



CITY OF
**PALO
ALTO**

City Council Staff Report

From: City Manager

Report Type: INFORMATION REPORTS

Lead Department: Administrative Services

Meeting Date: February 24, 2025

Report #:2411-3790

TITLE

Investment Activity Report for the Second Quarter, Fiscal Year 2025

RECOMMENDATION

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

EXECUTIVE SUMMARY

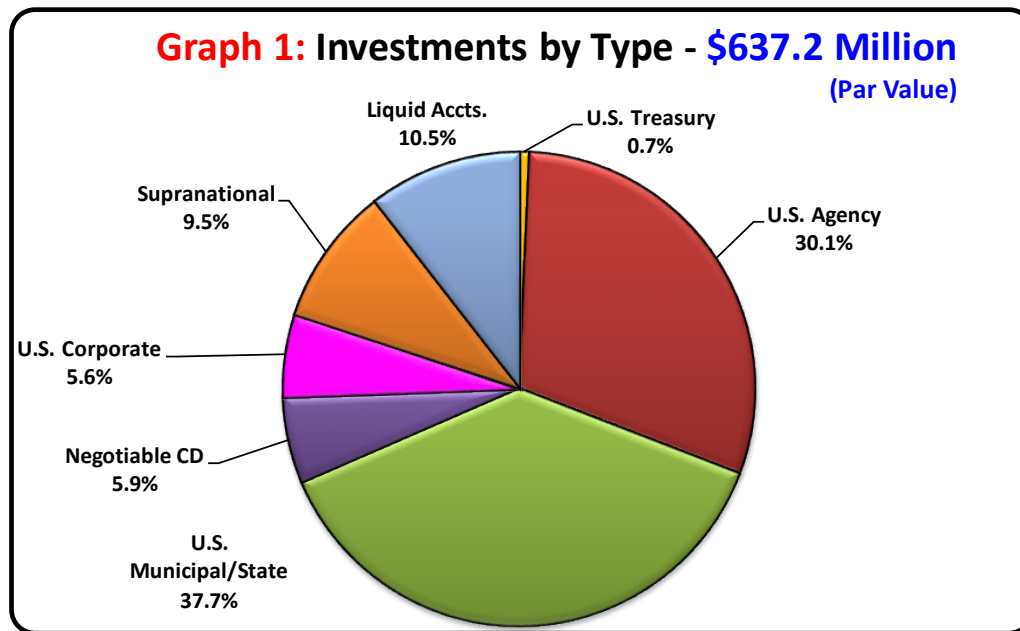
The City's Investment Policy¹ (Policy) requires that staff report to Council quarterly on the City's portfolio composition and performance compared to the Council-adopted Policy; discuss overall compliance with the City's Investment Policy; and provide recommendations, if any, for Policy changes. In 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 second quarter ending December 31, 2024 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 second quarter staff complied with all aspects of the Investment Policy and no significantly notable activity or changes in value occurred in this reporting period.

No impacts from the change in the Federal administration are reflected in this quarterly report, as investments pre-date the new administration. Staff continually monitors financial and economic impacts from the change in Federal administration and will address impacts, if any, as they arise. This report does however, per the City's Investment Policy, disclose rating downgrades results from the southern California wildfires (see "Compliance with Investment Policy" section of this report).

¹ City of Palo Alto website, Administrative Services Department, Money Management & Treasury:
<https://www.cityofpaloalto.org/files/assets/public/v/1/administrative-services/investment-policies/adopted-investment-policy-1-39-asd.pdf>

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.



The par value of the City's portfolio is \$637.2 million; in comparison, last quarter it was \$595.6 million. The \$41.6 million portfolio growth since the last quarter results from timing of cash flows, from the July 2024 prepayment of the City's Fiscal Year 2025 Unfunded Accrued Liability (UAL) pension cost for active employees to the Public Employers' Retirement System (PERS) (\$47.2 million) and major revenue receipt due to seasonality timing.

Prepayment of the PERS UAL results in \$0.6 million net Citywide pension expense savings. Regarding timing of major revenue receipts, property taxes and related receipts begin in the second quarter; for example, second quarter property related (taxes and assessments) receipts were \$21.6 million. Other major revenues such as sales, transient occupancy and utility user's taxes are historically lower in the first quarter.

The portfolio consists of \$66.7 million in liquid accounts and \$570.5 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 \$237.8 million in investments maturing in less than two years, comprising 37.3% 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 25.8% of the portfolio.

Table 1: Investment Type	FY 2025 Q2 Maturities - Par Value (millions)						
	Up to 1 Year	1 to 2 Years	2 to 3 Years	3 to 5 Years	Over 5 Years	Portfolio Total *	% of Portfolio
U.S. Treasury	\$ 1.5	\$ 3.0	\$ -	\$ -	\$ -	\$ 4.5	0.7%
U.S. Agency Bonds	54.9	20.2	8.6	13.4	94.9	192.0	30.1%
U.S. Municipal/ State Bonds	29.5	58.4	34.2	50.3	68.0	240.4	37.7%
Negotiable Certificates of Deposits (NCD)	11.6	6.2	8.2	10.2	1.2	37.4	5.9%
U.S. Corporate Bonds	12.8	4.7	13.4	5.0	-	35.9	5.6%
Supranational Organizations Bonds	8.0	27.0	6.0	19.3	-	60.3	9.5%
Liquid Accounts (LAIF & Fidelity)	66.7	-	-	-	-	66.7	10.5%
Grand Total	\$ 185.0	\$ 119.5	\$ 70.4	\$ 98.2	\$ 164.1	\$ 637.2	100%
% of Portfolio	29.0%	18.8%	11.0%	15.4%	25.8%	100.0%	

* \$120.3 million or 18.9% are in investments that support Environmental, Social, and Governance (ESG) Activities (aka "Green", local banks, and Supranational Bonds)

The current market value of the portfolio is 95.1% of the book value. The market value of securities fluctuates, depending on how interest rates perform.

As interest rates decrease, the market value of the City's portfolio will likely increase, and vice versa. There are inherent principal risks when actively buying and selling securities; reporting on market values a reporting requirement that informs staff of the portfolio's overall position. The market valuation is provided by U.S. Bank, the City's safekeeping agent. The average life to maturity of the investment portfolio is 2.95 years compared to 2.94 years last quarter.

To minimize investment principal risk of loss 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 at or above the market value.

Investments Activity During the Second Quarter

During the second quarter, \$17.7 million of securities with an average yield of 3.8% matured. During the same period, per the following Table 2, securities totaling \$48.7 million with an average yield of 4.4% were purchased. The interest rates rose on new investments, the City's portfolio's average yield also rose. The City's short-term money market and pool account increased by \$10.6 million compared to the first quarter of FY 2024. Staff continually monitors the City's short-term cash flow needs and adjusts liquid funds to meet them.

Per California Government Code Section 53607, the Administrative Services Department provides a monthly report of transactions (investments, reinvestment, sold, and exchanged securities) to Council via a separate report. Though not required by this code, included in this report are security maturities and cash movement activity in the City's two liquid operating cash pool accounts (Local Agency Investment Fund and Fidelity accounts). Monthly and

quarterly investment reports, along with the City’s Investment Policy, can be found on the City’s website².

Table 2: Investment Type	FY 2025 Q2 Security Purchases - Par Value (millions)						
	Up to 1 Year	1 to 2 Years	2 to 3 Years	3 to 5 Years	Over 5 Years	Portfolio Total *	% of Purchase
U.S. Agency Bonds	\$ -	\$ 1.0	\$ -	\$ 1.5	\$ 16.9	\$ 19.4	35.5%
U.S. Municipal/ State Bonds	-	-	-	2.8	6.1	8.9	16.3%
Negotiable Certificates of Deposits (NCD)	0.7	1.0	1.0	1.7	0.3	4.7	8.6%
U.S. Corporate Bonds	-	-	2.9	5.0	-	7.9	14.4%
Supranational Organizations Bonds	-	-	-	13.8	-	13.8	25.2%
Grand Total	\$ 0.7	\$ 2.0	\$ 3.9	\$ 24.8	\$ 23.3	\$ 54.7	100%
% of Purchase	1.3%	3.7%	7.1%	45.3%	42.6%	100.0%	

* \$18.0 million or 32.8% are in investments that support Environmental, Social, and Governance (ESG) Activities (aka "Green", local banks, and Supranational Bonds)

Availability of Funds 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.

Projections indicate that for the City’s cashflow, an overall growth in the portfolio of \$25.6 million is expected over the coming six months due to routine business activities. This reflects expected receipts of \$371.8 million and expenditures of \$346.2 million over the next six months.

As of December 31, 2024, the City had \$66.7 million deposited in the Local Agency Investment Fund (LAIF) and a money market account. In addition, investments totaling \$28.6 million will mature between January 1, 2025 and June 30, 2025.

Compliance with City Investment Policy

During the second 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.

The City’s Investment Policy requires new such security purchases to be rated AA or better and “If securities owned by the City are downgraded by Moody’s, Fitch, or Standard & Poor’s to a level below AA or Aa2, it shall be the City’s policy to review the credit situation and make a determination as to whether to sell or retain such securities in the portfolio.” The Southern California wildfires (Palisades and Eaton fires) have resulted in rating downgrades of the Los Angeles Department of Water & Power (LADWP) to “A” by Standard and Poor’s, Moody’s still

² City of Palo Alto, Administrative Services, Financial Reporting, City Investment Reports and Policy:
www.cityofpaloalto.org/investmentreporting

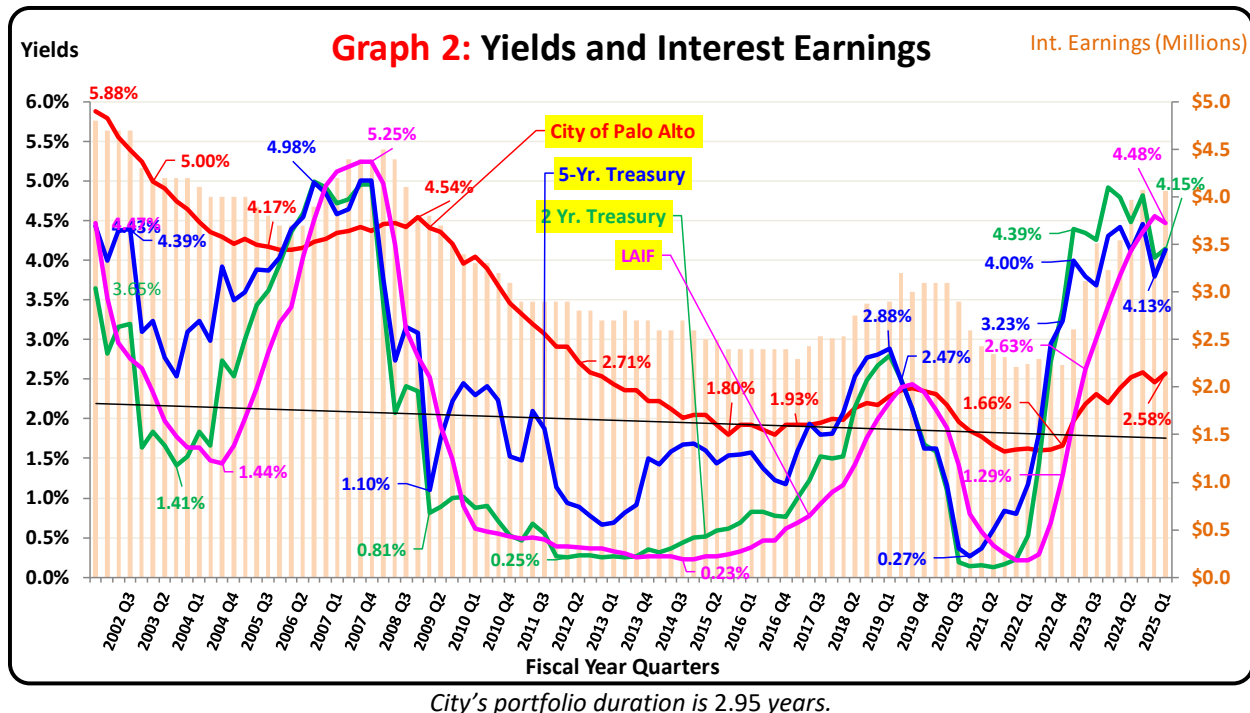
maintains its “Aa2”, and Fitch is at “AA-” with a negative credit watch by all three rating firms meaning further rating downgrade(s) could occur. The City’s investment portfolio has \$1.9 million in LADWP bonds with a remaining maturity duration of 2.4 years. LADWP potential issues revolve around lack of water supply and working hydrants and possibility of fires starting by downed power lines. Based on staff’s analysis, the likelihood of a loss of these investments is low so these investments should be retained.

In addition, the City of Los Angeles rating was also downgraded and is on a negative credit watch by the three rating agencies. The City’s \$5.4 million of securities in the City’s portfolio still have a rating of AA and are within the City’s Investment Policy guideline. The City’s portfolio does own other municipalities securities in the area whose ratings has not been impacted by this, but staff will actively monitor all these entities ratings and potential liability developments with the assistance of the City’s brokers.

Investment Yields

Interest income on an accrual basis, for the second quarter was \$4.1 million; compared to the prior year’s second quarter of \$3.5 million, \$0.6 million higher due to prudent long-term investments made in the last several years during the higher interest rate environment. As of December 31, 2024, the yield to maturity of the City’s portfolio was 2.58%; in the prior quarter it was 2.46%. In the second quarter, LAIF’s average yield was 4.48% while the average yield on the two-year and five-year Treasury bonds was approximately 4.15% and 4.13%, respectively. In comparison, in the prior quarter LAIF had higher 4.56% yield and the two-year and five-year Treasury bonds yields were lower at 4.03% and lower at 3.79%.

The City’s portfolio yield is lower than the two-year and five-year Treasury bond due to the fluctuating but still high interest rates environment. It is expected that as the City’s investments mature in the next few years, funds will continue to be reinvested and will follow the economic patterns. Graph 2 shows the City’s yields and interest earnings for the past 22+ 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. Then beginning July 31, 2024, they decreased the rate four times totaling 1.25%. In the January 2025, the Federal Reserve kept interest rates unchanged.

In January 2025, the FOMC held interest rate in the range of 4.25% to 4.50%. The cited reasons where the “recent indicators suggest that economic activity has continued to expand at a solid pace. The unemployment rate has stabilized at a low level in recent months, and labor market conditions remain solid. Inflation remains somewhat elevated.”

At their press conference they stated there is maximum employment and stable prices, economy is strong, labor conditions have cooled, inflation has moved towards their goals but remains elevated, resilient spending, investments has slowed but remained solid during 2024, nominal wage growth has slowed down and does pose a risk to Fed’s inflation target, and Fed is not in a hurry to continue to lower interest rates at this time, however, if inflation starts to increase and employment weakens considerably that could change this outlook.

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 #2404-2845³. The bond proceeds, reserves, and debt service payments

³ City Council, June 17, 2024, <https://portal.laserfiche.com/Portal/DocView.aspx?id=73964&repo=r-704298fc>

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 December 31, 2024.

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 #7553⁴. Through December 31, 2024, principal investment contributions of \$76.8 million made over time since May 2017, has increased to \$93 million and the net return for one and five years has been 11.5% and 5.1% respectively. Since inception, \$17.1 million net earnings have been realized with \$0.9 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.

⁴ City Council, January 23, 2017 Item #5, CMR 7553:

<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmr/year-archive/2017/7553.pdf>

ATTACHMENTS

Attachment A: Consolidated Report of Cash Management

Attachment B: Investment Portfolio

Attachment C: Investment Portfolio Compliance

APPROVED BY:

Lauren Lai, Administrative Services Director