A Primer on Cash Investment Policy Statements

BY ALLSPRING GLOBAL LIQUIDITY SOLUTIONS TEAM

An investment policy statement (IPS) is a document that serves as a policy guide to meet the goals and objectives of an investment portfolio over the long run. Therefore, it's an essential component of good corporate governance. Not only does having an IPS satisfy an important fiduciary duty and meet documentation requirements under the Sarbanes-Oxley Act, it provides discipline to the investment process, helps avoid misunderstandings with asset managers, and is an effective risk management tool to help manage the ups and downs of market cycles.

An IPS helps with several practical matters as well. It focuses everyone responsible for the management of an entity's assets on its unique circumstances by documenting the objectives, risk tolerance, and constraints. It facilitates an informed discussion with an entity's investment professional about risk and reward trade-offs. It can also clarify roles and responsibilities.

This primer is intended to help entities develop their own customized IPS and is aimed at those requiring liquidity solutions for mandates such as operating cash, working capital, strategic cash, cash being set aside for specific purposes, cash allocations within a larger investment plan, and employee benefit plans. Whether an entity ultimately invests in separate accounts or mutual funds, the first step in developing an IPS is the same: to fully understand the institution's specific situation, including investment objectives, risk tolerance, investment constraints, and return objectives.

Essential components of an IPS

This primer suggests seven main components, including a checklist for specific elements within some of the components, to consider when developing an IPS. An IPS should be specific to an entity. We offer this outline as a starting point for creating or revising an IPS.

01 **Purpose and scope.** The overview section of an IPS typically defines the institutional investor by legal name, be it a natural person or legal/corporate entity—and specifies which of the investor's assets will be governed by the IPS. It states the general purpose of the funds for the organization. This section may also document who—specified as a committee or role—is responsible for the application of the IPS and who has ultimate oversight responsibility.

02 **Roles and responsibilities.** The roles and responsibilities of all involved parties should be clearly defined. For example, they may include the board of directors, audit or investment committee, investment managers, investment consultants, custodians, and outside vendors. Including the CEO, CFO, and key members of the treasury department also may be appropriate.

03 **Investment objectives.** The objectives are the investment goals, which should be expressed in terms of both risk and return. As a practical matter, we usually see institutional investors with cash and short-duration assets prioritize their objectives in the order of capital preservation, liquidity, and competitive returns.

- **Investment risk tolerance.** While a risk-averse institutional investor is likely to seek capital preservation above all other objectives, there are a number of sources of risk that an investment committee needs to consider, such as credit risk, interest rate risk, and liquidity risk. The potential effect of these risks on a cash portfolio should help an investment committee understand the risk they may be undertaking and the amount of risk they are willing to take.
- **Liquidity.** Liquidity needs should be considered to ensure an appropriate time horizon is achieved to meet known and perhaps unknown liquidity requirements.
- **Return requirements.** Return objectives should be commensurate with risk tolerance and time horizon. For example, shorter-term operating cash portfolios may seek a competitive yield and focus primarily on liquidity and capital preservation. Others may have a longer time horizon and seek a combination of income and capital appreciation and therefore specify total return requirements.
- **Compliance protocol.** A clear course of action should be stated in the event that any aspect of the portfolio violates the restrictions of the policy (security downgrades, sector allocation breaches, etc.). As with other aspects of the policy, this procedure can be customized based on the risk tolerance of the entity. Most commonly, policies dictate that the manager notify the entity within a defined period of time of a violation as well as recommend a course of action to consider. Many policies attach “at time of purchase” language to some of their restrictions to allow for more flexibility.

04 **Investment constraints.** An entity’s unique situation will determine its constraints. Below is a checklist of potential constraints that may affect an investment strategy.

- **Liquidity needs.** An asset is liquid if it can be converted quickly to cash at a fair market value. Evaluate cash flow expectations by considering major uses and sources of cash to determine short- or medium-term needs for cash on an ongoing basis.
- **Time horizon.** Time horizon is closely related to liquidity needs and risk tolerance. A short time horizon is associated with greater liquidity needs and less tolerance for risk because the cash needs are immediate.
- **Tax concerns.** Depending on an entity’s tax status, taxable or tax-exempt investments may be preferred. Further, any restrictions on capital gains or losses need to be understood.
- **Legal and regulatory factors.** Common constraints may involve the Investment Company Act of 1940 that applies to research and technology firms with few hard assets, offshore investing regulations, Rule 144A offerings for qualified institutional buyers, and industry-specific regulations for banking or insurance companies.
- **Unique circumstances.** This category covers constraints that are specific to the entity. Environmental, social, and governance (ESG) investing has increasingly become an important consideration for investors. ESG objectives should be clearly outlined in an investment policy to ensure the desired outcome while pursuing investment goals and objectives. ESG factors and constraints have been more widely implemented to varying degrees over the past several years and will most likely continue to grow. There may be other limitations as well that don’t fit neatly into one of the categories above but that are important to the company and therefore must be registered in the IPS.

05 **Investment assets.** Within the cash and short-duration investable universe, the goal is to diversify risk across the asset class. Below are some considerations regarding the allowable security types.

- **Permitted investments.** Permitted investments describe the types of investments that are allowed (see Appendix A). The permitted investments should be consistent with credit and duration constraints and well diversified with limits per security and limits per issuer to provide downside protection by limiting volatility. We generally recommend a broad spectrum of investment types to pursue more diversification, which can lead to better risk-adjusted returns.

- **Money market funds and short-term bond funds.** A fund must be appropriate for both the goals and investment constraints of the entity as well as in accordance with the spirit of its IPS. It's important to treat a fund as an approved investment type rather than look at each security within the fund on an individual basis. For example, in the case of a money market fund, the SEC regulation, which covers money market fund assets, may permit certain securities that would otherwise be in violation of a company's policy due to rating or sector restrictions; however, the investor would still have daily liquidity, and the daily redemption feature of the money market fund, so they would meet the IPS maturity criteria.
- **Credit quality.** Investment committee members should begin their discussion about credit quality limits with an understanding of the risk/reward trade-offs of investing in lower-rated credits. Then they can determine the specifications within the IPS for the minimum average credit quality of the portfolio, the minimum rating for each security, and if the ratings must be those of a Nationally Recognized Statistical Rating Organization (. It's important to be specific about ratings. In particular, credit limits should specify the plus and minus tiers, such as whether a minimum rating of A means A- or mid-A. The treatment of split ratings—when an issue has different ratings from different rating agencies—should also be specified (see Appendix B).
- **Diversification.** Diversification limits are specified to help mitigate against downside risk and reduce overall portfolio volatility. The IPS language should note the maximum percentage of the overall portfolio that is allowed per issuer and per sector at the time of purchase.
- **Duration.** Duration measures the interest rate sensitivity of a portfolio. Investors must understand the risk/reward trade-offs—particularly those who desire returns and who are willing to accept some volatility of returns. Most policies assign an average portfolio duration target or band, commonly relative to an appropriate benchmark or index. Money market funds, which are limited to a maximum weighted average maturity of 60 days, largely avoid this issue by owning a high percentage of liquid, ultra-short-term investments so that maturing bonds or bonds trading near par can be used to adjust a fund's maturity profile, which moves in a narrower band than most short-duration strategies.
- **Liquidity targets.** Document if the portfolio must be constructed with a certain amount of liquidity. If so, set the minimum target level for the percentage of total cash that is to be available at all times for daily, monthly, or quarterly liquidity.
- **Taxable and tax-exempt investments.** Include the appropriate types of investment in the list of allowable investments. Understanding the entity's specific tax structure will help determine if tax-exempt or taxable investments make the most sense. A combination of both types may be appropriate if an investor seeks to maximize after-tax returns or achieve additional diversification.
- **Realized gains and losses.** Note restrictions on losses, such as a certain percent or dollars over a specific period. Note if there are any restrictions on gains. We have found that having a gain/loss budget is helpful because it allows an investment manager to be nimble, giving them the flexibility to sell a security to invest in a better opportunity or exit a deteriorating situation. In some cases, the gain/loss budget may be zero—especially for a buy-and-hold portfolio that aims to hold all bonds to maturity.

06 **Performance evaluation.** Performance evaluation aids oversight by providing a regular assessment of performance relative to established investment objectives.

- **Benchmarks.** Investment performance is evaluated in order to judge how the portfolio is performing relative to its established investment objectives. It's best to compare short-duration performance with a benchmark that is unambiguous (clearly understood by all parties), measurable, and appropriate to the risk tolerance and return objectives of the entity. Common benchmarks include Bloomberg and ICE BofA short-term fixed income indexes. Relative performance is commonly reviewed, such as to the average of a Lipper short-term funds category, but peer-group comparisons may include peers with different risk tolerances and constraints, and they are ambiguous because it's difficult to know the investment holdings of the peer group.

- **Performance appraisal.** It's important to establish a consistent set of appropriate metrics for performance and risk measurement so that meaningful comparisons can be made over time. The IPS should define the metrics that will be reviewed on a regular basis.

07 **Investment policy review.** An investment policy should be reviewed and updated periodically. It is appropriate to modify an IPS when, for example, material changes occur to an entity's own circumstances or competitive environment; government regulation; risk tolerance; time horizon; or permanent changes in the investment landscape, such as the development of new products.

Conclusion

An IPS is important because it enforces logical, disciplined investment decision-making and it limits the temptation to make counterproductive changes to an investment program during times of stress. Because there is not a one-size-fits-all IPS that's appropriate for all cash and short-duration portfolios, it is necessary to thoroughly understand and document an institutional investor's specific investment objectives, risk tolerance, and return needs; understand its investment constraints; and then establish an appropriate investment strategy.

APPENDIX A: Example of permitted investments for a short-term cash mandate

SECURITY TYPE	DESCRIPTION
U.S. Treasury bills, notes, and bonds	U.S. government-guaranteed securities that are generally considered the most liquid and creditworthy securities in the U.S. market
U.S. government agency debt	Debt obligations issued by agencies of the U.S. government, such as the Federal National Mortgage Association (FNMA), the Federal Home Loan Bank (FHLB), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal Farm Credit Bank (FFCB)
Sovereign and supranational debt	• Foreign-domiciled government or related entities that issue bonds denominated in U.S. dollars under U.S. securities law for sale in the United States as well as globally • Foreign agencies: entities or branches of a foreign government—while the debt may not be guaranteed by the government, there is an implied guarantee because their interests are aligned • **Sovereigns:** a bond issued by a foreign government denominated in U.S. dollars and registered with the Securities and Exchange Commission for sale in the U.S. and globally • **Supranational:** an entity that is formed by two or more central governments through international treaties with the purpose of promoting the economic development of the member countries. • **Foreign local governments:** local governments of a foreign country such as a state, province, or city
Repurchase agreements	A repurchase agreement (repo) is the sale of a security with a simultaneous commitment by the seller to repurchase the security from the buyer at a future date at a predetermined price This transaction allows one party (the seller) to obtain financing from another party (the buyer). The security is held as collateral, protecting the buyer against the risk that the seller is unable to repurchase the security as designated. In this way, a repo transaction may be thought of as a collateralized loan to the seller of the repo. The Securities and Exchange Commission categorizes repos according to the type of collateral as either Treasury repos, government agency repos, or other repos.
Commercial paper	An unsecured promissory note (maturities of 1 to 270 days) issued by banks, corporations, and finance companies
Asset-backed commercial paper	A form of short-term borrowing limited to a maturity of no more than 397 days; allows financial institutions to offer an additional funding option for their customers by pooling their assets to back the paper, which may consist of trade receivables, consumer receivables, auto loans and leases, student loans, corporate loans, or other types of financial assets—ABCP programs typically have 100% liquidity support provided by a financial institution
Certificates of deposit (domestic, Eurodollar, and Yankee)	A marketable receipt for funds deposited in a bank or thrift institution for a specific time period at a stated rate of interest; Eurodollar CDs are issued by large U.S. or foreign banks usually paid in London in U.S. dollars and Yankee CDs are obligations of foreign banks issued in the United States
Time deposits	Certificates of deposit held in a financial institution for a negotiated fixed term or with the understanding that the depositor can withdraw only by giving notice

SECURITY TYPE	DESCRIPTION
Money market funds	Money market funds (MMFs) are governed by Rule 2a-7 with strict rules to enhance liquidity, preservation of capital, and transparency. A MMF may be a standalone investment choice for short-term liquidity mandates. They are also used as a sweep vehicle to invest excess funds of longer-term mandates. MMFs may be rated by a Nationally Recognized Statistical Rating Organization. There are two main types of money market funds—prime and government—and they are primarily defined by their investable universes. **Prime money market funds:** invest in high-quality, short-term, U.S.-dollar-denominated money market instruments such as commercial paper and certificates of deposit. Issuers can be domestic or foreign corporations, financial institutions, or governmental entities. Institutional prime money market funds have a floating net asset value, or price, that may fluctuate over time albeit typically to a marginal degree. **Government money market funds:** invest exclusively in U.S. Treasuries, U.S. government agencies, and repurchase agreements (repos) that are fully collateralized by cash or government securities. These funds maintain a constant net asset value, so the principal value does not fluctuate. There are some funds in this category that only invest in U.S. Treasuries or Treasuries and Treasury-backed repos, omitting agency debt. These are commonly referred to as Treasury Money Market Funds.
Taxable short-term municipal debt	Taxable bonds issued by tax-exempt issuers, such as universities and municipalities
Corporate debt securities (notes, bonds, and medium-term notes)	Corporate debt instrument with maturities ranging from 9 months to 30 years • Rule 144A offerings: a Rule 144A security can be resold to persons or institutions that are reasonably believed to be qualified institutional buyers who own or invest on a discretionary basis at least $100 million of qualified securities • Yankee corporates: a dollar-denominated bond issued by a foreign corporation issued under U.S. securities law for sale in the United States and globally
Asset-backed securities	Pass-through securities backed by loans, leases, credit card receivables, or installment contracts; have final maturities ranging from three to five years at the time of issue with the average time to receipt of principal (average life) ranging from one to three years
Mortgage-backed securities, including collateralized mortgage obligations	Investment instruments that represent ownership of an undivided interest in a group of mortgages • Collateralized mortgage obligations: a security backed by a pool of pass-throughs or a pool of mortgage loans; prepayments are segmented to allow for more predictable cash flows
Commercial mortgage-backed securities	Instruments secured by loans on commercial properties
Variable-rate demand notes	Longer-term municipal securities that feature both a periodic coupon reset and a demand feature that allows an investor to periodically tender, or put, the securities at par plus accrued interest
Tender option bonds	A repackaging of long-term municipal obligations into a money-market-eligible class of floating-rate securities, which may be tendered at par plus accrued interest
Short-term municipal debt	Municipal securities typically secured by general governmental funds from tax revenue or a municipally operated enterprise
Short-term and ultra-short-term bond funds	Pooled investment vehicles that invest in short-duration fixed income assets with strategies for duration, credit, and security types as specified in their prospectuses; consider those funds that have similar objectives and risk tolerances for safety and liquidity as stated within an IPS—as a result, the fund will be approved as a specific investment type that is appropriate for the entity rather than looking through to its underlying investments

APPENDIX B: Credit ratings overview

These tables provide an overview of short- and long-term credit ratings by three of the NRSROs. The ratings definitions were derived from NRSRO ratings definition documentation. For further information about ratings criteria, please refer to the rating agencies.

Short-term taxable ratings

STANDARD & POOR'S		MOODY'S		FITCH	
LEVEL OF SAFETY	RATING	LEVEL OF SAFETY	RATING	LEVEL OF SAFETY	RATING
Extremely strong capacity to meet its financial commitments	A-1+	Superior ability to repay short-term debt obligations	P-1	Exceptionally strong capacity for timely payment of financial commitments	F1+
Strong	A-1	Strong	P-2	Highest short-term credit quality	F1
Satisfactory	A-2	Acceptable	P-3	Good	F-2
Adequate	A-3	–	–	Fair	F-3

Long-term credit ratings

STANDARD & POOR'S		MOODY'S		FITCH	
LEVEL OF SAFETY	RATING	LEVEL OF SAFETY	RATING	LEVEL OF SAFETY	RATING
Highest	AAA	Highest quality	Aaa	Highest	AAA
Very strong	A-1	High quality	Aa1 Aa2 Aa3	Very high	AA+ AA AA-
Strong	A+ A A-	Upper-medium grade	A1 A2 A3	High	A+ A A-
Adequate	BBB+ BBB BBB-	Medium-grade, subject to moderate credit risk and may possess certain speculative characteristics	Baa1 Baa2 Baa3	Good credit quality	BBB+ BBB BBB-
Significant speculative characteristics but less vulnerable in near term than lower-rated credits	BB+ BB BB-	Speculative and subject to substantial credit risk	Ba1 Ba2 Ba3	Speculative	BB+ BB BB-
Currently has ability to meet financial commitments but adverse conditions will likely impair	B+	Speculative and subject to high credit risk	B1 B2 B3	Highly speculative	B+ B B-
Currently vulnerable	CCC	Speculative of poor standing and subject to very high credit risk	Caa	Substantial credit risk	CCC
Highly vulnerable	CC	Highly speculative and likely in or near default	Ca	Very high levels of credit risk	CC
–	–	Lowest rated and likely in or very near default	C	Exceptionally high levels of credit risk	C
Default	D	See specific definitions of default from Moody's		Default	D

Source: Allspring Global Investments. For illustrative purposes only.

Note: Shaded rows indicate investment-grade credits.

A money market fund rating is a forward-looking opinion about a fixed income fund's capacity to maintain stable principal (net asset value). Standard & Poor's designates money market fund ratings with a subscript letter m (for example, AAAm), which distinguishes it from a Standard & Poor's long-term debt rating.

Moody's designates money market fund ratings with the subscript letters mf. Fitch designates money market fund ratings with the subscript letters mmf.

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Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses. All investing involves risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors, some of which may be unpredictable. Each asset class has its own risk and return characteristics.

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