

FINANCE OFFICER'S REPORT

September 30, 2005

To: Board of Directors

From: K. Suha Kilic, Finance Officer

Subject: **Investment of Reserve Funds Outside of the County Pool**

ISSUE

All District money is deposited in the Monterey County's Pooled Portfolio ("County Pool"), earning interest at the current portfolio yield of approximately 3.2%. If short-term interest rates continue to rise, the District may be able to increase interest earnings by investing a portion of its reserves outside of the County Pool. This may be achieved by investing that portion in securities with longer maturities with higher yields than shorter term securities held by the County Pool. On a previous occasion, in December 1999, the Board authorized the staff with the concurrence of the County Treasurer, to create a \$3.5 million custom portfolio outside the regular County Pool. The investment made pursuant to that authorization resulted in approximately \$45,000 additional interest earnings than what could have been earned in the County Pool during the 2000-2002 period. It is possible that if interest rates continue to increase, there may be another opportunity to augment interest revenue for the District. Advanced approval from the Board to establish a custom portfolio with a portion of District reserves will allow the staff to take action if the opportunity materializes.

RECOMMENDATION

It is recommended that the Board consider rescinding *Resolution No.99-28* and adopting *Resolution No.05-22* authorizing the General Manager in coordination with the County Treasurer to develop, under specified circumstances, a custom investment portfolio not to exceed \$7.0 million outside of the County Pool.

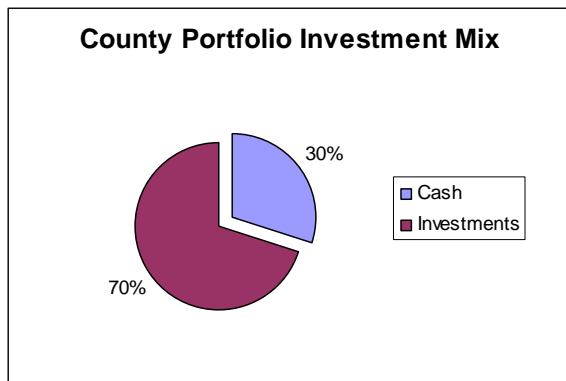
BACKGROUND AND DISCUSSION

California Government Code allows the Board to designate the County Treasury, or alternatively, a bank or a savings and loan association of its choice, as the depository of District funds (sections 61730 and 61737.2). The District has historically deposited all of its funds in the County Treasury. The Treasurer normally invests all District money in the regular County Pool which is comprised of deposits of the County, special districts and school districts. In 1999, pursuant to the provisions of the attached County Investment Policy (Section 10.0), the District requested the County Treasurer to invest a portion of the District money in a custom portfolio outside the regular County Pool, under the specific direction of the District. Following that arrangement, the Board authorized the General Manager to create a \$3,500,000 custom

portfolio for the District. The investments made pursuant to this authorization resulted in approximately \$45,000 additional interest earnings in years 2000 through 2002.

Since the end of 2002, no other custom portfolio was established: 1) in order to maintain the option of providing temporary financing for the Forest Lake Reservoir Project (any longer-term custom investments would have created a risk of selling securities prior to maturity and at a loss in a rising interest rate environment); and 2) because of the possibility the District would earn less than more liquid portfolios, such as the regular County Pool would, due to rapidly increasing interest rates. The staff now believes there may be an opportunity in the next few months to increase earnings by moving some funds to a custom portfolio. This is because interest rates may rise to a level where investing in securities with longer maturities than the average maturity of the County Pool may yield higher interest earnings. The following question and answer section provides more information on this issue.

How will the District earn more than the County Pool?



The County Investment Policy (section 4.2) requires the Treasurer to keep a minimum of 30% of the portfolio in cash to meet the operating demands of the pool participants. The remaining portion of the portfolio is invested in fixed income securities allowed by State Law as provided in the Appendix A of the attached County Investment Policy. Because all of the District's money is currently invested in the pooled portfolio, the "30% cash-70% fixed

income securities" ratio also applies to **all** District funds. At present, the District's cash flow needs would allow investing up to \$7.0 million of its money in relatively longer-term (two to three years) securities rather than keeping this amount in the County Pool. If interest rates continue to rise in the next few months, such investments may provide a better return than the aforementioned current "30%-70%" mix, especially if the investments could be made when interest rates are at high levels.

How much PBCSD money will be left in the regular County Pool?

As of August 31, 2005 the District has approximately \$11.7 Million in the County Pool. Within the next two years, it is anticipated that the District's balance will decrease to as low as \$10.5 million (in the months of November) and will be as high as \$15.5 million (in the months of December). If \$7.0 million is invested in a custom portfolio, it is estimated that the balance remaining in the regular portfolio will fluctuate between \$3.5 million (\$10.5 m - \$7.0 m) and \$8.5 million (\$15.5 m - \$7.0 m) and will be sufficient to meet the District's operational needs.

Why leave any PBCSD money in the regular County Pool?

The District requires sufficient liquidity (cash) to meet its operational needs. Similar to a checking account, all District money deposited in the regular County Pool is available for withdrawal anytime to pay for the District's expenses. In other words, it is 100% liquid. The rate of return of the County Pool regularly and significantly exceeds commercially available checking accounts due to its "30%-70%" investment mix as previously described (the Treasurer can do that because 30% liquidity has been sufficient to finance the operating expenses of the pool participants, allowing the other 70% to be invested in other instruments). Consequently, the District receives higher interest earnings while maintaining 100% liquidity in the County Pool.

Who will perform the investment transactions and other related duties?

The District General Manager and/or his designee will make the investment decisions and direct the County Treasurer to perform the transactions. The County Treasurer will be the custodian of the custom investments and keep them for the sole benefit of the District. The Treasurer will provide quarterly reports on the custom portfolio similar to the regular County Pool. He will not charge the District any fees for the duties related to establishing, maintaining and reporting on the custom portfolio.

What will be the type and maturity of the custom investments?

Custom investments will be limited to those instruments, maturities and maximum percentages stated in the Monterey County Investment Policy, which is in compliance with State law (see Appendix A of the attached Policy). The investments include obligations of the U.S. Treasury, U.S. government sponsored enterprises (GSEs) such as Federal National Mortgage Association ("Fannie Mae"), Federal Home Loan Mortgage Corporation ("Freddie Mac"), Federal Home Loan Bank ("FHLB") and Farmers Home Administration ("FHA") as well as "A" rated medium-term U.S. corporate bonds. In selection of the investments, the staff will consider acceptability of additional risks in comparison to the magnitude of the potential increase in returns provided by various types of permitted instruments.

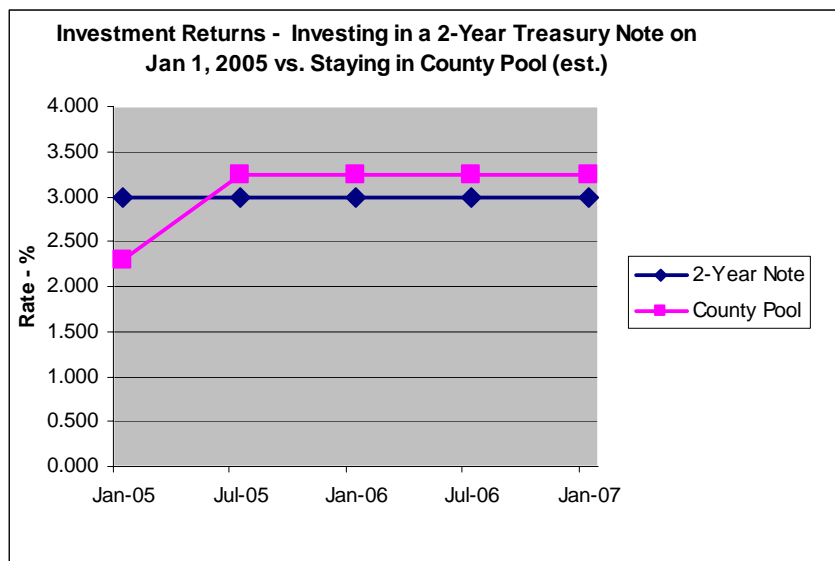
The maximum maturity of any single investment will not exceed five years and the weighted average maturity of the custom portfolio will not exceed three years.

What are the risks of a custom portfolio?

The two types of risks related to creating a custom portfolio are credit risk and market risk (also referred to as interest rate risk). "Credit risk" refers to the possibility of default by the issuer. The restrictions imposed by State law and County Investments Policy provide significant protection against credit risk. Notwithstanding, the staff believes that the District

must be very cautious in taking credit risks, because any single investment may represent a large portion of its relatively small sized portfolio. Consequently, the impact of a default would have more severe implications on its financial position than an agency with a larger portfolio. Therefore, in addition to restrictions imposed by State law and the County Policy, it is recommended the District impose a further restriction by limiting the amount that can be invested in instruments other than U.S. Treasury obligations ("credit risk free") to 50% of the amount authorized for the custom portfolio, or \$3,500,000.

Market risk is caused by increases in interest rates. The market price of a fixed income security changes in opposite direction of the change in interest rates. If, for example, interest rates increase, the market value of a previously purchased bond (or a note) goes down because newer bonds can be purchased at a higher yield. Consequently, if a need arises to sell a bond prior to its maturity, it may have to be sold at a loss. Based on a review of the District's cash flow projections and reserve requirements, the staff does not anticipate a requirement to sell an investment prior to its maturity.



Another possible yet smaller risk is that earnings in a custom portfolio may be less than what could have been achieved by remaining in the County Pool. Although it seems unlikely, this outcome is possible if interest rates continue to increase after the custom portfolio is created. A good example of this scenario occurred in 2005 when interest rates increased at a very rapid pace. The yield on two-year treasury notes increased from 1.6% to

3% between March 2004 and January 2005. On January 1, 2005, the 3% yield of two-year treasury notes appeared more attractive than the 2.3% yield of the County Pool. However, it is very likely that an investor who stayed in the County Pool will earn more than an investor who purchased two-year treasury notes at that time. This is because, as can be seen in the above chart, interest income from the two-year notes are fixed during their term while the return of the County Pool increased to 3.2% as of July 1, 2005 due to continued increases in interest rates. It is expected that the yield of the County Pool will possibly continue to increase, or at a minimum will be sustained, if the interest rates continue to increase. The purchaser of the two-year note will not only earn less, but will incur a loss, if the note has to be sold prior to the maturity date of January 1, 2007 because of the decrease in its market value. Therefore, it is important to be patient and fairly comfortable that: a) the note will not have to be sold prior to

maturity, and b) the interest earnings offered will likely provide a premium over the County Pool prior to making a purchasing decision.

What reward can be expected from a custom portfolio?

The reward from a custom portfolio will be additional interest revenue for the District. It will be measured by the amount earned in the custom portfolio in comparison to what could have been earned by remaining in the County Pool. For illustration, a 25 basis to 75 basis point premium over the County Pool will provide \$35,000 to \$105,000 additional interest earnings over a two-year period on a \$7,000,000 portfolio.

When will the custom portfolio be created?

When and if market conditions, as assessed by the General Manager, indicate that creating a custom portfolio within the concept presented in this report will likely provide higher interest income than remaining in the County Pool, the custom portfolio will be created. Advanced approval of the Board will allow the staff to take action, if and when such opportunity presents.

Encl.: [County of Monterey Investment Policy](#)

c: Paul Nowinski, CPA, Kasavan and Pope (PBCSD Outside Audit Firm)

Concur:

General Manager: RA Date: 9/23/05

Agenda Item No. 6

**PEBBLE BEACH COMMUNITY SERVICES DISTRICT
RESOLUTION NO. 05-22**

**RESCINDING RESOLUTION NO.99-28 AND AUTHORIZING ESTABLISHMENT
OF A SUPPLEMENTAL CUSTOM INVESTMENT PORTFOLIO NOT TO
EXCEED \$7,000,000 OUTSIDE OF THE MONTEREY COUNTY TREASURY
INVESTMENT POOL**

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WHEREAS, pursuant to *California Government Code Section 61730* the Board of Directors (“Board”) of the Pebble Beach Community Service District (“District”) has designated the Treasurer of the Monterey County (“County Treasurer”) to be the depository of District money, and said money is invested by the County Treasurer in the regular county treasury investment pool (“County Pool”); and

WHEREAS, in order to enhance interest earnings of the District, on December 22, 1999, this Board’s Resolution No. 99-28 authorized the General Manager of the District, in coordination with the County Treasurer, to establish a supplemental custom investment portfolio outside of the County Pool; and

WHEREAS, this Board, acting in its fiduciary capacity, has reviewed and considered a report prepared by District Finance Officer which concludes that a larger portion of the District’s reserve funds can from time to time be invested in a supplemental custom investment portfolio with specified guidelines, for the purpose of increasing interest earnings on the District’s reserve funds; and

WHEREAS, the County Treasurer has advised the District that a supplemental custom portfolio, comprised of securities permitted by *the California Government Code* and the *Monterey County Treasury Investment Policy*, can be maintained by the County Treasurer outside of the regular treasury investment portfolio if authorized by the District Board.

NOW, THEREFORE, BE IT RESOLVED by the Board of Directors of the Pebble

Beach Community Services District, that:

- 1) District Resolution No.99-28 adopted on December 22, 1999 is hereby rescinded.
- 2) The General Manager or his representative, in coordination with the County Treasurer, is authorized to establish a supplemental custom investment portfolio to be maintained by the County Treasury outside of the County Pool.
- 3) The amount that may be invested in the custom investment portfolio shall not exceed \$7,000,000.
- 4) Any single instrument that may be purchased for the custom investment portfolio must be in compliance with the type, maximum maturity and maximum percentage limitations established by the Monterey County Investment Policy.
- 5) The amount that can be invested in instruments other than obligations of the U.S. Treasury must not exceed \$3,500,000.
- 6) The weighted average maturity of the custom portfolio must not exceed three years.

PASSED AND ADOPTED by the Board of Directors of the Pebble Beach Community Services District, Pebble Beach, Monterey County, California, at a regular meeting held on **September 30, 2005**, by the following vote:

AYES: Directors:

ABSTAINED: Directors:

ABSENT: Directors:

ATTEST:

Gary D. Hornbuckle, Board President

Richard Andrews, Board Secretary