CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5A
May 12, 2022

TO: HONORABLE CHAIRMAN AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
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SUBJECT: REVIEW OF INVESTMENT PORTFOLIO STRATEGY AND BENCHMARK

SUMMARY:

The City has employed the same investment strategy for its externally managed investment portfolio since inception in 1993. This report provides options for implementing alternative investment strategies that will result in additional investment income for the City with minimal additional risk.

RECOMMENDED ACTION:

Provide feedback to staff regarding changing investment strategies.

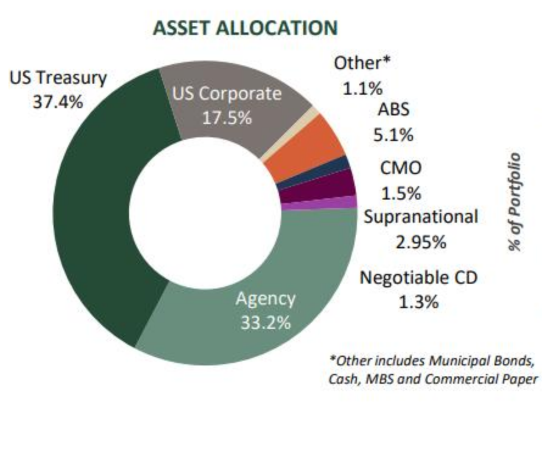
DISCUSSION:

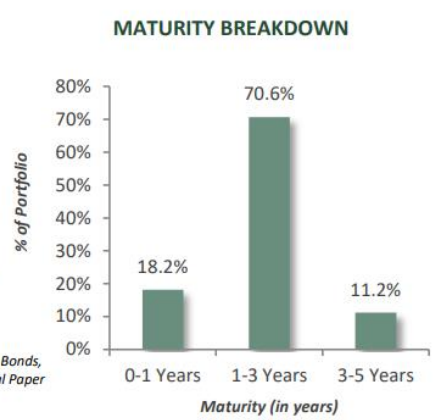
In November 2017, the City consolidated its investment management services with a single investment advisory firm – Chandler Asset Management (Chandler). Chandler had been one of the City's advisors under the prior investment management contracts and has served the City for decades. Chandler is currently responsible for managing both the City's marketable securities portfolio and its targeted maturities portfolio. As of March 31, 2022, the City's investment portfolio included the following components:

Portfolio Component	Managed By	Amount
Cash in Banks	City Staff	$ 14,719,000
Local Agency Investment Fund (LAIF)	City Staff	31,092,000
Targeted Maturities Portfolio	Chandler	23,978,000
Marketable Securities	Chandler	271,675,000
Total		**$ 341,464,000**

As can be seen in the table, the majority of the City's funds are managed by Chandler. City staff analyze cash flows and maintain adequate funds between bank accounts and LAIF to meet liquidity needs. Funds that will be needed for liquidity purposes, but not for some time, are invested in the Targeted Maturities Portfolio, which is very short-term in nature but has a higher yield than LAIF. This investment option is, for example, utilized when the City receives the two larger property tax payments in December and April and then draws down those funds for operations in subsequent months. The remaining $272 million managed by Chandler and invested in marketable securities is rarely if ever accessed by the City and over time has continued to grow as the City's various savings programs such as the Facilities Financing Plan and Harbor and Beaches Master Plan were implemented and funded. While there will be an occasional need to access the marketable securities portfolio over time for specific situations such as large capital projects, those events are rare and can be anticipated via the City's cashflow analysis process so that funds can be moved out of the marketable securities portfolio to LAIF as individual securities mature. Only in the very unlikely event of the City's response to an unanticipated natural disaster requiring a sizable draw on the contingency reserve would there be a need to access these funds with little notice.

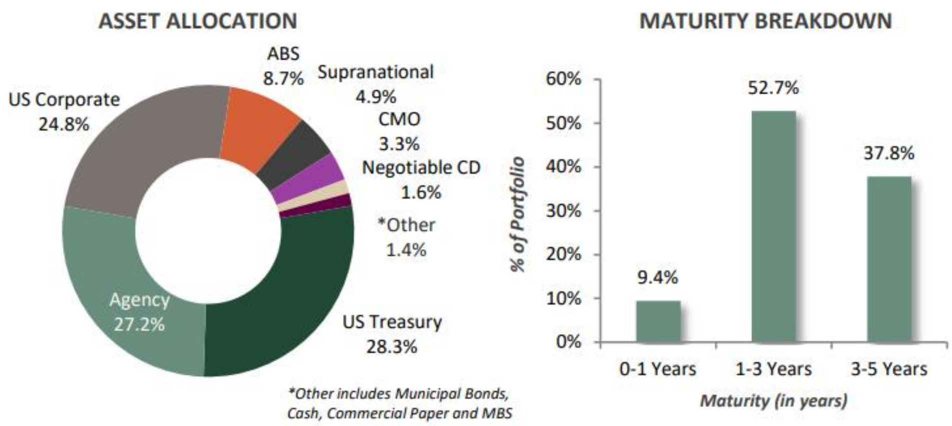
The California Government Code, as well as the City's Investment Policy and benchmark selection, set the parameters within which Chandler must operate when investing the City's funds. Upon initially contracting with Chandler, a one to three-year benchmark was selected against which to measure the performance of the Chandler-managed portfolio. This selection was made based on the desire for a very conservative investment strategy in the aftermath of the Orange County bankruptcy. Chandler currently terms this strategy its "Limited Maturity" strategy, which has an average duration (a measure of interest rate risk) of 1.77 and a yield to maturity (the rate of return if the securities are held until maturity) of 2.10% as of the first quarter of 2022. Key facts about this strategy are illustrated in the below charts.





This strategy utilizes the ICE Bank of America 1-3 Year US Treasury Index as its benchmark and is designed to invest primarily in US Treasuries, federal agencies, and investment grade corporate bonds rated "A" or above, with 71% of the current portfolio composition in US Treasury and agency securities and 18% in corporate bonds. Only 11% of the securities in the strategy have a maturity of more than three years.

As an alternative to the current strategy, Chandler offers an investment strategy tied to a one to five-year benchmark that they term their "Short Term Bond" strategy. This strategy is still conservative and fully compliant with the City's investment policy and the limitations prescribed in the California Government Code, but has an average duration of 2.48 and a yield to maturity of 2.36% as of the first quarter of 2022. Key facts about this strategy are illustrated in the below charts.



This strategy utilizes the ICE Bank of America 1-5 Year US Treasury and Agency Index as its benchmark and is designed to invest primarily in US Treasuries, federal agencies, and investment grade corporate bonds rated "A" or above, with 56% of the current portfolio composition in US Treasury and agency securities and 25% in corporate bonds. Nearly 38% of the securities in this strategy have a maturity between three and five years.

While the current difference between the yield to maturity of these strategies is 0.26%, this differential can fluctuate depending on market conditions. At the current differential, changing investment strategies would yield an additional $706,000 of annual investment income for the City. It should also be noted that Chandler offers a strategy that blends the Limited Maturity and Short-Term Bond strategies with a duration and yield somewhere in the middle of the two strategies for clients whose risk tolerance lies somewhere between the two strategies.

Making a change in the City's investment strategy and benchmark is within the authority delegated to the City Treasurer by the City Council and selection of an alternative strategy would be fully compliant with the existing City Council-approved Investment Policy F-1. However, this change in strategy does come with some caveats that should be evaluated before a change is made. Specifically, certain liquidity, market volatility, and interest income considerations must be understood prior to making such a decision. Staff, therefore, brought this item to the Finance Committee for their feedback on and concurrence with the change prior to moving forward.

Analysis
Beyond just serving as a method to measure performance against, a benchmark guides Chandler's investment strategy as they try to match the composition of the benchmark in the City's portfolio. The benchmark, therefore, serves as an objective standard against which to measure and evaluate the relative performance of the City's investment portfolio. The selection of a benchmark must take into consideration the City's liquidity needs, its tolerance for short-term reductions to the market value of the investment portfolio, and its tolerance for swings in paper interest income (as opposed to actual cash interest earnings) from year to year. It should also be noted that there is no one investment strategy that will provide the best performance under all market conditions. However, in the long-term, investing against a longer-term benchmark has the potential to increase investment earnings and is a strategy that is employed by many of Chandler’s clients, in particular clients like the City who have robust cashflow management programs in place that minimize the likelihood of needing to sell securities prior to maturity.

If yield is the only criteria, then a one to five-year investment strategy would make the most sense. However, there is a noteworthy aspect to the longer-term investment strategy that if not properly understood could be a cause for concern. Switching to this strategy can result in more sizable drops in the book value of the City's investment portfolio and paper losses ("total returns") that are more significantly negative when interest rates rise. These are then offset by paper gains and increases in the market value of the portfolio that are also more significantly positive when interest rates decline. The key concept to understand is that these paper losses and gains are irrelevant, provided that the City holds its investments until maturity (or until an opportunity for a trade that makes economic sense presents itself). In the event that the City ever had to sell securities prior to maturity due to unanticipated liquidity needs, the real losses (or gains) would be larger than they would be with a one to three-year strategy due to the longer-term nature of the investments. However, it is important to recognize that such losses would exist in either scenario.

In addition to the liquidity concern, the other concern is that accounting guidance requires that the paper losses and gains be booked each year. Therefore, there will be years in which the City records higher or lower investment earnings in its financial statements than the actual cash earnings received. This is the case now with the one to three-year benchmark, but the effect will be more pronounced with a one to five-year benchmark. These variances eventually net out, and the higher cash earnings under the one to five-year benchmark eventually are recorded in the City's financial statements and will yield higher long-term earnings as described earlier in this report. If interest revenue was a significant component of the City's revenue budget, this could be a cause for concern. However, interest revenue makes up less than 1% of the General Fund revenue budget and staff believes that it is worth weathering these variances with the higher long-term interest earnings in mind.

Based upon all of these considerations, it is staff's recommendation to move to a one to five-year investment benchmark. Over the long-term, the potential for additional investment earnings is significant, which can be utilized to provide additional services to the City's residents, pay down unfunded liabilities, and/or fund capital projects.

Prepared and Submitted by:

/s/ Scott Catlett

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