

# MEMORANDUM

Montana Board of Investments

Department of Commerce

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**To:** Board Members  
STIP Participants

**From:** Carroll South, Executive Director

**Date:** September 5, 2008

**Subject:** Montana Association of Counties e-mail

Yesterday, the Board was forwarded an e-mail, in which a legal opinion is cited relative to the Short Term Investment Pool (STIP) managed by the Board. This memorandum clarifies the Board's policies and procedures for management of the STIP.

## WHAT KIND OF INVESTMENT POOL IS THE STIP?

As published in the STIP Financial Statement and Investment Policy Statement, the STIP is an "amortized cost" investment pool. The definition in the Financial Statement is shown below:

**"Although the STIP is not registered with the Securities and Exchange Commission (SEC) as an investment company, the Board manages the STIP consistent with the SEC's rule 2a7 of the Investment Company Act of 1940. As a 2a7-like pool, the STIP utilizes an amortized cost unit value, rather than fair value to report net assets."**

Excerpts from the Investment Policy Statement are shown below:

**"The pool shall be designed and managed in accordance with the standards of a "prudent expert" and managed as a "2a-7-like" portfolio." "STIP holdings are carried at amortized cost."**

Both documents are posted on the Board's web site.

## WHAT IS AN AMORTIZED COST POOL?

An amortized cost pool maintains all securities in the portfolio at either original cost or amortized cost. Original cost is used for securities purchased at par (the principal amount due at maturity). Amortized cost is used for discount securities that may or may not pay interest and are purchased for less than par. The difference between the discount purchase price and par at maturity is "amortized" from the date of purchase to maturity and is counted as income earned on the security.

Income is distributed to participants based on the “accrued” interest and “amortized” discount of the STIP securities. The daily numerical value of the combined interest and amortization is divided by the daily amortized cost value of the pool to determine the STIP yield for the day. The STIP yield will most likely change each business day as securities with different yields are purchased to replace maturing securities. At the end of the month, each participant is distributed income based on the number of shares held each day of the month times the daily yield factor.

The amortized cost methodology is standard practice for money market type funds and is the only way these funds can maintain a constant share value of \$1.00. If the share value was based on the “price” of the underlying securities, the share value would change whenever the securities were priced. The methodology permits participants to purchase/sell shares on 24-hours notice at a constant value - \$1.00 in - \$1.00 out.

The underlying securities in the pool are not “priced” or “marked to market” because there is no intention of selling the securities and in some cases prices may not be readily available. While securities may be sold occasionally for strategic investment purposes, the assumption is made when a security is purchased that it will be held to maturity. This limits any potential principal loss to the issuer’s failure to repay the principal rather than realizing a loss of principal on a security sale.

#### **WHAT IS THE CURRENT STATUS OF THE STIP PORTFOLIO?**

All securities in the STIP portfolio are currently held at amortized cost, including the remaining \$140.0 million of Structured Investment Vehicles. The Vehicles are currently being restructured and the underlying securities are held by the Trustee and will not be sold without specific instructions from the senior creditors. In the meantime cash continues to build up in the Vehicles as underlying securities pay down and mature.

#### **WHAT IF THERE IS A REALIZED LOSS OF PRINCIPAL?**

The Board has no definitive information as of this date to indicate that there will be a realized principal loss on any of the securities in the portfolio. If there is a realized principal loss, it will be amortized with STIP income over a period of time to ensure that the constant \$1.00 share value is maintained. This is the same process used in other investment pools the Board manages. Realized losses from the sale of securities in the two bond pools are distributed to pool participants as are realized gains. Realized losses reduce interest income distributed to participants, while realized gains increase interest income distributed to participants. Realized gains and losses on securities in the pools **do not** change the “book value” of participant shares in the pools.

#### **WHAT DOES THE LAW SAY?**

The Short Term Investment Pool (STIP) was created by the Legislature on July 1, 1973 as an investment vehicle to manage state and local government cash. State agencies utilize STIP for accounts that are entitled to retain their interest earnings and have no

other options for the investment of their cash. Local governments have other options as permitted by law and use the STIP at their discretion. While the law does not specifically address state participation in the pool it is very specific to local government participation.

The law creating STIP and permitting local governments to participate was one of 10 sections contained in legislation to enact the Unified Investment Program required by the new Constitution. The pertinent section of that law as it relates to local government's ability to withdraw funds from the pool is listed below:

**“17-6-204(3) The principal and accrued income, and any part thereof, of each and every account maintained for a participant in the pooled investment fund shall be subject to payment at any time from the fund upon request. Accumulated income shall be remitted to each participant at least annually.”**

After searching the history of this law and finding no record of legislative committee discussion or other written records defining the legislative intent of this language, the Board's legal counsel has opined that this section of state law should be interpreted literally – that the Board is required to return local government principal when it is requested. In the absence of any legislative intent to the contrary, the Board must honor the strict language of the law.

However, the Board also has a fiduciary responsibility to treat all STIP participants equally. The Board's fiduciary responsibility does not allow, and the Board has never suggested, that state government accounts would absorb the entire realized loss of any principal in the STIP portfolio. The only method by which the Board can ensure that state and local participants are treated equally is to maintain a \$1.00 share value for all participants – state and local. If a realized loss of principal occurs, the loss would be offset against income over a period of time that would maintain a competitive yield for participants remaining in the pool.

### **CURRENT STIP PARTICIPATION**

As of September 4, 2008, STIP participants held \$2.38 billion in shares, with state participants holding \$1.95 billion and local participants holding \$425.3 million. The largest shareholder was the State Treasurer's Fund holding \$681.4 million in shares. There were 465 accounts, which included 288 state accounts and 177 local government accounts.

### **STIP CONTACT**

I am always available to answer questions and respond to concerns that any STIP participant may have regarding the STIP portfolio. My e-mail address and phone number are:

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