

BREMEN TOWNSHIP
TRUSTEES OF SCHOOLS

ANNUAL INVESTMENT REPORT
FISCAL YEAR ENDING JUNE 30, 2012

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“An investment in education always pays the best interest”

- Benjamin Franklin

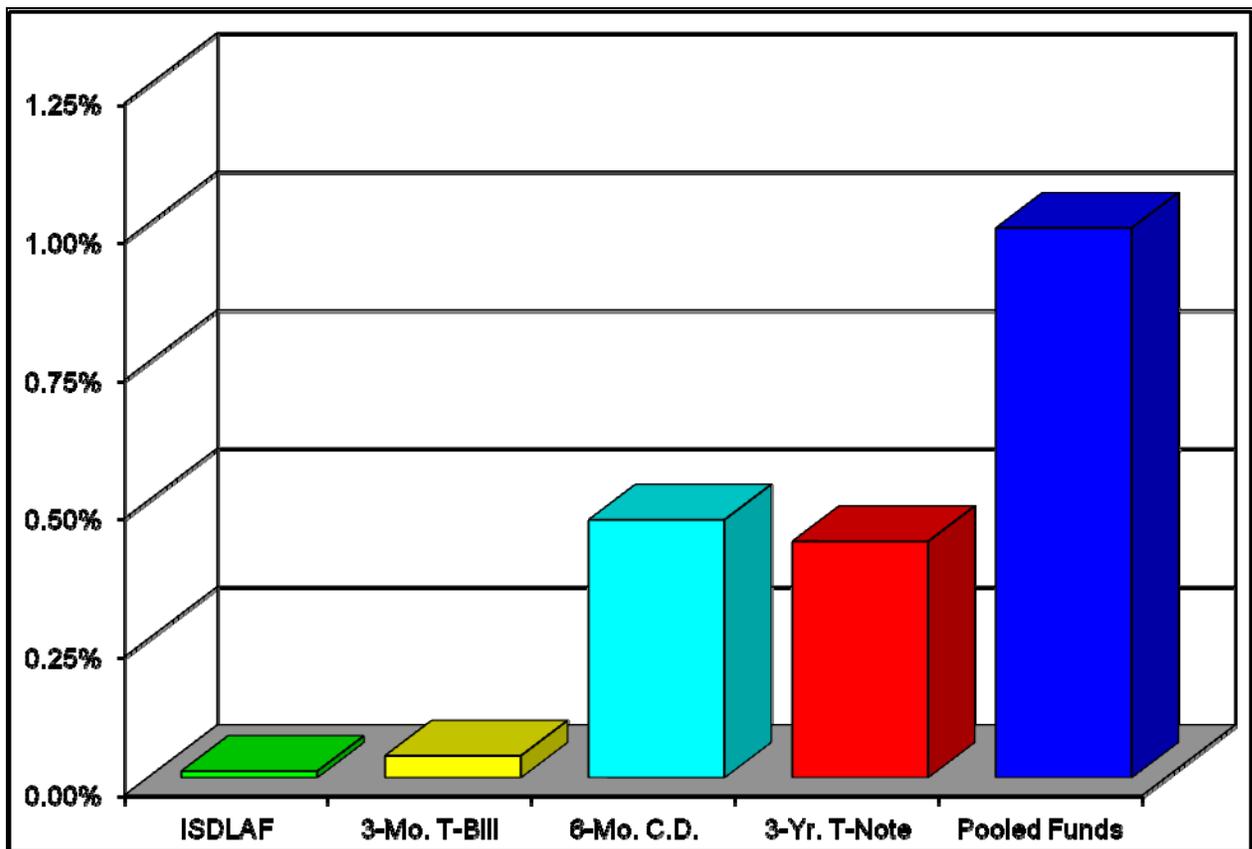
INTRODUCTION

The purpose of this report is to provide information to the administration and board members of the school districts that are serviced by the Bremen Township Trustees of Schools related to their funds for which we serve as custodian. All school districts that receive this report have their general funds invested in a pooled portfolio that consists of the funds of all the districts serviced by this office. Each district owns a portion of the pool based on their level of cash as a percentage of the entire cash being managed in the pool. There are many benefits to this investment structure, such as greater diversification, better liquidity and higher interest rates. Interest from the pooled funds is distributed to the districts based on their percentage of the fund.

The following report is divided into four sections. The first section will summarize the pooled fund's performance for the fiscal year ending June 30, 2012. The second section will provide a historical review of interest rate trends. The third section will analyze current market conditions and discuss the current portfolio as it relates to these conditions. The final section describes the general investment policy of the Bremen Township Treasurer's Office.

SUMMARY OF FISCAL YEAR 2012 INVESTMENT ACTIVITY

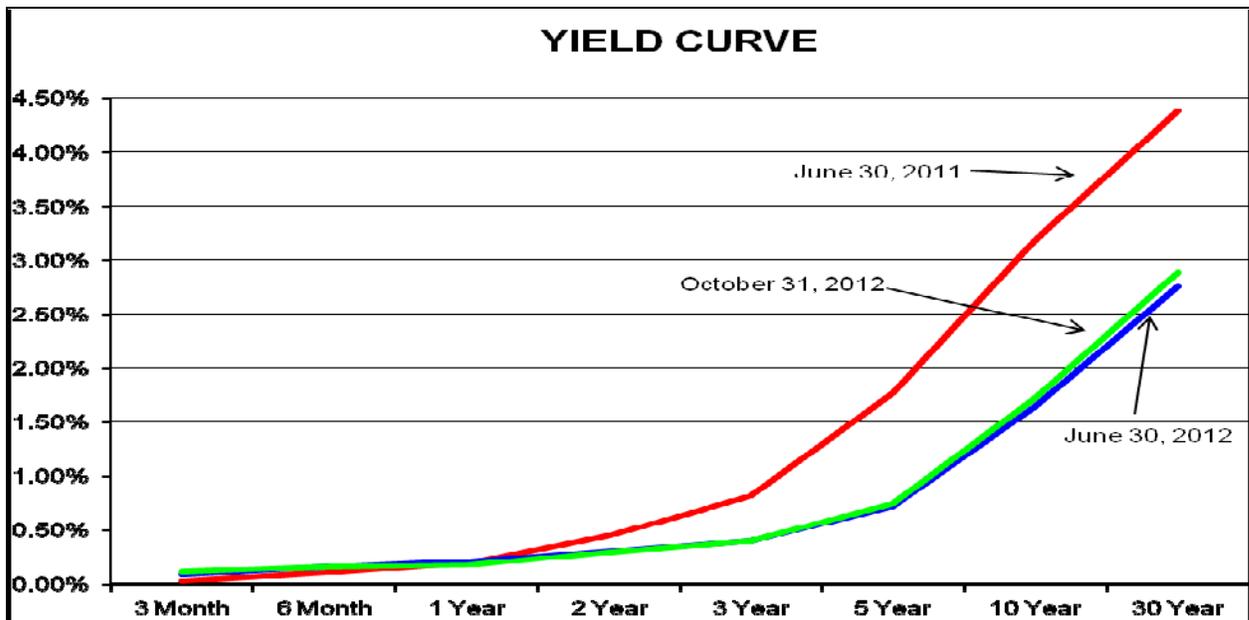
For the fiscal year ending June 30, 2012, I am pleased to report that the investment pool managed by the Bremen Township Treasurer's Office generated \$758,944 in interest earnings to the school districts serviced by this office. With an average investment portfolio of \$110,051,336 the cash basis rate of return for all the school districts was 0.69%. The yield on short-term investments continued to be at historical low levels, ranging from 0.01% to 0.07% during the fiscal year. Overall, the average yield on pooled funds managed by this office for the fiscal year was 0.99% and the average yield on funds that were held for liquidity purposes were 0.13%. The current yield on the portfolio as of June 30, 2012 is 0.79%, which represents the annualized current rate of return on June 30th. The rate of return produced by the pooled funds compared favorably with that of other investments available in the market as shown in the following chart:



The average yield from the Illinois School District Liquid Asset Fund (ISDLAF) for the same time period was 0.01%, the three month Treasury Bill was 0.04%, the six month Certificate of Deposit earned 0.47%, and the three year Treasury Note averaged 0.43%.

INTEREST RATE TRENDS DURING FISCAL YEAR 2012

Interest rates remained at historically low levels throughout the 2012 fiscal year. Short-term interest rates remained at near-zero percent and longer-term interest rates continued to decline to historically low levels. The following graph illustrates the yield curve on June 30, 2012 as compared to June 30, 2011. Included in the graph is the yield curve on October 31, 2012, which reflects a yield curve that has remained basically unchanged since June 2012.



Over the past year, the yield curve has flattened, as short-term rates remained unchanged, while longer-term rates fell. During the fiscal year, yields on the three-year Treasury Note decreased 41 basis points, from 0.81% to 0.40%, yields on the ten-year Treasury Bond decreased 153 basis points, from 3.18% down to 1.65%, and yields on the thirty-year Treasury Bond decreased 163 basis points, from 4.38% to 2.75%.

Short-term rates are primarily impacted by statements made, and actions taken, by the Federal Reserve. During the fiscal year, the Federal Reserve revised its stated policy of keeping short-term interest rates low and extended the target date of such policy to at least mid-2015. The purpose of such action is to stimulate an economy that has seen little signs of growth over the past several years.

Longer-term rates are driven more by perceived inflation and global credit demand. While inflation increased from 1.5% to 3.0% in 2011, there were four distinct one-off factors that combined to produce higher inflation: (1) a spike in oil prices due to Arab spring; (2) increased car prices relative to the Tsunami in Japan; (3) higher food prices resulting from poor U.S. corn yields and (4) higher apparel prices resulting from a spike in cotton prices due to floods in Pakistan.

Absent a severe disruption in crude oil supplies, or a disorderly breakup within the Eurozone, many economists see inflation moderating, with consensus inflation figures at slightly below 2% for the foreseeable future. The lower expected inflation levels explain, to some extent, the decline in longer-term interest rate levels.

Most professions conclude, however, that long-term interest rates are currently being driven by global demand. Investors have been willing to accept these extraordinary low rates, due to an increasing wariness of a global financial meltdown, most likely emanating from Europe. There are also major concerns about the impact of the U.S. “fiscal cliff”, a political instability in the Middle East, and a slowdown in economic growth in China. These meltdown fears, even if remote, directly raise the premium that savers are willing to pay for bonds that they perceive as the most reliable, causing interest rates to drop. Despite the challenges facing our Country, the United States is still perceived as one of the safest countries to invest funds.

The major issue that will likely impact the direction of interest rates on future investments purchased by the pool funds will be the timing and magnitude of an economic recovery. Interest rate levels will likely not increase until a sustainable economic recovery is achieved. The Federal Reserve has pumped significant money into our economy and has taken action to maintain near-zero interest rates to accomplish this objective. Economists have described this strategy as an attempt to reach “escape velocity”, a three-stage process where fiscal and monetary stimulus spurs business investment which leads to employment and income growth, which fuels increased consumer demand. Economists are looking for data that will show that “escape velocity” has hit a speed beyond fits-and-starts and into durable recovery.

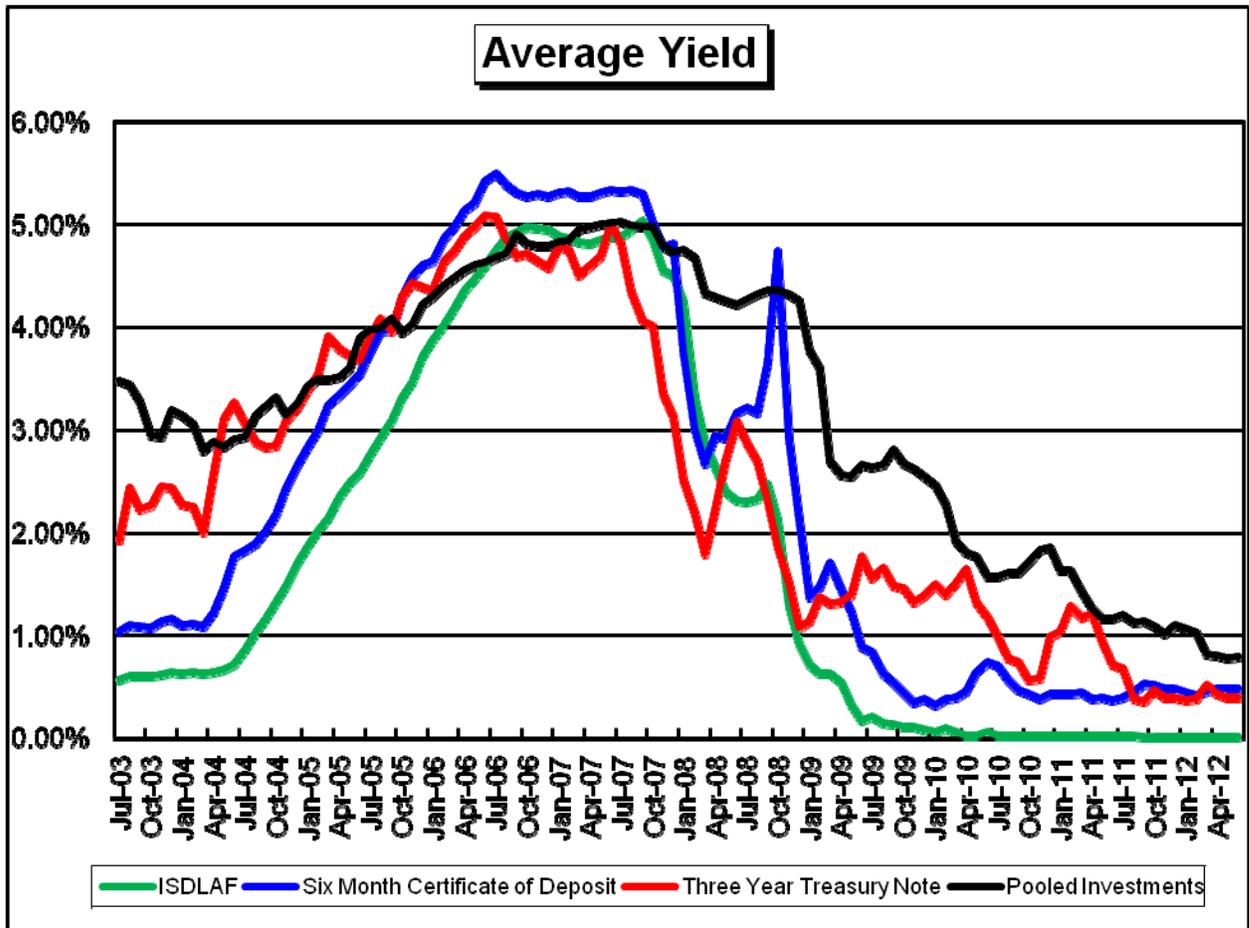
The trouble is that, even three years after the end of the last recession, our Country does not appear to be getting closer to getting there. There are some obvious reasons why the American economy continues to stall, including fears over Europe and the so-called “fiscal cliff”. Other factors, however, continue to generate headwinds that are slowing down the velocity needed to turn this economy around. The United States economy continues to be dragged down by historically high unemployment rates, a real estate market that is showing little signs of life, huge debt levels and uncertainties in major areas such as tax rates, regulation and the effects of Obamacare, which are causing job creators to hesitate before making decisions regarding hiring new employees and risking additional capital needed for expansion.

As we head into 2013, there are many conflicting indicators to consider and monitor. Whether we are entering into a period of limited economic growth or another recession, it is likely that interest rates will continue to be at historically low levels, for at least the next fiscal year.

Putting the change in interest rates over the past few years in perspective, the following summarizes the approximate short-term rates available in the marketplace for investing Fall real estate tax collections:

	<u>Investment Rates</u>
Fall of 2007	3.80% - 4.50%
Fall of 2008	1.00% - 3.00%
Fall of 2009	0.10% - 0.80%
Fall of 2010	0.02% - 0.40%
Fall of 2011	0.02% - 0.20%
Fall of 2012	0.01% - 0.15%

While interest rates have fluctuated dramatically over the past several years, the yield on the pooled funds investment portfolio has remained relatively stable. The following graph reflects interest rate patterns on the pooled funds and other investment vehicles over the past ten years and illustrates the stability of our pooled funds both in times of decreasing and increasing interest rate environments:



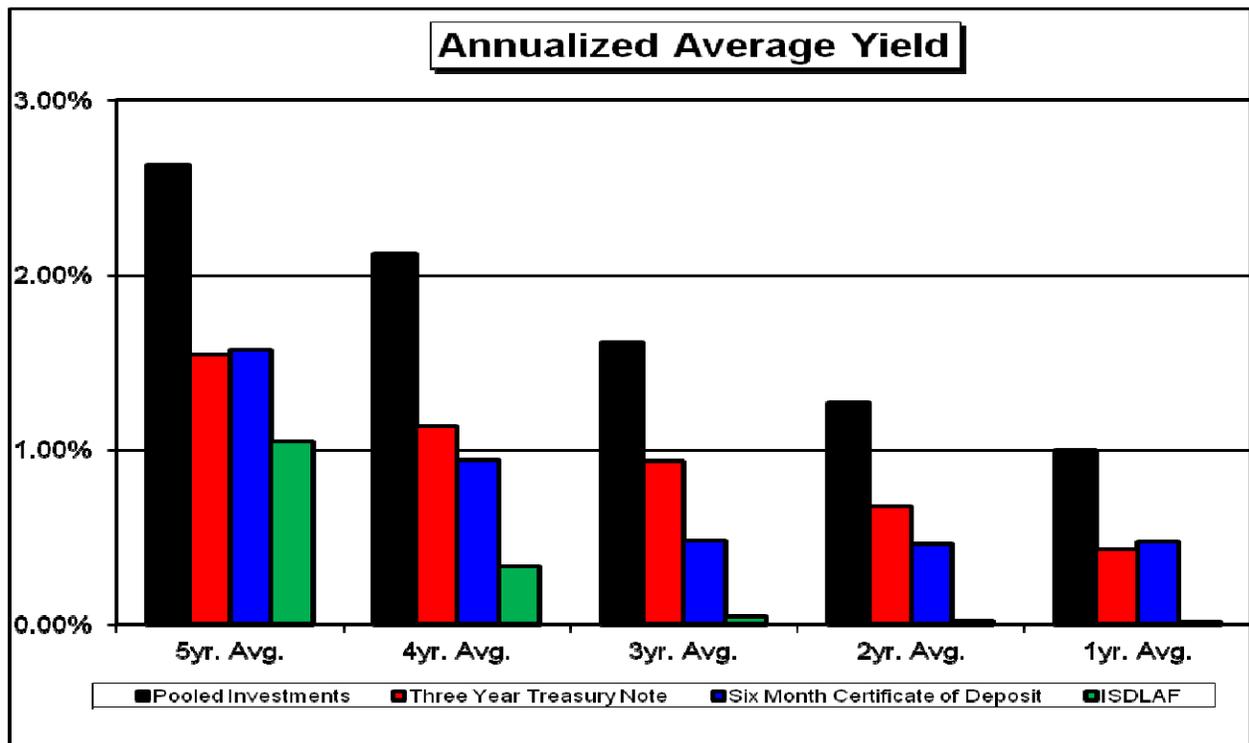
In analyzing the relative stability in the weighted average yield of the pooled investments, it is important to note that this is not a stagnant portfolio where rising interest rates have no benefit to our pooled fund holders. We receive in excess of \$242 million in revenues annually into the pooled funds. While our core portfolio is affected adversely by rising interest rates, this same rise in rates provides us the opportunity to invest new funds at higher rates of interest. The reverse is true in times of declining rates. While the value of our portfolio rises, new revenues are invested at lower rate levels, driving down the yields. As a result, our returns are less volatile during both rising and decreasing rate environments.

CURRENT STRATEGY

Since a significant percentage of the funds received by this office must be invested to meet short-term cash flow needs, interest rate direction is not the primary factor in investment decisions. It is important, however, to consider current interest rate conditions, yield curves and future interest rate trends in determining the overall desired duration of the portfolio.

Cognizant of the fact that we are in the midst of an extraordinary time of economic crisis and credit turbulence, we continue our strategy of maintaining liquidity and preserving capital with very low tolerance for risk. Since the Spring of 2008, nearly all revenues have been invested at the shorter end of the yield curve and our emphasis has been predominantly on safety and taking advantage of new government guarantees and assurances in making investment decisions. We anticipate that we will continue to keep the portfolio in the shorter end of the yield curve in the near future as we monitor how the bond markets react to the many challenges facing our economy.

A major benefit of pooling funds for investment purposes is the ability to invest in longer term maturities that enhance the yield on the portfolio. Although most of our investments have been in the shorter end of the yield curve, the flexibility to invest in longer term maturities has proven beneficial to the investment pool. This strategy has consistently allowed the pooled funds to compare favorably to other investment alternatives. As seen in the following graph, the five-year average interest rate yield on the pooled investments of 2.63% has outperformed all other investment vehicles presented below. The five-year average yield on the three-year Treasury Note was 1.54%, the six-month CD was 1.57%, and the ISDLAF was 1.04%. The higher five-year average interest rate yield on the pooled funds of 1.59% above the ISDLAF average rate has generated over \$5.5 million of additional interest earnings over the five-year period. This higher interest rate yield is primarily due to our strategy in managing the pooled investments.

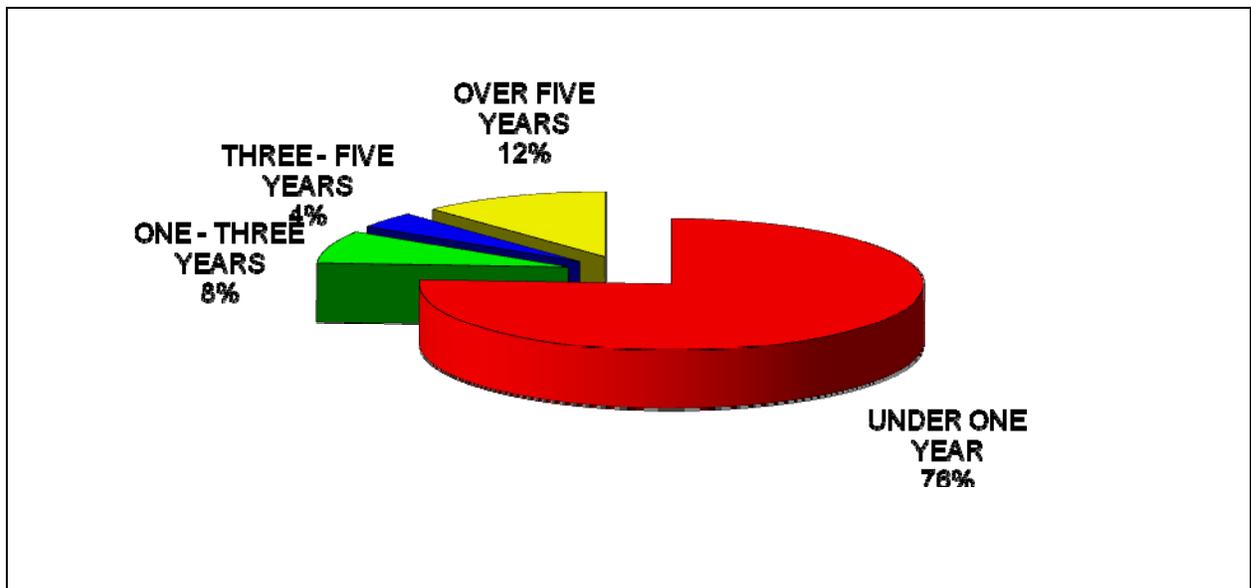


While risk in the credit markets seems to have diminished since last fiscal year, we still respect the uncertainty that exists in the near future. We are concerned about the possibility of either an unintended prolonged run of increased inflation (and interest rates) or, conversely, a double-dip recession and its potential impact on the credit quality of many assets within the fixed income markets. We will continue to strongly weigh all investment decisions towards maximum safety and liquidity until we are confident in the overall direction of our Federal, State and local economies.

CURRENT PORTFOLIO

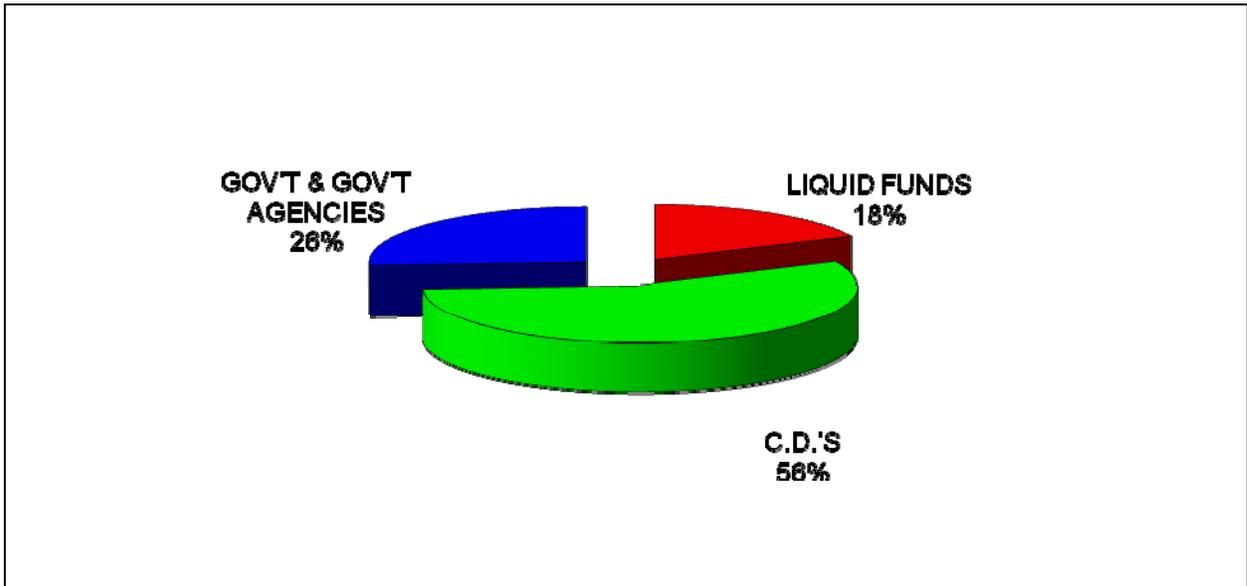
Over the past fiscal year, we have continued to maintain a significant position in the shorter end of the yield curve, due to the unprecedented uncertainty in market risk and uncertainty in revenue collections to the districts. As can be seen in the graph below, we continue to maintain a significant percentage of the portfolio maturing in under one year at 76% of the portfolio. This is mainly due to cash flow needs, resulting primarily from delays in State funding and real estate tax revenues in Cook County. The majority of our investments are being placed in CD's, with investment levels within FDIC insured maximum levels at each bank. From a cash flow perspective, we need to ensure that sufficient funds are available to meet district cash flow needs, with the understanding that there exist many cash flow uncertainties to school districts. In fact, the revenue stream from State and local sources is as uncertain as ever.

The following graph reflects the allocation of the portfolio by expected maturity date on June 30, 2012:



As mentioned previously, although funds received by this office must be invested to meet short-term cash flow needs, we have a portfolio that gives us the opportunity to consider current interest rate conditions, yield curves and interest rate trends in determining the overall desired duration of the portfolio. As of June 30, 2012, these indicators implied the use of a more liquid portfolio, which would afford us more flexibility in implementing our investment strategy.

Not only is diversification of maturities essential to the performance of the pool, but diversification of investment types is equally important. Diversification not only minimizes the risk in the pool, but also allows us the ability to consider the entire investment arena in determining which investments will maximize yields while emphasizing safety. As of June 30, 2012, the pooled funds of Bremen Township consisted of approximately 100 different investments that are monitored daily. The following pie chart reflects the investment composite of the pooled funds as of June 30, 2012:



As can be seen from the pie chart above, 26% of the pooled funds were invested in government/government agency obligations, 56% in C.D.'s and 18% in liquid funds. The higher than normal balance in liquid funds was due to the delay in State revenues and local property taxes. Our percentage of C.D.'s has increased, due to the shifting of liquid funds into higher earning investments. Our percentage of government/government agency obligations has decreased, mainly due to callable government agency securities being called as a result of the continued low interest rate environment. However, we remain active in the callable government agency securities market, which gives the pooled funds the credit strength of U.S. Government backed securities, with a higher rate of return.

There are five major categories of investments available to the pool as of June 30, 2012:

- 1) **Liquid Funds** - These comprise funds readily available for withdrawal at any given notice and include regular checking, deposit, and money market fund accounts.
- 2) **Certificates of Deposit** - These are direct obligations of a U. S. bank which are fully insured by the FDIC up to \$250,000 per entity or \$2,250,000 of this pool per banking institution.
- 3) **Banker's Acceptance (B.A.'s)** - Direct obligations of United States banks which are members of the FDIC. The banks must achieve size and profitability requirements in order to be eligible for investment.
- 4) **Commercial Paper** - Commercial paper is a direct obligation of United States corporations having more than \$500 million in assets. The maturity of such obligations must be less than 180 days. The corporations must also be rated in one of the three highest categories by the major rating agencies.
- 5) **Government and Government Agency Guaranteed and Collateralized Obligations** - These are investments that are guaranteed by the U. S. Government or its agencies. This also includes investments in which government/agency collateral has been pledged, as well as municipal bonds that are either insured or at the highest of rating categories.

INVESTMENT POLICY

The following is a list of various policies that are followed by the Bremen Township Treasurer's Office when implementing its investment decisions:

MAXIMIZING INTEREST REVENUES

I. In order to maximize interest revenues on the funds received by this office, it is essential that all revenues earn interest as soon as this office receives them. We have streamlined our communications with the county, the state and the brokers we deal with to ensure that funds due to the districts are received promptly by our banks. We have increased the use of wiring funds wherever possible, rather than dealing with checks that greatly reduce interest earnings. At the same time, we have established agreements with the banks that service our office to allow us to earn interest on the funds on the same day that the wire is received.

II. Through the pooling of revenues of eight school districts serviced by this office, we have the ability to invest in \$1,000,000+ blocks. This allows the districts' funds to be invested in instruments that would not otherwise be available in smaller lot sizes. Also, investing in \$1,000,000 lots often gives us the ability to earn higher yields than if investing in smaller lot sizes.

III. The Treasurer's Office works with several different brokers who have access to investments throughout the country. This allows for more thorough investment decisions to be made.

IV. Although local banks may offer rates that are slightly lower than rates offered by other institutions, consideration is given to those local institutions which provide needed assistance to our school districts.

V. The Treasurer's Office consistently updates cash flow projections to allow pooled funds to be invested at higher yields for the longest duration possible. The balance in the liquid funds is targeted to be around 5% of the total pool.

VI. The Treasurer constantly monitors the investment and economic arena working with both fundamental and technical analysts in order to determine when investments should be purchased and sold, as well as to determine the desired weighted average maturity of the portfolio.

MINIMIZING RISK

I. All funds invested by the Treasurer's Office are invested pursuant to the Public Funds Act of the Illinois Revised Statutes and all legislation that has affected such act.

II. When Certificates of Deposits are purchased by this office, the CD's are designated as "multiple taxpayer ID deposits" to ensure that the purchase is within the aggregated FDIC insurance limits of this office, which is \$2,250,000. If this is not sufficient to fully insure the investments, the CD's will be collateralized by the banking institution.

SUMMARY

There were two major objectives I had when preparing this report. The first objective was to provide an update to the administration and board members on the investment performance of the school districts' funds during the fiscal year ending June 30, 2012. The second objective was to assure the districts that all revenues, which are received by this office, are closely managed and to provide a partial list of the strategies, procedures and policies used by this office in order to ensure maximum investment performance of these funds.

We have been annually reporting our fund performance to the school districts we service for the past 17 years. In each of these years, we have performed well compared to all major financial indices we track. During that time, we have returned close to \$61 million in interest earnings to the school districts we service. We take the responsibility of managing your district's funds seriously and know that the partnership we have developed over the years, combined with the inherent value of a pooled funds system and the consolidation of fiscal services, has provided substantial benefits to the taxpayers we all service.

In projecting interest earnings for the upcoming fiscal year, I expect returns on a cash basis to continue to decline for three primary reasons: (1) interest rates are at historic low levels; (2) several of the callable bonds with higher yields have been or should be called during the upcoming fiscal year, and reinvestment of these funds will most likely be at lower rates; and (3) given the current crisis in the economy and great uncertainty in the credit markets, we will continue to invest in short-term conservative investments.

Our plans are to continue to produce this report on an annual basis. I would appreciate any suggestions or comments you may have. As always, if at any time during the year, information pertaining to the investment portfolio is desired, it will gladly be provided.

I thank you for letting us serve your district.

Joseph J. McDonnell
Bremen Township School Treasurer