



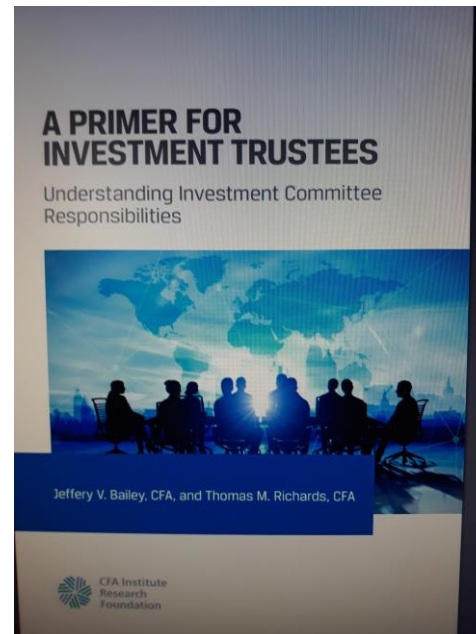
SABINO
INVESTMENT MANAGEMENT, LLC

A PRIMER FOR INVESTMENT TRUSTEES

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THIS PRESENTATION IS BASED ON THE BOOK, ***A PRIMER FOR INVESTMENT TRUSTEES – UNDERSTANDING INVESTMENT COMMITTEE RESPONSIBILITIES, 2ND EDITION*** BY JEFFEREY V. BAILEY, CFA AND THOMAS M. RICHARDS, CFA. CFA INSTITUTE RESEARCH FOUNDATION, 2017.



A full book PDF version is free at <https://www.cfainstitute.org/en/research/foundation/2017/a-primer-for-investment-trustees>

CHAPTER 1 - GOVERNANCE STRUCTURE

A basic philosophy that distinguishes strong governance structures from weak ones:

- Board members/trustees take ownership of oversight responsibilities
- Delegate to those who have the required expertise, experience, and authority to do their jobs
- Strong, well-articulated structure provides a mechanism for decision makers to function together effectively.
- Weak, ill-defined structure breeds confusion and acrimony.

GOVERNANCE POLICY STATEMENT

Purpose of a statement:

- Clearly specify lines of authority
- Maintain a culture of full and frank discussions

3 LEGS OF GOVERNANCE STRUCTURE

- Roles and responsibilities
- Lines of authority
- Accountability standards

OTHER ASPECTS OF GOVERNANCE

- Due diligence
- Checks and balances
- Reporting and monitoring
- Transparency
- Compliance with industry best practices

ROLES AND RESPONSIBILITIES

- Board Members or Trustees (or Investment Committee)
 - Set broad investment policy and oversee its implementation
 - Appoint a chief investment officer or investment manager
 - Update the investment policy statement
 - Review investment results
 - On course to achieve objectives?
- Investment Staff – for larger organizations
- Investment Managers – operate with designated investment mandates
- Custodians – safekeeping, recordkeeping, and valuation services
- Consultants
 - Advise on strategic issues such as investment policy
 - Provide manager selection and performance evaluation
- Investment Outsourcing Services

ACCOUNTABILITY STANDARDS

- Appropriate and realistic
- Established in advance
- Agreed to by both supervising and subordinate
- Evaluated in context of expected range of outcomes
- Designed to provide formal procedures for supervising authorities to review the results of subordinates' decisions

FIDUCIARY DUTY

- Investment trustees have an obligation to act in the best interest of the Fund's beneficiaries.
- Balance the interests of current and future beneficiaries
- Act in a prudent and reasonable manner
- Act in a transparent and accountable manner

CHAPTER 2 - INVESTMENT POLICY

“If you don’t know where you’re going, you’re liable to end up somewhere else.”

Yogi Berra

INVESTMENT POLICY STATEMENT

Investment Policy Statement serves 3 functions

- Facilitate internal and external communication of investment policy
- Ensure continuity of policy during periods of turnover among trustees, staff, and outside advisors
- Provide a baseline against which to evaluate proposed policy changes

Establish the mission or purpose of the investment fund and expectations for

- Contributions
- Investment performance
- Cash outflows

INVESTMENT POLICY STATEMENT (CONT)

- Investment Objectives - How you define success for the investment program
- Risk Tolerance - a risk budget establishes the acceptable tradeoff between expected return and risk.
- Establish Strategic Priorities - avoid counterproductive changes at the wrong time.

INVESTMENT POLICY STATEMENT (CONT)

Policy Asset Mix

- Set the policy asset mix
 - Define acceptable asset classes and ranges of allocations
 - Total investments can reasonably be expected to produce the required return over the long run with an acceptable level of volatility.
- Active vs. Passive
 - Index – lowest cost
 - Factor – modest cost with a strategic weighting
 - Active – higher cost with a strategy
- Rebalancing to original policy asset mix
- Changing the policy asset mix

PERFORMANCE EVALUATION

- Reinforces responsibility, authority, accountability
- 3 primary components
 - Measurement
 - Attribution
 - Appraisal

UN SOUND INVESTMENT POLICIES

Investment Policies that are unsound:

- Failure to follow an established sound policy
- Short-term focus – hiring and firing managers
- Lack of attention to important long-term issues
- Frequently changing and inconsistent investment strategies

CHAPTER 3 – THE FUND’S MISSION

- Who are the stakeholders?
- What liabilities or future expected expenditures are to be met?
- Primary conflict
 - Intention to make certain future cash expenditures
 - Desire to minimize the cost of funding
- Endowment Funds – spending policy?

CHAPTER 4 – INVESTMENT OBJECTIVES

- You must have long-range goals to keep you from being frustrated by short-term failures – Charles Noble
- Effective investment objectives meet several criteria
 - Unambiguous and Measurable
 - Specified in advance
 - Actionable and Attainable
 - Reflective of the investment committee’s risk tolerance
 - Consistent with the Fund’s mission
- The most useful objectives generally are expressed relative to an investable alternative such as a market index.

CHAPTER 5 – INVESTMENT RISK TOLERANCE

- Returns are only half the story
- Novice investors focus on returns and give little consideration to risk

3 PRIMARY CATEGORIES OF RISK

- Capital market risk
- Active management risk
- Liquidity risk

MEASURING RISK

- Estimation of the distribution of potential returns
- Normal distribution of risk?
- Stress tests?

MANAGING RISK THROUGH DIVERSIFICATION

- The “free lunch” of investing
- Use of low-correlation or uncorrelated assets
- Good diversification assets may have higher fee structures

RISK BUDGETING

- Quantifying the risk of various types of investments and combinations of investments
- Permits analysis of trade-offs between risk and expected return among available portfolio choices

CHAPTER 6 – INVESTMENT ASSETS

Asset classes = securities with common attributes. They facilitate discussions among trustees, staff and outside managers.

EQUITIES

Equities = common stocks. Preferred stocks and convertible securities are often included in this category.

- US
- Non-US Developed Market
- Emerging Markets
- Global

FIXED INCOME

Fixed Income = bonds. Preferred stocks and convertible securities are sometimes included in this category.

- Core fixed income
- High yield
- Emerging markets
- Global sovereign debt
- TIPS

ALTERNATIVES

Often private equity or hedge funds with limited liquidity.

- Real estate
- Private equity
- Absolute return

ACTIVE AND PASSIVE MANAGEMENT

Use of active management requires the following beliefs:

- Managers exist who can produce a positive excess return relative to an appropriate benchmark
- Decision makers (trustees, staff, consultant) can identify these managers
- Decision maker can hire these managers
- Trustees have the risk tolerance to endure periods of time when the managers underperform their benchmarks

INVESTMENT ASSETS – OTHER CONSIDERATIONS

- Separate Accounts and Commingled Funds
- Fees and Expenses

CHAPTER 7 - DEFINED CONTRIBUTION PLANS (401K AND 403B)

Investment Policy

- Focus – each option must pursue consistent, clearly defined investment strategy that is understandable by unsophisticated investors
- Diversification – each option as a standalone investment, must be sufficiently diversified that plan participants choosing one option would not be at serious risk of unsustainable losses because a small segment of market experiences distress
- Low cost – options must offer the lowest expenses compatible with a high-quality investment program.

CHAPTER 8 – PERFORMANCE EVALUATION

Reasons for periodic performance evaluation:

- Reinforces hierarchy of accountability, responsibility and authority in the Fund's governance structure.
- Enhances the effectiveness of the fund's investment program by acting as a feedback and control mechanism.
- Reaffirms a commitment to effective investment policies, strategies, processes, people, and organization.
- Directs attention to poorly performing operations.

MEASURING INVESTMENT RESULTS

Weighting of investment results:

- Time-weighted rate of return
- Money-weighted rate of return

Linking of periods

- Arithmetic average
- Geometric average – compound annual growth rate
- Higher volatility = greater difference between arithmetic and geometric average

PERFORMANCE BENCHMARKS

Performance Benchmarks should be

- Unambiguous
- Investable
- Measurable
- Appropriate
- Specified in advance
- Owned – accepted as appropriate by the responsible party

Peer group comparisons fail to satisfy a number of the properties required to be a valid benchmark.

PERFORMANCE ATTRIBUTION

- Macro attribution – at the asset class and total fund level
- Within Asset Classes – relative to asset class target or benchmark

PERFORMANCE APPRAISAL

- Active management risk - active managers display more variability relative to their benchmarks than do passive managers
- Risk-adjusted performance measures
 - Sharpe ratio – compares an account’s excess return (actual return less the risk-free return) with the total risk of the account, where risk is measured by standard deviation.
- Trustees often feel a need to “do something”
 - Often counterproductive
- Keep proper perspective re: past performance
 - Augment with additional insights and information
 - Review the rationale and decision process that was used to implement a particular investment

HIRING AND FIRING MANAGERS

It should involve an assessment of a range of quantitative and qualitative factors including the following:

- People
- Process
- Procedures
- Price
- Performance

CHAPTER 9 – ETHICS IN INVESTING

CFA Institute has published

- Code of Conduct for investment professionals
- Code of Conduct for trustees of pension and endowment funds

Summary of ethical principles

- Act in the best interest of the Fund's beneficiaries
- Act with prudence, competence, independence, and objectivity
- Adhere to the Fund's mission and all related legal requirements
- Act in a transparent manner in all official activities
- Maintain confidentiality with regard to the Fund sponsor, beneficiaries, and investments.

CREATE A CULTURE OF ETHICAL BEHAVIOR

- Adopt a Code of Ethics
- Guidelines can clarify specific situations and circumstances
- Ongoing training
- Best assurance of ethical investment conduct is the integrity, principles, and moral values of trustees and staff members.

APPENDICES – *A PRIMER FOR INVESTMENT TRUSTEES*

See Appendices for examples of

- Endowment Fund Governance Policy Statement
- Defined-Benefit Plan Investment Policy Statement
- Defined-Contribution Plan Investment Policy Statement