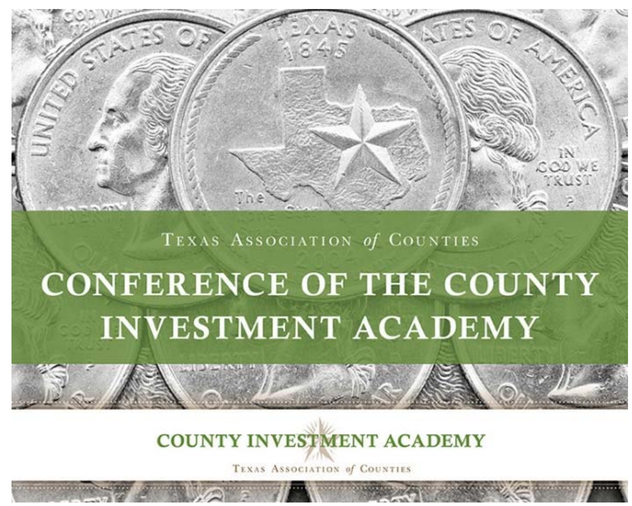
Common Mistakes in Managing your Investment Portfolio

Speakers:

Greg Warner, CTP
Director
Senior Portfolio Manager

300 West 6th Street
Suite 1940
Austin, Texas 78701
512.481.2012
Greg.Warner@HilltopSecurities.com



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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

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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

Appropriateness of Policies and Procedures

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 Government	Institutional	2.33%	0.14%	$14,000
Fidelity Government	Class I	2.29%	0.18%	$18,000
Fidelity Government	Select	2.24%	0.23%	$23,000
Fidelity Government	Class III	2.04%	0.43%	$43,000

**As of May 9, 2019*

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:

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, <u>it has not been spent!</u>

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 commercial paper (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 ?

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