Public Funds Investment Act: New Investments, New Strategies

By: Brian Hextell

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Governor Bruce Rauner signed legislation in August 2018 amending the Public Funds Investment Act to allow public entities to invest in corporate obligations with maturities up to three years. Prior legislation restricted corporate obligations to those maturing in 270 days or less.

This amendment allows public entities to invest in securities with higher credit risk compared to other allowable investments. Corporate notes and bonds are similar to commercial paper, but have longer maturities. While individual securities may hold higher credit risk, expanding allowable investments to include longer-term corporate obligations provides an opportunity for disciplined investors to increase portfolio diversification and potential returns over time.

Limitations on Investing in Corporate Obligations

Legislators recognize the risks and have maintained other important requirements intended to mitigate credit risk. The new legislation states that any public agency may invest any public funds in obligations of corporations organized in the United States with assets exceeding $500,000,000.

Purchases of these corporate obligations are only allowable under Illinois Statute if:

- Such obligations are rated at the time of purchase at one of the three highest classifications established by at least two standard rating services,
- Such purchases do not exceed 10 percent of the corporation's outstanding obligations and
- No more than one-third of the public agency's funds may be invested in obligations of corporations

The investment landscape has changed considerably for public funds investors over the past several years. This new legislation represents another significant market development and creates a need for more education for public funds investors. Change began in December 2015 when the Federal Reserve's Federal Open Market Committee increased interest rates by 0.25 percent for the first time since 2006. Since then, investors have seen yields on money market funds and local government investment pools improve substantially while bank deposit products, like savings accounts, have sometimes lagged behind.

During periods of rising rates, marketable securities such as U.S. Treasuries, U.S. Government Agencies, municipal securities and corporate obligations often offer higher yields compared to bank deposits. As a result, public funds investors seeking higher returns have needed to be more diligent about monitoring their bank deposit rates and purchasing other investments, including marketable securities.

Money market funds and local government investment pools may invest in marketable securities, including short-term corporate obligations. Investment Advisors who invest these funds generally invest in a diversified portfolio of high quality securities with short weighted-average maturities. It is best practice for local government investment pools to attain a rating from one of the major rating agencies. In order to maintain AAA ratings, local government investment pools must follow strict investment requirements with respect to security ratings, internal credit procedures, portfolio diversification and investment maturities. Please be aware that not all local government investment pools are rated AAA and risk factors should be considered for all investments.

Rising short-term interest rates have created improving returns for local government investment pools. Chart 1 below shows growing annual returns for a local government investment pool (LGIP) managed by Prudent Man Advisors.

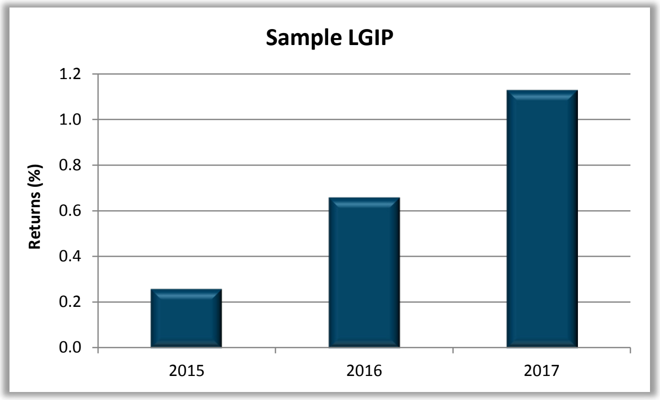

Chart 1
Source: PMA Financial Network, Inc.

The changing investment landscape may also produce a less desirable trend by investors – yield chasing. Yield chasing is characterized by investors who seek out the highest yields available in the market with limited regard to issuer credit risk, portfolio diversification, investment strategy or asset/liability considerations. The result can be portfolios highly concentrated by issuer, industry or maturity.

The new legislation allowing investments in longer-term corporate obligations increases the potential for undisciplined investors to engage in yield chasing. In general, securities with higher yields hold greater risk, so yield chasing investors are more likely to purchase riskier securities.

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Corporate obligations carry risks including default risk, downgrade risk and credit spread risk that can reduce returns. Since corporate obligations may have higher credit risks compared to Treasury and Agency securities, undisciplined investing could have an exaggerated negative impact on public entity investment returns.

Investing in corporate obligations requires robust credit policies and procedures. All public entity investment decisions should be guided by an investment policy that outlines the goals and objectives of the account and should define allowable investments and any investment restrictions needed to achieve these goals. The investment policy should be aligned with the risk tolerance of the Board/Counsel of the public entity.

A rigorous set of credit procedures should also be implemented before investing in corporate obligations. These procedures should include an independent credit review process for every issuer, development of an approved list, quarterly analysis of all approved issuers and ongoing surveillance of all issuers held in the portfolio. A prudent investor will also maintain a portfolio which is well-diversified by issuer, industry and maturity.

We believe the best way to integrate corporate obligations into your investment strategy is through a portfolio managed by a trusted Registered Investment Advisor. Public entities that wish to further diversify their reserve account portfolios should strongly consider utilizing an Investment Advisor to manage these funds. A broader and more complex investment tool set requires day-to-day oversight, risk management, and professional portfolio management offered by an Investment Advisor like Prudent Man Advisors. Public entity officials can then dedicate valuable time and resources to running their organization rather than creating the investment processes themselves and taking additional risks that they are unable to independently analyze.

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When invested prudently, corporate obligations have the potential to increase investment returns. Chart 2 below displays annual returns for a 1-3 year U.S. Treasury index compared to a 1-3 year U.S. Corporate index. Excess Returns represent the difference in annual returns between the two indexes. The Corporate index reported annualized excess returns of more than 1.50% for the period shown.

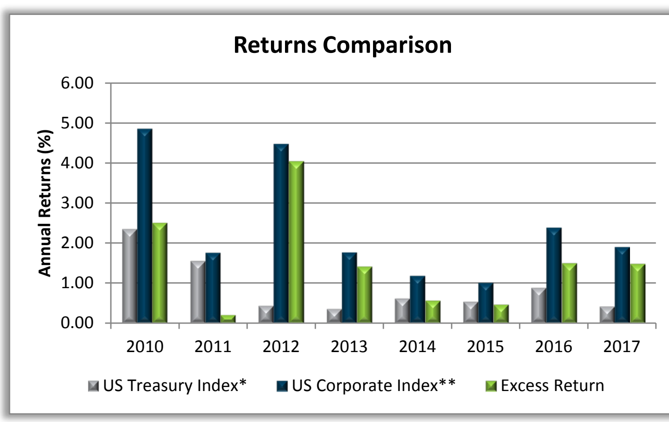

Chart 2
*BofA Merrill Lynch 1-3 Year U.S. Treasury Index
**BofA Merrill Lynch 1-3 Year U.S. Corporate Index

The investment landscape is always changing. Since 2009 we have seen a period of unprecedented low interest rates followed by gradual hikes in the Fed Funds rate by the Federal Reserve. This period has also been characterized as one with low credit risk. More recently, though, market volatility has increased. While our market outlook calls for the economy to maintain its course of moderate growth over the next year, we are well aware that market corrections tend to be swift and often occur when they are least expected. As a result, we believe a well-diversified portfolio will produce enhanced returns over time.

This new legislation allows Illinois public entities to build more highly-diversified investment portfolios. If implemented properly, this should be a positive development for public entities and taxpayers alike. As always, education is critical and maintaining a disciplined investment approach will help avoid potential pitfalls in the ever-changing investment market.

For more information, please contact:

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