# DEVELOPING A CULTURE OF GOOD GOVERNANCE

*A Self Evaluation Approach*

Strategic Investment Group®

Fiduciary Insights

**A CULTURE OF GOOD INVESTMENT GOVERNANCE IS BASED ON THE SHARED OBJECTIVES, MUTUAL RESPECT, JUDGMENT AND EXPERIENCE OF THE GROUP OF PEOPLE WORKING TOGETHER TO FULFILL FIDUCIARY RESPONSIBILITIES**. Developing and sustaining a supportive governance culture takes commitment, integrity and a degree of self-awareness. We hope that the self-evaluation of your corporate governance culture set out in this issue of Fiduciary Insights will stimulate reflection and discussion that foster a culture of good governance.

# Introduction

In this issue of Fiduciary Insights, we propose a self-evaluation of your corporate governance culture. Our focus is on the senior fiduciaries— investment committee, governing board and senior management— charged with aligning investment policies with the core operations and financial structure of the sponsoring institution.

Governance is an oft-overlooked but essential ingredient of successful investing by institutions. It is overlooked in part because it is a "soft" factor that is not easily quantified and that depends on the attitudes of individuals and the interaction of senior fiduciaries in group settings. It is essential because poor governance can lead to decisions that take a toll on investment performance.

We propose a self-evaluation approach because successful governance is much more than a mere structure of standard procedures; it is a culture built on the shared objectives, mutual respect, judgment, and experience of the people charged with governance responsibilities. That culture must be developed over time by the team of investment committee members, under the direction of the chair, and senior management.

No governance structure, no matter how well conceived, can function if an effective governance culture has not been carefully fostered over time. While a sound structure can help instill positive behavior, provide checks and balances, and contribute to the establishment of an effective governance culture, it cannot prevent the consequences of dysfunctional investment committee dynamics.

The issues that we pose for consideration are designed to stimulate reflection and discussion that we hope will help foster a culture of good governance. Each question is intended to provoke a constructive analysis of ways to improve your approach to framing investment decisions.

We have organized the survey around five categories:

- Mission Awareness
- Governance Structure
- Decision-Making Process
- Attitudes and Biases
- Controls

# 1. Mission Awareness

1. The committee has a well-defined and thoroughly thought-out vision for the role of investments in meeting organizational and stakeholder objectives.

**Agree** **Undecided** **Disagree**

2. The committee has a clearly articulated and shared understanding of investment objectives and constraints. These objectives and constraints balance short- and long-run considerations.

**Agree** **Undecided** **Disagree**

3. The investment objectives established by the committee are aligned with the broader mission of the sponsor, realistic, and based on a comprehensive appreciation of the full range of related risks, including unlikely but potentially very damaging outcomes.

**Agree** **Undecided** **Disagree**

4. Staff and service providers have a clear understanding of our objectives and constraints, and they also believe that they are achievable and appropriate.

**Agree** **Undecided** **Disagree**

# 2. Governance Structure

5. We have the right number of committee members that meet the right number of times and address the right issues.

**Agree** **Undecided** **Disagree**

6. The average tenure of our investment committee members is long enough (e.g., 5-10 years and staggered) to ensure institutional memory and continuity, while preserving sufficient turnover to benefit from fresh insights.

**Agree** **Undecided** **Disagree**

7. The committee focuses on policy issues and leaves implementation and operational decisions to staff/service providers (e.g., individual specialist investment managers).

**Agree** **Undecided** **Disagree**

8. The committee adequately monitors the implementation of its policy decisions.

**Agree** **Undecided** **Disagree**

9. There is an appropriate division of responsibilities between policy initiatives, review and analysis, decisions, implementation and monitoring.

**Agree** **Undecided** **Disagree**

10. The background material for committee meetings is focused, concise and based on sound analysis. Our committee has the information it needs to make decisions and takes the time to review that information.

**Agree** **Undecided** **Disagree**

11. All committee members are sufficiently well trained and knowledgeable about investments, capital markets and risk management to properly discharge their responsibilities. They come to meetings prepared.

**Agree** **Undecided** **Disagree**

12. All committee members have high ethical and professional standards, disclose possible conflicts of interest and take their fiduciary responsibilities seriously.

**Agree Undecided Disagree**

13. The committee fosters an environment of open discussion, trust and mutual respect. It encourages and listens attentively to constructive dissent.

**Agree Undecided Disagree**

14. Each committee member is an active participant in decisions. Committee members do not as a rule "defer to the majority" if they disagree.

**Agree Undecided Disagree**

15. Committee members are open and inquiring. They are not easily intimidated by apparent complexity. They have the patience, discipline and intellectual integrity to ask questions until they understand.

**Agree Undecided Disagree**

# 3. Decision-Making Process

16. The committee bases decisions on a thorough consideration of sound and objective analysis. When adequate supporting information has not been provided, a decision is postponed.

**Agree Undecided Disagree**

17. The committee sets clear expectations on the information required to support its decisions and holds information providers accountable for the quality of that information.

**Agree Undecided Disagree**

18. The committee is given a complete and balanced assessment, especially when decisions are not clear cut.

**Agree Undecided Disagree**

19. Management views the committee as a source of wise counsel, not a mere formality or rubber stamp. The committee, in turn, has confidence in the recommendations of management.

**Agree Undecided Disagree**

20. The committee makes timely decisions and its decisions are implemented in a timely manner.

**Agree Undecided Disagree**

21. Members of the committee feel comfortable raising doubts about a decision if circumstances change.

**Agree Undecided Disagree**

22. All members' views are fully aired and properly discussed before making decisions. Deliberations are open, thorough, engaging and lively.

**Agree Undecided Disagree**

23. The committee has established clear guidelines on the types of decisions that require its consideration and those that may be delegated to others. It periodically reviews these guidelines.

**Agree Undecided Disagree**

24. The committee is aware of the value of a fresh perspective. It periodically seeks objective reassessments of its policies, outlook and decisions by disinterested outsiders.

Agree Undecided Disagree

25. The committee typically focuses its limited resources on strategic policy issues, and avoids issues that are best handled by others.

**Agree Undecided Disagree**

26. The committee carefully plans its work schedule to ensure that all topics that need to be addressed to fulfill its fiduciary responsibilities are reviewed regularly.

**Agree Undecided Disagree**

# 4. Attitudes And Biases

27. The committee has confidence in the advice it receives from management and service providers. It nevertheless carefully probes the reports, analysis and recommendations it receives.

**Agree** **Undecided** **Disagree**

28. The committee welcomes investment policy innovation, and recognizes that capital markets are evolving every day. It adopts innovations with deliberate but not reckless speed.

**Agree** **Undecided** **Disagree**

29. The committee seeks to balance all types of risk—funding, market, liquidity, counterparty, operational, conflicts of interest and reputation—over the short and long run.

**Agree** **Undecided** **Disagree**

30. The committee understands that the tolerance for each type of risk varies from institution to institution and investment pool to investment pool.

**Agree** **Undecided** **Disagree**

31. The committee remains disciplined and continues to strike an appropriate balance between long-term and short-term considerations even in the face of significant setbacks.

**Agree** **Undecided** **Disagree**

32. The committee's investment decisions are forward-looking and value-oriented (i.e., price-sensitive), not driven by past returns or "rules of thumb."

**Agree** **Undecided** **Disagree**

33. The committee can be very tolerant of poor performance if it understands why it has occurred, believes the investment posture is likely to be rewarded going forward, and the cause of underperformance is not lack of discipline but rather adherence to a discipline.

**Agree** **Undecided** **Disagree**

34. In evaluating new investment strategies or managers, the committee focuses on process and current valuations, rather than past performance.

**Agree** **Undecided** **Disagree**

35. While it is aware of peers' asset allocation and performance, the committee's main focus is on setting objectives that are tailored to our needs and outperforming our own policy objectives.

**Agree** **Undecided** **Disagree**

36. I have great respect for my colleagues in the investment committee, although I can disagree and be vocal about the reasons for my disagreement with them.

**Agree** **Undecided** **Disagree**

37. I feel pride in the work we do on behalf of our stakeholders.

**Agree** **Undecided** **Disagree**

38. I read all of the material given to me in support of discussions and decisions we need to take, and come well prepared to the meetings.

**Agree** **Undecided** **Disagree**

39. The committee is price aware. It is only willing to pay high fees for demonstrable value-added.

**Agree** **Undecided** **Disagree**

40. The committee avoids jumping on the bandwagon of fads and bubbles.

**Agree** **Undecided** **Disagree**

41. The committee keeps abreast of financial innovations and devotes sufficient time and resources to education and training for committee members and management.

**Agree** **Undecided** **Disagree**

# 5. Controls

42. The committee has established a clear process of review and accountability. This process is used primarily to ensure that we are fulfilling our fiduciary responsibilities, not as an instrument of reward and punishment.

**Agree** **Undecided** **Disagree**

43. The committee sets clear expectations for the outcomes it is targeting and regularly reviews the results of its decisions.

**Agree** **Undecided** **Disagree**

44. The committee periodically reviews investment operations to ensure that there are effective and transparent compliance systems, legal reviews and control procedures in place.

**Agree** **Undecided** **Disagree**

45. We have an appropriate and easy to understand set of reports that tell me regularly all of our positions, the extent to which we are over or underweighted relative to our policy and peers, and the full set of risks we are taking both absolutely and relative to policy and peers.

**Agree** **Undecided** **Disagree**

46. We review performance in the short and long term, relative to appropriate investable (rather than aspirational) comparators and expectations, and understand the context in which the performance is being delivered.

**Agree** **Undecided** **Disagree**

47. We review the policy portfolio at regular intervals (generally no less than every three years) to make sure it reflects our current needs and circumstances and capital market outlook.

**Agree** **Undecided** **Disagree**

48. We review the appropriateness of asset class and manager benchmarks at least as often as we review the policy portfolio.

**Agree** **Undecided** **Disagree**

49. We review management succession plans to measure if we have sufficient depth of resources, institutional memory and management capabilities, over the long run.

**Agree** **Undecided** **Disagree**

50. We review our disaster recovery/business continuity provisions at least every two years and consider low probability but extreme events.

**Agree** **Undecided** **Disagree**

# Conclusion - Calculating Your Score and Warning Alerts

You have now completed a self-evaluation that we hope has triggered thoughts on how to enhance your governance culture. To calculate your score, assign two points to each time you agreed and one point wherever you were undecided. There are no points for disagreeing. The maximum number of points is 100 and the minimum passing grade is 60.

There is always room for improvement. The purpose of the survey is to help identify areas in your current governance culture that require attention. Every time you responded "undecided" or "disagree" represents an area where further work may be needed to raise governance standards.

Inevitably, however, your renewed commitment to promoting superior governance practices will be overtaken by other pressures and distractions. Good intentions will lose their edge and governance practices may start to slip. To help you fight against backsliding and recognize when governance practices once again need attention, we conclude with the following warning signs of poor governance.

- A narrow focus on manager selection, rather than a total portfolio approach to boosting returns and controlling risks. Once the strategic benchmark is selected, asset allocation decisions are too often narrowly based on selecting managers in each asset class with little attention to how the managers interact with others in the asset class and with the underlying exposures in the rest of the portfolio.
- Paint-by-the-numbers approach to asset class and management structure. A related problem arises when managers are pegged to an overly narrow style that impedes their ability to add value and react to changing market conditions, and when portfolios are structured more to ensure that each style box is filled than to reflect the opportunities and risks present in the investment environment.
- High manager turnover. High turnover can be a sign of conflicting agendas or confusion and frequently leads to subpar performance. High turnover resulting from chasing returns has a particularly pernicious effect on performance as it leads to a "buy high, sell low" approach.
- Manager terminations immediately after a period of poor absolute or relative returns. The application of formulaic rules of thumb based, for example, on the level or duration of underperformance rather than an understanding of the causes of underperformance can have perverse results. Even the most talented managers underperform sooner or later. Decisions on retaining managers generally should be based on their intellectual insight, analytical strengths, trading abilities, integrity, discipline and forward-looking prospects for generating strong absolute and relative returns.
- Simple rules for hiring and firing managers. A common, but potentially ill-fated approach involves the requirement that managers must have performed in the top quartile for a defined period prior to their hiring.
- Consistently poor performance in any type of market cycle, and especially following a period of high momentum. This symptom often results from chasing past performance.
- High management costs not commensurate with performance. Fiduciaries have a responsibility to generate strong risk-adjusted net-of-fee returns. This means paying for active management only when there are good prospects for adding value and pursuing passive management in all other cases.

### Scoring Your Committee

<60 points – Significant governance problems
60 - 90 points – Room for improvement
>90 points – Good governance process

## Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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