A Primer for Investment Trustees (a summary)

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Investment trustees oversee the investments and investment process for a variety of institutions, such as pension funds, endowments and foundations, insurance companies, Taft–Hartley funds, and some special-purpose trust funds. Even though trustees are not expected to be experts, their responsibilities require them to understand basic investment principles so they can exercise good judgment in their approval of investment policies, processes, investment managers, staff, and other related parties. This is no small task given the challenges and complexities of the investment markets and the scarcity of training materials and resources available to most trustees.

_A Primer for Investment Trustees_ is, as its title implies, a “go to” source of information that is essential for understanding basic investment principles and the role of trustees in the investment decision-making process. It has been written specifically for trustees in a language and style that is understandable and comprehensible. It is also a key resource for investment professionals and others who work with and for investment trustees.

The primer is the trustees’ “personal trainer,” guiding them through a fund’s entire investment decision-making process. It covers governance structure, investment policy, mission, investment objectives, investment risk tolerance, investment assets, performance evaluation, and ethics in investing.

**Governance Structure**

Investment trustees are fiduciaries—that is, people who assume responsibility to oversee a pool of investable assets on behalf of some other person or entity. As fiduciaries, trustees have a duty to act solely for the benefit of that person or entity. The governance structure provides the framework for the trustees to carry out their fiduciary duties and oversee not only the investment portfolio but also all the participants in the investment process—such as staff, investment managers, custodians, and consultants.
The governance structure can be thought of as a three-legged stool: one leg being the roles and responsibilities assigned to the various decision makers, a second leg being the lines of authority and reporting relationships, and the third leg being accountability standards and related reports for monitoring and evaluating the actions of those decision makers in carrying out their assigned responsibilities. Other aspects of the governance structure include due diligence (appropriate oversight), checks and balances (decentralized decision making), reporting and monitoring (timely distribution of information), transparency (access to pertinent information), and compliance with industry best practices (periodic audits and reviews).

The organizational design of the investment committee or board is an important element that facilitates good governance and the trustees’ ability to fulfill their fiduciary duties. Such matters as number of members, selection of members, diversity of experience, terms of office, meeting frequency, length of meetings, meeting agendas, and leadership are all components of a sound governance structure.

**Investment Policy**

The most important function of investment trustees is to establish, maintain, and adhere to the fund’s statement of investment policy, which is the “rule book” for all involved in the investment process. The policy statement is an expression of the trustees’ attitudes or investment philosophy and their long-range strategic plan for the investment portfolio. Too often, sound investment policies are either not established or are not followed, which leads to ad hoc direction and decision making and hinders all the decision makers. A properly constructed investment policy serves as an “autopilot” setting in normal times and as a stabilizer during stressful markets.

A comprehensive investment policy will cover the fund’s mission, investment objectives, investment risk tolerance, the portfolio asset mix (allocation), governance structure, and performance evaluation process and criteria. It is a living document that requires periodic review by the trustees. It is a means of communication with and between the trustees, staff, managers, custodians, consultants, and other interested parties. It ensures continuity through the turnover of trustees, staff, and investment managers. Finally, it is a baseline against which to evaluate proposed policy changes.

**Mission**

The mission of a fund or investment portfolio is to provide financial benefits to certain parties, such as pension benefits or grants distributed by endowments or foundations. The financial stability of the fund depends on a balance between the level of contributions and/or sufficiency of assets, the investment return earned, and the level of distributions or benefits. Various ratios of assets,
liabilities, and rates of return are used to measure a fund’s financial stability. Tension can develop, especially in the case of defined benefit pension plans, between those responsible for funding the plan and the beneficiaries in terms of the level of benefits provided. Market volatility, tax, and other considerations can add to the complexity of the fund’s mission. The market value of a fund’s assets varies over time and is subject to both short-term and long-term volatility, whereas the liabilities (obligations) funded can vary between short-term grants and long-term pension benefits. Funding (contribution) policies are subject to change over time as a result of the growth in liabilities, the level of investment returns, or in the case of defined benefit pension funds, the discount rate to determine the amount of future liabilities. All of these factors require understanding on the part of the trustees.

**Investment Objectives**

With the fund’s mission providing high-level direction, it is important that more detailed direction be included in the fund’s investment policy statement to assist in defining the structure of the investment program and to serve as a guide to the trustees, staff, and investment managers in the ongoing management of the investment portfolio. It also serves as a retrospective measure of results. By defining the fund’s investment objectives and risk tolerance, guidance is provided regarding the critical trade-off between expected reward and risk within the fund’s investment policy.

Investment objectives must be specified in advance (not ad hoc) and written so as to be unambiguous and measurable, actionable and attainable, and reflective of the fund’s risk tolerance as agreed to by the trustees. Objectives must be clearly stated and easily measured against general market and/or specific asset class benchmarks (indices). They must be capable of being acted upon by the staff and investment managers and attainable (realistic and achievable). Finally, the investment objectives must be consistent with the fund’s mission.

**Investment Risk Tolerance**

Investment returns are tangible and after-the-fact, whereas investment risk is, to some extent, intangible and before-the-fact. Risk is a measure of the range of investment values in the future and is difficult to measure and predict. Benjamin Graham, the father of security analysis, is attributed with saying that “the essence of investment management entails the management of risk, not the management of returns.”

A variety of investment risks can affect the attainment of investment objectives and thus the success of the investment program. The primary types of investment risk exposures fall into the following categories: capital market risk, active management risk, and liquidity risk. Capital market risk is broadly
defined as the sensitivity (volatility) of the markets to economic events (e.g., changes in the business cycle). Risk is inherent in the capital markets, and investors should hold risky assets only if they are paid (rewarded) to do so. Active management risk refers to the uncertainty of an individual manager’s performance relative to the market or peers. The difference between a manager’s performance and that of the benchmark is referred to as active management return, which can be either positive or negative. Liquidity risk arises when there is no active or organized market for a fund’s investment, such as private placement debt or private equity. It can also arise in the less actively traded sectors of the public market.

Risk is not easy to measure, but it needs to be measured and monitored either in qualitative or quantitative terms or some combination of both that is acceptable to the trustees, staff, and investment managers. Standard deviation is a widely used statistical measure of the dispersion of returns. But it should be understood that there is no single best measure of investment risk. As mentioned earlier, there is a balance between investment return and investment risk. Investors who accept a high level of risk do so with the expectation (but not the certainty) of a high level of return. Over long periods of time, asset classes with higher standard deviations of return (such as common stocks) actually have earned higher returns.

The most widely used means of managing risk is diversification, or not putting all (or most) of your eggs in one basket. It is often referred to as the “free lunch” for investors. Although diversification is effective, it is difficult to achieve and requires finding the appropriate balance between industries, sectors, and asset classes that are uncorrelated; that is, their returns are not affected equally or largely by common sources of risk. Thus, it is important to reflect both investment return objectives and risk tolerance in the diversification of the fund’s investment portfolio.

Many funds today engage in risk budgeting to manage their risk levels while striving to achieve their targeted expected returns. Risk budgeting involves the use of sophisticated quantitative risk models to help measure the risk–return balance and guide the determination of the most appropriate asset mix for the fund.

Trustees must guard against confusing their personal risk tolerance with the fund’s risk tolerance. Each trustee’s risk tolerance reflects his or her own financial situation. No formula can determine the trustees’ collective risk tolerance, but collectively, the trustees share a fiduciary responsibility to define the fund’s risk tolerance to the best of their ability.
Investment Assets

Asset classes are collections of securities that have common attributes. Broadly speaking, there are three major asset classes: common stocks (equities), bonds (fixed income or debt), and alternative investments (generally, real estate, commodities, hedge funds, and private debt and equity). The trustees’ primary responsibility, guided by the investment policy statement, is to diversify the fund’s portfolio widely among various classes of risky assets.

With regard to who will manage the fund’s assets, typically, investment managers with expertise in a particular asset class or subclass will be retained. In the case of larger funds, internal staff may have the requisite expertise. The question of internal versus external managers is typically a matter of cost and the degree of investment control.

With regard to how the fund’s assets will be managed, active versus passive management is yet another consideration for the trustees. Passive management (indexing) is a simple, low-cost form of investment management that has been gaining acceptance over the past four decades. Again, the higher cost of active management must be measured against the potential for earning positive active management returns.

With regard to what types of accounts to use for the external management of the fund’s assets, trustees must consider separately managed accounts versus commingled funds. Control, cost, and access are the key considerations. Because high minimum balances often are required by separate account managers, smaller funds tend to use commingled accounts. Separately managed accounts offer more direct control but generally involve higher fees.

No matter who manages them or how the funds are managed, the trustees need to select appropriate benchmarks for measuring the results (performance) of the staff, investment managers, and consultants. For publicly traded securities, market indices are widely used as benchmarks, and increasingly benchmarks are being developed for alternative investments. Approving benchmarks that are readily available, understandable, and appropriate for the investment assets being measured is an important responsibility of the trustees.

Performance Evaluation

Measuring and evaluating the performance of the fund’s assets is an important aspect of the hierarchy of accountability, responsibility, and authority within the fund’s governance structure. It is a quality control check that not only describes the investment results but also explains the sources of relative performance.

Selecting the right measure is important. The simplest measure is the change in the portfolio’s value from one measurement period to the next. However, that measure is limited because trustees typically have no control
over the cash flows in (contributions) and out (withdrawals) of the fund. Thus, the investment community uses rates of return that are calculated to remove the effect of various non-investment or non-trustee-controlled changes.

Rates of return can be calculated in several different ways. First, return is typically defined as the total return, which includes the change in market value and the investment income from the assets in the fund’s portfolio over a defined measurement period, such as a calendar quarter or a year. Total return can be calculated on a time-weighted or money-weighted basis. Again, because trustees typically have no control over fund cash flows, time-weighted rates of total return are most commonly used to measure performance.

Performance benchmarks serve as a standard for measuring relative performance. The most informative benchmarks have certain basic properties. They should be (1) unambiguous—clearly understood; (2) investable—represent an alternative investment, such as an index fund; (3) measurable—readily calculable; (4) appropriate—reflect manager’s typical risk characteristics and area of expertise; (5) specified in advance—identified for and communicated to managers prior to the evaluation period; and (6) owned—acknowledged and accepted by the trustees, staff, managers, and consultants. Although the performance of peers seems to be a simple and suitable alternative standard of measurement, peer groups are rarely appropriate because of differences in their missions, investment objectives, and risk tolerance. Plus, they are not investable.

Performance attribution is the process of identifying the factors that caused the fund’s performance. Many factors can explain performance. Identifying and attributing performance among those factors provides the trustees valuable feedback for evaluating the effectiveness of the investment process (macro attribution) and the investment managers (micro attribution).

Performance appraisal is the process of distinguishing between luck and skill on the part of the staff and investment managers and their ability to outperform an appropriate benchmark. To identify skill, active manager returns earned by the manager are compared with their active management risk, using such specific measures as the Sharpe ratio or the information ratio. The Sharpe ratio compares the manager’s excess return (actual return less the risk-free rate) with the total risk of the manager’s portfolio (the standard deviation of the portfolio’s return). The information ratio compares the manager’s active management return (actual return less benchmark return) with the active management risk of the manager’s portfolio (the standard deviation of the portfolio’s active management returns).
The trustees, staff, and consultants need to assess a range of qualitative and quantitative factors when hiring or terminating investment managers. These factors include people, process, procedures, price (fees), and performance. Also, the trustees and staff need to periodically assess investment strategy decisions relative to their economic rationale, diversification value, and liquidity characteristics.

Ethics in Investing

The ethical conduct of the trustees reflects on the individual, the entire board, and the institution they are serving. The guiding ethical principles for trustees should be (1) act in the best interests of the fund’s beneficiaries; (2) act with prudence, competence, independence, and objectivity; (3) adhere to the fund’s mission and all related legal requirements; (4) act in a transparent manner in all official activities; and (5) maintain confidentiality with regard to the fund sponsor, beneficiaries, and investments.