ATTACHMENT A

pfm

January 31, 2018

Memorandum

To: Sharif Etman, Administrative Services Director
City of Los Altos

From: Izac Chyou, Senior Managing Consultant
PFM Asset Management LLC

Re: Investment Policy Review

We have completed our annual review of the City's Investment Policy (the Policy). The City's policy is currently in compliance with California Government Code (the Code). There were no changes to the Code that regulate the investment of public funds requiring the City to change its policy. We do, however, recommend some changes to reflect current industry standards for the prudent management of public funds. Our recommended changes are as follows;

1. We recommend the City add local government investment pools (LGIPs), specially allowing the investment of Joint Powers of Authorities to its list of Allowable Investments.
2. We recommend the City extend the maturity limit of corporate notes and commercial paper to be consistent with Code.
3. We recommend the City increase its allowable exposure in commercial paper to
4. And, we recommend the City update its ratings language and requirements to be consistent with Code.

This memorandum summarizes our recommended revisions to the Policy. We have also attached a marked-up version of the Policy illustrating our recommendations.

Recommendations

Local Government Investment Pools

We recommend the City authorize investments in shares of beneficial interest that are state-administered or through joint powers statutes, which are authorized for use by California local governments in California Government Code § 53601 (p). The addition of this section could allow the City to expand and diversify its overnight liquidity options.

Extend the Maturity Limit of Corporate Notes and Commercial Paper

We recommend expanding the City's maturity limits on the corporate notes and commercial paper to match the maturity limits of the other allowable investments in the policy and to match the limits set in Code:

- Corporate Notes: 4 years → 5 years
- Commercial Paper: 180 days → 270 days

This change allows the City to optimize its portfolio by increasing the investable opportunity set as longer-term securities offer higher yields (as shown in the table below). However, the higher yields (and higher earnings potential) available in longer-term investment strategies must be weighted carefully against the greater risk and greater variability of returns inherent in longer-term securities. We look forward to further discussing the pros and cons of adopting a longer-term investment strategy with the City.

Increase Allocation Allowed to Commercial Paper

We recommend amending this section to allow up to a 25% investment in commercial paper, which is consistent with the Code guidelines. Note, the city currently has a sector limit of 15% for commercial paper and 30% limit for medium term corporate notes.

Maturity	Treasury	Federal Agency	Corporate Notes (A)	Commercial Paper
3-Month	1.45%	1.43%	1.91%	1.72%
6-Month	1.65%	1.58%	2.00%	1.92%
9-Month	1.68%	1.63%	2.09%	2.07%
1-Year	1.89%	1.74%	2.18%	-
2-Year	2.15%	2.15%	2.47%	-
3-Year	2.31%	2.34%	2.68%	-
5-Year	2.51%	2.58%	2.97%	-

Source: *Bloomberg BVAL yield curves for Treasury and Corporate. TradeWeb for Federal Agency yields. 3 and 6 month corporate yields from commercial paper; A-1 for A. Yields are for indicative purposes only; actual yields may vary by issue.. As of 1/31/2018.*

Update to Credit Rating Language

The Policy currently requires medium term notes and negotiable certificates of deposit to be rated in a rating category of "A" or its equivalent or better by two or more nationally recognized statistical-rating organizations (NRSROs). We recommend the City change this requirement such that medium term notes and negotiable certificates of deposit are rated in a rating category of "A" or its equivalent or higher by one or more NRSROs. This change will increase the investable opportunity set, allowing for a greater universe of investments, which include split-rated issues from corporations such as Goldman Sachs, Morgan Stanley, Coca-Cola, and AT&T. These companies are rated in a rating category of "A" or its equivalent or better by one NRSRO while another NRSRO rates the issues in the "BBB" category or is not rated (see Exhibit A). California code requires the use of only one NRSRO credit rating of "A" or its equivalent or better. This change will bring the policy up to code.

Furthermore, roughly 44% of the 1-5 year Corporate Index is made up of “A” rated issuers, split-rated corporate notes rated “A” or better by only one NRSRO represent 13% of the Index. From 1970-2015, on average, 86.6% of “A” rated corporate issuers remained “A” rated, 2.6% were upgraded to “Aa”, and only 5.4% were downgraded to “Baa”. Within “A ”rated issues, only 0.1% defaulted within a year (see Exhibit B).

Exhibit A
A-Rated Representative Issuer List

Top 10 Issuers	# of Issues	Amount Outstanding (millions)	% of Corp Index	Moody's	S&P	Fitch
J.P. Morgan Chase	19	$44,850	1.93%	A3	A-	A+
Morgan Stanley	19	$42,485	1.86%	A3	BBB+	A
Goldman Sachs	17	$38,750	1.69%	A3	BBB+	A
Bank of America	14	$33,964	1.48%	Baa1	BBB+	A
Citigroup	16	$27,350	1.15%	Baa1	BBB+	A
Wells Fargo	11	$24,950	1.05%	A2	A	AA-
Cisco Systems	11	$18,100	0.77%	A1	AA-	-
Toyota	16	$16,850	0.71%	Aa3	AA-	A
Daimler Finance	16	$15,950	0.66%	A2	A	A-
Sumitomo Mitsui	14	$14,500	0.60%	A1	A	A

Source: BofA Merrill Lynch 1-5 Year U.S. Corporate Index, as of 12/31/2016.

Exhibit C

Composition of the 1-5 Year Corporate Index				
	Financial	Industrial	Utilities	Total
AAA	0.2%	0.9%	0.0%	1.1%
AA	8.7%	6.5%	0.4%	15.5%
A	23.2%	18.4%	2.0%	43.6%
BBB	7.6%	29.3%	2.7%	39.5%
Total	39.6%	55.1%	5.1%	100%

Source: BofA Merrill Lynch 1-5 Year U.S. Corporate Index by face value, as of 12/31/2016.

Exhibit C

Average One-Year Letter Rating Migration Rates, 1970-2015

From\To:	Aaa	Aa	A	Baa	Ba	B	Caa	Ca-C	Default	WR
Aaa	87.5%	8.1%	0.6%	0.1%	-	-	-	-	-	3.7%
Aa	0.8%	85.2%	8.4%	0.4%	0.1%	-	-	-	-	5.0%
A	0.1%	2.6%	86.6%	5.4%	0.5%	0.1%	-	-	0.1%	4.7%
Baa	-	0.2%	4.3%	85.4%	3.7%	0.7%	0.2%	-	0.2%	5.3%
Ba	-	-	0.5%	6.2%	76.2%	7.2%	0.7%	0.1%	0.9%	8.2%
B	-	-	0.1%	0.4%	4.8%	73.5%	6.5%	0.6%	3.4%	10.6%
Caa	-	-	-	0.1%	0.4%	7.0%	66.8%	2.8%	8.5%	14.3%
Ca-C	-	-	0.1%	-	0.6%	2.5%	9.5%	39.6%	24.1%	23.7%

Legend: Upgrades; Downgrades to Non-Investment Grade; Downgrades to Investment Grade; Defaults

Source: Moody's Annual Default Study: Corporate Default and Recovery Rates, 1970-2015.

It is important to note that our ratings criteria recommendation does not represent a change in our stringent credit quality philosophy, rather it is a recognition of the realities of the marketplace and will provide enhanced flexibility for the City, allowing the portfolio to be optimally diversified and to capitalize on market opportunities without adding undue risk.

PFM's credit process ensures that all issuers are reviewed and evaluated before purchase. Portfolio managers and traders are only permitted to purchase securities from companies that have been thoroughly vetted by PFM's Credit Committee. PFM's Credit Committee is made up of our Chief Credit Officer, Chief Investment Officer, and senior portfolio managers and traders. All corporate research is completed by investment personnel with direct involvement in PFM's investment process.

Furthermore, since business and economic conditions can change dramatically, corporate exposure must be constantly monitored. An active approach to investing in corporate securities and negotiable CDs is essential. PFM performs periodic reviews to ensure each issuer continues to meet our credit standards. In addition, we follow news about economic, industry and issuer conditions. PFM has developed a process to detect changes in the financial condition or business outlook of a company. PFM monitors the trading of securities related to a company, including stock prices, credit spreads, and credit default swap levels. We have also developed the means to monitor any changes in the credit rating of an issuer as they are announced. Company quarterly and annual reports are reviewed and analyzed, as are industry trends. In addition, PFM reviews credit agency reports and research reports from major Wall Street firms to gain other perspectives. If the outlook for a company deteriorates, PFM may remove that issuer from our Approved List. If the deterioration is significant enough, PFM may recommend that the holdings of the company are sold. We would be happy to discuss any questions regarding our recommended changes to the Policy.