

- **Board of Directors**
Budget, Finance and Investment Committee

February 12, 2002 Board Meeting

9-4

Subject

Implementation of long-term investment management

Description

In November 2000, Chandler Asset Management completed a review of Metropolitan's investment practices. While the Chandler study was complimentary of current practices, Chandler also suggested a number of areas where improvements could be made. One of the most important recommendations was for Metropolitan to pool its investment portfolio and then segment the portfolio between a "long-term" portion and a liquidity (short-term) portion. As part of this pooling and segmentation, Metropolitan would be in a better position to measure performance. In addition, Chandler recommended that best practices would include measuring total return on the long-term segment, rather than just yield. Finally, Chandler recommended that Metropolitan more actively manage its funds.

Staff worked with the Subcommittee on Investments and Bond Financing (Subcommittee) to implement the recommendations in the Chandler report, including actively managing the long-term portfolio. As a way to achieve the objective to actively manage the portfolio, the Subcommittee recommended that this portion of the portfolio be handled by outside fund managers. These managers will be expected to manage to the Merrill Lynch Corporate and Government, 1 to 5 years, A Rated and Above Index ("Benchmark"). It is anticipated that, with the selection of the complementary group of fund managers recommended in this board letter, Metropolitan's total return on the long-term portfolio will be greater than the benchmark (and above the fees paid to the managers).

Selection Process

After working with the Subcommittee to establish criteria ([Attachment 1](#)), staff retained the services of the Consulting Services Group, an investment consulting firm, to help develop the Request for Proposals (RFP) and evaluate responses. The RFP was advertised in the Wall Street Journal and other investment publications. Ultimately, the RFP was distributed to about 100 firms, with 49 firms responding. Treasury staff and Consulting Services Group narrowed the list to seven firms. These seven firms were interviewed and due diligence visits were conducted at the facilities of the four finalists. The firms' qualifications and process are more fully described in [Attachment 2](#). As a result of this extensive review process, staff recommends that the following investment managers be hired to manage \$400 million in long-term investments for Metropolitan:

- Merganser Capital Management, Cambridge, MA
- Reams Asset Management, Columbus, IN
- SEB Asset Management, Stamford, CT

Management Process and Controls

The investment managers will actively manage investments to Benchmark. Investment manager performance will be measured over an interest rate cycle, and all managers are expected to exceed the benchmark plus fees. Annual fees could range from \$550,000 to \$700,000.

It should be noted that all securities will continue to be held by Metropolitan's custodian bank, the Bank of New York. In March, Metropolitan is implementing updated treasury management software to enhance the monitoring

and management of the portfolio. This system will provide improved reports, including information on portfolio duration and total return. This new system will also allow us to track the separate portfolios managed by outside investment managers and generate consolidated investment reports for presentation to management and the Board.

In addition, treasury staff will work with the investment managers to ensure that all investments comply with Metropolitan's investment policy, as that policy is amended from time to time. Treasury staff will continue to dedicate two full-time equivalents to the investment process. Finally, the audit department is working with the treasurer to ensure that reports are informative and controls are rigorous. The treasurer will continue to provide monthly reports to the Budget, Finance and Investment Committee, highlighting investment performance and trends. Each quarter, the Budget, Finance and Investment Committee will hold a special meeting to review investment performance, including the performance of the outside investment managers and the internally managed funds.

Investment Policy Changes

In March the Budget, Finance and Investment Committee will consider changes to Metropolitan's Statement of Investment Policy. These changes are consistent with the California Government Code and are necessary to actively manage investments and take advantage of the expertise that the outside firms bring. Examples of changes are to:

- Remove the 20 percent limit on securities that can be purchased with three- to five-year maturities.
- Allow purchases of securities with maturities in excess of five years.
- Increase the percentage of investments in asset and mortgage backed securities from 10 to 20 percent of the portfolio.
- Change the credit rating for corporate securities with maturities of five years or less from AA to single A. A credit rating of AA would be required for corporate securities with maturities in excess of five years.
- Change the percentage limit on purchases of AAA rated Federal Agency securities from 50 percent to 100 percent of the portfolio.

Policy

As discussed with and approved by the Subcommittee on Investments and Bond Financing, Metropolitan is changing its investment strategy. Long-term funds will be actively managed to the Merrill Lynch Corporate and Government, 1 to 5 years, A Rated and Above Index.

California Environmental Quality Act (CEQA)

CEQA determination for Option #1:

The proposed action is not defined as a project under CEQA, because it involves continuing administrative activities, such as personnel-related actions, general policy and procedure-making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed action is not subject to CEQA because it involves other government fiscal activities, which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed action is not subject to CEQA per Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

CEQA determination for Options #2 and #3:

None required.

Board Options/Fiscal Impacts

Option #1

Adopt the CEQA determination and:

- a. Approve the hiring of investment managers as recommended; and
- b. Authorize the Chief Executive Officer and Chief Financial Officer to negotiate contracts with Merganser Capital Management, Reams Asset Management and SEB Asset Management.

Fiscal Impact: Fees of between \$550,000 and \$700,000, which should be offset by higher expected returns from the actively managed portfolio.

Option #2

Do not approve the hiring of investment managers. Direct staff to review other firms.

Fiscal Impact: Fees of between \$550,000 and \$700,000, which should be offset by higher expected returns from the actively managed portfolio.

Option #3

Direct staff to continue to manage the long-term portion of the portfolio.

Fiscal Impact: No increase in fees, but additional expenditures on education and investment systems and the potential loss of investment income.

Staff Recommendation

Option #1


Brian G. Thomas
Chief Financial Officer

1/28/2002
Date


Ronald R. Gastelum
Chief Executive Officer

1/29/2002
Date

Attachment 1 – Subcommittee-Approved Criteria

Attachment 2 – Executive Summary

Attachment 1

The Subcommittee on Investments and Bond Financing approved the following scope of work and selection criteria for outside investment of Metropolitan's long-term funds.

SCOPE OF WORK

1. Separate management of Metropolitan's portfolio, which may not be commingled with other assets under Respondent's management.
2. Provide investment management in accordance with Metropolitan's specific investment objectives, Statement of Investment Policy, and California law governing the investment of public funds.
3. Actively manage, with full discretion, Metropolitan's funds using the Merrill Lynch United States Corporate and Government 1 to 5 Years A rated and above index as the performance benchmark.
4. Supply daily updates on investment transactions and monthly portfolio accounting and performance reports to Metropolitan's treasurer.
5. Furnish advice and recommendations to the treasurer regarding Metropolitan's Statement of Investment Policy and investment practices and procedures.
6. Present quarterly presentations to Metropolitan's Board of Directors and meet with Metropolitan's treasurer as requested.
7. Provide feedback on investment practices and procedures as requested by Metropolitan's treasurer.

CRITERIA FOR SELECTION

1. The firm must be registered as an investment adviser with the Securities and Exchange Commission.
2. The firm must have fixed income assets under management totaling \$1 billion or greater; and have at least a five-year track record managing assets to a 1 to 5 years index.
3. The firm's performance must be presented in full compliance with the Association for Investment Management & Research Performance Presentation Standards.
4. The firm's performance will be evaluated for the period from January 1, 1991 through December 31, 2000.
5. The soundness of the firm's investment strategy, including risks undertaken, decision-making process, and results achieved. Ability to provide performance attribution information.
6. The experience, resources, and qualifications of the firm and individuals assigned to this account.
7. The experience of the firm in managing a fixed income portfolio for state/local governments or other entities to a 1 to 5 years Corporate Government Index or similar benchmark.
8. Investment management fees and service levels.
9. Additional investment services offered or available through affiliation.



**Short-Term and Intermediate Term
Fixed Income Manager Search
Prepared For:
Metropolitan Water District**

Prepared By:

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Metropolitan Water District of Southern California Operating Fund Fixed Income Manager Search

Executive Summary

Purpose and Scope of Services

The Metropolitan Water District of Southern California (Metropolitan) is searching for qualified investment advisory firms to consider as potential candidates to manage a portion of the operating reserves portfolio. Metropolitan is looking for an investment advisor(s) to manage approximately \$400 million in operating fund assets out of a \$1 billion portfolio. The target is for the investment advisor(s) to manage these assets to a benchmark objective of the Merrill Lynch United States Corporate and Government 1 to 5 years A-Rated Index. The shorter duration portion of the portfolio will continue to be managed in-house at Metropolitan.

Methodology of Search

Public advertisements were placed in various investment industry publications notifying the investment community of this potential opportunity with the Metropolitan Water District. After screening our database, Consulting Services Group (CSG) submitted an additional list of firms, which we felt would be worthy of consideration. In total, approximately 94 firms requested to be included in the search. These firms were sent a detailed questionnaire that was jointly created by CSG and Metropolitan's Treasurer. This questionnaire focused on all aspects of the investment management firms' business including the following:

- Ownership Structure
- Firm Assets
- Investment Personnel
- Investment Strategy Description
- Research Capabilities
- Trading
- Operations
- Compliance – Litigation, Audits, Conflicts of Interest

Additional requested information included the following:

- Fee Schedule
- Forms ADV Parts I & II
- Financial Statements
- Employee Personal Trading Policies
- Proxy Voting Policy
- Errors & Omissions Insurance Policies
- Sample Contract
- Sample Client Reports
- Composite Performance & Disclosures
- Business Statement

A total of 49 firms responded with completed questionnaires for this search. In order to be considered as a viable candidate the firms had to meet the following minimum criteria as established by the Sub-Committee on Investments and Bond Financing:

The investment management firm(s) must provide, at a minimum, the following scope of services:

- Separate management of its portfolio, which may not be commingled with other assets under management.
- Investment management must be provided in accordance with Metropolitan's specific investment objectives, Statement of Investment Policy, and California law governing the investment of public funds.
- The investment manager will operate with full discretion to invest and reinvest the funds under its management within Metropolitan's policy guidelines.
- Metropolitan's funds will be actively managed.
- The performance benchmark for the funds will be the Merrill Lynch United States Corporate and Government 1 to 5 years A rated and above index.
- The investment manager will provide daily updates on investment transactions and monthly portfolio accounting and performance reports to Metropolitan's Treasurer.
- The investment manager will provide advice and recommendations to the Treasurer regarding Metropolitan's Statement of Investment Policy and investment practices and procedures
- The investment manager will be required to make quarterly presentations to the Board and meet with Metropolitan's Treasurer, and Board of Directors as requested.

Additional Criteria for Selection

The firm must be registered as an investment adviser with the Securities and Exchange Commission.

The firm must have fixed income assets under management totaling \$1 billion or greater.

The firm's performance must be presented in full compliance with the Association for Investment Management & Research Performance Presentation Standards.

The soundness of the firm's investment strategy, including risks undertaken, decision-making process, and results achieved. The firm must have the ability to provide performance attribution information.

The experience, resources, and qualifications of the firm and individuals assigned to this account.

The experience of the firm in managing a fixed income portfolio for state/local governments or other entities to a 1 to 5 year Corporate Government Index or similar benchmark.

Investment management fees and service levels will be an important consideration.

Additional investment services offered or available through affiliation.

Performance Criteria

Once the responses were initially reviewed, general performance criteria were established in order to narrow the list of firms to a more manageable number. Because few managers actually manage a 1 to 5 year A-rated portfolio, it was necessary to divide the managers into two sub-categories for better peer

comparison – short-term (1-3 year) fixed and intermediate (3-7 year) fixed. This criterion is designed to identify managers with consistent above-average returns and not managers with one big year. The criteria are as follows:

- Returns over various rolling time periods should generally out-perform the Merrill Lynch 1-5 Year Government/Corporate A+ Bond Index in addition to the sub-category specific index, especially over 3, 5 and 7 years.
- Returns should generally rank within the top-quartile of a Short-term or Intermediate Bond Account Universe over rolling time periods
- Returns on a calendar year basis should rank above median at least 80% of the time over the most recent five-year time comparison.

The list was then narrowed to a “Top 16”.

At that point we began to focus on each individual firm’s organization and investment strategy. Besides the overall stability of the companies’ structures, a large portion of the focus was on each investment strategy and how it would fit into MWD’s overall objectives and guidelines. Particular attention was paid to individual security quality ratings and overall maturity of the sample portfolios. We eliminated managers with more than 15% of their portfolio in BBB securities, average maturity outside guidelines, and focus on securities inappropriate for MWD. The finalists, which include two minority firms (NCM and Earnest) meet all minimum criteria and are as follows:

1. Bank of America Capital Management - Los Angeles, CA
2. Earnest Partners - Atlanta, GA
3. Merganser Capital Management - Cambridge, MA
4. NCM Capital Management - Durham, NC
5. Pacific Income Advisors - Santa Monica, CA
6. Reams Asset Management - Columbus, IN
7. SEB Asset Management America - Stamford, CT

Table 1 below, which is entitled MWD Fixed Income RFP Comparison Matrix, provides a brief description of the final 7 firms:

MWD Fixed Income RFP Comparison Matrix

Firm Name	# Of Years in business	# of employees	# of employees dedicated to Fixed Income	Municipal Clients	Firm Assets	(\$Billions) Fixed Income Assets	Strategy Assets	Female/Minority Firm
Earnest Partners	12	30	6	1. New England Teamsters 2. GA retirement sys. 3. LA Teacher's Ret. 4. City of Atlanta 5. NY Common Ret Fd 6. Miss. Health Care Trst	\$3.1	\$ 1.5	\$ 1.5	yes
Merganser Capital Mgt	18	5	5	1. Commonwealth of VA	\$ 3.3	\$ 3.3	\$ 2.4	no
NCM Capital Mgmt	15	26	3	1. Memphis Light, Gas, & Water Div	\$ 4.6	\$ 1.0	\$ 0.1	yes

				<ol style="list-style-type: none"> 2. CA State Teacher's Retirement 3. Teachers Ret of GA 4. State of Florida 5. Employees Ret System of GA 				
Pacific Income Adv	15	36	7	<ol style="list-style-type: none"> 1. State of Hawaii 2. Mass Bay Trans Auth 3. U.S. Chamber of Commerce 4. City of Southfield MI 5. LA Firemen's Relief Assoc 	\$ 4.0	\$ 3.6	\$ 0.6	no
Reams Asset Mgmt	20	23	9	<ol style="list-style-type: none"> 1. Ohio Bureau of Worker's Comp 2. Indiana State Teacher's 3. New Mexico Public Employees 4. Los Angeles Fire & Police 5. Municipal Employees of Michigan 	\$ 12.1	\$ 11.8	\$ 0.4	no
SEB Asset Mgmt America	14	22	4	<ol style="list-style-type: none"> 1. Texas Municipal Ret 2. Midland Fire Fighter's 3. City of New London 4. Wichita Falls Fire 5. City of Pawtucket 	\$1.7	\$ 1.3	\$0.9	no
Bank of America Capital Management	6	189	66	<ol style="list-style-type: none"> 1. Georgia State Teachers 2. North Carolina Retirement System 3. L.A. County Metropolitan 4. Calleguas Municipal Water District 5. Public Teachers of Chicago 	\$157.4	\$136.4	\$2.1	no

In addition, Appendix 1 contains a list of all of the firms that responded to the RFP.

Appendix 1

The following is a list of all firms that responded to the RFP.

Firm Name

American Express Asset Mgmt
AMR Investments
Banc of America Capital Mgmt
Barrow Hanley Mewhinney & Strauss
Bear Stearns Asset Mgmt
Chicago Capital Mgmt
Credit Suisse Asset Mgmt
Cutler & Co.
David L. Babson & Co.
Delaware Investment Adv
Dresdner RCM Global
Dwight Asset Mgmt
Earnest Partners
Fleet Investment Adv
Goldman Sachs
Harris Investment Mgmt
McMorgan & Company LLC
Mellon Bond Associates
Merganser Capital Management
Metropolitan West Asset Mgmt
Munder Capital Mgmt
NCM Capital Mgmt
Pacific Income Adv
Pacific Inv Mgmt Co. (PIMCO)
Peregrine Capital Mgmt
Public Financial Mgmt
Quantum/Gabelli
Reams Asset Mgmt
Sage Advisory Services
SEB Asset Mgmt America
Seix Investment Adv
Seneca Capital Mgmt
Sirach Capital Mgmt
Smith Graham & Co.
Standish Mellon Asset Mgmt
State Street Global Adv
Strong Capital Mgmt
STW Fixed Income Mgmt
Taplin, Canida & Habacht
Times Square Capital Mgmt
US Bancorp Piper Jaffray Asset
Utendahl Capital Mgmt
Vanderbilt Capital Adv
Waddell & Reed
Weaver C. Barksdale & Associates
Wellington Mgmt Co.
Wells Capital Mgmt
Western Asset Mgmt
WestAm/Criterion