TO:         HONORABLE CITY COUNCIL

FROM:      CITY MANAGER      DEPARTMENT:  ADMINISTRATIVE SERVICES

DATE:      OCTOBER 20, 2008    CMR: 418:08

REPORT TYPE:  INFORMATIONAL

SUBJECT: City of Palo Alto’s Investment Activity Report for the First Quarter, Fiscal Year 2008-09

BACKGROUND

The purpose of this report is to inform Council of the City’s investment portfolio status as of the end of the first quarter of Fiscal Year 2008-09. 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

Current Financial Crisis

The City has a conservative investment policy and strictly adheres to the following in priority order: safety, liquidity, and yield. During the current financial upheaval, the City has not lost any principal. A “buy and hold,” laddered investment strategy is strictly maintained so that principal is not risked and liquidity is assured. The majority of the City’s investments are in federally sponsored agency securities such as the Federal Farm Credit Bank, Federal Home Loan Bank, Tennessee Valley Authority, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal Agricultural Mortgage Corporation. These fixed income bonds have a triple A rating and the backing of the federal government. To date, the federal government has backed all of the debt issued by troubled agencies such as the Federal National Mortgage Association (aka Fannie Mae) and Federal Home Loan Mortgage Corporation (aka Freddie Mac). The City, by State regulation, cannot invest in stocks so there has been no exposure to agency stock losses. In addition, the City does not own any corporate bonds or any troubled commercial paper and does not participate in County investment pools.
Investment Portfolio as of September 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 $329.7 million; in comparison, last quarter it was $357.8 million. The decline in the portfolio of $28.1 million is mainly attributable to the City prepaying its annual employer pension costs. The portfolio consists of $10.0 million in liquid accounts and $319.7 million in U.S. government treasury and agency securities and certificates of deposit. The $319.7 million includes $114.5 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 101.2 percent of the book value. It is important to note that the City’s practice is to hold investments until they mature so 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 3.62 years compared to 3.47 years last quarter.

Investments Made During the First Quarter
During the first quarter, $18.4 million of government agency securities with an average yield of 3.7% percent matured. During the same period, government securities totaling $7.5 million with an average yield of 4.3% percent were purchased. The City’s short-term money market and pool account decreased by $17.2 million compared to the fourth quarter of 2007-08. The liquid funds were used to prepay the 2008-09 annual employer pension costs, thereby resulting in an estimated savings to the City on average and over-time of $295 thousand. 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 available 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 $204.6 million and expenditures will be $198.0 million over the next six months, indicating an overall growth in the portfolio of $6.6 million.

As of September 30, 2008, the City had $10.0 million deposited in the Local Agency Investment Fund (LAIF) and a money market account that could be withdrawn on a daily basis. In addition, investments totaling $28.5 million will mature between October 1, 2008 and March 31, 2009. On the basis of the above projections, staff is confident that the City will have more than sufficient funds or liquidity to meet expenditure requirements for the next six months.

Compliance with City Investment Policy
During the first quarter of 2008-09, staff complied with all aspects of the investment policy. 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 first quarter of 2008-09 was $3.8 million. As of September 30, 2008, the yield to maturity of the City’s portfolio was 4.54 percent. This compares to a yield of 4.42 percent in the fourth quarter of 2007-08. In the short term, as lower yielding investments purchased in prior years mature and are reinvested in higher yielding ones, the portfolio’s yield are expected to slightly increase. The City’s portfolio yield of 4.54 percent compares to LAIF’s average yield for the quarter of 2.78 percent and an average yield on the two-year and five-year Treasury bonds during the first quarter of approximately 2.35 percent and 3.09 percent, respectively.

**Yield Trends**
The Federal Open Market Committee (FOMC) decreased the federal funds and discount rate rates in the last year by 3.75 percent and 4.5 percent, respectively. These rates currently are 1.50 and 1.75 percent, respectively. The FOMC’s concerns of slowing economic growth have significantly heightened, while inflation concerns have decreased. The economy is faced with a tight credit market, weak mortgage market, high unemployment, and unprecedented government interventions in the private sector. Given the current volatility in the market, long-term interest rate trends are difficult to predict.

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