

Is Your Investment Policy Due for a Course Correction?

An Updated Investment Policy Can Help Treasury Professionals Navigate Today's Difficult Markets

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Investing with Discipline

In today's volatile, low-yield market environment, treasury professionals must adopt a deliberate, disciplined approach to managing their organizations' balance sheet cash. For many treasury professionals, a detailed investment policy is central to their efforts to meet their organizations' investment goals.

The Association of Financial Professionals 2011 Liquidity Survey reveals that nearly 80% of businesses today have written policy documents that guide the investment of their organizations' balance sheet cash. More than half of these organizations review their policies at least annually.*

You may want to update your investment policy more frequently to ensure it reflects changing market dynamics, new investment products, and the evolution of your organization. Regular updates also help ensure that the policy guidelines are as current as possible for quarterly auditor certification and Sarbanes-Oxley documentation.

As a treasury professional, you may face tough challenges these days trying to protect principle, maintain liquidity and optimize the yields on your organization's balance sheet cash. While it's never been easy to achieve those disparate goals, it's particularly difficult now due to a perfect storm of low interest rates, shifting regulations and macroeconomic headwinds generated by the European sovereign debt crisis and tepid economic growth in the U.S.

In this environment, it is especially important that you maintain an updated investment policy, an indispensable tool for those tasked with managing balance sheet cash. A detailed investment policy serves several purposes: it codifies your organization's investment objectives; it defines key portfolio metrics, e.g., liquidity levels and credit quality; and it identifies the investments you may leverage to achieve your investment goals. Structured correctly, an investment policy helps ensure that your investment strategy accurately reflects your risk tolerance and liquidity requirements, while providing guidance to the professionals managing your cash portfolios. Perhaps most important, it can instill the all-important element of discipline in your investment program.

Because each organization's investment policy will reflect its own liquidity needs and return objectives, each policy will be unique. That said, all investment policies should feature the following:

- A clear articulation of your organization's risk tolerance, liquidity requirements and return objectives
- Allowable securities (and those to be avoided)
- Guidelines for the construction and management of your investment portfolios
- Mechanisms to promote ongoing compliance with the policy

In short, a sound investment policy is central to the effective management of balance sheet cash because it requires that you clearly articulate your investment objectives and detail the means by which you'll seek to achieve them.

* Association for Financial Professionals (AFP) 2011 Liquidity Survey, June 2011.

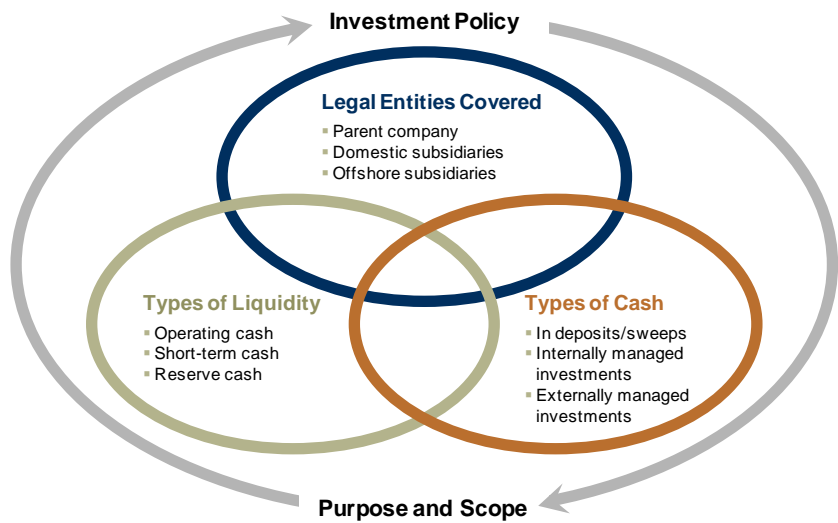
NOT FDIC INSURED	May Lose Value
NOT BANK ISSUED	No Bank Guarantee

By looking at your balance sheet cash more holistically, you can get a more complete picture of all the opportunities available to you—and the risks you need to manage.

Building a Better Investment Policy

The first step in updating your investment policy is to inventory all of your organization’s cash because an investment policy is most effective when it encompasses all cash holdings. This means the investment policy must account for all investment vehicles (bank deposits, money market funds, separate accounts, and portfolios managed in-house); the purpose of the cash (for daily operating expenses or reserves) and the location of the cash, e.g., home country or abroad (See Figure 1.) By looking at your balance sheet cash more holistically, you can get a more complete picture of all the opportunities available to you—and the risks you need to manage.

Figure 1. An investment policy should cover all liquidity from all entities.



Once all of your cash holdings have been accounted for, you need to determine your investment objectives. The cornerstone of any effective investment policy is the clear statement of your goals, because those goals drive — or should drive — the development and implementation of your investment strategy. Most organizations list principal preservation as their primary objective, with maintenance of liquidity and achieving attractive yields as secondary and tertiary goals. Indeed, in the Association of Financial Professionals (AFP) 2011 Liquidity Survey, more than 77% of respondents identified principal stability as their primary investment objective. Only 18% cited liquidity as their primary goal, and just 5% identified yield as their highest priority.¹

¹ Association for Financial Professionals (AFP) 2011 Liquidity Survey, June 2011 (p. 2).

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While most treasury professionals will agree that principal protection is of fundamental importance, they may pursue principal protection in different ways depending on their liquidity needs and risk tolerances. If, for example, you're investing cash you might need at any time (e.g., to fund your company's daily operations), you most likely would pursue a conservative investment strategy that emphasizes principal protection and daily liquidity. As such, your investment policy might dictate that those funds be invested in bank deposits and prime money market funds or Treasury funds, depending on your risk tolerance. Alternatively, if the cash you're investing is reserve cash and thus more stable, you might invest it more aggressively because you have a longer time horizon. In this case, your investment policy might specify that this cash could be invested in a separately managed account structured to reflect your unique risk tolerance and return objectives. For separate accounts, your investment policy likely would define allowable and prohibited investments, as well as establish the schedule for portfolio reporting to keep you fully apprised of your account's holdings and performance.

Just as the meaning of "principal protection" hinges, to a large degree, on the risk appetite of the investor, the definition of *liquidity* can vary depending on the nature and needs of the organization.

To accurately establish their liquidity needs, organizations must conduct a thorough analysis of their cash flows and requirements. For some organizations, the demand for operating cash remains steady throughout the year. Others may require access to larger amounts of cash at certain times of the year than they do at others. The physical location of your cash also can affect the liquidity equation. For example, some large multinational corporations with plenty of cash overseas can't count on that money to meet their U.S. liquidity needs without repatriating those funds and triggering regulatory and tax issues. That usually drives them to keep a significant amount of their U.S. cash in highly liquid, traditionally "ultra-safe" investment vehicles, such as money market funds.

Whatever the nature and needs of your organization, your investment policy should define the amount of cash necessary to fund daily operations and how it should be invested. Daily operating cash typically is invested in deposits or money market funds because they offer daily liquidity. Your investment policy might stipulate that operating cash be invested only in these highly liquid vehicles.

For more stable cash, meaning the cash you do not require access to on a daily basis, you might consider investing a portion of it in a separate account, which may be able to offer higher yields than those in money funds. If you include separate accounts in your investment program, your investment policy should clearly stipulate the types of investments you consider acceptable and those you deem inappropriate (more on this below).

If you decide to invest a portion of your cash in asset classes and longer-duration securities that historically have generated higher yields, you may want to consider hiring an outside manager with the resources and experience to effectively vet the risks associated with these investments. It's not unusual, for example, for internal investment managers to oversee portfolios of U.S. Treasuries and money market funds and use an outside firm to manage corporate securities or short-term municipal bonds, whose risks can be more difficult to evaluate.

Setting Boundaries

A clear articulation of your investment objectives leads naturally to another important component of a sound investment policy — the investment guidelines that determine the key characteristics of your investment portfolios. Typically this section of the investment policy will cover minimum credit ratings for your portfolios' securities; allowable investments; diversification; your organization's allowable maturities; and duration.

Given the fundamental importance of principal protection for most cash investors, it stands to reason that most investment policies will specify securities with high credit ratings for their portfolios. Traditionally, investment policies have stipulated the highest possible credit ratings for taxable short-term investments, i.e., A-1/P1, and A for longer-term debt (See Figure 2). There is a price to be paid, however, for insisting on only the highest-rated securities for your portfolio, namely a potential lack of diversification. For example, narrowing the list of approved securities to an AA rating recently has led to an overconcentration in financial services for some investors. Of course, an overconcentration in any sector runs counter to principal protection.

Figure 2. Cash investments typically include securities with ratings shown below.

Standard & Poor's (S&P)			Moody's			Fitch		
Long-Term	Taxable Short-Term	Municipal Short-Term	Long-Term	Taxable Short-Term	Municipal Short-Term	Long-Term	Taxable Short-Term	Municipal Short-Term
AAA	A-1+	SP-1+/A-1+	Aaa	P-1	VMIG 1	AAA	F1+	F1+
AA+	A-1+	SP-1+/A-1+	Aa1	P-1	VMIG 1	AA+	F1+	F1+
AA	A-1+	SP-1+/A-1+	Aa2	P-1	VMIG 1	AA	F1+	F1+
AA-	A-1+	SP-1+/A-1+	Aa3	P-1	VMIG 1	AA-	F1+	F1+
A+	A-1	SP-1/A-1	A1	P-1	VMIG 1	A+	F1	F1
A	A-1	SP-1/A-1	A2	P-1	VMIG 1	A	F1	F1
A-	A-2	SP-1/A-1	A3	P-2	VMIG 1	A-	F2	F1
BBB+	A-2	SP-2/A-2	Baa1	P-2	VMIG 2	BBB+	F2	F2
BBB	A-2	SP-2/A-2	Baa2	P-2	VMIG 2	BBB	F2	F2
BBB-	A-3	SP-2/A-3	Baa3	P-3	VMIG 3	BBB-	F3	F3
BB+	B1	SP-3/NR	Ba1	NP	NP	BB+	F-S	F-S
BB	B1	SP-3/NR	Ba2	NP	NP	BB	F-S	F-S
BB-	B2	SP-3/NR	Ba3	NP	NP	BB-	F-S	F-S
B+	B2	SP-3/NR	B1	NP	NP	B+	F-S	F-S
B	B3	SP-3/NR	B2	NP	NP	B	F-S	F-S
B-	B3	SP-3/NR	B3	NP	NP	B-	F-S	F-S

The credit quality ratings represent those of Moody's Investors Service, Inc. (Moody's, Standard & Poor's Corporation (S&P) and Fitch Ratings (Fitch)). The ratings represent their opinions as to the quality of the securities they rate. Ratings are relative and subjective and are not absolute standards of quality. The security's credit quality does not eliminate risk. For information regarding the methodology used to calculate the ratings, please visit Moody's at www.moodys.com, S&P at www.standardandpoors.com, or Fitch Ratings at www.fitchratings.com.

Potential investments for short-term cash

Taxable

- Obligations of the U.S. Treasury
- Obligations guaranteed by the U.S. government other than U.S. Treasuries
- Obligations of U.S. Federal Agencies and government-sponsored enterprises
- Repurchase agreements
- Certificates of deposit
- Bankers' acceptances
- Bank notes and time deposits
- Taxable money market funds
- Commercial paper
- Corporate bonds, notes and floating rate notes
- Taxable variable-rate demand notes
- Taxable municipal notes and bonds
- Asset-backed securities (as appropriate)
- Agency-backed collateralized mortgage obligations (as appropriate)

Tax-Exempt

- Tax-exempt money market funds
- Tax-exempt commercial paper
- Tax-exempt variable-rate demand notes
- Municipal notes and bonds

Allowable investments

A prominent feature of most investment policies is the allowable investments section, which simply defines the security types you'll permit in your cash portfolios. Allowable investments generally reflect the organization's unique investment objectives and risk tolerance. It may define allowable securities for portfolios managed internally and others for the cash managed by outside advisors. Once defined, your allowable investments must be regularly updated to account for new investment products and to reflect shifts in the market. Changes in the market environment might prompt you to add new strategies to your investment program. An example of the latter is a "cross-over" strategy, in which tax-exempt strategies are added to taxable bond portfolios to boost the taxable portfolios' performance and vice versa. It may make sense to specify in your updated investment policy that your managers have the latitude to pursue such a strategy.

When you define your allowable investments, you're implicitly defining your prohibited securities. Nevertheless, it's best to specify the securities you want to avoid for the sake of clarity. For many organizations, those "to-be-avoided" investments include variable net asset funds; auction rate securities; mortgage-backed securities; equity securities; and derivatives, such as inverse floaters, range notes, swaps and options. An overly restrictive definition of allowable investments may hamstring managers as they strive to execute an investment strategy that protects principal, maintains liquidity and delivers attractive yields. Meeting those difficult challenges requires strong risk management generally and effective diversification specifically. Needless to say, you can't achieve portfolio diversification if you take too many asset classes off the table.

Diversification

When we talk about diversification in the context of an investment policy, we're talking about concentration limits for your cash portfolios — both those managed internally and others overseen by outside managers. Your policy might spell out the maximum concentrations allowed per issuer and per security type as follows:

- No more than 5% of the portfolio to be invested in any one issuer
- No more than 50% of the total portfolio to be invested in corporate notes and bonds.
- No more than 10% of the total portfolio to be invested in asset-backed securities.

The policy also might stipulate that your organization's investment in a money market fund cannot account for more than 5% of the fund's total assets.

While these diversification guidelines can help limit concentration in a particular sector or issue, rigorous concentration limits can sometimes lead to unintended consequences, such as too much inefficiently invested cash. For example, if your policy has very tight restrictions on the amount of cash you can invest in corporate obligations, you may limit your options to the most conservative investments available, such as government debt. Limiting yourself to these low-yield investments can unnecessarily drag down your portfolio's overall performance.

Just as credit quality and diversification guidelines reflect your risk tolerance, the guidelines you establish with regard to maturities and duration will be influenced by your liquidity requirements.² Investment policies typically specify both a maximum maturity and a maximum duration for all securities. For example, the guidelines might limit eligible securities to those with “effective maturities of no more than 24 or 36 months,” and “weighted-average maturities (duration) not to exceed 12 or 18 months.”

If your risk tolerance permits, you may take on more duration and longer maturities to optimize yield. Even if you’re not comfortable moving the entirety of your cash farther out the yield curve (and assuming the interest-rate risk that entails), you might consider investing your reserve cash more efficiently by going farther out the yield curve. Organizations that keep all of their cash in investments offering overnight liquidity may be paying a very high “liquidity premium,” meaning they may be sacrificing yield to achieve a level of liquidity they don’t really need.

Staying Focused

As a blueprint for investment decision-making, an investment policy also should offer guidelines for measuring the effectiveness of those decisions. Your policy can do this by establishing individual performance benchmarks for the types of investments recommended — and the tiers or “buckets” they fall into — whether internally or externally managed. Common benchmarks for cash portfolios include:

- iMoneyNet Money Market Fund Averages (often used to benchmark money market funds)
- BofAML 3-Month T-Bill Index (investments with a targeted duration of three months)
- BofAML 6-Month T-Bill Index (investments with a targeted duration of six months)
- 1-Year T-Bill Index (investments with a targeted duration of one year)
- The BofAML 1–3 Year Government/Credit Index (investments with a targeted duration of one-and-a-half years and longer)

On the surface, the measurement of a money market fund’s performance appears relatively straightforward because you can compare it to iMoneyNet fund averages or to funds with the same mandate. However, gauging the performance of your fund simply by comparing it to an industry benchmark’s yield or another fund’s yield may not illustrate its true performance, i.e., its risk-adjusted yield. This is because two funds could have the same yield, but one may take on more risk to achieve it. It is even more difficult to assess the effectiveness of separate account managers than it is to measure the relative performance of funds because each separate account manager may assume very different risks. Assessing the performance of a separate account manager typically requires sophisticated attribution analysis and frequent communication with the manager to ensure you understand the amount and nature of the risk he or she is taking to generate the account’s return.

² Diversification cannot ensure profit or guarantee against loss.

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The final component of a sound investment policy is the section that defines compliance and governance practices. Typically these provisions specify the reports, meetings and other tools to ensure that day-to-day investment practices adhere to your policy's guidelines. For example, the compliance section of the policy might include language that stipulates:

- Quarterly certification that your portfolios remain in compliance with the terms of your investment policy;
- Regular meetings with your investment managers to review portfolio holdings, asset allocation and performance
- SSAE 16³ Type II documentation from investment managers on an annual basis.

Several companies provide technology and services to facilitate the compliance process through automated reviews and reporting, which can significantly reduce the burden on your treasury, accounting and audit departments. In addition, a formal annual review also can help ensure that the policy incorporates appropriate new products or strategies, adequately manages emerging risks, and remains responsive to your organization's evolving business objectives, risk profile, and strategic outlook.

Maximizing the Value of Your Investment Policy

Liquidity is the lifeblood of an organization. Creating and/or regularly updating an investment policy can help you maximize liquidity by clearly articulating your investment objectives and the steps you'll take to achieve them. The policy establishes the guidelines that will determine the key portfolio characteristics that drive portfolio construction and performance. Put simply, a regularly updated investment policy positions you to achieve your investment goals by providing the clarity of purpose and discipline that are central to the success of any initiative.

Of course, the effectiveness of an investment policy depends on the quality of the information and analysis on which it's based. The policy must be thoughtfully structured to reflect your organization's needs and the market's evolving risks and opportunities. Unfortunately, today's volatile market environment and investors' sensitivity to risk can undermine efforts to craft a sound investment policy. Strong risk aversion may lead to unnecessarily conservative investment guidelines, for example. At the same time, the complexities of today's short-term debt markets—and of specific investment products—can result in less-than-optimal policy guidelines regarding allowable investments and diversification. Given these realities, it is vital that you accurately assess the expertise and resources your organization can bring to bear when structuring your policy. If you have any doubts about your ability to effectively evaluate and update your investment policy, your first and most important task should be to identify an investment firm with the expertise, the resources and the objectivity necessary to help you capture the many benefits a well-structured policy can deliver.

³ The Statement on Standards for Attestation Engagements (SSAE) No. 16 is an internationally recognized auditing standard developed by the American Institute of Certified Public Accountants (AICPA) specifically for performing an examination of a service organization's controls and processes. Essentially, a SSAE 16 audit offers the service providers' customers third-party validation that the service provider has effective internal controls in place.

About the Author

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Nancy Jerez serves as managing director and head of national institutional sales for BofA Global Capital Management. She is responsible for a team of investment professionals that advises corporations, nonprofit organizations and public entities on a broad set of investment product solutions. In addition, Ms. Jerez is responsible for U.S. Western Region client coverage for BofA Global Capital Management. Ms. Jerez joined Bank of America in 1990 and has been a member of the investment community since 2000.

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Appendix. Benchmark Definitions

The iMoneyNet Money Market Fund Averages. iMoneyNet, Inc. is an independent mutual fund performance monitor. The iMoneyNet, Inc. averages are not intended to represent the past performance of the funds, but do represent the past performance of funds managed in a similar manner, and having similar investment objectives and policies. The iMoneyNet Government Category Average includes all retail and institutional funds: Treasury, Treasury & Repo, Government and Government Agencies. The iMoneyNet Prime Category Average includes all Prime Retail and Prime Institutional funds. The iMoneyNet Tax-Free National Category Average includes all retail and institutional national tax-free and municipal money funds.

The BofAML 3-Month T-Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue. The issue selected at each month-end rebalancing is the outstanding Treasury bill that matures closest to, but not beyond, three months from the rebalancing date. To qualify for selection, an issue must have settled on or before the rebalancing (month-end) date. While the index will often hold the Treasury bill issued at the most recent or prior three-month auction, it is also possible for a seasoned 6-Month or 1-Year Bill to be selected. As of January 1, 2009, Merrill Lynch & Co., Inc. is a wholly owned subsidiary of Bank of America Corporation and an affiliate of BofA Advisors, LLC. Effective September 25, 2009, the name of the index changed from the Merrill Lynch 3-Month T-Bill Index to the BofAML 3-Month T-Bill Index. The index is provided for comparative purposes only and is not a projection, prediction or guarantee of performance.

The BofAML 6-Month T-Bill Index is an unmanaged index tracking 6-month U.S. government securities. As of January 1, 2009, Merrill Lynch & Co., Inc. is a wholly owned subsidiary of Bank of America Corporation and an affiliate of BofA Advisors, LLC. Effective September 25, 2009, the name of the index changed from the Merrill Lynch 6-Month T-Bill Index to the BofAML 6-Month T-Bill Index. The index is provided for comparative purposes only and is not a projection, prediction or guarantee of performance.

Past performance is no guarantee of future results.

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Unlike CDs, which are insured up to certain limits and offer a fixed rate of return, mutual fund investments are subject to certain risks. An investor's principal and return will fluctuate with changes in market conditions so that the shares, when redeemed, may be worth more or less than their original cost.

For investments in ABSs generally, when interest rates decline, prepayments accelerate beyond the initial pricing assumptions, which could cause the average life and expected maturity of the securities to shorten. Conversely, when interest rates rise, prepayments slow down beyond the initial pricing assumptions, and could cause the average life and expected maturity of the securities to extend, and the market value to decline.

Treasury bills are less volatile than longer term fixed-income securities and are guaranteed as to timely payment of principal and interest by the U.S. Government.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

iMoneyNet First Tier Institutional category includes only non-government institutional funds that also are not holding any second tier securities. Portfolio holdings of first-tier funds include US Treasury, US other, repos, time deposits, domestic bank obligations, foreign bank obligations, first-tier commercial paper, floating rate notes and asset-backed commercial paper. It is not possible to invest directly in an iMoneyNet category.

The iMoneyNet Treasury Institutional category includes only institutional government funds that hold US Treasuries backed by the US Treasury. It is not possible to invest directly in an iMoneyNet category.