

## Active Investment Strategy Tools and Techniques for Small Governments: Part Two

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**Editor's Note:** *This article first appeared in Texas Town & City in August 2001 and has been revised slightly for current market conditions. Part one of the article, which appeared in the March issue of Texas Town & City, discussed the objectives of an investment program, the internal and external tools needed to implement investment strategies, common investment instruments for public entities, and types of risks that must be considered when analyzing investment strategies. Part two compares active and passive investment strategies. The author wishes to thank original authors Corinne Larson and Ned Connolly.*



### Passive Investment Strategies

Passive investment strategies are very common among small entities, because finance and treasury staff members wear many hats. The demands on their time make it difficult for them to actively manage their portfolios. Passive strategies are typically safe and defensible and can be expected to achieve average returns.

The customary passive investment strategies used by public entities include the following:

- **A liquidity pool**, which is created by depositing money in a local government investment pool or authorized money market mutual fund, entering into a repurchase agreement, or investing in short-term Treasury bills (T-bills). Some type of liquidity pool is always an important part of a passive or active investment strategy.
- **Laddered maturities**, which are structured to cover expected disbursements on a first-in, first-out approach. As funds become available, they are invested to match the next uncovered disbursement.

- **Cash horizon investing**, which requires the development of a cash flow forecast to determine the cash horizon. The funds are then invested to the longest feasible date according to the cash forecast.

- **Constant maturity**, which is the systematic purchase of a short-term marketable security when auctioned (for example, a T-bill) and, each time a new issue with that maturity is auctioned, the sale of the security previously purchased and the purchase of the new issue. This strategy results in a nearly constant maturity midway between the maturity when the security is purchased and the maturity when it is sold.

The disadvantages of passive investment strategies are the missed opportunities to lock in high yields when rates are falling, to realign the portfolio when rates are rising, to take advantage of shifting spread relationships, and to adjust the portfolio because of any credit quality erosion in issuers or sectors of the market in which securities are owned.

### Active Investment Strategies

The primary goal of implementing active investment strategies is to optimize the return on the portfolio by adjusting the maturities and mix of securities as yield and spread relationships change. Interest rates, the shape of the yield curve, and spread relationships are not static; they are always changing.

Active investment strategies require more work, training, and proper tools to implement than passive investment strategies. However, the benefits can more than make up for

the costs associated with these requirements when effectively implemented. The active investment strategies that are most common for public entities include the following:

- **Yield curve analysis**, which is the process of analyzing the shape of the yield curve to determine if it is a positive, flat, or inverted curve and to decide where the best relative value is. Funds are then invested in the maturity with the best relative value.
- **Riding the yield curve**, which is the mismatching of investments with expected disbursements to take advantage of attractive yields in maturities beyond the date of a disbursement. The security will have to be sold on the date of the disbursement to fund it, so a break-even analysis is required to evaluate the probability of selling the security at a price to generate a return greater than the return of just matching the investment to the disbursement.
- **Quality downgrading**, which is the buying of securities with greater risk whether it is credit, market, or liquidity risk, or some combination of all of them. The investment criterion for this strategy is that you get properly rewarded for the additional risk. Spread analysis is necessary for implementing this strategy.
- **Spread analysis**, which is the comparison of yields between two securities. It is performed within the same sector (Treasuries to Treasuries) but with different maturities, or between different sectors (Treasuries to instrumentality securities). The purpose of the comparison is to determine how the current yield pickup or spread compares to the average, widest, and narrowest spreads for some time period—often a minimum of a year. The objective is to take on additional risk in the form of maturity extension or lower credit quality only when adequately compensated by average or better than average yield pickup.
- **Market timing**, which is a strategy that attempts to optimize the return on the portfolio by timing the purchase or sale of an investment based on market factors. The implementation of this strategy involves the use of both fundamental and technical analysis. The objective is to determine the trend of interest rates, where they are in relation to their near-term highs and lows, and what economic reports are scheduled that could significantly impact the market. Timing investments is as much an art as a science, but at least being aware of the trend of interest rates can assist in deciding whether to invest in short or long maturities.

- **Portfolio realignments**, which is the selling of one security and the buying of another security to improve the structure of the portfolio because of changes in interest rates. This may require selling a security that had been purchased at a low yield, taking a loss, then recouping the loss quickly because the proceeds are reinvested in a much higher-yielding security. This strategy can be an effective way to get rid of the “dogs” in the portfolio that were purchased during a low-yield environment.

## Summary

Any investment program has to ensure legality, safety, and liquidity before attempting to optimize the return. This two-part article is an introduction to the considerations that are necessary for implementing an investment program and provides a brief comparison between active and passive investment strategies. There is not enough space in an article such as this to do any more than introduce these concepts.

For those who are inexperienced in any of the strategies described in this article, it is important to gain a thorough understanding of them before attempting to implement them. ★



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