DATE: September 10, 2013

AGENDA ITEM # 5

TO: City Council

FROM: Russell J. Morreale, Finance Director

SUBJECT: Investment Portfolio Report

RECOMMENDATION:

Receive the Investment Portfolio Report as of June 30, 2013

SUMMARY:

Estimated Fiscal Impact:

Amount: None

Budgeted: Not applicable

Public Hearing Notice: Not applicable

Previous Council Consideration: May 4, 2013

CEQA Status: Not applicable

Attachments:

1. City-wide Holdings and Investment Ladder
2. Portfolio Mix Charts
3. Investment Policy Compliance Chart
4. Second Quarter 2013 Review of Portfolio

BACKGROUND

This report presents the status of the City's investment portfolio up through June 30, 2013. The reporting model has been developed in coordination with PFM Asset Management LLC (PFM) and provides reporting on a pre-audit basis.

DISCUSSION

Current Portfolio Profile

The summary provided below, along with the investment ladder in Attachment 1, presents the sum total of all City cash holdings. The City's portfolio book value, excluding operating cash and bond holdings as of December 31, 2012 was $52,420,589. Including the Local Agency Investment Fund (LAIF), the portfolio carries investments in 2013 (65%), 2014 (8%), 2015 (17%), and 2016 (10%). With this reporting, the City has begun to invest in the 2016 term. The City continues to proceed slowly and cautiously in this historic low-yield environment.

The City realized several scheduled maturities in this term redeeming them at full par value. Investment durations remain short and consequently, the portfolio has performed on an inception-to-date basis slightly under the City's yield benchmark. The portfolio has experienced no principal losses. In that context, recent late FY 2012/13 jumps in rates, a positive sign for investing going forward, have caused market values to drop slightly below the cost of investments and quarterly total-return earnings to be slightly negative. Inception-to-date earnings continue to meet investment goals and far exceed LAIF rates.

The City's portfolio is placed 23% in Federal Agency Securities (Fannie Mae, Federal Home Loan Bank, Federal Home Loan Mortgage and Federal Farm Credit), 14% in U.S. Treasuries, 3% in medium-term Corporate Notes, and 61% in liquid funds. Sixty (60%) is placed in the State Local Agency Investment Fund (LAIF) as opposed to 59% in the prior period of reporting given a high period of tax collections. This portfolio mix is illustrated as part of Attachment 2.

Full compliance with the City's Investment Policy is monitored closely and on a per-trade basis as illustrated in Attachment 3.

As part of these quarterly updates, a status report is prepared by PFM that is included as Attachment 4 - Second Quarter 2013 Review of Portfolio**.** It is appropriate that, although LAIF holdings are included in the sum total, the PFM report highlights the performance of City investments that fall outside its liquid holdings with the LAIF. This has been intentionally crafted to isolate performance of the City's independently-managed investments. Investment ratings are included as well as a discussion of the economic environment.

Subsequent Period Activity of Note

The consensus of the Financial Commission is to target holdings in LAIF at 50% or lower, but to do so in a paced manner. The change in market valuations caused by rising rates this past quarter underscores the prudence of taking a slow but steady approach to investing. In the time period following this report, $1,350,000 of maturing security investments were re-invested in 2016 U.S. Treasuries and Agencies. These transactions will have the impact of extending duration, but still keep the investment duration relatively short as recommended by the Financial Commission and City staff.

FISCAL IMPACT

None

PUBLIC CONTACT

A review of the past two quarters of investment activity was presented at the August 19, 2013 Financial Commission meeting.

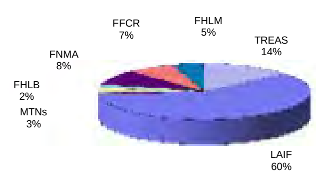
Posting of the meeting agenda serves as notice to the general public.

ATTACHMENT 1
Citywide Holdings and Investment Ladder
June 30, 2013

30-Jun-13

Month	2013					2014					2015					2016					
		YTM	Sec	Call Date	Amount		YTM	Sec	Call Date	Amount		YTM	Sec	Call Date	Amount		YTM	Sec	Call Date	Amount	
LAIF		0.24%			31,262,016																
MMKT		0.01%			358,573																
Jan																1/15/2016	0.36%	UT		300,000	
Feb																					
Mar											7/2/2015	0.61%	FNMA		900,000	4/25/2016	0.55%	FNMA	10/25/13	650,000	Cash
																					Surplus
Apr																					
																4/11/2016	0.56%	Wmart		800,000	
May																					
																5/13/2016	0.41%	FHLMC		500,000	
Jun																5/13/2016	0.72%	FHLMC		2,000,000	
																6/24/2016	0.77%	FHLB		1,200,000	
Jul											7/15/2015	0.38%	UT		750,000						
											7/15/2015	0.40%	UT		1,000,000						Period
																					of
Aug											8/7/2015	0.51%	FNMA	08/07/13	1,150,000						Cash
											8/27/2015	0.53%	FNMA	08/27/13	1,000,000						Deficiency
Sep																					
	9/15/2013	1.06%	UT		500,000																
Oct	10/15/2013	1.10%	UT		750,000	10/15/2014	0.49%	UT		1,700,000	10/9/2015	0.78%	CP GE		650,000						
Nov						11/10/2014	0.67%	FFCB		1,000,000	11/16/2015	0.45%	FFCB		1,600,000						
Dec	12/15/2013	1.19%	UT		750,000	12/31/2014	0.53%	UT		1,600,000	12/21/2015	0.40%	FNMA		750,000						Cash
											12/28/2015	0.41%	FFCB		1,250,000						Surplus
Total					$2,000,000					$4,300,000					$9,050,000					$5,450,000	
Count/Percent	3			0	13.03%	3			0	28.01%	9			2	58.96%	6			1	35.50%	
Avg YTM/Days		1.12%			117		0.56%			506		0.50%			810		0.56%			1,027	
Total Face Value					$ 2,000,000					$ 6,300,000					$ 15,350,000					$ 20,800,000	

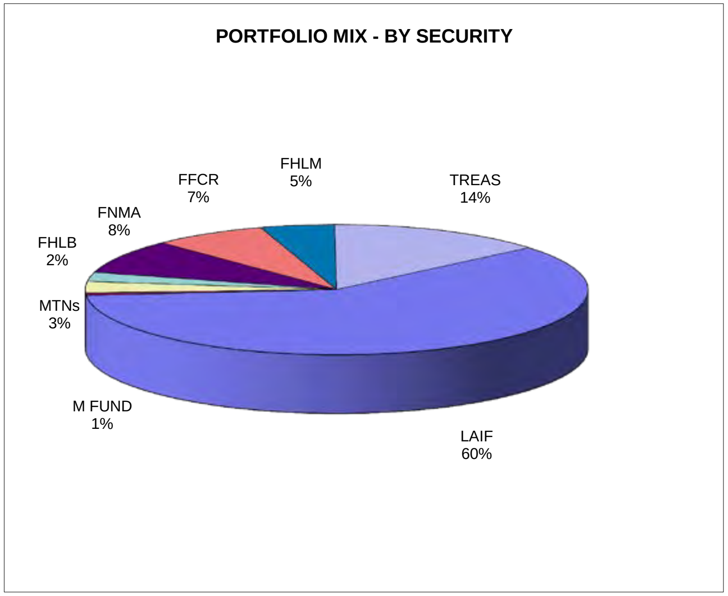
PORTFOLIO MIX - BY SECURITY



		No of Inv	Ladder Yield	Spread Over LAIF	%	Avg Mat	# of Callables	Face Value
LAIF		1	0.240%	0.000%	60%	0		31,262,016
$ Mkt Fund		0	0.010%	-0.230%	1%	0		358,573
2010		0	0.000%		0%	0	0	0
2013		3	1.117%	0.877%	4%	4	0	2,000,000
2014		3	0.563%	0.323%	8%	42	0	4,300,000
2015		9	0.497%	0.257%	17%	140	2	9,050,000
2016		6	0.562%	0.322%	10%	107	1	5,450,000
		22	0.38%	0.44%	100%	293	3	$52,420,589
							3%	

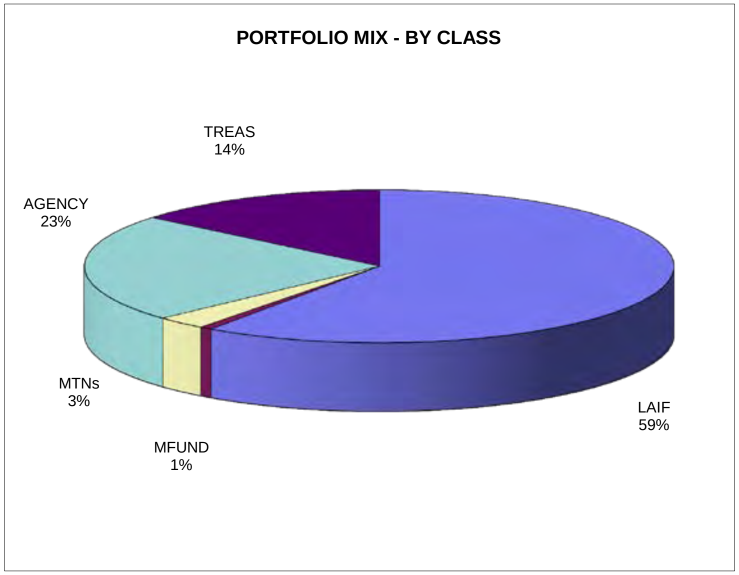
ATTACHMENT 2
Portfolio Mix Charts - June 30, 2013

		Face Value	Callables
LAIF	59.6%	31,262,016	
M FUND	0.7%	358,573	
MTNs	2.8%	1,450,000	
FHLB	2.3%	1,200,000	
FNMA	8.5%	4,450,000	2,800,000
FFCR	7.3%	3,850,000	
FHLM	4.8%	2,500,000	
TREAS	14.0%	7,350,000	
	100%	**52,420,589**	**2,800,000**
Callables			**5%**



		Face Value	Mkt Value
LAIF	60%	31,262,016	
MFUND	1%	358,573	
MTNs	3%	1,450,000	
AGENCY	23%	12,000,000	
TREAS	14%	7,350,000	
	100%	**52,420,589**	

MTNs	1,450,000	1,444,040
TREAS	19,350,000	19,361,573
Accrued Interest		19,508
	20,800,000	**20,825,121**
Margin Over (Under) Par		**25,121**



ATTACHMENT 3
Investment Policy Compliance Chart - June 30, 2013

City Investment	% Mix		Par Value	Latest Term	City Policy $ Limitation	City Policy % Limitation	CAPACITY	$ Compliance Yes/No	% Compliance Yes/No	Term Compliance Yes/No
LAIF	60%		31,262,016	04/29/10	50,000,000	100%	18,737,984	Yes	Yes	Yes
M FUND	1%		358,573	08/03/12						
MTNs	3%		1,450,000	01/00/00		15%	6,413,088	Yes	Yes	Yes
FHLB	2%		1,200,000	10/29/12		20%	9,284,118	Yes	Yes	Yes
FNMA	8%		4,450,000	04/05/12		20%	6,034,118	Yes	Yes	Yes
FFCB	7%		3,850,000	01/00/00		20%	6,634,118	Yes	Yes	Yes
FHLM	5%		2,500,000	12/05/11		20%	7,984,118	Yes	Yes	Yes
All Agencies		23%				100%		Yes	Yes	
TREAS	14%		7,350,000	08/05/12		100%	45,070,589	Yes	Yes	Yes
	100%		**52,420,589**							
All Agencies		23%	12,000,000			100%	40,420,589		Yes	
Callables		3%	1,650,000			35%	16,697,206		Yes	

City of Los Altos

Second Quarter 2013 Review of Portfolio

PFM Asset Management LLC
50 California Street, Suite 2300
San Francisco, CA 94111
415-982-5544

Attachment 4

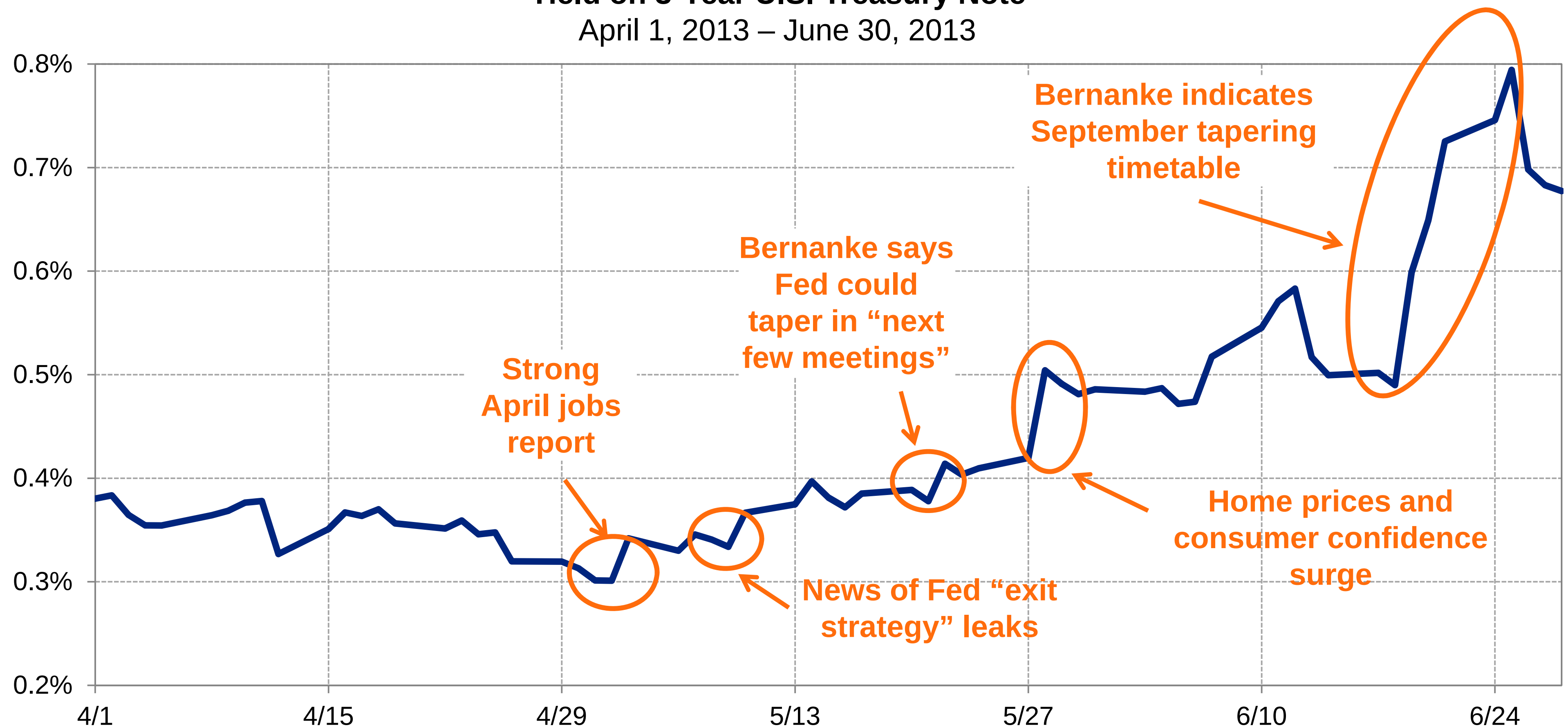
Second Quarter 2013 Recap

- During the second quarter, interest rates experienced their largest increase since the fourth quarter of 2010. The increase in interest rates was largely due to the Federal Reserve's May and June meetings, which revealed their bond purchases could be tapered beginning in September.
- Total returns, which take into account interest income as well as the change in market value of a portfolio, were negative for the second quarter for investments with durations longer than 1-year.
- Treasuries had higher returns than other sectors because, in addition to Treasury yields rising, spreads (yield difference) between Treasuries and Agencies or corporates also increased causing Agency and corporate yields to rise more (prices fall more).
- Active investment management strategies we used during the quarter were as follows:
  - Reinvested matured U.S. Treasury and corporate notes into the Federal Agency and corporate sector as the incremental yields within these sectors offered value over U.S. Treasuries.
  - Captured opportunities in yield and spread movements through strategic extensions into the 2- and 3-year area of the curve.

Interest Rates on the Rise

- Interest rates surged on a combination of positive economic news and the Federal Reserve's announcements that they would consider tapering their purchases of long-term Treasuries and mortgage-backed securities sooner than expected.

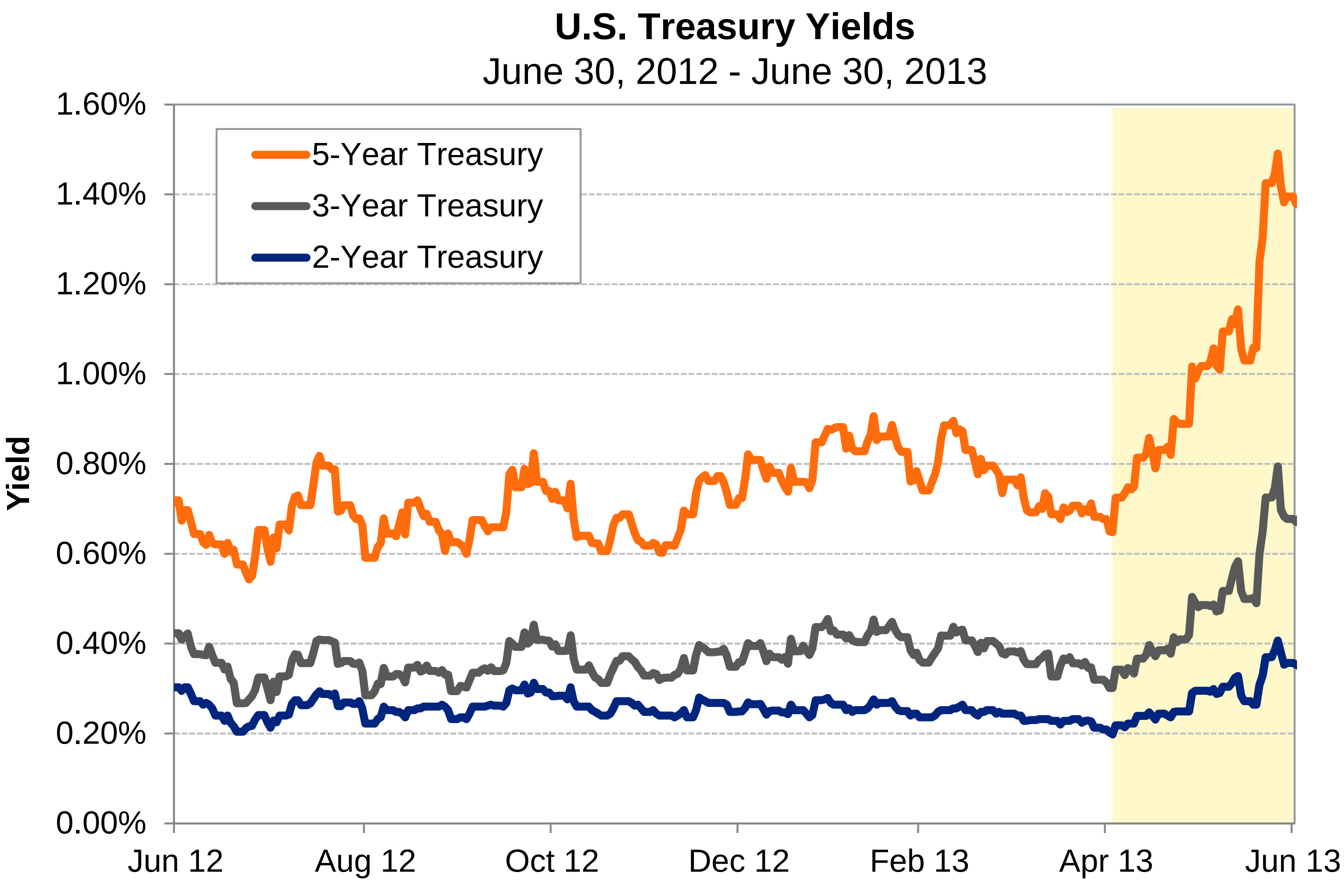
Yield on 3-Year U.S. Treasury Note
April 1, 2013 – June 30, 2013



Source: Bloomberg

Longer-Term Rates Broke Out of Range

- The increase in rates following Fed Chairman Bernanke's comments and positive economic releases impacted longer-term maturities more significantly than shorter-term maturities.
- The yield on 5-year U.S. Treasury securities increased by 75 basis points in less than two months.

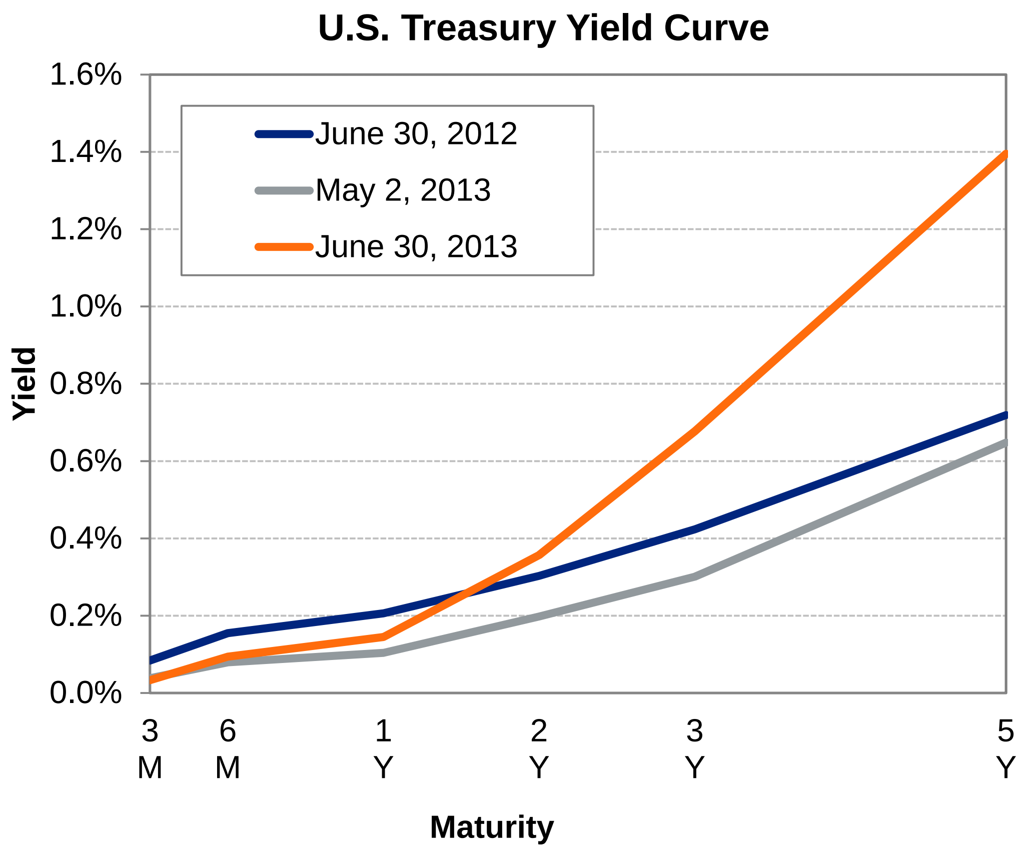


Source: Bloomberg

	5/2/13	6/30/13	Change
2 Year	0.20%	0.36%	**+0.16%**
3 Year	0.29%	0.68%	**+0.39%**
5 Year	0.65%	1.40%	**+0.75%**

Yield Curve Steepens in Mid-2013

- The recent increase in rates, especially in the 3- to 5-year maturity range, steepened the yield curve.



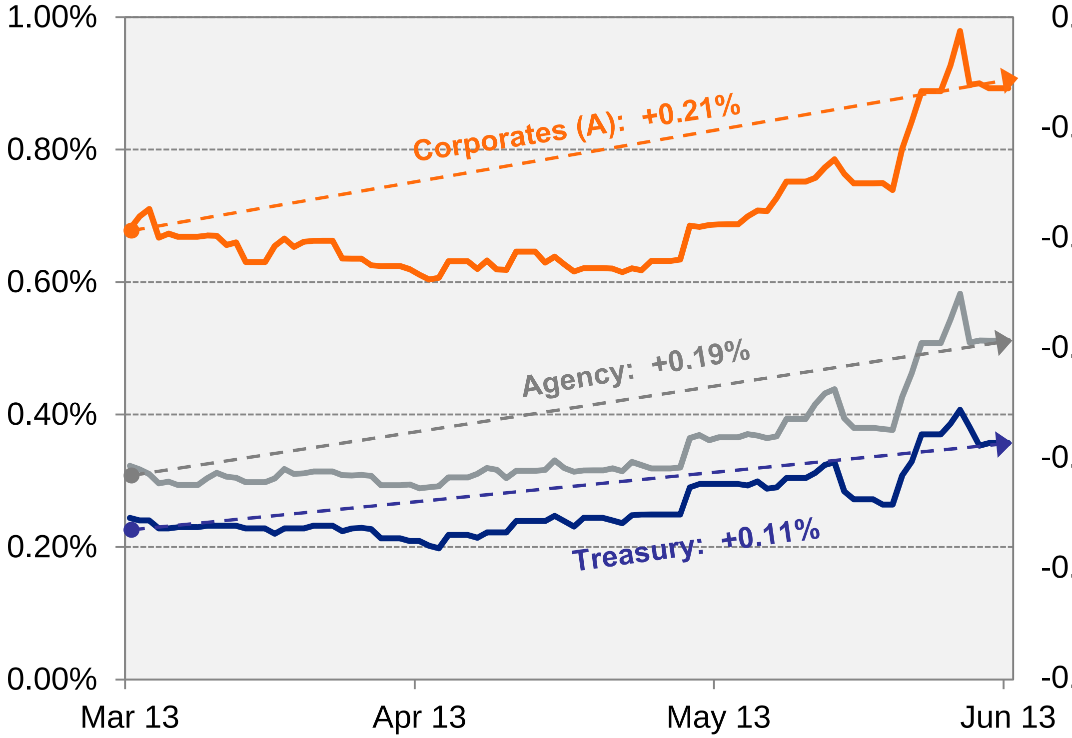
Source: *Bloomberg*

	6/30/12	5/2/13	6/30/13
3 Month	0.08%	0.04%	0.03%
6 Month	0.16%	0.08%	0.09%
1 Year	0.21%	0.10%	0.15%
2 Year	0.30%	0.20%	0.36%
3 Year	0.40%	0.29%	0.68%
5 Year	0.72%	0.65%	1.40%

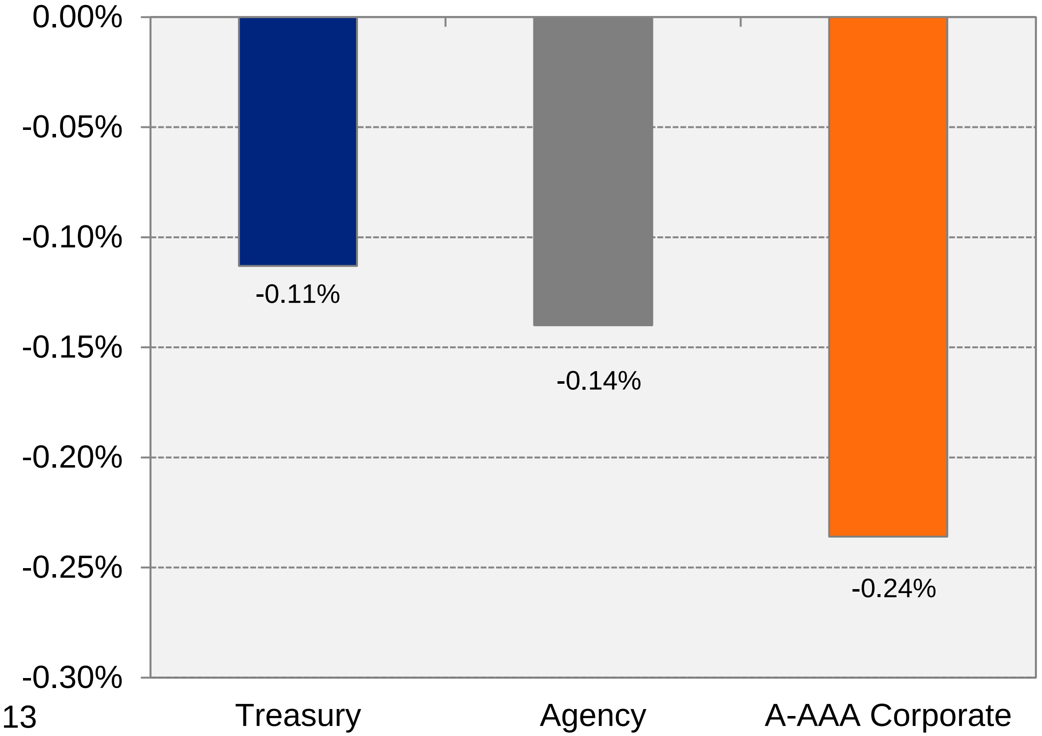
Spreads Also Widened, Causing Treasuries to Outperform

- As interest rates rose, yield spreads also widened on Federal Agencies, corporates and mortgage-backed securities. As a result, Treasuries outperformed other sectors.
  - Spreads have reversed since the beginning of the third quarter.

Comparison of 2-year Yields
March 31, 2013 – June 30, 2013



1-3 Year Index Total Returns (Sector)
March 31, 2013 – June 30, 2013



Source: Bloomberg, BofA Merrill Lynch Bond Indices

Returns Were Depressed Across All Sectors and Maturities

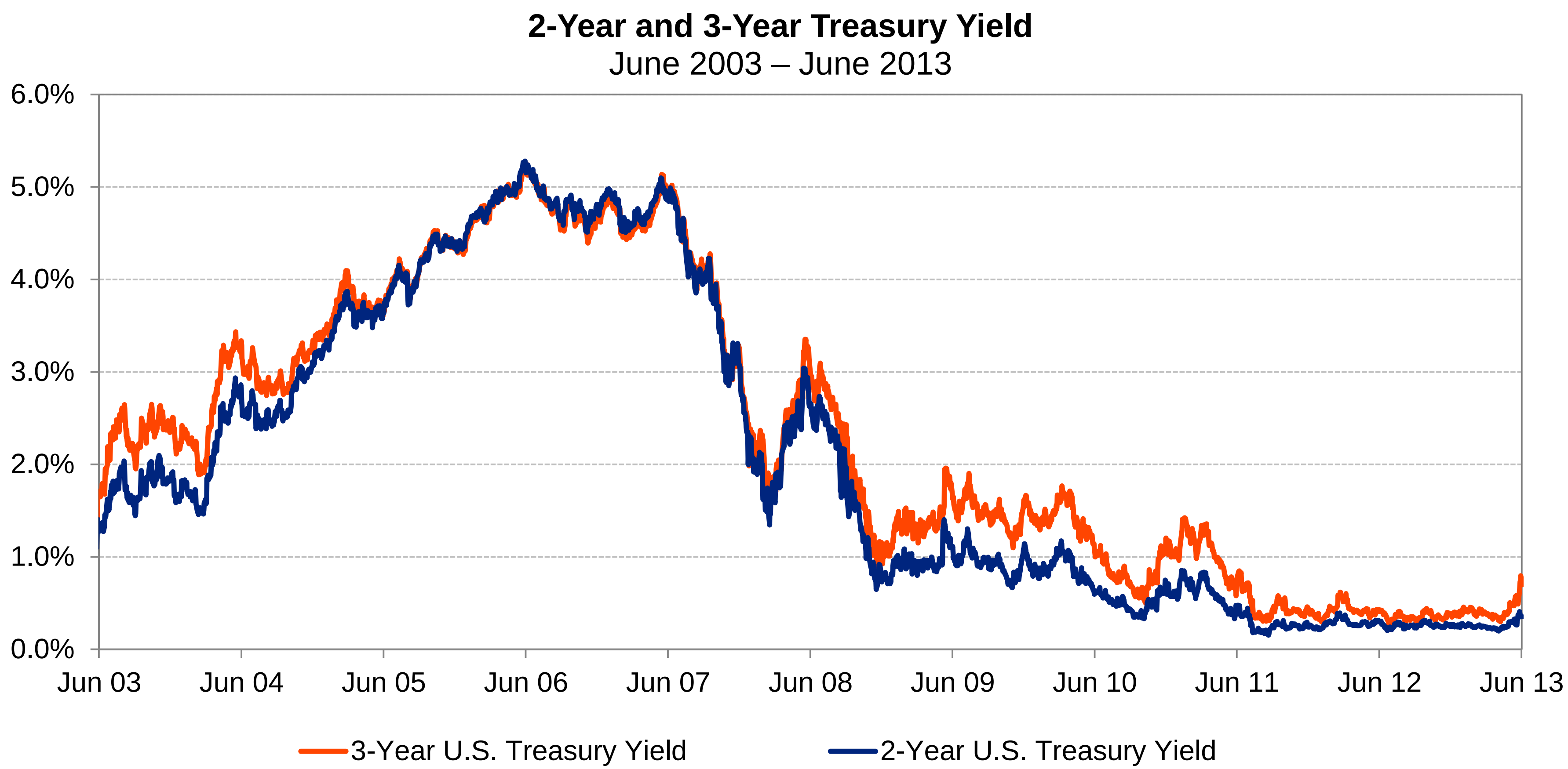
	As of 6/30/2013		Returns for Periods ended 6/30/2013		
	Duration	Yield	3 Month	1 Year	3 Years
1-3 Year Indices					
U.S. Treasury	1.89	0.37%	(0.10%)	0.33%	0.82%
Federal Agency	1.80	0.48%	(0.13%)	0.34%	0.97%
U.S. Corporates, A-AAA rated	1.99	1.20%	(0.22%)	2.16%	2.63%
Agency MBS (0 to 3 years)	1.69	1.67%	(1.00%)	(0.40%)	1.75%
Municipals	1.77	0.70%	(0.16%)	0.62%	1.27%
1-5 Year Indices					
U.S. Treasury	2.72	0.66%	(0.67%)	(0.03%)	1.44%
Federal Agency	2.61	0.81%	(0.74%)	0.01%	1.28%
U.S. Corporates, A-AAA rated	2.91	1.70%	(1.09%)	2.19%	3.40%
Agency MBS (0 to 5 years)	3.06	2.66%	(1.37%)	(0.60%)	2.46%
Municipals	2.51	1.04%	(0.61%)	0.53%	1.86%
Master Indices (Maturities 1 Year or Greater)					
U.S. Treasury	5.78	1.40%	(2.21%)	(2.00%)	3.03%
Federal Agency	4.01	1.34%	(1.97%)	(0.90%)	2.12%
U.S. Corporates, A-AAA rated	6.57	2.96%	(3.12%)	0.89%	5.08%
Agency MBS	4.61	2.96%	(1.92%)	(1.15%)	2.52%
Municipals	7.81	3.21%	(3.33%)	0.10%	4.66%

Return for periods greater than one year are annualized.

Source: BofA Merrill Lynch Bond Indices

Interest Rates Remain Low by Historical Standards

- While interest rates have risen recently, they still remain low by historical standards and thus have a long way to go until they normalize.



Source: Bloomberg

Portfolio Generated Strong Returns

- The rise in interest rates in May and June caused the fair value of the City's portfolio to decrease in value more than the amount the portfolio earned in interest for the quarter, generating negative returns for the first time since 2010. We continue to monitor yield changes for opportunities to enhance the return through higher yields.

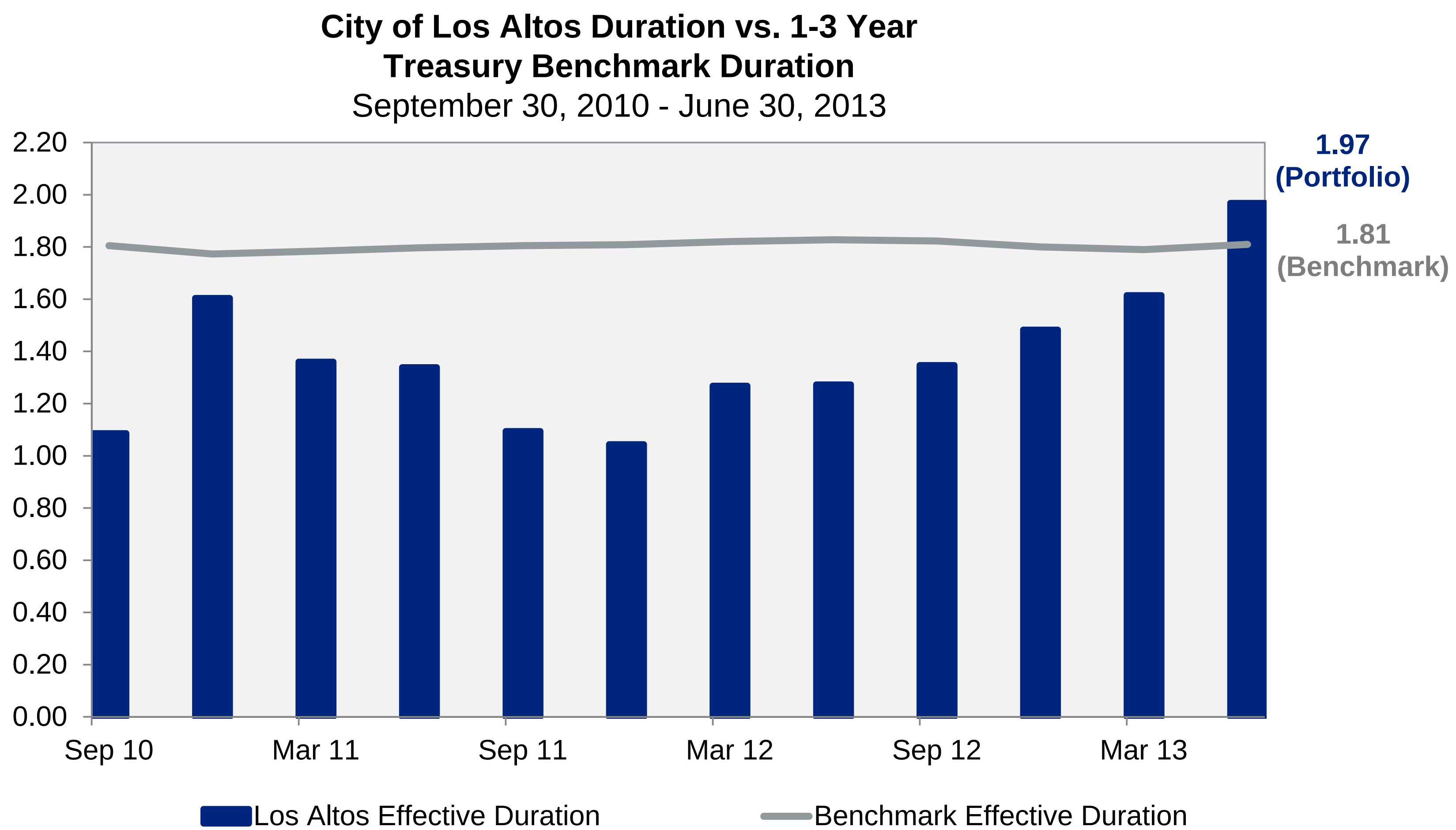
Total Returns
for Periods ending June 30, 2013

	Duration (years)	Past Quarter	Past Year	Past 2 Years	Since Inception
City of Los Altos	**1.97**	**-0.17%**	**0.23%**	**0.46%**	**0.74%**
Merrill Lynch 1 Year U.S. Treasury Index	0.91	0.04%	0.31%	0.29%	0.36%
Merrill Lynch 1-3 Year U.S. Treasury Index	1.81	-0.11%	0.33%	0.56%	0.82%

Notes:
- *Performance on trade-date basis, gross (i.e., before fees) in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).*
- *Merrill Lynch Indices provided by Bloomberg Financial Markets.*
- *Inception date is third quarter 2010.*
- *Return calculation excludes LAIF*

Portfolio Duration Near Benchmark Duration

- The recent rise in interest rates allowed us to extend portfolio duration to its target duration, while at the same time enhance the portfolio with additional yield. The portfolio duration generally changes when we purchase or swap securities.



Source: Bloomberg

Second Quarter Total Return Detail

- Although the portfolio's total return was -0.17% during the second quarter, the portfolio's total return, minus unrealized gains/losses, was 0.15% for the same time period.

Calculating Return in Dollars

	Ending Market Value + Accrued Interest		$21,204,695
-	Beginning Market Value + Accrued Interest	-	$18,236,389
+	Distributions	+	$0
-	Contributions	-	$3,000,000
	= **Total Return**		**-$31,693**

Components of Dollar Return

Realized Gain/Loss:		$0	**Realized Return**
Net Interest Income:	+	$26,566	
Realized Dollar Return:		**$26,566** →	**+0.15%**
Unrealized Gain/Loss:	-	$58,269	
Total Return		**-$31,693**	

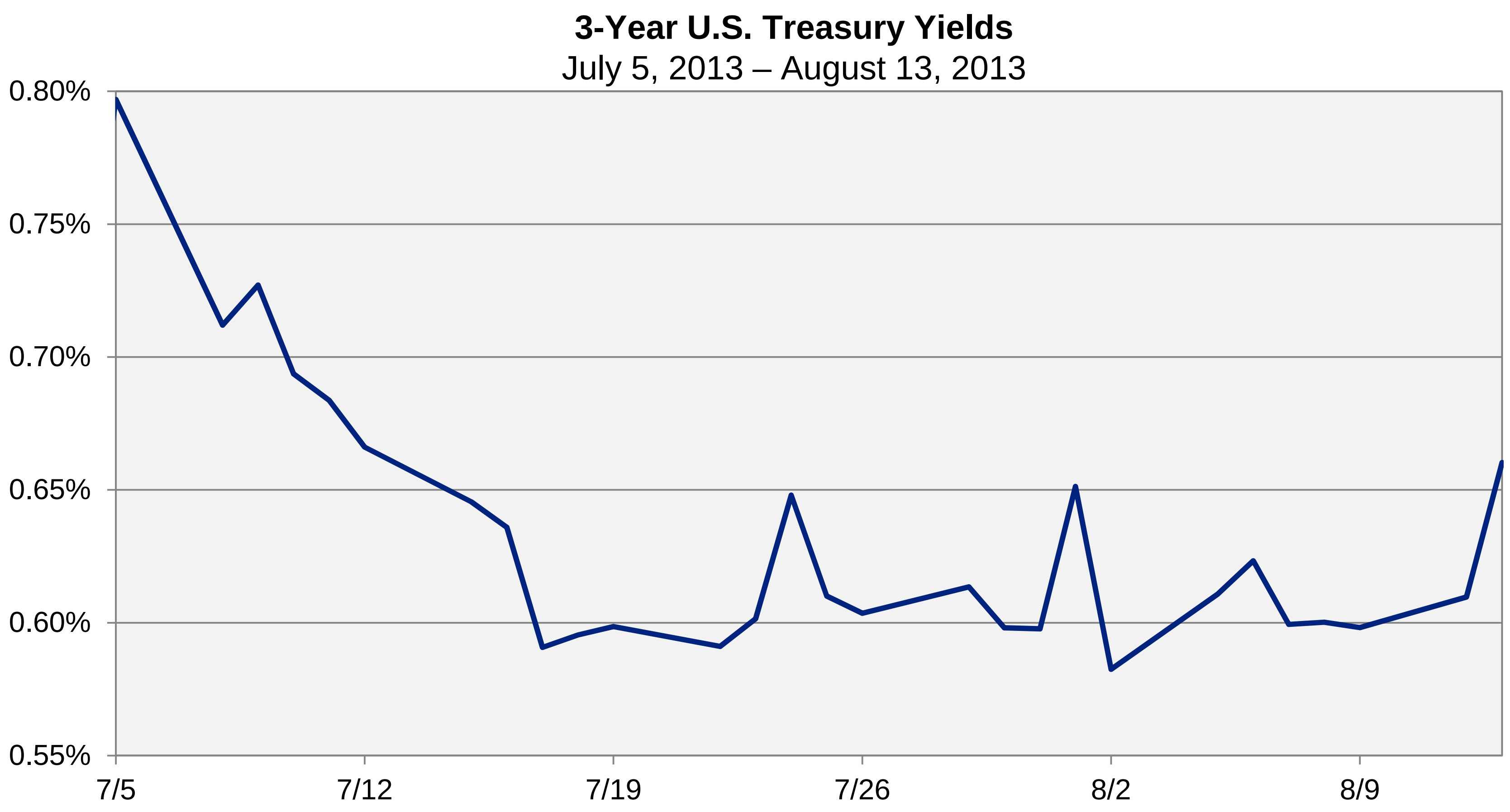
Calculating Average Balance

	Beginning Market Value + Accrued Interest		$18,236,389
-	Time-Weighted Distributions	-	$0
+	Time- Weighted Contributions	+	$131,868
	= **Time Weighted Average Balance**		**$18,368,257**

Total Return = **-$31,693** / **$18,368,257** = ***-0.17%***

Treasury Yields Retreat After Quarter-end

- Yields have fallen since the end of the quarter, which has boosted the portfolio's total return.



Source: Bloomberg

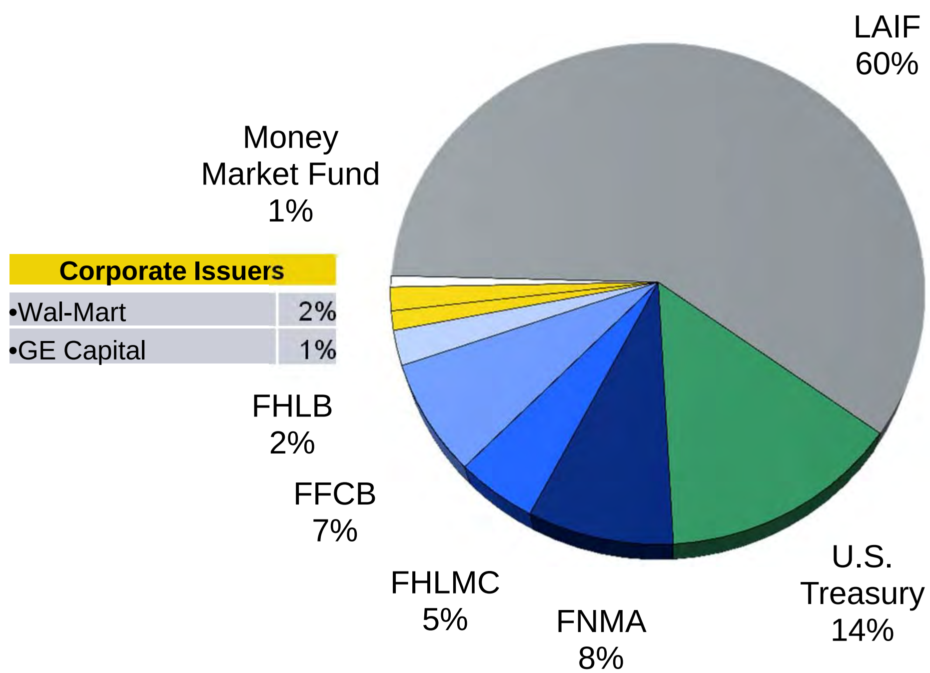
Portfolio Holdings in Compliance with California Code and City's Investment Policy

Security Type	Market Value as of June 30, 2013	Percent of Portfolio	Permitted by Policy	In Compliance
U.S. Treasury	$7,417,303	14%	100%	✓
Federal Agencies	$11,961,453	23%	100%	✓
Corporate Notes	$1,446,366	3%	30%	✓
LAIF	$31,262,016	60%	100%	✓
Money Market Fund	$379,573	<1%	20%	✓
Total	$52,466,711			

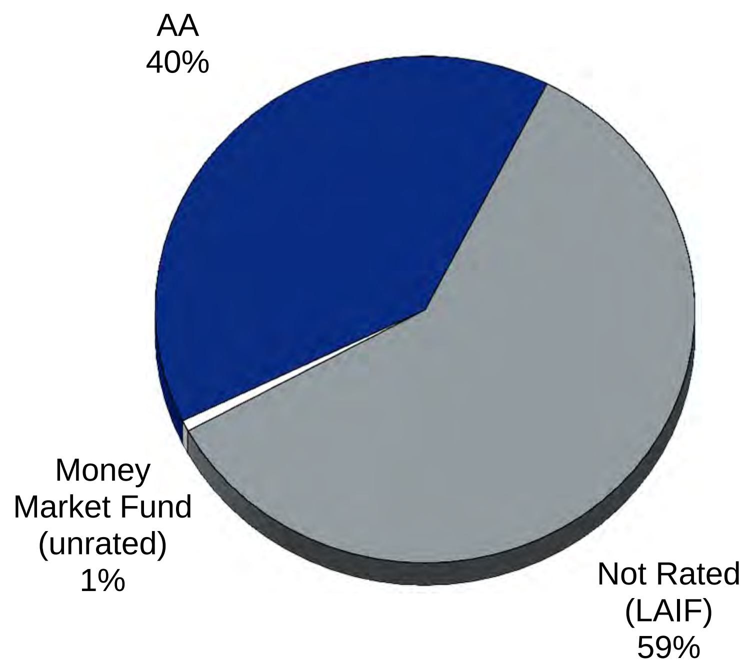
City’s Holdings Maintain Highest Credit Quality

- The portfolio has excellent credit quality: 98% of the portfolio (excluding LAIF) is invested in securities rated in S&P’s second highest ratings category, AA.
- The City’s portfolio continues to be well diversified by both sector and issuer.

Issuer Distribution



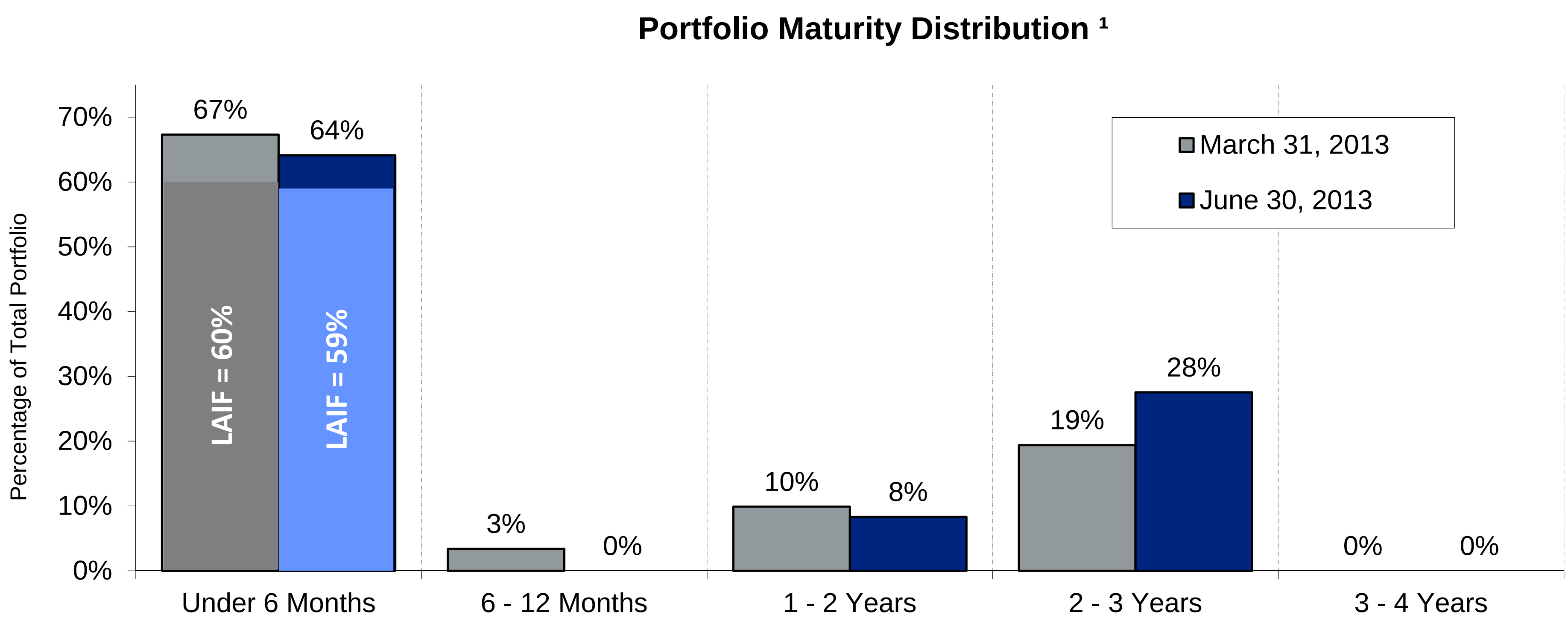
Credit Quality



Notes:
- *As of June 30, 2013*
- *Standard & Poor's Ratings*

Portfolio Holdings Are Diversified by Maturity

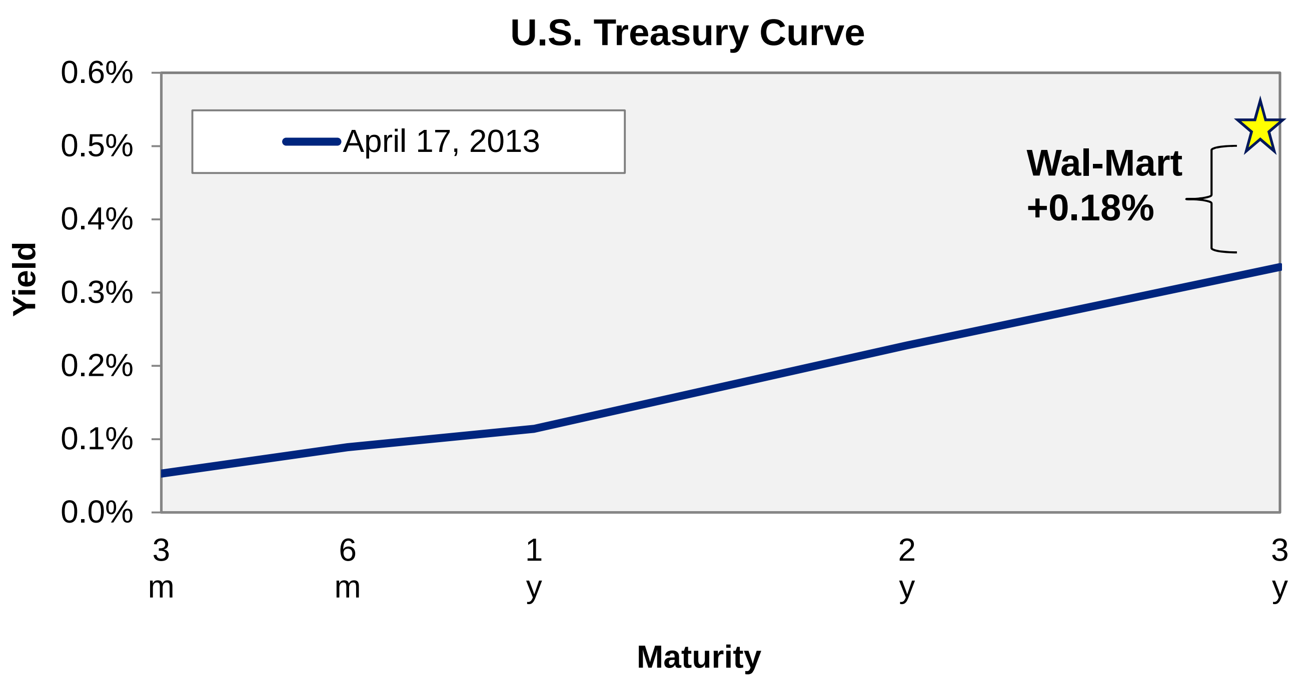
- We have continued to selectively invest in the 2- and 3-year range to expose the portfolio to higher yields and modestly.



Note: Callable securities in portfolio are included in the maturity distribution analysis to their stated maturity date, although they may be called prior to maturity.

Strategy—Increase Allocation to Non-Financial Corporates

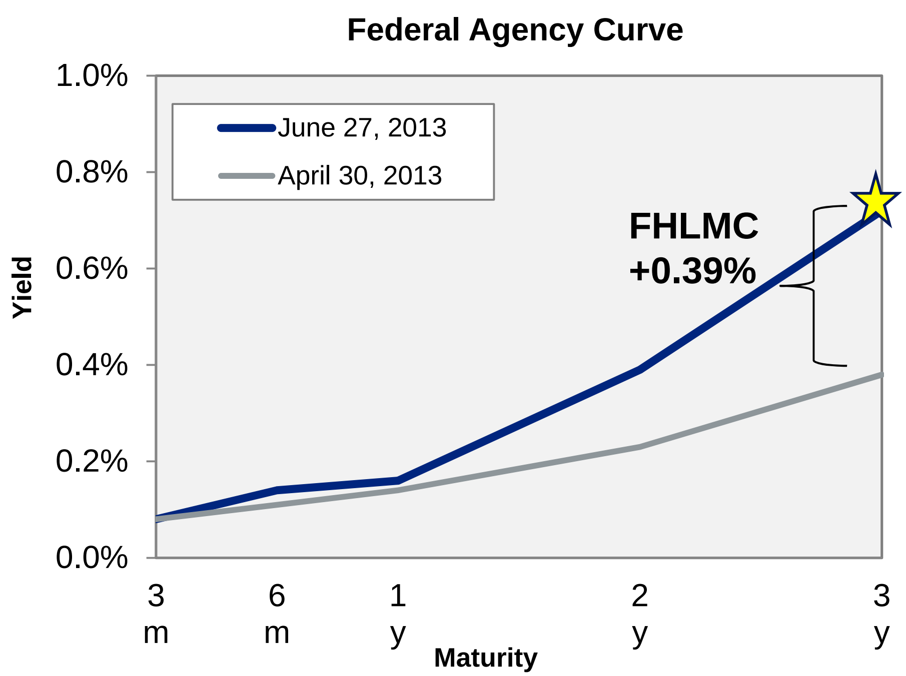
- We strategically increased the portfolio's holdings of non-financial corporates as the yield difference between U.S. Treasury securities and non-financial corporate obligations widened.
- The new investment will enhance portfolio yield and have the potential to increase in value through "roll-down."
  - Wal-Mart Stores.—Maturity: 4/11/16 Yield to Maturity: **0.52%**

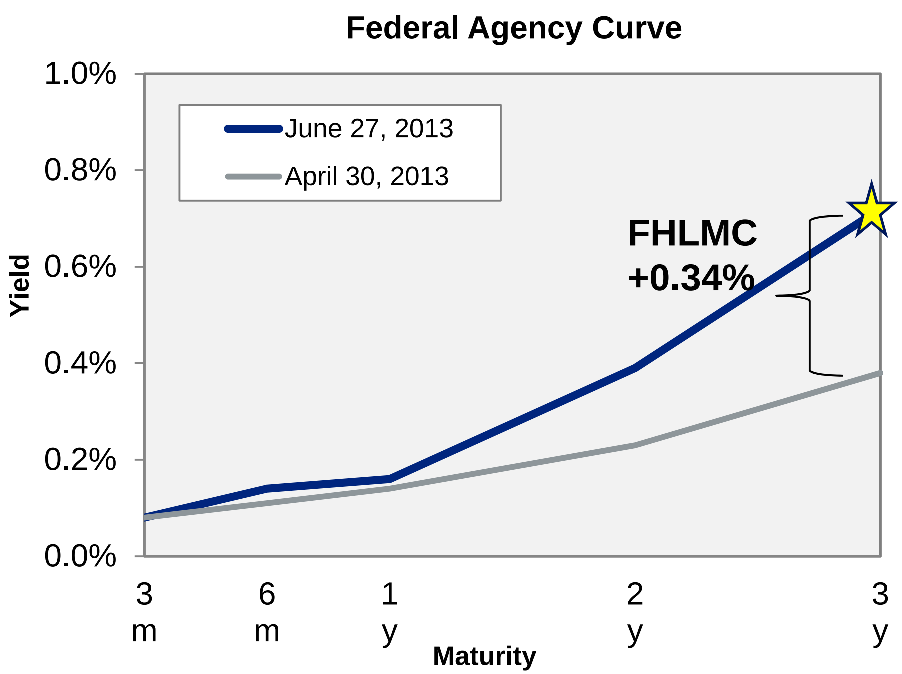


Source: Bloomberg

Strategy—Extend Duration After Rate Increase

- The rate increase that began in May presented a buying opportunity within the Federal Agency sector.
- The steepening in the yield curve increased the potential for "roll-down" return in longer-term securities.
- We made the following purchases after rates increased:
  - June 27, 2013: FHLMC—Maturity: 6/24/16 Yield to Maturity: **0.77%**
  - June 27, 2013: FHLMC—Maturity: 5/13/16 Yield to Maturity: **0.72%**





Source: Bloomberg

Third Quarter Investment Strategy

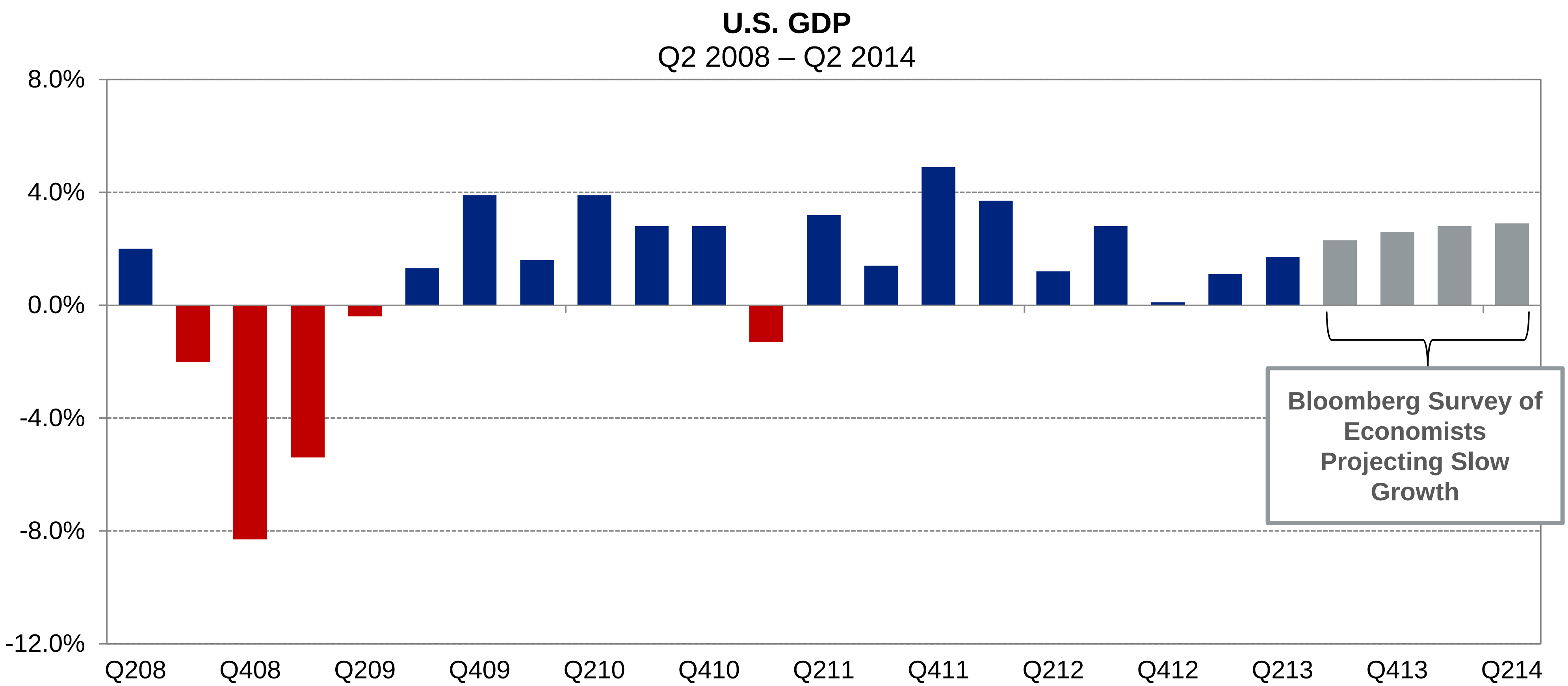
- The economic outlook continues to strengthen, however, headwinds to recovery still remain.

Positive	Challenges
– Modest GDP growth – Decreasing unemployment – Housing sector momentum – Strong corporate earnings	– Sequester and debt ceiling – Manufacturing sector weakness – On-going European crisis – Rising energy prices

- The Fed may begin to decrease its quantitative easing programs by the end of the year.
- Treasuries have risen to a new higher trading range. Additionally, we expect higher volatility in the bond market in the coming quarter.
  – This new environment should generate relative value opportunities in callable and non-callable Agencies, due to favorable pricing and overall higher interest rates.
- Corporate and municipal bonds are expected to remain the primary generators of excess return as the fundamentals of financial companies and local governments continue their positive trend.
- We will look to for value within floating rate notes and negotiable certificate of deposit sectors.
- We will focus on safety of principal and appropriate liquidity more than ever in this new and challenging environment while maximizing value through careful and prudent active management.
- Our strategy will remain appropriately flexible and may change in response to changes in interest rates, economic data, market outlook or as specific opportunities arise.

U.S. Economic Growth Remains Moderate

- GDP grew at 1.7% in the second quarter, beating economists' expectations. The positive second quarter news was offset by the downward revision of first quarter GDP from 1.8% to 1.1%.



Source: Bloomberg

Outline of July FOMC Meeting

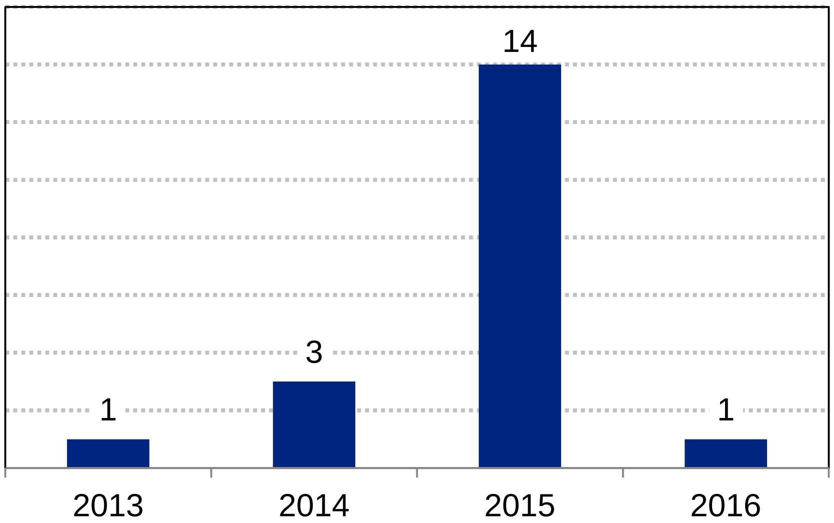
- The Federal Reserve Open Market Committee (FOMC) met July 31, making a slight change to its assessment of overall U.S. economic conditions:
  - **Prior Language:** *"Information received since the Federal Open Market Committee met in May suggests that economic activity has been expanding at a* ***moderate pace****."*
  - **Current Language:** *"Information received since the Federal Open Market Committee met in June suggests that economic activity expanded at a* ***modest pace*** *during the first half of the year."*
- The statement likely reflects some disappointment with the pace of economic recovery.
- The FOMC kept their assessment of inflation as "below" the committee's long run objective. They further added that inflation persistently below 2% posed risks to economic performance.
- The FOMC went on to state that the committee "reaffirmed its view" regarding accommodative monetary policy for a considerable time after the economy strengthens.

Source: Bloomberg, Federal Open Market's Committee.

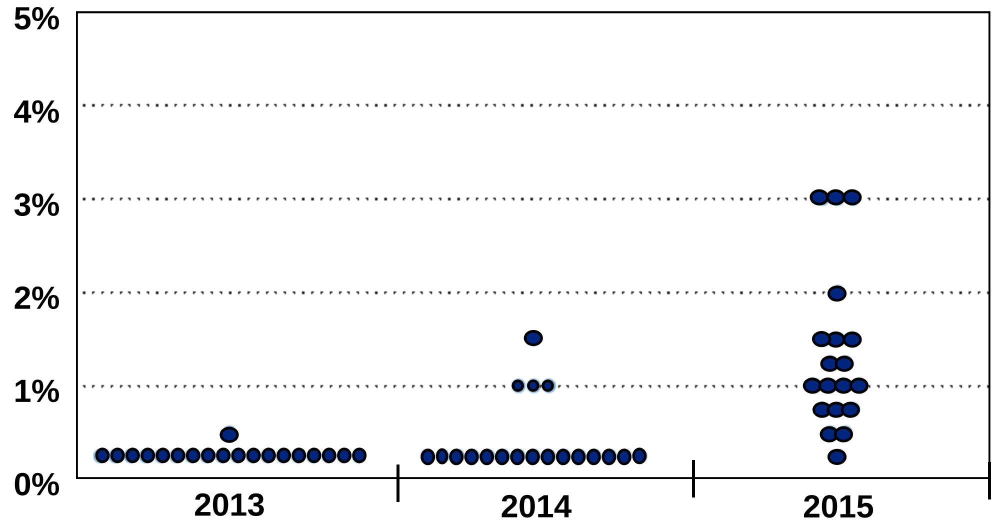
Fed Rate Guidance Indicates Continued Low Rates Through At Least 2015

- Since unemployment remains at uncomfortably high levels, and inflation remains at low levels, the Federal Reserve is still expected to keep interest rates low until 2015. However, in the Fed's June release they indicated that bond purchases are likely to taper near the end of 2013.

FOMC Participant Votes on Appropriate Timing of Policy Firming
as of June 19, 2013



Targeted Federal Funds Rate at Year-End FOMC Participant Forecasts
as of June 19, 2013



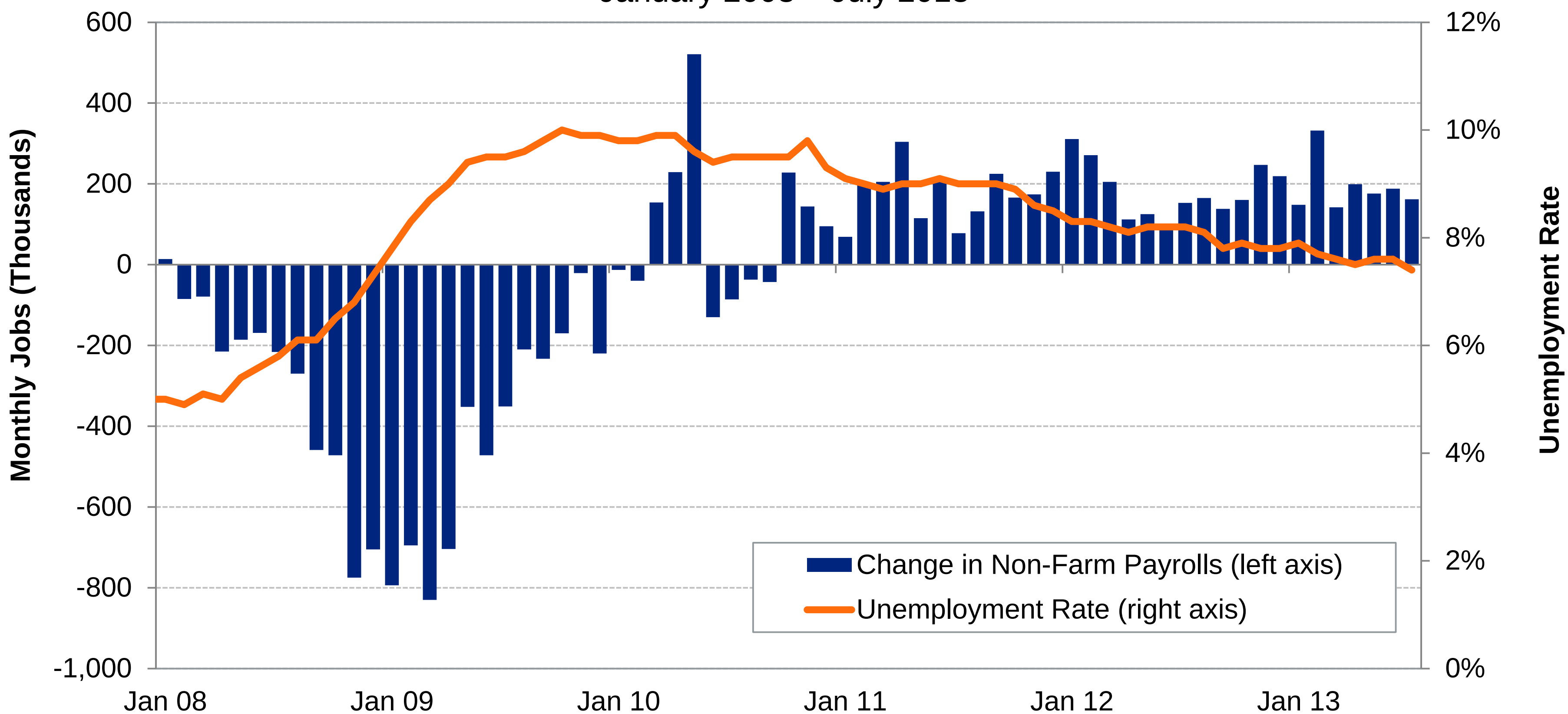
● *Individual FOMC participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year.*

Source: Federal Reserve Open Market Committee.

Job Market Continues Slow Improvement

- Over the past year, the unemployment rate has decreased from 8.2% to 7.4%, and the economy has added an average of 190,000 jobs per month.
- Part of the decrease in unemployment is attributed to the continued decline of the labor force participation rate, which is currently 63.4% — just 0.1% higher than the lowest level in over 30 years.

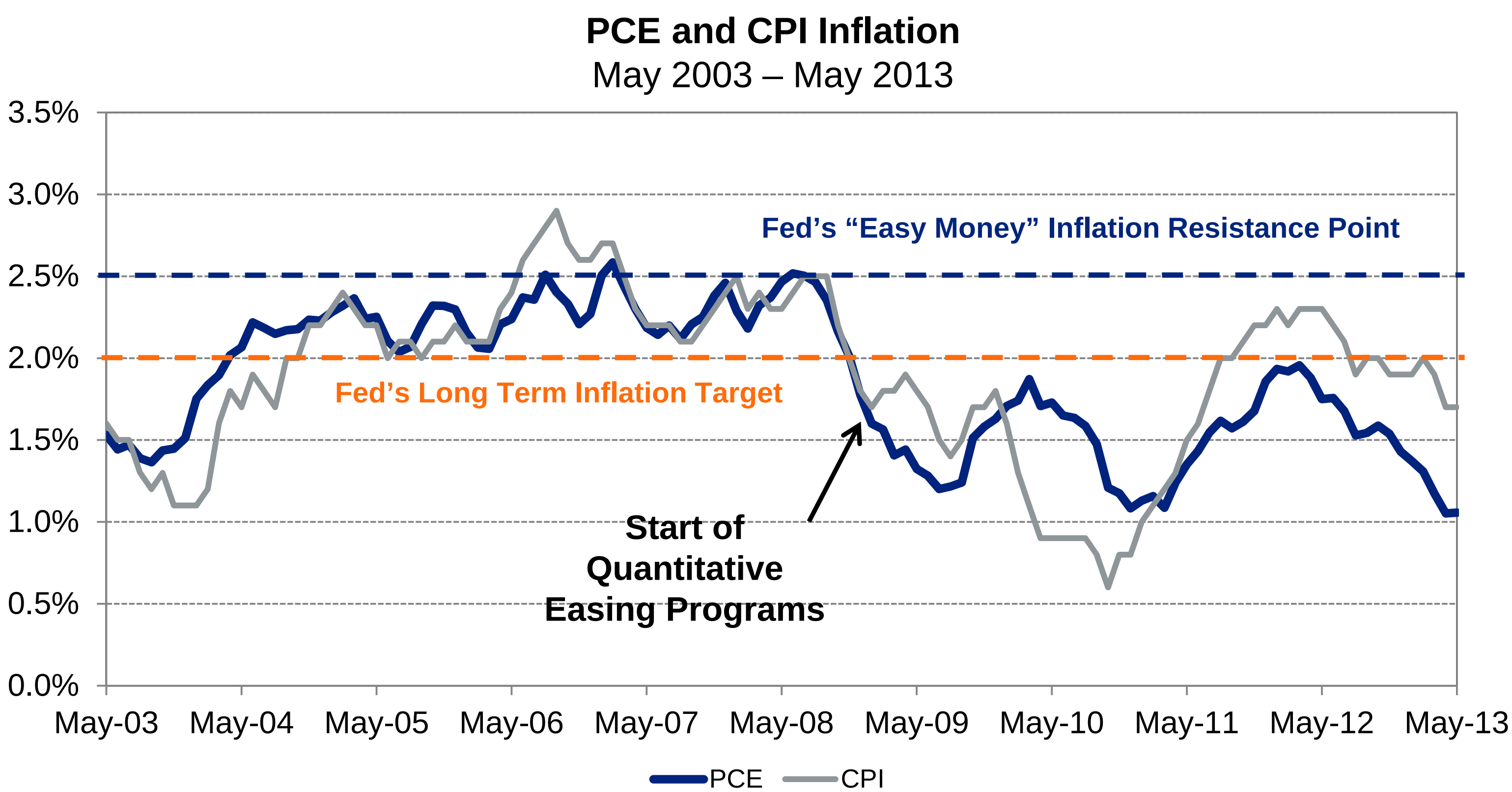
Change in Nonfarm Payrolls vs. Unemployment Rate
January 2008 – July 2013



Source: Bloomberg

Inflation Far From Near

- Personal Consumption Expenditures (PCE) and Consumer Price Index (CPI) are the two most commonly utilized measures of inflation. Both readings seem to confirm that inflation is not an imminent concern.
- When considering monetary policy, the FOMC's primary focus is PCE.



Source: Bureau of Economic analysis, Bureau of Labor Statistics, Bloomberg.