Is Your Investment Committee Doing Its Job?

Do your Investment Committee members know their fiduciary duties?

By Mike Ferman

If your organization has any investments, you need an Investment Committee. You may set it up as a subcommitee of your Finance Committee. Or it can be a separate stand-alone committee reporting directly to the board. Whatever structure you choose, be sure that its members understand what their fiduciary duties are.

What Does It Mean to Be a Fiduciary?

Fiduciaries are those who have agreed to live up to the highest standard of legal duty, stricter than normal standards of behavior. If you're a fiduciary, someone has placed their utmost trust in you. Thus, you're obligated to act ethically, loyally, and always in the interest of the other party rather than your own interest. Courts examine fiduciary transactions with special scrutiny.

As a fiduciary on the Investment Committee, you must do the following to uphold your responsibility:

- **Operate the investment fund for the exclusive benefit** of the organization.
- **Carry out your duties with the care, skill, and diligence** that would be exercised by a reasonably prudent person familiar with such matters (known as the Prudent Man Rule).
- **Diversify investments** to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
- **Be sure everything you do is in accordance with the documents and instruments** governing the investment fund.
- **Document everything** you do. Documentation is essential. As attorneys are fond of saying: If it isn't documented, you didn't do it.

Any breach of fiduciary duty can bring severe penalties. You could face civil damages and fees – even criminal penalties and jail.

To limit the potential for liability, follow these keys:

- **Establish and follow** clearly defined investment policy guidelines.
- **When the Committee meets, create and distribute** meeting minutes, and clarify responsibilities for future actions.
- **Provide close oversight and monitoring,** and report to the executive committee or full board on a regular basis.
- **Consider insurance** for any potential losses or events.
- **Avoid conflicts of interest** between the Investment Committee and the organization's board and staff. Create a conflict of interest policy, and ask all fiduciaries to sign a conflict of interest agreement.
- **Record everything** in as much detail as possible.

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How Big Should Your Committee Be, and Who Should Be On It?

We recommend that your Investment Committee be an odd-numbered group of five or seven people. Choose people who are familiar with the organization's mission and have experience in business, finance, and/or investments. It is useful to have both an attorney and accountant serving on the committee.

Do You Have an Investment Policy Statement?

Your Investment Policy Statement (IPS) is the single most important document you have to show that you're meeting your fiduciary duties regarding investments. Reviewed and approved by the full board of directors, the Investment Policy Statement provides an all-important framework for the work of your Investment Committee. The best ones identify:

- **the objectives** of your investment fund
- **the approach** your organization will take to selecting and monitoring investment managers
- **your desired asset allocation,** spending policy, required reporting, and criteria for rebalancing investments
- **compliance** with regulations and legal requirements such as the Uniform Prudent Management of Institutional Funds Act (UPMIFA)
- **types of investments you want to exclude** because they're contrary to your organization's mission
- **any restrictions presented by donors** for use of their funds
- **overall risk tolerance** guidelines.

What Is the Investment Committee's Role?

The role of the Investment Committee is to do the following:

- **Develop and follow** an Investment Policy Statement (defined above).
- **Establish** minimum investment standards.
- **Select and monitor** investments.
- **Report** on investments to the board.
- **Provide access** to appropriate investment management services.
- **Manage and control** costs.
- **Avoid** conflicts of interest.
- **Oversee** fund administration.
- **Retain** an investment advisor, as needed.

Choosing and Monitoring Investments: What Do You Evaluate?

A key responsibility of the Investment Committee is to establish the approach it will use to select and oversee the investments. The goal is to invest the organization's funds in a way that's consistent with its purpose, objectives, risk tolerance, and spending policy.

You'll need to create both quantitative and qualitative criteria to evaluate the investments in the fund and thus demonstrate that Committee members are being prudent. Ask questions such as the following:

QUANTITATIVE CRITERIA:

- **What is the size** of the fund and the assets?
- **What are the returns** (absolute and adjusted for risk)?
- **Has leverage** been used to pay for investments? (Using leverage can provide enhanced returns and also increases risk.)
- **Is our performance** consistent?
- **What fees and expenses** do we spend to manage our investments?
- **What is our minimum** performance history?
- **How does manager performance compare** to that of peer groups and industry benchmarks?
- **What is our upside/downside capture ratio** (a statistical measure showing whether a fund has gained more or less than a broad market benchmark during a period of market strength and weakness and, if so, by how much).

QUALITATIVE CRITERIA:

- **How stable is the organization** and its financial situation?
- **Which outside professionals** are used (legal and accounting)?
- **Where are assets held,** and how are they valued?
- **What role does each investment play** in the portfolio?
- **What is the manager's** investment philosophy?
- **Are there any redemption restrictions** or limitations?
- **Do the investments raise** any possible tax and financial reporting implications?
- **Are the investments registered** with the SEC?
- **What is the investment fund's** legal structure?

Should You Hire an Investment Advisor? If So, What Criteria Should You Use?

If the Investment Committee doesn't have the time or experience necessary to select and monitor the fund's investments, it may decide to retain an investment advisor. If so, it's vital to put time and care into the hiring process.

Look for someone who can function independently, give objective advice, and communicate with you frequently. For best results, find someone who takes a systematic approach to investing without trying to time the market in reaction to short-term market volatility. The best investment professionals are relationship-oriented, willing to educate clients about investments, rather than being driven by transactions.

Ask potential advisors:

- **What are your credentials** and experience?
- **Can you build a portfolio** that will meet the organization's objectives at a risk level we can tolerate?
- **What fees and expenses** can we expect?
- **Can you help formulate** an Investment Policy Statement for us?
- **Are you limited** to recommending only certain products and managers?
- **Do you have a fiduciary duty** to us? (Registered investment advisors do have such a duty, while brokers don't.)
- **Are there any conflicts of interest** regarding the products you recommend?
- **How will you design, implement, and manage** the investment plan?
- **What references** and other testaments to your firm's reputation can you show us?

Investment Committee members will have the privilege of seeing the organization's investments grow over time. Their work can propel your programs and services forward, attract new donors because of exceptional stewardship, and ensure your organization's long-term sustainability.

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