California Debt and Investment Advisory Commission

Webinar Transcript

The Public Investment Portfolio:
When It Makes Sense to Buy Municipals

June 24, 2015

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Municipal securities or "munis" are purchased either in the primary market when an issuer sells a new bond or in the secondary market from another investor. As with any investment instrument, investing in munis entails risk, but they can be a part of a diversified public investment portfolio. This webinar will provide an in-depth discussion of muni investing by public agencies.

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Title Slide – The Public Investment Portfolio: When It Makes Sense to Buy Municipals

Linda Louie: Good morning, everyone, and welcome to the California Debt and Investment Advisory Commission's webinar, *The Public Investment Portfolio: When It Makes Sense to Buy Municipals*. My name is Linda Louie, and I am the education manager at CDIAC. Before we proceed with the broadcast, if you are experiencing any technical problems please contact GoToMeetings at 1-800-263-6317 or you can try their website at the address on your screen. *When It Makes Sense to Buy Municipals* is the third of a nine-part webinar series on public investments that CDIAC has scheduled to run through the summer. Each webinar focuses on a category of statutorily authorized investments in a way that will help you understand many of the features and risks and how you might go about assessing whether or not a particular investment meets or fits into your agency's investment policy objectives. Thank you for joining us today and we hope that you will be able to participate in each webinar in this series to gain a fundamental understanding of the full spectrum of investment options for public investment portfolios.

Now, we do understand that schedules may not permit participation in every webinar, so to help you broaden your knowledge of other investment management topics, CDIAC has a number of different resources and recommended readings available to you on our website. You may visit them on the education website at your leisure. The presentation slides for today's webinar are also available on the CDIAC website at the address on the screen. All webinars in the series will be posted to the CDIAC website two to three weeks following each of the nine broadcasts. And may we point out that the 2015 edition of the CDIAC *Local Agency Investment Guidelines* and the *California Public Fund Investment Primer* are currently linked to CDIAC's main web page at the address listed on the screen.

Please know, if you would like to view live captioning during this program, you may paste the address on the screen on to your browser or click on the link in the chat section at the bottom of your control panel. If you would like to receive a certificate of attendance for CPE credit, you must be registered and logged in to the webinar under your own name and a certificate will be emailed to you with within a week. During this webinar you will have the ability to submit questions to the faculty by using the box marked "questions" near the bottom of your control panel. The speakers will address some of your questions during the presentation, and some may need to be held during question and answer sessions at the end of the webinar. However, we try to address your questions in a timely fashion to emphasize any points for your education. If we run out of time for any questions, we will follow up with responses on the CDIAC website.

Slide 2 – Disclaimer (03:05)

Linda Louie: Before I introduce our speakers, I ask you to take note of an important notice on the screen. It is a disclaimer. The presentation today is informational and does not constitute investment advice or recommendation. There are many risks, policy, portfolio and suitability factors that must be considered by an agency prior to making an investment decision. The webinar material is presented as of June 24, 2015, and in the current context. So keep in mind a replay of the webinar that will be posted will not reflect any changes in the investment authority or market conditions which can occur after today, and that may affect the suitability of an investment. Today's webinar is designed to provide you with an understanding of the types of debt issued by state and local governments that may be purchased for a public investment portfolio under government code. You will get a sense of what governments can do and cannot do when investing in municipals and begin to think about when it makes sense to include municipals as part of a diversified portfolio through understanding of code and a step-by-step analysis.

Slide 3 – The Public Investment Portfolio: When It Makes Sense to Buy Municipals (04:12)

Linda Louie: So with these objectives in mind, let me introduce our faculty for today's webinar. From a city, we have Mr. John Colville. John is the chief investment officer for the City of Sacramento and is a trustee for the CalTrust investment trust of California. Prior to 2004, when he joined the City, John served two years as an investment officer for the California State Teachers' Retirement System *[CalSTRS]* where he actively managed a synthetic portfolio of Standard & Poor's 500 futures contracts. Prior to his work at CalSTRS, Mr. Colville was the transition manager with the Barclays Global Investors for three years. He holds an MBA from

Golden Gate University and a Bachelor of Arts in economics from San Francisco University. In addition, John has a series 24, 7, 3 and 63 securities license.

Next, I would like to introduce Deborah Higgins. Deborah is a founder and the president of Higgins Capital Management, Incorporated. She has provided institutional pricing and services to California public agencies for 31 years. She is an active member of three major municipal Treasury and finance California associations, and she served as a member of the investment advisory committee for the City of San Diego since 2007. She also served three terms on the Technical Advisory Committee for the California Debt and Investment Advisory Commission and continues to work with CDIAC on various education programming and assists CDIAC with the updated *Local Agency Investment Guidelines*. So with these introductions, why don't we turn this program over to our faculty. Deborah.

Skip Slide 4 – Introduction

Slide 5 – LAIG Allowable Investment Table (05:58)

Deborah Higgins: Hello, good morning, everyone. Debbie Higgins and John here. I wanted to touch base with you and give you an idea of what we are going to be covering today. If you take a look, we are going over the local agency bonds, state obligations for California and others, and then other California local agency obligations. And we are reviewing this from the investment table that went out in 2015 in January from CDIAC. Our purpose today is to focus on these particular municipals and in particular, where applicable, we use the City of Sacramento's actual investments so that you would have a better understanding of why John chose what he bought and why.

Skip Slide 6 – LAIG Allowable Investment Table (cont.)

Skip Slide 7 – Table of Notes

Slide 8 – City of Sacramento Investment Pool A (06:47)

Deborah Higgins: We are going to start out with John giving you an idea of what his strategy is, and then we will go into specific securities and then wrap it up with what we like or don't like in this arena. John, you want to take it away?

John Colville: Sure. Good morning, everyone. Again, my name is John Colville. I am the chief investment officer for the City of Sacramento. Our objective today is to either introduce or to reaffirm the use of municipal securities as buyable investments in your investment pool. I believe this is an investment tool that is often avoided by municipal investment professionals, either due to concerns about risk or lack of understanding. Hopefully, after today’s discussion, it will open your eyes to an asset class that can really add yield and diversification to your investment pool without changing the risk profile that much.

Slide 9 – Investment Pool A Monthly Review – May (07:35)

John Colville: As background, I will give you a snapshot of the investment pool that my two investment officers and I manage on behalf of the City of Sacramento, and this will give you a better understanding of how we invest our funds and how we get the returns that we do. Deb, if you can go back one, please.

Slide 8 – City of Sacramento Investment Pool A (07:48)

John Colville: We will start with our investment strategy statement that kind of leads us through what we do, and it identifies the goals and objectives of the City of Sacramento's investment pool. I'm quite sure it is consistent with many of your own investment pools. As you can see, we strive to maximize yield under the constraints of liquidity and principal preservation. Only when those two constraints are met, we either extend the portfolio or use credit to boost income. As with all municipal investment pools, we work within the framework of California code 53601.

Slide 9 – Investment Pool A Monthly Review – May (08:24)

John Colville: Slide 9 is a snapshot of our investment pool at May's month end. It will give you an idea of what we do. As you can see, our investment pool is around $900 million, and other characteristics include a weighted average maturity of about a little over two years, which is probably longer than most of yours. We have been very consistent with the duration and average maturity of over two years for quite some time. Please note that it might be overinflated because the majority of the agency bonds that we hold in the portfolio are callable and probably will not reach their final maturity. As you will also note, we have a very minimal amount of money invested in LAIF, only $20 *[million]* of the $50 million that you are allowed given that LAIF is only yielding about 29 basis points. It's just a form of liquidity for us right now. The third part would be - we have a good, nearly 15% of our portfolio sitting in CalTrust. And as they mentioned earlier, I sit on the board of CalTrust. For those of you who aren't aware of what CalTrust is, it is an investment trust of California established by public agencies in California for the purpose of investing in local agency funds. It's similar to LAIF with a lot more flexibility. It offers a money market, a short-term portfolio and a medium-term portfolio all professionally managed by Wells Fargo. We use it as an effective tool to maintain liquidity and get a little bit of duration and yield into our portfolio, and as you can see, it is about 14% of our portfolio. The pie graph really explains the performance that we achieve in our portfolio. Again, it is all within the constraints of *[government code]* 53601 and we use just about all the tools within the tool box that 53601 allows.

We divide our portfolio into two distinctly different strategies. One is the liquidity portion, which consists mainly of the LAIF, the CalTrust, and commercial paper and CDs maturing under a year. And that is about 40% of our portfolio and yields about 37 basis points. So that is there to cover all the city's liabilities and liquidity needs. But the core portion our portfolio is made of agency debt, municipal bonds, corporate debt and variable rate securities. And that is about 60% of our portfolio and from that portion we are yielding about 191 basis points. And again, you can see the diversification we have in our investment pools. Please note on the table below it shows you what we are getting for yields in each of our different asset groups. And you can see that the most bang for our buck is with corporate bonds, which we are allowed to get up to 30% of our portfolio, and municipal bonds, which are yielding about 2.4%. We are only holding about 12%

of the portfolio in municipal bonds and that is not due to a desire to hold more. Too much money is chasing too few bonds, which you will see in the municipal bond. A lot of things are oversubscribed to, and a lot of times municipal bonds issues are very small and you really can't get the size. We like to hold anywhere between $3 *[million]* and $5 million of any given position.

Slide 10 – Investment Pool A Monthly Review – May (cont.) (11:35)

John Colville: Finally, we add yield to our portfolio through our maturities. We have a majority of it at about 46% sitting in one year and under, which covers city liabilities. And then we ladder our portfolio up to five years. Again, a lot of that five-year paper is really callable within a year.

Slide 11 – Monthly Highlights (12:00)

John Colville: And finally the performance of the portfolio. Finally, what does the attention to asset allocation to extend the portfolio really accomplish? We are yielding a little over one percent in the portfolio over the fiscal year. I know on face value that really stinks, but relative to LAIF and most other municipal investment pools it is pretty darn good. Actually, if the research that my investment officer has done is correct, we have one of the highest, if not the highest, yielding investment pool in the state. And what that creates is more parks being open, more pools being opened, more police and fire. So it is really important to my city council and to my city manager and treasurer that we try to get as much yield as we can. Yield curve, we have been dealing with for quite some time. Makes every general basis point of yield that we can add to the portfolio makes it extremely important. And we think adding municipal bonds to your portfolio can help you achieve that performance.

Slide 12 – Monthly Highlights (cont.) (13:05)

John Colville: Deb, do you want to go over the highlights?

Deborah Higgins: On the monthly highlights, his core fixed income, the markets sell in May and is measured by the Barclays Citigroup Aggregate [*Index*] to a -0.2%. Spread sectors in the index posted mixed results. The yield rose in response to signs of a reacceleration in US economic activity as housing activity outpaced his projections and the employment increases rebounded in April. During the month, the pool received $64 million in property tax receipts from the county and in addition $12 million was paid out to city debt payments. And then as stated, we are seeing short-term rates creep up. Economic data and the Fed are predicting the Fed will move before year-end; talk is September. And this, of course, is translated into a bump in the yields as people anticipate and look to that move. He is basically saying they are adding yield in the three- to five-year maturity ranges that will help the pool, specifically in the credit sectors. And then, John, do you want to talk about the cash in excess?

John Colville: Sure. We not only invest money for the City, we also have outside participants. So when we monitor our excess investment, that means if all of our external entities wanted to pull their money out of the portfolio and also all the debt service, payroll for the next eight months, any other city liabilities, be they SMUD [*Sacramento Municipal Utility District*] or what have you, are sitting in cash positions. And then anything above and beyond those cash positions are what we consider excess cash that we can move into credit, we can move out further along the yield curve in situations such as that.

Slide 13 – City of Sacramento Investment Policy Objectives (15:04)

John Colville: Our excess has been pretty stable for a while, but I can foresee in the next year or two that really becoming lower amounts as the yield curves rise.

Deborah Higgins: We wanted also to take a minute to talk about the investment policy objectives. We wanted to share with you the primary objectives that the City of Sacramento has. Obviously, one being safety; two, liquidity and yield. But specifically wanted John to take a minute and talk about credit risk, which is the loss due to failure of a security issuer or backer, and explain what he looks for to minimize his credit risk.

John Colville: Sure. Thanks, Deb. Consistent with our objective statement mentioned earlier, the investment policy for the pool identified the pool's objectives and risks associated with achieving them. Safety or the preservation of principal is the most important goal of the portfolio. Managing credit and interest rate risks are important to the safety of the pool. As Deb mentioned, credit risk is extremely prevalent when you invest in credit instruments like corporate bonds, commercial paper, and the topics of the day, municipal securities. It is important that you do your due diligence to determine the issuer's ability to meet the interest and principal payments. This includes on our side reading credit reports, official statements and reviewing any relevant bond disclosures that happened throughout the year. We do this to ensure that number one, when we purchase the security that there is going to be cash flows to pay the principal and interest. Number two, it is a reoccurring event. We deal with our public finance side within my office and have them keep close look on any disclosures that come out on any of the holdings we have to make sure we don't miss anything. The second portion is interest rate risk, which really hasn't been something that we had to be concerned about for quite a while, as rates have been extremely low with minimum volatility. But with the rate hikes just around the corner, we are being to see bond yields for securities maturing within five years starting to change. Any upward move in rates can have a significant effect on bond values given their extremely low coupons. As a result, to avoid interest rate risk, we are investing quite a bit of our available money into floating rate and step-up bonds as well as buying high coupon bonds as a premium to minimize the effect of higher rates.

Slide 14 – City of Sacramento Investment Policy Objectives (cont.) (17:30)

Deborah Higgins: I also wanted to talk about liquidity, and there are two types of liquidity that he looks for: static liquidity and dynamic liquidity. So we thought we would take a minute to give the audience an idea of what that means to the City of Sacramento.

John Colville: As I mentioned earlier, we have two distinct strategies within our portfolio to handle the static liquidity, or the things that we know are coming up: the payrolls, the debt service, utility bills, the cash flows expenditures that are given to us from all of our different investment pool entities. We hold about 40% of the portfolio in cash. And that is our CalTrust, that's our LAIF, that's our commercial paper, and that's our CDs that mature within a year. As far as the dynamic liquidity, we also maintain many short-term agencies. We don't hold Treasuries in the portfolio. Agencies that cover any of the dynamic liquidity, so as you know, agencies are very liquid, so we hold those. And the rest of the portfolio, again, is the quest for yield.

Slide 15 – City of Sacramento Investment Policy Objectives (cont.) (18:45)

Deborah Higgins: And finally, we wanted to take a minute, and of course, the last one of the safety, liquidity and yield is the yield portion of any portfolio. But in particular, I thought it would be interesting for the audience to talk about buy and hold and generally what happens and when John makes the decision to move out of a particular security and why. So John wanted to cover these exceptions.

John Colville: Sure. Quest for yield is the fun part and the heavy lifting of the portfolio. As I have mentioned before, after we meet all of our city obligations, we have about 60% of the portfolio that we can use to go out and grab yield. As I mentioned this, myself and two investment officers, a new one recently hired – it was just me and another for the 11 years I have been here – and we really for the most part actively trade our investment pool. We don’t really mess with the static liquidity portion of the portfolio, but for the dynamic portion and the core investment portion, we are really attentive to capital gains that are unrealized gains in the portfolio, whether issuers are being downgraded, if we are seeing significant changes in sectors on the corporate side where you are seeing financials really take a beating. We are really attentive to that and we kind of stay on top of that thing. So we tend to be a buy and hold portfolio for the majority of what we own, but for our corporate and somewhat similar municipal holdings, we are pretty active in being on top of things. So we will go out and instead of holding something to maturity, we will have opportunities where we will swap it for something else or we will sell it.

And as you see from the four bullets on the slide, we do monitor securities, and if we see a declining value and we don't see any chance of recovery or some recurring event, we will sell out of a position to minimize our loss. When bonds are approaching maturity or they are low coupon bonds, we will look to see if we can lock in gains or if we can swap them with similar issues credit ability but longer maturities to see if that is an add value to the portfolio. Number three is self-explanatory. When there are unforeseen liquidity needs and we do need to liquidate principal, which doesn’t happen very often because we do keep a pretty heavy portion of the portfolio in real short-term money. And then a lot of times when we see bonds really approaching, low coupon bonds really getting some capital appreciation, we will sell those bonds to realize the cash gain or we will sell those to offset any losses that we had from bullet point A. So we are very actively managing our portfolio. A lot of times in the Treasury market we will – Treasuries have been very range bound – we will put on a five-year Treasury trade when yields are high when it is at the top of the range and sell when it comes down the bottom of the range. We are active in that area, too.

Slide 16 – Other Risk Considerations (22:02)

Deborah Higgins: We wanted to briefly talk about other risk considerations in the markets in general and then some specific to municipalities. For example, event risk. That is the risk that an issuer will not be able to make a payment because of dramatic and unexpected events like a natural disaster or an industrial accident. So examples of this could be Hurricane Sandy and what that did to the municipalities in the Northeast. Also event risk for example, when Detroit went bankrupt, Detroit, the city itself, created event risk for the state and other local municipalities based on their bankruptcy. Liquidity risk is when investors look to leave funds or the market as a whole. There is a lot of talk in today's market with what has happened with the big money center banks and the concerns on liquidity and then not making market in agencies or corporates or municipals for investors to be able to move those positions. Inflation risk, like John talked about earlier, or interest rate risk, we haven't had a problem with that for six years, but as rates start to move up, then we are going to look at purchasing power risk as the lower coupons are sitting there and we are going to decline in value based on the cash flow.

I think the biggest risk that we are facing in the municipal market, quite frankly, is the retail outflows. The municipal market is smaller than the other fixed income markets and they are dominated by retail investors. And I think what we are going to see is concern over higher rates where we are going to see the retail investor move out of funds, and then when they move out of funds, it forces the money managers to liquidate, and that is going to impact liquidity and market prices. And then, of course, there is always a call risk. We play in the one- to five-year market so we are not really seeing a lot of calls that we are not aware of, but there is a risk that the bond issuer will exercise a call feature and redeem it prior to maturity. What we are going to do…

Slide 17 – Local Agency Bonds (24:22)

John Colville: Deb, can I interrupt for a second? Deb?

Deborah Higgins: Absolutely.

John Colville: I understand there are a few questions out there that people are already inquiring about.

Linda Louie: So just reflecting back on the City of Sacramento's portfolio, John, what is your monthly outflows given your portfolio size of $900 million and a duration of over two years, and why don't you hold Treasuries in your portfolio?

John Colville: Well, our monthly outflows, we pay about $13 million every two weeks in payroll. That includes CalPERS investments or CalPERS defined benefit payments. We are another $25 million out in accounts payable and debt service every six months. We are in the $75 *[million]* to $80 million in debt service. So on a monthly basis, I'm saying we are probably in the $100 million. As far as Treasuries, the yields aren't there. And the agencies that we do buy have the option-adjusteds, they are callables, so we are getting a spread above Treasuries. We do own Treasuries in short stints, like I mentioned before when we used them for trading purposes, but as a core investment, no. There is no yield and there are other opportunities out there with similar risk characteristics that we can get that will give you a higher return.

Linda Louie: Yes, so very expensive right now.

John Colville: Yes.

Linda Louie: Thank you.

Deborah Higgins: We wanted to take over and start going through the LAIG and the specific 53601 issues. And to start out the first local agency bonds that the code covers are bonds that are issued by the local agency. Basically, that is talking about your own bonds. You are looking at a five-year maximum maturity with a no percentage limit. And the key here is back in 2008 during the crisis, both the IRS and the California legislature amended their rules to allow you to own and hold certain types of your own debt. And that was a time when they were looking to allow the municipalities to be able to issue debt and to be able to offset some of the interest expense that you were realizing on your own debt. However, that did expire for the IRS in 2010. So there are certain things you need to be aware of if you happen to be looking at a situation where you have your own debt as an investment choice.

Slide 18 – Bonds Issued By The Local Agency (27:08)

Deborah Higgins: And we wanted to go over one particular issue. Now, I just want to clarify that Sacramento, this particular issue is the only one on the presentation that is not owned by the City of Sacramento, but it is a City of Sacramento revenue bond and it is an example only. So this particular issue, you can see with the issue size of $215 million, this particular series that we are using as an example, however, is only $1,645,000. So this particular issue can give you an idea of what we were talking about from a liquidity standpoint for the bigger entities when they are trying to buy in size, and this particular series is less than what even John likes to go into and buy. So in this particular case, John would not own this and there are reasons for it from a legal standpoint, which I will let him explain.

John Colville: Great. Let me amend that monthly, I do my math properly, it is about $60 million cash outflows. As Deb mentioned, in 2008, in response to the financial crisis and reduction of buyers of municipal debt, both the IRS and California amended rules allowing local agencies to buy their own debt, and we did. The federal exemption expired in 2010, but California law remains in effect. We did our due diligence and we talked to our city attorney and they came to the conclusion that we were going to fall under the federal mandate. He determined that the federal law prevailed and we could no longer hold our own debt because it would affect the tax-exempt status of any bond issuance, and any time that we would buy our own debt would be classified as retired debt. So it would affect the legalities of the portfolio. We would not buy our own debt. But would I advocate for the City of Sacramento debt? Of course.

Deborah Higgins: But he's not going to do it.

John Colville: But I can't do it.

Slide 19 – Buying "Own" Debt; Caveat Emptor (29:16)

Deborah Higgins: Exactly. And there are reasons for this. Buying your own debt, as John said, you have got to be aware of what is happening. The pros in this particular instance is you know the politics of your entity. You know the financials. You know whether how strong you are as an entity. So if you know the credit, that's one of the big pluses in buying and investing in a particular issue. The key to know here is if you are issuing taxable debt, there is no conflict with the IRS on taxable issues. The cons, however, if you are issuing tax-exempt debt, now that the exemption has expired, you are jeopardizing your tax-exempt status. Anytime you want to take a look at this, as John has done, you need to get a legal opinion on that transaction to make sure that you don't affect your outstanding issues. And then on new issues there is a perceived conflict of interest. As an issuer, your goal is to minimize the interest that you are paying on debt, but as an investor your goal is to maximize the interest income. So if there is a situation where you feel the need to do so, make sure you document what you are doing and why because that is a perceived conflict of interest when buying your own debt.

Slide 20 – State Obligations - CA (30:41)

Deborah Higgins: The next one we wanted to cover was state obligations California, registered state warrants or Treasury notes of bonds of this state. Again, five-year maximum maturity, no percentage limit, and the current rating on California, and I think John said that they were upgraded in November, is Fitch A+, Moody's underlying Aa3, and S&P the debt is now A+.

Slide 21 – Bonds of this State (31:10)

Deborah Higgins: And the example we wanted to show of issues of this state is a California state GO that John does hold in the portfolio. And if you will take a look, when you are looking at a screen, this is what you are looking for: State of California general obligation, and in this particular bond the issue size was $3.4 billion. So as John mentioned, tremendous liquidity in the issue. The purpose of this general obligation was for school, recreation and water improvements. The source: *ad valorem* property tax. As a GO, there is unlimited taxing authority, which is a very positive. And again the rating, Aa3, A+ and Fitch A+, stable by all three. John purchased these back in October of 2013, and he will give you an idea of what he was looking at at the time and why he bought these.

John Colville: Thank you, Deb. We are big advocates of California state debt. We participate in every new California GO issuance there is. The state has made great strides in dealing with budget and especially pension issues, which we look at. In the last couple of years they result in the State’s credit being upgraded seemingly on an annual basis. Unfortunately, as of late with each upgrade, the credit gets more expensive. We were buying this when the spreads were huge. As with all fixed income investments, it comes down to two questions: am I going to get paid both interest and principal, and am I getting compensated for the risk? We bought this bond when California was rated A with a stable outlook. And as Deb said, since then it has been upgraded to A+ with a positive outlook. At the time we bought that, the risk of California defaulting its GO was much lower than the rating reflected. Our perception was that given the outlook of the state's economy improving, we were comfortable with the state’s legislative body’s ability to back its full faith and credit towards its long-term debt by taxation if necessary. And we really liked the fact it was for school and water improvement projects. The State of California goes to credit markets quite regularly to fund projects, and any failure to repay outstanding debt would certainly cripple the state. And as a local municipality of the state, we would have bigger problems than just holding this debt. Repayment was not really a concern of ours. From a conversation standpoint, 65 basis points over a US Treasury was very enticing. We believed that the risk was minimal and the price of the bond was strictly cheap, relatively speaking. And finally, the high coupon was attractive not only from the income standpoint, but as a cushion against upward moving rates. Again, we bought this in 2013 and we thought rates were going up then. We have waited quite a while and they still haven't.

Slide 22 – State Obligations - CA (34:00)

John Colville: In conclusion, the City of Sacramento is a buyer of State of California debt for a long time and we continue to do so. We are extremely comfortable with the credit and we are not alone because every issuance is extremely oversubscribed to and the credit has become considerably more expensive as the state improves. Whenever we see a credit issue for the State of California, we go out with $10 *[million]* and $15 million requests. We were lucky to get three and five in any given time and most of the time less than that due to the amount of people that are really starved for the California debt.

Deborah Higgins: The debt is usually oversubscribed three to five times each issue, so he is absolutely right. Everybody wants to own the debt and it is very difficult to get. As we move on at looking at state obligations with California, we also wanted to touch base with our authority. Registered state warrants or Treasury notes or bonds of this state or you can also look at those issues of an authority of the state.

Slide 23 – Bonds of this State or Authority of the State (35:00)

Deborah Higgins: And in John's portfolio he does happen to own a California state earthquake authority issue. It is a revenue bond. The California Earthquake Authority *[CEA]* was created back in 1996 by the California legislature. It happens to be publicly managed and [*a*] privately funded entity. This particular issue was $350 million and the particular series that Sacramento owns was $250 million. So this particular issue is giving the city tremendous amount of liquidity. The purpose was miscellaneous and the ability to pay it back is from their revenue. And this was purchased in February of 2015, and John will give you an idea of why he owns this particular note.

John Colville: Yeah, we were lucky enough to be approached with a very small piece of this from the secondary market from one of our brokers. This was, again, oversubscribed to and there were way too many dollars chasing this bond. Unfortunately, we weren't able to participate when it was initially issued so we are now just acquiring scraps of this issue. We just picked up another $5 million last week. And as I will mention down below, the spreads have really tightened on this bond. It's gotten a lot more expensive. As Deb mentioned, these are revenue bonds issued by the California Earthquake Authority. The CEA sells basic residential earthquake insurance policies to California homeowners. The CEA writes 75% of all California earthquake policies and has annual premiums of $575 million. The premium is used for debt service and is not available to pay damage claims. Should claims be greater than the amount of funds held to pay claims, then the insurer receives pro rata payments. Therefore, we like this bond because there is a limit of the liability that the authority would have to pay is really capped out on what they have earned.

Deborah Higgins: I wanted to point out in this particular issue, the California Earthquake Authority, these are taxable notes and you can see down here under the tax provision: federally taxable and state tax-exempt. But the key here is the yield pickup on a taxable issue for the City of Sacramento.

Slide 24 – State Obligations – Other States (37:21)

John Colville: Right and taxability, as most of you guys deal with, it doesn't really affect you. So you are looking for yield because you don't deal with the tax consequences.

Deborah Higgins: That being said, back in 2008 during the crisis, Meredith Whitney, which was an economist on Wall Street, came out and talked about, I don't know if you guys remember, the bankruptcies that were going to happen in the public arena, and the yield shot up not only in tax-exempt, but taxables to outrageous levels. And so that was a time when you would see public entities going in and buying tax-exempt levels because they were anywhere between 100 or 200 above Treasury yield. So that did occur back in the financial crisis. The next section that we wanted to cover under obligations is the fact that under California code 53601, you can go in and buy registered Treasury notes or bonds of any of the other 49 states in addition to California. Again, in looking at other states' municipals, you have a five-year maximum maturity, but you do not have a percentage limit. But it is a little bit different because you are not in that state, so there are a lot of things that can be going on out of the State of California that you are not aware of. So when you start looking at other states, we feel that your due diligence is paramount in looking at those arenas.

Slide 25 – Bonds of Any of the Other 49 States (38:47)

Deborah Higgins: One is example is, like I said, for Detroit. When Detroit went bankrupt it created a lot of havoc throughout the state and with other local municipalities. And if you are not there listening and hearing what is going on, you may be out of that loop. One of the bonds that the City of Sacramento has bought is the Michigan State GO. And it is again, as we said, like the California State, State of Michigan, it is a general obligation. This particular issue is unlimited as far as taxing authority. This particular size of the issue was $225 million. And this series itself was about $18 million. This was issued to refund and school improvements out of revenue. The key is the unlimited taxing authority. And the rating for this particular GO is underlying Aa2 by Moody's. S&P has it as a AA- with a positive outlook by Moody's and stable by S&P. This particular issue was bought by the City of Sacramento back in 2012, and John will give you an idea of his focus on this issue.

John Colville: As Deb mentioned, you really need to do extra homework when you are buying state issuances outside of the State of California. Unlike bond issues from the State of California where the policies and economics are known, bonds from other states require additional research and investigation [*in*] getting to understand the state's particular GO requirements and budget and pension statuses, areas that we find important when investing in these sorts of bonds. When approached with this bond, we were apprehensive given the problems in Detroit, as Deb mentioned, and its reliance on the auto industry and the housing collapse. But the fact that the state has a AA and stable outlook caught our attention though. We were also attracted to the fact that these were school bonds because they generally have a strong repayment cash flows through various taxing mechanisms. And the state government is committed to paying underlying bonds for ongoing projects for schools. This bond was no different. After reading the reports and the official statement, we determined the bond was to be repaid with 2% of the state's 6% sales tax, 23% of the gross income tax and 41% of all tobacco tax. And if those weren't enough, the State of Michigan would cover any deficiencies. And then you have to look at the economics, and from an economics standpoint, the auto industry was recovering and the revenue projections of the state were growing. And finally on the pension front, the pension plan was 73% funded and was closed to all new employees hired after 1997. So anyone hired subsequent to 1997 were now in a defined contribution plan, so liability was closed there. And just like all of our other decisions, we believe that the yield of 80 basis points, which was 38 basis points over the Treasury, was a good price given it was a AA security. We felt like we were well compensated. And as you can see from the maturity schedule we are happy to report that bond did settle and we did get paid.

Deborah Higgins: Yes, sorry guys, but when we were putting this together it was still outstanding.

Slide 26 – Bonds of Any of the Other 49 States (Cont) (42:17)

Deborah Higgins: Moving on, we wanted also to touch on another bond in the portfolio. Again, from another state. The Ohio State Build America Bond [*BAB*]. And Build America Bonds are – John is going to talk about in depth about how they will come together and why they use these and what he liked about them. This particular issue is $136,815,000. This series size to June 2015, which it now is close to with three years to go, is $19 million. This was for public improvements. Again miscellaneous revenue is the purpose, the source of the money to pay back your interest and income. This is on non-toll highways. The rating on this is a Aa2 by Moody's, S&P AA, Fitch A+. And this particular issue, again, is stable by all three rating agencies. This was purchased in August of 2013 at a 106. And if you will notice these higher coupons, this is one way to work against interest rates increasing when you buy these higher coupons. The price of your bonds are not affected as much if rates start to move up. John, do you want to talk about this Ohio State Build America Bond?

Linda Louie: Can we ask a question?

John Colville: Sure. When you see a yield of two and five…sorry?

Linda Louie: Could we ask a quick question?

John Colville: Sure.

Linda Louie: A question came in from the audience: What's the non-California muni percentage like in the portfolio?

John Colville: That I'm only going off the top of my head because I don't have the number in front of me, but it is very small. We may only own three issues. So of the 12% we hold of that, maybe 2% of it is non-US – not non-US, I'm sorry – but non-California.

Linda Louie: Okay. Helpful. Thank you.

John Colville: We tend to shy away from buying things outside of the state because it does take that extra effort and it does take that extra bit of due diligence. And there is really an unknown factor. And as we know in the investment world, lack of knowledge means inherited risk. So it is something we stay away from for the most part unless we have the opportunity to do our due diligence. But those Ohio bonds, when you see a $2^{5}/_{8}$ yield, you go wow. And that is 126 basis points over the five-year treasury. And it is AA rated. It really raises a flag. You are saying, why are these people trying to sell this? There's something underlyingly wrong with this. But as Deb mentioned, it is a Build America Bond and we are big supporters of that program. It really caught our eye, being a AA rated and paying a nice spread over Treasuries. Plus, the BABs programs allows 35% of interest payments to be subsidized by the US government in the form of direct payments to the issuer. So the US government would pay 35% of all interest payments, go right into their account and help subsidize it. In addition, what we liked about this bond was that it was used to improve state highways and was going to be funded by the federal highway funds, which is generated by gas tax. And finally, the State had a debt service coverage of almost 8.6 times the debt outstanding. When looking at municipal securities we are really drawn to revenue bonds for essential services like schools, water, sewer and roadways, and I will touch upon that later when we go through our processes. The State of Ohio was appealing because it really carries a low unemployment rate of about 5.7% and it has a high median income level, which is just over $53,000. It's known for its education system, it's known for its science and technology, and in addition it's headquartered to about 23 Fortune 500 companies. As usual, we looked at the pension fund and it's 80% funded, and they are currently going through some pension reform. So we were confident that the source for payment of this investment was sound. And then to fall back on the yield we were getting, it certainly seemed like a steal for us and it has performed well thus far.

Slide 27 – Build America Bonds (BABs) (46:35)

Deborah Higgins: In talking about the Build America Bonds, just give the audience an idea of what they are – they were created under the American Recovery and Reinvestment Act that President Obama signed back in February of 2009 and they were taxable municipal bonds that, as John was saying, carried a special tax credit and federal subsidies for either the bond issuer or the bondholder. They were issued with three types. One was direct pay, where the Treasury department did provide the issuers with the cash subsidy payments equal to 35% of their interest costs. That is what John is talking about. Two, there was tax credit, where the investors received the right to a federal income tax credit equal to 35%. From what I understand, all the BABs issues were always direct pay. So even though there was a tax credit, most of them that came to the market were direct pay, where the issuer was getting the 35% interest subsidy, which is a positive thing. And the third one was a recovery zone economic development, and that's where the issuer had to spend a 100% of their available project proceeds, and there were a lot of different complicated rules to go into that particular type of BABs that was issued.

The risk that you have on the direct pay is that the federal government through an Act of Congress could technically go in and reduce or eliminate the subsidy payments at any time, but as John said, they had already done their due diligence from the standpoint of the credit. And as you can hear with the different things that he talked about, they do a substantial amount of review of what is happening in that state to figure out whether they are going to get paid. So that is, I believe, the 35% is kind of like a nice little "extra" involved. But there is a risk that the federal government could come in and take it away. There have been attempts, and they are ongoing, to revive this program. So it will be real interesting to see if we can ever get that to happen.

Slide 28 – CA State GO…OH State BABs (48:50)

Deborah Higgins: And this particular slide is not really a comparison from the standpoint of one versus the other because both the California state GO is owned by the City of Sacramento and so is the Ohio state BAB, but I wanted to take an opportunity to show you some of the differences when you start talking out-of-state. State of California, general obligation unlimited. Now, there are some nuances because I tried to use the City of Sacramento's portfolio, so they are not exact. Then you had Ohio state revenue bonds, Build America. Close in maturity. One is a 5.95 coupon and one is 4.168. The Aa2, AA, A+ on Ohio is actually a better rating; Aa3, A+, A+ on California state. So why does it matter?

Slide 29 – CA and OH…current review (49:49)

Deborah Higgins: Because in lies the difference between the review. You have different ratings, where actually California is rated somewhat lower, slightly lower than the Ohio Build America Bond. And despite the fact that Ohio is technically a better rated bond, the yield should be less, but in this case it is not. The Ohio BABs were bought in August of 2013 for a 2.625 yield and a 1.26 spread. And then not two months later, the GO was bought for a 1.96 yield and a 0.65 spread. So this is what happens when you have got out-of-state laws that may vary. You need to know those laws. California name trades better. You need to know what is happening in the county and the city dynamics, which you can tell by what John was rattling off on what they look at. They are very, very knowledgeable in what is happening in that state that they invest. An example is the Detroit bankruptcy and how it affected others. And then, you know, as you are reviewing California versus other 49 states, you need to keep pace with the political dynamics that could affect those states. Do you have anything you want to add, John, on just kind of looking at the other states?

John Colville: Well, I think a lot of the California municipals and especially the CalPERS and CalSTRS and such are really chasing the California debt, which is driving down yields on California money. You really – when you think of Ohio, you do think of Detroit. Well, I was thinking of Michigan and things like that, especially Illinois, places like that, Florida. You really have to be concerned and do your homework about where you are buying your money because places like Illinois, New Jersey, Florida – places that have real bad pension problems, have bad public employee issues with their unions – are something that you really want to stay away from. So do your homework because you don't want to get caught holding that bond when payday comes and it is not there. You saw what happened in Stockton. You are seeing it with Vallejo. They are forgoing – the bondholders are getting the haircuts whereas the public employees are getting fully paid. And you don't want that, being on the bondholder side, you don't want to be holding that bond.

Linda Louie: Sure. We have a couple questions. One of them is pertaining to the BABs. Isn't the taxable nature of the Ohio BABs also reflected in the higher yields relative to the California GO here in California?

John Colville: Is the BABs, is the higher yield?

Linda Louie: Is the taxable nature of the Ohio BABs reflected in the higher yield relative to the California GO BAB?

John Colville: I don't believe that California was a tax-free issue. So I think they are apples and apples.

Linda Louie: Okay, all right, good. And going back to the coupon analysis, can you explain why the higher coupon for protection against raising rate of interest is kind of the principal to function under? Is it coming from a point of duration, call risk, or something else? Deborah?

Deborah Higgins: It is coming from the cash flow, the interest income that you are getting. You are getting a higher coupon. So the cash flow off of that bond, if you are buying a premium bond, is substantially higher than a current coupon. So as interest rates move up, your coupon is not adversely affected as fast as a lower coupon bond because their cash flows are substantially lower than what the current market could provide. John, do you want to add anything to that?

John Colville: It is a percentage of the coupon. If you are getting higher rates, you are going to be most susceptible to total return losses on lower coupon, lower maturity rates. So it is a matter of being able to amortize it over a longer period of time, makes it cheaper. Plus, if you are having a 1% move on rates and you only have a 1% coupon, you are going to have more of a material effect on something than if you have a 5% coupon. Does that make sense?

Linda Louie: Yes. Thank you.

Slide 30 – Local Agency Bonds within CA (54:28)

Deborah Higgins: The next bond we wanted to cover for the code are bonds, notes, warrants or other evidences of indebtedness of any local agency within the state. Again, we are looking at five-year maximum maturity and no percentage limit on any local agency within the state that you can take a look at.

Slide 31 – Bonds, Notes…of Any Local Agency within this State (54:47)

Deborah Higgins: The bond that the City of Sacramento owns that we wanted to feature is a San Diego County pension obligation. This particular bond is a revenue bond. It has an issue size of $454 million, series from 2006 all the way to 2022. This particular issue – and when I am talking about series size, I'm talking about this particular issue that the City of Sacramento owns, which is the SDGFAC 5.665, 8/15/2017. This particular issue size is $26 million. The purpose of this is pension funding. It is again a revenue – is the source of the payback. Moody's has it underlying rated Aa2. It is insured Aa2. S&P AA with an underlying AA, too. Fitch is a AA+ with underlying +. Stable by all three. This was purchased in January of 2015, and John will give you an idea of what he liked about this particular issue.

John Colville: Thank you. Well, I must confess I have an inside source for this issue. I'm good friends with the treasurer of San Diego County. We serve on the same investment board and have become good friends. I looked him in the eye and I asked him if this was a good bond and he said yes, so I took note. In general, I don't like to buy pension obligation bonds or buy from issuers that are issuing those. I am not a big fan of using financial securities to subsidize pension fund shortfalls. But San Diego is San Diego. It is a very strong, wealthy community that is bolstered by a sizable, deep, and diverse economy. And we all know it has a favorable location. It was pretty much immune to any of the housing recession issues that happened, that many of us experienced. The county has strong budget with available reserves equal to almost 26% of expenditures and it also has reserves for emergency contingencies. In addition, the general fund has posted nearly 3% surpluses for the past few years. The issue is AA+ with a stable outlook. San Diego County itself is AAA. Funds will be paid back from property tax and vehicle licensing fees. Unemployment is relatively low there at 5.6%, and the median income is about $70,000, with the median housing price being $483,000. So it seems to me and my investment officers that there is a lot of taxes to collect to cover this bond given the housing prices and the income values. We purchased these bonds with two years left to maturity and we are happy to collect about a hundred basis points. The way it is, we figured we are getting twice the yield of a comparable Treasury from a security that carries the same rating of AA+, so we are getting 105 basis points versus the Treasury with the same AA+ that is yielding 50 basis points. The kicker was, of course, that San Diego County is AAA rated, which is outstanding. Deb.

Slide 32 – Municipal Characteristics (58:02)

Deborah Higgins: Municipal characteristics. I wanted to touch base and go over what we are looking at versus what most of you are used to seeing in the Treasury and agency market. Most of the issues are issued with substantially higher coupons – that is, the interest rate – than the current market. And this is a function of the fact that the majority of the buyers are what we call "retail," individuals. And for the individuals buying in the municipal market, they are looking for that tax-free or tax-exempt, the taxable cash flow in most instances. That is why you'll come and see a brand new issue come in and it is a 0.85 coupon but the dollar price is 1.10. You are not going to see it. You are going to see a 3% coming in at a 0.8 yield, and that is a function of the majority of the buyers being retail. From an accounting practice, I do see, I do have several cities that will go in and buy tax-exempt only or they will buy premium paper. And the big question I have heard, which quite frankly on my side I don't understand it, is some do and some don't amortize the premiums. If you are not amortizing premiums or creating discounts, then at the end of buying a coupon that is higher, you are going to pay and have to write off that premium paid at maturity. You guys could better understand that. Characteristics you have got to look at are credit, again, political. You have got your state and then you got sector dynamics, which we will go over sectors in a little while. And then, of course, liquidity varies from issue to issuer on what you are looking at from a municipal characteristics standpoint. Got anything to add to that, John? Guess not.

Slide 33 – Municipal Sectors (1:00:11)

Deborah Higgins: Let's move on. Municipal sectors that we are looking at dealing with. There are a lot. So when you buy a corporate – one corporate, let's say IBM, which we are just going to review briefly down the road – you are looking at one issuer, one name. If you buy Fannie Mae, Home Loan Bank, Freddie Mac – one issuer, one name, one dynamic. When you start looking at the municipal bond market, there are substantial sectors that are issuing debt all the time. You have got your state GOs, you've got local GOs, general obligation, you've got water and sewer municipal sectors, you've got public power, you've got housing finance, you've got transportation, you've got not-for-profit hospitals. And then now you have even got green economy sectors that are being issued out there in the municipal sector.

Slide 34 – Municipal Types (1:01:14)

Deborah Higgins: Municipal types. When we start talking about types, again, as you are looking to invest in this arena, you have got different types that are issued. You have got your general obligation, where you have got unlimited taxing authority and then you have others that have limited taxing authority. You have your revenue bonds. As you can see by most of the slides that we presented today with the City of Sacramento, they like the revenue bonds and where that money is coming from. You have special assessment municipal types, tax allocation, special tax. What I am trying to show here is there are a lot more variables and dynamics that come into play when you are looking at buying municipals. So it's hard. You can't really compare an agency like home loan with Fannie and then go into the municipals. You've got to do a little bit more to figure out what you are looking at buying. There are miscellaneous types of municipal types. You've got your tax anticipation notes, your bond anticipation notes, your grant anticipation notes. You've got certificates of participation, where you participate in the leasing the revenue stream. And then warrants and also other types of special obligations that you may be taking a look at when you're deciding whether you want to own a municipal bond.

Slide 35 – Sacramento's Selection Process (1:02:43)

Deborah Higgins: So in that with everything that is available in sectors and types, Sacramento has a specific selection process that they like to go through that John wanted to share. And take it away, John.

John Colville: Thanks. We are particular about what we buy in the municipal market because it does take that much more effort and that much more due diligence to be, to feel confident about what you are buying. It is not like going out and buying a Home Loan [*Federal Home Loan Bank*] or a Freddie Mac or something when you know that there is strong backing. You really need to do your homework. And that means reading all credit reports and unfortunately reading the official statement. As dry and boring as that can be, it really offers a lot of insight into how your bonds are going to get repaid, who is backing it, what the bond proceeds are going to be used for, all elements you need to take into account. As Deb mentioned, we do favor general obligation bonds because it is backed by the full faith and credit and taxing authority of the issuer. But you do need to know what the GO requirements are for each state. You need to know what the hierarchy of repayment is. Like California, we like to invest in schools because they are on the highest level of repayment. They have the best repayment funding options and they will get paid before anything else is. Like I said, we like local issuers, we like cities, we like school districts, water districts and other local agencies. And we like to examine the source of revenues to support the debt service. You also look at the bond repayment history, the financial performance of the issuers, the status of local economy of bonds, whether they cover periodic appropriations for local governments to make debt service payments or pension obligation bonds. We give higher credence to revenue bonds, essentially water, sewer, and utilities. We tend to avoid high-risk areas, like central California, which were hit the highest with foreclosure and most recently we are trying to avoid heavily drought areas that might impact local economies. But again, you need to carefully read the official statements. And as far as when we look outside of California, we really like state obligation bonds that cover school districts, cover airports, cover transportation. And if you can find a BAB that is decent priced, it really adds – the subsidy really adds to the value of the bond. It really makes it more like something we would like to own.

Slide 36 – Municipal Market Dynamics (1:05:23)

Deborah Higgins: We wanted to just give you an idea of what is happening, the dynamics of the municipal bond market. Rates peaked in October of 2008. And all of you out there understand that was due obviously to the credit crisis. As I mentioned before, there were people out there, I call them talking heads, saying that there was going to be substantial defaults on municipal bonds and therefore the interest rates, both tax-exempt and taxable hiked substantially during that time frame. The record lows in interest rates for municipals hit in 2012, late 2012, and that was due to the quantitative easing that was happening in the marketplace. Currently, if you are looking at municipals, the rates still remain below historical averages. And redemptions from 2010 through 2014 outpace new issuance. So there was a supply and demand problem going on here. The first half of 2015, that actually flipped, and where new issuance was outpacing redemptions. And I think that's a function of the fact that we have seen a tremendous amount of refundings, and that has happened over the last year. And I think that is close to a peak. Again, one of my comments earlier is I have a concern about outflows, retail outflows. And Lipper basically reported that there were $380.7 million in outflows from municipal mutual funds for the week ending June 3. That is the fifth consecutive week of negative outflows. So taking a look at your portfolio and knowing what is happening in the municipal market and the dynamics there I think is important.

Again, once these funds start seeing outflows, the managers on the funds have no choice but to liquidate their individual bonds. And if there is no one out there wanting to make a market in it, they are forced to not liquidate at what would be the current price on a mark-to-market but what the actual price is to move those and be able to match the outflows. So I think that's a concern. And quite frankly, it is not to the municipal market. I think it is a concern to fixed-income markets as a whole, as we are at the only way to go but up in an interest rates scenario, and the big question is going to be just how fast that it is going to take for rates to start moving up. So it is not just specific to municipals, but to all fixed-income. I think in general that people are recognizing that we are close to a top, if we are not already there, and we have seen that with the sell-off lately in the bond market, and we may see more and more outflows.

Slide 37 – Corporate vs. Municipal Characteristics (1:08:33)

Linda Louie: Deborah, so in current environments where there are more advanced refundings, how might that affect the yields on munis and would that be attractive for locals to consider munis in their portfolio?

Deborah Higgins: Well, they have peaked. I think it is all a function of where the current market is. I think locals looking now, if we start getting any backup, and we will talk about that a little bit later as far as the opportunity to buy. I think if we have major sell off – I think it behooves you to go in and take a look and buy on the dip as interest rates move up because the big question is how fast is it going to take the Fed to hike rates. And based on what they are saying, it could take a couple years down the road and depending on where you buy along the curve, you could be rolling down and off. I think there are opportunities on dips to take a look at different issues in this market. John, what are your thoughts on that?

John Colville: As mutual investors right now having to deal with 53601, we are kind of in a tough spot. We really are because when the Fed starts moving we are going see short-term rates rise. You are going to see a flattening of the yield curve. So within the five years and in that we have to deal with, we are going to see a whole lot of volatility. I don't know how fast it is going to happen, but it is all data dependent. So what we are doing now is we are incrementally adding to the two and three and four year time period. We are still keeping a lot of our powder dry. But rates – we have been looking for rate movements in the last two, three years that haven't happened and potentially that could continue to be the case given that the economy is not really robust in sorts. But munis, they were the buy last year and the year before. They were place to be. They were the best performing aspect of the fixed-income market. They really reeled in now. Our spreads are really tight now. I think a lot of people are moving money into it and as I said too much money is chasing too few dollars, too few issues. And as you mentioned Deb, if you buy the dips I don't think you are going to lose because spreads continue to narrow in this asset class. And as they narrow, your total return goes up. I'm still a buyer of munis. I am really sticking mostly to California debt right now because I feel that's the strongest credit out there. But when I see opportunities, I'm jumping on them because munis are still giving you a spread above Treasuries that agencies aren't.

Deborah Higgins: And I agree with that. The big question I think for me is not - yes, rates are moving up. Is it September, is it March? In the meantime, if we get major sell-offs like we had the other day where the long bond was down over two points, we have no choice. We play five years and in, and when I talk to public agencies and we talk about the long end and it is five years, we need to understand that that's the short side of the thing to the rest of the fixed-income market. As John said, we got to pick and choose because we are at the mercy of what is happening as rates start to move up. And of course it is the short end that leads it, but that is the market we are in. So we have got to try and pick and choose how we invest and where we invest.

In looking at municipals and the characteristics, I wanted to take just a minute to talk about most of the municipalities out there that do corporate notes. They are very familiar in how they work and what the characteristics there, but we wanted to take just a few minutes and review just so you get an idea. So the City of Sacramento owns IBM. And the key on the IBM corporate issuance is IBM is going to come to the market one time. They are going to come in and in this particular instance back in 2008 they came in with $1.6 billion in issuance. It is the IBM name. It is what is happening in technology. It is a Aa3 credit, AA-. And you know what you are getting with the IBM name. And you are buying and you are doing due diligence on this particular issue. What is the ability of IBM to pay you back? And then you can take a look based on the rating. One of the things that I do want to say about the rating agencies is they got absolutely clobbered during the crisis on their due diligence on what they were rating and how they were rating things. So they have had to clean up their act, which I think is a positive for those public entities that are investing in credit product. I think they are better at what they are doing at this stage of the game and they are still tweaking how they do their ratings. And I understand that several of them – I think Moody's is in the process of redoing. John, maybe you can speak about that. Is it Moody's that is revamping their credit rating strategy?

John Colville: I believe it is S&P from what I understand. They are really trying to have separate scales for corporates versus munis because there is really a different philosophy on performances and different default process. There is a different level of default. So a AA muni is not the same credit worthiness as a AA corporate. And they are trying to get to the point where you can be an apples to apples comparison because it is not an apples to apples right now.

Deborah Higgins: And that's what you need to be aware of from that standpoint. And so when we are looking at an IBM and we are looking at the dynamics to IBM, and then you start looking at a municipal bond like the Ohio state BABs, then there are a whole lot more variables, I believe, that go into play from what you are looking at from a state level. So you just have to be aware that you are in this instance comparing, as John said, apples with oranges. So we wanted to just clarify that from that standpoint.

Slide 38 – Perspective on Defaults – $3.6 Trillion Municipal Market (1:15:00)

Deborah Higgins: Speaking of that, John wanted to talk and touch-base with you guys on the safety of the municipal markets and the perspective on defaults and wanted to give you an idea of what is happening in the arena.

John Colville: Yeah, this piggybacks pretty much what I was saying that the rating agencies want to change their scales because if you notice, if you were to buy investment grade and above municipal bonds, you are only looking at less than 20 basis points of default on $3.6 trillion worth of issuance. Whereas in the corporate world, a AAA bond itself, you are looking at 124 basis points of default. So municipals carry a lot less, a lot smaller risk profile than corporates do, even of the same rating. So I think what really opened my eyes when I started investing in municipal debt is seldom do they default, and especially at the state level. The state GOs – most states aren't allowed to go into bankruptcy on a state level. So you are generally going to get paid. It is the smaller areas, like I mentioned before, the Stocktons or Vallejos that you really have got to be concerned because they can go into the bankruptcy courts. At state GOs by federal law they are not allowed to. So the risk profile of owning a muni versus a corporate is not even close.

Slide 39 – Focus on Carry and Liquidity (1:16:34)

Deborah Higgins: In this environment we wanted to touch base with what our focus would be in what to be buying. And for me my focus is on carry and liquidity. And again, we want to reiterate that we do expect the Fed to move sooner than later on rates. The big question as John was saying is we are looking to build a portfolio. Unfortunately, we are in the short end one to five. That is where rates are going to be moving up faster, but it depends on just how fast they do. Are they going to do 25 and be done? I don't think we are going to see anything like what we saw in 2004, where the Fed just came in and it was 25, 25, 25. Our economy doesn't look like it could withstand that type of increase. So I think we need to be patient in this environment and in building positions. And like I said earlier, if I see any type of a major sell off, I'm always looking to be able to buy on the dip. My focus is focused on the carry, which is the coupon income, and the liquidity. Most of my clients are buy and hold. So there are some, the total return – the liquidity really starts coming into play when you are looking at total return portfolios and you want to be able to move the position in and out. But if you are buy and hold, yes, you want to know that you are not the top dog in the whole issue, but I focus on the carry income. And right now I would be looking at high-quality municipals with above current market coupon. You can look at the floating rate notes. And then for those total return portfolios, you want to be in big names that have active trading on the secondary market. John, you want to add what your thoughts are on what your focus is?

John Colville: Well, I tend to agree. I do like higher coupons for the reasons I mentioned earlier as a cushion against upward moving bonds. I do prefer floating rate notes so I can stay along with the yield curve. But as a policy, we cannot hold more than 25% of any given issue. So sometimes with the $3 *[million]* to $5 million piece that we are looking for, it negates some of the stuff that is out there. So we do tend to go to the more liquid, the bigger names. But I don't have a crystal ball. I can't tell you how rates will go in the next few years, and you need to incrementally add yield to your portfolio now because you don't know six months from now, rates could be lower. Who knows what is going to happen. So municipal securities are a good safe mechanism to add yield, not affect the risk profile of your portfolio, and really bring more dollars into your plan.

Deborah Higgins: And I want to agree with that. I think the more public entities that take a look at municipals – with everything that is happening in the GSE market with what has happened in the investment grade corporate market from the standpoint of spreads have moved in so much. And if you are already close to your percentage and you are already close to the GSEs, you have got to be looking at other avenues because we are running out of options to invest. So this is a great way to go in and take advantage of a permissible investment that's out there if you do just a little bit more of your homework.

Slide 40 – Questions (1:20:14)

Deborah Higgins: So at that, do we have any questions?

Linda Louie: We do have one at the moment, and I think this is reflecting back to looking at what the holdings are. So given the higher risk of corporate bonds, why are you still considering holding corporate bonds over US Treasury?

John Colville: Why am I considering holding corporate bonds over US Treasuries? Because corporate balance sheets are so much better than they were. They hold a lot of cash on their balance sheet. I also manage the closed retirement fund for the Sacramento employees' retirement system, so I hold equities in that portfolio. So I do due the diligence on the equity side. If I am willing to hold the equity, I am willing to hold the fixed-income portion. I sleep well at night on what I own in the corporate world. I don't own a high yield anything such as that. I own mainly banks, a few industrials, and some technology names. I think it is a good way to – I mean I'm earning 1% in my portfolio. I don't know how many people are earning that in their investment pool. If you own Treasuries you might as well be putting your money in your mattress because you are not earning a real return on that at all given inflation.

Deborah Higgins: I have to agree on the corporate arena. Since the financial crisis, and you have to remember the financial crisis affected a lot of the corporate issuers and the commercial paper market. That market just dried up and went away, so they had to look at different avenues in which to fund their operations. And one of the things they have done over the last six years is clean up their balance sheet and they have gone out and they have issued debt at historical lows. So I think there is some advantages to owning good quality corporate names. That's my call on that.

Linda Louie: That's helpful. Good. Thank you. All right, we have another question. Would you sell a CD before maturity date to purchase another CD that is yielding a better rate? Just getting outside of the box, but if you would like to try to address that.

John Colville: Well, if there's no back-end fees on the CD, why not?

Deborah Higgins: Yeah. You can run a swap analysis and it will tell you what you are picking up moving from one to the other. Taking out, picking up. So, yeah, there are some variables in there, that is not a straightforward answer but if everything works, yes.

Linda Louie: Right. Thank you. We will take a second here to see if there's any more typed in questions. This has been very comprehensive presentation on municipals, where you have covered your portfolio, types of municipals, the code, various considerations, and the comparison between corporates and munis.

John Colville: One thing that I might add is you really need to have a partnership with your broker community because some brokers are very muni-oriented. It is good to find those people because they will know your portfolio, they will know what is out there and they will bring to it you. As a public municipal employee, you know you don't really have an avenue to a lot of these different direct purchases and munis, so you have to have a good brokerage community that will bring these things to your attention.

Linda Louie: Right. Good.

Deborah Higgins: I agree with that.

Linda Louie: Here's a question. What is the typical normal bid/ask spread with munis?

John Colville: That's a great question.

Deborah Higgins: That is a great question. It has narrowed. I can tell you it has narrowed substantially. That's a tough one for me to answer from the standpoint – every single issue is different. So one bid/offer spread on like a Cal GO will be substantially narrower than some tiny issue that is out there. And I don't know off the top of my head what would be an answer. John, do you got one?

John Colville: I don't look at the – well, I can't say I don't look at the bid/ask spread, but I look at the yield on what I'm going to receive on my purchase and that's what I make my decision based on, the yield. A lot of times like I told you, you are a buy and hold so the bid/ask spread really doesn't matter to me. I'm more worried about what this particular security is going to do for my portfolio, what value add it's going to be. So I look at the yield to maturity.

Linda Louie: Ok, thank you. Here is a question about brokers. What are some examples of those brokers that may be muni-oriented.

John Colville: Is Higgins Capital muni-oriented, Deb?

Deborah Higgins: I do a fair amount. I think it depends on your client base. I handle public agencies and they are in the market looking for alternatives. So I can tell you that prior to 2008 our public agency clients were not that big of buyers, but that changed. That changed, and we actually have taxable buyers and we actually have accounts that are mandated based on a bond deal to buy tax-exempt. So I'm in that market all the time looking at different types of investments to show out to the clients. So I think each type of broker and whether their clients are actually in that arena determines whether that is what they are looking at. I can say that my clients focus mostly on California issues.

John Colville: Yeah, I work with Stifel, which used to be Stone and Youngberg. They have a real good grasp. They do a lot of underwriting and issuance of debt for us, so they have a really good handle on the pulse of the municipal markets. I also deal with Raymond James, who used to be Keegan Morgan. They, again, have a municipal securities background so I get a lot of ideas from those people.

Linda Louie: Good. Well, a lot of players in the industry. We have a few more questions. Here one is a little more related to munis. Do you recommend going out more than five years to get the higher coupon as they will get called anyway?

John Colville: Well, I can't go out more than five years on my 53601 unless I get approval from my city council.

Linda Louie: Under code, what you can and cannot do. Thank you. This is reflecting back to I think the slide that you had, John, on page 11. How did you earn 2% in December in 2014?

John Colville: I knew that was going to come up. Through litigation. We did securities lending on our portfolio. Bank of New York, which I'll badmouth them until the cows come home if anyone wants to know. And I told them that after we settled with them. I said if this is what you want to sell it for then just remember that anyone that calls me about Bank of New York, I am going to badmouth the heck out of you. So here I am in front of 180 people badmouthing Bank of New York. They handled our securities lending. They did the cash collateral account. They invested in Lehman Brothers. They invested in mortgage-backed securities in 2008 and 2009. Lost their shirt on both sides. I lost about $5 million; after settlement, about $3 million. So we wrote it off in 2008, and then we settled in December. They were going to cover 25% of the losses. We covered 75%. So the cash inflow created a 2% return. So it is just a one-time cash inflow.

Deborah Higgins: But I will say kudos to who caught that.

John Colville: What's that, Deb?

Deborah Higgins: I said kudos to who picked up on that. Now, we at least know someone was listening and watching.

John Colville: Anyone wants to talk about Bank of New York, feel free to call me.

Linda Louie: You spoke of other state investments and what counties and municipal utilities within a state may have higher credit ratings. Can you expand upon that a little bit?

John Colville: Well, unfortunately, you can't own local agency money out of State of California, which we found out the hard way about nine months ago because we were buying New York state airport bonds, which we loved, and then our auditor came back and said, ahem, you can't own out of state local agency bonds. So after my investment officer who came from the city attorney's office read the mandate five or six times, he came to the conclusion that we couldn't.

Linda Louie: Right. Not permitted in code.

John Colville: Not permitted in code, but it is in the smaller text.

Linda Louie: All right. Thank you. This is getting back to the City of Sacramento. So, John, you stated that the city manages monies in an additional pool. Is that bond proceed of the water department, etc., or is it a truly voluntary participant money like some county pools manage?

John Colville: It is voluntary. We manage money for the library. We manage money for a couple flooding districts. We manage money for the California CADA [*Capitol Area*

Development Authority], which is a development authority, a certain development authority in Sacramento. We just got a new mandate to manage money for RD 1000 [*Reclamation District 1000*], which is a river flood control area. So we have different areas that aren't even city-affiliated that want to come into our fund because our yield is so high.

Linda Louie: Good. Thank you. Any other questions from the audience? This is your opportunity to access the experts.

John Colville: Experts...

Linda Louie: Okay. Seeing none, we would like to thank you – oh, we do have something here. One more question. Do you measure total return of the portfolio? What is your measurement?

John Colville: No, we are a cash-based. So we do our yield based on cash returns, but we do have to amortize the premium we pay. But that is generally just a cash-based yield.

Linda Louie: Thank you. Any other last questions on municipals? Here's a question. Would you recommend getting council approval to go out more than five years to get the higher yield as they will be called? Going back to our outside of code here.

John Colville: Would I advocate it?

Deborah Higgins: I'm going to stay out of that one.

John Colville: What's the disclosure at the front of the meeting? I don't know. There's a fine line that we walk as investment officers, and I have this conversation with my boss all the time. Unfortunately, I don't get paid to take risk. If there was a bonus pool that I could get and if I outperformed certain benchmarks, there would be reason for me to take that added risk. But to step outside the mandate and collect the salary and no bonus structure, I think you are giving yourself too much rope to hang yourself. That's just my perspective.

Linda Louie: Very high risk. Yes.

John Colville: Yeah. High risk and a lot of headline risk. And is it worth it? I don't think so.

Linda Louie: Thank you.

Deborah Higgins: I agree. And especially at this stage of the game. Maybe talk about it in five or six years when interest rates are substantially higher and then you can take a look at locking it in, but I stay out of that. I prefer not to see that because I feel like, like with John, if it's working, it is great, but when it goes against you it goes against you in a big way on all accounts in the portfolio, in the news, etc.

John Colville: That is what happened to Orange County, right? That's why 53601 came into effect. Orange County invested in bonds way outside their 10- and 15-year bonds, if I know correctly. The bond market went against them. They had to sell. They took a beating. And if they had waited a year later, he would have been a hero. But they needed the money. They needed to liquidate principal. That's kind of the basis of why 53601 came into existence, from what I understand.

Linda Louie: It goes back to the three tenants you started with safety, liquidity and yield. Probably with safety and liquidity being primary.

John Colville: Correct.

Deborah Higgins: And you know, I have to tell you over the years I have been working with the public agencies for about 30 years and I talk about California code and I say, look, the one thing is it is very plain and vanilla what we can and cannot do, but the upside is we don't razzle and dazzle ourselves out of business. And I think that is the key, being able to stick within it. It is tough. One to five years – the five years sounds like a long term, but in the scheme of the fixed-income market, that is the short end of the market. And we see what kind of volatility you get in the short end. You can imagine what happens if you have got longer dated paper and rates move up substantially from where your coupon is. So plain vanilla, razzle dazzle.

Linda Louie: Thank you.

John Colville: Don't be a hero.

Linda Louie: Ok. Well, we don't seem to have any more questions flowing in at the moment, so why don't we begin to close. Before we do, we would like to draw your attention to the remaining slate of webinars in this investment series.

Slide 41 – Public Investment Webinar Series: The Public Investment Portfolio (1:34:53)

Linda Louie: The agendas and the registration instructions for each of the webinars are now posted on the CDIAC website. And our next webinar will be on July 8th, which will be an introduction to money markets with a look at banker's acceptances and commercial paper. So it is part one of a part three series on money markets.

Slide 42 – Thank you for your participation. (1:35:16)

Linda Louie: In closing and on behalf of CDIAC, I would like to thank John Colville and Deborah Higgins for their dedication of time and expertise in making this program a success. We really appreciate having practitioners. And a big thank you for our team here at CDIAC, Susan Mills and Sandra Kent, for their work in producing this webinar. Thank you, everyone, for participating on this webinar, and we look forward to joining you in July.

Deborah Higgins: Thanks, everybody.

Linda Louie: Thank you.

John Colville: If anybody wants to talk further about it, I'm on Bloomberg. Give me a call. And as you can tell, I'll tell you the straight line. I don't pull punches. So give me a call.

Linda Louie: Thank you, John. Thank you, Debbie. Bye, all.