

Shaping Investment Policies for a Safer Cash Portfolio

Ten Common Questions on Cash Investment Policy Formulation

Abstract

We set out to answer 10 of the most common questions related to writing investment policy statements (“IPS”) for cash portfolios. In doing so, we will provide a number of peer group data comparisons to add insight into the process.

The treasury investment management landscape has undergone significant changes. We found that investors tended to shorten their maximum maturities, increase ratings requirements, reduce issuer-based concentration, and dial back the use of asset-backed securities. These changes represent a trend to upgrade portfolio credit characteristics, which is consistent with investor behaviors in the wake of major market downturns, in our opinion.

The 10 questions we address related to drafting investment policy statements focus on the following investment subjects:

1. *Maximum liquidity limits*
2. *Minimum credit ratings*
3. *Concentration limits*
4. *Percentage of portfolio in overnight liquidity*
5. *Benchmark selection*
6. *Appropriateness of ABS and MBS in cash portfolios*
7. *Prohibited transactions*
8. *Addressing conflicts of interest*
9. *Monitoring portfolio performance*
10. *Resolving out-of-compliance items*

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Revision Notes

Since we last updated this paper in 2009, the treasury investment management landscape has undergone significant changes that require a fresh look at how corporate investors construct their investment policy statements. The general guidelines contained in the Appendix still serve as a quick reference guide for key components in an IPS. This revision also offers a side-by-side view of the preferences of Capital Advisors Group’s client universe in 2012 versus 2009, which helps to illustrate the changes that have occurred since the financial crisis.

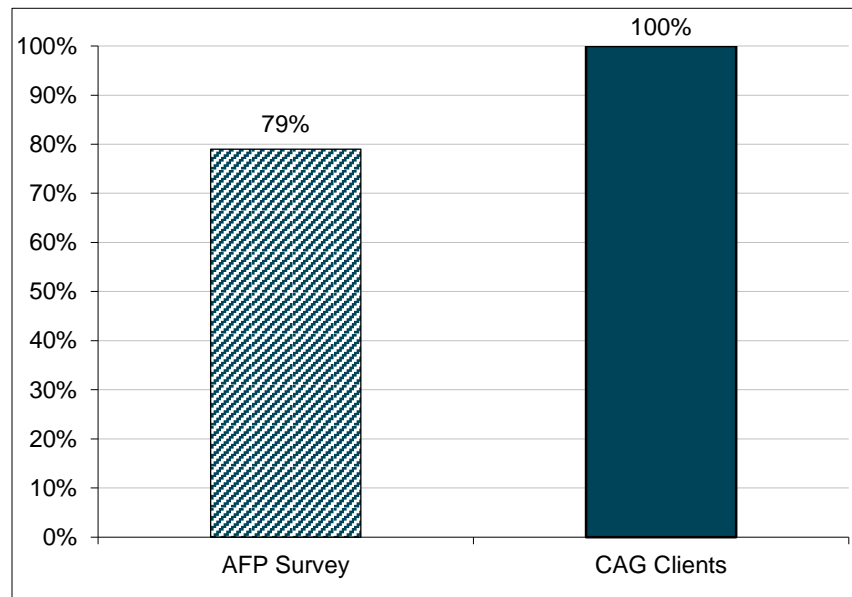
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In general, we found that investors have shortened their maximum maturities, increased ratings requirements, reduced issuer-based concentrations, and dialed back the use of asset-backed securities as permissible investments. All of these changes represent a trend to upgrade portfolio credit characteristics, which is consistent with investor behavior in the wake of major market downturns, in our opinion. We hope this update provides additional helpful insight for institutional investors in their own IPS construction or revision efforts.

Introduction

Investment policy statements, also known as investment guidelines, are widely used as important control documents in investment accounts. A recent industry survey showed that nearly 21% of corporate cash investors do not have written investment policies.¹ It also is quite common for some investors to permit wholesale adoption of policy guidelines recommended by outside investment managers, even though such recommendations may not always be in the best interests of the investors.

Figure 1: Do You Have a Written Cash Investment Policy?



Source: AFP 2011 Liquidity Survey and Capital Advisors Group, Inc.

Over the course of more than two decades of helping clients develop and review investment policies, we have come to understand the delicate balance between allowing an investment manager the flexibility to realize higher return potential and the important risk management function of an IPS. Instead of producing a “how-to” manual on writing investment policies, we will focus on some of the common issues faced by cash investors in the investment policy development process. Wherever

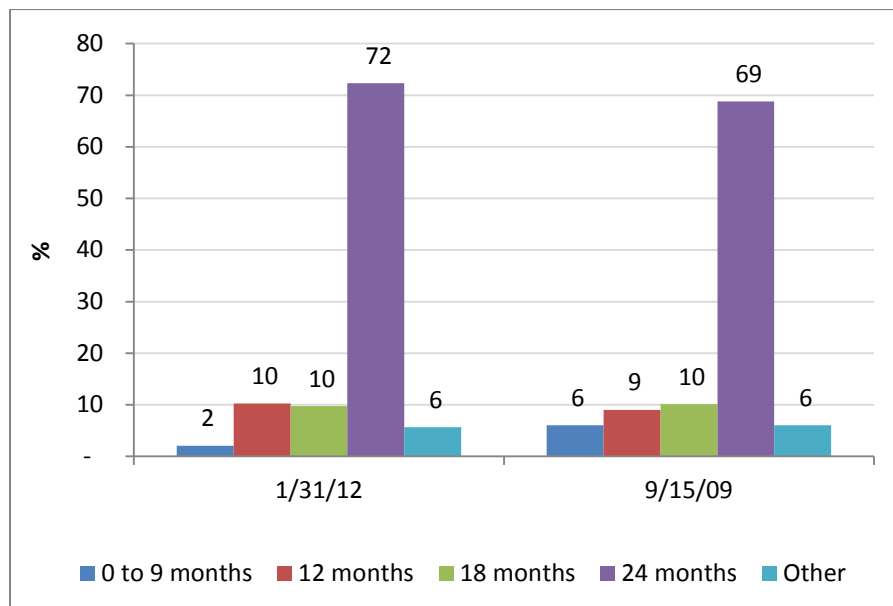
applicable, we will provide peer group data from corporate cash investors. Some of the information comes from our own client database and some of the information comes from third-party surveys. We hope that such peer group data will add helpful insight to the process.

1. What should be the maximum maturity limit?

We believe that an IPS should have a long-term view of maximum maturity tolerance in most interest rate situations. While interest rate cycles come and go rather fluidly, policy revisions often involve time-consuming board meetings and audit committee debates. It is neither efficient nor practical to constantly revise maturity limits to adapt to a prevailing interest rate situation. Therefore, the investment policy should define the investor’s maximum risk tolerance and allow the investment manager to make the tactical decisions of taking shorter maturity positions.

At Capital Advisors Group, as of 1/31/2012, about 72% of our institutional cash accounts state 24 months as their permissible maximum maturity limit. This is only slightly higher than the 69% of clients that we reported in 2009. While we think this small shift might reflect investors’ expectations that the current low yield environment will continue for the foreseeable future, it also demonstrates our clients’ long-term view of their maximum maturity tolerances through a period where interest rate expectations have changed considerably.

Figure 2: Maximum Maturity Limits of Capital Advisors Group’s Clients



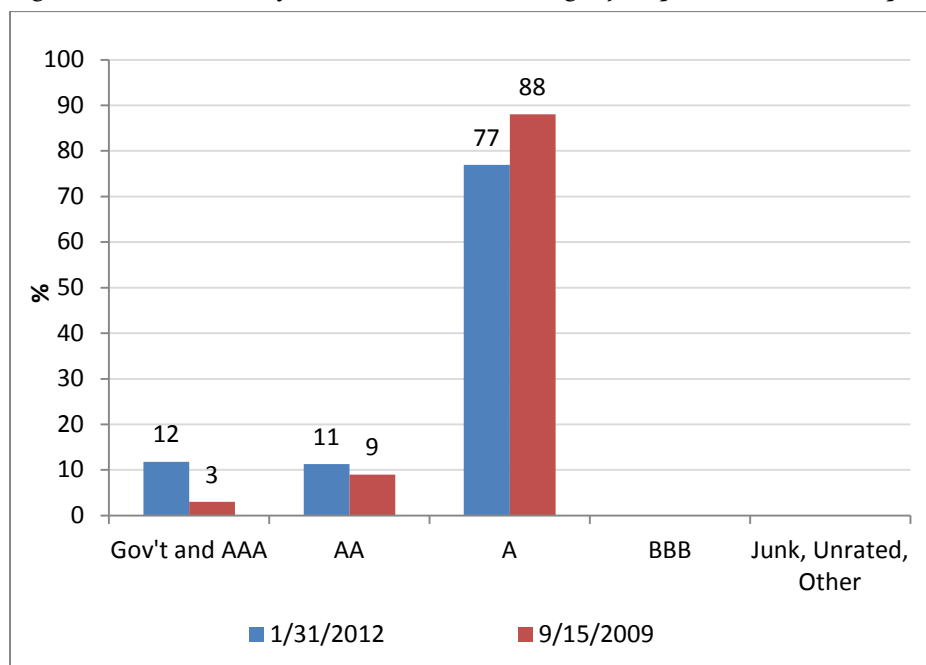
Source: Capital Advisors Group, Inc. as of 1/31/2012

2. What should be the minimum acceptable credit rating?

Using credit ratings from national rating agencies is still a good first step for controlling credit risk, despite the recent erosion of public confidence in the accuracy of the ratings. Although some investors are restricted by federal or state laws to invest only in U.S. Treasury and Agency debt, most corporate cash investors tend to be comfortable buying investment grade, non-government securities, and with good reason. According to Moody’s Investors Service, one of the national rating agencies, only 0.18% of issuer-weighted investment-grade corporate bonds failed to make payments on time within a year of issuance (with data from 1982 through 2011). Over a three-year period from the original date a bond was issued, that figure increased to 0.90%.²

All three major rating agencies, Moody’s, Standard & Poor’s and Fitch, use four letter grades to set investment-grade ratings (e.g., BBB, A, AA, and AAA). The agencies then apply finer degrees of upper, mid and lower numerical ratings (e.g., A1, A2, A3 from Moody’s) within a letter grade rating to further indicate relative credit quality. Although a BBB credit rating is considered to be investment grade, most cash investors prefer to purchase securities rated A or higher. In the event an A-rated security is downgraded, this allows for an added buffer before it slips into non-investment grade or “junk” status. The same Moody’s study indicates the payment default probability of corporate securities rated A or higher to be 0.05% within a year and 0.24% cumulatively within three years.³

Figure 3: Distribution of Minimum Credit Ratings by Capital Advisors Group’s Clients



Source: Capital Advisors Group, Inc.

Figure 3 shows that, likely as a result of the recent financial crisis, there was a slight uptick in investment policies requiring a minimum credit rating of AA or AAA today versus in 2009, although the vast majority of Capital Advisors Group's clients continue to require a minimum rating of A.

3. What should be the appropriate concentration limits?

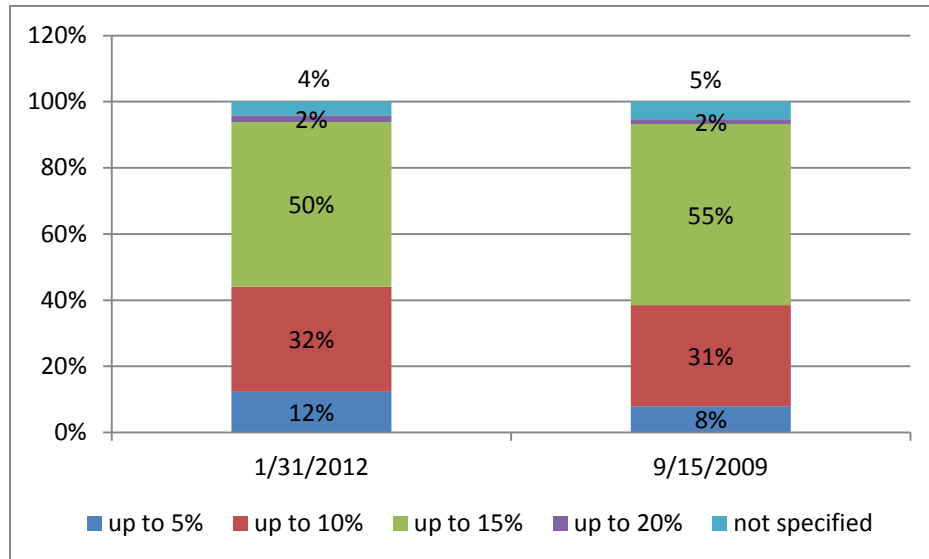
Issuer concentration limits are another important tool to control the idiosyncratic credit risk of individual issuers. Theoretically, the lower the concentration limit, the better risk diversification benefit there is to the investor. In practice, however, the dollar size of a cash portfolio may influence the degree of issuer diversification. This is because portfolio holdings tend to become less liquid, and less desirable to a potential buyer, when they fall below certain sizes – \$5 million in par value for short-term corporate bonds, for example.

The risk of over-diversification becomes especially evident with financial issuers when liquidity and credit support tend to focus on a few systemically important financial institutions. Smaller, less capitalized issuers in peripheral markets may suffer substantial shortages of liquidity and investor confidence, and may run into unexpected credit issues. Interested readers may refer to our July 2010 publication [Prudent Risk Diversification](#).

For a relatively small portfolio, a concentration limit of 10% to 15% for short-maturity securities rated A or higher may be appropriate. As the portfolio size increases, the limit may be reduced to 5% or lower. Securities issued and guaranteed by the U.S. federal government typically are exempt from concentration limits as they often are perceived as risk-free. Government-sponsored enterprises, including Fannie Mae, Freddie Mac and the FHLB System, typically enjoy higher issuer limits (such as 25%) because of their implicit support from the federal government.

Alternatively, investors may incorporate credit ratings into concentration limits, placing lower limits on securities with lower ratings. At Capital Advisors Group, about 32% of our institutional cash accounts allow for a 10% concentration limit per issuer, while 50% permit a 15% issuer concentration, as of January 2012. More investors moved to a 5% limit versus the 15% limit in 2009, suggesting the effects of the credit crisis and their growing portfolios.

Figure 4: Distribution of Issuer Concentration Limits at Capital Advisors Group



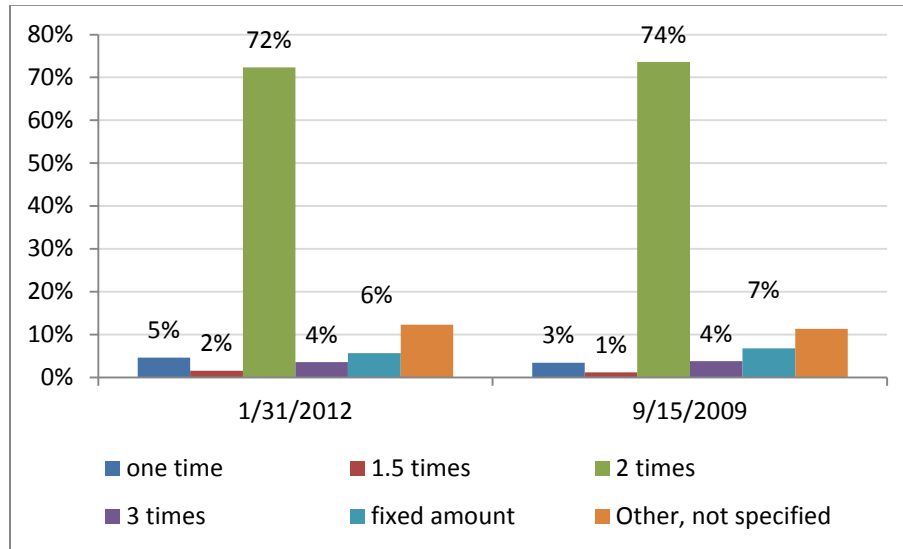
Source: Capital Advisors Group, Inc.

4. How much of my portfolio should be available overnight?

Not all investors specify how much of their portfolio should be in money market funds or other overnight instruments as an investment policy item. For investors who regularly withdraw funds from their cash accounts, it may be appropriate to have certain liquidity buffers for scheduled withdrawals and also to compensate for cash flow forecasting errors. The predictability of cash flow and the investor’s risk tolerance should dictate the portion of the portfolio allocated to liquid funds.

It is worth noting that a well-managed portfolio should be able to provide for unexpected liquidity needs through the sale of liquid assets in a reasonably quick fashion. Still, selling securities prior to maturity may result in undesirable capital gains or losses. Interested readers may refer to our [December 2011](#) article on how to define liquidity and use its characteristics effectively to meet liquidity goals.

Figure 5: Percent of Portfolio Required in Overnight Funds Measured by Times of Monthly Cash Needs



Source: Capital Advisors Group, Inc. as of 9/15/09 and 1/31/2012

5. How do I choose an appropriate performance benchmark?

A relevant policy issue to consider when making benchmark selections is that a good benchmark should reflect the “neutral” position for a given policy. If the investment strategy and the securities it allows for are substantially different from those of the benchmark, then the portfolio may be taking on too much benchmark risk.

A unique challenge faced by cash investors is that the most popular fixed income indices measure total return, which includes unrealized gains and losses. While market value changes in a portfolio certainly are important to monitor, most cash investors do not receive a real benefit from the gains or suffer unrealized losses if they intend to hold the investments to maturity. Instead, these investors generally are more concerned with the yield they are earning based on the securities’ book values.

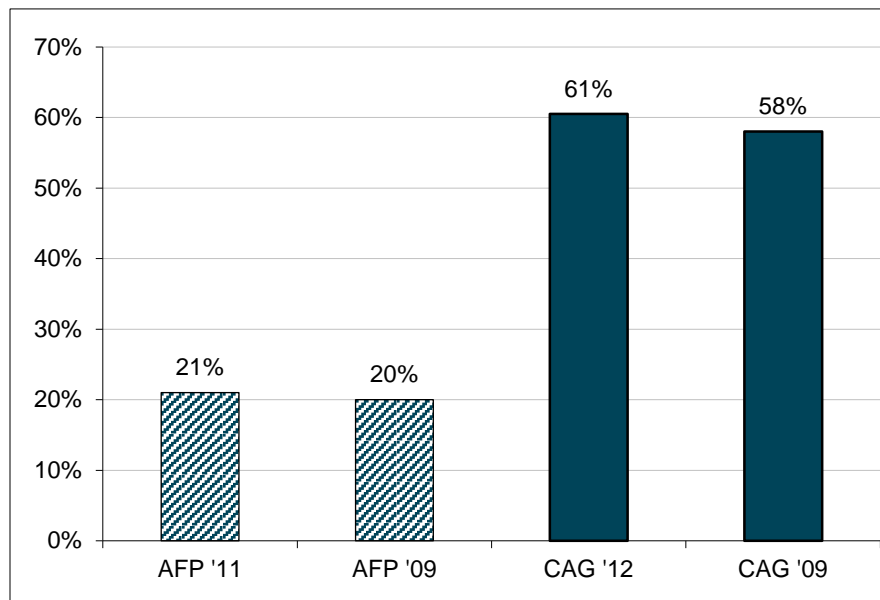
For relatively short buy-and-hold accounts, we generally use money market peer group averages, such as the Lipper Institutional Money Market Funds Average, as a benchmark. Since these funds use securities’ book values as their principal values, all of their returns effectively come from the securities’ yields, making the returns more directly comparable to cash accounts. The Citigroup 90-Day Treasury Index also may be a reasonable benchmark to use. For portfolios containing securities longer than a year, a market index with a comparable duration may be more appropriate. In a nutshell, a good benchmark should be simple, objective, representative and publicly available.

6. Are asset-backed or mortgage-backed securities appropriate for cash portfolios?

Unlike corporate bonds with specific maturity dates, asset-backed securities (“ABS”) and mortgage-backed securities (“MBS”) use a calculated number called “average life” to estimate the expected full principal payment date. To compensate for cash flow uncertainty, ABS and MBS tend to use credit enhancement tools to enable them to attain strong credit ratings (often AAA) and may offer attractive yields relative to corporate securities.

In a stable or improving consumer credit environment, we think cash investors may be able to benefit from ABS backed by credit card receivables and automobile loans. For credit card ABS, issuers often use a structure called a “soft bullet” to ensure that all the funds necessary to pay down the full principal of the bond are accumulated in a reserve account prior to the expected maturity date. In an automobile loan ABS, the expected full principal payment dates also are quite stable, usually within a few months, since relatively few car loan borrowers regularly refinance their loans.

Figure 6: Percentage of Accounts Listing ABS as Approved Assets



Source: AFP 2009 Liquidity Survey and Capital Advisors Group, Inc.

In the current credit cycle, ABS bonds backed by non-mortgage-related consumer receivables have performed well due to improved credit statistics in an economic recovery. We think they will continue to provide risk diversification benefits at attractive yield levels despite recent outperformance.

For MBS securities, changing interest rates may have a major impact on mortgage refinance activities. The average life of MBS securities, including those designed to

reduce cash flow fluctuations (collateralized mortgage obligations), can swing many months or years either before or after the expected payment date. Investors who rely on predictable cash proceeds to fund their treasury operations, thus, may find MBS less attractive than those who do not have such constraints. We think investors who approve MBS in their IPS should limit their investments to securities backed by agency mortgages instead of bonds backed by higher-risk, “non-conforming” mortgages.

7. What would you consider prohibited transactions?

As an additional measure of risk control, it may be a good practice to prohibit certain securities or procedures that are inconsistent with the principal protection, liquidity and yield objectives of cash investing. What one may put on this list is an individual choice based on objectives, risk preferences, and historical experience of the investor. An important point to remember is not to “throw the baby out with the bath water.”

Examples of prohibited securities may include buying common or preferred shares of equity, unrated or non-investment-grade securities, exotic forms of derivatives, the purchase of securities on margin or other types of financial leverage, and investments in physical real estate, venture capital or commodities, among others.

8. How do I address investment manager conflicts of interest?

A conflict of interest may exist when the manager of an investment portfolio has an interest with respect to the invested assets that may impair his or her ability to render unbiased advice or to make unbiased decisions affecting the investments. An effective investment policy should contain explicit language safeguarding against such conflicts.

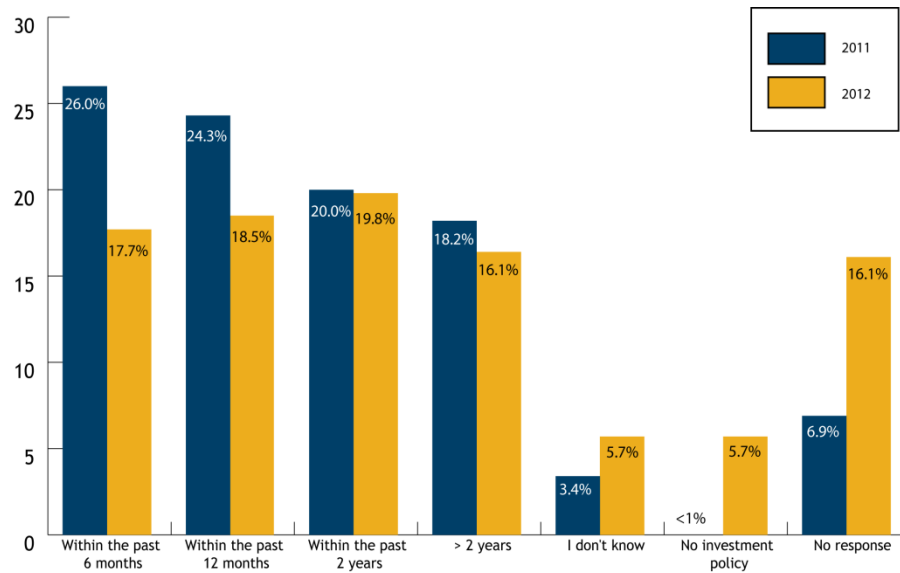
The formal adoption of the “prudent man rule” in an IPS may help set the ground rule. The “prudent man rule” is a common law standard applied to the investment of trust funds. The rule directs a fiduciary “to observe how persons of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested (Harvard College v. Amory (1830) 26 Mass (9 Pick) 446. 461).”

Although most institutional assets in pension and endowment funds are managed by SEC-registered investment advisors, some investors in the cash management space have retained brokerage representatives as managers. Interested readers may refer to our July 2008 publication [An Old Favorite Faces a New Paradigm](#) for our commentary on the broker cash management model.

9. How do I monitor my portfolio performance?

Investment management is a dynamic process. Cash portfolios are no exception. Formal procedures should be in place to review the portfolio on a regular basis - at least quarterly. The policy document should detail the frequency and subjects to be reviewed, as well as the persons responsible for such reviews. In addition to investment performance, other items to review may include the accuracy of cash flow projections, earned income estimates, credit rating changes and unrealized gains and losses in the portfolio, among others. The policy itself should be reviewed periodically, preferably annually, to assess its effectiveness in risk management and to reflect the changing investment environment.

Figure 7: When Was Your IPS Last Updated?



Source: CAG/Strategic Treasurer liquidity risk survey results 2011 & 2012

Figure 7 is taken from the annual liquidity risk surveys of corporate treasury professionals conducted by Capital Advisors Group and Strategic Treasurer in 2011 and 2012. The survey results show that 36.2% of firms updated their IPS in the previous twelve months through the survey closing date of March 2012. Another 19.8% updated their IPS in the previous 24 months.

10. How do I resolve an out-of-compliance item?

Due to the dynamic nature of business and investment environments, it is not uncommon to have an out-of-compliance situation in a cash portfolio. It is imperative to anticipate such situations in an investment policy and to include proper guidelines for issue resolution and escalation. It is impractical to list every type of out-of-compliance problem, but it may be helpful to address them using three general principles: materiality, timing and authority.

- **Materiality:** Will the portfolio incur a loss and, if so, what is the severity of the loss?
- **Timing:** Do I wait and let the problem cure itself or do I take action to remedy the current situation and to prevent future problems?
- **Authority:** What is the chain of command in making discretionary decisions regarding the first two principles?

For example, consider a portfolio with a minimum credit rating of A3: If a security representing 3% of the portfolio with three months to mature was downgraded to Baa1, the CFO may have the discretion to authorize the manager to continue holding the security to maturity rather than force a sale.

Conclusion

Investment policy statements are important investment documents that can help corporate investors achieve risk management objectives and help outside investment managers clarify clients' restrictions so that they may deliver expected results. Careful implementation of a well-crafted, written policy statement is an important part of a successful cash investment strategy that also may help to improve investor-manager communications.

Appendix: Introduction to Investment Policy Statements

What is an IPS?

An IPS is a written document outlining the process for an investor's investment-related decision making. The purpose of an IPS is to formally describe how investment decisions are related to an investor's goals and objectives. A well-constructed IPS provides evidence that a clear process and a methodology exist for selecting and monitoring cash investments.

The benefits of an IPS

In retirement plan administration, the Employee Retirement Income Security Act of 1974 (ERISA) stipulates that a plan sponsor has a fiduciary obligation to document the procedures for investment selection and evaluation. While such a requirement is not equally placed on cash managers, the passage of the Sarbanes-Oxley Act placed strong demand on a corporation's internal control procedures. The existence of a well-constructed investment policy statement provides evidence of a prudent investment decision-making process and, in doing so, it can serve as an important risk management function in defense of potential fiduciary liability claims.

Beyond the legal and regulatory reasons for adopting an investment policy statement, creating an IPS forces a corporation to put its investment strategy in writing and commit to a disciplined investment plan. It's both a blueprint and a report card. The ever-increasing number and variety of outside investment advisors also make it necessary for a corporation to develop an investment policy so that the managers' expertise can better match the investor's risk tolerance, liquidity constraints and return expectations. Furthermore, a written policy may help those responsible for investment decisions avoid the temptation of following short-term "fads" in the financial markets.

A typical IPS

An investment policy statement's content always should be customized to the investor's specific needs. Some corporations prefer to adopt a brief investment policy statement summarizing the critical aspects of their investment goals and decision-making processes, while others prefer a more detailed version that addresses topics more specifically. The following areas often are addressed in an investment policy statement:

- Purpose
- Investment Objectives
- Eligible Investments
- Concentration Limits
- Maturity Limits

- Liquidity Requirement
- Credit Quality
- Marketability
- Trading Guidelines
- Custody of Assets
- Fiduciary Discretion
- Monitoring and Reporting
- Manager Selection and Termination
- Benchmarking
- Fees
- Future Amendments

Resources from Investment Managers

Investment managers, including Capital Advisors Group, often offer sample investment policies to prospective clients for use as references to draw up their own policies. The investment managers often are involved in the ongoing efforts of reviewing and revising current policies. It is advisable for institutional investors to tap into this pool of resources and discuss certain aspects of an investment policy with independent advisors before formal policy adoption.

¹ Association for Financial Professionals, Inc. 2011 AFP Liquidity Survey.

² Sharon Ou, et al, Special Comment: Annual Default Study: Corporate Default and Recovery Rates, 1920-2011, Exhibit 22: Average cumulative credit loss rates by letter rating, 1982-2011, Moody's Investors Service, February 29, 2012.

³ Ibid.

Any projections, forecasts and estimates, including without limitation any statement using “expect” or “believe” or any variation of either term or a similar term, contained herein are forward-looking statements and are based upon certain current assumptions, beliefs and expectations that Capital Advisors Group (“CAG”, “we” or “us”) considers reasonable or that the applicable third parties have identified as such. Forward-looking statements are necessarily speculative in nature, and it can be expected that some or all of the assumptions or beliefs underlying the forward-looking statements will not materialize or will vary significantly from actual results or outcomes. Some important factors that could cause actual results or outcomes to differ materially from those in any forward-looking statements include, among others, changes in interest rates and general economic conditions in the U.S. and globally, changes in the liquidity available in the market, change and volatility in the value

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