By Bill Spitz, Principal

As a Co-Founder of Diversified Trust, Bill has been instrumental in the ongoing development of the firm's investment platform. Bill also serves on the Board of Directors of Mass Mutual Financial Group, Acadia Realty Trust, and is Trustee emeritus of Kenyon College in Ohio. He authored Get Rich Slowly: Building your Financial Future through Common Sense and is a frequent speaker at financial conferences.

Lost Opportunity

The New York University Endowment maintained equity exposure ranging from 7% to 35% during one of the greatest bull markets in history, a seventeen-year period (1982-1998) in which stocks returned 18.2% per annum. In contrast, roughly two-thirds of the average college endowment was allocated to stocks and the larger endowments had even greater exposure. The net result was an eight-fold increase in value for the average endowment while NYU's fund only increased by 4.6 times. Had NYU simply mirrored median college and university returns, its value would have been almost $1 billion greater in 1998 than the actual level of $1.3 billion. How could a large, prestigious university be so out of sync with both the markets and its peers? As described in both David Swensen's classic book Pioneering Portfolio Management and the New York Times, the answer is that NYU's Investment Committee deferred to Larry Tisch who was the powerful Chair of the NYU Board of Trustees from 1978-1998. Tisch was Co-CEO of Loews Corp. and a very generous donor to the University. He apparently viewed stocks as risky in general, and particularly so for NYU given that he considered the University's finances somewhat fragile. Since hindsight is clear, we should not be critical of Mr. Tisch's market views, but should instead focus on the fact that dominance of an investment committee by a single individual represents poor governance.

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DIVERSIFIED TRUST

Unfortunately, this is not an isolated example; I am ashamed to admit that I did not speak out forcefully on two different occasions when a prominent individual pushed an investment committee of which I was a member to reduce equity exposure at what turned out to be just the wrong time.

Domination of a committee by a powerful individual is just one of a large number of problematic behaviors that I have witnessed during a forty-eight year career in which I have served on, chaired, and reported to, a large number of both institutional and family decision making bodies. For a variety of reasons including committee dynamics, studies indicate that 25% of institutional portfolios significantly underperform their benchmarks while 74% roughly equal them. (By the way, that means that only 1% outperform!) So, if you assume average underperformance of say .50% per annum (and the gap may actually be larger), more than $60 billion is being squandered annually based on total U.S. endowment, foundation, and defined benefit retirement plan assets of $12 trillion. So, while my description of dysfunctional investment committees may come across as finger wagging, my intent is not to criticize but to help institutions achieve their objectives, many of which are charitable in nature. Additionally, many of the recommendations included herein are applicable to individual investors. I have divided committee shortcomings into six broad categories, and those shown in bold print are ones that I deem particularly egregious.

I. COMMITTEE COMPOSITION, ORGANIZATION, AND GOVERNANCE SHORTCOMINGS

- Many committees are not optimally sized. Four to six members seems to allow for sufficient diversity while also promoting crisp decision making.
- Many do not have a healthy balance between investment expertise and those with general business sense and experience. Too many investment experts may contribute to conflict and the inability to reach decisions while too few may result in the committee not having the requisite knowledge.
- Some committees do not rotate the Chair very often creating the potential for a fiefdom. Two- to three-year terms is probably about right.
- As discussed above, some committees are dominated by a vocal individual, frequently the Chair.
- In contrast, some Chairs fail to keep meetings on task and allow members to wander off onto tangents. It is the responsibility of the Chair to ensure that decisions are actually made after a full and thorough discussion.

The bottom line *is that high-functioning committees are composed of knowledgeable individuals who understand their responsibilities and make informed decisions in an atmosphere of openness, mutual respect, candor, and shared accountability.*

- Many committees do not have a charter that clearly defines the responsibilities and purview of the committee as well as those of outside vendors.
- **Committees often do not accept accountability and instead blame managers, consultants, and other vendors for sub-par results.** It is important for every member to have a thorough understanding of both the practical and legal implications of fiduciary responsibility. A committee should have an annual self-evaluation as well as a periodic assessment of the contribution of each member.
- At the other extreme, some committees micro-manage investment decisions, often without sufficient expertise and accountability to do so.
- Many committees are overly focused on peers and are fearful of taking a contrarian position for which they could be criticized. There is a truism that you will earn the same returns as everyone else if you have the same portfolio as everyone else.
- Committees often wait for clarity in the outlook before making decisions. The outlook is never clear, and if it were, markets would already reflect it. Similarly, they often miss out on opportunities because the committee is unable to reach consensus on a timely basis.
- Some committee members have conflicts of interest that are not adequately disclosed and managed. While it is logical for professional investors to serve on committees, it is important that the institution carefully consider the potential conflict arising from investing in the funds of those members or their friends.
- Committees have a strong tendency to take action, particularly when things are not going well. Generally, these decisions are impulsive and non-productive.

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II. KNOWLEDGE GAPS

Members of investment committees are universally highly intelligent and successful in their chosen field. However, many have not had to deal with the complexities of institutional investment management resulting in gaps in knowledge that need to be filled.

- Many committee members do not grasp the concept of a portfolio. Instead, they focus intently on the individual portfolio components without an understanding of how they interact to achieve an optimal balance between risk and return.
- Many members do not have an understanding of basic financial and statistical concepts.
- Many understandably have a difficult time evaluating the impact of volatility and most overestimate the actual level of volatility in the economy and financial markets.
- Many do not have perspective on historical returns nor do they understand the various methods of predicting future returns. The result is unrealistic return expectations, either high or low.
- **Some committees invest in strategies they really do not understand.**
- Committees often underestimate the impact of costs on net returns and do not actively consider them in making investment decisions.

As mentioned in the previous section, a committee composed entirely of investment professionals may be difficult to manage given their proclivity to have strong views. So, a diverse set of skills and experiences is important but every member should have or gain a basic level of understanding of the fundamentals of investment management.

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III. FAILURE TO CAREFULLY AND THOUGHTFULLY CRAFT INVESTMENT OBJECTIVES

- Many committees fail to tie stated investment objectives to the purpose for which the fund was created. Instead, they fixate on market indices and performance versus peer institutions.
- Many committees do not devote adequate time and discussion to determining the appropriate level of risk for the fund.
- Committees often focus on short term risks without considering truly existential risks.
- Some reach for return without understanding the risks involved.
- Many members think in terms of their own tenure on the committee as opposed to the true time horizon of the fund.
- Given the perpetual nature of many funds, committees are often overly concerned about portfolio liquidity to the detriment of returns.
- **Many committees increase their risk tolerance as markets rise.**
- **Some committee members impose their personal level of risk tolerance on the fund despite its different goals and time horizon. Similarly, some are overly strident in advocating for their own biases regarding investment strategy and asset classes.**

As will be discussed shortly, many committees devote the majority of their meeting time to excruciatingly detailed evaluation of investment performance without adequate discussion of the actual objectives and constraints of the fund. As the great philosopher, Yogi Berra, said, “If you don’t know where you are going, you might not get there.”

IV. NON-PRODUCTIVE MANAGER SEARCHES/ SELECTION OF INVESTMENT VEHICLES

- While institutions engage in formal manager search processes in which a great deal of information is gathered, the ultimate decision is generally based primarily on past performance. Study after study demonstrate that performance track records have little predictive value regarding future performance.
- Final decisions are also heavily based on the quality of manager presentations rather than on a detailed understanding of the candidates’ investment approaches, resources, and most important, alleged “edge” over the competition.

- **Committees hire and fire too often.** Again, careful studies consistently find that fired managers outperform newly hired managers in subsequent periods. Moreover, there may be significant costs involved in transitioning to new managers or funds.
- Committees typically become interested in new strategies or asset classes after they have outperformed based on inappropriate extrapolation of recent experience.

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Manager/vehicle selection is admittedly very difficult given that track records and other quantitative metrics do not provide much useful information. This implies that successful manager selection requires that committees delve into a broad range of qualitative factors that are not easily measured. This effort may exceed the time constraints and resources of many committee members suggesting that they would be better served by using passive vehicles. An additional conclusion is that committees should refrain from frequent hiring and firing which segues into the next section on performance management.

V. MISGUIDED PERFORMANCE MEASUREMENT

- Committees are highly focused on short measurement periods despite the fact that many years of data is required to statistically demonstrate that a manager has or has not added value.
- As mentioned above, committees frequently act on the basis of these short measurement periods which may entail significant expense without any improvement in future returns.
- **Committees focus intently on the performance of each component of the portfolio without adequate consideration of whether the overall fund is achieving the goal for which it is created.**
- Members immediately gravitate to the worst performing component of the portfolio and spend a disproportionate amount of time discussing it. This tendency is particularly non-productive when the overall portfolio is performing well and the segment in question represents a small portion of the portfolio. Another often overlooked consideration is that components designed to hedge other segments of the portfolio should be underperforming if the larger portion is performing as expected.

- Similarly, many committees are obsessed with performance versus competitors or peers despite the fact that they may have very different objectives and constraints.
- Many fail to adequately consider the risk assumed in achieving results.
- Many committees do not carefully consider the benchmarks used for each component of the portfolio. Given the huge number of available market indices and the differences between them, the result may be spurious comparisons leading to poor decisions.
- Committees are frequently so focused on the relative returns of each manager that they do not take into account other evaluative factors such as firm ownership, personnel turnover, and changes in investment approach.

Evaluating investment performance is certainly an important part of an investment committee's responsibilities. However, in fulfilling this obligation, the committee should first ensure that the fund is achieving the goal for which it was created. More granular analysis should recognize the many limitations of performance measurement since it suffers from the "illusion of precision." Finally, committees should focus on a number of both qualitative and quantitative factors before taking action and changes should be relatively infrequent.

VI. PROBLEMATIC INDIVIDUAL BEHAVIOR

A number of potentially destructive individual behaviors were included in the previous five sections, but here are a couple more items for self-reflection:

- Many, if not most of us, are susceptible to emotional overreaction to rising and falling markets. It is critical to control these impulses in order to prevent "group think" that leads to rash decisions.
- Similarly, many committee members are influenced by daily headlines, prognostications of pundits, politics, and other sources of "noise" that contribute to emotional ups and downs. This is particularly inappropriate for institutional funds that have a long if not perpetual time horizon.

- Many members overestimate their knowledge and ability to forecast future trends in the economy and markets. As was mentioned earlier, some attempt to dominate the committee and do not respect the views of their colleagues. Others are prone to second-guessing internal investment professionals and external managers. Strong committee members leave their egos at the door.
- Some members are overly focused on making an impact on the fund during their tenure on the committee.

The best committee members are defined by intellectual curiosity and a degree of rigor, the courage to take a controversial or unconventional position, the ability to balance patience and decisiveness, and a true commitment to the mission of the organization rather than to their own stature or role on the committee.

BENEDICTION

Serving on an investment committee is both an honor and responsibility that requires a certain level of knowledge and a commitment to fiduciary standards. While this paper described a large number of gaps in knowledge and problematic behaviors, it was written in the spirit of continuous improvement and dedication to accomplishing the worthwhile missions of these institutions.

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ATLANTA
877.955.8266

CHARLESTON
866.619.1003

GREENSBORO
855.821.4999

MEMPHIS
800.264.7498

NASHVILLE
877.386.7332

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