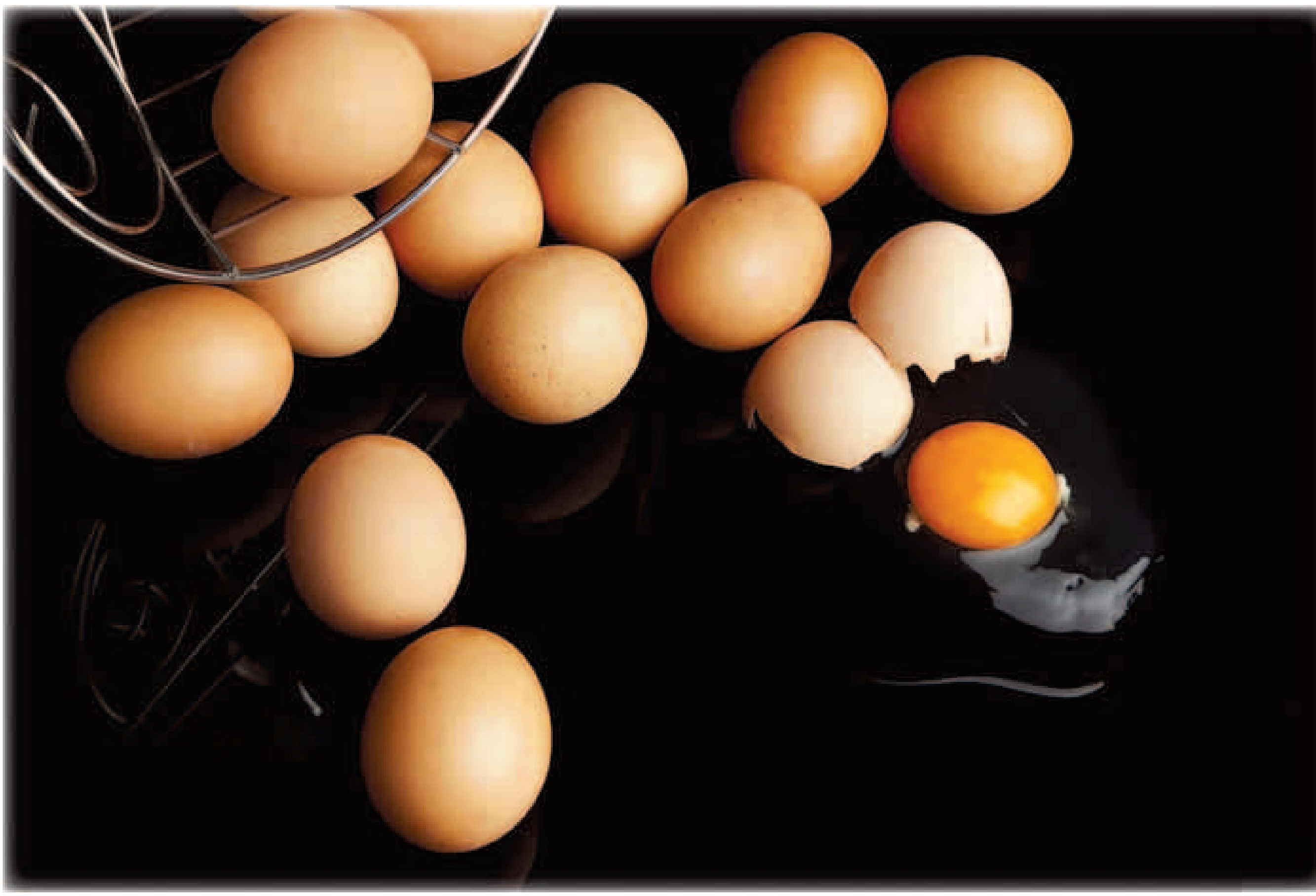
Risk Diversification: How Many Egg Baskets Should You Have?

How to manage risk to maximize yield and protect taxpayer dollars.

By Aimee Briles



No doubt you are familiar with the old adage "Don't put all your eggs in one basket." As a government body responsible for managing public dollars, a school district that commits to that maxim will more easily achieve portfolio risk diversification, which in turn will help accomplish the three primary objectives of managing public funds: safety, liquidity, and yield.

But how can districts manage the risk to ultimately maximize yield and still protect taxpayer dollars?

Objective: Safety

First and foremost, your district should have a board-adopted investment policy statement, reviewed annually, that defines the governing risk parameters of the individual investment portfolio and outlines the types of investments and collateral allowed.

Confirm that the allowable investments and collateral requirements outlined within the policy are in compliance with the statutes for your particular state, keeping in mind that some states' requirements may be more lenient than you or your board is willing to adopt. This document will guide your financial partners to work within your particular risk guidelines as they place funds on your behalf.

Ensure that you are maximizing your Federal Deposit Insurance Corporation coverage. The FDIC guarantees insurance coverage of up to at least $250,000 (including accrued interest) should an institution holding your deposits fail; however, as of January 1, 2013, it is possible for a public unit to receive up to $500,000 in coverage. That recent change applies to funds placed in an insured financial institution within the same state as the public depositor and allows balances in transactional checking accounts to be insured separately from interest-bearing accounts, including CDs, savings accounts, and money markets (www.fdic.gov/deposit/deposits/FactSheet.html).

The collateral requirements outlined in your investment policy dictate how funds in excess of those backed by FDIC insurance are secured. Although the Government Finance Officers Association recommends that all public deposits be insured or collateralized, the manner in which that is accomplished varies by state.

> If your state requires segregated collateral accounts for public entities, you should have an agreement in place with each institution that is holding your deposits.

Some states allow for pooled collateral accounts in which securities are pledged to cover funds belonging to multiple entities, whereas others require an individualized tripartite agreement between the depositor, the institution holding the funds, and a separate custodian that holds the securities.

If your state requires segregated collateral accounts for public entities, you should have an agreement in place with each institution that is holding your deposits.

Objective: Liquidity

Balancing the liquidity of your district's portfolio is likely a bigger struggle than in years past, but it is especially important to maintain some diversification in the portfolio maturities. Investing funds longer term in order to realize higher interest earnings may add some yield to the overall portfolio, but it is imperative that some assets are readily available should the district face unexpected changes to budgeted revenues or expenditures.

Local government investment pools and money market funds are useful investment types for maintaining the necessary liquidity in your overall portfolio. Although the yield of liquid investments is fairly nominal, they are readily available for use without being subject to penalties for early withdrawal or to fluctuations within the market like longer-term CDs or securities.

Because funding sources in so many states have become less predictable, and longer-term rates still provide little extra yield, it may be tempting to keep a high concentration of funds in a liquid account; however, keep in mind that there is interest rate risk in keeping an overconcentration of assets in a specific maturity or type of investment. The amount recommended that should remain liquid is typically dictated by your investment policy statement.

Objective: Yield

As a rule of thumb, the riskier the investment type, the higher the yield on that investment. Although public bodies typically have little leeway in the types of investments they can place and the collateralization requirements of those funds, the following considerations may help increase the yield.

The main factors used when determining the yield on bank deposits are type of funds and how much collateral is required to secure those funds. The economic crisis of 2008 and the ensuing rate cuts led to a significant amount of securities being called by the U.S. government, which made it necessary for banks to replace those securities at a significantly lower yield.

Collateralized investments have become much more costly for banks to hold because of those low-yielding securities within the investment portfolios, and because funds held at the bank that are collateralized cannot be included when calculating the liquidity ratios of the institution. Therefore, diversifying the allowable investments and collateral types leads to more options for those holding the deposits, which can equal higher yields for your district.

For example, if government treasuries are the only type of collateral allowed by your district's investment policy, those funds will likely realize a lower yield than deposits backed by agencies or mortgage-backed securities. Funds that require collateral at 102% versus 105% or 110% will likely result in a few extra basis points offered.

> Historically, public debt has had a much lower default rate than corporate bonds with similar ratings and yields.

Conversely, funds secured by FDIC insurance will typically earn a slightly higher rate than those backed by securities, as the bank is able to avoid both holding low-yielding investments and incurring the cost involved to monitor and maintain the collateral required. As a result, a portfolio that includes a laddering of multiple CDs under the $250,000 insured limit could help increase your overall portfolio yield.

Municipal debt can offer attractive yields with a minimum amount of credit risk. Historically, public debt has had a much lower default rate than corporate bonds with similar ratings and yields. If your investment policy allows, one option to help diversify your portfolio and boost overall yield is to consider purchasing high-quality debt issued by other public bodies.

Monitoring the Risk

To best maximize the yield in your district portfolio, you should balance the credit risk and interest rate risk; however, that can be done only if you understand the risks you are taking. Question rates that vary significantly from similar investments in the market. In the case of bank deposits, define what type of collateral is backing the funds, and review the financial strength of the institution.

When using local government investment pools, understand what types of investments are included in the pool, and ensure that they are allowed by your investment policy.

When using local government investment pools, understand what types of investments are included in the pool, and ensure that they are allowed by your investment policy. If purchasing public debt, commercial paper, or other securities, understand the credit quality of the instrument. All your financial partners should receive a copy of your most current investment policy; be certain to hold those partners accountable, and confirm that they invest within the parameters you have established.

Managing public funds to maximize interest income, while protecting principal, is a difficult task, especially in the current low interest rate environment. However, prudently investing within an appropriate combination of liquidity, credit, and interest rate risk can help you achieve that goal.

Aimee Briles is vice president of Wintrust Government Funds in Rosemont, Illinois. Email: abriles@wintrust.com

Index of Advertisers