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FINANCE AND BUDGET COMMITTEE
APRIL 16, 2008

SUBJECT: INVESTMENT AUTHORITY

ACTION: APPROVE INVESTMENT PROGRAM

RECOMMENDATION

Authorize the Treasurer to purchase and hold our outstanding variable rate bonds, including action rate securities (ARS) and variable rate demand bonds (VRDBs) having remaining maturities up to 25 years.

ISSUE

Interest rates for VRDBs and ARS have been driven up for reasons related to the "subprime" crisis and are currently costing us from 4% to 8%. The expected normal rates would be about 2%. At the same time short-term investment interest rates being earned by our Operating Fund Portfolio (OFP) have declined to less than 3%. To take advantage of this anomaly, tax exempt rates higher than taxable, we could increase the interest income earned on our investments by purchasing a portion of our outstanding variable rate bonds. Due to recent changes in tax law constraints we are limited to a maximum of 180 days of such investment for any bond issue purchased prior to October 1, 2008.

Our Investment Policy prohibits the purchase of variable rate securities. This provision is intended to preclude investment in derivative instruments. As a clarification, our ARS and VRDBs are not derivative securities because they do not derive their value from an underlying instrument, index, or formula.

Consistent with the California Government Code Section 53600 (the "Code"), our Investment Policy prohibits purchasing investments with a stated maturity of more than five years from the date of purchase, unless the instrument is specifically approved by the Board, or is approved by the Board as part of an investment program and such approval must be granted no less than three months prior to the investment. Our bond issues typically have a stated maturity in excess of twenty years.

DISCUSSION

Since the beginning of 2008, the financial markets have continued to experience significant strains and volatility resulting from the "subprime" crisis. Credit rating downgrades of major bond insurers and the liquidity crunch affecting the major investment banks have contributed to higher interest rates for our ARS and VRDBs. We have $936 million of ARS and $250 million of VRDBs outstanding, with maximum stated maturity dates of 7/1/2031 and 7/1/2020 respectively.

Currently, there are several legal and contractual issues that will need to be resolved before we can implement a strategy to buy our own bonds. We are requesting authorization at this time to meet the three month lead time required by the Code, while we work to resolve those issues. We are also pursuing permanent restructuring of the ARS and VRDB issues to make the bonds more attractive to investors.

FINANCIAL IMPACT

The proposed program would increase interest earnings in the operating fund portfolio, which will offset a portion of the increased bond interest.

ALTERNATIVES CONSIDERED

Should the Board elect not to grant the authority requested, the operating fund portfolio will continue to earn the lower rates paid on money market securities.

NEXT STEPS

1. Resolve legal and contractual issues
2. Participate as a purchaser in subsequent auctions of our bonds

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