

## **BLUE FOLDER ITEM**

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### **BUDGET & FINANCE COMMISSION MEETING AUGUST 14, 2025**

J.2 CITY TREASURER'S FOURTH QUARTER, FISCAL YEAR 2024-25 REPORT

**CONTACT:** EUGENE SOLOMON, CITY TREASURER

- **BEYOND TOTAL RETURN PRESENTATION**

# BEYOND TOTAL RETURN

## *“The Quest For A Universal Benchmark”*

### 2025 GIOA Conference

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*Nothing is so simple that it cannot be misunderstood.*

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– Freeman Teague Jr.

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*"Public funds have been **measured by market performance** — but should they be?"*

# What is a Benchmark?

A benchmark is a standard or reference point used to measure and evaluate performance. In investing, a benchmark is typically a market index, standard, or custom framework that serves as a comparison for measuring the success of an investment portfolio or strategy.

However, the effectiveness of a benchmark depends entirely on its relevance to the objective being measured.

*Quality of the Answer is directly  
proportionate to the quality of Question!*

*Are we asking: “**Did the portfolio beat the market?**”  
instead of “**Did we manage it prudently?**”*

For far too long, the public fund industry has been asking the wrong type of question!

The benchmark is not the investment portfolio— it is the Standard of Care exercised in managing the investment portfolio.

The **real benchmark** isn't **Total Return** — it's whether fiduciary stewardship aligns with prudence and investment policy objectives.

# Key Objectives

- **Challenge** conventional benchmarking practices.
- **Differentiate** public funds from pension funds.
- **Understand** the role of prudence in creating a Universal Benchmark.
- **Define** the performance measures of a Universal Benchmark.
- **Establish** why a Statement of Stewardship should become a best practice for investment reporting.

## Public Funds vs. Pension Funds

*"Public funds and pension funds operate under different mandates—yet the industry often benchmarks them the same way. Why?"*

*"The distinction between public and pension funds can be understood through five key metrics: philosophy, mission, risk, investment style, and performance measurement."*



# Public Funds vs. Pension Funds

*How To Modify Wall Street To Fit Main Street*

Key Distinctions	Pension Funds – Wall Street	Public Funds – Main Street
Philosophy	Manage <b>Return</b> – Maximize long-term gains – Sleepless Nights	Manage <b>Risk</b> – Preserve capital first Sleep Adjusted Returns
Mission	<b>Maximize</b> Growth – Focus on return <i>on</i> investment.	<b>Preserve</b> Capital – Ensure return <i>of</i> investment.
Risk Approach	<b>Beat</b> the Market – Risk vs. Reward.	<b>Be</b> the Market – Budget vs. GASB 31.
Investment Style	<b>Trader</b> – Intends to sell before maturity.	<b>Investor</b> – Intends to hold to maturity.
Performance Benchmark	<b>Market Benchmark</b> – Performance vs. Peers.	<b>Stewardship</b> – Suitability – a policy-based evaluation.

# Key Takeaways

Public funds and pension funds serve fundamentally different purposes—yet they are often benchmarked the same way. This misalignment creates a flawed evaluation framework.

Public funds are **not traders or return maximizers**—they are **stewards of capital** with a duty to ensure safety, liquidity, income and policy adherence. A benchmark based on market returns does not measure stewardship effectively.

*A new policy-based benchmark, A Suitability Benchmark, is required.*

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*Not everything that counts can be counted, and not everything that can be counted counts.*

– William Bruce Cameron ”

*“Which came first: the Standard of Care (chicken) or the Investment Policy (egg)?”*

*Hint: It's not the egg!*

## Why Standard of Care First?

The Standard of Care (Prudent Investor or Prudent Person Standard) is the **foundation** of all fiduciary responsibility, shaping how investment decisions are made. Investment policy objectives are then a **function** of that duty, outlining how investments should be managed within the boundaries of fiduciary responsibility.

Recall: The effectiveness of a benchmark depends entirely on its **relevance to the objective being measured**. A benchmark should measure stewardship—not just total return.

## The Origin of The Prudent Man Rule

In 1830, Judge Samuel Putnam formulated the Prudent Man Rule. He wrote as a judgement in Harvard vs Amory case:

*"Do what you will, the capital is at hazard...All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs... considering the probable **income**, as well as the probable **safety** of the capital to be invested."*

***The Prudent Person (or Investor) Rule has been cited in countless cases as the foundational principle defining the modern responsibilities of trustees and fiduciaries.***

# Prudent Person vs. Prudent Investor: Comparison

Key Distinctions	Prudent Person Standard (Bond Buyer)	Prudent Investor Standard (Portfolio Manager)
Origin	Established in <i>Harvard College v. Amory</i> (1830).	Codified in the <i>Uniform Prudent Investor Act (UPIA)</i> (1994).
Focus	<b>Individual investments</b> are independently prudent.	The <b>entire portfolio must be prudent</b> ; aligning strategy with overall policy objectives and constraints.
Risk Approach	<b>Avoid risk</b> ; emphasize capital preservation over all else.	<b>Manage Risk</b> , emphasize capital preservation through diversification and balancing risk and return tradeoffs.
Standard of Care	Based on what a <b>“prudent person”</b> would reasonably do managing their own assets. <b>Focus on safety.</b>	Based on <b>Modern Portfolio Theory (MPT)</b> and fiduciary standards. <b>Emphasis on informed and deliberate decision-making.</b>
Diversification	<b>Not explicitly required.</b> Allows for concentration risk if deemed prudent.	Fundamental <b>duty to diversify</b> investments to reduce risk.
Performance Evaluation	Focused on assessing prudence of each <b>individual security.</b>	Focus is on evaluating the <b>entire portfolio’s prudence and performance.</b>
Delegation	<b>Limited delegation</b> : fiduciary retains full personal responsibility for all decisions.	Explicitly allows delegation to qualified third parties (e.g., investment managers), <b>provided proper oversight.</b>
Flexibility	<b>Rigid, traditional “buy and hold”</b> approach to manage risk. Often ignores market conditions after purchase.	<b>Adaptable</b> to changing market conditions and beneficiaries’ needs, allowing for <b>rebalancing</b> when consistent with fiduciary principles and statutory goals.

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*It is not enough to do things right; we must also do the right things.*

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– Peter Drucker

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*A good fiduciary is legal – a good steward is suitable.*

*Stewardship requires both Fiduciary Obligation (compliance) and Fiduciary Suitability (judgment)*

# Two Fiduciary Standards Of Prudence

## 1. Fiduciary Obligation: A Legal Standard

**\*Definition:** The fundamental duty of a fiduciary to act in the best interests of beneficiaries by adhering to legal, regulatory, and policy requirements governing investments.

## 2. Fiduciary Suitability: The Performance Standard

**\*Definition:** The duty to ensure investments are not only legally compliant but also prudent and aligned with the specific objectives of the investment policy.

*A public fund manager can meet fiduciary duty by following policy, **but true stewardship ensures investments align with investment policy objectives in order of priority.***



# Key Takeaways

## 1. The Standard of Care Comes First.

*\*It is the **foundation** for evaluating stewardship and performance.*

## 2. The Standard of Care Has Evolved.

*\*From Prudent Person (**single-security** focus) → To Prudent Investor (**portfolio-based** risk management).*

## 3. There are Two Fiduciary Standards.

*\*Fiduciary Obligation: The **legal** standard to comply with laws and policies and act in the best interest of the beneficiary.*

*\*Fiduciary Suitability: The **performance** standard to measure whether investments align with policy objectives.*

## 4. Good Stewardship Requires Both.

*\*A fiduciary can follow the law, but true stewardship ensures investments **serve their intended purpose**.*

## 5. The Suitable Benchmark Measures Stewardship Not Just Return.

*\*Total return does not measure prudence—only a benchmark that aligns **all policy objectives** can.*

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*What Gets Measured Gets Managed*

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– Peter Drucker

”

*If Public Funds are not Pension Funds*

*If Standard of Care is the Benchmark*

*Then how do we measure Stewardship?*

*Hint: It's not Total Return!*

# The Problems With Market-Based Benchmark & Using Total Return

*“Market-based benchmarks were designed for return-driven investors, not stewards of public funds.”*

**Misaligned Priorities** → Can encourage yield-chasing over safety, liquidity, income and policy adherence.

**Increased Risk-Taking** → Pressures fund managers to match market movements rather than focus on prudence and policy priorities.

**Distorted Decision-Making** → Measures success by returns instead of stewardship.

**Peer Comparisons Create Misleading Incentives** → Encourages herding behavior instead of policy-driven decisions.

**Flawed Accountability** → Makes it harder to evaluate stewardship and public fund performance correctly.

# The Solution

## Suitability Benchmark - The Universal Benchmark

*A Suitability Benchmark provides a measurable way to evaluate Stewardship—ensuring prudent investment decisions align with policy objectives.*

**Stewardship means prioritizing policy objectives** → Safety, liquidity, income, and policy compliance over return maximization

**Risk Management must be Policy-Based** → Ensuring investments meets fiduciary obligations (legal compliance) and fiduciary suitability (performance alignment with policy objectives).

### **Quantify Suitability with Measurable Investment Policy Metrics.**

- **Liquidity** → Does the portfolio maintain liquidity to meet expected cash flow needs without forced sales?
- **Duration Management** → Does the portfolio's structure align with interest rate risk tolerance and limits?
- **Credit Risk** → Are credit exposures aligned with approved ratings and diversification requirements?
- **Legality** → Are all investments within statutory and policy constraints?
- **Book Yield** → Does the portfolio generate stable income (book yield) rather than fluctuating market-returns?"

# Key Takeaways

- Market-based benchmarks do not measure prudence or evaluate a public fund's Standard of Care.
- Market-based benchmarks prioritize returns over other policy objectives, making them incompatible with public fund mandates.
- The Suitability Benchmark **quantifies** stewardship by measuring how well the portfolio aligns with policy objectives.
- Unlike pension fund benchmarks that focus on total return, the Suitability Benchmark ensures **all** policy objectives not just return are measured and met.

# Why Statement of Stewardship Should be A Best Practice

The Standard of Care (Prudent Investor or Prudent Person Standard) is the **foundation** of all fiduciary responsibility, shaping how investment decisions are made. Investment policy objectives are then a **function** of that duty, outlining how investments should be **managed** within the boundaries of fiduciary responsibility.

Recall: The effectiveness of a benchmark depends entirely on its **relevance** to the objective being measured. A benchmark should measure stewardship—not just total return.

## Statement of Stewardship

*"The investment portfolio has been managed in accordance with the **Prudent Investor Standard**, ensuring compliance with all fiduciary obligations and investment policy constraints. The portfolio's performance has been evaluated based on suitability metrics, including safety, liquidity, income stability, and policy adherence. Returns have been achieved within the framework of prudent risk management, ensuring alignment with statutory requirements and long-term fund objectives. The portfolio's structure and decisions reflect a commitment to responsible stewardship, balancing risk and return in a manner consistent with fiduciary duty."*

# Summary

## **Book Yield vs. Total Return:**

*The Right Measure Matters*

## **Total Return vs Suitability Based Benchmarking**

*The Right Standard of Care*



# Book Yield vs. Total Return

*The Right Measure Matters*

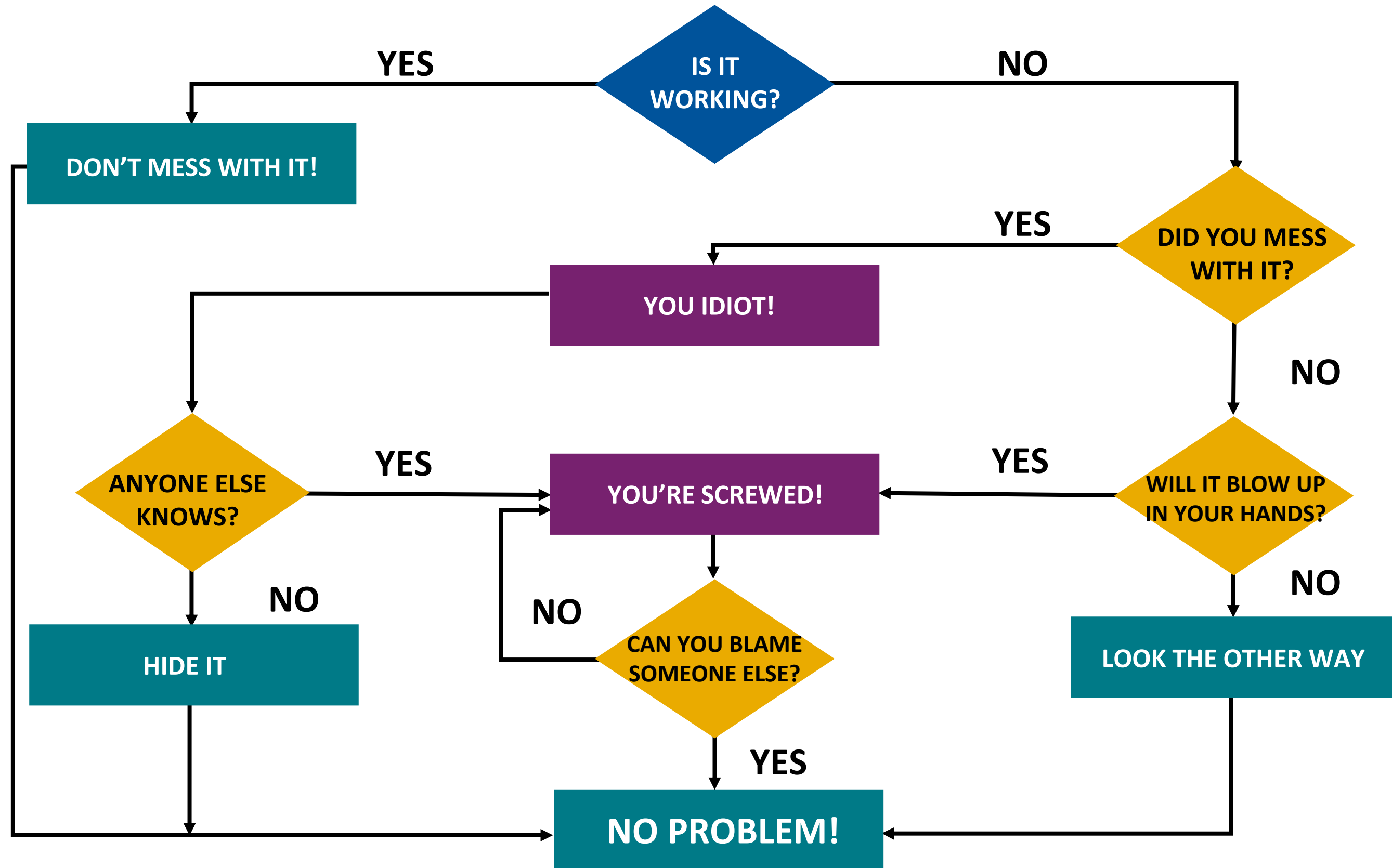
Key Distinctions	Total Return (Market-Based)	Book Yield (Budget-Focused)
Definition	Measures <b>fluctuations in market value</b> (realized & unrealized gains/losses).	Measures <b>actual income earned</b> on investments based on amortized cost.
Focus	<b>Market price volatility &amp; unrealized gains/losses.</b>	<b>Income stability &amp; policy adherence.</b>
Best For	<b>Market-driven investors</b> – prioritizes return maximization.	<b>Public funds with fixed income mandates</b> – focused on <b>cash flows &amp; budgets.</b>
Risk Sensitivity	<b>Highly sensitive to interest rate &amp; market movements</b> – creates misleading short-term results.	<b>Less affected by short-term market swings</b> – aligns with buy-and-hold strategies.
Policy Alignment	<b>Prioritizes yield over safety and liquidity.</b>	<b>Directly tied to investment objectives:</b> safety, liquidity, income.
Stewardship Measure?	<b>No</b> – market fluctuations do not reflect fiduciary prudence.	<b>Yes</b> – ensures prudent, policy-driven management.

# Total Return vs. Suitability Based Benchmarking

## *The Right Standard of Care*

Key Distinctions	Total Return Benchmarking (Market-Based)	Suitability-Based Benchmarking (Policy-Driven)
Primary Objective	Measures portfolio growth vs. market performance.	Measures Stewardship over Investment Portfolio.
Focus	<b>Return maximization</b> – prioritizes yield and performance vs. market.	Define and quantify the suitability metrics.
Risk Management	Encourages <b>higher risk-taking</b> to generate returns.	Ensures <b>risk is managed within policy constraints</b> – Liquidity, Duration, Credit, Legal, and Book Yield Target.
Performance Evaluation	<b>Compares performance to external market indices.</b>	Compares actual portfolio to Suitability Benchmark targets.
Policy Alignment	<b>Not tied to public fund mandates</b> – ignores unique liquidity, income, and statutory constraints.	<b>Directly aligned with investment policy objectives</b> – safety, liquidity, income, legality.
Decision-Making Impact	<b>Can distort priorities</b> – leads to short-term thinking and return chasing.	Ensures investment decision-making considers policy objectives in order of priority.
Stewardship Measure?	<b>No</b> – does not evaluate prudent fund management.	<b>Yes</b> – measures fiduciary obligation and suitability.

# Flowchart For Problem Resolution





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