Fiduciary Insights

Strategic Investment Group®

COMMON SYMPTOMS OF POOR GOVERNANCE:

Poor governance is more dangerous than poor performing managers.

POOR GOVERNANCE BY INVESTMENT COMMITTEES AND ASSET MANAGEMENT ORGANIZATIONS OFTEN TAKES THE FORM OF OTHER MALADIES, SUCH AS HIGH TURNOVER, HIGH COSTS, PERFORMANCE-CHASING, OR RIGID AND COUNTERPRODUCTIVE DECISION RULES. These are often symptoms of broader governance ills, such as inexperience with investments, lack of focus, misplaced priorities, inconsistent decision-making, lack of discipline or flexibility, or organizational disunity. Recognizing the symptoms of poor governance can be a useful first step in tracing the root causes and finding the cure.

Introduction

Poor governance is the underlying cause of many of the problems faced by investment fiduciaries. Like any disease, it reveals itself through certain telltale signs. These common symptoms of poor governance are valuable clues in tracing the root causes of organizational dysfunction and the poor investment performance that often results.

High Manager Turnover

One of the most obvious symptoms of poor governance is excessive manager turnover, which is expensive in several ways. Turnover consumes the time of everyone associated with the investment group: the investment committee, the investment staff, the legal staff, the custodian, and the outgoing and incoming managers. Fiduciaries whose organizations are constantly hiring and firing managers are often distracted from higher level decisions, such as asset allocation, which have more impact on performance.

The portfolio turnover costs generated by replacing managers—including market impact and brokerage—can run as high as several percent, depending on asset class, portfolio size, market movements, and the manner in which assets are transferred. A year's alpha on a given amount of assets can easily be forfeited by switching managers.

Frequent manager turnover may indicate broader governance problems, such as confusion about investment goals, excessive focus on the short term, poor manager due diligence, misguided manager selection, inability to coordinate manager selection with asset allocation, inappropriate benchmarks, or a dysfunctional investment committee. In short, most common elements of poor governance also lead to high manager turnover.

Frequent Committee and Staff Turnover

When members of a supervising investment committee leave, the organization loses continuity in policymaking, institutional memory of policy goals, and familiarity with the internal staff and external managers. Bringing new committee members on board requires a time-consuming education effort by other committee members and staff.

Frequent committee turnover may stem from discord or, less dramatically, lack of focus, engagement, or clarity of goals at the governing level.

Staff turnover, on the other hand, disrupts an organization's day-to-day operating relationships. New staff members must spend time becoming acquainted with investment policies and procedures, the investment committee, and external managers. As with committee turnover, the organization loses momentum. Constant staff turnover may indicate poor staff leadership, inadequate compensation, or blocked career paths.

Chasing Performance

Manager turnover often results from performance-chasing: the natural temptation to buy yesterday's winning asset class, style, or manager. A weakness for performance-chasing is most likely to bedevil those groups lacking a clear and coherent investment policy or disciplined investment process. Other risk factors include a poor understanding of investment cycles, insensitivities to the danger of being whipsawed, inappropriate benchmarks, or inability to identify causes of recent outperformance or underperformance. The less clearly an organization understands what drives its performance, the more inclined it will be to chase hot returns.

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Firing Managers After Underperformance

The flip side of chasing good performance is panicking about bad performance. Here, groups with governance problems often overreact. All managers underperform, at least for short periods, and even the best can be expected to underperform at least a third of the time. It is important to be able to distinguish between short-term and long-term causes of underperformance, and to determine which of them are likely to persist.

Investment committees comprised of corporate executives sometimes need to learn new decision-making habits when faced with lagging returns. The executive reflex to act quickly to eliminate poor performance, while appropriate to many management issues, can be counterproductive when applied to money managers. In investment management, decisiveness must often be tempered by patience and informed by long experience with investment cycles.

Simplistic Rules for Hiring and Firing Managers

Applying extremely simple, mechanical rules to a complex, judgmental process such as the hiring and firing of managers can be a sign of misdirected self-discipline or an abdication of intelligent discretion. This approach is characteristic of bureaucratic organizations that do not trust individuals to make decisions, and of committees that do not wish to wrestle with investment uncertainties. Whether inspired by a lack of trust, competence, or interest, simplistic rules give a false sense of control.

A Beauty Contest Process for Picking Managers

In many organizations, a consultant creates a short list of managers who are paraded past an investment committee for final selection in a series of “beauty contest” interviews. If the consultant has done his job, all the candidates are arguably qualified, and the committee’s attention shifts to the most obvious differences between the contestants: presentation skills, persuasiveness, and personality. Investment skills and suitability fade into the background at this critical stage. Effective PowerPoint slides may outsell investment prowess.

The beauty contest may spotlight the wrong skills, and substitute style for substance. In a situation already fraught with opportunities to lose focus, committees holding beauty contests may allow superficialities to distract them from discerning which manager is best suited for their mandate. Instead, committee time would be better spent on understanding the chosen manager firm and its process, and confirming that the manager is appropriate to the organization’s policies and goals.

A Paint-By-Numbers Approach to Asset Class Structure

Although investment categories can be useful, forcing all managers to adhere to narrow styles and allocating to them according to a set formula is akin to painting by numbers. The right answers are already predetermined. This approach frequently fails because investment categories themselves are fluid, markets do not respect boundaries, and the best managers need and deserve the broadest latitude. Groups using this method may be relying too much on conventional thinking. It is better to seek insightful managers and implement analytical systems to determine and evaluate the desired risk/style posture of the portfolio.

High Management Costs

Good performance depends on containing management costs within reasonable limits. High management costs can be a sign of inexperience or inattention to detail, especially at the operating level.

Well-run organizations hold the line on cost by using passive management when appropriate, keeping fees down, and suppressing unnecessary turnover and trading costs.

Yet they also maintain proportionality between cost and opportunity: they do not sacrifice big investment opportunities for the sake of small fee savings. Their goal is to maximize return net of costs, not just to minimize costs.

Conflicts of Interest

Fiduciaries must be ever-vigilant about becoming ensnared in conflicts of interest. Conflicts can grow slowly and insidiously out of normal business and personal relationships, and frequently go unrecognized because those involved may not feel conflicted. By their very nature, conflicts of interest are easy to rationalize.

The approach fiduciaries take to conflicts of interest reflects their ethical standards and expectations, and the whole organization takes its cue from their behavior. A permissive attitude can have a corrupting influence on the group's ethical self-discipline. Education and heightened awareness of what could be a conflict of interest, or create the appearance of one, can help prevent ethical lapses.

Competing Interests Among Fiduciaries

The members of an effective oversight committee, even if drawn from various backgrounds, should have some common goals—foremost among these, advancing the interests of the beneficiaries. A quarrelsome committee, on the other hand, may be so hampered by competing interests among its members as to impair the group's ability to set policy.

To paraphrase Tolstoy, every unhappy committee is unhappy in its own way. Egotistical or domineering attitudes, power struggles, jealousies, hidden agendas, constant reversals in policies, and other adverse behaviors are just a few possible signs of competing interests. Differences of opinion are to be expected, but when the group cannot pull together and make clear, coherent decisions, the issue of competing interests needs to be confronted.

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Moving from Symptoms to Cures

Recognizing symptoms of poor governance is a vital first step on the road to recovery. A committee must carefully examine why it operates as it does, and whether it is maximizing its own productivity and best serving the interests of its beneficiaries. It must challenge its own practices, and identify the logic and beliefs underlying them.

Troubled investment organizations—those undergoing high turnover, overreacting to performance, replacing discretion with simplistic rules, incurring high costs, tolerating conflicts of interest, or suffering internal strife—are themselves underperforming. Before they can improve the performance of their assets, they must first address their governance issues.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

For more information, please email us at inquiries@strategicgroup.com.

Strategic Investment Group®

1001 Nineteenth Street North
16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com