



MEMORANDUM

Investment Review Committee

DATE: December 6, 2016

TO: City Council

FROM: Ken S. Rosenberg, Chair, Investment Review Committee

SUBJECT: **Annual Report of the Investment Review Committee for Fiscal Year 2015-16**

INTRODUCTION

The Investment Review Committee (Committee or IRC) convened on October 18, 2016 for its annual review of the City's investment portfolio for Fiscal Year 2015-16. This report 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 "the 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."

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. After 15 years of service, Kevin Olsen resigned last year as an appointed member of the Committee. On September 13, 2016, the Council appointed to the Committee, Janice Phan, Corporate Treasurer for LinkedIn. The other public member appointed by the City Council is Steven Permut, Vice President, Senior Portfolio Manager, and Director of Municipal Investments for American Century Investment Management, Inc. (appointed June 28, 2005). The CFC is comprised of Councilmembers John M. Inks and John McAlister, and Vice Mayor Ken S. Rosenberg, Chair of the IRC.

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 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 recommendations regarding the management of the investment portfolio to the City Council. On October 18, 2016, 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.

PORTFOLIO PERFORMANCE

Performance Requirements

The Policy requires the portfolio be managed such that it closely reflects that of a segment of the securities market with characteristics similar to the City's investment objectives of safety, liquidity, and yield. Evaluation of the portfolio's financial performance and Policy compliance 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 Merrill Lynch indices weighted as follows: 10 percent three-month Treasuries, 10 percent six-month Treasuries, and 80 percent 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.
- Diversity 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

A 10-year history of the portfolio's duration and total rate of return (TRR) compared to the benchmark index referred to above is as follows:

Fiscal Year Ending June 30	Duration		TRR	
	City	Benchmark	City	Benchmark
2016	1.97	2.01	1.85	1.86
2015	2.03	2.00	1.11	1.10
2014	2.01	2.07	1.10	1.09
2013	2.11	2.13	0.07	0.05
2012	2.05	2.05	1.90	1.77
2011	1.80	1.92	1.84	1.76
2010	1.82	1.98	3.33	3.39
2009	1.88	2.02	5.39	5.47
2008	1.85	1.90	7.38	7.29
2007	1.80	1.85	5.43	5.41

As of June 30, 2016, the duration of the City's portfolio, excluding the Shoreline Bonds as approved by City Council, was 1.97, slightly lower than the benchmark duration of 2.01.

In Fiscal Year 2015-16, the City's TRR was slightly lower than the benchmark by one basis point. The annualized TRR of the portfolio compared to the benchmark since inception (August 31, 1995) is 4.00 percent and 3.95 percent, respectively. The portfolio generally tracks reasonably close to the benchmark and has outperformed the benchmark 7 of the past 10 years.

The City does not actively manage its investments with frequent buy and sell transactions but generally holds securities to maturity. While rising interest rates reduce the market value of portfolio securities acquired when rates were lower, market-value losses are not realized when securities are held to maturity.

The Policy requires that portfolio duration not exceed a maximum deviation of ± 15 percent from the benchmark duration. The portfolio must be rebalanced quarterly within ± 3 percent of the benchmark. These objectives were met throughout the fiscal year and the portfolio was managed within ± 3 percent for 10 out of the 12 months of the fiscal year. The average duration of the portfolio during this period of 1.99, matched to the average benchmark duration of 1.99.

Investment returns have suffered since this past recession as the Federal Reserve has held short-term interest rates at historical lows in order to support growth in the economy. The securities that have matured during this past fiscal year have been generally reinvested at about the same interest rates. The portfolio's yield for the fiscal year ending June 30, 2016 was 1.16 percent on an average portfolio of \$407.5 million, returning approximately \$4.7 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, 2015, in which the portfolio's yield was 1.14 percent on an average portfolio of \$373.0 million, returning approximately \$4.2 million. Over the past 10 years, the Interest Yield was as high as 4.18 percent with \$12.0 million in interest earned. During this same time period the size of the average portfolio has increased from \$280.6 million to \$407.5 million, thereby even more significantly contrasting the investment returns.

This current market condition has resulted in the IRC recommending, and the City Council approving, an amendment to the Policy allowing longer maturities and higher level of investments in Corporate Notes. The investment in Corporate Notes is being managed by the external investment advisor, Chandler Asset Management, and began in July 2013. As of June 30, 2016, the portfolio held \$37.3 million in Corporate Notes. The benchmark index used for Corporate Notes is the Merrill Lynch 1-5 year AAA-AA US Corporate Index. As of June 30, 2016, the Corporate Note segment of the portfolio TRR was 3.14 percent compared to the benchmark of 3.31 percent. Corporate Notes consists of 8.6 percent of the portfolio and up to 15 percent is allowed per the Policy.

Last year, 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, 2016, the portfolio held \$6.1 million in Supranational securities or about 1.4 percent of the portfolio.

Portfolio Value, Composition, and Diversification

As of June 30, 2016, 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	\$161.9	159.5	36.9%	Unlimited, Minimum 25%
Agencies				
FHLB	55.2	54.7	12.6%	25.0%
FHLMC	42.4	41.9	9.7%	25.0%
FNMA	<u>56.4</u>	<u>55.8</u>	<u>12.9%</u>	25.0%
Total – Agencies	154.0	152.4	35.2%	50.0%
LAIF*	58.0	58.0	13.4%	20.0%
Corporate Notes				
Apple, Inc.	5.1	4.9	1.1%	5.0%
Berkshire Hathaway	5.1	5.1	1.2%	5.0%
Chevron Corp.	5.6	5.5	1.3%	5.0%
Colgate-Palmolive	3.1	3.0	0.7%	5.0%
Exxon Mobil	3.1	3.0	0.7%	5.0%
General Electric Co.	4.5	4.9	1.1%	5.0%
Microsoft	3.1	3.0	0.7%	5.0%
US Bank	3.1	3.0	0.7%	5.0%
Walmart	<u>5.0</u>	<u>4.9</u>	<u>1.1%</u>	5.0%
Total – Corporates	37.7	37.3	8.6%	15.0%
Supranationals				
IBRD	<u>6.1</u>	<u>6.1</u>	<u>1.4%</u>	5.0%
Total – Supranationals	6.1	6.1	1.4%	10.0%
Municipal Bonds**	9.2	8.3	1.9%	
U. S. Bank Balance	0.3	0.3	0.1%	
Accrued Interest	<u>1.5</u>	<u>-0-</u>	<u>0.0%</u>	
Total Holdings	428.7	421.9		
City Bank Balance	<u>-0-</u>	<u>10.8</u>	2.5%	
Total Portfolio	<u>\$428.7</u>	<u>432.7</u>	<u>100.0%</u>	

* Local Agency Investment Fund managed by the State Treasurer.

** Municipal bonds issued by the City are permitted investments when approved by Council.

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 2016-17 budget process and are included in the Fiscal Year 2016-17 Adopted Budget. Fund ownership of portfolio assets are as follows (cost value and dollars in millions):

General Fund, Including Reserves	\$107.3	24.8%
Restricted Funds (Utility and Special Purpose Funds)	135.3	31.3%
Debt Service Funds	0.1	0.0%
Capital Projects	118.6	27.4%
Internal Service (Insurance Reserves and Internal Operations)	42.1	9.7%
Trust and Agency Funds	<u>29.3</u>	<u>6.8%</u>
 Total Portfolio	 <u>\$432.7</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 initially chose Strategy 1 to capitalize on returns while funding the trust. At the beginning of Fiscal Year 2014-15, the funds in CERBT were moved to Strategy 2 as approved by the Committee and Council, in order to preserve the balance in the trust. Later that same fiscal year, the CERBT adopted a lower discount rate and the rate for Strategy 2 was reduced from 7.06 percent to 6.73 percent. The retirees' health valuation is updated every two years as required by Generally Accepted Accounting Principles (GAAP). This change is included in the most recent July 1, 2015 valuation and about \$3.9 million of the \$21.9 million increase in the projected liability is due to this change in the discount rate. The balance in the trust as of June 30, 2016 is \$96.3 million (including interest earned, net of administrative expenses), towards the projected liability of \$130.5 million (based on Strategy 2), or 73.8 percent funded.

FINDINGS AND OBSERVATIONS

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 Assistant Finance and Administrative Services Director/Investment Officer.
- Monthly portfolio reports submitted by the Finance and Administrative Services Director and the investment advisor to the City Council, the IRC, and others.
- Quarterly meetings between the Finance and Administrative Services Director and the external investment advisor, with the City Manager attending semiannually (as required by Policy), to review 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 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 was noted.

As of June 30, 2016, the City had no investments subject to the socially responsible investing provisions of the Policy.

The City continues to hold \$5.0 million of General Electric Company (GE) corporate notes maturing December 2017. The GE note was downgraded by Moody's in April 2015 to an A1 rating while S&P confirmed its rating of AA+ with a stable outlook. The corporate note program is managed by Chandler, and based on their advice, the relative short duration of the security to maturity, S&P confirming its AA+ stable outlook rating, the belief it is still a strong credit, etc., the security continued to be held as allowed by the Policy. The current rating by S&P is AA- with a stable outlook and on August 2, 2016, Fitch began to provide a credit rating of AA- with a stable outlook. Based on the new Fitch rating, this security again meets the requirements of the Investment 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 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 requires gains or losses in portfolio market value to be recorded as revenues or expenditures in each fund based on each fund’s share of the portfolio balance.

The 2015-16 fiscal year-end market value (plus accrued interest) of the portfolio was higher than the cost value by approximately 1.62 percent or \$6.8 million. In comparison, the 2014-15 fiscal year-end market value (plus accrued interest) of the portfolio was higher than the cost value by approximately 0.65 percent or \$2.6 million. GAAP requires fiscal year-end portfolio gains to be treated as revenue and fiscal year-end portfolio losses to be expensed. Gains or losses are allocated to each fund in the same manner as interest is credited. 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.

COMMITTEE DISCUSSION

At the October 18, 2016 meeting, the Committee discussed the following aspects of the portfolio:

- The Committee discussed the Corporate Note Program. Although the Policy allows for a maximum of 15 percent of the portfolio invested in corporate notes, staff has worked with an internal limit of 10 percent as directed by the Committee when the Program was approved. The Committee supported staff’s recommendation to allow up to 15 percent of the portfolio for the Corporate Note Program.
- The Committee discussed investment of the \$400,000 Library donation endowment. Seventy-five percent (75%) of investment earnings may be used for Library materials or programs. The Committee was comfortable including the

\$400,000 in the City's pooled investment portfolio while segregating the endowment and interest earned.

RECOMMENDATIONS

No action is needed on the two discussion items above and there are no recommended changes to the Investment Policy.

CONCLUSION

The Councilmembers of the Committee would like to acknowledge and thank Committee member Steven Permut for his 11 years of service and Janice Phan for volunteering to serve on the Committee this year, and for their participation, advice, perspective, and contributions.

The Committee concludes the City's portfolio has been competently administered with no Policy violations over the past fiscal year.

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