TO:     HONORABLE CITY COUNCIL

FROM:  CITY MANAGER     DEPARTMENT: ADMINISTRATIVE SERVICES

DATE:  JANUARY 28, 2008     CMR: 126:08

SUBJECT:  CITY OF PALO ALTO’S INVESTMENT ACTIVITY REPORT FOR THE SECOND QUARTER, FISCAL YEAR 2007-08

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 2007-08. 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, 2007

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, 2007.

The par value of the City’s portfolio is $390.8 million; in comparison, last quarter it was $397.5 million. The decline in the portfolio of $6.7 million is attributable to higher utility commodity costs. In the coming quarters, the City’s portfolio will decrease, primarily as a result of transferring approximately $30 million from a City retiree medical reserve into a CalPERS trust fund and from higher electric commodity costs.

The portfolio consists of $19.6 million in liquid accounts and $371.2 million in U. S. government treasury and agency securities and certificates of deposit. The $371.2 million includes $151.3 million in investments maturing in less than two years, comprising 40.8 percent of the City’s
investment in notes and securities. The investment policy requires that at least $50 million shall be
maintained in securities maturing in less than two years.

The current market value of the portfolio is 101.7 percent of the book value. 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 2.74 years compared to 2.82 years last quarter.

Investments Made During the Second Quarter

During the second quarter, $23.0 million of government agency securities with an average yield of
4.2% percent matured. During the same period, government securities totaling $9.5 million with an
average yield of 4.8% percent were purchased. The City’s short-term money market and pool
account increased by $6.6 million compared to the first quarter. Investment staff continually
monitors the City’s short-term cash flow needs and adjusts liquid funds to meet those needs and take
advantage of investment opportunities.

Availability of Funds for the Next Six Months

Normally, the 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 $185.2 million, and expenditures will be $217.1 million over the next six months, indicating
an overall decline in the portfolio of $31.9 million. Again, the decrease is primarily attributable to
funding the retiree medical trust fund and from higher electric commodity costs.

As of December 31, 2007, the City had $19.6 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 $39.0 million will mature between January 1, 2008 and June 30, 2008. 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 2007-08, staff complied with all aspects of the investment policy
except the 20 percent callable limit on U.S. government agency securities. Due to a drop in the
portfolio’s assets, callable securities are 20.1 percent of the portfolio. The investment policy states
that an overage in this category that is due to a reduction in the portfolio’s size is not a violation of
the 20 percent callable restriction. The callable percentage limitation will be restored as callable
investments mature or if the portfolio grows. Staff will not invest in callable securities until they fall
below the policy’s 20 percent limit. Attachment C lists the restrictions in the City’s investment
policy compared with the portfolio’s actual performance.
Investment Yields

Interest income on an accrual basis for the second quarter of 2007-08 was $4.5 million. As of December 31, 2007, the yield to maturity of the City’s portfolio was 4.46 percent. This compares to a yield of 4.45 percent in the first quarter of 2006-07. As lower yielding maturing securities purchased in prior years mature and are reinvested in slightly higher yielding ones, staff expects the portfolio’s yield to slowly rise in the coming quarters. The City’s portfolio yield of 4.46 percent compares to LAIF’s average yield for the quarter of 4.97 percent and an average yield on the two-year and five-year Treasury bonds during the second quarter of approximately 3.46 percent and 3.77 percent, respectively.

Yield Trends

The Federal Open Market Committee (FOMC) decreased the federal funds and discount rate rates in the last two quarters by 1.0 percent and 1.50 percent, respectively. These rates currently are 4.25 and 4.75 percent, respectively. The consensus is that further rate cuts are likely. Some economists are forecasting a 0.50 percent decrease in rates as a consequence of the deteriorating economic conditions. The FOMC, however, continues to monitor consumer spending and inflationary and credit risks closely. Even though interest rates have declined in recent months, the City’s portfolio yield is expected to slowly increase in the coming quarter due to the mix of investments. If the FOMC does cut rates by 0.50 percent, the portfolio’s long-term yield is likely to decline.

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. 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, 2007.

**ATTACHMENTS:**

A) Consolidated Report of Cash and Investments  
B) Investment Portfolio, as of December 31, 2007  
C) Investment Policy Compliance