



## MEMORANDUM

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Finance and Administrative Services Department

**DATE:** February 27, 2024

**TO:** Honorable City Council

**FROM:** Lisa Matichak, Chair, Investment Review Committee

**SUBJECT:** Annual Report of the Investment Review Committee for Fiscal Year 2022-23

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### **INTRODUCTION**

The Investment Review Committee (Committee or IRC) convened on October 30, 2023 for its annual review of the City's investment portfolio for Fiscal Year 2022-23. 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 A). Acceptance of this memorandum 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 Councilmembers of the Committee are appreciative of the public members for their contributions over the years. Unfortunately, the public members were unable to participate in the October 30 meeting. The CFC is comprised of Councilmembers Lisa Matichak (Chair of the IRC), Lucas Ramirez, and Emily Ann Ramos.

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 30, 2023, the IRC and other required parties met and reviewed the status of the portfolio presented by the investment advisor and the Finance staff and considered other matters discussed in this memorandum. This memorandum presents the consensus findings and recommendations of the IRC from that meeting. Information on the portfolio's performance and Policy compliance over the past fiscal year as well as its status at fiscal year-end is included in this memorandum.

In addition to the status of the portfolio, the IRC also discussed proposed changes to the Investment Policy. The IRC agreed to move forward with a recommendation to add Joint Powers Authority (JPA) Investment Pools as authorized investments with some limiting language as well as some minor Policy clean-up edits and additions. Additionally, the IRC directed staff to do some research and report back about the risks and rewards of expanding the eligible investments and limits criteria for various types of investments. For example, the IRC discussed reducing the credit-rating requirements of corporate notes and increasing the portfolio limit on these types of investments as well as adding additional types of Mortgage-Backed Securities and adding Asset-Backed Securities as authorized investments.

## **ANALYSIS**

### **Portfolio**

#### *Performance Requirements*

The Policy requires the portfolio be managed in accordance with the California Government Code statutes that govern the investment of public funds. The City's investment objectives are safety, liquidity, and return. The 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
2023	1.88	1.85	0.62	0.59	1.61	0.48
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

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 9 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 1.88 years, slightly higher than the average benchmark of 1.85 years.

The 12-month TRR has increased in Fiscal Year 2022-23. 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 during Fiscal Year 2021-22 and seven times during Fiscal Year 2022-23, bringing the target rate to between 5.00% and 5.25%. This has caused market yields to rebound sharply when compared to the two-year period between March 2020 and

February 2022, when the target rate was 0.00% to 0.25%. This increase in yields has, in turn, caused the fair value of the portfolio to decrease. However, the increase in yields over this 16-month period has increased interest earnings for the City, somewhat offsetting unrealized losses of the fair value decrease, which is driving the positive TRR. Although the TRR is relatively low, the portfolio is still generating a competitive total return.

In Fiscal Year 2022-23, the City's TRR was higher than the benchmark by three basis points. The annualized TRR of the portfolio compared to the benchmark since inception (August 31, 1995) is 3.19% and 3.15%, 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):

<b>Fiscal Year Ending June 30</b>	<b>Average Portfolio</b>	<b>Interest Earned</b>	<b>Average Earnings Rate</b>
2023*	\$974.2	\$23.8	2.45%
2022*	\$841.9	\$11.3	1.35%
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%

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\* The fiscal year ended June 30, 2023 numbers are unaudited, and the June 30, 2022 figures have been updated to reflect the final audited numbers.

The portfolio's average earnings rate for the fiscal year ending June 30, 2023 was 2.45% on an average portfolio of \$974.2 million, returning approximately \$23.8 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, 2022, in which the portfolio's average earnings rate was 1.35% on an average portfolio of \$841.9 million, returning approximately \$11.3 million. Over the 10-year period, the size of the average portfolio has increased over 2.8 times, growing from \$343.7 million to \$974.2 million.

*Portfolio Value, Composition, and Diversification*

As of June 30, 2023, 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>528.7</u>	\$ <u>549.7</u>	<u>54.1%</u>	Unlimited, Minimum 25%
Agencies				
FHLB	117.8	122.1	12.0%	25.0%
FHLMC	54.1	58.0	5.7%	25.0%
FNMA	<u>67.5</u>	<u>72.0</u>	<u>7.1%</u>	25.0%
Total—Agencies	<u>239.4</u>	<u>252.1</u>	<u>24.8%</u>	50.0%
LAIF*	<u>53.7</u>	<u>53.7</u>	<u>5.3%</u>	20.0%
Corporate Notes				
Amazon.com, Inc.	7.6	8.0	0.8%	5.0%
Apple, Inc.	9.4	9.8	1.0%	5.0%
Berkshire Hathaway	2.9	3.3	0.3%	5.0%
Blackrock, Inc.	5.7	5.9	0.6%	5.0%
CME Group Inc.	1.9	2.0	0.2%	5.0%
Colgate-Palmolive	3.0	3.0	0.3%	5.0%
Guardian Life	3.6	3.9	0.4%	5.0%
MetLife	2.7	2.8	0.3%	5.0%
Microsoft	7.5	7.6	0.7%	5.0%
New York Life Global	2.8	2.9	0.3%	5.0%
Northwestern Mutual	4.2	4.3	0.4%	5.0%
Procter & Gamble	8.4	9.0	0.9%	5.0%
Toronto Dominion	3.0	3.1	0.3%	5.0%
U.S. Bank	5.0	5.3	0.5%	5.0%
Walmart	<u>6.5</u>	<u>7.0</u>	<u>0.7%</u>	5.0%
Total—Corporates	<u>74.2</u>	<u>77.9</u>	<u>7.7%</u>	15.0%
Supranationals				
IBRD	11.0	12.0	1.2%	5.0%
IFC	11.6	12.8	1.2%	5.0%
IADB	<u>19.4</u>	<u>20.5</u>	<u>2.0%</u>	5.0%
Total—Supranationals	<u>42.0</u>	<u>45.3</u>	<u>4.4%</u>	10.0%
Municipal Bonds**	3.1	3.2	0.3%	
Mutual Funds-US Bank Balance	31.1	31.1	3.0%	
Accrued Interest	<u>5.5</u>	<u>-0-</u>	<u>0.0%</u>	
Total Holdings	977.7	1,013.0	99.6%	
City Bank Balance	<u>3.7</u>	<u>3.7</u>	<u>0.4%</u>	
<b>Total Portfolio</b>	<b><u>\$981.4</u></b>	<b><u>\$1,016.7</u></b>	<b><u>100.0%</u></b>	

\* 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 \$1.0 billion (cost value), \$977.7 million (market value), compared to \$971.5 million (cost value) at the end of Fiscal Year 2021-22. The portfolio has grown significantly since Fiscal Year 2016-17, almost doubling in a six-year period.

The City began investing in corporate notes in July 2013. These corporate notes are currently managed by an external investment advisor, Chandler Asset Management (Chandler). As of June 30, 2023, the portfolio held \$77.9 million (cost value) in corporate notes. The benchmark index used for corporate notes is the Intercontinental Exchange Bank of America-Merrill Lynch (ICE-BAML) one to five 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, 2023, the corporate note segment of the portfolio TRR was 1.61% compared to the benchmark of 0.48%. Corporate notes are approximately 7.7% of the portfolio (up to 15% is allowed per the Policy).

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, 2023, the portfolio held \$45.3 million (cost value) in Supranational securities, or about 4.4% 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 2023-24 budget process and are included in the Fiscal Year 2023-24 Adopted Budget. Fund ownership of portfolio assets are as follows (cost value and dollars in millions):

General Fund, Including Reserves	\$ 210.9	20.8%
Restricted Funds (Utility and Special-Purpose Funds)	384.3	37.8%
Capital Projects	348.8	34.3%
Internal Service (Insurance Reserves and Internal Operations)	46.9	4.6%
Trust and Agency Funds	<u>25.8</u>	<u>2.5%</u>
<b>Total Portfolio</b>	<b><u>\$1,016.7</u></b>	<b><u>100.0%</u></b>

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 \$159.6 million

as of July 1, 2023. The balance in the trust as of June 30, 2023 is \$155.2 million (including interest earned, net of administrative expenses), representing a 97.2% funded level. This funded level is based on actual asset value as of June 30, 2023, which is different than how the actuary calculated the funded level in the actuarial study as they smooth gains and losses over five years. The most recent actuarial valuation (as of June 30, 2021) projected the trust to be fully funded. The next valuation will be as of June 30, 2023 and is currently in process.

### **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 with the Finance and Administrative Services Director, Assistant Finance and Administrative Services Director, and the Principal 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 has been noted by the external auditors.

Section 6 of the Policy addresses "Social Responsibility" as an objective of the Policy and pertains to investments in banker's acceptances, 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, 2023, 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 2022-23 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 3.5%, or \$35.3 million. Similarly, 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**

The portfolio was in compliance throughout Fiscal Year 2022-23.

### **Committee Discussion**

At the October 30, 2023 meeting, the Committee discussed the overall performance of the portfolio. The City’s risk profile as it relates to its investments and its Investment Policy was also discussed. The City’s conservative approach to investments has served the City well. However, there is interest in exploring other investment options that could allow the City to have greater diversification amongst investments and potentially provide a higher yield. The Committee also received additional details about the City’s investments in private placement 144A securities during the meeting.

The following aspects of the Policy were discussed:

### **Socially Responsible Investing and Environmental, Social, and Governance Ratings**

Staff researched Environmental, Social, and Governance (ESG) ratings and reported to the Committee that there have not been any significant changes to ESG since 2018, when the Committee last discussed this topic. The City's external investment advisor, Chandler Asset Management, reiterated that the ESG ratings can be inconsistent depending on which organization provides the rating. Additionally, if a particular investment receives a good ESG rating, it may still not meet the City's overall goals and objectives related to Socially Responsible Investing (SRI) or ESG. The exclusionary SRI language that is already captured in Section 6.3 of the Policy continues to serve the City well by clearly prohibiting investments that do not align with the City's character from an SRI prospective.

### **Joint Powers Authority Investment Pools**

The Joint Powers Authority (JPA) Investment Pools are also referred to as Local Government Investment Pools (LGIPs). These are formed when cities and agencies band together to sponsor investment pools. A board is formed that oversees these investment pools, which includes contracting with a custodian to hold the cash and an investment manager. These pools are run similarly to money market mutual funds. Since there are limits on how much can be invested in the Local Agency Investment Funds (LAIF), opening the option of investing in a JPA Investment Pool allows for additional diversification and a new opportunity for the City to manage its shortest, most liquid investments.

### **Expanding Investment Options in the Policy**

The City's Policy is more conservative when compared with California Government Code and most neighboring Cities. While this has served the City well in the past, the Committee asked staff to work with Chandler Asset Management to research and report back to the IRC the benefits and drawbacks of expanding investment options in the Policy to align more with California Government Code Section 53601. More specifically, the Committee is interested in looking closer at corporate notes one level below the current Policy on credit-rating restrictions, Mortgage-Backed Securities and Asset-Backed Securities. Additionally, the Committee asked staff to evaluate whether or not any limits on the percentage of the portfolio invested in the various investment vehicles should be changed.

## **Minor Policy Language Cleanup**

Staff recommended minor changes to Sections 14.1 and 14.2.

## **RECOMMENDATIONS**

Recommendations from the October 30, 2023 meeting:

1. The Committee approved staff's recommendation to add Subsections 10.1.14 and 11.16, and amend Subsections 10.1.8, 14.1, 14.2, and 14.3, adding JPA Investment Pools and other minor policy language cleanup as follows:

"10.1.8 Local Agency Investment Funds (LAIF) administered by the State Treasurer's Office. No more than 20% of the total portfolio may be invested in LAIF and JPA Investment Pools combined."

"10.1.14 Joint Powers Authority (JPA) Investment Pools. Shares of beneficial interest issued by a joint powers authority organized pursuant to California Government Code Section 6509.7 that invests in the securities and obligations authorized in California Government Code Section 53601(a) to (q), inclusive. Each share shall represent an equal proportional interest in the underlying pool of securities owned by the JPA. The JPA shall have retained an investment advisor that: (1) is registered or exempt from registration with the Securities and Exchange Commission; (2) has not less than five years of experience investing in the securities and obligations authorized; and (3) has assets under management in excess of Five Hundred Million Dollars (\$500,000,000). No more than 20% of the total portfolio may be invested in JPA Investment Pools and LAIF combined. No more than 10% of the total portfolio may be invested in any one JPA Investment Pool."

"11.16 No more than 20% of the portfolio may be invested in the LAIF and JPA Investment Pools combined, and no more than 10% of the portfolio may be invested in any one JPA Investment Pool."

"14.1 Monthly. Monthly investment reports shall be submitted by the Investment Officer to the City Council and the City Manager. These reports shall disclose the following information about the risk characteristics of the City's portfolio:"

"14.2 Semiannual. On a semiannual basis, the Finance and Administrative Services Director, or designee, and the City Manager, or designee, shall meet with an independent, external investment advisor. The advisor will review compliance with policies and procedures; calculate the market value of the City's holdings; report on overall portfolio risk exposure and investment results; and make

recommendations, if needed, regarding investment strategy, risk, or any aspect of the investment program.

The Finance and Administrative Services Director and the investment advisor shall prepare a report for the City Council, which summarizes the semiannual meeting and includes any pertinent findings or recommendations of the external investment advisor.”

“14.3 Annual. An Investment Review Committee shall be established by the City Council. The Investment Review Committee shall include the members of the City Council Finance Committee and two public members appointed by the City Council who have expertise in the area of fixed-income investments. The Investment Review Committee shall meet on an annual basis with the Finance and Administrative Services Director, or designee, the City Manager, or designee, and the external investment advisor to review the portfolio. The Investment Review Committee shall report its findings and recommendations to the City Council.”

2. The Committee recommended that staff research and report back to the IRC on the benefits and drawbacks of expanding the corporate notes program by reducing the rating requirements from “AA-/Aa- or its equivalent or better from 2 of 3 rating agencies” to “A or its equivalent or better” and increasing the amount allowed from 15% of the portfolio to 30% of the portfolio consistent with California Government Code Section 53601.
3. The Committee recommended that staff research and report back to the IRC on the benefits and drawbacks of adding additional types of Mortgage-Backed Securities and Asset-Backed Securities consistent with California Government Code Section 53601.
4. The Committee asked staff to evaluate whether or not any limits on the percentage of the portfolio invested in the various investment vehicle should be changed.

## **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.

LM/DR/1/FIN  
001-02-27-24M

Exhibit: A. Council Policy B-2, Investment Policy