Policy Governing the Investment of University Funds

FINANCE AND AUDIT COMMITTEE

February 9, 2016

The university's Policy Governing the Investment of University Funds outlines the allowable investments for the short- and intermediate-term non-general fund operating cash balances of the university. Authorized investments are set forth in the "*Investment of Public Funds Act*" in Sections 2.2-4500 et seq. of the Code of Virginia. Accordingly, all of the allowable investments, credit quality guidelines, and maturity parameters within the policy are authorized through, and compliant with, the Code of Virginia.

The primary objective of the investment policy is to provide the highest investment return at defined levels of risk, while providing both preservation of capital and sufficient liquidity to meet the daily cash flow needs of the university. To achieve this objective, investments are allocated between a Primary Liquidity portfolio and an Extended Duration portfolio. The Primary Liquidity allocation is the major source of daily disbursement and operational requirements of the university. The Extended Duration allocation is expected to generate an investment return, over the long-term, greater than the Primary Liquidity portfolio.

The current Policy Governing the Investment of University Funds needs two revisions:

- The current target allocations to the Primary Liquidity and Extended Duration portfolios are 75 percent and 25 percent, respectively. Due to the gradual accumulation of university operating cash balances, the portion allocated to the shorter-term Primary Liquidity portfolio needs to be reduced to 50 percent to more accurately reflect the actual operating expenditure needs of the university, which will then proportionately increase the Extended Duration allocation to 50 percent.

- One additional policy change is to include asset-backed securities with a duration within one year as allowable investments in the Primary Liquidity portfolio. These securities shall be rated no less than "AAA" by at least two nationally recognized rating agencies, one of which must be Standard & Poor's or Moody's Investors Service. Asset-backed securities with the same credit qualities and a duration of no more than five years are currently allowed within the Extended Duration portfolio.

<u>RECOMMENDATION:</u>

That the attached revisions to the Policy Governing the Investment of University Funds be approved.

Policy Governing the Investment of University Funds

General Guidelines

The University Treasurer of Virginia Polytechnic Institute and State University, or designee(s), shall be authorized to invest all endowment and quasi-endowment funds and operating funds of the university. The Treasurer may also engage the support services of outside professionals with regard to the university's investment program. Any firm hired to provide advice or assistance with the investment program shall be a registered investment advisor under the Investment Advisers Act of 1940, or exempt from registration. Investments shall be made with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

The primary objective for the management of the university's endowment and quasi-endowment funds is to achieve investment results over time that will support the purposes for which the endowment or quasi-endowment was established, while preserving the purchasing power of the funds. All gifts, local funds and nongeneral fund reserves and balances that the university determines appropriate and permitted by law may be invested in the Virginia Tech Foundation's Consolidated Endowment Program through an agency agreement. These endowment funds will be governed by the Foundation's investment and spending policies then in effect as adopted by the Foundation's Investment Committee, and shall be managed in accordance with the provisions of the Virginia *Uniform Prudent Management of Institutional Funds Act*.

The primary objective for the management of the university's operating funds is to provide the highest investment return at defined levels of risk, while providing both safety of principal and sufficient liquidity to meet the daily cash flow needs of the University. The operating funds shall be invested in instruments set forth in the *Investment of Public Funds Act* of the Commonwealth, as summarized below.

The Treasurer will review this policy at least annually and report any changes to the Board of Visitors. Also, any findings of non-compliance will be reported to the Board of Visitors, as well.

Account Structure for the Management of University Operating Funds

In order to meet the objectives of the university, investments will be divided into two major allocations: a Primary Liquidity allocation and an Extended Duration allocation. The Primary Liquidity allocation is to be the major source for the disbursement requirements and operational needs of the university. Liquidity and safety of principal at the expense of return on investment are the foremost objectives of the Primary Liquidity allocation.

The objective of the Extended Duration allocation is to generate an investment return, over the long-term, higher than the Primary Liquidity allocation. To generate higher investment returns, it is recognized that additional interest rate risk and credit risk, within prudent constraints, must be assumed in the management of the Extended Duration allocation. To help control these risks and to provide for sufficient management flexibility, the Extended Duration allocation may be structured into three sub-portfolios: a Short Duration Portfolio, an Intermediate Duration Portfolio, and a Long Duration Portfolio. However, in seeking higher investment returns, the portfolio managers will be cognizant of the university's objectives of liquidity and safety of principal. Securities lending is prohibited.

Asset Allocation Mix

The Primary Liquidity and Extended Duration target allocations are as follows:

	Target Allocation	Minimum Allocation	Maximum Allocation
Primary Liquidity	50%	30%	70%
Extended Duration	50%	30%	70%

The guidelines for the sub-portfolios of the Extended Duration allocation are as follows:

	Target Allocation	Minimum Allocation	Maximum Allocation
Short Duration Portfolio	20%	20%	100%
Intermediate Duration Portfolio	60%	0%	80%
Long Duration Portfolio	20%	0%	30%

The intent of the Asset Allocation Mix is to increase the overall average maturity and duration of the university's investment portfolios to enhance the returns over the long-term. Deviations from the Asset Allocation Mix may be made by the University Treasurer when economic conditions or liquidity needs warrant, or when it is determined that the aggregate deviation does not constitute a material departure from the spirit of the target allocation and the intent of the university. The target allocations and guidelines shall be reviewed at least annually.

Authorized Investments and Credit Quality

Authorized investments for qualified public entities are set forth in the "Investment of Public Funds Act" in Sections 2.2-4500 et seq. of the *Code of Virginia.* A qualified public entity is defined as any state agency or institution having an internal or external public funds manager with professional investment management capabilities. As a qualified public entity, the following securities are authorized for the investment of university funds:

1. Obligations issued or guaranteed by the U.S. Government, an agency thereof, or U.S. Government sponsored enterprises. This includes Agency Mortgage-Backed

Securities. These securities can be held directly, in the form of repurchase agreements collateralized by such debt securities, or in the form of registered money market or mutual funds provided that the portfolio is limited to such evidences of indebtedness.

2. Dollar denominated bonds and other obligations issued, guaranteed or assumed by the International Bank for Reconstruction and Development, the Asian Development Bank or the African Development Bank having a maturity of no longer than five years and a credit rating of at least “AAA” by Standard & Poor's and “Aaa” by Moody's Investors Service.

3. Non-negotiable certificates of deposit and time deposits of Virginia banks and savings institutions federally insured to the maximum extent possible and collateralized under the Virginia Security for Public Deposits Act, Sections 2.2-4400 et seq. of the *Code of Virginia* and having a maturity of no longer than five years.

4. Negotiable certificates of deposit, negotiable bank deposit notes, and bankers acceptances of domestic banks and domestic offices of foreign banks with a rating of at least “A-1” by Standard & Poor's and “P-1” by Moody's Investors Service for maturities of one year or less. For maturities over one year and not exceeding five years, a rating of at least “AA” by Standard & Poor's and “Aa” by Moody's Investors Service is required.

5. Repurchase agreements collateralized by securities that are approved for direct investment as stated herein. The collateral on overnight or open repurchase agreements is required to be at least 100% of the value of the repurchase agreement. Longer-term repurchase agreements are required to have collateralization in excess of 100% and be marked-to-market on a daily basis.

6. Prime quality commercial paper issued by domestic corporations. “Prime quality” shall be as rated by at least two of the following: Standard & Poor’s within its rating of “A-1”, Moody’s Investors Service within its rating of “P-1”, Fitch Investor’s Services within its rating of “F-1”, Duff and Phelps within its rating of “D-1”, or by their respective corporate successors, provided that at the time of any such investment the corporation meets the criteria specified in Section 2.2-4502 of the *Code of Virginia.*

7. Corporate notes and bonds having a credit rating of at least “A” or better by two nationally recognized rating agencies, one of which must be either Standard & Poor's or Moody's Investors Service. This includes all levels of the “A” rating.

8. Money market and other open-end investment funds provided that they are registered under the Securities Act of the Commonwealth of Virginia or by the Federal Investment Company Act of 1940, and that the investments by such funds are restricted to investments otherwise permitted by qualified public entities within the Commonwealth of Virginia.

9. Taxable and tax-exempt municipal securities of the following provided that at the time of any such investment the municipal security meets the criteria specified in Section 2.2-4501 of the *Code of Virginia*, including: (i) of any state of the United States (ii) of any county, city, town, district, authority or other public body of the Commonwealth of Virginia, and (iii) of any city, county, town or district situated in any one of the states of the United States provided that they are the direct legal obligations of the city, county, town or district, and the city, county, town or district has power to levy taxes on the taxable real property therein for the payment of such obligations without limitation of rate or amount. The municipal securities should be rated "A" or better by two nationally recognized rating agencies, one of which must be Standard & Poor's or Moody's Investors Service. This includes all levels of the "A" rating.

10. Asset-backed and non-agency mortgage-backed securities with a duration of no more than five years and rated no less than "AAA" by at least two nationally recognized rating agencies, one of which must be Standard & Poor's or Moody's Investors Service. Authorized mortgage-backed investments include Commercial Mortgage-Backed Securities (CMBS), Agency and Private Label Mortgage-Backed Securities (MBS & RMBS) including pass-throughs, Collateralized Mortgage Obligations (CMOs) and Planned Amortization Classes (PACs).

Prohibited Investments

1. Inverse floaters, Credit Default Swaps (CDSs), Collateralized Debt Obligations (CDOs), Collateralized Loan Obligations (CLOs), and Interest Only (IO), Principal Only (PO) and Z-tranche securities.

2. Futures, options, options on futures, margin buying, leveraging and commodities. Forward trades are permitted as long as they are procured during normal "when issued" periods for individual markets and as long as cash is reserved or a security will mature to cover the purchase at the time of settlement.

3. Securities with the ability to defer interest, securities with the ability to convert to perpetual maturities, and 144A securities.

In the event a security is downgraded to a level that ceases to meet Policy credit quality guidelines, the external manager will notify the University's investment staff within one business day of the downgrade. The security must then be sold within 30 days unless the manager's reasoning to continue to hold the security is approved in writing by the University Treasurer.

Diversification

Each individual portfolio within the primarily liquidity or extended duration allocations will be diversified so that no more than three percent of the value of the respective portfolios will be invested in the securities or individual trusts of any single issuer. The limitation shall *not* apply to securities of the U.S. Government, an agency thereof, U.S. Government sponsored enterprises, securities fully insured or fully guaranteed by the U.S. Government, or money market funds.

At the time of purchase, the maximum percentage in each eligible security type for the university's overall Primary Liquidity allocation shall be maintained as follows:

Primary Liquidity	
U.S. Treasury and Agency Securities	100%
Non-Negotiable Certificates of Deposit (CDs)	5%
Overnight/Open Treasury/Agency Repurchase Agreements	100%
Overnight/Open non-Treasury/Agency Repurchase Agreements	50%
Term Repurchase Agreements	20%
Bankers Acceptances	40%
Negotiable CDs and/or Negotiable Bank Deposit Notes	20%
Commercial Paper	35%
Corporate Notes	25%
Money Market Funds	35%
Municipal Securities	10%
Asset-Backed Securities	25%

At the time of purchase, the maximum percentage in each eligible security type for the university's overall Extended Duration allocation shall be maintained as follows:

Extended Duration	
U.S. Treasury and Agency Securities	100%
Non-Negotiable Certificates of Deposit	0%
Repurchase Agreements	0%
Bankers Acceptances	0%
Negotiable CDs and/or Negotiable Bank Deposit Notes	20%
Commercial Paper	0%
Corporate Bonds/Notes	40%
International Development Bank Obligations	5%
Municipal Securities	10%
Asset-Backed Securities	40%
Combined Agency MBS, Agency/Private CMOs,CMBS, RMBS, PACs	50%
Agency Mortgage-Backed Securities (MBS)	50%
Agency CMOs (including PACs)	10%
Commercial Mortgage-Backed Securities (CMBS)	10%
Private Label Residential Mortgages (including CMOs & PACs)	5%
Money Market Funds	10%

Duration and Maturity Limitations

The maximum maturity on any negotiable certificate of deposit or negotiable bank deposit note may not exceed five years.

Within the overall Primary allocation, the maximum duration for any single asset-backed or mortgage-backed security at the time of purchase may not exceed one year. Within the overall Extended allocation, the maximum duration for any single asset-backed or mortgage-backed security at the time of purchase may not exceed five years. In the event the duration of the individual security within either allocation subsequently exceeds its respective limit, the external manager shall notify the university's investment staff who shall determine whether the security should be sold.

The target duration (in years) for the Primary Liquidity allocation and the sub-portfolios of the Extended Duration allocation are as follows:

	Target	Minimum	Maximum
Primary Liquidity:	.15	.05	.25
Extended Duration:			
Short Duration Portfolio	Per Applicable Benchmark		
Intermediate Duration Portfolio	Per Applicable Benchmark		
Long Duration Portfolio	Per Applicable Benchmark		

Account Benchmarks

Primary Liquidity	BofAML 91 Day Treasury Bills Index, One Month LIBOR Index or other benchmark(s) that more appropriately reflects the manager(s) style within this particular allocation.
Short Duration Portfolio	BofAML 1-3 Year Treasury Index, Barclays 1-3 Year Government Bond Index, BofAML 1-3 year Gov/Corp Index or other benchmark(s) that more appropriately reflects the manager(s) style within this particular portfolio.
Intermediate Duration Portfolio	Barclays U.S. Treasury Intermediate Index, Barclays U.S. Intermediate Government Index, Barclays U.S. Intermediate Gov/Credit Bond Index or other benchmark(s) that more appropriately reflects the manager(s) style within this particular portfolio.
Long Duration Portfolio	Barclays U.S. Aggregate Treasury Index, Barclays U.S. Aggregate Government Index, Barclays U.S. Aggregate Bond Index, or other benchmark(s) that more appropriately reflects the manager(s) style within this particular portfolio.