City of Mountain View

# MEMORANDUM

Finance and Administrative Services Department

**DATE:** January 28, 2025

**TO:** Honorable City Council

**FROM:** Lisa Matichak, Former Chair, Investment Review Committee
Derek Rampone, Finance and Administrative Services Director

**SUBJECT:** **Annual Report of the Investment Review Committee for Fiscal Year 2023-24**

## INTRODUCTION

The Investment Review Committee (Committee or IRC) convened on December 6, 2024 for its annual review of the City's investment portfolio for Fiscal Year 2023-24. 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). 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 was comprised of Former Vice Mayor Lisa Matichak (Chair of the IRC), and Councilmembers 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 December 6, 2024, the IRC and other required parties met and reviewed the status of the portfolio presented by the investment advisor and Finance staff 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.

## 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 Ended June 30 | Average Duration | | Portfolio TRR (excluding corporate holdings) | | Corporate TRR | |
|---|---|---|---|---|---|---|
| | City | Benchmark | City | Benchmark | City | Benchmark |
| 2024 | 1.88 | 1.90 | 1.35 | 1.29 | 1.43 | 1.26 |
| 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 |

The Policy requires that portfolio duration not exceed a maximum deviation of ±15% from the benchmark. The portfolio must be rebalanced quarterly within ±3% of the benchmark. These objectives were met throughout the fiscal year, and the portfolio was managed within ±3% for 10 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 lower than the benchmark average of 1.90 years.

The 12-month TRR increased in Fiscal Year 2023-24. 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 seven times during Fiscal Year 2022-23 and once in Fiscal Year 2023-24, bringing the target rate to 5.5% through the end of Fiscal Year 2023-24. This has caused market yields to remain higher 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 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 2023-24, 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 3.19% 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):

| Fiscal Year Ended June 30 | Average Portfolio | Interest Earned | Average Earnings Rate |
|---|---|---|---|
| 2024 | $989.2 | $25.1 | 2.56% |
| 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% |

The portfolio's average earnings rate for the fiscal year ended June 30, 2024 was 2.56% on an average portfolio of $989.2 million, returning approximately $25.1 million, which was used during the fiscal year to fund various services and programs provided by the City. This compares to the prior fiscal year ended June 30, 2023, in which the portfolio's average earnings rate was 2.45% on an average portfolio of $974.2 million, returning approximately $23.8 million. Since June 30, 2014, the average size of the portfolio has increased by nearly 2.9 times, growing from $343.7 million to $989.2 million.

*Portfolio Value, Composition, and Diversification*

As of June 30, 2024, 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 | $512.0 | $ 523.1 | 50.1% | Unlimited, Minimum 25% |
| Agencies | | | | |
| FHLB | 77.5 | 80.0 | 7.7% | 25.0% |
| FHLMC | 45.0 | 47.0 | 4.5% | 25.0% |
| FNMA | 61.2 | 63.2 | 6.0% | 25.0% |
| Total—Agencies | 183.7 | 190.2 | 18.2% | 50.0% |
| LAIF* | 129.8 | 129.8 | 12.4% | 20.0% |
| Corporate Notes | | | | |
| Amazon.com, Inc. | 7.7 | 8.0 | 0.8% | 5.0% |
| Apple, Inc. | 7.1 | 7.3 | 0.7% | 5.0% |
| Berkshire Hathaway | 2.9 | 3.3 | 0.3% | 5.0% |
| Blackrock, Inc. | 8.1 | 8.2 | 0.8% | 5.0% |
| CME Group Inc. | 5.7 | 5.7 | 0.5% | 5.0% |
| Colgate-Palmolive | 3.0 | 3.0 | 0.3% | 5.0% |
| Guardian Life | 3.8 | 3.9 | 0.4% | 5.0% |
| MassMutual | 5.0 | 4.9 | 0.5% | 5.0% |
| Meta Platforms Inc. | 4.0 | 4.0 | 0.4% | 5.0% |
| MetLife | 5.7 | 5.7 | 0.5% | 5.0% |
| Microsoft | 5.0 | 5.1 | 0.5% | 5.0% |
| NextEra Energy, Inc. | 7.9 | 8.0 | 0.8% | 5.0% |
| New York Life Global | 5.8 | 5.9 | 0.5% | 5.0% |
| Northwestern Mutual | 4.3 | 4.3 | 0.4% | 5.0% |
| Procter & Gamble | 10.0 | 10.5 | 1.0% | 5.0% |
| U.S. Bank | 3.1 | 3.2 | 0.3% | 5.0% |
| Visa Inc. | 2.4 | 2.3 | 0.2% | 5.0% |
| Walmart | 6.5 | 7.0 | 0.7% | 5.0% |
| Total—Corporates | 98.0 | 100.3 | 9.6% | 15.0% |
| Supranationals | | | | |
| IBRD | 27.5 | 28.0 | 2.7% | 5.0% |
| IFC | 12.0 | 12.7 | 1.2% | 5.0% |
| IADB | 26.7 | 27.3 | 2.6% | 5.0% |
| Total—Supranationals | 66.2 | 68.0 | 6.5% | 10.0% |
| Municipal Bonds** | 2.3 | 2.4 | 0.2% | |
| Money Market—US Bank | 0.3 | 0.3 | 0.1% | |
| Money Market—Principal Bank | 25.5 | 25.5 | 2.4% | |
| Interest Receivables | 1.5 | 1.5 | 0.2% | |
| Accrued Interest | 5.2 | -0- | 0.0% | |
| Total Holdings | 1,024.5 | 1,041.1 | 99.7% | |
| City Bank Balance | 3.0 | 3.0 | 0.3% | |
| **Total Portfolio** | **$1,027.5** | **$1,044.1** | **100.0%** | |

* Local Agency Investment Fund managed by the State Treasurer.

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

The total portfolio increased to $1.04 billion (cost value), compared to $1.02 billion (cost value) at the end of Fiscal Year 2022-23.

The City began investing in corporate notes in July 2013 which is managed by an external investment advisor, Chandler Asset Management (Chandler). As of June 30, 2024, the portfolio held $100.3 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, 2024, the corporate note segment of the portfolio TRR was 1.43% compared to the benchmark of 1.26%. In addition, corporate notes are 9.6% 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, 2024, the portfolio held $66.2 million (cost value) in Supranational securities, or about 6.5% 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, commitments, and reserves. Unobligated balances in each fund were presented to the Council during the Fiscal Year 2024-25 budget process and are included in the Fiscal Year 2024-25 Adopted Budget. Fund ownership of portfolio assets are as follows (cost value and dollars in millions):

| | | |
|---|---|---|
| General Fund, Including Reserves | $ 198.4 | 19.0% |
| Restricted Funds (Utility and Special-Purpose Funds) | 398.3 | 38.1% |
| Capital Projects | 371.1 | 35.5% |
| Internal Service (Insurance Reserves and Internal Operations) | 50.7 | 4.9% |
| Trust and Agency Funds | 25.6 | 2.5% |
| **Total Portfolio** | **$1,044.1** | **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 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 the 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, 2023 using the discount rate of 5.6% and shows a projected liability of $163.7 million as of July 1, 2023. The balance in the trust as of June 30, 2023 is $170.1 million (including interest earned, net of administrative expenses), representing a 103.9% funded level. The next valuation will be as of June 30, 2025.

**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, Assistant Finance and Administrative Services Director, and the Principal Financial Analyst/Investment Officer.

- 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, 2024, 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 2023-24 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 1.6%, or $16.6 million. Similarly, 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. 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 2023-24.

## Committee Discussion

At the December 6, 2024 meeting, the Committee discussed the overall performance of the portfolio and potential updates to the Investment Policy in the areas noted below.

### 1. Medium-Term Notes

Staff reviewed Section 10.1.5 (Medium-Term or Corporate Notes), and noted that the requirement for a minimum rating of AA/Aa limits the City's flexibility in investing in Medium-Term Notes. While the investment policy allows for investing up to 15% in Corporate Notes, the limited availability of Corporate Notes with an AA rating has prevented staff from fully utilizing this asset class. Lowering the rating requirement to "A" would expand diversification opportunities by allowing access to a broader range of issuers across different sectors while still being subject to relatively low credit risk according to the Rating Agencies. Additionally, California Government Code Section 53600 permits investments with a rating of "A" or better from a nationally recognized rating agency, meaning the City's current AA/Aa requirement is more stringent than state guidelines and has constrained the City's investment options.

**2. Mortgage-Backed Securities**

Staff also reviewed Section 10.1.2 to determine whether the City's investment policy should allow mortgage-backed and asset-backed securities issued by entities other than the U.S. government. Securities issued by private industries, such as the automobile industry, carry higher risks. These securities are complex financial instruments, often involving the bundling of thousands of individual loans or assets, which makes it difficult to fully assess the associated risks. Additionally, these securities tend to have higher default risk during economic downturns.

**3. Minor Policy Language Cleanup**

Staff recommended minor changes in the Policy for cleanup or clarification.

**<u>RECOMMENDATIONS</u>**

Committee recommendations from the December 6, 2024 meeting are:

**1. Medium-Term Notes**

Lowering the City's rating requirement for Medium-Term Notes from AA to A to align with the broader options allowed under state law. Currently, Medium-Term Notes make up approximately 10% of the City's total investment portfolio, and the Policy allows up to 15%. Staff also recommend maintaining the 15% limit for now, with the expectation that lowering the rating requirement will increase investment opportunities. This limit can be reassessed once the City has successfully expanded its investments in Corporate Notes under the revised criteria.

**2. Mortgage-Backed and Asset-Backed Securities**

No changes to the current Policy regarding mortgage-backed and asset-backed securities. The existing Policy, which limits such investments to those issued by the U.S. government, should remain in place due to the higher risk associated with private-sector securities.

**3. Minor Cleanup of the Policy**

Minor cleanup of the Policy, specifically in Section 14.1 regarding the reporting requirements. This would involve issuing investment reports to the City Council and City Manager on a quarterly basis, rather than monthly. This change aligns with the common practice of other local municipalities.

## CONCLUSION

The Councilmembers of the Committee would like to thank Committee members Steven Permut and Douglas Radtke 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.

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