Over the past 15 years a number of institutional investment research studies have studied barriers to investment excellence or problems of implementation slippage. These research studies have noted a host of issues that appear to lead to poor performance in investment funds. The common theme is that investment underperformance is a symptom of ineffective decision-making or poor governance practices.

Despite the fact that these research papers are common knowledge, that pundits/consultants have offered many good solutions, and that investment fiduciaries know what should be done, poor governance practices persist in the institutional investment industry. The result is that the average Canadian institutional investment fund pays active management fees for passive performance or underperforms. When investment solutions are known but most fiduciaries fail to respond, it’s a good time to search for answers in other disciplines. Is this type of ineffective behavior common in most industries, or is it common only in institutional investing? To answer that question and others, this paper sought guidance in two relevant disciplines, organizational behavior and corporate governance.

Introduction

In 1999 Jeffrey Pfeffer, a professor of organizational behavior at Stanford’s Graduate School of Business, and Robert I. Sutton, a professor of organizational behavior at Stanford’s School of Engineering, co-authored The Knowing-Doing Gap. In short, they noted, “Time after time people understand the issues, understand what needs to happen to affect performance, but don’t do the things they know they should.” The problem was deemed not solely one of analysis (a lack of knowledge) but rather one of poor implementation (a lack of discipline or appropriate process). Based on these introductory comments, it appears that the institutional investment industry’s failure to deal with governance issues is not unique.

This paper applies the precepts of Pfeffer and Sutton’s insights about organizational behavior to investment management in a quest for practical solutions to governance problems that have long plagued institutional funds. In short, it attempts to provide fiduciaries with a competitive advantage by recommending positive action.

The Knowing-Doing Paradox

Pfeffer and Sutton explore one of the great mysteries of organizational management: “Why knowledge of what needs to be done frequently fails to result in action or behavior consistent with that knowledge.” They call this the knowing-doing problem—the challenge of turning knowledge about how to enhance organizational performance into action consistent with that knowledge.

Even though companies pour billions of dollars into training programs, consultants, and executive education, the so-called knowledge advantage often is a fallacy. This isn’t because knowledge isn’t important. It’s because most companies know, or can know, the same things. Moreover, even as companies talk about the importance of learning, intellectual capital, and knowledge management, they frequently fail to take the vital next step of transforming knowledge into action. The Knowing-Doing Gap confronts the paradox of companies that know too much and do too little.

Research demonstrates that the success of most interventions designed to improve organizational performance depends largely on implementing what is already known rather than from adopting new or previously unknown ways of doing things. The “Best Practice” hints were actually well-known practices, with the extra dimension that they were reinforced and carried out reliably in better performing organizations. They are in fact common sense. Yet it is interesting how uncommon common sense is in its implementation.

What is done is not so important as why and how it is done (the underlying philosophy of the people/business that provides a foundation for the practices). Attempting to copy just what is done—the explicit practices and policy—without holding the underly-
ing philosophy is a far more difficult task and is less likely to be successful. Competitive advantage comes from being able to do something that others don’t. Anyone can read a book or attend a seminar. The trick is turning that knowledge into organizational action. If you and your colleagues learn from your actions and behavior, then there isn’t much of a knowing-doing gap because you “know” on the basis of “doing” and implementing that knowledge is substantially easier.

Pfeffer and Sutton outline numerous barriers to performance in organizations. The five main barriers are the following:
1. When talk substitutes for action
2. When memory is a substitute for thinking
3. When fear prevents acting on knowledge
4. When measurement obstructs good judgment
5. When internal competition turns friends into enemies

Barriers to Action in Investments

Many issues outlined in *The Knowing-Doing Gap* seem relevant to the investment industry. The balance of this paper will address whether the barriers listed exist within the investment industry. If so, can these barriers be lowered or eliminated? What do the facts in the investment fund industry show? If similar barriers do exist in the investment industry, then perhaps the same guidelines for action outlined in *The Knowing-Doing Gap* can be applied to limit their influence.

Best Practice to Narrow the Knowing-Doing Gap in Investments

Pfeffer and Sutton noted there are no simple answers or easy solutions. Nonetheless, they described some evident recurring themes and outlined eight guidelines for action, as follows:
1. Why before how: philosophy is important;
2. Knowing comes from doing and teaching others;
3. Action counts more than elegant plans and concepts;
4. There is no doing without mistakes;
5. Drive out fear;
6. Beware of false analogies;
7. Measure what matters;
8. Leaders know how to spend time and allocate resources.

They concluded that organizations that can turn knowledge into action avoid the “smart talk trap.” Executives must use plans, analysis, meetings, and presentations to inspire deeds—not as substitutes for action. In short, the co-authors realized the importance of governance but arrived at the same solution as the investment pundits/consultants from a different perspective, organizational behavior. This paper therefore will put forth a number of practical actions or processes to limit barriers to action and narrow the knowing-doing gap in investments through better governance.

Governance is about assigning the authority to make decisions to ensure the organization is run effectively. Although regulatory compliance isn’t always easy, the real challenge is performance. Effectiveness is a function of the quality of the process rather than the time devoted to it. Few would debate that a properly governed investment fund has a much better chance of delivering the investment promise. John McCallum, professor of finance at University of Manitoba, points out that more probably goes wrong in the design phase than anywhere else: “A badly flawed investment mandate is often an accident waiting to happen.”

The investment mandate drives the standards that fund sponsors use to judge success. Each individual within the organization must have focus and understand the fund’s overriding investment objective and their role in its achievement. Action is required when performance continually and meaningfully appears to fall short of that objective.

Don Ezra, director of strategic advice at Russell Investments, identified the following four areas that need addressing to implement governance best practices in the investment industry.

1. Governance must be an explicit rational focus.
2. Fiduciaries need to know what is important.
3. They need to work as a team.
4. Use a long-term multidimensional framework for evaluation.

All four, although distinct, often are interrelated. Let’s delve into each of these broad areas and offer some practical observations and time-tested advice.

Governance Must Be an Explicit Rational Focus

For governance to be an explicit rational focus there must be unambiguous accountability, where each party knows its responsibilities and constraints but does not encroach on other territory. The investment board and/or investment committee (trustees) must recognize that their primary role of higher level decision-making is to set strategic direction and objectives, determine broad risk management policy, and perform fund oversight to track progress in achieving the primary investment goal. As part-time members of the organization they must acknowledge the limitations of time and recognize the need to delegate extensively to full-time staff and third-party providers with greater investment expertise and a full-time focus on investments. Effective delegation relates in particular to day-to-day operational issues but also, in many cases, to formulating strategies and tactics. All too often these trustees underestimate the resources required for successful strategic analysis and implementation. A logical framework will evaluate each and every issue based on the skills required and determine whether those requisite skills exist or need to be acquired (internally or externally). Insiders tend not to trust outsiders (or other insiders in some cases) and can fail to provide them...
the necessary power to facilitate change. However, without fresh eyes and outside experience, insiders may not be able to achieve success on their own.

In addition, trustees need training, development, and regular appraisal. Trustee performance demands a learning approach that continuously refines competencies that will add value. The mandates that govern trustees must be rigid and specific enough to keep them from meddling in operational issues but flexible enough so that they challenge but don’t stifle creative strategic thinking. A culture in which direct, serious, and important questions are asked and plainly answered ensures trust between trustees and staff. In short, mandates must be clear and focused with all fiduciaries (including staff) understanding their roles. In particular the role of the board, the chair, and the investment officer should be clearly defined. If the trustees and senior managers are going to trust each other, each must know their roles and limits. The role of the chair, as defined by Larry Tapp, former dean at the Richard Ivey School of Business at the University of Western Ontario, is to do the following:

- Build a strong, effective, well-balanced, and representative board and committees.
- Set the board agenda and schedule meetings.
- Manage the affairs of the board.
- Ensure all committees are working effectively.
- Head the evaluation of the chief investment officer (CIO) and review of performance.
- Act as adviser and sounding board to the CIO.
- Provide a link between management, the board, and stakeholders.
- Ensure the board and committees are receiving timely and appropriate information, before, during and after meetings.
- Appraise the board’s and committees’ performance.

Leadership comes from the chair, who must cultivate a common vision with the CIO and mentor committee members to clearly articulate and realize that vision. The chair’s effective leadership is vital to success, as is developing a competency and behavioral-based matrix for recruitment, continuing education, development, and tenure, while encouraging a climate of constructive challenge. These functions are well-captured in figure 1, which is based on a board effectiveness model put forth by Richard LeBlanc, Ph.D., at the Corporate Governance Program, Schulich School of Business.

This design phase therefore is one of the keys to success and should be well-thought-out and planned. It encompasses several sub-segments including: member orientation, functional behavior, proper organization, and succession planning. An organized orientation program greatly benefits all members. It outlines priorities, bylaws, regulation, structure, policies, and constraints, and it documents investment beliefs and process rationale, acting as a reference guide for past and future decisions. Best practice includes a trustees’ manual that provides background material that always is current and available to the new trustee, one-on-one orientation sessions with both the chair and CIO, and perhaps mentoring by a senior trustee. All communication must be in plain, understandable language to limit misinterpretation. Good organization requires a well-thought-out agenda with items ordered and prioritized and sufficient time for complete discussion and decision-making. Agendas must limit presentation time and maximize discussion time for trustees to make timely decisions. If members are to bring a critical eye to the debate, they must be well-versed and receive suitable material well in advance of the meeting. They must be prepared to do their pre-meeting homework and understand technical issues. Routine matters should be noted and tabled without undue discussion unless there is an exception to policy, allowing for adequate discussion of key issues. Good investment research will help discern those key issues.

Minutes should abide by the four C’s by being correct, concise, clear,
and consistent. They should be extensive enough to record decisions and important considerations, while outstanding action items should be noted with the individual responsible and due date for completion. Follow-up on these action items should occur at the next meeting and until full implementation.

Member assessment and succession planning assumes that trustees have assessed the expertise and experience required on the investment board/committee. The Rotman International Centre for Pension Management at the University of Toronto confirmed that board of trustee selection and board effectiveness evaluation processes continue to be problematic for many of the globe's largest funds.5

To summarize, the trustees’ role is one of oversight, but they must be decisive and prepared to act when action is required. An annual business plan should allow sufficient time, primarily for risk definition and management, as well as education/innovation and secondarily for monitoring, implementation, and tracking of performance to objectives. Everything on the agenda should have a clear purpose and be logically ordered, with time allotted by importance. The two greatest problems in investment governance are that trustees:

1. Don’t understand their role and tend to meddle (micromanage) in areas beyond their mandate; and
2. Spend a disproportionate amount of time on routine administrative and reporting aspects to the detriment of higher-level or emerging issues.

Fiduciaries Need to Know What is Important

At the end of the day this reflects a failure to sufficiently delegate and set up effective monitoring that reports on administrative matters but only discusses them, as necessary. This naturally leads to the second area of governance best practices: Trustees need to understand what is important. Eighty percent of directors reported that their boards spend more time monitoring than strategizing.6 Trustees need to spend more time engaged in policy and strategy—not owning the strategic process but providing expertise and guidance. They need to understand their primary investment objective (be it risk-adjusted return maximization or surplus risk management, etc.), stay focused on that long-term goal, and not succumb to short-term, behavioral thinking or multiple, secondary, and often competing, objectives. Ultimately they need to manage risk in a disciplined fashion by spending more time on understanding innovative, new strategies, the asset allocation decision relative to the liabilities, and overseeing risk within the fund. Each trustee need not be an investment expert, but there is no substitute for investment training, know-how, and experience. The board/committee must be able to distinguish noise and nonsense from items that are meaningful and material. One of the most common mistakes is not recognizing that assessing money managers is a specialized skill best left to full-time, dedicated professionals who can do adequate due diligence; it is not a good use of trustees’ time. Oversight, however, must be retained on both process and performance.

There is no substitute for good research. In addressing investment proposals, reasoning begins with research to gather enough relevant information to make sound decisions. The availability of these resources is very important. Having good in-house research or partnering with providers that have best-in-class research will limit errors in judgment. Also recognizing that there are no sure things in this industry (only probabilities) should force trustees to ensure they can live with the downside of any particular investment strategy. Risk analysis is essential. To determine what they need to know, trustees should insist that they have access to the best advice available and the information they need to make informed decisions. Those practitioners with implementation skills should be valued highly, because they have knowledge-by-doing. The chair plays a key role in assessing the expertise and experience of the board/committee members while determining their collective knowledge. Expertise entails theoretical investment wisdom based on industry experience, which ensures patience, discipline, and self-control. Members need to know when to act, when to consent, and when to hold the course. The chair must regularly assess the requisite business savvy of the group in regard to its deliberations and upgrade as necessary.

Understanding the trustees’ relative strengths and weaknesses will lead to the right additions to membership and continuous improvement in decision-making. No doubt an effective committee must be composed of members with diverse competencies. However, members must be able to work collaboratively. Partnering with professionals who have relevant, robust research and demonstrated implementation skills will ensure better strategies, better outcomes, and timely decision-making by trustees.

Work as a Team

Working as a team is the third area required for better investment governance. After achieving the right structure and the right membership, better governance lies in the working relationships among trustees, staff, and providers, as well as the social interaction within and among groups. This determines how decisions are made and often is based on the individual traits or behaviors of members themselves. In short, we are talking about interdependence, not independence. Independence of mind and character are valued member traits because they can lead to challenging the status quo when change is imperative. Nonetheless, it
Fostering trust, transparency, and a culture of collaboration, while recognizing that we can learn from our mistakes, ensures early detection of problems.

Use a Long-term Multidimensional Framework for Evaluation

The latter point brings us to the final area, a requirement for long-term, multidimensional evaluation. Successful investing is not about short-term gratification. It is about measuring what matters and not dwelling on the recent past. If trustees focus more on risk management and inconsistencies in the qualitative factors (people, processes, policy, and philosophy) as opposed to overreliance on short-term, often random, quantitative performance, they will be better served. Intelligent investors are disciplined and establish a consistent, risk-managed approach focused on understanding and progress toward the primary investment objective. Patience and self-control are tempered by independent thinking and an eagerness to understand new concepts through research and education. Diversification is one of the primary tools at an investor’s disposal for risk reduction. More-concentrated bets only should be applied to higher-conviction strategies that have been supported by sound research.

In conclusion, applying best practices in investment governance likely will lead to a narrowing in the knowing-doing gap. It is a rare fund that would not benefit from a periodic review of its investment fund governance practices. But best practices often are specific to the fund’s circumstance and cannot be implemented with checklists and codes. Rather a positive climate of assessment, analysis, innovation, and education must be fostered, to promote collaboration and challenge the status quo. These are the governance challenges facing most investment trustees.

I will leave the last word to Bob Garratt, professor of corporate governance at the University of London, who boldly stated that trustees “should be selected, trained, developed and appraised on their abilities to:

• Formulate policy and so give foresight;
• Think strategically;
• Collect accurate external and internal data;
• Generate imaginative ideas;
• Be capable of open questioning and critical review;
• Be rigorous in risk assessments;
• Be collegial in strategic decision-making;
• Be capable of open questioning and critical review;
• Learn systematically from its strengths and weaknesses;
• Ensure organizational capabilities for successful strategic implementation; and
• Ensure rapid feedback for honest information on the implementation of the strategy.”

Pension governance always has been difficult, but given the extensive changes expected in the market over the next several years (due to separation of alpha and beta, greater use of liability-driven investing, and countless new investment approaches), the fundamental principles outlined here should become even more relevant for fiduciaries today. Effective decision-making has never been easy, and it’s getting harder; but it’s never been more important.

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Endnotes
2. Ibid., 4.
3. Ibid., 15.

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