TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES

DATE: JANUARY 30, 2006 CMR: 121:06

SUBJECT: CITY OF PALO ALTO’S INVESTMENT ACTIVITY REPORT FOR THE SECOND QUARTER, FISCAL YEAR 2005-06

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 2005-06. The City’s investment policy requires that staff report quarterly 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, 2005

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, 2005.

The par value of the City’s portfolio is $344.6 million; in comparison, last quarter it was $346.3 million. The decline in the portfolio of $1.7 million is attributable to: (a) the settlement between PG&E and Western Area Power Administration for electric transmission which resulted in additional cost to the City of $1.6 million; and (b) the delayed sales (“triple flip”) and in-lieu vehicle license fee tax payments. Instead of receiving the delayed revenue payments on a monthly basis, they will be paid in January and May 2006. If not for the settlement payment and the delayed revenue receipt, the portfolio would have increased by $1.8 million.

The portfolio consists of $12.6 million in liquid accounts and $332.0 million in U.S. government treasury and agency securities. The $332.0 million includes $123.8 million in investments maturing in less than two years, comprising 37.3 percent of the City’s investment in notes and securities. The current market value of the portfolio is 98.3 percent of the book value. Staff anticipates this ratio will stabilize over the next few quarters as the low yield environment of the past three years transitions to high interest rates based on Federal Reserve Board actions. It is important to note that 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 2.52 years.

Investments Made During the Second Quarter
During the second quarter, $15.0 million of government agency securities with an average yield of 5.2 percent matured. During the same period, government securities totaling $21.0 million with an average yield of 4.5 percent were purchased. The City’s short-term money market and pool account decreased by $7.6 million compared to the first quarter of 2005-06. Investment staff continually monitors the City’s short-term cash flow needs and adjusts 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 in those respective funds. Projections indicate receipts will be $178.0 million and expenditures will be $175.4 million over the next six months, indicating an overall growth of the portfolio of about $2.6 million.

As of December 31, 2005, the City had $12.6 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 $27.3 million will mature between January 1, 2006 and June 30, 2006. 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 2005-06, staff complied with all aspects of the investment policy except the 20 percent callable limit on U.S. government agency securities. Due to a decline in the portfolio’s assets mainly attributable to the Enron settlement payment, callable securities now are 20.3 percent of the portfolio. The investment policy states that an overage in this category due to a reduction in the portfolio is not a violation of the 20 percent callable restriction. The callable percentage limitation will be restored as callable investments mature. Staff will not invest in callable securities until held callable securities fall below 20 percent of the City’s portfolio. 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 2005-06 was $3.7 million. As of December 31, 2005, the yield to maturity of the City’s portfolio was 4.13 percent, the same yield as the first quarter of 2005-06. With short-term interest rates moving upward slowly, staff expects the portfolio’s yield to remain at current levels in the coming quarters. The City’s portfolio yield of 4.13 percent compares to LAIF’s average yield for the quarter of 3.41 percent and an average yield on the two-year and five-year Treasury bond during the second quarter of approximately 4.36 percent and 4.39 percent, respectively.
Yield Trends

Since June 2004, the Federal Open Market Committee (FOMC) has increased the federal funds and discount rate by 3.25 and 3.50 percent, respectively. These rates currently are 4.25 and 5.25 percent, respectively.

In its last meeting, the FOMC indicated that its spate of rate increases may be coming to an end. With an outlook that economic growth is on solid ground and inflationary risks are being contained, the FOMC may raise rates by another 0.25 percent to 0.50 percent. Even with further rate increases, the City’s portfolio yields are expected to rise slowly because of the considerable lag time between the rise in interest rates and the portfolio’s ability to reflect them. This is a consequence of the portfolio being weighted at lower-yield instruments purchased in the past three years.

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 Wells Fargo and Bank of America. The bond proceeds, 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 federal agency and 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, 2005.

PREPARED BY: 
TARUN NARAYAN
Senior Financial Analyst

DEPARTMENT HEAD APPROVAL:
CARL YEATS
Director, Administrative Services

CITY MANAGER APPROVAL:
EMILY HARRISON
Assistant City Manager

ATTACHMENTS:
A) Consolidated Report of Cash and Investments
B) Investment Portfolio, as of December 31, 2005
C) Investment Policy Compliance