SHAPING INVESTMENT POLICIES FOR A SAFER CASH PORTFOLIO

10 Common Questions on Cash Investment Policy Formulation

EXECUTIVE SUMMARY:

We set out to answer 10 of the most common questions related to investment policy statement writing for cash portfolios. In doing so, we will provide a number of peer group data comparisons to further add helpful insight in the process.

The questions address 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

Careful implementation of a well-crafted policy statement is an important part of a successful cash investment strategy which may also improve investor-manager communication.

December 1, 2006

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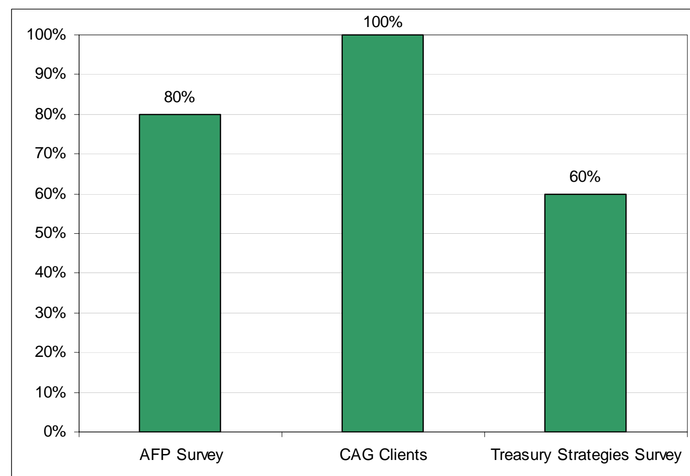
Introduction

Investment policy statements (IPS), also known as investment guidelines, are widely used as important control documents in investment accounts. However, a recent industry survey showed that up to 40% of corporate cash investors do not have written investment policies[1]. Of those that do, many contain vague over-permissive or prohibited practices. It is also quite common for investors to permit wholesale adoption of policy guidelines recommended by outside investment managers, even though such recommendations may not always be in the best interest of investors.

In our 15 years of helping clients develop and review investment policies, we've come to understand the delicate balance between allowing the 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 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 from third-party surveys. We hope that such peer group data will add helpful insight to the process.

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



Source: AFP 2006 Liquidity Survey, Capital Advisors Group, Inc., and Treasury Strategies, Inc. 2005 U.S. Corporate Liquidity Survey

1. What are the appropriate maximum maturity limits on securities?

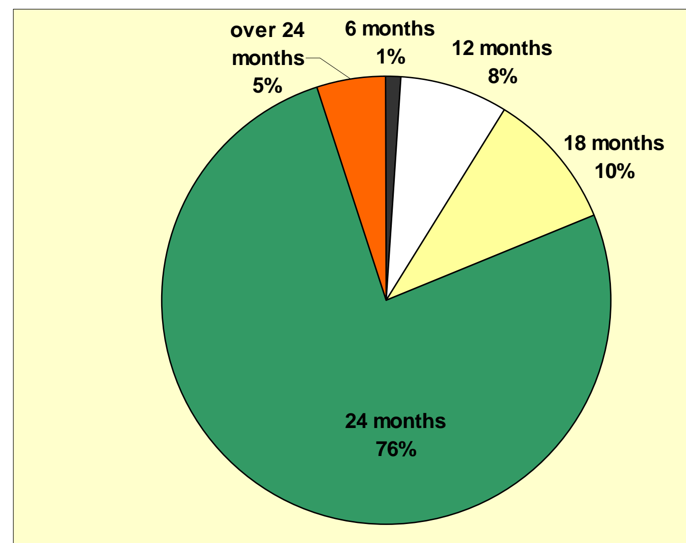
The answer to this question lies in the balance of expected yield pickup in longer-maturity securities and the need for liquidity. In a normal, upwardly sloping yield curve environment, investors generally receive higher yield for the inconvenience of waiting longer for a bond to mature. However, if interest rates move higher, bonds with longer maturities may have larger marked-to-market losses as prices move in opposition to the direction of yields.

We believe that a policy document should have a long-term view of maximum maturity tolerance in most interest rate situations. Interest rate cycles come and go rather fluidly,

but 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. The policy should define the investor's maximum risk tolerance and let the investment manager make the tactical decision of taking shorter maturity positions.

At Capital Advisors Group, about 76% of our institutional cash accounts allow 24 months as their maximum maturity limits for individual securities.

Exhibit 2: Maximum Maturity Limits of CAG Clients



Source: Capital Advisors Group, Inc.

2. What should the minimum acceptable credit ratings be?

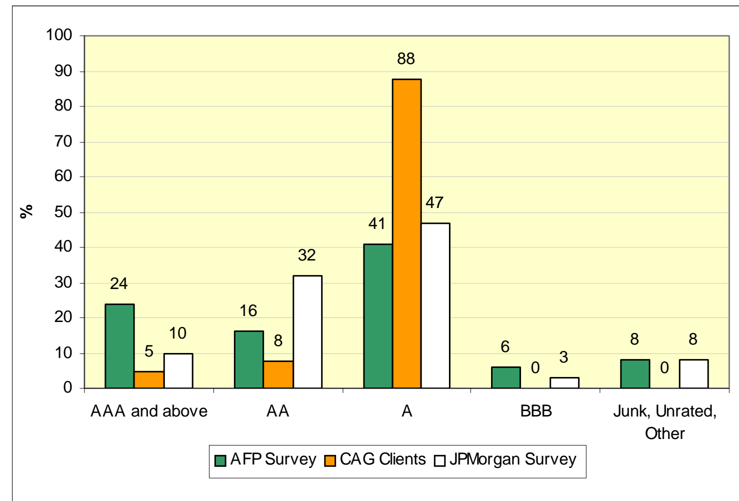
Credit ratings from national rating agencies are good tools for controlling credit risk. Although some investors are restricted by federal or state laws to invest in U.S. Treasury and agency debt only, most corporate cash investors tend to be comfortable buying investment grade, non-government securities, and with good reason. According to Moody's Investors Service, one of the national rating agencies, only 0.21% of issuer-weighted investment-grade corporate bonds failed to make payments on time within a year (with data from 1970 to 2005). Over a three-year period, that figure increased to 1.2%[2].

All three major rating agencies, namely Moody's, Standard & Poor's, and Fitch, have four letter grades for investment-grade ratings (BBB, A, AA, and AAA). The agencies apply finer degrees of upper, mid and lower numeric 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 investment grade, most cash investors prefer to purchase securities rated A or higher to have the added safety margin before securities slip 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 0.03% after a year and 0.28% cumulatively after three years[3].

Exhibit 3: Distribution of Minimum Credit Ratings



Source: AFP 2006 Liquidity Survey, Capital Advisors Group, Inc., and JPMorgan Asset Management Global Cash Management Survey 2005

3. What should the appropriate concentration limits be?

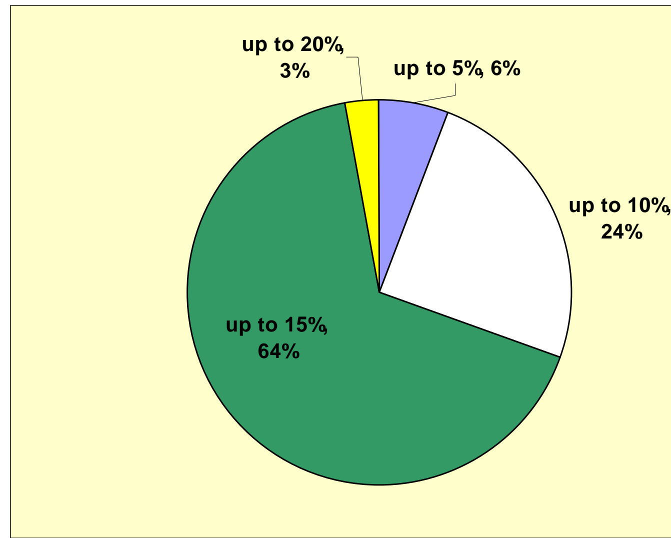
Issuer concentration limits are another important tool to control the idiosyncratic credit risk of individual issuers. Theoretically, the lower the concentration limit, the better risk diversification benefit there is to the investor. In practice, however, the dollar size of a cash portfolio can influence 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, for example, $5 million in par value for short-term corporate bonds.

For a relatively small portfolio, concentration limits of 10% to 15% for short-maturity securities rated A or higher may be appropriate. As the portfolio size increases, such limits may be reduced to 5% or even lower. Securities issued and guaranteed by the U.S. Federal Government are typically exempt from the limit as they are often 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 in concentration limits, placing lower limits on securities with lower ratings.

At Capital Advisors Group, about 64% of our institutional cash accounts allow for a 15% concentration limit per issuer, while 24% permit a 10% issuer concentration.

Exhibit 4: Distribution of Issuer Concentration Limits at CAG



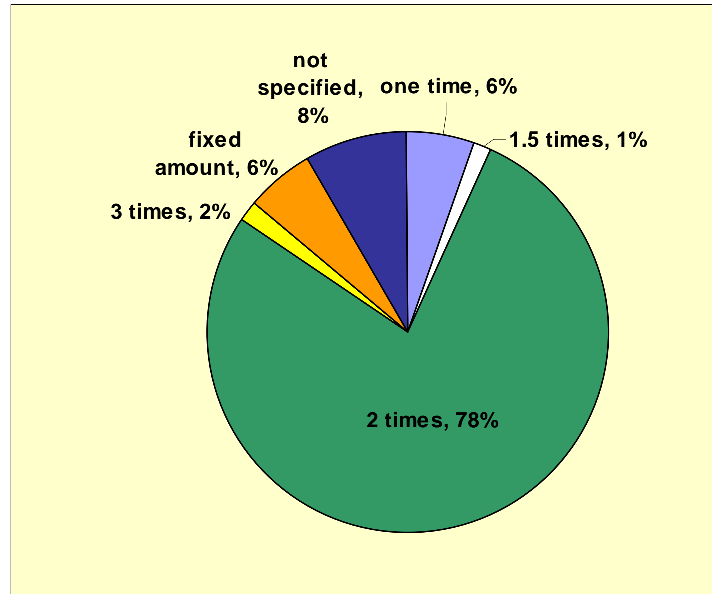
Source: Capital Advisors Group, Inc.

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

Not all investors specify how much of their portfolios should be in a money market fund or other overnight instruments as an investment policy item. For investors that withdraw funds regularly from their cash accounts, it may be appropriate to have a certain liquidity buffer for scheduled withdrawal and 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 in 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.

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



Source: Capital Advisors Group, Inc.

5. How to choose an appropriate performance benchmark?

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

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

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 value as their principal value, all of their returns effectively come from the securities' yield, making the returns more directly comparable to cash accounts. For portfolios containing securities longer than a year, a market index with comparable duration may be more appropriate. In a nutshell, a good benchmark should be simple, objective, representative, and publicly available.

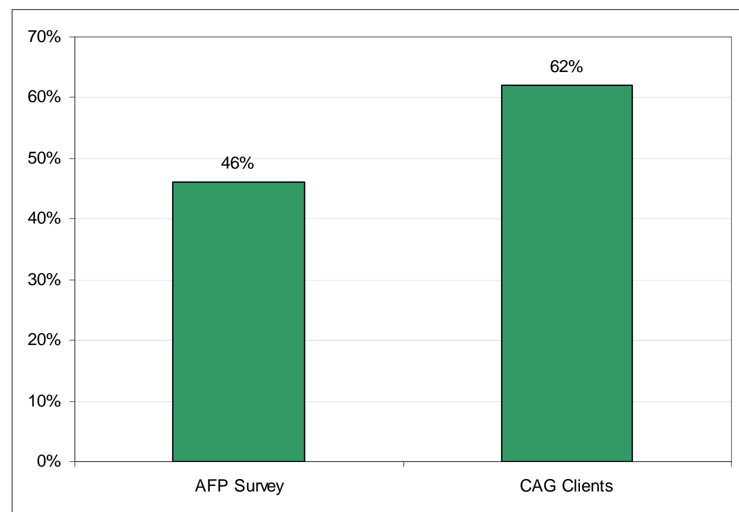
6. Are asset-backed or mortgage-backed securities appropriate for cash portfolios?

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 this cash flow uncertainty, ABS and MBS tend to have strong credit ratings (often AAA) and may offer attractive yields relative to corporate securities.

We think most 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 is accumulated in a reserve account prior to the expected maturity date. In an automobile-loan ABS, the expected full principal payment dates are also quite stable, usually within a few months, since relatively few car loan borrowers refinance their loans regularly.

On the other hand, changing interest rates may have a major impact on mortgage refinance activities. The average life of MBS securities, including those designed to reduce the cash flow fluctuations, can swing many months or years either before or after the expected payment date, and therefore, may not be appropriate for certain cash investors.

Exhibit 6: Percentage of Accounts Listing ABS As Approved Assets



Source: AFP 2006 Liquidity Survey, and Capital Advisors Group, Inc.,

7. What would you consider as 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 in this list is an individual choice based on objectives, risk preference, 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, purchase of securities on margin or other types of financial leverage, investments in physical real estate, venture capital or commodities.

8. How to address manager conflict 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 its ability to render unbiased advice or to make unbiased decisions affecting the investments. An effective 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".

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 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.

10. How to 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 provide the proper guidelines of issue resolution and escalation. It is impractical to list every type of out-of-compliance problem, but it may be helpful to address them at least in three general principals: materiality, timing, and authority.

Materiality refers to how severely the problem may cause the portfolio to incur a loss. Timing deals with how long it takes to either let the problem cure itself or to dispose of it in prevention of future problems. Authority refers to the chain of command in making the discretionary decisions regarding the first two. Consider a portfolio with A3 minimum credit ratings: 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 instead of forcing a sale.

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. Its purpose is to describe formally how investment decisions are related to its goals and objectives. A well-constructed investment policy statement 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, ERISA stipulates that a documented procedure for investment selection and evaluation is a plan sponsor's fiduciary obligation. While such a requirement is not equally placed on cash managers, the recent 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, can serve an important risk management function in defense against potential fiduciary liability.

Beyond the legal and regulatory reasons for adoption of 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 manager's expertise can better match with 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.

What a typical IPS contains

The investment policy statement's content should always be customized to each 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 addressing topics more specifically. The following areas are often 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

Conclusion

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

Endnotes:

[1] 2005 U.S. Corporate Liquidity Research Program participants' Report, Treasury Strategies, Inc. p. 5.

[2] David T Hamilton, et al, Special Comment: Default and Recovery Rates of Corporate Bond Issuers, 1920-2005, Moody's Investors Service, Revised March 2006.

[3] Ibid.

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