CMTA
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California Municipal Treasurers Association www.cmta.org

Check electronification comes of age

—by: Veronica Correa-Janssen, CCM, CDM

When the National Automated Clearing House Association (NACHA) instituted the Electronic Check Council (ECC) in 1995, its intent was to make the concept of electronic checks a reality for the financial services industry. This membership group of companies, financial institutions, industry associations and vendors was charged with the development and testing of electronic check services, as well as the rules supporting such applications. They developed the first electronic check product called the re-presented check entry, quickly followed by the point-of-purchase, telephone and, through the NACHA Internet Council, online payments. The newest electronic check application to be developed is the Accounts Receivable Conversion (ARC) ability to convert eligible consumer remittance checks into Automated Clearing House (ACH) transactions.

Ongoing studies in the United States show declining check volumes. The 2003/2004 Study of Consumer Payment Preferences conducted by American Banker's Association and Dove Consulting found that consumers used cash and check for in-store purchases 47 percent of the time in 2003 as compared to 57 percent in 1999 and 51 percent in 2001. Credit card, debit card and ACH now account for over half of all noncash payments. Retailers and billers continue to seek productivity gains and cost reductions in consumer transactions by promoting the consumers' use of electronic payments. As an example, the Study of Consumer Payment Preferences showed that recurring bill payment by

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Dear Plan Administrator, who is watching your funds?

If a tree falls in the forest and no one is there to hear it, does it make a sound? Such is the age-old argument. But if a mutual fund performs poorly and no one is there to watch it, it still performs poorly. And there is little argument.

So what is a plan administrator to do?

What is your provider's fiduciary responsibility? More importantly, what is your fiduciary responsibility? These questions are worth asking. Let me attempt to provide a few answers. As for the tree in the forest, however, I'll leave that to the philosophers.

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CMTA 2004-2005 Officers

PRESIDENT
Bill Gallardo, CCMT
Brea, CA
Tel: (714) 671-4418
Fax: (714) 671-4484
billga@ci.brea.ca.us

PRESIDENT-ELECT
Vacant

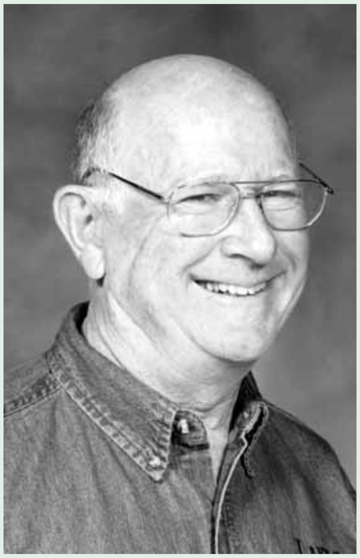
VICE-PRESIDENT
Victoria Beatley, CCMT
Costa Mesa, CA
Tel: (949) 574-1022
Fax: (949) 574-1035
vikkib@mesawater.org

SECRETARY
Christine Vuletich, CCMT
Folsom, CA
Tel: (916) 355-7297
Fax: (916) 985-0870
cvuletich@folsom.ca.us

TREASURER
Maureen Lennon, CCMT
Pacifica, CA
Tel: (650) 738-7395
Fax: (650) 738-7411
lennonm@ci.pacifica.ca.us

PAST-PRESIDENT
Shari L. Freidenrich, CCMT
Huntington Beach, CA
Tel: (714) 536-5200
Fax: (714) 374-1605
freidens@surfcity-hb.com

PARLIAMENTARIAN
Karen Hornung, CCMT
San Bruno, CA
Tel: (650) 616-7061
Fax: (650) 876-0256
khornung@ci.sanbruno.ca.us



Michael Prandini
President

President's Farewell...

It was with mixed emotions that I resigned as President of this great organization. I will miss all the great people who have contributed to make the CMTA what it is today. After 33 years with the City of Clovis, an opportunity arose that was just too good to pass up. As a result, I have retired from the City effective September 1 and have taken the position of President and CEO of the Building Industry Association of the San Joaquin Valley. As part of my retirement I also had to retire as City Treasurer. I leave the Board knowing that it is in capable hands. You have a very good Board and they will work for the interest of CMTA.

Note: At the September Board Meeting, the Board of Directors voted to have the current President-Elect, Bill Gallardo, fill the vacated President's position for the remainder of the term. The President-Elect position will remain vacant and the rest of the Board Officers will remain in their current positions.

Check electronification...

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check has fallen from 72 percent to 60 percent and the use of debit cards in 2003 has increased more than 20 percent over 2002. Data from the Federal Reserve Board's Survey of Consumer Finances shows households across most age and income categories are adopting basic electronic payment methods – all following the United States government's lead as they implement Electronic Benefit Transfer (EBT) programs, Electronic Federal Tax Payment Systems (EFTPS), and more recently point-of-purchase and ARC initiatives.

With the shift in payment channel usage from paper to electronic, and the corresponding shift in consumer attitudes and behavior, it is essential to have the tools in place to respond to these fundamental shifts in technology to ensure efficiency, safety and security. It is also imperative to have a robust system that provides processing continuity even in disasters, be it natural, such as extreme weather, or man made, such as September 11. Important legislation recently passed by the United States Congress is The Check Clearing for the 21st Century Act, also known as Check 21.

Check 21 – allowing depository institutions to take images of all checks, truncate any original check and present a substitute check – paves the way for banks to apply new technologies and market-based ideas to traditional check payment activities. For the first time, technology and legislation have converged to enable businesses to experience a variety of benefits, as banks become image enabled. Soon, businesses will be able to deposit all of their checks electronically. Up until recently, paper checks drawn on business accounts, the United States Treasury, credit cards, and a number of other checks were not eligible to be converted into ACH transactions. Check 21 closes this gap by allowing banks to accept electronic check images for all checks, as well as providing flexibility to the financial institutions in their choice of payment clearing mechanisms. For the first time, electronic check deposits can be made without checks to follow.

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Check electronification...

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More importantly, the potential exists to clear or settle a majority of checks via the ACH network. While at first, ineligible ACH check transactions will continue to be cleared in paper form through image replacement documents (IRDs), IRD processing will provide the necessary business drive to propel the exchange of electronic images between banks for the remaining check volume.

To this end, the banking industry has made, and continues to make significant investments in a number of check electronification initiatives that address the technological and operational opportunities and challenges surrounding the payment industry.

Lastly, creative minds within the industry are applying new legislation and advanced technology to create entirely new-to-the-world payments value propositions and products that make it possible for businesses to take advantage of the benefits check conversion and check truncation ultimately create.

- Banking now has the potential to be unbound by geography. Businesses will be able to make check deposits directly into their concentration accounts as opposed to the nearest local bank.
- Float assessments and calculations will also become geographically independent as image exchange becomes an every day virtual check-clearing pattern.
- By converting consolidated electronic deposits into a single depository account and/or a single depository institution, businesses will consolidate electronic returned item processing. Databases will be updated many days earlier than they are today in the paper environment, and reduced risk of check fraud losses are likely as potential fraud will be identified earlier. Collection activities can also begin earlier.
- Payments-related data streams will be concentrated and provided by fewer sources making banking interfaces simple matters.
- The need for physical transportation of paper checks will be eliminated, potentially extending the processing day for businesses and providing later cut-off times and earlier access to posting of financial position information.
- As image exchange becomes mainstream, real time posting of transactions will be demanded, and more significantly, real time information will be available for businesses to leverage.

Check electronification is indeed bringing about a banking industry metamorphosis. This is only a brief glimpse of what the future may be like in the payments industry, a future with unlimited potential.

Article submitted by:
Veronica Correa-Janssen, CCM, CDM
Senior Vice President & Manager
Treasury Management Product Development & Segmentation, U.S. Bank
Minneapolis, MN 55402-7202
Phone: 612-303-7301

Division Chairs

I
Janice Erickson Stillings, CCMT
San Diego, CA
Tel: (619) 686-6519
Fax: (619) 686-6480
jestillings@portofsandiego.org

II
Mary Kobus
El Segundo, CA
Tel: (310) 524-2310
Fax: (310) 640-2543
mkobus@elsegundo.org

III
Greg Wiles
Fresno, CA
Tel: (559) 621-7004
Fax: (559) 488-4636
greg.wiles@ci.fresno.ca.us

IV
Robert "Bob" Begun
Capitola, CA
Tel: (831) 475-5629
Fax: (831) 479-8879
rbegun@sbc global.net

V
Linda Lorenzetti, CCMT
Concord, CA
Tel: (925) 671-3183
Fax: (925) 671-3198
linda@ci.concord.ca.us

VI
Shaun L. Farrell, CCMT
Galt, CA
Tel: (209) 366-7144
Fax: (209) 745-2253
sfarrell@ci.galt.ca.us

VII
Marie Bernardo
Hillsborough, CA
Tel: (650) 375-7406
Fax: (650) 375-7475
mbernardo@hillsca.org

IX
Christine Calderon
Santa Ana, CA
Tel: (714) 647-5440
Fax: (714) 647-5304
ccalderon@ci.santa-ana.ca.us

X
Deborah Sousa
Apple Valley, CA
Tel: (760) 240-7000Fax: (760) 247-3885
dsousa@applevalley.org

Committees

EDUCATION
Dale Belcher, CCMT
Oxnard, CA
Tel: (805) 385-7810
Fax: (805) 385-7836
Dale.belcher@ci.oxnard.ca.us

LEGISLATION
Vince Amado
Rocklin, CA
Tel: (916) 624-2424
Fax: (916) 624-0969
vincea@ci.rocklin.ca.us

GENERAL CONFERENCE AND SITE SELECTION
Adair Most, CCMT
Victorville, CA
Tel: (760) 955-5060
Fax: (760) 245-6646
amost@ci.victorville.ca.us

CERTIFICATION
Michael Reynolds, CCMT
Redlands, CA
Tel: (909) 798-7544
Fax: (909) 792-6623
mreynolds@cityofredlands.org

MEMBERSHIP/BUDGET
See Treasurer

NEWSLETTER/PUBLIC RELATIONS
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STANDING RULES /BY-LAWS
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LEAGUE LIAISON
Fran Medema
Sacramento, CA
Tel: (916) 658-8218
Fax: (916) 658-8240
medemaf@cacities.org

COMMERCIAL ASSOCIATE LIAISON
Ray Higgins
La Jolla, CA
Tel: (800) 716-6510
Fax: (858) 720-9766
ray@higginscapital.com

2005 CONFERENCE
San Diego, CA
April 18-22, 2005

Strategies for finding value in today's market

—Nancy Jones, Managing Director
PFM Asset Management LLC

—Richard Babbe, Senior Managing Consultant
PFM Asset Management LLC

In times of change, it is very important that finance directors and treasurers consider whether their current investment approaches are likely to be productive going forward. Now is such a time: the interest rate environment is changing, with rates having risen to two-year highs. A continuing rise in interest rates will have some negative effects on portfolios—the market value of existing securities will decrease—but it will create opportunities for portfolio improvements—allowing new money to be invested at higher yields.

What investment strategies, then, can investors use to take advantage of this opportunity? In a changing rate environment, strategies that seek to "find value" are likely to be successful. But what does it mean to find value? Rather than selecting investments simply according to yield, a value-minded investor seeks to determine the best balance between risk and return from the available investment options. For example, as of May 11, 2003, a two-year U.S. Treasury was yielding about 2.59 percent while a five-year U.S. Treasury was yielding 3.91 percent. Though the longer-term security clearly offers the higher yield, it may not represent the best value due to the underlying risk characteristics. This article focuses on two strategies that address the balance between yield and interest rate risk: yield curve analysis and duration management.

Current Economic Conditions

After remaining near 45-year lows for 2003 and for the first months of 2004, interest rates have moved sharply higher on signs of a growing economy. U.S. Gross Domestic Product (GDP) grew at a rate of 4.1 percent for the fourth quarter of 2003 and 4.2 percent for the first quarter of 2004. Employment figures, which had been lagging for most of the recovery, are showing signs of improvement. Both the March and April employment reports came in well above expectations. This has raised expectations that the Federal Reserve might soon start raising the overnight federal funds rate, which has been at 1 percent since June 25, 2003. While the Federal Reserve left rates unchanged at its April meeting, in its May 4, 2004 release, the committee removed the statement that it could be "patient" in raising the federal funds rate. On expectations that this was an indication that the Federal Reserve will soon be increasing rates, intermediate- to longer-term interest rates have risen sharply. The two-year U.S. Treasury yield on May 11, 2004 was at 2.59 percent, up from 1.46 percent at the end of March.

While it is important to consider current and expected market conditions in managing a portfolio, the starting point for any investment decision always should be a thoroughly and carefully conceived investment plan. Safety, liquidity, and yield (in that order) should be the primary objectives of the public funds investor. In addition, each investor must take into consideration his or her agency's particular needs, preferences, and constraints.

Yield Curve Analysis

A fundamental principle of fixed-income investments is the inverse relationship between yield and price. When interest rates rise, market values fall. Likewise, when interest rates fall, market values increase. Duration is a measure of a security's or portfolio's interest rate sensitivity, or risk: The magnitude of the interest rate risk increases with the investment's duration. For example, if interest rates were to increase 1 percent instantly, an investment with a duration of one year would lose approximately 1 percent of its market value, and an investment with a duration of five years would lose approximately 5 percent of its market value. In a normal, upwardly sloping yield curve environment, the investor is compensated for the additional interest rate risk of the longer-term security by receiving additional yield.

When selecting among securities with different maturities, an investor needs to evaluate the trade-off between the security's yield and its interest rate risk. This trade-off between risk and return is not linear, but will vary depending on the shape of the yield curve. This can be seen in Figure 1, which illustrates the yield curve on May 11, 2004. By increasing the term of an investment from one year to two years, an investor picks up an additional 82 basis points (0.82 percent) in yield. However, by extending the term

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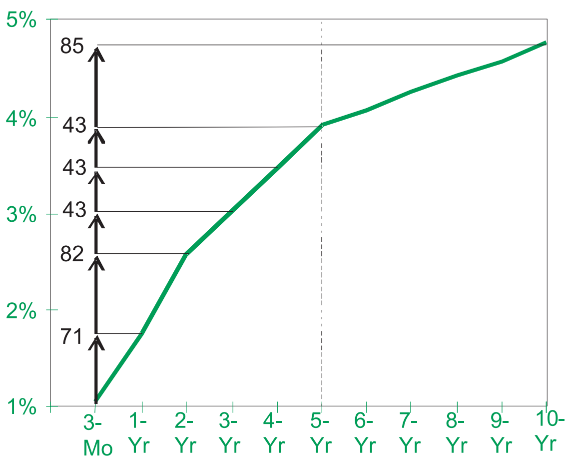
of the investment for an additional year—from two years to three years—the investor picks up only an additional 43 basis points (0.43 percent) in yield despite taking on a similar increase in interest rate risk. From this standpoint, the two-year investment offers more return relative to its interest rate risk. Rather than simply selecting the investment with the highest yield, the investor should look at the yield curve to determine which investment offers the best relative value consistent with his or her overall investment objectives.

Figure 1

U.S. Treasury Yield Curve
May 11, 2004



Source: Bloomberg

The determination of relative value will vary depending upon expectations of future interest rates. In the current interest rate environment with rising interest rates, the investor may give more importance to minimizing interest rate risk and select a shorter maturity than might otherwise be chosen. Conversely, if the investor expects interest rates to fall, they will discount the interest rate risk and choose a longer-term investment. It is not, however, enough to answer the question "Will market rates rise or fall?" to make the investment decision. Two additional questions need to be considered: "How much will market rates change?" and "When will market rates change?"

With a steep yield curve comes opportunity cost that must be factored into the analysis of an investment. By performing a "break-even" analysis, you can effectively incorporate all three questions into your decision-making process.[1] Let's apply these principles in considering a typical investment choice: should you invest for 12 months at a 2 percent rate, or keep funds shorter in a six-month investment at 1.50 percent? If you believe rates are going to rise, you might consider keeping investments short and therefore favor the six-month investment at 1.50 percent. By performing the break-even analysis, however, you can better gauge how much market rates must change in six months to enable you to equal the 2 percent yield available for the full term. In this case, after a six-month investment matures, you will need to earn at least 2.48 percent for the remaining six months to match the earnings you would have achieved by selecting the 12-month investment. So, if you expect six-month rates (i.e., the interest rate six months from now) to exceed 2.48 percent, then the six-month investment is appropriate. Conversely, if you believe 2.48 percent will be difficult to obtain, then the 12-month investment should be selected now.

The yield curve analysis focuses on determining the best relative value of an individual investment. However, each investment decision impacts the portfolio as a whole. The next step is to evaluate investment decisions from the perspective of the overall portfolio through duration management.

Duration Management

Historically, a portfolio's duration will have the greatest impact on a portfolio's performance over time. The longer a portfolio's duration, the greater its expected return. For example, over the past ten years the Merrill Lynch 3-5 Year U.S. Treasury Index with a duration of 3.8 years had an annualized return of 6.58 percent compared to only 4.43 percent for the Merrill Lynch 3-month U.S. Treasury Bill Index with a duration of 0.16 years. While longer duration portfolios generate higher ex-

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1 "Break-even" analysis is a method of analyzing investments to determine under what conditions the returns of different securities would be equal. "Gap analysis" is one form of break-even analysis, which compares an investment rate over one term to rates over two consecutive terms that equal in total the single term.

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Direct all correspondence to:

Victoria Beatley, CCMT
Costa Mesa, CA
Tel: (949) 574-1022
Fax: (949) 574-1035
vikkib@mesawater.org

Design by:
Donaghu Graphic Designs
(925-937-8283)
fdonaghu@aol.com

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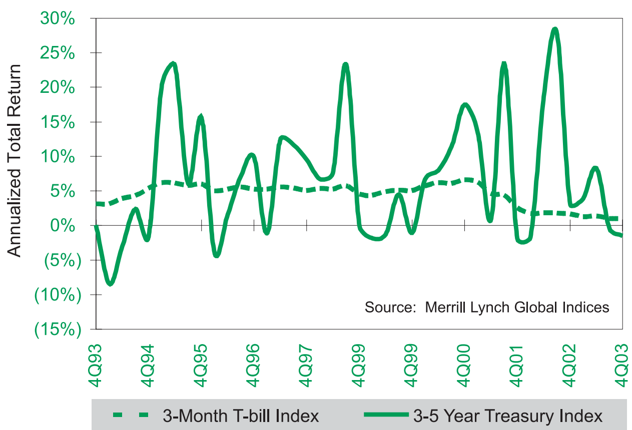
pected returns, they also have a higher exposure to interest rate risk, and consequently much greater volatility.

Figure 2 compares the quarter-by-quarter total returns (i.e., income plus or minus any market value changes) of the Merrill Lynch 3-5 Year U.S. Treasury Index with the Merrill Lynch 3-month U.S. Treasury Bill Index over the past ten years.

Figure 2

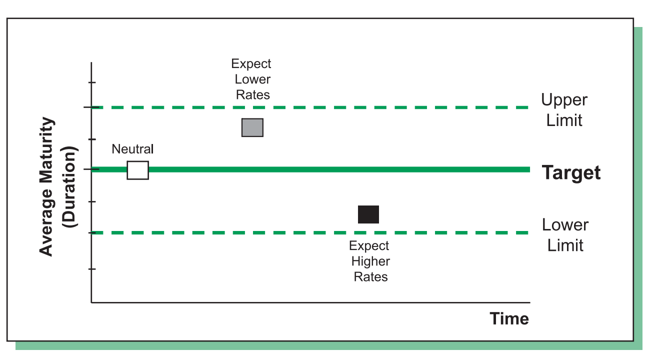
Comparison of Annualized Quarterly Returns
for Selected Benchmarks
12/31/93 to 12/31/03



A target duration should be selected based on what duration provides the best overall balance between risk and return consistent with an agency's cash flow requirements and investment preferences. Using the target duration as a starting point, a portfolio's return can be enhanced and risks reduced by how the portfolio's duration is managed relative to the interest rate environment. For example, in the current environment with rising interest rates, shortening the portfolio's duration relative to the target duration can reduce a portfolio's interest rate risk and market value depreciation. Conversely, in a falling interest rate environment an investor can lock in rates and capture additional market value appreciation by extending the portfolio's duration relative to the target duration. Figure 3 illustrates this concept, showing how a portfolios average duration may change over the course of time as interest rate expectations change.

To achieve the best long-term performance, the objective is to maintain good investment discipline and make only small adjustments within a preset duration band of perhaps 20 percent plus or minus from the target duration. For example, if interest rates were expected to rise, shortening the portfolio's duration to 90 percent of the target duration would represent a modest reduction of the portfolio's interest rate risk while providing some flexibility to extend maturities after yields rise, enabling the agency to lock in higher rates. If the market does not move as expected and rates actually decline further, the agency will then have the flexibility to sell securities at a gain and shorten the portfolio to 85 percent of the target. However, shortening the portfolio's duration to 50 percent of the target duration while further reducing a portfolio's interest rate risk would represent a much larger bet that interest rates will rise. It also would reduce the portfolio's return significantly if interest rates remained stable or fell.

Figure 3



Summary

While risk cannot be eliminated completely from the investment process, its effects can be minimized. To do this, an investor should evaluate each investment choice by determining whether it represents a favorable balance between risk and return, rather than simply selecting investments based on the highest yield. It also is important for an investor to make investment decisions that are consistent with the agency's long-term investment plan. An individual security could offer good relative value, but still not represent a good investment for the portfolio if it raises specific risks such as credit risk or reinvestment risk to an unacceptable level within the portfolio.

While public fund investors should take into consideration current and expected interest rates when making investment decisions, they should keep in mind that there is no way to predict interest rates with any degree of certainty. The best approach to achieving long-term investment objectives is to maintain good investment discipline. By sticking with a well-thought-out investment plan throughout the interest rate cycle, public fund investors are more likely to achieve their long-term investment objectives regardless of changes in interest rates.

Editor's Note: This article appeared in the June issue of Debt Line *which is published by CDIAC and is reprinted with permission.*

Dear plan administrator...

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First, let's discuss the role of the plan administrator. It's a tough job. Investors, young and old, novice and expert have entrusted a good portion of their retirement to you. And your role as plan administrator is to provide them a retirement plan that is priced right, includes funds that perform well financially *and ethically*, and has the services and features your investors want. If you're not sure what they want, you may wish to provide them with a brief survey. Participants' wants and needs do change over time so it's a good idea to periodically survey the group.

A few years back when "irrational exuberance" was the norm, retirement plans added funds quarterly, even monthly. No number of funds was too high. Today, we find that less is more. For many plan administrators, rational fund lineups include no more than a few solid performers from each of the twelve asset classes, which include:

Large Cap Growth	Small Cap Blend
Large Cap Blend	Small Cap Growth
Large Cap Value	Small Cap Value
Mid Cap Growth	International
Mid Cap Blend	Bond
Mid Cap Value	Stable Value

As plan administrator, you should meet with your provider and/or investment counsel at least annually to review the performance of the funds in your plan and overall investment trends. And speaking of your plan provider, let's discuss their fiduciary responsibility.

Many retirement plan providers have internal processes for reviewing, recommending or removing funds. Commonly referred to as "watch lists", your plan provider may have placed certain funds under the watchful eyes of their investment division. Ask your provider if any of the funds in your plan are on their firms "watch list". Furthermore, ask for information on the criteria they use to evaluate the funds they offer and to determine when a fund should be placed on a watch list. In fact, it is important that you understand their process for evaluating funds, determining when a fund is placed on a watch list, how long a fund may remain on the watch list and what changes are needed in order for a fund to be removed from the watch list. You will also want to know how many investment professionals at their organization analyze the mutual fund companies and their funds. How many funds have they proactively removed in the past year due to poor performance or other concerns? How do they notify you when and if they change the fund lineup? How do they notify your employees?

In the past few years the stock market has presented challenges for plan participant, providers and administrators alike. In the boom years, plan providers responded to participant requests by adding a bounty of funds. However, many fund lineups have become stagnant, unbalanced and lackluster. As a result, some plan administrators have developed investment strategies, which define the funds to be offered to plan participants by the plan provider. An investment strategy preserves the fiduciary role of the plan administrator by providing a framework for participant investment choices. Sample investment strategies should be available from your provider or you can get one by visiting http://www.icmarc.org.

So who *is* watching your funds?

With all the changes affecting the stock market, mutual fund industry, and your retirement plans, you cannot do it alone. Your plan provider is there to assist you. Don't be afraid to ask them. Odds are that your full time job is not plan administrator. Odds are that the tree also makes a sound.

If you would like to see how your plan provider stacks up in breadth of quality funds that best meet their clients needs, check out Fiduciary Analytics quarterly report at http://www.investmgt.com or by calling (866) 390-5080.

* "Fiduciary Analytics" rankings only include mutual fund families with five or more funds that have at least a three-year track record. The report being referenced here represents annualized performance as of December 31, 2003. Fiduciary Analytics methodology consists of assigning a "Fiduciary Score," which is the percentile rank of a mutual fund or separate account relative to its peer group for one-year, three-year and five-year performance. Other factors in addition to performance, which are considered and "scored" include assets under management, stability of the organization, holdings consistent with style, correlation to style or peer group, expense ratios/fees and performance relative to assumed risk. Additional information pertaining to Fiduciary Analytics can be obtained at http://www.investmgt.com or by contacting them directly at (866) 390-5080.

** This information is being provided for educational purposes only and is not intended to be construed as or relied upon as investment advice. The ICMA Retirement Corporation does not offer specific tax or legal advice. Individuals are advised to consider any new investment strategies carefully prior to implementing. Please consult both the current Vantagepoint Funds prospectus and MAKING SOUND INVESTMENT DECISIONS: A Retirement Investment Guide carefully for a complete summary of all fees, expenses, charges, financial highlights, investment and trading risks prior to investing any money. Vantagepoint securities are distributed by ICMA RC Services LLC, a broker dealer affiliate of ICMA RC, member NASD/SIPC. ICMA RC Services LLC, 777 North Capitol Street NE, Washington, DC 20002-4240. 1-800-669-7400. VantagePlanning fee based financial planning services are offered through the ICMA Retirement Corporation, a federally registered Investment Adviser. Please consult all disclosure documents prior to initiating any plan. AC: 0304-59.

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2005 CONFERENCE
San Diego, CA
April 18-22, 2005

SPECIAL ANNOUNCEMENT For COMMERCIAL ASSOCIATES

The 2005 CMTA Annual Conference to be held at the Catamaran Resort, San Diego, April 20-22, 2005, will once again provide Commercial Associates the opportunity to participate in a sponsorship consortium to benefit our organization. Because exhibit space will be limited, only those participating as full sponsors will have the opportunity to exhibit. We are providing this early notification so that you may place the conference on your calendar and include it in your budget process.

Sponsorship forms with complete details will be mailed the first week in December and will be processed on a first come, first served basis by mail after January 1, 2005.

SPONSORSHIP - $1850

- ☑ Two (2) conference registrations (value $375 each)
- ☑ Acknowledgement as SPONSOR in the conference schedule, banquet program, on banner, and receive luncheon award
- ☑ Full color logo in Passport
- ☑ A 6’ Vendor table

CONTRIBUTOR - $1050

(Note: NO VENDOR SPACE IN THIS OPTION)

- ☑ One (1) conference registration (value $375)
- ☑ Acknowledgement as CONTRIBUTOR in the conference schedule and banquet program

NON-Vendor SPONSORSHIP - $1800

- ☑ Two (2) conference registrations (value $375 each)
- ☑ Acknowledgement as SPONSOR in the conference schedule, banquet program, on banner, and receive luncheon award
- ☑ Full color logo in Passport
- ☑ Opportunity to place promotional information in conference packet!

Thank you for past participation and we look forward to working with continuing and new participants this year.

Watch for the December mailing. If it doesn’t answer all your questions, you may contact the following Consortium Development Committee members for further information.

Dale V. Belcher
dale.belcher@ci.oxnard.ca.us
Camee Lewis
lewiscl@wellsfargo.com

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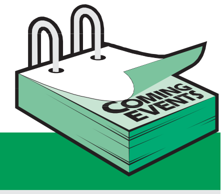
What's Inside....

Calendar of Events



CMTA DIVISION MEETINGS	
Division I	Dates, locations and topics tbd
Division II	Dates, locations and topics tbd
Division III	Dates, locations and topics tbd
Division IV	Dates, locations and topics tbd
Divisions V & VII	**Oct 14:** Chronicle Pavilion, Concord (Division V and joint with the East County Chapter of CSMFO) **Dec 3:** Canterbury Hotel, San Francisco (joint meeting)
Division VI	**Oct 14:** Santa Rosa, 10am. Jean Jackson from U.S. Bank, Mike Avery from RBC Dain Rauscher ,and Ray Higgins from Higgins Capital Management to be speakers. Contact Mary Morris at mmoris@sjwd.org for registration.
Division VII	**Dec 3:** Holiday Luncheon, Canterbury Hotel, San Francisco
Division IX	**Dec 15:** 2004 location and topic, tbd. **Feb 16:** 2005 location and topic, tbd
Division X	**Jan 26, 2005:** City of Corona, 10:00am to 1:00pm, $25 includes lunch. Topics will be announced later.

UPCOMING CONFERENCES/MEETINGS	
Jan 20–22, 2005	Quarterly Board Meeting, Sir Francis Drake, San Francisco
Apr 18–22, 2005	CMTA Conference, San Diego

California Municipal Treasurers Association
c/o Victoria Beatley, CCMT
Mesa Consolidated Water District
1965 Placentia Avenue
Costa Mesa, CA 92628-5008