REQUEST FOR CITY COUNCIL ACTION

MEETING DATE: NOVEMBER 27, 2018

TITLE: TREASURER'S REPORT FOR THE QUARTER ENDED SEPTEMBER 30, 2018

Director of Administrative Services

City Manager

RECOMMENDED ACTION

Receive and file the Treasurer's Report for the quarter ended September 30, 2018.

EXECUTIVE SUMMARY

This report provides a synopsis of investment activity for the City's three investment portfolios for the quarter ended September 30, 2018. The portfolios, managed by United American Capital Corporation (UACC) under the direction of the Treasurer, include the Irvine Pooled Investment Portfolio, Bond Proceeds Fund Portfolio, and the Special District Funds Portfolio. The total book value for all three portfolios was $875.18 million as of September 30, 2018.

This report provides information on assets, allocations, average maturities, yields, and valuations for each of the three portfolios. A discussion of market conditions is included to give additional perspective to these measurements.

COMMISSION/BOARD/COMMITTEE RECOMMENDATION

On November 5, 2018, with all members present, the Finance Commission voted 5-0 to recommend City Council receive and file the Treasurer's Report for the quarter ended September 30, 2018. At its special meeting of October 24, 2018, the Investment Advisory Committee unanimously voted to recommend that the City Council receive and file the Treasurer's Report.

ANALYSIS

The Treasurer's office is responsible for the investment of the City's three fixed income portfolios in conformance with the Investment Policy adopted annually by the City Council. In accordance with the Investment Policy, management of the Irvine Pooled Investment Portfolio, Bonds Proceeds Fund Portfolio and the Special District Funds Portfolio are delegated to a contract management firm, UACC, with full authority to execute investment transactions on behalf of the City. The Investment Policy is updated annually in accordance with the California State Government Code. Treasurer's reports are provided at quarter end and fiscal year end to the Investment Advisory Committee, Finance Commission, and City Council. The report includes investment activity and performance for each of the City's portfolios. The primary objectives of investing public funds, in order of importance, are safety of principle, liquidity of funds, and return on investment. All securities owned by the City are held in safekeeping by a third party custodial bank acting as the agent for the City instead of being held by a securities dealer or investment management firm. 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 after the funds have been sent in full as payment for the security.

Irvine Pooled Investment Portfolio

The Irvine Pooled Investment Portfolio contains funds invested for the daily operational requirements of the City and funds reserved for economic uncertainties, future rehabilitation and maintenance needs. The portfolio is a combination of various operational funds, including the City's Asset Management Plan and funds earmarked for the development of the Orange County Great Park. A summary of Irvine Pooled Investment Portfolio by Fund is presented at the end of this report (Attachment).

As of September 30, 2018, the book value (purchase price of securities as recorded on the City's books) of the portfolio was $674.48 million and the average weighted yield to maturity was 1.71 percent. Investment revenue (interest payments and capital gains) generated by the portfolio for quarter ending September 30, 2018 was $2.28 million. The following chart compares the portfolio's statistics over a rolling 12-month period.

Irvine Pooled Investment Portfolio
Rolling 12-Month Quarterly Comparison

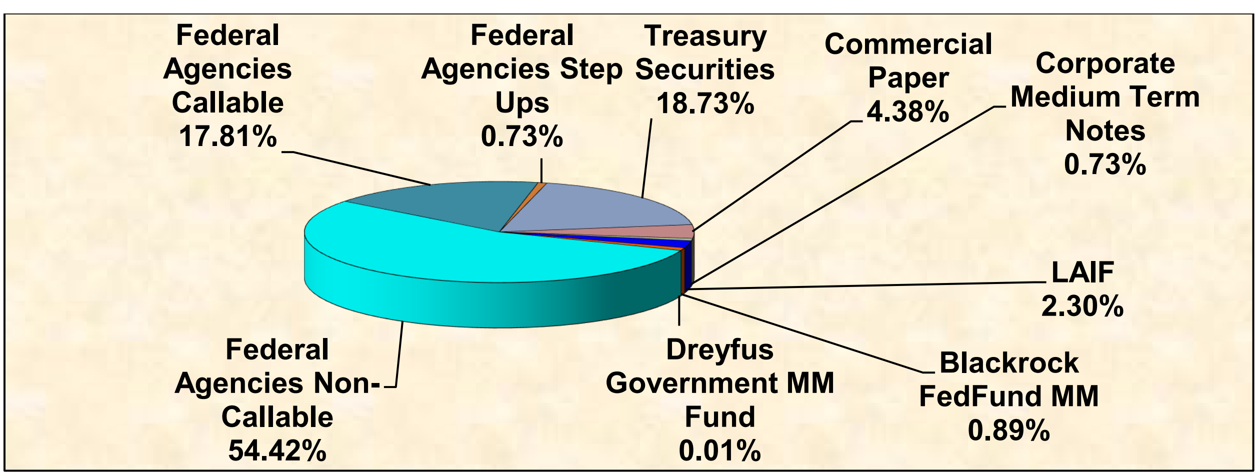
	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017
Book Value	$674,483,445	$707,103,573	$661,611,807	$634,945,838
Market Value	$665,082,116	$698,234,684	$653,215,825	$629,344,603
Unrealized Gain/(Loss)	($9,401,329)	($8,868,889)	($8,395,982)	($5,601,235)
Unrealized Gain/(Loss) as % of Book Value	(1.39%)	(1.25%)	(1.27%)	(0.88%)
Average Yield To Maturity	1.71%	1.60%	1.45%	1.36%
Liquidity 0–6 Months	18.10%	21.71%	17.40%	12.97%
Average Years To Maturity	1.80	1.85	1.90	1.97
Modified Duration (Years)	1.73	1.78	1.83	1.91
Quarterly Interest Earnings	$2,278,578	$2,078,965	$2,025,642	$1,919,383

The Irvine Pooled Investment Portfolio's book value decreased by $32.62 million from the previous quarter due to the prepayment of CalPERS pension liability for Fiscal Year 2018-19, and higher than average expenses related to capital projects. Portfolio yield to maturity increased for the quarter ended September 30, 2018 by 11 basis points to 1.71 percent. This was directly attributed to the increasing rate environment as maturing investments were reinvested into longer dated higher rate securities. With market rates increasing, the portfolio ended the quarter with an unrealized loss of $9.40 million as compared to an unrealized loss of $8.87 million on June 30, 2018. This is a normal result of the portfolio's modified duration of 1.73 years, and its price-sensitivity to changes in market interest 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 Treasury Securities and Federal Government sponsored entity debt, otherwise known as federal agency securities. Although 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 Corporation (Freddie Mac), remain under conservatorship and carry an implicit guarantee by the Federal Government. In addition, both are carefully monitored by the City's investment manager and Treasurer to ensure the continued safety of the City's funds.

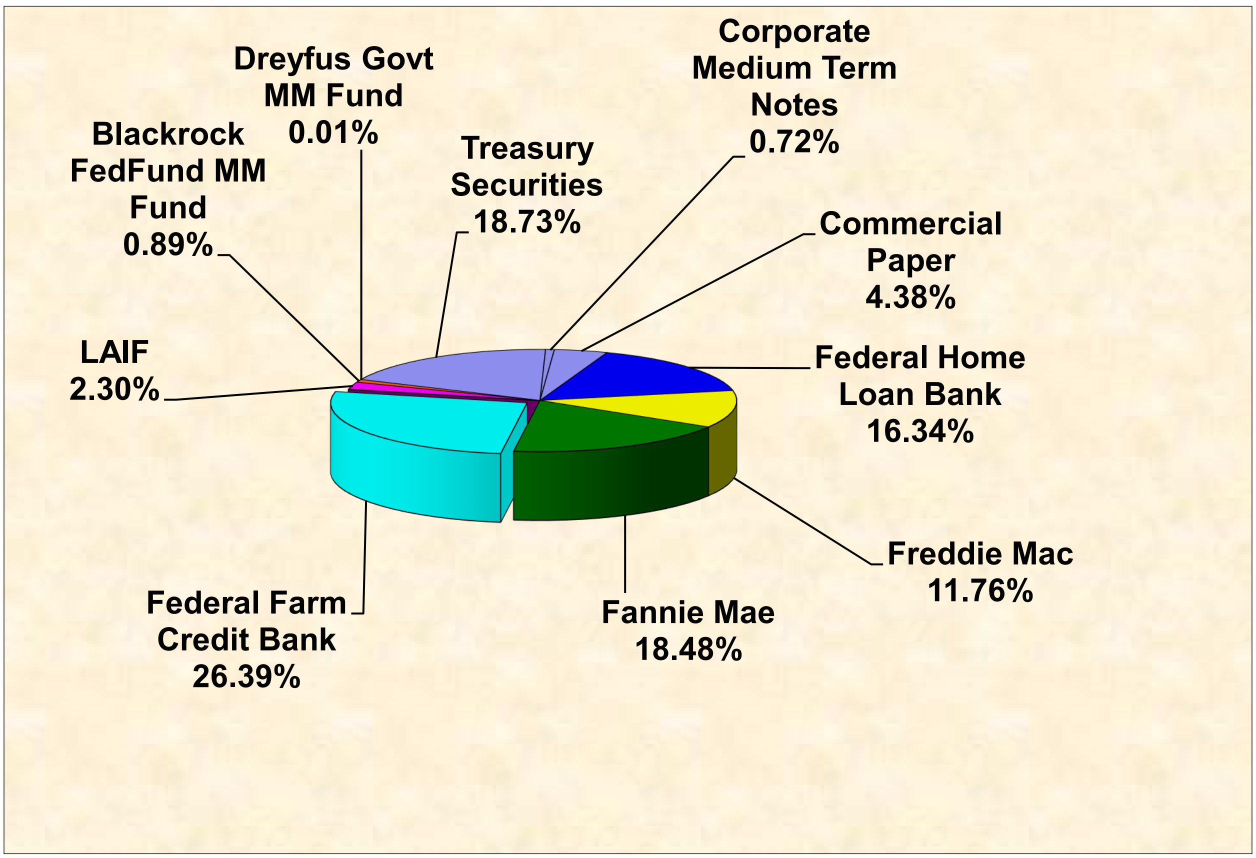
To manage liquidity, the Irvine Pooled Investment Portfolio is invested in Local Agency Investment Funds (LAIF), Dreyfus Government money market fund, Blackrock FedFund money market fund and short term Commercial Paper. Chart 1 shows the asset allocation of the portfolio.

Irvine Pooled Investment Portfolio
Chart 1 - Asset Allocation
as of September 30, 2018



To diversify, the City purchases United States Treasury notes Commercial Paper, Corporate Medium term notes, and securities from several different federal agencies. The four Federal Government sponsored entities the City owns are: Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (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 - Holdings by Issuer Name
as of September 30, 2018



Another key component in portfolio management is to ensure that the City has enough funds on hand to meet current expenses. As of September 30, 2018, the overnight to 6-month liquidity level for the Irvine Pooled Investment Portfolio was at 18.10 percent. 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 (Maturity Value)
as of September 30, 2018

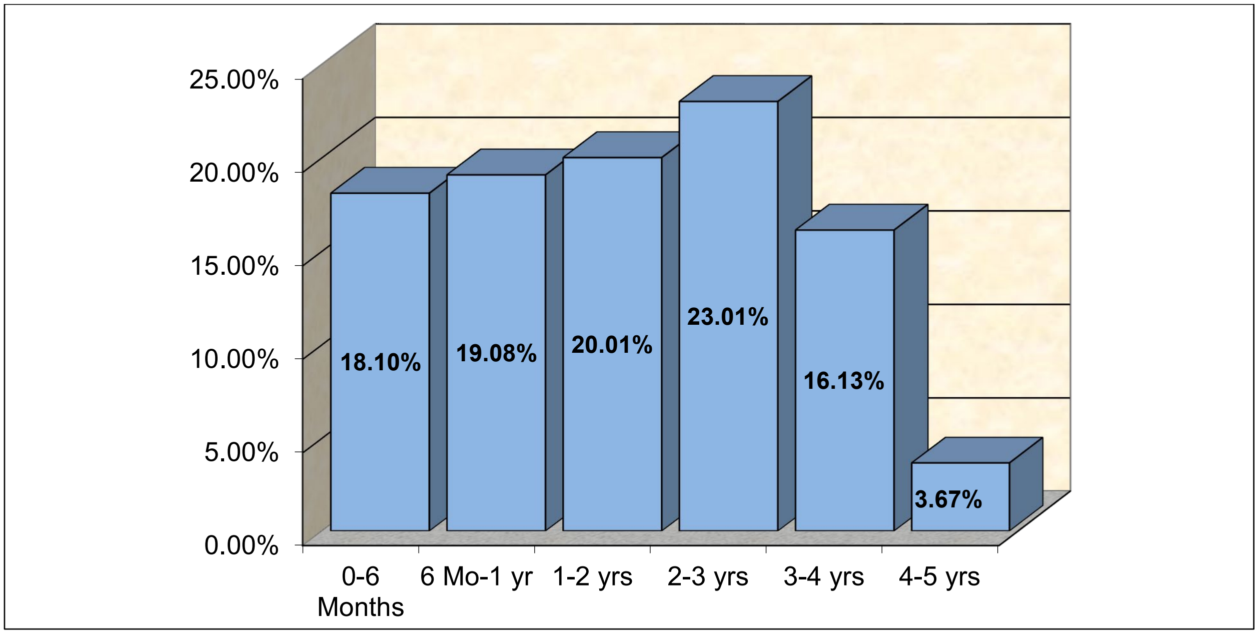
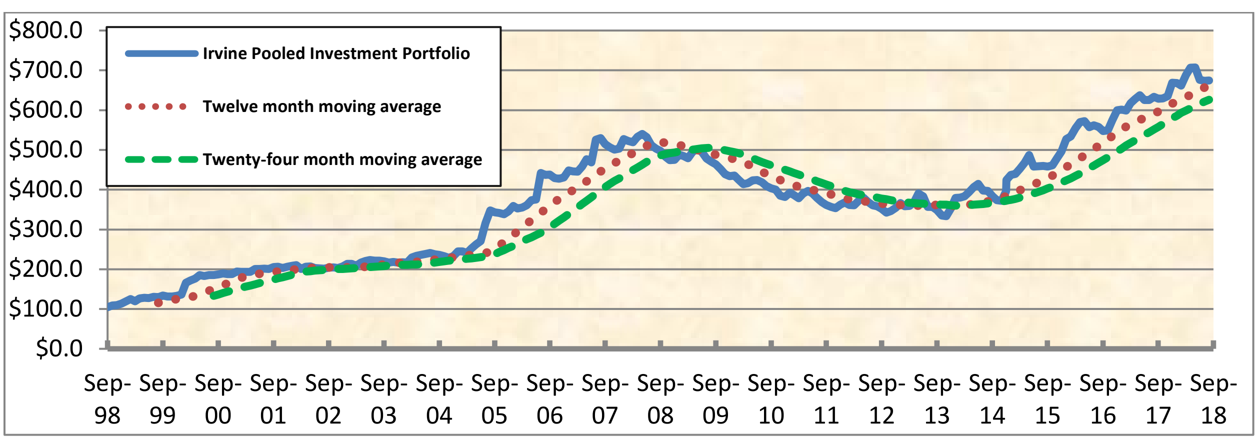
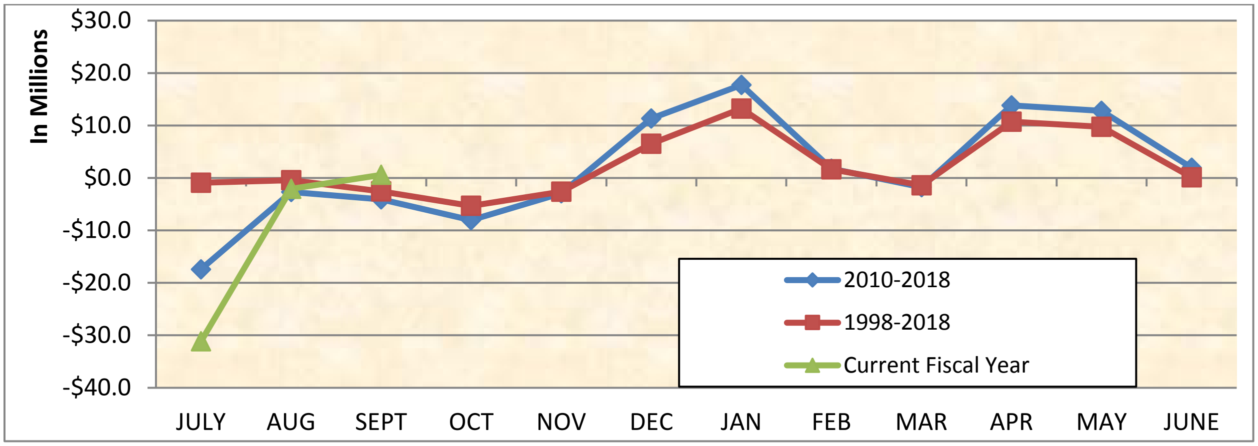


Chart 4 and Chart 5 show the volatility and cyclicality of the Irvine Pooled Investment Portfolio fund balance and cash flows between 1998 and 2018. As noted in chart 5, the portfolio experienced above average outflows in July due to the prepayment of CalPERS pension liability for Fiscal Year 2018-19, and higher than average expenses related to capital projects.

Irvine Pooled Investment Portfolio
Chart 4 - Portfolio Balance
September 30, 1998 through September 30, 2018

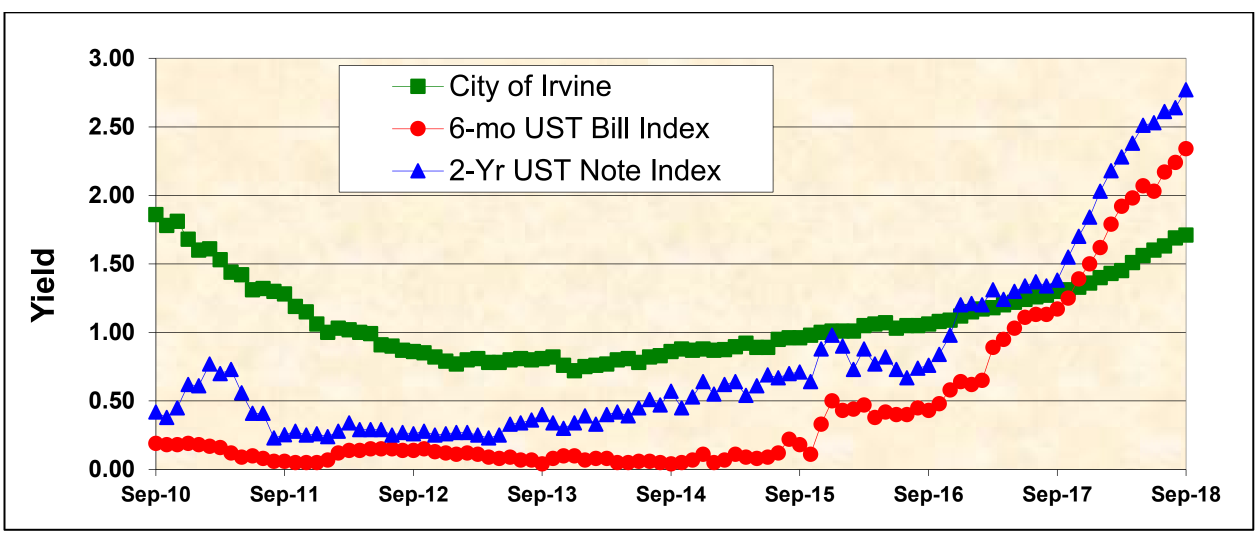


Irvine Pooled Investment Portfolio
Chart 5 – Balance Change Month by Month (Average)



To gauge performance, the City compares the Irvine Pooled Investment Portfolio's yield to maturity against two reference notes set in the City's Annual Investment Policy: the 6-month United States Treasury (UST) Bill Index and 2-year UST Note Index. The reference notes are used as a measure of the portfolio against market movement. Chart 6 compares the average yield to maturity of the portfolio to these reference notes, and shows the spread (difference between the index and the yield to maturity) for the past eight years. With the recent Federal Reserve rate hikes, the portfolio's book yield is less than the 6-month UST by 0.63 percent and the 2-year UST by 1.06 percent. However, over a period of 24 months, the average yield on the 2-year Treasury note is 1.77 percent, versus 1.71 percent for the Irvine Pooled Investment Portfolio.

Irvine Pooled Investment Portfolio
Chart 6 - Yield to Maturity Compared to Assigned Indices
September 30, 2010 through September 30, 2018



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, and funds on hand to finance the City's special district administration. Investment strategy in the Bond Proceeds Fund Portfolio differs from the Irvine Pooled Investment Portfolio due to the different cash needs between the two. The Bond Proceeds Fund Portfolio requires greater liquidity to meet debt related payments. The account balance in the Bond Proceeds Fund Portfolio fluctuates from quarter to quarter due to the timing of property assessment collections from the County of Orange and subsequent distributions. Several times a year, the portfolio receives special assessments and tax levies collected by the County. The special assessments and tax levies contain three major components:

(1) The collections from the various Assessment Districts (AD), Reassessment Districts (RAD) and Community Facilities Districts (CFD). Upon receipt, the City transfers these funds to the Districts' bond trustees.
(2) The collections for the guaranteed maintenance amount of the Great Park CFD. Upon receipt, the City transfers this amount to the Orange County Great Park Fund.
(3) The collections for the Districts' construction and administration funds held and managed by the City. This portion remains in the Bond Proceeds Fund Portfolio.

Fiscal year-to-date investment revenue (interest payments and capital gains) generated by the Bond Proceeds Fund Portfolio as of September 30, 2018 was $30,020.

Bond Proceeds Fund Portfolio
Rolling 12-Month Quarterly Comparison

	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017
Book Value	$6,580,000	$6,902,000	$6,056,000	$5,381,000
Market Value	$6,567,675	$6,885,007	$6,044,454	$5,375,845
Unrealized Gain/(Loss)	($12,325)	($16,993)	($11,546)	($5,155)
Unrealized Gain/(Loss) as % of Book Value	(0.19%)	(0.25%)	(0.19%)	(0.10%)
Average Yield To Maturity	2.09%	1.76%	1.52%	1.24%
Liquidity 0–6 Months	100.00%	100.00%	100.00%	100.00%
Average Days To Maturity	1	1	1	1
Modified Duration in Days	1	1	1	1
Fiscal Year to Date Income	$30,020	$65,370	$43,787	$28,053

Special District Funds Portfolio

The Special District Funds Portfolio contains project and reserve funds for 28 AD and RAD bond issues and four CFD bond issues. Investments in this portfolio are made in accordance with each bond's indenture and the strategy is based on the cash flow needs of each district. The Special District Funds Portfolio must also remain very liquid to provide project funds, when needed, as well as meet debt service payment requirements. Fiscal year-to-date investment revenue (interest payments and capital gains) generated by the Special District Funds Portfolio as of September 30, 2018 was $495,573.

Special District Funds Portfolio
Rolling 12-Month Quarterly Comparison

	September 30, 2018	June 30, 2018	March 31, 2018	December 31, 2017
Book Value	$194,119,024	$258,697,808	$265,277,405	$294,084,302
Market Value	$194,125,710	$258,660,961	$265,185,789	$294,001,956
Unrealized Gain/(Loss)	$6,686	($36,847)	($91,616)	($82,347)
Unrealized Gain/(Loss) as % of Book Value	0.00%	(0.01%)	(0.03%)	(0.03%)
Average Yield To Maturity	2.24%	2.09%	1.74%	1.41%
Average Days To Maturity	64	56	70	73
Fiscal Year to Date Income	$495,573	$2,908,722	$1,969,221	$863,441

Market Conditions

During the first quarter of FY 2018-19, interest rates increased moderately across the yield curve. As expected, the Federal Reserve increased the federal funds rate range by 25 basis points for the fourth time in the past 12 months at the September 26, 2018 Federal Open Market Committee (FOMC) meeting. The current federal funds rate range is 2.00 to 2.25 percent. During the quarter, the yields of the 6-month Treasury notes increased 25.90 basis points to 2.36 percent, the two-year notes increased 26.10 basis points to 2.82 percent, and the five-year notes increased 21.51 basis points to 2.95 percent. The Local Agency Investment Fund (LAIF) daily rate increased from 1.75 percent to 2.09 percent during the past quarter. The net effect to the Pooled Investment Portfolio was an increase in the unrealized market value loss which was in direct proportion to the stated duration of the portfolio. As bonds mature, proceeds are reinvested into higher yielding government bonds which increase the average rate of return.

Financial markets continued to focus on economic releases, including labor and wage data, global trade, protectionism, and Federal Reserve Fund policy. As of September 30, 2018, the unemployment rate declined to 3.70 percent. The under-employment rate improved to 7.50 percent from 7.80 percent last quarter. Labor force participation rate remains low at 62.70 percent, a level not seen since 1978. The yearly percentage change of the average hourly earnings has steadily risen since the financial crisis ended, and remains at the high end of the relatively narrow range of 1.50 percent to 2.90 percent signifying that labor cost growth is lagging behind employment growth.

The Federal Reserve remains focused on maximum employment, stable prices, and moderate long term interest rates. The probability of a 25 basis points Federal Funds rate increase at the December 19, 2018 FOMC meeting remains high. Subtle yet significant changes were made to the last two FOMC statements in describing the shift in Federal Policy. In June's statement, the constant reference to the Federal Reserve keeping rates "below levels that are expected to prevail in the longer term" was eliminated. "Policy remains accommodative" was removed in September's FOMC statement. Officials raised rates on September 26 and have signaled a fourth rate increase this year, and potentially three to four rate hikes in 2019. With unemployment at 3.70 percent, wage growth at 2.80 percent and continuing to rise modestly, the FOMC will remain focused on the historical inverse relationship between rates of unemployment and corresponding rates of inflation. Some Federal Reserve officials also worry that a long period of low interest rates amid scarce resources, including a smaller pool of available workers, could generate overly-inflated asset valuations. The number one complaint from small business hiring managers, as measured by the National Federation of Independent Business small business index, is their difficulty in finding qualified employees.

The long run impact of a trade war could negatively impact economic growth, inflation, and profit margins. The economy advanced at a moderate pace during the quarter with current projections predicting an increase above the 3.00 percent pace in the prior quarters' GDP index. The Atlanta Federal Reserve GDPNow Forecast is currently 4.08 percent as of October 1, 2018, and may continue to move higher during the remainder of the calendar year. Inflation remains slightly below the Federal Reserve's 2.00 percent target as measured by the Personal Consumption Expenditure Core Price index at 1.95 percent as of August 31, 2018.

In conclusion, the moderately expanding economy coupled with current benign but slowly accelerating inflation data will keep the Federal Reserve policy of interest rate normalization on a cautious path. The Federal Reserve began quantitative tightening during the final months of the calendar year 2017 and will gradually accelerate the drawdown of its balance sheet from $10 billion per month to $50 billion per month. The European Central Bank is also expected to end its quantitative easing by calendar year end, as the Bank of Japan continues to reduce its monetary stimulus. Fiscal policies with regard to federal government spending and taxation, trade issues, as well as the transition from easy to tighter monetary policy, would suggest increased volatility in the next quarter.

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 Funds Portfolio, and Special Districts Funds Portfolio totaled $2.80 million with investments structured for security and liquidity.

REPORT PREPARED BY Don Collins, City Treasurer

ATTACHMENT Summary of Irvine Pooled Investment Portfolio by Fund

City of Irvine

Summary of Pooled Investment Portfolio Book Value by Fund

As of September 30, 2018

General Fund	**$**	**108,648,140**
Capital Projects Funds:		
Capital Improvement Projects		32,231,426
Irvine Business Complex		92,064,794
North Irvine Transportation Mitigation		81,711,354
Orange County Great Park Development		6,223,484
Park Development		22,095,036
Total		**234,326,094**
Special Revenue Funds:		
Air Quality Improvement		387,377
County Sales Tax Measure M		2,504,018
Fees and Exactions		14,069,735
Grants		3,810,829
I Shuttle		880,736
Local Park Fees		116,477,769
Maintenance District		(400,495)
Major Special Events		(71,136)
Orange County Great Park		113,184,995
Slurry Seal Fees		1,976,764
State Gasoline Tax		12,523,356
Systems Development		31,002,536
Total		**296,346,484**
Internal Service Funds:		
Equipment & Services		16,142,403
Inventory		100,184
Self-Insurance		17,126,181
Total		**33,368,768**
Permanent Fund:		
Senior Services		830,125
Total		**830,125**
Fiduciary Fund:		
Successor Agency Debt Service		27,914
Redevelopment Obligation Retirement		935,920
Total		**963,834**
Total Pooled Investments at September 30, 2018	**$**	**674,483,445**

Notes:

1. Funds presented are consistent with the City's Comprehensive Annual Financial Report (CAFR).
2. Balances are not audited and subject to changes due to fiscal year end reconciliation.

ATTACHMENT