Investment Policy for State Budget Reserves: What Legislators Should Know

June 15, 2016

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Moderator:
Jackson Brainerd, research analyst, National Conference of State Legislatures
Investment Policy for State Budget Reserves

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NCSL Mission

The National Conference of State Legislatures is a bipartisan organization founded to:

• Improve the quality and effectiveness of state legislatures
• Promote policy innovation and communication among state legislatures
• Ensure state legislatures a strong, cohesive voice in the federal system
NCSL Policy Making

Eight Standing Committees

- Budgets and Revenue
- Communications, Financial Services and Interstate Commerce
- Education
- Health and Human Services
- Labor and Economic Development
- Law, Criminal Justice and Public Safety
- Legislative Effectiveness
- Natural Resources and Infrastructure
- Redistricting and Elections
Today's Speakers

Akshay Iyengar
Associate
The Pew Charitable Trusts

Giovanni Capriglione
State Representative
Texas

Matt Fabian
Partner
Municipal Market Analytics
Akshay Iyengar is an Associate with the States’ Fiscal Health group at The Pew Charitable Trusts. He previously worked at Avalere Health LLC, Chamber Hill Strategies, and as a survey researcher at the University of Missouri-St. Louis and the City of St. Louis Department of Health. He holds degrees from Georgetown University and Washington University in St. Louis.
Representative Capriglione was elected to the Texas House of Representatives in 2012 and is serving his second term representing District 98 which encompasses all or part of Grapevine, Colleyville, Southlake, Keller, Westlake, North Fort Worth and Haslet. He currently serves on the following committees: Appropriations, Local & Consent, and Investments & Financial Services where he serves as the Chair of the Bond Indebtedness sub-committee. He voluntarily serves as the Secretary of the House Energy Caucus and on the public school finance work-group during the interim session and has become a champion for public education, particularly focusing on equitable funding for robin-hood districts.

Giovanni is now the owner and President of his own small business, Texas Adventure Capital LLC, where he provides business services to various investment fund managers and business owners. His focus is investing in Texas-based small businesses. Prior to that Giovanni was a Senior Vice President at an investment firm where he managed the loan and equity portfolios of various American businesses. Before that Giovanni held various positions at computer engineering companies primarily centered around semiconductor design and Internet products.
Matt Fabian

Matt Fabian is a Partner at Municipal Market Analytics (MMA) where he leads market and credit research. Mr. Fabian is the lead contributor MMA’s weekly Outlook and biweekly Default Trends. His expansive knowledge of the idiosyncratic characteristics of the municipal market has made him one of the primary voices of the industry. Prior to MMA in 2015, Mr. Fabian served in a similar capacity at Municipal Market Advisors since 2006.

Mr. Fabian has served as chairman of the Municipal Analysts Group of New York (MAGNY) and was on the Board of Governors of the National Federation of Municipal Analysts (NFMA). He is routinely a featured speaker at numerous industry conferences on a wide range of topics, including investment strategy, demographic trends, bond insurance, tax reform, derivatives, defaults, state governments, and municipal credit. Mr. Fabian’s efforts in municipal default analysis led to the creation of MMA’s Credit Impairment Database, the most complete resource of troubled issuers in the industry.

Mr. Fabian has an undergraduate degree from Penn State University, and Masters of Public Administration from the Maxwell School of Citizenship and Public Affairs at Syracuse University.
Brenna Erford manages Pew's work on state budget policy, which helps states identify strategies to better manage fiscal pressures resulting from economic and revenue volatility. Erford oversees the project's work with state budget leaders, including technical assistance to develop and adopt policy solutions. She also manages a team of researchers who identify and analyze proven approaches that serve as models for states. She is a frequent conference speaker and has testified before state legislative bodies as well as professional associations.
Investment Policy for State Budget Reserves
What Legislators Should Know
States Manage Different Types of Accounts
Investments Differ Between Operating and Non-Operating Funds

**Operating Funds**
- General Funds
- Education Funds
- Medicaid Funds
- Capital Improvement Funds

**Non-Operating Funds**
- Pension Funds
- Funds for Other Post-Employment Benefits
- Land Trusts
- Severance Tax Funds
- State College Trust Funds
States Manage Different Types of Accounts
Investments Differ Between Operating and Non-Operating Funds

**Operating Funds**
- General Funds
- Education Funds
- Medicaid Funds
- Capital Improvement Funds

**Reserves**
- Rainy Day Funds
- Operating Fund Ending Balances
- Other Idle Cash Resources
Key Principles for Investing Operating Funds
Investments prioritize preservation, access to the principal

Safety

Investments should guarantee that the principal on the holdings is guaranteed

Liquidity

Investments should preserve policymakers’ ability to access fund dollars

Yield

Interest earnings are the last major priority for operating fund investments
Legal Restrictions Can Limit Investments
Aggressive Fund Investments May Conflict with State or Federal Regulations

State Laws

- Example: Indiana law says that in funds managed by the treasurer, only 25 percent of the portfolio may exceed maturities of 2 years and none can exceed 5 years
- Can only invest in securities backed by the US treasury, a federal agency, or a federal government-sponsored entity

IRS Rules

- Yield restriction rules can deny tax-exempt status to state-issued bonds if proceeds are invested in higher-yielding securities
Investments Should Balance Risk Against Yield

Operating Fund Investments Tilt Towards Short-Term, Low-Risk

More risk

SAFETY

Equities (Stocks)
Short-Term Corporate Debt
Commercial Paper
Agency Bonds
Treasury Bills (T-Bills)
Money Market Funds
Certificates of Deposit

LIQUIDITY

Alternatives

HIGHER RETURNS

Longer Time Horizon

Long-Term Corporate Debt
Treasury Notes
Treasury Bonds

SAFETY

Money Market Funds
Commercial Paper
Agency Bonds
Treasury Bills (T-Bills)
Money Market Funds
Certificates of Deposit
What is the purpose of a state’s rainy day fund?

Is it a short-term account or a long-term account?

Optimal investment strategy depends on the answer.
Long-Term Accounts Hold Riskier Investments
North Dakota Has Both Long and Short-Term Reserves

North Dakota Investment Portfolios, June 2015

<table>
<thead>
<tr>
<th>Long-Term Reserves</th>
<th>Short-Term Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legacy Fund</td>
<td>Budget Stabilization Fund</td>
</tr>
<tr>
<td>$3.3 billion, 3.3% Rate of Return (FY 2015)</td>
<td>$574 million, 1.9% Rate of Return (FY 2015)</td>
</tr>
<tr>
<td>Cash Equivalents, 0.3%</td>
<td>Cash Equivalents, 17.5%</td>
</tr>
<tr>
<td>Other, 15.7%</td>
<td>Short-Term Fixed Income, 82.5%</td>
</tr>
<tr>
<td>Equity, 49.6%</td>
<td>Fixed Income, 34.7%</td>
</tr>
</tbody>
</table>

Source: North Dakota Retirement and Investment Office
Interest Rates at Historic Lows

Returns on Short-Term Treasury Bills Near Zero Since 2009

Source: Board of Governors of the Federal Reserve System (US)
research.stlouisfed.org

myf.red/g/4BGT
Interest Rates at Historic Lows

Returns on Short-Term Treasury Bills Near Zero Since 2009

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research.stlouisfed.org
Alaska: Higher Yields, But Greater Risk
Alaska Permitted Equity Investments for Some RDF Balances

Alaska CBRF Market Value, FY 2006-15

(Billions)

- Main Account
- Subaccount

pewtrusts.org/fiscal-health
Alaska: Higher Yields, But Greater Risk
Alaska Permitted Equity Investments for Some RDF Balances

Investment Returns for Alaska's Constitutional Budget Reserve Fund Accounts, FY 2006-14

7.1% Avg Annual Return
3.8% Avg Annual Return
Texas Experiments with Higher-Yield Assets
Economic Stabilization Fund Holds Mix of Assets, Longer Maturities

**ESF Portfolio Composition**

- Commercial Paper, 30%
- Agencies, 19%
- Corporate Bonds, 10%
- Asset Backed, 10%
- Mortgage-Backed Securities, 10%
- Cash & Equivalents, 8%
- Treasuries, 11%
- Others, 2%

**Maturity Structure**

- < 30 days: 14%
- 31-90 days: 17%
- 91-180 days: 14%
- 181-365 days: 16%
- 1-3 years: 15%
- > 3 years: 24%

Source: Texas Treasury Safekeeping Trust Company
Several Issues Identified

- Tangential Concerns
- Alternatives to Investing $s
- Legislative Oversight of Investment Protocol
- Amount of dollars invested
- Concerns over Liquidity and Potential Loss of Principal
- Manager Selection
Rainy Day Fund Investment Bill v2.0

- Key Differences
  - Rainy Day Fund Projected Growth
  - Budget Strength
  - Amount of Dollars Tied to Legislative “Sufficient Balance”
    - Set by Legislative Committee
    - Takes testimony on projected balance, projected transfers into fund, budget funding demands, and other info. Including credit agency comments.
  - Target Yield Defined
  - Additional Investment Policy Rules
Portfolio Allocation Target
TESTIF $2.63 billion invested to date
Generally, resilient state financial health permits a wide range of behavior, including more aggressive investing strategies

1. For informal investment accounts held by states, this is only an incremental credit factor for investors
2. For local governments, or for legally pledged accounts, things get (much) more serious
3. Well defined rules, compliance regimes, and transparency are absolutely necessary
4. Remember that all investors are suffering from lack of income and return
Specific Risks

1. Federal arbitrage rules (i.e., “Replacement Proceeds”) limit returns for funds with a direct nexus to a bond issue
2. Because of risk of loss, credit analysts and rating agencies will discount less conservatively invested amounts
3. And more speculative investments may not be “liquid” when funds are needed
4. There is a history of problems with aggressive local investing: Orange Co CA; Cuyahoga Co OH; Walworth Co WI
5. At a minimum, more aggressive investing can amplify pro-cyclicality in state budget conditions
Questions?

- To ask a question, type your question into the box on the right-hand side of your screen.
  - You will not be identified and only the presenters will see your question.
Questions after the webinar

- If you have any questions regarding the issues discussed during this Webinar, please contact: Akshay Iyengar or Jackson Brainerd
  - aiyengar@pewtrusts.org
  - jackson.brainerd@ncsl.org

- This Webinar will be archived and will be available at the following link:
Resources

The Pew Charitable Trusts:

“Investment Policy to Preserve Fiscal Flexibility.” May, 2016:


“Why States Save.” December, 2015:

• [http://www.pewtrusts.org/~/media/assets/2015/12/whystatessaveresport.pdf](http://www.pewtrusts.org/~/media/assets/2015/12/whystatessaveresport.pdf)
Thank you for participating!

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