Evaluating Your Investment Policy

By Corrine Steeger

A recent issue of the *Treasury Management Newsletter* included an insightful article on using your organization's investment policy to communicate investment information to various audiences in the community (see "Telling Your Investment Story Effectively" by Susan K. Iverson, December 2010). To maintain the policy's effectiveness as a communication tool, you need to periodically evaluate it. How often a public entity's investment policy is formally reviewed may be dictated by state or local law, but if such a requirement is not in place, a thorough annual review is recommended (see the GFOA's Sample Investment Policy).

The task of evaluating the existing investment policy and adopting any changes will, of course, compete for your time and attention with everything else that is on your plate. The intent of this article is to provide a step-by-step plan that will both guide you through the process and help you complete it efficiently.

Step One: Know Your Organization

The first step in reviewing the policy is to determine what has changed in the organization since the last review was conducted. Has risk tolerance shifted because of concerns about certain types of investments? Are the concerns temporary (e.g., the result of headline risk), or are they fundamental? Temporary concerns may require short-term adjustments in the portfolio that don't lead to policy amendments. But if the concerns are not likely to abate in the short term, you might have to amend the policy at the time of the annual review to lower or eliminate the amounts placed in certain investments.

Reductions in resources due to budget constraints can also require investment policy amendments. For example, a policy that refers to using the Bloomberg Professional service to help with making investments would be amended if that service has been cancelled due to budget cuts. If staffing is reduced, a policy that assigns investment management responsibilities by position might require amendment.

Step Two: Review the Cash Forecast

The next step in reviewing the policy is to update the cash forecast. Organizations of all sizes use cash forecasting to varying degrees in investment management. The investment policy typically reflects the forecast in developing investment strategies by fund or group of funds and in setting limits for investments by maturity, type, and degree of liquidity. Just as the forecast is adjusted based on actual results, the policy should also be adjusted to be consistent with the forecast. Investment portfolios can increase or decrease significantly over a period of years as revenue and expense patterns change, resulting in amendments to investment strategies and limitations expressed in the policy.

Step Three: Rate the Policy's Effectiveness

The final step in reviewing your policy is to determine how well the policy has performed in guiding your investment program. Since 2008, the markets most public funds investors participate in have been challenging. During annual reviews in each of the last three years, the City of Dallas, Texas, found that its investment policy did not offer sufficient guidance in dealing with the challenges the city faced. As a consequence, it has made several amendments to the policy since 2008, three of which are described below.

Policy Issue No. 1: U.S. Government agency and instrumentality securities were authorized in the policy by name (e.g., Fannie Mae and Freddie Mac), which caused a variety of problems beginning in th.e summer of 2008. For example, investing within the policy's diversification limits by issuer (see Policy Issue No. 2) meant that avoiding certain U.S. agency securities could be accomplished only by finding other options that were not always available or effective.

Policy Amendment: Because the future of some of these organizations is uncertain, the specific names have been removed and replaced with a AAA rating requirement for agencies and instruments that are not direct obligations of the U.S. government. Further policy amendments might be considered to authorize investment in the securities of agencies and instruments that meet certain financial criteria, if a rating is not available.

Policy Issue No. 2: To promote diversification, the investment policy contained limits on how much of the total portfolio could be invested with one source. Since these limits were imposed on the total portfolio, rather than the portfolio for each fund, there had recently been some "competition" among funds for the few investments that offer a comparatively better interest rate.

Policy Amendment: The diversification limits are now applied only to the internal investment pool, which includes the majority of the city's funds. This amendment allows certain separately managed city funds to continue following a strategy of investing in a single investment type without affecting the internal pool's ability to participate in the same investment type. For example, the city is able to use tax-exempt money market mutual funds for both investment of internally pooled funds and investment of tax-exempt commercial paper proceeds. This product offers a higher rate than some other categories of money market funds in the current market, which benefits the internal pool while also providing an arbitrage rebate management tool for the commercial paper proceeds.

Policy Issue No. 3: In addressing the investment objective of yield, the policy noted that the "portfolio shall be designed with the objective of attaining the best yield throughout budgetary and economic cycles." It became apparent in 2008 that "attaining the best yield" was inadequate as an objective in prudent investing, when a money market mutual fund the city used failed. This money market mutual fund, the Reserve Primary Fund, had offered the best yield when compared to other funds approved for investment by the city. Staff recognized the amount of risk in the Primary Fund's investment portfolio and withdrew the majority of the city's investment before the fund failed. The return of the portion that remained in the fund has been slow. Using "the best yield" as an objective can result in exposure to considerable risk, whether from investment products, such as the Reserve Primary Fund, or from imprudent strategies, such as concentrating investment in one type of product or in one segment of the yield curve.

Policy Amendment: The phrase "the best yield" was replaced by "a market rate of return," the phrase used in the GFOA's Sample Investment Policy. Remember that investment income is a source of revenue for the organization, and putting the objectives of safety and liquidity before yield optimizes that source.

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