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Investing Bond Proceeds

CDIAC - Mechanics of a Bond Sale

May 1, 2009

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Topics

- Bond Proceeds Investing Framework
- Identification of Funds to Invest
- Permitted Investments
- Investment Alternatives & Considerations
- Current Market Environment

Introduction

- Bond issuer responsible for investment decisions
  - Consider investments in conjunction with bond issuance
  - Goal: prudently lower *net cost* of borrowing
- Focus on safety and liquidity…*then yield*
- Guide decisions by proceed (asset) relationship to debt issue (liability)

Example – Impact to Borrowing Cost

- Borrow $20 MM @ 5.00% = 30 years paying $1.3 MM
  - Annual interest expense of $1,000,000 in Year 1; $867,000 Year 10 and so on
  - **Debt service reserve fund** of $1.3 MM to invest at *up to* 5%
- Reserve Fund investment earnings: $65,175 to $0.
  - At 5% investment = slash effective borrowing cost **0.33% to 4.67%** (to 4.61% in Year 10, declining to 2.3% in Year 29)
  - At 0.50% investment ($6,500 year) = effective borrowing cost of 4.97% (4.96% Year 10)

Typical Proceeds to Invest – Fund Types

Short Term

- Construction fund
  - Per IRS, spend-down of funds cannot be anticipated to exceed 3 years
- Capitalized interest fund
  - Used to pay debt service during construction
- Debt service fund
  - Receives deposits on-going basis to pay debt service

Medium to Long Term

- Debt service reserve fund
  - Approx. 1 year of debt service funded as security for investors
  - Yearly investment earnings used to offset debt service payments
- Refunding escrow fund
  - Structured to pay debt service on prior bonds until the call date

Investment Options and Constraints

- Bond Legal documents (Indenture of Trust, e.g.)
  - Permitted Investments Section
- External investment approvals
  - Rating agencies and /or Credit enhancement providers
- Anticipated expenditure of bond proceeds
- Arbitrage and rebate restrictions
- California Govt. Code / Issuer investment policies

California Government Code Exception

- Proceeds accounted for separately, and may be invested differently, from other agency funds
- Statute allows for bond documents to govern permitted investments
  - Therefore, bond proceeds may be invested in securities that exceed five year limit (Section 53601)
- Issuer investment policies may offer policy (not legal) restrictions or guidance

IRS Treatment of Investment Earnings

- *Arbitrage:* investment earnings of tax-exempt bond proceeds that exceed the bond yield (*arbitrage yield)*
- Such incremental earnings, with a few exceptions, must be 100% remitted to the federal government
- Failure to comply = may jeopardize tax-exempt status of the bonds

Arbitrage Rebate

- Computation and payment required at least every five years
  - Typically performed by outside, specialized consultants
  - Also required upon redemption/final bond maturity
- Exemptions from arbitrage rebate requirements:
  - Investments made in other tax exempt securities
  - Small issuers issuing less than $5MM per calendar year
  - Segregated construction fund satisfying spending test
  - 6-month, 18-month, or 2-year spending tests
  - Certain debt service fund meeting specific requirements

Investment Risks and Mitigation

- Credit risk (safety)
  - Risk of investing in instruments that may default
  - Establish guidelines for permitted investments
- Market or Term risk (liquidity)
  - Risk of selling an investment prior to maturity or at less than book value
  - Match bond funds' expected duration to investments
- Opportunity risk (yield/return)
  - Risk of investing long term and having rates rise or investing short term and having rates fall
  - Integrate knowledge of prevailing and expected future market conditions with cash flow requirements

Investment Alternatives

- Mutual or pooled investment funds
  - Local Agency Investment Fund (LAIF), County pool, money market funds
- Certificates of deposit
  - Negotiable CDs, Collateralized CDs, CDARS
- Individual securities or portfolio of securities*
  - Treasuries, Agencies, municipal bonds, etc.
- Structured investment agreements*
  - Guaranteed investment contract (GIC), repurchase agreement, forward delivery agreement

*must be purchased at fair market value (beware of "yield burning")

Money Market or Pooled Investment Funds

- LAIF*, Money market funds, Trustee Sweep Accounts, MMDIAS
- Pooled Funds investing in a variety of short-term investments
  - Diversified portfolio with conservative investments
- Generally provide on-demand withdrawals and investments
  - Money market funds typically at a $1 NAV
  - Yields vary on a daily basis

*Local Agency Investment Fund – specific to California (run by State Treasurer)

Certificates of Deposit

- Collateralized CDs
- Negotiable CDs (NCDs)
  - Non-collateralized; can be purchased or sold anytime between the issue date and the maturity date
- CDARS
  - Aggregates deposit throughout network of community banks
  - Allows *entire deposit* amount to receive FDIC insurance coverage

Individual or Portfolio of Securities

- Typically only highest rated, most liquid fixed income instruments
  - US Treasuries, Agencies, Munis, Commercial Paper, etc
- Requires ongoing oversight and administration
  - Issuer must manage risks including market and reinvestment risk
- Holdings sized to meet projected draws (laddered maturities)
  - Matching cash flows reduces risk

Investment Agreements

- Guaranteed Investment Contracts (GICs), Repurchase Agreements (Repos), Forward Delivery Agreements
- Customized to permitted investments and expected draw down requirements
  - Provided by highly-rated entities
  - Issuer takes credit risk with regard to provider
- Administrative burden of initial structuring, bidding, and monitoring of provider's credit rating

Investment Agreements (Cont.)

- Liquid for purposes provided for under the agreement (e.g. construction draws, debt service, escrows)
- May require provider to post collateral upon credit downgrade
- Predictable yields and cash flows
- Bidding and fee requirements per federal regulations
  - Typically accounted for at par irrespective of market changes

Investment Strategy

- Determine bond fund type and expected uses of funds
  - Short and long-term funds
  - Determine appropriate investment duration
- Identify permitted investments per Bond documents
- Consider arbitrage yield restrictions
- Evaluate appropriate investments and market conditions

Construction Funds

- Used for planning, acquisition of land and equipment and construction costs
- Formulate a "draw schedule" to determine when funds will be needed
- Keep investments short and liquid
  - Pooled investment funds (i.e. LAIF, County pool)
  - Money market funds

Capitalized Interest Fund

- Used to pay debt service during construction period
- Time investments to mature just prior to interest payment dates
- Can borrow net amount to minimize debt costs
- Short term investments (6 months – 3 years)
  - Portfolio of securities
  - Pooled investment funds/money market funds
  - Investment agreements

Debt Service Reserve Fund

- Generally 7 – 10% of principal borrowed
- Needed in case of a debt service payment shortfall
- If drawn upon, issuer is having financial difficulties
- Daily liquidity not as important
- Longer duration
  - Historically invested in GICs or portfolios of securities to match bond duration

Investment Options – Market Conditions*

Security Type	Comments	Maturity	Yield
Money Market	Treasury Bills	60-70 days	0.29%
Money Market	Federal / Agencies	60-70 days	0.47%
Money Market	Prime	60-70 days	0.53%
Money Market	**LAIF**	**180 Days**	1.50%
CDARS CD	FDIC Insured	180 days	1.60%
CDARS CD	FDIC Insured	1 Year	1.85%
US Treasury Note		2 Year	0.93%
US Treasury Note		5 Year	1.90%
US Agency	Fannie/Freddy	5 Year	2.45%
US Treasury Bond		10 Year	2.95%
US Agency	Fannie/Freddy	10 Year	3.50%
Municipal Bond	AAA - Tax-Exempt	5 Year	2.25%
Municipal Bond	AAA - **Taxable**	5 Year	4.00%
Municipal Bond	AAA - Tax-Exempt	10 Year	3.50%
Municipal Bond	AAA - **Taxable**	10 Year	5.15%
GIC - Project Fund	assumes $20M - Uncoll.	18 mo. avg. life	2.00%
GIC - DSR	assumes $5M - Uncoll.	30 Years	3.40%

***As of April 28, 2009**

Internal Controls & Monitoring

- Develop internal controls/policies
- Hire experienced professional advisors to assist with bidding and/or structuring portfolio
- Monitor your fund performance frequently
  - *at least monthly in the current environment*
- Be an active participant: <u>do not assume Bond Trustee will proactively make best investments</u>

Conclusion

- Investment earnings can offset debt borrowing cost
- Be active in establishing permitted investments
- Identify permitted investments; match to appropriate bond fund types
- Successful investment management balances safety, liquidity and *then* yield

Questions and Discussion

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