Public Investor

A MONTHLY SUBSCRIPTION NEWSLETTER OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION VOLUME 14, NUMBER 8

Mid-cycle blues

by Girard Miller

A year ago, I noted that the U.S. economy was facing an interest-rate spike typical of the recovery stage of the business cycle. Ultimately, the rate cycle spike did its job. Rates surged to levels that slowed the GDP growth to sustainable levels. As often happens, the interest rate spike in late 1994 clobbered a major municipality; this time it was Orange County, California. And Mexico bit the dust again. History never repeats itself exactly, but the themes are certainly familiar if not predictable.

Since the year began, we have seen a remarkable although predictable downtrend in interest rates as the economy slowed. Today's lull is the product of last fall's rate spike. Monetary policy affects the real economy with a six-nine month lag, which brings us to where we are now. The "R" word has resurfaced, although there is no history of recessions induced by low interest rates in their current configuration.

The U.S. economy has simply crossed an inflection point in the business cycle, at which unsustainable rapid growth rates shift to sustainable slower growth rates after the bond vigilantes do their dirty work.

Despite all the din and clatter, the Fed has things right where it wants them. The market is doing its work for the Fed, by flattening the yield curve and discounting a prospective series of reductions in short rates. July's modest cut in the funds rate forced banks to drop their prime rates, which were holding tenaciously to unjustifiable levels given the 200 basis point plunge in the two-year sector of the curve. Borrowers will be induced through attractive interest rates. Corporate spending will resume after this inventory correction is complete. Houses will be refinanced, and ARM mortgage rates will reset at lower levels. Confidence will perk up, and money will begin flowing in the economy. The stage is now set for an extended business cycle.

Weak economies in Japan and Europe have suppressed export opportunities for U.S. businesses (except for technology, which is roaring). Whereas a year ago we saw surging

(continued on page 4)

Sample investment policy explained

by Alan McDougle

As more and more talk of derivatives has surfaced over the past 18 months, there has been more pressure on public finance professionals as it relates to investments/cash management in general. GFOA's Committee on Cash Management has worked diligently over the last several years in identifying best cash and investment management practices and in developing recommended practices in this area. The Cash Management Committee adopted four recent recommended practices that relate to the use of derivatives. These are as follows:

- use of derivatives by state and local governments (1994),
- market risks (volatility) ratings (1995),
- reverse repurchase agreements, leveraging and prudent investment practices for cash management (1995), and
- mark to market for state and local government investment portfolios and investment pools (1995).

(continued on page 5)

Florida's new investment policies act

by Steven Alexander, CCM, CGFO and Kenneth A. Kent

In response to local government investment problems around the nation and within the state of Florida, the Florida Legislature has passed a law requiring local governments to either develop and adopt investment policies or alternatively to invest in specified low-risk instruments. The law was developed through the efforts of the Florida Association of Court Clerks and Comptrollers (FACC) Investment Policies and Procedures Task Force. The FACC Task Force, which consisted of finance officers from state and local governments, met several times in early 1995 to develop recommendations for local government investment practices.

These recommendations formed the basis of the new law. The focus of the bill was to encourage the adoption of locally developed investment policies. To this end, the bill listed 14 required and recommended criteria that each policy must include but left the responsibility for

(continued on page 6)

drafting policies to local governments.

This law was approved by unanimous vote of the legislature and signed by the governor on June 8, 1995. It goes into effect on October 1, 1995, with the exception of the requirement for *written internal controls. This requirement has* an effective date of January 1, 1996. Currently, initiatives are underway by the FACC and the Florida GFOA to provide information and assistance on investment policies.

Significance of the legislation. Florida's investment policies legislation is significant for a number of reasons, which include 1) providing flexibility in developing investment policies, 2) emphasis on local control of investment decisions, 3) requirements for disclosure, and 4) knowledge of complex securities prior to using them as part of an investment program.

The new law requires the adoption of the prudent person rule as the standard for managing public funds and notes that investment polices, "shall be structured to place the highest priority on the safety of principal and liquidity of funds. The optimization of investment returns shall be secondary to the requirements of safety and liquidity." The law further requires that local governments adopt investment objectives that include safety, liquidity, and yield in that order.

In regard to investments in derivatives and the use of leverage, the major culprits in the Orange County, California, bankruptcy and other investment debacles, the law requires local governments to either avoid the use of derivatives and leverage or to use them only in specified circumstances. For example, derivatives are prohibited unless "specifically authorized in the investment plan." If so authorized, derivatives may be considered only if the unit of local government's chief financial officer has developed sufficient understanding of the derivative products and has the expertise to manage them. The use of reverse repurchase agreements also is prohibited except for transactions where the proceeds are intended to provide liquidity and again, only in circumstances where the local government has the knowledge and resources to manage these transactions.

The law also requires local governments to consider and determine appropriate policy positions for a number of investment criteria including maturity and liquidity requirements, portfolio composition, and risk and diversification. Two additional noteworthy requirements are 1) developing a written set of internal controls and 2) developing periodic reports that provide portfolio market values along with book values and in-

As previously noted, under this law, local governments can decide not to write investment policies. However, if they choose not to develop policies, then they are limited to investments in the state investment pool, other local government investment pools, money market funds, *bank certificates of deposit, Treasurys, and* agencies. With the exception of the pools and money market funds, local governments must match the term of the investment with the maturity of the security purchased.

While no law can eliminate poor judgment, this law places an emphasis on investment fundamentals for the purpose of safeguarding public funds—the first and most important objective of any local government investment program. The FACC Task Force noted that with this legislation, Florida has acknowledged the tremendous fiduciary responsibility of investing public monies, and taken strong steps to provide better planning and accountability for these investments, while allowing local governments the flexibility to address local needs.

Steven Alexander, CCM, CGFO, is the investment manager for the Orange County, Florida, Comptroller's Office. Kenneth A. Kent is the director of Management Services for the Florida Association of Court Clerks and Comptrollers.

GFOA releases new videotapes

GFOA became an important new source of videotapes on government financial topics with the taping of 11 sessions held at the GFOA's recent conference in Baltimore. If you were unable to attend, would like to review information on a specific topic, or simply want to expand your office videotape library, now is the perfect opportunity. Videos that may be of special interest to readers of *Public Investor* include:

"Explaining the Investment Portfolio to the Public" provides ideas on how to present investment portfolios to the public, how to allay fears of investment losses, how to work with the media, and how to answer questions regarding investment practices. (Order No. FO9503V)

"Derivatives: They May Be Hazardous to Your Health" explores the use of derivatives as a cash management tool and focuses on the appropriate use of derivatives. Viewers will learn how to evaluate a derivative product and how to identify risks. (Order No. FO9505V)

A flier containing detailed information on all 11 videos along with ordering information may be obtained by contacting: **ACTS, Inc. at 800/642-2287, 314/394-0611 or faxing them at 314/394-9381.**