SESSION ONE

Portfolio Management Principles

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Successful investing is about managing risk not avoiding it

– Benjamin Graham

Learning Outcomes

- Participants will learn who was the most successful investor of all time.
- Participants will gain valuable insights into how the Prudent Investor Standard of Care significantly influences Public Fund Investing practices.
- Participants will be introduced to the "political" aspects of investment policy surrounding core objectives and peer groups.
- Participants will be able to differentiate between two investment strategies suitable for a public fund investment portfolio.
- Participants will explore what constitutes acceptable interest rate and credit risk.

The Code
Prudent Investor Standard

Government Code - GOV § 53600.3

all governing bodies of local agencies or persons authorized to make investment decisions on behalf of those local agencies investing public funds pursuant to this chapter are trustees and therefore fiduciaries subject to the prudent investor standard.

History - Prudent Person Rule

In 1830, Judge Samuel Putnam formulated the Prudent Man Rule. He wrote as a judgement in Harvard vs Amory case:

> *"Do what you will, the capital is at hazard...All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion.* ***He is to observe how men of prudence, discretion, and intelligence manage their own affairs...*** *considering the probable income, as well as the probable safety of the capital to be invested."*

This is the earliest record of an attempt to establish prudent standards for investments.

Source: Investopedia.

Standard Of Care - Evolution

Prudent Person

Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

Prudent Investor

A U.S. law that sets the standard of fiduciary duty for those entrusted with the responsibility of managing others' money, such as trustees and estate administrators. It requires that a trustee weigh risk versus reward when making investment decisions, taking into account the income that may be generated by the investment as well as the probable safety of the invested capital.

Prudent investing entails considerably more than simply selecting legal securities.

Prudent Investor – What Changed?

1. *Entire portfolio is considered when determining prudence of investment. Fiduciary not held liable for losses as long as investments consistent with policy objectives*
2. ***Diversification is explicitly required as a duty for prudent fiduciary investing.***
3. *No category or type of investment is deemed inherently imprudent. Instead, **suitability** to portfolio needs are considered. However, speculation and outright risk taking is not sanctioned by the rule and remain subject to possible liability.*
4. *Fiduciary permitted to delegate investment mgmt. to third parties.*

Why is a Suitability Statement Needed?

Investment Reports are supposed to capture the various actions taken by the trustee or fiduciary regarding the overall investment portfolio. Ultimately Investment reports are disclosing not only the ***Legal*** *test of "is portfolio in compliance with State Code and their Investment Policy" but also has a duty to report how the trustee /* ***fiduciary decision making applied*** *the Prudent Investor Standard in constructing and managing the portfolio. The Prudent Investor Standard speaks to both the* ***Fiduciary Obligation*** *as well as the* ***Fiduciary's Stewardship.***

Distinctions With A Difference

Fiduciary Obligation

Refers to the legal and ethical duties that a fiduciary owes to the stakeholder i.e. citizens. Its primary focus is on legal compliance and ethical standards.

- **Duty of Loyalty:** act in sole interest of public fund
- **Duty of Care:** Acting with competence, diligence and prudence.
- **Duty of Good Faith:** Acting honestly and transparently
- **Duty of Full Disclosure:** Informing beneficiary of relevant information

Fiduciary Stewardship

Extends beyond legal obligations to emphasize a focus on ongoing responsibility for public funds under care.

Core Principles:

- **Responsibility:** Managing portfolio with foresight and accountability
- **Sustainability:** Investment strategies benefit both present and future stakeholders
- **Leadership:** Establishing standards for responsible performance i.e., **Suitability Benchmark**

Key Takeaways

1. UPIA's **most important change** was that the standard of prudence would be applied to any investment in context of total portfolio rather than individual investments.
2. A prudent investment **will not** always turn out to be a highly profitable investment; in addition, **no one can predict** with certainty what will happen with any investment decision.
3. More recently, the prudent man rule has been renamed the **prudent person rule**. This set of guidelines can also be applied where it is referred to as the **prudent investor rule**.

California Code

Government Code – GOV § 53600.5

Investment Policy Objectives

When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds;

The **primary objective** of a trustee shall be to **safeguard the principal** of the funds under its control.

The **secondary objective** shall be to **meet the liquidity needs** of the depositor.

The **third objective** shall be **to achieve a return** on the funds under its control.

Investment Policy “Politics”

Ensuring Investment Practice Follows Policy

Peer Group Comparisons

Preservation of Principal

Rank The Risk

Safety	________
Liquidity	________
Income	________
Total	100%

What is the most frequent question asked about the portfolio?

If above is true, is investment practice following investment policy?

Key Takeaways

When yield is the primary focus, ***investment practice is not following investment policy.***

Therefore, investment decision-making should reflect not only an effort to comply with policy, i.e., legal but also suitable, i.e., investments bought or sold are filtered using the policy objectives in order of priority.

The Tale Of Two Cities

Peer Groups Comparison

City of Me

- PM retires in 6 months
- Affluent community
- No Infrastructure needs
- All funds in LAIF or cash
- Portfolio yields 4.50%

City of Me-Too

- PM young MBA Finance
- New Community
- No surplus operating funds
- High infrastructure needs
- Portfolio yields 5.00%

The Tale Of Two Cities

Peer Groups Comparison Logic

City of Me versus City of Me-Too

- If both are located in the same state of California
- If both share the same goal of principal preservation
- If both have same investment policy objectives
- If both have same portfolio size
- If both hold legal securities

Does City with a higher yield have a better PM?

The Tale Of Two Cities

Peer Group Performance Evaluation

City of Me

- Equals Benchmark
- Legal Holdings
- Safety: LAIF and Cash
- Liquidity: LAIF and Cash
- Income: 4.50%

City of Me-Too

- Beating Benchmark
- Legal Holdings
- Safety: All UST’s / Agy’s
- Liquidity: Portfolio Gains
- Income: 5.00%

Tale of Two Cities

Situation Summary

- **City of Me:** *The retiring Treasurer is overseeing a City with no immediate infrastructure needs, large surpluses due to its large tax base and 100% of public funds invested in LAIF and/or Cash.*

- **City of Me-Too:** *The young MBA Investment Officer's City has large infrastructure demands with all portfolio holdings between three- and five-year maturities.*

City of Me
Stewardship Grade

- Treasurer chose to avoid GASB 31 mark-to-market losses and instead hide behind the Investment Policy Objective of Safety.
- Treasurer has all liquidity eggs in one basket, clearly violating Prudent Investor Standard that requires a fiduciary to construct a diversified portfolio.
- Apparently, no effort has been made to evaluate risk tolerance and investable liquidity (surplus).

***City of Me* Stewardship Grade?**

City of Me-Too

Stewardship Grade

- Outperformed his Peer's portfolio yield 5% to 4.5%
- Outperformed his and Peer's benchmark 5% to 4.5%
- Holds the view AAA US Treasuries as well as US Agencies assure the portfolio complies with Safety Objective.
- Investment Strategy is to use securities with gains to pay current obligations coming due.

***City of Me-Too* Stewardship Grade?**

Key Takeaways

Public funds are unique! While they share the same state code, principal preservation goal and investment policy objectives of safety, liquidity and income, ***they do not possess*** *the same risk tolerance, investment expertise and budget priorities.*

There is only one "Peer Group" to compare a public funds fiduciary obligations to:

Investment Policy “Politics”

What is the Greatest Principal Threat?

Safety

Liquidity

Income

Main Street versus Wall Street Speak

Which Bond Is Safest?

Which Is The Most Liquid?

Which Is Greatest Principal Threat?

Five-Year US Treasury Note yield 5.00%

or

Three-Year US Agency Note yield 5.00%

Key Takeaways

Safe Doesn't Mean Liquid

Policy **Practice**

Greatest Threat to Principal?

What do you manage?

I know you think you understand what you thought I said but I'm not sure you realize that what you heard is not what I meant.

– Alan Greenspan

Investment Strategies

Investment Goals

Investor Profile

Investment Portfolio

What Is An Acceptable Level Of Interest Rate Risk?

*Align your portfolio duration with your budget cycle — **minimum eighteen months.***

*If you do not rely on portfolio income to meet the budget and assume you have allowed for obligations to be paid without resorting to the sale of an existing holding, then portfolio duration should be as **long as legally permissible.***

What Is An Acceptable Level Of Credit Risk?

"Be the Code" – 30% with A or higher rating

Comply with Prudent Investor Standard by diversifying portfolio with Medium Term Notes

Take advantage of Muni's well. There are no percentage limits, and Muni's relative credit risk are considerable stronger than MTN's.

Why Public Funds <u>Don't</u> Need In-House Credit Analysts or Investment Advisors <u>to Approve MTNs</u>

The Problem

- Post-2008, larger public funds hired in-house credit analysts as a **political response**, not a substantive fix.
- Some public funds are **intimidated** into thinking they cannot invest in MTNs without similar resources.
- This misconception:
  * **Inhibits Diversification** critical to complying with the Prudent Investor Standard.
  * **Deprives Taxpayers** of funds that could support public services.

Key Regulatory Protections

- **Strict Regulations for MTNs** (e.g., California Govt Code 53601)

  * Rated **A or higher** by NRSROs
  * **30% cap** of portfolio allocation
  * Maturities of **5 years or less**

- These rules ensure fiduciary stewardship remains focused on the goal of **principal preservation** by **minimizing not eliminating default risk.**

Flaws With In-House Credit Analysts Reasoning

- Hiring in-house credit analyst was a **political strategy**, not a solution to 2008 failures:

  * Real Issues: Misleading credit ratings, systemic corporate fraud, complex instruments (e.g., SIVs).

  * These issues are beyond the scope of an individual analyst.

- **Larger public funds** can afford this expense, some funds cannot.

Why In-House Credit Analyst Or IA's Are Unnecessary

- **External Expertise is Sufficient:**
  - * NRSRO credit ratings:
  - * Equity and credit analyst from Wall Street firms.
- **Prudent Investor Rule:**
  - * Focuses on **portfolio diversification**
- **Cost Efficiencies**
  - * Avoids duplicating existing resources
  - * Preserves taxpayer funds for public services

Conclusion

Empowering Some Public Funds

The post 2008 era has produced a more cautious and rigorous approach to ratings. Rating agencies have implemented stricter standards while reducing the previous conflicts of interest.

For public funds this means while vigilance is necessary, the combination of tougher regulations and diversified external resources provide sufficient safeguards for prudent investment decisions without the need of in-house credit analyst or Investment Advisory services

Why An In-house Credit Analyst Is Unnecessary – CYA Tools

Credit Rating

Default Probability

Analyst Buy/Sell

Source: Bloomberg.

Who Was The Most Successful Investor Of All Time?

QUESTIONS?

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