

Overseeing your Investment Program: Best Practices for Fiduciaries

2017 IGFOA Conference



Presentation Team



Michelle Binns
PFM Asset Management LLC
Senior Managing Consultant
binnsmpfm.com
312-523-2428



Jason Myers
Lombard Park District
Director of Finance & Personnel
jmyers@lombardparks.com
630-620-7322



Jason Palmer
PFM Asset Management LLC
Senior Managing Consultant
palmerj@pfm.com
312-523-2421

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



**Navigating
the Path to Leadership**



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
 - o 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
 - o Define investment objectives
 - o Develop adequate controls and oversight
 - o Review your policies and practices periodically
- Authorization of an outside Investment Advisor?



Cash Flow Analysis



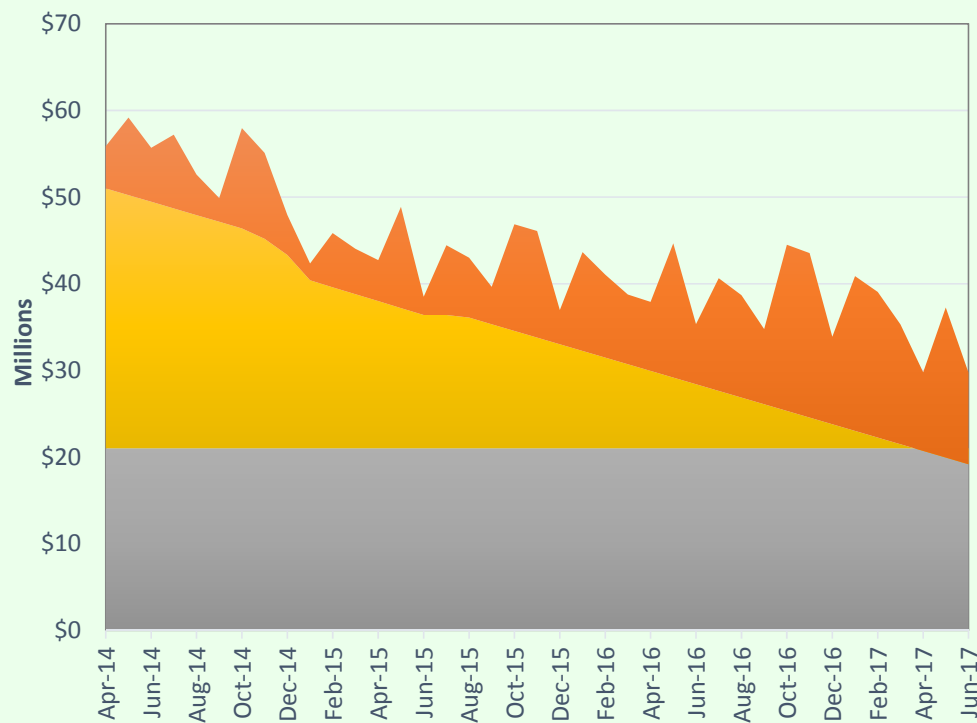
**Navigating
the Path to Leadership**

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



**For Illustrative Purposes Only*

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

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



**Navigating
the Path to Leadership**

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

Sector	Allowed
U.S. Treasuries	✓
Federal Agencies	✓
Certificates of Deposit	✓
Repurchase Agreements	✓
Local Government Investment Pools	✓
Municipal Securities	✓
Commercial Paper	✓
Corporate Notes	NO*
Mutual Funds (Equity)	NO

* 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

Sector	Allowed
U.S. Treasuries	✓
Federal Agencies	✓
Certificates of Deposit	✓
Repurchase Agreements	✓
Local Government Investment Pools	✓
Municipal Securities	✓
Commercial Paper	✓
Corporate Notes	✓
Mutual Funds (Equity)	✓

Establish a Risk Profile



**Navigating
the Path to Leadership**

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 / errors



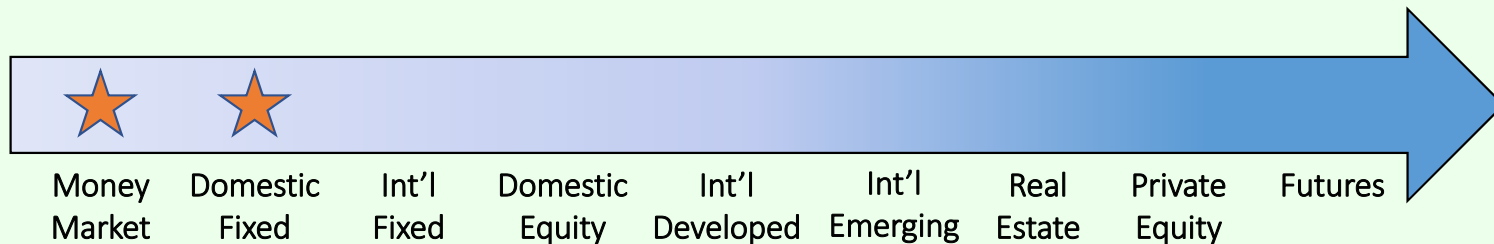
Risk Tolerances



V.S.



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

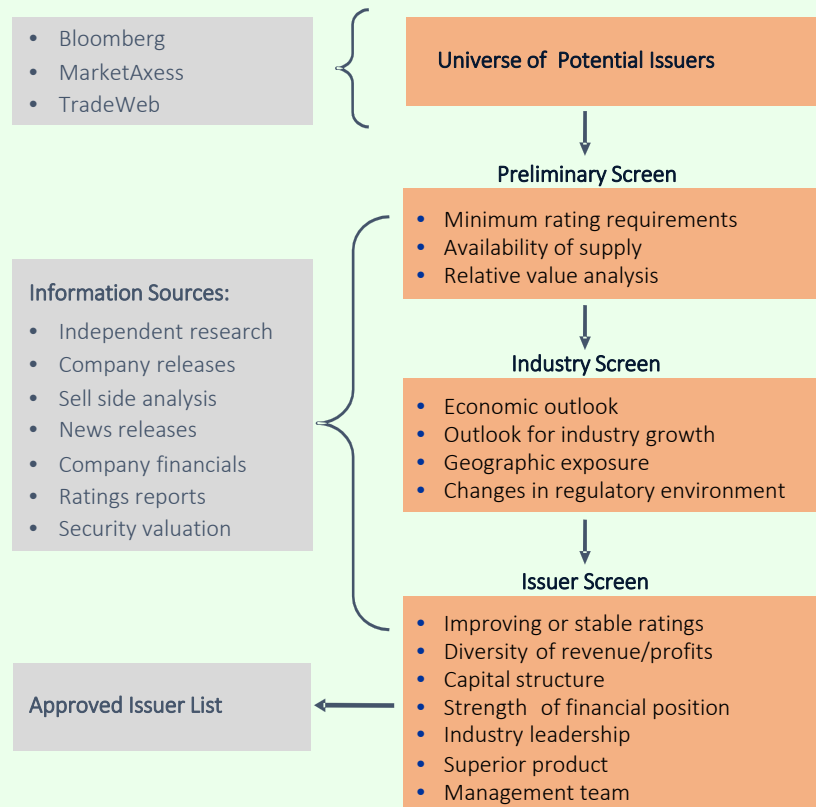
- Longer strategies can increase earnings potential, however they also come with increased risk

Risk/Return of Various Benchmarks 10 Years Ended 6/30/2017				
Merrill Lynch Index	Duration	Average Annual Return	Cumulative Value of \$25,000,000	Quarters With Negative Returns
3-Month Treasury Bill	0.24 Years	0.57%	\$26,463,471	0 out of 40
1 Year Treasury Index	0.99 Years	1.21%	\$28,188,248	5 out of 40
1-3 Year Treasury Index	1.89 Years	1.95%	\$30,336,174	8 out of 40
1-5 Year Treasury Index	2.69 Years	2.65%	\$32,488,378	12 out of 40
1-10 Year Treasury Index	3.78 Years	3.51%	\$35,310,863	13 out of 40

*Source: Bloomberg



Sample Credit Screening Process



Determine the Portfolio Management Team



**Navigating
the Path to Leadership**

Options For Public Entities

- 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	Transparent Fee
Fees are fully disclosed	
Owens no portfolio or inventory of securities	
Fees based on assets under management	

Broker/Dealer

Suitability responsibility	Unknown Costs
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	

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



**Navigating
the Path to Leadership**

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

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



**Navigating
the Path to Leadership**

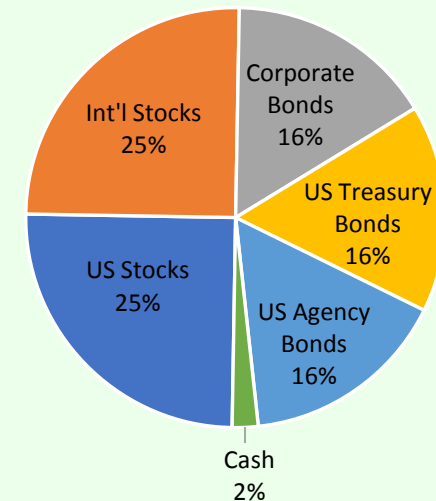
Understanding the Investment Advisory Models

	Manager / Advisor (Discretionary)	Consultant (Non-Discretionary)
Provides Asset Allocation Advice	X	X
Provides Investment Policy Help	X	X
Quarterly Performance Reporting	X	X
Portfolio Changes	Acts on Your Behalf within IPS guidelines	Acts with Board Approval
Portfolio Implementation	Implements on Fund's Behalf	Consultant or Board may be responsible
Responsible for Fund Performance	Manager / Advisor	Board
Board Involvement	Low/Moderate	High
Manager Contracts	Should not be necessary	Likely if investing in separate accounts

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



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

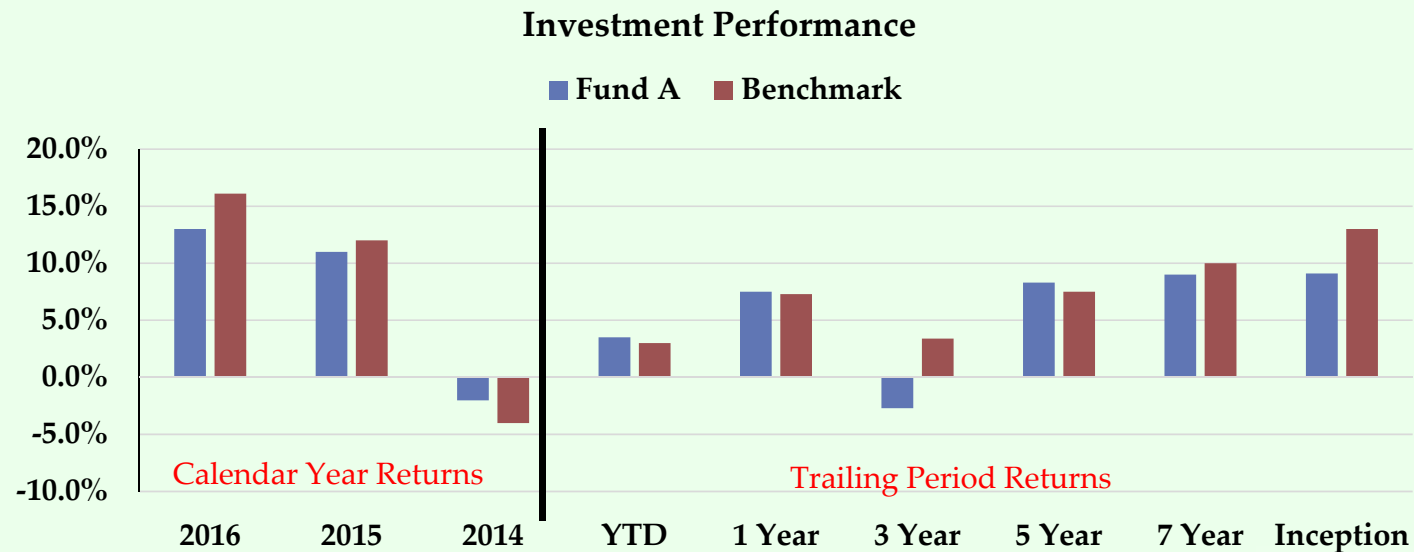
Evaluating Investment Performance

- 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

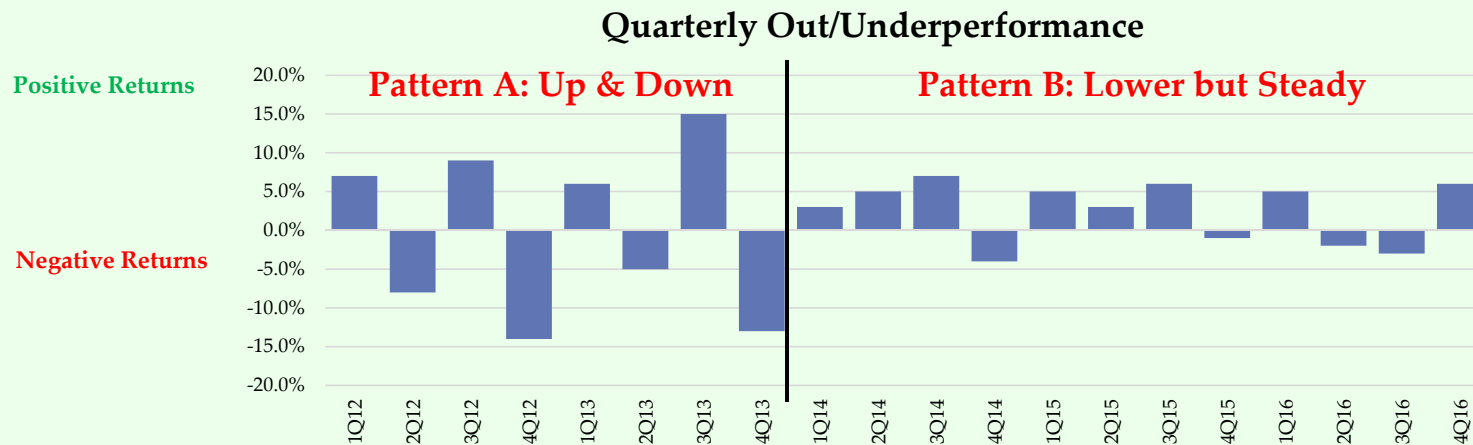
- Ask for Trailing and Calendar Year performance returns
- Avoid making hiring decisions solely based on past returns



**For Illustrative Purposes Only*

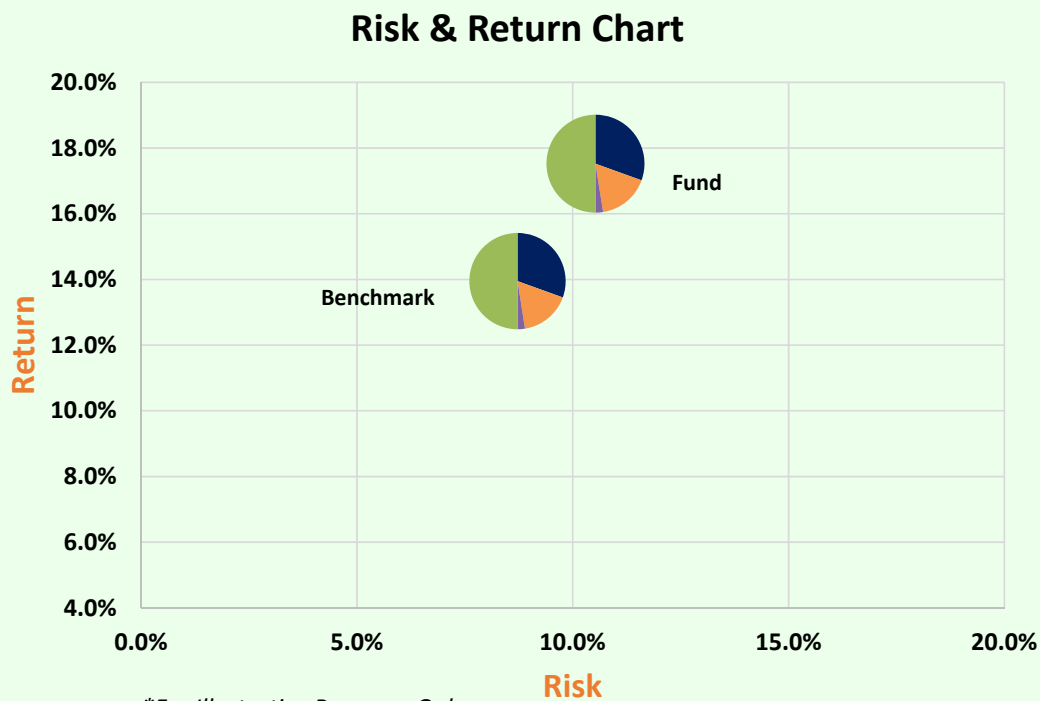
Evaluating Investment Performance

- 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



**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

Understanding Fees

Fees to Consider

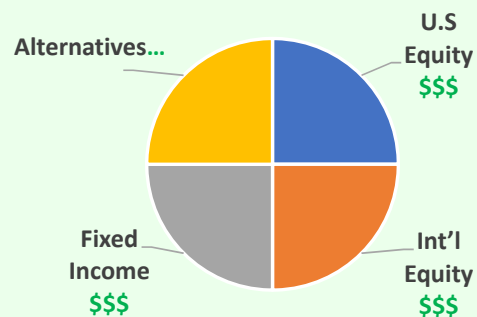
- Advisor Fees / Compensation Structure
- Mutual Fund Fees and other Transaction Fees
- Custody

Ask for the potential “All-In” Fee

Advisor Fees + Underlying Investment Manager Fees = 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” :

<http://www.gfoa.org/investment-program-public-funds>

- GFOA’s Best Practice “Cash Flow Analysis”:

<http://www.gfoa.org/cash-flow-analysis>

- GFOA’s Best Practice “Investment Policy”:

<http://www.gfoa.org/investment-policy>

- GFOA’s “An Introduction to Investment Advisers For State and Local Governments”:

<http://www.gfoa.org/sites/default/files/AnIntroductionToInvestmentAdvisersForStateAndLocalGovernments-SecondEdition.pdf>



**Navigating
the Path to Leadership**

Disclaimers

PFM is the marketing name for a group of affiliated companies providing a range of services. All services are provided through separate agreements with each company.

This material is for general information purposes only and is not intended to provide specific advice or a specific recommendation, as it was prepared without regard to any specific objectives or financial circumstances. It is based on information obtained from sources generally believed to be reliable and available to the public; however, PFM's asset management group cannot guarantee its accuracy, completeness or suitability. The views expressed within this material constitute the perspective and judgment of PFM's asset management group at the time of distribution and are subject to change

Investment advisory services are provided by PFM Asset Management LLC which is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. The information contained is not an offer to purchase or sell any securities. Additional applicable regulatory information is available upon request.