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Seven critical, introspective questions for investment committees

The following commentary is adapted from remarks by Vanguard Chairman John J. Brennan delivered at a national conference for institutional investors in early 2007.

In my position at Vanguard, it's my privilege to talk to and meet with many institutional clients. I get invited to meet with their professional teams and their oversight committees and, at times, participate in their deliberations. In addition, I'm pleased to serve on some investment committees—a couple of which, in fact, are in important transition periods.

I was reflecting recently on the other investment committee discussions I've observed and participated in—both productive ones and not-so productive ones. I've noticed that the questions that are used to tee up the discussion among the staff and committee members have a great deal to do with whether a productive discussion ensues and sound decisions are made.

Thomas Watson, the founder of IBM, once said, "The ability to ask the right question is more than half the battle of finding the answer." He wasn't speaking about investment committees, but the saying is apropos.

So let me see if I can provide a few insights by sharing some reflections from my personal experience—taking off my Vanguard chairman's hat and putting on my investment committee member's cap where appropriate.

I'll list seven crucial questions that should be asked by committees and investment professionals, and contrast each one with a misguided alternative, which I've seen people focus upon as well.

1. How do we define and measure success?

When fiduciaries take the long-term view, the first question to focus on is, "How do we define and measure success?" Too often, the first question asked is, "How did Harvard and Yale (or whoever is seen as a competitor) do?"

Measures of success are a challenging issue for every person or group trying to outline the performance goals for a pool of capital. But the difficult task of answering this "measurement of success" question offers a very high return on the time invested. Clear goals will allow the professional teams to do their jobs most effectively. Fuzzy goals will lead to fuzzy execution.

By the way, there are many ways to define and measure success. Success can be measured in absolute terms, or against "the market," against a benchmark, relative to a policy portfolio or a competitive group. What you measure against is your choice. The key is to make a choice, not a decision by default.

And once you've answered the question, you still need to revisit the issue from time to time to ensure that changed circumstances—within the organization, in the markets, in the broader environment—haven't altered the answer to this question.

2. How do we define and measure risk?

When fiduciaries take the long-term view, the next question to consider is, "How do we define and measure risk?" The misguided view is: "How do we maximize return?"

There are many ways to define risk. The definition could be based on a traditional measure like volatility. Or the definition could be as simple as the loss of principal … or the loss of the staff members' jobs. In some organizations, perhaps risk would be related to constituents' opinions about how we're dealing with "their" money.

Once risk is defined, it's easier to discuss how much you're willing to risk to achieve your return objectives. And the discussion of risk tolerance must be very candid—touching on quantitative and qualitative "gut check" factors.

I know of one investment committee that took itself through a laundry list of ten questions on this topic. The list of "gut check" questions included some tough ones, such as, "How much of the portfolio are we willing to risk over a one- or two-year holding period to achieve our return objectives?"

3. Are we making realistic return assumptions for the future—for the markets and for our managers?

The third key question gets to the heart of expectations: "Are we making realistic return assumptions for the future—for the markets and for our managers?" Asking such a question forces you to examine assumptions about the drivers of future returns—valuation, liquidity premiums or discounts, momentum, etc.

Too often I see investment committees, and even financial staffs, accept the conventional wisdom about returns, or worse, extrapolate the past into the future without considering the drivers of returns for that future. The worst practice of all, of course, is the blind-faith route of accepting the investment manager's sales pitch about what they will be able to produce on a nominal or relative basis.

And, frankly, getting this right becomes more important as the asset class becomes less traditional. At an endowment strategy meeting that I attended last year, a consulting firm shared their analysis of the variation among managers for different mandates. Here's the annualized performance spread, as calculated by the firm, between the 75th and 25th percentiles of various asset classes over the prior ten-year period ended June 30, 2005:

> 25th–75th Percentile Dispersion of Active Management Returns

U.S. bonds	0.5
U.S. stocks	2.0
Non-U.S. stocks	4.0
Absolute return	5.8
Buyout	17.9
Venture capital	25.4

Source: Cliffwater, LLC.

As the wide spread in returns among managers of less liquid asset classes shows, being correct in your forecast of returns from, say, your managers of venture capital funds can be very rewarding. Being wrong can be very painful.

4. What's the right asset mix for accomplishing our goals?

The next, natural question that should be asked is, "What's the right asset mix for accomplishing our goals?" (Not, "What portfolio mix would put us on or above the efficient frontier?"*) There are trade-offs in different portfolio mixes that have important ramifications for an organization's objectives, risk tolerance, and market expectations. If you're focused solely on the efficient frontier, you can overlook those issues.

Again, there are both quantitative and qualitative aspects to this assessment, and each should be considered equally important. So this question also requires another "gut check" by the professional staff and their overseers.

With all due respect to the valid concept of the efficient frontier analyses, I've seen how dangerous it can be to rely on "objective" assessments for investment allocation decisions without factoring in one's experience, intuition, and judgment. As part of a level-setting exercise for a committee meeting that I attended a while ago, all of the attendees were asked to forecast returns for a number of asset classes and, based on those forecasts, the staff gave us each a personal efficient frontier portfolio, designed to produce maximum return for a given level of risk. Mine was awful—only 12% in domestic equities, but 20% in absolute return hedge funds and 10% in global bonds, for example. While I'm sure their math was correct, the portfolio looked nothing like what I'd recommend to someone.

How did I end up with that allocation? The staff who prepared the analysis took my forecasts of prospective returns and applied historic volatility and correlation observations to come up with an optimized portfolio. It was an apples-and-oranges analysis that produced an interesting fruit salad, but not a portfolio that I'd recommend to an endowment.

5. Are our investment costs reasonable and appropriate?

When fiduciaries take the long-term view, there must be some questions about fees, beginning with, "Are our investment costs reasonable and appropriate?" The misguided approach asserts that "Fees don't matter as long as you get alpha."**

The fact of the matter is that fees always matter. Every investor "eats" after-cost returns so, all other things equal, lower fees will always be better.

Fees are a greater determinant of relative success in some asset classes than others. As I mentioned earlier, history will tell you that the spread between the 25th and the 75th performance percentiles in long-only equity for long-term periods is about two points for U.S. stocks and 0.5 points for bonds. A meaningful portion of that difference is attributable to differentiated fees. But this is something that seasoned investors already know.

*A line showing investments that may potentially deliver the highest expected return for a given amount of risk.

**A measure of risk-adjusted performance.

And yet, when it comes to nontraditional asset classes, people seem to think fees aren't an issue. Fees are just as much an issue here as in traditional asset classes. You know the math … to net a 10% return in a 2-and-20 hedge fund, the fund must have a gross return of 14.5%. For a 2-and-30 fund, it's even more daunting. Will some alternative managers earn that result? Sure. Will the majority? No.

So, paying attention to the total costs of managing your assets is critically important to ensuring your long-term success—irrespective of the strategy you pursue. I'm always shocked when I ask investment managers what their total costs of operation are, and the answer comes back, "I don't know." Wrong answer.

6. Do we have a long-term strategy and the patience to implement this plan?

As every investment professional knows, managing a pool of assets is a complicated task full of temptations to second-guess oneself. And when you throw a committee into the mix, that temptation grows exponentially.

As a result, one of the really insidious things that I've observed with committees is a temptation to change strategies far too frequently. So my sixth question for investment committees is one that I myself posed at a committee meeting recently. It's this: "Do we have a long-term strategy and the patience to implement this plan?" The misguided alternative is, "How can we be opportunistic in setting our asset allocation? It's common to assess an investment manager's performance over a three- to five-year period. Shouldn't we give our strategy at least that long too?

And yet, otherwise disciplined and thoughtful people can be tempted to allow a strategic asset allocation only months to work.

If the committee and its staff did a thorough job of setting investment policy at the outset, there should be almost no need to do anything for years—except to oversee a sensible rebalancing policy and see that cash flows are put to work effectively.

7. Do we have the right team in place—professionals and committee members—to execute this strategy?

Once a strategy has been developed, the seventh prudent question to ask—as a professional or an overseer—is this: "Do we have the right team in place—professionals and committee members—to execute this strategy?"

The misguided (and far too prevalent) approach today says, "The Ivy League endowments have made a lot of money in alternatives. Shouldn't we be willing to take the same risks to get the same return?"

But copying the investment strategies of other organizations can mean adopting a far more labor-intensive and complex investment strategy. It works only if it fits with your risk tolerance and strategies—and only if you have the capabilities to manage the strategy effectively.

Organizations that are headed down the path of moving to a more complex strategy typically use funds of funds as quasi-consultants, or they deepen their relationship with a consultant to help with the process. What seems to happen next is that committees and financial staffs realize that they've become involved in a different game and they need their own teammates with them.

Don't underestimate the need to have a truly talented team of professionals assessing the programs in which you invest. It is the only way to fully understand potential return and risks and to monitor performance effectively. The top-performing, larger endowments with the terrific investment results tend to have staffs that are quite large and very sophisticated and, generally, long-tenured.

Having humility about your personal or institutional capabilities and humility in the definition of an execution plan for your asset strategy will serve you and your institution very well.

Conclusion

I hope my seven questions have offered a practical framework for thinking about your responsibilities, whether you are a full-time investment professional or involved with endowment management on a part-time basis.

You and the people with whom you work bear a huge responsibility for making investment decisions on behalf of current or future beneficiaries of that pool of assets.

And when you consider the impact of those decisions, I'll leave you with an eighth important question, one that I often ask myself, in both my day job and as a volunteer committee member. "What are the consequences for our institution if our execution is merely average (or worse than average), rather than outstanding?"

I posed this question to the head of a university endowment who has one of the best records in his profession. When I asked him what having a top-performing endowment meant to his institution, his answer was quick and succinct.

He said, "It means our financial aid budget has grown by something like ten times. Now, any kid who wants to come to our university, but couldn't afford to turn down another institution's financial aid package in the past, comes here."

What a great, humanistic way to describe the payoff from a disciplined investment process with a long-term focus. I keep this perspective in mind continually—in my professional life and in my role as a volunteer helping people manage their pools of capital. I hope you will, too.

Notes

Investments are subject to risk. Investments in bonds are subject to interest rate, credit, and inflation risk. Foreign investing involves additional risks including currency fluctuations and political uncertainty. Past performance is no guarantee of future returns.

P.O. Box 2900
Valley Forge, PA 19482-2900

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