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Briefing Report on the
Risks and Benefits of Certain Investments

August 1996

Overall Conclusion

The State Auditor's Office has assessed the risks and benefits generally associated with mutual funds other than money market mutual funds, investment pools that do not function as money market mutual funds, and guaranteed investment contracts as required by statute. However, the evaluation of these risks and benefits should be considered in conjunction with the management controls needed to ensure these types of investments are in the best interest of the governmental entity and the public. The Public Funds Investment Act mandates many of these controls for entities which choose to include these types of investments in their portfolios.

Key Facts and Findings

- Investing in mutual funds other than money market mutual funds involves risks which can include fluctuation in the value of principal, lack of performance guarantees, and loss of control of some decision-making. The benefits include potential enhancement of yield, participation in a professionally managed portfolio, and economies of scale for small local government investors.

- Investing in investment pools that do not function like money market mutual funds involves risks which include fluctuation in the value of principal, lack of performance guarantees, and loss of control of some decision-making. The benefits include potential enhancement of yield, participation in a professionally managed portfolio, and economies of scale for small local government investors.

- Investing in guaranteed investment contracts involves risks which include reliance on the insurance company's (issuer's) ability to repay the investor, limited marketability, and being subject to market risk if interest rates decline. The benefits include the ability to require the insurance company to provide collateral and/or establish a separate account, and to make liquidity arrangements and agree upon a maturity date up front.

- Certain controls are necessary if these types of investments are considered for an investing entity's portfolio. Key controls over the investments function have already been mandated by the Public Funds Investment Act. In addition to these controls, an effective cash management system is needed to distinguish operating funds from those funds available for long-term investment. This cash management system should identify the length of the investment and liquidity requirements so that available funds can be matched to suitable investments.

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This project was conducted in accordance with House Bill No. 2459, Acts 1995, 74th Legislature, Chapter 402, § 9.
No investments are risk-free. The risk with an investment represents the chance, due to uncertainty, that intended objectives will not be attained. Risk is directly proportional to investment returns. That is, investments yielding higher returns will also carry greater risk. The trade-off between risk and return must be assessed by the investing entity or governing body that establishes the investment policy.

This report covers the risks and benefits associated with three types of investments:

- Mutual funds, other than money market mutual funds
- Investment pools, other than investment pools that function as money market mutual funds
- Guaranteed investment contracts

The three investments mentioned in this report are currently authorized for government entities subject to the Public Funds Investment Act. Each of these investments is long-term in nature, in that the maturities are longer than one year. Like any long-term security, these investments are more susceptible to market risk than short-term securities. Investments with longer maturities are inherently subject to more chances that changes in market conditions may occur, resulting in the devaluation of the investment.

Section 1:
Mutual Funds Other Than Money Market Mutual Funds

Section 1-A:
The Public Funds Investment Act (Act) Authorizes Investment in

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**Definition of Mutual Fund**

A mutual fund is an entity that invests on behalf of individuals and institutions who share common financial goals and authorized investments, as identified in the fund’s prospectus. The mutual fund pools the money of these individuals and institutions. Professional money managers then use the pool of money to buy a variety of stocks, bonds, and/or money market instruments that, in their judgement, will help the fund’s shareholders achieve their financial goals.

Under the Public Funds Investment Act (Government Code, Chapter 2256.014) an entity may invest in no-load money market mutual funds and in no-load mutual funds (other than money market funds) if certain conditions are met. (The term “load” refers to the sales charge associated with a mutual fund. Therefore, a “no-load fund” is a mutual fund which does not have a sales charge.) The conditions include:

- Investing entities cannot invest in the aggregate more than 15 percent of its average fund balance in mutual funds other than money market mutual funds.
- The investing entities cannot invest, in any one mutual fund, an amount greater than 10 percent of the total assets of that particular mutual fund.
Detailed Issues

- Mutual funds must be registered with the Securities and Exchange Commission (SEC).
- The weighted average maturity for mutual funds other than money market funds must be less than two years.
- No-load mutual funds must also have an investment quality rating no lower than AAA or its equivalent.

The Act prohibits the investment of any portion of bond proceeds, reserves, and funds held for debt service in mutual funds other than money market mutual funds.

Background on Mutual Funds

Mutual funds other than money market mutual funds are generally used by long-term investors seeking professional management and additional investment opportunities. Classified into four categories and 22 subcategories, more than 6,000 mutual funds exist to serve a variety of investors of both public and private funds. For the purposes of this report, the term “mutual funds” refers to those other than money market funds.

Mutual funds are considered long-term investments. While the industry identifies long-term as more than one year, many experienced mutual fund investors consider this investment to be at least five years, in order to weather the five to ten year market cycles.

Types of Mutual Funds

The 4 categories and 22 subcategories of mutual funds can make identifying the proper mutual fund a difficult and time-consuming process for the potential investor. Mutual funds are generally recognized by the following categories:

- **Stock funds** invest in the stock of various corporations with the anticipation that per share prices of the stocks will increase in value, or grow, over time. This increases the net asset value of a stock fund investment. (Also called growth funds)
- **Bond funds** invest in bonds which, through the accompanying interest rate, produce steady income for shareholders. (Also called income funds)
- **Growth and income funds** comprise a combination of stock and bond investments. (Also called balanced funds)
- **Money-market mutual funds** are considered the safest mutual fund investment because they invest in high-quality, short-term securities. They are managed to keep a constant per share net asset value of $1.00, and a weighted average portfolio maturity of less than 90 days.

Section 1-A-1: Controls Needed for Entities Which Choose to Invest in Mutual Funds (Other Than Money Market Mutual Funds)

If state investing entities plan to participate in mutual fund investments, the entity should have a number of controls in place to ensure that the investments are in the best interest of the public. Proper planning and written investment policies for the investing entities can minimize the risks to the investor.
Detailed Issues

Currently, the Public Funds Investment Act requires investing entities to maintain written investment policies.

The investing entity should have an effective cash management system which accurately distinguishes operating funds from those funds available for long-term investment. This cash management system should also identify the length of investment, yield, risk to principal, and liquidity requirements so that the funds available for investment can be matched to a prospective mutual fund.

The potential investor should also have the expertise, either in-house or in the form of contracted assistance, to track and analyze the fund’s performance.

Investing entities should also review the mutual fund’s prospectus and written investment policies. Traditionally, a prospectus identifies the fund’s:

- Operations
- Investment strategy
- Goals
- Objectives
- Performance information
- Shareholder rights
- Capital gains distributions

The prospectus also describes expenses and fees charged to shareholders.

The Public Funds Investment Act requires additional disclosure which applies to mutual funds other than money market mutual funds and investment pools other than those that function as money market mutual funds. (This additional disclosure information is discussed in Section 2-A of Investment Pools.) These disclosure requirements provide information an investing entity can use to assess and monitor the mutual funds.

The investing entity should also consider the following elements, which are addressed by the Public Funds Investment Act:

- Portfolio diversification
- Maturity limits
- Management fees and transaction costs
- Investment rating

Section 1-B: **Risks and Benefits Associated with Mutual Funds (Other Than Money Market Mutual Funds)**

The risks related to mutual funds generally refer to issues of performance, term length, and control over investment decisions. The risks associated with investing in mutual funds include:

- Investors assume the market risk, in which the value of the principal fluctuates according to the market trends. Inherently, long-term investments are subject to greater market risk.
- There are no performance guarantees. Past performance is not necessarily indicative of future performance.
- Investors give up control over investment decisions to the fund’s managers.

Investors are attracted to the mutual funds because they offer access to a professionally managed portfolio that may not otherwise be available to the small investor. Benefits of mutual funds other than money market mutual funds include:

- Potential for yield enhancement, as a result of changes in the market
**Detailed Issues**

- Participation in a professionally managed portfolio that would not otherwise be available to small investors
- Access for small investors to the economies of scale generally available only to larger investors
- Access to a multitude of investment opportunities, which help diversify an entity’s portfolio
- Regulation by the Securities and Exchange Commission
- Availability of educational information for investors

**Contingent deferred sales load** - a sales charge which encourages long-term investment. The sales load decreases over the holding period of the investment until such time as the charge would be zero. If the investor decides to redeem the investment before the sales charge has disappeared, the investor must pay whatever the sales charge is at that time.

No-load funds, which are currently authorized by the Public Funds Investment Act, operate without a sales charge because they sell their products directly to the public without the aid of field sales representatives.

Some funds also charge “12b-1 fees” for a fund’s distribution costs. Named after a federal government rule, these charges include advertising expenses to promote the fund and dealer compensations to sell the fund.

**Section 1-C: Fees Related to Mutual Funds (Other Than Money Market Mutual Funds) Should Also Be Considered**

Some mutual funds contain a sales charge, known as a load, which is included in the per share offering price that investors pay. Funds without sales charges are called no-load funds. For some investors, the load can erode the benefits of mutual fund investments. Sales charges that can accompany mutual funds include:

- **Front-end load** - the sales charge paid upon investing
- **Back-end load** - paid when the investor sells his/her shares of the fund

These fees are used in the calculation of the total expense ratio of a fund, which represents the total expenses of the fund compared to its total assets. In general, the total expense ratios of most long-term funds run between one and two percent, while money market fund ratios run less than one percent annually.

- Salaries of the fund’s portfolio managers and staff
- Insurance
- Rent
- Mailing costs
- Other costs related to the fund’s management
**Detailed Issues**

Section 2:
**Investment Pools (Other Than Investment Pools That Function as Money Market Mutual Funds)**

**Section 2-A:**
**The Public Funds Investment Act (Act) Authorizes Investment in Investment Pools (Other Than Investment Pools That Function as Money Market Mutual Funds) Under Certain Conditions**

Under the Public Funds Investment Act (Government Code, Chapter 2256.016) an entity may invest its funds and funds under its control through an eligible investment pool if the governing body of the entity authorizes investment in the particular pool. A local government investment pool (LGIP) must invest only in securities that are authorized by the Act.

**Definition of Local Government Investment Pools (LGIPs)**

An arrangement that pools the moneys of more than one legally separate entity, or more than one component of an entity, and invests on the participants' behalf in an investment portfolio. Investment pools can be internal or external.

An LGIP must meet eligibility requirements before it can invest funds on behalf of an entity subject to the Act. These requirements also pertain to mutual funds other than money market mutual funds. To qualify, LGIPs and mutual funds must disclose adequate financial information including, but not limited to:

- Types of investments in which money can be invested
- Objectives of the LGIP (or mutual fund)
- Weighted average maturity
- Maximum average dollar-weighted maturity allowed, based on stated maturity date
- Size of the LGIP (or mutual fund)
- Guarantee, if any
- Whether the LGIP (or mutual fund) intends to maintain a constant net asset value of $1 per share
- Risk of market price fluctuation
- Performance history
- Names and terms of advisory board members
- Maximum stated maturity date of any security in the portfolio
- Custodian bank responsible for safekeeping the assets
- Name and address of independent auditor for the LGIP (or mutual fund)
- Deposit and withdrawal deadlines

The investment pool (or mutual fund) must disclose relevant financial information to remain eligible to invest on behalf of an entity subject to the Public Funds Investment Act. This information includes, but is not limited to, the investment transaction confirmations and a monthly report indicating:

- Types and percentage breakdown of the pool’s (or mutual fund’s) investments
Definition of Net Asset Value

The net asset value (NAV) is a per-share dollar figure that represents the total assets of the fund, minus the fund’s liabilities, divided by the current number of shares that the fund has outstanding.

Detailed Issues

- Current average dollar-weighted maturity of the pool (or mutual fund), based on the stated maturity date
- Book value of the portfolio, compared to market value, using amortized cost valuation
- Size of and number of participants in the LGIP (or mutual fund)
- Yield and expense ratio of the LGIP (or mutual fund)
- The portfolio managers
- Current percentage of LGIP’s (or mutual fund’s) portfolio in securities with stated maturities of more than one year
- Any changes or addenda to the prospectus
- Custodian bank responsible for safekeeping the assets
- Daily transaction activity for the participating entity

The Act appears to allow for investments in LGIPs with both stable and variable net asset value (NAV) investment pools. The Act specifies that an investment pool created to function as a money market mutual fund must maintain a stable net asset value ($1/share) to the extent reasonably possible.

However, the Act does not set this requirement for LGIPs which are not created to function as money market mutual funds.

Currently, the Texas Association of School Boards (TASB) administers a variable net asset value LGIP which does not function as a money market mutual fund. The LGIP was established as a long-term investment alternative for Texas school districts.

The Act also requires investment pools to receive a credit rating which does not fall below AAA or AAA-m (or the equivalent rating) by at least one nationally recognized rating service.

Section 2-A-1: Controls Needed for Entities Which Choose to Invest in Local Government Investment Pools

If state investing entities plan to participate in LGIPs, the entity should have a number of controls in place to ensure that the investments are in the best interest of the public. Proper planning and written investment policies for the investing entities can minimize the risks to the investor. Currently, the Public Funds Investment Act requires investing entities to maintain written investment policies. According to the Act, each investing entity’s governing board must authorize participation in the pool and exercise general oversight of the pool’s activities.
Background on Investment Pools

Local government investment pools (LGIPs) function much in the same manner as mutual funds, providing state and local government entities investment opportunities that might otherwise be inaccessible. A pool’s investment objectives determine the level of risk as well as the benefits afforded to an investing entity.

However, LGIPs are not open to the general public, and they are subject to different forms of regulation than are mutual funds. While mutual funds are regulated by the federal Securities and Exchange Commission, states are responsible for the regulation of these investment pools.

Categories of Investment Pools

This report focuses on external investment pools that do not function like money market mutual funds. LGIPs generally include one or a combination of the following:

- **External investment pools** can be sponsored by an individual government, jointly by more than one government, or by a nongovernmental entity. A pool sponsored by an individual government is considered external if it includes participation by another entity which is legally separate from the sponsoring entity.

- **Internal investment pools** include only the primary government and its component units.

- **2a7-like pools** are external investment pools not registered with the Securities and Exchange Commission (SEC) as investment companies, but operate under the same parameters as an SEC-regulated money market mutual fund.

The investing entity should have an effective cash management system which accurately distinguishes operating funds from those funds available for long-term investment. This cash management system should also identify the length of investment, yield, risk to principal, and liquidity requirements so that the funds available for investment can be matched to an appropriate LGIP.

Investing entities should also review the LGIP’s prospectus and written investment policies. Traditionally, a prospectus identifies the operations, investment strategy, goals, objectives, performance information, and shareholder rights. The prospectus also describes expenses and fees charged to shareholders.

The Public Funds Investment Act requires additional disclosure for mutual funds other than money market mutual funds and investment pools other than those that function as money market mutual funds. (See Section 2-A of Investment Pools.) These disclosure requirements provide information an investing entity can use to assess and monitor the investment pools.

As addressed in the Act, investors should maintain:

- A diversified portfolio to minimize the effects of poor performance in a particular market segment or investment (To maintain a diversified portfolio, investors can specify concentration limits for their investments in the pool.)

- Ongoing communication with the pool’s manager

- Statement of the pool’s financial objectives and authorized investments

- Composition and role of independent Advisory Board
The National Association of State Treasurers also identifies other sources of information that LGIP investors should obtain, including:

- LGIP’s legal authority and participant eligibility, including an explanation of the relationship between the Pool Manager and the Pool Participants
- Procedures to ensure liquidity
- Either in-house expertise or an independent consultant which can provide an assessment of the pool’s performance and provide information about current market trends
- Demonstration of compliance with the Association for Investment Management and Research Yield (AIMR)/Securities and Exchange Commission (SEC) yield calculation, frequency and method of earnings and earnings distribution, and other relevant disclosure
- Evidence of safekeeping practices, proper account administration, and an annual opinion audit
- Disclosure of additional administrative costs and fees, and notification of and/or input from pool participants in the event fees are changed
- Disclosure about the risks of an LGIP, including a statement that clearly warns that the state or government entity does not guarantee invested moneys
- Other forms of disclosure, including that which regards the commingling of funds, arbitrage requirements, and any other information that the investor might reasonably expect to receive that will enable them to make more informed decisions

Section 2-B: Risks and Benefits Associated with Investment Pools (Other Than Investment Pools That Function as Money Market Mutual Funds)

The risks associated with LGIPs include:

- Investors assume the market risk, in which the value of the principal fluctuates according to the market trends. Inherently, long-term investments are subject to greater market risk.
- There are no performance guarantees. Past performance is not necessarily indicative of future performance.
- Investors give up control over investment decisions to the LGIP’s managers.

The benefits of investing in LGIPs include:

- Opportunity for yield enhancement
- Participation in a professionally managed portfolio that may not otherwise be available to small investors
- Access for small local government investors to the economies of scale generally available to larger investors only
- Access to investment opportunities which help diversify an entity’s portfolio
- Minimal research time to identify an appropriate investment, since there are a small number of LGIPs from which to choose
Section 2-C: 

**Fees Related to Investing in Local Government Investment Pools (Other Than Investment Pools That Function as Money Market Mutual Funds) Should Also Be Considered**

Investment pools have management and administrative staff costs that vary from pool to pool and may change over the life of the investment. Potential pool fees and the process for changing them are generally disclosed in the prospectus. Pool fees may include, but are not limited to:

- Administration
- Custodial services
- Legal counsel
- Investment advisors
- Consultants
- Sponsorship and endorsement
- Accounting
- Printing
- Mailing expenses

Section 3: 

**Guaranteed Investment Contracts**

Section 3-A: 

**The Public Funds Investment Act Authorizes Investment In Guaranteed Investment Contracts Under Certain Conditions**

Currently, the Public Funds Investment Act (Government Code, Chapter 2256.015) authorizes only state agencies to invest bond proceeds in guaranteed investment contracts (GICs) when certain conditions and eligibility requirements are met. These contracts must:

- Have defined termination dates
- Be pledged to the entity and deposited with a third party selected and approved by the entity
- Be secured by obligations authorized by section 2256.009 (a)(1) in an amount equal to the amount of bond proceeds invested under the contract
- Not have a term of longer than five years from the date of issuance of the bonds unless the bond proceeds are used for reserve or debt service purposes

To be eligible as an authorized investment:

- The entity’s governing body must authorize GICs as an eligible investment when the bonds are authorized.
- The entity must receive at least three bids for the GIC and purchase the highest yielding GIC for which a qualifying bid is received.
- The GIC must take into account the reasonably expected drawdown schedule for the bond proceeds to be invested.
- The issuer must certify the administrative costs reasonably expected to be paid to third parties in connection with the GIC.
Detailed Issues

Definition of Guaranteed Investment Contracts (GICs)

A GIC is a contract between an insurance company and an investor that guarantees a specific rate of return on the invested capital over the life of the contract. Although the insurance company takes all market, credit, and interest rate risks on the investment portfolio, it can profit if its return exceeds the guaranteed amount. Only the insurance company backs the guarantee, not any governmental agency, so if the insurance company fails, it is possible that there could be a default on the contract. GICs are also referred to as Guaranteed Income Contracts, Guaranteed Interest Contracts, or Guaranteed Insurance Contracts.

Background on Guaranteed Investment Contracts (GICs)

The term guaranteed investment contract applies only to the interest rate and expense schedule. It does not mean an absolute, fail-safe guarantee of principal.

Although the insurance company (the issuer) may imply the protection of principal, that guarantee is only as good as the insurance company's claims-paying abilities. If the insurance company defaults on the investment, then the investor loses the principal.

Because the Public Funds Investment Act deals with the non-pension market, for the purposes of this report, we are examining non-qualified GICs. Qualified GICs deal with the pension market and are subject to certain tax exemptions. In Texas, GICs are an authorized investment for state agencies seeking to invest bond proceeds.

Section 3-A-1: Controls Needed for Entities Which Choose to Invest in Guaranteed Investment Contracts

Investors should review and analyze investment information prior to the purchase and throughout the life of the GIC. Prior to purchasing a GIC, investors should review the following information related to their prospective investment:

- Expected cash flows
- Time and form of bidding
- Specifications for the agreement
- Criteria for awarding bids
- Underwriting information
- Collateral agreement

Additional controls needed to maintain and monitor GICs include:

- Requiring the issuer to establish a separate account for the investing entity to ensure protection from creditors
- Setting the maturity date to meet the needs of the investing entity
- Conducting market forecasts to determine which form of GIC would be more advantageous to the investor

Although more complicated GICs can require a level of expertise that many government entities may not have in-house, external assistance can be obtained to assist in designing an appropriate GIC investment.
Categories of Guaranteed Investment Contracts (GICs)

GICs are classified according to the investors who invest in them. Qualified GICs are associated with pension plan investments and therefore qualify for certain tax exemptions. Non-qualified GICs, also called funding agreements, are used by the non-pension market and do not qualify for any special tax exemptions.

For the purposes of this report, we consider non-qualified GICs which can be either participating or non-participating. A participating GIC allows the investor to capitalize in a period of rising interest rates. However, the participating GIC can be costly to the investor in a down market.

A non-participating GIC allows the investor to lock interest rates which provides protection from changing market conditions. However, if interest rates rise, the non-participating GIC does not allow the investor to capitalize on higher yielding investments.

Section 3-B: Risks and Benefits Generally Associated with Guaranteed Investment Contracts

GICs are subject to several risks, including:

- The return of principal depends on the ability of the insurance company (issuer) to repay the investor, constituting a credit risk.
- Limited marketability because they are neither assignable nor traded in the secondary market, constituting a liquidity risk.
- As a long-term investment, GICs are subject to market risk. Participating GICs are costly to the investor in periods of declining interest rates, while non-participating GICs may not enjoy higher yields that result in a rising interest rate environment.

- Structured GICs may contain some of the same risk associated with structured notes and derivatives. (Moody’s Investors Service issued a cautionary report citing inadequate disclosure and the potential for unfair pricing due to a lack of qualified bids.)

- Many GICs may not be considered securities, and therefore would not be regulated by the SEC. Each prospective GIC would have to be analyzed to determine if it qualifies as security. According to SEC Rule 151, a GIC issued by an insurance company would not be considered a security if three conditions are met:
  - The insurance company is regulated by a state insurance commission.
  - The insurance company assumes the investment risk under the contract.
  - The contract is not marketed primarily as an investment.

For debt financings of municipalities or other governmental units, SEC Rule 131 may apply, preventing GICs from being classified as securities. A GIC, under SEC Rule 131, would not be considered a security for a governmental unit if it:

- Is payable from general revenues of a governmental unit
- Relates to a public project owned and operated by or on behalf of and under the control of a governmental unit
Detailed Issues

- Relates to a facility leased to and under the control of a commercial enterprise but is part of a public project that is, as a whole, owned by and under control of a governmental unit

Investing in GICs can provide the following benefits:

- Investors can require the insurance company to provide collateral to cover the investment and have the collateral held by the investor or a third party.

- Investors can require the insurance company to establish a separate account which is not subject to the insurance company’s creditors.

- The liquidity arrangement and maturity date can be agreed upon up front, according to the needs of the investor.

- The insurance company generally assumes market and interest rate risks.

- They offer an investment alternative which diversifies the investor’s portfolio and can offer attractive yields.

Section 3-C: Fees Related to Investing in Guaranteed Investment Contracts

GICs can be subject to a variety of management and administrative costs, which are usually stated at the time of purchase. Because the purchase of GICs requires a bid process, fees generally include the services of bond counsel and other financial advisors, who review the bids and provide advice regarding the strength of the contract.
Objective, Scope, and Methodology

Objective

The objective of this project was to assess the risks and benefits associated with authorizing entities subject to the Public Funds Investment Act to invest in:

- Mutual funds other than money market mutual funds
- Investment pools other than investment pools that function as money market mutual funds
- Guaranteed investment contracts

Audit Scope

The initial scope of this project included consideration of:

- Public Funds Investment Act (Government Code, Chapter 2256)
- Industry recognized risks and benefits associated with mutual funds other than money market mutual funds, investment pools other than investment pools that function as money market mutual funds, and guaranteed investment contracts
- Investor uses for these types of investments
- Controls needed to manage the risks generally associated with each investment type
- Characteristics of each investment type

Methodology

Information collected to accomplish our objective included the following:

- Professional literature relating to each investment type
- Securities and Exchange Commission (SEC) rules as applicable to guaranteed investment contracts
- Potential disclosure requirements under consideration by the SEC for mutual funds

Procedures conducted to accomplish our objective included:

- Interviewing industry professionals
- Identifying risks and benefits of each investment type
- Documenting management controls for potential investors of these investment types

Other Information

Fieldwork was conducted between April and June 1996. This project was conducted to satisfy the requirements set forth in the Public Funds Investment Act (Government Code, Chapter 2256.055, § 9).

The project was performed by the following members of the State Auditor’s staff:

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