

# City of Sealy, Texas

## Investment Policy





# **CITY OF SEALY, TEXAS INVESTMENT POLICY**

## **I. POLICY**

It is the policy of the City of Sealy, Texas (hereinafter referred to as the “City”) that, after allowing for the anticipated cash flow requirements of the City and giving due consideration to the safety and risk of investment, all available funds shall be invested in conformance with these legal and administrative guidelines, seeking to optimize interest earnings to the maximum extent possible.

Effective cash management is recognized as essential to good fiscal management. Investment income is a source of revenue to the City’s funds. The City’s investment portfolio shall be designed and managed in a manner designed to maximize this revenue source, to be responsive to public trust, and to be in compliance with legal requirements and limitations.

Investments shall be made with the primary objectives of (a) safety and preservation of principal, (b) maintenance of sufficient liquidity to meet operating needs, (c) public trust from prudent investment activities, and (d) optimization of interest earnings on the portfolio.

## **II. PURPOSE**

The purpose of this investment policy is to comply with Chapter 2256 of the Government Code (hereinafter referred to as the “Public Funds Investment Act”), which requires each municipality to adopt a written investment policy regarding the investment of its funds and funds under its control. The investment policy addresses the methods, procedures, and practices that must be exercised to ensure effective and judicious fiscal management of the City’s funds.

## **III. SCOPE**

This investment policy shall govern the investment of all financial assets of the City. These funds are accounted for in the City’s Comprehensive Annual Financial Report (CAFR) and include:

- General Fund
- Special Revenue Funds
- Capital Projects Funds
- Enterprise Funds
- Trust and Agency Funds, to the extent not required by law or existing contract to be kept segregated and managed separately
- Debt Service Funds, including reserves and sinking funds, to the extent not required by law or existing contract to be kept segregated and managed separately
- Any new fund created by the City, unless specifically exempted from this policy by the City Council or by law.

This investment policy shall apply to all transactions involving the financial assets and related activity for all the foregoing funds.

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## IV. INVESTMENT OBJECTIVES

The City shall manage and invest its cash with four primary objectives, listed in order of priority: **safety, liquidity, public trust, and yield, expressed as optimization of interest earnings.** The safety of the principal invested always remains the primary objective. All investments shall be designed and managed in a manner responsive to the public trust and consistent with state and local law.

The City shall maintain a comprehensive cash management program, which includes collection of accounts receivable, vendor payments in accordance with invoice terms, and prudent investment of available cash. Cash management is defined as the process of managing monies in order to ensure maximum cash availability and maximum earnings on short-term investment of idle cash.

### Safety

Safety of principal is the foremost objective of the investment program. Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. The objective will be to mitigate credit and interest rate risk.

- *Credit Risk:* The City will minimize credit risk, the risk of loss due to the failure of the issuer or backer of the investment, by:
  - Limiting investments to the safest types of investments,
  - Pre-qualifying the financial institutions with which the City will do business, and
  - Diversifying the investment portfolio so that potential losses on individual issuers will be minimized.
  
- *Interest Rate Risk:* The City will minimize the risk that the interest earnings and the market value of investments in the portfolio will fall due to changes in general interest rates by:
  - Structuring the investment portfolio so that investments mature to meet cash requirements for ongoing operations, thereby avoiding the need to liquidate investments prior to maturity,
  - Investing operating funds primarily in certificates of deposit and local government investment pools functioning as money market mutual funds, and
  - Diversifying maturities and staggering purchase dates to minimize the impact of market movements over time.

### Liquidity

The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This is accomplished by structuring the portfolio so that investments mature concurrently with cash needs to meet anticipated demands. Because all possible cash demands cannot be anticipated, all or a portion of the portfolio will be invested in local government investment pools that offer same-day liquidity.

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## **Public Trust**

All participants in the City's investment process shall seek to act responsibly as custodians of the public trust. Investment Officers shall avoid any transaction that might impair public confidence in the City's ability to govern effectively.

## **Yield (Optimization of Interest Earnings)**

The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above.

## **V. RESPONSIBILITY AND CONTROL**

### **Delegation of Authority**

In accordance with the Public Funds Investment Act, the City Council designates the Director of Finance as the City's Investment Officer. The Investment Officer is authorized to execute investment transactions on behalf of the City. No person may engage in an investment transaction or the management of City funds except as provided under the terms of this investment policy as approved by the City Council. The investment authority granted to investing officers is effective until rescinded by the City Council.

### **Quality and Capability of Investment Management**

The City shall provide periodic training in investments for the designated Investment Officer and other investment personnel through courses and seminars offered by professional organizations, associations, and other independent sources in order to ensure the quality and capability of investment management in compliance with the Public Funds Investment Act.

### **Training Requirement**

In accordance with the Public Funds Investment Act, the designated Investment Officer shall attend an investment training session no less often than once every two years commencing September 1, 1997, and shall receive not less than ten (10) hours of instruction relating to investment responsibilities. A newly appointed Investment Officer must attend a training session of at least ten (10) hours of instruction within twelve (12) months of the date the officer took office or assumed the officer's duties. The investment training session shall be provided by an independent source approved by the City Council. For purposes of this policy, an "independent source" from which investment training shall be obtained shall include a professional organization, an institution of higher education, or any other sponsor other than a business organization with whom the City may engage in an investment transaction.

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## **Internal Controls**

The Director of Finance is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the City are protected from loss, theft, or misuse. The internal control structure shall be designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management.

Accordingly, the Director of Finance shall establish a process for annual independent review by an external auditor to assure compliance with policies and procedures. The internal controls shall address the following points:

- Control of collusion,
- Separation of transactions authority from accounting and record keeping,
- Custodial safekeeping,
- Avoidance of physical delivery securities,
- Clear delegation of authority to subordinate staff members,
- Written confirmation for telephone (voice) transactions for investments and wire transfers, and
- Development of a wire transfer agreement with the depository bank or third party custodian.

## **Prudence**

The standard of prudence to be applied by the Investment Officer shall be the “prudent investor” rule. This rule states, “Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.” In determining whether the Investment Officer has exercised prudence with respect to an investment decision, the determination shall be made taking into consideration:

- The investment of all funds, or funds under the City’s control, over which the officer had responsibility rather than a consideration as to the prudence of a single investment, and
- Whether the investment decision was consistent with the written approved investment policy of the City.

## **Indemnification**

The Investment Officer, acting in accordance with written procedures and exercising due diligence, shall not be held personally responsible for a specific investment’s credit risk or market price changes, provided that these deviations are reported immediately and the appropriate action is taken to control adverse developments.

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## **Ethics and Conflicts of Interest**

Officers and employees involved in the investment process shall refrain from personal business activity that would conflict with the proper execution and management of the investment program or that would impair their ability to make impartial decisions. Employees and Investment Officers shall disclose any material interests in financial institutions with which they conduct business. They shall further disclose any personal financial/investment positions that could be related to the performance of the investment portfolio.

An Investment Officer of the City who has a personal business relationship with an organization seeking to sell an investment to the City shall file a statement disclosing that personal business interest. An Investment Officer who is related within the second degree by affinity or consanguinity to an individual seeking to sell an investment to the City shall file a statement disclosing that relationship. A statement required under this subsection must be filed with the Texas Ethics Commission and the City Council.

## **VI. SUITABLE AND AUTHORIZED INVESTMENTS**

### **Portfolio Management**

The City currently has a “buy and hold” portfolio strategy. Maturity dates are matched with cash flow requirements and investments are purchased with the intent to be held until maturity. However, investments may be liquidated prior to maturity for the following reasons:

- An investment with declining credit may be liquidated early to minimize loss of principal.
- Cash flow needs of the City require that the investment be liquidated.

### **Investments**

City funds governed by this policy may be invested in the instruments described below, all of which are authorized by Chapter 2256 of the Government Code (Public Funds Investment Act). Investment of City funds in any instrument or security not authorized for investment under the Act is prohibited. The City will not be required to liquidate an investment that becomes unauthorized subsequent to its purchase.

#### **A. Authorized**

- Certificates of Deposit issued by a bank organized under Texas law, the laws of another state, or federal law, that has its main office or a branch office in Texas, or by a savings and loan association or a savings bank organized under Texas law, the laws of another state, or federal law, that has its main office or a branch office in Texas and that is guaranteed or insured by the Federal Deposit Insurance Corporation or its successor or secured by obligations in a manner and amount provided by law for deposits of the City.

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- Local government investment pools, which (1) meet the requirements of Chapter 2256.016 of the Public Funds Investment Act, (2) are rated no lower than AAA or an equivalent rating by at least one nationally recognized rating service, (3) seek to maintain a \$1.00 net asset value, and (4) are authorized by resolution or ordinance of the City Council.

All prudent measures will be taken to liquidate an investment that is downgraded to less than the required minimum rating.

## **B. Not Authorized**

Investments including interest-only or principal-only strips of obligations with underlying mortgage-backed security collateral and collateralized mortgage obligations with an inverse floating interest rate or a maturity date of over 10 years are strictly prohibited.

## **VII. INVESTMENT PARAMETERS**

### **Maximum Maturities**

The longer the maturity of investments, the greater their price volatility. Therefore, it is the City's policy to concentrate its investment portfolio in shorter-term securities in order to limit principal risk caused by changes in interest rates.

The City attempts to match its investments with anticipated cash flow requirements. The City will not directly invest in securities maturing more than two (2) years from the date of purchase; however, the above described certificates of deposit may be collateralized using longer dated investments.

### **Diversification**

The City recognizes that investment risks can result from issuer defaults, market price changes, or various technical complications leading to temporary illiquidity. Risk is controlled through portfolio diversification that shall be achieved by the following general guidelines:

- Limiting investments to avoid over-concentration in investments from a specific issuer or business sector (excluding certificates of deposit that are fully insured and collateralized in accordance with state and federal law), and
- Continuously investing a portion of the portfolio in readily available funds such as local government investment pools (LGIPs) to ensure that appropriate liquidity is maintained in order to meet ongoing obligations.

The following maximum limits, by instrument, are established for the City's total portfolio:

- Certificates of Deposit ..... 75%

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- Authorized Pools ..... 100%

## VIII. SELECTION OF FINANCIAL INSTITUTIONS

### Depository

At least every three (3) years, a depository shall be selected through the City's banking services procurement process, which shall include a formal request for proposal (RFP). The selection of a depository will be determined by competitive bid, and evaluation of bids will be based on the following selection criteria:

- The ability to qualify as a depository for public funds in accordance with state law,
- The ability to provide requested information or financial statements for the periods specified,
- The ability to meet all requirements in the banking RFP,
- Complete response to all required items on the bid form, and
- Lowest net banking service cost, consistent with the ability to provide an appropriate level of service.

### Authorized Investment Providers

The City shall, at least annually, review, revise, and adopt a list of qualified financial institutions authorized to engage in investment transactions with the City. All investment providers, including financial institutions, banks, and local government investment pools, must sign a certification acknowledging that the organization has received and reviewed the City's investment policy and that reasonable procedures and controls have been implemented to preclude investment transactions that are not authorized by the City's policy.

### Competitive Bids

It is the policy of the City to require competitive bidding for all individual security purchases and sales except for transactions with local government investment pools. The Director of Finance shall develop and maintain procedures for ensuring a competition in the investment of the City's funds.

### Delivery vs. Payment

Securities shall be purchased using the **delivery vs. payment** method with the exception of investment pools. Funds will be released after notification that the purchased security has been received.

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## **IX. SAFEKEEPING OF SECURITIES AND COLLATERAL**

### **Safekeeping and Custodian Agreements**

The City shall contract with a bank or banks for the safekeeping of securities either owned by the City as part of its investment portfolio or held as collateral to secure demand or time deposits. Securities owned by the City shall be held in the City's name as evidenced by safekeeping receipts of the institution holding the securities.

Collateral for deposits will be held by a third party custodian designated by the City and pledged to the City as evidenced by safekeeping receipts of the institution with which the collateral is deposited. Original safekeeping receipts shall be obtained. Collateral may be held by the depository bank's trust department, a Federal Reserve bank or branch of a Federal Reserve bank, a Federal Home Loan Bank, or a third party bank approved by the City.

### **Collateral Policy**

Consistent with the requirements of the Public Funds Collateral Act, it is the policy of the City to require full collateralization of all City funds on deposit with a depository bank, other than investments. In order to anticipate market changes and provide a level of security for all funds, the collateralization level will be 102% of market value of principal and accrued interest on the deposits or investments less an amount insured by the FDIC. At its discretion, the City may require a higher level of collateralization for certain investment securities. Securities pledged as collateral shall be held by an independent third party with which the City has a current custodial agreement. The Director of Finance is responsible for entering into collateralization agreements with third party custodians in compliance with this Policy. The agreements are to specify the acceptable investment securities for collateral, including provisions relating to possession of the collateral, the substitution or release of investment securities, ownership of securities, and the method of valuation of securities. A clearly marked evidence of ownership (safekeeping receipt) must be supplied to the City and retained. Collateral shall be reviewed at least monthly to assure that the market value of the pledged securities is adequate.

### **Collateral Defined**

The City shall accept only the following types of collateral:

- Obligations of the United States or its agencies and instrumentalities,
- Direct obligations of the state of Texas or its agencies and instrumentalities,
- Collateralized mortgage obligations directly issued by a federal agency or instrumentality of the United States, the underlying security for which is guaranteed by an agency or instrumentality of the United States,
- Obligations of states, agencies, counties, cities, and other political subdivisions of any state rated as to investment quality by a nationally recognized rating firm not less than A or its equivalent with a remaining maturity of ten (10) years or less,
- A surety bond issued by an insurance company rated as to investment quality by a nationally recognized rating firm not less than A, and

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- A letter of credit issued to the City by the Federal Home Loan Bank.

## **Subject to Audit**

All collateral shall be subject to inspection and audit by the Director of Finance or the City's independent auditors.

## **X. PERFORMANCE**

### **Performance Standards**

The City's investment portfolio will be managed in accordance with the parameters specified within this policy. The portfolio shall be designed with the objective of obtaining a rate of return through budgetary and economic cycles, commensurate with the investment risk constraints and the cash flow requirements of the City.

### **Performance Benchmark**

It is the policy of the City to purchase investments with maturity dates coinciding with cash flow needs. Through this strategy, the City shall seek to optimize interest earnings utilizing allowable investments available on the market at that time. Market value will be calculated on a quarterly basis on all securities owned and compared to current book value. The City's portfolio shall be designed with the objective of regularly meeting or exceeding the average rate of return on U.S. Treasury Bills at a maturity level comparable to the City's weighted average maturity in days.

## **XI. REPORTING**

### **Methods**

The Investment Officer shall prepare an investment report on a quarterly basis that summarizes investment strategies employed in the most recent quarter and describes the portfolio in terms of investment securities, maturities, and shall explain the total investment return for the quarter.

The quarterly investment report shall include a summary statement of investment activity prepared in compliance with generally accepted accounting principals. This summary will be prepared in a manner that will allow the City to ascertain whether investment activities during the reporting period have conformed to the investment policy. The report will be provided to the City Council. The report will include the following:

- A listing of individual securities held at the end of the reporting period,
- Unrealized gains or losses resulting from appreciation or depreciation by listing the beginning and ending book and market value of securities for the period,
- Additions and changes to the market value during the period,

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- Average weighted yield to maturity of portfolio as compared to applicable benchmark,
- Listing of investments by maturity date,
- Fully accrued interest for the reporting period,
- The percentage of the total portfolio that each type of investment represents, and
- Statement of compliance of the City's investment portfolio with state law and the investment strategy and policy approved by the City Council.

### **Monitoring Market Value**

Market value of all securities in the portfolio will be determined on a quarterly basis. These values will be obtained from a reputable and independent source and disclosed to the governing body quarterly in a written report.

## **XII. INVESTMENT POLICY ADOPTION**

The City's investment policy shall be adopted by resolution of the City Council. It is the City's intent to comply with state laws and regulations. The City's investment policy shall be subject to revisions consistent with changing laws, regulations, and needs of the City. The City Council shall adopt a resolution stating that it has reviewed the policy and investment strategies annually, approving any changes or modifications.

## **XIII. INVESTMENT STRATEGY**

The City shall maintain an investment portfolio that utilizes specific investment strategy considerations designed to address the unique characteristics of its various fund groups. In order to minimize risk of loss due to interest rate fluctuations, investment maturities will not exceed the anticipated cash flow requirements of the funds. Authorized securities will be of the highest credit quality, and when not matched to liabilities, they will be short-term and liquid. The portfolio will be diversified to avoid market and credit risks. Diversification and full liquidity requirements will be met through the use of investment pools and certificates of deposit. Investment guidelines by fund type are as follows:

- A. Investment strategies for operating funds and commingled cash pools containing operating funds have as their primary objective to assure that anticipated cash flows are matched with adequate investment liquidity. The secondary objective is to create a portfolio structure which will experience minimal volatility during economic cycles.
- B. Investment strategies for debt service funds shall have as their primary objective the assurance of investment liquidity adequate to cover the debt service obligation on the required payment date. Securities purchased shall not have a stated final maturity date which exceeds the debt service payment date.
- C. Investment strategies for debt service reserve funds shall have as their primary objective

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the ability to generate a dependable revenue stream to the appropriate debt service fund from securities with a low degree of volatility. Securities should be of high quality and, except as may be required by the bond ordinance specific to an individual issue, of short-to intermediate-term maturities.

- D. Investment strategies for special projects or special purpose fund portfolios will have as their primary objective to assure that anticipated cash flows are matched with adequate investment liquidity. The stated final maturity dates of securities held should not exceed the estimated project completion date.

### **XIV. APPROVED INVESTMENT PROVIDERS**

#### **Local Government Investment Pools**

TexPool  
TexPool Participant Services  
Federated Investors, Inc.  
1001 Texas Avenue, Suite 1400  
Houston, TX 77002  
Phone: (866) 839-7665  
Fax: (866) 839-3291

TexSTAR  
TexSTAR Participant Services  
First Southwest Asset Management, Inc.  
325 North St. Paul Street, Suite 800  
Dallas, TX 75201  
Phone: (800) 839-7827  
Fax: (214) 953-8878

#### **Financial Institutions/Banks**

Any bank organized under Texas law, the laws of another state, or federal law, that has its main office or a branch office in Texas, or by a savings and loan association or a savings bank organized under Texas law, the laws of another state, or federal law, that has its main office or a branch office in Texas and that is guaranteed or insured by the Federal Deposit Insurance or its successor or secured by obligations in a manner and amount provided by law for deposits of the Entity.

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## GLOSSARY OF INVESTMENT TERMS

**Accretion:** The increase in value of an asset toward its redemption price over time as it approaches maturity. The discount amount is accreted to par over the life of the security on a daily basis.

**Accrued Interest:** The accumulated interest due on a bond as of the last interest payment made by the issuer of the bond. The security is always sold with the accrued interest included.

**Agency Security:** A U.S. government-issued security that was not issued by the Treasury Department but that may be backed by the full faith and credit of the United States depending upon the issuing agency. A debt security issued by a federal or federally sponsored agency, such as the Federal National Mortgage Association (FNMA).

**Amortization:** The decrease in value of an asset to its redemption price over time as it approaches maturity. On a mortgage backed security, the reduction through periodic repayments of both interest and principal. The premium amount is amortized to par over the life of the security on a daily basis.

**Arbitrage:** Profiting from the differences in price when the same security, currency, or commodity is traded on two or more markets.

**Arbitrage Bonds:** Bonds issued by a municipality in the tax exempt markets and reinvested in the taxable markets in order to gain interest rate advantage or the advantage earned by refunding higher-rate bonds in advance of their call date. Proceeds from the lower-rate refunding issue are invested in treasuries until the first call date of the higher-rate issue being refunded.

**Ask Price:** The price at which securities are offered by the broker/dealer. The price at which a governmental entity buys a security.

**Asset Allocation:** The way that investments are distributed and weighted among different types of investment vehicles. The objective of asset allocation is to diversify market and credit risk while obtaining the greatest possible return consistent with the investor's risk tolerance.

**Average Life:** The average length of time that an issue of serial bonds and/or term bonds with a mandatory sinking fund feature is expected to be outstanding.

**Bankers Acceptance (BA):** A draft, bill, or exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill as well as the issuer. Used primarily in international trade.

**Basis Point:** A unit of measurement used in the valuation of fixed-income securities equal to 1/100 of a percent of yield. For example, "1/4" of 1 percent is equal to 25 basis points.

**Bear Market:** A prolonged period of falling security prices, usually caused by declining economic

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conditions and/or rising interest rates.

**Benchmark:** The performance of a predetermined group of securities or an individual security for comparative risk and performance purposes. Benchmarks may be based on available indexes, such as the Standard and Poors Index or selected for specific investment strategies.

**Bid Price:** The price offered by the seller of a security. (When you are selling securities, you ask for a bid.) See **Offer**.

**Book Value:** The value at which a security is carried on the inventory lists or other financial records of an investor. The book value may differ significantly from the security's current value in the market.

**Broker:** A broker brings buyers and sellers together for a commission paid by the initiator of the transaction or by both parties; he or she does not position. In the money market, brokers are active in markets in which banks buy and sell money and in interdealer markets.

**Callable Bond:** A bond issue in which all or part of its outstanding principal amount may be redeemed before maturity by the issuer under specified conditions.

**Call Price:** The price at which an issuer may redeem a bond prior to maturity. The price is usually at a slight premium to the bond's original issue price to compensate the holder for loss of income and ownership.

**Call Risk:** The risk to a bondholder that a bond may be redeemed prior to maturity.

**Cash Sale/Purchase:** A transaction which calls for delivery and payment of securities on the same day that the transaction is initiated.

**Certificate of Deposit (CD):** A time deposit with a specific maturity evidenced by a certificate. Large-denomination CDs are typically negotiable.

**Collateral:** Securities, evidence of deposit or other property that a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposits of public monies.

**Collateralization:** The process by which a borrower pledges securities, property, or other deposits for the purpose of securing the repayment of a loan and/or security.

**Commercial Paper:** An unsecured, short-term promissory note issued by corporations, with maturities ranging from 2 to 270 days.

**Comprehensive Annual Financial Report (CAFR):** The official annual report for the City of Sealy. It includes combined statements and basic financial statements for each individual fund and account group prepared in conformity with generally accepted accounting

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principles (GAAP). It also includes supporting schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, extensive introductory material, and a detailed statistical section.

**Convexity:** A measure of a bond's price sensitivity to changing interest rates. A high convexity indicates greater sensitivity of a bond's price to interest rate changes.

**Coupon:** (a) The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value. (b) A certificate attached to a bond evidencing interest due on a payment date.

**Coupon Rate:** The annual rate of interest received by an investor from the issuer of certain types of fixed-income securities. Also known as the "interest rate."

**Credit Quality:** The measurement of the financial strength of a bond issuer. This measurement helps an investor to understand an issuer's ability to make timely interest payments and repay the loan principal upon maturity. Generally, the higher the credit quality of a bond issuer, the lower the interest rate paid by the issuer because the risk of default is lower. Credit quality ratings are provided by nationally recognized rating agencies.

**Credit Risk:** The risk to an investor that an issuer will default in the payment of interest and/or principal on a security.

**Current Yield (Current Return):** A yield calculation determined by dividing the annual interest received on a security by the current market price of that security.

**Dealer:** A dealer, as opposed to a broker, acts as a principal in all transactions, buying and selling for his own account.

**Debenture:** A bond secured only by the general credit of the issuer.

**Delivery Versus Payment (DVP):** There are two methods of delivery of securities: delivery versus payment and delivery versus receipt (DVR) (also called free). Delivery versus payment is delivery of securities with an exchange of money for the securities. Delivery versus receipt is delivery of securities with an exchange of a signed receipt for the securities.

**Derivatives:** (1) Financial instruments whose return profile is linked to, or derived from, the movement of one or more underlying index or security, and may include a leveraging factor, or (2) financial contracts based upon notional amounts whose value is derived from an underlying index or security (interest rates, foreign exchange rates, equities, or commodities).

**Discount:** The difference between the cost price of a security and its maturity when quoted at lower than face value. A security selling below original offering price shortly after sale also is considered to be at a discount.

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**Discount Securities:** Non-interest bearing money market instruments that are issued at a discount and redeemed at maturity for full face value; e.g., U.S. Treasury Bills.

**Diversification:** Dividing investment funds among a variety of securities offering independent returns.

**Duration:** A measure of the timing of the cash flows, such as the interest payments and the principal repayment, to be received from a given fixed-income security. This calculation is based on three variables: term to maturity, coupon rate, and yield to maturity. The duration of a security is a useful indicator of its price volatility for given changes in interest rates.

**Fair Value:** The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

**Federal Credit Agencies:** Agencies of the Federal government set up to supply credit to various classes of institutions and individuals; e.g., S&Ls, small business firms, students, farmers, farm cooperatives, and exporters.

**Federal Deposit Insurance Corporation (FDIC):** A federal agency that insures bank deposits, currently up to \$100,000 per deposit.

**Federal Funds (Fed Funds):** Funds placed in Federal Reserve banks by depository institutions in excess of current reserve requirements. These depository institutions may lend fed funds to each other overnight or on a longer basis. They may also transfer funds among each other on a same-day basis through the Federal Reserve banking system. Fed funds are considered to be immediately available funds.

**Federal Funds Rate (the “Fed Rate”):** The rate of interest at which Federal funds are traded. This rate is currently pegged by the Federal Reserve through open-market operations.

**Federal Home Loan Banks (FHLB):** Government-sponsored wholesale banks (currently 12 regional banks) which lend funds and provide correspondent banking services to member commercial banks, thrift institutions, credit unions, and insurance companies. The mission of the FHLBs is to liquefy the housing-related assets of its members who must purchase stock in their district bank.

**Federal National Mortgage Association (FNMA or “Fannie Mae”):** FNMA, like GNMA, was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing and Urban Development (HUD). It is the largest single provider of residential mortgage funds in the United States. Fannie Mae is a private stockholder-owned corporation. The corporation’s purchases include a variety of adjustable mortgages and secondary loans, in addition to fixed-rate mortgages. FNMA’s securities are also highly liquid and widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

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**Federal Open Market Committee (FOMC):** Consists of seven members of the Federal Reserve Board and five of the twelve Federal Reserve Bank Presidents. The President of the New York Federal Reserve Bank is a permanent member, while the other Presidents serve on a rotating basis. The Committee periodically meets to set Federal Reserve guidelines regarding purchases and sales of government securities in the open market as a means of influencing the volume of bank credit and money.

**Federal Reserve System:** The central bank of the United States created by Congress and consisting of a seven-member Board of Governors in Washington, DC, twelve regional banks, and about 5,700 commercial banks that are members of the system.

**Government National Mortgage Association (GNMA or “Ginnie Mae”):** Securities influencing the volume of bank credit guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations, and other institutions. The security holder is protected by the full faith and credit of the U.S. Government. Ginnie Mae securities are backed by FHA, VA, or FmHA mortgages. The term “pass-throughs” is often used to describe Ginnie Maes.

**Government Securities:** An obligation of the U.S. government, backed by the full faith and credit of the government. These securities are regarded as the highest quality of investment securities available in the U.S. securities market. See “Treasury Bills, Notes, and Bonds.”

**Interest Rate:** See “Coupon Rate.”

**Interest Rate Risk:** The risk associated with declines or rises in interest rates which cause an investment in a fixed-income security to increase or decrease in value.

**Internal Controls:** An internal control structure designed to ensure that the assets of the entity are protected from loss, theft, or misuse. The internal control structure is designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the cost of a control should not exceed the benefits likely to be derived and (2) the valuation of costs and benefits requires estimates and judgments by management.

**Inverted Yield Curve:** A chart formation that illustrates long-term securities having lower yields than short-term securities. This configuration usually occurs during periods of high inflation coupled with low levels of confidence in the economy and a restrictive monetary policy.

**Investment Policy:** A concise and clear statement of the objectives and parameters formulated by an investor or investment manager for a portfolio of investment securities.

**Investment-grade Obligations:** An investment instrument suitable for purchase by institutional investors under the prudent person rule. Investment-grade is restricted to those obligations rated BBB or higher by a rating agency.

**Liquidity:** A liquid asset is one that can be converted easily and rapidly into cash without a substantial loss of value. In the money market, a security is said to be liquid if the spread

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between bid and asked prices is narrow and reasonable quantities can be purchased at those quotes.

**Local Government Investment Pool (LGIP):** The aggregate of all funds from political subdivisions that are managed for investment and reinvestment.

**Mark-to-market:** The process whereby the book value or collateral value of a security is adjusted to reflect its current market value.

**Market Risk:** The risk that the value of a security will rise or decline as a result of changes in market conditions.

**Market Value:** The price at which a security is trading and could presumably be purchased or sold.

**Master Repurchase Agreement:** To protect investors, many public investors will request that repurchase agreements be preceded by a master repurchase agreement between the investor and the financial institution or dealer. The master agreement should define the nature of the transaction, identify the relationship between the parties, establish normal practices regarding ownership and custody of the collateral securities during the term of the investment, provide remedies in the case of default by either party, and clarify issues of ownership. The master repurchase agreement protects the investor by eliminating the uncertainty of ownership and, hence, allows investors to liquidate collateral if a bank or dealer defaults during the term of the agreement.

**Maturity:** The date on which the principal or stated value of an investment becomes due and payable. The final stated maturity is the date on which the issuer must retire a bond and pay the face value to the bondholder. See “Weighted Average Maturity.”

**Money Market:** The market in which short-term debt instruments (bills, commercial paper, bankers’ acceptances, etc.) are issued and traded.

**Money Market Mutual Fund:** Mutual funds that invest solely in money market instruments.

**Mutual Fund:** An investment company that pools money and can invest in a variety of securities, including fixed-income securities and money market instruments. Mutual funds are regulated by the Investment Company Act of 1940.

**National Association of Securities Dealers (NASD):** A self-regulatory organization (SRO) of brokers and dealers in the over-the-counter securities business. Its regulatory mandate includes authority over firms that distribute mutual fund shares as well as other securities.

**Net Asset Value (NAV):** The market value of one share of an investment company, such as a mutual fund. This figure is calculated by totaling a fund’s assets which include securities, cash, and any accrued earnings, subtracting this from the fund’s liabilities, and dividing this total by the number of shares outstanding. This is calculated once a day based on the closing price for each security in the fund’s portfolio.

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**No Load Mutual Fund:** A mutual fund which does not levy a sales charge on the purchase of its shares.

**Nominal Yield:** The stated rate of interest that a bond pays its current owner, based on par value of the security. It is also known as the “coupon,” “coupon rate,” or “interest rate.”

**Offer:** The price asked by a seller of securities. (When you are buying securities, you ask for an offer.) See **Asked** and **Bid**.

**Open Market Operations:** Purchases and sales of government and certain other securities in the open market by the New York Federal Reserve Bank as directed by the FOMC in order to influence the volume of money and credit in the economy. Purchases inject reserves into the bank system and stimulate growth of money and credit; sales have the opposite effect. Open market operations are the Federal Reserve’s most important and most flexible monetary policy tool.

**Par:** Face value or principal value of a bond, typically \$1,000 per bond.

**Portfolio:** Collection of securities held by an investor.

**Positive Yield Curve:** A chart formation that illustrates short-term securities having lower yields than long-term securities.

**Premium:** The amount by which the price paid for a security exceeds the security’s par value.

**Primary Dealer:** A group of government securities dealers who submit daily reports of market activity and positions and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission (SEC)-registered securities broker-dealers, banks, and a few unregulated firms.

**Prime Rate:** A preferred interest rate charged by commercial banks to their most creditworthy customers. Many interest rates are keyed to this rate.

**Principal:** The face value or par value of a debt instrument. Also may refer to the amount of capital invested in a given security.

**Prospectus:** A legal document that must be provided to any prospective purchaser of a new securities offering registered with the SEC. This can include information on the issuer, the issuer’s business, the proposed use of proceeds, the experience of the issuer’s management, and certain certified financial statements.

**Prudent Person Rule:** An investment standard outlining the fiduciary responsibilities of public funds investors relating to investment practices, which states: “Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for

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speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.”

**Qualified Public Depositories:** A financial institution which does not claim exemption from the payment of any sales or compensating use or ad valorem taxes under the laws of this state and that has segregated for the benefit of the Public Deposit Protection Commission eligible collateral having a value of not less than its maximum liability and which has been approved by the commission to hold public deposits.

**Rate of Return:** The yield obtainable on a security based on its purchase price or its current market price. This may be the amortized yield to maturity on a bond or the current income return.

**Reinvestment Risk:** The risk that a fixed-income investor will be unable to reinvest income proceeds from a security holding at the same rate of return currently generated by that holding.

**Repurchase Agreement (RP or REPO):** A holder of securities sells these securities to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security “buyer” in effect lends the “seller” money for the period of the agreement, and the terms of the agreement are structured to compensate him for this. Dealers use RP extensively to finance their positions. Exception: When the Fed is said to be doing RP, it is lending money, that is, increasing bank reserves.

**Safekeeping:** A service to customers rendered by banks for a fee whereby securities and valuables of all types and descriptions are held in the bank’s vaults for protection.

**SEC Rule 15C3-1:** See **Uniform Net Capital Rule.**

**Secondary Market:** A market made for the purchase and sale of outstanding issues following the initial distribution.

**Securities & Exchange Commission (SEC):** Agency created by Congress to protect investors in securities transactions by administering securities legislation.

**Serial Bond:** A bond issue, usually of a municipality, with various maturity dates scheduled at regular intervals until the entire issue is retired.

**Sinking Fund:** Money accumulated on a regular basis in a separate custodial account that is used to redeem debt securities or preferred stock issues.

**Structured Notes:** Notes issued by Government Sponsored Enterprises (FHLB, FNMA, SLMA, etc.) and Corporations which have imbedded options (e.g., call features, step-up coupons, floating rate coupons, derivative-based returns) into their debt structure. Their market performance is impacted by the fluctuation of interest rates, the volatility of the imbedded options, and shifts in the shape of the yield curve.

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**Swap:** Trading one asset for another.

**Term Bond:** Bonds comprising a large part of all of a particular issue which come due in a single maturity. The issuer usually agrees to make periodic payments into a sinking fund for mandatory redemption of term bonds before maturity.

**Total Return:** The sum of all investment income plus changes in the capital value of the portfolio. For mutual funds, return on an investment is composed of share price appreciation plus any realized dividends or capital gains. This is calculated by taking the following components during a certain time period: Price Appreciation + Dividends Paid + Capital Gains = Total Return.

**Treasury Bills (T Bills):** A non-interest bearing discount security issued by the U.S. Treasury to finance the national debt. Most bills are issued to mature in three months, six months, or one year in minimum denominations of \$10,000. The yields on bills are monitored closely in the money markets for signs of interest rate trends.

**Treasury Bonds:** Long-term, coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities of more than ten (10) years.

**Treasury Notes:** Medium-term, coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities from two (2) to ten (10) years.

**Uniform Net Capital Rule:** Securities and Exchange Commission requirement that member firms as well as nonmember broker-dealers in securities maintain a maximum ratio of indebtedness to liquid capital of 15 to 1; also called *net capital rule* and *net capital ratio*. Indebtedness covers all money owed to a firm, including margin loans and commitments to purchase securities, one reason new public issues are spread among members of underwriting syndicates. Liquid capital includes cash and assets easily converted into cash.

**Volatility:** A degree of fluctuation in the price and valuation of securities.

**Volatility Risk Rating:** A rating system to clearly indicate the level of volatility and other non-credit risks associated with securities and certain bond funds. The ratings for bond funds range from those that have extremely low sensitivity to changing market conditions and offer the greatest stability of the return (“aaa” by S&P, “V-1” by Fitch) to those that are highly sensitive with currently identifiable market volatility risk (“ccc” by S&P, “V-10” by Fitch).

**Weighted Average Maturity (WAM):** The average maturity of all the securities that comprise a portfolio. According to SEC Rule 2A-7, the WAM for SEC-registered money market mutual funds may not exceed 90 days and no one security may have a maturity that exceeds 397 days.

**When Issued (WI):** A conditional transaction in which an authorized new security has not been issued. All “when issued” transactions are settled when the actual security is issued.

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**Yield:** The rate of annual income return on an investment, expressed as a percentage. (a) **Income Yield** is obtained by dividing the current dollar income by the current market price for the security. (b) **Net Yield** or **Yield to Maturity** is the current income yield minus any premium above par or plus any discount from par in purchase price, with the adjustment spread over the period from the date of purchase to the date of maturity of the bond.

**Yield Curve:** A graphic representation that depicts the relationship at a given point in time between yields and maturity for bonds that are identical in every way except maturity. A normal yield curve may be alternatively referred to as a positive yield curve.

**Yield-to-call (YTC):** The rate of return an investor earns from a bond assuming the bond is redeemed (called) prior to its nominal maturity date.

**Yield-to-maturity:** The rate of return yielded by a debt security held to maturity when both interest payments and the investor's potential capital gain or loss are included in the calculation of return.

**Zero-coupon Securities:** Security that is issued at a discount and makes no periodic interest payments. The rate of return consists of a gradual accretion of the principal of the security and is payable at par upon maturity.