Managing Money
State SRF Short-Term Investing

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About the Authors

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MANAGING MONEY; SRF SHORT-TERM INVESTING

Forward

Investment is an integral part of overall State Revolving Fund (SRF) program management, especially as the individual state funds gain maturity and increasing equity. This paper (prepared by CIFA with grant assistance from EPA) is aimed at providing SRF managers with information to develop a strategy for increasing yields on fund investments. In the current environment of historically low returns on investment earnings, this may prove helpful to some fund managers where short-term investments are in play. This continues some of CIFA's previous work on fund investment which was aimed primarily at longer term investments, especially those associated with bond indentures; investments in amounts and durations substantial enough to qualify for higher yielding investments. As such, the training materials had most application for those SRFs leveraging or considering leveraging their funds where invested bond reserves in comparatively large amounts are requisite to satisfy the indentures. The following information should be considered as guidelines for investing on-hand cash balances.

This material is focused more on shorter-term investment goals where consideration of liquidity and accessibility are controlling factors. Anticipated demands for new loans, draws for ongoing construction, and upcoming costs for program administration, place limitations on investment options. Strategies for shorter-term investment need to be closely integrated with the fund's cash flow model to avoid what is referred to as **market risk:** the need to access invested funds sooner than originally planned, possibly incurring penalties or loss of principal.

This guidance may have significant applicability to all SRF programs where there are accumulating cash balances in the "equity funds" where federal grant and state match monies are deposited, as well as the “recycled” monies from loan repayments. These funds are typically used for direct loans or the debt service reserve funds for leveraged programs, but normally warehoused for some period of time before these dollars are needed.

As SRF managers, we are charged with the task of operating these SRF programs in perpetuity. In these recent economic times of very low interest rates, the job of keeping the SRF funds growing through the use of investment options has been daunting.

The process of evaluating cash needs based on volume of loans in various stages of readiness makes it difficult for SRF managers to precisely determine what and when their cash flow needs will occur. But that uncertainty should not keep the SRF manager from exercising prudent fiscal management. As managers, there is a responsibility to ensure that the funds are being put to work in investment vehicles that maximize earnings, while at the same time ensuring that the principal investment is protected, and maximum flexibility maintained. This will guarantee solid investment earnings and fund growth, while allowing for cash needs for loans to be fully realized.

To illustrate the significance of the size of SRF funds, states reported that in the fiscal year ending June 30, 2003,cumulative payments of principal and interest (net of payment on leveraged bonds) reached nearly one half billion dollars in the Drinking Water SRF program, with cumulative earnings on invested funds at $276.2 million. As a point of comparison, the Clean Water SRF, which has been operative in every state for more than a decade, reports that cumulative loan repayments reached more than $15 billion dollars in the 2003 reporting period, more than $2.4 billion of which was returned to the programs in the last year. The same report shows that earnings on invested funds over the life of the program amounts to nearly $4 billion dollars, $420 million of which was earned during the last reporting year. While investment earnings are down somewhat from the previous 4 reporting years, (no doubt a factor of lower interest rates and more active lending,) it is still a substantial amount of money flowing annually back into the fund, which together with loan repayments, and short term availability of some grant funds and state match, provide opportunities for states to increase equity in their SRFs through well designed investment strategies.

Constraints and Limitations on Investment

In a number of states, SRFs have little or no control over the investment of their funds, restricted either by state statute or policy to the use of state operated investment pools or investments made exclusively by the state treasurer. Some other states, while not so limited, find state operated investment pools a convenience, relieving them of the necessity of developing and engaging in investment management strategies. Certainly, self-directed SRF investments require time and expertise on the part of the manager, or the acquisition of outside financial investment assistance. Some SRF managers may be reluctant to allocate time and resources to engage in investing, relying instead on other state money managers.

Many states, however, find savings and efficiencies in directing their own investments. One state, for example, reported that while they had experience with the use of state managed investment pools, they found it difficult to structure the maturities of these investments to correspond to their anticipated cash flow needs. As a result, they now direct their own investments using, to the extent possible, shorter term, laddered investments in United States Securities (an option that will be explained in more detail later in this text). In any event, states with the flexibility to direct their own investments must closely integrate them with anticipated cash flow needs for construction draws, new lending and possible administrative costs. For this purpose, a sophisticated cash flow model may not be necessary, but some fairly precise projection of short term draws on the fund, as well as the timing of anticipated grant funding and loan payments need to be in place in order to make confident and efficient investment decisions.

Other factors that may operate as constraints on SRF fund investment are limitations imposed by the states themselves on allowable investment of public funds. For the most part, these state investment rules or guidelines are general in nature and not overly restrictive, primarily seeking to assure that sound and conservative money management procedures are followed. Mainly, they prohibit or discourage speculative investments which might endanger the corpus of the fund. An example of typical state investment guidelines can be found in the State of Colorado's SRF. (See Exhibit A).

In addition to state regulations that might restrict options for investment of public funds, there are also Federal requirements that can influence or affect investment of SRF funds. Most important is the provision in Section 602 (b) (4) of the Clean Water Act requiring that all money in the fund be "…expended in an expeditious and timely manner." This suggests that Congress held some concerns that states might hold on to funds rather than obligating them for new lending, an issue, that at times, has been controversial between the states and EPA. Characterized by EPA as the "Pace of the Program" issue, the Agency asserted that some states were maintaining excessive reserves in their SRF accounts that should be directed toward making more loans. The states counter that given the uncertainty of renewed federal grant funding each year (authorization for funding expired in l992) it is only prudent management to first use the federal grant dollars that have so far been appropriated each year for lending, and nurture other available funds against the eventual time when federal grant funding dries up.

Principles of Public Fund Investment

Whether short or long term, the same basic principles apply to the investment of public funds. Fundamentally, these are conservative, non-speculative investments aimed at protecting the principal equity while, at the same time, maximizing earnings. The main distinction between short term and longer term investment is the anticipated need for access to the funds. Since there is often a direct relationship between maturity and yield, shorter term investments are less remunerative. To further this discussion, it is useful to review the principles of public investment as described in CIFA's State Revolving Fund Training Manual (Chapter 4).

> *Safety and Security*. The primary objective in investing public funds is to provide for safety and security of invested funds. The SRF staff has a fiduciary responsibility to minimize risk to the invested principal. Risk that the issuer of the investment defaults and is unable to return any portion of the original cash invested is called **credit risk**. For the most part, this is not a major concern for most public investments. By definition, the investment options open to public fund managers are reasonably safe, free from major credit risk, which is not to say that the value of a "safe" investment will not fluctuate, depending on the exigencies of the bond market and its effect on U.S. securities. This, however, is not credit risk per se, but the inherent risk of the market, a chance that a term bond investment might have to be cashed prior to maturity, thus risking exposure to a market deviation. Consequently, the need to "time your investments" to meet anticipated cash flows is of major importance.
>
> *Investment horizon or investment term.* Since interest rates generally increase the longer funds are invested, and since there can be a penalty for withdrawing funds before the end

of the investment period, accurate information about fund usage is critical to efficient investment. Very simply, cash from various sources should be invested based on the *cash needs* of the program. As an SRF grows and becomes more complex, matching funds for investment with the cash needs can be challenging. Programs are traditionally managed conservatively, typically carrying uninvested cash reserves on the books – safe, but of little advantage to the long term financial viability of the program. The more accurately the cash flow schedule can be projected, the more efficiently investment choices can be made. Even if another entity such as the state treasurer is the investing authority, the SRF staff is the primary source of critical cash flow information. The period from the present to the furthest point in time that funds can be invested based on project cash needs is sometimes referred to as the **investment horizon**, the period during which an investment is made. Only the SRF manager has this knowledge.

Flexibility and Liquidity The primary consideration is to determine, as accurately as possible, the timing in which cash is needed. This will help determine the investment horizon, or the term or time period that cash can be invested. Even with carefully prepared cash flows, however, there may be occasions when decisions on project funding, construction schedules, or other factors disrupt planned cash flows. There may be occasions when funds must be accessed sooner than planned. The need to access funds sooner than planned is called **market risk**, because if the investment must be liquidated in a higher interest rate environment, there may be a resulting loss of principal, or original cash investment. To avoid market risk when cash flows are uncertain, investments should be structured to provide the ability to access funds earlier than planned without loss of principal and/or interest earned value.

Conversely, invested funds that are not used as rapidly as originally assumed, create a mismatch of investment horizon. The likelihood that cash is needed later than originally anticipated, so that the funds may need to be reinvested in a lower interest rate environment, is called **reinvestment risk**. An investment plan should consider the capacity to maximize returns from these funds, beyond the term of the investment, until they are actually needed.

The perfect investment strategy would, of course, provide absolute security for the principal, allow complete flexibility in timing the end of the investment, and provide a high rate of return. Since there is no perfect investment instrument, the investment challenge is to weigh and balance these competing objectives in a way that best reflects the constraints, uncertainties, and risk tolerance of your particular SRF program.

To summarize, the three risks associated with protecting the investment of SRF funds are:

1. Credit Risk : the risk that the entity which holds the invested funds defaults, with the consequent loss of the original invested cash;
2. Market Risk : the risk that the invested proceeds will be needed by the SRF program *sooner* than expected, requiring the investment be liquidated or sold in a higher interest rate environment, resulting in loss of principal or original cash invested; and

3. Reinvestment Risk: the risk that funds will not be needed as soon as planned, and consequently the return will be lower for the subsequent time the funds are invested. Rather than risking principal, reinvestment risk relates to not necessarily maximizing returns, thus having less monies available to carry out SRF programmatic objectives.

Investment Products and Strategies

Investment Product Definitions

A US Treasury Bill or T-Bill is a debt instrument of the US Government that has a maturity of not greater than one year. It is traded at a discount to face value and accretes this discount until maturity at which time it achieves full face value. The accreted value over the life of the security is the interest income earned on the T-Bill.

US Treasury notes and bonds are debt instruments of the US Government with maturities between 2 and 30 years. Notes and bonds typically pay interest semi-annually. Treasury bills as well as notes and bonds are considered extremely safe investment instruments due to a direct federal guarantee of payment of principal and interest.

US Government Agency notes and bonds are debt instruments issued by various government agencies such as Fannie Mae, Federal Home Loan Bank, Federal Farm Credit Bank, and the Federal Home Loan Mortgage Corp to name a few. Maturities of less than one year are typically a similar instrument to T-Bills, while longer maturities are usually in the form of notes and bonds, again paying interest semi-annually. Agencies often offer yields slightly higher than

Treasuries. This is due to an implied slightly higher level of risk albeit small because agencies are considered indirect or "moral" obligations of the US Government since the agencies were created by acts of Congress. Most agency debt is rated "AAA" by both Moody's and Standard & Poors rating agencies. Another type of agency debt involves call structures. Agencies also issue callable debt daily to fund their operations. Issuers like to create these structures as they insulate them from drops in interest rates. Such structures do not alter the payment of semi-annual interest, but allow the issuer to call/redeem the bonds at a stated call date prior to maturity at par (full face value). The advantage to the investor is increased yield over non-callable securities.

Certificates of deposit or CD are a receipt from a bank for monies deposited there for a specific time period at some specific rate of return. CD's typically have maturities greater than 30 days. Since most banks issuing CD's only afford the investor insurance protection up to $100,000, it is necessary to determine the underlying credit quality of the issuing bank. Rates of return on CD's therefore are usually slightly more than Treasuries since holding a CD exposes an investor to some credit risk.

Repurchase agreements or REPO's are simply financing vehicles for security dealers and others to leverage their balance sheets by using their securities as collateral and lending them to investors in return for receiving money. Interest is then paid to the investor who borrows the collateral for short periods of time, often for one to 7 days. The underlying securities for these transactions are usually government securities including Treasuries and Agencies. The rate of return if often just below the Federal Funds rate, which is the lending rate between Federal Reserve member banks.

Commercial Paper or CP is an unsecured note issued by a borrower who promises to pay the investor (or buyer) some fixed amount of interest on the loan on a specific date. This vehicle is traded mostly like T-Bills, discounted from face value. The issuer pledges no assets or security in exchange for this loan, rather the credit quality of the investment is the short term debt rating of the issuer as established by the rating agencies. Many issuers turn to secondary means to improve the credit worthiness of this paper by having their paper "backed" by large bank letters of credit often giving them A-1/P1 or even A-1+/P1 ratings which are the highest ratings given by the rating agencies for short term debt. Typically, yields on CPs exceed those of REPOs and their terms or maturities can run from 1 to 270 days.

Institutional money market funds often invest in all of the above securities and are vehicles well suited to keeping extremely liquid cash needs, usually cash needed for the next business day. Most funds have an average weighted maturity of less than 120 days. Their yields are often near money market instruments yields. While the underlying securities in these funds are often of impeccable quality, most money market funds state in their prospectuses that they strive to maintain a $1 per share value at all times but cannot guarantee this. Several such funds do receive "AAA" ratings on their holdings.

Auction Rate Securities are securities typically with maturities of 7 and 28 days which are bought and sold at par (face value) on their "auction" dates. Issuers of this paper are often student loan corporations which although tax exempt entities, can issue taxable debt. Most of these securities are issued with "AAA" ratings because of their senior subordinated debt structure or because they are linked with secondary insurance. One of the main advantages of this security type is clearly yield. Spreads between this security type and commercial paper often are seen between 10 and 30 basis points (a basic point is 1/100th of a percent).

Corporate bonds are long term promissory notes issued by corporations. Most are similar in structure to Treasury and Agency debt in terms of paying semi-annual interest. While yields on these instruments are often higher than Treasury and Agency securities, the investor must consider the credit merits of each bond issuer prior to investing.

Guaranteed investment contracts or GIC's share many of the characteristics of a Certificate of Deposit or CD in that it guarantees the return of the initial principal investment and a guaranteed rate of return based on the size of the investment and the terms of the contract. The duration of an investment in a GIC is typically 1 to 4 years, but the terms of the contract are typically negotiated with the issuing financial institution and the investment manager based on the cash needs of the program. While yields can be higher than CD's and other instruments, care must be given in assessing the credit quality of each entity supporting the GIC.

Investment Strategies

The overriding goal in managing short term portfolios is to take the “**SLY**” approach to investing money. That is, to consider before executing any transaction, the **Safety, Liquidity** and **Yield** consequences of the purchase of a specific security. The purpose of employing such a strategy is to make more money by actively managing it rather than by passively allowing it to sit in a money market fund and earn a money market rate of return. Clearly, the ability to earn even a mere 1/1000 of a percent (10 basis points) on a pocket of $10 million over the course of a year is worth $10,000. The process for achieving even modest results requires a minimum amount of time, planning and accounting. The value of adding such dollars to your income streams can be enormous in terms of reducing overhead and/or increasing revenues.

The key principle to managing funds dates back to 1830. Judge Samuel Putnam stated: "Those with responsibility to invest money for others should act with prudence, discretion, intelligence and regard for the safety of capital as well as income" Today, we call this simply the **Prudent Man Rule** and it is the mantra by which much of today's investing is guided. The investment policy described here, as well as those written by individual SRF entities, are clear guidelines to be followed, however simply, because an investment is allowed in a portfolio doesn't make it a prudent investment.

Diversification is a primary strategy in assembling a portfolio. A portfolio holding several different kinds of securities helps reduce risk and tends to provide less volatile returns over the long run. While there is a limited amount of risk in investing in a "AAA" security of any type, if a default were to occur in a "AAA' name of commercial paper (for example), all commercial paper would come under scrutiny and some issues might be "downgraded" while being held in one's portfolio.

As a general rule, it is proper to set concentration rules for each class of security within a portfolio. For example, no limit is necessary on the amount of Treasuries or agencies in one's portfolio. Auction rate securities should make up no more than 80% of a short term portfolio, while commercial paper should account for no more than 50% of a portfolio. CD's should be limited to 20% and REPOS 10% of a portfolio. While most money market funds are looked upon as being virtually riskless, there is a certain risk associated with any money market fund maintaining a $1 per share value, specifically if investors stampeded out of a fund and liquidations of holdings were forced upon the fund's portfolio manager. For this reason, and particularly for maximizing the yield on one's portfolio, a 50% concentration limit should be applied to investment in these funds. (See Exhibit B for "Sample Short Term Investment Policy")

Cushioning investments from interest rate fluctuations can be achieved by the timing of when one buys securities and staggering of the maturities within a portfolio. The staggering of maturities is often referred to as **laddering**. By laddering maturities, bonds are allowed to mature at different times. These maturities can then be matched with specific cash requirements or can again be reinvested. Laddering helps a portfolio to achieve higher yields by allowing the purchase of some longer maturities (usually at higher rates of return). As bonds mature, one can reinvest proceeds (at each maturity) thus cushioning a portfolio from interest rate risk. Other advantages to laddering include providing the investor with a steady income stream which can be used for operations or can be reinvested back into the ladder. A byproduct of laddering is the reduction of interest rate volatility because the investor can choose the best investment as each investment matures within the ladder. When rates are rising, an investor might choose to stay in very short maturities whereas when rates are falling, an investor may be prone to investing out (the yield) for a longer time period.

Investment selection is a critical component of portfolio management. Pinpointing the maturities needed to meet specific cash flow needs is of paramount importance. Investment maturities can be either perfectly matched, or a target range for a maturity can be determined. Several other factors are also to be weighed such as the yield "spread" or difference between several products and between different maturities. For example, if a portfolio manager is looking for a maturity between 10 and 30 days and is indifferent to product, typically the highest yielding security available (within investment policy parameters) will be the right fit. If, however, a portfolio manager has money which may be invested in a longer term reserve portfolio, many factors enter into the decision making process including, as we have discussed, current interest rate projections, maturity fit within an existing ladder of investments, and diversification.

In a long term reserve portfolio, the investor has several security types in which to invest. One security type within government agency bonds involves callable securities. Today, many government agency issues are callable because it affords the issuers greater flexibility with regard to maturity. These bonds typically offer the investor greater yield than bullets (non-callable bonds) due to the option of the issuer to call or redeem the bonds on a specified call date, typically at par. Usually, the call date coincides with a coupon payment date, but depending on the bond's structure, could occur monthly, quarterly or with a certain amount of notice. In a rising rate environment, it is rare that a callable bond would be called. The converse is true in a falling rate environment.

Callable bonds work well in portfolios when the investor has the flexibility to invest money to a specific maturity date, for example 2 years, but also the tolerance to accept the bonds being called prior to that time, for example in 1 year. In this example, at the end of year 1, the investor would be able to reinvest, principal plus interest on the called bond, into a new security of his/her choice. Since bonds are called at par (unless specified otherwise at issuance), the investor of the called bonds incurs no capital loss or gain. The investor can incur interest rate risk depending upon prevailing interest rates.

Guaranteed Investment Contracts or GIC's offer several distinct advantages over short term investment funds for cash management of SRF programs. The first advantage GIC's have over money funds is their yield pickup. Because most SRF funds do not need all their investments in liquid cash balances, investment agreements can offer yield by allowing the SRF manager to invest assets for a longer term than the average liquidity fund. For SRF programs that can define their approximate cash flow patterns, GIC's allow the manager to extend out on the yield curve and increase returns. By capturing the forward rates, GIC's allow investors to lock in future deposit rates across the curve today.

GIC's are extremely flexible in their structure and can be tailored to fit SRF funds exact specifications. Draws and deposits under the agreement can be based on the issuer's funding needs over terms ranging from 6 months to 20 years, but for purposes of this discussion leave the duration up to 4 years. Maturities can be specified or flexible, based on historical draw patterns of the construction season. The size of deposits and withdrawals can be specified or vary with the actual amounts needed by the individual SRF program. Rates can be either fixed or floating and follow a variety of market indices. Interest can be reinvested or paid out depending on the SRF cash flow needs.

While GIC are generally only available to large amounts (over $20 million for short-term construction funds and $2-4 million for longest-term investment) their flexibility can solve a multitude of investment and management risks for an SRF. By reducing the exposure to reinvestment of excess funds, GIC's can lock in the returns on future cash flows. These earnings can be budgeted and used to structure programs and pay administrative expenses. Moreover, GIC's can reduce the administrative time and expertise needed to manage a portfolio of fixed income securities and their related cash movements. GIC's can also reduce the risk of a trustee or paying agent leaving funds in a low interest sweep account, thus reducing the earnings of funds on hand.

The pricing (interest rate setting) of GIC's is similar to corporate notes and commercial paper. For issuers requiring a flexible withdrawal schedule, rates will reflect the extent of the uncertainty in the schedule. For SRF's with a predictable expenditure pattern, fixed maturities can be used to increase yield. Other GIC features can be customized, such as credit, valuation or contingent draws. Most counterparts (financial institutions and or major insurance companies) to investment contracts are highly rated (AA or better) and will offer protection to investors in the event of a credit downgrade such as collaterizing the investment for a percentage above 100% of the initial principal invested.

Conclusion

This discussion should be viewed as a helpful guideline when considering the short term investment of SRF program funds. Obviously, some of this information may work for certain programs and not for others. The key is to establish the investment goals of the program, and tailor the available investment products to those goals. The guidelines on fund investment offered here can be used and customized by the SRF manager to fit the investment goals of their particular program. Given the diversity of the SRF programs across the country, investment goals will be equally diverse. This may help increase the size of the funds available to the SRF programs now and long into the future.

Principal authors of this guidance are Nancy Parrillo, Treasurer, Massachusetts Water Pollution Abatement Trust; Julian Hyman, Citigroup, Smith Barney; and Michael Frasco, CDC Funding. Organizer and editor of the project is James N. Smith.

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Amended: August 27, 1999

COLORADO WATER RESOURCES AND POWER DEVELOPMENT AUTHORITY
INVESTMENT POLICY

1. **BASIC POLICY:**

The purpose of the Colorado Water Resources and Power Development Authority (Authority) investment policy is to manage the Authority's assets in a manner which will maximize return while controlling and minimizing risk. The Authority's investments shall be made in accordance with the State and Federal laws governing the actions of the Board of Directors of the Authority and its staff.

All investments shall be governed by C.R.S. Sections 24-75-601 through 605, and these guidelines. These sections delineate the types of permissible investments for governmental agencies. The Authority Board has a fiduciary duty to assure that all funds are invested prudently and according to law. The Board has these specific investment objectives:

- Preserve Principal. All investments shall be made in such manner as to minimize the risk of diminution of principal.
- Maximize Earnings. Investments of Authority cash should be made at the highest possible yield, while preserving principal and minimizing the volatility of the asset values. For bond proceeds investments should be made to achieve the highest yield possible under the tax code while preserving principal.
- Provide Liquidity. Money should be available when needed to pay for administrative, programmatic and project costs.

The timing of expenditures should be planned and tracked so that funds can be invested in longer-maturity instruments to meet projected expenditures and to maximize earnings.

2. **INVESTMENT COMMITTEE:**

The Authority has established an Investment Committee to authorize and direct all of the Authority's cash investments. The Investment Committee consists of the Treasurer and the Executive Director. The Executive Director and Finance Director shall be authorized to invest bond proceeds and bond resolution moneys to meet debt service payments, project draws and other expenses.

3. **STATE TREASURER - CASH FUNDS:**

The amount of cash funds of the Authority invested with the State Treasurer's pool shall be determined by the Investment Committee.

4. **<u>PERMITTED INVESTMENTS:</u>**

<u>AUTHORITY CASH</u>

The Authority shall, in accordance with law, invest its cash assets in the following instruments:

1) Direct Obligations of, or Guaranteed by, the U.S. Government
(i.e., Treasury Bills, Notes and Bonds).

2) Direct Obligations of Federal Agencies
(i.e., Government National Mortgage Association) backed by the Full Faith and Credit of the U.S. Government.

3) Direct Obligations of Other Federal Agencies Rated in the highest rating category by one or more nationally recognized organizations which regularly rate such obligations.
(e.g., Federal Farm Credit Bank)
● Federal Land Bank
● Federal Home Loan Bank
● Federal Home Loan Mortgage Corporation
● Federal National Mortgage Association
● and any Additional Agencies Approved in the Future by the Board of Directors).

4) Colorado State Treasurer's Investment Pool.

5) Money Market Funds authorized by Colorado Statutes and rated in the highest rating category by one or more nationally recognized organizations which regularly rate such obligations.

<u>BOND PROCEEDS AND DEDICATED CONTRIBUTIONS TO A DEBT SERVICE RESERVE FUND</u>

The Authority shall, in accordance with law and the authorizing bond resolution, invest bond proceeds and bond resolution moneys in the following instruments:

1) Direct Obligations of, or Guaranteed by, the U.S. Government (i.e., Treasury Bills, Notes and Bonds).

2) Direct Obligations of Federal Agencies (i.e., Government National Mortgage Association) backed by the Full Faith and Credit of the U.S. Government.

3) Direct Obligations of other Federal Agencies rated in the highest rating category by one or more nationally recognized organizations which regularly rate such obligations.
(e.g., Federal Farm Credit Bank)
● Federal Land Bank
● Federal Home Loan Bank
● Federal Home Loan Mortgage Corporation
● Federal National Mortgage Association
● and any Additional Agencies Approved in the Future by the Board of Directors).

4) Commercial Paper that, at the time of purchase, is rated in the highest rating category by one or more nationally recognized organizations which regularly rate such obligations.

5) Repurchase Agreements concerning any securities referred to in Paragraphs 1, 2 and 3 above that can otherwise be purchased under those Paragraphs if all of the conditions of Subparagraphs (I) to (IV) of this Paragraph (5) are met:

(I)the Securities Subject to the Repurchase Agreement must be marketable.

(II) the Market Valve of such Securities must be at all times at least equal to 102% of the funds invested by the Authority.

(III) the Title to or a Perfected Security Interest in such Securities along with the necessary transfer documents must be transferred to the Authority or to a Custodian acting on behalf of the Authority.

(IV) Such Securities must be actually delivered to the Authority or to a Third-Party Custodian or Third-Party Trustee for safe keeping on behalf of the Public Entity.

6) Money Market Funds authorized by Colorado Statutes and rated in the highest rating category by one or more nationally recognized organizations which regularly rate such obligations.

5. **LENGTH OF DEPOSIT:**

No deposit or investment of the Authority shall exceed more than five years unless it is approved by the Board of Directors.

6. **REVIEW AND AUDIT OF INVESTMENTS:**

All investments shall be subject to annual review and audit by the Authority's auditor.

7. **INVESTMENT POLICY REVIEW:**

This Investment Policy shall be subject to review at the October Board of Director's Meetings, or at the request of the Board.

8. **REPORTING REQUIREMENTS:**

The Treasurer shall report to the Authority no less frequently than at regular Board meetings on its investments. These reports shall describe such items as investment balances, income and yields.

9. **DELIVERY AND CUSTODY OF SECURITIES:**

Unless the securities are held in book-entry form, all securities purchased shall be delivered to and held by the Authority or a custodian designated by the Authority, which custodian shall be the State Treasurer, a Colorado bank or bank and trust company authorized to do business in Colorado, any trustee under a bond resolution or an agent of the Authority in New York, New York and such delivery shall be simultaneous with payment for the securities. The Authority recognizes that the custodian may designate an agent to act for it to receive and hold certain securities (for example, securities deliverable only in New York City). Deposits in interest bearing accounts shall be made in such manner as to assure that funds are held as deposits in the name of the Authority at all times.

Sample Short Term Investment Policy

<u>Purpose</u>

To establish guidelines for managing the available cash of the "*XXX SRF Program*" and to maximize the return with minimum risk. No investment strategies will be employed or individual securities purchased which might impair the soundness of the balance sheet or constrain corporate management in implementing tactical and strategic operating decisions.

Objectives

Investments must be selected to achieve the following in priority order:

1. Preserves principal
2. Liquidity to meet cash flow needs
3. Diversification and minimum risk of loss
4. Maximize return on investments

Investment Guidelines

Liquid Reserves (0 to 90 days)

1. Funds allocated to support the day to day operating needs of the business
2. Liquidity and safety are the prime objectives
3. Target weighted average maturity - 30 days
4. Eligible investments
   a. Obligations issued by Government Treasuries such as Treasury Bills, Notes, or Bonds
   b. Obligations issued by the U.S. Government or U.S. Government agency securities
   c. Obligations of U.S. approved commercial banks, limited to certificates of deposit
   d. Repurchase agreements (repo's) collateralized by U.S. Governmental and/or agency securities
   e. Prime quality Commercial Paper (minimum rating A-1/P-1 as rated by Moody's or Standard and Poor's)
   f. Institutional Money Market Funds
   g. "AAA" rated Auction Rate Securities

5. Concentration Limits are as follows

Concentration Limits are as follows	<u>% of Portfolio</u>
a. Government Treasuries - Bills	No Limit
b. U.S. Government or U.S. Government agencies securities	No Limit
c. Auction Rate Securities	No Limit
d. U.S. Commercial Banks - BA's and CD's	15%
e. Repurchase agreement (repo's)	5%
f. Commercial Paper	50%
g. Institutional Money Market Funds	50%

Secondary Reserves (0 to 1 year)

1. Funds allocated to support seasonal requirements or cash needs that can be anticipated with some lead-time
2. A balance between liquidity and return
3. Target weighted average maturity - 180 days
4. Eligible Investments in addition to those above:
   a. U.S. Treasury Notes or U.S. Government Notes and Government agency securities

Long term Reserves (up to 4 years)

1. Funds allocated are unlikely to be called upon for operating purposes, but are held in support of the term strategic goals of the business, such as an acquisition or capital investments. Lead-time for drawing down these reserves or shifting them into Secondary or Liquid reserves is likely to be long.
2. Target weighted average maturity - 2 years
3. Limited term GIC's

Note: Suggested Prohibited Securities

Due to the volatility and high risk profile, the following is a list – but not limited to – examples of types of securities that should be avoided :

1. Reverse Repurchase Agreements
2. Futures, Interest Rate Swaps, Options
3. Inverse Floaters
4. Interest Only Securities
5. Forward Contracts
6. Interest bearing securities that have a possibility of not accruing current income
7. Closed end management type companies
8. Securities whose yield/market value is based on currency, commodity, or non-interest indices
9. Bearer-form securities
10. Mortgage backed securities
11. Derivative securities

Marketability

Holdings should be of sufficient size and held in issues that are traded actively to facilitate transactions at a minimum cost and accurate market valuation.

Trading

All purchases and sales will be executed at the best net price to the Corporation. All securities purchased will be held in the name of the Company.

Broker/Dealers

Investing transactions shall only be conducted with properly licensed and registered financial institutions, primary government securities dealers, or broker/dealers engaged in the business of selling government securities which are registered in compliance with Section 15 or 15C of the Securities Exchange Act of 1934 and registered pursuant to A.R.S. 44-3101 as amended. In addition, investment transactions shall be conducted only with those direct issuers who meet both credit and capital requirements established by the State Treasurer or designated investment professional.

Diversification

Adequate diversification is required to spread credit risk among various issuers.

Common or Preferred Stock

No direct purchases of any Common or Preferred Stock. Stocks may be present in money market funds.

Sales of Securities

Need two (2) authorized individuals to sell any investment, either at a gain or a loss.

Reporting

Monthly or quarterly reporting on the portfolio to be issued to the Senior Management. The performance of the Secondary and Liquid reserves would be measured against the IBC Donahue's money market fund index. The IBC is published weekly. The long-term reserves performance would be compared to the Salomon Government/Corporate 3-year index on a monthly basis.

Delivery and Custody

All security transactions, including collateral for repurchase agreements, entered into by the *"program"*, shall be conducted on a delivery-versus-payment (DVP) basis. Securities will be held by an independent third party custodian designated by the appropriate governing body and evidenced by safekeeping receipts and a written custodial agreement.

ABOUT CIFA

The Council of Infrastructure Financing Authorities (CIFA) is a national, non-profit organization of State and local authorities providing financial assistance to meet infrastructure needs. CIFA seeks to: (1) encourage the exchange of information on infrastructure financing among the states and between the states, the national government and the private sector; (2) conduct research on issues, trends and events of interest to its members; and (3) advocate sound public policies governing infrastructure financing. The CIFA monograph series is intended to provide a national platform for the presentation of new ideas and analyses of issues affecting the Federal, State and local infrastructure programs.

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