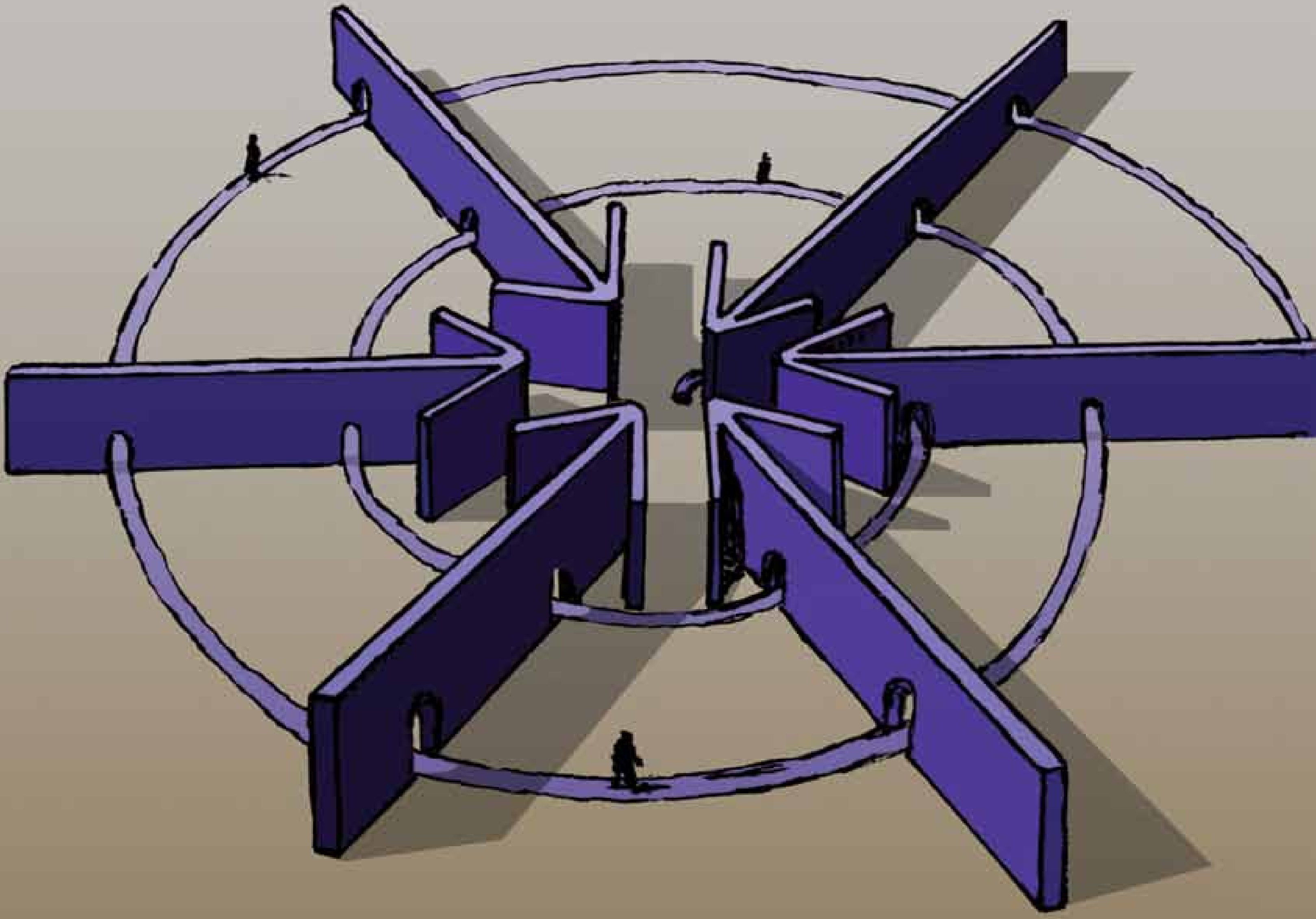

DEVELOPING AN INVESTMENT POLICY

BY SONIA ANDREWS, JOHN GRADY, AND JAMES M. NICHOLSON

A detailed, up-to-date investment policy is a vital tool for every government. Every investment policy is unique, so the format, language, and content may differ among jurisdictions, even those that are very similar, because of state laws, the size of the organization, risk tolerance, and a variety of other reasons. Even the structure of the policy may vary. This article describes a few of the most common sections within public funds investment policies and strategies for implementing the policy after it has been created.

THE COMPONENTS

Statement of Scope. When defining the scope of the investment policy, a jurisdiction needs to identify the specific funds that will be governed. Specifying the types of funds that will be excluded can also be beneficial. Public entities include many types of funds, including operations, reserves, enterprise funds, bond proceeds, capital project funds, and pension funds, to name a few. Pension funds usually permit an allocation to equities, for example, while other funds may not; in these cases, separate investment policies may be required.[1]

An investment policy may include provisions for investing bond issuance proceeds. If so, it should refer to and incorporate the specific bond documents that comprise permitted investments. This section should also specifically refer to state laws that authorize and govern investments for the jurisdiction.

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Investment Objectives. Investment objectives for public funds are primarily designed to protect taxpayer money from the risk of loss. The most common objectives are, in this order:

1. The safety of principal.
2. Liquidity.
3. Yield, or a competitive rate of return without incurring undue risk.
4. Transparency, or the ability of interested parties to review investment information like portfolio holdings and transaction information in real time.
5. Compliance, or the assurance that the investment portfolio is within all the parameters set forth in the policy (such as credit ratings, asset allocation, maturity limits or self-imposed restrictions).

Allocations of Authority and Responsibility. The responsibility and authority for each person involved in managing an organization's public funds should be specifically detailed. The appropriate level of authorization must be provided to relevant staff members, allowing them to efficiently manage the investment program internally; otherwise, that task should be delegated to an outside investment firm.

This section should also refer to the entity's internal controls document, which is designed to minimize the risk of losses from fraud, employee error, or misrepresentation. Confirm titles and the associated responsibilities for the designated individuals to ensure compliance with the organization's policy and to prevent unauthorized transactions.

Ethics and Conflicts of Interest. An organization's investment policy should require the standard of prudence to be applied in managing the portfolio. The policy should also specifically address potential conflicts of interest vis-à-vis public officials, employees, and any third parties involved in the investment process. These parties should be instructed to refrain from conducting any personal activity that could conflict, or appear to conflict, with the proper execution and management of the investment program, or that could impair their ability to make impartial investment decisions.

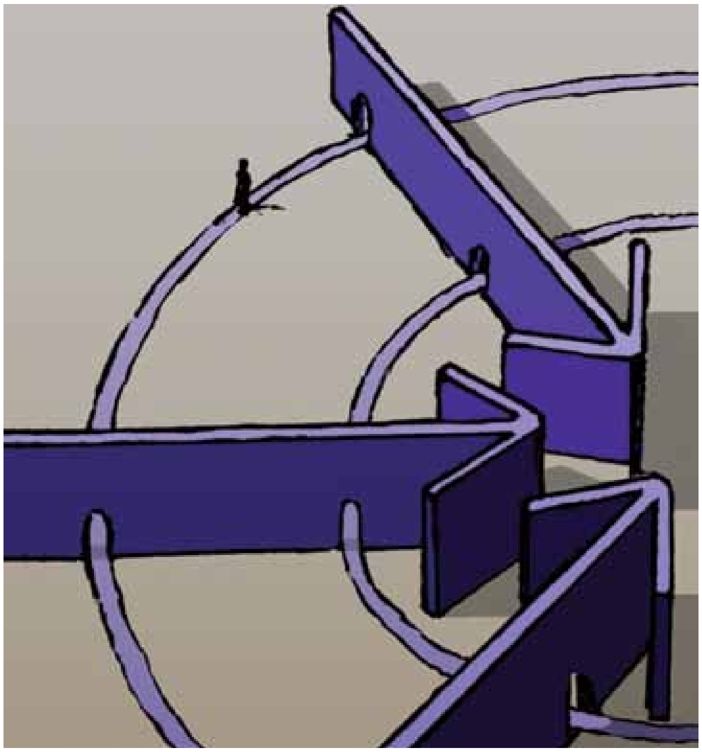
Individuals or officials who are delegated with the authority and responsibility for investing an organization's public funds should also be explicitly prohibited from undertaking personal investment transactions with the same party that conducts the jurisdiction's investment transactions.

Although many state ethics laws require that public funds investors disclose any material financial interests in financial institutions with which the organization conducts business, the organization's investment policy should explicitly require the disclosure of this information as well.

Authorized Dealers and Investments. The investment policy should identify those parties who are authorized to conduct transactions on behalf of the government. It should spell out the requirements for being included on that list as well as those who have the authority to administer it.

Peer-to-peer sharing is an excellent way to obtain appropriate and relevant policies that can be used as examples in developing or revising policies.

Financial dealers and institutions that want to conduct business with the organization must be in good standing with the Central Registration Depository database of the Financial Industry Regulatory Authority (FINRA) Public Disclosure Program. In addition they should submit the following: proof of FINRA certification and any state-required registration; completed broker/dealer questionnaire; audited financial statements; and a signed certificate acknowledging receipt of, and agreement to comply with, the organization's investment policy. An organization should perform periodic due diligence reviews of its authorized brokers and dealers, and also require competitive bids or offers from separate brokers and dealers to verify that it is receiving fair market prices for the investments.



This section of the policy document should also identify and list permitted security types and parameters within each type, including allocation limits, maturity limits, and minimum ratings requirements.

As an example, the fixed-income sector has changed significantly over time, and public funds investment policies have evolved to accommodate it. Where permitted by state law, some public entities now permit A- and AA-rated corporate debt. Other investment types that are becoming more common include supranational (e.g., a pool of sovereign nations) debt issuers and asset-backed securities. Authorized investments and the characteristics associated with each security type must continue to align with the organization's goals, investment objectives, risk tolerance, and the individuals responsible for the organization's investment management program. A good rule of thumb is that if the investing authority does not understand an investment vehicle well enough to adequately explain the inherent risks and rewards to the organization's governing body or electorate, that security type should be avoided — even if the policy permits it. Investment policies should also be compared against any recently adopted legislation to confirm compliance. Lastly, a good way to allow for a quick check of an organization's policy limitations is to include a summary table of authorized investments.

Finally, this section of the document should address portfolio diversification, which should be optimized to minimize the overall risk of loss. The policy should spell out the maximum percentage, or a desired target range, to be maintained in any one specific investment type, and address any short-term liquidity management holdings as well. (Consider diversification by investment type, issuers, and industries.) Outside of federally insured investments (which are guaranteed by the U.S. government), concentrating too much of the portfolio in any one issuer or segment can dramatically increase the risk of loss.

Safekeeping and Custody Guidelines. The policy should address the method of settling investment transactions, along with how and where the securities will be held. Include a reference to the delivery versus payment (DVP) process (the settlement procedure stipulating that cash payment must be made before or at the same time as the security is delivered), as well as who has the authority to appoint such a custodian and how that appointment should be made. Incorporating this information in your investment process ensures that the organization physically receives all deliveries before making a payment, minimizing the potential for loss.

> Organizations should have their governing bodies adopt the proposed or updated investment policy by formal action. Otherwise, the policy is just a guideline.

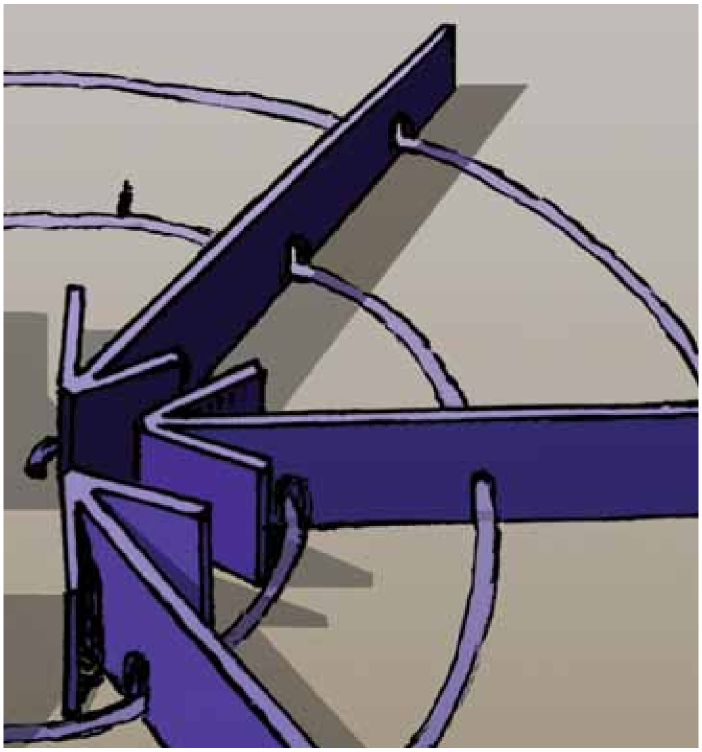
A key step in the DVP process is the identification and designation of a central custodian for the organization's investment holdings. A custodian should be identified to hold the securities in the organization's name at a nationally recognized depository such as the Depository Trust Company. In addition, the custodian should provide regular (typically monthly) independent reporting and confirmation of holdings. The benefit of having a third party provide settlement services and hold the organization's securities is that it significantly minimizes the risk of fraud and loss in the investment portfolio.

Collateralization. Unlike longer-term investments, funds that are held for day-to-day operations and liquidity management are typically on deposit with a financial institution in order to ensure availability. Although regulations and approach vary from state to state, one point is critical — deposits that exceed the maximum level covered by FDIC insurance (currently $250,000) must be collateralized to ensure against the risk of loss. Some states have a statewide collateralization pool in which all financial institutions in the state are required to participate. In this case, a simple reference to the pool might be satisfactory. Most states do not have a statewide pool, however, so they should spell out the specific collateralization rate (typically 105 percent or 110 percent of the value of the holdings).

The policy should also identify when specific collateral is required. Under the pooled collateral approach, the financial institution provides the organization with the total amount of public funds from all entities on deposit, the total amount of collateral held, and the organization's pro-rata share of both. The specific collateral approach requires the financial institution to provide the organization with a list of specific securities and amounts held in trust by a third party to ensure adequate collateralization of deposits.

Reporting. The policy's reporting section should identify the specific items required to be reported to the organization on a regular basis (i.e., monthly, quarterly, annually, or some combination of the three). Investment reporting serves many purposes, including an evaluation of the portfolio's current performance. At a minimum it should provide the following:

- Current holdings at a security-level detail (including CUSIP; trade, settle, and maturity dates; yield to maturity; and other features of the investment).
- Security type and classification.
- Investment transaction details.
- The current market value for each holding.



- A comparison of the portfolio's overall performance against the desired benchmarks.

Reporting can also serve as compliance verification. Investment holdings within the report can be compared against the organization's investment policy parameters to ensure compliance. Current reporting tools can often provide this information in just one business day, significantly increasing the transparency of the investment program.

Financial dealers and institutions that want to conduct business with the organization must be in good standing with the Central Registration Depository database of the FINRA Public Disclosure Program.

TAILORING THE POLICY TO YOUR ORGANIZATION

Peer-to-peer sharing is an excellent way to obtain appropriate and relevant policies that can be used as examples in developing or revising policies. Using examples is an excellent way to save time and ensure that the policy aligns with those of similar organizations — keeping in mind, of course, that every investment policy is unique. Care and consideration must be taken to tailor the policy to your organization's specific investment objectives, risk tolerance, and circumstances.

For example, an organization's investment portfolio may consist primarily of operating funds with a high level of liquidity needs. As such, the policy might have a maturity limitation that is lower than what the jurisdiction's peers or state statutes allow. Another factor to consider would be the comfort level of the governing body; a council or board may prefer to adopt a more conservative policy. Access to information, investment advisors, and staff expertise can also affect the organization's risk tolerance, making it a factor in policy development.

IMPLEMENTING THE POLICY

Adoption. Organizations should have their governing bodies adopt the proposed or updated investment policy by formal action. Regardless of whether the body adopts it by ordinance, resolution, or motion, adoption gives the policy the rule of law, making it the structure within which the investment portfolio must be managed. Otherwise, the policy is just a guideline, and investments can quickly run afoul of the provisions without any consequences beyond increased risk of loss to the portfolio.

Conducting an Annual Review. The Great Recession, and the credit crisis of 2007 and 2008 in particular, remind us how important it is to have an up-to-date investment policy in place — although significant events in the national, state, and local economies should not be the exclusive reason to review the investment policy regularly. Additional reasons might include recent updates to existing regulations, newly enacted federal and state laws, and changes in authorized individuals responsible for the organization's investment program. It is also a good idea to confirm that all aspects of the organization's investment policy are consistent with its current investment strategy, while allowing for flexibility — just like the fixed-income markets where public funds are invested.

CONCLUSIONS

While having an investment policy is no guarantee against losses or other risks associated with a treasury and investment program, a properly written and up-to-date investment policy is an essential tool. It minimizes the risk of loss and offers many other benefits. A fully developed investment policy establishes guidelines, places restrictions and limitations on investment types and maturities, and defines the scope and investment objectives of an organization's investment program.

Note

1. The Government Finance Officers Association's Treasury & Investment Management Committee's best practice, *Creating an Investment Policy*, provides additional guidelines, recommendations and suggestions. *Pension Investment Policies* provides outlines for defined benefit plans. For more information on these best practices and other investment policy resources, please visit www.gfoa.org.

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