Setting the standards

Public fund managers create their own measures of success.

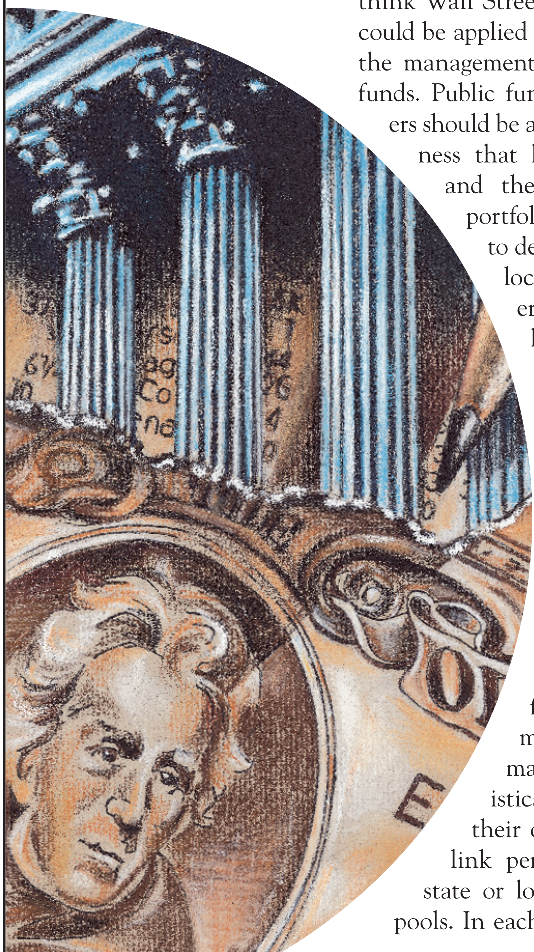
By Ben Finkelstein

The author is senior managing director of public funds for Houston-based Stanford Group Co.

Every year, public fund managers are challenged to defend the performance of their investments. The Chicago-based Government Finance Officers Association (GFOA) says that investment portfolios "should obtain a market average rate of return through budget and economic cycles" and that a series of appropriate benchmarks should be established "against which portfolio performance shall be compared on a regular basis." The GFOA, however, recognizes that each public fund is unique.

Wall Street — the universe of broker-dealers, investment bankers, traders and money managers — has been the home port of money management for well over a century. It's natural to think Wall Street methods could be applied directly to the management of public funds. Public fund managers should be able to harness that knowledge and the tools of portfolio theory to deliver what local governments desire most: safety, liquidity and a competitive market rate of return on capital. But, the more one understands Main Street's unique requirements, the less appropriate Wall Street methods become. In other words, Wall Street manages returns, Main Street manages risk.

A public fund should establish its own standards based on suitability.



In turn, public funds lack a universal standard of performance. Some jurisdictions may use a market index with maturity and risk characteristics comparable with those of their own portfolios, while others link performance to that of their state or local government investment pools. In each case, external benchmarks may not indicate what is suitable for the individual fund. Each fund should establish its own standards based on suitability, the one standard capable of specifying the performance measures appropriate to individual funds. Suitability can be measured by:

1. Liquidity. Having to sell a treasury or other security prior to its maturity could result in a loss of principal, violating the standard of safety. Cash or cash-equivalent assets should meet all anticipated obligations.

2. Appropriate level of interest-rate risk. Even the most creditworthy bonds are subject to interest-rate risk — the market value of existing bonds declines when prevailing interest rates increase. Any fund with bills, bonds or notes with maturities greater than 30 days lives with this fact of life.

3. Diversification. Diversification of a public fund should focus on liquidity and individual holdings. In addition, state pools should not be the only source of primary liquidity; individual security holdings should not exceed a certain percent of portfolio market value; and individual corporate issuers other than federal agencies should not exceed the policy level percent of portfolio holdings.

4. Legal investments. A suitable portfolio must conform to investment policy and law as to issuers, maturities and structure.

5. Market rate of return. Public funds should pursue a market rate of return, a 12-month moving average of two-year U.S. Treasury note yields. Unlike a total return, a moving average of coupon yield eliminates the ups and downs of short-term market moves.

Determining an investment portfolio's suitability will ensure that investment practice follows investment policy. ACC

For information on Ben Finkelstein's book, "The Politics of Public Fund Investing: How to Modify Wall Street to fit Main Street," visit www.PublicTreasuryInstitute.com.