

INVESTMENT COMMITTEE BEST PRACTICES: GETTING ORGANIZED

Whether you are forming a new committee or confirming the focus of your current one, structure and purpose are a good thing to review. The main documents that are involved in this effort are the Investment Committee Charter and the Investment Policy Statement (IPS).

INVESTMENT COMMITTEE CHARTER

Many organizations mix a Committee Charter within the Board Policies and the IPS. This approach can be suboptimal with vague committee references, lack of accountability in the board policy and adding complexity to an IPS with no relevance to investments.

Drafted at the board level, the Investment Committee Charter outlines the roles and responsibilities of its members, support staff and, if applicable, external advisors. It should outline the ideal size of the organization's Investment Committee, which usually stands between five and eight members.¹

In our experience, committees under five have a difficult time with achieving quorum and diversity of opinion. Committees over eight have difficulty with decision-making. One struggling committee had 12 members. The committee schedule often had to limit debates to 30 minutes. However, that only left a few minutes for each member to participate. Therefore, debates often went over time, decisions were delayed, more meetings had to be added, and, most importantly, it didn't allow the committee to address all of the critical items on the agenda.

The Investment Committee Charter should specify the purpose of the assets along with a clear understanding of how to measure success in meeting the organization's objectives and goals. The Charter should outline what the Investment Committee needs to prepare before, during, and after its meetings, along with the rules for all members while on the Investment Committee. It should outline each member's commitment to the organization, their fiduciary responsibility, and specify in detail that there should be no conflicts of interest when making decisions.

The first step in creating an effective and successful investment committee starts before you select committee members. It starts at the board level with drafting an effective, well-written Investment Committee Charter.

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Finally, the Investment Committee Charter should also outline the term limits and detail the rotation of members on the board and subcommittees. Nonprofits should consider a minimum of five years of service by members and be wary of rotating more than one-third of the committee members in any one term.² One of our clients had a rotation of members every seven years, which caused more than 50% of the board members to roll off at the same time. The training of new members was very disruptive to the board's mission because the focus had to shift to onboarding rather than on important issues. Additionally, there is a tendency for new members to challenge historical policies. When there is significant turnover in the committee, the details of a decision is occasionally lost. Without a majority of voters available to support these decisions, the committee revisits these policies more frequently than expected. We had a client who finally achieved Qualified Investor status and was eligible for an expanded private investment program. After several quarters of informational meetings, the client decided to move forward with the expanded program. A couple of years later, there was a large rotation of members and the new members did not understand why there was a commitment to an expensive private program with no return while it was still in the J-curve, gaining dramatically after an initial loss. They voted to pause the program while they were educated on the program which took several quarters and negatively impacted their returns.

INVESTMENT POLICY STATEMENT

Once the committee members are selected, the first priority of any Investment Committee should be to draft an effective Investment Policy Statement (IPS). An IPS is a document that outlines a successful long-term investment process that meets your organization's unique short- and long-term goals, gives details on how to measure success, and specifies both short- and long-term thresholds on investment decisions that enable the organization to keep human emotions and poor decisions out of the investment process.

The IPS outlines the investment objectives, which will set the guidelines around the critical trade-off between expected reward and risk embedded in the investment process. It will also specify in detail how to assess and judge the investment program's results. These assessments should be measurable, specified in advance, actionable and attainable, reflective of the investment committee's risk tolerance, and consistent with the organization's mission statement and long-term goals.³

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Northern Trust uses a 24 point analysis to outline and draft an effective Investment Policy Statement.

IPS Best Practice Provision	Current IPS	Summary of Policy Language / Changes to Consider
Policy Date	✓	Review the policy at least annually and update the policy at least every 3 years.
Introduction	✓	Establishes the policies that govern the management of the investment pool.
Definitions	✓	Defines all parties subject to the policies.
Purpose	✓	Articulates the purpose of the investment portfolio.
Board Delegation of Authority	✓	Outline the specific direction of approval for decision making.
Enterprise Considerations	✓	What are the organizations unique goals, risks, and long-term success measures?
Risk Profile Reconfirmation	✓	Consider annually analyzing and reconfirming risk tolerance level.
Outsourced Chief Investment Officer Responsibilities (OCIO)	✓	Outlines the roles/responsibilities of Chief Investment Officer or internal manager of the funds.
Staff Responsibilities	✓	Sets the roles/responsibilities of staff, board, and investment committee.
Conflicts of Interest	✓	The Board/Committee members shall not have material economic interests in firms advising the organization.
Policy Exceptions	✓	Defines how to document any policy modifications and reporting them to the Board.
Investment Principles	✓	Considering defining a set of principles to help improve investment decision making.
Spending Policy / Calculation	✓	Defines a minimum and maximum spending draw along with outlining the calculation used to process periodic distributions.
Financial Objective	✓	Are funds perpetual or have a time stamped expiration date? Are funds used for organizational spending, grant giving, or other unique needs? What are the long-term goals and use cases for this capital?
Investment Objective	✓	What long-term return is needed to pay for the spending policy, keep pace with inflation, and pay for fees within the fund?
Diversification	✓	Investments shall be diversified across asset classes and within asset class to reduce risk.
Risk Categories	✓	Bond and cash allocation should be sufficient enough to stabilize portfolio during periods of volatility and/or deflation. This allocation should cover a certain percentage of your spending policy rate, depending on the risk profile of the organization and its members.
Asset Class Categories	✓	Identifies asset classes, general role for each and typical investments.
Long-term Portfolio Targets	✓	Establishes asset allocation targets and allowable ranges.
Rebalancing Policy	✓	What are the rules for periodic rebalancing that will help maintain desired asset allocation and risk exposures?
Performance Benchmarking	✓	Provide unique benchmarks for short-term pools, bonds, equities, real asset, and private equity.
Performance Monitoring	✓	Monitoring returns at various levels (total portfolio, asset class categories and individual strategy level) against a set of relevant benchmarks.
Policy Portfolio Benchmark	✓	Define a custom benchmark for the overall pool of assets along with a long-term hurdle rate.
Approved Investment Vehicles	✓	Provide guidance for investment vehicles that can and cannot be used within the fund.

Consideration of these twenty-four points is critical for an organization to provide a structured framework to guide decision-making, ensure alignment with the organization's unique financial goals, and mitigate both market and behavioral risks associated with investment activities. The policy should clearly

set expectations of the committee and its members along with any outside party the committee chooses to engage. One clarity issue we have seen is an IPS that has multiple benchmarks for the portfolio return. The committee may have an overall performance target sometimes stated in the purpose section that is assigned at the board level, for example 60% Global Equity and 40% US Fixed Income. Later in the document, the portfolio target has a more diversified allocation with assigned performance benchmarks. This leads to ambiguity as to which benchmark the Outsourced Chief Investment Officer (OCIO) is expected to beat. In one case, the target ranges did not allow for the OCIO to invest 60% of the portfolio in global equity yet the board expected the OCIO to outperform.

During the Pandemic of 2020, our Advisors were actively engaged with many clients on financial planning and resetting IPS parameters to fit with the dynamic organizational needs. Several of our clients were forced to shut their doors and rely solely on their reserves for expenses. We balanced short-term needs with long-term planning in our firm view that we should overweight risk assets. By documenting these decisions in the policy, the board expectation of performance is corrected by the need to have cash to fund operations while giving credit to Northern Trust's overweight risk view.

Once finalized and adopted, the Investment Policy Statement becomes a living, breathing document, requiring regular review and updates to reflect changes to your organization's financial goals and enterprise risk profile.

REFERENCES

- 1 Ellis (2010) and Greenwich Roundtable (2014).
- 2 Vanguard, "Fulfilling Your Missions, a Guide to best Practices for Nonprofit Fiduciaries."
- 3 Bailey, Jeffery V, CFA, and Thomas M. Richards, CFA, "A Primer for Investment Trustees: Understanding Investment Committee Responsibilities," The CFA Institute Research Foundation, 2017.

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