LOCAL INVESTMENT ADVISORY BOARD
915 Capitol Mall, Room 110
Sacramento, CA 95814

Minutes
January 31, 2002

William Sherwood, acting as Chairperson for State Treasurer Philip Angelides, called the Local Investment Advisory Board (LIAB) meeting to order at 1:08 p.m., Thursday, January 31, 2002.

AGENDA ITEM 1: Roll Call

LIAB Members present were Patricia Elliott, Leslie Wells, Robert Torrez, Byron Scordelis, and William Sherwood representing State Treasurer Philip Angelides; A quorum was present. State Treasurer's Office staff present were Theodore Eliopoulos, Dan Dowell, Eileen Park, Connie Kim, and Kim Lee.

Mr. Sherwood introduced and welcomed the new LIAB Executive Secretary Theodore Eliopoulos to the Treasurer's Office. Mr. Sherwood stated that former LIAB Executive Secretary Jennifer Ducray-Morrill has transferred to another commission within the Treasurer's Office; therefore, Mr. Eliopuolos will serve as the new Executive Secretary for the LIAB. Mr. Sherwood further stated that Mr. Eliopoulos will also oversee the Investments, Cash Management, and Information Technology Divisions as well as represent the Treasurer on the Boards of California State Teachers' Retirement System, California Public Employees' Retirement System, and the California Earthquake Authority. Mr. Eliopuolos worked as an associate attorney for Latham & Watkins, was a special assistant to the Office of Environmental Management at the US Department of Energy, and since 1996 served as president for the Actium Development Corporation.

Ms. Park introduced and welcomed two delegates from China representing the bureaus of finance of the budget divisions for their provinces. Ms. Feixue Wang from the Sichuan Province and Ms. Jian Ming Gao from the Gansu Province were visiting to observe the state's finance operations, making the State Treasurer's Office one of their many stops.

AGENDA ITEM 2: Approval of the Minutes

The minutes of the September 26, 2001, meeting were approved as submitted with a motion by Ms. Elliott and seconded by Mr. Torrez.

AGENDA ITEM 3A
Evaluation of the 2001 LAIF Annual Conference/Planning the 2002 LAIF Annual Conference

Ms. Park reported that 132 LAIF participants attended the conference representing 97 agencies. Ms. Park further stated that participants were quite receptive of moving the conference to Thursday and the Treasurer's Office tour to Friday. The conference evaluations reflected positive comments to the changes in conference format, scheduled sessions, and speakers. Ms. Park reported that in spite of the tragedy of September 11, 2001, conference cancellations were less than 5%.

Ms. Park announced that the 2002 Annual LAIF Conference would be LAIF's 25th anniversary. The LAIF Conference has been scheduled for Thursday, September 12, 2002, at the Sacramento Convention Center and the post conference tour is scheduled for Friday, September 13, 2002, at the Treasurer's Office. Although not confirmed, September 12th and 13th has been reserved on the Treasurer's calendar.

Ms. Park requested that the Board Members provide ideas and suggestions for the up-coming conference.

Ms. Elliott and Mr. Wells suggested that the method to register attendees be changed. They stated that during registration the attendees bottlenecked at the table due to staff preparing and packaging handouts during process. They suggested preparing packages prior to registration, recruiting more volunteers, or having multiple stations for attendees to sign-in, which might improve the process.

Ms. Park stated sixty conference evaluations were returned. The evaluations noted two criticisms of the conference: 1) lack of handouts which would allow the audience to follow along during presentations and 2) reducing the time for introductions of speakers and staff which would allow more time for substantive content and questions during the sessions.

Mr. Sherwood stated that approximately 80% of attendees were at the conference for the first time. He further stated that the introductions allow participants to become familiar and comfortable with the individuals that are responsible for PMIA investments. Mr. Sherwood stated that shortening introductions or presenting staff qualifications in another way might be considered for the up-coming conference.

Mr. Wells suggested that the introductions and biographies for the investment staff who run the program remain in place, but should be kept to a minimum for staff from other departments of the Treasurer's Office.

Mr. Torrez suggested that speaker handouts could include a short biography that should be passed out prior to speaker presentation or during registration and a shorter version could be read for the introduction.

Ms. Park stated she would look into including resumes with handouts. Ms. Park further noted that some speakers were last minute substitutions due to the September 11, 2001, crisis and were unable to provide handouts.

Mr. Dowell suggested finding a means to determine the subject matter that may be of interest to local agencies as opposed to what the investment staff thinks participants want to hear. Mr. Dowell asked Board Members if there was a means to reach participants and to receive feedback for potential topics to be presented at the up-coming conference.

Ms. Elliott suggested that Board Members could ask California Municipal Treasurer Association (CMTA) and the California Society Municipal Finance Officers (CSMFO) about possible conference topics.

Mr. Sherwood stated that it would be helpful to staff if the Associations could obtain information from its members regarding possible conference topics. Mr. Sherwood stated that an economist has already been contacted and scheduled for the LAIF conference.

Ms. Park stated that Maury Harris, Managing Director and Chief Economist at UBS Warburg was contacted and has accepted the invitation to speak at the conference.

Mr. Sherwood stated that Mr. Harris was scheduled to speak at the 2001 Conference but the conference date conflicted with an observed holiday. Mr. Harris is well respected in the finance industry. Mr. Sherwood further stated that the agenda items for the conference program are open except for PMIA Portfolio presentation.

Ms. Elliott suggested performing a skit of the morning investment session, similar to what was done at the post conference. The performance, to include the broker and investor conversation on trades, would allow participants to observe how the investors purchase and sell securities. Ms. Elliott further stated it maybe beneficial to do a historical presentation of the STO and LAIF as a special session for the 25th Anniversary.

Mr. Sherwood stated that any other suggestions for the conference agenda should be forwarded to Ms. Park.

Board Members discussed methods to solicit ideas from local officials and their organizations for the conference agenda.

Ms. Park stated that she would use all possible resources and suggestions to develop a draft agenda. Some of the investment staff will be attending the CMTA and CSMFO conferences. Perhaps LAIF participants that attend these conferences will provide a few ideas for the LAIF Conference agenda.

AGENDA ITEM 3B
Effects of the LAIF Deposit Limit Increase

Ms. Park reported that effective January 1, 2002, the Treasurer increased the LAIF Deposit limit for regular accounts from $30 million to $40 million. As of January 24, 2002, LAIF totaled $20 billion compared to $18.9 billion as of December 31, 2001. There were 142 accounts between $30 million and $40 million, 27 of these accounts were at the $40 million cap. Of the 27 accounts at the $40 million cap, 12 accounts were counties, 4 accounts were cities, and 11 accounts were special districts.

Mr. Scordelis asked if the increase in the LAIF balance happened immediately on January 2, 2002.

Ms. Park stated that the LAIF gained about $75 million on January 2, 2002, while the remaining increase was gained over the course the month.

Mr. Wells stated that while attending the CMTA board meeting, constituents expressed concern about smaller accounts that have the option to deposit their entire portfolio into LAIF without regard to diversification. Mr. Wells informed CMTA that the deposit limit was increased pursuant to requests from many of the LAIF participants and that the State Treasurer's Office believes in the diversification of all portfolios.

Mr. Sherwood stated that some local officials expressed their concerns on the survey submitted by Mr. Torrez. Mr. Torrez communicated with many participants and asked for their input following the announcement of the LAIF deposit limit increase. Most were pleased with deposit limit increase but there were a few concerns expressed. Mr. Sherwood stated that Mr. Dowell would address a few of the issues expressed on the survey.

Mr. Dowell complimented Mr. Torrez on the survey he distributed regarding the LAIF deposit limit increase. Mr. Dowell stated that overall the responses were very receptive to the LAIF limit increase, but felt it necessary to address the concerns that were expressed by some of the local officials. Mr. Dowell read into the meeting's official record the questions from local officials and the staff's responses to those questions.

Who initiates the request for an increase in the deposit limit for regular accounts?

The first limit was initiated in 1981 at the request of the Treasurer's Office to address the volatility issue created by the lack of a cap. Subsequent increases (4 in all over twenty years) were presented to the State Treasurer by the Local Investment Advisory Board on behalf of requests submitted by local agencies.

Why in the midst of a cash crunch is the State offering to manage more local agency money?

The increase in the deposit limit is the result of numerous local agency requests, rather than being construed as a State offer. Without local government petitions, the offer would not have been made. Local agencies with additional available funds are attempting to find the best rate through the most prudent investment course. Increases to the cap are attributable to lower interest rates, and not to any General Fund cash crunch.

I am concerned about the timing of the increase. A large influx of new money may significantly impact the yield on moneys invested with LAIF. What discussion took place regarding the negative impact?

Requests for an increase in the deposit limit were presented to the Treasurer's Office prior to the June Quarterly LIAB Meeting. Board Members requested the LAIF staff to gather information for discussion at the September Board meeting. Historical account data presented to the LIAB in September suggested that approximately 9 percent of the participants were within $5 million of the current cap. Investment staff advised the Board that, considering the small number of accounts potentially affected by the proposed increase, and considering historical experience in the aftermath of three prior increases at the request of local agencies, there would not be a measurable impact to the portfolio yield going forward.

My concerns are that the LAIF and SMIF monies invested in loans to the General Fund are growing, and that to my knowledge, there is no limit on the percentage of GF loans. Given the current economic condition of the State, an increase in loans could create an imbalance in the pool's makeup.

As of December 15th, there were no loans to the General Fund on the portfolio. The last loan in the Pool to the General Fund was recorded on October 1st. This loan was repaid on October 2nd. Balances in General Fund Loans in the Pooled Portfolio have average 1.2% over the last four to five years. General Fund loans are limited to the amount of available "borrowable resources." These resources are defined and limited by the exclusion of trust monies such as the Local Agency Investment Fund, and are determined by the State Controller at the time a General Fund Loan request is received. The makeup of the participants in the Pool, as well as the exclusion of trust monies from "borrowable resources" argue against any imbalance in the Pool's investment allocations.

It is not clear what the basis for determining the limit is. The limit appears very subjective and it keeps increasing every few years by very large percentages. The change primarily benefits the larger entities that use the pool to their advantage, which ends up costing the smaller agencies that maintain a more constant usage of the pool. Larger agencies tend to invest the maximum allowed when interest rates are falling to

benefit from the pool's previous purchase of higher yielding long-term securities, even though their new money must be invested in lower yielding securities. Then, when interest rates are rising, they sell out of the pool to get higher rates elsewhere without sharing the unrealized loss on LAIF's portfolio. If LAIF were managed like a money market fund where all investors' accounts were carried at market value, this problem with larger investors jumping in and out of the pool would not exist.

Generally, when programs such as the PMIA increase in size due to an increase in available resources, then the limit on individual participation in the program should increase as well. Over the last ten years, the PMIA has more than doubled in size. During that same period, the LAIF as a percentage of the PMIA has gone from 32% to 36%. This would indicate that the increase in the Pool is not a direct result of "subjective" or "large percentage" increases in the regular account cap in the LAIF.

The Pool exists for the benefit of all participants. Those participants who feel that there is a bias in the program toward large investors can take solace in the fact that participation by all agencies is voluntary. Fair market valuations are presented quarterly to enable all participants to assess the risk/reward of LAIF participation. Because the program is managed to conform to a dollar-in-dollar-out philosophy, there have been no material changes in market value resulting in unrealized losses. No local agency wishing to remain a depositor for the long term is placed in a negative cash position in the pool by those agencies that choose to invest for the short term only. The amount of cash that may jump in and out of our program has historically been tracked effectively in both our long and short-term cash flow forecasts. Because of these forecasting abilities, we see no measurable impact to the portfolio yield or underlying values due to the in-and-out investment practices suggested here. In addition, it is the policy of this office to maintain an 80% liquidity level within 90 days for LAIF dollars on deposit. This policy is adhered to regardless of the interest rate environment, or the participant behavior due to that rate environment.

Realizing that there are convenient differences between money market funds and the LAIF should serve to broaden investment choices for all participants.

In summary, Mr. Dowell stated that the goal of the State Treasurer's Investment Division is to earn as much safe money as possible for the participants of the LAIF. The programs that are established and the policies that are followed are never to the detriment of the LAIF program. Mr. Dowell further stated that he wanted these concerns expressed by local officials addressed.

Mr. Torrez developed the survey when asked by staff if there were any comments about the LAIF deposit increase from local officials. A copy of the responses was transmitted to Ms. Park. Mr. Torrez stated he surveyed CSMFO members and received 42 responses, generally the responses were positive. Mr. Torrez explained the survey had 2 questions: 1) Are you aware of the LAIF deposit limit increase and 2) are you supportive of the LAIF deposit limit increase? The League of California Cities informed him that city officials were alerted about the deposit limit increase through the their newsletter. The

League further stated the increase provides greater investment flexibility to local agencies that invest with LAIF. Mr. Torrez noted responses were generally receptive of the deposit limit increase.

Mr. Scordelis asked as a LAIF investor if there are negative consequences to a smaller passive portfolio versus a large aggressive portfolio. If the large depositors should decide to pull their funds out of LAIF, does liquidation of their accounts have a consequence for the participants that remain in the fund?

Mr. Dowell stated that the PMIA has several sources of funds: the General Fund, Surplus Money Investment Funds (SMIF), and LAIF. Mr. Dowell explained that the PMIA does not liquidate securities to facilitate withdrawals. Under policy the PMIA maintains 80% liquidity in the Pool, regardless of the interest rate environment.

Mr. Sherwood stated that LAIF is the voluntary portion of the PMIA that shares in Pool revenues earned by the Pool. The other funds in the Pool, the General Fund and SMIF do not have the flexibility to move in and out of the Pool as the LAIF participants.

AGENDA ITEM 4: Overview LAIF Operations and PMIA Participation

LAIF Operations

Ms. Park presented Board Members with the graphic reports for the LAIF participation and LAIF deposits as of December 31, 2001.

Ms. Park reported that current LAIF participation is about 3,000 accounts. She said that staff is working with some agencies to identify inactive accounts and to determine if any of them might be closed to save program costs. However, many of these local agencies may want these accounts to remain open to allow for the most flexibility for investment of their local funds. Staff will be working closely with agency staff to determine their needs and will abide by their wishes to allow agencies the most flexibility in their finance decisions.

Mr. Dowell stated that if there is any decline in the number of LAIF accounts, it should be footnoted in all reporting documents for the program. LAIF participants should understand that any decrease in the number of accounts is not an outflow of LAIF participants or deposits, but rather inactive accounts being closed.

PMIA Performance

As of January 29, 2002, the PMIA totaled approximately $52 billion, with the daily rate at 2.959%, the quarter-to-date rate at 3.01%, and the year-to-date rate at 3.87%. The Federal Reserve Board refrained from making any change in the Fed Funds rate or the discount rate when it met during the week. Since the Fed did not ease, current performance rate will continue for a while longer. The PMIA rates are lower and less attractive to many; however, for any participant that invests overnight in LAIF, they still earn 3.07% which is 100 to 150 points better than other market instruments.

Mr. Dowell further stated that the investment staff ran some estimates for the Pool based on worst case scenario for rates and staff estimates that the Pool may go to 2.45%, 2.50%. Current cash flow investments for the Pool are between 1.75% and 2.00% with occasional purchases in the long-term sector.

On the *Double Bottom Line* program, the Pool purchased $175 million in the Teacher Assisted Mortgages at 6.07%. The Pool is looking very cautiously at corporate securities, Treasuries and agencies with three-year and longer maturities. The investment staff purchased approximated $1 billion in new Treasury Notes in the two- year area. The investment staff intends to look at mortgages for the *Double Bottom Line* program because the underlying collateral has been very predictable and has performed well.

AGENDA ITEM 5: Public Comment

There was no public comment for this meeting.

AGENDA ITEM 6: Other Business

Mr. Wells stated CMTA met last weekend and discussed introducing legislation to protect LAIF monies in the event the State does not pass a budget by June 30th. Frances Medema of the League of California Cities is working on this issue.

Mr. Sherwood confirmed that CMTA's legislative proposal was being developed to address this issue for local agencies. In a discussion with Ms. Medema, he suggested that while CMTA was working on the legislative front, they should also seek a confirmation in writing from the State Controller's Office regarding the ability of the Controller's Office to release LAIF funds, in the event there is a budget stalemate. He explained that the court case is at the Appellate Court level and was filed by the Howard Jarvis Taxpayers Group in July 22, 1998. This court injunction froze State operations temporarily until the legal staff of the various effected departments could review and analyzed the case. Until the legal issues were examined, the State Controller was unable to pay any claims against the State Treasury system, including investment and LAIF warrants for about a 24-hour period. During this time period, the Governor’s Office and the State Legislature passed an emergency appropriations bill so that the business of the State could go forward until the budget was adopted. This case has been in the court system since 1998 and there has been no action on this case since that time. However, staff has learned that the case has been scheduled for hearing on March 21, 2002.

Mr. Torrez stated that the State Controller announced that the State would be issuing revenue anticipation notes to take care of cash shortages before the end of the fiscal year. He asked how the LAIF program is impacted by the State’s cash shortfall. He also asked how the program would be impacted if there was no budget adopted by the June 30th deadline.

Mr. Sherwood explained that any State cash shortfalls projected by the State Controller does not effect the LAIF program, in that LAIF funds are not State monies. However, statute requires the State Controller to issue warrants in payment of all investment and LAIF claims. Amendments to the LAIF statutes are being proposed to clarify that in a budget stalemate that LAIF monies are not state monies and should be released to local agencies on demand, regardless of whether there is a budget or not.

Mr. Sherwood commented that CMTA’s legislative effort was a good idea; however, it would not be a guarantee that a new court injunction, or another unforeseen event could not impact the release of LAIF monies. As a prudent investor, he stated that he always recommends that local agencies diversify their investments to ensure that operational monies are available when needed.

AGENDA ITEM 7: Adjournment

There being no further business, the meeting was adjourned at 2:30 p.m.