# Active Investment Strategy Tools and Techniques for Small Governments: Part One

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Local governments, whether big or small, are mandated to collect, concentrate, and disperse public funds in a legal, safe, and prudent manner. Between the time funds are collected and the time they are dispersed, an entity can earn additional revenue if funds are properly deposited or invested. Large governments often have a staff member who is experienced at actively managing a diversified portfolio. Small governments tend to implement a passive strategy by putting their funds in certificates of deposit, local government investment pools, or money market mutual funds.

What considerations are necessary if a small government wants to implement a more active investment strategy with the goal of enhancing the return on the portfolio? This article will discuss important considerations in implementing an investment strategy.

Active and passive investment programs have as their foundation the same objectives in the following order of priority: legality, safety, liquidity, and return. It is important not to let the return objective rise in the order of priority, which sometimes can happen unconsciously when actively managing a portfolio.

## Tools for Active Management

Tools necessary for active investment management can be divided into internal tools and external tools. Internal tools include the investment policy, which defines the rules and specifies who is responsible for the investment program. A well-written investment policy customized to the needs of each local government can be an invaluable tool. Cash flow projections help identify cash needs that can be covered by maturing investments. Core money, funds that will not be needed for more than 12 months or except in an emergency, can be invested to take advantage of optimal points along the yield curve. Portfolio reports provide ongoing information on the structure of the portfolio and on the way income and return are being generated.

External tools have costs associated with them that can be relatively low to rather significant. Investment decisions are based on information. Theoretically, the better the information, the better the decisions one can make. The more sophisticated and timely the information, the more it will cost. Costs can range from several hundred dollars a year for a subscription to a daily or weekly financial publication, to more than a thousand dollars a month in access fees for an electronic market news and data service. To actively manage a portfolio, investors have to decide how to obtain the information needed for sound investment decisions and how much the entity is willing to spend on it. Whatever information is used must be dependable and unbiased, and investors must have enough investment acumen to use the information effectively.

## Investment Instruments

The following investment instruments are commonly used by public entities and afford ample opportunity for active investment management.

**U.S. Treasury securities** are considered the safest, because of their full faith and credit backing of the U.S. government, and most liquid, because of the breadth and depth of their market. They come in the form of bills, notes and bonds, and zero coupon securities known as STRIPS.

**Instrumentality securities** are issued by government-sponsored enterprises such as FNMA, FHLB, FHLMC, and FFCB. They are not backed by the U.S. government, but are currently rated in the highest credit category, which is AAA. Many instrumentality issues are liquid because of the size of the issues and their standardized structures. While these securities are rated AAA, the government-sponsored entities have been affected by recent economic conditions; therefore, the credit quality of these issuers should be monitored regularly.

**Commercial paper** is unsecured debt issued by corporations and financial institutions to provide short-term funding with a maximum maturity of 270 days. When buying commercial paper, due diligence on the credit of an issuer of commercial paper is always necessary before investing. At a minimum, the current ratings from a nationally recognized statistical rating organization should be reviewed to verify compliance with the investment policy. Given the recent turmoil in the credit markets, commercial paper is a more complicated investment decision for unsophisticated investors. When purchasing commercial paper, investors should check both the short-term and long-term credit ratings of the issuer.

**Local government investment pools** provide excellent liquidity vehicles for short-term investments and provide liquidity to meet cash flows needs. When evaluating pools, investors should analyze the pool as they would any other investment. A well-managed pool will provide full disclosure of investments in the portfolio and will be open to answering questions from pool participants.

Since **certificates of deposit** are commonly used by small governments, the important safeguard is to monitor the credit quality of the banks from which the CDs are purchased and to obtain proper collateralization for amounts above the FDIC-insured amount.

## Evaluating Risk

Investing requires an evaluation of the risk/return relationship. As an investor begins to implement more active investment strategies, the evaluation of that relationship becomes more important and more demanding.

Oftentimes, the risk given the most attention is credit risk. Will the issuer be able to pay principal and interest when it is due? Nationally recognized statistical rating organizations provide evaluations of that risk in the form of credit ratings. However, given the recent problems with the credit crisis, investors must perform more extensive due diligence on the issuers' financial condition.

There are other equally important risks to consider:

- Market risk, or how volatile the price change in a security will be, given a change in interest rates;
- Liquidity risk, or how easily a security can be liquidated prior to maturity without incurring a significant loss;
- Safekeeping risk, or who has control over the investor's securities and whether the investor has perfected ownership of the securities;
- Reputational risk, or how investment decisions can affect the investor's job. Public investors are particularly prone to having their investment decisions second-guessed in the press.

It is essential to know the risk tolerance of the governing body and have a plan for controlling risks in the portfolio so that the investment program is maintained at an acceptable risk level. ★