Governance: The Five Imperatives of 21st Century Investing

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Private Wealth Management
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80% of financial assets in the United States

1.5% of the working American population are governance fiduciaries (trustees)

U.S. Asset Ownership

Asset Value

<table>
<thead>
<tr>
<th>Trillions</th>
<th>Public Pensions</th>
<th>Private Pension</th>
<th>College Endowments</th>
<th>Public Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$14</td>
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<td>$12</td>
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<td>$10</td>
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Number of Organizations

<table>
<thead>
<tr>
<th>Thousands</th>
<th>Public Pensions</th>
<th>Private Pension</th>
<th>College Endowments</th>
<th>Public Foundation</th>
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<tbody>
<tr>
<td>100</td>
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<td>90</td>
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<td>80</td>
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<td>70</td>
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<td>60</td>
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<td>50</td>
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<td>40</td>
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<td>30</td>
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</table>

FoundationSource, 2014
Heavy Lies the Crown

**Retirement Security***

45% of U.S. households don’t have a retirement account.

Ann. (DB) pension benefit pmts. cover est. 25-50% of avg. household expenditures for 35 mm. Americans age 65+ ($15K)*.

**Education**

$2 trillion in total student debt. Avg. of $37K in debt upon graduation

170 institutions have closed since 2013

Spending rates are lower, but have increased for institutions with budgets under pressure.

**Welfare, Culture & the Arts**

Public foundations annually contribute nearly 20% of all charitable giving ($60 billion).


^New York Fed Consumer Credit Panel/Equifax 12/2018, Education Dive, NACUBO, 2018

** [www.givingusa.org](http://www.givingusa.org)
Lots of Opinions on Governance

They range from the apt…to the misguided…. to the entirely vapid or clichéd:

• **U.S. pension boards are under scrutiny — from fees to salaries to investment performance.**

• **So what is better governance worth? The truth is that it is hard to be definitive about the answer. Measurement is very difficult.**

• **Suboptimal governance can extend disappointing performance or perpetuate suboptimal past decisions.**

• **Great boards understand that the buck stops with them.**

• **Creating a good foundation board is hard work.**

As a bottom line, what should boards really be concerned about?

Source: various
Mixed results

Top

Good governance

Avg.

#1 - Be Well Governed
Difference in performance is two to one.

Source: Asset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Plans by Christopher K. Merker, Ph.D., CFA, ©2017, Marquette University.
Fiduciary Effectiveness

FEQ™ = Structure + Process + People

Management Model

In-house Management  Traditional consulting  Outsourced CIO (OCIO)  Turnkey Asset Management (TAMP)

Source: Asset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Plans by Christopher K. Merker, Ph.D., CFA, ©2017, Marquette University.
Fiduciary Effectiveness

FEQ™ = Structure + Process + People

- Board professionalism
- Board composition
- Engagement
- Staff / consultant

- Institutional knowledge
- Diligence
- Transparency

Source: Asset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Plans by Christopher K. Merker, Ph.D., CFA, ©2017, Marquette University.
Fiduciary Effectiveness

$\text{FEQ}^{\text{TM}} = \text{Structure} + \text{Process} + \text{People}$

- Mission and planning
- Financial stewardship
- Human resources stewardship
- Performance monitoring / accountability
- Risk management
- Community rep / advocacy
- Board development
- Board management
- Decision-making

Fiduciary Effectiveness

FEQ™ = Structure + Process + People

- Leadership
- Culture: degree of trust & openness
- Competency
- Experience
- Diversity
- Group process / interaction

#2 - Be Knowledgeable
(beware of common errors)
How Much Do You Need?

General population

Trustees

Professionals

Expert

Competent

Financially literate

Literate: Basics of budgeting, credit, saving and investing

Competent: Literacy + understanding of time value of money and probability theory, fiduciary duty.

Expert: Literacy + Competency + knowledge of accounting, investments and / or actuarial science, typically specialized

## Two Forms of Human Error (in Investing)

<table>
<thead>
<tr>
<th>Form</th>
<th>Safeguard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational</td>
<td>Procedural / system enhancement</td>
</tr>
<tr>
<td>discrete</td>
<td></td>
</tr>
<tr>
<td>Behavioral</td>
<td>Governance structure / process enhancement</td>
</tr>
<tr>
<td>continuous</td>
<td></td>
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</tbody>
</table>
# Prospect Theory: The Fourfold Pattern

<table>
<thead>
<tr>
<th></th>
<th>Gains</th>
<th>Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Probability</td>
<td>95% chance to win $10,000 (100% to win $1,000)</td>
<td>95% to lose $10,000 (100% chance to lose $1000)</td>
</tr>
<tr>
<td>Certainty Effect</td>
<td>Fear of disappointment</td>
<td>Hope to avoid loss</td>
</tr>
<tr>
<td></td>
<td>RISK AVERSE</td>
<td>RISK SEEKING</td>
</tr>
<tr>
<td></td>
<td>Accept unfavorable settlement (e.g. legal settlements)</td>
<td>Reject favorable settlement (e.g. rogue traders)</td>
</tr>
<tr>
<td>Low Probability</td>
<td>5% chance to win $10,000 (95% chance of $0)</td>
<td>5% chance to lose $10,000 (95% chance of $0)</td>
</tr>
<tr>
<td>Possibility Effect</td>
<td>Hope of large gain</td>
<td>Fear of large loss</td>
</tr>
<tr>
<td></td>
<td>RISK SEEKING</td>
<td>RISK AVERSE</td>
</tr>
<tr>
<td></td>
<td>Reject favorable settlement (e.g. lotteries)</td>
<td>Accept unfavorable settlement (e.g. insurance)</td>
</tr>
</tbody>
</table>

## Summary of Behavioral Biases

<table>
<thead>
<tr>
<th>Active trading</th>
<th>Framing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belief persistence</td>
<td>Groupthink</td>
</tr>
<tr>
<td>Causal attribution theory</td>
<td>Hindsight bias</td>
</tr>
<tr>
<td>Confirmation bias</td>
<td>Lack of knowledge / trust</td>
</tr>
<tr>
<td>Conformity bias</td>
<td>Ringelmann effect</td>
</tr>
<tr>
<td>Disposition effect</td>
<td>Noise trading</td>
</tr>
<tr>
<td>Familiarity bias</td>
<td>Overconfidence</td>
</tr>
<tr>
<td>Over-optimism</td>
<td>Self-serving bias</td>
</tr>
<tr>
<td>Reluctance to save and invest</td>
<td>Sunk costs</td>
</tr>
<tr>
<td>Time-delay traps</td>
<td>Under-diversification</td>
</tr>
</tbody>
</table>

Common Committee Errors

1) Focusing on manager selection over asset allocation
2) Not focusing on liabilities
3) Backward looking bias
4) Lack of an investment policy
5) Dysfunctional committees
6) Failure to exercise duty of loyalty
7) Working with a conflicted advisor
#3 - Be Diversified
Structured Product  
Market Neutral  
Materiality

30,000+ Products  
Integrative Risk

Target Rate of Return  
Duration Unconstrained  
Donor Restrictions

The Problem of the Black Box  
(What do we own again and why?)

ESG

100,000 stocks

Cost

1,000,000+ bonds

Market-linked

Countless derivatives  
(cryptos among the latest)

Sector-based

Private investments  
(companies, real estate, reinsurance)

Sustainability

Active vs. Passive

Greenwashing

Simple, Optimal and Well-Timed

The Efficient Frontier

- 100% Stocks
- 80% Stocks/20% Bonds
- 60% Stocks/40% Bonds
- 40% Stocks/60% Bonds
- 20% Stocks/80% Bonds
- 100% Bonds

Source: “Investment Holding Period Analysis”, Baird Private Asset Management, 2017
#4 – Be Disciplined
(and control costs)
Laser Focused

1) Setting goals and being engaged
2) Document, review and update policy as needed
3) Educating and rotating the board
4) Board self-assessment
5) Going to RFP, occasionally changing consultants
6) Also, keeping an eye on things (audit, finances and operations)
7) Overseeing the portfolio and rebalancing
8) (Avoiding) market timing
9) Controlling costs

Governance functions

Investment functions

Reality-check from the FGS (aka the “Data Collector”)

62% - Never or Infrequently

100% of public companies do it.

Over 50% of Non-profits do it.

This needs to become a standard practice.

We can help. The Governance Self-Assessment Checklist (GSAC)

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)
Reality-check from the FGS (aka the “Data Collector”)

80% - Yes
Pretty good.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)
Reality-check from the FGS (aka the “Data Collector”)

77%: every 1-2 years
Also, pretty good.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)
Reality-check from the FGS (aka the “Data Collector”)

Range of professional experience.

Not necessarily more, but better quality training is needed.

Why?

80% are conducting training at least once per year.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)
Expense structures are all over the board.

This one is striking, but not overly concerning.
Board turnover is a significant factor.

An organization should neither be too high or to low.

A number of other structural factors apply, like board size.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)
**Reality-check from the FGS**  
(aka the “Data Collector”)

**FEQ Comprehensive Report 2018 - U.S. Governance Survey**

**FEQ Factors – Audit Committee by Quintile**

A high percentage of board members serving on the audit committee is another strong indicator of engagement among top performers.

Board members serving on audit are a very high predictor of good governance performance.

Similar picture for investments.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)
Now, About Those Costs

It’s important but…

Average of Top Five and Bottom Five Public Pension Plans as Ranked by 5-Year Investment Returns

- Top Five
  - 5YR Return: (80%)
  - FEQ: (30%)
  - Expense Ratio: (25%)

- Bottom Five
  - 5YR Return: (20%)
  - FEQ: (50%)
  - Expense Ratio: (5%)

Average 5 YR Return is in percent, the FEQ™ is in standardized governance units and the Expense Ratio is in basis points.

Quadrant Summary: Active Management Universe

- **Frequency of outperformance**
- **Magnitude of outperformance**

**Quadrants**:
- Large Cap Value
- Large Cap Core
- Large Cap Growth
- International

**Legend**:
- Small Cap
- Large Cap Core
- Large Cap Growth
- International

**Axes**:
- Frequency of outperformance (0% to 40%)
- Magnitude of outperformance (0% to 20%)

#5 – Be Impactful
Farewell to Uncle Milt

There is only one social responsibility of business -- to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.

- Milton Friedman

Each man is locked into a system that compels him to increase his herd without limit — in a world that is limited. Ruin is the destination toward which all men rush, each pursuing his own best interest in a society that believes in the freedom of the commons. Freedom in a commons brings ruin to all.”

- Garrett Hardin

“ESG and the Commons: From Tragedy to Governance”, Christopher K. Merker, CFA Enterprising Investor, June 12, 2019
Hello to Elinor Ostrom

But until a theoretical explanation – based on human choice – for self-organized and self-governed enterprises is fully developed and accepted, major policy decisions will continue to be undertaken with a presumption that individuals cannot organize themselves and always need to be organized by external authorities.

Unfortunately, many analysts – in academia, special-interest groups, governments, and the press – still presume that common-pool problems are all dilemmas in which the participants themselves cannot avoid producing suboptimal results, and in some cases disastrous results.

- Elinor Ostrom, Governing the Commons

Elinor Ostrom
Nobel Laureate
The first woman to be awarded the Nobel Prize for Economic Sciences (2009)

Ostrom received the 2009 Nobel Prize in Economic Sciences for her groundbreaking research demonstrating that ordinary people are capable of creating rules and institutions that allow for the sustainable and equitable management of shared resources.

“ESG and the Commons: From Tragedy to Governance”, Christopher K. Merker, CFA Enterprising Investor, June 12, 2019
### Top Risks to Global Development

**World Economic Forum, 2018**

<table>
<thead>
<tr>
<th>Likelihood</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extreme weather events</td>
<td>Weapons of mass destruction</td>
</tr>
<tr>
<td>Natural disasters</td>
<td>Extreme weather events</td>
</tr>
<tr>
<td>Cyber attacks</td>
<td>Natural disasters</td>
</tr>
<tr>
<td>Data fraud or theft</td>
<td>Failure of climate change mitigation or adaptation</td>
</tr>
<tr>
<td>Failure of climate change mitigation or adaptation</td>
<td>Water crisis</td>
</tr>
</tbody>
</table>
Why This Matter to Investors

ESG Risk

"One is to see how the physical facilities of the S&P 500’s constituent companies are affected by hurricanes, sea-level rise, and heat stress. How is this important to investors? Thanks to globalization, “you’re exposed” no matter where a company has its headquarters…

- Barron’s, January 2019

"A rising share of issuance in the $3.8 trillion is set to come from regions facing climate-related economic losses," the strategists said of the municipal bond market’s creditworthiness.

- Blackrock, April 2019

https://www.barrons.com/articles/companies-climate-change-risks-51548451729
A final thought (and a challenge)
Invert the Pyramid

Current Practice

Recommended Practice

Mission & Governance

Asset Allocation

Manager Selection

Portion of time allocated by the board

Portion of time allocated by the board
Thank you!

Governance and leadership are the yin and the yang of successful organizations. If you have leadership without governance you risk tyranny, fraud and personal fiefdoms. If you have governance without leadership you risk atrophy, bureaucracy and indifference.

- Mark Goyder

Upcoming FGA Research

- SB 322 Assessments with CEFEX
- 2019 Public Pension Governance Survey
- Public Company Short-termism – with CFA Institute
- Foundation / Endowment Governance – with Commonfund
- Public Sector ESG Ratings