



# Investment Policy Fundamentals

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# Why an 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.



# What Does an Investment Policy Do?

- 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



## 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



# 1 – Policy

- 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



## 2 – Scope

- 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
  
- Maximum 5 points



## 3 – Prudence

- 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



## 3 – Prudence

- 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...”***

- Maximum 5 points



## 4 – Objective

- 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
- Maximum 5 points



## 5 – Delegation of Authority

- 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
  
- Maximum 5 points



## 6 – Ethics and Conflict of Interest

- 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
- Maximum 5 points



## 7 – Authorized Financial Dealers and Institutions

- 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
  
- Maximum 5 points



## 8 – Authorized and Suitable Investments

- 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
  
- Maximum 10 points



## 9 – Review of Investment Portfolio

- 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
  
- Maximum 5 points



## 10 – Investment Pools and Mutual Funds

- 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
  
- Maximum 5 points



# 11 – Collateralization

- Collateralization
  - Certificate of Deposit
    - Collateral needs to be 110% of market value
  - Repurchase Agreements
    - Collateral needs to be 102% of market value
  
- Maximum 5 points



## 12 – Safekeeping and Custody

- Safekeeping and Custody
  - All securities must be held by a third party custodian
  - Delivery vs payment (DVP) settlement
    - Fed wire
    - Depository Trust Company (DTC)
  
- Maximum 5 points



## 13 – Diversification

- Diversification
  - Diversification among asset classes
  - Diversification among issuers and issuer limitations
  - Diversification across industries
  
- Security type and issuer percentage of portfolio limits
  
- Maximum 5 points



## 14 – Maximum Maturities

- 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
  
- Maximum 5 points



## 15 – Internal Controls

- 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
  
  
- Maximum 5 points



## 16 – Performance Standards

- 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?
- Improves Communication
- Maximum 5 points



## 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



## Examples of common fixed-income benchmarks

- There are several providers of fixed income market indices such as Barclays (formerly Lehman Brothers), 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



# Measuring Performance

- 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



## 17 - Reporting

- 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
- Maximum 10 points



## 18 – Investment Policy Adoption

- 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
- Maximum 5 points



# Investment 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/>
  
- Maximum 5 points



# Additional Policy Thoughts

- 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>



# Investment Policy Resources

- 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)



# Investment Policy Resources

- Government Finance Officers Association 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>