Common Mistakes in Managing your Investment Portfolio

Speakers:

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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
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.
### Banking and Cash Management

**Mistake: Being in the wrong money fund class**

- **Institutional class vs retail class**

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

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

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

<table>
<thead>
<tr>
<th>Duration (Years)</th>
<th>Change in Interest Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-2.0%</td>
</tr>
<tr>
<td>1</td>
<td>$200,000</td>
</tr>
<tr>
<td>2</td>
<td>$400,000</td>
</tr>
<tr>
<td>3</td>
<td>$600,000</td>
</tr>
<tr>
<td>4</td>
<td>$800,000</td>
</tr>
<tr>
<td>5</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>
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
Trading and Diversification

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**
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