

March 28, 2023

Ron Munds, General Manager
Los Osos Community Services District

Dear Mr. Munds,

It was a pleasure speaking with you yesterday. As we discussed, Wulff, Hansen & Co. has a U.S. Treasury Investment Program that may be of interest to the Los Osos Community Services District. More specifically, our investment program is referred to as a “laddered portfolio of U.S. Treasury securities”.

Like the District, most participants in our investment program previously deposited their money in the Local Agency Investment Fund (**LAIF**) and/or in bank accounts. LAIF, a pool of funds managed by the State Treasurer’s Office, is popular among cities, towns and special districts throughout California due to its low cost and convenience, and its emphasis on safety and liquidity. The advantage of depositing funds in LAIF and/or in bank accounts is that these deposits are very liquid, meaning local public agencies can easily access their funds, typically within just a few days. However, the drawbacks include:

- Local public agencies forgo the opportunity to potentially earn additional interest income, and
- Returns on short-term variable-rate deposit accounts such as LAIF and local bank accounts may be subject to a high degree of volatility, making it difficult to accurately budget annual interest income.

Interest Rates

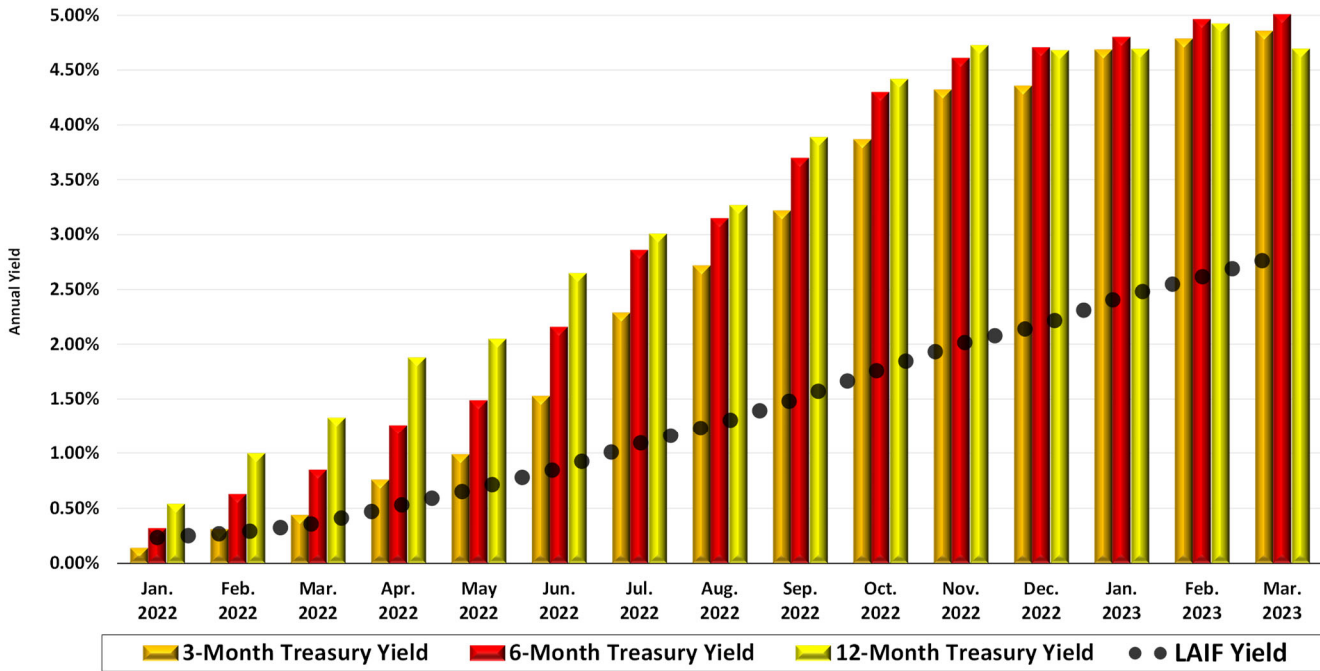
Interest rates or ‘bond yields’ increased dramatically throughout 2022 and into early 2023, due to a sharp and persistent rise in the rate of inflation and due to the Federal Reserve Board’s ‘tight money’ policy of raising interest rates to combat inflation.

For example, the yield-to-maturity on a 3-month U.S. Treasury security is currently **4.80%** as compared to **0.59%** one year ago. Moreover, until this year the last time a 3-month Treasury security had a yield greater than 4.80% was **more than 15 years ago**.

Similarly, the difference between Treasury yields and the yield paid on deposits in LAIF has also increased over time. For example, on July 1, 2022 the yield on a 3-month Treasury exceeded the yield paid by LAIF by less than **1.00%**. Today the difference is almost **2.00%**.

As you can see from the graph below, the yields on short-term U.S. Treasury securities have surged since last year, whereas the yield paid on LAIF balances has increased by far less.

Comparison of Average Monthly Yields: Short-Term U.S. Treasury Securities vs. LAIF
(Sources: U.S. Department of Treasury and California State Treasurer's Office)



Investing in U.S. Treasury Securities

Given the large difference or ‘spread’ between the yield on Treasury securities and the yield paid on deposits in LAIF, the Los Osos Community Services District may wish to invest some of its money in Treasury securities in order to earn more interest income.

U.S. Treasury securities are direct debt obligations of the United States Federal Government that are issued to fund its day-to-day outlays for national defense, discretionary spending, etc.

The payment of principal and interest on U.S. Treasury securities is guaranteed by the ‘full faith and credit’ of the U.S. Treasury, which is similar to the pledge that secures FDIC-insured bank account deposits. However, unlike FDIC insurance there is no dollar limit on the unconditional Federal guarantee for Treasury securities.

U.S. Treasury securities are widely considered to be the safest and most liquid investments in the world, and the market for U.S. Treasury securities is vast. Approximately **\$24.5 trillion** of Treasury securities are owned by investors worldwide including foreign central banks, foreign and domestic commercial banks, mutual funds, private investors, corporations, pension funds, State and local governments, etc.

On average, investors worldwide buy and sell more than **\$500 billion** of Treasury securities every day on the ‘secondary market’. Like any fixed-income securities, the values of Treasury investments fluctuate in the secondary market in a manner inverse to that of any fluctuations in interest rates.

Treasury securities come in many varieties – some Treasuries mature in **30 days** while others mature in **30 years**, and everything in between. Treasury securities with maturities of 5 years or less presently constitute ‘Allowable Investment Instruments’ for local agencies per the relevant sections of the California Government Code. The wide variety of Treasury securities offers investors like the Los Osos Community Services District the flexibility to design an investment portfolio that exactly meets their cash flow and liquidity needs.

Investing in a Laddered Portfolio of U.S. Treasury Securities

The investment approach discussed in this proposal is called a ‘laddered portfolio’. Laddered portfolios are not a new idea. They’ve been around for decades and remain popular today among certain retail and institutional investors. Laddered portfolios are appealing because they are relatively simple, inexpensive, flexible and transparent.

Over time the term ‘laddered portfolio’ has come to mean different things to different people. Some investment advisors use the term to describe virtually any ‘basket’ of securities that mature sequentially over time, but that is an over-simplification.

Presented below is an illustrative example of the type of laddered portfolio that may be suitable for the Los Osos Community Services District. The portfolio shown below has the following features:

- The portfolio consists entirely of short-term U.S. Treasury securities;
- The results are based on interest rates as of today, March 28, 2023;
- The initial start date is assumed to be April 1, 2023;
- The initial investment amount or ‘face value’ is \$4.50 million; and
- The portfolio has a 12-month term with quarterly principal maturities on June 30, 2023, September 30, 2023, December 31, 2023 and March 31, 2024.

The illustrative portfolio shown below has an initial investment amount of \$4.50 million; however, the size of the portfolio is scalable to almost any level. However, because certain costs are fixed, it should be noted that they have more impact on a smaller portfolio than on a larger one. Similarly, the ‘start date’ can be virtually any date.

With this portfolio, one Treasury security will mature approximately every three months, whereupon the Treasury Department will wire the scheduled principal and interest payment directly to the District’s Custodian Bank account, whereupon the District can spend the money on capital projects, operating costs or any lawful purpose.

Alternatively, if the District has no immediate need for the money, then it can reinvest all or any portion of the funds in additional short-term U.S. Treasury securities.

Additionally, each security in the portfolio will be held in the District’s name by its Custodian Bank, and **only** the Los Osos Community Services District will have access to these funds. No one other than the District will be granted authority to make investment decisions or direct the purchase of specific investments. This differs from the ‘managed account’ approach whereby an investment advisor has discretionary authority over the investment of District funds and can buy and sell securities as it sees fit.

As of March 28, 2023 this portfolio would yield **4.07%** and generate **\$182,925** of net interest earnings during the first 12-months, including projected net reinvestment earnings. By comparison, as of the most recent reporting date (March 22, 2023) the yield on LAIF deposits was **2.87%**.

It is impossible to predict for how long, or to what extent if any, Treasury yields will exceed the yield on deposits in LAIF. Regardless, the advantage of a properly structured laddered portfolio of U.S. Treasury securities is the ease with which the District can re-allocate funds into or out of Treasury securities as market conditions change over time.

\$4.50MM Laddered Portfolio with a 12-Month Term and Quarterly Principal Maturities

Date of Investment	Face Value of Investment	Term of Investment	Principal Maturity	Annual Yield (3-28-2023)	1st Year Earnings ⁴
4/1/2023	1,125,000	3-months	6/30/2023	4.80%	13,000
4/1/2023	1,125,000	6-months	9/30/2023	4.90%	27,000
4/1/2023	1,125,000	9-months	12/31/2023	4.72%	40,000
4/1/2023	1,125,000	12-months	3/31/2024	4.55%	51,000
	4,500,000				131,000

Date of Re-investment ¹	Face Value of Re-investment	Term of Re-investment	Principal Maturity ²	Annual Yield (3-28-2023) ³	1st Year Earnings ⁴
6/30/2023	1,125,000	12-months	6/30/2024	4.55%	42,000
9/30/2023	1,125,000	12-months	9/30/2024	4.55%	28,000
12/31/2023	1,125,000	12-months	12/31/2024	4.55%	14,000
					84,000

Gross 1st Year Interest Earnings	4.78%	215,000
One-Time Up-Front Expenses⁵	-0.44%	(20,000)
On-going Annual Expenses⁵	-0.27%	(12,075)
Net 1st Year Interest Earnings	4.07%	182,925

¹ Re-investment of the proceeds from each maturing Treasury security.

² Denotes securities that will also generate interest earnings during year 2.

³ Re-investment rate as of 3/28/2023; actual re-investment rate will be higher or lower.

⁴ 1st Year Earnings are rounded to the nearest \$1,000.

⁵ Please refer to the next page for a breakdown of all estimated Program Expenses.

Fees and Expenses

The estimated fees and expense for creating, maintaining and monitoring a \$4.50 million ladder portfolio of U.S. Treasury securities for Los Osos Community Services District are as follows:

One-Time Up-Front Fees:	
Municipal Advisor	\$14,250
Bidding Agent (est.)	\$5,000
Custodian Bank (est.)	<u>\$750</u>
	\$20,000
On-Going Quarterly Fees:	
Municipal Advisor	\$1,644
Custodian Bank (est.) ¹	\$625
Bidding Agent (est.) ²	<u>\$750</u>
	\$3,019

¹ Bidding Agent fee is fully contingent and payable quarterly in arrears only if the District elects to reinvest some of all of the proceeds of a maturing Treasury security in its portfolio; the actual quarterly Bidding Agent fee will depend on the size and frequency of each reinvestment.

² Custodian Bank fee estimated at 1.25 basis points per year subject to \$2,500 aggregate annual minimum; payable quarterly in arrears.

Notes to Fee Schedule

All of the one-time up-front fees are fully contingent and payable only upon the delivery of the portfolio of Treasury securities to the Custodian Bank.

The on-going quarterly Municipal Advisor fee is payable quarterly in arrears following the delivery of each Quarterly Review (and after each quarterly meeting).

***The Municipal Advisor does not receive any form of compensation from any third party;
The Municipal Advisor is compensated exclusively by the District.***

Competitive Bidding Process

To help ensure the Los Osos Community Services District pays a competitive price for the Treasury securities in its portfolio, the entire portfolio can be purchased via a competitive bidding process, much like the RFP process used by the District to purchase other goods and services.

The firm of Causey Demgen & Moore (“CDM”)³ could serve as the District’s Bidding Agent for the portfolio. CDM is a Registered Investment Advisor (“RIA”) and would be acting as such when recommending the purchase of individual Treasury securities.

³ Further information on CDM and their qualifications and services may be accessed online at: <https://www.causeycpas.com/services/public-finance-consulting/>.

Advantages of a Laddered Portfolio of U.S. Treasury Securities

- A laddered portfolio can be created and maintained at relatively low cost, and is easy to understand, administer, modify and track performance;
- Each security in the portfolio will be held in the District's name and held on behalf of the District by its Custodian Bank. Only the District will have access to its funds;
- A laddered portfolio of Treasury securities will provide the District with a U.S. Government-guaranteed amount of cash flow and financial liquidity on a fixed schedule;
- Laddered portfolios are very flexible and can accommodate whatever principal payment frequency and term-to-maturity best aligns with the District's cash flow and liquidity needs. Moreover, if circumstances change over time and the District ever needs to modify the term structure of its portfolio, making such changes is easy and inexpensive;
- If interest rates rise, the proceeds from each maturing security in the portfolio can be reinvested in new, higher yielding Treasuries. Likewise, if interest rates fall the impact on earnings will be cushioned by the portfolio's blend of higher yielding older securities with lower yielding newer securities;
- A properly structured laddered portfolio is very flexible in that over time as circumstances change the District can increase or decrease the size of its Treasury portfolio or modify the term structure;
- If an emergency should occur (e.g. an earthquake) and the District needs to quickly raise a large sum of capital, some or all of the Treasury securities in the portfolio could be liquidated almost immediately, in a matter of days. While in such a sale the prices received may be more or less than the initial cost, liquidating the shortest maturities first can help to minimize any such fluctuations.

Scope of Municipal Advisory Services

Wulff, Hansen & Co. will provide the Los Osos Community Service District with the following services in connection with its investment in a laddered portfolio of Treasury securities:

- Municipal Advisor will help the District determine the appropriate amount of funds to be invested in a laddered portfolio of U.S. Treasury securities;
- Municipal Advisor will help the District design a portfolio term structure that aligns with the District's cash flow requirements and liquidity needs;
- Municipal Advisor will help the District identify a suitable Custodian Bank;
- Municipal Advisor will help engage a Registered Investment Advisor (RIA) to serve as Bidding Agent for the solicitation of competitive bids for all security purchases;
- Municipal Advisor will support the Investment Advisor (RIA) as it coordinates the process of scheduling, soliciting, reviewing and accepting bids and arranging the delivery of Treasury securities to the Custodian Bank;
- Municipal Advisor will report the published returns of LAIF to the District each quarter so the District can consider whether it would be advantageous to shift funds out of Treasury securities and into LAIF;
- If the District ever needs to quickly raise funds to meet a large unexpected need, Municipal Advisor will act promptly to assist the District in making arrangements for an efficient liquidation of Treasury securities to meet the need;
- Municipal Advisor will provide the District with any other services within its purview that are necessary or desirable to help the District achieve its investment objectives.

Quarterly Review

One of the services Wulff, Hansen & Co. provides is that at or about the maturity of each security in the District's portfolio, we will provide you with a written Reinvestment Analysis. The Reinvestment Analysis will include a description of potential Treasury reinvestment options for the upcoming principal maturity, options which the District can then use to compare with the current rates being paid on deposits in LAIF.

The purpose of the Reinvestment Analysis is to evaluate whether the District's Treasury portfolio remains properly aligned with its cash flow requirements and liquidity needs, and to make any incremental adjustments to the portfolio that may be necessary or desirable. We will also confer with the District each quarter to discuss the District's upcoming cash flow requirements and liquidity needs and whether any modifications to the size or term structure of the District's Treasury portfolio are warranted.

Finally, every quarter we will provide the District with a written Quarterly Review that details how much the District's laddered portfolio of U.S. Treasury securities earned during the preceding quarter. In conjunction with statements from the District's Custodian Bank, the ongoing reports will provide the District with summary statistics such as quarterly earnings and the annualized yield of the portfolio.

Timeline

The process of investing in a laddered portfolio of U.S. Treasury securities takes approximately three weeks to complete and includes the following steps:

- Week 1:** Retain Municipal Advisor and select Custodian Bank and Bidding Agent;
- Week 2:** Bidding Agent/RIA solicits competitive bids from eligible bidders;
- Week 3:** Winning bidder delivers portfolio of securities to Custodian Bank.

Statement Regarding Potential Conflict of Interest

Municipal Advisor's fees for the anticipated services are intended to be contingent on its delivery of services to the District. Because neither the District nor Municipal Advisor can control or influence market conditions, it is possible that there could be future periods in which Municipal Advisor's provision of such services (e.g., quarterly reviews and/or reinvestment reports) may not produce any quantifiable financial benefit to the District despite the District's obligation to pay for such services. In such a period Municipal Advisor would have an incentive to continue providing services despite the absence of immediate tangible benefit to the District. This conflict is mitigated by the fact that it is anticipated that Municipal Advisor's contract will allow the District to terminate its contract and the provision of services at any time upon thirty days' notice, thus eliminating its obligation to continue paying Municipal Advisor any ongoing quarterly fees if the District believes that it is no longer receiving benefits exceeding the amount of the fee.

Thank you for considering our proposal to provide municipal advisory services to the Los Osos Community Services District. We are available to discuss our proposal with you and answer any questions at your convenience, either in-person, by phone or via a Zoom meeting.

Very truly yours,

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