NORTHERN TRUST
ASSET MANAGEMENT

REVIEW OF AND BEST PRACTICES IN NOT-FOR-PROFIT INVESTMENT COMMITTEE GOVERNANCE: ROLES, TIME, SUCCESS AND CONTINUITY

Northern Trust Asset Management
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Investment committee governance for long horizon, not-for-profit investment pools is uniquely challenging. Not-for-profit investors typically seek to balance steady support of near term activity with maintenance of purchasing power net of ongoing distributions into perpetuity. They are pursuing these objectives in a currently difficult investment environment where expected returns are lower than long-term historical average returns and the investment opportunity set is increasingly complex and global. Not-for-Profit Investment Committees (NFPICs) are the guiding hand of stewardship amidst these challenges – setting objectives and maintaining accountability for outcomes.

In this paper, we provide a review and summary of best practices in NFPIC governance by drawing on peer perspectives generously shared by 50 premier Northern Trust clients[1], as well as our own thoughts in this regard. The paper is organized into four sections, each focusing on a key factor contributing to good investment committee governance:

- **Roles:** Governance is distinct from management and both are "full time jobs."
- **Time:** Meetings scheduled well in advance, adherence to agendas, and effective time allocation help a NFPIC focus on top priorities.
- **Success:** Risk parameters, time frames, and self-assessment are all elements of assessing success.
- **Continuity:** Balancing consistency with fresh thinking contributes to effective long-term stewardship.

ROLES

Governance is distinct from management and both are "full time jobs" amidst the pressures of balancing near- and long-term objectives, lower expected returns, and a more complex, global opportunity set. Effective investment committee governance clearly defines the roles and responsibilities for a NFPIC in its governance capacity and for the management function implementing the portfolio to meet the objectives defined by the NFPIC.

A NFPIC:

- *Defines* portfolio objectives as they relate to supporting the non-profit organization's goals;
- *Approves* an investment policy[2] that provides a framework for the portfolio, including targeted absolute returns, asset allocation targets and ranges, position size parameters, and risk tolerances such as targeted volatility, market and drawdown exposures, and liquidity requirements; and
- *Assesses* outcomes relative to the policy framework and objectives over time frames consistent with the portfolio's long-term horizon.

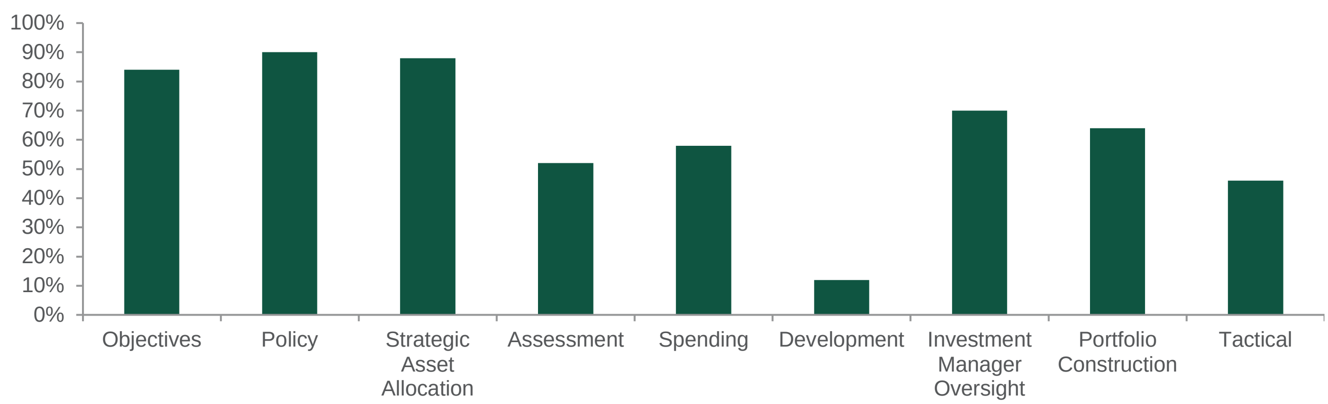
The management function, using internal staff, an external partner, or a mix thereof:

- *Supports* development of portfolio objectives and the related policy framework through informed input;
- *Implements* a portfolio to achieve objectives within the parameters of the policy framework, including sub-allocation weightings, manager selection and oversight, detailed portfolio construction, and tactical asset allocation within ranges;
- *Communicates* efficiently and consistently regarding outcomes relative to the policy framework and objectives; and
- *Is Accountable* for results.

In the survey, we asked how NFPICs interact with key elements of an investment program: did they approve or recommend, were they consulted or informed, or not involved? A summary of approval by area is presented in the chart below.

EXHIBIT 1: ROLES AND RESPONSIBILITIES

Peer committees are focused on strategy; opportunity to increase focus on assessment and flows and reduce focus on detailed management.



SOURCE: 2018 Investment Committee Governance Practices Survey, Northern Trust Survey Asset Management

The survey shows that 90% of respondents stated their committee approves investment policy and that over 80% of committees approve the definition of objectives and strategic asset allocation. However, only 52% reported that their committee approves assessment of outcomes relative to objectives, with almost as many, 42%, reporting that the committee was only informed regarding the assessment of outcomes relative to objectives. This indicates an opportunity for NFPICs to increase their focus on assessing outcomes relative to objectives and holding the management function accountable for those outcomes.

Some committees are focusing at a level of detail that may be best delegated to management. For example, 70% of survey respondents noted their committees approve investment manager oversight and only 22% noted the committee is only informed regarding investment manager oversight. Certainly, at a strategic level, the NFPIC approves investment manager oversight as part of assessing outcomes relative to objectives. However, as we noted above, there seems to be less emphasis on assessing outcomes at the NFPIC level, which means that more frequent or detailed manager oversight may be more appropriately conducted by management.

Additionally, over 60% of respondents stated their committees approved portfolio construction (sub-allocations, manager sizing, and combinations thereof) and that 46% of committees approve tactical allocation. This indicates that more than half of committees are not involved, merely informed, or consulted regarding tactical moves, while at least four in ten seem to be involved at a detailed management level.

Committee involvement at the management level was referenced by several respondents when asked to note barriers to success for an investment committee.

- *"Too much meddling in the implementation details."*
- *"…trying to make individual investment decisions at the committee level instead of at the management level…"*

On the flip side, one respondent summarized a key enabler of investment committee success as: *"Once confidence in management is established, the committee should not micro manage..."*

A good summary of roles in a well-balanced structure was provided by another respondent:

"Management can approve new investment managers and termination of investment managers and has an internal approval/dismissal process. Management can also rebalance the portfolio and implement tactical asset allocation moves within the approved ranges of the normal portfolio. Management can also make decisions on portfolio construction."

TACTICAL POSITIONING

Regarding tactical positioning, one of the most concerning potentialities is an NFPIC overruling the investment positioning of management in an attempt to reduce exposure to near term risk. When a committee does this, it is undoubtedly acting on what it perceives to be the best interest of the portfolio and its beneficiary, but takes on the risk of significant opportunity cost for a long horizon, growth-oriented portfolio. Opportunity cost is rarely tracked and measured, and only manifests itself over time in lost returns. The notion brings to mind a Winston Churchill quote – *"Why, you may take the most gallant sailor, the most intrepid airman or the most audacious soldier, put them at a table together – what do you get? The sum of their fears."* Committees can be too cautious. They need to set objectives, hire effective management and let them implement the portfolio to best meet the objectives, while being accountable for outcomes over time frames consistent with the portfolio's long-term horizon.

SPENDING POLICY

If roles for some committees may be blurred between governance and management, there also may be roles appropriate to a NFPIC that are being missed. Of the survey respondents, 58% reported their committees approve spending policy, and another 10% recommend regarding spending policy, but nearly one-third are only informed (12%), are not involved (16%) or are merely consulted (4%). Spending policy is an important tool for a not-for-profit portfolio and has important linkages with investment policy. For example, if you have an objective of reducing the variability of distributions, spending policy can have a critical role and careful consideration of spending policy may even change target volatility parameters for investment policy. Ideally every NFPIC would approve or recommend regarding spending policy and incorporate these considerations in their investment policy decisions.

DEVELOPMENT POLICY

Fewer than 15% of respondents reported their committees approve of or make recommendations regarding development policy, with nearly three-quarters citing no involvement and only 12% being consulted or informed. Not every respondent oversees a portfolio with development opportunities – private foundations may be fully funded with no additional inflows sought or accepted, operating not-for-profits such as healthcare entities may be at least in part subject to operating results driving potential additions. For those portfolios that can seek additional contributions, development is crucially important and portfolio investments and the investment committee can support those efforts. Ongoing flows into the portfolio can also impact investment policy, for example, an increasing denominator can make reaching and maintaining allocation targets more challenging, particularly for illiquid investments. Ideally every NFPIC with development opportunities would have a level of involvement regarding those opportunities and consider the impact of those flows on investment policy over time.

Certain peers are focused on the potential impact of Development Policy. In one of our pre-survey calls, a senior management professional for an entity actively accepting additional contributions stated that a primary objective of investment policy is to protect and support development. Another senior management professional similarly cited that an important reason to manage volatility in the investment portfolio, even when spending policy is providing substantial reduction in the translation of investment market volatility to the charitable institution, is to enhance the optics around the return stream that support development.

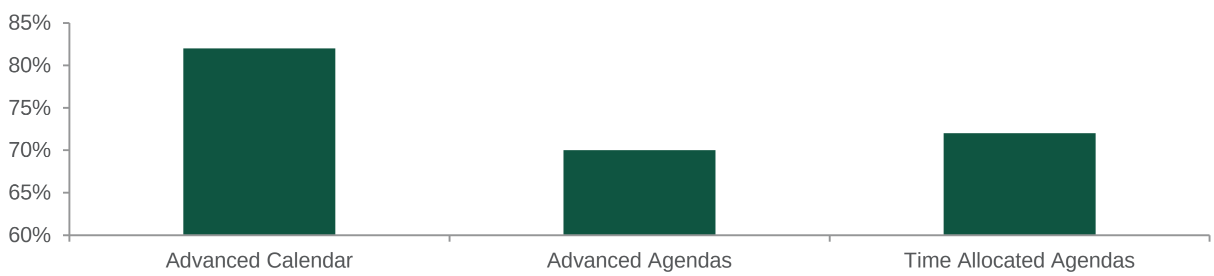
Clear and detailed definition of governance and management roles helps position a NFPIC for success. Based on our survey results, NFPICs are focusing on governance level priorities of setting objectives, investment policy and strategic allocation, but many may have the opportunity to increase focus on assessment of outcomes, spending policy and development policy, for some shifting attention away from management elements including investment manager oversight, portfolio construction and tactical allocation.

TIME

NFPIC activity centers on several key meetings each year and this time must be spent effectively. Thoughtful, consistent structure is an important starting point. In the survey, we asked if NFPICs incorporate certain practices within their time structure such as setting a meeting calendar in advance, circulating agendas in advance and allocating time on each meeting agenda. These results are summarized in the graphic below.

EXHIBIT 2: TIME STRUCTURE

Peer committees are organized regarding calendar, agendas and time allocation on agendas…



SOURCE: 2018 Investment Committee Governance Practices Survey, Northern Trust Survey Asset Management

Consistent with the graph, best practices include:

Setting an annual calendar for NFPIC meetings in advance:

- Regular face-to-face meetings allow for consistent engagement regarding the portfolio and its objectives. Setting an annual meeting schedule in advance helps assure that busy committee members can schedule time to engage in these discussions.
- Many institutions are committed to this practice, with 82% of survey respondents noting their committee set annual meeting calendars well in advance, at the beginning of their annual cycle.

Setting agendas and circulating materials for each NFPIC meeting in advance:

- Meetings should focus on dialogue around key strategic issues. The expected focus for meetings should be set in advance and may even be framed within the investment policy. A sample agenda for the year could include:

    - 1Q Review of Policies and Committee Charter
    - 2Q Special Topic Review
    - 3Q Strategic Asset Allocation Review
    - 4Q Detailed Investment Performance Review

- Advance notice of the focus for an upcoming meeting, including the relevant materials, allows committee members to prepare for discussions. This helps everyone "jump right in" to engage in dialogue and facilitate decisions in a timely manner.

- From our survey, peer institutions are committed to this practice with:
    - 70% of respondents said their committee sets agendas more than two weeks in advance.
    - 96% of respondents reported sending materials out more than two days in advance; only 36% reported sending materials a week or more in advance.

- Entities are also seeing committee members preparing outside of meeting times, spending over seven hours per year on average.

Time allocation on agenda for meetings:

- Time committed to particular topics should be outlined in the agenda and the committee chair should keep committees on this schedule. This helps facilitate focus on strategic discussions and minimize time spent on less important topics. The chair must also be prepared to call a vote on items that require a decision after due discussion.
- Peer institutions are reasonably consistent regarding time slots on agendas, with 72% of survey respondents noting their committee regularly follows this practice. For committees where there is a desire to spend time on topics that are strategically less important (e.g., near term economic and market reviews), some peers create dedicated time over lunch or dinner for less structured discussions.
- In addition to spending time preparing for meetings mentioned above, 56% of survey respondents cited meetings last two hours or more. Quantity does not always align with quality, but survey results indicate a correlation between longer meetings and respondents' positive perceptions of investment performance and committee effectiveness.

Having the right structural elements in place helps position the NFPIC for success. For instance, committees which use time allocation on meeting agendas are substantially more likely to report that they are fulfilling their charter (see Continuity below for a discussion of charters), compared to committees which sometimes or do not use time allocation (86% vs 70% reporting 'very good' or 'superior' performance in fulfilling their charter).

Within regular meetings, NFPICs need to keep from getting bogged down in near term market noise or management issues and focus their time on strategic priorities, discussions and decisions. In the survey, we asked respondents to summarize minutes spent on topics across a year's worth of committee meetings.

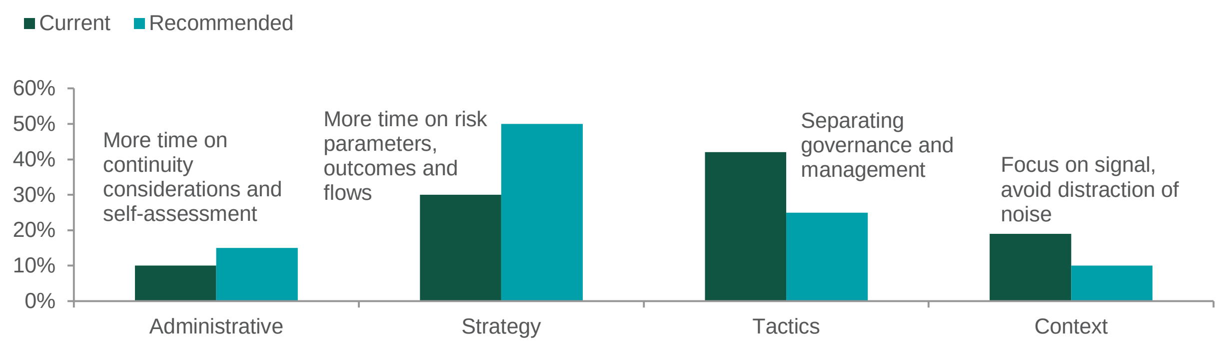
These topics can be categorized as:

- Administrative matters such as revisiting the charter, reviewing past meeting minutes, setting agendas for future meetings, reviewing fees and finalizing reports to the Board
- Strategy matters such as defining policies, objectives and strategic asset allocation, and assessing performance and outcomes
- Tactical matters such as investment manager oversight, portfolio construction, and tactical asset allocation
- Context matters such as review of economic and market conditions and the outlook thereof

The following graph compares how committees are currently allocating their time in meetings on a percentage basis and our recommendations for allocation of time.

EXHIBIT 2: AVERAGE AGENDA

Peer committees focus time in meetings on "tactics"; opportunity to increase focus on strategy.



SOURCE: 2018 Investment Committee Governance Practices Survey, Northern Trust Survey Asset Management

This "average agenda" weighting may vary by meeting. Referring to the sample annual meeting agenda above, certain meetings would have a greater emphasis in different areas:

- **1Q Review of Policies and Committee Charter:** strategy (policies) and administrative matters (self-assessment, charter)
- **2Q Special Topic Review:** investment related strategy; for example, investing in emerging markets over the next generation
- **3Q Strategic Asset Allocation Review:** investment strategy and context (e.g. considering shifts in expected returns)
- **4Q Detailed Investment Performance Review:** tactical level considerations including investment manager results

Respondents cited issues with the balance of time spent in meetings as barriers to success:

- *"…too much time in the weeds, hearing about and discussing economy and markets and near term performance results rather than focusing on strategic objectives…"*

- *"Focusing on the wrong things. Spending time on tactical decisions vs. strategic…"*

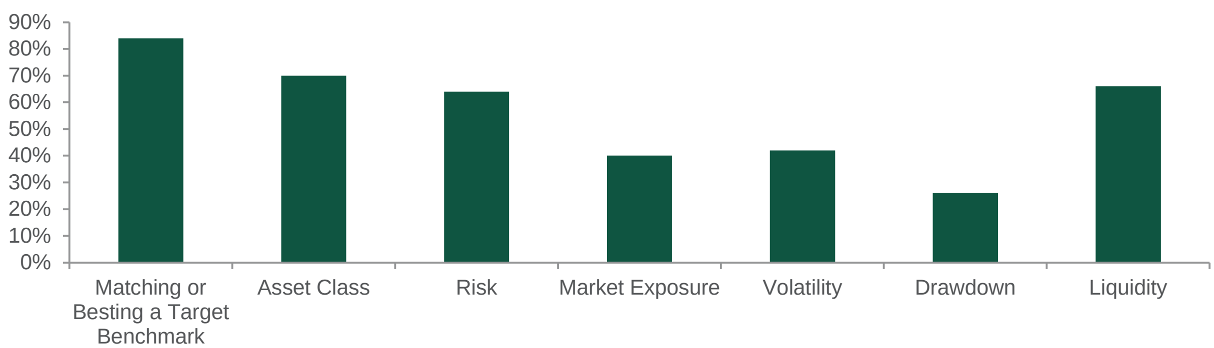
Effective structuring and prioritized use of NFPIC time aligned with its governance role helps support long-term success.

ASSESSING SUCCESS

NFPICs should consistently and candidly assess success relative to a variety of strategic objectives using time frames consistent with their long-term horizons. On balance, committees seem reasonably pleased with outcomes. The survey results tell us that 62% of respondents self-assessed as having "very good" to "superior" performance in achieving investment objectives. However, we note the majority of respondents cited investment performance as the focus of their self-assessment. This can be shown in the chart below, which summarizes what NFPICs assess when considering their success.

EXHIBIT 3: ASSESSING SUCCESS

Peer committees focused on investment returns, opportunity to increase focus on risk (and opportunity) parameters...



SOURCE: 2018 Investment Committee Governance Practices Survey, Northern Trust Survey Asset Management

As the chart shows, 84% of respondents cited matching or beating a target benchmark as a measure of success and 70% focused on asset class returns. On the other hand, just 64% of respondents focused on overall risk positioning, 40% on market exposure, 42% on volatility, and 26% on drawdown exposure.

Additionally, our survey results show that committees reported spending 68% more time assessing performance relative to market benchmarks than they do relative to objectives and risk tolerances (65 minutes vs. 39 minutes on average). Accordingly, committees could benefit from increasing their focus on outcomes relative to objectives as a way to increase time spent on strategy and governance. Furthermore, by consistently considering risk positioning relative to target parameters, committees can better fulfill their governance requirements.

LIQUIDITY

A unique risk, and opportunity, for long horizon portfolios revolves around exposure to illiquid investments. Committees are focusing attention on liquidity with 66% of respondents citing it as a regular review topic, as seen in the chart above. The investment advantage provided by capacity to invest in illiquid opportunities is of such great importance for large perpetual investment pools and the definition and management of the right level of illiquid exposure is so unrefined in the investment world, it requires particular attention by each large, not-for-profit investor. Assessing success includes assuring the portfolio is maximizing its exposure to illiquidity within each NFPIC's defined limits.

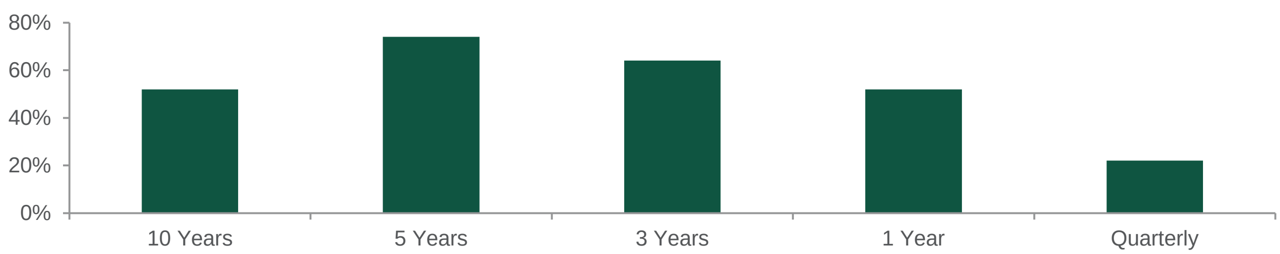
TIME FRAMES

Time frames for assessing success should align with time horizon. An annual in depth review of investment performance is a good fit for large, long horizon, alternative investment intensive, portfolios that are not as impacted by quarterly market movements and where strategy may take years to fully show in results. Similarly the "shortest" time frame relevant for review may be three years or even longer. Alternatively, during our pre-survey interviews, one senior management professional said they have had success in "reverse ordering" time frame columns, i.e. having a longer time frame as the first column of results with time frames getting shorter as you move left to right. This naturally focuses attention on longer term results and deemphasizes shorter term noise.

As part of our survey, we asked respondents to note the top three time horizons their committee uses in assessing outcomes. The results of which are summarized in the chart below.

EXHIBIT 4: TOP TIME FRAMES

Peer committees most frequently prioritizing 5 and 3 year time frames, opportunity to further deemphasize "noisier" short term views...



SOURCE: 2018 Investment Committee Governance Practices Survey, Northern Trust Survey Asset Management

As seen in the chart, five-year (74%) and three-year (64%) time horizons were most frequently reported. Some committees take a much longer view on performance assessment, with 52% of respondents citing the use of ten-year horizon. However, 52% did cite yearly and 22% cited quarterly, indicating that there is reasonably significant focus on shorter time frames which may provide more noise than signal for long term oriented portfolios.

Respondents noted issues with time frames as barriers to success for committees:

- *“Inability to adopt the perspective that the endowment is a perpetuity and should have a very long-term view when evaluating investments and performance.”*

- *“Following trends instead of staying focused on pre-established investment objectives and asset allocations, especially during periods of market turmoil. Also reacting to current market factors instead of focusing on the long-term horizon.”*

SELF-ASSESSMENT

Sixty-two percent of respondents noted they were performing in a “very good” or “superior” manner with regard to being a “good and effective” investment committee. However, few have formal measures in place to assess committee performance beyond returns and reporting to or being reviewed by their institution’s Board of Trustees. Only 16% of survey respondents noted their committee does an annual self-assessment, yet 88% of these committees report “very good” or better investment performance. We believe more NFPIC members should complete an annual self-assessment on their effectiveness in fulfilling the charter in support of the organization’s objectives. Assessing success across multiple measures relative to a variety of objectives over appropriate time frames is a fundamental responsibility for NFPICs.

CONTINUITY

Clear roles, effective use of time, and candid self-assessment help support success in the near term and a deliberate approach to continuity helps extend that success over the long term, which is the essence of stewardship.

Committees represented in the survey have been in place for extended periods. More than 85% of respondents reported their committees have been in place for more than ten years and nearly half for more than 20 years, with 62% self-reporting they do at least a ‘very good’ job ensuring continuity of culture. Moreover, to further the goal of continuity, respondents reported meeting regularly, with 84% meeting at least four times per year..

Turnover on committees surveyed tends to be low, averaging less than one member per year, with an average committee size of nine and median of seven members. Ninety-six percent of committees have a designated chairperson, helping to support continuity across and within meetings. Attendance at meetings is good, with an average of seven attendees in person, one or two attending by phone, and only one not attending.

Continuity for committees is supported by full time investment staff who sometimes have more history with the portfolio than committee members. Eight-eight percent of respondents have at least one full-time equivalent

(FTE) employee at the institution supporting the investment portfolio, with an overall average of 4.8 FTEs. These FTE employees are highly beneficial to maintaining continuity through regular interaction with the committee in support of the institution's objectives.

Robust continuity is more than shared history; it is also shared values. It may be hard to achieve these goals, but survey results indicate pursuing them is worthwhile. Stronger relationships between the committee and its supporting personnel are associated with greater satisfaction with a range of key outcomes. The better the relationship between the NFPIC and its FTE staff, external advisors, or its (o)CIO, the better self-reported performance is with regard to investment achievements, hitting other targets, committee effectiveness, and continuity of culture.

There are also points where NFPICs can improve, based on the survey data:

- The NFPIC should have a charter that outlines its charge, membership and other key framing elements. The charter[2] should be reviewed annually alongside the annual review of investment policy. Sixty-four percent of survey respondents reported their committee has a charter, while more than one-third do not.
- Seventy-three percent of respondents noted their current chair has been acting in that capacity for five years or less and nearly half reported their chair has been in place three years or less.
- For those with shorter chair tenures, 71% of the respondents reported the previous chair served in that role five years or less.

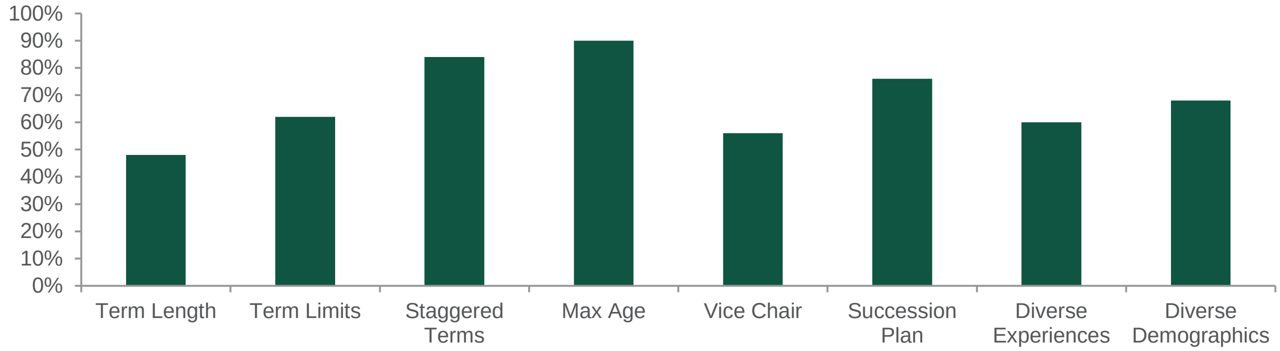
In our starting point charter[2], we recommend a committee chair should be in place for five years and able to serve up to three terms (15 years). It may take five years or longer for a strategic direction to take hold in impacting a portfolio and consistency in chair leadership may support staying the course.

One survey respondent indicated that "not having an experienced, effective committee chairman to manage the committee" was a barrier to success. Another respondent cited that an enabler of success is having a "long tenured effective committee chairman".

In the survey, we asked about other elements of continuity and noted that most committees did not have these measures in place. The chart below summarizes several areas.

EXHIBIT 5: LIMITED FORMAL CONTINUITY MEASURES

Peer committees generally have limited formal measures in place regarding continuity, an opportunity to position for long-term stewardship…



SOURCE: 2018 Investment Committee Governance Practices Survey, Northern Trust Survey Asset Management

As seen in the chart:

- 48% had no prescribed term lengths for committee members (and 56% did not have prescribed term lengths for the chair)
- 62% had no consecutive term limits for members (and 64% did not have term limits for the chair)
- 84% lacked staggered committee member terms
- 90% did not have a maximum age limit for members
- 56% did not have a vice chair role or chairperson elect
- 76% lacked a formal succession plan

Consistent with our sample charter[2], we believe many committees can benefit from greater formalization around continuity including:

- Defined term lengths
- Consecutive term limits
- Maximum age limits
- Staggering of terms
- A formal succession plan including structured use of a vice chair role

As committees consider continuity and succession plans, there is an opportunity to increase focus on diversity. As also seen in the chart above:

- 60% of committees had no formal or informal diversity goal for the committee regarding business or investment experience
- 68% of committees had no formal or informal diversity goals regarding demographics including age, gender, race, and ethnic background.

We believe that diverse perspectives add value to strategic discussions and suggest that the consideration of diversity can improve dialogue and outcomes over time. This thinking is mirrored in several comments contributed in the survey when we asked respondents to identify “the biggest enabler of success”.

- *“Diversity of thought”*
- *“…diverse perspectives…”*
- *“Well diversified members who are willing to listen to others and ask questions. The more sophisticated the investment committee member, the more willing they are to listen to others’ thoughts.”*
- *“…the varied perspectives of the members, they don’t all think alike which makes for some very engaging discussions…”*

In contrast, several respondents cited “groupthink” as a barrier to success. Another noted the importance of “Making sure that all voices are heard and not just the (more) vocal (members).” Overall this engagement by a diverse committee resonated as critical, with one respondent noting as a key enabler to success “Willingness to engage in debate and to reflect on successes AND failures.”

With a perpetual time horizon, NFPICs have to bring a stewardship mindset that is engaged in the present and always thinking about long-term implications. An organized approach to continuity can be crucial to supporting long-term success.

SUMMARY

Investment Committee Governance is of great importance to the long-term financial health of not-for-profit organizations and at the same time is uniquely challenging. It pushes the thoughtful committee member out of their natural comfort zone focused on nearer term events and a time horizon linked to the current generation. As one survey respondent put it, “…the biggest barrier is not thinking institutionally and as a fiduciary, but rather as an individual investor.”

It is likely that every investment committee can benefit from regular self-assessment and introspection, noting what it is doing well and how it can improve by considering roles, time, success, and continuity. NFPIC members are engaged and passionate in supporting the missions of the institutions they serve and continuous improvement including learning with and from peers can help them fulfill those goals.

ABOUT THE SURVEY

[1]We are fortunate to interact with many of the largest and most sophisticated not-for-profit investment pools in the world. In the first quarter of 2018, we distributed a survey to 222 not-for-profit entities and received responses from 50.

[2]Northern Trust Asset Management has a sample Investment Committee Charter and a sample Investment Policy that we make available to clients to help guide their development of these important documents.

NORTHERN TRUST ASSET MANAGEMENT

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*Assets under management as of March 31, 2018.