

*“A pension fund is a special sort of a financial business. To manage it as a business, the first job is to figure out in whose interest it should be managed, and who is to be accountable for results.”*

- Keith Ambatchsheer

# Value Added

A Product of the MOSERS Investment Staff

A Newsletter  
for the MOSERS  
Board of Trustees

In the June 2001 edition of Value Added, we featured the topic of Board Governance. In a world in which Board Governance issues tend to make newspaper headlines daily, it seems only appropriate that we take this opportunity to revisit this important topic. Whether you are a newcomer to the Board, or a veteran, we hope this newsletter will be beneficial to you in your role as a Trustee.

## What is Board Governance?

This is more than just the \$64,000 question when it comes to retirement. The Board of Trustees has the fiduciary obligation to make sound decisions concerning all aspects of the system, including investment of the system's assets. This is an awesome responsibility. How can the Board be assured that it is meeting its fiduciary obligations? That is where the concept of governance enters into the picture. Governance in the retirement context describes how decisions are made by a board of trustees and how those decisions are implemented. In essence, the Governance Policy is the means which allows one to fulfill their fiduciary duties.

In the summer of 1999, the MOSERS Board of Trustees made a major operational policy decision when it adopted MOSERS' Governance Policy. During the months leading up to the adoption of this policy, the Board had some help. Dr. John Carver, a consultant, first presented his governance ideas to the Board at a seminar. By way of background, Carver developed a governance model that has been utilized by many boards across the United States and abroad. His approach reinforces the notion that boards can be more effective decision makers if they will concentrate their efforts on maintenance of a big picture focus. Carver illustrated how this could be accomplished by defining the roles and responsibilities of a board and its CEO (or, in our case, the executive director).

Carver later conducted a workshop at MOSERS in which all of the Board members, the executive director, the deputy executive directors, and the chief counsel participated. During the workshop, Carver discussed a number of problems that often plague boards. For example:

### **Boards that are focused on implementation minutia**

One problem that can affect boards occurs when a board tries to control all aspects of the organization down to picking the paint color on the walls. Boards that engage in this kind of behavior fall into the trap of spending a lot of time on relatively minor or meaningless issues. That tends to happen because it is easier to fill up the available time with simple decisions than it is to decide on the more challenging issues such as what the priorities of the organization should be and how to monitor progress toward achieving those priorities.

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## **Boards that act based upon the views of an individual, not the views of the group**

Boards are intended to make decisions as a group and, as such, should speak with one voice. Unfortunately, some boards are controlled by one or two board members who essentially make all the decisions or who are divisive with respect to group activity. Carver calls these board members “renegades” because they tend to be disruptive to sound governance processes. He was also quick to point out that renegade board members are not the real problem, rather the problem arises from the tolerance of the renegade by the balance of the board members.

## **Boards that do not control their own agenda**

Staff can also contribute to board inefficiencies by controlling a board’s agenda. When this happens, a board ends up rubber stamping staff decisions. This kind of activity is an abdication by a board of its charge to provide leadership and vision to an organization.

In the process of explaining and implementing his governance model, Carver asked MOSERS’ Board members to sit down with the executive director and develop written policies to avoid these situations and to empower the Board to become a more efficient and stronger decision-maker. The Board developed each policy by making broad policy decisions first. It then filled in the detail of each policy until it was comfortable with the final product. By the end of the workshop, MOSERS’ Board made a number of specific policy decisions in writing that became the foundation for MOSERS’ Governance Policy. This policy was ultimately adopted in September 1999 and has since been amended. A copy of the most recent Policy may be found on the Trustee website.

## **The Role of the Board and the Executive Director**

**T**he Board’s authority and responsibilities are described in the state statutes that established the system. The General Assembly has given the Board broad power to administer the system. By virtue of being responsible for the overall operation of the system, the Board is the link between the members of the system and the system itself. In this capacity, the Board makes decisions regarding risk management in both the investment of system assets and the administrative aspects of the retirement plans, as well as decisions about their customer service expectations. The Board may consider input from members regarding the kind of services needed under the retirement plan as well as plan design requests that can be forwarded to the

General Assembly for legislative consideration. Of course some decisions cannot be made without explicit authority from the General Assembly. Nevertheless, there are many policy decisions that the Board has the discretion and responsibility to make in order to see that the system is properly administered. Those decisions have been described in MOSERS’ Governance Policy under the subheading titled “Ends Policy.” The Ends Policy will be discussed in more detail later in this article.

Once the Ends Policy was defined, the Board described in the balance of the Governance Policy parameters for achievement of the Ends. The Board was aware that it did not have the time to implement its decisions, let alone deal with the day-to-day issues that are part of operating the system. The Board resolved that dilemma by delegating authority to the executive director to bring the Board’s policy objectives to fruition. A key component of the delegation process is that the executive director has the freedom to choose the means of accomplishing the Board’s policy objectives so long as the executive director complies with the specific limitations established by the Board.

Such limitations include operating the system in a manner which does not violate the law. In addition, there are other specific limitations that apply to the executive director’s conduct in the following areas:

- ◆ Treatment of Consumers
- ◆ Treatment of Staff
- ◆ Budgeting
- ◆ Financial Condition and Asset Protection
- ◆ Emergency Executive Director Succession
- ◆ Compensation and Benefits of Staff
- ◆ Communication and Support to the Board

These limitations help to ensure that the executive director will not engage in behavior that is unacceptable to the Board. At the same time, the Board understood that no written policy could cover every possible issue that might come before the executive director, and it expected that the executive director would use good judgement when dealing with these issues. Therefore, the Board authorized the executive director to make reasonable interpretations of the policies in situations where the policies did not provide specific details to cover a particular situation. If at anytime the Board is not comfortable with an interpretation made by the executive director, it can rewrite a policy to make it more specific so that the executive director has clearer direction regarding how to proceed in a particular area. Carver commented that the executive limitations are analogous to having a horse in a corral versus having a horse on a lead – the one on a lead requires constant attention while the one in a corral requires only periodic monitoring to ensure its well-being. He also commented that the common condition he encounters is the “horse on a lead approach” which wastes a lot of time and is not very satisfying to either the owner or the horse.

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The overall governance process, which has been adopted at MOSERS, establishes the Board as the policymaker and delegates to the executive director responsibility for putting the Board's policies into action. The next part of the Governance Policy describes the duty of the Board to make sure that its policy objectives are being met.

## **Monitoring Executive Director Performance**

**T**he policies (including the limitations) are of no value unless the executive director takes steps to properly implement the policies and act in accordance with the Board's wishes. The mechanism for ensuring proper implementation is a two-step process. Here, Carver stressed the importance of the Board acting collectively rather than individually. He noted that the only time the CEO should take direction from an individual Board member is if the Board has delegated certain authority to that Board member and has a process in place for monitoring that delegation.

The first step in the process requires the executive director to report all progress made toward achieving the goals described in the Ends Policy. Likewise, the executive director is required to report efforts made to satisfy the Board's limitation requirements. The executive director will make those reports annually just prior to the June board meeting. Finally, violations of any of the limitation requirements are to be reported to the Board immediately by the executive director, chief legal counsel, and/or the internal auditor (depending on which limitation is involved).

After the Board receives these reports, the second step is for the Board to judge whether the executive director's performance is in alignment with its expectations as stated in the policies. The Board will not use any other criteria to judge the executive director's performance. If the Board finds that the executive director has successfully met its expectations as reflected in the policies, it can be assured that it has met its fiduciary duties. If the executive director has not successfully met the Board's expectations, the Board should investigate the cause of the deficient performance. It is possible that the Board may need to modify its policies or give the executive director more time to implement its policies. Another possibility is that the executive director may not have the skill or desire to achieve the results expected by the Board. Once the Board identifies the cause of the deficient performance it should be able to correct the situation. Finally, the Board should consider the executive director's performance when establishing or reviewing the director's compensation.

It is important to note that, under the Governance Policy, the executive director is the link between the Board and staff. This structure is a necessary part of the delegation and monitoring process. Without it, the Board would have a difficult time monitoring the executive director's performance and holding the executive director accountable for carrying out its policy objectives.

## **The Goals of the Board – The Ends Policy**

**T**he Ends Policy may be the most important policy developed by the Board. This policy reflects the Board's values and expectations and centers on the system's end product – the payment of retirement benefits. Before benefits can be paid, funds must be available. The system's Investment Ends Policy addresses this important aspect of system administration.

### **Investment Ends**

**T**he most important investment decision made by the Board is the establishment of the Real Return Objective (RRO). In establishing the RRO, the Board's primary goals are to keep contribution rates reasonably level over long periods of time and to maintain a contribution rate between 8 to 10 percent of covered payroll.

The Board relies on the system's actuary to provide advice on a RRO that, if realized, would successfully meet the objectives stated above. Based on the current benefit provisions and projections of plan experience and future economic conditions, the actuary has indicated that a five percent RRO should achieve these objectives. At the direction of the Board, the actuary uses an RRO of five percent in determining the financial condition of the system and in computing contribution rates based upon the September 2001 actuarial assumptions. However, the Board recognizes that the RRO requirement will likely need to exceed the five percent target to cover operating and rebalancing expenses. These assumptions were used in the modeling of the asset/liability study conducted in the spring of 2002. This study established the asset mix based upon expected future returns and correlations of the various asset classes under consideration.

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The system's success in achieving the investment RRO will only be evaluated over long time periods. The reason for the long-term focus on this objective is to preclude the temptation to overreact to events in the marketplace that have no relevance in long-term asset/liability management. The resulting dilemma is the conflicting need to evaluate investment policy implementation decisions over shorter time frames while maintaining the longer-term focus necessary to manage and measure the fund's performance relative to the investment RRO. As a result, the Board adopted a series of benchmarks to measure short-term, intermediate-term, and long-term performance. These benchmarks are part of the Investment Ends Policy and are designed to give the Board a clear sense of whether the investment program is successfully moving toward its goals. The periodic timing and nature of the reports utilized by the Board to monitor the investment program versus the benchmarks are further detailed in the Investment Ends Policy.

## Benefits Ends

The Board created the Member Benefits Ends Policy in much the same manner as the Investment Ends Policy. The Member Benefits Ends Policy reflects the Board's expectations of how the member/customers should be treated and what services should be provided during the process of paying retirement benefits. The Board's values are reflected in this policy. For example, the Board has decided that members are to receive:

- ◆ High quality service from staff
- ◆ Adequate benefit education training
- ◆ Access to benefit information in a cost-effective and timely manner
- ◆ Updates on plan changes that are tailored to the individual
- ◆ Benefit payments in a cost-effective and timely manner

The Board monitors performance under this policy by reviewing the annual report made by the executive director that describes the progress made in achieving the Board's goals. The Board also receives information about how MOSERS compares with other retirement systems in terms of customer service and cost effectiveness.

In addition to the foregoing Ends Policies, the Board has also established Ends Policies in the areas of Legislation, Sound Actuarial Condition, and Rulemaking. The Board reviews all of its Ends Policies annually, making changes to these policies as it deems appropriate. In addition, the Board continually looks to the executive director to provide advice that will help shape its critical policy decisions.

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## In Conclusion

The work the Board has accomplished in the area of governance reflects its commitment to retain control over the major issues faced by the system while assuring that an efficient mechanism is in place for implementation of Board policies. MOSERS' Governance Policy holds the executive director responsible for achieving the Board's goals, using any means so long as those means do not violate the limitations established by the Board. The Board has chosen a system of monitoring the executive director's performance that will allow it to be able to judge whether its goals have been put into action, and if not, why. In that sense, the Board has also adopted an effective risk management tool. In addition, MOSERS' Governance Policy will allow for continuity in decision making as membership on the Board changes periodically. All of these aspects of the Governance Policy are vital for the efficient administration of the system and should give the Board confidence that it is continuing to live up to its fiduciary obligations.

This newsletter will be produced and distributed in advance of each scheduled board meeting with the objective of educating the Trustees regarding investment issues facing the pension fund. If you have questions or would like additional information on any topic contained herein, please contact Meg Cline.

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The Investment staff wishes to acknowledge and extend thanks to Jake McMahon for authoring this month's newsletter.

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