DATE: September 11, 2012

AGENDA ITEM # 4

TO: City Council

FROM: Russell J. Morreale, Finance Director

SUBJECT: Investment Portfolio Report

RECOMMENDATION:

Accept the Investment Portfolio Report through June 30, 2012

SUMMARY:

Estimated Fiscal Impact:

Amount: None

Budgeted: Not applicable

Public Hearing Notice: Not applicable

Previous Council Consideration: April 24, 2012

CEQA Status: Not applicable

Attachments:

1. City-wide Holdings and Investment Ladder
2. Portfolio Mix Charts
3. Investment Policy Compliance Chart
4. Investment Performance Review Second Quarter 2012

BACKGROUND

This report presents the status of the City's investment portfolio through June 30, 2012. The reporting model has been developed in coordination with PFM Asset Management LLC (PFM) and provides reporting for the past two quarters through the end of fiscal year 2011/12 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 June 30, 2012 was $46,768,662. Including the Local Agency Investment Fund (LAIF), the portfolio carries investments in 2012 (75%), 2013 (14%), 2014 (9%) and 2015 (2%). Since the very first investment purchase in 2010, 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 and has made its first purchase into 2015. 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 and the market value of investments exceeds the par values of its holdings.

At June 30, 2012, 12% of the City's portfolio is placed in Federal Agency Securities (Fannie Mae, Federal Home Loan Bank, Federal Home Loan Mortgage and Federal Farm Credit), 17% in U.S. Treasuries, 5% in medium-term Corporate Notes, with the balance of 66% in liquid funds. Sixty-four percent of the total portfolio is in LAIF. 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 – Investment Performance Review Second Quarter 2012. It is important to note that this report highlights the performance of City investments that fall outside its liquid holdings with the LAIF. This has been intentionally crafted to isolate the performance of the City's independently-managed investments. Investment ratings are as listed with an important note that this report reflects the U.S. Treasury downgrade as announced by Standard & Poor's earlier this year.

Subsequent Period Activity of Note

The consensus of the Financial Commission is to target holdings in LAIF at 50% or lower in a paced manner. In the time period following this report, $3.8 million of maturing security investments were re-invested in 2014 and 2015 U.S. Treasuries and Agencies. An additional $4.3 million was invested similarly to further diversify holdings. These transactions will have the impact of extending duration, but still keep the investment duration relatively short as recommended by the Financial Commission and staff.

FISCAL IMPACT

None

PUBLIC CONTACT

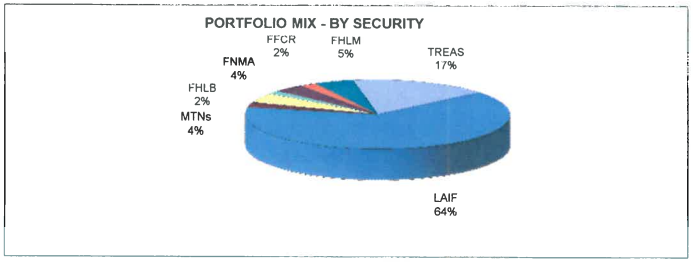
A review of the past two quarters of investment activity was presented at the July 19, 2012 Financial Commission meeting.

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

ATTACHMENT 1
City-wide Holdings and Investment Ladder
June 30, 2012 (Pre-Audit)

30-Jun-12

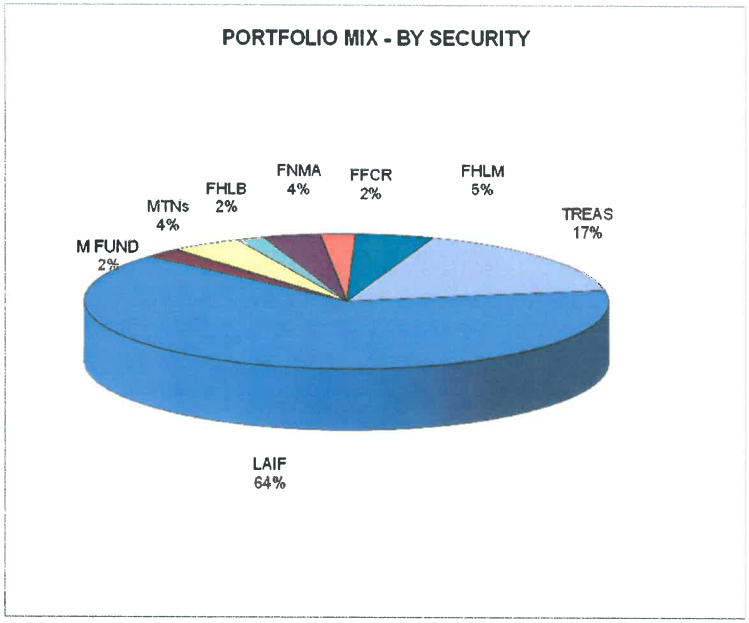
Month	2012 YTM	2012 Sec	2012 Call Date	2012 Amount	2013 YTM	2013 Sec	2013 Call Date	2013 Amount	2014 YTM	2014 Sec	2014 Call Date	2014 Amount	2015 YTM	2015 Sec	2015 Call Date	2015 Amount	
LAIF	0.36			30,014,088													
MMKT	0.02			1,104,574													
Jan	Matured				1/9/2013	0.65%	FHLMC	1,500,000									
Feb	Matured																
Mar					3/31/2013	0.81%	UT	500,000									Cash Surplus
Apr	Matured				4/1/2013	1.13%	CP BNY	650,000									
					4/15/2013	0.91%	CP WMRT	750,000									
May																	
Jun	Matured				6/26/2013	0.78%	FNMA	750,000									
					6/15/2013	0.94%	UT	500,000									
Jul	7/15/2012	1.01%	UT	800,000											7/2/2015	0.61%	FNMA	900,000	Period of Cash Deficiency
Aug	8/15/2012	1.09%	UT	800,000													
Sep					9/15/2013	1.06%	UT	500,000									
Oct	10/19/2012	1.19%	CP GE	650,000	10/15/2013	1.10%	UT	750,000	10/15/2014	0.49%	UT	1,700,000					
Nov	11/21/2012	1.42%	FHLB	800,000					11/1/2014	0.67%	FFCB	1,000,000					
Dec	12/28/2012	0.71%	FHLMC	750,000	12/15/2013	1.19%	UT	750,000	12/31/2014	0.53%	UT	1,600,000					Cash Surplus
Total				$3,800,000				$6,650,000				$4,300,000				$900,000	
Count/Percent	5		0	24.28%	9		0	42.49%	3		0	27.48%	1		0	5.75%	
Avg YTM/Days	1.08%			99	0.95%			354	0.56%			868	0.61%			1,097	
Total Face Value								$ 10,450,000				$ 14,750,000				$ 15,650,000	



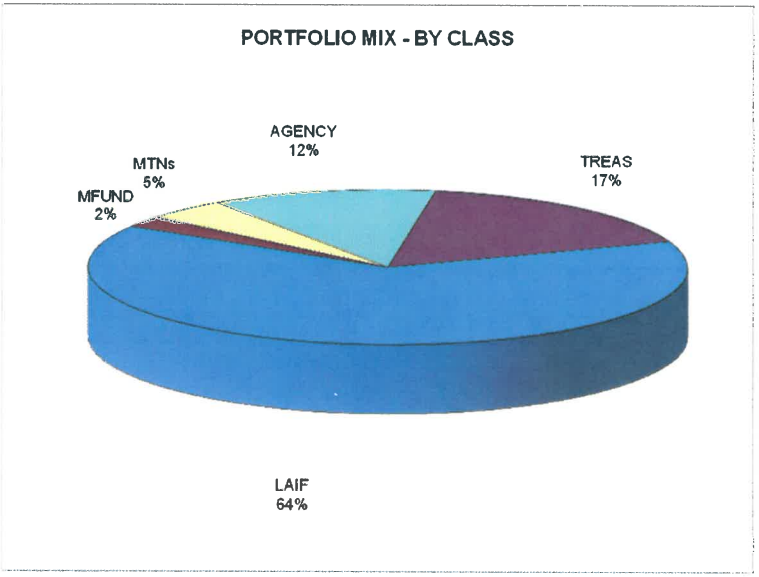
		No of Inv	Ladder Yield	Spread Over LAIF	%	Avg Mat	# of Callables	Face Value
LAIF		1	0.360%	0.000%	64%	0		30,014,088
$ Mkt Fund		0	0.020%	-0.340%	2%	0		1,104,574
2010		0	0.000%		0%	0	0	0
2011		0	0.000%		0%	0	0	0
2012		5	1.084%	0.724%	8%	8	0	3,800,000
2013		9	0.952%	0.592%	14%	50	0	6,650,000
2014		3	0.563%	0.203%	9%	80	0	4,300,000
2015		1	0.610%	0.250%	2%	21	0	900,000
		19	0.52%	0.44%	100%	159	0	$46,768,662
							0%	

ATTACHMENT 2
Portfolio Mix Charts
June 30, 2012 (Pre-Audit)

		Face Value	Callables
LAIF	64.2%	30,014,088	
M FUND	2.4%	1,104,574	
MTNs	4.4%	2,050,000	
FHLB	1.7%	800,000	
FNMA	3.5%	1,650,000	
FFCR	2.1%	1,000,000	
FHLM	4.8%	2,250,000	
TREAS	16.9%	7,900,000	
	100%	46,768,662	-
Callables			0%



		Face Value	Mkt Value
LAIF	64%	30,014,088	
MFUND	2%	1,104,574	
MTNs	4%	2,050,000	
AGENCY	12%	5,700,000	
TREAS	17%	7,900,000	
	100%	46,768,662	
MTNs		2,050,000	2,101,376
TREAS		7,900,000	8,013,440
AGENCY		5,700,000	5,726,767
		15,650,000	15,841,583



ATTACHMENT 3
Investment Policy Compliance Chart
June 30, 2012 (Pre-Audit)

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	64%		30,014,088	04/29/10	50,000,000	100%	19,985,912	Yes	Yes	Yes
M FUND	2%		1,104,574	08/03/12						
MTNs	4%		2,050,000	01/00/00		15%	4,965,299	Yes	Yes	Yes
FHLB	2%		800,000	10/29/12		20%	8,553,732	Yes	Yes	Yes
FNMA	4%		1,650,000	04/05/12		20%	7,703,732	Yes	Yes	Yes
FFCR	2%		1,000,000	01/00/00		20%	8,353,732	Yes	Yes	Yes
FHLM	5%		2,250,000	12/05/11		20%	7,103,732	Yes	Yes	Yes
All Agencies		12%				100%		Yes	Yes	
TREAS	17%		7,900,000	08/05/12		100%	38,868,662	Yes	Yes	Yes
	100%		**46,768,662**							

All Agencies		12%	5,700,000			100%	41,068,662		Yes	
Callables		0%	0			35%	16,369,032		Yes	

ATTACHMENT 4

City of Los Altos

Investment Performance Review
Second Quarter 2012

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

Summary

- During the second quarter, investors searched for a safe place to hide amid weaker economic data and the ongoing European sovereign debt crisis. European efforts to stem contagion from its ongoing debt crisis resulted in higher volatility for European markets.
- U.S. economic data showed mixed results. While the labor market and the manufacturing sector looked weaker, the housing market showed signs of a rebound.
- PFM Asset Management LLC (PFMAM) believes the domestic economy will continue to expand, albeit at a slower pace, and aims to take advantage of the more volatile market environment by finding compelling yet undervalued investment opportunities.

Economic News

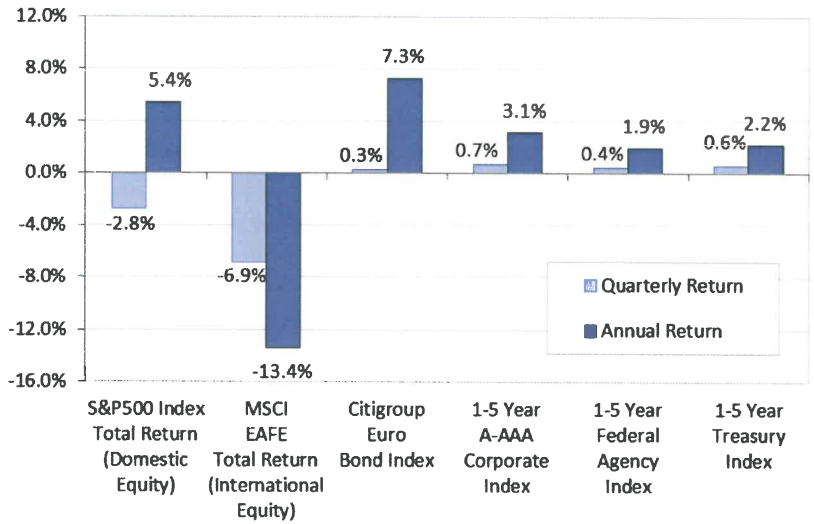
Economic data was weaker across the globe. Gross domestic product (GDP) in the U.S. for the first quarter of 2012 was 1.9%, compared to 3.0% for the fourth quarter of 2011. At the same time, the European economic picture worsened, as Spain fell into its second recession since 2009 and the European debt crisis continued to pose challenges. Emerging-markets economies also experienced slower growth, as China had its slowest pace of economic growth since 2009 and India reported first-quarter growth of 5.3% compared to a 6.1% rate of growth for the previous quarter. In response, central banks have kept accommodative policies in place and, in some cases, added further support to their economies.

U.S. job market conditions deteriorated during the quarter, as the unemployment rate had its first increase since June 2011, rising to 8.2% in May from 8.1% in April. However, the housing market has shown some improvements during the quarter. New-home sales in May exceeded economists' expectations, reaching their highest level since April 2010, and the S&P/Case-Shiller Index reported a third consecutive month of price gains for single-family homes.

Oil and other commodity prices fell for most of the quarter due to reports of slower growth in the global economy. However, they rebounded sharply at the end of June, with the S&P GSCI Index rising the most in three years when the European Union announced it would increase its aid to struggling member nations. The S&P 500 Index rallied on this positive news as well, after losing ground in the first two months of the quarter.

Total Returns of Various Asset Classes

Quarter ended June 30, 2012



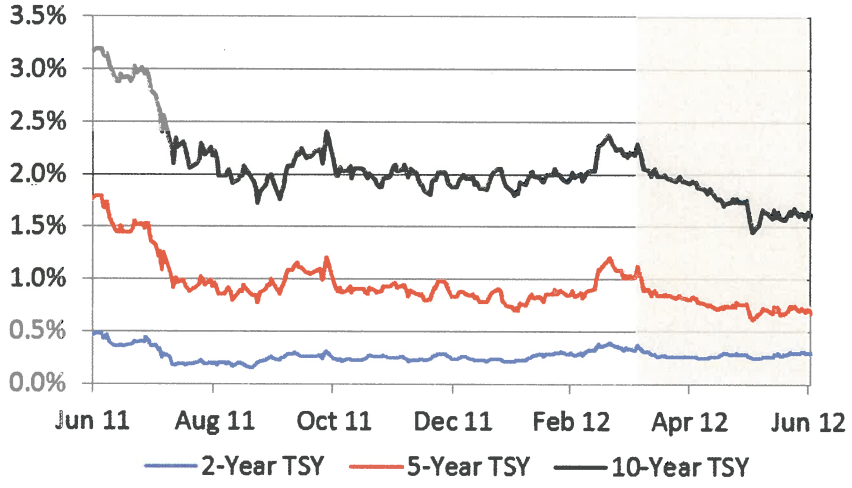
Sources: Bank of America Merrill Lynch, Citigroup, Bloomberg

Interest Rates

U.S. interest rates declined across the yield curve. Slowing growth, a decline in inflation, and a flight to quality all fed the decline. The Federal Reserve (the "Fed") maintained its commitment to keeping interest rates at low levels until at least late 2014, and the federal funds rate stayed within a band from zero to 0.25%. The central bank also stated that it would extend its program of buying longer-dated Treasuries while selling short-dated Treasuries, also known as "Operation Twist," until the end of the year. The Fed lowered its forecasts for domestic economic growth, while at the same time increasing its forecasts for unemployment.

2-Year, 5-Year, and 10-Year U.S. Treasury Note Yields

June 30, 2011 through June 30, 2012



Source: Bloomberg

Thirty-year mortgage rates fell to new lows, which drove some of the positive developments in the housing market. As shown in the charts on the following page, longer-dated Treasuries performed well for the quarter and 12-month period. Corporate bonds outperformed Treasuries and Agencies on a duration-adjusted basis for the quarter and 12-month period, and Treasuries beat Agencies for the quarter but not for the 12-month period. Agencies and corporate bonds had a difficult time during the month of May as the markets dealt with the uncertainties surrounding the European debt crisis; however, both sectors improved markedly in June as a result of Europe's new commitments to resolving its debt crisis.

Five- and ten-year Treasury yields dropped to record lows after the employment report was released on June 1, and then increased slightly during the month. Agency spreads remained mostly unchanged from May to June, and outperformed Treasuries in June due to their relatively higher yields. With Agency and corporate spreads narrowing, PFMAM believes that municipal and Agency mortgage-backed securities provide good value with acceptable levels of risk.

U.S. Treasury Yields – Quarter and Year-over-Year Changes

Date	3-month	1-year	2-year	5-year	10-year	30-year
30-Jun-12	0.08%	0.21%	0.30%	0.72%	1.65%	2.75%
31-Mar-12	0.07%	0.17%	0.33%	1.04%	2.21%	3.34%
Change over Quarter	0.02%	0.04%	-0.03%	-0.32%	-0.57%	-0.58%
30-Jun-11	0.02%	0.19%	0.46%	1.76%	3.16%	4.37%
Change over Year	0.07%	0.02%	-0.16%	-1.04%	-1.52%	-1.62%

Source data: Bloomberg

PFMAM Outlook

We believe that the domestic economy will continue to grow, despite weaker reports on the jobs market. Shorter-term rates are range-bound, while longer-term yields are declining, resulting in a flatter yield curve. Currently, we do not believe that rates will head substantially higher, as the Fed is maintaining a loose monetary policy and inflation remains within the Fed's mandate of 2% for core personal consumption expenditures.

Lower oil prices may currently provide some relief to U.S. consumers. On the other hand, the gloomy employment picture is still weighing on consumer spending, as is higher core inflation.

The extension of "Operation Twist" announced by the Fed in June should place continued downward pressure on intermediate-term Treasury yields, as the Fed will buy up to $267 billion in securities over the coming months. The action should support rates for Treasuries with maturities of two years and under, as the Fed offsets its purchases by selling short-dated Treasuries.

Short-term yields have stayed within a narrow range for the quarter. There are also fewer opportunities for investment in the money market sector, as Fannie Mae and Freddie Mac reduce their short-term debt issuance. Agency and corporate spreads have been volatile and reactive to risk-on/risk-off psychology in the market, which creates opportunities for active management strategies to add value.

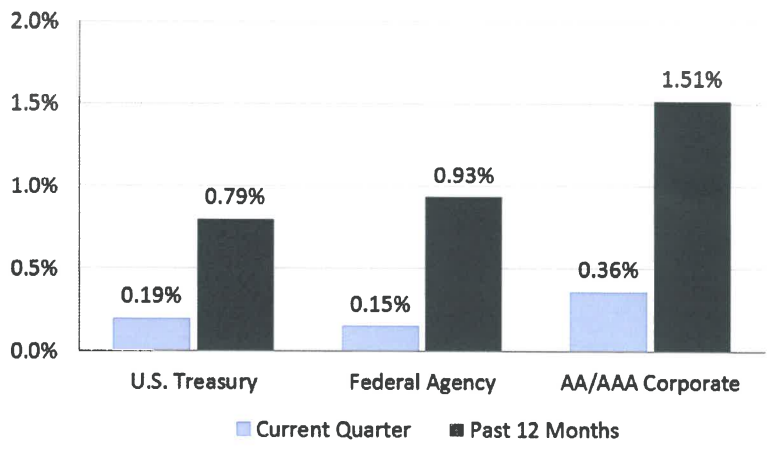
Returns for 2-Year, 5-Year, and 10-Year Treasuries

Quarter ended June 30, 2012

Source: Bloomberg, using Bank of America Merrill Lynch indexes.

Duration-Adjusted Returns for Fixed-Income Securities

Quarter ended June 30, 2012



Source: Bloomberg, using Bank of America Merrill Lynch 1-3 year indexes.

The views expressed within this material constitute the perspective and judgment of PFM Asset Management LLC (PFMAM) at the time of distribution and are subject to change. Information is obtained from sources generally believed to be reliable and available to the public; however, PFMAM cannot guarantee its accuracy, completeness or suitability. This material is for general information purposes only and is not intended to provide specific advice or recommendation. The information contained in this report is not an offer to purchase or sell any securities.

Portfolio Summary

Total Portfolio Value	June 30, 2012
Market Value	**$47,009,989.98**
Amortized Cost	**$46,941,660.46**

PORTFOLIO RECAP

- The portfolio complies with the California Government Code and the City's investment policy. The portfolio is diversified among U.S. Treasury, Federal Agency, and high-quality corporate securities.
- The pace of economic activity in the U.S. slowed further in the second quarter, kicking off a strong rally in the Treasury market. Weaker than expected economic data, the continuation of the Fed's "Operation Twist" program, and a flight-to-quality caused by worsening turmoil in the Euro-Zone pushed long-term yields sharply lower.
- After starting the quarter at a yield of 2.21%, the 10-year Treasury fell 76 basis points (0.76%), hitting an all-time low of 1.45% in early June. At that point, investors decided that getting just 145 pennies of interest each year for every $100 lent to the U.S. government was perhaps a bad deal, and rates moved modestly higher through June.
- In contrast to long-term maturities, 2-year Treasury yields stayed within a narrow range of 0.24% to 0.37% as the Federal Reserve's near-zero interest rate policy anchored the front end of the yield curve.
- The turmoil in Europe triggered a shift from the first quarter's "risk on" trade, which strongly favored agencies, corporate bonds and riskier asset classes, to the second quarter's "risk off" trade, which favored Treasuries in April and May. Widening yield spreads created good investment opportunities, though, as market psychology reversed again in June. The quarter ended with a solid rally in spread product, benefitting portfolios with allocations to agency and corporate debt.
- Our allocations to Treasuries, benefitted the portfolio early in the quarter as spreads widened and Treasuries outperformed. Mid-quarter, we gradually shifted our emphasis and began favoring agencies, which benefitted the portfolio again as spreads reversed and ended the quarter at narrow levels.
- After a very strong Q1, corporate yield spreads widened sharply early in Q2. As a result of their higher yields and a partial recovery in spreads in June, A-rated and AA-rated issues ultimately performed well for the quarter. Careful issuer selection remained critical to prudent risk management as many issuers suffered downgrades, in some cases up to 3 rating notches, resulting from Moody's sweeping reassessment of bank ratings.

Portfolio Summary

PORTFOLIO STRATEGY

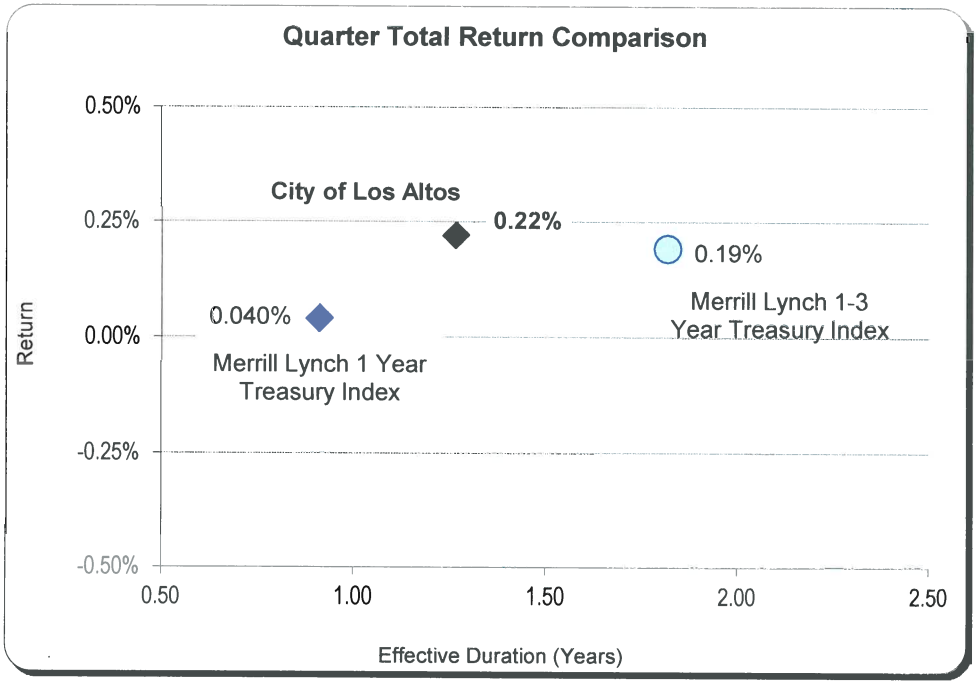
- The Euro-Zone debt crisis and decelerating growth across the globe will continue to drive the financial markets. Central banks around the world remain accommodative. Additional intervention by the ECB, and perhaps by the U.S. Federal Reserve as well, is likely if conditions weaken. Investments based in U.S. dollars and other non-Euro currencies are perceived as safe-havens, despite their very low yields.
- Another factor driving the U.S. bond market is the prognosis for weaker domestic growth. The U.S. economy will likely muddle through a slow period, but avoid a double dip recession. Consumer spending is expanding, energy costs have fallen, and borrowing costs at record lows have eased debt service burdens. With so much bad news priced into the markets, things could turn out better than expected, which would drive equity prices higher and corporate bond spreads narrower.
- A growth surprise in the U.S. could also kick-start a back-up in yields, but that risk is concentrated in longer maturities. With the Federal Reserve on hold through at least late 2014, shorter-term investments will likely remain range-bound near current levels.
- We currently favor extending maturities into the intermediate (2-4 year) range. We also plan to keep portfolio durations near their benchmark targets as we begin the new quarter, using any bouts of market weakness to time monthly extensions advantageously.
- Agency-Treasury spreads are narrow, so we favor Treasuries in most shorter maturities. Callable agencies continue to underperform and will generally be avoided.
- We remain constructive on corporates, as the combination of strong balance sheets and higher income create an adequate buffer against any turbulence due to headline risk. In shorter maturities, carefully selected commercial paper and CDs also offer good value versus government securities.
- As always, we strive to maintain safety of principal, while seeking opportunities to add value through active management. Our strategy will remain flexible and may change in response to changes in interest rates, economic data, market outlook or specific opportunities that arise.

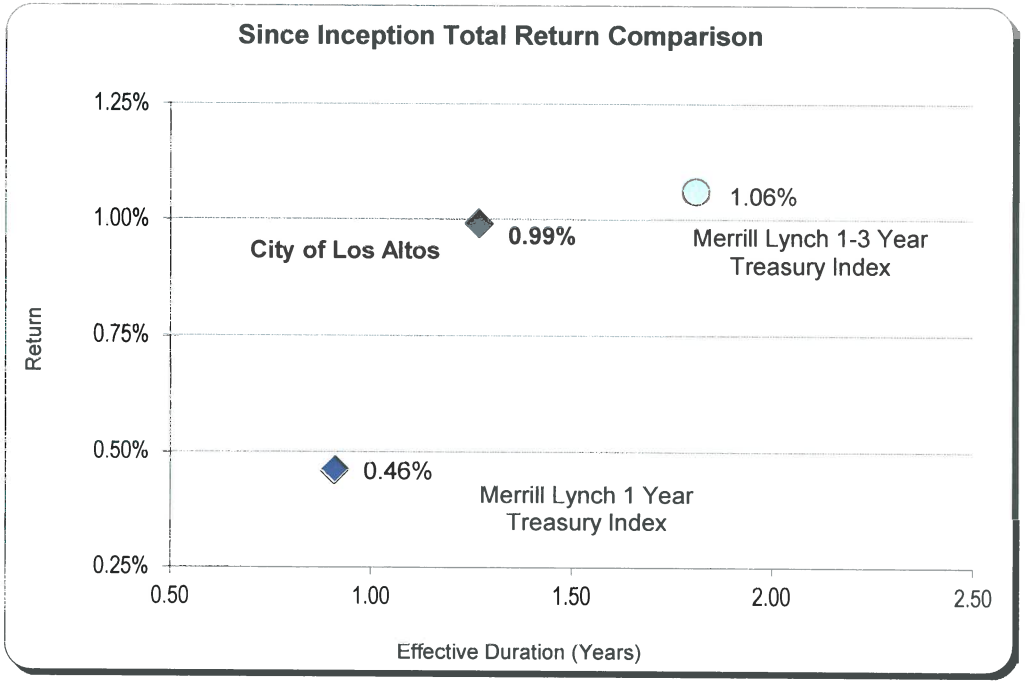
Portfolio Performance

Total Return[1,2,3,4]	Quarter Ended June 30, 2012	Past 12 Months	Since Inception
City of Los Altos	**0.22%**	**0.69%**	**0.99%**
Merrill Lynch 1-3 Year Treasury Index	0.19%	0.79%	1.06%
Merrill Lynch 1 Year Treasury Index	0.04%	0.26%	0.46%

Effective Duration[4]	June 30, 2012	March 31, 2012
City of Los Altos	**1.27**	**0.53**
Merrill Lynch 1-3 Year Treasury Index	1.81	1.82
Merrill Lynch 1 Year Treasury Index	0.91	0.91

Yields[4]	June 30, 2012	March 31, 2012
Yield on Cost	**0.84%**	0.89%
ML 1-3 Year Yield on Cost	**0.26%**	0.23%





Notes:

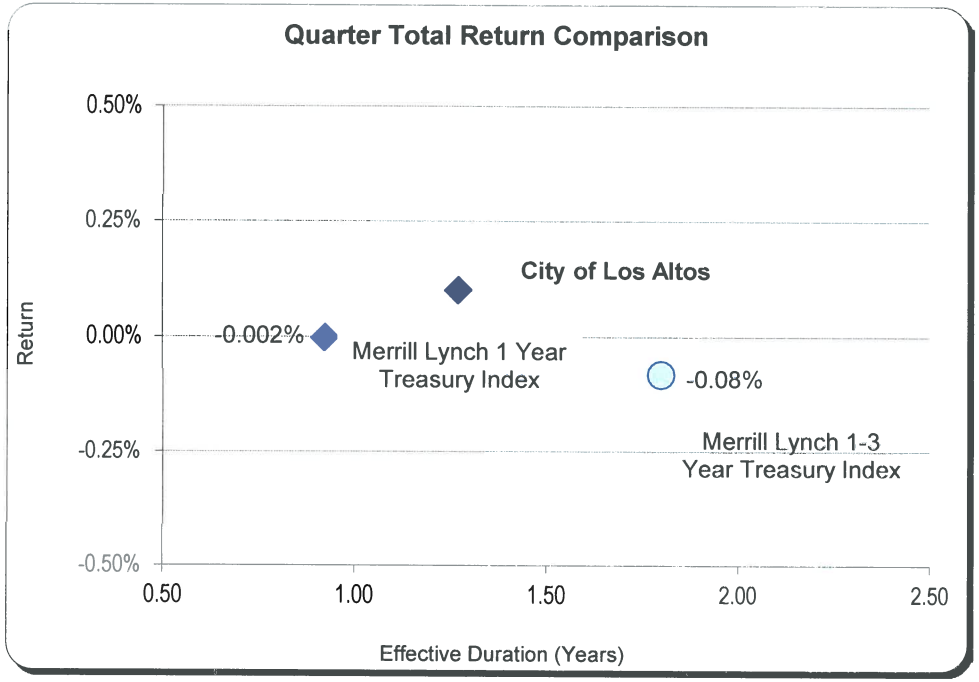
1. Performance on trade date basis, gross (i.e., before fees), in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).
2. Merrill Lynch Indices provided by Bloomberg Financial Markets.
3. Quarterly returns are presented on an unannualized basis. Performance numbers for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

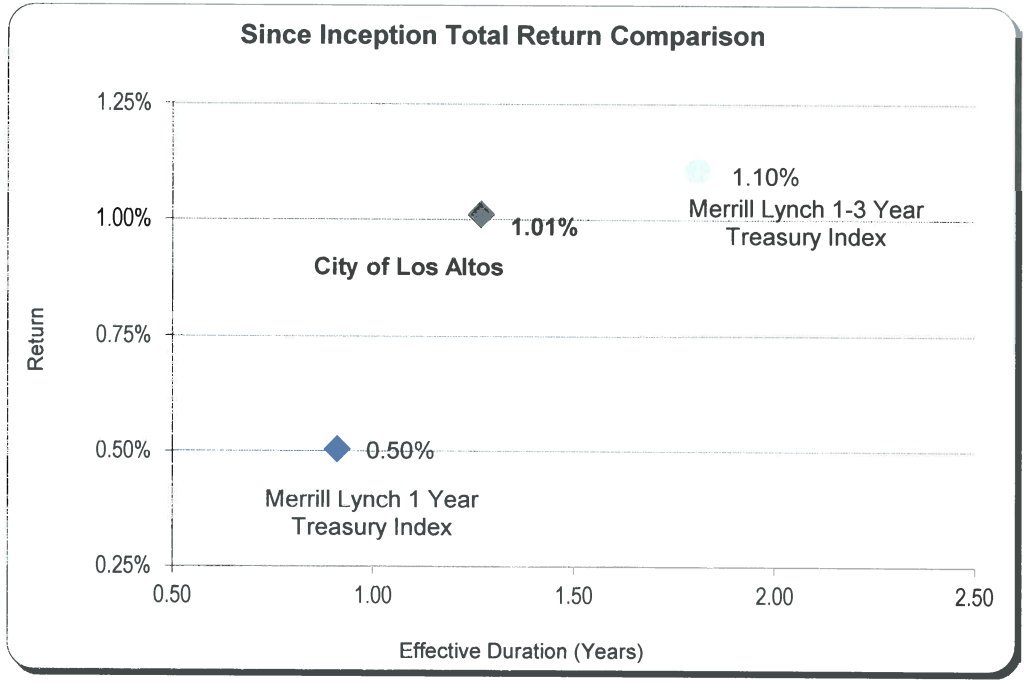
Portfolio Performance

Total Return[1,2,3,4]	Quarter Ended March 31, 2012	Past 12 Months	Since Inception
City of Los Altos	**0.10%**	**1.17%**	**1.01%**
Merrill Lynch 1-3 Year Treasury Index	-0.08%	1.44%	1.10%
Merrill Lynch 1 Year Treasury Index	-0.002%	0.41%	0.50%

Effective Duration[4]	March 31, 2012	December 31, 2011
City of Los Altos	**1.27**	**1.04**
Merrill Lynch 1-3 Year Treasury Index	1.81	1.80
Merrill Lynch 1 Year Treasury Index	0.91	0.92

Yields[4]	March 31, 2012	December 31, 2011
Yield on Cost	**0.89%**	0.98%
ML 1-3 Year Yield on Cost	**0.23%**	0.15%





Notes:

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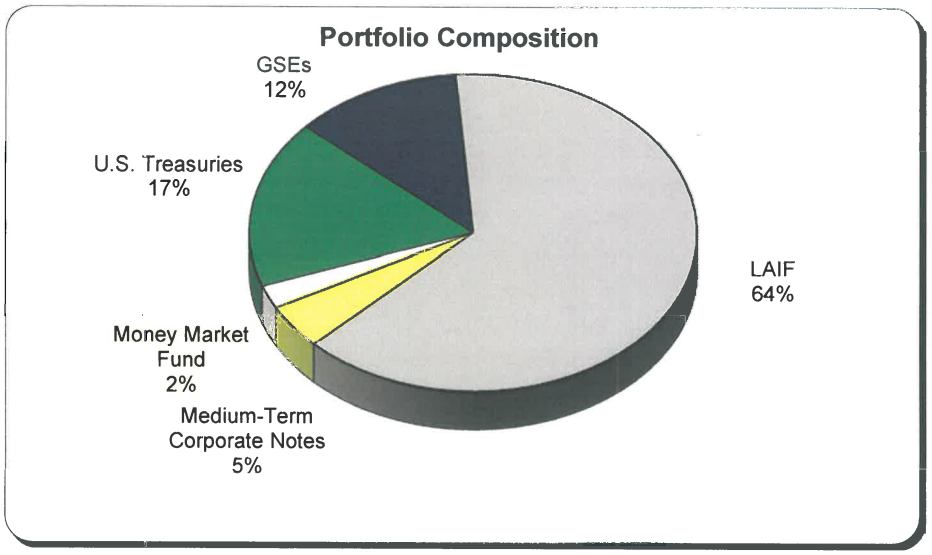
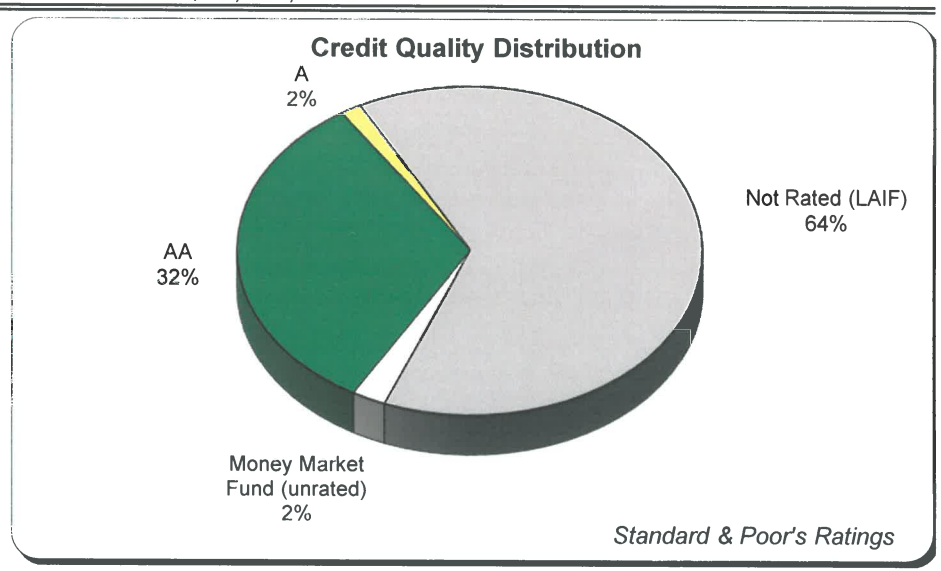
4. Inception date is 6/30/2010

Portfolio Composition and Credit Quality Characteristics

Security Type[1]	June 30, 2012	% of Portfolio	March 31, 2012	% of Portfolio	Permitted by Policy
U.S. Treasuries	$8,029,473.81	17%	$8,044,841.40	19.9%	100%
Federal Agencies	$5,739,610.70	12%	$5,651,347.18	15.5%	100%
LAIF	$30,014,088.00	64%	$23,541,762.21	58.1%	100%
Medium-Term Corporate Notes	$2,122,243.47	5%	$3,193,491.59	7.9%	30%
Money Market Fund	$1,104,574.00	2%	$69,728.83	0.2%	20%
Totals	$47,009,989.98	100%	$40,501,171.21	100.0%	





Notes:

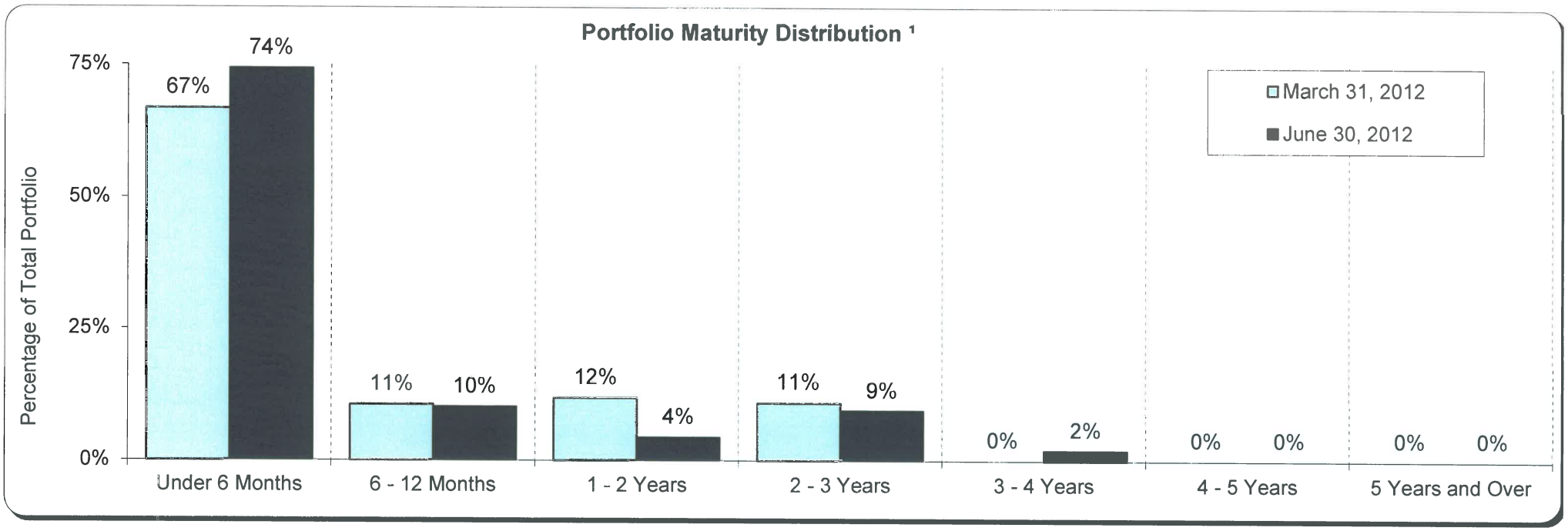
1. End of quarter trade-date market values of portfolio holdings, including accrued interest.

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, 2012	March 31, 2012
Under 6 Months	**$34,954,923.89**	$27,056,227.73
6 - 12 Months	**$4,741,799.81**	$4,267,787.50
1 - 2 Years	**$2,011,851.62**	$4,769,016.14
2 - 3 Years	**$4,402,027.06**	$4,408,139.84
3 - 4 Years	**$899,387.60**	$0.00
4 - 5 Years	**$0.00**	$0.00
5 Years and Over	**$0.00**	$0.00
Totals	**$47,009,989.98**	$40,501,171.21



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.