

Changing Roles of Investment Professionals

CDIAC's Advanced Concepts and Practices for Investing
Public Funds

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Bill Blackwill Sr Vice President
Institutional Client Group
Citigroup Global Markets Inc.



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William C. Blackwill
Senior Vice President
Institutional Client Group
650 Town Center Dr., Suite 1550
Costa Mesa, CA 92626
We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

I will discuss:

- Broker/Dealers- types and roles
- Changes in technology and financial markets
- Significant Events
- Changing Roles
- What this means to a public agency



Are the Financial markets getting more complex? An “example”

- Swaps/Vol
- Despite the realized move in swap rates yesterday, the activity was based on book-squaring and unwinds. As similar to the above in UST space, the desk saw accounts take profit on receive positions in US Swaps 2s5s10s fly around 51.5bps (52bps this AM). Similarly, accounts taking off US Swaps 2s10s flatteners at 227bps after 14bps of flattening in one week. Front-end spreads wider again today despite 3mL restored to its downward trajectory. Interesting enough, the first set higher since 7/23 in 3mL yesterday was explained by an errant submitted offer. A quick look at the individual bank data this AM shows this 'fat finger' has been corrected today. In vol, more selling, but this time with a directional view in taking advantage of the rally. Low strike receivers in gamma space were better offered all day, while some dusted off looking at high-strike caps. 1y10y closes at, you guessed it, 10bp/d



Broker/Dealer – Investment Advisor

Typical Features

Broker/Dealer

- Transaction based compensation
- Subject to FINRA's suitability standard
- Makes Markets, executes transactions, provides research and analysis
- Registered with and regulated by the SEC and FINRA
- Also subject to State Securities Laws

Investment Advisor

- Fee based compensation
- Has Fiduciary duty and subject to suitability standard
- Provides discretionary or non-discretionary portfolio management
- Registered with and regulated by the SEC (if AUM > 30mm), otherwise regulated by states



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William C. Blackwill
Senior Vice President
Institutional Client Group
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We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

How can a Broker/Dealer add value to the Investment Process?

- Provides access to markets and execution of transactions
- Provides Economic and Market analysis and insight
- Provides strategic and tactical recommendations
- Educational resource



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William C. Blackwill
Senior Vice President
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Citigroup Global Markets Inc 800-258-6663

Types of Broker/Dealers

- Brokers, Dealers, and Broker/Dealers
- Primary Dealers vs Regional Dealers
- Institutional or Retail client base



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William C. Blackwill
Senior Vice President
Institutional Client Group
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We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

Broker and Dealer Defined

- Dealer - Underwrites new issues, makes markets and maintains inventory of secondary market securities
- Broker- Brings buyers and sellers together to effect a transaction
- A firm can perform both functions
- Individual Registered Representative often referred to as a “broker”



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William C. Blackwill
Senior Vice President
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We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

Primary Dealer vs Regional Dealer

Primary Dealer

- Makes a market in US Govt Securities
- Trades with Federal Reserve Bank of NY
- Meets minimum capital adequacy standards
- Required to participate in the Fed's Open Market Operations and Treasury Auctions
- 16 today vs 46 in 1988

Regional Dealer

- Also referred to as Secondary Dealer
- No Primary Dealer Status
- Can vary in size, geographical presence, capitalization, and specialization



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William C. Blackwill
Senior Vice President
Institutional Client Group
650 Town Center Dr., Suite 1550
Costa Mesa, CA 92626
We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

Institutional vs Retail

- Financial Markets, Investment Firms, and Institutional Investors have all become much more complex and diverse
- Need for specialization has increased
- Institutional brokers have access to institutional traders, inventories, and research capabilities



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William C. Blackwill
Senior Vice President
Institutional Client Group
650 Town Center Dr., Suite 1550
Costa Mesa, CA 92626
We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

Significant Events and their impact

- Ponzi Schemes: Wymer and now Madoff and resulting changes in practices and procedures and for both investors and Broker/Dealers
- 9/11 Terrorist Attacks: US Patriot Act etc
- Orange County Bankruptcy: Investment Code changes, Investment Policy Statements, Broker/Dealer Questionnaires etc
- Accounting and Conflict of Interest issues including Worldcom and Enron: Sarbanes Oxley, Separation of Research and Investment Banking at Investment Firms
- Current Financial and Credit Crisis: less reliance on rating agencies, Investment Firms shifting from proprietary trading back to customer business, wider bid offer spreads as well as wider yield spreads, reengineering of Risk Management



Evolution of Technology

- Internet and Email have transformed the way we interact and communicate
- Security and Portfolio Analytics: Bloomberg, Excel, Yieldbook and BondEdge
- Electronic Trading Platforms: Bloomberg Trading, Tradeweb, Market Axess
 - Platform types: interdealer, dealer to customer, new issue
 - Services offered: Trade clearing and settlement, confirmation and allocation services, order management, regulatory and compliance services, pre trade analytics, risk monitoring and management
- Technology has not replaced brokers or their firms but it has dramatically altered their roles



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William C. Blackwill
Senior Vice President
Institutional Client Group
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Costa Mesa, CA 92626
We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

How have these roles changed?

- Greater need for specialization with regard to product and client type
- Brokers must distill and derive meaning from information, not just deliver it
- Brokers can communicate with more clients more quickly and effectively
- Brokers must leverage technology to provide better service and more value
- What hasn't changed: Investors still value a relationship with a person and a Firm based on trust, good communication, good execution and value added service



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William C. Blackwill
Senior Vice President
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Costa Mesa, CA 92626
We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

Broker/Dealer Role

Past

- Communicate via phone, fax and mail
- Execute via phone
- 20-40 customer contacts per day
- Limited portfolio and security analytics
- Less regulatory, compliance and legal oversight
- Wider bid/offer spreads
- Less transparency
- Limited choices of security types, issuers, and structures

Present

- These + email & internet
- Execute via phone, internet, electronic platforms
- 100's of communications per day
- Vast array of analytics
- Much more
- More transparency and competition
- Many more choices and options



What does all this mean to a Public Agency Investor?

- Must embrace technology
- More effective and efficient investment process
- Better Portfolio management tools
- More important than ever to establish relationships with individuals and firms that understand a Public Agency's investment needs



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We.blackwill@citi.com

Citigroup Global Markets Inc 800-258-6663

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William C. Blackwill
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