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White Paper

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The Whys and Wherefores of Short–Term Investment Policies

The efficient management of liquidity is central to every organization's treasury goals. Typically, temporary, short-term investing is an integral part of liquidity management strategies. Ensuring adequate funds to meet liabilities and provide a cushion for the unexpected requires an asset pool that can be converted to cash on short notice, with a minimum risk of loss.

Meaningful cash forecasting is an essential step in structuring and managing an investment portfolio. Accurate forecasting not only ensures there are no excess idle cash balances, but also prevents nasty surprises that make it necessary to sell a security prior to maturity. Selling a security prior to maturity exposes an investor to a potential loss of principal.

There are several types of investors, each with different reasons for and approaches to investing. Regardless of the type of investor, however, an investment policy ensures that the objectives of the investment strategy and the standards by which performance will be evaluated are clearly defined.

Why Invest

The purpose of the investment determines the degree of risk the investor is willing to take. Risk is inherent in all investments and is in inverse proportion to return. For example, the yield on a U.S. Treasury bill is lower than on corporate subordinated bonds because there is minimal risk of loss of principal on U.S. Treasuries. U.S. Treasuries are often described as yielding a risk free rate of return because of the lack of default risk.

For investment officers managing treasury assets for a corporation, organization, or government, the reason for investment is to realize a return on surplus funds or to generate revenue from the corpus of endowment funds. This type of investing is a supportive administrative function of the entity. Fiduciaries hold assets in trust for a beneficiary and are charged with the responsibility to invest funds for their benefit. In many senses, an organization's treasury department is a fiduciary investor. As such, the Prudent Man Rule may serve as the guiding principal in the development of investment strategies and policies. Simply stated, the Rule requires the investor

to act as a prudent man or woman would be expected to act — with discretion and intelligence, to seek reasonable income, preserve capital and, in general, avoid speculative investments.

How to Stay Out of Trouble

1. **Don't be a lone ranger --** Investing should not be a solitary activity. The authority to invest is typically delegated by the Board of Directors or an equivalent body. What is not always defined are investment guidelines and accountability. Don't assume this means that *carte blanche* has been given for portfolio management. Determine with the Board or other delegating authority its appetite for risk and the type of investments deemed appropriate. Once there has been a loss, it's too late to find out that the Board never intended to authorize risky investment strategies such as day trading. It is important to establish an oversight mechanism for investment activities, so that the Board is constantly aware of how the portfolio is managed and is never surprised.

2. **Don't buy anything you don't understand --** The financial world has developed sophisticated and complex financial instruments based on options, futures and varying combinations of simple investment vehicles to manage risk, appeal to speculators and sometimes take advantage of legal and tax loopholes. These products are often referred to as derivatives. There are great sales incentives for the firms that market these complex investments. The market for combined instruments and derivatives is currently over $100 trillion. If you can't explain the investment to your Board, pass! It's okay to be cautious and pass up an opportunity; it's not okay to lose $1.7 billion, as Robert Citron, Treasurer of Orange County California did in 1994, pushing the County into bankruptcy and ending up in jail. His offered defense was that he trusted his brokers and didn't know what he was buying.

3. **Play the matching game** -- Enter into investments which match the maturity timeline to the cash forecast. Purchase securities that mature when funds are needed to meet expected obligations. This strategy requires careful forecasting of future cash flows and capital spending. Some companies may match investment maturity with known events, such as the payment of insurance premiums and planned capital projects while also maintaining a more liquid, shorter term money market pool of investments. Investing for a date shorter than or beyond the period when the funds are required (riding the yield curve) risks realizing a market loss in the event interest rates change.

   NOTE: Riding the yield curve can result in a greater return when a company buys investments that mature beyond the date funds are needed then sells prior to maturity. The risk is that when interest rates rise more rapidly than anticipated, the value of the underlying security is reduced and a loss of principal may occur on the sale. A greater return results when interest rates are expected to drop and securities are purchased for a shorter time than when the funds are needed, then reinvested at a higher rate when they mature. Unfortunately, if the rates fall further than expected, the funds must be reinvested at a lower rate than planned.

4. **Write it down** -- Develop and follow investment policy guidelines. Failing to invest surplus funds according to prudent principles and procedures may result in not only a loss of the potential revenues short term investments can return, but may also jeopardize the principal

invested. Making poor and inappropriate investment choices is taking unnecessary risks. Developing an investment policy is a collaborative effort. The body, most likely the Board of Directors, which has the authority to invest should lead the policy project although frequently, the policy is developed by the treasury and finance staff and presented to the Board for review and approval.

How to Write an Investment Policy

There are three facets of each investment: safety, liquidity and return. **Safety,** the preservation of the principal invested, is inherent in the fiduciary model of investment. **Liquidity** recognizes that investments need to be readily marketable to meet unexpected shortfalls or to take advantage of sudden opportunities. **Return**, the income earned on the investment, is determined by the degree of risk an organization is willing to take, and this risk should be squarely addressed in the investment policy.

Investment Policies and Guidelines

(Suggested language is presented in italics)

It should be noted that short term and long term investment strategies have different objectives. Policies should be separately developed for each. Securities that are inappropriate for short term investment may be an essential component of an endowment fund portfolio. External funds management requires the development of a policy to provide clear instructions and guidelines to the funds manager and establish clear expectations against which performance results can be held accountable.

Policies are established to prohibit risky choices and to protect the staff and the organization. Formal adoption by the Board of Directors or similar authoritative body, with a provision for annual review, ensures reasonable protection of the organization's assets. In the event of unexpected losses, both the Board and the staff share blame equally, avoiding finger pointing.

Mission Statement -- Each policy should begin with an investment mission statement establishing the principles of safety, return and liquidity.

> *The organization's funds shall be invested to provide reasonable security of principal with the best investment return, while ensuring daily/operating/capital expenditure cash flow requirements are met.*

Scope -- The scope of the policy is defined next.

> *This policy applies to all financial assets of the organization, including short term operating surpluses; capital projects/building funds, and endowment, except for the pension and retirement fund.*

Due Diligence -- Reference should be made to the fiduciary nature of the investment activity and relevance of the Prudent Man Rule as a guiding principle.

The Investment Officer or responsible designee shall adhere to a standard of prudence, discretion and intelligence, to seek reasonable income, preserve capital and, in general, avoid speculative investments. Officers acting in accordance with written procedures and policies and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes, provided such deviations are reported timely and appropriate action is taken to mitigate losses.

Investment Objectives -- A concise statement of investment objectives will depend, in part, on scope. Short-term and long-term investments will set a different order of priority on the safety, return and liquidity requirements for the portfolio.

The primary objectives for investment activities of a short-term operating fund shall be:

*a. **Safety** of principal is the foremost objective of the investment program. The preservation of capital shall be ensured by investing in several financial institutions and a variety of investment instruments.*

*b. **Liquidity** requirements are defined as the on-going availability of funds necessary to meet all reasonably anticipated operating requirements.*

*c. **Return** on investments shall be expected to attain a benchmark rate of return commensurate with investment risk constraints and cash flow characteristics of the portfolio. The benchmark standard shall be reviewed annually by the Board of Directors.*

Authority -- The authority to manage the investment program should be documented in the policy by citing the specific organizational resolution. Delegation of that authority to designated officials and the scope of the authority should also be spelled out.

Authority to conduct transactions and manage the investment program for the organization is derived from the board resolution adopted [date]. Management responsibility is delegated to the [state the title of the responsible officer, such as Director of Finance] who shall be responsible for all transactions undertaken; the [title of the responsible officer] may, at his/her discretion, further delegate such authority to the [title, such as controller].

Ethics -- Many organizations have ethics statements that are signed by all employees on an annual basis. Financial officers may be required to provide personal financial disclosures on a periodic basis. Absent either of these organizational requirements, the investment policy must include a conflict of interest clause.

The Investment Officer shall refrain from personal business activity that conflicts with proper execution of the investment program or which impairs their ability to make impartial investment decisions.

Procedures -- Procedures are developed separately from the investment policy. In addition to providing operational guidelines, processes and reporting, they establish internal control and other safeguards of assets. The policy should spell out the requirement for the development of a procedures manual.

The Investment Officer shall prepare and periodically review a separate written investment procedures manual consistent with the provisions of this policy. This manual shall include specific guidance with respect to the delegation of investment authority, collateral and depository agreements, safekeeping arrangements, and other matters necessary to ensure reasonable internal controls are established.

Broker-Dealer Selection -- An important factor in the protection of invested assets is the reputation and financial circumstances of the financial dealers and institutions with which the investment officer deals. The investment policy should establish the guidelines for the selection and review of authorized brokers, dealers and financial institutions with which investment transactions are made.

The Investment Officer shall maintain a list of financial institutions and securities broker-dealers authorized to provide investment services. Financial institutions and securities broker-dealers shall be selected based upon creditworthiness, appropriate registrations and qualification under the Securities & Exchange Commission net capital rule.

On an annual basis, the approved list should be reviewed with respect to the current audited financial statements, proof of NASD certification, and state registration. Prior to placing any trades, the organization should provide a copy of the investment policy to those individuals with whom they will be trading and ask that they provide a written, signed statement that they have read the policy and will not offer for sale to the organization unauthorized or prohibited investment instruments. The policy might further state:

Any broker-dealer or institution found to repeatedly offer inappropriate or prohibited investments to the organization shall be removed from the list of authorized investment services providers.

Some organizations do not actively manage an investment portfolio, but rather contract with professional investment managers to perform this service. If an investment manager is retained, this section will define the process and criteria used to select the managers and establish guidelines to monitor performance.

Investment managers shall be selected through a competitive bid process. The Finance Committee, in conjunction with the Investment Officer, shall develop the selection criteria with respect to eligible bidders. Award of the advisory services contract shall be made for a period not to exceed five years by the Investment Officer, with the approval of a simple majority of the Finance Board. At the end of contract period, the incumbent is eligible to compete and may be reappointed for an additional five year period. Portfolio performance shall be reviewed at least quarterly and shall include a review of investment policy compliance.

Portfolio Structure -- The structure of the portfolio should be defined in the investment policy. In addition, authorized investments need to be clearly identified. The guidelines for diversification, the average and maximum maturities, covenant restrictions, and tax considerations should be clearly addressed.

a. Define **prohibited and permitted investments**, and provide guidelines for determining the types of instruments permitted. Provide methods for evaluating the addition of new

types of investments or changing or deleting permitted investments should they become less desirable as a result of market shifts. This section will also define the investment grade for instruments within the portfolio and what action, if any, is taken should the investment be downgraded prior to maturity.

b. Define **diversification** requirements to reduce **credit** risk, which include market segmentation, rating classification, and entity securities' issuers. The policy may specify acceptable ranges for investment sectors, i.e., no more than 40% in corporate notes and equities, or no more than 10% of the portfolio may be invested in any single corporate commercial paper.

c. Define **maturity** guidelines to control liquidity requirements and interest rate risk.

Accountability and Monitoring -- Performance standards and reporting should be defined in a manner that identifies the target rate of return or benchmark to be used in measuring portfolio performance. Also identified in this section is the method of reporting to be used, how often reports are to be produced and to whom the reports are directed. Benchmarking standards might include money market indices, Fed funds or 3-month T-bill rates, the S&P 500, or other measures that approximate the maturity and types of investments that comprise the portfolio; these returns are published daily in various newspapers and on-line services. The policy may state that:

Investment activity is expected to yield a rate of return consistent with portfolios with the similar stated risk constraints and average maturities. The selection of the benchmark shall be determined by the U.S. Treasury bill approximating the average maturity of the portfolio at [state the reporting point e.g., 3-month U.S. Treasury bill]. The Investment Officer shall prepare and distribute quarterly investment reports detailing portfolio holdings including their par value, market value and earnings rate for each security, the average maturity calculation, diversification statistics and performance results. The quarterly report shall be distributed to the Finance Committee of the Board of Directors.

Safekeeping Requirements -- If the company has elected to purchase securities as delivery versus payment, a custodial safekeeping arrangement has to be arranged with a third party and stated in the investment policy.

All securities transactions shall be on a payment versus delivery (PVD) basis. Securities shall be held in a custodian safekeeping account at the company's safekeeping bank. An exception shall be made for repurchase agreements for duration of one week or less and entered into under a Master Repurchase Agreement. The safekeeping account shall be audited quarterly by the internal control unit and the results presented directly to the Board of Directors.

Board Approval Adoption and Review -- The method by which formal acceptance of the policy by the authorizing body should be defined in the policy. Further, there should be a provision requiring periodic review of the policy to determine its appropriateness for changing economic markets, company operations and other factors as conditions change.

This policy was adopted by Board Resolution on [date]. The Investment Officer shall be responsible for reviewing and modifying investment guidelines as conditions warrant, subject to the approval of the Board of Directors, on at least an annual basis.

A Stitch in Time Saves…

The case for establishing a strong investment policy cannot be overstated. Though it is true that investment policies do not guarantee returns, what is certain is that a poorly developed policy, or having no policy at all, weakens an organization's investment management and increases the likelihood that the portfolio is not consistent with investment objectives. An organization that fails to consistently follow its investment policy, monitor compliance to the policy and review investment reports on a regular basis deprives itself of a strong internal control to prevent unnecessary risk.