UNC School of Government:
Cash Management & Investment of Public Funds

External Money Managers and Investment Issues

Presented by :

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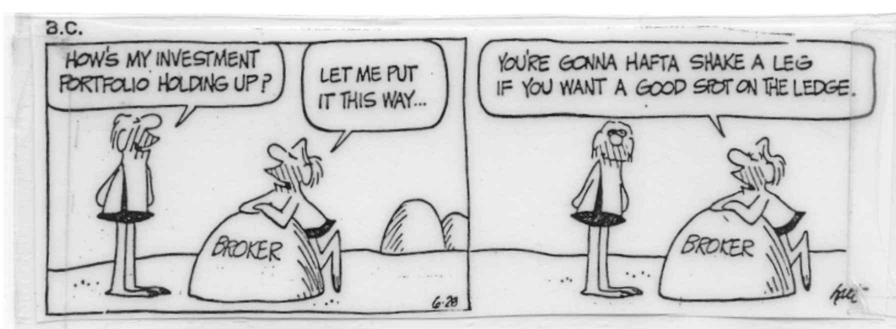

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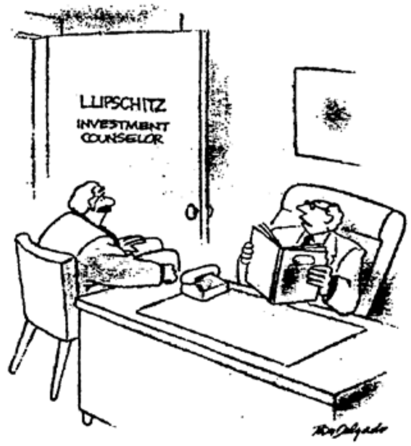

"You have a balanced investment portfolio. Everything you own is losing money at an equal rate."
Barron's

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- <u>Legality</u> – know what your unit can invest in (GS 159-30)
  - Can your local government use external investment managers w/o specific local legislation?
    - Winston-Salem – pension plan
    - City of Charlotte – Firefighters Retirement fund

- Decide what you want to achieve
  - Investment policy
  - Increased yield
  - Safekeeping
  - Cash flow analysis
  - Portfolio reporting
  - Training

Constraints -

- Safety – low default or credit risk
- Liquidity – able to turn asset into cash quickly, w/o great loss of principal
- Yield – always the last consideration

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- What funds do you want to include –
  - Short-term
  - Long-term
  - Operating funds
  - Bond funds
  - Reserve funds

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- Internal Managers – usually the Finance Officer or Investment Officer
- External Managers –
  - bank trust departments
  - national investment management firms
  - small independent consultants
  - broker/dealers

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- External Investment Programs –
  - Manager -
    - actively manages portfolio
    - executes purchases/sales
    - coordinates safekeeping
  - Advisor –
    - advises local unit as to purchases/sales, portfolio operations
    - no direct control
    - local unit maintains direct control of process
    - advisor only gives suggestions

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- Investment Managers/Advisors

  - Brokers -
    - Don't maintain their own inventory
    - Put buyers and sellers together
  - Broker/Dealer –
    - Maintain an inventory of securities to sell
    - Can offer and trade from their own account
    - Investment advice **may not be an objective opinion** but one that is designed to sell securities for a commission.

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- Common To All External Managers/Advisors
  - They offer investment advice or management for a fee

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- Selecting Investment Managers
  - Provide to Prospective Advisors
    - State investment statutes
    - Local investment statutes
    - Current investment policy
    - Current portfolio listing
    - Cash flow projections for coming year

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- Selecting Investment Managers
  - Use an RFP process (ask about)
    - Organization of the firm
    - Ownership of the firm
    - SEC or regulatory censure/litigation (all yrs)
    - Personnel qualifications
    - Size and type of assets managed
    - Investment management style and philosophy
    - Reporting practices
    - Historical performance
    - Fees
    - References (preferably public sector)

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- Selecting Investment Managers
  - Personal interview for final candidates
  - Insist on formal contract
    - Term of contract
    - Description of services to be performed
    - Liabilities
    - Assurance of compliance with all laws, statutes and policies
    - Reporting requirements
    - Fees
  - Require investment results comply with Global Investment Performance Standards **(GIPS®)**

- Why Units May Use Managers
  - Develop investment policy
  - Active investment strategies
    - Yield curve, sector analysis, spread analysis
  - Market timing strategies – very difficult, most "active" managers underperform their benchmark
  - Portfolio realignment
  - Access to additional resources (Bloomberg)
  - Reduce staff workload

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- Why Units May Not Use Managers
  - Size of Unit -
    - May consider themselves too large
    - May consider themselves too small
  - Level of Sophistication -
    - Experienced, well-trained staff in place
  - Legality & Control –
    - Do your statutes permit it?
    - "Losing control" of investment program

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May Not Use (cont.)

- Enjoyment – this is a fun part of the job
- Cost – Units just don't see the value
  - Staff still needed to monitor investment program
    - Finance Officer is still ultimately responsible
  - Is it worth the fee? What is value added "net of fees"
  - How are managers paid?
    - Flat fee
    - Fee based on assets under management
    - Fee based on performance
    - Paid out of earnings
    - Line item expense

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Discretionary vs. Non-Discretionary Authority

- Discretionary Authority – granting to an investment manager complete authority to execute investment transactions subject to general constraints set by the unit's investment policy or by contract with the manager
  - Advantages –
    - quicker response time to market opportunities
  - Disadvantages –
    - probably **not** legal
    - loss of control over funds
    - loss of control over the decision making process

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Discretionary vs. Non-Discretionary Authority

- Non-Discretionary Authority – manager must obtain approval for individual transactions

Advantages -

- **Legal**
- government retains control over it's funds
- provides input to the process

Disadvantages –

- staff time is used handling investments
- manager performance is more difficult to evaluate because of local government input

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Benefits of Using External Managers

- Professional manager – that is their business
- Greater access to investment markets/information
- Enhanced credit research available for unsecured investments (i.e. - commercial paper, professional research)
- Can complement internal resources or personnel
- Could increase internal control and "separation of duties"

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- Costs of Using External Managers
  - All returns should be quoted "net-of-fees".
    - Take the total yield or return that the manager earns and subtract the fees they charge to manage the portfolio. The remaining earnings will be the "net earnings".
    - "Net-of-fees" can be used for bank products also. Different products have different fee structures.
  - The manager must earn excess returns at least equal to their fee for the local unit to "break even".
  - Loss of Control – Have to monitor compliance, what if manager purchases an ineligible investment, FO still responsible

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- Cost - there is a fee charged for managing assets
  - Flat fee - Fixed dollar charge for managing investment program ($15,000/year, $50,000/year or any other agreed upon price)
  - Percentage of Assets- average invested balance multiplied by percentage rate (30 basis points, 50 basis points, etc…)
    - Ex. - $10,000,000 x .0030 = $30,000 per year
  - Combination - flat fee, percentage of assets, percentage of gains or combinations thereof
    - If manager performs well, are you going to have problems explaining a large investment management fee to your governing board (it's not what you are earning for me, it's what you are costing me, view)

- <u>Costs of Using External Managers (cont.)</u>
  - <u>Choosing the wrong manager</u> - the manager underperforms the market, (**you can do this for free**)
  - <u>Choosing the wrong benchmark</u> - if wrong benchmark is chosen, manager may be compensated for sub-par performance

- <u>Investment Agreements</u>
  - Investment Agreements should include:
    - Acceptable risks
    - Allowable investment instruments
    - Allowable strategies
    - Diversification requirements
    - Required reporting (Minimums)
      - Detailed portfolio transactions - to monitor compliance
      - Investment performance report - should include total return

      Maturity/Duration indicators - to monitor interest rate risk
      - Portfolio holdings -
      - Mark-to-Market report –
    - Clear Custody

- Custody - the legal responsibility for someone else's assets
- Custodian - responsible for:
  - safekeeping of the assets
  - accurate record keeping
  - accounting of assets
  - timely delivery of securities/interest payments
  - reporting to the client

- For local government units, the custodian is normally the trust department of a bank.
- This is your first and last line of defense for safety of assets.

- Custody (cont.)
  - Third Party Custodial Account – **very important**
    - Needed for all investment programs (internal or external)
    - Custodian is independent of the trade and holds the investment for the benefit of the governmental unit only
    - Assets are held in the unit's name only and should never be registered in "street name" or held by a dealer.
  - A good custody account should protect the unit's assets in case of liquidation of the firm.
  - "Delivery vs. payment" (DVP) – must have this
    - Securities and funds are exchanged simultaneously
    - Assets are protected in case of failure

- Ways for External Managers to Outperform
  - Extension - going further out on the yield curve, increasing volatility, mark-to-market issues (especially in times of rising interest rates)
  - Reduce Credit Quality - buying lower credit quality instruments to pick up the risk premium offered
    - Treasuries
    - Government agencies
    - Commercial paper
  - Trading - active trading of security positions to capture potential gains (at what cost, ST income vs. LT yield)

- Ways for External Managers to Outperform
  - Increase risk – this is the only way
    - Credit Quality – use lower credit quality investments
    - Extension – go further out the yield curve
    - Trading – try to capture gains in market value
  - Finance Officer ultimately accountable

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- State of North Carolina –
  - What do they use external managers for?
    - Equities
    - Venture capital
    - Real estate
    - Alternative investments
  - What do they manage internally?
    - Fixed income
    - Almost exclusively internally managed

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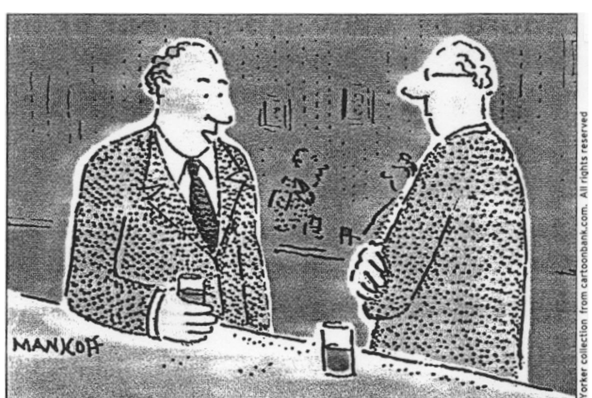
LIGHTEN UP



"Long-term, I like bonds; intermediate-term, I like equities; and short-term, I like scotch."