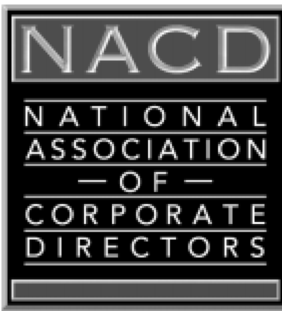

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Retirement Fund Management: Strengthening the Board's Oversight Position

Mike Stolte
President
Asset Allocation Incorporated
Minneapolis, Minnesota

Directors can and should strengthen their oversight of corporate retirement funds.

Under the Employee Retirement Income Security Act of 1974 (ERISA), corporate directors are the ultimate fiduciaries of their companies' retirement funds. After establishing a long-term investment policy, directors may delegate management of the funds to others but they remain accountable for the results. Therefore, in an effort to bring investment expertise to the management of these funds, corporate boards usually approve the hiring of professional portfolio managers. This is standard operating procedure. So why, then, do nearly all large diversified pension funds fail to capture the investment returns made available to them by the directors' investment policies?

Many corporate directors at some time share responsibility for retirement fund oversight. You too have probably served in that capacity and followed the principles of ERISA in exercising your fiduciary duties. Your adherence to these guidelines will get you by but will do nothing extra for the company or its retirement funds. This article is written to encourage you to go beyond the fiduciary minimums and, just by eliminating generally tolerated inefficiencies, lower your company's

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DIRECTOR'S *Monthly*

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contribution and management costs while adding significantly to future pension fund values.

A Board's Role

To pursue these objectives you will have to challenge that standard paradigm, which has brought about an underlying problem: Directors are uncharacteristically passive in their oversight of pension fund management. This allows investment managers and consultants to control the information flow between the fund and the board. Deference to "experts" weakens the corporation's position and costs the nation's shareholders and plan beneficiaries tens of billions of dollars annually.

The solution: Directors must regain the initiative in overseeing fund management. One way they can do this is to install a basic, performance attribution system that isolates the value added to fund assets by each set of decision makers, including those inside the company. This enables the board to control the review process from a director's frame of reference, focusing on the particular needs of the board in meeting its oversight responsibilities. The cost can be less than a clerk's salary. The benefit can be measured in millions of dollars for a typical large corporation.

The Continuing Conundrum

Exactly 20 years ago, I outlined a methodology for delineating the decision layers in an investment management structure and calculating the values each one adds to corporate pension funds.* The need revealed itself while I was reorganizing 3M Company's pension fund management arrangement. The board did not fully recognize the power of its own investment policy or claim due credit for its dominating impact. Portfolio managers, to whom the credit was forfeited, were

* Myron D. Stolte, "Pension Plan Sponsors: Monitor Yourselves," *Harvard Business Review*, March/April 1981, pp. 136-143.

happy to reinforce the board's generous perception of the managers' relative importance.

Corporate sponsors are not alone. Numerous reports prepared over the past two decades for various fund sponsors present essentially the same profile for corporate (private) pension funds, public funds, foundations, and college endowments: Once the board establishes an investment policy, in terms of a diversified mix of several classes of securities, the myriad decisions that follow are far more likely to detract from the funds' worth than to enhance it.

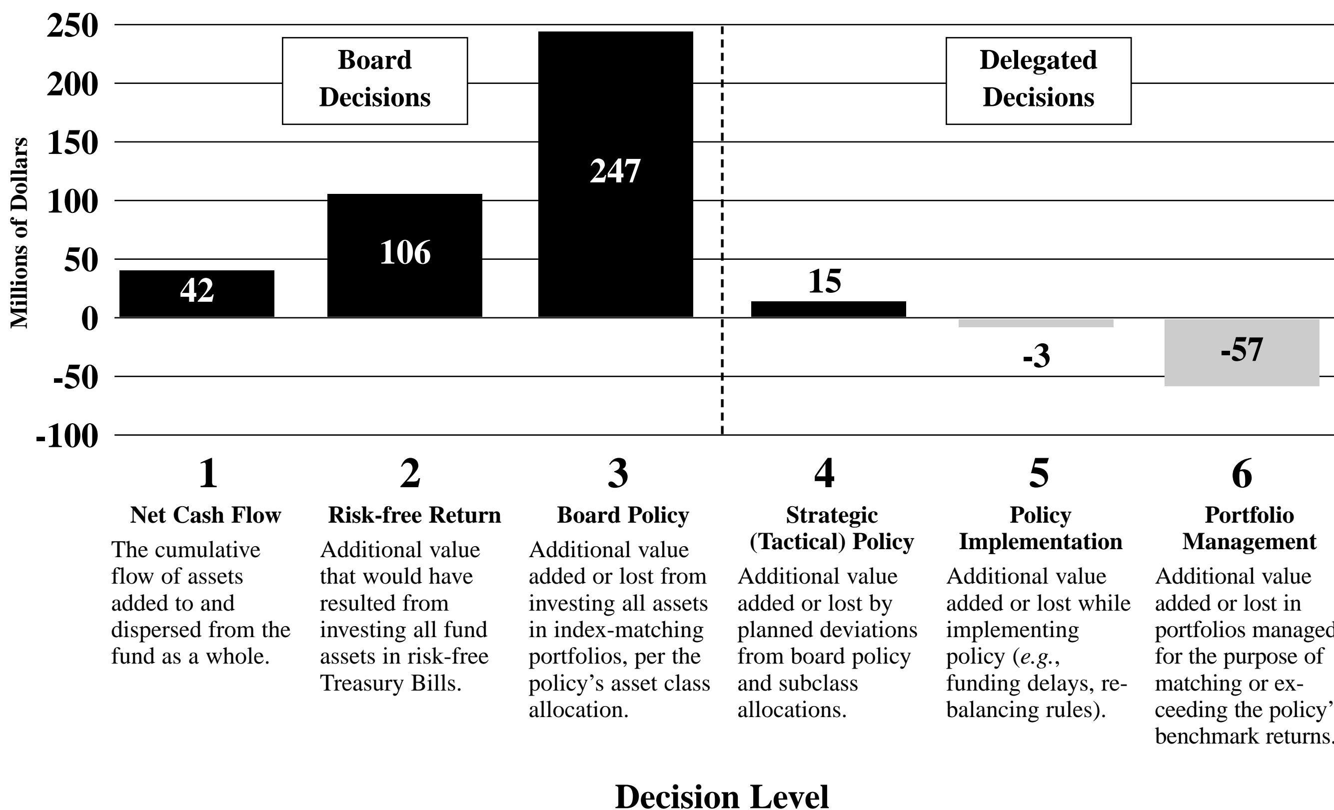
The exhibit below demonstrates the point. It is condensed from the summary of a representative decision audit covering a five-year period. Each component of value added is incremental. When combined, the components account for the entire increase in the fund's value over the period analyzed.

In this example, the board is directly responsible for the first three levels. While devoting about an hour to policy considerations every three months, directors decide how and when to fund the pension plan, acknowledge the risk-free option, then wisely and continuously commit the assets to a long-term policy mix of historically more rewarding asset classes. In the five-year time period shown, these decisions benefited the pension fund by $395 million as the asset classes appreciated.

All the while, however, the board delegated the job of *implementing* the policy to management and staff, who retained the services of numerous outside portfolio managers, consultants, and performance measurement professionals. The result from Levels 4 to 6—where the actual outcomes were determined—was a $45 million give-away. Strategy moves were beneficial in this instance but not enough to offset the negative portfolio management impact, which summarizes dozens of component values.

Yes, the outside professionals spent many hours dutifully massaging the portfolios. They also made impressive presentations, and rationalized their disappointments with Wall Street war stories about unexpected earnings developments and Federal Reserve surprises. But, good intentions aside, their aggregate effect was to diminish the value of the pension fund by $57 million, which included fees of $14 million for trying.

What sustains this inverted sense of relative importance? Part of the answer may lie in a study of nine large pension funds by William M. Barr and John M. Conley, on "Managing Relationships: The Culture of Institutional Investing," *Financial Analysts' Journal* (September/October 1992). The authors noted:



❝ It is not an exaggeration to say that the most prominent feature of several of the fund structures is their effectiveness in shifting responsibility for decision-making away from identifiable individuals. As the number of investment decisions—and, consequently, the likelihood of error—increases, so too do the complexity and consequent impenetrability of the decision-making structure. ❞

The complexity and murkiness of fund decisions fosters dependence upon outside service providers, who prosper from keeping the arrangements complicated. With a seemingly infinite supply of numbers to slice and dice, they can disgorge mounds of analyses to explain any possible outcome. They thrive by diverting directors' attention from the few important truths they really need to know.

Inadequate Reporting Conventions

Decades-old reporting conventions serve the investment community quite well, but they allow too much relevant performance information to slip through the cracks. Consider rates of return and the benchmarks to which they are compared, which show how things are not always as they seem.

So-called time-weighted rates of return are the primary means by which portfolio managers are monitored. They are—quite properly—calculated to exclude the effects of the size and timing of cash flows over which the managers have no control. This exclusion facilitates performance comparisons, but it leaves a hole in the evaluation process.

The following hypothetical offers an example of how misleading and inadequate performance percentages can be.

Assume a plan sponsor retains an aggressive stock manager and allocates to it $10 million at the beginning of the year. A first-half return of 40 percent leads the investment department to add another $10 million to the $14 million portfolio at mid-year. The second half is rather flat and lowers the full-year return to 35 percent. At year-end the portfolio's value is $23.1 million.

If the appropriate benchmark index rose 20 percent during the first half year and finished with a gain of 30 percent, most observers would consider the manager's performance quite acceptable. But although the fund would have experienced a substantial gain, the benchmark's index fund alternative would have grown to $23.8 million with the same cash flow. The manager's 35 percent time-weighted rate of return would outperform the index, but the pension plan would actually *lose* nearly $700,000 due to the very funding effects generally eliminated from performance reports.

Just as a pension fund can lose value with a manager who performs better than its benchmark, so the converse applies. If the "manager" and "benchmark" labels above are switched, the fund *gains* $700,000 with an "under-performing" manager.

It is certainly important to know how well portfolio managers are performing against their peers, but it is equally important for directors to know how effectively managers are being used in the company's particular structure.

Loose benchmarking undermines the usefulness of the most carefully calculated rates of return. Performance evaluations are only as valid as the standards to which they are compared. Index benchmarks are essentially quantified job descriptions that should clearly represent the work to be done by portfolio managers. They should not just be treated as useful references or accepted without challenge.

One client's experience with a foreign equities manager underscores the point. The manager was retained after several years of outperforming the Europe, Australasia, Far East Index (EAFE), a widely followed index of established non-U.S. stocks. The firm's subsequent under-performance surprised the board, but a review of the selection process uncovered the problem. The manager's track record had been generated by investing primarily in a more risky class of assets (emerging foreign markets) than was represented by EAFE, the board's policy benchmark. When compared to the proper standard, the same track record was found to be inferior from the start.

A common trap is built from the "style" benchmarks developed by consultants. Managers unable to beat a broad policy index like the S&P 500 can extend their employment by convincing boards to accept benchmarks that represent sub-sets of the larger asset classes. For example, a manager may argue that an index of small capitalization growth stocks is a more appropriate benchmark. "It better fits his firm's investment style." Another may urge adoption of a mid-cap value index.

By accepting style benchmarks in place of their own policy benchmarks, directors buy into a role reversal. Initially, directors established a few policy-based job descriptions and authorized the hiring of portfolio managers to do the work. Now the managers are redefining their jobs, and the board is going along with it. The tail is wagging the dog.

Such accommodations can derail a company's chances of capturing the primary policy's return. The reason: The aggregate commitment to all those style indices is almost surely not equivalent to the overall investment policy mix directors established for the retirement fund. The whole is no longer equal to the sum of its parts. So even if all those style bogeys are hit, a fund's basic objectives may be missed.

Style assignments should be left to the subordinates to whom other tactical decisions are delegated. Remember, those styles are already included in the board's broader policy benchmarks. Adjusting their weights can be left to others. And the results can be measured.

When the boundaries of its responsibilities are compromised, the board's oversight authority is severely undermined. This underscores the need to carefully

DIRECTOR SUMMARY

Directors are responsible for the oversight of corporate pension funds. Although they may and do delegate the management of these funds to others, directors can and should provide more vigorous oversight of fund performance. ◗

delineate the roles of all participants in the decision-making process, and to maintain an accountability system that quantifies the value added or lost at each level in the decision hierarchy. The subtle effects of allocation decisions, manager changes, asset transfers, and benchmarking procedures should not be ignored.

The message for you as a director is clear: Hold the high ground and stand behind your own policy benchmarks. Don't allow yourselves to be seduced into the valley of unnecessary choices.

How Safe is Your Harbor?

ERISA has provided some guidelines to both the providers and the beneficiaries of the nation's corporate pension plans for a quarter century. Its general language appears to provide safety for a wide variety of investment arrangements. But the harbor has a few shallow spots that will be difficult to avoid as the winds of scrutiny get stronger. Boards can benefit from running a much tighter ship than ERISA demands.

In some ways ERISA encourages plan sponsors to inject additional risk into the investment management process. Sponsors always have the duty to select and monitor the plan's investments. If they decide to use outside managers, they always have the additional duty to select and monitor such managers in a prudent manner. But consider the uncertainty those choices introduce. The primary investment policy (Level 3 in the exhibit) reflects the board's acceptance of a risk level that is based on decades of securities markets history. Delegated decision layers reflect the board's acceptance of additional risk for the purpose of adding to the policy return. As a director, you need to know if the incremental risk is being rewarded and whether the added costs are being recovered.

Three areas of concern stand out. They involve manager selection and interpretations of such terms as "independent expert" and "reasonable expenses."

Manager Selection

Picking superior fund managers is a difficult challenge to begin with. From the outset, the endeavor can be described as an attempt to win a zero-sum game, the objective of which is to outperform the board's policy return. But it's actually a *negative*-sum game. After manager fees and turnover costs less return remains available, in the aggregate, than the securities markets offer. That explains why, for decades, only about a third of equity managers have been able to win the game. And those apparent winners seldom retain their standing in the long run. Investors' reluctance to accept the consequences of poor selections allows under-performers to continue managing trillions of dollars of the nation's retirement assets.

Directors' participation in the retention of active portfolio managers implies belief that their selection process can beat the odds. Given the likelihood of success with each selection, the chances of assembling an above-average group are slim. The added risks to the fund are inherent in the selection process.

Boards can benefit from running a much tighter ship than ERISA demands.

Ponder this question: How many of our managers were selected in spite of a history of performance below their asset class indices? The probable answer is, none. Superior past performance usually dominates selection criteria. That implies greater confidence in a few years of return data, generated in conditions that will never repeat, than in decades of index returns. Qualified statisticians, even the Securities and Exchange Commission, have declared such performance "evidence" to be statistically irrelevant.

Manager terminations are the other side of the selection coin. These invariably occur after portfolios have performed short of expectations. These shortfalls become "realized losses" when the managers are replaced with successors who start with clean slates. Although these losses seem to disappear with the terminated managers, their negative affects on the pension fund linger and actually compound over time. The opportunity to invest the missing assets no longer exists. The endemic pattern of hiring high and firing low is far more costly than it appears. The impact must be measured and included in any comprehensive oversight system.

Independence

A prominent ERISA attorney, Fred Reish, of Reish Luftman McDaniel & Reicher, points out the Department of Labor's (DOL) position that fiduciaries have a duty to investigate and may use—but not blindly rely on—experts. "A fiduciary...may retain a qualified independent expert provided he first determines the expert is independent."* As a director, you need to ask: How independent are your experts?

Your portfolio managers, consultants, and other investment professionals all draw incomes from the investment management system. They have a huge stake in maintaining the status quo and promoting their services. Do they ever recommend that you dispense with their services? These conflicts of interest are difficult to reconcile with the unbiased objectivity you should expect from ERISA's "independent expert."

Reasonable Expenses

Another challenge facing directors as fiduciaries of pension funds is fund expenses. Under ERISA one of a fiduciary's obligations, solely in the interest of the plan participants, is to "defray reasonable expenses of administering the plan." Conventional formulas for manager fees seem to defy this provision on at least two fronts. Most conspicuous are rewards for under-performance. Once managers have been retained, they have reason to avoid bold decisions that could go awry and lead to termination. After a manager's employment has been nurtured into a relationship, modest under-performance seldom brings termination. Fees continue to flow even though the portfolios may be diminishing total fund values by millions of dollars.

Another challenge to "reasonable" is the payment of substantial fee increases resulting from the rising tide of securities prices over which managers have no influ-

* American Society of Pension Actuaries Annual Conference workshop, Washington, D.C., October 30-31, 2000.

ence. Fees can double with portfolio values even when the manager's decisions have lost millions of dollars for the fund.

401(k) Issues

Some companies have shifted from pension plans for their employees to 401(k) plans. The shift to 401(k) plans, however, does not relieve sponsors of such plans from liability for investment results. Reish cautioned the sponsors of 401(k) plans in a recent workshop:

> “The initial selection of the investment options, and the periodic monitoring of their performance, cannot be delegated to the participants. The failure to monitor the investment options and, where appropriate, to replace an under-performing option is a fiduciary breach under ERISA. The plan should have an investment policy that specifies how the company (or the plan investment committee, if there is one) will perform the monitoring function, indicating the appropriate benchmarks for assessing the performance of each option. Once the policy is in place the company must then compare the performance of the plan's investment options against the appropriate benchmarks and take appropriate action if an option fails to meet the criteria specified in the policy.”

Reish referred to DOL language when stating: “Employers must ensure that fees to service providers and other expenses to the plan are reasonable in light of the level and quality of services provided.”

With support from legal counsel, boards too often view the expensive payments to outside managers and consultants as insurance premiums—protection against criticism in case something goes wrong. “The professionals did it.” That notion may not withstand serious challenge.

In the area of retirement fund management, the board's perception of risk may be misplaced. If not, why do relatively small management firms and consultants accept such risk? The answer is simple: Because it is largely imaginary. Once the board has established a reasonable long-term policy, it has accepted nearly all of the “risk” from investment outcomes. Active portfolio managers don't mitigate that risk. They actually add to the uncertainty. The “insurance” may be nothing more than a very expensive, threadbare security blanket.

Take Charge Internally

The audit committee is in an ideal position to establish an oversight system to monitor the entire decision-making process that controls the management of all of a company's retirement funds. It can assure the board that internal control and disclosure is adequate and effective enough to enable the board to confidently carry out its oversight responsibilities. This function is routinely applied to corporate operations, but it can easily be extended to outside investment management operations as well.

The objective is not to interfere with the investment management function. It is to support it by providing the board with a means of ensuring that the entire investment process is operating as intended.

Jacqueline Wagner, the general auditor of General Motors, offers fitting advice in her recent article in *Director's Monthly* (October 2000): “I encourage every audit committee member to ask the hard questions. Challenge processes, issues, and activities, and err on the side of caution for the good of the organization and its shareholders.” She includes an example in another context and concludes: “This audit committee was effective primarily because its members had asked the right questions.” Such questions might include the following during performance presentations:

- How much value is our long-term investment policy adding over lower-risk alternatives?
- How much value is being added or lost by our most recent policy change?
- How much value is being added or lost by strategic departures from policy?
- How much value is each portfolio adding above its index fund alternative—net of fees?
- How much value is being added by each manager's market timing and security selection decisions?
- How much value has advice from our pension consultant added or lost?

Companies with an internal audit department have in place a readily available resource through which the audit committee can obtain information for asking these questions. Consider the new definition for the profession recently adopted by the Institute of Internal Auditors.

> “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”

Concerns about expertise may instill some reluctance, but there is no need at this level to get caught up in the intimidating lexicon of Wall Street. Alphas, betas, and “efficient frontiers” are the tools of investment analysts. The extent to which such techniques help deliver intended results will be incorporated in the summary reports provided to the audit committee. A few charts and tables, tailored to the committee's needs, will support appropriate inquiry. And they can all be prepared from the portfolio values, cash flows, asset transfers, and benchmark indices readily available in existing files.

The public in general, and employees and shareholders in particular, are rapidly coming to understand the costs and limitations of the investment management industry. It is just a matter of time before shareholders call for directors to disclose more about how they have been addressing these realities. Directors who have anticipated that call will be better positioned than those who must react to it. ◗

Myron D. (Mike) Stolte *is president of Asset Allocation Incorporated, a registered investment advisor to retirement fund fiduciaries. He previously served as manager of pension fund analysis at 3M Company. Before that Stolte managed retirement fund assets as vice president of an investment advisory firm. His concepts have been featured in the* Harvard Business Review, Management Accounting, Institutional Investor, Pensions & Investments, *and in investment conferences.*