

MEMORANDUM

TO: Governing Board Members
FROM: Paul E. Dumars, Sr.
DATE: April 9, 2008
SUBJECT: Update on the District's Investment Portfolio Review and Evaluation

Attached is a staff update and response to the recommendations made by PFM Asset Management concerning modifications to the District's investment policy and review of investment procedures. The report was presented to the Audit and Finance Committee on February 13, 2008.

Overview

PFM was hired by the District to review and make recommendations to update and improve the investment process with the goal of ensuring that the District's cash funds are managed safely and prudently. An overview of the recommendations and a summary response from staff is listed below.

Key Recommendations

1. Revise the Investment Policy Statement to include the following:
 - (A) Establish a Treasury Investment Committee
 - (B) Provide monthly and quarterly performance reports
 - (C) Revise benchmarks
 - (D) Revisions to permitted Investments
2. Develop a program to obtain the necessary cash flow information from Department heads.
3. Increase the formality of the credit review process for securities, broker-dealers, and counterparties.
4. Foster greater communication of investment reporting information between the Treasurer and the District.
5. Develop and document an investment plan for both the short-term and long-term portfolios.
6. Develop an internal controls operational procedures manual as required by Florida Statutes.

Review and Response to Recommendations

- 1A. *Recommendation* – Establish a Treasury Investment Committee

Staff Response – Staff agrees with the recommendation. A sub-advisory committee will be created consisting of internal District staff to include the CFO, Treasurer and key District personnel knowledgeable in finance. Meetings will be held quarterly. A charter will be created to outline the purpose and function of the committee. All recommendations will be reported quarterly to the Audit and Finance Committee.

1B. *Recommendation* - Provide monthly and quarterly performance reports

Staff Response – Staff agrees that it is important to provide a comprehensive report on investment holdings, strategy and performance on a quarterly basis. The Audit and Finance Committee members were in concurrence that quarterly reports rather than monthly were sufficient to meet the oversight objective of the committee.

1C. *Recommendation* - Revise benchmarks.

The current portfolio benchmarks are the State of Florida’s Local Government Investment Pool, the “SBA” and an average of the 2-year US Treasury. In discussions with the advisor it is recommended that the District split the portfolio into two separate funds for reporting purposes.

Staff Response – Staff is in agreement with this approach. Policy changes will be made to have the District benchmarked to an appropriate short-term index which is suitable for Local Government funds. In addition, the longer dated portfolio will be benchmarked to an index such as the widely used Merrill Lynch 1-3 year Treasury index.

1D. *Recommendation* – Revisions to Permitted Investments.

On pages 7-8 of the PFM report there is a matrix outlining the recommended changes to several investment asset classes. The responses below address those investments where a change is being recommended.

- **Local Government Investment Pool** – reduce permitted holdings from 100% to 25%, require a AAA rating
- Staff agrees
- **Commercial Paper** – prohibit investment into asset backed commercial paper and provide credit and ratings support for holdings
- Staff Agrees
- **Corporate Notes** – Increase allowed holding from 5% to 10%, reduce maximum maturity from 5 years to 3 years, and provide credit and ratings support for holdings
- Staff Agrees
- **Money Market Mutual Funds** – Increase rating from AA to AAA, increase total allowable investments from 50% to 75% and increase the per fund limit from 5% to 25%
- Staff Agrees

- **Master Repurchase Agreement** – expand language to include a restriction of a total of 20% of the portfolio and 10% per issuer
- Staff Agrees
- **Hedging Instruments** – Transfer to the Debt Policy
- *Staff would recommend to add clarifying language* - The District's debt policy currently includes language which specifically addresses investment into hedge instruments specifically for the purpose of hedging debt transactions. Staff will agree to add clarifying language that specifies that investments in this class are only as they relate to the hedging of District issued debt instruments.
- **Reverse Repurchase Agreements**– remove from policy
- *Staff would like to keep the policy language as is* – The use of this instrument is done on an extremely limited and short-term basis for the express purpose of cash management. On rare occasions District investments may be pledged as collateral for a very short-term loan i.e. 1-30 days to fund unexpected large cash expenditure. These Repo transactions are an excellent financing vehicle and are used to avoid unnecessary losses on investments sold prior to maturity. Staff feels the policy language is sufficient as written and would like the ability to continue to have the use of this cash management tool when needed.
- **Mortgage Backed Securities** - Reduce allocation from 35% to 25% of the total portfolio, limit types to agency only investments and develop policies and procedures for evaluation and trading
- *Staff acknowledges the need to expand and update the language related to this asset class.* The PFM report acknowledges that MBS investments can offer good return with limited risk and promotes diversification. Staff would like to add language to further identify these investments as a separate asset class from direct investment into US Government Sponsored Enterprises.

Further, in recognizing the benefit of safe, higher yielding investments that provide cashflow staff would propose the following: Limit the investment class to 30%, allow for non-agency MBS investments but limit them to 5% of the portfolio with an additional layer of credit review. As an added procedure, all MBS investments will receive additional analysis and review with reports made to the Treasury Investment Committee and Audit & Finance Committee on an on-going basis.

2. *Recommendation* - Develop a program to obtain the necessary cash flow information from Department heads.

Staff Response – Staff strongly recognizes the need for improvements to the District's current annual cashflow forecast. Currently, the full scope of forecasting expenditures by division or functional area goes beyond the resources currently available to the Treasury staff.

We agree that the District would benefit greatly if cash forecasting and expenditures were better communicated to Treasury and upper level management. This would be recognized through noticeable increases in investment returns, improvements to project costs, lower debt service payments and numerous other benefits that organizations realize when accurate cash forecasts and tight financial system controls are fully utilized.

There has been an on-going effort by Treasury and the finance staff to improve the current cash forecasting model but further improvements can be made. It is conservatively estimated that improvements to cash flow forecasting would add \$2M a year to investment earnings. Total cost savings and investment earnings could potentially be much higher.

The report recognizes that staff will need more management support in its goal of obtaining better information from departments within the District. Staff will seek help from management in initiating this process. In addition, staff proposes to work with budget, accounting, and the newly created Treasury Investment Committee to look for areas of improvement and make recommendations that can be adopted District wide.

3. *Recommendation* - Increase the formality of the credit review process for securities, broker-dealers, and counterparties.

Staff Response – Staff agrees with the recommendation. A more formal credit review process will be established as needed for securities and counterparties. In addition, a rigid broker-dealer qualification form will be created and used as part of the qualification process when approving any firm attempting to do business with the District. A full review of firms currently servicing the District will be conducted.

Going forward, procedures will be put into place to perform a quantitative and qualitative review of all broker-dealer firms annually. Firms or individual brokers who do not meet credit standards or who do not add value to the needs of the Treasury and investment staff will be removed from the approved list. In addition safeguards will be put into place so that the treasury staff is not induced to do business with unqualified brokers.

4. *Recommendation* - Foster greater communication of investment reporting information between the Treasurer and the District.

Staff response – The initial recommendation was for a detailed monthly report to be presented to District's board members on a monthly basis. Based on feedback from members of the audit and finance committee, staff will distribute a detailed investment report to the committee on a quarterly basis. This report will include, but is not limited to issues related to policy, compliance, trading activity and current market conditions. A full presentation will be given to the Audit and Finance Committee members on a semi-annual basis.

As recommended, the report will also include a brief discussion of the investment strategy employed during the period and planned changes to the strategy. Similar reports will be reviewed quarterly with the Treasury Investment Committee.

5. *Recommendation* - Develop and document an investment plan for both the short-term and long-term portfolios.

Staff response – Staff agrees with the recommendations. The benefit to the District will be enhanced by better cashflow forecasting and the ability to invest in longer term securities where appropriate. This could potentially result in increased investment earnings.

A policy change will be recommended and revisions to the daily investment strategy will be made to reflect a two portfolio strategy approach. As noted above, the new benchmarks will be the Standard and Poor's LGIP index for short term funds and the Merrill Lynch 1-3 year Treasury index for the longer duration portfolio.

6. *Recommendation* - Develop an internal controls operational procedures manual as required by Florida Statutes.

Staff response – Staff agrees with the recommendation. Steps have been initiated to develop and document a full procedures manual for all investment related activities. As suggested, the procedures manual will include items related to compliance monitoring, credit review and notification of material events.