

# Fairlington Commons Council of Co-Owners

3367 South Wakefield Street  
Arlington, Virginia 22206

## Investment Policy

Adopted 12 September 2011

The purpose of this document is to establish an investment policy for the reserve funds of Fairlington Commons. This policy addresses the

- appropriate levels for restricted reserve funds and the Unrestricted Reserve Fund
- degree of liquidity appropriate for the Commons
- kinds of securities and security trading activities appropriate for the Commons

### **Definitions**

Restricted Reserve Funds: Moneys set aside to fund a particular project that is not to be financed from the revenue of a single budget year of Fairlington Commons. Each such project has been identified in the Fairlington Commons Capital Replacement Study and in the annual budget.

The Unrestricted Reserve Fund: Moneys set aside to meet future contingencies. This fund is used to meet the costs of: (1) seasonal shortfalls in cash flow; (2) major disasters; (3) projects not currently scheduled and under-budgeted activities; and (4) Restricted reserve fund underfunding.

Reserve Funds: The restricted reserve funds and the Unrestricted Reserve Fund.

Planned Annual Expenditures: The total budgeted expenditures in the current annual budget minus the budgeted reserve withdrawals. Additions to reserve funds in the annual budget are not classified as expenditures. (If the Commons increases its reliance on restricted reserve funds in the future, it may be appropriate to include additions to restricted reserve funds in planned annual expenditures.)

Liquid investments: Assets available on demand from an account, such as a savings or money market account, and assets invested in instruments that mature within the year.

Long-term investments: Assets in certificates of deposit, treasury notes, retail deposit notes, and bonds that mature over one year from the present.

Capital preservation investments: Savings accounts, money market accounts, and certificates of deposit at federally insured institutions, treasury notes, and bonds with a rating equivalent to Standard & Poor's AA-/A-1+ or better.

## **Restricted Reserve Funds**

If a project cannot be funded from income raised within a single year, the Board sets money aside in a restricted reserve fund over an appropriate number of years prior to the need. The following methodology is used:

- A project the Board does not plan to fund from the annual operating budget is identified. The Board reviews projects annually.
- The target date is set based on life expectancy, as determined by experience, advice of contractors or other experts, and other information sources.
- A current estimate of the cost is obtained, usually from the actual cost of a recent project or from a contractor.
- An inflation factor is applied to the estimate.
- A deposit plan is developed and incorporated into the annual budgets. The planned additions are usually the same amount each year, although they need not be.
- The current estimate and life expectancy are reviewed at least every five years in accord with requirements of the Virginia Condominium Act for capital replacement plans.

Restricted reserve funds should be invested so money is readily available when needed and without forfeiture of interest for early withdrawal, even if the target date must be moved forward a year or two. Restricted reserve funds are not to be used to finance projects other than those for which the fund was established and withdrawals are made only by a majority vote of the Board of Directors.

## **The Unrestricted Reserve Fund**

Past history provides guidance on both the appropriate levels of reserve funds and the appropriate degree of liquidity.

### **A. Unrestricted Reserve Fund--Seasonal Shortfalls**

The income of the Commons is very stable from month to month, whereas expenditures fluctuate seasonally. Planned annual expenditures are typically lower during the first and last months of the year. Painting, building maintenance projects, sidewalk replacement, fence and deck work, roof replacement, and pool operations drive expenditures up from late spring through the fall and sometimes cause short-term cash flow shortages in the late summer or fall. Transfers are made from the Unrestricted Reserve Fund to meet these short-term needs. Historically, withdrawals from the Unrestricted Reserve Fund to address cash-flow problems have been no more than 5% of the planned annual expenditures and the money has been repaid in November or December. Five percent has proven to be a reasonable amount in the Unrestricted Reserve Fund to meet seasonal shortfalls.

## **B. Unrestricted Reserve Fund--Major Disasters.**

Disasters happen. Hurricanes have struck; a tornado caused significant damage to uninsured trees; in the first decade of the 21<sup>st</sup> century alone, we have had two “storms of the century.” Most water and tree damage has not been covered by insurance. Minor unplanned expenses are normally met by making adjustments in planned expenditures for a year and, in some cases, cutting back on the full annual contribution planned for the Unrestricted Reserve Fund. When major disasters have struck, the Unrestricted Reserve Fund has been utilized, as intended. In the two worst cases, the Commons was forced to withdraw from the reserve funds approximately 20% of the planned annual expenditures to meet these severe storm disasters, which occurred in back-to-back years. Both of these experiences predated the increased cost of replacing our aging infrastructure and the beginning of professional management. A comparable disaster today would be closer to 15% of the planned annual expenditures. It is not acceptable to enter a third year with the Unrestricted Reserve Fund depleted, even though the likelihood of major disasters three consecutive years is very small. The Unrestricted Reserve Fund must not only be funded, but also in sufficient amounts to sustain major disasters for several consecutive years.

The appropriate level for the Unrestricted Reserve Fund is not only determined by the amount of potential withdrawals, but also by the amount of potential deposits. It is unrealistic to expect to achieve annual increases to the Unrestricted Reserve Fund in excess of roughly 10% of the planned annual expenses in good years. If an unplanned expense has forced a withdrawal from the Unrestricted Reserve Fund, it is very likely that planned projects have been deferred and will need to be financed in the next year or two, causing further pressure on the annual budget. A prudent level to meet major disasters is 40% of planned expenditures. This would enable the Commons to meet back-to-back withdrawals of about 15% of the planned annual expenditures and enter the third year with approximately 10% available for emergencies in the third year.

## **C. Unrestricted Reserve Fund—Unplanned Projects and Cost Overruns.**

Another kind of major expense is an unplanned project or activity that incurs a significant cost overrun. Historically, we have had to deal with significant problems that have come upon us unexpectedly. A need for underpinning has become known within a year, and sometimes sewer laterals have required expensive work with little warning. Especially during inflationary times, overruns can affect multiple projects and activities. Allowing 5% of the planned annually funded expenses provides a safety margin for an unplanned project and/or underestimation of inflation.

## **D. Unrestricted Reserve Fund—Restricted Reserve Underfunding.**

Yet another kind of unplanned expense concerns projects to be funded from restricted reserve funds. If inflation has been underestimated and/or the project must be undertaken earlier than expected, there can be a significant shortfall in the restricted reserve fund to finance the project. A target of 10% beyond the estimated cost of such projects at the estimated date when the work will begin is a reasonable long-term target.

## **Unrestricted Reserve Fund--Summary**

A cautious long-term target for the level of the Unrestricted Reserve Fund is 50% of the planned annually funded expenses, plus 10% of the estimated costs of projects to be funded from Restricted Reserve accounts. Roughly 15% to 20% of the planned annually funded expenses should be readily available; i.e., in the form of liquid assets. It is possible, but unlikely, that through a combination of worst cases, the needs in a given year could exceed 20%. However, through a combination of postponing projects and forfeiting interest by early withdrawals, the Commons can meet its needs for such a combination if the Unrestricted Reserve Fund is funded at the recommended level.

## **Managing Reserve Funds**

1. The Board of Directors has a fiduciary responsibility to manage the Fairlington Commons' financial assets. Commons' moneys will be invested in capital preservation investments in Point 2 below. When balances at an institution exceed the limit for federal insurance, the Board will take appropriate action to move money to another institution. The Board will confer with its financial advisors about potential risk before making any investment that is not federally insured or guaranteed.
2. The Board may invest Unrestricted Reserve Fund assets in excess of 80% of the target level in growth securities, provided that all restricted reserve funds are funded according to plan, the liquidity is at the target level, and the Board confers with the association's financial advisor about potential risk.
3. Long term investments will be made with the intent of keeping the investments until maturity, rather than bought and sold as prices fluctuate. Change in a bond rating after it has been acquired does not require the divestiture of that investment.
4. Restricted reserve funds will be established for each project or activity not financed from revenue raised in the year it is to be undertaken. Amounts will be based on a base price, life expectancy, and inflation rate. Base prices will be re-examined at not less than 5-year intervals. Details for these funds will be presented in the Capital Replacement Study, which will be updated annually.
5. A goal of the Commons will be to have the Unrestricted Reserve Fund funded at a level equal to at least 50% of the planned annual expenditures, plus 10% of the target levels of the restricted reserve funds. This amount should be sufficient to address seasonal cash-flow shortfalls and sustain major unplanned expenses. If the Unrestricted Reserve Fund is below this goal, the Board will exercise due diligence to bring the Unrestricted Reserve Fund to the goal within a reasonable time. If the Unrestricted Reserve Fund is below 25% of the planned annual expenditures, the Board will exercise urgency in restoring it to above that level, even though this may take more than one year.

6. A goal of the Commons will be to have liquid assets of roughly 15% to 20% of the planned annually funded expenses. This is sufficient to sustain a major disaster of the largest size the Commons has experienced in the past with only modest forfeiture of interest from long-term capital preservation investments that might have to be liquidated. If the liquid assets fall below this goal, the Board will exercise due diligence to make future additions to the Reserve Funds to bring the liquidity up to this goal quickly. The Board is not required to liquidate existing long-term financial investments should the liquid assets fall below goal, whether from an increase in planned annual expenditures or from a reserve withdrawal. Notwithstanding this goal, additions to a restricted reserve fund may be invested in long-term capital preservation financial investments provided that such investments do not exceed the planned balance of the Restricted Reserve Funds for that year.
  
7. Reserve funds are controlled by the Board. Withdrawals are made only by a vote of the Board and only officers of Fairlington Commons shall have the authority to withdraw money from accounts in which reserve funds are invested. Details about the Restricted Reserve Funds are found in the Fairlington Commons Capital Replacement Study.