RVK INVESTMENT PERSPECTIVES

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Best Practices for Investment Governance

Overview

Over the past several years, academics, investment professionals, and investment firms have produced numerous papers about investment governance best practices. Interest in this topic is fueled by the fact that past research suggests that effective governance may add as much as 100 to 300 basis points to investment returns.[1] While existing research on best practices is valuable, we believe a critical shortcoming is the absence of actionable tactics that governing bodies can use to translate theory into practice, thereby producing organizational improvements. As an example, many research papers assert that orienting new committee members is an essential practice for governing bodies; however, simply knowing this fact does not provide governing bodies with the information and tools needed to establish an effective orientation program. Many implementation questions must be answered: What topics should be covered in the program? Who is capable of producing educational materials? Who should serve as the educator? Are there third party resources that should be used? In short, simple awareness of a "best practice" does not translate into improved decision making and performance.

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The first objective of this paper is to explain how and why effective investment governance is a critical performance driver for institutional investors. For simplicity, we focus on investment committees; however, we acknowledge that many institutional investors employ a different governance structure and/or naming convention. While these differences may lead to some variance in capabilities and constraints, we believe most insights are applicable to all forms of governing bodies. The second objective of this paper is to outline a best practice framework that investment committees can use as a reference and guide to improve performance and decision making.

Availability of Full RVK Study

In follow up to this paper, RVK conducted a one-year study investigating best practices in investment committee governance. Originally published in 2015, and updated in 2017, the 58-page study is based on insights garnered from more than 30 interviews with investment committee members, as well as two surveys evaluating key criteria for the design of effective committees and selection of committee members. RVK has summarized the results of this study onsite for more than 20 institutional investors and has been featured in presentations at conferences, such as Pension Bridge, SACRS, and the International Foundation for Employee Benefit Plans. If you are interested in receiving this study, please follow the instructions below.

RVK Clients: Please send an email to mark.higgins@rvkinc.com. The study will be provided at no cost.

Non-RVK Clients: Please send an email request to mark.higgins@rvkinc.com. The cost is $250. Please note that due to RVK's strict conflicts of interest policy, investment managers and 3rd party service providers to institutional investors will not be permitted to purchase this report.

Investment Committee Role and Value Proposition

An investment committee, or similar body, is generally charged with advising a board of governance ("board") and providing management oversight of an investment portfolio on behalf of current and future beneficiaries. Committees, such as investment, audit, human resources, and executive, were originally established as part of an overarching effort to improve board effectiveness and productivity by delegating specific responsibilities to smaller groups of individuals.[2] While investment committees emerged in the governance domain, their continued use persists due to the substantial benefits that a well-functioning committee offers to investors. As investment consultants, we observe these benefits directly. On the following page we outline several benefits and supporting drivers associated with well-functioning committees.

1. **Collective Intelligence**—Collective intelligence, as defined by philosopher Pierre Lévy, is "a form of universally distributed intelligence, constantly enhanced, coordinated in real time, and resulting in the effective mobilization of skills."[3] In basic terms, this suggests that the collective thoughts of a group of individuals produce outcomes that are of higher quality than those produced by any single individual. Proof of this concept can be found in a number of settings. One example—which is particularly important in the world of investing—is the case of GDP forecasting. As future GDP growth is subject to a wide variety of drivers often unknown and unmeasurable, even the best economists have a poor track record of individually predicting GDP growth.[4] However, when a group of forecasts are averaged the result tends to be substantially more accurate. A primary reason may be that individual forecasters may be subjected to personal biases in their forecasts causing them to overweight or underweight specific factors at any given time. However, when averaging multiple forecasts such biases tend to cancel out yielding a result that is closer to the correct prediction. Similarly, a committee environment which fosters active dialogue and healthy debate often benefits from the collective sharing of ideas while avoiding the pitfalls of "group-think."

2. **Investment-Related Comparative Advantages**—Successful investment committees tend to understand their organization's capabilities and constraints and respond by assembling a group of individuals who possess skills and experiences that magnify or create comparative advantages. For example, a large university endowment may be able to exploit the institution's large asset size and stability to gain access to differentiated investment opportunities. Although a due diligence process for making prudent investment decisions should provide appropriate checks and balances, the institution may improve investment access by recruiting alumni who may have contacts, relationships, or other forms of access to desirable investment opportunities. Alternatively, a small foundation with limited resources may benefit by recruiting investment professionals who can voluntarily provide the institution with opinions and value added during screening processes, as well as access to desired institutional products at lower fees.[5]

3. **Ancillary Benefits**—Committee membership or involvement in governing bodies may provide indirect benefits. Although there are practical limits, having many individuals on an investment committee, particularly in the case of foundations and endowments, may generate opportunities to bolster fundraising efforts. Committee members may be more likely to give and engage their personal and professional networks to do the same. While this benefit is important, effective governing bodies often have mechanisms in place to identify committee members that offer tangential benefits (such as fundraising), and the ability to bolster the decision making and/or comparative advantages of the committee.

Investment Committee Best Practice Framework

The formation of an investment committee does not guarantee success. Our ongoing research effort in 2014 has two goals:

Goal #1: Construct a comprehensive framework (and associated capabilities) that are essential for a best practice committee.

Goal #2: Identify and profile tactics that committees have used to hardwire these capabilities into their organization.

Based on our research thus far, involving extensive review of secondary research and internal discussions with our consulting staff and select clients, we list and describe three broad capability sets that we view as essential for an effective committee.[6] We credit the work of Gordon Clark and Roger Urwin for helping to shape our overarching framework. Specific capabilities related to each of the three broad sets are presented in the best practice framework in **Figure 1** and then described on the following page.

Figure 1
Investment Committee Best Practice Framework

Institutional Coherence

Committee members are aware of and highly motivated to fulfill the core mission and strategy of the Plan.

Key Capabilities

- Effective process for orienting and educating new committee members.
- Full engagement of committee members ensuring diligent preparation and participation in meetings and initiatives.
- Clear understanding of the mission, strategy, and constraints among all committee members.
- Clear definition of all committee member roles and responsibilities.
- Comprehensive, clear, and accurate documentation of mission and strategy in key documents (e.g., investment policy).
- Explicit policy for identifying and managing conflicts of interest.
- Disciplined and continuous process for reviewing mission, strategy, and investment policy to reinforce key points and evolve as needed.

Optimized Staffing

Committees are supported by members, staff, and third parties that possess the required skills, resources, experience, and temperament to fulfill the mission.

Key Capabilities

- Optimal committee size that balances conflicting need for diversity and efficiency.
- Highly qualified investment committee chairperson who combines sufficient investment experience, commitment, and facilitation skills.
- Thoughtful member selection process that produces groups with complementary skills, full engagement, and disciplined decision-making.
- Clear expectations and accountability mechanism for investment committee member contributions.
- Skillful selection of staff and/or third party providers to fill critical gaps related to skill, information, and execution.

Best Practice Decision Making & Execution

Committees institute a disciplined decision making process that is efficient, informed, prioritized, and accountable.

Key Capabilities

- Effective prioritization framework to ensure appropriate time allocation to key tasks.
- Meeting materials that optimize timeliness, level of detail, and readability.
- Skilled decision facilitation that balances efficiency and sharing of all relevant information and perspectives.
- Constant awareness of key comparative advantages and investment constraints.
- Broad awareness of common behavioral biases and tactics to avoid them.
- Explicit process for evaluating past decisions to diagnose cause of successes and failures.
- Clear accountability process for committee members, staff, and third parties.

Sources: Clark & Urwin (2008); RVK (2014).

Descriptions of Key Capabilities

1. **Institutional Coherence**—In their insightful paper, Clark and Urwin coined the term "institutional coherence" to define one of three key attributes of best practice pension plan governance. According to Clark and Urwin, institutional coherence refers to the clarity and focus of investment objectives. Organizations with high institutional coherence demonstrate a distinct clarity of mission, high commitment of stakeholders to uphold the mission, and a highly competent, accountable, and well-resourced investment function tasked with specific, delegated responsibilities.[6] In summary, investment committees that distinguish themselves in this area know their mission and seamlessly translate it into a functional strategy.

2. **Optimized Staffing**—Clear differentiators for successful investment committees are the characteristics of the committee members themselves, as well as their supporting staff and third parties. Exceptional committees assemble groups of individuals that possess diverse but complementary skills and experiences, temperaments conducive to effective group decision making, and an unwavering commitment to the mission. Optimal staffing is an essential prerequisite for generating the collective intelligence that yields better decisions.

3. **Best Practice Decision Making and Execution**—Even an optimally staffed investment committee with a well-defined mission can still fall short of performance expectations if it lacks an effective structure for decision making and execution. The most successful investment committees appreciate the inherent constraints of the committee-based decision structure but are able to implement effective processes within these constraints.

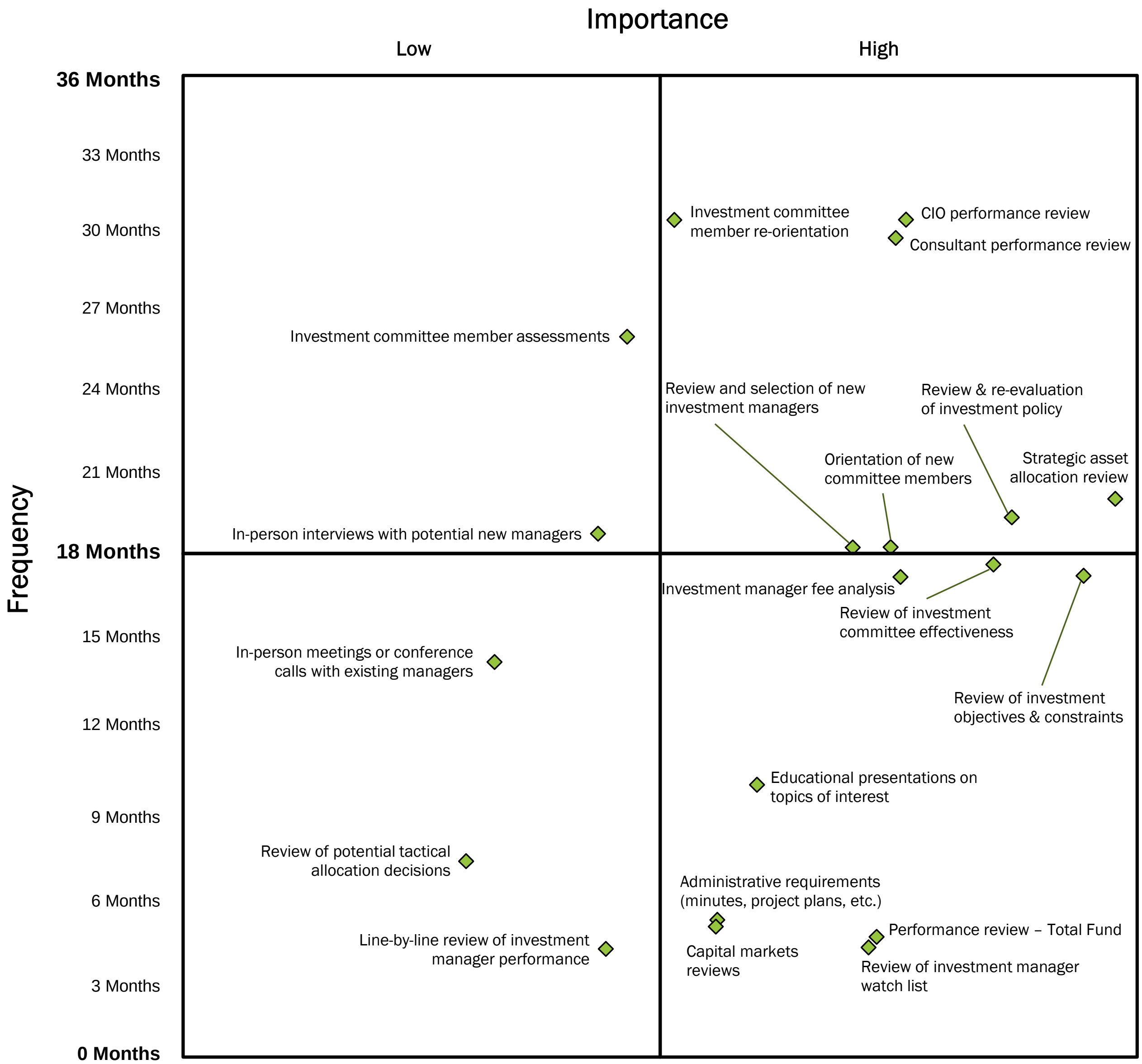
For clients who want to perform an initial assessment of how their committee rates in these areas, we have included a quick self-assessment tool in **Appendix A**.

Profiling Investment Committee Best Practices

The second goal of our 2014 research effort is to profile tactics that successful committees can use to establish the capabilities highlighted in **Figure 1**. Because identifying the most compelling tactics requires extensive primary research, largely in the form of client interviews and data collection, we will complete this phase of the research over the next several months and share detailed results in late 2014.

In the meantime, our preliminary research efforts have already yielded interesting insights. As illustrated in **Figure 1**, one critical investment committee capability is effective prioritization of competing time demands. While prioritization is important for all organizations, it is especially critical for investment committees given common constraints such as infrequent meeting schedules and limited time commitments from volunteer committee members, among others. In an effort to explore the challenge of prioritization we conducted a survey of our investment consulting team to measure their beliefs on the relative importance and recommended frequency of critical investment committee tasks. In the survey we asked our consultants to rank each task along two dimensions: frequency and importance. **Figure 2** summarizes those results.

Figure 2
RVK Consultant Prioritization Survey Results



Source: RVK (2014).

We believe that that this matrix provides a valuable reference point, which may help committees determine what tasks they should be prioritizing and how often they should address them. In fact, after reorganizing the data from the chart into short-, medium-, and long-term objectives (**Figure 3**), one can arrive at a reasonable work plan. **Figure 3** suggests that the high importance, short-term items should be prioritized and covered repeatedly and efficiently in recurring meetings, while additional time should be reserved to continually rotate medium- and long-term items into the agenda. While our consultants must always adapt to different client needs and preferences, this framework is largely consistent with the work plans and meeting agendas that we formulate collaboratively with clients. We also recognize that certain items, such as "Review and Selection of New Managers" will be handled on an as-needed basis, while others will be delegated if resources are available.

Figure 3
Investment Committee Tasks by Required Frequency

Short-Term (Every 3-12 Months)	Medium-Term (Every 1-2 Years)	Long-Term (Every 2-3 Years)
High Importance 1. Performance review - Total Fund 2. Review of investment manager watch list 3. Educational presentations on topics of interest 4. Administrative requirements (minutes, project plans, etc.) 5. Capital markets reviews	**High Importance** 1. Strategic asset allocation review 2. Review of investment objectives & constraints 3. Review & re-evaluation of investment policy 4. Review of investment committee effectiveness 5. Investment manager fee analysis 6. Orientation of new committee members 7. Review and selection of new investment managers	**High Importance** 1. CIO performance review 2. Consultant performance review 3. Investment committee member re-orientation
Lower Importance 1. Line-by-line review of investment manager performance 2. Review of potential tactical allocation decisions	**Lower Importance** 1. In-person interviews with potential new managers 2. In-person meetings or conference calls with existing managers	**Lower Importance** 1. Investment committee member assessments

Conclusions and Next Steps

A wealth of secondary research and our collective experience as investment consultants reveal that committee-based management of the investment process can produce significant benefits for institutional investors. This value stems from drivers such as the ability to leverage collective intelligence to improve decision making, creating and/or amplifying institutional comparative advantages, and introducing a variety of ancillary benefits that may be non-investment in nature. However, experience also shows that simply creating a committee does not guarantee its success. Broadly speaking, the committee must establish strong institutional coherence, assemble an optimal mix of committee members and support staff, and institutionalize effective decision making and execution processes.

Although we credit the existing research on investment committee best practices, we believe that a significant gap persists, primarily in the area of implementation. We intend to address this gap by identifying and sharing profiles of specific governance tactics that we deem to have been successful. We anticipate completion of this effort in late 2014, and our hope is that our clients will leverage these tactics to improve performance. In the meantime, we encourage clients to take the self-assessment in **Appendix A** and to learn from several of the insights presented thus far.

Appendix A: Investment Committee Self-Assessment

Instructions: For each statement, indicate the extent to which you agree and then total the numbers for each column. Your organization may benefit from our research if you have several items that are marked "disagree" or "strongly disagree." In addition, we believe this assessment can help you prioritize improvements if you find that there are certain categories that are weaker than others.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Institutional Coherence					
1. Our committee members can easily articulate the core mission of the organization and investment strategy to fulfill this mission.	1	2	3	4	5
2. Our investment policy statement clearly and accurately articulates the organizational mission, investment strategy, and execution process.	1	2	3	4	5
3. Our investment policy statement clearly defines roles, responsibilities, performance objectives, and process for accountability.	1	2	3	4	5
4. Our committee provides an effective orientation program for new members.	1	2	3	4	5
5. Our committee has an effective process for "re-orienting" existing members to ensure continued mission and strategic awareness.	1	2	3	4	5
6. Our investment committee periodically re-evaluates the organizational mission and strategy to ensure that it is appropriate.	1	2	3	4	5
7. Our investment committee has a clearly articulated no conflicts of interest policy with specific mitigation steps should conflicts arise.	1	2	3	4	5
TOTAL – Institutional Coherence					

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Staffing					
8. Our committee understands the optimal mix of skills and experiences of an effective investment committee.	1	2	3	4	5
9. Our committee understands the ideal traits of an investment committee chairperson.	1	2	3	4	5
10. Our committee is deliberate in their selection of committee members to optimize the collective experiences, skills, and perspectives of the group.	1	2	3	4	5
11. We believe that our investment committee has the optimal number of members.	1	2	3	4	5
12. Our committee members are fully prepared for meetings.	1	2	3	4	5
13. Our committee members are accountable for the quality of their contributions and commitment to their job.	1	2	3	4	5
TOTAL – Staffing					

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Decision Making & Execution					
14. Staff and/or third party meeting materials provide an appropriate level of detail and analysis to facilitate effective decision making.	1	2	3	4	5
15. Our meeting agendas have explicit objectives that appropriately reflect key strategic priorities of the Fund.	1	2	3	4	5
16. Our investment committee meeting time is appropriately allocated to the highest priority items.	1	2	3	4	5
17. Our investment committee members understand common behavioral biases and take action to avoid behavioral traps.	1	2	3	4	5
18. Our investment committee members fully understand key investment constraints and make decisions that recognize these constraints.	1	2	3	4	5
19. Our committee continually evaluates past decisions to assess success and/or failure.	1	2	3	4	5
20. Our committee has an effective process for monitoring performance and holding responsible parties accountable.	1	2	3	4	5
TOTAL – Decision Making & Execution					

Endnotes

[1] Keith Ambachtsheer. Pension Revolution: A Solution to the Pensions Crisis (New Jersey: John Wiley, 2007); "Changing Lanes." Watson Wyatt (2006).

[2] "White Paper No. 31 – Reinvigorating the Investment Committee: Introducing the Investment Committee Operating Manual." Greycourt & Co., Inc. (2013).

[3] Pierre Lévy. Collective Intelligence: Mankind's Emerging World in Cyberspace. (New York: Basic Books, 1999).

[4] Nate Silver. The Signal and the Noise: Why So Many Predictions Fail — but Some Don't. (New York: Penguin Press HC, 2012).

[5] An important point in this case is that the investment professionals provide access to lower-cost investment products that are independently determined to be advisable. Simply investing in lower cost products that would not otherwise be recommended may not add value—in fact, it may very well result in suboptimal performance.

[6] Clark, Gordon L. and Urwin, Roger. "Best Practice Pension Fund Governance." Journal of Asset Management 9 (2008).

About RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Chicago and New York. RVK is one of the ten largest consulting firms in the U.S. (as defined by Pensions and Investments) and has a diversified client base of over 170 clients covering 28 states. This includes endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high net worth clients. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.