The 10 Essential Elements of Investing

Essential Element 4
Simplify

Beaver Investing

The investment guide for Canadian foundations and charities
Third edition

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In this paper, we emphasize that investing, to use Warren Buffett's phrase, is simple but not easy. Some of the less easy parts involve defining the universe of investments from which to select (investment selection); dealing with advisors and intermediaries who want to make things more complex than they are (investment industry); and governing the investment program, so that the investment plan remains true to purpose over the long term (investment governance). We will look in turn at investment selection, industry and governance, showing that simplicity is the ultimate sophistication.

Investment selection

Foundations and charities can avoid complexity and cost by simply refusing to go with alternative investments. Real estate, hedge funds and venture capital require tremendous breadth and depth of investment knowledge and are generally suitable only for institutions with assets of $1 billion or more. For investors in hedge funds and venture capital, a small number of investment managers produce almost all of the returns and on average returns are low or even negative – poor compensation for high fees, lack of transparency and long holding periods. For small and medium institutions, alternative investments would be more aptly described as alternatives *to* investments.[1]

At a stroke, investment selection is now much simpler. However, there are many ways of being diverted from the simple but profound importance of asset mix (the blend of stocks, bonds and cash in the portfolio). Institutions can easily be diverted from asset mix by over-thinking asset classes or security selection. A portfolio might have a 20% allocation to US stocks. The simplest and cheapest way to gain this exposure is by investing in an index fund that tracks the Standard and Poor's 500 index of US stocks. Instead, institutions could drift into a more complex approach and allocate their US stocks to four different managers – one managing small-capitalization stocks, one managing high-technology stocks, one managing high-divided stocks and another managing distressed stocks. Each manager might easily have a portfolio of 50 individual securities. The 20% exposure to US stocks, instead of being represented by a single index fund, is now comprised of perhaps 200 individual securities, where each stock represents 0.1% of the portfolio. Institutions are likely to get drawn into discussions about a myriad of individual investments, focusing on one company's new product launch or another company's accounting scandal. If they are not careful, this will cause them to forget that the purpose of the whole 20% is to get exposure to US stocks, as distinct from Canadian stocks or international stocks. Complexity can make institutions forget why they invest in an asset.

Investment industry

Small and medium institutions can avoid a great deal of complexity and cost by refusing to work with investment consultants (firms that help to select and monitor investment managers) and refusing to work with multiple investment managers. Here are the two simplest approaches for these institutions:

Approach one: Manage their own portfolio. Buy a portfolio of stocks and bonds, using low-cost, broadly diversified index funds. This is a perfectly fine approach, as long as investors set the right asset mix to achieve long-term objectives and can tolerate losses of 20-30% in a bad year without abandoning their plan. This approach is simple, although following it is not easy.

Approach two: Hire one investment manager. The manager should follow a broadly diversified, low-cost and risk-managed approach. Instead of monitoring several investment managers with complex and changing approaches to the market, institutions can build a long-term relationship with a single manager who follows a clear and consistent process.

The most complex approaches in the investment industry involve first paying an investment consultant to select a range of investment managers and then monitoring the investment managers who will typically charge high fees but struggle to match not only the performance of a market portfolio but even struggle to follow their own approach. In contrast, managing one's own portfolio or partnering with a single low-cost investment manager are approaches that are simple, low-cost and much easier to govern.

Investment governance

In overseeing or governing the investment program, simple roles, plans and meetings make a world of difference to the long-term investor. The discussion below previews some of the points we will explore in Essential Elements 8-10, where we focus on governance.

Simple roles are about who will govern and manage the investment program. For a small institution, the decision would often be that the board of directors will delegate the investment committee to govern the investment program (including setting the asset allocation, risk tolerance and performance evaluation process), while the executive director or finance director will manage the program (including quarterly portfolio monitoring and cash management in support of the spending policy). Being clear on who is doing what is critical in developing and keeping an investment program on track to achieve its long-term objectives, especially for small organizations where roles can easily get blurred.

Simple plans can be surprisingly sophisticated. A complex investment plan often covers the what and how of investing, while saying little or nothing about why institutions invest the way they do. For example, if they do not explain the reasoning why full currency exposure to US stocks is desirable (that the US dollar can rise during stock market turmoil and help to reduce risk for Canadian investors), then the investment committee might be tempted to constantly revisit the currency hedging decision, reacting to the short-term fluctuations of the Canadian dollar. In contrast, once this decision is made and the reasoning behind the decision is explained in the plan and shared with current and future committee members, the institution has a consistent process that the committee will be able to govern over the long term.

Simple meetings promote clarity and consistency. Below is a simple but thoughtful agenda for an investment committee meeting:

1) Review investment and spending policy. The default is that no changes are required, so changes are by exception.

2) Review performance. Performance can be reported quarterly but should be evaluated only annually (preferably over five-year periods), to maintain an appropriately long-term perspective.
3) Understand the process. For example, a committee decides over the course of four meetings to explore one of the stock investment strategies, to better understand its strengths and weaknesses over the long term.
4) Explore a learning theme. For example, a committee decides over the course of four meetings to explore the effect of inflation on long-term returns, learning how other institutions have addressed this in their investment policy.
5) Discuss other business. Address points raised by committee members, the executive director or the investment manager. Where possible, these points should be submitted in advance with a clear question, to encourage thoughtful reflection and discussion.

We suggest that the quarterly investment committee meeting should include extended learning and reflection on points 3-5 and only summary discussion of points 1-2, deferring evaluation of performance to the annual meeting. This replaces the usual focus on short-term performance with sustained reflection on the investment process. For institutions investing for the long term, process sets up performance.

Conclusion

Let's picture the opposite of simplicity. Imagine institutions have a complex way of selecting investments, where they hold stocks in hundreds of companies that have been individually selected for various reasons at various times; a complex way of navigating the investment industry, where they pay a consultant to select and monitor a range of different investment managers who follow highly discretionary strategies; and a complex way of governing the investment program, where they have ad hoc roles, plans and meetings.

As an investment committee member or executive director at a small or medium institution, which approach would you prefer – complex or simple? If you'd prefer a simple approach but don't have one, why do you think that is?

[1] Ben Carlson, based in part on his experience at a college endowment in the United States, highlights the cost, complexity, risk and illiquidity of alternative investments, together with their low returns over the last decade.
http://awealthofcommonsense.com/2019/02/simple-vs-complex-2018-edition