



# Investment Policy: A Public Fund's Rule Book

## CSMFO 2018 Conference

February 22, 2018



## Section 1 | Investment Policy



*“A written investment policy is the single most important element in a public funds investment program.”*

From GFOA’s *Best Practice* on “*Creating an Investment Policy*”

- Why?
  - It improves the quality of decisions.
  - It demonstrates a commitment to the fiduciary care of public funds, with emphasis on balancing safety of principal and liquidity with yield.
  - It signals to rating agencies, the capital markets, and the public that a government entity is well managed and is earning interest income suitable to its situation and economic environment.

- Defines the investment program
  - Legal and permitted activities and investments
  - Who's in charge
  - Measurement of results
  - Relationship to counterparties
- Provides protection for the agency
- Addresses the dynamic nature of the investment process



- Finance officers have a fiduciary duty to perform:
  - Primary goals - *safety, liquidity, yield*
  - Secondary goals
    - Revenue goals
    - Establishing an investment strategy
    - Project-specific goals
    - Overall financial health of Agency
- These are all important—it isn't enough to simply park the funds and hope for the best outcome!

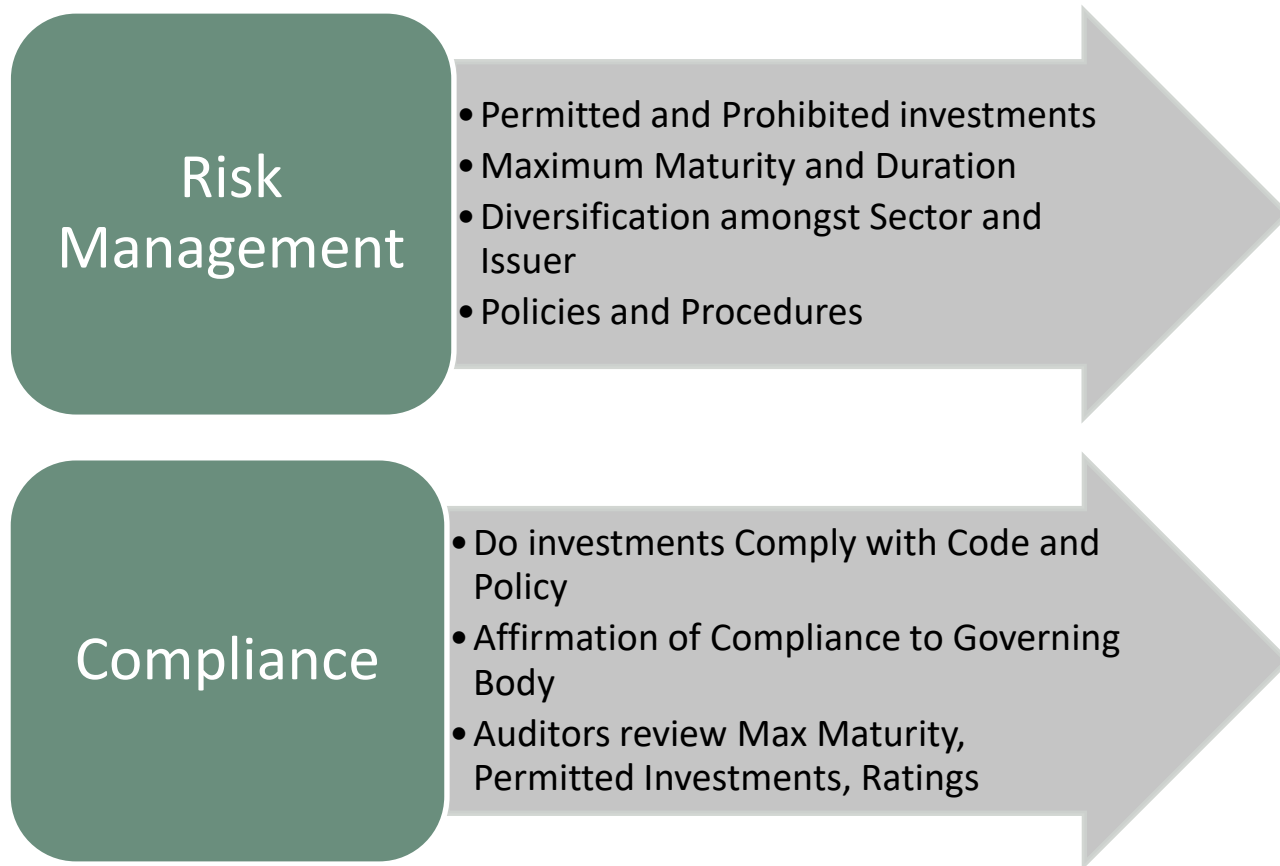


- Primary objectives of investment activities:
  - Safety
    - Mitigate interest rate risk
    - Mitigate credit risk
  - Liquidity
    - Meet anticipated cash flow requirements
    - Since all possible demands cannot be anticipated, hold securities that have active secondary markets
  - Yield / Total Rate of Return
    - Earn a reasonable return commensurate to appropriate level of risk
    - Establish appropriate benchmark(s)
- Quantify objectives and write them into the policy to create the foundation of an effective investment program

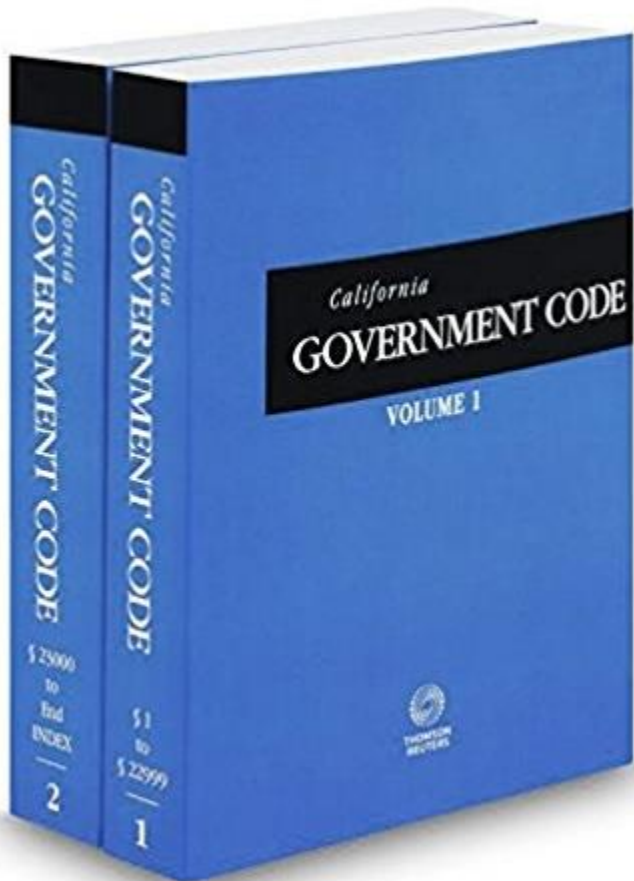


- Clear summary of internal controls
  - Handling of transactions
  - Requirements for 3<sup>rd</sup> party relationships
  - Custody arrangements
  - Protect the Agency from loss of funds due to:
    - Fraud
    - Employee error
    - Misrepresentation by 3<sup>rd</sup> parties
    - Unanticipated changes in the financial markets
    - Imprudent actions by employees and officers

## *An Investment Policy Formalizes Guidelines for Best Practices, Risk Management and Compliance*







- GFOA recommends an annual review:
  - To capture updates to Code
  - To include latest best practices
  - To review risk tolerances
  - To update permitted investments
  - To capture changes in Agency's operating environment
  - To update investment program goals and objectives



## Getting started

- Review state statutes governing investing and depositing public funds
- Consider:
  - Staffing expertise
  - Resources
  - Time availability
  - Risk tolerances
  - Political environment

- The objectives of the investment program are to achieve safety, liquidity, and return
- The investment policy serves as the framework for implementing the investment program
- The investment strategy establishes how to manage the portfolio with the proper risk profile
- The investment strategy is reflected in the choice of an appropriate benchmark
- Once chosen, the portfolio strategy should seldom change
- Tactical changes are made within the broader framework of the portfolio strategy

## Section 2 | Component Parts



- Components not all defined by Code
- Reflecting Industry Best Practices
- Sources for outlining your policy:
  - GFOA
  - CMTA
  - APT of US & C



- Introduction and Statement of Intent
  - Overview of entity
  - Invest funds in compliance with State and Local laws
  - Ensure prudent money management
  - Provide for daily cash flow requirements
  - **MAY** submit to the governing body and treasury oversight committee should one exist

- Scope
  - Funds covered by policy
    - General Fund
    - Special Revenue Funds
    - Debt Service Funds (may be subject to indenture)
    - Capital Project Funds
    - Enterprise Funds
    - Internal Service Funds
    - Other funds
- Not covered—Employee retirement benefit funds

- Persons authorized to make investment decisions are Fiduciaries
  - Board of Supervisors
  - Treasurers
  - Finance Directors
  - Investment Personnel
  - Oversight Boards
  - Investment Advisers
  - Brokers are ***NOT*** fiduciaries at this time
- Test of fiduciary duty compliance is one of conduct, not performance



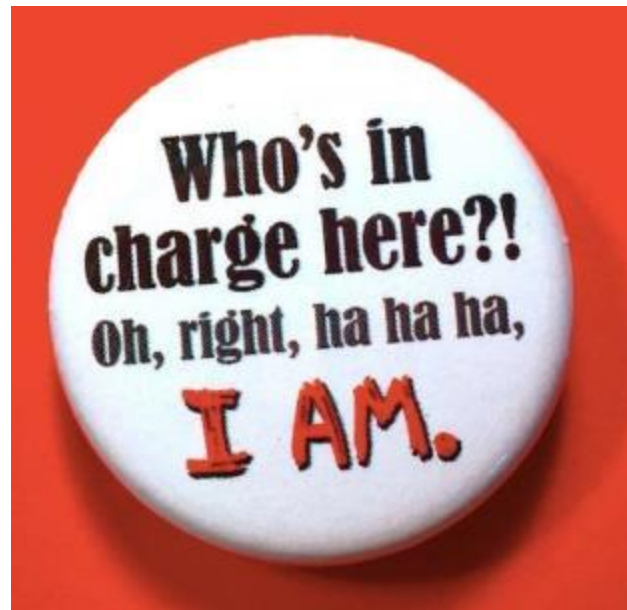
- By law a fiduciary must
  - Make decisions in the best interest of the beneficiary
  - Always put the beneficiaries' interests before their own
  - Act prudently
- Prudent Investor Standard

*“...a trustee shall act with care, skill, prudence, and diligence, under the circumstances then prevailing,...that a prudent person acting in a like capacity and familiarity with those matters would use...”*

- Beware: Prudent Investor Standard and Prudent Person Standard are not the same

- Primary objectives of investment activities:
  - Safety
    - Mitigate credit risk
    - Mitigate interest rate risk
  - Liquidity
    - Meet anticipated cash flow requirements
    - Since all possible demands cannot be anticipated, hold securities that have active secondary markets
  - Yield / Rate of Return
    - Earn a reasonable return relative to the risk being assumed
    - Establish appropriate benchmark(s)
- Quantify objectives and write them into the policy to create the foundation of an effective investment program

- Legislative body may delegate the investment authority to the Treasurer
- The Treasurer
  - Responsible for all transactions
  - Shall establish a system of controls to regulate the activities of subordinate officials





- Refrain from personal business activity that could conflict with investment program
- Provide public disclosure document by February 1 each year
- Refrain from personal investment transaction with same individuals employed by financial institutions conducting business with the local agency

- Maintain a list of authorized financial institutions
- Financial institutions and Broker/Dealer must provide
  - Audited financial statements
  - Proof of NASD certification
  - Trading resolution
  - Proof of State of California registration
  - Completed Broker/Dealer questionnaire
  - Certification of reading investment policy and depository contracts
- Conduct an annual review of financial institutions condition and registration



- Authorized and suitable investments
  - Research state statutes
  - Risk tolerance
  - Types of securities and transactions
  - Maximum maturities and weighted average maturities
  - Credit criteria
  - Repurchase agreement criteria
- California State Code
  - Section 53601 – local governments that do not pool money
  - Section 53635 – local governments that pool money





- Local agency's bonds
- Municipal securities—CA & local munis/treasuries of other 49 states
- US Treasuries
- Federal Agencies
- Bankers' Acceptances
- Commercial Paper
- Negotiable CDs
- Repo/Reverse Repo
- Medium-Term Notes
- Money Funds/Mutual Funds
- Pass-through securities
- LGIP
- Supranationals

- Review of holdings to ensure compliance with policy and code
  - Compliance at time of purchase
  - Annual review to identify securities out of compliance
  - Report out of compliance securities to governing board and oversight committee
  
- Develop procedure for out of compliance or downgraded securities



- Due diligence
  - Criteria for evaluating pools and mutual funds
- Questionnaire should answer these questions
  - Description of eligible securities and investment policy
  - Interest calculation and distribution methodology
  - Safekeeping and settlement information, pricing, and audit procedures
  - Eligibility to invest in program, limits on transaction frequency, deposit and withdrawal size
  - Schedule for receiving statements, including holdings and transaction list
  - Are reserves or retained earnings utilized
  - Fee schedule and method for assessing fee
  - Does pool accept bond proceeds



- Collateralization
  - Certificate of Deposit
    - Collateral needs to be 110% of market value
  - Repurchase Agreements
    - Collateral needs to be 102% of market value

- Safekeeping and Custody
  - All securities must be held by a third party custodian
  - Delivery vs payment (DVP) settlement
    - Fed wire
    - Depository Trust Company (DTC)



- Diversification
  - Diversification among asset classes
  - Diversification among issuers and issuer limitations
  - Diversification across industries
  
- Security type and issuer percentage of portfolio limits



- Match investments with anticipated cash flow requirements
- Maximum Maturities
  - Limitations per code
    - 5 year overriding limitation
    - Maximum maturity stated by security type
  - Permitted investments beyond 5 years
    - Requires governing body approval and a 60 day waiting period before investments are made
    - Limited to Treasury, Agency, and Municipal securities

- Internal controls are designed to ensure assets are protected from loss, theft or misuse
  - Controls are detailed in the investment policy procedures
  
- Establish an annual process of independent review by an external auditor



- Objective is to obtain a rate of return throughout budgetary and economic cycles commensurate with the risk constraints and cash flow needs
- Choose a benchmark that represents the appropriate level of risk for the portfolio
- Compare Returns:
  - How is your portfolio performing relative to the benchmark?
- Compare Risk:
  - Is your portfolio's volatility within expectations versus benchmark?
- Using an earnings target as a benchmark

# What Makes a Good Benchmark?



- An unmanaged portfolio that includes the types and maturities of securities that are permitted in the investor's policies
- Representative of assets in which the fund may invest
- Constructed in a disciplined and objective manner
- Formulated from publicly available information
- Exhibit similar risk characteristics as the investment objectives
- Known in advance
- The information derived from both the benchmark and the portfolio should use the same calculation methods





- There are several providers of fixed income market indices such as Barclays (formerly Lehman Brothers), ICE Bank of America Merrill Lynch, and Citigroup
  - Index of 91 day T-bill Security
  - Index of 1 Year T-bill Security
  - Index of 1-3 Year Treasury Securities
  - Index of 1-3 Year Government Securities
  - Index of 0-5 Year Treasury Securities
  - Index of 1-5 Year Government Securities
  - Index of 1-5 Year Corporate (A and above)/Government Securities

- Yield = income from current investments + projection of reinvestment income
  - Used to forecast income for line item in next year budget
  - And often, to compare portfolio return to a yield benchmark
- Realized return: Adds realized gains and losses
  - No realized return benchmark
  - Return information can be distorted
- Total rate of return
  - Incorporates all elements of return – income, realized and unrealized gains and losses, reinvestment of cash flows
  - Can be used to provide comparable results in a consistent format

- If the governing body delegates investment authority to the Treasurer, the Treasurer must submit a transaction report monthly
- The Treasurer **MAY** submit a quarterly report to the governing body
- The quarterly report must be submitted within 30 days of quarter end
- If a quarterly report is submitted it must include
  - Type of investment, issuer, maturity date, par value, amount invested
  - Descriptions of funds under management of contracted parties
  - Current market value and source for contracted funds excluding LAIF

- Empower staff to control risk parameters
- Provide tools for booking earnings
- Ensure transparency for stakeholders
  - Be careful with the information you share
    - Robust enough to understand status
    - Specific enough to be relevant
    - Broad enough to not bog readers down with minutiae
  - Common components
    - Par value, amortized cost, market value
    - Transactions
    - Weighted average maturity and/or duration
    - Yield to maturity

- The policy shall be adopted by resolution by the governing body
- The policy shall be reviewed annually by the governing body and any modifications approved by the governing body
- The designated official shall establish written investment policy procedures

- An Investment Procedures Manual assists the staff in day-to-day operations of the investment program
- It should include explicit delegation of authority for executing transactions and investment decisions and include reference to procedures like:
  - Review of daily cash balances
  - Process for selecting investments
  - Steps for purchasing an investment
  - Settlement and safekeeping process
  - Wire transfer agreements
  - Banking service contracts
  - Collateral/depository agreements



- Glossary
  - Definitions of investment terms
  - Definitions of investment vehicles
  - Definitions of accounting terms
  - Sample
    - <http://chandlerasset.com/news-resources/glossary/>

- Start by
  - Examining State Statutes
  - Review sample investment policies, but don't just copy
- The Policy is an internal document
  - Involve staff responsible for investments
  - Prepare draft of new policy and anytime making revisions
  - Have the right parties review the drafts
- The Policy is an external document
  - Distribute to outside parties
- Get governing body approval
  - As resolution, ordinance, etc.
- Perform annual reviews & updates



- CMTA
  - CMTA Investment Policy Certification Program and Application
    - [https://c.ymcdn.com/sites/cmta.site-ym.com/resource/resmgr/imported/forms/2013\\_CMTA\\_Investment\\_Policy.pdf](https://c.ymcdn.com/sites/cmta.site-ym.com/resource/resmgr/imported/forms/2013_CMTA_Investment_Policy.pdf)
- CMTA
  - Sample Certified Investment Policies
    - [http:// www.cmta.org/?page=39](http://www.cmta.org/?page=39)
- APT of US & C
  - Investment Policy Certification Program and Application
    - [https://www.aptusc.org/images/certification/investment\\_model\\_policy\\_app\\_2015.pdf](https://www.aptusc.org/images/certification/investment_model_policy_app_2015.pdf)

- CDIAC
  - Local Agency Investment Guidelines, 2017
    - [http:// www.treasurer.ca.gov/cdiac/LAIG/guide](http://www.treasurer.ca.gov/cdiac/LAIG/guide)
- CDIAC
  - Investment Policy Reporting Practices: An Informational Guide, 2006
    - [http:// www.treasurer.ca.gov/cdiac/reports/policy.pdf](http://www.treasurer.ca.gov/cdiac/reports/policy.pdf)
- CDIAC
  - California Public Fund Investment Primer, Updated 2009
    - [http:// www.treasurer.ca.gov/cdiac/invest/primer.pdf](http://www.treasurer.ca.gov/cdiac/invest/primer.pdf)

- Government Finance Officers Association (GFOA) Best Practices
  - Investment Program for Public Funds
    - <http://gfoa.org/investment-program-public-funds>
  - Investment Policy
    - <http://gfoa.org/investment-policy>
  - Local Government Investment Pools
    - <http://gfoa.org/local-government-investment-pools>
  - Using Benchmarks to Assess Portfolio Risk and Return
    - <http://gfoa.org/using-benchmarks-assess-portfolio-risk-and-return>
  - *Investing Public Funds* by Girard Miller et. al.—a GFOA publication

## Section 3 | Recent Legislative Changes





- Credit Rating Agency Modifiers
- Private sector assistance placing deposits
- Supranationals
- Security suitability
- Depository institution balance report
- CRA rating change

- Chapter 366, Statutes of 2016 (SB 974)
- State Code now makes reference to the rating category only
- The 3 major NRSROs use letter rating categories
  - Fitch (AAA to A)
  - Moody's (Aaa to A)
  - Standard & Poor's (AAA to A)
- Each use a modifier within each whole letter rating category
  - Fitch (+ or -)
  - Moody's (1, 2, or 3)
  - Standard & Poor's (+ or -)



- Chapter 181, Statutes of 2015 (AB 283)
- Extends the authority to use a private sector entity to assist placing deposits to January 1, 2021
  - Invest up to 30 % in placement service certificates of deposit (CDs)
  - Invest 30 % in negotiable certificates of deposit

- Chapter 59, Statutes of 2014 (AB 1933)
- Invest in US dollar denominated senior unsecured unsubordinated obligations issued or unconditionally guaranteed by
  - International Bank for Reconstruction and Development (IBRD)
  - International Finance Corporation (IFC)
  - Inter-American Development Bank (IADB)
- Maximum 30% and 5 year maturity
- Minimum credit rating of AA





- Financial Industry Regulatory Authority (FINRA) Rule 2111
- A broker must perform reasonable diligence to understand the nature of the recommended security or investment and determine whether the recommendation is suitable
- A broker must have a reasonable basis to believe that a recommendation of a security or investment is suitable for the particular customer based on the customer's investment profile



- Chapter 214, Statutes of 2014 (AB 2298)
- Depository institutions that accept local agency deposits to submit their weekly balance report of those deposits to the Commissioner of Business Oversight by fax or email in addition to hand-delivery or mail



- State Code 53635.2 requires a minimum CRA rating of “satisfactory” by appropriate federal financial supervisory agency
- The Office of the Comptroller of the Currency downgraded the final rating of Wells Fargo Bank to “Needs to Improve”
  - Which Local Agencies does this effect
    - Local Agency definition under 53630
    - Local Agency definition under 53635
  - What does this effect
    - Deposits
    - Investment

- California Debt and Investment Advisory Commission
  - Debt Line Newsletter
    - <http://www.treasurer.ca.gov/cdiac/debtpubs/2017/201703.pdf>
  - Local Agency Investment Guidelines
    - <http://www.treasurer.ca.gov/cdiac/LAIG/guideline.pdf>
- California State Treasurer
  - Intersections Newsletter
    - <http://www.treasurer.ca.gov/newsletter/2017/201703/lead.asp>



- Financial Industry Regulatory Authority - FINRA
  - Regulatory Notice 12-25, Suitability
    - <http://www.finra.org/file/regulatory-notice-12-25>

## Section 4 | Disclosures





The information herein is provided for informational purposes only and should not be construed as a recommendation of any security, strategy or investment product, nor an offer or solicitation for the purchase or sale of any financial instrument. References to asset classes, securities, portfolio structure, or strategies are for informational purposes and do not imply that managing portfolios with those securities will achieve comparable returns. Past performance is not indicative of future results. Unless otherwise noted, Chandler is the source of data contained in this presentation.

Fixed income investments are subject to interest, credit and market risk. Interest rate risk: the value of fixed income investments will decline as interest rates rise. Credit risk: the possibility that the borrower may not be able to repay interest and principal. Low rated bonds generally have to pay higher interest rates to attract investors willing to take on greater risk. Market risk: the bond market in general could decline due to economic conditions, especially during periods of rising interest rates.

Source ice Data Indices, LLC ("ICE"), used with permission. ICE PERMITS USE OF THE ICE INDICES AND RELATED DATA ON AN "AS IS" BASIS; ICE, ITS AFFILIATES AND THEIR RESPECTIVE THIRD PARTY SUPPLIERS DISCLAIM ANY AND ALL WARRANTIES AND REPRESENTATIONS, EXPRESS AND/OR IMPLIED, INCLUDING ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, INCLUDING THE INDICES, INDEX DATA AND ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM. NEITHER ICE DATA, ITS AFFILIATES OR THEIR RESPECTIVE THIRD PARTY PROVIDERS GUARANTEE THE QUALITY, ADEQUACY, ACCURACY, TIMELINESS OR COMPLETENESS OF THE INDICES OR THE INDEX DATA OR ANY COMPONENT THEREOF, AND THE INDICES AND INDEX DATA AND ALL COMPONENTS THEREOF ARE PROVIDED ON AN "AS IS" BASIS AND LICENSEE'S USE IS AT LICENSEE'S OWN RISK. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD PARTY DO NOT SPONSOR, ENDORSE, OR RECOMMEND CHANDLER ASSET MANAGEMENT, OR ANY OF ITS PRODUCTS OR SERVICES.