Investment Committees: What you may not know

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Board committees such as Audit, Remuneration and Nomination have been around for a long time, and their duties and practices are generally well defined. An Investment Committee (IC) is a more recent development. Members of ICs would be well guided to understand idiosyncrasies in investments which are not well appreciated and even counter-intuitive, such as not meeting too often, leaving a portfolio alone during bear markets, focusing on costs rather than returns, and not "weather forecasting".

Typically, an Investment Committee (IC) is set up to help an organisation get a better return from its reserves than what it can get from fixed deposits. With this in mind, the IC would go about finding external fund managers to meet this objective at an acceptable risk, which is usually taken to mean not losing money.

This is a reasonable expectation. But it gets complicated when overlaid with the time horizon – is it fine to lose money in a financial year so long as over a longer-time frame the reserves are making money? Unfortunately, not everyone is prepared to see red ink in any financial year even though such losses may simply be marked-to-market and not realised.

What should you invest in?

For those who are not prepared to lose money in any given year, there are very few avenues to increase the rate of return other than staying in fixed deposit. Even a short-term bond held to maturity is subject to market volatility, and its marked-to-market price before maturity may be lower than the cost price.

Other alternatives, such as a capital guarantee on an underlying investment with more upside than fixed deposits, are not attractive once the cost of guarantee is priced in.

Practically, there is no running away from having to invest in asset classes with volatility

and hence marked-to-market losses. Such asset classes are equities, longer term government bonds and non-government bonds (for this article, the discussion will be restricted to investments in the public markets, i.e. excluding private equities, real estate and infrastructure).

Model portfolio

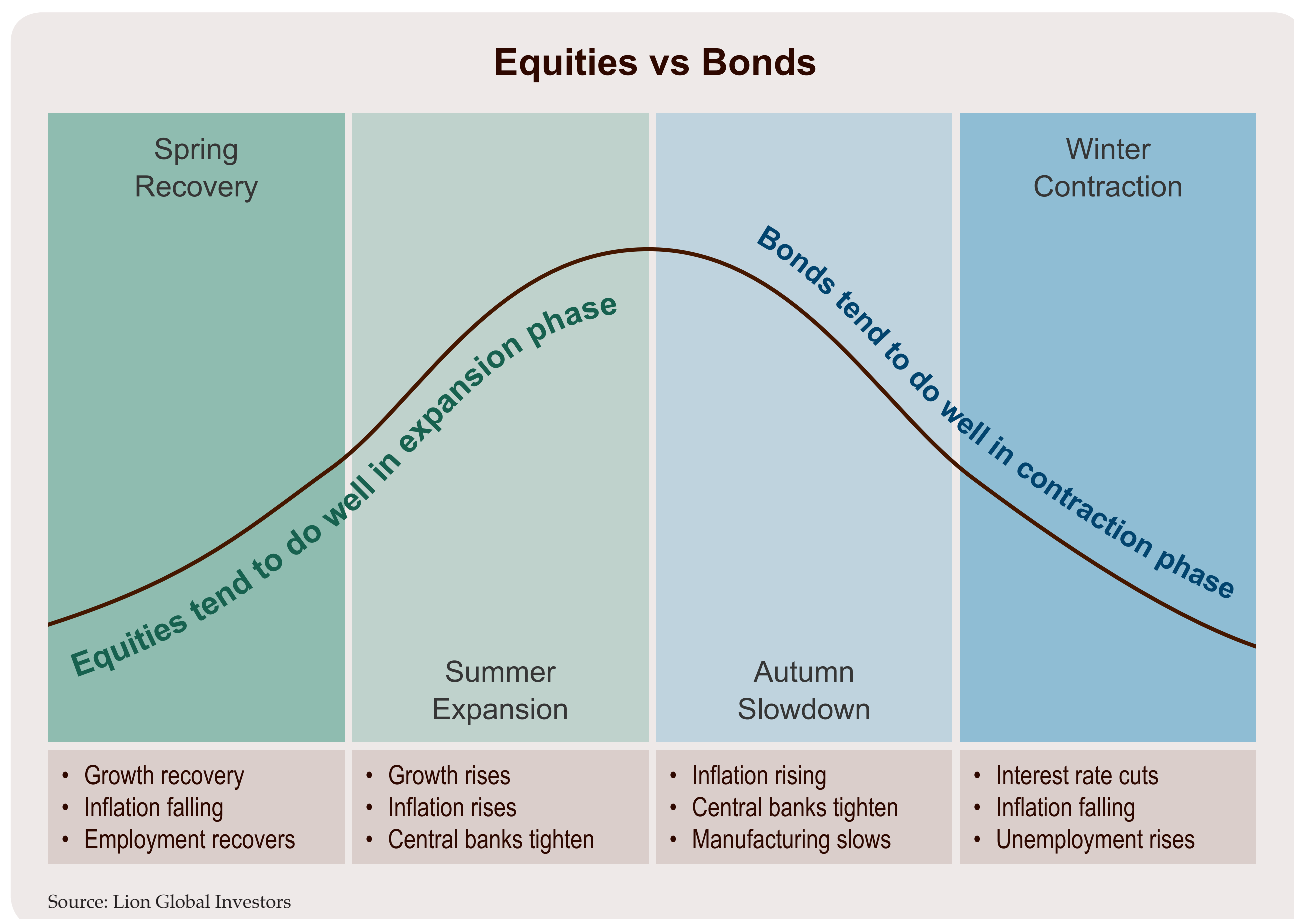
Having accepted the need to bear marked-to-market losses, it is the job of the IC to compose a portfolio which, over time, will give a rate of return better than a fixed deposit. This will involve having to look at returns on a rolling time-frame basis, such as the three-year moving average or five-year moving average.

To achieve this, a balanced portfolio consisting of some equities and bonds is required. Investors with a longer time frame should have a higher percentage in equities versus bonds.

The objective of the IC must be to construct a portfolio that is "all weather". What this means is not a portfolio that will not lose money on a year-on-year basis, but one that minimises losses in bear markets and has sufficient investments in equities to partake in the upside when a bull market comes around.

Having exposure to equities in a bear market is critical in ensuring that the portfolio is positioned to partake in the upside when the market turns around. Many investors make the mistake of getting out of equities in bear markets because they only see dark clouds and shadows. However, a bull does not pre-announce its arrival and often most returns are made at turning points when things look most gloomy.

The diagram, "Equities vs Bonds", depicts how equities and bonds perform over an economic cycle.



Source: Lion Global Investors

Singapore dollar

Most ICs are hand-held by consultants, and it is not unusual for them to be provided with model portfolios based on best practices in other countries. However, for Singapore-based clients, an added consideration should be the effect on the Singapore dollar (SGD), which historically has appreciated against most currencies, including the US dollar (USD).

Most of the model portfolios recommended by consultants and external fund managers do not take sufficient consideration of this point and the resulting "neutral" portfolio has a currency exposure that departs hugely from the Singapore dollar trade weighted index (TWI). The TWI measures the effective value of an exchange rate against a basket of currencies, depicting the overall performance of a currency. As a result, changes in the USD, or other key currencies, may nullify the returns made from underlying equities and bonds.

Consider that in the late 1980s, the USD/SGD rate was 2.12 versus the current rate of 1.36, a 55 per cent appreciation on the part of the SGD. Therefore, it is important for the IC to look at the currency exposure of the recommended portfolio versus the SGD TWI.

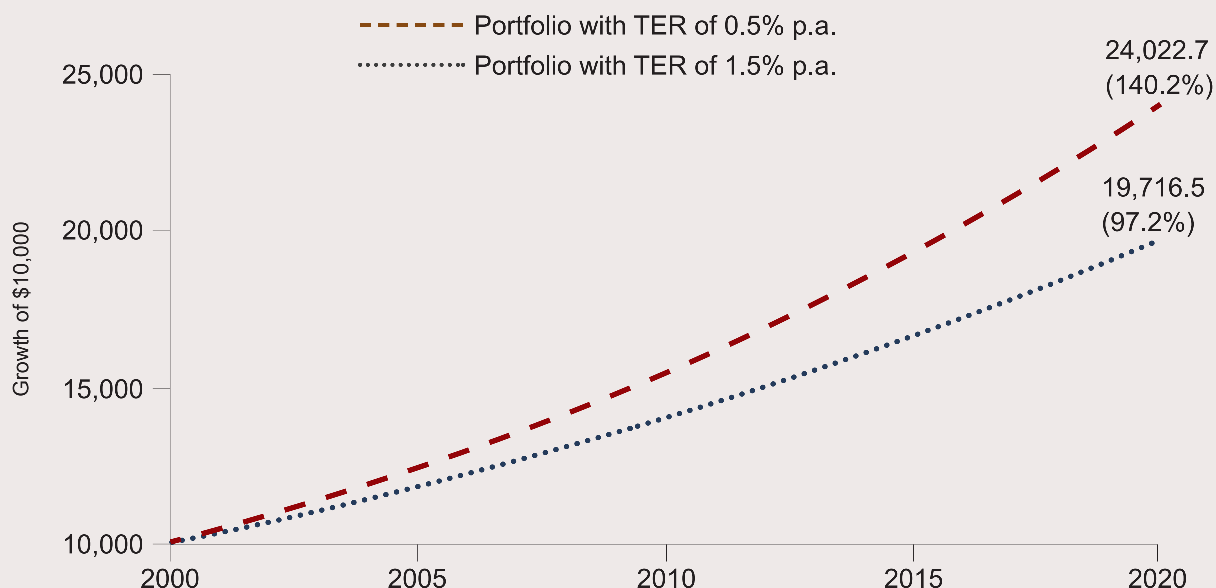
Active vs passive investing

With the advent of exchange traded funds, much has been written about passive investing versus active investing, mainly because active managers are unable to outperform their benchmarks consistently.

However, not all passive funds are low cost and vice versa. The real issue is actually about keeping investment cost low which is a key determinant of longer-term returns.

Research firm Morningstar has shown through predictive tests that expense ratios (cost) are a good predictor of future fund returns. Using historical data, the researchers found that using low expense ratio to choose funds helped in every asset class and in every quintile from 2010 to 2015.

The diagram, "Comparison of Total Expense Ratios", illustrates the power of low-cost investing



Source: Lion Global Investors

over time. It assumes a 50/50 balanced portfolio and gross returns of 5 per cent per annum (equity returns 8 per cent and bond returns 2 per cent). A 0.5 per cent per annum total expense ratio (TER) is compared against a TER of 1.5 per cent per annum. After 20 years, the difference in returns is huge, about 40 per cent (140 per cent less 97 per cent).

Most investors focus too much on finding external fund managers who have stellar returns. This is an exercise of looking at the rear-view mirror. Fund managers take turns to outperform and rarely does the same fund manager outperform consistently.

Since outperformance is not easy to predict *a priori*, it would be much better for investors to focus on low cost, which is something that one can choose upfront. Therefore, ICs should resist the temptation of overly focusing on historical returns when a key determinant of performance is keeping cost low.

Entry point

One of the most important decisions for an investor is the point of entry. Should one commit money during a bear market or bull market? It is very human to avoid putting in money when there is gloom and doom but, ironically, this is the best time to go in.

The reverse is also true. To mitigate against this human condition, ICs should consider putting in their funds in two or three tranches over various parts of a market cycle. This approach is called dollar cost averaging which is usually practised by individuals but seldom by institutions.

Weather forecasting

ICs, like other board committees, meet regularly, usually quarterly. The drill is to review performance and plan for the future based on what has transpired and what is expected. There is often a fair bit of "weather forecasting" that goes on in such meetings. In most endeavours, this is a commendable discipline, in fact, mandatory.

For investing, however, it is probably one of the main detractors of performance. Market direction is dictated by the extreme emotions of greed and fear, which drives people to sell at bottoms and buy at peaks. One of the key advantages of long-term investors is their time horizon (three to five years or longer).

Investors should therefore stick by their conviction and leave their portfolios alone. Weather forecasting is notoriously difficult and it is best for ICs not to meet often and when they meet, it is more productive to focus on whether the external fund managers are sticking by their convictions or getting whipsawed.

Fiduciary responsibility

Board members take their fiduciary responsibility seriously. As a result, it is quite normal for IC members to avoid risk. But, in finance, volatility is taken to mean risk (the statistical measure, standard deviation, is used as a proxy for risk) and ICs are prone to avoid investments which have higher volatility. This results in portfolios which are too conservatively invested, negating the opportunity to make a sufficient return.

This exposes a key risk of investment which is often neglected – the risk of not making enough for your stakeholders. This is a blind spot for most people – risk is a bell curve and the right side of the curve is often forgotten. Therefore, directors should remember that their fiduciary responsibility covers both the risk of loss and the risk of not making enough.

Hopefully, the above suggestions can help IC members achieve both objectives. ■

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