Section 7 – Cash Management and Investing

Overview

Pursuant to Section 280.03, F.S., all public deposits must be deposited in a qualified public depository (QPD). The term "public deposits," which is defined by Section 280.02(23), F.S., includes time deposit accounts, demand deposit accounts, and nonnegotiable certificates of deposit, but does not include moneys in deposit notes and in other non-deposit accounts such as repurchase or reverse repurchase operations, securities, mutual funds, and similar types of investments. The term "qualified public depository" is defined by Section 280.02(26), F.S. Governments should periodically reaffirm that all its public deposits are held with a QPD.

For the purposes of this section, "investments" include certain cash deposits as well as investments as defined in Sec. 218.415, Florida Statutes. Investing public funds is usually a core responsibility of local government finance professionals and can be one of the most complicated responsibilities. This topic can be complex; however, it is not necessary for a finance officer to possess knowledge of every element of the securities industry in order to invest public funds. Following a few basic rules will serve your community and keep you out of trouble.

The main objectives of effective cash management and investing public funds is, in this specific order, to ensure the safety of principal, provide sufficient liquidity to pay obligations when due, and earn a reasonable rate of return on invested funds. Typically, the rate of return earned will be inversely related to the other two objectives; however, the first two objectives must remain primary to the third. An easy method to remember the objectives is by utilizing the acronym S.L.Y. (Safety, Liquidity, and Yield).

While it may appear preferable to favor greater safety and liquidity, it is more preferable to strike an appropriate balance between the three objectives in order to earn an appropriate rate of return while protecting principal and ensuring adequate liquidity. For example, funds kept in an FDIC-insured checking account are safe and liquid, but if the liquidity maintained is more than is needed, a greater rate of return could be earned by reinvesting some of the funds in a higher yielding investment account without sacrificing safety of principal or reducing liquidity below the required level.

Investment Strategy

The main strategic decision that must be made is whether to invest "passively" or "actively". A passive investment strategy essentially means that securities are purchased for the yield earned and held until maturity, assuming that the securities are non-callable. Active investing is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity in order to exploit profitable conditions. Studies have shown that the majority of active investment managers do not beat their established benchmarks in any given year, both with equity investments and fixed income investments. And, it is even more difficult to consistently replicate above average returns from year to year. So, it is prudent to evaluate and compare both active and passive investment strategy results over 1, 3, 5, and 10 years before investing any funds.

The key determinants of whether to adopt a passive or an active investment strategy include:

- Time Available
- Risk Tolerance
- Expertise
- Need or Desire for Additional Income
- Political Environment

In general, the more time, risk tolerance, and expertise that is available, the more able a government is to adopt an active investment strategy; however, the political environment must be such that realized investment losses (if any) are understood and accepted.

Most small governments tend to adopt passive investment strategies to reduce the amount of effort spent in purchasing securities and to eliminate the risk associated with securities trading. Most passive investment strategies include the following practices:

- Securities are held to maturity, rather than traded for gains.
- Securities are purchased frequently throughout the year to achieve an average weighted yield, rather than purchased sporadically in order to time the market.
- Securities purchased are relatively low-risk, which reduces the need to closely monitor changes in the issuer's financial strategy.

Florida Statutes

The following statutes are of primary interest in managing public funds:

- Section 215.855, F.S. - Investment Manager External Communication.
- Chapter 218, F.S. - Part IV – Investment of Local Government Surplus Funds.
- Section 218.415, F.S. - Local Government Investment Policies.
- Chapter 219, F.S. - County Public Money Handling by State and County.
- Chapter 280, F.S. - Security for Public Deposits.

Major Guidelines and Requirements

- Pursuant to Section 218.415(17), F.S., local governments without a written investment policy may invest in:
  - The State of Florida Local Government Surplus Trust Fund or any intergovernmental investment pool authorized pursuant to the Florida Interlocal Cooperation Act.
  - SEC registered money market funds with the highest credit equity rating from a nationally recognized rating agency.
  - Interest-bearing time deposits or savings accounts in qualified public depositories as defined in Section 280.02, F.S.
  - Direct obligations of the U.S. Treasury.

- Pursuant to Section 218.415(16), F.S., local governments with a written investment policy may invest in the items listed in number one above, in addition to:
  - Federal agencies and instrumentalities.
  - Securities of, or interest in, any open-end or close-end.
  - Management-type investment as further described in Section 218.415, F.S.
  - Other investments authorized by law or ordinance.
  - For local governments that adopt an investment policy, the policy must comply with the requirements of Sections 218.415(1) through (15), F.S.

Risk

There are different types of risks associated with cash management and investing that must be understood and managed to ensure the safety of principal.

Credit Risk – The risk that an issuer or other counterparty to an investment will not fulfill its obligations. This risk can be managed by purchasing only high-rated securities and monitoring the credit worthiness of issuers.

- *Concentration of Credit Risk* – The risk of loss attributed to the extent of investments held from a single issuer. This risk can be managed by limiting the amount of investments held from any single issuer (diversification).

- *Custodial Credit Risk* – The risk that, in the event of the failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party.

- *Interest Rate Risk* – The risk that changes in interest rates will adversely affect the fair value of an investment. When rates rise, security values fall and vice versa. This risk can be managed by matching investment maturities with accepted disbursements, purchasing shorter-term securities, and staggering maturity dates throughout the year (laddering the portfolio).

- *Liquidity Risk* – The risk that securities must be sold before anticipated to provide liquidity, which may result in a loss of principal. See interest rate risk discussion above.

Quick Tips and Caveats

- Never invest in any security that is not fully understood, even if the security is an approved investment in an investment policy.

- Many governments adopt a “buy and hold” investment strategy to reduce administrative time required for investment related activities. This strategy typically employs a “laddered” portfolio, whereby securities are purchased on a regular recurring basis (weekly, monthly, quarterly, etc.), in relatively equal amounts, which provides for recurring liquidity and generates an average rate of return over an interest rate cycle.

- Avoid inordinately extending maturities in search of higher yields, because market values on long-term securities can decline rapidly in a rising interest rate market.
- Consider shortening maturities in a rising interest rate market to reduce interest rate risk.
- Consider lengthening maturities of securities purchased in a falling interest rate market to lock-in higher interest rates.
- Reconciliations of bank account and investment account balances to the accounting records should be performed on a timely, routine basis to provide reasonable assurance that cash and investments agree with recorded amounts, permit prompt detection and correction of unrecorded and improperly recorded cash transactions or bank errors, and provide for the efficient and economic management of cash resources.
- When deciding whether to invest and when investing public funds, make decisions based solely on pecuniary factors as defined in Section 218.415(24)(a), F.S. (this is a new Florida Statute created by Section 13 of Laws of Florida Chapter 2023-28).

Investment Reports

Internal Reports

Monthly or quarterly reporting of investment results and portfolio composition to upper management and/or to the elected body is common. Typical items reported include:

- Types of investments held.
- Average rate of return for period reporting and year to date.
- Average maturity of portfolio.
- Compliance with investment policy provisions.
- Changes in investment strategy.
- Comparison of portfolio return with benchmarks.
- Interest rate environment changes.

External Report: Annual Public Depositor Report to be filed with the Florida Department of Financial Services by November 30th, pursuant to Section 280.17(6), F.S.

Depository, Broker, and Dealer Relations

Depositories are usually retained through a competitive bid process conducted by the local government directly or by another government that allows other governments to "piggy-back" on an established contract. Relationships generally extend 5 years before rebidding, due to extensive switching costs. Typically, one depository is selected for all cash management and investing safekeeping services to achieve an economy of scale, which lowers the overall cost of services and reduces administrative time.

Brokers and dealers are usually selected by an informal selection process. Criteria used may include office proximity, services provided, references from other governments, and competitiveness of bids. If brokers or dealers become non-competitive, other providers can be substituted relatively easily. Retaining three to five broker/dealers is usually sufficient to ensure adequate competition, depending on the portfolio size, frequency of purchases, and services required.

Purchasing Investments

All securities should be purchased using the "payment vs. delivery" method, using an independent third party. This method ensures that securities purchased are delivered before payment is made.

The Florida Qualified Public Deposit System enhances the safety of principal if funds are invested with member banks. Investing with non-QPD institutions may result in higher yields, but at a greater risk.

Where possible, obtain more than one quote on securities purchased to ensure the highest rate of return has been obtained. Competition will usually enhance the rate of return achieved. Similar securities can be substituted if maturity dates and credit risk is comparable. For example, federal instrumentalities (Freddie Mac, Fannie Mae, etc.) are usually comparable in credit risk. Requesting quotations on specific security types and specific maturity dates (or narrow date ranges) is a common practice to facilitate comparison of competitive offers.

Social, Political or Ideological Activism Prohibited in Banking, Investment and Financing Decisions

In accordance with Chapter 2023-28, Laws of Florida, banking services, investments, investment managers, and other service providers are required to use "pecuniary factors" and to not sacrifice investment return or undertake additional investment risk to promote nonpecuniary factors such as the furtherance of social, political or ideological interests. Pecuniary factors are factors prudently expected to have a material effect on risk or returns of an investment based on appropriate investment horizons consistent with applicable investment objectives and funding policy. In addition there are Prohibitions against considering social, political or ideological interests in government contracting. For more information, see Sections 218.415, 287.05701, 215.855, Florida Statutes.

References

The scope of this section on cash management and investing is intentionally limited and is not intended to provide a comprehensive presentation of cash management and investing principles or practices. Additional information is available from a variety of sources, including:

Florida State Board of Administration:
http://www.sbafla.com/prime/

GFOA:
https://www.gfoa.org/

- *Investing Public Funds*, Girard Miller
- *Local Government Finance - Concepts and Practices,* Peterson and Strachota
- *Best Practices and Policy Examples:* https://www.gfoa.org/best-practices
- *Best Practice - Managing Market Risk in Investment Portfolios*: https://www.gfoa.org/materials/managing-market-risk-in-investment-portfolios

Florida State Treasury:
www.Fltreasury.org/treasury/

Qualified Public Depository listing:
https://app.smartsheet.com/b/publish?EQBCT=c300ba31539243d5b8f2198b700d6c5a

FGFOA:
www.fgfoa.org

Federal Reserve Bank of New York:
www.newyorkfed.org

Bureau of Public Debt, Department of Treasury:
https://www.fiscal.treasury.gov/