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## PORTFOLIO MANAGEMENT STRATEGIES FOR LOCAL AGENCIES

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*Editors note: Part one of this two-part series appeared in the April issue of* ***Debt Line*** *and discussed the commonly used authorized investment instruments for California agencies and the types of risks that must be considered when analyzing investment strategies.*

The following article describes the conventional passive and active investment strategies available to investors of public funds. These strategies, when implemented properly, can achieve the safety, liquidity and competitive returns that are the investment objectives of most public entities.

**Passive Investment Strategies**

Passive investment strategies are very common among small public entities. The customary passive investment strategies utilized by public entities are usually implemented as a "buy and hold" strategy, except in the case of the constant maturity strategy. The passive strategies include:

- **Creating a liquidity pool**, which is accomplished by depositing money in a local government investment pool or money market mutual fund, entering into a repurchase agreement or investing in short-term Treasury bills (T-bills). Some type of liquidity pool is always an important part of both passive and active investment strategies.

- **Laddered maturities**, which are structured to cover expected disbursements on a first-in, first-out approach. As funds become available, they are invested to match the next uncovered disbursement.

- **Cash horizon investing**, which requires the development of a cash flow forecast to determine the cash horizon. The funds are then invested to the longest feasible date according to the cash forecast.

- **Constant maturity**, which is the systematic purchase of a short-term marketable security when auctioned (e.g. T-bill) and each time a new issue with that maturity is auctioned, selling the security previously purchased and buying the new issue. This strategy results in a nearly constant maturity midway between the maturity when the security is purchased and the maturity when it is sold.

Passive investment strategies are advantageous for public entities whose staff has many other responsibilities and cannot spend much time and effort managing the investments. Often the staff may not have much experience selecting investments and the entity does not have the technology available to monitor investment market developments and analyze investment alternatives. Passive investment strategies are a time-efficient method of managing the investments that is safe, defensible and can be expected to achieve average rates of return.

The disadvantages of passive investment strategies are the missed opportunities to lock in higher yields when rates are falling; to realign the portfolio when rates are rising; to take advantage of shifting spread relationships between different types and qualities of investment instruments; and to adjust the portfolio because of any credit quality erosion in issuers or sectors of the market in which securities are owned.

**Active Investment Strategies**

The primary goal of implementing active investment strategies is to optimize the return on the portfolio by adjusting the maturities and mix of securities as yields and spread relationships change. Interest rates, the shape of the yield curve and spread relationships are not static; they are always changing.

Active investment strategies require more work, training and proper tools to implement than passive investment strategies. However, the benefits can more than make up for the costs associated with these requirements when effectively implemented. The active investment strategies that are most common for public entities include:

- **Yield curve analysis**, which is the process of analyzing the shape of the yield curve to determine if it is a positive, flat or inverted curve and to identify the point on the curve having the best relative value. Funds are then invested in the maturity with the best relative value.

- **Riding the yield curve**, which is the mismatching of investments with expected disbursements to take advantage of attractive yields in maturities beyond the date of a disbursement. The security will have to be sold on the date of the disbursement to obtain cash, so a break-even analysis is required to evaluate the probability of selling the security at a price to generate a return greater than the return of just matching the investment to the disbursement.

- **Quality downgrading**, which involves the buying of securities with greater risk whether it is credit, market or liquidity risk or some combination of all of them. The investment criterion for this strategy is that you get properly rewarded for the additional risk. Spread analysis is necessary for implementing this strategy.

- **Spread analysis**, which is the comparison of yields between two securities. It is performed within the same sector (Treasury to Treasury) but with different maturities, or between different sectors (Treasury to instrumentality securities). The purpose of the comparison is to determine how the current yield pickup or spread compares to the average, widest and narrowest spreads for some time period—often a minimum of a year. The objective is to take on additional risk in the form of maturity extension or lower credit quality only when adequately compensated by average or better than average yield pickup.

- **Market timing**, which is a strategy that attempts to optimize the return on the portfolio by timing the purchase or sale of an investment based upon market factors. The implementation of this strategy involves the use of both fundamental and technical analysis. The objective is to determine the trend of interest rates, where they are in relation to their near-term highs and lows, and what economic reports are scheduled that could significantly impact the market. Timing investments is as much an art as a science, but at least being aware of the trend of interest rates can assist in deciding whether to invest in short or long maturities.

- **Portfolio realignments**, which is the selling of one security and the buying of another security to improve the structure of the portfolio because of changes in interest rates. This may require selling a security that had been purchased at a low yield, taking a loss, then recouping the loss quickly because the proceeds are reinvested in a much higher yielding security. This strategy can be an effective way to get rid of the "dogs" in the portfolio that were purchased during a low-yield environment.

The active strategy that is most often used to enhance return on a portfolio is spread analysis. As spread relationships change through cycles of widening and narrowing, the duration and/or sector allocation of a portfolio can be adjusted to take advantage of the changing relative values in the market.

The goal of active investment management is not to outperform the market, but to make sure that an entity is attaining full value from its investments. The disadvantages of active strategies include the time and technology required to implement and monitor the strategies. Will the portfolio be able to generate higher returns that at least offset the expense required for resources for active investment management?

There is also the potential for greater risk in some of the active strategies. There is greater credit risk when quality downgrading. There is liquidity risk when riding the yield curve. And there is market risk when extending maturities farther out on the yield curve. However, these risks can all be effectively managed with proper due diligence.

**Summary**

Any investment program has to ensure legality, safety, and liquidity before attempting to optimize the return. This article is an introduction to the considerations that are necessary for implementing an investment program and provides a brief description of passive and active investment strategies. There is not enough space in an article such as this to do any more than introduce these concepts.

For those who are inexperienced in any of the strategies described in this article, it is important to gain a thorough understanding of them before attempting to implement them. CDIAC provides beginning and advanced one and one-half day seminars on investing public funds and can provide recommendations on other excellent resources for more comprehensive explanations of these ideas.

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*This Offprint was previously published in DEBT LINE, a monthly publication of the California Debt and Investment Advisory Commission (CDIAC). CDIAC was created in 1981 to provide information, education, and technical assistance on public debt and investment to state and local public officials and public finance officers. DEBT LINE serves as a vehicle to reach CDIAC's constituents, providing news and information pertaining to the California municipal finance market. In addition to topical articles, DEBT LINE contains a listing of the proposed and final sales of public debt provided to CDIAC pursuant to Section 8855(g) of the California Government Code. Questions concerning the Commission should be directed to CDIAC at (916) 653-3269 or, by e-mail, at cdiac@treasurer.ca.gov. For a full listing of CDIAC publications, please visit our website at http://www.treasurer.ca.gov/stocda.htm.*