TO:         HONORABLE CITY COUNCIL

FROM:      CITY MANAGER          DEPARTMENT: ADMINISTRATIVE SERVICES

DATE:      JANUARY 20, 2004     CMR: 127:04

SUBJECT:   CITY OF PALO ALTO’S INVESTMENT ACTIVITY REPORT FOR THE SECOND QUARTER, FISCAL YEAR 2003-04

This is an information report and no Council action is required.

BACKGROUND

The purpose of this report is to inform Council of the status of the City’s investment portfolio as of the end of the second quarter of Fiscal Year 2003-04. The City’s investment policy requires that staff report to Council on the City’s portfolio composition compared to Council-adopted policy; portfolio performance; and other key investment and cash flow information.

DISCUSSION

Investment Portfolio as of December 31, 2003
The City’s investment portfolio is detailed in Attachment B. It is grouped by investment type and includes the investment issuer, date of maturity, current market value, the book and face (par) value, and the weighted average maturity of each type of investment and of the entire portfolio as of December 31, 2003.

The par value of the City’s portfolio is $357.7 million; in comparison, last quarter it was $353.9 million. Growth in the portfolio of $3.8 million since the last quarter results from property tax receipts for the new fiscal year that are not received until the second quarter and the City’s continued effort to constrain expenditures.

The portfolio consists of $23.8 million in liquid accounts and $333.9 million in U. S. government treasury and agency securities. The $333.9 million includes $118.1 million in investments maturing in less than two years, comprising 35.4 percent of the City’s investment in notes and securities. The current market value of the portfolio is 102.9 percent of the book value. Because the City’s practice is to hold securities until they mature, changes in market price do not affect the City’s investment principal. The market valuation is provided by Union Bank of
California, which is the City’s safekeeping agent. The average life to maturity of the investment portfolio is 2.75 years.

**Investments Made During the Second Quarter**
During the second quarter, $21.0 million of government agency securities with an average yield of 5.8% percent matured. During the same period, government securities totaling $16.7 million with an average yield of 3.9% percent were purchased. The City’s short-term money market and pool account increased by $8.1 million compared to the first quarter of 2002-03. Investment staff continually monitor the City’s short-term cash flow needs and adjust liquid funds to meet those needs and to take advantage of investment opportunities.

**Availability of Funds for the Next Six Months**
The normal flow of revenues from the City’s utility billings and general fund sources is sufficient to provide funds for ongoing expenditures. Projections indicate receipts will be $144.4 million and expenditures will be $142.4 million over the next six months, indicating an overall growth of the portfolio of about $2.0 million.

As of December 31, 2003, the City had $23.8 million deposited in the Local Agency Investment Fund (LAIF) and a money market account that could be withdrawn on a daily basis. In addition, securities totaling $33.7 million will mature between January 1, 2004 and June 30, 2004. On the basis of the above projections, staff is confident that the City will have more than sufficient funds to meet expenditure requirements for the next six months.

**Compliance with City Investment Policy**
During the second quarter of 2003-04, staff complied with all aspects of the investment policy. Attachment C lists the restrictions in the City’s investment policy compared with the portfolio’s actual compliance.

**Investment Yields**
Interest income on an accrual basis for the second quarter of 2003-04 was $4.1 million. As of December 31, 2003, the yield to maturity of the City’s portfolio was 4.48 percent. This compares to a yield of 4.65 percent in the first quarter of 2003-04. The City’s portfolio yield will decrease further in the second quarter of 2003-04 as a result of reinvestment of maturing securities at lower interest rates. The City’s portfolio yield of 4.48 percent compares to LAIF’s average yield for the quarter of 1.64 percent and an average yield on the two-year and five-year Treasury bond during the second quarter of approximately 1.84 percent and 3.23 percent, respectively.

**Yield Trends**
The Federal Open Market Committee (FOMC) has not changed the federal funds rate in the last two quarters of 2003-04. Since it began cutting the federal funds and discount rates in January 2001, the FOMC has reduced the federal funds rate by 5.50 percent and discount rate by 5.25 percent to 1.00 and 0.75 percent, respectively.

At its December 2003 meeting, the FOMC maintained a “balanced” outlook on the economy. This outlook reveals an expectation that the upside and downside risks associated with sustaining
economic growth are equal. The FOMC has acknowledged an improving national economy, productivity gains, and stronger business spending. It has expressed concern, however, about job growth and is expected to leave rates at the current level at its next meeting and in the near future. The City can expect declining yields on its portfolio given the FOMC’s low interest rate policy.

To somewhat offset the steady and dramatic drop in interest rates, staff has been purchasing securities with longer maturities. The average life to maturity has increased from 2.27 years in 2001-02 to 2.75 years in the second quarter of 2003-04. In addition, staff continues to purchase the maximum amount of callable securities allowed under the City’s Investment Policy. This strategy, which is possible given the size and stability of the City’s portfolio, has kept the City’s yields relatively strong. Nevertheless, as older investments continue to mature, overall yields will continue to fall in future quarters.

Funds Held by the City or Managed Under Contract
Attachment A is a consolidated report of all City investment funds, including those not held directly in the investment portfolio. These include cash in the City’s regular bank account with Bank of America. The bond proceeds, bond reserves, and debt service payments being held by the City’s fiscal agents are subject to the requirements of the underlying debt indenture. The trustees for the bond funds are U.S. Bank and California Asset Management Program (CAMP). Bond funds with U.S. Bank are invested in money market mutual funds that consist exclusively of U.S. Treasury securities. Bond funds in CAMP are invested in banker’s acceptance notes, certificates of deposit, commercial paper, federal agency securities, and repurchase agreements. The most recent data on funds held by the fiscal agent is as of December 31, 2003.

ATTACHMENTS:

A) Consolidated Report of Cash and Investments
B) Investment Portfolio, as of December 31, 2003
C) Investment Policy Compliance