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S&P: California County and Local Government Investment Pools Report Few Changes Despite Persistently Low Interest and Improved State Revenue in 2014.

Standard & Poor's Ratings Services' yearly survey of California local county investment pools (LCIPs) and local government investment pools reveals most pool managers expect participants' liquidity demands in the upcoming year to be unchanged or less than previous-year demands. This is mostly due to additional revenue and the budgeted payment of most of the remaining interyear prior funding deferrals disclosed in Gov. Jerry Brown's fiscal 2015 May budget revision (please refer to the article, titled "California Governor's Fiscal 2015 May Budget Revision Proposal Highlights Good News," published May 22, 2014, on RatingsDirect).

Economic growth and the authorization of temporary personal income taxes and sales-and-use taxes have helped bolster California's revenue profile; we expect similar trends to persist through at least fiscal 2015, further supporting the revenue projections included in the governor's May 2015 budget revision. With interest rates expected to remain low and state revenue improvement expected to continue, a significant majority of pool managers cite interest rate risk as their primary concern. Our survey, however, shows few managers have made, or plan to propose, changes to their investment strategy to manage this risk.

Overview

- With state budget improvements, most California investment pool managers expect liquidity demands to remain unchanged or less than previous-year demands.
- Pool managers highlight interest rate risk as a primary concern, but few managers have changed their investment strategy.
- Most investment pools continue to hold a majority of assets in relatively low-risk federal or state agency bonds and investment funds.
- We received responses from 55 of the 58 LCIP managers in California.

Interest Rate Risk Has Not Affected Duration

Consistent with the 2013 survey, the 2014 survey found that 37 LCIPs monitor, and can report, their current portfolio duration. Some LCIPs, however, did not respond to this question. We also asked LCIPs to express the greatest risk they see to the portfolio during the next year: interest rate risk, unplanned liquidity, or underlying investment default. Survey results show that 70% of respondents answered interest rate risk, slightly higher than the 65% that responded similarly in 2013. In addition, all three of the statewide investment pools surveyed cited interest rate risk as the most significant risk they expect for the next year.

From an LCIP standpoint, interest rate risk is the risk that adverse interest rate movement will create a negative effect on investments held in the pool, as a whole. In the low interest rate environment that has persisted for the past several years, interest rate risk means overall market rates in the economy increase, causing a decrease in the value of fixed-income investments. Duration

is a measure commonly used to measure interest rate risk.

Although an increasing number of respondents cited interest rate increases as their primary portfolio risk, survey results reveal the average duration among LCIPs monitoring this data remained unchanged from the 1.173 average reported last year; this is only slightly lower than the 1.182 average reported in 2012. Although the average was unchanged, responses show some LCIPs report shorter durations; this is perhaps a better demonstration of their concern that interest rates will likely rise gradually over time. LCIP managers also cited added investment flexibility as one of their reasons for a continued short duration. Such consistency in average duration across all LCIPs, however, further enforces our position that pool managers believe duration is meeting their expectations of adequately matching higher yield and principal preservation despite continued expectations of gradually increasing interest rates.

Asset Allocations Demonstrate Little Change

With consistently low interest rates and higher state revenue, we believe there is an increased likelihood LCIPs could slightly modify their asset allocations in search of additional yield, potentially exposing LCIPs to a modest amount of added risk. The willingness of LCIP managers to take on additional risk in search of added return, however, appears minimal. The 2014 survey found that 56% of LCIPs expect to adjust, or have already adjusted, their investment strategy due to the current interest rate environment. The remaining 44% report no recent or proposed changes. Of those that have changed or expect to change their strategy, most describe the adjustments as more of an effort to rebalance the portfolio as a whole rather than undertake a new or more aggressive investment approach. A handful of respondents who expect lower liquidity needs on the portfolio, however, made corresponding portfolio adjustments to extend the duration of their portfolio modestly.

Just 39% of assets matured in less than 90 days for the fiscal year-ended March 31, 2014, down slightly from 41% in 2013 and consistent with the 39% reported in 2012. In addition, 63% of responses indicated the LCIPs' largest holdings are federal agency bonds (government-sponsored entities), which generally provide a higher yield and have low-risk characteristics similar to those of treasuries. The second-largest investment was in the state local agency investment fund. The ranking of these two leading categories of investments remains unchanged for the past two years. Similar to last year, on average, LCIPs invest 51% of fund assets in their largest holdings.

Pool Participants*	Book value (Mil\$)	Market value (Mil\$)	Market-to-book value	Effective duration	Weighted average maturity (days)	Weighted average life (days)	% of assets maturing in less than 90 days
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Alameda
County

3,577.3 3,573.8 0.999

NP

NP

516.0

42.0

Alpine County	30.7	30.8	1.001	0.38	138.7	138.7	79.8
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70.2

NP

NP

NP

704.0

NP

35.0

<u>Butte County</u>	412.7	410.9	0.996	1.83	634.0	634.0	32.0
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Calaveras
County

106.3

106.6

1.002

1.07

416.1

394.2

46.1

<u>Colusa County</u>	48.8	68.5	1.404	0.67	180.0	180.0	84.1
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Contra Costa
County

2,470.0	2,460.0	0.996	0.50	160.6	N.A.	70.0
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Del Norte
County

35.1	35.1	1.000	NP	511.0	252.1	60.0
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El Dorado
County

Fresno County 2,443.4 2,456.7 1.005 2.20 895.0 895.0 12.0

Glenn County 59.8 59.7 0.998 1.04 NP NP 11.0

Humboldt
County

311.4	310.3	0.996	0.55	N.A.	804.0	24.0
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**Imperial
County**

465.8	466.4	1.001	NP	NP	NP	37.9
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<u>Inyo County</u>	114.5	114.2	0.998	NP	846.0	843.2	5.5
<u>Kern County</u>	2,479.0	2,464.0	0.994	0.57	522.0	N.A.	46.0

Kings County 268.2 267.1 0.996 0.63 239.0 739.0 23.3

Lake County

Lassen
County

70.6	70.6	1.000	0.32	116.0	NP	25.0
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**Los Angeles
County**

23,491.2 23,385.5 0.995

1.84

693.0

N.A.

42.9

Madera
County

334.9

334.7

1.000

2.27

334.0

828.0

74.8

<u>Marin County</u>	791.1	791.0	1.000	0.21	80.0	235.0	51.1
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Mariposa County	27.6	27.5	0.996	N.A.	NP	NP	NP
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Mendocino
County

198.3 198.4 1.000 0.95 339.5 368.7 48.1

Merced
County

637.8 638.0 1.000 1.38 434.0 434.0 46.1

<u>Modoc County</u>	24.3	24.3	1.000	NP	NP	NP	61.5
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<u>Mono County</u>	65.8	65.6	0.997	2.00	714.0	NP	8.4
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Monterey
County

1,013.3	1,010.8	0.997	0.69	485.0	690.0	46.6
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<u>Napa County</u>	529.6	527.4	0.996	0.88	338.0	NP	23.1
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Nevada
County

181.4	181.1	0.998	1.28	571.0	NP	40.2
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Orange
County

6,890.5	6,891.3	1.000	NP	440.0	443.0	33.0
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<u>Placer County</u>	1,116.1	1,111.6	0.996	2.30	NP	1785.0	NP
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Riverside
County

5,256.3 5,248.8 0.999 1.33 500.1 328.1 39.1

Sacramento
County

2,389.5	2,390.2	1.000	0.84	311.0	311.0	55.0
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San Benito
County

94.7

94.9

1.002

1.33

325.0

485.0

29.6

San
Bernardino
County

5,033.6	5,033.1	1.000	1.02	400.4	386.9	38.0
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<u>San Diego County</u>	7,543.4	7,536.1	0.999	0.88	288.0	390.0	35.0
<u>San Francisco City & County</u>	6,725.0	6,717.0	0.999	1.22	708.0	456.3	25.0
<u>San Joaquin County</u>	1,881.5	1,881.7	1.000	NP	NP	284.0	39.0
<u>San Luis Obispo County</u>	595.7	595.7	1.000	NP	205.0	205.0	80.0
<u>San Mateo County</u>	3,333.7	3,331.2	0.999	1.91	715.4	715.4	18.0
<u>Santa Barbara County</u>	1,125.3	1,123.1	0.998	0.69	579.0	NP	31.0
<u>Santa Clara County</u>	4,567.6	4,572.2	1.001	1.00	NP	426.0	24.3
<u>Santa Cruz County</u>	657.4	656.6	0.999	1.62	589.0	589.0	22.0
<u>Shasta County</u>	370.2	368.3	0.995	2.18	785.9	N.A.	11.8
Sierra County	16.0	16.0	1.001	0.54	NP	NP	57.5
<u>Siskiyou County</u>	104.2	103.4	0.992	NP	522.0	890.0	40.5
<u>Solano County</u>	797.9	798.7	1.001	0.88	326.2	305.8	38.2
<u>Sonoma County</u>	1,483.8	1,488.9	1.003	1.51	N.A.	877.0	10.1
<u>Stanislaus County</u>	1,022.4	1,026.2	1.004	NP	545.0	1279.0	20.2
Sutter County	193.5	192.7	0.996	3.93	1303.0	1135.0	16.0
<u>Tehama County</u>	130.3	129.9	0.997	NP	NP	NP	27.0
<u>Trinity County</u>	36.7	36.4	0.991	NP	NP	NP	100.0
<u>Tulare County</u>	1,113.7	1,114.7	1.001	NP	736.0	736.0	25.3
<u>Tuolumne County</u>	117.6	119.2	1.014	NP	564.0	NP	46.0
<u>Ventura County</u>	1,994.4	1,995.0	1.000	NP	346.0	NP	25.5
<u>Yolo County</u>	328.2	328.3	1.000	0.54	198.0	231.0	63.0
<u>Yuba County</u>	296.7	296.3	0.999	NP	425.0	NP	31.2
Average			1.007	1.22	480.1	577.4	38.8
CAMP (statewide)	1,740.5	1,740.6	1.000	0.15	52.9	82.0	64.3
CalTrust Short-Term (statewide)	674.1	674.4	1.001	0.66	368.7	492.4	33.6
CalTrust Medium-Term (statewide)	647.9	649.7	1.003	1.65	609.6	707.0	5.1
PMIA	57,518.5	57,568.2	1.001	NP	NP	185.0	40.1

*All valuation dates are as of March 31, 2014. ¶Not participating. N.A. — Not available. NP — Not provided.

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