SHORT-TERM INVESTMENT POOL (STIP) INVESTMENT POLICY

Approved April 3, 2018

Table of Contents

Page

1. Introduction

This policy is effective upon adoption and supersedes all previous Investment Policies related to the investment management of the Short-Term Investment Pool (STIP)*.*

STIP is an investment program managed and administered under the direction of the Montana Board of Investments (MBOI) as authorized by the Unified Investment Program. STIP invests the operating funds of the State of Montana, participating local government entity funds, and the liquidity requirements of the various pension and trust funds managed by MBOI.

STIP is a commingled pool for investment purposes. The use of a commingled pool allows for simplified investing and accounting, as well as broader investment diversification, and it provides opportunities for fee savings.

2. Purpose

The purpose of this policy statement is to provide a strategic framework for the STIP investments under the guidance of the Board of Investments.

3. Legal and Constitutional Authority

The Montana Constitution, Article VIII, Section 13, requires that the Legislature provide for a Unified Investment Program for public funds. Section 17-6-201, MCA, established the Unified Investment Program, created the Montana Board of Investments (the "Board") and gave the Board sole authority to invest state funds, including the Short-Term Investment Pool (STIP) in accordance with state law and the state constitution.

The Unified Investment program for public funds must be administered by the Board of Investments in accordance with the "prudent expert principle," defined as:

1) discharging its duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of like character with like aims;
2) diversifying the holdings of each fund to minimize the risk of loss and maximize the rate of return, unless under the circumstances it is clearly prudent not to do so; and
3) discharging its duties solely in the interest of and for the beneficiaries of the funds managed.

The Board created the Short-Term Investment Pool (STIP) to allow qualifying funds, per sections 17-6-201, 202, and 204, MCA, to participate in a diversified pool. Although state agencies with accounts that retain their interest earnings are legally required to invest in STIP, local governments may voluntarily participate in the STIP.

The Board, as the investment fiduciary, is responsible for establishing the investment parameters for the STIP.

STIP is not registered with the Securities and Exchange Commission (SEC) as an investment company and therefore is not required to abide by the SEC's rule 2a7 of the Investment Company Act of 1940.

STIP has a defined set of investment objectives and investment guidelines, including permitted investments, which are detailed in this policy statement.

4. Financial Reporting

The STIP financial statements are included in the Board's Consolidated Unified Investment Program financial statements, which are audited by the Montana Legislative Auditor.

On October 6, 2015, the Board approved, that for financial reporting purposes the STIP portfolio will be reported on a Net Asset Value basis versus amortized cost.

5. Strategic Investment Objectives

The Board's objective for STIP is to achieve a high level of investment income that is compatible with the preservation of principal, providing STIP participants with liquidity with one-day notification, and the prudent investment practices of the Board.

No Guaranteed Return – There is no minimum or maximum amount of interest rate or any guaranteed rate of return on STIP shares or funds invested in STIP shares.

No Warranty – The Board makes no warranty that funds will be immediately available in the event of any failure of a third party or that STIP participants will not suffer losses due to acts of God, or other calamities, or other market dislocations or interruptions.

STIP Not Insured Against Loss – STIP is NOT FDIC insured or otherwise insured or guaranteed by the federal government, the State of Montana, the Board or any other entity against investment losses.

Reserve fund – This Policy requires maintenance of a reserve fund to offset possible losses. STIP interest earnings may be used to fund this reserve before the net earnings are distributed to the STIP Participants. However, the reserves may not be adequate to cover investment losses.

6. Reserve

The STIP will maintain a reserve account. The reserve will be available to offset realized gains or losses. Additionally, the reserve will be available to offset unrealized gains or losses, or to limit fluctuations in the net asset value (NAV), to the extent deemed prudent by Staff.

A deduction from earnings will occur while the amount of the reserve is below 1.15% of the NAV.

The level of deduction will be calculated based on the deemed best balance between participants' need for current earnings and the increase in safety from building the reserve. When the reserve is between 0.50% and 1.15% of the NAV the deduction from earnings will be an amount, including recoveries, sufficient to reach the target within 3 years. Should the reserve fall below 0.50% of the NAV, staff will evaluate the amount of deduction appropriate to return the reserve to 0.50% and make recommendations to that effect to the Board.

The STIP NAV will be calculated based on the assumption that the STIP reserve is considered a liability on the financial statements.

Any use of the reserve will be reported to the Board.

7. Time Horizon

The STIP investment portfolio shall be managed with the goal of attaining its objectives throughout market and economic cycles, after giving prudent consideration to the investment risk constraints (described as part of the Investment Guidelines in Appendix I) and the liquidity needs of the participants.

The Board expects to meet or exceed these objectives over a long-term investment horizon. Over shorter periods, the anticipated market volatility and specific actions, including risk mitigation efforts of the Board, may lead to unfavorable, but expected, deviation from these objectives.

8. Performance Measurement

Investment performance is measured by two integrated long-term return objectives:

1) The ***investment policy benchmark.*** The investment policy benchmark represents the return that would be achieved if the Pool implemented a passively managed portfolio. Deviations from the policy benchmark measure the contribution of active investment management throughout the fund and investment implementation generally.

2) The Board also compares STIP's total performance, before all fees, to appropriate ***peer universes***. While the Board seeks to rank favorably compared to peers, the Board recognizes that other short-term investment funds may have investment objectives and risk tolerances that differ substantially from STIP.

9. Roles and Responsibilities

Board of Investments – The Board is responsible for approving the STIP Investment Policy Statement and has the authority to manage STIP as it considers prudent, and subject to such limitations as contained in law and the Constitution. The Board reviews this document periodically and, as needed, approves any changes to the policy.

As described in the Board of Investments Governance Manual, the Board delegates authority to the Executive Director, Chief Investment Officer, and other Staff to execute the day to day duties required to carry out the Board's mission.

Executive Director – The Executive Director is empowered by the Board to sign any and all documents required to conduct Board business, unless there are specific written policies or instructions from the Board to the contrary. The Executive Director is responsible for the oversight of the STIP investment program and the establishment of the STIP financial reporting procedures and the collection and reporting of all income.

Chief Investment Officer – The Chief Investment Officer (CIO) is empowered by the Board to serve as the principal staff person responsible for overseeing the investment activities under the Board's jurisdiction in compliance with the Board's policies. The CIO, with the support of other staff, is responsible for recommending investment policy changes for Board approval.

Investment Staff – The investment staff is responsible for, but not limited to, the following:

- Managing day-to-day STIP investment operations;
- Investing STIP assets and monitoring compliance in accordance with this Policy;
- Reporting to the Board the STIP investment results and investment characteristics at the Quarterly Board meetings; and
- Reporting any deviations from this Investment Policy to the Board.

Investment Consultant – The investment consultant assists the CIO and Staff with policy recommendations and provides advice to the Board. The investment consultant shall provide assistance to Staff as requested in conjunction with the management of the STIP.

10. Risk Management

Short-term investments held within STIP are exposed to a number of risks. The objective will be to mitigate the inherent risks associated with these securities, primarily liquidity risk, credit risk and interest rate risk.

a) <u>Liquidity Risk</u>

Based on the percentage of STIP Units Value usually necessary to meet the daily distribution requests of STIP participants, the liquidity needs for the STIP are generally low. However, illiquidity risk still needs to be monitored and managed by staff on a regular basis to ensure that assets are not required to be sold too quickly, or at an unfavorable time, and potentially at a discount to fair value to meet the cash needs of STIP participants.

In order to improve liquidity and manage both the expected and unexpected STIP participants' need for cash, the STIP Investment Objectives and Guidelines (Appendix I) require certain percentages of the STIP Units Value to either be invested in cash, direct obligations of the U.S. government, or in securities that will have an effective maturity for specifically defined short periods or time (daily and weekly).

b) <u>Credit Risk</u>

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation in making full and timely principal and interest payments. The STIP will utilize credit ratings, issued by at least two of the nationally recognized statistical rating organizations (NRSRO), to assist in the monitoring and management of credit risk.

Approved List – Purchases of securities other than U.S. government or U.S. Agency obligations are restricted to those which are pre-approved. The approved list shall be maintained by Staff with issuers added or removed from time to time depending on an analysis of their risk characteristics and suitability for use in the portfolio. At least two investment staff must approve names on the list. One of the investment staff should be part of the internally managed fixed income team and the other person from the Risk Management team. Issuers on the list shall be reviewed at least semi-annually for continued inclusion on the approved list.

The STIP will minimize credit risk by means of the following:

1. Limiting Permissible investments to securities on the "Approved List";
2. Pre-qualifying the financial institutions, broker/dealers, intermediaries and advisers with whom the STIP will conduct business;
3. Diversifying the investment portfolio so that potential losses on individual securities will be minimized; and
4. The STIP will maintain a reserve account.

c) <u>Interest Rate Risk</u>

The STIP portfolio will minimize the risk that the market value of the securities will deviate significantly from cost due to changes in the general level of interest rate by means of the following:

1. Structuring the investment portfolio so that securities mature to meet cash requirements for ongoing operations thereby normally avoiding the need to sell securities on the open market prior to maturity;
2. Maintaining a dollar-weighted average portfolio maturity of 60 days or less (for this purpose, the date to the next coupon reset date will be used for all floating or variable rate securities); and
3. The STIP will maintain a reserve account.

11. Securities Lending

Section 17-1-113, MCA, authorizes the Board to lend securities held by the state. The Board may lend its publicly traded securities held in the investment pools, through an agent, to other market participants in return for compensation. Currently, through an explicit contract, State Street Bank and Trust, the state's custodial bank, manages the state's securities lending program. The Board seeks to assess counterparty and reinvestment risk, associated with each aspect of its securities lending program. The Board requires borrowers to maintain collateral at 102 percent for domestic securities and 105 percent for international securities. To ensure that the collateral ratio is maintained, securities on loan are marked to market daily and the borrower must provide additional collateral if the value of the collateral falls below the agreed-upon ratio of over- collateralization. In addition to the strict collateral requirements imposed by the Board, the credit quality of approved borrowers is monitored continuously by the contractor. From time to time, Staff or the investment manager may restrict a security from the loan program upon notification to State Street Bank. Staff will monitor the securities lending program, and the CIO will periodically report to the Board on the status of the program. The Board's participation in securities lending may change over time given Plan activity, market conditions and the agent agreement.

STIP assets are currently not available for securities lending.

12. Investment Policy Review

The Board intends to keep this Policy updated as it modifies or amends the underlying contents. As stated in the Governance Policy, "the Board shall review this Investment Policy at least annually or more frequently at the request of Board staff. Statements may only be revised in a public meeting. All Statements shall be posted on the Board's web site for review by the public."

Appendix I: Investment Objectives and Guidelines

Schedule I-A:
Investment Objectives and Guidelines
Short Term Investment Pool (STIP)

Effective Date of Schedule: May 1, 2018

This Schedule is effective upon adoption by the Board of Investments and supersedes all previous Investment Objectives and Guidelines for the STIP.

1. Statement of Purpose:

The purpose of these objectives and guidelines is to:

1. Establish the investment objectives and performance standards of the Pool; and
2. Provide diversified exposure to Cash Equivalent and Short-Term Fixed Income Investments in a prudent and cost-effective manner.

2. Investment Objective:

Strategic:
The objective of the STIP is to attain the highest possible total return within the parameters of the Investment Guidelines set forth below.

Performance:
Success in achieving this objective will be measured by comparing the risk and the net of expenses return of STIP to **the Federal Reserve US Treasury Constant Maturity 1 Month Index** (the "Benchmark"). Performance results will be monitored and evaluated quarterly. However, the success in achieving the objective will be measured on a three-year, five-year, and ten-year annualized basis.

3. Investment Guidelines:

The Montana Board Investment Staff will have full discretion to manage STIP consistent with the investment guidelines stated below. Compliance with the following guidelines for permitted investments and other restrictions is the sole responsibility of the Staff. Any exceptions or compliance violations are to be reported to the Board of Investments at the next scheduled quarterly Board meeting.

Permitted Investments:
Purchases of securities other than U.S. government or U.S. Agency obligations are restricted to those which are pre-approved and part of an "Approved List." STIP may invest only in the following securities and investment vehicles:

1. U.S. Treasury or U.S. dollar denominated securities fully guaranteed by the U.S. Government;
2. U.S. Government Agency securities denominated in U.S. dollars;

3. Publicly traded U.S. dollar denominated corporate bonds, notes, and medium term notes (MTNs);
4. U.S. dollar denominated Commercial Paper (CP);
5. U.S. dollar denominated Bankers' Acceptance (BA);
6. U.S. dollar denominated Certificates of Deposits (CD);
7. U.S. dollar denominated Asset-Backed Commercial Paper (ABCP);
8. Repurchase or Reverse Repurchase Agreements with an approved primary dealer or the custodial bank, and under the terms of a written master repurchase agreement;
9. Investments required to implement the bond credit enhancement authorized by Resolution 219;
10. SEC registered 2a-7 Institutional Money Market Funds that are considered "U.S. Treasury" or "U.S. Government" money market mutual funds according to the SEC regulations; and
11. Short term investment vehicle available through the custodial bank.

<u>Other Restrictions</u>

1. A maximum of 65% of the STIP Units Value shall be held in U.S. Government Agency securities;
2. A maximum of 30% of the STIP Units Value shall be held in any single issuer of U.S. Agency securities;
3. STIP shall maintain a dollar-weighted average portfolio maturity of 60 days or less (for this purpose, the date to the next coupon reset date will be used for all floating or variable rate securities);
4. All securities, with the exception of securities fully guaranteed by the U.S. Government and approved Institutional Money Market Funds, must be rated by at least two of the three rating agencies (S&P, Moody's or Fitch) at the time of purchase.
5. A maximum of 25% of the STIP Units Value shall consist of corporate bonds, notes, or MTNs;
6. Risk assets will be purchased only when the estimated aggregate effect of a worst-case scenario spread widening event does not exceed the amount of the STIP Reserve. Risk assets are assets other than Treasuries, Agencies and Government money markets. The estimated worst-case scenario is a calculation equal to the days to maturity divided by 365 multiplied by 2.0% for securities maturing in less than one year and 3.5% for securities maturing in greater than one year.
7. ABCP, CP, BA or CD shall not have a rating lower than A-1 (S&P), P-1 (Moody's) or F1 (Fitch) at the time of purchase;
8. Corporate bonds, notes, or MTNs shall not have a rating lower than A (S&P), A2 (Moody's) or A (Fitch) at the time of purchase;
9. A maximum of 40% of the STIP Units Value shall be held in ABCP;
10. A maximum of 10% of the STIP Units Value shall be held in ABCP, CP, BA or CD rated at A-2 (S&P), P-2 (Moody's), or F2 (Fitch), or at a lower rating at any time;
11. ABCP purchases shall be limited to maturities of 90 days or less;
12. A maximum of 10% of the STIP Units Value in the aggregate shall be held in any one financial sponsor of ABCP as well as any direct obligations associated with the sponsor. Repurchase agreement obligations of a financial institution shall not be considered in this limit;
13. A maximum of 30% of the STIP Units Value shall be held in BAs and CDs combined;
14. A maximum of 10% of the STIP Units Value shall be held in Repurchase Agreements;
15. A maximum of 5% of the STIP Units Value shall be held in Repurchase Agreements with any single primary dealer or financial institution;
16. The maximum term of any Repurchase Agreement will be 30 days;

17. Acceptable forms of collateral under Repurchase Agreements will consist of U.S. Treasury Securities which will be required to be maintained at a market value of 102% of the value of the Repurchase Agreement;
18. The maximum term of any Reverse Repurchase Agreement will be 90 days and must be matched to anticipated cash flows adequate to liquidate the transaction;
19. A maximum of 10% of the STIP Units Value shall be pledged to secure Reverse Repurchase Agreements. Transactions will be used only to secure borrowings for temporary or emergency purposes;
20. A maximum of 15% of the STIP Units Value shall be held in permitted SEC registered 2a-7 Institutional Money Market Funds;
21. A maximum of 5% of the STIP Units Value shall be held in any single SEC registered 2a-7 Institutional Money Market Funds;
22. Any permitted investments with floating rate coupons shall have the floating rate tied to LIBOR, Fed Funds, Treasury Bills, or Commercial Paper indices;
23. The maximum final maturity of any Permitted Investment shall not exceed 397 days (not including securities used as collateral in Repurchase Agreements or Permitted Investments considered "Variable Rate" securities, which on any reset date can reasonably be expected to have a market value that approximates its amortized cost);
24. A Variable Rate security shall have a maximum maturity of 2 years;
25. A maximum of 25% of the STIP Units Value in the aggregate shall be held in all non- Government Variable Rate securities with maturities greater than 397 days;
26. A maximum of 3% of the STIP Units Value shall be invested in any one issuer with the exception of U.S. Treasury and U.S. Agency securities as well as any Repurchase Agreements with a financial institution; and
27. A minimum of 10% of the STIP Units Value shall qualify as "daily liquid assets." For this guideline is it assumed that "daily liquid assets" is defined as cash, direct obligations of the U.S. government, securities that will mature or are subject to a demand feature that is exercisable and payable within one business day, and a permitted SEC registered 2a-7 Institutional Money Market Fund;
28. A minimum of 15% of the STIP Units Value shall qualify as "weekly liquid assets." For the purpose of this guideline, it is assumed that "weekly liquid assets" is defined as "daily liquid assets" (as defined above), government agency discount notes with remaining maturities of 60 days or less, securities that will mature or are subject to a demand feature that is exercisable and payable within five business days, and a permitted SEC registered 2a-7 Institutional Money Market Fund; and
29. A maximum of 10% of the STIP Units Value shall be invested in Permitted Investments that are considered "illiquid." For the purpose of this guideline, "illiquid" shall be defined as "a security that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by STIP."

If at any time, due to market fluctuations or any other circumstances, any of the guidelines are not maintained, Staff will use its best efforts to conform to these limits in a timely manner, while taking into account current market conditions and the associated costs. At the Board's next regularly scheduled quarterly meeting, the CIO or Staff shall inform the Board of any cases that the Pool allocations were outside of the limits and either inform the Board of the actions that were taken to return the Pool back within guidelines or a plan to do so.

Schedule I-B:

Investment Objectives and Guidelines Short Term Investment Pool (STIP) Reserve

Effective Date of Schedule: February 14, 2017

This Schedule is effective upon adoption by the Board of Investments and supersedes all previous Investment Objectives and Guidelines for the Reserve.

1. Statement of Purpose:

The purpose of these objectives and guidelines is to:

1) Establish the investment objectives and performance standards for the STIP Reserve
2) Provide exposure to low risk Cash Equivalent and Short-Term Fixed Income Investments in a prudent and cost-effective manner.

2. Investment Objective:

Strategic:
The objective of the Reserve is to attain the highest available total return within the parameters of the Investment Guidelines set forth below.

Performance:
Success in achieving this objective will be measured by comparing the risk and the net of expenses return of the Reserve to a **U.S. Treasury Constant Maturity 1 Month Index** (the "Benchmark"). Performance results will be monitored and evaluated quarterly. However, the success in achieving the objective will be measured on a three-year, five-year, and ten-year annualized basis.

3. Investment Guidelines:

The Montana Board Investment Staff will have full discretion to manage the STIP Reserve consistent with the investment guidelines stated below. Compliance with the following guidelines for permitted investments and other restrictions is the sole responsibility of the Staff. Any exceptions or compliance violations are to be reported to the Board of Investments at the next scheduled quarterly Board meeting.

<u>Permitted Investments</u>:

Purchases of securities other than U.S. government; U.S. Agency obligations or qualifying government money market funds are prohibited.

1) U.S. Treasury Securities
2) U.S. Government Agency securities issued at a discount
3) SEC registered 2a-7 Institutional Money Market Funds that are considered "U.S. Treasury" or "U.S. Government" money market mutual funds according to the SEC regulations

4. <u>Other Restrictions</u>

1) The maximum final maturity of any Permitted Investment shall not exceed 183 days
2) A minimum of 50% of the Reserve shall qualify as "daily liquid assets." For this guideline is it assumed that "daily liquid assets" is defined as cash, direct obligations of the U.S. government, securities that will mature or are subject to a demand feature that is exercisable and payable within one business day, and a permitted SEC registered 2a-7 Institutional Money Market Fund;

If at any time, due to market fluctuations or any other circumstances, any of the guidelines are not maintained, Staff will use its best efforts to conform to these limits in a timely manner, while taking into account current market conditions and the associated costs. At the Board's next regularly scheduled quarterly meeting, the CIO or Staff shall inform the Board of any cases that the Pool allocations were outside of the limits and either inform the Board of the actions that were taken to return the Pool back within guidelines or a plan to do so.

Appendix II: Definitions

DEFINITIONS

1. Asset-Backed Security – Bonds or notes backed by loan paper or accounts receivable originated by banks, credit card companies, or other providers of credit; not mortgages.

2. Banker's Acceptance – A short-term credit investment which is created by a non-financial firm and whose payment is guaranteed by a bank. Often used in importing and exporting, and as a discount money market fund investment.

3. Certificate of Deposit (CD) – A short-or medium-term, interest-bearing deposit obligation offered by banks and savings and loans. These may include "Yankee CDs" which are CDs issued by foreign banks or their U.S. affiliates in the U.S. which are denominated in U.S. dollars.

4. Commercial Paper – An unsecured obligation issued by a corporation or bank to finance its short-term credit needs, such as accounts receivable and inventory. Maturities typically range from 2 to 270 days. Commercial paper is available in a wide range of denominations, can be either discounted or interest-bearing, and usually have a limited or nonexistent secondary market. Commercial paper is usually issued by companies with high credit ratings, meaning that the investment is almost always relatively low risk.

5. Corporate Note – A type of unsecured debt issued by a corporation that may be longer-term than Commercial Paper, but shorter-term than a typical Corporate Bond.

6. Repurchase Agreement – A contract in which the seller of securities, such as Treasury Bills, agrees to buy them back at a specified time and price. May also be called "Repo" or "Buyback." Typically used a short-term form of collateralized borrowing by a bank or securities dealer.

7. Reverse Repurchase Agreement – A purchase of securities with an agreement to resell them at a higher price at a specific future date. The investor essentially borrows money and allows its securities to be held as collateral. Reverse Repurchase Agreements occur most often in government securities or other securities that are highly valued and thus considered a good form of collateral.