APPENDIX 2

HEREFORDSHIRE COUNCIL

TREASURY MANAGEMENT INVESTMENT STRATEGY 2004/05

1. INTRODUCTION

1.1 Under CIPFA's Treasury Management Code of Practice, the Council is required to formulate a strategy each year regarding its investments. From 2004/05 onwards, the requirements of the Treasury Management Code have been supplemented by guidance from the Office of the Deputy Prime Minister (ODPM), designed to replace the terms of the Approved Investment Regulation 1990, which cease to have effect from 1st April 2004. Authorities are required to take the guidance into account under the terms of section 15(1)(a) of the Local Government Act 2003.

1.2 Owing to the late issue of the OPDM guidance in March 2004, this 2004/05 Investment Strategy has been prepared separately for approval from the Treasury Management Strategy. In future, the Investment Strategy will form part of the annual Treasury Management Strategy passed to Cabinet for endorsement before the start of each financial year.

1.3 This Annual Investment Strategy states which investments the Council may use for the prudent management of its treasury balances during the financial year under the headings of **Specified Investments** and **Non-Specified Investments** as detailed in **Annex A**.

1.4 This Annex sets out:

- The procedures for determining the use of each category of investment (advantages and associated risk), particularly if the investment falls under the category of "non-specified investments."
- The maximum periods for which funds may be prudently committed in each category.
- Whether the investment instrument is to be used by the Council's in-house officers and/or by the Council's appointed external fund managers (Investec Asset Management); and, if non-specified investments are to be used in-house, whether prior professional advice is to be sought from the Council's treasury advisors (Sector Treasury Services Ltd).

2. INVESTMENT OBJECTIVES

2.1 All investments will be in sterling. The general policy objective for Herefordshire Council is the prudent investment of its treasury balances*. The Council's investment priorities are:

(a) the **security** of capital; and

(b) **liquidity** of its investments.

The Council will aim to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity.

* This includes monies borrowed for the purpose of expenditure in the reasonably near future (i.e. borrowed 12-18 months in advance of need).

2.2 The ODPM guidance maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

3. SECURITY OF CAPITAL: THE USE OF CREDIT RATINGS

3.1 The Council relies on credit ratings published by *Fitch Ratings, Moody's Investors Service or Standard & Poor's* to establish the credit quality of counterparties and investment schemes. The Council has also determined the minimum long-term, short-term and other credit ratings it deems to be "high" for each category of investment in conjunction with its Treasury Management advisor.

3.2 **Monitoring of credit ratings:**

- All credit ratings will be monitored monthly: The Council has access to Fitch credit ratings and is alerted to changes from its Treasury Management advisor.

- If a counterparty's or investment scheme's rating is downgraded with the result that it no longer meets the Council's minimum criteria, the further use of that counterparty/investment scheme as a new investment will be withdrawn immediately. Any intra-month credit rating downgrade which the Council has identified that affects the Council's pre-set criteria will also be similarly dealt with. The Council will also immediately inform its external fund manager of the withdrawal of the same.

- If a counterparty is upgraded so that it fulfils the Council's criteria, its inclusion will be considered for approval by the County Treasurer.

4. INVESTMENTS DEFINED AS CAPITAL EXPENDITURE

4.1 The acquisition of share capital or loan capital in any body corporate is defined as capital expenditure under Section 16(2) of the Local Government Act 2003. Such investments will have to be funded out of capital or revenue resources and will be classified as 'non-specified investments'.

4.2 Investments in "money market funds" which are collective investment schemes and bonds issues by "multilateral development banks" (both defined in Statutory Instrument Number 534), will not be treated as capital expenditure.

4.3 A loan or grant by this Council to another body for capital expenditure by that body is also deemed by regulation to be capital expenditure by this Council. It is, therefore, important for this Council to clearly identify if the loan has made for policy reasons (e.g. to the registered social landlord for the construction/improvement of dwellings) or if it is an investment for treasury management purposes. The latter will be governed by the framework set by the Council for 'specified' and 'non-specified' investments.

4.4 This Council will not use or allow its external fund managers to use any investment which will be deemed as capital expenditure.

PROVISION FOR CREDIT-RELATED LOSSES

4.5 If any of the Council's investments appeared at risk of loss owing to default (i.e. this a credit-related loss, and not one resulting from a fall in price due to movements in interest rates), the Council will make revenue provision of an appropriate amount.

5. INVESTMENT STRATEGY

5.1 The County Treasurer manages part of the Council's investment portfolio. Investments managed by the in-house team are generally temporary in nature and short-term. All decisions are made in the light of the Council's forecast cash flow requirements.

5.2 If, during the course of the year, the County Treasurer detects that the market's expectation for base rates has been too high, the strategy will be to keep investments as long as possible with a view to locking in higher rates of return than may be available at a later stage when market expectations are corrected.

5.3 The money market yield curve is currently anticipating rising base rates in 2004/05. This authority views the markets' expectation for base rates as being too low; investment maturities will generally be kept short (1-3 months), with a view to enabling returns to be compounded more frequently.

5.4 Investment returns are forecast to be less than the cost of new borrowing during most of the year. It may, therefore, be beneficial to finance new capital expenditure by running down cash balances.

5.5 Based on its cash flow forecasts, the Council anticipates its fund balances in 2004/05 to average around £15,000,000.

5.6 Giving due consideration to the Council's level of balances over the next three years, the need for liquidity, its spending commitments and provisioning for contingencies, the Council has determined that a maximum of £10,000,000 of its overall fund balances can be prudently committed to longer term investments (i.e. those with a maturity exceeding a year).

5.7 In relation to the Council's internally managed funds, the County Treasurer does not currently plan to invest over 364 days. However, the Council's External fund manager could have a maximum 50% of its investment portfolio invested for periods in excess of 364 days. The market will be continuously monitored for opportunities to lock in to higher, longer-term rates, if it is viewed that this will add stability and value to returns.

5.8 With investment returns at historically low levels, there is limited scope to generate higher returns. However, the County Treasurer continuously seeks to add value over general market levels of returns. To this end, Call Accounts and Money Market Funds are some of the recent investment opportunities which have added value to the internally managed funds. Internally managed investments have generally exceeded the benchmark return.

6. EXTERNALLY MANAGED FUNDS

6.1 A cash fund of £6,822,721.42 (as at 31st March 2004) is currently managed by Investec Asset Management on a discretionary basis. The Council, in conjunction with the Council's Treasury Management adviser, will monitor the external fund manager's performance in 2004/05.

6.2 The fund management agreement between the Council and Investec Asset Management formally documents the instruments it can use within pre-agreed limits.

7. COMPLIANCE WITH INVESTMENT STRATEGY

7.1 All internally managed investments must be carried out in accordance with this Investment Strategy.

7.2 The contract with the External Fund Managers will be amended to ensure that the investments managed by them comply with the Council's Annual Investment Strategy.

8. END OF YEAR INVESTMENT REPORT

8.1 At the end of the financial year, the Council will prepare a report on its investment activity as part of its Annual Treasury Report.

SPECIFIED INVESTMENTS

All investments listed below must be sterling-denominated

Investment	**Share/ Loan Capital?**	**Repayable/ Redeemable within 12 months?**	**Security / Credit Rating**	**Capital Expenditure?**	**Circumstance of use**	**Maximum period**
Debt Management Agency Deposit Facility* (DMADF) * this facility is at present available for investments up to 6 months	No	Yes	Govt-backed	No	In-house	1 year*
Term deposits with the UK government or with UK local authorities (i.e. local authorities as defined under Section 23 of the 2003 Act) with maturities up to 1 year	No	Yes	High security although LAs not credit rated.	No	In-house and by external fund manager	1 year
Term deposits with credit-rated deposit takers (banks and building societies), including callable deposits, with maturities up to 1 year	No	Yes	Yes-varied *Minimum rating "A" Long-term and "F1" Short-term (or equivalent)*	No	In-house and by external fund manager	1 year
Certificates of Deposit issued by credit-rated deposit takers (banks and building societies): up to 1 year. *Custodial arrangement required prior to purchase*	No	Yes	Yes-varied *Minimum rating "F1+" Short-term (or equivalent)*	No	External fund manager	1 year
Gilts: up to 1 year *Custodial arrangement required prior to purchase*	No	Yes	Govt-backed	No	(1) Buy and hold to maturity: to be used in-house after consultation with Treasury Management advisor (2) For trading: by external fund manager only subject to the guidelines and parameters agreed with them	1 year

Investment	Share/ Loan Capital?	Repayable/ Redeemable within 12 months?	Security / Credit Rating	Capital Expenditure?	Circumstance of use	Maximum period
Reverse Gilt Repos: maturities up to 1 year [*A transaction where gilts are bought with a commitment (as part of the same transaction) to sell equivalent gilts on a specified date, or at call, at a specified price].* *Custodial arrangement required prior to purchase*	No	Yes	Govt-backed	No	External fund manager only subject to the guidelines and parameters agreed with them	1 year
Money Market Funds *[i.e. a collective investment scheme as defined in Statutory Instrument 2004 No. 534]* *These funds do not have any maturity date*	No	Yes	Yes-varied *Minimum AAA credit rated*	No	In-house and by external fund manager subject to the guidelines and parameters agreed with them	The period of investment may not be determined at the outset but would be subject to cash flow and liquidity requirements
Forward deals with credit rated banks and building societies < 1 year (i.e. negotiated deal period plus period of deposit)	No	Yes	Yes-varied *Minimum rating "A" Long-term and "F1" Short-term (or equivalent)*	No	In-house	1 year in aggregate
Commercial paper *[Short-term obligations (generally with a maximum life of 9 months) which are issued by banks, corporations and other issuers]* *Custodial arrangement required prior to purchase*	No	Yes	Yes-varied *Minimum rating "F1+" Short-term (or equivalent)*	No	External fund manager only subject to the guidelines and parameters agreed with them	9 months

Investment	Share/ Loan Capital?	Repayable/ Redeemable within 12 months?	Security / Credit Rating	Capital Expenditure?	Circumstance of use	Maximum period
Gilt Funds and other Bond Funds***. *[These are open-end mutual funds investing predominantly in UK govt gilts and corporate bonds. These funds do not have any maturity date. These funds hold highly liquid instruments and the Council's investments in these funds can be sold at any time.]*	No	Yes	Yes *Minimum rating "AA-"*	No (ensure it is not a body corporate by virtue of its set up structure)	External fund manager only subject to the guidelines and parameters agreed with them (NB: In the selection of a fund the manager will ensure that the fund is not a body corporate by virtue of its set up structure).	
Treasury bills [*Government debt security with a maturity less than one year and issued through a competitive bidding process at a discount to par value*] *Custodial arrangement required prior to purchase*	No	Yes	Govt-backed	No	In-house and external fund manager subject to the guidelines and parameters agreed with them	1 year
Bonds issued by a financial institution that is guaranteed by the UK Government *[As defined by Statutory Instrument 2004 No. 534, with maturities under 12 months].* *Custodial arrangement required prior to purchase*	No	Yes	Govt-backed	No	1) Buy and hold to maturity: to be used in-house after consultation with Treasury Management advisor (2) For trading: by external fund manager only subject to the guidelines and parameters agreed with them	1 year
Bonds issued by a multilateral development bank *[As defined by Statutory Instrument 2004 No. 534, with maturities under 12 months].* *Custodial arrangement required prior to purchase*	No	Yes	AAA	No	1) Buy and hold to maturity: to be used in-house after consultation with Treasury Management advisor (2) For trading: by external fund manager only subject to the guidelines and parameters agreed with them	1 year

***Open-ended funds continually create new units (or shares) to accommodate new monies as they flow into the funds and trade at net asset value. (NAV).

NON-SPECIFIED INVESTMENTS

All investments listed below must be sterling-denominated

Investment	(A) Why use it? (B) Associated risks?	Share/ Loan Capital?	Repayable/ Redeemable within 12 months?	Security / Minimum credit rating	Capital Expen-diture?	Circumstance of use	Max % of overall investments	Maximum maturity of investment
Term deposits with credit rated deposit takers (banks and building societies) with maturities greater than 1 year	(A) (i) Certainty of rate of return over period invested. (ii) No movement in capital value of deposit despite changes in interest rate environment. (B) (i) Illiquid: as a general rule, cannot be traded or repaid prior to maturity. (ii) Return will be lower if interest rates rise after making the investment. (iii) Credit risk: potential for greater deterioration in credit quality over longer period.	No	No	YES-varied *Minimum rating "AA-" Long-term and "F1" Short-term (or equivalent) Support 1,2 or equivalent*	No	External Fund Manager. In-house	50% 20%	5 years
Certificates of Deposit with credit rated deposit takers (banks and building societies) with maturities greater than 1 year *Custodial arrangement required prior to purchase*	(A) (i) Although in theory tradable, are relatively illiquid. (B) (i) 'Market or interest rate risk': Yield subject to movement during life of CD which could negatively impact on price of the CD.	No	Yes	YES-varied *Minimum rating "AA" Long-term and "F1+" Short-term (or equivalent)*	No	External fund manager. In-house after consultation with Treasury Management advisor	50% 20%	5 years

Investment	(A) Why use it? (B) Associated risks?	Share/ Loan Capital?	Repayable/ Redeemable within 12 months?	Security / Minimum credit rating	Capital Expen-diture?	Circumstance of use	Max % of overall investments	Maximum maturity of investment
Callable deposits with credit rated deposit takers (banks and building societies) with maturities greater than 1 year	(A) (i) Enhanced income - Potentially higher return than using a term deposit with similar maturity. (B) (i) Illiquid – only borrower has the right to pay back deposit; the lender does not have a similar call. (ii) Period over which investment will actually be held is not known at the outset. (iii) Interest rate risk: borrower will not pay back deposit if interest rates rise after deposit is made.	No	No	YES-varied *Minimum rating "AA-" Long-term and "F1" Short-term (or equivalent) Support 1,2 or equivalent*	No	External Fund Manager. In-house after consultation with Treasury Management advisor	50% 20%	5 years in aggregate
UK government gilts with maturities in excess of 1 year *Custodial arrangement required prior to purchase*	(A) (i) Excellent credit quality. (ii) Very liquid. (iii) If held to maturity, known yield (rate of return) per annum - aids forward planning. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity) (v) No currency risk (B) (i) 'Market or interest rate risk': Yield subject to movement during life of sovereign bond which could negatively impact on price of the bond i.e. potential for capital loss.	No	Yes	Govt backed	No	(1) Buy and hold to maturity: in-house after consultation with Treasury Management advisor (2) For trading: by external fund manager only subject to the guidelines and parameters agreed with them	20% 50%	10 years (but also including the 10 year benchmark gilt)

Investment	(A) Why use it? (B) Associated risks?	Share/ Loan Capital?	Repayable/ Redeemable within 12 months?	Security / Minimum credit rating	Capital Expen-diture?	Circumstance of use	Max % of overall investments	Maximum maturity of investment
Sovereign issues ex UK govt gilts: any maturity *Custodial arrangement required prior to purchase*	(A) (i) Excellent credit quality. (ii) Liquid. (iii) If held to maturity, known yield (rate of return) per annum - aids forward planning. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity) (v) No currency risk (B) (i) 'Market or interest rate risk': Yield subject to movement during life of sovereign bond which could negatively impact on price of the bond i.e. potential for capital loss.	No	Yes	AAA	No	(1) Buy and hold to maturity in-house after consultation from Treasury Management advisor (2) For trading: by external fund manager only subject to the guidelines & parameters agreed with them	20% 50%	10 years
Forward deposits with credit rated banks and building societies for periods > 1 year (i.e. negotiated deal period plus period of deposit)	(A) (i) Known rate of return over period the monies are invested - aids forward planning. (B) (i) Credit risk is over the whole period, not just when monies are actually invested. (ii) Cannot renege on making the investment if credit rating falls or interest rates rise in the interim period.	No	No	Yes-varied *Minimum rating "AA-" Long-term and "F1" Short-term (or equivalent) Support 1,2 or equivalent*	No	External Fund Manager In-house after consultation with Treasury Management advisor	50% 20%	5 years

Investment	(A) Why use it? (B) Associated risks?	Share/ Loan Capital?	Repayable/ Redeemable within 12 months?	Security / Minimum credit rating	Capital Expen-diture?	Circumstance of use	Max % of overall investments	Maximum maturity of investment
Deposits with unrated deposit takers (banks and building societies) but with unconditional financial guarantee from HMG or credit-rated parent institution: any maturity	(A) Credit standing of parent will determine ultimate extent of credit risk	No	Yes	Not rated in their own right, but parent must be rated. *Minimum rating for parent "AA-" Long-term and "F1" Short-term (or equivalent) Support 1,2 or equivalent*	No	In-house	20%	1 year
Bonds issued by a financial institution that is guaranteed by the UK Government (as defined in Statutory Instrument 2004 No. 534) with maturities in excess of 1 year *Custodial arrangement required prior to purchase*	(A) (i) Excellent credit quality. (ii) relatively liquid (although not as liquid as gilts). (iii) If held to maturity, known yield (rate of return) per annum - aids forward planning, enhanced return compared to gilts. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity) (B) (i) 'Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond i.e. potential for capital loss. (ii) Spread versus gilts could widen.	Yes	Yes	AAA / Govt guaranteed	No	(1) Buy and hold to maturity: in-house after consultation with Treasury Management advisor (2) For trading: by external fund manager only subject to the guidelines and parameters agreed with them	20% 50%	10 years

Investment	(A) Why use it? (B) Associated risks?	Share/ Loan Capital?	Repayable/ Redeemable within 12 months?	Security / Minimum credit rating	Capital Expen-diture?	Circumstance of use	Max % of overall investments	Maximum maturity of investment
Bonds issued by multilateral development banks (as defined in Statutory Instrument 2004 No. 534) with maturities in excess of 1 year *Custodial arrangement required prior to purchase*	(A) (i) Excellent credit quality. (ii) relatively liquid (although not as liquid as gilts). (iii) If held to maturity, known yield (rate of return) per annum - aids forward planning, enhanced return compared to gilts. (iv) If traded, potential for capital gain through appreciation in value (i.e. sold before maturity) (B) (i) 'Market or interest rate risk': Yield subject to movement during life of bond which could negatively impact on price of the bond i.e. potential for capital loss. (ii) Spread versus gilts could widen.	Yes	Yes	AAA / Govt guaranteed	No	(1) Buy and hold to maturity: in-house after consultation with Treasury Management advisor (2) For trading: by external fund manager only subject to the guidelines and parameters agreed with them	20% 50%	10 years