by Bruce A. Ring, Jr.

Investing Public Funds: What You Need To Know

The Missouri State Treasurer's Office (STO) is asked on a fairly regular basis about appropriate investments for political subdivisions in the state of Missouri. The answers are not usually a simple "do this." We look at quite a bit of background information on cash flow timing, history, comfort with investment alternatives, experience of the portfolio manager, and more. This article provides a little guidance on the appropriate considerations when investing excess cash.

Safety

In general, Missouri laws only allow for relatively safe investments. That said, there is a degree of risk associated with most investments allowed under the law. For instance, Commercial Paper (CP) is nothing more than a promise to pay from a private company. There is risk of default associated with the purchase of CP, unlike the purchase of a Treasury bill or note that is widely considered risk free. You, as the investor, need to decide whether or not the increase in yield afforded by the CP is worth the added risk. Do not buy CP if you are not familiar with commercial credit and default risk. Many political subdivisions prefer what they consider risk-free investments like Treasuries, or fully-insured bank deposits. Since both carry a full faith and credit promise of the U.S. government, investors feel they are going to be assured of getting back the investment and return.

Government-Sponsored Enterprises, or agencies, as they are referred to, (Fannie Mae, Freddie Mac, Farmer Mac, Farm Credit and Home Loan) carry what is known as a "moral obligation" of the federal government. They are not specifically guaranteed, but there is a perceived obligation on the part of the government to pay the debt if something were to happen to one of the agencies. That said, there is a degree of risk associated with the agencies, albeit very negligible. There are some government agencies (TVA, SBA, Ginnie Mae and FDIC) that do carry a specific full faith and credit obligation of the U.S. government, and are akin to Treasuries and bank deposits from a safety standpoint. However, these securities tend to be a little more complex and require a thorough understanding of the structure before purchasing them.

In order, from safest to riskiest investments, the following would apply:

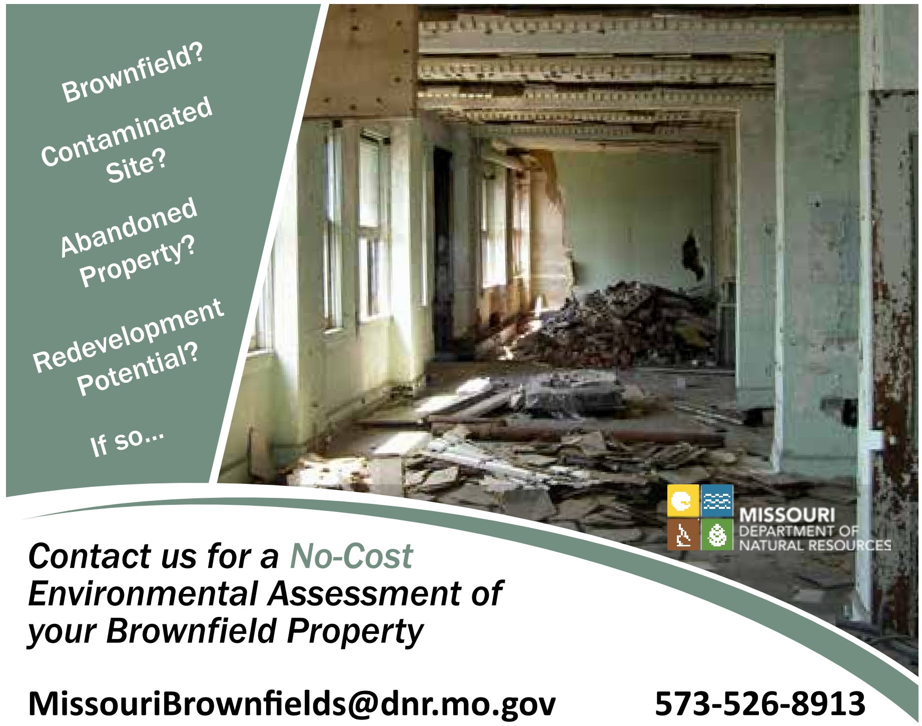
- U.S. Treasury bills and notes;
- Fully insured bank deposits, obligations issued by agencies carrying the full faith and credit backing of the U.S. government;
- Fully-collateralized bank deposits and repurchased agreements;
- Obligations issued by one of the GSE's (agency debt); and
- Commercial Paper and Bankers Acceptances (both carry commercial credit risk but have an extremely low risk of default).

Liquidity

Liquidity is often overlooked yet is extremely important. Treasuries, bank deposits, negotiable CD's and agency bonds are all fairly liquid and can be disposed of in times of need. A community might not have to take a loss on the investment in times of rising interest rates or during lock-up periods on CD's; but, they are all relatively liquid with broad markets. It is not good practice to purchase an investment with a maturity longer than the expense time horizon just to obtain a higher yield or with the hope that it will get called or it can be sold at a profit when cash is needed. Always match the investment time horizon to the expense horizon. You might be surprised by the number of instances where someone has been caught off-guard by the markets and been unable to liquidate an investment they hoped would get called or sold at a profit.

Returns

This brings us to the third leg of the stool, returns. Chasing yield, as described above, is never advisable. Do not overlook safety and liquidity in favor of yield. Doing this has historically caused a lot of heartache and sleepless nights for portfolio managers. Through planning and measured purchases, you can enhance the yield of a portfolio while still maintaining safety and liquidity. For instance, the STO uses step-up callable bonds in its portfolio to accomplish two things. They keep pace with rising interest rates through built-in coupon increases at specific future dates, and they enhance overall portfolio yield to maturity by carrying higher interest rates. In general, callable bonds carry higher interest



rates than non-callable or bullets of the same maturity. The risk is that these investments are subject to call, so you might lose them to a call and be forced to reinvest in the future at a lower rate. Diversification of the investments in the portfolio should provide enough yield enhancement without sacrificing the two most important factors – safety and liquidity.

Investment And Asset Allocation

If you don't have an investment policy or asset allocation policy, one or both, now is the time to get them done. The STO's website has a model investment policy in either PDF or Word versions for communities to review and use, as required by law at www.treasurer.mo.gov/content/for-local-governments. These policies are living breathing documents that are meant to be guides for your investments. As situations and personnel change, so too should these documents change to suit the new environment. They should be adapted to market conditions, desired investment outcomes, and portfolio manager skill sets as they change over time.

Other important considerations when investing funds revolve around the professionals with whom you choose to do business – mainly, custodial banks and broker-dealers. A high degree of trust is necessary for these service providers in order to rely on them for market offerings, price discovery and safekeeping. Your custodial bank will ensure proper delivery and payment for investments, as well as provide safekeeping and record keeping for investments. They can also provide ongoing pricing for your portfolio.

Personally, I prefer to do business with people I have met in person. It is nice to know who is on the other end of the telephone when doing business, especially brokers. I am not trying to disparage brokers, but I do feel that if you are not important enough to visit in person, you are probably not going to be important enough to service well. When dealing with brokers, it is important to have several on an approved list. It is important to be able to see differing prices and investment options, so do not limit yourself to just one or two firms. If you need to find additional brokers, our office can assist. The State Treasurer's Office currently has 27 firms on an approved broker-dealer list. This makes for a very nice competitive environment.

STO is also required to obtain at least three competing offers/bids when buying/selling securities. This is an excellent guardrail to ensure the best pricing in transactions and keeps all the brokers on an even footing. Remember, your job as a portfolio manager is to get the best price for your stakeholders, the taxpayer. The broker's job is to service your needs, as well as make money for his firm and himself. There is nothing wrong with a broker making a living, but be sure to get the best possible deal you can through competition.

I hope this has helped in your future endeavors to put idle cash to work. Every political subdivision has differing cash flows and differing needs so there is no cookie cutter approach to investments. The best way to handle things is to understand your constraints and limits, work within your guardrails and policies, and always strive to do what is right for the taxpayer. Remember, this is someone else's money you are managing, and you should take great care and prudence when exercising your fiduciary duty. As always, the Missouri State Treasurer's Office is here to help whenever possible.

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