Investment Committee Governance: The Forgotten Foundation of Investment Success

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Of all the contributors to investment success, the role of the investment committee is the most neglected.

It's rarely the most exciting topic to discuss. It's never as urgent or volatile as market-related issues. But it's probably more critical to your investment process than the investment strategies themselves. It's the foundation of your team's success and a suboptimal committee will slowly degrade and destroy a quality investment team.

Investing is difficult. To compound those difficulties with a second-rate committee will guarantee mediocrity and underperformance.

Weak committees are easy to spot:

- They will second guess sound, long-term strategies just when they are the most attractive
- They will micromanage the investment team
- They will focus on noise and randomness
- They will overreact to short-term underperformance
- They will enjoy the perks of committee membership, but not do the work
- They will prioritize consensus, comfort, and conformity vs. active debate and disagreement
- They will use their position to advance personal or political ambitions
- They will fall asleep during meetings, as I've witnessed firsthand

Investment committee change is difficult. By design, committee turnover is structured to be slow and deliberate. Second, educating and shaping the thought process of a committee takes a long time. Opinions change slowly. In fact, it may take many years, meeting after meeting, of reinforcing the proper investment process before you see acceptance.

From the beginning, it's the CIO's responsibility to shape the expectations and governance style of the board.

Below are 11 ideas that cultivates a supportive and growing relationship between the investment committee and the investment team. Not every idea is actionable nor practical for a given firm. But there's enough potential improvement, under control of the CIO, to create change. Improve on a few of these and you'll notice a more responsive and supportive investment committee, increasing the odds of investment success.

I've included many ideas from David Swenson, former CIO at Yale's Endowment. While Swenson gets a lot of credit for his investment acumen, I believe the management and structure of their investment committee was a critical, yet completely underappreciated part of Yale's success.

Principle #1: Consistent Communication

Committees don't like surprises. But given markets are unpredictable, how do you manage surprises when you only meet four times a year?

The key is to foreshadow and provide as much explicit guidance for future investments well in advance of any actual transactions.

In short, reiterate to the committee what you are likely to do, long before you have to do it.

Don't just rely on broad asset allocation targets and IPS guidelines. Guide the committee to what specific strategies you will buy/sell at different valuation/spread levels. Do this for as many asset classes and strategies as is practical. You can't cover everything, but you can hit the major asset classes and exposures. Show them what managers are on deck and the price/signal you are waiting for. This gives the committee enough time to think, ask questions, and get comfortable well before transacting.

A crisis is not the time to ask for new approvals or consideration of new strategies. The key during a crisis is to execute the plan that has been agreed to in prior meetings, not seek approval for the plan. Volatile markets are not the time to pitch new ideas, as the committee is in a heightened emotional state, ready to play it safe and shoot down ideas with any element of uncertainty. Committees don't want to be rushed into a decision.

A committee operating in a communication vacuum is a dangerous thing. Silence magnifies committee anxiety. Communication voids are always filled with something, and it's rarely calm, rational thinking.

Principle #2: Healthy and Vigorous Debates

David Swenson, former CIO at Yale's endowment, describes their Investment Committee:

> Since beginning its oversight of the Endowment in 1975, the Investment Committee has brought together remarkable men and women from various backgrounds, united in their support of the mission of the University. The diversity of the Committee serves as a source of strength in the management of the Endowment. Corporate executives, investment managers, educators, and non-profit leaders provide disparate viewpoints and specialized knowledge that inform the decision-making process. Healthy debate and discussion set the stage for consensus decisions. As Hume noted, "Truth springs from argument amongst friends."

As Swenson highlights, disparate viewpoints and healthy debates are a key part of the Yale committee process. This rarely happens in most committees, for a few reasons.

First, overloaded agendas are packed into compressed meeting times. Everyone's too busy, so the first thing to go is the time for thorough debate. This is a shame. Thoughtful conversations aren't possible when the committee is just trying to get through the agenda.

Investing is not easy. It's unreasonable to think committees can engage in a thoughtful discussion on portfolios and markets, all within an hour or two. Make the time to have a real discussion. And if that doesn't work for some members, get them off the committee.

Second, most committee members want an easy meeting. They aren't there to rock the boat and have uncomfortable conversations, even when they are needed. And being a passive participant is easy, especially when you can hide within a big committee.

The default is to hold back and not challenge other's views. Committees are rarely accountable to someone else – after all, they are the committee. Someone needs to push the committee members. And that needs to come from both the CIO and fellow members.

Peer pressure is a useful tool. Create the expectation and feedback that committees come prepared to debate. People will come around when they realize their lack of effort is an outlier. Most people don't want to let others down, so the best thing a committee can do is hold other members accountable.

Here's David Swenson's advice on selecting committee members:

> Investment committee members should be selected primarily for having good judgment. While no particular background qualifies an individual to serve on the committee, broad understanding of financial markets proves useful in overseeing the investment process. Aggregating a collection of investment specialists occasionally poses dangers, particularly when committee members attempt to manage the portfolio, not the process. Successful executives bring a valuable perspective to the table provided they suspend their natural inclination to reward success and punish failure. The sometimes deep-rooted corporate instinct to pursue winners and avoid losers pushes portfolios toward fundamentally risky momentum-driven strategies and away from potentially profitable contrarian opportunities. The most effective investment committee members understand the responsibility to oversee the investment process and to provide support for the investment staff, while avoiding actual management of the portfolio.

Committee membership is not a passive activity.

Committees need independent thinkers that will voice their opinions. Independent thinking leads to productive disagreement, which is healthy and necessary for investment success.

Principle #3: Do the Work

In order for committees to have rigorous discussions, they need to DO THE WORK.

Meaning, they need to prepare ahead of time and study the proposals and approvals that are needed. Unprepared board members hinder the investment process. Committee meetings are not the time to get caught up. It's not the time to review materials for the first time. It's a time to debate and discuss. If members can't prepare, they need to get off the committee or face pushback from other members. Unprepared members not only don't contribute, they waste everyone's time when needing to get caught up. It's a double hit.

I've been both a committee member and presented to enough investment committees to know that many read the recommendations and reports for the first time in the meeting. Board membership is an active process. It takes work outside the meeting. Unprepared board members can't contribute.

Set expectations for the board, especially incoming members. While CIO's serve at the discretion of the board, the CIO should be clear about the expectation for thorough preparation.

Principle #4: Written Memos

Detailed written memos allow committees to do the work. Memos are not PowerPoints. Memos are deep, well-researched reports that describe everything the investment team and committee would want to know regarding a new investment.

Memos force the investment team to articulate their recommendation. Writing reveals sloppy thinking and clarifies potential confusion. This benefits both the team and the committee. Writing has a way of revealing lazy thinking that the spoken word can obfuscate. Writing allows everyone to do their homework well in advance of the meeting.

Here's how Yale describes their memo approach:

> Each new manager is recommended through a formal memorandum that details all "due diligence" research; explains the manager's record, organization, investment philosophy, and decision-making process; and provides the professional record of each principal. Each of these in-depth background briefings—typically 15 to 20 pages long— provides the basis for a thorough discussion with staff professionals. Quarterly Investment Committee meetings are much like an advanced seminar in investment theory and practice, led by two Yale Ph.D.'s: President Richard Levin and Chief Investment Officer David Swensen

Writing is hard work, and many investment teams will resist. In the long run, however, it saves a lot of time and improves performance by clarifying thinking and forcing effort by all those involved.

Principle #5: Diversity Drives Better Discussion

The benefits of diversity are well documented. Diversity is achieved in many ways, but it's paramount that investment committee members realise their diverse background by arguing different viewpoints. Diversity without implementation doesn't add value.

Committees need both institutional investment experts and non-investors. Investment expertise is needed to decipher what is not being said, what is being overlooked, and where to push back. Non-investors simply lack the experience and details to understand the nuance and gaps in a recommendation.

However, non-investors are great at compensating for investment professionals' tunnel vision. Investors can get caught up in the weeds and miss the big picture. You need others who can counteract this tendency. In addition, a big part of the committee is overseeing leadership, management, and organizational concerns, where non-investors add a lot of value.

Principle #6: Long-term Orientation

Organizations operating under an investment committee will never win the short-term investment game. In fact, most investors will never win the short-term game. But it's especially true for slower-moving organizations that have committees and red tape to fight through. So a long-term orientation is a requirement.

Long-term orientation is an advantage many others don't have. When other investors are overreacting or being forced sellers, you use long-term thinking to invest where opportunities are created.

Swenson elaborates:

> At the same time, fund fiduciaries hope to retain power by avoiding controversy, pursuing only conventional investment ideas. By operating in the institutional mainstream of short-horizon, uncontroversial opportunities, committee members and staff ensure unspectacular results, while missing potentially rewarding longer term contrarian plays.
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> Two important tenets of investment management—contrarian thinking and long-term orientation—pose challenges for governance of endowment funds. Because large bureaucratic organizations invariably use groups of people (investment committees) to oversee other groups of people (investment staff), consensus-building behavior permeates the investment process. Unless carefully managed, group dynamics frequently thwart contrarian activities and impose shorter than optimal time horizons.

Long-term orientation facilitates independent and contrarian investing. If you play a short-term game, you'll be chasing everyone else. At every meeting, CIO's need to reinforce the long-term focus, as the pressure to focus on the short-term is unrelenting.

Principle #7: "Cutting Edge" Organizations

Committees should support building world-class investment organizations. This sounds like wishful thinking for many small organizations or public institutions. You may not be the next Yale, but you can be exceptional at something.

Don't expect you'll be the world's greatest VC allocator when you don't have the resources of a major endowment. Don't expect to build a large, internal, actively-managed team with a small AUM base.

Think about where a small team with limited resources can be exceptional. Perhaps it's a well-developed asset allocation strategy. Perhaps it's an active way to manage a portfolio of ETFs or closed end funds. Either way, you can pick something to be exceptional at, even if it's different than the big funds. So choose carefully where you want your team to excel and focus on that one thing.

Good people don't want to work for boring organizations. They don't want to go through the motions. They want to add value and do interesting things - that's being on the cutting edge.

Here's an excerpt from Yale's Annual Report, where Hank Paulson, formerly of Goldman Sachs, describes the ideal work environment:

> In October 1987, Treasury Secretary Henry Paulson, then senior executive at Goldman Sachs, spoke at Yale's School of Management and articulated a compelling case for the ideal work environment. Paulson said that high-quality individuals gravitate toward entities that operate on the cutting edge, that embrace a global strategy, that provide opportunities to benefit from focused mentorship, and that encourage early acceptance of significant responsibility. The Yale Investments Office has worked to create such an environment over the past quarter-century.
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> The driver behind the Endowment's cutting-edge, global work is its people. The rigorous nature of the work at the Investments Office attracts people who are intellectually curious. Investments Office employees enjoy digging deep into their research and developing unconventional approaches to the problems they face. In addition to an academic interest in their work, staff share an interest in Yale and in doing meaningful work. The combination of those factors creates a strong culture in which people love what they do. That passion attracts people who share the same values to join the Office, creating a virtuous feedback loop.

Creating a "cutting-edge" organization is not about assets. It's not about being an endowment or family office. It's about having a CIO and committee who will take a stand and do the hard work to create a meaningful and purposeful investment strategy. CIO's and investment committees should sit down and think about where the team can be exceptional. It won't occur overnight, but your team will thank you when they truly believe they can be great at something.

Principle #8: Stop Using Peer Performance

Like most things in life, peer comparison is a guaranteed way to ensure failure and misery. It applies equally to investing.

Nothing kills an investment team's morale quicker than constantly worrying about peer rankings.

It's endemic in the endowment world. Everyone gossips about the latest 1-year rankings, speculating about why some teams are struggling and some are thriving. And why some are geniuses and others have lost their touch.

It's all nonsense. It's a typical attempt to create stories and issues out of randomness. It's a waste of time, but people do it anyway. No one is good enough to be on top every year.

The solution is simple. As a CIO, stop using peer rankings. Stop worrying about what your peers are doing. Focus on the internal team and process. And above all, don't allow the committee to berate the investment team for falling behind in the rankings. Or start to question the investment process. Or demand answers for poor performance. This overreaction drives short-term thinking, thereby killing any chance of long-term outperformance and team satisfaction.

Principle #9: Governance, Not Management

Investment committees govern, not manage. As former CEO Ken Dayton exclaimed:

> Governance is governance and management is management and the difference between the two must be clearly understood and accepted.

Many committees miss the sweet spot on the governance spectrum:

- On one extreme, they do the bare minimum and go through the motions.
- On the other extreme, they become overly engaged, thinking themselves as an investment manager and interfering with the investment team.

There's a balance that needs to be struck.

Swenson explains:

> A strong investment committee brings discipline to the endowment management process. By thoroughly and thoughtfully vetting investment recommendations, the committee inspires staff to produce ever more carefully considered proposals. Ideally, committees rarely exercise the power to reject staff recommendations. If a committee frequently turns down or revises investment proposals, the staff encounters difficulty in managing the portfolio. Investment opportunities often require negotiation of commitments subject to board approval. If the board withholds approval with any degree of regularity, staff loses credibility in the eyes of the investment management community. That said, the committee must provide more than a rubber stamp for staff recommendations. In a well-run organization, committee discussion of investment proposals influences the direction and nature of future staff initiatives. Effective portfolio management requires striking a balance between respect for the ultimate authority of the investment committee and delegation of reasonable responsibility to the investment staff.

Committees make sure the investment process is being followed in a rigorous and consistent manner.

They point out if something is missing or if clarification is needed.

They oversee the process. They don't run the process.

Principle #10: Committee Size

Nothing ruins group decisions quicker than too many members. Investment committees are no exception.

- It's harder to speak up in a big group. Speaking in front of 10 people feels like a speech. Speaking in front of 5 is a conversation.
- It's easy to hide in anonymity when there are too many members.
- Increasing the size means exponentially increasing the interactions, conversations, and conflicts.

Once a group gets bigger than 5 people, the interaction quality goes down and group management becomes a headache. Have enough members to drive diverse opinions, but not so big it's unmanageable. When committee size is governed by legislature or law, you don't have any choice. But if you have any discretion on board size, think smaller, not bigger.

Principle #11: Tenure

Getting new committee members isn't a problem; getting rid of them is. Organizations need change. It's better to lose some good members with regular change then keep the bad ones with extended terms. Long-tenured committee members, even those who bring value, become hardened to doing things one way and lose the vigor they once had.

Committee members shouldn't be hanging around. It's not supposed to be a cushy retirement gig. This isn't a part-time job. It's a full-time commitment, even if you meet four times per year.

Shorter board terms of 3-5 years are ideal. Two shorter terms of 2-3 years each can work too. This allows enough continuity but allows consistent change.

Fresh ideas and energy are the lifeblood of investment committees. Even the best start to settle over time. This isn't the Supreme Court - there are no lifetime appointments. Instead, give it everything you have for a few years, and then move on.