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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

*How to Make Prudent Investments
for Your Organization*

RUSSELL L. OLSON



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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

To Jeanette, my wife and my best friend

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 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.

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

CHAPTER 1

The Investment Committee

Who is responsible for the investment of our *investment fund*? Ultimately, the board of directors of the fund's sponsor is responsible. But it is not practical for boards of directors to make investment decisions for the fund, so the board almost always appoints an investment committee to take on this responsibility.

STANDARDS TO MEET

Members of the investment committee are fiduciaries. What does this mean? State laws differ in the precise way they define the term. Many funds look to the federal law for private pension plans—ERISA (the Employees Retirement Income Security Act of 1974)—for guidance, even though the law does not in any way apply to public pension plans or endowment funds. Key standards of ERISA, as adapted for an endowment fund, would be:

- 1.** All decisions should be made solely in the interest of the sponsoring organization.
- 2.** The investment portfolio should be broadly diversified —“by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.”
- 3.** “The risk level of an investment does not alone make the investment per se prudent or per se imprudent. . . . An investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is

made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have . . . a relatively high degree of risk.”¹

Specifically, the prudence of any investment can be determined only by its place in the portfolio. This was a revolutionary concept, as the old common law held that each individual investment should be prudent of and by itself. There are a great many individual investments in *investment funds* today—such as start-up venture capital—that might not be prudent of and by themselves but, in combination with other portfolio investments, contribute valuable strength to the overall investment program.

4. The standard of prudence is defined as “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.” This is often referred to as the “prudent expert” rule and strikes me as an appropriate standard. Everyone involved in decision making for the fund should be held to this standard. This does not mean that committee members should be experts. But they should be relying on experts.²

That said, I fear that the words “fiduciary” and “prudence” have all too often been impediments to investment performance because of the scary emotional overtones those terms arouse. Such emotions lead to a mentality such as “It’s okay to lose money on IBM stock but don’t dare lose money on some little known stock.” Neither should be more nor less okay than the other.

Prudence should be based on the soundness of the logic and process supporting the hiring and retention of an *investment manager*, and on an a priori basis—not on the basis of Monday morning quarterbacking. According to the Center for Fiduciary Studies, “Fiduciary liability is not

determined by investment performance, but rather by whether prudent investment practices were followed.”³

Another aspect of my concern is that the terms “prudence” and “fiduciary” all too often motivate decision makers to look at what other funds are doing and strive to do likewise on the assumption that this must be the way to go. An underlying theme of this book is that this is not necessarily the way to go. As fiduciaries, we should do our own independent thinking and apply our own good sense of logic.

Everything comes down to facts and logic. Do we have all relevant facts we can reasonably obtain? Are the facts accurate? What are the underlying assumptions? We should ask questions, ad nauseam if necessary. Does a proposal make sense to us? If not, challenge it. And we should work hard to articulate our reasons.

COMMITTEE ORGANIZATION AND FUNCTIONS

Organization

Well, who should be on this all-important fiduciary committee? A committee may consist of outside investment professionals, as is often the case with some of the members of endowment committees of large universities, or the committee may be composed of a group of members of the sponsoring organization (perhaps including certain members of the board of directors), none of whom may have any special expertise in investing. All should meet the criteria listed on page xiv of the Introduction to this book.

What does the fiduciary committee do, and how should it function?

Initially, the committee may adopt a written Operating Policy that addresses such things as committee membership, meeting structure and attendance, and committee communications. As part of this Operating Policy, it should specify the *adviser* on whom the committee will rely, so selecting the *adviser* is the committee's first job. A sample Operating Policy is included at the end of this chapter as Appendix 1.

Then the committee should adopt a written statement of Investment Policies, such as those described in Chapter 3, including the fund's Policy Asset Allocation. These are clearly the committee's most important functions—ones that will have more impact on the fund's future performance than anything else the committee does. After that, the committee must decide whom to hire and retain as *investment managers*. All of these matters are a big responsibility, and the committee will need to rely heavily on its *adviser* for help.

Selecting an Adviser

The Uniform Prudent Investor Act empowers fiduciaries to “delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.” Jay Yoder, writing for the Association of Governing Boards of Universities and Colleges, adds that “because investing an endowment or any large pool of money is a complex and specialized task requiring full-time professional attention, I would argue that fiduciaries may even be required to delegate responsibilities.”⁴

Yoder argues forcefully for a strong investment office: “Endowments of \$150 million and larger can and should create an investment office and hire a strong chief investment officer. . . . Hiring a consultant is no substitute for employing a strong investment office.” A first-rate

internal staff “can be expected to produce a stronger, more advanced investment policy . . . much better implementation of that policy; early adoption of new asset classes and strategies; greater due diligence and monitoring of managers; and, most important, better, more timely decision making.”⁵

Many *investment funds* are too small to afford a first-rate internal staff to recommend the asset classes in which they should invest and then select the best *investment managers* in those asset classes. Those funds therefore need to hire an outside consultant who understands the benefits of diversification and who specializes in trying to find the best *managers* in each asset class.

Such a consultant could be our local bank. Some banks have developed expertise in mutual funds, but most would rather guide us into investment programs managed by their own trust departments, very few of which rank among the better investment managers. And few banks have cutting-edge competence in asset allocation.

Many brokers and insurance company representatives offer mutual fund expertise. But can we expect totally unbiased advice from them when they are motivated to gravitate to the range of *investment managers* that compensate them? Many such consultants are paid through front-loaded mutual funds—those that charge an extra 3% to 8% “load” (read “selling commission”)—or those that charge an annual 0.25% through a so-called 12(b)(1) deduction from assets (read “another form of selling commission”)—or those that charge a back load when we sell the mutual fund, or get compensated in some other way.

A consultant’s advice is more likely to be unbiased if the firm’s only source of compensation is the fees that it charges its investor clients. Its direct fees will be higher, of course. But we will know fully what the consultant is costing

us because none of its compensation will be coming through the back door.

If such a consultant recommends mutual funds to us, he will typically steer us toward no-load mutual funds that do not charge 12(b)(1) fees. Many world-class mutual funds fit this category. On occasion, the consultant might steer us toward a load fund or one with 12(b)(1) fees. If so, the consultant's only motivation should be that he believes future returns of that mutual fund, net of all fees, will still be the best in its particular asset class.

I suggest that an *investment fund*, in hiring a consultant, require the following:

- 1.** The consultant should acknowledge in writing that it is a fiduciary of the pension plan (or the foundation or endowment fund).
- 2.** The consultant should make a written representation *annually* that either:
 - a.** It receives no income, either directly or indirectly, from investment management firms, or
 - b.** If it does receive such income, the names of all investment managers from whom it has received such income during the prior 12 months, and in each case, the approximate amount of income and the services provided.
- 3.** The consultant affirms it is prepared to provide to the *fund* all the services included in this book as expected from a *fund's adviser*.

It is easier to draw up the criteria for selecting such a consultant than to find and hire one. Some members of the committee may, in their regular businesses, have contact with investment consultants for whom they have high regard. But we shouldn't necessarily stop there. We can look in consulting directories, such as that provided by the A.S.A.P. Investment Consulting Directory, whose web site