BEST PRACTICES IN OCIO

The Art of Effective Governance

Avoiding Investment Committee Pitfalls

Key Takeaways:

- Practicing good governance is easier said than done. Despite best intentions, investment committees can easily fall into well-documented traps that derail constructive stewardship.
- In GEM's experience, failings in investment committee effectiveness typically stem from avoidable breakdowns of people, processes, or behaviors; these manifest as either loss of integration with the institution, unhealthy action bias, or a failure to sort what's relevant from what isn't.
- Avoiding these pitfalls in the first place is the best way to improve an investment committee's effectiveness.

GEM

Introduction

An investment committee is the lynchpin of an institutional investment program. At GEM, we have observed that a committee's ability to translate an institution's mission into the language of financial goals, portfolio allocations, and endowment oversight shapes the probability of long-term success to a greater extent than any other variable. Sound portfolio strategy, a high-quality investment team, or an expert board of trustees are all powerless against a dysfunctional investment committee.

Fortunately, an extensive body of literature on governance best practices already exists, and there is very little disagreement about what those best practices are. And yet, we see countless institutions struggle to implement them; to corral the energy of their committee members into a set of useful organizing principles and oversight norms.

We have seen that these deficiencies can levy an extraordinary tax on institutions: a loss of integration between the investment portfolio and an institution's needs, a bias to change or act when patience is the wiser course, and a misallocation of time and attention.

With So Much Clear Guidance, Why Do Committees Still Struggle?

Failings of a committee are generally not for lack of will or effort. The committee members with whom we partner and interact regularly are extraordinary civic leaders, engaged deeply in the missions of the institutions they serve. Most governance literature implores trustees to act, but we believe that committees are better served by understanding and avoiding behaviors and activities that undermine effectiveness. The primary objective should be to guard against mistakes rather than to strive for success.

Good governance is distinct and elusive. Notable former philanthropist, chairman, CEO, and board member Ken Dayton once wrote: "Governance is not management and it surely is not volunteering. Governance is governance." It is an obligation "to protect the long-range future of your organization and see to it that it fulfills its obligations to its constituencies, however defined...to see to it that the organization is well managed, rather than managing it yourself."[1]

For committees eager to structure for success—by placing the right people in the right roles, by clarifying the group's mandate, and by establishing the rules of engagement—we offer some insights and suggestions to avoid common pitfalls.

People: Building the Right Team

"The most important decisions...are not what decisions, but who decisions." – Jim Collins, American researcher and author focused on organizational management, sustainability, and success

A committee is a people-driven organism only as strong as its members, and hence the foremost committee challenge is staffing. Committee recruitment, training, and engagement are all required for success.

We have observed three primary people-related missteps: (1) poor member recruitment, (2) little sense of collectivism, and (3) a weak Chair.

1. Poor Member Recruitment

Committees are teams, and **the most effective teams are comprised of effective players who play well together.** Investment consultant Keith Ambachtsheer argues for "a preponderance of people of character who are comfortable doing their organizational thinking in multi-year time frames."[2] Unfortunately, preferred virtues are often overshadowed by other less important qualities during the selection process: the dominance of someone's personality, the size of their recent donation, stature in the community, or the extrapolation of skill in one arena (convertible arbitrage fund management, for example) to the one at hand (stewardship of perpetual resources).

Suggestions:

- Institutions should document the candidate attributes that correlate with effectiveness and ensure any prospective committee member satisfies minimum requirements.
- On balance, those with the requisite soft skills will add more value than those with merely investment-related hard skills. The exception to this is if the committee is in a primary investment decision-making role; in that case, both hard and soft skills will be equally important.
- Key members should recruit continuously for a next-gen committee roster, performing active due diligence on candidates' softer qualities. A more structured process helps to blunt the effects of social pressure and ego.

People: Building the Right Team

2. Little Sense of Collectivism

Working together as a team demands **a shared sense of purpose**. A nonprofit's mission is often assumed to be a sufficient proxy for shared purpose—and of course volunteers care deeply about the organization's sustained success—but it is not a strong enough foundation for committee alignment. To wit, we have not observed that a Zoom call every three months can build sufficient relationship capital with fellow committee members to enable a clear sense of goals, robust discussion, and maximum candor.

Suggestions:

- The best committees we've observed take retreats, utilize facilitators, or otherwise find ways to set strategy together, building a common sense of vision and goals.
- In theory, virtual meetings enable wide participation; in practice they can encourage disengagement and distraction. There is no substitute for face-to-face collaboration.
- Seek a wide audience when strategy setting. Engage with finance teams, advancement staff, finance committees, and other stakeholders to ensure the institution's purpose is always top of mind.

3. A Weak Chair

Committee Chairs often view themselves as just another committee member. But the role requires much more. The Chair is the primary defense against committee entropy. It is **the leader of the committee, ambassador to the board, setter of the strategic agenda, advocate for the investment process, and archivist of the committee's critical norms and culture.** Without a strong Chair, meetings are ineffective, and continuity is squandered.

Suggestions:

- The Committee Chair does not *have* to be the longest-tenured committee member. Elect someone who has the respect of his or her peers and is prepared to manage the group's activity, maintaining an active communication thread between meetings.
- A Chair should have the clearest sense of *"the why"* behind the investment program. He or she is the advocate for the strategy and for its consistent execution, so they must intimately understand it.
- A Chair must set expectations, hold people accountable, and strive to minimize the costs of conformity by empowering or even encouraging dissent and discussion.

Process: Executing with Consistency

"Efficiency is doing things right; effectiveness is doing the right things."
– Peter Drucker,[3] one of the most widely-known and influential thinkers on management

Process deficiencies—or paying attention to the wrong things at the expense of the right things—typically arise when committees have not documented policies and procedures effectively or structured themselves in a manner that best supports consistent execution.

We have observed three primary process-related deficiencies: (1) nebulous goals, (2) unclear responsibilities, and (3) excessive turnover.

1. Nebulous Goals

We've observed that many **Investment Policy Statements (IPS) are far too vague.** "The goal is to generate satisfactory returns within a reasonable level of risk," they say. *What is a satisfactory return? What is a reasonable level of risk? What types of risks matter? Against what benchmarks and over what time horizon should they be measured? How does that align with the institution's operations and spending needs?*

The standard should be to answer those sorts of questions explicitly, such that a new investment team or committee member could pick up the document with no prior exposure and correctly tell you the answers. "The principal reason we should all articulate our investment policies explicitly and in writing," Charley Ellis reminds us, "is to protect our portfolios from ourselves."[4]

Suggestions:

- An IPS should answer fundamental questions about the purpose of capital, roles in its deployment, tolerance to risk, return objectives, allocation guidelines, benchmarks, and oversight steps, and all should be rooted in an enterprise assessment of the organization's financial and operating condition.
- Committee members must be prepared to have candid conversations about institutional needs under worst-case conditions in order to remove any vagueness from the process.
- The IPS should be reviewed annually or as needed to revisit key operating and investment assumptions.

Process: Executing with Consistency

2. Unclear Responsibilities

It is not uncommon for committee members to wonder how they are meant to contribute. That's because the model of governance and oversight can vary considerably across institutions based on skills, resources, and ambitions. A committee could be responsible for all or none of the following: investment policy development, asset allocation, manager selection and oversight, trading and rebalancing, risk management, and performance analysis. Regardless of what model the board has adopted, the roles and responsibilities of staff, committee, and investment advisor must be plainly defined. **People must understand their jobs in order to do them well.**

Suggestions:

- Committees need a clear and agreed-upon charter that documents roles and responsibilities for all key parties at each step of the investment process. This may be part of the IPS or not, but a description of duties should be made available to every member at every meeting as a reminder and guidepost.
- Lest everyone take credit for successes and no one blame for failures, accountability must be explicit, with bylaws updated periodically to reflect the realities of committee size, skills, resources, and composition.
- Governance shifts—meaning changes to the model—should be made delicately and with due consideration to the required adjustments to charter and behavior.

3. Too Much Turnover

Some committees regard frequent turnover of committee members as an important means of stimulating new ideas and fresh thinking. In GEM's experience, however, that ethic can be overemphasized. Investing is not an innovation industry; it favors continuity, discipline, and a healthy respect for history. A lack of stability can derail the steady hand of portfolio management and cause unhealthy pinballing from one reasonable strategy to another—capitulations that often arise at precisely the wrong time. **Turnover's primary cost to an institution is the erosion of institutional memory, which creates a void that is often filled by an action bias to do something different or to repeat whatever has worked most recently.**

Suggestions:

- Among other policies on committee size, balance, diversity, structure, average age, and conflicts of interest, ensure there are policies on tenure along with appropriate staggering of terms so that transitions are slow. Effective committees favor continuity.
- Craft an Investment Constitution, or a historical record of the committee's beliefs and the rationale for its critical decisions. Committees are always turning over, but such a document spares future committees from the distortions of an oral record.

Behavior: Standards of Excellence

"The mass never comes up to the standard of its best member, but on the contrary degrades itself to a level with the lowest."
– Henry David Thoreau,[5] American naturalist, essayist, poet, and philosopher

Norms are the cultural underpinnings of a committee. We've briefly touched on some—a shared purpose, commitment to candor, vulnerability, a willingness to engage—but there are other more actionable forms of standard-setting that emerge from several conventional dysfunctions.

We have observed three primary behavior-related pitfalls to investment committee effectiveness: (1) meandering meetings, (2) lack of preparation, and (3) little self-critique.

1. Meandering Meetings

Committee members should insist on holding tight meetings with clear agendas, enough room to foster productive collaboration, and sessions that start and end on time. Although a Chair may have to make difficult in-the-moment decisions—like cutting off a rich conversation to move on to the next agenda item, or punting topics to subsequent meetings—the Chair does no favors by allowing side bars and redirections. **Undisciplined meetings are an incubator of committee ineffectiveness.**

Suggestions:

- Resist packing agendas. These are perpetual pools of capital with few substantive changes quarter-to-quarter. Robust discussions at each meeting about a narrow, rotating set of topics are more engaging and useful than short bursts on all forms of minutia.
- Consider at least ninety minutes for quarterly committee meetings, or longer sessions if meeting less often. Establish a formal Activity Plan of topics so that the committee emerges from a calendar cycle with a deeper understanding of the program and in a better position to evaluate it holistically.
- Prioritize deeper dives into thought processes, changes in activity, market assessments, and evolutions in team or process. These may not impact short-term results, but in our experience, they are by far the most important predictors of long-term results.

Behavior: Standards of Excellence

2. Lack of Preparation

The staff at Duke University Management Company had a roughly ninety-page orientation book that started with some prodding message to the effect of: *Thank you for supporting the stewardship of the resources of this venerable institution. Now start reading.* The Yale Investment Office is similarly famous for sending out healthy stacks of material to its Investment Committee and fanning the social pressure to consume and understand that material in advance. We have watched committee members show up ice cold to meetings, and their contributions reflected as much. A good Chair can elevate the expectations of members, but all members must understand that **reading, participating, listening, and engaging with the material that is produced for their benefit is a <u>requirement</u> of service.**

Suggestions:

- Immediately establish the cultural standard for meeting preparation with new committee members. When a new member joins, there is a window of malleability after which behavioral change becomes very difficult.
- Work closely with the investment team or advisor to prepare materials that are relevant—not so dense they bury the lede, but neither so high level that they don't encourage probing. There is a balance between too much and too little information that must be agreed upon by the committee and overseen by the Chair.
- Require orientations for new committee members. Sitting down in-person with investment team leadership and the Chair to build a deeper understanding of the program is essential. Asking questions like: *How was the portfolio designed and why? What are the benchmarks used and why? How is the opportunity set parsed by the team and why? How are specific decisions made and why?* And on and on, will build confidence in the program and in the common language of stewardship and success.

3. Little Self-Critique

Very few committees actively and routinely evaluate themselves and their members for effectiveness. *How have we supported good decision-making? How have we ensured alignment between the investment program and the institution? How have we responded to changes in operating conditions? How have we improved our engagement with the investment manager?* And at the individual member level: *Are they prepared? Are they engaged throughout the meeting? Do they ask questions in advance? Do they contribute to the conversation? Do they divert discussions? Do they listen effectively?* **Continuous improvement does not come without critique and a willingness to admit shortcomings.**

Suggestions:

- Committees should develop a scorecard for themselves as a group and as individuals, and engage in an annual review process. The willingness to be coached and to improve is an important quality of the highest performing teams.
- If the process is too difficult to self-administer or the committee wants more impartial feedback, hiring a third party to facilitate evaluations can also be helpful.

Conclusion: Simple, but not Easy

Throughout GEM's history, we have had the privilege of watching hundreds of investment committees in action. They vary in all manner of dimensions. Nevertheless, it should come as no surprise that every one of them has some tendency—borne of people, process, or behavior—that encourages a loss of integration with the institution, some action bias, or distraction from what matters to the institution's long-term results and stability.

The first priority for most committees should be to establish practices and protocols that align with the governance model that best suits their institution, and then to ensure that committees are properly staffed and their responsibilities well-defined. In so many facets of life, we're meant to strive and push for success, but overseeing an investment program is less about the reach than it is about the grasp. That which is often said about investing, can also be said of governance: It is simple, but not easy. Document what matters, coach people, and hold them accountable to standards of excellence. That is the most likely path to more effective, and more fulfilled, investment committees.

Endnotes

[1] Dayton, Kenneth N. "Governance is Governance." Independent Sector. https://cardinalboardservices.com/wp-content/uploads/2015/02/governance_is_governance.pdf

[2] Ambachtsheer, Keith P., and D. Don Ezra. Pension Fund Excellence: *Creating Value for Stockholders*.

[3] Drucker, Peter F. Management: *Tasks, Responsibilities, Practices*.

[4] Ellis, Charles D. Winning the Loser's Game: *Timeless Strategies for Successful Investing*.

[5] Thoreau, Henry David. *The Heart of Thoreau's Journals*.

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