Investment Policy and Guidelines

Calaveras County Treasury Funds

INVESTMENT POLICY AND GUIDELINES

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I. **Investment Philosophy**

A. Policy

1. This Investment Policy is set forth by the County, for the following purposes:

   a. To establish a clear understanding for the governing body, management, employees, citizens and third parties of the objectives, policies and guidelines for the investment of public funds; and,

   b. To offer guidance to investment staff and any external investment advisers on the investment of County funds; and,

   c. To establish a basis for evaluating investment results.

2. The County establishes investment policies that meet its current investment goals. The County shall review this policy annually, and may change its policies as its investment objectives change.

B. Objectives

The objectives of this investment policy are, in order of priority:

1. To ensure safety of invested funds;

2. To maintain sufficient liquidity to meet cash flow needs;

3. To attain a "market average rate of return" consistent with the primary objectives of safety and liquidity. The expected rate of return on the County's portfolio is more specifically defined in Section IV; and

4. To assure ongoing compliance with all Federal, State and local laws governing the investment of moneys under the control of the County Treasurer.

C. Prudence

1. The Prudent Investor Standard: When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the County. Within the limitations of this section and considering individual investments as part of an overall strategy, a trustee is authorized to acquire investments as authorized by law.

2. **The Prudent Investor Standard** shall be used by investment officials, and shall be applied in the context of managing an overall portfolio. Investment staff acting in accordance with written procedures and the investment policy and exercising due diligence shall be relieved of personal responsibility for each security's credit risk or market price changes, provided deviations from expectations are reported within 30 days and appropriate action is taken to control adverse developments.

D. Ethics and Conflicts of Interest

Officers and employees, including members of the Oversight Committee involved in the investment process, shall refrain from personal business activity that could conflict with proper execution of the investment program or which could impair their ability to make impartial investment decisions.

II. Operational and Procedural matters

A. Scope

This investment policy applies to all financial assets and investment activities of the County with the following exceptions:

1. Proceeds of debt issuance shall be invested in accordance with the general investment philosophy of the County as set forth in this policy; however, such proceeds are invested in accordance with permitted investment provisions of their specific bond indentures.

B. Oversight Committee

Pursuant to Government Code Section 27131, an Oversight Committee shall consist of 3 to 11 members as nominated by the Treasurer and confirmed by the Board of Supervisors. Currently the Treasury Oversight Committee Members consist of; County Treasurer-Tax Collector, and a representative of the County Administrative Officer, County Auditor-Controller, Board of Supervisors, Superintendent of Schools or their respective appointees.

The Oversight Committee shall:

1. Annually review the investment policy and submit it to the Board of Supervisors for approval each year.

2. Annually review the investments and rate of return.

3. Pursuant to Government Code Section 27134 request an annually audit to determine compliance.

4. Conduct regular meetings as determined by the committee—currently this is quarterly.

5. Meet on other matters as necessary.

Members of the committee may not accept any gift, honoraria, gratuity or service which would be in violation of the regulations set forth by the Fair Political Practices Commission, the Government Code or County Ordinance. Members may make personal contributions in accordance with FPPC rules, but may not engage in money raising activities on behalf of the Treasurer or a member of the Board of Supervisors. A member may not secure employment with bond underwriters, bond counsel, security brokerages or dealers, or with financial services firms for 1 year after leaving the committee.

C. Depositors with the County Investment Pool

The Government Code requires the County Treasurer to define the limits and conditions under which local agencies having their money in the Investment Pool may deposit and withdraw their funds. The Government Codes confer upon the Treasurer the final authority as to how funds for which the Treasurer is held responsible for overseeing, will be invested. The Treasurer must take into account the current financial condition of the sum total of the Pool's cash needs. The Treasurer must not only protect each individual local agency, but also see that no decision will reward a particular agency or group of agencies within the Pool at the expense of another or others within the Pool.

The Treasurer has determined that withdrawals of less than $1 million will not affect the stability and predictability of the investments in the county Treasury. The Treasurer’s Office requires 48 hours notice on withdrawals of $1 million to $5 million, and at least 30 days notice for amounts over $5 million. If the Treasurer determines that a request for a withdrawal of funds for a specific or outside investment is not, in the Treasurer's opinion, in the best interest of a particular agency, or is overly detrimental to the pool as a whole, the Treasurer must legally deny the request, or find a means of neutralizing the harm to all those others affected.

The Investment pool is designed as an operating fund for Calaveras County departments and entities that by law are required to deposit with the County’s investment pool. By approval of the Treasurer, voluntary depositors may be accepted providing the agency’s administrative body has agreed to the terms of the Calaveras County Investment Policy. The depositor shall deliver to the County Treasurer and Auditor, a resolution accepting the terms of the Calaveras County Investment Policy and identifying the authorized official(s) acting on behalf of the agency.

D. Delegation of Authority

1. The County Treasurer is responsible for investing the surplus funds, money not required for the immediate necessities of the County, in the County Treasury in accordance with the California Government Code, Section 53601 et.seq. and 53635 et.seq.

2. Authority to manage the County's investment program is derived from the California Government Code Sections 53600 et seq.

3. The County may engage the services of one or more external investment managers to assist in the management of the County's investment portfolio in a manner consistent with the County's objectives. Such external managers may be granted discretion to purchase and sell investment securities in accordance with this Investment Policy. Such managers must be registered under the Investment Advisers Act of 1940.

E. Authorized Financial Dealers and Institutions

1. Selection of financial institutions and broker/dealers authorized to engage in transactions with the County shall be at the sole discretion of the County, within the requirements of the California Government Code Section 53600 *et seq.*

2. All financial institutions which desire to become qualified bidders for investment transactions (and which are not dealing only with the investment adviser) must supply the County Treasurer with a statement certifying that the institution has reviewed the California Government Code Section 53600 *et seq*. and the County's Investment Policy and that all securities offered to the County shall comply fully and in every instance with all provisions of the Code and with this Investment Policy.

3. Public deposits shall be made only in qualified public depositories within the State of California as established by State law. Deposits shall be insured by the Federal Deposit Insurance Corporation, or, to the extent the amount exceeds the insured maximum, shall be collateralized with securities in accordance with State law.

4. Selection of broker/dealers used by external investment advisers retained by the County shall be at the sole discretion of the investment advisers, after consultation with the County Treasurer.

F. Apportioning of Costs and Interest

Interest earnings on the County's pooled investments shall be credited quarterly. Earnings are based on the average daily cash balance of funds on deposit during the quarter in the County Treasury. Authorized costs of investing, depositing, auditing, reporting or otherwise handling or managing funds, and the costs of the county treasury oversight committee will be subtracted from the total interest earnings before the interest earnings are apportioned.

G. Delivery vs. payment

All investment transactions of the County shall be conducted using standard delivery-vs.-payment procedures.

H. Safekeeping of securities

To protect against potential losses by collapse of individual securities dealers, and to enhance access to securities, interest payments and maturity proceeds, all securities owned by the County shall be held with a third party safekeeper, acting as agent for the County under the terms of a custody agreement executed by the bank and by the County.

III. Permitted investments and portfolio risk management

A. Authorized Investments

The County's investments are governed by California Government Code, Sections 53600 et seq. Within the investments permitted by the Code, the County seeks to further restrict eligible investments to the guidelines listed below. In the event a discrepancy is found between this policy and the Code, the more restrictive parameters will take precedence. Percentage holding limits listed in this section apply at the time the security is purchased. For the purpose of evaluating credit ratings in this policy, a nationally recognized statistical rating organization (NRSRO) is defined as Moody's, Standard and Poor's' and Fitch or their successors.

Any investment currently held at the time the policy is adopted which does not meet the new policy guidelines can be held until maturity, and shall be exempt from the current policy. At the time of the investment's maturity or liquidation such funds shall be reinvested only as provided in the current policy.

An appropriate risk level shall be maintained by primarily purchasing securities that are of high quality, liquid, and marketable. The portfolio shall be diversified by security type and institution to avoid incurring unreasonable and avoidable risks regarding specific security types or individual financial institutions.

Concentration and credit limits apply at the time the security is purchased.

Permitted investments under this policy shall include:

1. **U.S. Treasury** and other government obligations for which the full faith and credit of the United States are pledged for the payment of principal and interest. There are no limits on the dollar amount or percentage that the County may invest in U.S. Treasuries

a. The maximum maturity of an issue shall be no more than 5 years at time of purchase.

2. **Federal Agency** or United States government-sponsored enterprise obligations, participations, or other instruments, including those issued by or fully guaranteed as to principal and interest by federal agencies or United States government-sponsored enterprises. There are no limits on the dollar amount or percentage that the County may invest in government-sponsored enterprises.

a. The maximum maturity of an issue shall be no more than 5 years at time of purchase; and,

b. No more than 30% of the pool value shall be invested in any single issuer

3. **Supranationals**, provided that:

a. Issues are unsubordinated obligations issued by the International Bank for Reconstruction and Development, International Finance Corporation, or Inter-American Development Bank.

b. The securities are rated in the “AA” category or higher by a NRSRO.

c. No more than 30% of the total portfolio may be invested in these securities

d. No more than 10% of the portfolio per issuer

e. The maximum maturity does not exceed 5 years.

4. **Municipal Securities** include obligations of the County, the state of California, and any local agency within the state of California, provided that:

a. The maximum maturity of an issue shall be no more than 5 years at time of purchase; and,

b. No more than 5% per issuer.

c. No more than 30% of the portfolio may be invested in Municipal Securities.

d. The securities are rated in a rating category of “A” or its equivalent or higher by at least one NRSRO.

5. **Municipal Securities (Registered Treasury Notes or Bonds)** of any of the other 49 states in addition to California, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by a state or by a department, board, agency, or authority of any of the other 49 states, in addition to California.

   a. The maximum maturity of an issue shall be no more than 5 years at time of purchase; and,

   b. No more than 5% per issuer.

   c. No more than 30% of the portfolio may be invested in Municipal Securities.

   d. The securities are rated in a rating category of “A” or its equivalent or higher by at least one NRSRO.

6. **Corporate medium term notes,** provided that:

   a. Such notes have a maximum maturity of five years; and,

   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; and,

   c. Are Rated ”A” category or better by a NRSRO; and,

   d. Holdings of medium-term notes may not exceed 30% of the portfolio; and,

   e. No more than 5% per issuer.

7. **Federally Insured Time Deposits** (Non-negotiable certificates of deposit) in state or federally chartered banks, savings and loans, or credit unions, provided that;

   a. The amount per institution is limited to the maximum covered under federal insurance; and,

b. The maturity of such deposits does not exceed 5 years; and,

c. No more than 5% per issuer.

8. **Time deposits (Non-negotiable certificates of deposit)** in California banks in excess of insured amounts which are fully collateralized with securities in accordance with California law, provided that:

   a. No more than 20% of the portfolio shall be invested in a combination of federally insured and collateralized time deposits; and,

   b. The maturity of such deposits does not exceed 5 years; and,

   c. no more than 5% of investment funds invested in any one bank
   .

9. **Negotiable certificates of deposit (NCDs)** provided that:

   a. The amount of the NCD insured up to the FDIC limit does not require any credit ratings.

   b. For any amount above the FDIC insured limit they must be issued by institutions which have short-term debt obligations are rated "A-1" or higher, or the equivalent, by at least one NRSRO; or long-term obligations are rated in the "A" category or higher by a NRSRO; and,

   c. The maturity does not exceed five years; and,

   d. No more than 30% of the total portfolio may be invested in NCDs; and,

   e. No more than 5% per issuer

10. **Mortgage Pass-Through Securities, Collateralized Mortgage Obligations (CMO) and Asset-Backed Securities,** provided that such securities:

    a. have a maximum stated final maturity of five years; and,

    b. are rated in a rating category of "AA" or its equivalent or better by a NRSRO; and,

    c. Purchase of securities authorized by this subdivision may not exceed 20% of the portfolio.

11. **Commercial paper** provided that:

   a. The maturity does not exceed 270 days from the date of purchase; and,

   b. The issuer is a corporation organized and operating in the United States with assets in excess of $500 million; and,

   c. They are issued by institutions whose short term obligations are rated ”A-1” or higher, or the equivalent, by a NRSRO; and whose long-term obligations, if any, are rated in the ”A” category or higher by a NRSRO; and,

   d. No more than 40% of the portfolio is invested in commercial paper; and,

   e. No more than 5% per issuer.

12. **Banker’s acceptances** provided that:

   a. They are issued by institutions with short term debt obligations rated ”A-1” or higher, or the equivalent, by NRSRO; and have long-term debt obligations which are rated in the ”A” category or higher by a NRSRO; and,

   b. The maturity does not exceed 180 days; and,

   c. No more than 40% of the total portfolio may be invested in banker’s acceptances; and,

   d. No more than 5% per issuer.

13. **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 30 days; and,

   b. No more than 10% of the portfolio shall be invested in repurchase agreements; and,

   c. Securities used as collateral for repurchase agreements, shall be delivered to the County’s custodian bank, except that securities used as collateral for the one to seven day repurchase agreements with the County’s depository bank may be held in safekeeping by the depository bank’s trust department in the name of the County, 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 County and the provider of the repurchase agreement. The master repurchase agreement shall be substantially in the form developed by the Public Securities Association;

14. **State of California Local Agency Investment Fund (LAIF)**, provided that:

    a. The County may invest up to the maximum permitted amount in LAIF; and,

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

15. **California Asset Management Program (CAMP)** California Asset Management Trust, a professionally managed Money Market portfolio established in 1989 as a Joint Powers Authority, provided that:

    a. The County may invest in CAMP as approved by the County Treasurer.

16. **Mutual Funds and Money Market Mutual Funds** that are registered with the Securities and Exchange Commission under the Investment Company Act of 1940, provided that:

    a. **Mutual Funds** that invest in the securities and obligations as authorized under California Government Code, Section 53601 (a) to (k) and (m) to (q) inclusive and that meet either of the following criteria:

        1. Attained the highest ranking or the highest letter and numerical rating provided by not less than two NRSROs; or

        2. 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 and with assets under management in excess of $500 million.

3. No more than 10% of the total portfolio may be invested in shares of any one mutual fund.

b. **Money Market Mutual Funds** registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and issued by diversified Management Companies and meet either of the following criteria:

   1. Have attained the highest ranking or the highest letter and numerical rating provided by not less than two NRSROs; or

   2. Have retained an investment adviser registered or exempt from registration with the Securities and Exchange Commission with not less than five years' experience managing money market mutual funds with assets under management in excess of $500 million.

   3. No more than 20% of the total portfolio may be invested in Money Market Mutual Funds.

c. Purchase of securities authorized by this subdivision may not exceed 20% of the portfolio.

B. Prohibited investment vehicles and practices

1. State law notwithstanding, any investments not specifically described herein are prohibited, including, but not limited to, unregulated and/or unrated investment pools or trusts along with 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 re-purchase agreements, securities lending or any other form of borrowing or leverage is prohibited.

7. Prohibited investments held in the portfolio at the time of adoption of this policy may be held until maturity at the discretion of the Treasurer.

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 County 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; and,

2. No more than 5% of the total portfolio, at the time of purchase, may be invested in securities of any single issuer, other than the money market funds, mutual funds, Local Agency Investment Pools, US Government, its agencies and instrumentalities, and supranationals, or unless otherwise specified in this investment policy; and,

3. The County 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 County's risk preferences; and,

4. If securities owned by the County are downgraded by below the minimum credit rating requirements defined in this investment policy, it shall be the County'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 policy, the security shall be sold immediately.

    b. If a security is downgraded one grade below the level required by this policy, the County Treasurer 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 Oversight Committee.

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 County recognizes that, over time, longer-term portfolios achieve higher returns. On the other hand, longer-term portfolios have higher volatility of return. The County 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 cash flow purposes. The County further recognizes that certain types of securities, including variable rate securities, securities with principal pay downs prior to maturity, and securities with embedded options, will affect the market risk profile of the portfolio differently in different interest rate environments. The County, therefore, adopts the following strategies to control and mitigate its exposure to market risk:

1. The maximum stated final maturity of individual securities in the portfolio shall be five years; and,

2. The County shall maintain a minimum of three months of budgeted operating expenditures in short term investments; and,

3. The duration of the portfolio shall typically be plus or minus 10% of the Benchmark index.

E. Performance Standards

The County's investment portfolio shall be designed to attain a market-average rate of return throughout budgetary and economic cycles, taking into account the county's investment risk constraints and cash flow. In order to assist in the evaluation of the portfolio's performance, the County will use a performance benchmark for the portion of the portfolio that is not required for short term liquidity. The market-average rate of return for benchmark purposes will be the Bank of America\Merrill Lynch 1-3 Year Treasuries Index. The Bank of America\Merrill Lynch 1-3 Year Treasuries Index represents all U.S. Treasuries securities maturing over one year, but less than 3 years. The maturity range is an appropriate benchmark based on the objectives and risk tolerance of the County.

IV. Specific 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 Benchmark Index (see III E1).

V. Reporting, disclosure and program evaluation

A. Monthly reports

Monthly investment reports shall be submitted by the County Treasurer to the County Board of Supervisors. These reports shall disclose, at a minimum, the following information about the risk characteristics of the County's portfolio:

1. An asset listing showing par value, cost and accurate and complete market value of each security, type of investment, issuer, interest rate, and rating; and,

2. A one-page summary report which shows:

    a. Average maturity of the portfolio and modified duration of the portfolio; and,

    b. Maturity distribution of the portfolio; and,

    c. Time-weighted total rate of return for the portfolio for the prior three months, twelve months, year to date, and since inception compared to the Benchmark Index returns for the same periods;

3. A statement of compliance with investment policy, including a schedule of any transactions or holdings which do not comply with this policy or with the California Government Code, including a justification for their presence in the portfolio and a timetable for resolution; and,

4. A statement that the County has adequate funds to meet its cash flow requirements for the next six months.

5. A transactions report.

B. Annual reports

The investment policy shall be reviewed and adopted at least annually within 120 days of the end of the fiscal year to ensure its consistency with the overall objectives of preservation of principal, liquidity and return, and its relevance to current law and financial and economic trends.

C. Internal controls

The County Treasurer is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the entity are protected from loss, theft or misuse. The internal control structure shall be designed to provide reasonable assurance that these objectives are met. Internal controls shall be in writing and shall address the following points: control of collusion, separation of transaction authority from accounting and record keeping, safekeeping of assets and written confirmation of telephone transactions for investments and wire transfers.

D. Annual audit

The County Treasurer shall establish an annual process of independent review by the County's external auditor to assure compliance with internal controls. Such audit will include tests deemed appropriate by the auditor.

E. Special audits

The County Board of Supervisors may at any time order an audit of the investment portfolio and/or the County Treasurer's investment practices.

GLOSSARY OF INVESTMENT TERMS©

Agencies. Shorthand market terminology for any obligation issued by *a government-sponsored entity (GSE)*, or a *federally related institution*. Most obligations of GSEs are not guaranteed by the full faith and credit of the US government. Examples are:

FDIC. The Federal Deposit Insurance Corporation provides insurance backed by the full faith and credit of the US government to certain bank deposits and debt obligations.

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.

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.

Asset Backed Securities. Securities supported by pools of installment loans or leases or by pools of revolving lines of credit.

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.

Callable. A callable security gives the issuer the option to call it from the investor prior to its maturity. The main cause of a call is a decline in interest rates. If interest rates decline since an issuer issues securities, it will likely call its current securities and reissue them at a lower rate of interest. Callable securities have reinvestment risk as the investor may receive its principal back when interest rates are lower than when the investment was initially made.

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 T-bills 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 Deposit Insurance Corporation. The US Government Corporation insuring deposits in the U.S. against bank failure. The FDIC was created in 1933 to maintain public confidence and encourage stability in the financial system through the promotion of sound banking practices.

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.

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.

Local Agency Investment Fund (LAIF). A voluntary investment fund open to government entities and certain non-profit organizations in California that is managed by the State Treasurer's Office.

Make Whole Call. A type of call provision on a bond that allows the issuer to pay off the remaining debt early. Unlike a call option, with a make whole call provision, the issuer makes a lump sum payment that equals the net present value (NPV) of future coupon payments that will not be paid because of the call. With this type of call, an investor is compensated, or "made whole."

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.

Municipal securities. A debt security issued by a state, municipality or county to finance its capital expenditures.

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.

Nationally Recognized Statistical Ratings Organization (NRSRO). Credit rating agencies that provide credit ratings that are used by the U.S. government in several regulatory areas. Ratings provided by Nationally Recognized Statistical Ratings Organizations (NRSRO) are used frequently by investors and are used as benchmarks by federal and state agencies.

Negotiable Certificate of Deposit. A certificate of deposit guaranteed by a bank that can usually be sold in the secondary market.

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.

Supranational. A supranational entity is formed by two or more central governments with the purpose of promoting economic development for the member countries. Supranational institutions finance their activities by issuing debt, such as supranational bonds.

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; it includes interest earnings, realized and unrealized gains, and losses in 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.