RECOMMENDED PRACTICE

Use of Local Government Investment Pools (LGIPs) (2007 and 2008) (CASH)

Background. In many states, the state treasurer or the authorized governing board of another governmental entity (such as a county) oversees a pooled investment fund that operates like a money market mutual fund for the exclusive benefit of governments within the entity's jurisdiction.

Unlike mutual funds, however, local government investment pools (LGIPs) are not registered with the Securities and Exchange Commission (SEC) and are exempt from SEC regulatory requirements because they fall under a governmental exclusion clause. While this exemption allows pools greater flexibility, it also reduces investor protection. Investments in these pools are not insured or guaranteed and substantial losses have occurred in the past.

These pools typically combine the cash of participating jurisdictions and invest the cash in securities allowed under the state's laws regarding government investments. By pooling funds, participating governments benefit from economies of scale, full-time portfolio management, diversification, and liquidity (especially in the case of pools that seek a constant net asset value of $1.00). Interest is normally allocated to the participants on a daily basis, proportionate to the size of the investment. Most pools offer a check writing or wire transfer feature that adds value as a cash management tool.

Government Sponsored versus Joint Powers Agreement Pools
Local government investment pools (LGIPs) may be authorized under state statutes and sponsored by the state or local governments, or may be set up through intergovernmental agreements known as "joint powers" agreements.

In several states, local governments have joined together through joint powers agreements to sponsor the creation of LGIPs that operate independent of the state government. The investment authorization to pool funds is generally derived from state statutes that allow governments to perform collectively any service or administrative function that they may undertake individually. A board of trustees, normally made up of public officials, oversees these pools and typically selects a financial services firm to provide services such as the following: investment management, custodial services, participant record keeping, independent audits, and legal services. These pools may invest only in securities otherwise allowed to individual governments.

Whether the LGIP is state-sponsored or created through a joint powers agreement, it is important to be aware that the authorizing entity typically does not guarantee investments in the LGIP.

Not All Pools Are the Same
Although there are many similarities between the various LGIPs, there are also differences. One significant difference among pools that must be understood before placing money in them is their investment objectives. When LGIPs were first created, most emulated money market mutual funds with the objective of maintaining a "constant" Net Asset Value (NAV) of $1.00 and providing excellent liquidity for the investor. Such LGIPs invest in short-term securities with average maturities sufficiently short to avoid market price risk. The "constant" NAV pools are appropriate investments for funds that must be liquid and have virtually no price volatility.

There are also government investment pools that have an investment objective of maximizing return. These pools are variable Net Asset Value (NAV) pools and introduce market risk to the investor through a fluctuating NAV. They invest in longer-term securities, thus subjecting their portfolios and their participants to greater market price volatility. The principal invested in the pool may not be the same principal returned to the investor, depending on the movement of interest rates. While they may be appropriate for longer-term strategies, these pools ***would not*** be appropriate for funds that must be liquid and stable.

Other differences among pools include legal structure, authorized investments, procedures for depositing and withdrawing money, and services provided to participants. Each pool has a process that a participant must complete, including documents to be signed and banking information to be provided, in order to establish an account. Sources of information for evaluating pools may include a pool offering statement, investment policy or audited financial statements.

Rated LGIPs[1]

Rating agencies rate constant dollar LGIPs using the same criteria that they use for rating money market mutual funds. These ratings are based on safety of principal and ability to maintain a NAV of $1. Fluctuating NAV pool ratings include a volatility factor. Pool ratings can provide an additional method of due diligence.

Recommendation. The Government Finance Officers Association (GFOA) makes the following recommendations to governments that invest in or are considering investing in Local Government Investment Pools (LGIPs). Government investors should:

1. Confirm LGIPs are eligible investments under governing law and the government's investment policy.

2. Fully understand the investment objectives, legal structure and operating procedures of the investment pool before they place any money in the pool. When evaluating an LGIP, investors should read the pool's offering statement, investment policy, and audited financial statements carefully.

3. Pay particular attention to the investment objectives of a pool to determine whether the pool seeks to maintain a constant NAV of $1.00 or could have a fluctuating NAV. This information is essential in order to determine which pools are appropriate for liquidity strategies (constant NAV) and which ones are only appropriate for longer-term strategies (fluctuating NAV).

4. Review the pool's list of eligible securities to determine compliance with the participating government's investment policy. Portfolio maturity restrictions and diversification policies should be evaluated to determine potential market and credit risks.

5. Evaluate portfolio pricing practices.

6. Review custodial policies (e.g., delivery versus payment).

7. Evaluate the qualifications and experience of the portfolio manager, management team and/or investment adviser.

8. Review the earnings performance history relative to other investment alternatives. On constant NAV LGIP funds, the current yield of the portfolio can be compared with

[1] Not all LGIPs are rated.

competitive institutional money market funds, or overnight repurchase agreement rates. Standard & Poor's releases an index of LGIPs on a weekly basis that reports the average 7- and 30-day yields and average maturities of LGIPs holding its highest ratings (AAAm and AAm). Any pool with above-average yields or longer maturities should be further evaluated for risk.

9. Evaluate variable NAV LGIPs in relation to appropriate benchmarks.

10. Although ratings are not mandatory, seek LGIPs with the highest ratings, where possible.

11. Fully understand procedures for establishing an account, making deposits and withdrawals, and allocating interest earnings. There may be limits to the number of deposits and withdrawals in a month. There may also be dollar limits for deposits, withdrawals and balances. Deposits or withdrawals may require advanced notification, especially if they are large. If so, investors should be aware of the deadlines.

12. When selecting an LGIP, consider any additional services offered by an LGIP, such as: check writing, wire transfers, issuing paying agent services, setting up multiple accounts for an entity, and arbitrage accounting for bond funds.

13. Confirm that an LGIP provides regular, detailed reporting to pool participants and follows accepted reporting standards.

    GFOA recommends that pool administrators, on a daily basis, determine the market value of all securities in the pool and report this information to all pool participants on at least a monthly basis. These values should be obtained from a reputable and independent source. This information should be included in the report to the governing body prepared on at least a quarterly basis.

14. Be aware that an LGIP may be a part of a diversified portfolio but that a portfolio comprised solely of an LGIP may not provide the government entity with appropriate diversification.

References:

- *An Elected Officials Guide to Investing*, 2nd Edition, Sofia Anastopoulos, GFOA, 2007
- GFOA Recommended Practice: Diversification of Investments in a Portfolio, 2007
- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998
- *Standard & Poor's Guide to LGIPs*

Approved by the GFOA's Executive Board, October 17, 2008.