we published a paper titled "The Ten Biggest Mistakes in Investing" which gave our take on why so many investors do not perform very well. A few of the more common mistakes we cited were:

- Frequent hiring and firing of investment managers due to overreliance on short term performance
- Hiring managers after they have outperformed
- Moving into asset classes after they have performed well
- Abandoning sensible investment strategies at exactly the wrong time

This paper provides our thoughts on how to structure an investment committee or other governing body that is less likely to make these and other common investment mistakes. While we focus primarily on institutions, families will be well served by following the recommendations discussed herein to the extent possible. Of course, we don't have all of the answers, but what follows represents a blend of our own experience with committees and the writings of some of Wall Street's most astute observers.

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investment versus finance committees.

Some institutions have separate finance and investment committees while others choose to concentrate the investment and budget/finance functions in a single committee. There are pros and cons of each approach. The primary rationale for a separate investment committee is that it should contain members with specific skills and experience in the investment arena and they should assume direct accountability for the performance of the fund. In contrast, the principal benefit of the combined committee is that it allows for a holistic view of the institution or family that includes the interaction of budget and investment issues. Specifically, some more sophisticated institutions now look at issues such as risk, liquidity, and sensitivity to economic/market shocks on an enterprise basis rather than for the investment fund and operating entity separately. While we have seen both models operate successfully, we come down in favor of a separate investment committee that is truly accountable.

However, under this model, it is critical to have strong communication between the two committees and a periodic joint meeting is appropriate.

size and membership.

Interestingly, there is a large body of academic literature on committees in general, and optimal size in particular. There is some variation in their conclusions but most agree that smaller is better. Specifically, the consensus seems to be that four to six members represents a size that allows for a diversity of skills while also increasing the likelihood of crisp decision making.

Practical Application

Peer Group Resources on Governance Best Practices
Many groups such as the Council on Foundations, NAIS (National Association of Independent Schools), NACUBO and others have best practices on board committee governance. These groups can serve as a resource for your investment committee with new member orientation and training.

Risk Management
Inquire with the institution about their level of Directors' and Officers' (D&O) Insurance and your own personal coverage. D&O provides coverage against actual or alleged errors, omissions, misleading statements, and neglect or breach of duty. The Volunteer Protection Act of 1997 protects volunteers from liability for simple negligence but board members can be included in a variety of litigation such as sexual harassment, wrongful termination, and discrimination.

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Some social psychologists recommend an even number of members because that allows for a majority vote without forcing the chair to be the tiebreaker. With regard to term length, most agree that the optimal length of service should balance the value of institutional memory with the energy and new ideas frequently associated with "new blood."

What kinds of people make good investment committee members? Of course, the best committees contain a diverse set of skills and personalities so there is no ideal candidate. But, as a point of reference, we divide desirable personal characteristics into three groups: skills/knowledge, personality traits, and behavior. Let's begin with skills/knowledge. Members should have:

- Enough investment knowledge to have an understanding of the nature of the fund, its goals and objectives, and the resulting risk/return characteristics of the investment portfolio
- Some knowledge of the principles of portfolio construction including correlation, diversification, and related topics
- Knowledge of current investment trends and best practices
- Knowledge of specific investment categories as well as general financial savvy

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These characteristics clearly suggest that some members of the committee need to be financial professionals, or at a minimum, serve on other committees that provide considerable information on investment trends and practices.

Keen observers of investment committees report that most gravitate toward middle-of-the road, consensus decisions that are comfortable but result in mediocre performance.

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The best antidote to this tendency is to include members with the following personality traits:

- Intellectual curiosity and a degree of rigor
- The courage to take a controversial or unconventional position
- The ability to balance patience and decisiveness
- An open mind-particularly to new or controversial ideas

A quick reading of these personal characteristics points to knowledgeable, experienced people who are independent, frequently opinionated, and generally decisive. Unfortunately, these traits can also lead to dysfunctional committees because some individuals with these characteristics engage in the following behaviors:

- Dominating the discussion without allowing for the opinions of others
- Imposing their own risk preferences on the committee
- Imposing their own investment or political outlook on the committee
- Over-advocating for a particular investment strategy or manager

So, it is critical that members leave their egos at the door and focus solely on making a significant contribution to the effective functioning of the committee by respecting the input of colleagues and allowing for open discussion. Although sometimes difficult, it is also important for the chair to gently but firmly step in if a member of the committee persists in any of these behaviors.

Of course, finding individuals with all of these traits is easier said than done and some boards may not have members with the requisite skills and experience. For that reason, many institutions and some families now allow for membership on the investment committee by individuals who are not members of the governing board or family. In addition to marshaling the desired skills, this practice also allows for a "free look" at potential future board members. Once you identify suitable members of an investment committee, how do you improve the odds that it will function effectively? We believe the answer lies in effective governance and healthy committee dynamics.

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good governance.

Important Notes And Disclosures

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Every fund, either individual or institutional, should be governed by an investment policy statement that governs all aspects of managing the fund. Specifically, it should include, among other things, clear delineation of the responsibilities of the committee, internal staff, consultants, external investment firms, and so on. The responsibilities assigned to the committee should lead directly to a charter that should govern all aspects of its work. And, as should be specifically addressed in both the policy statement and charter, the committee must formally assume direct and collective responsibility for investment performance and risk management. The fund's investment objectives should be specific and quantifiable and performance benchmarks identified.

The Committee should also have a clear policy regarding conflicts of interest. Because investment professionals make logical candidates for membership on investment committees, the committee must determine whether it is acceptable for the firms that employ committee members to manage funds for the institution or family. Similarly, members of the committee should disclose any personal investments with the fund's investment managers or any other business dealings that might give the appearance of a conflict. There should be strong communication between the committee and the entire board regarding the fund's goals, risk tolerance, and the achievement of performance objectives. Perhaps the greatest sin that an investment committee can commit is to surprise the rest of the board with unwelcome news.

Finally, good governance calls for an annual self-evaluation of the performance of the committee as a whole as well as periodic evaluation of each of its members. Given the potential for some of the difficult behavior that was described in the previous section, it is critical to have a mechanism to provide feedback to committee members. In some cases, the chair conducts the evaluation and communicates his or her findings to each member.

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Another model calls for each member to evaluate every other member with the chair once again providing feedback. A third model is for a separate group, frequently the governance committee, to conduct the individual evaluation process based on inputs from each committee member. One advantage of using a separate group is that it facilitates evaluation of the chair by the remainder of the committee. The actual model used can vary as long as the process allows for anonymous input from members of the committee and candid, constructive feedback to each member.

committee dynamics.

Unfortunately, having a right-sized committee with well qualified members and an appropriate governance structure does not guarantee success because many committees suffer from poor dynamics. How do you create a healthy atmosphere? The starting point is the committee chair who should be strong but not autocratic. Most institutions limit the term of the chair to 2-3 years in order to ensure that the committee does not become a personal fiefdom with an entrenched leader. Among other things, it is the chair's job to create an environment that is conducive to open and candid discussion. The climate in committee meetings should foster creative thinking, unconventional ideas, and the ability to move in the opposite direction from the Wall Street herd. Committee members should be able to challenge one another as well as external service providers such as investment managers and consultants without fear of ridicule or retribution. All of these things can only occur in an atmosphere characterized by trust, mutual respect, and a collective ethic to do the right thing. Once again, this tone must be set by the chair. It is also important for the chair to keep the discussion moving at an appropriate pace. The committee should have a thorough discussion of critical issues but then must be willing to act decisively and refrain from second-guessing or re-hashing recent decisions. And, it is important to maintain a list of action items with the assignment of specific responsibilities to ensure proper follow-up. Similarly, there should be a formal calendar that requires that both critical investment issues and housekeeping details be reviewed at appropriate intervals.

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One of the most important keys to success is allocating committee time to the truly important issues which include the fund's investment objectives and risk tolerance, optimal asset allocation, risk management, and performance evaluation. These are the "make or break" decisions that will largely determine the success of the investment program. In contrast, while certainly interesting to many committee members, presentations by investment managers that focus on market prognostications and discussion of individual securities are often non-productive and unlikely to enhance the performance of the fund.

keys to success.

In conclusion, the best investment committees have a certain amount of technical expertise combined with an open, intellectually honest atmosphere. Their members have a proclivity to think unconventionally and a willingness to take positions that are contrary to the prevailing wind. They focus on the truly important issues and refrain from the urge to manage rather than govern. Finally, and perhaps most difficult, they maintain their composure during difficult times. ■

About Bill Spitz: As a Co-Founder of Diversified Trust, Bill has served on the board since its inception and has been instrumental in the ongoing development of the company's investment platform. From 1985 to 2007, Bill served as Treasurer and Vice Chancellor for Investments of Vanderbilt University where he presided over a ten-fold increase in endowment assets, during which time its investment performance placed in the top quartile of large endowments. Bill received NACUBO's Rodney H. Adams Award which recognizes significant contributions to the field of endowment management, and the Hirtle Callaghan Award of Investment Leadership with exemplary investment management performance and unwavering professional ethics. He is also the 2008 recipient of Foundation & Endowment Money Management's Lifetime Achievement award.

Bill also serves on the Board of Directors of Mass Mutual Financial Group, Acadia Realty Trust as well as for the YMCA Foundation of Middle Tennessee. He is also a Trustee of Kenyon College in Ohio. He authored Get Rich Slowly: Building your Financial Future through Common Sense and is a frequent speaker at financial conferences. Bill earned a Bachelor of Arts degree from Vanderbilt University and a Master of Business Administration degree from the University of Chicago, where he was a Leon Carroll Marshall scholar.