

# **Investment Pool: Temporarily Closed for Repairs**

Will reopen with a  
Lifeguard on Duty

**What are we doin' in a mess like  
this?...and what are we gonna tell all  
our friends?**

Kenny Rogers



# The Subprime Mess

- Made to weak (non prime) borrowers.
- With high levels of debt relative to income.
- Often with low down payments.
- Often with little “documentation” (proof of income, etc.).

## NINJA – No Income, No Job, No Assets



<u>Mortgage Product</u>	<u>% of U.S. Subprime Originations, at Peak</u>
No proof of income	43%
No money down	38%
Interest Only	37%
Low, “teaser” interest rate, “exploding” after 2 years	~80%
“Layered risk” combines all of the above	26%

## **BUT Securitization....**

turned 82% of every dollar of subprime mortgage into a AAA security.

**The economic reality is we gave the wrong loan to the wrong borrower at the wrong time.**

Katie Reeves  
Director, Securitization Research  
Deutsche Bank

**What started out as scattered problems with sketchy subprime loans somehow managed to infect the broader housing market, batter the biggest financial institutions, bring Bear Stearns Cos. down and Fannie Mae and Freddie Mac to their knees, decimate the derivatives market, and cause businesses to cut payrolls and consumers to curtail spending.**

Caroline Baum, Bloomberg

# The Record Shows I Took The Blows And Did It My Way...

Frank Sinatra

- Some money funds are paying the price for chasing high returns in securities like structured investment vehicles (SIVs) when times were good. When the credit markets froze up one year ago, SIVs started to collapse and some stopped making payments on their notes. As a result, the prices of such securities began plummeting.

# Propping Up The Funds

- During the last year, big banks and investment companies have committed more than \$10 billion to shore up money market funds that were tainted by the mortgage mess.
- Since the credit crisis flared last summer, at least 17 financial companies have moved to bolster funds.

# From Wall Street To Main Street

- The contraction in credit markets has saddled banks and brokerage firms with more than a half trillion dollars in writedowns since the beginning of last year.

# Widespread Panic

- The subprime crisis caused a widespread liquidity crunch in the commercial paper (CP) market.
- SIVs issued asset-backed commercial paper (ABCP) using the financial assets as collateral for the CP.
- In 2007-2008, many of these assets performed poorly versus expectations, making buyers less willing to purchase ABCP.
- As markets became unwilling to purchase ABCP, this caused trouble for SIVs that had relied on sales of ABCP to obtain funds for use in longer-term investments.
- SIVs had trouble rolling over their ABCP and were forced to quickly liquidate their longer-term investments at a substantial loss.

## So How Did State and Local Government Investment Pools Get Involved?

- Many state and local government investment pools purchase tier 1 commercial paper (A1/P1 or better rating).
- ABCP issued by SIVs carried ratings of A1/P1 or better and therefore were eligible investments for many state and local government investment pools.
- At its peak on August 8, 2007, the total CP market was \$2.182 trillion. At that time, ABCP represented \$1.210 trillion or 55% of the CP market.

# We've Lost Our Appetite

- Given the funds' troubles, the industry is starting to rethink its ways. The Securities and Exchange Commission has proposed rules that would prevent fund managers from relying too heavily on credit ratings.
- Money fund managers have ratcheted back their risk appetite after several years of reaching for higher returns.

# 1994 – The “OC” Mess

Lessons Learned and  
Lessons Forgotten



**Experience is that marvelous thing  
that enables you to recognize a  
mistake when you make it again.**

Franklin P. Jones



## 1994 versus 2007

- Orange County headlines included the words “derivatives” and “leverage”.
- The subprime contagion headlines included the acronyms “SIVs” and “ABCP”.

# The Lesson We Forgot

- 1994: Orange County Treasurer Robert Citron increased the interest earnings of the pool (and therefore offering shareholders a higher yield) by taking on a highly leveraged position using repurchase agreements (repos) and floating rate notes.
- 2007: As the Fed kept the overnight rate steady at 5.25% from June 2006 through August 2007, state and local government pools were reaching for yield by purchasing asset-backed commercial paper (ABCP).
- Buying an A1+ piece of ABCP gave investors a pickup of 5 to 7 basis points versus General Electric CP and a range of 7 to 10 basis points versus an industrial name.

**In the boom, all that mattered to money market funds was yield, and they did not need help finding it. Now they crave liquidity and sanctity of principal – a welcome rediscovery that short-term holdings should “bore you into a good night’s sleep.”**

Reserve Management’s  
Bruce Bent, creator of the  
first money fund in 1970.

# **Sometimes You Gotta Go Back To The Basics**

# **Best Practices For Government Investment Pools**

# Risky Business



## Credit Risk

- Credit Spread Risk
- Downgrade Risk
- Default Risk
- Interest Rate Risk
- Headline Risk

**The number one objective for corporate short-term investments is preservation of capital, not return.**

Jeffrey Wallace,  
managing partner at  
Greenwich Treasury  
Advisors

# Investment Policy 101

- **Safety of Capital** – Investments should be managed in a manner that seeks to ensure *preservation of principal*.
- **Liquidity** – The fund should remain sufficiently liquid to enable the funding of all cash needs reasonably anticipated.
- **Yield**
- **Diversification** – To reduce overall portfolio risks while maintaining market rates of return.

# High Returns = Higher Risk

- High returns have been a way to attract more assets. Nevertheless, higher returns are also associated with greater risks.
- Treasurers and Boards must establish investment policies that are strict enough to prevent fund managers from taking risks that are not in the best interest of the shareholders.

## Credit Criteria in our Investment Policies

- When it comes to credit quality, most states' investment policies simply state that the security must carry a rating of 'A-1/P-1 or better' at the time of purchase to be considered an eligible investment.

## Ratings: What Makes The Security A-1/P-1 or Better?

- We have all learned that we cannot rely solely on the credit rating agencies for our credit analysis.
- Use the rating as a starting point.
- Have your own credit team evaluate the creditworthiness of a name.

**Recognize the skills and traits you don't possess, and hire people who have them.**

Warren Bennis



# Know Your Strengths

- If you don't have the staff or the expertise to evaluate credit:
  - Stick to what you know; or
  - Hire an outside manager to manage credit.

# The Customer is #1

- A money fund's market price exposure is also affected by the flow of money in and out of the fund.
- Know your shareholders' typical cashflow patterns.
- Understand your shareholders' appetite for risk.

# Sounding Board

- Regularly scheduled meetings with an independent group of the fund's largest shareholders can help fund management gain insight into the shareholders' appetite for risk and for future cashflow patterns of the fund.
- Smaller municipalities will tend to “follow the leader” and will ask “What is everyone else doing?”

## Why Get Rated?

- Provides an additional level of oversight.
- On a stable Net Asset Value (NAV) pool, the portfolio is monitored weekly.
- Annual management review meetings are held to evaluate any changes that may have occurred in policy, philosophy, personnel and operations.

# S&P Criteria For a AAA-rated Pool

- Asset Types
- Treasurer/Board Oversight
- Credit Quality
- Diversification
- Disclosure
- Fund Manager(s) Experience
- Shareholder Profile
- Weighted Average Maturity (WAM) of the pool

# [www.yourstatetreasury.com](http://www.yourstatetreasury.com)

- Disclose information regarding your state's investment pool to both your shareholders and potential shareholders. Your state's website is a great place to start.
- Information should be easily accessible including the pool's holdings, yield and the WAM.

**And the next risk we need to  
worry about is...**

Interest Rate Risk



## Back to 1994

- In 1994, Orange County was too highly leveraged for rising interest rates.
- Securities in the Orange County Investment Pool fell in value as rates rose.
- As a result, dealers were requesting extra margin payments from Orange County.

# Can You Take Me Higher?

- Many pools, both rated and non-rated, are listed as 2a-7 like; however, many pools have WAMs as long as 200 days and still use a \$1 NAV.
- A \$1 NAV may be misleading to the pool's shareholders in regards to assumed interest rate risk.
- How much of an increase in rates can your fund sustain? Should your fund consider operating as a variable NAV?

**The real discipline comes in saying no to the wrong opportunities.**

Peter Drucker

**Rule No. 1: Never Lose Money.  
Rule No. 2: Never Forget Rule No. 1**

Warren Buffett