Overseeing your Investment Program: Best Practices for Fiduciaries

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Agenda

• Operating/ Reserve Funds*
  • Develop an Investment Leadership Team
  • Cash Flow Analysis
  • Review Applicable Laws and Regulations
  • Establish a Risk Profile
  • Determine the Portfolio Management Team
  • Create and Investment Policy

• Pension Funds
  • Review Applicable Laws and Regulations
  • Understand How Portfolios are Created
  • Developing Benchmarks
  • Evaluating Performance
  • Evaluating Risk
  • Understanding Fees

*Based upon the GFOA Best Practice “Investment Program for Public Funds”
Develop an Investment Leadership Team
This “fiduciary” thingy really complicates exploiting my job to get stinking rich.
Develop an Investment Leadership Team

- **Fiduciary responsibility** – Legal obligation of one party to act solely in the best interest of another party
  - Rests ultimately with the public entity
    - Investment advisors also have a fiduciary responsibility
  - Funds collected and invested on behalf of constituents
  - Stringent oversight by citizens and press

- Explicit delegation of authority to an investment officer, typically the treasurer

- Investment Committee / Pension Board
  - Define investment objectives
  - Develop adequate controls and oversight
  - Review your policies and practices periodically

- Authorization of an outside Investment Advisor?
Cash Flow Analysis
Cash Flow is Key

- Identifies “core” vs liquid funds
- Helps ensure adequate liquidity and seeks to enhance cash management techniques
- Identifies trends in cash balances
- Can increase investment income
  - Amounts available for investment
  - Period of time to hold the investment
  - Assists with investment strategies
- Helps forecast potential deficits
Cash Flow Analysis and Forecasting

Liquidity and Operating Funds
- Daily Liquidity
- Funds to cover specific, predictable cash flows
- Investment horizon less than 12 months

Bond Proceeds
- Funds dedicated for a specific use
- Investments matched to draw schedule

“Core” Reserves
- Funds with stable balances
- Investment horizon more than 1 year

*For Illustrative Purposes Only*
Why Prepare a Cash Flow Analysis

- There are advantages to keeping money liquid
  - Money is available for unexpected expenses
  - Funds usually earn interest in fully-liquid accounts
- There are also costs to keeping cash on hand
  - Lost investment income
  - Market risk
  - Potentially bad press
- Time is money
  - Many priorities competing for staff time
  - Finding the right mix of investments takes time, continually monitoring of changing market conditions
Review Applicable Laws and Regulations
Applicable Laws for Public Funds

- **Operating Funds**
  - Short-term horizon
  - Uncertain cash flows
  - 1st priority = protect investment principal
  - Limited by the Illinois Public Funds Investment Act (30 ILCS 235)

- **Pension Funds**
  - Long-term horizon
  - Actuarial Assumptions
  - 1st priority = achieve long term growth
  - Limited by the Illinois Pension Code (40 ILCS 5)
Permitted Investments – Operating Funds

- Define general universe
- Complies with the Illinois Public Funds Investment Act (30 ILCS 235)
- Set diversification limits
  - Term
  - Sector
  - Credit Quality
- Restrictive clauses

<table>
<thead>
<tr>
<th>Sector</th>
<th>Allowed</th>
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<td>U.S. Treasuries</td>
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<td>Repurchase Agreements</td>
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<td>✓</td>
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<td>Municipal Securities</td>
<td>✓</td>
</tr>
<tr>
<td>Commercial Paper</td>
<td>✓</td>
</tr>
<tr>
<td>Corporate Notes</td>
<td>NO*</td>
</tr>
<tr>
<td>Mutual Funds (Equity)</td>
<td>NO</td>
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* Corporate Notes and other securities may potentially be allowed if the entity has the right to exercise “Home Rule.”
Permitted Investments – Pension Funds

- Define general universe
- Complies with the Illinois Pension Code (40 ILCS 5)
- Set diversification limits
  - Term
  - Sector
  - Credit Quality
- Restrictive clauses

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Establish a Risk Profile
Credit Risk
The risk of loss due to the failure of the security issuer or backer.

Market Risk
The risk that changes in the market will reduce the value if sold prior to maturity.

Custodial Risk
The risk that the custodian of the investment will not have funds available when requested.

Interest Rate Risk
The risk that the market value of securities will fall due to changes in general interest rates.

Liquidity Risk
The risk that the investment portfolio is not sufficiently liquid to meet cash flow needs.

Reputational Risk
The risk that government officials will lose stature by making investment mistakes or errors.
Risk Tolerances

"We've considered every potential risk except the risks of avoiding all risks."

V.S.

- NOTHING
- VENTURE
- NOTHING
- GAINED
Public Funds – High Quality Fixed Income

- The overall market is made up of a broad spectrum of asset classes
- Most public funds are invested in conservative and liquid assets
- Diversified asset classes may be used for pensions, Other Postemployment Benefits (OPEB), endowments, foundations, etc.
Public Funds – High Quality Fixed Income

- Longer strategies can increase earnings potential, however they also come with increased risk

<table>
<thead>
<tr>
<th>Merrill Lynch Index</th>
<th>Duration</th>
<th>Average Annual Return</th>
<th>Cumulative Value of $25,000,000</th>
<th>Quarters With Negative Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-Month Treasury Bill</td>
<td>0.24 Years</td>
<td>0.57%</td>
<td>$26,463,471</td>
<td>0 out of 40</td>
</tr>
<tr>
<td>1 Year Treasury Index</td>
<td>0.99 Years</td>
<td>1.21%</td>
<td>$28,188,248</td>
<td>5 out of 40</td>
</tr>
<tr>
<td>1-3 Year Treasury Index</td>
<td>1.89 Years</td>
<td>1.95%</td>
<td>$30,336,174</td>
<td>8 out of 40</td>
</tr>
<tr>
<td>1-5 Year Treasury Index</td>
<td>2.69 Years</td>
<td>2.65%</td>
<td>$32,488,378</td>
<td>12 out of 40</td>
</tr>
<tr>
<td>1-10 Year Treasury Index</td>
<td>3.78 Years</td>
<td>3.51%</td>
<td>$35,310,863</td>
<td>13 out of 40</td>
</tr>
</tbody>
</table>

*Source: Bloomberg*
Sample Credit Screening Process

- Bloomberg
- MarketAxess
- TradeWeb

Universe of Potential Issuers

- Preliminary Screen
  - Minimum rating requirements
  - Availability of supply
  - Relative value analysis

- Industry Screen
  - Economic outlook
  - Outlook for industry growth
  - Geographic exposure
  - Changes in regulatory environment

- Issuer Screen
  - Improving or stable ratings
  - Diversity of revenue/profits
  - Capital structure
  - Strength of financial position
  - Industry leadership
  - Superior product
  - Management team

Information Sources:
- Independent research
- Company releases
- Sell side analysis
- News releases
- Company financials
- Ratings reports
- Security valuation

Approved Issuer List
Determine the Portfolio Management Team
Options For PublicEntities

- Internal management
  - Staff purchasing individual securities through broker/dealer
  - Certificates of deposit (CDs)
  - Local Government Investment Pools
- External management
  - Hire an independent investment advisor
- Combination of internal and external management
Investment Advisor vs Broker/Dealer

SEC Registered Investment Advisor

- Fiduciary Responsibility
- Fees are fully disclosed
- Owns no portfolio or inventory of securities
- Fees based on assets under management

Broker/Dealer

- Suitability responsibility
- May be undisclosed fees
- Can set price and sell from own inventory of securities
- Fees based on transactions plus difference between bid and ask price

Unknown Costs
Potential Benefits of Utilizing an Investment Advisor

- Complement to Internal Resources.
- Independent Audit of Investment Program.
- Enhanced Internal Controls and Potential Audit Savings.
- Transaction Cost Savings.
- Enhanced Portfolio Return.
- Risk Management.
- Diversification.
- Continuity.
- Personnel Time.
- Access to Technology and Outside Data Sources.

*Source: GFOA's “An Introduction to Investment Advisers For State and Local Governments”*
Potential Drawbacks of Utilizing an Investment Advisor

- Cost.
- Oversight and Responsibility.
- Reputational Risk.

*Source: GFOA’s “An Introduction to Investment Advisers For State and Local Governments”*
Create an Investment Policy
Define Investment Objectives

For general operating, reserves, and bond proceeds:

- Protect principal
- To meet ongoing and uncertain needs
- Maximize earnings
- While simultaneously providing safety and liquidity

Navigating the Path to Leadership
Investment Policy Statement

- Develop, Review, Amend, Improve ... Then Review, Amend, and Improve again
  - Objectives
  - Standard of Prudence
  - Ethics & Conflicts
  - Delegation of Authority
  - Selection of Broker / Dealers
  - Competitive Selection
  - Safekeeping and Custody
  - Internal Controls

- Authorized Investments
  - Specifically define
- Belts and Suspenders
  - Diversification
  - Sector
  - Issuer
- Maximum Maturity
- Security Downgrades
  - What to do?

- Performance and Reporting Standards
Best Practices for Pension Funds
### Understanding the Investment Advisory Models

<table>
<thead>
<tr>
<th>Service</th>
<th>Manager / Advisor (Discretionary)</th>
<th>Consultant (Non-Discretionary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provides Asset Allocation Advice</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Provides Investment Policy Help</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Quarterly Performance Reporting</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Portfolio Changes</td>
<td>Acts on Your Behalf within IPS guidelines</td>
<td>Acts with Board Approval</td>
</tr>
<tr>
<td>Portfolio Implementation</td>
<td>Implements on Fund’s Behalf</td>
<td>Consultant or Board may be responsible</td>
</tr>
<tr>
<td>Responsible for Fund Performance</td>
<td>Manager / Advisor</td>
<td>Board</td>
</tr>
<tr>
<td>Board Involvement</td>
<td>Low/Moderate</td>
<td>High</td>
</tr>
<tr>
<td>Manager Contracts</td>
<td>Should not be necessary</td>
<td>Likely if investing in separate accounts</td>
</tr>
</tbody>
</table>
Understand How Portfolios are Created

- Portfolio should be constructed to help the Fund achieve its long-term actuarial return
- What capital market assumptions are being used?
- Portfolios should be constructed within IL Pension Guidelines
  - Asset allocation requirements
  - Allowable securities
- Use of active versus passive strategies
- Ask if/how/why/when the portfolio might be adjusted over time
- Similarities/differences compared to other clients

Sample 50/50 Portfolio

- Int'l Stocks 25%
- Corporate Bonds 16%
- US Treasury Bonds 16%
- US Agency Bonds 16%
- Cash 2%
- US Stocks 25%

Navigating the Path to Leadership
Developing Benchmarks

- A benchmark is a measurement standard used to evaluate investment performance (portfolio level or by fund manager)
- Your portfolio benchmark may be some combination of one or more equity benchmarks (e.g. S&P 500 Index or Russell 3000 Index) and bond benchmarks (e.g. – Bloomberg Aggregate Bond Index)
- It should reflect your long-term strategic asset mix
- Your benchmark should be established in the investment policy and should not be modified without board approval and advisor support
- US Equities – Russell 3000 Index
- Int’l Equities – MSCI ACWI ex US Index
- Fixed Income – Bloomberg Intermediate Govt/Corp Index
Evaluating Investment Performance

- Global Investment Performance Standards ("GIPS")
  - Created by the CFA Institute
  - GIPS are a set of industry-wide principles that guide investment firms on how to calculate and present their investment results to prospective clients
- Gives the investment community the ability to fairly compare performance of investment managers
- Helps to avoid presenting or “cherry-picking” well-performing accounts
- Establishes performance presentation standards and states how to create composites
  - www.gipsstandards.org
  - www.cfainstitute.org
Evaluating Investment Performance

- Ask for Trailing and Calendar Year performance returns
- Avoid making hiring decisions solely based on past returns

*For Illustrative Purposes Only*
Evaluating Investment Performance

- This chart displays how consistently an advisor or fund manager has outperformed their benchmark each quarter.
- Which return pattern do you prefer?
- Ask your advisor or potential advisor to create this chart for your Board.

**Quarterly Out/Underperformance**

<table>
<thead>
<tr>
<th>Positive Returns</th>
<th>Negative Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pattern A: Up &amp; Down</td>
<td>Pattern B: Lower but Steady</td>
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</table>

*For Illustrative Purposes Only*
Evaluating Portfolio Risk

- Boards should understand how much risk is being taken to achieve portfolio returns
- Is your Board comfortable taking on more risk to achieve desired returns?
- Ask for a “5-year or 10-year standard deviation of returns figure

*For Illustrative Purposes Only*
Understanding Fees

**Fees to Consider**
- Advisor Fees / Compensation Structure
- Mutual Fund Fees and other Transaction Fees
- Custody

**Ask for the potential “All-In” Fee**

\[
\text{Advisor Fees} + \text{Underlying Investment Manager Fees} = \text{Total Fees}
\]

$\$$ $\$$ $\$$ $\$$ $\$$

Navigating the Path to Leadership
Summary

- Devote the time to develop an investment strategy
- Don’t expect higher returns without higher risks
- Follow your Investment Policy and review it periodically
- Be proactive
- Engage your program partners/vendors for support
- Look to GFOA for Best Practices and sample documents
Links to GFOA Referenced Documents

- GFOA Best Practice “Investment Program for Public Funds”:
- GFOA’s Best Practice “Cash Flow Analysis”:
- GFOA’s Best Practice “Investment Policy”:
  [http://www.gfoa.org/investment-policy](http://www.gfoa.org/investment-policy)
- GFOA’s “An Introduction to Investment Advisers For State and Local Governments”:
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