

BEYOND TOTAL RETURN

Is Investment Practice Following Investment Policy?

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The nature of public fund investing is unique. As stewards of public moneys, government portfolio managers have the fiduciary responsibility to insure that investments are suitable. The Wall Street approach to investment management and performance evaluation does not apply when one is referring to the investment of public funds. Let's see why...

What is a legitimate measure of performance in the management of a public fund? Is it "total return," as Wall Street would have it? Is it a comparison to peers, as others suggest? Or is it something totally different?

This article attempts to answer the question of whether a total return method of measuring investment performance in practice, follows policy. To begin to answer that question, let's look at how the typical public fund manager ranks investment policy objectives. In a room full of public fund managers, when asked the question, "In importance, how do you rank the objectives of safety, liquidity, and income in the performance of your job?" most of the respondents would rank safety and liquidity combined, at 80% to 90%.

In light of the above example, why then would the typical performance evaluation be based on a portfolio's total return – or even a peer group comparison – given that, of the three policy objectives, return receives the lowest priority?

As for peer group comparisons, how can these provide relevant insight into how well a public fund performed relative to its peer, when no risk adjustment or standard return calculation is provided? Having the same investment policy objectives does not necessarily mean having the same liquidity and risk tolerance. The only "peer group" that a public fund realistically has is its own policy and plan, not another public fund.

To take this one step further, should not a performance measurement standard capture and include all investment policy objectives, not just return?

Our hope is, that after reading this article one understands that a suitable benchmark is a fiduciary benchmark; and a fiduciary benchmark adds the qualitative component to the quantitative component of performance evaluation.

We will propose a performance measurement standard, which in practice will follow policy.

We will demonstrate the shortcoming of using total-return market benchmarks to judge public funds' fiduciary performance, and suggest how to modify a market benchmark to capture the unique investment objectives of public funds.

A Tale of Two Cities

A portfolio manager says, "I have great news for the board! Our unit of local government is in the top 1% quartile of all professional money managers using the Merrill Lynch 1-3 yr. Government index. We realized only a 5.00% portfolio loss while the Merrill Lynch benchmark lost 5.5%."

Needless to say the board or council did not share the enthusiasm of the manager.

A critical error common in the investment practice is for one manager to compare his or her fund's performance to that of a "peer" – another public fund. Comparing returns does not capture the qualitative elements of performance evaluation. Return is not capturing the differences in risk between the two public funds. You will see in the following example how making this comparison may also obscure the fact that neither portfolio may be suitable.

Let's look at two hypothetical cities - City A and City B. They each are located in the same state and have the same portfolio size. In both cities the public fund managers believe that the most important responsibility is to preserve the principal of the fund. Likewise, they share the same investment objectives – safety, liquidity, and income - in that order. Could one say that these two cities are "one or the same"? Let's look closer, and see.

A retiring investment professional manages the public fund for City A. The city is a wealthy community with large surpluses. The investment manager invests all funds in the state pool and benchmarks the portfolio return against that of the pool. On average the funds earned 2% over the past year.

In contrast, a young, highly educated professional manages the investment portfolio for City B. City B is a new community with huge developmental needs and no surpluses. City B earned a portfolio return of 4.5% over the past year.

A peer comparison between the two may lead to misleading, erroneous or irrelevant conclusions. Because the cities are in the same state; have the same investment goals and policy objectives; and both invest in legal securities, can one conclude that City B has done a better job than City A, because a 4.5% return is better than a 2% return? *Is this type of comparison relevant to insuring public money is being invested wisely?* In drilling down deeper, one can see that legal does not mean that it is suitable.

City A fund manager has the fiduciary role to manage risk, not to avoid it. The taxpayers may not think highly of what may appear to be a “risk avoidance retirement strategy.” With 100% of the assets and liquidity in the state pool, is the portfolio sufficiently well diversified? Because the investment in the pool is legal, and the comparison with the benchmark is equal, is City A manager fulfilling his or her role as steward of taxpayer money? One might argue, no.

City B uses as its benchmark the Merrill Lynch 1-5 year market index. City B beat its benchmark by .5%, and therefore must be doing a good job. Right? The city outperformed its benchmark and peer group (income); invested in all U.S. Treasuries (safe); and paid all obligations without a principal loss (liquid). The results seem positive, however, was risk properly accounted for in the evaluation? Without including a thorough risk assessment as part of the equation, beating an index is not relevant to determining investment prudence.

If City B was using gains as a source of liquidity, any significant move in interest rates could leave City B with no short-term cash equivalent securities. The current practice of peer group comparison doesn't pick up the fact that City A and City B have different indexes, and that neither is suitably fulfilling his or her role as financial steward. Liquidity, interest rate risk, and market rate of return have a large impact on performance and should be included as part of the performance evaluation process. Evaluating return without accounting for risk is incomplete and rather meaningless.

Benchmarking Suitability

Suitability is the one standard that can “specify performance measures as are appropriate for the nature and size of the public funds within the custody or the unit of local government” – Sec. 218.415 (3), F.S.

In the beginning of this article, we made the statement “The only peer group that a public fund has is its policy and plan, not another public fund.” What do we mean by this? An investment plan converts a static investment policy – the rulebook – into a dynamic portfolio interpretation – the playbook. The plan is pre-determined. It is a portfolio representation of what is suitable for the public entity, and what the portfolio should look like over time – i.e. diversification of investments, liquidity, level of interest rate risk, etc. *Investment plans provide strategic flexibility as well as a framework for monitoring and reporting the suitability of an investment portfolio.* In performance evaluation, the qualitative as well as quantitative components form the basis for reporting how well a manager is doing in meeting investment objectives.

The Five We’s of Suitability

“We have enough *liquidity* to pay obligations.”

“We have *appropriate* interest rate *risk*.”

“We have a *diversified* portfolio.”

“We have a portfolio of *legal* investments.”

“We have an *appropriate market rate of return*.”

A public fund manager makes the above statements to her investment policy committee. Assuming that these statements are accurate and can be verified, has this fund manager comprised a suitable investment portfolio? We would argue, yes. Let’s look further at each component, and illustrate how Palm Beach County benchmarks the suitability of its \$1.8 billion portfolio.

Liquidity

Liquidity risk, or the premature sale of a security to meet an unexpected obligation, is the greatest principal risk to preserving principal. If a fund manager is forced to sell a security when market conditions are unfavorable – i.e. prices down, rates up – principal losses may be incurred. Likewise, a “safe” AAA rated security sold before maturity to pay an obligation, exposes principal to market risk. As Orange County, CA aptly demonstrated, safe does not mean liquid.

Palm Beach County uses cash flow forecasting and scenario analysis in order to insure that the portfolio has sufficient liquidity without having to prematurely sell a security. The budget office provides the schedule of receipts and expenditures that are incorporated into a spreadsheet of projected portfolio cash flows. The spreadsheet may be shocked up and down using various interest rate environments to gain a truer picture of liquidity. Having this information available helps the investment manager to balance the need to preserve principal with investing to optimize return.

Interest Rate Risk

Interest rate risk quantifies a public fund’s willingness to take principal risk in pursuit of the third investment policy objective – income. How is interest rate risk determined for a given entity? Each public fund may or may not extend duration in order to increase income. And each will define different levels of interest rate risk appropriate to their budget, politics and other immediate needs. Again, we are highlighting why peer group comparisons are irrelevant. For example, if you compare two counties, and one has the ability to incur a longer duration than the other, then the idea that one has a higher yield is unrelated to providing insight into which one did the better job.

In the County, duration and convexity are two measures that are calculated and useful in managing interest rate risk. Duration is a measure of a bond’s price sensitivity to a change in interest rates; and convexity is a measure of the stability of duration of that bond. Both are calculated using various rate shifts to insure that the portfolio’s interest rate risk is fully understood. For investments containing options, such as callable bonds and mortgage-backed securities, the portfolio is frequently “shocked” up and down 300 basis points in order to see potential extension and contraction impact on the total portfolio.

The investment plan provides an advance warning system for interest rate risk management. Supervisors and/or investment policy committee members can easily monitor and compare the actual portfolio to the proposed investment plan. The investment plan provides non-financial peers an effective tool for oversight and review of the day-to-day investment decisions.

Diversification

Florida Statutes 218.415, section 8 states that "Investments held should be diversified to the extent practical to control the risk of loss resulting from over concentration of assets in a specific maturity, issuer, instrument, dealer, or bank through which financial instruments are bought or sold." As Orange County, CA has shown, having all of your money, or an over-concentrated amount, in one issuer who has a diversified portfolio, does not make you diversified. Having different issuers is diversified. Public funds who have all of their money invested in their state pool may believe they are safe, but they clearly are not diversified.

To insure diversification, Palm Beach County sets limits within its policy. Two examples are: "Investments in commercial paper shall be limited to a maximum amount of 25% of the total portfolio, at the time of purchase, with no more than 3% of the portfolio invested with any single issuer." and "Investments in Collateralized Mortgage Obligations (CMOs) shall be limited to 10% of the market value of the total portfolio..." Limitations are also tracked in the investment plan – adjustable rate mortgages may not exceed 15%, and all mortgages combined may not exceed 60% of the total portfolio.

Legal

A public fund should be able to demonstrate that investment holdings are in fact authorized as to issuer, maturity and structure. At Palm Beach County, as part of the annual audit, external auditors review investment holdings and indicate compliance.

Market Rate of Return

Palm Beach County moved from using a total return benchmark to a market rate of return benchmark in August 2002. Their reasoning focused on suitability and relevance. Their mandate is to preserve principal and protect the public money while achieving a reasonable rate of return. Reasonable rate of return is in the context of the ability of the portfolio to achieve a stable, market rate of return for budget purposes. Looking at short-term price fluctuations inherent in a total return benchmark would confuse budget stability with market volatility.

A mention should be made here that the County complies with GASB Statement No. 31. Investments are valued and reported at fair value, and changes from year to year are recognized as investment income. The County does not however, incorporate these fair value changes for budgeting purposes. The changes are recognized, yet not realized. GASB 31 in our view has focused on the bondholder at the expense of the taxpayer. By utilizing a market rate of return while complying with GASB 31 reporting requirements, both the bondholder and the taxpayer are equally served. It is important that practitioners avoid allowing GASB 31 reporting requirements to exert undue influence over their investment practices and strategy. The investment plan and policy should be the primary governors for constructing, managing and monitoring the investment portfolio.

Summary

To insure investment practice follows investment policy means modifying Wall Street to fit the needs and realities of Main Street (public funds). The most important modification is to move away from peer group comparison and total return performance measurement. Adopting a fiduciary benchmark founded on suitability will measure not one, but all of the investment policy objectives, and will provide both relevant and reliable insight into the quality of that stewardship.

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