

The Handbook for Investment Committee Members

*How to Make Prudent Investments
for Your Organization*

RUSSELL L. OLSON



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The Handbook for Investment Committee Members

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Olson, Russell L., 1933–

The handbook for investment committee members : how to make prudent investments for your organization / Russell L. Olson.

p. cm.—(Wiley finance series)

Includes bibliographical references and index.

ISBN 0-471-71978-1 (CLOTH)

1. Institutional investments—Handbooks, manuals, etc. 2.

Investments—Handbooks, manuals, etc. 3. Pension trusts—Investments. 4.

Endowments—Finance. I. Title. II. Series.

HG4527.046 2005

332.67'253—dc22

2004024099

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

*To Jeanette,
my wife
and my best friend*

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Acknowledgments

This book is a much easier read—geared specifically for committee members—than my two prior books, *Investing in Pension Funds and Endowments: Tools and Guidelines for the New Independent Fiduciary*, published in 2003 by McGraw-Hill, and *The Independent Fiduciary: Investing for Pension Funds and Endowment Funds*, published in 1999 by John Wiley & Sons. Those books would be appropriate for a student or anyone who serves as an *adviser* to an *investment fund*. This book, for committee members, has been materially strengthened by input from several persons.

One is Joe Grills, former chief investment officer of the IBM retirement funds and currently serving on various investment organizations, such as the investment advisory committees of the state funds in New York and Virginia, and the boards of directors of the Duke University Management Company and selected Merrill Lynch mutual funds. Joe also is vice-chairman of the Montpelier Foundation and serves on the investment committees of two other endowment funds with assets between \$120 and \$150 million.

Another is Katherine Noftz Nagel of Masterwork Consulting Services. Kat has never served on an investment committee. Kat reviewed the manuscript from the standpoint of someone appointed to an investment committee for the first time, and she provided helpful suggestions as to what would make this handbook more helpful to someone who suddenly was asked to be a fiduciary.

Additional valuable input has come from Mike Manning, president of New England Pension Consultants, and two persons who happen to be attorneys—Jordan Sprechman, vice president and wealth advisor at J. P. Morgan Private Bank, and Edward Siedle, president of the Center for Investment Manager Investigations at Benchmark Financial Services, Inc.

Russell L. Olson

Introduction

Let's say I am a member of the investment committee of an endowment fund—for a college, hospital, museum, local Boy or Girl Scouts council, or my church or synagogue—or a member of the investment committee of a pension fund or foundation. Whether they've told me or not, I am a “fiduciary” for that organization. As such, what is my job? What is expected of me?

That's what this book is about.

Our job as a fiduciary is to act solely in the interests of our organization and, according to one definition, “to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”¹ That sounds heavy.

What qualifications are we expected to bring to this responsibility?

It is helpful if we are familiar with investments—to the extent that we participate in our employer's 401(k) plan, have an IRA account (Individual Retirement Account), or have other investments in stocks or bonds. We may even be a professional manager of common stock or bond investments, but that is certainly not necessary (and could, under some circumstances, be a drawback). Although investment sophistication helps, it is not a requirement for a committee member.

Neither we nor our fellow committee members are expected to be experts. One of the first responsibilities of a committee is to find an expert to rely on. If we have a very large fund, we may have a professional investment staff of sufficient competence on whom we can rely. If not, we should find a broad-gauged investment consultant on whom we can rely. If our fund is too small to afford a broadly knowledgeable consultant, we will need to rely on a member of our committee who has this experience and who would be competent and willing to serve in this capacity on a volunteer basis. Relying on an expert in whom we have confidence is a sine qua

¹From ERISA (The Employee Retirement Income Security Act of 1974).

non, because we must recognize that we and our fellow committee members can't do it ourselves. And if we lose confidence in the expert we are relying on, we must get another.

If not investment expertise, then what criteria should a committee member meet? Here are some of the most important:

- High moral character, ready to avoid even the perception of a conflict of interest.
- Knowledge of how the fund relates to the financial situation of the plan sponsor.
- A healthy dose of common sense—the ability to reason in a logical manner, to apply abstract principles to specific situations, and to relate questions at hand to everything else we know.
- A flexible mind, willing and able to consider, weigh, and apply new concepts and ideas, and to challenge previously held concepts, including one's own.
- A willingness to accept a level of risk high enough to gain the investment return advantage of a long time horizon.
- A willingness to learn—about the kinds of concepts discussed in this book and about individual investment opportunities.
- An ability and willingness to attend all meetings of the investment committee and to do the homework before each meeting—to be prepared to discuss the subjects and proposals to be addressed at the meeting.

The purpose of this book is not to make anyone an investment expert—that's not necessary, or even realistic. The purpose is to help us understand information presented at committee meetings, to ask meaningful and productive questions, to evaluate the responses we receive, and to vote on recommendations knowledgeably.

ORGANIZATION OF THIS BOOK

We start in Chapter 1 with the functioning of our investment committee. In Chapter 2 we provide a primer on risk, return, and correlation—basic concepts in investing. Chapter 3 discusses the statement of Investment Policies that every investment committee should establish at the outset, and Chapter 4 covers how to put together a portfolio of asset classes. Chapter 5

serves as a reference about alternative asset classes. Then Chapter 6 deals with how to select and to monitor the investment managers or mutual funds that actually invest our assets. The importance of a competent custodian is covered in Chapter 7. Chapter 8 provides the kind of questions we might ask in evaluating the investment organization of an endowment fund, foundation, or pension fund.

Chapter 9 covers the structure of an endowment fund, the handling of restricted money in the fund, and the importance of using the Imputed Income method to calculate annual payments to the fund's sponsor. And Chapter 10 briefly summarizes what's different about a pension fund. Chapter 11 provides a brief summary of the book.

I have tried to make this book appropriate for both sophisticated investors and relative neophytes. One way I have done this is to place some of the more advanced concepts in boxes or in footnotes. This should allow someone with little investment background to comprehend the main information without reading them, while the more experienced investor may find interest there.

To make this book easier to read, I have taken four shortcuts you should be aware of:

Shortcut 1. All of this book applies to endowment funds and foundations as well as to pension funds. There are innumerable instances where I have referred to our “endowment fund, foundation, or pension fund,” but instead of using those words, I have simply said our *investment fund* or simply our *fund*. Whenever you see these words in italics you should interpret their meaning as our “endowment fund, foundation, or pension fund.” The similarities in managing all three are overwhelming.

Shortcut 2. I have already stressed that one of the first responsibilities of a committee is to find an expert to rely on. We must rely on a professional investment staff, or else a consultant, or if the fund is too small to afford either of these, then a member of our committee who is a professional in the investment of endowment or pension funds. There are innumerable instances in this book where I refer to our “staff, consultant, or other source of investment expertise.” This phrase is entirely too cumbersome, so I have substituted the term *adviser*, and the italics denote that this term stands for our “staff, consultant, or other source of investment expertise.”

Shortcut 3. Unless our *fund* manages its investments in-house, which in most case is inadvisable, it needs to hire investment managers or invest

in commingled funds such as mutual funds. There are innumerable instances in this book where I refer to our “investment managers or commingled funds such as mutual funds.” This phrase also is entirely too cumbersome, so I have substituted the term *investment manager* or simply *manager*, and again the italics denote that this term stands for “investment manager or commingled fund such as a mutual fund.”

If the word “manager” is not in italics, then we are referring to the particular person who manages a separate account or commingled fund.

Shortcut 4. Throughout this book, in referring to investment managers, *advisers*, or committee members, I shall for convenience’s sake use the masculine pronoun. In all such cases, the “he” is used in the classical sense as a shorthand to designate “he or she.” In the current age, this may open me to criticism, and I’m sorry if it does. Clearly, investing is every bit as much a woman’s world as a man’s world.