Portfolio
Construction
Forum

5 essential investment committee tools

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An Investment Committee (IC) is a key part of any well-constructed portfolio. It's a central plank in an investment manager's governance framework and it's well accepted that good governance leads to better return outcomes. In fact, in 2007, Keith Ambachtsheer estimated a badly governed fund gives up between 100 to 200 basis points per annum compared to a well-governed fund.[1] Good governance[2] helps manage human biases, allocates resources appropriately and provides a structured framework to make clear and logical decisions.

So, what are the most important governance tools for an Investment Committee?

1. PURPOSE

An IC must be clear on its purpose. Is it charged with setting the objectives, risk appetite and asset allocation of the portfolios? Does it oversee an external research house or an internal investment team? Or does the IC become involved in manager and security selection? Whatever the mission, it needs to be clearly agreed by all members and documented in the Investment Committee Charter (see below).

It's also important to consider the best use of the IC's time. The famous Brinson study[3] is a good reminder of the relative importance of setting investment policy compared with security selection. As 'exciting' as it may be discussing the merits of holding BHP versus RIO, the returns from security selection are small relative to asset class returns as a whole.

2. EXPERTISE AND EXPERIENCE

A well-functioning IC needs the right attributes and mix of skills. It must include investment specialists with appropriate qualifications and experience. Consider candidates with specific investment related credentials including:
- Masters of Applied Finance;
- Chartered Financial Analyst (CFA); and/or
- Certified Investment Management Analyst (CIMA)

Also seek individuals who have constructed portfolios in the past and contributed to an IC. It's important to appoint an effective Secretary who is charged with the preparation of clear and concise papers and recording of decisions and action items. Finally, nominate a Chair who can move through the agenda and moderate constructive debate to extract the most value from all IC members.

Use a skills matrix[4] to get the right mix of attributes, diversity and experience across your IC.

3. INVESTMENT COMMITTEE CHARTER

A Charter cements the purpose of the IC, its reporting lines (generally to the Board), meeting frequency, composition of the IC, how a quorum is constituted (for example, a majority of members present), and how a decision is made. It may also include the individual responsibilities of each IC member and the review frequency of the Charter. Vanguard's

Sample Investment Committee Charter[5] provides a reasonable starting point (albeit from a US perspective).

The Charter (or the Investment Policy Statement - see below) may also include a Delegations Schedule whcih defines who is responsible for which decision or decision level. For example, the investment manager may be responsible for recommending a change of asset allocation and the IC may need to approve it prior to implementation. Or, the investment manager may be delegated to change asset allocation within agreed ranges with any change reported to the IC in arrears. NZ Super's (extensive) Delegations Policy[6] provides an example.

4. INVESTMENT POLICY STATEMENT

The Investment Policy Statement (IPS) outlines the key investment beliefs and restrictions for a fund or portfolio. It serves as a guide as to how a portfolio will be invested.

Investment Beliefs

A clear set of (documented) beliefs should not be underestimated. Beliefs and values underpin our actions and help us prioritise what's important in life. Investment beliefs are no different. VicSuper's IPS contains its Investment Mission and Beliefs.[7] These include:

- Investors are rewarded for taking long-term market risk;
- There is value in integrating ESG factors into our investments; and,
- Good governance and transparency helps us to act in the best interest of our members.

Belief statements often resolve contentious debates such as "Strategic Asset Allocation versus Dynamic Asset Allocation", "Active versus Passive", and "Listed versus Unlisted". Forming and documenting a set of investment beliefs helps the IC stay the course during difficult periods and prevent it from simply following the latest trends.

Investment Guidelines or Restrictions

Investment Guidelines serve as the foundation for how a portfolio is invested. They often form the key terms in a Product Disclosure Statement, but with more detail or narrower ranges for internal use. Some of the key guidelines include:

Criteria	Example^	Notes
Investment objectives of the fund	CPI + 3% pa over a five year rolling horizon	The objective may also include a volatility or risk measure.
Asset allocation ranges	Cash 0% – 20% Equities 0% – 70% Fixed Interest 0% – 70%	The IPS may also include tighter operational limits (e.g. cash may never drop below 1% - 2%).
Investment universe	Unlisted managed funds and cash accounts only	Depending on how the portfolio is invested^ the universe could extend to direct equities, exchange traded funds, or even derivatives (if it's through a fund).
Liquidity	Daily priced, daily redemption	Depending on how the portfolio is invested^ using daily priced funds may be the best option, to ensure appropriate rebalancing and implementation.
Fee budget	Maximum 50 bps (base fee only)	Setting a performance fee budget is extremely difficult (unless it's possible to structure performance fee caps on the underlying investment), so a fee budget is often limited to base fees.
Rebalancing	Every six months or within a tolerance (e.g. 20% threshold[8] – if the position is 10%, rebalancing only occurs if the position moves above 12% or below 8%).	How the portfolio is invested^ may dictate the rebalancing policy.

Note: The examples provided are for illustrative purposes only and do not constitute a recommendation. ^ e.g. through a managed account, a fund or on a platform)

5. SCORECARDS

Scorecards are useful for tracking specific objectives and risks of funds or portfolios. It provides the IC with an opportunity to consider the goals and boundaries set for the fund, in a concise format and question its performance. Remember the adage "What's measured gets managed"? Be thoughtful about how you define success or risk and how this may incentivise or disincentivise the agents involved in the portfolio construction and decision making process.

KEY TAKEOUT

While scorecards, frameworks, charters, and checklists seem bureaucratic, these tools help minimise human error and biases and optimise decision making. In an environment where forward-looking returns will be challenging, every 50bps or 100bps of outperformance counts. It's worth ensuring your IC's governance toolbox has all the appropriate tools, making governance a key pillar of your portfolio construction process.

ENDNOTES

1. Ambachtsheer, K. P., 2007, Pension Revolution: A Solution to the Pensions Crisis, Wiley & Co.

2. Willis Towers Watson, 2016, "The Investment Case for Better Asset Owner Governance", White Paper.

3. Brinson, G.P., Hood, L.R., & Beebower, G.L., 1995, "Determinants of Portfolio Performance", *Financial Analysts Journal,* Jan-Feb 1995

4. Van Vulpen, E., "How to Create a Skills Matrix for Success".

5. Vanguard, 2017, "Sample Investment Committee Charter"

6. New Zealand Super Fund, "Delegations Policy", V13a.

7. VicSuper, 2014, "Investment Policy Statement".

8. Kitces, M., 2016, "Finding the Optimal Rebalancing Frequency", Nerd's Eye View

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