Ask the Expert: Your questions on investment committee issues answered

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Vanguard's Catherine Gordon took a range of questions on investment committee practices from institutional.vanguard.com visitors in this edition of Ask the Expert*. She is a principal and head of Vanguard Institutional Advisory Services®.*

How often should an investment committee meet?

When evaluating the actions of a fiduciary investment committee, the U.S. Department of Labor (DOL) generally will look to see whether those actions were reasonable, prudent, and consistent with the participants' best interests under the relevant facts and circumstances. There may be facts and circumstances (e.g., extraordinary market volatility, changes in a fund's makeup, philosophy, or management) that necessitate more frequent meetings. The investment committee must be flexible and may need to schedule ad hoc meetings if dictated by the circumstances.

It also can depend on the complexity of the portfolio that the committee is overseeing. Larger, more complex portfolios may suggest quarterly meetings, while smaller, less complex portfolios might suggest semiannual sessions.

What would prompt a committee to want to release meeting minutes that are usually kept confidential?

There is no requirement to release the minutes, but in the interest of greater transparency we encourage committees to consider releasing them. Committees overseeing defined contribution (DC) plans can particularly benefit because, inevitably, plan participants have ideas about what funds should be in the plan. By releasing the minutes—while at the same time respecting the confidential nature of some discussions—participants see their ideas were discussed. It greatly increases their level of confidence and comfort if they know how decisions are being made and who's involved.

What are the risks in signing a fiduciary acknowledgment letter?

To me there are few risks in signing such a letter because, by serving on a committee, you're a fiduciary whether you sign the letter or not. The letter is a kind of insurance policy to make sure that the person physically acknowledges that, "Yes, I am a fiduciary." This is especially critical for committee members overseeing ERISA qualified plans where they are personally liable for their decisions as fiduciaries.

Having said that, I think it's a very good idea to sign a fiduciary acknowledgment letter. Sadly, there have been a number of instances where, apparently, people didn't realize they were fiduciaries, or at least didn't know what it

meant to be a fiduciary. If they had been asked to sign fiduciary acknowledgment letters they might have made different decisions.

What's the best way for a plan committee to monitor stable value funds and other collective trust accounts?

As part of the management agreement with collective trust managers (including stable value managers), the investment committee can establish guidelines that require disclosure similar to that of the typical mutual fund. The committee can require things such as performance reporting versus a benchmark or peer group. It can ask for some type of sector breakdown or credit quality breakdown. Don't be afraid to engage the manager. Be really frank. Ask questions like: "What worries you most about the portfolio?" or, "What's the worst case scenario?" Put the manager on the spot.

Do committee charters provide true value add for committees, or are they just another opportunity for committees to be out of compliance with written procedures?

The value of the committee charter is that it really gets at the essence of why the committee exists. Unlike an investment policy statement—which is a living, breathing document—the charter is the foundation, or the cornerstone, of what the committee is charged with doing. Not that it can't change. But the charter should be permanent. It should only change if you change the mission of the organization.

As for whether a charter provides another opportunity to be out of compliance, I think that opportunity is greatest with the investment policy statement. The investment policy statement contains specific information on matters such as asset allocation, risk tolerance, and liquidity requirements. It's potentially a problem, but not if plan sponsors adopt a dynamic asset allocation concept and hardwire that into their investment policy statement.

When considering a fund change, do you believe it's necessary to record voting details for each committee member in meeting minutes (assuming there's no contentious issue related to the voting), or just record that the committee voted to approve the change?

I don't think that you need to record how individual committee members vote. For example, it's the committee as a whole that determines when a fund is added or deleted in a defined contribution plan. That's the decision upon which someone will act. It's like a Supreme Court decision; you know who voted, but it doesn't really change the Court's decision.

A bigger issue facing committees is whether they're basing their votes on the best possible criteria. A recently released Vanguard study—*What matters most? An analysis of investment committee hire/fire decisions*—suggests committee members' approach to hiring and firing managers seems very effective. The only caveat is that the respondents rated performance as the top factor. And while performance is certainly important, we consider that more of an outcome. It may be more useful to focus on factors that could lead to performance issues down the line—factors such as cost—and to make sure portfolio characteristics stay in line with the fund's investment mandate.

What's the best way to keep an investment committee focused on the long term?

Keep discussions forward looking. We recently surveyed over 100 committee members and asked them how they spend their time at committee meetings. The results indicated they spent an average of 40% of meeting time reviewing managers' past performance. While I think reviewing performance is an important responsibility, the emphasis should be on whether or not these are the right managers for the portfolio going forward.

Also, when committees are planning a meeting, make sure you've allowed for a balanced discussion. Encourage the "devil's advocate." Some people, by nature, are devil's advocates, but not every committee has one, and those committees are vulnerable. It's so critical to have balance to keep the committee's focus on the long term.

How do committees typically define an "underperforming" fund, and how long do they typically keep such funds on a watch list before swapping the underperforming fund for a better-performing fund in the same category?

As we state in Vanguard's recent paper, *Investment committees: Vanguard's view of best practices*, we don't recommend putting a specific time limit on when to drop a fund. Instead, we suggest aligning the time horizon to the nature of the investment. For example, I'm going to have a pretty low tolerance over the course of three years for an underperforming money market fund because, by definition, money market funds invest in securities that mature in less than a year. I don't need to wait three years to figure that out. Now, when evaluating my long-only, large-growth fund, I might look at that over a three- to five-year-period. Here's where the investment policy statement can provide guidance on time limits.

It's also important to note that performance should not be the defining criterion for concern. There may be other manager issues to consider in addition to performance. For example, has there been unexpected turnover on the investment team? A recent merger that could distract from portfolio management? An overly aggressive new strategy push that drains resources from the existing team?

Another thing to consider is how managers view their benchmark. We think of managers being in one of three categories. We have benchmark-sensitive managers who run portfolios based on what's in an index. I'm going to have a much lower tolerance for underperformance in an index fund than I am in a fund where the manager is merely benchmark-aware. A benchmark-aware manager keeps an eye on the benchmark, but is not a slave to it. Then there are the benchmark-agnostic managers. They couldn't care less about the benchmark. That's an important point for the committee to understand. Knowing what category the manager fits into will help a committee determine when or whether a fund should be replaced.

Do you recommend that an investment committee engage professionals to assist it in the manager search process?

It depends. Consultants can be very valuable in that they can play that devil's advocate role. They can bring information to the committee that helps foster a balanced discussion. Some committees need that third-party intermediary to help manage personalities. It's very dependent on a committee's comfort level with its decision-

making process. It also can be an economic question: Can the organization afford the additional cost?

Notes:

All investments are subject to risk. Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund.

An investment a stable value fund is neither insured nor guaranteed by the U.S. government. There is no assurance that the fund will be able to maintain a stable net asset value, and it is possible to lose money by investing in the fund.