



REQUEST FOR CITY COUNCIL ACTION

MEETING DATE: SEPTEMBER 24, 2013

TITLE: TREASURER'S ANNUAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2013

*Jan Walden for
Ken Brown*

Acting Director of Administrative Services

Sean Joyce

City Manager

RECOMMENDED ACTION

Receive and file.

EXECUTIVE SUMMARY

This report provides a synopsis of investment activity for the City's three investment portfolios for the fiscal year ended June 30, 2013. 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 \$699.42 million as of June 30, 2013.

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

Not applicable.

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, in accordance with the adopted Investment Policy, 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.

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, 2013, the book value (purchase price of securities as recorded on the City's books) of the Irvine Pooled Investment Portfolio was \$382.98 million and the average weighted yield to maturity was 0.79 percent. Fiscal year-to-date investment income (interest payments and capital gains) generated by the Irvine Pooled Investment Portfolio as of June 30, 2013 was \$2.86 million. Based on the average size of the portfolio, the annual effective rate of return was 0.76 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, 2013 | March 31, 2013 | Dec 31, 2012 | Sept 30, 2012 |
|--|--------------------------|---------------------------|-------------------------|--------------------------|
| Book Value | \$382,983,315 | \$359,368,846 | \$354,378,826 | \$352,053,216 |
| Market Value | \$381,136,798 | \$360,707,990 | \$356,003,429 | \$353,941,345 |
| Unrealized Gain/(Loss) | (\$1,846,517) | \$1,339,144 | \$1,624,602 | \$1,888,129 |
| Unrealized Gain/(Loss) as % of Book Value | (0.48%) | 0.37% | 0.46% | 0.54% |
| Average Yield To Maturity | 0.79% | 0.81% | 0.79% | 0.86% |
| Liquidity 0 – 6 months | 19.90% | 15.92% | 14.31% | 13.93% |
| Average Years To Maturity | 2.47 years | 2.49 Years | 2.48 years | 2.56 years |
| Effective Duration | 2.40 years | 2.42 Years | 2.44 years | 2.39 years |

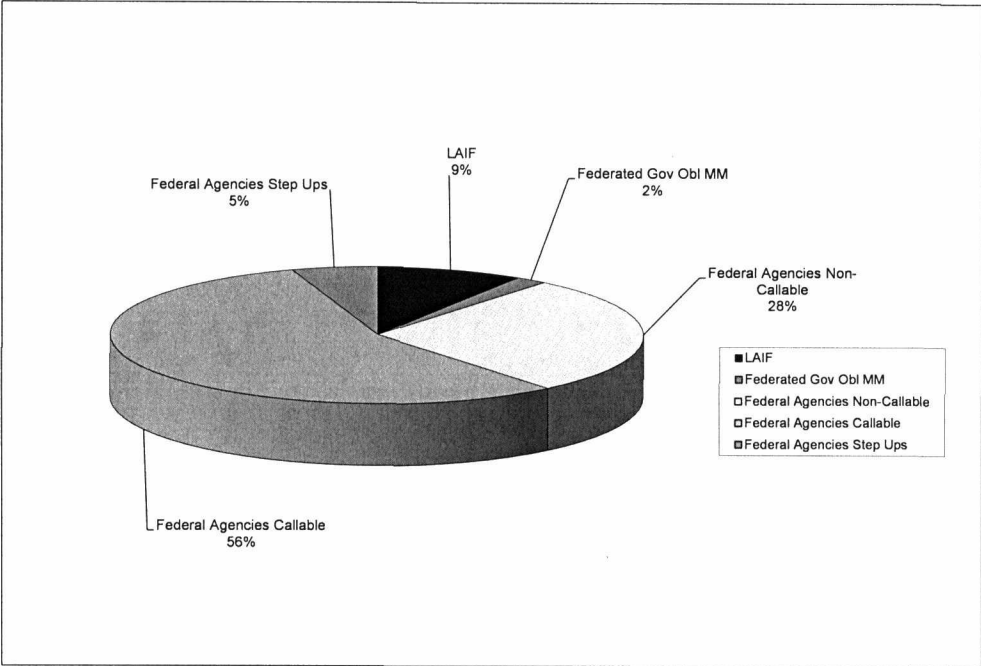
The two most notable changes to the Irvine Pooled Investment Portfolio from the last quarter are an increase in book value of approximately \$23.62 million and the shift from unrealized gains in the portfolio to unrealized losses. The increase in book value is attributable to the receipt of the second installment of property taxes in April of approximately \$24 million that was fully invested.

Due to a significant increase in bond market yields in the last two months of the fiscal year, the market value of the City's portfolio has declined. The increase in interest rates was a direct response to the May 2013 Federal Open Market Committee (FOMC) minutes release and Federal Reserve Board Chairman Bernanke's congressional testimony which indicated that the FOMC may begin slowing the pace of open market bond purchases in the near future. When interest rates rise, fixed income portfolios (such as the City's) will experience unrealized losses instead of unrealized gains, which the City's portfolio has had over the past several years during the historically low interest rate environment. During this past year, the City's investment manager instituted an investment strategy to mitigate market value decline in a rising rate environment. The strategy included shortening the duration of the portfolio by limiting longer maturity purchases and increasing deposits to the State's Local Agency Investment Fund (LAIF). The strength of the portfolio's front-end liquidity position affords the City the ability to avoid realized losses and have available resources to invest in a higher interest rate environment. If rates continue to rise, the City may see increased earnings as a result of reinvestments at higher market rates.

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 are considered the safest securities in the global market next to Treasury securities. Two of the government sponsored agencies, Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Company (FHLMC) remain under conservatorship 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.

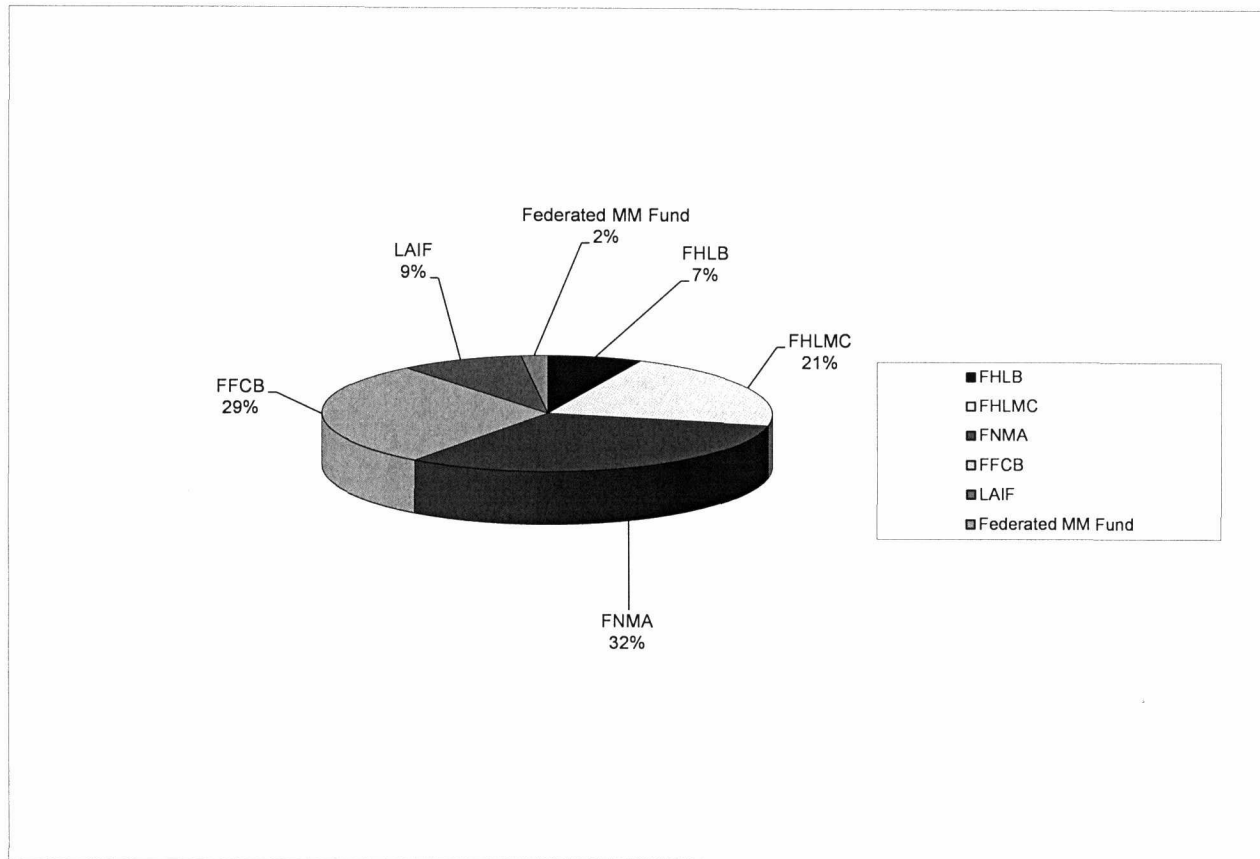
To manage liquidity, the Portfolio is invested in LAIF and the Federated Government Obligation money market fund. Chart 1, on the following page, shows the asset allocation of the Irvine Pooled Investment Portfolio.

**Irvine Pooled Investment Portfolio
Chart 1 - Asset Allocation
as of June 30, 2013**



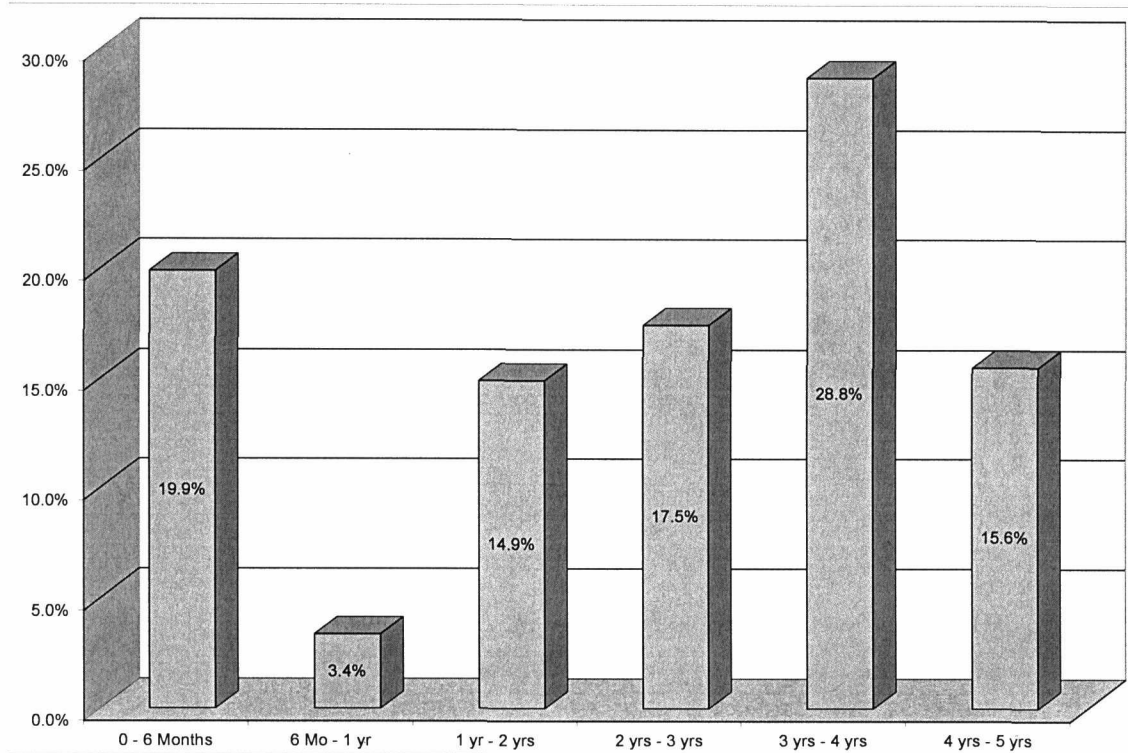
Since 89 percent of the portfolio is invested in Federal Agency securities, the safety of the Portfolio is further protected by purchasing securities from several different Federal Agencies. The four Federal Government sponsored entities that the City purchases securities from are Federal Home Loan Bank (FHLB or Home Loan), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), Federal National Mortgage Association (FNMA or Fannie Mae), and Federal Farm Credit Bank (FFCB or Farm Credit). Because Fannie Mae and Freddie Mac are under conservatorship by the U.S. government, securities issued by these government sponsored entities carry an explicit guarantee by the Federal Government. Home Loan and Farm Credit carry an implied guarantee of the Federal Government. Chart 2, on the following page, identifies portfolio holdings by issuer name.

**Irvine Pooled Investment Portfolio
Chart 2 - Allocation by Issuer Name
as of June 30, 2013**



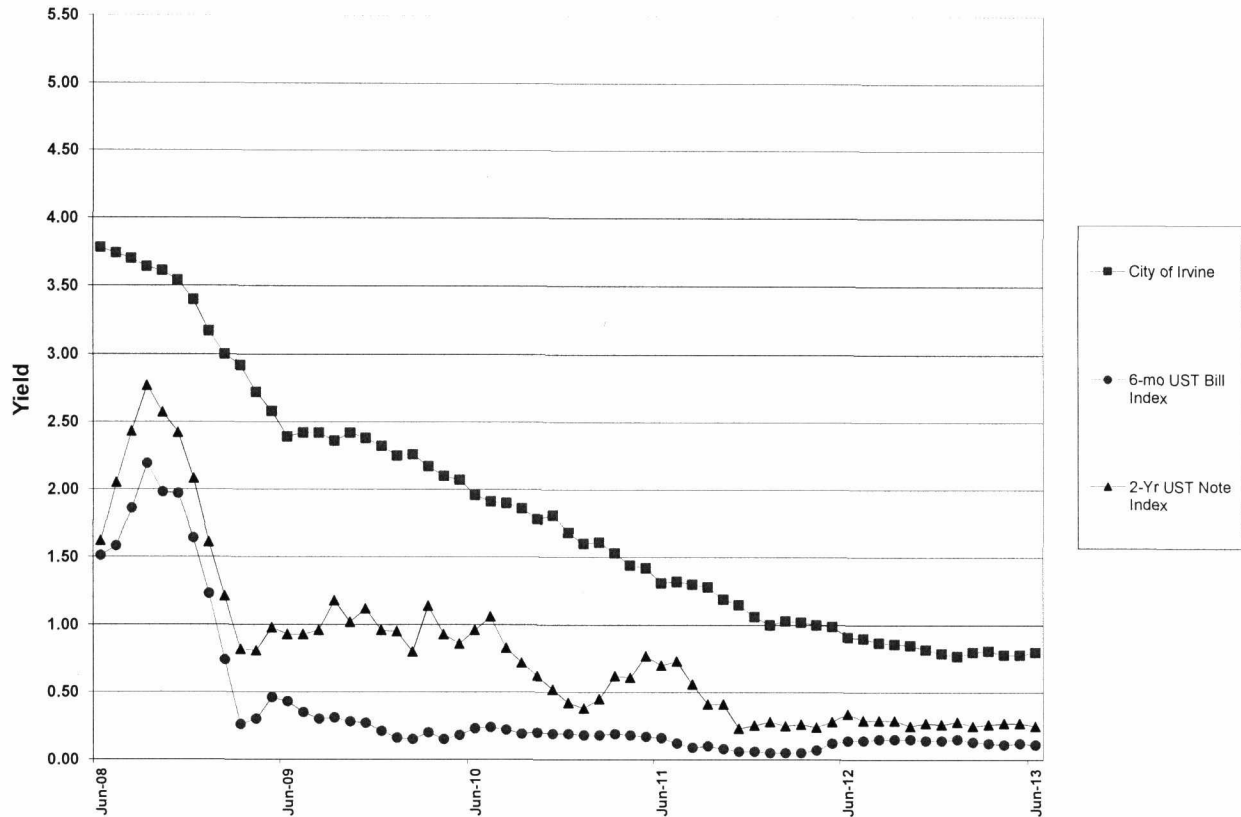
Another key component in portfolio management is to ensure that the City has enough funds on hand to meet current expenses. By using cash flow forecasts, the portfolio manager is able to project short and long-term cash needs to help make informed and appropriate investment decisions. As of June 30, 2013, the overnight to 6-month liquidity level for the Irvine Pooled Investment Portfolio was at 19.90 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.

**Irvine Pooled Investment Portfolio
Chart 3 - Aging of Maturing Investments
as of June 30, 2013**



To gauge performance of the Portfolio, 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 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 0.71 percent and higher than the 2-year UST by 0.47 percent.

Irvine Pooled Investment Portfolio
Graph 1 - Yield to Maturity Compared to Assigned Benchmarks
June 2008 through June 2013



The Irvine Pooled Investment Portfolio invests funds attributable to the Asset Management Plan (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 (AMP) 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 \$311,175 for the year ended June 30, 2013 based on an average cash balance of \$61.08 million.

Great Park Corporation Funds

Through the first close of June's books, the Great Park funds earned interest of \$249,139 for the fiscal year ended June 30, 2013. The Great Park funds had a combined average daily cash balance of \$50.15 million for the year ended June 30, 2013.

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, 2013.

- Book Value \$23,533,061
- Market Value \$23,539,491
- Unrealized Gains/(Losses) \$6,430
- Average Weighted Yield to Maturity 0.244%
- Annual Effective Rate of Return 0.240%
- Fiscal Year to Date Investment Income \$53,356

Special District Funds Portfolio

The Special District Funds Portfolio contains project and reserve funds for 27 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, 2013.

- Book Value \$294,713,600
- Market Value \$294,739,314
- Unrealized Gains/(Losses) \$25,714
- Average Weighted Yield to Maturity 0.042%
- Average Annual Yield 0.045%
- Fiscal Year to Date Investment Income \$139,048

Market Conditions

In the first half of the fiscal year, bond interest rates were mostly unchanged compared to the end of Fiscal Year 2011-12. Bond interest rates remained at historic low levels supported by the Federal Reserve Board's accommodative monetary policies. In addition to "Operation Twist," whereby the FOMC purchases securities in the open market with maturities of 6 to 30 years, and simultaneously sells securities with maturities of 3 years or less, the Fed initiated a third round of quantitative easing (QEIII) in September 2012. QEIII involved the monthly purchase of \$40 billion in agency mortgage-backed securities in addition to the \$45 billion in monthly "Operation Twist" purchases. In effect, both programs created downward pressure on long term interest rates in hopes of stimulating the economy. The bond market did experience some volatility during the first half of the fiscal year. The volatility was primarily attributable to concerns regarding the potential consequences of the year-end "fiscal cliff" of tax increases and spending cuts, and whether or not lawmakers would pass legislation to avoid the "fiscal cliff."

Until the last two months of the fiscal year, the bond market was still experiencing the historically low interest rate environment due to the accommodative monetary policies of the Fed. Although "Operation Twist" officially expired on December 31, 2012, the Fed continued their open market purchases of \$85 billion per month to continue depressing long-term interest rates. The automatic budget cuts (sequestration) on March 1, 2013 provided some volatility to the market midway through the second half of the fiscal year. During the last quarter of the fiscal year, stronger than expected economic growth prompted Fed indications that they may scale back on open market purchases in the near future if the economic growth proved sustainable. Interest rates rose significantly across the curve in May and June, especially in the 10- and 30-year sectors.

The FOMC continued to leave the Federal Funds rate at a range of 0 percent to 0.25 percent during the fiscal year. Midway through the fiscal year, the Fed changed the focus of when it would consider increasing interest rates from a defined time period (i.e. mid-2015) to an evaluation of certain economic data thresholds (i.e. an unemployment rate below 6 ½ percent). The Fed continued to support its accommodative monetary policy through monthly open market purchases of longer-term Treasury and mortgage-backed securities. During the May and June FOMC meetings, there were indications that the Committee may decrease the amount of purchasing if increased economic growth is experienced.

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 and Investment Advisory Committee.

FINANCIAL IMPACT

Fiscal year-to-date investment income for the Irvine Pooled Investment Portfolio, Bond Proceeds, and Special Districts portfolios totaled \$3.05 million with investments structured for security and liquidity.

REPORT PREPARED BY Michele C. Lund, City Treasurer