

# Rethinking Your Investment Policy Statement

Cash investing is undergoing a transformation. As the post financial crisis market evolves, new bank liquidity and capital requirements coupled with money market fund (MMF) reform, are reshaping the landscape of investment options. In the wake of these new regulations, cash investors need to adapt to the new complexities of cash investing and it is critical that your investment policies are prepared for a new paradigm. In the following pages we propose an investment policy statement framework that can be used as a path to develop your own document. The aim of this document is to provide the necessary clarity and suggest the parameters that will guide your organization's cash investment strategy.

The investment policy statement is the investment blueprint for an organization. A well-designed investment policy statement identifies the key risks and concerns that could affect a business and will establish controls to mitigate those risks. It considers factors such as the liquidity of an organization, the reliability of cash flow forecasting, corporate investment philosophy and risk tolerance, the breadth of resources available and the experience of those resources. The document will likely be shaped by the entity's current liquidity situation, but should be flexible enough to respond to changing events. Also, the investment policy should be written such that everyone has a clear view of the goals and objectives, yet should be specific to avoid ambiguity and misunderstanding.

## OVERALL CASH SEGMENTATION STRATEGY

The liquidity forecast is an integral component to the investment policy and likely shapes the risk appetite and investment objectives of your investment policy. The ability to forecast cash with a reasonable degree of success has long-term benefits and may provide opportunities to adopt certain strategies while also mitigating funding and liquidity risks.

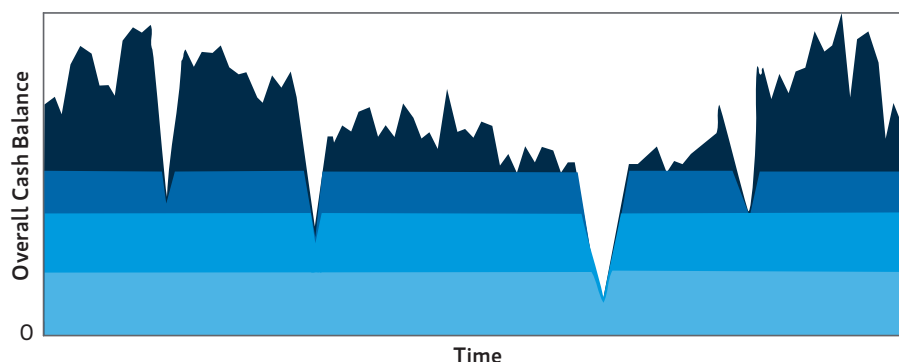
### Overall Cash Segmentation Strategy Model Cash Flow

Daily Operating Cash  
(Typical Investment  
Horizon: 0-30 days)

Reserve Operating Cash  
(Typical Investment  
Horizon: 31-180 days)

Strategic Cash  
(Typical Investment  
Horizon: 181 days-1 year)

Longer Term Investments  
(Typical Investment  
Horizon: 1-3 years)



The information shown is provided for illustrative purposes only.

As investors adapt their investment strategy to the new market paradigm, we believe an important aspect will be the ability to stratify liquidity. Investors who can reasonably forecast their cash flows are better equipped to segment their liquidity into distinct pools, each with its own purpose and investment opportunity set. More specifically, investors will likely need to segment their liquidity into balances needed immediately and those that are more stable. The cash stratification process can clearly offer advantages. Because liquidity can come at a steep cost, bifurcating your cash may enhance the investment return and provide improved portfolio diversification. Today, many clients follow this approach where excess cash is invested in securities with varied maturities and credit quality to earn incremental returns. As you contemplate changes to your investment policy statement, we believe optimizing cash flow forecasting and liquidity management will help better manage the high cost of liquidity.

### Cash Segmentation Detail

	DAILY OPERATING CASH	RESERVE OPERATING CASH	STRATEGIC CASH	LONGER-TERM INVESTMENTS
Investment Horizon	0-30 Days	31-180 Days	181 Days-1 Year	1-3 Years
<b>Objective (in order of priority)</b>	<ul style="list-style-type: none"> <li>High liquidity</li> <li>Late-day access</li> <li>Capital preservation</li> </ul>	<ul style="list-style-type: none"> <li>Liquidity</li> <li>Capital preservation</li> <li>Potential for higher yield</li> </ul>	<ul style="list-style-type: none"> <li>Capital preservation</li> <li>Potential for enhanced liquidity returns</li> </ul>	<ul style="list-style-type: none"> <li>Potential for enhanced liquidity returns</li> <li>Capital preservation</li> </ul>
<b>How cash is used</b>	<ul style="list-style-type: none"> <li>Daily operating needs</li> </ul>	<ul style="list-style-type: none"> <li>Known periodic payments (payroll, supplier payments, accounts payable, tax payments, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>Dividend payments</li> <li>Debt repayment</li> <li>Bond proceeds</li> <li>Share buybacks</li> <li>Capital expenditures</li> </ul>	<ul style="list-style-type: none"> <li>Acquisitions</li> <li>Capital expenditures</li> <li>Other strategic uses</li> <li>Unforeseen needs</li> </ul>
<b>Cash flow volatility</b>	High	High to medium	Medium to low	Low
<b>Commentary</b>	<ul style="list-style-type: none"> <li>This cash is needed to be used immediately, but this high liquidity comes with a sacrifice of lower yields</li> <li>Deposit supply could be cut back by banks, especially for non-operating cash, due to Basel III banking reforms. U.S. Government and Treasury MMFs could see pressure on yields as MMF reform pushes more investors to these products. Despite these pressures weighing on yields, this might not be a concern for this ultra-liquid short-term cash segment</li> </ul>	<ul style="list-style-type: none"> <li>Where immediate liquidity is not needed, more options are available to investors</li> <li>These additional options can help diversification and slightly enhance potential returns</li> <li>Prime and Municipal MMFs need to be reviewed for their level of appropriateness between the first two operating cash segments due to the possible imposition of liquidity fees and redemption gates</li> </ul>	<ul style="list-style-type: none"> <li>This segment focuses on cash not needed in the short-term, but designated for a specific use in the future</li> <li>Recent regulatory and market changes had less impact on this segment than the first two more liquid operating cash classifications. With that being said, the pressures on the most liquid cash will provide even more opportunities for yield advantages going farther out the curve</li> </ul>	<ul style="list-style-type: none"> <li>Excess cash with no planned need (barring a major business change) offers investors with the ultimate flexibility and potential to enhance returns</li> <li>This segment is a sweet-spot for strategies that focus on purchasing securities that are outside of the normal parameters permitted by MMFs</li> </ul>

## Components of an Investment Policy Statement

### STATEMENT OF PURPOSE

The statement of purpose identifies the entities covered by the investment policy statement and the policies and procedures that shall guide those involved.

Some questions to consider include:

- Has the policy been adopted by the Board of Directors?
- Is the policy intended to comply with bond covenants and collateral agreements?
- Is the policy specific to the company's balance sheet assets or are other activities covered?
- Is the policy global or local? Have all subsidiaries and entities of the broader organization been considered? Does the policy cover restricted and unrestricted cash?
- Is the policy aligned with the organization's structure?

An example of this would be: The purpose of the Company's Investment Policy is to establish guidelines and procedures for the investment and management of Entity XYZ and its subsidiaries' global cash.

### INVESTMENT OBJECTIVES

The investment objectives define the purpose of the portfolio and profile the broad characteristics. The objectives can generally be organized into three categories: risk, return, and liquidity. Below are objectives that might be found in an investment policy:

The principal objectives of the investment policy are to:

- 1) Preserve principal
- 2) Maintain appropriate liquidity
- 3) Generate yield

Additional objectives may include:

- Diversify investments to minimize concentration risk
- Deliver returns consistent with benchmark indices for similar investments
- Maximize the risk adjusted return
- Provide fiduciary control of the cash and investments by individuals approved by the entity's Board of Directors

## RISK TOLERANCE

Understanding an organization's propensity to take risk and how risk tolerance may change over time is one of the most important aspects to consider when creating or updating your investment policy statement. Many factors will ultimately determine the overall level of risk tolerance an organization is willing to take, including:

- Risk appetite – how much risk are you willing to take with your liquidity?
- Time horizon – what is your investment horizon? When will the funds be needed? If the time horizon is long or excess cash is available, opportunities to take on incremental risk might be appropriate.
- Corporate philosophy – How do the key stakeholders view risk and what are their expectations? Is the strategy aligned with your firm's broader strategic objectives and how might a shift in strategy affect the debt rating and growth prospects?
- Location of cash – Is your cash readily available for corporate purposes or is the cash trapped? Are there plans or is it possible to repatriate the cash?
- Investment experience – Can the risks be appropriately defined and articulated to management and the Board of Directors?
- Ability to monitor – can the strategy be integrated into the reporting and governance structure? What additional controls and procedures need to be developed to monitor risk and do we have the technology/resources to support the revised investment framework?

According to KPMG,<sup>1</sup> a well-defined risk appetite should have the following characteristics:

- Reflective of strategy, including organizational objectives, business plans and key stakeholder objectives
- Reflective of all key aspects of the business
- Acknowledges a willingness and capacity to take on risk
- Considers the skills, resources and technology required to manage and monitor risk exposures in the context of risk appetite
- Is inclusive of a tolerance for loss or negative events that can be reasonably quantified

- Is periodically reviewed and reconsidered with reference to evolving industry and market conditions
- Has been approved by the Board of Directors

Understanding risk tolerance allows you to define the acceptable boundaries upon which you can build your investment policy statement. Acceptable boundaries can be designed to limit the degree to which the investment strategy varies relative to the risk free rate (cash), to minimize the probability of potential losses, and to demonstrate consistency with the corporate attitude toward risk.

## USING BENCHMARK DATA TO ESTIMATE RISK

Assessing risk by using proxies, such as benchmark indices, provides insight into the level of risk inherent in different investment strategies. Benchmark indices provide guidance for the trade-offs involved and can help communicate to management the probability of different events and the likely "worst case scenario" should they decide to pursue a different strategy for their cash management. Benchmark indices can be used to explain:

- The benefits of extending duration and/or adding credit risk to your portfolio.
- The probabilities of experiencing a negative return over trailing time periods.
- Historical portfolio drawdowns and subsequent recovery.
- Implications for financial statement volatility.

## INVESTMENT OPTIONS

Investments options should outline the permissible strategies that the entity may consider for investment. There are many factors to consider when evaluating investment options as individually they have their own advantages and disadvantages.

With money market fund (MMF) regulatory reform changes on the horizon, we believe now is an ideal time to review your investment policy statement. While the U.S. Securities and Exchange Commission (SEC) has adopted amended rules to protect MMF investors, improving diversification, disclosure, liquidity and risk management, questions about Prime funds will inevitably continue. Investors will need to decide whether "gating" options are suitable for daily, on-demand liquidity needs and should consider other aspects as well, including:

- Does your language limit investments solely to stable NAV funds?
- What MMF language is appropriate going forward?
- Does language that limits MMFs to "Rule 2a-7 funds" consider all strategies that might be used as global investment options for your cash?
- What concentration limits should exist for MMFs? Is it an absolute dollar amount or percentage? Should the fund size and concentration limit for floating NAV funds be different from stable NAV funds?

<sup>1</sup> Source: KPMG, "Understanding and Articulating Risk Appetite," 2008.

- Does your language reference ratings? Will all 2a-7 funds carry ratings going forward? Will AAA ratings continue to be used in Europe if the funds are no longer able to meet their dual objectives of principal stability and liquidity?
- How does a floating NAV affect your reporting infrastructure including pricing, accounting, compliance, and tax?

Answering these questions and preparing for changes driven by the yield environment and regulatory reforms are critical steps and may allow your organization to better optimize liquidity.

The examples below suggest appropriate language as well as investment options typically used for liquidity management:

- Bank deposits
- Direct securities
- Money Market Funds
  - Government MMFs
  - Prime and Municipal MMFs
- Other Structures
  - Ultra-short bond funds
  - Short Duration bond funds
  - Separately Managed Accounts
  - Private Funds

#### PERMISSIBLE INVESTMENTS

The permissible investments section of your organization's investment policy statement takes the process one step further and outlines the specific securities which have been authorized for investment as well as additional restrictions as to credit quality, maturities, and concentration limits. The list of permissible investment types should be transparent and within sectors, and any limitations should be identified within each sector. For example, if you permit securitized investments you may limit the collateral type, the collateral guarantee, and the quality of the collateral allowed. The table below illustrates how different security types should fit into each tier of your cash segmentation strategy.

#### PROHIBITED SECURITIES

The investment policy statement should be explicit to prevent users from “reading between the lines” and making assumptions on permitted risks. The policy statement should include a section of prohibited securities which likely is shaped by risk tolerance. Some examples of securities, security types, and strategies which may be prohibited include derivatives, securities with embedded options, short selling, and margin transactions. We suggest adding language that states unless a specific security type is permitted by this policy, it should be viewed as prohibited.

#### Permissible Investments

	DAILY OPERATING CASH	RESERVE OPERATING CASH	STRATEGIC CASH	LONGER TERM INVESTMENTS
<b>MONEY MARKET FUNDS</b>				
Government MMFs	•	•	•	•
Prime and Municipal MMFs	•	•	•	•
<b>DIRECT SECURITIES</b>				
Government Securities	•	•	•	•
Sovereign, Sovereign Guaranteed, Supranationals and Foreign Agency Securities	•	•	•	•
Bank Obligations (CDs, TDs, Bank Accounts)	•	•	•	•
Overnight Repo	•			
Term Repo		•	•	•
Commercial Paper	•	•	•	•
Asset Backed Commercial Paper	•	•	•	•
Corporate Bonds		•	•	•
Asset Backed Securities		•	•	•
Covered Bonds		•	•	•
Mortgage Backed Securities			•	•
Municipal Securities	•	•	•	•
<b>OTHER STRUCTURES</b>				
Ultra-short Bond Funds		•	•	•
Short Duration Bond Funds			•	•
Liquidity Separate Accounts		•	•	•
Separate Accounts			•	•

## EVALUATING CREDIT QUALITY RISK CONCENTRATIONS

The investment policy should adequately define sources of credit risk, the overall credit risk tolerance, permitted exposures, and the procedures for monitoring credit risk. Lending arrangements, counterparties, and investments should be evaluated in aggregate for significant concentrations and strategies that offer balance sheet diversification should be considered. Key considerations should include:

- What is the minimum credit quality acceptable to your organization?
- How do you evaluate credit today? Do you have the breadth of credit resources internally to assess credit risk or should it be outsourced?
- How does your organization monitor and measure credit risk and changes in credit risk?
- If you limit credit quality, what does it mean for available supply?
- Does the minimum credit quality potentially leave you with concentrated risk exposures? Historically, having a high credit quality bias has left balance sheets with significant exposures to financials. Policies to ensure prudent diversification of credit risks should be evaluated and considered.
- For each eligible security type, minimum credit quality, maximum maturity, and maximum exposure per security type and per issuer for each sector should be defined. Pay particular attention to the percentages as these bands should anticipate changes in supply that result from regulatory reform.
- What is the policy for reporting issuers who are downgraded? Should you maintain a “downgrade basket” so that forced sales are not required? How do you communicate downgraded securities across the organization?
- How should you evaluate split rated securities? Should the same ratings methodologies as the benchmark providers or should you follow a different approach which may be more closely aligned with your risk appetite?
- What are the current credit trends and how do they impact your organization? For example, post-2008 public resistance to the use of taxpayer support has led to a shift in the credit quality of many financials as the likelihood of extending government support has been lowered. Sovereign ratings volatility can also influence the credit ratings of national banks and investment policies should anticipate the consequences of sovereign credit downgrades.

## Credit and Maturity Guidelines

	MAXIMUM MATURITY	MAXIMUM % OF PORTFOLIO	SINGLE ISSUER MAXIMUM % OF PORTFOLIO	MINIMUM CREDIT RATING*
<b>MONEY MARKET FUNDS</b>				
Government MMFs	NA	100%	N/A	AAAm/Aaa-mf
Prime and Municipal MMFs	NA	100%	N/A	AAAm/Aaa-mf
<b>DIRECT SECURITIES</b>				
Government Securities	5 years	100%	NA	NA
Sovereign, Sovereign Guaranteed, Supranationals and Foreign Agency Securities	5 years	50%	10%	AA-/Aa3
Bank Obligations (CDs, TDs, Bank Accounts)	1 year	50%	5%	A-1/P-1
Overnight Repo	1 Day	25%	5%	A-1/P-1
Term Repo	90 Days	10%	5%	A-1/P-1
Commercial Paper	270 days	50%	5%	A-1/P-1
Asset Backed Commercial Paper	270 days	50%	5%	A-1/P-1
Corporate Bonds	5 years	50%	5%	A-/A3
Asset Backed Securities	5 year WAL	20%	5%	AAA/Aaa
Covered Bonds	5 years	20%	5%	AAA/Aaa
Mortgage Backed Securities	5 year WAL	20%	5%	AAA/Aaa
Municipal Securities	5 years	25%	5%	A-/A3
<b>OTHER STRUCTURES</b>				
Ultra-short Bond Funds	NA	50%	10%	NA
Short Duration Bond Funds	NA	50%	10%	NA
Liquidity Separate Accounts	NA	50%	NA	NA
Separate Accounts	NA	50%	NA	NA

\* Credit Rating refers to the rating given by a Nationally Recognized Statistical Rating Organization (“NRSRO”) such as Standard & Poor’s Ratings Group (“S&P”), Moody’s Investors Services, Inc. (“Moody’s”) or Fitch Ratings (“Fitch”) and is the rating firms’ subjective opinion concerning the ability and willingness of an issuer to meet its financial obligations in full and on time. Ratings apply only to the underlying holdings of the portfolio and do not remove the Fund’s market risk. If two or more NRSROs have assigned a rating, the highest rating is used. Ratings other than S&P ratings are converted into their equivalent S&P rating.

## BENCHMARK

Benchmarking is the process of using data to identify, understand, and evaluate the practice or performance of one's organization versus others. A benchmarking exercise enables entities to assess how well they measure up to a standard as well as whether or not that standard is best in class. Benchmarks are also used in investment portfolios for similar reasons; however, their limitations should be well understood.

- ***Benchmark data can be used to help identify an appropriate strategy for your liquidity.*** Evaluating benchmark returns, whose risks are similar to those you may consider, can assist management in identifying how a change in investment strategy may influence their liquidity portfolio. Benchmark data with varied duration, credit, and volatility characteristics can be analyzed to understand how a shift in strategy may influence the expected return/net income characteristics, the distribution of possible outcomes and impact to corporate financials.
- ***Benchmarks can be used for evaluation purposes*** provided it is representative of the intended risks an investor is seeking. In order for the benchmark to be considered acceptable, it should be transparent, consistent, measurable, investable, and known in advance. Often, simple market indices do not reflect the permitted risks an investor may desire and constructing a customized benchmark with the desired duration and credit characteristics is the path investors will need to pursue.
- ***Benchmarks also have limitations.*** While benchmarks may also serve as tools to assess your strategy, the choice of benchmark and the limitations of benchmark construction should be well understood. Often, benchmarks are used to assess performance; however, the comparison may be more difficult due to limitations in portfolio strategy or benchmark construction. For example a benchmark should be investable and reflect all assets available to investors. Often the benchmark may not be replicable or investable because the index choice may include exposures not permitted in a client's investment policy including debt issued by companies domiciled in emerging markets, subordinated debt, or of issuers whose credit quality is not permitted by policy. Investors should be aware of how benchmarks are constructed, the underlying risk inherent in the benchmark, and whether the design and mechanics of the benchmark are consistent with the strategy being pursued. Additionally, benchmarks are rebalanced monthly with new constituents being added and removed from the index and the portfolio similarly should be rebalanced with the same frequency.

## ACCOUNTING AND RATING AGENCY CONSIDERATIONS

Included in your investment blueprint should be input from key stakeholders, including your accounting and tax colleagues. As investors evaluate the opportunities for diversification and incremental yield, the accounting implications should be well understood. Significant shifts in strategy may influence your organization's financial metrics which may have implications for credit ratings and funding levels. While the rating agencies likely have adjusted how they view liquidity, reflective of the way many organizations now manage their cash, articulating the strategy and the risk profile of the portfolio will be critical. Additionally, understanding the differences between how investments can be classified and reported can influence the ultimate strategy selected. Questions we believe are appropriate include:

- How will the rating agencies view the investment strategy shift and what are the implications for the leverage calculations and credit ratings?
- Will this strategy change the accounting for the investment portfolio?
- Which accounting category (Held to Maturity, Available for Sale, or Trading) is most important to your organization?
- What changes to accounting are FASB/IFRS contemplating in the future and do those changes have any effect on your strategy?
- Do you have an impairment policy? Will you need to develop an impairment framework and how do you go about doing it?
- What are your peers doing?
- What financial statement disclosures will you need to make regarding portfolio liquidity, fair value pricing, and investment risk?

## RISK ORGANIZATION AND GOVERNANCE

Risk management begins with a strong and visible commitment from the entire organization to understand risk and develop the appropriate controls, including oversight, monitoring, and reporting. Critical to the success is establishing an organizational structure and policies that seek to mitigate risks. The following topics, we believe, should have a place in your investment policy:

### Custody

The custodian plays a key role in managing your assets as they are responsible for settlement, safekeeping, and reporting of the investment portfolio. Often, clients hire an independent custodian to segregate investment management from the safekeeping of assets. The basic premise behind segregation is that by separating responsibilities the ability to perpetrate and conceal fraud is greatly reduced. Custodians also can provide standardized pricing, investment guideline compliance and reporting across multiple portfolios, which may also be sought by clients.

## Reporting

Taking stock of the reporting needs across your organization and including it in the investment policy statement is also important. Reports may be designed to identify investment holdings, performance, key risks, and should be calibrated to meet the needs and objectives of senior management and/or the investment committee. To ensure that the key risks are identified, monitored, and reported an organization might need to identify infrastructure that can be leveraged or deployed and your organization should be willing to allocate resources to ensure the right governance structure is designed. Lastly, policies around record retention and business continuity should be highlighted.

## Roles and Responsibilities

An investment policy should also identify who is responsible for the implementation, oversight, management of the strategy, and the roles and responsibilities of the Board of Directors, senior management and the treasury staff. The investment policy should clearly define:

- Duties and responsibilities of all parties involved.
- Procedures for periodic review and policies for implementing change.
- Procedures for approving policy exceptions if permitted.
- Criteria for outsourcing or insourcing management of the corporate liquidity. The segregation of responsibilities with escalating approval depending on risk.
- The authority to implement investment strategy decisions, wire transfers, and other critical tasks.

## Compliance

Compliance reporting to satisfy internal auditors and management will be required. The source of that information, the frequency, and requirements should also be determined. Independent compliance monitoring is generally preferred as the separation of duties is critical to effective risk management. The policy should be written in a way such that testing can be appropriately conducted and that reference data is available from independent sources to validate compliance rules.

## Summary

The investment policy statement serves as a blueprint for your organization and guides the planning and implementation of a liquidity program. The examples provided in the template should serve as a roadmap to build your policy. However, one should recognize that entities are idiosyncratic and that the final blueprint you build should reflect the objectives, restrictions, risk tolerances, and preferences that are important to your organization. At Morgan Stanley, we are committed to working with our clients and assisting you in designing your investment policy statement to best suit your needs.

## About Morgan Stanley Investment Management

Morgan Stanley Investment Management has managed money market assets since 1975 and is dedicated to offering clients unique investment solutions through institutional money market funds and highly customized solutions. The Global Liquidity Solutions team, which has over \$153 billion in assets under management,\* is comprised of highly experienced professionals across the U.S. and Europe and welcomes the opportunity to advise on the issues impacting short-term markets both broadly and with respect to your investment policy statement. If you have further questions or require additional assistance, please contact your Morgan Stanley Relationship Manager.

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\* As of December 31, 2015.

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Please consider the investment objectives, risks and fees of the strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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Morgan Stanley Investment Management



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