THE CITY OF LAKE FOREST

STATEMENT OF INVESTMENT POLICY

I. INTRODUCTION

The City Council of the City of Lake Forest recognizes its responsibility to wisely direct the investment of the City's funds on behalf of the City's existing and future residents. The City Council further recognizes that the City's investment assets are essential to the City's financial strength, the effective implementation of long range financial plans, and ultimately its ability to respond to the needs of the community.

The investment policies and practices of the City of Lake Forest take into consideration the City's particular needs including the City's risk-avoidance, size of portfolio, number and qualifications of staff, and other relevant factors. This Statement of Investment Policy ("Policy") is based upon principles of prudent money management and Federal and State laws. In instances in which the Policy is more restrictive than Federal or State law, the Policy supersedes.

This Policy sets forth procedures and practices which shall govern the investment of the City's funds. The Policy will be used by the City's Treasurer, other City officials and staff, as well as all other third-party providers of investment or investment-related services. Its purpose is to direct the prudent investment and protection of the City's funds and investment portfolio.

II. INVESTMENT GOALS

The City's investment goals are to:

- Maintain the principal value of assets entrusted to the City.

- Safeguard and protect the City’s investment portfolio and funds.

- Ensure that the City has adequate cash to meet budgeted expenditures, including an additional amount to cover reasonably estimated contingencies.

- Earn a reasonable market rate of return consistent with the primary objectives of safety and liquidity.

- Increase the value of funds within the City's general fund category over time by reinvesting 100% of the interest earnings into the investment portfolio for the purpose of building a financially-strong City and establishing and maintaining funds required for important future City projects.

- Minimize the City's working capital needs and increase interest earnings by investing a high percentage of idle cash with the exception of compensating balances required to pay the City's primary bank for banking services.

- Assure ongoing compliance with all Federal and State laws governing the investment of moneys under the control of the City Treasurer.

III. DELEGATION OF AUTHORITY

The City of Lake Forest's Resolution No. 92-34 appoints the Director of Finance to serve as the Treasurer. It further authorizes the Treasurer to invest or deposit the City's funds in accordance with California Government Code Sections 53600 and 53630 *et seq.* and all related State and Federal laws.

In the Treasurer's absence, the Treasurer will assign investment responsibilities to City staff. The Treasurer will provide prior written notification to the City Manager and the City Council regarding the designation of responsibilities. In the event that the Treasurer is unable to assign responsibility, the City Manager will select an interim Treasurer.

The responsibility for establishing, monitoring, and maintaining a strong system of investment controls and directing an independent audit of the investment function is delegated to the City Manager. The City Manager's designee(s) may assist in carrying out these functions.

The City Council's primary responsibilities over the investment function includes establishing investment policies, annually reviewing such policies, reviewing monthly investment reports issued by the

Treasurer, authorizing bond documents and other unique financing transactions, and authorizing any deviations from the Policy.

IV. SCOPE

This Policy applies to all funds except investments related to the City's Deferred Compensation Plan. Investments related to debt issued will be governed by Sections I, II, III, and Sections X through XVI unless a separate policy is adopted by the City Council. With regard to the Deferred Compensation Plan, investment decisions are made by the individual participant for their own deferred funds.

All funds, except as noted below in this Section (IV Scope), entrusted to the Treasurer will be aggregated in a diversified fixed income and money market portfolio with the exception of any endowments, trusts or grants or other funds which are legally required to be invested in a segregated investment account. The dollar amount of each of the City's fund's principal investment will be recorded in the City's accounting records. Interest earned or accrued and capital gains or losses will be allocated to the individual funds based on the principal invested and average overall return on the portfolio consistent with governmental accounting standards.

Subject to this Policy, the Treasurer is authorized, at his/her discretion, to make specific investments for specific funds when special funds have been set-aside for long-term purposes.

Investments related to debt issues will be invested by the Treasurer in accordance with each issue's respective bond indenture provisions. Investments related to the City's Deferred Compensation Plan (“Plan”) are managed by a third-party administrator and investment and mutual fund selection is directed by the individual Plan participants.

V. INVESTMENT PHILOSOPHY

The City's investment philosophy, policies, practices and procedures are conservative in order to minimize risk.

"The City Council or persons authorized to make investment decisions on behalf of the City investing public funds pursuant to Chapter 4 of Division 2 of Title 5 of the Government Code are trustees and therefore fiduciaries subject to the prudent investor

standard. When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the City."

Any investment officer exercising his/her authority and acting pursuant to the Prudent Investor Rule, in accordance with the City's Policy, will not be held personally liable for any individual investment losses or for total portfolio losses.

The fundamental principles of the City's conservative philosophy are:

- Diversification of the portfolio by investment type.
- Limits on the amount which can be invested in any one type of investment and on the maximum which can be invested in any one issuer.
- Minimum quality standards for securities' issuers.
- Limits on the maximum maturity of any one investment and monthly reporting of the weighted average maturity (WAM) of the portfolio.
- Passive investment strategy.

Accordingly, the City's philosophy prohibits speculation; i.e., the purchase of securities with the intent to profit from favorable changes in market prices or market conditions. Leveraging or borrowing money for the purpose of investing is specifically prohibited.

The City's passive investment strategy results in the practice of purchasing investments with the intent to hold each investment until its stated maturity. However, the City may elect to sell a security prior to its maturity and record a capital gain or loss in order to improve the quality, liquidity or yield of the portfolio in response to market conditions or City needs.

VI. INVESTMENT SELECTION OBJECTIVES

A. Safety / Preservation of Principal

The City's primary objective is to safeguard the principal value of investment assets. The Treasurer selects each investment based primarily on its relative degree of risk of potential loss of invested capital. Only investments which the fixed income markets generally ascribe a relatively low degree of risk compared to other investment alternatives are purchased.

B. Liquidity

The second objective is to meet the liquidity needs of the City of Lake Forest. Consistent with the City's conservative investment philosophy, all investments purchased will be traded in large daily volumes in the secondary market except for non-negotiable time deposits (Certificates of Deposit) and investment pools.

The City will maintain sufficient cash in the form of cash and short-term money market instruments which, together with projected revenues, will cover at least approximately six months of budgeted capital and operating expenses. To the extent possible, the maturity of investments selected will match the City's projected cash flow requirements.

C. Yield / Return on Investment

The third objective shall be to achieve a return on the funds under the Treasurer's control. Investments are selected based upon their suitability for a conservative, risk-averse public portfolio. Thus, investments are selected first on the basis of safety, marketability and maturity and *lastly* based on reasonable market rate of return based on the characteristics of the portfolio.

The market-average rate of return is defined as the average return on Treasury securities with a maturity which matches the weighted average maturity of the portfolio as tracked by common fixed income indexes.

VII. PORTFOLIO MATURITY LIMITS

The maximum maturity for any single investment purchase may not exceed five years.

Maturities will be selected based on a sufficiently detailed cash flow projection which facilitates selecting investment maturity dates to approximately match the projected dates for budgeted expenditures. Once cash flow needs are matched, maturity selection is based on a strategy of laddering maturities and the shape of the yield curve.

Additional maturity limits by investment type which may further restrict individual investment purchases are provided in Section VIII "Allowable Investments."

VIII. ALLOWABLE INVESTMENTS, QUALITY AND LIMIT GUIDELINES

All local agencies are governed by the California Government Code, Sections 53600 *et seq.* However, consistent with the City's conservative investment philosophy, the types of investments authorized for purchase by the City are further restricted. Limits governing the maximum amount by investment type and the maximum amount which can be purchased by a particular issuer are specified below.

Investments other than government bills, notes, bonds, and agencies are limited based on the quality rating of the issuing institution in order to minimize credit risk. It is to be expected that an issuer's rating may be downgraded from time to time. In the event that an issuer's quality is downgraded two grades below the City's minimum, the City will sell the investment. In the event an issuer's rating has dropped one grade, the Treasurer will use discretion in determining whether to sell or hold the security based on the current maturity, the loss in value, and the economic outlook for the issuer and other relevant factors. In no event will the Treasurer hold on to an investment solely to avoid an investment loss unless specifically authorized or directed by the City Council after full disclosure of the risks and advantages of such action.

A. United States Treasury Bills, Notes and Bonds

These are instruments issued by the U.S. Treasury. They are backed by the full faith and credit of the federal government.

U.S. Treasury issues are considered to be the safest of all investments. These securities are very liquid and marketable and they offer a wide range of available maturities.

Maximum: No limit

B. Federal Agencies

These are instruments issued by federally-owned or sponsored Agencies of the federal government. They have either the implied or guaranteed backing of the federal government.

Next to U.S. Treasury issues, Federal Agencies are typically considered the safest class of securities available. These securities are very liquid and marketable and they offer a wide range of available maturities.

Acceptable investments only include traditional fixed-income securities (notes and bonds) as more complex, structured products are not permitted.

Issuer Limits: 70% per Federal Agency or Government Sponsored Agency.

Maximum: No Limit

C. Bankers' Acceptances (BAs)

Bankers’ Acceptances (BAs) are a suitable short-term investment because they provide an attractive yield, and they are considered a relatively safe and liquid investment.

The Bankers’ Acceptance is a time draft drawn on and accepted by a bank for payment, of the shipment or storage, of merchandise. The initial obligation of payment rests with the drawer, but the bank substitutes its credit standing for that of the borrower and assumes the obligation to pay face value at maturity.

Quality: Only issuer's deemed "eligible" for purchase by the Federal Reserve Bank.

Issuer Limit: 5%

Maturity Limit: 180 days

Maximum: 20%

D. Time Deposits (Non-Negotiable Certificates of Deposit)

A Time Deposit is a non-negotiable instrument evidencing a deposit with a financial institution for a fixed period of time and normally for a fixed rate of interest.

The Federal Deposit Insurance Corporation can insure Time Deposits if issued by a bank, or the Federal Savings and Loan Insurance Corporation if issued by a savings and loan association.

Quality: Top 25% of peer group as independently rated.

Collateral Requirement: Amounts in excess of the $250,000 FDIC-insured amount are collateralized in accordance with the California Government Code.

Maximum: 30%

E. Negotiable Certificates of Deposit (Negotiable CDs)

A Negotiable Certificate of Deposit (CD) is a negotiable instrument evidencing a time deposit with a bank. Negotiable Certificates of Deposit shall not exceed the FDIC insurance limit of $250,000.

Quality: Top 25% of peer group as independently rated.

Maximum: 30%

F. Repurchase Agreements

Collateral Requirement: Securities acceptable as collateral shall be securities which are fully or de facto guaranteed as to principal and interest by the United States Government or any agency of the United States. The market value of securities that underlay a repurchase agreement must be valued at 102 percent or greater of the funds borrowed against those securities. Securities values must be marked to market weekly and be equal to their par value plus an additional standard market percentage. A signed master repurchase agreement shall be on file with the City of Lake Forest prior to execution of any repurchase trades.

Repurchase Agreements (Repo's) are one of the most flexible investments available to invest short-term funds and, when proper guidelines are followed, relatively safe.

A Repurchase Agreement involves two simultaneous transactions. One transaction involves the sale of securities (collateral) by a borrower of funds, typically a bank or broker/dealer in governments or agencies, to a lender of funds. The lender can be any investor with cash to invest. The second transaction is the commitment by the borrower to repurchase these securities at the same price plus a predetermined amount of interest on an agreed future date.

Collateral Requirement: Securities acceptable as collateral shall be securities which are fully or de facto guaranteed as to principal and interest by the United States Government or any agency of the United States. The market value of securities that underlay a repurchase agreement must be valued at 102 percent or greater of the funds borrowed against those securities. Securities values must be marked to market weekly and be equal to their par value plus an additional standard market percentage. A signed master repurchase agreement shall be on file with the City of Lake Forest prior to execution of any repurchase trades.

Maturity Limit: 92 days

Maximum: 10%

G. Commercial Paper

Commercial Paper is negotiable corporate dept, usually unsecured, and issued on a continuous basis for short time frames. Commercial Paper can offer some of the most attractive short-term rates available, odd amounts of funds can be invested and a wide range of maturities are normally available.

Issuer Limit: 5%

Quality: Highest rating category by a nationally-recognized statistical rating organization, and that satisfies California Government Code section 53601, subdivision (h).

Maximum: 25%

Maturity Limit: 270 days or less

H. Local Agency Investment Fund (LAIF)

The Local Agency Investment Fund (LAIF) allows local government agencies to obtain higher yields while maintaining safety and liquidity through pooling surplus cash with the State's surplus cash thereby creating a multi-billion dollar money pool and enabling investment in diversified instruments.

The LAIF fund is a special fund with the State of California's Treasury, created by law. The law permits local government agencies to pool surplus monies in this fund and utilize the trained personnel in the State Treasurer's Office for its investments.

LAIF investments in instruments prohibited by or not specified in the City's Policy do not exclude it from the City's list of allowable investments provided that the fund's reports allow the Treasurer to adequately judge the risk inherent in the portfolio.

Maximum: $50 million for each permitted investment account in accordance with LAIF requirements

I. ORANGE COUNTY INVESTMENT POOL (OCIP)

The Orange County Investment Pool (OCIP) allows local government agencies to voluntary invest surplus cash to obtain competitive yields while maintaining safety and liquidity thereby creating a multi-million dollar County investment pool that utilizes the trained personnel in the County's Treasurer's Office for its investments.

The Treasurer's foremost objective in investing public funds is to ensure that public funds are invested in a manner that provides for maximum security of principal and preservation of capital, while conforming to all Federal and State laws, statutes and resolutions government investment of public funds. The second objective is to maintain sufficient liquidity to enable participants to meet their operating cash flow needs. Liquidity is essential to the safety of principal. The third and least important objective is to obtain a market rate of return throughout budgetary and economic cycles within the investment policy risk parameters and cash flow needs.

Maximum: No limit

J. Investment Joint Powers Authorities

The City may invest in investment joint powers authorities provided that the City is a member, that the pool provides comprehensive, timely, monthly reports which include transaction listings, reports gains and losses, provides market values for securities, provides a quality rating for investment securities, takes delivery of securities prior to payment, third-party safekeeping of all investments, for whom an audit is conducted annually by an independent authority other than the local agency's internal auditors, and that leveraging of the portfolio is not permitted.

Maximum: 30%

K. <u>Money Market Mutual Fund</u>

Quality: Highest rating from not less than two of the three nationally-recognized rating services.

Maximum: 10%

Meet the criteria contained in Government Code Section 53601(l).

L. <u>Prohibited Investments</u>

State law not withstanding, any investments not specifically described herein including, but not limited to, medium term corporate notes, zero coupon bonds, first mortgages or trust deeds, customized mortgage- and asset-backed securities, derivatives, inverse floaters, common stock, equity investments, securities that could result in zero-interest accrual, range notes, collateralized mortgage obligations, interest-only strips, reverse repurchase agreements, unregulated and/or uninsured investment pools or trusts except as specified above, futures, options (excluding callable securities as described in Section VIII B), derivative securities and securities with high price volatility, limited marketability, where the interest accrual could be zero if held to maturity, are prohibited. Investment transactions which would impair public confidence in the Lake Forest City government are to be avoided.

IX. REPORTING

The Treasurer shall render a monthly report to the City Manager and the City Council within thirty (30) days following the end of the month covered by the report. The report shall provide the following information:

- Breakdown of portfolio by type of investment, showing dollar amount and percent of portfolio invested in each.
- Side-by-side comparison of the current portfolio to the Policy limits for type, maturity, issuer and quality.
- Annualized return and the weighted average maturity on portfolio.

- Annualized return and the weighted average to call on portfolio.

- Summary of market value by type of security and for total portfolio compared to book value.

- Breakdown by issuer within each investment type with actual vs. allowed percentages and most recent quarterly rating of issuer.

- Distribution of investments broken down by selling institution in dollar amount.

- Any funds, investments or programs, including loans, which are under management of contracted parties.

- Detailed listing of current holdings.

    - Shows book value, market value (with source at valuation), and par value as of the date of the report

    - Shows coupon or discount rate, yield to maturity, and total return

    - Shows type, issuer, seller, and safekeeping institution

    - Shows purchase date, actual maturity date, and projected maturity date

        - A statement denoting the ability of the City to meet its expenditure requirements for the next six months.

        - Summary of transactions, by category, of all purchases, maturities, and sales for the period.

        - Explanation of degree of interest rate sensitivity inherent in the portfolio.

        - Treasurer's compliance statement.

        - Narrative explanation of any significant changes.

X. QUALIFICATIONS OF FINANCIAL INSTITUTIONS WHICH SELL THE CITY INVESTMENTS

The Treasurer will obtain information from qualified financial institutions to determine if the institution makes markets in securities appropriate to the City's needs, can assign qualified sales representatives and can provide written agreement to abide by the conditions set forth in the City of Lake Forest’s Policy. The Treasurer will recommend to the Council three to six institutions for inclusion on the City's approved list. Any changes to the City's approved list of selling financial institutions must be reviewed by the City Council based on documented rationale. The Treasurer shall review the approved list every five (5) years. Investment accounts with all financial institutions are standard non-discretionary accounts and may not be margin accounts.

A. Broker/Dealers

The purchase by the City of any investment other than those purchased directly from the issuer shall be purchased from a broker/dealer firm that is on the City’s approved list. To be considered for placement on the City’s list, the broker/dealer must comply with the following:

1. Minimum capital of $10 million.

2. Be a “primary” or regional dealer and qualify under the Securities and Exchange Commission (SEC) Rule 15c3-1.

3. Be in operation for at least five (5) years.

4. Submit annual audited financial statements.

5. Submit a completed City of Lake Forest Broker/Dealer Questionnaire.

B. Banks

The City shall purchase securities from banks which are: (1) nationally or State chartered banks, (2) registered as investment securities dealers, and (3) ranked in the top twenty-five percent (25%) of its peer group as independently rated by a nationally recognized ranking service.

C. The Federal Reserve Bank

Direct purchases of bills, notes, and bonds from the U. S. Federal Reserve Bank branches are allowed and are exempt from quality requirements.

D. Investment Bankers, Underwriters and Financial Advisors

The purchase by the City of any investments from these providers in the course of completing a bond transaction must be expressly authorized by the City Council after such a provider discloses their commission, spread, or fee in approximate dollar amount. Otherwise, the acquisition of such investments must be procured from the broker/dealer customarily used by the City.

XI. QUALIFICATIONS FOR SAFEKEEPING INSTITUTIONS

The City will safekeep investments only with a Federal or State association (as defined by Section 5102 of the Financial Code), a trust company or state or national bank located within this State or with the Federal Reserve Bank, or with any state or national bank located in any city designated as a reserve city by the Board of Governors of the Federal Reserve System. Such safekeeping institutions must be rated in the top twenty-five percent (25%) of their peer group as ranked by an independent rating service and/or is ranked at least AA or Aa by Standard and Poor’s and Moody’s.

In the event an institution's rating is downgraded two letter rankings or drops in the lower sixty percent (60%) of its peer group, the Treasurer will conduct a Request for Proposal process for an alternative safekeeping bank which meets the City's criteria.

XII. INVESTMENT CONTROLS

The City Manager will implement and maintain a system of internal investment controls and segregated responsibilities of the investment function in order to prevent fraud, theft, loss of principal, loss of control over funds, inaccurate reporting, negligence, over-reliance on a single employee for investment decisions, controls, transactions, and recording and reporting. In addition to limits related to investment type, quality, maturity and amount, controls will include:

A. Safekeeping of Securities

Third-party safekeeping with an institution is required for all investments. Third-party safekeeping institutions may not act as custodians for any securities which that institution has issued or sold to the City.

Collateral should always be at safekeeping.

Payment procedures for all securities transactions will be delivery vs. payment.

B. Competitive Bidding of Investments

The City's investment procedures require that approved broker/dealers compete for investment purchases and sales in order that the City obtain the highest yield available in the market for a comparable investment and to ensure that all investment transactions are free from favoritism. A comparable investment represents a similar instrument maturing within 90 days of the first quote obtained.

For the purchase of original issuances of Treasury Bills, Notes, and Bonds, the Treasurer shall either rotate among the approved broker/dealers when obtaining one bid or accept the best bid when a minimum of two bids are solicited. For all other investments a minimum of two bids will be solicited. The City Treasurer shall determine the best bid for the City, if any, and act accordingly.

If a specific type of instrument is considered to be necessary for diversification by the City Treasurer, and only one authorized broker owns the targeted instrument, the City Treasurer shall have the authority to purchase the instrument.

C. Annual Management Review and Audit

An annual audit of the City's Policy, practices, procedures, and portfolio status will be conducted by an independent auditor of all items including, but not limited to, items specified in the Audit Checklist provided in the City's Procedure Manual. The auditor will provide the City with written observations and recommendations regarding the adequacy of investment controls.

D. Segregated Investment, Execution, Record Keeping, and Reporting

The Treasurer's investment execution records will be recorded (input) to the City's Investment System by independent City staff. The monthly reconciliation of the Treasurer's investment records to bank, broker/dealer and safekeeping confirmations will be performed by independent staff.

E. Secondary Approval for All Accounts, Agreements, Contracts, and Services

The City Manager will review and approve the establishment of all investment accounts, relationships with investment providers, and any agreements or contracts related to investments or investment-related services.

F. Wire Transfer Controls

All City wire transfers will be executed in accordance with a written agreement specifying control procedures required for wire transfers of funds; including establishment of repetitive wires to pay for securities transactions with approved securities dealers as well as any other routine money transfers. All other non-repetitive wires require City Manager or Assistant City Manager approval prior to release.

XIII. QUALIFICATIONS OF THE CITY TREASURER AND STAFF

The Treasurer for the City shall be a City employee. The Treasurer will be selected on the basis of educational background and experience relevant to the Treasury function. The City recognizes the need for and is committed to providing on-going education specific to the investment function for the Treasurer and other City staff and officials involved in the investment process.

XIV. POLICY REVIEW

This Policy shall be reviewed annually by the City Council, at a public meeting, to ensure it meets the changing needs of the City, is consistent with the overall objectives of preservation of principal, liquidity, and return, is relevant to current financial and economic conditions, and to ensure that the City's ongoing investment practices and procedures are consistent with the Policy. The City Manager, City Treasurer, and the City Attorney shall review the Policy for compliance with the State Government Code and other related laws prior to submittal to City Council.

Any changes, whether legislative or internal, which impact the Policy will be promptly reported to the City Council.

XV. CONFLICT OF INTEREST

Any firm proposing to provide any type of investment service to the City shall acknowledge their familiarity with the provisions of the Political Reform Act, (Government Code Section 81000 *et seq.*, and 2 Cal. Code of Regs. 18110 *et seq.*, hereinafter “PRA”) and the provisions limiting contractual conflicts of interest under Government Code Section 1090 *et seq.* Any firm proposing to provide any type of investment service to the City shall also acknowledge their familiarity with and agree to abide by any Federal or State law, regulation, rule, or policy pertaining to or limiting campaign contributions by such firms, their employees, spouses, and agents.

The provisions of the PRA shall continue to apply to require disclosure and disqualification by any City official or employee and shall apply to require disclosure of the same by any candidate for City office.

All persons, firms, dealers, brokers and advisors providing investment service or bond issue assistance shall disclose to the City Manager and the Treasurer all fee sharing, fee-splitting, and commission arrangements with other entities or persons prior to the City agreeing to buy an investment, or issuing bonds.

APPENDIX A
GLOSSARY

BANKER'S ACCEPTANCE (BA)

Banker's Acceptances (BAs) are instruments which arise from bank letters of credit used by importers to finance purchases of tangible goods from exporters. The letter of credit is transformed into a BA when the exporter's bank reviews, approves and stamps "accepted" on the draft. A BA is a short-term, negotiable, non-interest bearing note sold at a discount and redeemed by the accepting bank at maturity for full face value. BAs carry the issuer's pledge to pay, are backed by the underlying goods being financed and also carry the guarantee of the accepting bank. An active secondary market exists in BAs.

BROKER

A middleman who brings buyer and seller together and handles their orders, generally charging a commission for his/her services. In contrast to a "principal" or a "dealer," the broker does not own or take a position in the security.

BERMUDAN CALL

Securities that may be redeemed according to a pre-specified schedule (e.g., monthly, quarterly or semi-annually) after the initial lockout period.

CALLABLES

Securities that the issuer has the right to redeem prior to maturity.

CAPITAL GAIN/LOSS

Capital is another word for principal. At the purchase of an investment, capital is the cost for the security. It does not include any interest which may have accrued which is included in the total price of the security. At the time of sale, capital is the actual price received for the security. If the price is less than the price paid, a capital loss results. If the price is higher than the original price paid, a principal gain results. Actual or realized gains and losses are only realized at the time of sale, when a bonafide gain or loss occurs. Pursuant to Governmental Accounting Standards Board Statement No. 31 (titled "Accounting and Financial Reporting for Certain Investments and for External Investment Pools") (GASB #31), a change in the fair value of investments occurs at the end of the period based on the difference between the fair value (or commonly known as market value) at the beginning of the period and at the end of the period. The change in fair value is essentially an unrealized gain or loss.

CERTIFICATE OF DEPOSIT (CD)

See “Negotiable CDs” and “Non-Negotiable CDs.”

CODE

Refers to California Government Code Sections 53600 and 53630 *et seq.* and all related State and Federal laws.

COLLATERAL

Securities, evidence of deposit, or other property which a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposits of public monies. In California, State law requires that repurchase agreements, reverse repurchase agreements, non-negotiable CDs and public deposits be collateralized. Collateral used to secure these investments and public deposits can be any eligible security allowed by State law, ranging from U. S. Treasury securities to mortgages.

COMMERCIAL PAPER

Commercial paper is a promissory note, usually unsecured, issued for a specific amount and maturity on a specific date. Although commercial paper does trade in the secondary market, it is not quite as liquid as treasuries and agencies. Issuers and dealers of commercial paper will, in most cases, buy back their paper. The maximum maturity of commercial paper is 270 days, although, in practice, most maturities range from 1 to 180 days. Commercial paper is normally sold at a discount from face value. Most issuers back their paper with lines of credit from banks to protect investors from the issuer’s potential credit risk. Almost all commercial paper is rated with respect to credit risk.

DEALER

An individual or firm which ordinarily acts as a principal in security transactions. Typically, a dealer buys for his/her own account and sells to a customer from his/her inventory. His/her profit or loss is determined by the difference between the price he/she pays and the price he/she receives for the same security.

DELIVERY

There are two methods of delivery of securities: delivery vs. payment and delivery vs. receipt (also called free). Delivery vs. payment is delivery of securities with an exchange of money for the securities. Delivery vs. receipt is delivery of securities with an exchange of a signed receipt for the securities.

DERIVATIVE

Derivative securities are investments which are created or derived from other securities. A good example is a Treasury strip. Treasury notes and bonds receive interest every six months. Before electronic record keeping, the interest was represented by coupons attached to the physical note or bond. In order to receive interest, the investor presented the coupons. Therefore, Treasury notes, bonds and all other securities which pay interest semi-annually became known as “coupon securities.” When the principal and coupon portions of a bond are separated, the resulting parts are known as strips, because the coupons have been “stripped” away. What remains are two different investment types, the interest only strip and the principal only strip. These investments have very different characteristics than the underlying original security.

Other commonly used derivative securities include forward currency contracts, Treasury futures contracts and stock index futures contracts. Other commonly used derivatives are options. For example, options to buy or sell Treasury securities. These derivatives are most often used to “hedge” a position. Many of these types of derivatives have been around for twenty years or more.

Exotic derivatives are derivatives which have been developed only over the last few years and are relatively untested. Most are not widely traded and they are frequently customized for a particular customer. This group of securities is therefore very illiquid, difficult to value and subject to volatile price swings. Examples of exotics include a wide variety of investment types whose common characteristic is that the interest rate is tied to a particular benchmark rate, or a relationship between rates.

ELIGIBLE BANKER'S ACCEPTANCES

In the BA market, an acceptance may be referred to as eligible because it is acceptable by the Federal Reserve Bank (Fed) as collateral at the Fed discount window and/or because the accepting bank can sell it without incurring a reserve requirement.

EUROPEAN CALL

Securities that may be redeemed only one time on a pre-specified date after the initial lockout period.

FEDERAL CREDIT AGENCIES

Agencies of the Federal government set up to supply credit to various classes of institutions and individuals; i.e., S & Ls, small business firms, students, farmers, farm cooperatives and exporters.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

The Federal Deposit Insurance Corporation (FDIC) is an independent agency of the federal government which preserves and promotes public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions for at least $250,000; by identifying, monitoring and addressing risks to the deposit insurance funds; and by limiting the effect on the economy and the financial system when a bank or thrift institution fails.

FEDERAL HOME LOAN BANKS (FHLB)

The institutions which regulate and lend to savings and loan associations. The FHLB plays a role analogous to that played by the Fed vis-à-vis member commercial banks.

ISSUER

Any corporation, governmental unit or financial institution which borrows money through the sale of securities.

LIQUIDITY

A liquid asset is one which can be converted easily and rapidly into cash without a substantial loss of value. In the money market, a security is said to be liquid if the spread between bid and asked price is narrow and reasonable size can be done at those quotes. U. S. Treasury bills are very liquid and are sometimes called “cash.”

LOCKOUT PERIOD

The period of time that an issuer of callable securities cannot call the securities.

MAKING A MARKET

A dealer is said to be making a market in a given security when he/she stands prepared to buy or sell at the bid and offer prices that he/she quotes. The market is maintained when he/she continues to quote bids and offerings over a period of time.

MARKETABILITY

A measure of the ease with which a security can be sold in the secondary market.

MATURITY

The date upon which the principal or stated value of an investment becomes due and payable.

MORTGAGE-BACKED SECURITIES

Investments whose principal and interest are generated by the payment of interest and principal on a group or pool of single-family, multi-family, or mobile homes. There are many types of mortgage-backed securities with varying levels of risk. Some mortgage pools are partly insured by a government agency or a private entity. Some mortgage pools are divided, with mortgage principal repayments first paying off certain investors prior to other investors receiving principal repayments. The total return to the investor varies depending upon the rate of repayment of principal, the relationship between the original mortgage rate and prevailing rates, the number of foreclosures, losses due to fire, flood, earthquake, etc. A prudent investor investigates the particular characteristics of each individual pool to determine the level of risk and thoroughly understands the web of economic variables which affect maturity, price volatility, rate of return, and ultimate repayment of capital invested.

NEGOTIABLE

A term used to designate a security, the title to which is transferable by delivery.

NEGOTIABLE CERTIFICATE OF DEPOSIT

A large-denomination CD is generally issued in $1 million increments. They are issued at face value and typically pay interest at maturity, if maturing in less than twelve (12) months. CDs which mature beyond this range pay interest semi-annually. Negotiable CDs are issued by: U. S. banks (domestic CDs); U. S. branches of foreign banks (Yankee CDs) and thrifts. There is an active secondary market for negotiable domestic and Yankee CDs. However, the negotiable thrift CD secondary market is limited. Yields on CDs exceed those on U. S. Treasuries and Agencies of similar maturities. This higher yield compensates the investor for accepting the risk of reduced liquidity (CDs, especially those issued by small and less well-known banks, are less liquid) and the risk that the issuing bank might fail. The Code does not require the collateralization of negotiable CDs. Bank rating services are available to assist the investor in selecting CDs issued by the most creditworthy banks.

NON-NEGOTIABLE CERTIFICATE OF DEPOSIT

A time deposit with financial institution which earns interest at a specified rate for a specified term. Liquidation of the CD prior to maturity incurs a penalty. There is no secondary market for those instruments. They are not liquid. The Code classifies these investments as public deposits and requires all State financial institutions to provide collateral to secure them. Generally, financial institutions use mortgages to collateralize these deposits. The collateral is held only by financial institutions authorized by the Superintendent of Banks which administrates the collateral program for public agencies. In the event of a default by the financial institution with whom the time deposit was placed, the local agency would own the underlying collateral which it could sell. In practice, it may be difficult to obtain and sell mortgages quickly because of the length of bankruptcy proceedings and the conditions present in the real estate market.

PORTFOLIO

Collection or group of securities held by an investor.

PRINCIPAL

Principal describes the original cost of a security. It represents the amount of capital or money which the investor puts up for the investment.

RATE OF RETURN

When an investment matures, the investor receives the original amount invested plus interest. The earnings' rate, expressed as a percentage, is the yield to maturity. When an investment is sold, the investor receives more or less than the original amount invested plus interest earned. The total amount earned expressed as a percent of the original amount invested is the total rate of return. It takes into consideration principal gains and losses.

RATINGS

An evaluation given by Moody's, Standard & Poor's, Fitch, or other rating services of a security's creditworthiness.

REPURCHASE AGREEMENTS (REPOs)

The purchase of portfolio securities by a public body (or any other investor), with a simultaneous agreement to resell the securities back to the seller on a specific future date, at the original purchase price, plus a negotiated interest payment. California State law requires that repurchase agreements be collateralized.

SAFEKEEPING

A service to customers rendered by banks for a fee whereby securities and valuables of all types and descriptions are held in the bank's vaults for protection.

SECONDARY MARKET

A market made for the purchase and sale of outstanding issues following the initial distribution. For example, once the U. S. Treasury issues a note, it can be easily bought and sold again in the secondary market.

SECURED DEPOSITS

Bank deposits of State or local government funds which, under the laws of certain jurisdictions, must be secured by the pledge of acceptable securities (collateral).

TREASURY BILL

A non-interest-bearing discount security issued by the U. S. Treasury to finance the National debt. Most bills are issued to mature in three months, six months or one year.

TREASURY BONDS

Direct debt obligations of the Federal Government, issued by the U.S. Department of the Treasury with original maturity of a 30 year term.

TREASURY NOTES

Direct debt obligations of the Federal government, issued by the U. S. Department of the Treasury with original maturity of over one year up to ten years.

WIRE TRANSFER

A computer message system linking major banks. It is used not for effecting payments, but as a mechanism to advise the receiving bank of some action which has occurred; i.e., the payment by a customer of funds into that bank's account.

YIELD CURVE

When interest rates or yields are plotted across a horizontal axis representing time, for example, three months, six months, one year, etc., the shape which results is called a yield curve. The yield curve is used by investors to assist in the maturity selection process. Since yields are normally higher the longer an investment's maturity, the shape is usually upward sloping. However, the yield curve moves constantly and may be steep, flat, negatively sloping or some combination of these. Obviously, if a two-year investment yields exactly the same as a three-year investment, a three-year investor is not being compensated for the additional year of credit and interest rate risk.

ZERO-COUPON BOND

A zero-coupon does not pay any interest until maturity. The coupon of interest portion of the bond is essentially zero percent. These bonds are sold at deep discounts to their par or face value. When the investment matures, the investor receives the full par value.

APPENDIX B

ILLUSTRATION OF CITY'S DIVERSIFICATION GUIDELINES AND RELEVANT GOVERNMENT CODE PROVISIONS

			City Policy	
Investment Type	Government Code	% Limit of City's Total Portfolio*	City Max. Term Limit Per Transaction	Issuer Limit
U.S. Treasury Bills, Notes, Bonds	§53601(b); No limit	No limit	5 years	No limit
Obligations of Federal Agencies or Government-Sponsored Enterprises Federal Home Loan Bank (FHLB) Federal Farm Credit Bank (FFCB) Federal Home Loan Mortgage Corporation (Freddie Mac) Federal National Mortgage Association (Fannie Mae) Federal Agricultural Mortgage Corporation (Farmer Mac) Government National Mortgage Association (Ginnie Mae) Community Development Corporation (CDC) Student Loan Marketing Association (Sallie Mae) Small Business Administration (SBA) Tennessee Valley Authority (TVA)	§53601(f); No limit	70%	5 years	No limit
Banker's Acceptances	§53601(g); 40% Max.; 180 days	20%	180 days	5%
Time Certificate of Deposit (Non-negotiable CDs)	§53649; No limit	30%	5 years	FDIC Insured or collateralized
Negotiable CDs	§53601(i); 30% Max.	30%	5 years	FDIC Insured
Repurchase Agreements	§53601(j); 1 year	10%	92 days	No limit
Commercial Paper	§53601(h); 25% Max.; 270 days	25%	270 days	5%
LAIF	§16429.1	No limit	N/A	N/A
OCIP	§53684	No limit	N/A	N/A
Investment Joint Powers Authorities	§6509.5 and	30%	N/A	N/A

	53601			
Money Market Mutual Funds	§53601(l); 20% Max.	10%	N/A	N/A

* For conformance with this Policy, all percentage limitations are measured at the time of purchase.

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