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*Local governments sometimes look to investment earnings to compensate for declining revenues. Adhering to established investment policies can help ensure that they don't compromise the safety of public funds in the process.*

# Back to Basics: Making the Case for Investment Policies

*By Francie Heller, Sally Walton, and Jeremy Willmoth*

The historically low interest rates caused by the Federal Reserve's aggressive efforts to minimize the effects of the most recent recession have created a serious dilemma for local governments. Already confronted by substantial budget gaps because of declining tax revenues, eroding interest earnings from investments have further exacerbated fiscal woes. Faced with the same problem in the early 1990s, some governments tried to compensate for revenue shortfalls by pumping up investment earnings through extended maturities and exotic securities. These misguided efforts resulted in unprecedented losses of taxpayer dollars prompting some states to pass legislation requiring governments to develop written investment policies. Many governments have since heeded the advice of professional associations to institute such policies.

It remains to be seen whether if not all of the attention focused on public investing following the losses of the last decade and the canonization of investment policies since that time will be enough to prevent a recurrence of those events this time around. What is certain is that investment policies are much more pervasive now than they were before. The prevalence of such policies, however, does not eradicate the temptation to plug budget holes with the putty of investment earnings. As such, this article reviews the importance of investment policies and describes how they can be used to maintain proper perspective now that governments are again challenged by the double whammy of declining tax revenues and eroding interest earnings.

## Developing the Investment Policy

The foundation of any successful investment program is a comprehensive policy that reflects the government's investment philosophy and tolerance for risk. For many governments, developing policies and procedures is a time-consuming process that is low on their list of priorities. Confronted by legal or political imperatives to develop an investment policy, governments turn almost instinctively to the policies of other jurisdictions, changing little more than their name. Although sample policies provide useful guidance for the development of an investment policy, governments should do more than simply cut and paste the work of others. An effective policy demands careful consideration of those factors that make each

government unique, including the timing of revenues and expenditures, liquidity constraints, and the expertise of the investment staff.

An investment policy is much more than a simple list of authorized investment instruments. A well-developed investment policy can and should be a valuable tool for managing a government investment program. Such a policy defines the parameters of the investment program and indemnifies investment officers from personal liability so long as they adhere to the tenets of their respective policies. Frequently, state investment statutes provide specific guidance on local government investing. Some states go so far as to require by law that their political subdivisions develop and follow written investment policies. Investment guidance at the state level, however, is necessarily general. As such, local governments should tailor their investment policies and programs to their unique considerations.

Although investment policies should be customized by jurisdiction, there are a number of important components or categories

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that should be included in any investment policy. Sample policies developed by both the Government Finance Officers Association and the Municipal Treasurers Association can serve as useful checklists for the kinds of information governments should consider including in their investment policies

(Exhibit 1).<sup>1</sup> These components include—but are not limited to—scope, objectives, delegation of authority, prudence, collateralization requirements, authorized investment instruments, interim and annual reporting, and selection criteria for depositories, broker/dealers, and safekeeping institutions.

Every investment policy should include a clear and concise statement of objectives. Investment objectives, which should be equally well defined for short-term cash as for long-term investments, typically encompass safety, liquidity, and yield. All governments have cash flow needs that must be carefully managed to ensure that there is sufficient cash to meet obligations and that idle cash is efficiently invested. Written investment policies should be available to guide cash managers as they make daily decisions about the allocation of public funds among allowable investment instruments. In the absence of such policies, investment officers expose themselves to

the second guessing of both management and elected officials.

Investment policies are generally assumed to be intended exclusively for the individual or individuals who have direct responsibility for a government's investment program. This assumption is reasonable in that the purpose of such policies is to guide investment decisions so as to realize stated objectives. However, because investment decisions contribute to a government's overall financial condition, responsibility for the policy that guides these decisions should extend beyond the finance department to the chief executive, governing body, and others who have direct oversight of fiscal affairs. All of these parties should be included in the development and review of the investment policy, which should uniformly apply to local government employees, officials, representatives, and authorized agents.

Once a government has developed an investment policy, the governing body should officially approve the policy. Securing legislative approval legitimizes the policy as the authoritative guide for the government's investment program. Upon approval, the investment officer should evaluate the government's current investment program to ensure that all activities comply with the new policy. Any discrepancies should be immediately corrected. This is also an ideal time to formalize procedures for implementing the investment policy. Written procedures outline the process for making investment decisions, detail the activities of the investment staff, and specify how investment decisions are to be carried out. Many governments require a regular review (or audit) of the investment function to verify that the requirements of the investment policy are being met.

## Managing Risk and Return

Governing body approval of investment policies should not relegate these documents to the dust-collector status often reserved for government policies and procedures manuals. To the contrary, investment policies should be referred to again and again as governments manage their investment programs. Written investment policies can help governments manage market risk and return by specifying tolerance for risk, defining risk parameters, and minimizing ambiguity.

### INVESTMENT POLICY CHECKLIST

- Scope
- Objectives
- Delegation of authority
- Prudence
- Ethics and conflicts of interest
- Internal controls for the investment function
- Investment committee
- Interim and annual reporting
- Instruments
- Collateralization
- Selection of financial institutions and broker/dealers
- Maturities and volatility
- Diversification
- Risks
- Safekeeping and custody
- Performance evaluation and operations audit

The most common types of investment risk are credit risk, liquidity risk, and market risk. Credit risk is the risk that some or all of the principal amount of an investment will be lost because of default by the issuer, securities broker or dealer, or financial institution. Liquidity risk is the risk of not being able to sell an investment prior to maturity in order to obtain needed cash. Market risk is the risk that changes in the financial market will reduce the value of an investment. These risks can be mitigated to various degrees by limiting investments to high-quality credits, insisting on collateralization for certain investments, ensuring that there is an active secondary market for investments, and shortening maturities when interest rates are expected to rise.<sup>2</sup>

Governments should explicitly state their tolerance for risk, taking into consideration their overall financial condition, their short- and long-term financial goals, and their unique political and administrative environments. An investment policy should specify the government's risk-to-return ratio and describe how it plans to maintain that ratio. This is usually accomplished through some combination of the risk mitigation strategies identified above. Because governments operate in a politically charged environment in which stewardship for public funds is sacrosanct, financial stability and protection against investment losses are of paramount importance.

In buying and selling securities for their investment portfolios, governments need to be careful so as not to assume more risk than they can tolerate. Broker/dealers and investment advisers can help governments establish appropriate risk parameters for their portfolios based on the investment objectives and tolerance for risk specified in their investment policies. Otherwise, public investors can easily fall into the trap of chasing yield according to prevailing market conditions. Ideally, investment policies are developed when market conditions are neutral—neither decidedly bullish nor decidedly bearish. This makes the investment policy a stable guide through the inevitable fluctuations in the market.

Investment policies must be able to stand the test of time; that is, their usefulness in guiding investment decision making should not wax and wane with the financial markets. If a policy stifles a government's ability to adjust its investment program to changing market conditions, the policy should be revised accordingly. But an investment policy should not be a work in progress, subject to the whims of broker/dealers, portfolio managers, administrators, and elected officials. Frequently revising investment policies to accommodate the latest "sure thing" undermines their very purpose, which is to guide investment activities and protect against losses—in any given circumstance.

In articulating allowable securities in their investment policies, governments should be as clear and detailed as possible. Ambiguous language opens the door for the "loose" translations that can get governments in trouble. If, for example, state law limits the use of commercial paper or securities lending and a government decides to engage in such transactions, the policy should be written so as to clearly prohibit illegal investments. If a government decides to invest in a state-sponsored local government mutual fund (investment pool), that fund should be explicitly identified. Otherwise, a portfolio manager might reasonably assume that the policy extends to all municipal mutual funds. The more precise an investment policy's language, the less room for interpretation and mistakes.

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## INVESTMENT POLICY TIPS AND TRAPS

### Tip

Clearly describe which funds are covered by the policy and which funds are covered by a separate policy.

Include a clear and concise statement of objectives.

Know your investment statutes and determine if all of the allowable investment instruments are appropriate for your investment program.

Use explicit language to describe allowable investment instruments; include clear definitions of investment types, credit criteria, maturity restrictions and other requirements.

Require governing body approval for new security types, securities that are not clearly allowed by the policy, and deviations from the policy.

Include collateralization requirements in the policy.

Avoid arbitrary percentages when discussing diversification requirements; instead, use guidelines such as "no more than 5 percent of the portfolio can be invested in the securities of a single issuer" or "no more than 20 percent of the portfolio may be invested beyond one year."

Require a formal process for selecting financial institutions and broker/dealers and describe this process in the policy.

Require competitive quotes from at least three financial institutions and/or broker/dealers.

Pick relevant benchmarks to gauge investment performance.

Adopt your investment policy as a resolution or an ordinance.

Keep in mind the difference between a policy and a procedure.

Include specifics such as authorized personnel and authorized financial institutions and broker/dealers in an appendix attached to the policy.

### Trap

The policy should be clear on which funds are covered by the policy since some funds, such as bond proceeds or pension funds, may have different investment objectives or different investment horizons and would be better managed under a separate policy.

Simply stating investment objectives as safety, liquidity, and yield will not help governments protect their funds. Statements describing how these objectives will be achieved offer better guidance. GFOA's Sample Investment Policy includes explicit statements of objectives.

Some governments copy the state statute into their investment policies, thus allowing the use of investment instruments that staff may not fully understand or that may be inappropriate for their investment program. Many governments may prefer an investment program that is more restrictive than that allowed by state statute.

Vague language leaves room for interpretation. For example, although many derivative investment instruments are guaranteed by the U.S. government, they carry high market risk, which makes them inappropriate instruments for public funds. However, many policies include all U.S. government securities as allowable investments. Clear, explicit language describing allowable investment instruments leaves little room for interpretation and helps protect governments from imprudent investment decisions.

Requiring governing body approval forces investment officials to analyze the security in question and explain why it should be included, thereby preventing decisions that have not been fully thought out.

Governments often require collateralization for their deposit-type investments (e.g., certificates of deposit and repurchase agreements) but do not include specific guidelines. Investment policies should specify allowable collateral securities, collateral ratios, and third-party safekeeping requirements.

Many investment policies include specific diversification guidelines such as, "The portfolio must be invested in 50 percent Treasuries, 30 percent certificates of deposit, 10 percent commercial paper, and 10 percent local government investment pool." Arbitrary percentages can restrict the ability of governments to implement effective investment strategies. The purpose of diversification is to reduce risk in the portfolio. This can be accomplished by investing in a variety of maturities and avoiding over-concentration in specific business sectors.

The point of this section is to specify what process governments will use to screen firms selling securities. This section should require a due diligence review of prospective firms, specify minimum credit criteria for financial institutions, and limit transactions to only those firms on the approved list. The list should be included as an appendix item.

Many governments obtain competitive quotes for their investment transactions but do not specifically require them in the investment policy. By not requiring competitive quotes, this practice could be lost over time. Adding this requirement to the investment policy ensures that the competitive quoting process is always used and ensures the best trade execution for investment transactions.

Many investment policies specify the 90-day Treasury bill as the benchmark in one section and then state that the portfolio must maintain a one-year weighted average maturity in another section. The benchmark should mirror the weighted average maturity of the portfolio in order to provide a meaningful performance comparison. A list of benchmarks with varying weighted average maturities can be included in the policy to cover times when the portfolio's weighted average maturity changes.

Many governments develop investment policies as internal documents and do not require formal governing body approval. By adopting the policy through ordinance or a resolution, the policy becomes an official document.

A policy sets out what you can do. A procedure spells out how you are going to do it. Some policies get bogged down in too much detail and become quickly outdated.

Policies that include names rather than titles of personnel and specific names of authorized business partners can become outdated and require governing body approval to change. Using only titles and referencing appendix items in the policy allows the policy itself to stay current. Appendix items can be easily updated and do not require governing body approval.

## Reviewing the Investment Policy

It is worth reiterating that investment policies are not meant to be fluid documents; once approved, they should be able to stand on their own with minimal revisions. The realities of the new economy, however, demand that governments review their policies whenever new financial opportunities arise, current investments jeopardize the health of the portfolio, or cash needs change. Even in the absence of such developments, governments should review their investment policies at least once every two years to make sure that their portfolios are in line with their policies and that their policies are meeting their needs.

In today's ever-changing marketplace, new securities are constantly coming to market. In addition, some states have relaxed statutory requirements to permit certain types of securities that were not allowed in the past. Although the mere availability or permissibility of new investment instruments does not justify changing an investment policy, governments would be wise to at least consider the appropriateness of such offerings within the context of their overall investment programs. If a new security were to meet a government's risk and return profile, it would make sense to add it to the list of allowable instruments in the investment policy.

Just as governments may need to amend their investment policies to accommodate new investment instruments, they should be prepared to make periodic adjustments if their portfolios are underperforming because of flaws in the policies themselves. Governments should not jeopardize the viability of their portfolios simply to remain true to investment policies that prevent them from achieving minimum yield standards. Before changing their investment policies, however, governments should make sure that flawed policies—not flawed strategies or fluctuating market conditions—are responsible for poor portfolio performance.

Governments also might need to consider revising their investment policies when their cash flow needs change. For example, a change in the timing of property tax collections at the county level could force a local government to issue tax anticipation notes to

cover expenditures until the receipt of tax revenues. This kind of change would have a significant impact on investment activities, fundamentally altering the amount of money available for investment and the maturity structure of the portfolio. Investment policies may need to change with evolving cash flow needs so that governments can continue to efficiently manage idle cash.

## Conclusion

Investment policies are the foundation of sound government investment programs. A well-designed investment policy can enhance portfolio performance, protect against losses, and limit the liability of investment staff. Of course, the extent to which an investment policy facilitates the purposes for which it was designed depends on the importance assigned to it by the organization and the willingness of investment staff to follow its guidance. As government finance officers face increasing pressure to plug budget holes without raising taxes or cutting services, the temptation to offset revenue shortfalls with investment earnings can lead investment officials to deviate from their policies. Renewed emphasis on investment policies and procedures by governing bodies and chief executives can help governments avoid the investment problems experienced under similar economic conditions during the 1990s. ■

## NOTES

- <sup>1</sup> Both of these sample investment policies are available online free of charge. GFOA's policy is available at [www.gfoa.org/services/specials/invplyc.shtml](http://www.gfoa.org/services/specials/invplyc.shtml), while the Municipal Treasurers' Association's can be found at [www.mtausc.org/certification/model.pdf](http://www.mtausc.org/certification/model.pdf).
- <sup>2</sup> M. Corinne Larson, *An Elected Official's Guide to Investing* (GFOA: Chicago, 1996), 7-8.

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FRANCIE HELLER is president of MBIA-MISC, SALLY WALTON is vice president of investments for US Bancorp Piper Jaffray, and JEREMY WILLMOTH is budget administrator for Jackson County, Missouri. The authors are all members of the Subcommittee on Investments of GFOA's Committee on Cash Management.