

INVESTMENT MANAGEMENT FUNCTION REVIEW

March 2009

Purpose of the Report

Fairmount Capital Advisors, Inc. (Fairmount) has been retained by the Clerk and Comptroller of Palm Beach County, Florida (the Clerk) to perform a review of the Clerk's investment management function, which manages a unified investment fund (the Fund) for the County totaling in excess of \$1.7 billion. The purpose of this review is to make recommendations intended to assist in the process of bringing the investment management function in line with industry standard best practices. In addition, we have made recommendations as to the organizational structure of the investment management function to strengthen operations and increase accountability. It is important for organizations to conduct this type of review on a periodic basis to get an outside perspective on complicated functional areas.

Strengths of the Investment Management Function

During the course of our review, we have noted a number of organizational strengths, which contribute significantly to the ability of the investment management team to manage the County's funds in a prudent and cost-effective manner.

- The County has a formal investment policy. This policy provides clear guidelines for the investment of County funds, while providing sufficient flexibility for the Clerk's investment management team to react and adjust to changing market conditions.
- The County has a formal Investment Policy Committee which is comprised of both County officials and outsiders with expertise/interest in the investment management function. The Investment Policy Committee meets three times per year to review the Fund's performance and provide its counsel.
- The Clerk's Investment Manager has developed a solid understanding of the investment products available and the applicability of fixed income investment principals such as duration and convexity.
- The investment management staff has developed reasonable procedures for handling the sale of investments prior to maturity to ensure receipt of competitive bids.
- It appears that the Fund has been structured in a manner that allows for meeting the County's cash needs appropriately.

Improvement Opportunities

While the Clerk's investment management team has safeguarded public funds and earned appropriate returns for the County, there are several opportunities to improve overall Department performance and accountability by applying industry standard best practices through revised policies and procedures. A visionary approach to maintaining high level performance requires continuous reevaluation and improvement. As part of this, the policies, procedures and structure of the Treasury function can be strengthened. Strengthening of these areas would lead to better accounting of performance and allocation of returns, more robust and independent risk analysis, improved internal controls and accountability, and potentially greater returns.

Reorganization of the Treasury Department

To improve accountability and segregation of duties within the Treasury Department, we propose the following changes to the current organizational structure:

1. The Treasurer should undertake the role of "Compliance and Valuation Officer" and should no longer have trading authority with respect to County funds. In this role, the Treasurer will have new responsibility for:
 - Reviewing trades in the portfolio for policy compliance
 - Performing independent valuation, risk analysis and performance reporting
 - Coordinating procurement of services related to investment management function with the internal investment portfolio review committee
2. There should be an expedited process to establish trading authority for the Investment Analyst so that there is a minimum of two authorized traders for the Fund
3. The Clerk should form an internal investment portfolio review committee, chaired by the Clerk or her designee, with members including the Chief Financial Officer, the Investment Manager, the Treasurer, and such other staff as the Clerk deems appropriate
4. The Investment Manager should continue to have responsibility for the management of the Fund and for cash management responsibilities (though such cash management responsibilities may eventually be transferred to the Treasurer)

We believe that the proposed reorganization of the Treasury Department will be helpful in addressing the following needs:

- Providing more effective segregation of duties, such that there is more independent monitoring of trade activity and valuation of the County's funds
- Providing a means for this monitoring to be effective by ensuring more regular reporting to the Clerk and, at the Clerk's direction, to the Investment Policy Committee
- Reducing the administrative burden on the Investment Manager such that the position can be more focused on the management of the County's funds

Specific Recommendations

A. Staffing

Our major staffing recommendations are addressed in the reorganization proposed above.

Recommendation #1: *Ensure that a minimum of two people who are actively involved in the investment management function are authorized to trade securities. This will provide for coverage in the event of vacations, illnesses and unforeseen circumstances.*

Management Response #1 - Management concurs with the recommendation. Paperwork necessary to omit the Director of Treasury and to add the Investment Analyst as an authorized trader is being drafted, to be executed in March, 2009.

B. Information Systems and Technology

It is critical that a well-managed investment fund have appropriate access to real-time information that allows it to establish value and evaluate the risk of its portfolio(s). This includes both the information resources themselves (typically available on a subscription basis) and the software systems necessary to provide full-scale analyses of portfolio risk metrics and evaluation of opportunities.

Recommendation #2: *The Clerk's investment management team should be fully responsible for its own portfolio analytics. The size of the County's portfolio justifies the addition of deeper analytic capabilities to the work performed as part of the Clerk's investment management functions. Such capabilities could be purchased through a contract with an outside vendor or could be built within the Clerk's investment management team through additional staffing, software and information services. The ability of the Clerk's investment management team to perform its own regular analytic analysis will ensure the availability of this analysis on a constant basis and will mitigate perceptions of conflict of interest with respect to providers of services.*

Management Response #2 - Management concurs with the recommendation. The Clerk's investment management team is researching alternative solutions which will allow for more dynamic and independent risk analysis and reporting as well as

improved accountability. This review includes portfolio analytic and management systems provided/contracted with a third-party vendor, proprietary software of broker/dealers that may be used in-house, and further utilization of the Bloomberg.

C. Organization of Fund

The County's fund is set up as a single, commingled pool. Funds are deposited into and withdrawn from the Fund as needed. Accrued interest is computed daily, and gains and losses are computed and allocated to deposits on a monthly basis.

Recommendation #3: *The Clerk's office should consider a recasting of the Fund such that specific investments are associated with individual bond proceeds accounts. The Clerk's investment management team should consider dedicating a portion of the shorter-term investments in the Fund to these funds and managing them separately, without necessarily changing its overall investment portfolio. This would serve to reduce the yield associated with these funds, and consequently, reduce the magnitude of future yield reduction payments.*

Management Response #3 - Management concurs with this recommendation conceptually. However, management cannot simply designate certain lower-yielding investments in the pool as the bond proceeds to avoid arbitrage. According to the arbitrage rebate consultant, Integrity Public Finance Consulting, it may be possible to establish a separate bond proceeds-specific fund. Within this fund, all of the securities allocation and mark to market requirements would need to be met. Under this scenario, the fund could then be monitored on a subaccount level to identify specific bond proceeds. Alternatively, management could invest each fund separately in external money market instruments that are currently earning lower rates and have high liquidity capability. The mechanics of such an endeavor will be discussed with the financial reporting department as well as the arbitrage rebate consultant.

D. Investment Management Process

The investment management process is the process by which sales and purchases of securities are handled by the Fund on a regular basis. This process is managed on a day-to-day basis by the Investment Manager, with the assistance of the Investment Analyst and the Investment Clerk.

Recommendation #4: *The investment policy should include a solid minimum net capital standard for broker/dealers with which it is comfortable. Once new standards are set (whatever they are), each of the authorized broker/dealers should be evaluated annually to ensure compliance with such standards.*

Management Response #4 - Management concurs with the recommendation. The Investment Policy Committee has recommended that the minimum net capital requirement be lowered from \$25 million to \$15 million. The item will be brought to the Board of County Commissioners on March 17, 2009 for formal approval.

Annually, each of the authorized broker/dealers is currently, and will continue to be, evaluated to ensure compliance with such standards.

Recommendation #5: *The Investment Manager and the investment management team should work diligently to maximize the potential benefits offered by all of the authorized broker/dealers. Implementation of the other recommendations with respect to increased internal capabilities and analysis should help “level the playing field” and provide greater opportunities for all of the broker/dealers to compete on price and availability of securities rather than the level of service.*

Management Response #5 - Management concurs with the recommendation. *The Investment Manager and the investment management team will implement the other recommendations of this audit with respect to internal capabilities and analysis. All of the broker/dealers will continue to be held to the standard of best price and availability of securities in order to transact business with the Clerk & Comptroller, in her capacity as custodian of county funds.*

Further, the broker/dealer selection process will be reviewed under the direction of the Director of Compliance and Revenue, who will review the current process and, along with the investment team, make improvements as necessary to reflect the best practices in the industry.

E. Fund Operating Procedures, Internal Controls and Risk Metrics

The Fund invests large amounts of County funds on a daily basis. Formal operating procedures and internal controls help establish the parameters by which these funds are managed and provide appropriate checks and balances to ensure the safety of such funds. The use of risk evaluation metrics with respect to the securities in the Fund helps ensure that the risk profile of the Fund is compatible with the County’s Investment Policy and the goals and objectives established by the Clerk and the Investment Policy Committee.

Recommendation #6: *As the Clerk’s office develops the depth of its investment management staff, it should document procedures for certain duties, including trade entry and review, valuation and performance monitoring, ensuring segregation of such duties where appropriate. The Clerk’s office should focus on the development of policies that include effective monitoring, review and internal checks and balances.*

Management Response #6 - Management concurs with the recommendation. *The investment management team will look to the best practices in the industry and to the highest audit standards in developing and documenting policies and procedures to monitor, review and value individual transactions as well as the portfolio overall, while also providing for a system of internal checks and balances within the investment function.*

Recommendation #7: *The Clerk should establish an internal portfolio review committee that would meet at least monthly to review the portfolio, discuss broad issues and*

consider performance. This would increase the degree to which investment management decisions are based on a consensus approach to the County's goals and objectives.

Management Response #7 - Management concurs with the recommendation. The Clerk has created an internal portfolio review committee called the "Internal Advisory Committee." It first met to review the portfolio and to discuss broad issues and consider performance. The structure of future monthly meetings as well as the dissemination of information will be an evolving process whereby the committee provides input to the investment management team in terms of preferred reporting formats and information flow. Performance measurement, broker/dealer selection and disqualification as well as the CEFEX certification process will be pertinent issues that will be brought to the committee for discussion during the current quarter.

Recommendation #8: *Detailed portfolio information should be made available to all of the County's authorized broker/dealers on a regular basis.* Broader dissemination of this information may spark additional ideas and greater competition for the portfolio.

Management Response #8 - Management concurs with the recommendation. The Investment Manager and the investment management team will meet to determine a consistent method to distribute detailed portfolio information to all of the County's authorized broker/dealers on a regular basis, but no less than monthly.

Recommendation #9: *Portfolio restructurings should be discussed by the internal portfolio review committee discussed above.* These restructurings can have a material impact on the quality of the Fund's results and each represents a material shift in the portfolio that is intended to accomplish one or more specific objectives. Development of a team approach to the review of these restructurings (which should be initiated by the Investment Manager) would increase the degree to which there is greater internal discussion of the goals and objectives of such restructurings and those restructurings are viewed by the Clerk's office as serving broader investment management objectives.

Management Response #9 - Management concurs with the recommendation. Potential future restructurings that are strategic and represent a shift in overall investment philosophy and direction will be brought by the Investment Manager to the CIAC. The Investment Manager will present the recommended restructurings in the context of what each will specifically accomplish in meeting broad investment management objectives. Restructurings that might be time sensitive, tactical in nature and that are intended to improve the performance of the portfolio by one or more variables will be discussed amongst the investment management team and executed as appropriate. The Investment Manager will subsequently report activities and results of these transactions to the CIAC at their next regularly scheduled meeting.

Recommendation #10: *Investment management staff should document the informal procedures already in place and continue to develop policies and procedures, with the guidance of the internal portfolio review committee.* Although many formal policies

exist, documentation of all policies and procedures will add significant structure and accountability to the investment management function.

Management Response #10 - Management concurs with the recommendation. The Investment Manager will document informal policies and procedures already in place for the investment management function as well as those referred to in Recommendation #6. Such procedures will be presented to the CIAC at regularly scheduled monthly meetings for review, comments and possible discussion.

F. Reporting

Effective internal and external reporting of results and risk metrics is essential in monitoring overall portfolio performance as well as exposures in different segments of the portfolio. Effective reporting allows the investment team, the Clerk and the Investment Policy Committee to understand what has worked well, what has worked less well, and how the portfolio has reacted to market changes. Effective reporting is essential in reassuring those outside parties who may be interested in the Fund's performance and exposure to the changing fixed income market.

Recommendation #11: All sources of portfolio income/loss should be reflected in the reporting provided internally and to the Investment Policy Committee. The performance of the Fund includes both the interest income received and the realization of capital gains and losses. These should all be considered in the broadest evaluation of the Fund's performance.

Management Response #11 - Management concurs with the recommendation. Reports that are currently produced that reflect all sources of portfolio income/loss, including a breakdown of interest income received versus realized and unrealized gains/losses will be brought to the CIAC, and adjusted as necessary to best meet the information requirements of both committees, in order to best evaluate the Fund's performance.

Recommendation #12: The County's investment portfolio should be marked-to-market on a daily basis. Given the volatility inherent in the County's Fund (which is not structured as a money market fund, with a stable net asset value) and the intra-month transfers of funds in and out of the County's portfolio, the Clerk's investment management team should move to daily valuation of the portfolio to better account for the valuation fluctuations inherent in a portfolio of this type. Such a move will add approximately \$2,000/month to the County's data costs, but will ensure that each of the County's funds will be correctly allocated their fair share of capital gains/losses.

Management Response #12 - Management concurs with the recommendation conceptually. However, to move to a more frequent evaluation than monthly will require testing and possible modifications to the Clerk's investment management software system used internally, SymPro, which in the past, did not support more frequent valuation of the portfolio.

To move from monthly updates to daily updates will add approximately \$32,000 annually to the budget. Additionally, approximately 10 securities within the portfolio will require manual pricing from a broker/dealer, as the contracted pricing service does not price these bonds (IANs). We will discuss this recommendation and the issues surrounding it at the next Investment Advisory Committee meeting.

Conclusion

While the financial performance of the Fund has been successful in meeting the County's cash needs while protecting against principal losses, having received a AAAf/S1 rating from Standard & Poor's, it is clear that there are a number of areas in which the management of the Fund could be improved to better meet industry standard best practices. We have made several observations and recommendations which, if implemented, will significantly improve the management of the Fund from a risk and controls perspective. We also believe that it is likely that the implementation of these recommendations as a package would "pay for itself."

In our view, the Clerk's office has two possible approaches to follow in implementation of recommended improvements to the investment management process – it can "buy" the needed improvements (through contracts with outside providers), or it can "build" the improvements through additional staff and in-house technology. If the Clerk chooses to build the improvements in-house, it may be desirable to contract out some of the desired improvements on an interim basis until in-house capabilities meet the appropriate level. Naturally, the Clerk could also opt for a combination of these approaches, where certain information technology and/or reporting services are purchased and additional staffing is used to enhance internal control and reporting.

Implementation of these recommendations should increase the accountability and transparency of the Clerk's investment management function, should help to maintain a high level of public trust in the Clerk's management of the County's funds, and could lead to enhanced real returns for the County's funds.