Diversification Mitigates Risk

Do not put all your eggs in one basket.

Diversification is one of the most fundamental tools available to a government investor for managing risk. But for public funds, diversification is about more than simply owning a variety of investments. It means structuring the **entire portfolio** so that it is not overly dependent on any one issuer, sector, maturity, security type or source of liquidity.

GFOA identifies diversification as an important strategy for managing three primary types of investment risk:

- **Credit risk** — the possibility that an issuer or financial institution fails to meet its obligations.
- **Interest-rate and market risk** — the potential for the value of an investment to change as interest rates or market conditions change.
- **Liquidity risk** — the possibility that funds will not be available when the government needs them.

GFOA recommends establishing a **target risk profile** based on the government's investment objectives and constraints, risk tolerance, liquidity requirements and prevailing risk/reward characteristics of the market. Diversification can then be used to manage that risk through appropriate allocation among maturities, sectors, issuers and security structures.

See GFOA's Best Practice Diversifying the Investment Portfolio

For public funds, the objective is not simply to maximize investment return. The priorities are **safety, liquidity and return**. GFOA's current investment guidance emphasizes that safety and liquidity take priority over return and that the government's unique cash flow needs should be considered when evaluating its investment program.

See GFOA's 2026 Best Practice Performance Measures for Government Investment Portfolio Objectives

Practical Steps

A well diversified public investment portfolio should:

- **Start with cash-flow needs.** Prepare and regularly update a cash-flow forecast so investments mature when funds are expected to be needed. Diversification should support—not interfere with—the government's ability to meet its obligations.

- **Maintain adequate liquidity.** Keep a portion of the portfolio in readily available investments, such as permitted local government investment pools, money market funds or other highly liquid investments.

- **Limit issuer concentration.** Establish appropriate limits on the amount invested with any single issuer or financial institution.

- **Diversify credit exposure.** Avoid excessive reliance on one type of credit, sector or issuer. For investments such as **commercial paper and other corporate obligations**, establish appropriate limits for individual issuers, sectors, credit quality and maturities.

- **Diversify maturities.** Establish maturity and duration parameters that reflect the government's cash-flow requirements and tolerance for interest-rate risk.

- **Consider security structure.** Pay attention to features such as call provisions, embedded options, amortization and other characteristics that can affect a security's liquidity or market value.

- **Limit higher-risk investments.** Investments with greater credit, market or structural risk should be limited and must remain consistent with applicable law and the government's investment policy.

- **Look at the whole portfolio.** A diversified investment pool does not eliminate the need to consider the government's overall exposure. Total cash and investments—including bank deposits, CDs, investment accounts, LGIPs, money market funds and other holdings—should be considered when evaluating concentration, credit and liquidity risk.

- **Establish a target risk profile.** The appropriate level of diversification should reflect the government's investment objectives, legal and policy constraints, liquidity requirements and risk tolerance.

- **Monitor the portfolio regularly.** Diversification is not a one-time decision. Holdings, concentrations, maturities, credit quality, liquidity and compliance with the investment policy should be reviewed regularly.

Diversification Starts with the Investment Policy

Diversification should not be left to individual investment decisions. It should be established in the government's **written investment policy**.

GFOA recommends that every government establish and have its governing board adopt an investment policy. The policy should address investment objectives, risk tolerance, authorized investments, maturity and credit-quality parameters, risk management, diversification, performance measurement and reporting. GFOA also recommends that the investment policy be reviewed and updated **at least annually** and whenever changes in state law or other circumstances warrant an earlier review.

See GFOA's Best Practice Investment Policy.

The Bottom Line

Diversification is not about owning more investments. It is about managing risk intelligently.

A properly diversified public-funds portfolio should protect principal, provide the liquidity needed to meet government obligations and earn a reasonable return—all within the limits of applicable law and the government's investment policy.

For Illinois public entities, that means understanding not only **what investments are permitted**, but also how much exposure to any particular issuer, sector, maturity or investment type is appropriate.

The **Illinois Public Funds Investment Act provides the legal framework. The investment policy establishes the government's rules. Diversification provides the discipline for managing the portfolio.**

And, as GFOA's current guidance makes clear, the ultimate test is not simply **"What did we earn?"** but, rather:

Were the funds safe?
Were they available when needed?
And did we earn a reasonable return consistent with those priorities?

Additional guidance, check:

GFOA Resources

- **GFOA Best Practice — Investment Policy:** GFOA recommends that all governments establish and have their governing board adopt an investment policy.
- **GFOA Best Practice — Investment Program for Public Funds:** Establishes the framework for investment governance, risk and return objectives, portfolio management and cash-flow forecasting.
- **GFOA Best Practice - Cash Flow Forecasting:** Recommends an ongoing, generally 12-month rolling cash forecast.
- **GFOA Best Practice — Managing Market Risk in Investment Portfolios:** Addresses liquidity, maturity, WAM, duration and security structures.
- **GFOA Best Practice — Diversifying the Investment Portfolio:** Provides guidance on issuer, sector, security-type, maturity, duration and structure diversification.
- **GFOA Best Practice — Performance Measures for Government Investment Portfolio Objectives:** Establishes the current framework for measuring safety, liquidity and return and reporting performance at least quarterly.

- **GFOA Best Practice — Local Government Investment Pools:** Provides guidance on evaluating LGIPs and their role in a government investment portfolio.

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This material is provided for educational purposes and is not intended to constitute legal or investment advice. Government investors should consult applicable statutes, regulations, their investment policies and qualified advisers before investing.