TO:            HONORABLE CITY COUNCIL
FROM:           CITY MANAGER       DEPARTMENT: ADMINISTRATIVE SERVICES
DATE:           APRIL 28, 2008        CMR: 221:08
SUBJECT:        CITY OF PALO ALTO’S INVESTMENT ACTIVITY REPORT FOR THE THIRD 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 third 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 March 31, 2008

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 March 31, 2008.

The par value of the City’s portfolio is $359.9 million; in comparison, last quarter it was $390.8 million. The decline in the portfolio of $30.9 million is attributable to the establishment of an irrevocable trust fund for retiree medical benefits with the California Public Employees Retirement System (CalPERS). The City transferred $32.8 million accumulated in its Retiree Health Benefits Internal Service Fund into the new CalPERS retiree medical trust. In the coming quarters, the City’s portfolio will decrease further as a result of the City beginning to prepay its annual employer pension and retiree medical costs. This pre-payment will result in City savings because of the higher interest rate CalPERS earns, on average, compared to the City’s portfolio yield. Savings from this transaction will
be one component of a financing plan to pay debt associated with the planned construction of a new public safety building.

The portfolio consists of $13.7 million in liquid accounts and $346.2 million in U. S. government treasury and agency securities and certificates of deposit. The $346.2 million includes $123.8 million in investments maturing in less than two years, comprising 35.8 percent of the City’s investment in notes and securities. The investment policy requires at least $50 million shall be maintained in securities maturing in less than two years.

The current market value of the portfolio is 103.5 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 3.56 years compared to 2.74 years last quarter.

Investments Made During the Third Quarter
During the third quarter, $76.5 million of government agency securities with an average yield of 4.2% percent matured. During the same period, government securities totaling $51.5 million with an average yield of 4.5% percent were purchased. The City’s short-term money market and pool account decreased by $5.9 million compared to the second 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 $185.5 million and expenditures will be $196.7 million over the next six months, indicating an overall decline in the portfolio of $11.2 million. The decrease is primarily attributable to prepaying the fiscal year 2008-09 employer pension obligation of $16.4 million in July instead of making bi-weekly payments. Again, the pre-payment is expected to result in savings due to higher interest earnings from CalPERS’ investment portfolio.

As of March 31, 2008, the City had $13.7 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 $38.9 million will mature between April 1, 2008 and September 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 third quarter of 2007-08, staff complied with all aspects of the investment policy except the 30 percent limit of securities with maturities beyond five years. Due to a drop in the portfolio’s assets, securities maturing over five years are 34.1 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 this restriction. This limitation will be restored over time as maturities decline to less than five years or if the portfolio grows. Staff will not invest in securities with maturities greater than five years until the portfolio percentage falls below the policy’s 30 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 third quarter of 2007-08 was $4.4 million. As of March 31, 2008, the yield to maturity of the City’s portfolio was 4.47 percent. This compares to a yield of 4.46 percent in the second quarter. As higher yielding securities purchased in prior years mature and are reinvested in slightly lower yielding ones, staff expects the portfolio’s yield to slowly decline. The City’s portfolio yield of 4.47 percent compares to LAIF’s average yield for the quarter of 4.19 percent and an average yield on the two-year and five-year Treasury bonds during the third quarter of approximately 2.07 percent and 2.73 percent, respectively.

**Yield Trends**
The Federal Open Market Committee (FOMC) decreased the federal funds and discount rate rates in the last three quarters by 3.0 percent and 3.75 percent, respectively. These rates currently are 2.25 and 2.50 percent, respectively. The FOMC continues to monitor consumer spending, inflation, and credit risk closely. The City’s portfolio yield is expected to slowly decrease in the coming quarters as the FOMC keeps rates low due to the ailing economy.

**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 March 31, 2008.

**ATTACHMENTS:**
A) Consolidated Report of Cash and Investments  
B) Investment Portfolio, as of March 31, 2008  
C) Investment Policy Compliance