



# **CITY OF VALLEJO, CALIFORNIA**

## **STATEMENT OF INVESTMENT POLICY**

**Adopted by the City Council  
On January 31, 2012**

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# CITY OF VALLEJO INVESTMENT POLICY

## 1.0 POLICY

It is the policy of the City of Vallejo (hereinafter "City") to invest public funds of the City in a prudent manner which will preserve principal, maintain liquidity and achieve a reasonable rate of return. Sufficient liquidity will insure that the City is able to meet daily cash flow requirements, while conforming to all state and local statutes governing the investment of said public funds.

## 2.0 SCOPE

Pursuant to California Government Code Section 53600 et. seq., the City Council as the legislative body of the City has primary responsibility for investment of money in the City Treasury not required for the immediate needs of the City. In accordance with the Charter of the City, the City Council has assigned the responsibility of investing the unexpended cash of the City Treasury to the City Manager. Furthermore, the City Manager has delegated his or her responsibility for investing the unexpended cash of the City Treasury and daily management of the investment portfolio to the City Finance Director who serves as the City Treasurer. The City Finance Director/Treasurer is authorized to invest or reinvest the City's funds, to sell or exchange securities so purchased, and to deposit securities for safekeeping.

Therefore, as authorized under California Government Code Section 53607, the City Council hereby delegates its authority to invest or reinvest the funds of the City, and to buy, sell or exchange securities so purchased, to the City Finance Director/Treasurer who shall assume full responsibility for all such transactions until such time as this delegation of authority may expire or be revoked by the City Council.

- A. This investment policy shall apply to all financial assets and investment activities of the City of Vallejo including the following fund types:
1. General Fund
  2. Special Revenue Funds
  3. Debt Service Funds
  4. Capital Project Funds
  5. Enterprise Funds
  6. Internal Service Funds
  7. Trust & Agency Funds
- B. This policy does not cover funds held by the Public Employees Retirement System nor shall it apply to investments held by the administrators of the City's IRS Code Section 457 Deferred Compensation program.
- C. Except for cash in certain restricted and special funds, the City will consolidate cash balances from all funds to maximize investment options.

- D. The proceeds of City bond issues, notes or similar financings including, but not limited to reserve funds, project funds, debt service funds and capital trust funds derived from such financings, as well as funds set aside to defease City debt in conjunction with an advance refunding agreement, shall be invested pursuant to their respective bond or trust indentures or the State of California Government Code 53600 et. seq., as applicable and not necessarily in compliance with this policy.
- E. This Investment Policy is now amended and adopted as of January 31, 2012, and will serve as the City of Vallejo Investment Policy. The Investment Policy will be reviewed annually and recommendation for revision will be made to the Council when necessary.

### **3.0 INVESTMENT INCOME AND EXPENSE ALLOCATIONS**

Investment income will be allocated to the various funds based on their respective participation based on the cash balance in each fund as a percentage of the entire pooled portfolio, or other such method as directed by the City Finance Director/Treasurer, and in accordance with generally accepted accounting principles.

The costs of managing the investment portfolio, including but not limited to: investment management fees; accounting for the investment activity; custody of the assets and oversight control expenses are charged to the individual funds on an annual basis, based upon actual expenses incurred, or using other such methods as directed by the City Finance Director/Treasurer.

### **4.0 PRUDENCE**

The City will manage the investment portfolio under the Prudent Investor Standard, which as authorized under California Government Code Section 53600.3 states that:

*“Except as provided in subdivision (a) of Section 27000.3, all governing bodies of local agencies or persons authorized to make investment decisions on behalf of those local agencies investing public funds pursuant to this chapter are trustees and therefore fiduciaries subject to the prudent investor standard. When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to, the general economic conditions and the anticipated needs of the agency, 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 agency. Within the limitations of this section and considering individual investments as part of an overall strategy, investments may be acquired as authorized by law.”*

In determining whether an investment official has exercised prudence with respect to an investment decision, the determination shall be made taking into consideration the investment of all funds over which the official had responsibility rather than consideration as to the

prudence of a single investment and, whether the investment decision was consistent with the City's Investment Policy and written investment procedures.

The City recognizes that in a diversified portfolio selected losses may occur when selected securities are sold to meet cash flow needs or to improve the overall portfolio performance and must be considered within the context of the overall portfolio's investment return.

This standard of prudence shall be applied in the context of managing the City's investment portfolios.

## 5.0 INVESTMENT OBJECTIVES

The objective of this policy is to provide guidance to invest City funds in accordance with California Government Code Section 53600 et. seq., using sound treasury management principles with the following objectives, in order of priority:

- A. **Safety:** Safety of invested funds is the first and primary objective of the City's investment program. The highest priority must be accorded to the preservation and protection of principal.
- B. **Liquidity:** Maintenance of sufficient liquidity to meet all cash flow requirements that might be reasonably anticipated for at least six (6) months.
- C. **Return:** The City's investment portfolio shall be designed with the objective of attaining the best return, throughout budgetary and economic cycles, commensurate with the City's investment risk constraints and the cash flow requirements of the portfolio. Return will however be a secondary consideration subordinate to the higher priorities accorded to the safety and liquidity of principal.

Investments shall be selected in a manner that will attempt to ensure the safety of the City's principal. This will be accomplished through a program of investment instrument selection, diversification, maturity limitations, and quality constraints. Investment transactions shall seek to keep principal losses at a minimum, whether they are from individual security defaults/downgrades or general erosion of market value due to rising interest rates.

### A. SAFETY

To protect the value of the principal and interest of the invested funds, the City will invest only in securities with acceptable credit quality as outlined in the California Government Code Section 53600 et. Seq. which include, but are not limited to, those backed by the U.S. Government or its agencies; those which have insurance on principal backed by FDIC, or those which have been legally defeased with U.S. Government collateral.

Investments shall be undertaken in a manner that seeks to ensure the preservation of principal in the overall portfolio. This statement refers to the overall portfolio as opposed to individual investments. The objective will be to minimize credit risk and market risk.

It is recognized that within a well-diversified portfolio, at any particular point in time, that security valuations are impacted by changes in interest rates and economic conditions. Accordingly, securities may at times be worth less than the original purchase price based on market fluctuations. It is further understood, that in the event of the need for a forced liquidation of investments to meet unplanned or unanticipated cash flow demands, a potential loss of investment principal might occur.

The City recognizes that investment risk can result from issuer defaults, market price changes or various technical complications leading to temporary illiquidity. Portfolio diversification is employed as a way to minimize and control these risks.

**a. Credit Risk** - Credit Risk is the risk of loss due to the failure, degradation, or decreased likelihood that the security issuer or backer will fulfill its obligations with respect to timely principal and interest payment. Credit risk will be mitigated by:

- Limiting investments to the acceptable credit quality as outlined in the California Government Code Section 53600 et. Seq.; and
- Pre-qualifying the financial institutions, broker/dealers and intermediaries with which the City will do business; and
- Diversifying the investment portfolio so that the failure of any one issuer would not unduly harm the City's cash flow.

**b. Market Risk** - Market risk is the risk that the market value of securities in the portfolio will fall due to market influence such as changes in general interest rates. Market risk may be minimized by:

- Structuring the investment portfolio to limit the average maturity of the City's portfolio to a maximum of three years and the maximum legal final maturity of any one security in the portfolio to five years, and by structuring the portfolio with an adequate mix of highly liquid securities and maturities to meet major cash outflow requirements.

## **B. LIQUIDITY**

Maturity dates of investments will be timed to assure that funds are available for payment obligations that may be reasonably anticipated. Liquidity refers to the ability to sell investments at any given moment while minimizing the chance of losing some portion of principal. Since all possible cash demands cannot be anticipated, the portfolio should consist largely of liquid securities with active secondary or resale markets.

Furthermore, the City shall maintain short term investments which offer same day liquidity for short-term funds.

## **C. RETURN ON INVESTMENTS**

The City of Vallejo's investment portfolio shall be designed with the objective of attaining a rate of return throughout budgetary and economic cycles, commensurate with the City's investment

risk constraints and the cash flow characteristics of the portfolio. Return on investments is subordinate to the requirements of safety and liquidity. The core of investments is limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed.

## **6.0 PERFORMANCE STANDARDS**

In order to assist in the evaluation of the portfolios' performance, the City will employ a relevant performance benchmark for the portfolio consistent with the Investment Policy mandated maturity, quality and concentration constraints. Useful comparative benchmarks of the City's portfolio performance will be the quarter-to-date LAIF apportionment rate, and the two-year U.S. Treasury Note yield. This maturity range is an appropriate benchmark based on the objectives of the City and the investment constraints set forth herein. Since return on investment is not the most important objective of the portfolio, the benchmark will be used solely as a reference tool. The reporting of a benchmark does not imply that the City Treasurer will add additional investment risk to the portfolio in order to attain or exceed the benchmark. Whenever possible, and consistent with risk limitations as defined herein and prudent investment principles, the Treasurer shall seek to augment returns above the risk free rate of return.

## **7.0 DIVERSIFICATION**

The City will diversify its investments to reduce credit risk or market risk losses to the portfolio as a whole, while still attaining a market-average rate of return. Diversification requires not just an array of instrument types, but also an array of maturities and issuers. The following represents the quality and concentration limits to which the investment portfolio must conform:

- a. No more than 5% of the portfolio is to be invested in any single issue/issuer at the time of purchase (except U.S. Treasury and Agency securities and the Local Agency Investment Fund).
- b. No more than 50% of the portfolio will be invested in any one asset class (with the exception of U.S. Treasury securities, and authorized pools).
- c. No more than 5% of any total outstanding issue may be purchased.

## **8.0 REPORTING**

Government Code Section 53646 previously mandated that annual investment policies and quarterly investment reports be rendered to the legislative body. AB 2853 amended Government Code Section 53646 to remove these requirements; now, the rendering of these documents is permissive rather than mandated.

In accordance with California Government Code Section 53646, the Treasurer may submit an investment report to the City Council on a quarterly basis within 45 days of the end of the quarter, which provides a review of investments and summarizes total investment return as described in items A through E found below within this section.

The report shall include the following information:

- A. Type of investment, issuer, date of maturity, par value and dollar amount invested in all securities, investments and money held by the City at the end of the reporting period; and
- B. A listing of individual securities held at the end of the reporting period by authorized investment category and percentage of portfolio represented by each investment category; and
- C. Average life and final maturity of all investments listed, and coupon, discount or earnings rate; and
- D. Par Value, Fair Value and Cost Value; and
- E. For all securities held by the City or under management by an outside party that is not a local agency pool or the State of California Local Agency Investment Fund, the current fair value as of the date of the report; and
- F. Statement that the portfolio complies with the Investment Policy or the manner in which the portfolio is not in compliance; and
- G. Statement that the City has the ability to meet its pooled expenditure requirements (cash flow) for the next six months or provide an explanation as to why sufficient money shall or may not be available.

If the City places all of its investments in the Local Agency Investment Fund, Federal Deposit Insurance Corporation-insured accounts in a bank or savings and loan association (or any combination of these three), the Finance Director can simply submit, on at least a quarterly basis, the most recent statements from these institutions to meet the requirements of items A - D above, with a supplemental report addressing items E - H above, per California Government Code Section 53646(b)-(e).

## **9.0 SAFEKEEPING AND CUSTODY**

All security transactions of the City, including collateral on repurchase agreements, will be executed by delivery-versus-payment (DVP). This ensures that securities are deposited in the eligible financial institution prior to the release of funds. A third party custodian, as designated by the Treasurer and as evidenced by safekeeping receipts, will hold securities of the City.

## **10.0 AUTHORIZED FINANCIAL DEALERS AND INSTITUTIONS**

If deemed necessary by the Finance Director/Treasurer, the Treasurer's office will maintain a list of financial institutions authorized to provide investment services, including approved security broker/dealers.

- A. The City shall transact business only with banks, savings and loans, and with investment securities dealers as defined in Government Code Section 53601.5:

53601.5 – Designated entities from whom a local agency may purchase authorized investments:

“The purchase by a local agency of any investment authorized pursuant to Section 53601 or 53601.1, not purchased directly from the issuer, shall be purchased either from an institution licensed by the state as a broker-dealer, as defined in Section 25004 of the Corporations Code, or from a member of a federally regulated securities exchange, from a national or state-chartered bank, from a federal or state association (as defined by Section 5102 of the Financial Code) or from a brokerage firm designated as a primary government dealer by the Federal Reserve Bank.”

- B. Before accepting funds or engaging in investment transactions with the City, the supervising officer at each depository and recognized securities broker/dealer shall submit a certification that the officer has reviewed the investment policies and objectives and agrees to disclose potential conflicts or risks to public funds that might arise out of business transactions between the firm/depository and the City of Vallejo.

## 11.0 COLLATERALIZATION

Collateralization will be required on two types of investments: certificates of deposit and repurchase agreements. In order to anticipate market changes and provide a level of security for all funds, the collateralization level for any amount exceeding FDIC coverage shall be in accordance with California Government Code Section 53652 and/or 53651 (m)(1).

The City chooses to limit acceptable collateral to the following: Cash, U.S. Treasury Bills, Notes and Bonds, and Federal Agency issues.

Collateral will always be held in the City's name by an independent third party with whom the City of Vallejo has a current custodial agreement. A clearly marked evidence of ownership (safekeeping receipt) must be supplied to the City.

The right of collateral substitution is reserved by the City.

## 12.0 DELEGATION OF AUTHORITY

In accordance with State law (SB 109), the City Council designates the Finance Director/Treasurer and/or those person(s), city employees, outside professional investment managers or fund managers assigned or designated by the Finance Director/Treasurer, to perform the needed investment transactions in accordance with this Policy. At times of absence of the Finance Director/Treasurer, the Assistant Finance Director, or other City Finance Director/Treasurer designee shall perform those functions of the investment of City Funds. In the absence of the Finance Director/Treasurer, the Assistant Finance Director, and other City Finance Director/Treasurer designees, the City Manager shall assume this responsibility. The investment authority granted to the investing officers is effective until rescinded by the City Council or until termination of the person's employment by the City. No person may engage in an investment transaction except as provided for under the terms of this policy. Although the Finance Director/Treasurer may delegate these duties to another official in the Department of Finance, the Finance Director shall be responsible for all transactions

undertaken and will establish a system of controls to regulate the activities of subordinate officials. Section 53607 of the State of California Government Code limits the authorization of the legislative body to delegate investment authority to a one-year period, renewable annually.

### **13.0 ETHICS AND CONFLICT OF INTEREST**

In accordance with California Government Code Sections 1090 et seq. and 87100 et seq., officers and employees of the City will refrain from any activity that could conflict with the proper execution of the investment program or which could impair their ability to make impartial investment decisions for the City. All investment personnel shall comply with the reporting requirements of the Political Reform Act, to include the annual filing of Statements of Economic interest. No investments will be made with or through any family or blood-related relative or any firm that employs any family or blood-related relative of any City Elected Official, Appointed Official, or City employee.

### **14.0 INTERNAL CONTROL**

The Treasurer shall establish an annual process of independent review by an external auditor. This review will provide internal control by assuring compliance with policies and procedures.

### **15.0 POLICY REVISION AND ADOPTION**

This Investment Policy shall be reviewed and adopted at least annually by resolution of the City Council of Vallejo. Furthermore, it can be revised whenever necessary by the City Council or Finance Director with City Council approval, and any modifications made thereto must be approved by the City Council, as required by law.

### **16.0 PROHIBITED TRANSACTIONS**

Certain investment practices and instruments may be inconsistent with the safety of invested funds, or prohibited by the State of California Government Code Section 53601.6 and are therefore prohibited transactions. Prohibited investments include securities not listed in Attachment A below, as well as but not limited to:

A. Investments Prohibited by State of California Government Code Section 53601.6:

1. Mortgage Derived Interest-Only Strips.
2. Any security that could result in zero interest accrual if held to maturity.
3. "Complex" derivative structures such as range notes or inverse floaters.
4. Auction-rate preferred securities.

B. Additional Investments Prohibited by the City of Vallejo:

1. No direct investment in financial agreements whose returns are linked to or derived from the performance of some underlying assets such as stocks, bonds, currencies or commodities products (“Derivatives”). Only allowed as part of the City’s investments in Government Investment Pools and sweep accounts. This may include dual index notes, leveraged or de-leveraged floating rate notes, or any other complex variable rate or structured note, and any other financial derivative.
2. Leveraged investing, such as in margin accounts or any form of borrowing against or otherwise obligating city investments for the purpose of investment.
3. Options and future contracts.
4. Taking short positions; that is, selling securities that the City does not own.
5. Equity Securities (Common or Preferred Stocks).

Purchasing these types of instruments does not coincide with the City’s Investment Policy objectives and would require a thorough review and monitoring of the underlying security. Although some of these transactions are legal under California Government Code, they do not meet the objectives contained in this Investment Policy.

Prohibited investments already held in the portfolio at the time of adoption of this policy may continue to be held until maturity at the discretion of the Finance Director/Treasurer.

#### **17.0 MAXIMUM MATURITY LIMIT**

To the extent possible, the City of Vallejo will attempt to match its investments with anticipated cash flow requirements. In compliance with State of California Government Code Section 53601, the City will not directly invest in any securities with a legal final maturity of more than five years from the date of purchase unless specifically approved by the City Council.

Furthermore, in order to maintain liquidity, the weighted average time to maturity of the City’s investment portfolio shall not exceed three years. The Treasurer shall adjust average portfolio maturity to market conditions and specific investment goals/return objectives, as needed.

#### **18.0 PORTFOLIO MANAGEMENT**

Following the primary objective of preservation of capital, the investment portfolio may be actively managed to take advantage of market opportunities. In doing so, negotiable securities may be sold prior to their maturity to provide liquid funds as needed for cash flow purposes, to enhance portfolio returns, or to restructure maturities to increase yield and/or decrease risk. In addition, fluctuations in market rates or changes in credit quality may produce situations where securities may be sold at a loss in order to mitigate further erosion of principal or to reinvest proceeds of sale in securities that will out-perform the original investment. In practice, however, it is primarily a hold to maturity portfolio.

## **19.0 USE OF EXTERNAL PROFESSIONAL INVESTMENT MANAGERS**

The City may employ the services of professional investment managers to assist in the management of the City's investment portfolio. Such managers may be granted the discretion to purchase and sell investment securities in accordance with this Investment Policy. In addition, such managers may review cash flow requirements, formulate investment strategies, and execute security purchases, sales and deliveries. External investment managers must be well established and exceptionally reputable. Members of the staffs of such companies who will have primary responsibility for managing the City's investments must have a working familiarity with the special requirements and constraints of investing municipal funds in general and this City's funds in particular. Such managers shall only be retained by written agreement with the City, and approved by the City Council. They must contractually agree to conform to the City's Investment Policy and all provisions of governing law and collateralization and other requirements contained herein.

Investment Managers shall exercise reasonable care in compliance with this Investment Policy and their Investment Management Agreements. If an Investment Manager causes a loss of funds to the City where the Manager is held to be liable for the loss of funds, compensation due to the City from the Investment Manager for such loss of funds is defined in each investment management agreement.

No more than 40 percent of the City's total investment portfolio may be placed in any one investment management account. In order to implement this requirement, the City's portfolio assets will be reallocated annually among its investment managers based on June 30 year-end values.

## **20.0 INDEMNIFICATION OF CITY INVESTMENT OFFICIALS**

The City Finance Director/Treasurer and any other City of Vallejo employee designated or assigned to perform the investment transactions and/or manage the City's investment portfolio, acting within the intent and scope of the investment policy and other written procedures and exercising due diligence, will not be held personally liable for any individual investment losses or total portfolio losses and shall be relieved of personal responsibility and liability for any individual security's credit risk or market price changes. Such indemnity shall extend to judgments, fines, attorney fees, and any other amounts paid in settlement of any such claim, suit, or proceeding, including any appeal thereof.

## **21.0 ALLOCATION OF ANY INVESTMENT GAIN OR LOSS**

Any gain or loss realized on any investments will be distributed on a pro rata basis to all non-restricted funds which at the time of the investment gain or loss were part of the City's portfolio, or using other such methods as directed by the City Finance Director/Treasurer, and in accordance with generally accepted accounting principles.

## **22.0 POLICY EXCEPTIONS**

Occasionally, exceptions to some of the requirements specified in this Investment Policy may occur for pooled investments because of events subsequent to the purchase of investment instruments, e.g., the rating of a corporate note held in the portfolio is downgraded below an "A" rating, or total assets in the portfolio decline causing the percentage invested in corporate notes to rise above 30%.

State law is silent as to how exceptions should be corrected. Exceptions may be temporary or more lasting; they may be self-correcting or require specific action. If specific action is required, the City Finance Director/Treasurer should determine the course of action that would correct exceptions to move the portfolio into compliance with State and City requirements. Decisions to correct exceptions should not expose the assets of the portfolio to undue risk, and should not impair the meeting of financial obligations as they fall due. Evaluation of divestiture of securities will be determined on a case-by-case basis. At maturity or liquidation, such monies shall be reinvested only as provided by this policy.

## **23. USE OF STATE GUIDELINES**

State of California Government Code Sections 16429.1, 53600, 53601, 53631.5, 53635, and 53646 regulate investment practices. It is the policy of the City of Vallejo to use the State's provisions for local government investments as a guide in the developing and implementing the City's investment policies and practices with the exception of those investments listed as Prohibited Transactions in Section 16 above.

## **24. LEGISLATIVE CHANGES**

Any State of California legislative action that further restricts allowable maturities, investment types or percentage allocations will be incorporated into the City of Vallejo Statement of Investment Policy and supersede any and all previous applicable language. If the City is holding an investment that is subsequently prohibited by a legislative change, the City may hold that investment until the maturity date, if it is deemed prudent by the Finance Director/Treasurer.

## ATTACHMENT A

### SCHEDULE OF AUTHORIZED INVESTMENT INSTRUMENTS

#### **Allowable Investment Instruments**

The City Finance Director/Treasurer is authorized to invest in any of the investment instruments allowed by Sections 53601, 53635 and 16429.1 of the California Government Code with the exception of those investments listed as Prohibited Transactions in Section 16 above. Exclusion of the instruments in Section 16 (B) is consistent with the City's overall objective of achieving reasonable yields on public funds while minimizing risk and capital losses. Although the potential exists for greater interest yields with these instruments, it is believed that the potential level of risk exceeds their benefits except in very limited circumstances. Accordingly, City Council approval is required on a case-by-case basis for any investments listed in Prohibited Transactions Section 16 (B).

#### **Term**

Reserve funds from the proceeds of debt issues of the City may be invested by the City Finance Director/ Treasurer in government agency securities with terms exceeding five (5) years if the maturity of such investments is made to coincide as nearly as practicable with the life of the debt issue.

In all other cases, City Council approval to make investments with terms in excess of five (5) years is required on a case-by-case basis.

The City's funds may be invested in any of the following instruments, which are not prohibited by law (California Government Code Section 53601.6):

- A. **LOCAL AGENCY INVESTMENT FUND (LAIF).** As authorized in Government Code Section 16429.1, local agencies may invest in the Local Agency Investment Fund (LAIF), a pooled investment money market fund established by the State of California, and overseen by the State Treasurer, which allows local agencies to pool their investment resources. Principal may be withdrawn on a one-day notice. Interest earned is paid quarterly. The fees charged are limited to one-quarter of one percent of the earnings of the fund. Current policies of LAIF set minimum and maximum amounts of monies that may be invested as well as maximum numbers of transactions that are allowed per month. Currently, there is a limitation of \$50 million per agency subject to a maximum of 15 total transactions per month. The LAIF is in trust in the custody of the State Treasurer. The City's right to withdraw its deposited monies from LAIF is not contingent upon the State's ability to adopt a State Budget by July 1<sup>st</sup> of each new fiscal year.
- B. **U.S. TREASURY BILLS.** Commonly referred to as T-Bills, these are short-term marketable securities sold as obligations of the U.S. Government. They are offered in three-month, six-month, and one-year maturities. T-Bills do not accrue interest but are sold at a discount to pay face value at maturity.
- C. **U.S. TREASURY NOTES.** These are marketable, interest-bearing securities sold as obligations of the U.S. Government with original maturities of one to ten years at

issuance. Interest is paid semiannually. Purchases of these assets are limited to a remaining maturity of 5 years or less.

- D. **U.S. TREASURY BONDS.** These are the same as U.S. Treasury Notes except they have original maturities of ten years or longer at issuance. Purchases of these assets are limited to a remaining maturity of 5 years or less.
- E. **U.S. GOVERNMENT AGENCY ISSUES AND GOVERNMENT SPONSORED ENTERPRISES (GSE's).** This includes obligations, participations, or other instruments of, or issued by, a federal government agency or a United States government-sponsored enterprise. Purchase of U.S. Government Agency securities may not exceed 50% of the City's Portfolio.

These securities fall into three categories: 1) Issues which are backed by the full faith and credit of the United States, 2) Issues which are conditionally backed by the full faith and credit of the United States and 3) Issues which are not backed by the full faith and credit of the United States.

These Issues include, but are not limited to:

1. Issues, which are unconditionally backed by the full faith and credit of the United States, including: Small Business Administration (SBA) and General Services Administration (GSA).
  2. Issues which are not backed by the full faith and credit of the United States including but are not limited to: Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB), Farm Credit System, Banks for Cooperation (Co-ops), Federal Lands Banks (FLB), Federal Intermediate Credit Banks (FICB), Tennessee Valley Authority (TVA), Student Loan Marketing Association (SLMA) and the Federal Deposit Insurance Corporation (FDIC).
- F. **BANKER'S ACCEPTANCE.** Otherwise known as bills of exchange or time drafts, are negotiable instruments with a maturity of six months or less drawn on and accepted by a commercial bank. These instruments are usually created to finance the import or export of goods, or the shipment of goods within the United States.
- G. **CERTIFICATE OF DEPOSIT (CDS).** As authorized in Government Code Section 53601.7 (7), local agencies may invest in Certificates of Deposit. These instruments must comply with Government Code Sections 16500 or 16600. This is a receipt for funds deposited in a Bank or Savings and Loan Association for a specified period at a specified rate of interest. The first \$250,000 of a CD is guaranteed by the FDIC. CD's with a face value in excess of \$250,000 can be collateralized by Treasury Department Securities, which must be at least 110% of the face value of the CD's in excess of the first \$250,000, or by first mortgage loans, which must be at least 150% of the face value of the CD balance in excess of the first \$250,000.

All institutions must: (1) have a minimum of \$100 million in assets; (2) have a demonstrated history of positive earnings; and, (3) must carry a minimum 3.5% equity ratio and hold that ratio for at least one year prior to the City's investment. All

institutions must be located within the State of California. For collateralized or negotiable certificates of deposit, the institution must have a minimum \$1 billion in assets, in addition to meeting the above criteria.

- H. **NEGOTIABLE CERTIFICATE OF DEPOSIT.** Allowable certificates of deposits must be issued by a nationally or state-chartered bank or a state or federal association or by a state-licensed branch of a foreign bank. The maturity period for this investment vehicle may not exceed five years unless approved by the Council.
- I. **COMMERCIAL PAPER.** As authorized in Government Code Section 53601(g), 25% of the City's portfolio may be invested in "prime" quality commercial paper of the highest ranking or of the highest letter and numerical rating as provided for by Moody's or Standard and Poor's, with maturities not to exceed 270 days. These notes are secured promissory notes of industrial corporations, utilities and bank holding companies. State law limits a city to investments in US corporations having assets in excess of five hundred million dollars with an "A" or higher rating.
- J. **REPURCHASE AGREEMENTS.** As authorized in Government Code Section 53601(i), repurchase agreements are agreements between the local agency and seller for the purchase of government securities to be resold at a specific date and for a specific amount. Repurchase agreements are generally used for short term investments for the City's daily automatic sweep account and will generally not exceed 30 days. The legal limitation on the maturity period for a repurchase agreement is for one year with the required market value underlying the agreement at 102% of the funds borrowed with the value adjusted quarterly.
- K. **BONDS OF THE STATE OF CALIFORNIA OR LOCAL AGENCIES.** Bonds of the State of California and any local government in the State of California, which bonds have at the time of investment one of the three highest credit ratings of a nationally recognized rating agency. In no event shall this classification of investment exceed 10% of the value of the portfolio.
- L. **MUTUAL FUNDS.** Mutual Funds are referred to in California Government Code, Section 53601(k), as "shares of beneficial interest issued by diversified management companies." The following mutual funds and money market funds are authorized investments for funds subject to the following provisions:
  - 1. Shares of mutual funds with portfolios consisting only of United States government bonds or United States government agencies with average maturities less than four years.
  - 2. Shares of money market funds with portfolios consisting of only bonds of states and local governments or other issuers authorized by State law for investment by local governments, which bonds have at the time of investment one of the two highest credit ratings of a nationally recognized rating agency.
  - 3. Shares of money market funds with portfolios consisting of securities otherwise authorized by State law for investment by local governments.

M. **LOCAL GOVERNMENT INVESTMENT POOLS (LGIP).** Established by the State of California to enable Finance Directors to place funds in a pool for investments. In no event shall this classification of investment exceed the maximum limit allowed by the pool.

N. **CORPORATE NOTES.** As authorized in Government Code Sections 53601(j), local agencies may invest in corporate notes issued by corporations organized and operating in the United States that have an "A" or higher rating for the issuer's debt as provided by at least two of nationally recognized rating services and having a maximum remaining maturity period of five years or less in an amount not to exceed 30% of the agency's portfolio. Furthermore, the maximum principal amount in any one company will not exceed 5% of the City's portfolio.

Issuers must possess an acceptable long-term senior debt rating by one of the nationally recognized rating services, i.e. Moody's, Standard and Poors, or Fitch or Duff & Phelps, as detailed below:

1. For maturities of two years or less, a minimum rating of "A" or better.
2. For maturities of two to four years, a minimum rating of "AA" or better.
3. For maturities of four to five years, a minimum rating of "AAA".

O. **ASSET BACKED SECURITIES.** As authorized in Government Code Section 53601(n), local agencies may invest in any equipment lease-backed certificate, consumer receivable pass-through certificate or consumer receivable-backed bond with a maximum remaining maturity of five years.

Securities eligible for investment under this subdivision shall be rated "AAA" by a nationally recognized rating service. Purchases of securities authorized by this subdivision may not exceed 20% of the agency's portfolio.

P. **MORTGAGE-BACKED SECURITIES.** As authorized in Government Code Section 53601(n), local agencies may invest in any mortgage pass-through security, collateralized mortgage obligation, mortgage-backed or other pay-through bond, with a maximum remaining maturity of five years.

Securities eligible for investment under this subdivision shall be rated "AAA" by a nationally recognized rating service. Purchases of securities authorized by this subdivision may not exceed 20% of the agency's portfolio.

It should be noted that while the Government Code specifies the maximum percentage of the portfolio that may be held in each type of investment at any one time, fluctuations in the portfolio balance will prevent strict adherence to such restrictions. Therefore, the constraints listed in this policy are to be applied at the time the investment is made and not necessarily to subsequent events which may change the percentage.

**SUMMARY OF AUTHORIZED SECURITIES AND CRITERIA INCLUDING DIVERSIFICATION CRITERIA**

The City’s investment portfolio, in aggregate, will be diversified to limit market and credit risk by observing the following City Policy Legal limitations:

Permitted Investments	State Code Legal Limit (% or \$)	City Policy Legal Limit (% or \$)	City Maximum Maturity Constraints	City Policy Other Constraints
U.S. Government Treasury Bills	Unlimited	Unlimited	5 years	None
U.S. Government Treasury Notes	Unlimited	Unlimited	5 years	None
U.S. Government Treasury Bonds	Unlimited	Unlimited	5 years	None
U.S. Government Agencies (e.g., GNMA, FNMA)	Unlimited	50%	5 years	None
Repurchase Agreements	Unlimited	20%	N.A.	Collateralized by securities with a market value of at least 102% of the loan amount.
Bankers Acceptances	40%	5%	180 days	No more than \$1,000,000 invested in any one commercial bank
Commercial Paper	25%	25%	270 days	U.S. Corporations with assets in excess of \$500,000,000; “A” debt rating; maximum of \$1,000,000 from an issuing corporation
Corporate Medium Term Notes	30%	30%	5 years	U.S. Corporations; minimum “A” debt rating; maximum of 5% of portfolio per issuing company
Certificates of Deposit	Unlimited	10%	5 years	Must be collateralized to 110% of the CD value by other eligible securities
Negotiable Certificates of Deposit	30%	5%	5 years	State and Federally chartered banks and savings institutions, “AA” rating by one agency
LAIF State Pool	\$50,000,000	\$50,000,000	On Demand	Limited to 15 transactions per month, per account, per State Policy
State of California or Local Agency Bonds	Unlimited	10%	5 years	None
Mutual Funds	20%	20%	4 years	Funds invested as defined in Section 53601 (a) to (l); maximum of 10% in any one fund
Asset-backed Securities	20%	20%	5 years	Minimum “AAA” Debt rating
Mortgage-backed Securities	20%	20%	5 years	Minimum “AAA” Debt rating
Local Government Investment Pools	Unlimited	Unlimited	On Demand	None

1) Limits on percent of portfolio do not apply to investments made by LAIF or other Government Investment Pools.

2) U.S. Treasury Bonds are currently only available for 10 years or more, which currently prohibits the use of newly issued bonds as an investment tool. However, existing bonds could be purchased if remaining term to maturity is less than 5 years.

### **MASTER REPURCHASE AGREEMENT**

If repurchase agreements are legal or authorized, a Master Repurchase Agreement must be signed with the bank or dealer.

## **ATTACHMENT B**

### **GLOSSARY OF CASH MANAGEMENT TERMS**

**ACCRETION OF DISCOUNT** - Periodic straight-line increases in the book or carrying value of a security so the amount of the purchase price discount below face value is completely eliminated by the time the bond matures or by the call date, if applicable.

**ACCRUED INTEREST** - Interest earned but not yet received. The interest accumulated on a bond since issue date or the last coupon payment. The buyer of the bond pays the market price and accrued interest, which is payable to the seller.

**AGENCIES** - A debt security issued by a federal or federally sponsored agency.

In the government securities industry, investors frequently refer to all debt instruments issued by U.S. government agencies, departments, and related instrumentalities as *agency* securities. Only those securities backed by the full faith and credit of the U. S. Government are true agency securities. Only securities issued by the Government National Mortgage Association (Ginnie Mae or GNMA) are widely used by public investors as true agency securities backed by the full faith and credit of the U.S. Government.

Generally, the underlying security associated with a U.S. agency is considered to be as risk-free as direct Treasury securities. The key difference in risk with these instruments is their liquidity and marketability, which is diminished as a result of smaller, irregular, and less familiar issues.

U.S. Government Instrumentalities, also known as government sponsored enterprises (GSEs), are financial intermediaries established by the federal government to fund loans to certain groups of borrowers, such as homeowners, farmers, and students. In short, GSEs are privately owned corporations with a public purpose. The most common instrumentalities are:

- Federal Farm Credit System Banks,
- Federal Home Loan Banks (FHLB),
- Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC),
- Federal National Mortgage Association (Fannie Mae or FNMA),
- Tennessee Valley Authority (TVA),
- Federal Deposit Insurance Corporation (FDIC).

GSEs sell securities on a regularly scheduled basis through selling groups, which are chosen groups of dealers that the GSE uses to "bring the paper to the streets." Short-term securities are regularly issued as discount notes with maturities ranging from overnight to 360 days. GSEs also issue securities with fixed interest rates, ranging in maturity from three months to 30 years.

**AMORTIZATION OF PREMIUM** - Periodic straight-line decreases in the book or carrying value of a security so the premium paid for a bond above its face value or call price is completely eliminated.

**ASK** – The price at which securities are offered for sale.

**ASSET BACKED SECURITIES (ABS)** – Asset Backed Securities are pass-through instruments collateralized by installment loans, leases, revolving lines of credit or other consumer finance receivables. Securitizations are structured to separate the credit of the ABS issuer from the assets being securitized.

**AVERAGE MATURITY** - A weighted average of the expiration dates for a portfolio of debt securities. An income fund's volatility can be managed by shortening or lengthening the average maturity of its portfolio.

**BANK WIRE** - A virtually instantaneous electronic transfer of funds between two financial institutions.

**BANKERS ACCEPTANCES (BAs)** - Bankers Acceptances generally are created based on a letter of credit issued in a foreign trade transaction. They are used to finance the shipment of commodities between countries as well as the shipment of some specific goods within the United States. BAs are short-term, non-interest bearing notes sold at a discount and redeemed by the accepting bank at maturity for full face value. These notes trade at a rate equal to or slightly higher than Certificates of Deposit (CDs), depending on market supply and demand.

Bankers Acceptances are sold in amounts that vary from \$100,000 to \$5,000,000, or more, with maturities ranging from 30 - 270 days. They offer liquidity to the investor as it is possible to sell BAs prior to maturity at the current market price.

**BASIS POINT** - A measure of an interest rate, i.e., 1/100 of 1 percent, or .0001.

**BID** - The indicated price at which a buyer is willing to purchase a security or commodity. When selling a security a bid is obtained.

**BOND** - A long-term debt security, or IOU, issued by a government or corporation that generally pays a stated rate of interest and returns the face value on the maturity date.

**BOOK ENTRY SECURITIES** - U.S. government and federal agency securities that do not exist in definitive (paper) form; they exist only in computerized files maintained by the Federal Reserve Bank.

**BOOK VALUE** - The amount at which an asset is carried on the books of the owner. The book value of an asset does not necessarily have a significant relationship to market value.

**BROKER** – A broker brings buyers and sellers together for a commission.

**CALLABLE BOND** - A bond issue in which all or part of its outstanding principal amount may be redeemed before maturity by the issuer under specified conditions. Bonds are generally called when interest rates fall so that the bond issuer can save money by floating new bonds at the lower rate. The first call date is the date which a specific call price will be offered by the issuer, usually a premium price to par, as an incentive to the bondholder to redeem the bond.

**CALL PRICE** - The price at which an issuer may redeem a bond prior to maturity. The price is usually at a slight premium to the bond's original issue price to compensate the holder for loss of income and ownership.

**CALL RISK** - The risk to a bondholder that a bond may be redeemed prior to maturity.

**CASH SALE/PURCHASE** - A transaction which calls for delivery and payment of securities on the same day that the transaction is initiated.

**CERTIFICATES OF DEPOSIT** - Certificates of Deposit, familiarly known as CDs, are certificates issued against funds deposited in a bank for a definite period of time and earning a specified rate of return. Certificates of Deposit bear rates of interest in line with money market rates current at the time of issuance.

**COLLATERALIZATION** - Process by which a borrower pledges securities, property, or other deposits for the purpose of securing the repayment of a loan and/or security.

**COMMERCIAL PAPER** - Commercial paper is an unsecured promissory note issued by a corporation for a specific amount and maturing on a specific day that cannot be farther into the future than 270 days. Commercial Paper is typically rated by credit agencies that attempt to evaluate the liquidity, cash flow, profitability, and backup credit availability of the entity that is issuing the paper.

**COMPETITIVE BID PROCESS** - A process by which three or more institutions are contacted via the telephone to obtain interest rates for specific securities.

**CONVEXITY** - A measure of a bond's price sensitivity to changing interest rates. A high convexity indicates greater sensitivity of a bond's price to interest rate changes.

**COUPON RATE** - The annual rate of interest received by an investor from the issuer of certain types of fixed-income securities. Also known as the "interest rate."

**CREDIT QUALITY** - The measurement of the financial strength of a bond issuer. This measurement helps an investor to understand an issuer's ability to make timely interest payments and repay the loan principal upon maturity. Generally, the higher the credit quality of a bond issuer, the lower the interest rate paid by the issuer because the risk of default is lower. Credit quality ratings are provided by nationally recognized rating agencies.

**CREDIT RISK** - The risk that another party to an investment transaction will not fulfill its obligations. Credit risk can be associated with the issuer of a security, a financial institution holding the entity's deposit, or a third party holding securities or collateral. Credit risk exposure can be affected by a concentration of deposits or investments in any one investment type or with any one party.

**CUSIP NUMBER** - A nine-digit number established by the Committee on Uniform Securities Identification Procedures that is used to identify publicly traded securities. Each publicly traded security receives a unique CUSIP number when the security is issued.

**CURRENT YIELD** - A yield calculation determined by dividing the annual interest received on a security by the current market price of that security.

**CUSTODIAN** - An independent third party (usually bank or trust company) that holds securities in safekeeping as an agent for the city.

**DEBENTURE** – A bond secured only by the general credit of the issuer.

**DEFEASE** - To discharge the lien of an ordinance, resolution, or indenture relating to a bond issue, and in the process, render inoperative restrictions under which the issuer has been obliged to operate. Comment: Ordinarily an issuer may defease an indenture requirement by depositing with a trustee an amount sufficient to fully pay all amounts under a bond contract as they become due.

**DELIVERY** - The providing of a security in an acceptable form to the City or to an agent acting on behalf of the City and independent of the seller. Acceptable forms can be physical securities or the

transfer of book entry securities. The important distinction is that the transfer accomplishes absolute ownership control by the City.

**DELIVERY VS PAYMENT** - 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.

**DEPOSITORY BANK** - A local bank used as the point of deposit for cash receipts.

**DEPOSITORY INSURANCE** - Insurance on deposits with financial institutions. For purposes of this policy statement, depository insurance includes: a) Federal depository insurance funds, such as those maintained by the Federal Deposit Insurance Corporation (FDIC).

**DERIVATIVE SECURITY** - Financial instrument created from, or whose value depends upon, one or more underlying assets or indexes of asset values.

**DISCOUNT** - 1. (n.) selling below par; e.g., a \$1,000 bond selling for \$900. 2. (v.) anticipating the effects of news on a security's value; e.g., "The market had already discounted the effect of the labor strike by bidding the company's stock down."

**DISCOUNT SECURITIES** – Non-interest bearing money market instruments that are issued at a discount and redeemed at maturity for full face value, e.g., U.S. Treasury Bills.

**DIVERSIFICATION** - Dividing available funds among a variety of securities and institutions so as to minimize market risk.

**DOLLAR-WEIGHTED AVERAGE MATURITY** - The sum of the amount of each outstanding investment multiplied by the number of days to maturity, divided by the total amount of outstanding investment.

**EFFECTIVE RATE** - The yield you would receive on a debt security over a period of time taking into account any compounding effect.

**FACE VALUE** - The value of a bond stated on the bond certificate; thus, the redemption value at maturity. Most bonds have a face value, or par, of \$1,000.

**FAIR VALUE** - The amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

**FDIC Insured Notes** - Notes issued by corporations under the Federal Deposit Insurance Corporation's (FDIC) Temporary Liquidity Guarantee Program (TLGP). These notes are backed by the full faith and credit of the United States Government.

**FEDERAL AGENCY SECURITIES** - Several government-sponsored agencies, in recent years, have issued short and long-term notes. Such notes typically are issued through dealers, mostly investment banking houses. These Federal government-sponsored agencies were established by the U.S. Congress to undertake various types of financing without tapping the public treasury. In order to do so, the agencies have been given the power to borrow money by issuing securities, generally under the authority of an act of Congress. These securities are highly acceptable and marketable for several reasons, mainly because they are exempt from state, municipal and local income taxes.

Furthermore, agency securities must offer a higher yield than direct Treasury debt of the same maturity to find investors, partly because these securities are not direct obligations of the Treasury.

The main agency borrowing institutions are the Federal National Mortgage Association (FNMA), the Federal Home Loan Bank System (FHLB), and the Federal Farm Credit System (FFCS).

**FLOATING-RATE NOTES** - The term floating-rate notes includes different types of securities with a similar feature that the interest rate or coupon rate is adjusted periodically to a benchmark or base rate. A simple example of a floating-rate instrument is a Series EE savings bond where the semiannual interest rate is determined in May and November based on 85 percent of the average market return of the five-year Treasury note for the preceding six months. In theory, floating-rate notes are securities with coupons based on a short-term rate index.

**FNMA - FEDERAL NATIONAL MORTGAGE ASSOCIATION** - issues notes tailored to the maturity needs of the investor. Maturities range from 30 days up to 10 years. These notes are made attractive by their denominations from \$5,000 to \$1 million.

**FHLB - FEDERAL HOME LOAN BANK SYSTEM** - consists of twelve Federal Home Loan Banks, issues, in addition to long-term bonds, coupon notes with maturities of up to one year. Their attractiveness stems from their investment denominations of \$10,000 to \$1 million.

**FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)** - A Federal institution that insures bank deposits.

**FEDERAL FUNDS (Fed Funds)** - Funds placed in Federal Reserve banks by depository institutions in excess of current reserve requirements. These depository institutions may lend fed funds to each other overnight or on a longer basis. They may also transfer funds among each other on a same-day basis through the Federal Reserve banking system. Fed funds are considered to be immediately available funds.

**FEDERAL FUNDS RATE** - The rate of interest at which Fed Funds are traded between banks. Fed Funds are excess reserves held by banks that desire to invest or lend them to banks needing reserves. The particular rate is heavily influenced through the open market operations of the Federal Reserve Board. Also referred to as the "Fed Funds rate."

**FEDERAL HOME LOAN BANKS (FHLB)** - The institutions that regulate and lend to savings and loan associations. These are Government sponsored wholesale banks which lend funds and provide correspondent banking services to member commercial banks, thrift institutions, credit unions and insurance companies. The mission of the FHLB's is to liquefy the housing related assets of its members who must purchase stock in their district bank.

**FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA)** - FNMA, like GNMA, was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a Federal corporation working under the auspices of the Department of Housing and Urban Development, HUD. It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. The corporation's purchases include a variety of adjustable mortgages and second loans, in addition to fixed-rate mortgages. FNMA's securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

**FEDERAL OPEN MARKET COMMITTEE (FOMC)** – Consists of seven members of the Federal Reserve Board and five of the twelve Federal reserve Bank Presidents. The President of the New

York Federal Reserve Bank is a permanent member, while the other Presidents serve on a rotating basis. The Committee periodically meets to set Federal Reserve guidelines regarding purchases and sales of Government Securities in the open market as a means of influencing the volume of bank credit and money.

**FEDERAL RESERVE SYSTEM** - The central bank of the United States which has regulated credit in the economy since its inception in 1913. Includes the Federal Reserve Bank, 12 district banks and the member banks of the Federal Reserve, and is governed by the Federal Board.

**FLEXIBLE REPURCHASE AGREEMENTS (Flex Repos)** - Similar to a term repurchase agreement, a flex repo is a contractual transfer of U.S. government securities during the investment period, whereby the Seller agrees to repurchase the collateral securities from the Buyer on the Buyer's demand, subject to provisions of the agreement. The Seller is generally a financial institution such as a securities dealer or a bank. As buyers, most issuers require over-collateralization, marking-to-market of collateral and delivery-vs.-payment of collateral.

**GINNIE MAES (GNMAs)** - Mortgage securities issued and guaranteed, as to timely interest and principal payments, by the Government National Mortgage Association, an agency within the Department of Housing and Urban Development (HUD).

**GOVERNMENT SECURITY** - Any debt obligation issued by the U.S. government, its agencies or instrumentalities. Certain securities, such as Treasury bonds and Ginnie Maes, are backed by the government as to both principal and interest payments. Other securities, such as those issued by the Federal Home Loan Mortgage Corporation, or Freddie Mac, are backed by the issuing agency.

**GOVERNMENT-SPONSORED ENTERPRISES (GSE's)** - Payment of principal and interest on securities issued by these corporations is not guaranteed explicitly by the U.S. government, however, most investors consider these securities to carry an implicit U.S. government guarantee. The debt is fully guaranteed by the issuing corporations. GSE's include: Farm Credit System, Federal Home Loan Bank System, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, and the Tennessee Valley Authority.

**HAIRCUT** - This term describes the way brokers and clients protect themselves from market risk in doing repos. An entity wanting to finance the purchase of \$100 million in Treasury bonds may borrow just \$98 million of the money. The two percent difference between the amount of securities purchased and the amount of money borrowed is the haircut. Similarly, an entity looking to borrow \$100 million may need to provide, as collateral, Treasury securities with a market price equal to \$102 million.

**INTERNAL CONTROLS** - An internal control structure designed to ensure that the assets of the entity are protected from loss, theft, or misuse. The internal control structure is designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that 1) the cost of a control should not exceed the benefits likely to be derived and 2) the valuation of costs and benefits requires estimates and judgments by management. Internal controls should address the following points:

1. **Control of collusion** - Collusion is a situation where two or more employees are working in conjunction to defraud their employer.

2. **Separation of transaction authority from accounting and record keeping** - By separating the person who authorizes or performs the transaction from the people who record or otherwise account for the transaction, a separation of duties is achieved.
3. **Custodial safekeeping** - Securities purchased from any bank or dealer including appropriate collateral (as defined by state law) shall be placed with an independent third party for custodial safekeeping.
4. **Avoidance of physical delivery securities** - Book-entry securities are much easier to transfer and account for since actual delivery of a document never takes place. Delivered securities must be properly safeguarded against loss or destruction. The potential for fraud and loss increases with physically delivered securities.
5. **Clear delegation of authority to subordinate staff members** - Subordinate staff members must have a clear understanding of their authority and responsibilities to avoid improper actions. Clear delegation of authority also preserves the internal control structure that is contingent on the various staff positions and their respective responsibilities.
6. **Written confirmation of transactions for investments and wire transfers** - Due to the potential for error and improprieties arising from telephone and electronic transactions, all transactions should be supported by written communications and approved by the appropriate person. Written communications may be via fax if on letterhead and if the safekeeping institution has a list of authorized signatures.
7. **Development of a wire transfer agreement with the lead bank and third-party custodian** - The designated official should ensure that an agreement will be entered into and will address the following points: controls, security provisions, and responsibilities of each party making and receiving wire transfers.

**INVERSE FLOATER** - A bond or note that does not earn a fixed rate of interest. Rather, the interest rate that is earned is tied to a specific interest-rate index identified in the bond/note structure. The interest rate earned by the bond/note will move in the opposite direction of the index, e.g., if market interest rates as measured by the selected index rises, the interest rate earned by the bond/note will decline. An inverse floater increases the market rate risk and modified duration of the investment.

**INVERTED YIELD CURVE** - A chart formation that illustrates long-term securities having lower yields than short-term securities. This configuration usually occurs during periods of high inflation coupled with low levels of confidence in the economy and a restrictive monetary policy.

**INVESTMENT COMPANY ACT OF 1940**- Federal legislation which sets the standards by which investment companies, such as mutual funds, are regulated in the areas of advertising, promotion, performance reporting requirements, and securities valuations.

**INVESTMENT POLICY** - A concise and clear statement of the objectives and parameters formulated by an investor or investment manager for a portfolio of investment securities.

**INVESTMENT-GRADE OBLIGATIONS** - An investment instrument suitable for purchase by institutional investors under the prudent person rule. Investment-grade is restricted to those obligations rated BBB or higher by a rating agency.

**LIQUIDATION** - Conversion into cash.

**LIQUIDITY** - Refers to the ease and speed with which an asset can be converted into cash without a substantial loss in value. In the money market, a security is said to be liquid if the spread between bid and asked prices is narrow and reasonable size can be done at those quotes.

**LOSS** - The excess of the cost or book value of an asset over selling price.

**LOCAL GOVERNMENT INVESTMENT POOL (LGIP)** - The aggregate of all funds from political subdivisions that are placed in the custody of the Treasurer for investment and reinvestment.

**LONG-TERM INVESTMENTS** - Investments considered long-term are generally defined as those instruments maturing in one year or longer.

**MARK-TO-MARKET** - The practice of valuing a security or portfolio according to its market value, rather than its cost or book value. An adjustment in the valuation of a securities portfolio to reflect the current market values of the respective securities in the portfolio.

**MARKETABILITY** - Ability to sell large blocks of money market instruments quickly and at competitive prices.

**MARKET VALUE** - The price at which a security is trading and could presumably be sold.

**MARKET RISK** - The risk associated with declines or rises in interest rates which cause an investment in a fixed-income security to increase or decrease in value. The risk that the market value of an investment, collateral protecting a deposit, or securities underlying a repurchase agreement will decline.

**MASTER REPURCHASE AGREEMENT** - An agreement between the investor and the dealer or financial institute. This agreement defines the nature of the transactions, identifies the relationship between the parties, establishes normal practices regarding ownership and custody of the collateral securities during the term of the investment, provides for remedies in the event of a default by either party and otherwise clarifies issues of ownership.

**MATURITY** - The date upon which the principal or stated value of an investment becomes due.

**MONEY MARKET** – The market in which short-term debt instruments (bills, commercial paper, bankers' acceptances, etc.) are issued and traded.

**MORTGAGE-BACKED SECURITIES** - Mortgage-backed securities have several unique characteristics, beginning with the payment of interest on a monthly basis. Mortgage Backed Securities also differ from standard Treasury investments in that the cash flow pattern is uncertain due to the risk of prepayments or the unscheduled payment of principal. Moreover, a change in the future assumption for prepayments will also affect the rate of return on the investment of a mortgage-backed security. Mortgage-backed securities are created when mortgage pools are collateralized into interest-bearing securities. This securitization process can be accomplished via either a sale of assets or as a debt obligation of the issuer. In the former, a mortgage pass-through security is created, while in the latter case a mortgage-backed bond is originated.

**MUTUAL FUND** - An investment company that pools money and can invest in a variety of securities, including fixed-income securities and money market instruments. Mutual funds are regulated by the Investment Company Act of 1940 and must abide by the following Securities and Exchange Commission (SEC) disclosure guidelines:

1. Report standardized performance calculations.
2. Disseminate timely and accurate information regarding the fund's holdings, performance, management and general investment policy.
3. Have the fund's investment policies and activities supervised by a board of trustees, which are independent of the adviser, administrator or other vendor of the fund.
4. Maintain the daily liquidity of the fund's shares.
5. Value their portfolios on a daily basis.
6. Have all individuals who sell SEC-registered products licensed with a self-regulating organization (SRO) such as the National Association of Securities Dealers (NASD).
7. Have an investment policy governed by a prospectus which is updated and filed by the SEC annually.

**MUTUAL FUND STATISTICAL SERVICES** - Companies that track and rate mutual funds, e.g., IBC/Donoghue, Lipper Analytical Services, and Morningstar.

**NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD)** - A self-regulatory organization (SRO) of brokers and dealers in the over-the-counter securities business. Its regulatory mandate includes authority over firms that distribute mutual fund shares as well as other securities.

**NEGOTIABLE CERTIFICATES OF DEPOSIT** - Large denomination (\$100,000 or more) interest bearing time deposits, paying the holder a fixed amount of interest at maturity. Issues can be sold to a new owner before maturity.

**NET ASSET VALUE** - The market value of one share of an investment company, such as a mutual fund. This figure is calculated by totaling a fund's assets which includes securities, cash, and any accrued earnings, subtracting this from the fund's liabilities and dividing this total by the number of shares outstanding. This is calculated once a day based on the closing price for each security in the fund's portfolio.  $[(\text{Total assets}) - (\text{Liabilities})]/(\text{Number of shares outstanding})$

**NO LOAD FUND** - A mutual fund which does not levy a sales charge on the purchase of its shares.

**NOMINAL YIELD** - The stated rate of interest that a bond pays its current owner, based on par value of the security. It is also known as the "coupon," "coupon rate," or "interest rate."

**OFFER** - The indicated price at which a seller is willing to sell a security or commodity. When buying a security an offer is obtained.

**OPEN MARKET OPERATIONS** – Purchases and sales of government and certain other securities in the open market by the New York Federal Reserve Bank as directed by the FOMC in order to influence the volume of money and credit in the economy. Purchases inject reserves into the bank system and stimulate growth of money and credit; sales have the opposite effect. Open market operations are the Federal Reserve's most important and most flexible monetary policy tool.

**PAR VALUE** - The nominal or face value of a debt security; that is, the value at maturity.

**PORTFOLIO** – Collection of securities held by an investor.

**POSITIVE YIELD CURVE** - A chart formation that illustrates short-term securities having lower yields than long-term securities.

**PREMIUM** - The amount by which a bond sells above its par value.

**PRIMARY DEALERS** - A group of government securities dealers that submit daily reports of market activity and positions and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission (SEC), registered securities broker-dealers, banks, and a few unregulated firms.

**PRIME RATE** - The interest rate a bank charges on loans to its most credit worthy customers. Frequently cited as a standard for general interest rate levels in the economy.

**PRINCIPAL** - An invested amount on which interest is charged or earned.

**PRUDENT PERSON RULE** – An investment standard. In some states the law requires that a fiduciary, such as a trustee, may invest money only in a list of securities selected by the custody state – the so-called legal list. In other states the trustee may invest in a security if it is one which would be bought by a prudent person of discretion and intelligence who is seeking a reasonable income and preservation of capital.

**QUALIFIED PUBLIC DEPOSITORY** - A financial institution which does not claim exemption from the payment of any sales or compensating use or ad valorem taxes under the laws of this state, which has segregated, for the benefit of the commission, eligible collateral having a value of not less than its maximum liability and which has been approved by the Public Deposit Protection Commission to hold public deposits.

**RANGE NOTE** - An investment whose coupon payment varies (e.g. either 7% or 3%) and is dependent on whether the current benchmark (e.g. 30 year Treasury) falls within a pre-determined range (e.g. between 6.75% and 7.25%).

**RATE OF RETURN** - The amount of income received from an investment, expressed as a percentage. A market rate of return is the yield that an investor can expect to receive in the current interest-rate environment utilizing a buy-and-hold to maturity investment strategy.

**REGISTERED SECURITY** - A security that has the name of the owner written on its face. A registered security cannot be negotiated except by the endorsement of the owner.

**REINVESTMENT RISK** - The risk that a fixed-income investor will be unable to reinvest income proceeds from a security holding at the same rate of return currently generated by that holding.

**REPURCHASE AGREEMENT (REPO)** - The Repo is a contractual transaction between an investor and an issuing financial institution (not a secured loan). The investor exchanges cash for temporary ownership of specific securities, with an agreement between the parties that on a future date, the financial institution will repurchase the securities at a prearranged price. An "Open Repo" does not have a specified repurchase date and the repurchase price is established by a formula computation.

**REPRICING** - The revaluation of the market value of securities.

**REVERSE REPO's** - The opposite of the transaction undertaken through a regular repurchase agreement. In a "reverse" the City initially owns securities and the bank or dealer temporarily exchanges cash for this collateral. This is, in effect, temporarily borrowing cash at a high interest rate. Most typically, a Repo is initiated by the lender of funds. Reverses are used by dealers to borrow

securities they have shorted. Such investments are not authorized in the City of Vallejo's Investment Policy.

**RULE 2a-7 OF THE INVESTMENT COMPANY ACT** - Applies to all money market mutual funds and mandates such funds to maintain certain standards, including a 13- month maturity limit and a 90-day average maturity on investments, to help maintain a constant net asset value of one dollar (\$1.00).

**SAFEKEEPING** - A service to customers rendered by banks for a fee whereby all securities and valuables of all types and descriptions are held in the bank's vaults for protection, or in the case of book entry securities, are held and recorded in the customer's name and are inaccessible to anyone else.

**SALLIE MAES** - Pooling of student loans guaranteed by the Student Loan Marketing Association (SLMA) to increase the availability of education loans. The SLMA purchases the loans after buying them on the secondary market from lenders. SLMA stock is publicly traded.

**SECONDARY MARKET** – A market made for the purchase and sale of outstanding issues following the initial distribution.

**SECURITIES** - Bonds, notes, mortgages, or other forms of negotiable or non-negotiable instruments.

**SECURITIES & EXCHANGE COMMISSION** – Agency created by Congress to protect investors in securities transactions by administering securities legislation.

**SERIAL BOND** - A bond issue, usually of a municipality, with various maturity dates scheduled at regular intervals until the entire issue is retired.

**SETTLEMENT DATES** - The day on which payment is due for a securities purchase. For stocks and mutual funds bought through an investment dealer, settlement is normally five business days after the trade date. Bonds and options normally settle one business day after the trade date, mutual fund shares purchased directly by mail or wire settle on the day payment is received.

**SHORT-TERM INVESTMENTS** - Short-term investments are generally defined as those instruments maturing in one year or less.

**SINKING FUND** - Money accumulated on a regular basis in a separate custodial account that is used to redeem debt securities or preferred stock issues.

**SPREAD** - (a) Difference between the best buying price and the best selling price for any given security. (b) Difference between yields on or prices of two securities of differing quality or differing maturities. (c) In underwriting, difference between price realized by the issuer and price paid by the investor.

**STRIPS** - Separation of the principal and interest cash flows due from any interest-bearing securities into different financial instruments. Each coupon payment is separated from the underlying investment to create a separate security. Each individual cash flow is sold at a discount. The amount of the discount and the time until the cash flow is paid determine the investor's return.

**STRIPPED TREASURIES** - U.S. Treasury debt obligations in which coupons are removed by brokerage houses, creating zero-coupon bonds.

**STRUCTURED NOTES** – A complex, fixed income instrument, which pays interest, based on a formula tied to other interest rates, commodities or indices. Examples include inverse floating rate

notes that have coupons that increase when other interest rates are falling, and which fall when other interest rates are rising, and "dual index floaters," which pay interest based on the relationship between two other interest rates - for example, the yield on the ten-year Treasury note minus the Libor rate. Issuers of such notes lock in a reduced cost of borrowing by purchasing interest rate swap agreements.

Notes issued by government Sponsored Enterprises (GSE) such as FHLB, FNMA, and Corporations which have imbedded options (e.g., call features, step-up coupons, floating rate coupons, derivative-based returns) into their debt structure. Their market performance is impacted by the fluctuation of interest rates, the volatility of the imbedded options and shifts in the shape of the yield curve.

**TERM BOND** - Bonds comprising a large part or all of a particular issue which come due in a single maturity. The issuer usually agrees to make periodic payments into a sinking fund for mandatory redemption of term bonds before maturity.

**TOTAL RETURN** - The sum of all investment income plus changes in the capital value of the portfolio. For mutual funds, return on an investment is composed of share price appreciation plus any realized dividends or capital gains. This is calculated by taking the following components during a certain time period. (Price Appreciation) + (Dividends and Interest received) + (Capital gains) = Total Return

**TRIPARTITE CUSTODIAN AGREEMENT** - An agreement that occurs when a third party or custodian becomes a direct participant in a repurchase transaction. The custodian ensures that the exchange occurs simultaneously and that appropriate safeguards are in place to protect the investor's interest in the underlying collateral.

**THIRD-PARTY SAFEKEEPING** - A safekeeping arrangement whereby the investor has full control over the securities being held and the dealer or bank investment department has no access to the securities being held.

**TIME DEPOSIT** - Interest-bearing deposit at a savings institution that has a specific maturity.

**TREASURY BILLS** - Treasury bills are short-term debt obligations of the U.S. Government. They offer maximum safety of principal since they are backed by the full faith and credit of the United States Government. Treasury bills, commonly called "T-Bills," account for the bulk of government financing, and are the major vehicle used by the Federal Reserve System in the money market to implement national monetary policy. T-Bills are sold in three, six, nine, and twelve-month bills. Because treasury bills are considered "risk-free," these instruments generally yield the lowest returns in the major money market instruments.

**TREASURY NOTES AND BONDS** - While T-Bills are sold at a discount rate that establishes the yield to maturity, all other marketable treasury obligations are coupon issued. These include Treasury Notes with maturities from one to ten years and Treasury Bonds with maturities of 10-30 years. The instruments are typically held by banks and savings and loan associations. Since Bills, Notes and Bonds are general obligations of the U.S. Government, and since the Federal Government has the lowest credit risk of all participants in the money market, its obligations generally offer a lower yield to the investor than do other securities of comparable maturities.

**UNDERLYING SECURITIES** - Securities transferred in accordance with a repurchase agreement.

**UNIFORM NET CAPITAL RULE** – Securities and Exchange Commission requirement that member firms as well as nonmember broker-dealers in securities maintain a maximum ratio of indebtedness

to liquid capital of 15 to 1; also called net capital rule and net capital ratio. Indebtedness covers all money owed to a firm, including margin loans and commitments to purchase securities, one reason new public issues are spread among members of underwriting syndicates. Liquid capital includes cash and assets easily converted into cash.

**VARIABLE RATE** - An interest rate which is adjusted periodically, usually based on a standard market rate outside the control of the bank or savings institution, such as that prevailing on a Treasury bill or the prime interest rate. These rates often have a specified floor and/or ceiling, called a cap or a collar, which limit the adjustment. Also called adjustable rate or floating rate.

**WEIGHTED AVERAGE MATURITY** - The sum of the amount of each outstanding investment multiplied by the number of days to maturity, divided by the total amount of outstanding investment.

**WHEN-ISSUED TRADES** - Typically, there is a lag between the time a new bond is announced and sold and the time it is actually issued. During this interval, the security trades "wi," "when, as, and if issued."

**Wi** - When, as, and if issued. See When-issued trades.

**YIELD** - The rate at which an investment pays out interest or dividend income, expressed in percentage terms and calculated by dividing the amount paid by the price of the security and annualizing the result.

**YIELD BASIS** - Stated in terms of yield as opposed to price. As yield increases for a traded issue, price decreases and vice versa. Charts prepared on a yield basis appear exactly opposite of those prepared on a price basis.

**YIELD CURVE** - A graphic representation that depicts the relationship at a given point in time between yields and maturity for bonds that are identical in every way except maturity. A normal yield curve may be alternatively referred to as a positive yield curve.

**YIELD SPREAD** - The variation between yields on different types of debt securities; generally a function of supply and demand, credit quality and expected interest rate fluctuations. Treasury bonds, for example, because they are so safe, will normally yield less than corporate bonds. Yields may also differ on similar securities with different maturities. Long-term debt, for example, carries more risk of market changes and issuer defaults than short-term debt and thus usually yields more.

**YIELD-TO-CALL (YTC)** - The rate of return an investor earns from a bond assuming the bond is redeemed (called) prior to its nominal maturity date. It is the percentage rate of a bond or note, if an investor were to buy and hold the security until the call date. This yield is valid only if the security is called prior to maturity. Generally bonds are callable over several years and normally are called at a slight premium. The calculation of yield to call is based on the coupon rate, length of time to the call and the market price.

**YIELD-TO-MATURITY (YTM)** - The rate of return yielded by a debt security held to maturity when both interest payments and the investor's potential capital gain or loss are included in the calculation of return. The calculation for YTM is based on the coupon rate, length of time to maturity and market price. It assumes that coupon interest paid over the life of the bond will be reinvested at the same rate.

**ZERO-COUPON BONDS** - Securities that do not pay interest but are instead sold at a deep discount from face value. They rise in price as the maturity date nears and are redeemed at face value upon maturity.