GHAD PROPOSAL: TREASURER

June 9, 2015

Proposal to appoint Watermark Asset Management, Inc. as Treasurer for a Geological Hazard Abatement District (GHAD) organization

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Geological Hazard Abatement District (GHAD)

A GHAD is an independent, state-level public agency that oversees geological hazard prevention, mitigation, abatement and control. A “geologic hazard’ is broadly defined as an actual or threatened landslide, land subsidence, soil erosion, earthquake, fault movement or any other natural or unnatural movement of land or earth.

The GHADs are funded through supplemental property assessments commonly included on a property tax bill. The ongoing revenue stream, combined with reserves when available, funds current operations and reserve accumulation.

The funds dedicated to operations are invested in cash like instruments with an emphasis on liquidity and preservation of principal. The reserve fund, should it be available, covers unexpected events and generates income for future use.

Proposal for Treasurer

In its role as Treasurer, Watermark Asset Management, Inc. provides the following services:

- Design and implementation of an Investment Policy Statement (IPS) for each GHAD
- Investment of GHAD revenues and reserve funds
- Coordination, review and monitoring of cash disbursements
- Monthly and quarterly performance and flow reporting
- Recommendation and utilization of asset custodians

Watermark Asset Management, Inc.

- Fee only, independent investment advisory firm, founded in 1997
- Manages over $300 million in assets for individuals, corporations, company retirement plans and non-profit organizations
- SEC Registered Investment Advisory Firm (RIA)
- Currently serving as Treasurer for seven Contra Costa County GHADs
- A GHAD Treasurer since 2009

Watermark Advisors

- **Mark Miller** is a principal and the founder of Watermark Asset Management, Inc. Early in his career he worked for Coldwell Banker Real Estate and later as a district manager with Allstate Insurance. Prior to establishing Watermark in 1997 he was a vice president and national sales manager for Schwab Institutional’s Retirement Plan Services, a division of Charles Schwab & Co., Inc.

He has an undergraduate degree from Stanford University and a Master's Degree in Financial Planning from the College for Financial Planning.

- **Irina Torelli, CFA** is a portfolio manager with Watermark Asset Management, Inc. She is responsible for investment research, risk evaluation, performance attribution, trading, and asset allocation strategies.

  Irina began her career as a systems engineer with Selfin, in Rome, Italy. After earning her master's degree in the U.S., she joined American Century Mutual Funds as a qualitative analyst before being promoted to Portfolio Manager. Prior to joining Watermark, she co-managed the American Century Asset Allocation funds. Irina was responsible for the launch of the first target date fund at the company and managed over $13 billion in assets.

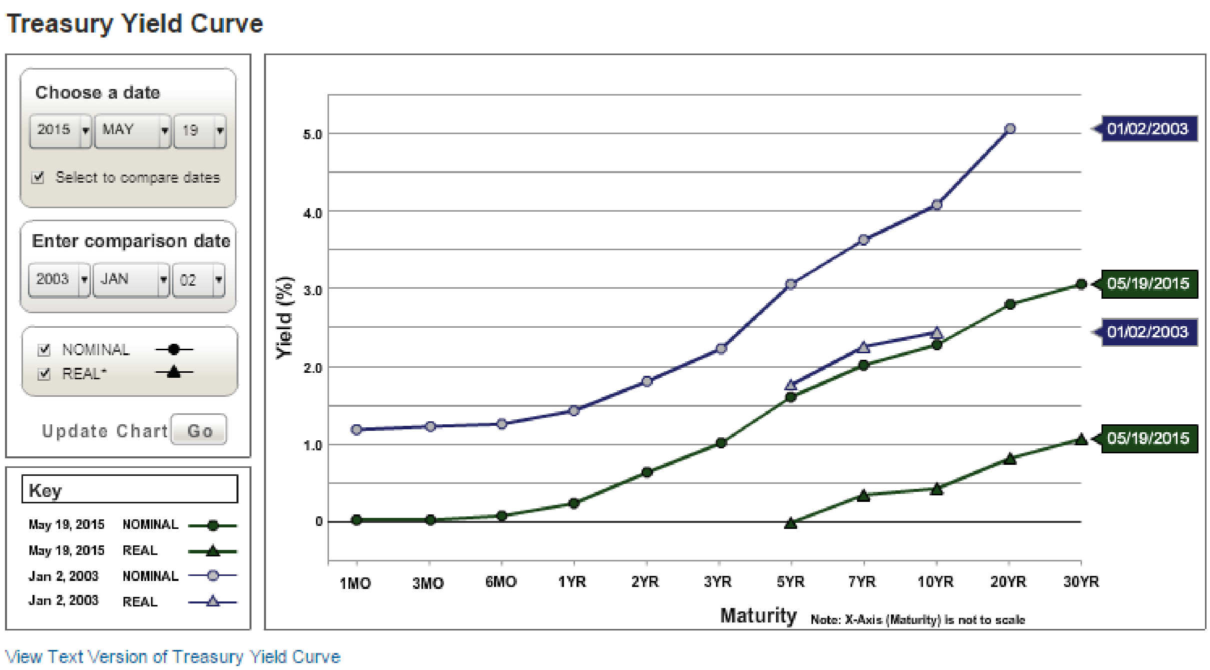
  She has an undergraduate degree in Electrical Engineering from Sapenzia University in Rome, Italy, and a Master's Degree in Engineering Economic Systems and Operational Research from Stanford University. She has been a Chartered Financial Analyst since 2000 and is a member of Women in ETFs and the San Francisco chapter of CFA.

Investment Policy Statement (IPS) for the

Geological Hazard Abatement District (GHAD)

Current investment environment

The years after the 2008 financial market crisis have been particularly challenging for savers. Unprecedented stimulus measures have lead to an environment of zero short term interest rates and historically low long term rates. As illustrated in the Fed chart below, real rates in the 5 to 10 year maturity spectrum have moved from a range of 1.75% - 2.43% at the beginning of 2003, to -0.02% -1.42% as of May 19th 2015.



At earlier maturities nominal rates are at 0%. This presents a significant challenge as cash and short term investments lose purchasing power every year. In search of higher returns and stronger yields, many investors have increased the risk in their portfolios by buying equities, or extending the duration and/or credit of their fixed income investments. Conservative allocations present a tough dilemma in that investors investing the majority of their assets in short term fixed income instruments, find themselves forced to increase risk exposure or accept real return losses until financial conditions change.

Property/Casualty Insurance Investment Portfolios

In designing an investment allocation for a GHAD portfolio, we thought it helpful to look closely at how Property & Casualty insurance companies allocate investment reserves. While the GHADs are different in that risk is very concentrated, we find it useful to analyze the insurance companies' investment strategies. From the NAIC Capital Markets Special Report as of the end of 2013 the allocation was:

Asset Type	% Allocation
Bonds	56%
Stocks	29%
Cash & Short Term Investments	5%
BA & other	10%

The specific bond breakdown shows:

Bond Type	%Allocation
Corporate Bonds	32%
Municipal Bonds	36%
US Government	8.5%
Agency Backed RMBS	8.8%
Foreign Government	3%
ABS	4.4%
Other	7.3%

The fixed income exposure is predominantly investment grade with 96% allocated to high quality bonds.

Historical returns

By using unmanaged indices we find that at the current allocation this portfolio would have experienced a 6% return with a 6% standard deviation (risk), at a time when inflation was running at 2% per year. That equates to a 4% real return. The analysis represents data for the period March 2000 to February 2015.

Outlook

Considering that the yield on high quality bonds is a good predictor of future returns, the insurance portfolios are targeted to produce 3% annualized returns over the next 5 to 10 years. If future inflation stays at the current level, the real return will be 1%. Using Inflation Protected Treasuries as a benchmark implies that the real return may be about 1.5%.

Investment Portfolios Risks

The following are the main risks inherent in a portfolio containing a mix of bonds and equities:

Interest rate risk: the chance that bond prices will decline because of rising interest rates

Credit risk: the chance that the issuer of a security will fail to pay interest or principal in a timely manner or that negative perception of the issuer's ability to make such payments will cause the price of that security to decline

Income risk: the chance that a portfolio's income will decline because of falling interest rates

Call risk: if a portfolio holds securities that are callable, the underlying portfolio income may decline because of call risk, which is the chance that during periods of falling interest rates, issuers of callable bonds may call (redeem) securities with higher coupons or interest rates before their maturity dates

Country/regional risk: the chance that world events—such as political upheaval, financial troubles, or natural disasters—will adversely affect the value or liquidity of securities issued by foreign governments, government agencies, or companies

Stock market risk: the chance that stock prices will decline. Stock markets tend to move in cycles, with periods of rising prices and periods of falling prices

Currency risk: the chance that the value of a foreign investment, measured in U.S. dollars, will decrease because of unfavorable changes in currency

The predominant risks in an insurance portfolio are interest rate and credit risk.

Investment Proposal for GHADs

We propose that the GHAD funds budgeted for operating expenses be invested in cash like instruments such as short term certificates of deposit.

We also advise earmarking a medium term cash allocation to cover the budgeted cost for extraordinary expenses. This portion of the portfolio will be invested in an inflation protected bond ladder, or fund targeting a 5 year maturity, currently yielding a 0% real return. Depending on the size of the extraordinary expense allocation, it could be argued that the fund might be too liquid, however marginally extending the duration or the credit risk of the portfolio yields little advantage in an environment where rates are low and credit spreads narrow. Should interest rates rise and financial conditions change we would consider extending the duration, or take on more credit on this part of the portfolio. Cash investments and inflation protected bonds are a good hedge against inflation, the primary risk facing the GHAD. As an example, cash performed better than bonds and stocks on a risk adjusted basis in the inflation rich 1970's.

For the remaining part of the portfolio we recommend an investment in a Property/Insurance like portfolio allocation. The investments we intend to target are:

50% High quality bond mix

30% Strategic bond mix

20% Equities

Over the long term, and assuming yields eventually increase, we expect that the cash portion of the portfolio will yield a -1% real return; the TIP allocation 0% real return; and the balance of the portfolio about 1 - 2% real return. The risk of the overall portfolio will be dependent on the relative size of the three parts of the allocation.

For illustrative purposes four possible portfolios might look like this:

	Cash	TIPs	Investment Portfolio	Historical Return *	Risk	Expected Return (Nominal)
Portfolio 1	30%	35%	35%	4.3%	2.8%	1.7%
Portfolio 2	30%	50%	20%	4.1%	2.5%	1.5%
Portfolio 3	30%	70%		3.8%	2.5%	1.2%
Portfolio 4	15%	15%	70%	5.0%	4.5%	2.4%

*March 2000 – Apr 2015

Investment Strategy Implementation

Given the investment strategy proposal, we intend to manage the inflation protected bond ladder internally, buying the bonds at auction or on the secondary market.

The investment portfolio will be managed by external managers.

Core Bond Mix

We propose that this part of the portfolio use an equal mix of the PIMCO Total Return fund (PTTRX) and the Metropolitan West Total Return Bond fund (MWTIX). These two funds, with top performing managers, construct portfolios according to different investment strategies. As such they complement each other. The resulting blend produces a better risk adjusted return than either fund alone.

Strategic Bond Mix

This part of the portfolio is reserved for managers that have more leeway in deciding how to allocate funds. These managers tend to have mandates that exhibit a higher risk than core bond funds and are more closely correlated with stocks. The funds that we use include: Templeton Global Bond fund TGBAX, Loomis Sayles Bond fund LSBDX and PIMCO All Asset All Authority fund PAUIX.

The Templeton Global fund has a worldwide focus. It tries to take advantage of opportunities in interest rates, currencies and sovereign credit markets. The manager currently believes that we are on a path to higher interest rates, therefore the fund is positioned to keep its correlation to interest rates at zero.

The Loomis Sayles Bond fund holds at least 80% of its assets in bonds. It can invest up to 35% of the fund in below investment grade bonds, and up to 20% in equity securities. The fund has quite a wide mandate when looking for global opportunities across different markets.

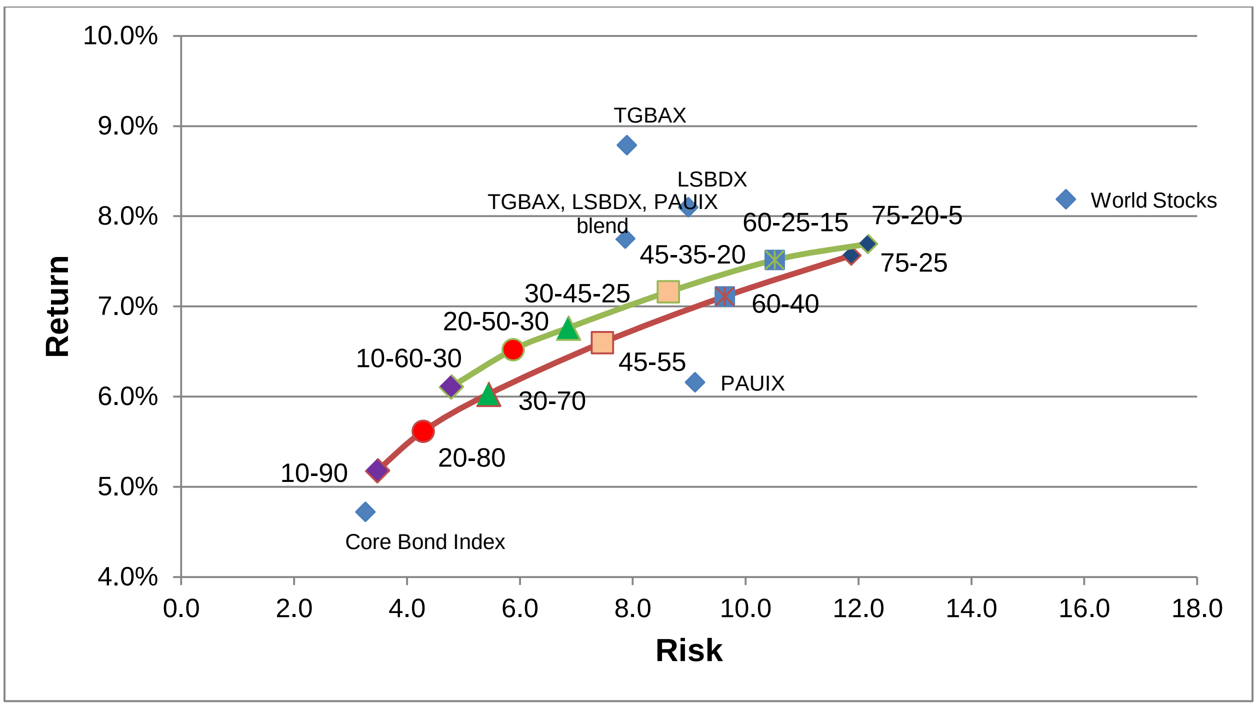
The PIMCO All Asset All Authority fund seeks maximum real return consistent with the preservation of real capital and prudent investment management. The strategy intends to have a low correlation to equities.

Equities

A small part of the portfolio will be allocated to equites and will function mainly as a diversifier. We propose to use Exchange Trades Funds (ETFs) that give broad exposure to world markets at a very low cost. For U.S. markets we'll use the Vanguard Total Stock Market (VTI) and for foreign markets, the Vanguard FTSE All-World ex-US (VEU) fund.

The following chart reports the historical risk and return for the above discussed funds and combination of them for the period Mar-2003 to Dec 2014.

An insurance portfolio is similar to the 20-50-30 portfolio.



Extraordinary Expenses Allocation

The annual operating budget for each GHAD is determined every year and is generally lower than expected revenues. We can consider it separate to the long term investment risk of the GHAD funds.

The size of the planned extraordinary expense allocation will determine the risk of the GHAD portfolio. Each GHAD should assess the size of each extraordinary event and its frequency and from that its yearly average impact.

The GHAD Manager will evaluate how many years should be set aside into this allocation. Budgeting for unexpected events is always problematic, but the objective is to be able to avoid the need to sell assets during a negative financial event.

Of course, major and infrequent catastrophic events (e.g. earthquake) may necessarily lead to asset sales, but while the timing is uncertain it is also uncorrelated with financial market events.

Watermark Services

- **Cash Management Services**
    - Separate account for each GHAD
    - Match cash outflow with investment horizon
    - Asset mix: Cash like investments, Bonds and Equities

- **Use of Independent 3rd Party Custodians for GHAD assets**

    - **TD Ameritrade Institutional**
        - A division of TD Ameritrade., Inc.
        - Leading provider of comprehensive brokerage and custody services to more than 4,000 fee-based, Independent Registered Investment Advisors (RIA) and their clients
        - Custody of over $600 Billion in client assets
        - Member of the Securities Investor Protection Corporation (SIPC). Securities in accounts are protected up to $500,000. Up to an aggregate of $250 million of additional securities protection, of which $900,000 may be applied to cash, is provided by London insurers.

    - **Schwab Institutional**
        - A division of Charles Schwab & Co. Inc.
        - Leading provider of comprehensive brokerage and custody services to more than 7,000 fee-based, Independent Registered Investment Advisors (RIA) and their clients
        - Custody over $1.3 Trillion in client assets
        - Member of the Securities Investor Protection Corporation (SIPC). Securities in your account are protected up to $500,000. Up to an aggregate of $250 million of additional securities protection, of which $900,000 may be applied to cash, is provided by London insurers.

- Independent verification of assets
  - Institutional account statements
- Watermark maintains Limited Power of Attorney (LPOA) for investment purposes
- Disbursements by custodians to approved vendors with GHAD authorization
- Check or electronic receipt of GHAD deposits from City/County

Service Standards

- **Reporting**
  - Monthly account statements from custodians for each GHAD (5 days after month end)
  - Quarterly performance statements from Watermark (15 days after quarter end)
  - Available transaction reporting for account audits
  - Additional reporting abilities as needed

- **Investment Policy Statement**
  - Clear investment objectives between Watermark and GHAD
  - Predetermination of investment risk parameters
  - Investment horizon and cash flow requirements suitable for each GHAD

- **Disbursement Process**
  - Through independent 3rd party custodians via check or electronic payment
  - Watermark able to facilitate disbursement documentation and payments with GHAD authorization
  - Payments disbursed ONLY to GHAD approved vendors
  - Watermark disbursement verification
  - Service Standards:
    - Payment authorization: 24 hours
    - Payment disbursement: 48 hours

Additional Information

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References Available Upon Request