



City Council Staff Report

From: City Manager

Report Type: INFORMATION REPORTS

Lead Department: Administrative Services

Meeting Date: November 13, 2023

Report #:2310-2094

TITLE

Investment Activity Report for the First Quarter, Fiscal Year 2024

RECOMMENDATION

This is an informational report and no City Council action is required.

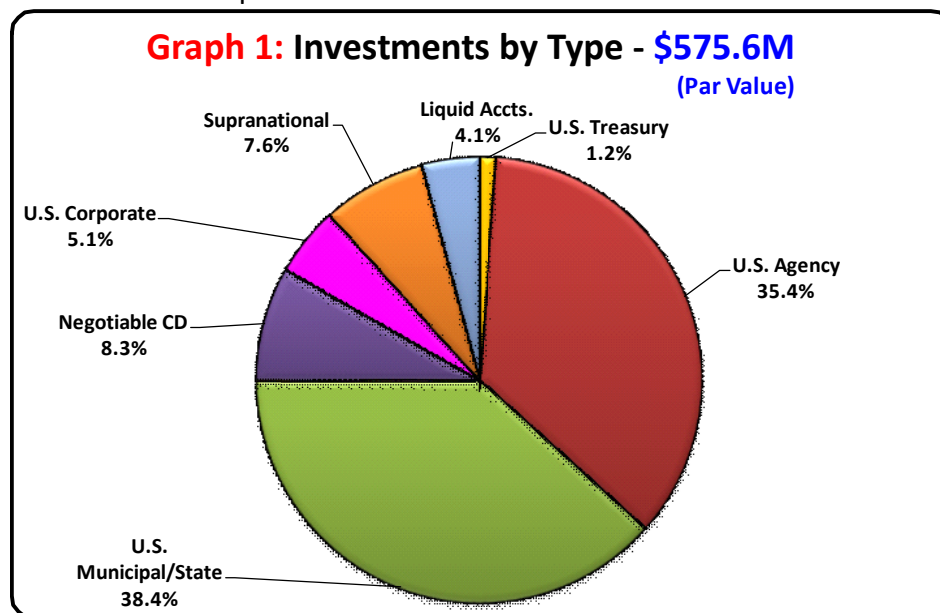
EXECUTIVE SUMMARY

The City's Investment Policy¹ (Policy) requires that staff report to Council quarterly on the City's portfolio composition and performance compared to the Council-adopted Policy; discuss overall compliance with the City's Investment Policy; and provide recommendations, if any, for Policy changes. In addition, staff provides a detailed list of all securities and reports on the City's ability to meet expenditure requirements over the next six months. This report is to inform Council of the City's investment portfolio performance as of the first quarter ending September 30, 2023 and to disclose staff's cash flow projections for the next six months. Staff expects that the City will have sufficient funds or liquidity to meet expenditure requirements for the next six months. The portfolio details, activities, and performance are discussed below, and additional information is provided in the attachments. During the first quarter staff complied with all aspects of the Investment Policy.

The Investment Policy limits callable agency securities to 25 percent of the par value of the portfolio. As of the end of the first quarter, investments in callable agency securities exceeded this limit by 1.62% due to the overall decline in the portfolio for the planned prepayment of the City's Fiscal Year 2024 Unfunded Accrued Liability (UAL) pension cost for active employees to the Public Employers' Retirement System (PERS) and other cash needs driven by increased capital expenditures. Per the Policy, this is not considered a violation of the Policy since a later increase or decrease in percentage resulting from a change in portfolio's assets or values shall not constitute a violation of that restriction (limit). Staff is monitoring the percentage of callable agency securities to ensure that the percentage limitations will be restored as investments mature in each category and/or the portfolio increases which as of the writing of the report the latter has begun to happen.

ANALYSIS

The City's investment portfolio is summarized in Graph 1 and detailed in the Investments by Fund Report (Attachment B). The Investments by Fund Report groups the portfolio's securities by investment type and includes details of 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.



Due to rounding, the above graph's percentage total is greater than 100 percent.

The par value of the City's portfolio is \$575.6 million; in comparison, last quarter it was \$623.2 million. The \$47.6 million portfolio decline since the last quarter results from timing of cash flows from the prepayment of the City's Fiscal Year 2024 Unfunded Accrued Liability (UAL) pension cost for active employees to the Public Employers' Retirement System (PERS) totaling \$41.6 million, major revenue receipt due to seasonality timing, an extra pay period costs in the first quarter, and delayed reimbursement of State Revolving Fund (SRF) loans for Wastewater Treatment capital projects. As noted in the FY 2023 Q4 Investment Activity Report, delayed SRF reimbursement from the state, along with increased capital expenditures in the Wastewater Treatment Fund is expected to impact and constrain the City's cash position. Administrative Services and Public Works staff continues to monitor this activity closely to ensure the fund's solvency.

The City expects to save \$1.4 million by paying the UAL in advance and is partially offset by the loss of approximately \$0.8 million in interest income in the City's portfolio. The net citywide savings of prepaying the UAL cost is \$0.6 million. The saving is a consequence of PERS' ability to earn interest earlier and at a higher rate than the City's portfolio could realize. Without this prepayment, after factoring in \$11.6 million in UAL payments that would have been made in the first quarter, the portfolio would have increased by \$36.0 million, compared to the \$47.6 million

decline noted above. In addition, due to seasonality, the first quarter major tax revenues receipts are lower (e.g., sales, transient occupancy, and utility user's taxes) and property tax being received by the City in the second, third, and fourth quarters.

The portfolio consists of \$23.8 million in liquid accounts and \$551.8 million in various investment types as detailed in the following Table 1. The Investment Policy requires that at least \$50 million be maintained in securities maturing in less than two years. The portfolio includes \$152.2 million in investments maturing in less than two years, comprising 26.4% of the City's investment portfolio. In addition, the Investment Policy allows up to 30% of the portfolio to be invested in securities with maturities beyond five years; actual at the end of the second quarter is 26.6% of the portfolio.

The current market value of the portfolio is 90.5% of the book value. The market value of securities fluctuates, depending on how interest rates perform. When interest rates decrease, the market value of the securities in the City's portfolio will likely increase; likewise, when interest rates increase, the market value of the securities will likely decrease. Understanding and showing market values is not only a reporting requirement, but essential to knowing the principal risks in actively buying and selling securities. It is important to note, however, that the City's practice is to buy and hold investments to maturity, therefore changes in market price do not affect the City's investment principal. The market valuation is provided by U.S. Bank, which is the City's safekeeping agent. The average life to maturity of the investment portfolio is 3.52 years compared to 3.57 years last quarter.

The Investment Policy states "Should the ratio of the market value of the portfolio to the book value of the portfolio fall below 95%, the Administrative Services Department will report this to the City Council within a reasonable time frame and evaluate whether there is any risk of holding any of the securities to maturity." In the prior five quarters the market value fell below 95%; it was 93.5% in the fourth quarter of fiscal year 2022 ([CMR 13998²](#)), 89.7% in the first quarter ([CMR 14001³](#)) of fiscal year 2023, 90.7% in the second quarter of fiscal year 2023 ([CMR 2301-0865⁴](#)), 89.6% in the third quarter of fiscal year 2023 ([CMR 2212-0520⁵](#)) and 91.9% in the fourth quarter of fiscal year 2023 ([CMR 2307-1783⁶](#)). The market rate this first quarter is 90.5% of book value. Interest rates on new investments have fluctuated so the expectation is the market value of the portfolio is expected to stay in the current range in the coming quarters. To minimize risk of loss for investment principal due to lower market values, the City's investment practice is to buy and hold investments to maturity; in the instances where there is a need to sell securities for contingency cash flow planning, the City's practice is to sell securities that are above the market value.

Investments Made During the First Quarter

During the first quarter, \$21.9 million of securities with an average yield of 4.0% matured. During the same period, there were no new investment purchases to increase liquidity to meet expected cash needs. As expected, with the exception of this quarter, as interest rates rose on new

investments, the City's portfolio's average yield has begun to gradually rise. In the prior two fiscal years or during the height of the COVID-19 economic closures, the portfolio's interest rate had steadily declined. The City's short-term money market and pool account increased by \$15.1 million compared to the third quarter of Fiscal Year 2022. Staff continually monitors the City's short-term cash flow needs and adjusts liquid funds to meet them.

Availability of Funds for the Next Six Months

Normally, the flow of revenues from the City's utility billings and General Fund sources is enough to provide funds for ongoing expenditures in those respective funds. Projections indicate that for the City's cashflow, an overall growth in the portfolio of \$10.1 million is expected over the coming six months due to routine business activities. This reflects expected receipts of \$355.6 million and expenditures of \$345.5 million over the next six months.

As of September 30, 2023, the City had \$23.8 million deposited in the Local Agency Investment Fund (LAIF) and a money market account that could be withdrawn on a daily basis. Though as of writing of this report (October 26th), after the large payments discussed above, the \$23.8 million has increased to \$53.6 million which includes \$7.2 million is investment securities sold prior to maturity. Since the sales resulting in the \$7.2 million was dependent on a worse-case cash needs scenario that never materialized, a third has already been reinvested with an average yield being higher by 0.85% than the average yield of the sold securities. The remaining amount is expected to be also reinvested in the coming months. In addition, investments totaling \$26.0 million will mature between October 1, 2023 and March 31, 2024. Based on the above, staff expect that the City will have sufficient funds or liquidity to meet expenditure requirements for the next six months.

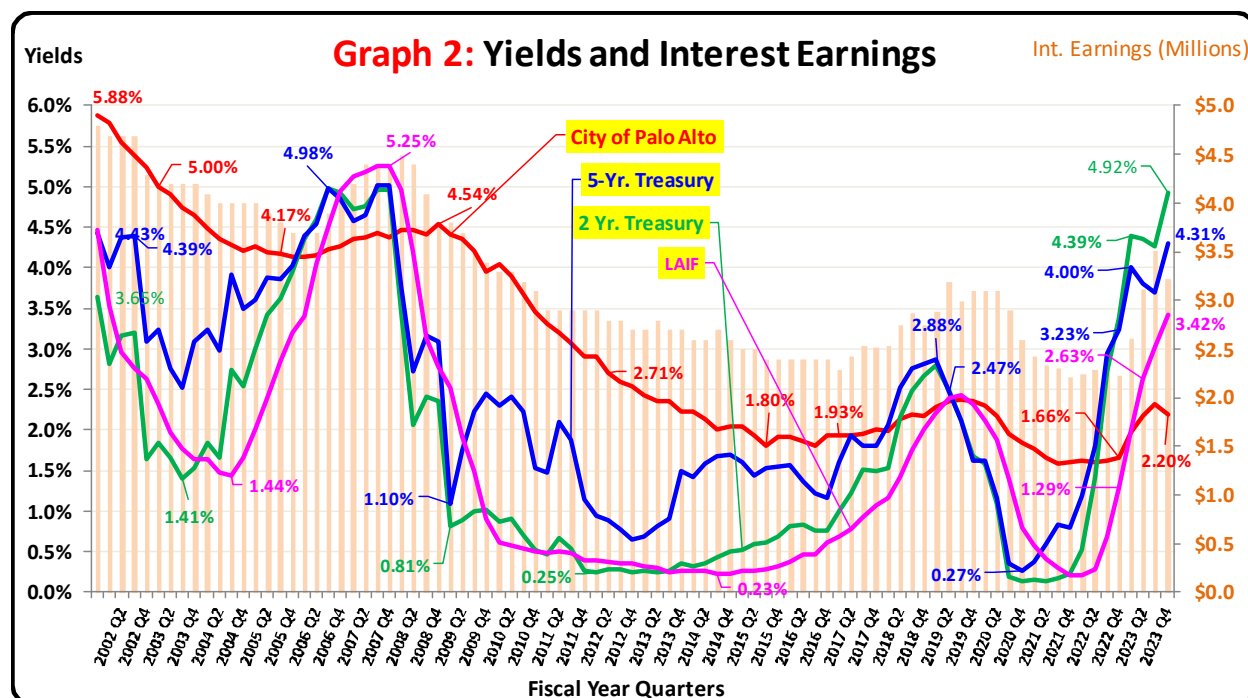
Compliance with City Investment Policy

During the fourth quarter, staff complied with all aspects of the Investment Policy. Attachment C lists the major restrictions in the City's Investment Policy compared with the portfolio's actual performance.

Investment Yields

Interest income on an accrual basis, for the General Fund, for the fourth quarter was \$3.5 million; compared to the prior year's first quarter of \$2.2 million or \$1.0 million higher than the prior year's quarter due to higher yield investment environment. As of September 30, 2023, the yield to maturity of the City's portfolio was 2.20%; in the prior quarter it was 2.31%. The lack of new security purchases in this quarter resulted in this lower yield. In the first quarter, LAIF's average yield was 3.42% while the average yield on the two-year and five-year Treasury bonds was approximately 4.92% and 4.31%, respectively. In comparison, in the prior quarter LAIF had 3.01% yield and the two-year and five-year Treasury bonds yields were higher at 4.26% and 3.69%.

Historically, the City's portfolio yield has outperformed the two-year and five-year Treasury bond rates and did so again several years ago; this is an expected occurrence during economic downturns. However, during economic recovery periods, interest rates rise, and the City's portfolio yield is expected to be lower, which is the current financial environment. As the City's laddered portfolio investments mature in the next year or two, funds will continue to be reinvested and trends will follow the economic patterns. Graph 2 shows the City's yields and interest earnings for the past 21+ years.



City's portfolio duration is 3.52 years.

Yield Trends

The Federal Open Market Committee (FOMC), since March 2020, has raised the federal funds rate 11 times totaling 5.25% with the first occurring on March 16, 2022. Prior to this the rate was near zero. To mitigate the persistent elevated inflation rate from the peak of 9.1% in June 2022 to a to 3.7% in September 2023 with a 2% target. There was a softer decline in energy prices primarily driven by a rebound in fuel prices, offset by slowing inflationary pressures in other categories like food, new vehicles, apparel, medical care commodities, and transportation services.

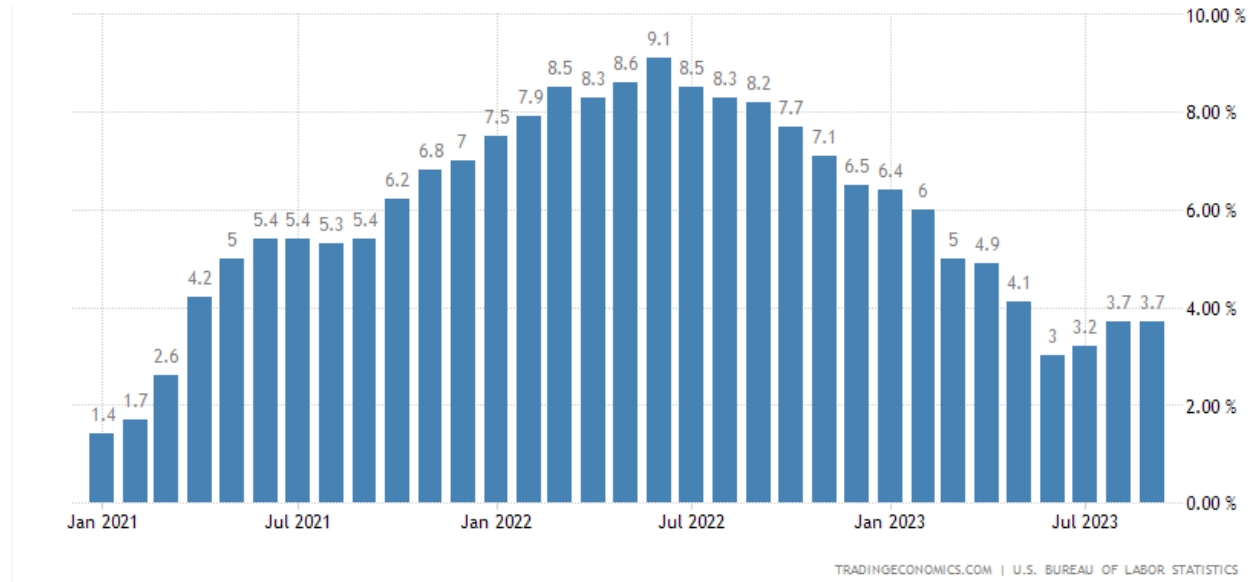
The expectation is FOMC might do one additional federal funds rate interest rate increase but ultimately that will depend on whether the inflation rate is still elevated above the target rate. The FOMC states "Recent indicators suggest that economic activity has been expanding at a solid pace. Job gains have slowed in recent months but remain strong, and the unemployment rate has remained low." Previously and currently, they had stated the U.S. banking system is sound

and resilient, tighter credit conditions are likely to weigh on economic activity, hiring, and inflation risks. FOMC’s are still firmly focused on further bringing down inflation.

The following tables show the U.S. inflation and unemployment rates and the U.S. Gross Domestic Product (GDP) past and recent trends.

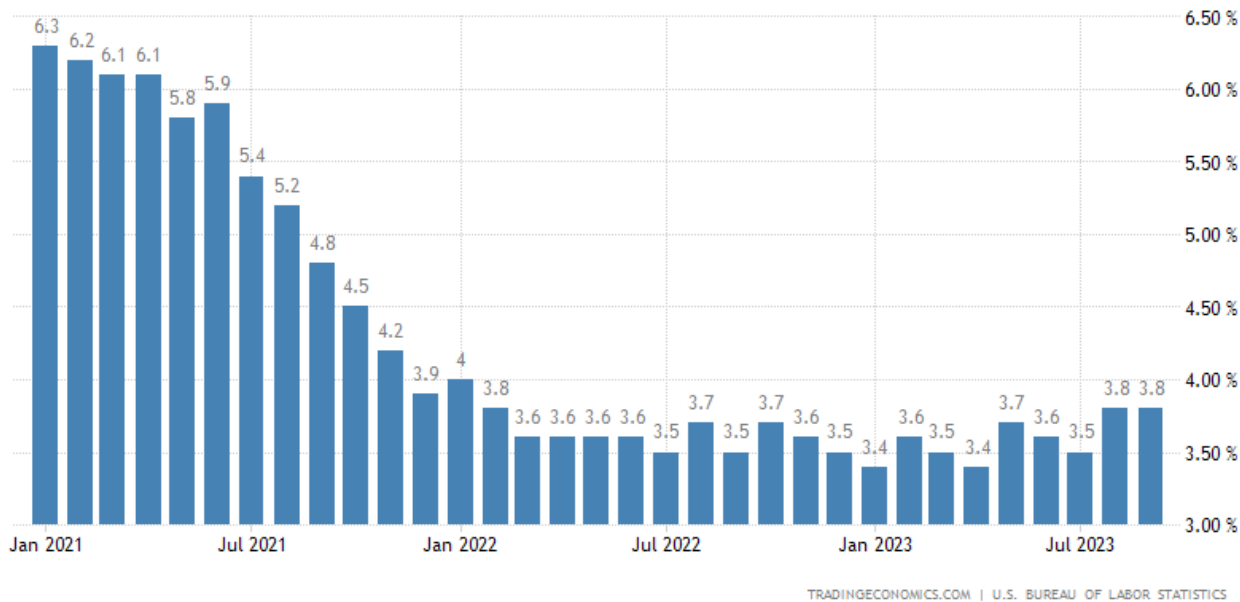
Graph 3: U.S. Inflation Rate

The annual inflation rate in the U.S. remained steady at 3.7% in September 2023, defying market expectations of a slight decrease to 3.6%.



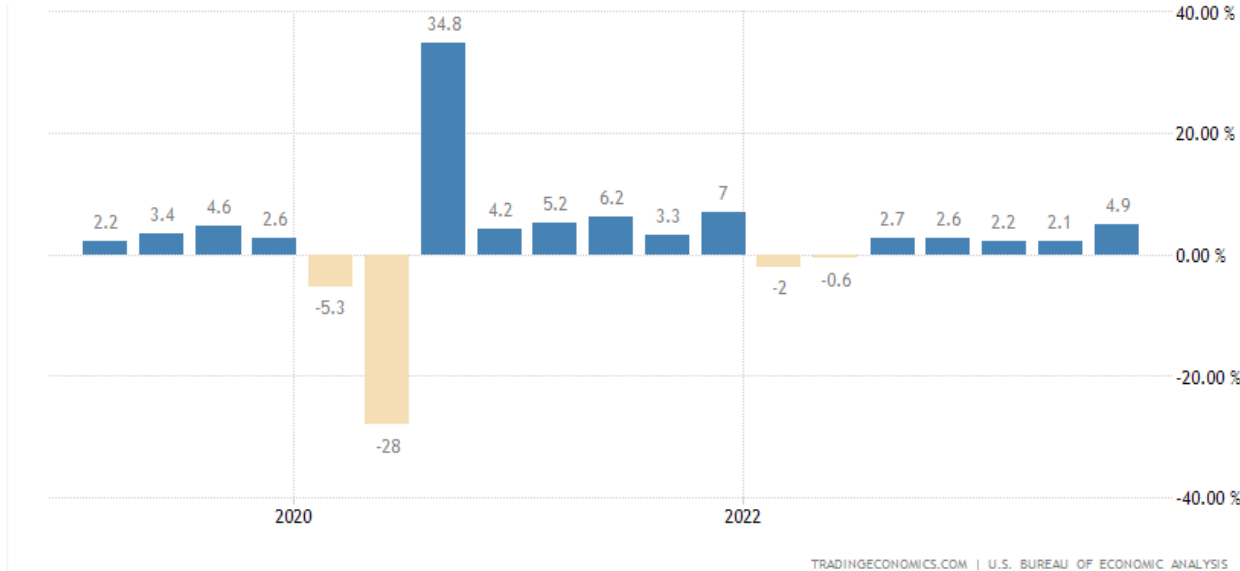
Graph 4: U.S. Unemployment Rate

The unemployment rate in the U.S. was 3.8% in September 2023. The jobless rate has fluctuated between 3.4 percent and 3.8 percent in calendar year 2023, indicating a consistently tight labor market.



Graph 5: U.S. Gross Domestic Product (GDP) Annual Growth Rate

The Gross Domestic Product (GDP) in the United States expanded an annualized 4.9% in the third quarter of 2023, up from 2.1 percent in the previous period.



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 US Bank and Wells Fargo. A description of the City's banking relationships can be found in City Council Staff Report ID # 7858⁷ and ID # 11402⁸. 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 September 30, 2023.

In January 2017, the City established a Section 115 Irrevocable Trust (Public Agencies Post-Employment Benefits Trust) administered by Public Agency Retirement Services (PARS). This fund is governed by the City's Retiree Benefit Policy as opposed to the Investment Policy; however, it is discussed in this report to present the full picture of the City's investments. It is the City's intent to prefund pension costs and began to address the Net Pension Liabilities (NPL) as calculated by Governmental Accounting Standards Board Pronouncement No. 68 (GASB 68). The Section 115 Trust offered by PARS has five portfolios from which to choose in making investments of City funds. In February 2023, the City Council revised the City's portfolio selection from "Moderately Conservative" to "Moderate", shifting from the second most conservative to third. Additional information on the establishment of this trust can be found in City Council Staff Report ID # 7553⁹. Through September 30, 2023, principal investment contributions of \$54.4 million made over time since May 2017, has increased to \$56.4 million or by \$2.0 million and the net return for one and five years has been 7.6% and 2.8% respectively. Since inception, \$2.5 million net earnings have been realized with \$0.56 million in administrative expenses.

FISCAL/RESOURCE IMPACT

This is an information report.

STAKEHOLDER ENGAGEMENT

Staff works internally and with external parties (U.S. Bank's custodial, U.S. Bank's bonds, Wells Fargo and U.S. Bank's banking, California Asset Management Program (CAMP), and Public Agency Retirement Services (PARS)) statements to prepare this report.

ENVIRONMENTAL REVIEW

This Council informational report is not a project under California Environmental Quality Act (CEQA) as defined in CEQA Guidelines, section 15378, because it has no potential for resulting in either a direct or reasonably foreseeable indirect physical change in the environment.

ATTACHMENTS

Attachment A: Consolidated Report of Cash Management

Attachment B: Investment Portfolio

Attachment C: Investment Portfolio Compliance

APPROVED BY:

Kiely Nose, Assistant City Manager

¹ City of Palo Alto website, Administrative Services Department, Money Management & Treasury: [Microsoft Word - Proposed City of Palo Alto Investment Policy - Fiscal Year 2023-24.doc](#)

² City Council, August 8, 2022 Item #9, CMR 13998: <https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20220808/20220808pccsm-amended-rev-final1.pdf#page=134>

³ City Council, November 7, 2022 Item #13, CMR 14001: <https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/agendas-minutes/city-council-agendas-minutes/2022/20221107/20221107pccsm-amended-linked-q.a-2.pdf#page=188>

⁴ City Council, February 13, 2023, Item #10, CMR 2301-0865: <https://cityofpaloalto.primegov.com/Portal/Meeting?meetingTemplateId=1073>

⁵ City Council, May 8, 2023, Item #9, CMR 2212-0520: <https://cityofpaloalto.primegov.com/Portal/Meeting?meetingTemplateId=11197>

⁶ City Council, May 8, 2023, Item #18, CMR 2307-1783: <https://cityofpaloalto.primegov.com/Portal/Meeting?meetingTemplateId=12606>

⁷ City Council, April 11, 2017, under “Additional Information”, CMR 7858: <https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2017/7858.pdf>

⁸ City Council, September 21, 2020 Item #2, CMR 11402: <https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2020-2/id-11402.pdf>

⁹ City Council, January 23, 2017 Item #5, CMR 7553: <https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2017/7553.pdf>