TREASURY MANAGEMENT – ALTERNATIVE INVESTMENT OPTIONS

FINANCE ADVISORY GROUP – 28 MARCH 2012

Report of the:	Deputy Chief Executive and Director of Corporate Resources
Status:	For consideration
Key Decision:	No

Executive Summary: At the last meeting of the Group, Members were advised of the difficulty in placing investments in the light of worsening credit ratings in the banking sector.

Officers had begun to investigate alternatives to the traditional fixed term deposits with banks and building societies and this report gives details of their findings and suggests an alternative approach.

This report supports the Key Aim of effective management of Council resources.

Portfolio Holder	Cllr. Ramsay
Head of Service	Group Manager - Financial Services – Mr Adrian Rowbotham

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Recommendations to Finance Advisory Group:

(a) That investment in money market funds be commenced; and

(b) That an update on performance be brought to the next meeting of the Group.

Background

1. At the last meeting of the group, Members were advised of the large number of banks and building societies being downgraded by the ratings agencies, Fitch, Moodys and Standard & Poor's, in response to the worsening financial climate principally within the Euro Zone but also globally. The investment strategy for 2011-12 includes, amongst other restrictions, the requirement for a counterparty to have a minimum long term credit rating of AA- or better. The only exceptions to this rule are the part government owned UK banks, Lloyds TSB Group and the Royal Bank of Scotland (RBS) Group, owing to the inherent guarantee in place from the UK Government.

2. The effect of maintaining the AA- minimum limit was to exclude all UK banks and building societies from our lending list except for Lloyds and RBS. From the time of the ratings downgrades, investments have had to be recalled as they matured because the institution no longer met minimum requirements. In the absence of other suitable counterparties, investments were placed with other local authorities or with the UK Government's Debt Management Account Deposit Facility (DMADF).

However, this came at a cost in terms of yield. The DMADF pays 0.25% interest across all periods up to six months, whilst the 3 and 6 month rates with other local authorities ranged between 0.35% and 0.55%. The equivalent fixed term deposit would have yielded at least 0.65% more. Instant access accounts with a number of banks are paying 0.80%.

3. In response to this issue, the investment strategy for 2012-13 has been amended to make the minimum long term credit rating requirement A rather than AA-. This will allow investments to be made again with some of the institutions that had been downgraded and hence removed from our lending list.

Introduction

4. At the time of the downgrades, alternatives to using fixed term deposits with banks or building societies were being investigated in order to give more flexibility in making investment decisions as well as maintaining a relatively reasonable rate of return. The alternatives being discussed were:

- Treasury bills
- Certificates of deposit
- Index-linked gilts
- Money market funds

All four of these options are available within both the 2011-12 and 2012-13 investment strategies.

5. Officers' investigations have now been completed and each of the options are described below.

Treasury bills

6. UK treasury bills are AAA rated and a short dated form of government debt, issued by the Debt Management Office, usually by weekly tender. They are issued at a discount, so par value is received at maturity. They are negotiable instruments that are extremely liquid. Maturities are normally for one, three or six months duration.

7. In order to operate in the treasury bill market, clients need to have custodian facilities with a major bank. The cost of such an account is prohibitive for a participant such as this Council and hence specialist dealing arrangements would be required.

8. A company called King & Shaxson Limited were approached on the recommendation of the Council's treasury advisors, Sector Treasury Services Limited. King & Shaxson have operated in the treasury bill market since its inception in the mid 19th century and are what is known as a primary participant in the weekly treasury bill tender. They also have access to the secondary market, which is extremely active.

9. The company offers a dealing and custody service with guidance on the weekly tender, but clients are not obliged to take it. A bid outside their suggested range can be submitted, but there is the risk of missing out completely or being scaled back on the nominal amount.

10. The company's fee structure is built into the price of the investment and amounts to 0.03% p.a. equivalent. The minimum investment is £500,000. A charge of 0.01% equivalent is levied if a security is sold before the maturity date.

11. A copy of the most recent week's tender results appear at Appendix A. Yields are in the range of 0.365% to 0.439%

12. It is unlikely that the Council would be active in the secondary market, the preference being to hold to maturity. However, the option is always there should it be necessary to liquidate the investment.

Certificates of deposit

13. Certificate of deposit (CDs) are negotiable deposits. They are ranked pari passu with fixed deposits. Funds can be placed with any of the main UK or international banks as well as building societies, in any period from one month to five years. The main benefits of investing in the CD market are liquidity, diversity of counterparty exposure and yield.

14. A fixed deposit cannot be liquidated until maturity and hence there is a risk of counterparty deterioration. A CD can be sold at any point. This provides the additional benefit of being able to switch investment counterparties should they fall outside of our specified rating criteria. Although CDs are tradeable, their coupon (interest rate) is fixed so the interest earned is constant.

15. As with treasury bills, custodian facilities are required, so King & Shaxson would operate as a matched principal dealer. They deal in their own name which guarantees client anonymity and offers the ability to lend to counterparties that would not usually accept, or be in the market for, local authority money.

16. King & Shaxson monitor all client CD holdings on a daily basis. The Council would be alerted if the opportunity arises to realise a capital gain. If the market does not favour selling, the CD can be held to maturity in the same way as with a fixed deposit. It should be noted that buying CDs with a view trading them is not advocated as an investment principal for local authorities.

17. King & Shaxon's fees are the same as for treasury bills. CDs are usually purchased through the secondary market and yields tend to be marginally lower than equivalent fixed term deposits owing to their increased liquidity. By way of example, the yield on a major UK clearing bank CD ranged from 0.55% with a one month maturity to 1.79% on a one year maturity.

Index-linked gilts

18. Gilts (or gilt-edged securities) are AAA rated, sterling denominated negotiable bonds. They form the largest part of the government's debt portfolio. Conventional

gilts are the most abundantly issued with maturities up to 50 years. Index-linked and undated gilts are also available, though they are not as commonly traded.

19. Conventional gilts are denoted by the coupon and maturity date (e.g. 5% Treasury Gilt 2012). The coupon often reflects the market interest rate when the gilt was issued. Currently, there is a wide range of coupons in the market from 2% to 9%. The coupon indicates the cash payment per £100 nominal that the holder will receive per year (£100 nominal as a price, is known as par or 100.00). This is paid in two equal instalments six months apart, with the principal repaid on maturity. Index-linked gilts differ from conventional gilts in that both the semi-annual coupon payments and the principal payment are adjusted in line with movements in the General Index of Retail Prices in the UK (also known as the RPI).

20. Depending on the date of first issue, index-linked gilts have different indexation lags, and hence different methodologies for calculating cash flows. All index-linked gilts first issued prior to 2005 have an eight-month indexation lag, while all issued from 2005 onwards use a three-month indexation lag methodology. Calculation of cash flows can be extremely complex and further information is available should any Member wish to know.

21. Again, custodian facilities would be required and King & Shaxson could operate these on our behalf. They are actively involved in the gilt market and are able to quote net prices in any gilt upon request. All gilts are dealt on a price. This price also correlates to an equivalent market yield, known as the gross redemption yield (GRY). If the GRY is below the coupon at the time of purchase, the price of the gilt will be above par in order to counter the additional interest received from the higher coupon at the end of the coupon period. This means that the settlement consideration (or cost) increases. On the other hand, if the GRY is above the coupon of the gilt, the price will be below par and the settlement consideration decreases.

22. King & Shaxson's fee structure is as before, and yields range from approximately 0.50% for one month to three year maturities, out to just over 3% for 30 year maturities.

Money market funds

23. Money market funds are mutual funds that invest in short-term debt instruments. They provide the benefits of pooled investment, as investors can participate in a more diverse and high-quality portfolio than they otherwise could individually. Like other mutual funds, each investor who invests in a money market fund is considered a shareholder of the investment pool, a part owner of the fund. Money market funds are actively managed within rigid and transparent guidelines to offer safety of principal, liquidity and competitive sector-related returns.

24. There are two basic types of money market funds: constant net asset value (NAV) and accumulating net asset value. Shares in constant net asset value funds are issued with an unchanging face value (such as £1 per share). Income in the fund is accrued daily and can either be paid out to the investor or used to purchase more units in the fund at the end of the month. Accumulating net asset value funds, known alternatively as 'roll-up' funds, operate under the same investment guidelines as constant NAV funds and income is accrued daily. However, unlike

constant net asset value funds, income is not distributed. Instead income is reflected by an increase in the value of the fund shares.

25. Money market funds have as their primary objective the preservation of capital. Liquidity and competitive, sector related, returns are other key objectives. The rating process methodically identifies, assesses and weights each fund in terms of its ability to deliver on these objectives. The rating criteria broadly comprise four main areas of analysis that systematically address a fund's operating principles: its credit quality, portfolio construction, fund management and regular post-rating inspection. These are described in more detail below.

a) Credit quality

26. Credit quality is evaluated on three levels: what the fund can buy, who it can do business with (including the exact nature of business) and who it can appoint to keep its assets safe. The rating criteria therefore stipulate the fund's asset range and restrictions (such as quality, type and currency), acceptable counterparty risk (for all transaction based investments) and acceptable choice of custodian.

b) Portfolio construction

27. The most complex part of analysing a money market fund is judging a fund's sensitivity to changing market conditions and, therefore, gauging a measure of its ability to shield investors from adverse market swings. All money market securities (rated or otherwise) are subject to price fluctuations – based on interest rate movements, maturity, liquidity and the supply and demand for each type of security. Quantifying the cumulative effect of these is crucial to assessing overall portfolio performance.

28. Capital preservation is expressed in terms of the stability or constant accumulation of the fund's net asset value per share. As such, both formats are scrutinised for potential deviation in the fund's market value. Determination of market value, or portfolio price exposure, starts with the examination of susceptibility to rising interest rates. A critical component of this is the fund's weighted average portfolio maturity (or WAM), which is specifically restricted by rating category. The trade association for money market fund providers is the Institutional Money Market Fund Association (IMMFA). IMMFA members' funds, which are triple-A rated, must stay within a 60 day limit, an optimal level derived from portfolio stress testing analysis. Other variables evaluated include instrument liquidity, index and spread risk, portfolio diversification, potential dilution of investor holdings and portfolio valuation.

c) Fund management

29. The rating process requires an assessment of a fund manager's operations – in common parlance, the front, middle and back offices. Key areas of interest are the fund manager's level of experience, the stated investment objectives, portfolio management techniques, risk aversion strategies, operating procedures and internal controls, including disaster recovery. Owing to the precision necessary in running a money market fund successfully, every aspect of the fund's management must be able to withstand close scrutiny and demonstrate effective, ongoing integrity of operation.

d) Post-rating inspection

30. Owing to the constraints of the rating criteria and the extremely low margin of error permitted at the level of fund valuation, rated money market funds are contractually obliged to supply all portfolios for periodic rating agency inspection or fund surveillance, as it is called. Appendix B sets out recommended limits to be adhered to by fund managers.

31. The attraction of money market funds is that they operate much like a call account with instant access to deposits plus a yield that outperforms the DMADF and, usually, the other three types of alternative investment detailed above. A typical money market fund portfolio holding appears at Appendix C, whilst the latest data on all the available funds, including yields, appears at Appendix D. Fund manager fees vary between 10 and 25 basis points per annum, dependent on the level of investment and are netted from the overall rate of return.

Evaluation of individual money market funds

32. Part of the service offered by our treasury management advisors, Sector Treasury Services Ltd, is an independent selection process to aid clients investing in money market funds to choose a fund that best suits them. It has been designed to ensure the selection is independent and solely based on the characteristics of that fund. Using the Council's top three criteria of fund size, number of clients and fund performance, the results suggested the following five funds most closely matched those criteria:

- Ignis Asset Management
- Insight Investment
- BlackRock Investment Management
- Prime Rate Capital Management
- Legal & General Investment Management

Fact sheets supplied by the companies appear at Appendix E. Interviews with a representative from each one took place during December 2011 and January 2012. All of the companies satisfactorily answered Officers' pre-set list of questions relating to constant or variable NAV, fund sponsors, instrument composition, ease of access and other local authority clients.

33. In December 2011, Fitch Ratings announced that they had placed the Sterling Liquidity Fund managed by Prime Rate Capital Management on 'Negative Watch' pending a fuller review. This was somewhat of a technical issue, as concern had been raised about the financial resources of the fund sponsor (the Matrix Group) and its ability to provide support in extreme cases. It was stressed that the move was not in any way reflective of the underlying investments within the fund or the way the fund is managed. The fund remained AAA rated by Fitch pending the outcome of the review whilst another ratings agency, Standard & Poor's, had no plans to conduct a review. The outcome was that the sponsor sold its interest in

the fund to a much larger institution and Fitch immediately removed the Negative Watch in late January 2012.

34. Enquiries of nine other Kent districts have revealed that an average of 33% of their investment portfolios are in money market funds as at January 2012, ranging from 0% in two cases up to 59% at the top end. Nationally, from a sample of 150 authorities, 27% of the average portfolio was invested in money market funds.

Key Implications

Financial

35. The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

36. There are financial implications arising from the restriction of the Council's lending list following recent credit rating downgrades in that a large part of the portfolio has had to be placed with the Government or other local authorities at an inferior rate of interest.

Community Impact and Outcomes

37. There are no community impacts arising from this report.

Legal, Human Rights etc.

38. None.

Conclusions

39. Whilst the options of treasury bills, and index-linked gilts offer AAA rated security, investment returns on them are only marginally above the rate offered by the Government's own DMADF facility to which we already subscribe. Certificates of deposit are attractive from the point of view of counterparty diversification and liquidity with only marginally worse rates of return over equivalent fixed term deposits. The major drawback of all three options is their complexity and/or the need to keep them under constant review for the possibility of disposal. This is evidenced by the fact that very few local authorities, either in Kent or nationally, make use of them. They appear to be an important means of diversification for larger metropolitan districts, counties or pension fund authorities.

40. The analysis of the money market fund option shows that, amongst local authorities, this is a popular means of holding liquid cash assets with a reasonable rate of return. The five funds under consideration all meet the Council's requirements and it is proposed that two of them are selected for an initial investment of £1m. The maximum allowable under the Council's investment strategy is £5m per fund. Once we are comfortable with the way the funds operate, one or more of the other funds could be added.

41. The two money market funds being proposed for investment are Ignis and Insight, being the two that most closely match our requirements, plus the fact that they

are two of the largest in terms of asset size. However, Members' views on alternatives would be welcome.

Risk Assessment Statement

42. Treasury Management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and

- A counterparty to which the Council has lent money fails to repay the loan at the required time.

43. The movement towards having a restricted lending list of better quality institutions but higher individual limits with those institutions reduces the chances of a default. But if a default did occur, the potential loss would be greater. Previously, the preference was to have smaller investments with a greater range of institutions.

44. These risks are mitigated by the annual investment strategy which has been prepared on the basis of achieving the optimum return on investments commensurate with proper levels of security and liquidity. However, Members should recognise that in the current economic climate, these remain significant risks and that the strategy needs to be constantly monitored.

Appendices:	Appendix A – Treasury bill tender results Appendix B – Money market fund surveillance Appendix C – Typical money market fund composition Appendix D – Money market fund data Appendix E – Money market fund factsheets
Background Papers:	Treasury Management Strategy for 2012/13 - Council 21 February 2012 Submissions from five money market fund operators Submission from King & Shaxson Ltd. Weekly investment monitor, investment benchmarking service, and money market fund analysis provided by Sector Treasury Services Ltd.
Contact Officer(s):	Roy Parsons ext.7204

Dr. Pav Ramewal
Deputy Chief Executive and Director of Corporate Resources