

BECAUSE THAT'S WHERE THE MONEY IS

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The current markets call to mind the old explanation for robbing banks attributed to Willie Sutton. The financial markets have had their-apocalypse. For many of you, your portion of the business of government is counting the money, budgeting the money, you get the picture. So, where is the money and where is it going? Since “the times, they are a’changin’” the most relevant question is whether the places money goes are changin’ as well. Right now, we’ve got plenty of questions, answers are in shorter supply.

The financial crisis raises the big questions of life, . . . and investing. First, how are those financial investments working out for you now? It seems that for most treasurers, financials were the extent of their investment in corporate America. Debt of Lehman and Washington Mutual are virtually worthless, while other surviving commercial banks have sustained stunning losses. Investments that were previously considered prudent and strong have resulted in some tangible losses. Moreover, those losses have occurred at very difficult times in the government world—times of decreased revenues and increased demands. The funds on which public employees depend for their retirement (as well as the investments the private sector relies on) have racked up an impressive losing streak. We are now waiting for years to pass before recovery seems feasible.

The three bulwarks of investing are safety, liquidity and yield. In the current environment, does the maximizing of yield—return—actually have a significant place at the table? A fundamental quality of the financial crisis is the recognition of risk in financial instruments. While credit spreads have increased to reflect a more realistic approximation of the actual investment risk, it is not clear that the risk premium paid on investments is sufficient to overcome the inherent risk averse nature of governments. If safety is the “prime directive,” with a renewed realization of the risk in financial instruments, we wonder whether there can be room for any real focus on yield as a goal.

The related question arises: does that “prime directive” under current conditions morph into an imperative to invest so as to cover your tuckus regardless of value? Traditional investment of government funds operates in a world with a high penalty for negative performance (loss of principal) and a low reward for positive investment gains. Of course this risk averse approach can lead one to miss real and substantive opportunities afforded in the market. However, on the upside, it often has the benefit of job security for the finance or investment officer.

Our perspective is to apply a realistic appraisal of investment risk in light of the risk premium available in the market—value investing. Market inefficiencies can provide opportunity to realize gains in return through the careful selection of investment vehicles of similar actual risk. For example, a high grade corporate bond (relatively rare now) or general fund debt of a neighboring government may offer returns at a real spread to comparable Treasuries with virtually no increase in risk. Even tax-exempt debt may provide value in this market.

In the final analysis, where the money is depends on the balance between risk and return. This is going back to basics. ♦

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