How Cash Flow Forecasting Helps with Investing

A good cash flow forecast is one of the most important tools a public entity can use to manage its investment portfolio. It helps answer three basic questions: **How much cash do we need? When will we need it? And how much can we invest for longer periods?**

GFOA recommends using cash flow forecasting to ensure adequate liquidity while avoiding unnecessarily large cash balances. A rolling forecast of at least 12 months, updated regularly, can provide the foundation for sound investment decisions.

Ensure Liquidity

The first priority is having sufficient cash available when obligations come due.

- Maintain an appropriate liquidity reserve based on projected revenues and expenditures.
- Schedule investment maturities to coincide with anticipated disbursements.
- Use a laddered maturity structure so investments mature systematically as cash is needed.
- Keep funds that may be needed immediately in highly liquid investments.

For IMET participants, the **Convenience Fund** can provide a source of same-day liquidity, subject to applicable cutoff times. It also accepts direct deposits of State and local tax distributions, allowing funds to be invested promptly.

Manage Investment Risk

Cash flow forecasting also helps manage **interest-rate and liquidity risk**.

Investing too long can create unnecessary market-value volatility and may force an investor to sell securities when cash is needed. Investing everything too short, however, can create reinvestment risk and reduce potential earnings.

By matching investment maturities to projected cash needs, an investor can establish an appropriate maturity structure while reducing the likelihood of having to sell investments prematurely.

Enhance Returns

Once immediate and intermediate cash needs are identified, a forecast can reveal funds that are not expected to be needed for an extended period.

Those funds may be appropriate for longer-term investments, such as individual securities, CDs, or an investment fund with a longer maturity profile, provided they comply with applicable law and the entity's investment policy.

The objective is **not to maximize yield at the expense of safety or liquidity**. Rather, it is to avoid the opportunity cost of keeping long-term funds unnecessarily liquid.

Make Forecasting an Ongoing Process

Cash flow forecasting works best as a rolling process rather than a once-a-year exercise. Compare projected cash flows with actual results and update assumptions as circumstances change.

A useful forecast should incorporate major revenues and expenditures, including taxes, grants, payroll, debt service, capital projects, and investment maturities.

Even a well-designed spreadsheet can provide valuable insight. More sophisticated organizations may use financial planning or cash management systems to model different scenarios and identify periods of surplus or potential cash shortfalls.

From Forecast to Investment Strategy

A sound cash flow forecast allows a public entity to build its investment portfolio around its actual financial needs:

Immediate needs → liquidity
Near-term needs → appropriately timed maturities
Longer-term funds → longer investment horizons

The result is a portfolio designed to achieve the fundamental objectives of public investing: **safety, liquidity, and yield/return—in that order.**

GFOA Resources

- **GFOA Best Practice - Cash Flow Forecasting:** Recommends an ongoing, generally 12-month rolling cash forecast.
- **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 — Managing Market Risk in Investment Portfolios:** Addresses liquidity, maturity, WAM, duration and security structures.
- **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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