BEST PRACTICE

Diversification of Investments in a Portfolio (2002 and 2007) (CASH)

Background. Government investors have a fiduciary responsibility to protect public funds and to prudently manage their investments in order to achieve the investment objectives of safety, liquidity, and return. Generally, greater risk in a portfolio increases the opportunity for higher returns. However, greater risk also increases the volatility of the returns, which is another definition of risk. The effective management of risk in a portfolio is critical for achieving an entity's investment objectives.

A useful strategy for managing risk in a portfolio is through diversification. To this end, a government should establish a target risk profile. In establishing a risk profile, an entity considers its investment objectives and constraints, risk tolerances, liquidity requirements and the current risk/reward characteristics of the market. The profile should be adjusted as needed to changes in any of those considerations. Such a profile provides a framework and discipline for making individual investment decisions that manage the risk and create the structure of a portfolio.

The government entity's risk profile, in turn, helps it determine appropriate levels of diversification. Diversification of investments in a portfolio is based on the different types of risk – primarily interest rate or market risk, liquidity risk and credit risk. Diversification is achieved by investing in a variety of securities with dissimilar risk characteristics that respond differently to changes in the market. Areas where diversification can be achieved include the maturity distribution in a portfolio (market and liquidity risk), sector allocation (credit risk), issuer allocation (credit risk), and the structures (noncallable vs. callable) of securities (market and liquidity risk).

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments properly manage the risk in their portfolios to achieve their investment objectives and comply with their investment constraints. GFOA further recommends the use of diversification in a portfolio as an important strategy for managing risk. Diversification strategies can be implemented through the following steps:

- carefully and clearly defining what the objectives safety, liquidity and return mean to the government entity
- preparing a cash flow projection to determine liquidity needs and the level and distribution of risk that is appropriate for the portfolio
- considering political climate, stakeholders' view toward risk, and risk tolerances
- ensuring liquidity to meet ongoing obligations by investing a portion of the portfolio in readily available funds, such as Local Government Investment Pools (LGIPs), money market funds, or overnight repurchase agreements
- establishing limits on positions in specific securities to protect against default risk
- establishing limits on specific business sectors
- developing strategies and guidelines for investments in single class of securities (such as commercial paper or bankers acceptances)
- limiting investments in securities that have higher credit and/or market risks (such as derivatives)
- limiting particular structures (i.e. optionality, amortizing components, coupons, issue sizes)
- defining parameters for maturity/duration ranges
- establishing a targeted risk profile for the portfolio based on investment objectives and constraints, risk tolerances, liquidity requirements and the current risk/reward characteristics of the market.

References

- *Elected Official's Guide Investing*, *Second Edition,* Sofia Anastopoulos, GFOA, 2007.
- *Investing Public Funds*, *Second Edition,* Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- Sample Investment Policy, GFOA, 2003.

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