

Memorandum

June 5, 2000

TO: City Council

FROM: Karl Mohr, Finance Director

SUBJECT: Investment Policy

Recommendation

Approve the following investment policy.

Fiscal Impact

This policy will guide the investment of all City financial resources.

Background and Analysis

The following investment policy has been drafted based on model investment policies developed by the Government Finance Officers Association (GFOA), a national organization of local agency finance officials. In addition, the policy has been reviewed and critiqued by the City's independent auditors, Maze & Associates. We appreciate the valuable input of our auditors and professional organizations in the development of this important policy. This policy is adopted concurrently with approval of the 2000/2001 City of Davis budget.

1. Purpose

The purpose of the investment management policy is to establish strategies, practices, and procedures to be used in administering the City of Davis portfolio. The goal is to establish guidelines to manage City funds to maximize security and liquidity while also complying with this investment policy and California Government Code Sections 53600 through 53659, which governs investments for municipal governments.

2. Investment Objectives

The City's primary investment objective is to achieve a reasonable rate of return on public funds while minimizing the potential for capital losses arising from market changes or issuer default. Although pursuit of interest earnings on investment is an appropriate City goal, the primary consideration is preservation of capital resources. Thus, the City's yield objective is to achieve a

reasonable rate of return rather than the maximum generation of income that might expose the City to unacceptable levels of risk.

In determining individual investment placements, the following factors shall be considered in priority order: safety, liquidity, yield.

A. Safety

Safety of principal is the foremost objective of the investment program. Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. The objective is to mitigate credit risk and interest rate risk as summarized below.

Credit Risk – This is the risk of loss due to the failure of the security issuer or backer. Credit risk may be mitigated by:

- Limiting investment to the safest types of securities;
- Pre-qualifying the financial institutions, brokers/dealers, intermediaries, and advisers with which the City will do business;
- Diversifying the investment portfolio so that potential losses on individual securities will be minimized.

Interest Rate Risk – This is the risk that the market value of securities in the portfolio will fall due to changes in the general interest rates. Interest rate risk may be mitigated by:

- Structuring the investment portfolio such that securities mature to meet cash requirements for ongoing operations, thereby avoiding the need to sell securities on the open market prior to maturity;
- Investing operating funds primarily in shorter-term securities, money market mutual funds, or similar investment pools.

B. Liquidity

The investment portfolio shall remain sufficiently liquid to meet all operating requirements that may be reasonably anticipated. This is accomplished by structuring the portfolio so that securities mature concurrent with the cash needs to meet anticipated demands (static liquidity). Furthermore, since all possible cash demands cannot be anticipated, the portfolio should consist largely of securities with active secondary or resale markets (dynamic liquidity). A portion of the portfolio also may be placed in money market mutual funds or local government investment pools which offer same-day liquidity for short-term funds.

C. Yield

The investment portfolio shall be designed with the objective of attaining a market rate of return throughout the budgetary and economic cycles, taking into account the investment risk of constraints and liquidity needs. Return on investment is of secondary importance compared to the safety and liquidity objectives described above. The core of investments are limited to relatively low risk securities in anticipation of earning a fair return relative to the

risk being assumed. Securities shall not be sold prior to maturity with the following exceptions:

- A declining credit security which could be sold early to minimize loss of principal;
- A security swap which would improve the quality, yield, or target duration of the portfolio;
- Liquidity needs of the portfolio that require the security be sold;
- A capital gain that would be realized to better position the overall portfolio to achieve investment policy goals.

3. Standards Of Care

A. Prudence. The City shall operate its pooled idle cash investments under the “Prudent Person Rule” which obligates a fiduciary to ensure that investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation but for investment considering the probable safety of their capital as well as the probable income to be derived.

Investment officers acting in accordance with written procedures and this investment policy and excising due diligence shall be relieved of personal responsibility for an individual security’s credit risk or market price changes, provided deviations from expectations are reported in a timely fashion and the liquidity and the sale of securities are carried out in accordance with the terms of this policy.

Investment officials shall recognize that the investment portfolio is subject to public review and evaluation. The overall program shall be designed and managed with a degree of professionalism worthy of the public trust.

B. Government Code. Government Code Sections 16481.2 , 53601, 53635, and 53646 of the State of California regulate the investment policies of jurisdictions within the State. The City of Davis will adhere to these provisions in developing and implementing the City’s investment policies and practices.

C. Ethics And Conflict Of Interest. Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or could impair their ability to make impartial investment decisions. City employees involved in the investment process shall disclose to the City Manager any material financial interest in financial institutions that conduct business within the jurisdiction. They shall further disclose any large personal financial/investment positions that could be related to the performance of the investment portfolio. Officers shall refrain from undertaking any large personal investment transactions with the same individual with whom business is conducted on behalf of the City.

D. Delegation Of Authority. Authority to manage the investment program is granted to the City Treasurer. Under the oversight of the City Treasurer, responsibility of the operation of the investment program may be delegated to the Accounting Manager or other staff who shall act in accordance with established written procedures and internal controls consistent with the investment policy.

E. Internal Control. The City Treasurer is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the City are protected from loss, theft or misuse. The internal control structure shall be designed to provide reasonable assurance that these objectives are met. The concept of reasonable assurance recognizes that (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgements by management.

Accordingly, the investment officer shall establish a process for an annual independent review by an external auditor to assure compliance with policies and procedures. The internal controls shall address the following points:

- Control of collusion
- Separation of transaction authority from accounting and record keeping
- Custodial safekeeping
- Avoidance of physical delivery securities
- Clear delegation of authority to subordinate staff members
- Written confirmation of transactions for investments and wire transfers
- Development of a wire transfer agreement with the lead bank and third-party custodian.

4. Scope

This investment policy shall apply to all financial assets of the City of Davis as accounted for in the Comprehensive Annual Financial Report, including, but not limited to:

- General Fund
- Special Revenue Funds
- Capital Projects Funds
- Debt Service Funds
- Enterprise Funds
- Internal Service Funds
- Trust and Agency Funds
- Redevelopment Funds
- Public Financing Authority Funds
- Any new fund created by the City Council unless specifically exempted with the exception of the following:
 - The City's Deferred Compensation Plan which is controlled by federal law, specific provisions of the City's adopted Plan, and individual employee decisions.

- The City Employee Retirement Plan which is subject to regulation by federal and state laws.

Any funds held by third-party trustees subject to prior written consent and approval by the City Treasurer and City Manager. Should these funds be exempted from this policy the trustee is still subject to regulations established by the State of California pertaining to the investments by local agencies as well as the related bond indentures.

5. Safekeeping And Custody

A. Selection Of Eligible Financial Institutions

All financial institutions and broker/dealers who desire to become qualified for investment transactions must supply the following as appropriate:

- Audited financial statement (annually);
- Proof of National Association of Securities Dealers (NASD) certification;
- Proof of state registration;
- Completed broker/dealer questionnaire;
- Certification of having read and understood and agreeing to comply with the City's investment policy.

These documents shall be provided annually as appropriate. In selecting financial institutions for deposit or investment of funds, the authorized Investment Officers shall consider the credit-worthiness of the institution.

B. Broker/Dealers

Investments must be purchased directly from the issuer, from an institution licensed by the State as a broker/dealer, from a member of a federally regulated securities exchange, or from a brokerage firm designed as a primary government dealer by the Federal Reserve Bank. Broker/dealers shall be selected by creditworthiness (e.g. a minimum capital requirement of \$10,000,000 and at least five years of operation).

The City Treasurer will maintain a file of broker/dealers with which the City is currently doing business which will include (at minimum) the firm name, contact person, telephone number, fax number, e-mail address, and annual audited financial statements.

C. Delivery vs. Payment

All trades where applicable will be executed by delivery vs. payment to ensure that securities are deposited prior to the release of funds. To protect against potential losses by collapse of individual securities dealers, all securities owned by the City shall be held in safekeeping by a third party bank trust department acting as agent for the City under terms of a custody agreement executed between the bank and the City.

D. Collateralization

Collateral is required for investments in non-negotiable certificates of deposit and repurchase agreements. In order to reduce market risk, the collateral level shall be at least 102% of market value of principal and interest and marked to market weekly. Securities acceptable as collateral shall be the direct obligations of, or are fully guaranteed as to principal and interest, by the United States or any agency of the United States.

6. Authorized Investments

Investment of City funds is governed by the California Government Code Sections 53600 et seq. Within the context of such limitations, the following investments are authorized:

United States Treasury Bills, Bonds, and Notes or those for which the full faith and credit of the United States are pledged for payment of principal and interest. There is no percentage limitation of the portfolio which can be invested in this category.

Federal Agency Obligations – Obligations issued by the Federal Government agencies such as Government National Mortgage Association (GNMA), the Federal Farm Credit Bank (FFCB), the Federal Home Loan Bank (FHLB), the Federal National Mortgage Association (FNMA), the Student Loan Marketing Association (SLMA), and the Federal Home Loan Mortgage Corporation (FHLMC). There is no percentage limitation of the portfolio which can be invested in this category.

Banker' Acceptances – These are bills of exchange or time drafts drawn on and accepted by commercial banks. Purchase of banker's acceptances may not exceed 270 days maturity and 40% of the cost value of the portfolio. Furthermore, no more than \$5 million or 10% of the cost value of the portfolio, whichever is less, may be invested in the banker's acceptances of any one commercial bank.

Commercial Paper – Commercial paper must be rated P1 by Moody's Investor's Service and A1 by Standard and Poors, issued by domestic corporations having assets in excess of \$500,000,000 and having a AA or better rating on its long term debentures as provided by Moody's and Standard and Poors. Purchases of eligible commercial paper may not exceed 180 days maturity nor represent more than 10% of the outstanding paper of the issuing corporation. Purchases of commercial paper may not exceed 15% of the cost value of the portfolio.

Negotiable Certificates of Deposit – These are issued by nationally or state chartered banks, state or federal savings institutions, or state licensed branches of foreign banks. Purchases of negotiable certificates of deposit may not exceed 30% of the cost value of the portfolio. A maturity limitation of two years is applicable.

Local Agency Investment Fund (LAIF) – As authorized in Government Code Section 16429.1, local agencies may invest in the Local Agency Investment Fund, a money market fund which allows local agencies to pool their investment resources. Current policies of

LAIF set minimum and maximum amounts of monies that may be invested as well as maximum numbers of transactions that are allowed per month.

Certificate of Deposit (CD) - Purchased through a bank or savings and loan association for a specified period of time at a specified rate of interest. The first \$100,000 of a certificate of deposit is guaranteed by the Federal Deposit Insurance Corporation (FDIC). CD's with a face value in excess of \$100,000 will be collateralized by U.S. Treasury Department securities, which must be at least 110% of the face value of the CD. No other collateralization will be accepted.

Medium Term Corporate Notes with a maximum maturity of five years may be purchased. Securities eligible for investment shall be rated AA or better by Moody's and Standard & Poor's rating services. Purchase of medium term notes may not exceed 30% of the cost value of the portfolio and no more than 10% of the cost value of the portfolio may be invested in notes issued by one corporation. Commercial paper holdings should also be included when calculating the 10% limitation.

Money Market Mutual Funds - Mutual funds invested in U.S. Government securities are permitted under this policy and under the California Government Code Section 53601. In order to be eligible for investment under this section, an investment objective of such a fund must be the maintenance of a price per share of \$1.00. The following criteria must also be met:

- The fund shall have a minimum of \$500 million in total portfolio value.
- The fund shall be registered with the Securities and Exchange Commission, and shall have achieved a rating of Aaa by Moody's and AAA by S&P.
- The fund shall have retained an advisor which is registered with the SEC, or which is exempt from such registration, and has at least 5 years experience managing money market funds, including those in excess of \$50 million.
- Investment in such funds shall not exceed 15% of the City's total portfolio.
- No more than 10% of the City's total portfolio may be invested in any one mutual fund.

Repurchase Agreements (REPOs) - A contractual arrangement between a financial institution, or dealer, and an investor. This agreement normally can run for one or more days. The investor puts up his funds for a certain number of days at a stated yield. In return, he takes a given block of securities as collateral. At maturity, the securities are repurchased and the funds repaid plus interest. The market value of the securities used as collateral for the repurchase agreement shall be monitored and not allowed to fall below 102% of the value of the repurchase agreement. A Master Repurchase agreement is required between the City and the financial institution for all repurchase agreements transacted. Maximum maturity is one year.

California Pooled Investment Authority (CPIA) - Known as CLASS (California Liquid Asset Securities System), this investment pool fund is an alternative to the Local Agency Investment Fund (LAIF). It is managed by MBIA-Municipal Investors Service Corporation,

an investment subsidiary of MBIA, Inc. The CPIA may be used only as an alternative to LAIF.

Security Swaps - The City may take advantage of security swap opportunities to improve the overall quality, yield or target duration of the portfolio. A swap which improves the portfolio yield may be selected even if the transactions result in an accounting loss. Documentation for swaps will be included in the City's permanent investment file documents.

Ineligible Investments - Ineligible investments are those that are not described herein, including but not limited to, common stocks, reverse repurchase agreements, inverse floaters, range notes, mortgage derived interest only strips, derivatives securities, or any security that could result in zero interest accrual.

7. Investment Parameters

A. Diversification

Investments shall be diversified by:

- Limiting investments to avoid concentration in securities from a specific issuer or business center (excluding Local Agency Investment Fund and U.S. Treasury securities);
- Limiting investment in securities that have higher credit risks;
- Investing in securities with varying maturities; and
- Continuously investing a portion of the portfolio in readily available funds such as local government investment pools (LAIF and CLASS), or money market funds to ensure that appropriate liquidity is maintained in order to meet ongoing obligations.

B. Maximum Maturities

In order to minimize the impact of market risk, it is intended that all investments will be held to maturity. Investments may be sold prior to maturity for cash flow, appreciation purposes or in order to limit losses, however, no investment shall be made based solely on earnings anticipated from capital gains.

To the extent possible, the City shall attempt to match its investments to anticipated cash flow requirements. Unless matched to a specific cash flow, the City will not directly invest in securities maturing more than 5 years from the date of purchase or in accordance with state and local statutes and ordinances. The City shall adopt weighted average maturity limitations (2 years) consistent with investment objectives.

Because of inherent difficulties in accurately forecasting cash flow requirements, a portion of the portfolio should be continuously invested in readily available funds. No more than 30% of the portfolio should be invested for longer than 18 months.

8. Reporting

A. Methods

The City Treasurer shall prepare at least quarterly investment reports to the City Manager and City Council which shall include the:

- par amount of the investment,
- classification of the investment,
- percentage of the total portfolio which each type of investment represents, name of the institution or entity,
- rate of interest,
- maturity date,
- current market value,
- source of the market value, and
- weighted average maturity of the portfolio.

Reports shall also include a statement that the projected cash flow is adequate to meet expected obligations over the next six months, and that the portfolio is in compliance with this policy.

The report shall be due within 30 days of the end of the quarter. Reports may be rendered more frequently at the discretion of the City Manager or City Treasurer.

Annually there shall be provided to the City Manager and the City Council a report on the performance of the investment program and an update to this policy. The report shall include a narrative discussion of the performance of the investment portfolio and shall include comparisons with appropriate benchmarks to facilitate this evaluation.

B. Performance Standards

The investment portfolio will be managed in accordance with the parameters specified within this policy. The portfolio should obtain a market average rate of return during a market/economic environment of stable interest rates. An appropriate benchmark of the 90-day U.S. Treasury bill shall be established against which portfolio performance shall be compared.

C. Marking To Market

The market value of the portfolio shall be calculated at least quarterly and a statement of the market value of the portfolio shall be issued at least quarterly with the investment report.