

Preparing an Investment Policy

By Michael Ablowich

During the 1995 legislative session, House Bill 417 was introduced that would have given municipalities a broader choice of investment management options for financial assets. The bill was referred to committee and reintroduced and passed in the 1996 session with added provisions requiring municipalities to adopt and implement investment policies for certain funds for which public officials act as a fiduciary. These funds include local operating (general) funds, capital reserve funds and trust funds.

The adoption of an investment policy is a prudent and advisable action for an oversight group to take. The bill is a mandate for municipalities to take actions that should have already been taken by any public officials who act as a fiduciary for any funds under their supervision. The purpose of this article is to outline the basic information that should be contained within an investment policy for adoption by municipalities or any other organizations with fiduciary responsibilities. While nonprofit organizations are not covered under this recent bill, the information contained in this article may also be relevant to these groups. It should be noted that this is merely an outline and the views expressed by the author are his own, not a legal interpretation of any RSA and not to be interpreted as official policy of the State of New Hampshire or the State Treasury Department.

What is an investment policy?

An investment policy is a statement about the monies for which you act as a fiduciary, how you intend them to be managed and what controls should be placed on them. It is the guidelines by which fiduciaries expect their goals and objectives for a particular financial asset to be met. The investment policy should also reference the applicable RSA's that govern the investment of the particular funds. An investment policy is not meant to absolve fiduciaries of the decision making process or provide unchecked power to an investment manager to make decisions on behalf of fiduciaries.

The overriding themes in an investment policy should be safety, liquidity and yield. Each decision making junc-

ture in investing any public funds can be made within the context of these three terms. Safety is preserving the value of principal. Liquidity is the ability to turn an investment into cash without significant loss of principal. Yield is the return expected for a particular investment. The choice of an investment objective for a particular fund and the eventual choice of the types of securities used to meet those objectives will be driven by a need for safety of the funds, the ability to use the funds when needed (liquidity), and the return expected given the safety and liquidity of the investment.

Why is an investment policy important?

As a public official there is a need to insure that the proper controls are placed on the management of assets, particularly cash and investments. A well written investment policy is your statement as a public official or group of officials about those controls over public monies. An investment policy should also act as a guide within which to frame decisions made by either the fiduciaries or the person hired by the fiduciaries to manage those financial assets.

Elements of an Investment Policy

An investment policy can be divided into seven basic components: 1) Purpose, 2) Investment Objective, 3) Investment Authority, 4) Responsibilities, 5) Approved Investments, 6) Constraints, and 7) Reporting.

Purpose

It is important to clearly identify the funds that will be covered under an investment policy. The trust documents, RSA's or resolutions of ruling bodies should be referenced as a means of differentiating between different classifications of funds. This is especially important when funds may be commingled in larger investment accounts. The purpose of the funds or interpretation of the trust documents that establish them should also be included.

It is also important to specifically identify the type of funds

involved. For example, if the monies are classified as trust funds, they should be further identified as expendable or nonexpendable. The classification of nonexpendable versus expendable trusts or capital reserve versus agency funds is important to understand the accounting procedures and treatments used in each case as well as the appropriate RSA's that may govern the allowable menu of investment choices.

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Investment Objective

A clear statement should be made about the goals of investing particular funds: For example, the trust fund is to be invested to insure that the purchasing power of the principal is maintained, while providing a level of income sufficient to support the programs intended to be financed under the terms of the trust document. The ensuing sections of the policy should support the investment objective.

Investment Authority

The individual or individuals with fiduciary responsibility for carrying out the terms of the trust or safeguarding the monies should be identified. Generally, trustees of trust funds or treasurers may be charged through the RSA with the fiduciary responsibility for the vast majority of municipal monies. It is, however, likely that other groups may have responsibility for overseeing the investment of public funds. For example, local housing authorities or economic development councils may have monies in their possession which may not be large, but still need the same attention that larger pools of monies require. While these other groups are not affected under the new legislation, there would appear to be a prudent and practical reason for adopting an investment policy for all funds under their control for the same reasons that the use of investment policies at the local municipal level are important.

Responsibilities

As a practical matter, trustees of trust funds or treasurers may employ individuals that execute the day to day operations of managing public monies. Those individuals and the powers delegated to them should be clearly identified. For example, an investment manager may be permitted to use mutual funds as an investment vehicle. However, the trustees of trust funds will have final approval over the use of particular mutual funds at the request of the manager.

Similarly, an investment manager may be delegated with the sole responsibility of buying and selling individual securities, but may have restrictions as to the total number or dollar volume of transactions within a particular time frame. The identification of specific responsibilities is important to insure that those individuals with fiduciary responsibility understand the power conveyed to their employees to make decisions on their behalf. This delegation of power is not meant to absolve fiduciaries of responsibility for investment decisions, but rather to insure that, for those powers delegated, appropriate controls are in place.

Approved Investments

The choice of approved investments will be based on the categories permissible under the RSA's for particular types of funds and the objective of the funds. Based on historical rates of return for different asset classes and rates of inflation, an equity component may be appropriate for an investment program to allow a portion of a fund to appreciate faster than the rate of inflation and preserve the purchasing power of any income generated. In theory, these gains can be allocated periodically to income producing assets to continually increase the amount of income generated by a particular fund. Public officials need to determine the types of equity investments which may be appropriate. While there are a number of different types of equity investment options from aggressive growth or small cap stocks to blue chip stocks, the investment policy should specify the types of stocks they are comfortable with given the objective. For example, stocks, in general, may be an approved investment, so long as they are blue chip or large cap stocks, that may be held in the fund as individual stocks or through a mutual fund with an investment strategy that includes similar types of stocks.

Each type of investment should be included in this section with a brief description of the limitations of the particular

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type. For example, bonds may be approved only if they are issued by the federal government, one of its agencies or by companies whose debt is rated AAA or better. There are certainly more investment types than stocks and bonds and some mention should be made of those other types (money market funds, certificates of deposit, repurchase agreements, etc.) if their use is to be permitted.

Constraints

Once the approved investments are outlined, the allowable amounts of each should be determined. The allowable amounts may be defined in total dollars or as percentage of the total monies invested. For example, fifty percent of the fund may be invested in stocks and fifty percent in bonds and cash. Defining the constraints in percentage terms will permit more flexibility for the portfolio of securities to be adjusted from time to time as securities change in price. The constraints may include, for example a plus or minus ten percent of the targeted value, since this will allow for variance given monthly changes in market value which will invariably occur. It may also be advisable to further breakdown the asset allocations. For example, fifty percent may be permitted in stocks with up to ten percent invested in aggressive growth stocks or fifty percent in bonds with up to twenty percent in other than U.S. Government obligations. In the constraints section there may also need to be some discussion of maximums permitted in any one issuer of stocks or bonds. For example, no more than five percent of stocks may be in any one company or twenty-five percent in any single mutual fund.

Bonds are perceived as fairly low risk investments. However, a thirty year treasury bond is riskier than a five year treasury bond because of the variability in the price of the bond over its life. To properly manage this particular risk associated with investing in bonds, the investment policy should include a limit on the maximum maturities of individual fixed income securities and also a weighted average maturity of the total portion of the portfolio allocated to bonds. For example, bonds are permitted up to fifty percent for the portfolio with a weighted average maturity of less than ten years, with no single maturity longer than fifteen years.

Reporting

The reporting may be the most important part of an investment policy, especially if the fiduciaries hire others to execute the investment objectives on their behalf. In this section the type and frequency of financial statements should be addressed. In addition to periodic reports with a list of investments, their costs, current values and transaction history; other routine reports should document compliance with the investment policy (constraints, use of approved investments, etc.). The format of any reporting should be determined by the fiduciaries with input from their investment manager or other employees.

Performance standards (benchmarks) for the fund as well as the frequency of performance reviews should also be outlined in this section. Setting benchmarks, commensurate with the investment objectives, to evaluate performance is important to insure financial goals are being met. For example, the benchmark may be that the fund grows at a rate greater than the Standard and Poor's 500 stock index. Charting the fund's performance against a benchmark is especially critical in evaluating the performance of an investment manager hired by fiduciaries.

Summary

The establishment of an investment policy is the basis for proper management of public funds. Writing an investment policy forces public officials to think through their role as fiduciaries and how they can meet the intent of the law or a trust document in the most prudent manner possible. An investment policy also can be the source document for delivering instructions to a contracted individual or an employee whose job it may be to make investment decisions for a fiduciary. Many public officials, especially those at the local level, may serve on a part-time or volunteer basis and are required to act in a fiduciary role. These fiduciaries may or may not have the resources to explore all the issues related to the investment of public funds. For such officials, preparing an investment policy is the first step to insuring that they have the tools to excel in their important role as a guardian of public funds.

ABOUT THE AUTHOR

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