Investment Process: Investment Committees

Too many cooks spoil the broth. Investment committees don't work. In fact, I have yet to see an executive committee in any industry. Committee's are good in an oversight role but in an executive role they tend to fail. If the committee moves forward it is on groupthink. If there is not groupthink, there is no progress. Yet many institutional investment businesses have a sizeable investment committee of which they appear very proud. I recall talking to the head of marketing of a big fund of hedge funds from the US and he was telling me all about his firm, the investment process and how there was a defined and structured investment process involving an investment committee of 6 people which worked by consensus. Every member of the committee held a veto. What was even more surprising was that said head of marketing was also on the committee. One hoped that he had investment experience to match his marketing credentials.

Alas, in an industry paradoxically driven by information yet where information is burdened with massive search costs, popular misconceptions are perpetuated by interested parties. And so even small investment firms are sometimes lured into the labyrinth of process. Investing is a lonely game. Yes, we talk, we network, we trade ideas endlessly, but at the end of the day, when the time for execution is upon us, our decisions are ours alone. These decisions are of course influenced by the information and opinion of those around us, but they otherwise play no direct part in the final decision. The investor who second guesses his own decisions is soon whipsawed and confused. The investment committee ruling by consensus is sclerotic, arthritic, inflexible. It acts too late, it acts too little, or too much, but never just enough and never in time.

I once advised a friend at a good sized US fund of funds. They had an investment committee which ruled by consensus and they were finding difficulty moving forward. Moreover the team consisted of consummate professionals. I presented the following example:

For the sake of illustration, say each individual makes good decisions 80% of the time and poor decisions 20% of the time. The team consisted of 8 people. This meant that when a good investment was put before them, the committee would make the investment only 16.8% of the time and would make a mistake and turn the investment down 83.2% of the time. Of course the converse was also true. Faced with a bad investment the committee would turn it down nearly 100% of the time, making the right decision, and make a mistake only once in 390,000 times.
What happens if we reduce the number of members?

– 8 members:

Accept good investment: 16.78%, Reject bad investment 100.00%
– 5 members:
Accept good investment: 32.77%, Reject bad investment 99.97%
– 3 members:
Accept good investment: 51.20%, Reject bad investment 99.20%
– 2 members:
Accept good investment: 64.00%, Reject bad investment 96.00%
One might ask how sensitive the above analysis is to the quality of the committee members. My comment is that if the quality of members was questionable then they should not be on the committee in the first place. If the error rate of the individuals rises to say 40%, a committee of 8 almost never makes an investment since it will reject a good proposition 98.32% of the time and reject a bad investment 99.93% of the time. The only rationale for having large investment committees ruling by consensus appears to be a paranoid fear of accepting a bad investment. This hardly shows faith in the abilities of the members.

An interesting combination is one where there are two decision makers and they both have to agree. Assuming that each one made an error 30% of the time, the collective decision would accept a good investment 50% of the time but reject a bad one 91% of the time. Unfortunately, if faced with 100 investments where 10 are good and 90 are poor, which is a fair distribution in certain quarters of the investment universe, such a team would accept 5 good investments, reject 5, accept 7 dud investments and turn down 83. That means 5 good versus 7 duds in terms of what will impact the portfolio. Not very encouraging. If the individual error rate is 20%, the good versus dud ratio improves to 6 is to 3. Much better.

The moral of the story is that the most efficient mechanism will not save you from a bunch of monkeys. And, if you have a bunch of good people, don't let them get in each others' way.

Warning: The analysis assumes independence, a condition too strong to be found even in the most professional investment firm.