CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5A
September 16, 2021

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
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SUBJECT: ANNUAL REVIEW OF INVESTMENT PERFORMANCE

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, 2021, the City's entire investment portfolio totaled over $335 million. These investments are pooled assets of the City of Newport Beach, which includes the General Fund, special revenue funds, internal service funds, enterprise funds (e.g., water and wastewater), as well as various other funds.

Liquidity Portfolios

The City uses several accounts and carve-out portfolios to accomplish its investment objectives. For liquidity, the City uses a combination of demand deposit accounts (DDAs), 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 the Fiscal Year ending June 30, 2021, amounted to approximately 0.17%, while LAIF produced an income return of approximately 0.56% during the Fiscal Year. Because of the current disparity in earnings potential between our DDAs and LAIF, only the bare minimums are maintained in the DDAs.

Funds needed to meet specific cash flows that can be invested at a rate higher than LAIF are accounted for in our targeted-maturities portfolio. For the Fiscal Year, the targeted-maturities portfolio provided an income return of approximately 0.33%. Because LAIF offered higher interest rates than the securities available to the targeted-maturities portfolio, LAIF was the preferred account for keeping funds needed for liquidity, and the targeted-maturities portfolio's balance decreased substantially. As of June 30, 2021, the targeted-maturities portfolio's balance was about $574, with a yield-to-maturity at cost, a forward-looking measure, of about 0.01%. Should future interest rates available to the targeted-maturities portfolio improve relative to LAIF, the future balance of the targeted-maturities portfolio should increase as well. Generally, LAIF's interest rate changes slower than market interest rates. Therefore, LAIF's interest rate will be higher than the market's rate at the beginning of a falling rate environment. Conversely, at the beginning of a rising rate environment, LAIF's rate will be lower than the market's rate.

Short-Term Portfolio

The City's core investment portfolio of about $237 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, 2021, with an income return of 1.83%.

Performance Benchmarking

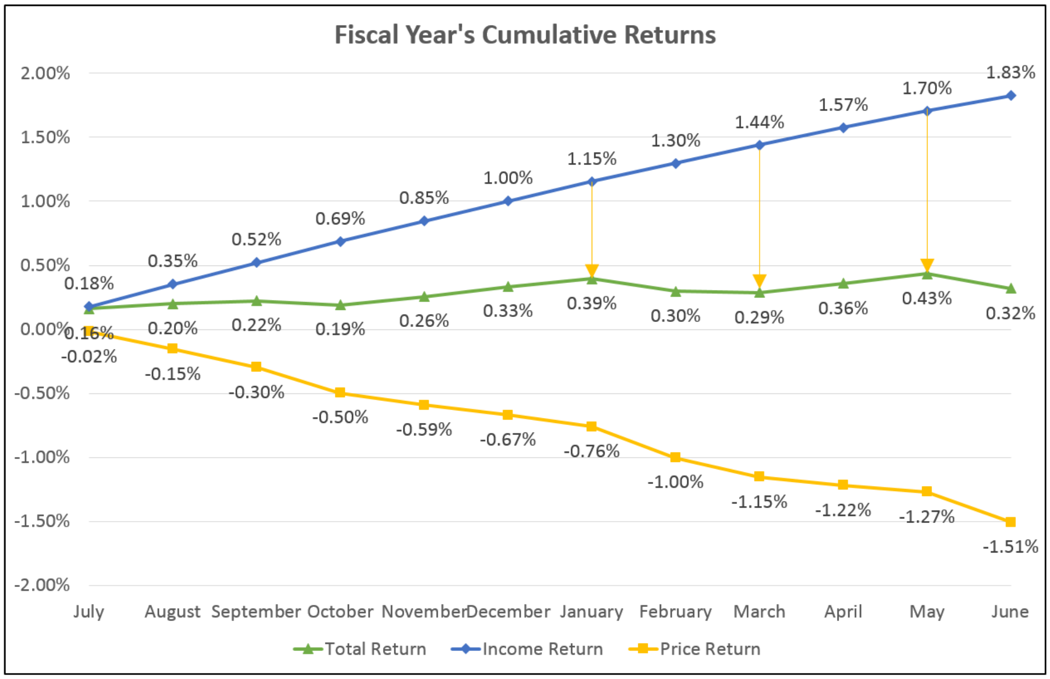
The City's investment policy statement identifies the City investment objectives. The objectives are to preserve principal and liquidity while earning a market rate of return commensurate with the City's investment risk tolerance, liquidity needs, and significant constraints imposed by the California Government Code Section 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 increase, the market value of bonds held in the portfolio decreases because they are paying a lower interest rate than comparable bonds in the market. Market interest rates trended slightly upward during the Fiscal Year. As shown in the following chart, the core portfolio's price return trended downward to -1.51%, offsetting the portfolio's 1.83% income return, for a net 0.32% total return.

While total return is useful for benchmarking, generally, the City's securities are held to maturity, making the 1.83% income return a better indicator of the City's cash flows from these securities. At 1.83%, the core portfolio's income return exceeds LAIF's 0.56% income return. The City seeks higher income returns within the core portfolio whenever possible by avoiding selling securities before maturity due to liquidity needs. This is accomplished by holding sufficient liquid assets outside the core portfolio, primarily in LAIF, to meet these needs. Price risk from the core portfolio is mitigated by generally holding securities to maturity. Liquidity risk from the core portfolio is managed by holding liquid assets outside of the core portfolio. Price risk from the core portfolio is managed by generally holding securities to maturity.

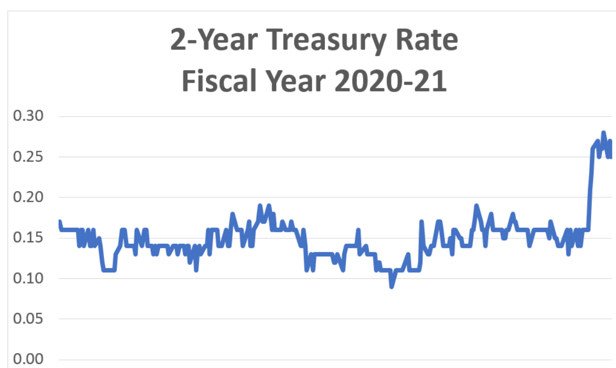


The core portfolio currently follows a short-term bond strategy. This portfolio aims to find value and maximize yield within the high-quality fixed income market within the duration range of the City's strategic benchmarks. The City uses the ICE BAML 1-3 Year US Treasuries Index as one benchmark. The 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 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 24.7 basis points (bps).

	June 30	
	2021	**2020**
Portfolio Returns for Fiscal Year		
Income Return	1.826%	2.200%
Price Return	-1.507%	2.161%
Total Return	0.320%	4.361%
Benchmark Returns for Fiscal Year		
ICE BAML 1-3 Year US Treasuries Index	0.073%	4.065%
ICE BAML 1-3 Year US Corp / Gov Rated AAA-A Index	0.267%	4.176%
Ending Duration		
Short-term Portfolio	1.826	1.755
ICE BAML 1-3 Year US Treasuries Index	1.905	1.892
ICE BAML 1-3 Year US Corp / Gov Rated AAA-A Index	1.902	1.889

Total return on the portfolio declined between Fiscal Year 2019-20 and Fiscal Year 2020-21, decreasing from 4.36% to 0.32%. The difference in total return between the two Fiscal Years is mostly related to the difference in bond price return between the two Fiscal Years. Bond prices move inversely to interest rates, and Fiscal Year 2019-20 had an overall decrease in interest rates, while Fiscal Year 2020-21 had an overall increase in interest rates. The following charts of two-year Treasury yields illustrate these differing interest rate environments.



(Source: Federal Reserve Bank of St. Louis)

Two-year Treasury rates started Fiscal Year 2019-20 at about 1.78% and ended at about 0.16%, about a 91% decrease. Fiscal Year 2020-21 differed, with 2-year Treasury rates starting at about 0.17% and ending at about 0.25%, about a 47% increase. If interest rates do not increase more substantially, future total returns from fixed income portfolios may be muted. Future income returns will continue to decrease as money is invested/reinvested at interest rates that, while increasing, are below the portfolio's previous income return. Price return is not likely to be significantly positive if rates continue to fluctuate higher, because bond prices move inversely with interest rates.

Consequently, it is reasonable to expect the City's Fiscal Year 2021-22 total return to be lower than the City's Fiscal Year 2020-21 total return.

PORTFOLIO CHARACTERISTICS LOOKING FORWARD

As of June 30, 2021, the City's net unrealized gains on the short-term investment portfolio were over $3 million. Although this is a good position to be in, the gain is simply a result of lower interest rates and realizing the gain immediately by selling securities would simply reduce future earnings. The City's income return will continue to decrease as maturing investments and earnings are reinvested at market rates, which though rising are still below the past income return of the City. 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. These strategies have served the City well in the current economic environment and over the long term, as demonstrated by the above-benchmark returns.

Prepared by:	Submitted by:
/s/Jeremiah Lim	/s/Scott Catlett
Jeremiah Lim	Scott Catlett
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Attachments:

A. Financial Markets Overview
B. Treasury Report for the Month Ended June 30, 2021