



CMTA 2019 Conference

Investment Policy Fundamentals and Legislative Update

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Section 1 | Investment Policy



“A written investment policy is the single most important element in a public funds investment program.”

From GFOA’s *Best Practice on “Creating an Investment Policy”*

- Why?
 - It improves the quality of decisions.
 - It demonstrates a commitment to the fiduciary care of public funds, with emphasis on balancing safety of principal and liquidity with yield.
 - It signals to rating agencies, the capital markets, and the public that a government entity is well managed and is earning interest income suitable to its situation and economic environment.

- Defines the investment program
 - Legal and permitted activities and investments
 - Who's in charge
 - Measurement of results
 - Relationship to counterparties

- Provides protection for the agency

- Addresses the dynamic nature of the investment process



- Finance officers have a fiduciary duty to perform:
 - Primary goals - *safety, liquidity, yield*
 - Secondary goals
 - Revenue goals
 - Establishing an investment strategy
 - Project-specific goals
 - Overall financial health of Agency

- These are all important—it isn't enough to simply park the funds and hope for the best outcome!





- Primary objectives of investment activities:
 - **Safety**
 - Mitigate interest rate risk
 - Mitigate credit risk

 - **Liquidity**
 - Meet anticipated cash flow requirements
 - Since all possible demands cannot be anticipated, hold securities that have active secondary markets

 - **Yield / Return**
 - Earn a reasonable return commensurate to appropriate level of risk
 - Establish appropriate benchmark(s)

- Quantify objectives and write them into the policy to create the foundation of an effective investment program



- Clear summary of internal controls
 - Handling of transactions
 - Requirements for 3rd party relationships
 - Custody arrangements
 - Protect the Agency from loss of funds due to:
 - Fraud
 - Employee error
 - Misrepresentation by 3rd parties
 - Unanticipated changes in the financial markets
 - Imprudent actions by employees and officers

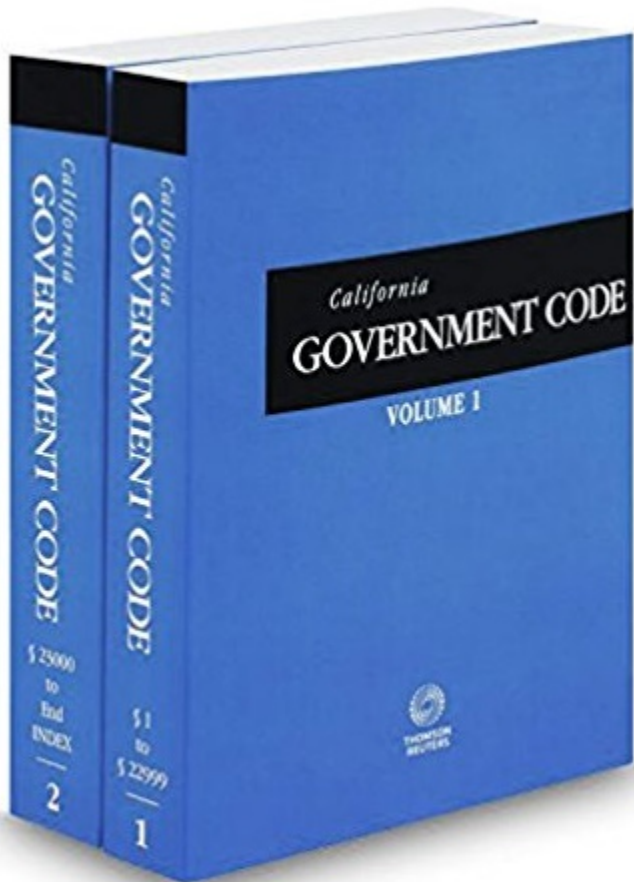
An Investment Policy Formalizes Guidelines for Best Practices, Risk Management and Compliance

Risk Management

- Permitted and Prohibited investments
- Maximum Maturity and Duration
- Diversification amongst Sector and Issuer
- Policies and Procedures

Compliance

- Do investments Comply with Code and Policy
- Affirmation of Compliance to Governing Body
- Auditors review Max Maturity, Permitted Investments, Ratings



- GFOA recommends an annual review:
 - To capture updates to Code
 - To include latest best practices
 - To review risk tolerances
 - To update permitted investments
 - To capture changes in Agency's operating environment
 - To update investment program goals and objectives



Getting started

- Review state statutes governing investing and depositing public funds
- Consider:
 - Staffing expertise
 - Resources
 - Time availability
 - Risk tolerances
 - Political environment

- The objectives of the investment program are to achieve **safety, liquidity, and return**
- The investment policy serves as the framework for implementing the investment program
- The investment strategy establishes how to manage the portfolio with the proper risk profile
- The investment strategy is reflected in the choice of an appropriate benchmark
- Once chosen, the portfolio strategy shouldn't change often
- Tactical changes are made within the broader framework of the portfolio strategy

Section 2 | Component Parts



- Components not all defined by Code
- Reflecting Industry Best Practices
- Sources for outlining your policy:
 - GFOA
 - CMTA
 - APT of US & C



- Introduction and Statement of Intent
 - Overview of entity
 - Invest funds in compliance with State and Local laws
 - Ensure prudent money management
 - Provide for daily cash flow requirements
 - **MAY** submit to the governing body and treasury oversight committee should one exist



- Scope
 - Funds covered by policy
 - General Fund
 - Special Revenue Funds
 - Debt Service Funds (may be subject to indenture)
 - Capital Project Funds
 - Enterprise Funds
 - Internal Service Funds
 - Other funds
- Not covered—Employee pension funds and retiree medical



- Persons authorized to make investment decisions are Fiduciaries
 - Board of Supervisors
 - Treasurers
 - Finance Directors
 - Investment Personnel
 - Oversight Boards
 - Investment Advisers
 - Brokers are ***NOT*** fiduciaries at this time
- Test of fiduciary duty compliance is one of conduct, not performance



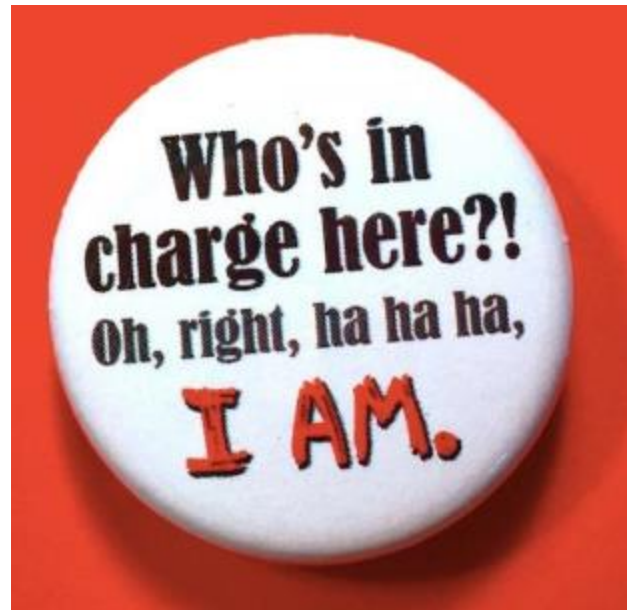
- By law a fiduciary must
 - Make decisions in the best interest of the beneficiary
 - Always put the beneficiaries' interests before their own
 - Act prudently
- Prudent Investor Standard

“...a trustee shall act with care, skill, prudence, and diligence, under the circumstances then prevailing,...that a prudent person acting in a like capacity and familiarity with those matters would use...”

- Beware: Prudent Investor Standard and Prudent Person Standard are not the same

- Primary objectives of investment activities:
 - Safety
 - Mitigate credit risk
 - Mitigate interest rate risk
 - Liquidity
 - Meet anticipated cash flow requirements
 - Since all possible demands cannot be anticipated, hold securities that have active secondary markets
 - Yield / Rate of Return
 - Earn a reasonable return relative to the risk being assumed
 - Establish appropriate benchmark(s)
- Quantify objectives and write them into the policy to create the foundation of an effective investment program

- Legislative body may delegate the investment authority to the Treasurer
- The Treasurer
 - Responsible for all transactions
 - Shall establish a system of controls to regulate the activities of subordinate officials





- Refrain from personal business activity that could conflict with investment program
- Provide public disclosure document by February 1 each year
- Refrain from personal investment transaction with same individuals employed by financial institutions conducting business with the local agency

- Maintain a list of authorized financial institutions
- Financial institutions and Broker/Dealer must provide
 - Audited financial statements
 - Proof of FINRA certification
 - Trading resolution
 - Proof of State of California registration
 - Completed Broker/Dealer questionnaire
 - Certification of reading investment policy and depository contracts
- Conduct an annual review of financial institutions condition and registration



- Authorized and suitable investments
 - Research state statutes
 - Risk tolerance
 - Types of securities and transactions
 - Maximum maturities and weighted average maturities
 - Credit criteria
 - Repurchase agreement criteria

- California Government Code
 - Section 53601 – local governments that do not pool money
 - Section 53635 – local governments that pool money





- Local Agency bonds
- Municipal securities—CA & local muni/treasuries of other 49 states
- US Treasuries
- Federal Agencies
- Bankers' Acceptances
- Commercial Paper
- Negotiable CDs
- Repo/Reverse Repo
- Medium-Term Notes
- Money Funds/Mutual Funds
- Pass-through securities
- LGIP
- Supranationals



- Review of holdings to ensure compliance with policy and code
 - Compliance at time of purchase
 - Annual review to identify securities out of compliance
 - Report out of compliance securities to governing board and oversight committee

- Develop procedure for out of compliance or downgraded securities



- Due diligence
 - Criteria for evaluating pools and mutual funds
- Questionnaire should answer these questions
 - Description of eligible securities and investment policy
 - Interest calculation and distribution methodology
 - Safekeeping and settlement information, pricing, and audit procedures
 - Eligibility to invest in program, limits on transaction frequency, deposit and withdrawal size
 - Schedule for receiving statements, including holdings and transaction list
 - Are reserves or retained earnings utilized
 - Fee schedule and method for assessing fee
 - Does pool accept bond proceeds



- Collateralization
 - Certificate of Deposit
 - Collateral needs to be 110% of market value
 - Repurchase Agreements
 - Collateral needs to be 102% of market value

- Safekeeping and Custody
 - All securities must be held by a third party custodian
 - Delivery vs payment (DVP) settlement
 - Fed wire
 - Depository Trust Company (DTC)





- Diversification
 - Diversification among asset classes
 - Diversification among issuers and issuer limitations
 - Diversification across industries

- Security type and issuer percentage of portfolio limits



- Match investments with anticipated cash flow requirements

- Maximum Maturities
 - Limitations per code
 - 5 year overriding limitation
 - Maximum maturity stated by security type
 - Permitted investments beyond 5 years
 - Requires governing body approval and a 60 day waiting period before investments are made
 - Limited to Treasury, Agency, and Municipal securities

- Internal controls are designed to ensure assets are protected from loss, theft or misuse
 - Controls are detailed in the investment policy procedures
- Establish an annual process of independent review by an external auditor





- Objective is to obtain a rate of return throughout budgetary and economic cycles commensurate with the risk constraints and cash flow needs
- Choose a benchmark that represents the appropriate level of risk for the portfolio
- Compare Returns:
 - How is your portfolio performing relative to the benchmark?
- Compare Risk:
 - Is your portfolio's volatility within expectations versus benchmark?
- Using an earnings target as a benchmark

What Makes a Good Benchmark?



- An unmanaged portfolio that includes the types and maturities of securities that are permitted in the investor's policies
- Representative of assets in which the fund may invest
- Constructed in a disciplined and objective manner
- Formulated from publicly available information
- Exhibit similar risk characteristics as the investment objectives
- Known in advance
- The information derived from both the benchmark and the portfolio should use the same calculation methods



- There are several providers of fixed income market indices such as Barclays (formerly Lehman Brothers), ICE Bank of America Merrill Lynch, and Citigroup
 - Index of 91 day T-bill Security
 - Index of 1 Year T-bill Security
 - Index of 1-3 Year Treasury Securities
 - Index of 1-3 Year Government Securities
 - Index of 0-5 Year Treasury Securities
 - Index of 1-5 Year Government Securities
 - Index of 1-5 Year US Corporate (A and above)/Government Securities



- Yield = income from current investments + projection of reinvestment income
 - Used to forecast income for line item in next year budget
 - And often, to compare portfolio return to a yield benchmark
- Realized return: Adds realized gains and losses
 - No realized return benchmark
 - Return information can be distorted
- Total rate of return
 - Incorporates all elements of return – income, realized and unrealized gains and losses, reinvestment of cash flows
 - Can be used to provide comparable results in a consistent format



- If the governing body delegates investment authority to the Treasurer, the Treasurer must submit a transaction report monthly
- The Treasurer **MAY** submit a quarterly report to the governing body
- The quarterly report must be submitted within 30 days of quarter end
- If a quarterly report is submitted it must include
 - Type of investment, issuer, maturity date, par value, amount invested
 - Descriptions of funds under management of contracted parties
 - Current market value and source for contracted funds excluding LAIF



- Empower staff to control risk parameters
- Provide tools for booking earnings
- Ensure transparency for stakeholders
 - Be careful with the information you share
 - Robust enough to understand status
 - Specific enough to be relevant
 - Broad enough to not bog readers down with minutiae
 - Common components
 - Par value, amortized cost, market value
 - Transactions
 - Weighted average maturity and/or duration
 - Yield to maturity



- The policy shall be adopted by resolution by the governing body
- The policy shall be reviewed annually by the governing body and any modifications approved by the governing body
- The designated official shall establish written investment policy procedures



- An Investment Procedures Manual assists the staff in day-to-day operations of the investment program
- It should include explicit delegation of authority for executing transactions and investment decisions and include reference to procedures like:
 - Review of daily cash balances
 - Process for selecting investments
 - Steps for purchasing an investment
 - Settlement and safekeeping process
 - Wire transfer agreements
 - Banking service contracts
 - Collateral/depository agreements

- Glossary
 - Definitions of investment terms
 - Definitions of investment vehicles
 - Definitions of accounting terms
 - Sample
 - <http://chandlerasset.com/news-resources/glossary/>

- Start by
 - Examining State Statutes
 - Review sample investment policies, but don't just copy
- The Policy is an internal document
 - Involve staff responsible for investments
 - Prepare draft of new policy and anytime making revisions
 - Have the right parties review the drafts
- The Policy is an external document
 - Distribute to outside parties
- Get governing body approval
 - As resolution, ordinance, etc.
- Perform annual reviews & updates



- **CMTA**

- CMTA Investment Policy Certification Program and Application

- https://c.ymcdn.com/sites/cmta.site-ym.com/resource/resmgr/imported/forms/2013_CMTA_Investment_Policy.pdf

- **CMTA**

- Sample Certified Investment Policies

- <http://www.cmta.org/?page=39>

- **APT of US & C**

- Investment Policy Certification Program and Application

- https://www.apusc.org/images/certification/investment_model_policy_app_2015.pdf



- **CDIAC**
 - Local Agency Investment Guidelines, 2017
 - [http:// www.treasurer.ca.gov/cdiac/LAIG/guide](http://www.treasurer.ca.gov/cdiac/LAIG/guide)

- **CDIAC**
 - Investment Policy Reporting Practices: An Informational Guide, 2006
 - [http:// www.treasurer.ca.gov/cdiac/reports/policy.pdf](http://www.treasurer.ca.gov/cdiac/reports/policy.pdf)

- **CDIAC**
 - California Public Fund Investment Primer, Updated 2009
 - [http:// www.treasurer.ca.gov/cdiac/invest/primer.pdf](http://www.treasurer.ca.gov/cdiac/invest/primer.pdf)

- **Government Finance Officers Association (GFOA) Best Practices**
 - Investment Program for Public Funds
 - <http://gfoa.org/investment-program-public-funds>
 - Investment Policy
 - <http://gfoa.org/investment-policy>
 - Local Government Investment Pools
 - <http://gfoa.org/local-government-investment-pools>
 - Using Benchmarks to Assess Portfolio Risk and Return
 - <http://gfoa.org/using-benchmarks-assess-portfolio-risk-and-return>
 - *Investing Public Funds* by Girard Miller et. al.—a GFOA publication

Section 3 | Recent Legislative Changes





- Chapter 181, Statutes of 2015 (AB 283)
- Extends the authority to use a private sector entity to assist placing deposits to January 1, 2021
 - Invest up to 30 % in placement service certificates of deposit (CDs)
 - Invest 30 % in negotiable certificates of deposit

- Chapter 366, Statutes of 2016 (SB 974)
- State Code now makes reference to the rating category only
- The 3 major NRSROs use letter rating categories
 - Fitch (AAA to A)
 - Moody's (Aaa to A)
 - Standard & Poor's (AAA to A)
- Each use a modifier within each whole letter rating category
 - Fitch (+ or -)
 - Moody's (1, 2, or 3)
 - Standard & Poor's (+ or -)



- (o) A mortgage passthrough security, collateralized mortgage obligation, mortgage-backed or other pay-through bond, equipment lease-backed certificate, consumer receivable passthrough certificate, or consumer receivable-backed bond ~~of a maximum of five years' maturity.~~ bond. Securities eligible for investment under this subdivision shall be ~~issued by an issuer rated in a rating category of "A" or its equivalent or better for the issuer's debt as provided by an NRSRO and~~ rated in a rating category of "AA" or its equivalent or better by an ~~NRSRO.~~ NRSRO and have a maximum remaining maturity of five years or less. Purchase of securities authorized by this subdivision shall not exceed 20 percent of the agency's surplus moneys that may be invested pursuant to this section.



- **California Debt and Investment Advisory Commission**

- Debt Line Newsletter

- <http://www.treasurer.ca.gov/cdiac/debtpubs/2017/201703.pdf>

- Local Agency Investment Guidelines

- <http://www.treasurer.ca.gov/cdiac/LAIG/guideline.pdf>

- **California State Treasurer**

- Intersections Newsletter

- <http://www.treasurer.ca.gov/newsletter/2017/201703/lead.asp>



- **Financial Industry Regulatory Authority - FINRA**
 - Regulatory Notice 12-25, Suitability
 - <http://www.finra.org/file/regulatory-notice-12-25>

Section 4 | Disclosures





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