



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Julia H. Cooper

**SUBJECT: INVESTMENT REPORT FOR
THE QUARTER ENDED
MARCH 31, 2019**

DATE: April 30, 2019

Approved

 Date

5-7-19

Transmitted herewith is the City's Investment Report for the quarter ended March 31, 2019. To meet the reporting requirements set forth in the City of San Jose Investment Policy, an electronic version of this report will be posted on the City's website at <http://www.sanjoseca.gov/index.aspx?NID=759> and a hard copy will be on file at the City Clerk's Office located at 200 East Santa Clara Street.

This report will be distributed to the Public Safety, Finance and Strategic Support Committee (PSFSS) for the May 16, 2019 meeting and will be agendized through the PSFSS Committee to the City Council meeting on June 4, 2019.

Summary of portfolio performance and compliance for quarter ended March 31, 2019:

- Size of total portfolio: \$1,704,612,867
- Earned income yield: 2.289%
- Weighted average days to maturity: 579 days
- Fiscal year-to-date net interest earnings: \$24,963,754
- No exceptions to the City's Investment Policy during this quarter

During the quarter, the City's external auditor, Macias, Gini, & O'Connell LLP, evaluated the City's investment program for the six months ended December 31, 2018. The Independent Accountant's Report on Applying Agreed-Upon Procedure is included herewith. The report noted no exceptions to the Investment Policy. No response is required from management.

If you have any question on this investment report, please do not hesitate to call me at 535-7011.

/s/

JULIA H. COOPER
Director of Finance

cc: David Sykes, City Manager
Joe Rois, Acting City Auditor
Richard Doyle, City Attorney

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**INVESTMENT REPORT FOR
THE QUARTER ENDED
MARCH 31, 2019**



Prepared by
Finance Department
Treasury Division

Julia H. Cooper
Director of Finance

**Investment Report for
The Quarter Ended
MARCH 31, 2019**

**City of San José
Department of Finance
Treasury Division**

Julia H. Cooper
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Courtney Brown, Staff Specialist

**CITY OF SAN JOSE
INVESTMENT REPORTS FOR
THE QUARTER ENDED MARCH 31, 2019
TABLE OF CONTENTS**

LETTER OF TRANSMITTAL

SECTION A. PORTFOLIO STATISTICS

Portfolio Statistics – Quarter-to-Date

Portfolio Statistics – Year-to-Date

SECTION B. EARNED INCOME REPORTS

Total Earnings – Quarter-to-Date

Total Earnings – Year-to-Date

SECTION C. PORTFOLIO HOLDINGS AT COST

Investment Status Report

SECTION D. MARKET VALUE OF PORTFOLIO

Portfolio Details - Investments

SECTION E. DETAIL OF INVESTMENT ACTIVITY

Transaction Activity Report

Reconciliation of Investment Activities

Purchase Report

SECTION F. INDEPENDENT ACCOUNTANT'S REPORT

Independent Accountant's Report on Applying Agreed-Upon
Procedures as of December 31, 2018

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April 30, 2019

HONORABLE MAYOR and CITY COUNCIL

INVESTMENT REPORT FOR THE QUARTER ENDED MARCH 31, 2019

I am pleased to present this report of investment activity for the quarter ended March 31, 2019 in compliance with the reporting requirements set forth in the City of San José Investment Policy. The report presents information in the following major categories: Portfolio Statistics, Portfolio Performance, Compliance Reporting Requirements, Investment Trading Activity, and Investment Strategy.

The information presented in the table below highlights the investment activity for the quarter ended March 31, 2019, as well as provides a comparison to the quarters ended December 31, 2018, and March 31, 2018.

INVESTMENT SUMMARY			
For the Quarter Ended	March 31, 2019	December 31, 2018	March 31, 2018
<u>Total Portfolio</u>			
Portfolio Value ^{(1) (2)}	\$1,704,612,867	\$1,523,155,876	\$1,565,162,468
Earned Interest Yield	2.289%	2.070%	1.566%
Dollar-weighted average yield			
Purchases	2.800%	3.023%	2.032%
Maturities	1.674%	1.569%	1.316%
Called Securities	2.571%	1.915%	N/A
Weighted avg. yield at end of period	2.281%	2.123%	1.573%
Weighted avg. days to maturity	579	559	524
<u>Portfolio Fund 3</u>			
Portfolio Value ^{(1) (2) (3)}	\$1,702,265,134	\$1,515,330,209	\$1,556,385,495
Earned Interest Yield	2.281%	2.068%	1.567%
Dollar-weighted average yield			
Purchases	2.800%	3.023%	2.032%
Maturities	1.674%	1.569%	1.316%
Called Securities	2.571%	1.915%	N/A
Weighted avg. yield at end of period	2.281%	2.122%	1.573%
Weighted avg. days to maturity	579	561	527

¹ Reflects book value (principal plus any purchased interest) of investments.

² Total excludes bond proceeds held by trustees for the City of San José (\$228,189,938.74).

³ Total excludes other restricted funds required to be invested separately.

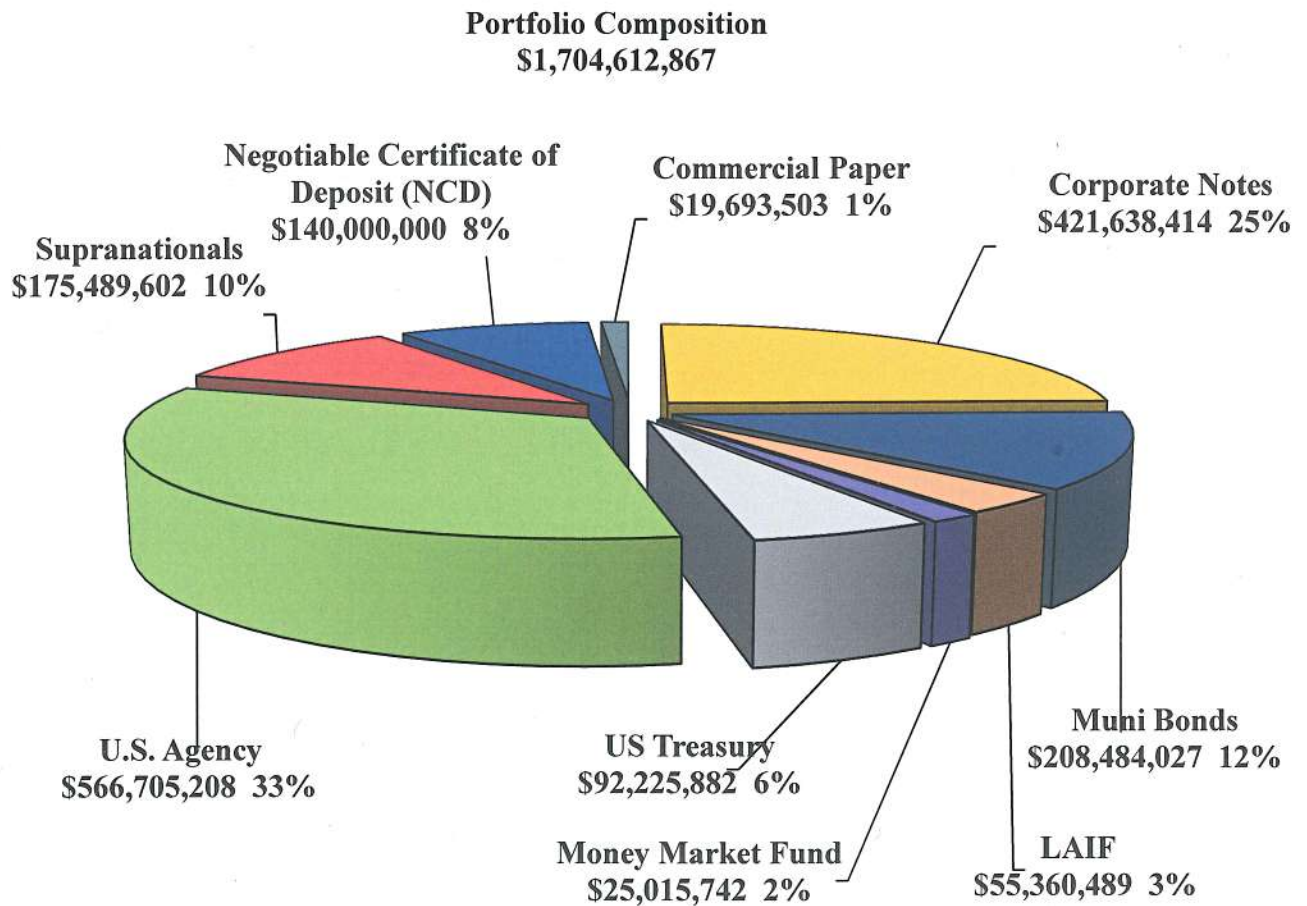
PORTFOLIO STATISTICS

Detailed information can be found in the attachments while summaries are provided below.

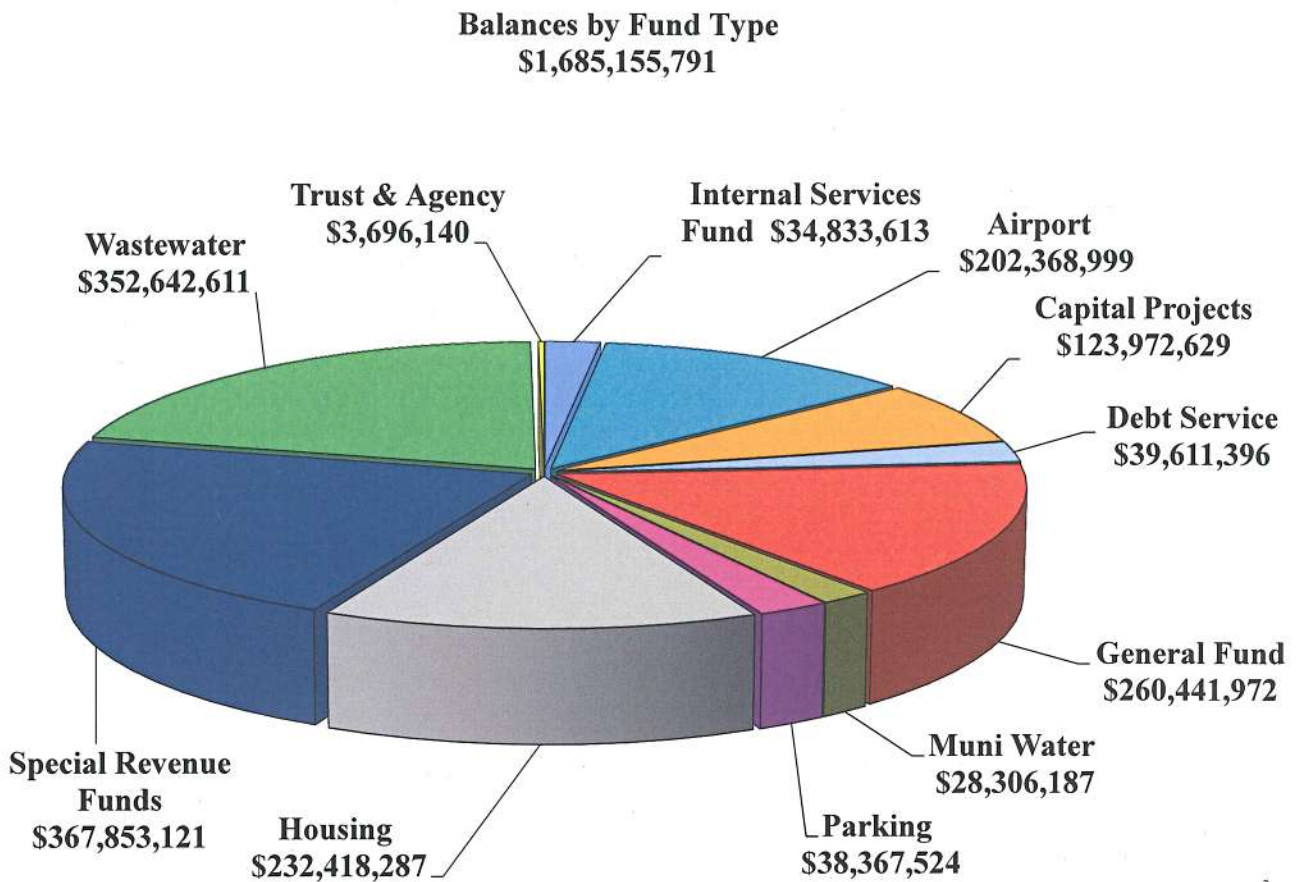
Portfolio Composition

Within this section are snapshots of the City's total investment portfolio as of March 31, 2019.

The first graph shows the portfolio composition by investment type.



The graph below reflects the reconciliation of total balances reported by the investment program's record-keeping system to the City's Financial Management System (FMS).



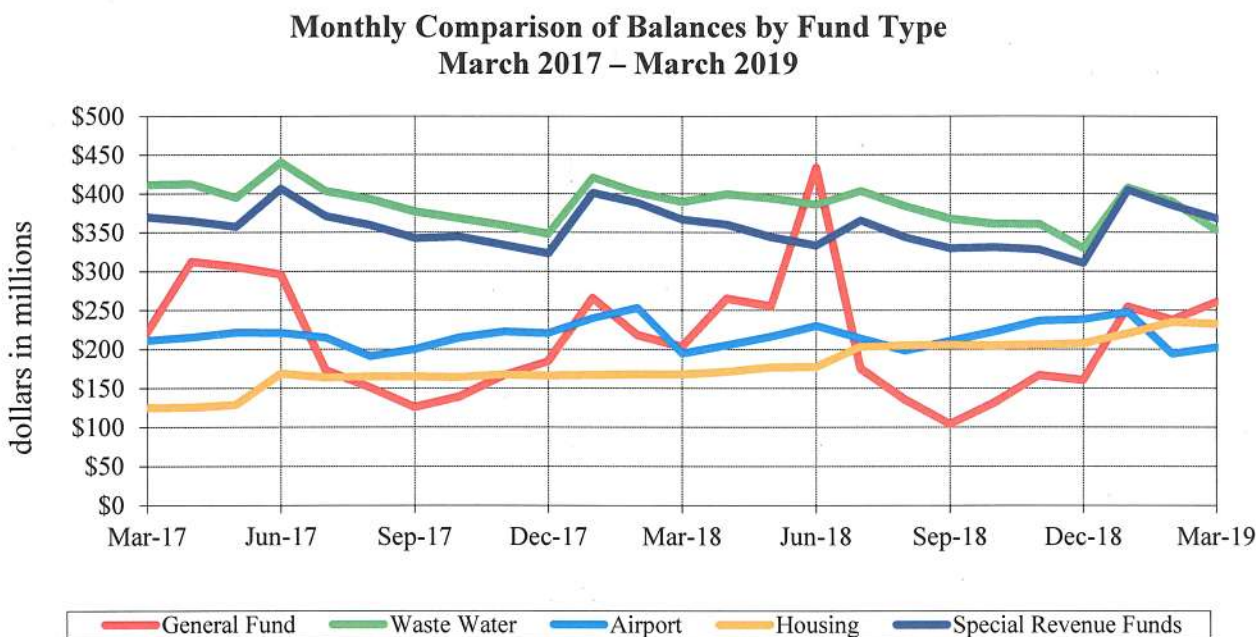
Total Balances per FMS	\$1,685,155,791
Deposit-in-Transit, Outstanding Checks ¹	19,457,076
Portfolio Balance Total	<u>\$1,704,612,867</u>

¹ Reflects timing difference between when deposits are made and accounted for in FMS or when checks are written and not yet cashed by the receiving party

General Fund Balances

With the receipts of property tax advances in January, General Fund balances increased by \$100.18 million during the quarter and ended with a balance of \$260.44 million as of March 31, 2019. General Fund cash balances usually peak during the months of January and June when the bulk of property taxes are received, and decline in the summer months due to retirement prefunding, debt service payments and operational expenditures.

The following graph compares monthly balances of five largest City funds as reported by FMS.



Prefunding of Annual Retirement Contributions and Issuance of Short-Term Notes

The City opted to prefund a significant portion of the annual employer retirement contributions for Fiscal Year 2018-19. The prefunding amount was \$358.5 million at the beginning of the year. In anticipation of this cash outflow, the City set aside \$208.5 million in cash and matured investments and additional funding of \$150 million came from Tax Revenue Anticipation Notes (TRAN) issued on July 2, 2018. The TRAN was redeemed in full on April 1, 2019.

The City will cease prefunding retirement contributions in Fiscal Year 2019-20.

Successor Agency to the Redevelopment Agency of the City of San José

Historically, the Redevelopment Agency participated in the City's investment pool with both restricted bond proceeds and operating cash balances. As of February 1, 2012, redevelopment agencies in California were dissolved by legislative action and the City, acting as the Successor Agency to the Redevelopment Agency ("SARA"), transferred Redevelopment Agency's funds from the investment pool to SARA's own bank accounts.

In July 2018, the City entered into the final stage of dissolution and absorbed the entire SARA operations into City operations. City staff will manage SARA's accounts until all assets are liquidated and bonds are redeemed.

As of March 31, 2019, SARA reported cash balances as outlined in the table below:

SARA CASH SUMMARY			
	<u>Restricted/Reserved</u>	<u>Pledged</u>	<u>Totals</u>
LAIF	\$ -	\$ 10,769,034	\$ 10,769,034
Wells Fargo			
General Account-80% Funds		841,711	841,711
Total Wells Fargo Funds	-	841,711	841,711
Wilmington Trust:			
Debt Service Fund	-	46,201,156 ^(A)	46,201,156
Total Wilmington Trust Funds	0	46,201,156	46,201,156
TOTAL	\$ -	\$ 57,811,901	\$ 57,811,901

^(A) Funds restricted for tax allocation bond debt service payments

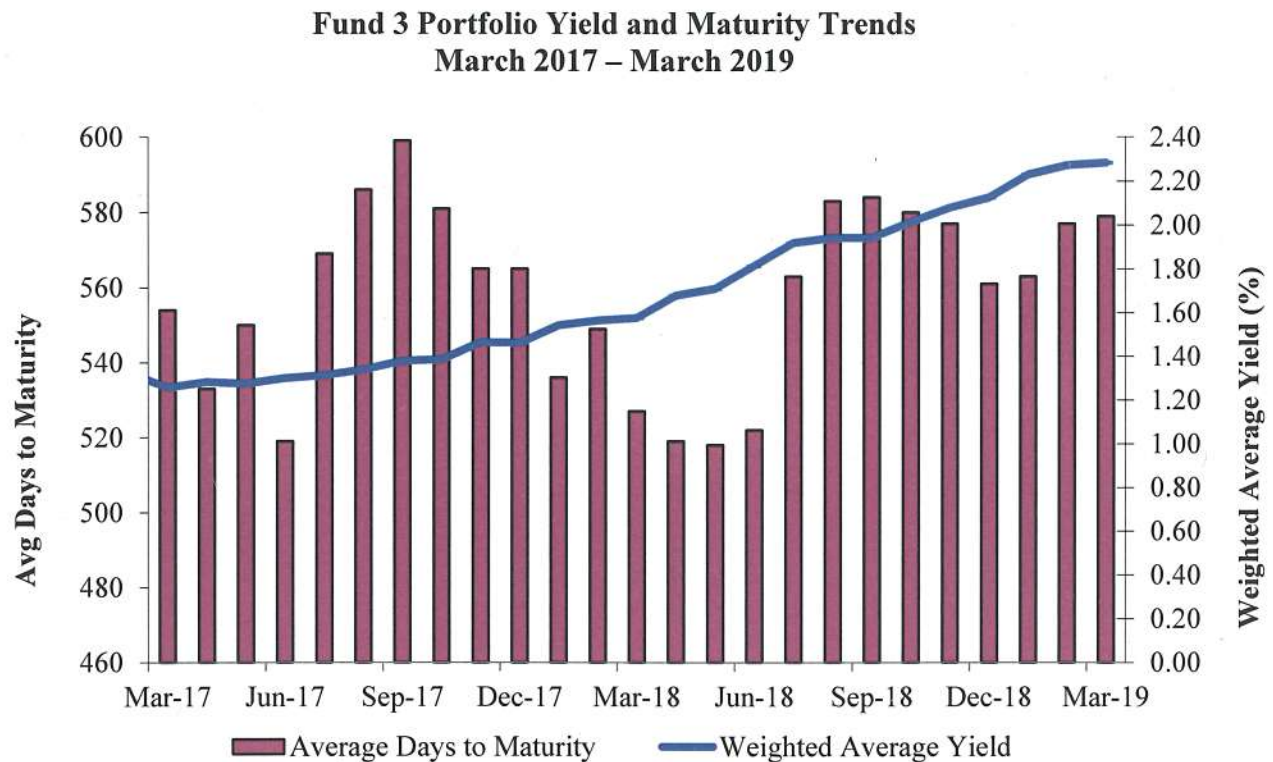
PORTFOLIO PERFORMANCE

The following table illustrates the total portfolio income recognized for the last quarter as compared to the prior quarter and the same quarter one year ago.

TOTAL PORTFOLIO INCOME RECOGNIZED			
	Accrual Basis		
Total Portfolio	<u>March 31, 2019</u>	<u>December 31, 2018</u>	<u>March 31, 2018</u>
<u>Quarter-End</u>			
Total interest earnings	\$ 9,595,606	\$ 7,746,397	\$ 6,195,140
Realized gains (losses)	0	0	0
Total income recognized	\$ 9,595,606	\$ 7,746,397	\$ 6,195,140
<u>Fiscal Year-to-Date</u>			
Total interest earnings	\$ 24,963,754	\$ 15,368,148	\$ 16,555,339
Realized gains (losses)	0	0	0
Total income recognized	\$ 24,963,754	\$ 15,368,148	\$ 16,555,339

Yield and Maturity Trend

The following graph illustrates monthly dollar-weighted average-days-to-maturity (“ADM”) of Fund 3 Portfolio (bar graph) along with the weighted average yield (line graph) for the past two years.



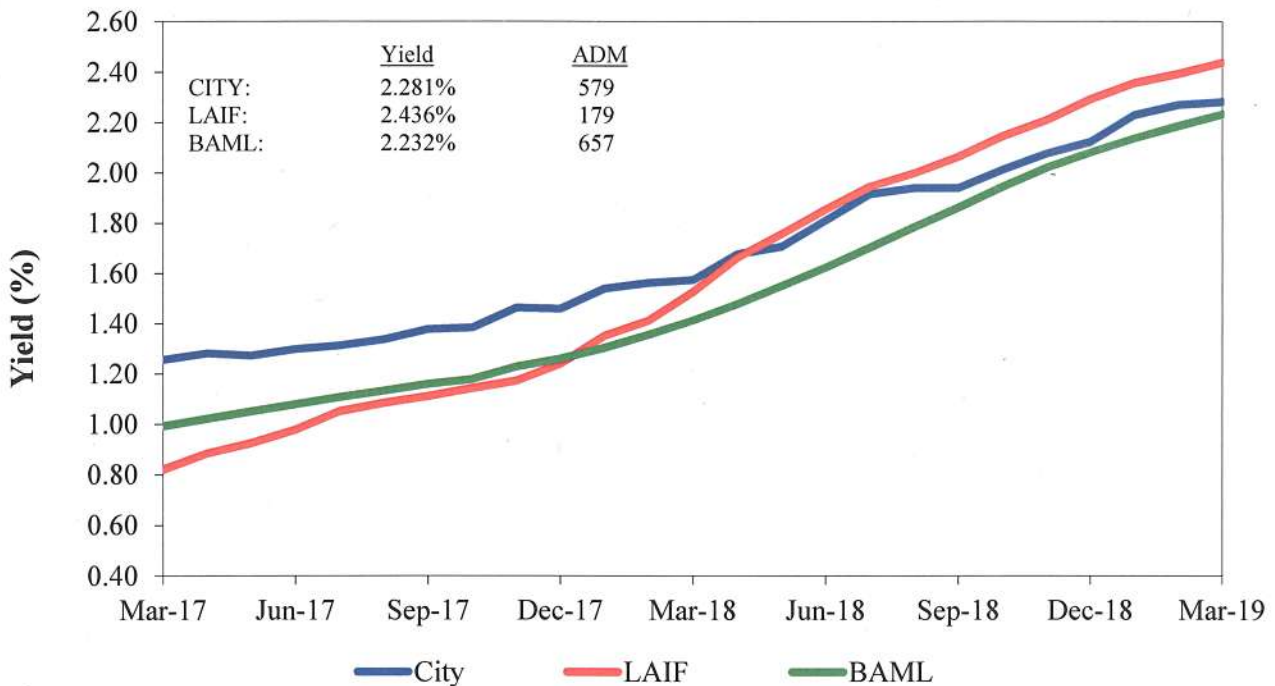
The Fund 3 Portfolio’s average days to maturity (ADM) increased from 561 days as of December 31, 2018, to 579 days on March 31, 2019. The weighted average yield increased from 2.122% as of December 31, 2018 to 2.281% on March 31, 2019.

Yields declined throughout the quarter and a curve inversion occurred in March where the 3-month Treasury Bill yield exceeded the 5-year Treasury yield. Investment staff took advantage of longer federal agency callable papers with lockout periods, which contributed to the increase of the portfolio’s ADM. Even with declining yields, staff continued to purchase new investments at higher yields than matured ones. As a result, the overall portfolio yield increased by 16 basis points.

Comparison with Benchmarks

The City’s Total Portfolio is not compared to benchmarks because it includes various funds which have separate cash flows and investment requirements. Only the City’s Fund 3 Portfolio is compared against benchmarks for performance purposes. The following graph demonstrates a yield comparison by month of the City’s Fund 3 Portfolio, the California LAIF, and the BAML Index for the period from March 2017 to March 2019.

Portfolio vs. Benchmarks March 2017 – March 2019



Notes:

1. **City** refers to City's Fund 3 Portfolio, and the yield data are month end weighted average yields.
2. **LAIF** refers to the State of CA Local Agency Investment Fund and yield data are average monthly effective yields.
3. **BAML** refers to Bank of America Merrill Lynch 1-3 Year AAA-A US Corporate & Government Index and yield data are rolling 2-year effective yield.

LAIF is a short-term investment option available to local agencies in California. The City invests most of its short-term funds in LAIF and often references LAIF as a floor benchmark when making investment decisions. LAIF has a high turnover ratio and its ADM was 179 days as of March 31, 2019. The City generally follows a buy-and-hold strategy and maintains a longer ADM, 579 days as of March 31, 2019. The majority of the City's holdings were purchased when interest rates were lower. Although \$338.93 million of new investments were purchased at current market rates during the quarter, the quantity was insufficient to keep the City's portfolio yield on par with LAIF. Nevertheless, the yield gap between the City's portfolio and LAIF tightened slightly this quarter. The gap may further narrow in 2019, since the Federal Reserve is not expected to raise interest rates for the remainder of the year. In the near future, staff still expects that the City portfolio performance to lag behind LAIF, especially when the yield curve inversion persists.

The BAML Index is a broad market index and tracks dollar denominated investment-grade debt with a remaining maturity up to 3 years. The City's Investment Policy allows investments, in a

few sectors, up to a 5-year final maturity. Although the City portfolio is mainly composed of investments shorter than 3 years, staff is making a conscious effort to place a portion of the portfolio in the 3- to 5-year maturity range to add incremental yield when appropriate. As a result, the City's portfolio outperformed the BAML Index during the last two years, despite having a shorter ADM. However, as the yield curve inverts, the performance gap between the BAML Index and the City's portfolio has narrowed considerably over time.

Unrealized Losses and Gains

As shown in the Investment Summary Table on page 1 of this report, the total portfolio size as of March 31, 2019, was approximately \$1.70 billion. The following table illustrates the net unrealized gains or losses on the portfolio when comparing the portfolio's market value to both its original cost and amortized cost.

UNREALIZED GAINS & LOSSES			
Cash Basis			
Market Value	\$1,701,134,468	Market Value	\$1,701,134,468
Original Cost	<u>(1,704,243,976)</u>	Amortized Cost	<u>(1,702,708,672)</u>
Net Unrealized Loss	\$ (3,109,508)	Net Unrealized Loss	\$ (1,574,204)

An inverse relationship exists between general changes in interest rates and the value of investment securities. As interest rates decrease, the value of the City's investments increases. Conversely, as interest rates increase, the value of the City's investments declines. The City's investment practice, per the Investment Policy, is generally to hold securities to maturity, with exceptions as noted in the Policy. The net unrealized losses noted above are "paper losses" and would only be realized if securities were sold prior to maturity.

Earned Interest Yield

The earned interest yield of the total investment portfolio for the quarter ended March 31, 2019 was 2.289%, 0.219% higher than the previous quarter and 0.723% higher than the quarter ended March 31, 2018.

COMPLIANCE REPORTING REQUIREMENTS

Pursuant to Section 21.0 of the City's Investment Policy, "No less than semi-annually each year, a compliance audit shall be conducted of the City's investment program to determine whether the City's investments within the City's pooled portfolio are in compliance with the City's Investment Policy, internal controls and department procedures." These compliance audits per the Investment Policy can be included in the City Auditor's work plan, or can be conducted by an external auditor at the request of the Director of Finance. During the quarter, the City Auditor's Office engaged the services of Macias, Gini, & O'Connell LLP ("MGO") to audit the City's investments within the pooled portfolio.

MGO completed its evaluation for the six month ended December 31, 2018 and found the City's investment program to be in compliance with the City's Investment Policy, internal controls and department procedures. The report noted no exceptions to the Investment Policy. A copy of the Independent Accountant's Agreed-Upon Procedures Report is attached to this quarterly report (Section F).

Cash Management Projection

Based on the Finance Department's cash flow projection as of March 31, 2019, total revenues and investment maturities for the next six months are anticipated to be approximately \$1.72 billion. This is sufficient to cover projected expenditures of approximately \$1.45 billion.

Statement of Compliance with the Policy

There were no exceptions or violations outstanding for the quarter ended March 31, 2019. The investment portfolio meets the requirements of the City's Investment Policy and California Government Code section 53601.

Comparison of Portfolio Investment Earnings to FY 2018-19 Budget

The following is a comparison of actual General Fund investment earnings, on an accrual basis, to the fiscal year 2018-19 budget. The fiscal year 2018-19 budgeted interest earnings for the General Fund is \$3 million, and the forecasted net interest yield is 1.66%. The schedule below compares the unaudited actual net investment earnings to the General Fund budget for the quarter ended March 31, 2019. The interest earnings are greater than the forecast for the quarter and for the fiscal year.

BUDGET COMPARISON

<u>Net Investment Earnings</u>	<u>Yield</u>
<i>Quarter Ended March 31, 2019</i>	
Budget ^(a)	1.66%
Actual ^(b)	2.14%
Variance	0.48%
<i>Fiscal Year to Date</i>	
Budget ^(a)	1.66%
Actual ^(b)	1.95%
Variance	0.29%

(a) Reflects the 2019-2023 General Fund Forecast Information submitted by Finance on February 13, 2018.

(b) Reflects the earned interest yield less costs to administer the investment program, adjusted for funds with negative cash balances at month end.

INVESTMENT TRADING ACTIVITY

Section E provides a detail of the City's investment activities, including purchases, maturities, amortization, received interest, and realized gains or losses from trading activities.

INVESTMENT STRATEGY

The Investment Program continues to focus on its core mandates of safety, liquidity, and yield. Investments have been matched to known cash flow outlays in the next 24-month horizon. Beyond the 24-month horizon, staff extends maturities in order to provide income and structure for the portfolio when appropriate.

The Federal Reserve kept the Fed Funds Target Rate unchanged at 2.5% in March 2019 and indicated there would likely be no interest hike in 2019. Equity markets rebounded during the quarter and market volatility came down from the peak in December 2018. U.S. economy continues to stay as the bright spot in the world, and recent economic data and corporate earnings show limited signs of downside risks. However, risks of slowing global growth and ongoing trade tensions may loom larger and stall the US economy with the rest of the world.

The investment staff will closely monitor the market development, focus on the overall quality of the portfolio and invest with care, prudence and diligence.

Future Commitments – As of March 31, 2019, the City had no obligations to sell securities and no commitments to participate in securities trading.

Executed Reverse Repurchase Agreements – No reverse repurchase agreements were executed this quarter.

Restructuring – No restructuring activities took place during the quarter ended March 31, 2019.

CONCLUSION

The total investment portfolio as of March 31, 2019 was \$1,704,612,867, increased by approximately \$181.46 million from the previous quarter. For the quarter ended March 31, 2019, the earned interest yield was 2.289%, an increase from 2.07% reported for the previous quarter. The average days to maturity increased from 559 days on December 31, 2018, to 579 days on March 31, 2019. As of March 31, 2019, approximately 39% of the total portfolio was invested in U.S. Treasuries and agency securities.

/s/
JULIA H. COOPER
Director of Finance