

Market Update and Key Compliance Issues

Volusia/Flagler Chapter FGFOA

Daytona Beach, FL – June 19, 2015

Presented by Steve Alexander



Lincoln Plaza, Suite 1170
300 S. Orange Avenue
Orlando, FL 32801
P: 407-648-2208
www.pfm.com

PFMAM Presenter



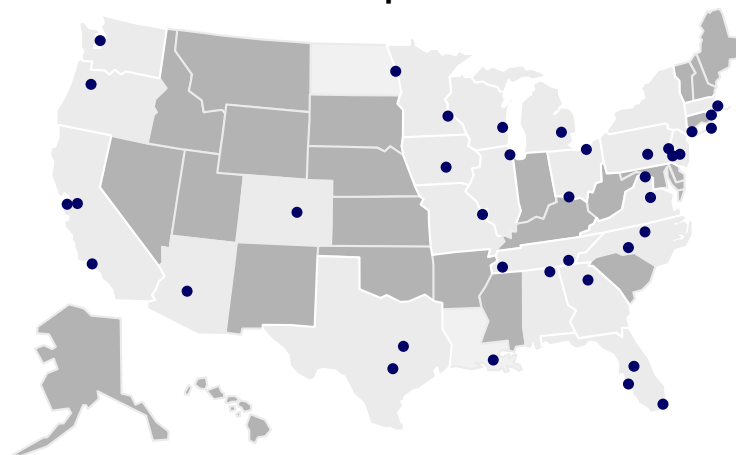
Steven Alexander, CTP, CGFO, CPPT
Managing Director/Partner

- Head of PFM Florida Asset Management Team
- 29 years of Institutional and Public Finance Experience
- Former Treasurer of Orange County, Florida
- Stetson University
- Rollins College
- Series 6 and 63 FINRA Licenses

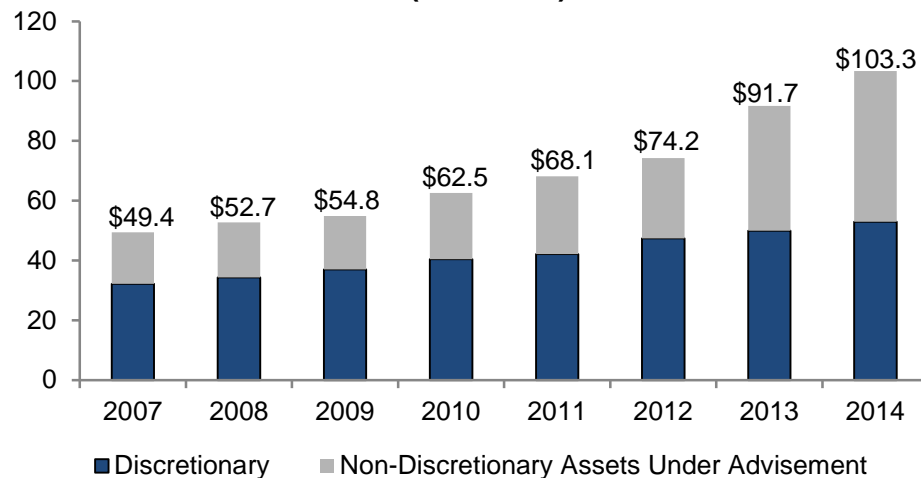
PFM Asset Management LLC

- Managing public funds for over 34 years
- The PFM Group has offices in Coral Gables, Orlando, and Largo
- **\$103.4 billion total assets including:**
 - \$53.0 billion in discretionary assets
 - \$1.9 billion for Transportation clients
 - \$7.6 billion in Florida
- **Specialists in:**
 - High-quality short- and long-term fixed-income portfolios
 - Bond proceeds
- **Stable team of senior professionals**
 - Portfolio management leadership team members average over 25 years of investment experience
- Strong track record of investment performance relative to market benchmarks
- **Culture of transparency and risk management**
- Extension of staff approach

The PFM Group's 38 Offices

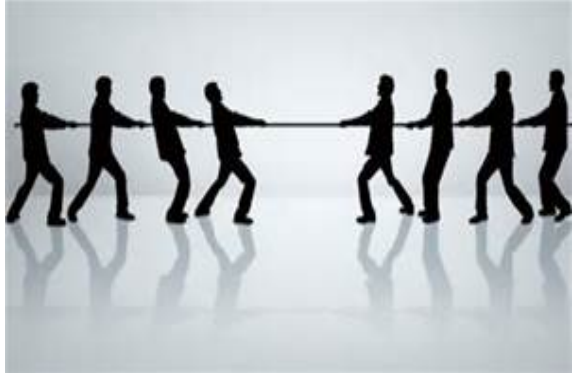


Assets Under Management and Advisement (\$ billions)



All data is as of 12/31/14 unless otherwise noted.

Topics for Today





“The government is doing you a favor. If they didn’t take most of your money, you’d have to find time in your busy schedule to spend it yourself.”

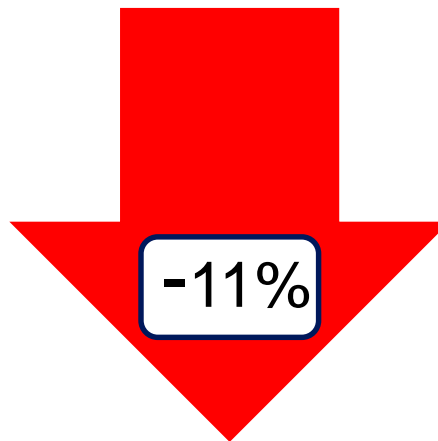


Market Update

Economic Summary – 2015 Q1

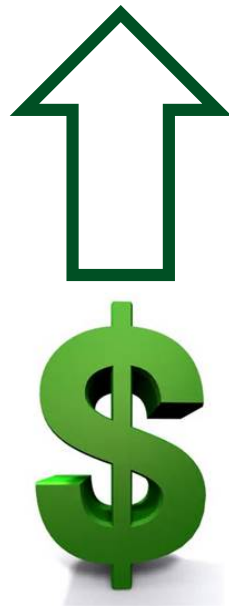
- Rates fell during the quarter in reaction to weaker economic data in the U.S. and revised expectations about future Fed actions. 2- year Treasury yields fell 11 basis points (0.11%), while longer maturities generally fell 20-30 basis points (0.20%-0.30%)

2 Year U.S. Treasury



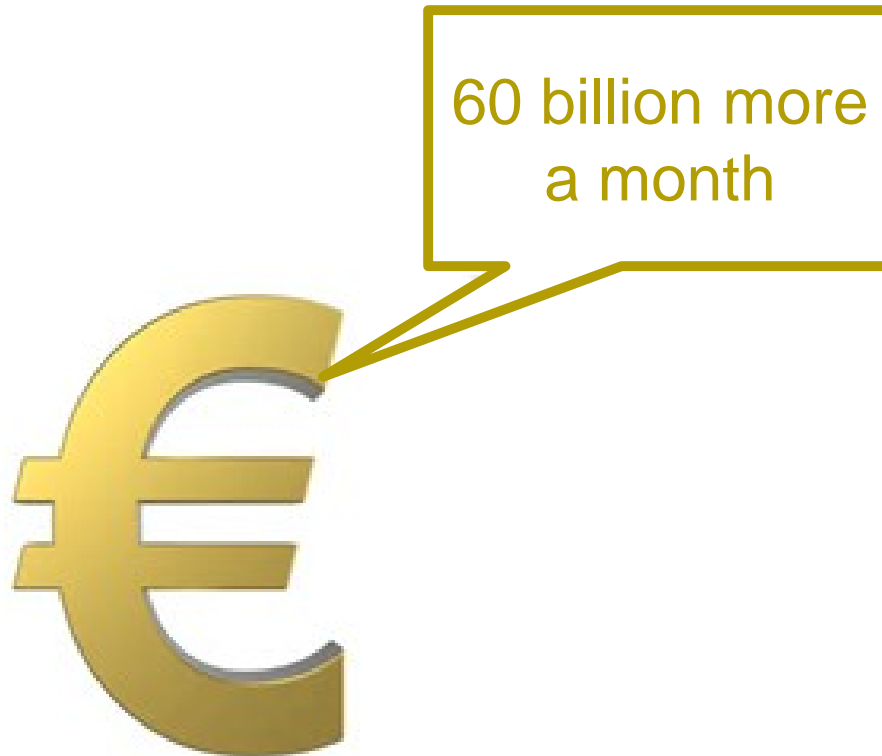
Economic Summary – 2015 Q1

- Fourth quarter trends continued in the first quarter of 2015:
 - Interest rates driven by the expected path and pace of Fed policy actions
 - A strengthening U.S. dollar and falling oil prices
 - Strong rally in European equity and bond markets
 - Heightened volatility in bond, stock and currency markets



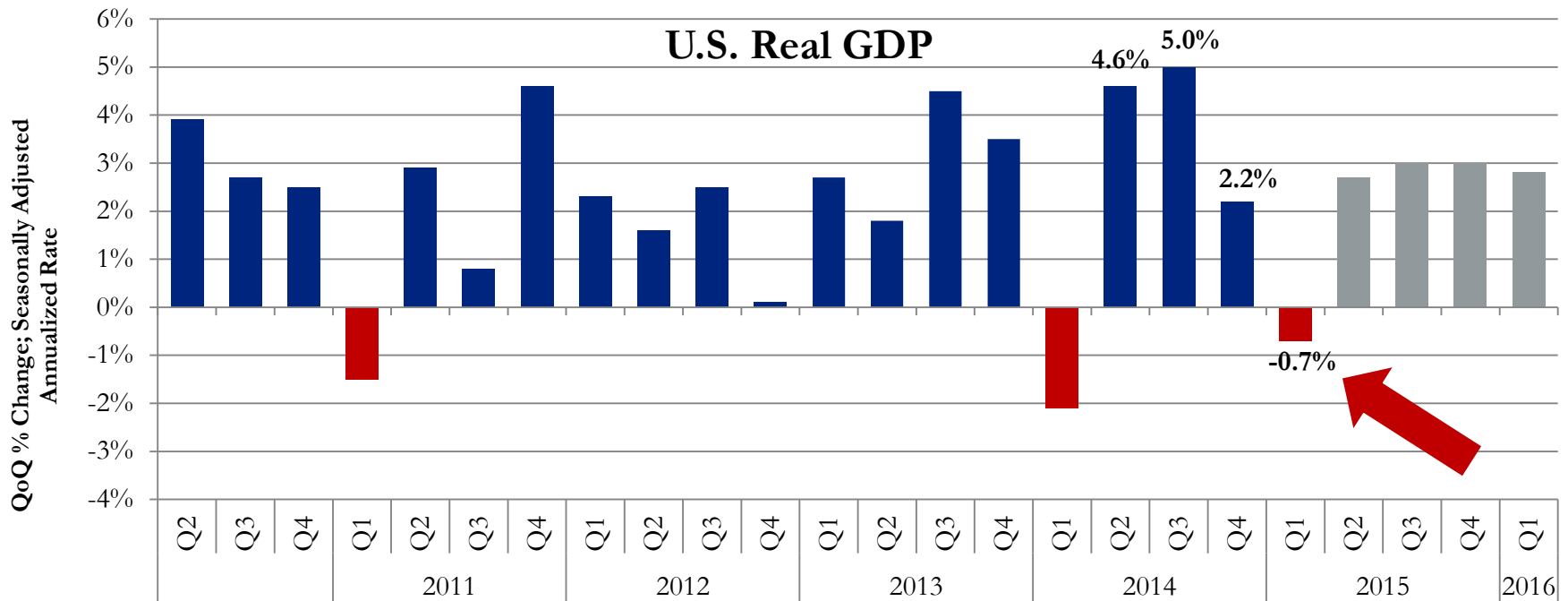
Economic Summary – 2015 Q1

- The European Central Bank (ECB) began its program of Quantitative Easing (“QE”) during the first quarter as it began buying approximately 60 billion euros in assets per month. As a result, European sovereign bond yields have reached record low levels.



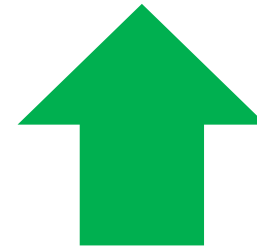
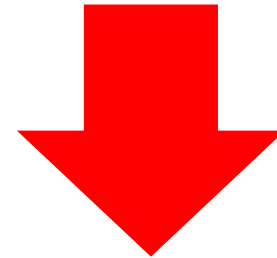
Economic Summary – 2015 Q1

- U.S. GDP contracted at a 0.7% annualized rate in the first quarter, driven by decreased government and business spending, and the negative impact of a strong U.S. dollar on exports. The pullback was the third time since the current recovery began in mid-2009 that the U.S. economic activity had experienced a quarterly contraction.



Major factors affecting 1st Quarter Growth

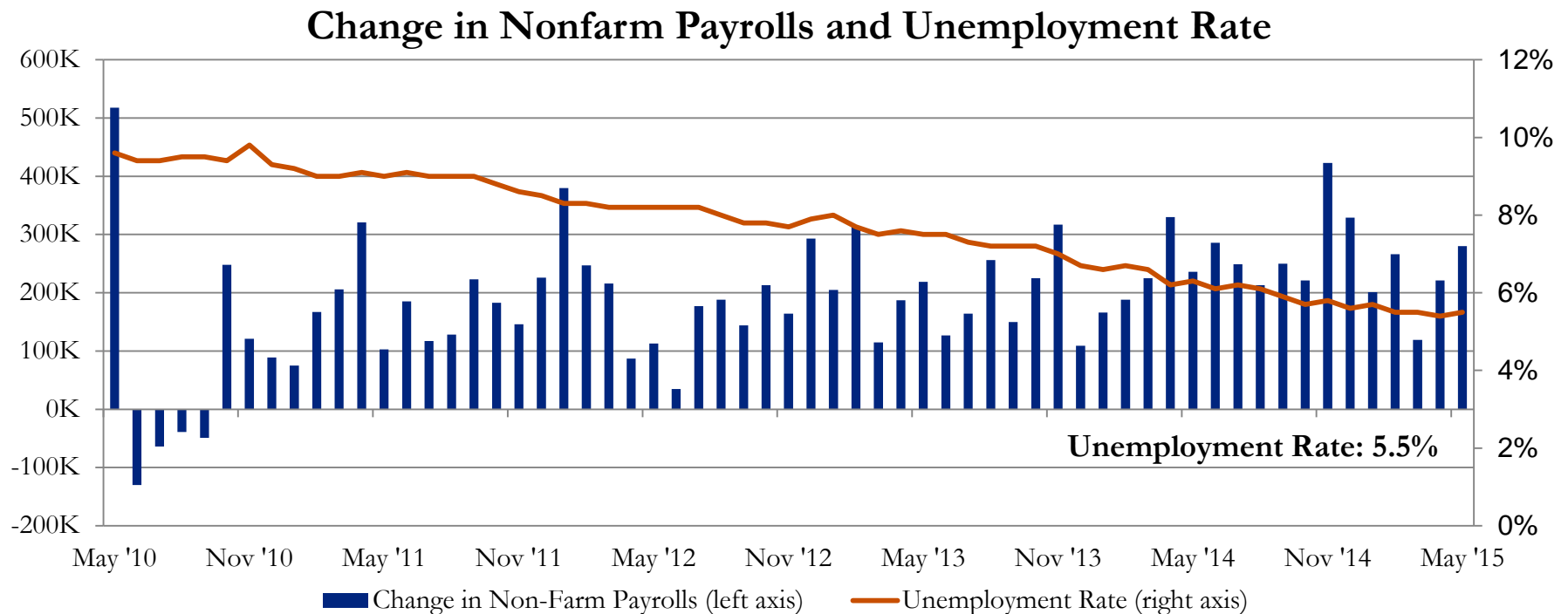
- **Weather:** harsh winter weather reduced workers' hours, adversely affected consumer spending, and dampened construction activities.
- **Oil prices:** falling crude oil prices led to slow-down in capital expenditures in the energy sector.
- **U.S. Dollar:** rising U.S. dollar weakened exports.



Source: Bureau Of Economic Analysis, Bloomberg Economist Survey, as of 06/01/2015.

Economic Summary – 2015 Q1

- U.S. Labor market added 280,000 jobs in May, confirming hopes that the economy is performing well after a slow start to the year. The unemployment rate increased slightly to 5.5% from 5.4%, as more Americans returned to the workforce and started actively looking for jobs.



Economic Summary – 2015 Q1

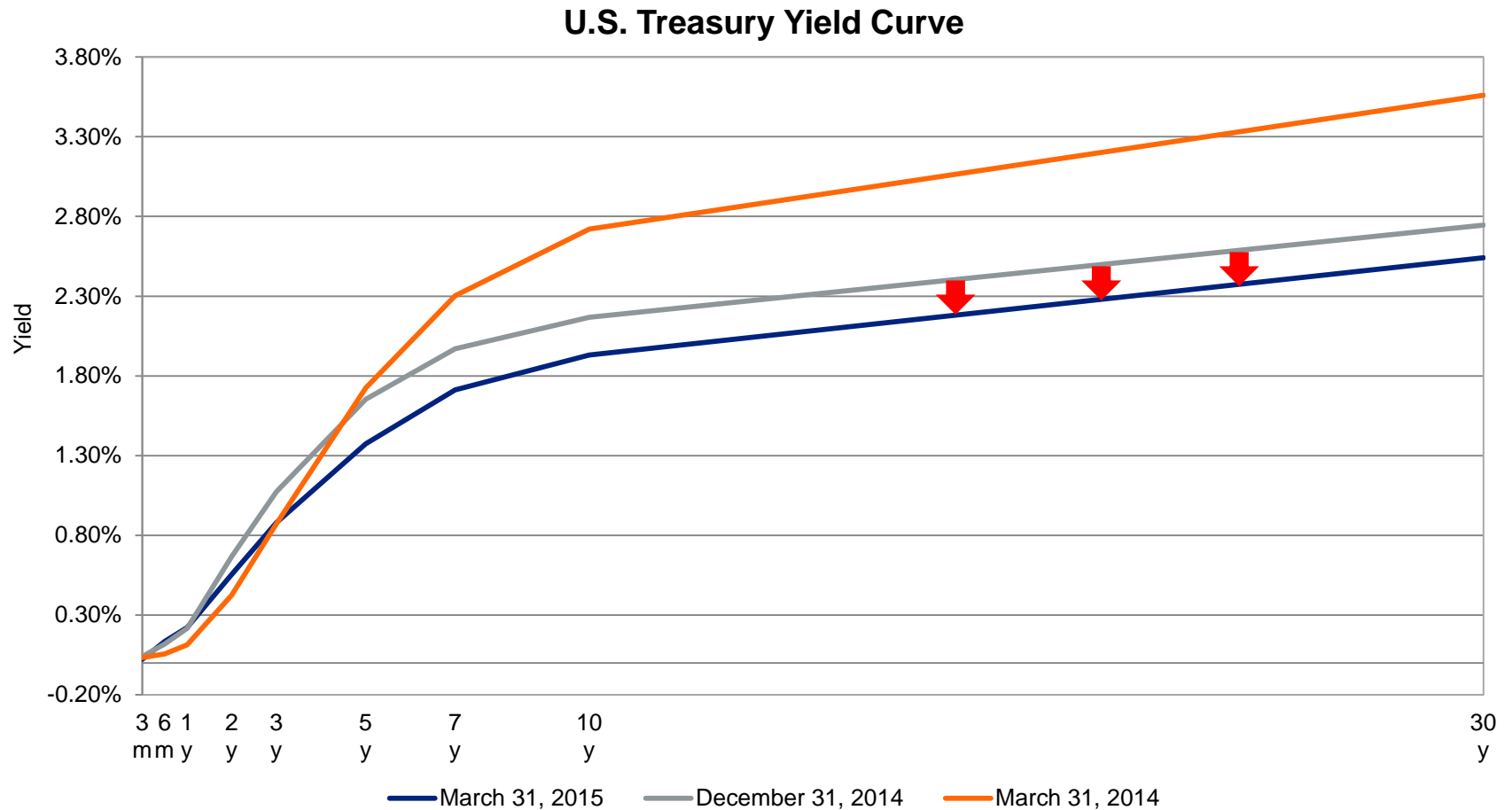
- In its April meeting, the FOMC repeated that it will raise rates when it sees further labor-market improvement and is “reasonably confident” inflation will move back to its 2% target over time.



Inflation is now
closer to 2%

Economic Summary – 2015 Q1

- The yield curve flattened over the quarter as rates continued to see downward pressure.



FOMC Rate Guidance: A Moving Target

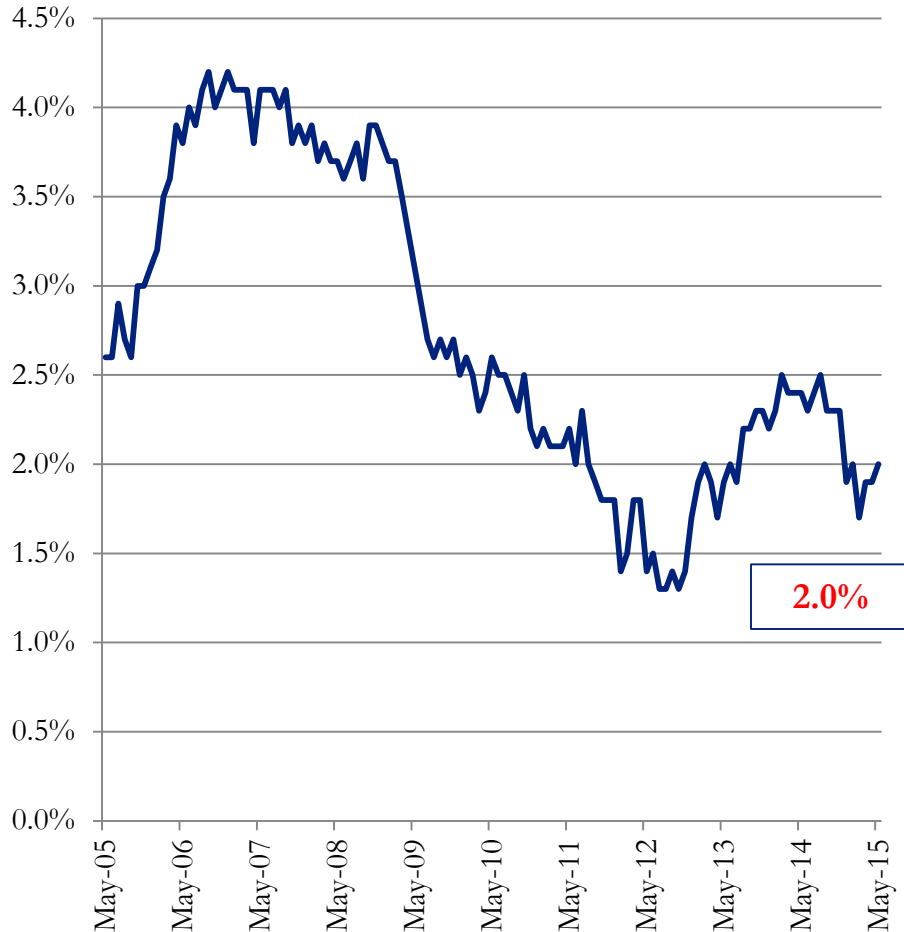
Fed fund rates are expected to remain low...

December 2008:	“for some time”
August 2011:	“at least through mid-2013”
January 2012:	“at least through late 2014”
September 2012:	“at least through mid-2015”
December 2012:	“as long as the unemployment rate remains above 6.5%”
December 2013:	“for a considerable time after the asset purchase program ends” “well past the time that the unemployment rate declines below 6.5%”
January 2015:	“can be patient in beginning to normalize the stance of monetary policy”
March 2015:	“Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvements in the labor market and is reasonably confident that inflation will move back to its 2% objective over the medium term”

Source: Federal Reserve

Not Every Labor Indicator is Strong

Avg. Hourly Earnings (yoy %)

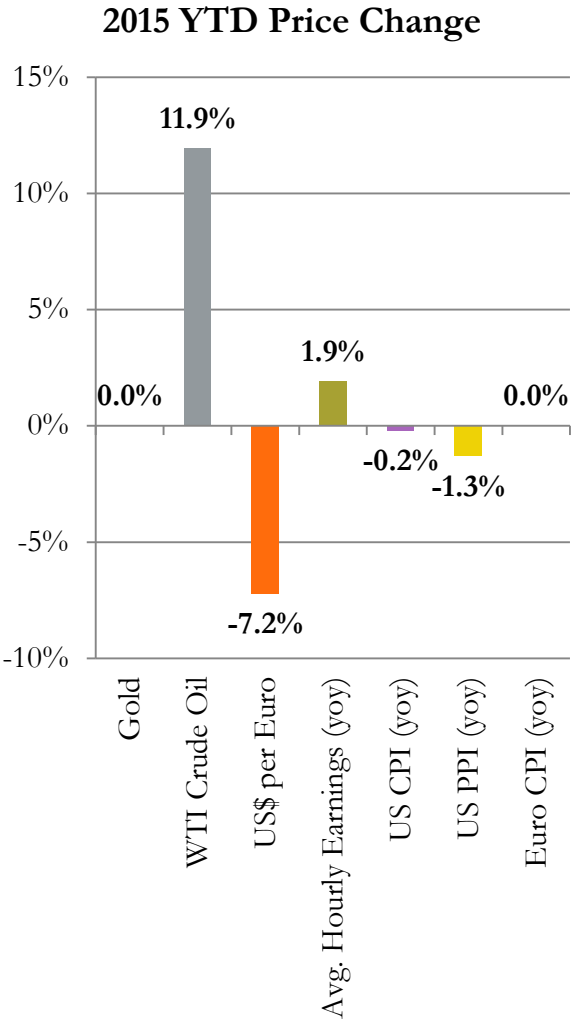
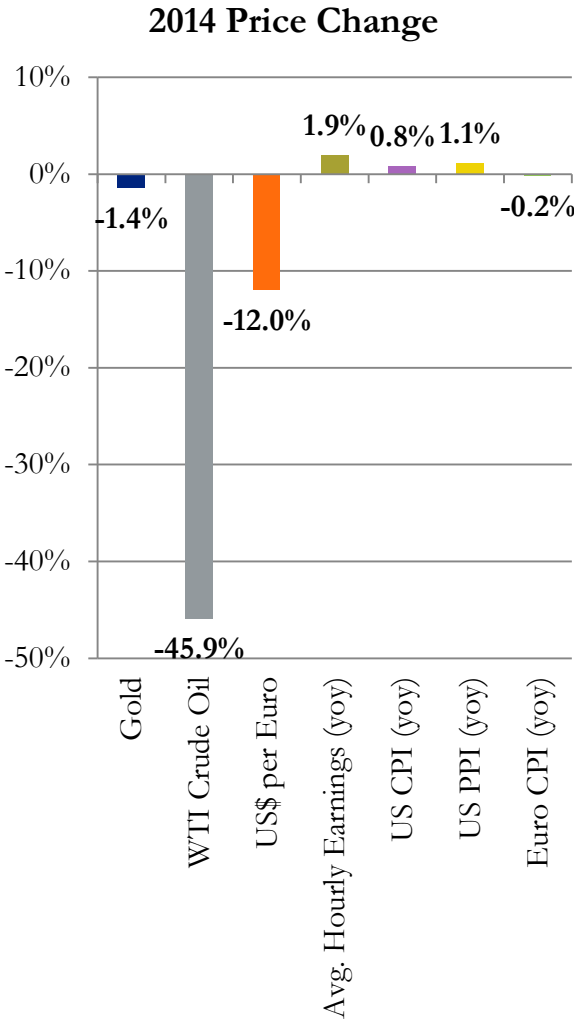
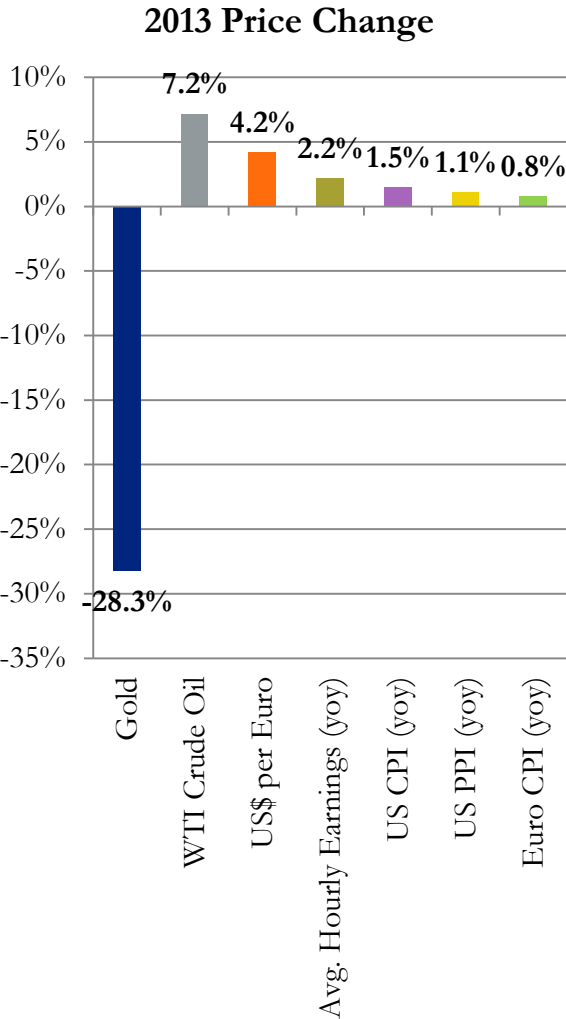


US Labor Force Participation Rate



Source: Bureau of Labor Statistics

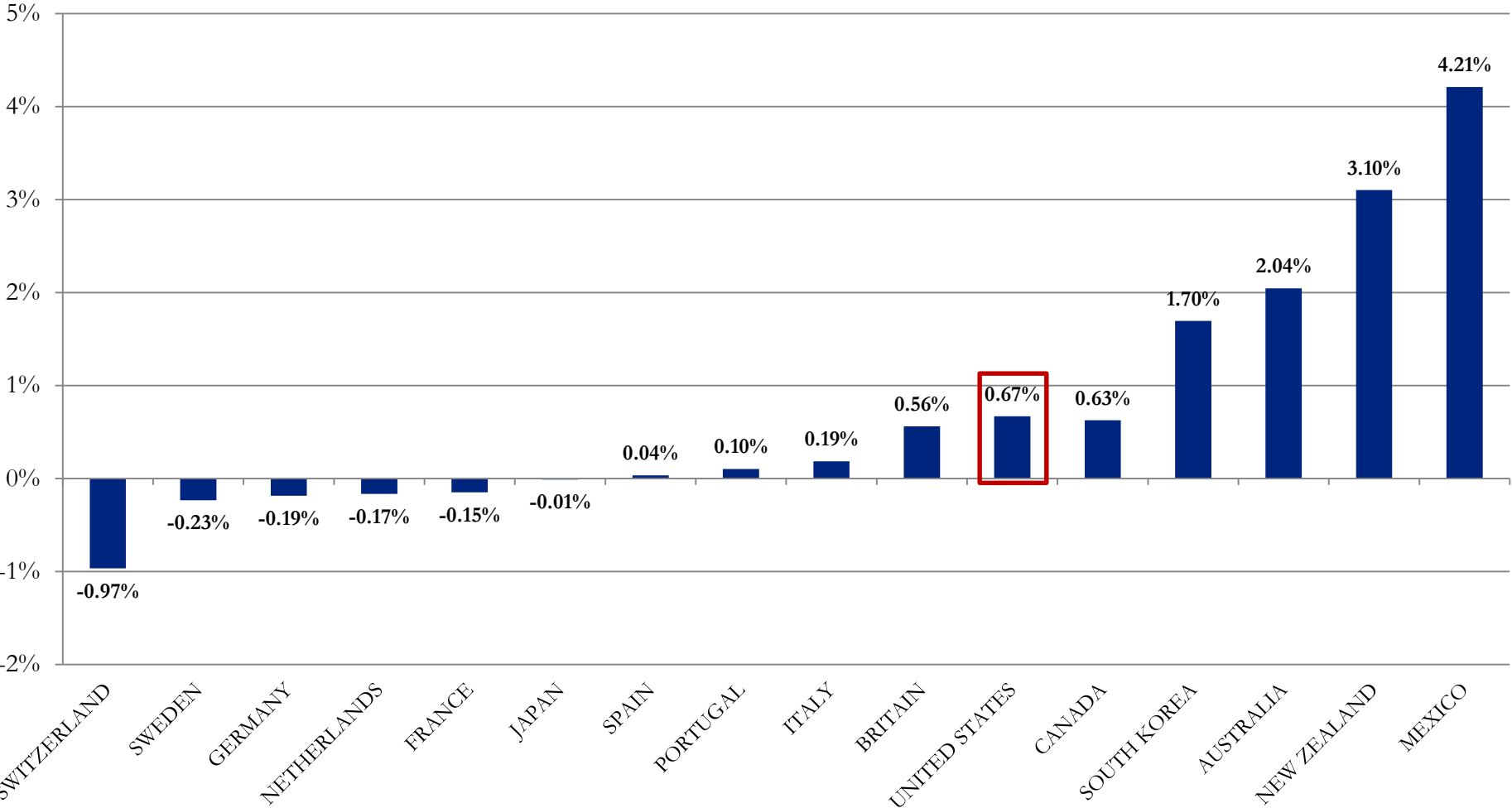
Inflation Indicators



Source: Bloomberg, 2015 YTD is as of 4/30/2015.

Global Interest Rates Have Diverged

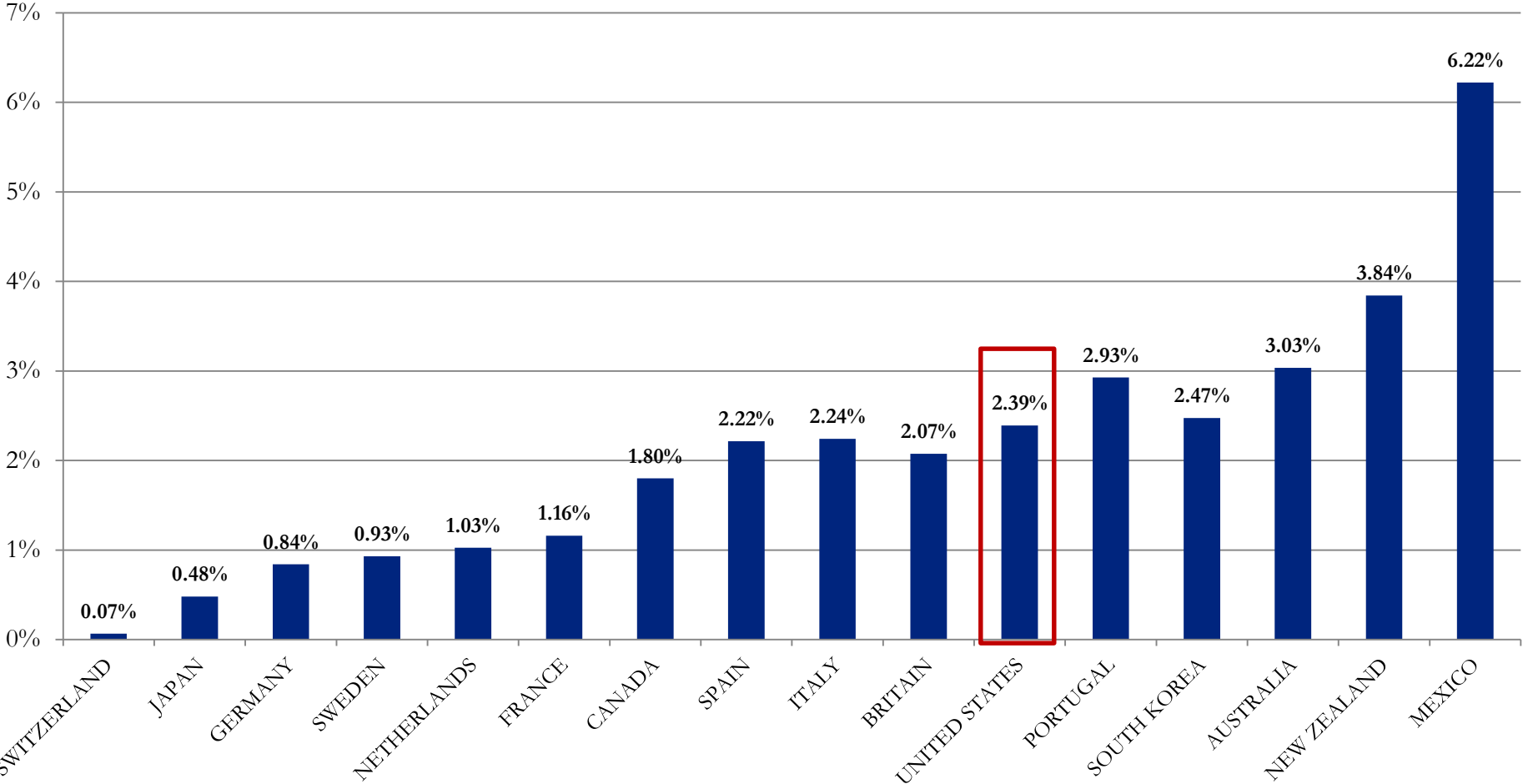
2-Year Bond Yields



Source: Bloomberg, as of 6/5/2015.

Global Interest Rates Have Diverged

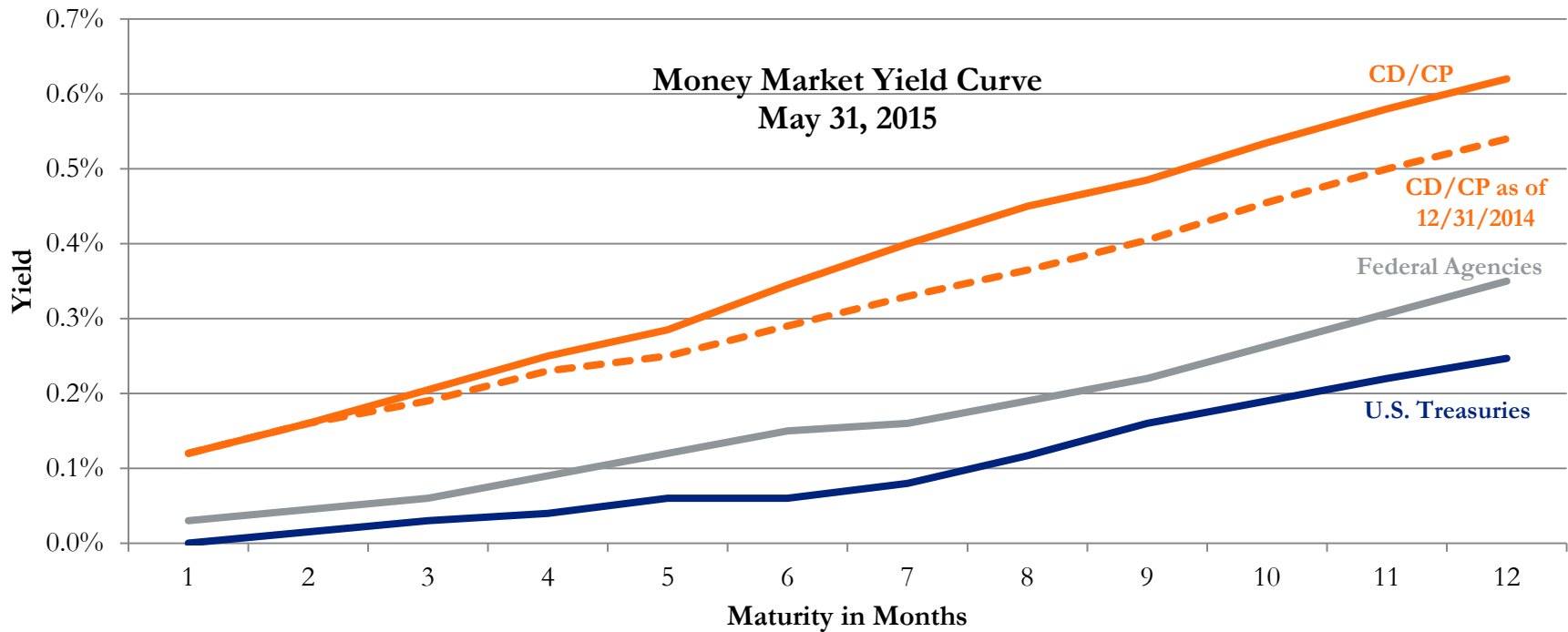
10-Year Bond Yields



Source: Bloomberg, as of 6/5/2015.

Short Maturity Yield Environment

- Yields on Commercial Paper and Negotiable CDs remain attractive alternatives to Treasury Bills and short-term Agencies where yields are constrained by Fed policy.
- CP/CD rates vary significantly by issuer, credit quality and structure



Source: Bloomberg, PFMAM. Information on CD/CP ranges are estimates based on independently compiled data, are for general information purposes only, and are not intended to provide specific advice or specific recommendations.



ACTIVE



PASSIVE

Investment Strategies

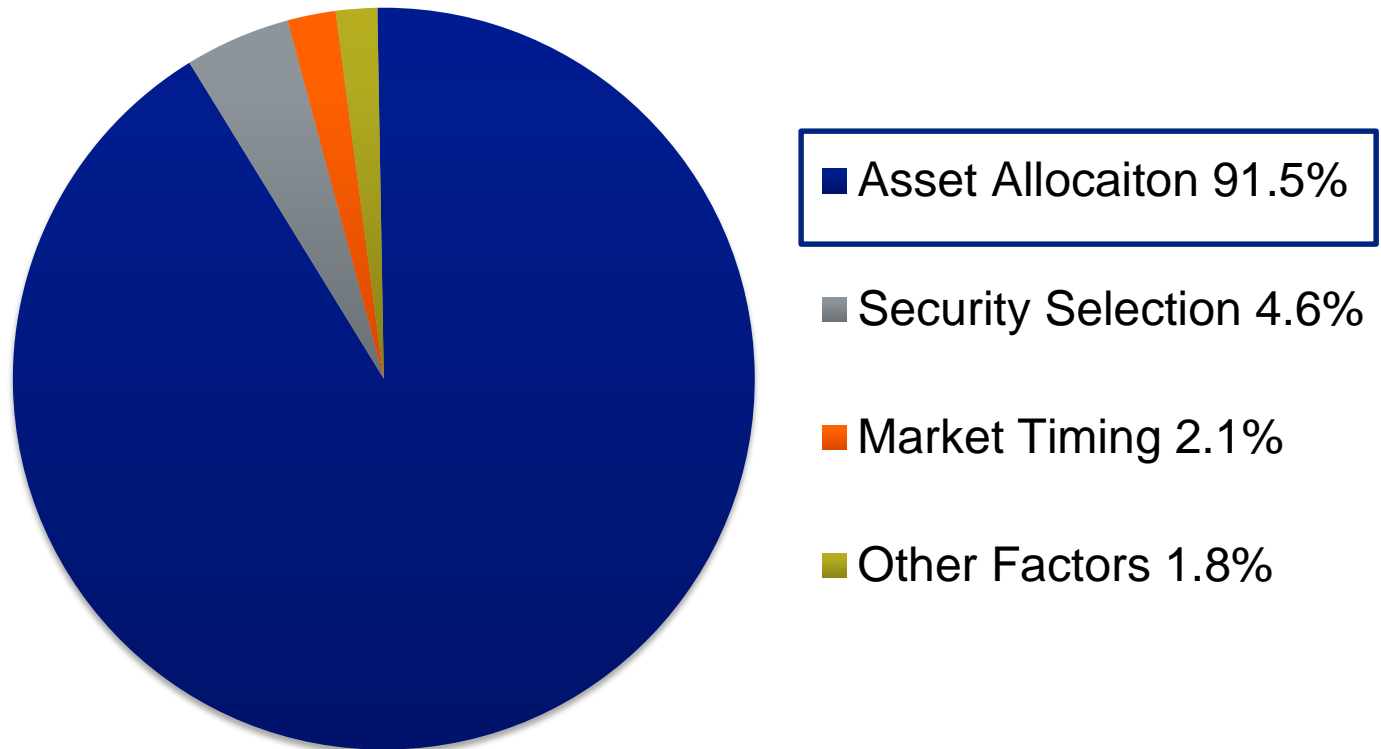
Develop and Update Investment Policies

- Identify the fiduciaries – roles and responsibilities
 - Governing body, trustees
 - Investment advisors, managers
 - Custodian and other parties
- Identify the portfolio's goals and objectives
 - Time horizon
 - Liquidity and cash flow needs
 - Target rate of return
- Define risk tolerances (volatility, drawdown, VAR, etc.)
- Establish the asset allocation
 - Guideline for portfolio holdings
 - Target allocation and ranges for each asset class
- Consider applicable state statutes and governing laws
- Establish control procedures

Asset Allocation: Most Important Decision

- Of all the possible sources of investment returns, only asset allocation matters (both strategic and tactical)

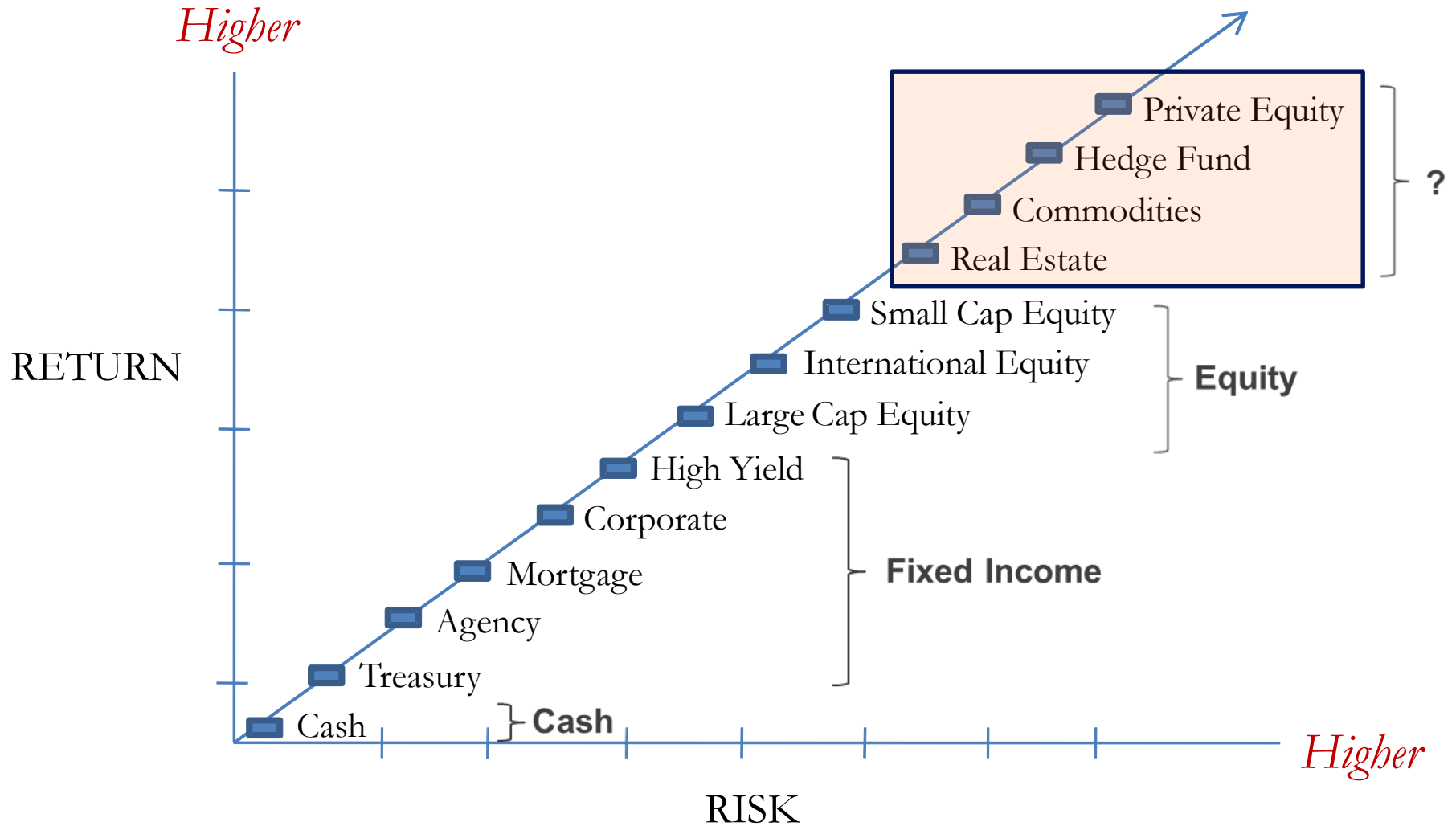
Sources of Investment Returns



Source: Gary Brinson, "Determinants of Portfolio Performance II." *Financial Analyst Journal* May-June 1991.

Identifying Suitable Asset Classes

- Are so called “alternative investments” an asset class?



Strategic Asset Allocation

- Represents asset classes to include in the portfolio and the long-term allocation to each
- Optimized to achieve the target return at minimized risks
- Defines the policy portfolio (blended benchmark)
 - For example: a 60/40 policy portfolio specifies investing 60% of the assets in equities and 40% in fixed income
- This does not necessarily mean a “static” Asset Allocation

Tactical Asset Allocation

- Temporary deviation from the strategic asset allocation based on current valuation of various asset classes
- Over time, opportunities present themselves to sell overpriced assets and buy undervalued assets
- For example: in our “60/40” model, we may be 66% in equities and 34% in fixed income

Long-term Equity Average Returns Based on Valuations

Current PE	Average Next 10-Year Annual Return
Less than 10	15.7
10-15	13.4
15-20	7.4
>20	4.7

1/1954 – 12/2002; Source: for stock prices, Morningstar/Ibbotson EnCorr; for stock PE: Bloomberg



GLASBERGEN

**“I don’t know what sort of salary you’re offering,
but on my last job I made a lot of dough!”**

Rebalancing May Reduce Risk by Nearly 20%

- Have a process to bring allocations back in balance
- Be thoughtful: base it on your tactical convictions
- Not possible with illiquid investments (alternatives)

Diversified Portfolio Results

Type	Drifting	Rolling Period		
		Mthly	Qtrly	Annual
Return	7.71%	7.53%	7.66%	7.73%
Risk	13.25	10.70	10.65	10.48

Annualized returns for trailing twenty years ending December 31, 2013

Passive Management Wins Most of the Time...

- Active managers do not consistently add value (net of fees)
- Passive management helps reduce overall costs

Percentage of Active Funds Outperformed by Index

	One Year	Three Years	Five Years	Ten Years
U.S. Equity	87.23%	76.77%	80.82%	76.54%
Non-U.S. Equity	76.89%	73.74%	75.17%	79.17%
EM Equities	68.70%	65.97%	72.19%	89.71%
High Yield	73.09%	77.03%	88.83	92.98%
EM Debt	84.27%	93.22%	89.66%	75.00%

Source: S&P; as of December 31, 2014

Including in Down Markets

- Most equity active managers have underperformed their relative index over the two most recent bear markets

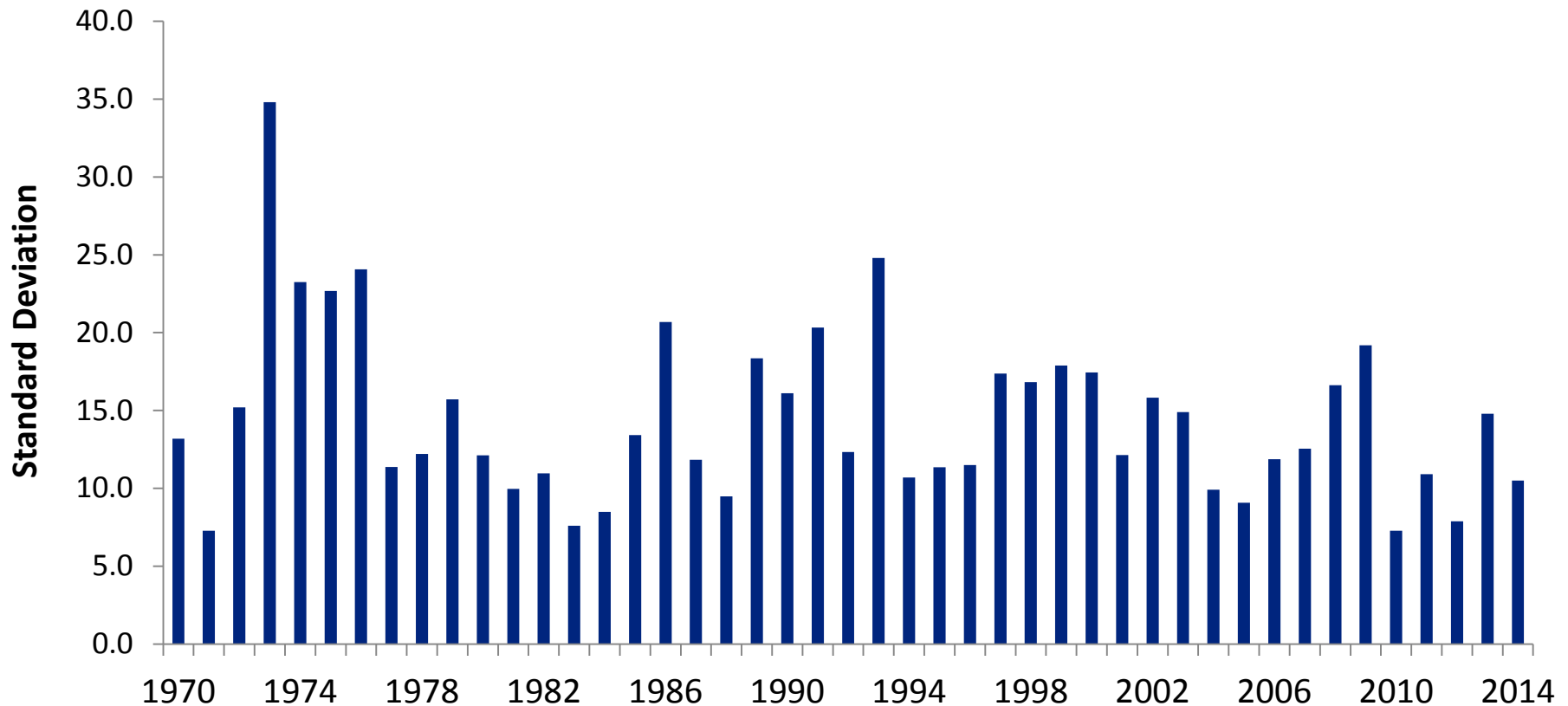
Percentage of Active Funds Underperforming Benchmarks in Bear Markets

Fund Category	Benchmark	2008	2000 to 2002
All Cap Funds	S&P 500	54%	54%
All Mid-cap Funds	S&P Mid-cap	75	77
All Small-cap Funds	S&P Small-cap	84	72
Large Growth	S&P 500 Growth	90	49
Large Core	S&P 500	52	53
Large Value	S&P 500 Value	22	37
Mid Growth	S&P Mid-cap Growth	89	82
Mid Core	S&P Mid-cap	62	70
Mid Value	S&P Mid-cap Value	67	83
Small Growth	S&P Small-cap Growth	96	88
Small Core	S&P Small-cap	83	71
Small Value	S&P Small-cap Value	73	58

Source: S&P Indices and CRSP (Center for Research in Security Prices) Database as of December 31, 2008

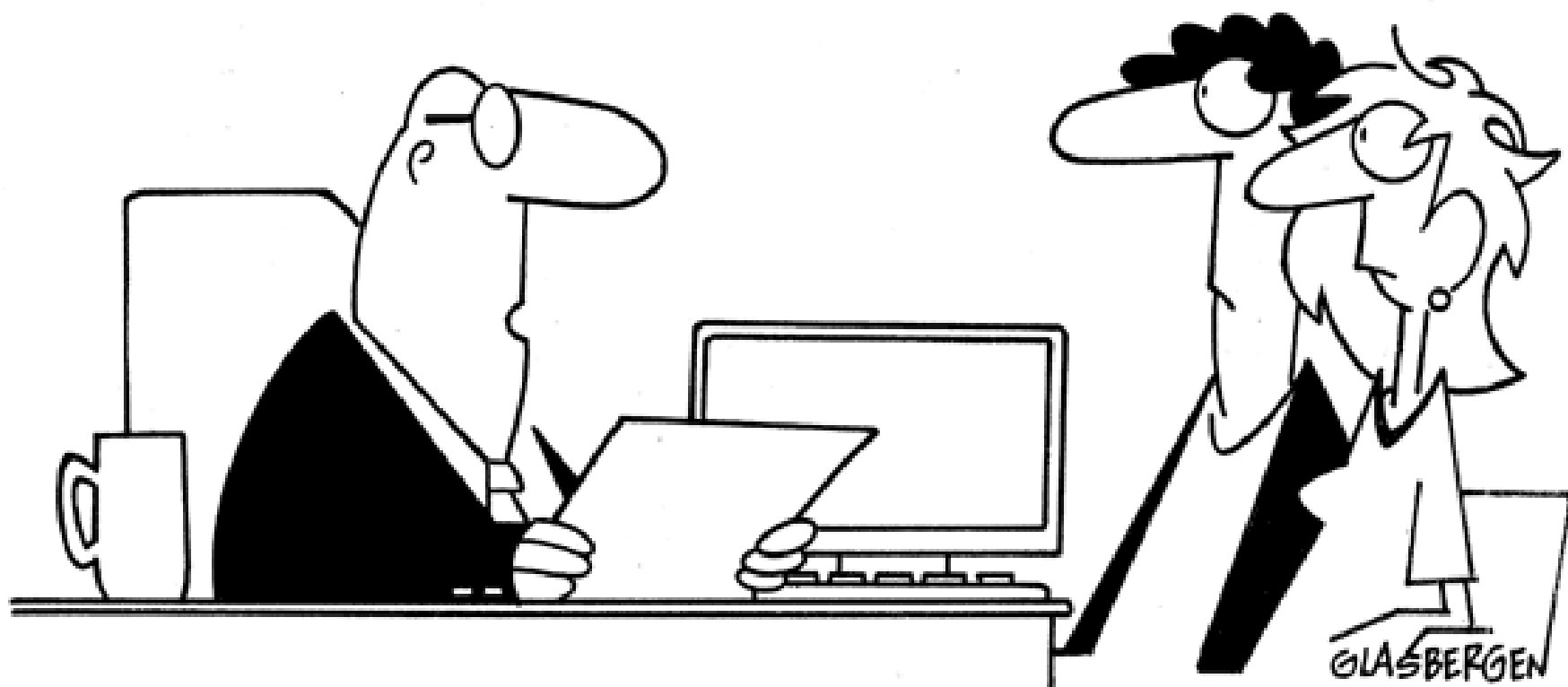
Dispersion of Returns – Asset Classes

- Active managers claim that “everything has been moving together recently” but the dispersion of returns among different asset classes shows no declining trend



Source: Ibbotson/Morningstar EnCorr; dispersion is measured as the standard deviation of returns for US and non-US equities, commodities, REITs, US and non-US fixed income

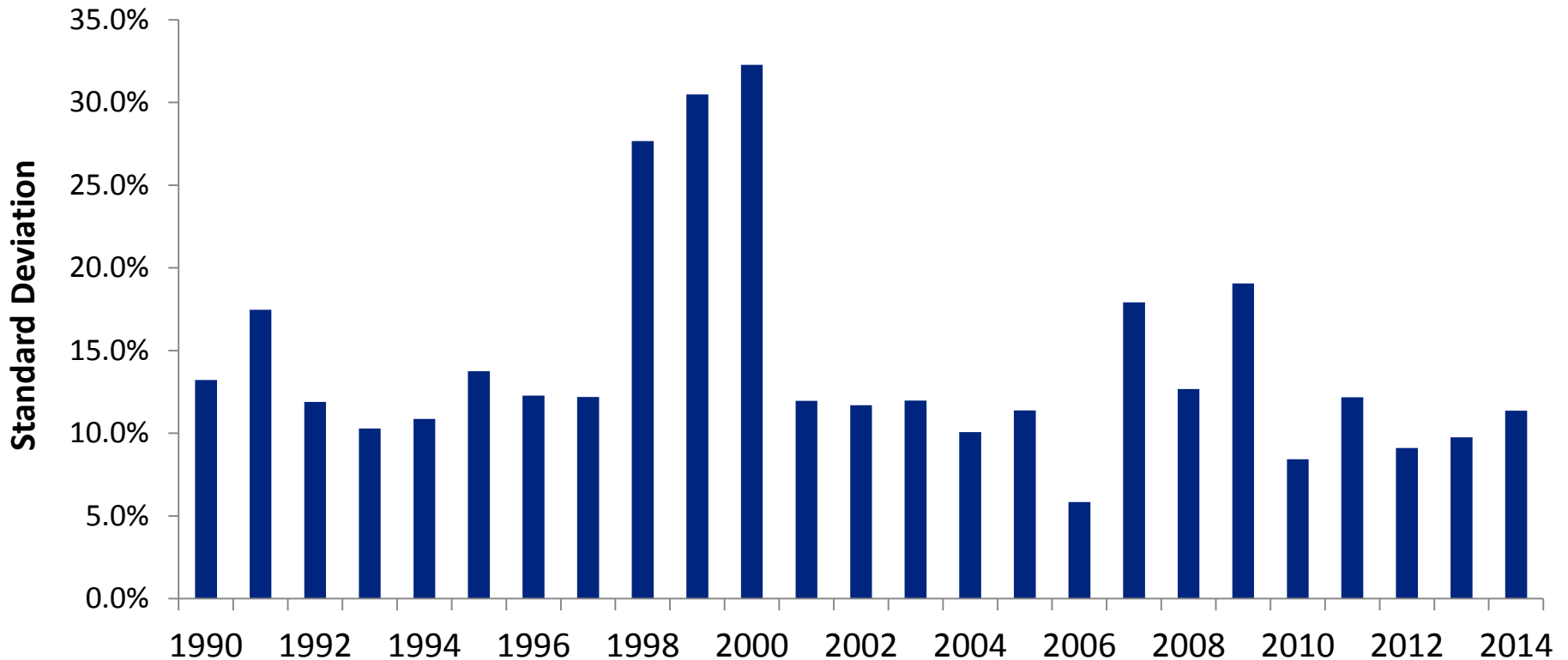
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“Allowing for inflation and the rising cost of tuition, you’ll need to save 40 billion dollars for your children’s education.”

Dispersion of Returns – S&P 500 Sectors

- Excluding the tech bubble of the late 1990s, dispersion of S&P 500 sector returns is no tighter today than average



Source: Ibbotson/Morningstar EnCorr; dispersion is measured as the standard deviation of returns for S&P 500 Index sectors

Persistence

- It is virtually impossible for most active managers to maintain “top” performance status

	Fund Count at Start	Funds Remaining (%)			
	Sep 2010	Sep 2011	Sep 2012	Sep 2013	Sep 2014

Top Quartile

All Domestic Funds	706	37.68	10.34	4.67	1.27
Large-Cap Funds	257	41.25	9.34	5.06	0.39
Mid-Cap Funds	106	29.25	9.43	4.72	0.94
Small-Cap Funds	151	34.44	9.93	3.97	1.32
Multi-Cap Funds	192	40.10	12.50	4.69	2.6

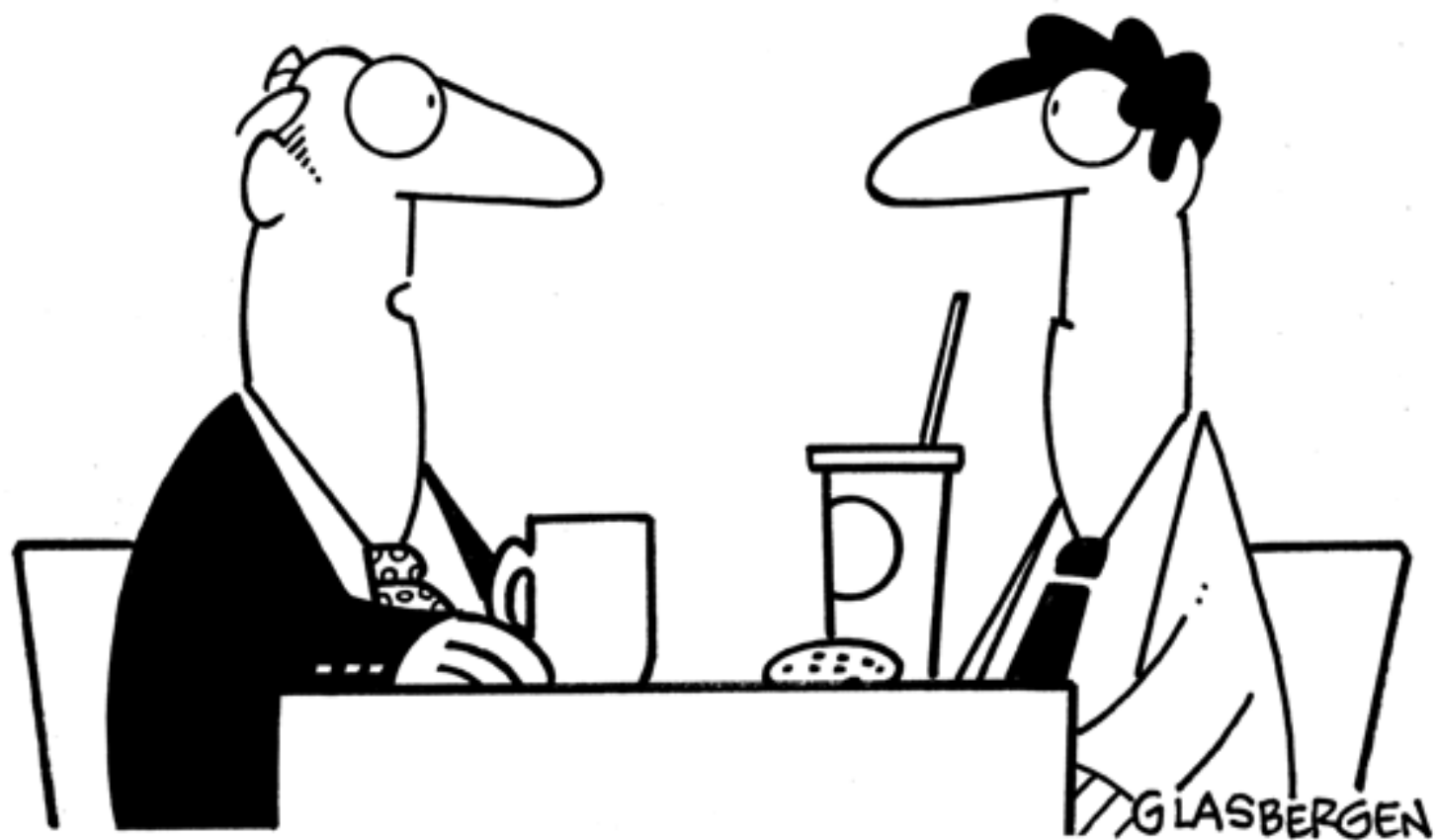
Top Half

All Domestic Funds	1412	52.20	24.01	12.89	6.87
Large-Cap Funds	514	57.59	23.74	11.28	5.84
Mid-Cap Funds	212	48.58	15.09	5.19	2.83
Small-Cap Funds	302	52.32	29.47	18.54	7.95
Multi-Cap Funds	384	46.88	25.00	14.84	9.64

Source: S&P, December 2014



Monitoring Performance



“I’m worried about my investments. My broker has stopped quoting Warren Buffett and started quoting Jimmy Buffet.”

Investment Performance & Benchmarks

- Seek GIPS[®] compliant performance standards*
- Understand performance both gross and net of fees
 - Consultant fee, underlying manager fees, custodian fee, brokerage/commissions, etc.
- Accurately Benchmark
 - Primary benchmark: blend of indices that represents the portfolio's strategic asset allocation targets
 - Secondary benchmarks:
 - Actuarial rate of return (Pensions / OPEBs)
 - Hurdle rate (Endowments)
 - Peer universe

* CFA Institute's Global Investment Performance Standards (GIPS[®]).

RISK?

YES

NO

Compliance Issues

I KNOW IT'S DIFFICULT TO STAY IN COMPLIANCE WITH EVERYTHING, FERGLISON, BUT THIS IS *RIDICULOUS!*



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File

Formal Compliance Program

- Rule 206(4)-7 under the Advisers Act
- Investment Advisor must:
 - Implement written policies and procedures designed to prevent violations of federal securities laws by the firm and its personnel
 - Annually review the effectiveness of the policies and procedures
 - Designate a chief compliance officer
 - Maintain records of the policies and procedures and annual reviews

Annual Training of Firm Personnel

- Annual review of policies and procedures

PFM ASSET MANAGEMENT LLC COMPLIANCE MANUAL

November 24, 2014

This Compliance Manual is the sole property of PFM Asset Management LLC (the "Company") and must be returned to the Company should an Employee's association with the Company terminate for any reason. The contents of this Compliance Manual are confidential. Employees may not reproduce, duplicate, copy, or make extracts from or abstracts of this Compliance Manual, or make it available in any form to non-employees without the written approval of the Company's Chief Compliance Officer.

The following persons currently hold the following positions as used in this manual:

Chief Compliance Officer/ AML Compliance Officer	Leo J. Karwejna Harrisburg Office, Ext. 3847 karwejna@pfm.com
Financial and Operations Principal (PFM Fund Distributors, Inc.)	Debra Goodnight Harrisburg Office, Ext. 6220 goodnightd@pfm.com

Other members of the Firm's Compliance Department include:

Richard Michael Compliance Director	717-231-3816 michaelsr@pfm.com
Jennifer Berrier SMC Compliance Manager	717-231-6219 berrierj@pfm.com
Dana Shanaberger Compliance Analyst	717-231-6279 shanabergerd@pfm.com
Gloria Wells Compliance Analyst	717-305-8904 wells@pfm.com
General questions and comments	ComplianceGroup@pfm.com

PFM Asset Management LLC – Annual Compliance Review Matrix – June 2015

The following matrix outlines the detailed procedures that were performed to evaluate the effectiveness of PFM Asset Management LLC's Compliance Manual:

	PFMAM Procedure or Activity	Testing Performed	Testing Results	Additional Comments	Resolution	Source of Information
I. Overview of Company and IA Activities						
1	Adopt and implement written compliance policies/procedures.	Review a copy of PFMAM compliance manual. (Dana Shanaberger, date)	Most recently updated as of August 15, 2011.			Manual
2	Review on an annual basis the adequacy and effectiveness of policies/procedures.	Discuss with CCO to confirm that annual testing of policies and procedures occurred. (Gloria Wells, date)	Performed 1st annual review of compliance manual in 2005. Annual review was conducted in 2013.			Manual, CCO
3	Designate CCO responsible for administering policies/procedures.	Reviewed PFMAM compliance manual to determine whether CCO had been designated. (Gloria Wells, date)				Manual
4	Maintain records of policies/procedures including records related to the review of such policies/procedures.	Reviewed the Compliance network folder to determine if historical and current drafts are maintained. Reviewed the Compliance CBK site to determine if the current version of the manual is posted. (Dana Shanaberger, date)				Network
5	Adopt and implement risk assessment management procedures.	Reviewed a copy of the Risk Assessment matrix completed prior to 2013 annual testing. (Leo Karwejna, date)				Network

Form ADV, Part 2A – Advisory Business

■ Discretionary Advice

The advisor has the authority to determine:

1. Overall asset allocation
2. The specific securities to be bought and sold
3. The amount of securities to be bought and sold
4. The broker or dealer through which the securities are bought or sold.

■ Nondiscretionary Advice

1. The advisor must receive client approval before trade execution
2. Client may reserve right to make trades; advisor simply offers recommendations

■ Consulting Services

Contracts

“A verbal contract isn’t worth the paper it’s written on.”

Samuel Goldwyn



Contract Discussion Points

- Identify Basis for Calculation of Fees
 - Fixed income – amortized cost, plus accrued interest
 - Treatment of cash and money market fund balances
 - MACM – end-of-month market value as provided by Custodian
- CPI adjustments, on occasion
- Minimum annual fees
- Other services for additional fees, as identified in separate writing

Compliance Issues

- Scope of PFMAM's authority over client's account
 - Discretionary vs. Nondiscretionary
 - PFMAM makes recommendations, client decides whether to execute – authorized individuals
 - Share account with other advisors?
 - Investment guidelines or limitations (often in the form of an IPS)
 - Will PFMAM select third party broker/dealers?
- Other Compliance Department issues
 - GIPS reporting – inclusion in appropriate composite



Money Market Reform

Summary of SEC Money Fund Reforms

Traditionally, money market funds have represented a fairly secure short-term investment for institutional investors such as pension and insurance funds, short investment options for 401(k) plans, as well as public agency investors across the country. As of June 4, 2015, \$1.7 trillion is invested in institutional money market funds and \$865 billion in retail money funds.

As part of their mandate to prevent liquidity issues like those that froze investor assets in some funds in 2008, the SEC passed a second round of rules in June 2014. The SEC set a 2 year window for overall implementation of these rules to conclude in October 2016.

Reforms:

- Institutional prime money market funds will be required to float the net asset value, or NAV, rather than keeping share prices fixed at \$1.
- Money market funds can impose a liquidity fee on redemptions if the fund's weekly liquidity falls below the level required by regulations.
- Redemptions may also be suspended temporarily. The SEC calls these redemption "gates."

Summary of SEC Money Fund Reforms (cont).

Reforms (continued):
















- Retail money market funds, the types of money market funds most individual investors purchase, will only be subject to liquidity fees and redemption gates. Share prices for retail money market funds will stay fixed at \$1.
- Disclosure and reporting
 - Funds must report a daily market NAV to 4 places
 - Funds must show net cash flows from previous day
 - Funds must promptly disclose if weekly liquid assets drop below 10%
- Stress testing
 - Test ability to maintain liquid assets
 - Report results of stress testing to Board


Implementation Timing

<u>Topic</u>	<u>Implementation Date</u> (From Rule Release / Actual Date)
Form N-CR Reporting	9 months / 7-15-2015
Diversification	18 months / 4-14-2016
Stress Testing	18 months / 4-14-2016
Disclosures	18 months / 4-14-2016
Additional Reporting Requirements	18 months / 4-14-2016

<u>Topic</u>	<u>Implementation Date</u> (From Rule Release / Actual Date)
Application of floating NAV	2 years / 10-14-2016
Definition of retail fund	2 years / 10-14-2016
Definition of government fund	2 years / 10-14-2016
Redemption gates	2 years / 10-14-2016
Liquidity fees	2 years / 10-14-2016

Summary of Key Amendments

SEC Major Amendments	Prime Institutional Funds	Retail Funds	Government Funds
Required to "float" net asset value			
Publish daily market based <i>shadow</i> net asset value			
Required to round prices and transact to four decimal places			
May use amortized cost for securities with 60 days or less to maturity			
Disclosure of daily and weekly liquid asset levels			
Fees and Gates			 

 Permissible, but not mandatory

Two chocolate bunnies are shown against a white background. The bunny on the left is a standard chocolate bunny with a hole in its rear. The bunny on the right is a chocolate bunny with a hole in its head. Both bunnies have small chocolate droppings on the ground in front of them. A speech bubble above the bunny on the left says "My arse hurts" and a speech bubble above the bunny on the right says "What?".

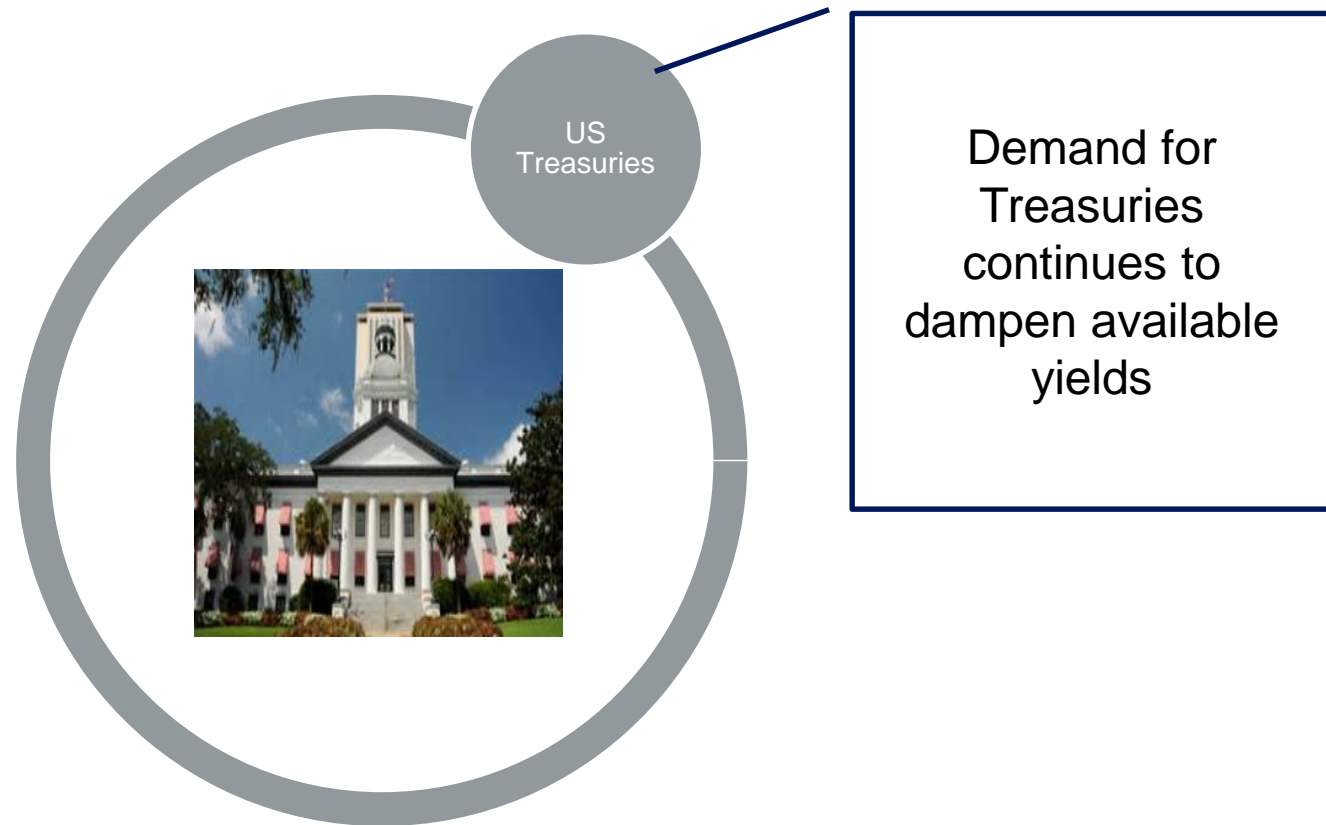
My arse hurts

What?

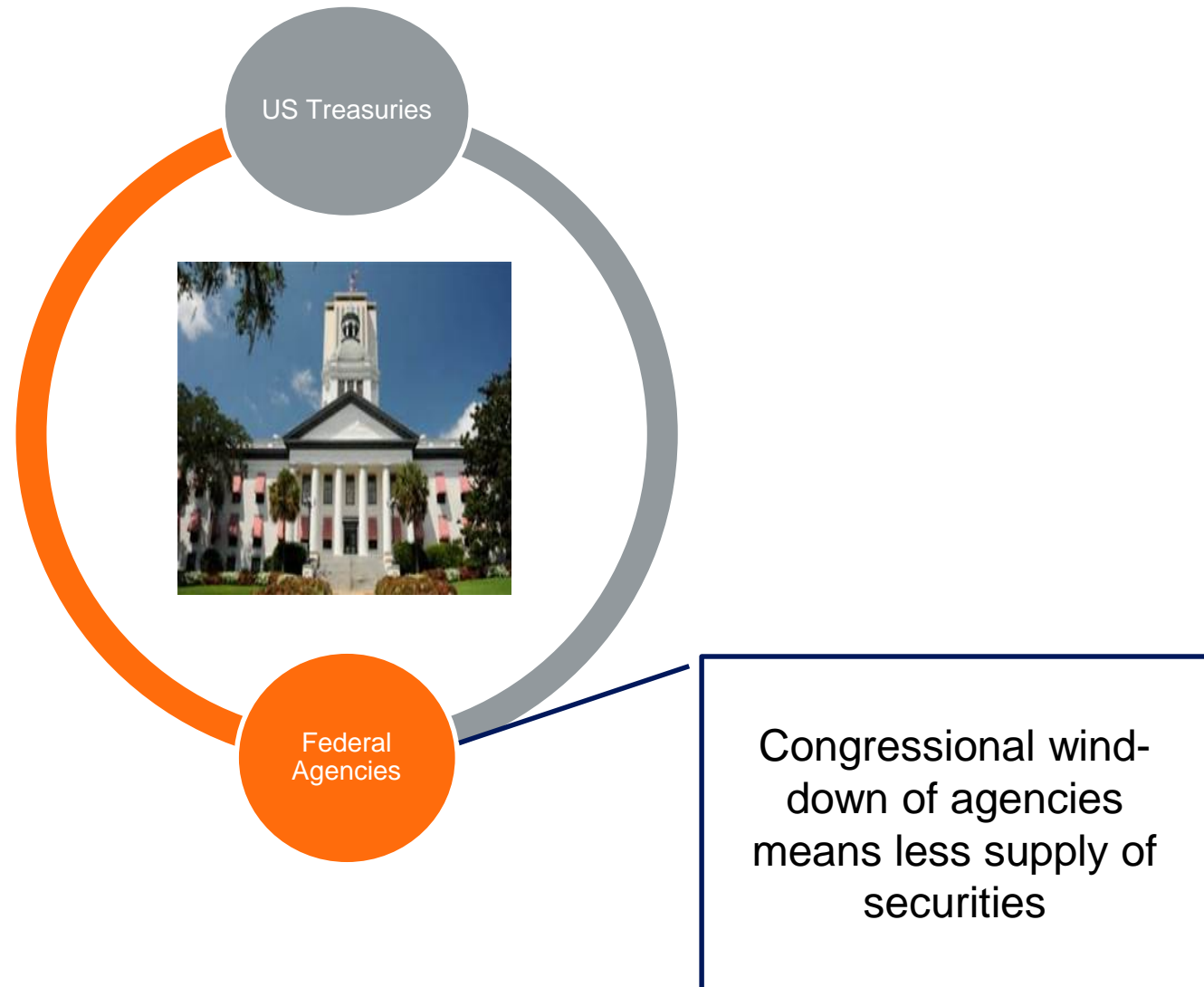
What Do SEC Money Fund Reforms Mean for Florida Public Investors?

- Institutional SEC-registered money market funds may not continue to operate in their current form after October 2016.
 - Funds could close
 - Could change to a fund that only invests in treasuries
 - Funds may no longer be open to new investments
- Medium-term funds like SPIA that have reported goals of a stable NAV may begin to impose redemption gates or liquidity fees.
- Bank instruments, sweep vehicles, or “platforms” utilizing these funds may also feel affects or limitations on investment opportunities
- Accountants and finance staff at a school district may need to input the market value of any investment in an institutional money market fund on a daily basis, instead of once per month.
- **There will probably be less investment options available that offer safety, daily liquidity, and yield than before.**

Market Forces and Regulations Affecting Investment Options for Public Agencies

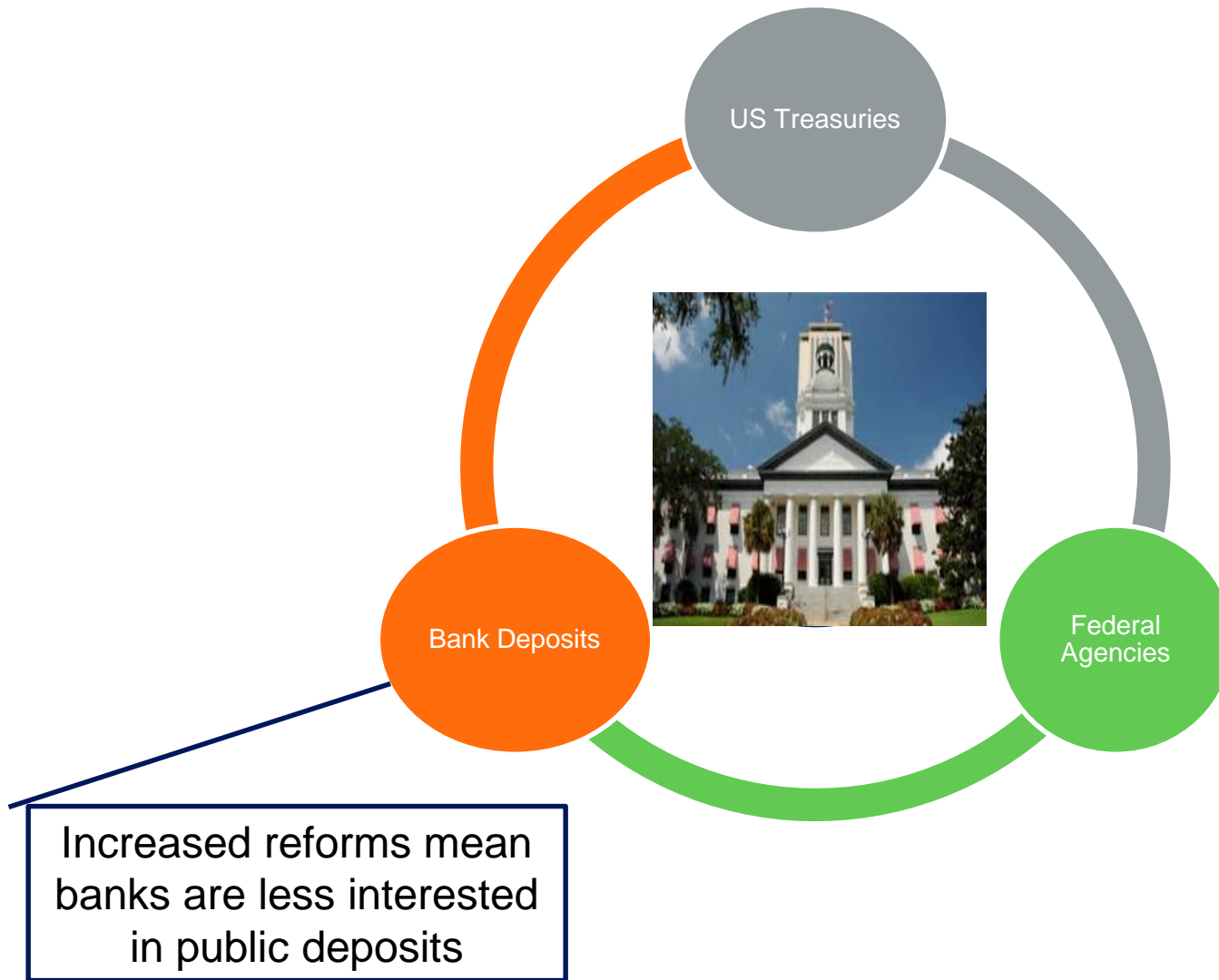


Market Forces and Regulations Affecting Investment Options for Public Agencies

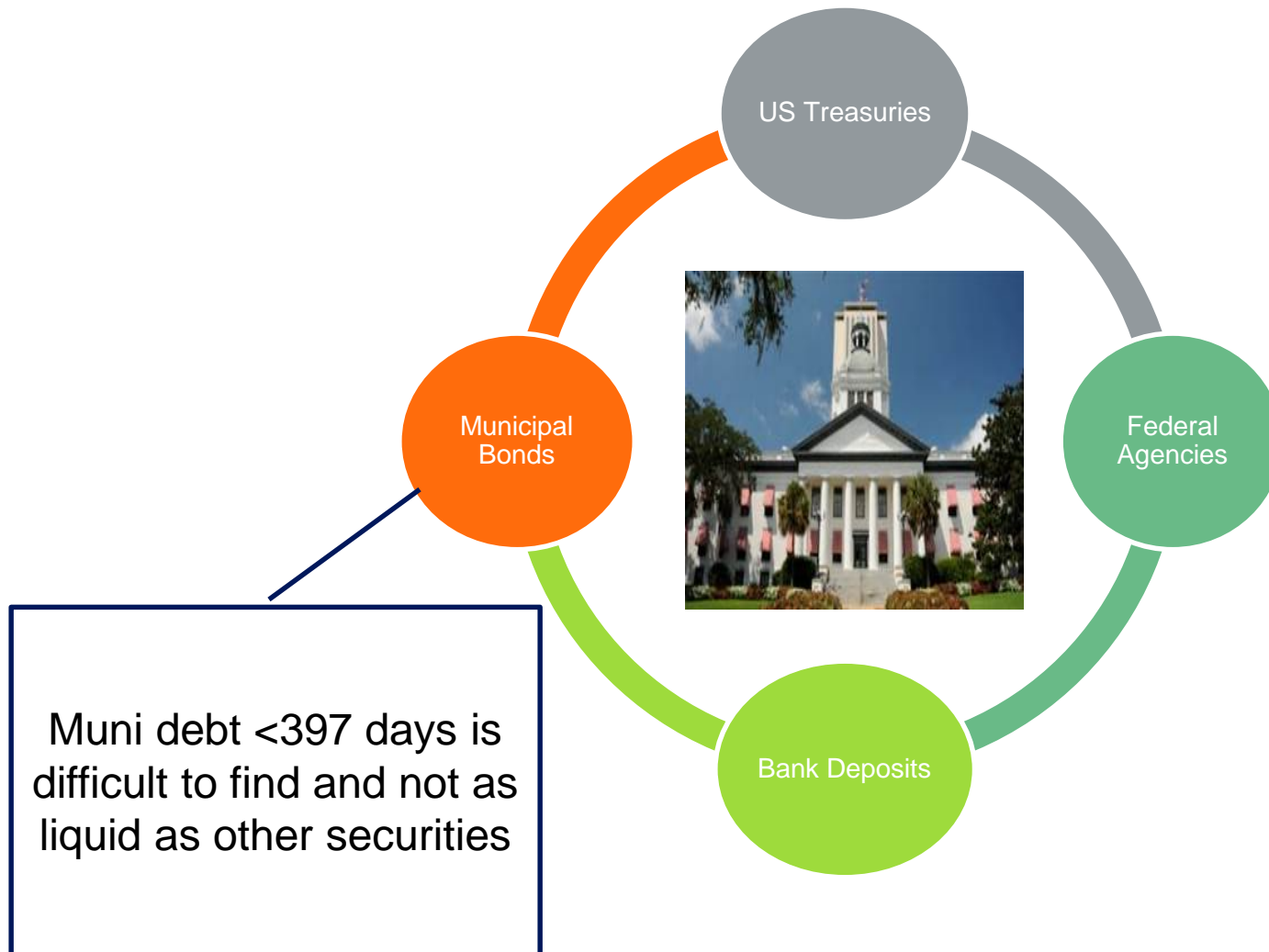


Congressional wind-down of agencies means less supply of securities

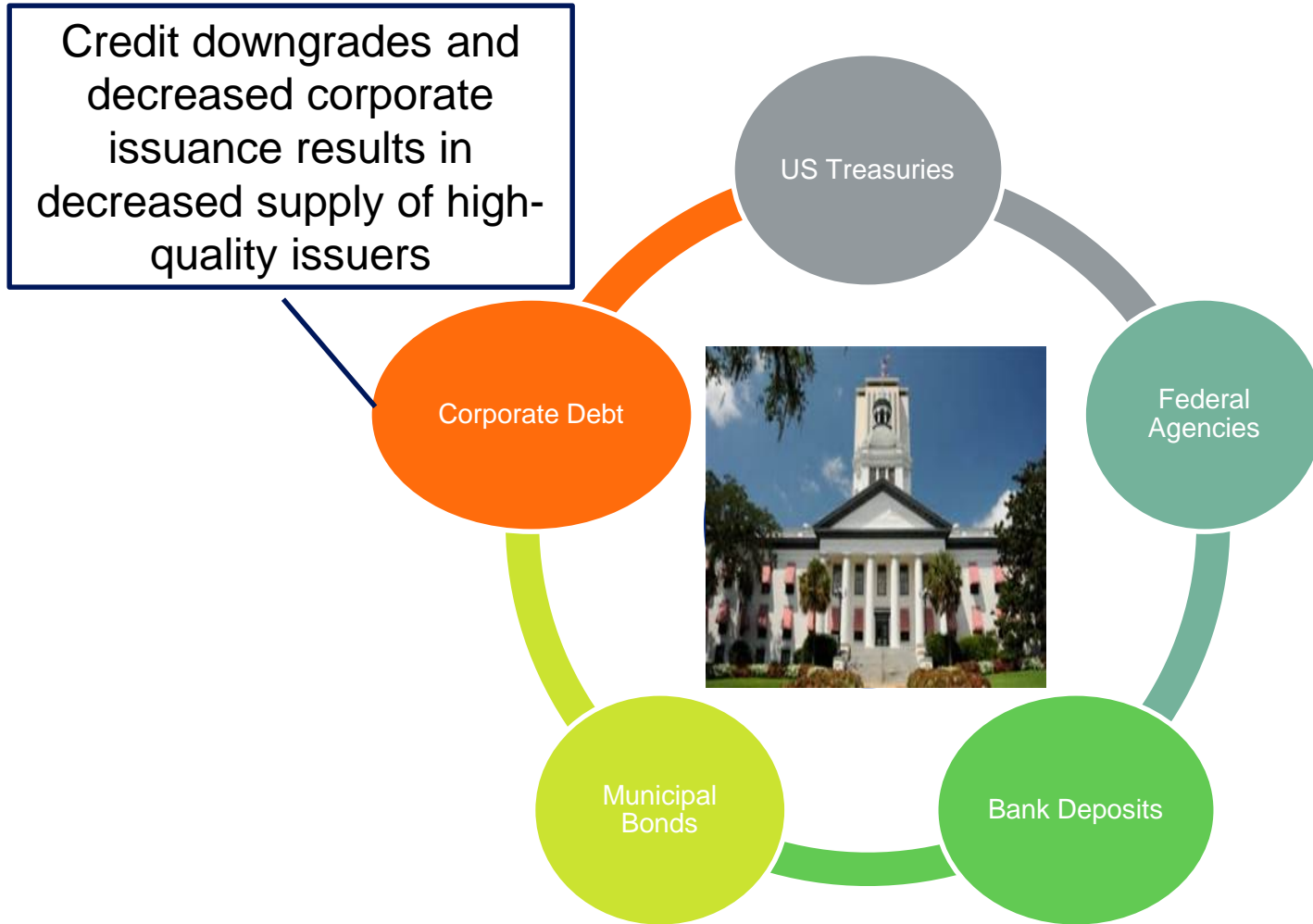
Market Forces and Regulations Affecting Investment Options for Public Agencies



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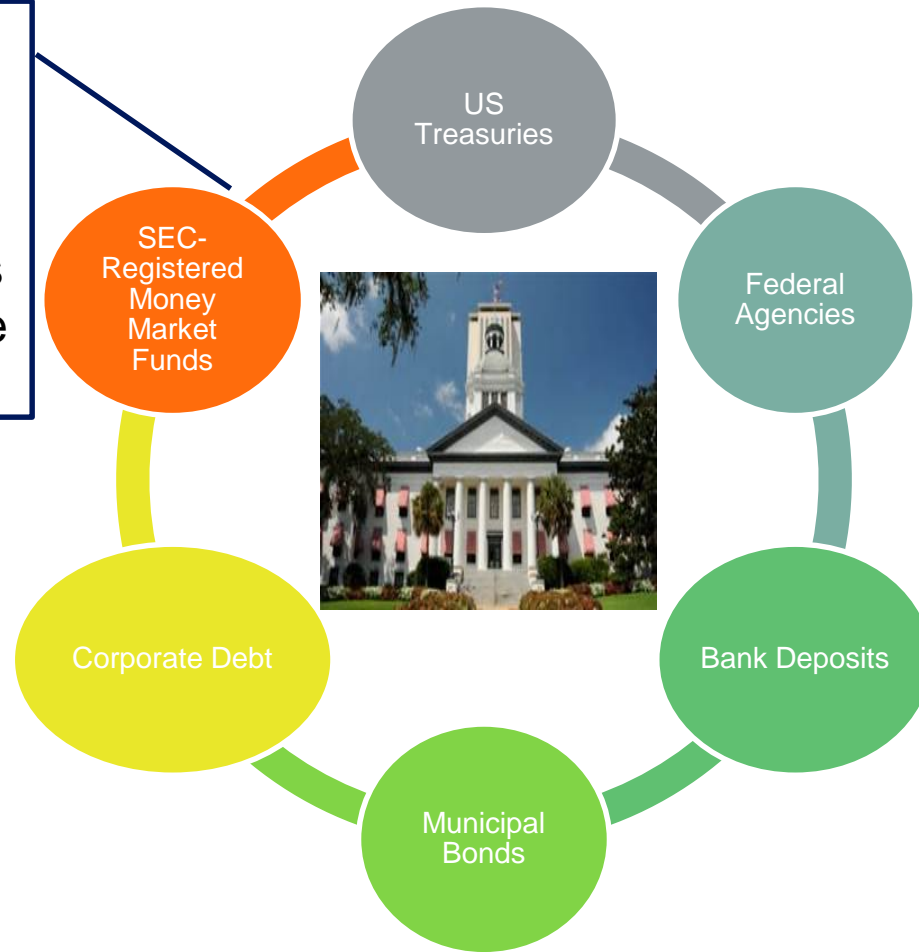


Market Forces and Regulations Affecting Investment Options for Public Agencies

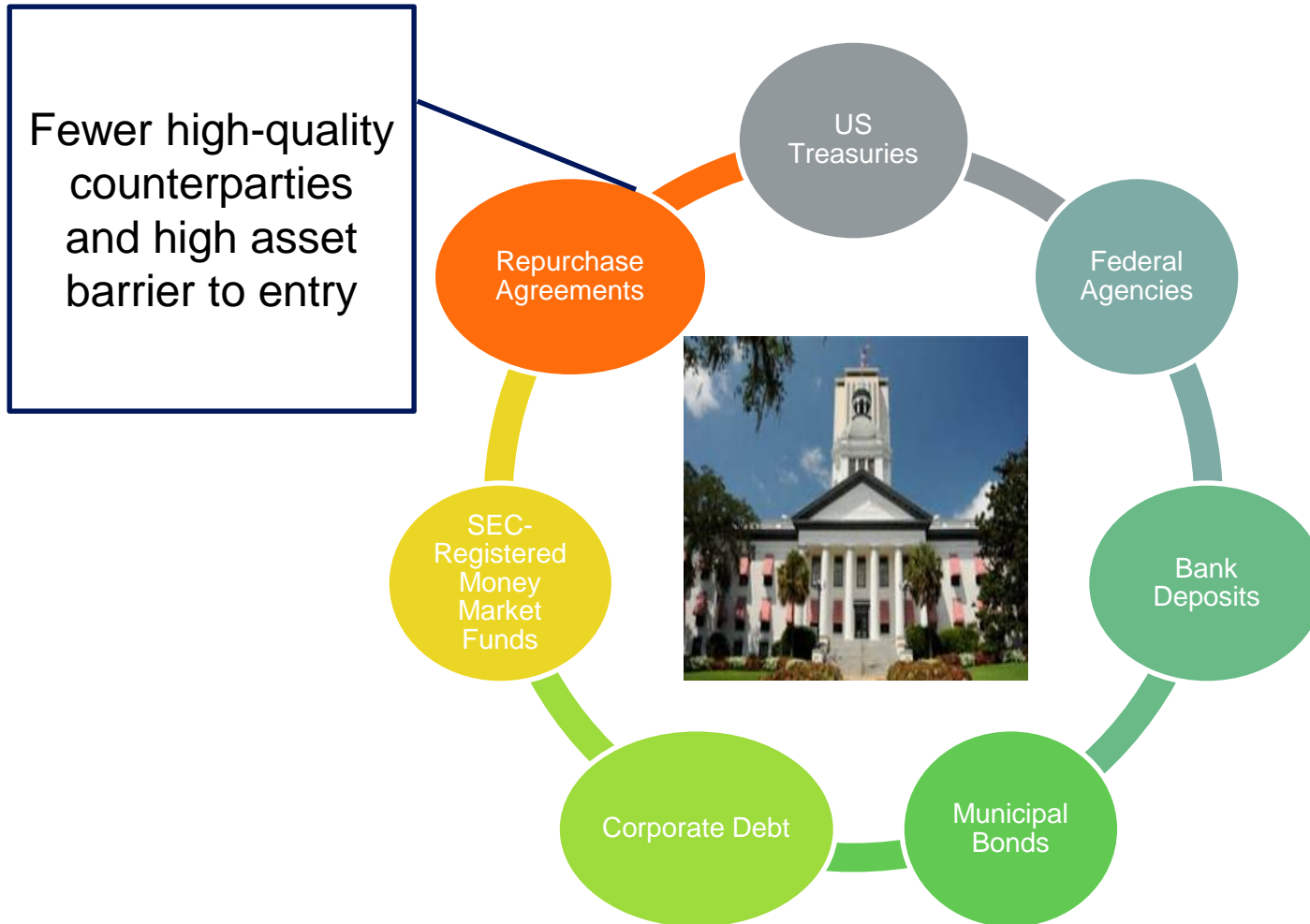


Market Forces and Regulations Affecting Investment Options for Public Agencies

MMF Reforms mean more accounting work and potentially less liquidity than before



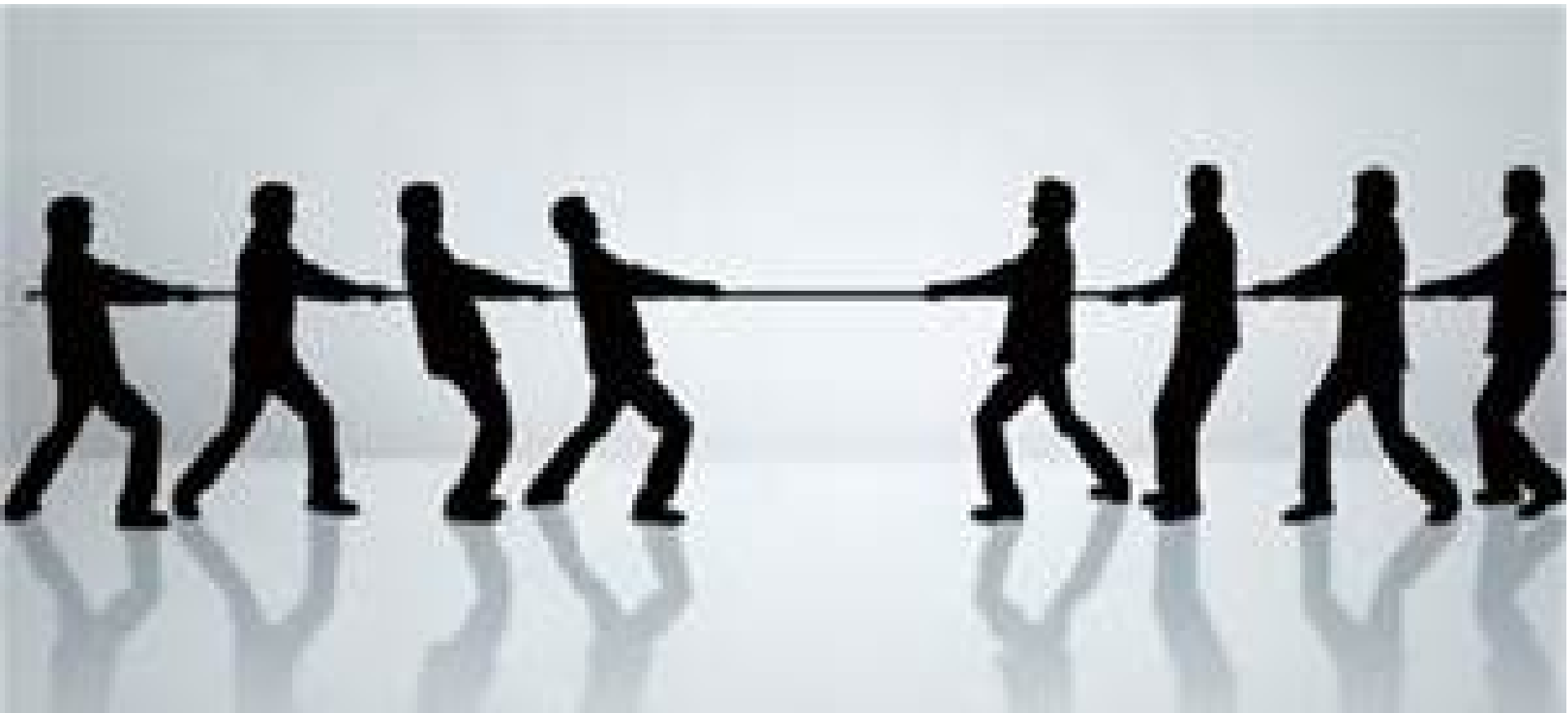
Market Forces and Regulations Affecting Investment Options for Public Agencies



The Solution

State-specific Local Government Investment Pools offer goals of safety, liquidity, and yield, and can take advantage of opportunities across these permitted investments



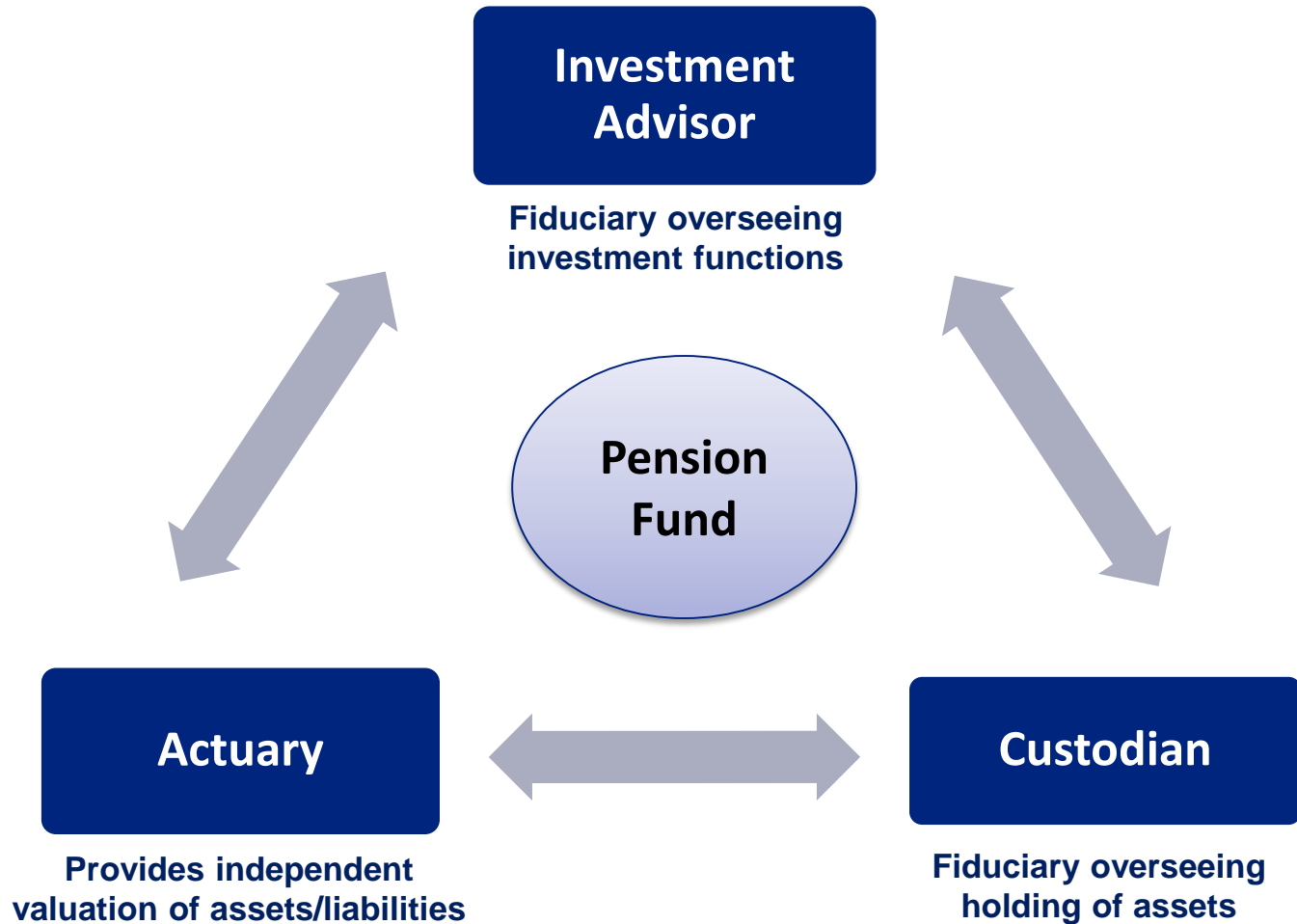


Potential Conflicts of Interest



*“So, I’m the only one who sees a
conflict of interest here?”*

Separation of Services



Independent Custodian

“One of the most important protections and a control against fraud is the separation of the safekeeping and custody function from the investment function” – GFOA

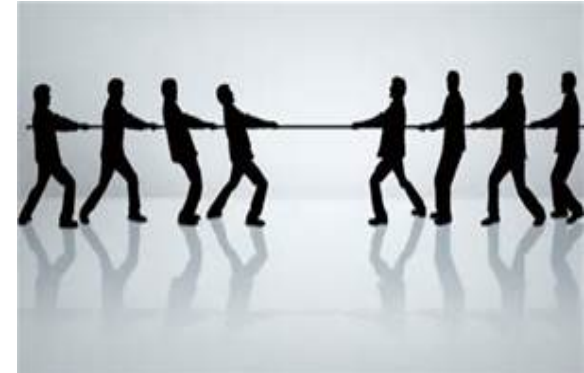
- Competitively select third-party custodian/safekeeping agent
- Agreement reviewed by legal counsel
- All transactions on a delivery-versus-payment (DVP) basis
- Designate a specific DDA clearing account
- Require mark the portfolio to market at least monthly
- Require reports, statements received directly from custodian
- Have electronic access to custody account for monitoring
- Require custodian be insured for errors and omissions

Source: Government Finance Officers Association (GFOA), Using Safekeeping and Third-Party Custodian Services, 2010

Potential Advisor Conflicts

- Consider independent, SEC registered investment advisors willing to commit in writing to being a fiduciary
- Advice 100% free from any conflicts, such as:
 - No propriety investment products recommended
 - No financial arrangements with third parties
 - No custody of assets
 - No commissions
 - No directed brokerage
 - No soft dollars
- Advisors with institutional focus on similar funds
- Independent, employee-owned

Recap of Today's Topics



Disclaimers

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