

Investment Policy

CCTA/CPTA

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Why an investment policy?

- Defines investment program
 - Legal & permitted activities
 - Who's in charge
 - Measurement of results
 - Relationship to counterparties

- Protection

- Dynamic process



Writing or updating policy

Getting started

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



Components of an investment policy - 1

1. Introduction
2. Scope
3. Objectives
4. Statement of Prudence and Indemnification
5. Ethics and Conflicts of Interest
6. Delegation of Authority
7. Authorized & Suitable Investments
8. Authorized Financial Dealers & Institutions
9. Safekeeping and Custody



Components of an investment policy - 2

9. Risks
10. Diversification
11. Internal Controls and Investment Procedures
12. Performance Standards
13. Reporting
14. Investment Committee
15. Investment Policy Adoption
16. Appendices

- This section specifies which funds are covered by this investment policy and which are not
- Possible language:
 - “This policy applies to the investment of all funds, excluding the investment of employees' retirement funds.”*
 - “Proceeds from certain bond issues, as well as separate foundation or endowment assets, are covered by a separate policy.”*
- Can also address pooling of funds
 - “...the [agency] will consolidate cash and reserve balances from all funds to maximize investment earnings and to increase efficiencies ...”*

**source – GFOA Sample Investment Policy*



Investment objectives - SLY

- Sets tone for policy and program
 - Safety
 - Preserve principal
 - Invest in high-grade fixed-income securities
 - Prudence in managing risk
 - Liquidity
 - Assure funds available when needed
 - Invest in highly marketable securities
 - Yield/return
 - Yield measures income
 - Total return measures outcomes



Standard of prudence

- Prudent person
- Prudent investor
- Prudent expert



Prudent Person language – CRS 15-1-304

Standard for investments

“In acquiring, investing, reinvesting, exchanging, retaining, selling, and managing property for the benefit of others, *fiduciaries shall be required to have in mind the responsibilities which are attached to such offices** and the size, nature, and needs of the estates entrusted to their care and shall exercise the judgment and care, under the circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of the property of another, not in regard to speculation but in regard to the permanent disposition of funds, considering the probable income as well as the probable safety of capital...”

* emphasis added

- An individual or institution
- Special relationship of trust with another person or group
- Legally responsible for their assets



Examples of fiduciaries

- Treasurers
- Finance directors
- Investment personnel
- Oversight boards
- Investment advisers
- Brokers are not



Fiduciary decisions and actions

By law a fiduciary must:

- Make decisions in the best interest of the beneficiary
- Act prudently
- Always put the beneficiaries' interests before their own



Evaluating compliance with fiduciary duty

- Test of compliance is one of conduct, not performance
- Measures for evaluating compliance
 - Establishment of formalized investment policy
 - Compliance with policy
 - Prudent investment decisions
 - Best price trade executions
 - Diversification of risk
 - Strict avoidance of conflicts of interest



Fiduciary case study

Scenario

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 treasurer 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.



Indemnification

- Protection for investment staff who are acting in accordance with policies and procedures
- Possible language:
 - “Investment officers acting in accordance with written procedures and this investment policy and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely fashion and the liquidity and the sale of securities are carried out in accordance with the terms of this policy.”*

**source – GFOA Sample Investment Policy*



Ethics and Conflicts of Interest

- May be governed by other laws
- Possible language:
 - “Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with the proper execution and management of the investment program, or that could impair their ability to make impartial decisions. Employees and investment officials shall disclose any material interests in financial institutions with which they conduct business. They shall further disclose any personal financial/investment positions that could be related to the performance of the investment portfolio. Employees and officers shall refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of the [agency]. “*

**source – GFOA Sample Investment Policy*



Delegation of Authority

- Explicit delegation of responsibility for conducting transactions and managing program

- Possible language:
 - “Authority to manage the investment program is granted to [designated official, hereinafter referred to as investment officer] and derived from the following: [insert code citation, ordinances, charters or statutes]. Responsibility for the operation of the investment program is hereby delegated to the investment officer, who shall act in accordance with established written procedures and internal controls for the operation of the investment program consistent with this investment policy.”*

**source – GFOA Sample Investment Policy*



Authorized Investments

- Considerations:
 - Research state statutes
 - Risk tolerance
 - Types of securities & transactions
 - Maximum maturities & weighted average maturities
 - Credit criteria
 - Repurchase agreement criteria
- Establish:
 - Competitive transaction execution procedures
 - Delivery-versus-payment (DVP)
 - Third-party custody



CRS Approved Investment Instruments

- Treasury securities
 - Bills, notes, bonds
- Agency securities
 - Discount notes, coupon notes, callable securities
- Commercial paper
- Corporate bonds
- Local Government Investment Pools
- Repurchase agreements
- Money Market Mutual Funds
- Certificates of deposit
- Municipal bonds

CRS 24-75-601.1 - Legal investments - 1

- a) **Treasuries** - “Any security issued by, fully guaranteed by, or for which full credit of US treasury is pledged for payment...”
 - Maximum maturity - 5 years

- b) **Agencies** – “Any security issued by, fully guaranteed by, or for which the full faith and credit of the following is pledged for payment: federal farm credit bank, federal land bank, federal home loan bank, federal home loan mortgage corporation, federal national mortgage association, export-import bank, Tennessee valley authority, government national mortgage association, world bank, or an entity...created by...legislation enacted by US congress...”
 - Maximum maturity – 5 years
 - Rated in highest category by two or more NRSROs

CRS 24-75-601.1 - Legal investments - 2

- d) **GO bonds** – “...general obligations of any state..., District of Columbia, or territorial possession...or any political subdivision...”
 - Rated in one of two highest rating categories by two or more NRSROs (nationally recognized statistical rating organization)
 - Maximum maturity – 3 years

- e) **Revenue bonds** - “...revenue obligations of any state..., District of Columbia, or territorial possession...or any political subdivision...”
 - Rated in one of two highest rating categories by two or more NRSROs
 - Maximum maturity – 3 years

CRS 24-75-601.1 - Legal investments - 3

- h) Entity's own bonds** – “Any security of the investing public entity or any certificate of participation or other security evidencing rights in payments to be made by the investing public entity...”
- i) LGIP** – “Any interest in any local government investment pool organized pursuant to part 7 of this article.”
- j) Repo** – “Purchase of any repurchase agreement concerning any securities referred to in paragraph (a) or (b)...if <following> conditions are met:”

 - Securities are marketable
 - DVP settlement at 3rd party custodian for perfected interest
 - Collateral at no less than 102% and marked-to-market at least weekly
 - Collateral may have maturity in excess of 5 years
 - Repo 5-year maturity limit unless authorized by governing body

CRS 24-75-601.1 - Legal investments - 4

- k) Money Market Fund** – “Any money market fund that is registered as an investment company under the federal “Investment Company Act of 1940”, as amended, if, at the time the investing public entity invest in such fund:”
- Policies of fund includes maintaining constant share price
 - No sales or load fee
 - Complies with rule 2a-7 under the “Investment Company Act of 1940”
- l) GICs** – “Guaranteed investment contract, guaranteed interest contract, annuity contract, or funding agreement if...the long-term credit rating...of the <counter-party> is...in one the two highest rating categories by two or more <NRSROs>.”
- Maximum maturity 3 years unless purchased with bond proceeds

CRS 24-75-601.1 - Legal investments - 5

- m) Corporate and bank debt** – “Any corporate or bank security issued by corporation or bank...organized and operated within US...must carry at least two credit ratings from <NRSROs> and must not be rates below “AA- or Aa3”...If...money market instrument such as commercial paper or bankers’ acceptance...must carry at least two credit ratings from <NRSROs> and must not be rates below “A1, P1, or F1”
- Maximum maturity is 3 years
 - At no time shall aggregate book value of corporate and bank debt exceed 50% of portfolio book value unless authorized by governing body
 - At no time shall aggregate book value of a single issuer exceed 5% of portfolio book value unless authorized by governing body
 - **What about TLGPs (Temporary Liquidity Guarantee Program)?**



Financial Institutions

- **Depositories and custodian** – possible language
 - “A list will be maintained of financial institutions and depositories authorized to provide investment services. “*

- **Broker/dealers** – possible language
 - “In addition, a list will be maintained of approved security broker/dealers selected by creditworthiness (e.g., a minimum capital requirement of \$10,000,000 and at least five years of operation). These may include "primary" dealers or regional dealers that qualify under Securities and Exchange Commission (SEC) Rule 15C3-1 (uniform net capital rule).”*

- **Investment advisers** – possible language
 - “The <agency> may engage the services of an external investment manager to assist in the management of the <agency’s> investment portfolio in a manner consistent with the <agency’s> objectives. Such managers must be registered under the Investment Advisers Act of 1940.”

**source – GFOA Sample Investment Policy*



Depositories and Custodians

- Treasury management services
 - Primary bank
 - Secondary bank(s)
- Custodial services
 - Settlement of security transactions
 - Depository for physical & book-entry securities
 - Receive payments from:
 - Interest income
 - Sold, matured and called securities
 - Provide safekeeping receipt of investment transactions
 - Monthly statements

- Brokers
 - Bring buyers and sellers together
 - Don't take positions
- Dealers
 - Take positions
 - Inventory
 - Primary
 - Secondary
- Some firms perform both functions



Selecting Broker - Dealers

- Perform due diligence
- Possible required documentation as appropriate:
 - Audited financial statements
 - Proof of Securities Industry and Financial Markets (SIFMA) registration
 - Proof of state registration
 - Completed broker/dealer questionnaire
 - Certification of having read and understood investment policy
 - Evidence of adequate insurance coverage



Investment Adviser

- Investment firm with demonstrated expertise in managing portfolios
- SEC registration and regulation under Investment Advisers Act of 1940
- Fiduciary
- “Prudent Expert” Standard of Care
- Fee-based compensation



Working with an Investment Adviser

- Selecting an investment adviser
 - RFP, interviews, references
- Getting started
 - Agreement, approval, expectations, strategy, procedures
- Controls
 - Documentation, reporting, 3rd party safekeeping, no self-dealing
- Evaluations
 - Benchmark, performance results, fulfilling expectations



Managing investment risk

Portfolio management is risk management

- The greater an investor's exposure to properly diversified risk, the higher the expected return over time.
- The greater an investor's exposure to risk, the higher will be the volatility of return from period to period.
- The objective of "safety" requires establishing risk constraints.



Types of risk

- **Market risk** - is the risk that the portfolio value will fluctuate due to changes in the general level of interest rates
- **Credit risk** - is the risk that a security or a portfolio will lose some or all of its value due to a real or perceived change in the ability of the issuer to repay its debt.
- **Liquidity risk** – 1) portfolio won't provide adequate cash flow for the agency; 2) a security can't be sold, if necessary, at a good price
- **Reinvestment risk** – reinvesting cash flows from bond at the market rate at the time the cash flow occurs



Mitigating risk

- Market risk
 - Maximum maturities
 - Weighted average maturity
 - **Diversification** of maturities
- Credit risk
 - Authorized sectors of the market
 - **Diversification** of sectors and issuers
 - % maximum and minimums for each sector
 - % maximum per issuer
 - Procedures for rating changes



Mitigating risk

- Liquidity risk
 - Minimum percent in short, liquid investments
 - Segmenting portfolio
 - Marketable securities
- Reinvestment risk
 - Maturity **diversification**
 - Callable security limits
- Using benchmarks
 - To define risk profile for portfolio
 - To provide guidance for portfolio structure
 - To measure performance
 - To measure risk management



Procedures and controls

- Policymakers assign:
 - The responsibility for establishing written procedures and internal controls in the policy
 - The areas to be addressed in the policy
- Management develops:
 - Detailed procedures and a system of internal controls in a separate document
- Monitoring procedures and controls
 - Internal auditors
 - External auditors

- Possible language:
 - “The Finance Director/Treasurer shall establish written investment policy procedures in an *Investment Procedures Manual* to assist investment staff with day-to-day operations of the investment program consistent with this policy. Such procedures shall include explicit delegation of authority to persons responsible for investment transactions. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the Finance Director/Treasurer. The procedures should include reference to:
 - Review of daily cash balances;
 - Process for selecting investments;
 - Steps for purchasing an investment;
 - Settlement and safekeeping process;
 - Wire transfer agreements;
 - Banking service contracts; and,
 - Collateral/depository agreements.”



Internal controls

- Possible language:
 - “The Finance Director/Treasurer is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the City are protected from loss, theft or misuse. The internal control structure shall be designed to provide reasonable assurance that these objectives are met. Internal controls shall be in writing and shall address the following points:
 - Control of collusion;
 - Separation of transaction authority from accounting and record keeping;
 - Third-party safekeeping of assets;
 - Clear delegation of authority to subordinate staff members;
 - Staff training;
 - Dual authorizations of wire transfers; and,
 - Written confirmation of telephone transactions for investments and wire transfers.



Performance standards

- Possible language:
 - “The investment portfolio shall be designed with the overall objective of obtaining a total rate of return throughout economic cycles, commensurate with investment risk constraints and cash flow needs, which is approximately equal to the return on the agency’s selected market benchmark index.”

- Measurements
 - Yield
 - Realized return
 - Total return



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
- The information derived from both the benchmark and the portfolio should use the same calculation methods
- Known in advance



What a benchmark does

- Replicates entity's selected risk profile for portfolio
- Keeps you focused on managing risk in entire portfolio
- Provides guidance for investment decisions
- Controls exposure to:
 - Market risk (duration; weighted average maturity)
 - Credit risk (sector allocation)
- Improves expectations in all market environments
- Provides clarity of strategy communication to board



Documentation, Reporting and Evaluation

- Trade documentation
 - Trade ticket
 - Broker confirmation
 - Custodian statements
- Comprehensive reports
 - Summary of portfolio characteristics
 - Accounting of investments
 - How frequent – monthly; quarterly
- Performance results
 - Yield – earnings
 - Total return - how is risk being managed versus benchmark



Evaluating return

- Yield: income from current and new investments + projection of income from reinvestment
 - Used to project income for line item in next years budget
 - Does not reflect the outcome of portfolio decisions
- Realized return: Actual income plus realized gains and losses
 - Used to measure the realized level of income from the portfolio
 - No realized yield benchmark
 - Return information can be distorted

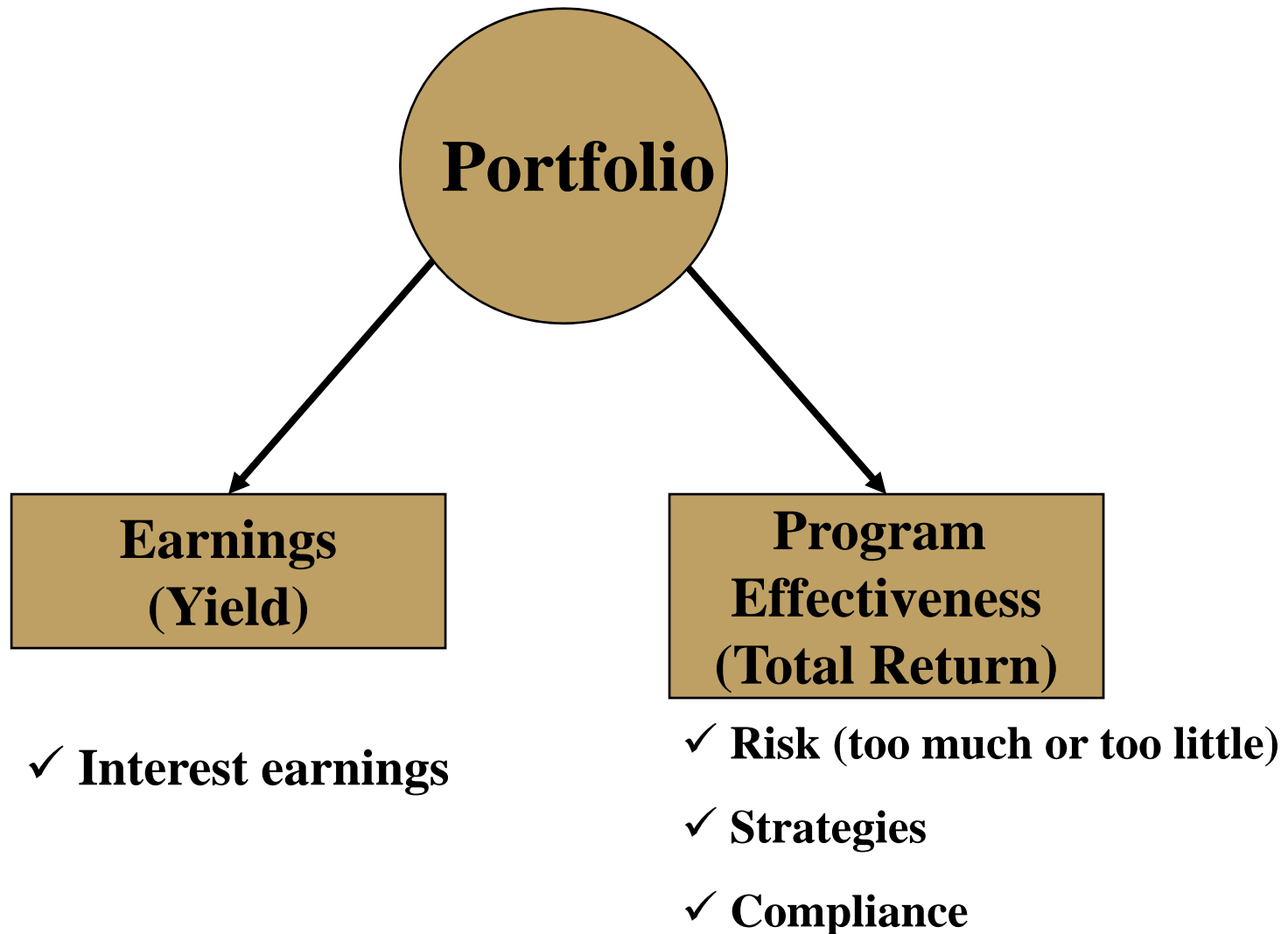


Total rate of return

- Total rate of return (TRR) measures the outcome of the portfolio
- Incorporates all three elements of return
 - Interest income
 - Market value gains and losses—realized and unrealized
 - Reinvestment of interest
- Agreed upon industry standard
- Uniformly applied to all portfolios
- To provide comparable, consistent results



Evaluating the investment program





Investment committee

- To have or not to have – that is the question?
 - Not necessary nor practical for all entities
- Purpose of committee
- Composition of committee
 - Internal members
 - External members
- Oversight role
- Frequency of meetings
- Types of reports for meetings



Possible Appendix Items

- Glossary of terms
- Authorized personnel
- Statutes, ordinances, etc.
- Authorized broker-dealers
- Authorized depositories



Additional policy thoughts

- Internal document
 - Involve staff responsible for investments
- External document
 - Distribute to outside parties
- Board approval
 - As resolution, ordinance, etc.
 - Signatures
- Annual reviews & updates
- Investment committee
- Possible appendices



Investment policy help

- GFOA
 - Sample Investment Policy
 - (312) 977-9700 www.gfoa.org

- Association of Public Treasurers
 - “Model Investment Policy”
 - (301) 495-5560; www.aptusc.org
 - Policy certification program \$200 for members; \$300 for non-members



Biography

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Ned Connolly is Senior Vice President for Chandler Asset Management, an investment advisory firm specializing in the management of public funds, headquartered in San Diego with offices in Golden, CO. He has twenty-four years experience in the investment industry in the areas of institutional fixed-income investing and portfolio management. He has assisted public entities in Colorado and throughout the country develop and implement sound and successful investment programs and practices. Mr. Connolly is a member of the Government Finance Officers Association's Committee on Treasury and Investment Management. He has been an instructor and speaker on various investment topics for the GFOA; CGFOA; Association for Public Treasurers; California Debt and Investment Advisory Commission; and numerous state and regional associations.

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