Investment Committee Governance in the Age of COVID-19

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6 North Park Drive | Suite 208
Hunt Valley, MD 21030
Tel 410-528-8282 | Fax 410-528-8305
mail@assetstrategyconsultants.com
www.assetstrategyconsultants.com

Presenter Biographies

India Suter, Director of Business Development, joined Asset Strategy Consultants in 2011 and oversees all the firm’s marketing efforts. In addition, she acts as relationship manager and peer review for several client accounts.

Her role includes planning and coordinating educational programs for clients and regional affinity groups. In addition to strengthening the firm's existing client relationships, she is the outside connection that allows ASC to stay abreast of industry trends.

Prior to joining ASC, she had 12 years of experience working in management for major law firms, both in Baltimore and Washington, DC, including Semmes Bowen and Semmes, and Venable LLP. India holds a BA in History from the University of Mary Washington, an ABA Paralegal Certificate from Georgetown University, and an MBA from Johns Hopkins University Carey School of Business.

Andy Conner, Principal and Chief Investment Officer, joined Asset Strategy Consultants in 2019 and serves as Portfolio Manager for the firm’s Outsourced Investment Office (OCIO) clients.

Prior to joining ASC, he spent 12 years as a senior member of the Johns Hopkins University Office of Investment Management, which managed $7 billion of assets including University and Hospital endowment funds, the University's operating cash, and ERISA-qualified retirement plans.

Andy has over 20 years of investment experience, including extensive involvement investing in public and private equity, venture capital, fixed income, hedge funds, real estate, and real assets managers, and has underwritten investments on five continents.

Andy holds a BS in Finance with High Honors and an MS in Economics from Lehigh University in Bethlehem, Pennsylvania and is a CFA Charterholder.

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Asset Strategy Consultants, LLC

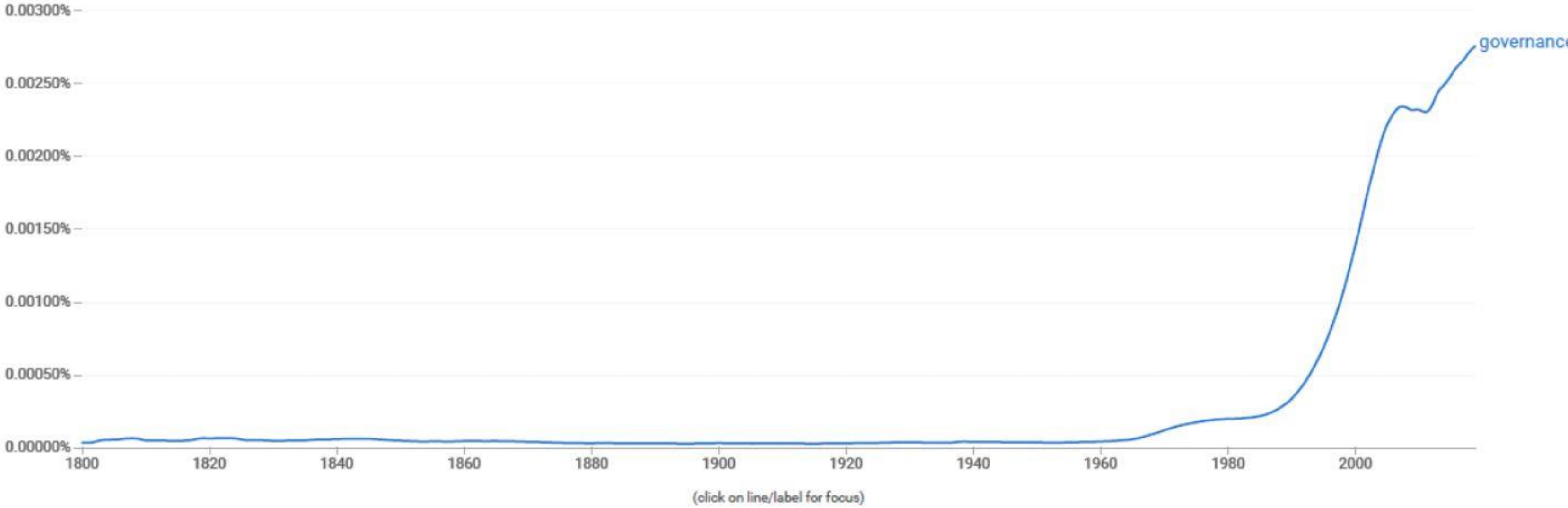
Asset Strategy Consultants (ASC) is an independent investment advisory firm headquartered in Baltimore, Maryland.

- Nearly 30 years providing objective advice to fiduciaries of long-term pools of capital.
- Over $11 billion of assets under advisement.
- Independent and 100% owned by the firm’s partners.
- Open access to a full universe of asset classes and investment managers.

What is Governance?

governance noun

: the act or process of governing or overseeing the control and direction of something (such as a country or an organization)



Source: Merriam-Webster, Google Ngram Viewer ("governance," 1900-2019, American English (2019), no smoothing https://books.google.com/ngrams/graph?content=governance&year_start=1900&year_end=2019&corpus=28&smoothing=0)

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What is Governance, Really?

- The set of formal policies and collective norms that guide our behavior.
  - Governance can be weak or strong. It can be good or bad.
  - Governance tends to be self-reinforcing but needs to be consciously built and regularly nurtured or it will fade away.
- Governance can be a strong force that promotes positive outcomes or negative pressure that drags a Committee down.
  - In the absence of intentional effort, good and strong governance is rare.
  - Investment Committee governance is often a function of the Committee Chair and/or other vocal Committee members.
  - Good news: governance can be aided and abetted by concrete polices such as a strong Investment Policy Statement, a commitment to data-driven decision making, and/or specific portfolio structures.

Governance Matrix

	Bad	Good
Strong	Investment Committee dominated by outspoken member leading to negativity and disengaged Committee and investment team. Insecurity leads to short-term decision-making which severely hinders performance.	Investment Committee engages and empowers talented advisor. Communication and performance reinforce trust which further empowers investment team, leading to long-term stability and success.
Weak	Investment advisor is a miss-match for Investment Committee. Poor performance erodes trust which leads to blame and undermines institution's ability to retain talent, which further deteriorates investment performance.	Investment Committee and staff share mutual respect and cordial relations. Performance is dependent on talent, but Committee dynamics are vulnerable to outside influences which could upset good governance.

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Knowing is Half the Battle

Behavioral Finance documents all of the ways that our "wiring from the factory" is poorly suited for investing.

REGRET

Confirmation Bias

Endowment Effect

Availability Heuristic

LOSS AVERSION

OVERCONFIDENCE

Hindsight Bias

RECENCY

ANCHORING

Sunk cost fallacy

Fortunately, there is evidence that awareness of cognitive bias and training can partially inoculate us against these pitfalls. But, it's more like a flu shot than a measles vaccine.

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Investment Committee Best Practices

Plan for success.

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Source: Thinking Ahead Institute, *Going from Good to Great; A best practice guide for investment committees* (p 4), Figure 2.

IC Meeting Best Practices

Sample meeting protocols.

- Meeting attendance is expected (in-person or virtual).
- Committee members read/review materials in advance.
- Phones are turned off.
- Only one discussion is allowed at a time.
- Everyone should actively participate.
- “Don’t beat a dead horse.”

A good Committee Chair allows Committee members to have their say while keeping the meeting on track.

Two Dimensions of Change

The COVID-19 Pandemic has changed the fundamental ways Investment Committee governance is conducted and significantly altered the investment environment.

- Practical Matters
  - The way we communicate is profoundly different.
  - New technology is excellent but is not a direct substitute for in-person interaction.
- Investment Matters
  - The market drawdown in Q1 of 2020 has been a wakeup call after a decade of steady growth and generally low volatility.
  - Lessons have been learned (or reinforced) and expectations have been reset.
  - Heavy-handed monetary and fiscal policy intervention has shortened the down-cycle but stimulus has not reached every corner of the market.

Committee Dynamics

Meetings have transitioned from in-person to tele- or video-conference.

- In-person interaction is ideal for open communication.
- Physically paging through materials has benefits.

- Less travel is more convenient and lower-impact.
- Digital materials are a less expensive, greener alternative.

Communication Best Practices

New modes of communication require additional effort to be an adequate substitute for in-person meetings.

- Most of the commercial grade video-conference providers are suitable.
  - After initial concerns with security were addressed, Zoom has become the leader. “Zoom” is now a verb.
  - Microsoft Teams and BlueJeans are slightly less intuitive but just as good. Google Meet is one step behind.

- More is required of Committee Chairs/CIOs/Consultants.
  - Observe closely and proactively ensure that Committee members have an opportunity to share their ideas.
  - Ensure that meetings remain on topic and on time, but also encourage social interactions that occur naturally in person so they are not totally lost (i.e. “What are you streaming?”).
  - Personal relationships, which form a foundation of trust between Committee members, staff, and advisors, require more intentional effort.

Wakeup Call

The market correction between February 19th and March 23rd was a wakeup call after a decade of smooth sailing.

S&P 500 Index

S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, October 5, 2020..

ICE BoA High Yield Bond Spreads

Source: Ice Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread [BAMLH0A0HYM2], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLH0A0HYM2, October 5, 2020.

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Market Down-Cycles have Accelerated

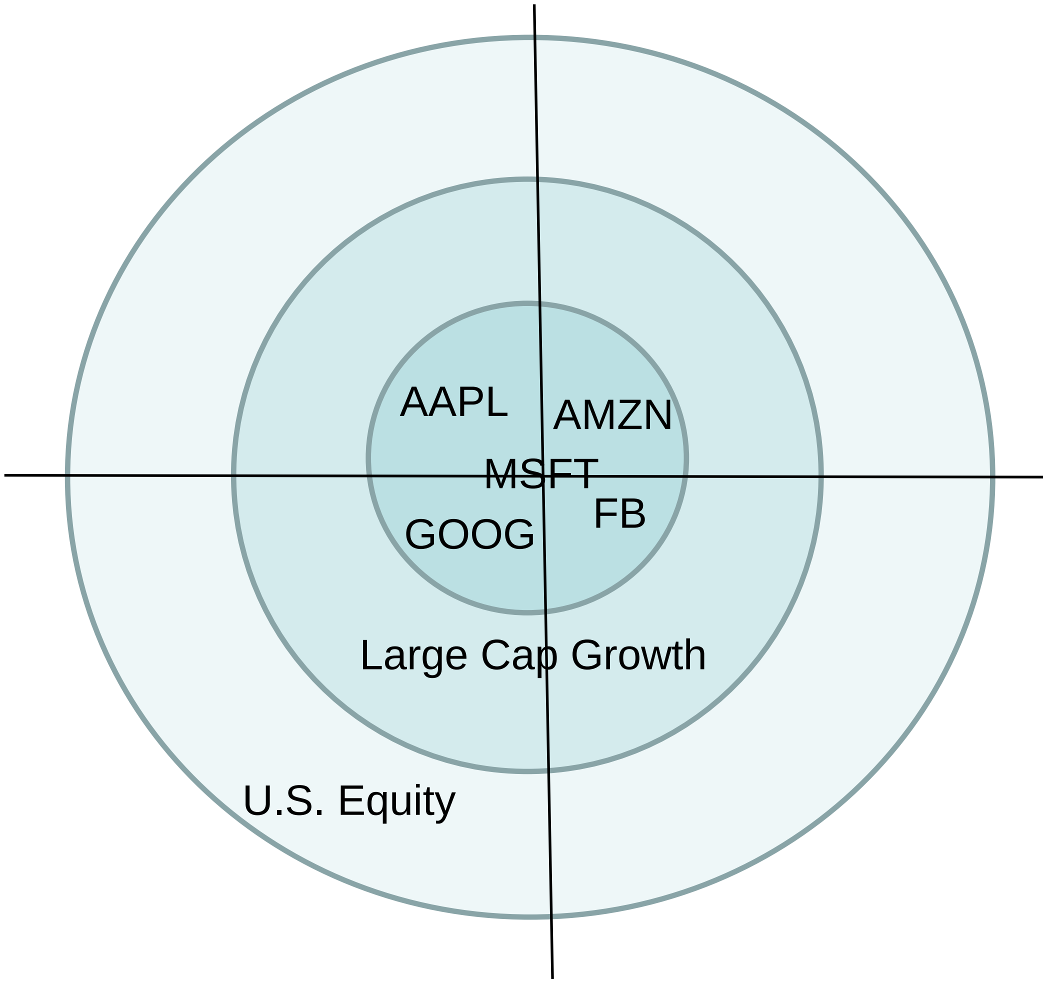
The Fed's playbook and society's leverage to financial markets means that market corrections—and recoveries—are happening much more quickly.

- The S&P 500 fell 35% from its intraday high on February 19th to its intraday low on March 23rd. Within three days the market had rebounded, closing up 20% from its intraday low, exiting the bear market.
- The first phase of the credit cycle that took many months in the Financial Crisis unfolded within a one-month period.
- Investment managers who had been closed for years opened…and then closed again.

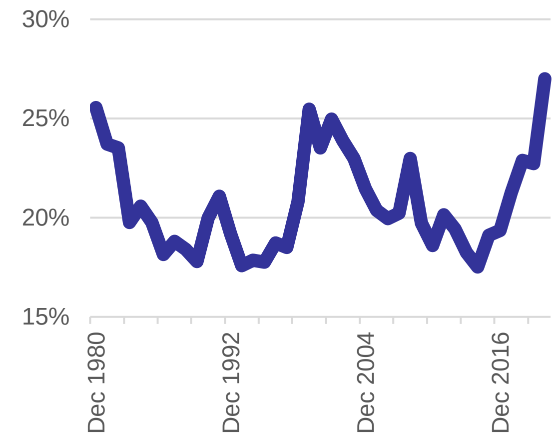
Investment Committees may need to explore new governance structures, such as meeting more frequently, or hiring an investment team or an outsourced investment office, in order to manage risk and respond quickly to opportunities when they present themselves.

Narrow Leadership

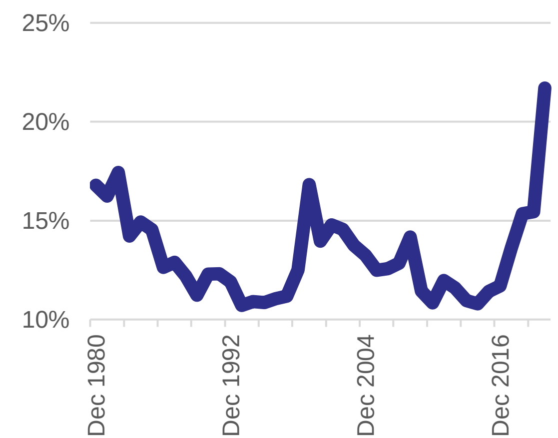
The long bull market narrowed our aperture of risk.



Weight of Top 10 Stocks in the S&P 500



Weight of Top 5 Stocks in the S&P 500



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Committees Must Focus on the Big Picture

Big-picture risks have been tabled relative to FOMO and a single decision on a small cadre of tech names.

Depression

Deflation

INFLATION

Confiscation

DEVASTATION

Default

HYPER-INFLATION

Risk means more things can happen than will happen.

—Professor Elroy Dimson

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Fooled by Randomness

Probability of success is inversely proportional to observation frequency—the more often you look at performance the more noise you will see.

<u>Hypothetical 15% expected return with 10% standard deviation.</u>

Scale (Observation Frequency)	Probability (of Positive Return)
1 Year	93%
1 Quarter	77%
1 Month	67%
1 Day	54%
1 Hour	51.3%
1 Minute	50.17%
1 Second	50.02%

To think long term, look at long term results. Would your Investment Committee governance permit an investment in an asset at an opportune entry point even if that meant historical performance looked poor?

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Source: Taleb, Nicholas Nassim, <u>Fooled by Randomness</u> (2nd edition, p 65), Table 3.1.

Two Ways to Address Short-Term Volatility

Use strong governance rather than reducing expected return by “de-risking” the portfolio.

- Taking risk out of the portfolio can be very expensive (in terms of opportunity cost) for a long-term investor.
  - Historically, equity-oriented growth assets have been best-equipped to fund payout and keep up with inflation—but also subject to short-term volatility.
  - Yields on risk-free and low-risk assets are historically low.

- Good governance can allow the Committee to overcome short-term volatility—and costs nothing.
  - Relentlessly build a culture that is focused on the long-term.
  - Plan for market corrections regularly when times are good.
  - Build adequate security and liquidity into the portfolio to psychologically weather a downturn. Staying power in a crisis is priceless.

The Noah Principle

Predicting rain doesn't count. Building arks does.

—Warren Buffett

- Don't just plan. Take action to prepare.
- The timing and nature of the next crisis are unknown—trying to predict specifics is wasted energy.

Implication: In a robust, well-diversified portfolio it's unrealistic to expect everything to be working at once. If you want to have something performing at any given time, most likely something is going to be underperforming at a given time. Focus on the whole rather than over-scrutinizing the pieces in isolation.

In Summary

Five key takeaways.

- The COVID-19 market correction beginning in the first quarter of 2020 has changed the ways Investment Committees interact and acted as a wakeup call to refocus on the bigger picture.
- Governance can be weak or strong; good or bad. Good governance requires intentional effort or it will slowly erode into weak governance; weak governance is vulnerable to becoming bad governance.
- After a decade-long bull market, Investment Committees can be forgiven for narrowing their focus to short-term performance relative to large-cap U.S. equity benchmarks.
- However, the Committee’s highest and best use is focusing on a broader set of risks and ensuring that governance structures are in place that allow the portfolio to thrive throughout the market cycle.
- The typical Investment Committee spends too much time on minutiae like manager selection and short-term performance measurement and too little on these big picture strategic issues.

Questions & Answers

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