

Investment Responsibilities of a Governing Body and its Individual Members

MARCH 2024





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STRATEGIC ASSET ALLIANCE
20 YEARS OF PARTNERING WITH GOVERNMENTAL RISK POOLS

Key Takeaways

- 1. Identify and Understand** a Governing Body's Key Investment Responsibilities
- 2. Understand Common Errors** Governing Body Members Make
- 3. Differentiate Responsibilities** of an Individual vs. a Governing Body Member
- 4. Review Use-Case Examples** of These Lessons in Pooling
- 5. Review Best Practices, Key Questions & Next Steps**

Governing Body Investment Responsibilities

Three Key Duties:

1. To act with “reasonable” skill and care
2. To take advice where appropriate
3. To keep investments under review

1: Act with 'Reasonable' Skill & Care

Keep Building Your Knowledge Base:

- You **do not need to be an “investment expert”**
- Keep learning** at level appropriate for your pool
- Strive for complete clarity** in all aspects of your pool's investments
- Maintain a balance of perspectives** (internal guidance and external resources)

1: Act with 'Reasonable' Skill & Care

Assessing Understanding: Investment Process

- As an Individual Member:** Do you understand all parts of the process equally?
- As a Collective Governing Body:**
 - Are all parts of the process considered equally?
 - Is any section overlooked or over-weighted?



Resource: [AGRIp Advisory Standards](#)

1: Act with 'Reasonable' Skill & Care

Assessing Understanding: Fees

- As an Individual Member:** Do you know all investment-related costs that might apply to your pool?

- As a Collective Governing Body:**
 - Do you know how fees are reflected in the pool's investment performance?

 - Have you reviewed fees for changes recently?

1: Act with 'Reasonable' Skill & Care

Assessing Understanding: Hidden Fees

- Remember: Fixed Income Bonds have no trading commissions
- Stocks/Equities do have trading commissions
- Trading bonds is more expensive than trading stocks
- Check whether your broker/dealer has sold a bond to your pool (*Where the broker/dealer could benefit twice*)

1: Act with 'Reasonable' Skill & Care

Standard Fixed Income Management Fees: Overall *(basis points)*



1: Act with 'Reasonable' Skill & Care

Assessing Understanding: Opportunity Costs

- As an Individual Member:** Do you understand what opportunity costs are and examples of what they might be?
- As a Collective Governing Body:** Have you recently asked, “where haven’t we looked yet to find potential improvements?”

1: Act with 'Reasonable' Skill & Care

Example: Expanded Investment Authority - Texas

- **In July 2019, S.B. 2551 was passed:**
 - Clarified 11 Presumption Cancers
 - Expanded Investment Authority for Current and Future Death & Lifetime Income Benefits Reserves/Equity

- **Establishing a Plan for a Texas P&C Pool:**
 - \$830MM Investment Portfolio
 - 19 Board Members/Trustees
 - City Managers, Mayors, Appointed Citizens, etc.

1: Act with 'Reasonable' Skill & Care

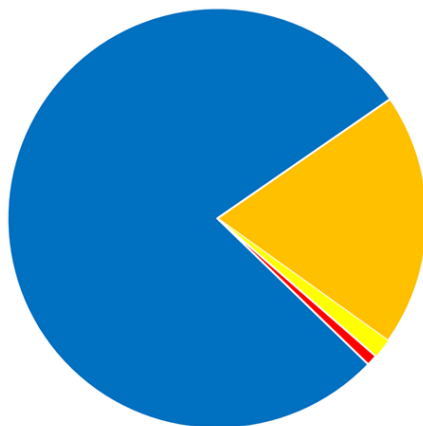
Example: Expanded Investment Authority - Texas

- **Plan After Law Went Into Affect:**
 - **Oct. 2019: Educate/Familiarize Board with:**
 - Expanded Investment Options
 - Investment Process of Other Pools
 - Prudent Person Flexibility
 - Implementation and Operation of New Program
 - **Jan. 2020: Develop & Review/Approve Plan with Board**
 - **Feb. 2020: Begin Investing & Monitoring Program**

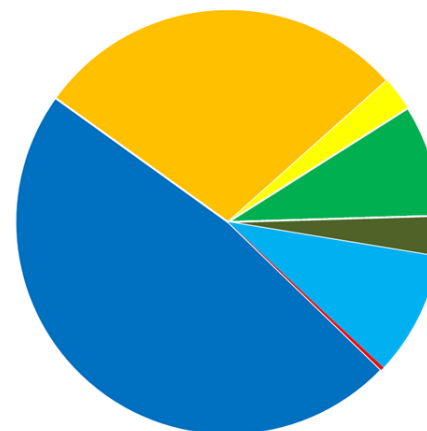
1: Act with 'Reasonable' Skill & Care

Example: Expanded Investment Authority - Texas

Before and After



Combined Asset Allocation	Market Value &	
	Accrued Interest	Portfolio (%)
Mortgages	\$ 526,869,571	75.3
Municipal Bonds	131,338,588	18.8
Money Market & Accrued Interest	10,115,324	1.4
US Treasury	5,646,792	0.8
Total Market Value	\$ 699,872,605	100.0



Combined Asset Allocation	Market Value &	
	Accrued Interest	Portfolio (%)
Mortgages	\$ 360,930,886	47.7
Municipal Bonds	215,796,792	28.5
Money Market & Accrued Interest	19,686,517	2.6
Stock Mutual Funds	64,370,236	8.5
High Yield Corp. Bond Mutual Fund	23,218,266	3.1
Investment Grade Corp. Bonds	70,987,731	9.4
US Treasury	1,868,313	0.2
Total Market Value	\$ 756,858,741	100.0

1: Act with 'Reasonable' Skill & Care

Assessing Understanding: Investment Risk

- As an Individual Member:** Do you agree with the current level of risk in the pool's portfolio? (*For example, impact to surplus/net position*)
- As a Collective Governing Body:** Have you recently (*within the past year*) discussed organizational changes that may change the level of risk in the pool's portfolio?

1: Act with 'Reasonable' Skill & Care

Example: Assessing the Pool's Investment Risk Tolerance

- **Self-Insured P&L Pool in Kansas:**
 - \$25MM Investment Portfolio
 - Wanted to Construct Investment Policy & Asset Allocation, but Unsure of Comfort with Riskier Assets
- **Gauging Risk Tolerance via Questionnaire:**
 - As their Board/Trustees were very risk averse, in lieu of drawdown modeling, a survey was utilized
 - Responses were then used to put constraints on models and investments they would consider

1: Act with 'Reasonable' Skill & Care

Example: Assessing the Pool's Investment Risk Tolerance

○ Risk Tolerance Survey Conclusions:

Question	Response Summary
How do you define risk?	50% – Volatility 33% – Permanent Loss 17% – New normal/unknown risks
Is 'temporary' loss considered risk?	50% – Yes 50% – No
How long is 'temporary' to you?	17% – One month 17% – One quarter 50% – One year 17% – Two years
Acceptable % Loss of Net Position in a 'Worst Case' Scenario	4% Loss – 84% 5% Loss – 66% 8% Loss – 50% 10% Loss – 17% >10% Loss – 0%

1: Act with 'Reasonable' Skill & Care

Example: Assessing the Pool's Investment Risk Tolerance

○ **Conclusions & Next Steps:**

- Main Board/Trustee Concern was Volatility (*temporary loss*) and the Risk of Permanent Loss
 - *Board's View of "Temporary" was Very Short*

- Given Concerns and Lack of Risk Appetite, Modeled Options Focused on the Lower End of the Risk Spectrum (*~4% to ~8% of net position*).

2: Take Advice Where Appropriate

Advice Considerations

- Request advice** unless the cost of advice is prohibitive relative to the size of your pool. Consider stated cost vs opportunity cost.
- Any **advice under consideration should carry a suitable level of risk and diversification**

Seek advice:

- Whenever there are **material change to operations** (*i.e. regulatory, financial, staff changes*)
- It's been several years** since the last review

2: Take Advice Where Appropriate

When Seeking Advice, Utilize a **True Fiduciary**

- ❑ **Legally and Ethically** required to ensure investment services are provided in the best interest of your pool - *Fiduciaries are registered with a regulatory body (state or federal)*
- ❑ Common in two forms: An **investment consultant** or **investment manager**
- ❑ Fiduciaries are **not brokers/dealers** who determine suitability of investments

2: Take Advice Where Appropriate

Compilation: SWOT Analysis of Pools Utilizing a Broker/Dealer

STRENGTHS | WEAKNESSES | OPPORTUNITIES | THREATS

- Based on Current Asset Size – the ‘All-In’ Service Currently Provide an Appropriate Value-Add but Needs May Change as Assets/Business Grow.
- Portfolio Structure and/or B/D Recommendations Lack an Explicit Connection to the Board/Trustee’s Operational Goals & Objectives.
- Fee structures not clearly outlined, with **profits hidden within transactions.**
- No performance attribution to help explain under/over performance and their overall effectiveness with respect to the benchmark.
- Performance returns are not GIPS compliant.
- Potential Conflicts of Interest with B/D’s Selected Partners and Investment Recommendations

3: Keep Investments Under Review

Ongoing Process: Focus on Suitability, Diversification

- ❑ **Suitability:** As change occurs, ensure the portfolio stays aligned with goals and objectives (*i.e. member needs, new coverages, cash needs, etc.*)
- ❑ **Diversification:** Consider utilizing multiple investment types within the pool's portfolio to achieve higher long-term returns on average, while reducing risk exposure (*subject to regulatory constraints*)

3: Keep Investments Under Review

Checklist: What to Review

- Regulatory constraints on allowable asset classes
- Compare** the pool's current portfolio structure to potential alternatives
- Monitor** These Key Metrics: **Book Yield, Duration, and Credit Quality**

3: Keep Investments Under Review

Example: Pools Investing Under Great Constraints

- Pools/JPAs in California Must Adhere to the 'Government Code':

Allowed & Prohibited Investments Under the CA Government Code		Overnight	180 Days	270 Days	1 Year	5 Years	Beyond 5 Years	
Traditional Investment-Grade Fixed Income	Asset-Backed Securities	Allowed				Prohibited		
	Bankers' Acceptances	Allowed		Prohibited				
	Commercial Paper	Allowed			Prohibited			
	Federal Agencies	Allowed					Subject to Approval	
	Local Government Investment Pools	Allowed	Prohibited					
	Medium-Term Corporate Notes ('A' or higher)	Allowed					Prohibited	
	Money Market Funds / Bond Mutual Funds	Allowed	Prohibited					
	Municipal Securities	Allowed					Subject to Approval	
	Negotiable Certificates of Deposit	Allowed					Subject to Approval	
	Repurchase Agreements	Allowed				Prohibited		
	Supranationals ('AA' or Higher)	Allowed					Prohibited	
	U.S. Treasuries	Allowed					Subject to Approval	
Additional Fixed Income Vehicles	Bank Loans	Allowed				Prohibited		
	Convertibles	Prohibited						
	Emerging Market Debt	Prohibited						
	Fixed Income ETFs	Prohibited						
	Foreign Sovereign	Prohibited						
	High-Yield Bonds	Prohibited						
	Non-U.S. Dollar Investment Grade	Prohibited						
	Private Placements	Prohibited						
Equities (Common Stock)	Domestic - Large Cap	Prohibited						
	Domestic - Mid-Cap	Prohibited						
	Domestic - Small Cap	Prohibited						
	Emerging Markets	Prohibited						
	Equity Mutual Funds and ETFs	Prohibited						
	International - Large Cap	Prohibited						
	International - Mid Cap	Prohibited						
	International - Small Cap	Prohibited						
	Preferred Stock	Prohibited						
Alternative Investments	Commodities	Prohibited						
	Derivatives, Futures, and Options	Prohibited						
	Hedge Funds	Prohibited						
	Other Tangible Assets	Prohibited						
	Private Equity	Prohibited						
	Real Estate	Prohibited						
	Venture Capital	Prohibited						

3: Keep Investments Under Review

Example: Pools Investing Under Great Constraints

- **CA JPA Providing W/C, P&L, and HB:**
 - \$375MM Investment Portfolio
 - *Primarily Invested in Treasuries, Short Gov/Credit, Core IG Bonds*
 - No Material Concerns w/ Asset Allocation
 - Review Conducted for Potential Improvements/Considerations
- **Assess Available Flexibility, Including:**
 - Adjusting Duration
 - Lowering Default Risk (*i.e. Credit Quality*) vs. Maximizing Return
 - Expand Pool of Allowed Investments, i.e. Corporate Bonds

3: Keep Investments Under Review

Example: Pools Investing Under Great Constraints

Recommendation	Reasoning
Increase Duration of W/C and P&L Portfolios	Increases Investment Grade Yields Better Alignment with Reserves Duration
Increase Maturity of US Treasury, Municipal, Federal Agency, and Negotiable CD Securities	Government Code allows for increase in maturity limits, which allows Board/Trustees with more flexibility
Add Limits & Specify Prohibited Investments	Ensures compliance and governance over the investment portfolio and reflects Board/Trustee's investment perspectives
Focus on Duration Limits Instead of Maturity Limits	Provides a better measure of interest rate risk and more investment flexibility

3: Keep Investments Under Review

Ways to Compare the Current Portfolio Structure

- ❑ Models that focus only on the **asset side of the Balance Sheet**
- ❑ **Consider possible impacts** on reserves and surplus/net position
- ❑ **Test portfolios** with different allocations towards the same asset class(es)

3: Keep Investments Under Review

Example: Modeling Different Portfolio Structures (2020 Risk Pool Client Example)

Asset Type	Current Allocation 5/31/2020	Lower Risk / Maintain Return	Higher Return / Maintain Risk	Add High Yield	Add High Yield & Equity
Core Fixed Income	100.0%	88.9%	85.0%	90.0%	85.0%
U.S. Large Cap Equity	0%	0%	0%	0%	5.0%
U.S. Mid Cap Equity	0%	0%	0%	0%	0%
U.S. Small Cap Equity	0%	1.1%	0.1%	0%	0%
Developed International Equity	0%	0%	4.7%	0%	0%
Emerging Market International Equity	0%	0%	0.1%	0%	0%
U.S. REITS	0%	0%	0%	0%	0%
U.S. Bank Loans	0%	10.0%	6.5%	5.0%	5.0%
U.S. High Yield	0%	0%	3.5%	5.0%	5.0%
Expected Annualized Return	2.25%	2.61%	2.96%	2.63%	2.88%
Expected Annualized Volatility	3.00%	2.71%	2.99%	2.83%	2.90%

3: Keep Investments Under Review

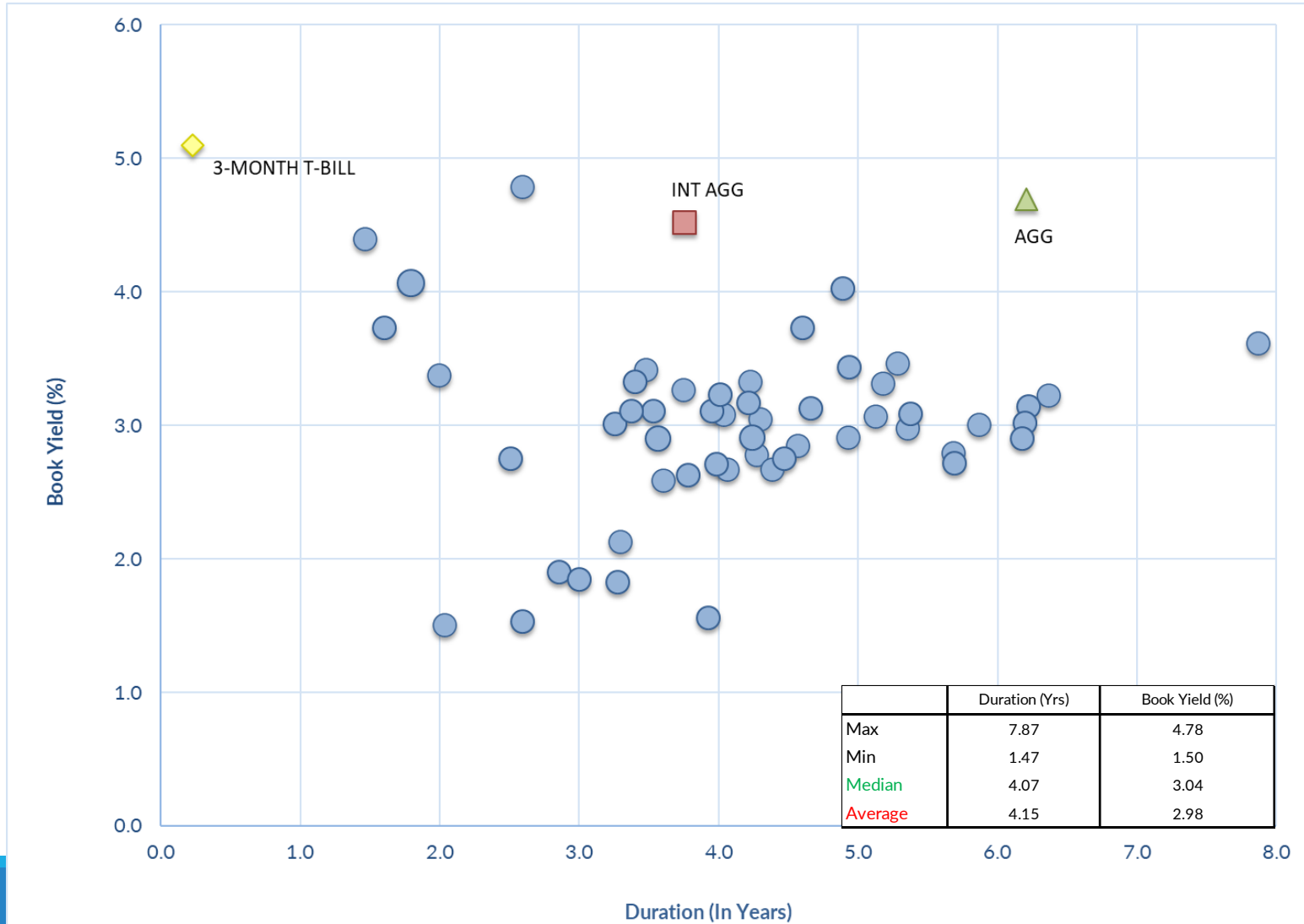
Reviewing Book Yield, Duration, and Credit Quality

- ❑ **Book Yield:** Reflects the “raw” earnings power of the portfolio, which is important for financial statements, and is based on the pool’s investment selections
- ❑ **Duration:** Reflects a bond’s sensitivity to interest rate changes and can be tied to the duration of your pool’s liabilities & reserves.
- ❑ **Credit Quality:** Reducing credit quality, which reflects the likelihood of default, provides higher potential yields.

3: Keep Investments Under Review

Example: Comparing Investments to Other Risk Pools

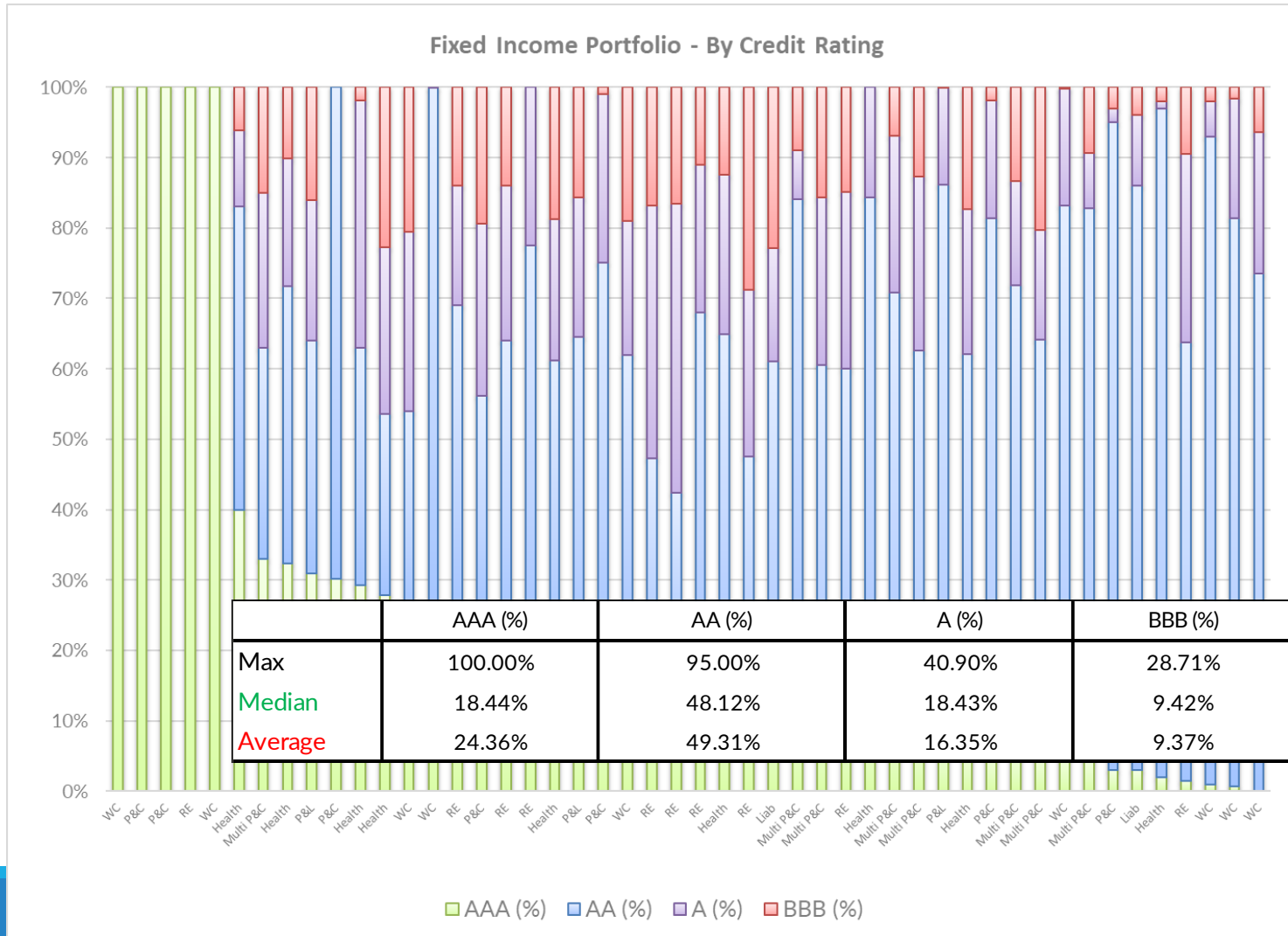
Book Yield to Duration



3: Keep Investments Under Review

Example: Comparing Investments to Other Risk Pools

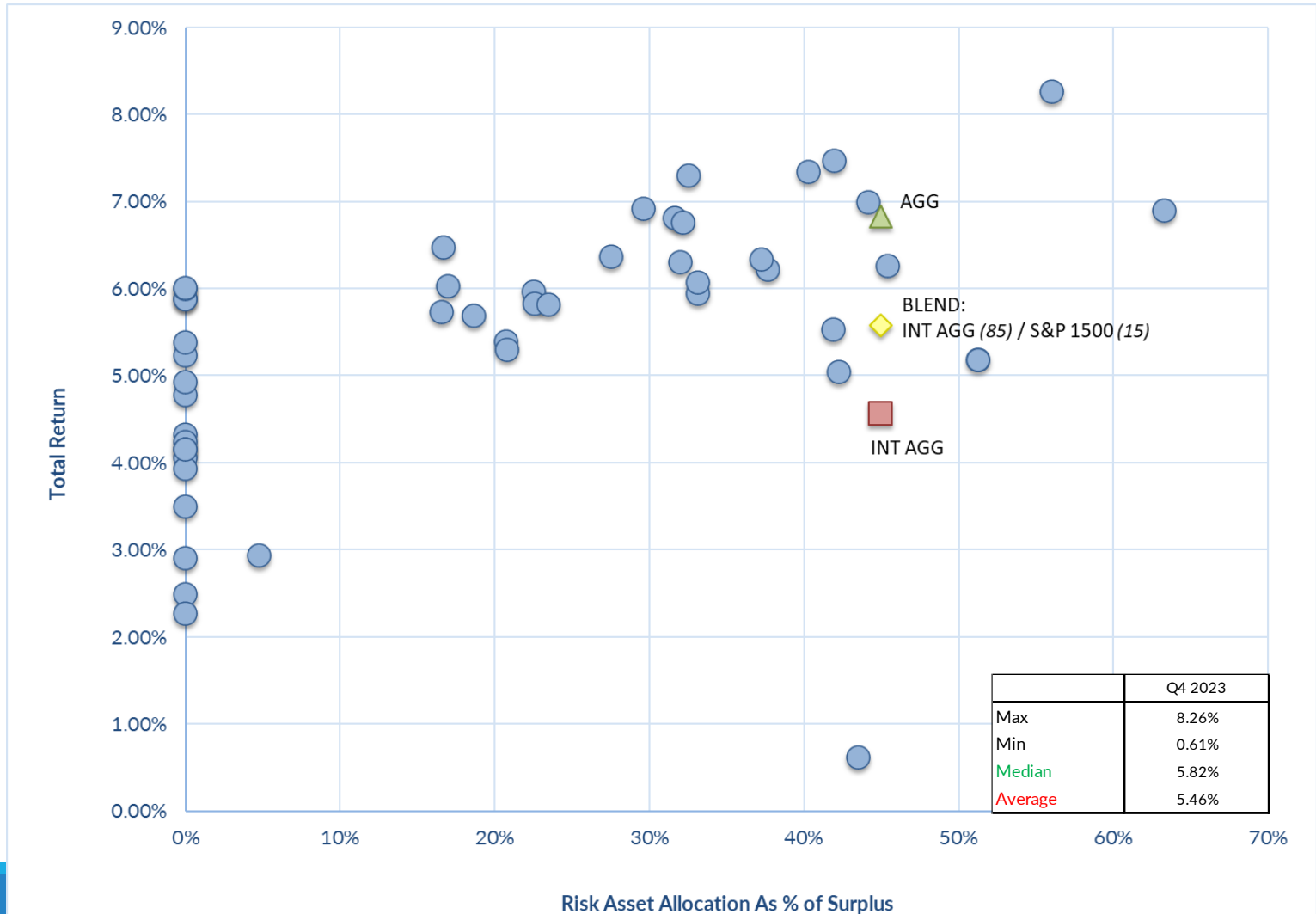
Credit Quality Allocation



3: Keep Investments Under Review

Example: Comparing Investments to Other Risk Pools

Total Return Performance – Q4 '23



Common Errors Made by Governing Body Members

Reduced Investment Income Often Results From:

- Not considering **all allowable asset classes available** to your pool's investment portfolio
- Not considering the **impacts (both risks and benefits) of a more diversified** portfolio
- Foregoing **periodic reviews** of the pool's overall investment process
- A lack of consistent reviews for your portfolio's **investment management fees**

What's Next?

Potential Next Steps:

- Ensure the pool's **investment policy** is followed by all parties
- Check that the pool has **considered all allowable asset classes**
- Review fees** that may impact the pool's investment returns
- Implement an **education program** or plan
- Keep asking questions**

What's Next?

Questions to Ask:

- As an individual member of the governing body, are you comfortable with the depth of the governing body's investment responsibilities?
- Does the governing body know it can delegate – but not abdicate – its responsibilities?
- Have governing body members considered all parts of the investment process in their deliberations?
- Are governing body members aware of hidden costs and opportunity costs within the investment process?
- Are any hidden costs or opportunity costs degrading the pool's interests?
- Are governing body members comfortable with the overall level of risk within the investment portfolio?
- Are governing body members comfortable with the current level of portfolio monitoring, including performance measures and comparisons?