MINUTES OF THE
MOULTON NIGUEL WATER DISTRICT
INVESTMENT BOARD OF DIRECTORS
MEETING
JANUARY 17, 2011

A meeting of the Investment Board of Directors of the Moulton Niguel Water District was held at the District's office, 27500 La Paz Road, Laguna Niguel, California, at 9:00 a.m. on Monday, January 17, 2011. There were present and participating:

DIRECTORS	
LARRY R. LIZOTTE	Chairman
SCOTT COLTON	Director
RICHARD S. FIORE	President
DON FROELICH	Vice President
GARY R. KURTZ	Director

Also present and participating were:

STAFF MEMBERS	
ROBERT C. GUMERMAN	General Manager
DAVID D. CAIN	Director of Finance/Treasurer
LESLIE GRAY	MNWD
NANCY DESAI	MNWD
FRANI BAILEY	Recording Secretary

DISTRICT CONSULTANTS	
TED PIROKOWSKI	Chandler Asset Management

Absent were:

LARRY MCKENNEY	Director
BRIAN PROBOLSKY	Director

Chairman Larry Lizotte presided at the meeting and Frani Bailey recorded the minutes thereof.

Approval of Minutes of Investment Board of Directors Meeting of October 18, 2010

Chairman Lizotte reported that he would entertain a motion to approve the minutes of the Investment Board of Directors meeting of October 18, 2010.

THEREAFTER, UPON A MOTION DULY MADE BY DIRECTOR FIORE AND SECONDED BY DIRECTOR KURTZ, THE BOARD OF DIRECTORS OF MOULTON NIGUEL WATER DISTRICT APPROVED THE MINUTES OF THE OCTOBER 18, 2010 INVESTMENT BOARD MEETING AS PRESENTED BY THE FOLLOWING VOTE: AYES: DIRECTORS KURTZ, FIORE, LIZOTTE, AND FROELICH; NOES: NONE; ABSTAIN: DIRECTOR COLTON.

<u>Public Comments</u>

Chairman Lizotte inquired if there were any public comments to come before the Committee meeting. Hearing none, he closed the public comments portion of the meeting and turned the meeting over to Mr. David Cain.

<u>Review and Discussion of District Investment Report for Quarter Ended December 31, 2010 by Chandler Asset Management Inc.</u>

Mr. Cain invited Mr. Ted Pirokowski of Chandler Asset Management to review the investment report for the quarter ended December 31, 2010.

<u>Investment Objectives</u>

Mr. Pirokowski briefly reviewed the District's investment objectives and reported that the investment goals of the Liquid Fund are to provide liquidity for operating expenses and current capital requirements, to preserve principal, and to earn a total rate of return commensurate with the first two goals.

Mr. Pirokowski reported the investment goals of the Operating Reserve Fund are to preserve real capital and provide growth over the long term by earning the rate of return available from longer-term investments permitted under the California Government Code.

Mr. Pirokowski reported the performance objective for the Liquid Fund is to earn a return in excess of the return on 90-day Treasury bills. He reported the investment performance objectives of the Operating Reserve Fund are (1) to earn a total rate of return over a market cycle which exceeds the return on a market index of government securities with maturities of one to ten years (the Bank of America-Merrill-Lynch 1-10 Year Government Index); and (2) to avoid a negative total rate of return over any one-year period in an environment where there is up to a 200 basis point parallel shift in the yield curve. He reported that he would be discussing the negative total rate of return clause in the Investment Policy when the Investment Policy is reviewed later in the meeting.

Mr. Pirokowski reported in order to meet the performance objective the Liquid Fund is invested in short-term securities and LAIF. The average maturity of the Liquid Fund may not exceed 90 days, and the maximum maturity of individual securities in the fund shall be one year.

Mr. Pirokowski reported that in order to meet the performance objectives of the Operating Reserve Fund, it is invested in a diversified portfolio of high quality, fixed income securities with a maximum maturity of ten years. No more than 40% of the fund may be invested in securities with maturities in excess of five years.

Compliance with Investment Policy

Mr. Pirokowski indicated that the District's portfolio complies fully with state law and the District's Investment Policy.

Portfolio Characteristics

Mr. Pirokowski reviewed the portfolio characteristics and transactions for the quarter for the Liquid Fund and the Operating Reserve Fund.

Liquid Fund

	Benchmark 12/31/10	**Portfolio 12/31/10**	**Portfolio 9/30/10**
Portfolio Book Value	--	$11,821,516	$3,662,333
Market Value	--	$11,825,207	$3,671,553
Average Book Yield	--	0.55%	0.55%
Average Maturity (yrs)	0.15	0.00	0.00
Modified Duration	0.15	0.00	0.00
$ Change in value for 1% change in rates	--	$0	$0
% Maturing within 1 year	100%	100%	100%
Average Credit Quality	AAA	Not Rated	Not Rated

Mr. Pirokowski reported the total market value of the Liquid Fund increased to $11.8 million. In addition, because this fund has instant liquidity, there will be no change in the market value as interest rates fluctuate, and the entire fund matures within one year. He reported LAIF is a very attractive vehicle for this type of money, because the liquidity is there and the yield is higher than other comparable money market alternatives.

Mr. Pirokowski commented that although the yield in LAIF is high, it is a short-term fund. He commented the money in LAIF is not available for investment in the long-term program, which has a higher return in the long run.

Mr. Pirokowski reviewed the Operating Reserve Fund, as follows:

Operating Reserve Fund

	Benchmark 12/31/10	**Portfolio 12/3110**	**Portfolio 9/30/10**
Portfolio Book Value	--	$102,009,812	$100,761,072
Market Value		$107,023,124	$108,570,045
Average Book Yield	--	3.11%	3.21%
Average Maturity (yrs)	3.97	3.86	4.15
Modified Duration	3.58	3.43	3.67
$ Change in value for 1% change in rates	--	$3,670,893	$3,984,521
% Maturing within 2 Years	26.9%	25.2%	21.0%
Average Credit Quality	AAA	AAA	AAA

Mr. Pirokowski reported the total market value of the Operating Reserve Fund decreased from $108 million to $107 million, which is in response to interest rates rising significantly during the quarter. He reported the Average Book Yield of the fund is 3.11%. Mr. Pirokowski reported the yield to maturity is essentially what the District will get on the fund over time if securities are not sold.

Mr. Pirokowski reported the average maturity of the portfolio is 3.86 years, slightly lower than the benchmark. He reported the modified duration of the fund is 3.43, slightly lower than the benchmark.

Mr. Pirokowski reviewed the portfolio activity during the quarter. He reported that during the quarter portfolio activity included a series of rebalancing transactions in order to maintain the portfolio's structure and duration target. He reported that newly purchased securities included Agencies and Corporates with maturities ranging from April 2014 through October 2015. Mr. Pirokowski reported that Chandler continues to invest with Corporate holdings to take advantage of favorable relative valuations for these securities.

Mr. Pirokowski directed the Board's attention to the transactions recap from

September 30, 2010 through October 31, 2010. He reported that the transactions should be looked at in the context of the portfolio as a whole, because while there might be gains, there will be times when the portfolio will take losses.

Mr. Piorkowski reported that prior to September 30, 2010 Chandler had been running the District's portfolio duration equal to or slightly greater than the benchmark because the interest curve was relatively steep and there was substantial compensation to have a slightly longer positioning. He reported that in the beginning of October the Federal Reserve announced its second round of asset purchases to support the economy, and the response of the bond market was to drive rates up. Mr. Pirokowski explained that the combination of sovereign debt and the possibility of going back into recession caused interest rates to rise after the Federal Reserve announced it would buy more bonds.

Mr. Pirokowski reported that the transactions made in October adjusted the portfolio duration to slightly shorter than the benchmark index duration. Chandler again increased the Corporate sector exposure with the additions of Bank of New York and Ebay; and also added one FFCB Agency security. He reported that the sales transactions included FDIC Insured Corporates and shorter Agencies. For the month, the cumulative sale transactions realized gains of $342,509.

Mr. Pirokowski reported that Chandler did not have any transactions in November or December and allowed the portfolio duration to shorten due to its current duration strategy.

Mr. Pirokowski reviewed two graphs comparing the allocation of the District's Operating Reserve in different areas of the market on December 31, 2010 and on September 30, 2010. He reported that the portfolio sector allocation changed modestly as Chandler increased the portfolio's holdings in Corporates by 2.2% and decreased its holdings in FDIC Insured Corporates by 2.2%.

Mr. Pirokowski reviewed the graph of the portfolio duration compared to the duration of the benchmark index and reported the duration of the District's portfolio closely matches the 1-10 year Government Index benchmark. He reported that over two of the last three months the portfolio duration has been slightly shorter than the benchmark index. Mr. Pirokowski reported this is in response to the fact that the risk-reward trade-off is such that risk is more prevalent than reward. He explained that the models Chandler uses to analyze this data indicate that given the shape of the yield curve rates cannot continue to fall much lower.

Mr. Pirokowski reviewed the maturity distribution of the portfolio on December 31, 2010 vs. September 30, 2010. He reported that given the risk-reward profile of the fixed income markets, Chandler expects to position the portfolio duration to be shorter than that of the District's 1-10 Year Government benchmark.

Investment Performance

Mr. Pirokowski reviewed the investment performance of the portfolio from its inception to the period ending December 31, 2010. He reported the total rate of return for the latest three months is -1.42%, compared to the benchmark of -1.57%. He commented the rate of return is not comparable to the yield, but is an absolute change in value for the three-month period.

Mr. Pirokowski reported the total rate of return of 5.54% for the latest 12 months is significantly higher than the benchmark of 4.94%. He reported that since inception, the total return on the portfolio on a before-fees basis is 5.93%, as compared to the return of 5.57% on the 1-10 Year Government Index benchmark. Mr. Pirokowski reported that Chandler does not expect the portfolio to return 5.54% over the next 12 months, as we are not in a rate environment that would support that.

Operating Reserve Fund Growth of $1 Million

Mr. Pirokowski reviewed a graph depicting the historical return of the portfolio on $1 million invested in September 1995, as follows:

Historical Return on $1 Million Invested in September 1995

Fund	**12/31/2010**	**Return**
Operating Reserve Fund	**$2,405,770**	**5.93%**
1-10 Government Index	$2,286,507	5.57%
LAIF	$1,771,383	3.82%

Portfolio Holdings

Mr. Pirokowski reviewed the District's portfolio holdings as of

December 31, 2010 and the summary of the issuers, the type of investment, and the percentage of each investment in the portfolio, sorted by the percent in the portfolio and answered the Board's questions. He reported that the legislation passed at the end of the year did not address Freddie Mac or Fannie Mae; however, Chandler thinks this will be resolved in a positive manner. Mr. Pirokowski reported that Freddie Mac and Fannie Mae holdings total 16.5% of the District's portfolio and Chandler thinks that ultimately anything in the past will be grandfathered and supported as a government-sponsored enterprise. He commented that the Legislature may create a new entity to support housing in the future, and as the hearings occur on what to do there will be a lot of negative information.

Mr. Piorkowski reported that the country will finish the year with a positive gross domestic product of between 2.5% and 3%, and most people believe we will continue on that pace throughout 2011. He commented that probably by the end of the first quarter we will have gained back everything lost in the great recession.

Economic Update

Mr. Pirokowski reported that the economic update is contained in Section 3 of the investment report.

Review Investment Policy

Mr. Cain reported that he included in the agenda a copy of the District's Investment Policy, which staff is required to bring to the Board for approval on an annual basis. He reported that when he and Mr. Pirokowski discussed the last quarter investments Mr. Pirokowski brought up two sections in the existing policy that he felt the Board should be aware of. Mr. Cain reported that if the Board decides to make changes to the language in the sections to be discussed staff will make the changes and bring the Investment Policy back for discussion at the Finance & IT Board meeting on Wednesday and for approval on Thursday; if not, staff will bring the Investment Policy before the Board on Thursday for adoption in its present form.

Mr. Cain directed the Board's attention to Sections IV-C and VI-B-3 and reported that Mr. Pirokowski would discuss these with the Board. Mr. Pirokowski commented that the District's Investment Policy is supposed to embody the amount of risk the Board is willing to take, and within that amount of risk the returns that the District can expect over time are laid out. He explained that the District's Investment Policy addresses risk and return, and Section IV-C on Page 3 references one of the investment performance objectives. Mr. Pirokowski reported that this section states that the Operating Reserve Fund shall be managed so as to avoid a negative total rate of return over any one-year period in an environment where there is up to a 200 basis point parallel upward shift in the yield curve.

Mr. Pirokowski explained that the District's other marketing objectives relate to market cycles for the Liquid Fund and the Operating Fund. He explained that the marketing objective for the Operating Fund is that it shall earn a rate of return that exceeds the rate on the Merrill-Lynch 1-10 Year Government Index. Mr. Pirokowski commented that he does not know the history of why Section IV-C was put into the Investment Policy and commented that it might have been a result of the Orange County bankruptcy.

Mr. Pirokowski commented that the problem that this section presents is that if there is a one-year upward shift in rates it can be reversed in the market cycle, and if the portfolio is managed to the one-year criteria it might not be possible to attain the goal of exceeding the benchmark. Mr. Pirokowski explained how an upward shift of 200 basis points would impact the return on the portfolio and a discussion ensued. He commented that Chandler cannot guarantee that it can uphold Section IV-C given the current risk/reward tradeoff, because right now the risks are greater than the rewards because historically we are in a very low interest rate environment.

Mr. Pirokowski commented that the Board could keep this section in the Investment Policy to mitigate performance risk and acknowledge that potentially Chandler may violate it; however, if the Board wants Chandler to take steps to protect against this in all instances Chandler would have to shorten the District's portfolio, and the cost of doing that is that the District would give up income. President Fiore asked why Mr. Pirokowski is bringing this up and Mr. Pirokowski explained that he is bringing this to the Board's attention because we are in a market environment that poses a risk that a

200 basis points parallel upward shift in the yield curve could happen. A discussion ensued and Mr. Pirokowski answered the Board's questions.

Director Lizotte asked Mr. Pirokowski what he would suggest and Mr. Pirokowski commented that the Board could either remove this section from the Investment Policy or acknowledge that Chandler could violate this policy. He commented the Board has to determine if the greater priority is slightly exceeding the benchmark, which Chandler has been doing, and acknowledge that there is a possibility that in this interest rate environment with a 200 basis points shock up the District could have negative rates of return. He commented that Chandler is not supposed to violate this policy and does not want to do so. A discussion ensued and Mr. Pirokowski commented that Chandler's recommendation is to remove this section from the policy, and commented that Chandler would still have the expectation of exceeding the District's benchmark for the portfolio. He cautioned that in a 200 basis points move the District could possibly have a negative one-year return.

President Fiore asked what staff recommends and Mr. Cain commented that he is relying on Mr. Piorkowski's expertise and Chandler's research, but would be somewhat uncomfortable totally taking Section IV-C out of the policy. He commented that if the terminology is changed from one year to "market cycle" it would give Chandler more flexibility to deal with the type of situation Mr. Pirokowski described.

Mr. Pirokowski commented that the District has a second issue with the Investment Policy, e.g., Section VI-B-3, which states that over a market cycle the duration of the Operating Reserve Fund may vary within a range of plus or minus +/-20% of the duration of the Merrill Lynch 1-10 Year Government Index. He commented that Chandler believes it can operate within those parameters now; however, if a rising rate environment occurs Candler could come back to the Board and report that it would like to go shorter than 20% of the benchmark due to the extraordinary times. Mr. Pirokowski suggested revising Section VI-B-3 to read "Over a market cycle the duration of the Operating Reserve Fund ***typically will*** vary within a range of plus or minus +/-20% of the duration of the Merrill Lynch One-to-Ten Year Government Index."

A discussion ensued and Mr. Pirokowski reiterated Chandler's recommendation to delete Section IV-C from the Investment Policy and to revise the wording in Section VI-B-3 to read "Over a market cycle the duration of the Operating Reserve Fund ***typically will*** vary within a range of plus or minus +/-20% of the duration of the Merrill Lynch One-to-Ten Year Government Index." Dr. Gumerman commented that he concurs with Mr. Pirokowski's recommendation and Directors Lizotte and Kurtz commented that they would support Mr. Pirokowski's recommendation. President Fiore commented that he could support any of the three options discussed with regard to Section IV-C, e.g., delete it, change "one-year period" to "market cycle," or change "one-year period" to "three-year period" and asked that Dr. Gumerman, Mr. Cain, and Ms. Desai provide staff with a recommendation regarding Section VI-B-3 on Wednesday. Mr. Cain reported that this matter is on the agenda for discussion at the Finance & IT Board meeting on Wednesday and for action on Thursday. He commented that if the Board wants to change the Investment Policy staff would draft the changes recommended by the Board, discuss them on Wednesday, and bring the revised Investment Policy to the Board for approval on Thursday.

Next Quarterly Investment Subcommittee Meeting

Chairman Lizotte reported that the next Investment Subcommittee meeting is Monday, April 18, 2011 at 9:00 a.m., at which time the investments for the quarter ending March 31, 2011 would be reviewed.

Adjournment

There was no further business to come before the Investment Board and the meeting was adjourned at 10:20 a.m.

Respectfully submitted,

Frani Bailey
Recording Secretary