CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

DEBT LINE *Off Prints*

California Debt And Investment Advisory Commission
Philip Angelides, Chair

Volume 21, No. 9 **September 2002**

MANAGING YOUR INVESTMENT PROGRAM IN TODAY'S MARKET

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Interest earnings from investments often are an important revenue source for many government agencies regardless of their size. In today's markets, historically low interest rates make maximizing this revenue source especially difficult. Investors of public funds may be tempted to chase yield by extending maturities too far into the future or purchasing exotic securities. These investment tactics add volatility to the agency's portfolio and should be avoided.

Since history tends to repeat itself, investors would do well to remember the highly publicized investment losses of 1994. From California to Maine, public agencies lost millions of dollars when the market value of their investments fell because of rising interest rates. How did this happen? The early 1990s brought low interest rates, prompting investors to purchase securities with high market volatility to increase their investment earnings. With higher returns, however, comes higher risk. Investors learned this lesson the hard way when they needed to sell an investment prior to maturity and found that they either couldn't find a buyer for their securities or they had to sell the securities below the principal amount. Investors who held their investments to maturity discovered the market value of their portfolios was significantly less than the historical cost.

To make the most effective use of investable funds, public investors must try to earn the best returns possible without sacrificing the safety of their funds or subjecting their portfolios to undue risks. Investors must achieve this goal within the constraints of applicable laws, investment policies and other internal practices. In addition, investors must make their decisions within the overriding principles of safety, liquidity and yield. Investors who follow these principles can avoid being tomorrow's headlines.

Making Investment Decisions

Investing is a complicated process. While a formal investment policy identifies investment objectives, defines risk tolerance, assigns responsibility for the investment function, and establishes control over the investment process, it does not tell the investor what investment instrument to purchase, how much to invest, or how long to invest. Public investors typically make investment decisions based on cash flow needs. In many cases, idle funds are deposited in interest-bearing accounts or invested in short-term liquid investments such as investment pools until the funds are needed. When large amounts of cash will be available for a set period of time, the investor may choose to invest in longer-term investments such as U.S. Treasury securities or other term instruments allowed by the California Government Code Sections 53601 and 53635.

When evaluating investment options, investors can use the following criteria to ensure they achieve their investment goals:

- **Legality** - Is this investment an allowable investment option? Public investors should be aware of all of the investment options available to them and avoid purchasing any securities that may be questionable. Sections 53601 and 53635 of the Government Code outlines what investments are allowable for California agencies and should be reviewed in conjunction with the agency's investment policy. In many cases, the agency's investment policy may be more restrictive than the state statute.

- **Safety -** How safe is the investment? What is the credit risk? Is there any possibility the agency could lose its principal? Generally, the higher the yield, the greater the risk an investment instrument carries. Therefore, high-yield investments with high credit risk should be ruled out.

- **Maturity -** How long will the investment be held? Remember, the longer the investment, the greater the degree of market risk (the risk that changes in the financial market will reduce the value of a security). Investors should consider investing in instruments with varying maturities to provide a natural hedge against changes in interest rates.

- **Liquidity -** How easily can invested funds be converted to cash without a significant loss in price? The more liquid an investment, the easier it will be to obtain funds if unanticipated cash needs arise. If an agency does not have a good handle on its cash flow projections, illiquid investments should be used to a much lesser degree. Term products that carry a penalty or loss of interest earnings to liquidate must be carefully evaluated. Many agencies keep a portion of their portfolios in readily available assets such as an investment pool or a money market fund. These types of products help to ensure that the agency will have cash on hand to meet unexpected needs. The agency can then invest a core portion of its portfolio in longer-term securities such as a Treasury note or a U.S. government agency security to take advantage of higher yields in a normal yield curve environment.

- **Yield -** What is the return of the investment? Investors should seek to earn the highest return possible after balancing the concerns for legality, safety, liquidity, and maturity.

Obtain Competitive Bids - One way to ensure that investors receive the best price and yield on securities is to seek competitive bids for all investment purchases. Many agencies establish a minimum number of bids that must be obtained before making an investment purchase.

Smaller governments often do not use the services of broker-dealers but limit their investment purchases to financial institutions. These investors still benefit from obtaining competitive bids for certificates of deposit if they use more than one bank. Local agencies also can compare investment options by obtaining quotes on all allowable investment instruments and making decisions based on that data. For agencies that may have only one or two sources for investments, investors can check quotes they receive against quotes published in the financial press or from online sources to make sure they are getting a fair price.

Know Your Investment Professional - When looking at investment options, investors should take time to know the investment professionals calling on them. Some investment professionals specialize in certain securities and others try to be a jack-of-all trades. Investors should not allow themselves to get bullied into purchasing securities that will have to be explained to governing boards—or worse the media—that perhaps they do not completely understand. Take the time to know whom you are dealing with and know the strength of the company they represent. Obtain financial reports from the parent company. Ask about any history of SEC complaints on both the firm and the individual.

Analyze Allowable Investment Instruments - When looking at investment options, investors should analyze all investment options and choose the most optimal for their investment needs. Some investments are more liquid than others, some investments are subject to more price volatility, and some investments are more expensive relative to other options. In addition, the attitudes of the citizens and the governing body should be taken into consideration before making an investment purchase. If the agency has a low risk tolerance, only plain vanilla, relatively stable investments should be used.

Insist on Delivery versus Payment and Third-Party Safekeeping - In a delivery-versus-payment (DVP) transaction, the buyer's funds are released when delivery of the seller's securities is received. Both parties send their respective cash and securities to a third-party custodian who will send a written confirmation of the transaction to the investor when the transaction is successfully completed. This payment arrangement protects the buyer from any fraudulent activities on the part of the seller and from any credit risk on the seller's part. If the seller were to default or go bankrupt, the buyer would have ownership of the securities.

Regardless of the type of investment purchased, the investor should receive a confirmation of the transaction once the deal is complete. If a confirmation is not received from the custodian, the investor should immediately question why. Many investment losses have occurred because the investor failed to follow proper safekeeping procedures and failed to take delivery of securities.

Evaluating and Reporting on Investment Performance

Timely and accurate reporting is an important part of the investment program. Governments need timely reports to see how their investments are performing. For this reason, it is necessary to establish and measure performance against a benchmark and to prepare regular investment reports for review by the governing body. Government Code Section 53646 provides guidance on the frequency of reports and the information that should be included in the reports.

Set performance benchmarks - Benchmarks can be set in a number of ways. A local agency should choose a benchmark that closely matches its portfolio in terms of risk and maturity. An agency whose portfolio is invested in cash and Treasury securities with a weighted average portfolio maturity of 90-days should measure its performance against a benchmark such as a 3-month U.S. Treasury bill. Likewise, a government that invests only in an investment pool should measure its performance against a comparable measure such as other investment pools with similar weighted average maturities or an index such as the S&P Rated LGIP Index. The agency also can measure the pool's performance against a Treasury security with a similar weighted average maturity. Treasury securities make good benchmarks because they simulate the performance of a passive investment strategy.

Monitor investment performance - Since reporting is such an important part of the investment process, reports should be sent at least quarterly to the governing body, the investment oversight committee, if one exists, and others as deemed appropriate. Some agencies may choose to issue monthly reports. The following information is required by Government Code 53646:

- Type of investment
- Issuer
- Maturity date
- Cost of each investment
- Description of investments under the management of contracted parties
- Market value of each investment

A well-run investment program protects the agency's funds and makes effective use of those funds through the efficient investment of funds. In these times of low rates, investors should follow the guidelines of their investment programs and not subject their funds to undue risk by chasing yield.

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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/cdiac.