



## CITY COUNCIL STAFF REPORT

**From: City Manager**

**Report Type: Action**

**Lead Department: Administrative Services**

**Meeting Date: May 8, 2023**

**Report #: 2212-0520**

### **TITLE**

Investment Activity Report for the Third Quarter, Fiscal Year 2023

### **RECOMMENDATION**

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

### **EXECUTIVE SUMMARY**

The City's Investment Policy<sup>1</sup> (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 third quarter ending March 31, 2023 and to disclose staff's cash flow projections for the next six months. The portfolio details, activities, and performance are discussed below, and additional information is provided in the attachments.

During the third quarter staff complied with all aspects of the Investment Policy. Staff expect that the City will have sufficient funds or liquidity to meet expenditure requirements for the next six months.

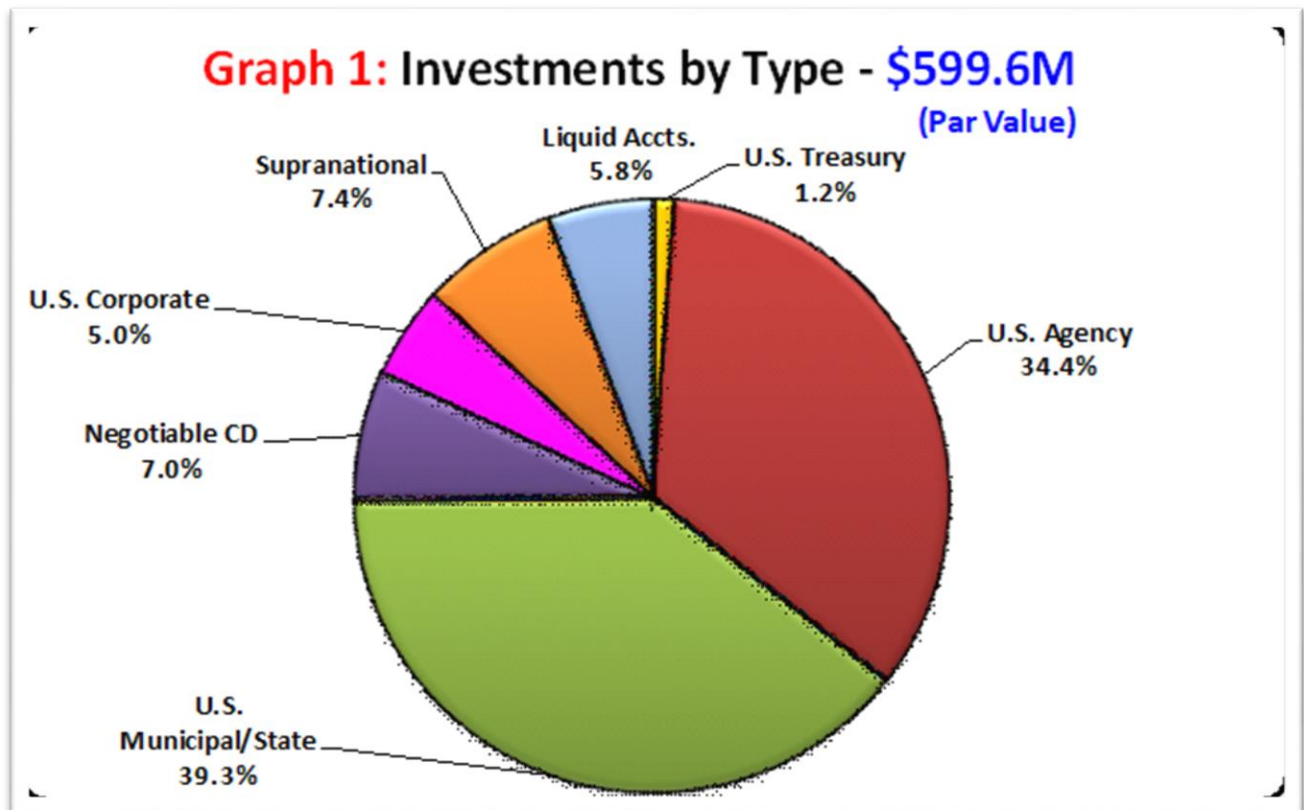
Given the recent news in the banking industry, the Analysis section of this report includes information regarding the City's banking relationships for its cash balances.

---

<sup>1</sup> City of Palo Alto website, Administrative Services Department, Money Management & Treasury:  
<https://www.cityofpaloalto.org/files/assets/public/administrative-services/investment-policies/adopted-investment-policy-2022-23.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.



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

The par value of the City's portfolio is \$599.6 million; in comparison, last quarter it was \$579.3 million. The \$20.2 million portfolio growth since the last quarter results from timing of cash flows from the prepayment of the City's Fiscal Year 2023 Unfunded Accrued Liability (UAL) pension cost for active employees to the Public Employers' Retirement System (PERS) totaling \$43.1 million and additional major revenue receipt due to seasonality timing. By prepaying PERS instead of making payments with each payroll period, the City expects savings of \$1.5 million in PERS payments; however, this savings will be partially offset by the loss of approximately \$333 thousand in interest income in the City's portfolio. The net citywide savings of prepaying the UAL cost is \$1.2 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, an additional \$12 million in UAL payment would have been made in the second

quarter; this payment was made in first quarter's prepayment. As far as additional major revenue receipt due to seasonality timing, property taxes and related receipts don't begin until the second and third quarters and major revenues such as sales, transient occupancy and utility user's taxes are historically higher in the third quarter. For example, second quarter property related (taxes and assessments) receipts were \$19.8 million.

The portfolio consists of \$34.5 million in liquid accounts and \$565.1 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 \$96.4 million in investments maturing in less than two years, comprising 16.1% 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 29.6% of the portfolio.

<b>Table 1:</b>  Investment Type	FY 2023 Q3 Maturities - Par Value (millions)						% of Portfolio
	Up to 1 Year	1 to 2 Years	2 to 3 Years	3 to 5 Years	Over 5 Years	Portfolio Total *	
U.S. Treasury	\$ -	\$ 2.5	\$ 3.0	\$ 1.5	\$ -	\$ 7.0	1.2%
U.S. Agency Bonds	19.4	10.4	64.6	19.6	92.3	206.3	34.4%
U.S. Municipal/ State Bonds	12.4	21.5	28.6	90.6	82.4	235.5	39.3%
Negotiable Certificates of Deposits (NCD)	9.9	11.9	6.9	10.5	2.7	41.9	7.0%
U.S. Corporate Bonds	3.4	3.0	14.0	9.5	-	29.9	5.0%
Supranational Organizations Bonds	1.0	1.0	26.5	16.0	-	44.5	7.4%
Liquid Accounts (LAIF & Fidelity)	34.5	-	-	-	-	34.5	5.8%
<b>Grand Total</b>	<b>\$ 80.6</b>	<b>\$ 50.3</b>	<b>\$ 143.6</b>	<b>\$ 147.7</b>	<b>\$ 177.4</b>	<b>\$ 599.6</b>	<b>100%</b>
<b>% of Portfolio</b>	<b>13.4%</b>	<b>8.4%</b>	<b>23.9%</b>	<b>24.6%</b>	<b>29.6%</b>	<b>100.0%</b>	

\* \$98.2 million or 16.4% 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 89.6% 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 until they mature so changes in market price do not affect the City's investment principal. As a result, there is no risk of principal loss due to the declining market value. 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 3.80 years compared to 3.87 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 fact 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 three quarters the market value fell below 95%; it was 93.5% in the fourth quarter of fiscal year 2022 (CMR 13998<sup>2</sup>), 89.7% in the first quarter of fiscal year 2023 (CMR 14001<sup>3</sup>), and 90.7% in the second quarter of fiscal year 2023 (CMR 2301-0865<sup>4</sup>). The market rate decreased an additional one percentage points \_ this third quarter to 89.6% of book value. Though the total portfolio’s market value is below book value, \$61.8 million in par value of securities are at or above market value. Interest rates on new investments have begun to decrease so the market value of the portfolio is expected to increase 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.

#### Investments Made During the Third Quarter

During the third quarter, \$27.0 million of securities with an average yield of 2.5% matured. During the same period, per the following Table 2, securities totaling \$43.5 million with an average yield of 4.7% were purchased. As expected, 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 \$3.7 million compared to the second quarter of Fiscal Year 2022. Staff continually monitors the City’s short-term cash flow needs and adjusts liquid funds to meet them.

---

<sup>2</sup> 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>

<sup>3</sup> 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>

Table 2: Investment Type	FY 2023 Q3 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. Treasury	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	0.0%
U.S. Agency Bonds	6.2	-	-	1.5	3.0	10.7	24.6%
U.S. Municipal/ State Bonds	-	0.3	2.2	11.3	4.6	18.4	42.3%
Negotiable Certificates of Deposits (NCD)	2.5	3.5	1.2	2.7	0.2	10.1	23.2%
U.S. Corporate Bonds	-	-	-	2.8	-	2.8	6.4%
Supranational Organizations Bonds	-	-	-	1.5	-	1.5	3.4%
<b>Grand Total</b>	<b>\$ 8.7</b>	<b>\$ 3.8</b>	<b>\$ 3.5</b>	<b>\$ 19.8</b>	<b>\$ 7.8</b>	<b>\$ 43.5</b>	<b>100%</b>
<b>% of Purchase</b>	<b>20.0%</b>	<b>8.7%</b>	<b>8.0%</b>	<b>45.5%</b>	<b>17.9%</b>	<b>100.1%</b>	

\* \$12.4 million or 28.5% 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

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 decline in the portfolio of \$32.7 million is expected over the coming six months due to routine business activities. This reflects expected receipts of \$334.2 million and expenditures of \$366.9 million over the next six months.

The expected decline in the portfolio is attributable to pre-paying a portion of the Fiscal Year 2024 Public Employers' Retirement System's (PERS) employer contribution of \$41.6 million, representing the City's unfunded accrued liability (UAL) lump-sum prepayment for FY 2024. By prepaying PERS instead of making payments with each payroll period, the City is expected to save \$1.4 million in pension expense; the savings will be offset by the loss of approximately \$0.8 million in interest income in the City's investment portfolio. This results in net citywide savings of \$0.6 million because PERS has the ability to earn interest earlier and at a higher rate than the City could realize.

As of March 31, 2023, the City had \$34.4 million deposited in the Local Agency Investment Fund (LAIF) and a money market account that could be withdrawn on a daily basis. In addition, investments totaling \$36.3 million will mature between April 1, 2023 and September 30, 2023. Also, the City will soon receive \$24 million in damages awarded through a lawsuit that established that the Bureau of Reclamation overcharged the City for hydroelectric power for 28 years. The U.S. Court of Appeals ordered the federal government to issue refunds to power purchasers to compensate for the overcharges. Based on the above, staff expect that the City will have sufficient funds or liquidity to meet expenditure requirements for the next six months.

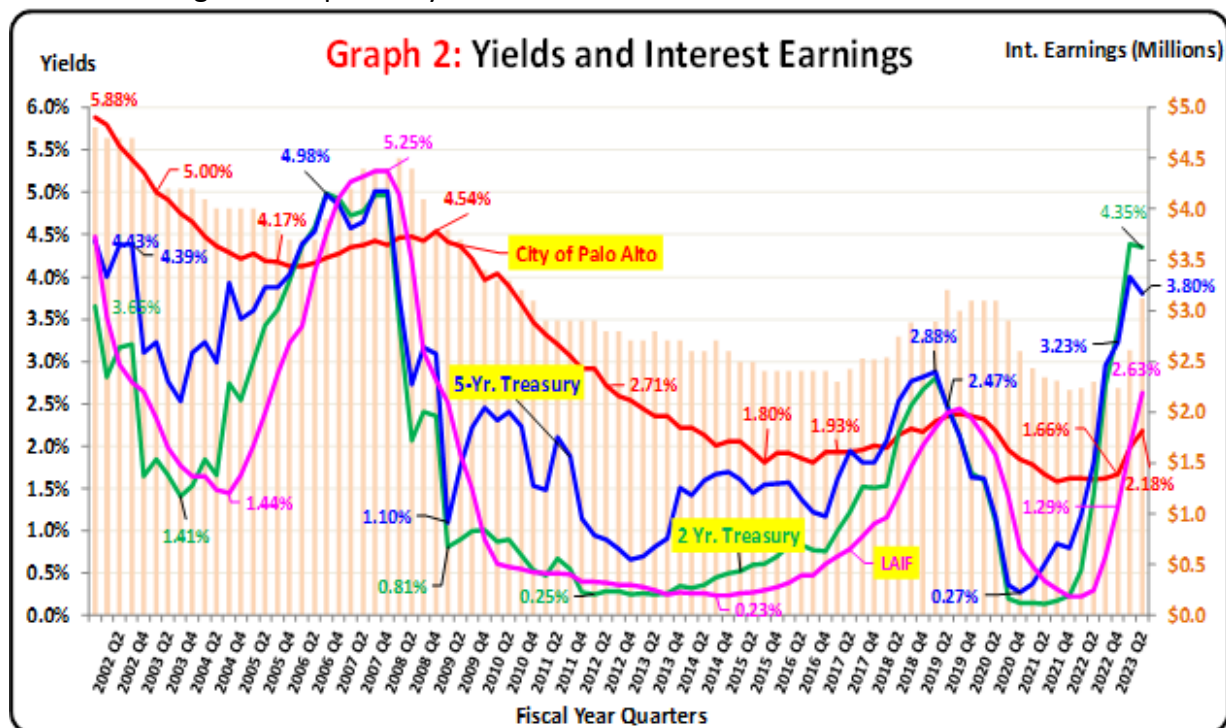
### Compliance with City Investment Policy

During the third 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 third quarter was \$3.1 million; \$0.5 million higher than the prior quarter due to new higher yielding investments in the portfolio. As of March 31, 2023, the yield to maturity of the City's portfolio was 2.18%; in the prior quarter it was 1.97%. In the third quarter, LAIF's average yield was 2.63% while the average yield on the two-year and five-year Treasury bonds was approximately 4.35% and 3.80%, respectively. In comparison, in the prior quarter LAIF had 1.98% yield and the two-year and five-year Treasury bonds yields were higher at 4.39% and 4.0%.

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 3.80 years.



### Yield Trends

The Federal Open Market Committee (FOMC), since March 2020, has raised the federal funds rate nine times totaling 4.75% 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 to a low 5% in April 2023 with a 2% target. The primary cause of declining inflation rate is falling energy and transportation prices.

The expectation is FOMC will continue to do additional federal funds rate interest rate increases in 2023 but at a slower pace. This is due to the inflation rate failing to come down as quickly as the FOMC had hoped in the past few quarters. While the FOMC states “The U.S. banking system is sound and resilient,” they are mindful that rising borrowing costs will elevate stress to the banking system. Consistent with the prior four quarters, job growth remains “robust” and unemployment rate remains low, however, FOMC’s are firmly focused on 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. slowed for the ninth consecutive period to 5% in March 2023, the lowest since May 2021 which is below market forecasts. Food prices grew at a slower rate and energy cost fell while prices for used cars and trucks declined.



#### Graph 4: U.S. Unemployment Rate

The unemployment rate in the U.S. edged down to 3.5% in March 2023 which is slightly below expectation.



#### Graph 5: U.S. Gross Domestic Product (GDP)

The Gross Domestic Product (GDP) in the United States expanded 0.90% in the fourth (calendar) quarter of 2022 over the same quarter of the previous year.



**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 # 7858<sup>4</sup> and ID # 11402<sup>5</sup>. 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, 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 not governed by the City's 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. The City has selected the "Moderately Conservative" portfolio which is the second most conservative. Additional information on this trust can be found in City Council [Staff Report ID # 7553](#)<sup>6</sup>. Through March 31, 2023, principal investment contributions of \$45.3 million made over time since May 2017, has slightly increased to \$47.5 million or by \$2.2 million and the net return for one and five years has been -3.8% and 3.2% respectively. Since inception, \$2.6 million net earnings have been realized with \$0.4 million in administrative expenses.

#### City's Banking Relationships

Cash in bank balances (U.S. Bank and Wells Fargo) are maintained with a \$3-5 million balance range to cover recurring activity (A/P, payroll, investment purchases, etc.). These cash accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000 each; balances beyond the FDIC insured amounts are collateralized under California law. California law requires banks to deposit securities as collateral with the State Treasurer valued at 110% of the amount beyond the FDIC insurance for public deposits. Both U.S. Bank and Wells Fargo meet these

---

<sup>4</sup> City Council, April 11, 2017, under "Additional Information":

<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmr/year-archive/2017/7858.pdf>

<sup>5</sup> City Council, September 21, 2020 Item #2:

<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmr/year-archive/2020-2/id-11402.pdf>

<sup>6</sup> City Council, January 23, 2017 Item #5:

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

requirements. LAIF, a State of California run program, and Fidelity's Money Market Treasury Portfolio mutual fund (triple A rated). Each of the City's investments in negotiable certificate of deposits (NCD) are under \$250,000, therefore are fully FDIC or the credit union bank equivalent insured.

#### **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

#### **ATTACHMENTS**

Attachment A: Consolidated Report of Cash Management

Attachment B: Investment Portfolio

Attachment C: Investment Policy Compliance

#### **APPROVED BY:**

Kiely Nose, Assistant City Manager