Governance: The Five Imperatives of 21st Century Investing

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Who’s in Charge Here?

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80%

of financial assets
in the United States

1.5%

of the working
American population
are governance
fiduciaries (trustees)

Source: “Proposed Rule: Definition of Fiduciary under ERISA”, CFA Institute Letter to the Department of Labor, February 2, 2011

U.S. Asset Ownership

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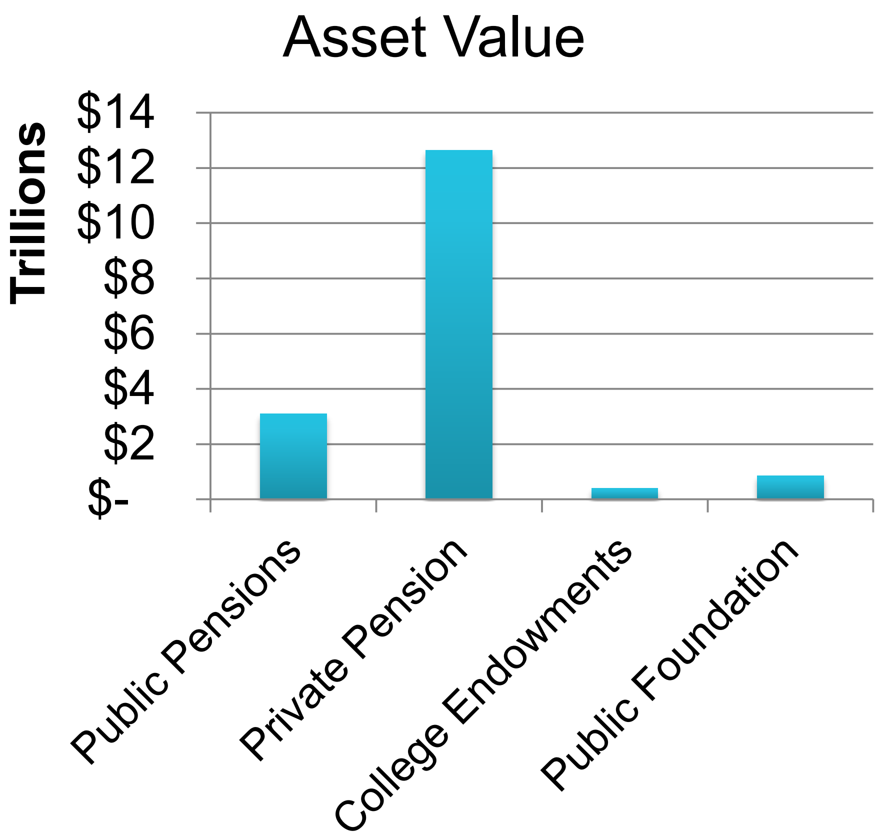

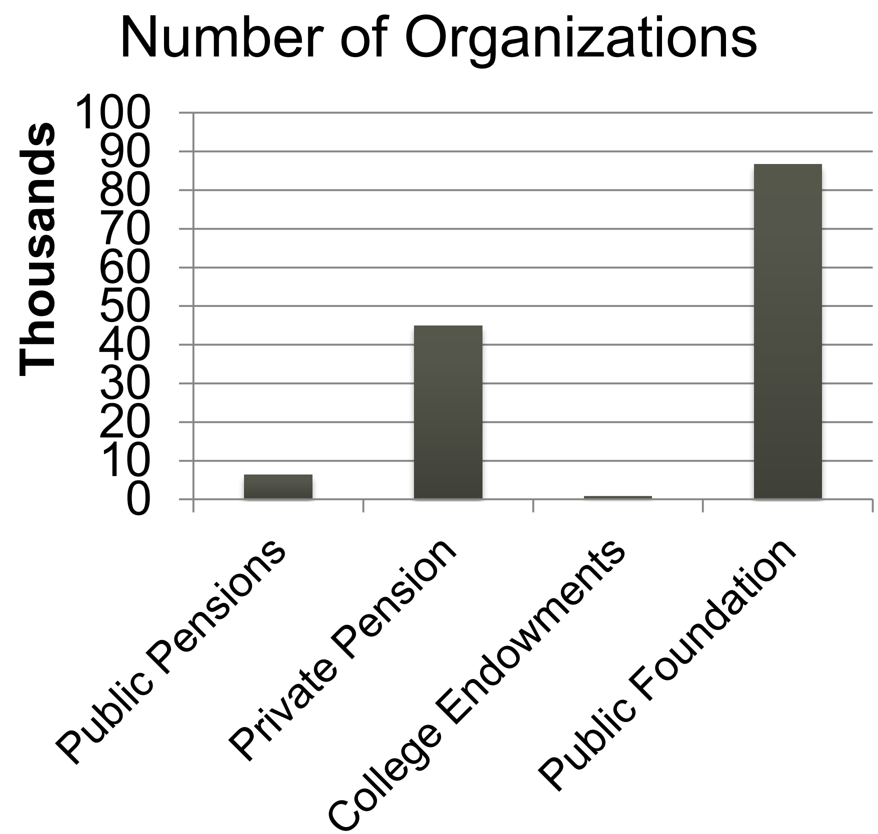

Source: NACUBO, Federal Reserve, U.S. Census, 2012
FoundationSource, 2014
.

Heavy Lies the Crown

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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).

Source: *U.S. Census, Bureau of Labor Statistics 2012 Pension Rights Center, 2015 Bureau of Labor Statistics, 2015
^New York Fed Consumer Credit Panel/Equifax 12/2018, Education Dive, NACUBO, 2018
** www.givingusa.org

Lots of Opinions on Governance

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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

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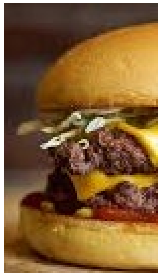
Top

Avg.



?

Good governance →

Source: "Proposed Rule: Definition of Fiduciary under ERISA", CFA Institute Letter to the Department of Labor, February 2, 2011

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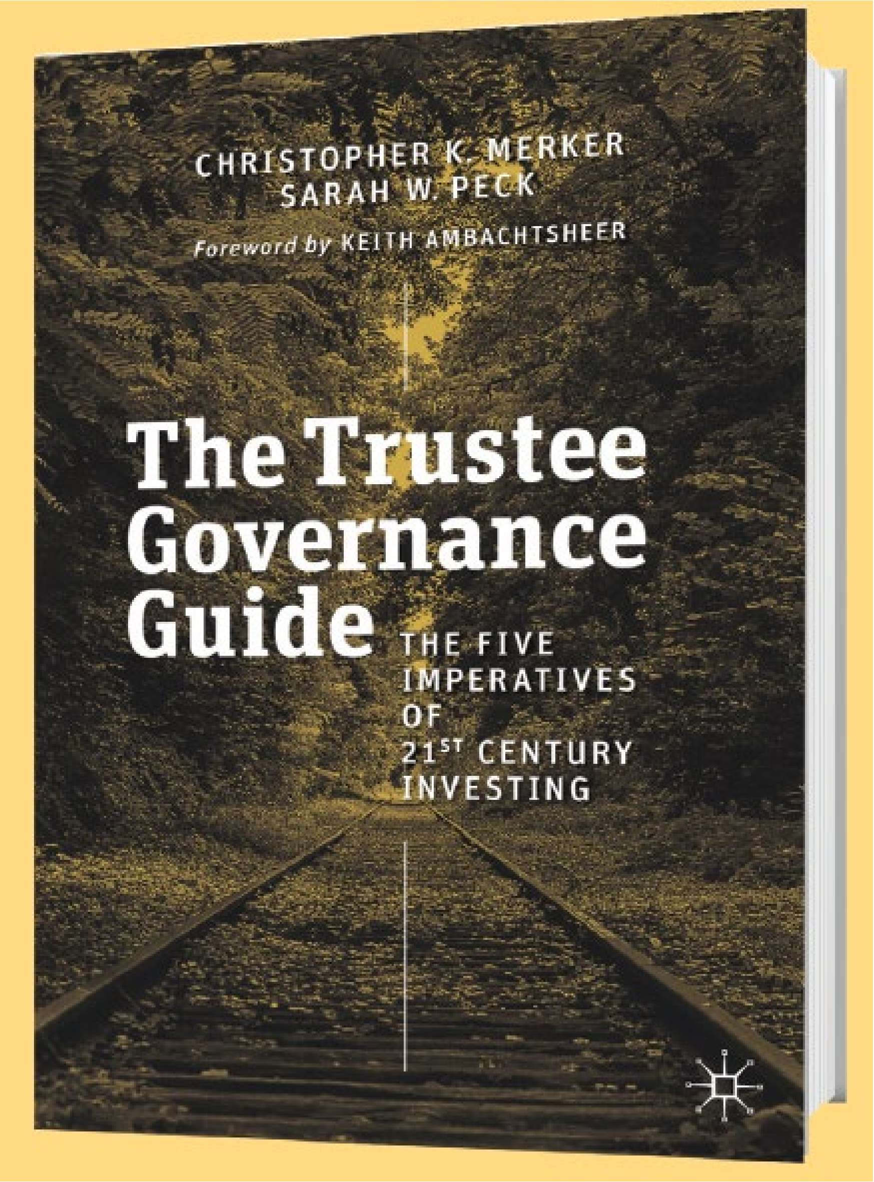

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#1 - Be Well Governed

Governance Matters

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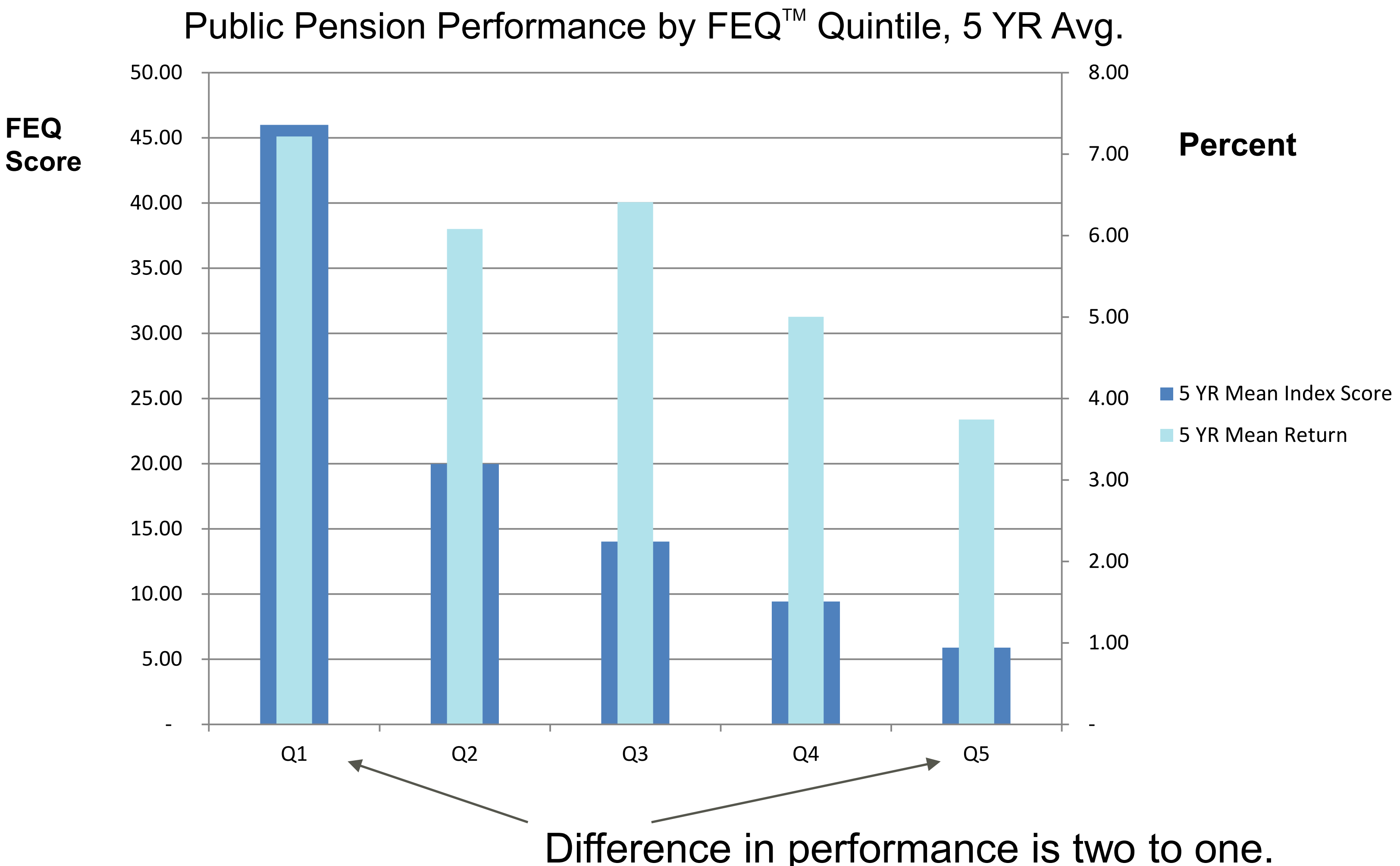

Source: *Asset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Plans* by Christopher K. Merker, Ph.D., CFA, ©2017, Marquette University.

Fiduciary Effectiveness

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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

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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

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FEQ™ = Structure + Process + People

- Mission and planning
- Financial stewardship
- Human resources stewardship
- Performance monitoring / accountability
- Risk management

- Community rep / advocacy
- Board development
- Board management
- Decision-making

Source: *Asset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Plans* by Christopher K. Merker, Ph.D., CFA, ©2017, Marquette University. *Governing for Results: A Directors Guide to Good Governance,* by Mel Gill, Trafford Publishing 2005

Fiduciary Effectiveness

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FEQ™ = Structure + Process + People

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

Source: *Asset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Plans* by Christopher K. Merker, Ph.D., CFA, ©2017, Marquette University. *Governing for Results: A Directors Guide to Good Governance,* by Mel Gill, Trafford Publishing 2005

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#2 - Be Knowledgeable

(beware of common errors)

How Much Do You Need?

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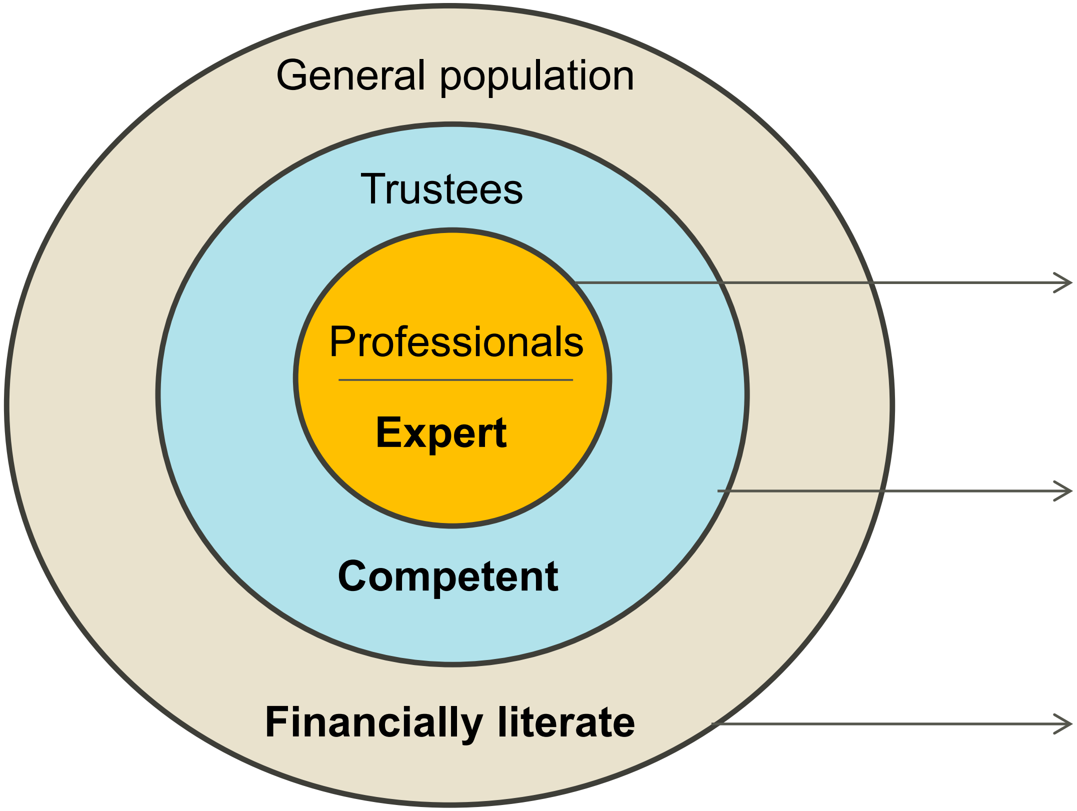

Expert: Literacy + Competency + knowledge of accounting, investments and / or actuarial science, typically specialized

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

Literate: Basics of budgeting, credit, saving and investing

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Two Forms of Human Error (in Investing)

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	Form	Safeguard
Operational	discrete	Procedural / system enhancement
Behavioral	continuous	Governance structure / process enhancement

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Prospect Theory: The Fourfold Pattern

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

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Summary of Behavioral Biases

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Active trading

Belief persistence

Causal attribution theory

Confirmation bias

Conformity bias

Disposition effect

Familiarity bias

Framing

Groupthink

Hindsight bias

Lack of knowledge / trust

Ringelmann effect

Noise trading

Overconfidence

Over-optimism

Self-serving bias

Reluctance to save and invest

Sunk costs

Time-delay traps

Under-diversification

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Common Committee Errors

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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

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#3 - Be Diversified

Structured Product
ex fossil fuels
Impact

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30,000+ Products
Market Neutral
Materiality
Integrative
Risk
Target Rate of Return
Liquidity
Duration Unconstrained
100,000 stocks
Donor Restrictions
Cost
ESG
1,000,000+ bonds
Market-linked
Countless derivatives (cryptos among the latest)
Sector-based
Private investments (companies, real estate, reinsurance)

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

Mutual funds
SDGs
ETFs / ETNs
SMAs
Credit
Divestment
Commingled
Factors
PE Funds
Smart Beta
Hedge Funds
Thematic
Reserves

ALM - Immunization
Ethical Restrictions
Distribution Rates
Engagement
Sustainability
Asset Liability Matching
Active vs. Passive
Inflation
Interest Rates
Greenwashing

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Simple, Optimal and Well-Timed

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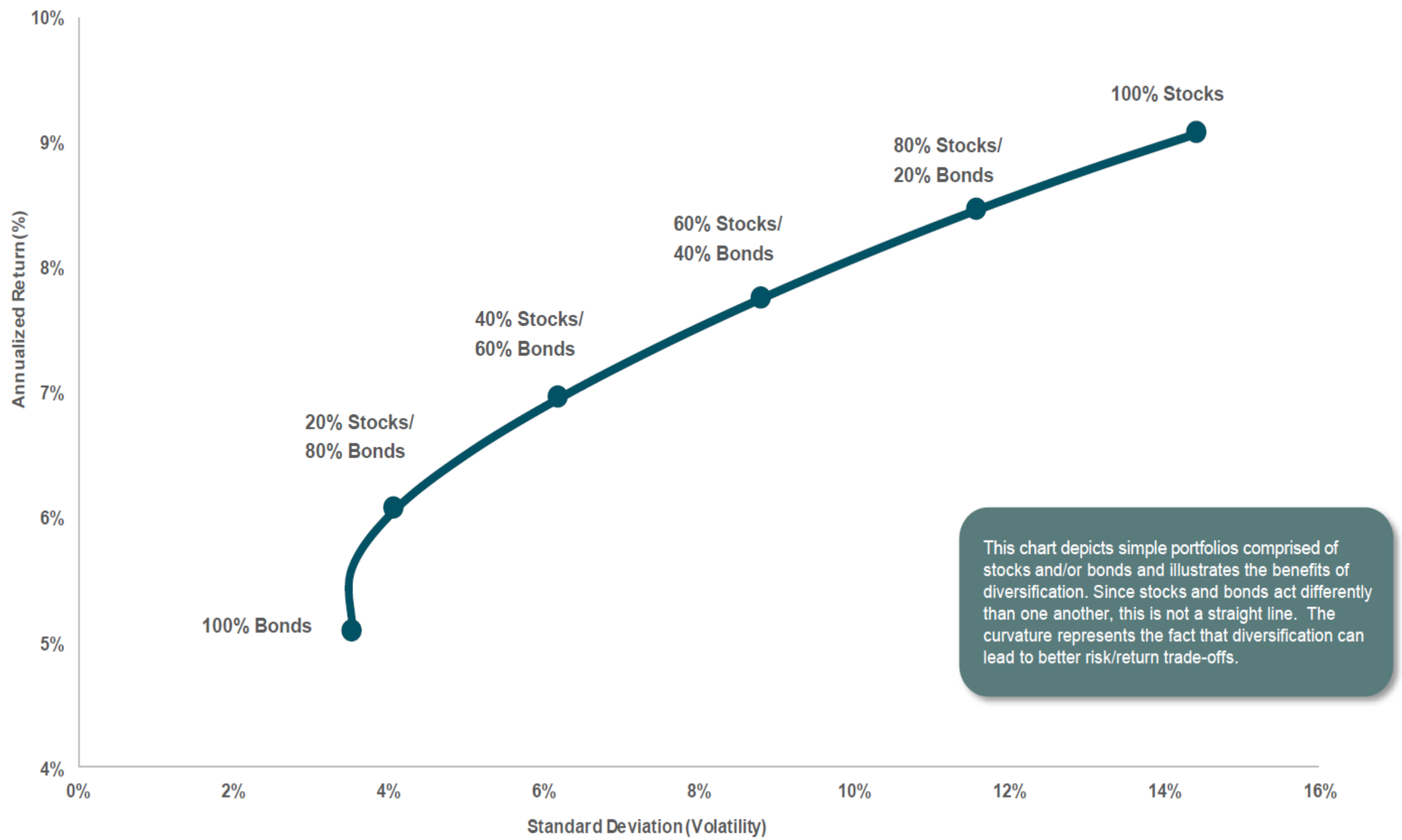
The Efficient Frontier



Source: "Investment Holding Period Analysis", Baird Private Asset Management, 2017

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#4 – Be Disciplined

(and control costs)

Laser Focused

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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

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Reality-check from the FGS
(aka the "Data Collector")

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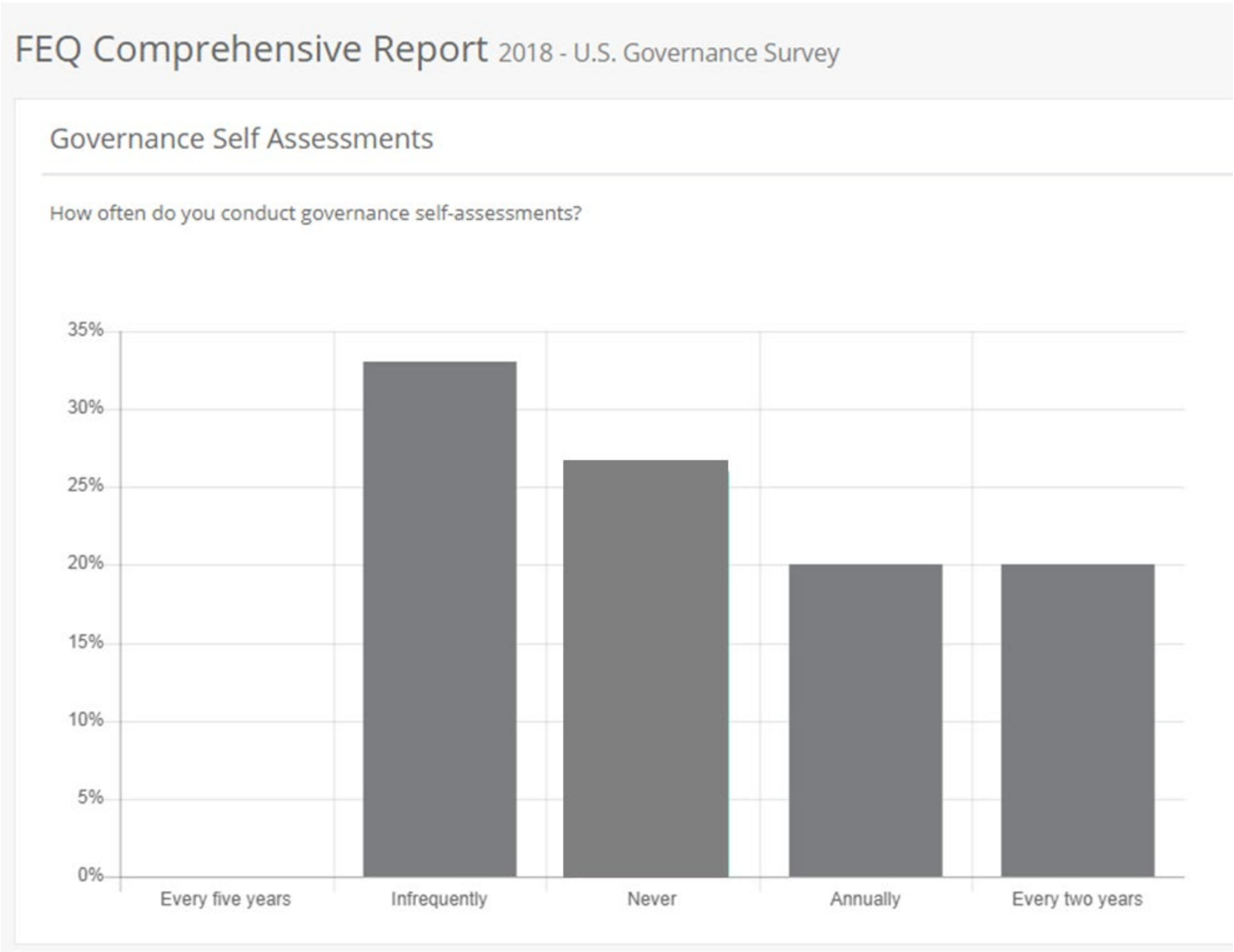

62% - Never or Infrequently

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)
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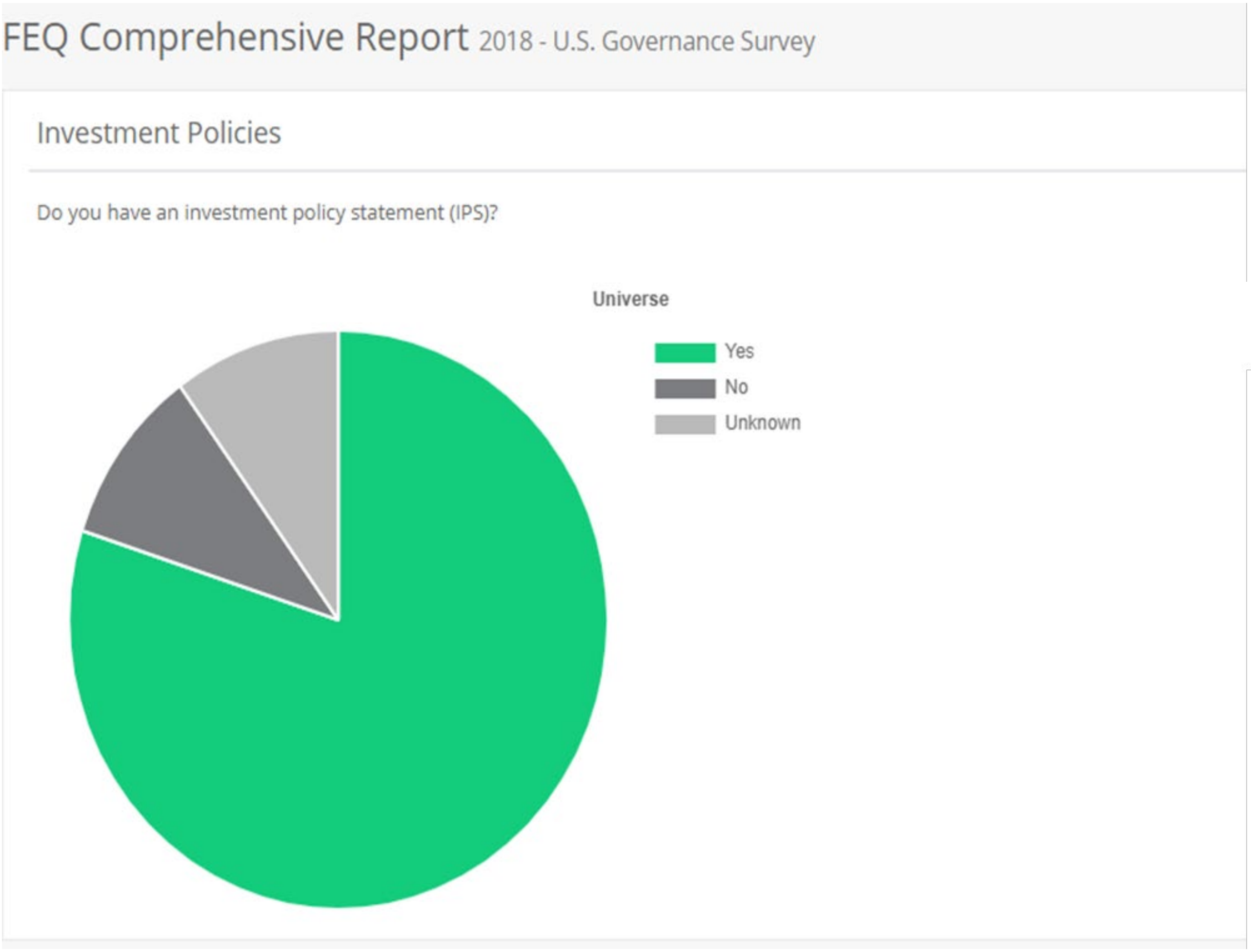

80% - Yes

Pretty good.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)

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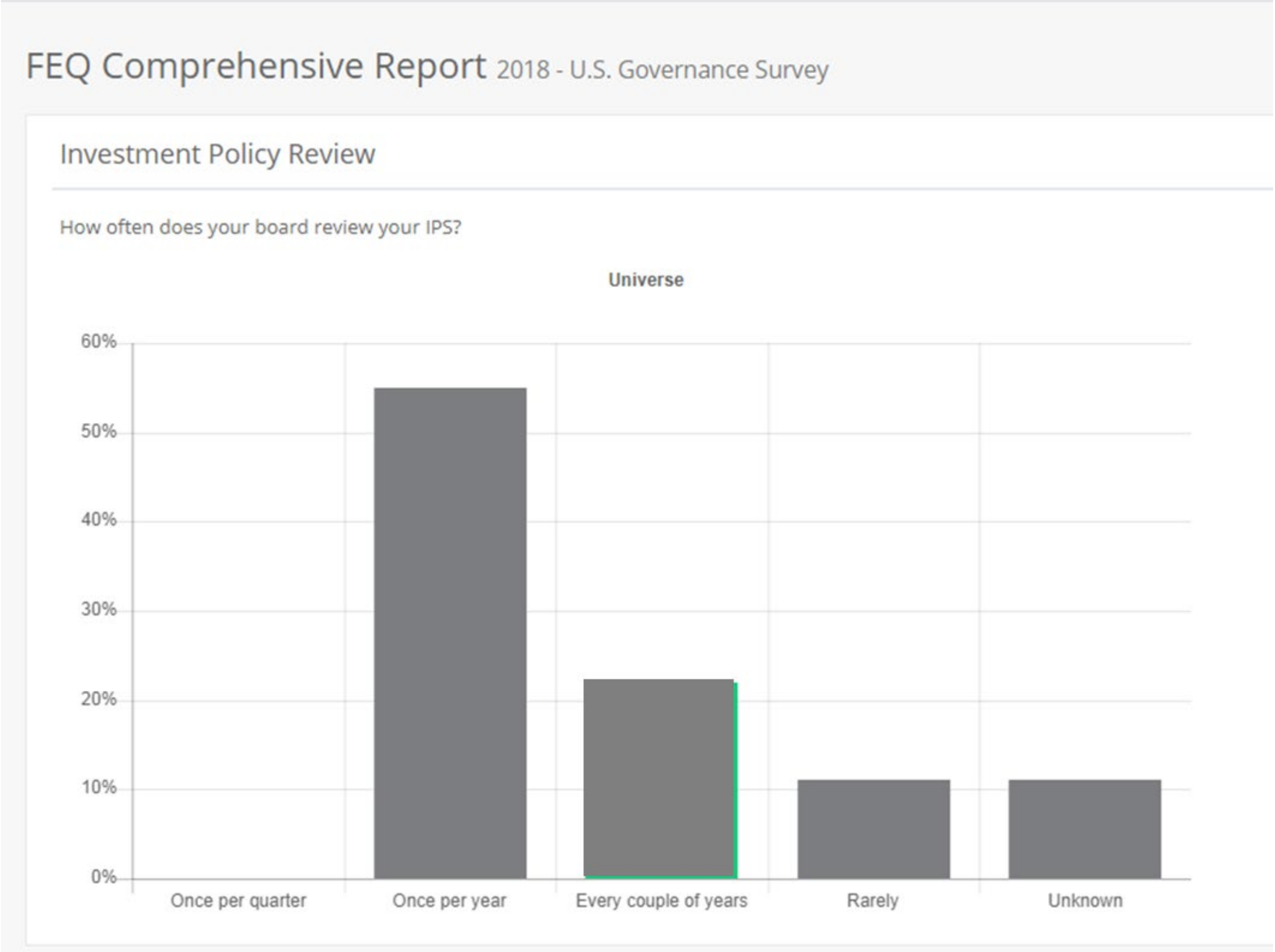

77%: every 1-2 years

Also, pretty good.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)

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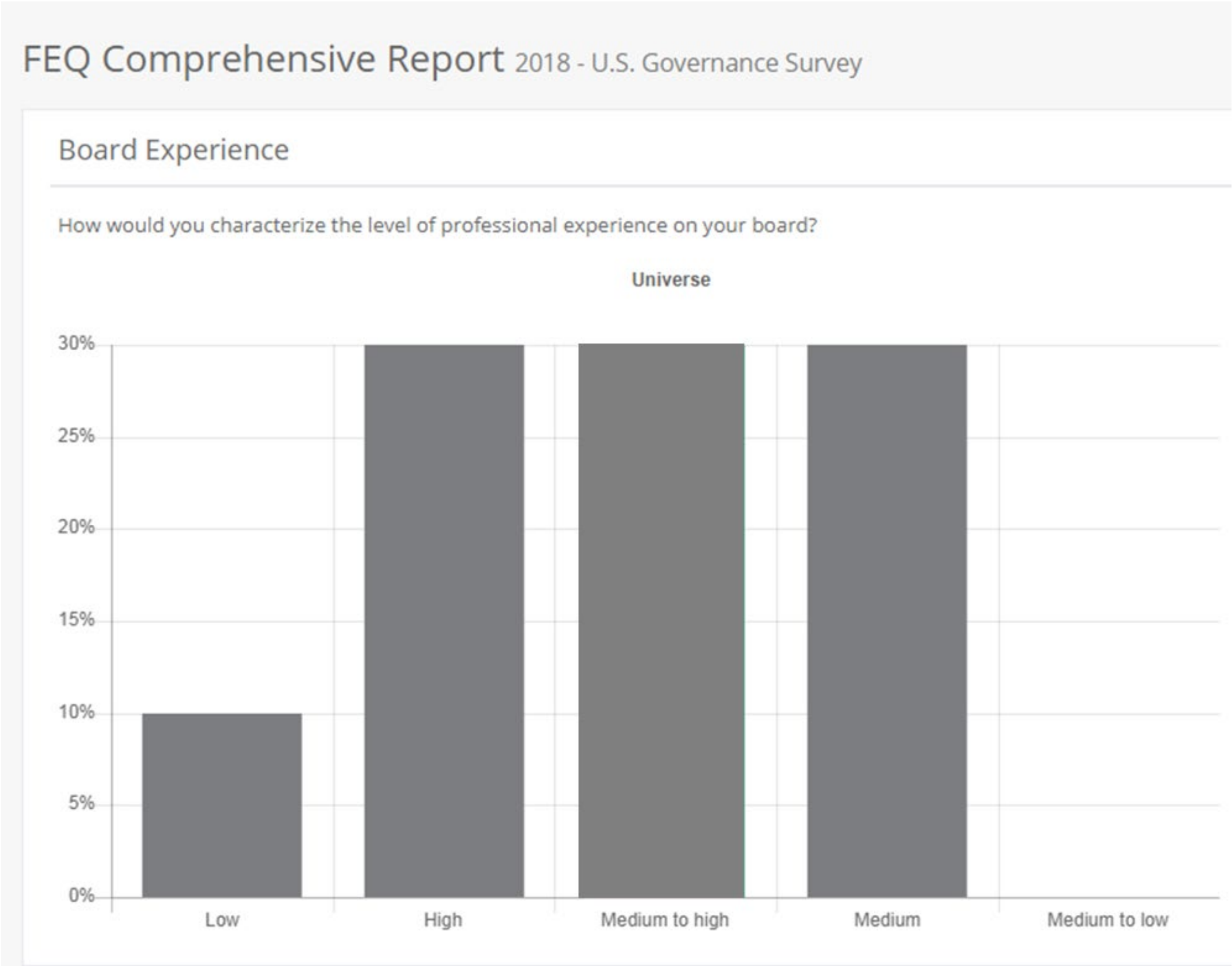

Range of professional experience.

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)

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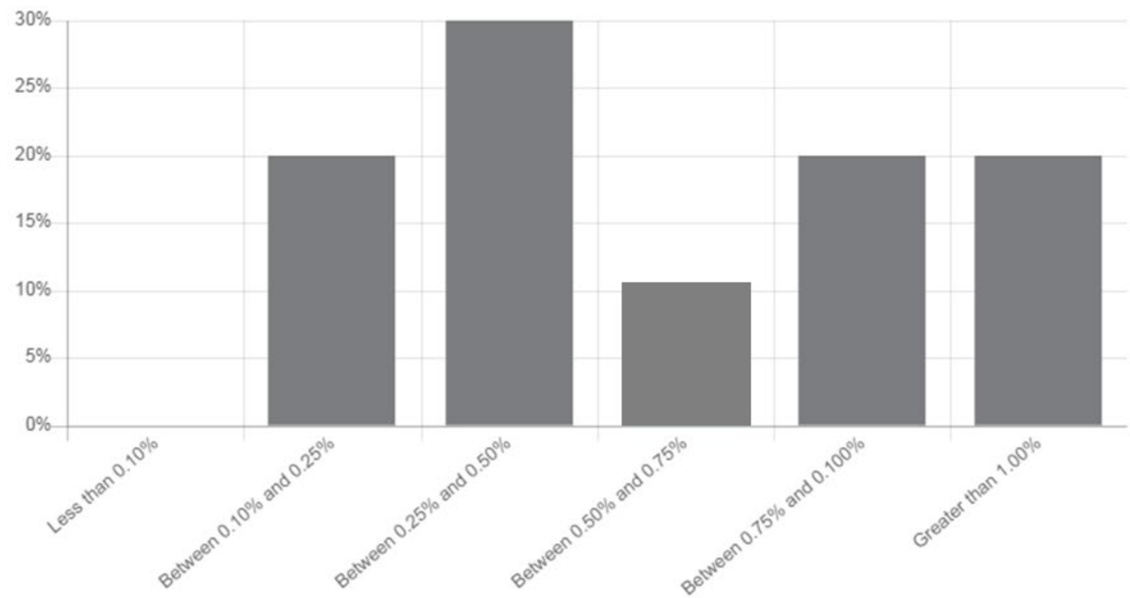
FEQ Comprehensive Report 2018 - U.S. Governance Survey

Investment Fees and Expenses

What is your total annual investment expense as a percentage (basis points) of total assets?

Universe



Expense structures are all over the board.

This one is striking, but not overly concerning.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)

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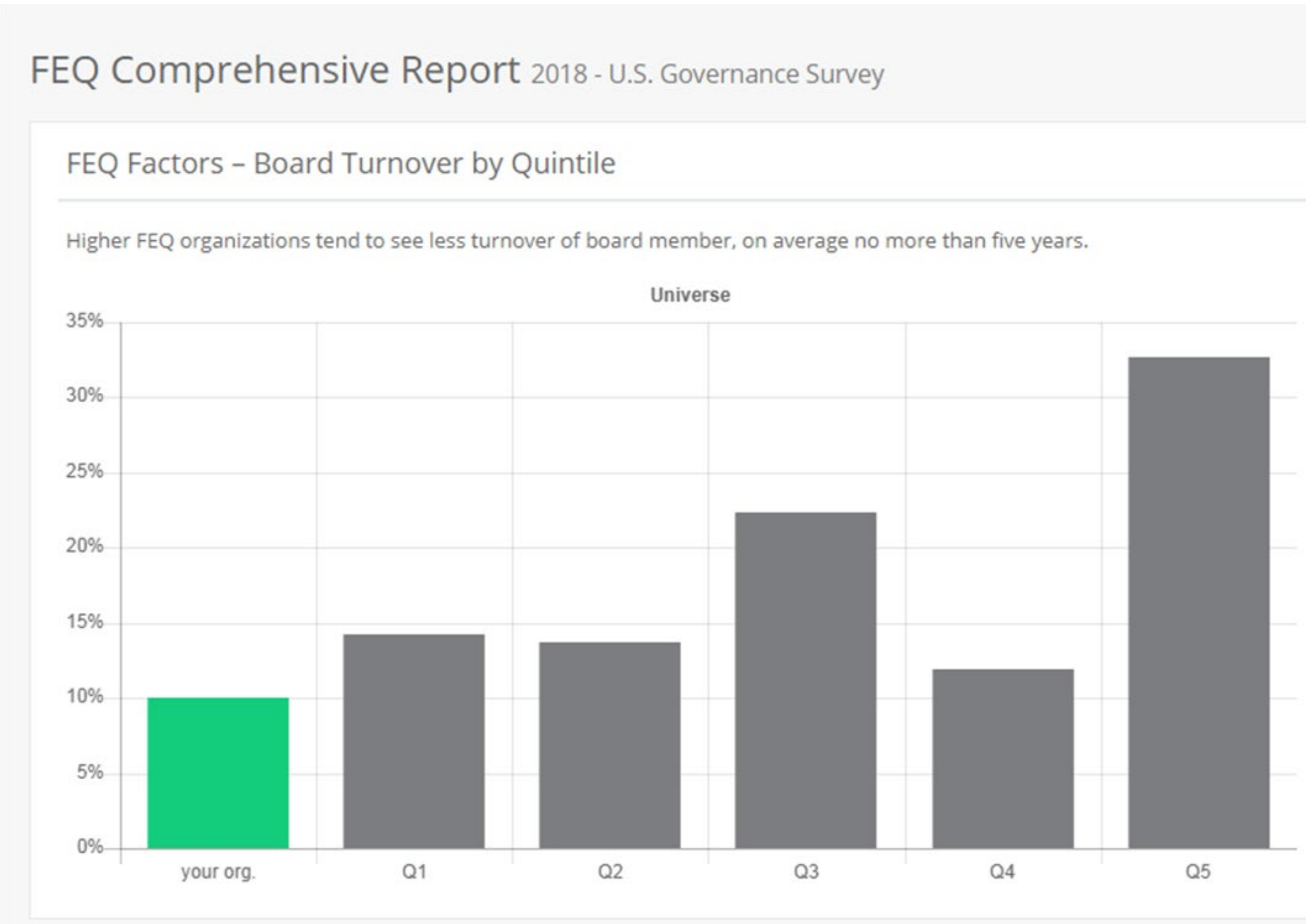

Board turnover is a significant factor.

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)

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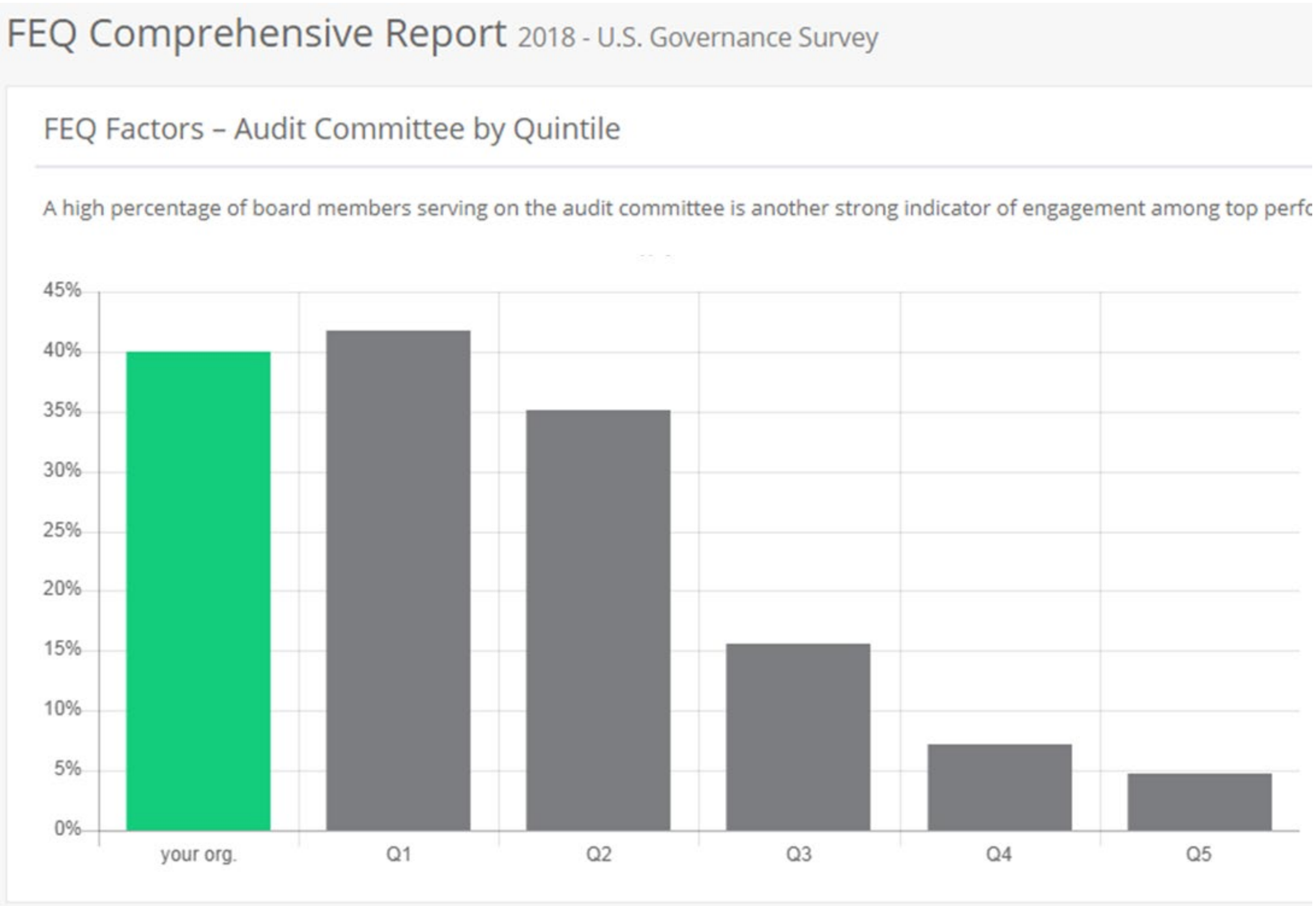

Board members serving on audit a very high predictor of good governance performance.

Similar picture for investments.

Source: Fund Governance Assessment System (FGS)™ (Fund Governance Analytics, LLC)

Now, About Those Costs

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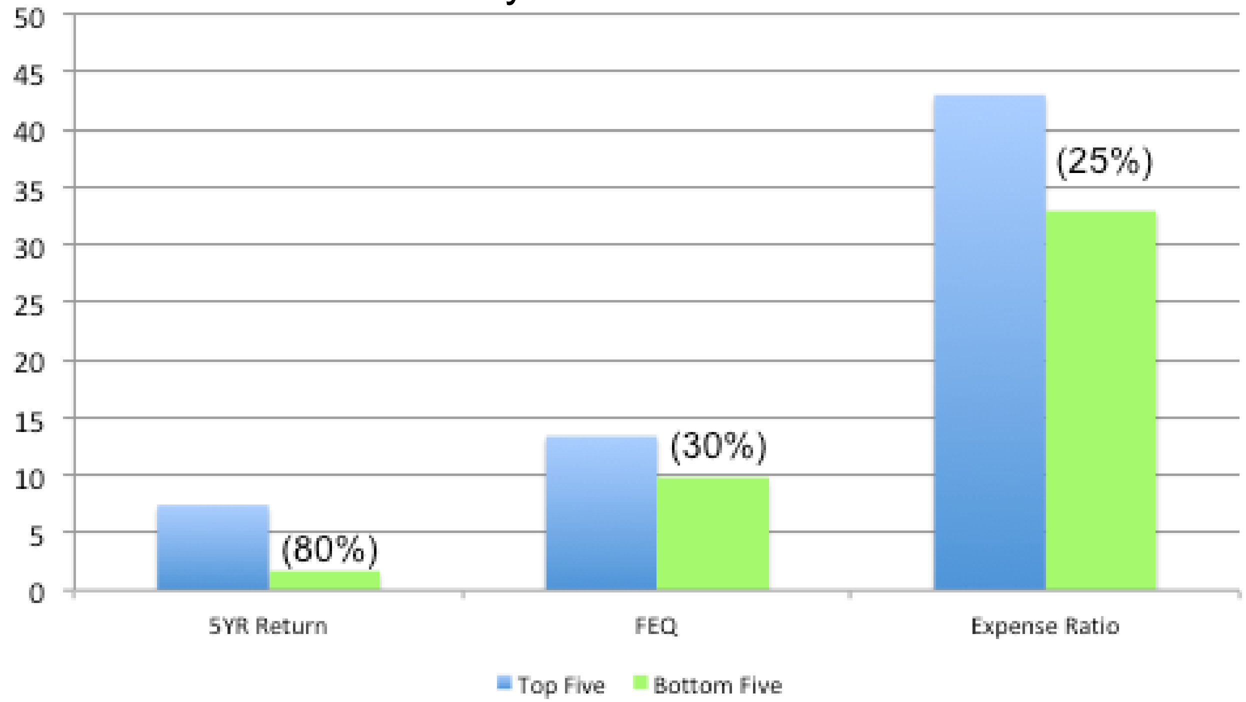
It's important but…

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



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

A v. P

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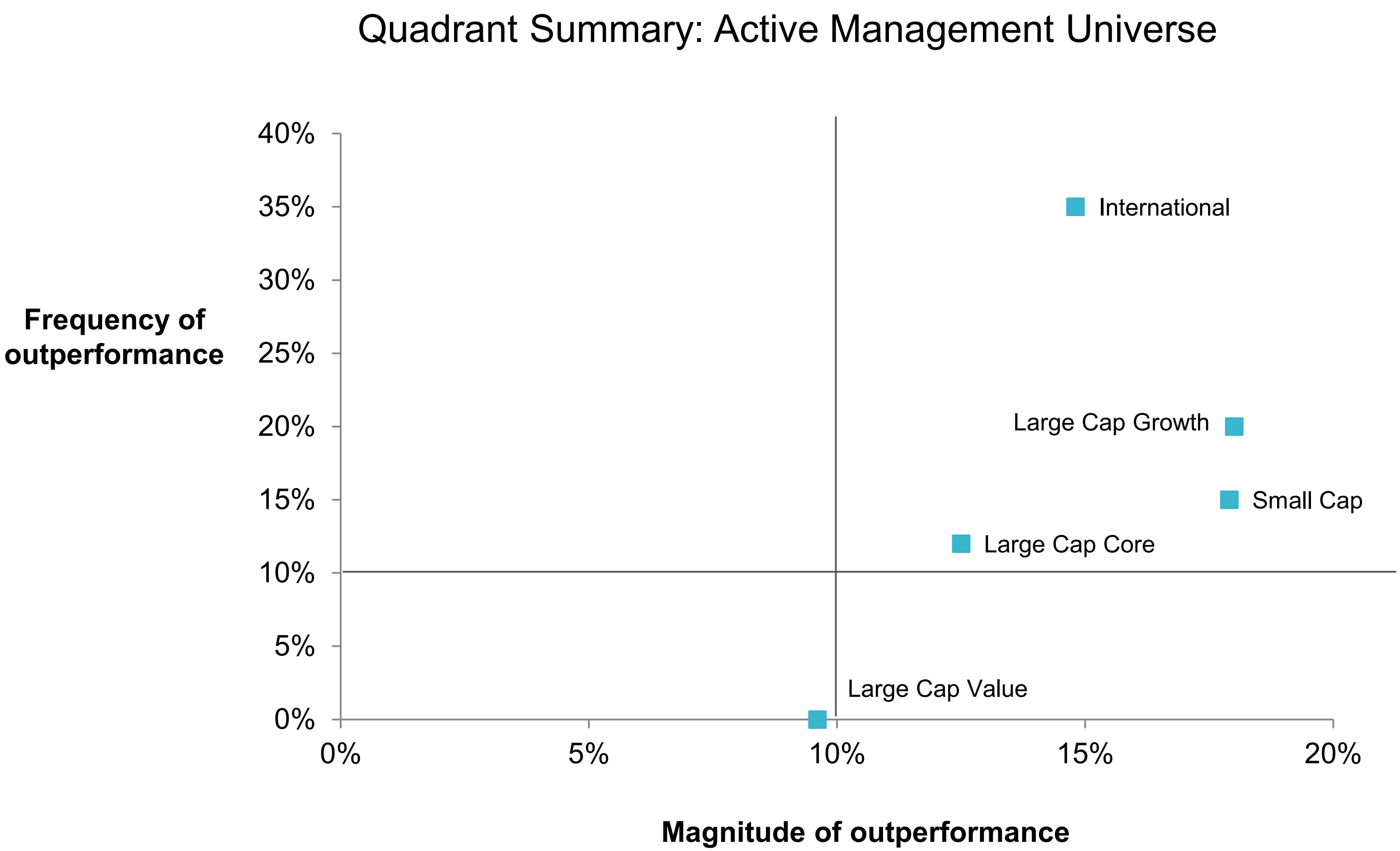

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#5 – Be Impactful

Farewell to Uncle Milt

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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

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"ESG and the Commons: From Tragedy to Governance", Christopher K. Merker, *CFA Enterprising Investor*, June 12, 2019

Hello to Elinor Ostrom

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BAIRD

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.

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"ESG and the Commons: From Tragedy to Governance", Christopher K. Merker, *CFA Enterprising Investor*, June 12, 2019

Top Risks to Global Development

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World Economic Forum, 2018

Likelihood	Impact
Extreme weather events	Weapons of mass destruction
Natural disasters	Extreme weather events
Cyber attacks	Natural disasters
Data fraud or theft	Failure of climate change mitigation or adaptation
Failure of climate change mitigation or adaptation	Water crisis

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Why This Matter to Investors

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ESG Risk

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"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
https://markets.businessinsider.com/news/stocks/climate-change-risk-to-38-trillion-municipal-bond-market-blackrock-2019-4-1028123832

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A final thought (and a challenge)

Invert the Pyramid

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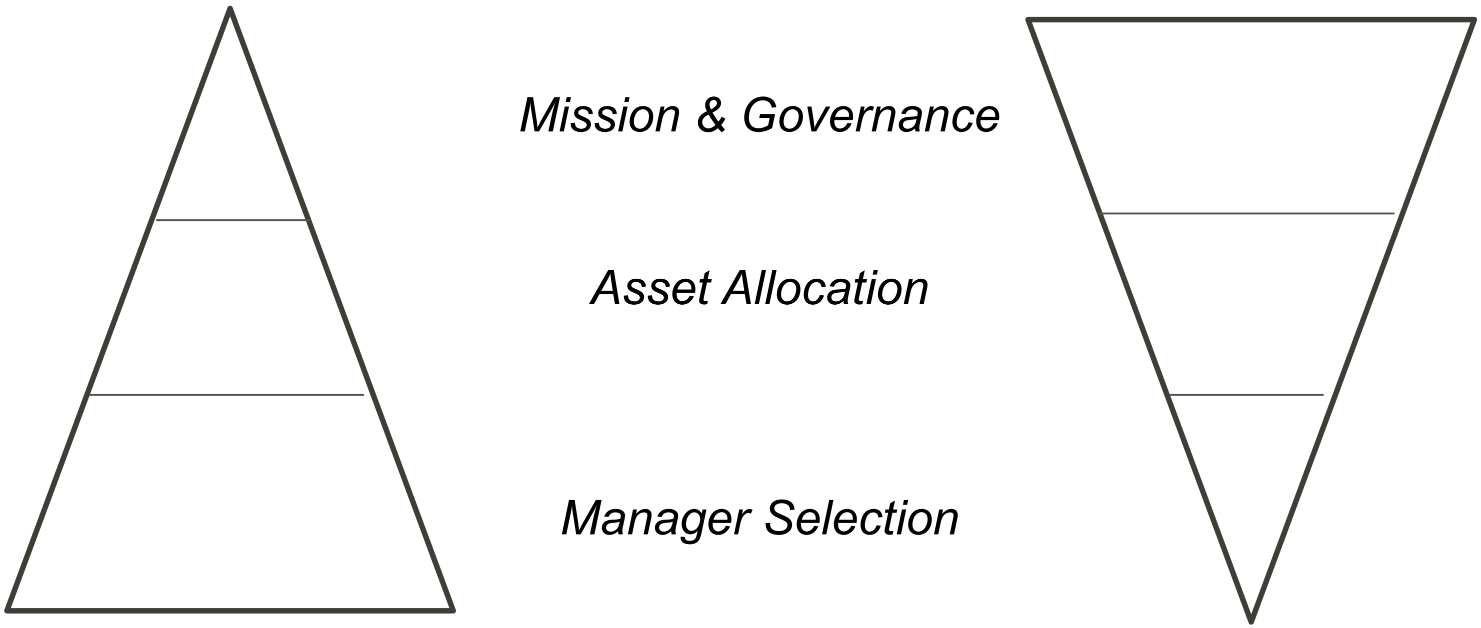
Current Practice | **Recommended Practice**



Portion of time allocated by the board | Portion of time allocated by the board

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Thank you!

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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

Fund Governance Analytics

A research partnership with Marquette University

- 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

CEFEX CENTRE FOR FIDUCIARY EXCELLENCE

CFA Institute

commonfund

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