TO: HONORABLE CITY COUNCIL
FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES
DATE: APRIL 23, 2007 CMR: 210:07
SUBJECT: CITY OF PALO ALTO’S INVESTMENT ACTIVITY REPORT FOR THE THIRD QUARTER, FISCAL YEAR 2006-07

This is an information report and no Council action is required.

BACKGROUND

The purpose of this report is to inform Council of the status of the City’s investment portfolio as of the end of the third quarter of fiscal year 2006-07. The City’s investment policy requires that staff report quarterly to Council on the City’s portfolio composition compared to Council-adopted policy, portfolio performance, and other key investment and cash flow information.

DISCUSSION

Investment Portfolio as of March 31, 2007
The City’s investment portfolio is detailed in Attachment B. It is grouped by investment type and includes the investment issuer, date of maturity, current market value, the book and face (par) value, and the weighted average maturity of each type of investment and of the entire portfolio as of March 31, 2007.

The par value of the City’s portfolio is $392.4 million; in comparison, last quarter it was $386.6 million. The growth in the portfolio of $5.8 million since the last quarter primarily results from the timing of cash flows. This includes delayed sales tax (“triple flip”) and in-lieu vehicle license fee tax payments received in January and May 2007 and the timing of payroll periods.

The portfolio consists of $17.6 million in liquid accounts and $374.8 million in certificates of deposit, and U. S. government treasury and agency securities. The $374.8 million includes $164.3 million in investments maturing in less than two years, comprising 43.8 percent of the City’s investment in notes and securities. The investment policy requires at least $50 million shall be maintained in securities maturing in less than two years.
The current market value of the portfolio is 99.1 percent of the book value. It is important to note that because the City’s practice is to hold securities until they mature, changes in market price do not affect the City’s investment principal. The market valuation is provided by Union Bank of California, which is the City’s safekeeping agent. The average life to maturity of the investment portfolio is 2.56 years compared to 2.52 years last quarter.

**Investments Made During the Third Quarter**
During the third quarter, $30.5 million of government agency securities with an average yield of 4.9% percent matured. During the same period, government securities totaling $30.0 million with an average yield of 5.0% percent were purchased. The City’s short-term money market and pool account increased by $6.3 million compared to the second quarter. Investment staff continually monitors the City’s short-term cash flow needs and adjusts liquid funds to meet those needs and take advantage of investment opportunities. Staff is gradually increasing liquid fund deposits in anticipation of Council’s approval to transfer approximately $26.5 million in retiree medical funds to a PERS trust fund and because short-term interest rates are higher than long-term instrument yields.

**Availability of Funds for the Next Six Months**
The normal flow of revenues from the City’s utility billings and General Fund sources is sufficient to provide funds for ongoing expenditures in these respective funds. Projections indicate receipts will be $172.1 million and expenditures will be $165.6 million over the next six months, indicating an overall growth in the portfolio of $6.5 million.

As of March 31, 2007, the City had $17.6 million deposited in the Local Agency Investment Fund (LAIF) and a money market account that could be withdrawn on a daily basis. In addition, securities totaling $49.8 million will mature between April 1, 2007 and September 30, 2007. On the basis of the above projections, staff is confident that the City will have more than sufficient funds to meet expenditure requirements for the next six months.

**Compliance with City Investment Policy**
During the third quarter of 2006-07, staff complied with all aspects of the investment policy. Attachment C lists the restrictions in the City’s investment policy compared with the portfolio’s actual compliance.

**Investment Yields**
Interest income on an accrual basis for the third quarter of 2006-07 was $4.4 million. This total is 4.8 percent higher than what the City received last quarter. As of March 31, 2007, the yield to maturity of the City’s portfolio was 4.37 percent. This compares to a yield of 4.35 percent in the second quarter. As lower yielding maturing securities purchased during the prior years low interest rate period are reinvested in higher yielding ones, staff expects the portfolio’s yield will gradually rise in the coming quarters. The City’s portfolio yield of 4.37 percent compares to LAIF’s average yield for the quarter of 5.18 percent and an average yield on the two-year and five-year Treasury bonds during the third quarter of approximately 4.77 percent and 4.65 percent, respectively.
Yield Trends
After two years of increasing the federal funds and discount rate by 4.25 and 4.50 percent, respectively, the Federal Open Market Committee (FOMC) has left rates unchanged in the last two quarters. These rates currently are 5.25 and 6.25 percent, respectively. Although the consensus is that the FOMC will not lower rates in the near future, there is an emerging view that rates may rise if current inflation rates persist or rise.

The FOMC indicated that “moderate” economic growth is expected to continue. However, increasing inflationary pressures and the residential housing market changes are of concern. As in past pronouncements, the FOMC continues to monitor these risks closely and indicated future rate changes are dependent on the future course of both inflation and economic growth. The City’s portfolio yield has gradually increased and is expected to continue this trend for the next few quarters.

Funds Held by the City or Managed Under Contract
Attachment A is a consolidated report of all City investment funds, including those not held directly in the investment portfolio. These include cash in the City’s regular bank account with Wells Fargo. The bond proceeds, reserves, and debt service payments being held by the City’s fiscal agents are subject to the requirements of the underlying debt indenture. The trustees for the bond funds are U.S. Bank and California Asset Management Program (CAMP). Bond funds with U.S. Bank are invested in federal agency and money market mutual funds that consist exclusively of U.S. Treasury securities. Bond funds in CAMP are invested in banker’s acceptance notes, certificates of deposit, commercial paper, federal agency securities, and repurchase agreements. The most recent data on funds held by the fiscal agent is as of March 31, 2007.

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ATTACHMENTS:
A) Consolidated Report of Cash and Investments
B) Investment Portfolio, as of March 31, 2007
C) Investment Policy Compliance