TO: HONORABLE CITY COUNCIL
FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES
DATE: OCTOBER 24, 2005 CMR: 399:05
SUBJECT: CITY OF PALO ALTO’S INVESTMENT ACTIVITY REPORT FOR THE FIRST 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 first 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 September 30, 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 September 30, 2005.

The par value of the City’s portfolio is $346.3 million; in comparison, last quarter it was $349.1 million. The decline in the portfolio of $2.8 million is attributable to the final Enron settlement payment. Controlling for the Enron payment, the portfolio would have increased by $3.7 million.

The portfolio consists of $20.2 million in liquid accounts and $326.1 million in U. S. government treasury and agency securities. The $326.1 million includes $119.3 million in investments maturing in less than two years, comprising 36.6 percent of the City’s investment in notes and securities. The current market value of the portfolio is 98.8 percent of the book value. Staff anticipates this ratio to decline over the next few quarters due to the low yield environment of the past three years and because interest rates are expected to begin to gradually increase in coming quarters. 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 2.63 years.

**Investments Made During the First Quarter**
During the first quarter, $15.5 million of government agency securities with an average yield of 5.3% percent matured. During the same period, government securities totaling $8.5 million with an average yield of 4.2% percent were purchased. The City’s short-term money market and pool account increased by $4.1 million compared to the fourth quarter of 2004-05. 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 $165.6 million and expenditures will be $162.5 million over the next six months, indicating an overall growth of the portfolio of about $3.1 million.

As of September 30, 2005, the City had $20.2 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 $27.7 million will mature between October 1, 2005 and March 31, 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 first 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 attributable to the Enron settlement payment, callable securities now are 20.2 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 first quarter of 2005-06 was $3.7 million. As of September 30, 2005, the yield to maturity of the City’s portfolio was 4.13 percent. This compares to a yield of 4.17 percent in the fourth quarter of 2004-05. With short-term interest rates moving upward slowly, staff expects the portfolio’s yield to hover 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 3.21 percent and an average yield on the two-year and five-year Treasury bond during the first quarter of approximately 3.95 percent and 4.03 percent, respectively.

**Yield Trends**
Since June 2004, the Federal Open Market Committee (FOMC) has increased the federal funds and discount rate by 2.50 percent. These rates currently are 3.75 and 4.75 percent, respectively.
The FOMC continues to maintain a “balanced” outlook on the economy in its official pronouncements. This outlook reveals an expectation that the upside and downside risks associated with sustaining economic growth are equal. Though the FOMC believes the damage caused by Katrina elevates inflationary concerns and creates short term economic performance uncertainty, the long term economic outlook fundamentals are not expected to be threatened. Economists expect the FOMC to continue increasing rates in the near future due to its focus on keeping inflationary pressures low. Even though it is expected that the FOMC will continue to raise the rates this year, the City’s portfolio yields are not expected to significantly change from current levels. This is attributable to continued reinvestment of older maturing securities at lower interest rates.

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 September 30, 2005.

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ATTACHMENTS:
A) Consolidated Report of Cash and Investments
B) Investment Portfolio, as of September 30, 2005
C) Investment Policy Compliance