Keys to Effective Governance: Investment Committees & Decision-Making

HIGHLAND

Highland Associates, Inc.
2545 Highland Avenue, South
Suite 200
Birmingham, AL 35205
205-933-8664
www.highlandassoc.com

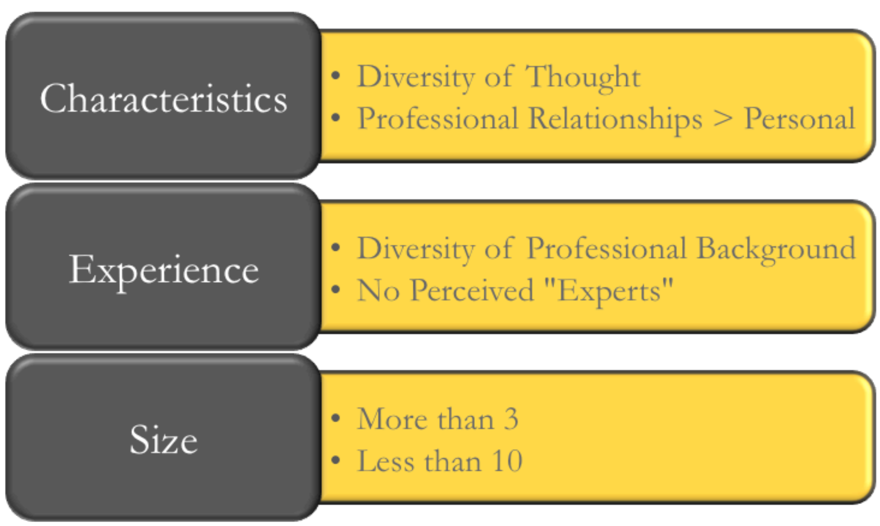
Committees, and the decisions they make, are an important part of the governance process in any organization. At the same time, committee decision-making is prone to problems that can adversely impact the organizations they serve, the contribution of the individual members of the committee, and create stress in the relationships of the members with each other. Michael Mauboussin of Legg Mason has written extensively about the characteristics of a successful investment program and two of his publications, *More Than You Know: Finding Financial Wisdom in Unconventional Places*[1] and "Investment Committees: How to Build a Team to Make Good Decisions" [2], speak specifically to decision making and investment committee structure and functioning.

KEYS TO AN EFFECTIVE INVESTMENT COMMITTEE:

Committee Structure
How to Classify "Problems"
How to Make a Decision
Leadership
Avoiding Common Pitfalls

Committee Structure

The factors that impact an effective committee structure include the characteristics of the members, the experience of the members, and the number of members. Within those broad factors lie a number of underlying keys to effectiveness including:



How to Classify "Problems"

The allocation of time is one of the most challenging jobs for a committee as a whole and its chairperson in particular. The structure of the committee (discussed above) has a great deal to do with how efficiently a committee operates.

The table below[2] highlights one of the main challenge of committees: a committee is really just a collection of individuals. People like to spend their time on what is most interesting to them personally as well as on issues that can be neatly resolved in the course of meeting. That desire leads committees to spend the most time on Unimportant Knowable issues like past performance and the least time on Important Unknowable issues like determining the proper allocation for the future based on an organization's expected objectives and constraints.

	Unimportant	Important
Unknowable	No Time	Most Time
Knowable	Little Time	Some Time

Properly allocating time is one of the largest factors in determining the effectiveness of a committee.

How to Make a Decision

Decision-making is a combination of two activities: (1) information gathering and (2) discussion / voting. An interesting idea that Mauboussin introduces is the concept of the Premortem. The Premortem can be a valuable part of the information gathering process where committees research what could go wrong with any given idea or decision, and measure the impact prior to making the decision (in contrast to a postmortem). This activity helps to identify potential problems, but it also serves to solicit unexpressed concerns from committee members regarding a potential decision. This type of research is fairly common in the investment management industry in the form of a "devil's advocate" role. The devil's advocate takes the counter position for any investment thesis and tries to raise every possible reason why a decision should not be made.

Keys to Information Gathering

- Solicit the input of all members
- Use a long-term evaluation period for evaluating probability-based strategies like investment managers
- Match the time period to the particular investment

Keys to Discussion / Voting

- Voting style (unanimous, majority, consensus) can impact decisions
- Proper style also depends on the importance of the decision (approving meeting minutes vs. a strategic plan)
- Document decisions

The end result of both processes is the same – a full accounting of the positive and negative consequences of every decision resulting in a fully informed decision.

Committee Leadership

Selecting the right chairperson has one of the largest impacts of any factor on the decision-making ability of a committee. An effective chairperson should exhibit the following behaviors:

- Support Process-Oriented Decisions – this idea will be explained in more detail in the following section but an effective chairperson should ensure that all decisions are made based on a well defined process;
- Maintain Focus on the Mission – the mission of the committee and the role it serves within the organization should be at front of mind at all times. This can mean that some decisions are beyond the scope of a particular committee and must be left to another to settle - which can be hard for dedicated committee members to handle. An effective chairperson can help to maintain focus so each committee member can feel good about their place in and contribution to the organization while making the most efficient use of their committee's time and energy; and
- Solicit Input – an effective chairperson can gracefully solicit the input of all the members of the committee to ensure that all points of view have been expressed, the issue has been fully vetted, and that all members will buy in to a particular decision.

Avoiding Common Pitfalls

Committee decision-making often suffers from two main challenges: (1) social loafing and (2) groupthink.

- Social Loafing – members of a larger committee can feel that their full effort and contribution are not necessary and may give less input. As a result, important points of view may be left out of the decision-making process and individual members might become less personally invested in decisions. Strong leadership, as discussed above, can help to minimize this problem.
- Groupthink – the human desire to avoid conflict and disagreement, especially in social environments, is extremely strong. This desire can lead to ill-informed decisions and bad outcomes. Committee members that have more of a professional relationship than a personal relationship are less likely to conform simply to avoid conflict and can help to avoid this pitfall.

With the structure of an effective committee outlined, how does a committee set a framework for effective decision-making?

KEYS TO EFFECTIVE DECISION-MAKING:

Focus on the Process, Not the Outcome
Focus on the Long-Term, Not the Short-Term

Mauboussin's recommendations on decision-making can be summarized in two simple statements: focus on the process, not the outcome and focus on the long-term, not the short-term.

Focus on the Process, Not the Outcome

Successfully implementing the preceding statement is easier said than done. Results are easily measured, clearly defined, and easily compared – they are the most clear and effortless path for evaluating a decision. The problem with focusing solely on the results is that it completely ignores how the results were achieved. Robert Rubin, Secretary of the Treasury under President Clinton, expressed it well in his 2001 commencement address at Harvard University, "Individual decisions can be badly thought through, and yet be successful, or exceedingly well thought through, but be unsuccessful, because the recognized possibility of failure in fact occurs. But over time, more thoughtful decision-making will lead to better overall results, and more thoughtful decision-making can be encouraged by evaluating decisions on how well they were made rather than on outcome."

Interestingly, decision-making standards for those acting as fiduciaries reflect this same theme of process versus outcome. Broad fiduciary guidelines such as the Prudent Investor Rule and more targeted guidelines found in the Employee Retirement Income Security Act of 1974 (ERISA) focus on the due diligence performed by the fiduciary and the diversification of the ending allocation. Obviously everyone is interested in the end results (outcome), but the prevalence of process in a number of different fiduciary standards suggests that a greater focus on process is appropriate.

Focus on the Long-Term, Not the Short-Term

As with the "process versus outcome" debate, long-term focus is a common sense practice that is very difficult to implement. Investing is a probability-based exercise; therefore, the longer the time frame over which you choose to evaluate success, the greater the likelihood is that you will be successful. This is especially true when investing with active investment managers. By definition, active managers will be different from the index and can, depending on their level of concentration of holdings, experience results that are very different from the index in a given year. While some active managers may be more consistent in their success, others may go years without beating their index and then make up any underperformance in a couple of strong relative years. This type of relative performance volatility must be thoroughly understood at the inception of the strategy in order to prevent a disappointing outcome.

Patience with relative performance volatility was extremely important over the past 10 years and will, in Highland's opinion, continue to be crucial. Mauboussin conducted a survey of managers that outperformed the S&P 500 from 1997-2006 where the fund had a single manager and at least $1billion in assets.

Four Traits of Successful Investment Managers (1997 - 2006)

- Lower Portfolio Turnover (35% vs. 89% for the universe)
- Higher Portfolio Concentraion (35% in Top 10 Holdings vs. 20% for the S&P 500)
- Investment Philosophy Focused on Valuation
- Geographic Location (many outside the major financial centers)

Interestingly enough, the 1997-2006 study was an update of Mauboussin's original study from 1995 – 2004 and ¼ of the names on the original list were also on the 2006 update. Since both study periods include the market run up in the late 1990's and the dramatic decline from 2000 – 2002, it is reasonable to assume that there were some significant short-term relative performance differences but the result of the study showed the managers' long-term success. In other words, there were many stumbling blocks in the path of short-term thinkers that could have derailed the successful long-term run for the survey list of managers.

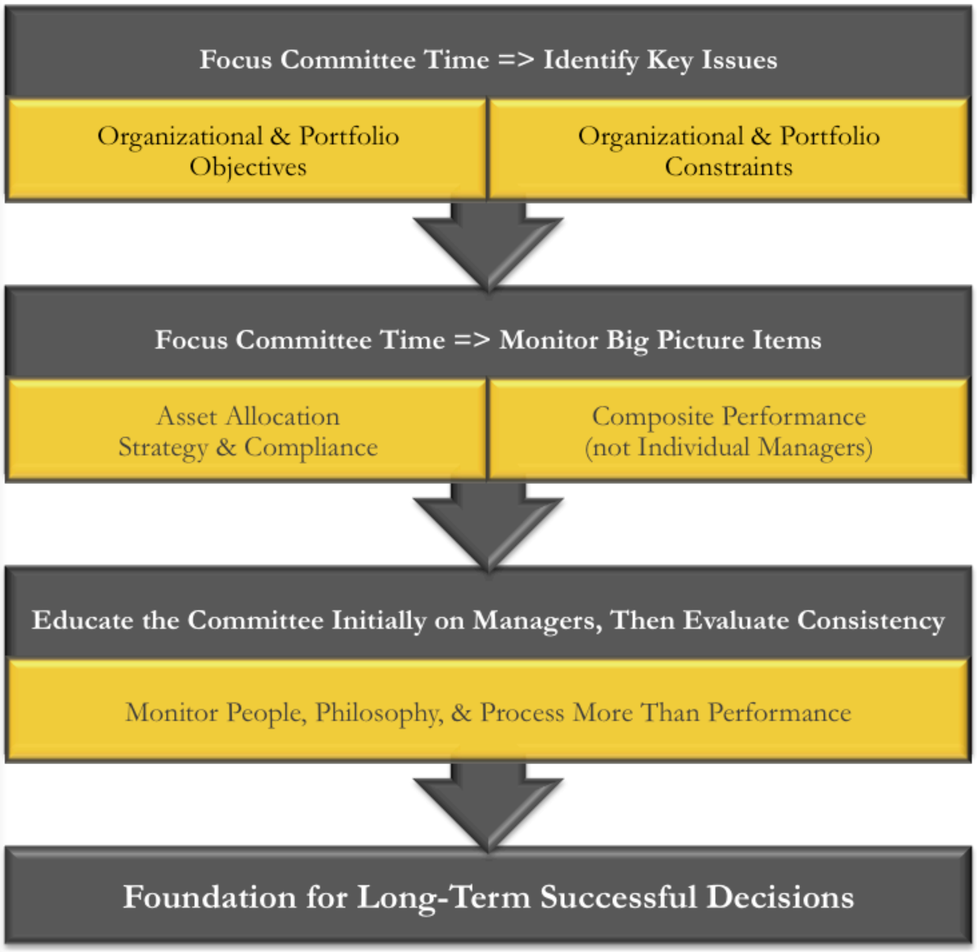
APPLICATION:
LAYING THE FOUNDATION FOR LONG-TERM SUCCESS

Highland believes the foundation for long-term success must include the practices outlined above. From a tangible / practical point of view, the following graphic offers three key steps to help achieve a long-term perspective:

ABOUT HIGHLAND:

Highland Associates, Inc. was founded in 1987 as an independent institutional investment advisor to assist not-for-profit institutions in the development, implementation, and maintenance of treasury and investment management programs.

The firm is headquartered in Birmingham, AL and, as of December 31, 2013, serves as investment consultant on approximately $18 billion in assets.



A related issue is the level of discretion an organization is comfortable delegating to an outside investment advisor to provide the time necessary for the governing committee to focus on the process, the long-term, and the bigger picture. This decision is unique to each organization but is worth exploring in more detail to see what benefits might accrue from such an arrangement. Please contact us to schedule a time to discuss how this paper applies to your specific organization and how Highland can help.

References:

[1] Mauboussin, M. (2006). *More Than You Know: Finding Financial Wisdom in Unconventional Places*. New York: Columbia University Press.

[2] Mauboussin, M. "Investment Committees: How to Build a Team to Make Good Decisions". Legg Mason Capital Management: Mauboussin on Strategy. September 1, 2009.

Bill A. Terry, CFA
Co-founder | Principal | bterry@highlandassoc.com | 205.933.8664

Mr. Terry is an original founder of Highland Associates. He is a principal of the firm and a shareholder. Prior to forming Highland Associates, Mr. Terry co-founded and co-managed the Investment Management Consulting Group of Interstate/Johnson Lane securities. Mr. Terry is a member of the Board of Directors for Protective Life Corporation, a NYSE listed company, where he serves on both the Finance and Investment, and Audit Committees. In addition he serves as immediate past Chairman of the Executive Board of the Greater Alabama Council of Boy Scouts of America and on the Finance Committee of the Birmingham Museum of Art. Mr. Terry holds a Bachelor's of Arts degree from Davidson College and is a CFA Charterholder. Mr. Terry has 31 years of investment experience.

Charlie D. Perry
Co-founder | Principal | President | cperry@highlandassoc.com | 205.933.8664

Mr. Perry is an original founder of Highland Associates. He is a principal of the firm and a shareholder. Prior to forming Highland Associates, Mr. Perry co-founded and co-managed the Investment Management Consulting Group at Interstate/Johnson Lane Securities (a New York Stock Exchange Listed Company). Mr. Perry currently serves as the chair of the Investment Committee for the University of Alabama at Birmingham Health Services Foundation and sits on the Board of the Health Services Foundation, the University of Alabama Health System, the UAB Medical Leadership Committee and the Comprehensive Cancer Center of the University of Alabama at Birmingham. He is the current Vice Chairman and past President of the Alabama Symphony Orchestra and is Chair of the Alabama Symphony Endowment. He earned his Bachelors of Arts in Economics from Washington and Lee University. Mr. Perry has 37 years of investment experience.

Michael T. Lytle, CFA
Consultant | mlytle@highlandassoc.com | 205.933.8664

Mr. Lytle joined Highland Associates in 2006 as a consultant to the firm's institutional client base. He is a shareholder in the firm. Prior to joining Highland Associates, he worked as a fixed income portfolio manager in AmSouth Bank's Asset Management Department. Mr. Lytle is the Chairman of the Investment Committee of the Greater Alabama Council of Boy Scouts of America, serves on the advisory board for the Department of Economics, Finance and Quantitative Analysis at Samford University and is a past president of the Vestavia Hills Library Foundation. He is also the Chairman of the Finance Committee and Vice-Chair of the Deacon Board at Dawson Memorial Baptist Church. Mr. Lytle earned his Bachelors of Science from Berry College. He is a CFA Charterholder and past board member and president of the CFA Society of Alabama. Mr. Lytle has 15 years of investment experience.

Paige B. Daniel
Consultant| pdaniel@highlandassoc.com | 205.933.8664

Ms. Daniel joined Highland Associates in 2006 as a consultant to the firm's institutional group. She is a shareholder in the firm. Prior to joining Highland Associates, she was director of alternative strategies with AmSouth Bank's Wealth Management Group. Ms. Daniel also worked for CIBC Oppenheimer and with Quick and Reilly. She is a member of the YWCA of Central Alabama's Board of Directors and Endowment Committee. She is also on the Executive Committee and Board of the Parkinson's Association of Alabama. Ms. Daniel serves on the Board of the Girl Scouts of North Central Alabama and chairs their Finance Committee. She earned her Bachelors of Arts in Economics from Vanderbilt University and her Masters of Business Administration from Georgia State University. Ms. Daniel has 19 years of investment experience.

R. Scott Graham, CFA
Consultant| sgraham@highlandassoc.com | 205.933.8664

Mr. Graham joined Highland Associates in 2006 as a consultant to the firm's institutional client base. He is a shareholder in the firm. Prior to joining Highland Associates, he worked at Vulcan Materials Company as a senior financial analyst. Mr. Graham previously worked at CNHI and NCP Solutions in an analyst role. Mr. Graham earned his Bachelors of Science in Finance from Troy University and his Masters of Business Administration from the University of Alabama at Birmingham. He is a CFA Charterholder and a member of the CFA Society of Alabama. Mr. Graham has 11 years of investment experience.