

Township Investments: Strategies and Techniques

By Jeffery L. Cyphert, CMFA, Treasurer,
Grand Blanc Charter Township
(Genesee County)

Township treasurers within Michigan have a variety of state-mandated duties and responsibilities to which they must adhere. However, there are two statutes that affect a treasurer's work and have a major financial impact on township residents. The first is found in MCL 41.76 which states: "The township treasurer shall receive and take charge of money that belongs to the township ..." The second directive is found in MCL 129.91 (Public Act 20 of 1943, as amended). It reads, "The township treasurer shall invest public funds as directed by the township board in lawful investments as authorized by this section."

Taking charge of township monies and properly investing these funds has great consequences. The returns on township investments, in larger townships, can equal one-quarter to one-half a mill in tax dollars. These funds can be converted to a new multi-purpose copier, or even extra police officers or general clerical help. They can also allow a township to maintain an operating millage that is lower than the maximum allowed by state law.

There are obviously many financial and political rewards for prudently handling and investing township funds. However, there can be massive negative consequences if the handling and investing of funds is not done correctly—including

above-the-fold newspaper stories, possible recall, loss of taxpayers' monies, and possible state takeover of township government. I do not know of statutory duties whose results could be more diametrically opposite.

So how does a treasurer start to protect him or herself against the potential negative side of these responsibilities? Through continued education, a comprehensive investment policy, and an understanding of the available investment instruments and strategies.

Most Townships Use Passive Investment

There are two styles of governmental investing: active and passive. Large governmental entities utilize active investing, and will often have the designated staff to actively manage a diversified investment portfolio. These individuals are experienced in adjusting maturities and the security mix of the portfolio as yields and interest rates fluctuate. They are constantly performing yield curve and security spread analysis.

However, approximately three-quarters of Michigan's townships are under 5,000 in population. Because of limited resources, many townships in Michigan tend to utilize a passive strategy for invest-

ing their funds. Treasurers use investment instruments that are typically for specific periods of time and at specified interest rates. One could describe them as safe, low-risk and even mundane investments. But this is a good strategy, as will be discussed later.

Investment Philosophy and Objectives

Prudent investing for a treasurer starts with an approved investment policy—which is required under Public Act 20—for the investments tools are found within a comprehensive investment policy. A policy should comment on investment philosophy by establishing a written "prudent person rule." This rule requires a treasurer to exercise the judgment and care under circumstances then prevailing which persons of prudence, discretion and intelligence exercise in the management of their own affairs. However, MTA Legal Counsel is of the opinion that the more stringent "fiduciary" standard is more appropriate. A fiduciary has a duty to protect the assets of another party to a standard even higher than how he or she would manage his or her own affairs.

A more stringent definition of a prudent person is the concept of a "prudent

expert." A prudent expert is not just expected to be familiar with investments applicable to his or her own affairs, but also through due diligence, to be familiar with the organization involved, its investment objectives and the investments appropriate for it.

A policy must establish investment objectives. The utmost important objective is **safety**. This objective relates to the volatility of the principal of the funds. Zero volatility of principal sharply restricts the types of investment vehicles that can be used. Safety, as it relates to the preservation of principal, is the most important investment duty for a treasurer.

The second objective facing a treasurer is **liquidity**. This is the ability to convert investments into cash to meet the cash flow needs of the township. Cash flow projections are arguably the single most important tool for managing the liquidity structure of an investment portfolio. Liquidity will allow a treasurer to have the funds to meet payroll obligations or to cover accounts payable requests.

The third objective for a treasurer is **return on investment**. An income objective is usually stated as an annual percent of the principal amount invested. The higher the rates of return, the higher the risk factor. As of press time, savings accounts were providing around .8 percent return on principal. Commercial paper, A2/P2 rated, was providing around a 2.40 percent return. Of the three objectives, this one requires the treasurer to continually improve his/her education of the types of investment vehicles that are allowed by PA 20. Before we can review the different types of state-allowed investments, we must understand the different levels of risk.

Evaluating Risk

Obtaining a return on the township's investments involves risk. Treasurers face the following types of investment risk:

- Volatility of income—the fluctuation in the income or underlying value of security price received by the portfolio in a particular time period. Volatility can be either up or down.
- Inflation risk—the chance that the

value of assets or of income will be eroded as inflation shrinks the value of our currency. For public funds, which have a much shorter time horizon, this risk is minimal, except perhaps for reserve or contingency funds that would have a longer investment time horizon.

- Interest rate risk—the possibility that a fixed-rate debt instrument will decline in value as a result of a rise in interest rates.

- Prepayment risk—when an actual prepayment of interest is different from the expected payment.

- Credit or financial risk—when a debtor fails to make timely payments of principal and/or interest when due or that a company or bank fails.

- Opportunity risk—placing all township funds in a savings account at possibly the lowest rate of return thus missing higher yields on other allowable investments.

Every investment has some degree of risk. Generally speaking, the higher the potential return on an investment, the higher the risk for treasurers, taxpayers and the entity's legislative body.

Allowable Investment Instruments

The following investment instruments are approved through PA 20 as amended. They afford ample opportunity for sound diversification and cash flow investment management.

- U.S. Treasury bills—an obligation of the U.S. government. "T-bills" are a short-term (maturities up to six months), discounted government security sold through competitive bidding at weekly or monthly auctions in increments of \$1,000, with the denomination being no higher than the total issuance. Three- and six-month bills are auctioned weekly. Although yield on bills may barely surpass the inflation rate, the high degree

of safety—together with the liquidity provided by an active secondary market—make T-bills a popular instrument for a governmental portfolio. Purchase of T-bills can be accomplished through a primary broker/dealer or a bank.

- U.S. Treasury notes—obligations of the U.S. government bearing interest payable at six-month intervals until maturity. Denominations—after a minimum of \$5,000—are in \$1,000 multiples. The notes are sold by cash subscription, in exchange for outstanding or maturing government issues. The big difference between T-bills and notes is that notes have longer maturities from two to 10 years (if bought at auction) but can also be bought with shorter maturities in the secondary market. Possible investment opportunities include township capital project funds or contingency funds. Treasury notes can be purchased through primary broker/dealers or major banks.

- U.S. Treasury bonds—similar to notes except original maturities are 10 years and longer (if bought at auction) but can also be bought with shorter maturities in the secondary market. It would be rare for a township to invest out more than 10 years.

- U.S. Treasury STRIPS—U.S. government bonds that are separated into two components: periodic interest payments and principal repayment. Each of the interest payments and principal payments are stripped apart and sold individually as zero-coupon securities. Maturities for STRIPS fall on the 15th of the following months—January, February, May, July, August and November. Contact

continued ▶

EARTH  TECH

A **tyco** INTERNATIONAL LTD. COMPANY

| | |
|-------------------------|--------------------|
| Operation & Maintenance | Infrastructure |
| Water/Wastewater | Technical Services |
| Municipal Facilities | Design/Build |

(800) 688-9828
Grand Rapids and Livonia

a broker/dealer or a major bank for more information.

- **TINTS** (“Coups”)—interest rate options on notes and bonds, Government National Mortgage Association mortgage-backed securities, and municipal bonds. Contact your banker or broker/dealer.

- **PRINS** or **STRIP** (“Ps”)—similar to coups, but only principal on notes and bonds.

- **CUBES**—government bonds that pay their interest, which is issued semi-annually through the use of book-entry coupons.

- **U.S. government agency obligations**—securities issued by U.S. government agencies or quasi-government agencies and are guaranteed directly or indirectly by the U.S. government. These securities are generally used because their safety of principal is almost as great as that of the U.S. Treasury’s, and the yield is somewhat higher. Contact a major broker/dealer or bank for details. Some of the issuing agencies are:

- Federal Home Loan Bank (FHLB)
- Federal National Mortgage Association (FNMA)
- Federal Farm Credit Bank (FFCB)
- Small Business Administration (SBA)
- Government National Mortgage Association (GNMA)
- Student Loan Marketing Association
- Resolution Funding Corporation (REFCORP)
- Savings account—deposit account at a commercial bank, savings and loan, or credit union that pays interest, usually from a day-of-deposit to day-of-withdrawal basis. Financial institutions can pay whatever rate they like on savings accounts, but the rate tends to be in relation to the actions of the money center banks in re-pricing their prime rate.

This instrument is often used to accumulate small amounts of funds until a larger, higher yielding investment can be made. Savings accounts can also be used for small funds such as cemetery funds. All banks, savings and loans, or credit unions would be able to establish a savings account.

- **Savings deposit receipt**—a non-negotiable receipt evidencing a deposit with interest to be paid at a stated rate. The maturity may be fixed, but normally is subject to presentation by the depositor for payment. The amounts may be small or large but the federal regulations will regulate the interest rate to be paid. This instrument is outdated due to the popularity of regular passbook and statement savings accounts with daily interest. Again, see your banks, savings and loans, or credit unions for more information.

- **Certificates of deposit (CD)**—a receipt of funds deposited in a financial institution for a specified period at a specified rate of interest. Denominations can be any agreed amount, and interest is calculated using actual number of days on a 360 or 365-day year. When comparing rates for institutions, it is important to understand which yearly day base—360 or 365—is being used. Maturities range from a few weeks to longer periods of time, which allows matching cash flow needs, but liquidation prior to maturity usually carries a penalty.

CDs are a favorite investment instrument for townships. However, Michigan does not require collateralization by the bank to cover the face amount of the CD. Because of this, a treasurer must perform due diligence by monitoring the credit quality and asset strengths of the investment banks.

There are national organizations that quarterly review banks, savings and loans, and credit unions. Three of these reviewers are Sheshunoff, Thompson Bank Watch, and Lace. Besides the library, check with your county treasurer, who may sub-

scribe to these services. Contact your banks, savings and loan, and credit unions for CD interest rates and their financial credit rating.

- **Commercial paper**—a short-term unsecured debt obligation of a corporation. Such paper is either issued by companies directly or sold through broker/dealers or banks. The paper is normally sold at discount. Commercial paper is rated by credit agencies such as Fitch, Moody’s, and Standard & Poor. Per PA 20, Michigan treasurers can only invest in the two highest-rated commercial paper, F1/F2, A1/P1 or A2/P2, and for a period no longer than 270 days. Contact your banks or broker/dealers.

- **Repurchase agreement**—a contractual arrangement between a financial institution or dealer and an investor. The agreement normally runs for one to 30 days, but some can be longer. The investor loans funds for a certain number of days at a stated yield. In return, a block of securities is pledged as collateral.

CENTEC CAST METAL PRODUCTS



PLAQUES & MARKERS

Cast Bronze and Aluminum
Memorial & Dedication Plaques
Custom Signs & Markers for
Parks, Buildings, Houses
Police, Military & Firemen Service Markers



FLAGS & FLAGPOLES

US & State Flags In All Sizes
Special Flags, Indoor Sets
Flagpoles & Accessories



PO Box 645
501 Knapp St.
Fremont, Ohio 43420

Phone 419-355-1414
Toll-Free 800-969-3740
Fax 419-355-1422

centec@nwnline.net
www.centeccast.com




CALL US FOR A FIRM, NO-CHARGE QUOTE ON YOUR SPECIAL PLAQUE NEEDS

At maturity, the securities are returned and the funds are repaid, plus interest. Extreme caution should be exercised to obtain an undivided interest in the securities under a master repurchase agreement.

Also, the securities should be delivered on a delivery-versus-payment basis thereby being held by a third party custodian designated by the treasurer and evidenced by safekeeping receipts. For safety of principal, the securities under the repurchase agreement should also be "Marketed-to-Market," meaning that the value of the underlying collateral should be maintained during the entire life of the agreement at levels equal to (100 percent) or greater than (105 percent) the amount advanced for the agreement. Only governmental securities can be pledged as collateral. For repurchase agreements, contact your banks or broker/dealer.

- Bankers' acceptance—investments of short-term credit arrangements that allow businesses to obtain funds to finance commercial transactions, although when accepted by a bank, they are direct obligations of that institution. Maturities range from 30 to 270 days. They are sold at a discount from par similar to U.S. Treasury bills, and, since an acceptance is tied to a specific loan transaction, the amount and maturity of the acceptance are fixed. Contact your bankers or broker/dealers.

- Money market mutual fund—an open-ended mutual fund that invests in a wide variety of investment instruments. Most brokers and banks offer money market mutual funds and most national

mutual fund distributors have a fund that would be allowable for township investment. The mutual fund can only invest in state-approved investment instruments (all of the bulleted points above).

A treasurer needs to perform due diligence by acquiring a copy of the mutual fund's prospectus and reviewing the fund's objectives, the securities that are found in the fund's portfolio, fees, schedule of financial statements, size of deposits and withdrawals. Another source for this information is Mutual Funds Update by CDA/Wiesenberger. Money market mutual funds provide an efficient way to manage short-term funds, with daily deposits and withdrawals permitted.

- Investment pools—Michigan does not offer a state-managed government investment pool for local treasurers. However, Michigan does offer pooled investment through several other statutes. PA 367 of 1982 allows banks to form investment pools that are available for municipalities to use. Securities in this type of pool must also comply with PA 20.

Another type of pool allowed is found under the Urban Cooperation Act (PA 7 of 1967, 2nd Extra Session). There are at least two urban cooperation pools: MBIA/Michigan Class and CADRE. The advantages for pools are identical to mutual funds in that they pro-

vide an excellent liquidity vehicle for holding money when treasurers are market timing investments or needing necessary liquidity to meet cash flow needs. Similar due diligence is required for proper investment protection.

All townships have a number of checking accounts for their obvious large funds. A treasurer can maximize return on these funds while they wait for payments to be drawn on the funds through the use of bank sweep accounts. Under these arrangements, the bank "sweeps"—moves unused funds—to its investment pool product at the end of the day, and the following morning sweeps the funds back to cover any clearing checks. Your current bank representative should be able to assist you with this product.

Investment Strategies

After understanding the different types of risk and the variety of investment instruments available to townships, we

continued ▶



LANDMARK APPRAISAL COMPANY

- ◆ COMPLETE REAPPRAISALS
- ◆ COMPUTER ASSISTED
- ◆ CERTIFIED PROPERTY TAX APPRAISERS
- ◆ ASSESSMENT ROLL MAINTENANCE

G-3247 BEECHER, SUITE 800
FLINT, MI 48532

-- Contact Mark R. MacDermaid, Sales Representative --

810-230-1550



Fishbeck, Thompson, Carr & Huber, Inc.
Engineers, Scientists, Architects

Grand Rapids
(616) 575-3824

Kalamazoo
(616) 349-3717

www.ftch.com

Lansing
(517) 627-1141

Farmington Hills
(248) 324-2090

ftc&h

need to return to protecting the taxpayers' monies through the spreading of risk. A means of reducing overall portfolio risks is through diversification. This concept spreads risk by putting the township's money in several types of investment instruments/securities, different maturity dates and by utilizing a variety of banks, savings and loans, and credit unions. A township investment policy should address this issue to prevent an over-concentration of the township's funds in too few financial institutions or too few investment securities.

A common investment technique is laddered maturities. This concept involves having investment maturities coming due in equal increments, for example, every two weeks when accounts payable and/or payroll is due. This ensures that there will be funds available to cover checks. This technique also provides a continuous cash flow over time that can be reinvested at prevailing rates. This strategy provides protection against reinvestment risk by spreading investment over a larger interest rate cycle.

Cash horizon investing requires the creation of a cash flow forecast to determine the ultimate cash horizon. The funds are then invested to the longest feasible date according to the cash needs forecast.

Creating a liquidity pool is accomplished by depositing money in an investment pool or money market mutual fund, purchasing repurchase agreements, or investing in short-term Treasury bills. Such instruments are lower risk (in some cases federally backed) and easily accessible where the original sum invested is returnable to the investor either at investor's option or at the end of some short contractual period. Some type of a liquidity pool is always important for the unknown or to park monies for short-term needs.

Sound Strategy, Sound Investing

Township treasurers can never have enough information, and continual education on the principles of sound investment of township funds is key to maxi-

mizing the township's returns. Township treasurers armed with a cash flow program, a comprehensive investment policy, and basic understanding of the risk and reward for the various state-allowed investment instruments, should only see their name "above the fold" to complement their investment philosophy and techniques.

The author wishes to thank Maureen Donehue, Salomon Smith Barney, and Keith Sawdon, investment officer for Oakland County, for their contributions and review of this article.

A sample township investment policy is available on-line at www.michigan-townships.org, or by calling (517) 321-6467. For a more comprehensive policy, visit the Municipal Treasurers' Association of the United States and Canada Web site, www.mtausc.org, or call (202) 737-0660. When drafting a township policy, consult your township attorney or accountant.



BS&A SOFTWARE
5668 OKEMOS RD
EAST LANSING, MI 48823

517.339.5514

www.bsasoftware.com

Equalizer Software Systems are designed with flexibility to operate in both large networked offices and small single user environments. All of our software systems provide a PC based, 32-bit Windows solution at a fraction of the cost of mainframe systems. Our "Open-Data" philosophy makes it easy to communicate between Equalizer products and other applications.

To see why over **1,000 Michigan governmental units** have chosen one or more Equalizer products, please contact us for a free demonstration CD.

Equalizer Software Systems for Michigan Government

- Assessing/Equalization
- Tax Administration
- County Delinquent Tax
- Delinquent Personal Property
- Special Assessments
- Building Permits
- Utility Billing
- PRD Web Application
- General Ledger/Budgeting
- Accounts Payable
- Cash Receipting
- Miscellaneous Receivables
- Fixed Assets
- Purchase Orders
- Payroll