Agenda Item 2.A
Action

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

Minutes
May 19, 2010

Patricia Wynne, Deputy Treasurer chairing for State Treasurer Bill Lockyer called the Local Investment Advisory Board (LIAB) meeting to order at 1:30 p.m. on Wednesday, May 19, 2010.

AGENDA ITEM 1: Roll Call

Present: Patricia Wynne for State Treasurer Bill Lockyer
Russ Branson, LIAB member
Martin Krieger, LIAB member
Beth Renge, LIAB member

Staff: Dan Dowell, Director of Investments
Christine Solich, Assistant Director of Investments
Pam Milliron, LAIF Administrator
Marian Yee, Treasury Manager
Diann Theis, Treasury Program Officer

The Chair declared a quorum at 1:32 p.m.

AGENDA ITEM 2.A: Approval of the October 20, 2009, Minutes

The minutes for the October 20, 2009, meeting were approved as submitted with a motion by Mr. Krieger and seconded by Mr. Branson. The motion passed unanimously.

AGENDA ITEM NO.3.A: Evaluation of 2009 Annual LAIF Conference

Pam Milliron presented the evaluation of the 2009 Annual LAIF Conference.

AGENDA ITEM NO.3.B: Planning of 2010 Annual LAIF Conference

Pam Milliron presented the agenda for the upcoming 2010 Annual LAIF Conference on Thursday, October 21, 2010.

<u>AGENDA ITEM 4</u>: Overview of LAIF Operations and PMIA Performance

PMIA Performance

Christine Solich reported:

- PMIA was $70 billion dollars
- LAIF was $23.2 billion dollars
- The daily rate was .52%
- The quarter to date was .58%
- The year to date was .67%
- The average life of the portfolio was 194 days

Ms. Solich gave an update regarding the legislative efforts concerning the LAIF reimbursement cap. The process was started in October of 2009 after the LIAB board members and the LAIF Conference participants were alerted that LAIF would not be able to recover the costs of managing the LAIF program under the current cap of .50% of earnings due to the very low interest rate environment. Ms. Solich stated that the investment division would be pursuing Legislative action to remedy the fact that the costs could not be reimbursed. There was complete support from the participants at the LAIF Conference in October 2009 and support letters were collected from various municipal treasurers. The Legislative Director in the Department of Finance determined that it was best to address the shortfall through a finance letter which would be part of the 2010/11 Budget Act. Ms. Solich provided a chart to the board to give a visual picture of the reimbursement totals for the past few years and the fact that the reimbursements are expected to cover the costs of LAIF but haven't covered costs since September of 2009. Ms. Solich stated the current language authorizes reasonable cost not to exceed a maximum of 5.00% of the earnings of the fund nor the amount appropriated in the annual budget act for LAIF administrative costs. As of May 19, 2010 the language has been approved by two budget sub-committees in the Assembly and the Senate. It will now go to the full budget committees and to the floor in the House and the Senate.

Dan Dowell gave an overview of the current investment portfolio and investment strategies. As of April 1, 2010, the daily rate was .55% and the quarter to date rate was also .55%. During the quarter the daily yield went down as expected, but the quarter to date rate went up. Generally, the quarterly rate will track the direction of the daily rate. However, in the current quarter the portfolio realized capital gains, which increased the quarterly rate. The daily rate, unlike the quarterly rate, does not factor capital gains into the posted return. Because of this accounting policy, LAIF posted a statement on the webpage performance report chart explaining the divergence of the daily and quarterly rates.

As of May 18, 2010, year to date the portfolio realized capital gains of $10.6 million above the revenues trading securities. Treasury bills accounted for approximately $1.4 million, and Treasury notes accounted for approximately $9.2 million of this additional revenue. In the current quarter beginning April 1st, $4.8 million of the $10.6 million has been realized. The breakdown of capital gains within the current quarter shows approximately $139,000 trading profits in Treasury bills and approximately $4.7 million trading profits in Treasury notes.

In April there was a lot of uncertainty in both the equities market and fixed income market. The investment team took advantage of the uncertainties in the markets and traded Treasury bills and notes accordingly. Treasury note trading concentrated on the three year note sector, with long positions taken in the 1.40%--1.70% range and sales of these same positions in the 1.20%--1.40% range. We concentrated on the three year area because of the dramatic swings in response to market rumors and economic news. These swings allowed us to trade in and out of these securities a number of times

Currently we have $7.5 billion treasury notes with an average life of 1.3 years and an average yield of 1.13%. To put this in perspective, the Treasury yield on the curve at 1.3 years is approximately 0.55%. Treasury bills in the portfolio presently have an average life of 190 days and an average yield of 0.38%. To put this in perspective, the Treasury yield curve is 0.22% in 190 days.

Dan Dowell shared a chart representing the current market valuation on the Treasury bill portfolio positions, reflecting unrealized gains of $17.5 million dollars on $26.7 billion in bills. Mr. Dowell suggested that this portfolio may be one of the largest holders of bills in the country. Between positions in bills and notes the Pool has approximately 48% of the portfolio in Treasuries. To put this in perspective, in September, 2007, the portfolio held 3.5% in Treasuries. Since the summer of 2007 the Fed, the economy, and all credit markets were watched very closely. Because of uncertainties in credit markets worldwide, the investment staff determined that as long as the short term cash flow needs were met ongoing, any excess funds would be invested in the Treasury market, with emphasis on Treasury bills. Rather than place funds in riskier money market instruments ongoing at anywhere from 17 to 25 basis points, staff began buying bills anywhere from 0.50% to 0.29% in lieu of the potential money market risks.

Whenever excess liquidity was needed our plan was to liquidate bills. As an example of the liquidity provided by the bill portfolio, in April, 2010, a school apportionment date for a $2 billion disbursement was moved one day earlier. Staff determined that it would be more prudent to use the Treasury bills to fund the early disbursement, rather than attempt to invest $2 billion in riskier money market securities within a 7 day window. Staff opted to competitively sell a considerable number of positioned Treasury bills, which accounted for some of the bill trading profits mentioned earlier.

This month Water Resources had an opportunity to do an unscheduled refunding which brought the bond proceeds in on one day and sent them out the next day. The original refunding size wasn’t a problem for the portfolio when it was $300 million, but the refunding was so well received by investors that DWR continued to build it to $2.5 billion. Unfortunately, this upsizing ongoing meant the portfolio would have to invest bond proceeds of $2.5 billion overnight. Staff determined that because of the Treasury bill curve, it was prudent to use the proceeds of the refunding sale to increase bills, while the proceeds of bill sales the following day were used to meet the refunding obligations.

The only downside in having large positions in Treasuries is that once the Fed does decide to tighten monetary policy, if they move aggressively (which isn't expected) treasury positions will lose market value. However, because of our investment strategy of stair-stepping our purchases of year bills, there are large positions of Treasury bills maturing every month. Even though most excess cash has been earmarked for bill purchases, there is a positive cash flow in June of over 10 billion dollars.

One area of investment that was expected to benefit the portfolio was the floaters staff purchased ongoing using the 3 month LIBOR as the reset index, which is a European basket of bank rates. When many of the Yankee banks were having credit problems, or were exhibiting the potential for problems, we were buying AAA agencies with their floating rates set off of troublesome Yankee bank index. When 3 month LIBOR dipped down to the low 0.20s% we stopped buying the floaters. Now LIBOR is sitting at 47 basis points for 3 month LIBOR, because the European problems have come to fruition. With the LIBOR increase from 0.22% to 0.47%, we are picking up 25 basis points without swapping AAA agencies for risky investments. The best floating rate agency investment so far is the green bond bought one and half years ago from the World Bank. The negotiated investment in the World Bank was for $300 million, AAA rated, and was the first dollar denominated green bond issued. Staff negotiated +22.5 basis points off of 3 month LIBOR, so recently due to the LIBOR increase we have a AAA World Bank bond yielding 70 basis points for 3 months. Dan stated that he likes where the portfolio is as far as composition, average life, and cash flow. The AB55 Loans are not a problem because they are neither being increased nor initiated as new loans. The general fund continues to use its general fund borrowing ability but it is a considerably smaller percentage of the portfolio.

LAIF Operations

Pam Milliron reported:

- The quarterly apportionment rate for December 31, 2009, was 0.60% with administrative costs of .50% of earnings.
- The quarterly apportionment rate for March 31, 2010, was 0.56% with administrative costs of .50% of earnings.
- As of April 30, 2010, there were 2,779 participants in LAIF. This total includes 1,797 Special Districts, 54 Counties, 474 Cities, 291 Trustee accounts and 175 bond accounts.
- LAIF was approximately 37% of the total PMIA with a current balance of $23,244,018,714.34.

AGENDA ITEM 5: Public Comment

None

AGENDA ITEM 6: Other Business

AGENDA ITEM 7: Adjournment

There being no further business the meeting was adjourned at 2:20 p.m.