by John J. Haas, Ranson Financial Consultants, LLC

Better safe than sorry! Local units of government should not be gamblers with investments

On January 23, 2003 I had my first opportunity to testify before a legislative body on behalf of the Kansas Rural Water Association (KRWA). The legislative body was the Kansas House Committee on Local Government. The Bill under consideration was HB 2011: Investments of public moneys; duration; equity-linked certificates of deposit. The basis of the Bill was to allow Kansas' local units of government to invest in the stock market. Well, not actually in the stock market but in a certificate of deposit that parallels the Standard and Poor's 500 Index (commonly referred to as the S&P 500). The S&P 500 is an index of 500 stocks chosen primarily for market size, liquidity and industry group. The S&P 500 is one of the most commonly used benchmarks for the overall U.S. stock market. The certificate of deposit of this type is often referred to as a "derivative".

Why did someone promote allowing local units of government to invest in certificates of deposit indexed to the S&P 500? The theory was to allow local units of government to share in the investment returns of the U.S. stock market. From 1950 through 2002 the S&P 500 had an average annual return of approximately 7.66%. According to the Federal Reserve the average interest rate on a certificate of deposit was only 1.36% in December 2002. Local units of government were looking for more yield; innovative corporations were looking for ways to accommodate that need. Does this all sound familiar to today's financial situation? I find it interesting, however, that S&P Indexed certificates of deposit were being promoted when the S&P 500 index had a terrible three-year period. It was down about 23.37% in 2002, 13.04% in 2001 and 10.04% in 2000. For comparison purposes the S&P 500 index was down about 32.4% for 2008.

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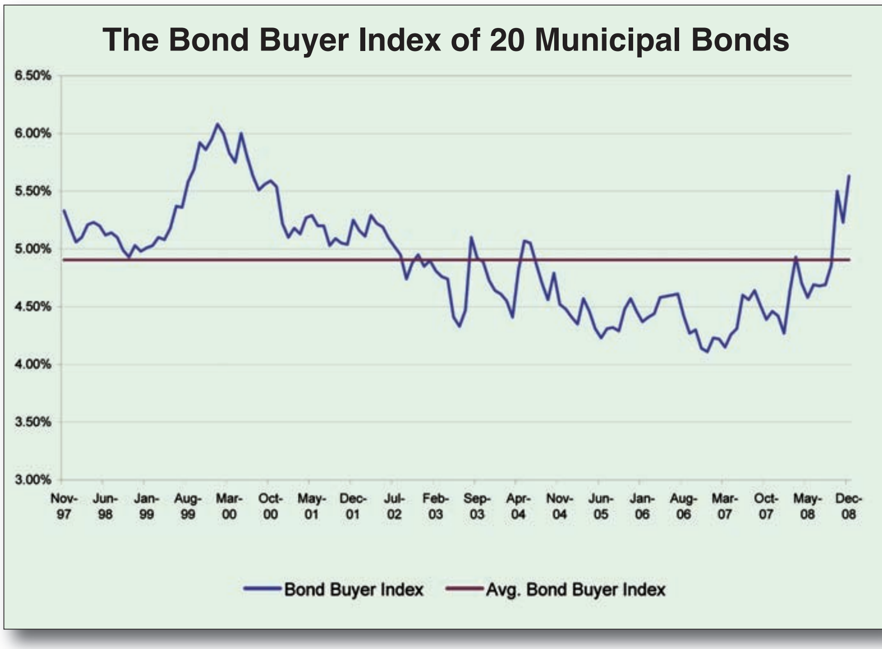
We asked representatives supporting the bill about the return of principal in down markets, like that currently being experienced. We noted that the FDIC guarantees return of principal for up to $100,000 per deposit against bank losses – not market losses. That is when the discussion got very interesting. We were told that the certificates of deposit would be guaranteed against market loss by AAA rated corporations or financial instruments rated AAA. These corporations may include life insurance companies or traditional non-financial corporations. Financial instruments used to secure the certificates of deposit not issued by either AAA life insurance companies on non-financial corporations would have been insured by AAA bond insurance companies to achieve the required AAA rating. In 2006 there were six AAA life insurance companies; this was down from 15 in 1995. Currently, there are still six AAA rated life insurance companies. This sector has held up relatively well over the past year. However, prior to the credit crunch of 2008 there were seven AAA rated bond insurance companies; now there are only two and they are both on credit watch. In 2002 there were eight U.S. companies with AAA ratings; now there are only five.

Ratings are established to measure the relative strength of a corporation's financial position, or, in other words, the corporation's ability to pay debt obligations when they come due. An AAA rating is presently the highest achievable rating. A downgrade doesn't mean the corporation cannot meet its debt obligations; it is just an indication of the Rating Agency's opinion of the corporation's ability to repay the debt obligation. When testifying before the House Committee on Local Government in 2003 we did not foresee the "Panic of 2008". What we did think about, however, was why try to capture an additional few percentage points in yield on certificates of deposit by investing in something that wasn't governmentally guaranteed. In an instant the value of

the local unit of government's investment could have been worth less than its original value, or nothing at all – and maybe waiting on a Federal Government bailout (get in line). In a nutshell, this is generally what happened to the U.S. financial system. Investors went after a little higher return by investing in a risky security that they did not understand. I don't know what would have happened to the investments of Kansas Local Units of Government if HB 2011 had passed – I really don't want to know. It is hard to say or measure what may have been prevented. However, as I said at the end of my testimony, "Committee members, we don't live in California. Why take on its ways?"



Borrowing and investing

For Kansas municipalities investing money at a good rate of return is still a greater challenge than borrowing money at a low interest rate. As of December 31, 2008, the yield on the one-year Treasury Bill (the rate many certificates of deposit are based on) is .11%. No, I did not misplace that decimal point! On December 1, 2008 the yield on the one-year Treasury Bill was .09%! Going from .09% to .11% represents a one-month increase of over 22% in yield. But it sure doesn't seem like much of an increase. As long as there is a flight to safety of investment dollars, the rate of return of U.S. Government Securities is going to remain low. The average return on a one-year treasury bill from November 2007 to January 2009 is 3.60%. Someday, rates will go back closer to average. But I still would not recommend S&P 500 indexed certificates of deposit!

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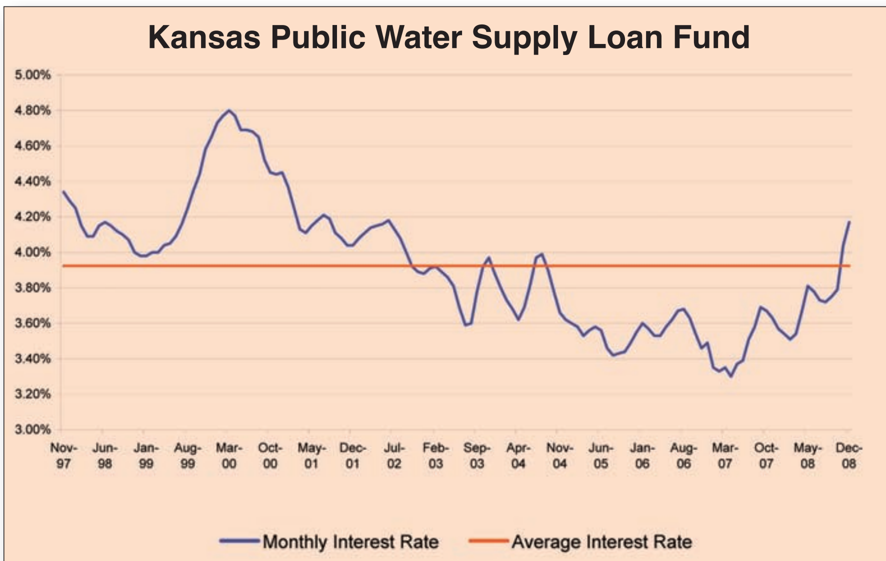
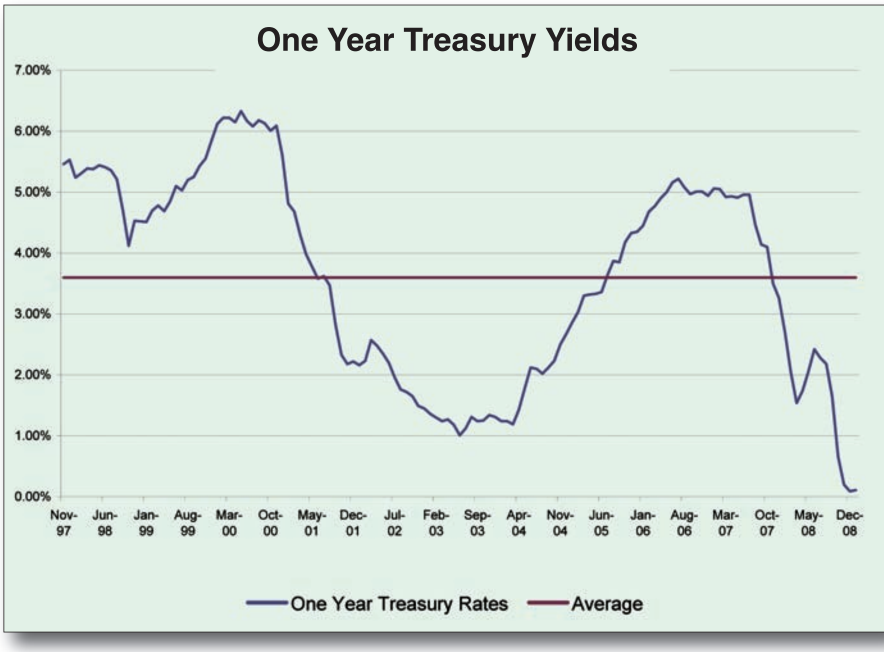
The double whammy for Local Units of Government is while the return on investment has decreased, the cost of borrowing money over the past few months has increased. For December 2008, the Bond Buyer Index of 20 Municipal Bonds was 5.63%. This is an increase from 4.69% in August 2008. The average for the Index from August 2007 to December 2008 is 4.91% – so we are a little above average. But the Index was 6.08% in January 2000; therefore, we are still in a good borrowing environment.

I am frequently asked why interest rates are going down (treasury rates), but municipal borrowing rates are going up. I continue to stress the flight to quality in U.S. Government securities. Plus, investors in municipal securities no longer rely on municipal bond insurance, but look at the underlying credit rating of the issuer. This increases the interest rate for the largest borrowers as represented by the Index. This higher borrowing cost then trickles down to the smaller borrowers.



The Kansas Public Water Loan Fund

If a city or RWD is seeking for a water system project, the Kansas Public Supply Loan Fund is a good option. Also known as the "SRF" (for State Revolving Fund), this program is administered by the Kansas Department of Health and Environment (KDHE). The interest rate as of December 2008 for the Loan Program was 4.17% (a great interest rate. Remember the Bond Buyer Index of 20 Municipal Bonds was 5.63% for the same date. The difference between 4.17% and 5.63% represents an annual savings of $10,000 per $1,000,000 borrowed. Since August 1997 the average interest rate for the Loan program is 3.92%. Plus the loan program only has a 1% loan origination fee.



2008 results

During calendar year 2008, nine cities and seven rural water districts received loan commitments from KDHE for more than $41,680,000. The nine cities included St. Mary's, Pittsburg, Newton, Marysville, Cheney, Blue Rapids, Ottawa, Riley and Pratt. The seven rural water districts or public wholesale water supply districts included RWD No. 2, Brown County, Consolidated RWD No. 4, Shawnee County, RWD No. 3, Douglas County, RWD No. 3, Jackson County, RWD No. 2, Clay County, RWD No. 5, Osage County and Public Wholesale Water Supply District No. 4. The largest loan for 2008 was $12,500,000 for Consolidated RWD No. 4, Shawnee County and the smallest was $140,845 for RWD No. 2, Brown County. The Loan Program can assist a wide range of water projects.

The Kansas Rural Water Finance Authority, which contracts with Ranson Financial for further assistance, provides 'no-cost' assistance to cities and RWDs with their loan applications. Again, there is no fee for that assistance. Please give us a call at 316-264-3400 if your city or RWD is interested in discussing funding options or which to have assistance with the loan application process to the Public Water Supply Loan Fund. We will also be available at the KRWA Annual Conference March 24 – 26 at Century II Convention Center in Wichita. Look for us in the Finance Authority's booth which is Booth #151.

John J. Haas is President of Ranson Financial Consultants, L.L.C. John has been a financial advisor to Kansas local units of government since 1978. He received a Master's Degree from the Hugo Wall Center for Urban Studies at Wichita State University and has a Certificate of Public Management and graduate hours in finance from Wichita State. John specializes in general public finance and analytical services.