



BEST PRACTICE

Selection and On-Going Review of Investment Advisors for Non-Pension Fund Investment Portfolios (2003, 2007, and 2009) (TIM)

Background. Many governments engage investment advisers for assistance in managing their non-pension fund investment portfolios. State and local government treasury and investment managers augment their investment programs by retaining investment advisers to perform various portfolio services, ranging from advice-only consultation to full discretionary management. In engaging an investment adviser, a government may benefit from professional portfolio management, risk management, potential audit savings, and continuity in the investment function, among other benefits. Most of these engagements have been positive. However, there have been some instances of inappropriate investment activities. The problems and reported losses have often resulted from governments hiring an adviser before they have clearly defined their needs, performed sufficient due diligence, and established proper controls and ongoing oversight.

It is important for governments to take a careful and informed approach in the selection and use of investment advisers. When hiring an investment adviser, the government must determine the level of authority to grant the adviser. Advisory services will differ in the level of authority the government grants the adviser and the corresponding level of involvement the government retains in the investment process.

Under a **non-discretionary** agreement, the adviser must obtain approval before executing any trade. All activity must comply with the guidelines of a government's investment policy, investment objectives, governing laws, and written or oral instructions. With a non-discretionary agreement the government is directly involved in investment transactions, whether to establish a comfort level with external management or the adviser, to learn from the adviser, or for some other reason.

Under a **discretionary** agreement, the adviser can execute trades for the government without prior approval on each transaction. The adviser follows the same guidelines and restrictions as a non-discretionary adviser. With a discretionary agreement the government is less involved in the investment transactions, thus enabling staff resources to be directed to other duties, giving the adviser the ability to execute investment strategies more quickly, and allowing the government to hold the adviser totally responsible for the performance in the portfolio.

Under either agreement type, the government maintains control of its investment program by establishing the guidelines and policies to which the adviser must adhere.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments exercise caution and prudence in their selection of investment advisers. Because fiduciary responsibility for the safety and liquidity of government funds cannot be delegated to an investment adviser, the implementation of a safe and effective investment program must be carefully coordinated with the adviser.

The GFOA urges state and local governments that are considering retaining an investment adviser to define and control the procurement process and assure periodic reviews of investment advisory services. Adhering to defined due diligence in selecting a qualified investment adviser and establishing proper controls will help a government achieve its objectives for hiring an adviser while protecting its funds and reducing risk to its reputation.

Within the scope of Securities and Exchange Commission (SEC) regulations, state and local laws, and any other requirements, relationships with investment advisers should address the following:

- **Identification of adviser responsibilities.** Responsibilities of the investment adviser should be identified before the selection process. During the process these should be clearly defined and communicated.
- **Impartial procurement.** The responsible government official or the governing board should appoint a consultant and/or internal review committee to conduct the search process. Such staff, consultant, and/or review committee members should be independent of any interest in or relationship with any investment advisory firm. The procurement process should be competitive and merit-based.
- **On-going review.** Investment advisory services should be reviewed on an on-going basis. The on-going review, monitoring and evaluation of the investment adviser are as important as the due diligence undertaken during the initial selection process. The responsible government official or the governing board and/or review committee should determine the scope and frequency of such review process.

Criteria - The responsible government official or the governing board and/or review committee should determine the criteria to be used in the selection process. Identifying relevant criteria upfront promotes transparency in the selection process. Assigning weightings to these criteria can create a workable method to rank or quantify the importance of each. Criteria should include:

- the investment adviser's understanding of the government's investment program, objectives and constraints
- the investment adviser's background, including the experience, resources, and qualifications of the firm in general, that of the individuals assigned to handle the government's account, and the firm's experience in managing state and local government operating funds
- the investment adviser's recommended approach to management of the portfolio: Is this approach appropriate for the government?
- fees and fee basis

Risk Control - As part of the procurement process and prior to a final decision on the investment adviser, the government entity should have made decisions regarding its risk tolerance and developed corresponding risk control requirements, including:

- the level of discretion afforded the investment adviser
- prohibitions against self-dealing for trade execution
- competitive trade execution
- trade confirmations
- delivery versus payment trade settlement
- independent third-party custody of securities (no investment adviser custody)
- timely reconciliations of trade confirmations and custodial statements
- monthly reporting that complies with industry standards and local requirements
- ongoing compliance reviews
- allowance for independent audits

Selection Process - Once the government defines the services it seeks to obtain and the criteria it will use to make its selection, a Request for Proposal (RFP) is useful to gather information for the decision-making process.

Information that might be part of the RFP include:

- SEC licenses
- quantitative information (e.g., financial stability and performance review)
- organizational structure of firm including any business affiliations

- experience and depth of personnel in firm, including turnover and single versus team management
- reporting standards (Global Investment Performance Standards or GIPS)
- firm-specific investment philosophy and portfolio management strategies
- trading process
- interviews with finalists
- understanding of current or historic regulatory censure or litigation

The sources for potential candidates may include:

- references from other governments
- consultants' database(s) on investment advisory firms
- association databases
- industry reports and articles
- marketing materials

Final decisions will require an objective compilation and analysis of the results of the RFP. Most importantly, the investment adviser and the services offered must match the needs of the particular government entity.

Advisory Agreement - A well-constructed agreement containing specific instructions concerning objectives and risk parameters, allowable investment instruments and strategies, and required reporting procedures is critical to a successful outcome. After a recommendation regarding the selection of an investment adviser has been made, the contractual agreement should include:

- scope of services
- appointment of the investment adviser and fiduciary responsibilities
- establishment of account responsibilities
- definition of accounts and custody
- definition of discretionary or non-discretionary services with appropriate limitations
- definition of standards (Prudent Expert)
- establishment of objectives, restrictions and benchmarks
- definition and processing of transaction procedures in accordance with policy including brokerage limitations
- representations by entity and investment adviser
- determination of reasonable liability insurance for errors and omissions
- establishment of invoicing and payment
- procedure for termination by either party
- specifications related to nondiscrimination in contracting and ethics rules
- certification of the government's policy by the investment adviser
- all provisions of the RFP as part of the contract

References.

- *Investing Public Funds*, Second Edition, Girard Miller with M. Corrine Larson and W. Paul Zorn, GFOA, 1998.
- *An Introduction to Investment Advisers for State and Local Governments*, Sofia Anastopoulos, GFOA 2007. This publication includes a sample Request for Proposal (RFP) for investment advisory services and a sample investment advisory agreement.
- *An Elected Official's Guide: Investing*, second edition, Sofia Anastopoulos, GFOA, 2007.
- GFOA Sample Request for Proposal for Investment Advisory Services, GFOA, 2007.

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