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# Investment committees should follow best practices

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Investment committees have the responsibility to oversee assets belonging to others, such as retirement plan participants or nonprofit organizations. All investment committee members have the immense role of serving as fiduciaries, including the obligation to ensure that organizations meet their financial obligations.

Investment committees have reacted in various ways to the rough markets of the past year. Some committees froze, doing nothing despite the markets' massive dislocations, and quickly changing risks and opportunities.

Other committees panicked in the middle of the meltdown and raised large amounts of cash (typically near the market bottom). Those committees now are faced with the issue of what to do next, as equity markets have rebounded and money-market yields are at record lows.

Sound investment committees were active, yet reasoned, in their approach in the past year. Investment objectives were revisited, portfolios were rebalanced and studies were conducted to identify risks and opportunities in the changed market environment. Accordingly, portfolios were thoughtfully adjusted.

Now is an ideal time for all investors to emulate successful committees' best practices. Some suggestions:

• **Reaffirm and outline goals and objectives —** Specific rate-of-return targets, such as an actuarial assumption or spending rate, need to be revisited regularly. Once a target return is solidified, the downside risk that accompanies this target should be quantified as well.

Committees need to understand their portfolio's short-term downside risk potential in order to help them maintain a reasonable perspective in difficult times. Too many investors focus only on a long-term rate-of-return assumption, and therefore, have the potential to panic in difficult times.

Cash flows should drive investment objectives. Positive net cash flows (through fundraising or plan contributions) may allow a more aggressive asset allocation. Conversely, if cash flows are negative through grantmaking or pension payments, the portfolio should be more conservative.

• **Review and understand the portfolio's asset allocation —** The design, or asset allocation, of the portfolio is more important than the choice of manager. However, many investment committees spend little time and research on the most crucial element of portfolio success: asset allocation.

While academic studies vary somewhat, most investment professionals agree that asset allocation determines a large majority of a portfolio's returns.

In the last year, many have re-learned lessons about diversification, such as leverage has a gigantic downside. In bad stock markets, all equities go down. High-grade bonds are a quality hedge in bad markets for equities.

At least annually, committees should review the portfolio's asset allocation, its characteristics and the likelihood of meeting long-term goals and objectives.

• **Create or review an investment policy statement —** This outlines the goals and objectives of both the organization and its investment portfolio. It should outline asset-allocation guidelines, as well as the process for selecting managers, funds, strategies and other investment products.

It should determine the benchmark for each component, and you should create a custom benchmark to help explain total portfolio performance. Additional items, such as portfolio-rebalancing procedures, securities guidelines, conflicts of interest and prohibitions, also are desirable. Consider hiring a consultant to help create this document.

The investment policy statement should be stringently followed. It's a dynamic document that's modified when prudent. In addition, a well-crafted policy serves as an excellent paper trail for new investment committee members.

• **Review practices and management —** Every committee should recognize "that investment theory is often at odds with behavioral tendencies," as Vanguard puts it.

Although having investment and finance professionals on the committee usually is positive, irrational behavior can come from almost anyone. It's beneficial to have varied backgrounds, ages, experiences and educational levels represented on the committee.

Beware of committee members who wield too much influence. While challenge and debate are important, discussions should be based on facts and research, instead of allowing the strongest opinions to prevail. Each committee member, including the CEO, has an equal vote.

Term limits are recommended to allow members to gracefully bow out, as well as poor members to "term" out. Successful committees benefit from reserving the right to ask quality members to serve additional terms.

Investment committee members need to be dedicated in their service and not conflicted in their advice. Attendance at meetings (quarterly is recommended) should be consistent. Minutes should be taken and supplemented with a detailed report on the portfolio's investment performance and specific managers. It's best when these items tie back to the investment policy statement.

Fiduciary responsibility hinges on process. While reviewing managers is important, the downfall of most committees isn't the performance of managers, but an ill-conceived asset allocation, and a lack of understanding and commitment to long-term goals and objectives. Prudent processes designed for fiduciaries are time-tested. All investors would benefit by adopting this institutional approach to managing investment portfolios. -- R.T.

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