# REQUEST FOR CITY COUNCIL ACTION

**MEETING DATE:** SEPTEMBER 11, 2012

**TITLE:** TREASURER'S ANNUAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2012

Director of Administrative Services

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, 2012. 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 $583.9 million as of June 30, 2012.

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

On August 8, 2012, at a regular meeting of the Investment Advisory Committee, the Committee Members recommended the City Council receive and file the Treasurer's Annual Report by a unanimous vote of 3-0 (Committee Members Shanahan and Walther absent). On September 4, 2012, at an adjourned regular meeting of the Finance Commission, the Commission received and filed the Treasurer's Annual Report by a unanimous vote of 4-0 (Commissioner Chai absent).

## 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 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 safekeeper 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, 2012, the book value (purchase price of securities as recorded on the City's books) of the Irvine Pooled Investment Portfolio was $369.8 million and the average weighted yield to maturity was 0.91 percent. Investment income (interest payments and capital gains) generated by the Irvine Pooled Investment Portfolio for the fiscal year ended June 30, 2012 was $4.5 million through the first close of June's books. Based on the average size of the portfolio, the annual effective rate of return was 1.17 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, 2012 | Mar 31, 2012 | Dec 31, 2011 | Sept 30, 2011 |
|---|---|---|---|---|
| Book Value | $369,761,787 | $360,681,836 | $362,257,751 | $361,207,864 |
| Market Value | $371,336,805 | $362,118,825 | $363,928,644 | $363,079,325 |
| Unrealized Gain/(Loss) | $1,575,018 | $1,436,989 | 1,670,903 | $1,871,461 |
| Unrealized Gain/(Loss) as % of Book Value | 0.04% | 0.40% | 0.46% | 0.52% |
| Average Yield To Maturity | 0.91% | 1.01% | 1.06% | 1.27% |
| Liquidity 0 – 6 months | 12.91% | 18.64% | 19.73% | 13.10% |
| Average Years To Maturity | 2.65 years | 2.45 years | 2.34 years | 2.31 years |
| Effective Duration | 2.54 years | 2.38 years | 2.29 years | 2.22 years |

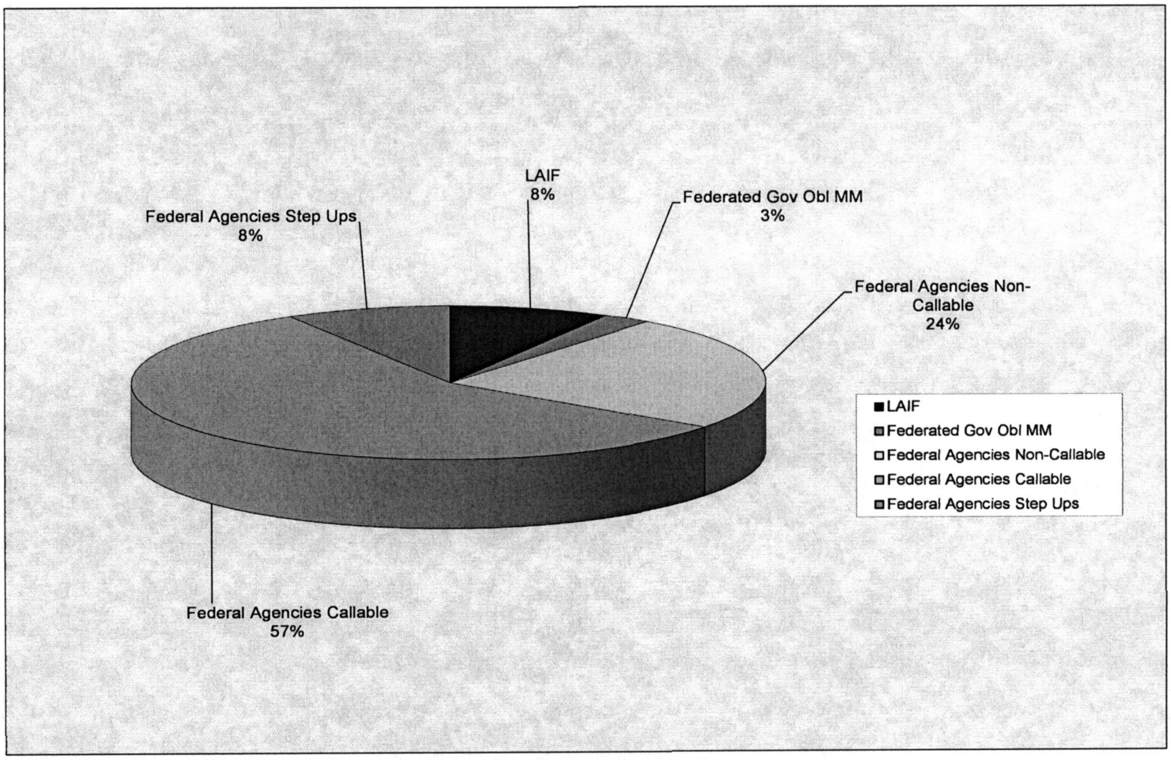
Portfolio average yield to maturity declined 11 basis points (0.11 percent) as compared to the prior quarter that ended on March 31, 2012. Despite a decline in interest rates during the fiscal year, the average yield to maturity has only declined 36 basis points (0.36

percent) as compared to June 30, 2011. The portfolio strategy to invest in longer term maturities to capture incremental yield has helped reduce the decline in average yield to maturity the portfolio otherwise would have experienced. The overnight to 6-months of liquidity level of 12.91 percent will meet anticipated cash needs and provide the ability to invest in higher yielding securities should interest rates increase in the future.

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.

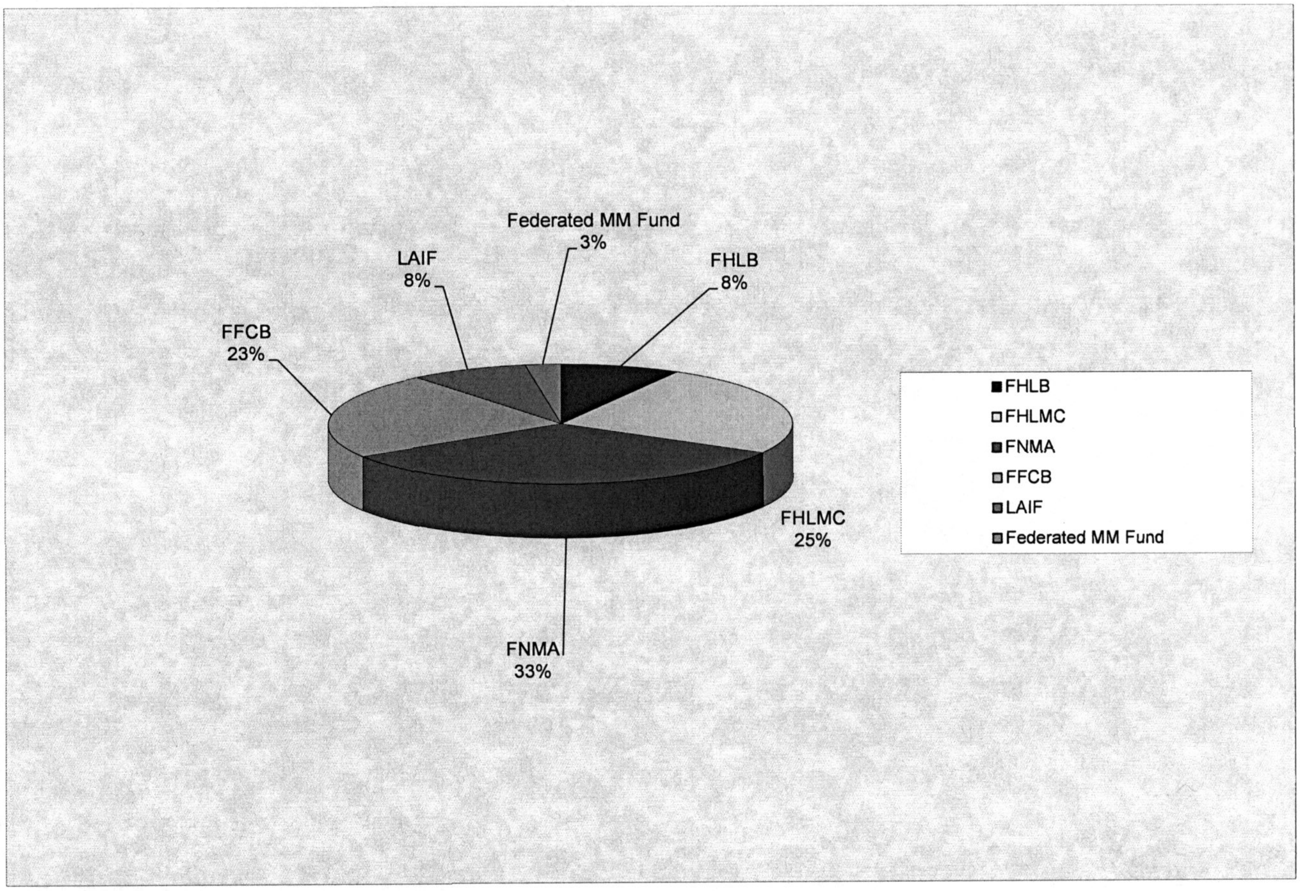
To manage liquidity, the Portfolio is invested in the State of California's Local Agency Investment Fund (LAIF), and the Federated Government Obligation money market fund. Chart 1 below shows the asset allocation of the Irvine Pooled Investment Portfolio.

**Irvine Pooled Investment Portfolio**
**Chart 1 - Asset Allocation**
**as of June 30, 2012**



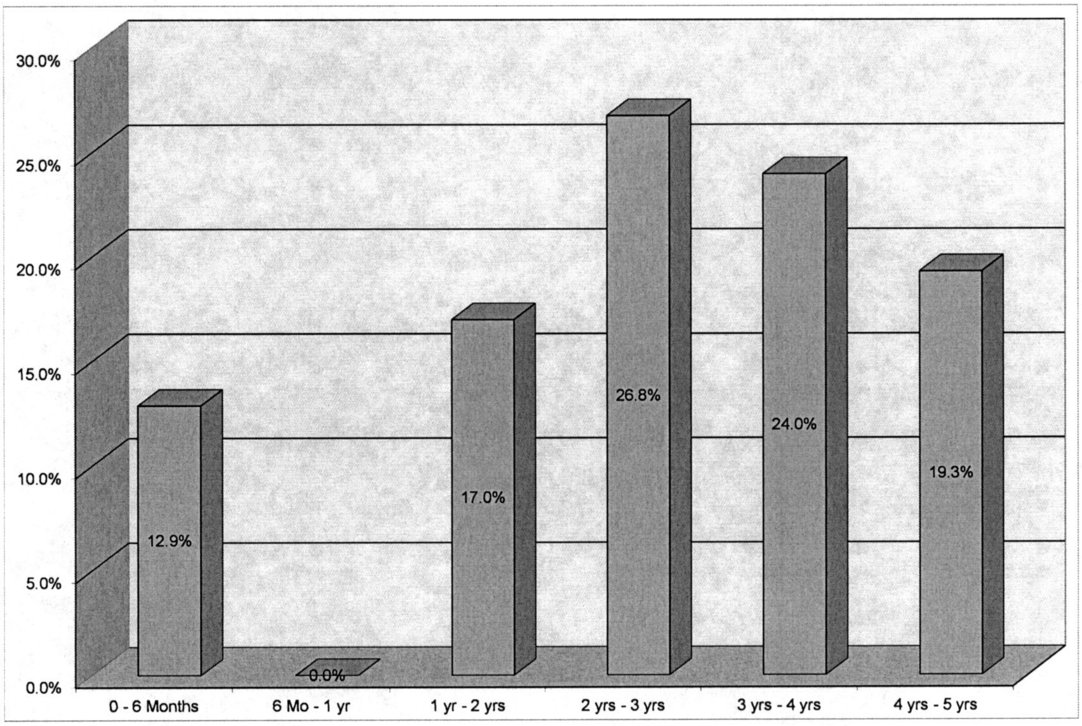
Since 89.20 percent of the portfolio is invested in Federal Agency securities, the safety of the Portfolio is further protected by purchasing securities from several different Federal Agencies. The four Federal Government sponsored entities that the City purchases securities from are Federal Home Loan 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 below identifies portfolio holdings by issuer name.

**Irvine Pooled Investment Portfolio**
**Chart 2 - Allocation by Issuer Name**
**as of June 30, 2012**



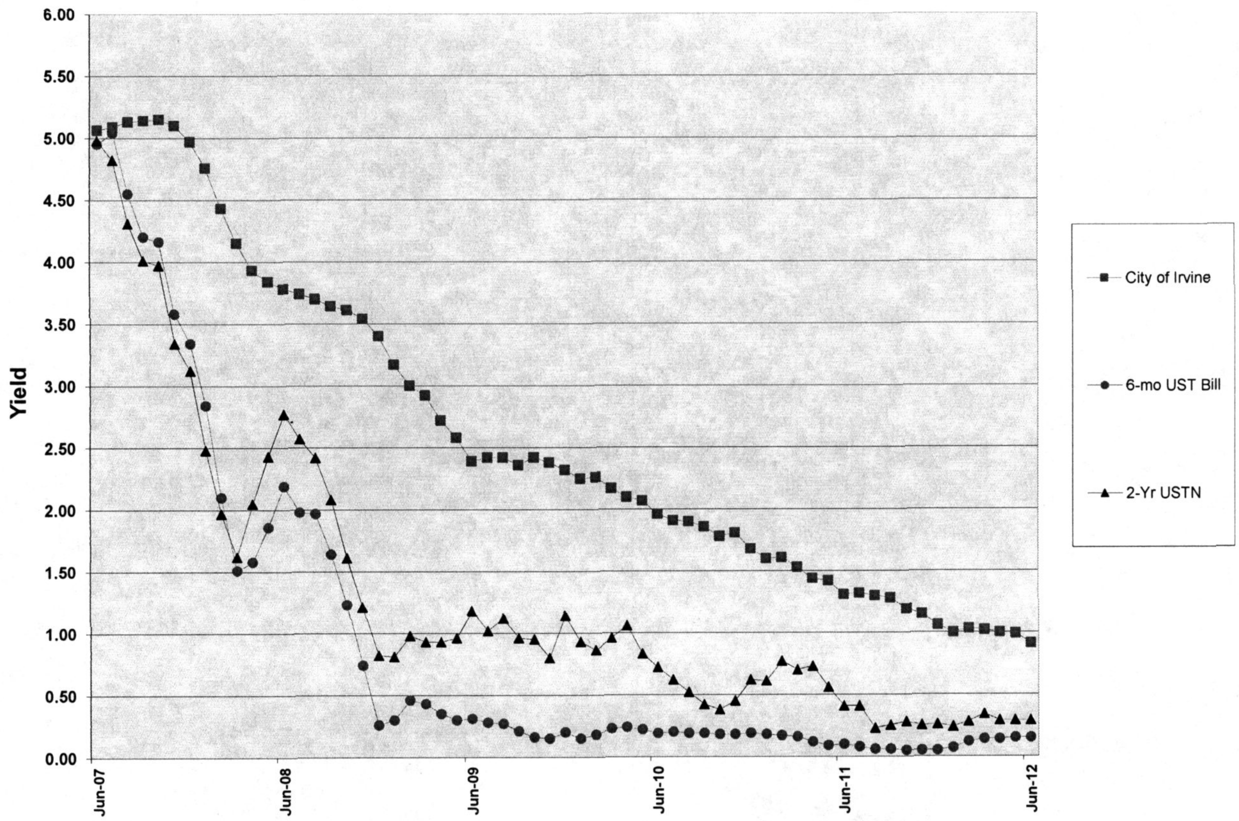

Another key component in portfolio management is to ensure that the City has enough funds on hand to meet current expenses. By using cash flow forecasts, the portfolio manager is able to project short and long-term cash needs to help make informed and appropriate investment decisions. As of June 30, 2012, the overnight to 6-month liquidity level for the Irvine Pooled Investment Portfolio was at 12.91 percent, which provides adequate liquidity to meet anticipated expenses. Chart 3 below 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, 2012**




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 0.76 percent and higher than the 2-year UST by 0.62 percent.

**Irvine Pooled Investment Portfolio**
**Graph 1 - Yield to Maturity Compared to Assigned Benchmarks**
**June 2007 through June 2012**




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 $573,874 for the year ended June 30, 2012 based on an average cash balance of $61.7 million. Two loans, made by AMP in 2005 and 2006 to the Irvine Redevelopment Agency (Agency) have an outstanding balance of approximately $9.8 million, including $3.2 million of accrued interest. Repayment of these loans is scheduled to begin in fiscal year 2015-16.

Assembly Bill x1 26, enacted in 2011, dissolved all redevelopment agencies effective February 1, 2012. The Irvine City Council as the Successor Agency to the dissolved Agency is responsible for winding down the affairs of the dissolved Agency, with certain actions subject to the approval of an Oversight Board and review by the State

Department of Finance. These loans are among the obligations of the dissolved Agency included on the Recognized Obligation Payment Schedule (Payment Schedule), which is the list of obligations to be paid from tax increment revenues formerly allocated to the Agency.

*Great Park Corporation Funds*
Through the first close of June's books, the Great Park funds earned interest of $603,156 for the fiscal year ended June 30, 2012. The Great Park funds had a combined average daily cash balance of $67.0 million for the year ended June 30, 2012.

**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 year ended June 30, 2012.

- Book Value $27,686,089
- Market Value $27,719,844
- Unrealized Gains/(Losses) $33,755
- Average Weighted Yield to Maturity 0.358%
- Annual Effective Rate of Return 0.450%
- Fiscal Year to Date Investment Income $89,546

**Special District Funds Portfolio**
The Special District Funds Portfolio contains project and reserve funds for 46 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 year ended June 30, 2012.

- Book Value $184,898,244
- Market Value $184,910,550
- Unrealized Gains/(Losses) $12,306
- Average Weighted Yield to Maturity 0.010%

- Average Annual Yield 0.023%
- Fiscal Year to Date Investment Income $52,067

**Market Conditions**
In the first half of the fiscal year, bond interest rates declined, particularly in the longer end of the curve (5- to 30-year sectors). European sovereign market issues continued to be a driving force in pushing interest rates lower. In addition to the weakened credit markets in Greece, Ireland and Portugal, both Italy and Spain (the 3rd and 4th largest economies in Europe) were added to the list of troubled countries. On the domestic front, the Federal Open Market Committee (FOMC) announced at its September 2011 meeting the implementation of a new quantitative easing program named Operation Twist, which also contributed to the decline in interest rates. In Operation Twist, 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. In effect, the program extends the average maturity of the securities held by the Federal Reserve, which creates downward pressure on long term interest rates. The desired outcome of Operation Twist is to stimulate the economy due to the lower long term interest rates.

Similar to the first half of the fiscal year, the interest rates in the second half of the year were driven lower due to continued problems in Europe and the continued use of Operation Twist by the FOMC. There was a brief period in February 2012 when bond market interest rates rose. The European Union (EU) agreed to a Greece bailout as relief for the country's debt issues. In response to the bailout, the Dow Jones Industrial Average crossed the 13,000 mark. In the domestic economy, improvement in the labor and housing markets contributed to the increase in interest rates. Unfortunately, the increase in rates was short-lived as the Greece bailout proved to be ineffective, drawing investors back to the United States treasury market. The domestic economy began to show weakness again indicating a slower growing economy than first hoped.

The FOMC continued to leave the Federal Funds rate at a range of 0 percent to 0.25 percent during the fiscal year. At the January 2012 FOMC meeting, the Committee changed its target date for maintaining the Federal Funds rate at their current levels. The expectation for the change in monetary policy was extended to late 2014 from mid-2013. The extension of the accommodative policy played a part in keeping bond interest rates at low levels along with the other factors previously stated.

## ALTERNATIVES CONSIDERED

None.

**FINANCIAL IMPACT**

Fiscal year-to-date investment income for the Irvine Pooled Investment Portfolio, Bond Proceeds, and Special Districts portfolios totaled $4.6 million with investments structured for security and liquidity.

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