

# Good Governance, Better Decisions?

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*Good governance is “... the process of decision-making and the process by which decisions are implemented (or not implemented).”*  
—Wikipedia

Investment managers have philosophies (beliefs in what will win) and processes (the steps toward solidifying victory) that drive their decisions. If we assume certain managers have an edge in the markets, it's because their philosophies and processes (P&Ps) add value over time. However, markets and competition evolve over time and P&Ps also need to evolve to maintain an edge. What does evolving—i.e., continuous improvement—look like? All top managers are asking this question, all the time. Are you curious?<sup>1</sup>

Philosophies don't change much over time, so the real challenges are how to improve processes. Processes benefit from questions that examine and challenge why and how they are executed and how they might improve. The process steps broadly defined include the following:

1. Finding new ideas
2. Analyzing those ideas
3. Communicating the ideas (among the team)
4. Making decisions (buy, sell, trim, add) on the ideas and in concert with the portfolio

Good governance documents how each of those four steps is executed and reviewed for potential quality improvements. Documented reviews maintain valuable, detailed past perspectives—and defend against hindsight bias<sup>2</sup>—all of which supports learning and personnel succession over time. Should we share these documents or some portion of them with clients and prospects? Such transparency could

help validate why real deal active managers should be maintained during sub-par periods or were hired in the first place. Any managers have the stomach for that?

We've assembled below some fundamental questions and observations about each of the four steps, based on our work with hundreds of investment teams.

## Finding New Ideas

- How systematic is your approach to idea generation? In our experience, purely fundamental managers, i.e., those who avoid funnels, can have inconsistent idea generation.
- Do the managers who are part quant or who use funnels to help filter for ideas take the time to learn about the screened-out securities (i.e., their trash)? Our experience is that quant managers—and most fundamental managers—do not regularly get curious. How do the other quintiles of screened-out securities compare/contrast to the filtered ideas, and how do different economic cycles matter to those quintiles? Too often, managers cannot answer. A well-known dividend filter, which only allows the highest payers to pass through, illustrates why this is important. With strict yield filters, the second quintile of dividend-payers often outperform the top, highest-paying quintile. Of course there's more to security selection, but if the second process step (analyzing new ideas) is done only for the top quintile of payers, a closer look at the second quintile would widen the idea net, in a good way.

## Analyzing New Ideas

- What's the first step in the manager's analysis? A more qualitative review such as how companies compete vis-à-vis

Porter's Five Forces<sup>3</sup>, or a more quantitative review that results in the construction of a company (economic) model? There is no correct first step; both help complete a better mosaic of information. We have seen a range of techniques for how each of these steps might be executed, but we often don't see both steps taken. And, because most managers use models, it's important to ask questions about how much they understand, respect, and have tested the model limitations (e.g., the duration and fade rate of growth).

- Next, invite the manager's response to the following question: Why has the market mispriced the security? A documented view on why the market mispriced a security offers an important double check of the manager's analysis and perhaps some insight on which catalyst(s) might correct the error as well as when. This powerful step is often not taken, in our experience.

## Communicating Ideas

- What does an idea/recommendation submission to the team (for vetting) look like? Is the submission a thick research report or does it have a single (summary) page that drives constructive debate? Too often, piles of pages hinder good debates. However, good debates also depend on the levels of curiosity and candor among the team. How safe does the team make it for a teammate to be wrong? Meeting minutes can help illustrate the quality of debate and counter hindsight bias. Our experience is that summary pages (i.e., the company's critical factors, why the market is wrong, and why this is going to change) are in the minority and that quality debate is often lacking.

- Do all vetting processes include a raging skeptic, i.e., a devil's advocate? Does the raging-skeptic role rotate among team members, or is it always the same person? Nobody should be this way all the time, right? Challenging views act as sunlight, and we know that "sunlight is the best disinfectant" for less-than-good ideas.<sup>4</sup> Unfortunately, we rarely see this approach, regardless of the known benefits of good debate. Or, we see debate used in destructive ways, with people arguing and growing more disrespectful as they do it.

### Making Decisions

- Does each member of the team understand (and accept) how decisions are made and who has the decision rights? For example, the portfolio manager may have all the rights all the time (leader decides); the decision may be made by the portfolio manager after consulting with analysts (leader decides with input); the portfolio manager may delegate the decision to a group of analysts (sub-group decides); or the decision could require a consensus vote among the team. Clarity on the decision rights for important decisions expedites decision making. We see more and more teams leveraging the benefits of clear decision rights; this is good governance.
- Are both good and bad decisions documented and reviewed over time with post-mortems for lessons about the quality of analysis, the decision process, and potential improvements? Sadly, in our experience, fewer than 10 percent of teams conduct regular post-mortems. We recommend post-mortems and we also recommend keeping a quality scorecard: How many decisions over time (1) deserved success, (2) suffered a bad break, (3) experienced dumb luck, or (4) earned the poetic justice label due to bad results for less than good work? Managers who remind themselves that they can control only the decisions, not the outcomes (i.e., humility) are motivated to improve decision inputs.

#### How Execution Factors In

A quality and consistent P&P is the most important determinant of success, assuming

a real edge of course, but it's not sufficient in and of itself. All those P&P steps taken day after day, month after month, year after year by the team are based on the team's execution. Execution is the ongoing adherence to the P&P but it is wholly dependent upon the various behaviors exhibited by and among the team members over time. Are those behaviors about continuous improvement and growth mindsets that can improve decisions?<sup>5</sup> Good individual governance documents and reviews an individual's decisions to better understand how to improve by using tools such as the following:

**A decision journal.** This is a private document with the individual's ideas, decisions, and their corresponding emotional states. A hand-written journal allows one to best learn one's strengths and weaknesses through personal post-mortems, devoid of any hindsight bias.<sup>6</sup> Once one's strengths and weaknesses become better known, one can play toward their strengths and away from their weaknesses.

**A behavioral checklist.** Once an individual's weaknesses/decision traps become more apparent from the decision journal, a personal behavioral checklist could be developed to specifically help them avoid less-than-effective behaviors or tendencies, and work more efficiently.

**A mindfulness pursuit.** Mindfulness means paying attention in a particular way; on purpose, in the present moment, and nonjudgmentally. The potential gains include more clarity of one's thoughts and motivations. It interrupts the habitual, automatic pilot thinking of the mind, brings more creativity, and increases the likelihood we will catch our biases in action—govern thyself?

Unfortunately, as with post-mortems, fewer than 10 percent of the investment professionals we know use and leverage such tools. However, the pursuit of mindfulness is growing.

#### Team Questions

Another approach to learning individual strengths—but at a team level—is through a talent audit. It's essentially a customized 360 review of the investment professionals

based on a range of the team's processes and needs. The results can be better positioning of team members, clarity about team needs, or development plans/coaching for individuals. We have seen many teams benefit from this approach. But, do the team members play well together? After all, collaboration and debate among a team can enhance the quality of decision making. A team's effectiveness also can be reviewed. Our team scorecard includes six questions in each of the following four areas:

1. Results: Is the team clear about its goals and is it achieving them?
2. Process: Does the team have good processes in place?
3. Relationships: How are the levels of trust and respect on the team?
4. Leadership: Is the leader providing good direction, feedback, appreciation, etc.?

Good governance uses the team scorecard to pursue improvements.

If the team concept supports better decision making, then how well does the whole firm play at being a team? What happens outside the investment team impacts the team; this is a culture question. When we ask investment leaders their opinions about the top benefits of a cohesive culture, they consistently cite the ability to attract and retain talent, and improved decision making. Ergo, good governance includes a cohesive culture.

### Good Governance Means Better Decisions

Markets are unpredictable and uncontrollable, so good governance should focus on making the best decisions possible through controlling what can be controlled. To do this, investment teams must continuously seek better inputs and better execution. This article has highlighted areas where investment teams and their professionals can achieve these improvements through better governance. ●

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*Continued on page 14* ➔

GOOD GOVERNANCE, BETTER DECISIONS  
Continued from page 6

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**Endnotes**

1. People are better at learning information that they are curious about. [http://www.cell.com/neuron/abstract/S0896-6273\(14\)00804-6](http://www.cell.com/neuron/abstract/S0896-6273(14)00804-6).
2. "The inclination, after an event has occurred, to see the event as having been predictable, despite their having been little or no objective basis for predicting it, prior to its occurrence. It is a multifaceted phenomenon that can affect different stages of designs, processes, contexts, and situations. Hindsight bias may cause memory distortion, where the recollection and reconstruction of content can lead to false theoretical outcomes. It has been suggested that the effect can cause extreme methodological problems while trying to analyze, understand, and interpret results." [http://en.wikipedia.org/wiki/Hindsight\\_bias](http://en.wikipedia.org/wiki/Hindsight_bias).

3. Porter's Five Forces are named after Michael E. Porter, whose model identifies and analyzes five competitive forces that shape every industry and helps determine an industry's weaknesses and strengths. They are: (1) competition in the industry, (2) potential of new entrants into industry, (3) power of suppliers, (4) power of customers, and (5) threat of substitute products.
4. To quote U.S. Supreme Court Justice Louis Brandeis, who was describing the benefits of openness and transparency.
5. See Carol Dweck, *Mindset: The New Psychology of Success* (New York: Ballantine, 2006). In a growth mindset, people believe that their most basic abilities can be developed through dedication and hard work—brains and talent are just the starting point. This view creates a love of learning and a resilience that is essential for great accomplishment. Conversely, a fixed mindset exists when one is protecting a status and reputation, thereby avoiding challenges that might tarnish an existing image.
6. There seems to be better learning when writing longhand (<http://pss.sagepub.com/content/25/6/1159>) AND "do this by hand because that will help reduce the odds of hindsight bias. It's easy to look at a print-out and say, I didn't see it that way. It's a lot harder to look at your own writing and say the same thing." <http://www.farnam-streetblog.com/2014/02/decision-journal/>.



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