



City Council Staff Report

From: City Manager

Report Type: INFORMATION REPORTS

Lead Department: Administrative Services

Meeting Date: August 7, 2023

Report #:2307-1783

TITLE

Investment Activity Report for the Fourth Quarter, Fiscal Year 2023

EXECUTIVE SUMMARY

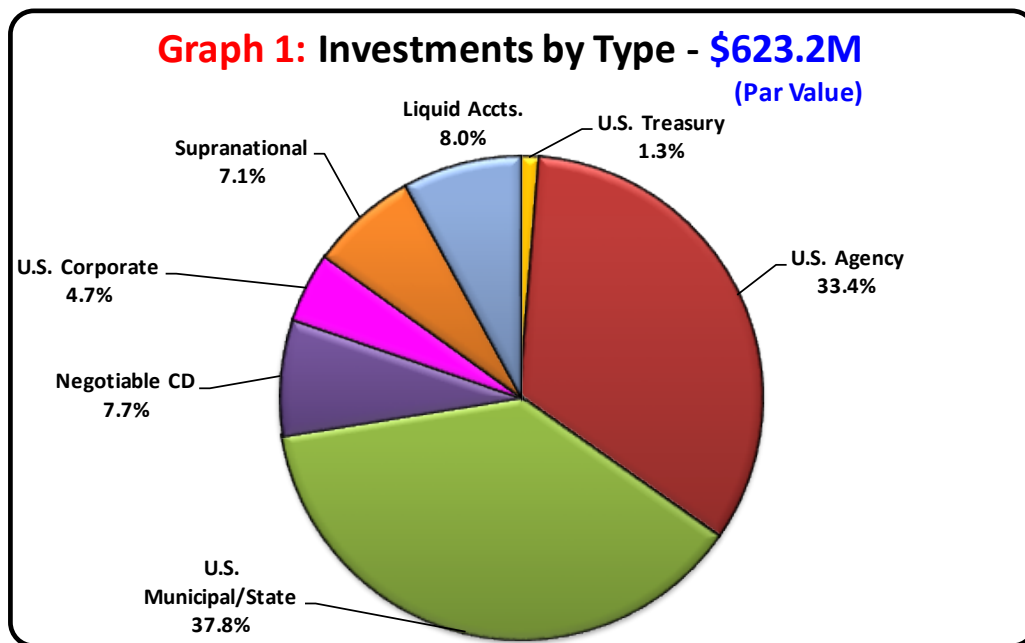
The City's [Investment Policy](#)¹ (Policy) requires that staff report to Council quarterly on the City's portfolio composition and ¹performance compared to the Council-adopted Policy; discuss overall compliance with the City's Investment Policy; and provide recommendations, if any, for Policy changes. 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 fourth quarter ending June 30, 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. The report includes a discussion of the sale of investments prior to maturity, which occurred in July 2023 to potentially mitigate higher than expected cash flow needs under a worst-case projection model; sale of the securities resulted in a principal gain of \$42,405.

During the fourth 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.

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.

¹ 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>



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

The par value of the City's portfolio is \$623.2 million; in comparison, last quarter it was \$599.6 million. The \$23.6 million portfolio growth since the last quarter results from expected and typical timing of cash flows and a legal resolution relating to the City's Electric Utility. The federal government (via Bureau of Reclamation) agreed and refunded Palo Alto \$23.9 million for overcharging on electricity for hydroelectric power for 28 years. Other factors include property tax receipts including Excess ERAF (Education Revenue Augmentation Funds) totaling \$28.8 million. These sources are partially offset by higher expenditures like Wastewater Treatment primary sedimentation tank Rehabilitation & equipment room electrical upgrade and secondary treatment upgrades projects. Though some of these expenditures are reimbursed by loans such as from the State Revolving Loan Funds, there is a timing difference when the funds are spent and when loan reimbursements are received. This timing difference is expected to impact and constrain the City's cash position and will be monitored closely as capital work continues to increase at the Wastewater Treatment Plant.

The portfolio consists of \$49.6 million in liquid accounts and \$573.6 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 \$109.0 million in investments maturing in less than two years, comprising 17.5% 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 28.1% of the portfolio.

Table 1: Investment Type	FY 2023 Q4 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	\$ 2.5	\$ 1.0	\$ 3.0	\$ 1.5	\$ -	\$ 8.0	1.3%
U.S. Agency Bonds	20.3	6.4	65.1	21.1	95.4	208.3	33.4%
U.S. Municipal/ State Bonds	10.5	29.7	35.8	81.6	77.8	235.4	37.8%
Negotiable Certificates of Deposits (NCD)	11.4	14.4	6.4	13.7	2.2	48.1	7.7%
U.S. Corporate Bonds	4.3	6.5	9.0	9.5	-	29.3	4.7%
Supranational Organizations Bonds	1.0	1.0	32.0	10.5	-	44.5	7.1%
Liquid Accounts (LAIF & Fidelity)	49.6	-	-	-	-	49.6	8.0%
Grand Total	\$ 99.6	\$ 59.0	\$ 151.3	\$ 137.9	\$ 175.4	\$ 623.2	100%
% of Portfolio	16.0%	9.5%	24.3%	22.1%	28.1%	100.0%	

* \$99.7 million or 17.2% 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 91.9% 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. The City's practice is to buy and hold investments until they mature so changes in market price do not typically impact the City's investment principal. Should the City find necessity to sell securities prior to maturity, such as in July 2023, securities are analyzed to ensure the City mitigates or eliminate any loss to the portfolio as a result of securities sold. As a result, there is minimal 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 3.57 years compared to 3.80 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 four quarters the market value fell below 95%; it was 93.5% in the fourth quarter of fiscal year 2022 ([CMR 13998²](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)), 89.7% in the first ([CMR](#)

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>

[14001³](#)), 90.7% in the second (CMR 2301-0865⁴), and 89.6% in the third quarters of fiscal year 2023 ([CMR 2212-0520⁵](#)).

The market rate slightly improved this third quarter to 91.9% of book value. Though the total portfolio's market value is below book value, \$38.7 million in par value of securities are at or above market 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 and, if needed, only sell security that are above the market value.

Matured Investments and Purchases During the Fourth Quarter

During the fourth quarter, \$11.4 million of securities with an average yield of 3.1% matured. During the same period, per the following Table 2, securities totaling \$20.0 million with an average yield of 5.2% 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 \$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 on a daily basis as needed to meet them.

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>

Table 2: Investment Type	FY 2023 Q4 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	\$ 1.00	\$ -	\$ -	\$ -	\$ -	\$ 1.00	5.0%
U.S. Agency Bonds	-	-	-	-	7.0	7.0	35.0%
U.S. Municipal/ State Bonds	-	1.0	-	0.7	2.1	3.8	19.0%
Negotiable Certificates of Deposits (NCD)	1.5	3.5	0.2	3.0	-	8.2	41.0%
U.S. Corporate Bonds	-	-	-	-	-	-	0.0%
Supranational Organizations Bonds	-	-	-	-	-	-	0.0%
Grand Total	\$ 2.5	\$ 4.5	\$ 0.2	\$ 3.7	\$ 9.1	\$ 20.0	100%
% of Purchase	12.5%	22.5%	1.0%	18.5%	45.5%	100.0%	

* \$9.6 million or 33.9% 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 \$26.1 million is expected over the coming six months due to routine business activities. This reflects expected receipts of \$330.3 million and expenditures of \$356.4 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. This prepayment is made annually, however, had this prepayment not been made there would have been a \$15.4 million increase in the portfolio.

As of June 30, 2023, the City had \$49.6 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 (July 20th), after the large payments discussed above, the \$49.6 million has declined to \$22.5 million which includes \$7.2 million is investment securities sold prior to maturity. In addition, investments totaling \$24.7 million will mature between July 1, 2023 and December 31, 2023. Based on the above, staff expect that the City will have sufficient funds or liquidity to meet expenditure requirements for the next six months.

Sale of Investments Prior to Maturity (July 2023)

As mentioned earlier in this report, a primary objective of the City's [Investment Policy](#) is safety with preservation of capital being the approach in the execution of investment activities. The sale of securities is permitted in the Investment Policy (see p. 8) and was authorized by the Director of Administrative Services to maintain required liquid cash for daily City operations.

In late June 2023, the City's Assistant City Manager/Administrative Services Director approved the Treasury's Division's recommendation to sell some of the City's portfolio investments (prior to maturity). This recommendation was based on a conservative approach to cash balances acknowledging higher cash volatility seen in the prior months' expenditures. Accounts Payable expenditures for April, May and first half of June, were 30%, 26%, and 26%, respectively, higher over the prior year. This translates in \$14.3 million in higher cash outflow over two and a half months. If this or a higher pattern of cash outlay continued, under the worst-case cash forecast model for July, an elevated risk was identified that there might not be sufficient cash to cover all liquidity needs. To mitigate this risk, the security sales were estimated to net \$14.2 million in additional cash. A key criterion in the securities selected to be sold was the security sales would have a net market gain when sold.

The final security sales was less than estimated, it netted \$7.2 million in cash (17 investment securities), with a net gain on of \$42,405 due to the securities being sold at a higher price than its value on the City's books.

Compliance with City Investment Policy

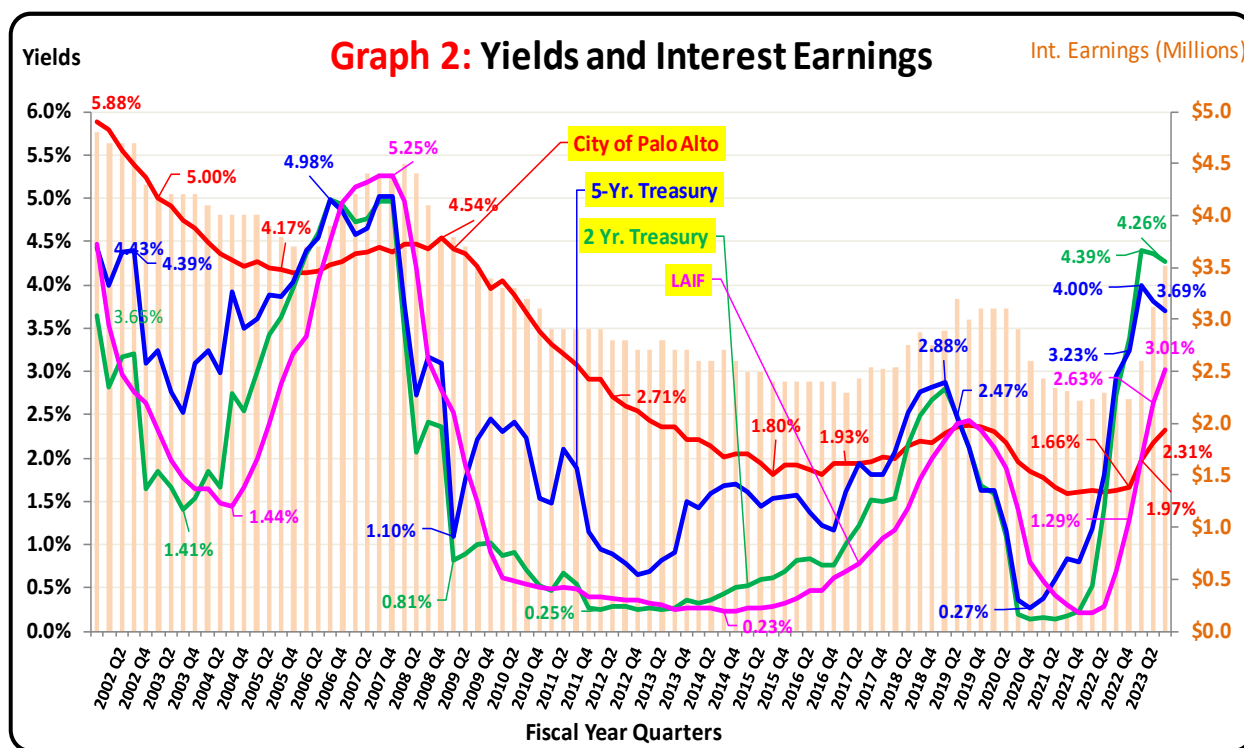
During the fourth quarter, staff complied with all aspects of the Investment Policy. Attachment C lists the major restrictions in the City's Investment Policy compared with the portfolio's actual performance.

Investment Yields

Interest income on an accrual basis for the fourth quarter was \$3.5 million; compared to the first, second, and third quarters this was \$1.3 million, \$0.9 million and \$0.4 higher than the prior quarters due to new higher yielding investments in the portfolio. As of June 30, 2023, the yield to maturity of the City's portfolio was 2.31%; in the prior quarter it was 2.18%. In the fourth quarter, LAIF's average yield was 3.01% while the average yield on the two-year and five-year Treasury bonds was approximately 4.26% and 3.69%, respectively. In comparison, in the prior quarter LAIF had 2.63% yield and the two-year and five-year Treasury bonds yields were higher at 4.35% and 3.80%.

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 3.57 years.

Yield Trends

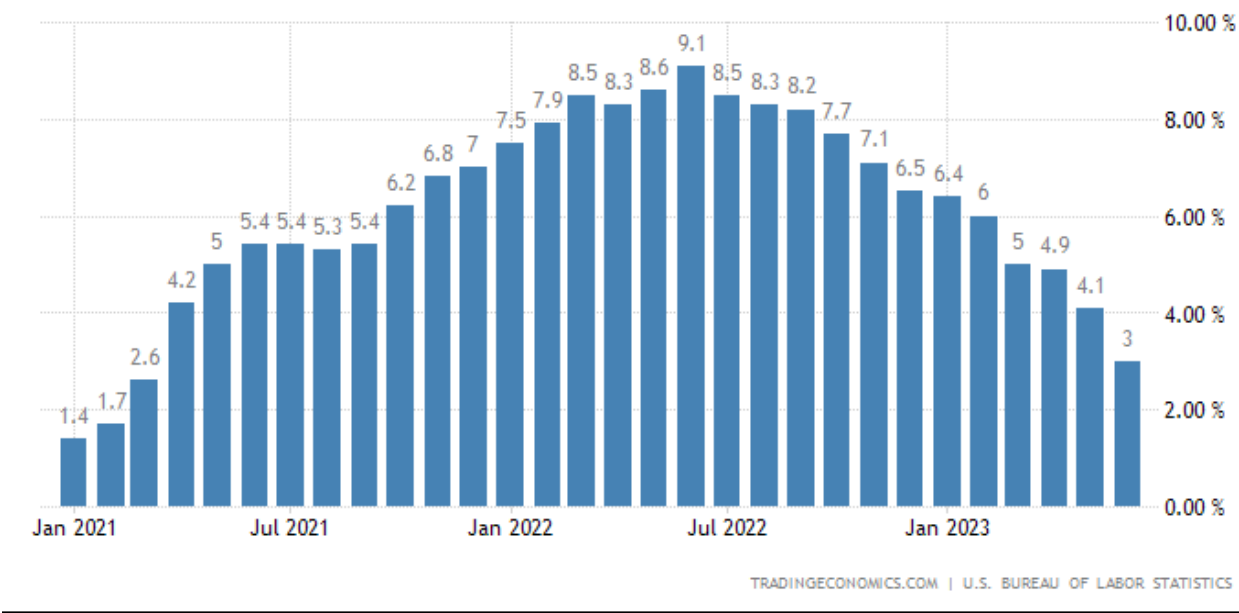
The Federal Open Market Committee (FOMC), since March 2020, has raised the federal funds rate ten times totaling 5% with the first occurring on March 16, 2022. Prior to this the rate was near zero. To mitigate the persistent elevated inflation rate from the peak of 9.1% in June to a low 3% in June 2023 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 still elevated above the target rate. The FOMC states "The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation." 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.

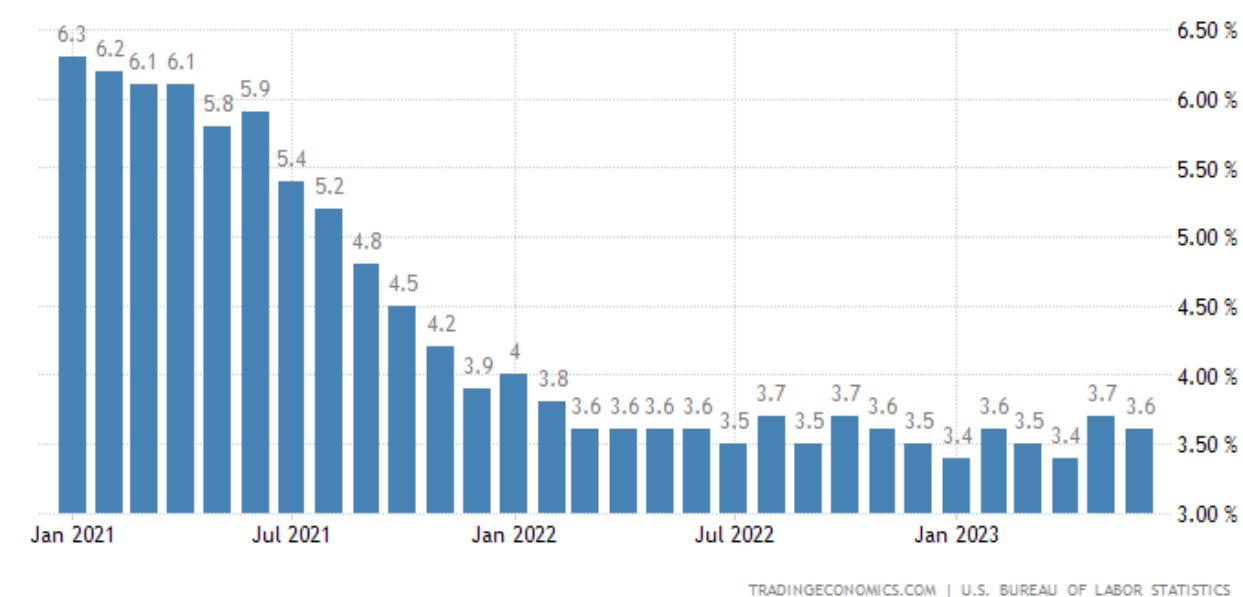
Graph 3: U.S. Inflation Rate

The annual inflation rate in the U.S. slowed to 3% in June 2023, the lowest since March 2021 which is below market forecasts.



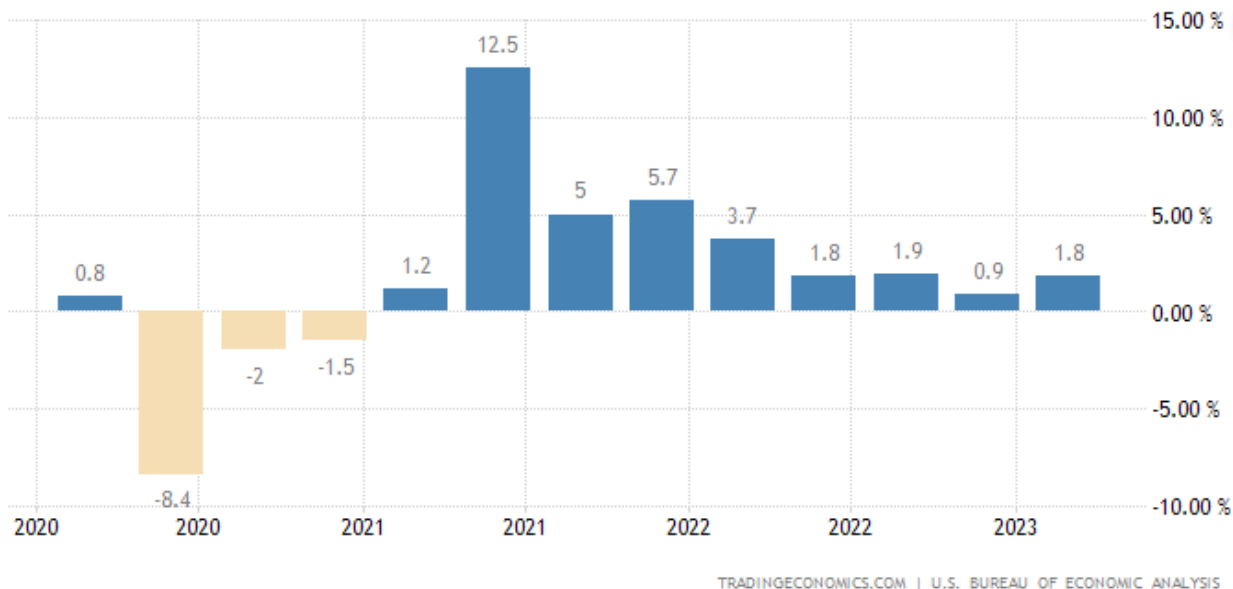
Graph 4: U.S. Unemployment Rate

The unemployment rate in the U.S. edged down to 3.6% in June 2023. The jobless rate has fluctuated between 3.4 percent and 3.7 percent since March 2022, 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 growth accelerated to 1.8 percent year-on-year during the first (calendar) quarter of 2023, up from 0.9 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 # 7858](#)⁶ and [ID # 11402](#)⁷. 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 June 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

⁶ City Council, April 11, 2017, under “Additional Information”, CMR 7858:

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

⁷ City Council, September 21, 2020 Item #2, CMR 11402:

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

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 revised the selected portfolio from "Moderately Conservative" the second most conservative, to "Balanced" a slightly more aggressive asset mix, in alignment with the City Council direction in January 2023. The City Council adopted revisions to the Long Term Liabilities Policy (formerly Pension Policy) including this change in asset allocation. This change has been implemented with the City's provider. Additional information on this trust can be found in City Council [Staff Report ID # 7553](#)⁸. Through June 30, 2023, principal investment contributions of \$54.4 million made over time since May 2017, has increased to \$58.4 million or by \$4.0 million and the net return for one and five years has been 3.6% and 3.8% respectively. Since inception, \$4.5 million net earnings have been realized with \$0.5 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 item is not a project as defined by the California Environment Quality Act because the Investment Activity Report is for informational purposes only with no action required by the Council.

ATTACHMENTS

Attachment A: Consolidated Report of Cash Management

Attachment B: Investment Portfolio

Attachment C: Investment Portfolio Compliance

APPROVED BY:

Kiely Nose, Assistant City Manager

⁸ 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>