CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5C
November 14, 2019

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
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SUBJECT: **INVESTMENT PERFORMANCE REVIEW**

EXECUTIVE SUMMARY

This memorandum provides an overview of the structure and the performance of the City's investment portfolio. As guided by the City's investment policy objectives, the City strives to maintain a portfolio emphasizing safety and liquidity while earning a market rate of return commensurate with the City's risk tolerance and investment restrictions imposed by the California Government Code. The City has complied with all the limiting parameters of both the California Government Code and the City's Investment Policy Statement while earning a rate of return comparable to the City's established benchmarks, the Intercontinental Exchange Bank of America Merrill Lynch (ICE BAML) 1-3 Year US Treasuries Index and the ICE BAML 1-3 Year US Corporate / Government Rated AAA-A Index.

DISCUSSION

Investment Portfolio Overview

The City's strategy continues to focus on identifying value from high quality, marketable securities among the full range of investment options, ensuring the portfolio continues to be well diversified.

As of June 30, 2019, the City's entire investment portfolio totaled over $290 million. These investments are pooled assets of the City Newport Beach, which includes the general fund, special revenue funds, internal service funds, enterprise funds (i.e., water and wastewater), as well as various other funds.

Liquidity Portfolios

The City uses a number of accounts and carve-out portfolios to accomplish its investment objectives. For liquidity, the City uses a combination of demand deposit accounts (DDA), the Local Agency Investment Fund (LAIF), and a targeted-maturities portfolio to provide sufficient liquidity to meet its day-to-day cash flows. Municipal deposits in DDAs are 110 percent collateralized by bank assets, and the City receives a compensating balance credit that can only be used to offset banking fees but does not produce income beyond bank fees. The average compensating balance credit for fiscal year ended June 30, 2019, amounted to approximately 0.6%, while LAIF produced an income return of approximately 2.4% during the fiscal year. Because of the current disparity in earnings potential between our DDA accounts and LAIF, only the bare minimums are maintained in the DDA accounts.

Funds that are needed to meet specific cash flows needs but can be invested at a rate higher than LAIF are accounted for in our targeted-maturities portfolio. As of June 30, 2019, this targeted-maturities portfolio held about $35 million in securities and provided an income return for the fiscal year of approximately 2.5%. Yield-to-maturity at cost, a forward-looking measure, was about 2.7%.

Short-Term Portfolio

The City's core investment portfolio of almost $217 million is actively managed in accordance with the California Government Code and the City's investment policy. The investments are held by a custody bank and are registered in the City's name. The City accounts for and monitors the portfolio independently of the investment advisors, by a direct feed from the custody bank and the use of third party analytical software. The City's core portfolio finished the twelve months ending June 30, 2019, with an income return of 2.0%.

Performance Benchmarking

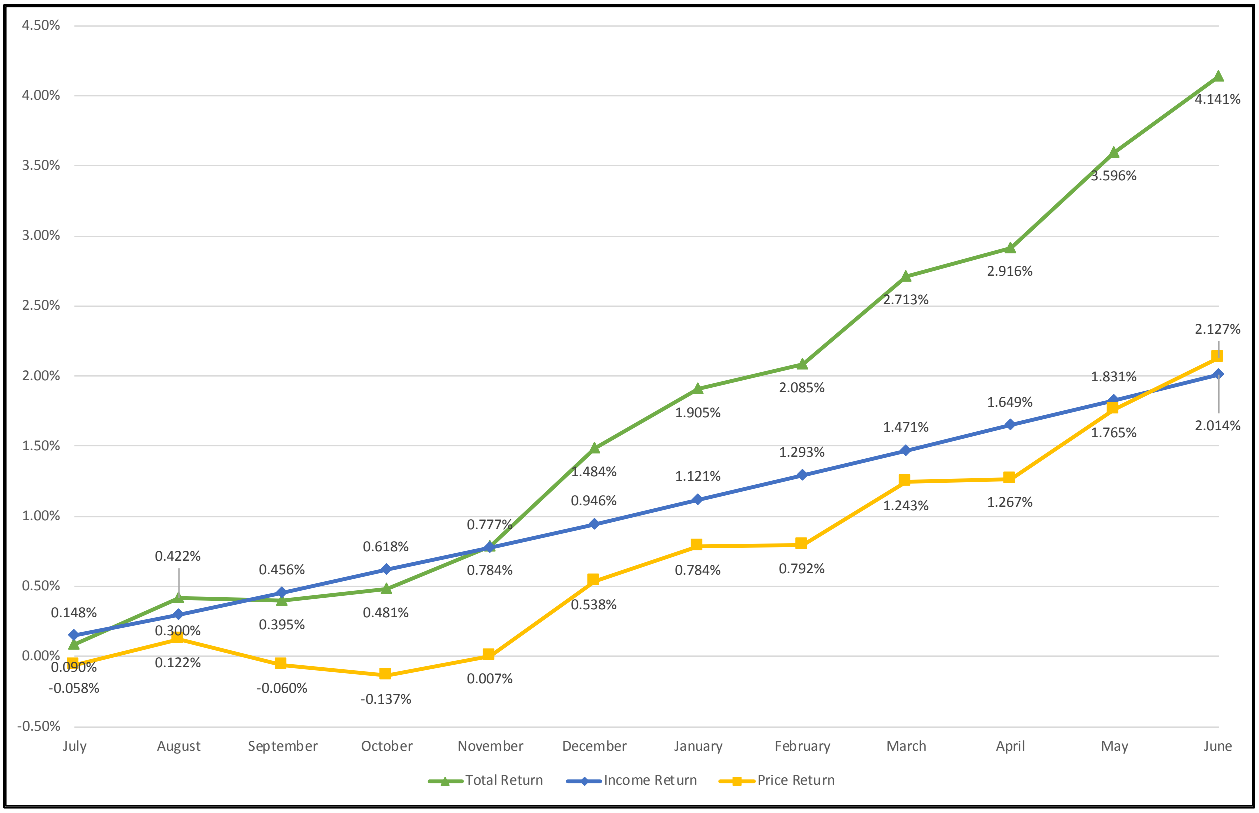
The City's investment policy statement identifies the City investment objectives. The objectives are to preserve principal and liquidity while earning a market rate of return commensurate with the City's investment risk tolerance, liquidity needs, and significant constraints imposed by the California Government Code 53601 as to the type and quantity of securities that may be purchased by local agencies.

"Total return" is the accepted industry standard measure for comparing portfolio performance to established benchmarks. Total return benchmarks provide valuable information to those charged with governance of the investment portfolio by:

- Communicating a transparent risk profile and related investment strategy;
- Managing expectations of risk and return; and
- Providing relative variances that can be used to identify decisions made regarding portfolio durations, sector weighting, credit quality and maturity structure.

The City uses total return to measure performance and risk against its benchmarks. Total return is made up of both income return and unrealized gains and losses due to changing interest rate environments. The market value of bonds moves inversely to the direction of interest rates. As interest rates decrease, the market value of bonds held in the portfolio increases because they are paying a higher interest rate than comparable bonds in the market.

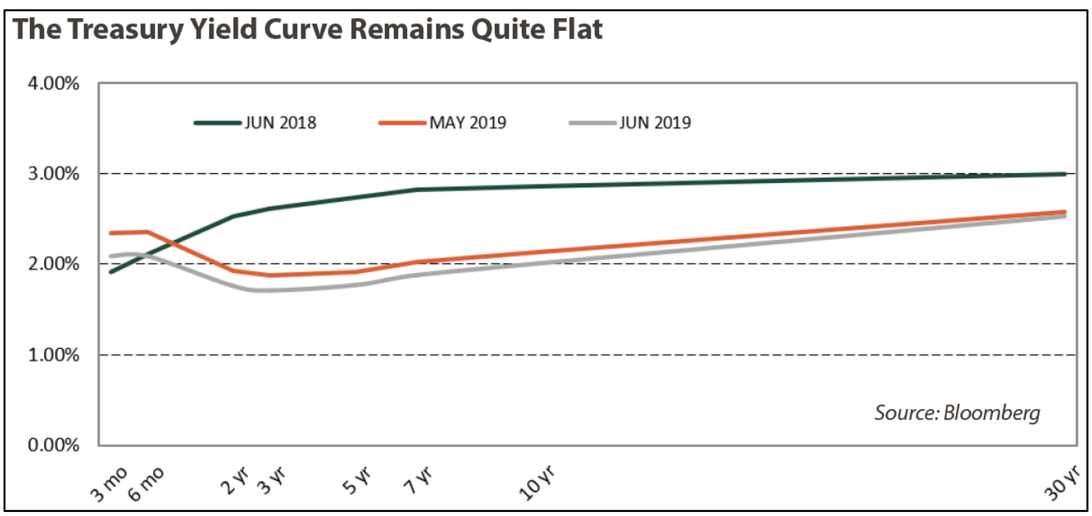
As illustrated in the chart below, the City's income return was about 2.0%. As interest rates trended downward, price return turned positive lifting the total return up to about 4.1% even though the unrealized gains were not realized.



The core portfolio currently follows an ultra-short-term bond strategy. This portfolio aims to find value and maximize yield within the high quality fixed income market within the duration range of the City's strategic benchmarks. The City uses the ICE BAML 1-3 Year US Treasuries Index as one benchmark. The City also uses a second benchmark, the ICE BAML 1-3 Year U.S. Corporate / Government Rated AAA-A Index, which is more reflective of the portfolio's risk and return characteristics. The use of two benchmarks provides a means to evaluate the added value that high quality corporate bonds bring to the portfolio.

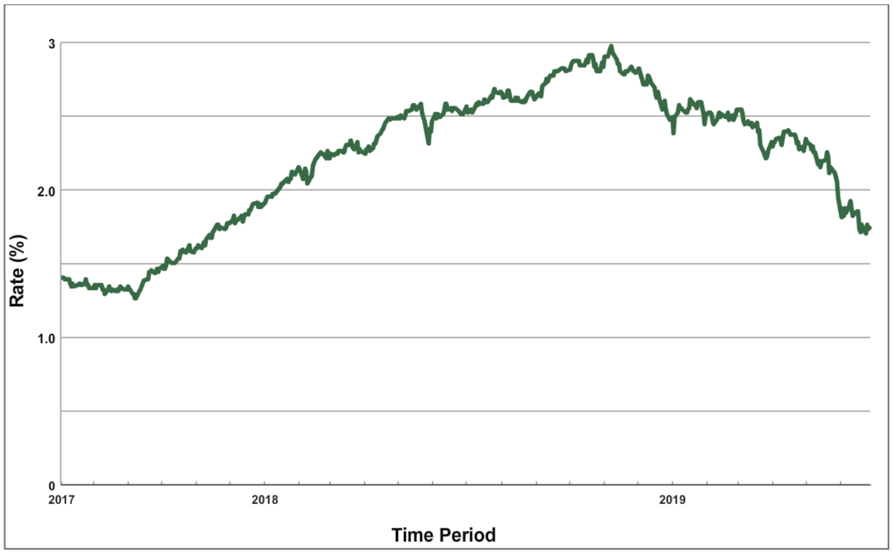
As demonstrated in the table below, the City's investment portfolio was positioned shorter in duration than its benchmarks and outperformed the ICE BAML 1-3 Year US Treasuries Index by 17.9 basis points (bps). During the fiscal year, a shorter duration likely provided better income returns as Treasury yields on shorter durations exceeded those of longer durations during the fiscal year.

	June 30	
	2019	**2018**
Portfolio Returns		
Income Return	2.014%	1.529%
Price Return	2.127%	-1.069%
Total Return	4.141%	0.460%
Benchmark Returns		
ICE BAML 1-3 Year US Treasuries Index	3.962%	0.079%
ICE BAML 1-3 Year US Corp / Gov Rated AAA-A Index	4.158%	0.204%
Ending Duration		
Short-term Portfolio	1.764	1.661
ICE BAML 1-3 Year US Treasuries Index	1.877	1.870
ICE BAML 1-3 Year US Corp / Gov Rated AAA-A Index	1.869	1.880



Total return on the portfolio for FY 2017-18 and FY 2018-19 went from 0.5% to 4.1%. Most of this change is attributable to the portfolio's price return increasing from (1.1%) to 2.1%. Seemingly dramatic, this price appreciation is expected given the corresponding interest rate environments. Illustrating the interest rate environments, below is a chart of two-year Treasuries yields. Fiscal Year 2017-18 witnessed a steady increase in interest rates. Because bond prices move inversely to interest rates, a negative price return is expected for FY 2017-18. Conversely, FY 2018-19 experienced decreasing interest rates and a corresponding positive price return. Contributing to the interest rate environment change between the two fiscal years were concerns about foreign countries and their impact on the United States of America.

Nominal Yields on Two Year Treasuries from July 2017 through June 2019



(Source: U.S. Department of the Treasury)

Fiscal Year 2017-18 saw growth in foreign and domestic economies, and interest rates. During the fiscal year, the Federal Reserve raised the federal funds target rate range three times, December 2017, March 2018, and June 2018. Jerome Powell, chair of the Federal Reserve, in a June 2018 press conference noted, “Fiscal policy is boosting the economy, ongoing job gains are raising incomes and confidence, foreign economies continue to expand, and overall financial conditions remain accommodative.”

Subsequently, uncertainties and concerns about foreign economies came to the forefront, leading to the Federal Reserve deciding to reduce the federal funds target rate range on July 2019. Chair Powell noted during a July 2019 press conference that the rate reduction was “intended to insure against downside risks from weak global growth and trade policy uncertainty, to help offset the effects these factors are currently having on the economy, and to promote a faster return of inflation to our symmetric 2 percent objective.” If a decreasing interest rate environment persists, the City’s portfolio will earn less interest income but more unrealized gains.

PORTFOLIO CHARACTERISTICS LOOKING FORWARD

While total return is an excellent benchmarking measure it does not always provide intuitive information regarding what the portfolio is earning on a cash basis since the total return measure assumes all unrealized gains and losses are ultimately realized at a particular date. This difference is especially magnified in a changing interest rate environment and when the duration of the portfolio is longer than the benchmark.

As of June 30, 2019, the City's net unrealized gains on the short-term investment portfolio were approximately $2.1 million. Overall, this is neutral news. The City will be earning lower bond yields as maturing investments and earnings are reinvested. The short-term portfolio's yield to maturity (YTM) at market value at June 30, 2019, ticked down to about 2.0% from 2.6% from a year earlier. The upside is the City will have more latitude in its cash flow forecasting. Liquidating securities prior to their maturity date may result in realized gains that would otherwise have been unrealized by holding a security to maturity. That is not to say that the City automatically sells securities when unrealized gains arise. The City deploys an active investment strategy. Before investments are sold, various factors are considered, such as the difference in yield between the market and the City's portfolio. This is the primary difference between an active versus a passive investment strategy, which simply follows the attributes of a given benchmark. Currently, the City's strategies have served the City well in the current economic environment.

Prepared by:	Submitted by:
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Jeremiah Lim	Dan Matusiewicz
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Attachments:

A. Financial Markets Overview
B. Treasury Report – Month Ended June 30, 2019