The Key Attributes of a Successful Investment Program

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Why is it that some investment programs do consistently well while others tend to lag their benchmarks and peers?

The need for a long-term focus

Success starts with having a long-term focus and not being unduly distracted by short-term events. This is because over the long-term there is a clear equity risk premium and a long-term investor has a decided advantage due to the ability to capitalize on liquidity premiums and market dislocations. And by long-term, I don't mean a year or two but a full business cycle, i.e. six years or more.

The challenge, however, is that many organizations have difficulty with this approach because short-term issues frequently make their way on to the agenda and fiduciaries feel obligated to make change, irrespective of whether or not such change is necessary. Most often this change comes in the form of an investment manager termination, occasionally at the worst possible time. More on investment managers later.

In addition to a long-term focus, there are certain factors that have been observed across a variety of organizations that increase the likelihood of success, below are five key factors:

- Strong Governance Framework
- Well Defined Investment Policy Statement
- Thoughtful Asset Mix
- Efficient Portfolio Construction
- Partner with Investment Managers

A strong governance structure will greatly improve the odds of meeting policy objectives

A successful investment program has a strong governance structure and a well-defined investment policy. Governance is the process for making and implementing decisions. Ultimately, it is about accountability and allocating resources to meet objectives.

It is important to note that, without the necessary resources, even a well-developed investment program may not deliver the desired results. These resources are often provided through a contractual arrangement with a third party or can be developed internally. The following are five of the more common resources that are required:

- Investment Committee or Similar Governing Body
- Chief Investment Officer or Similar Position
- Portfolio Manager(s)/Investment Fund(s)
- Performance and Risk Monitoring Tools/Software
- Custodian or Record-keeper

The investment policy is the foundation for developing an investment program

Good governance starts with a well-defined investment policy that reflects the objectives and risk profile of the organization. The investment policy is the foundation for developing an investment program and the tool by which trustees exercise their fiduciary responsibilities. The content of an investment policy will vary among organizations and will typically cover the following topics;

- ✓ Scope & Purpose
- ✓ Definition of Duties, Roles & Responsibilities
- ✓ Selection & Monitoring of Third Party Advisors
- ✓ Investment, Return and Risk Objectives
- ✓ Asset Mix
- ✓ Risk Management

The role of a well-functioning investment committee cannot be overstated. It is preferable that the committee have terms of reference that clearly outline the roles and responsibilities of the members. In order to facilitate decision making, the investment committee should be comprised of a cross section of experts (preferably with complementary investment skills) and membership should remain small (three to five members).

Asset Allocation is key

There is overwhelming evidence that asset allocation is the single most important consideration in determining performance and managing risk. The next most important contributor is portfolio construction. It is not surprising to find that committees that emphasize asset mix and portfolio construction in their deliberations tend to experience better results.

View investment managers as long-term partners

Successful organizations look at their investment managers as long-term partners and keep turnover to a minimum. Frequent changes with investment managers and chasing above median performance will, for the most part, lead to disappointing results due to the implied cost and a lack of consistency in performance.

It is often argued that there is too much manager turnover, citing that part of the problem is the existence of ratings/rankings or the "buy list". This process of ranking managers simplifies a very complex selection process and creates a questionable split between managers with no verifiable benefits.

Our experience is that there are some consistent attributes among successful investment managers but skills and process will vary. We recognize that some excellent managers, that can serve a client well, may never make it onto a "buy list". In fact, some of the best managers that we have hired were not a on a buy list and occasionally some excellent managers are not covered by the consultant community.

Long-term out-performance and short-term Under-performance are inseparable

The belief that an investment manager can consistently outperform a benchmark is not supported by fact. We observe that long-term out-performance and short-term under-performance are inseparable. You cannot have the former without the latter. The acceptance of this premise combined with the long-term focus outlined earlier is a catalyst for driving results.

I would like conclude with a few words on <u>peer groups</u> and <u>risk management</u>. These are two areas that require special attention because they are often misunderstood.

The best way to do well in peer group rankings is to ignore them

Peer groups may arouse a lot of interest but they have inherent shortcomings. To begin with, the members of a peer group have different investment policies, asset mix and risk profiles that significantly limit their usefulness as a tool for comparison. They also suffer from survivorship bias whereby poor performing members are frequently removed from the group, leaving primarily the better performing members. These factors create an artificial and unrealistic comparison. Experience suggests that the best way to do well in peer groups rankings is to ignore them and focus on those areas that are under your control, i.e., asset mix, portfolio construction and manager selection.

Risk is multi-faceted and not always apparent or well understood

Risk metrics fail to capture the full extent of risk. Part of the problem is that modern portfolio theory defines risk as the volatility of returns measured by standard deviation. But there is strong evidence that risk can and will manifest itself in a variety of ways. For example, when we look at two of the most recent market corrections, i.e., the collapse of the tech bubble during 1999–2001 and the credit crisis of 2008, these events created significant financial stress and forced investors to revisit their definition of risk. Organizations that do well tend to define risk in broad terms and regularly conduct scenario analysis in an effort to anticipate emerging risks, and evaluate their impact on the portfolio.

Notwithstanding the above, there is no doubt that volatility and liquidity are areas of major concern for defined benefit pension plans that need to deal with legislative requirements designed to fund their liabilities. Defined benefit plans have unique challenges that are best addressed by liability driven strategies designed to minimize funding risk.

No one has a monopoly on the definition of risk and over the years pundits have provided us with a variety of views and few resonate better in terms of simplicity than the following: “Risk comes from not knowing what you are doing”- Warren Buffet.