# REQUEST FOR CITY COUNCIL ACTION

**MEETING DATE:** SEPTEMBER 9, 2014

**TITLE:** TREASURER'S ANNUAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2014

Director of Administrative Services

City Manager

## RECOMMENDED ACTION

Receive and file the Treasurer's Annual Report for the fiscal year ended June 30, 2014.

## EXECUTIVE SUMMARY

This report provides a synopsis of investment activity for the City's three investment portfolios for the fiscal year ended June 30, 2014. These portfolios, which are managed by United American Capital Corporation (UACC) under the direction of the Treasurer, are categorized as the Irvine Pooled Investment Portfolio, Bond Proceeds Fund and Special District Funds. The market value of all investments under the Treasurer's management totaled $646.97 million as of June 30, 2014.

Total portfolio assets, asset allocations, average maturities, yields, and portfolio valuations are presented within this report. A discussion of market conditions is also provided to give perspective to these measurements.

## COMMISSION/BOARD/COMMITTEE RECOMMENDATION

The Finance Commission, at its regular meeting of August 18, 2014, recommended the City Council receive and file the Treasurer's Report by a unanimous vote. The Investment Advisory Committee, at its regular meeting of August 13, 2014, also recommended City Council receive and file the Treasurer's Report by a unanimous vote.

## ANALYSIS

The Treasurer's office is charged with investing the City's three fixed income portfolios in conformance with the Annual Investment Policy adopted by City Council. The Investment Policy is updated annually in accordance with the California State Government Code. Quarterly and annual treasury reports that provide investment activity and performance information for the City's portfolios are submitted to the Investment Advisory Committee, Finance Commission, and City Council. The primary objectives of investing these public funds are the protection of principal (safety), provision of ample funds to meet cash requirements (liquidity), and to obtain a competitive market rate of return (yield), in that order. All securities owned by the City are held in safekeeping by a third party custodial bank acting as the agent for the City rather than held by a securities dealer. Any trade executed with a broker/dealer is required to settle with the City's safekeeping agent on a delivery versus payment basis, where the delivery of a security to the appropriate party is made only in the event the funds have been sent as payment for the security.

**Irvine Pooled Investment Portfolio**

The Irvine Pooled Investment Portfolio contains funds invested for both the daily operational requirements of the City, as well as funds reserved for economic uncertainties, and future rehabilitation and maintenance needs. The Irvine Pooled Investment Portfolio is a combination of several operational funds, including the City's Asset Management Plan (AMP) and funds earmarked for the development of the Orange County Great Park.

As of June 30, 2014, the book value (purchase price of securities as recorded on the City's books) of the Irvine Pooled Investment Portfolio was $414.76 million, and the average weighted yield to maturity was 0.78 percent. As of June 30, 2014, the fiscal year-to-date investment income (interest payments and capital gains) generated by the Irvine Pooled Investment Portfolio was $2.95 million. Based on the average size of the portfolio, the annual effective rate of return was 0.73 percent. The following chart compares the Irvine Pooled Investment Portfolio statistics over a rolling 12-month period.

**Irvine Pooled Investment Portfolio**
**Rolling 12-Month Quarterly Comparison**

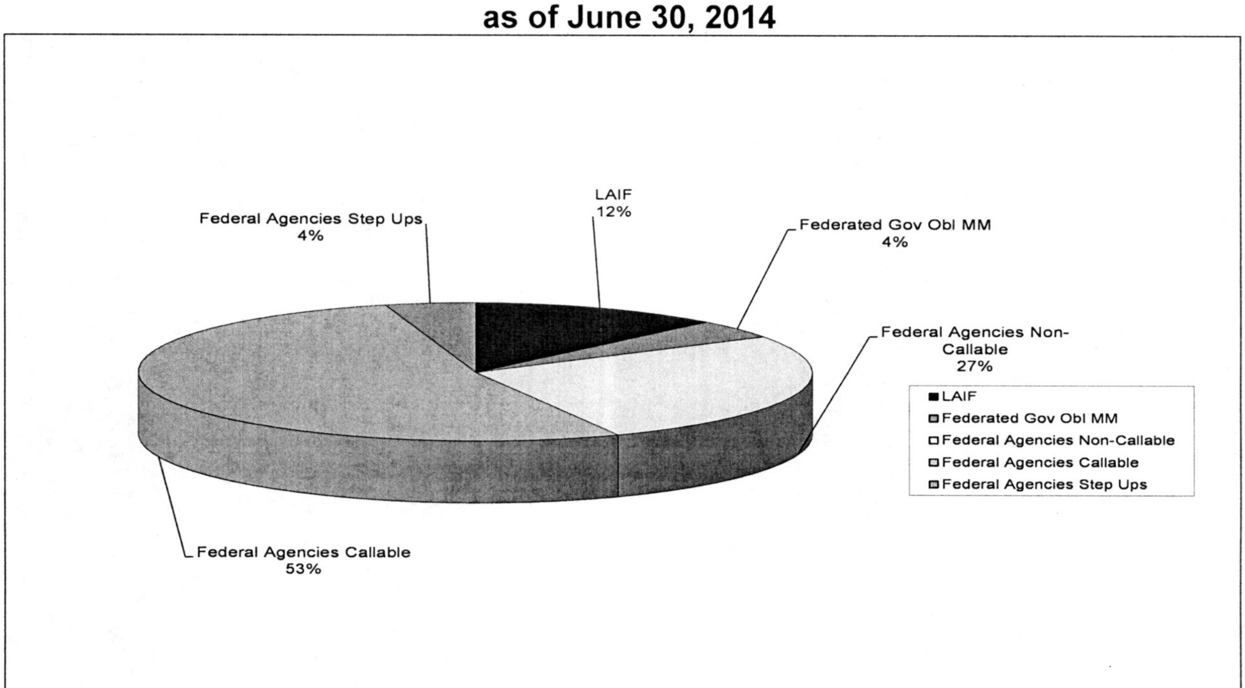
| | **June 30, 2014** | **March 31, 2014** | **Dec 31, 2013** | **Sept 30, 2013** |
|---|---|---|---|---|
| Book Value | $414,760,236 | $382,978,062 | $353,424,287 | $348,836,003 |
| Market Value | $414,767,525 | $381,555,730 | $351,926,503 | 347,866,493 |
| Unrealized Gain/(Loss) | $7,289 | $(1,422,332) | $(1,497,784) | ($969,510) |
| Unrealized Gain/(Loss) as % of Book Value | 0.00% | (0.37%) | (0.42%) | (0.28%) |
| Average Yield to Maturity | 0.78% | 0.77% | 0.72% | 0.81% |
| Liquidity 0 – 6 months | 20.25% | 17.33% | 16.47% | 15.79% |
| Average Years to Maturity | 2.20 Years | 2.40 Years | 2.27 years | 2.47 years |
| Effective Duration | 2.12 Years | 2.28 Years | 2.21 years | 2.40 years |

The Irvine Pooled Investment Portfolio's book value increased by $31.78 million from the last quarter. Due to the cyclical nature of the City's revenue stream, the book value often fluctuates $5 to $10 million each quarter. Additionally, last quarter, the City received $21 million in development fees associated with Planning Area 36 (Irvine Business Complex). The positive cash in-flow was deposited in money market assets in preparation for the prepayment of the Fiscal Year 2014-15 CalPERS retirement contribution ($19 million), as well as to provide necessary liquidity to cover cash flow disparities that are typically experienced during the first quarter of a fiscal year. Stable to declining bond interest rates during the quarter contributed to the diminishment of unrealized losses in the portfolio; however, the return of unrealized losses is anticipated as interest rates continue to rise overall.

To ensure the safety of the portfolio, investments that hold the highest credit quality are selected. The Irvine Pooled Investment Portfolio is comprised primarily of Federal Government sponsored entity debt, otherwise known as Federal Agencies. Although the Federal Agency securities were downgraded by Standard & Poor's to AA in August 2011, they continue to be regarded as among the safest securities in the global market. Two of the government sponsored agencies, Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Company (Freddie Mac) remain under conservatorship by the Federal Government and carry an explicit guarantee by the Federal Government. Both of these agencies are being carefully monitored by the City's investment manager to ensure the continued safety of the City's funds.

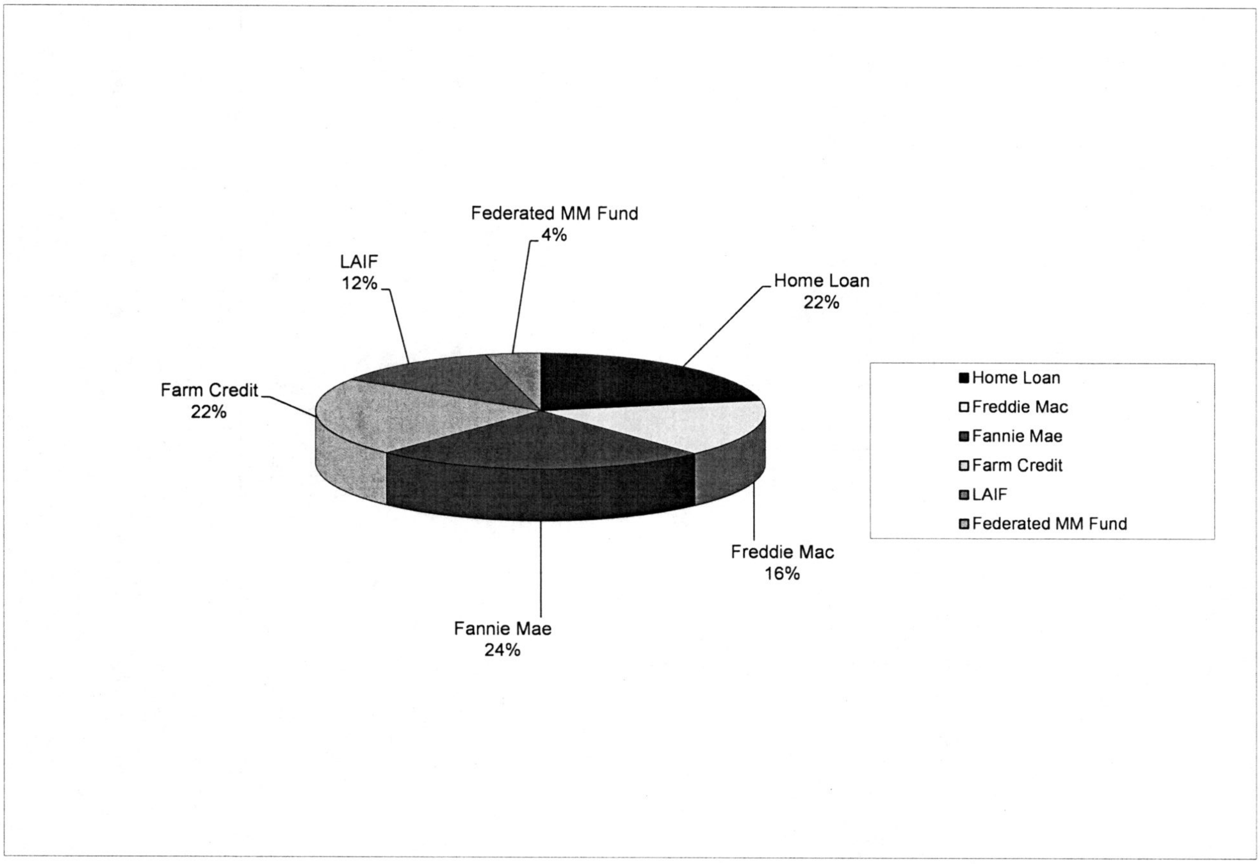
To manage liquidity, the Irvine Pooled Investment Portfolio is invested in LAIF (Local Agency Investment Funds) and the Federated Government Obligation money market fund. Chart 1 shows the asset allocation of the Irvine Pooled Investment Portfolio.

**Chart 1 - Asset Allocation**
**as of June 30, 2014**



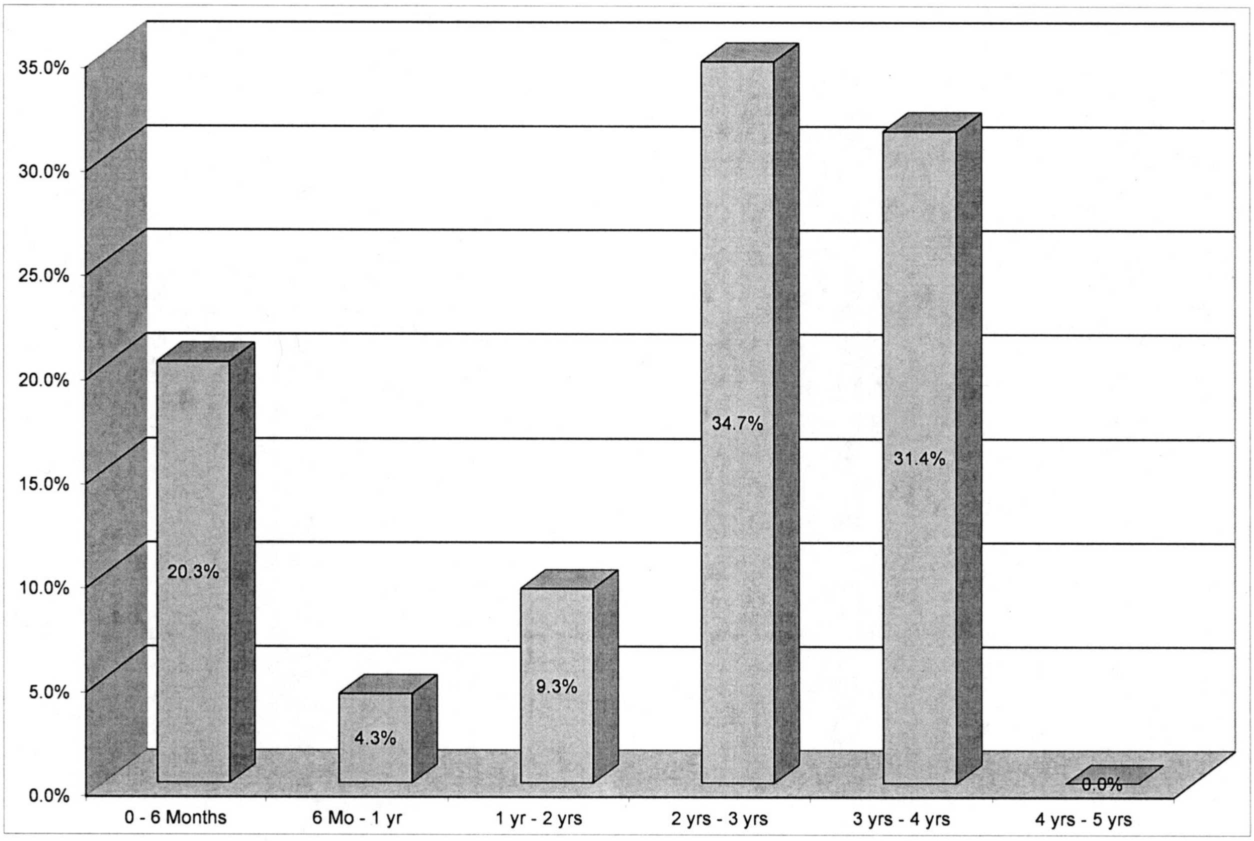
Since 84 percent of the portfolio is invested in Federal Agency securities, the safety of the Irvine Pooled Investment Portfolio is further protected by purchasing securities from several different Federal Agencies. The four Federal Government sponsored entities that the City purchases securities from are Fannie Mae, Freddie Mac, Federal Home Loan Bank (Home Loan), and Federal Farm Credit Bank (Farm Credit). Chart 2 identifies portfolio holdings by issuer name.

**Irvine Pooled Investment Portfolio**
**Chart 2 - Allocation by Issuer Name**
**as of June 30, 2014**



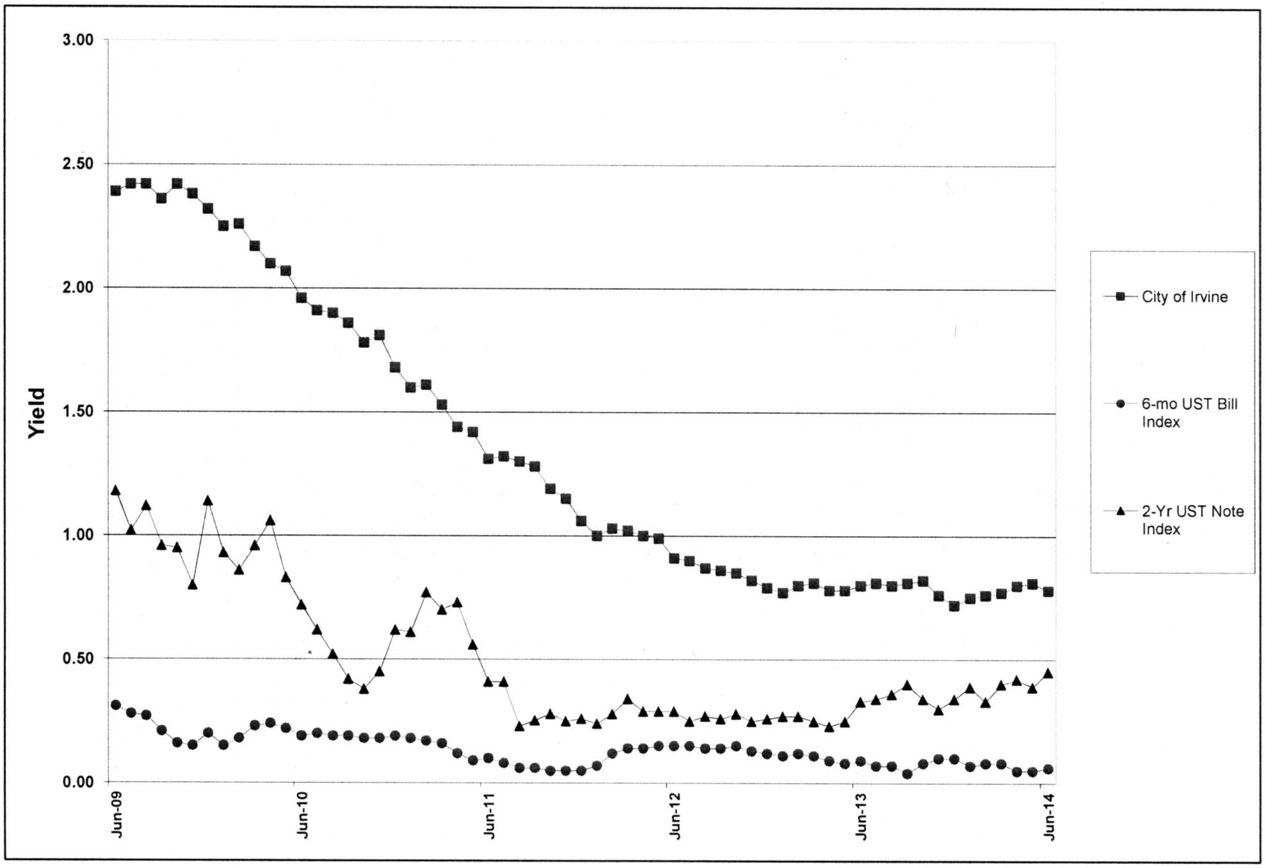

Another key component in portfolio management is to ensure that the City has enough funds on hand to meet current expenses. By using cash flow forecasts, the portfolio manager is able to project short and long-term cash needs to help make informed and appropriate investment decisions. As of June 30, 2014, the overnight to 6-month liquidity level for the Irvine Pooled Investment Portfolio was at 20.25 percent, which provides adequate liquidity to meet anticipated expenses. Chart 3, on the following page, is an aging of investment maturities up to 5 years (the maximum maturity allowable by policy and state code) of the Irvine Pooled Investment Portfolio.

**Chart 3 - Aging of Maturing Investments
as of June 30, 2014**




To gauge performance, the City compares the Irvine Pooled Investment Portfolio's yield to maturity against two benchmarks set in the City's Annual Investment Policy; the 6-month United States Treasury (UST) Bill Index and 2-year UST Note Index. The benchmarks are used as a measure of the Irvine Pooled Investment Portfolio against market movement. Graph 1, on the following page, compares the average yield to maturity of the Irvine Pooled Investment Portfolio to these benchmarks, and shows the spread (difference between the index and the yield to maturity) for the past five years. The City is experiencing a positive spread against both benchmarks. The Portfolio's yield is higher than the 6-month UST by 0.72 percent and higher than the 2-year UST by 0.33 percent.

**Irvine Pooled Investment Portfolio**
**Graph 1 - Yield to Maturity Compared to Assigned Benchmarks**
**June 2009 through June 2014**




The Irvine Pooled Investment Portfolio invests funds attributable to the AMP and the Great Park Corporation. Pertinent information related to the AMP and Great Park Corporation funds are explained in the following paragraphs.

***Asset Management Plan Funds***

Interest earnings for the AMP funds are allocated based on the AMP fund average daily cash balance. Through the first close of June's books, the AMP earned interest of $285,008 for the fiscal year ended June 30, 2014, based on an average cash balance of $55.92 million.

***Orange County Great Park Funds***

Through the first close of June's books, the Great Park funds earned interest of $169,793 for the fiscal year ended June 30, 2014. The Great Park funds had a combined average daily cash balance of $34.08 million for the year ended June 30, 2014.

**Bond Proceeds Fund Portfolio**

The Bond Proceeds Fund Portfolio contains special district construction and administration funds that are not held by a trustee. These include older bond issues, funds on hand to finance the City's assessment district inspection and administration, and property assessments received from the County prior to being sent to the trustee. Investment strategy differs in the Bond Proceeds Fund Portfolio from the Pooled Investment Fund Portfolio due to different cash needs between the two. The Bond Proceeds Fund Portfolio needs to be much more liquid to meet debt service payments.

The bullet points below provide a brief synopsis of the Bond Proceeds Portfolio for the fiscal year ended June 30, 2014.

| | |
|---|---|
| • Book Value | $31,306,436 |
| • Market Value | $31,315,789 |
| • Unrealized Gains/(Losses) | $9,353 |
| • Average Weighted Yield to Maturity | 0.228% |
| • Annual Effective Rate of Return | 0.230% |
| • Fiscal Year to Date Investment Income | $47,058 |

**Special District Funds Portfolio**

The Special District Funds Portfolio contains project and reserve funds for 30 Special Assessment District bond issues and one Community Facilities District. Investments in this Portfolio are made in accordance with each bond's indenture and the strategy is set according to the cash flow needs of the individual district. The Special District Funds Portfolio must also remain very liquid to provide project funds, when requested, as well as meet debt service payment requirements.

The bullet points below provide a brief synopsis of the Special District Funds Portfolio for the fiscal year ended June 30, 2014.

| | |
|---|---|
| • Book Value | $200,851,171 |
| • Market Value | $200,885,820 |
| • Unrealized Gains/(Losses) | $34,649 |
| • Average Weighted Yield to Maturity | 0.079% |
| • Average Annual Yield | 0.059% |
| • Fiscal Year to Date Investment Income | $ 71,718 |

**Market Conditions**

During the final quarter of FY 2013-2014, bond interest rates declined compared to the prior quarter's end (March 2014), especially in the 5-year to 30-year sectors of the yield curve where rates were lower by as much as 24 basis points (0.24%). Contributing factors to the decline in rates included a flight to quality over concerns regarding overseas markets and geopolitical tensions, and the Federal Open Market Committee (FOMC) reiterating that rates are likely to remain low for a considerable time. In comparison to FY 2012-2013, interest rates ended higher overall. Unlike the previous two fiscal years, the yield curve did not experience a significant shift in rates. Mid-term interest rates (2 to 7 year sectors of the curve) increased by 10 to 25 basis points; however, the 30 year bond declined 11 basis points. All other sectors of the curve were relatively unchanged.

Although interest rates did not change much when comparing 2013 to 2014, the markets experienced considerable volatility during the fiscal year. In the first half of the fiscal year, speculation over when the Federal Reserve would begin to taper asset purchases contributed to overall market volatility. The markets were also affected by the uncertainty surrounding the ability of Congress to resolve budget and debt ceiling issues by their respective deadlines. Once the budget and debt ceiling issues were resolved, the market calmed briefly; however, at the December FOMC meeting, the Committee announced it would begin tapering asset purchases, causing interest rates to rise.

The second half of the fiscal year saw the beginning of the Fed's reduction of its asset purchase program. Commencing in the fall of 2012, the Fed had been purchasing a total of $85 billion in longer-term securities ($45 billion in treasury securities and $40 billion in agency mortgage-backed securities) in hopes of creating downward pressure on long term interest rates to stimulate the economy. Following its announcement at the December FOMC meeting, the Fed has tapered five times by $10 billion each time. The current level of the Fed monthly purchases stands at $35 billion ($20 billion in treasury securities and $15 billion in agency mortgage-backed securities). At the onset of the tapering program interest rates surged; however, the market rallied several times on concerns over emerging market issues and the Russian/Ukrainian conflict.

The FOMC continued to leave the Federal Funds rate at a range of 0 percent to 0.25 percent during the fiscal year; however, Fed Chair Janet Yellen suggested at a press conference that the Fed may begin increasing the Fed Funds rate after the tapering is complete (presumably spring of 2015). Prior to Yellen's comment, market analysts had been predicting an increase in the Fed Funds rate no sooner than 2016.

**ALTERNATIVES CONSIDERED**

None. The Treasurer's Report is intended to provide historical information about the City's investment portfolios. Pursuant to the City's Investment Policy, the Treasurer is required to submit quarterly Treasurer's reports to the City Council.

**FINANCIAL IMPACT**

Fiscal year-to-date investment income for the Irvine Pooled Investment Portfolio, Bond Proceeds, and Special Districts portfolios totaled $3.06 million with investments structured for security and liquidity.

**REPORT PREPARED BY** Michele C. Lund, City Treasurer