TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES

DATE: JULY 28, 2008 CMR: 320:08

SUBJECT: CITY OF PALO ALTO’S INVESTMENT ACTIVITY REPORT FOR THE FOURTH 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 fourth 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 June 30, 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.

The par value of the City’s portfolio is $357.8 million; in comparison, last quarter it was $359.9 million. The decline in the portfolio of $2.1 million is attributable to higher utility commodity costs. Compared to the fourth quarter of 2006-07, the portfolio has decreased by $40.6 million. This is primarily due to the establishment of an irrevocable trust fund for retiree medical benefits with the California Public Employees Retirement System (CalPERS) and higher utility commodity costs. The City transferred $33.8 million accumulated in its Retiree Health Benefits Internal Service Fund into the new CalPERS retiree medical trust. In addition, hydroelectric generation for the year was lower due to drought conditions, resulting in a need to buy replacement electric energy at high market prices and, thereby, drawing down utility reserves. In the coming quarters, the City’s portfolio will decrease further as a result of the City prepaying its annual employer pension costs. This prepayment 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 used to pay debt associated with a new public safety building.
The portfolio consists of $27.2 million in liquid accounts and $330.6 million in U.S. government agency securities and certificates of deposit. The $330.6 million includes $143.0 million in investments maturing in less than two years, comprising 43.3 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 101.4 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 3.47 years compared to 3.56 years last quarter and 2.74 years at the end of 2006-07.

**Investments Made During the Fourth Quarter**

During the fourth quarter, $27.5 million of government agency securities with an average yield of 3.7 percent matured. During the same period, government securities totaling $12.0 million with an average yield of 3.8 percent were purchased. The City’s short-term money market and pool account increased by $13.5 million compared to the third 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. The liquid funds were increased in anticipation of prepaying 2008-09 annual employer pension costs.

**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 $193.0 million and expenditures will be $205.5 million over the next six months, indicating an overall decline in the portfolio of $12.5 million. The decrease is attributable to prepaying the Fiscal Year 2008-09 employer pension obligation of $16.4 million in July instead of making bi-weekly payments. This has the effect of decreasing expenditures in subsequent quarters. The prepayment is expected to result in savings due to higher interest earnings from CalPERS’ investment portfolio.

As of June 30, 2008, the City had $27.2 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 $31.1 million will mature between July 1, 2008 and December 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 fourth 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 31.2 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 they fall 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 fourth quarter of 2007-08 was $4.1 million. This total is
8.1 percent lower than what the City received last fiscal year, primarily as a consequence of the
portfolio decreasing by 10.2 percent. As of June 30, 2008, the yield to maturity of the City’s
portfolio was 4.42 percent. This compares to a yield of 4.47 percent in the third quarter and 4.37
percent as of June 30, 2007. As higher yielding maturing securities purchased in prior years mature
and are reinvested in slightly lower yielding ones, staff expects the portfolio’s yield to slowly
decline in the coming quarters. The City’s portfolio yield of 4.42 percent compares to LAIF’s
average yield for the quarter of 3.12 percent and an average yield on the two-year and five-year
Treasury bonds during the fourth quarter of approximately 2.41 percent and 3.16 percent,
respectively.

Recently, there have been numerous news articles about the financial condition of the Federal
National Mortgage Association (Fannie Mae) and the Federal Home Loan Corporation (Freddie
Mac). These companies, charted by Congress to increase home ownership, either own or guarantee
almost half of the U.S. home mortgages outstanding that are worth some $5.2 trillion. These
institutions raise funds by issuing bonds which many municipalities like Palo Alto purchase. The
City currently holds $65.2 million or 18.2 percent of its investment portfolio in Fannie Mae and
Freddie Mac bonds. These fixed income investments are rated AAA due to their implicit backing by
the federal government and their line of credit with the U.S. Treasury.

Because the stock prices of these publicly traded companies have declined significantly due to
concerns over mortgage defaults, the U.S. Treasury has taken steps to make its implicit guarantee
more explicit. These steps include, for example, making available a short-term line of credit of
$2.25 billion and seeking Congressional approval to temporarily increase the line of credit limit.

Due to the importance of the two agencies to the U.S. housing and mortgage market and the severe
financial consequences of their failure, staff believes it highly unlikely that the City’s investments
are at risk. Nevertheless, staff believes it prudent to discontinue purchases of Fannie Mae and
Freddie Mac instruments until market confidence in these agencies returns.

Yield Trends
The Federal Open Market Committee (FOMC) decreased the federal funds and discount rate rates in
the last year by 3.25 percent and 4.0 percent, respectively. These rates currently are 2.00 and 2.25
percent, respectively. The FOMC continues to monitor consumer spending, labor market, inflation,
and credit risks closely. In light of higher commodity costs, including energy prices, the FOMC
inflationary concerns have heightened. The City’s portfolio yield is expected to slowly decrease in
the coming quarters given the low interest rate environment.

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 June 30, 2008.

**ATTACHMENTS:**
A) Consolidated Report of Cash and Investments
B) Investment Portfolio, as of June 30, 2008
C) Investment Policy Compliance

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