REQUEST FOR CITY COUNCIL ACTION

MEETING DATE: **SEPTEMBER 13, 2011**

TITLE: **TREASURER'S ANNUAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2011**

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, 2011. These portfolios, which are managed by United American Capital Corporation (UACC) under the direction of the Treasurer, are categorized as the Pooled Investment Portfolio, Bond Proceeds Fund and Special District Funds. The market value of all investments under the Treasurer's management totaled $690 million as of June 30, 2011.

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

At a regular meeting of the Investment Advisory Committee on August 10, 2011, the committee members recommended the City Council receive and file the Treasurer's annual report by a unanimous vote of 4-0 (Chair Nicolas absent). On August 15, 2011, at a regular meeting of the Finance Commission, the Commission received and filed the Treasurer's report by a unanimous vote of 3-0 (Commissioners Bollard and 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 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.

Pooled Investment Portfolio

The 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 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, 2011, the book value (purchase price of securities as recorded on the City's books) of the Pooled Investment Portfolio was $392.6 million and the average weighted yield to maturity was 1.31%. Fiscal year-to-date investment income (interest payments and capital gains) generated by the Pooled Investment Portfolio, as of the fiscal year ended June 30, 2011, was $8.0 million through the first close of June's books. Based upon the average size of the portfolio, the annual effective rate of return was 1.80%. The following chart compares the Pooled Investment Portfolio statistics over a rolling 12-month period.

Pooled Investment Portfolio
Rolling 12-Month Quarterly Comparison

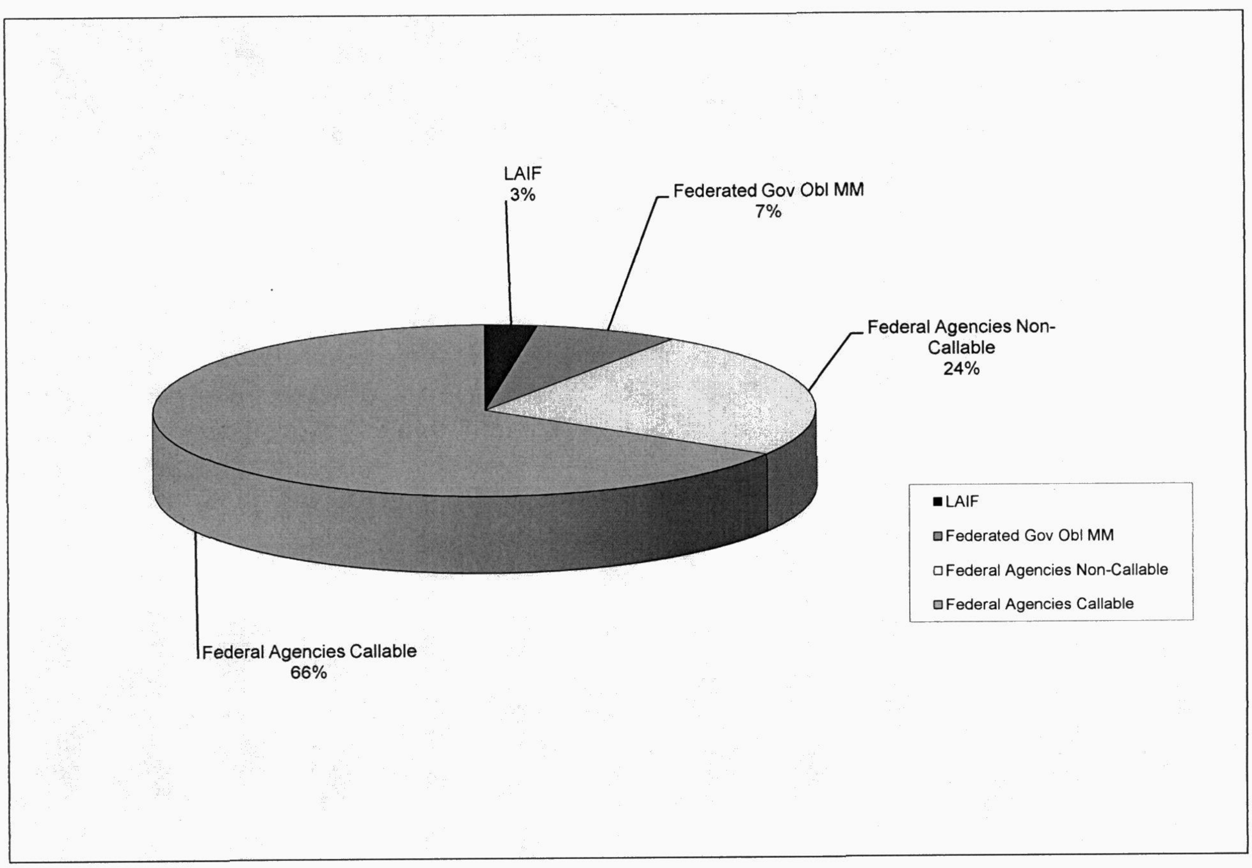
	Jun 30, 2011	Mar 31, 2011	Dec 31, 2010	Sept 30, 2010
Book Value	$390,796,869	$378,178,635	$381,398,248	$403,617,050
Market Value	$392,583,506	$378,532,425	$383,270,170	$407,235,061
Unrealized Gain/(Loss)	$1,786,637	$353,790	$1,871,922	$3,618,011
Unrealized Gain/(Loss) as % of Book Value	0.46%	0.09%	0.49%	0 90%
Average Yield To Maturity	1.31%	1.53%	1.66%	1 85%
Liquidity 0 – 6 months	10.87%	16.56%	24.63%	19.36%
Average Years To Maturity	2.25 years	2.12 years	2.03 years	2.04 years
Effective Duration	2.10 years	2 03 years	1 89 years	1.94 years

The Pooled Investment Portfolio Book Value increased by $12.6 million during the fourth quarter of the fiscal year due to the receipt of the second installment of property taxes in April. The average yield to maturity declined 22 basis points (0.22%) as securities with coupons between 2% and 3% matured or were called and replaced by securities with significantly lower coupons. Pooled Investment Portfolio strategy during the past fiscal year has been to invest in long term to capture incremental yield, as seen by the increased average years to maturity and effective duration. If interest rates begin to increase, there is sufficient liquidity in the Pooled Investment Portfolio to ensure immediate cash flow needs are met and take advantage of the shift in interest rates, which will add higher yielding securities to the portfolio.

To ensure the safety of the Pooled Investment Portfolio, investments that hold the highest credit quality are selected. The Pooled Investment Portfolio is comprised primarily of Federal Government sponsored entity debt, otherwise known as Federal Agencies. In August 2011, the United States government and all the Federal Agencies were downgraded by Standard & Poors (S&P) from AAA to AA+. Two of the major rating agencies, Moody's and Fitch, reaffirmed the AAA ratings of the U.S. Government and the Agencies, however, retained a negative outlook status. Despite the downgrade by S&P, investors sought the safety of the Treasury market, driving interest rates to record lows in the week that followed the downgrades. Throughout the resulting turmoil from the downgrade, Treasury securities, followed closely by Agency securities, remain the safest assets in the global market.

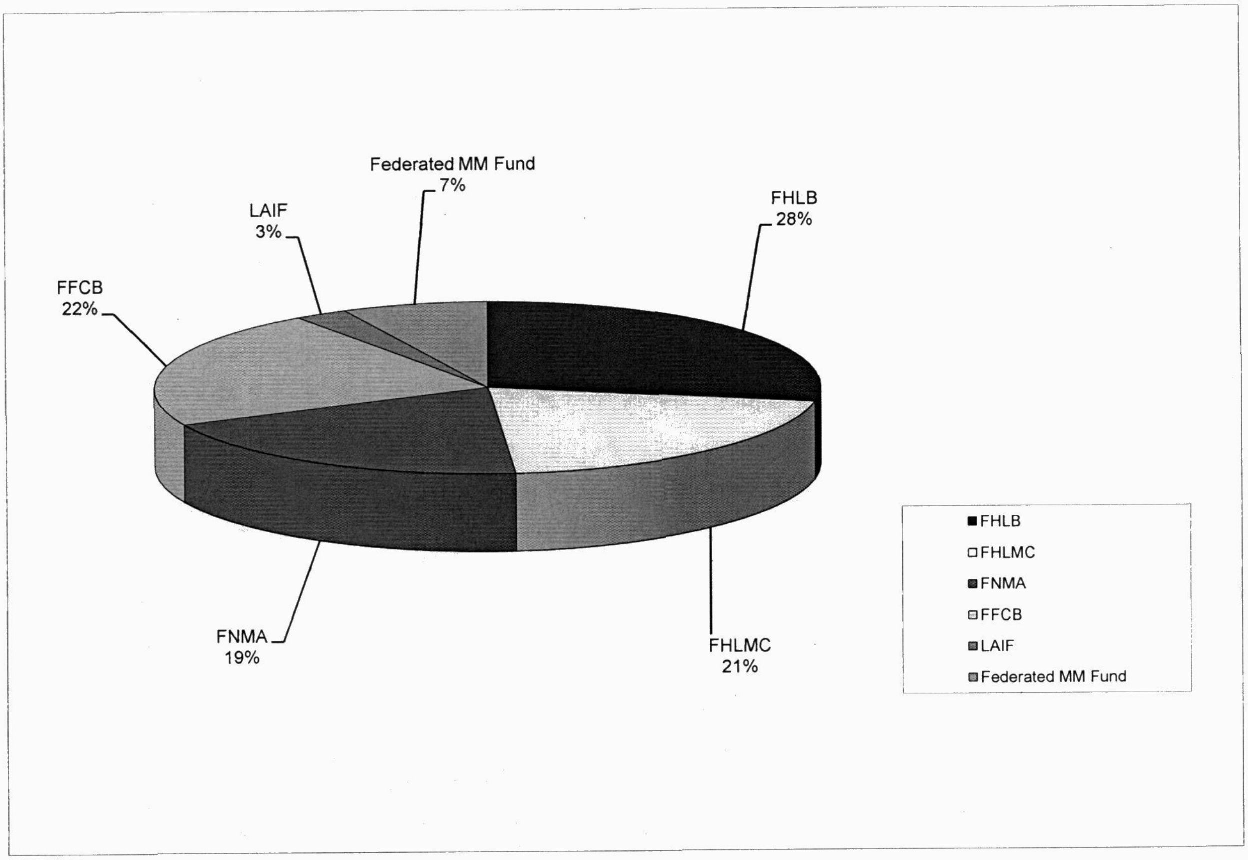
To manage liquidity, the Pooled Investment Portfolio is invested in the State of California's Local Agency Investment Fund (LAIF), and the Federated Government Obligation money market fund. The following chart shows the asset allocation of the Pooled Investment Portfolio.

Pooled Investment Portfolio
Asset Allocation
as of June 30, 2011



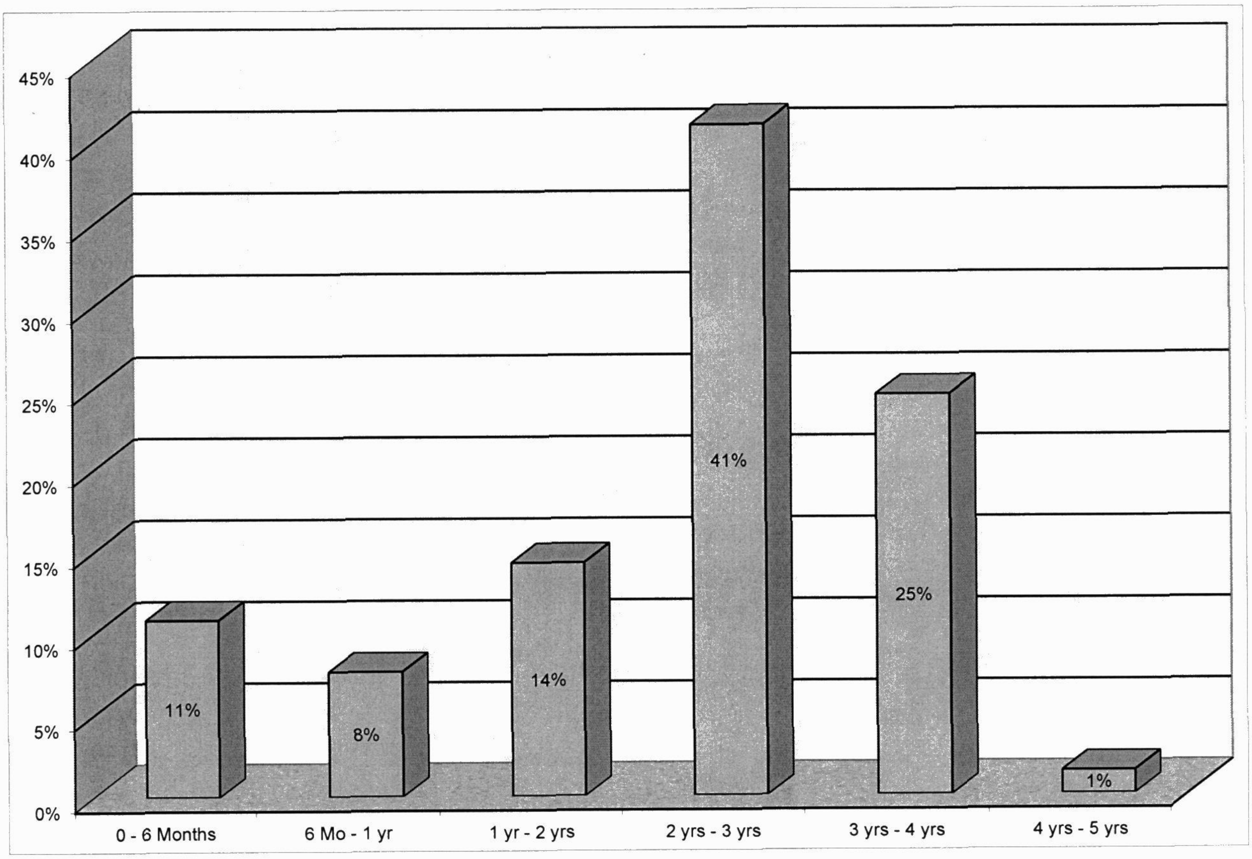
Since over 90% of the Pooled Investment Portfolio is invested in Federal Agency securities, safety is further protected by purchasing securities from several different Federal Agencies. The four Federal Government sponsored entities that the City purchases securities from are Federal Home Loan Bank (FHLB 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. The breakdown of holdings by issuer name is demonstrated on the following chart.

Pooled Investment Portfolio
Breakdown by Issuer Name
as of June 30, 2011



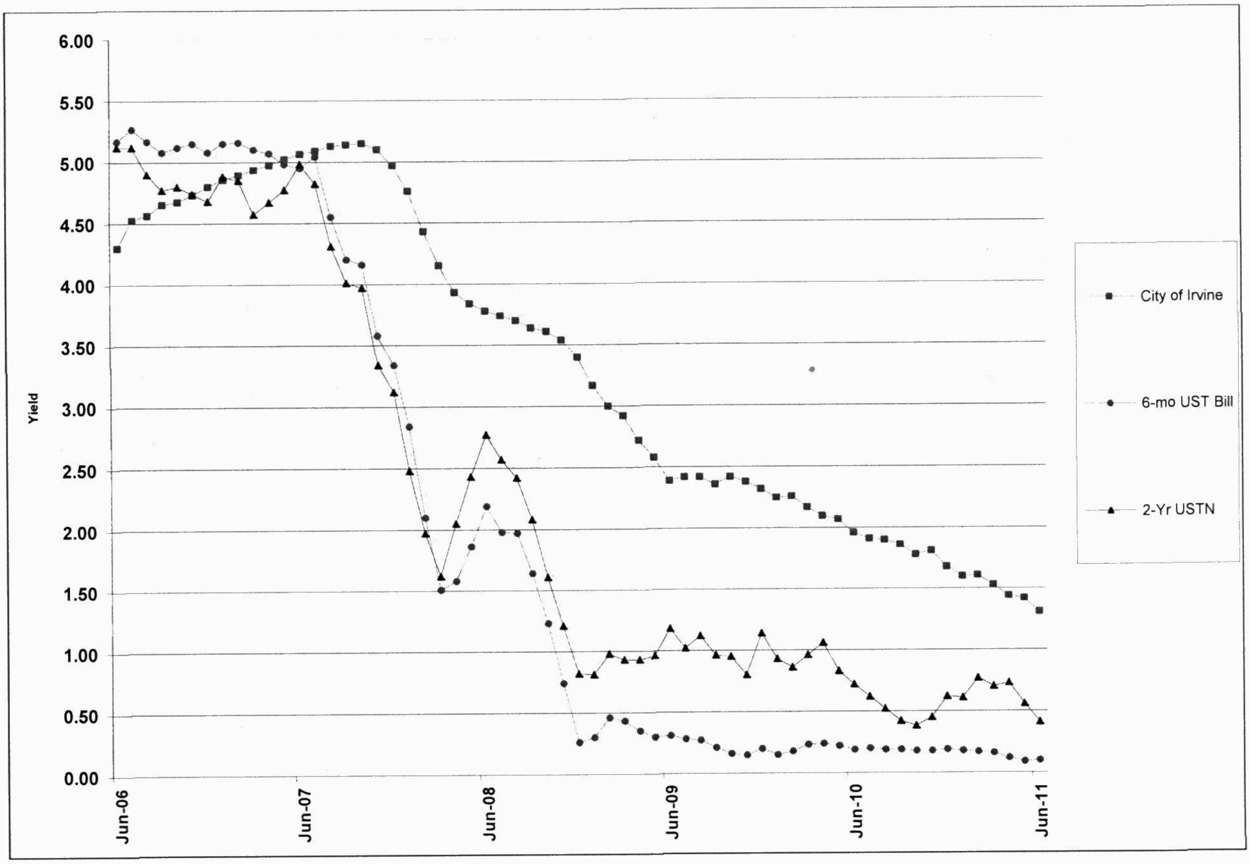
Another key component in Pooled Investment Portfolio management is to ensure that the City has enough liquidity available to meet current expenses. By using cash flow forecasts, the portfolio manager is able to project short and long-term cash needs to help make informed and appropriate investment decisions. As of June 30, 2011, the 0 to 6-month liquidity level for the Pooled Investment Portfolio was at 10.87%, which provides adequate liquidity to meet anticipated expenses. The chart on the following page is an aging out to 5 years (the maximum maturity allowable by policy and state code) of the Pooled Investment Portfolio.

Pooled Investment Portfolio
Aging of Maturing Investments
as of June 30, 2011



To gauge performance of the Pooled Investment Portfolio, the City compares the Pooled Investment Portfolio's yield to maturity against two benchmarks established in the City's Annual Investment Policy. The benchmarks are used as a measure of the Pooled Investment Portfolio against market movement. The graph on the following page compares the average yield to maturity of the Pooled Investment Portfolio to the 6-month United States Treasury (UST) Bill Index and 2-year UST Note Index, the two benchmarks stated in the Annual Investment Policy. The graph shows the spread (difference between the index and the yield to maturity) over the past five years. The City is experiencing a positive spread against both the 6-month UST and the 2-year UST. The Pooled Investment Portfolio's yield is higher than the 6-month UST by 1.21% and higher than the 2-year UST by 0.90%.

Pooled Investment Portfolio
Yield to Maturity Compared to Assigned Benchmarks
June 2006 through June 2011



The 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 AMP funds are allocated based on the AMP fund average daily cash balance. The AMP earned interest of $917,535 for the year ended June 30, 2011 based on an average cash balance of $53.1 million. Additionally, the AMP has accrued interest through June 30, 2011 of approximately $2.8 million. This accrual is the result of $6.6 million in loans made in 2005 and 2006 by the AMP to the Irvine Redevelopment Agency to fund Agency activities prior to the receipt of tax increment funds. Principal and interest payments are scheduled to be repaid to the AMP from tax increment revenue starting in fiscal year 2015-16, however, interest is accruing at the City's earnings rate plus 3%.

Great Park Corporation Funds
The Great Park earned interest of $7.03 million for the year ended June 30, 2011. Of the earned interest, $5.50 million represents partial repayment of interest accrued under

the Purchase and Sale and Financing Agreement between the Redevelopment Agency and the City dated August 14, 2007. City Council authorized the receipt of payment from the Irvine Redevelopment Agency on March 8, 2011. The repayment amount was deposited in the Great Park Fund pursuant to Section 2.4 of the Agreement. The remaining interest earnings of $1.53 million are based on the Great Park funds' average daily cash balance. The Great Park had an average daily cash balance of $95.1 million for the year ended June 30, 2011.

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, 2011.

• Book Value	$36,579,212
• Market Value	$36,637,265
• Unrealized Gains/(Losses)	$58,053
• Annual Effective Rate of Return	0.31%
• Fiscal Year to Date Investment Income	$95,137

Special District Funds Portfolio

The Special District Funds Portfolio contains project and reserve funds for 50 Special Assessment District bond issues and one Community Facilities District. Investments 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, 2011.

• Book Value	$260,380,970
• Market Value	$260,394,234
• Unrealized Gains/(Losses)	$13,264
• Average Weighted Yield to Maturity	0.017%
• Average Annual Yield	0.08%
• Fiscal Year to Date Investment Income	$276,019

Market Conditions
During the first half of the fiscal year, interest rates slowly declined as market investors tried to decipher whether the U.S. economy was entering into a double-dip recession and a deflationary environment, or merely continue with sluggish growth and low inflation. However, interest rates rose in November due to evidence of economic strength and revised forecasts for future economic growth. At the beginning of the second half of the fiscal year, rates increased again as more economic indicators supported evidence for an improved economy. However, unrest in the Middle East and North Africa, combined with higher oil prices and the Japanese earthquake, prompted a rally in March, leading to lower interest rates from the highs posted earlier in the quarter. In the final quarter of the fiscal year, interest rates reversed course as weaker than expected economic data was released, especially in the labor and housing markets. This renewed speculation that the country could be entering into another recession. Other factors contributing to the decline in rates included the continued flight to quality from the equity markets (due to unrest abroad) and resurfaced concerns over the European sovereign debt crisis.

The Federal Open Market Committee continued its accommodative monetary position during the fiscal year, leaving the Federal Funds rate at a range of 0% to 0.25%. The Federal Reserve (Fed) also began a second round of purchasing Treasury securities in the open market, keeping interest rates low in an effort to stimulate the economy. The Federal Reserve concluded its purchase program in June and will continue to reinvest principal and interest payments from its securities portfolio. The Fed is not expected to increase the Federal Funds rate any time in the near future.

ALTERNATIVES CONSIDERED

None.

FINANCIAL IMPACT

Fiscal year-to-date investment income for the Pooled Investment Portfolio, Bond Proceeds, and Special Districts portfolios totaled $9.08 million with investments structured for security and liquidity.

REPORT PREPARED BY Michele C. Lund, City Treasurer