

COUNTY OF MILWAUKEE
Inter-Office Communication

Date: March 11, 2002

To: Supervisor Lynne D. De Bruin, Chairperson, Committee on Finance and Audit

From: Jerome J. Heer, Director of Audits

Subject: Outsourcing of Investment Management Services

On March 1, 2002 you asked the Department of Audit to assist the Finance and Audit Committee as it considers whether to proceed with a policy change to abolish the Cash and Investment Manager position in the County Treasurer's Office and outsource investment advisor services. Specifically, you requested that we assess the projected fiscal impacts of finalizing this policy change and whether the change to contracting out investment advisor services is fiscally in the best interest of Milwaukee County at this time.

Background

During 2002 budget deliberations, the Finance and Audit Committee approved the abolishment of the Cash and Investment Manager position effective April 12, 2002 with the outsourcing of services provided by this position in order to achieve higher investment returns. According to the adopted 2002 budget, the immediate fiscal impact of this change was a savings of \$69,308, partially offset by increased money management fees of \$23,049. The Committee approved the change with the understanding that the issue would be reviewed by the Committee after the full cost of outsourcing and the anticipated increase in earnings on investments had been projected via the Request for Proposal (RFP) process.

Results of the RFP Process

The RFP was divided into two separate parts: custodial/safekeeping services and investment advisor services. A member of the Department of Audit was part of the RFP evaluation team. Eleven firms submitted proposals for investment advisor services and four firms submitted proposals for custodial services. The successful proposer submitted an annual fee of \$100,000 for investment advisor services (eight basis points on an investment portfolio averaging \$125 million, 100 basis points = 1%). Further, the \$100,000 fee includes custodial/safekeeping services at no additional charge. (These free custodial/safekeeping services will save the County Treasurer's Office approximately \$8,000 in its current annual banking services contract with another bank.) According to a respected local government finance director who contracts for investment advisor services, the \$100,000 fee is a very competitive fee. By comparison, the current cost of the Cash and Investment Manager position is: \$71,528 for salary, \$20,414 for fringe benefits and \$5,471 for payroll taxes for a total position cost of \$97,413. The incumbent in this position is currently on leave through April 12th exhausting remaining off-time balances.

The term of the outside investment advisor contract is one year with three one-year extensions, subject to annual approval by the County Board or termination by either party upon 120 days prior written notice.

Payment of Investment Advisor Fees

While the proposed \$100,000 fee is very competitive, the County Treasurer's 2002 adopted budget includes only \$23,049 for outside money management fees. The \$23,049 amount originated as a \$30,000 budget submission by the Treasurer's Office which was subsequently prorated down by the Department of Administration during the budget process to reflect an anticipated second quarter start by the outside investment advisor. If the outside investment advisor is hired by April 1st, the County Treasurer plans to use the \$23,049 to partially pay for the services which will cost \$75,000 for the

balance of 2002. The Treasurer plans to pay the balance of the fees (\$51,951) from an offset to budgeted earnings on investments (org. unit 1900-1850). According to the Treasurer, this netting of investment earnings in 1900-1850 is already being used to pay for the Treasurer's Office current outside investment advisor, Dana Inc. This revenue account is budgeted at \$7,275,000 (4.88%) for 2002 investment earnings. However, current projections by the Treasurer's Office indicate a worst case scenario of a \$3 million shortfall in that organization unit. Any netting of adopted budgeted investment earnings to pay for outside investment advisor fees should be properly disclosed. Organization unit 1900-1850 is separate from the County Treasurer's Office (org. unit 3090). Therefore, any transferring of revenues or expenses between the two organization units will need to be accomplished by an appropriation transfer request form.

Past Performance

The investment advisor RFP asked for past performance statistics net of fees in comparison with an appropriate benchmark. The successful proposer used the Merrill Lynch 1-5 Year Treasury/Agency Index as a benchmark. This is a widely accepted benchmark for government portfolios. The successful proposer provided statistics for three of its accounts with investment parameters most like those of the County. Over the past three years (1999-2001), all three accounts bettered the benchmark in two of the three years. In the other year, the three accounts missed the benchmark by less than one percentage point.

By comparison, in February of each year, the County Treasurer's Office presents an investment portfolio performance report to the Finance and Audit Committee. The report includes the portfolio yield achieved for the prior calendar year. The report also compares the yield with three conservative government-type fund benchmarks, but not including the Merrill Lynch 1-5 Year Treasury/Agency Index. Over the past three years, when compared to the Merrill Lynch Index, the County portfolio yield was under the index in two of the three years by approximately three percentage points. In the other year, the County yield bettered the index by more than three percentage points.

As a result, when we use the Merrill Lynch benchmark and compare the successful proposer's selected account performance over the past three years with the County portfolio's performance, the proposer's performance has been better and more consistent with the benchmark.

The successful proposal estimates that by reallocating the County portfolio to other investment sectors, they anticipate picking up an additional 25-35 basis points in return for the portfolio when compared to the Merrill Lynch benchmark. These additional basis points translate into increased annual returns of \$312,500 to \$437,500 when compared to the Merrill Lynch benchmark. Keep in mind, these are just estimates with no guaranties of future performance.

Best Interest of Milwaukee County

In regard to the question of whether contracting out investment advisor services is fiscally in the best interest of Milwaukee County, we divided the answer into two parts.

The first part of the answer addresses the professional management aspect of investment advisor services for the County's portfolio. In this regard, we support the contracting out of such services. The potential contractor can provide a host of professional experience and services which should translate into the best possible management and investment yield of the County's portfolio. As stated earlier, the cost of these outside services (\$100,000) is very competitive and is comparable with current position costs (\$97,413). In addition, the outside provider is anticipating an increase to annual portfolio returns in the range of \$312,500 to \$437,500 when compared to the Merrill Lynch benchmark. The associated free custodial services from the successful proposer will also save the County Treasurer's Office \$8,000 in current fees with another bank.

The second part of the answer addresses the management of the County's cash flow needs and associated investment accountability issues, including monitoring the outside investment advisor services. The County's cash flow needs are cyclical and vary throughout the year. Cash flows can also vary dramatically on a daily basis as well. As a result, there must be strong coordination between investment advisor services and the cash flow needs of the County. Cash flow responsibilities include establishing cash flow forecasting techniques, performing on-going cash analysis and managing the County's cash balances. These duties are specifically excluded from the outside investment advisor's proposal. The Cash and Investment Manager position was originally created in 1986 in the Department of Administration. The original position reported to the County Controller and was relocated to the County Treasurer's Office in 1994. According to the County Treasurer, cash flow job duties are currently being handled by an Accounting Coordinator position in the Treasurer's Office and have been for a number of years. If the outside investment advisor is hired, the Treasurer plans to share the Accounting Coordinator's daily cash flow analysis with the outside investment advisor. This will be an important piece in the success of the overall investment process.

In regard to investment accountability, the Treasurer plans to establish a three or four person investment advisory committee of outside professionals to assist her in monitoring the investment mix of the County's portfolio, investment performance and the outside advisor contract. The Treasurer plans to have the committee meet on a monthly basis along with ongoing contacts, if necessary, in between the monthly meetings.

The Treasurer's plan for addressing cash flow responsibilities and investment accountability issues appears to be reasonable under current circumstances. However, if in fact the Treasurer contracts out for advisor services, we recommend the Committee have the Treasurer report back to the Finance and Audit Committee periodically regarding all aspects of the new arrangement plus the results of 2002 earnings on investments, org. unit 1900-1850.

If you have any further questions, we are available to respond.



Jerome J. Heer

JJH/JWG/cah

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