



To: First 5 Alameda County Commission

From: Patricia Zapanta, Acting Director, Finance & Administration

Date: June 25, 2009

Subject: Investment Policy Revision Recommendation

ACTION REQUESTED

To review and approve a revision to the Investment Policy

BACKGROUND

First 5 Alameda County adopted an Investment Policy in May 2005, which was amended on December 2005, May 2006, June 2007 and June 2008. In accordance with the Investment Policy Section VIII.1, "the CEO or his designee shall annually render a statement of investment policy, which the Board will consider at a public meeting".

Each year, prior to such review, First 5 Alameda County Finance staff meets with the money managers to discuss any proposed changes to the policy or changes in California Government Code Section 53600, which guides the investment of public funds.

RECOMMENDATION

Below is the recommendation and is made in the attached document in track changes format.

Section VI. 2. a. (page 5) Addition of a new authorized investment category called FDIC (Federal Deposit Insurance Corporation) insured notes under the TLGP (Temporary Liquidity Guarantee Program). This is classified under Other Federal Government Agency securities since they are backed by the full faith and credit of the U.S. government.

FISCAL IMPACT

There is no fiscal impact.

RECOMMENDATION

To review and approve the following revisions to the Investment Policy

Submitted by:

Reviewed by:

Patricia Zapanta, Acting Director,
Finance and Administration

Mark Friedman, Chief Executive Officer



FIRST 5 ALAMEDA COUNTY INVESTMENT POLICY —

ADOPTED MAY, 2005, AMENDED DEC. 2005, MAY 2006, JUNE 2007, JUNE 2008

I. APPLICABILITY

The investment policy of First Five Alameda County (“F5AC”) is intended to cover all funds and investment activities under the direction of F5AC. All funds shall be invested in accordance with this investment policy and California Government Code Section 53601 et seq. related to the investment of public funds.

The primary funds available for investment are maintained in F5AC’s Sustainability Fund. The Long Range Financial Plan guides F5AC’s use of the Sustainability Fund with the goal of sustaining program spending at a high level as the tobacco tax declines. It is anticipated that the Sustainability Fund will be used by First 5 for program services over the course of the next 6-10 years.

The Sustainability Fund was accumulated in several ways: First, the Fund developed through the initial reserve that occurred when tax dollars were accumulated but funds could not be spent until a Strategic Plan was passed (Jan. 1999 - Jan. 2000). In addition, contributions to the Sustainability Fund were budgeted over a number of years (2001 - 2004). Finally, budgeted funds that remained unspent were directed to the Sustainability Fund rather than rolling to the subsequent year’s budget (2001-present).

The Finance Advisory Committee shall assure that F5AC operates its investing activities in accordance with this policy. The responsibilities of the Finance Advisory Committee in carrying out this charge include the following:

1. Review the overall investment philosophy of F5AC, determine whether the investment practices follow that philosophy and this policy, and recommend appropriate changes to the Board.
2. Establish benchmarks and strategies for the investment portfolio. Monitor the investment performance of F5AC’s portfolio for compliance with established benchmarks.
3. Monitor the cash flow requirements of F5AC and assure investments mature to provide the amounts needed. Periodically review the appropriateness of the model and assumptions used to estimate these requirements.
4. Ensure F5AC’s compliance with applicable laws and regulations.
5. Monitor and direct the selection, evaluation, and retention of each broker/dealer, investment manager, custodian or other agent utilized by F5AC to implement the investment function. Negotiate compensation with them and monitor expenses paid and services received.
6. Prepare quarterly investment reports and present to the Commission. Also communicate to the Commission actions taken by the Committee in meeting the responsibilities described herein.

II. OBJECTIVES

The primary objectives, in priority order, of F5AC's investment activities shall be:

1. **SAFETY.** Safety of principal is the foremost objective of the investment program. The objective will be to mitigate credit risk and interest rate risk.
 - a. *Credit Risk.* F5AC will minimize credit risk, which is the risk of loss due to the failure of the security issuer or backer, by:
 - Limiting investments to the types of securities listed in Section VI of this investment policy
 - Pre-qualifying the financial institutions, broker/dealers, intermediaries, and advisers with which F5AC will do business in accordance with Section IV.
 - Diversifying the investment portfolio so that the impact of potential losses from any one type of security or from any one individual issuer will be minimized.
 - b. *Interest Rate Risk.* F5AC will minimize interest rate risk, which is the risk that the market value of securities in the portfolio will fall due to changes in market interest rates, by:
 - Structuring the investment portfolio so that securities mature to meet cash requirements for ongoing operations, thereby avoiding the need to sell securities on the open market prior to maturity to meet liquidity needs.
 - Investing operating funds primarily in shorter-term securities, money market mutual funds, or similar investment pools and limiting the average maturity of the portfolio in accordance with this policy (see section VII).
2. **LIQUIDITY.** The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This is accomplished by structuring the portfolio so that securities mature concurrent with cash needs to meet anticipated demands (static liquidity). Furthermore, since all possible cash demands cannot be anticipated, the portfolio should consist largely of securities with active secondary or resale markets (dynamic liquidity). In addition, the Agency shall maintain a minimum of three months of operating expenditures in the Alameda County Treasury.
3. **YIELD.** The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. The core of investments is limited to relatively low risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall generally be held until maturity with the following exceptions:
 - A security with declining credit may be sold early to minimize loss of principal.
 - A security swap would improve the quality, yield, or target duration in the portfolio.
 - Liquidity needs of the portfolio require that the security be sold.

III. STANDARDS OF CARE

1. **PRUDENCE.** The standard of prudence to be used by investment officials shall be the "prudent investor" standard and shall be applied in the context of managing an overall portfolio. The "prudent person" standard states that, "Investments shall be made 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 .
2. **ETHICS AND CONFLICTS OF INTEREST.** Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with the proper execution and management of the investment program, or that could impair their ability to make impartial decisions. Employees and investment officials shall disclose any material interests in financial institutions with which they conduct business. They shall further disclose any personal financial/investment positions that could be related to the performance of the investment portfolio. Portfolio managers who are dealers should not buy securities from their own or related companies. Employees and officers shall refrain from undertaking personal investment transactions with the same individual with whom business is conducted on behalf of F5AC. Individuals acting on behalf of F5AC in accordance with this Investment Policy and related written procedures and exercising due diligence shall be relieved of personal liability for any individual security's risk or market changes.
3. **DELEGATION OF AUTHORITY.** The management responsibility for the investment program is hereby delegated to the Chief Executive Officer who shall monitor and review all investments for consistency with this investment policy. The Chief Executive Officer may delegate responsibility for day-to-day management of the portfolio, investment decision-making and/or execution authority to an investment advisor(s). The advisor(s) shall follow this policy and such other written instructions as are provided.

IV. AUTHORIZED FINANCIAL INSTITUTIONS, DEPOSITORIES AND BROKER/ DEALERS

1. **AUTHORIZED FINANCIAL INSTITUTIONS, DEPOSITORIES, AND BROKER/DEALERS.** A list will be maintained of financial institutions and depositories authorized to provide investment services. In addition, a list will be maintained of approved security broker/dealers selected by creditworthiness (e.g., a minimum capital requirement of \$10,000,000 and at least five years of operation). These may include "primary" dealers or regional dealers that qualify under Securities and Exchange Commission (SEC) Rule 15C3-1 (uniform net capital rule).

All financial institutions and broker/dealers who desire to become qualified for investment transactions must supply the following as appropriate:

- Audited financial statements demonstrating compliance with state and federal capital adequacy guidelines

- Proof of National Association of Securities Dealers certification (not applicable to Certificate of Deposit counterparties)
- Proof of state registration
- Completed broker/dealer questionnaire (not applicable to Certificate of Deposit counterparties)
- Certification of having received and reviewed F5AC's investment policy.
- Evidence of adequate insurance coverage.

An annual review of the financial condition and registration of all qualified financial institutions and broker/dealers will be conducted by the Chief Executive Officer and Finance Advisory Committee.

2. **MINORITY AND COMMUNITY FINANCIAL INSTITUTIONS.** From time to time, the Chief Executive Officer may choose to invest in instruments offered by minority and community financial institutions. In such situations, a waiver to certain parts of the criteria under Paragraph 1 may be granted by the Finance Advisory Committee. All terms and relationships will be fully disclosed to the Finance Advisory Committee prior to purchase.
3. **WORKING WITH INVESTMENT ADVISORS/PORTFOLIO MANAGERS.** Investment advisors and portfolio managers will be selected by the Finance Committee or their designee after an initial screening and an interview process. Among the criteria for selection will be the stability of the institution, track record, customer service, ability to comply with these investment policies, and typical return on investment.

Portfolio managers shall maintain detailed accounting records related to investment transactions and balances. They shall prepare and submit the following reports and records to F5AC:

- Report of investments owned, including type of security, CUSIP number, number of shares, date purchased, maturity date, interest rate, accrued interest, purchase cost and market value – monthly
- Investment advice – within 5 business days of any trade
- For each security purchased or sold, documentation supporting 3 bids or offers obtained, when possible, shall be maintained.
- Report demonstrating compliance with this investment policy – quarterly
- Notice of noncompliance, when the rating of an individual security declines below that allowed by this policy, or the percentage of the portfolio in an investment type exceeds the maximum allowed by this policy, or the amount allowed to be invested in one issuer exceeds the percentage allowed by this policy - within 5 business days of the noncompliance

V. SAFEKEEPING AND CUSTODY

1. **DELIVERY VS. PAYMENT.** All trades of marketable securities will be executed by delivery vs. payment to ensure that securities are deposited in an eligible financial institution prior to the release of funds.

2. **SAFEKEEPING.** Securities will be held by an independent third-party custodian as evidenced by safekeeping receipts in F5AC's name. The safekeeping institution shall annually provide a copy of their most recent report on internal controls (Statement of Auditing Standards No. 70).
3. **INTERNAL CONTROLS.** The Chief Executive Officer or his designee shall establish a system of internal controls, which shall be documented in writing. The controls shall be designed to prevent losses of public funds arising from fraud, employee error, and misrepresentations by third parties and imprudent actions by employees or officers of F5AC. The internal controls shall be reviewed with the independent external auditor.

VI. ELIGIBLE INVESTMENTS

A. Authorized Investments

All investments shall be made in accordance with Sections 53600 *et seq.* of the Government Code of California and as described within this Investment Policy. Permitted investments under this policy shall include:

1. **Securities issued by the US Treasury**, provided that there shall be no maximum allowable investment in US Treasury securities;
2. **Securities issued by a Federal Agency also referred to as a Government Sponsored Enterprise (GSE)** . Examples of such Federal Agencies are Federal Agencies such as Federal National Mortgage Association, Federal Home Loan Mortgage Corp, Federal Home Loan Bank, Federal Farm Credit Bank), provided that there shall be no maximum allowable investment in such securities;
 - a. 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. NO more than 30% of the total portfolio may be invested in TLGP notes and no more than 5% per issuer. Notes must be rated AAA by nationally recognized statistical rating agency (NRSRO).
3. **Negotiable certificates of deposit (NCDs)** provided that:
 - a. They are issued by institutions which have long term debt rated "A" or higher by S&P and Moody's; and/or have short term debt rated at least A1 by S&P or P1 by Moody's;
 - b. The maturity does not exceed five years; and
 - c. No more than 30% of the total portfolio may be invested in NCDs;

4. **Repurchase agreements** collateralized with securities authorized under Sections III(A1-2) of this policy maintained at a level of at least 102% of the market value of the repurchase agreements, provided that:
 - a. The maximum maturity of repurchase agreements shall be 1 year;
 - b. There is no limit to the amount to be invested in repurchase agreements;
 - c. Securities used as collateral for repurchase agreements, shall be delivered to the Agency's custodian bank, except that securities used as collateral for the one to seven day repurchase agreements with the Agency's depository bank may be held in safekeeping by the depository bank's trust department in the name of the Agency, as evidenced by appropriate receipts of trust (See Section II E); and
 - d. The repurchase agreements are the subject of a master repurchase agreement between the Agency and the provider of the repurchase agreement. The master repurchase agreement shall be substantially in the form developed by the Public Securities Association;
5. **Commercial paper** provided that:
 - a. The maturity does not exceed 270 days from the date of purchase;
 - b. The issuer is a corporation organized and operating in the United States with assets in excess of \$500 million;
 - c. The paper is rated a minimum of P1 by Moody's Investor Services (Moody's) and A1 by Standard & Poor's Inc. (S&P); and
 - d. No more than 25% of the portfolio is invested in commercial paper;
6. **State of California Local Agency Investment Fund (LAIF)**, provided that:
 - a. The Agency may invest up to the maximum permitted amount in LAIF (currently \$40MM); and
 - b. LAIF's investments in instruments prohibited by or not specified in the Agency's policy do not exclude it from the Agency's list of allowable investments, provided that the fund's reports allow the Agency Treasurer to adequately judge the risk inherent in LAIF's portfolio;
7. **Corporate medium term notes**, provided that:
 - a. Such notes have a maximum maturity of five years;

- b. are issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States;
- c. are rated in a rating category of "A" (not A-) or its equivalent or better by Moody's and S&P; and
- d. holdings of medium-term notes may not exceed 30 percent of the portfolio;

8. Mortgage pass-through securities and asset-backed securities, provided that:

- a. such securities shall have a maximum stated final maturity of five years;
- b. shall be rated AAA by S&P or Aaa by Moody's; and
- c. purchase of securities authorized by this subdivision may not exceed 20 percent of the portfolio.

9. Money market mutual funds, provided that such funds:

- a. Are registered with the Securities and Exchange Commission and are rated AAA by S&P or Aaa by Moody's; OR
- b. Have retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience investing in the securities and obligations authorized by California Government Code Section 53601 (a through j) and with assets under management in excess of \$500 million.
- c. Purchase of securities authorized by this subdivision may not exceed 20 percent of the portfolio.

10. Local agency Obligations, provided that

- a. Are rated A-1 / P-1, or equivalent or better short term by two nationally recognized statistical rating agencies; OR
- b. Are rated Aa / AA or better long term by two nationally recognized statistical rating agencies.

B. Prohibited investment vehicles and practices

- 1. State law notwithstanding, any investments not specifically described herein are prohibited, including, but not limited to, mutual funds (other than government money market funds as described in Section III A(12), unregulated and/or unrated investment pools or trusts, collateralized mortgage obligations and futures and options.

2. In accordance with Government Code Section 53601.6, investment in inverse floaters, range notes, or mortgage derived interest-only strips is prohibited.
3. Investment in any security that could result in a zero interest accrual if held to maturity is prohibited.
4. Trading securities for the sole purpose of speculating on the future direction of interest rates is prohibited.
5. Purchasing or selling securities on margin is prohibited.
6. The use of reverse repurchase agreements, securities lending or any other form of borrowing or leverage is prohibited.
7. The purchase of securities issued by company in the tobacco business, including parent companies and their controlled subsidiaries.
8. The purchase of foreign currency denominated securities.
9. Prohibited investments held in the portfolio at the time of adoption of this policy may be held until maturity at the discretion of the Finance Director.

C. Mitigating credit risk in the portfolio

Credit risk is the risk that a security or a portfolio will lose some or all of its value due to a real or perceived change in the ability of the issuer to repay its debt. The Agency shall mitigate credit risk by adopting the following strategies:

1. The diversification requirements included in Section III (A) are designed to mitigate credit risk in the portfolio;
2. No more than 5% of the total portfolio may be invested in securities of any single issuer, other than the US Government, its agencies and instrumentalities;
3. The Agency 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 the Agency's risk preferences; and
4. If securities owned by the Agency are downgraded by either Moody's or S&P to a level below the quality required by this Investment Policy, it shall be the Agency's policy to review the credit situation and make a determination as to whether to sell or retain such securities in the portfolio.
 - a. If a security is downgraded two grades below the level required by the Agency, the security shall be sold immediately.
 - b. If a security is downgraded one grade below the level required by this policy, the Agency Finance Director will use discretion in determining

whether to sell or hold the security based on its current maturity, the loss in value, the economic outlook for the issuer, and other relevant factors.

- c. If a decision is made to retain a downgraded security in the portfolio, its presence in the portfolio will be monitored and reported monthly to the Agency Council.

D. Mitigating market risk in the portfolio

Market risk is the risk that the portfolio will decline in value (or will not optimize its value) due to changes in the general level of interest rates. The Agency recognizes that, over time, longer-term portfolios achieve higher returns. On the other hand, longer-term portfolios have higher volatility of return. The Agency shall mitigate market risk by providing adequate liquidity for short-term cash needs, and by making some longer-term investments only with funds that are not needed for current cashflow purposes. The Agency further recognizes that certain types of securities, including variable rate securities, securities with principal paydowns prior to maturity, and securities with embedded options, will affect the market risk profile of the portfolio differently in different interest rate environments. The Agency, therefore, adopts the following strategies to control and mitigate its exposure to market risk:

- 1. **Maximum Maturities.** F5AC shall attempt to match its investments with anticipated cash flow requirements. Maximum final maturity of investments in the Treasury and Agency securities shall not exceed 6 years. All other investments shall have a final maturity as stated in section VI., Eligible Investments. The weighted average maturity of the portfolio will not exceed 3 years. Reserve funds and other funds with longer-term investment horizons may be invested in securities exceeding 6 years if the maturities of such investments are made to coincide as nearly as practicable with the expected use of funds.

VII. Performance objectives and expectations

- A. **Overall objective.** The investment portfolio shall be designed with the overall objective of obtaining a total rate of return throughout economic cycles, commensurate with investment risk constraints and cash flow needs.
- B. **Specific objective.** The investment performance objective for the portfolio shall be to earn a total rate of return over a market cycle which is approximately equal to the return on the agreed upon Benchmark Index.

VIII. REPORTING REQUIREMENTS

- 1. **ADOPTION OF INVESTMENT POLICY.** In accordance with Government Code Sections 53600 through 53609, the Chief Executive Officer or his designee shall annually render to the Commission a statement of investment policy, which the Commission shall consider at a public meeting.

2. **QUARTERLY REPORTING.** The Chief Executive Officer shall submit quarterly an investment report that summarizes recent market conditions, economic developments and anticipated investment conditions. The report shall summarize the investment strategies employed in the most recent quarter, and describe the portfolio in terms of investment securities, maturities, risk characteristics and other features. The report shall explain the quarter's total investment return and compare the return with budgetary expectations. The report shall include an appendix that discloses all transactions during the past quarter: The report shall be in compliance with state law and shall be distributed to the Finance Advisory Committee and others as required by law.

Each quarterly report shall indicate any areas of policy concern and suggested or planned revision of investment strategies.

Within 40 days of the end of the fiscal year, the Chief Executive Officer shall present an annual report on the investment program. The annual report shall include 12-month and separate quarterly comparisons of return and shall suggest policies and improvements that might be made in the investment program.

GLOSSARY OF INVESTMENT TERMS[©]

Agencies. Shorthand market terminology for any obligation issued by a *government-sponsored entity (GSE)*, or a *federally related institution*. Obligations of GSEs are not guaranteed by the full faith and credit of the US government. There are eight GSEs, five of which are currently active in the new issue market. The five include:

FFCB. The Federal Farm Credit Bank System provides credit and liquidity in the agricultural industry. FFCB issues discount notes and bonds.

FHLB. The Federal Home Loan Bank provides credit and liquidity in the housing market. FHLB issues discount notes and bonds.

FHLMC. Like FHLB, the Federal Home Loan Mortgage Corporation provides credit and liquidity in the housing market. FHLMC, also called "FreddieMac" issues discount notes, bonds and mortgage pass-through securities.

FNMA. Like FHLB and FreddieMac, the Federal National Mortgage Association was established to provide credit and liquidity in the housing market. FNMA, also known as "FannieMae," issues discount notes, bonds and mortgage pass-through securities.

Federally related institutions are arms of the federal government. Most do not issue securities directly into the market. Those, which do issue directly, include the following:

GNMA. The Government National Mortgage Association, known as "GinnieMae," issues mortgage pass-through securities, which are guaranteed by the full faith and credit of the US Government.

PEFCO. The Private Export Funding corporation assists exporters. Obligations of PEFCO are not guaranteed by the full faith and credit of the US government.

TVA. The Tennessee Valley Authority provides flood control and power and promotes development in portions of the Tennessee, Ohio and Mississippi River valleys. TVA currently issues discount notes and bonds.

Asked. The price at which a seller offers to sell a security.

Average life. In mortgage-related investments, including CMOs, the average time to expected receipt of principal payments, weighted by the amount of principal expected.

Banker's acceptance. A money market instrument created to facilitate international trade transactions. It is highly liquid and safe because the risk of the trade transaction is transferred to the bank which "accepts" the obligation to pay the investor.

Benchmark. A comparison security or portfolio. A performance benchmark is a partial market index, which reflects the mix of securities allowed under a specific investment policy.

Bid. The price at which a buyer offers to buy a security.

Broker. A broker brings buyers and sellers together for a transaction for which the broker receives a commission. A broker does not sell securities from his own position.

Certificate of Deposit (CD). A time deposit with a specific maturity evidenced by a certificate. Large denomination CDs may be marketable.

Collateral. Securities or cash pledged by a borrower to secure repayment of a loan or repurchase agreement. Also, securities pledged by a financial institution to secure deposits of public monies.

Collateralized Mortgage Obligations (CMO). Classes of bonds that redistribute the cash flows of mortgage securities (and whole loans) to create securities that have different levels of prepayment risk, as compared to the underlying mortgage securities.

Commercial paper. The short-term unsecured debt of corporations.

Cost yield. The annual income from an investment divided by the purchase cost. Because it does not give effect to premiums and discounts which may have been included in the purchase cost, it is an incomplete measure of return.

Coupon. The rate of return at which interest is paid on a bond.

Credit risk. The risk that principal and/or interest on an investment will not be paid in a timely manner due to changes in the condition of the issuer.

Current yield. The annual income from an investment divided by the current market value. Since the mathematical calculation relies on the current market value rather than the investor's cost, current yield is unrelated to the actual return the investor will earn if the security is held to maturity.

Dealer. A dealer acts as a principal in security transactions, selling securities from and buying securities for his own position.

Debenture. A bond secured only by the general credit of the issuer.

Delivery vs. payment (DVP). A securities industry procedure whereby payment for a security must be made at the time the security is delivered to the purchaser's agent.

Derivative. Any security that has principal and/or interest payments which are subject to uncertainty (but not for reasons of default or credit risk) as to timing and/or amount, or any security which represents a component of another security which has been separated from other components ("Stripped" coupons and principal). A derivative is also defined as a financial instrument the value of which is totally or partially derived from the value of another instrument, interest rate or index.

Discount. The difference between the par value of a bond and the cost of the bond, when the cost is below par. Some short-term securities, such as Tbills and banker's acceptances, are known as **discount securities**. They sell at a discount from par, and return the par value to the investor at maturity without additional interest. Other securities, which have fixed coupons trade at a discount when the coupon rate is lower than the current market rate for securities of that maturity and/or quality.

Diversification. Dividing investment funds among a variety of investments to avoid excessive exposure to any one source of risk.

Duration. The weighted average time to maturity of a bond where the weights are the present values of the future cash flows. Duration measures the price sensitivity of a bond to changes in interest rates. (See modified duration).

Federal funds rate. The rate of interest charged by banks for short-term loans to other banks. The Federal Reserve Bank through open-market operations establishes it.

Federal Open Market Committee: A committee of the Federal Reserve Board that establishes monetary policy and executes it through temporary and permanent changes to the supply of bank reserves.

Haircut: The margin or difference between the actual market value of a security and the value assessed by the lending side of a transaction (i.e. a repo).

Leverage. Borrowing funds in order to invest in securities that have the potential to pay earnings at a rate higher than the cost of borrowing.

Liquidity: The speed and ease with which an asset can be converted to cash.

Margin: The difference between the market value of a security and the loan a broker makes using that security as collateral.

Market risk. The risk that the value of securities will fluctuate with changes in overall market conditions or interest rates.

Market value. The price at which a security can be traded.

Marking to market. The process of posting current market values for securities in a portfolio.

Maturity. The final date upon which the principal of a security becomes due and payable.

Medium term notes. Unsecured, investment-grade senior debt securities of major corporations which are sold in relatively small amounts either on a continuous or an intermittent basis. MTNs are highly flexible debt instruments that can be structured to respond to market opportunities or to investor preferences.

Modified duration. The percent change in price for a 100 basis point change in yields. Modified duration is the best single measure of a portfolio's or security's exposure to market risk.

Money market. The market in which short term debt instruments (Tbills, discount notes, commercial paper and banker's acceptances) are issued and traded.

Mortgage pass-through securities. A securitized participation in the interest and principal cashflows from a specified pool of mortgages. Principal and interest payments made on the mortgages are passed through to the holder of the security.

Mutual fund. An entity which pools the funds of investors and invests those funds in a set of securities which is specifically defined in the fund's prospectus. Mutual funds can be invested in various types of domestic and/or international stocks, bonds and money market instruments, as set forth in the individual fund's prospectus. For most large, institutional investors, the costs associated with investing in mutual funds are higher than the investor can obtain through an individually managed portfolio.

Premium. The difference between the par value of a bond and the cost of the bond, when the cost is above par.

Prepayment speed. A measure of how quickly principal is repaid to investors in mortgage securities.

Prepayment window. The time period over which principal repayments will be received on mortgage securities at a specified prepayment speed.

Primary dealer. A financial institution (1) that is a trading counterparty with the Federal Reserve in its execution of market operations to carry out U.S. monetary policy, and (2) that participates for statistical reporting purposes in compiling data on activity in the U.S. Government securities market.

Prudent person (man) rule. A standard of responsibility which applies to fiduciaries. In California, the rule is stated as "Investments shall be managed with the care, skill, prudence and diligence, under the circumstances then prevailing, that a prudent person, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of like character and with like aims to accomplish similar purposes."

Realized yield. The change in value of the portfolio due to interest received and interest earned and realized gains and losses. It does not give effect to changes in market value on securities, which have not been sold from the portfolio.

Regional dealer. A financial intermediary that buys and sells securities for the benefit of its customers without maintaining substantial inventories of securities, and that is not a primary dealer.

Repurchase agreement (RP, Repo). Short term purchases of securities with a simultaneous agreement to sell the securities back at a higher price. From the seller's point of view, the same transaction is a **reverse repurchase agreement**.

Safekeeping. A service to bank customers whereby securities are held by the bank in the customer's name.

Structured note. 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 which 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.

Total rate of return. A measure of a portfolio's performance over time. It is the internal rate of return, which equates the beginning value of the portfolio with the ending value, and includes interest earnings and realized and unrealized gains and losses on the portfolio.

U.S. Treasury obligations. Securities issued by the U.S. Treasury and backed by the full faith and credit of the United States. Treasuries are considered to have no credit risk, and are the benchmark for interest rates on all other securities in the US and overseas. The Treasury issues both discounted securities and fixed coupon notes and bonds.

Treasury bills. All securities issued with initial maturities of one year or less are issued as discounted instruments, and are called Treasury bills. The Treasury currently issues three- and six-month T-bills at regular weekly auctions. It also issues "cash management" bills as needed to smooth out cash flows.

Treasury notes. All securities issued with initial maturities of two to ten years are called Treasury notes, and pay interest semi-annually.

Treasury bonds. All securities issued with initial maturities greater than ten years are called Treasury bonds. Like Treasury notes, they pay interest semi-annually.

Volatility. The rate at which security prices change with changes in general economic conditions or the general level of interest rates.

Yield to Maturity. The annualized internal rate of return on an investment which equates the expected cash flows from the investment to its cost.

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