# Section 2

# Selecting an Investment Adviser

Adhering to a defined due diligence process in selecting an investment adviser will help a government protect its funds, reduce the risk to its reputation, and enhance the likelihood of being satisfied with the investment adviser's service. The Government Finance Officers Association (GFOA) Committee on Cash Management recommends that governments exercise caution and prudence in the selection of investment advisers. Regardless of who makes investment decisions, ultimate responsibility for government funds remains with government officials. It can never be delegated to an external investment adviser. The GFOA further urges government investors to develop policies on the procurement and periodic review of investment advisory services. Appendix A contains the complete text of the GFOA Recommended Practice "Selection of Investment Advisers for Non-Pension Fund Assets."

## The Selection Process: A Step-by-Step Approach

To ensure the best outcome, a government should conduct an objective procurement process and use a competitive, merit-based process for selection. As its first step in the process of hiring an investment adviser, a government may consider engaging a consultant and/or appointing a committee to conduct the search process. Some consulting firms specialize in helping clients set their objectives, and select and engage investment or money managers. A consultant can help the government's staff properly interpret the information submitted by potential advisers. A selection committee can take on a similar advisory function. It is important that a consultant, selection committee members, or any involved government official or staff not be affiliated with or have interests in any investment advisory firm under consideration.

Another important element in finding and engaging a competent investment adviser is to establish procedures and to follow a step-by-step process. Often the consultant's or committee's search process begins with identifying the government's investment goals and objectives, as well as its expectations of an adviser. It

**Steps to Selecting an Investment Adviser**

1. Appoint consultant or committee to lead search
2. Identify government's objectives and investment adviser's responsibilities
3. Establish criteria for selection
4. Identify sources for information
5. Create and send a request for proposal (RFP) to potential candidates
6. Compile and analyze the data
7. Select and interview finalists
8. Select an adviser that most closely meets the government's needs
9. Negotiate a contract

is crucial to define clearly what type of investment advice is being sought and the government's goals in hiring an investment adviser. The services to be provided and responsibilities expected of the investment adviser should be stated plainly:

- Will the adviser provide only portfolio management, or are there additional advisory services sought?
- Will the adviser be given discretionary authority and conduct investment transactions on behalf of the government, or will the adviser be given nondiscretionary authority?
- What area of expertise is the government interested in engaging?
- Will the adviser be directed to manage according to a passive style or an active style?
- Is the adviser being hired to provide investment advice only, or will other consulting services be required? (See page 5 for services provided by investment advisers.)

Governments should identify criteria for the selection process. These key criteria should include the firm's:

- Understanding of the overall investment program, objectives, and its constraints;
- Background, including the experience, resources, and qualifications of the firm and individuals assigned to the government's account;
- Experience in managing state/local government operating funds. In evaluating the firm's experience, past performance data should be reviewed in the context of portfolio objectives and constraints, as well as risks;
- Recommended approach to portfolio management; and
- Fees and fee basis.

This list of criteria is not exhaustive. Identifying relevant criteria upfront promotes transparency in the selection process. Assigning weightings to these criteria creates a workable method to rank or quantify the importance of each. It also attempts to quantify a process open to interpretation.

The sources a government can tap for information are varied and may include consultant databases on investment advisory firms, association databases, industry reports and articles, marketing materials, references from other jurisdictions, and other special research and/or reports.

If a consultant has been retained to help steer the process, he or she should be able to assist in generating a list of potential candidates. Alternatively, a government can take a "word-of-mouth" approach and/or include money managers widely known to meet broad management criteria.

## Request for Proposal

A request for proposal (RFP) helps ensure that a fair, competitive process is followed. Additionally, the RFP process can confirm for participants that the government is conducting its business in a fair manner and encourage them to participate in future RFP opportunities. The RFP can serve as a formalized procedure for information collection, as well as an outline for the selection process. A sample RFP appears in Appendix E to give governments an idea of the types of questions to ask and information to request. Not all of the RFP's content will be relevant in every situation, so government officials should review the suggested document carefully and select only that which is appropriate for the type of services being sought.

The RFP process includes the creation and distribution of the RFP, a review of proposals, interviews of finalists, selection of an adviser, and contract negotiation. The document itself includes the following sections:

### *Scope of Services*

The RFP should start with a scope of services section in which the government specifies precisely the investment advisory services it seeks, as well as its investment objectives. In addition, the introduction should briefly describe the government and portfolio size. A copy of the government's investment policy should be referenced in the RFP and attached to it.

### *Selection Criteria*

A section identifying the selection criteria should follow next. This section can list the criteria previously discussed, and may assign a percentage weight illustrating the relative importance of the criteria to aid in the evaluation.

### *Government Description*

The next section of the RFP should include a full description of the government, including the size of its portfolio and its cash flow characteristics. In addition, officials can include information on the jurisdiction's geographic location, form of government, current population, current budget size, current and expected bond issues, portfolio make-up and size by fund, Web site address, and identities of authorized government contacts.

### *Submission Process*

The RFP should itemize steps in the submission process. This will help ensure that all respondents to the RFP clearly understand the process. Submission instructions should include the required proposal format, including required order of responses to each question, acceptable attachments, limits on the length of a response or proposal, and a schedule for the proposal submission and evaluation process. The government should spell out restrictions in communications with government staff and/or officials, consultants, and selection/evaluation committees, and should specify appropriate procedures for proposers to follow when making inquiries about the RFP. Any reservation of rights should be included in this section. As part of the proposal submission instructions, the government should expressly state the date and time that proposals should be received, as well as the form of submission required (paper or electronic).

### *Investment Adviser Information*

This key section of the RFP specifies what background and organizational information the government requires the investment adviser to include in its proposal. Respondents are expected to provide information in the following areas:

- Firm background and organization;

- Manager and firm experience;
- Personnel to be assigned;
- Assets under management (AUM);
- Investment management approach and discipline;
- Reporting practices and capabilities;
- Proposed fee arrangement; and
- Any additional information the government needs.

### *Evaluation of Responses to the RFP*

The next step involves compiling the responses to the RFP, and analyzing and verifying the data provided. The selection committee or consultant may direct this process. After verifying that participating firms meet the minimum requirements, the selection criteria identified in the RFP can be used to develop a list of finalists. Finalists should be interviewed in person. The use of a committee for the interview process is recommended. This approach allows multiple opinions to be expressed and mitigates the chance of favoritism. Formal presentations can be followed by a question-and-answer session. Finally, the government must carefully check references.

After these due diligence steps have been taken, the government should have sufficient information to select the candidate that most closely meets its needs. Alternatively, if the government does not believe any of the firms under consideration are an appropriate match, it may choose to restart the process. The investment adviser selected must meet the government's needs and the government's staff must feel comfortable working with the adviser.

## Questions to Ask in the Selection Process

The following questions can help the government team assigned to selecting an investment adviser:

**How is the firm organized?** Any affiliations, soft dollar, finder's fees, or similar arrangements should be disclosed as part of the response.

**What experience does the firm have managing fixed income portfolios for public funds and government entities?**

**What is the firm's experience in developing policies and portfolio management guidelines for government operating funds and managing such funds?**

**Who will manage the government's portfolio? What are the backgrounds and qualifications of the individuals to be assigned?** It is a good idea to find out if the portfolio manager is a principal or partner in the firm. If other representatives will manage the portfolio, information concerning their backgrounds should also be obtained. Both educational and professional backgrounds should be reviewed. The government should ask about the firm's procedures for keeping its employees current in the investment field.

Identify and understand who the key personnel are and what experience they have with public funds. Determine whether there have been recent personnel changes, and find out how the firm would address any future departure of key staff.

**What are the total assets under management (AUM) and how many portfolios are managed?** Answers to these questions will help the government understand the types of clients the firm serves. It is important to find a match with an investment adviser managing comparably sized portfolios to ensure that adequate attention is paid to the portfolio. Some government funds may be too small for a particular adviser, for example. It also is important to find out how many accounts the adviser feels can be managed at one time while still retaining a high level of service and quality.

The government should ask the following types of questions:

- Has the firm's experience been mostly with small, retail customers?
- What are the portfolio sizes of the firm's largest and smallest clients?
- Will the government entity be its largest client?
- Alternatively, will the government's portfolio be among the smallest?

**Has the firm experienced significant client losses or gains recently?** This question attempts to gauge client satisfaction trends. Governments can check current client satisfaction levels by asking about the number of new accounts the firm acquired and the number it lost during the last five years, and requesting an explanation of each addition or loss. Net outflow may mean poor service. It is also important to compare firms with the same approach to see if they have had similar account losses.

**What is the firm's investment style and approach?** When selecting an investment adviser, it is important to choose one whose investment style is consistent with the parameters of the entity's investment policy and the government's risk tolerance levels. Inquire specifically about the firm's fixed income management style to determine if it is appropriate for the government's investment portfolio. Further, the government's staff should feel comfortable with the firm chosen.

**What approach to managing the government's specific portfolio does the firm propose?** This is another question aimed at ensuring that the government staff agrees with the proposed approach and how it will address the government's distinct objectives and risk tolerance.

**What is the firm's investment decision-making process?** The response should provide the government with a sense of the individual portfolio manager's independence within the firm. In addition, the answer also offers a perspective on how the firm approaches its investment decisions and how it handles the oversight of individual portfolio managers.

**What is the firm's trading process?** Responses can help a government determine the firm's internal trading capabilities as well as its relationships with the investment community. This information will also clarify whether an investment adviser intends to act as a broker-dealer, which would be unacceptable.

**How often will the portfolio manager review the account and meet to review and discuss performance?** The manager should review the government's account at least weekly, more often for more active accounts. The account's volatility will dictate how often the portfolio needs to be reviewed. Each entity must determine, based on the makeup of its portfolio, what its comfort level is and set the review period accordingly. The investment adviser should hold periodic meetings to ensure the government fully understands the investment adviser's activities and rationale.

**What does the manager think is an appropriate benchmark and measurement period?** The government should agree with the proposed benchmark and measurement period. Further, the proposed period should be within the normal range for similar portfolios.

**How are fees set?** Fees may be set in a variety of ways. Generally, fees are charged as a percent of total assets managed and are based on a sliding scale, descending as the account size increases.

Smaller portfolios may be charged a flat fee. If this is the case, determine what percentage the fee works out to be. For example, a $5,000 fee on a $10 million portfolio is 5 basis points, whereas a $5,000 fee on a $1 million portfolio is 50 basis points.

Fees can range anywhere from a few basis points to full percentage points of assets, depending on the type of management (active versus passive) and type of investments (fixed income versus equities for longer-term funds). Larger portfolios generally have lower fees. Fees often are negotiable.

**What is the minimum account fee and what is the expected fee for this account?** Governments should consider how fees fit into the total picture of choosing an adviser.

**What is the firm's billing frequency?** The critical point is that fees should be charged after services are received.

**What is the firm's track record, net of fees?** Governments should evaluate the firm's past performance based on composite portfolio figures. Performance and variance should be reviewed. The government should compare the data to other firms' track records.

**What public sector or other tax-exempt clients does the firm provide as references?** This question should offer additional information about the firm's experience with comparable clients and portfolios. Governments should be sure to check the references, even though advisers are likely to offer their best clients as references. As part of the due diligence process, government officials should look for past or present clients that were or are dissatisfied. One way to do so is to network with peers, as bad news tends to travel quickly. Most important, remember that past performance does not indicate future results.

**What insurance does the firm carry?** Answers to this question can illuminate what protection an investment adviser has. Governments should make sure the insurance is relevant. Consulting with the government's risk management staff or insurance agent may be useful in determining adequate coverage levels.

**Is the firm registered with the SEC or appropriate state regulatory bodies?**

## Common Mistakes

There are several common pitfalls to avoid when hiring an investment adviser:

**Past performance is too good to pass up.** Impressive numbers probably are the most overrated criterion for selecting an investment adviser. As stated above, past performance is no guarantee of future success.

Government officials should be cautious of composite number presentations. Ensure meaningful comparisons. Investment portfolios should be compared using the same time frames (e.g., long-term portfolios should be compared to those of similar duration). It also is important to obtain performance figures on composites with closely related strategies and objectives.

**The firm's client contact is aggressive and persistent.** Do not misconstrue marketing savvy for investment expertise. Hire the latter, not the former.

**The firm made the best presentation.** Do not allow the selection process to become a beauty pageant. Do not get sidetracked by unnecessary details and lose focus.

**The firm came highly recommended.** Although it is important to network with others, make sure it is an "apples-to-apples" comparison and that the person making the recommendation has a similar portfolio and management style.

**The investment adviser already has a relationship with the government.** Providing other services to the government (e.g., banking services or custodial services) does not mean that the firm will be able to provide the government with the investment advisory services needed. Follow the same step-by-step approach and treat the firm as a fresh prospect. It is important to make sure that the firm has sufficient expertise to deliver the results needed.

**The adviser will manage all of the assets.** Governments must always protect their own interests and should not simply hand over the government's assets, trusting that the adviser will perform well. Even if the adviser is managing the total portfolio, government officials must stay involved in the process and monitor the investment adviser's performance and its compliance with the government's investment policy.

**The governing body does not consider the benefit of hiring more than one manager.** There are advantages and disadvantages to hiring more than one manager. An advantage is that a second manager can be considered a safety valve, and provides the government with the option of diversifying by management style or sectors of expertise. A disadvantage is that dividing the portfolio may eliminate potentially attractive advisers because of the minimum account sizes some firms require. Cutting the portfolio into smaller portions could also result in higher fees and make record keeping more difficult. The government should weigh the advantages against the disadvantages and feel comfortable with the decision it makes.

**The firm has the lowest fees.** As mentioned earlier, the fee should not be the primary factor in the selection process. There may be a good reason the firm has lower fees. For example, if the investment adviser is investing in a commingled fund, the fee will be lower. Or a new firm might use a lower, introductory fee to attract business. Keep in mind, however, that firms with a record of poor performance may also have lower fees.

## Summary

Government officials considering engaging an investment adviser should have a complete understanding of what they wish to accomplish. Exercising due diligence and thorough research during the selection process will pay off in the long run. It is important to remember that once an investment adviser has been hired, the government has formed a new partnership and will need to maintain the relationship over time.