A TEARFUL TIME FOR THE DUKE
The Day John Wayne's Orange County Went Broke

By Jeanne Sinquefield*, Arthur B. Laffer, and L.W. Vitanza

Introduction and Summary

There's a New Year's Eve tradition in parts of California that at the stroke of midnight revelers fire handguns into the night air. I've never seen this happen, except of course in the movies, but the police report that in spite of the exceedingly low probability of any one bullet hitting someone on its descent there are several deaths reported each year. The principle is that no matter how improbable, if the event occurs enough times the unlikely outcome becomes certain. This principle is of the essence for both astrophysics and evolutionary biology as well as economics.

And, carrying the logic a step further, knowledge that a death is a virtual certainty doesn't much help in predicting which specific person is going to die. In the same vein while we surely didn't foresee what was going to happen to Orange County, we did predict that something was going to happen to someone. The fiscal pressures in California are incredible and have been extraordinarily high for the last four and one half years. But even here in California the fiscal pressures have not been borne evenly.

The state raised tax rates in 1990 and 1991 causing a precipitous decline in the state's economy relative to the rest of the nation. But in spite of the economic collapse suffered by the whole state, the state government experienced a lesser revenue decline than did the municipalities because the state government's revenue losses were partially offset by higher tax rates at the state level. For municipal governments the offsets were few and far between. Municipalities did not have the tax rate increases.

Municipalities also suffered more than the state government because the state government stopped sending monies to the cities, counties, and local districts. California's state government has exceptional influence over the funds allocated to cities, counties, and local districts. Following the passage of Proposition 13 in 1978 the state government adopted a program of financial subvention whereby large amounts of funds were transferred from the state's coffers to cities, counties, and local districts. During the last four and one half years of California's economic malaise the state government has chosen to withdraw its financial support to local governments. It is hard to imagine a more burdensome scenario. Given the fiscal stresses and the lack of sophistication you didn't have to be Nostradamus to forecast trouble.

The huge reverse movement of the yield curve that began in late 1993 was a catalytic event for a number of investment portfolios, and Orange County was the first public pool victim. While we can't be sure where the next collapse will occur or even if there is going to be another collapse, we can say that the fiscal pressures in California are still very high. And, if the U.S. economy weakens as we believe it will and if interest rates rise further as we believe they will those fiscal pressures exerted on California and elsewhere will increase.

Additional crises are definitely possible. Investors would be prudent to consider both the likelihood and the implied consequences of additional crises. Other factors such as fraud, leverage, or simply misjudging the market also contribute to financial crises.

It is clear from the public records that former Orange County Treasurer Robert Citron was not some retrograde criminal type. People knew what was in his portfolio and amongst people who were in the know he had both detractors and supporters. Citron had used his basic investment strategy for quite some time and when that strategy had been successful Citron was a hero. What happened to Robert Citron was something that happens frequently in the financial markets; he made a major misjudgment about the market. As a consequence Orange County's investment pool lost a lot of money.

Robert Citron and those responsible for shepherding Orange County's investment pool may well have been extreme in their willingness to accept risk and they also may have been in the lowest echelon of interest rate forecasters. But from all I've seen they did behave within the broad guidelines of their charter. The Orange County investment pool collapse was a consequence of economics and the financial realities of the times.

Any attempt on the part of the press or anyone else to lay the primary blame for the Orange County pool's losses on Citron's illegal or fraudulent behavior is just not accurate. The collapse was not a consequence of fraud, theft, or other such illegal acts. If Citron or others are charged with crimes those charges will be based on legal technicalities and not on premeditation to defraud or fraudulent intent.

A Note of Optimism for Constructive Change

When an event is bad enough to dislodge received comfortable myths, major benefits can emerge. It was the fiscal crisis of the late 1970s that ultimately resulted in Proposition 13 and the Reagan supply side revolution. It took a lot of suffering and a lot of hardship to make the case against high taxes and a weak dollar. But the case was made and the prosperity of the 1980s ensued. There's a general principle that sometimes, after all other possible courses of action have been tried, the right thing will be done. Maybe the examples of Orange County, Mexico, the devastation of some hedge funds and the Republican sweep of Congress will ignite just such a change once again. The opportunity for doing things differently is ripe and it is our view that the changes are imminent. Orange County's troubles may well turn out to be a blessing in disguise.

Tax increases are tremendously unpopular everywhere, but especially in Orange County. Any serious attempt to raise taxes in Orange County would immediately be met by the electorate voting the tax increasers out of office. John Wayne country isn't friendly to revenuers.

Governor Wilson also has fiscal problems of his own and every chance he gets he distances himself from the Orange County crisis. Goodness knows the circumstances surrounding the Orange County crisis don't elicit great sympathy in Washington D.C. either. The earthquake in Los Angeles could pull on people's heartstrings but Citron's ill-fated investment strategy seems an unlikely tear-jerker. And, with the new breed of cost-conscious Republicans in charge it is a stretch of the imagination to foresee any major federal aid package for Orange County. All in all Orange County will have to deal with the bankruptcy and losses in the Orange County investment pool. And, the results of having to be held responsible for one's own actions may well be good news.

Orange County has been put into the enviable position of actually having to come to grips with local government spending. Their credit card has hit its limit. This type of budget constraint is exactly the catalyst for Orange County and the surrounding local spending jurisdictions to reevaluate just what is and what is not needed.

In my best judgment Orange County will soon become the nation's leader in privatizing public services and the selling of non-essential public assets. John Wayne airport is a natural for a sale to private interests and believe me, the Duke would have wanted it that way. There are also several landfills that could be privatized along with ambulance services, vacant land, the County's Santa Ana administrative complex, the administration of public parks, etc. If this privatization trend really takes hold it could be great news for Orange County.

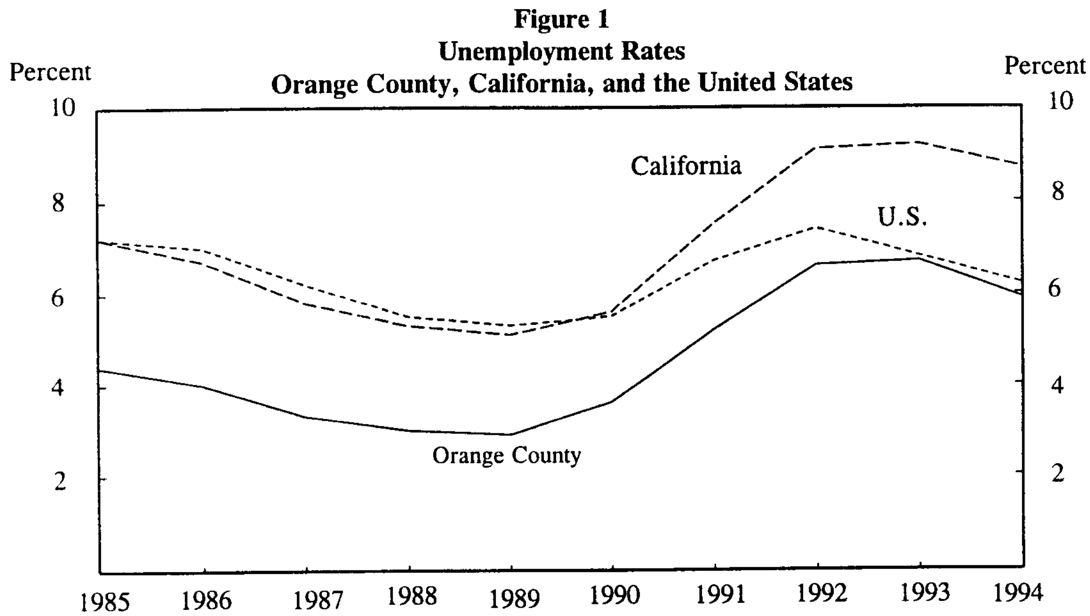
On balance I believe the Orange County crisis will lead to a major revamping and improvement in Orange County. The short run problems will be just that.

Here now is the story of Orange County.

The California and Orange County Backdrop

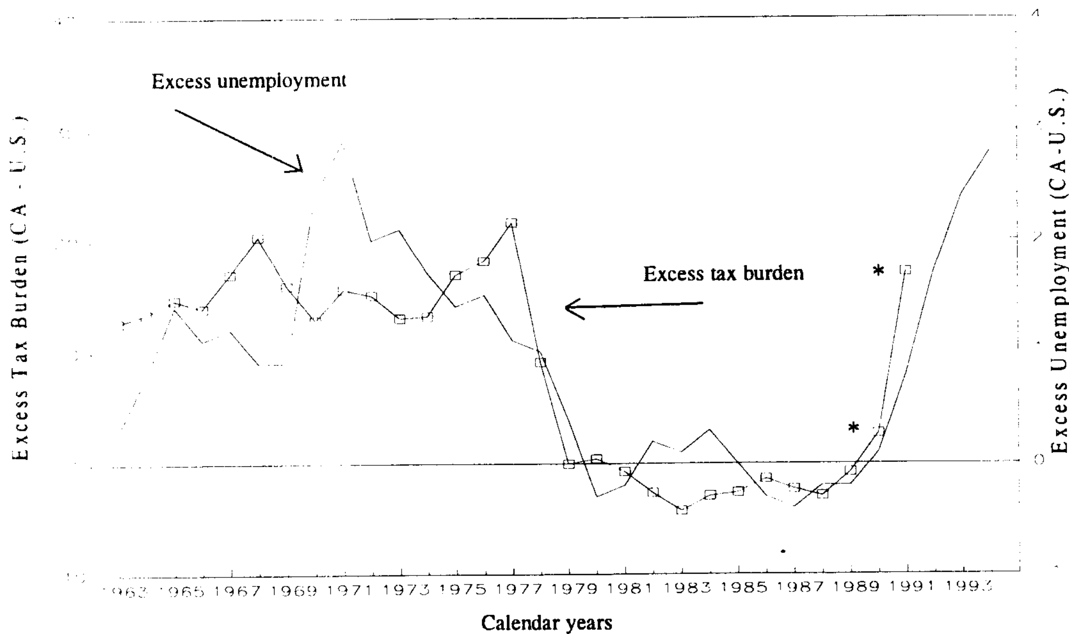
In 1989, California stood out as an example of what supply-side economics can do to create economic growth and prosperity across all income groups. Housing prices in California were double the national average. California had become such a Mecca for financial success during the 1980s that the state's population grew by some six and one half

Figure 1
Unemployment Rates
Orange County, California, and the United States



Source: Bureau of Labor Statistics; County of Orange Administrative Office.

Figure 2
California Excess Tax Burden Versus Excess Unemployment, 1963-94



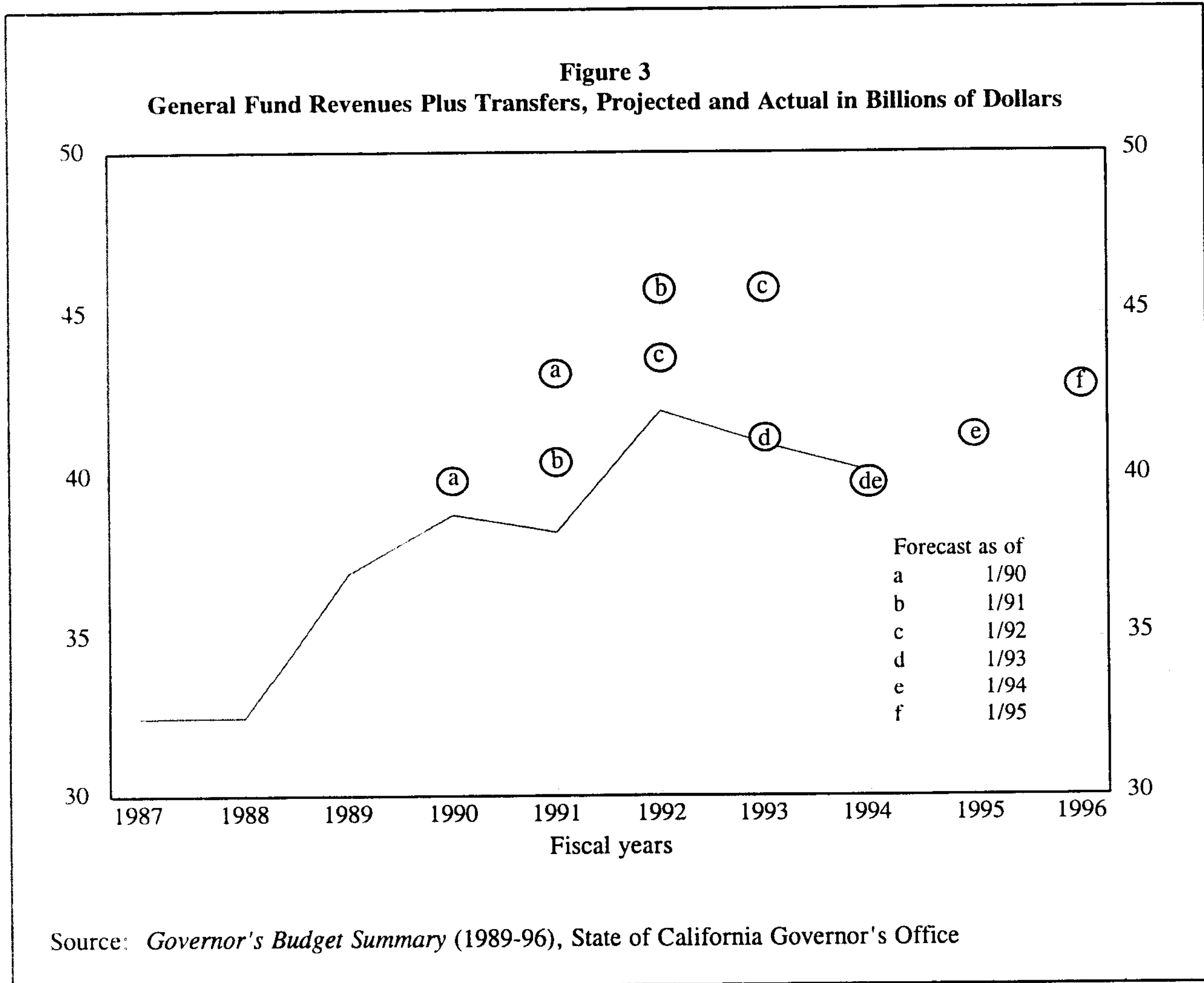
Excess unemployment equals California's unemployment rate less the unemployment rate for the U.S. as a whole.
Excess tax burden equals California's state and local tax burden per $1,000 of personal income less the average of that same number for all states in the U.S.
* Adjusted tax burden for 1990 and 1991.
Source: *Government Finances*, U.S. Department of Commerce, Bureau of the Census.

million people. Unemployment was below the national average and California enjoyed a large advantage in per capita income relative to the rest of the nation. California was where it was happening.

With the passage of Proposition 111 in June of 1990, California's economy began to falter (figure 1, 2). Prop. 111 doubled the state's gas tax from 9 cents to 18 cents per gallon, increased the truck weight tax by 40 percent, and removed highway spending from the Gann spending limitations of Proposition 4. In late 1991, before California could even begin to digest the massive new tax burdens placed upon her, the largest state tax increase in the history of the United States was passed by California's government.

In the case of California's state tax increases an important dynamic was established. First the tax increase itself caused government forecasters to project additional tax revenues. Second, given the size of California and the magnitude of the tax increases, the projected increase in revenues was huge. And third, legislated spending at both the state and local level increased in anticipation of the projected revenue gains.

Figure 3
General Fund Revenues Plus Transfers, Projected and Actual in Billions of Dollars



Source: *Governor's Budget Summary* (1989-96), State of California Governor's Office

At no time did the government's forecasters entertain the notion that the tax increases might actually hurt the state's economy. In truth, the tax increase itself dampened economic activity, and as a result of the sharp drop in income and employment, state tax revenues did not increase anywhere close to their projected levels (figure 3). At the municipal level, tax revenues fell much more sharnly than they had at the state level.

The failure for the projected revenues to materialize and the increased spending based on excessive optimism led to a compound problem. The California financial crisis of 1990-1991 was guaranteed to last a long, long time.

The Orange County Investment Pool Collapse

On December 6, 1994, Orange County filed for Chapter 9 bankruptcy protection in the Santa Ana District Federal Bankruptcy Court. Municipalities fall under the jurisdiction of Chapter 9 rather than Chapter 11. Chapter 9 bankruptcy status prohibits creditors from seizing and liquidating assets of a municipality while the protected municipality attempts to rearrange its finances in order to work out repayment schedules for its creditors.

Orange County's investment pool as of November 30, 1994, was highly leveraged and had been on the wrong side of a large interest rate move. As a consequence Orange County's investment pool had experienced substantial market losses. County records indicate that the book value of the fund consisted of $20.59 billion in assets and $13.01 billion in debt.[1] The investment pool's published accounts were not marked to market, and therefore on the official books the investors' net worth was $7.58 billion. In market terms however the net value of the investment pool's securities was actually more like $5.03 billion or 34 percent below the published book value.

Table 1
Orange County Portfolio Book Value
Assets in Millions of Dollars as of November 30, 1994

Asset Description	Total Principal	Average Coupon	Average Maturity
Agencies	$10,036.0	5.74%	4.08 years
Agency Inverse Floaters	5,396.7	5.41	3.44
Corporates	3,583.0	5.84	3.26
Cash	825.9	5.13	0.03
Treasuries	466.8	5.43	3.14
Collateralized Mortgage Obligations	196.3	5.67	16.10
Ginnie Maes	24.4	8.00	22.47
GICs	5.7	8.12	1.00
Total	**$20,534.8**	**5.64%**	**3.72 years**

Source: Orange County Treasurer - Tax Collector

Orange County is the largest municipality to file for bankruptcy in the history of the United States. Orange County has long been one of the wealthiest counties in the United States and California. In 1994 the average household income for Orange County was $71,540 compared with a national average of $59,020. The median home price in Orange County was $210,000 compared with $110,000 for the rest of the nation. And, as of October 1994, unemployment in Orange County was 5.2 percent compared to 7.7 percent for California and 5.4 percent for the United States. Orange County is John Wayne country.

On December 5, 1994, CS First Boston demanded payment in full on a $1.2 billion loan to Orange County's investment pool; the money due CS First Boston was not paid. As a result of Orange County's failure to pay, CS First Boston liquidated $2.6 billion of securities that were held as collateral for the loan. To avoid additional sales of securities held as collateral for other loans, Orange County filed for bankruptcy. The bankruptcy filing, however,

did not prevent brokerage houses from selling a total of $11.5 billion of securities, held as collateral, in the first few days immediately following the bankruptcy filing. This massive collateral sell-off occurred in spite of a lawsuit filed by Orange County against Nomura Securities and threats of other such lawsuits against any and all such brokerages engaged in the sale of Orange County securities.

The seeds specific to the Orange County fiscal calamity were planted years ago. In California there are two types of counties: charter counties and at-law counties. In a charter county the board of supervisors appoints a Treasurer along with other top executive officers. In at-law counties the Treasurer is elected by the voters of the county and the role played by the supervisors in overseeing the Treasurer is not well defined. Orange County was set up as an at-law county, and consequently the Orange County Board of Supervisors had no choice but to work with the person elected by the Orange County voters to serve as Treasurer.

From the standpoint of any reasonable standard there is no way Orange County supervisors could ever be expected to oversee Citron's stewardship of Orange County's investment pool. Citron is immersed day and night in financial issues unique to sophisticated Wall Street investments. Supervisors on the other hand come with no special skills in the field of finance and spend only a small amount of their time on such issues. A true fiduciary standard of behavior could never be expected of these supervisors.

Even in the case of Citron there has been no evidence to our knowledge of intentional fraud or of an exceptional life style. The Orange County investment pool's portfolio of assets was well known in the financial community. Citron also made his investment style known to the investors in the pool and to the Orange County Board of Supervisors.

In a letter to the Orange County Sanitation District dated April 12, 1993, Citron states,

> "The negative side of this transaction is that if interest rates rise, it is possible not to have a 'positive carry.' Where the bid or the interest rate paid for borrowing the money would be more than the coupon on the treasury note. In this event the District would need to come up with $50 million to buy outright these securitites, or what would likely happen is to sell them at a price that is lower than originally paid for the securities. A principal loss would occur. The likelihood of this happening is minimal; particularly if the investment is closely monitored. If interest rates start rising the security could be sold and/or swapped for a like security with a higher coupon. The Orange County Treasury currently has over $900 million securities reversed against themselves, so we are well versed in monitoring this type of investment."

In a letter to the Supervisors dated September 10, 1993, Citron states that,

> "If rates were to rise materially, it is reasonable to expect that the overall performance of the portfolio would decline. Although we strongly believe that future interest rates will remain low, to insure against the eventuality of materially rising interest rates, for the last six months we have not been buying structured/ floating interest rate instruments but have been purchasing fixed interest rate coupon instruments."[2]

Several big brokerage firms now tout their own financial acumen by saying that given what they knew they wouldn't do business with Citron. To err is human and Robert Citron is as human as anyone I've seen.

In 1970, Citron was elected to serve as Tax-Collector, and began his tenure as Treasurer in 1973 when the office of Tax Collector was merged with the office of Treasurer. Citron, a Democrat, served as Orange County's Treasurer for more than two decades, only once facing a reelection challenge, in June of 1994.

In 1985 the Orange County Board of Supervisors agreed to allow Citron to invest the pool's monies in reverse repurchase agreements. Reverse repos, as they are called, are nothing more than loans to the pool using securities as collateral. The borrowed funds are then used to purchase additional securities for the pool. By the terms of the reverse repos the loans are to be repaid at specified dates and the collateralized securities returned to the pool. Reverse repos have a legitimate place in finance and when used properly can limit the sensitivity of the pool's net

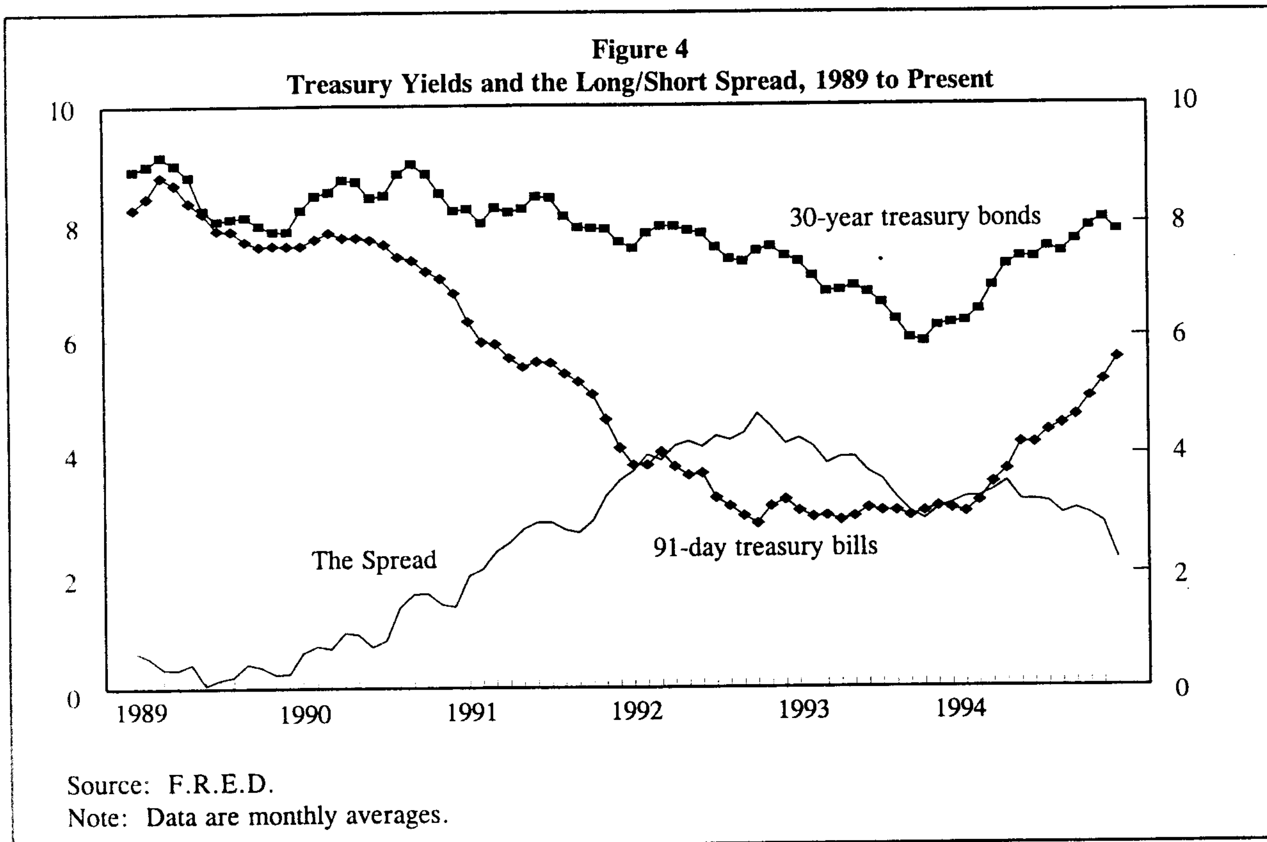


Figure 4
Treasury Yields and the Long/Short Spread, 1989 to Present

Source: F.R.E.D.
Note: Data are monthly averages.

value to changes in interest rates. Citron, however tried to use reverse repos to increase the pool's leveraged return and thereby increased the pool's sensitivity to interest rate fluctuations. In effect, all Citron was doing was borrowing short and lending long. In this regard his investment strategy was little different from the strategies followed by some of the highly publicized hedge funds. And, when those hedge funds did what Citron had done they too experienced huge losses.

As of December 13, 1994, Salomon Brothers established that for every one hundredth of a percent increase — one basis point — in interest rates, the market value of Orange County's portfolio would decrease by $3 million. According to Salomon Brothers' William D. Rifkin, managing director of mergers and acquisitions and point man for the Orange County investment pool restructuring, as of December 13 the market value of Orange County's portfolio including cash and excess collateral was $5.4 billion. Thus a one percentage point increase in interest rates would cause the market value of the pool's existing assets to fall by $300 million, or by more than 5 percent.

From the October 1993 low of 5.94 percent the thirty year Treasury bond yield rose to 8.08 percent in November of 1994. That is a 214 basis-point rise in the long rate (figure 4).

The magnitude of the change that a levered municipal investment pool can experience with an adverse movement of interest rates is substantial. But for a municipal investment pool the loss in market value isn't reported because municipal investment pools don't report the market value of their asset holdings. Municipal investment pools only report the price that was paid for an asset at the time of purchase, the asset's book value. In this regard Orange County's investment pool was designed to be similar to a money-market fund. Straight-line accrual accounting using historical costs was used to price the portfolio. Asset prices were only determined at the point of purchase and at the point of sale, and were not marked to market at any time during the interim. Consequently losses in market values of portfolio assets were not factored into the value of the pool.

For municipal pool investors accounting ultimately comes to grips with reality when the pool's assets are sold and losses realized, or when coupon yields are reduced by the rising cost of the pool's borrowings.

In the case of Orange County, Citron had borrowed on the short end of the yield curve where interest rates had been relatively low. He then used those borrowed funds to buy securities with longer maturities and higher nominal yields. In the vernacular of finance Citron was playing the yield curve. Were interest rates to have remained unchanged, Citron's pool would have earned the higher yield on all fund assets whether borrowed or invested and would have only had to pay the lower interest cost on the borrowings. Ignoring transactions costs and fees the net yield to the pool's investors could be very large indeed. In fact, Citron had acquired quite a reputation as a savvy investor by playing the yield curve.

With the advent of falling interest rates as occurred from March 1989 to October 1993, the yield on Citron's portfolio was quite impressive. During 1994 however all interest rates rose, and the largest increases were at the short end of the yield curve where Citron was a borrower. What had worked to his great advantage during the 1989-1993 period turned sharply negative in 1994. In fact, the reversal of interest rates during 1994 was one of the largest reversals in recent history. Along with the sharp reduction in net cash flows to Citron's portfolio, the decrease in the market value of the portfolio's assets triggered concern as to whether Citron could actually meet his debt obligations. Ultimately this concern about the vaue of the pool's assets led to asset sales and the prospective withdrawals of investors' funds.

One additional feature of Citron's pool and its accounting practices added a ponzi feature to withdrawals from the pool. Investors who withdraw funds were allowed to do so at book value. Therefore whenever the market value of the investment pool is less than the book value of the pool investors have an incentive to withdraw funds and withdraw them quickly. The last investors left in the pool after the other investors have withdrawn will be stuck with the full brunt of the loss in market value. This ponzi scheme dynamic dramatically increases the propensity for a run on the pool by the investors.

Over the years Orange County had, along with County agencies, school districts, water districts, and cities both inside and outside of the County, invested $7.4 billion in Citron's investment portfolio. By the time the County filed for bankruptcy, Citron had levered the portfolio up from the original net position of $7.4 billion to over $20 billion gross including investments of borrowed funds. While some outside investors were required by law to turn all excess monies over to Citron's fund, many agencies were not. Citron had become a favorite for outside investors. Agency and district managers were impressed with Citron's investment performance, pure and simple, and wanted to be a part of his investment pool.

Local agencies and districts have incoming revenues, often from debt-issuances that the agencies themselves originate. These districts and agencies are required to hold a reserve fund equal to the sum total of interest payments on the issuance and the debt service for the final year of the issuance. In some cases an agency may invest the value of plant and equipment depreciation in an investment pool rather than simply allowing depreciation to accumulate on their balance sheet.

The Irvine Ranch Water District had $450 million to invest as of 1994 in whichever way the District directors saw fit. The District directors had chosen to invest slightly more than $400 million of District money with Citron, specifically because Citron's investment pool was earning a higher rate of return than the Water District's in-house management team had been earning. According to District director Peer Swan the District withdrew $100 million from the investment pool in November of 1994 because they had had concerns about the pool's high level of interest rate risk. Now that the County has declared bankruptcy, they are unable to withdraw funds from the pool, and $300 million remains frozen in the pool.

In order to understand the relationship between Orange County and its investment portfolio, one must consider the California economy and its terrible performance relative to the rest of the nation since 1990.

Table 2
Orange County General Fund
Projected vs. Budgeted Revenues for Fiscal Year 1995
Millions of Dollars

Source	Budgeted	Projected	Surplus/Deficit
Interest	$162	$2	($160)
Taxes	118	116	(2)
Department of Motor Vehicles	96	98	2
FBA	55	55	0
Sales Tax	18	18	0
Other	14	9	(5)
Total	**$463**	**$298**	**$(165)**

Source: Orange County FY 1995 Annual Budget; Auditor - Controller Records.

Fiscal stringencies as they filtered down to the county level added pressures on fund managers to make up for the gap in local budgets. In Orange County's case that help came in the form of extra interest earned on Orange County's contribution to Citron's investment pool. By FY95 interest paid to Orange County from Citron's investment pool had grown to account for 35 percent of Orange County's $463 million general fund budget.[3] Although Orange County receives money from both the state and the federal governments for a variety of state and federally mandated programs, Orange County relies on its general fund to pay for Orange County operating expenses, such as road construction, police and fire, etc. At over $160 million annually, interest income was by far the largest single component of the general fund budget, eclipsing the next largest component, tax revenues, by more than $40 million.

Not only was the interest component of Orange County's investment pool the biggest revenue item for Orange County's general fund, but Citron's investment record had widely been considered good. From July of 1972 through June of 1994 Citron earned an average annual yield of 9.4 percent or a cumulative $3.6 billion in interest for Orange County's investment pool. By way of comparison the Local Agency Investment Fund, run by the state of California over the same 22-year period had an average annual yield of 8.2 percent, or a full 1.2 percentage points less than Citron's yield on Orange County's funds. The higher yield earned by Citron above and beyond the state's yield added an extra $700 million to Orange County's pool over the 22 years. Of that $700 million in extra interest, $500 million was earned in the three-year period from July 1991 through June 1994.[4] Citron's good reputation is certainly understandable. The July 1991 through June of 1994 period was one of the worst economic periods in California history and that was precisely when Citron most outperformed other investment pools. He was a genuine hero at the time.

Other comparisons are somewhat less flattering to Citron's investment record but they still show him having an excellent historical performance record. Citron's record collapses, of course, during the six month period beginning in July of 1994. Citron's 22-year excess yield of some $700 million pales in comparison to his absolute loss of $1.69 billion from July 1994 through December 1994.

To say that Orange County's investment portfolio was unusual for a municipality is an understatement. Citron used the portfolio to make large bets that interest rates would continue to fall. When interest rates increased earlier in 1994, the market value of the Orange County investment pool began to drop. The levered nature of the Orange County portfolio caused the pool's losses to be magnified. Our analysis indicates that the pool, which already had an average maturity of over four years, was equivalent in risk to an unlevered portfolio with an average maturity of over eleven years.

Citron sold short-term debt instruments, predominantly 90-day Fannie Mae notes and other government agency debt, and then invested the proceeds in longer-term inverse floaters. Inverse floaters are rather exotic in that their coupon yield is the difference between two interest rates. They also have a rather long maturity. While not required, it is common practice that the yield on an inverse floater will be fixed for the first year or two. Citron's inverse floaters had a yield that was the difference between the 30-year Treasury bond yield and the London Interbank Offered Rate in dollars. In Citron's case the first two years' yields were fixed in order to provide a certain yield for Orange County's budget.

As is clear from the construction of Citron's inverse floaters, he was betting on a large and increasing spread between the long and the short maturity yields and low and falling short term borrowing rates. Put into normal everyday parlance Citron was making bet upon bet that interest rates would fall and fall the most at the short end of the yield curve.

This strategy worked well as interest rates dropped during the Bush recession. But, by the second year of the Clinton presidency the threat of future inflation caused interest rates to rise rapidly. The term structure of interest rates not only rose but also flattened which means that short rates rose more than long rates. This was the grist of Citron's worst nightmare. Citron's short-term borrowing costs began to rise, and simultaneously the value of his existing longer-term assets began to fall, and with the $3.4 billion of inverse floaters that Citron held, coupon rates fell as well. Even historical cost accounting couldn't save Citron this time.

Citron's attempts to liquidate some portion of the portfolio were unsuccessful. In fact, a senior executive at one of the largest Wall Street firms said after turning Citron down that "no one wanted to trade with them. The people who looked at [the portfolio] were frightened by it."[5] Orange County supervisors promptly drafted Citron's resignation letter, and on Sunday, December 4, Citron signed it. By December 5 the difference between the bid and the asked prices for Orange County municipal bonds had grown so large that trading in these instruments came to a standstill. As the county declared bankruptcy, Governor Wilson maintained an arms-length position, stating that Orange County must bring its finances back into solvency. On December 6, 1994, CS First Boston made the first move with it's $2.6 billion sale of collateral, to cover its $1.2 billion loan to Orange County's investment pool.

Faced with creditors refusing to roll over these liabilities, the county turned to Salomon Brothers to restructure the portfolio. As it now stands the pool is frozen; investors cannot retrieve their money from the pool without a court order.

County vendors have begun to question the County's ability to pay; in Fullerton a routine order for 8,000 gallons of gas for school buses was refused. Anaheim stopped hiring. All major county projects have been halted, such as the widening of Interstate 5 (a major artery through the heart of the county), the renovation of a La Habra elementary school, and the purchase of an $82 million police communication system previously deemed "vital to county security". Orange County defaulted on a $110 million Pension Obligation Bond due on December 8. Some local districts were also forced to default on their own debts, including Santa Ana's $5.3 million debt-service obligation, and others fear additional defaults, such as Montebello's $25.5 million obligation due December 30. Orange county expects to lay off between 800 and 1,000 county employees, having already voided labor contracts with several unions.

As if the budget crisis wasn't bad enough, investigators from all levels of government have descended upon the offices of the Orange County Treasurer. The SEC has issued subpoenas to all County Supervisors, along with Citron, his ex-assistant Treasurer Matthew Raabe and Ernie Schneider, the chief county executive officer. The Orange County District Attorney's office was late getting into the game, but has made up for lost time. With search warrants in hand the District Attorney spun spools of crime-scene tape around Citron's offices and removed boxes of files for closer scrutiny.

The issues under investigation include 1) whether Citron violated Federal law regarding the use of invested funds as collateral for additional borrowings, 2) whether Citron improperly accepted gifts from lead brokers and underwriters, and 3) whether Citron actively misled county officials and fund investors regarding the composition and risky nature of fund investment instruments. To date all parties involved maintain their complete innocence, including at least three brokers at Merrill Lynch who are also under investigation.

Merrill Lynch was responsible for 20 percent of Orange County Investment Pool business, and is reported to have earned something of the magnitude of $100 million in commissions over the past twenty years. Merrill Lynch was also among the largest contributors to Citron's only reelection campaign, waged in June 1994 against John M.W. Moorlach. Interestingly, Moorlach made the nature of Citron's investments the centerpiece of his campaign, stating repeatedly that the County was headed for a serious crisis, and soon. "Had I been elected," said Moorlach recently, "I would have immediately liquidated the entire portfolio."

Meanwhile on December 8, Thomas W. Hayes, the former California State Finance Director under Governors Deukmejian and Wilson, was appointed as the investment pool's financial advisor, and together with Salomon Brothers' William D. Rifkin set out to completely liquidate the pool within 180 days. As of January 18, 1995, they had liquated all but $481 million of securities from the fund, and total losses were put at $1.69 billion.

Orange County, for all of this, is still perceived to be in fine shape by many in the financial community. In fact recently several Wall Street firms offered to "help Orange County" by underwriting sales of additional bonds, in an apparent attempt to capture the high coupon rates of what they consider to be a buying opportunity. Orange County itself isn't so sure about the future; the prediction is for a $172 million deficit in the County's budget by this summer, due largely to the loss of interest income from the investment pool which had been written into the $470 million FY95 County budget.

But Orange County may still turn out to be bigger than life. With John Wayne as the County's guiding role model adversity can precede greatness. The fiscal crisis of 1994 could well be the precursor of fiscal restraint and privatization well on into the next century. A phrase from the vintage B-movie *The Hanging Tree* expresses our view precisely. "To really live you must almost die." It is our view that Orange County's overall long-term solvency will be a direct result of Orange County's government's bankruptcy.

January 19, 1995

FOOTNOTES

1 Office of the Orange County Treasurer-Tax Collector.

2 "Citron's Best Defense May Be His Warnings," Michael A. Hiltzik, *Los Angeles Times*, p. A27, December 30, 1994.

3 Orange County FY 1995 Annual Budget; Auditor - Controller Records

4 "Citron's Track Record Falls Short of Reputation," Jeff Brazil, Jodi Wilgoren, and Matt Lait, *Los Angeles Times*, p. A1, January 8, 1995.

5 "Orange County Files For Bankruptcy," Mark Platte, Matt Lait, and Scot J. Paltrow, *Los Angeles Times*, p. A20, December 7, 1994.

* *Jeanne Sinquefield is Vice President of Dimensional Fund Advisors.*

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