CITY OF MOUNTAIN VIEW

MEMORANDUM
Investment Review Committee

DATE: December 8, 2015

TO: City Council

FROM: John M. Inks, Chair, Investment Review Committee

SUBJECT: **Annual Report of the Investment Review Committee for Fiscal Year 2014-15**

INTRODUCTION

The Investment Review Committee (Committee or IRC) convened on October 20, 2015 for its annual review of the City's investment portfolio for Fiscal Year 2014-15. 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. The public members appointed by the City Council are: Kevin Olson (appointed May 1, 2000); and 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 Mayor John McAlister and Councilmembers Ken S. Rosenberg and John M. Inks, 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 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 20, 2015, the IRC and other required parties met and reviewed the status of the portfolio presented by the investment advisor 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	City Portfolio		Benchmark	
	Duration	TRR	Duration	TRR
2015	2.03	1.11	2.00	1.10
2014	2.01	1.10	2.07	1.09
2013	2.11	0.07	2.13	0.05
2012	2.05	1.90	2.05	1.77
2011	1.80	1.84	1.92	1.76
2010	1.82	3.33	1.98	3.39
2009	1.88	5.39	2.02	5.47
2008	1.85	7.38	1.90	7.29
2007	1.80	5.43	1.85	5.41
2006	1.83	1.90	1.88	1.68

As of June 30, 2015, the duration of the City's portfolio, excluding the Shoreline Bonds as approved by City Council, was 2.03, on target with the benchmark duration of 2.00. The City is able to better match duration as of June 30 due to the amendment to Section 1.2 of the Investment Policy approved November 15, 2011. This change allows the accumulation of short-term funds for lump-sum payments in excess of $5.0 million to be excluded from the portfolio's duration calculation.

In Fiscal Year 2014-15, the City's TRR was slightly higher than the benchmark by one basis point. The annualized TRR of the portfolio compared to the benchmark since inception (August 31, 1995) is 4.11 percent and 4.03 percent, respectively. The portfolio has outperformed the benchmark over 80 percent of the time during the past 10 years and generally tracks reasonably close to the benchmark.

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 the entire fiscal year. The average duration of the portfolio during this period of 2.04, matched to the average benchmark duration of 2.04.

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 lower interest rates. The portfolio's yield for the fiscal year ending June 30, 2015 was 1.14 percent, returning approximately $4.2 million, which was used during the fiscal year to fund the services and programs provided by the City. Over the past 10 years, the Interest Yield was as high as 4.18 percent with $12.0 million in interest earned.

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, 2015, the portfolio held $31.3 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, 2015, the Corporate Note segment of the portfolio had a TRR of 1.84 percent compared to the benchmark of 1.40 percent. Corporate Notes make up 7.8 percent of the portfolio and up to 15 percent is allowed per the Policy.

Portfolio Value, Composition, and Diversification

As of June 30, 2015, 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):

	Market Value	Cost Value	Cost Value as Percent of Total	Policy Limit
Treasuries	$155.1	154.3	38.4%	Unlimited, Minimum 25%
Agencies				
FHLB	43.5	43.3	10.8%	25.0%
FHLMC	43.0	43.0	10.7%	25.0%
FNMA	63.3	63.6	15.8%	25.0%
Total—Agencies	149.8	149.9	37.3%	50.0%
LAIF*	57.1	57.1	14.2%	20.0%
Mutual Funds	-0-	-0-	0.0%	10.0%
Corporate Notes				
Apple, Inc.	5.0	4.9	1.2%	5.0%
Berkshire Hathaway	5.1	5.1	1.3%	5.0%
Chevron Corp.	5.5	5.5	1.4%	5.0%
Colgate-Palmolive	3.0	3.0	0.7%	5.0%
General Electric Co.	4.7	4.9	1.2%	5.0%
Microsoft	3.0	3.0	0.8%	5.0%
Walmart	5.0	4.9	1.2%	5.0%
Total—Corporates	31.3	31.3	7.8%	15.0%
Commercial Paper	-0-	-0-	0.0%	15.0%
Municipal Bonds**	9.3	8.7	2.2%	
U. S. Bank Balance	0.3	0.3	0.0%	
Accrued Interest	1.4	-0-	0.0%	
Total Holdings	404.3	401.6		
City Bank Balance	-0-	0.5	0.1%	
Total Portfolio	$404.3	402.1	100.0%	

* 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 2015-16 budget process and are included in the Fiscal Year 2015-16 Adopted Budget. Fund ownership of portfolio assets are as follows (cost value and dollars in millions):

General Fund, Including Reserves	$100.6	25.0%
Restricted Funds (Utility and Special Purpose Funds)	145.4	36.2%
Debt Service Funds	0.1	0.0%
Capital Projects	87.4	21.7%
Internal Service (Insurance Reserves and Internal Operations)	38.9	9.7%
Trust and Agency Funds	29.7	7.4%
Total Portfolio	$402.1	100.0%

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 balance in the trust is $89.8 million (including interest earned, net of administrative expenses), towards the projected liability of $106.1 million (based on Strategy 2), or 84.6 percent funded as of June 30, 2015. The retirees' health valuation is updated every two years as required by Generally Accepted Accounting Principles (GAAP). The last update was as of July 1, 2013 and staff is in the process of updating the valuation as of July 1, 2015. During this past year, the funds in CERBT were moved to Strategy 2 as approved by the Committee and Council. A lower discount rate for the CERBT was adopted during the fiscal year as mentioned at last year's annual IRC meeting. The rate for Strategy 2 was reduced from 7.06 percent to 6.73 percent. This change will be included in the updated valuation and will increase the projected liability.

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.

- Semiannual meetings between the City Manager or his designee, Finance and Administrative Services Director, and the external investment advisor 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, 2015, the City had no investments subject to the socially responsible investing provisions of the Policy.

Staff notified the City Council and the IRC of the following in the monthly Investment Information Report for April 30, 2015 sent in mid-May: In April 2015, Chandler notified staff of a credit downgrade by Moody's of General Electric Company (GE) as a result of the company's divestiture of real estate from the General Electric Capital subsidiary.

S&P affirmed its rating of AA+ with a stable outlook and GE is not rated by Fitch. The City's Investment Policy stipulates Medium Term Notes must have a rating of AA- or equivalent by two of the three rating agencies. The City holds $5.0 million of GE corporate notes maturing December 2017. If a security is downgraded, the Policy provides the Finance and Administrative Services Director will use discretion in determining whether to sell or hold the security based on its current maturity, the economic outlook for the issuer, and other relevant factors. 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., it was determined to hold the security as allowed by 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 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 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. Compared to the 2013-14 fiscal year-end, market value (plus accrued interest) of the portfolio was higher than the cost value by approximately 0.59 percent or $2.2 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 20, 2015 meeting, the Committee discussed the following aspects of the portfolio:

- The Corporate Note program, implemented during Fiscal Year 2013-14, was reviewed. Investments in corporate notes are managed by the City's external investment advisor, Chandler Asset Management (Chandler). The General Electric Co. rating downgrade (discussed above) was reviewed. The Committee was comfortable holding the General Electric Co. corporate note because the rating downgrade was associated with the GE Capital subsidiary divesting in real estate. The minor downgrade is offset by the overall GE financial strength and the remaining short duration of the note.

- At last year's annual meeting, Bill Dennehy from Chandler updated the Committee regarding a change to California Government Code (CA GC) Section 53601 effective January 1, 2015. The modification (Assembly Bill 1933) allows a local agency to invest up to 30 percent of their surplus moneys in obligations issued by the International Bank for Reconstruction and Development (IBRD or World Bank), International Finance Corporation (IFC), or Inter-American Development Bank (IADB); these are more commonly known as "Washington-Based Supra Nationals." He recommended the City consider modifying the Policy to include this new asset class as it is very similar to Government Agencies and provides a diversification alternative. The Committee recommended staff return with an analysis and recommendation at the next annual meeting.

  Staff reviewed Assembly Bill 1933 and the added CA GC Section 53601(q). This new asset class is limited to United States dollar denominated senior unsecured unsubordinated obligations issued or unconditionally guaranteed by the IBRD, IFC, or IADB with a maximum maturity of five years or less, eligible for purchase and sale within the United States, with a rating of AA or better by a Nationally Recognized Statistical Rating Organization (NRSRO), and shall not exceed 30 percent of the agency's moneys that may be invested pursuant to CA GC Section 53601.

  Staff recommended adding the new asset class to the Policy, limiting the total exposure of each Supra National entity to 5 percent of the portfolio and total not to exceed 10 percent of the portfolio. Upon further discussion, the Committee supported investing in these types of obligations because of rating quality and additional portfolio diversification. The Committee recommended that the Supra

National security also be rated at least "AA-/Aa-" or equivalent by at least two of the three rating agencies (S&P, Moody's, and Fitch).

- The Finance and Administrative Services Director began a discussion on callable securities to gauge the Committee's comfort level on investing in callable securities. Callable securities were added to the Policy in 2012, however the Committee was not comfortable at that time investing in callable securities and asked that the topic be brought back prior to investing in callable securities. After further discussion, the Committee supported moving forward with callable securities based on staff and Chandler's advice, because the slight risk of the security being called is offset by the reduced cost of the callable security.

RECOMMENDATIONS

Recommendations from October 20, 2015:

Approve the addition of the Supra National security asset class as a permitted investment with the recommended limitations.

CONCLUSION

The Councilmembers of the Committee would like to acknowledge and thank Committee members Kevin Olson for his 15 years of service and Steven Permut for his 10 years of service, and for their participation, advice, perspective, and contributions. Kevin Olson has resigned from the IRC and a certificate of appreciation for his 15 years of service has been given to him.

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

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