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What Are Your Fiduciary Responsibilities?

By Ned Connolly, CCM

Several high profile cases have made the term “fiduciary responsibility” a regular part of conversations around conference tables across the country. For example, a number of mutual funds have allowed illegal late-day trading and controversial market timing to favored investors. Thousands of employees at Enron and other companies lost their retirement savings because of fraudulent financial reporting. In the mid-1990s, Orange County, California, lost more than \$2 billion in its pool and declared bankruptcy because of inappropriate investment practices and continues to be the subject of many of these discussions. Although these cases have people talking about fiduciary responsibility, there is still confusion about what the term means because different standards may be used in evaluating compliance with it.

What Is a Fiduciary? A fiduciary is an individual or institution that has a special relationship of trust with another person or group of people and is legally responsible for

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Still Time to Register for GFOA’s 2005 Annual Conference

Last-minute registrants are still welcome for the GFOA 2005 Annual Conference, to be held in San Antonio, Texas, June 26-29. As always, state and local treasurers will have the opportunity to hear an array of experts on treasury management and investment topics. For registration information, go to the GFOA’s Web site, www.gfoa.org ☘

Strategies for the Mid-Cycle Inflection Point

By Girard Miller, CFA

Markets have been jittery this past month because of cross-currents in the economic data. The only consistent news was inconsistency. On two days we had inflation data on the rise; on three days we saw oil prices drop 4 percent; and one report showed core inflation was flat last month. Factory growth and durable goods orders softened, but retail sales and housing were strong while most companies reported healthy earnings. Yet leading economic indicators were down for the fourth consecutive month. Meanwhile, the Federal Reserve keeps ratcheting short-term interest rates up by one quarter of a percent at each meeting.

The U.S. economic expansion, which began in October 2001, is now 44 months old. In my opinion, we have crossed the “inflection point” from a strong-growing economic recovery to a slower-growth economic expansion. This is perfectly normal, and is consistent with prior business cycles.

In past cycles, the markets often required a spike in interest rates to cool down the rate of growth as the economy bounced back from prior recessions and began to expand capacity, which requires capital. That is not happening this time. Instead, the Fed is raising interest rates at a “measured pace.” And it will likely continue to do so.

The usual “mid-cycle spike” in the markets this time around is in the petroleum markets, not the financial markets. The impact at the gas station was enough to dampen the economy as lower-income households have had to cut back their

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spending elsewhere. Essentially the spring 2005 oil spike acted like a tax increase.

Bond investors meanwhile have allowed long-term interest rates to drift slightly lower even while the Fed has raised overnight interest rates by two full percentage points during this tightening campaign. In the stock market, investors have been skittish and unwilling to make bets in favor of growth stocks, which historically have outperformed value stocks during the expansion phase of the business cycle.

A Return to “Real” Interest Rates. On the interest rate front, I would expect to see the Federal Reserve continue on its measured course and raise its overnight funds rate at each meeting until that rate clearly exceeds the inflation rate. At the beginning of this cycle, the “real” interest rate was negative, so the Fed had no choice but to raise rates and “remove excessive accommodation” as the economy strengthened. By the end of the year, we should expect to see the Fed Funds rate reach four percent. If oil prices stabilize in a \$45-\$55 range centering on recent levels, then the year-end core inflation numbers should remain safely below the overnight rate.

A 4 percent Fed Funds rate implies a 7 percent bank prime rate. That is the interest cost to a bank’s best customers—hardly cheap money. Less creditworthy borrowers will pay even more.

Meanwhile, the American economy should continue to chug along at a slower but sustainable rate. Global growth should continue to outpace America’s, despite weakness in Germany and the United Kingdom.

2006: Goldilocks Expansion Is Possible. The Fed now stands within reach of delivering a Goldilocks economy in 2006. Not

Performance Benchmarks				
Public Investor Performance Indexes				
The Public Investor 10-bill index				
	Index Value	Quarterly/Monthly Return Annualized	Annualized Returns Since	
			Jan. 1, 2004	Jan. 1, 2003
Jan. 1, 2004	276.6328	1.0%(Q)	1.1%	1.4%
Jan. 1, 2005	280.0364	1.9%(Q)	1.2%	1.2%
May 1, 2005	282.1957r	2.8%(M)	1.5%	1.3%
June 1, 2005	282.9079	3.1%(M)	1.6%	1.4%
The <i>Public Investor</i> 10-bill index consists of 10 hypothetical Treasury bill investments, with an average maturity of approximately 80 days. Every other Thursday, a T-bill matures and proceeds are reinvested alternately in three-month and six-month T-bills. This rolling index provides a benchmark for evaluating cash management portfolios with biweekly payment and payroll requirements. The original value of the index was 97.6765 on July 1, 1984.				
The money market fund index				
	Average Return	Annualized Returns Since		
		Jan. 1, 2004	Jan. 1, 2003	
Jan. 1, 2004	0.5%	0.67%	1.61%	
Jan. 1, 2005	1.5%	0.76%	0.82%	
May 1, 2005	2.2%	1.02%	0.90%	
June 1, 2005	2.3%	1.09%	0.92%	
The money market fund index is the simple average of <i>Money Fund Report Averages</i> ™ seven-day money market fund indexes, as reported for the two weeks closest to the end of each month. The annualized return is calculated using these rates for a four-week period centering on the first of each month. The results should simulate returns from passive investment in an average money market fund.				
S&P Rated LGIP Index (May 20, 2005)				
	7-day yield	30-day yield	Maturity (Days)	
	2.74%	2.67%	33	
This index is comprised of local government investment pools that are rated AAAM or AAM by Standard & Poor’s and represent pools that strive to maintain a stable net asset fund.				
Key Rates: Cash Markets				
Rate	5/27/05	Year Ago		
Fed funds	3.02	1.02		
CDs: Three months	3.25	1.27		
CDs: Six months	3.50	1.55		
BAAs: One month	3.04	1.05		
T-bills: 91-day yield	2.90	1.05		
T-bill: 52 week yield	3.31	1.83		
Commercial paper, dealer-placed, 3 months	3.22	1.26		
Bond Buyer 20-bond municipal index	4.24	5.01		
Tax-exempt notes	2.81	1.57		

too hot, not too cool, just right. The most likely scenario now, I believe, is that the U.S. economy will flutter into a sustainable pace of roughly 3 percent annual real GDP growth in 2006, with inflation at similar but declining rates, and moderately expanding production and employment. Such an environment has historically been favorable to corporate earnings, and bolstered the “E” component of the stock market’s P/E ratios. Capital

investment should improve. Bond yields would likely rise gradually in this scenario, at least to levels that reflect the possibility of several years of economic expansion, which presently are not priced into the markets. Interest rates could rise yet further across the board in 2006, perhaps another .5 percent, to balance growth, prices and capital flows.

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Databank Analysis

Growth and Inflation Forecasts

The most recent National Association for Business Economics (NABE) survey predicts that real GDP growth will average 3.3 percent in 2005 and 3.4 percent in 2006. The Philadelphia Fed, meanwhile, foresees that real GDP will increase to 3.5 percent in the third quarter of 2005 and moderate to an average rate of 3.3 percent in 2006.

Inflation forecasts suggest that the recent increase in inflation may be temporary. In March, the consumer price index (CPI) rose at an annual rate of 7.8 percent and the "core" CPI (which excludes food and energy) increased 4.3 percent. Looking forward, the NABE survey predicts that inflation will moderate and the "core" CPI will remain around 2.4 percent over the next 12 months. **RGM**

Interest Rate Analysis

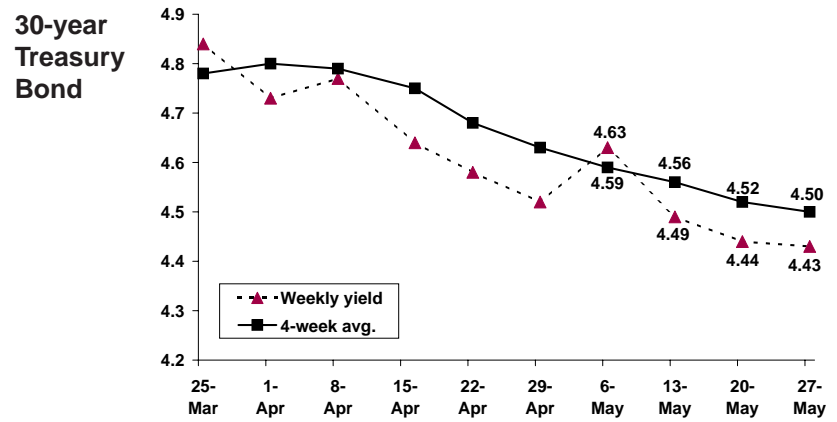
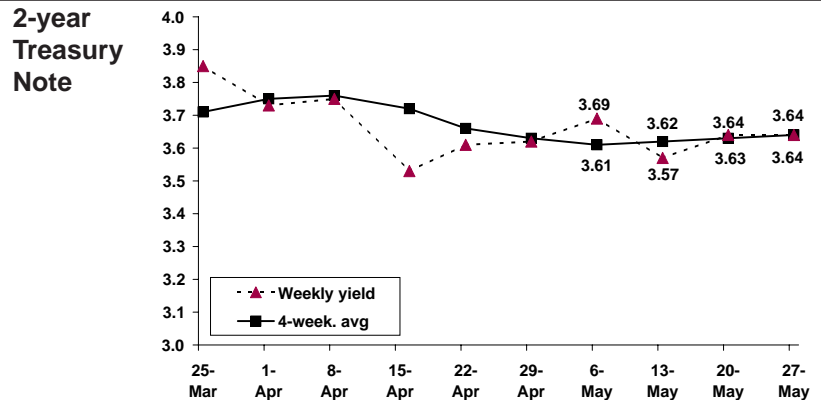
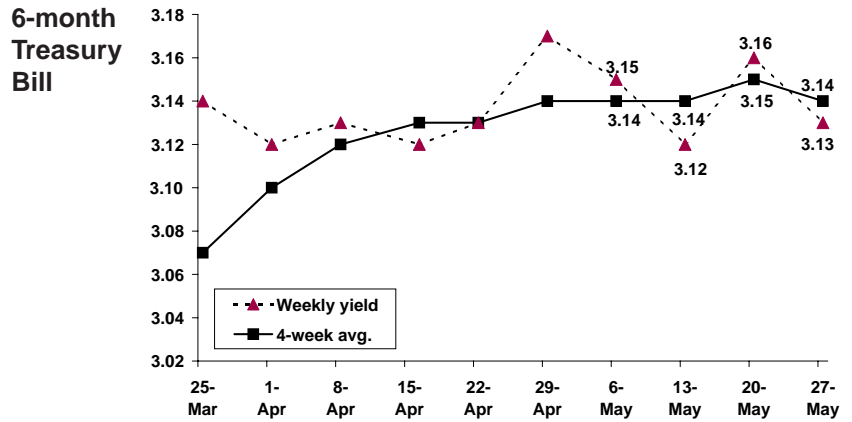
Fed Rate Hikes Expected to Continue

At its most recent meeting on May 3, the Federal Reserve Open Market Committee continued its series of measured rate increases by raising the Fed Funds rate to 3.0 percent. Thus far, the Fed has raised the rate 200 basis points since it began tightening a year ago. The Fed Funds futures market predicts that the central bank will continue to raise rates through the rest of the year. By the end of 2005, the most recent NABE survey predicts that the Fed Funds rate will reach 4.00 percent.

The NABE survey predicts that the ten-year Treasury bond will see a parallel shift to 4.90 percent by December 2005 and 5.30 percent by December 2006. The Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, similarly predicts the 10-

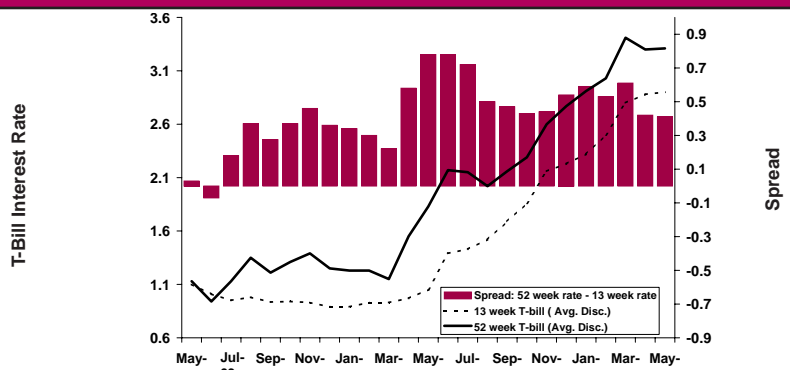
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Moving Averages



Public Investor's four-week moving averages are calculated as a simple average of Friday closing yield quotations for the most recently offered six-month Treasury bill (discount basis), two-year Treasury note, and 30-year Treasury bond. Moving averages are used by analysts to monitor trends and trend changes. Generally, interest rates are increasing (prices falling) when the moving average yield is rising and the current rate exceeds the moving average. Conversely, current yields below a declining moving average are associated with lower interest rates (high prices on fixed-income securities). Some market timers buy (or sell) longer maturities when current market yields fall below (or penetrate above) their moving averages.

Relative Yield Value Chart



Fiduciaries — *continued from page 1*

their assets. By law, fiduciaries must act prudently and make decisions they believe will manage the assets in the best interest of the beneficiary. A fiduciary's actions must always be in the best financial interest of the beneficiaries and they may never put their own interests before the beneficiaries.

Examples of fiduciaries include treasurers, finance directors, investment personnel, oversight boards and pension boards. Investment advisers retained by a government are also considered fiduciaries. Brokers, on the other hand, are not considered fiduciaries unless they maintain discretionary control over an account or engage in financial planning. Because of the competing interests of a brokerage firm to sell its products and that of a client to obtain the best trade execution, brokers are not bound by the standard of fiduciary duty. They are bound by the standard of “knowing your customer” which addresses the issue of investment suitability.

An initial step in fulfilling one's fiduciary responsibility is to determine to whom the responsibility is owed. A fiduciary for an individual client has an easy job of identifying to whom their loyalty is owed. For fiduciaries of large entities, however, the answer can be less clear because competing interests of various subgroups within the entity can sometimes inappropriately influence decisions affecting the investments.

That is why a thoughtful, well-written investment policy is so critical. Clearly defined objectives, constraints, risk tolerances and overall investment responsibilities provide critical criteria for determining the prudence and appropriateness of investment decisions.

The first objective of a fiduciary should be always to comply with investment policies and objectives. Should an entity contract with an external investment adviser, the fiduciaries within the entity along with the investment adviser are bound by the standards of fiduciary responsibility. The bottom line: you can

never delegate fiduciary responsibility itself, you can only delegate the activities related to investing.

The Evolving Standard of Care for a Fiduciary. For years the standard of care for a fiduciary was the prudent person rule. That rule requires a fiduciary to exercise judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived. The prudent person standard requires that a fiduciary consider the safety of principal and the yield of an investment, but does not address the issue of how any specific investment fits into an overall portfolio.

The shortcomings of the prudent person rule gave rise to the fiduciary standard that has become more common, the prudent investor rule. This rule differs from the prudent person rule in two major ways. First, it emphasizes diversification to achieve a reasonable rate of return at an acceptable level of risk. Second, it specifically supports the delegation of decision-making authority to investment experts. A prudent investor manages the total portfolio to achieve a desired risk profile considering the potential for growth of the overall assets.

The most stringent fiduciary standard is one that has come into play in recent years. It is the prudent expert rule. This rule applies to a fiduciary acting as a professional investment adviser. The investment expert is held to the highest standards of fiduciary responsibility because of his or her investment expertise and professional knowledge. The benchmark for evaluating the prudence of an expert's actions will be the actions of other experts,

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What Is Your Take on Fiduciary Responsibility?

Even though compliance with fiduciary responsibility is evaluated using measurable standards, it does not mean the compliance answer is immediately clear. Read the following scenarios and ask yourself whether or not these scenarios constitute responsible investing. If so, why? If not, why not? Consider discussing these with your peers.

Scenario 1—The growing complexities of a city's budget process demands much greater effort and many more weeks to complete than it used to, requiring the finance director to place maturing funds and new money in the local government investment pool because there is not time to review the market even though better investment opportunities exist.

Scenario 2—A socially active citizenry has influenced a public entity's policy so that it prohibits investing in the bonds of certain issuers because their products have been suspected of causing pollution, even though the issuers' credit ratings are high and their bonds often provide good value.

Scenario 3—An experienced investment officer for a fast growing city has managed the portfolio in full compliance with the policy and executed all transactions on a competitive basis, but has underperformed the city's benchmark for two consecutive quarters.

Fiduciaries — *continued from page 5*

not other investors.

Although the core principle of fiduciary responsibility is always the same—protecting the assets of the beneficiaries and always acting solely in their best interest—the standard for evaluating those actions becomes more exacting as one progresses from the prudent person to prudent investor to prudent expert rule. Be sure to know by which rule your actions and the actions of your advisers will be evaluated. These rules should be clearly stated in your investment policy.

Evaluating Compliance with Fiduciary Responsibility.

Fiduciary duty requires legal and responsible actions that adhere to a measurable standard. However, exercising fiduciary duty does not guarantee what the investment results will be. Even though you are making prudent investment decisions, you may not always experience investment success.

Accordingly, the test of compliance with fiduciary responsibility is one of conduct, not performance. The following are appropriate measures for evaluating that conduct:

- ❖ Establishment of a formalized investment policy that clearly defines the objectives, constraints and overall responsibilities of managing the assets based on a detailed understanding of the needs and risk tolerances of the beneficiaries (e.g., cities, counties, states, school districts, and their constituents)
- ❖ Compliance with all policies, rules and laws that govern the assets being managed
- ❖ Prudent portfolio management in the sole interest of the beneficiaries, either by the prudent investor, or by a prudent expert to whom the authority has been delegated

- ❖ All transactions done on a best execution basis through a competitive process (e.g., obtaining three quotes on any investment transaction)
- ❖ Diversification of portfolio to reduce risk of loss
- ❖ Strict avoidance of any conflicts of interest
- ❖ Loyalty—investment actions are carried out for the sole benefit of the beneficiaries to the assets.

Fiduciary duty is a concept that is essential to understand and adhere to fully when you assume the responsibility of managing others' assets. The costs can be high when fiduciary duty is breached. On the other hand, a tremendous sense of satisfaction is experienced from legally and prudently protecting and effectively managing the assets of others. ❧

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Strategies — *continued from page 2*

Of course, there are economic risks. Terrorism is the most troublesome, as it is so unpredictable. China's resurgent economy could cool down unexpectedly and pull the rest of the world down with it. A hedge fund could blow up and threaten the financial markets like Long Term Capital Management did in 1998. Oil could spike above \$60 on Asian demand and Mideast supply disruptions. But these are possibilities, not probabilities.

In this environment, bond investors will face difficulty earning their coupons in a moderately rising rate environment. Cash managers need to do their homework and calculate

their break-even forward interest rates before lengthening maturities to capture yield. Patient long-term investors (such as public pension funds) should again see positive returns in the stock market, with growth stocks finally reaching the potential to outperform value stocks in the next 24-26 months. ❧

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Economists — *continued from page 3*

much less dependent on energy. He expects the impact on inflation and growth to be small (less than a half percent per year).

John Lonski states that the primary reason for the jump in oil prices has been a faster growth in the demand for oil relative to the supply of oil. Energy price deflation in the past and stricter environmental regulation have curbed the growth of production capacity. Most of the economy has not been hit very hard by higher energy prices, except for lower income customers. He adds that higher energy prices will put upward pressure on core inflation. **RGM**

Interest Rate— *continued from page 4*

year Treasury bond will increase to 5.2 percent by the second quarter of 2006. **RGM**