



CDIAC

**CALIFORNIA
DEBT AND
INVESTMENT
ADVISORY
COMMISSION**

INVESTING IN RISK: CITY OF SAN DIEGO'S CREDIT EVALUATION PROCESS

KENT MORRIS, MBA, CTP
CHIEF INVESTMENT OFFICER
CITY OF SAN DIEGO

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Agenda

- Asymmetric Nature of Bonds
- City of San Diego's Credit Analysis Process
- Credit Aspects of:
 - Commercial Paper
 - Certificates of Deposit
 - Corporate Notes
 - Asset Backed Securities
- Parting Thoughts

Investing in Bonds

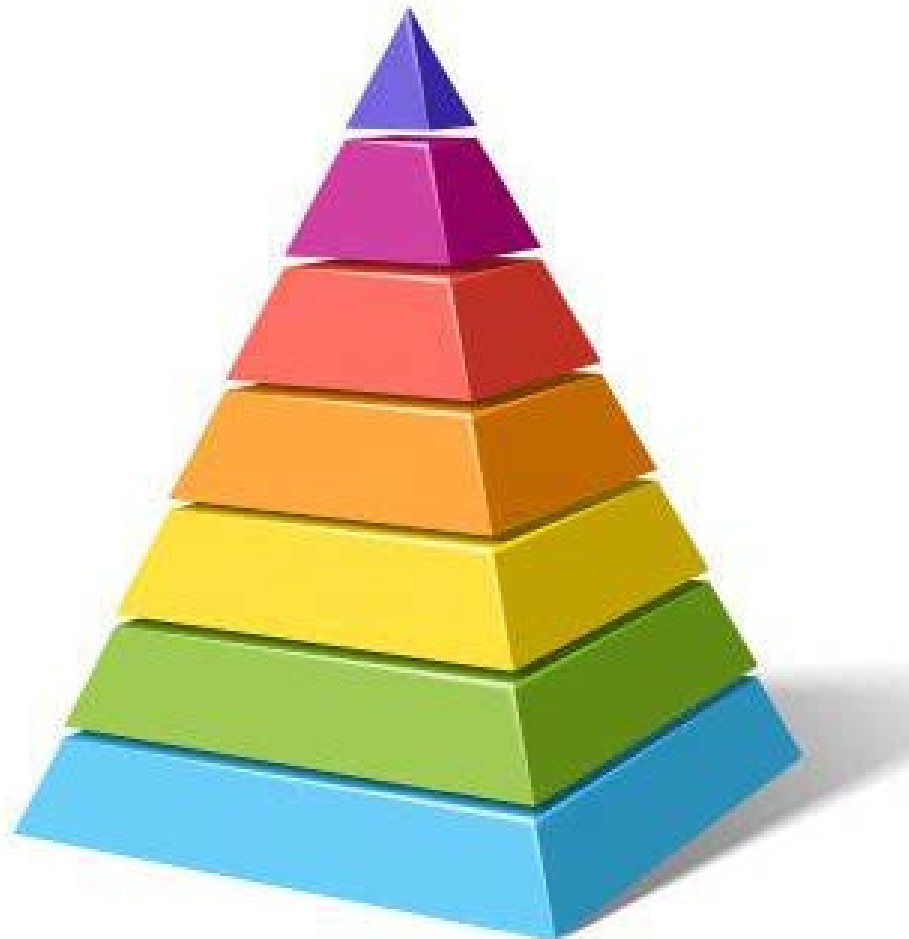


- Bonds have an asymmetric return

City of San Diego's Credit Analysis Process

- Investment Strategy Meetings
- Credit Philosophy
- Credit Screening Matrix
- Egan Jones Reports
- Earnings Calls
- News
- Investment Advisory Committee
- Education/Conferences/Peers

Build a Complimentary Credit Evaluation Process



Investment Strategy Meetings

- Investment Staff attend
 - ▣ Open door policy
- Meet twice a month
- Fill out our economic questionnaire in advance
 - ▣ Questionnaire spurs and directs discussion
 - ▣ Discussion guides short term strategy
 - Looks out 3 months
 - Spurs discussion of specific investment options and credit names
 - Discuss investment studies
 - ▣ Questionnaire evolves over time
- Cultivates a philosophy of open dialogue

Credit Philosophy

- Top Down Approach
 - Starts with Domestic Economy
 - Includes possible Global flashpoints
 - Domestic outlook starts with the FED
 - Read various research outlooks and track economic indicators
 - Sector Outlook
 - How does my outlook for the Domestic Economy effect the various sectors?
 - If the FED is going to raise interest rates is that good/bad for the banking industry?
 - Individual Names
 - Does my evaluation validate its credit rating

Credit Screening Matrix

- Use Bloomberg to evaluate two major categories
 - ▣ Medium Term Notes
 - ▣ Commercial Paper/CDs
- Bloomberg screens companies based on our credit metric criteria
 - ▣ Capitalization
 - ▣ Liquidity Ratios
 - ▣ Profitability Ratios
 - ▣ Debt Ratios
 - ▣ Credit Ratings
- Screening criteria evolves and discussed at Investment Strategy Meetings
- Helps provide a list of companies to start reviewing
- Runs the screening matrix twice a month and reconciles its results
 - ▣ Investigates discrepancies
 - ▣ Identify new credit names

Egan Jones Credit Reports

- Financing model invites less conflict of interest speculation
 - ▣ Egan Jones funded by investors
 - ▣ NRSROs are financed by issuers
- Relatively inexpensive compared to hiring a credit analyst
 - ▣ Industry expert with extensive modeling methodology
- Supplements our own evaluation
- Quarterly calls with their analysts
 - ▣ Can ask questions about their reports
- Provides evaluation framework to listen to earnings' call
- Bloomberg has its own rating model

Earnings Call

- Cliff Notes to recently announced company earnings
 - ▣ Review earnings announcement below call
- Understand the natural bias about information
- Helps explain changes in their financial ratios
- Listen for company's strategic vision and its business environment outlook
- Listen to Q&A
 - ▣ Benefit from expertise of analyst

News

- Must be aware of new company news
- Daily financial periodicals are useful
 - ▣ Take advantage of technology
- Bloomberg
- Use “news alerts” for your corporate holdings or approved list
 - ▣ Set up Google alerts or Bloomberg alerts
- Create folders for them
 - ▣ Make time to review
 - ▣ Prevents critical news from slipping by

Investment Advisory Committee

- Have both employees and outside professionals as members
- Provides additional viewpoints on your corporate holdings
 - Ask for recommendations to improve your credit evaluation process
 - Make presentations to Committee about your credit exposure and future plans

Education, Conferences, and Peers

- Continue to improve your staff's skills
 - ▣ Education
 - CFA, CTP, CPA, webinars
 - ▣ Conferences & Seminars
- Talk with your Peers
 - ▣ We should be sharing ideas with each other
 - IMPAC
 - ▣ Find a comparable government agency
 - Use your broker to make introductions
 - ▣ We need each other to succeed

Commercial Paper

- Focus on Liquidity and Debt Ratios
- Key is making sure they have enough cash to meet their short term obligations
- Are their other relative liquid assets a company has to pay expenses with something other than cash?
- Look at their maturing debt schedule
 - Can the company rollover the debt or pay it when it comes do?
- Do they have any guarantees, credit facilities or LOCs as back up liquidity options
- If the yield is much higher than other similar credits why is that?
- Is there a sector that is under stress and should you continue to buy more paper?

Certificates of Deposits

- Focus is on liquidity and debt ratios like CP but look at the bank's loan portfolio performance
- You are investing in the bank's name
- Investment below the FDIC amount to get fully guaranteed deposit
 - Don't forget to leave room for your interest
- Do you have enough liquidity to hold time deposits until maturity?
- Negotiable CDs can be sold on the open market

Certificates of Deposits (CDARS)

- CDARS investment must be reconciled monthly for investments over FDIC amount
 - ▣ Must notify CDARS' bank of other bank deposits
 - ▣ Does your organization want reciprocity deposits?
- Be cautious to invest in new options approved by State
 - ▣ Review the new California Government Code Section (CGC 53601)
 - ▣ Talk with Peers and government organizations for guidance (AB 279)

Corporate Notes

- Can you tolerate the duration of the corporate security?
 - ▣ Duration of 5-yr security is 4.75 yrs.
 - ▣ Duration of 1-yr security is 0.94 yrs.
 - ▣ How about the spread risk?
- How do you feel that industry sector will perform over the life of the bond?
- Evaluate its Profitability Ratios and Financial Statements closely since it will need to perform to pay its obligations
- Is it possible that its core services become obsolete?

Corporate Notes

- Evaluate its current management and their future business plans for the company
- Any possible or current trademark or class action lawsuits?
- What is the recent history of NRSRO actions for the company?
- What is your process if the security falls below the “A” credit rating category?
- Do you have any kind of “Social Investing” consideration?

Asset Backed Securities

Credit Card Structure

- Underlying sponsor “A” ratings
- Non-Amortizing Structure
- Chase is only qualified issuer
- Expected final 2 or 3 years
- Bank Sponsor
 - ▣ Large issues
 - ▣ Purchase bank cards

Auto Loan Structure

- Buy mostly new Issues
- Amortizing Structure
- Money Market or A2 tranches
 - ▣ Short WAL
 - ▣ “AAA” structure
- Underlying sponsor “A” ratings

Asset Backed Securities

Credit Card Structure

- Excess Spread
- Delinquencies/Charge offs
- Payment Rate
- Available on Web & Broker Research report
- Macro-Personal bankruptcies

Auto Loan Structure

- Collateral and performance monitoring essential part of investing:
 - 30, 60, 90 cumulative loans
 - Compare vs other issues
 - Available on Bloomberg

Parting Thoughts

- Evaluate your agency's level of risk tolerance
 - ▣ Be mindful of your organization's investment objectives
- What other resources are available
 - ▣ Staffing
 - ▣ Systems
 - ▣ Additional resources
- Be as transparent as possible
 - ▣ Credit evaluation process should be explainable
 - ▣ Consider ways to disclose risk to management
 - ▣ NO SURPRISES
- Be ahead of the evaluation game