

RECORD OF PROCEEDINGS

CHERRY CREEK VALLEY WATER AND SANITATION DISTRICT

SPECIAL MEETING OF THE BOARD OF DIRECTORS

August 30, 2011

The special meeting of the Board of Directors of the Cherry Creek Valley Water and Sanitation District was held at the District Offices, 2325 S. Wabash Street, Arapahoe County, Colorado at 7:00 p.m. on August 30, 2011.

PRESENT

Paul Hanley – Chairman
Jorge-Ayn Riley – Vice-Chairman
Paul Thayer – Secretary/Treasurer
Louis D. Halsell Jr. – Director
Mark Lampert – Director

OTHERS PRESENT

John R. Warford – Manager
April Clendenin – Accountant
Gregory Kennedy – MorganStanley SmithBarney
J.M. Fay – Board member candidate

ABSENT

None

Mr. Hanley, Chairman of the Board, called the meeting to order at 7:02 p.m.

Mr. Hanley introduced Mr. Kennedy, whose presentation on the investments that Cherry Creek Valley Water and Sanitation District (“CCV”) has with his firm, MorganStanley SmithBarney (“SB”), is the only agenda topic for this special meeting.

Mr. Kennedy started with an explanation of why he was unable to be present at the last regular meeting, and that he would start with an overview and try to keep things simple as he has had requests in the past for simplicity. He handed out a sheet titled “Current Portfolio Metrics” to the Board, Mr. Warford, and Mrs. Clendenin. As of the date of this special meeting, the total of the portfolio is about \$31.122 million.

About 52% of the portfolio, \$16.008 million, is invested in the money market funds that SB currently offers. The majority of that, \$13.846 million, is in the Western Asset Institutional Treasury Money Market fund, which is U.S. government sponsored securities only. The remaining \$2.162 million is in the Morgan Stanley AAA Money Market fund is more of a corporate money market fund. Both of these money market funds are yielding less than 10 basis points at the moment, basically zero.

The other 48% of the portfolio, \$15.816 million, is invested in Government Sponsored Enterprise (Agency) bonds. They have been owned for a number of years. Mr. Kennedy estimated about 6 years total. The average coupon is 3.55%. He added that the average maturity is listed as 8.675 years, but that doesn't factor the money in the money market – so the portfolio's average maturity is less than 2 years.

Year-to-Date Performance section shows that the portfolio is up 3.1%, or \$948,088. Most of this return has come from income of about \$639,000.

The call schedule shows that about \$11 million of bonds will potentially be called in the next sixth months. SB doesn't know whether or not they will be called until their potential call date, but Mr. Kennedy said that they do have a good feeling that they will be called. The agencies

RECORD OF PROCEEDINGS

MINUTES OF THE SPECIAL MEETING OF THE BOARD OF DIRECTORS OF THE CHERRY CREEK VALLEY WATER AND SANITATION DISTRICT OF AUGUST 30, 2011, CONTINUED.

were calling in their bonds more in August than in July.

Mr. Kennedy commented that in August, there was a credit scare with the US government and Standard & Poor's ("S&P") downgraded the Federal Sovereign Debt. S&P felt that because of the gridlock in Washington, the current debt situation in Washington, and the inability to make change in Washington; they felt that they needed to downgrade the sovereign debt on a long-term basis and went from a AAA to a AA+. S&P has two ratings, a short-term and a long-term. Short-term is still A1P1, which is the highest rating available under the S&P model. This, as well as the situation going on in Europe, as well as the Fed's quantitative easing number two ending, and economic data; he and Mr. Warford had spoken over lunch and felt that they should take a conservative stance since it is public money, and let things mature and move them into the money market funds and get out of couple different types of investments – which he will explain later in this meeting. He asked if anybody had any questions.

Mr. Hanley asked for clarification on what happened to the investments that CCV used to have in municipal bonds. Mr. Kennedy answered that they were all sold. CCV had roughly \$3 million in municipal bonds. When they were bought back in 2008, the spread was 129% of the underlying Treasury at that time – which meant that the yield was 29% greater than that of a Treasury bond at that time. That's now back to a normal number of 89%. The spread tightened, which drove the value of the municipal bonds that CCV held way up. There was a realized gain of \$50,000 in 2011. Mr. Kennedy expressed that he and Mr. Warford are also somewhat concerned that the budget crisis in Washington D.C. will flow down to the States. People don't know how they are going to trim the \$2 trillion plus, but they do know that most States and municipalities in the US rely on about 29% subsidy from the Federal government. The ability of the States and other municipalities to repay their own debt is more at risk if they lost their subsidies. Since it is public money, and they had already achieved what they had wanted with the healthy gain in that part of the portfolio, they decided to get out of that investment type. There have been 12,250 municipal downgrades in the U.S. this year to date. Since 8/8/11, 11,000 have to do with the Federal government downgrade. Two of the bonds that CCV held were forced to be sold because they were downgraded below the top two ratings categories that the State of Colorado allows CCV to use. He anticipates that there will be more and more of that seen. The States are good at trimming the fat from their budgets, but 29% may be more than they can handle. So the main two reasons for selling all the municipal bonds were the spread narrowing and the increased risk.

Mr. Kennedy added that there were also some Build America bonds in the portfolio earlier, and they were cashed in since the government took that subsidy away from those. The other securities that were sold during this time were primarily Fannie Mae issued. The current portfolio does not have any investments in Fannie Mae or Freddie Mac, and SB would not advise for an organization like CCV to have any. The government subsidy and conservatorship ends at the end of the year 2012. They may move it forward in 2012, but they need to meet certain capital ratios, and SB doubts that they will meet them. It may get ugly next year with downgrades for Fannie Mae & Freddie Mac. If you take away the government's sponsorship, their underlying credit, stand-alone credit, with S&P is a rating of A. For example, Federal Farm Credit & Federal Home Loan Bank, agencies that CCV owns bonds issued by, have stand-alone credit that is AA+. Federal Home Loan Bank is the primary mortgage issuer in the U.S. They don't get involved in secondary mortgages, packaging mortgages, or anything like that. There are twelve Federal Home Loan Banks. Ten of them were AAA rated before the US downgrade, and they were downgraded to AA+ standalone. Two of them, Chicago and Seattle, were AA+, and they were downgraded to AA standalone. Those two markets have floundered worse than the others, but the system overall is AA+ standalone and no longer on CreditWatch. In August, everything was on CreditWatch. Fannie Mae are rated AA+, but not as standalone – standalone for Fannie Mae is A. Mr. Warford said that he made decisions to get out of these investments in case the Federal government couldn't get their deadline met, and the Board could decide to get back into them later if they so chose.

Mr. Hanley said that with \$11 million coming due and \$16 million already in money market -

RECORD OF PROCEEDINGS

MINUTES OF THE SPECIAL MEETING OF THE BOARD OF DIRECTORS OF THE CHERRY CREEK VALLEY WATER AND SANITATION DISTRICT OF AUGUST 30, 2011, CONTINUED.

that will be \$27 million basically in cash making 10 basis points or less. He asked what other investment options there are to make better yield.

Mr. Kennedy said that they contacted the Department of Local Affairs for the State of Colorado after August 8th to see about their investment guidelines. They responded that they have not revised their guidelines since the middle of 2009. They are suggesting that they will review their guidelines. SB pushed a little harder to get a little more information on what the State was considering changing. The response was that the changes would most likely be limited changes in dealing with FDIC insured banks and lending institutions and probably no changes to the legally permitted investments for local governments, but they wouldn't give a definitive answer and when that might occur. Mr. Hanley added that this means CCV will have to plan within the current framework, and Mr. Kennedy agreed.

Mr. Kennedy said that for the capital markets today, the municipal bonds compression is done – the U.S. is back to normal spreads on municipal bonds. Since CCV doesn't pay taxes anyway, there isn't a financial incentive to choose them over a treasury bond. Corporate investment grades, less than 3 years of maturity, highest two ratings categories, CCV could invest in and there is opportunity there. Mr. Kennedy would say that it's in the global banks – but he wouldn't want to recommend investments in the European banks like BNP, because he thinks that there will be sovereign defaults with Portugal, Greece, Spain.

Mr. Kennedy continued his presentation with U.S. Treasuries. The ten-year treasury is our best benchmark in our country, always has been. Currently, 2.18% at the end of business the day of this special meeting. The Federal Reserve said on August 26th that inflation would be subdued, which Mr. Kennedy says can be interpreted as being less than 3%. Earlier in August, the Federal Reserve said that interest rates would be low to stable through the middle of the year 2013. He said that it is a bold statement – the Feds can't expand their balance sheet, they've already been told by S&P that their balance sheet is out-of-whack. They will likely accomplish this by selling the long end of the yield curve and buying the short end of the yield curve. Yield curve will steepen, long end will go up and short end will go down. CCV has always used a laddered approach in the six years that Mr. Kennedy has worked with their investments. SB is now recommending that they change from the laddered approach to a barbell approach, which means that they will buy a lot on the short end and a lot on the long end – long end being ten years. This approach will likely yield a 2.5% cash flow. Mr. Kennedy doesn't think rates will go much lower, but they likely will continue to be low for a few more years.

In 2010, CCV made a little over \$1 million of income and had a capital gain of \$408,000. In 2009, CCV had \$875,000 of income and \$150,000 capital gain. In 2008, CCV had a little over a \$1 million of income and \$400,000 capital gain. So far, in 2011, about \$639,000 of income and about \$900,000 of portfolio increase. Going forward, for 2012, Mr. Kennedy wants to get the income back up. If investments stay as they are, the income will be less than \$500,000 in 2012, assuming the money market rates don't change. Mr. Kennedy recommends to the Board that CCV continue to use only Federal Home Loan Bank and Federal Farm Credit agency securities. The current spread over the Treasury is 60 basis points. He said that he can buy a ten year Treasury at 2.18%, and a ten year Federal Farm Credit at 2.78%. He needs the extra 60 basis points in case inflation more towards 3%. If he buys a 2.2% ten-year bond and there is some inflation, the convexity of that bond – which means the interest rate risk in that bond – will likely cause a 10% capital depreciation with the first rate increase in a ten-year 2.2% U.S. government bond. He added that there have not been these high rates on ten-year U.S. government bond in his lifetime. He said the media this past weekend was calling the U.S. government bond market a bubble. His firm that if there is a bubble it is from the S&P downgrade – it used 2.60%, now after the downgrade it is at 2.20%. His firm also believes that the ten-year U.S. government bonds will be at 2.75% within two years. He added that he can't recommend going with something that is 2.20%, because it doesn't keep up with the cost of inflation.

Mr. Hanley asked if he was recommending some mixture of agency and Treasury bonds. Mr.

RECORD OF PROCEEDINGS

MINUTES OF THE SPECIAL MEETING OF THE BOARD OF DIRECTORS OF THE CHERRY CREEK VALLEY WATER AND SANITATION DISTRICT OF AUGUST 30, 2011, CONTINUED.

Kennedy said that he had some ideas and would like to ask the Board for its guidance. He understands that there is a reservoir project that is roughly estimated to cost around \$5 million that may be coming up soon. He is thinking that CCV should keep a minimum of \$2 million in money market at all times and an additional \$3 million in six-year U.S. Treasuries. He added that the six-year U.S. Treasuries are the most liquid because, his firm feels, the Federal government will buy back if they need to. For the rest of it, he would like to use Federal Farm Credit and Federal Home Loan Bank bonds. He can't buy big blocks of it. He used to be able to buy \$1 million at a time before, but now they are only selling blocks of \$100,000 at a time. Mr. Hanley asked if the agencies will be issuing refunding bonds to do the calls. Mr. Kennedy answered that they will, but there is usually a thirty to sixty day lag and his firm is the primary dealer for the agencies, so he will have the access to those options. But, he needs bullet bonds – stated maturity on a certain date with no call – for the long-term side of the barbell. He needs callable bonds, which is what the current holdings are and the refundings will likely be, for the short-term side of the barbell. He is currently over-weighted on the short-term side of the barbell. Mr. Hanley asked what the allocations should be between short-term and long-term for the barbell approach. Mr. Kennedy said that for an organization like CCV, it should be 60% on the short end and 40% on the long end, without including the money market fund since that will likely go away soon with the reservoir project. Mr. Warford added that this is something that will need to be looked at whenever the budget is done, as to which way CCV may want to go. Mr. Lampert commented that there would not be any money left in money market – which would leave limited amounts of cash reserves, except the short-term bonds. Mr. Kennedy answered that he doesn't know how long the reservoir will take, so he's keeping its \$5 million short-term. Mr. Lampert said that the reservoir's costs are not going to be all upfront, and not all at the tail-end either – it would be spread out over the construction life. Mr. Warford said that he believes that the construction will move fairly fast, probably less than a year to finish, once the permitting is done. Mr. Hanley said that there would always be a market for the short-term bonds though. Mr. Kennedy agreed. Mr. Hanley added that they may have to be sold at a loss though. Mr. Kennedy said that is also true, but he is hopeful that they wouldn't need to.

Mr. Kennedy told the Board that there was one Fannie Mae subordinate bond that CCV owned for years which kept getting worse and worse, which he sold at a loss. His opinion is that if he took the loss now, in the long-term there will likely be more gains to offset. He said that in the last 3 ½ years, there was \$1 million capital gain, which does give some cushion against capital losses. Mr. Hanley added that anybody who looks at the history could complain about the investment returns. He thinks that the portfolio was under \$20 million when he started as a Director on the Board.

Mr. Hanley stated that he thinks it sounds like a pretty decent strategy to him, and invited comments from the rest of the Board. Mr. Hanley then asked to clarify about the spread between the Federal Home Loan Bank and Federal Farm Credit agency securities and the Treasury – is it 70 basis points? Mr. Kennedy said that it can be – it varies day-by-day. Mr. Hanley asked to clarify that Mr. Kennedy feels that it is worth any incremental risk over an equivalent term spread. Mr. Kennedy answered yes, and added that the stand-alone credit rating for these two agencies is the same as the U.S. Treasury. Mrs. Riley asked what the low end of the spread could be – since 70 points is the high end. Mr. Kennedy answered that they have seen them trade at par with Treasury when things get a little whacky. He added that when the interest rates start to move up, and it did move up to 2.75% a few months ago, this portfolio recommendation will be defensive against losses. Mr. Hanley asked if those higher rates then were what led to the \$50,000 gain. Mr. Kennedy answered that it was a big part of it, yes. Mr. Kennedy added that CCV has been able to be more aggressive in the last four years, but he thinks it's becoming more risky now to be as aggressive and now is the time to be more defensive. Historically speaking, a ladder approach works best when rates are going down and a barbell approach works best when rates are going up. Mr. Hanley asked Mr. Kennedy how he would be able to get into the Federal Farm Credit and Federal Home Loan Bank bonds to build the barbell if there is trouble getting them in volume right now. Mr. Kennedy said that Mr. Warford is very easy to get a hold of and if Mr. Kennedy sees an opportunity, or a new issuance, he will call Mr. Warford to get a quick

RECORD OF PROCEEDINGS

MINUTES OF THE SPECIAL MEETING OF THE BOARD OF DIRECTORS OF THE CHERRY CREEK VALLEY WATER AND SANITATION DISTRICT OF AUGUST 30, 2011, CONTINUED.

go-ahead and make it happen. Mr. Hanley asked if CCV wants to invest \$26 million, and Mr. Kennedy can only find \$100,000 at a time, would it make sense to go into some Treasuries if they are easier to find and buy. Mr. Kennedy answered that there is term called the "cost of waiting index", which he believes Mr. Hanley is talking about. Mr. Hanley agreed. Mr. Kennedy said that he agrees that with the current money market rate of 10 basis points, there is currently the largest cost of waiting index that he has ever seen. He clarified that it does cost money for the longer that it takes. He is asking for thirty to sixty days, as the majority of the bonds are potentially being called, and if he can't find enough Federal Farm Credit and Federal Home Loan Bank bonds to invest in he will call Mr. Warford and ask if he can invest at least a portion of that cash into five-year U.S. Treasuries just to get out of the 10 basis point money market fund. Mr. Warford and Mr. Hanley both expressed that they agree with this philosophy. Mr. Kennedy added that if he buys U.S. Treasury bonds, his firm buys them straight from the Fed, so it is completely liquid immediately and there's no additional cost. It would basically be a holding place – five-year U.S. Treasuries will yield 1%, which is better than 10 basis points.

Mr. Warford asked Mr. Kennedy if the costs of managing the assets and transactions will be increased, because a form letter was received recently that vaguely mentioned that the pricing structure would be changing. Mr. Kennedy said that some clients have fees for managing the portfolio, but his firm doesn't charge fees to CCV – they earn their money from commission from the Federal government based on bonds that they buy directly from them, which all say "par" on the transaction statement. Mrs. Clendenin left the room to seek a copy of the letter to show to Mr. Kennedy. The yields as they are quoted to Mr. Warford over the phone are net yields that already include any fees.

Mr. Hanley asked for an example of the fees. Example: CCV buys a \$5 million five-year U.S. Treasury bond thirty days from now and then sells it sixth months later, what would the fees be? Mr. Kennedy answered that to buy the bond, it wouldn't cost CCV anything. His firm would receive \$5,000 commission from the Federal Reserve for distributing it – the firm is a primary dealer. To sell it, the firm usually charges 1/32 of a dollar, which is called a tick, which he said is about free. He added that it causes accounting problems to trade things for the sake of trading, but he understands that the question was to clarify that there wouldn't be a large amount of transaction costs.

Mr. Kennedy said that his main concern for this meeting was to be sure the Board understood the differences between the agencies. He added that there are three other agencies, but he hasn't seen anything offered from them in over a year, which are all financial companies that the government sponsors. He added that sometimes he receives an argument that Fannie and Freddie are not implied, that are now explicit, so they are in some ways better than the other agencies. But in the year 2012, that explicit guarantee could go away, and Mr. Kennedy thinks that this will be the case and they will phase out Fannie and Freddie, so he doesn't want to hold onto them any longer.

Mr. Hanley said that he is concerned about waiting on the sidelines for too long, giving the way he understands the transaction costs. He'd like to see forward movement and get more money invested, and even if it's 1% to 2%, that would be better than ten basis points, as long as it's a safe investment. Mr. Warford expressed that he would prefer investing in U.S. Treasuries if the wait gets to be too long for the agency bonds. Mr. Kennedy agreed. Mr. Lampert asked when Mr. Kennedy would start, if approval was received from the Board at this meeting. Mr. Kennedy answered tomorrow. Mr. Lampert asked to clarify, would Mr. Kennedy be looking out to get as much as he can as quickly as he can. Mr. Kennedy confirmed. Mr. Hanley added, until conditions change again. Mr. Kennedy said that when the calls occur, there's a thirty to sixty day lag but there will be more issuances because the agencies still need the money – the debt's not going away. Mr. Hanley asked if they use Treasury auctions, and Mr. Kennedy answered that is where they get them. Mr. Kennedy added that he states the yield and maturity he needs and he buys a lot of them, all day every day. Mrs. Clendenin re-entered the room and said that she was unable to find a copy of the letter regarding the fee changes to show to Mr. Kennedy. Mr.

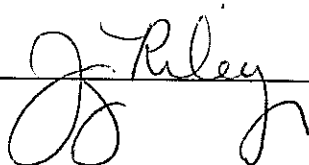
RECORD OF PROCEEDINGS

MINUTES OF THE SPECIAL MEETING OF THE BOARD OF DIRECTORS OF THE CHERRY CREEK VALLEY WATER AND SANITATION DISTRICT OF AUGUST 30, 2011, CONTINUED.

Lampert asked how the investments are normally approved – as a block or only partial amounts? Mr. Hanley answered that the Board historically has given only general guidelines and set general parameters. As long as they stay within the plan, Mr. Warford has the authority to execute the plan. And when the market changes, Mr. Kennedy will call Mr. Warford and then Mr. Warford contacts the Board and asks to make some changes to the investment plan. The Board doesn't get involved in specific trades or micro-manage it. Mr. Hanley added that what they are looking for tonight is for the Board to give general approval to the general program that Mr. Kennedy has outlined here and giving Mr. Warford authority to go ahead and execute. Mr. Hanley said that some thought should be given to moving more into Treasuries if the agency bonds can't be bought. There's a big difference between ten basis points and two-hundred basis points. Mr. Kennedy added that S&P did a stress test after August 8th. S&P feels that the country could withstand GDP declines of up to 15%, unemployment of up to 20%, and a stock market decline of up to 70% before the stand-alone credit ratings of AA would go to A. This isn't even talking about a default, but shows that the country is likely far away from another credit downgrade. Mr. Hanley asked each of the Board members if they agreed with the new general investment plan, and each agreed. Mr. Hanley told Mr. Kennedy and Mr. Warford to execute the new plan. Mr. Lampert asked if there will be an update at the next meeting for the thirty day period. Mr. Hanley said that the Board receives monthly statements before each meeting, and Mr. Warford is also available at the meetings to answer questions. Mr. Kennedy said he can come again too, if needed. Mr. Hanley said that they will see how things go. Mr. Warford says that they will need to look at the budget and see how the situations will be handled if they exist and how they can make up the differences.

Mr. Hanley asked if there was any additional business. There being no further matters to come before the Board, Mr. Hanley called for the Board to adjourn. Mr. Lampert moved to adjourn, seconded by Mr. Halsell. Motion carried. Mr. Hanley declared meeting adjourned at 7:44 p.m.

READ AND APPROVED



DATED

9/21/11