Welcome to the River City

Investment Policies and Strategies

Tuesday, October 16
1:50-3:05 p.m.

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This session will outline the Public Funds Investment Act and discuss key elements of an effective investment policy for your county. We’ll introduce basic investment strategies and how to safely maximize earnings in the current challenging rate environment. We’ll also look at where interest rates have been and speculate on where they might end up in the coming years.
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McIntyre is a managing director and senior portfolio manager with First Southwest Asset Management, where he provides investment advice and consulting, as well as portfolio management to local governments throughout the nation. McIntyre is also responsible for reviewing investment policies, assisting in overall strategy formulation, evaluating account performance and overseeing the day-to-day operations of the investment management division. Prior to joining First Southwest in June 1998, McIntyre spent four years as a partner in an Austin-based investment advisory firm specializing in the management of public funds, and five years as an Investment officer for the Texas State Treasury.
Why Adopt an Investment Policy?

- It's a primary investment control
- It's the law
- It prioritizes investment goals
- It establishes risk tolerance
Governing Statutes

- **Investments**
  - Government Code, Title 10, Chapter 2256 (Public Funds Investment Act)
  - Local Government Code, Chapter 116.112

- **Collateral**
  - Government Code, Title 10, Chapter 2257 (Public Funds Collateral Act)
  - Local Government Code, Chapter 116.051-060

Investment Policy

- Review other policies *(There’s no plagiarism in policy-making)*
- Refer to PFIA *(Take language directly from the Act)*
- Consult your attorney for compliance
- Approach Commissioners for feedback
- Balance your need for flexibility with your need for control
- Make sure policy is not too restrictive ...*or too liberal*
Overview

- An effective policy should provide more than just the basic PFIA requirements.
- An effective policy provides the foundation for all investment decisions and establishes critical controls. The policy should clearly define:
  - Portfolio Objectives
  - Acceptable Risk
  - Permitted Investments

Policy Requirements of the Act

- Each governing body must adopt a written investment policy and fund strategies.
- The policy must emphasize safety and liquidity
- Address diversification, yield, maturity and capability of management.
- Include: a list of authorized investments, maximum allowable maturity for individual securities and the maximum WAM for pooled fund groups.
Policy Requirements of the Act

- The governing body must review policy and strategies at least annually and adopt written proof of the review.
- A compliance audit of management controls on investments and policy compliance must be performed annually.

Elements of the Policy
Scope

- State the funds or pooled fund group to which the policy applies.
- *Does not* apply to retirement funds.
Objectives

- Clearly sets the tone of the policy

- Investment of Funds shall be governed by the following priorities:
  - Safety of principal (detail)
  - Liquidity
  - Yield

Delegation of Responsibility

- Designate one or more persons as investment officer(s) to be responsible for investment of its funds.

- A person may not deposit, withdraw, transfer or manage funds without express written authority consistent with the policy.
Training

- The Treasurer, CFO (if not the Treasurer) and the investment officer(s) shall:
  - Attend 10 hours training from an independent source within 12 months after taking office
  - Ongoing 10 hours training not less than once every 2 years
  - Receive instruction in investment controls, security risks, strategy risks, market risks, diversification and compliance with the Act

Prudence

- Competitive bidding requirement
- Prudent Person statement
- In determining whether investment officer has exercised prudence, consider:
  - investment of the total portfolio and not the performance of any individual security
  - whether the investment decision was consistent with written policy
Authorized Investments

- Obligations of, or guaranteed by the U.S. Government (2256.009) to include:
  - Direct obligations of the U.S. and its agencies and instrumentalities, including letters of credit.
  - Direct Obligations of the state of Texas
  - Collateralized Mortgage Obligations (CMOs)
  - Other obligations of Texas, the U.S., or their agencies.
  - Obligations of U.S. states, cities, counties, school districts or other political subdivisions rated A or better.
  - State of Israel Bonds

- Certificates of Deposit (2256.010)
  - May be secured by obligations described in 2256.009 or in any other manner provided by law
  - Includes “shared certificates” or CDARS CDs.

- Repurchase Agreements (2256.011)
  - Must be secured by obligations in 2256.009

- Securities Lending (2256.0115)
- Bankers Acceptances (2256.012)
- Commercial Paper (2256.013)
Authorized Investments

- Mutual Funds (2256.014)
  - Money Market Mutual Funds are appropriate
- Guaranteed Investment Contracts (2256.015)
  - Includes Flex Repos within this section
  - Very Specific IRS Bidding Requirements (Be careful!)
- Investment Pools (2256.016)
  - Specific pools must be approved by resolution
- Additional investments options for specified entities:
  - Higher Education (2256.020); Municipal Utility (2256.0201); Funds from mineral rights (2256.0202); Ports and Navigation Districts (2256.0203); Qualified Independent School Districts (2256.0204)

New Authorized Investments

- Section 2256.009(a) was modified to allow interest bearing bank deposits insured by the FDIC or National Credit Union Share Insurance Fund. In addition, specific language was added authorizing the shared deposit programs in a manner very similar to the shared certificates of deposit.
- 2256.014(b) was amended to allow so-called ultra-short bond funds that have a duration of less than one year and whose investments are limited to investment grade securities, excluding asset-backed securities.
- Section 2256.0206 authorizes certain entities (generally those with at least $250 million of outstanding debt) to enter into hedging agreements in order to “protect against economic loss due to price fluctuation of a commodity or related investment...” Eligible entities would be allowed to lock in costs of fuel, energy, construction expenses and similar.
Unauthorized Investments

- These are expressly prohibited:
  - ✗ Principal-Only CMOs or “POs”
  - ✗ Interest-Only CMOs or “IOs”
  - ✗ Inverse floating rate CMOs
  - ✗ Any CMO with a stated final maturity longer than 10 years

Investment Limitations

- The maximum allowable percentage of each security type should be clearly stated.
- Specific limits are not defined by PFIA.
- Minimum % only for liquidity purposes.
- Example: At no time shall (the entity) exceed the stated percentage of each investment type
  - Treasuries 100%
  - Agencies 75%
  - Authorized Pools 50%
  - Commercial Paper 10%
- Specific issuer limitations may be added as well
  - CP issuers 5%
  - Agencies issuers 25%
Suggested Further Qualifications

- Governmental obligations:
  - Be specific in your policy
  - Are all agency names acceptable?
  - Callable limits
  - Investments not authorized (2256.009b)

- Repurchase Agreements
  - Limited to Primary Dealers?
  - Are Reverses authorized? Limits?

Suggested Further Qualifications

- Commercial Paper and Bankers Acceptances
  - Authorized list of issuers
  - Domestic names only(?)

- Mutual Funds
  - Does the fund invest in securities not authorized in your policy?
  - Are non-MM mutual funds authorized?

- Pools
  - AAA and AAAm only
Inter-local Agreements

- The Commissioners Court has to execute inter-local agreements to participate in Local Government Investment Pools.

- Listing LGIPs in the policy isn’t enough to allow you to invest in a pool.

Authorized Brokers and other Financial Institutions

- A copy of the policy shall be presented to any person seeking to sell an investment to the entity. The Registered Principal shall certify in writing that:
  - The RP has read the policy and
  - Has reasonable procedures and controls in place to preclude investment transactions not authorized by policy.

- Prohibited from buying securities from any person not providing this document in substantially the same form

- The governing body shall annually review and adopt a list of qualified brokers authorized to transact business (2256.025)
Suggested Broker Due Diligence

- In addition, any broker seeking to transact business with the entity should:
  - Provide updated financial statements
  - Complete a broker/dealer questionnaire
  - Provide a recent resume for the account rep
  - Provide references in the public sector
  - Use FINRA's Broker Check to review regulatory filings and employment history: (http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/)

Safekeeping

- All securities shall be held by a third-party custodian in the entity's name.
- A monthly safekeeping statement must be provided by the custodian and reconciled monthly by the investment officer
- All securities shall settle on a "delivery-versus-payment" basis.
Collateralization

- Repurchase Agreements and CDs
  - ✔ State required collateral percentages
  - ✔ List acceptable securities
  - ✔ State a “mark-to-market” requirement

Reporting

- The Act requires that specific data be reported.
- A quarterly written report, jointly prepared and signed by each investment officer, must be presented to the governing body and CEO.
- State compliance of the portfolio with the policy, strategy and Act provisions.
- Portfolio pricing frequency and source
- Reviewed by auditors if securities are purchased
Reporting (cont.)

- The following must appear in quarterly reports:
  
  ✓ Detail of the investment position on reporting date
  ✓ Summary statement for each fund group stating:
    - beginning market value
    - ending market value
    - fully accrued interest for the period
  ✓ Book value, market value and maturity of each separate asset by type of security and fund

Ethics and Conflict of Interest

- Language: Investment officers shall refrain from personal business activity that could be interpreted as a conflict of interest or which could impair their ability to make unbiased decisions.

- Disclose personal business relationships with any firm or individual seeking to sell investments.

- A statement must be filed with the Texas Ethics Commission and the Governing Body if present.
Internal Controls

- The investment officer is responsible for establishing and maintaining a set of written controls designed to ensure that financial assets are protected from theft, loss or misuse.
  - Detailed Procedures
  - Examples
  - Back-ups
  - Phone numbers

Other Key Points

- The policy should be expected to govern future investment officers who may have less experience than current officers.
- Understand all investments that are authorized by policy.
- Take the time to review your policy on a regular basis.
Investment Strategies
for Texas Counties

Strategy Basics

- The Public Funds Investment Act
- Individual Investment Policy
- Dynamic Investment Strategies
BE A SLY INVESTOR

• PFIA requires that investment strategies address the following objectives in order of importance:
  – Suitability – Is the investment suitable for the entity
  – Safety – preservation and safety of principal
  – Liquidity – does the investment meet the entities need for funds
  – Marketability – in case the investment must be sold
  – Diversification – strategies should address diversification
  – Yield – dead last in order of priorities

• SLY = Safety, Liquidity, Yield

Common Strategies

• 100% Cash (pools, bank deposits, money markets)
• “Ladder”
• “Barbell”
• Buy and Hold
• Active Management
100% Pools or Full Liquidity

- All funds held in fully liquid cash instruments – bank deposits, local government investment pools, money market funds

This strategy is beneficial when:
- Interest rates are rising quickly
- The yield curve is flat or inverted
- No clear understanding of cash flow

Drawbacks:
- Very low yields
- Lacks diversification
- Can be a problem when the market shifts directions and yields drop.

The Laddered Portfolio

- The idea behind a laddered portfolio is that securities are positioned so that maturities occur in regular intervals, providing a known stream of cash.

- Cash Flow Matching – The laddered portfolio may, or may not, correspond with expected future expenditures.

- Regardless of the direction interest rates move, you will be reinvesting at the prevailing market yield.
The Barbell Portfolio

- The idea behind a barbell is to maintain some of the portfolio in pools or bank deposits and a portion in higher yielding securities with longer maturities – usually 18 to 36 months.

- Pool rates will gradually rise as the Fed increases the funds target. The longer portfolio securities will earn higher yields immediately.

Buy and Hold

- Works well with a laddered portfolio
- Effective when used in conjunction with a formal cash flow.
- Keeps transaction costs down

✓ Has been proven to outperform “active management” on a total cost basis.
Active Investment
or Active Management?

Active Management

• Duration Management
• Market Timing
• Security Swaps
Duration Management

- Duration is a measure of portfolio risk
- It tells us how much the portfolio’s value will change for a given change in interest rates
- Duration is closely tied to weighted average maturity
- Duration management involves lengthening or shortening a portfolio’s duration (or average maturity) depending on the outlook for future interest rates
- Difficult and marginally effective

Market Timing

- The use of economic factors, such as strength of the economy and interest rates, as well as technical factors, such as the direction of security prices and trading volume, in the decision-making process over what and when to buy or sell.
- Difficult to implement, requires extensive analysis and time
- Historically not effective
Security Swaps

- Selling existing securities that have become expensive in the market and replacing them with *comparable but cheaper* securities.
- Profit may be taken on the trade and a higher yield booked.
- Typically shorter Treasury or agency issues are sold and replaced with longer government securities, municipal securities or CP.

Investing in Different Security Types
Defining “Spread”

The yield difference between two individual securities

- **Example:** A 2-year T-note yields 2.00%
  A 2-year agency yields 2.05%

  - The spread between these two securities is 5 basis points, 0.05% or 1/20 of 1%.
  - The agency is said to trade at +5 to the 2-yr

“Spread Product”

Agencies, CP and other security types provide higher yields by paying a “spread” over comparable Treasury issues.

✓ **First Rule of Thumb:** Spread increases with the level of risk.
  
  Higher risk = higher spread. The more risk you are willing to take, the more you will get paid.

✓ **Second Rule of Thumb:** Longer maturities mean more market risk and higher yields.
Relative Value *Within* Security Types

- If a brokerage firm owns a particular security, they should be able to offer it at a cheaper price than one who doesn’t.
- Quoted yields differ by offering size.
- There are typically large differences in offering yields from CP issuers.
- Being particular about dates can be costly.

Spread to Overnight Rates

- The most common investment decision for public investors is whether the security beats available pool or bank deposit rates.
- In a “bear” market (yields rising) you must be compensated for future rate increases.
- In a “bull” market (yields expected to fall), you may lock in yields below liquid rates.
Historical Spreads

- History determines an average spread between different security types.
- When that spread widens, it encourages investors to place more in the higher yielding securities.
- Keeping tabs on spreads helps pinpoint relative value, as well as perceived risk.

Risk Spreads

- Reasons why security spreads differ:
  - Credit risk (specific security risk)
  - Maturity length
  - Call risk
  - Liquidity

- Risk/Return
  - Key: Are you being adequately paid for the risk you are assuming?
Diversification Strategies

Diversification Basics

Variable Rate vs. Fixed Rate

• Pools, money market funds, and floaters pay *variable rates* that rise and fall with the market.
  • …so, as the Fed cuts rates, variable earnings fall.

• *Fixed rate* securities “lock in” yields to a determined maturity date.
  • …so, *as the Fed cuts rates*, fixed rate security yields are unaffected.

  – Be careful with callable securities. Although they have a fixed rate, if interest rates fall, they will be called.
Diversification Basics
Variable Rate vs. Fixed Rate

- Even “experts” cannot predict future interest rates.
- Variable securities (alone) cannot diversify!

**Objective 1:** Strive to achieve a mix of fixed and variable rate investments.

- Remember- Pools and money market funds are variable rate.

Diversification Basics
Diversification by Security Type

- All securities are subject to event risk and many securities are subject to default risk.
- An unforeseen event may force a sale at unfavorable times at below market prices.
- Investors cannot avoid the risk, but they can minimize the potential negative effect.

**Objective 2:** Limit overall exposure to CP issuers, municipals, and agency issues.
Diversification with Commercial Paper

General Safety Rules:

1. PFIA requires a minimum A1 / P1 rating
2. Research/document before buying
3. Create an authorized issuer list
4. Immediately liquidate downgraded issues
5. Review CP placed on Credit Watch (negative)

Diversification Basics

Diversification by Maturity Date

- Again, even experts can't predict interest rates.
- In the future, yields may be higher or lower than they are today.
- Don't “lock in” high % of funds on the long end.
- Don’t maintain high % of funds in the short end.

Objective 3: By spreading out maturities, or laddering the portfolio, investors can continually invest funds into the current market.
Discipline and Patience

- Long-term advantage of a good strategy
- Timing risk

General Investing in Actual Rate Environments
Fed Funds History

Yield Curves

- Positive

- Flat

- Inverse
Market Trends

Indicative Yield Comparison 2/17/00

- Pool rate: 5.77%
- 91 day discos: 5.97%
- 180 day discos: 6.30%
- 270 day discos: 6.37%
- 1 yr. agency: 6.62%
- 2 yr. agency: 6.98%
Market Trends

Flat yield curve …with no clear market direction

Indicative Yield Comparison 8/31/00
Market Trends

Falling yields (Rising prices)

Indicative Yield Comparison 2/28/01
Market Trends

Rising rates (Falling prices)

What do we do?

Indicative Yield Comparison 2/3/2017
Indicative Yield Comparison *8/7/2018*

- Pool rate: 1.92%
- 91 day discos: 2.00%
- 180 day discos: 2.20%
- 270 day discos: 2.35%
- 1 yr. agency: 2.50%
- 2 yr. agency: 2.75%

**Final Thoughts**

- Many investment strategies may appear counter-intuitive
- **Diversification** is always the right answer
- Sometimes the least obvious way to lose money is being too conservative
- NEVER invest in securities that you don’t understand
QUESTIONS?