Case 4
Orange County’s Yield Curve Plays

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Interest Rate Speculation: Case of Orange County Bankruptcy

Orange County managed, through its Treasurer, an investment pool that was the temporary repository of the proceeds of municipal bond offerings. The fund was also the temporary repository for tax and other revenue collections from Orange County and the various municipal agencies within the County. Other municipalities and agencies within the state of California also invested their surplus or working capital funds in the Orange County pool. The state of California manages a similar investment pool, called the Local Agency Investment Fund (LAIF), as do a number of other counties throughout the state.

Robert Citron was elected Orange County Treasurer in 1973. He modernized the office by upgrading his investment management tools and developed software programs to forecast and match the maturities of fixed income investments and revenue collections to the cash requirements of the county and state agencies. Interest earned on the investment portfolio became an increasingly important part of the county budget, particularly after 1978 and the passage of Proposition 13 limited the base and increase in property taxes.

Mr. Citron petitioned the state to liberalize and expand the investment powers of county treasurers. His efforts were successful. As a result, Mr. Citron began to use riskier investment instruments, including derivatives and arbitraged interest rate spreads by the use of repurchase agreements.

Additionally, the county investment pool borrowed funds short-term to invest the proceedings in longer maturity bonds with the expectation that investment returns would exceed the borrowing costs. The borrowed funds or margin approximated $12.5 billion on the $7.5 billion of invested funs in the pool.

Mr. Citron's investment strategy was based on a continuing decline in interest rates. When interest rates turned upward in the fall of 1993, the portfolio began to experience losses as the market price of interest-rate sensitive securities in the portfolio fell. In a stubborn belief that interest rates would not rise any further, despite repeated signals to the contrary by the Federal Reserve, Mr. Citron continued to leverage the portfolio and resisted liquidating interest-rate sensitive securities. As the investments continued to decline in value, margin calls were triggered forcing the sale of portfolio assets. On December 6, 1994, the county declared bankruptcy. Investment losses are estimated at $2 billion or about 26 percent of the $7.4 billion portfolio.
The lesson of Orange County is that risk accompanies excessive returns. Investors should assume risk with equity investments not fixed-income investments.

**The Orange County Bankruptcy**

In December 1994, after suffering staggering losses in the financial markets, Orange County was forced to declare bankruptcy. Orange County’s investment pool had suffered a loss of $1.6 billion. This was the largest loss ever recorded by a local government investment pool, and when Orange County, California, filed for Chapter 9 protection on December 6, 1994, it became the largest municipality in U.S. history to declare bankruptcy.

This loss was the result of several factors. Primarily, this was the result of unsupervised investment activity of Bob Citron, the County Treasurer, who was entrusted with a $7.5 billion portfolio belonging to county schools, cities, special districts and the county itself. Traditionally, municipal funds are invested conservatively to provide stable, modest earnings for local governments. However, county treasurer Citron, following the advice of Merrill Lynch investment brokers, had for years committed the county pool to high-risk securities that yielded higher earnings. Citron's investments would earn well if interest rates stayed low, but they would lose money if interest rates rose. For several years, interest rates were low and the pool's investors profited. Citron further enhanced earnings by borrowing more than $12 billion at low interest rates (using the pool's securities as collateral), and then investing the borrowed money in high-yield securities.

Citron was able to increase returns on the pool by investing in derivatives securities and leveraging the portfolio as much as he possibly could. The pool was in such demand due to its track record that Citron had to turn down investments by agencies outside Orange County. Some local school districts and cities even issued short-term taxable notes to reinvest in the pool (thereby increasing their leverage even further). This was in spite of repeated public warnings, notably by John Moorlach, who ran for Treasurer in 1994, that the pool was too risky. Unfortunately, he was widely ignored and Bob Citron was re-elected.

But in 1994 Citron's risky investment strategy backfired. The Federal Reserve Board started a rapid series of interest rate hikes in order to fight inflation. This caused severe losses to the paper value of the pool, and Orange County's investments suffered big losses. In early December, the county was unable to pay off a $1.2-billion loan that had become due to one of its
Wall Street creditors, who refused to continue the loan and began selling off the Orange County securities it was holding as collateral. Shortly thereafter, the county declared bankruptcy and decided to liquidate the portfolio, thereby realizing the paper loss.

The Orange County fiasco clearly involves financial irresponsibility on the part of Citron, and perhaps also on the part of the county board of supervisors who gave ready approval to the ex-treasurer's high-risk investments. Citron and the county supervisors ignored many warning signs, and pool investors claim they were not given sufficient warning of the risks involved. There is also the possibility of political corruption, such as campaign contributions or kickbacks being provided to county officials in exchange for the county's lucrative bond business; several investigations are under way by federal, state, and county authorities. Orange County's leading brokerage, Merrill Lynch, and its lobbyists had given at least $80,000 to Orange County state legislators and local officials since 1987, and the brokerage had reportedly earned about $80 million in fees and commissions in dealing with the county's investment pool.

Besides the risky investment strategy employed by the county treasurer, a two-decade trend of voter initiatives to simultaneously minimize tax increases and control the allocation of state tax funds, along with Orange County's political fragmentation, were contributing factors. Contrary to its reputation as a stronghold of wealthy conservatives, the county is primarily made up of middle-class suburbanites of moderate political temperament. In other words, Orange County is a lot like the rest of America, and what happened there can happen again.