

**MEMORANDUM**

Finance and Administrative Services Department

DATE: _____, 2022

TO: Honorable City Council

FROM: Sally Lieber, Chair, Investment Review Committee
Jesse Takahashi, Finance and Administrative Services Director

SUBJECT: Annual Report of the Investment Review Committee for Fiscal Year 2021-22

INTRODUCTION

The Investment Review Committee (Committee or IRC) convened on October 6, 2022 for its annual review of the City's investment portfolio for Fiscal Year 2021-22. This memorandum contains the Committee's findings and recommendations regarding the City's portfolio and the portfolio's management program as required by [City Council Policy B-2, Investment Policy](#) (Policy) (Exhibit 1). Acceptance of this report by the City Council constitutes voluntary compliance with California Government Code Section 53646(a)(2), which states that: "[T]he treasurer or chief fiscal officer of the local agency may annually render to the legislative body of that local agency and any oversight committee of that local agency a statement of investment policy, which the legislative body of the local agency shall consider at a public meeting. Any change in the policy shall also be considered by the legislative body of the local agency at a public meeting."

BACKGROUND

Section 14.3 of the Policy requires the establishment of an Investment Review Committee comprised of the members of the Council Finance Committee (CFC) and two public members with expertise in the area of fixed-income investments appointed by the City Council. The public members appointed by the City Council are Steven Permut, Retired Vice President, Senior Portfolio Manager and Director of Municipal Investments for American Century Investment Management, Inc. (appointed June 28, 2005); and Douglas Radtke, CPA, Radtke & Company (appointed December 8, 2020). The CFC is comprised of Councilmembers Sally Lieber (Chair of the IRC), Lisa Matichak, and Mayor Lucas Ramirez.

The purpose of the IRC is to provide oversight and an objective assessment of the City's investment portfolio and related matters. It is required to meet annually to review and discuss portfolio management matters with the City's external investment advisor, the City Manager, and the Finance and Administrative Services Director. All Committee members and City Councilmembers receive monthly and quarterly investment portfolio status reports. A primary function of the IRC is to annually report their findings and any policy recommendations regarding the investment portfolio to the City Council.

On October 6, 2022, the IRC and other required parties met and reviewed the status of the portfolio presented by the investment advisor and the Finance and Administrative Services Director and considered other matters discussed in this report. This report presents the consensus findings and recommendations of the IRC from that meeting. Detailed information is included in this report summarizing the portfolio's performance and Policy compliance over the past fiscal year as well as its status at fiscal year-end.

(Add discussion of any changes to the investment policy dependent upon discussion of the Committee at its meeting on October 6, 2022.)

ANALYSIS

Portfolio

Performance Requirements

The Policy requires the portfolio be managed in accordance with California Government Code statutes that govern the investment of public funds. The City's investment objectives are safety, liquidity, and return. Evaluation of the portfolio's financial performance is done by comparison to a published index referred to in the Policy as the "benchmark index." The Policy specifies the investment objective is to earn a total time-weighted rate of return over a market cycle that equals the total time-weighted rate of return of the benchmark index. The benchmark index for the portfolio is a blend of three published InterContinental Exchange Bank of America Merrill Lynch (ICE BAML) indices weighted as follows: 10% three-month Treasuries, 10% six-month Treasuries, and 80% one- to five-year Governments, which is a composite of Treasury and Agency securities.

In addition to earning a market rate of return, there are several other criteria, primarily aimed at minimizing investment risk, which are used in evaluating portfolio management and compliance with the Policy. These criteria include the following:

- Investing only in securities with very high credit quality as permitted by the Policy.
- Diversification requirements that limit the percentage of the portfolio that can be invested in any one type or issuer of a security.
- Target duration requirements that limit the portfolio's risk exposure to changes in market interest rates.
- Limits on the maximum maturity of individual investments.

Evaluation of Portfolio Performance

The chart below shows the 10-year history of: (1) the portfolio's average duration; (2) the 12-month total rate of return (TRR) for the portfolio, excluding corporate holdings compared to the benchmark index referred to above; and (3) the 12-month TRR for the corporate portion of the portfolio compared to a one- to five-year U.S. Corporate Rated AAA-AA benchmark index (it should be noted that the Shoreline Bonds are excluded from these metrics as approved by the City Council).

Fiscal Year Ending June 30	Average Duration		Portfolio TRR (excluding corporate holdings)		Corporate TRR	
	City	Benchmark	City	Benchmark	City	Benchmark
2022	2.00	1.97	-3.38	-3.44	-3.79	-5.34
2021	2.09	2.11	0.01	-0.02	0.62	0.80
2020	1.97	1.97	4.46	4.44	6.03	5.69
2019	1.89	1.89	4.13	4.21	5.80	5.67
2018	1.96	1.94	0.21	0.15	0.32	0.07
2017	2.02	2.02	-0.03	-0.12	0.49	0.53
2016	1.99	1.99	1.85	1.86	3.14	3.31
2015	2.04	2.04	1.11	1.10	1.84	1.40
2014	2.10	2.09	1.10	1.09	N/A	N/A
2013	2.05	2.11	0.07	0.05	N/A	N/A

The Policy requires that portfolio duration not exceed a maximum deviation of $\pm 15\%$ from the benchmark. The portfolio must be rebalanced quarterly within $\pm 3\%$ of the benchmark. These objectives were met throughout the fiscal year, and the portfolio was managed within $\pm 3\%$ for 11 of the 12 months in the fiscal year. The average duration of the City's portfolio, excluding the Shoreline Bonds as approved by the City Council, during this period was 2.00 years, slightly higher than the average benchmark of 1.97 years.

The 12-month TRR has decreased in Fiscal Year 2021-22. The Federal Reserve began raising the Federal Funds Target Rate in March 2022 to combat inflation. In total, the Federal Funds Target Rate was raised three times in Fiscal Year 2021-22, bringing the target rate to between 1.50% and 1.75%. This has caused market yields to rebound sharply when compared to the past two years. This increase in yields has, in turn, caused the fair value of the portfolio to decrease over the past fiscal year, which is driving the negative TRR. However, the interest income is still robust as evidenced by the current yield, and the portfolio is still generating a competitive total return.

In Fiscal Year 2021-22, the City's TRR was higher than the benchmark by six basis points. The annualized TRR of the portfolio compared to the benchmark since inception (August 31, 1995) is 3.29% and 3.25%, respectively. The portfolio generally tracks reasonably close to the benchmark and has outperformed the benchmark eight of the past 10 years. The TRR is a measure of the portfolio's performance over a given period of time. It includes interest earnings as well as realized and unrealized gains and losses in the portfolio.

The City generally buys and holds securities to maturity. Accordingly, while increasing interest rates lower the market value of portfolio securities acquired when rates were lower, market-value losses are not realized when securities are held to maturity.

A 10-year history of the average portfolio, the interest earned, and the average earnings rate are as follows (dollars in millions):

Fiscal Year Ending June 30	Average Portfolio	Interest Earned	Average Earnings Rate
2022	\$841.9	\$10.0	1.30%
2021	\$784.0	\$12.1	1.55%
2020	\$713.9	\$14.9	2.09%
2019	\$648.1	\$13.3	2.06%
2018	\$585.8	\$9.3	1.58%
2017	\$454.6	\$5.8	1.27%
2016	\$407.5	\$4.7	1.16%
2015	\$373.0	\$4.2	1.14%
2014	\$343.7	\$4.3	1.26%
2013	\$306.9	\$4.9	1.59%

The portfolio's average earnings rate for the fiscal year ending June 30, 2022 was 1.30% on an average portfolio of \$841.9 million, returning approximately \$10.0 million, which was used during the fiscal year to fund the services and programs provided by the City. This compares to the prior fiscal year ending June 30, 2021, in which the portfolio's average earnings rate was 1.55% on an average portfolio of \$784.0 million, returning approximately \$12.1 million. During this same time period, the size of the average portfolio has increased over 2.7 times, growing from \$306.9 million to \$841.9 million.

Portfolio Value, Composition, and Diversification

As of June 30, 2022, the City's portfolio was composed of investments in the following types of securities, shown here with comparison to the Policy limit (dollars in millions):

	<u>Market Value</u>	<u>Cost Value</u>	<u>Cost Value as Percent of Total</u>	<u>Policy Limit</u>
Treasuries	<u>\$461.0</u>	<u>\$475.8</u>	<u>49.0%</u>	Unlimited, Minimum 25%
Agencies				
FHLB	71.0	73.8	7.6%	25.0%
FHLMC	54.6	58.0	6.0%	25.0%
FNMA	<u>77.4</u>	<u>81.0</u>	<u>8.3%</u>	25.0%
Total—Agencies	<u>203.0</u>	<u>212.8</u>	<u>21.9%</u>	50.0%
LAIF*	<u>150.2</u>	<u>150.2</u>	<u>15.5%</u>	20.0%
Corporate Notes				
Amazon.com, Inc.	5.9	6.0	0.6%	5.0%
Apple, Inc.	9.7	9.8	1.0%	5.0%
Berkshire Hathaway	5.6	5.9	0.6%	5.0%
Blackrock, Inc.	5.9	5.9	0.6%	5.0%
Colgate-Palmolive	2.5	2.5	0.3%	5.0%
Guardian Life	3.6	3.9	0.4%	5.0%
Metlife	2.7	2.8	0.3%	5.0%
Microsoft	2.5	2.5	0.3%	5.0%
New York Life Global	2.9	2.9	0.3%	5.0%
Procter & Gamble	5.6	6.0	0.6%	5.0%
Toronto Dominion	3.0	3.1	0.3%	5.0%
Toyota Motor Corp.	2.5	2.5	0.2%	5.0%
U.S. Bank	7.1	7.3	0.8%	5.0%
Walmart	<u>9.7</u>	<u>10.0</u>	<u>1.0%</u>	5.0%
Total—Corporates	<u>69.2</u>	<u>71.1</u>	<u>7.3%</u>	15.0%
Supranationals				
IBRD	6.4	7.0	0.7%	5.0%
IFC	11.8	12.8	1.3%	5.0%
IADB	<u>24.4</u>	<u>24.9</u>	<u>2.6%</u>	5.0%
Total—Supranationals	<u>42.6</u>	<u>44.7</u>	<u>4.6%</u>	10.0%
Municipal Bonds**	8.8	8.8	0.9%	
US Bank Balance	0.2	0.2	0.0%	
Accrued Interest	<u>3.7</u>	<u>-0-</u>	<u>0.0%</u>	
Total Holdings	938.7	963.6	99.2%	
City Bank Balance	<u>-0-</u>	<u>7.9</u>	<u>0.8%</u>	
Total Portfolio	<u>\$938.7</u>	<u>\$971.5</u>	<u>100.0%</u>	

* Local Agency Investment Fund managed by the State Treasurer.

** Municipal bonds issued by the City, or a component unit, are permitted investments when approved by the City Council.

The total portfolio increased to \$971.5 million (cost value), \$938.7 million (market value), compared to \$841.1 million (cost value) at the end of Fiscal Year 2020-21. The portfolio has grown significantly since Fiscal Year 2016-17, almost doubling in a five-year period.

The City began investing in corporate notes in July 2013 and is managed by an external investment advisor, Chandler Asset Management (Chandler). As of June 30, 2022, the portfolio held \$71.1 million (cost value) in corporate notes. The benchmark index used for corporate notes is the ICE BAML 1-5 Year AAA-AA US Corporate Index. This benchmark is a higher standard as it includes investments that are not permitted under the City's Policy (e.g., corporations operating outside the U.S.). As of June 30, 2022, the corporate note segment of the portfolio TRR was -3.79% compared to the benchmark of -5.34%. Corporate notes are approximately 7.3% of the portfolio (up to 15% is allowed per the Policy).

As of June 30, 2022, the City held \$2.5 million (par value) of Toyota Motor Credit corporate notes, which matured September 2022. Toyota Motor Credit was downgraded by Moody's on March 26, 2020, changing their credit rating from Aa3 to A1, and, on May 20, 2020; Standard and Poor's also took negative rating action, downgrading Toyota Motor Credit from AA- to A+. The current ratings of Toyota Motor Credit Corporation are A1 (Moody's), A+ (Standard and Poor's), and A+ (Fitch). These downgrades were due to the impact of the COVID-19 virus on the economic outlook, consumer spending, and consumer sentiment.

Chandler manages the City's corporate note program and continued to view the credit quality of Toyota Motor Credit as sound. In the short term, Chandler recommended maintaining exposure to the Toyota name in the City's all-corporate portfolio and did not recommend the City exit their position in Toyota Motor Credit. This investment has since matured.

In Fiscal Year 2014-15, the Committee recommended, and the City Council approved, adding the Supranational security asset class as a permitted investment with certain limitations. As of June 30, 2022, the portfolio held \$44.7 million (cost value) in Supranational securities, or about 4.6% of the portfolio (up to 10% is allowed per the Policy).

The portfolio investments above represent the cash assets of the various funds and reserves of the City. Most of the City's portfolio is budgeted or obligated for specific purposes such as capital improvement projects, operating budgets, liabilities, and commitments and reserves. Unobligated balances in each fund were presented to Council during the Fiscal Year 2022-23

budget process and are included in the Fiscal Year 2022-23 Adopted Budget. Fund ownership of portfolio assets are as follows (cost value and dollars in millions):

General Fund, Including Reserves	\$192.7	19.8%
Restricted Funds (Utility and Special-Purpose Funds)	302.7	31.2%
Debt Service Funds	0.0	0.0%
Capital Projects	400.3	41.2%
Internal Service (Insurance Reserves and Internal Operations)	44.8	4.6%
Trust and Agency Funds	<u>31.0</u>	<u>3.2%</u>
Total Portfolio	<u>\$971.5</u>	<u>100.0%</u>

The City began depositing funds into the California Employer's Retirement Benefit Trust (CERBT) Fund in February 2009 for the City's obligation of retirees' health benefits. The CERBT offers three investment strategy options, Strategy 1 being the least conservative with the highest estimated return and Strategy 3 being the most conservative with the lowest estimated return. Agencies are allowed to choose which strategy option to place funds. The City currently participates in Strategy 2, as approved by the Committee and Council, in order to preserve the balance in the trust. The retirees' health valuation is updated every two years as required by Generally Accepted Accounting Principles (GAAP). The valuation was most recently updated as of June 30, 2021 using the discount rate of 6.00% and shows a projected liability of \$154.2 million as of July 1, 2022. The balance in the trust as of June 30, 2022 is \$151.5 million (including interest earned, net of administrative expenses), representing a 98.3% funded level. The next valuation will be as of June 30, 2023 and prepared during Fiscal Year 2023-24.

Internal Control and Reporting

A significant process of internal control, oversight, and reporting is set out in the Policy. Additional controls and reporting beyond Policy requirements are also employed. All Policy-required controls, reports, and meetings have been complied with during the fiscal year. The control and oversight process encompasses the activities outlined below:

- Monthly internal investment status and strategy meetings between the Finance and Administrative Services Director and the Senior Financial Analyst/Investment Officer.
- Monthly portfolio reports submitted by the Finance and Administrative Services Director and the external investment advisor to the City Council, the Committee, and others.
- Quarterly meetings between the Finance and Administrative Services Director and the external investment advisor, with the City Manager, or designee, attending semiannually (as required by Policy), to review economic indicators, portfolio status, and Policy compliance with related reports distributed to the City Council and the Committee.

- Annual meeting of the Committee to review and discuss portfolio status and management, the Policy, and Policy compliance.
- Submission of an annual report to the City Council from the Committee and Finance and Administrative Services Director containing the findings and recommendations of the Committee.

In addition, the City's external auditors annually review internal controls on portfolio transactions, including segregation of duties between staff, controls on access to funds, and compliance with State laws regarding public agency investing as part of their annual audit of the City's financial statements. No finding of a material weakness in internal controls is noted.

Section 6 of the Policy addresses Social Responsibility as an objective of the Policy and pertains to investments in banker's acceptances, medium-term corporate notes, and certificates of deposit. The policy encourages applicable investments to be made in entities that support social and environmental concerns, the production of renewable energy and sustainable agriculture, and community investment. Investments in companies that manufacture cigarettes and firearms as identified by the Investors Responsibility Research Center are prohibited. Investments in entities that engage in the direct exploration, production, refining, or marketing of fossil fuels are also prohibited. As of June 30, 2022, the City was in compliance with the socially responsible investing provisions of the Policy.

Staff attempts to "ladder" the portfolio by allocating investments so that a relatively equal portion of the portfolio matures in each fiscal year of the five-year maximum investment maturity permitted by Policy. This is done to manage cash flow and to minimize the risk of interest rate movements over time. In a period of declining interest rates, this approach results in the average portfolio yield and market value exceeding current market rates due to holdings of prior year investments yielding above-market interest rates. In periods of rising interest rates, however, the opposite occurs. Securities purchased in prior years with interest rates below current market rates results in market value losses compared to the cost of securities. Gains and losses are considered as "paper" impacts because the City generally does not sell securities before they mature and receives the full value of invested principal at maturity. However, at fiscal year-end, GAAP require these unrealized gains or losses in portfolio market value to be recorded as if they were realized.

The 2021-22 fiscal year-end market value (plus accrued interest) of the portfolio was lower than the cost value (excluding the City's bank balance) by approximately 2.6%, or \$24.9 million. In comparison, the 2020-21 fiscal year-end market value (plus accrued interest) of the portfolio was higher than the cost value by approximately 2.0%, or \$16.3 million. Gains or losses are allocated to each fund based on each fund's share of the portfolio balance; interest is credited in the same manner. Gain entries increase fund balances reported in the fiscal year-end financial statements and loss entries reduce reported fund balances. Neither have an effect on the balances available for budgetary purposes.

Findings and Observations

(Comments to be added after the October 6, 2022 meeting.)

Committee Discussion

At the October 6, 2022 meeting, the Committee discussed the following aspects of the portfolio
(To be updated with discussion by the Committee):

RECOMMENDATIONS

Recommendation from October 6, 2022 meeting *(To be updated if any recommendations are to be made by the Committee):*

CONCLUSION

The Councilmembers of the Committee would like to thank Committee members Douglas Radtke and Steven Permut for their continuing service and for their participation, advice, perspective, and contributions during this time. The Committee concludes the City's portfolio has been competently administered with no Policy violations over the past fiscal year.

SL-JT/TC/4/FIN
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Exhibit: 1. City Council Policy B-2, Investment Policy