



By Michelle R.B. Saddler

Since the first edition of GFOA's *Investing Public Funds*, "investment policy" has become a commonly used term of art in state and local government. An investment policy is a set of guidelines used by public agencies and others to prudently manage their investments. A disquieting history of losses in the public funds arena—and a strong sense of foresight—motivated author Girard Miller and GFOA's Committee on Cash Management to first develop guidance for government finance officers charged with investing their communities' financial assets.

Investing Public Funds provided the first known “sample” investment policy for government investors. In response to a series of high-profile investment losses in the government sector during the 1990s, the sample policy was developed into a “model” policy. As more states have adopted mandatory requirements for investment policies at the local level, the result unfortunately has been a proliferation of identical policies that may or may not be understood by key constituents. Further, despite the guidance of the sample policy, governments have continued to experience investment losses. In an effort to make policies more germane to the limitations and tolerance levels of individual units of government, the Committee on Cash Management recently revised the model investment policy.

This article will review the need for investment policies and discuss why the earlier version of the model investment policy warranted revision. The article will provide an overview of GFOA’s revised model investment policy and will highlight the major differences between the two versions. Finally, the article will offer guidance on how to use the new model policy to either develop an investment policy for the first time or revise an existing policy.

WHY INVESTMENT POLICIES? AN HISTORICAL PERSPECTIVE

Despite the best of intentions and efforts, investment losses do happen from time to time in the public sector. Although these losses can be devastating to the governments and individuals involved, the lessons learned from their mistakes are of great value to the rest of us. For example, the lessons of the 1980s and 1990s prompted government investors to develop policies and procedures by which they can better safeguard public funds. Many practitioners have since adopted the mantra of Will Rogers: “I am more concerned about the return of my principal than the return *on* my principal.”

The following sections highlight some of the high-profile investment losses in the public sector over the last two decades, as well as the lessons learned from these unfortunate mistakes. It should be noted that most of the entities identified here have since adopted strong investment policies and procedures. In fact, some of these entities are now leading the way in safeguarding public funds.

Lessons from the 1980s. In 1982, an agency in the State of New York invested \$305 million (60 percent of its portfolio) in

repurchase agreements with Lombard Wall, a brokerage firm that had filed for Chapter 11 bankruptcy. This agency lost \$21 million when the repurchase agreements were considered merely collateralized loans.

In March 1985, the bankruptcy of ESM Government Securities caused municipal investment losses of approximately \$100 million. In most of these cases, the losses were a result of governments investing in repurchase agreements and other instruments without taking delivery of the collateral instruments. In the end, nine government entities in seven different states suffered investment losses averaging nearly \$11 million each. After lengthy disputes and litigation, these municipalities were able to recover only 60 cents on the dollar. On a positive note, the City of Tempe, Arizona, which had taken delivery of its investments with ESM, neither suffered a loss nor saw its assets tied up in legal proceedings.

Improper brokerage selection and failure to take delivery of collateral instruments took a heavy toll on the public investment community during the 1980s. A case of price gouging in one Ohio county only added to the woes. But these incidents ultimately galvanized the profession and led to the widespread adoption of a number of remedies, including the use of delivery versus payment, improved broker/dealer selection and agreements, the development and use of master repurchase agreements, and competitive bidding for investments.

Lessons from the 1990s. In the 1990s, investment losses stemmed not from relying on less creditworthy trading partners or failing to properly secure investments, but rather from unsuitable investment instruments and the leveraging of public funds. These problems actually began in 1984, when the fourth largest city in California invested \$750 million of its cash in long-term bonds with an average maturity of 17 years. With its cash invested in long-term securities, the city did not have the funds to meet its day-to-day operating requirements. The city covered its cash needs by *borrowing* against the long-term securities—a practice known as leveraging. The market value of the long bonds eventually declined by more than 10 percent and the city lost \$60 million when it finally had to liquidate the securities.

There were other debacles from leveraging funds and investing money in unsuitable and risky instruments. The most staggering case occurred in Orange County, California, where a countywide



investment pool lost more than \$2 billion after the value of its long-term investment holdings declined by 20 percent. The pool borrowed money via reverse repurchase agreements for the purpose of reinvesting those funds, converting an initial \$7.3 billion into \$21.7 billion of purchasing power through the use of leverage. The proceeds of these loans were invested in risky, long-term derivative securities.

Losses resulting from unsuitable investments were not limited to the West Coast. In 1994, a system of city colleges in Illinois placed its entire investment portfolio of \$96 million in risky mortgage-backed securities whose value subsequently declined by more than 30 percent. The extraordinary magnitude of these losses brought high public visibility to the problem, and the GFOA Committee on Cash Management quickly sprang into action, proposing model investment legislation and approving numerous recommended practices during the mid 1990s. The model investment legislation consisted of three components: a legal list of permissible securities, a prudent investor clause requiring investment officers to adopt procedures that reflect concern for the preservation of principal, and the mandatory enactment of written investment policies by governments.

Today's Investment Environment. As we enter 2004, we find ourselves fast approaching another low-interest, rising-rate environment. The Board of Governors of the Federal Reserve Bank eased interest rates 11 times in 2001. Public investors have watched their returns decrease through 2002 and 2003, and strong total returns seem nowhere to be found. To make matters worse, the 2001 recession has had a lingering effect on tax revenues, leaving many state and local governments looking for ways to balance their budgets. In this environment, the temptation to “chase yield” is strong. But as the economy rebounds, interest rates will eventually rise and long-term bond prices will fall, setting up investors for potential losses.

It is critical that public treasurers and finance officials avoid the temptation to chase yield. Rather, we must go back to the basics, as admonished by the leaders of key national associations. In and of themselves, written investment policies will not prevent loss of capital. To be effective, investment policies must have the complete buy-in of governing bodies in the form of legally adopted and regularly reviewed and updated policies. Governing bodies will only buy into these policies when they are brought to an understanding thereof through meaningful discussion.

THE REVISED MODEL INVESTMENT POLICY

The purpose of the model investment policy is to provide guidance to governments in developing an effective invest-

ment policy. The model is not intended to supplant an existing policy; rather, it is presented as a sample to help investing entities customize a policy to fit their particular needs, constraints, and capabilities.

The revised model policy, like the original, provides sample language for key sections of an investment policy, including but not limited to governing authority, scope, general objectives, standards of care, authorized financial institutions, safekeeping and custody, suitable and authorized investments, investment parameters, reporting, and approval. The sample language is applicable to the investment of all cash management, core, and reserve funds, excluding the investment of employee retirement funds. Proceeds from certain bond issues, as well as separate foundation or endowment assets, should be covered by a separate policy.

The single greatest difference between the previous model investment policy and the revised version is that the latter offers *choice*. The revised model policy includes more than one offering of sample language for some of the key sections. The purpose of the alternative language is to accommodate the varying needs of government entities and to stimulate discussion of important issues. The alternative sample language may be used *in place of* or *in addition to* the first paragraph of each section, depending on the goals and objectives of the government. The seven sections that now offer some degree of choice and a higher level of stimulus for discussion include the following:

- General Objectives – Yield
- General Objectives – Local Considerations
- Safekeeping and Custody – Internal Controls
- Investment Parameters – Diversification
- Reporting – Methods
- Reporting – Performance Standards
- Policy Considerations – Exemptions

In addressing the objective of yield, for example, governments have the option of using language that either (A) generally describes the investment *philosophy* that yield is of secondary importance to safety and liquidity or (B) states a specific investment *objective*, such as meeting or exceeding the average return of a given benchmark. The former outlines a basic buy-and-hold strategy, whereas the latter focuses more on yield outcome. Exhibit 1 shows the differences between the section on yield in the previous version of the model investment policy and this same section in the revised model policy.

Exhibit I: The Old vs. The New

PREVIOUS VERSION

Yield The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. The core of investments are limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall not be sold prior to maturity with the following exceptions:

- A security with declining credit may be sold early to minimize loss of principal.
- A security swap would improve the quality, yield, or target duration in the portfolio.
- Liquidity needs of the portfolio require that the security be sold.

REVISED VERSION

Yield The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. The core of investments are limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall generally be held until maturity with the following exceptions:

- A security with declining credit may be sold early to minimize loss of principal.
- A security swap would improve the quality, yield, or target duration in the portfolio.
- Liquidity needs of the portfolio require that the security be sold.

Alternative sample language:

The [entity's] cash management portfolio shall be designed with the objective of regularly meeting or exceeding the average return on three-month U.S. Treasury bills, the state investment pool, a money market mutual fund (specify) or the average rate on Fed funds, whichever is higher. These indices are considered benchmarks for lower risk investment transactions and therefore comprise a minimum standard for the portfolio's rate of return. The investment program shall seek to augment returns above this threshold, consistent with risk limitations identified herein and prudent investment principles.

GFOA's revised model investment policy is available for download on GFOA's Web site at www.gfoa.org. For further information on developing an investment policy, please refer to GFOA's *Investing Public Funds* by Girard Miller with M. Corinne Larson and W. Paul Zorn. Governments should obtain legal counsel to ensure compliance with state and local laws, regulations, and other policies concerning the investment of public funds.

The addition of alternative sample language to the model investment policy is a far more realistic representation of the public funds investment process. Safety, for instance, is not merely defined by the full collateralization of public deposits (although collateralization is an important factor); safety can be achieved in the context of each individual investment or in the context of the overall portfolio. Governing board members—to use another example—must choose whether to specify a high-level listing of necessary internal controls or to provide general direction and purpose behind the development and implementation of necessary internal controls.

The process of drafting and redrafting the revised model investment policy elicited stimulating and even controversial discussion among the members of GFOA's Committee on Cash Management. Committee members were generally in agreement about the types of language to include in certain sections (such as alternative examples for diversification), yet they were divided on whether or not to include a section on local considerations. This is precisely the kind of discussion that is important to have early in the process of developing or updating an investment policy. Otherwise, staff and elected officials may face new or unresolved issues after the policy is adopted.

HOW TO USE THE MODEL POLICY

As with the previous version of the model investment policy, the sample language in the revised version can be copied verbatim or modified to most accurately express the policy intentions of the government. The policy is available for download on GFOA's Web site at www.gfoa.org. The downloadable feature of the model policy will make it easy to more fully concentrate on *content* rather than on the production of the investment policy. Below are some suggestions on how to use the model policy to either develop an investment policy for the first time or update an existing one.

Starting from Scratch. For governments that do not yet have an investment policy, public cash managers and finance officers may wish to take the lead in drafting a policy for the consideration of the governing board. If you are using the model investment policy as a guide, you might begin by reading each section carefully in turn and deciding how best to customize that section to the needs of your jurisdiction. For instance, the initial section on legality would have to be modified to reference all applicable legal citations that govern the investment of public funds in your locale. The section on scope would need to be modified to list all funds that are, and are not, covered by the policy. Under general