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10 Practical Tips for Investment Committees

This webinar will begin at 10 am PDT

April 12, 2017

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About the Presenters

Ronald D. Peyton is Chairman and Chief Executive Officer for Callan Associates Inc., an employee-owned firm whose mission is: "Collaborating with each client to build tailored and lasting investment solutions."

Ron provides firm-wide oversight by conferring with associates and clients to improve communications, process, and service quality. He regularly meets with senior industry professionals and actively engages in industry and community events to advocate for the institutional investment industry. Ron is Chairman of Callan's Management Committee and the Emerging and Minority, Women, or Disabled-owned Managers Committee and a member of Callan's Client Policy Review Committee. He is Chairman of Callan's Board of Directors and a shareholder of the firm.

Brady O'Connell, CFA, CAIA, is a Senior Vice President in Callan's Chicago Fund Sponsor Consulting office. Brady has worked with a variety of fund sponsor clients including corporate and public defined benefit plans, defined contribution plans, and endowments and foundations. He is a member of Callan's Client Policy Review and Alternatives Review Committees. Brady has 20 years of investment consulting experience.

Brady received his MBA in Finance and Marketing from Northwestern University's Kellogg School of Management. He earned a BBA in Finance from the University of Michigan in Ann Arbor. He earned the right to use the Chartered Financial Analyst designation and is a member of the CFA Society of Chicago and CFA Institute. Brady has also earned the right to use the CAIA designation.

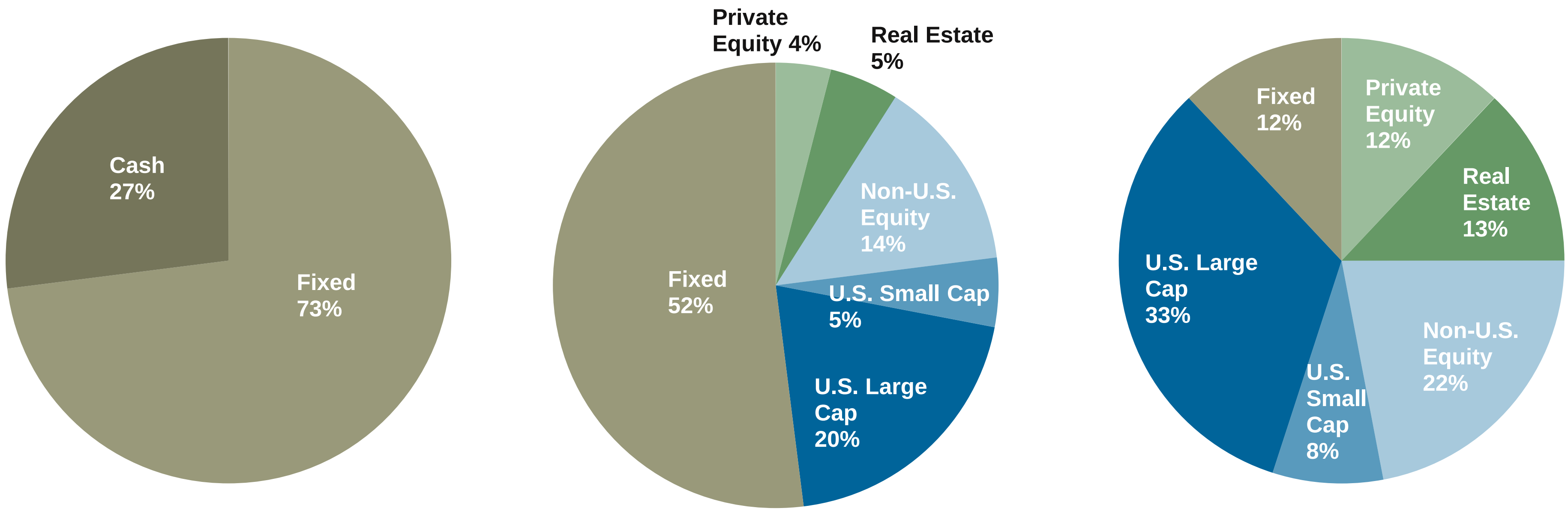
1. Commit to a long-term investment strategy—then stick to it

- Select a strategy that satisfies the long-term return needs and can be understood and maintained by future administrations
- Avoid making decisions based on strictly short-term inputs
- Avoid changing a good strategy to prepare for an anticipated “next crisis” when it was the original strategy that got the investor through the last one
- A poor strategy is disastrously revealed in situations like the Global Financial Crisis
- Risks to strong investment outcomes: Not knowing your true time horizon (or not being able to adhere to it), not understanding your true liquidity needs, and overreacting to short-term market developments

Increasing Volatility and Complexity

Expected Portfolio Returns Over Past 20 Years

Increasing Complexity



1995	2005	2015
Expected Return: 7.5%	Expected Return: 7.5%	Expected Return: 7.5%
Standard Deviation: 6.0%	Standard Deviation: 8.9%	Standard Deviation: 17.2%

Increasing Risk

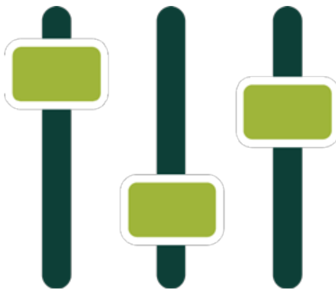
2. Understand the investment strategy

- Do not employ investment strategies the committee does not fully understand
- Complexity is not a taboo, but a complex strategy should not be employed simply because it is popular
- The right strategies will solve a specific problem for the fund in achieving its long-term goals
- Be sure that current and future decision-makers will be able to understand complex strategies
- Never employ a strategy that cannot be maintained, explained, or defended by the next CIO, investment committee, administration, or the participants at its worst possible moment

3. Hire and fire managers for the right reasons

- Hire managers for their investment strategy and their perceived ability to achieve the strategy—NOT recent performance ranking
- Fire when the manager's investment strategy is faulty or the competence to achieve the strategy does not exist in the manager's organization
- Do NOT hire or fire based on recent performance alone
- Periodically conduct a formal review of the decision-making process and its effectiveness in making active manager hiring and firing decisions
- Consider use of an index fund
- The most successful Callan clients have hired able managers and kept them through thick and thin—even when it appeared they had suddenly lost all reason

4. Develop proper controls and oversight



- Even though certain investment functions may be delegated, fiduciaries retain the responsibility to oversee and control delegated activities
- It is nearly impossible to insulate from fraud entirely, but strong controls and oversight of external advisors and internal players can reduce its potential
- Thorough operational due diligence is a critical aspect of oversight that may prevent fraudulent investments
- Beyond out-and-out fraud, the industry abounds with examples where poor oversight and controls resulted in losses for the fund
- Custodial arrangements, securities lending operations can pose problems

5. Vigorously monitor costs

- Tracking and managing investment-related costs is critical: the first step in ensuring they are reasonable with respect to the value added
- Understand all aspects of investment costs—including those related to the administration of the investments—and manage them wherever possible
- Alternatives: costs come in different forms and are often indirectly assessed—do you really know how much you pay private equity or real asset advisers?
- Fees and expenses have become much more transparent in recent years, but much more progress is needed

49 bps

Average expense for public DB plans, 2015

55 bps

Average estimated expense for DC plans, 2016

Source: Callan

6. Create well-defined rebalancing practices

- Establishing a clear asset allocation along with well-defined rebalancing ranges is a critical risk management function
- Rebalancing is often counterintuitive to human nature, but it is the only proven way to buy low and sell high successfully over time
- Failure to rebalance can result in taking on too much—or too little—investment risk
- Too much risk is often painful over the short-term, but too little risk can also present a real possibility of failing to meet long-term investment objectives
- The key to objective, successful rebalancing is to believe in the long-term strategy

7. Understand the strategy’s investment restrictions

- A well-diversified portfolio can be hurt by restrictions on the type of investments allowed
- Understand how any restrictions can impact the investment opportunity set and the potential effect these restrictions can have on long-term returns
  - Recent examples of restrictions include: divestment of shares in tobacco firms, firearms makers, and those doing business in South Africa; and economically targeted investments
- Review critically all investments that purport to have secondary economic or social benefits, including the costs of these decisions
- Base decisions on restricted investments on the same criteria as other investments: competitiveness of the potential return and risk

8. Attract and retain a qualified investment team

- As institutions have increasingly embraced more complex alternative investments, the need to attract and retain talent to identify, implement, and oversee these investments has grown in importance
- Stability in decision makers can help institutions stick to other best practices and increase the odds of long-term success
- Attracting and retaining a qualified investment team, as well as developing new talent, is a challenge in a very competitive industry and requires a budgetary commitment and committee support

9. Delegate strategy & policy implementation to CIO/staff

- Investment committees are primarily responsible for:
  - setting investment strategy, policy guidelines, and asset allocation
  - monitoring results
  - overseeing the plan
  - representing the plan on behalf of the beneficiaries
- Rely on the expertise of your qualified investment team and delegate as much of the implementation of the investment program as possible
- By carefully considering what issues must have approval and what can be delegated to staff, operational efficiencies such as rebalancing and dealing with investment manager issues in a timely fashion will likely improve long-term results

10. Prepare for turnover

- Excessive changes in decision-making bodies can destroy institutional knowledge and result in excessive changes to investment strategy
- Changes in investment strategy are costly and often occur at the worst possible time
- Committee members for institutions with higher turnover should be aware of how their decisions can impact future decision makers, and they should seek to design an investment program that can endure changes in decision makers

Key Takeaways

- Long-term investment success requires a strong governance and decision-making framework
- Governance, not investments, is the primary responsibility of investment committees
- Our guiding principle for institutional investors: focus on avoiding losses rather than trying to achieve extraordinary gains
- Simple math illustrates that a loss of 20% requires a gain of 25% to break even, and a loss of 50% requires a 100% recovery

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