



Permitted Investments and Avoiding the Pitfalls

Missouri GFOA Conference 2015



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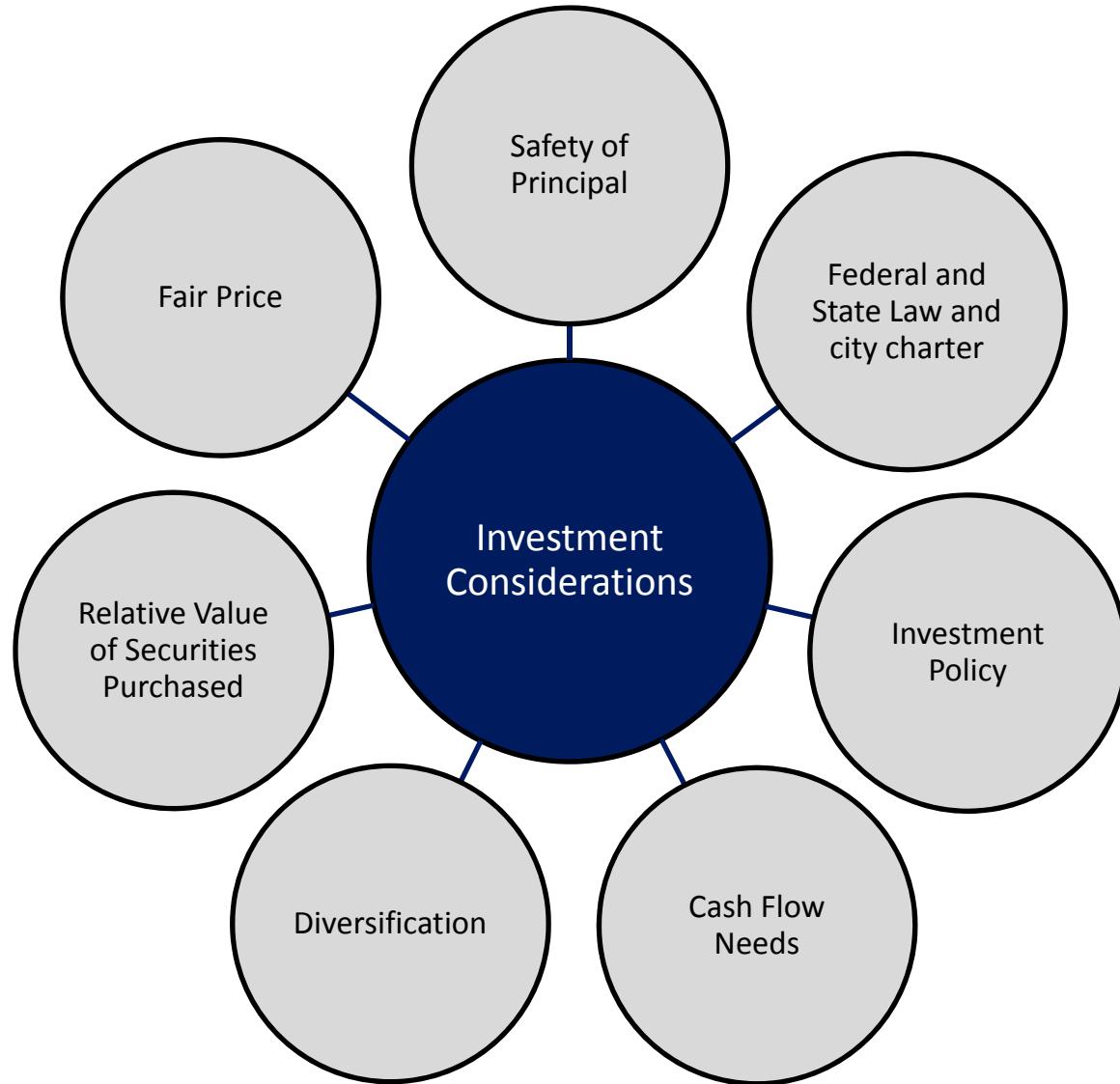


I. Understanding Your Cash Flow

Understand Your Cash Flow

- Identify amounts and timing of your cash inflows and outflows
- Determine your excess cash flows
- Know how long you can invest reserve funds
- By identifying a portion of a portfolio that can be invested for a longer duration, investors can increase yield while still maintaining adequate liquidity.
- Using your investment policy as a guide, an investor can now allocate funds to permitted investments, but should follow restrictions:
 - Maximum maturity
 - Minimum credit quality
 - Maximum sector allocation
 - Maximum per issuer
- Investment objectives should always be: safety, liquidity, yield

What are basic Investment Considerations?





II. Developing an Investment Policy

What to include?

The Investment Policy should be an all-inclusive, living document including, at a minimum, the following:

- **Scope**
- **Investment Objectives**
 - Safety
 - Liquidity
 - Yield
- **Standards of Care**
- **Investment Transaction**
- **Suitable and Authorized Investments**
- **Reporting**
- **Policy Considerations**
- **Missouri Constitution Requirements**
- **Appendices**
 - Attach a list of the Revised MO State Statutes that apply to your public entity
 - Missouri Constitution Article IV Section 15 applies to all public entities in Missouri for investments and deposits of public funds

Defining Scope

- To what funds does it apply?
 - General Funds
 - Reserves
 - Bond Proceeds
 - Other Post Employment Benefit (“OPEB”)Funds
- Applies to both Internal and External Management
 - Define role
 - Titles
 - List responsibilities

Investment Objectives

- **Safety**
 - Preservation of Capital
 - Legal Compliance
 - Risk Management or Mitigation
 - Credit risk and interest rate risk
- **Liquidity**
 - Ability to meet payment obligations
 - Expected vs. unexpected
- **Yield**
 - Secondary to safety and liquidity
 - Obtain a “market rate of return”
 - Earn a “fair return relative to the risk being assumed”



Standards of Care & Investment Transactions

- **Standards of Care**
 - “Prudent Person” standard
 - Ethics and conflicts of interest
 - Delegation of authority
 - Designated investment officials
 - External manager
- **Investment Transactions**
 - Authorized dealers
 - Primary dealers
 - Internal controls
 - Delivery vs. payment
 - Competitive shopping

Suitable and Authorized Investments

- Permitted Investment Types (e.g. Treasury, Agency, CP)
- For each type, specify:
 - Maximum maturity
 - Minimum credit quality
 - Maximum sector allocation
 - Maximum per issuer
 - Collateral requirements
- Listed prohibited investment types
- Collateralization
- Consider nature of funds
- Consider capabilities of staff
- Safekeeping and Custody



Reporting

- Complete information
 - Monthly and quarterly
- Full transparency
- Market valuation
 - Identify problems early
- Performance reporting
 - Feedback loop
 - Reassess objectives
 - Review portfolio structure
- Recheck ratings



Policy Consideration

- Formal adoption of policy
- Initial adoption by governing body
- Annual review and update
 - Changes in personnel
 - Changes to statutes
 - Changes in objectives
 - Changes in market conditions

Missouri Constitutional Requirements

- Missouri State Law requires a minimum of:
 - Commitment to principles of Safety, Liquidity and Return (in that order)
 - Prohibition of:
 - Purchase of Derivatives
 - Use of Leverage
 - Speculation
 - Periodic Mark to Market
 - Periodic and regular reporting of investment results to the governing body
 - Downgrade review for possible sale of investments in a timely fashion
 - You may use the “Model Investment Policy” supplied by Missouri State Treasurer’s Office (RSMo 30.950).
 - Or write your own investment policy

Missouri Constitutional Requirements cont'd

Chapter 30 – State Treasurer Section 30.950

- 30.950 As used in this section, the following terms shall mean:
 3. The state treasurer shall prepare a model form of an investment policy reflecting the principles set forth herein which shall be made available to political subdivisions in the state. **Any political subdivision which formally adopts such a model investment policy shall be deemed to be in compliance** with requirements of this section.

Missouri Constitutional Requirements cont'd

Chapter 30 – State Treasurer Section 30.950

4. Notwithstanding any other law to the contrary, any political subdivision of the state which manages and invests public funds, but does not promulgate, formally adopt and comply with a written investment policy as described herein shall have its investment authority limited to those investments authorized by law as of January 1, 1997. Except for those political subdivisions authorized by law to place public funds in the investment authorized by section 15, article IV of the Constitution of Missouri, and only then if the political subdivision complies with the requirements of this section nothing in this section shall be deemed to expand the investment authority of a political subdivision beyond the currently permitted by law.



III. Home Rule

Home Rule - Statute

Missouri Constitution

Article VI LOCAL GOVERNMENT Section 19(a)

August 28, 2012

Power of charter cities, how limited.

Section 19(a). Any city which adopts or has adopted a charter for its own government, shall have all powers which the general assembly of the state of Missouri has authority to confer upon any city, provided such powers are consistent with the constitution of this state and are not limited or denied either by the charter so adopted or by statute. Such a city shall, in addition to its home rule powers, have all powers conferred by law.

(Adopted October 5, 1971)

(1976) Held, Kansas City, being a charter city, "has authority to grant city funds to school districts, or portions of school districts, lying within its corporate limits." Enright v. Kansas City (Mo. Banc), 536 S.W.2d 17.

(2000) Proposed city charter amendments, requiring two-thirds voter approval on every tax increment financing measure and abrogating city power of eminent domain incident to any tax increment financing redevelopment plan or project, violated state statutes and thus were unconstitutional. State ex rel. Hazelwood Yellow Ribbon Committee v. Klos, 35 S.W.3d 457 (Mo.App.E.D.).

Home Rule Cities

- In 1875, Missouri was the first state to adopt a constitutional provision on municipal home rule.
- Home rule cities are all cities which have a population of 5,000 or more AND have adopted a home rule charter.
- A home rule city cannot institute changes that directly conflict with the Missouri Constitution, state statutes or the city charter.

Source: *A Model Charter For Missouri Cities*, Missouri Municipal League

Home Rule Cities

Cities with Home Rule			
Berkeley	Ferguson	Lee's Summit	St. Charles
Blue Springs	Florissant	Maplewood	St. John
Bridgeton	Fulton	Neosho	St. Joseph
Cape Girardeau	Hannibal	Nevada	St. Louis
Carthage	Hazelwood	Olivette	Springfield
Clayton	Independence	Palmyra	University City
Columbia	Jefferson City	Raymore	Webster Groves
Crestwood	Joplin	Republic	Wildwood
Creve Coeur	Kansas City	Richmond Heights	
Ellisville	Kirkwood	Sikeston	

Source: Missouri Municipal League publication "Forms of Government for Missouri Municipalities" (June 2007)



IV. Local Government Investment Pool Versus Bank Money Market Fund or a Registered 2-a7 Money Market Fund

Local Government Investment Pool (“LGIP”)

- Created under intergovernmental Cooperation Agreement
- Governed by a Board of Directors who are elected by the participating entities
- Pool may only invest in permitted investments. Weighted average maturity may not be longer than 60 days with the longest maturity not to exceed 13 months
- Has a stable NAV of \$1.00
- Rated AAAm by S&P rating agency
- Participants own a pro-rata share of each investment in the Pool’s Portfolio of Investments
- Most importantly the LGIP is owned by the participating public entities
- LGIP’s are not bank deposits they are an investment
- The marketing of the LGIP comes under the MSRB



Missouri has an LGIP for all public entities

Bank Money Market Fund / Account

- How do you know if a Bank Money Market Fund is a permitted investment?
- Here are some questions to ask your bank;
 - Is it a bank deposit and does it require collateral?
 - Anything over FDIC insurance (\$250,000 P+I) requires collateral and the collateral must be perfected
 - What is the collateral?
 - Be sure to verify the collateral is a permitted collateral in accordance to Missouri Constitution (RMO section 30.270)
 - Does it have a prospectus?
 - If yes, its not a permitted investment.
 - Is it a Bank Mutual Fund?
 - If yes, its not a permitted investment.



Check the sweep vehicle offered by your bank. Is it sweeping into a Mutual Fund of Government Securities – This is not a permitted investment.

Registered 2a-7 Money Market Fund

- Registered 2a-7 Money Market Fund is NOT permitted under the Missouri Constitution on Investments
- How do you know if it is a Bank Account or a Registered 2a-7 Mutual Fund



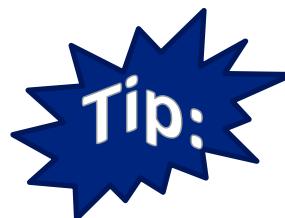
Ask if it has a prospectus or a Cusip number if it does it is a 2a-7 fund and not a permitted investment



V. Permitted Investments

Investment Guidelines

Missouri Constitution		Missouri Constitution	
U.S Treasuries		Collateralized Repurchase Agreements (Repo)	
Sector Allocation	100%	Sector Allocation	100%
Issuer Limit	None	Issuer Limit	None
Maximum Maturity	5 years	Maximum Maturity	90 days
Bulleted Federal Agencies		Collateralized Certificates of Deposit	
Sector Allocation	100%	Sector Allocation	100%
Issuer Limit	None	Issuer Limit	None
Maximum Maturity	5 years	Maximum Maturity	5 years
Callable Federal Agencies		Commercial Paper/Bankers' Acceptances (CP/BA)	
Sector Allocation	100%	Sector Allocation	100%
Issuer Limit	None	Issuer Limit	None
Maximum Maturity		Maximum Maturity	180 days



All investments shall mature and become payable not more than five years from the date of purchase except Repo and CP/BA which have earlier maturities.

U.S. Treasuries

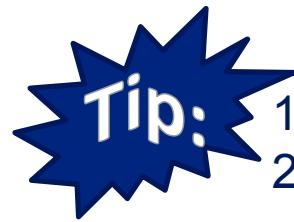
- Securities issued directly by the U.S. Government and secured by the full faith and credit of the United States.
 - Bills - Discount securities with original maturities of 4 weeks to 1 year.
 - Notes - Semi-annual coupon-bearing securities with original maturities between 2-10 years.
 - Bonds - Identical to Treasury notes except have original maturities longer than 10 years.
 - STRIPS - Discounted securities created by separating principal and interest payments on eligible Treasury issues. Maturities range from 1 month to 30 years.
- Typically offer lower yields compared to other fixed income securities because of highest credit quality.

U.S. Federal Agencies

- A Federal Agency security is a term used to describe two types of bonds: Bonds guaranteed by U.S. Federal Government Agencies and bonds issued by Government Sponsored Enterprises (GSEs) – corporations created by Congress to foster a public purpose, such as affordable housing.
- Federal Agency security types:
 - Discount notes - Similar to T-bills, discount securities that mature from 1 day to 1 year.
 - Notes/Debentures - Uncollateralized coupon-bearing securities with a stated maturity and coupon rate.
 - Callable notes - Identical to notes/debentures except for specified call provision which grants option to issuer to redeem prior to maturity.
- U.S. Federal Government Agency securities are backed by the full faith and credit of the United States Government while GSE securities are considered to be implicitly backed by the government.
- Frequent issuers include FNMA, GNMA, FHLB, FHLMC and FFCB.

Repurchase Agreements

- An agreement in which an investor buys securities from a counterparty who agrees to buy them back at a later date at an agreed upon price.
- Repurchase agreements can be made on or collateralized by many investment types:
 - U.S. Treasuries
 - Federal Agency securities
 - Mortgage-backed securities, Collateralized Mortgage Obligations
 - Money Markets (CP, CDs, BAs)
 - Corporate Notes
- Frequently overnight or “term repo” up to 1 year. (Missouri State Statute only allows a term of 90 days or less)
- Investor should require over-collateralization or “haircut” of at least 102%.
- Most repurchase agreements are now done on a “tri-party” basis, using a 3rd party custodian as intermediary.



1. Watch out for maturity limit of 90 days
2. Ensure you follow guidelines on slides 38-41 to ensure safety of your funds

Certificates of Deposit

- A time deposit issued by banks and thrifts that bears a specified dollar amount of the deposit, a maturity date and an interest rate.
- Yields vary depending on credit rating of issuing bank, final maturity and money supply. There are two types of CDs:
 - Non-negotiable CDs – have a fixed interest rate and fixed term to maturity. Most Non-negotiable CDs carry insurance coverage which makes the CD virtually risk free. The Federal Deposit Insurance Corporation, or FDIC, permanently raised insurance coverage on CDs to \$250,000 on July 21, 2010. They are not traded in the secondary market.



Only invest if you do not need your funds until maturity

Commercial Paper

- Unsecured promissory note, issued by corporations and financial institutions to raise funds on a short-term basis.
- Backed by corporate guarantee or bank letters of credit.
- Typically offer higher yield than short-term Treasuries or Federal Agency securities because of additional credit risk.
- Credit quality varies with issuer by national securities rating services such as Moody's (P-1, P-2, P-3) & Standard & Poor's (A-1+, A-1, A-2, A-3).
- Sold at a discount with maturities ranging from 1-270 days (State statute in Missouri limits maturities to 180 days or less).



Watch out for maturity limit of 180 days

Bankers' Acceptances

- A bank obligation issued by a domestic or international bank created to facilitate commercial trades.
- Credit strength of accepting bank, drawer endorsing bank, pledge of documents representing ownership of trade goods, and insurance on the goods.
- Not FDIC insured.
- Traded on a discount basis with maturities usually of 6 months or less.
- Offered at yields higher than Treasuries and Federal Agency securities.



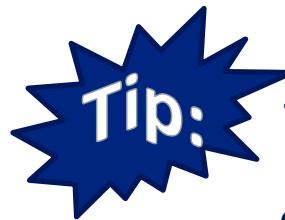
VI. Investment Collateralization

Acceptable Collateral in Missouri

- Treasuries (*recommended*)
- US Govt Agencies (*recommended*)
- State of Missouri Bonds
- State Agency Bonds,
including Revenue Bonds
- FHLB Letters of Credit**(recommended)*
- Surety Bonds*
- Bonds issued by:
 - Missouri Cities with population>2,000
 - Missouri Counties
 - School Districts
 - Special Road Districts
 - Other States
- Tax Anticipation Notes*
- AAA rated out of state muni bonds*

*See section 30.270 for more specifics on restrictions

- Each agency should have a depository contract and pledge agreement with each pledging bank



1. These are **not permitted investments** and **may only be used as collateral**
2. Ensure your collateral is perfected

Collateralization

Collateralization must comply with the requirements of **Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)**,

Collateralization will be required on two types of investments:

- Certificates of Deposit
- Repurchase Agreements



Deposit accounts are not an investment but anything over \$250,000 (FDIC Deposit Insurance Assessment) must also be collateralized

To Collateralize CDs and Deposits

- To be properly collateralized
 - Must have a perfected interest in collateral securities
 - Must be able to sell collateral in the secondary market to recoup your investment (does not apply to Federal Home Loan Bank Letter of Credit “FHLB LOC”)
 - Must have a depository contract and pledge agreement with each pledging bank
 - Must be in writing and approved by the Board of Directors of depository or its loan committee
 - Has been continuously an official record of the depository institution

In order to anticipate market changes and provide a level of security for all funds, the market value (including accrued interest) of the collateral shall be at least 102 percent (except for a Federal Home Loan Bank letter of credit, which shall be at 100 percent) or the greater of the amount of certificates of deposit, less the amount, if any, that is insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Unions Share Insurance Fund. Market value shall be calculated using industry convention (collateral substitution may be granted).

To Collateralize Repurchase Agreements

- Limited to Treasury, agency and instrumentality securities that are eligible to be delivered via the Federal Reserve Book-entry system.
- In addition to the collateral requirements (slide 36), must also have in place;
 - A Master Repurchase Agreement
 - Custodian Bank Agreement to hold the securities

Collateralization – Third Party Custodian

All securities that serve as collateral against the deposits of a depository institution must be safe kept at a non-affiliated custodial facility. Depository institutions pledging collateral against deposits must, in conjunction with the custodial agent, furnish the necessary custodial receipts within five business days from the settlement date.

Federal law provides that a depositor's security agreement that tends to diminish or defeat the interest of the FDIC in an asset acquired by it as receiver of an insured depository shall not be valid against the FDIC unless the agreement:

- Is in writing
- Was approved by the Board of Directors of the depository or its loan committee, and
- Has been continuously, from the time of its execution, an official record of the depository institution.



VII. Investment of Bond Proceeds

Investment of Bond Proceeds

- Make sure the bond resolution's permitted investments match those of the investment policy
- Bond Account Management Portfolio (Discretionary)
 - Individual portfolio of fixed income securities actively managed specifically to meet special investment objectives of a bond proceeds account.
- Laddered Investment Portfolio (Non-Discretionary)
 - Invest proceeds in a portfolio of fixed rate securities and hold securities to maturity.
- LGIP and laddered investments



Ensure your bond attorney adds language to your official statement under permitted investments that states investments per the Missouri Constitution



Questions?

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