STAFF REPORT

AGENDA NO: 8l

MEETING DATE: November 18, 2019

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To: Honorable Mayor and City Council

Date: November 18, 2019

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

Subject: Quarterly Investment Report, Period Ending September 30, 2019

RECOMMENDATION

Staff recommends that the City Council receive and approve the City's investment report through September 30, 2019.

BACKGROUND

This report represents the City's investment portfolio as of September 30, 2019. 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 the City Council reviews and approves annually. The Council last approved the Policy on June 3, 2019. 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

The third calendar quarter was characterized by declining yields for a fourth consecutive quarter, deceleration in the labor market and manufacturing, and growing risks to the global economic outlook. Positive economic data for the third quarter included a 50-year low unemployment rate, a strong housing market as consumers took advantage of lower mortgage rates, and exceptionally strong performance in the U.S. equity markets. However, job and wage growth continued to decelerate, and manufacturing activity declined significantly. The Institute for Supply Management

(ISM) manufacturing index fell in August and in September to its lowest level since 2009, indicating that the manufacturing sector may be headed for contraction.

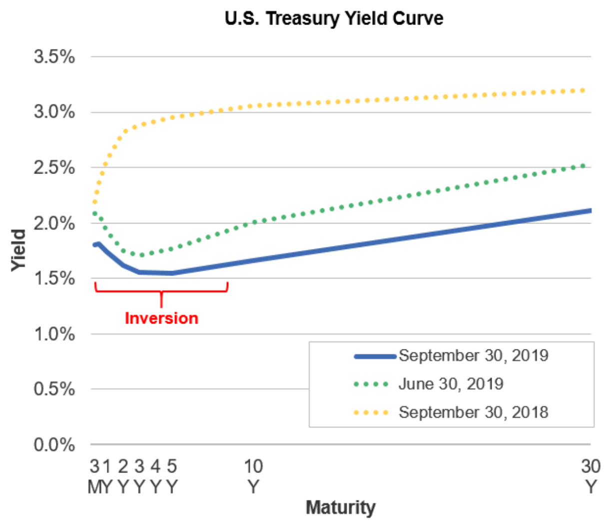
A deteriorating U.S. economic outlook, made worse by ongoing trade tensions, prompted the Federal Open Market Committee (the "Committee") to cut the overnight fed funds rate by 25 basis points (0.25%) at the July and September Committee meetings to a new target range of 1.75% – 2.00%. Federal Reserve Chair Jerome Powell acknowledged slowing manufacturing activity and global growth, persistently low inflation measures, escalating trade tensions, and deteriorating business confidence and investment as factors impacting the Committee's decision to cut rates. While the Committee initially characterized the July cut as "a mid-cycle policy adjustment," Committee members are now more divided on the need for further action given the lower outlook for global growth.

U.S. Gross Domestic Product (GDP) grew by 2.0% in the second quarter (the data was released during the third quarter), down from 3.1% in the first quarter. Growth was driven by consumer spending, which makes up more than two-thirds of total economic output. Business fixed investment, private inventories, and net exports were all detractors from GDP growth. Forecasts for the third and fourth quarter are substantially lower, largely due to the further weakening in manufacturing and some softening of consumer spending.

The U.S. labor market was mixed for the third quarter. While unemployment fell to 3.5% in September, a 50-year low, average hourly earnings slowed to 2.9%, the slowest pace since mid-2018 and a potential threat to future consumer confidence and spending. As expected, job growth tempered in the third quarter, with the U.S. economy adding 136,000 jobs in September. For the year, the economy has added an average of 161,000 jobs per month in 2019 as compared to 223,000 in 2018.

Inflation drifted slightly higher during the quarter as tariff policies put upward pressure on the prices of goods. In August, the Fed's preferred inflation gauge, the Core Personal Consumption Expenditure (PCE) Price Index, which excludes food and energy prices, rose 1.8% over the past year, just below the Fed's target of 2%.

Yields on U.S. Treasury obligations decreased quarter over quarter. During the month of August, the yields on most maturities posted their largest monthly decline since 2015, as the ongoing trade tensions between the U.S. and China and fears of slowing global growth boosted demand for high-quality U.S. Treasury obligations. Yields on 30-year U.S. Treasury obligations reached record lows during the month, falling below 2% for the first time ever. By quarter-end, yields had rebounded from August lows as the yield on a 3-month Treasury bill stood at 1.81%, the 2-year note was 1.62%, the 5-year was 1.54%, and the 10-year was yielding 1.66%. The yield curve inversion remained as the spread between the 3-month and 10-year Treasuries registered at 15 basis points (0.15%) by quarter-end. For the year, intermediate and longer-term yields are down nearly 1%, while shorter-term yields have generally trended downward in tandem with the Fed's two recent rate cuts.



Yield Curve History

Maturity	9/30/19	6/30/19	Change
3-Mo.	1.81%	2.09%	-0.28%
6-Mo.	1.81%	2.09%	-0.28%
1-Yr.	1.74%	1.93%	-0.19%
2-Yr.	1.62%	1.75%	-0.13%
3-Yr.	1.56%	1.71%	-0.15%
5-Yr.	1.54%	1.77%	-0.23%
10-Yr.	1.66%	2.01%	-0.35%
30-Yr.	2.11%	2.53%	-0.42%

The City's cash, excluding bond proceeds, is pooled for investment purposes. As of September 30, 2019, invested funds totaled $190,162,385.25. 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 September 30, 2019	
Main Investment Portfolio	$118,823,271.05
Main Investment Portfolio - Cash Balance in Custody Account	$306,294.31
CAMP Balance	$41,061,562.29
LAIF Balance	$29,971,257.60
	$190,162,385.25

In this somewhat uncertain market environment, PFM has advised the City to maintain a neutral duration stance relative to the benchmark (allowing for a 1% - 2% variance) in order to minimize risk and maximize relative performance. At the end of the quarter, the main portfolio's duration was 2.54 years, in line with the benchmark's duration of 2.56 years. Maintaining durations—despite the inverted yield curve—continues to be a key component of the portfolio's total return performance as the continued drop in yields translates into strong market value appreciation. Factoring in liquid investments, such as LAIF and CAMP, the effective duration of the City's aggregate investments was 1.58 years.

The City continues to benefit from a strategy of broad diversification, which serves to reduce the overall risk in the portfolio while providing for the opportunity for better returns over the long-term. PFM continued to recommend rotating out of the federal agency and supranational sectors as yield spreads remained unattractive relative to comparable Treasuries. While limited supply is partly to blame, insatiable market demand has essentially capped any upside to yield. One exception was a new issue Fannie Mae (FNMA) note with three years to maturity that came to market in early September. PFM recommended this note for purchase as it offered a relatively attractive yield pick-up of 6 basis points (0.06%) compared to similar-maturity U.S. Treasury obligations. In general, however, U.S. Treasuries continued to be the preferred outlet for government exposure. As of September 30, 2019, the main portfolio held a 36.8% allocation to U.S. Treasury obligations – a 3% increase over the prior quarter's allocation to the U.S. Treasury sector.

As a result of a more accommodative Fed, a temporary lull in the trade war, and a general feeling of cautious investor optimism, investor demand for corporate notes remained strong during the quarter. PFM sought to maintain the portfolio's allocation to high-quality corporate notes while extending the sector's duration. In mid-July, PFM recommended selling a shorter-dated BNY Mellon note and reinvesting the proceeds in a longer-dated note issued by US Bank.

After narrowing in the first half of 2019, yield spreads on negotiable bank certificates of deposit (CDs) gradually increased from multi-year lows. In one instance, PFM recommended selling a short-dated Nordea Bank negotiable CD at a gain and reinvesting the proceeds in a longer-dated negotiable CD issued by the same bank at a yield of 1.87%. This represented an attractive yield pick-up of approximately 44 basis points (0.44%) over comparable-maturity U.S. Treasury notes.

Please see below for a summary of transactions for the quarter ended September 30, 2019:

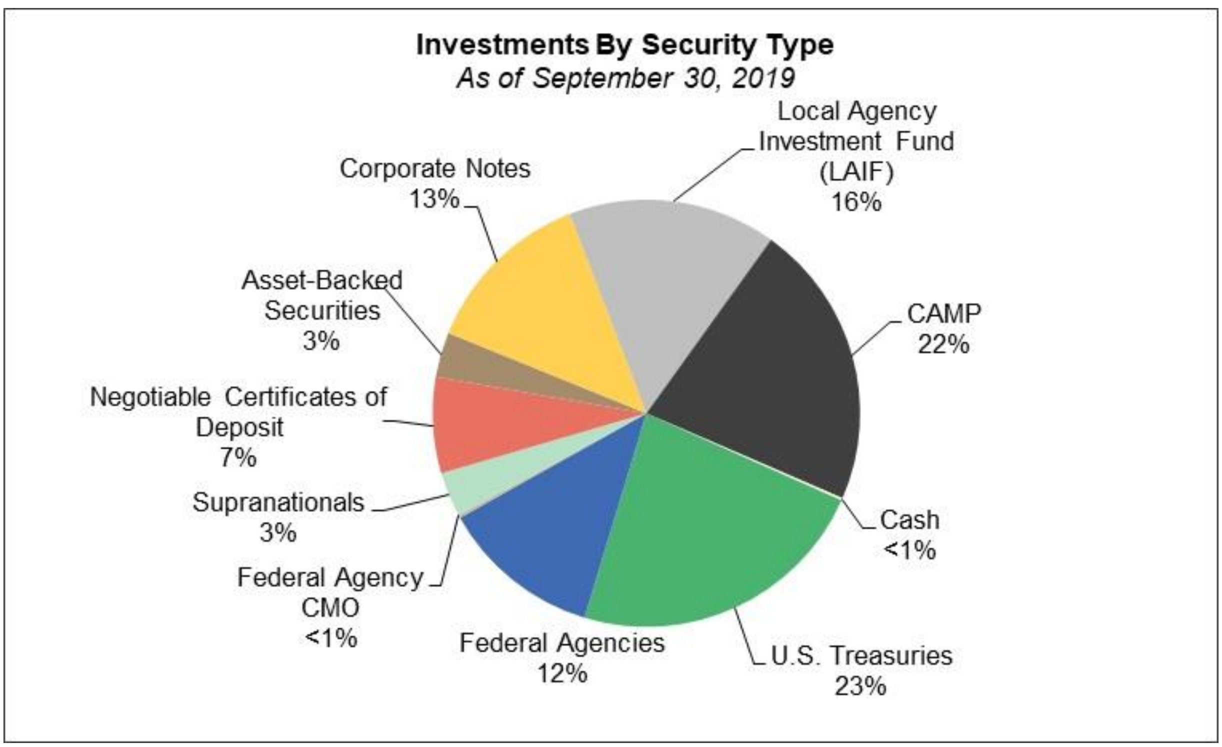
Trade Date	Settlement Date	Transaction	CUSIP	Issuer	Term (Mths)	Yield	Principal
7/1/2019	7/3/2019	Sale	3135G0N82	FNMA Notes	26	1.82%	1,575,000
7/1/2019	7/3/2019	Sale	3135G0N82	FNMA Notes	26	1.82%	585,000
7/1/2019	7/3/2019	Sale	45905UP32	IBRD Note	14	1.91%	1,870,000
7/1/2019	7/3/2019	Purchase	9128282D1	U.S. Treasury Notes	50	1.75%	4,195,000
7/22/2019	7/24/2019	Sale	06406HCW7	BNY Mellon Corporate (callable)	2	2.37%	1,785,000
7/22/2019	7/24/2019	Purchase	91159HHV5	US Bank Corporate Note	54	2.26%	1,790,000
8/1/2019	8/2/2019	Purchase	912796VT3	U.S. Treasury Bill	1	2.04%	1,300,000
8/1/2019	8/2/2019	Purchase	9128282N9	U.S. Treasury Notes	60	1.83%	500,000
8/2/2019	8/2/2019	Maturity	83050FXT3	Skandinaviska Enskilda Bank CD	-	-	1,800,000
8/27/2019	8/29/2019	Purchase	65558TLL7	Nordea Bank CD	36	1.87%	1,500,000
8/27/2019	8/29/2019	Sale	65590ASN7	Nordea Bank CD	6	2.00%	1,500,000
8/30/2019	9/3/2019	Purchase	912828D56	U.S. Treasury Notes	59	1.44%	1,650,000

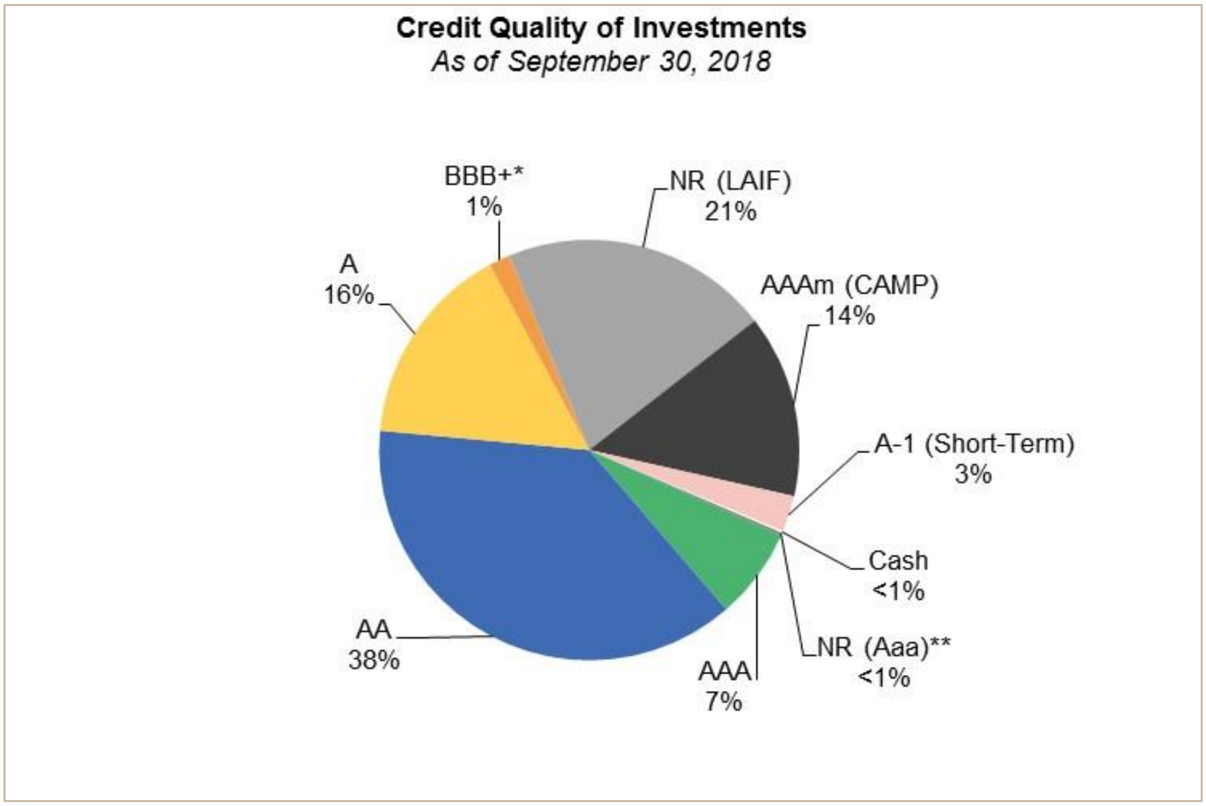
Trade Date	Settlement Date	Transaction	CUSIP	Issuer	Term (Mths)	Yield	Principal
9/3/2019	9/3/2019	Maturity	912796VT3	U.S. Treasury Bill	-	-	1,300,000
9/5/2019	9/6/2019	Purchase	3135G0W33	FNMA Notes	36	1.54%	2,385,000
9/5/2019	9/6/2019	Sale	912828L57	U.S. Treasury Notes	37	1.48%	665,000
9/5/2019	9/6/2019	Sale	912828L57	U.S. Treasury Notes	37	1.48%	1,685,000

Given ongoing policy and market uncertainty, PFM continues to recommend a neutral duration positioning and a continued strategy of broad diversification across the high-quality sectors permitted by California Government Code and the City's Statement of Investment Policy.

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. PFM will continue to carefully monitor the creditworthiness of all current issues in the City's portfolio and any new issues recommended for purchase.

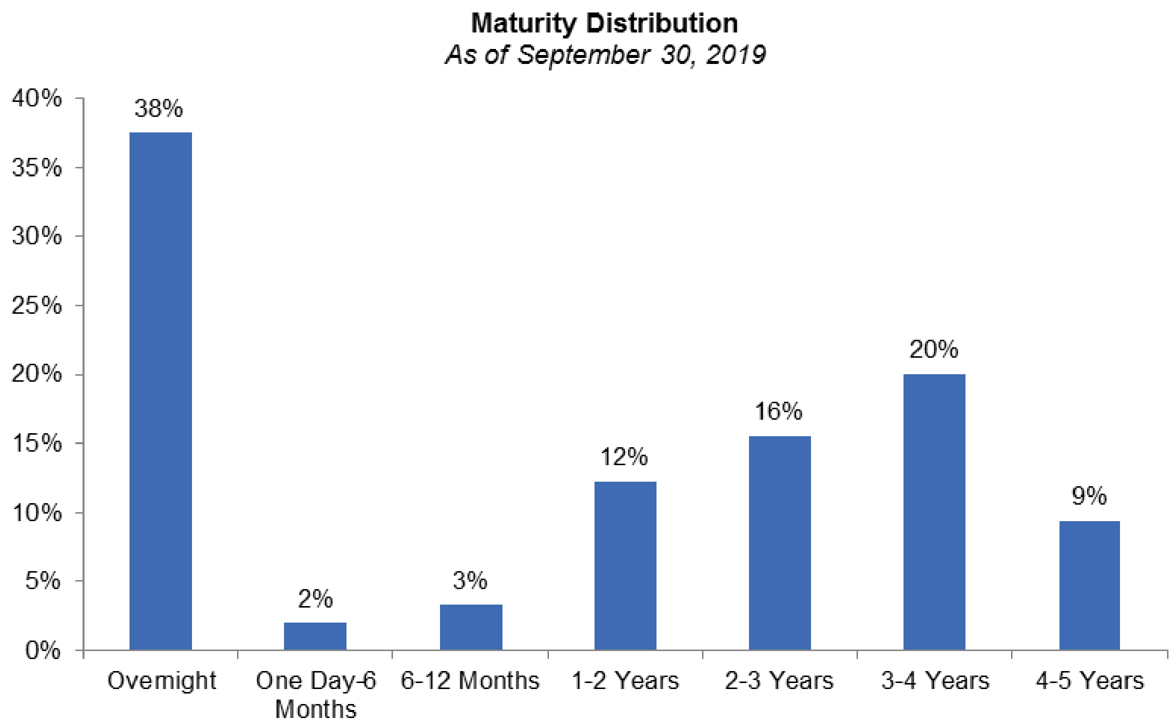
As noted in the following pie charts, the City's investment portfolio, as of September 30, 2019, was heavily weighted towards the State Local Agency Investment Fund (LAIF), the AAAm-rated CAMP Fund, and high-quality (AA+ rated) U.S. Treasury and federal agency securities to maintain the focus on safety 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 September 30, 2019, 38% of the City's funds were invested in very short-term liquid investments; 17% of the funds were invested with maturities between one day and two years; and 45% 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 1.58 years and currently generate annual income of 2.37% 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.

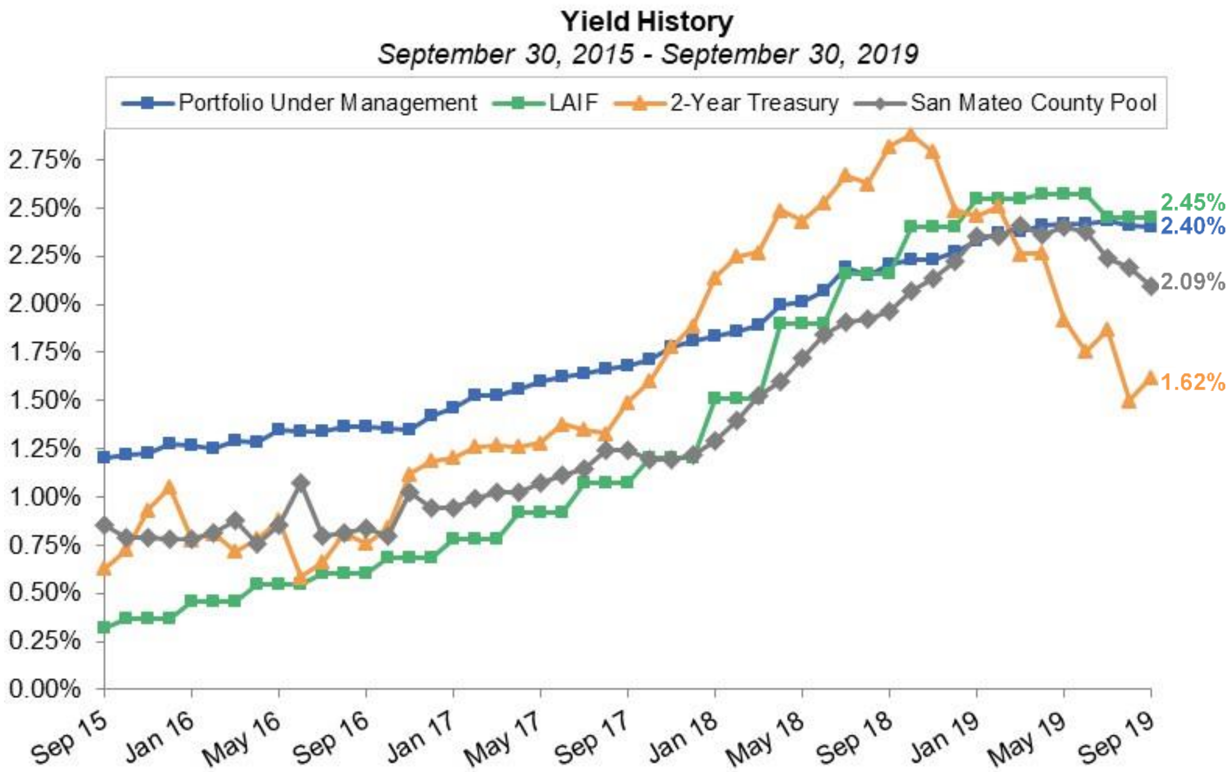


As of September 30, 2019, the yield to maturity at cost on the main portfolio of securities was 2.40%. Including additional investments such as LAIF and CAMP, the average yield to maturity** on the City's aggregate investments was 2.37%. During the quarter, the main portfolio generated amortized cost basis earnings (which includes interest earnings and realized gains and losses) of $722,671.80.

City's Investments Statistical Information	
Market Value	$190,162,385.25
Effective Duration	1.58 Years
Average Credit Quality*	AA
Yield to Maturity**	2.37%

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

The chart below compares the yield on 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 September 30, 2019, the gross yield on the City's managed portfolio was 2.40%; net of PFM's investment advisory fees, the yield on the City's managed portfolio was 2.32%.



Below is a summary of cash and investment holdings held by each fund as of September 30, 2019, 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 09/30/19	As of 06/30/19	Change $
General Fund	$ 38,281,702	$ 38,291,119	$ (9,416)
Capital Project Funds	55,300,871	57,775,643	(2,474,772)
Internal Service Funds	20,226,809	19,737,315	489,494
Water Fund	20,286,248	18,165,708	2,120,540
Sewer Fund	19,084,158	19,251,907	(167,748)
Solid Waste Fund	4,665,558	4,624,332	41,226
Parking Fund	10,899,593	10,280,142	619,450
Building Fund	12,072,822	12,221,730	(148,908)
Landfill Fund	1,921,187	1,805,810	115,377
Debt Service Fund	8,024,350	8,353,106	(328,756)
Subtotal, Operating Funds	190,763,297	190,506,811	256,486
Other Funds	15,634,803	14,294,571	1,340,232
Total Cash and Investments	$ 206,398,101	$ 204,801,382	$ 1,596,719

A decrease in cash holdings in the General Fund is typical for the first quarter of the fiscal year. The reduced balance reflects the $3.7 million lump-sum payment to CalPERS for the unfunded accrued liability for pensions for the 2019-20 fiscal year, with only regular operating revenues and expenditures, and no major property tax receipts. (Property taxes are received in December and

May). The $2.4 million decrease in Capital Project Funds is due to large construction progress payments in the first quarter, most notably $610,000 for the Community Center Master Planning project, $407,000 on the Annual Street Resurfacing Program 2019, and $373,000 for the Washington Park Playground, Sport & Picnic Areas project. An increase in the Water Fund is a reflection of regular cash flow with no large payment for capital projects. The Sewer Fund reflects a fairly large capital investment of nearly $526,000 for the Easton Addition/Ray Park Neighborhood sewer project during the quarter. Neither utility fund has major annual debt service (principal and interest on outstanding revenue bonds) payments scheduled until April.

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 relatively low (<30%), the City's trust account is invested in the most aggressive (Strategy 1) portfolio available with the California Employers' Retiree Benefit Trust (CERBT) Fund. The average annualized internal rate of return for the year for the portfolio as of September 30th was 5.23%. The PARS §115 trust account for funding the City's pension liabilities was established in October 2017, and the September 2019 statement attached shows a rate of return of 5.58% for the year.

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 September 30, 2019
- CERBT Monthly Fact Sheet for September 30, 2019
- PARS Monthly Statement for September 30, 2019