John
Moorlach, CPA, CFP for Orange County Treasurer-Tax Collector

Congressman Chris Cox
Campaign Chairman

May 31, 1994

Mr. Thomas F. Riley, Chairman
Orange County Board of Supervisors
10 Civic Center Plaza
Santa Ana, CA 92701

Dear Mr. Riley:

The race for Orange County Treasurer-Tax Collector has garnered significant media attention. The media has offered many insights; some most enlightening, some very disturbing. Most disturbing was your quote concerning Mr. Robert L. "Bob" Citron in the April 2nd issue of the Los Angeles Times:

"This is a person who has gotten us millions of dollars. I don't know how in the hell he does it, but he makes us all look good."

I have high regard for you and for your personal contributions to our great county. However, your quote displays an ignorance that prompts me to write so that you may, in fact, understand what your current Treasurer is doing. Especially since he is doing it with your tacit approval. So your "if it ain't broke, don't fix it" attitude is a serious leadership mistake. It's synonymous to sticking your head in the sand.

My major concern has been "interest rate risk." I have been consistent with this concern throughout my campaign. During this campaign the Federal Reserve Board has raised interest rates four times. Should interest rates continue to rise, then our County will not "look good." And it will be your successor Supervisors and the citizens of this County who will have to deal with the ramifications of the activities which occurred during your watch. The victims will be our school children from even less funding; residents waiting longer for infrastructure improvements; read users tolerating poor driving conditions due to further _____________ ______________________________ ____________________________.

After personally reviewing the Orange County Investment Pool (Pool) and also having numerous bond brokers analyze its various components, I would like to provide the following observations:

1. Overall, the portfolio is a major bull market bet in the middle of a bear market. The incumbent has structured the portfolio only on the premise that interest rates would continue to decline for the next four years. This is a major gamble with public funds that he is losing as of late.

   Mr. Citron said as much as recently in a letter to the Board of Supervisors, dated September 10, 1993 (one month before the top of the bond market):

   "This strategy has been predicated on interest earning rates to continue to remain low for a minimum of the next three years. 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."

   In managing a portfolio, certain assumptions must be made. But who can accurately predict interest rates for the next six months? Let alone, the next three to four years?

2. Citron, labeled "a Democratic leverage artist" (Grant's Interest Rate Observer, May 6, 1994), has borrowed an additional $8 billion dollars in the twelve months ended March 31, 1994, bringing the total funds under management to $22 billion. The top of the bond market was October 15, 1993. Accordingly, $8 billion of investments were purchased at the highest ask prices (over 36 percent of the portfolio).

3. The refinancing of this debt comes due every 90 or 180 days. Accordingly, the cost of borrowing increases as interest rates increase, similar to an adjustable rate mortgage.

4. Twenty-five percent of the portfolio, $5.5 billion, was invested in derivatives, the most controversial product in the investment community. Unfortunately, seventy-five percent of the derivatives are "inverse floaters." Inverse floaters have a lower yield when interest rates rise.

5. Over ninety percent of the derivatives and the $7 billion in FNMA investments in the Pool mature in 1998. Over half of the portfolio has to be held for four years until maturity. As interest rates rise the value of these assets will decrease and cannot be repositioned for four years without a substantial loss. Also, the yield will be lower than market rates, presenting an opportunity cost, the less of the time value of money, to the participants. The Pool has borrowed short-term and loaned long-term, analogous to the Savings and Loan fiasco.

6. If interest rates continue to increase, investment opportunities offered by Citron's competitors in the open market will out perform the County's Pool. And the better performance will be provided with low or no risk investments.

7. The borrowing costs at March 31, 1994, averaged 3.7 percent. Recently, they have been as high as 4.7 percent. According to our model of the Pool as of March 31, 1994, if the borrowing costs go up to 7.7 percent the Pool will have a break even cash flow. That is, the investment income will equal the interest costs and result in net zero income to the Pool's participants. Should rates exceed 7.7 percent the Pool would have a negative cash flow and implode. A recent example that you should research and become familiar with is the University of Houston and their reverse repurchase agreement experience.

8. Due to recent interest rate increases the Pool has incurred over $300 million in collateral calls. Because the derivatives have no secondary market, their value may be down as much as twenty percent. It is safe to say that the value of the Pool is down as much as $1.2 billion. This is equal to a loss in value of $1,000 per registered voter in the County of Orange. It's enough to build a nice airport, let alone a terminal.

   Quiet frankly, if interest rates do not drop, Mr. Citron will have lost as much in principal value as he has earned in income during the last three years. Such is the cost of taking risks.

Mr. Citron is relying on his past record which has provided great returns because his bull market bet was actually in a bull market. Unfortunately, when it was time to disengage this approach he, in fact, doubled down. This is extremely risky for any investor to do with his or her own money. But with public tax dollars it is dangerous.

A public official in a fiduciary role should not have made such risky investments. However, the conclusion of Mr. Citron's letter of September 10, 1993 provides a clue as to why he did:

"We also look forward to continue to manage these funds in the professional manner that constantly out-performs the market as a whole."

Mr. Citron believes he can accurately anticipate the market all of the time and also out-perform everyone. That's impossible. Ask David Askin and George Sorros, two individuals who built aggressive, highly leveraged portfolios on the same assumptions Citron is using, resulting in large losses of investor dollars.

Local political writers have supported Citron's strategies. Unfortunately, they have not researched the Pool. They were provided a copy, but failed to do the necessary analysis. I can understand the old adage of "don't confuse me with the facts," but it is intellectual bankruptcy for them to comment on a business/investment issue without having the proper background. They certainly qualify for the "I don't get it" award.

The utilization of Standard & Poor's to defend Citron has also been dubious at best. This organization has to monitor over 37,000 municipalities. They have also commented on the one-year "tax and revenue anticipation notes (TRANs)" which the Treasurer is guaranteeing. Diane P. Brosen, whom the local papers have quoted, is S & P's director of short-term debt ratings, and is happy to have any $22 billion portfolio guaranteeing the bonds of local municipalities: she is not rating the Pool, only the bonds that look to the largesse of the Pool as a buyer of last resort.

The irony is that the TRANs are being issued only to invest in Citron's Pool. This is immoral I can assure you that if interest rates continue to rise, these bond issues will be a bust. And the Finance Directors and elected officials approving these transactions will have serious explaining to do to their constituents.

The problem you face is that Mr. Citron is using the County of Orange to guarantee these TRANs. Who will bear the loss, should one occur? The County? The participants in the Pool? Have the over 180 participants agreed to share losses?

One only needs to look at the bond issue that the Newport-Mesa Unified School District is participating in. They have borrowed some $47 million, which Mr. Citron invested in Federal National Mortgage Association (FNMA) government bonds. These bonds collateralized another roughly $46 million in funds, through the use of a reverse repurchase agreement, allowing the purchase of additional FNMAs.

The TRANs are due mid-June, but the approximately $93 million in FNMA investments are down some five percent in value. According to Mr. Citron, the County will take the nearly $5 million loss: He states that he will hold the FNMAs, which are intermediate bonds with a life of five years, until maturity.

However, for every one percent more in yield that the participants of the Pool could have received elsewhere, they lose nearly $1 million in annual income. Put simply, the Pool could even lose more by holding to maturity if rates increase by more than 125 basis points (1.25 percent). Obviously, this strategy of Mr. Citron's is somewhat shallow, if not disingenuous.

Mr. Citron goes on to state in his letter of September 10, 1993:

"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."

I hope, for the sake of Orange County, that Citron's prognosis is correct. Unfortunately, most economists and others familiar with the Federal Reserve Board do see inflation on the horizon. Even the commodities markets are portending of things to come.

Most interest rate experts do not expect a decline in interest rates soon or at all. This will negatively impact the Pool. Our research indicates that for every point increase in interest rates, the Pool's yield decreases two points. This is due to the extensive use of leverage. Therefore, if interest rates continue to rise we may incur major financial losses in Orange County.

It is interesting to point out that Mr. Citron has predicated the majority of his basis for a long-term interest rate decline on the theories proposed by Mr. Charles Clough, Chief Investment Strategist for Merrill Lynch. Is so happens that Merrill Lynch is the major broker for the Orange County Pool and the major underwriter of the Pool's derivative investments!

It is of great concern to me as a citizen of Orange County to see our Treasurer wager away our tax dollars on long-term bets. And he's doing it under the noses of elected officials at the Board of Supervisors and at almost every small District level.

Citron has structured an open ended, highly leveraged mutual fund about which he confidently proclaimed "we believe that our comparative higher interest earning rate yields over the next three fiscal years is insured." They say that pride comes before the fall. It is tragic that Citron did not factor in a major problem: President Clinton's new fiscal program.

If I am elected I will pursue a major revision in the Pool's reporting of it's investments with the participants. The Pool must be marked to market and treated like the mutual fund that it is. Money market funds trade at a $1 net asset value, but the Pool does not even resemble a money market fund. In fact, money market mutual funds are specifically prohibited by the Securities and Exchange Commission from investing in inverse floaters. Mr. Citron has over $3.5 billion of inverse floaters in the Pool. Ironically, his office stated recently that inverse floaters are "one of those securities you say, 'I wish I hadn't bought that'" (Orange County Register, May 8, 1994). The participants have to face the music, have their investments reported at their net asset value, and not anticipate a dollar back for every dollar invested. This must be done for the financial integrity of Orange County.

This task will require a tremendous amount of cooperation with the Treasurer's office, the Board of Supervisors, and the Finance Directors of the municipalities in the Pool. This is the only realistic approach to take. If interest rates continue to rise, not doing so will only postpone the inevitable.

Furthermore, if elected, I will request that you and the rest of the Board of Supervisors provide me with independent forensic accountants, legal counsel, and investment counsel. We must determine the extent of Mr. Citron's side deals, such as the one with the Newport-Mesa Unified School District, his derivative investments, etc.

It is time to recognize that the County has been in a high risk situation and the participants have to bear the costs of those risks. Actions have consequences.

I provide no miracle cure. I provide no secret "exit plan." Mr. Citron's Pool has minimal defensive positions. His approach has been to purchase "fixed interest rate coupon instruments," hardly a dramatic hedging maneuver.

The Pool is focused on decreasing interest rates, even after those rates have been at all time lows as far as recent history is concerned. The only quasi-legitimate “exit plans” Citron has are increased leveraging or increased contributions to the plan.

It was Citron’s use of leveraging that prompted the City of Tustin’s withdrawal from the Pool. Let me quote from that City’s “Statement of Investment Policy:”

“Cash Purchase Only. Securities shall not be purchased on margin, credit or for other than full cash payment and shall not be pledged as collateral.

“Repurchase agreements. Funds shall not be invested in repurchase or reverse repurchase agreements of any kind.”

Their policies are no different than that of any other prudently run institution. Accordingly, they had to pull out. And Mr. Jeff Thomas’ involvement as a City Councilmember was appropriate in his fiduciary role in that position.

It would be interesting to see how many other municipalities who are participants in the Pool who are in violation of their own investment policies. Why has Mr. Citron enticed them to circumvent their own investment policies?

For some reason Mr. Citron and his cronies, like Assemblymember Tom Umberg, just don’t get it. Instead, they prefer intimidation and belligerence. They send a strange message. Instead of wishing the City of Tustin well and encouraging them to consider modifying their investment policies and then returning to the fold, they try to make a “political” issue out of it. How narrow minded. Mr. Thomas did his job and he did it properly, I can not say the same for Mr. Citron or Mr. Umberg.

If elected I will take a conservative approach with the Pool. It will take a considerable length of time to do so, thanks to Mr. Citron’s long-term bets. It would be fair to inform you where my forecasts of the near-term market will be. My forecast for the future parallels that described in the May 6, 1994, issue of Grant’s Interest Rate Observer, page 1 and forward. The 1994 bear market can be compared to the 1958 market which saw a significant amount of margin calls:

“In the spring of 1958, a recession was ending, and the Federal Reserve was preparing to change course. The bulls, rich and thinking well of themselves for owning bonds that had risen by more than 10 points since the autumn of 1957, were bearish on business activity and skeptical about inflation. Such was the shape of the yield curve that they could borrow at 1 1/2% or so-- Garvin, Bantel & Co. was a leader in the repo business--and invest at 3% or so. [George K. Garvin, senior partner of Garvin, Bantel & Co., was suspended from the New York Stock Exchange for overlending to bond speculators and the leveraged purchase of Treasurys was condemned on moral grounds by a writer at The New York Times]. ‘The equity margins put up in this period by credit speculators were, in too many instances, either nonexistent or too thin,’ the Fed and Treasury concluded in a 1959 postmortem of the bear market. That sentence may be recycled for the inevitable official postmortem of the 1994 bear market.”

Another article in the same issue of Grant's Interest Rate Observer, on page 10, it was observed about this Treasurer's race in Orange County:

"It isn't every year that the suitability of leveraged derivative securities comes up for the vote on a local ballot; watch this space."

A copy of the articles are attached and are reprinted with permission from The Interest Rate Publishing Corp., copyright 1994.

I believe a conservative approach to investing is needed for our County. Every prudent investor chooses safety of principal as the top priority. Next comes the need for liquidity. The last priority is achieving yields. It's time to get back to basics. Mr. Citron has these priorities inversed. He has focused primarily on yields. He has poor liquidity. And he has put our principal at risk. He is willing to make highly leveraged, highly speculative and highly aggressive investments. I am very uncomfortable with that, and you should be, too.

I would strongly recommend that you prepare for a worst case scenario. As for myself, I will pray that interest rates go down. If they do, you had better inform your Treasurer that although he survived that scare he must modify his investment approach immediately.

Should you have any questions regarding the above or the attachments, please do not hesitate to contact me.

Very truly yours,

John M. W. Moorlach

JMWM:jmwm

Copies of referenced documents attached:

1. Letter regarding the Annual 1992-1993 Financial Statement, dated September 10, 1993, from Robert L. "Bob" Citron to the Board of Supervisors.
2. Grant's Interest Rate Observer, May 6, 1994, applicable pages (copied with permission).

cc: Supervisor Roger R. Stanton
Supervisor Gaddi X. Vasques
Supervisor William G. Steiner
Supervisor Kerrick K. Wieder
Interested members of the media