

**TO:** Financial Commission  
**FROM:** Russell J. Morreale, Staff Liaison  
**SUBJECT:** Investment Portfolio

**RECOMMENDATION:**

Overview of the City Council report of January 14, 2014

---

**BACKGROUND**

City council is updated on a quarterly basis of the performance of the City's investment portfolio. The latest report to Council is attached.

**DISCUSSION**

The Investment Portfolio report through September 30, 2013 was presented to City Council the night of January 14, 2014 and is attached. The portfolio for the subject quarter was reviewed by the Financial Commission prior to Council delivery and is being presented at this meeting as an introductory and informational item on this agenda. It will support related items on tonight's agenda on the topic of investments.

**Attachments:**

- A. Investment Portfolio Report to City Council - January 14, 2014

Attachment A

Investment Portfolio Report to City Council - January 14, 2014



DATE: January 14, 2014

AGENDA ITEM # 6

**TO:** City Council  
**FROM:** Russell J. Morreale, Finance Director  
**SUBJECT:** Investment Portfolio Report

**RECOMMENDATION:**

Receive the Investment Portfolio Report as of September 30, 2013

---

**SUMMARY:**

**Estimated Fiscal Impact:**

**Amount:** None

**Budgeted:** Not applicable

**Public Hearing Notice:** Not applicable

**Previous Council Consideration:** September 10, 2013

**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 Third Quarter 2013

## **BACKGROUND**

This report presents the status of the City's investment portfolio up through September 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 September 30, 2013 was \$49,473,596. Including the Local Agency Investment Fund (LAIF), the portfolio carries investments in 2013 (60%), 2014 (9%), 2015 (19%), and 2016 (12%). The portfolio is currently invested through the 2016 term with an average maturity of approximately 280 days. 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 closet to the City's yield benchmark. The portfolio has experienced no principal losses and the market value of holdings exceeds face values. In that context, recent jumps in yield rates have created a positive trend for investing going forward. Inception-to-date earnings fall slightly below investment goals and far exceed LAIF liquid rates.

The City's portfolio is placed 24% in Federal Agency Securities (Fannie Mae, Federal Home Loan Bank, Federal Home Loan Mortgage and Federal Farm Credit), 15% in U.S. Treasuries, 3% in medium-term Corporate Notes, and 58% in liquid funds. Fifty-seven percent (57%) is placed in the State Local Agency Investment Fund (LAIF) as opposed to 60% in the prior period of reporting given investment activity. 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 Third Quarter 2013. 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 remains as stated in prior reports - to target holdings in LAIF at 50% or lower, but to do so in a paced manner. Recent changes in market valuations have presented improving yields on the longer-side of the curve presenting some investment opportunities to consider. In the time period following this

report, over \$3M of maturing security investments and new investments were executed within the 2016 term of duration. These transactions 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**

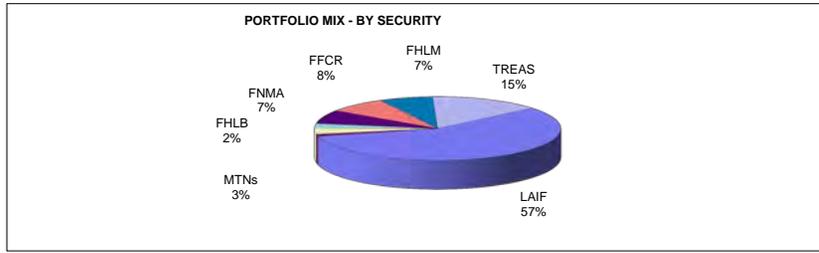
A review of this period's investment activity was presented at the November 18, 2013 Financial Commission meeting.

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

Attachments 1  
Citywide Holdings and Investment Ladder  
September 30, 2013

30-Sep-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	0.26%			28,281,301													
MMKT	0.01%			542,295													
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	
Apr																	
May													4/11/2016	0.52%	Wmart	800,000	
Jun													5/13/2016	0.41%	FHLMC	500,000	
													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						
Aug								8/7/2015	0.51%	FNMA	1,150,000						
Sep																	
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					
								12/28/2015	0.41%	FFCB	1,250,000						
<b>Total</b>				<b>\$1,500,000</b>				<b>\$4,300,000</b>				<b>\$9,050,000</b>				<b>\$5,800,000</b>	
Count/Percent	2			0	10.10%			3	28.96%			9	60.94%			1	39.06%
Avg YTM/Days		1.15%		46		0.56%		414		0.50%		720		0.56%		947	
<b>Total Face Value</b>				<b>\$ 1,500,000</b>				<b>\$ 5,800,000</b>				<b>\$ 14,850,000</b>				<b>\$ 20,650,000</b>	

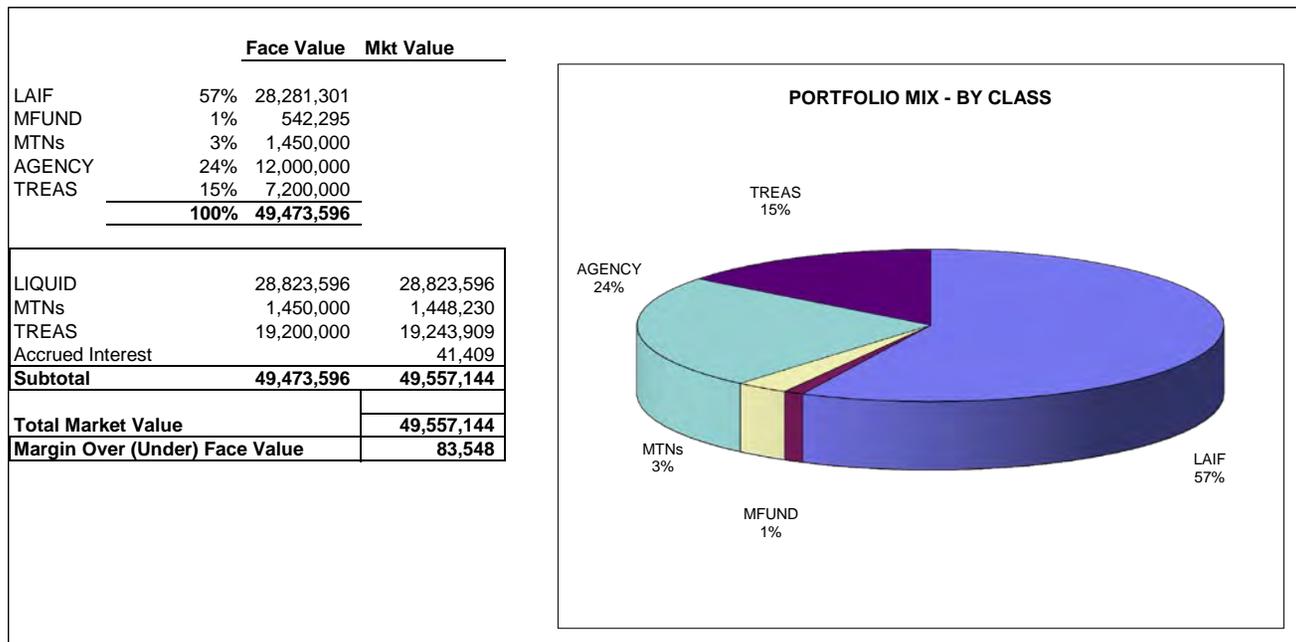
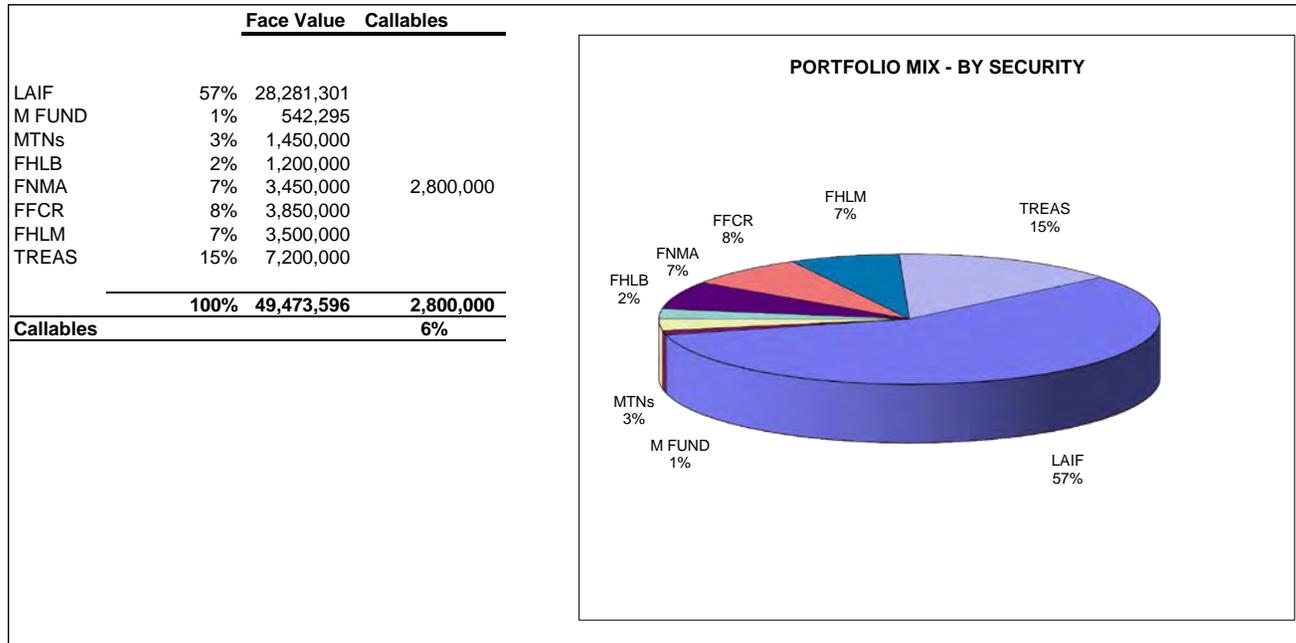


	No of Inv	Ladder Yield	Spread Over LAIF	%	Avg Mat	# of Callables	Face Value
LAIF	1	0.260%	0.000%	57%	0		28,281,301
S Mkt Fund	0	0.010%	-0.250%	1%	0		542,295
2010	0	0.000%		0%	0	0	0
2013	2	1.145%	0.885%	3%	1	0	1,500,000
2014	3	0.563%	0.303%	9%	36	0	4,300,000
2015	9	0.504%	0.244%	18%	132	2	9,050,000
2016	7	0.560%	0.300%	12%	111	1	5,800,000
<b>Total</b>	<b>22</b>	<b>0.39%</b>	<b>0.43%</b>	<b>100%</b>	<b>280</b>	<b>3</b>	<b>\$49,473,596</b>

Purchases this quarter  
 Maturities this quarter

0.07	3.31	20,650,000.00
------	------	---------------

**Attachment 2  
Portfolio Mix Charts  
September 30, 2013**



**Attachment 3**  
**Investment Policy Compliance Chart**  
**September 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	57%	28,281,301	04/29/10	50,000,000	100%	21,718,699	Yes	Yes	Yes
M FUND	1%	542,295	08/03/12						
MTNs	3%	1,450,000	01/00/00		15%	5,971,039	Yes	Yes	Yes
FHLB	2%	1,200,000	10/29/12		20%	8,694,719	Yes	Yes	Yes
FNMA	7%	3,450,000	04/05/12		20%	6,444,719	Yes	Yes	Yes
FFCB	8%	3,850,000	01/00/00		20%	6,044,719	Yes	Yes	Yes
FHLM	7%	3,500,000	12/05/11		20%	6,394,719	Yes	Yes	Yes
All Agencies	24%				100%		Yes	Yes	
TREAS	15%	7,200,000	08/05/12		100%	42,273,596	Yes	Yes	Yes
	100%	<b>49,473,596</b>							
<b>All Agencies</b>		<b>24%</b>	<b>12,000,000</b>		<b>100%</b>	<b>37,473,596</b>		Yes	
<b>Callables</b>		<b>6%</b>	<b>2,800,000</b>		<b>35%</b>	<b>14,515,759</b>		Yes	



# City of Los Altos



## Investment Performance Review Third Quarter 2013

**PFM Asset Management LLC**  
50 California Street, Suite 2300  
San Francisco, CA 94111  
415-982-5544  
[oblitesc@pfm.com](mailto:oblitesc@pfm.com)

### Summary

- Markets were whipsawed during the third quarter, as rates marched steadily higher into September, only to reverse on:
  - Weaker-than-expected employment and economic data;
  - Larry Summers' withdrawal from consideration as the next Federal Reserve (Fed) Chairman; and
  - The Fed's surprise announcement that it would await more evidence of sustainable economic progress before adjusting the pace of its bond purchases.
- As a result of the Fed's decision not to taper its bond-purchasing programs, ten-year Treasury yields ended the quarter at 2.6%, only slightly higher than the end of June, when yields were 2.5%.
- The domestic economy continued to grow modestly, although forecasts for growth into next year have been reduced.
- Partisan wrangling over the federal budget, looming debt ceiling, and impact of the government shutdown have created a great deal of uncertainty.

### Economic Snapshot

- U.S. gross domestic product (GDP) grew at a modest 2.5% for the second quarter. The release of the Fed's September economic projections confirmed that growth is unlikely to pick up in the next few quarters, as its GDP growth forecast was revised slightly downward for 2013, 2014, and 2015.
- During the quarter, the unemployment rate continued to fall from 7.6% in June to 7.3% in August. The economy created 169,000 jobs in August, but that figure was overshadowed by large downward revisions to the prior two months' figures.
- Consumer confidence fell to 79.7 in September, marking its weakest reading since May.
- The euro zone emerged from recession but generated second-quarter GDP growth of only 0.3%.

### Interest Rates

- Intermediate-term interest rates were slightly lower at the end of the quarter, as the market re-priced the yield curve to reflect the Fed's surprise inaction on tapering.
- At its September 17-18 meeting, the Federal Open Market Committee (FOMC) maintained its commitment to low short-term rates until the unemployment picture improves, as long as inflation remains within expectations. Its decision not to taper was based partially on its belief that growth in the near term would be somewhat lower than expected.
- While rates have come down from two-year highs in early September, once tapering starts, they may resume their gradual trend toward normalization, resulting in higher levels over time.

### Sector Performance

- Fixed-income securities generally performed well across most segments of the U.S. market, with intermediate-term maturities performing best.
- The corporate sector led the way with strong returns, as yield spreads reversed much of the spread widening that occurred in the second quarter.
- Agencies modestly outperformed Treasuries for the quarter, but yield spreads remain near historically narrow levels, especially in shorter maturities.
- Agency mortgage-backed securities had a very good quarter, as option-adjusted spreads narrowed, while the worst of the rate-induced duration extensions appear to be behind us.
- Short- and intermediate-term municipal bonds also had a good quarter, despite the Detroit bankruptcy filing in July.

### Economic Snapshot

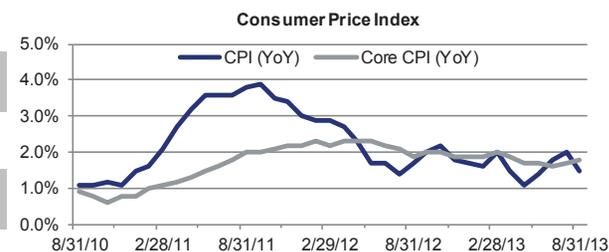
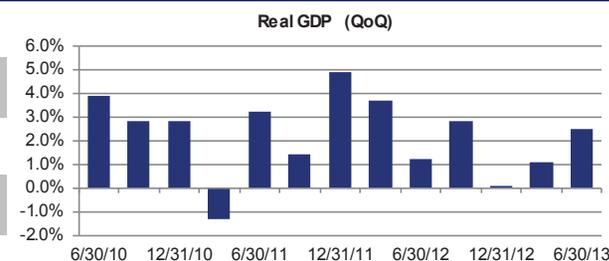
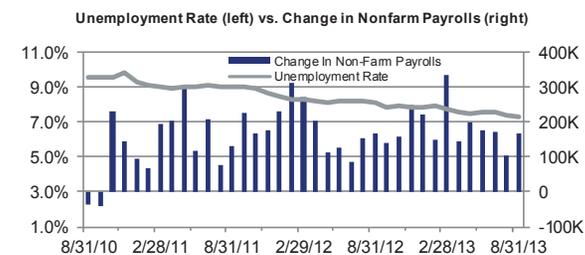
Labor Market		Latest	Jun 2013	Sep 2012
Unemployment Rate	Aug'13	7.3%	7.6%	7.8%
Change In Non-Farm Payrolls	Aug'13	169,000	172,000	138,000
Average Hourly Earnings (YoY)	Aug'13	2.2%	2.1%	2.0%
Personal Income (YoY)	Aug'13	3.7%	3.2%	3.6%
Initial Jobless Claims (week)	10/4/13	374,000	344,000	368,000

Growth				
Real GDP (QoQ SAAR)	2013Q2	2.5%	1.1% <sup>1</sup>	2.8% <sup>2</sup>
GDP Personal Consumption (QoQ SAAR)	2013Q2	1.8%	2.3% <sup>1</sup>	1.7% <sup>2</sup>
Retail Sales (YoY)	Aug'13	4.7%	6.0%	5.7%
ISM Manufacturing Survey (month)	Sep'13	56.2	50.9	51.6
Existing Home Sales SAAR (month)	Aug'13	5.48 mil.	5.06 mil.	4.78 mil.

Inflation / Prices				
Personal Consumption Expenditures (YoY)	Aug'13	1.2%	1.3%	1.7%
Consumer Price Index (YoY)	Aug'13	1.5%	1.8%	2.0%
Consumer Price Index Core (YoY)	Aug'13	1.8%	1.6%	2.0%
Crude Oil Futures (WTI, per barrel)	Sep 30	\$102.33	\$96.56	\$92.19
Gold Futures (oz)	Sep 30	\$1,327	\$1,224	\$1,771



1. Data as of First Quarter 2013

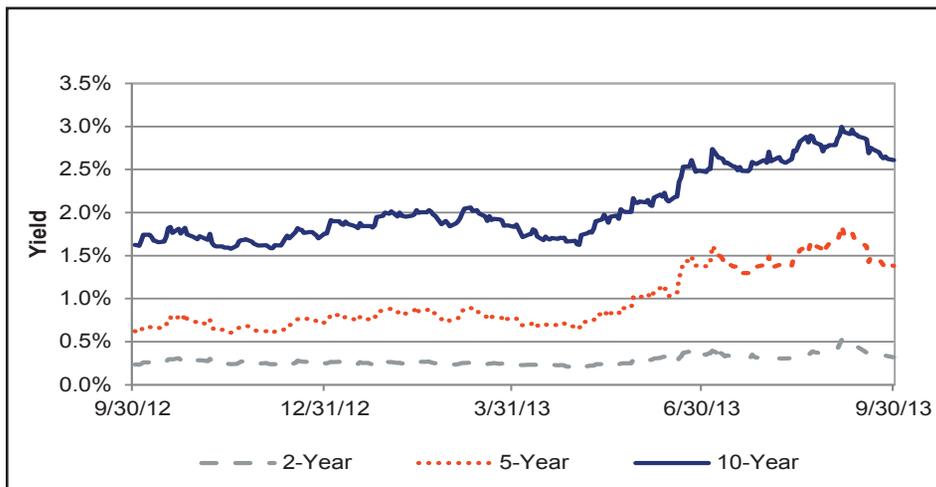
2. Data as of Third Quarter 2012

Note: YoY = year over year, QoQ = quarter over quarter, SAAR = seasonally adjusted annual rate, WTI = West Texas Intermediate crude oil

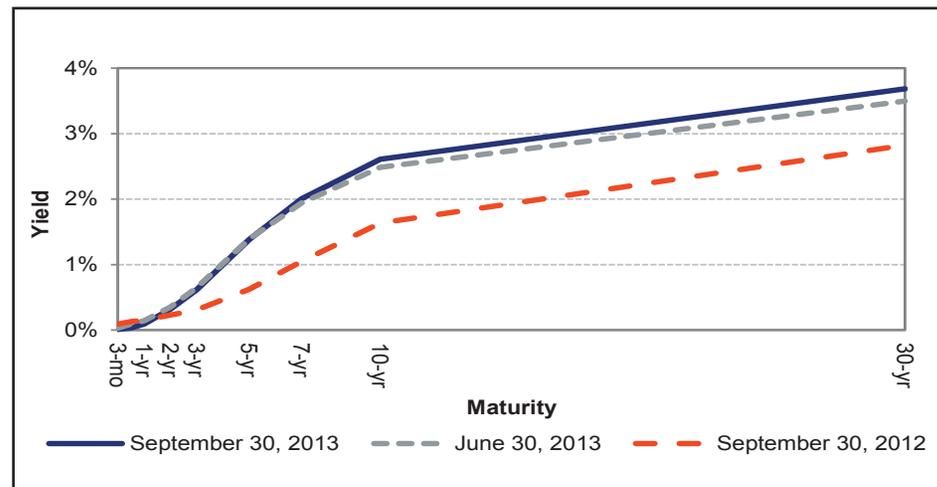
Source: Bloomberg

### Interest Rate Overview

#### U.S. Treasury Note Yields



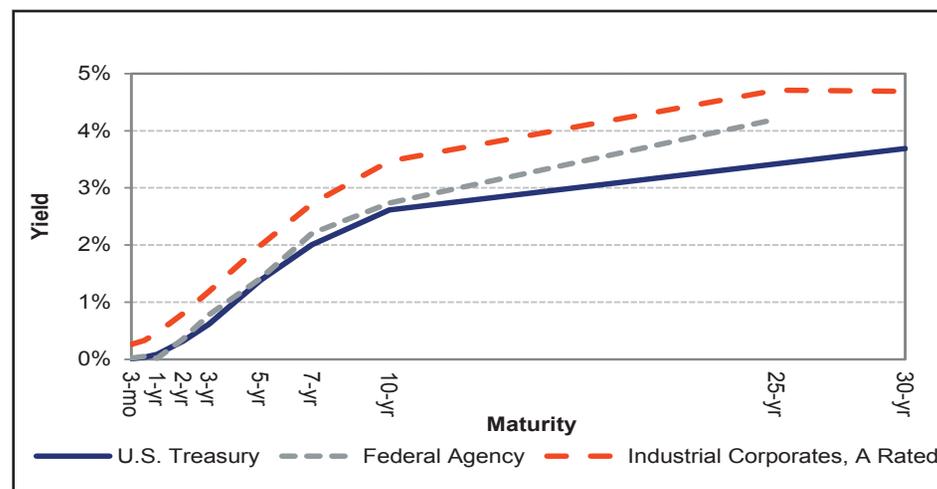
#### U.S. Treasury Yield Curve



#### U.S. Treasury Yields

Maturity	9/30/13	6/30/13	Change over Quarter	9/30/12	Change over Year
3-month	0.01%	0.03%	(0.02%)	0.09%	(0.08%)
1-year	0.11%	0.17%	(0.06%)	0.16%	(0.05%)
2-year	0.32%	0.37%	(0.05%)	0.25%	0.07%
5-year	1.39%	1.40%	(0.01%)	0.63%	0.76%
10-year	2.67%	2.52%	0.15%	1.70%	0.97%
30-year	3.68%	3.48%	0.20%	2.82%	0.86%

#### Yield Curves as of 9/30/13



Source: Bloomberg

### BofA Merrill Lynch Index Returns

	As of 9/30/2013	Returns for Periods ended 9/30/2013			
	Duration	Yield	3 Month	1 Year	3 Years
<b>1-3 Year Indices</b>					
U.S. Treasury	1.90	0.33%	0.29%	0.37%	0.71%
Federal Agency	1.75	0.45%	0.30%	0.39%	0.87%
U.S. Corporates, A-AAA rated	1.93	1.00%	0.74%	1.39%	2.22%
Agency MBS (0 to 3 years)	1.78	1.34%	1.03%	(0.28%)	1.92%
Municipals	1.83	0.64%	0.47%	0.76%	1.25%
<b>1-5 Year Indices</b>					
U.S. Treasury	2.70	0.62%	0.46%	(0.03%)	1.16%
Federal Agency	2.48	0.75%	0.52%	0.07%	1.15%
U.S. Corporates, A-AAA rated	2.83	1.49%	1.16%	1.17%	2.79%
Agency MBS (0 to 5 years)	3.26	2.54%	0.93%	(0.74%)	2.55%
Municipals	2.57	0.98%	0.67%	0.58%	1.72%
<b>Master Indices (Maturities 1 Year or Greater)</b>					
U.S. Treasury	5.70	1.42%	0.03%	(2.54%)	2.12%
Federal Agency	3.93	1.33%	0.35%	(1.38%)	1.63%
U.S. Corporates, A-AAA rated	6.44	2.84%	0.86%	(1.72%)	3.83%
Agency MBS	5.17	2.94%	1.08%	(1.20%)	2.66%
Municipals	8.04	3.40%	(0.41%)	(2.75%)	3.28%

Returns for periods greater than one year are annualized

Source: Bloomberg

### Disclosures

*The views expressed within this material constitute the perspective and judgment of PFM Asset Management LLC at the time of distribution and are subject to change. Any forecast, projection, or prediction of the market, the economy, economic trends, and equity or fixed-income markets are based upon current opinion as of the date of issue, and are also subject to change. Opinions and data presented are not necessarily indicative of future events or expected performance. Information contained herein is based on data obtained from recognized statistical services, issuer reports or communications, or other sources believed to be reliable. No representation is made as to its accuracy or completeness. This material is intended for informational purposes only and should not be relied upon to make an investment decision, as it was prepared without regard to any specific objectives or financial circumstances. It should not be construed as an offer to purchase/sell any investment. References to particular issuers are for illustrative purposes only, and are not intended to be recommendations or advice regarding such issuers. PFMAM is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940. PFMAM's clients are state and local governments, non-profit corporations, pension funds, and similar institutional investors. [www.pfm.com](http://www.pfm.com)*

*Further distribution is not permitted without prior written consent.*



**PFM Asset Management LLC**

**Portfolio Summary**

<u>Total Portfolio Value</u>	<u>September 30, 2013</u>
Market Value	\$49,557,144.71
Amortized Cost	\$49,528,249.70

**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.
- Our investment strategy was based on two assumptions:
  - Interest rates will trend gradually higher as modest economic expansion in the U.S. continues.
  - The Federal Reserve must eventually curtail its bond purchases and rates will begin to normalize from artificially low levels.
- The key components of our strategy included:
  - Letting duration move a bit shorter and more conservative than benchmarks
  - Careful timing of purchases when rates were near the top of their recent range
- The portfolio was positioned with a duration shorter than the benchmark's duration for much of the quarter to dampen capital losses as yields rose. This strategy worked well early in the quarter and allowed us to lock in yields at the higher end of their recent range in September.
- Unlike stock market indexes whose composition remains fairly constant (e.g., Dow Jones 30 industrials or S&P 500), bond market indexes change constituents every month. Shorter maturity bonds drop out and newly-issued or longer maturity bonds roll into the designated maturity range (e.g., 1-3 year, 1-5 year). This causes the average maturity of the typical bond index to extend at the beginning of each new month. Portfolio managers normally execute monthly trades to match the extension of their benchmarks. Because rates were rising, however, PFMAM chose not to extend at the beginning of July and August, preferring to wait as rates marched even higher.

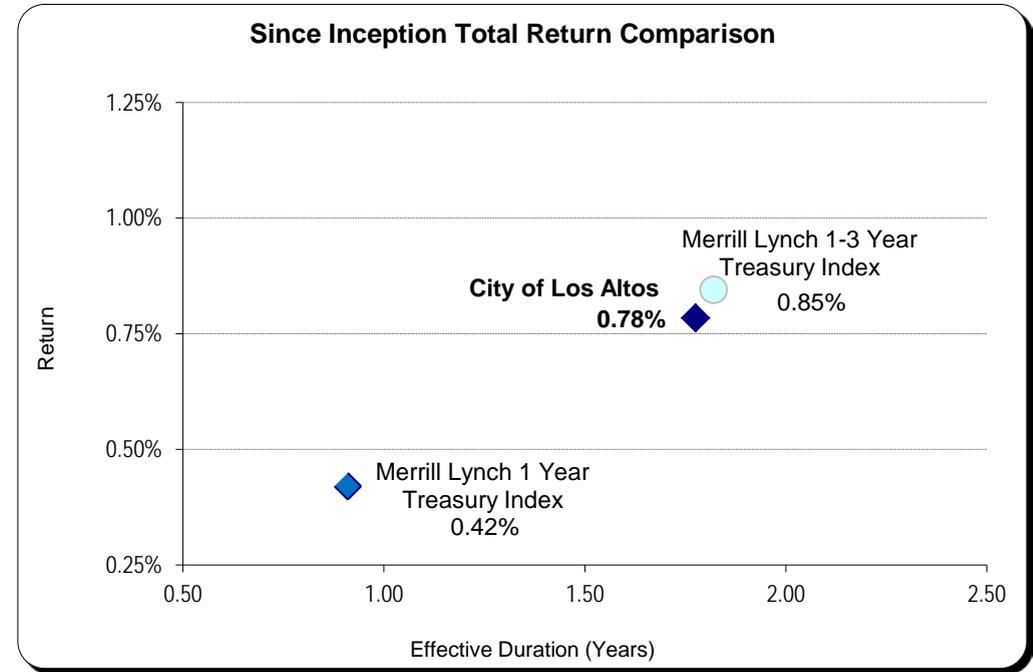
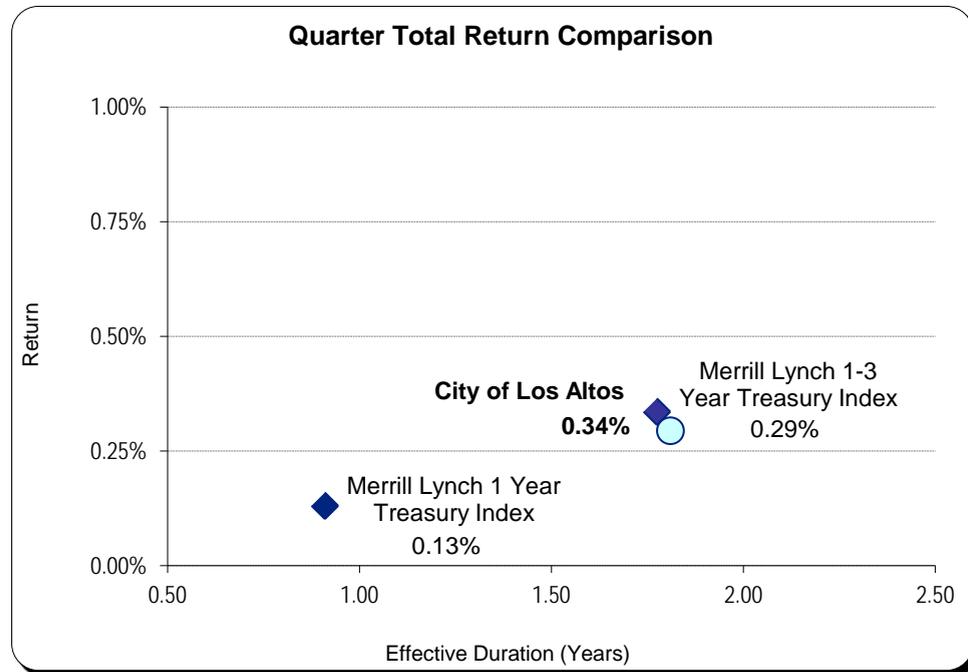
**Portfolio Summary****PORTFOLIO STRATEGY**

- Our expectations are that U.S. economic growth will continue, but Fed projections may prove too optimistic. We believe that the U.S. will not default on its debt, and Janet Yellen will be confirmed as the next Chair of the Federal Reserve and will continue Bernanke's accommodative monetary policies.
- Treasury yields will likely be range bound due to the unevenness of the economic recovery. The tradable range for Treasury yields will gradually rise as monetary policy accommodation is slowly removed.
- The current modestly conservative duration posture for portfolios will likely be maintained for the foreseeable future. Bouts of market weakness may be used to match monthly index extensions at favorable levels, when deemed appropriate.
- Yield spreads on shorter maturity Agency bonds remain minimal. We favor Agency positions in 2-3 year maturities and Treasuries with maturities 2 years and under. As Agency holdings shorten over time, we may swap into like maturity Treasuries, or reposition into longer maturity Agencies or corporates at higher yields and wider spreads.
- Corporate yield spreads should remain stable as long as Treasury yields move in an orderly manner. We generally find the yield advantage of corporate notes fair compensation for the credit risk being assumed. Corporate profits are firm, borrowing costs are low, and economic conditions are reasonably favorable. We especially like issues of banks and financial companies whose balance sheets have improved, and who are subject to increasing regulatory constraints that are bondholder friendly. Increased corporate allocations remain a key method in seeking to enhance relative return. New issues continue to offer both supply and value, as they are typically priced at a concession.
- As always, we seek to maximize portfolio value through careful and prudent active management. Our strategy will remain flexible and may change in response to changes in interest rates, economic data, or our market outlook.

Portfolio Performance

Total Return <sup>1,2,3,4</sup>	Quarter Ended 9/30/2013	Past 12 Months	Past 2 Years	Past 3 Years	Since Inception
<b>City of Los Altos</b>	<b>0.34%</b>	<b>0.36%</b>	<b>0.50%</b>	<b>0.73%</b>	<b>0.78%</b>
Merrill Lynch 1-3 Year Treasury Index	0.29%	0.37%	0.46%	0.71%	0.85%
Merrill Lynch 1 Year Treasury Index	0.13%	0.31%	0.29%	0.37%	0.42%

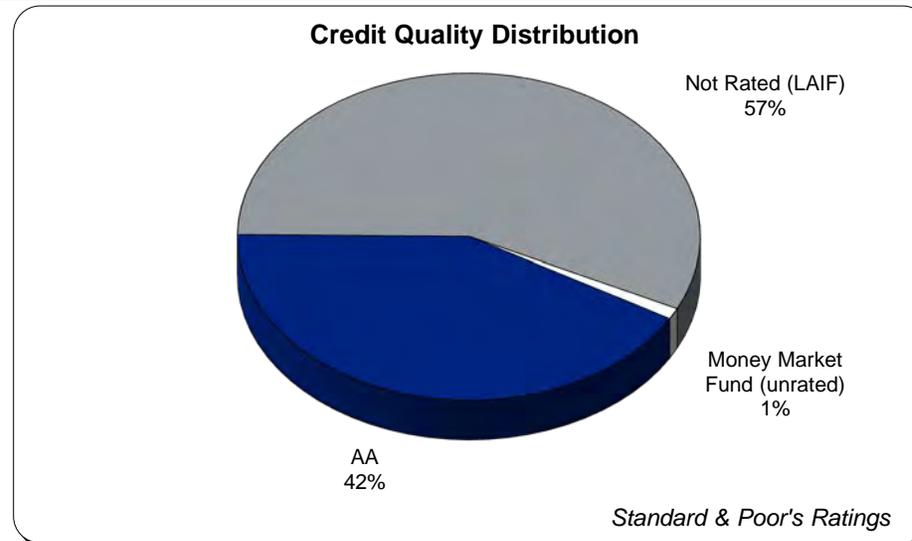
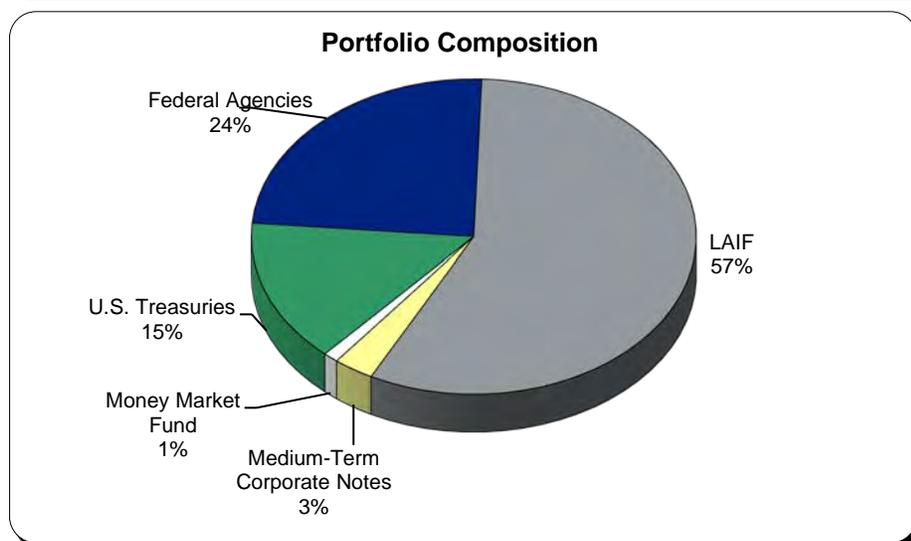
<u>Effective Duration<sup>4</sup></u>	<u>September 30, 2013</u>	<u>June 30, 2013</u>	<u>Yields<sup>4</sup></u>	<u>September 30, 2013</u>	<u>June 30, 2013</u>
<b>City of Los Altos</b>	<b>1.78</b>	<b>1.97</b>	Yield on Cost	<b>0.59%</b>	0.60%
Merrill Lynch 1-3 Year Treasury Index	1.82	1.81	ML 1-3 Year Yield on Cost	<b>0.41%</b>	0.50%
Merrill Lynch 1 Year Treasury Index	0.91	0.91			



- 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

<u>Security Type</u> <sup>1</sup>	<u>September 30, 2013</u>	<u>% of Portfolio</u>	<u>June 30, 2013</u>	<u>% of Portfolio</u>	<u>Permitted by Policy</u>
U.S. Treasuries	\$7,275,184.45	15%	\$7,417,303.29	14%	100%
Federal Agencies	\$12,005,227.52	24%	\$11,961,453.39	23%	100%
LAIF	\$28,281,301.00	57%	\$31,262,016.00	60%	100%
Medium-Term Corporate Notes	\$1,453,136.64	3%	\$1,446,365.44	3%	30%
Money Market Fund	\$542,295.10	1%	\$379,573.35	<1%	20%
<b>Totals</b>	<b>\$49,557,144.71</b>	<b>100%</b>	<b>\$52,466,711.47</b>	<b>100%</b>	

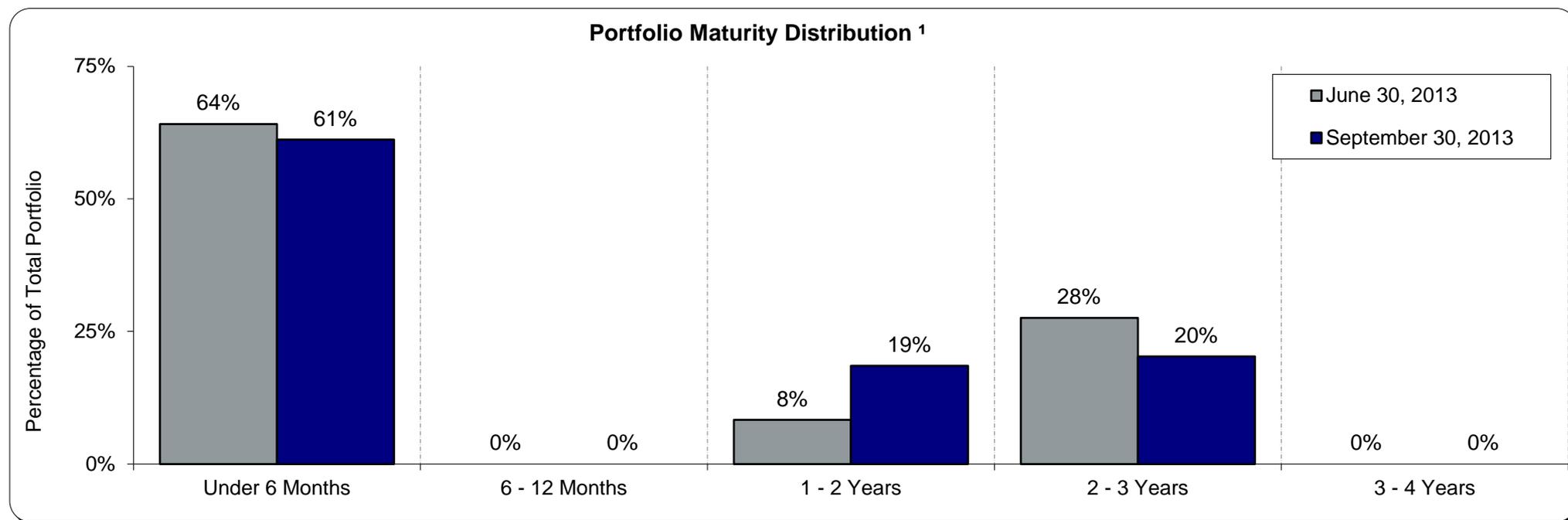


Notes:

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

<u>Maturity Distribution</u> <sup>1</sup>	<u>September 30, 2013</u>	<u>June 30, 2013</u>
Under 6 Months	\$30,328,188.25	\$33,647,455.47
6 - 12 Months	\$0.00	\$0.00
1 - 2 Years	\$9,182,501.51	\$4,369,323.52
2 - 3 Years	\$10,046,454.95	\$14,449,932.48
3 - 4 Years	\$0.00	\$0.00
4 - 5 Years	\$0.00	\$0.00
5 Years and Over	\$0.00	\$0.00
<b>Totals</b>	<b>\$49,557,144.71</b>	<b>\$52,466,711.47</b>



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.