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COUNTY OF ORANGE

OFFICE OF THE TREASURER–TAX COLLECTOR
September 10, 1993

Board of Supervisors
10 Civic Center Plaza
Santa Ana, CA 92701

SUBJECT: **Annual 1992-93 Financial Statement**

The Orange County Treasury manages money for 187 different and separate governmental agencies. Seventeen percent of the total monies that we manage is controlled directly by the Board of Supervisors (County General Fund, Environmental Management Agency and the John Wayne Airport, etc.). The remaining 83% that we manage is for governmental agencies that are not under the control of the Board of Supervisors. Of the remaining agencies, 44 are invested in our Local Agency Investment Pool. These are agencies that have their own treasurers and are not required by law to invest with the County Treasurer. Six of the agencies are situated in other counties. Therefore, this financial report is intended for all governmental agencies for which the County Treasury manages their funds.

HIGHLIGHTS OF THE FINANCIAL STATEMENT: The Orange County Treasury has had an unusually high earnings rate in the face of very low investment earning interest rates. We have earned yields that we believe are the largest in the country for a very large size portfolio with a short average maturity of only two years, three months. There may be large portfolios that have higher yields because they are invested in the high end of the yield curve of more than five years average maturity, such as retirement portfolios.

We earned an average yield for the fiscal year of **8.52%** based upon an average monthly balance of $4.696 Billion, a $1.425 Billion increase average over the previous fiscal year. (We reached an outstanding balance of $5 Billion for the first time in December. The balance averaged $5.423 Billion for April, May and June 1993.) The State of California Treasury, with an average monthly balance of $22.950 Billion had an average yield of $4.71%. This is a minus difference to the Orange County yield of $3.81%. (See attached graph.) The following is a comparison of yields and average monthly balances of other California treasurers: City of Anaheim, 7.69%, $350 Million (Anaheim has over $100 Million invested with the Orange County Treasurer). County of Los Angeles, 3.88%, $8 Billion; San Bernardino County, 6.25%, $1.5 Billion; San Diego County, 7.30%, $3 Billion; Sonoma County, 6.77%, $625 Million.

The total interest earnings received and paid out from investments was an all time high of $364,147,000. This was a 30.6% increase of $86,382,000 over interest earnings for 1991-92. The total interest earnings are prorated amongst our various governmental clients based upon the average daily balances that they have on deposit in the Treasury. Our investors also only pay an average of 6/100% (6 basis points) as a cost of managing their funds. This further increases their net yield in comparison to other county treasuries who charge an average of 10 to 20 basis points.

The actual net amounts of receipts that we received was $7,782,707,000. This is accounted for as follows:

	AMOUNT	% OF TOTAL
TAX COLLECTIONS	$2,115,133,000	27.17%
SHORT TERM LOANS	242,535,000	3.16%
BONDS (NOTES)	171,305,000	2.20%
STATE SUBVENTIONS	1,944,710,000	24.98%
INTEREST RECEIVED	364,147,000	4.67%
OTHER (Court Fines/Fees, Recorder Fees, Licenses & Permits, etc.)	2,944,877,000	37.82%
TOTAL	$7,782,707,000	100.00%

The total receipts (cash flow) from all sources including the rollover or reinvestment of investments was $230.224 Billion, an increase of $58.1 Billion over the previous fiscal year.

INVESTMENT POLICY: Our consistently high interest yields are realized from doing Reverse Repurchase Agreements. This is a strategy that utilizes leverage, and also involved in this strategy is the use of structured or floating interest rate securities. The use of floating rate and other securities in the past has enabled us an approximate leverage figure of 2 to 1. This strategy has been predicated on interest earning rates to continue to remain low for a minimum of the next three years. For example, instead of buying securities that are either a fixed rate or that are indexed to increase as interest rates rise, these securities, sometimes called "inverse floaters" are indexed to produce a higher yield when interest rates remain steady or decline. An example of an "inverse floater" is a U.S. government security that pays interest at a rate of 10% minus 6 month LIBOR. (LIBOR, currently at 3.31%, is a commonly used benchmark for indexing securities.) That security would earn a current rate of 6.69% (10% - 3.31%). If interest rates declined 1/2 percent, LIBOR would drop from its current rate of 3.31% to 2.81%, and our investment yield would increase from 6.69% to 7.19% (10% - 2.81%). The reasons for the future projection of low interest rates can be found in the section titled "THE FUTURE."

If rates were to rise materially, it is reasonable to expect that the overall performance of the portfolio would decline. Although we strongly believe that future interest rates will remain low, to insure against the eventuality of materially rising interest rates, for the last six months we have not been buying structured/floating interest rate instruments but have been purchasing fixed interest rate coupon instruments. This adjustment in investment policy lessens our leverage ratio and diversifies our interest rate risk. It has always been our investment policy to hold the securities we buy to their maturity, which assures us principal repayment and shields us against market volatility. Our basic investment strategy has really not changed in the last 12 years. Structured/floating rate securities were initially not available until July 1991, when we originally began to acquire them. Although acquiring these instruments did not in any way change our original investment strategy, they did add a potential of more volatility to the portfolio. Consistent monitoring of all factors of the structure of our portfolio has continued to allow us to take advantage of the upside of earning higher yields in a downward trending interest rate environment and at the same time, protect us if interest yields should turn around and start rising.

In the fiscal year just ended, the above-stated investment strategy allowed us to earn an additional $153,835,000 on Reverse Repurchase Agreement investments. This was the equal of adding 2.50% yield to our portfolio from doing these type of investments. These Reverse Repurchase earnings were at an all-time high compared to the previous fiscal year's all-time high of $61,652,291. The typical treasurer's investing strategy is to trade or buy and sell government securities. This type of strategy involves the prospect of taking losses as well as gains. We do not take losses through the process of leveraging our securities and holding them to maturity.

The Future: In last year's financial statement dated August 28, 1992, we said, "United States interest rates are low and could become lower. We do not expect them to rise because of the very slow growth out of the current recession." The shape of the yield curve extends from the yield on the two-year treasury note to the 30-year maturity treasury bond yield. On September 3, 1992, the two-year note was yielding 4.17%. On September 3, 1993 it was yielding 3.72%. On September 3, 1992, the 30-year bond was yielding 7.42% and on September 3, 1993 it was yielding 5.97% (and falling). The spread in yield between the two-year note and the 30-year bond on September 3, 1992 was 3.25%. On September 3, 1993 it was 2.25% (a marked narrowing of the shape of the yield curve). What is and has been occurring is the lack of supply of longer maturity securities of five years and longer in respect to the amount of demand for investment securities of all types. Medium and large corporations have been restructuring and consolidating instead of borrowing money for expansion and have used the additional profits gained from restructuring to pay off debts on their balance sheets. All of this, and other factors, has affected interest rates. It is the threat of inflation returning because of perceived economic circumstances that would cause interest rates to rise. The long-term prospects are that we are going to have very slow growth; and, therefore, forestall inflation growth from happening that would have a material effect on interest rates rising. Interest rates could rise 100 basis points (1.00%) tomorrow, because of some temporary phenomena happening in the world. **But higher interest rates are not at all sustainable.**

The theory of lower interest rates through this decade, to my knowledge, was first put forward by Mr. Charles Clough, Chief Investment Strategist for Merrill Lynch & Company in December 1991. Now you will have to remember at that time George Bush seemed to have a lock on being reelected president. Bill Clinton was not at all a viable factor in the presidential race. Also, therefore, Mr. Clough's predictions or any other economist's predictions did not and could not perceive what Clinton's budget proposals would have on the economy. (sic) Mr. Clough talked of debt deflations that started in 1981 with the bust in the energy sector, migrated to the agricultural sector (you remember when the farmers were going broke) and then to the industrial sector. He spoke of the deflation of real estate values which now has continued to become much worse since December 1991. Real estate is by far the largest credit user in our economy. This deflation in real estate credit then signaled a migration of credit contraction in the nation's important business services sector. He stated then that money and credit, the signposts of spending, simply are not growing. He spoke of a contracting banking system which lacked borrowers and discouraged depositors by lowering deposit interest rates. He predicted that banks would gradually stop paying interest on checking accounts. In July of 1992, my bank paid me 2 1/2% on my personal checking account. In August of 1993, they are now paying me 1%. Mr. Clough spoke of a diminishing labor force growth which leads to lower interest rates, and he produced a graph from 1955 to 1995 which showed as the number in the labor force rose, so did interest rates. But as the labor force started to come down in 1985, so did interest rates. He said, "Today's problem isn't an unwillingness to lend, it is an unwillingness to borrow. Unless lending suddenly booms, the banks will likely hold more deposits than they can leverage." He said that unless banks and insurance companies suddenly find themselves with a multitude of lending opportunities, they will find that after many years of aggressive bidding for deposits and insurance savings plans, they have attracted far too much in liability/deposits from the household sector. The household sector is lending $3.5 Trillion to the banking system in the form of deposit liability in one sort or another. It appears banks are coming to realize that they hold a too vast excess of deposits than the economy is likely able to borrow in the years ahead. The deposit interest rate will rightly remain among the lowest points on the yield curve. Returns are likely to remain discouragingly low. Even as investors clamor for safe securities, might the mighty Certificate of Deposits become extinct? His predictions are even more prophetic today where you see traditional Certificate of Deposit investors in a quandary with what to do with their investable monies because of very, very low CD rates. Many of those that can, are fleeing the CD market and are speculating in the stock market. Mr. Clough's other and more technical predictions on low interest rates made in December 1991 and the spring of '92 are too involved and lengthy to restate here. But they all point to and establish the theory that we will have level if not lower interest rates through this decade. Certainly there is nothing on the horizon that would indicate that we will have rising interest rates for a minimum of three years. Based upon the current structure of the County Treasurer's Investment portfolio, we believe that our comparative higher interest earning rate yields over the next three fiscal years is insured.

We expect to earn gross yields this fiscal year of 7.00% compared to the 8.52% that we earned in the 1992-93 fiscal year. This prediction of 7.00% is conservative, and although we could earn higher yields, the ever-lowering of investment interest rates which will affect the investment of new cash received in the November, December and March, April period forces us to make our predictions conservative. The great majority of our securities are rated AAA and AA by the credit rating agencies. We do not own any investment that there would be any liability of a principal loss due to the failure of the issuer. We do not believe that we have any other investments where there is a potential of a principal loss, only the prospect of an interest rate reduction in some of our structured floating rate instruments. But based on what you have read previously here, we think even that factor is a very minimal one. To assist us in obtaining our 7.00% or higher yield this fiscal year, in the months of July and August 1993, we have already booked, through the Reverse Repurchase Agreements process, profits of $82,089,406.

We are continually gratified to be able to earn comparatively high interest earnings for all of our 187 different governmental clients. Most particularly, in these very severe economic conditions that have forced municipal agencies to lay off policemen, firemen and cut back other necessary services. What we are able to do for all our clients is best described by an unsolicited letter we received January 11, 1993 from the City of Laguna Beach (sic) who expressed their appreciation for the efforts the County Treasury did in investing their funds. Laguna Beach had about 98% of its surplus funds invested in the Treasury. Since we were then earning approximately 4 percentage points more than the State investment pool, the City would receive approximately $640,000 per year in additional revenue because of the County Treasury's excellent efforts. This was extremely important for a smaller size city, particularly given the State reductions they have been forced to endure.

We look forward to our continued relationship with all the districts for whom we invest. We also look forward to continue to manage these funds in the professional manner that constantly out-performs the market as a whole.

Robert L. Citron
Treasurer-Tax Collector

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Attachment