MINUTES OF THE INVESTMENT ADVISORY COMMITTEE
DECEMBER 15, 2003

I. CALL TO ORDER AND ROLL CALL

Chair Brown called the Investment Advisory Committee Meeting of December 15, 2003 to order at 1:35 p.m. in the Town Council Chambers. In attendance were: Chair Stephen L. Brown, Dr. Michael Andrews, Edward L. Hennessy, Jr., Jane Skittone, Finance Director, Cheryl Somers, Assistant Finance Director, and Betty Cotton, Finance Secretary.

Also present for a portion of the meeting were: Michael Hole and Rick Patterson from CitiGroup, Rick Miller and Mark David Adams from Edwards & Angell, and Greg Coleman, Florida League of Cities, via conference call.

II. PLEDGE OF ALLEGIANCE

Chair Brown led the pledge of allegiance.

III. APPROVAL OF AGENDA

Mr. Hennessey moved to approve the agenda, Dr. Andrews seconded, motion carried.

IV. COMMUNICATIONS FROM CITIZENS (3 MINUTE LIMIT PLEASE)

No citizens attended.

V. APPROVAL OF MINUTES FROM JANUARY 23, 2003 MEETING

Mr. Hennessy moved to approve, Dr. Andrews seconded, motion carried.

VI. APPROVAL OF MINUTES FROM FEBUARY 4, 2003 MEETING

Mr. Hennessy moved to approve, Dr. Andrews seconded, motion carried.

VII. STATUS REPORT REGARDING INVESTMENT RETURNS THROUGH NOVEMBER 30, 2003

Chair Brown asked Ms. Skittone to lead the discussion.

Ms. Skittone said the committee has been receiving the monthly reports that give the status of the Florida League of Cities and State Board income. Through September 30, 2003, we had $194,594 year to date income balance. From October to November, the balance for that year to date was a negative $90,000 or 3.3% which would be $104,269 for the Florida League of Cities investment for that time period that it's been invested in. She explained that she is looking at two reports. The September is the year to date through September because that's our fiscal year. The other one is just for the two months of the new fiscal year. The investment carries over two different fiscal years. The sheet that was just handed out summarizes the investment income for the whole time period.

Chair Brown asked for clarification of the definitions of the items in the reports for September and then updated through November. When you talk about total monthly earnings, that includes both income and capital gains and losses?

Ms. Skittone said that's correct and unrealized gains and losses.

Chair Brown said then this is really a total return report, it's really not a report that breaks it down except in this latest sheet you just gave us?

Ms. Skittone said that's correct.

Chair Brown stated as he understands it, the Florida League does not give you that breakdown on a monthly basis, they just give you the total return figure?

Ms. Skittone replied correct.

Chair Brown said so the only way you can find out is to call back and ask them questions and that's how you've gotten these figures for the latest sheet that was just passed out.

Ms. Skittone said correct.

Chair Brown stated he just wanted the committee to understand what's happened here. He had assumed incorrectly that the Florida League would report a more detailed monthly report that would show what happens to income in unrealized and realized gains and losses, etc., so you could see what was happening by type of income. He does think we should ask them to do that in the future rather than having to go back and resurrect what happened. One of the things that is surprising about the sheet that has been just handed out is that there are in fact some realized gains and losses and in fact fairly substantial losses and we'd really like an explanation of that from the money managers.

Ms. Skittone said Greg Coleman from Florida League is now on the phone for the conference call.

Ms. Somers explained to Mr. Coleman that we have our Investment Advisory Committee and Ms. Skittone here.

Chair Brown explained to Mr. Coleman that the summary from the staff on what has happened in the two funds in which the Town is invested is broken down by investment income, realized gains and losses, unrealized gains and losses, and expenses. Chair Brown said he had assumed incorrectly that the only losses would be unrealized losses but there is $57,217 worth of realized losses in the 1 – 3 year bond fund and the Committee and Staff wondered what the source of those losses were.

Mr. Coleman stated as far as individual transactions, the Town probably had about thirty on the buy side and only five on the sell side of which those were trade securities. As is our portfolio manager custom, when we maintain some of our liquidity of our duration in treasury securities, we in general will try to always own the most recently issued treasury to your note, or Fannie Mae, etc. for a couple of reasons.

1) liquidity is better
2) when the auctions come out, and I'm going into detail because this is the actual where some of the gains and losses occur, the gains or losses will occur when the new Fannie Mae issue is coming out replacing the old Fannie Mae issue, specifically if they issued security that's to 1/15/08 and now they are coming out with a security that's to 8/15/08. It would suffice investors like us to buy the new security. We will sell the old and buy the new and pick up a better rate of return on these specific securities. In one case it was 12 basis points and in one case it was 20 basis points. It's not always that high but it was in this case. That is the driving force, if we can sell the one that we own because we think we see something that will provide a greater total rate of return for the life of that security, we'll do it. If we don't, whether there is a gain or loss, we don't.

Chair Brown said to put the explanation in my own words is that what happens is you will sell the security at a loss or gain in order to get a higher income or better liquidity or both?

Mr. Coleman said correct.

Chair Brown said the only thing we really need to think about here is that that locks in losses which if you had held the securities to maturity, it would have disappeared, isn't that true?

Mr. Coleman said, yes that's true. The rejoinder to that would be to go one step further. Say at maturity, let's deal with the 2 year treasury, you'd end up with your 10m to use that number plus interest to your corporate bonds that you've gotten every six months, you put out 10m and got corporate bonds at maturity and you get 10m back.

Page B, you sell a 2 year treasury six months into the holding, we take a $20,000 loss but we are able to reinvest at a higher rate than when purchased and sold out at. At maturity, the same 2 years, at the end of the day, do you have more dollars than you would have had you just held that bond to maturity? In general, when you are buying at a higher yield than you sold out at whether it's a gain or loss, the answer to that question is yes.

Chair Brown said ok he does understand the theory against the $57,000 net realized loss. It looks like a rather high magnitude relative to the total income of the portfolio. It strains credulity a little bit that you could make that up in income but maybe you can.

Mr. Coleman said you are exactly right. What you are effectively doing is putting that loss exactly in one month only, that you're realizing that in the accounting period that you booked it in. Whereas the gain, even in the present value basis, still accrues over the 1, 2, 3 or 4 year period. So it does highlight that. It also does it in the gain side too. But before the period April 30 to date, just your 2 year 3 year securities has risen about a half of one percent, 50 basis points. So that's a reasonably good high move where you are selling securities that you own that you bought at a lower rate, you are going to take a loss but the bigger loss you take, the higher the new rate that you're investing at is. But your point is correct, I think the reason it seems that way is because it's all rammed in the accounting period. We don't amortize the losses over the useful life of the bonds so to speak. We recognize them for accounting purposes in the period that they were lost but the portfolio yield is higher than it was then and the securities that we bought are higher than the securities that we sold. It can be demonstrated over the life of the securities as long as you invest in a higher rate than you sold at. You will be dollars ahead.

Dr. Andrews asked in the unrealized appreciation/depreciation, is that strictly market actions?

Mr. Coleman replied that's correct.

Dr Andrews asked is there any way we can relate this information in percentages?

Mr. Coleman said the period he was looking at was April 30th to November 30th. For the fund I got about $100,000 but it works out in the total fund less than 5 basis points.

Dr Andrews asked if he had any idea what the basis point loss would be?

Mr. Coleman said about 5 basis points.

Dr. Andrews said it was about 5 basis points realized loss. Is it also safe to assume it's about 12 basis points in market loss?

Chair Brown said we're looking at a figure that was obtained from your folks of $127,000 plus unrealized depreciation. We are looking at figures that say $57,000 of realized losses, $127,000 of unrealized losses and I think what Dr. Andrews is saying is that if the $57,000 is 5 basis points then $127,000 ought to be a little more than double that.

Mr. Coleman said he was using a higher number because he went through November 30th.

Chair Brown said the heading of this sheet says April through November. We are just looking at the 1 – 3 year bond fund. We haven't even gotten to the intermediate bond fund yet.

Mr. Coleman said on the 1 – 3 year bond fund, they are doing mark to market and he does not have the book value accounting numbers. He was giving you period to period. Those accumulated gains and losses would straddle. If you bought an investment in December of 2001 that was still in your portfolio, that gain and loss is still traveling with those securities. They would be in the numbers that you just said. Whereas, he is measuring total rate of return period to period April 30th to November 30th.

Dr. Andrews said if we are going period to period, I hear you saying that the realized gains or losses may not be period to period gains or losses. Because, as you quoted before, it travels with the investment. You said the information we have on the $57,000 is period to period.

Mr. Coleman said that the $57,000 realized loss in the area questioned, amounts to about 2.5 basis points on the overall portfolio. In the unrealized portion as stated there, that's the change from April 30th to November 30th, then you are right, you can just divide one into the other.

Dr. Andrews said you originally said 5 basis points.

Mr. Coleman said he was using the $108,000 loss figure. We don't keep the book value categories. I'm looking at something that says "Funds 4/30 to 11/30". And that could be because we don't advertise printing or discount. We just do week to week. It all depends on mark to market accounting. So I would use records of the custodian and the Florida League for those numbers.

Chair Brown said we didn't get this data directly from the money managers. We got it from the Florida League. I guess the Florida League has its own way of accounting for these summaries.

Mr. Coleman said if they bought a security two years ago at a premium, if we bought everything at par, the numbers would be the same. There are different ways to do things. We look at market value on 9/30 and market value on 12/31. We only advertise premiums for discount as with an insurance company or something that's maintained full value accounting. He believes the Florida League does do that. If they bought a bond at 102.46 and held it two years, the book value would be lower than that because they will show it as original cost. We don't provide any book value records. In transactions in a series of Fannie Mae's sold during that period 4/30 to 11/30, the original cost not amortizing the book value is about $100,000. So he would prefer the $57,000.

Chair Brown suggested so that we don't get too lost here, maybe we ought to concentrate on what kind of reports we would like to see the staff and the committee get in the future on a monthly basis so that we all are speaking from the same page and are understanding things a little more consistently. I think what we have heard is that what is reported to us on a monthly basis is not what you have in front of you in the summary sheet. Rather, it's simply the total net investment income. I might call it something else, total return or something like that, but the breakdowns that we have in front of us, we just received for the first time today and the staff does not receive these breakdowns in their monthly reports. I think they should and I think they should share those breakdowns with the committee and I think they should also talk about those differences in the final column. Because I think it's significant.

Mr. Coleman said he can't speak for the Florida League but he is sure they they would be more than happy to provide whatever they can.

Chair Brown said I think the key is that if we look at just total return, it would appear that the total return compared to simply having left the money in the State Board may not be that good because we've had generally upward rising interest rates during this period. What is missing, I think, from the information flow is the fact that the investment income just from income is substantially better than it would have been if it had just been left in the fund. A lot of those mark to market losses are either temporary if they are unrealized or are going to be made up for in future higher investment income according to your testimony.

Mr. Coleman said right.

Chair Brown said none of that is getting communicated appropriately to anyone as far as I can see. So I think it is a communication issue more than an investment issue.

Dr. Andrews said Mr. Coleman, I think the Chairman is very eloquent and I'll put in a more succinct way, we can't follow your numbers very well. Do we get them directly from you or do we get them from the Florida League of Cities? Somehow or other we have to get something and I'd like to know for the money we have invested, how we are doing and I happen to like percentages. We get it from the SBA in percentages. I would figure we had a certain amount invested, we had a certain amount of income, we had some unrealized expenses, and some gains and we had some realized. That's kind of what I'd like to see. If we could get that on a monthly basis, that would allow us to compare this investment with other investment opportunities.

Mr. Coleman said I am with you. As I recall, maybe three or four years ago, the reports were presented that way because there was a distinction and income was broken out, the accounting was monthly, because they wanted to see what was paid or accrued and my understanding was that the change was because everybody felt they should get back to trading accounts. Securities that are not stable assets, which the SBA is, but most money market funds can just quote interest because there are no market value gains and losses. The League still can say here in the month of December, your total rate of return would be income accrued and received, gains and losses taken.

Chair Brown said we are going to have a meeting in February and we need to have the Florida League of Cities here so that we can better understand what's being communicated to us and give them an idea of what we'd like to see because I think we are asking the money manager to explain something that he's not actually calculating.

Mr. Coleman said correct.

Chair Brown said I think that they're both important because while there are real fluctuations and apparently some actual losses taken in order to improve income, the whole idea is that over a long period of time, the income stream from this investment process will be better. We'll have what you pay in terms of a price for that in some fluctuations in capital prices and we've seen that in spades but we don't want that to be so dominant in the reporting system that people don't understand.

Mr. Coleman said he hears what the committee is saying and he understands. He will talk to the League as well. He will make sure he is giving them whatever they need to produce what you want. He thinks perhaps in the calendar year to date 9/30/03, both the index and the fund returned about 1.8%. There were negative months and months when they were very positive and rolling it all together from your investment, you've earned about 1% more than you would have if you were in T bills.

Chair Brown said you are including capital gains and losses in that number. The number we have is different and it shows that we actually did worse than if we had just left our money with the State Board for the whole period April 30, 2003 through November 30, 2003.

Mr. Coleman asked what the numbers are.

Chair Brown said he thinks the figures Mr. Coleman has are through November and the figures you are looking at are through September. And I believe October and November were difficult months for the bond portfolio from a capital depreciation point of view. That may explain the difference. Through the month of November which is the latest information that we have, we actually did worse than having our money in the State Board when you include all the capital gains and losses. He said he thinks we have pursued this as much as we need to.

Dr. Andrews said we have expenses in here, are those the fees?

Mr. Coleman said yes.

Chair Brown said Mr. Coleman, we can straighten this out because I think we are looking at two different time periods. I think we have gotten our answers. We appreciate your help and let's see if anyone else has any questions.

Mr. Coleman asked that Ms. Somers or Ms. Skittone give him a call to decide what information is needed. The fact that we are a total rate of return almost exclusively doesn't mean that the rest of the world should be. We want to help you and the Florida League get you what you want.

Chair Brown thanked Mr. Coleman and asked if there were any other questions for Mr. Coleman.

Mr. Hennessy asked Ms. Skittone what do we report to the population here? Would it show these losses?

Ms. Skittone said yes, only what it would be as of September 30th.

Mr. Hennessy asked so next year as of September 30th, if we have gains that offset those losses, we are all right?

Chair Brown asked how the committee feels about what has happened so far? We can take another look at this in January or February and this would be a tentative conclusion at this point but are we achieving what we wanted to achieve. Is there some change we should make in the actual investment procedure or is this more at this point a question of an appropriate communication issue?

Dr. Andrews said he thinks there are two issues: We don't understand the information to interpret as well as we should. As far as the investment policy that we started off, I think it's still valid. What concerns me is the variation or the movement, the standard deviation of how much it goes up one month and down another. We also haven't had the money invested any period of time. I don't think we have a real good track on what we have and I don't think our original assumptions were incorrect. I think they were accurate. We always should review the Investment Policy and the decisions we made but I don't see any major changes that I would make at this particular time until we get some more data or information that we can more readily interpret.

Chair Brown and Mr. Hennessy agreed.

Chair Brown said he thinks this is the first time that we've actually gotten some information that breaks down what's really happening underneath the total return data that we've been seeing. I do think it's significant to understand the difference between the income and the capital gains and realized and unrealized.

Mr. Hennessy said he would just like to see one other number, the average investment for the period. Then we would see what we really have.

Chair Brown said yes, the average assets and if that can be turned into a rate of return.

Dr. Andrews said he thinks that the key is getting some type of rate of return or some ability to go against the benchmark. Because we really don't know how we are doing here.

Chair Brown said he thinks in terms of total return, the best we can say is that as of the end of November, we are actually slightly behind if these numbers are correct, and on income, we are quite a bit ahead.

Dr. Andrews said the theory behind it is if we have enough time in the investments, it should net out at zero as far as the gains and losses. That's the theory, and then our income will be substantially better.

Chair Brown said if this is the right approach, eventually the income will swamp the capital gains losses but right now that's not the case. In the meantime, I think it's important to have a reporting system not only to us and to the staff but hopefully to the Town as well which will give them some idea what's really happening here and the philosophy behind this investment program.

Ms. Skittone said we can try to modify the report so that it shows the breakdown between these items. As far as the interest rate, she is not sure exactly how to do that.

Chair Brown and committee said that would be very helpful. He said you have some interest rates in here. He suggests that the committee delegate him to work with Ms. Skittone and Ms. Somers to try to come up with a reporting format that might be better and the committee can take a look at it in the next meeting.

The committee agreed.

VIII. PRESENTATION BY MICHAEL HOLE, CITIGROUP, REGARDING INVESTMENTS IN INTEREST RATE SWAPS

Chair Brown welcomed Michael Hole and Rick Patterson from CitiGroup.

Michael Hole introduced his partner, Rick Patterson and the two gentlemen in the audience, Rick Miller and Mark David Adams from Edwards & Angell law firm. They serve as the Town's bond counsel and he asked them to join us today because he is going to be talking about some things related to bonds and more specifically the use of derivative products in your investment strategy. The Town has not done that before and if you did decide to employ some of that strategy, you would need to amend your investment policy and these gentlemen have the experience having done that in several places here locally. In addition to being your bond counsel, he thought that they would be good in addition to CitiGroup's presentation here.

He gave a little background also stating that he has stood in this chamber for many years actually since 1986 as the Town's investment banker and still stands before you as your investment banker. He also said they are not money managers. They are not going to talk about investments or many of the details that you are talking about. They are going to talk about derivative products and how they can be applied on the asset side of your balance sheet. He thanked the staff for inviting them. He has been in front of the Mayor and Town Council many times but never had the opportunity to be in front of the Investment Advisory Committee so this is new for them.

Again, just to make sure it's clear, they are not going to talk about investments. They are the Town's investment bankers and one of the things that's changed over the eighteen years or so that he's been in this business is, as opposed to just focusing strictly on the debt side or the liability side of your balance sheet and using municipal bonds in the case for the Town (and you take advantage of your tax exemption), they have taken a broader approach in looking at both sides of the balance sheet. They are not from the money management side of the business but the advent of derivative products and the way they have been used to essentially remove balance sheet risks has direct application to your asset side even it's a product that we as municipal bankers are used to using on the debt side.

Rick Miller, Ms. Skittone, and Mr. Elwell have seen the advent of these products used on the asset side as well as the debt side and thought this might be a good time for us to come and brief you. Today they are here in an education mode. This is something that as investment policy committee men, you may not have seen a lot of depending on your backgrounds in banking and on the corporate side you may actually have seen interest rate swaps or worked with them so please let us know as we go along. This material is presented pretty much from the basics of how they are applied and hopefully when we are done, you'll understand why we are talking to you even though we are bankers that specialize on the debt side.

He said they will just flip through the book as a guide and on page 1 is one of the things we do from the debt perspective. To try to frame some of our discussion today, as you know in 2000 the Town issued debt for the beach bonds, approximately $24 mil. That debt was at an interest rate at the time of just over 5%. One of the things that they do as part of that plan of finance is that they have locked you into an investment until that money is spent and the way the IRS works, they could only do that for a three year period. Not unusual for projects like beaches that are very environmentally sensitive and have a lot of permitting issues, that type of project did slow down and so that investment contract matured after the three years and there were still unspent bond proceeds in it. The key to that investment contract is it was pegged very close to your bond yield so you bonds were costing you 5%. You were also locked into an investment at 5%. So there was really no carry cost to you while those bond proceeds remain unspent. Of course, the three year anniversary came and that contract matured at a time when interest rates were already falling and continued to fall further. So you do have unspent proceeds out there that are now in the SBA pool that are earning what they are earning certainly nothing close to the 5%. That gives you a little context of why a banker on the debt side comes and starts talking about what you might do for your assets because quite a bit of your assets that are in these funds are indeed unspent bond proceeds. That's a little bit of why we are here and now we will hopefully show you how we are going to apply these derivative products to enhance your yield while at the same time pulling risk out of your balance sheet. The risk specifically is this interest rate risk, you've got debt out there that is costing you 5% or actually since refinancing this year, it's just over 3%, but the point is you're clearly not getting 3% in SBA where those bond proceeds are parked while you are waiting for the rest of the beach project to be permitted and spent out.

Mr. Hennessy asked if there is a report that comes out that says that the progress that they are making depending on having the permits, etc. is slowing it down and do you have a chance to reinvest or is it just locked in for three years?

Mr. Hole said you are locked in for three years. That particular contract was a fixed rate contract so the fixed rate that you are earning was tied specifically to the three year point on the curve. At the end of the three years, obviously you do reinvest but you are exposed to the reinvestment risk of whatever the rate of return is at the time that investment matured.

Chair Brown said a couple of things occurred to him during Mr. Hole's introductory comments. First as he understands it on this bond, the reason we purchased a three year was because we expected that the money would be put out in three years. Now however even though the money has not been spent, the maturity may be considerably less than three years that remains on the liability side. The most you can do is look at something in a year or so or something like that. But also, the rest of the money for which we are trying to get advice as far as I know does not have a specific kind of liability interest rate and only rather vague maturities. So it's been hard to pin down unlike bonds that are very, very clear, you have this maturity, that interest rate, most of our roughly $100 mil are reserves some of which may be used at different times but it's very, very hard to predict when.

Mr. Hole said this is where you have to take off your normal investment hat where you are used to investing money. In the interest rate swap that we are going to talk about, we don't move the investments. You are not going to invest in the swap. The swap is something that you overlay on top of your existing investments. In fact, we are going to specifically tell you as an example that you should leave whatever portion that we are going to talk about of entering into a swap, you should leave that amount of money invested in the SBA. That's where the money is invested, nothing changes there. If you need it, obviously, you draw it out. Obviously, it's a liquid investment and I'll draw your attention back to this intro on page 1, the third bullet says "the Town's expressed an interest in investing approx. $46-50 mil, including unspent bond proceeds, in longer term investments in an effort to enhance investment returns. To accomplish this goal while maintaining the short term liquidity, the Town should consider leaving the funds invested in SBA and overlaying an interest rate swap to potentially enhance the investment return. With an interest rate swap, the Town would pay a variable rate of interest and, in return, receive a fixed interest rate (which is currently higher than today's variable rates)". My point is, you're not going to move the money for our example today. It would stay there so if the permitting moved up or some of these other investments that you're not quite sure when you're going to need the money. If you ever need to get to that money, the money is in SBA. It's not in the swap. The swap is going to be a separate contract that we're going to overlay to enhance the net return to the Town.

Chair Brown stated you are aware of previous discussion that we already have moved some money from the SBA to Florida League at somewhat longer maturities.

Mr. Hole said as far as the Florida League is concerned to the extent that you wanted to apply or overlay a swap on those investments, it can certainly be done. It would be something that we would want to look at what those underlying investments are to match some of the maturities there with the swap. Again, just for our workshop today, I assume you are still leaving a substantial portion in SBA.

Chair Brown said that's correct.

Mr. Hole said so it's easier to think about it the way we have the book laid out here. Think about the swap being applied to all or a portion of the investments that you will end up having in SBA.

Mr. Hole proceeded to page 2 – derivatives. He said the main thing he wants you to take away from this page is first of all where derivatives get the name. The derivative is a financial instrument created from and whose value depends on the value of one or more separate assets or indexes of asset values. Example, an interest rate swap, the value of that is derived from bonds. Goals of the derivatives is lowering interest expenses, hedging interest rate risks, and matching interest rate sensitive assets to liabilities. That's really where we are talking here if you want to think about it in terms of the bond proceeds. You've got the bond proceeds at a fixed rate of interest and you've got the bond proceeds of debt from the fixed rate of interest meanwhile you've got the proceeds invested in SBA. So you have this mismatch of this very short term variable rate investment that was derived from bonds that are fixed rate at the 5%. Diversifying financial risks is essentially what we are going to be doing in terms of pulling some of this variability out of the liability side and asset side of your balance sheet. The last point on this page is just to show you how the market has grown. The derivative market right now is mostly on the corporate side but municipals is growing tremendously, it's over a 100 trillion in today's market.

Mr. Hole said the next page is a little bit of Florida flavor of what municipalities are using this. He asked Ms. Skittone if she included in the package the article that she showed him with Orlando and Jacksonville that some of the municipalities are starting to use. Micky Miller is a CFO up in Orlando that all the major firms work with and he is a great believer in these types of products to do what we are talking about today. As you can see, there are two particular issuers locally here, the School District and the Solid Waste Authority. In fact, Rick Miller works with both of those entities as well and drafted the investment policies for those entities for them to be able to apply the derivative products.

Dr. Andrews asked if he could give us a rough idea of what percentage of their investment assets they are considering to be in derivatives?

Mr. Hole said with respect to the Solid Waste Authority, they have approximately 50% of their assets in one way or another covered with a derivative agreement. The School District has not applied the derivative product on the asset side of the balance sheet. All their products and applications have been on the debt side. Analagous to your 100 million, the Solid Waste Authority has about 200 million all of it in SBA but they have purposely left all of it in SBA. In part because they are using derivative products on about half of that to enhance the return above the low SBA rate. They want to be able to maintain the liquidity as well given the nature of that operation out there. So they are comfortable. They see it as the best of both worlds. We are not talking tremendous yields here, not in this environment. They are able to enhance their yield somewhat above the SBA levels but maintain that liquidity. If they need to get that money on any given day, they can do it.

Chair Brown explained that just nine months ago, the committee decided to move some money out of SBA into Florida League with the same idea of getting somewhat higher yields on a portion of our funds. I guess we could have used swaps instead to do that. The question I have and you don't have to answer this right now but as you go along, it seems to me that's it's either one or the other. I'm not sure what the benefits are of using swaps instead of actual bonds. For example, when you went out and suggested the guaranteed investment contracts to invest in to back up the bond proceeds, we could have used a swap instead. We don't want both just one or the other. We've already done one, why should we do the other?

Mr. Hole said, you are correct, Mr. Chairman. In the context of the fixed receiver swap that we are going to talk about, I think it would be either/or from the perspective of the Florida League's money management. I think it is looked at more as an alternative instead of moving all or a portion of your money from SBA to money management where they are going to be investing in those short term and intermediate bonds. Those are fixed income assets that they are moving into. The fixed receiver swap acts in the same manner as a fixed income asset and it would be comparable in terms of comparing the two – one or the other. The difference is of course the swap is not the investment. You would pick up fixed income bond money management income by leaving the money in SBA and overlaying a swap. The difference is obviously in some markets you get a better net return with a swap. You don't have any fees and that sort of thing. There is nothing being managed. The money is just sitting in SBA and you have the additional comfort of the liquidity. If you ever need that money you can go and get it. In a rising interest rate environment, there is a risk to the swap if interest rates shoot way up just like any fixed income security before the term matures.

Chair Brown said the risks are the same either way. You have to value the swaps as if they were fixed income investments if the interest rates change.

Mr. Hole said correct. The difference is if you need the money you don't need to break the investment. The investment stays in SBA. You pull the money out in part at any time. The swap can stay in place without having to break the swap. You don't have to have a perfect match between the two.

Dr. Andrews said you just mentioned that there were no expenses.

Mr. Hole said not related to the swap. We'll get to that in a minute.

Mr. Patterson said to add to what Mr. Hole said this is an educational type presentation so I would encourage you to interrupt. We can spend as much or as little time as you want. So let us know if we are not providing enough or too much detail.

He stated page 4 provides an overview of interest rate swap mechanics and a swap is simply a contract between two parties to exchange payments. There is no bond, no debt issue. It's simply an investment contract and typically in its simplest form, one party under the contract pays a fixed rate, the other pays a floating rate. There are a lot of different alternatives but that's the basic swap structure. Under the type of structure that we are going to describe today, it's called a fixed receiver, where the town would be receiving a fixed rate from CitiGroup who would be B in this diagram paying a fixed rate and the Town in turn would be paying a floating rate back to us. The notional amount is the par amount if you will that the payments are based on and that can be any number that the Town chooses based on the way that we are suggesting that you consider applying a product. You would want to pick a notional amount that you are very comfortable with that you could always hedge with what you've got invested in the SBA. As we'll disucss, we'll assume that this is a hedge swap and we'll talk about how that works. In the analyses that we've shown, we've assumed 50 mil notional based on the assumption that that's the amount that the Town might consider investing longer but certainly you could do a much smaller amount. If 10, 15, 25 mil was the number that you were comfortable with that would always be hedged with SBA over the life of the contract, that's the number that you choose. Payments are netted. You don't make two separate payments on the actual payment date. You calculate who owes and that party pays the other. These contracts are typically done on a monthly, quarterly, semi-annually pay. Again, the Town chooses that basad on what works best for the Town. We have assumed, and there are a lot of different types, taxable, tax-exempt, and different types of each contract. We've assumed that this swap would be libor based where the fixed rate that we're paying you is a taxable Libor based rate and the rate that you pay back to us is the one month Libor. The reason that we have selected that structure is one month Libor as we'll see on the next page very closely correlates to the funds that you have been gaining on the SBA. The last thing I would point out on page 4 is just like with a fixed rate investment as long as you're in a normal, upwardly shaped yield curve, the farther you go out, the longer the term of the contract, the higher the fixed rate that we would pay you as your counterparty.

He said page 5 shows over the last seven years how the returns on the SBA have been tracked against 1 month Libor. What you see is there's been a very close correlation. Currently, SBA minus Libor is positive by 19 basis points. In the graphic, we show SBA as the green line, Libor as the gold. Obviously, since you are receiving SBA, you always like the green line to be higher. That means you would be earning positive basis. The SBA return that you are receiving would exceed your Libor rate. As long as SBA and Libor equal, those payments net out and what you've effectively earned under this transaction assuming that your overlay the swap on SBA, is the fixed receiver rate that we'd be paying you under the contract. Anytime that Libor is greater than SBA, that would cut into your return. Anytime the SBA exceeds Libor, the opposite would be true. What we see is on the average over the last seven years, they've tracked by about 4 basis points of negative basis care if you will comparing the two. The maximums and minimums obviously don't correspond to the highs for the individual endices but the highest spread has been 35 basis points over the last six years which would be to the Town's benefit. The worst case looks like in the period of December 1999 for one month, there was a negative 61 basis point loss. You would net that 61 against the fixed receiver rate and that would have been your return in that month. So again, for clients that have been interested in looking at this structure, they have been comfortable that Libor and SBA are very closely correlated. That's how they see this as a hedge transaction.

He said page 6 gets into more specifics of the actual cash flow and on this page we've chosen a 50 mil notional amount and we've chosen for purposes of illustration a seven year fixed receiver rate and a seven year term for the swap. We would be paying a seven year rate. Currently that seven year rate is a little over 4% for .06%. That would be the fixed rate that we would pay you under the contract. Libor at the time that this booklet was prepared, I think a week or two ago for purposes of getting into your agenda packet, the one month Libor was at a 1.17%. If you assume that Libor over the course of the next year averages 1.17%, the net receipt or benefit to the Town would be roughly 1.4 mil. Obviously, the risk that the Town takes is that Libor goes up to the point that it exceeds the fixed receiver rate of a little over 4%. At that point, your returns become negative under the swap. The flip side of that would be at a rising rate environment, if you assume that fixed rates are going up also, the Town has the opportunity to terminate the swap, make a termination payment, amortize that termination payment against the higher replacement swap rate that you could take advantage of at that time. Effectively, if you assume that

LIBOR and SBA act as a hedge, what you've done is locked in a rate of return that would equal the swap rate and what you've done is given up the up side in the event that LIBOR goes above the fixed receiver rate over the term of the contract.

Dr. Andrews said for my information, let's just say we had 10 million dollars invested in the SBA and you overlay your swaps?

Mr. Patterson said the market rate would pretty well stay at 10 million dollars so there would be very little fluctuation.

Dr. Andrews said and the 10 million dollars would stay 10 million dollars? Let's just say that we get on the wrong side of the Libor rate and we actually lose 500,000 dollars, does that mean that we have 9,500,000? I'm not sure how we account for that.

Mr. Patterson said the only accounting treatment for municipalities under current GASB is at the end of your fiscal year, you have a note that reflects the mark to market value of the swap as of that date. That's from an accounting standpoint, I don't know if that answers your question or not.

Mr. Hole said the money is in SBA. So being a money market, it doesn't matter where rates go. That 10 million is 10 million. The fact that you do have the swap that's overlaying the swap has a mark to market value. Only to the extent like any fixed income as an instrument if you wanted to terminate that swap before it finished. In this case it's a seven year term.

Dr Andrews asked what would we report to the Town on a $10,000,000 investment and a $500,000 negative? There's a difference if rates go up.

Mr. Patterson said if rates go up above the fixed receivable rate on the swap that the Town is losing money on the swap, but at the same time rates have gone up on your SBA investment, your SBA return should exactly offset the cash flow on the Swap on the falling rate side. So the Town is still left with a 4.06% return on the combined investment strategy.

Dr. Andrews said so we had the $10,000,000 and at the end of the year we had 4.06%.

Mr. Patterson said correct. The difference is between cash flow loss during the period and value of the underlying asset. We're not moving your assets. The assets are always marked at par, $10,000,000 or better. To the extent that interest rates went up above the 4.06% and the 1month Libor went to 5%, now you owe money in the swap. At the end of year because SBA also went to 5%, that's why it's a hedged investment. Where do you get that money to pay CitiBank on the swap? You get that money from the 5% that's in SBA. It's yielding 5 so you owe 94 basis points under the 4.06% example and you pull that from the SBA to pay the swap with money and you're left with the 4.06%.

Dr. Andrews said our investment strategy shows that we are down a negative $40,000. What would it look like if we had the money invested with CitiBank?

Mr. Hole asked is the $40,000 a balance of the fixed income bonds that were sold prior to maturity? Where does the loss come from?

Chair Brown said it was a combination of realized and unrealized loss.

Mr. Hole said the SBA doesn't lose money.

Chair Brown said but the longer term maturities do in a higher interest rate market whether you sell them or not because we mark those to market.

Mr. Hole this is really a competitor to your fixed income side of your assets. Unlike that, this is what the difference is. On the fixed income side, if you need to break the real investments before they mature because you find other things you want to invest in that are higher or whatever reason you realize, those are real losses. In this case, the investments are staying with SBA so there are never any losses pertaining to the underlying investments. You will never have a cash flow loss. However, what there will be aside from the cash flow, at the end of the year at September 30, a swap can have a negative mark to market just like the fixed income. It's not recorded on the balance sheet other than when GASB has to do it in the footnotes.

Chair Brown asked isn't that sort of the same thing? If interest rates go up after you've made this swap transaction, there will be an unrealized loss right now in your footnotes somewhere for the value of the swap unrealized. If you decide to terminate the swap and buy another swap, that unrealized will become a realized loss. So I don't see any difference, the numbers may be different. The theory seems to be the same. The fixed income investment and a swap have about the same characteristics. If interest rates go up, there is going to be some unrealized loss somewhere and the Town is going to have to reflect that somewhere. If you terminate the swap the way these guys terminated some of their bonds, you're going to convert that into a realized loss.

Mr. Patterson said page 7 reflects the additional Libor. The swap curve looks very similar to generally the types of yield curves you've been getting in the past. Just as in the rising rate environment, the Town probably likes to keep the tenure of its investments short so that they can reinvest in a higher rate later on as those investments mature. The same strategy is typically taken with respect to the swaps and what we are seeing in this market. As you know this is a very steep yield curve which is terrific for the fixed receiver transaction. We see great marginal benefit in going out to a term of seven years and beyond seven years that marginal benefit starts to drop. For example, going from six to seven, you pick up 25 basis points in your fixed receiver rate. Beyond seven going out to eight years, that marginal benefit drops to 15 basis points. So again, three, five, seven year terms appear to be the most attractive fixed receiver terms for this type of contracts right now. Typically, just as you would with fixed rate investments, the strategy is stay short when you expect rates to rise. When rates do rise, you have the opportunity to terminate this contract, amortize the cost of terminating against the higher market rate at that time, extend your term and then you have the opportunity when rates fall lower to terminate the contract altogether for a cash payment from CitiBank.

Chair Brown asked how is the marginal benefit column calculated?

Mr. Patterson said it is the Libor swap rate from the first column minus the swap rate in the previous year. It really just shows you the additional benefit.

Chair Brown said it is just the difference in the term, going from 3 to 4 or 4 to 5.

Mr. Patterson said that's correct.

Mr. Patterson said pages 8, 9 and 10 are similar pages and what they show is the cash flow at different swap curves. We've chosen this for illustration purposes today at 3, 5 and 7 year swaps. It shows where Libor is, what the floating payment you would make at that Libor level versus the fixed receiver rate and the annual cash flow or benefit to the Town at that Libor rate. The fixed receiver rate for a three year transaction is a 2.79%. We mentioned that the strategy typically is to stay short early, look to extend the swap at a higher rate environment but the flip side of staying short is obviously you have a lower fixed receiver rate. The lower your fixed receiver rate, the less hedged that you have against increases in Libor. This page illustrates that. At the current Libor of 1.17%, if you had a fixed receiver transaction where you're receiving 2.79%, the Town's annual benefit, assuming that Libor is staying at that level the course of the year, would be a little over $800,000. The break even rate is a little different than the fixed receiver rate because the day count issue here would be a 2.75%. So if Libor was an average of 2.75% over the course of the year, you would break even, your cash flows would be zero. The 5 year average Libor is a 3.78%. At that level, the cash flows over the course of the year would be a negative $521,000. As we mentioned, you are not looking at doing this derivative in isolation. You would be hedged by higher returns on your SBA to net returns. You would still be at the 2.79% rate but looking at the trade in isolation, the ten year average Libor is 4.58, the negative cash flow under the swap transaction only would be around $927,000.

Mr. Patterson said page 9 shows the same type of information looking at a 5 year swap rate and that rate increases from 2.79 for a 3 year up to 3.57 for 5 year. The breakeven with this analysis is 3.52.

Chair Brown said going to Dr. Brown's question earlier, if you go from a 3 year to a 5 year to a 7 year, the cash flows look better typically at the lower rates but the capital loss mark to market would be higher and that's not shown.

Mr. Hole said that's correct and also it limits your ability to extend the transaction because as you mentioned you have a higher mark to market which means a higher termination payment if you chose to terminate and extend when rates were higher. It works just like the fixed income investment, the longer the term on a fixed income investment, the more swing in value.

Chair Brown said while we are seeing those numbers from the Florida League, we don't see those numbers here.

Mr. Hole said if it would be helpful, we could certainly prepare you mark to market values at different interest rates.

Chair Brown said certainly if we took a great interest in this, we would want to see that.

Mr. Hole said that is a typical third step in the process. We would start looking for a given notional and swings in interest rates. When you go into this though the way we do ,being conservative on the banking side, there is the opportunity to rate them, put them back on, extend them and manage them. Also, you need to think about this if you are planning to do this with a hedge, that you are planning to leave that money in the SBA. You are planning to not break the contract prior to its term unless it's to your advantage to do that. Obviously, the mark to markets can swing against you and swing for you but we don't ever go into a derivative trade planning to take a loss. Any time our clients have ever broken a transaction, in talking about termination, you look at the contract. You can always have the ability to terminate at any time. You can call us any time and see what's the mark to market. But on the other side, CitiBank does not have the opportunity to break the contract. You can trade it as a fixed income security and it's there as long as you like it. The only time you can choose to break it is if it made sense to you whether in isolation and you are receiving a large payment for it or in connection with other things that, sure you are taking a hit if you break this, but you are making it up somewhere else.

Mr. Patterson said Page 11 shows historical LIBOR. The blue bar on the page shows the 10 year average of a 4.58% and the red bar shows the moving quarterly average at a 1-month LIBOR and as the Committee is clearly aware, the LIBOR rates are extremely low in this environment.

Page 12 is a diagram that describes how the mark to market calculation works. Basically, the mark to market under swap is calculated as the cost of replacing that swap at any given point in time. On the diagram, we've assumed that we originally enter into a seven year fixed receiver transaction with the Town where we pay a 4.06%. If at some point in time for whatever reason, the Town chose to reverse? The transaction and rates had fallen to a 3.06%, obviously, the Town would be hurt if it couldn't receive a payment from Citi because the Town in a replacement swap would continue to pay LIBOR but now the receiver rate has dropped to a 3.06%. At that point, Citi would owe the Town the present value difference of 1% over the remaining term of the contract. That's how the mark to market is calculated. As we will discuss in a few moments, the opportunity for the Town is to terminate in a low rate environment. At that point, you would receive a payment from us as counterparty and you'd be back with your investments with SBA which is where they were to begin with. On the flip side, in a higher rate environment, the Town would owe a termination payment to Citi because at that point, we'd have to replace the transaction with a new trade where we pay somewhat a higher rate than 4.06%. So you would owe us the present value difference in that scenario. As Mr. Hole mentioned, practically the only opportunity that we would have to cancel a transaction prior to maturity would be a situation where the Town was downgraded below investment grade which I don't think anyone would see happening over the course of the next several years probably ever. The Town on the other hand has the opportunity to cancel at any time for any reason or to make or to receive a payment.
Mr. Hole said we are not making light of the fact that in today's environment looking forward everyone feels that at some point interest rates will start going up. We know that. That's another reason to stay short and to go into this thinking we want this contract to stay in place for the whole term.

Mr. Patterson said page 13 is a page that we include particularly when we are meeting with elected officials for people who are not really familiar with how contracts work. It could appear that we are making a bet against the Town which we certainly **are not**. Board Members sometimes believe if I'm paying fixed and receiving floating, I must assume that floating rates are going to go above the fixed rate that I'm paying otherwise I wouldn't have entered into the contract. They believe that they might be making a sucker bet. That's not the case. As with most derivative firms, we have a fully hedged book so any transaction that we enter into with the Town or any of our municipal clients is all set by single or multiple trades on the other side. So effectively what we are doing under this scenario, we are in a transaction where the variable rate that we receive from you we're paying to another counterparty and those two payments wash. Effectively we were earning the bid ask spread between the fixed rate that we're receiving from the other counterparty and the fixed rate that we are paying to you. So we are not making a bet one way or another. We do not care which way rates go.

Chair Brown asked just out of curiosity, what is CitiBank's rating?

Mr. Patterson replied CitiBank is AA.

Mr. Hole gave an example by asking Mr. Patterson , "you're saying we should enter into this contract where you are going to pay us 4% and we are going to pay you LIBOR, you must think that LIBOR is going up above 4% sometime between now and the contract's end"? That is not at all what we think. We don't care if their rates go up. That's what page 13 is intended to show that we are hedged on either side. This is not a bet at all. This is a hedge. These are hedge strategies. If LIBOR did go to 10%, then SBA is going to be at 10% as well.

Mr. Patterson said page 14 illustrates the ability of the Town to extend the transaction at a higher rate. Under this illustration, the original swap rate would be the green bar in a higher rate environment. The Town would have the ability to terminate, amortize the termination payment against the then market rate and extend the swap at a higher rate. Assuming that SBA and LIBOR continue to cancel one another, at that point the Town is locked into a higher return on the portfolio. As we illustrate, the left end of the pink bar which is the higher swap rate, at that point, the market rate is higher. The difference between the market rate and the replacement swap rate would just be amortized value of that termination payment that you make in a higher rate environment.

Chair Brown said he is not sure the Town would have the ability to amortize the loss.

Mr. Patterson said actually there wouldn't be an actual cash exchange.

Ms. Skittone said the GASB is requiring that you book your losses but she is not sure about a swap.

Chair Brown said this is very much like the conversation we had with the money manager earlier. The money manager said the Town would amortize the loss against the higher interest rate. Meanwhile, the Town can't really do that.

Mr. Patterson said from their standpoint they simply tear up the old trade and enter into a new trade with you that day at a higher rate. We show you how we calculated that higher rate.

Chair Brown said they put it into the swap rate.

Mr. Patterson said exactly.

Chair Brown if we didn't have that loss, we could have gotten out and gotten a swap.

Mr. Patterson said exactly, you'd be at the higher blue line on the graphic.

Mr. Hole said, Mr. Chairman , you're right when you are thinking about this, there is a loss in there but the advantage of the swap is you are not dealing with underlying investments. You are just dealing with a contract with one of the parties, in this instance, CitiBank. You call us up and you just roll it up. If you want to know on that date, what loss did we take and how did we roll it up, we can get that number.

Chair Brown said he thinks one of the advantages of swaps is if you don't have fixed income investments that happen to meet your criteria, we can pretty much manufacture whatever swap you want. So it has a little more flexibility in that sense. But if you have fixed income investments that you think you need, it's harder to compare.

Mr. Hole said then it's just a matter of yield.

Mr. Patterson said page15 quickly looks at a client we have that entered into a series of three different swaps, a 5 year, a 3 year and a 10 year in higher rate environments and then terminated those transactions in a lower rate environment for profit. Over the course of the last two years looking at these transactions, they generated 2 million in payments from Citi as a result of us reversing those positions. There is the ability to actively manage a swap once it's put on your books.

Mr. Hole said he will be calling Ms. Skittone at certain points if rates go up and down and say, by the way, your swap is valued at such and such today, this might be a smart time for you to extend or terminate all or a portion of the swap. So there is a management that goes along with this. There is no fee.

Dr. Andrews asked if GASB governs the accounting treatment? Do they only book the gain or loss once a year?

Mr. Hole said GASB requires any swap outs be mark to market at year end.

Chair Brown said you've mentioned a couple of times that there's no fee. How does CitiBank make its money?

Mr. Hole said it's the bid ask spread that was shown on page 13. In addition to showing that we were not looking at you as making a sucker bet, it shows how we get paid. We are making a bid ask on a fixed receiver rate.

Dr. Andrews asked if CitiBank would only make a fee if we made an additional 3 year swap and held it to maturity, we'd only make one fee at the beginning?

Mr. Patterson said correct.

Dr Andrews said but the other two years there would be no fees?

Mr. Patterson said actually you could look at it that way or you could assume that we are paying you an ongoing rate that's a little lower than the ongoing rate that someone else is paying us. Basically, it's all in that rate.

Mr. Hole said really to wrap up, there's benefits and considerations on having a longer term investment in addition to what you are doing with Florida League to enhance your underlying return with the SBA. It's just a different way of doing it and in a lot of cases this can be a little better than fixed agencies in getting the net return to you. John Green, CFO, Solid Waste Authority, was in the habit of doing short agencies. It took a lot for him as he had tried many things. So he said you know I'm getting net 10, 20, 30 basis points on some alternate swap on top of the fixed agency and it's very attractive so I'm just going to leave it in SBA. I know it's there, I'm not going to worry about it, and if I need it, I'm going to go ahead with the swap. That's a much easier thing.

That's really the perspective that we want to bring to you as your balance sheet is getting larger and the balances are getting larger. Thanks again for the invitation. Hopefully, our presentation is more from the balance sheet perspective and at the same time looking at proceeds that are sitting there more directly to what we do in looking for ways to enhance that yield.

Chair Brown thanked Mr. Hole and Mr. Patterson for the presentation.   He asked for any other questions for our presenters?

Ms. Skittone said with the School District and Solid Waste Authority, do they have a lot of people managing the swaps or like you said Mr. Green did this because it was a lot easier for him than investments?

Mr. Hole said there is just one person at the Solid Waste Authority. It's not too much to manage when you think of it as a fixed income. You put it in place and let it go. If the markets move in some manner that gain some extreme value, we will know it and call you and say this is what's happening in the market and this is where we think it's going but it's not a weekly call. It's every couple of months depending on what interest rates do.

Mr. Patterson said typically what's involved is depending on how frequently you have payments being made under the swap. That individual would double check, we make a calculation for what the net payments are, our counter party at the staff level would look to make sure that they agree with the math. They ask us for the market calculation, for whatever schedule they like. Some ask for quarterly, some only once a year, some like to see it each month. We provide that and walk them through the math of the calculation and how that works and typically we also provide at least quarterly or oftener if you want to see an update of your accruals under the transaction and what total cash flows have been from the outset of the swap plus what it's been for that most recent three month period. We would also bring to you if there is an opportunity to manage the swap or do something different to either extend at a higher rate or potentially terminate for poor profit. We are responsible for identifying those opportunities for you.

Ms. Skittone asked if all we would have to do is to change the Investment Policy at this point?

Mr. Hole said yes.

Chair Brown asked if anyone had any questions.

Dr. Andrews asked did you do this presentation in front of the Town Council or something similar to this on the beach bonds?

Mr. Hole said no, this is our first time talking to the Town.

Chair Brown said he had just a clarifying question, SBA is currently earning 1.17% and with a three year swap, we'd be earning on that portion of the funds 2.79% if I remember correctly. Now in the next few years, let's say the rate goes up to LIBOR and SBA goes up to 5% so obviously we'd still be earning 2.79% but we wouldn't be earning 5%.

Mr. Hole said even at the outside the LIBOR is a little more than that assuming that you didn't exercise the ability to terminate and extend at a higher rate.

Chair Brown said but there is opportunity lost there somewhere even if you extend.

Mr. Hole said you would lose that termination value.

Chair Brown asked if there are any other questions from staff? From the committee? He thanked them very much for their presentation. He asked the Edwards & Angell people for comments.

Rick Miller, Edwards & Angell, introduced himself. It's nice to see a straightforward, clear presentation and people who can receive it so well, frankly, because it's a complex area. Swap transactions often times take a long time to digest and understand. But I think sophisticated governments are able to deal with it and I do think its important for people that you do see deal with these, Palm Beach County, The Solid Waste Authority, The School District, who have sophisticated financial advisors, sophisticated Board Members, etc., who can digest this. In fact, what is proposed here and what we have always seen when we do them is a hedge swap, one where the risk element is to the extent possible removed. That's what you've had presented to you. That's the kind of thing, if we were to do something like this, and you were to amend your investment policy to do it, we'd suggest that the termination provisions, because that's where you can get caught, be as limited as possible. That's the type of thing we'd need to negotiate fully with CitiGroup by the investment banker.

Chair Brown thanked him. He suggested taking a five minute break, let the group go and come back and discuss this matter and the rest of the agenda.

Chair Brown said he wanted to give the committee the benefit of some experience that he's had. In his own company, they used swaps extensively and managed certain portfolios of investments and it's a very complicated area. It's not an easy area to understand what's really happening and he was only comfortable because they had people on staff that did this full time. Otherwise, you'd have a situation where you have to depend entirely on the outside agency that's doing this for you. It's kind of a black box sort of situation.

Dr. Andrews said it's a trust me.

Chair Brown said it does have its place where you can't find good fixed income investments that meet the criteria you are trying to meet. It's sort of an alternative to fixed income investing. He thinks the capital gain and loss impact, even though the accounting may be different, if rates go up or down is the same. There may be some accounting or liquidity advantage to doing swaps instead of fixed income investing but there's definitely a kind of difference in the complexity of really understanding what's happening and how the swaps really work particularly if you start getting into whether you should terminate one and buy another. You really have to depend pretty much entirely in a town like this on your outside advisor. He doesn't know how comfortable we would feel in having this kind of situation.

Mr. Hennessy said he had a negative experience as Chairman of the Audit Committee at the Bank of New York when they got into derivatives. He was told that there were people inside that really understood it because he sure didn't. Suddenly they woke up and they did have a nice loss. That's the thing he kept remembering while listening to the presentation. It happened ten or twelve years ago.

Dr. Andrews asked Ms. Skittone if it specifically stated in the Investment Policy that the Town would not have derivatives?

Ms. Skittone said that would have to be changed.

Ms. Somers said the decision was made not to use derivatives because of the Orange County loss from derivatives a few years ago.

Chair Brown said there's also something called basis risk which they kind of glossed over a little. If for some reason the SBA does not follow Libor, then you are really not hedged. Some of those differences were as much as ¾ of a percent in certain periods. In a higher interest rate market, you are actually paying out real money to these folks. His instinct would be that a town of this size with a staff that is trying to do lots of things to farm this out in an area that is so sophisticated and so complicated, he would feel uncomfortable.

Mr. Hennessy said he feels the same way and having had a bad experience with the bank and he still does not completely understand it.

Chair Brown said they roughly operate like fixed income investments and if we have fixed income investments that meet our needs, he is not sure, unless there is some wonderful accounting reason for it, why we would go in this direction.

Mr. Hennessy asked if these people asked to be put on the agenda?

Ms. Skittone said they had met with Mr. Elwell and wanted to talk to the Town Council and he suggested that they go through this committee first.

Dr. Andrews asked for comments and concerns from the Town staff.

Ms. Skittone said she was concerned that it would be a lot more work for the Finance staff but they seem to think that they are staff.

Dr. Andrews said yes they think they are our staff.

Ms. Skittone said yes you do have to trust.

Chair Brown said they are your staff but it's still your responsibility. The problem is do you want to be responsible for something where it's really a black box. You don't really know exactly what they are doing.

Mr. Hennessy said you want to understand what it's all about and he admits he doesn't. He has never liked relying on outsiders because they are selling a product.

Dr. Andrews said they make money no matter what whether we make or lose.

Chair Brown said we made a decision, who knows if it is the right decision, to put a certain amount of money in longer term investments and as Dr. Andrews rightly pointed out, we haven't given that a long time yet to see how it works. He thinks we've seen at least one surprise in some realized losses although the explanation was probably reasonable. He doesn't think a decision has been made to go even further with fixed income investing. That seems to be what they are suggesting is that in addition to what we've already done that we put another $50,000,000 in essence in fixed income. That's wonderful if interest rates stay the same but if they were to go up 5% and you did a seven year swap then three years from now they are at 5% and the Town is asking why we are only earning 2.79% instead of 5%. He doesn't know how comfortable the Committee and staff would be at that point.

Mr. Hennessy said he would not be comfortable because just looking at the dynamics that are going on today. Look at what happened to gold, gold has gone from the higher 200's to $400 an ounce. That means somebody is anticipating a huge amount of inflation that's coming. When you look at what's going on here in the states, tremendous imbalance of trade, plus the hugh deficit we are going to run for this year. You're going to have inflation for some time.

Dr. Andrews said he has a consideration of having our esteemed Chairman stand in front of the Town Council and defend derivatives.

Ms. Somers said derivatives were a bad word six years ago. Has something changed since then?

Dr. Andrews said these guys are obviously very good at what they do and they understand the hedging position. They say oh well this tracts up and this tracts down but as the Chairman said at some point they were 50 to 75 basis points apart and if there's some reason we need the money or whatever. The Chairman is also right that we have essentially the same types of investments available to us right now. He feels that we are covered basically at this point in time. He doesn't have a problem with having the opportunity for derivatives in the policy but he would not want to have to defend that against the Town Council. Even if you have additional help, if these gentlemen explained it to the Town Council, he does not think it would be any better.

Dr. Andrews asked if the Chairman had anything he would like to propose?

Chair Brown said he would personally propose that we put this one on the back burner and see how the current policy works out for a while.

Dr. Andrews and Mr. Hennessy agreed.

Chair Brown said he thinks at the next meeting we should have both the Florida League and again have the money manager. It's hard to talk to them over the phone. He would rather have them here then we will try again to talk about capital gains and losses.

Dr. Andrews said we definitely missed having the Florida League here because of their accounting, we are not dealing with the same numbers.

Chair Brown said the money manager thought of things this way, and they think of things the other way.

Mr. Hennessy said he would like to get their projections too of interest rates and if they could do it separately.

Ms. Skittone said we do have the $18,000,000 that is from that proceeds of the bond of which we'll need $2,000,000 in the spring and another $11,000,000 by next February. The balance of $5,000,000 is uncertain when that will be used.

Chair Brown said when you need to pay the money out, you can't use other funds, it has to be these specific funds you use? If it isn't that way, when you need to pay $5,000,000 or whatever it is, if you could take it from different sources, I would invest this money the same way we are investing all.

Ms. Skittone said we could pull $2,000,000 from the Florida League of Cities.

Chair Brown said that would be his first inclination is to just invest it the same way we are investing all the rest of the money which is roughly 75/25. Unless you any problems with that. We stay with 60% in the SBA and 40% split 75/25 in the Florida League of Cities.

IX. DISCUSSION OF THE FUTURE OF THE INVESTMENT ADVISORY COMMITTEE

Ms. Skittone said as you know the committee expires on March 1, 2004. Because of the size of our portfolio, to some $100,000,000 isn't that much, and with the market environment the way it is, it would be helpful to us to have some guidance on what to do with these investments as things change if interest rates suddenly spike up.

Mr. Hennessy asked if the fee is going to remain the same?

Ms. Skittone said yes.

Dr. Andrews asked if we have advisory boards on some of the other Town investments?

Ms. Skittone said there are two retirement boards. Of course, there are other advisory boards like the Zoning Commission, Recreation Board, etc. The retirement boards are the only other financial boards.

Dr. Andrews asked if she could give them an idea of what the size of the retirement board is? Should the board stay the size it is or would you like to see additional members?

Ms. Skittone said most of the Town boards are seven or five member boards. Five would probably be the best to be consistent with the other boards.

Chair Brown said it might be easier to have more board members if someone is absent in order to have a quorum.

Ms. Skittone said the Public Safety Retirement Board and the General Employee Retirement Boards each have five members.

Chair Brown asked how do you visualize the meeting frequency of such a permanent committee?

Ms. Skittone said obviously it would not need to be monthly. The retirement boards meet quarterly and that seems to handle most of their needs. They probably have more pressing needs than this committee would. It could be semi-annually and then as needed. She is concerned that some of the members do not live in Town and it would be hard to get quarterly meetings.

Chair Brown asked if it is legal to have a conference call?

Ms. Skittone said it has been done. As long as it doesn't make a quorum.

Chair Brown said but you could have three meetings such as in November, February, and April and then if you needed one, maybe a conference call in the summer.

Dr. Andrews said that would make sense. He thinks six months in an investment environment is too long. He thinks monthly is too short. His suggestion would be quarterly. If you are going to have a quorum type meeting in summer, probably five members would make a lot of sense. He doesn't think you can always count on everyone being here.

Dr. Andrews said he is here full time.

Mr. Hennessy leaves May 1.

Chair Brown leaves by late April and returns mid November. Maybe you can find some people who are full time but it was hard to do last time.

Ms. Skittone said because the present committee was to expire on March 1, we may have to redo everything. We advertise for the additional people.

Chair Brown asked if all members would be willing to serve longer. Mr. Hennessy made a motion to make the committee permanent. Motion passed.

Ms. Skittone asked if the committee thinks the qualifications should be similar, some sort of fixed income background?

There was discussion that about what was required before. Dr. Andrews said he thinks the financial requirement was that you had to be familiar and have a working knowledge of fixed income investments. It didn't specify bonds. Chair Brown said he thinks it would be the same for additional members.

Ms. Skittone said we had six applications. Town Council voted on the three.

Chair Brown said the committee is in favor and they agree with staff that this would be a good idea to pursue a permanent committee of this type. As long as we have substantial assets of anywhere near this magnitude.

Mr. Hennessy asked if we need the approval of the Town Council to do this?

Ms. Skittone said yes they will have to actually formulate the board.

X. ESTABLISH FEBRUARY MEETING DATE

Dr. Andrews suggested that Ms. Skittone give them some dates and they will pick the best date. They agreed that the meeting time of 1:30 p.m. is a good time.

XI. ANY OTHER MATTERS

There were no other matters to discuss.

XII. ADJOURNMENT

Mr. Hennessy made a motion to adjourn. Dr. Andrews seconded. Motion passed.