

INVESTMENT ACCOUNTING & REPORTING *MEETS STRATEGY*

ACHIEVING
EXCELLENCE
Together 2019

IGFOA ANNUAL CONFERENCE • SEPTEMBER 8-10, 2019

IGFOA ANNUAL CONFERENCE • SEPTEMBER 8-10, 2019



Brian Hextell | SVP, Institutional Portfolio Manager
Prudent Man Advisors, LLC
SVP, Chief Credit Officer
PMA Financial Network, LLC
PMA Securities, LLC



Susan Jones | Principal, CPA, MBA
Miller Cooper & Co., Ltd.
Government Services Group
Practice Leader

Today's Agenda

- State Statute Allowable Investments; *Explanation and Risks*
- Understanding Investment Accounting & Disclosures; *GASB 31, 40, 72, 79 & Mark to Market Accounting*
- Yield versus Total Return – *Aligning Investment Strategy with Accounting*

Illinois State Statute

- Public Funds Investment Act (30 ILCS 235)
- Investment Policy – Section 2.5
 - Safety, Liquidity and Return
 - Prudent Person Rule
 - Authorized Investments
 - Diversification
 - Collateral Requirements
 - Internal Controls
 - Performance Measures
- Authorized Investments – Section 2

US Treasury Securities

- What are they?

- Debt instruments issued by the Federal Government.
- Backed by full faith and credit of the US Government.

- Treasury Bills

- Issued at a discount of face value
- Duration less than one year

- Government Notes and Bonds

- Original maturities of 1 to 30 years
- Discount, Premium, Par
- Coupon bearing

Government Sponsored Enterprises

- What are they?
 - Financing entities to fund loans to certain groups of borrowers.
 - Unsecured debt obligations with implied guarantee of the US Government.
 - Federal National Mortgage Association (FNMA) (Fannie Mae)
 - Federal Home Loan Mortgage Corporation (FHLMC) (Freddie Mac)
 - Federal Home Loan Bank (FHLB)
 - Federal Farm Credit System (FFCS)

Corporate Obligations

- What are they?
 - Unsecured debt issued by corporations
 - Default risk present
 - Companies may issue short-term Commercial Paper or longer term notes or bonds
 - Debt, not equity

Corporate obligations

- 3 year maximum maturity
- Rated in one of 3 highest classifications by at least 2 standard rating services
- Purchases do not exceed 10% of the corporation's outstanding obligations
- No more than 33% of the public agency's fund may be invested in short term obligations of corporations
- The corporation must be organized in the United States and have assets exceeding \$500,000,000

New Investments, New Strategies

- Understand the Risks
 - Downgrade
 - Widening Credit Spreads (Lower Prices)
 - Default
 - Higher Yield = Higher Risk
- Risk Management is Key
 - Research
 - Diversification by Issuer, Industry and Maturity
- Consider Professional Investment Management
 - Registered Investment Advisor

Money Market Funds

- What are they?
 - Money market mutual funds registered under the Investment Company Act of 1940
 - These funds invest in short-term debt instruments
 - Not a bank deposit
 - Not insured or guaranteed by the Federal Deposit Insurance Corporation
- No ratings requirements in State Statute
 - AAAM is highest money market fund rating

Local Government Investment Pools

- What are they?
 - An intergovernmental agreement formed for the purpose of investing
 - Not a bank deposit
 - Not insured or guaranteed by the Federal Deposit Insurance Corporation
- No ratings requirements in State Statute
 - AAAM is highest money market fund rating
- Two General Types of LGIPs
 - Stable Net Asset Value (\$1.00 NAV)
 - Variable Net Asset Value

Required Elements of Cash & Investment Disclosures

- Investment valuation methodology
- Legal & contractual provisions
- Investment risks
- Credit ratings
- No third party custodian

Understanding GASB 40; Deposit & Investment Risk Disclosures

- Custodial credit risk
- Concentration risk
- Interest rate risk
- Foreign currency risk

Mark to Market Accounting

- What is it?
 - Periodically adjusting the value assigned to investments to reflect changes in their fair value
 - GFOA best practice recommendations
 - Investments should be marked to market at least:
 - Monthly for investment pools
 - Quarterly for non-investment pools
 - Market values obtained from a reputable independent source and reported quarterly to the governing body or oversight committee with a written report

Mark to Market-Individual Investment Example

- Purchase & Sale of a government security

A government investor purchases a 5% \$1 million Treasury security on 1/1/XX.

To record the purchase, the following journal entry is made:

<i>Dr. Investment</i>	<i>\$1,000,000</i>
<i>Cr. Cash</i>	<i>\$1,000,000</i>

From 1/1-6/30, interest rates rise and the market value of this security falls to \$925,000.

To record coupon and interest:

<i>Dr. Cash</i>	<i>\$25,000</i>
<i>Cr. Income</i>	<i>\$25,000</i>

To record mark to market adjustment:

<i>Dr. Unrealized Loss</i>	<i>\$75,000</i>
<i>Cr. Mkt Value Adj./Investment</i>	<i>\$75,000</i>

Marking to Market-Individual Investment Example - (cont.)

- Operations impact after 6 months:

Income From 5% coupon	\$25,000
Marked- Market Loss	<u>\$(75,000)</u>
6-Month Performance	\$(50,000)

- On 7/1/XX, the investor decides to sell the security. The following entry is made to record the sale:

Dr. Cash (sales proceeds)	\$925,000	
Dr. Mkt Value Adj./Investment	\$75,000	
Cr. Investment		\$1,000,000
Dr. Realized Loss	\$75,000	
Cr. Unrealized Loss		\$75,000

Marking to Market-Portfolio - Example

Income Statement	
Interest Income	\$ 677,080.58
Misc. Income	\$ 11,145.01
Income Subtotal	\$688,225.59
Net Realized Gain/Loss	(\$43,553.05)
Management & Custody Fees	(\$34,695.18)
Investment Income Before Unrealized Gain/Loss	\$609,977.36
Change in Unrealized Gain/Loss	\$1,033,051.25
Investment Income	\$1,643,028.61

Balance Sheet	12/31/18	7/31/19
Book Value	\$40,968,032.66	\$41,544,235.83
Accrued Balance	\$172,402.37	\$206,176.56
Book Value + Accrued	\$41,140,435.03	\$41,750,412.39
Net Unrealized Gain/Loss	(\$911,124.24)	\$121,927.01
Market Value + Accrued	\$40,229,310.79	\$41,872,339.40

Marking to Market Portfolio-Journal Entries

Dr. Cash	\$ 609,977	
Dr. Market value adj.	1,033,051	
Dr. Realized loss	43,553	
Dr. Fees	34,695	
Cr. Unrealized Gain		\$1,033,051
Cr. Interest & other income		688,225

Local Government Investment Pool

- GASB 72 requires investments in 2a7 like pools to be valued at NAV per share of the pool. Otherwise, investment in pool (if not 2a7 like) should be reported at fair value.
- Most government investment pools are not 2a7 like and have not been for almost two years since the SEC changed the rules for 2a7 like.
- GASB 79 superseded GASB 72 on this issue and allows for investments in pools that meet the GASB 79 criteria to be accounted for at amortized cost – otherwise the investment should be reported at fair value in accordance with GASB 31, par. 11.

Check with your local government investment pool – variations in reporting

Local Government Investment Pool (cont.)

- If the pool chooses not to meet the GASB 79 criteria, this results in the pool accounting for its investments at fair value and each participant must account for their investment at fair value
 - Due to the short-term nature and liquidity of the investments within many of these pools, when they make fair value adjustments are minimal.
 - Since reporting at fair value using GASB 31 through GASB 79 and not through GASB 72, then the leveling disclosure requirement does not apply to this investment.

Recording Income in a Floating NAV Fund

- General themes that may apply:
 - Only realize gains/losses on sales
 - Changes in price reported at month-end and year-end are Unrealized
 - Realized and Unrealized gains/losses are both recorded as investment income

Record Income in a Floating NAV Fund

Date	Transaction	Shares	Price	Cost/Proceeds	Market Value	Comments
07/06/18		-	-		-	
07/10/18	Buy	500,000	10.02	5,010,000.00	5,010,000.00	
09/15/18	Buy	300,000	10.07	3,021,000.00	8,051,000.00	
12/04/18	Sell	200,000	10.09	2,018,000.00	6,048,000.00	*All gains realized based on cost (FIFO)

<u>Debit</u>				<u>Credit</u>			
\$ 2,018,000.00 Cash							
				\$ 14,000.00 Realized Gain on Sale			
				\$ 2,004,000.00 Reduction in investments			

*Alternately, the local government may choose to value holdings using a different valid cost basis such as LIFO. The local government may also choose to report unrealized gains/losses on a monthly basis based on changes in market value.

Aligning Investment Strategy with Accounting

Accountant

[ac·coun·tant] 

1. Someone who solves a problem you didn't know you had in a way you don't understand.

See also: wizard, magician

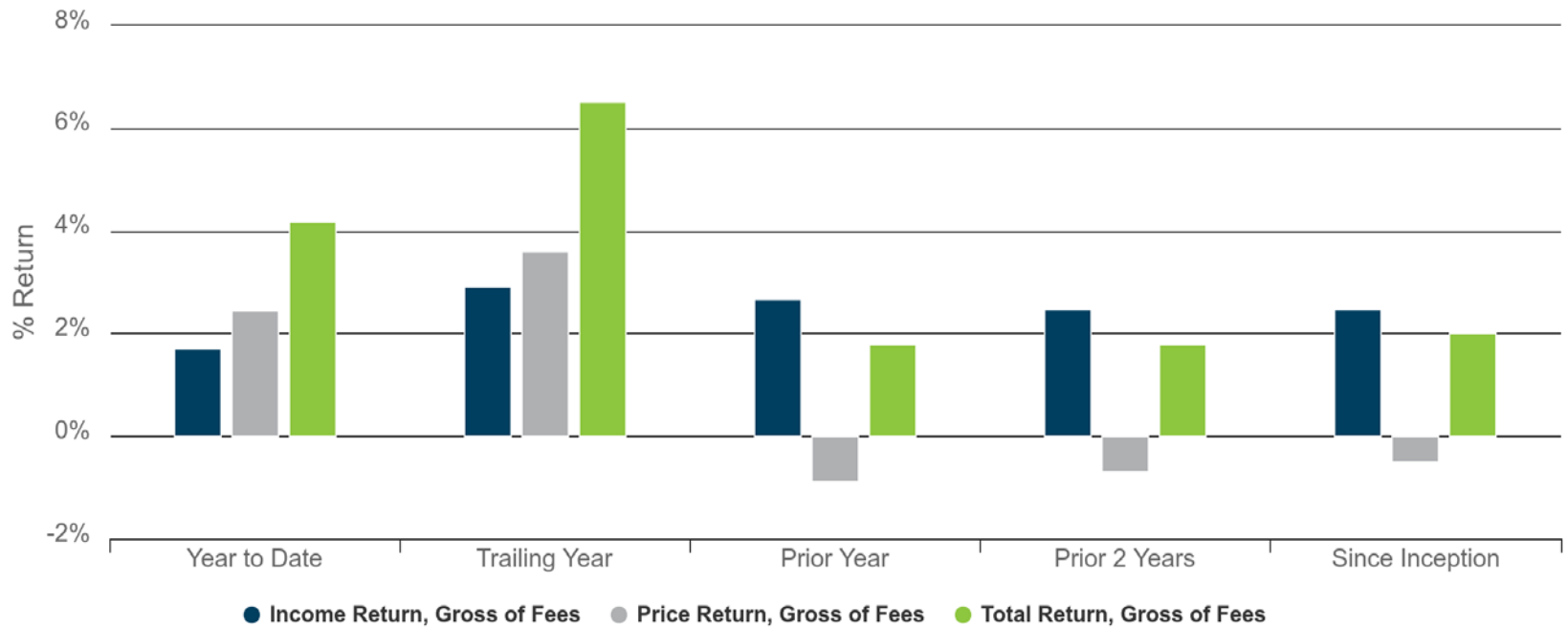
INVESTMENT RETURNS



ACCOUNTING FOR INVESTMENTS



Investment Returns



Investment Strategy: Buy and Hold versus Active Management

- Buy and Hold: Hold to maturity investments such as CD's.
- Active Management: Continuous review of best alternatives
 - Hold to maturity
 - Roll down the yield curve
 - Sell security as it ages and rolls to a lower yield (higher price)
 - Credit Quality
 - What has value today?
 - Determine if we are getting paid to take credit risk
 - Diversification
 - Duration/Curve positioning
 - Evaluate best duration fit for client objectives
 - Continuously evaluate yield curve for best return potential

Key Takeaways

- Understand allowable investments under the Public Funds Investment Act
- Investing longer in corporates adds new risks and opportunities
- Proper interim reporting of investments can lead to an enhanced understanding of investment yields and returns
- Disclosures are meaningful. Ensure your disclosures are an accurate representation of your current investment portfolio, strategy and policy.
- Investment accounting and Investment returns are more related than you might think
- Create an investment portfolio aligned with your investment objectives

Appendix - Valuation Methodologies

Asset Type	Remaining Maturity	Hierarchy Level/Cost/NA
Local government investment pools	N/A	NAV
Deposits accounts (savings)	N/A	Cost
Non-participating interest earning contracts-non negotiable/non-transferable – No CUSIP- [CDs, repurchase agreements, guaranteed and bank investment contracts (GICs & BICs)]	N/A	Cost
*Participating interest earnings contracts-redemptions considers market terms-CUSIP (DTCs/negotiable/brokered CDs)	> 1 year	Level 2
Commercial Paper/U.S. Agency and Treasury obligations	< 1 year	Cost
T-Note/T-Bond/Muni/Corp	> 1 year	Level 2
* If remaining maturity at time of purchase is less than 1 year, a cost based measure may be used subject to para. 9 of GASB 31-leveling not required		



DISCLAIMER

This document was prepared for clients of Prudent Man Advisors, LLC. It is being provided for informational and/or educational purposes only without regard to any particular user's investment objectives, financial situation or means. The content of this document is not to be construed as a recommendation, solicitation or offer to buy or sell any security, financial product or instrument; or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation, or trading strategy would be illegal. Nor does it constitute any legal, tax, accounting or investment advice of services regarding the suitability or profitability of any security or investment. Although the information contained in this Investment Advisory Report has been obtained from third-party sources believed to be reliable, PMA cannot guarantee the accuracy or completeness of such information. It is understood that PMA is not responsible for any errors or omissions in the content in this document and the information is being provided to you on an "as is" basis without warranties or representations of any kind.

Securities, public finance services and institutional brokerage services are offered through PMA Securities, LLC. PMA Securities, LLC is a broker-dealer and municipal advisor registered with the SEC and MSRB, and is a member of FINRA and SIPC. Prudent Man Advisors, LLC., an SEC registered investment adviser, provides investment advisory services to local government investment pools and other institutional clients. All other products and services are provided by PMA Financial Network, LLC. PMA Financial Network, LLC, PMA Securities, LLC and Prudent Man Advisors (collectively "PMA") are under common ownership.

Securities and public finance services offered through PMA Securities, LLC are available in CA, CO, FL, GA, IL, IN, IA, KS, MI, MN, MO, NE, OH, OK, PA, SD, TX and WI. This document is not an offer of services available in any state other than those listed above, has been prepared for informational and educational purposes and does not constitute a solicitation to purchase or sell securities, which may be done only after client suitability is reviewed and determined. All investments mentioned herein may have varying levels of risk, and may not be suitable for every investor. PMA and its employees do not offer tax or legal advice. Individuals and organizations should consult with their own tax and/or legal advisors before making any tax or legal related investment decisions. Additional information is available upon request.

©2019 Prudent Man Advisors, LLC



IGFOA ANNUAL CONFERENCE • SEPTEMBER 8-10, 2019