Priorities for investing public funds

Safety, liquidity and yield – in that order – are the priorities for public fund investment managers because we have a fiduciary duty to protect the funds when choosing among various investment options. Yield is always lowest priority – especially when we account for cash needs in selecting investments to minimize the risk of loss in a changing market. It is never enough to look only at whether an investment is permitted under state statute; we must also use the "prudent investor" standard found in RCW 43.250.040.

Pressure on public fund managers builds

Because interest income is an important source of revenue for state and local governments, public fund managers are under increasing pressure to meet revenue targets – especially as the depth and breadth of budget cuts in public agencies take hold. But, this mounting pressure to produce returns comes at a time when interest rates are at historic low levels due to the effects of the Fed's quantitative easing measures. The Fed has indicated that it expects to keep rates at very low levels at least through year-end 2015 as it responds to both domestic and international economic conditions.

This means interest revenue goals assumed in many government budgets may be too high to safely reach – which could be pushing fund managers to "do what it takes" to meet the targets. But trying to "reach for yield" brings with it added risks of loss, either by investing at lower credit quality or for longer durations that increases exposure to future market movements.

Since interest rates will likely stay very low for the foreseeable future, returns are not expected to increase any time soon. As a result, investors seeking yield have responded to these lower returns on risk-free assets by moving toward lower quality bonds. Yields in these substitute assets have in turn fallen, and investors have shifted funds into successively riskier investments. As this all continues to unfold, it is important for public fund investors to carefully consider their needs and priorities before taking on too much risk in search of additional earnings.

Current market temptations

In the current market, riskier investments have outperformed as returns on safe investments plunged, which can tempt some fund managers to seek higher-yielding opportunities. This means public fund investors need to consider the safety and liquidity of funds more carefully before venturing into investments that take them beyond their tolerance and capacity for risk.

Risks of substitute investments

As investors evaluate substitute assets that might generate a higher yield than traditional risk-free assets, the following are some areas of risk and examples of specific investments that carry additional risk. While in most cases these investments are allowed by Washington state laws governing public fund investing, they are typically not suitable in the current market.

1. ***Liquidity Risk***. Investment in a small bond issue means that it may be difficult to sell those bonds quickly or at a good price in the future. Many municipal bond issues are much smaller than agency issues, and less frequently traded. The incremental yield realized by investing in a municipal bond may have the effect of inhibiting the investor's liquidity. Farmer Mac is another example of an illiquid security; while it is a government sponsored entity, it is not rated and its issues are much less liquid than those of the rated GSEs.
2. ***Credit Risk***. While the credit quality of government and agency issuers is known, many other bond issuers are not rated. Whether or not a rating is available, public funds investors' fiduciary responsibility includes looking beyond ratings scores in evaluating the credit quality of a security. Most public funds managers do not have the resources to perform their own due diligence, and are therefore taking on an unknown degree of risk when they invest in securities from lesser-known or unrated issuers. In other cases it is important to be aware that an issuer's debt may carry different ratings for different degrees of risk; for example, subordinated debt of certain issuers is rated lower than their senior debt.
3. ***Duration Risk***. Managers must consider the optimal duration of their portfolio in the current market as well as their vulnerability to future market movements. Certain callable bonds (American callables, with continuous callability) present a challenge in duration management because of the uncertainty around their call option. In a market rally, a portfolio carrying a high proportion of American callables could see all of them called and be forced to reinvest in lower yield instruments. Portfolios carrying these investments are difficult to value as their interest rate risk exposure is difficult to quantify. One important strategy for mitigating duration risk is diversification of portfolio assets among a range of investments.
4. ***Statutory Eligibility.*** Certain investments, while generally considered safe, do not satisfy the Washington state requirements for public fund investments. As part of evaluating an investment opportunity it is important to confirm that the investment is permitted by statute. The statutes that stipulate eligible investments of public funds include RCWs 39.58, 39.59 and 43.84.