TO: Finance and Audit Committee  
RE: ALA Cash Management Policy

ACTION REQUESTED/INFORMATION/REPORT: 
To establish a Spending/Payout formula for the ALA Cash Management Policy

ACTION REQUESTED BY: 
Gregory Calloway - AED Finance and the Senior Management Group

OVERVIEW OF DISCUSSION: 
1. For ALA management to recommend to the Finance and Audit Committee approval of an annual spending/payout (formula) for the ALA Cash Management policy.  
2. Update the Cash Management Policy to allow for the expansion of the average credit rating of the portfolio to include the investment grade ratings of AAA, AA, A, and BBB.  
3. The initial recommended option should be applied to the FY 2015 and FY 2016 budgets.

PURPOSE OF RECOMMENDATIONS:

1. Provide a degree of certainty from a budget and planning perspective in order to augment the funding of the Associations’ activities i.e. general operations.  
2. Enhances the prospects for higher investment yields

DATE: January 31, 2015

BACKGROUND: 
Over the years the American Library Association (ALA), through the success of its many units, has established a “Cash Management” account which provides a significant source of revenue in the form of interest income for the benefit of the Association. Currently policy permits drawing down the interest/dividends which provides budget support to ALA programs. 

The recommended spending/payout from the Cash Management accounts require that these contemplated policy adjustments be made within the context of positively impacting the overall return of the portfolio and its future sustainability.

---

1 The annual spending rate will be subject to an annual review and assessment by the ALA senior management as part of the annual budget process.
Why the Change in Policy? By way of the current ALA Cash Management policy, the Association’s general operation receives interest/dividends based on market performance. This interest income is generated from the investment results of funds held in ALA’s working capital bond accounts (3) at Merrill Lynch:

- Lord Abbott – Short/Limited Duration
- Neuberger Berman – Intermediate
- Blackrock – Intermediate Tax

These accounts are primarily in bonds (94.6%) focused on a diversified mix of fixed maturities\(^2\) – Long-Term (8.4%), Intermediate-Term (25.9%), Short-Term (64.3%) and Blend (1.4%). Note that the longer the term of a security the higher the rate which reflects the perceived additional risk investors feel they need to invest. In this regard management has taken a conservative stance on both the length of maturities and the quality of invested securities. Over the last few years (5) these investments have provided an average of approximately $446,950\(^+3\) per year interest income. This support is warranted, necessary and has served the Association well from an operation standpoint.

Additional reasons for a recommended adjustment to the Cash Management policy for additional support include the following:

- It will create additional certainty in the budget planning process. As a result of the every two-year disruption in expected overhead from the division conferences a change in policy would provide a much needed smoothing affect.

- Similar to the changes made in the spending/payout formula for the ALA endowment fund, this change will allow the Association to take advantage of the growth in interest and capital appreciation realized from its investments.

- Closely related to the above is the timing. Budgeting for expected interest for the upcoming year is captive to how the market performs. As such, only estimates are made to determine what the interest will be.

- The need to contemporize the draw down policy for maximum programmatic benefit – using the total return available, expands the potential uses for a broader base of programmatic efforts and benefit to the Association

Spending Policy Considerations: Spending and investment policies generally operate with conflicting goals. As such, the first order of business is to devise a spending policy that will balance the competing objectives of supporting programs/operations and the need to preserve the Cash Management account’s purchasing power for future generations.

In order to achieve a balance between these competing objectives and develop a reasonable spending policy the following objectives need to be considered:

1. Maintaining the purchasing power to ensure that Cash Management distributions keep pace with inflation

\(^2\) Short-Term bonds are 1 – 3.5 years, Intermediate – Term bonds are 3.5 – 6 years and Long-Term bonds are 6+ years.

\(^3\) 2010 ($689,946), 2011 ($564,091), 2012 ($361,805), 2013 ($322,056) and 2014 ($296,854).
2. Maximizing total investment return within appropriate risk constraints
3. Achieving smooth and predictable spending distributions

Any adoption of a spending policy for the Cash Management account should both be responsive to changes in the accounts value and minimizing year-over-year fluctuations in spending.

**Recommendation**

After consideration of the options listed, as well as, some internal financial analysis, the following recommendation was deemed the optimal solution for meeting the goals of providing greater access to the gains realized from the long-term growth in the Cash Management account:

**Action**

To change the Cash Management policy to allow for a yearly spending/payout based on the annual five-year rolling average of the cash and working capital accounts (i.e. intermediate bond fund) dividend and interest income earned.

Additionally, the following conditions will also apply:

- The first use of this recommendation will be applied to the FY 2015 and FY 2016 budgets and annually thereafter
- The spending/payout rate will be reviewed and set annually during the budget process

**Benefits of Recommended Change** - The recommendation will do two very important things from the perspective of senior management for the benefit of the Association:

1. It will provide a higher degree of clarity and certainty from a planning perspective that has been difficult to realize with the widely changing swings in revenue. The volatility of the market is accounted for and neutralized.

2. It will make available more dollars for general day to day operations and or program initiatives.

**Expansion of Allowable Investment Securities**

Closely related to the recommended change in the Cash Management policy is a recommended change in the “Investment Grade” of allowable securities for the cash and working capital account.

**BACKGROUND**

The ALA cash and working capital account is an investment account made up of a mix of assets of which fixed income makes up the majority i.e. no equities. The available asset mix is as follows:

- Certificates of Deposit
- Repurchase Agreements
- Money funds
- U.S. Government Securities
• Managed Fixed Income Accounts
• Compensating Balances
• Other Investments – To Be Defined

As previously mentioned the Association’s general operation receives benefits of generated interest/dividends based on market performance. This interest income is generated primarily from the investment results of funds held in ALA’s cash and working capital management bond accounts (3) at Merrill Lynch:

• Lord Abbott – Short/Limited Duration
• Neuberger Berman – Intermediate
• Blackrock – Intermediate Tax

These accounts are primarily in bonds (94.6%) focused on a diversified mix of fixed maturities – Long-Term (8.4%), Intermediate-Term (25.9%), Short-Term (64.3%) and Blend (1.4%). Note that the longer the term of a security the higher the rate which reflects the perceived additional risk investors feel they need to invest. In this regard management has taken a conservative stance on both the length of maturities and the quality of invested securities. Over the last few years these investments have provided an average of approximately $446,950+ per year interest income with an average yield of approximately 2.4%. This support is warranted, necessary and has served the Association well from an operation standpoint. It’s important to note that the amount of interest and dividends generated each year has been trending downward since 2009. As a result, any opportunity to further maximize the generation of additional interest & dividends must be explored.

Recommendation
After careful consideration of the prospects for future interest & dividends, based on the current investment guidelines, as well as, financial analysis from Merrill Lynch, the following recommendation was deemed the optimal solution for meeting the goals of providing greater access to the gains realized from the long-term growth in the cash and working capital account:

Action:

To change the Cash Management policy to allow for an expansion of the average credit rating of the portfolio to include AAA, AA, A, and BBB and replace the Lord Abbett Limited separate account with four mutual funds (Vanguard Short-Term ETF, Lord Abbett Short Duration Fund, Metro West Total Return Fund and Guggenheim Total Return Fund).

The analysis has revealed that if this portfolio had been in place over the last five years the total return would’ve been approximately 4.2%, nearly 50% higher than the actual return. In view of today’s low interest rate environment as supported by the Federal Reserve, expanding the range of allowable investments grades seems prudent. This is particularly true in view of the fact that the portfolio’s risk profile is maintained with the recommended changes.

4 Short-Term bonds are 1 – 3.5 years, Intermediate – Term bonds are 3.5 – 6 years and Long-Term bonds are 6+ years.
5 2010 ($689,946), 2011 ($564,091), 2012 ($361,805), 2013 ($322,056) and 2014 ($296,854).