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LOCAL AGENCY INVESTMENT PORTFOLIO MANAGEMENT

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All local government jurisdictions have the opportunity to invest their receipts from the time they are collected until the time they are disbursed. This article is the first of a two-part series reviewing the investment landscape for California local governments. While local agency investment professionals will be familiar with the information presented here, others may find it a useful introduction to the investment of public funds. Part one reviews the investment instruments legally available to local governments and the associated risks. Part two will address optimal investment strategies.

Authorized Investments

Government Code Sections 53601 and 53635 itemize most of the investments authorized for use by public entities in California. The following are examples of common investment instruments chosen by California local jurisdictions.

United States Treasurys

The U.S. government is the world's largest issuer of debt, making Treasury Securities the primary instrument in the fixed-income market. Treasurys are backed by the full faith and credit of the U.S. government. Another primary factor in their appeal is their liquidity, as Treasurys are traded in active secondary markets. The Code prohibits a local treasurer from investing in Treasurys with a remaining maturity of more than five years, unless a longer maturity is approved by the local agency's legislative body. There are no concentration limits or minimum ratings stated in the Code.

Federal Agencies

These refer to securities issued by government-sponsored enterprises. The Federal Farm Credit Bank and the Federal Home Loan Mortgage Corporation (Freddie Mac) are examples of federal agencies that support agricultural loans and purchase residential mortgages, respectively. Unlike Treasurys, most federal agencies' debt is not guaranteed. However, many investors consider the securities a moral obligation of the U.S. government and believe Congress would intervene before these agencies ever would default on one of their obligations. Consequently, they are rated in the highest credit category. The Code prohibits a local treasurer from investing in Agencies with a remaining maturity of more than five years, unless a longer maturity is approved by the local agency's legislative body. There are no concentration limits or minimum ratings stated in the Code.

Commercial Paper

Commercial paper is a short-term, unsecured promissory note issued for a specified maturity. It is a financing tool primarily used by corporations. Because it is issued at short-term money market rates, commercial paper enables a corporation to obtain funds at a cost below the prime rate on bank loans. Public entities may purchase commercial paper only from corporations that are organized and operating in the U.S. and having total assets in excess of $500 million. Local governments are prevented from holding more than 10 percent of the outstanding paper of an issuing corporation. The Code prohibits investing in commercial paper with a maximum remaining maturity of more than 270 days. With the exception of counties, local government's investment in commercial paper is limited to 15% of its portfolio, with an additional 15% (30% total) allowed if the dollar weighted average maturity of the entire amount does not exceed 31 days. For counties, the concentration maximum is 40% of the portfolio regardless of the 31 day restriction. All concentration limits apply at the time of purchase. The Code also requires "prime" quality (A1 or P1 short-term ratings) and if there is a rating for debt other than commercial paper, that rating must be at least "A."

County Pools and the Local Agency Investment Fund (LAIF)

These are voluntary programs designed to allow local agencies to invest their funds in larger, pooled portfolios, which invest on a comingled, pro rata, basis. In addition to obtaining access to professional management services, these larger pools allow funds to be moved in and out on very short notice, and thus are highly liquid. While county pools are restricted to the allowable investments under the previously cited Government Code Sections, LAIF's statutory guidelines allow for longer investment horizons. For instance, LAIF is statutorily permitted to invest in Treasurys and Agencies out to 30 years. However, maximum maturities in LAIF policy generally mirror those of county pools. As of March 20, LAIF's weighted average maturity was 189 days.

Determining Risk

In exchange for a return on investment, the investor may expose assets to potential losses. Risk can be defined as the probability of such losses. Investments expose an investor to one or more of several types of risk, including:

Market Risk

This refers to the impact that changes in the prevailing level of interest rates have on the market value of all outstanding bonds. When interest rates decline, bond prices rise, and when interest rates rise, bond prices decline. Longer-term securities have greater market risk due to the chance for more market variation over a longer period of time.

Reinvestment Risk

This refers to the variability in the reinvestment rate of a given investment strategy because of changes in market interest rates. The risk is that the interest rate at which interim cash flows can be reinvested will fall.

Default Risk (also known as Credit Risk)

This refers to the risk that the issuer of the bond may be unable to make timely principal and interest payments on the issue. [Among other factors, the commercial rating agencies, such as Moody's, Standard and Poor's, and Fitch, focus primarily on default risk when assigning their credit ratings.

Liquidity Risk

This risk relates to the ability to sell a security without taking a loss. Liquidity is higher when there is an active secondary market for the security. For an investor who plans to hold the bond until maturity date, liquidity risk is less important.

Inflation Risk

This risk results from the variation in the value of cash flows from a security due to inflation, as measured in terms of purchasing power. For example, if an investor purchased a bond paying five percent, but the inflation rate is six percent, the investor's purchasing power actually has decreased.

Each of the investment vehicles described earlier carry varying degrees of each of the different types of risk. For example, investing in commercial paper involves more credit risk than investing in U.S. Government Agency bonds. Likewise, longer-term Treasury Securities have more market risk than T-Bills and T-Notes, which mature in 10 years or less. The various types of risk have different meanings for different portfolios. For example, managers of a portfolio of very short weighted average maturity (due to frequent demands on its cash) will avoid significant market risk, but will have to accept greater reinvestment risk. Due to relatively short holding periods, they may not be concerned with default risk, but focus greatly on mitigating liquidity risk. In addition, some local governments are concerned with avoiding the loss of value on any individual investment, while others focus on the performance of the portfolio as a whole.

Portfolio management is the process of managing, balancing and diversifying risk. Next month's edition of *DEBT LINE* will discuss various portfolio management strategie

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.

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