Common Mistakes in Managing your Investment Portfolio

Speakers:

Scott McIntyre
Managing Director
300 West Sixth Street, Suite 1940
Austin, Texas 78701
512.481.2009
scott.mcintyre@hilltopsecurities.com

November 2018

Objectives

- Identify and avoid common mistakes made in key areas of portfolio management:
  - Appropriateness of investment policies and procedures
  - Banking and cash management costs, fees, and safekeeping
  - Selection of brokers and investment advisors
  - Development and implementation of investment strategies
  - Trading and diversification
  - Documentation and reporting

Appropriateness of Policies and Procedures

Appropriateness of Policies and Procedures

Mistake 1: *Investment policy is too restrictive… or too permissive*

- Does the policy include things you don't understand?
- How conservative do you need to be?
  - Agencies?
  - Municipals?
  - Commercial paper?
- Maturity limits
  - Too short
  - Too long
  - Too restrictive
  - Don't match needs
- Diversification limits (type/issuer)
- Primary dealers

Mistake 2: *Investment policy does not reflect actual practice*

- Investment committees that do not exist
- Investment officers that do not exist
- Funds that do not exist
- Maturity and diversification limits that are not followed
- Unintended references and dead organizations
  - NASD (2007)
  - FSLIC (1989)
  - Bond Market Association (2006)
  - Public Securities Association (1997)
  - Sallie Mae (Privatized in 1996)

Banking and Cash Management

Mistake 3: *Not fully understanding costs and fees*

- Earnings credit (it's not real interest)
  - Rates no longer competitive with market
- *Are you better off paying bank fees and investing elsewhere?*
- There is a cost to collateral
  - What level is appropriate?
  - 110%?
  - Letters Of Credit

Mistake 4: *Overpaying for safekeeping / custody*

- Failure to "shop around"
- Asset-based fees versus fixed fees and maintenance fees
- Trust Departments
- Do transaction costs scale with size / activity?
- Public entities need to *push* banks and *demand* better!
- Include safekeeping in your depository RFP

Anecdote: We recently saw a major bank wanting to charge a flat annual safekeeping fee of $100,000.

Mistake: *Being in the wrong money fund class*

- Institutional class vs retail class

Fund	Class	Daily Yield*	Net Expense Ratio	Annual Cost for $10 Million Investment
Fidelity Treasury	Institutional	0.99%	0.14%	$14,000
Fidelity Government	Institutional	0.98%	0.14%	$14,000
Fidelity Treasury	Class I	0.95%	0.18%	$18,000
Fidelity Government	Class I	0.94%	0.18%	$18,000
Fidelity Treasury	Select	0.90%	0.23%	$23,000
Fidelity Government	Select	0.89%	0.23%	$23,000
Fidelity Treasury	Retail	0.72%	0.42%	$42,000
Fidelity Government	Retail	0.69%	0.42%	$42,000

Strategies

Mistake 5: *Failure to devote appropriate time to the investment function*

- Budget season / Audit season
- *Is there an Investment season?*

TPFIC 2018

Mistake 6: *Failure to define risk parameters in advance*

- Credit risk, liquidity risk, interest rate risk, reinvestment risk
- Unrealized losses after a rise in rates should not be surprising
- Importance of weighted average maturity / duration
- The expected dollar change in the market value of a $10 million bond based on duration and change in interest rates is shown below:

Change in Interest Rates

Duration (Years)	-2.0%	-1.0%	-0.5%	+0.0%	+0.5%	+1.0%	+2.0%
1	$200,000	$100,000	$50,000	$0	-$50,000	-$100,000	-$200,000
2	$400,000	$200,000	$100,000	$0	-$100,000	-$200,000	-$400,000
3	$600,000	$300,000	$150,000	$0	-$150,000	-$300,000	-$600,000
4	$800,000	$400,000	$200,000	$0	-$200,000	-$400,000	-$800,000
5	$1,000,000	$500,000	$250,000	$0	-$250,000	-$500,000	-$1,000,000

Strategies

Mistake 7: *Failure to communicate / warn governing bodies before the losses show up*

- Manage expectations!
- Share strategy and thought process
- Unrealized versus realized losses
- An entity's board should understand and *accept* this risk

Mistake 8: *Failure to understand the balance between liquidity management and core investing*

- Importance of understanding cash flow needs and portfolio cycles
- When you invest your money, it has not been spent!

Trading and Diversification

Mistake 9: *Failure to delegate trading to responsible staff*

- Decision-making too high up the chain of command results in:
  - Approval delays
  - Opportunity cost of missed trades
  - Frustrated brokers

Mistake 10: *Purchasing commercial paper based on rating alone*

- Know what you are buying
- Difference between program types – 3(a) vs 4(2) /144A
- Sector and country restrictions
- Is there a rating watch?
- *Will your governing board be comfortable with that name?*

Mistake 11: *Callable securities – too little or too much?*

- What happens to callable securities when rates fall?
- When rates rise?
- Is there an appropriate environment to buy callable bonds?

Mistake 12: *Failure to solicit competitive offers*

- Too few brokers
- Just soliciting an offer does not mean it's competitive
- Does this broker carry any inventory? …Why is this important?

Mistake 13: *Appropriate diversification between fixed and floating rates*

- Too much in pools – all floating rate!

Mistake 13½: *Thinking multiple pools = diversification*

- The pools all invest in basically the same instruments
- Related – not understanding differences between government pools and CP pools

Mistake 14: *Excessive market risk*

- Duration or WAM too long = too much price sensitivity / market exposure

Mistake 15: *Failure to establish effective benchmarking*

- It should be familiar, verifiable and appropriate.
  - Don't use an industry benchmark without understanding how it is constructed and what it contains.
- The benchmark should match the weighted average maturity of the portfolio and the degree of credit risk.
- Don't set the target too high. The intent is not to create a hurdle that encourages risk.

Documentation and Reporting

Mistake 16: *Failure to retain proper trade files for audit purposes*

- Broker confirms / trade tickets
- Competitive bids/offers
- Current market snapshot, benchmark treasury yields
- Security description and yield analysis
- Backup material related to market conditions, expectations for interest rates, economic conditions, etc.
- In the future, will you be able to answer the question, “Why did you buy this?”

Mistake 17: *Failure to provide appropriate reporting*

- Too much or too little information on reports
- Too many separate funds
- Elements of a good report set
  - Totals for par, book and market value
  - Breakdown by security type
  - Breakdown by issuer
  - Breakdown by maturity
  - Weighted average for yield at cost, weighted average maturity
  - Income earned
  - Comparison to benchmarks
  - Detailed list of holdings

Word to the Wise

You must learn from the mistakes of others. You can't possibly live long enough to make them all yourself. ***Samuel Levenson***

Experience is simply the name we give our mistakes. ***Oscar Wilde***

The only real mistake is the one from which we learn nothing. ***John Powell***

Questions ?

Disclaimer

DISCLAIMER: This presentation is prepared for general circulation and for general educational and informational purposes only. The information in this presentation is designed to give general and timely information on the subjects covered. It does not have regard to the specific investment objectives, financial situation or the particular needs of any specific person or entity that may receive it. It is not intended to be used as the basis for investment decisions by any individual or entity or as a recommendation for any particular securities, financial instruments or strategies. Any discussion of risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of the risks that are mentioned. All information contained herein is obtained by FSAM from sources believed by it to be accurate and reliable. Information is provided "as is" without warranty of any kind, and FSAM makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information or analysis. Neither the information contained herein nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to securities or investments. Nothing herein constitutes or should be construed as a legal opinion or advice. Recipients should consult their own attorney, accountant, financial or tax advisor or other consultant with regard to their own situation or that of any entity which they represent or advise. Neither FSAM nor any of its affiliates shall have any liability for any use of the information set out or referred to herein.