STAFF REPORT

AGENDA NO: 8d

MEETING DATE: February 4, 2019

To: **Honorable Mayor and City Council**

Date: **February 4, 2019**

From: **Carol Augustine, Finance Director—(650) 558-7222**

Subject: **Quarterly Investment Report, Period Ending December 31, 2018**

RECOMMENDATION

Staff recommends that the City Council receive and approve the City's investment report through December 31, 2018.

BACKGROUND

This report represents the City's investment portfolio as of December 31, 2018. The report includes all invested City funds with the exception of bond proceeds, the City's account with the California Employers' Retiree Benefit Trust Fund (CERBT), which is used to pre-fund the City's retiree medical obligations, and the §115 trust account with the Public Agency Retirement Services (PARS) Pension Rate Stabilization Program. All other investments are covered by and in compliance with the City's adopted Statement of Investment Policy.

DISCUSSION

The City's investments are guided by the Statement of Investment Policy (the "Policy"), which is reviewed and approved by the Council annually The Policy was last approved by the City Council on June 18, 2018. The Policy directs that investment objectives, in order by priority, are safety, liquidity, and return. This conservative approach ensures assets are available for use while also allowing the City to earn additional resources on idle funds. The City utilizes a core portfolio of investments managed by the City's investment advisor, PFM Asset Management (PFM), and also maintains funds invested in the State's Local Agency Investment Fund (LAIF) and the California Asset Management Program (CAMP) to achieve its investment goals.

CURRENT MARKET CONDITIONS

In contrast to the relative calm that defined the financial markets throughout most of 2018, the fourth quarter was dominated by trade war worries, fears of a slowdown in global growth, and political uncertainties, all of which led to increased market volatility and a sharp sell-off in the stock market. All three major U.S. equity indices stumbled during the quarter, ending the year in the red. In particular, the S&P 500 equity index plummeted 14.0% over the quarter, nearing bear market territory and erasing gains for the year. International indices did not fare better, as they were not exempt from rising rates, rising protectionism, falling oil, and growing policy uncertainties.

While the domestic economy remains generally on solid footing, bolstered by a robust labor market and slow, steady economic expansion, global growth concerns weighed heavily on investors' minds as international news grabbed headlines. Top concerns included a global trade war, ongoing wrangling over Brexit details, Italian debt concerns, violent protests in France over labor unrest, and the end of the European Central Bank's massive quantitative easing program.

As was widely expected, the Federal Reserve (Fed) raised the federal funds' target to a new range of 2.25% to 2.50% at its meeting in December, holding true to its stated intentions of four rate hikes in 2018. However, unlike the well-choreographed rate hikes of 2017 and 2018, the future pace of overnight monetary policy is unclear. The Fed's most recent estimates called for two rate hikes in 2019, while the market's expectation (as measured by fed funds futures) calls for zero hikes in 2019. Moreover, Federal Reserve Chair Jay Powell noted that the Fed is "prepared to adjust policy quickly and flexibly" if necessary, adding greater uncertainty to the path of future rate hikes.

Real gross domestic product (GDP) in the U.S. grew at an annualized rate of 3.4% in the third quarter (Q3), making Q2 and Q3 the best back-to-back quarters since 2014. The American consumer continued to drive strong Q3 growth, which more than offset moderation in business investment and an outright contraction in trade.

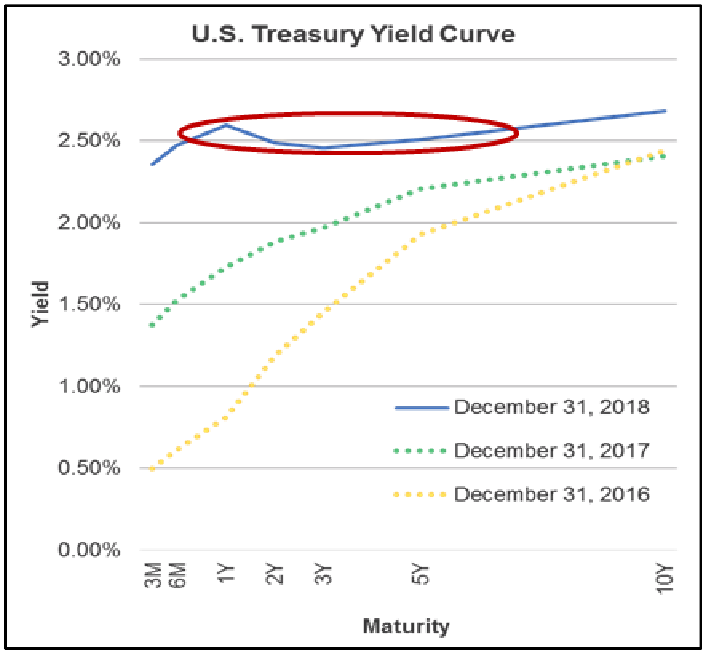
The U.S. labor market continues to be a shining star of the U.S. economy, as the domestic labor market added 312,000 jobs in December. The overall unemployment rate ticked up just slightly to 3.9% in December as the labor force participation rate edged upward, suggesting that potential job-seekers are feeling more optimistic about job prospects and are coming off of the sidelines.

Domestic inflation remained in the Fed's comfort range throughout the quarter as the most recent reading of Core PCE, the Fed's preferred gauge of inflation, registered at 1.9% year-over-year through November. While wage growth has risen to match the expansion high, it has yet to translate into higher inflation. Moreover, weakening investor sentiment led to a drop in future inflation expectations. As of year-end, investor expectations of average inflation over the next five years fell to just 1.5%.

Equity market volatility during the fourth quarter sparked a flight to quality, as investors sought the safety of U.S. Treasury obligations, resulting in a quarter-over-quarter decline in intermediate-and longer-term U.S. Treasury yields for the first time in several years. For example, the yield on the 2-year U.S. Treasury note dropped by 33 basis points (0.33%) during the quarter.

Perhaps even more noteworthy, the U.S. Treasury yield curve inverted between 1- and 5-year maturities for the first time since 2007. Short-term yields, bolstered by increases to the federal funds target rate, continued their upward ascent, while intermediate- and longer-term yields fell in response to souring investor sentiment on future growth prospects. This continues the trend of flattening of the yield curve that has remained in play for the better part of the last two years. While this modest inversion in the belly of the yield curve may be explained away due to market anomalies (Central Bank intervention and increased foreign demand for intermediate- and longer-term U.S.

Treasuries), investors will be closely watching for any inversion in the 10-year tenor – historically a more meaningful and market-adopted warning signal.



Yield Curve History

Maturity	12/31/18	9/30/18	Change
3-Mo.	2.35%	2.20%	**+0.15%**
6-Mo.	2.48%	2.36%	**+0.12%**
1-Yr.	2.60%	2.56%	**+0.04%**
2-Yr.	2.49%	2.82%	**-0.33%**
3-Yr.	2.46%	2.88%	**-0.42%**
5-Yr.	2.51%	2.95%	**-0.44%**
10-Yr.	2.68%	3.06%	**-0.38%**
30-Yr.	3.01%	3.21%	**-0.20%**

The City's cash, excluding bond proceeds, is pooled for investment purposes. As of December 31, 2018, invested funds totaled $170,087,803.37. These investments are assets of the City of Burlingame and include the General Fund, the enterprise funds (such as Water, Sewer, and Solid Waste), as well as various non-major funds. Note that the City's account with the California Employers' Retiree Benefit Trust Fund (CERBT), used to pre-fund the City's retiree medical obligations, is not included in the City's managed portfolio. Similarly, funds held within the City's §115 Trust account with the Public Agency Retirement Services (PARS) Pension Rate Stabilization Program are not part of the City's investment portfolio.

City's Investments Market Value as of December 30, 2018	
Main Investment Portfolio	$109,200,496.06.87
Main Investment Portfolio - Cash Balance in Custody Account	$127,169.99
CAMP Balance	$26,401,167.20
LAIF Balance	$34,358,970.12
	$170,087,803.37

As has been the case for most of 2018, the portfolio's duration was kept slightly short of the benchmark's duration in order to hedge against the negative impacts of rising interest rates. At the end of the quarter, the main portfolio's duration was 2.33 years, short of the benchmark's duration of 2.56 years. Factoring in additional liquid investments, such as LAIF and CAMP, the effective duration of the City's aggregate investments was 1.50 years.

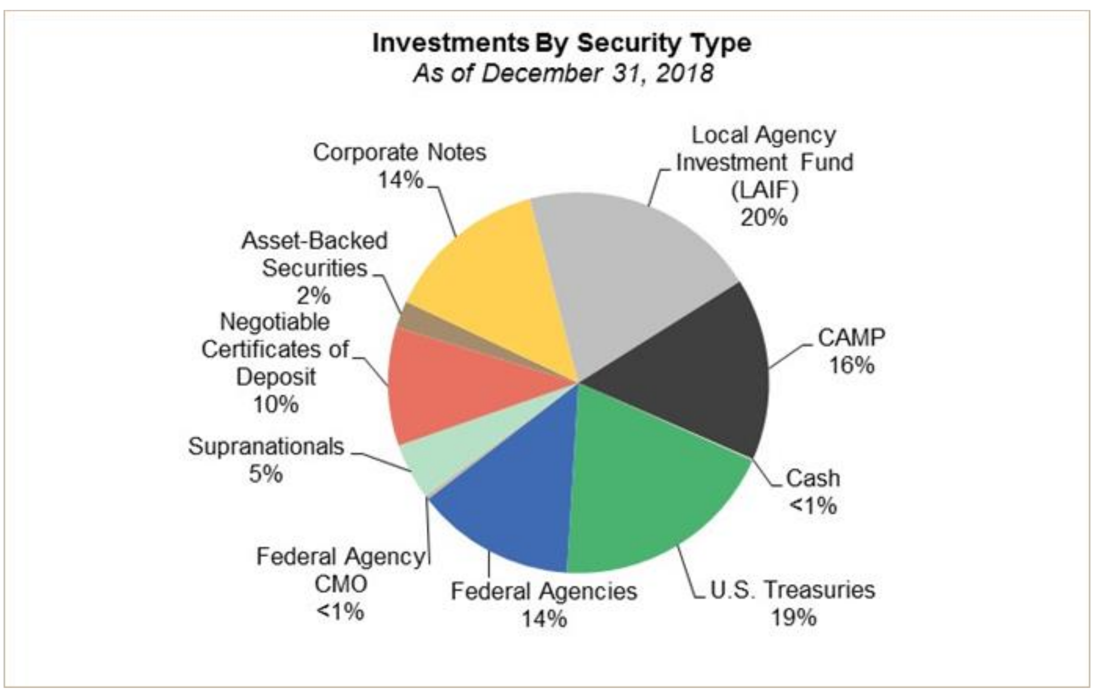
Given the recent market volatility, the City's portfolio was managed with a more conservative stance during the quarter, as purchases were focused in the U.S. Treasury and federal agency sectors.

In early December, PFM recommended the sale of shorter-dated Fannie Mae notes in exchange for the purchase of longer-dated notes issued by the same agency. This purchase enabled the City to take advantage of one of the widest yield spreads (the difference in yields) between the federal agency and U.S. Treasury obligations with less than five years to maturity.

Please see below for a summary of transactions for the quarter ended December 31, 2018:

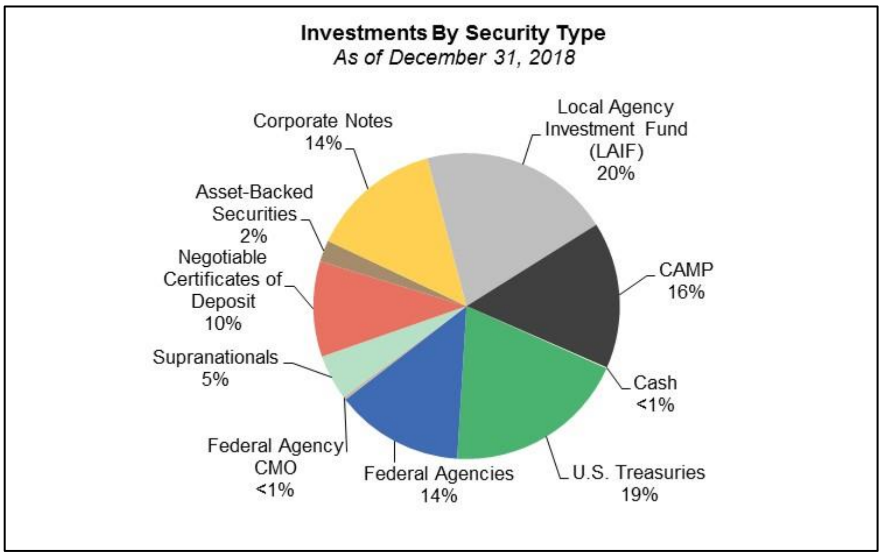
Trade Date	Settlement Date	Transaction	CUSIP	Issuers	Term (Mths)	Yield	Principal
10/02/2018	10/03/2018	Sale	06427KRC3	Bank of Montreal Chicago Neg. CD	4	2.10%	200,000
10/02/2018	10/04/2018	Sale	3137EAEE5	FHLMC Notes	16	2.74%	1,500,000
10/02/2018	10/04/2018	Purchase	912828P38	U.S. Treasury Notes	53	2.93%	2,000,000
12/03/2018	12/06/2018	Purchase	3135G0U43	FNMA Notes	58	2.92%	3,550,000
12/03/2018	12/06/2018	Sale	3135G0A78	FNMA Notes	14	2.79%	3,150,000

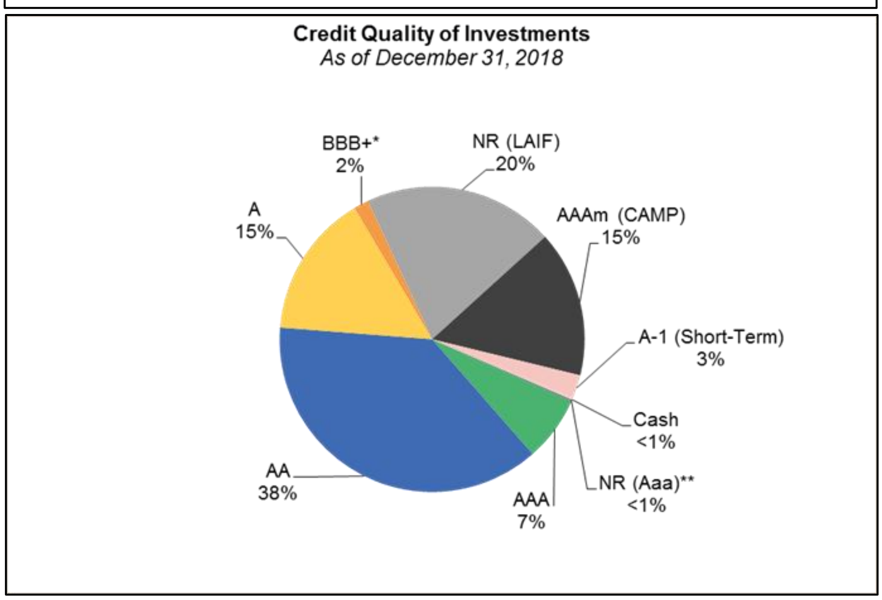
While the path of future Fed rate hikes is less clear than in recent years, PFM expects future tightening (additional Fed rate hikes) to be modest. Further, political gridlock adds additional uncertainty. As a result, PFM will seek to increase portfolio duration to be more in line with (neutral to) the benchmark.



PFM continues to monitor the markets and recommend relative-value trades as appropriate in order to safely enhance the City’s portfolio earnings. However, the priority will always be to maintain the safety and liquidity of the City's investments. Since some of the market volatility that dominated the markets at year-end seems to have dissipated, PFM may increase the portfolio's allocation to non-government sectors in coming months, provided that all issuers continue to meet PFM's stringent credit quality guidelines. Because yield spreads (the difference in yields) between the federal agency and U.S. Treasury obligations remain low by historic standards, PFM generally prefers the use of U.S. Treasuries over federal agencies, unless a particular federal agency issue offers significant value. Supranationals continue to provide a high-quality alternative to federal agency debt. The portfolio's holdings in these instruments may increase in coming months, as Supranational debt issuance is expected to increase in the first few months of the year.

As noted in the following pie charts, the City's investment portfolio as of December 31, 2018, was heavily weighted towards the State Local Agency Investment Fund (LAIF), the AAAm-rated CAMP Fund, and high-quality (AA+ rated) federal agency and U.S. Treasury securities to maintain the focus on safety and liquidity.

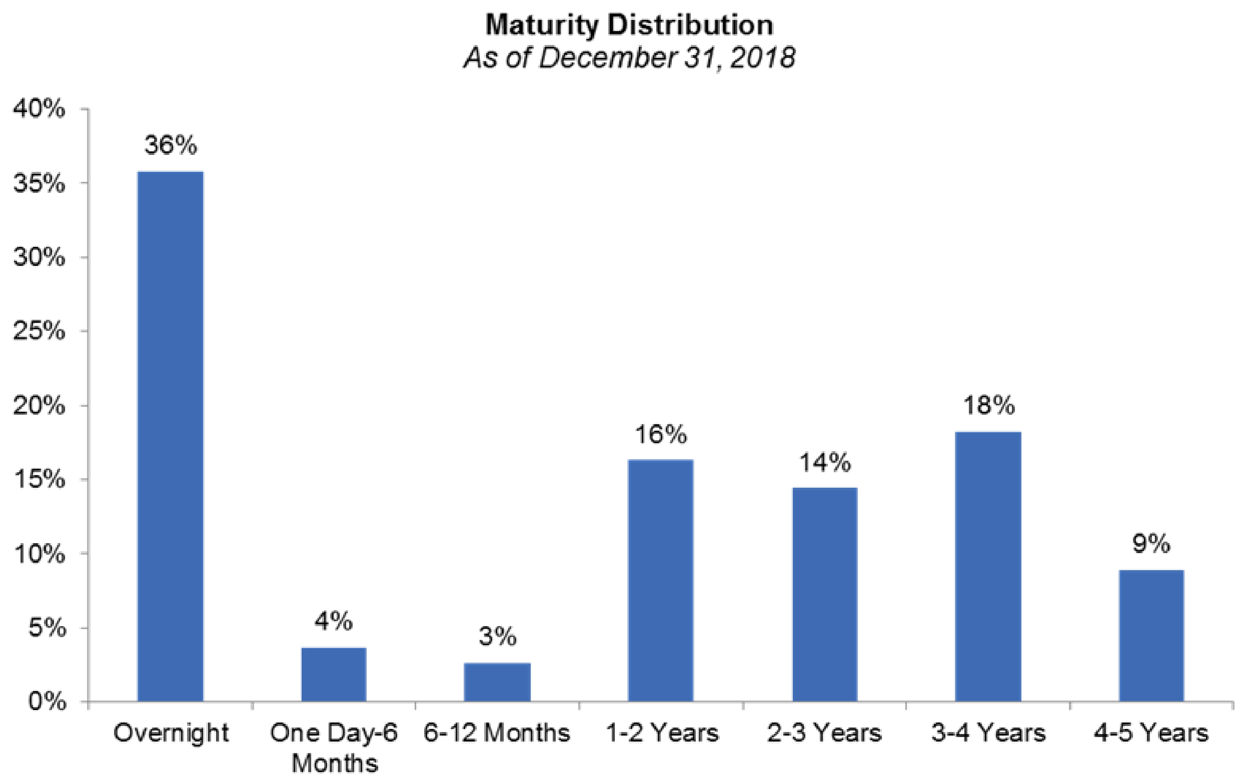




**The "BBB+" category comprises securities rated in the category of A or better by Moody's and/or Fitch, which meets the credit rating criteria established in the City's Statement of Investment Policy.*

*** The NR (Aaa) category comprises asset-backed securities that are not rated by S&P but are rated Aaa by Moody's*

As of December 31, 2018, 36% of the City's funds were invested in very short-term liquid investments; 23% of the funds were invested with maturities between one day and two years; and 41% of the investment portfolio had a maturity ranging from two to five years. This distribution gives the City the necessary liquidity to meet operational and emergency cash needs while maximizing returns on funds not needed in the immediate future. The City's aggregate investments maintain an effective duration of 1.50 years and currently generate annual interest income of 2.33% before investment expenses. The City's funds are invested in high credit quality investments and continue to meet the City's goals of safety, liquidity, and yield/return.

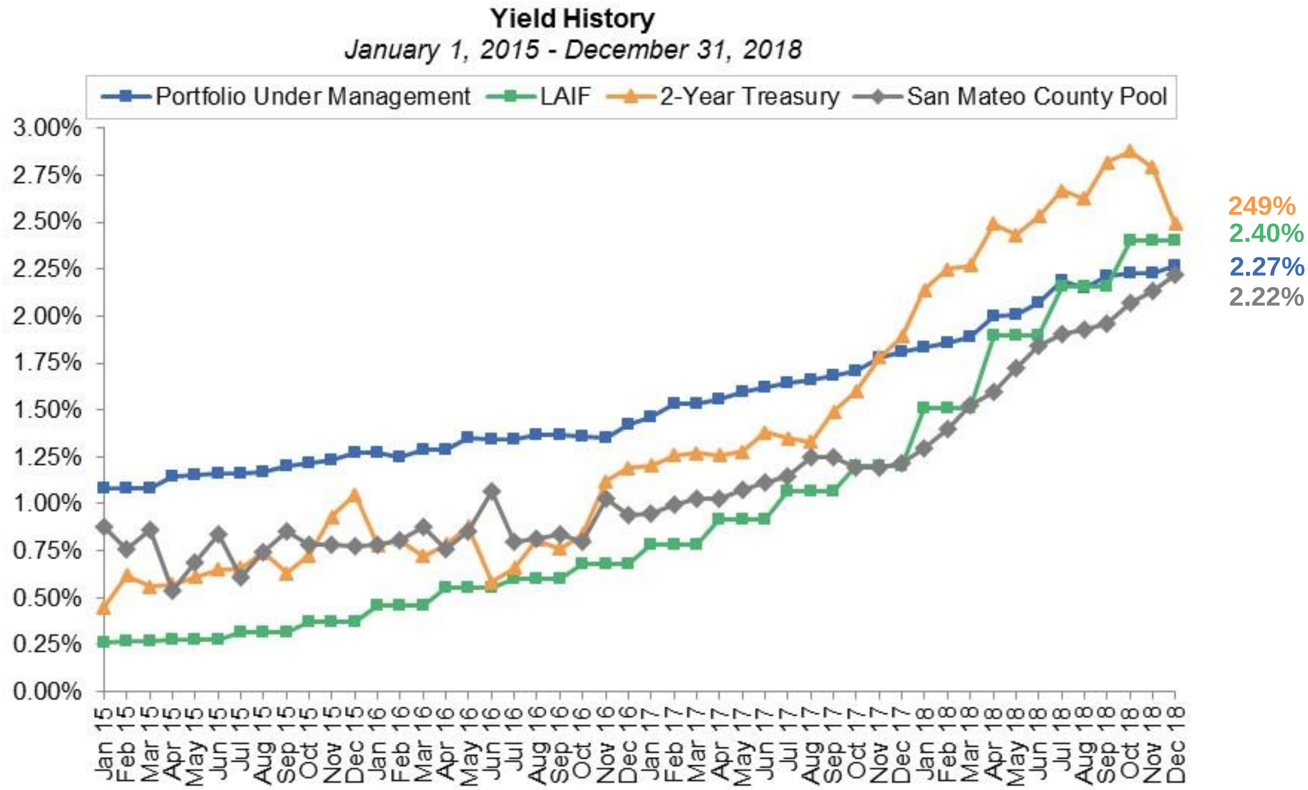


As of December 31, 2018, the yield to maturity at cost on the main portfolio of securities was 2.27%. Including additional investments such as LAIF and CAMP, the average yield to maturity** on the City's aggregate investments was 2.33%. During the quarter, the main portfolio generated amortized cost basis earnings (which includes interest earnings and realized gains and losses) of $550,813.

City's Investments Statistical Information	
Market Value	$170,087,803.37
Effective Duration	1.50 Years
Average Credit Quality*	AA
Yield to Maturity**	2.33%

** Ratings by Standard & Poor's. Average excludes 'Not Rated' securities.*
*** Yield to maturity at cost.*

The chart below compares the yield of the City's managed portfolio to the yields on the 2-year U.S. Treasury note, LAIF, and the San Mateo County Pool. As of December 31, 2018, the gross yield on the City's managed portfolio was 2.27%; net of PFM's investment advisory fees, the yield on the City's managed portfolio was 2.19%.



Below is a summary of cash and investment holdings held by each fund as of December 31, 2018, which includes invested funds, debt service reserves, amounts held in overnight (liquid) accounts, the City's main checking account, and other operating funds:

	Cash and Investments by Fund		
	As of 12/31/18	**As of 09/30/18**	**Change $**
General Fund	$ 25,201,062	$ 24,406,509	$ 794,554
Capital Project Funds	57,318,451	49,919,157	7,399,293
Internal Service Funds	19,999,768	19,643,006	356,762
Water Fund	17,894,026	17,798,494	95,532
Sewer Fund	18,859,507	17,595,672	1,263,835
Solid Waste Fund	4,681,611	4,697,898	(16,288)
Parking Fund	9,581,059	9,410,216	170,843
Building Fund	10,895,961	10,877,970	17,991
Landfill Fund	1,640,452	1,579,939	60,513
Debt Service Fund	14,331,679	8,284,679	6,047,000
Subtotal, Operating Funds	180,403,576	164,213,541	16,190,035
Other Funds	11,858,749	13,557,134	(1,698,385)
Total Cash and Investments	$ 192,262,325	$ 177,770,675	$ 14,491,650

Cash holdings in the General Fund increased slightly in the second quarter of the 2018-19 fiscal year. Although major property tax receipts of over $8.5 million were received in December, transfers in/out of the General Fund were also posted during the quarter. In accordance with the adopted budget, the General Fund received $1.9 million from other funds, largely to reimburse the cost of administration of the utility funds. Transfers out of the General Fund totaled $15.1 million, including $4.2 million for debt service, $7.8 million for authorized capital improvement projects, and $3 million for the Capital Investment Reserve within the Capital Projects Fund.

The $7.4 million increase in Capital Project Funds is due to the large transfers from the General Fund, offset by $4.3 million in capital spending. The largest spending for the quarter includes the El Portal Creek, Trousdale Channel, and Gilbreth Creek Improvements ($961,000); the California Drive Roundabout ($702,000); the Neighborhood Storm Drain Project #10 ($465,000); the 2018 Sidewalk Repair Program ($439,000); and the Murray Field Renovations ($380,000). Capital expenditures in the Sewer Fund have been less robust this quarter, so that cash balance is temporarily higher. And the Debt Service Fund received transfers in for the entire fiscal year's debt service payments, as well as transfers from the General Fund and Measure I funds to provide funding for the eventual bond financing of the Community Center project.

As for the performance of the City's trust funds, which adhere to different strategies than reflected in the City's Investment Policy for its main portfolio, the most recent statements are attached to this staff report. Because the City's funding of its retiree medical obligations is still relatively low (<30%), the City's trust account is invested in the most aggressive (Strategy 1) portfolio available with the California Employer's Retiree Benefit Trust (CERBT) Fund. The average annualized internal rate of return since the initial contribution (in October 2013) for the portfolio as of December 31st (five years) was approximately 3.78%. The PARS §115 trust account for funding the City's pension liabilities was established in October 2017, and the December 2018 statement attached is the most current information available for the City's account.

CONCLUSION

All City funds are invested in accordance with the approved Statement of Investment Policy, with an emphasis on safety, liquidity, and return (in that order). The City's investment strategy of balancing the investment portfolio between short-term investments (to meet cash flow needs) and longer-term maturities (to realize a higher rate of return) is appropriate, given current market conditions.

Due to the ease of access of the City's funds in liquid accounts such as LAIF and CAMP, the City has more than sufficient funds available to meet its liquidity (expenditure) requirements for the next six months.

Staff and the City's investment advisor will continue to closely monitor the City's investments to ensure the mitigation of risk and ability to meet the City's investment goals while being able to respond to changes in market conditions.

FISCAL IMPACT

Quarterly reporting of the City's Investment Portfolio will not result in any direct impact on City resources.

Exhibits:

- Portfolio Holdings as of December 31, 2018
- CERBT Monthly Statement for December 31, 2018
- PARS Monthly Statement for December 31, 2018