

Investing for small governments: Best practices for your investment program



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**Illinois Metropolitan
Investment Fund**

Expectations and agenda

- I. Introductions and review of attendee expectations
- II. Investment program
- III. Investment policy
- IV. Investment procedures
- V. Cash flow forecasting & investing
- VI. Safekeeping
- VII. Diversification

GFOA Best Practice: Investment program for public funds

- ❑ Management and monitoring of investment activity
- ❑ Allows structure to set policy, make decisions, and safeguard the government's financial assets
- ❑ Fiduciary responsibility, regardless of size or type of government entity
- ❑ Components:
 - ✓ Develop investment leadership team
 - ✓ Identify funds used for investments & characteristics
 - ✓ Review all federal, state and local laws & regs
 - ✓ Establish a risk profile
 - ✓ Determine portfolio management team (internal/external)
 - ✓ **Create and implement an investment policy**

Investment program

“Governments have a fiduciary responsibility in managing their funds, including the ongoing management and monitoring of investment activity. A government’s investment program should derive from the entity’s Investment Policy.

Developing a public funds investment program is essential to effective financial management, and it sets the foundation for creating protocols and internal controls, constructing and managing the portfolio, navigating changing economic conditions, and communicating information to stakeholders. While different types and sizes of governments require differing levels of complexity in their investment programs, all governments need to recognize their fiduciary responsibility. Having an established public funds investment program provides the structure to effectively set policy, make decisions, and safeguard a government’s financial assets.”

Investment program

Also – program should include:

- Managing risk
- Managing external factors (constantly changing)
- Oversight
 - ✓ Compliance
 - ✓ Reporting
 - ✓ rebalancing

Fiduciary duty

- ❑ An Individual / Institution that has special relationship of trust with another person/ group (legally responsible for their assets). Examples:
 - ✓ Treasurers
 - ✓ Finance directors
 - ✓ Investment personnel
 - ✓ Oversight boards
 - ✓ Investment advisers
- ❑ Brokers are **NOT** fiduciaries
- ❑ ***By law a fiduciary must:***
 - ✓ Make decisions in the best interest of beneficiary;
 - ✓ Always put beneficiaries' interests before their own; &
 - ✓ Act prudently.

Prudence standard

1. Prudent Person
2. Prudent Investor
3. Prudent Expert

Prudence language typically includes statement similar to :

“...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...”

Compliance with fiduciary duty

- ❑ Test of fiduciary duty compliance is one of **conduct**, not performance
- ❑ Measures for evaluating compliance
 - ✓ Establishment of formalized investment policy
 - ✓ Compliance with policy
 - ✓ Prudent investment decisions
 - ✓ Best price trade executions
 - ✓ Diversification of risk
 - ✓ Strict avoidance of conflicts of interest

Investment policy

- Does your entity have an investment policy?

Investment policy

- Defines and guides the investment program
 - ✓ Enhances quality of decisions
 - ✓ Demonstrates commitment to fiduciary care
 - ✓ Defines legal & permitted activities, who's in charge, how you measure results, who your counterparties are to counterparties

- Protection
- Dynamic process
- Do not regurgitate state statute
- Do not copy, clip and paste

Investment policy – first line of defense

- ❑ Single most important element of investment program
 - ✓ Provides flexibility to change within controls
 - ✓ Communicates investment philosophy and objectives for board and to constituents
- ❑ An adopted policy:
 - ✓ Demonstrates commitment to fiduciary care of public funds
 - ✓ Indicates government investments well-managed to:
 - Rating Agencies
 - Capital markets
 - Citizens
- ❑ Should be reviewed annually / updated periodically
- ❑ Note – It is both an internal and external document

Investment policy

GFOA Best Practice



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BEST PRACTICES & RESOURCES

ADVOCACY & AWARDS

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BEST PRACTICES



Investment Policy

GFOA recommends that all governments establish a comprehensive written investment policy, which should be adopted by the governing body.

An investment policy describes the parameters for investing government funds and identifies the investment objectives, preferences or tolerance for risk, constraints on the investment portfolio, and how the investment program will be managed and monitored. The document itself serves as a communication tool for the staff, elected officials, the public, rating agencies, bondholders, and any other stakeholders on investment guidelines and priorities. An investment policy enhances the quality of decision making and demonstrates a commitment to the fiduciary care of public funds, making it the most important element in a public funds investment program.

Investment policy

GFOA Best Practice

GFOA recommends that all governments establish a comprehensive written investment policy, which should be adopted by the governing body.

The investment policy should be reviewed and updated annually and should include statements on the following:

Scope and investment objectives: Tailor the scope and investment objectives to the type of investment to which the policy applies (e.g., excess operating funds, bond proceeds, pension fund assets).

- **Roles, responsibilities, and standards of care:** Identify the roles of all persons involved in the investment program by title and responsibility. Standards of care should include language on prudence (i.e., the prudent person rule), due diligence, ethics and conflicts of interest, delegation and authority, and knowledge and qualifications.
- **Suitable and authorized investments:** Include guidelines on selecting investment types, investment advisors, interest rate risk, maturities, and credit quality, along with any collateralization requirements.
- **Investment diversification:** State the government's approach to investment diversification, identifying the method that will be used to create a mix of assets that will achieve and maintain the government's investment objectives.
- **Safekeeping, custody, and internal controls:** Develop guidelines to enhance the separation of duties and reduce the risk of fraud.
- **Authorized financial institutions, depositories, and broker/dealers:** Establish a process for creating a list of financial institutions, depositories, and broker/dealers that will provide the primary services necessary for executing the investment program.
- **Risk and performance standards:** Establish one or more appropriate benchmarks against which the portfolio should be measured and compared.
- **Reporting and disclosure standards:** Define the frequency of reporting to the governing body and the government's management team.

Investment policy

How to create a policy

1. Examine state statutes
2. Examine collateral/depository/investing statutes
3. Review sample investment policies (learn from your peers)
4. Draft investment policy
5. Have right party's review
6. Adopt by formal action of governing body
7. Establish written investment procedures
8. Review annually

Never adopt a boilerplate policy – you are unique!!!!

Who is involved?

- Investment officers or treasurers
- Governing bodies
 - ✓ Investment committee (optional)
- Support staff
- Legal staff
- Auditors
- Accounting
- Commercial bankers
- Advisers, broker/dealers
- Roles of all involved parties must be considered
 - ✓ Impact on parties also must be considered

Policy components

1. Policy
2. Scope
3. Prudence
4. Objective
5. Delegation of Authority
6. Ethics and Conflicts of Interest
7. Authorized Financial Dealers and Institutions
8. Authorized and Suitable Investments
9. Investment Pools/Mutual Funds
10. Collateralization
11. Safekeeping and Custody
12. Diversification
13. Maximum Maturities
14. Internal Control
15. Performance Standards
16. Reporting
17. Investment Policy Adoption
18. Glossary

Policy components

- ❑ Introduction and Statement of Intent
 - ✓ Overview of entity
 - ✓ Sound fiscal management
 - ✓ Adoption of policy
 - ✓ Approval by governing board
- ❑ Scope
 - ✓ Funds covered by policy (comingling)
 - Economic development
 - Specific Purpose
 - Other

Policy components – objectives

❑ **Safety**

Protect principal

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

❑ **Return**

Once safety and liquidity requirements have been met, portfolios are structured to earn **“market rates of return”** or **reasonable return**

Policy components

- ❑ Delegation of Authority
 - ✓ Recognizing and referencing:
 - State Statutes (investments, collateral, etc...)
 - Local ordinances and rules
 - Federal Tax requirements (ex... Arbitrage bond proceeds)
 - ✓ Establishing local control
- ❑ Statement of Prudence, Indemnification & Ethics

Policy components

- ❑ Authorized Investments & Transactions
 - ✓ State Statutes
 - ✓ Risk tolerance
 - ✓ Types of securities & transactions
 - ✓ Maximum maturities & weighted average maturities
 - ✓ Credit criteria
 - ✓ Repurchase agreement criteria
- ❑ Collateralization
 - ✓ Repurchase Agreements
 - ✓ Bank deposits
 - ✓ CD's > \$250K

Policy components

Competitive procurement is essential

- ❑ Competition enhances government knowledge
 - ✓ technical
 - ✓ pricing
- ❑ Competition promotes “fairness”
 - ✓ vendors more likely to participate, support government
 - ✓ citizens and interested parties appreciate government’s care of their monies

Policy components

Safekeeping and custody

- ❑ A firm other than the party that sells the investment provides transfer and safekeeping of the security.
- ❑ Financial firms should not serve as both broker-dealer and custodian.
- ❑ Investments should be settled in a delivery-versus-payment (DVP) basis

Policy components

Safekeeping and custody

The safety of public funds should be the primary investment objective of all governments. One of the most important protections and a control against fraud is the separation of the safekeeping function from the investment function. Investment policies should include a section regarding safekeeping and custody that defines how the government should have its securities held by an independent third-party for safekeeping to minimize the risk of a fraudulent transaction. An independent third-party in a safekeeping arrangement may be a financial institution completely separate from where the depository cash assets are being held, or it may be a separate division of that same named institution. Governments should ensure that if they are using the same institution for both trading their assets and engaging in safekeeping services, that there are proper firewalls and protections in place to safeguard your entity's money. Governments should also be aware of and incorporate state and local laws related to custody and safekeeping.

It is also important to be aware that banks and financial institutions may use the terms of custody and safekeeping interchangeably. However, as discussed below and in the Procurement of Safekeeping and Custodial Services Resource, these agreements have different protections and offerings, and the government needs to determine what is the best service level.

Policy components

Delivery / Safekeeping

- ✓ Criteria for selecting safekeeping institution (usually a bank)
- ✓ Delivery versus payment (DVP) settlement (Best practice)
 - Fed wire
 - Depository Trust Company (DTC)
- ✓ 3rd party needed to perfect ownership (in govt's name)
- ✓ Consider a custodial and/or trust relationship

Policy components

- ❑ Risk management and diversification
 - ✓ Managing market and credit risk
 - ✓ Maximum maturities and weighted average maturities, duration
 - ✓ pricing
- ❑ Competition promotes “fairness”
 - ✓ vendors more likely to participate, support government
 - ✓ citizens and interested parties appreciate government’s care of their monies

Policy components

- ❑ Reporting
 - ✓ Disclosure of activities & holdings
 - ✓ Methods for calculations
 - ✓ Frequency of reports & who receives them
- ❑ Performance Benchmarks
 - ✓ Criteria for selecting benchmarks
 - ✓ Minimum yield standards
 - ✓ Methods of calculation

Reporting

- ❑ Monthly and quarterly reporting
 - ✓ Monthly could be internal
 - ✓ Prices obtained from an independent source
 - ✓ Reporting of complete portfolio including bank positions

- ❑ Quarterly reporting is a minimum to governing body
 - ✓ To allow the reader to ascertain positions and policy compliance
 - ✓ Possibly signed by investment officers stating compliance
 - ✓ Review by the governing body
 - ✓ Possible presentation with economic or cash flow changes explained

Policy components

In Illinois – recent changes...

❑ ESG issues

- ✓ Environmental/social/governance factors are used to more comprehensively analyze an investment based on its risk profile and return potential
- ✓ complements traditional and technical analysis
- ✓ Integrating these factors helps public funds better fulfill their fiduciary duty
- ✓ Signed into law – 2019, & became effective 1/1/20
“All state and local government entities that hold and manage public funds should integrate material, relevant and useful factors into their policies, processes and decision-making

Policy components

In Illinois – recent changes...

❑ Corporate securities

- ✓ Public funds investment act allows for corporate securities
- ✓ Provides that no more than one-third of a public agency's funds may be invested in short-term obligations of corporations that mature not later than 270 days
- ✓ Provides that no more than one-third of a public agency's funds may be invested in obligations of corporations that mature more than 270 days but less than 3 years from the date of purchase.
- ✓ Effective 8/6/21

Investment policy

- When was the last time your government reviewed your investment policy?

Annual review

- ❑ Annual compliance and policy review
 - ✓ Has the “circumstance then prevailing” changed
 - ✓ Should the policy change?
 - ✓ Is the benchmark still viable?

- ❑ Policy reviews will often result in policy updates which are taken to the governing body
 - ✓ The approach for a review parallels the initial creation process

- ❑ Review does not necessitate changes

Portfolio management is risk management

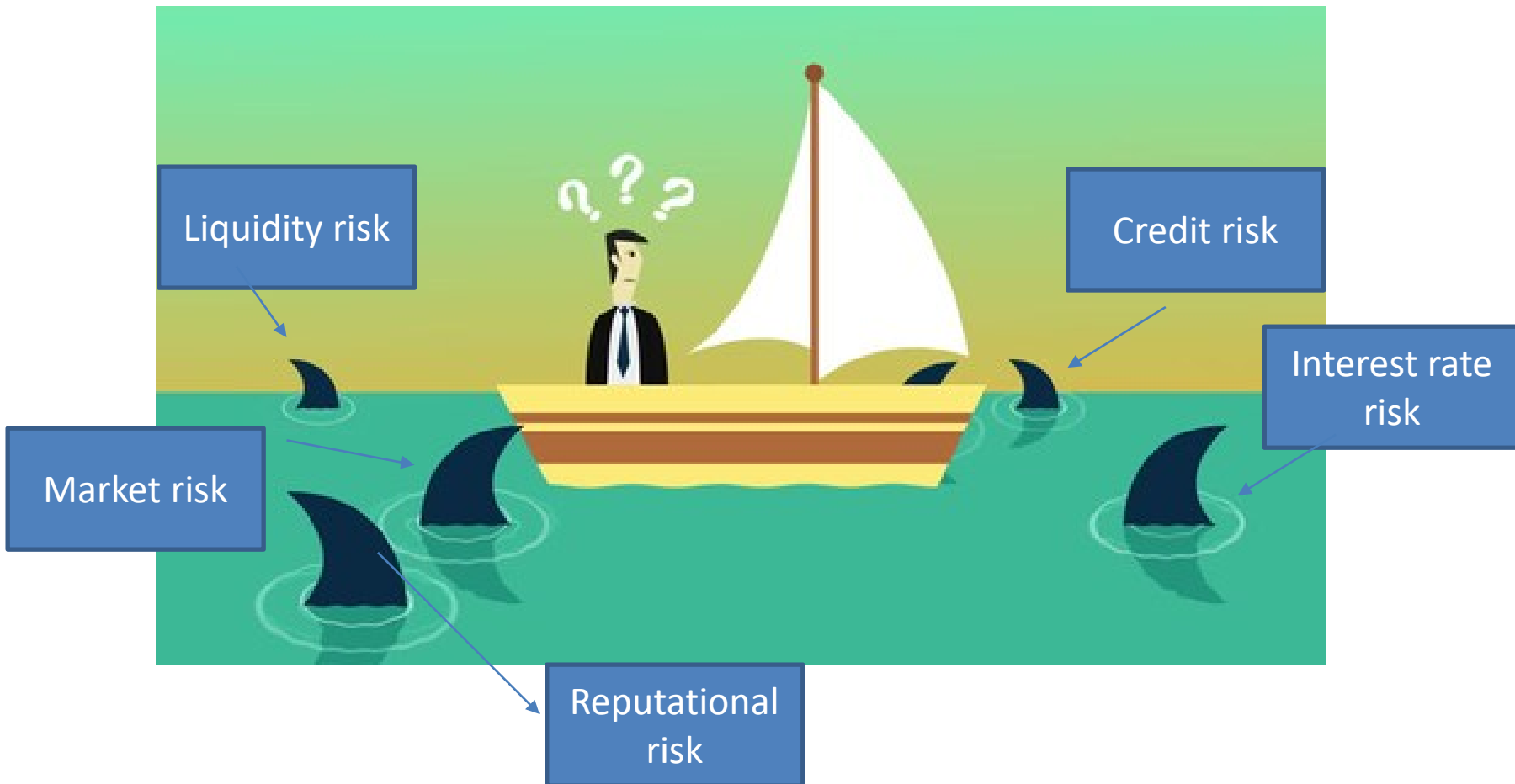
- ❑ Greater an investor's exposure to properly diversified risk, higher expected return over time

BUT

- ❑ Greater an investor's exposure to risk, higher volatility from period to period

Think about your risk – what you can “handle”

Understand and manage risk



Know your risks

- ❑ Interest rate risk – the value of your securities falls when rates rise
- ❑ Credit risk – loss of all or some of your P&I due to inability or perception of inability to pay back
- ❑ Liquidity risk – you do not have adequate liquidity in the portfolio and have to sell
OR
not able to turn your securities to cash
- ❑ Reputational risk – YOU ARE DONE!

Manage or mitigate risk

- ❑ Establish risk profile
- ❑ Use profile to determine limits
- ❑ Diversification can be achieved by investing in variety of securities with dissimilar risk characteristics
 - ✓ Maturity distribution
 - ✓ Sector allocation
 - ✓ Issuer allocation
 - ✓ Structures

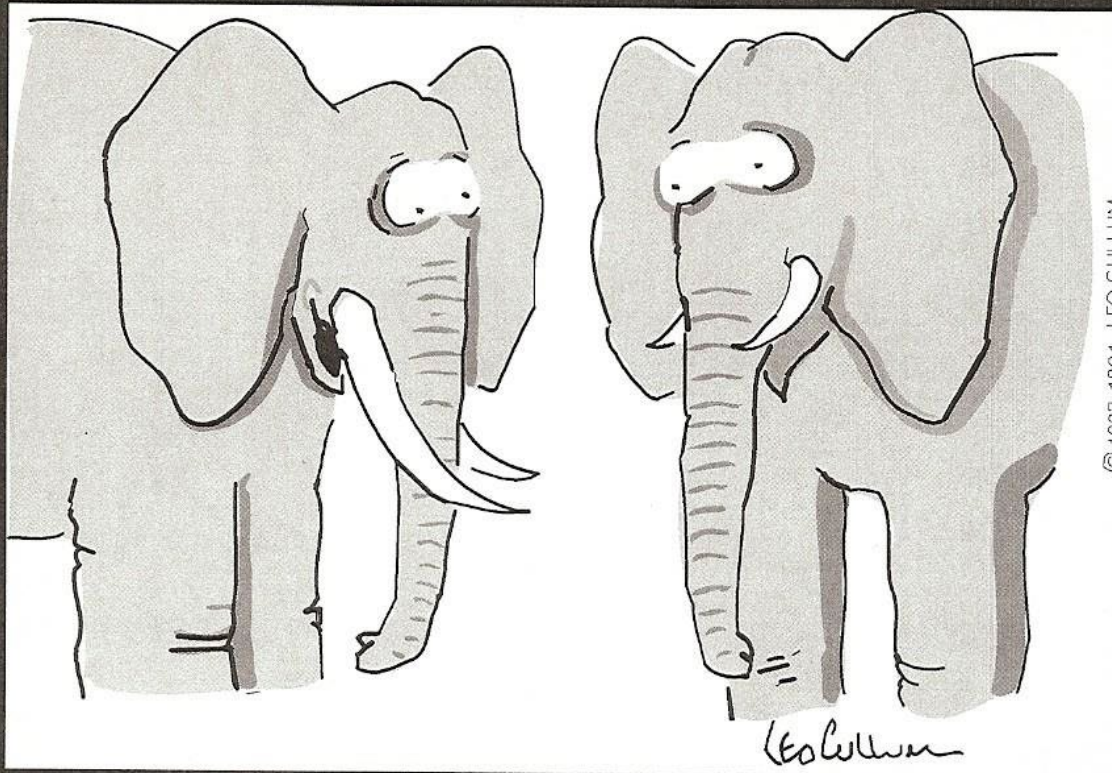
Diversification as a risk mitigant



Diversification as a risk mitigant



Diversification



"I'm worth quite a bit but it's all tied up in ivory."

Cash flow forecasting

- ❑ Cash flow management is the art of successfully estimating the magnitude and timing of your government's cash flows
 - ✓ How much, when, & how long
- ❑ The key to good cash management is understanding the sources of cash flows
- ❑ The prerequisite to great cash management is experience

Tips

- ❑ Use cash data and not accrual data
- ❑ Keep it simple
- ❑ Be conservative
- ❑ Focus on major items
- ❑ Consider changes
- ❑ Retain documentation

What is a cash flow forecast?

- ❑ Projection of anticipated cash receipts
- ❑ Projection of anticipated cash disbursements
- ❑ To create an estimate of investable cash balance
 - ✓ Liquid funds
 - ✓ Core funds

GFOA best practice

The GFOA recommends:

- ✓ Involve all operating departments
- ✓ Goals prioritize expenditures
- ✓ Historical data identifies/measures cyclical activity
- ✓ Receipt forecasts include expected inflows, investment maturities
- ✓ Disbursement forecasts include regular expenditures - payroll - and recognize non-repetitive expenditures
- ✓ Cash flow forecasts help recognize items and controls that affect cash position
- ✓ Be conservative
- ✓ Update regularly

Why a cash flow forecast?

- ❑ Match sources and uses of funds
- ❑ Improve investment earnings
- ❑ Ensure liquidity for disbursements
- ❑ Manage investment risks
 - ✓ Market risk
 - ✓ Liquidity risk
- ❑ Identify short-term cash deficits
- ❑ Warn of impending budget problems

Info sources

- ❑ Historical data from general ledger
- ❑ Historical data from bank and pool statements
- ❑ Current year budget
- ❑ Capital project spending projections
- ❑ Schedule of investment maturities and coupon payments

Revenues & Expenses

☐ Revenues

- ✓ Property tax
- ✓ Sales tax
- ✓ User tax
- ✓ Shared revenues
- ✓ Bond proceeds
- ✓ grants

☐ Expenses

- ✓ Payroll, benefits
- ✓ Commodities
- ✓ Interest

☐ Non-recurring

- ✓ Bond issuance
- ✓ Capital expenditures
- ✓ Lawsuits

Using historical to forecast

HISTORICAL MONTHLY AVERAGES	JANUARY	FEBRUARY
Sales Tax Collections	8.5%	9.0%
Property Tax Collections	2.0%	40.0%
Airport Revenues	5.0%	5.0%
User Fees	10.0%	13.0%
Other Revenues	7.0%	9.0%
Payroll and Benefits	8.3%	8.3%
Accounts Payable	22.0%	5.0%
Airport Expenditures	8.0%	11.0%
Debt Service	25.0%	2.0%

Review 2-3 year monthly historical data to calculate averages

Project the future

MONTHLY PROJECTIONS`	ANNUAL BUDGET	JAN-24	FEB-24
Sales Tax Collections	\$125,000,000	\$10,625,000	\$11,250,000
Property Tax Collections	\$50,000,000	\$100,000	\$2,000,000
Airport Revenues	\$20,000,000	\$1,000,000	\$1,000,000
User Fees	\$15,000,000	\$1,500,000	\$1,950,000
Other Revenues	\$19,000,000	\$1,330,000	\$1,710,000
Payroll and Benefits	\$95,000,000	\$7,885,000	\$7,885,000
Accounts Payable	\$75,000,000	\$16,500,000	\$3,750,000
Airport Expenditures	\$20,000,000	\$1,600,000	\$2,200,000
Debt Service	\$10,000,000	\$2,500,000	\$200,000

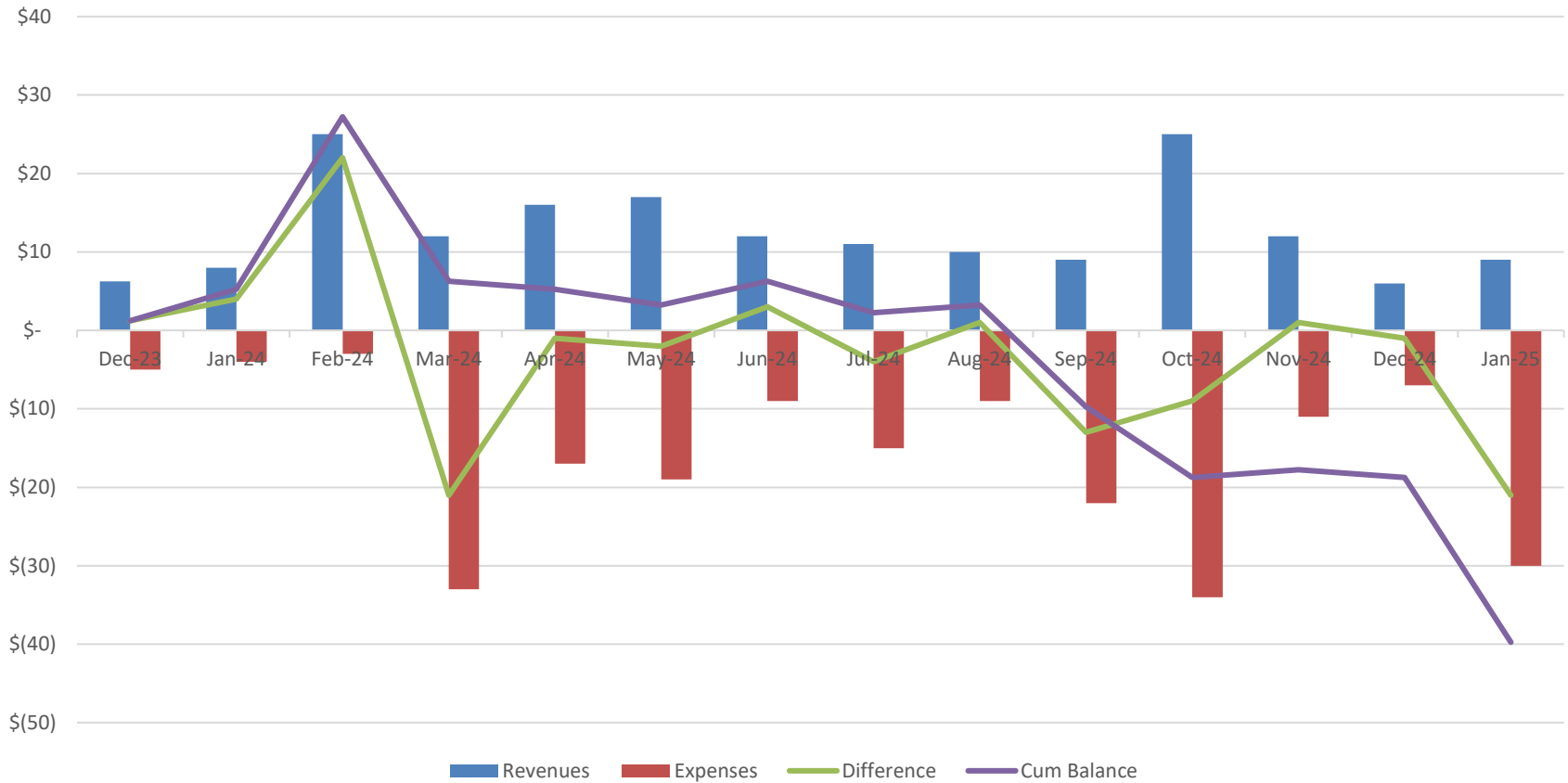
Apply calculated average monthly to projected budget to determine future projections (revenues and expenses)

Create the cash flow

- Beginning balance of cash and investments
- Monthly revenue projections
- Monthly expenditure projections
- Projected net change
- Projected cumulative balance of cash and investments
- Schedule of current investments and coupon payments

Graph the flows

Chart Title



Simpler ways

- ❑ It can be tedious and time-consuming to prepare traditional cash flow forecast, and incremental information gained may not be worth effort
- ❑ An alternative - liquidity/core model

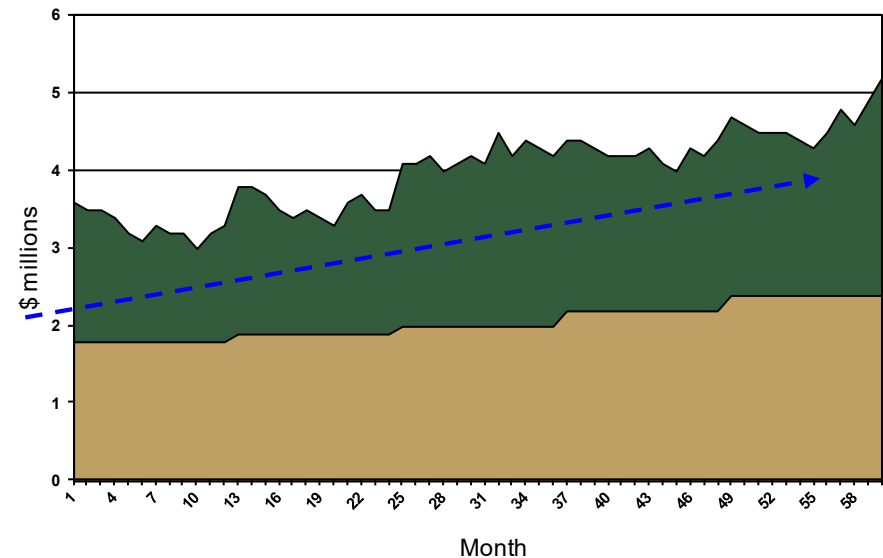
Liquidity / core

Based on the overall balance

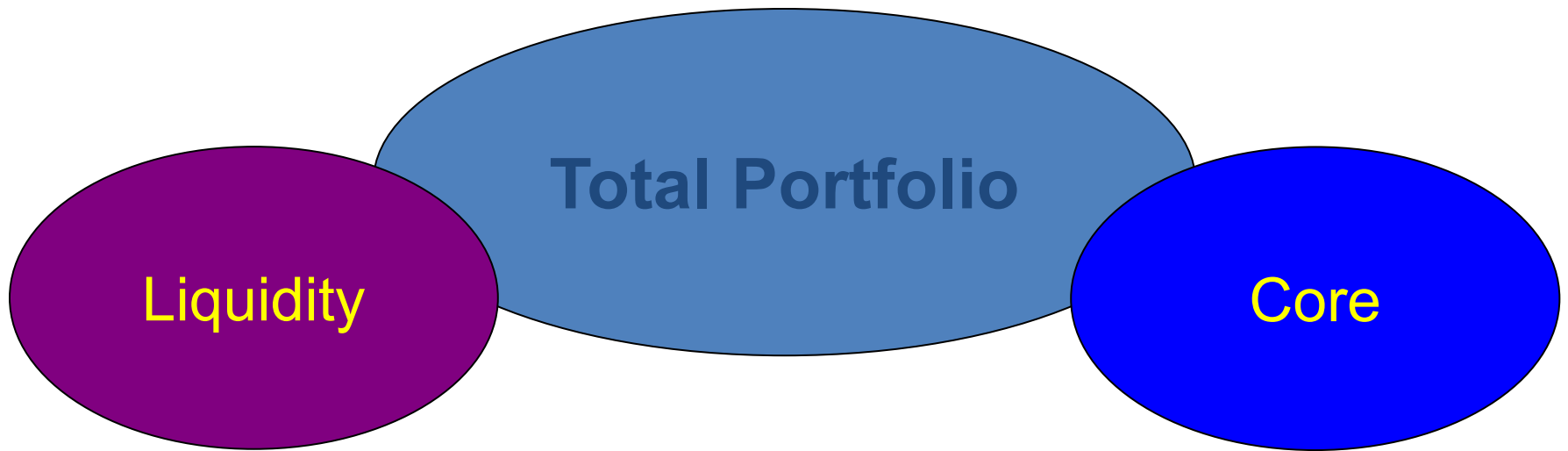
- What is the balance now?
- Over the last few years, is it
 - ✓ Growing?
 - ✓ Shrinking?
 - ✓ Stable?
- How much does the balance fluctuate during the year?

Liquidity / core

- The total portfolio is growing
- But the maximum value fluctuates over the course of the fiscal year
- The “liquidity” portion is established to meet cash needs
- The “core” is what's always available for longer-term investments



Liquidity / core



Collateral

Must have agreement that:

- ✓ is in writing;
- ✓ was approved by the board of directors of the depository or its loan committee
- ✓ has been, continuously, from the time of its execution, an official record of the depository institution

Investment management is risk management

- ❑ Liquidity risk



Investment procedures manual



Investment procedures

- ❑ Who has written investment procedures?
 - ✓ Memorialized in a manual?

Procedures

- ❑ Projection of anticipated cash receipts
- ❑ Projection of anticipated cash disbursements
- ❑ To create an estimate of investable cash balance
 - ✓ Liquid funds
 - ✓ Core funds

Over time, longer term investments can generate higher returns

Procedures

- ❑ Guidelines for more specific *written* procedures (support policy)

- ❑ Key control elements
 - ✓ Control of collusion
 - ✓ Separation of transactions and recordkeeping
 - ✓ DVP in safekeeping
 - ✓ Delegation of subordinates
 - ✓ Written transaction records and confirmations
 - ✓ Dual authorization on wires
 - ✓ Continuing Education
 - ✓ Maintenance and monitoring of procedures

Procedures

- ❑ Monitoring Credit Rating
 - ✓ Credit ratings should be monitored at least monthly
 - ✓ What action will be taken
 - Disclosure
 - Immediately liquidate or consider conditions
- ❑ Monitoring FDIC Status
 - ✓ Check on FDIC status for your CDs in a bank's merger/acquisition
 - ✓ Officer should monitor at least each Friday
 - ✓ What action will be taken
 - Immediate liquidation

Procedures

- ❑ Securities no longer in compliance with a changed policy or new statute
 - ✓ *Any security currently held that does not meet the guidelines of this policy shall be exempted from the requirements of the policy. At maturity or liquidation, such monies shall be reinvested only as provided by policy.*
- ❑ A temporary holding period of time can be established for securities not meeting policy guidelines.
 - ✓ Securities must come into compliance within xx months of a
 - policy's adoption by the governing body.

Procedures

Collateralization

- ❑ Require collateral on all time and demand deposits
 - ✓ Repurchase collateral is a buy/hold but should meet conditions

- ❑ Perfection of pledge
 - ✓ Reporting should come directly from the custodian not the trader or broker/dealer

Procedures

Mitigate / Manage market / liquidity risk

☐ Sample controls:

- ✓ Liquidity buffer handles unexpected liabilities
- ✓ Maximum % of callables
- ✓ Establish \$\$ bucket targets by time horizons
- ✓ Maximum maturity
- ✓ Maximum weighted average maturity

Questions

