

COUNTY TREASURY INVESTMENT POOL

Our “Surplus” Money

June 9, 2014

SUMMARY

Mendocino County is the sponsor of an Investment Pool that consists of funds belonging to 37 local government agencies in addition to the county schools and the county government. The Board of Supervisors is responsible for the management of this investment pool. This report outlines the seriousness, extent, and complexity of investing this money to gain a return with minimal risk, while providing access to the funds needed for current operations. All this is to be accomplished by the County Treasurer in accordance with California Government Code §27007.

The County government and local county agencies receive cash resources to perform their duties. These funds are received at various times during the year and are expended as necessary. Funds not needed for near term expenses are referred to as “surplus” and must be invested securely for yield, yet easily available for use in the future. Surplus funds become the “Investment Pool” and are contained within the Mendocino County Treasury.

The Investment Pool does not include funds belonging to the retirement system or to the incorporated cities within the County.

The Investment Pool varies in magnitude during the year as the monies flow in and out. During the last fiscal year the average monthly amount was \$200,610,000.

The County Treasurer is charged by the Board of Supervisors to manage the Investment Pool. This stewardship by the County Treasurer is reported monthly, quarterly, and annually to the Board of Supervisors.

This money generates concerns about the effectiveness of the pool investments as related to the social and economic needs of the community. Some people have concerns regarding the possible economic advantages of utilizing a portion of these funds within the local economy.

The County Treasurer must administer the Investment Pool to assure the safety, liquidity, and return on the funds therein.

The Grand Jury recommends increased transparency, oversight, and financial valuation of the performance of the Investment Pool.

GLOSSARY

Basis Point	A unit of measure that is equal to 1/100 th of 1 percent and used for calculating financial change
Benchmark	A standard or measurement to be followed
Calvert Social Index	A listing of large companies that are considered socially responsible or ethical related to the environment, workplace issues, product safety, community relations and human rights
CAMP	California Asset Management Pool
Certificate of Deposit	A deposit with a specific time maturity which may be marketable

Churning	Excessive trading by a broker in a client's account largely to generate commissions
Corporate Notes	Debt securities issued by publicly held corporations
FFCB	Federal Farm Credit Bank. Issues discount notes and bonds in the agricultural industry
FHLB	Federal Home Loan Bank. Issues notes and bonds within the housing market
FHLMC	Federal Home Loan Mortgage Corporation. Also called "Freddie Mac", issues discount notes, bonds, and mortgage pass-through securities in the housing market
FNMA	Federal National Mortgage Association, also known as "Fannie Mae" issues notes, bonds and pass-through mortgages in the housing market
LAIF	Local Agency Investment Fund
Liquidity	The speed and ease of converting an asset to cash
Liquid Funds	Cash or financial instruments that may be immediately converted to cash
Maturity	The due and payable date of a security
TVA	Tennessee Valley Authority
U.S. Treasury Bills	Securities issued by the U.S. Treasury with a maturity of one year or less
U.S. Treasury Notes	Securities issued by the U.S. Treasury with maturities of two to ten years
U.S. Treasury Bonds	Securities issued by the U.S. Treasury with maturities greater than ten years
U.S. Treasury Obligations	All securities issued by and backed by the U.S. Treasury
Volatility	The rate of change in the price of securities as the economic and the interest rate conditions fluctuate

BACKGROUND

The fiscal condition of Mendocino County (County) and local government agencies has been a concern since the "Great Recession of 2008". The health of the County Treasury is important. The misuse of the Investment Fund of Orange County caused that county's bankruptcy in 1995.

In addition, there have been comments made by both government management and the public as to whether the funds in the County Investment Pool could be better invested in local financial institutions for the benefit of the local economy.

Also, some people have concerns that the Investment Pool should not be invested in carbon producing industries. On May 1, 2012, the County contracted with a financial asset management firm to assist in determining the proper investments to be made.

The 2013-2014 Grand Jury in its role as an advocate for the community, decided to review the husbandry of the investment pool as an expression of the Grand Jury's responsibilities.

APPROACH

The Grand Jury interviewed the Mendocino County Treasurer. The Grand Jury reviewed the Management Contract between the County and Chandler Asset Management Inc., the past and current investment reports, the treasurer's financial reports, the County Investment Policy, the Department of the Treasurer budget, the related California Government Code, related community publications and communications, and the investment pool reports of other counties.

FACTS

Most people are not aware of the amount of money, typically millions of dollars, flowing into and out of the County Treasury on a daily basis. The County Treasury is the keeper and distributor of much of the government funds that government agencies within the County receive. The government agencies that currently contribute to the Investment Pool include the County Government, the Schools, and 37 Special Districts. (Appendix A)

As required by California law, the County Board of Supervisors is responsible for managing these funds. The Board of Supervisors must assure that these funds are properly accounted for, invested, and made available on demand to meet the expenditures of the contributing agency. By ordinance, the Board of Supervisors annually designates the County Treasurer with this responsibility.

This collection of funds is known as the "Investment Pool". In addition to the County government and the school districts, many other government agencies such as special districts contribute to this Investment Pool. The County and the school districts are required by law to participate. Other agencies elect to participate because of the financial advantages.

The total amount of the Investment Pool occasionally exceeds \$200 million with the largest receipt of funds occurring during the months April and December. Approximately 67% of the Investment Pool are school district funds, 29% are County funds, and 4% are Special Districts funds from various agencies such as sanitation, water, fire, lighting, community services, and cemetery. No retirement funds are included.

The execution of these investments requires a thorough up-to-date knowledge of the financial markets and economic conditions. To this end, Mendocino County on May 1, 2012 contracted the services of Chandler Asset Management Inc. to assist the County Treasurer with timely and reliable financial and risk information regarding particular investments. The basic services provided by Chandler Asset Management are:

- Analyzing the cash flow requirements of the fund participants to determine the amount of funds that may be invested
- Assisting in determining the investment risk tolerance of investments per the benchmarks of the County Investment Policy
- Advising the County on recommended changes to investments based on new legislation or changes in the financial market
- Providing on-line investment information to the County Treasurer

- Providing periodic reports on the investment pool portfolio

Chandler Asset Management does not handle any funds or financial instruments of the Investment Pool. The County uses the services of two banks as the custodians of all Investment Pool cash and securities, i.e., the Bank of Mellon, New York and the Bank of America, Sacramento, California.

The Treasurer has developed a County Investment Policy that defines the guidelines to be used in managing the Investment Pool. The Investment Policy has three basic principles that must be followed:

1. Safety: The safeguarding of the principal.
2. Liquidity: The availability of the principal for agency needs.
3. Return on Investment: An increase in value of the principal and/or interest.

Government Code §53600 *et seq.* contains the State guidelines and regulations used by the County Treasurer in managing and investing the County Investment Pool. The Chandler Asset Management Report indicates that the County meets and exceeds those requirements.

The Board of Supervisors requires periodic financial reports on the investments made and the status of the investment fund. Monthly, quarterly, and annual investment reports are presented to the Board of Supervisors by the County Treasurer for review and approval. These reports are available for public review.

The most recent annual report was issued June 30, 2013. The report submitted by the Treasurer is prepared by Chandler Asset Management. It presents the investment pool portfolio together with statements regarding the financial conditions of the national economy.

The Chandler report explains that the investments made are within the benchmarks set forth in the Investment Policy of the County. There is information regarding the safety and liquidity of the investments. There is a lack of information regarding the return on investment.

The report contains a listing of individual investments (approximately 83) and qualitative performance measurements of investment classes to benchmark standards. The aforementioned 83 individual investments are in various types of instruments such as FFCB Notes, FNMA Callable Notes, FHLB Notes, FHLMC Callable Notes, TVA Notes, various banks commercial notes, government agencies LAIF and CAMP, Money Market Funds, Negotiable CD's, U.S. Corporate Notes, and U.S. Treasuries.

The investments must be risk adverse as the funds are public monies entrusted to the County Treasury for safekeeping. The funds contained in the Investment Pool must necessarily be available to meet the needs of the participating agencies. Within the above parameters, some return on these investments is attained.

The County Treasurer and Chandler Asset Management provide investment reports monthly, quarterly, and annually to the Board of Supervisors and the public. The reports outline the investments by agency, type, and percentage. The following figures are from the Chandler Asset Management Investment Report for the year ending June 30, 2013.

- Local Government Investment Fund (LGIF): A State of California agency that invests funds from local governments. Total: 0.6 %

- Local Area Investment Fund (LAIF): A State of California investment agency that invests local government funds into a Pooled Money Investment Account managed by the State Treasurer's Office. Total: 14.6 %
- Agencies: Various functional agencies such as Fannie Mae and Freddie Mac. Total: 29.2 %
- Commercial Notes: Banks, Credit companies. Total: 3.5 %
- Negotiable Credit Deposits: CD's. Total: 5.9 %
- Money Market Funds. Total: 16.2 %
- U.S. Corporate Notes. Total: 18.3 %
- U.S. Treasury Notes. Total: 11.5 %
- Cash. Total: 0.2 %

The annual Chandler report shows many changes in the cash flow in the various categories of investment (Appendix B). The variance in volume within these categories gives the appearance of churning. Changes in the quantity of funds within the various categories of assets from month to month during the year are noticeable. This indicates multiple transactions occurring with some attendant fees. These fees are expected to be separately identified as such or be included in the price of the financial instrument. The County Treasurer attributes these changes in cash flow within the various categories to the controlling guidelines of the investment policy and the fluidity of the financial market, not due to churning.

Evident in the report is the omission of any rate of return experienced during this period. California Government Code §53684 *et seq.* specifies that all interest income, gain or losses on the portfolio be distributed quarterly to each participant based upon their average daily balance in the fund. In response to our inquiry, the County Treasurer informed the Grand Jury that, after management and operational costs, the amount apportioned to the participants was a 0.58 % return on the funds for the year.

The Grand Jury considered the costs of managing the Investment Pool. Some counties perform the entire function within the county government, without contracted assistance. This increases the net gain on the investments to the advantage of the participants in the Investment Pool. Currently, the County Treasurer's Office employs approximately four persons to manage the Investment Pool. The other costs are incurred by the Chandler Asset Management firm.

The Chandler Asset Management's compensation is based on the amount of money in the Investment Pool. For year ending June 30, 2013, Chandler Asset Management was paid approximately \$105,000 based on 6 basis points (.0006) of the total amount in the Investment Pool. The cost of investment management incurred within the Treasurer's office was approximately \$252,000 for the fiscal year for a total cost of approximately \$357,000 or 17.85 basis points. Yuba County, similar to Mendocino County in population, experiences a cost of approximately 16.1 basis points in managing their investment pool.

An audit of the County is performed annually by an outside firm. The audit report for year ending June 30, 2013, contains a description of the cash and investments in the Investment Pool but does not address the gain or loss measurement of the Investment Pool.

A report titled *Counties Financial Transactions Report* is prepared by the County Auditor each year. This report states that the revenue from interest and investments for fiscal year 2012-2013 was \$614,526. In addition to this report, California Government Code §26920(a) requires the Auditor to perform a quarterly review of the assets in County Treasury and provide a report to the Board of Supervisors. These reports are not available.

The Grand Jury noted that some government officials and community members have expressed concerns regarding the nature of the investments made by the Investment Pool. To wit:

- The funds should not be used to invest in businesses that are not socially responsible.
- The funds should not be used to invest in carbon producing businesses.
- The funds should be invested in banks and businesses that benefit the local economy.

The County Treasurer has responded by using the Calvert Social Index to evaluate the current selection of investments. The Index contains those companies that are not only financially sound but exhibit social responsibility and sustainability. Arguably, any determination of the social responsibility and sustainability of a company is somewhat subjective and analysts may differ on methodology and degree. The Calvert Social Index is a widely accepted tool to determine which companies contribute to the welfare of society. The County Treasurer's evaluation of the corporate investments found that of the 24 current investments only two were not on the Calvert Social Index.

At a recent meeting of the Board of Supervisors, a member of the public submitted a list of some 200 companies considered by the speaker as unfit investments with Investment Pool monies. Some community members are adamant that any investment that would worsen the global warming climate disaster should be banned. Of special concern to these community members are the fossil fuel companies involved in exploration and production of coal, gas, and oil.

At the Board of Supervisors meetings, some people have expressed that the Investment Pool should be banked locally for a positive ripple effect on the local economy. The City of Santa Rosa is an example of local banking. Santa Rosa reviewed nine local financial institutions to see if they met their criteria of safety, liquidity and provide a fair return. Five were selected: two banks and three credit unions. Santa Rosa intends to deposit \$1.25 million amongst the five agencies.

In 2012, the Mendocino County Treasurer solicited bids from local banks to handle the County checking account. The Savings Bank of Mendocino County, Umpqua, and WestAmerica Bank all declined to submit a proposal. California Government Code requires that a depository secure the County's cash by pledging securities or mortgages greater than the deposits to offset any custodial risk. This is a heavy burden for small banks as the annual volume of cash passing through the cash account could approximate \$500 million. A committee formed of the Treasurer's Office, the County Auditor's Office, and the county schools evaluated all proposals and selected the Bank of America Merrill Lynch of Sacramento as the best option as custodian of the liquid investment funds.

In addition to the question of banking funds for custodial purposes as previously discussed, there is the subject of investing the funds. Counties in California that handle surplus funds of other government agencies together with their own are obligated to conform to the investment guidelines of Government Code §53635 *et seq.* The various investment instruments allowed are

identified in Government Code §53651. There is no provision for any local investment instrument in this code.

A group in the community has expressed the need for a County Government Bank that would act as the County Treasury and the custodian of the County funds thus retaining money in the County for economic growth. There is no precedence for this in California or in any other state except North Dakota.

The Bank of North Dakota was founded by the North Dakota State Legislature in 1919. For Mendocino County to establish a public-owned bank to accommodate the County Treasury some novel legal issues would have to be addressed.

In response to this question Mendocino County Counsel issued Opinion #13-0025 that states:

- “There is no State constitutional or statutory authority allowing for the creation of a State or political subdivision agency publicly owned and managed lending institution or bank at this time. Constitutional and statutory changes would be needed to allow the County to create such a lending institution or bank”
- “...an investment of the excess public funds into a lending institution or bank public (*sic*) owned and managed by the County is not allowed.”

Mendocino County functions as a county authorized under the government laws of the State of California regarding county governments. In order to function differently, the County would have to become a Charter County. Indeed, there is a group of citizens that is striving for the creation of a Charter County.

California Government Code contains a process that is extensive and involved to accomplish the creation of a Charter County. It requires the intent and approval of the County Board of Supervisors, the election of a group of citizens to develop a constitution, the approval of the constitution by the electorate of the County and the approval of the proposed charter constitution by the State Legislature.

A Charter County is governed by a distinct set of laws defined in a constitution developed by the citizens and approved by the county electorate and the State Legislature. A Public Bank created by a Charter County cannot be funded with County Investment Pool funds. The County could only invest County funds appropriated especially for that purpose.

California Government Code §27131(a) originally contained a requirement that the County establish an Oversight Committee for the Investment Pool. In September 2004, this law was amended and now the formation of an oversight committee is elective, not a requirement. The County does not have an Oversight Committee at this time. An existing Oversight Committee was disbanded in 2008. In lieu, the County Treasurer at times has conducted Treasury Pool Round Table Discussions to which Investment Pool participants and the public are invited. The last meeting was held on March 14, 2013. No meeting is currently scheduled.

FINDINGS

- F1. The Mendocino County Investment Pool is a major responsibility of the County Board of Supervisors and the County Treasurer. The magnitude of the funds coupled with the legal requirements regarding their investment requires a thorough knowledge of the financial markets, the economy, and the financial needs of the participants.
- F2. Chandler Asset Management is contributing an essential function as financial advisor in the performance of the Investment Pool and providing periodic professional reports. These periodic reports would be improved by the addition of an explanatory report by the County Treasurer.
- F3. The management of the Investment Pool has been successfully investing in accordance with the County approved investment plan, with consideration given to socially responsible companies as identified in the Calvert Social Index.
- F4. There is no Oversight Committee or a treasury investment round table discussion group meeting scheduled. The Grand Jury believes community involvement is required to improve local economic growth.
- F5. The County Board of Supervisors is exercising proper responsibility in requiring periodic performance reports on the Investment Pool from the County Treasurer. The reports on the investments meet the County Investment Policy goals of security and liquidity. The reports do not provide information regarding whether a reasonable rate of return on the investments was obtained.
- F6. The establishment of a public-owned bank by the County, although desired by some, and arguably beneficial to the local economy, is problematic for many reasons.
- F7. The investment of Investment Pool funds locally is not possible under current legislation.
- F8. In 2012 the local financial institutions did not show interest in being a custodian of the Investment Pool liquid assets and out-of-county banks were selected.
- F9. The quarterly reviews of the County Treasury by the County Auditor per Government Code §26920(a) are not available or reported to the Board of Supervisors.

RECOMMENDATIONS

The Grand Jury recommends that:

- R1. Additional resources for evaluating the social responsibility of the investment instruments in the portfolio be identified and applied. (F3)
- R2. Performance parameters be included in the Pooled Investment Reports that indicate what return on investments has been obtained. (F2, F5)
- R3. An Oversight Committee of members of the participating agencies and representatives of the financial and interested community be organized and utilized. (F4)
- R4. Out-reach be made to local banks to obtain dialogue concerning future participation among the banks and the County Treasury Investment Pool. (F7)

R5. The quarterly review of the County Treasury be performed and a report be provided to the Board of Supervisors as required by Government Code §26920(a). (F9)

RESPONSES

Pursuant to Penal Code §933.05, responses are required from the following individuals:

- Auditor, Mendocino County (All Findings, All Recommendations)
- Treasurer, Mendocino County (All Findings, All Recommendations)

Pursuant to Penal Code §933.05, responses are required from the following governing bodies:

- Board of Supervisors, Mendocino County (All Findings, All Recommendations)

BIBLIOGRAPHY

County of Mendocino Statement of Investment Policy, dated January 2014.

Mendocino County Investment Report by Chandler Asset Management for period ending June 30, 2013.

Mendocino County Pooled Investments Report, dated December 31, 2013.

Reports issued by the Civil Grand Jury do not identify individuals interviewed. Penal Code §929 requires that reports of the Grand Jury not contain the name of any person or facts leading to the identity of any person who provides information to the Civil Grand Jury.

Appendix A. INVESTMENT POOL PARTICIPANTS

1	Albion/Little River Cemetery	22	Mendocino Co. Soils Conservation
2	Alexander Estates Lighting District	23	Mendocino Fire District
3	Anderson Valley Cemetery	24	Mendocino Little Lake Cemetery
4	Covelo Cemetery	25	Mendocino Unified School Systems
5	Covelo Fire District	26	Noyo Lighting District
6	Covelo Lighting District	27	Oak Knoll Lighting District
7	Fairview Acres Lighting District	28	Piercy Fire District
8	Fort Bragg Rural Fire District	29	Redwoods Cemetery
9	Hopland Cemetery	30	Redwood Valley/Calpella Fire District
10	Hopland Lighting District	31	Riverwood Terrace Lighting District
11	Lakewood Lighting District	32	Round Valley Fire District
12	Laytonville Lighting District	33	Ukiah Valley Fire District
13	Leggett Fire District	34	Ukiah Valley Sanitation District
14	Little Lake Fire District	35	Ukiah Village Lighting District
15	Long Valley Fire District	36	West Talmage Lighting District
16	Meadowbrook Sanitation District	37	Potter Valley Cemetery
17	Mendocino Co. Air Quality Mgmt.	38	Potter Valley Community Services Dist.
18	Mendocino Co. Fair Grounds	39	Russian River Cemetery
19	Mendocino County Government	40	Sanel Valley Fire District
20	Mendocino Co. Inland Water & Power Dist.	41	Westport/Ten Mile Cemetery
21	Mendocino Co. Water Agency		

Appendix B. POOL INVESTMENTS YEAR ENDING JUNE 30, 2013

US CORP.	TREAS.	AGENCY	CASH	COMM. PAPER	LAIF	LGIF	M.M.	C.D.	TOTAL AMOUNT x 1000	DATE
25.6%	7.3%	23.3%	0.1%	4.7%	9.6%	0.5%	7.3%	21.6%	\$198,855	JULY 2012
26.3%	9.6%	23.8%	0.1%	4.3%	6.3%	0.5%	10.6%	20.5%	\$193,357	AUG.2012
27.6%	8.0%	25.8%	0.2%	3.9%	5.5%	0.5%	7.0%	21.5%	\$184,505	SEPT2012
25.0%	8.2%	25.0%	0.2%	3.9%	7.8%	0.5%	9.8%	19.6%	\$182,950	OCT.2012
24.3%	7.7%	28.7%	0.3%	3.9%	17.6%	0.6%	9.1%	11.8%	\$194,342	NOV 2012
22.4%	8.7%	22.4%	0.2%	3.6%	22.3%	0.5%	9.2%	10.7%	\$214,574	DEC 2012
20.2%	8.8%	24.2%	0.2%	2.4%	23.5%	2.8%	7.2%	10.7%	\$212,906	JAN 2013
18.8%	9.2%	25.5%	0.1%	3.2%	24.7%	0.5%	10.6%	7.4%	\$202,454	FEB 2013
18.6%	9.2%	25.8%	0.2%	3.1%	24.6%		11.1%	7.4%	\$203,507	MAR 2013
14.8%	8.4%	22.7%	0.1%	2.8%	22.6%		21.8%	6.8%	\$221,729	APR 2013
17.1%	8.9%	23.4%	0.3%	3.5%	24.0%		18.4%	4.8%	\$207,946	MAY 2013
18.0%	9.7%	26.6%	0.4%	3.1%	21.5%		14.6%	6.2%	\$190,197	JUNE2013

