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DATE: March 9, 2009

TO: Hon. Board of Supervisors

FROM: Lee Buffington

The County Treasurer's Office is pleased to respond to the
Risk Analysis of the Treasurer's Investment Pool.

Our response will be in three sections, the areas of agreement, philosophical issues, and issues for consideration in the revised Investment Policy.

In the Areas of Agreement, I have simply quoted the statements from the Analysis.

Areas of Agreement:

Report Outline, page 2.

- "We did not identify any securities in the portfolio, as of January 5, 2009, that represent an immediate risk to the County."

Investment Policy Compliance – Overview, page 3.

- "Overall, the Investment Policy's provisions are consistent with the California Government Code."
- "The portfolio is in compliance with the requirements of the County's Investment Policy."

Investment Pool Compliance, page 8.

- "The sector allocations are all within the County's Policy limits."
- "All securities are within the Policy's credit rating limits."
- "The maximum maturities of all investments are within Policy requirements."
- "All securities are within the Policy's issuer requirements."

Overall Credit Quality, page 12.

- "This overall credit profile is consistent with a short term, high quality portfolio."

Market Risk Maturity and Duration, page 13.

- “The current duration of the County’s investments appear reasonable for the purpose and objectives of the County Pool.”

Market Risk Maturity, page 14.

- “The Pool’s current weighted average is reasonable given the County’s primary investment objectives of safety and preservation of principal.”

Risk Profile, Call Risk, page 15.

- “The amount and types of call risk in the portfolio appear reasonable and in keeping with the County’s overall investment objectives.”

Risk Profile, Liquidity, page 16.

- “The portfolio appears to maintain adequate liquidity.”

Risk Profile, Liquidity, page 17.

- “The largest current unrealized losses on corporate securities total \$14.3 million. Less than ¾% of the County’s portfolio.”

Risk Profile, Sector Diversification, page 19.

- “The portfolio is generally well diversified by sector/type. These allocations are generally well diversified and have high credit quality.”

Risk Factor by Sector, U.S. Treasuries, page 20.

- “The County maintains a very low allocation to Treasuries, the security type with the least amount of credit risk. Generally, we recommend diversified portfolios that include Treasury securities. Although low risk from a credit perspective, at current rates, there is more interest rate risk than usual in Treasury securities.”

Risk Factor by Sector, Federal Agencies, page 22.

- “The County’s Federal Agency holdings make up 40% of the overall portfolio and are well diversified among different issuers.”
- “Agency mortgage portfolios remain well diversified and historically, have experienced significantly lower credit losses than bank portfolios.”

Risk Factors by Sector, FDIC Guaranteed Corporate Notes, page 24.

- “Debt issued under the TLGP has been widely accepted by the market, and there are no current problems with these holdings.”

Risk Factors by Sector FDIC Guaranteed Commercial Paper, page 25.

- “The overall allocation to General Electric in the County Pool is 7% given that the GECC Commercial Paper holding here is FDIC guaranteed, the 4% in this instrument represents minimal risk.”

Negotiable Certificates of Deposit, page 26.

- “The credit profile of CDs meets the criteria established.”

- “Given the size and quality of these banks, the County should have a relatively high degree of comfort in these CD holdings.” (page 27)

Repurchase Agreements, page 28.

- “The allocations of the County Investment Pool to repo are fully exposed to Bank of America.”
- “The County executes repo agreements with a well supported counterparty. The Bank of America currently represents an appropriate counterparty.”

Commercial Paper, page 29.

- “The overall portfolio’s allocation to commercial paper is only 3%. Issuer concentrations are reasonable and the County’s commercial paper holdings are well diversified among issuers. Each issuer makes up less than 2% of the overall portfolio.”

Bankers’ Acceptances, page 30.

- “The County maintains exposure to Bankers’ Acceptances from just one issuer, Bank of America. The credit rating of Bank of America’s short term obligations remains very high at A1 (from S&P).
- “The County should consider Bankers’ Acceptances along with other short-term high quality money market instruments for the County Pool.”

Corporate Notes, page 31.

- “The current corporate note holdings are well diversified among issuers, credit rating, and structure. There are large allocations to A rated securities which represent heightened credit risk in the current market.”
- “Floating rate securities immunize a portfolio against interest rate movements, but they do not avoid basis risk relative to the index that they float off of. Furthermore, they are exposed to credit risk consistent with their final maturities.”

There are a number of clean-up issues that PFM suggest for the Investment Policy with which we are in total agreement.

Philosophical Issues:

Corporate securities in the County Pool are managed on a “buy and hold” philosophy which in essence says we buy securities to match our requirements. Our primary interest is that we know the money will be there when we need it. The Treasurer’s primary responsibility is to protect principal and pay the bills when they come due. The variations in price and/or ratings (within reason) during the period we are holding the security, are not as significant to us as our knowledge that the issue will pay off at par on maturity.

For the afore mentioned reasons, suggestions like “the County should consider the trade-offs between continuing to hold securities that could be downgraded, but probably will not default, and selling these securities now at losses due to their depressed market values”, we would not disagree with the suggestion, but our criteria for making the decision might be different than the authors.

There are a number of suggestions for adding more specificity to the Investment Policy, such as the firms with whom we will do business for specific products, the criteria for allowing withdrawals, the approved broker list, shortening the allowed maturity for any security to 5 years etc. We recognize the Investment Policy performs two functions, it is a working document and it is a vehicle for transparency. We do not disagree with the idea behind any of the suggestions made by PFM, but we are running a very dynamic business in a market where there are firms that we can do business with today that may be gone tomorrow. It is essential that the Policy be flexible enough for us to do our job, specificity can take that flexibility away.

The problem of a maximum maturity for any security is particularly difficult as PFM points out “the County may still want to permit the use of longer-maturity securities for special purpose investments”. Our present practice is a maximum of 5 years for any security with a maximum Pool average maturity of 2 years or less. However, when we get into a different interest rate environment, this may not be in the Pools best interest.

The County Pool does security lending with one firm, Bank of New York. The contract with BONY specifies all of the conditions under which these transactions take place. We periodically revise this contract to improve our pricing and/or reflect a change in the market. It does not seem practical to include all of the terms of that contract in the Investment Policy.

Areas for Debate:

The PFM report listed three securities of possible areas of disagreement, the first two questioned if the inclusion of BP and Deutsche Bank in the County Pool met the requirements of Government Code 53601 (k). The basis for this question was a listing in Bloomberg that indicated the country of origin for BP was England and Deutsche Bank was Germany. We looked at the prospectus for both issues. On page 5 of 65, BP’s prospectus reads “the notes and the guarantee are governed by New York law. Any legal proceeding arising out of or based upon the indenture, the notes or the guarantee may be instituted in any state or Federal court in the Borough of Manhattan in New York City, New York. For the Deutsche Bank Series A notes, page 7 of 64, the prospectus reads: “The Series A notes issued under our Series A program will be governed by the indenture (the “indenture”) among us, Law Debenture Trust Company of New York, as trustee, and Deutsche Bank Trust Company Americas, as issuing agent, paying agent and registrar”.

We feel this meets the requirements of 53601 (K) which read in part, (securities) issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States, are authorized for investment.

The third area of potential disagreement occurs with the statement, “Pfizer Inc. CP may not have been eligible for purchase by the County as it is a Private Placement issued under 4(2) and/or 144A, which may only be sold to “Accredited Investors” and/or a “Qualified Institutional Buyer”. From our standpoint, the important words here are “Qualified Institutional Buyer”.

The SEC defines a “Qualified Institutional Buyer” as having ownership of at least \$100 million and must fall into one of several categories which include employee benefit plans and trust funds. The University of Cincinnati, College of Law is more explicit in describing governmental entities as “any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions for the benefit of its employees”.

A “Qualified Institutional Buyer” is generally defined as a buyer with over \$100 million in assets under management. We have \$2.6 billion under management, and we are organized for the benefit of the County and its employees.

All other suggestions in this report are currently being considered for inclusion in the County Investment Policy.

cc: David Boesch
Reyna Farrales