



Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL **FROM:** Scott P. Johnson
Larry Lisenbee

SUBJECT: SEE BELOW **DATE:** June 7, 2007

Approved Ray Winer Date 6/11/07

COUNCIL DISTRICT: City-wide

SUBJECT: ADOPTION OF 2007-2008 APPROPRIATION ORDINANCE AND FUNDING SOURCES RESOLUTION AMENDMENTS IN THE GENERAL FUND IN THE AMOUNT OF \$273,000 FOR THE PURPOSE OF IMPLEMENTING PHASE I OF AN ACTIVE PORTFOLIO MANAGEMENT PROGRAM FOR THE CITY'S INVESTMENT PROGRAM IN THE FINANCE DEPARTMENT

RECOMMENDATION

1. Approve a phased approach relating to recommendations contained in the Macias Consulting Group's Evaluation of the City's Investment Program for additional resource allocations to the Department of Finance to implement active management initiatives in the City's investment program for the purpose of enhancing the City's investment yield.
2. Adopt the following 2007-2008 Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund:
 - a) Increase the appropriation for the Personal Services to the Finance Department by \$105,000;
 - b) Increase the appropriation for Non-Personal / Equipment to the Finance Department by \$168,000; and
 - c) Increase the estimate for Other Revenue by \$273,000.
3. Authorization by the City Council to add 1.0 FTE position in the Finance Department to serve in the capacity of an Investment Manager.

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OUTCOME

Approval of the recommended budget changes for the 2007-2008 Budget will enable the Finance Department to begin to move forward with the implementation of the first phase of a more active, analytical portfolio management program for the City's Investment Program for the purpose of providing the necessary management oversight and training for this critical citywide program with the opportunity of examining opportunities to enhance the City's investment yield.

BACKGROUND

At the June 5, 2007 City Council meeting, the Finance Department made a presentation on the supplemental information requested by the Public Safety, Finance & Strategic Support Committee at their May 17, 2007 meeting. This supplemental information included a "high-level" analysis of the benefits of additional resources to the City's Investment Program and a proposed implementation schedule. The City Council directed preparation of a budget proposal for consideration during the final budget hearings and budget approval next week (June 11 and 12).

After the Council meeting on June 5, the Finance Director and Budget Director met with the City Manager and discussed a phased implementation plan which will be developed by the Finance Department in coordination with the Budget Office. This phased approach will include adding expenditures and offsetting revenue (increased interest earnings) which will allow for commencement of implementation of a portion of the resource additions in the Investment Unit for more active, analytical portfolio management. The current proposal includes scaling back the up-front costs for Phase I as discussed and presented to Council on June 5. This revised phased approach moves one full time equivalent (FTE) position and associated non-personnel costs from Phase I to Phase II contingent upon achieving results in Phase I.

On June 6, a recommendation was made to the Rules & Open Government Committee to incorporate an agenda item regarding this phased approach and recommendations for related 2007-2008 budget actions for the June 26 City Council Meeting.

ANALYSIS

The supplemental report (item 3.7(b)) presented to the City Council on June 5 contained a discussion of additional investment opportunities, potential yield benefit, and staffing/resource requirements to realize the additional opportunities within the current boundaries of the Council-adopted Investment Policy. The City's Investment Policy allows for a diversity of investment vehicles, including such investment options as commercial paper, money market mutual funds, repurchase agreements and corporate notes. These investment options would require more staff analytics and ongoing monitoring in order to ensure continued compliance with the Investment Policy and meet the Investment Program's primary criteria of safety, liquidity and yield.

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The report discussed on June 5, included an estimate on additional potential interest earnings if additional resources were added to the Investment Program. The Council direction on June 5, directed Finance Staff to work with the Budget Office and return with a phased approach for adding resources as program enhancements are able to demonstrate portfolio diversification which results in higher interest earnings for the City.

It should be noted that on a monthly basis the costs of the Finance Department's Investment Program are allocated to all of the funds included in the portfolio, transferring the total costs of the Investment Program from the General Fund to the other funds proportionately based on the respective funds' average monthly balances. The portfolio's interest earnings are allocated by fund as well under the same proportional method. During the course of the fiscal year, the City's General Fund represents 15% to 20% of the total portfolio.

Investment Opportunities

As discussed in the report presented on June 5, understanding the dynamics of the day-to-day management of the City's portfolio, currently valued at approximately \$1.2 billion is critical. The permitted investments according to the City's Investment Policy, which is in general conformance with the California Government Code, is very restrictive as compared to the investments included in the City's two retirement fund portfolios. Pension fund investing has only a very limited number of elements in common with investment of a local agency's surplus cash and operate within an entirely different framework than investment of surplus cash.

Given the difference in the ultimate use, timing of disbursements of funds (short for the City's surplus cash vs. very long-term, disbursements from pension systems), investments in the City's portfolio are restricted to a maximum maturity of five years with maximum average days to maturity of two years. Additionally, the types of investments in the City's investment portfolio are generally restricted (per the City's Investment Policy and California Government Code) to fixed income, government securities, high-grade corporate notes and commercial paper. This is in contrast to the investments in the retirement fund portfolios, which according to California Government Code, any type of investment is permissible so long as it is considered prudent by the body (the Retirement Boards), authorized to make investments. The primary duty of retirement board trustees is to manage funds in the exclusive interest of the beneficiaries; minimizing employer contributions is a secondary duty. As a result of these very different investment objectives and duties, the retirement portfolio investments include real estate, equities, and international funds, which are not allowable, permitted investments in the City's investment portfolio per the City's Investment Policy and the California Government Code.

The City's goals when making investment decisions for the investment portfolio, in priority order, is to **first** safeguard its principal (safety), **second**, to ensure liquidity to meet expenditures (liquidity), and **third**, to earn a market rate of return on investments (yield). Individual investment decisions are based on these three tenets and always in this order. In general, the

portfolio must be closely monitored to ensure public funds are safe, available for necessary disbursements and invested in accordance with the policy parameters.

Potential Portfolio Yield Benefit

As noted in the previous report to the City Council, for every basis point¹ increase in overall portfolio yield, the portfolio earns approximately \$120,000 in additional interest earnings². Several additional investment options are available (without changes to the current Investment Policy) which, with additional research and monitoring, could increase portfolio diversification without moving away from the primary investment strategy of "buy and hold". These activities would be included in the Phase I implementation plan. Phase II of the implementation plan would be recommended for funding only after tangible demonstrated financial benefits of the additional resources. It is critical to note, that the changes in the investment portfolio performance are highly dependent on market conditions, cash flow (net revenues in and expenditures out) needs of the City, and the time period examined after resources are added and individuals hired. Given the size of the portfolio, significant changes can take months to materialize in actual increased interest income.

As previously discussed, over time, with additional staff resources and consulting services, staff believes that portfolio yields could be increased by 5 to 7 basis points (\$600,000 to \$840,000 per year) over the yield obtained by maintaining our current portfolio mix. This additional yield could begin to be realized incrementally as staff is hired, trained and investment/reinvestment opportunities present themselves and after securing an investment advisor through a Request for Qualifications (RFQ) process. It is expected to take six to twelve months from placing the additional resources (staff, consulting services and technology enhancements) in service to start to realize the full benefit of the investment in these additional resources.

Phased Staffing and Resources Implementation

The current authorized staffing levels in the Investment Unit include two managers and two clerical staff: an Administrative Officer (vacant), Financial Analyst, Senior Account Clerk and Account Clerk. As noted in the Macias Audit Report, this limited staffing level creates the inability to undertake ongoing market analysis, prepare detailed cash flow analyses, ensure appropriate coverage levels, and places the program at significant risk in the current managing of the City's day-to-day cash/liquidity needs.

¹ Basis Point equals one-hundredth of one percent (0.01%).

² Assuming portfolio size of \$1.2 billion.

Phase I – Recommendations for resource additions for Phase I (\$273,000) and other strategy development in the Investment Program to be implemented in Phase I include:

Resource Additions and Activities

- Hiring of Investment Officer (position currently vacant, due to retirement)
- Addition of an Investment Manager Position (\$140,000 annual cost; but only .75 FTE funding in first year (\$105,000), considering time to hire staff)
- Associated Non-Personal/Equipment costs (\$50,000) for computer equipment, on-line market services (ie., Bloomberg services), and ongoing training
- Addition of Non-Personal/Equipment funds for technology enhancements (\$70,000)
- Conduct RFQ process for Investment Advisory Services
- Hire Investment Advisor for purpose of providing City input on investment options, cash flow forecasting, market analysis, and assist in Investment Oversight Committee (\$48,000, which for the first year is proposed at 60% of the estimated annualized cost of \$80,000)
- Participation of staff in site visits of other large California cities to examine investment practices and develop peer benchmarks

Expected Results (6 – 12 months post implementation of all of the resource additions)

- Increase in number of authorized Commercial Paper (CP) Dealers
- Expand investment portfolio holdings to include:
 - Increase in maturity date of CP purchased
 - Addition of Corporate Notes to portfolio investments
 - Increase in number of callable US Agencies in portfolio
- Enhancement of cash flow modeling to better estimate various City and departmental cash flow needs
- Technology enhancements and automation of daily investment functions
- Work with Independent Investment Advisor to evaluate the feasibility of modifying the City's investment strategy of "buy-and-hold" and providing additional market insight.
- Establishment of an Investment Advisory Committee (after hiring of Independent Investment Advisor)

Phase II – Recommendations for resource additions for Phase II:

Resource Additions

- Addition of one FTE (Financial Analyst) & associated non-personnel costs
- Development of recommendation for purchase of additional technology enhancements
- Development of RFP for Portfolio Manager to undertake more active portfolio management
- Modification of Investment Policy as necessary

Expected/Anticipated Results (6 – 12 months post implementation of all of the resource additions)

- Increased portfolio performance
- Sufficient staff coverage
- Documented, detailed oversight of out-sourced Portfolio Manager
- Development of benchmarks for internal and outsourced portfolio management
- Enhanced internal controls and procedures
- Automated processes

ALTERNATIVES

Not applicable

PUBLIC OUTREACH/INTEREST

Not applicable

- Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

COORDINATION

This report has been prepared by the Finance Department in coordination with the City Manager's Budget Office and the City Attorney's Office.

COST SUMMARY/IMPLICATIONS

The costs of the Finance Department's Investment Program are spread proportionally across all of the funds included in the portfolio, and interest earnings are allocated proportionally as well.

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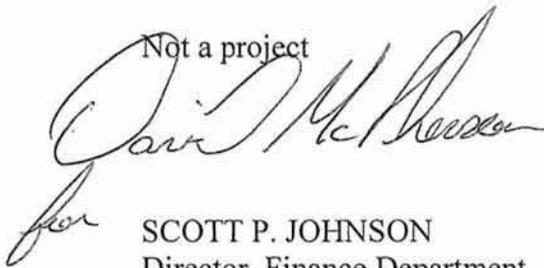
During the course of the fiscal year, the City's General Fund represents 15% to 20% of the total portfolio.

AMOUNT OF RECOMMENDATION/ COST OF PROJECTS: \$273,000

1. SOURCE OF FUNDING: 001 - General Fund
2. FISCAL IMPACT: N/A

CEQA

Not a project


for
SCOTT P. JOHNSON
Director, Finance Department


LARRY D. LISENBEE
Budget Director

I hereby certify that there will be available for appropriation in the General Fund in the Fiscal Year 2007-2008 monies in excess of those heretofore appropriated there from, said excess being at least \$273,000.


LARRY D. LISENBEE
Budget Director

For questions, please contact Scott P. Johnson, Director, at (408) 535-7000.