BEYOND TOTAL RETURN

Using a Fiduciary Standard to Evaluate Investment Performance

BY BENJAMIN FINKELSTEIN AND FELICIA LANDERMAN

The nature of public fund investing is unique. As stewards of public moneys, government portfolio managers have the fiduciary responsibility to ensure that investments are suitable. The Wall Street approach to investment management and performance evaluation does not apply to the investment of public funds. But this raises the question: What is the most appropriate measure of investment performance for state and local governments? If it is not Wall Street's total return measure, then what is it? Is it comparison to peers, as some suggest, or is it something totally different?

If we were to ask a room full of public fund managers to rank, in order of importance, the investment objectives of safety, liquidity, and yield, most would rank either safety or liquidity as the most important objective. Yield would invariably rank as the least important of these objectives. Why, then, is the performance of public investments typically based on total return?

Peer group comparisons also are an inadequate measure of investment performance. How can such comparisons provide useful insight into how well a public fund performed relative to its peers when no risk adjustment or standard return calculation is provided? Just because several governments have similar investment policies and objectives does not necessarily mean they have the same liquidity and risk tolerance. Thus, the only relevant "peer group" for a state or local government investor is its own investment policy and plan.

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A good measure of investment performance is one that captures all investment policy objectives, not just yield. The most suitable benchmark is a *fiduciary* benchmark that adds a qualitative component to the quantitative measures commonly used by investment managers. We propose a performance measurement standard that allows investment practice to follow investment policy. In this article, we explain why total-return market benchmarks are a poor measure by which to judge the fiduciary performance of state and local government investment portfolios and suggest a way to modify a market benchmark to capture the unique investment objectives of public entities.

A TALE OF TWO CITIES

Picture the following scenario: A local government portfolio manager says, "I have great news! We are in the top 1 percent quartile of all professional money managers based on the Merrill Lynch 1-3 Year Treasury Index. We realized only a 5 percent portfolio loss, while the Merrill Lynch benchmark lost 5.5 percent." Needless to say, most city managers and local elected officials would not share this portfolio manager's enthusiasm.

This vignette illustrates the problem with judging investment performance by comparing your returns to a market benchmark or to another government's returns. Comparing returns does not capture the qualitative elements of performance evaluation, such as the differences in risk tolerance between the two governments. Focusing exclusively on yield may obscure the fact that neither government's portfolio is suitable.

Consider two hypothetical cities — City A and City B. The cities are located in the same state and have approximately the same portfolio size. The portfolio managers for both cities believe their most important responsibility is the preservation of principal. Their primary investment objectives are safety, liquidity, and yield — in that order. At least on the surface these two cities appear identical in terms of their investment programs.

A retiring investment professional manages City A's investment portfolio. The city is a wealthy community with large surpluses. The investment manager invests all funds in the state's local government investment pool and benchmarks the portfolio's returns against that of the pool as a whole. On average, the portfolio earned 2 percent over the past year.

In contrast, a young, highly educated professional manages City B's portfolio. City B is a new community with huge developmental needs and little in the way of surpluses. City B earned a portfolio return of 4.5 percent over the past year.

A simple comparison of the returns of these two portfolios likely would lead to misleading, erroneous, or irrelevant conclusions. Given that the two cities are located in the same state, have the same investment goals and policy objectives, and invest only in legal securities, many observers likely would conclude that City B has done a better job managing its money than City A. After all, a 4.5 percent return is better than a 2 percent return. But does this type of comparison provide any useful information about how well either city is managing its investments? If one looks beyond investment returns, it becomes apparent that legal does not mean suitable.

The investment manager for City A has a fiduciary responsibility to manage risk, not avoid it. The taxpayers probably do not think highly of what looks like a "risk avoidance retirement strategy."

Furthermore, with 100 percent of the city's assets and liquidity parked in the state's local investment pool, there is some doubt about whether the portfolio is sufficiently diversified. The city's investments are no doubt legal, but is the portfolio manager a good steward of taxpayer money? Most informed observers would say no.

City B uses the Merrill Lynch 1-5 Year Market Index as the measure of its portfolio's performance. The city outperformed its benchmark by .5 percent, invested exclusively in U.S. Treasuries, and paid all obligations without a principal loss. These results seem to indicate that the city is effectively managing its money. Yet this assessment fails to consider the city's risk exposure. For example, because City B is using gains as a source of liquidity, any significant move in interest rates could leave the government with no short-term cash equivalent securities.

Peer group comparison does not pick up the fact that City A and City B use difference indices or that neither portfolio manager is effectively performing his role as a 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.

THE SUITABILITY STANDARD

At the beginning of this article we made the statement that the only relevant peer group for a state or local government investor is its own investment policy and plan. As such, the best standard for judging the performance of a government investment portfolio is *suitability*. The Florida Statues provide a good description of the suitability standard: "The investment policy shall specify performance measures as are appropriate for the nature and size of the public funds within the custody of the unit of local government."[1]

An investment plan converts a static investment policy — the rulebook — into a dynamic portfolio interpretation — the playbook. The plan is a portfolio representation of what is suitable for a particular government and what that government's portfolio should look like over time in terms of diversification of investments, liquidity, interest rate risk, and other factors. The plan provides strategic flexibility as well as a framework for monitoring and reporting the suitability of an investment portfolio. Both qualitative and quantitative factors form the basis for reporting how well a manager is doing in meeting investment objectives.

To take the suitability standard from the abstract to the concrete, we have developed what we call the five "we's" of suitability:

- We have sufficient liquidity to pay our 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

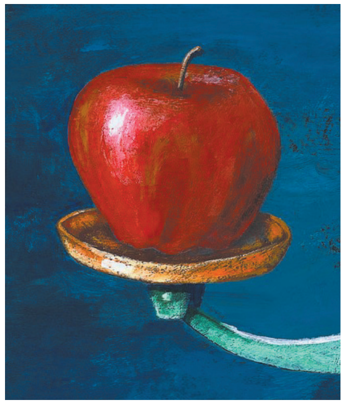
We argue that a government that can make these statements has a suitable investment portfolio. To illustrate how a government can use the suitability standard to evaluate the performance of its investment pool, we will show how Palm Beach County uses these five components to evaluate the suitability of its $1.8 billion investment portfolio.

Liquidity Risk. Liquidity risk, or the premature sale of a security to meet an unexpected obligation, is the greatest risk to the preservation of principal. If a government is forced to sell a security when market conditions are unfavorable — for example, when prices are down and rates are up — principal losses may be incurred. Likewise, a "safe" triple-A rated security sold before maturity to meet cash flow needs, exposes principal to market risk. As Orange County, California, aptly demonstrated, safety does not mean security.

Palm Beach County uses cash flow forecasting and scenario analysis to ensure that its portfolio has sufficient liquidity and to prevent the premature sale of securities to meet cash flow requirements. The county's budget office provides a 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 more accurate picture of the portfolio's liquidity. Having this information available helps the investment manager to balance the need to preserve principal with the goal of optimizing investment returns.

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. Every government must establish a level of interest rate risk that is appropriate for its unique budgetary and political environment. Again, peer group comparisons do not account for the differences in risk tolerance among different governments and, as such, are not a good measure of investment performance. For example, a county that has the ability to incur greater interest rate risk than another will likely earn a higher yield. The notion that this county is doing a better job managing its investments than the other is simply not true.

Palm Beach County uses duration and convexity to measure and manage interest rate risk. Duration is a measure of a bond's price sensitivity to a change in interest rates; convexity is a measure of the stability of duration of that bond. Both are calculated using various rate shifts to ensure that the portfolio's interest rate risk is fully understood. For securities with options, such as callable bonds and mortgage-backed securities, the portfolio is frequently shocked up and down 300 basis points to see potential extension and contraction impact on the total portfolio.



The county's investment plan provides an advance warning system for interest rate risk management. Supervisors and/or members of the Investment Policy Committee can easily monitor and compare the actual portfolio to the investment plan. The investment plan is also an effective tool for oversight and review of the day-to-day investment decisions.

Diversification. The Florida Statutes state 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."[2] Again drawing from the lessons learned from the Orange County bankruptcy, investing all your money — or an inordinate share of your money — in a single issuer with a diversified portfolio does not make you diversified. For example, governments that invest all of their money in the state investment pool clearly are not diversified, even though the investments themselves are likely very safe. A diversified portfolio is one in which assets are spread among a number of different issuers.

To ensure that it maintains a diversified investment portfolio, Palm Beach County sets specific limits in its investment policy. Consider the following language from the policy: "Investments in commercial paper shall be limited to a maximum amount of 25 percent of the total portfolio, at the time of purchase, with no more than 3 percent of the portfolio invested with any single issuer." Limitations are also tracked in the investment plan; for example, adjustable rate mortgages may not exceed 15 percent of the total portfolio, and all mortgages combined may not exceed 60 percent of the total portfolio.

Legal. A government should be able to demonstrate that investment holdings are in fact authorized as to issuer, maturity, and structure. As part of Palm Beach County's annual financial audit, external auditors review investment holdings to verify compliance with state laws.

Market Rate of Return. Palm Beach County moved from a total return benchmark to a market rate of return benchmark in August 2002. The rationale for this move focused on suitability and relevance. The county's mandate is to preserve principal and protect taxpayer dollars while achieving a reasonable rate of return. A reasonable rate of return is one that achieves a stable, market rate of return for budgetary purposes within the constraints of the county's investment policy.

It is worth noting 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. However, the county does not use these fair value changes for budgetary 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 tools for constructing, managing, and monitoring the investment portfolio.

SUMMARY

Ensuring that investment practice follows investment policy means modifying the norms of Wall Street to fit the needs and realities of Main Street (public investors). 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 investment policy objectives, and will provide both relevant and reliable insights into the quality of a government's stewardship over its investment portfolio.

Notes:

1. Florida Statutes, Title XIV, Chapter 218.415, Section 3.
2. Ibid, Section 8.

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