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SARAH W. PECK

Foreword by KEITH AMBACHTSHEER

The Trustee Governance Guide

THE FIVE IMPERATIVES OF 21ST CENTURY INVESTING

The Trustee Governance Guide

"With this book, Merker and Peck put forth a highly useful guide for both board members and those with an interest in coaching boards to achieve better financial outcomes for their organizations. Their thoughtful and focused work lays out practical approaches for avoiding the myriad impediments, which can prevent successful governance and institutional investing. Their prescriptions are concise, interesting and actionable—this should be a must read for investment committee heads nationwide. Bravo."

—Sterling Shea, *Global Head of Wealth & Asset Management, Dow Jones*

"Everywhere we look, fiduciary duties, norms, standards, and processes continue to receive heightened scrutiny in the wake of the last financial crisis and the worldwide growth of socially responsible investing strategies. This book offers a timely, understandable, enlightening, and critically important discussion of the importance of fiduciaries to investment performance and the role of governance in driving fiduciary quality complete with useful tips and tactics for practitioners in finance."

—John Taft, *Vice Chairman, Baird*

"This book puts the 'G' in Environmental, Social and Governance factors for impact investing. ESG is not a trend, it is a mega trend—and for good reason. As Merker and Peck prove, an ESG approach to management and governance adds value to sponsors, participants and to society. It is incumbent upon fiduciaries to understand the implications and process behind this win/win/win approach to portfolio management. Thought provoking and full of compelling data, *The Trustee Governance Guide* is an approachable and actionable book for trustees and fiduciaries of any skill level to understand the potential benefits of sustainable investing and governance."

—Tom Anderson, *Former Executive Director of Morgan Stanley Wealth Management; Author of The Value of Debt series; Executive Chairman of Supernova Companies*

Christopher K. Merker • Sarah W. Peck

The Trustee Governance Guide

The Five Imperatives of 21st Century Investing

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Dedicated to our families.
From Chris to S, G, and K…you are the light and apples of my eye.
From Sarah to T, L, and M…you are my greatest joy.

Ten percent of proceeds from the sale of this book benefit the CFA Society Milwaukee Foundation and SecureFutures, partner organizations dedicated to fostering financial and investor literacy, locally and across the nation.

Foreword

Out of the 39 books on management practices Peter Drucker wrote during his long and illustrious career, only one dealt with pensions. He wrote *The Unseen Revolution* in 1976. In a reprint 20 years later, he would call it his “least-read but most prescient book”. I was one of those few people who did read the book when it first came out in 1976. Through it, I saw how Drucker’s pension revolution would unfold in the decades ahead, and decided to play a role in that unfolding.

In the book, he addressed three broad topics: (1) how the design and sponsorship of retirement income systems might unfold, (2) the issues around how these systems would be governed, and (3) how and in whose interests retirement savings would be invested. Forty-three years and four books later, I am still at it. Framing the pension revolution around integrating design, governance, and investing challenges was a stroke of Drucker genius. In one of the professional highlights of my life, I was able to tell him that in person in August 2005. At age 96, he died four months later.

Given Chris Merker and Sarah Peck’s kind mention of my early work in trustee governance research in this book, I thought I should disclose the source of my original interest in the topic. To their credit, the authors too integrate governance issues into the effective fiduciary management of pension and endowment assets. Also to their credit, they do so in a reader-friendly manner. I fully appreciate the three reasons they give for ‘why this book now’: (1) governance as a process is finally receiving the bright spotlight it deserves, (2) the time has come to recognize the rise of behavioral economics and its lessons for trustee decision-making, and (3) sustainable investing is increasingly displacing “quarterly capitalism” as the philosophical foundation for long-term wealth creation. These three elements are neatly woven into their "five imperatives of 21st Century investing" for governing fiduciaries.

The authors deserve a special "shout-out" for the new research findings on the value of good governance they describe in the book. Using an extensive database on US public sector pension plans they themselves built over the course of the last few years, the authors make a significant contribution to the growing evidence that good governance is a value-creating 'asset' in itself. Specifically, using seven key drivers of governance quality to create a fiduciary effectiveness quotient (FEQ) for each fund in the database, they found that first quartile FEQ funds outperformed fifth quartile FEQ funds by a highly material average of 3.5% per annum.

I commend this book to all those with an interest in understanding what fiduciary effectiveness is, and have the aspiration to put it into practice.

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Preface

Since the 1990s, books on the topic of governance and investments seem to come around every few years. So, why is it time for another one? Well, a lot has changed in the past few years. First, there is the surge in ESG-oriented funds. ESG stands for environmental, social, and governance factors, which can be used in an investment process as a potential risk mitigation tool and can offer the prospect of promoting sustainable development goals. In the decade prior to 2015, ESG investing was largely a backwater, championed by only a socially conscious few. Now many boards are faced with figuring out how to align ESG or impact objectives with their fiduciary obligations to beneficiaries.

A 2017 study by McKinsey & Co. found that over a quarter of the $88 trillion of assets under management globally are now invested according to environmental, social, and governance principles.[1] And yet, while asset managers have jumped onboard the ESG movement, board trustees have been left trying to play catchup. A 2017 State Street survey of institutional investors captures one of the causes of the disconnect: 56% of ESG adopters indicated there is a lack of clarity over ESG terminology, along with confusion over what ESG is or should be.[2] The industry's confusion has spilled over to trustees, making their problem of how to address ESG even more intractable. We saw the need for a framework to help trustees to identify ESG goals and to integrate ESG into their investment policy. We provide that framework in this book.

[1] https://www.institutionalinvestor.com/article/b15cc1dxds8k97/mckinsey-esg-no-longer-niche-asassets-soar-globally

[2] https://www.ssga.com/investment-topics/environmental-social-governance/2018/04/esg-institutional-investor-survey.pdf

The second thing that has changed has been the focus of our research: the importance of how trustees govern *themselves* in achieving better financial outcomes. Industry and academia have long accepted the positive impact good *corporate* governance can have on stock and bond returns. While many boards have embraced the importance of corporate governance in making investments, they have struggled with how to govern themselves to achieve better returns for the assets entrusted to their care. Our research has sought to change that by taking an empirical approach to the problem—employing the same research paradigms used in the study of corporate governance.

While hard verifiable data on corporate governance is plentiful, there is no such data on trustee governance. The availability of good data has been a major obstacle to solid research on the topic of trustee governance. Before we began collecting data for our US public pension plans database, the data simply didn't exist. We assembled our initial database by hand collecting the information, lifting it from publicly available meeting minutes. That effort bore fruit. Through rigorous statistical analysis of our data, we established results that showed that trustee governance, like corporate governance, improves the financial outcomes of the plan's assets. More importantly, we were able to identify the board practices that matter. Through a series of articles and working papers, we began publishing our results. Then in 2018, we converted our method to a national survey. The next step was to make these findings available in book form to a much broader audience, hence this book.

Finally, the third change has been the acceptance of the role behavioral economics plays in investment decision-making. The behavioral economics movement began 40 years ago as an opposing theory to *homo economicus*, which has dominated our collective thinking since the Enlightenment. The "new" theory asserts that human beings apply heuristics to decision-making under a condition of either paucity of knowledge or too much information, leading to outcomes that are suboptimal. While this theory has been confirmed by study after study, the application to "real world" activity has been more limited. Trustees need to understand the pitfalls of their all too human behavior.

Research into—and better understanding of—best practices within the governance arena, how groups work together to drive more optimal outcomes especially within the context of investment management, we believe, offers one of the best opportunities to apply what has been learned from behavioral finance. Why? Quite simply because that is where the money is; 80% of financial assets in the US fall under the purview of an investment board.[3]

[3] "Proposed Rule: Definition of Fiduciary under ERISA", CFA Institute Letter to the Department of Labor, February 2, 2011.

If we want to drive better outcomes for investment decisions, we need to focus on the people who are responsible for them.

With any body of work, no one is an island, and for us we have many to thank over the course of this journey. First, we must thank our families for their love and support. To the many graduate assistants who have worked with us over the years, thank you for your contributions. At Marquette University, thank-you to the many of the faculty who supported us in this endeavor, particularly Farrohk Nourzad, especially on the econometric work, and Nadelle Grossman at Marquette Law, on corporate governance.

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Christopher K. Merker
Sarah W. Peck

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