Ten Mistakes
in Investment Policy Development

Adapted from GEM's keynote sessions at Philanthropy Southeast's Annual Meeting and the AGB Foundation Leadership Forum

Good afternoon. In your programs, it says our topic today is *Top 10 Mistakes in Investment Policy Development*. But before we get there, we'll spend a minute building our resume and qualifications on the topic.

Our firm was founded in 2007 by investment leadership from Duke—both the University and the family foundation—to replicate the investment sophistication and governance model of the leading investment offices. We wanted to do it in a format where we could be aligned and independent, not as a consultant or an advisor, but as a fiduciary. And we *also* wanted to do it in a format where we could be focused and integrated with clients; to make the experience as similar to Duke's—with its in-house investment team—as we could.

Since GEM's inception, we have probably seen over five hundred Investment Policy Statements—from clients, prospective clients, peer institutions, and the boards that we sit on personally. Though they're varied in length, style, and level of detail, we've observed that there is a consistent and recurring set of issues. They relate to Purpose, Governance, Construction, Evaluation, and Alignment.

Why is it important to identify investment policy pitfalls?

The Investment Policy Statement is the governing document for your investment program. It is the first—and arguably last—line of defense against muddled thinking, behavioral mistakes, and a misalignment of risk that can undermine long-term objectives. For organizations that hope to successfully execute an investment program into perpetuity, a well-constructed Investment Policy Statement is a prerequisite.

Why are we focusing on mistakes?

There are two reasons: First, our industry is inundated with "best practices" that, from our experience, are often honored by institutional investors more in breach than in observance. The second is that there's no template or cookbook for these documents. Investment policy design relies on asking the right questions and codifying clear answers. Thus, our goal here is not to lecture you to eat your vegetables, but to shine a light on a few ways that thinking can go awry and spoil sound stewardship.

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Get The Purpose Right

Mistake 1: An Undefined Purpose

Institutions too often neglect to clarify the purpose of the investable capital.

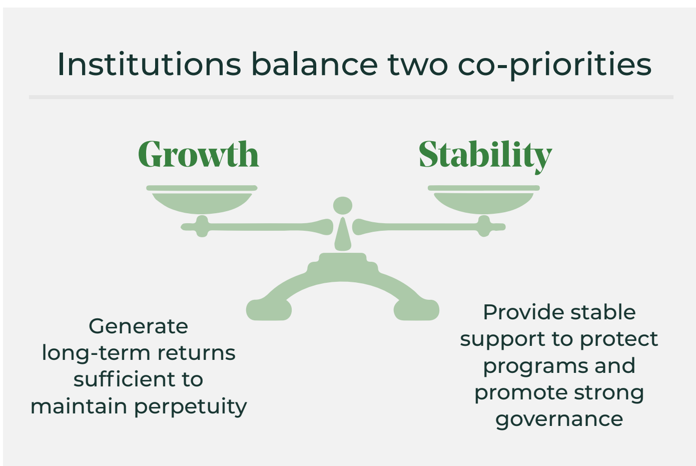
Ask yourself: What is this capital meant to do? To what ends is this money the means? Its purpose is not merely to beat benchmarks or peers, but rather to fund philanthropy or scholarships or payouts to beneficiaries now and in the future.

- Does the capital support a fixed portion of a dynamic annual operating budget?
- Is the goal to grow the fund to enhance the institution's reach and prestige?
- Is it to fund episodic research or grants?
- Does it serve as a rainy-day resource?

These distinctions have significant implications for how capital is invested, so it is important to establish the capital's role in the context of the broader mission. Otherwise, you risk becoming untethered from your long-term objectives.

Mistake 2: Vague Investment Goals

Another area of vagueness that we commonly see is with investment goals. We often see investment goals articulated as something like: *"The goal is to preserve and grow, without taking undue risk."* First, preserving and growing are different objectives. Which comes first? Second, how is "undue risk" defined and/or quantified? What types and degrees of risk is the institution willing to incur in pursuit of its goals? How much shortfall risk, drawdown risk, illiquidity risk, and tracking error can you and the organization bear? We've found that risk aversion is the most consistent, time-unvarying attribute of people and organizations.



Do not fall prey to semantic ambiguity. "Taste great, less filling" sounds terrific and is easily agreed on by committees and boards, but it's a devastatingly imprecise way to think about real portfolio tradeoffs.

Ultimately, all investment goals should be well-defined, quantified, and rank ordered. Investment goals have to be right for, and aligned with, the unique needs of each institution. Clearly defining these goals is critical to ensuring everyone is on the same page.

Get The Governance Right

Mistake 3: Unclear Roles and Responsibilities

Investment programs have many stakeholders: staff members, committees, boards, advisors, etc. Because they all have a keen interest in the program's success, it is critical to spell out where the discretion lies for each stage of the process, including budget planning, advancement, and other adjacent activities. Failing to do so may mean that oversight can fall through the cracks, have inefficient overlap, or become detached from organizational needs.

Moreover, it's important to ensure that the governance model you've chosen matches stakeholder expectations and responsibilities. For example, if you choose to outsource the discretion of portfolio decisions, don't imply that committee members can opine on manager selection. Don't confuse or conflate management or execution with good oversight or governance.

	Roles			
	Board of Trustees	Investment Committee	Finance Staff & Management	OCIO/Investment Advisor
Responsibilities	✓			
Establish and approve the IPS				
Developing an appropriate spending policy				
Engage with OCIO to understand and review portfolio implementation at a pre-defined cadence				
Evaluate OCIO performance with respect to the objectives and guidelines in the IPS				
Maintain discretion and authority to manage the assets consistent with the IPS				
Uphold records of committee meetings and work				

Get The Construction Right

Mistake 4: Under- or Over-Diversification

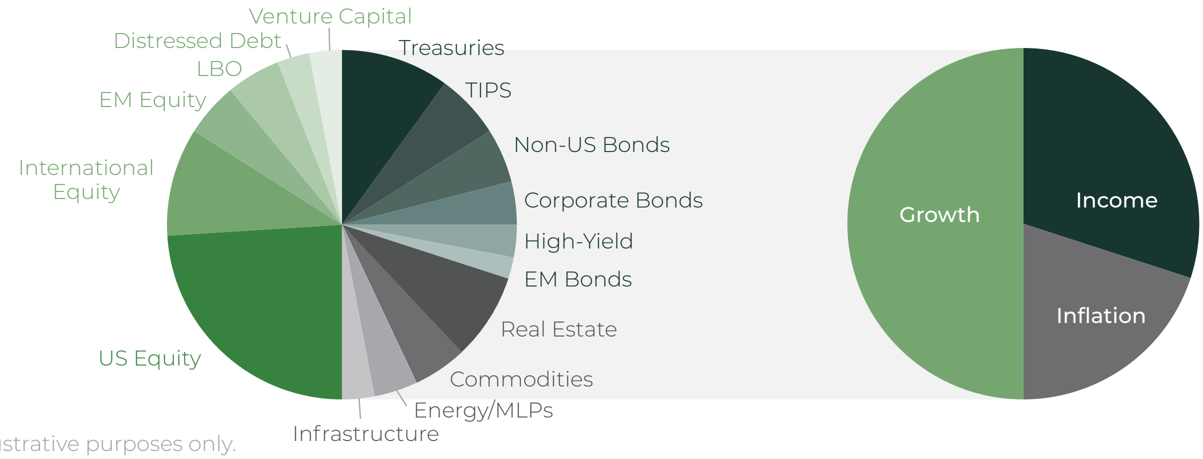
Most asset classes respond in fairly predictable ways to two prevailing economic variables: **growth** (how fast the economy and corporate earnings are growing) and **inflation** (how fast consumer prices are climbing). For example, commodities and real estate have historically tended to perform best in high-inflation, high-growth periods, while low-growth, low-inflation environments tend to favor Treasuries. In high-growth, low-inflation—the Goldilocks zone—stocks and high yield debt tend to outperform. There's nuance here, of course, but we've observed that too many policy statements are not sufficiently balanced across various economic environments, instead perhaps leaning too heavily into the Goldilocks zone.

Some of that is learned behavior—we hadn't experienced inflation for 40 years until 2021. Some of it is because stocks and bonds have been so reliably negatively correlated, which made broader diversification unnecessary. But don't give up the ship. We believe diversification *is* absolutely critical over a full cycle—there should be something in your portfolio that's working *at all times*. If there isn't something in the portfolio that leads someone to ask every quarter why on earth you're continuing to hold it, you're not diversified.

However, there is a limit to diversification. We see other policy statements that stipulate 15 different asset types: large cap US stocks, foreign stocks, emerging stocks, global macro hedge funds, event-driven hedge funds, large buyouts, small buyouts, venture capital, high yield debt, emerging market debt, investment grade debt, and on and on and on. The reality is that most of these are pseudo-asset classes, meaning that, while they may appear (in benign environments) to offer diversification benefits, those benefits often disappear in times of market stress or drawdown when diversification is needed the most.

Committees should seek to tie policy allocations to a set of assets that are fundamentally discrete and balanced across economic regimes. Optimal diversification should insist on efficient portfolio balance.

Myth: Asset Classes = Diversification



Note: For illustrative purposes only.

Mistake 5: Assuming Historical Correlations Will Hold

Ideally, a portfolio manager has as many independent sources of return as possible. Portfolio returns are simply the weighted average of the returns of the portfolio's assets. And portfolio volatility goes down as long as the portfolio's assets aren't perfectly correlated. That is the power of diversification.

However, two things can happen:

1) An asset's *properties* can change. If the market recognizes an asset type as having certain diversification benefits, the asset is likely to be bid up and its properties fundamentally changed. This was the case with international real estate in the 1990s, and again with commodities in the early 2000s after Goldman Sachs famously published a paper on the topic.

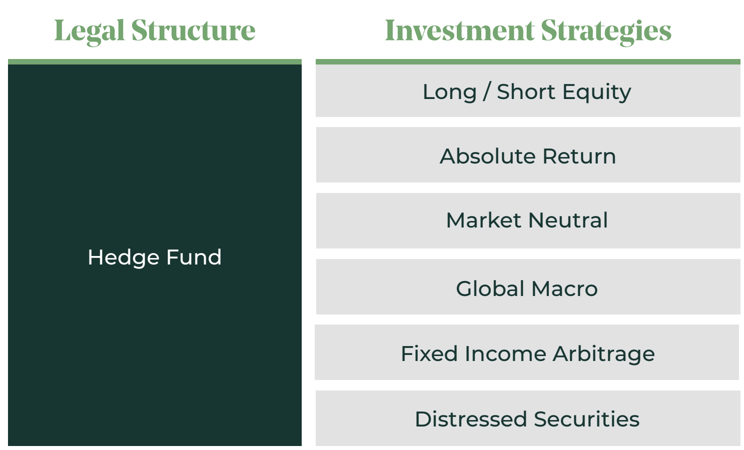
Once an asset changes from something that is the domain of one type of asset owner—producers and buyers, in the case of commodities—and made the province of another type of asset owner—here, every long-term capital allocator and trader—the properties of its pricing and correlation pattern are likely changed forever.

2) The *environment* can change. For decades, we were taught that stocks and bonds move in opposite directions. However, in 2022, this historical relationship was tested as inflation hurt both stocks and bonds in tandem. After a decade of zero interest rates, inflation even hurt real estate because of higher funding costs.

Consider whether the historical data used to justify a particular mix of assets is from a relevant market environment. As long-term investors, our job is to plan for a wide range of possible future states of the world.

Mistake 6: Mistaking Legal Structures for Investment Strategies

It is not uncommon for *products* to be inadvertently conflated with *asset classes*, and hedge funds are a great example. If a manager is categorized as a "hedge fund," what is its investment strategy? What risks does it contribute to a portfolio? There is no objective answer because the "hedge fund" category includes a dizzying array of distinct strategies: long/short equity, absolute return, market neutral, global macro, multi-strategy, managed futures, fixed income arbitrage, and distressed securities, to name a few.



Given the wide variety of underlying investment strategies, there is no one environment when hedge fund performance, in aggregate, can be anticipated ex ante. Some benchmark providers do a decent job—less some survivorship issues—reporting industry performance ex post, but that isn't useful to people trying to decide how much to allocate to hedge funds.

Categories like hedge funds are merely *expressions* of risks, so it is critical to look through to the strategy, and further to the underlying positions, to understand how those risks fit into a portfolio.

Mistake 7: Confusing Beta and Alpha

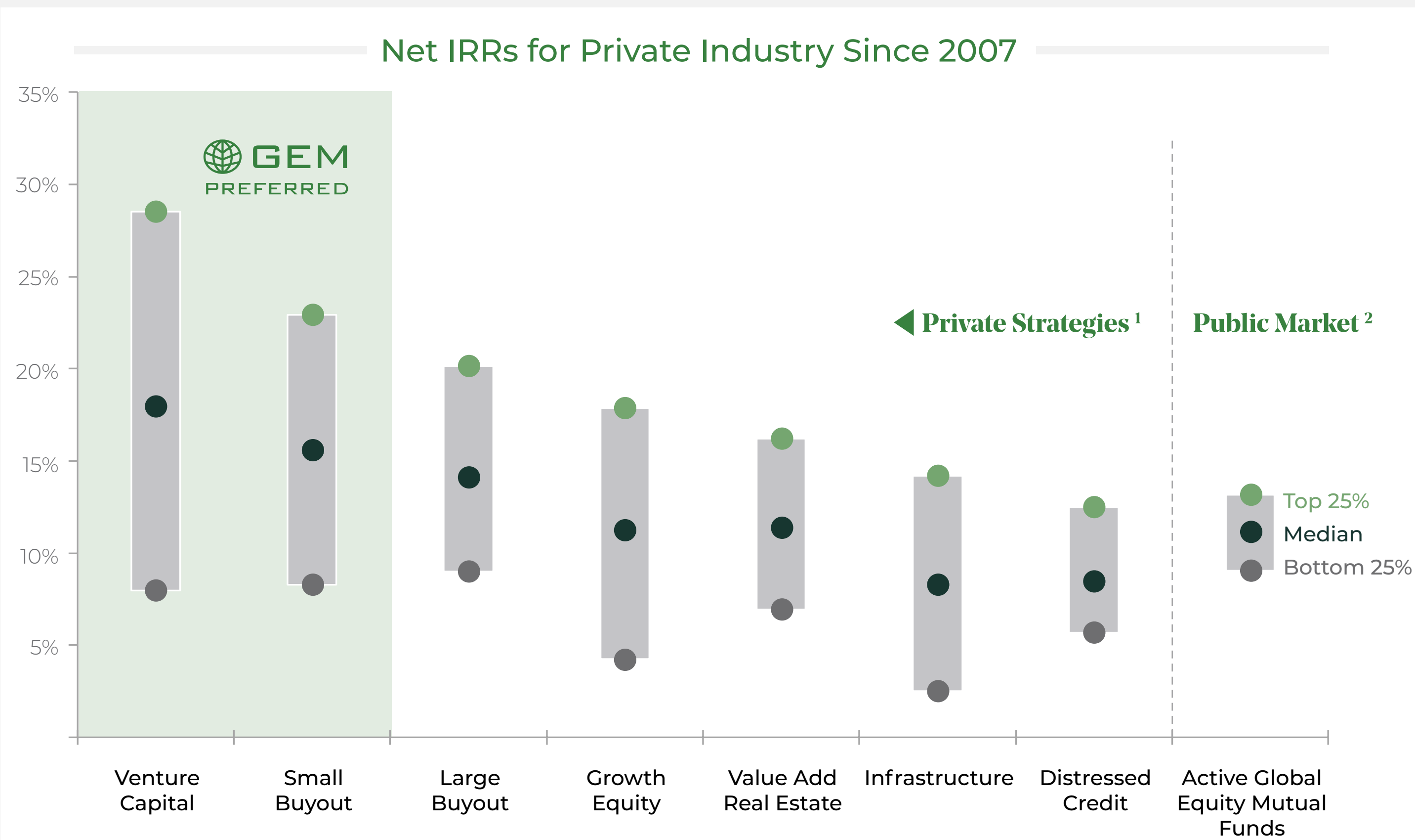
Private equity is another segment that is often treated, for risk purposes, as a distinct asset type relative to its public counterparts in Investment Policy Statements. But, in our view, private equity no longer offers a net-of-fee premium to public markets. It may have in the past; the vaunted illiquidity premium may have existed at one time when purchase prices were lower in private markets than in public. As the asset class has become institutionalized, fund sizes have grown, and industry valuations have converged with public markets.

Thus, it begs the question: *If the underlying beta—the fundamental equity risk that contributed to the portfolio—is the same for private and public equity, what's the role of the private form?*

Private equity (and other alternative assets, for that matter) are simply rich opportunity sets with high dispersion between those who can outperform and those who cannot. For private equity, in particular, manager alpha generation comes from rigorous sourcing of opportunity, good transaction structuring, post-acquisition value creation, and exits. Allocator alpha comes from deep networks and strong selection skill.

The goal is to clearly separate the opportunity set as a source of alpha, and the asset type for the risks that it contributes.

Private opportunity sets = high alpha potential



1. Source: Burgiss as of 3/31/2022. Depicts Burgiss net IRR for 2007-2015 vintage funds globally.
2. Source: S&P SPIVA Report as of 12/31/2021.

Get The Evaluation Right

Mistake 8: Lacking Specific Benchmarks and Time Periods

Our industry's one universal output is performance. Every investor, regardless of the strategy employed, is obligated to measure and report returns, and over the very long term it's really the only output that matters.

But the interpretation of those returns can be perilous. Suppose, for example, that a university endowment returned +5% for the previous fiscal year. What does +5% mean? Is that good? To help clarify, consider the following questions:

- Against what benchmark should the performance be compared?
- Is the benchmark an absolute number, such as 5% plus inflation, or is it market-relative?
- What's the appropriate market-relative benchmark? Is it representative of the risk taken?
- What drove the out- or underperformance? Are there asset classes that should be measured individually?

Once you establish *what* the benchmark is, you must then determine *when* to evaluate it. As tempting as it can be, quarterly performance and even annual performance does not provide enough time to let the portfolio perform. Institutions need mileposts, but they should be rooted in process, not performance (think *inputs*, not *outputs*). The longer you can wait to measure results, the better. Consider adding seven-year, ten-year, or even fifteen-year evaluation periods to ensure that performance is measured over a long-term proxy and through a complete market cycle.

These key questions on *types* of benchmarks and *timeframe* of benchmark evaluation should be clearly answered in an IPS. A lack of clarity and confidence around benchmarks and timing can make committees susceptible to moving the goalposts for evaluation, which can spell disaster for stakeholders.

Mistake 9: Too Much Backseat Driving

Within the Investment Policy Statement, we've found that some committees attempt to legislate around almost *all* possible states of the world. We see people stipulate acceptable asset types, exact bond duration, a target Chinese yen allocation, or required rebalancing mechanisms. While we understand discipline, you will likely be hard-pressed to find a leading investment office who ties itself to such rigid guidelines.

We tend to agree with the consultant and writer Charley Ellis' view: "The purpose of an Investment Policy Statement is to protect us against ourselves." The document should not try to preordain decisions that are better made by a dedicated team exercising its professional judgment. Instead, an IPS should offer investors some discretion to position the portfolio for the real world, to react to novelty and regime shifts, and to implement flexibly, especially if they expect to win over time with active management.

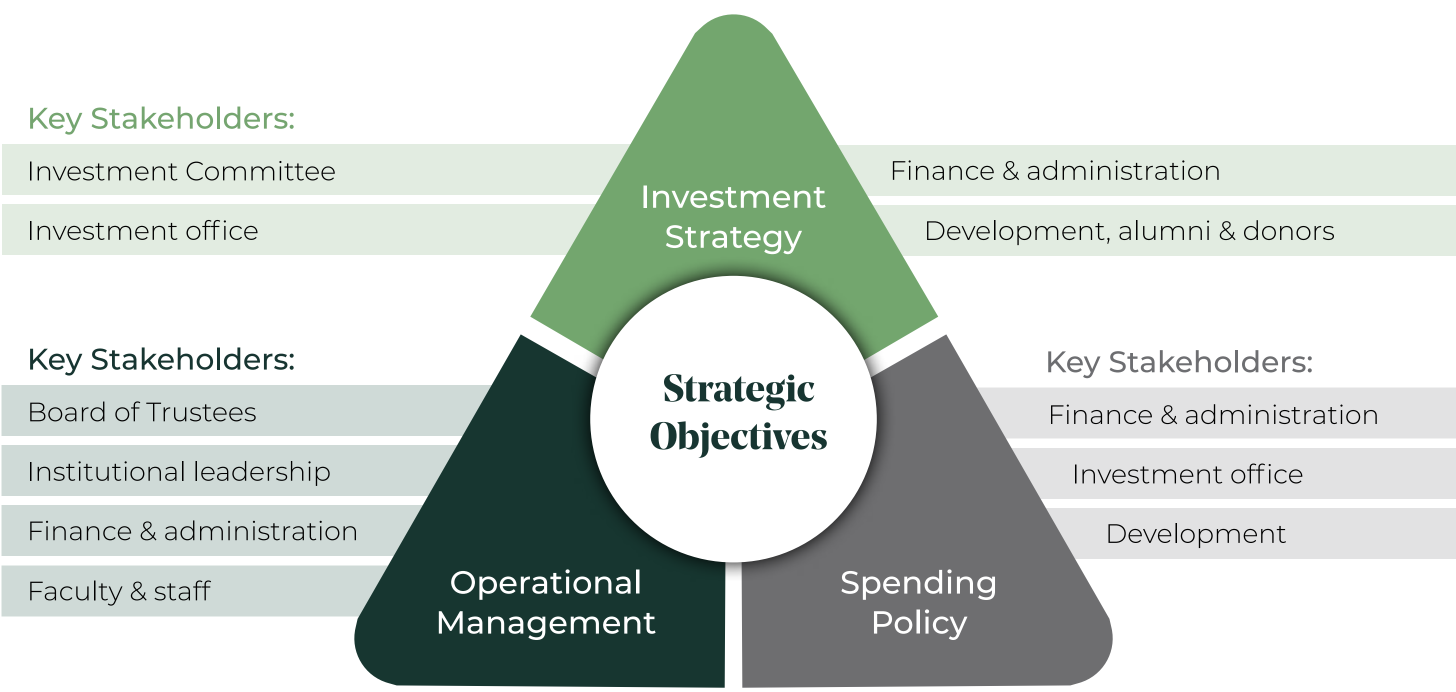
Get The Alignment Right

Mistake 10: No Linkage Between the Institution, the Spending Policy, and the IPS

We often observe committees thinking about their investment strategy *in isolation* instead of *in conjunction* with spending policy and broader operational management. To better align these three priorities and prevent silos, committees can ask themselves questions like the following:

- Is the investment strategy aligned with the strategic objectives of the institution?
- Is the investment strategy aligned with the advancement strategy?
- Is the investment strategy aligned with the committee's philosophical views?
- Do the committees understand the implications of spending policy on the investment strategy and risk management framework? If so, are the two integrated deeply with operations or grantmaking teams to balance investment goals and the operational flexibility that might be required to achieve them?

Further, considering these policies holistically has the behavioral benefit of being able to shift support for mission between these points of the below triangle. For example, if the endowment is going through a challenging period, the spending policy can offset some of that volatility and support operations and grantmaking.



Conclusion

The goal for an Investment Policy Statement should be to create a living document that supports good governance and the unique needs of your institution—not the institution's needs up the road, or anyone else's. As you review your IPS, consider this litmus test: Could a casual observer with limited investment experience pick up the document cold and mostly implement the program correctly? If not, there may still be some work to do because, at some point in the future, that precise scenario will likely play out. A new board, new executive director, or new advisor will step in with the need to carry on the program—and will look to the IPS as a North Star.

So, review your Investment Policy Statement:

- Get the purpose right
- Get the governance right
- Get the construction right
- Get the evaluation right
- Get the alignment right

Ask questions, and push for clarity.
Institutional mission, perpetuity, and all current and future beneficiaries depend on it.

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About GEM

GEM is a leading provider of institutional investment solutions for endowments, foundations, sovereigns, families, and other long-term investors. Since 2007, GEM has specialized in delivering the highest quality service and support to our clients, enabling them to achieve their long-term investment goals. With a global reach, broad investment capabilities, and an experienced team, GEM strategically tailors solutions to meet the unique needs of each investor we serve. For more information, visit www.geminvestments.com.