

City of Los Angeles Treasury



STATEMENT OF INVESTMENT POLICY FOR THE CITY'S GENERAL POOL Effective: March 4, 2003

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Statement of Investment Policy for the City of Los Angeles

II. Policy Statement

The purpose of this Investment Policy (Policy) is to establish cash management and investment guidelines for the Treasurer, who is responsible for the stewardship of the City of Los Angeles Investment Program. Each transaction and the entire portfolio must comply with California Government (Code) sections 53600 and 53635 et seq. and this Policy. All general pool portfolio activities will be judged by the standards of the Policy and ranking of investment objectives. Those activities that violate its spirit and intent will be deemed to be contrary to the Policy. This Policy conforms to customary standards of prudent investment management. Should the provisions of the Code change from those contained herein, such provisions will be considered as immediately incorporated in this Policy. This Policy shall remain in effect until a subsequent revision is approved by the City Council and the Mayor.

II. Scope

This Investment Policy applies to all financial assets and investment activities of the City, with the following exceptions:

1. Investments in the City's Defined Contribution Plans (Deferred Compensation)
2. Investments of Debt Service, Construction, Acquisition, Project, and Reserve Funds (Debt Issuance)
3. Investments in the City's Defined Benefit Plans (Pension)
4. Investments in special investment pools. These pools will be managed in accordance with the respective pool's policy. If none exists, the pool's policy will be deemed to be the California State Government Code Sections 53600 - 53635.

III. Delegation

In accordance with the California Government Code, Section 53607, the City Council hereby delegates the authority to invest or reinvest the City's funds, to sell or exchange securities so purchased, and to deposit securities for safekeeping to the City Treasurer.

- A. The City Treasurer shall establish written procedures for the operation of the investment program consistent with this Policy, including establishment of appropriate written

IV. Standard of Care

California Government Code Section 53600.3 states that “. . . all governing bodies of local agencies or persons authorized to make investment decisions on behalf of those local agencies investing public funds pursuant to this chapter are trustees and therefore fiduciaries subject to the prudent investor standard. When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to, the general economic conditions and the anticipated needs of the agency, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the agency. Within the limitations of this section and considering individual investments as part of an overall strategy, investments may be acquired as authorized by law.”

Investment officials in the management of the City’s funds shall use the “Prudent Investor” standard. Investment officers acting in accordance with this Policy, written portfolio guidelines and procedures, and exercising due diligence shall be relieved of personal responsibility for individual security’s credit risk or market price changes, provided deviations from expectations are reported in the monthly and quarterly investment reports to the City Council, and appropriate action is taken to control adverse developments.

The Treasurer, employees involved in the investment process, and the members of the Investment Advisory Committee shall refrain from all personal business activity that could conflict with the management of the investment program. All individuals involved will be required to report all gifts and income in accordance with City Ordinance and California state law. When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing public funds, the Treasurer shall act with the care, skill, prudence and diligence to meet the aims of the investment objectives listed in order in Section V., Investment Objectives.

V. Investment Objectives

The Investment Program shall be prudently invested in order to earn a reasonable return, while awaiting application for governmental purposes. In managing the Investment Program, the Treasurer and the authorized investment officers should avoid any transactions that might impair public confidence in the City of Los Angeles. Investments should be made with precision and care considering the safety of the capital as well as the income to be derived. The specific objectives for the Program are ranked in order of importance.

standards.

The Treasurer's goal is to safeguard the principal of the funds invested; however, the Treasurer 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 rate of return of the portfolio in response to market conditions and/or the City's risk preferences.

B. Liquidity

As a second objective, the Investment Program should remain sufficiently flexible to enable the Treasurer to meet all operating requirements of the City that may be reasonably anticipated (e.g. daily cash flow requirements). Flexibility may be achieved in a number of ways, which may include purchasing short-maturity investments; purchasing investments that are readily marketable to a large number of securities dealers; etc.

C. Rate of Return

As the third objective, the Investment Program should be designed to attain a market average rate of return through budgetary and economic cycles consistent with the risk limitations, prudent investment principles, and cash flow characteristics identified herein. For comparative purposes, the City will compare its performance to the performance of market benchmarks of similar duration and sector allocation.

VI. Implementation

In order to provide direction to those responsible for management of the Investment Program, the Treasurer has established this Policy and will render it to the City Council for review and approval annually in accordance with California Government Code section 53646, et seq.

This Policy provides a detailed description of investment parameters used to implement the investment process and includes the following: investable funds; authorized instruments; prohibited investments; credit requirements; maximum maturities and maximum concentrations; repurchase and reverse repurchase agreements; securities lending program; Linked Banking Program; criteria and qualifications of broker/dealers and direct issuers; investment guidelines, management style and strategy; Approved Lists; and calculation of yield, return, and costs.

as needed, to adjust to changing financial market conditions. The guidelines may be more conservative or match the Policy language. In no case may the guidelines offer more latitude than the Policy.

The Treasurer shall establish a process for daily, monthly, quarterly, and annual review and monitoring of the Investment Program activity. Investment of City funds is governed by the following documents:

5. Authority to manage the City's investment program is derived from the California Government Code, Sections 53600-56309 and Section 53635 et seq.
6. This Investment Policy establishes specific objectives and parameters for the investment of City funds. While the City's Investment Policy may include provisions that are more conservative than the California Government Code, it may not offer investment staff more latitude than permitted under the California Government Code.
7. The Treasurer shall develop Investment Guidelines that delineate specific policies or strategies, including credit requirements, permitted transaction, delegations to staff, maturity and concentration limits, and so forth. While the Investment Guidelines may include provisions that are more conservative than the Investment Policy, it may not offer investment staff more latitude than permitted under the Investment Policy.
8. The Treasurer shall develop Approved Lists, as described on Page 10 herein.

Daily, the Treasurer or his/her designees shall review the investment activity and corresponding bank balances.

At least quarterly, the Investment Advisory Committee shall review all investment activity and its compliance to the corresponding governing articles and investment objectives.

An annual audit shall be conducted by the City's Controller Office of the activities within the Investment Program. It is to be conducted to determine compliance with the Policy and California Government Code.

All securities purchased, with the exception of time deposits, LAIF and bank short-term Investment Funds (bank's overnight investment fund), shall be delivered to the City's custodian, which shall be an independent, third-party bank custody, trust, or safekeeping department. This includes all collateral for repurchase agreements. All trades, where applicable, will be executed

VIII. Investment Parameters

A. Investment of Funds

The Cash Flow Horizon is the time period in which the Pooled Investment Fund cash flow can be reasonably forecasted. This Policy establishes the Cash Flow Horizon to be six months.

When the Treasurer has deemed that the cash flow forecast can be met, funds may be invested beyond six months. The six month liquidity requirements will constitute the core portfolio. The total portfolio less the core portfolio will constitute the reserve portfolio.

B. Competitive Bidding

All investment purchases should be made through competitive bidding. However, this policy recognizes that competitive bidding is not applicable for new issues since these issues are quoted at the same price (usually par) for a certain period of time. This policy also recognizes that for secondary market agencies, corporate bonds, and some money market securities, it is not always possible to locate three brokers who offer the same security. In the event that three quotes are not obtained, supporting documentation from an independent financial source must be included to demonstrate market pricing.

C. Authorized Investments

Authorized investments shall conform to the general categories established by the California Government Code sections 53601 et seq. and 53635 et seq. Authorized investments shall also include, in accordance with California Government Code section 16429.1 et seq., investments into the Local Agency Investment Fund (LAIF) or the Los Angeles County Pool Fund in accordance with California Government Code section 53684. Authorization for specific instruments within these general categories, as well as narrower portfolio concentration and maturity limits, may be established and maintained by the Treasurer as part of the Investment Guidelines.

D. Prohibited Investments

E. Credit Requirements

For all asset classes except Linked Banking bank certificates of deposits, the issuers' minimum credit ratings shall be Standard and Poor's A-1/A or Moody's P-1/A2 and, if available, Fitch IBCA F1/A. In addition, domestic banks are limited to those with a current Fitch Ratings BankWatch of "B/C" or better and a A-1 short-term rating. The Treasurer is granted the authority to specify approved California banks with a Fitch Ratings BankWatch of "C" or better and a A-2 rating where appropriate. Foreign banks with domestic licensed offices must be rated AAA for country risk, "B" or better, and a TBW-1 short term for the company by Fitch Ratings BankWatch. Domestic savings banks must be rated "B/C" or better and a TBW-1 short-term rating by Fitch Ratings BankWatch.

Linked Banking Program Credit Requirements

Maximum Amount	Minimum Requirements
Up to \$100,000 FDIC coverage	<p>(Any 2 of 3 ratings)</p> <p>S&P: A-2</p> <p>Moody's: P-2</p> <p>Fitch IBCA: F2</p> <p style="text-align: center;">AND</p> <p style="text-align: right;">Fitch Bank Individual and Support Ratings: B-2</p>
\$100,000 to \$5 million Collateral is required	<p>(Any 2 of 3 ratings)</p> <p>S&P: A-1</p> <p>Moody's: P-1</p> <p>Fitch IBCA: F1</p> <p style="text-align: center;">AND</p> <p style="text-align: right;">Fitch Bank Individual and Support Ratings: A-1</p>

All commercial paper and medium term note issuers must be issued by corporations operating within the United States and having total assets in excess of five hundred million dollars (\$500,000,000).

The maximum maturity, determined as the term from the date of ownership to the date of maturity, for each investment shall be established as follows:

U.S. Treasury and Agency Securities	5 years
Bonds issued by local agencies	5 years
Registered State Warrants and Municipal Notes	5 years
Bankers Acceptances	180 days
Commercial Paper	270 days
Negotiable Certificates of Deposit or Time Deposits	180 days
CRA Certificates of Deposit or Time Deposits	1 year
Repurchase Agreements	32 days
Reverse Repurchase Agreements	92 days
Medium Term Corporate Notes	5 years
Shares of a Money Market Mutual Fund	N/A
Asset Backed Securities	5 years
Collateralized Mortgage Obligations	5 years

These maturity limits may be reduced to a shorter term as part of the Investment Guidelines and the Approved Lists.

The ultimate maximum maturity of any investment shall be five (5) years.

G. Maximum Concentrations

The maximum allowable percentage for each type of security is set forth as follows:

U.S. Treasury and Agency Securities	100%
Bonds issued by local agencies	100%
Registered State Warrants and Municipal Notes	100%
Bankers Acceptances	40%
Commercial Paper	40%
Negotiable Certificates of Deposit or Time Deposits	30%
Repurchase Agreements	15%
Reverse Repurchase Agreements.....	5% **
Medium Term Corporate Notes	30%
Shares of a Diversified Mutual Fund	20%
Asset-Backed Securities	20% *
Collateralized Mortgage Obligations	20% *

full 20% allocation, the City may enter into reverse repurchase agreements in accordance with the Government Code. The term to maturity of such agreements may not exceed 92 days, and the maturity of the securities purchased with the proceeds must match the maturity of the reverse repurchase agreement.

These concentrations may be reduced as part of the Investment Guidelines and the Approved Lists.

No more than 10% of the portfolio, except Treasuries and Agencies, may be invested in securities of a single issuer including its related entities.

Where a percentage limitation is established above, for the purpose of determining investment compliance, that maximum percentage will be applied on the date of purchase.

H. Repurchase Agreements

Under California Government Code section 53601, paragraph (i) and section 53635, the Treasurer may enter into Repurchase Agreements and Reverse Repurchase Agreements. The maximum maturity of a Repurchase Agreement shall be one year. The maximum maturity of a reverse repurchase agreement shall be 92 days, and the proceeds of a reverse repurchase agreement may not be invested beyond the expiration of the agreement. The reverse repurchase agreement must be "matched to maturity" and meet all other requirements delineated in the State code.

All repurchase agreements must have an executed City of Los Angeles Master Repurchase Agreement on file with both the Treasurer and the Broker/Dealer. Repurchase Agreements executed with approved broker-dealers must be collateralized with either (1) U.S. Treasuries or Agencies with a market value of 102% for collateral marked to market daily; or (2) money market instruments which are on the Approved Lists of the City and which meet the qualifications of the Policy, with a market value of 102%. Since the market value of the underlying securities is subject to daily market fluctuations, investments in repurchase agreements shall be in compliance if the value of the underlying securities is brought back up to 102% no later than the next business day. Use of mortgage-backed securities for collateral is not permitted, except that the City's demand deposit bank may use mortgage-backed securities as collateral for repurchase agreements only for the investment of excess bank balances in overnight repurchase agreements. Such mortgage collateral shall be valued at 110% of the amount

The Treasurer has allocated within the Investment Program a maximum of \$10 million for the Linked Banking Program to encourage community investment by financial institutions and to acknowledge and reward locally active banks which support the community's financial needs. The minimum credit requirements are located on Page 6 of Section VIII.E.

K. Criteria and Qualifications of Brokers/Dealers and Direct Issuers

All transactions initiated on behalf of the Investment Program and City of Los Angeles shall be executed through either government security dealers reporting as primary dealers to the Market Reports Division of the Federal Reserve Bank of New York or direct issuers that directly issue their own securities which have been placed on the Approved List of brokers/dealers and direct issuers.

Transactions may be executed through secondary dealers subject to the following conditions:

1. The broker/dealer must qualify under the SEC Rule 15C3-1 (uniform net capital rule).
2. The broker/dealer and the individual must be properly registered with the appropriate state and federal regulatory bodies (i.e. NASD, SEC, MSRB). In addition, the firm should have the minimum level of capital to comply with applicable regulatory requirements.
3. The broker/dealer should be a market maker and have a strong market presence in one or more product areas. Generally, firms that rank in the top 25 in a market sector (i.e., Federal Agency, U.S. corporate, municipal) will be deemed to have sufficient market presence.
4. As with primary dealers, secondary broker/dealers will be evaluated on trade execution, accuracy and timeliness of information, and quality of service.

Each secondary broker/dealer will be sent a copy of this Policy, a broker/dealer registration, and a list of those persons authorized to execute investment transactions. Each firm must acknowledge receipt of such materials to qualify for the Approved List of brokers/dealers.

be consistent with this Policy and its objectives.

M. Approved Lists

The City Treasurer shall issue and maintain various Approved Lists. These lists are:

1. Approved Commercial Paper and Medium Term Note Issuers.
2. Approved Money Market Treasury Mutual Funds.
3. Approved Firms for Purchase or Sale of Securities (Brokers/Dealers).

N. Calculation of Earnings and Costs

The costs of managing the investment portfolio including, but not limited to, investment management, accounting for the investment activity, custody of the assets, managing and accounting for the banking, receiving and remitting deposits, oversight controls, etc. are charged to the investment earnings based upon actual costs.

IX. Reviewing, Monitoring and Reporting of the Portfolio

The Investment Advisor will prepare and present at least monthly a comprehensive review and evaluation of the transactions, positions, and performance of the Investment Program and compliance to the California Government Code, Investment Policy and Investment Guidelines.

Monthly, and every calendar quarter, the Treasurer will provide to the City Council a detailed report on the Investment Program. Pursuant to California Government Code section 53646, the report will list the type of investments, name of issuer, maturity date, par, and dollar amount of the investment. For the total Investment Program, the report will list average maturity, the market value, and the pricing source. Additionally, the report will show any funds under the management of contracting parties, a statement of compliance to the Policy, and a statement of the Investment Program's ability to meet the expected expenditure requirements for the next six months.

As mandated by the California State Government Code, the Treasurer will provide to the California Debt and Investment Advisory Commission (CDIAC) a copy of the City's second and fourth calendar quarter investment reports no later than sixty (60) days following the close of the calendar quarter.

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- C. The oversight responsibility is placed with the IAC composed of the City Treasurer, Office of the Mayor, City Controller, City Administrative Officer, Chief Legislative Analyst, Office of Finance, and a finance professional. The Treasurer shall be the Chairperson.

Appendix A

Comparison and Interpretation of Credit Ratings¹

Long Term Debt Ratings				
Rating Interpretation	Moody's	Standard & Poor's	Fitch IBCA	Fitch Ratings BankWatch
Best-quality grade	Aaa	AAA	AAA	A
High-quality grade	Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-	A A/B B
Upper Medium Grade	A1 A2 A3	A+ A A-	A+ A A-	B B/C B/C
Medium Grade	Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-	C C/D C/D
Speculative Grade	Ba1 Ba2 Ba3	BB+ BB BB-	BB+ BB BB-	D D D
Low Grade	B1 B2 B3	B+ B B-	B+ B B-	D/E D/E D/E
Poor Grade to Default	Caa	CCC+	CCC	D/E
In Poor Standing	- -	CCC CCC-	- -	D/E D/E
Highly Speculative Default	Ca C	CC -	CC -	D/E E
Default	- - -	- - D	DDD DD D	E E E

Short Term / Commercial Paper Investment Grade Ratings				
Rating Interpretation	Moody's	Standard &	Fitch IBCA	Fitch Ratings

GLOSSARY

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.

SLMA: The student loan marketing association, also known as "SallieMae," provides liquidity to private lenders who make various types of loans for education. SLMA currently issues floating rate notes.

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

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. This instrument 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 comparative base for measuring the performance or risk tolerance of the investment portfolio. A benchmark should represent a close correlation to the level of risk and the average duration of the portfolio's investments.

BID: The price at which a buyer offers to buy a security.

BOND: A bond is essentially a loan made by an investor to a division of the government, a government agency, or a corporation. The bond is a promissory note to repay the loan in full at the end of a fixed time period. The date on which the principal must be repaid is the called the maturity date, or maturity. In addition, the issuer of the bond, that is, the agency or corporation receiving the loan proceeds and issuing the promissory note, agrees to make regular payments of interest at a rate initially stated on the bond. Interest from bonds is taxable based on the type of bond. Corporate bonds are fully taxable, municipal bonds issued by state or local government agencies are free from federal income tax and usually free from taxes of the issuing jurisdiction, and Treasury bonds are subject to federal taxes but not state and local taxes. Bonds are rated according to many factors, including cost, degree of risk, and rate of income.

BROKER: A broker brings buyers and sellers together for a transaction for which the broker receives a

investment. Maturities may be as short as a few weeks or as long as several years. Most banks set heavy penalties for premature withdrawal of monies from a CD. Large-denomination CD's are typically negotiable.

COLLATERAL: Securities, evidence of deposit or other property which a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank 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.

COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR): The official annual report for the City of Los Angeles. It includes combined statements for each individual fund and account group prepared in conformity with GAAP. It also includes supporting schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, extensive introductory material, and a detailed Statistical Section.

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

COUPON: (a) The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value. (b) A certificate attached to a bond evidencing interest due on a payment date.

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

DEFAULT: To default is to fail to repay principal or make timely interest payments on a bond or other debt investment security. Also, a default is a breach of or failure to fulfill the terms of a note or contract.

DELIVERY VERSUS 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.

DERIVATIVES: (1) Financial instruments whose return profile is linked to, or derived from, the movement of one or more underlying index or security, and may include a leveraging factor, or (2) financial contracts based upon notional amounts whose value is derived from an underlying index or security (interest rates, foreign exchange rates, equities or commodities).

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.

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

DIVERSIFICATION: Dividing investment funds among a variety of securities offering independent returns.

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

FEDERAL CREDIT AGENCIES: Agencies of the Federal government set up to supply credit to various classes of institutions and individuals, *e.g.*, S&L's,

establishes this rate.

FEDERAL HOME LOAN BANKS (FHLB): Government sponsored wholesale banks (currently 12 regional banks) which lend funds and provide correspondent banking services to member commercial banks, thrift institutions, credit unions and insurance companies. The mission of the FHLBs is to liquefy the housing related assets of its members who must purchase stock in their district Bank.

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

FEDERAL OPEN MARKET COMMITTEE (FOMC): Consists of seven members of the Federal Reserve Board and five of the twelve Federal Reserve Bank Presidents. The President of the New York Federal Reserve Bank is a permanent member, while the other Presidents serve on a rotating basis. The Committee periodically meets to set Federal Reserve guidelines regarding purchases and sales of Government Securities in the open market as a means of influencing the volume of bank credit and money. The FOMC establishes monetary policy and executes it through temporary and permanent changes to the supply of bank reserves.

FEDERAL RESERVE SYSTEM: The central bank of the United States created by Congress and consisting of a seven member Board of Governors in Washington, D.C., 12 regional banks and about 5,700

throughs" is often used to describe Ginnie Maes.

HEDGE: Hedging is a strategy of reducing risk by offsetting investments with investments of opposite risk. Risks must be negatively correlated in order to hedge each other; for example, an investment with high inflation risk and low immediate returns with investments with low inflation risk and high immediate returns. Long hedges protect against a short-term position and short hedges protect against a long-term position.

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

LIQUIDITY: The ease with which investments can be converted to cash at their present market value. Liquidity is significantly affected by the number of buyers and sellers trading a given security and the number of units of the security available for trading.

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

MARKET RISK: Market risk is the risk that investments will change in value based on changes in general market prices.

MARKET VALUE: The price at which a security is trading and could presumably be purchased or sold.

MARKING TO MARKET: The process of posting current market values for securities in a portfolio.

MASTER REPURCHASE AGREEMENT: A written contract covering all future transactions between the parties to repurchase–reverse repurchase agreements that establishes each party's rights in the transactions. A master agreement will often specify, among other things, the right of the buyer-lender to liquidate the underlying securities in the event of default by the seller-borrower.

of a bond with no embedded options 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 (bills, commercial paper, bankers' acceptances, etc.) are issued and traded.

MORTGAGE PASS-THROUGH SECURITIES: A securitized participation in the interest and principal cash flows from a specified pool of mortgages. Principal and interest payments made on the mortgages are passed through to the holder of the security.

NET ASSET VALUE (NAV): NAV is the price of a share in a mutual fund or investment company. This price is calculated once or twice daily. Net asset value is the amount by which the assets' value exceeds the company's liabilities. It is calculated by adding up the market value of all securities owned by the company, subtracting the company's liabilities, and dividing this value by the number of shares of the company outstanding. Thus, the NAV indicates the current buying or selling price of a share in an investment company.

OFFER: The price asked by a seller of securities. (When you are buying securities, you ask for an offer.) See Asked and Bid.

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

OPTION: A marketable security contract that fixes the purchase price of some other security at a point in time.

PREPAYMENT WINDOW: The time period over which principal repayments will be received on mortgage securities at a specified prepayment speed.

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

PRUDENT INVESTOR RULE: An investment standard of accountability that applies to fiduciaries.

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

QUOTATION: A quotation, or quote, refers to the current price of a security, be it either the highest bid price for that security or the lowest ask price, as provided by a broker or dealer.

RATE OF RETURN: The yield obtainable on a security based on its purchase price or its current market price. This may be the amortized yield to maturity on a bond the current income return.

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 in the portfolio not yet sold.

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

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

SECURITIES AND EXCHANGE COMMISSION

(SEC): A federal government agency comprised of five commissioners appointed by the President and approved by the Senate. The SEC was established to protect the individual investor from fraud and malpractice in the marketplace. The Commission oversees and regulates the activities of registered investment advisers, stock and bond markets, broker/dealers, and mutual funds.

SEC RULE 15C3-1: See Uniform Net Capital Rule.

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

TOTAL RATE OF RETURN: A measure of a portfolio's performance over time. It is the internal rate of return that 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.

TREASURY BILLS: A non-interest bearing discount security issued by the U.S. Treasury to finance the national debt. Most bills are issued to mature in three months, six months, or one year.

TREASURY BONDS: Long-term coupon-bearing U.S. Treasury securities issued as direct obligations of the U.S. Government and having initial maturities of more than 10 years.

TREASURY NOTES: Medium-term coupon-bearing U.S. Treasury securities issued as direct obligations of the

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

U.S. TREASURY OBLIGATIONS (TREASURIES):

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 (Tbills). The Treasury currently issues three-month and six-month Tbills at regular weekly auctions. It also issues "cash management" bills as needed to smooth cash flows.

Treasury Notes: All securities issued with initial maturities of two to ten years are called Treasury Notes (Tnotes), and pay interest semi-annually.

Treasury Bonds: All securities issued with initial maturities greater than ten years are called Treasury Bonds (Tbonds). Like Treasury Notes, they pay interest semi-annually.

VOLATILITY: Volatility is an indicator of expected risk. It demonstrates the degree to which the market price of an asset, rate, or index fluctuates from average. Volatility is calculated by finding the standard deviation from the mean, or average, return.

WARRANT: A warrant is similar to an option, giving the holder the right to purchase securities at a set price for a specific period of time. Warrant certificates last longer than options, typically holding value for a few years or indefinitely. Warrants are often traded as securities at a price that reflects the underlying

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adjustment spread over the period from the date of purchase to the date of maturity of the bond.

YIELD TO MATURITY: The annualized internal rate of return on an investment which equates the expected cash flows from the investment to its cost.