

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

**Minutes
October 26, 2004**

Director of Investments Daniel Dowell, acting as Chairperson for State Treasurer Phil Angelides, called the Local Investment Advisory Board (LIAB) meeting to order at 1:30 p.m. on Tuesday, October 26, 2004.

AGENDA ITEM 1: Roll Call

LIAB Members present were Russ Branson, Patricia Elliott, Byron Scordelis, Leslie Wells, and Daniel Dowell representing State Treasurer Phil Angelides. A quorum was present. The State Treasurer's Office staff in attendance were LIAB Executive Secretary Ted Eliopoulos, Christine Solich, Eileen Park, and Kim Lee.

AGENDA ITEM 2: Approval of the Minutes

The minutes for May 19, 2004, were approved as submitted with a motion by Mr. Wells and seconded by Mr. Branson.

AGENDA ITEM 3: 2004 Annual LAIF Conference

Ms. Park briefed the Board Members on the LAIF Annual Conference that would commence on Wednesday, October 27, 2004, at the Sacramento Convention Center and conclude with the post-conference tour at the State Treasurer's Office on Thursday, October 28, 2004. Ms. Park stated that the final LAIF conference agenda was available in the meeting packets for Board Members information.

Ms. Park thanked Board Members for their cooperation and flexibility in rescheduling the conference from the original dates of October 21 and October 22, to October 27 and October 28. The change was necessary due to scheduling issues between the convention center and the State Treasurer's Office.

Ms. Park stated the staff was still receiving registrations the morning of the Board meeting. Ms. Park reported that as of the morning of October 26, 2004, there were 151 registered participants: 131 attendees were LAIF participants and 20 were attendees from banks, State Controller's Office, and the State Treasurer's Office. The registered LAIF

participants represent 62 special districts, 33 cities, and 8 counties. Ms. Park also reported that 47 percent of the registered LAIF participants were first-time attendees.

There were 42 people signed up to attend the post-conference tour at the State Treasurer's Office in the Investment Division on Thursday, October 28, 2004, at 7:00 a.m. A tour was arranged for representatives of Sacramento-area state and local agencies during the previous week to relieve some of the overcrowding for the tour.

Ms. Park stated that the conference agenda was changed to incorporate some of the Board's wishes, as was discussed at its last meeting on May 19, 2004. Concurrent sessions were added to the program for a legislative update and for a technical assistance segment. Attendees that do not wish to participate in either session may elect to leave early.

Mr. Dowell asked if separate rooms were available to accommodate these concurrent sessions.

Ms. Park stated that the legislative update session would take place in the main conference room with microphones and the podium. The session will be presented by Frank Moore of the California Debt & Investment Advisory Commission (CDIAC) and Vince Amado representing the California Municipal Treasurers Association (CMTA). The technical assistance session conducted by the Investments and LAIF staff will take place in the registration area. Ms. Park stated that using the registration area for the technical assistance session would not accrue additional costs for the conference.

Mr. Wells inquired if chairs would be available for individuals that wish to attend the technical assistance sessions. He stated that with 53 first-time attendees, many attendees might be interested in the technical assistance session.

Ms. Park responded that chairs would be available for the technical assistance session and would be moved to the area by the Investment Division staff.

Mr. Branson asked how conference registrations compared for 2003 and 2004.

Ms. Park stated that past conference attendance totaled approximately 200 registered attendees, which included LAIF participants, bank representatives, State Controller's Office staff, and the State Treasurer's Office staff. She stated that the 2004 conference had about 20 fewer registrations than in previous years. She further stated that many local governments usually met for their regular business meetings on Wednesdays. The conference may have lost some attendees by changing the conference from a Thursday-Friday schedule to a Wednesday-Thursday schedule. In addition, CDIAC was conducting a bond financing conference in southern California on October 26, 2004. While attendance at both the LAIF and CDIAC conferences were a little lower, attendance was good considering the other demands on local agencies' resources.

Mr. Wells stated that the number of attendees registered to attend the conference is outstanding considering that local agencies' travel budgets have been cut.

Ms. Elliott asked if Board Members should arrive early to greet the attendees.

Ms. Park responded that Board Members should arrive early. She further stated that she would introduce all the Board Members and the LIAB Executive Secretary Ted Eliopoulos at the beginning of the program. Ms. Park asked Board Members to assist her with covering the conference room during the question and answer period during each session. Ms. Park requested that Mr. Wells lead the audience with the Pledge of Allegiance.

Mr. Wells stated that the question and answer format was done well last year. He stated that many attendees have valid questions but may be shy about asking their questions on an open-microphone in front of 200 people.

Ms. Park stated that the 2003 conference evaluations showed that many attendees appreciated the ability to ask question in this format.

Ms. Elliott stated that she observed that this format allowed for good interactive communication between speakers and the audience during the LAIF Conference.

Ms. Park stated that the agenda for the 2004 LAIF Conference and a list of current conference and tour attendees were included in the meeting packet. The last session of the conference would end at 3:45 p.m. for those that remain for the legislative update and technical assistance session or at 3:15 p.m. for those who chose not to attend either concurrent sessions.

AGENDA ITEM 4: Overview LAIF Operations and PMIA Performance

PMIA Performance

Ms. Solich, the newly appointed Assistant Director of Investments, introduced herself to the Board Members and provided a brief history of her tenure at the State Treasurer's Office, which began in 1991.

Ms. Solich reported that the PMIA had \$53.3 billion in assets as of October 26, 2004. She further reported that the average life of the portfolio was 182 days, the daily rate was 1.89 percent, the quarter-to-date rate was 1.88 percent, and the year-to-date rate was 1.72 percent. LAIF participants received their earnings for the quarter ending September 30, 2004, which were apportioned at 1.67 percent.

Ms. Solich reported that the most significant portfolio event that took place during the last six months was the sale of the \$6 billion revenue anticipation note (RAN), which settled on October 6, 2004. The proceeds were invested to cover short-term cash flow needs and to provide liquidity for LAIF's participants. Due to the recent Federal Reserve

Board (Fed) tightening, the investment staff took advantage of the monetary policy moves by investing in securities that laddered out two years.

Ms. Solich stated that due to the large sum of money coming into the Central Treasury System, investment managers completed approximately \$2.7 billion in forward settlement transactions. Managers invested \$600 million in six-month Treasury Bills that yielded 1.95 percent and matured in March 2005 and about \$700 million was invested in 2-year Treasury Notes, which yield 2.65 percent. About \$400 million was invested in Federal Agency Notes maturing in 1.5 to 2.5 years, which yielded between 2.73 percent and 3.11 percent, which took advantage of the rising interest rate environment. Ms. Solich also reported that \$1.3 billion was invested in Yankee CDs and Domestic Bank Notes which yielded 1.85 percent to 1.95 percent, to cover short-term cash flow needs of the State and local agencies.

Ms. Solich reported that on October 6, 2004, the settlement date for the RAN issue, \$1.1 billion was invested in Yankee CDs that would mature in March 2005, to yield between 2.03 percent to 2.1 percent. Another \$500 million was invested in Commercial Paper, which would yield approximately 2.00 percent to cover cash flow dates between October 2004 and March 2005.

Ms. Solich stated that the proceeds from the \$1 billion General Obligation Bond sale settled on October 21, 2004, and those proceeds were invested to cover short-term cash flow needs out to March 2005.

Ms. Solich reported that the portfolio has positive cash flow over the next 3 months and approximately \$3 billion in securities maturing each month to cover LAIF and other state short-term cash flow needs.

The Fed is expected to continue increasing rates. The Fed Funds rate is expected to be approximately 2 percent by the end of the year and between 3.5 percent and 4 percent by the end of next year.

Ms. Solich reported that Leann Gonsalves, one of the Investment Division's key employees, returned to work in September after a one-year medical leave. Portfolio manager Donna Lucas remains on long-term medical leave.

Ms. Elliott asked how much money would be available for the post-conference tour to invest.

Ms. Solich estimated that about \$1.6 billion would be available for investment on the morning of October 28, 2004, for the post conference tour.

Mr. Branson asked if investment managers would invest funds shorter in anticipation of Fed tightening.

Ms. Solich stated the investment managers have been, and would continue to, ladder out its investments as interest rates rise. This strategy allows the portfolio to react quicker as interest rates increase.

Mr. Dowell stated that his conference presentation would cover how investment managers are investing during the rising interest rate environment. He would explain the strategy of “bar belling” the portfolio. While with each investment, investment managers are not putting equal weight on each end of the barbell, but additional weight was put on the short end, which would enable the portfolio to increase as the Fed increases. He stated that there was advantage to the Feds announcing exactly what they would do in tightening monetary policy. With this information the Investment Division team could put the portfolio in a comfortable position to move up the yield curve as rates increase and keep liquidity for those that feel that the rate on the PMIA portfolio is not increasing fast enough.

Mr. Wells said that there would be questions from the conference attendees about the Pooled Money Investment Account’s continued investment into Freddie Mac (FHLMC) and Fannie Mae (FNMA) given the current investigations of those agencies. Questions may arise about the credit quality of the securities and how the investment managers are viewing the investigations.

Mr. Dowell stated that the problems facing both FHLMC and FNMA are two different issues. FHLMC accounting practices resulted in a restatement to the positive side and the agency would be required to increase their capital. According to industry findings` and analysis, FNMA may have to restate earnings because it appears they have pushed off some negative performance numbers so that targets would be reached to create benefits and bonuses for the upper management.

Mr. Dowell stated that FNMA would be investigated for this reason. Until the Securities Exchange Commission and Congress comes to a conclusion as to what should be done, investment managers will hold off on buying any more FNMA securities. Fannie Mae still has a AAA-rating on their senior unsecured debt, which is what the PMIA portfolio owns. Managers do not feel that FNMA, as an institution, is in jeopardy of going down. Managers would not liquidate or sell any of the portfolio’s FNMA holdings, but managers will not buy new FNMA securities. The portfolio holds about \$4.7 billion in Agencies, with approximately \$600 million in FNMA securities with the longest maturity in July 2007.

Mr. Dowell stated that the situation with FNMA is not an institutional problem and that he anticipated that the settlement would include replacing some of the leadership, as opposed to additional regulations. Oversight of FNMA would be increased but this would not limit FNMA ability to compete in the market. He further stated that Chairman and CEO Franklin D. Raines would probably be removed.

Mr. Dowell stated that 15 percent of the portfolio was comprised of agency discount notes. About \$4 billion were FNMA discount notes and about \$4 billion were FHLMC

discount notes. The longest discount FNMA note maturity is February 28, 2005, and the longest FHLMC discount note matures in March 2005.

Mr. Dowell stated that he had only one question from a county treasurer at the California Association of County Treasurers & Tax Collectors (CACTTC) Conference in Ventura regarding FNMA. The county treasurer wanted to know if their county's funds deposited with LAIF were at risk due to FNMA being in the PMIA portfolio. He explained the issues to her, just as he did during this Board meeting, and she was satisfied with her investment decision to stay in LAIF.

LAIF Operations

Ms. Park provided standard graphics for LAIF operations and PMIA performance. Ms. Park reported that LAIF continues to be approximately 40 percent of the portfolio. The apportionment rate for the quarter ending September 2004 was 1.67 percent and administrative cost remains under the cap of one-half of one percent of earnings for the quarter, which is equivalent to less than one basis point of earnings. When the Fed started to increase their rates, the LAIF balance was about \$21.9 billion at the end of June 2004, and as of October 26, 2004, the balance was \$19.3 billion. Even as the LAIF deposits decrease, the LAIF continues to be about 40 percent of the total PMIA portfolio. Ms. Park stated that she felt the program is working the way it should as an investment alternative for local agencies. Voluntary funds deposited in LAIF are being withdrawn for various reasons and some withdrawals are due to lags in transfers of State monies to the local level. Participation in LAIF remains stable.

Mr. Branson stated that during the last Board meeting, there was some concern regarding low rates and the program's ability to keep costs below the statutory limit. He asked if the increasing rates have alleviated some of those concerns.

Ms. Park responded that due to increasing rates, the program has had some relief. Staff monitors the budget and spending closely to ensure that costs are limited to the State Controller's Office and the State Treasurer's Office.

Ms. Park reported that Mr. Dowell and she attended the CACTTC Conference in Ventura in mid-October. Ms. Park stated that this was the first conference Mr. Dowell attended as the new Director of Investments and that many attendees were pleased to see him in attendance. Mr. Dowell and she had the opportunity to talk to many of the county treasurers as well as their staff that invest with LAIF.

Ms. Park reported that the *LAIF Answer Book* was posted on State Treasurer's Office website in August 2004. Posting the *LAIF Answer Book* and the quarter-end updates to the website would save the LAIF program printing and postage costs. Ms. Park also reported that the Information Technology Division (IT) worked with Douglas Spittler, staff to the Pooled Money Investment Board, and the LAIF staff to develop a new web page for the Pooled Money Investment Account/Local Agency Investment Fund. The new web page was migrated to the State Treasurer's Office website on Friday, October

22, 2004. This web page would provide a more accurate representation of the State's investment Pool and demonstrate that LAIF is a part of the Pool. Ms. Park informed Board Members that a copy of the web page was included in the meeting binders. A copy of the web page would be included in the conference packages and Ms. Solich would discuss the new website at the conference.

Ms. Elliott stated that the new format makes it easier to find LAIF information. Many local agencies forget to log on to the website to access the information that is available. Ms. Elliott suggested that in the future the ability to store local agencies emails be made available in order to send out reminders to local agencies regarding website updates. She also suggested that investment and LAIF staff continue to attend local government association meetings and stay in touch with participants since we provide a unique service for local governments.

Ms. Park also reported that the LAIF Oracle application was recently updated to a more current version of Oracle. The testing and conversion was uneventful due to the hard work of the State Treasurer's Office IT programmer, Bob DeYoung and cooperation from the LAIF staff. The upgrade provided the impetus to improve the performance of the application. One such improvement was a change in the assignment of confirmation numbers to transactions. The change would process transactions more quickly, as the confirmation numbers would no longer be random and unique but sequential and unique. This change would require the system to produce seven-digit confirmation numbers. The migration of the Oracle upgrades and the program for the new confirmation numbers would be done on Thursday afternoon, October 28, 2004, after the LAIF Conference and tour.

Ms. Park stated that the investment managers have already been approached to provide presentations and assistance to some of the local government association conferences in the future. She stated that she recently assisted the League of California Cities in making contact with a global economist for their financial management seminar, which would take place on December 1-3, 2004, in the Monterey area. She also stated that she had been approached by the CMTA to do a presentation at their annual conference, which would take place in San Diego during April 2005.

Mr. Scordelis asked what would happen to the LAIF balances over the next couple of years, if the Fed Funds rate increases from 2.00 percent to 4.00 percent.

Mr. Dowell stated that the LAIF program experienced some decline in balances since the 75 basis point move by the Fed, although, the Pool had 42 basis point advantage prior to the Fed move. Mr. Dowell stated that as long as the Fed stays with measured gradual rate increases, there would be no massive exodus by participants. He said that with past experience when the Fed increased rates approximately seven different times in a year, as long as the portfolio performance was 3/8ths of a point within a 90-day period, the participants would stay with the fund. Some use LAIF to arbitrage against what they can do in the short area and those agencies will come into and go out of the program. Mr. Dowell stated that the portfolio was reacting quickly in response to the Fed and that the

Pool's daily rate is currently at 1.90 percent. He further stated that in the event that the local agencies wanted their funds to pursue increasing yields, 80 percent of the total LAIF is covered by positive cash flow, and not dependent on liquidating securities.

Mr. Branson stated that besides increasing interest rates for local governments, there are major shifts in the way local governments receives funds. Twenty-five percent of sales tax would be sent with property taxes as opposed to the monthly allotments, which creates cash flow problems. Due to the changes in the State allocations, local agencies have cash flow needs. There may be some deposits and withdrawals from LAIF in response to the allocation changes.

AGENDA ITEM 5: Public Comment

There was no public comment for this meeting.

AGENDA ITEM 6: Other Business

Mr. Dowell stated that Ms. Elliott had announced her retirement from the Eastern Municipal Water District (EMWD). He thanked Ms. Elliott for her time, help, counsel, and effort that she had given the LAIF program and the participants. Her public service has been truly outstanding and her knowledge and dedication would be difficult to replace.

Ms. Elliott stated that before the EMWD she served three cities, which totaled 19 years. She stated she had been with the EMWD for 15 years and has been on the LIAB since 1991. She stated her official retirement date would be June 22, 2005. Ms. Elliott extended best wishes to all the Board Members and expressed her appreciation to the Treasurer, Mr. Dowell and Mr. Eliopoulos.

Mr. Eliopoulos thanked Ms. Elliott for here service to the State Treasurer's Office and stated that Treasurer Phil Angelides would have some words of appreciation at tomorrow's conference.

Mr. Wells stated that it had been a pleasure serving with Ms. Elliott on the Board. He stated that Ms. Elliott should be commended for her dedication to this Board, local agencies, and the State of California.

AGENDA ITEM 7: Adjournment

There being no further business, the meeting was adjourned at 2:15 p.m.