

Governance Matters

It really does



A deal too good to be true?

If someone offered you a low cost investment that could improve your fund's performance by up to 1%+ per year with very little risk what would you think? Too good to be true? What if you were told that the world's leading investors had all made the same investment and that capacity for other investors to join in was almost limitless? Interested now? Read on.



A feature that distinguishes the world's best institutional investors is that they have all paid a lot of attention to their governance. And, as you would with any high return, low risk asset they continue to do so by making small maintenance investments to ensure that their prized asset remains in its best possible shape.

What is governance?

Governance, as a term, is most often focused on Board activities, but to be comprehensive it needs to consider all the people and processes an organisation puts in place to achieve its mission. When sophisticated investors talk about governance they do so with this wider context in mind. That means they're not just thinking about how to make their Board (or Investment Committee) work more effectively but how the management team (whether internal or outsourced) contributes to mission success and the various frameworks put in place to guide good decision-making.

You better believe it

It's commonplace now for investors to have a developed set of investment beliefs. Amongst those beliefs it's also common to say something about governance. Here's a small sample:

High quality governance and decision making are critical to success.

Sound investment governance practices lead to better investment outcomes.

Effective governance, leadership and a strong culture are essential for a world-class investor.

Despite a professed belief in the value of governance, it is also very common that the topic gets little dedicated time on Board agendas.

If you say governance matters to you, how are you demonstrating that?

How governance quality impacts returns

Think of your favourite competitive activity. You might enjoy participating but you know there are competitors out there who are just that much better at it than you. Sometimes they are just more “naturally gifted” but usually it’s because they are driven to compete and put in long hours of practice.

Investing is a highly competitive activity. The lure of higher returns attracts organisations who are prepared to apply considerable effort to find 101 ways to eke out small performance gains. To do that they will hire well trained (and well paid!) specialists, invest in sophisticated systems and adopt exacting regimes for making decisions (i.e. how they play the game).

Investors that don't invest in these good governance attributes tend to be inconsistent in their approach

In this high-stakes game the smartest investors know that not only are they set up to beat their competitors, but they feed off their weaknesses. Their competitors' losses are their gains. Let's pause for a moment to consider how the winners win:

- They engage top quality decision makers and empower them to reach their full potential.
- They're very disciplined about how they make decisions. In particular, they know that as humans we are subject to biases that are detrimental, so they put in place consistent and coherent decision-making processes that counter those biases.
- They're constantly learning and striving for better ways to do what they do. They can always improve. They look for new opportunities that come out of this learning process.
- They have a clear understanding of what they are good at and, just as important, what they're not.
- These steps enable them to confidently adopt strategies that require more sophistication and patience, safe in the knowledge that they can stay the course through whatever turmoil markets throw at them.

Conversely, investors that don't invest in these good governance attributes tend to be inconsistent in their approach. Their goals might keep shifting. They miss key warning signals. Very commonly they look for success in chasing past returns. Often they lose their nerve when times get tough and then fall into playing the 'blame game'.

Do you have mechanisms in place to ensure that your organisation is creating, not destroying, value?

Sounds simple, why isn't everyone doing it?

If the returns from better governance are within reach, why doesn't everyone grab them? It's not a cost issue – financial costs to transform governance are relatively small in the context of other decisions that funds routinely make. The reasons are diverse: some funds are constrained by legislatively enshrined poor institutional structures or are burdened by competing multiple objectives; some lack the awareness to recognise that there are better governance models available, and some who are aware simply might not know where to start.

Organisations will also have their own inherent view of the quality of their governance. The danger with self-assessment in this area is the human tendency to be over-confident in one's own abilities. Few funds will be willing to admit that they have below average governance.

Are you the best you can be? The table in the next page is a simplified checklist of factors that distinguish best-practice investors. How many questions can you answer an unqualified “yes” to?

Good takes many shapes

Governance is very context specific – a small fund with a simple portfolio will have considerably less sophisticated governance arrangements than a large one with complex private market investments.

A useful way to think about what is required is by considering your organisation's governance budget. An organisation's governance budget is its capacity to apply governance disciplines, whether at Board or management level. You can look at this in one of two ways. Either your governance capacity drives your investment arrangements - or vice versa. If your budget is low, then you either need to keep your strategy simple or outsource to someone who can offer a deeper governance budget.

Does your governance budget match your strategy?

A 12-factor approach to good governance

The following table summarises characteristics that Willis Towers Watson evaluates when considering the governance quality of an organisation. 25 or more unqualified “yes” responses indicates governance in pretty good shape. 15 or fewer suggests that you would likely benefit from some significant work on governance effectiveness.

The checklist

		Please tick ✓	YES	NO
Mission Clarity	Do you have a clear organisational mission?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Is it supported by a business plan than aligns activities to the mission?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Are key stakeholders aligned behind the mission?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Effective use of time	Do you have clearly specified delegations?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Does the Board (Investment Committee) focus on strategic decisions leaving operational decisions to management*?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do strategic issues (like governance) dominate the agenda?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Leadership	Are the key leaders in your organisation (e.g. Board chair; CEO or CIO*) effective in focusing different skills and style in the organisation?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do they engage well with stakeholders?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do they bring passion and energy to their roles?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Beliefs	Do you have well developed investment beliefs?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Are the Board and management aligned on these?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Are beliefs frequently referenced in decision making?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Risk management	Do you have a clearly laid out risk appetite statement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do you have a process for budgeting and monitoring allocations to different risk factors in your portfolio?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Manager selection	Do you have a clear framework for hiring and firing investment managers?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Is this forward looking, focusing more on organisational elements than past performance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Investment team	Are you able to attract a highly skilled, appropriately sized investment team*?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do they have clearly defined responsibilities and are these aligned to your organisational goals?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Board competencies	Does your Board have members with strong finance or investment backgrounds who are able to effectively challenge and guide management thinking?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Is there a trusting, constructive relationship between the Board and management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Compensation	Are you able to offer an employee value proposition that attracts the highest quality people*?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do you have results-based performance compensation?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Is it deferred to recognise sustainable performance?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Competitive positioning	Do you have a clear idea of your organisation's competitive strengths and weaknesses?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Is your strategy aligned with these?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Can you add value through the quality of your investment team* and investment model?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Operating in real time	Are you able to make decisions in real time when required?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Are you able to make the most of the time horizon afforded to your organisation?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Learning	Do you have an organisational culture of always striving to be better?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do you have processes to learn from past decisions?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
	Do you network with peers to learn how they do things?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

* if CIO responsibilities are outsourced, think about the OCIO when answering questions related to management.

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