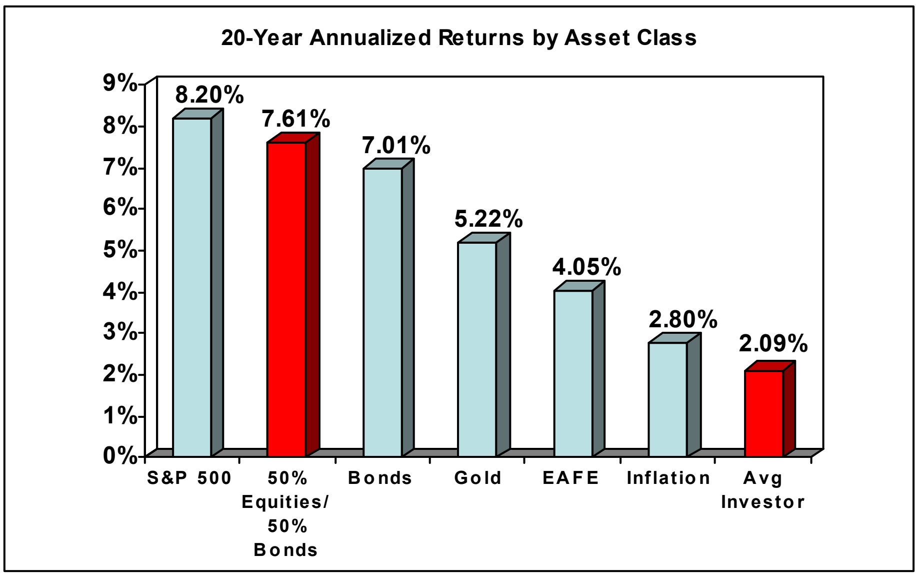
October Topic of Interest

"Time and effort spent on tasks to improve your organization's investment returns will be wasted if you do not have an effective decision making process in place."

- Michael Stellato, Senior Consultant at The Concord Advisory Group, Ltd.

A recent Dalbar study of investor behavior during the twenty year period ending 12/31/2009, reveals that the average investor with a 50% equity / 50% fixed income asset allocation has achieved an annual return of just 2.09% over the period.

The chart below compares the average investor's return to the average returns of several major asset classes for the period 1 /1/1989 - 12/31/09.



The Dalbar study shows the average investor's returns are in stark contrast to what you would expect from a 50% equity / 50% fixed income asset allocation. To put this in perspective, an average investor with a beginning portfolio value of $10 million would have ended this 20-year period with a portfolio value of $15.1 million. In contrast, a similarly sized portfolio that experienced index-like returns would have been worth $43.3 million at the end of the 20-year period. That is a difference of over $28 million! What accounts for this vast difference in expected and actual returns? It likely has to do with investor's decision making processes.

Investment committees are prone to some behaviors that lead to sub-optimal investment decisions:

- **Anchoring:** Relying on only the most recent information available to predict the future.
- **Loss Aversion:** Tendency for individuals to strongly prefer avoiding losses than to acquiring gains.
- **Following the Crowd:** Peer pressure to act similarly to other organizations.
- **Groupthink:** Avoiding conflict in order to maintain consensus.
- **Confirmation Bias:** Using information that confirms thoughts while discarding information that conflicts.

The key to avoiding these behaviors is to develop an effective investment committee decision making process. This starts with establishing and documenting the roles and responsibilities for all parties involved in the process, including organizational leadership and staff, and the investment committee itself. An evaluation of the size and makeup of the committee is the first step to improving group decision making. Ideally, committees should consist of five to seven members with a diversity of expertise, personalities, careers, and ages. The best decisions can be made in a group where everyone is comfortable making their opinion known and no lone voice dominates the process. Too few committee members may prevent dissenting opinions from being heard during the decision-making process. Conversely, too many committee members may result in continual deadlock as consensus is unable to be achieved.

To be effective, an investment committee needs to be forward-looking, rather than backward-looking. Although important, less time should be spent on backward-looking topics such as past investment performance. Debating issues such as asset allocation, manager selection, and the effect the overall market environment has on the portfolio is the best use of the committee's time since these topics have the biggest impact on future performance.

It is the job of the committee leader to continually drive the decision making process forward by fostering open communication among members while maintaining focus on the agenda and specific objectives for each meeting. Many times investment committees can not accomplish this without guidance from outside the committee. An independent investment consultant can be hired to guide the decision making process. When hiring a consultant look for one that has experience working with investment committees, one that is familiar with avoiding the behavioral pitfalls. Make sure the consultant you hire will put your organizations best interests' above their own. A qualified investment consultant's fee should be offset by lower structural costs and/or increased investment returns.

Ensuring that you have an effective decision-making structure in place will enhance the investment committee's ability to perform its fiduciary duties. Taking these small steps to better decision-making will allow you to close the gap between the average investor's returns and returns you could be experiencing.

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