

Best practice investment governance

Going from good to great

“No matter how much you have achieved, you will always be merely good relative to what you can become. Greatness is an inherent dynamic process, not an end point.”

Jim Collins

In short...

The links between good governance and good performance seem reasonably obvious (see *Flight Plan*¹). What is less obvious, is what describes 'good governance' or even 'great governance'. In this paper we consider the key attributes of global best practice in governance, summarising the findings from a recent academic paper² written by Gordon L Clark of Oxford University and Roger Urwin of Watson Wyatt.

Governance – a quick reminder

In institutional investment, 'governance' describes the system of decision-making and oversight used to invest the assets of a fund. The responsibility for this role lies

with trustees or other types of fiduciaries who are faced with high level issues (where they will typically take responsibility) and more detailed implementation actions (where delegating to others is more likely to be used and the fiduciaries' role becomes monitoring those actions).

Investment governance, therefore, employs skills, resources and processes to create value for institutional funds.



Previous published research has demonstrated that good governance is required to be effective in the competitive and complex environment of institutional fund management. Some prior research references include:

- *Fortune and folly*³ written in 1992 by two anthropologists (O'Barr and Conley), who suggested that funds were not managed for financial efficiency, but more for convenience or relationships with outside managers and the avoidance of risks from these relationships
- *Pension Revolution: A Solution to the Pensions Crisis*⁴, in which Keith Ambachtsheer demonstrated a 'governance shortfall' (the return foregone due to internal governance and management problems) between good and bad governance of 100 to 200 basis points per annum in his database of funds.

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Governance challenges

While governance is typically thought of as a constraint, the Clark/Urwin research suggests it can be developed to meet higher performance ambitions.

The best-practice research carried out by Clark and Urwin (see note ²) cherry-picked ten funds from around the world which had built excellent reputations for governance and had delivered strong performance in

addition. The research drew from highly detailed qualitative discussions on how these funds operated, what they considered as 'success' and what had made them successful.

The funds required certain confidentiality to be observed to achieve the candour the research required. They comprised six superannuation funds, two endowments and two sovereign funds located in North America (five funds), Europe (three funds) and Asia-Pacific (two funds). They ranged in size from around \$5 billion to \$100 billion.

Their success was built on their strengths in dealing with five big challenges, as described below.

(A) Risk management

Decisions on how much risk to take in a fund and the management of that risk is critical to long-term value creation in a superannuation fund.

Taking risk effectively requires good governance to set strategy and monitor and control progress. Given that the investment world is dynamic and competitive, those governance resources need to be able to adapt to change in order to secure a competitive advantage.

(B) Focus on appropriate time horizon

The differences between short-term and long-term investing are significant⁵. Most institutional funds have a long-term investment mission. The governance challenge is generally to manage to the long-term plan but be resilient to the short-term pressures that build up from time to time.

Best practice funds had built up a balance around these issues.

(C) Innovation capability

The concept of 'early mover advantage' in the corporate world is well-known. In the context of investment markets, it relates to successfully identifying and accessing markets and asset classes early in the cycle, ahead of the crowd.

Funds investing in newer, less popular asset classes, newer strategies or newer managers face many challenges. This places significant demands on governance, not least from the challenge of peer pressure.

(D) Alignment with a clear mission

Institutional funds have difficulty with their mission. A particular complication for superannuation funds is their shared purpose. The role of a superannuation fund is to produce value propositions for both members and sponsor, but sometimes it will be difficult to satisfy both needs. A clear statement of goals is an important step to building alignment between the parties, so that the appropriate investment risk profile and strategy can be identified.

Best practice funds tend to have not only a clear primary objective, but a number of defined secondary objectives which enable all parties to match operational goals with the mission.

(E) Managing agents

In general, superannuation funds are not resourced to manage all of their activities in-house, and consequently employ agents in both advice and delegated roles. This exposes them to the risk that the goals of the agents do not align with those of the superannuation fund⁶.

Governance is critical to monitor and control these misalignments, particularly with a large line-up of managers. Best-practice funds are experts in managing these agents and building good alignment.

Core attributes of best practice

The Clark/Urwin study identified 12 governance-related factors common amongst leading edge funds. Six of these could be regarded as being within the reach of most funds, and are shown in Figure 1. These six attributes have been grouped by the institution's coherence, people and process. Coherence includes consideration of the clarity and focus of investment objectives; people includes those involved in the investment process, their skills and responsibilities; and process includes how decision making is managed and implemented.

Figure 1 | Global best practice – core attributes

Core best practice factors		
Coherence	Mission clarity	Clarity of the mission and the commitment of stakeholders to the mission statement
	Effective focusing of time	Resourcing each element in the investment process with an appropriate budget considering impact and required capabilities
People	Leadership	Leadership, being evident at the board/investment committee (IC) level, with the key role being the IC Chairman
Process	Strong beliefs	Strong investment beliefs commanding fund-wide support that align with the goals and informs all investment decision-making
	Risk budget framework	Frame the investment process by reference to a risk budget aligned to goals and incorporate an accurate view of alpha and beta
	Fit-for-purpose manager line-up	The effective use of external managers, governed by clear mandates, aligned to goals, selected on fit for purpose criteria

A clear mission

As noted above well-governed funds have a clearly defined set of goals, to which stakeholders are committed. The board and their staff understand what they are trying to achieve and how their strategy fits with these goals.

Effective focusing of time

In most circumstances funds work within a constrained governance budget. Given these limitations, well-governed funds focus their resources so as to maximise the cost/benefit trade-off. Generally less time could be spent on the lower impact area of monitoring managers leaving more time to devote to asset allocation decisions where the impact is greater.

Leadership

Parallels can be drawn here with the corporate world. Strong leaders have the ability to create a positive culture, and organise the team into an effective and cohesive force. In the institutional funds setting, the key leader is the Investment Committee chairperson. In this role the influence is considerable and best practice would be demonstrated by:

- dealing effectively with all stakeholders
- addressing the institutional funds' challenges
- creating a strong culture of responsibility and accountability for both board members and executive management.

Strong investment beliefs

Investment is essentially about making judgements and decisions in the present, typically with reference to the past, to cope with or exploit an uncertain future. Investors do this by using their underlying beliefs about how the world works. The quality of those underlying beliefs is a major determinant of success in investment.

Superannuation fund boards and investment committees with well-developed and well-documented beliefs would tend to secure a competitive advantage over other investors. There are four key areas in which beliefs are required, as illustrated in Figure 2.

Risk budget framework

As noted previously, decisions on how much risk to take in a fund and the management of that risk are critical to long-term value creation in a superannuation fund. Risk budgeting⁷ provides a framework for guiding investment strategies consistent with the goals of the fund. The funds in the Clark/Urwin study concentrated on management of both alpha and beta sources of return, and were clear on how to manage this mix consistent with their goals.

Manager line-up

To varying degrees, institutional funds will delegate portfolio management to external managers. Best practice governance suggests that this delegation should be covered by clear mandates which are aligned to the goals of the fund. The assessment of managers and products should be on a fit-for-purpose basis, focusing on investment efficiency after costs and considering alignment of the organisation to the fund's goals to achieve sustainability of performance.

Attention to the selection of managers is rarely matched in de-selection. In both cases good processes are important. The industry has poor experience overall with hiring and firing managers⁸.

Figure 2 | High level investment beliefs

- Asset class and security pricing, what are 'fair' prices, the reasons why mispricing can occur, the degree of this mispricing
- The fund's ability (competitive advantage) to exploit strategy opportunities
- How the fund might exploit these beliefs in its strategy
- What these (alpha and beta) strategies can produce in value added and risk terms, individually and fitted together

Exceptional best practice attributes

There were six further governance factors identified in the Clark/Urwin study which are associated with the leading edge funds. These attributes, summarised in Figure 3, differentiate the best-in-class funds from the rest. It was these factors that took what were 'good' funds and moved them into a 'great' category.

Investment executive

We are strong advocates of the merits of separating governance into a governing function, which sets the framework, monitors and controls, and an executive function, which makes the decisions within the given framework and implements (or oversees implementation)⁹. Not only does this improve efficiency and accountability, but it also allows for the concentration of investment expertise within the executive function.

Research suggests that the majority of institutional investors fall short on this organisational design.

Best practice funds adopt a clear separation of governing and executive functions, with a strong culture of accountability. Furthermore the executive function has a high level of investment competency, enabling the funds to implement and monitor complex investment arrangements. The 10 funds in the research study all have CIO's of sorts, with varied sizes of investment team – ranging from small (around 5) to very large (around 60).

Board selection and competence

These sound investment competencies are also observed at the board level of best practice funds. Board members ideally have strong numeric skills and the ability to think logically within a probability based domain, such skills enabling

Figure 3 | Global best practice – exceptional attributes

Exceptional best practice factors		
Coherence	Highly competent investment executive	The use of a highly investment competent investment function tasked with clearly specified responsibilities, and accountabilities to Investment Committee
People	High level Board competencies	Selection to the board and senior staff guided by: numeric skills, capacity for logical thinking, ability to think about risk and probability
	Supportive compensation	Effective compensation practices used to build bench strength and align actions to the mission, different strategies according to fund context
Process	Competitive positioning	Frame the investment philosophy and process by reference to the institution's comparative advantages and disadvantages
	Real-time decision making	Utilise decision-making systems that function in real-time not calendar-time
	Learning organisation	Work to a learning culture which deliberately encourages change and challenges the commonplace assumptions of the industry

the board to function effectively in its long horizon mission¹⁰.

Supportive compensation

There are significant issues related to introducing effective compensation practices in institutional funds. Leading funds, however, have been addressing these issues at both the board and executive level, with some success at using compensation to attract appropriate skills and align actions to the goals of the fund.

Current practice amongst funds in general appears to result in significantly more being paid to external agents. There is scope to address this imbalance to some extent through greater use of internal resources, an approach which is becoming more widely adopted amongst the top funds.

Competitive advantage

As noted above, investment is a highly competitive activity. For funds to succeed, they need to be aware of their competitive advantages and disadvantages and adapt their decision making accordingly.

Much of their competitive advantage will be built on a sound belief

structure, but will also maximise their own particular areas of competence. It is equally important that funds should be aware of areas where they have no expertise and seek to limit their strategy accordingly.

Real-time decisions

Most funds are geared towards making decisions around a calendar-based series of meetings. Best practice funds, however, tend to have processes in place that enable decisions to be taken as and when necessary, based on investment market conditions. Making such a change from calendar to real time focus involves more delegation and a clear definition of responsibilities.

Learning organisation

Best practice funds tend to be innovative. To be successful they need to operate in a culture that learns from experience. They also need to be willing to challenge conventional wisdom and deal enthusiastically with change.

The 123 model – a recap

In *Flight Plan*, we introduced our '123 model' for governance. We suggested that there are three ways to be successful in managing an investment fund, corresponding with different levels of governance. (see Figure 4).

We would suggest that model 1 and particularly model 2 funds can achieve a best practice level by adopting the six core principles. The six exceptional best practice factors are not realistic for these funds to adopt. It is model 3 funds that can achieve the higher level best practice by attaining the additional six factors. While model 2 funds can be very good at their mission if they follow such principles, only model 3 funds have the opportunity to be considered great at what they do.

Governance gap

These three models give a useful framework for thinking about how to exploit different investment opportunities given differing governance budgets. One common fault is for funds to be overly ambitious in terms of the complexity of the investment structures in place relative to governance.

As a short-term measure, funds should focus on aligning their investment arrangements with existing governance. In the long term, however, funds might well set their sights on improving governance, so laying the foundation for the successful exploitation of more complex strategies.

Figure 4 | Three models for investment governance

① Limited	Single fiduciary board resources constrained by expertise and time
② Middle-range	Investment committee resources increased by experts and more time
③ Advanced	CIO and investment team use of investment experts with support of strong trustee board/IC

Bridging the gap

If the long-term objective is to bridge the governance gap and achieve model 3 structure, the question then becomes how to achieve this – essentially how to access a suitably qualified executive function.

The choice of how to introduce a separate executive function is largely between building internal resources and delegating to an external party. The advantages and disadvantages of the two approaches are outlined in Figure 5.

The list alludes to the difficulties of recruiting and retaining internal resources as the skills required are essentially the same as those valued by investment consultants and investment managers. There may be significant HR issues around the level of remuneration, as well as continuity issues in the event of departures. It seems unlikely that smaller institutional funds would have the ability to build appropriate internal resources, and that it may not suit even some of the largest funds.

The alternative to building is to 'buy in' (or outsource) the executive function. While addressing the primary drawbacks of internal resourcing, outsourcing will also provide access to a greater breadth and depth of specialist resources.

However, the disadvantages of outsourcing warrant mention, particularly the issue of alignment of interest and management of capacity problems, where external propositions will have certain conflicts to manage.

Figure 5 | Buy or build the executive function

Advantages and disadvantages of approaches to executive function		
	'Build' (internal arrangements)	'Buy' (external arrangements)
Costs	Principally fixed sum cost – usually favours large funds	Principally basis points cost – usually favours mid-sized funds
Value added people	Hard to attract top quality professionals. Narrower skill base	Can generally gain access to highest quality professionals. Wider/deeper skill base
Value added alignment	Easier to build alignment to fund's specific goals. Conflicts generally are fewer	Harder to build alignment to fund's specific goals. Conflicts generally are greater
Sustainability	Continuity of key professionals can be problematic	Continuity more sustainable through organisational continuity

In conclusion

The Clark/Urwin research shows that outstandingly good governance carries a performance advantage. By studying best practice examples, a number of ways to improve governance become evident. The Clark/Urwin study describes the best practice attributes to which funds may aspire.

The use of an investment executive functioning in real-time decision-making is the big step necessary to implement the most ambitious investment arrangements. The research is clear that it is only with this step that funds can make the leap from good to potentially great arrangements. While this move is a large one, it can be accomplished by external delegation as well as internal resourcing. In the short term funds are encouraged to align their investment arrangements with the governance available, but seek to build their governance in line with their value creation ambitions in the longer term.

Watson Wyatt Investment Consulting Thinking Ahead

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¹ *Flightplan*, Watson Wyatt, November 2006.

² See *Best-practice investment management: lessons for asset owners from the Oxford-Watson Wyatt project on governance*, Gordon L Clark and Roger Urwin, September 2007.

³ *Fortune and folly* (Irwin, 1992) by William O'Barr and John Conley.

⁴ *Pension revolution: a solution to the pensions crisis* by Keith Ambachtsheer was published in 2007.

⁵ See *Long-term vs short-term investing* in *Changing lanes*, Watson Wyatt, December 2004.

⁶ See *Sales, stewardship and agency issues*, Watson Wyatt, September 2007.

⁷ See *Risk budgeting* in *Remapping our investment world*, Watson Wyatt, October 2003.

⁸ See *Hiring and firing managers – an excellent opportunity to destroy value*, Watson Wyatt, November 2005.

⁹ See *Pension fund governance* in *Changing lanes*, Watson Wyatt, December 2004.

¹⁰ For a longer explanation see *Are you proficient at probability?*, Watson Wyatt, March 2007.