

Investment Tutor Surgery

Chris Wagstaff answers questions on the setup and structure of investment committees

Is there an ideal size and composition for an investment committee?

The importance attached to the size and composition of an investment committee, or indeed trustee board, cannot be overstated if a pension scheme is to make the right decisions to secure its long-term financial health. Interestingly, the operation of many investment committees have been likened to that of juries – though juries tend to be more diverse; hardly a sustainable model by which to run a pension scheme. In fact, evidence suggests the performance hit attributable to such poor governance to be in excess of 1 per cent per annum – sufficient to fund future improvements in scheme member longevity.

Given that the number of performance problems a typical investment committee encounters grow exponentially as the committee's size increases and the inverse relationship between the size of the committee and each member's contribution, all the evidence points to smaller committees being more effective than larger ones. Around six members are typically cited as the ideal, with double figures being frowned upon. However, size isn't everything. Probably of greater importance is the committee's diversity in terms of age, race, gender, socio-economic and cultural background and education. Also, never underestimate the value of independent thinkers. Indeed, drawing on the diverse knowledge and opinions accumulated by individuals through their many and varied life experiences typically outsmarts the smartest individual. The guess-the-number-of-jelly-beans-in-a-jar experiment is often quoted to demonstrate this, with the average of the many individual guesses usually being within a few percentage points of the correct answer and typically better than the best individual guess.

Unfortunately, many investment committees, by virtue of their relatively homogenous composition and the fact that, as social animals, most of us are hardwired not to think independently, i.e. we typically prefer to have our opinions validated by others (would you rather go into a busy or empty restaurant?), means that we find it difficult to stick to a view that differs markedly from others on the committee. Consequently, many committees are destined to succumb to "groupthink".

Groupthink, which has been variously blamed for a number of catastrophic events throughout history, arises from the decision making of similar, like-minded individuals and is typically characterised by dominant personalities, closed-mindedness and pressure to adopt the group view. However, taking things to the other extreme, too much diversity can, of course, result in a committee experiencing problems of integration and communication, especially when dealing with complex problems where there is no one simple answer, not least because of the difficulty of separating luck from skill, such as deciding upon asset allocation and manager selection. It's all about finding the right balance.

How should investment committee decisions be made?

Even after having addressed size and diversity, quality decision making cannot be guaranteed unless strong and unbiased leadership is demonstrated by the committee chair.

Given that democratic decisions tend to outperform dictatorial ones, the chair should encourage each individual to share their knowledge and opinions with the committee. It is often the information that individuals fail to share with others that holds the key to arriving at the right decision. In particular, the chair should ensure sufficient time is devoted to evaluating bigger picture complex problems, as this is where the diversity of the committee has the potential to reach what should prove to be a more correct answer than that arrived at by any one individual. Crucially, the introverted within the committee should be encouraged to contribute to the debate and given as much air time as the extroverts, with the chair ensuring that all of this information, without exception, is captured, debated, evaluated and weighted accordingly. Dissenting views, in particular, should not be ignored in the interests of time and efficiency. Even though collective decision making can become more complicated when information is shared and evaluated, this democratic approach to group decision making has proved to be extremely valuable for the success, indeed survival, of other social animals, such as bees, when deciding where to set up home for example. Good decision making also incorporates "pre-mortems" – analysing

that which could possibly go wrong once the decision is implemented. The chair should refrain from swaying opinion and seek to ensure the committee reaches a decision by consensus in a decentralised fashion (casting individual votes around the room is a definite no, no). Once a decision has been made, the committee should agree on the timing of its implementation and action this accordingly. However, this is where many committees fall down badly.

Any discussion of investment committee decision making wouldn't be complete without looking at the contribution of experts, or advisers, to the decision making process. Evidence suggests that when evaluating or forecasting complex phenomena, such as economics or financial markets, experts fare no better than informed non-experts, such as the vast majority of investment committee members. However, much depends on whether the experts are "hedgehogs" or "foxes". The former are those who operate in a very narrow field of expertise with set ideas, whilst the latter are those whose knowledge base is very diverse and treat forecasting and problem solving as a flexible exercise. Unsurprisingly, the latter with their cognitive diversity have the better record in analysing complex problems. However, as intimated earlier, as social animals we tend to rely on the actions and opinions of others, especially those of "experts" and from experience this is especially true of investment committees, unless they comprise a sufficient number of independent thinkers who have the competence and confidence to challenge the adviser's views, particularly those of hedgehogs. ■

Access a wealth of pensions and investment training and information at www.investmenttutor.com



The opinions expressed are those of Aviva Investors Global Services Limited (Aviva Investors) as at 1 October 2009. The content is provided for information only and should not be viewed as a recommendation of any nature.
Aviva Investors Global Services Limited, registered in England No. 1151805. Registered Office: No. 1 Poultry, London EC2R 8EJ. Authorised and regulated in the UK by the Financial Services Authority and a member of the Investment Management Association. Contact us at Aviva Investors Global Services Limited, No. 1 Poultry, London EC2R 8EJ. 09/0952/310910