ASCALON CAPITAL

Investment Governance and Best Practice -Stewardship

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Are you ready to add value in the investment process by improving investment governance?

Introduction

The recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry shone a spotlight on governance in Australia's financial services industry. Investment governance has attracted a growing focus in the global investments landscape. The world's largest institutional investors have focused considerable resources on improving investment governance frameworks.

Good governance is more than just meeting regulatory compliance requirements. Identifying and implementing good governance frameworks into the investment process can demonstrably add value for clients over the long run. Conversely, poor governance can destroy value.

With this in mind, our white paper sets out foundations for improving investment governance, moving towards best-practice stewardship, and building investment processes that are clearly in the client's best interest.

What is investment governance?

"Investment governance refers to the effective use of resources—people, policies, processes, and systems—by an individual or governing body (the fiduciary or agent) seeking to fulfil a fiduciary duty to a principal (or beneficiary) in addressing an underlying investment challenge."[1]

The investment landscape has changed over past decades. The available investment universe is increasingly complex.

Investment objectives are under scrutiny as demographics shift towards an aging and retiring population. Historically low, and in some cases negative, cash returns present difficult investment challenges for achieving investment performance in line with those investment objectives.

Investment governance is vital for investors to balance these myriad forces. The very purpose of investment governance is to help address an underlying investment issue or objective. Good governance can help achieve this by drawing effectively on the people, policies, processes and systems available to the investor. Aligning those resources to the investors' investment principles and the beneficiary's needs is a critical part of good investment governance.

1. Drew & Walk, 2019.

People

- In-source vs Out-source
- Time commitment
- Institutional expertise
- Fiduciary duty

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Policies

- Beliefs and philosophy
- Investment policy
- Investment committee charter
- Regulatory compliance

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Processes

- Strategic Asset Allocation
- Dynamic Asset Allocation
- Manager research and selection
- Risk management
- Implementation

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Technology & Systems

- Risk management
- Portfolio reporting
- Performance review
- Best execution

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Best-practice Stewardship

Fig 1: Investment governance is effectively using all of the resources available to sincerely and transparently fulfil a fiduciary duty.

Takeaway: The purpose of investment governance is to help address an investment issue or achieve an investment objective.

Figure Source: Bloomberg LP, Oreana Portfolio Advisory Service

Don't confuse investment expertise with investment governance

There is an important distinction between investment governance and investment expertise. Investment expertise is about having a clear and technical understanding of portfolio theory, investment practices and financial markets.

Investment governance, on the other hand, is about good processes, the effective use of investment professionals, clear and equitable investment policies and adoption of new technology and resources to deliver on your investment mission and objectives.

"(To) navigate the increased complexity of portfolios and short-term pressures, it is important to establish the right feedback mechanisms between governance and implementation of investment policy."[2]

Investment governance and investment expertise are complementary. They should work together to achieve a coherent, clear investment objective. But good governance separates the responsibilities between the investment function and oversight function in order to achieve best-practice outcomes.

2. Jarvis & Chua, 2018.

A three level approach can help achieve best-practice outcomes:

Level 1: Oversight body

• Focused on meeting longer term stakeholder outcomes
• Oversight of roles and responsibilities across the investment process
• Approves Policies, sets risk appetite and appoints key stakeholders

Level 2: Investment committee

• Provides Policy advice to the Oversight Body
• Decides how to allocate assets, monitors performance and managers
• Preferably an independent memeber present

Level 3: Portfolio management

• Management and implementation of the portfolio on a day to day basis
• Meeting the investment objective

Takeaway: Investment governance and investment expertise needs to work together towards a coherent, clear investment objective.

Compliance, governance and best-practice stewardship

Implementing investment governance is just a beginning.

There should be an ongoing focus on achieving best-practice stewardship—ensuring all levels of compliance, decision making,

risk management and use of resources are guided by a transparent and sincere commitment to act in the client's best interests.

This framework helps distinguish between compliance, governance and best-practice stewardship.3

- **Compliance:** Compliance includes being clear about regulatory compliance and ensuring actions do not breach those regulatory requirements. It aims to prevent illegal activity. But that is not sufficient for best-practice stewardship.
- **Governance:** Governance requires a continuous commitment to improvement, to reviewing decision making frameworks, and for managing risk.
- **Best-practice stewardship:** Best-practice stewardship is effectively using all resources – people, policies, processes and systems – to fulfil a fiduciary duty clearly and transparently, and in the client's best interests. It is an ongoing exercise within a comprehensive framework. It is a dedication to continuous improvement, robust risk management, clear accountabilities and responsibilities, and disciplined, repeatable processes with a sincere and transparent goal of acting in the client's best interests.

"Management consulting firms, business schools, and sections of the business press are pre-occupied with best-practice; the subject is increasingly important to organisations worldwide."[4]

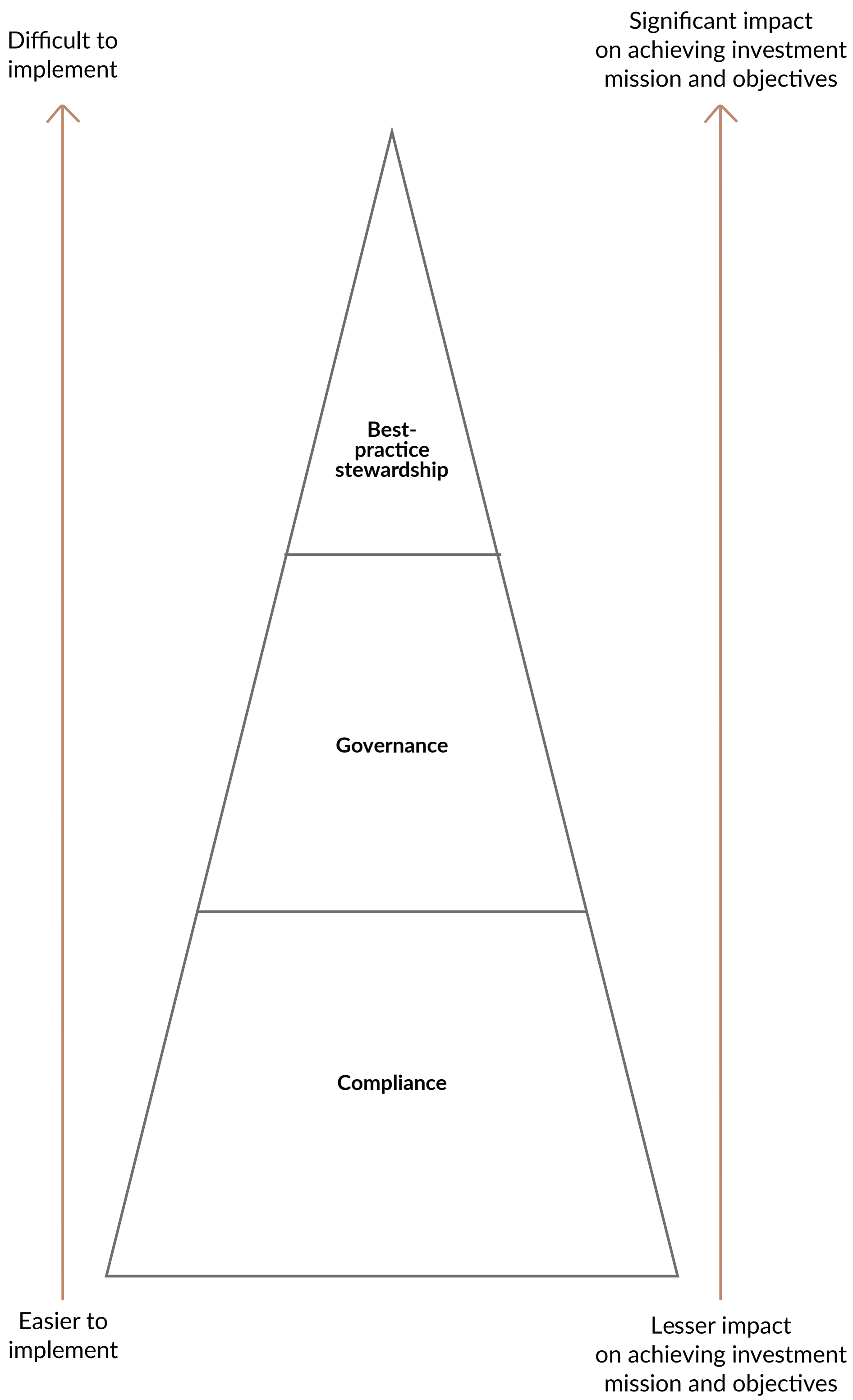


Fig 2: Best-practice stewardship is difficult to implement but important for achieving investment mission and objectives.

Takeaway: An investment governance framework should be a journey towards best-practice stewardship.

Why should I strive for best-practice stewardship?

"Failings of organisational culture, governance arrangements and remuneration systems lie at the heart of much of the misconduct examined in this commission."[5]

The recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry provides some key insight into the expectations of the Financial Services

Industry. Both the importance of governance and the quality of advice were highlighted in this report.

Commissioner Hayne's Final Report highlights that "failings of organisational culture, governance arrangements and remunerations systems, lie at the heart of much of the misconduct examined in

the Commission". Hayne further highlighted "Culture, governance and remuneration march together. Improvements in one area

will reinforce improvements in others; inaction in one area will undermine progress in others. Making improvements in each area is the responsibility of financial services entities."

Another area of focus in the Hayne report was the Quality of Advice.

The Report highlighted a range of recommendations to improve the quality of financial advice and highlighted the need to review the effectiveness of these measures, including the 'safe harbour'

provision by 2022. Regardless of the review decision, we believe an increasing area of focus will be on satisfying best interest duty.

We think that one practical way to assist Advisers continue to build the required resources around meeting the best interests of clients is best-practice stewardship.

For us that means having defensible, repeatable and documented processes that gives evidence of the adviser's efforts to serve clients and manage both the complexity and uncertainty in meeting objectives.

Strong Investment Governance and Best-practice Stewardship may provide definitive steps in providing further evidence of meeting the clients best interest.

Takeaway: Best-practice stewardship means demonstrably putting the client's interests first in every decision.

5. Commonwealth, 2019.

A commitment to best-practice stewardship is a framework that ties investment governance and investment management together. A strong governance framework

allows investors to focus on multiple time frames – in particular, the medium-term and the long-term. From this perspective, a commitment to best-practice stewardship is best treated as an investment in long-term performance rather than a short-term cost.

Risk taking is a critical part of investing. Risk taking against coherent and clearly understood investment objectives is a critical part of being well-governed. The extent to which risk taking is clear and deliberately managed at each level of the governance framework – Oversight, Investment Committee and Portfolio Management – can result in value destruction or value creation.

And the benefits of a commitment to continually improve and review the success of governance frameworks – which is a hallmark of best-practice stewardship – can be significant.

Research indicates that the impact of strong governance could be as high as 100–300bps per year.6

"While performance was not our principle selection criteria, almost all of our best- practice funds had a performance margin of 2 per cent per annum or more over their benchmarks."[7]

Takeaway: A commitment to best-practice governance frameworks can result in higher investment returns over the long-run.

6. Ambachtsheer, Pension Revolution: A Solution to the Pensions Crisis, 2007

7. Clark & Urwin, Best practice pension fund governance, 2008

A universal blueprint to improve investment governance

Investing can be complex. Taking on risk and managing risk are key parts of achieving investment objectives. Different investment objectives – reflecting risk tolerance, required rate

of return, income needs, and time frame – may require different investment strategies.

Investment governance, on the other hand, should be a clear framework that can be almost universally applied across a range of investment objectives. Like air travel, the destination might be different, but the frameworks in place to ensure passengers arrive safely at the destination can be broadly applied.

8. Merton, 2007.

In investing, as in air travel, we must select a destination (investment objective). Arriving at the destination will take time, distance and face uncertain weather (market) conditions.

Navigating the journey is critical. In investment governance, a clear and coherent investment policy helps to map the pathway.

When flying, there are many different airlines and aircraft. In investing, portfolios can be made up of different investment strategies.

Operating a passenger aircraft involves managing risk and requires qualified crew to do so safely. In investing, a strong governance framework can help select appropriately skilled investment professionals to manage the portfolio.

Even the best planned journeys can face turbulence or uncertain weather conditions. A clear monitoring and review process and risk-management strategy is essential to arriving safely. Similarly, best-practice investment governance should monitor and review the outcomes relative to the investment objective to increase the likelihood of arriving at the investment objective.

The above metaphor fails in some key respects.

First, the overwhelming majority of passengers that embark on an airplane journey arrive safely at their destination. The same cannot be said of investors. Poorly governed investments can fail to achieve their investment objective over the long run.

Second, every passenger embarking on air travel knows their final destination. Poorly governed investments may fail to coherently specify what their investment objective is!

Be aware of your governance budget

"Governance refers to all of the structures and processes by which an entity is run Notions of accountability lie at the heart of governance. Who is to be held accountable for what is done or not done? How are those who are accountable held to account?"[9]

Governance is a finite resource. Investors have a limited governance budget that they can spend. The efficient and effective use of this resource will directly impact risk and return.

The governance budget is a function of time, expertise and organizational effectiveness – or the ability to harness resources in spending the governance budget.10

The governance budget is linked to the three layers in the governance framework. Without a clear separation of roles and accountabilities, the limited time budget is likely to result in worse outcomes.

From an investor point of view, investors and Advisers should be clear about their ability to effectively spend a governance budget and manage investment implementation. Holding investment beliefs is one thing but effectively implementing those beliefs can be another thing. The more complex the beliefs the higher the required governance budget.

Being an effective fiduciary is less about the technical investment assessment and more about managing risk and overseeing a defensible, repeatable, accountable and documented process.

Time × **Expertise** × **Organisational Effectiveness** = **Good Governance**

Fig 3: Good governance requires effective use of finite resources.

Takeaway: A lack of time and expertise can result in poor governance applied across different levels of clients and higher potential for client value destruction.

9. Commonwealth, 2019.

10. Clark & Urwin, Innovative Models of Pension Fund Governance in the Context of the Global Financial Crisis, 2009.

Points of reflection for best-practice stewardship

- **How well do you know your practice's investment beliefs or philosophy? Do your clients know those beliefs or philosophy?**
- **Can you list the beliefs or present a copy of those beliefs? Can you explain clearly the implications to clients?**
- **Are your investment beliefs clearly reflected in your investment portfolios?**
- **Are your investment processes clearly documented? Are they defensible and repeatable?**
- **How does your practice define the investment opportunity set? Is it reflective of your investment beliefs and philosophy?**
- **Can you comfortably say that the investment portfolio is the best way to achieve the investment objectives of your clients?**
- **Is your approach to implementing an investment strategy the best way to achieve the objectives of your clients?**
- **Is your approach to implementing an investment strategy the best for clients? Have you considered insourcing and outsourcing parts of the strategy to improve outcomes for clients?**
- **Can you explain simply how you have aligned investment implementation with the investment policy?**

Move beyond compliance today

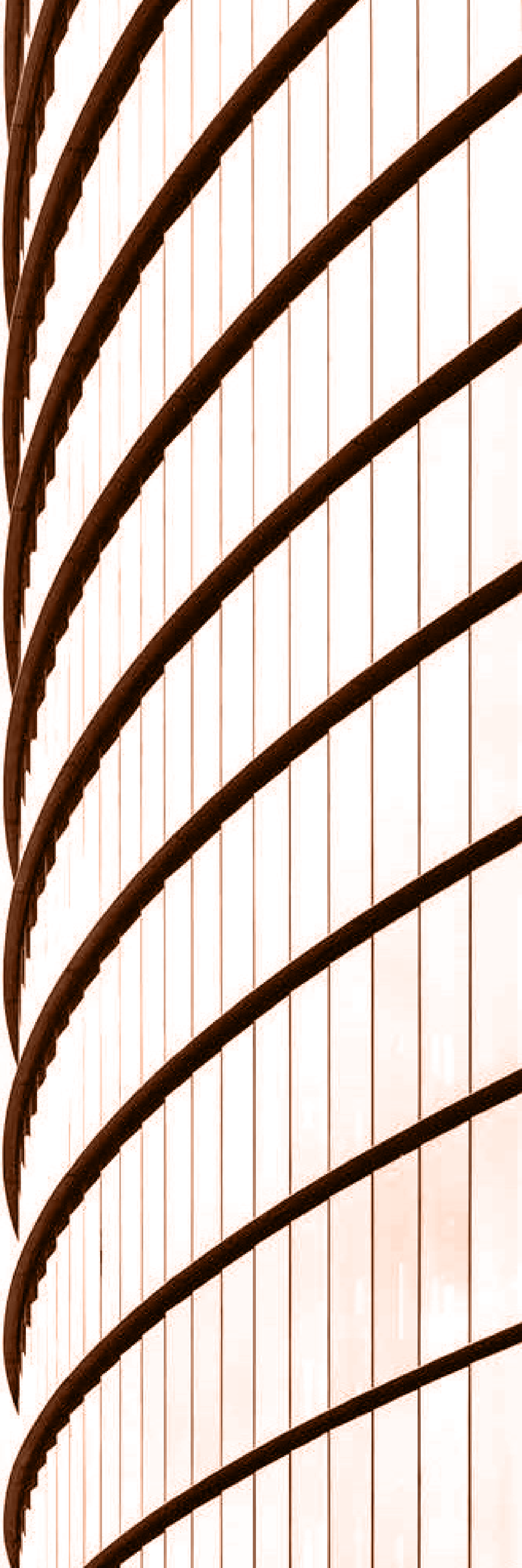
Moving beyond compliance to governance and best-practice stewardship provides a framework for ensuring all actions are in the best interest of the client. An investment

governance framework that strives for best-practice stewardship can be applied universally across businesses and clients.

Implementing these frameworks requires time, expertise and organizational effectiveness. This represents a cost that can either be insourced or outsourced to investment governance experts.

While there is a cost, this can be offset by a good governance framework adding to long-term investor returns.

Recognising this clear benefit to clients means that being an effective fiduciary– and demonstrably acting in the best interest of the client – is as much about good governance as it is about technical investment ability.



Key Takeaways

Takeaway: The purpose of investment governance is to help achieve an investment issue or objective.

Takeaway: Investment governance and investment expertise needs to work together towards a coherent, clear investment objective.

Takeaway: An investment governance framework should be a journey towards best-practice stewardship.

Takeaway: Best-practice stewardship means demonstrably putting the client's interests first in every decision.

Takeaway: A commitment to best-practice governance frameworks can result in higher investment returns over the long-run.

Takeaway: Governance frameworks should be coherent and clear, and almost universally applicable.

Takeaway: A lack of time and expertise can result in poor governance applied across different levels of clients and higher potential for client value

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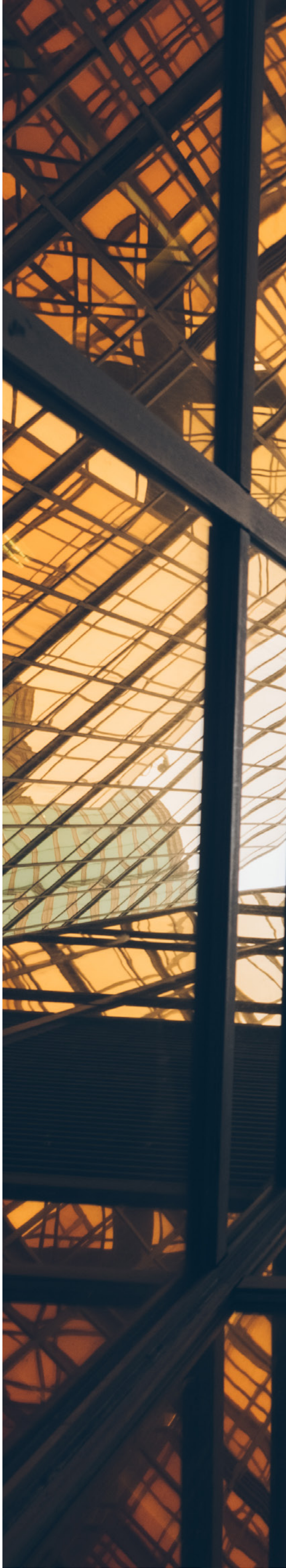

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