FIXED INCOME ACADEMY

Course 14 | Building Win-Win

- **Written for:** Public Agency Investors and the Service Providers doing business with them. Lessons also provide value for any institutional fixed income investor or issuer.
- **Written by:** Terry McCall, Portfolio Services for Government, LLC
- **Original Release date:** March 2013
- **More about the author:** Terry McCall is President of Portfolio Services for Government, and former CFO for the City of Gresham, OR. He is an advisor to GFOA's standing committee on Treasury & Investment Management and an educational contributor to Fixed Income Academy. He may be contacted at terrymccall@ps4gov.com or at 503.667.5407.

What You'll Learn

Our tendency to view relationships with service providers as “us” versus “them” stems from a misunderstanding over the roles those providers are meant to perform. Learn the various roles and business models of service providers and how to identify which are best suited for you. We also review the evolving concept of fiduciary responsibility and share best practices for building win-win relationships

This Course Supplement was created for our FIA students and CFIP graduates to enhance the learning experience. Please feel free to pass it along to colleagues and friends you think would also benefit from the information provided.

Fixed Income Academy, LP is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: www.learningmarket.org.

FIXED INCOME ACADEMY

This is a written version of the information presented in the first three Course 14 lecture videos. For more on the subject, please review all videos, presentation slides, quizzes and supplemental resources.

In this report, Terry addresses the following topics:

Page 3 - **Why Build Win-Win?**

Page 4 - **Institute Trust and Verify**

Page 5 - **Relationships and the Impact on Reputation**

Page 6 - **Multiple Aspects of Fiduciary Responsibility**

Page 7 - 8 **Understanding the Roles Service Providers Play**

Page 9 - **Business Objectives Impact the Service Model**

Page 10 - **A Strategic Look at When or How to Use Advisors**

Building Win-Win Relationships between Public Agencies and Service Providers

Terry McCall
terrymccall@ps4gov.com

Building win-win relationships is universally important. The reverse, win-lose, usually results in the ultimate opposite: lose-lose. This is certainly true in our personal lives but it is equally valid in how we conduct business. The expression, "*What goes around, comes around"*, is a valid guide. For the purposes of this topic, let's define winning as accomplishing whatever goal we have in mind, such as having or developing an optimal investment portfolio for our organization.

Major components of "optimal" would be appropriate degrees of *safety, liquidity* and *yield*. In order to keep the discussion focused, I am going to eliminate *liquidity* from the discussion, although it is important too. Safety and yield in their rawest forms create a natural tension between themselves. If you want to earn a very high yield, you will likely have to give up more safety (credit safety, rate safety or both) than is prudent. Conversely, if you insist on the highest degree of safety, you will have to sacrifice some yield. So the word, *optimal,* fits pretty well in this discussion. You may be able to earn an *optimal* yield and achieve *optimal* safety by creating an appropriate balance between the two. Optimal does not always mean the highest yield or the absolute safest mix of securities. For investors it should mean somewhere on the very good side of reasonable.

But safety and yield are inanimate objects. Let's turn to the human relationships that influence the safety and yield outcomes.

I was in Phnom Penh a few years ago and went to a market to find a piece of silver jewelry for my wife. And while I am not a very good shopper at home, I think I'm pretty sharp at buying in other countries where respect may be lost if you do not haggle for a lower price. Well, that time I was a bit too sharp. I tried to bargain the vendor down so much that she refused to sell the jewelry to me, and I could tell that I had offended her. I felt worse at offending her than at losing the deal. So I went back an hour or so later to apologize and to offer a higher price. And her response was "go away!" I had very obviously not established a win-win relationship, and to this day I have regretted it. I came away feeling like the Ugly American.

As an investment officer or manager, you interact with other people to do your job. When you purchase a security, you most likely do so based on policy compliance, quality, liquidity, price, or expected yield, and perhaps even political or social responsibility considerations. By itself, it is a pretty simple, straightforward transaction that is not very dependent on relationships. But you do not work in a world where you do just one transaction. Whether your portfolio is small and simple or large and complex, you make investment decisions over the course of your assignment. And you do so by working with others in order to accomplish your investment strategies.

When you purchase an investment, all parties to the trade need to make money from it. You need yield for your organization, and the broker needs to earn a commission. If you work through an investment advisor, the advisor does not earn money from the transaction but serves on contract as a rather sophisticated "personal shopper" for an annual fee. The advisor helps arrange the transaction with a broker-dealer, who benefits directly from the sale.

> When you purchase an investment, all parties to the trade need to make money from it.

Who is the broker going to find the best deals for? Who is the advisor going to work the hardest for? While they should and most often do act responsibly for all clients, it is human nature to strive a bit harder for those clients who understand that good relationships are a critical part of the business. Neither they nor you should ever feel inappropriately "handled". Aside from the very important need to observe professional boundaries, the best relationships are where both parties can state that they were treated fairly.

Investment programs cannot be conducted in a vacuum. For example, you or people on your staff interact with banks for depository and securities custody services. Also, you may deal with bond counsel and financial advisors who advise on debt issues. All need to treat you by the same high professional and ethical standards, and you need to give them the same consideration.

How do we get to that point?

Institute a culture of "Trust & Verify".

Trust is a critical component of most relationships, whether personal or business. A good, trusting relationship means that I trust you and you trust me. In the context of investing, trust is absolutely essential.

A wise investor will be influenced more by trust than the lure of higher than normal returns.

But how do you know whom to trust? An old adage is that you should "trust everybody but cut the cards." That is to say that you also need to verify so that your trust is well informed and not based on feelings alone.

When contemplating using a new broker or hiring an investment advisor or investment manager, you should ask your peers about their experiences. Require references from the brokers and advisors and at least spot-check them. And require that brokers complete a new broker questionnaire.

Use the Internet to go to *FINRA Broker Check* to research individual brokers and advisory or management firms. FINRA is the *Financial Industry Regulatory Authority.*

The *FINRA check* will verify that the broker or advisory firm is or is not registered with the Securities & Exchange Commission and whether there are any adverse actions or complaints.

The *advisor check* on the same page will lead you to the SEC Investment Advisor Public Disclosure, often called the ADV. It is somewhat cumbersome reading but the information is there. You should also require advisors to answer this question: "Does your firm now have or ever have had adverse information reported in SEC form ADV? If so, please comment and explain." Occasionally there may be some technically adverse information reported that is not critical but you need to understand it and form your judgment accordingly.

It is also prudent to examine the creditworthiness of depository institutions. This is available through firms such as PMA Financial Network and Highline Banking Data.

Also, make sure that you have written post-trade confirmations of securities bought and sold from your custodial bank and that every safekeeping receipt is matched and retained.

Understand the importance of creating a winning environment for all involved.

Let's assume that trust has been intelligently established and move to why a multi-lateral winning environment is important for ongoing success.

Investors do not typically engage in short-term relationships with their investment *providers,* such as brokers or investment advisors and managers. This underscores the unique relationships involved with investments that are ongoing ones as opposed to those that are more project-oriented. But with projects such as bond issues, we often use the same bond counsel and financial advisor. So it is important to treat them much the same way, as if they are long-term relationships, which they may well be.

A good part of your reputation within your organization is based on the results you achieve – not just yield but also your ability to manage a trouble-free portfolio that is transparent enough that top management and elected and appointed officials feel they understand the portfolio reasonably well. If you think of these people as your customers, how you report information and how you respond to their inquiries is really the *verify* portion of *trust and verify* that helps earn their trust in you.

A good part of your reputation within your organization is based on the results you achieve – not just yield but also your ability to manage a trouble-free portfolio that is transparent enough that top management and elected and appointed officials feel they understand the portfolio reasonably well.

Another part of your reputation and overall success is often dependent on how well you work with your professional service providers. And this applies to them as well. If you are working with a vendor that you don't trust, you will replace them.

But it's also valid to terminate relationships where the technical trust might be there, but the relationship still doesn't fit. I caution against using this option frequently, but don't be afraid to use it when it's really needed. Make sure your contracts allow for termination for any cause.

Identify the benefits of establishing appropriate relationships.

Establishing appropriate professional relationships makes everyone's life easier, makes coming to work less stressful and will help all parties achieve more optimal results than relationships that lack trust, integrity and collegiality.

Overall performance can improve by having service providers offer suggestions to you that you might not have considered before. They will go the extra mile for those clients who see and practice their business lives as two-way streets. That certainly was my experience as a city CFO.

Fiduciary responsibility demands certain behaviors.

An important element of developing and maintaining win-win relationships is strong commitment and adherence to fiduciary responsibility.

Broker-Dealers generally must become members of FINRA and are subject to securities rules relating to "just and equitable principles of trade and high standards of commercial honor". Broker-dealers are required to deal fairly with their customers. While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. Moreover, broker-dealers are subject to statutory, SEC and FINRA requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent. The federal securities laws and rules and FINRA rules address broker-dealer conflicts in one of three ways: express prohibition, mitigation, or disclosure. An important aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which generally requires a broker-dealer to make recommendations that are consistent with the interests of its customer.

So much for advisors and broker-dealers and the ongoing SEC determination of what categories of investment professionals and consultants are fiduciaries. Let us now turn to *you* as a fiduciary. While you may not fit the precise definition of a fiduciary, you are certainly the moral equivalent of one. Therefore, you must strive to meet the high ethical standards that come with the trust placed in you.

Overlooked aspects of fiduciary responsibility

Because safety and liquidity take precedence over yield, it is not uncommon for newer public investors to not concern themselves with yield. This was even more so when yields were higher than during the low-rate environment in the years following 2008.

> … regardless of the rate environment, public investors have a fiduciary responsibility to optimize returns while paying keen attention to safety and liquidity.

In an era of 5% or higher in yields, portfolios were generating meaningful income. But regardless of the rate environment, public investors have a fiduciary responsibility to optimize returns while paying keen attention to safety and liquidity. Finding a few extra basis points should not be misconstrued as yield chasing. In fact, when I was a CFO we improved our safety and were still able to gain an average of 55 basis points during the first five years of our improved strategies. Gaining that much today might be a bit of a stretch but gains are still possible by understanding how to structure your portfolio. And effective duration management accomplishes much of that *without any increase in credit risk.*

How many of you have very short-term portfolios because you think rates will rise? And how many years have you been thinking this? What have you given up during this wait-and-see period?

So remember that part of your fiduciary responsibility to your organizations and your citizens is to pay thoughtful consideration to yield improvement – again without sacrificing safety or liquidity.

Continuing education is also a fiduciary responsibility and is a vital component in a successful investment operation. In some states, there are requirements for a certain number of hours of investment training. Also, most professional investment organizations strongly recommend ongoing continuing education. For example the California Municipal Treasurers Association Code of Ethics states that it is the responsibility of all active members to … “observe the professions’ technical standards and continually strive to improve the Treasurers’ level of competence.” You will find similar language with other state and national associations.

Continuing education does not assure that you will have an effective investment program but it certainly improves the odds. This is good for your program, and it is also good for your résumé.

While curiosity is not an investment term, it is clearly an important investment behavior. Read, read, read, and tune in to financial news frequently.

The use of investment consultants can assist in creating a win for portfolios.

Using investment consultants can be an effective method to assure effective portfolio management.

A customary type of consultant is the investment advisor or investment manager.

- **Investment advisors** assist with policy development and with securities selection, the timing of buying and selling securities, and trade execution. They also assist with reporting, training, and presentations to senior management and elected officials. They do not replace staff but serve as a resource to staff.

- **Investment managers** do much the same as investment advisors but they do the buys and sells without their clients' involvement. But as with advisors, all activity must conform to the clients' investment policies.

Both advisors and managers receive no compensation from trades, so there is no advantage to them to "churn" the portfolio. In both cases they get paid an annual fee, which may be stated in basis points or as a flat fee. If basis points are used, they are assessed against average portfolio size for the billing period and do not include cash, nor do they include money in local government investment pools. Also, they tend to get the best price for you from the broker-dealers because of the larger volumes they work with.

Investment consultants are a less common but emerging type of service provider. The consultant may be a firm that specializes in advising or managing portfolios but in this more narrow role, they advise on overall strategy, future securities selection, as well as investment policy. And if contracted to do so, they can provide investment reporting services. Fees are typically lower than advisory or management services.

… carefully analyze which type of provider relationship is best for your organization.

Broker-dealers are another commonly used source for securities transactions. It is common for public investors to have relationships with several broker-dealers. The investment officer will often "shop" with 3 or more broker-dealers for each transaction in order to obtain the optimal price or yield. They trade securities for their own account. They get paid via the security's price as a portion of the markup or markdown and the income is not disclosed to the client. Aside from pricing not being transparent, broker-dealers are also registered and are subject to SEC rules.

If you use broker-dealers, determine which ones are doing the best job for you and reward them with business when you can. Cull out those that you use very infrequently. You want the good ones to appreciate you and to have your best interest at heart.

I strongly recommend that you carefully analyze which type of provider relationship is best for your organization. Make sure you know how their pricing structures work. Do you know what your true costs are? Are you better off with the price being imbedded in the security or would you rather have the fees stated separately? Does one model work better for your budgeting and accounting systems?

Also, pay attention to those providers who are active and helpful in governmental finance and treasury organizations. They tend to understand your business better than those who do not participate in local or national organizations.

Understanding service provider business models & fitting them to your business model

Compensation structures can drive service provider behaviors.

As mentioned earlier, it is good to understand how compensation structures can drive service provider behaviors. If broker-dealers have inventory to move quickly, the sales force may get compensated according to the needs of the broker-dealer.

Conversely, if investment advisors or managers do not actively seek the best prices, they still get paid the same fee. In this case, you need to make sure that the overall portfolio performance is what it should be. You can do this through benchmarking.

Whatever your organization's objectives are, they may change over time in order to respond to current or unforeseen circumstances.

Develop an understanding of how business objectives impact service models.

Business objectives are naturally inherent in the development of service models. I think we can all agree that your service providers need to earn a living, just like you do. So we should accept that they should make a profit. And if they are not able to make a profit, just like the woman in Phnom Penh selling jewelry, they will stop selling the product to you, or completely stop selling the product or service all together.

But enough about service providers - let's talk about **you** as investors.

Identify the appropriate business model to achieve your objectives.

What are the objectives of your organization in particular?

If you are the City of Weston, Florida, your city objective would be to provide good service while keeping the cost of business down by outsourcing nearly everything. Weston has a population of over 65,000 and has just nine employees. So Weston's investment objective may well be to earn a reasonable return on a safe investment but to do so without any direct staff. That's an unusual experiment in this city that is just 17 years old.

Your objective may be very different because your organization's model is probably more traditional than Weston's.

Whatever your organization's objectives are, they may change over time in order to respond to current or unforeseen circumstances. In a struggling economy, you may be charged with "doing more with less". That may sound good but it is not so easy to do. Rather than increasing investment staff, it may be to your advantage to hire an investment advisor or investment manager. This also helps when turnover of key staff occurs, because it helps in maintaining a degree of operational continuity.

On the other hand, some organizations feel strongly that contracted work should be kept to the bare minimum, if allowed at all. In this case, you would most likely be better off with direct interaction with broker-dealers and banks. You may work in an organization that requires all vendors be local. That will also drive your model.

If you are an investment advisor or broker-dealer, your business objectives will be different from those of the public investor but should be complementary. It is perfectly natural for profitability to be a key objective. Without profits, it would be impossible to stay in business for very long. And the public investors need you, so they should accept the profit motive. Beyond that, the business objective is to make a reasonable profit by providing the needed service that your sector offers.

As market conditions change, advisors' and broker-dealers' approaches to business may change too. In fact, they have changed over the past few decades with the introduction of investment advisory services. Broker-dealers have symbiotic relationships with advisors because the advisors act much the same as personal shoppers for their public clients. The clients still buy from the broker-dealers but they do so either through or with the advice of the investment advisor -- and they typically do so with lower net cost because of the trading volumes involved.

Give thought to what your overall organization's objectives are, and try to fit your model accordingly.

Recognize how internal conditions such as staffing constraints may cause the business model to change.

Internal conditions can change quickly. If you leave the organization for another job, who will replace you, and what investment skills do they have? Does that worry you? Does that worry your boss? If your operating unit is required to downsize, will outsourcing some of the work help?

If you are involved in strategic planning, there are additional questions you need to consider. As you think this through, ask yourself these questions:

1. What are my investment capabilities?
2. How much time do I have to devote to investments on a daily or weekly basis?
3. If I supervise but do not engage directly in the investment process, how much do I know about the subject?
4. How do I know if our program is earning an appropriate return?
5. If we were able to earn 10 to 25 more basis points or perhaps even more, what would that mean to the organization?
6. What will we do if we have unexpected staff turnover?

7. What will we do if we need to reduce staffing levels?
8. What are the net costs of operating the investment program?
9. How much in fees are we currently paying for transactions, either stated as direct costs or as part of the securities' prices?
10. Would our program gain or lose if we moved from directly using broker-dealers to an advisory program? What tools or information do we need to make that determination?
11. Would our program gain or lose if we were to move from using an advisor to directly using broker-dealers? What tools or information do we need to make that determination?

Establishing and maintaining win-win relationships is ultimately self-serving for all parties involved, whether you manage the portfolio with or without external assistance. Accomplishing this typically results in optimal portfolio performance. In the process, your constituents (the real customers) are winners and so are you.

Terry McCall is president of Portfolio Services for Government, and former Chief Financial Officer for the City of Gresham, OR. He is an advisor to GFOA's standing committee on Treasury & Investment Management and an educational contributor to Fixed Income Academy. He may be contacted at terrymccall@ps4gov.com or at 503.667.5407.