Decision Sciences 101 – Why Many Board Decisions Can be Sub-Optimal[9]

Why some people think groups make better decisions	Why others think that they may not

○ "none of us could be as smart as all of us"
 	
○ Committees exist to provide different knowledge sets, different values and different background experiences
 	
○ Committees exist to check errors in individual thinking and human behavioural foibles.
	○ Committees capture "least common-denominator thinking".
	
	○ Committees mostly exist to share blame
	
	○ Most committees aren't diversified enough to provide different sets of insights
	
	○ If individuals make bad decisions, committees make worse because of:
	  ○ Biases get reinforced, not dissipated
	  ○ Dominant members "sway" other members
	  ○ Illusion of effectiveness
	  ○ Commitment to an idea increases to please other members

75% of Trustees think they make better decisions as a group – in spite of evidence to the contrary[3]

"Madness is the exception in individuals…

…and the rule in crowds."

- Nietsche

Groupthink = Groupstink or…
Why Decisions in Groups Can be Sub-optimal

People are gregarious or herding animals:

- Being a “trustee” is often regarded as a point of honour – Trustees will do almost anything to ensure they are not ostracised out of the “club”
- For most members of a group, it is better to be wrong with the group – because if you’re wrong as an individual, you are finished as a viable member.
- Decisions that are non-contentious are the easiest ones to make because they keep group unity, even if they are not the best decisions for the fund.
- The more social interaction between members, the stronger the need to minimise dissonance in the group
- The more prestigious the group, the more the members will interact in such a way as to ensure they retain membership.[10.]

Social Dynamics Summary:

Simply put, the group dynamic is a social one,

where the primary activity is devoted to determining whether one belongs or not,

or in assessing how one might go about increasing one’s acceptance in the group. [11]

Test Your Board – Does It Have What It Takes to Succeed? [12]

The Structure of the Decision-making	The Quality of the Decision-making
1. Has the Board gone through a governance budgeting exercise to determine: • Who makes what decisions? • How much time can they afford to give to addressing different decisions • How conflicts will get resolved? • Under what conditions new decisions must be made? 2. Does each sub-group of the Board know where its responsibilities begin and leave off? 3. Are there any key decisions that don't seem to fit anywhere? 4. Does the current structure allow for decisions to be made and implemented timeously?	1. Does the Board have the right diverse composition for effective interaction? 2. Are the members "tuned-in" to their decision-making dynamics and foibles as a group/ 3. Does the Board understand the conflicts of interests of all the players it interacts with and have an open plan to deal with each of them? 4. How does the Board balance rule-based decision-making with "this time it's different"?

Most Boards have the wrong governance make-up to succeed:

The average number of Board members is 16, but the optimal number for effective decision-making is less than 7.

If the group is truly heterogeneous, (different socio-economic backgrounds, ages, sexes, education and value systems) than the optimal group size for decision-making can be as low as 4.[13]

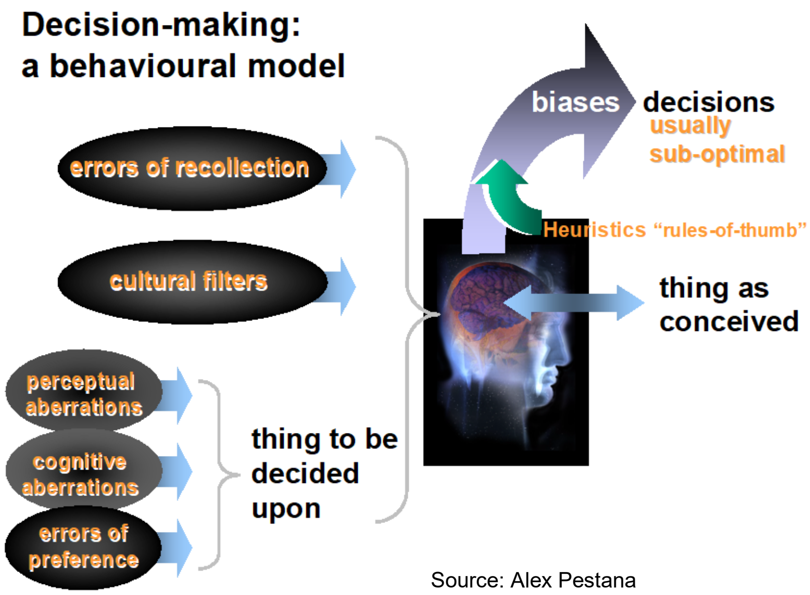
One of the worst habits of Boards is to assume they need to regular meetings of pre-determined time periods. This almost guarantees that not enough time is allocated to really big decisions and too much time is devoted to short term assessments.

Why Understanding Human Behaviour is Critical to Your Fund's Wealth

The field of Behavioural Finance teaches us that, while most investment theory is predicated on the belief that markets are rational, experience and psychological assessment indicate that individual investors definitely are not. The more Trustees understand how and why they (and all investors) are more naturally inclined to make the *wrong* decisions about investing, the more receptive they will be to the right decisions.[14]

Behavioural phenomenon	Impact on Investment Decision-making

Biases of Judgement:
• Over confidence
  ○ Investors over-estimate chance of success
  ○ Investors find probabilities difficult to understand
• Optimism
  ○ Low probabilities of winning greatly overweighted
  ○ Leads to myopia or short-sightedness in retirement planning
  ○ Leads to failure to diversify
• Oversimplification Bias
  ○ Markets are extremely complex – but Trustees will opt for the simple solution because it's easier to comprehend – not because it's right
• Pain of loss is greater than the joy of success
• Fear of Regret (not same as risk)
  ○ Because Trustees are terrified of making the "wrong" decision, they have a natural bias towards the familiar and to maintaining the status quo
	• Call the market right, and Trustees will invariably ascribe the outcome to luck, even though chance probably had a greater hand.
	
	• Rankings in performance surveys are often ascribed to skill – even though more than 95% of most performance has nothing to do with skill.
	
	• Trustees more often opt for reckless conservatism, preferring to protection from downside risk to a strategy that is aggressive enough to outpace inflation.
	
	• Consensus decision-making, buying the "familiar" instead of the "better", and reverting to peer performance benchmarks are all hallmarks of Trustees who allow "fear of regret" to dominate decision-making.
	
	• The two factors that dominate Trustee decision-making tend to be the "seems good" factor and the "sleeps well" factor. If a trustee believes the decision can't be criticised because it would seem acceptable to a broader audience, then this will outweigh a potentially "right" decision.



Source: Alex Pestana
Sanlam investment Management

Human beings are "wired" to make bad investments.

Whenever possible, they need to develop automated irreversible investing habits that are tailor-made for neutralising the brain's worst liabilities while optimising its greatest assets.15

What Investors Need To Understand About Investment Decision-Making

Because behavioural quirks are almost impossible to eliminate….the ultimate investment policy will probably never be optimal…

Why perfection is unachievable -
The Principle of Best Endeavours

There is a trade-off for every concession the Board makes to satisfying the "seems good" and "sleeps well" requirements of the Trustees. But the most effective Boards will be those that have the impact making those trade-offs and have deemed the results reasonable for the Fund.16.

Trustee Syndromes to be aware of

The Alpha Member

Every board has its dominant member – whether overt or covert. Identify this member openly. Structure decision-making procedures to ensure that decisions reflect the group's wishes and not the dominant voice.

Leaders must have wisdom, not answers. An effective Chairman is one that encourages debate. [17]

The "Expert" Member

For many boards, investment expertise is typically in short supply. But a little knowledge can be a dangerous thing. Don't abdicate decisions to members who "appear" to know more about investing than you. Every trustee must understand why decisions are being made or ensure that expert opinion is really being obtained.

The New Trustee Syndrome Version 1

The most common form of new Trustee is the one that assumes that they know nothing – and so do nothing – and go along with every proposal made, whether they understand it or not .

Never forget that Trustees are guardians for the Fund's members. As such, your ignorance is your greatest asset. If there's something you don't understand, you can be sure your members probably won't understand either. Your job is not to have the wisdom to make the right decisions , but to have the wisdom to ask why decisions are being made.

The New Trustee Syndrome Version 2.

Being elected a new Trustee does not bring with it the obligation to make changes to prove your worth. In fact, one of the fastest ways to destroy value is to tinker with a well structured, long term strategy.

Of course, this assumes the strategy already in place *is* appropriate, is optimally structured to control costs and *has* a reasonable probability of achieving what designed. The job of the new Trustee is to find out if it is. To challenge all previous decisions until the Board can properly demonstrate why they were made