



# City of Palo Alto

## City Council Staff Report

(ID # 5847)

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**Report Type: Consent Calendar**

**Meeting Date: 6/15/2015**

**Summary Title: Investment Policy Update**

**Title: Adoption of Fiscal Year 2016 Investment Policy**

**From: City Manager**

**Lead Department: Administrative Services**

### **Recommendation**

Staff recommends that Council approve the City's Investment Policy with the following change:

Modify under Authorized Investments section (number 4) the title from "Bonds of State of California Local Government Agencies" to "California State, California Local Government Agencies, and other United States State Bonds."

### **Background**

During the annual budget process, staff submits the Investment Policy to Council for review and approval (Attachment A). State regulations mandate annual approval of the Investment Policy.

### **Discussion**

For Fiscal Year 2016, staff is proposing a change in authorized investments. This change clarifies staff's flexibility to invest in State of California and California local government agencies. California local government agencies include: any city, county, city and county, district, or other local governmental body or corporation, including the California State Universities (CSU) and University of California (UC) systems, K-12 schools and community colleges empowered to expend public funds.

In addition, changes would allow City staff to purchase the notes and bonds of the remaining 49 states in the United States. This would permit investments in all state level registered treasury notes or bonds including the state and state departments, boards, agencies or authorities that demonstrate the capacity or revenue sources to repay their bonds. Investments in any of the non-state level jurisdictions of the other 49 states would **not** be permitted.

All California state and municipal obligation investments as well as investments in the other 49 states will, at the time of purchase, require a minimum Double A (AA/AA2) rating as provided by a nationally recognized rating service (e.g. Moody's, Standard and Poor's, etc.). Total

investments in state and California local jurisdiction bonds will not exceed 10 percent of the par value of the portfolio.

The rationale for detailing and expanding the scope of City investments, which are in alignment with the State of California code covering allowable investments, is to compensate for the current and future scarcity of U.S. agency investments. Agencies such as the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation are issuing fewer securities under Congressional scrutiny. In fact, there is movement toward shrinking these quasi-government agencies as a consequence of their financial losses during the Great Recession and to decouple them from the security umbrella offered by the federal government. By adding the obligations of the remaining 49 states to the City's investment armamentarium, the City has more options in investing idle cash, maintaining a solid portfolio yield; and, most importantly, preserving City capital in secure investment instruments.

Staff recommends Council approve the proposed changes to the Investment Policy to provide greater investment flexibility and diversification opportunities.

#### **Resource Impact**

There is no significant budget impact associated with this report.

#### **Policy Implications**

This recommendation contains a clarification to the City's Investment Policy.

#### **Environmental Review**

The actions requested in this report do not constitute a project for the purposes of the California Environmental Quality Act (CEQA).

#### **Attachments:**

- Attachment A: Draft Investment Policy 2015-16 (DOC)

# **ATTACHMENT A**

## **PROPOSED CITY OF PALO ALTO Investment Policy Fiscal Year 2015-16**

### **With Changes**

#### **INTRODUCTION**

The City of Palo Alto invests its pooled idle cash according to State of California law and the charter of the City of Palo Alto. In particular, the City follows “The Prudent Investor Standard” cited in the State Government Code (Section 53600.3). Under this standard, all governing bodies of local agencies or persons authorized to make investment decisions on behalf of the City are trustees and therefore fiduciaries subject to the prudent investor standard. When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to the general economic conditions and the anticipated needs of the agency, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the agency.

#### **INVESTMENT PHILOSOPHY**

The basic principles underlying Palo Alto's investment philosophy is to ensure the safety of public funds; provide that sufficient money is always available to meet current expenditures; and achieve a reasonable rate of return on its investments.

The City's preferred and chief practice is to buy securities and to hold them to their date of maturity rather than to trade or sell securities prior to maturity. The City may, however, elect to sell a security prior to its maturity should there be a significant financial need. If securities are purchased and held to their maturity date, then any changes in the market value of those securities during their life will have no effect on their principal value. Under a buy and hold philosophy, the City is able to protect its invested principal. The economy, the money markets, and various financial institutions (such as the Federal Reserve System) are monitored carefully to make prudent investments and to assess the condition of the City's portfolio.

## **INVESTMENT OBJECTIVES**

The primary objectives, in priority order, of investment activities shall be safety, liquidity, and yield:

1. **Safety:** Safety of principal is the foremost objective of the investment program. Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. The objective will be to mitigate credit risk and interest rate risk.
  - a) Credit risk is the risk that an obligation will not be paid and a loss will result. The City will seek to minimize this risk by:
    - Limiting investment to the safest types of securities as listed in the “Authorized Investment” section.
    - Diversifying its investments among the types of securities that are authorized under this investment policy.
  - b) Interest rate risk is the risk that changes in interest rates will adversely affect the value of an investor’s portfolio. For example, an investor with large holdings in long-term bonds has assumed significant interest rate risk because the value of the bonds will fall if interest rates rise. The City can minimize this risk by:
    - Buying and holding its securities until maturity.
    - Structuring the investment portfolio so that securities mature to meet cash flow requirements.

To further achieve the objective of safety, the amount that can be invested in all investment categories, excluding obligations of the U.S. Government and its agencies, is limited either as a percentage of the portfolio or by a specific dollar amount. These limits are defined under the “Authorized Investments” section.

2. **Liquidity:** Liquidity is the second most important objective of the investment program. The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This is accomplished by maintaining a portion of the portfolio in liquid money market mutual funds or local government investment pools. In addition, the City will maintain one month’s cash needs in short term investments and at least \$50 million shall be maintained in securities maturing in less than two years. Since all possible cash demands cannot be anticipated, however, the portfolio will consist of securities with active secondary or resale markets should the need to sell a security prior to maturity arises.

3. **Yield:** Yield on the City's portfolio is last in priority among investment objectives. The investment portfolio shall be designed to obtain a market rate of return that reflects the authorized investments, risk constraints, and liquidity needs outlined in the City's investment policy. Compared to similar sized cities, the City of Palo Alto should be able to take advantage of its relatively large reserve balances to achieve higher yields through long-term investments. In addition, the City will strive to maintain the level of investment of idle funds as close to 100 percent as possible.

### **SCOPE**

- A. This investment policy shall apply to all financial assets of the City of Palo Alto as accounted for in the Comprehensive Annual Financial Report (CAFR), including but not limited to the following funds:
  1. General Fund
  2. Special Revenue Funds
  3. Debt Service Funds
  4. Capital Project Fund
  5. Enterprise Funds
  6. Internal Service Funds
  7. Trust and Agency Funds
- B. The policy does not cover funds held by the Public Employees Retirement System or funds of the Deferred Compensation program.
- C. Investments of bond proceeds shall be governed by the provisions of the related bond indentures.

### **GENERAL INVESTMENT GUIDELINES**

1. The maximum stated final maturity of individual securities in the portfolio should be ten years.
2. A maximum of 30 percent of the par value of the portfolio shall be invested in securities with maturities beyond five years.
3. The City shall maintain a minimum of one month's cash needs in short term investments.
4. At least \$50 million shall be maintained in securities maturing in less than 2 years.
5. Should the ratio of the market value of the portfolio to the book value of the portfolio fall below 95 percent, the Administrative Services Department will report this fact to the City Council within a reasonable time frame and evaluate whether there is any risk of

holding any of the securities to maturity.

6. Commitments to purchase securities newly introduced on the market shall be made no more than three (3) working days before pricing.
7. Whenever possible, the City will obtain three or more quotations on the purchase or sale of comparable securities and take the higher yield on purchase or higher price on sale. This rule will not apply to new issues, which are purchased at market no more than three (3) working days before pricing, as well as to LAIF, City of Palo Alto bonds, money market accounts and mutual funds, all of which shall be evaluated separately.
8. Where the Investment Policy specifies a percentage limitation for a particular category of investment, that percentage is applicable only at the date of purchase. A later increase or decrease in a percentage resulting from a change in the portfolio's assets or values shall not constitute a violation of that restriction. As soon as possible, percentage limitations will be restored as investments mature in each category.

### **AUTHORIZED INVESTMENTS**

The California Government Code (Sections 53600 et seq.) governs investment of City funds. The following investments are authorized:

1. **U.S. Government Securities** (e.g. Treasury notes, bonds and bills) Securities that are backed by the full faith and credit of the United States
  - a) There is no limit on purchase of these securities.
  - b) Securities will not exceed 10 years maturity.
  - c) All purchased securities must have an explicit or a de facto backing of the full faith and credit of the U.S. Government.
2. **U.S. Government Agency Securities** – Obligations issued by the Federal Government agencies (e.g. Federal National Mortgage Association).
  - a) There is no limit on purchase of these securities except for:
    - Callable and Multi-step-up securities provided that:
      - The potential call dates are known at the time of purchase;
      - the interest rates at which they “step-up” are known at the time of purchase; and
      - the entire face value of the security is redeemed at the call date.
    - No more than 25 percent of the par value of the portfolio.

b) Securities will not exceed 10 years maturity.

3. **California State, California Local Government Agencies, and other United States State Bonds**~~**Bonds of State of California Local Government Agencies**~~

a) Having at time of investment a minimum Double A (AA/AA2) rating as provided by a nationally recognized rating service (e.g. Moody's and/or Standard and Poor's).

b) May not exceed 10 percent of the par value of the portfolio.

**c) Investments include:**

i) Registered state warrants or treasury notes or bonds of the State of California and bonds, notes, warrants, or other evidences of indebtedness of any local agency within California, including bonds payable solely out of the revenues from a revenue producing property owned, controlled, or operated by the state or local agency or by a department, board, agency, or authority of the state or local agency.

ii) Registered treasury notes or bond of any of the 49 United States in addition to the State of California, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by a state or by a department, board, agency or authority of any of the other 49 United States, in addition to the State of California.

4. **Certificates of Deposit (CD)** - A debt instrument issued by a bank for a specified period of time at a specified rate of interest.

a) May not exceed 20 percent of the par value of the portfolio.

b) No more than 10 percent of the par value of the portfolio in collateralized CDs in any institution.

c) Purchase collateralized deposits only from federally insured large banks that are rated by a nationally recognized rating service (e.g. Moody's and/or Standard and Poor's).

d) For non-rated banks, deposit should be limited to amounts federally insured (FDIC). – See Appendix C

e) Rollovers are not permitted without specific instruction from authorized

City staff.

5. **Banker's Acceptance Notes (BA)** – Bills of exchange or time drafts drawn on and accepted by commercial banks. Purchase of banker's acceptances are limited to:
  - a) No more than 30 percent of the par value of the portfolio.
  - b) Not to exceed 180 days maturity.
  - c) No more than \$5 million with any one institution.
  
6. **Commercial Paper** - Short-term unsecured obligations issued by banks, corporations, and other borrowers. Purchases of commercial paper are limited to:
  - a) Having highest letter or numerical rating as provided for by a nationally recognized rating service (e.g. Moody's and/or Standard and Poor's).
  - b) No more than 15 percent of the par value of the portfolio.
  - c) Not to exceed 270 days maturity.
  - d) No more than \$3 million or 10 percent of the outstanding commercial paper of any one institution, whichever is lesser.
  
7. **Local Agency Investment Fund (LAIF)** – A State of California managed investment pool may be used up to the maximum permitted by California State Law.
  
8. **Short-Term Repurchase Agreements (REPO)** – A contractual agreement between a seller and a buyer, usually of U.S. government securities, whereby the seller agrees to repurchase the securities at an agreed upon price and, usually, at a stated time.
  - a) Not to exceed 1 year.
  - b) Market value of securities that underlay a repurchase agreement shall be valued at 102 percent or greater of the funds borrowed against those securities.
  - c) A Master Repurchase agreement must be signed with the bank or dealer.
  
9. **Money Market Deposit Accounts** – Liquid bank accounts which seek to maintain a net asset value of \$1.00.
  
10. **Mutual Funds** which seek to maintain a net asset value of \$1.00 and which are limited essentially to the above investments and further defined in note 9 of Appendix A



- a) No more than 20 percent of the par value of the portfolio.
  - b) No more than 10 percent of the par value with any one institution.
11. **Negotiable Certificates of Deposit (NCD)** issued by nationally or state chartered banks and state or federal savings institutions and further defined in note 11 of Appendix A. Purchases of negotiable certificates of deposit:
- a) May not exceed 10 percent of the par value of the portfolio.
  - b) No more than \$5 million in any one institution.
12. **Medium-Term Corporate Notes** – Issued by corporation organized and operating within the United States or by depository institutions licensed by the United States or any state and operating with the United States.
- a) Not to exceed 5 years maturity.
  - b) Securities eligible for investment shall have a minimum rating of AA from a nationally recognized rating service (e.g. Moody's and/or Standard & Poor's).
  - c) No more than 10 percent of the par value of the portfolio.
  - d) No more than \$5 million of the par value may be invested in securities of any single issuer, other than the U.S. Government, its agencies and instrumentality.
  - e) If securities owned by the City are downgraded by either Moody's or Standard & Poors to a level below AA, it shall be the City's policy to review the credit situation and make a determination as to whether to sell or retain such securities in the portfolio.

Appendix A provides a more detailed description of each investment vehicle and its security and liquidity features. Most of the City's short-term investments will be in securities which pay principal upon maturity, while long-term investments may be in securities that periodically repay principal, as well as interest. Most of the City's investments will be at a fixed rate. However, some of the investments may be at a variable rate, so long as that rate changes on specified dates in pre-determined increments.

**PROHIBITED INVESTMENTS:**

Includes all investments not specified above, and in particular:

1. Reverse repurchase agreements
2. Derivatives, as defined in Appendix B

Appendix B provides a more detailed description of each investment, which is prohibited, for City investment.

### **AUTHORIZED INVESTMENT PERSONNEL**

Idle cash management and investment transactions are the responsibility of the Administrative Services Department. The Administrative Services Department is under the control of the Director of Administrative Services (Director), as treasurer, who is subject to the direction and supervision of the City Manager.

The Assistant Directors of Administrative Services, who reports to the Director, are authorized to make all investment transactions allowed by the Statement of Investment Policy. He or she may authorize the Senior Financial Analyst/Investments (Analyst) to enter into investments within clearly specified parameters.

The Investment function is under the supervision of the Assistant Director of Administrative Services (Assistant). The Assistant is charged with the responsibility to manage the investment program (portfolio), which includes developing and monitoring the City's cash flow model and developing long-term revenue and financing strategies and forecasts.

The Analyst is subject to the direction and supervision of the Assistant. The Analyst assists the Assistant, in the purchase and sale of securities. The Analyst also prepares the quarterly report, and records daily all investment transactions as to the type of investment, amount, yield, and maturity. Cash flow projections are prepared as needed.

In all circumstances, approval from the Director of Administrative Services is required before selling securities from the City's portfolio. The Analyst may also transfer no more than a total of \$8 million a day from the City's general account to any one financial institution, without the prior approval of the Assistant Director of Administrative Services.

No other person has authority to make investment transactions without the written authority of the Assistant Director of Administrative Services.

### **USE OF BROKERS AND DEALERS**

The Administrative Services Department maintains a list of acceptable dealers. A dealer acts as a principal in security transactions, selling securities from and buying securities for their own position. A dealer must have

- a) At least three years experience operating with California municipalities;
- b) Maintain an inventory of trading securities of at least \$10 million; and

- c) Be approved by the Assistant Administrative Services Director before being added to the City's list of approved dealers. In addition, individual traders or agents representing a dealer:

A dealer will be removed from the list should there develop a history of problems to include: failure to deliver securities as promised, failure to honor transactions as quoted, or failure to provide accurate information.

**SAFEKEEPING AND CUSTODY**

All securities shall be delivered to the City's safekeeping custodian and held in the name of the City of Palo Alto, with the exception of the following investments:

- a) Certificates of deposit, which may be held by the City itself.
- b) City shares in pooled investment funds, under contract.
- c) Mutual funds
- d) Local Agency Investment Fund (LAIF)

**POLICY REVIEW AND REPORTING ON INVESTMENTS**

Monthly, the Administrative Services Department will review performance in relation to-Council-adopted Policy. Quarterly, the Department will report to Council on: its performance in comparison to policy, explain any variances from policy, provide any recommendations for policy changes, and discuss overall compliance with the City's Investment Policy. In addition, the Department will provide Council with:

- a) A detailed list of all securities, investments and monies held by the City, and
- b) Report on the City's ability to meet expenditure requirements over the next six months.

Annually, the Administrative Services Department will present a Proposed Statement of Investment Policy, to include the delegation of investment authority, to the City Council for review during the annual budget process. All proposed changes in policy must be approved by the Council prior to implementation.

Adopted by City Council October 22, 1984	Amended by City Council January 26, 1998
Monthly reporting effective January 1985	Amended by City Council June 22, 1998
Amended and Adopted by City Council June 24, 1985	Amended by City Council June 28, 1999
Amended by City Council December 2, 1985	Amended by City Council June 19, 2000
Amended by City Council June 23, 1986	Amended by City Council June 11, 2001
Amended by City Council June 22, 1987	Amended by City Council June 17, 2002
Amended by City Council August 8, 1988	Amended by City Council June 17, 2003
Amended by City Council November 28, 1988	Amended by City Council June 28, 2004
Amended by City Council June 26, 1989	Amended by City Council June 20, 2005
Amended by City Council May 14, 1990	Amended by City Council June 12, 2006
Amended by City Council June 24, 1991	Amended by City Council June 11, 2007

Amended by City Council June 22, 1992	Amended by City Council June 09, 2008
Amended by City Council June 23, 1993	Amended by City Council June 15, 2009
Amended by City Council June 20, 1994	Amended by City Council June 28, 2010
Amended by City Council June 19, 1995	Amended by City Council June 20, 2011
Amended by City Council June 24, 1996	Amended by City Council June 18, 2012
Amended by City Council June 18, 2012	Amended by City Council June 03, 2013
Amended by City Council June 23, 1997	Amended by City Council June 16, 2014

## APPENDIX A

### EXPLANATION OF PERMITTED INVESTMENTS

1. **U.S. Government Securities** – United States Treasury notes, bonds, bills, or certificates of indebtedness or those for which the faith and credit of the United States are pledged for the payment of principal and interest.
  
2. **U.S. Government Agency Securities** - U.S. Government Agency Obligations include the securities of the Federal National Mortgage Association (FNMA), Federal Land Banks (FLB), Federal Intermediate Credit Banks (FICB), banks for cooperatives, Federal Home Loan Banks (FHLB), Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Student Loan Marketing Association (SLMA), Small Business Administration (SBA), Federal Farm Credit (FFC), Federal Agricultural Mortgage Corporation (FAMC or FMAC), and Tennessee Valley Authority (TVA). Federal Agency securities are debt obligations that essentially result from lending programs of the Government. Federal agency securities differ from other types of securities, as well as among themselves. Their characteristics depend on the issuing agency. It is possible to distinguish three types of issues: (A) participation certificates (pooled securities), (B) Certificates of interest (pooled loans), (C) notes, bonds, and debentures. The securities of a few agencies are explicitly backed by the full faith and credit of the U.S. Government. All other issues purchased by the City have the de facto backing from the federal government, and it is highly unlikely that the government would let any agency default on its obligations.
  
3. **Certificates of Deposit** - A certificate of deposit (CDs) is a receipt for funds deposited in a bank, savings bank, or savings and loan association for a specified period of time at a specified rate of interest. Denominations are \$250,000 and up. The first \$250,000 of a certificate of deposit is guaranteed by the Federal Deposit Insurance Corporation (FDIC), if the deposit is with a bank or savings bank, or the Savings Association Insurance Fund (SAIF), if the deposit is with a savings and loan. CDs with a face value in excess of \$250,000 can be collateralized by U.S. Government Agency and Treasury Department securities or first mortgage loans. Government securities must be at least 110 percent of the face value of the CD collateralized in excess of the first \$250,000. The value of first mortgages must be at least 150 percent of the face value of the CD balance insured in excess of the first \$250,000. Generally, CDs are issued for more than 30 days and the maturity can be selected by the purchaser.
  
4. **Bankers' Acceptance** - A Banker's acceptance (BA) is a negotiable time draft or bill of exchange drawn on and accepted by a commercial bank. Acceptance of the draft irrevocably obligates the bank to pay the bearer the face amount of the draft at maturity. BAs are usually created to finance the import and export of goods, the shipment of goods within the United States and storage of readily marketable staple commodities. In over 70 years of usage in the United States, there has been no known instance of principal loss to any investor in BAs. In addition to the guarantee by the accepting bank, the transaction is identified with a specific commodity. Warehouse receipts verify that the pledged commodities exist, and, by

definition, these commodities are readily marketable. The sale of the underlying goods generates the necessary funds to liquidate the indebtedness.

BAs enjoy marketability since the Federal Reserve Bank is authorized to buy and sell prime BAs with maturities of up to nine months. The Federal Reserve Bank enters into repurchase agreements in the normal course of open market operations with BA dealers.

As are sold at a discount from par. An acceptance is tied to a specific loan transaction; therefore, the amount and maturity of the acceptance is fixed.

5. **Commercial Paper** - Commercial paper notes are unsecured promissory notes of industrial corporations, utilities, and bank holding companies. Interest is discounted from par and calculated using actual number of days on a 360-day year. The notes are in bearer form, with maturities up to 270 days selected by the purchaser, and denominations generally start at \$100,000. There is a small secondary market for commercial paper notes and an investor may sell a note prior to maturity.

Commercial paper notes are backed by unused lines of credit from major banks. Some issuer's notes are insured, while some are backed by irrevocable letters of credit from major banks. State law limits a City to investments in United States corporations having assets in excess of five hundred million dollars with an "A" or higher rating by a nationally recognized rating service for the issuer's debentures. Cities may not invest more than 25 percent of idle cash in commercial paper.

6. **Local Agency Investment Fund Demand Deposit** - The Local Agency Investment Fund (LAIF) was established by the State to enable treasurers to place funds in a pool for investments. The City is limited to an investment of the amount allowed by LAIF (currently \$40 million). LAIF has been particularly beneficial to those jurisdictions with small portfolios. Palo Alto uses this fund for short-term investment, liquidity, and yield.

7. **Repurchase Agreements** - A Repurchase Agreement (REPOS) is not a security, but a contractual arrangement between a financial institution or dealer and an investor. The agreement normally can run for one or more days. The investor puts up funds for a certain number of days at a stated yield. In return, the investor takes title to a given block of securities as collateral. At maturity, the securities are repurchased and the funds repaid, plus interest. Usually, amounts are \$500,000 or more, but some REPOS can be smaller.

8. **Money Market Deposit Accounts** - Money Market Deposit Accounts are market-sensitive bank accounts, which are available to depositors at any time, without penalty. The interest rate is generally comparable to rates on money market mutual funds, though any individual bank's rate may be higher or lower. These accounts are insured by the Federal Deposit Insurance Corporation or the Savings Association Insurance Fund.

9. **Mutual Funds** - Mutual funds are shares of beneficial interest issued by diversified management companies, as defined by section 23701 M of the Revenue and Taxation Code. To be eligible for investment, these funds must:
- a) Attain the highest ranking in the highest letter and numerical rating provided by not less than two of the three largest nationally recognized rating services; or
  - b) Have an investment advisor registered with the Securities and Exchange Commission with not less than five years experience investing in the securities and obligations, as authorized by subdivisions (a) to (n), inclusive, of Section 53601 of the California Government Code, and with assets under management in excess of five hundred million dollars; and
  - c) Invest solely in those securities and obligations authorized by Sections 53601 and 53635 of the California Government Code. Where the Investment Policy of the City of Palo Alto may be more restrictive than the State Code, the Policy authorizes investments in mutual funds that shall have minimal investment in securities otherwise restricted by the City's Policy. Minimal investment is defined as less than 5 percent of the mutual fund portfolio; and
  - d) The purchase price of shares of beneficial interest purchased shall not include any commission that these companies may charge.
  - e) Have a net asset value of \$1.00.
10. **Callable Securities and Multi-Step-ups:** Callable securities are defined as fixed interest rate government agency securities that give the issuing agency the option of returning the invested funds at a specific point in time to the purchaser. Multi-step-ups are government agency securities in which the interest rate increases ("steps-up") at preset intervals, and which also have a callable option that allows the issuing agency to return the invested funds at a preset interval. Callable and multi-step-ups are permitted, provided that:
- the potential call dates are known at the time of purchase;
  - the interest rates at which they “step-up” are known at the time of purchase; and
  - the entire face value of the security is redeemed at the call date.

11. **Negotiable Certificates of Deposit (NCD).** NCDs are large-dollar-amount, short-term certificate of deposit. Such certificates are issued by large banks and bought mainly by corporations and institutional investors. They are payable either to the bearer or to the order of the depositor, and, being negotiable, they enjoy an active secondary market, where they trade in round lots of \$5 million. Although they can be issued in any denomination from \$100,000 up, the typical amount is \$1 million. Also called a Jumbo Certificate of Deposit.

State law prohibits the investment of local agency funds in negotiable certificates of deposit issued by a state or federal credit union if a member of the legislative body of the local agency, or any person with investment decision making authority in the administrative, manager's, budget, auditor-controller's, or treasurer's offices of the local agency also serves on the board of directors, other credit committee or the supervisory committee of the state or federal credit union issuing the negotiable certificate of deposit.

12. **Medium-Term Corporate Notes:** Notes of a maximum of five years maturity issued by corporations organized and operating with the United States or by depository institutions licensed by the United States or any state and operating with the United States. According to California Code Section 53601, "Notes eligible for investment under this subdivision shall be rated in the rating category of "Double A" or its equivalent or better by a nationally recognized rating service. Purchase of medium-term notes may not exceed 30 percent of the agency's surplus money which may be invested pursuant to this section."



## **APPENDIX B**

### **EXPLANATION OF PROHIBITED INVESTMENTS**

1. **Reverse Repurchase Agreements:** A Reverse Repurchase Agreement (Reverse REPO) is a contractual agreement by the investor (e.g. local agency) to post a security it owns as collateral, and a bank or dealer temporarily exchanges cash for this collateral, for a specific period of time, at an agreed-upon interest rate. During the period of the agreement, the local agency may use this cash for any purpose. At maturity, the securities are repurchased from the bank or dealer, plus interest.

California law contains a number of restrictions on the use of Reverse REPOS by local agencies.

2. **Derivatives:** A derivative is a financial instrument created from, or whose value depends on (is derived from), the value of one or more underlying assets or indices. The term "derivative" refers to instruments or features, such as collateralized mortgage obligations, forwards, futures, currency and interest rate swaps, options, caps and floors. Except for those callable and multi-step-up securities as described under Permitted Investments, derivatives are prohibited.

Certain derivative products have characteristics which could include high price volatility, liquid markets, products that are not market-tested, products that are highly leveraged, products requiring a high degree of sophistication to manage, and products that are difficult to value.

According to California law, a local agency shall not invest any funds in inverse floaters, range notes, or interest-only strips that are derived from a pool of mortgages.

## **APPENDIX C GLOSSARY OF INVESTMENT TERMS**

**AGENCIES:** Federal agency and instrumentality securities.

**ASKED:** The price at which securities are offered.

**BID:** The price offered by a buyer of securities (when one sells securities, one asks for a bid). See “*Offer*”.

**BROKER:** A broker brings buyers and sellers together so that he can earn a commission.

**COLLATERAL:** Securities, evidence of deposit, or other property, which a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposits of public monies.

**COMPREHENSIVE ANNUAL FINANCIAL REPORT (“CAFR”):** The official annual report for the City of Palo Alto. It includes combined financial statements for each individual fund and account group prepared in conformity with GAAP. It also includes supporting schedules that are necessary to demonstrate compliance with finance-related legal and contractual provisions, extensive introductory material, and a detailed statistical section.

**COUPON:** (a) The annual rate of interest that a bond’s issuer promises to pay the bondholder on the bond’s face value. (b) A certificate attached to a bond evidencing interest due on a payment date.

**DEALER:** A dealer, as opposed to a broker, acts as a principal in all transactions, buying and selling for his own account.

**DEBENTURE:** A bond secured only by the general credit of the issuer.

**DELIVERY VERSUS PAYMENT:** There are two methods of delivery of securities: (1) delivery versus payment (DVP); and (2) delivery versus receipt (DVR). DVP is delivery of securities with an exchange of money for the securities. DVR is delivery of securities with an exchange of a signed receipt for the securities.

**DISCOUNT:** The difference between the acquisition cost of a security and its value at maturity when quoted at lower than face value. A security that sells below original offering price shortly after sale, is also is considered to be at a discount.

**DISCOUNT SECURITIES:** Non-interest bearing money market instruments that are issued a discount and that are redeemed at maturity for full face value (e.g., U.S. Treasury Bills).

**DIVERSIFICATION:** Dividing investment funds among a variety of securities that offer

independent returns.

**FEDERAL AGRICULTURAL MORTGAGE CORPORATION (“FAMC” or “FMAC”):** A federal agency established in 1988 to provide a secondary market for farm mortgage loans. Informally called *Farmer Mac*.

**FEDERAL CREDIT AGENCIES:** Agencies of the Federal Government that were established to supply credit to various classes of institutions and individuals (e.g., S&Ls, small business firms, students, farmers, farm cooperatives, and exporters).

**FEDERAL DEPOSIT INSURANCE CORPORATION (“FDIC”):** A federal agency that insures all types of deposits received at an insured bank, including deposits in a checking account, negotiable order of withdrawal (NOW) account, savings account, money market deposit account (MMDA) or time deposit such as a certificate of deposit (CD). FDIC insurance covers depositors' accounts at each insured bank, dollar-for-dollar, including principal and any accrued interest through the date of the insured bank's closing, up to the insurance limit.

The FDIC does not insure money invested in stocks, bonds, mutual funds, life insurance policies, annuities or municipal securities, even if these investments are purchased at an insured bank. The FDIC does not insure U.S. Treasury bills, bonds or notes, but these investments are backed by the full faith and credit of the United States government.

The standard maximum deposit insurance amount is described as the “SMDIA” in FDIC regulations. The SMDIA is \$250,000 per depositor, per insured bank.

**FEDERAL FUNDS RATE:** The rate of interest at which Fed funds are traded. This rate is currently pegged by the Federal Reserve through open-market operations.

**FEDERAL HOME LOAN BANKS (“FHLB”):** Government-sponsored wholesale banks (currently 12 regional banks) which lend funds and provide correspondent banking services to member commercial banks, thrift institutions, credit unions, and insurance companies. The mission of the FHLBs is to liquefy the housing-related assets of its members, who must purchase stock in their District Bank.

**FEDERAL NATIONAL MORTGAGE ASSOCIATION (“FNMA”):** FNMA, like GNMA, was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing and Urban Development (HUD). It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. The corporation’s purchases include a variety of adjustable mortgages and second loans, in addition to fixed-rate mortgages. FNMA’s securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

**FEDERAL OPEN MARKET COMMITTEE (“FOMC”):** The FOMC consists of seven

members of the Federal Reserve Board and five of the 12 Federal Reserve Bank Presidents. The President of the New York Federal Reserve Bank is a permanent member, while the other Presidents serve on a rotating basis. The Committee periodically meets to set Federal Reserve guidelines regarding purchases and sales of government securities in the open market, as a means of influencing the volume of bank credit and money.

**FEDERAL RESERVE SYSTEM:** The central bank of the United States created by Congress and consisting of a seven-member Board of Governors in Washington, D.C., 12 regional banks, and about 5,700 commercial banks that are members of the system.

**GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (“GNMA” or “Ginnie Mae”):** Securities that influence the volume of bank credit that is guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations, and other institutions. A security holder is protected by the full faith and credit of the U.S. Government. Ginnie Mae securities are backed by the FHA, VA, or FMHM mortgages. The term “pass-throughs” is often used to describe Ginnie Maes.

**LIQUIDITY:** A liquid asset is one that can be converted easily and rapidly into cash without a substantial loss of value. In the money market, a security is said to be liquid if the spread between bid and asked prices is narrow, and reasonable amount can be done at those quotes.

**LOCAL GOVERNMENT AGENCY:** A local government agency is any city, county, city and county, district, or other local governmental body or corporation, including the California State Universities (CSU) and University of California (UC) systems, K-12 schools and community colleges empowered to expend public funds.

**LOCAL GOVERNMENT INVESTMENT FUND (“LAIF”):** Monies from local governmental units may be remitted to the California State Treasurer for deposit in this special fund for the purpose of investment.

**MARKET VALUE:** The price at which a security is trading and could presumably be purchased or sold.

**MASTER REPURCHASE AGREEMENT:** A written contract covering all future transactions between the parties to repurchase-reverse repurchase agreements that establish each party’s rights in the transactions. A master agreement will often specify, among other things, the right of the buyer (lender) to liquidate the underlying securities in the event of default by the seller (borrower).

**MATURITY:** The date upon which the principal or stated value of an investment becomes due and payable.

**MONEY MARKET:** The market in which short-term debt instruments (e.g., bills, commercial paper, and bankers’ acceptances) are issued and traded.

**OFFER:** The price asked by a seller of securities (when one buys securities, one asks for an offer).

See “*Asked*” and “*Bid*”.

**OPEN MARKET OPERATIONS:** Purchases and sales of government and certain other securities in the open market by the New York Federal Reserve Bank, as directed by the FOMC in order to influence the volume of money and credit in the economy. Purchases inject reserves into the bank system and stimulate growth of money and credit; sales have the opposite effect. Open market operations are the Federal Reserve’s most important and most flexible monetary policy tool.

**PORTFOLIO:** A collection of securities that an investor holds.

**PRIMARY DEALER:** A group of government securities dealers that submit daily reports of market activity and positions, and monthly financial statements to the Federal Reserve Bank of New York, and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission (SEC) -- registered securities broker-dealers, banks, and a few unregulated firms.

**PRUDENT INVESTOR RULE:** An investment standard cited in the California Government Code (CGC) Section 53600 et seq. Under this standard, all governing bodies of local agencies or persons authorized to make investment decisions on behalf of the City are trustees and therefore fiduciaries subject to the prudent investor standard. When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, a trustee shall act with care, skill, prudence, and diligence under the circumstances then prevailing, including, but not limited to the general economic conditions and the anticipated needs of the agency, that a prudent person acting in a like capacity and familiarity with those matters would use in the conduct of funds of a like character and with like aims, to safeguard the principal and maintain the liquidity needs of the agency.

**QUALIFIED PUBLIC DEPOSITORIES:** A financial institution that: (1) does not claim exemption from the payment of any sales, compensating use, or ad valorem taxes under the laws of this state; (2) has segregated for the benefit of the commission eligible collateral having a value of not less than its maximum liability; and (3) has been approved by the Public Deposit Protection Commission to hold public deposits.

**RATE OF RETURN:** The yield obtainable on a security based on its purchase price or its current market price.

**SAFEKEEPING:** A service to customers rendered by banks for a fee whereby securities and valuables of all types and descriptions are held in the bank’s vaults for protection.

**SECONDARY MARKET:** A market made for the purchase and sale of outstanding issues following the initial distribution.

**SECURITIES AND EXCHANGE COMMISSION:** An agency created by Congress to administer securities legislation for the purpose of protecting investors in securities transactions.

**STRUCTURED NOTES:** Notes issued by instrumentalities (e.g., FHLB, FNMA, SLMA) and by corporations, that have imbedded options (e.g., call features, step-up coupons, floating rate coupons,

derivative-based returns) in their debt structure. The market performance of structured notes is affected by fluctuating interest rates; the volatility of imbedded options; and shifts in the yield curve.

**TIME CERTIFICATE OF DEPOSIT:** A non-negotiable certificate of deposit, which cannot be sold prior to maturity.

**TREASURY BILLS:** A non-interest bearing discount security that is issued by the U.S. Treasury to finance the national debt. Most T-bills are issued to mature in three months, six months, or one year.

**TREASURY BONDS:** Long-term, coupon-bearing U.S. Treasury securities that are issued as direct obligations of the U.S. Government, and having initial maturities of more than 10 years.

**TREASURY NOTES:** Medium-term, coupon-bearing U.S. Treasury securities that are issued as direct obligations of the U.S. Government, and having initial maturities of two to 10 years.

**YIELD:** The rate of annual income return on an investment, expressed as a percentage.

**YIELD-TO-CALL (YTC):** The rate of return an investor earns from a bond assuming the bond is redeemed (called) prior to its nominal maturity date.

**YIELD-TO-MATURITY:** The current income yield minus any premium above par or plus any discount from par in purchase price, with the adjustment spread over the period from the date of purchase to the date of maturity.

**ZERO-COUPON SECURITIES:** Security that is issued at a discount and makes no periodic interest payments. The rate of return consists of a gradual accretion of the principal of the security and is payable at par upon maturity.