

City of Sarasota

Quarterly Investment Committee Report

Quarter Ending June 30, 2007

Economic Developments

With the recent stock market correction and current credit crunch everyone's asking, "Is the music about to stop with everyone scrambling for a chair?" The whole world has been enjoying easy and cheap credit through the globalization of finance, which has tapped the savings of billions of people in the developing countries. This in turn has fueled the longest and strongest period of global growth in modern history, the most spectacular effect of which has been a housing boom allowing millions of people to buy homes they never thought they could afford. But the credit boom, which also inflated the market price of stocks and bonds, is now being superseded by a global credit crunch.

The first signs of the credit crises came in what is called the sub-prime market – home loans made to people with poor credit that were then packaged into pools and sold to investors. For more than a-half-dozen years, low interest rates made buying a house such a good deal that some thought prices would rise forever. Lenders relaxed their standards, and borrowers signed for loans that they couldn't afford. The resulting housing bubble is now bursting, leaving us with prices way out of line with reality and an overhang of unsold property and rising defaults. Sales of new homes are down 22 percent below a year ago. More than 20 percent of adjustable rate mortgages are already in negative equity, where the loan is worth more than the property. This will get worse as the low "teaser" rates on mortgages start expiring, especially those taken out last year.

The impact of the scary 2006 mortgages won't even be felt until 2008. Some of these loans were given to people with no income, no job, and no assets – so they were called "ninja"

loans. According to Credit Suisse, the number of no – or low – documentation loans had increased to 49 percent last year, from 18 percent of all home purchase loans in 2001. Fully a third of all mortgages last year were "nontraditional" – mostly interest-only and adjustable-rate deals that let the borrower defer paying back principal or even increase his loan balance every month. And those who put up less than 5 percent down payment increased to 46 percent of all home purchases. Five years ago these risky loans were virtually non-existent. Little wonder sub-prime delinquencies amount to almost 24 percent of the market, up from 15 percent from the same period last year.

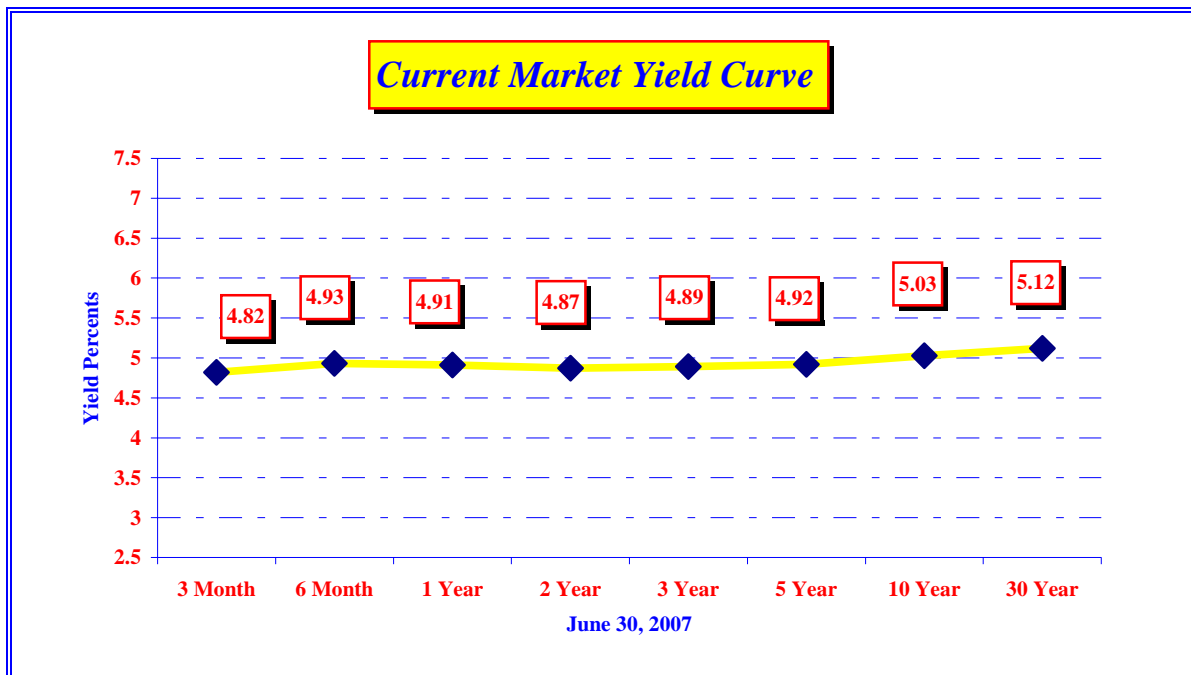
The credit squeeze is spreading to home equity loans as well, where even borrowers of prime home equity loans have missed payment at the rate of 5 percent, almost triple a year earlier. And more defaults loom as huge numbers with adjustable interest rates will have to cope with higher payments. The rating agencies don't know how many will miss payments, but the situation is already creating problems in corporate finance. So far this year, the agencies have downgraded billions of dollars in outstanding bonds and warned of possible downgrades in tens of billions more. The reduction in collateral forces lenders to re-price the risks so that the spread between yields on corporate bonds and yields on the riskless U.S. Treasury Security of the same maturity has widened.

Not-So-Easy-Money. Banks that got into the easy-lending mode are reverting to the days when they avoided the riskier (and more profitable) loans. But the biggest

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(Source: U.S. Treasury - Daily Treasury Yield Curve)
 Treasury Yield Changes During the Second Quarter of 2007

	6/30/2007	3/31/2007	BP Change
3 Month	4.82%	5.04%	-0.22%
6 Month	4.93%	5.06%	-0.13%
1 Yr.	4.91%	4.90%	0.01%
2 Yr.	4.87%	4.58%	0.29%
3 Yr.	4.89%	4.54%	0.35%
5 Yr.	4.92%	4.54%	0.38%
10 Yr.	5.03%	4.65%	0.38%
30 Yr.	5.12%	4.84%	0.28%



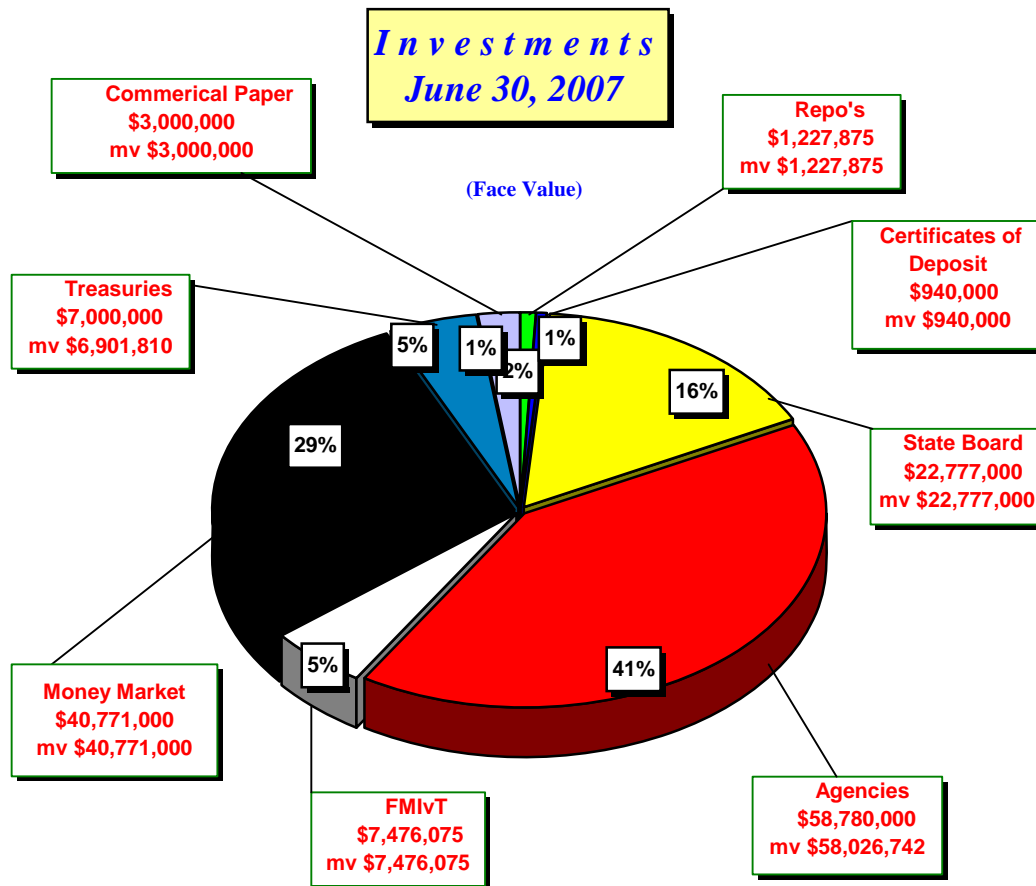
Interest Revenue vs Budgetary Expectation

General Operating Fund

	<u>12/31/06</u>	<u>03/31/07</u>	<u>06/30/07</u>	<u>09/30/07</u>
Interest Revenue	\$346,378	\$503,272	\$381,283	\$000,000
Budgetary Expectation	<u>320,000</u>	<u>320,000</u>	<u>320,000</u>	<u>320,000</u>
Excess (Shortfall)	<u>\$26,378</u>	<u>\$183,272</u>	<u>\$61,283</u>	<u>\$(320,000)</u>

Water & Sewer Operating Fund

	<u>12/31/06</u>	<u>03/31/07</u>	<u>06/30/07</u>	<u>09/30/07</u>
Interest Revenue	\$ 50,263	\$ 53,325	\$ 61,919	\$ 00,000
Budgetary Expectation	<u>37,500</u>	<u>37,500</u>	<u>37,500</u>	<u>37,500</u>
Excess (Shortfall)	<u>\$ 12,763</u>	<u>\$15,825</u>	<u>\$24,419</u>	<u>\$(37,500)</u>



Total Investment - \$141,971,950

Market Value - \$141,120,502

Total Portfolio Weighted Avg. Maturity - 1.15 Years

CD'S & Agency Bond Weighted Avg. Maturity - 2.35 Years

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problem is that many cannot afford the loans they wish they'd never made; they will have to live with them for a long time. It is this inability of the large banks to syndicate – sell off – their leveraged loans that is causing the credit markets to freeze up.

With housing prices falling for the first time since 1991, a chain reaction has begun. Bundled mortgages sold to investors as interest-paying bonds are falling in value. Major credit rating firms warn that loan delinquencies may be much worse than anticipated because when homes become worth less than the loan, the owners cannot sell or refinance their way out of trouble. This confirms the caution made by several editorials in early May by several prominent newspapers.

With more than \$1.8 trillion worth of securities backed by sub-prime mortgages created since 2000, banks and investors are suffering losses that are exposed every week, affecting the overall confidence in the credit markets.

The housing boom was dependent on these relatively reckless loans that pushed home prices to levels far above what many current and would-be owners could afford, and the risk of a further, nationwide decline in home prices will inflict real hardship on millions of Americans.

On the plus side, employment levels remain strong, and people do not tend to give back the keys to their homes while they still have jobs. But lending terms are getting tighter, financial investors are becoming increasingly risk averse, and the liquidity tap is being turned down, or even off, raising the prospect of an economic downturn before the end of this year. No wonder speculation is growing that the Federal Reserve will have to lower interest rates to contain the damage to the overall economy.

The current crisis is a potential \$67 billion mess in a \$14 trillion economy, so the problem is most likely getting more attention than it deserves. Recent statistics

indicate the economy is looking quite robust.

Many economists think growth topped a 4 percent annual rate in the second quarter, not the 3.4 percent first estimated by the Commerce Department. However the torrent of bad lending news is creating a lot of fear in the market and that is why the Fed is likely to cut rates in September. Fear can lead to panic, and the Fed does not want to get anywhere near that and that is why the market is anticipating a quarter point cut in short-term rate at the next Fed meeting. However, Bernanke doesn't want to appear to be flinching in the face of market turmoil and with inflation hovering near the top end of Bernanke's preferred 1 to 2 percent range; the Fed is loath to cut rates too quickly and perhaps squander its reputation as a tough inflation fighter.

INVESTMENT STRATEGY

The Fed indicated satisfaction with the pace of economic growth as the June quarter came to a close. Interest rates were expected to remain in a fairly narrow band but with the development of the sub-prime market crises the Fed may be forced to lower rates sooner rather than later. Therefore, longer maturities of U.S. Treasuries and Agency Securities with twelve month call features will be increased to lock in existing yields. Certificates of Deposit and Commercial Paper in the 90 to 180 day range with a rating of A1, P1 or better will be purchased for the purpose of diversity. Overnight liquidity will continued to be decrease during the quarter as investment opportunities develop going forward. Short-term (3-12 months) will be set at 10% to 12% or approximately \$14 to \$17 million. The medium term range (12-36 months) will continue to be targeted at approximately 65% or \$92 million of the portfolio. Long-term range (3-5 years) will continue to be reduced as call options are exercised and agencies securities are sold or mature over time.

Investment Policy

The City Commission adopted resolution No. 01R-1397 on September 4, 2001, authorizing the Finance Director to invest surplus funds, as delegated by the City Manager. Quarterly reports are submitted to the investment

committee which consists of the City Manager, Finance Director, Cash and Investment Manager and the City Auditor and Clerk.

Performance Measurements:

Actual Rate of Return

- 1) 4.82% Annualized rate of return based on portfolio Investments on 06/30/07.
- 2) 4.53% Annualized rate of return based on Treasury, Agency and C. D. portion of the portfolio on 06/30/2007.

Benchmarks

- 1) 3.75% Target rate based on U.S. Treasury Market Securities on 06/30/2007.
- 2) 5.19% Rate of return based on Lehman Brothers 1-3 Yr. Index for U.S. Governments maturing in June 2008, which is the duration equivalent of the portfolio's weighted average maturity.

Authorized Investment Institution and Dealers:

Bank -

- 1) Wachovia Bank, NA

Region Firms -

- 1) Sun Trust Equitable Securities Corp.
- 2) Vining Sparks Securities
- 3) Shay Financial Services, Inc.
- 4) Mutual Securities Inc.
- 5) Sovereign Securities Corporation, LLC

Primary Dealers -

- 1) Morgan Stanley, Inc.
- 2) UBS Financial Services Inc.
- 3) Citigroup Global Market Inc.
- 4) Prudential Securities

Periodical publications used as source documents for articles appearing in June 2007 report.

1. The Wall Street Journal
2. The Economist Magazine
3. U. S. News Magazine