

LAGUNA MADRE WATER DISTRICT INVESTMENT POLICY

I. POLICY

Laguna Madre Water District (the "District") recognizes that effective cash management is good fiscal management. Investment earnings are a source of revenue for the District. Therefore, it is the District's policy to consider safety and risk of investment, allow for anticipated cash flow requirements, and invest all available funds in conformance with these legal and administrative guidelines, while seeking to optimize investment earnings.

Investments shall be made with the primary objectives of:

- Safety and preservation of principal
- Maintenance of liquidity
- Responsiveness to the public trust
- Diversification of investments
- Optimization of investment earnings

II. PURPOSE

The purpose of this Investment Policy is to comply with Chapter 2256 of the Government Code (the "Public Funds Investment Act"), which requires the District to adopt a written investment policy regarding the investment of its funds and funds under its control. This Investment Policy addresses the methods, procedures and practices that must be exercised to ensure effective and judicious fiscal management of the District's funds.

III. SCOPE

This Investment Policy shall govern the investment of all financial assets of the District as accounted for in the District's Financial Statements, including but not limited to, general operating, debt service, debt reserve, and capital project funds.

When possible, the District will consolidate cash balances to maximize investment earnings. Investment income will be allocated, if necessary, to the various funds based on their respective participation and in accordance with generally accepted accounting principles.

This Investment Policy shall apply to all transactions involving the financial assets and related activity of the District. However, this Policy does not apply to the assets administered for the benefit of the District by outside agencies under deferred compensation programs.

IV. INVESTMENT OBJECTIVES

The District shall manage and invest its cash with five primary objectives, listed in order of priority: safety, liquidity, public trust, diversification, and yield, expressed as optimization of investment earnings. The safety of the principal invested always remains the primary objective. All investments shall be designed and managed in a manner responsive to the public trust and consistent with State and local law.

The District shall maintain a comprehensive cash management program, which includes collection of account receivables, vendor payments in accordance with invoice terms, and prudent investment of available cash. Cash management is defined as the process of managing monies in order to insure maximum cash availability and maximum earnings on short-term investment of idle cash.

Safety

Safety of principal is the foremost objective of the investment program. Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. The objective will be to mitigate credit and interest rate risk.

- Credit Risk - The District will minimize credit risk, the risk of loss due to the failure of the issuer or backer of the investment, by:
 - Limiting investments to the safest types of investments.
 - Pre-qualifying the financial institutions, pools, and broker/dealers with which the District will do business.
 - Diversifying the investment portfolio, where appropriate, so that potential losses on individual issuers will be minimized.
- Interest Rate Risk - the District will minimize the risk that the investment earnings and the market value of investments in the portfolio will fall due to changes in general interest rates, by:
 - Structuring investments to meet cash requirements.
 - Investing operating funds primarily in financial institution deposits, shorter-term securities, money market mutual funds, or local government investment pools functioning as money market mutual funds.
 - Diversifying maturities and staggering purchase dates to minimize the impact of market movements over time.

Liquidity

The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This is accomplished by structuring the portfolio so that investments mature concurrent with cash needs. Because all possible cash demands cannot be anticipated, a portion of the portfolio will be invested in financial institution deposits, money market mutual funds or local government investment pools functioning as money market mutual funds that offer same-day liquidity.

Public Trust

All participants in the District's investment process shall seek to act responsibly as custodians of the public trust. Investment Officers shall avoid any transaction that might impair public confidence in the District's ability to govern effectively.

Diversification

The investment portfolio shall be diversified to avoid unreasonable risks and over concentration of risks. This is accomplished by structuring the portfolio so that a variety of investments are utilized.

Yield (Optimization of Investment Earnings)

The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. "Weighted Average Yield to Maturity" shall be the performance measurement standard for the portfolio.

V. RESPONSIBILITY AND CONTROL

Delegation of Authority

The District designates the General Manager and the Director of Finance as the Investment Officers. No person may engage in an investment transaction or the management of District funds except as provided under the terms of this Investment Policy. The investment authority granted to the Investment Officers is effective until rescinded by the District's Board of Directors.

Quality and Capability of Investment Management

The District shall provide periodic training in investments for the designated Investment Officers and other investment personnel through courses and seminars offered by professional organizations, associations, and other independent sources in order to insure the quality and capability of investment management in compliance with the Public Funds Investment Act.

Training Requirement

The designated Investment Officers shall attend an investment training session no less often than once every two years and shall receive not less than 6 hours of instruction relating to investment responsibilities. A newly appointed Investment Officer must attend a training session of at least 6 hours of instruction within six months of the date the Officer took office or assumed the Officer's duties. The District Board shall annually approve the list of authorized investment training providers. Training must include education in investment controls, security risks, strategy risks, market risks, diversification of investment portfolio, and compliance with Public Funds Investment Act. Water Entities (Chp. 36 or 49)

The approved independent sources of training are: Government Finance Officers' Association (National and Texas), Government Treasurers' Organization of Texas, University of North Texas and the Texas Municipal League.

Internal Controls

The District's Director of Finance is responsible for establishing and maintaining an internal control structure designed to ensure that the financial assets of the District are protected from loss, theft, or misuse. The internal control structure shall be designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the cost of a control should not exceed the benefits likely to be derived; and (2) the valuation of costs and benefits requires estimates and judgments by management.

Accordingly, the District shall establish a process for annual independent review by an external auditor in conjunction with the annual audit to assure compliance with policies and procedures. The internal controls shall address the following points.

- Control of collusion.

- Separation of transactions authority from accounting and record keeping.
- Custodial safekeeping.
- Avoidance of physical delivery securities.
- Clear delegation of authority to subordinate staff members.
- Written confirmation for telephone (voice) transactions for investments and wire transfers.

Prudence

The standard of prudence to be applied by the Investment Officers shall be the "prudent person" rule. This states that "Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived." In determining whether Investment Officers have exercised prudence with respect to an investment decision, the determination shall be made taking into consideration:

- The investment of all funds, or funds under the District's control, over which the Investment Officers had responsibility rather than a consideration as to the prudence of a single investment.
- Whether the investment decision was consistent with the written approved Investment Policy of the District.

Indemnification

The Investment Officers, acting in accordance with the prudent investor rule and otherwise with respect to the District's written procedures and exercising due diligence, shall not be held personally responsible for a specific investment's credit risk or market price changes, provided that these deviations are reported immediately and the appropriate action is taken to control adverse developments.

Ethics and Conflicts of Interest

Investment Officers involved in the investment process shall refrain from personal business activity that would conflict with the proper execution and management of the investment program, or that would impair their ability to make impartial decisions. Investment Officers shall disclose all interests in financial institutions with which they conduct District business. They shall further disclose any personal financial/investment positions that could be related to the performance of the investment portfolio. Investment Officers shall refrain from undertaking personal investment transactions with the same individual with which business is conducted on behalf of the District.

An Investment Officer of the District who has a personal business relationship with an organization seeking to sell an investment to the District shall file a statement disclosing that personal business interest. An Investment Officer who is related within the second degree by affinity or consanguinity to an individual seeking to sell an investment to the District shall file a statement disclosing that relationship. A statement required under this subsection must be filed with the Texas Ethics Commission and the District's Board of Directors.

VI. SUITABLE AND AUTHORIZED INVESTMENTS

Portfolio Management

The District currently has a "buy and hold" portfolio strategy. Maturity dates are matched with cash flow requirements and investments are purchased with the intent to be held until maturity. However, investments may be liquidated prior to maturity for the following reasons:

- An investment with declining credit may be liquidated early to minimize loss of principal.
- Cash flow needs of the District require that the investment be liquidated.

Investments

District funds may be invested in the instruments described below, all of which are authorized by the Public Funds Investment Act. Investment of District funds in any instrument or security not authorized for investment under the Investment Policy is prohibited. The District will not be required to liquidate an investment that becomes unauthorized subsequent to its purchase.

I. Authorized

1. Obligations of the United States of America, its agencies and instrumentalities.
2. Certificates of deposit and other evidences of deposit at a financial institution that, a) has its main office or a branch office in Texas and is guaranteed or insured by the Federal Deposit Insurance Corporation or its successor, b) is secured by obligations in a manner and amount provided by law for deposits of the District, or c) is executed through a broker or depository institution that has its main office or a branch office in Texas that participates in the Certificate of Deposit Account Registry Service (CDARS), or similar program, and meets the requirements of the Public Funds Investment Act.
3. Money Market Mutual Funds that are 1) registered and regulated by the Securities and Exchange Commission, 2) invest only in "government" securities or repurchase agreements (PFIA Sections 2256.009 – 2256.016 & 2256.019 – 2256.0201), 3) rated AAAM, or its equivalent, by a least one nationally recognized rating service, and 4) seek to maintain a net asset value of \$1.00 per share.
4. State and local government investment pools organized under the Interlocal Cooperation Act that 1) meet the requirements of the Public Funds Investment Act, 2) invest only in "government" securities or repurchase agreements, 3) are rated no lower than AAAM or an equivalent rating by at least one nationally recognized rating service, and 4) are authorized by resolution or ordinance by the Board of Directors. A public funds investment pool created to function as a money market mutual fund must mark its portfolio to market daily and seek to maintain a \$1.00 net asset value. Any investment pool that does not meet the requirements of one that is created to function as a money market mutual fund must maintain a maximum average dollar weighted maturity that does not exceed 365 days, or 366 days in the case of a leap year, and must provide a fixed interest rate and fixed maturity term for each pool position.

The District shall routinely monitor investment ratings from independent sources, and all prudent measures will be taken to liquidate an investment that is downgraded to less

than the required minimum rating.

II. Not Authorized

Investments including interest-only or principal-only strips of obligations with underlying mortgage-backed security collateral, or collateralized mortgage obligations with an inverse floating interest rate coupons or a maturity date of over 10 years are strictly prohibited.

With respect to authorized investments, this Policy is more restrictive than the Public Funds Investment Act.

VII. INVESTMENT PARAMETERS

Maximum Maturities

The longer the maturity of investments, the greater their price volatility. Therefore, it is the District's policy to concentrate its investment portfolio in shorter-term investments.

The District will not directly invest in instruments maturing more than two (2) years from the date of purchase.

Diversification

The District recognizes that investment risks can result from issuer defaults, market price changes, or various technical complications leading to temporary illiquidity. Risk is controlled through portfolio diversification that shall be achieved by the following general guidelines:

- Diversifying investments to avoid over concentration,
- Prohibiting investment with higher credit risks,
- Varying maturities, and
- Continuously investing a portion of the portfolio in alternatives that offer same-day liquidity.

VIII. INVESTMENT STRATEGIES

Investment Strategies by Fund Type

General Operating Funds; These funds shall have as their primary objectives: safety, investment liquidity, and maturity sufficient to meet anticipated cash flow requirements.

1. **Suitability:** Any investment eligible in the Investment Policy is suitable.
2. **Safety:** All investments shall be of high quality with no perceived default risk. Market price fluctuations will occur. Managing the weighted average days to maturity for the General Operating Fund's portfolio to less than 365 days and restricting the maximum allowable maturity to two years will minimize the price volatility of the overall portfolio.
3. **Liquidity:** The General Operating Fund requires the greatest short-term liquidity. Financial institution deposits, short-term investment pools and money market mutual funds will provide daily liquidity and may be utilized as a competitive yield alternative to fixed maturity investments.

4. **Marketability:** Securities with active and efficient secondary markets are necessary in the event of an unanticipated cash flow requirement. The District must maintain a reasonable balance of highly liquid assets relative to less liquid assets to ensure adequate liquidity and diversification mix.
5. **Diversification:** Investment maturities should be staggered throughout the cash flow cycle. Diversifying the appropriate maturity structure out through two years will reduce market cycle risk.
6. **Yield:** Attaining a competitive market yield for comparable security-types and portfolio restrictions is the desired objective. The yield of an equally weighted, rolling three-month Treasury-Bill portfolio will be the minimum yield objective.

Debt Service Funds: Investment strategies for debt service shall have as their objective sufficient investment liquidity to timely meet debt service payment obligations in accordance with provisions in the bond documents.

1. **Suitability:** Any investment eligible in the Investment Policy is suitable.
2. **Safety:** All investments shall be of high quality with no perceived default risk. Market price fluctuations will occur. However, by managing Debt Service Funds to not exceed the debt service payment schedule the market risk of the overall portfolio will be minimized.
3. **Liquidity:** Debt Service Funds have predictable payment schedules with reduced liquidity requirements. Investment maturities should not exceed the anticipated cash flow requirements. Financial institution deposits, investments pools and money market mutual funds may provide a competitive yield alternative for short term fixed maturity investments.
4. **Marketability:** Securities with active and efficient secondary markets are not necessary as the event of an unanticipated cash flow requirement is not probable.
5. **Diversification:** Market conditions influence the attractiveness of fully extending maturity to the next "unfunded" payment date. At no time shall the debt service schedule be exceeded in an attempt to bolster yield.
6. **Yield:** Attaining a competitive market yield for comparable investment-types and portfolio restrictions is the desired objective. The yield of an equally weighted, rolling three-month Treasury-Bill portfolio will be the minimum yield objective.

Debt Service Reserves: Investment strategies of debt service reserve funds shall have as their primary objective the generation of a dependable revenue stream from high quality investments in accordance with provisions in the bond documents.

1. **Suitability:** Any investment eligible in the Investment Policy is suitable.
2. **Safety:** All investments shall be of high quality with no perceived default risk. Market price fluctuations will occur. However, managing Debt Service Reserve Fund maturities to not exceed the call provisions of the borrowing reduces the investment's market risk if the debt is redeemed and the Reserve Fund liquidated. No stated final investment maturity shall exceed the final maturity of the borrowing.
3. **Liquidity:** Debt Service Reserve Funds have no anticipated expenditures. The

Funds are deposited to provide annual debt service payment protection to the debt holders. Market conditions and arbitrage regulation compliance determine the advantage of investment diversification and liquidity.

4. **Marketability:** Securities with less active and efficient secondary markets are acceptable.
5. **Diversification:** Market conditions and the arbitrage regulations influence the attractiveness of staggering the maturity of fixed rate investments for Debt Service Reserve Funds. At no time shall the final debt service payment date of the bond issue be exceeded in an attempt to bolster yield.
6. **Yield:** Achieving a positive spread to the applicable borrowing cost is the desired objective. Debt Service Reserve Fund portfolio management shall operate within the limits of the Investment Policy's risk constraints.

Capital Projects Funds: Investment strategies for capital project funds shall have as their primary objective sufficient investment liquidity to timely meet capital project obligations. If the District has funds from bond proceeds, they shall be invested in accordance with provisions in the bond documents.

1. **Suitability:** Any investment eligible in the Investment Policy is suitable.
2. **Safety:** All investments shall be of high quality with no perceived default risk. Market price fluctuations will occur. However, by managing Capital Project Funds to not exceed the anticipated expenditure schedule the market risk of the overall portfolio will be minimized.
3. **Liquidity:** Capital Project Funds programs have reasonably predictable draw schedules reducing liquidity requirements. Financial institution deposits, investment pools and money market mutual funds will provide readily available funds or a competitive yield alternative for short term fixed maturity investments.
4. **Marketability:** Securities with active and efficient secondary markets are necessary in the event of an unanticipated cash flow requirement. The District must maintain a reasonable balance of highly liquid assets relative to less liquid assets to ensure adequate liquidity and diversification mix.
5. **Diversification:** Market conditions and arbitrage regulations influence the attractiveness of staggering the maturity of fixed rate investments for Capital Project Funds. Generally, when investment rates exceed the applicable cost of borrowing, the District is best served by locking in most investments. If the cost of borrowing cannot be exceeded, then concurrent market conditions will determine the attractiveness of diversifying maturities or investing in shorter and larger amounts. At no time shall the anticipated expenditure schedule be exceeded in an attempt to bolster yield
6. **Yield:** Achieving a positive spread to the applicable borrowing cost is the desired objective. Capital Project Fund portfolio management shall at all times operate within the limits of the Investment Policy's risk constraints.

IX. SELECTION OF BANKS AND BROKER/DEALERS

Depository

In compliance with statutory requirements, a primary depository shall be selected through the District's banking services procurement process, which shall include a formal request for proposal (RFP). The selection of a primary depository will be determined by competitive Request For Proposal and evaluation of proposals will be based on the following selection criteria:

- The ability to qualify as a depository for public funds in accordance with state law.
- The ability to provide requested information or financial statements for the periods specified.
- The ability to meet all requirements in the banking RFP.
- Complete response to all required items in the banking RFP.
- "Best value" net banking service cost, consistent with the ability to provide an appropriate level of service.
- The credit worthiness and financial stability of the bank.

All depository deposits shall be insured or collateralized in compliance with applicable State law. The District reserves the right, in its sole discretion, to accept or reject any form of insurance or collateralization pledged towards depository deposits. Depositories will be required to sign a Depository Agreement with the District. The collateralized deposit portion of the Agreement shall define the District's rights to the collateral in case of default, bankruptcy, or closing and shall establish a perfected security interest in compliance with Federal and State regulations, including:

- the Agreement must be in writing;
- the Agreement has to be executed by the Depository and the District contemporaneously with the acquisition of the asset;
- the Agreement must be approved by the Board of Directors or Designated Committee of the Depository and a copy of the meeting minutes must be delivered to the District; and
- the Agreement must be part of the Depository's "official record" continuously since its execution.

Authorized Broker/Dealers

The Audit Committee shall, at least annually, review, revise, and adopt a list of qualified broker/dealers and financial institutions authorized to engage in securities transactions with the District. Those firms that become qualified shall provide certification stating the firm has received, read and understood the District's Investment Policy and agree to comply with the Policy. Authorized firms include primary dealers or secondary dealers that qualify under Securities & Exchange Commission Rule 15C3-1 (Uniform Net Capital Rule), and qualified depositories.

All investment providers, including financial institutions, banks, money market mutual funds, and local government investment pools, must sign a certification acknowledging that the organization has received and reviewed the District's Investment Policy and that reasonable procedures and controls have been implemented to preclude investment transactions that are not authorized by the District's Policy.

Authorized Broker/Dealers are:

- Bonwick Capital Partners
- FTN Financial
- Raymond James
- Rice Financial
- Wells Fargo

Competitive Bids

It is the Policy of the District to provide a competitive environment for all individual investment purchases and sales, and money market mutual fund and local government investment pool selection. The Investment Officers shall develop and maintain procedures for ensuring a competition in the investment of the District's funds.

Delivery vs. Payment

Securities shall be purchased using the **delivery vs. payment** method. Funds will be released after notification that the purchased security has been received.

Investment Advisors

Investment advisors shall adhere to the spirit, philosophy and specific terms of this Policy and shall advise within the same "Standard of Care". Selected investment advisors must be registered under the Investment Advisors Act of 1940 or with the State Securities Board. A contract with an investment advisor may not be for a term longer than two years and must be approved by the District's Board of Directors, including any renewals or extensions.

X. SAFEKEEPING OF SECURITIES AND COLLATERAL

Safekeeping and Custodian Agreements

The District shall contract with a bank or banks for the safekeeping of securities either owned by the District as part of its investment portfolio or held as collateral to secure financial institution deposits.

The District's Director of Finance shall maintain evidence of the held securities either owned by the District as part of its investment portfolio or held as collateral to secure financial institution deposits. Safekeeping institutions shall be independent from the parties involved in the investment transaction.

Collateral for deposits will be held by an independent third party custodian designated by the District and pledged to the District as evidenced by safekeeping receipts of the institution with which the collateral is deposited. Collateral may be held by a Federal Reserve Bank or branch of a Federal Reserve Bank, a Federal Home Loan Bank, or a third party bank approved by the District and eligible under State law.

Collateral Policy

Consistent with the requirements of the Public Funds Collateral Act, it is the Policy of the District to require full collateralization of all District funds on deposit with a depository bank. In order to anticipate market changes and provide a level of security for all funds, with the exception of deposits secured with irrevocable letters of credit at 100% of amount, all deposits with financial institutions shall be secured by pledged collateral with a market value equal to or greater than 102% of total value of principal and accrued interest on the deposits less any amount insured by the FDIC. At its discretion, the District may require a

higher level of collateralization for certain investment securities.

Securities pledged as collateral shall be held by an independent third party with whom the District has a current custodial agreement. The District's Director of Finance is responsible for entering into collateralization agreements with independent third party custodians in compliance with this Investment Policy. The agreements are to specify the acceptable investment securities for collateral, including provisions relating to possession of the collateral, the substitution or release of investment securities, ownership of securities, and the method of valuation of securities. A clearly marked evidence of ownership (safekeeping receipt) must be supplied to the District. Collateral shall be reviewed at least monthly to assure that the market value of the pledged securities is adequate.

Subject to Audit

All collateral shall be subject to inspection and audit by the District's designated financial officer or the District's independent auditors.

XI. REPORTING

Methods

The Investment Officers shall prepare an investment report at least quarterly in compliance with the Public Funds Investment Act. This report will be prepared in a manner that will allow the District to ascertain whether investment activities during the reporting period have conformed to the Investment Policy. The report will be provided to the District.

In conjunction with the annual audit, an independent auditor will perform a formal annual review of the quarterly reports with the results reported to the Board of Directors.

Monitoring Market Value

Market value of all collateral, pools and securities will be monitored quarterly and obtained from a reputable and independent source. Quarterly reports with the results will be reported to the Board of Directors.

XII. INVESTMENT POLICY ADOPTION

The District's Investment Policy shall be adopted by resolution of the Board of Directors. It is the District's intent to comply with State laws and regulations. The District's Investment Policy shall be subject to revisions consistent with changing laws, regulations, and needs of the District. The Board of Directors shall annually adopt a resolution stating that it has reviewed the Policy and investment strategies, approving any changes or modifications.