

The Investment Committee

Who is responsible for the investment of our *investment fund*? Ultimately, the board of directors of the fund's sponsor is responsible. But it is not practical for boards of directors to make investment decisions for the fund, so the board almost always appoints an investment committee to take on this responsibility.

STANDARDS TO MEET

Members of the investment committee are fiduciaries. What does this mean? State laws differ in the precise way they define the term. Many funds look to the federal law for private pension plans—ERISA (the Employees Retirement Income Security Act of 1974)—for guidance, even though the law does not in any way apply to public pension plans or endowment funds. Key standards of ERISA, as adapted for an endowment fund, would be:

1. All decisions should be made solely in the interest of the sponsoring organization.
2. The investment portfolio should be broadly diversified—“by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.”
3. “The risk level of an investment does not alone make the investment per se prudent or per se imprudent. . . . An investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have . . . a relatively high degree of risk.”¹

¹Preamble to Final DOL Reg § 2550.404a-1, reprinted in *Preambles to Pension and Benefit Regulations*, 80,352 and 80,354 RIA (1992).

Specifically, the prudence of any investment can be determined only by its place in the portfolio. This was a revolutionary concept, as the old common law held that each individual investment should be prudent of and by itself. There are a great many individual investments in *investment funds* today—such as start-up venture capital—that might not be prudent of and by themselves but, in combination with other portfolio investments, contribute valuable strength to the overall investment program.

4. The standard of prudence is defined as “the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” This is often referred to as the “prudent expert” rule and strikes me as an appropriate standard. Everyone involved in decision making for the fund should be held to this standard. This does not mean that committee members should be experts. But they should be relying on experts.²

That said, I fear that the words “fiduciary” and “prudence” have all too often been impediments to investment performance because of the scary emotional overtones those terms arouse. Such emotions lead to a mentality such as “It’s okay to lose money on IBM stock but don’t dare lose money on some little known stock.” Neither should be more nor less okay than the other.

Prudence should be based on the soundness of the logic and process supporting the hiring and retention of an *investment manager*, and on an a priori basis—not on the basis of Monday morning quarterbacking. According to the Center for Fiduciary Studies, “Fiduciary liability is not determined by investment performance, but rather by whether prudent investment practices were followed.”³

²With respect to charitable trusts and charitable corporations, the Uniform Management of Institutional Funds Act issued in 1972 by the National Conference of Commissioners on Uniform State Laws (NCCUSL) includes provisions that are generally consistent with the above standards. For a discussion of that Act and the states that have adopted it, see John Train and Thomas A. Melfe, *Investing and Managing Trusts Under the New Prudent Investor Rule* (Boston: Harvard Business School Press, 1999), pp. 128–131 and 173–182. With respect to personal trusts, see discussion of standards (also generally consistent) promulgated by the American Law Institute in 1992 and the NCCUSL in 1994, *ibid.*, pp. 24–34.

³Donald B. Trone, Mark A. Rickloff, J. Richard Lynch, and Andrews T. Rommeyer, *Prudent Investment Practices: A Handbook for Investment Fiduciaries* (Center for Fiduciary Studies, 2004), p. 8.

Another aspect of my concern is that the terms “prudence” and “fiduciary” all too often motivate decision makers to look at what other funds are doing and strive to do likewise on the assumption that this must be the way to go. An underlying theme of this book is that this is not necessarily the way to go. As fiduciaries, we should do our own independent thinking and apply our own good sense of logic.

Everything comes down to facts and logic. Do we have all relevant facts we can reasonably obtain? Are the facts accurate? What are the underlying assumptions? We should ask questions, ad nauseam if necessary. Does a proposal make sense to us? If not, challenge it. And we should work hard to articulate our reasons.

COMMITTEE ORGANIZATION AND FUNCTIONS

Organization

Well, who should be on this all-important fiduciary committee? A committee may consist of outside investment professionals, as is often the case with some of the members of endowment committees of large universities, or the committee may be composed of a group of members of the sponsoring organization (perhaps including certain members of the board of directors), none of whom may have any special expertise in investing. All should meet the criteria listed on page xiv of the Introduction to this book.

What does the fiduciary committee do, and how should it function?

Initially, the committee may adopt a written Operating Policy that addresses such things as committee membership, meeting structure and attendance, and committee communications. As part of this Operating Policy, it should specify the *adviser* on whom the committee will rely, so selecting the *adviser* is the committee's first job. A sample Operating Policy is included at the end of this chapter as Appendix 1.

Then the committee should adopt a written statement of Investment Policies, such as those described in Chapter 3, including the fund's Policy Asset Allocation. These are clearly the committee's most important functions—ones that will have more impact on the fund's future performance than anything else the committee does. After that, the committee must decide whom to hire and retain as *investment managers*. All of these matters are a big responsibility, and the committee will need to rely heavily on its *adviser* for help.

Selecting an Adviser

The Uniform Prudent Investor Act empowers fiduciaries to “delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.” Jay Yoder, writing for the Association of Governing Boards of Universities and Colleges, adds that “because investing an endowment or any large pool of money is a complex and specialized task requiring full-time professional attention, I would argue that fiduciaries may even be required to delegate responsibilities.”⁴

Yoder argues forcefully for a strong investment office: “Endowments of \$150 million and larger can and should create an investment office and hire a strong chief investment officer. . . . Hiring a consultant is no substitute for employing a strong investment office.” A first-rate internal staff “can be expected to produce a stronger, more advanced investment policy . . . much better implementation of that policy; early adoption of new asset classes and strategies; greater due diligence and monitoring of managers; and, most important, better, more timely decision making.”⁵

Many *investment funds* are too small to afford a first-rate internal staff to recommend the asset classes in which they should invest and then select the best *investment managers* in those asset classes. Those funds therefore need to hire an outside consultant who understands the benefits of diversification and who specializes in trying to find the best *managers* in each asset class.

Such a consultant could be our local bank. Some banks have developed expertise in mutual funds, but most would rather guide us into investment programs managed by their own trust departments, very few of which rank among the better investment managers. And few banks have cutting-edge competence in asset allocation.

Many brokers and insurance company representatives offer mutual fund expertise. But can we expect totally unbiased advice from them when they are motivated to gravitate to the range of *investment managers* that compensate them? Many such consultants are paid through front-loaded mutual funds—those that charge an extra 3% to 8% “load” (read “selling commission”)—or those that charge an annual 0.25% through a so-called 12(b)(1) deduction from assets (read “another form of selling commis-

⁴Jay A. Yoder, *Endowment Management: A Practical Guide* (Association of Governing Boards of Universities and Colleges, 2004), p. 13.

⁵*Ibid.*, pp. 54 and 46.

sion”)—or those that charge a back load when we sell the mutual fund, or get compensated in some other way.

A consultant’s advice is more likely to be unbiased if the firm’s only source of compensation is the fees that it charges its investor clients. Its direct fees will be higher, of course. But we will know fully what the consultant is costing us because none of its compensation will be coming through the back door.

If such a consultant recommends mutual funds to us, he will typically steer us toward no-load mutual funds that do not charge 12(b)(1) fees. Many world-class mutual funds fit this category. On occasion, the consultant might steer us toward a load fund or one with 12(b)(1) fees. If so, the consultant’s only motivation should be that he believes future returns of that mutual fund, net of all fees, will still be the best in its particular asset class.

I suggest that an *investment fund*, in hiring a consultant, require the following:

1. The consultant should acknowledge in writing that it is a fiduciary of the pension plan (or the foundation or endowment fund).
2. The consultant should make a written representation *annually* that either:
 - a. It receives no income, either directly or indirectly, from investment management firms, or
 - b. If it does receive such income, the names of all investment managers from whom it has received such income during the prior 12 months, and in each case, the approximate amount of income and the services provided.
3. The consultant affirms it is prepared to provide to the *fund* all the services included in this book as expected from a *fund’s adviser*.

It is easier to draw up the criteria for selecting such a consultant than to find and hire one. Some members of the committee may, in their regular businesses, have contact with investment consultants for whom they have high regard. But we shouldn’t necessarily stop there. We can look in consulting directories, such as that provided by the A.S.A.P. Investment Consulting Directory, whose web site lists 74 consultants and whose volume titled *Investment Consultant Directory* lists 380 consultants.

How should we decide among alternative consultants? If we as committee members have first gained some perspective by reading a book such

as this one, we will be better prepared to send prospective consultants a questionnaire, to place a consultant's response and presentation in perspective, and to ask meaningful questions.

Our selection should be based on the consultant's track record with other institutional funds, and on the predictive value we feel we can attribute to that track record when we evaluate all the subjective factors—including breadth of diversification in his approach, and continuity of staff.

Role of Committee Members

Once the committee decides on its *adviser*, the committee must expect to approve most of the *adviser's* recommendations. And if the committee has lost confidence in its *adviser*, it must make a change and get an *adviser* in whom it can place its confidence.

Does that mean that once the committee has an *adviser* in whom it has confidence, it should essentially turn all decisions over to him? No, decisions on investment objectives are not readily delegated. They should be developed in the context of the needs and financial circumstances of that particular plan sponsor. Authority to hire and fire *investment managers* may be delegated to an *adviser* who is registered with the SEC as an "investment adviser," but even then the committee has the responsibility to monitor results. The committee's written Operating Policies should specify which actions the *adviser* is authorized to take upon his own judgment, and which actions must first be approved by the committee.

What, then, should we as committee members do? We should ensure that the fund's objectives are consistent with the financial condition of the plan sponsor, and we should ensure that the fund's investment policies are consistent with the plan's objectives. Then we should review each of the *adviser's* recommendations from the following standpoints:

- First and foremost, is the recommendation consistent with the fund's objectives and policies? If not, should the committee consider modifying its objectives and policies, or is the recommendation therefore inappropriate?
- Is the recommendation consistent with the committee's Policy Asset Allocation? If not, should the committee consider modifying its Policy Asset Allocation?
- Is the recommendation internally consistent?

- Has the *adviser* researched all of the right questions relative to things such as:
 - Character and integrity of the recommended *investment manager*,
 - Assessment of the predictive value of the *manager's* track record,
 - Nature of the asset class itself,
 - Credentials of the *manager's* key decision makers,
 - Depth of the *manager's* staff,
 - The *manager's* decision-making processes and internal controls.
- What alternatives did the *adviser* consider?
- Have adequate constraints and controls been established, especially with respect to derivatives that a manager may be authorized to use?
- Does the fee structure seem appropriate?
- Is the recommendation consistent with all applicable law?

Does this sound like a heavy-duty demand on investment sophistication? Although investment sophistication helps, it's not among the criteria for committee members as I've listed them in the Introduction to this book.

Should a committee strive to include at least some investment professionals among its members? In many cases, investment professionals contribute valuable experience to the committee. They can sometimes suggest particular managers for the *adviser* to consider and perhaps open doors that might otherwise be closed.

But investment professionals should be conscious of any conflicts of interest. And if their experience is focused on particular investment areas, they may be less comfortable considering recommendations about other investment areas. Do they understand their limitations? To be successful committee members, they must become generalists, not specialists. Unless they can make this transition, their investment experience can actually be a drawback.

“What is the difference between competent and incompetent boards?” write Ambachtsheer and Ezra in their book *Pension Fund Excellence*.⁶ “Competent boards have a preponderance of people of character who are comfortable doing their organizational thinking in multiyear time frames. These people understand ambiguity and uncertainty, and are still prepared

⁶Keith P. Ambachtsheer and D. Don Ezra, *Pension Fund Excellence* (New York: John Wiley & Sons, Inc., 1998), p. 90.

to go ahead and make the required judgments and decisions. They know what they don't know. They are prepared to hire a competent CEO⁷ and delegate management and operational authority, and are prepared to support a compensation philosophy that ties reward to results.”

Committee procedures usually call for decisions to be decided by a majority vote. In practice, it is best if most decisions are arrived at by consensus. That doesn't mean that everyone must agree that a decision is the best possible, but everyone should ultimately agree that it is at least a *good* decision.

Number of Committee Members

How many members should compose the investment committee? This is not a committee that needs to be representative of the different constituencies that may compose the sponsor. This committee has a technical purpose, not an organizational policy purpose.

I favor a smaller committee of members who will take their responsibility seriously and will attend meetings regularly. A committee of five might be optimal for purposes of generating good discussion, giving each member a feeling he is important to the committee, and—not inconsequentially—the ease of assembling the committee for a meeting.

It is for the last reason that I am wary of including out-of-town members on an investment committee. Out-of-town members can bring special qualifications, but they must commit to attending regularly scheduled meetings in person, if possible. They must also be ready to participate in meetings called on relatively short notice to address a special investment opportunity or an unexpected problem. Conference calls, in combination with e-mails and overnight delivery of advance information, can facilitate full participation in such special meetings. Conference calls, however, should ideally be kept to half an hour.

Role of Adviser

The *adviser* and his people must be the source of expertise and the ones who do the work. But they should always remember that the investment

⁷The pension fund's Chief Executive Officer (or Chief Investment Officer). For example, the staff's director of pension investments. For our purposes, we might substitute the term *adviser*.

committee is the one deciding on the objectives and policies, making the actual investment decisions, and shouldering the final responsibility. The *adviser* cannot be moving in one direction and the committee in another.

This fact leads to what I believe is the number-one responsibility of the *adviser*: to provide continuing education to the committee members. Few committee members start out with a broad grasp of the issues that fill the pages of this book. It is up to the *adviser* to teach them. Such education—including the setting of realistic expectations for return and volatility—should be provided on a continuing basis. Each decision opportunity should be related to the fund's investment policies.

What can the *adviser* do routinely for committee education? The following may be helpful if done regularly, whether times are good or bad:

- Demonstrate the need for a long-term orientation and the futility of short-term thinking.
- Illustrate how the various security indexes have compared with one another at different times over the last 30 years.
- Compare the price/earnings ratio, dividend yield, and earnings-per-share growth rate of today's stock market with their historic norms.
- Show a matrix of future total returns of the stock market as a factor of future P/Es and EPS growth rates.
- Carry out Efficient Frontier studies, using as many asset classes as possible and, if feasible, using Monte Carlo probability methods.
- When analyzing a recommended or existing *investment manager*, show how the *manager* performed relative to his benchmark (or benchmarks) over a variety of different intervals, not just intervals to the latest date.
- If possible, arrange an occasional off-site conference and bring a range of noted investment thinkers—not necessarily the fund's *investment managers*—to discuss in an informal and extemporaneous way the fund's current investment strategy and other questions related to investment philosophy.

Advisers at times have come upon a highly attractive but offbeat investment opportunity but have not considered recommending it to the committee for fear they would be laughed out of the room. To the extent this is true, it is a sorry reflection on the openmindedness of the committee, a reflection on the inadequate education given the committee by the *adviser*, or both. Offbeat opportunities may require much greater due

diligence and more careful explanation to committees than more traditional opportunities. But offbeat opportunities, if they pass this test, can add valuable diversification to a fund's overall portfolio.

INTERACTION OF COMMITTEE AND ADVISER

Committee Meetings

We might well set dates a year in advance for meetings—whatever number of meetings may be expected to be necessary. That way, committee members can plan their calendars around those dates. But the committee should be available for interim, unscheduled meetings if needed.

Many organizations simply plan four meetings a year—at the end of each quarter to review results for the quarter. I do not favor that approach. Most such meetings consist mainly of a myopic review of the markets during the last quarter and how each *investment manager* performed. Performance summaries should be sent to committee members in advance—and reviewed by them as part of their expected homework. At meetings, discussion of performance should respond to any question and focus on lessons to be learned or decisions to be made, such as:

- Should we consider terminating one of our current *managers*, or changing his benchmark, or adding money to his account, or withdrawing money from his account?
- Should we be looking for a new *manager* in some asset class?
- Is there a reason why we should consider revising our investment policy or target asset allocation?

It is sufficient for the *adviser* to mail quarterly results to committee members with an explanation that helps to put those results in a longer time frame perspective. Each meeting should be devoted to consideration of a recommendation or continuing education from the *adviser*.

If the *adviser* happens not to have sufficient business to justify a meeting, the *adviser* should suggest that the committee chairman consider canceling the meeting. If a two-hour meeting is scheduled and the *adviser* needs only half an hour of business, the *adviser* should notify committee members as far in advance as possible.

On the other hand, if the committee is in the process, for example, of selecting the *managers* to fill a revised Policy Asset Allocation, then meet-

ings should be scheduled more often until the process is completed—as often as every week or two. Such a process should be completed in a couple of months, at most, not a year or two.

If an urgent matter arises that can't wait for the next scheduled meeting, a special meeting should be called at whatever date most committee members may be available. If the matter is simple and routine enough, the committee chairman can avoid a special meeting by circulating to committee members by e-mail a “consent to action,” which is sufficient to authorize action, when agreed to by a majority of the committee.

Committee members should make every effort to attend all meetings, if not in person, then by conference call—which I have found can work very well.

In any case, relative to recommendations, the *adviser* should send committee members copies of his full presentation materials several days before each meeting. Committee members should review these materials with care, so they'll be prepared to ask better questions during discussions at the meeting. The danger is that a committee member may decide how he will vote on the recommendation prior to the meeting. This he should avoid. Advance preparation should lead to questions, not preconceived minds.

I have found it helpful at meetings if the *adviser* reviews each recommendation page by page. This does not mean reading each page out loud. Every committee member should already have read it. Instead, the *adviser* should discuss briefly the meaning—the “so what”—of the page. This tends to elicit more and better discussion and gives greater assurance that no key considerations have been glossed over.

Once each year, the *adviser* should give a thorough review of the overall fund and of each individual *manager*. The *adviser* should explain why each individual *manager* should be retained and why that *manager* remains the best the fund can obtain in his asset class.

Committee Leadership

Successful investment committees require a strong leader who is focused and able to keep discussion on track, and who can bring committee members to final resolution of issues. In planning the agenda, the chairman should schedule the most important items first. If the committee can't adequately resolve all items on the agenda without rushing, the chairman should strongly consider calling a special meeting in, say, two weeks rather than wait possibly a few months until the next scheduled meeting.

Committee members should understand that by not making a decision, they are actually making one, and sometimes that can be costly.

At the end of each meeting, a careful record of all decisions should be prepared and retained in a permanent file, together with a copy of the *adviser's* recommendation for those decisions.

Long-time Morgan Stanley strategist Barton Biggs has suggested that many investment committees make misguided judgments because of the negative dynamics of group interaction. "Groups of highly intelligent people are reaching bad decisions that reflect the easy, prevailing consensus of what has worked recently. . . . Groupthink plagues every committee, and most don't even know it. . . . The more compatible the group, the more its members respect and like each other, the bigger the committee, and the more 'spectators' that attend meetings, the likelier it is to make bad decisions."⁸

Recommendations to the Committee

Jay Yoder, writing for the Association of Governing Boards of Universities and Colleges, contends that "policy implementation . . . should be delegated to a chief investment officer. This senior investment professional should be authorized to take any actions that are consistent with the investment policy, including hiring and firing managers and rebalancing the portfolio."⁹

Still, many investment committees reserve to themselves decisions on hiring and firing managers. In that case, they should lean heavily on their *adviser*.

In making a recommendation to hire an *investment manager*, the *adviser* should be expected to cover concisely the key questions the committee ought to ask about the *manager*. Generally, such a presentation should provide:

- The precise recommendation, including the full name of the *investment manager*, the amount of money to be assigned to its management, and the particular asset class it will manage.

⁸Yoder, op. cit., p. 42.

⁹Ibid., p. 49.

- How does the *manager* fit into the portfolio's overall asset allocation and policies? The *adviser* should include information about the asset class itself if the asset class is relatively new to the committee.
- Who is the *manager*? What are the corporate affiliations, date of founding, location of offices, size of staff, and so on?
- How does the *manager* invest? What distinguishes his investment approach from that of other *managers* in his asset class?
- The *manager's* past performance, and why the *adviser* thinks it has predictive value.
- Risks in the *manager's* approach and how to deal with them.
- Who are the key people, and why do we have confidence in them? How deep is the staff, how long have they been with the firm, and what turnover of people has the *manager* experienced?
- Why do we think the *manager* is the best we can get in that asset class?
- Who are the *manager's* other clients, especially for the same kind of program we are recommending? (This consideration is often overemphasized, since it is not the actions—or inactions—of other funds that should determine what we do.)
- What's the fee schedule, and why is it appropriate?

The presentation should cover only the salient points, not try to snow the committee with the whole study nor, in fact, provide any more than a committee member might be expected to absorb. Does the committee really need to know this? The *adviser* should not try to cover his tail by giving an information dump. Of course, the *adviser* should have a rich depth of additional information and background so that he can answer briefly but with authority any reasonable question that might come up.

Meeting with *Investment Managers*

It is customary for many committees to meet the recommended manager of a separate account or commingled fund . . . and sometimes to meet several “finalist” managers one after the other in what I call a beauty contest. The committee can, at best, determine how articulate the manager is. But articulateness has a low correlation with investment capability. In 20 to 30 minutes, a committee's interview can be little more than superficial. Committee members cannot bring the perspective of having met with hundreds of *managers*, as the *adviser* can, nor can they do the kind of homework the *adviser* should have done. Ultimately, the committee's decision comes

down, after discussion, to whether the committee has confidence in the *adviser's* recommendation.

I don't even recommend bringing managers to the committee for routine performance reports—for much the same reasons. I have sat through countless manager reports to committees. These reports generally cover the manager's outlook for the economy (which may have little to do with his investment approach), his interpretation of the account's recent performance, and the particular transactions he has made recently. The reports are superficial, usually highly myopic, leaving the committee members with little more than the general feeling that they have “done their fiduciary duty.” A cogent, concise report by the *adviser* can do a better job of surfacing issues and placing things in a helpful perspective for education and decision making.

Bringing a manager to meet with the committee can on occasion be a useful part of the committee's education. It can broaden the minds of committee members and help them feel more connected to the investment world about which they are making decisions.

Working with New Committee Members

Whenever a new person is appointed to the committee, the chairman should devote much effort to bringing the newcomer up to speed quickly with the rest of the committee. The new member should immediately be given key documents, such as the fund's objectives and policies, and its Policy Asset Allocation, together with their underlying rationale.

Understanding the “why” of everything is critically important, and the above documents may well need to be supplemented by one-on-one sessions with the *adviser*.

Proxies

An issue at some committee meetings is, if the committee is using separately managed accounts rather than mutual funds, who should vote the proxies for the many common stocks in the portfolio. Certainly, as share owners, we should see that our proxies are voted responsibly.

But who should vote our proxies? I feel strongly that the investment manager who holds a stock in his account should be the one to vote it. He is in the best position to know what vote would most likely promote the value of that stock.

If we invest in mutual funds, the *adviser* is in the best position to vote mutual fund proxies.

SOCIAL INVESTING

A number of endowment fund sponsors—churches and others—overlay their investment objectives with a set of social goals that constrain them from investing in the stocks and bonds of certain kinds of companies.

This practice was most publicized in the 1980s, when many funds avoided securities of companies that did business in South Africa. Other fund sponsors are sensitive to companies that do business in one or more other categories, such as cigarettes, alcoholic beverages, munitions, chemical fertilizers, and so on. Still other funds consciously allocate a small part of their endowment funds to minority-owned enterprises or other companies they view as performing a particular social good.

Overlaying our investment policies with social objectives is one way to “put our money where our mouth is,” and as such, is perfectly appropriate—provided the majority of constituents of that fund sponsor agree with the social objectives and with the costs in terms of lower investment returns. Social investing probably does more to enable investing institutions to be consistent with their principles and probably less, from a practical standpoint, to effect social change.

But how can an organization gain the consensus of its constituency as to what industries to avoid? Tobacco companies might be easy. And maybe munitions . . . but should we even avoid companies for whom munitions are only 1% of their business? How about industries that pollute the environment? Which industries are they? Where should we draw the line?

If a fund sponsor is to take a social investing approach, everyone involved must be realistic about the fact that exercising social investing is likely to be costly, for the following reasons:

- Competent investing is difficult enough. Avoiding any set of companies adds to complexity and reduces the *investment manager's* range of opportunities.
- The best investment managers are competitive people and are driven to achieve the best they can. They tend to avoid clients who want them to observe any particular constraints.
- Very few mutual funds observe social investing constraints and become eligible for consideration. Those few mutual funds that do

social investing have—over the long term—achieved performance that is much closer to the bottom of the pack than the top.

- We must consider whether the social objectives of any social investment mutual fund are the same as our social objectives, those of the fund sponsor.
- Without the use of multiple mutual funds, it is difficult to achieve the wide diversification I believe institutional investors should strive for.
- If we are using a separate account rather than a mutual fund, then social investing has an unintended byproduct: Most large companies are so diversified that social-investing limitations eliminate many of them from consideration. Our remaining universe therefore is more heavily weighted toward small stocks, companies we know less about.
- Social investing may also limit us to investments in U.S. companies, because we may be too unfamiliar with specific foreign companies to know whether or not they meet our social investing criteria.
- Members of the fund sponsor must expend a lot of effort to maintain a complete, accurate, and timely list of companies to avoid. Members must be willing to devote the time.

In short, it is unrealistic to expect as good long-term total investment return from a socially invested investment fund as from one that has no such constraints.

Whether or not an endowment fund pursues social investing, I still recommend that the endowment fund use the Imputed Income method for recognizing income (see Chapter 9). But whereas endowment funds with unconstrained investments might use an Imputed Income formula of 5%¹⁰, I would recommend no more than 4%, perhaps less, for an endowment fund limited by social investing constraints.

The sponsor's board should recognize this reduced investment expectation and buy into it explicitly by lowering the Imputed Income formula. And I think the board has a moral obligation to inform the fund sponsor's constituents and make sure they agree.

If everyone agrees, then of course the board should go ahead with its plans for social investing.

Some fund sponsors try to pursue their social objectives through proxy voting. They have at times introduced and supported motions on a com-

¹⁰Of the average market value of the endowment fund over the past five years.

pany's proxy to effect some social or environmental change. I believe such efforts have done more to sensitize companies to the issues than to effect change *directly*—and that has probably been the realistic expectation by the fund sponsors.

The investment downside of this approach is that we can only vote a company's proxy if we are direct owners of its stock, and that constrains us from using mutual funds or other commingled funds, which are such a convenient and effective means of gaining strong investment management and broad diversification.

The issue of social investing does not arise for pension funds, which are required by ERISA to make all decisions “solely in the interest of participants and beneficiaries” of the pension plan. For funds not governed by ERISA, fiduciary responsibilities seem to suggest that social investing be avoided unless there is a compelling mandate from the plan sponsor on specific issues.

IN SHORT

- All who are involved in decisions for an *investment fund* are fiduciaries and are held to a very high standard.
- Decisions are usually made by an investment committee that typically devotes a relatively few hours per year to the fund. The committee must have a competent *adviser* to rely on.

APPENDIX 1

Example of an Investment Committee's Operating Policies

1. The Committee will consist of [number] members, appointed by [whom]. They will serve [staggered] terms of [number] years and may be reappointed for [number] terms.
2. To be eligible for appointment as a Committee member, a person should be familiar with investments—at least to the extent he or she participates in an employer's defined contribution plan or an IRA, or has other investments in stocks or bonds. He or she should also have a broad and open mind with a willingness to learn, be willing and able to attend all meetings of the Committee, and be prepared to review carefully in advance any materials distributed in preparation for meetings.

3. The chairman will be [appointed by whom or elected by a majority vote of the Committee members].
4. The Committee is to hire
 - A Chief Executive Officer (CEO) who will hire staff and manage the entire investment program, subject to the oversight of the Committee, or
 - A consultant who will advise the Committee on investment policy, asset allocation, and the hiring and monitoring of all Investment Managers.
5. The Committee is to meet at least [four times] a year and at any other time either the Committee chairman, CEO, or any two Committee members request a meeting. There may be occasions, in order to complete specific Committee business, when the Committee may have to meet multiple times within a month.
6. Committee members are to make every effort to attend each Committee meeting. If a member cannot attend in person, he or she should participate by conference call.
7. Committee members who participate in fewer than 80% of meetings over a rolling two-year interval are to be terminated from the Committee, subject to a majority vote for retention by the remaining Committee members.
8. Because it is essential to avoid even a perception of conflict of interest, the Committee should consider preparing a Code of Ethics, to be reviewed with legal counsel, which will deal with the appropriate conduct for Committee and staff members. The Code should deal with investment transactions, conflicts of interest, and independence issues, and it should be reviewed and signed by each member of the Committee and staff annually.
9. The Committee will establish statements of Operating Policies and Investment Policies. The latter is to include a Policy Asset Allocation and a related Benchmark Portfolio. Draft policy statements are to be submitted by the CEO [or consultant], who may propose amendments to these statements at any time. Both policies should be reviewed annually.
10. The CEO [or consultant] is to act at all times within the Committee's Operating Policies and Investment Policies. If so authorized, the CEO may deviate from the Committee's Policy Asset Allocation within any range the Committee may establish for an asset class, but he or she is

to report promptly to the Committee any deviation from the Policy Asset Allocation and the reasons for that change.

11. Prior to any Committee meeting, the Committee chairman, upon the recommendation of the CEO [or consultant], will establish the agenda. Wherever possible, the CEO [or consultant] will mail presentation materials to Committee members in time for them to receive the materials a week before the meeting. Committee members are expected to review these materials in preparation for the meeting.
12. The Committee will appoint a secretary, who will prepare minutes of all actions decided by the Committee, and retain these minutes, together with any presentation materials recommending those actions, in a permanent file.
13. Decisions by the Committee are to be made by majority vote, although Committee members should first endeavor to reach a consensus.
14. The Committee, at the recommendation of the CEO [or consultant], will appoint a master custodian, and all fund assets are to be held by the master custodian.
15. The fund may not borrow money except for overnight emergencies, although the Committee may authorize specific Investment Managers of the fund to use leverage.
16. The CEO [or consultant] will submit to Board members a brief quarterly report in writing, including
 - Recent performance (net of fees) versus benchmarks, in the context of the long term;
 - Current asset allocation versus Policy Asset Allocation;
 - Principal actions implemented by the CEO [or consultant] since the last quarterly report;
 - Potential issues or actions for future meetings.
17. The CEO [or consultant] will submit to the Committee a detailed annual report in writing on investment results and follow it with a thorough verbal presentation to the Committee. At this meeting, the CEO [or consultant] will comment on the continued appropriateness of current Operating and Investment Policies and the rationale for continuing to retain each of the fund's Investment Managers.
18. The Committee will select an accredited accounting firm as the fund's auditor, which will submit an annual audit report to the Committee.

19. The fund will publish an annual report, cosigned by the Committee chairman and CEO [if there is one], that will include:
 - Investment results,
 - Year-end asset allocation,
 - Contributions and payouts during the year,
 - Key actions during the year,
 - A summary of the actuarial reports (if for a pension fund),
 - A summary of the audit report,
 - Names of Committee members and key staff members [or consultants],
 - Total compensation paid to or accrued by directors and executive officers,
 - An appendix that includes statements of the Committee's Operating Policy and Investment Policy.

If the Committee employs a CEO and investment staff, rather than relying mainly on a consultant, several more operating policies might be added:

20. Either:
 - The Committee is to approve the selection of all Investment Managers and investment funds; or
 - if the Committee has authorized staff to appoint any Investment Manager or investment fund that is to manage less than [X%] of the fund's assets, any decision involving more than [X%] is to be approved by the Committee. In any case, the Committee must approve the use of any asset class that is being used for the first time.
21. The Committee is to approve any assets to be managed internally—by the CEO and staff.
22. The CEO will have authority to make all decisions that are not reserved for the Committee.
23. Each year, the Committee shall approve an operating budget, submitted by the CEO, covering all fund expenses except fees and expenses of Investment Managers. Fees and expenses of Investment Managers shall not be a part of the budget but shall be summarized in the CEO's annual report to the Committee.
24. The Committee will hire a lawyer, with whom the CEO is to review all legal documents and consult on all legal issues.