AGENDA REPORT

MEETING DATE: September 13, 2011

TO: City Council

FROM: Russell J. Morreale, Finance Director

SUBJECT: Investment Portfolio Report – June 30, 2011

RECOMMENDATION: Accept and receive the investment portfolio report.

SUMMARY:

Estimated Fiscal Impact:

Amount: None - Informational Only

Budgeted: N/A

Public Hearing Notice N/A

Previous Council Consideration: October 26, 2010

CEQA Status (If Required): N/A

Attachments:

1. Citywide Holdings and Investment Ladder
2. Investment Performance Review Second Quarter 2011

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Russell J. Morreale, Finance Director Date

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Douglas J. Schmitz, City Manager Date

BACKGROUND:
This report presents the status of the City's investment portfolio through June 30, 2011 to City Council as a normal course of periodic reporting to City Council. This reporting will be provided on a quarterly basis heretofore now that a formal reporting model has been developed in coordination with PFM, our investment advisors.

DISCUSSION:
Current Portfolio Profile
Since the first reports, staff has developed a quarterly status report in coordination with PFM that is included as an attachment to this cover report - **Attachment 2 – Investment Performance Review.** For sake of brevity, this report will not repeat what is presented therein, but presents a concise summary. As Council accepts the Investment Performance Review, it is important to note that it includes City investments that fall outside of liquid holdings with the Local Agency Investment Fund (LAIF). This has been intentionally crafted to isolate the performance of the City's independently managed investments. That being said, the summary provided below along with the investment ladder on **Attachment 1**, presents the sum total of all City operating cash holdings.

The City's portfolio book value, excluding operating cash and bond holdings, as of June 30, 2011 was ***$45,156,173.*** This represents the City's investment portfolio report for the second calendar quarter of 2011 and the City's fourth fiscal year 2010-2011 quarter. Including LAIF, the portfolio has placed investments in 2011 (69%), 2012 (17%) and 2012 (15%). Since its very first purchases in 2010, the City has moved ahead slowly and cautiously given historic short-term yield curve trends. Put another way, investment durations have remained extremely short yet the portfolio has performed, on an inception to date basis near to, but slightly under, the City's yield benchmark. The portfolio has realized no principle losses and complies with the investment policy. The market value of the City's portfolio exceeds original cost and par values of the investments purchased.

As of June 30, 2011, 14% of the City's portfolio is placed in Federal Agency Securities (Fannie Mae, Federal Home Loan Bank and Federal Home Loan Mortgage), 13% in US Treasuries, 7% in medium-term corporate notes, with the balance of 66% in liquid LAIF funds. Investment ratings are as listed with the important note that this investment report does not yet reflect the US treasury downgrade as announced by Standard & Poor earlier this year – a change that will be noted in the next report.

FISCAL IMPACT:
To date the City's investment portfolio has remained within target duration and is performing close to, but just under, its yield benchmark given its risk adverse and cautious stance.

ALTERNATIVES:
N/A

Attachment 1
Citywide Holdings and Investment Ladder

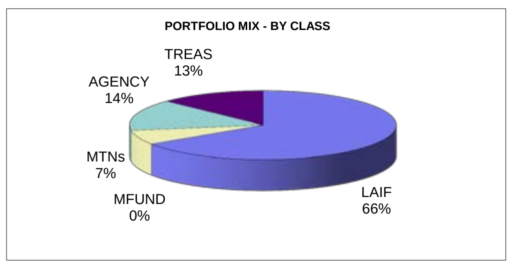
30-Jun-11

ATTACHMENT 1
Citywide Holdings and Investment Ladder
June 30, 2011

Month	2011	YTM	Sec	Call Date	Amount	2012	YTM	Sec	Call Date	Amount	2013	YTM	Sec	Call Date	Amount	2014 YTM	Sec	Call Date	Amount	2015 YTM	Sec	Call Date	Amount
LAIF		0.51			29,611,496																		
MMKT		0.03			94,676																		
Jan						1/12/2012	0.95%	FA		800,000	1/9/2013	0.63%	FA		1,500,000								
Feb																							
						2/29/2012	0.88%	UT		1,200,000													
Mar											3/31/2013	0.81%	UT		500,000								
Apr											4/1/2013	1.12%	BNY		650,000								
											4/15/2013	0.88%	WMRT		750,000								
						4/4/2012	1.06%	FA		800,000													
May																							
Jun						6/15/2012	1.39%	GE		1,000,000	6/26/2013	0.73%	FA		750,000								
											6/15/2013	0.93%	UT		500,000								
Jul						7/15/2012	1.01%	UT		800,000													
Aug						8/15/2012	1.09%	UT		800,000													
Sep																							
											9/15/2013	1.05%	UT		500,000								
Oct						10/19/2012	1.18%	GE		650,000	10/15/2013	1.10%	UT		750,000								
Nov						11/21/2012	1.42%	FA		800,000													
Dec	12/28/2011	0.899%	FA		1,200,000	12/28/2012	0.70%	FA		750,000	12/31/2013	1.18%	UT		750,000								
Total					$1,200,000					$7,600,000					$6,650,000				$0				$0
Count/Percent	1			0	7.77%	9			0	49.19%	9			0	43.04%	0		0	0.00%	0		0	0.00%
Avg YTM/Days		0.899%			181		1.08%			377		0.94%			722	0.00%			0	0.00%			0
Total Face Value															$ 15,450,000				$ 15,450,000				$ 15,450,000

Security legend:

UT	US Treasury
FA	Federal Agency
CP	Corporate Note



		No of Inv	Ladder Yield	Spread Over LAIF	%	Avg Mat	# of Callables	Face Value
LAIF		1	0.510%	0.00%	66%	0		29,611,496
$ Mkt Fund		0	0.200%	-0.31%	0%	0		94,676
2010		0	0.000%		0%	0	0	0
2011		1	0.899%	0.39%	3%	5	0	1,200,000
2012		9	1.075%	0.57%	17%	64	0	7,600,000
2013		9	0.937%	0.43%	15%	106	0	6,650,000
		20	0.678%	0.21%	100%	175	0	$45,156,173
							0%	

Mkt Value	$15,731,544.00
Cost Basis + Accrued Int	$15,788,972.00
Mkt Value Above Par	$281,544.00
Mkt Value Above Cost	$57,428.00

Attachment 2
Investment Performance Review Second Quarter 2011

City of Los Altos

Investment Performance Review
Second Quarter 2011

Carlos Oblites, Senior Managing Consultant
PFM Asset Management LLC
50 California Street, Suite 2300
San Francisco, CA 94111

Interest rates across the yield curve fell during the second quarter on fears of an economic slowdown, and as a result, fixed-income portfolios with longer durations posted strong positive returns. With their highest quarterly returns in a year, longer-duration fixed-income portfolios significantly outperformed cash-equivalent portfolios, where returns remained near zero.

Two factors caused the interest rate drop: first, weak economic reports set off fears of slower growth and lowered inflation expectations; second, sovereign debt concerns in Europe sparked a flight-to-quality. By the end of the quarter yields on Treasury securities had fallen from their 2011 highs, in some maturities, to all-time lows. The significant bond market rally made fixed-income investments one of best performing asset classes in the second quarter.

The Economy

Worries over slowing growth emerged after a series of releases of weak economic data. The final GDP estimate put first quarter growth at 1.9%, below expectations and lower than the 3% to 4% that is typical at this stage in an economic recovery.

After several months of strong job growth, the labor market appeared to slow down as well. Only 22,000 new jobs on average were created during the last two months of the second quarter compared to 215,000 new jobs on average during the last two months of the first quarter. Manufacturing activity slowed with the ISM manufacturing index falling from 61.2 in March to 55.3 in June, closer to the threshold of 50, which marks the beginning of a contraction in industrial activity.

Although the economic slowdown is troubling, many economists believe it is temporary. The earthquake and tsunami in Japan disrupted supply chains across the world causing repercussions to the global industrial system and affecting U.S. manufacturers who faced shortages of auto and electronics components. Toward the end of the quarter, production levels in Japan rebounded and U.S. companies started to increase production. Other temporary factors were higher food prices due to the floods in the Midwest and higher oil prices due to the geopolitical tensions in the Middle East and Northern Africa. Higher food and energy prices had a dampening effect on consumer purchasing power and spending. For example, the pace of retail sales excluding automobiles and gas slowed in the second quarter to a monthly average of 0.2% compared to the preceding 3 month average of 1.0%.

Interest Rates and Returns

Treasury yields fell steadily over the quarter with intermediate-term Treasuries showing the most change. As the following table shows, the yield on the 5-year U.S. Treasury Note declined by 52 basis points (0.52%) from 2.28% on March 31, 2011 to 1.76% on June 30, 2011. At the end of June, the yield on the 2-year U.S. Treasury Note reached a new all-time low on speculation that Greece's government would fail to pass austerity measures needed to secure a bailout.

Short-term interest rates, which are anchored to the Federal Funds rate, declined as well. A flight-to-quality, lack of short-term Treasury supply, and quarter-end demand from investors such as banks and securities firms drove the yield on the 3-month Treasury bill to 0.01%, and at some points in June some Treasury bills actually traded at negative yields.

Comparison of U.S. Treasury Yields

Date	3M	6M	1Y	2Y	3Y	5Y	10Y
June 30, 2011	0.01%	0.10%	0.18%	0.46%	0.80%	1.76%	3.16%
March 31, 2011	0.09%	0.17%	0.27%	0.82%	1.30%	2.28%	3.47%
Change over Quarter	-0.08%	-0.07%	-0.09%	-0.36%	-0.50%	-0.52%	-0.31%
June 30, 2010	0.17%	0.22%	0.31%	0.60%	0.96%	1.77%	2.93%
Change over Year	-0.16%	-0.12%	-0.13%	-0.14%	-0.16%	-0.01%	0.23%

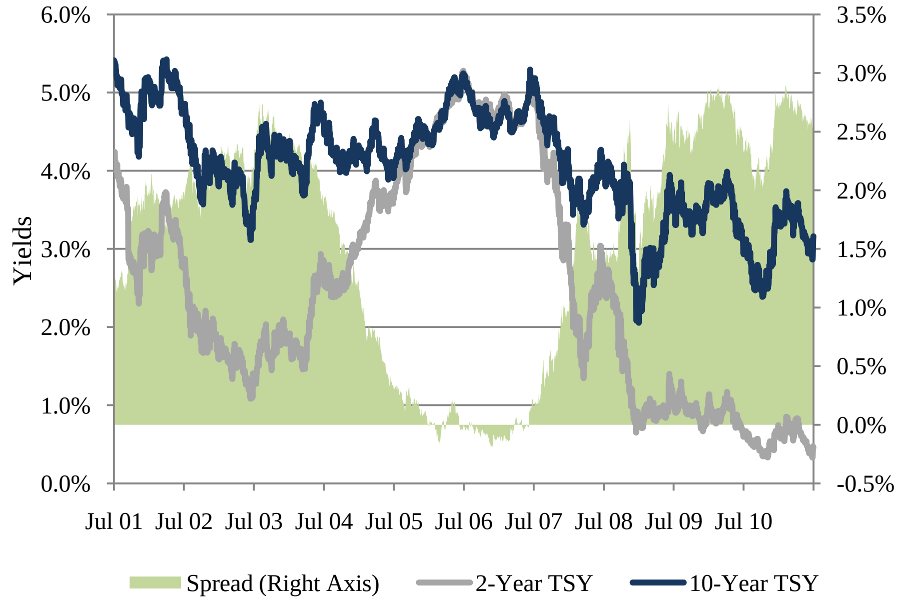
Source data: Bloomberg

The sharp decline in interest rates through the quarter is illustrated by performance of the 2-year Treasury note (following chart) which ranged from 0.83% to 0.33%.

2-Year U.S. Treasury Note Yield
July 1, 2010 through June 30, 2011

Source data: Bloomberg

U.S. Treasury Yields and Yield Curve Steepness
July 1, 2001 to June 30, 2011



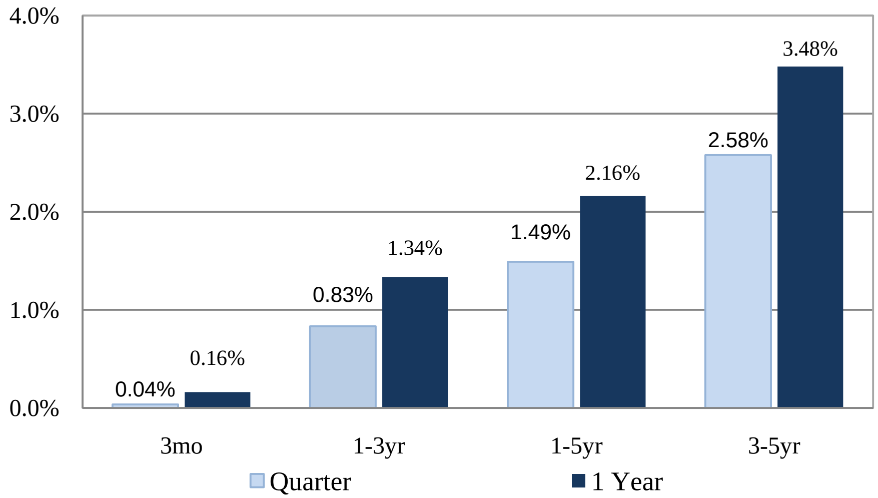
Source data: Bloomberg

Despite low absolute yields, the yield curve remained steep. As seen in the chart on the right, the steepness of the yield curve, measured by the spread between 2-year and 10-year U.S. Treasury notes, was approximately 2.70% by the end of the quarter, very close to its 10 year widest spread. Market observers generally view a steep yield curve as anticipating rising growth and inflation, but in this case factors such as the flight to quality and the trillions of dollars of excess cash created by the Fed have boosted demand for short maturities.

Since intermediate and long-term rates fell more than short-term rates, longer-duration strategies outperformed shorter-duration strategies as seen in the following chart. For example, the 3- to 5-year U.S. Treasury index returned 2.58% (10.71% annualized) for the quarter versus a return on the 1- to 3-year U.S. Treasury index of 0.83% (3.36% annualized).

In the current positively sloped yield curve environment, portfolios with less duration than their benchmarks may perform just as well as, if not better than, their benchmarks as securities approaching their maturity dates will “roll-down” the curve and be priced as shorter, lower-yielding securities, increasing their return.

. **Total Returns of Merrill Lynch U.S. Treasury Indices**
Quarterly and 12-Month Total Return as of June 30, 2011

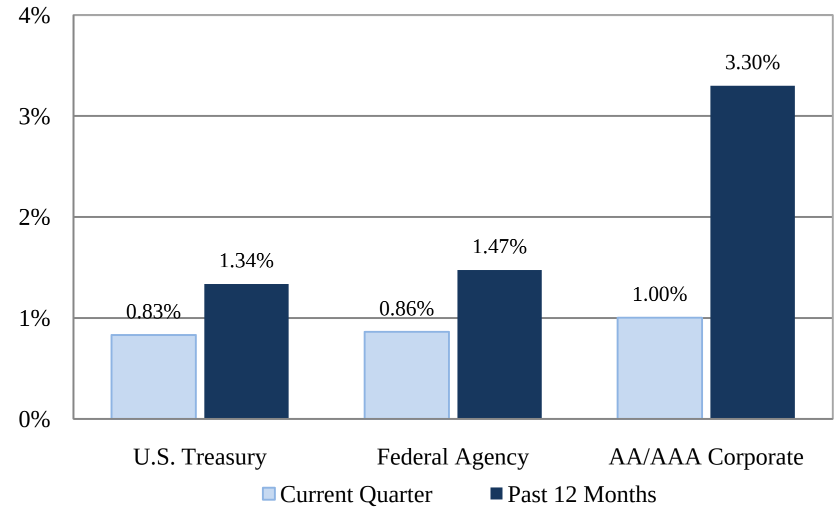


Source data: Bank of America Merrill Lynch; Bloomberg

Performance during the second quarter accounted for most of the return for the trailing 12 months. For example, the total return during the quarter represented more than 74% of the trailing 12-month return on the 3- to 5-year U.S. Treasury Index. Shorter-duration strategies continue to be limited by the extremely low Federal Funds rate and lag the performance of longer-duration strategies. So, for the 12 months ended June 30, 2011, the 3- to 5-year U.S. Treasury index returned 3.48% versus a return of 0.16% on the 3-month index, an outperformance of 332 basis points.

After several quarters of outperforming Treasuries, federal agency and corporate securities barely held their own in the second quarter. On a duration-adjusted basis, agencies and corporates returned 0.86% and 1.00% respectively, while Treasuries returned 0.83% as seen in the chart on the right. In these cases although credit spreads slightly widened, the additional income for agency and corporate securities was higher and offset the spread widening.

Duration Adjusted Returns of Merrill Lynch 1-3 Year Indices
Quarterly and 12-Month Total Return as of June 30, 2011



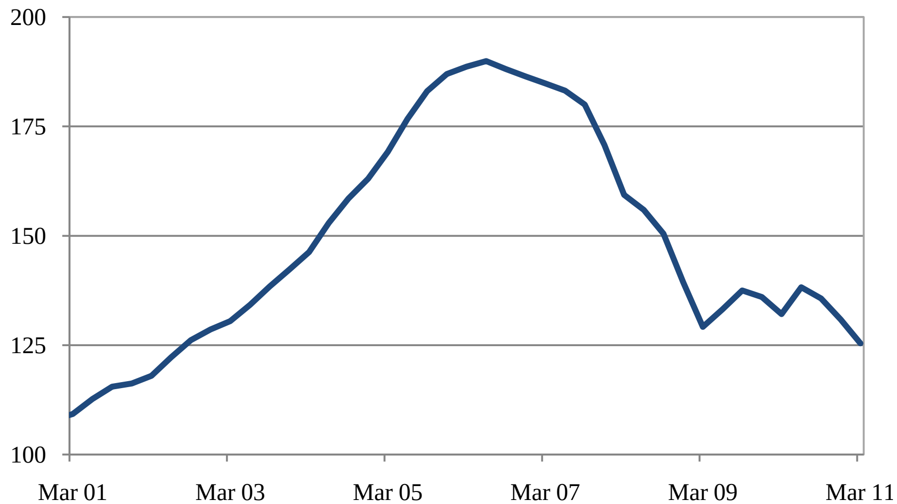
Source data: Bank of America Merrill Lynch; Bloomberg
Duration-adjusted return incorporates an adjustment to the market value return (but not the income return) of each benchmark to account for their varied durations, making it easier for investors to assess the relative risk and return of benchmarks of different lengths.

Economic Outlook

The temporary factors that slowed the economy in the second quarter should subside and lead to a rebound in the second half. However, Federal Reserve officials have lowered their growth forecasts for the second time this year from 3.1% to 3.3% in April to 2.7% to 2.9%. The Fed's latest forecast reflects the obstacles that continue to weigh on the domestic and global economies.

The lack of a rebound in the housing market in the United States is a big reason why the current recovery is stagnant. Banks have imposed tighter underwriting standards for home mortgages and uncertain job prospects have constrained the demand for housing. Meanwhile, with a large supply of vacant and foreclosed properties on the market, potential home buyers can strike deals, making new construction a more costly alternative. As shown on the following chart, the Case Shiller Home Price Index fell 4.2% over the first quarter to $125.41. Despite the support for sales seen in 2009 and 2010 due to the first-time home buyers' tax credit, there has been no recovery or stabilization in home prices. Home prices are down 5.1% compared to their level a year-ago and continue on their downward spiral with no relief in sight.

Case-Shiller Home Price Index
March 31, 2001 to March 31, 2011



Source data: Bloomberg

Another growth obstacle is the shrinking government sector. State and local governments are cutting spending and government employment is shrinking with a loss of 390,000 government jobs over the past three years. As the stimulus provided by the American Recovery and Reinvestment Act winds down there is a widening revenue gap for state and local government. Cutbacks in Federal spending--which seem inevitable--may in the long run reduce the Federal deficit and boost the private sector but in the short run they will further reduce economic activity and retard the recovery.

Despite these obstacles and the recent economic slowdown, the Federal Reserve believes the recovery is still underway. Though the pace is slower than desired, the Fed is wary of doing more to bolster growth and a third round of quantitative easing is unlikely.

Investment Strategy

Value is difficult to find in the fixed income markets because interest rates are at or near all-time lows, and the corporate and Federal agency sectors are not particularly attractive, as interest rate spreads have narrowed considerably from recent levels. A stagnant economy, the uncertainty surrounding the sovereign debt situation in both the United States and Europe and commodity-related pressure on global prices add to the challenge.

Our portfolio strategy is a defensive one: we are positioning portfolios somewhat short of benchmark durations with the expectation that the positively-sloped yield curve will reduce the effect of a sharp rise in interest rates, and the additional value gained by rolling down the curve will compensate for the shorter duration. We plan to take advantage of any widening in spreads to add incremental income by re-allocating assets into Federal Agency or high quality corporate obligations where policies permit, but we will carefully manage interest rate risk to minimize the effects of an inevitable rise in rates.

Portfolio Summary

Total Portfolio Value	June 30, 2011	March 31, 2011
Market Value	**$15,884,195.70**	$12,198,453.11
Amortized Cost	**$15,780,194.08**	$12,161,890.74

PORTFOLIO RECAP

- The portfolio complies with the California Government Code and the City's investment policy.
- Yields began the quarter near one-year highs, and then proceeded to fall for 11 straight weeks—the longest such streak in 27 years. By late June, 2-year Treasury note yields retested their all-time low of 0.33%. Yields spiked during the last week of the June, but still ended the quarter 30-50 basis points (0.30%-0.50%) lower for maturities between 2 and 10 years.
- Economic data weakened dramatically during the second quarter, including dismal reports on employment, housing and business activity. Many other indicators were weaker than forecast, including factory orders, auto sales and manufacturing purchasing manager surveys. The business disruption from the Japanese earthquake in March continued throughout the quarter, likely depressing GDP growth in the U.S. to just 2.0%. While the market impact due to unrest from the "Arab Spring" seems to have waned, the debt crisis in Greece took center stage. In June, Standard and Poor's lowered Greece's sovereign debt to a CCC rating, the lowest in the world. Prime Minister Papandreou's government won a vote of confidence (barely), and the Greek parliament passed a significant set of austerity measures. The turmoil sent global equity markets reeling and sovereign debt issues across Europe continue to be a major issue and are a source of much market volatility.
- The Federal Reserve reiterated its position to keep short-term rates in their current, near zero range. The Fed completed its $600 billion "QE2" Treasury purchase program by quarter end, but the liquidity created by those purchases has not yet flowed into creating economic activity. While economists do not expect a "QE3" program, the Fed indicated it plans to keep a high degree of monetary accommodation and will reinvest principal and interest payments from security holdings in its inflated balance sheet back into Treasury securities. Meanwhile, the deadline looms for resolving the debt ceiling issue in the U.S. It is very unclear what the final outcome will be and when it will be resolved.
- Early in the quarter, we maintained the portfolio duration slightly short of the benchmark duration. As the quarter progressed and yields plummeted, we allowed durations to drift shorter, ending the quarter on the conservative side around 75% of benchmark duration. Though our goal is to bring the portfolio duration more in line with the benchmark duration, we must weigh any maturity extensions against the possibility of market value-reducing interest rate hikes. As a result, the portfolio return will fall between the portfolio's performance-measuring benchmark (Merrill Lynch 1-3 Year Treasury Index), and the shorter Merrill Lynch 1-Year Treasury Note Index.
- At the beginning of the quarter, agency spreads were narrow, so the portfolio had more treasuries than normal. Treasuries generally performed well, appreciating from the "flight-to-quality" bid caused by the European debt crisis. Near quarter end, spreads began to widen, so we favored Treasuries over Agencies in some maturities. As we have for some time, we favored "bullet" maturities and avoided securities with early call features. In some cases, we also favored floating-rate securities, when their yields were favorable compared to shorter-term alternatives.
- **The portfolio continues to provide good long-term performance. Over the past year, when short-term rates have remained near 0%, the portfolio has an annualized total return of 1.34%.**

Portfolio Summary

PORTFOLIO STRATEGY

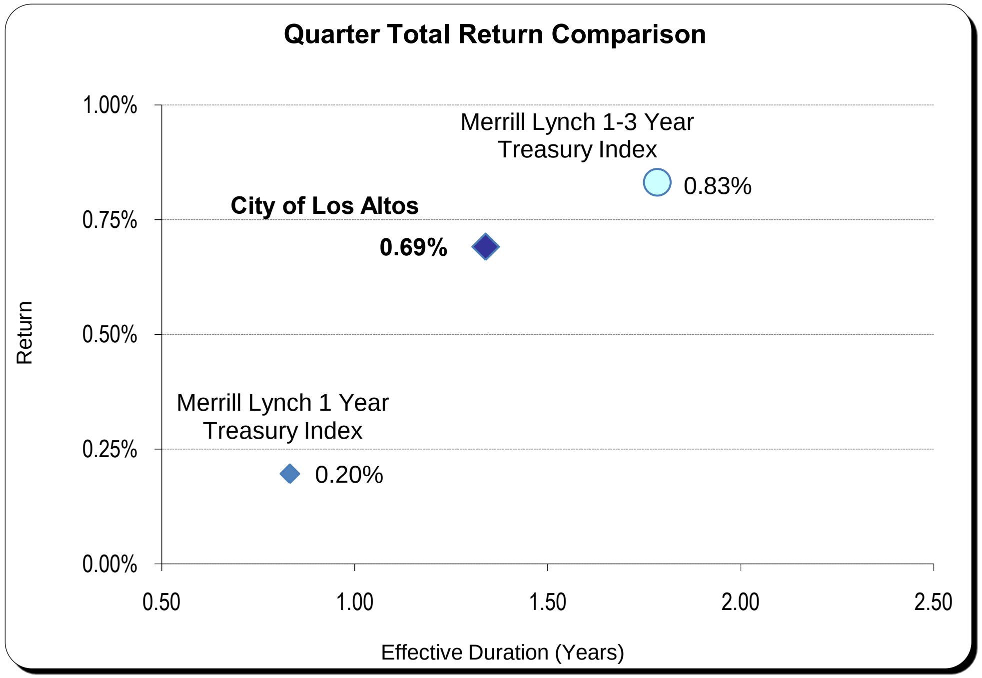
- Early in the third quarter, yields began to fall anew on news of a spreading debt crisis in Europe. While Greece was a relatively small player, the crisis has begun to implicate larger economies like Spain and Italy. The prospect for a resolution that does not involve a default or “haircut” for Greek bondholders remain uncertain. If the European crisis worsens, it could damage global economic growth.
- Economic indicators in the U.S. remain disappointing, especially the unemployment rate, which has risen back over 9%. With high unemployment, the Fed can only achieve this half of its dual mandate by keeping rates low for the next year or more. This will likely result in persistently low yields for the foreseeable future. Despite this expectation, the markets could still experience significant yield movements caused by changing economic dynamics, rising inflation expectations, or loss of confidence in U.S. debt. The U.S. must continue to issue large amounts of debt to fund its budget deficit, as even the most aggressive budget cutting proposals back load those measures into future years.
- As we have noted on occasion in the past, with 2-year Treasury note yields under 0.40%, they provide little current yield and very little protection against the negative market value impact of a potential rise in rates—just a 6 basis point yield increase will overwhelm the meager amount of interest earned over the course of the quarter.
- We began the third quarter on the conservative side, with portfolio durations around 85% of benchmark duration. With short-term rates near zero and rates in some intermediate maturities near record lows, we believe a conservative stance is warranted for now. Although the yield curve provides an incentive to invest “out the curve,” we remain cautious and will do so very selectively.
- Our strategy will continue to focus on maintaining the safety of the invested principal and achieving the City’s long-term investment objectives. We will maintain a safe, well-diversified, high quality portfolio and continue to evaluate all the sectors available to the City and to capitalize on investment opportunities presented by the market. Our strategy will likely emphasize Treasuries, non-callable federal agency securities, select high-quality corporates, and agency mortgage-backed securities, where permitted.

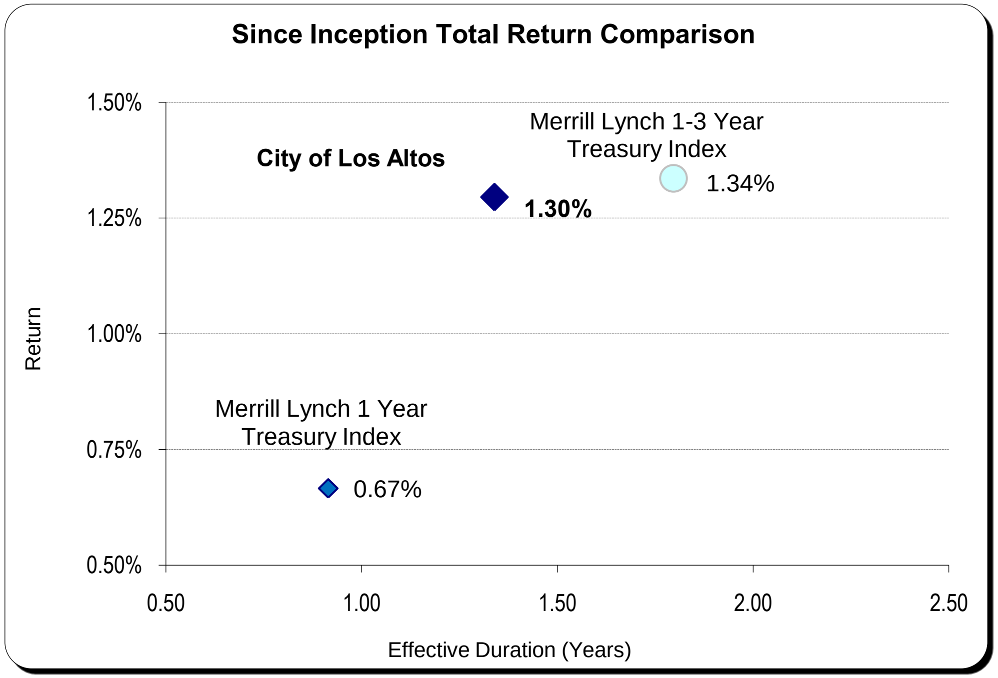
Portfolio Performance

Total Return[1,2,3,4]	Quarter Ended June 30, 2011	Past 12 Months	Since Inception
City of Los Altos	**0.69%**	**1.30%**	**1.30%**
Merrill Lynch 1-3 Year Treasury Index	0.83%	1.34%	1.34%
Merrill Lynch 1 Year Treasury Index	0.20%	0.67%	0.67%

Effective Duration[4]	June 30, 2011	March 31, 2011
City of Los Altos	**1.34**	**1.36**
Merrill Lynch 1-3 Year Treasury Index	1.80	1.78
Merrill Lynch 1 Year Treasury Index	0.92	0.83

Yields[4]	June 30, 2011	March 31, 2011
Yield on Cost	**1.00%**	1.00%
ML 1-3 Year Yield on Cost	**0.46%**	0.73%





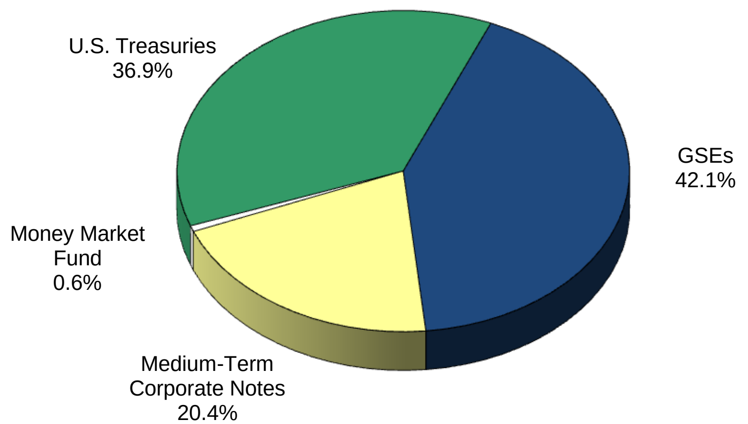
Notes:

1. Performance on trade date basis, gross (i.e., before fees), in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).
2. Merrill Lynch Indices provided by Bloomberg Financial Markets.
3. Quarterly returns are presented on an unannualized basis. Performance numbers for periods greater than 1 year are presented on an annualized basis.
4. Inception date is 6/30/2010

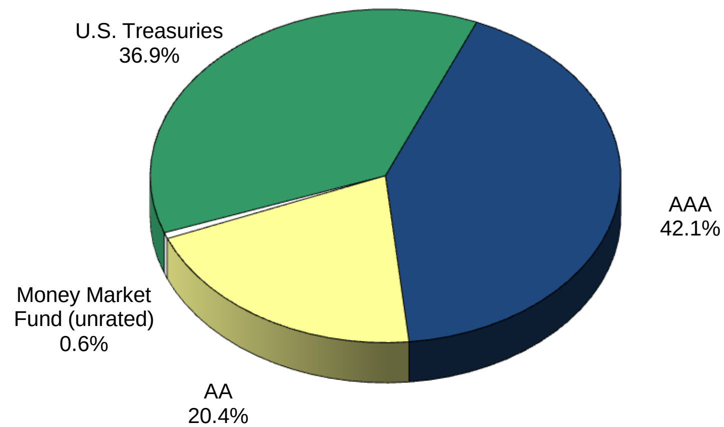
Portfolio Composition and Credit Quality Characteristics

Security Type[1]	June 30, 2011	% of Portfolio	March 31, 2011	% of Portfolio	Permitted by Policy
U.S. Treasuries	**$5,860,316.93**	**36.9%**	$2,836,261.41	23.3%	**100%**
Federal Agencies	**$6,681,717.46**	**42.1%**	$5,922,270.90	50.0%	**100%**
Medium-Term Corporate Notes	**$3,247,485.09**	**20.4%**	$3,301,135.59	27.1%	**30%**
Money Market Fund	**$94,676.22**	**0.6%**	$138,785.21	1.1%	**20%**
Totals	**$15,884,195.70**	**100.0%**	$12,198,453.11	100.0%	

Portfolio Composition



Credit Quality Distribution



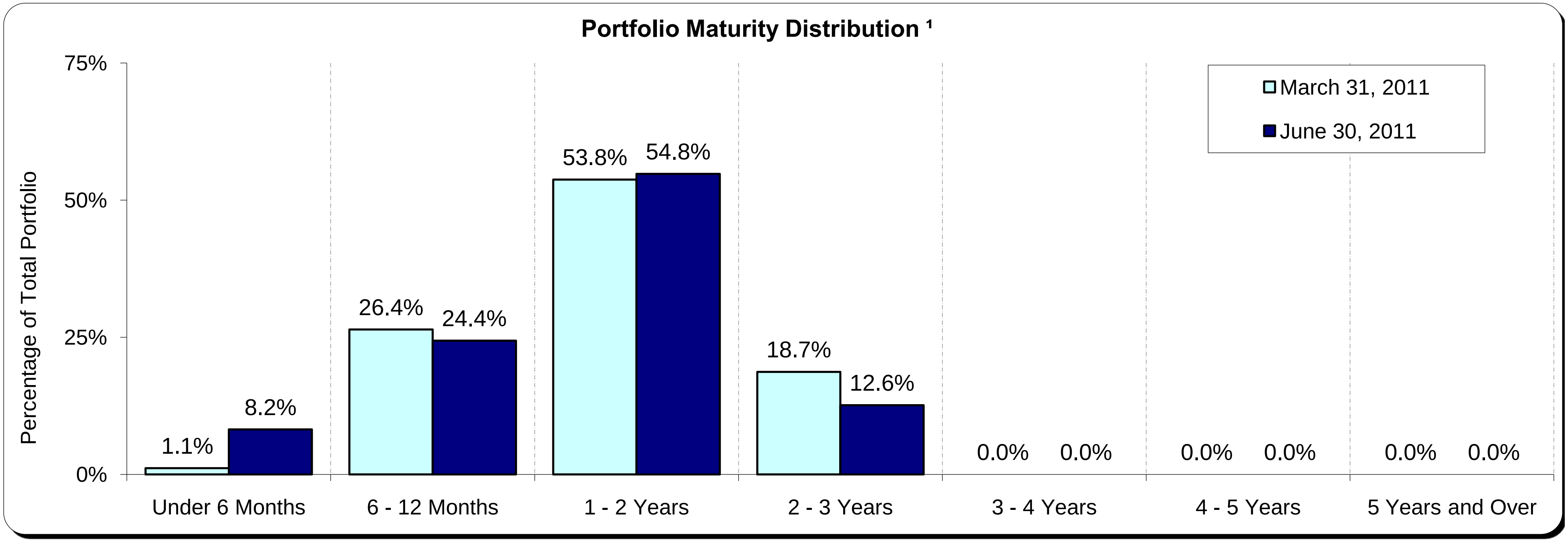
Standard & Poor's Ratings

Notes:

1. End of quarter trade-date market values of portfolio holdings, including accrued interest.
2. Government sponsored enterprises including, but not limited to Fannie Mae, Freddie Mac, Federal Home Loan Bank system and Federal Farm Credit Banks.
3. Debt guaranteed under the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program and backed by the full faith and credit of the United States.

Portfolio Maturity Distribution

Maturity Distribution[1]	June 30, 2011	March 31, 2011
Under 6 Months	**$1,299,691.42**	$138,785.21
6 - 12 Months	**$3,875,491.22**	$3,221,175.15
1 - 2 Years	**$8,703,205.44**	$6,557,210.13
2 - 3 Years	**$2,005,807.62**	$2,281,282.62
3 - 4 Years	**$0.00**	$0.00
4 - 5 Years	**$0.00**	$0.00
5 Years and Over	**$0.00**	$0.00
Totals	**$15,884,195.70**	$12,198,453.11



Notes:

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