The Frontier Line

Thought leadership and insights from Frontier Advisors

The secrets to good investment decision making

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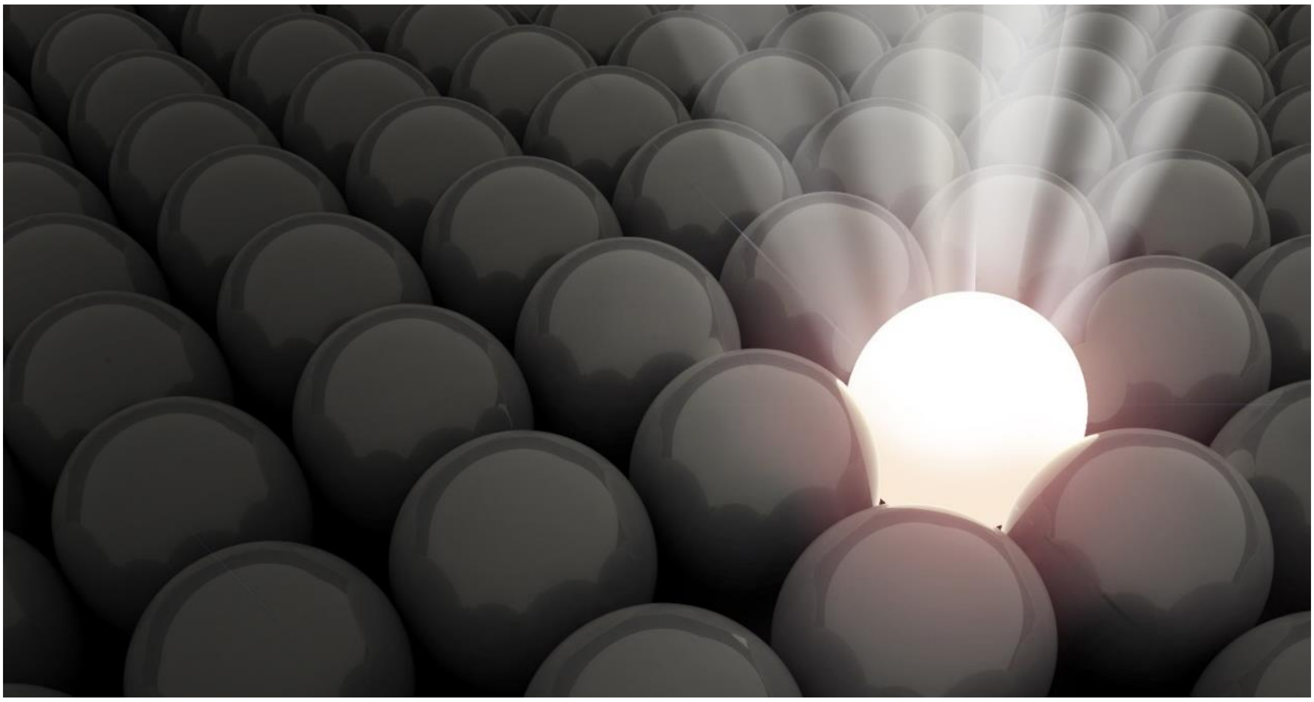

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Good investment decision making

We are often asked "what makes a good investment decision making body?" This is a question many of our superannuation fund clients in particular have been asking recently following the introduction of the new Stronger Super standards around investment governance. The benefit of experience is that you get to see lots of things happen, and in the context of the work we do, to see lots of decisions get made (and not made). This paper covers some of the things we have learned over the years watching various committees in the institutional investment arena make decisions about their investments, and it provides a set of actions for any institutional investor to follow in the pursuit of decision making excellence.

"If you chase two rabbits, both will escape"
Anonymous

"You cannot create experience. You must undergo it"
Albert Camus

What is governance?

Governance is the framework connecting decision makers around a specific area.

Investment governance is the process for overseeing and making decisions around investments. It implies a fiduciary responsibility in the context that we most commonly use it.

Importantly, governance is not management. Being a fiduciary or steward of other people's money, whether it is a superannuation fund, a university endowment, a hospital, a redundancy trust and so on, should not include portfolio or investment management.

The recognition of the strategic role that can be played by trustees or directors is an important step in the path to understanding how each party can add value to the overall portfolio or entity. In our experience, trustees and directors often struggle with this distinction between management and strategy, and this can lead to confusion.

An investment governance system defines the process by which a fund's investments will be run, with a focus on maximising the outcome to the various stakeholders within a framework appropriately controlled for risk and cost.

Groups involved in the investment process for an institutional investor managing money on behalf of other people can be classified into six broad categories.

1. Trustees/directors[1]
2. Management/internal staff
3. Investment advisor
4. Investment managers
5. Custodian
6. Others, like tax and legal experts

We set out what we believe should be the primary responsibilities of the first two groups in Table 1, over the page.

[1] Can be divided into a Board and an Investment Committee – can complicate governance matters but the Trustees/directors remain responsible.

Good investment decision making

Table 1: Parties involved in institutional investment decision making

If you are a:	You are responsible for:
Trustee/director	▪ The success of fund ▪ Delivering on the objectives of members or sponsors ▪ Defining investment philosophy, investment objectives and purpose ▪ Ensuring an appropriate risk assessment and management culture and framework are developed ▪ Overseeing all aspects of risk within the Fund's business ▪ Providing direction to other stakeholders ▪ Appointing people to execute the Fund's strategy and manage the investment platform ▪ Monitoring results, questioning staff and others, but don't second guessing ▪ Taking remedial action as needed
Management/Internal staff member	▪ Implementing the strategy, converting policy into action ▪ Managing the fund on a daily basis ▪ Managing liquidity, risks, cash flows etc ▪ Implementing the risk assessment and management framework ▪ Overseeing fund manager relationships – hiring and firing decisions can be delegated to the internal team or retained at the trustee/director level ▪ Overseeing the investment advisor relationship, but the advisor should report to the Board ▪ Overseeing the custodian relationship, but the custodian should report to the Board ▪ Potentially managing assets internally but this requires a different governance structure

Are governance and performance linked?

If governance is about a process leading to outcomes, then it seems intuitive a good process should lead to good outcomes. It follows that a strong governance structure should provide the opportunity for good investment decisions while a weak governance structure would lead to greater confusion and poorer outcomes.

However, nothing can guarantee good investment outcomes and luck has certainly been known to play a part in explaining good returns at times.

The type of organisation and its business philosophy can cause governance structures to vary. For example, funds with conservative business models will tend to have different governance arrangements compared to those with more aggressive or growth oriented models.

There are very few studies on this topic and unfortunately they are limited in scope. This means it is hard to draw definitive and scientifically robust conclusions.

Within the superannuation or pension fund arena, most of the work in this area quotes a survey called *“Excellence in Pension Fund Management: What is it”* by Keith Ambachtsheer, Craig Boice, Don Ezra, and John McLaughlin in 2004.

The survey asked respondents to “*estimate the excellence shortfall in their organisations*”, which resulted in a median response of 0.66% from the fifty senior pension fund executives who participated in the survey.

These executives described poor decision making processes, inadequate resources, and lack of clarity of focus or clarity in the fund’s mission, as the key issues leading to this shortfall.

There are a greater number of studies that analyse the performance of companies in the listed market environment and specifically the relationship between performance and the governance practices of those companies.

Some of these studies provide insightful findings.

1. The Australian Treasury released a paper in 2009 entitled *“Corporate Governance and Financial Performance in an Australian Context”*. This paper analysed the relationship between a company’s adoption of the Australian Securities Exchange (ASX) Corporate Governance Council’s Principles of Good Corporate Governance and Best Practice Recommendations, and the subsequent shareholder performance, operating performance, and one year sales growth.

   The paper covered the top 300 Australian listed companies in 2004, 2005 and 2006. Its conclusions were *“that companies with better corporate governance outperform poorly governed companies, particularly in relation to earnings per share and return on assets. Furthermore, we find companies that are fully compliant with the ASX Corporate Governance Principles perform better than companies that are only partially compliant.”*

“There is continuing debate about the existence or otherwise of a correlation between good corporate governance and successful performance. Good governance processes are likely in my view to create an environment that is conducive to success. It does not follow that those with good governance processes will perform well or be immune from failure. Risk exists to some extent at the heart of any business. Risks are taken in the search for rewards. No system of corporate governance can prevent mistakes or shield companies and their stakeholders from the consequences of error. Corporate failures will occur. However, good practices help to focus those in charge of a company on the very purpose of their corporate activity and the direction of their business, and enable them to identify emerging problems early.”

Justice Owen, The failure of HIH Insurance, HIH Royal Commission, 2003

Are governance and performance linked?

However, the paper also states *"it is important to note the governance structures of a firm are endogenous, making it difficult to draw causal inferences. For example, while it is possible companies that choose to comply with the ASX Corporate Governance Principles will perform better because of it, it is also possible companies that perform better are more likely to choose to comply as it is easier for them to do so when things are going well."*

2. In his paper entitled "*Better Governance = Better Performance?*", Kouwenberg tested the introduction of the good governance code introduced in Thailand in 2002 and found a positive relationship with stock price returns in 2003-05 and adoption of the code.

3. In their paper entitled "*The Unexpected Benefits of Sarbanes-Oxley*", Wagner and Dittmar found the implementation of management systems by companies required to comply with the Act also provided useful insights into the operation of their businesses which management used to increase efficiencies and save on costs through improved internal controls, better documentation, standardisation of processes, and reduced complexity.

4. The same Australian Treasury paper referred to in point 1 also conducted its own literature review including studies from the US, Australia, Germany, Great Britain, Korea and Switzerland. These studies found positive links between good governance and good performance.

While there are some parallels between listed companies and institutional investors, and both groups of trustees or directors should be in control (i.e. the listed company or the institutional investor entity), there is a difference at the investment level.

Institutional investors in Australia typically outsource at least part of the "manufacturing" i.e. they appoint external agents like fund managers to pick and choose underlying stocks, bonds, property etc. Many however retain control of the asset allocation component.

The aggregation of all those decisions creates the portfolio and the products/return outcomes. But many of the factors that can influence portfolios can be external to the governance structures used by an institutional investor, for example, stock selection outcomes are provided by external managers with their own governance models, or the fact markets can behave unpredictably and surprise even the best structured investor, and so on.

This makes it hard to directly correlate institutional investor performance with governance structure.

Nevertheless, it does seem intuitive that good governance and processes should create the opportunity for good outcomes.

A range of studies are also supportive of this linkage, albeit less so in the institutional investor space as we define it. Whether investment decisions are best made at an Investment Committee, a Board, or an internal group, does not appear to have been specifically tested and is less relevant in our view.

The main challenge is to make the best investment decisions possible.

What makes a good decision making body?

Investment decision making is one of the most important tasks of any institutional investor, as delivering the right investment outcome is critical for the members and/or sponsors of any fund.

The models common in Australia are:

1. The Board retains all investment decision making responsibilities;
2. The Board establishes an Investment Committee (or equivalent working group type structure) with varying delegations to that Committee; or
3. Either 1 or 2 along with varying delegations to an internal investment team.

Each of these has its own pros and cons and we do not discuss those in this paper. For the purposes of this paper, we call them all investment decision making bodies.

Clarity of Purpose

For any investment decision making body to function well, it must be clear about its purpose and we believe the best way to do this is to have a Charter or other governing document that sets out all of the requirements in plain language. Ideally the Charter would be included in each set of meeting papers and acknowledged at each meeting. This keeps the purpose at front of mind for the members of the body and provides the framework within which all members operate.

The preparation of the Charter should involve the participation of all key stakeholders to ensure that everyone is “on the same page”. Objectives and responsibilities of the various parties should be explicitly stated and agreed.

In the preparation of the Charter, it could also be helpful to talk through some “what if” scenarios so that expectations are clear.

What makes a good decision making body?

For example, if delegations are given around effecting asset allocation changes, then good scenarios to test would be "what if the markets moved by X%", or "what if the markets were very volatile and moved up then down the next day". The main goal is to ensure the actions of the body are within the range of expectations of those who have delegated to it, that is, "no surprises".

The Charter should also reference the expectations and rules (if any) around the formality of the decision making process, for example, the need for a formal agenda, written papers, other supporting material, minutes and all voting requirements. In order to reinforce the importance of the body and its work, and to facilitate high quality debate, we believe formal meeting papers should be required and sent out one week ahead of time to enable adequate time for participants to read them.

We also believe that minutes of all meeting discussion should be kept.

Leadership

All investment decision making bodies need to be well led – this is critical.

Clarity of leadership has flow-on effects to the healthy functioning of the body internally, and also to the level of confidence in the body by those who have delegated to it.

There are essentially three types of Chair styles from a leadership perspective: autocratic, democratic, and hands off.

While the autocratic and hands off approaches can be successful, a democratic approach tends to lead to more rounded decision making and a greater buy-in from all on key issues. In our opinion, a good Chair:

- Engenders an atmosphere for quality debate, discussion, a free-flow of ideas, and the ability for all to say what they think in a non-combative environment;
- Keeps the discussion at the right level and focussed on the right things;
- Has an effective, polite and professional process to manage conflicts or differences in opinion;
- Avoids compromise decisions;
- Encourages everyone to participate at the right level and does not allow one person, or a small number of people, to dominate proceedings;
- Knows when discussion needs to stop and decisions need to begin; and
- Has time to prepare for and run the body in a proper manner.

Membership and member skills

Determining the right members, and the right number of members, for any investment decision making body is critical to its success.

Our experience tells us there is no "magic" number of members – although the consensus is around six to nine is probably right. There is also a view that an odd number is better so as to avoid tied votes.

There is a balance to be found between appropriate diversity of opinion and timely decision making. We often find many members of a Board are interested in participating on the Investment Committee. This can mean the number of members on the Investment Committee is high and in that case it would probably be better to retain the Board as the decision making body, but allow more time on investments in Board meetings.

There should be a balance of skills, supported by an annual regimen of investment training for those who require it. In our view, Directors do not need to be investment experts to be on an investment decision making body, but they should:

- Share the fund's vision and investment philosophy;
- Be investment aware;
- Receive regular investment skills training including at the advanced level if needed to keep the skill base at an appropriate level;
- Recognise it is a total portfolio that is being managed and some components will lag at times;

What makes a good decision making body?

- Recognise if a long-term strategy is being pursued, it needs time to be successful and therefore patience is a valuable trait;
- Read the papers and any other supporting material to enable effective discussion and decisions at the meeting;
- Contribute during meetings;
- Be engaged in the Fund and its investment challenges; and
- Have common sense and the discipline to avoid fads.

The process for bringing new directors in should ideally recognise the skills already in place and retain or build the collegiality needed for good and robust decision making.

Situations can also arise where one or a small number of directors can become too dominant – typically because they have more investment knowledge than others. This means those who are less investment aware can tend to defer to their knowledge, creating an unbalanced situation. This can be managed by a good Chair, unless that dominant person is the Chair, in which case other directors will need to take action.

Given the responsibility involved, there is no such thing as “a dumb question” and members should be encouraged to ensure they have all their questions answered. However, it would be expected papers supporting the meeting, and the decisions, should answer most questions and the director will have read and analysed them beforehand.

External experts can be valuable but only if they understand the Fund and its objectives and philosophy.

On a practical front, there are decisions to be made about the number of members that constitute a quorum, member tenure and member turnover.

There is generally no prescription around tenure but a balance should be found between retaining experience and getting new blood. Some long-standing directors remain very valuable contributors, but others can become stale.

A common view is that five to eight years tenure is about right, however, our view is the calibre of the individual and their contributions are better used as the guide to whether an individual retains an on-going role. Managing member turnover is very important and changing more than 25% of the body at one time can undermine the strategy being pursued.

The Chair is a special case. The Chair’s role is critical and requires a strong commitment, and some specialist skills. Ideally the Chair would have some experience at the Board level of the entity before taking on the Chair’s role to enable time to build an understanding of the business and the issues, as well as some rapport with their fellow Directors.

Someone with an external focus can be valuable but can also be destabilising. We believe there are pros and cons of appointing an external person that should be considered at the individual level (i.e. individual external candidates should be considered on their merits and in the context of what is best for the investment entity).

Tenure in the role is a further complication where it is clear individuals can stay “too long” but it is not necessarily clear how long “too long” is. Our view is that, as long as the individual is adding value and doing the job well, then several years as Chair is reasonable. If the individual is not performing well, then the sooner they go, the better. Some entities have policies that rotate the Chair’s role, for example, superannuation funds given their joint trusteeship. This is not an unreasonable approach but it can mean the person in the role is simply there by default. It can also mean a very strong Chair is rotated off simply because his or her time is up.

There is also a view the departing Chair should stand down altogether from the Board. In our view, this depends on the individual and what they can continue to bring to the group and we would not be prescriptive about this.

Finally, being a member of any investment decision making body is a big responsibility and all members need to be engaged and prepared. The Americans call it “social loafing” but we simply term it “dead wood”, and any member in this category ought to be asked to leave.

What makes a good decision making body?

Related to this, while debate is beneficial, any director who is consistently disagreeing with others, and with decisions of the majority, very likely has a philosophical difference of opinion and should also be asked to leave. While debate and discussion should be encouraged, decisions do need to be made and some form of consensus reached.

Accountability, self-assessment and external assessment

It is good practice to regularly assess the performance of the body with respect to its investment decision making.

An internal or self-assessment ought to be complemented by an external review on an annual basis in our opinion.

An external assessment should be conducted by an independent party and include feedback from key service providers and observations of the decision making body in action.

In terms of measuring success, this should be linked to the objectives set. Basically, did the body achieve its objectives?

This would include any investment policy type targets around return and risk, measured over the appropriate period, but also include a review of the process used and its effectiveness. Feedback from management should also be sought around instructions and delegations given to them from the body.

The Board should also undertake an annual assessment of its collective investment skills and identify any skill gaps. Future directors can be targeted and appointed with these gaps in mind and appropriate training can also be sought.

Clearly non-investment skills will also be valuable but we do not cover those here as this paper is focussed on investment decision making.

"Things that matter most must never be at the mercy of things that matter least." Goethe

However, investment decision making can be improved by having people with strong general business skills, and lots of common sense.

Directors who regularly miss meetings, fall asleep, leave the room to take telephone calls, or are routinely underprepared, should be asked to leave the group.

Avoiding conflicts of interest

Conflicts of interests should be avoided to the greatest extent possible when making investment decisions in a fiduciary capacity. In our experience, they typically manifest themselves in directors with multiple relationships where entities compete with each other, or where one entity can provide services to the other.

In our view, the most difficult investment related conflict in the superannuation system is a director who is employed by, or has some financial relationship with, a service provider (e.g. a fund manager) and also sits on the Board or Investment Committee in an investment decision making capacity.

People in this category are often employed for their expertise, but we think it is inappropriate for them to be privy to information from other parties about their firm, but particularly their competitors.

Guidelines on conflict management are critical and the selection of any independent investment specialists as directors should be conducted with this issue in mind.

What should you spend time on?

This is a challenging area for any investment decision making body, and one where we have observed significant possibilities for improvement over the years.

The key challenge arises from Boards and Investment Committees not being clear about what their roles and objectives are, relative to each other and more importantly, relative to management. As stated earlier, Boards should govern and management should manage. Determining what the respective roles are is a critical first step to everyone being clear about what they are meant to be doing.

What makes a good decision making body?

Secondly, challenges arise from confusion around what the true objective for the portfolio is. Artificial measures such as peer returns mostly have no real connection to a fund's true objective.

Defining success when the objectives are confused is difficult. Spending time agreeing the true objective then the plan to achieve that objective is time well spent. If this is not achievable, then it can be valuable to prioritise the objectives along with a specific recognition that absolute and relative return and risk objectives are often in competition.

Thirdly, many Boards and Investment Committees spend a lot of time talking about the past. In fact, Vanguard surveyed 110 representatives from a number of US funds in 2009 and asked how much time they spent talking about the past e.g. past manager and market performance etc. The average was 40%.

That is 40% of the precious time talking about the past – something that no-one can change! Admittedly, we can learn from the past, but if we know one thing in investments, it is that the past does not necessarily predict the future.

Spending some time on historical reviews is appropriate but only in the context of lessons learned and whether changes are needed to improve the probability of achieving the overall objective.

On a practical matter, decision oriented agendas can be helpful in making it clear to directors what requires a decision and what is just for information.

Putting more important strategic matters higher on the agenda can also facilitate good decision making. A well developed agenda can also assist the Chair to run the meeting and make sure time is spent on the areas that are important.

Avoiding behavioural finance traps

While this may seem like a peripheral topic for this paper, finance literature is now filled with research on the topic of decision making in investments known as behavioural finance. In fact, the areas of investments and finance are littered with examples of the foibles of human decision making.

There are a number that apply specifically to groups of people who make investment decisions, as follows.

What makes a good decision making body?

Loss and regret aversion: Human beings typically have a high degree of loss aversion. Most people want to avoid the pain of regret and the responsibility of making a bad decision. This is quite a reasonable thing to want to do, but not if it makes them reluctant to make any decisions or to make enough decisions. Controlled experiments have shown people hate losses two times more than they like gains, and this desire to avert or avoid losses can lead to poor judgment.

Prospect theory: Investors generally experience more regret over mistakes of action in the short term, but of loss of opportunity or inaction in the long term.

The sunk cost fallacy: Humans also have a strong inability to forget money that has already been spent on something. This can make people too ready to throw good money after bad. This can also be caused by the desire to stay with what they know, called the status quo effect.

The preference to retain the status quo: Humans also generally have a strong preference for what they know, or for things that they have a higher degree of familiarity with. This can lead to not making decisions. However, studies have also shown the longer people take to make a decision, called decision paralysis, the less likely they are to actually make a decision. And, arguably, not making a decision is actually an implicit agreement to follow the current course. This will have consequences in the same way that actually making a decision does.

The home bias: Most people are much more comfortable in their own environment than in foreign ones.

Overconfidence and the ego trap: It is a general phenomenon that most people are not as smart as they think they are. People routinely overestimate their abilities, skills and knowledge, although this is not typically for malicious reasons, it is just that they don't know. A recent success can make investors think they do have an advantage over others.

Humans generally more clearly remember the winners and forget the losers. There are strong psychological factors at work here that enable the human population to remain optimistic, confident, and for the world to go forward.

People are also good at taking credit for the winners and blaming others for the losers. This tends to mean they have a more positive memory of their own ability than is actually the case.

The endowment effect: Human beings have a tendency to fall in love with things they already own, and to place higher values on these. Even professional investors are typically much better buyers than sellers.

Anchoring: How people see and frame decisions can have a major impact on the decision that they actually make. "Anchoring" refers to the adherence to a fact or a view that should actually have no impact on the decision. This is related to a second issue called the "confirmation bias" – where people tend to look for things that confirm what they already think and treat these more favourably than others. This is often associated with a tendency to be reluctant to change once they have a view about something or to be reluctant to seek information that would be contrary to what they already think. And once they form a view about something, it becomes harder and harder to change that view. Sometimes this may well be a good outcome, but there is also a risk that one becomes unable to see the forest for the trees.

Recency effect: People can have a tendency to place a greater weight on more recent events than earlier events.

Forecasting effect: Most people think they a better forecasters than they really are – despite knowing that forecasting the future is an inherently difficult task.

"Group think" and "herding": These are committee phenomena whereby the decisions made in a group can suffer from consensus decision making, an inability to think laterally about an issue and a desire to look like others just in case things go wrong.

When elephants attack!

Inevitably there will be times when things go wrong. No decision making body can get things right all of the time. However, adverse outcomes generally happen due to often quite predictable events – when an elephant attacks, it is usually for good reason.

It can be instructive to look at where things go "wrong" in investment decision making and where lessons can be learned.

We have covered a number of these in this paper, however the key impediments, and some possible solutions, are summarised below.

Table 2: Impediments to good investment decision making and possible solutions

Impediments	**Solutions**
Roles not properly defined	Define roles and objectives clearly and in writing
Unclear delegation	Define delegations clearly and in writing
Under-resourced	Formally review resources and skills needed to develop and implement the fund's strategy over the medium to long term
Poor process e.g. no investment policy statement or statement of investment beliefs	Document process so that all stakeholders are clear
Inconsistent or unclear investment policy e.g. confusion between relative and absolute return objectives	Define the true objective, and if this cannot be easily done, then prioritise amongst objectives and recognise that they may conflict with each other
Implementation slippage	Review implementation protocols and resources and determine if changes are needed
Information overload – decision paralysis	Require preparation of more succinct, action oriented papers
Wasted time at meetings	Good chairmanship and engaged directors who have read the papers in advance of the meeting
Behavioural finance impacts on decision making	Discuss common behavioural finance traps and develop strategies to combat them
Conflict of Interest	Declaration of all possible conflicts, sit out of meetings if needed to avoid perception of conflict and enforce hospitality policy with reasonable limits

So what's the secret?

The astute reader will have worked out by now that there is in fact no secret.

Most of this is common sense, but as with all areas of life, sometimes common sense can be overwhelmed with disunity and disorder.

As Voltaire said in the Dictionnaire Philosophique Portatif (1764), "*le sens commun est fort rare*", which is commonly translated into English as "*common sense is not so common*".

However, our experience has taught us that the following are important characteristics to have.

1. Be very clear about the various roles and responsibilities – Boards should lead and management should manage.
2. Employ strong but fair leadership.
3. Use the right combination of people in terms of skills and levels of investment knowledge, shared vision, cultural fit and personal traits.
4. Be accountable at all levels.
5. Embrace the value of self and external assessment.
6. Tolerate no conflicts of interest, or at worst, permit minimal ones that are openly declared and managed.
7. Spend time on things that matter.
8. Understand how behavioural finance can create traps and develop strategies for how to avoid them.
9. Take responsibility.
10. Act in a timely manner when things go wrong.

Frontier Advisors has many years of experience assisting clients develop their approach to governance practices and their decision making philosophies. To talk to us about helping you, please contact our Governance, Risk & Strategy team.

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