

Chapter 3

Picking Investments to Match Your Strategy

In This Chapter

- ▶ Using elements of a good strategy
 - ▶ Making safe, moderate, and aggressive plays
 - ▶ Working with durations and benchmarks
 - ▶ Putting your plan together
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Having a plan or strategy is critical. Without a plan, you're just picking investments and chasing today's yield, and that's not always the most profitable bet, nor the safest.

Ironically, many without a plan will simply purchase CDs, shopping to find the best-paying interest rate. Most people feel safe with this approach because CDs are very safe and typically short-term, so there's no problem with liquidity (refer to Chapter 2). But if interest rates start to fall, this approach results in a major risk.



How do you develop a strategy? If you haven't put one together already, I would suggest getting some help. One place to look is www.reserve-fund-management.com, where you'll find some sample strategies and tools to help you.

Elements of a Good Strategy

Your strategy or plan has to work within the guidelines of your investment policy, so if that policy needs clarification or work, now's a great time. After you define and meet your liquidity

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needs, you can look at designing your portfolio — also known as your reserve fund.

Write it down

Why put your plan in writing? Here are a couple of reasons why it's important to do so:

- ✓ It helps you put your thoughts together and communicate them effectively.
- ✓ It helps you connect with the inevitable someone who can show you a better way of doing things.

For example: Suzie Financial Officer and her trusty broker set up a barbell strategy — that means about half short-term investments and about half longer-term investments (refer to Chapter 1 for more about barbell strategies). The tea leaves were implying that interest rates would not keep rising, so to further protect against falling interest rates, the portfolio went 60 percent long and 40 percent short.

Everything was fine until Bill, the new city manager, decided to add his two cents' worth and asked why they had so many long-term investments. Suzie's trusted broker had talked about the barbell strategy but couldn't articulate it. Bill said too much long-term, sell it all, and invest in short-term.

Two years later, the portfolio was earning \$500,000 a year less because the organization exited the good coupon rates it had "locked in" by having a portion of the portfolio in longer-term investments. Unfortunately, for most Financial Officers in this situation, the new city manager was oblivious to the mistake of getting rid of all longer investments in a falling interest rate market.

In this example, a written strategy could have saved the city a pretty penny.

Make some decisions

Next, you need to identify someone who is authorized to make investment decisions. An investment policy (refer to Chapter 2) gives the investment decision-making process to a designated person.

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If the person designated as the decision maker in your investment policy is being second-guessed or can't make decisions without running everything past a committee, your plan won't work as well.

Minimize your risks

In order to reduce the risk of a portfolio, you need to define the risk. Take a look at the portfolio risk calculator at www.reserve-fund-management.com for some ideas on ways to define risk.

Although you have multiple risks to consider, first look at the interest-rate risk. I've watched portfolios lose millions because no one considered the interest-rate risk. Understanding this risk and having a strategy for dealing with it is imperative to avoid falling into the trap of going longer-term when you should be shorter, and shorter-term when you should be longer.



To minimize your risks, you need to diversify your investment maturities, which you can do by using one of three strategies: matching, laddering, or barbell. I talk more about these strategies later, but for now, just remember that the key to minimizing risk is to diversify. Don't put all your investments in short-term security or all in long-term investments, unless there's a specific reason spelled out in your written strategy.

Get help if you need it

If you don't know what you're doing, for the sake of the taxpayers and your job, find someone who does.

It's okay to ask for help from a professional in the marketplace, and many can do a lot more for you than simply give you a bid on an investment. A professional can help you with your investment strategy, and in some cases, you can turn over the strategy to that expert completely (for a fee, of course).



If you are of the mindset that you know all there is to know about investing a public fund portfolio and don't need any help, you're not likely to improve your investment results.

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The Safe Play: Barbell Strategy

Your safest bet is to hire a professional, tell him or her to come up with a plan, get the plan approved by the board, review your investment policy, and design the portfolio.

Here's a strategy that you can consider a safe play: the *barbell* or *dumbbell strategy*. The concept is fairly simple. Think of a barbell, with big weights on both ends and nothing between. That's the visual representation of this strategy. For the investment representation, read on.



A *barbell strategy* involves using only short-term and long-term bonds. By not having mid-term bonds in the portfolio, the financial officer is better positioned to take advantage of any anticipated changes in the interest rates.

If half the portfolio is invested in short-term bonds but lower rates are expected to be on the way, you would sell the short-term bonds and reinvest in long-term bond issues while rates are still high. On the other hand, if your crystal ball suggests that higher rates are on the way, you'd beef up on shorter-term bonds while you wait for the more attractive rates to come along.

The Moderate Play: Laddering

If you're feeling a bit more confident, go for the moderate play. You still may want to hire a mentor, but also have a firm hold on the reins yourself.

Laddering is a good moderate play for your investments. It's a passive strategy that requires you to structure a portfolio of bonds with different maturities over a specified time period. The idea of laddering is that each year one portion of the portfolio matures. If the funds aren't needed at that point, they're reinvested.

For example, if you're setting up a five-year laddered portfolio, you'd put a fifth of your funds into bond issues with a one-year maturity, another fifth into two-year issues, and so on up to five years. After the first bonds mature, you replace them with five-year bonds.