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The good and bad of investment committees and boards

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In working with more than 100 investment committees in our careers, and as sitting board and investment committee members for various non-profit entities, we have experienced the good and bad of committees. While the committees themselves are inconsistent, the standards that apply are very consistent across all lines of organizations responsible for fiduciary assets. Regardless of whether a retirement plan or non-profit investment committee, the following principles apply.

Eliminate conflicts of interest

While a seemingly obvious flaw in a board or investment committee, conflicts are surprisingly common. If a committee member, their family or business receives an economic benefit by being a member or by making any committee decision, they are conflicted. Further, if a decision can benefit any other organization of which they are associated, a conflict exists.

It is common for community foundation board members to join other non-profit boards to help encourage the movement of those assets to the community foundation. This is a conflict of interest and simply abstaining from voting after the wheels are greased is unethical.

Case study

A non-profit board member travels the country speaking to conference attendees on fiduciary responsibility as a "trustee" and "investment committee member." The "trustee" also has a side business doing consulting for hire as a fiduciary expert. Is this a conflict? We think so. The marketing of oneself as a trustee and fiduciary expert, leveraging off the plan, encourages self-dealing in this case. A solid code of ethics policy should prohibit public speaking as a member of a board if they could benefit financially.

Give investment committee authority

Nothing is more frustrating than being delegated a task only to find out you don't have the authority to complete it. We find this structure frequently with investment committees.

Investment committees typically comprise individuals with investment expertise, yet in many cases, boards to which they report retain all authority to make investment decisions. Board members are asked to vote on investment policy, asset allocation changes and investment products, even though they are often removed from the research and analysis done by the investment committee. We believe this is not prudent.

We recommend boards set objectives and delegate investment policy, asset allocation and investment manager decisions to an experienced investment committee.

Case study

The investment committee of a not for profit experienced tremendous turnover. After in-depth "exit interviews," it was determined that many committee members were frustrated by what they believed was "second guessing" by members of the board. They felt that their value added in the current structure was non-existent and a waste of their time.

The bylaws of many of our clients are in the process of being revised to give more authority to the investment committees, because they are the closest to the analysis and usually have the most investment expertise. The board retains fiduciary responsibility to periodically review the investment committee's work, but the committee has the authority to make decisions. This model is the Uniform Prudent Management of Institutional Funds Act model for delegation.

Define detailed objectives

A defined benefit pension plan has an advantage in that specific objectives are defined by the actuary. With an endowment's or foundation's board, the objectives are based on the spending policy, grant-making and fundraising abilities. Essentially, the healthier an organization and the better the fundraising, the more risk a portfolio can take.

In addition, risk is a difficult subject for many investment committee members to evaluate, but is much more complicated with the poor markets over the last 10 years. We believe that an ideal way to quantify risk is to quantify the downside loss of a portfolio in a one-year period. There are plenty of data points in the last 20 years to reasonably calculate a number. By understanding return objectives, downside risk tolerance, time horizon, spending and fundraising, the formula is virtually set for designing a fiduciary prudent portfolio.

Case study

Trustees of a non-profit organization retained a number of managers and brokers to independently manage a foundation portfolio. Each was given the guidelines of "safety with growth" and were subsequently managing their section of the portfolio in their own way. The overall portfolio consequently was haphazard — it had strategy overlap and lack of diversification in some areas, and was expensive. After the recent difficult markets, the board took a step back and quantified expectations based on grant-making expectations, fundraising and downside risk tolerance. A diversified, efficient, cohesive portfolio was designed to meet these expectations and the committee was able to reduce fees in the process.

Ensure a diverse investment committee

A single perspective can unduly influence a board's thinking. If possible, we recommend a board comprising various departments, position levels and backgrounds. Having finance and human resources as members of a retirement plan board is a must, but the having an "all" finance or "all" H.R. board is a mistake. Many studies show that diversity results in better decisions.

Case study

One of the most difficult non-profit investment committees that we've worked with was composed entirely of stockbrokers. Overconfidence in calling markets (remember 90% of all automobile drivers think they are better than average drivers), and their ability to select products and strategies based on back-testing dominated. While having investment professionals on a committee is generally a positive, their experience and expertise could have been complemented nicely by a CPA, a banker, a money manager, a donor, a fundraiser and experienced investment committee members from outside the investment business. Their decisions would be more grounded and they would better understand the organization's impact of all their decisions such as budgeting, grant making, and fundraising.

Tone down overly dominant board and committee members

Typically, the "dominant" board member could be a senior member of the board, is the highest-level executive on the board or may be a large benefactor to a charity. Effective boards recognize that their "one vote" really does mean "one vote" and aren't swayed to a poor decision by dominance.

Leadership can play a crucial role in making certain all sides are reviewed, analyzed, and the benefits and detriments of each decision are considered. Often, volunteer boards are composed of senior executives (typically used to leading with type "A" personalities). Letting all sides give their points, an effective chair will lead the group to consensus. Jim Collins, author of "Good to Great," has written about the huge difference between "for profit" and "non-profit" leadership. The chair's role is not to force feed his/her personal view, but to lead to agreement. If the "bully" board member is the chair, the board and the organization will suffer. All board seats should have term limits, with possible re-election or reappointment, and a code of conduct.

Case study

Elected by plan participants, this retirement plan board member, a self professed investment "guru" and director of a large department, was very comfortable offering his personal investment advice to plan participants, and wanted to extend his expertise to the whole plan. The board felt that as a board member, his personal advice was fiduciarily risky, could be construed as board advice, and sought to reel him in. The board passed a "code of conduct" that prohibited personal investment advice, which effectively stopped the problem.

Conclusion

Violation of the aforementioned principles is common, and is almost always to the detriment of the board and often to the organization. While plenty of advice is given to trustees and investment committees as the size, meeting frequency, documentation, process, and protocol, focusing on some of these principles will help ensure success.

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