WELLS FARGO ASSET MANAGEMENT

Primer series

A primer on cash investment policy statements

An investment policy statement (IPS) is a document that serves as a policy guide to meet the goals and objectives of an investment portfolio over the long run. Therefore, it is an essential component of good corporate governance. Not only does having an IPS satisfy an important fiduciary duty and meet documentation requirements under the Sarbanes-Oxley Act, it provides discipline to the investment process, helps avoid surprises from asset managers, and is an effective risk management tool that endures the ups and downs of market cycles.

An IPS helps with several practical matters as well. It focuses everyone responsible for the management of an entity's cash assets on its unique circumstances as they document the objectives and constraints. It facilitates an informed discussion with an entity's investment professional about risk and reward trade-offs. It also clarifies roles and responsibilities.

This primer is intended to help investment committee members develop their own IPS and is most relevant for clients requiring liquidity solutions for mandates such as operating cash, capital market proceeds, construction funds, cash being set aside for specific purposes, cash allocations within a larger investment plan, and employee benefit plans. Whether clients ultimately invest in separate accounts or mutual funds, the first step in developing an IPS is the same: to fully understand the institution's specific situation, including investment objectives, risk tolerance, return needs, and investment constraints.

Essential components of an IPS

This primer suggests seven main components, including a checklist for specific elements within some of the components, to consider when developing an IPS. An IPS should be specific to a client; we offer this outline as a starting point for creating or revising an IPS.

1. **Purpose and scope.** The overview section of an IPS typically defines the institutional investor by legal name, be it a natural person or legal/corporate entity, and specifies which of the investor's assets will be governed by the IPS. It states the general purpose of the funds for the organization. This section may also document who—specified as a committee or role—is responsible for the application of the IPS and who has ultimate oversight responsibility.
2. **Roles and responsibilities.** The roles and responsibilities of all involved parties should be clearly defined. Parties will likely include the board of directors, the investment committee, investment managers, investment consultants, custodians, and outside vendors. Including the CEO, CFO, and treasury department also may be appropriate.
3. **Investment objectives.** The objectives are the investment goals, which should be expressed in terms of both risk and return. As a practical matter, we usually see clients with cash and short-duration assets prioritize their investment objectives in the order of capital preservation, adequate liquidity, and competitive returns.
   - **Investment risk tolerance.** While a risk-averse client is likely to seek capital preservation above all other objectives, there are a number of sources of risk that an investment committee needs to consider, such as credit risk, interest-rate risk, and liquidity risk. The potential effect of these risks on a cash portfolio should help an investment committee understand the risk they may be undertaking and the amount of risk they are willing to take.
   - **Return requirements.** Here an investment committee should consider how much return is

needed and is realistic for various yield environments. The type of return matters as well. Shorter-term operating cash portfolios may not require much in terms of total return and may focus primarily on capital preservation. Others may need a certain amount of income, or yield, and still others may seek a combination of income and capital appreciation and therefore specify total return requirements.

4. **Investment constraints.** A client's unique situation will determine its investment constraints. Below is a checklist of potential constraints that may affect an investment strategy.
   - **Liquidity needs.** An asset is liquid if it can be converted quickly to cash at a fair market value. Evaluate cash-flow expectations by considering major uses and sources of cash to determine short- or medium-term needs for cash on an ongoing basis.
   - **Time horizon.** Time horizon is closely related to liquidity needs and risk tolerance. A short time horizon is associated with greater liquidity needs and less tolerance for risk because the cash needs are immediate.
   - **Tax concerns.** Depending on an entity's tax status, taxable or tax-exempt investments may be preferred. Further, any restrictions on capital gains or losses need to be understood.
   - **Legal and regulatory factors.** Common constraints may involve the Investment Company Act of 1940 that applies to research and technology firms with few hard assets, offshore investing regulations, Rule 144A offerings for qualified institutional buyers, and industry-specific regulations for banking or insurance companies.
   - **Unique circumstances.** This category covers constraints that are specific to the client. One example is a client's choice to ban investments that do not fit their socially responsible criteria, such as investments in tobacco, alcohol, firearms, or environmentally harmful companies. There may be other limitations as well that don't fit neatly into one of the categories above but that are important to the company and therefore must be registered in the IPS.

5. **Investment assets.** Within the cash and short-duration asset class, the goal is to diversify risk across the asset class. Below is a checklist of considerations for a client's investment assets.
   - **Permitted investments.** A list of permitted investments describes the types of investments that are allowed. (See Appendix A.) The permitted investments should be consistent with credit and duration constraints and well diversified with limits per security and limits per issuer to provide downside protection by limiting volatility. We strongly recommend a broad spectrum of investment types should be allowed because it enables more diversification, which in turn provides better risk-adjusted returns and less volatility.
     - i. **Money market funds and short-term bond funds are listed here.** A fund must be appropriate for both the goals and investment constraints of the client as well as in accordance with the spirit of its IPS. It is important to treat a fund as an approved investment type rather than look at each security within the fund on an individual basis. For example, if an IPS stated that an investment's maximum final maturity was 365 days, then it would be consistent to approve an investment in a money market fund that buys floating-rate notes (FRNs)—including FRNs with two-year final maturities—because the client would have daily access to its money and the daily redemption feature of the money market fund would meet the IPS maturity restriction. The FRNs would meet the spirit of the IPS and the investment constraints of the client.
   - **Credit quality.** Investment committee members should begin their discussion about credit-quality limits with an understanding of the risk/reward trade-offs of investing in lower-rated credits. Then they can determine the specifications within the IPS for the minimum average credit quality of the portfolio, the minimum rating for each security, and if the ratings must be those of a Nationally Recognized Statistical Rating Organization (NRSRO). It is important to be specific about ratings. In particular, credit limits should specify the plus and minus tiers, such as whether a minimum rating of A means A- or only A. The treatment of split ratings—when an issue has different ratings from different rating agencies—should be specified. (See Appendix B.)
   - **Diversification.** Diversification limits are specified to mitigate against downside risk and reduce overall portfolio volatility. The IPS language should note the maximum percentage of the overall portfolio that is allowed per issuer and per sector.

- **Duration.** Duration measures the interest-rate sensitivity of a portfolio. Investment committee members understand the risk/reward trade-offs, particularly those clients who desire returns and who are willing to accept some volatility of returns. Money market funds, which are required to have a maximum weighted average maturity of 60 days, largely avoid this issue by owning a high percentage of liquid, ultra-short-term investments so that maturing bonds or bonds trading near par can be used to adjust a fund's maturity, which moves in a more narrow band than most short-duration strategies.

- **Liquidity targets.** Document if the portfolio must be constructed with a certain amount of liquidity. If so, set the client's minimum target level for the percentage of total cash available for daily, monthly, or quarterly liquidity.

- **Taxable and tax-exempt investments.** Include the appropriate types of investment in the list of allowable investments. Understanding a client's specific situation will allow the IPS to specify if only tax-exempt investments or taxable investments are allowed. Both types may be allowed if a company seeks to maximize after-tax returns.

- **Realized gains and losses.** Note restrictions on losses, such as a certain percent or dollars per month. Note if there are any restrictions on gains. We have found that having a gain/loss budget is helpful because it allows an investment manager to be nimble, giving them the flexibility to sell a security to invest in a better opportunity or exit a deteriorating situation.

6. **Performance evaluation.** Performance evaluation aids oversight by providing a regular assessment of performance relative to established investment objectives.

   - **Benchmarks.** Investment performance is evaluated in order to judge how the portfolio is performing relative to its established investment objectives. It is best to compare short-duration performance with a benchmark that is unambiguous (clearly understood by all parties), investable, measurable, and appropriate to the risk tolerance and return objectives of the client. Common cash benchmarks include Bloomberg Barclays and BofA Merrill Lynch short-term fixed-income indexes. Relative performance is commonly reviewed, such as the average of a Lipper short-term funds category, but peer-group comparisons may include peers with different risk tolerances and constraints, and they are ambiguous because it is difficult to know the investment holdings of the peer group.

   - **Performance appraisal.** It is important to review a consistent set of appropriate metrics for performance and risk measurement so that meaningful comparisons can be made over time. The IPS should define the metrics that will be reviewed on a regular basis.

7. **Investment policy review.** An investment committee should periodically review the IPS, and the frequency of review should be stated within the IPS. It is appropriate to modify an IPS when, for example, material changes occur to a client's own circumstances or competitive environment; government regulation; or permanent changes in the investment landscape, such as the development of new products.

Conclusion

An IPS is important because it enforces logical, disciplined investment decision-making and it limits the temptation to make counterproductive changes to an investment program during times of stress. Because there isn't a one-size-fits-all IPS that is appropriate for all cash and short-duration portfolios, it is necessary to thoroughly understand and document a client's investment objectives, risk tolerance, and total return needs; understand the client's investment constraints; and then establish an appropriate investment strategy.

For more information, please contact:

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APPENDIX A: Example of permitted investments for a short-term cash mandate

Security type	Definition
U.S. Treasury bills, notes, and bonds	U.S. government-guaranteed securities. These are generally considered the most liquid and creditworthy securities in the U.S. market.
U.S. government agency debt	Debt obligations issued by agencies of the U.S. government, such as the Federal National Mortgage Association (FNMA), the Federal Home Loan Bank (FHLB), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal Farm Credit Bank (FFCB).
Sovereign and supranational debt	Foreign-domiciled government or related entities that issue bonds denominated in U.S. dollars under U.S. securities law for sale in the United States as well as globally. ▪ **Foreign agencies:** entities or branches of a foreign government. While the debt may not be guaranteed by the government, there is an implied guarantee because their interests are aligned. ▪ **Sovereigns:** a bond issued by a foreign government denominated in U.S. dollars and registered with the Securities and Exchange Commission for sale in the U.S. and globally. ▪ **Supranational:** an entity that is formed by two or more central governments through international treaties with the purpose of promoting the economic development of the member countries. ▪ **Foreign local governments:** local governments of a foreign country such as a state, province, or city.
Repurchase agreements	A repurchase agreement (repo) is the sale of a security with a simultaneous commitment by the seller to repurchase the security from the buyer at a future date at a predetermined price. This transaction allows one party (the seller) to obtain financing from another party (the buyer). The security is held as collateral, protecting the buyer against the risk that the seller is unable to repurchase the security as designated. In this way, a repo transaction may be thought of as a collateralized loan to the seller of the repo. The Securities and Exchange Commission categorizes repos according to the type of collateral, as either Treasury repos, government agency repos, or other repos.
Commercial paper	An unsecured promissory note (maturities of 1–270 days) issued by banks, corporations, and finance companies.
Asset-backed commercial paper	Asset-backed commercial paper (ABCP) is a form of short-term borrowing limited to a maturity of no more than 397 days. ABCP allows financial institutions to offer an additional funding option for their customers by pooling their assets to back the paper. These assets may consist of trade receivables, consumer receivables, auto loans and leases, student loans, corporate loans, or other types of financial assets. ABCP programs typically have 100% liquidity support provided by a financial institution.
Certificates of deposit (domestic, Eurodollar, and Yankee)	A marketable receipt for funds deposited in a bank or thrift institution for a specific time period at a stated rate of interest. Eurodollar CDs are issued by large U.S. or foreign banks usually paid in London in U.S. dollars. Yankee CDs are obligations of foreign banks issued in the United States.
Time deposits	Certificates of deposit held in a financial institution for a negotiated fixed term or with the understanding that the depositor can withdraw only by giving notice.
Money market funds	Money market funds (MMFs) are governed by Rule 2a-7 with strict rules to enhance liquidity, preservation of capital, and transparency. A MMF may be a standalone investment choice for short-term liquidity mandates. They are also used as a sweep vehicle to invest excess funds of longer-term mandates.
Taxable short-term municipal debt	Taxable bonds issued by tax-exempt issuers, such as universities and municipalities.

Security type	Definition
Corporate debt securities (notes, bonds, and medium-term notes)	Corporate debt instrument. Maturities range from 9 months to 30 years. ▪ **Rule 144A offerings:** a Rule 144A security can be resold to persons or institutions that are reasonably believed to be qualified institutional buyers who own or invest on a discretionary basis at least $100 million of qualified securities. ▪ **Yankee corporates:** a dollar-denominated bond issued by a foreign corporation issued under U.S. securities law for sale in the United States and globally.
Asset-backed securities	Pass-through securities backed by loans, leases, credit card receivables, or installment contracts. Asset-backed securities have final maturities ranging from three to five years at the time of issue with the average time to receipt of principal (average life) ranging from one to three years.
Mortgage-backed securities, including collateralized mortgage obligations	Investment instruments that represent ownership of an undivided interest in a group of mortgages. ▪ **Collateralized mortgage obligations:** a security backed by a pool of pass-throughs or a pool of mortgage loans. The prepayments are segmented to allow for more predictable cash flows.
Commercial mortgage-backed securities	Instruments secured by loans on commercial properties.
Variable-rate demand notes	Variable-rate demand notes are longer-term municipal securities that feature both a periodic coupon reset and a demand feature that allows an investor to periodically tender, or put, the securities at par plus accrued interest.
Tender option bonds	Tender option bonds are a repackaging of long-term municipal obligations into a money market–eligible class of floating-rate securities, which may be tendered at par plus accrued interest.
Short-term municipal debt	Municipal securities typically secured by general governmental funds from tax revenue or a municipally operated enterprise.
Short-term and ultra short-term bond funds	Pooled investment vehicles that invest in short-duration fixed-income assets, with strategies for duration, credit, and security types as specified in their prospectuses. Consider those funds that have similar objectives and risk tolerances for safety and liquidity as stated within an IPS; as a result, the fund will be approved as a specific investment type that is appropriate for the client rather than looking through to its underlying investments.

APPENDIX B: Credit ratings overview

These tables provide an overview of short- and long-term credit ratings by three of the NRSROs. The ratings definitions were derived from NRSRO ratings definition documentation. For further information about ratings criteria, please refer to the rating agencies.

Short-term taxable ratings

Standard & Poor's		Moody's		Fitch	
Level of safety	**Rating**	**Level of safety**	**Rating**	**Level of safety**	**Rating**
Extremely strong capacity to meet its financial commitments	A-1+	Superior ability to repay short-term debt obligations	P-1	Exceptionally strong capacity for timely payment of financial commitments	F1+
Strong	A-1	Strong	P-2	Highest short-term credit quality	F1
Satisfactory	A-2	Acceptable	P-3	Good	F-2
Adequate	A-3	–	–	Fair	F-3

Long-term credit ratings

Standard & Poor's		Moody's		Fitch	
Level of safety	Rating	Level of safety	Rating	Level of safety	Rating
Highest	AAA	Highest quality	Aaa	Highest	AAA
Very strong	A-1	High quality	Aa1 Aa2 Aa3	Very high	AA+ AA AA-
Strong	A+ A A-	Upper-medium grade	A1 A2 A3	High	A+ A A-
Adequate	BBB+ BBB BBB-	Medium-grade, subject to moderate credit risk and may possess certain speculative characteristics	Baa1 Baa2 Baa3	Good credit quality	BBB+ BBB BBB-
Significant speculative characteristics but less vulnerable in near-term than lower-rated credits	BB+ BB BB-	Speculative and subject to substantial credit risk	Ba1 Ba2 Ba3	Speculative	BB+ BB BB-
Currently has ability to meet financial commitments, but adverse conditions will likely impair	B+	Speculative and subject to high credit risk	B1 B2 B3	Highly speculative	B+ B B-
Currently vulnerable	CCC	Speculative of poor standing and subject to very high credit risk	Caa	Substantial credit risk	CCC
Highly vulnerable	CC	Highly speculative and likely in or near default	Ca	Very high levels of credit risk	CC
–	–	Lowest rated and likely in or very near default	C	Exceptionally high levels of credit risk	C
Default	D	See specific definitions of default from Moody's		Default	D

Note: *Shaded rows indicate investment-grade credits.*

A money market fund rating is a forward-looking opinion about a fixed-income fund's capacity to maintain stable principal (net asset value). Standard & Poor's designates money market fund ratings with a subscript letter *m* (for example, AAA_m), which distinguishes it from a Standard & Poor's long-term debt rating. Moody's designates money market fund ratings with the subscript letters *mf*.

The views expressed and any forward-looking statements are as of December 2015 and are those of Wells Fargo Funds Management, LLC.

You could lose money by investing in a money market fund. Funds that seek to preserve the value of your investment at $1.00 per share cannot guarantee to do so. Because the share price of some funds may fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. Some money market funds may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the fund's liquidity falls below required minimums because of market conditions or other factors. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. A fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.

Carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For a current prospectus and, if available, a summary prospectus, containing this and other information, visit wellsfargofunds.com. Read it carefully before investing.

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