PUBLIC AGENCY FINANCIAL ADVISORY
A Division of BHWM

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Mr. Michael Gregoryk
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Dear Mike,

Thank you for an opportunity to summarize and outline our strategy as to how we manage and invest the funds for the Mt SAC OPEB and Auxiliary Trusts. I have tried to be as brief as possible, but as you know for me, that can sometimes be challenging!

Our strategy for the Management of the Mt SAC OPEB and Aux Trusts is first and foremost, guided by the provision of the CA Government Code and the Investment Policy Statement. CA Gov't Code section 53600.5 states:

> *"When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, the primary objective of a trustee shall be to safeguard the principal of the funds under its control. The secondary objective shall be to meet the liquidity needs of the depositor. The third objective shall be to achieve a return on the funds under its control."*

We are also guided by CA Government Code Section 53622:

> *(a) Funds intended for the payment of employee retiree health benefits shall only be held for the purpose of providing benefits to participants in the retiree health benefit plan and defraying reasonable expenses of administering that plan.*
>
> *(b) The governing body or designated officer, when making investments of the funds, shall discharge its duties with respect to the investment of the funds.*
>
> > *(1) Solely in the interest of, and for the exclusive purposes of providing benefits to, participants in the retiree health benefit plan, minimizing employer contributions thereto, and defraying reasonable expenses of administering the plan.*
> >
> > *(2) With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.*
> >
> > *(3) Shall diversify the investments of the funds so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.*

To comply with these code sections, we take a conservative approach to managing Mt SAC's OPEB and AUX funds. Our strategy can be defined somewhat by the phrase, "Winning by not losing". We don't try to swing for the fences and take exceptional risks; we build on good investment choices, and solid returns. We have done extensive research to find investments that meet that goal as much as possible.

While we employ a conservative approach, we understand that, in order for the OPEB plan to be successful, we must hit or exceed certain target rates of return, between 5% and 7% over the actuarial life of the program. That is what we are focused on. We also understand that cash flow is important, as Retiree Health Care premiums need to be paid every Quarter/Year, so we factor that into our investment recommendations.

Putting all those elements together, we have created a portfolio of fixed income securities (approximately 70%), Equities (approximately 25%) and Cash (approximately 5%).

Our fixed income positions generate significant interest income, and we track the cash flow created. We also look for bonds that have some upside potential for principal gains. Using our Bond Horizon Report, we track how the bonds are performing, and look for opportunities to take gains and re-invest them to increase value and income. When we buy bonds, we look at, among other things, the issuer, the credit rating, the Maturity, the Coupon, the Current Yield, the Yield to Maturity and the Price. We go into the Broad market and work to find best pricing. We also look at different sectors, and manage our concentration as to not overly weight one area. By using individual fixed income positions, we limit our ultimate downside risk. Looking at and tracking the Yield to Maturity, and monitoring the issuer and credit quality, we know our worst case scenario, so we can manage the portfolio accordingly. Our Bond Horizon report also allows us to run scenarios, to see how movements in Interest Rates might hypothetically affect the portfolio.

As an example, here's the details on a recent trade: We had a Nokia bond in the portfolio for just about 1 year. There was about 4 years to go to Maturity, and the yield to Maturity was 3.45%. My Bond Horizon program showed me that, up to the current date, the Total Return was 4.03%, and the Annualized Return was 4.04%. The program gave me a sell signal. It also told me that, to break even on the Yield to Maturity, I would have to replace it with another bond that had a YTM of 3.45%. I found a good substitute that had a similar Maturity date, with a YTM of 5.371%. So we took a profit and increased our return. To put this in context, we made 4.03% on a relatively safe investment for holding it 1 year. Compare that to what a 1 year CD is paying right now (around 1.25%).

When we look for equities, we look for solid companies with good balance sheets, potential for grow, and ones that pay good dividends. We monitor share prices, and track the overall gain that the equities have generated through appreciation and dividend payout. With that information, we can establish "break even points" on the positions, and know, as the equity price fluctuates in the market, how we are doing relative to where we bought the position. This helps us control downside risk, and also adds to cash flow.

For Example, one of the equity positions we hold is Main Street Capital Group, a principal investment firm that provide long-term debt and equity capital to companies. We bought this positon in 2011 at a price of $17.15. Today's price is $30.74, and the stock current has an annual dividend yield of 6.84% at the current price, which translates into an annual yield to us of 12.25% at our cost. We continue to hold this position as our consensus research report continues to tell us the stock will "Outperform". We certainly like the yield and appreciation.

These are just a couple of examples of the process we use and what we look for as we select investments for the portfolio.

We maintain a position in cash, to ensure that liquidity is available to pay any scheduled Retiree Health Premiums or any other expenses that may be incurred by the Trusts. While we do sacrifice some return for this, we feel we make it up with good cash management, which allows us to not be forced to sell any positons to just raise cash. If there was ever a shortfall (which is unlikely) we would take profits first. Having cash available also allows us to take advantage of any opportunities that might arise.

One might wonder why we don't, like many other Advisory firms, use Mutual Funds. For a portfolio with the stated goals of the OPEB and Aux Trusts, we feel that Mutual Funds would be a "retail solution" to an Institutional objective. Mutual Funds can be good for certain scenarios, but when markets turn, or interest rates start to rise significantly, mutual fund holders tend to panic and sell their shares. This causes the fund manager to sell securities to pay of the investors, so they are forced to sell into a declining market, which in turn continues to affect the net asset value of the fund. We think this lack of control on us as Advisors, and the portfolio, is a true disadvantage. It is difficult in that scenario to control your downside risk. Also, expense ratios and trading costs for mutual funds can be a drag on their returns.

I hope I have given you enough information in regards to outlining our strategy. Good Forward, we will continue to keep the goals and objectives of the OPEB and Aux Trusts clearly in our windscreen, and manage the portfolio within the parameters that we have outlined. We continue to be guided by Warren Buffet's 2 rules of investing:

1. Don't lose Money
2. Don't forget Rule #1

By sticking to our plan, we feel we can be "on time and on target" and best navigate the volatility and changing environments of the financial markets. So far, the results seem too bear this strategy out.

If you have any other questions, or need any further information, please let me know.

Cheers,

Andy Fass
Director

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F A