CITY OF NEWPORT BEACH
FINANCE COMMITTEE STAFF REPORT

August 11, 2011

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
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SUBJECT: INVESTMENT PERFORMANCE REVIEW

DISCUSSION:

The City Investment Portfolio balances throughout Fiscal Year 2010-11 are summarized as follows:

Quarterly Market Value				
FY 2010-11				
Operating Portfolios	**Q1**	**Q2**	**Q3**	**Q4**
Demand Deposit Accounts	9,079,591	9,900,437	6,925,826	9,578,016
Money Market Funds	90,571	90,575	90,579	90,584
Local Agency Investment Fund	10,732,287	20,488,328	12,498,407	17,020,953
Managed Investment Portfolio (MIP)	132,662,104	147,507,092	147,834,001	154,019,913
TOTAL OPERATING FUNDS	**152,564,552**	**177,986,432**	**167,348,812**	**180,709,466**
Bond Fund Portfolios	**Q1**	**Q2**	**Q3**	**Q4**
2011 Civic Center COPs	0	106,625,271	102,431,245	106,254,521
Assessment Districts	2,994,918	2,367,092	2,758,606	2,992,248
Special Improvement Districts	3,143,961	1,973,938	2,568,572	2,896,398
TOTAL BOND FUNDS	**6,138,879**	**110,966,301**	**107,758,423**	**112,143,168**

Market Review

The current market view remains uncertain as the economic recovery continued to start, stall and even regress. Momentary concerns about high inflation led some analysts to consider the possibility that Fed officials might end their near-zero short-term rate policy for a period of time. Over the past year, headline CPI increased 3.6% while core CPI was up only 1.6%. Commodity prices have started to ease confirming Bernanke’s view that the recent “increase in inflation will be transitory.” At present most economists now expect that the prospect of Fed officials raising interest rates to be “on hold” for most of 2012. Many market participants are also concerned about a weakening economy as leading economic indicators have been sluggish, uneven and have recently stalled again.

Sovereign debt issues, both at home and abroad, have dominated headlines and are not likely to go away anytime soon. Gross Domestic Product (GDP) increased at an annualized rate of 1.3% during the fourth quarter of FY 2010-11 compared to an expected growth rate of 1.8%. Consumer spending, which accounts for 70% of the economy, stalled with an increase of only 0.1% compared to 2.1% in the third quarter. The housing market remains weak and continues to struggle to gain momentum. Even though the economic recovery is two years old, the pace of recovery in the labor market is extremely weak by historical standards and is one of the primary reasons why the recovery has been tepid. In recent months, manufacturing indices have been falling which has intensified some anxiety about the economy.

“Risk Free” Treasury Yields

The yield curve remains steep with yields on longer securities rising more than those of shorter securities. Treasury yields were volatile during the year, increasing during the third quarter of the fiscal year but retreating in May and are again near all-time lows in July. See Two-Year yield [1] trend below.

Treasury Yields						
Yields	**6/30/10**	**9/30/10**	**12/31/10**	**3/31/11**	**6/30/11**	**7/30/11**
3 Month	0.18%	0.16%	0.12%	0.09%	0.03%	0.01%
2 Year	0.61%	0.42%	0.61%	0.80%	0.45%	0.36%
3 Year	1.00%	0.64%	1.02%	1.29%	0.81%	0.55%
5 Year	1.79%	1.27%	2.01%	2.24%	1.76%	1.35%
7 Year	2.42%	1.91%	2.71%	2.90%	2.50%	2.09%
10 Year	2.97%	2.53%	3.30%	3.47%	3.18%	2.82%
30 Year	3.91%	3.69%	4.34%	4.51%	4.38%	4.12%

(1) The Two-Year yield is most representative of our target portfolio duration.

Short-term Portfolio

The City manages liquidity through its demand deposit accounts, money market funds and Local Agency Investment Fund (LAIF) managed by the California State Treasurer’s office. While money market funds return practically zero yield, LAIF is the primary vehicle used for liquidity. Per California Government Code section 16429.3, the State may not impound, seize, transfer or borrow funds in order to resolve their budget deficits. The average investment life of the LAIF fund is 237 days. The average effective yield during the fiscal year was 0.45%

The City has maintained higher balances in its demand deposit accounts than it has historically. The reason for this is our primary banking institution offers a compensating balance credit of 0.9% to offset banking fees. This compensating balance credit is obviously better than other available short-term yields.

Medium-Term Portfolio

The California Government Code restricts municipal investments to not exceed 5 years in Term and uses three professional investment advisors to manage the bulk of its investment portfolio, which is referred to as the Managed Investment Portfolio (MIP) in the above table.

The portfolio manager directive is to focus on maintaining safety of the invested principal and achieving the City's long-term investment objective of maintaining a safe, well diversified, high quality portfolio while continuing to evaluate all the sectors available to the City and capitalize on investment opportunities presented by the market. As long as interest rates remain at historic lows, portfolio managers will likely continue to manage the portfolio with a conservative duration bias, but also capitalize on the steep yield curve to make selective investments. By regularly and selectively adding long-term investments to the portfolios, this strategy has historically generated consistently favorable long-term returns relative to our benchmark (1-3 Year Treasury Index).

A summary of the current yield spread to treasuries is as follows:

Mixed Credit Spreads	Spread to Treasuries		
Credit Spreads	**May**	**June**	**Change**
3-Month Top-Rated Commercial Paper	0.18%	0.17%	-0.01%
2-Yr AA Corporate Note	0.39%	0.37%	-0.02%
5-Year AA Corporate Note	0.57%	0.58%	0.01%
5-Year Agency Note	0.34%	0.36%	0.02%

When yield spreads are narrow, managers will likely lean toward Treasury securities. As opportunities for yield spreads increase, Agency and high quality corporate bonds present the normal opportunity to diversify the portfolio and pick-up additional yield, always cognizant of security of principal.

A summary of each advisor's historical rate of return is as follows:

TOTAL RETURN			
	1 Yr	**3 Yr**	**5 Yr**
Benchmark *	1.35%	2.76%	4.04%
Chandler	1.84%	3.62%	4.60%
PFM	1.77%	3.53%	4.58%
Cutwater	0.98%	2.97%	4.16%

While historically, the long-term performance of these advisors has been similar, the Cutwater total return has suffered in the current year, primarily due to shortening of the portfolio duration. This occurred because the City relied on this portfolio for extraordinary cash flow demands in the most recent fiscal years while construction efforts were underway for OASIS and the Civic Center projects prior to the Civic Center Bond issuance in December 2010.

A more robust summary of portfolio characteristics and performance by each investment advisor is summarized in the Summary of Managed Investment Portfolio Characteristics.

Prepared by:

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Summary of Managed Investment Portfolio Characteristics
Credit Concentration Report