RESOLUTION NO. 86-003

Adopted by the Administration, Investment
and Fiscal Management Board of the
Sacramento City Employees' Retirement System
on April 21, 1986

A RESOLUTION TERMINATING AGREEMENTS WITH LOOMIS-SAYLES AND CO., INC., RELATING TO FULL OPTION MANAGEMENT AND COVERED CALL OPTIONS

WHEREAS, on February 14, 1986, the Board by Resolution No. 86-001, at item 4, terminated the Agreement between Loomis-Sayles and the System, while leaving intact on an interim basis the covered call program; and

WHEREAS, the City Treasurer by letter dated February 27, 1986 (Attachment "A" hereto) confirmed the Board's action with Loomis-Sayles; and

WHEREAS, the City Treasurer determined on or about March 12, 1986, that immediate termination of the covered call program was necessary, and so notified Loomis-Sayles; and

WHEREAS, in that phone conversation, Loomis-Sayles, through Bill Mullen, its authorized agent, consented to immediate termination; and

WHEREAS, on March 13, 1986, the City Treasurer confirmed that conversation by a letter of that date (Attachment "B" hereto); and

WHEREAS, by written report to the Board on March 14, 1986, the City Treasurer reported his actions (Attachment "C" hereto);

NOW, THEREFORE, BE IT RESOLVED BY THE ADMINISTRATION, INVESTMENT AND FISCAL MANAGEMENT BOARD OF THE SACRAMENTO CITY EMPLOYEES' RETIREMENT SYSTEM that:

1. The Agreement dated August 1, 1983, as amended March 19, 1985, is terminated for all purposes effective March 12, 1986.

2. The acts of the City Treasurer as set forth in Attachment "A" and "B" are hereby confirmed and ratified.

3. The report of the City Treasurer set out in Attachment "C" is approved and adopted.

VICE CHAIRMAN

APPROVED AS TO FORM:

WILLIAM P. CARNAZZO
Deputy City Attorney

ATTEST:

RICHARD E. SNYDER
Secretary to the Board

Attachment A

CI OF SACRAMENTO

FFICE OF THE TREASURER

D. 10TH STREET
ITE 1

SACRAMENTO, CA 95814
TELEPHONE (916) 449-5318

THOMAS P. FRIERY
TREASURER

DONALD E. SPERLING
ASST. TREASURER

February 27, 1986

Mr. William T. Mullen
Vice President, Options
Loomis Sayles & Co., Inc.
5100 Poplar Ave.
Memphis, Tennessee 38137

RE: Options Management

Dear Mr. Mullen:

This letter confirms the Board action taken February 24, 1986 relative to the Covered Call Options Program of SCERS. The Board action taken continued the Covered Call Options Program only and stated the terms and conditions of the August 1, 1983 agreement "relative to Covered Call" which had been terminated on February 14, 1986 would stay in effect until such time the Board executes a new contract with your firm, which is envisioned to occur at the March Board meeting.

I hope this correspondence meets your request to clarify your authority to continue the Covered Call program. Please call if you have any questions.

Sincerely,

THOMAS P. FRIERY, Chairman
AI & FM Board

TPF/lv:options

cc: Bill Carnazzo
Dick Snyder

Attachment B

CITY OF SACRAMENTO

OFFICE OF THE TREASURER

800 - 10TH STREET
SUITE 1

SACRAMENTO, CA 95814
TELEPHONE (916) 449-5318

THOMAS P. FRIERY
TREASURER

DONALD E. SPERLING
ASST. TREASURER

March 13, 1986

Mr. Bill Mullen
Loomis Sayles & Co., Inc.
5100 Poplar Ave.
Memphis, Tennessee 38137

SUBJECT: Confirmation of Termination of Covered Call Program

Dear Bill:

The purpose of this correspondence is to confirm our telephone call March 12 during which I directed you to close off the covered call program that you had been managing under the authority of my February 27, 1986 correspondence (see attached). For your information, I will make a presentation to the Board at our upcoming Board meeting on Monday, March 17, 1986.

As stated, Bill, my concern with the covered call program emanates from the magnitude of potential loss that could be incurred by a program in a significant and/or prolonged upward movement in price of the underlying stocks. In such an environment it appears that the covered call program can erode gains made on the underlying stocks which ultimately retard the income benefit to the Retirement System.

Please provide me as soon as possible with your recapitulation as to the extent of cost and/or loss of the covered call program as of the termination date. For your information, I will be recommending to the Board that we not proceed with a covered call program (as described at the February 14, 1986 Board meeting) at this time and/or until such time as the market reflects a pattern that would be more conducive to such a program.

Please advise if there are any questions.

Sincerely,

THOMAS P. FRIERY
City Treasurer

TPF/lv

Attachment

cc: Dick Snyder
Bill Carnazzo

Attachment C

CITY OF SACRAMEN_O

OFFICE OF THE TREASURER

800 - 10TH STREET
SUITE 1

SACRAMENTO, CA 95814
TELEPHONE (916) 449-5318

THOMAS P. FRIERY
TREASURER

DONALD E. SPERLING
ASST. TREASURER

March 14, 1986

TO: Administration, Investment and Fiscal Management Board

FROM: Thomas P. Friery, City Treasurer

SUBJECT: Termination of Covered Call Program

I wanted to bring to the Board's attention that on March 12 I directed Bill Mullen to terminate the covered call options program and I confirmed this action with correspondence dated March 13 (see attached). By way of background, on March 7, 1986, while working on the proposed new covered call program with Loomis Sayles, I attempted to ascertain the anticipated annual income from such a program to determine the reasonableness of the proposed compensation schedule. In talking to Bill Mullen, the comment was that the covered call program might produce net revenues of between 1% and 3% of the market value of stocks written under a covered call program. On the supposition that $23-25 million would have been authorized for such a proposed new covered call program, such program would have produced annual revenues between $230,000 and $750,000 per year which appeared moderate at best.

However, I asked Mr. Mullen to confirm how much the covered call program already existing would have lost had that program been terminated as of the prior Board meeting, February 24. Bill advised that as of the prior Board meeting, February 24, the loss would have been $1,750,000 as he had reported at that meeting. Further, I asked Bill as of this date what that potential loss would be. Bill advised that had he had to liquidate as of this date the approximate loss would have been $2.224 million. Further discussion with Bill showed that the market valuation had been previously accomplished on February 19 when the DJIA was 1658.26. As of March 7 the DJIA was 1699.83. Therefore, in the period from February 19 through March 7 the broad market average as measured by the DJIA had increased 2.50% (1658.26 to 1699.83), whereas the loss on the covered call program increased 27.5% from $1,750,000 to $2,224,000. Further discussion of this program revealed both the impact of leverage on a covered call program and the potential loss as the market continues in a prolonged upward price cycle.

Bill suggested that he could sell additional options to generate money to buy back existing options that would somewhat reduce the potential for loss (so long as the market ultimately would decline or move sideways). Bill commented that the market should be due for a technical correction. However, in view of what had transpired in the market place I had concluded that with the program currently losing in excess of $2 million, any major correction would at best cause Bill to break even, although that was highly unlikely as, in my opinion, any major decline in the market value of stocks would have triggered sell recommendations by our stock managers which would have forced Bill to buy back in. Instead, I directed Bill to work towards closing out and I established a limit stating that in the event the DJIA were to approach the 1750 level we buy in the program and not risk any further losses. The rationale for this action was that if the market were to move to that level there would have been an increase in the overall broad market average of 3%. Based on the previous price action, that would have had the potential to increase the loss 27.1% from the levels of March 7.

On March 12, 1986, the DJIA hit an interday high in excess of 1750. I called Bill and directed him to close the position out. I confirmed this action formally on March 13. Our preliminary analysis indicates that the loss on the covered call program was approximately $2.4 million which was approximately 9 1/2% higher than March 7 and well below the 27% level that had occurred previously.

At the February 24 Board meeting the Board had approved the concept of developing a contract for a new covered call program and had directed the Treasurer to work with counsel and Bill Mullen for a contract for such a program. This work has been completed. However, it is my recommendation that the covered call contract not be accomplished or authorized at this time. Further, I believe the Board would be better advised to only consider covered call programs when markets are not in the position they have been over the last 12-18 months (basically a straight upward movement). Such a market environment with a covered call program results in the covered call program detracting from any gains on the stocks ~~if~~ as they increase in value. Further, if and when the Board implements such a program in the future, it is imperative that a comfort index measurement be developed so the Board can follow the movement in price of stocks (either up or down) from the options sale date and direct the options manager to close out risky positions or defend to the Board why such position should be continued.

THOMAS P. FRIERY
City Treasurer

TPF/lv:board

Attachment

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