

Introduction to Portfolio Management

Most savings associations use a team approach when engaging in portfolio management activities. However, the two key players in the portfolio management process are the account portfolio manager and the account administrator. The portfolio manager is responsible for the account investments. In fulfilling this responsibility, the portfolio manager must choose investments that are suitable for the account. In making these choices, the portfolio manager keeps in mind the investment management objective for the account while operating within defined risk parameters. In order to achieve the identified objectives, each account's needs should be defined as specifically as possible. These needs and the account objectives are generally identified by the account administrator. Once the needs have been established and the account objectives identified, the portfolio manager can then design a portfolio that will achieve the desired rate of return, keeping within an acceptable level of risk.

Determining Account Objectives

The account administrator must determine the objectives of the account. This can be accomplished through a combination of discussions with the settlor and other interested parties, as well as a review of the governing account instrument. In order to establish the account objectives, the account administrator must first determine the specific income requirements and needs of the account and/or the beneficiaries.

The account administrator must carefully consider the amount of income that the beneficiaries need from the account. Although guidance for a specific amount may be found in the governing instrument, most instruments simply provide that the beneficiaries should receive income sufficient to maintain a standard of living to which they have grown accustomed or that sufficient income be generated to meet the ascertainable standards of health, education, maintenance and support. In order to determine this amount, the account administrator must be aware of the beneficiary's current financial condition, including the beneficiary's current and future expenses as well as income from other sources. Also important in determining the income requirements, are the interests of the remainder beneficiaries in preserving and increasing the principal of the account. All this information must be weighted together and certain conclusions reached which is then passed on to the portfolio manager to devise an investment strategy that meets the needs of the account.

Designing the Portfolio

In designing a mix of assets for an account, the portfolio manager must consider the timing of probable distributions from the account. For example, if the account beneficiary is elderly or disabled, then the portfolio should contain enough liquid assets to meet expected medical expenses.

It may be in the best interest of a beneficiary to minimize income, estate and generation-skipping taxes and the portfolio manager should design a portfolio accordingly. For example, tax-sheltered investments such as municipal bonds may be more appropriate for an account whose beneficiaries are in a high tax bracket, other considerations being equal. Although the tax consequences of retaining, purchasing and selling investments should not be the primary determinant for investment decisions, the tax consequences of such actions may be significant and the portfolio manager should be aware of such effects.

Investment objectives should, to the extent possible, be related to the age of the beneficiaries and the expected duration of the account. Establishing long-term investment goals for fiduciary accounts, which terminate within a relatively short period, would be inappropriate. For example, an account that will remain

in existence through several levels of beneficiaries (spouse, children, grandchildren) should ordinarily have different investment objectives than an account that will terminate within a short period of time.

There are various investment strategies that may be utilized by a portfolio manager to achieve the objectives of an account. If the account's objective is to minimize risk, then a conservative strategy will provide stability of income and principal and will also allow as much opportunity for appreciation as is consistent with that objective. If the objective is to provide large financial returns to the account, then a more aggressive strategy will provide higher yields or principal appreciation; however, this strategy requires a greater degree of risk and wider tolerance for losses to achieve the objective. Attainment of these or other objectives can in most cases be best achieved by adopting specific investment vehicles or an appropriate mix of those vehicles. The portfolio manager should carefully document the decision-making process to show how the chosen investment strategy will achieve the stated goals of the trust account.

Next, the portfolio manager must implement the investment strategy. The implementation should correspond closely to the initial review of assets required by 12 CFR §550.210, one purpose of which is to compare assets used to fund the trust or received from a prior trustee for suitability and compatibility with the needs of the account. Assuming some restructuring of the portfolio is necessary, the portfolio manager should develop and implement a systematic program for retaining assets, purchasing appropriate assets and/or disposing of assets that are unsuitable for achieving the investment objectives. This restructuring may involve an extended time period so as to avoid sharp initial losses, take advantage of market timing or avoid adverse tax consequences, such as large capital gains. Documentation of the decision-making regarding the restructuring process is a good risk management practice.

Asset Review

One of the most important steps in the asset management process is the review and monitoring of the approved account objectives and investment strategies. Compliance with the agreed upon objectives and investment strategies is an important aspect to monitoring and controlling risk to both the individual account and the savings association. Both the objectives and the investment strategies must be periodically reviewed and monitored in order to determine conformance. The process should include a review of the account's objectives to ensure that they remain valid in light of current circumstances or developments. The overall investment portfolio, as well as the individual assets held in the portfolio must be reviewed to determine if they conform to the investment strategy designed to meet the account objectives.

By way of illustration, an asset review will normally consider the following:

- account objectives and beneficiary needs for continued applicability;
- characteristics of the overall portfolio, for conformance with account objectives;
- transactions since last review, for accuracy and conformance with objectives and department policies and procedures;
- asset holdings, for adequacy (e.g., rate of return, risk attributes, quality, asset mix, diversification); and
- future needs of the account, for liquidity (e.g., anticipated or unusual expenses or distributions).

The frequency of an asset review for individual accounts should be based on the volume and complexity of the department's overall business as well as the complexity of a particular account. For example, most accounts may be set up for an annual review but specific accounts, due to the nature of their holdings, may need to be reviewed more frequently. 12 CFR §550.200 - 220 establishes the outer limits of an asset review,

by requiring that such reviews be conducted promptly after the account has been accepted and at least once during every calendar year thereafter.

Types of Investments

There are various investment vehicles available for the investment of trust account assets. With the increased use of the “modern portfolio theory” and the majority of states adopting some version of the uniform prudent investor rule, no single investment within a portfolio is considered to be per se imprudent. It is the overall portfolio holdings or the overall investment strategy that can be considered imprudent and subject to examiner criticism, beneficiary complaints or lawsuits.

There are many types of investments that may be found in a trust department of a savings association. Some of these investments are described in the narrative sections attached to a specific examination program. One type of investment not described elsewhere is a cash management instrument.

Cash Management Instrument

A savings association may provide various instruments for the short-term investment of idle cash. As fiduciary, the savings association is responsible for making all assets productive, even those assets awaiting investment or distribution, as outlined in 12 CFR §550.140(e). Given the current technology and the prudent investor standards, there are few defenses for fiduciaries that permit idle cash to remain unproductive and not invested. There are several vehicles available for managing short-term investments. These instruments can include money market funds, sweep arrangements and deposits. The use of these instruments should be for short-term purposes and be appropriate for achieving the overall investment objective for the account.

Money market funds are a type of mutual fund that has relatively low risks compared to other mutual funds. They are limited by law to certain high-quality, short-term investments. Money market funds try to keep their value net asset value (NAV) at a stable \$1.00 per share but the NAV may fall below \$1.00 if their investment performs poorly, in which case management should be aware of “breaking the buck.” Investor losses are rare but they are possible. Some of the more common investments held in these funds include time deposits of financial institutions, commercial paper, bankers acceptances and short-term U.S. Government or agency obligations.

Another alternative for achieving the investment of idle cash is the use of a sweep arrangement. This arrangement allows the fiduciary to automatically invest all cash into an interest earning short-term investment. In most instances the investment is a money market fund. The investment instrument into which the cash is swept should be reviewed on a periodic basis to ensure appropriateness.

Deposits are another alternative, however, given the number of other available alternatives, the use of deposits should be limited. Deposit investments can be with the same institution conducting the fiduciary activities, however this does create a conflict of interest and should only be permitted when allowed by applicable law.