



**Date:** April 21, 2014  
**To:** Mayor and City Council  
**From:** City Manager  
**By:** Director of Finance  
**Subject:** 2014 First Quarter Investment Report

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As required by Government Code and the City's Statement of Investment Policy, I am transmitting for your review the quarterly investment report for the period January 1 – March 31, 2014 (Q1 2014). The City's Investment Advisory Committee (IAC) reviewed and approved this report during their quarterly meeting held on April 21, 2014. The attached report provides a summary of market and economic conditions, the composition of the City's portfolio, investment performance and investment strategy.

Monthly summaries of all of the City's account holdings along with the quarterly reports are posted on the Finance Department's web page: <http://www.hayward-ca.gov/CITY-GOVERNMENT/DEPARTMENTS/FINANCE/> under the "Documents" tab.

The City's investment portfolio (pooled cash) totaled \$185.2 million as of March 31, 2014 – with the City's investment advisor, The PFM Group, managing about \$82 million, \$88.1 million on deposit in the Local Agency Investment Fund (LAIF), and the remaining portfolio balance of \$15.1 million residing in the City's general checking account. Cash flow needs cause the balances of the LAIF and general checking accounts to fluctuate.

The overall interest earned on the City's portfolio is low – and is reflective of the prolonged poor market conditions. The 48% of the City portfolio on deposit with LAIF is currently earning .23% and the 44% of the portfolio actively managed by The PFM Group is earning about .38% (the balance held in cash is not earning interest). The City's investments are within a 1-3 year range and are consistent with the City's Investment Policy.

Pursuant to the provisions of Government Code section 53646, the City establishes that it is able to meet its pooled expenditure requirements for the next six months.

**Attachments:**

- First Quarter 2014 Performance Investment Report by The PFM Group
- First Quarter 2014 LAIF performance summary

**Department of Finance**



# City of Hayward Performance Review First Quarter 2014

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**The PFM Group**

Public Financial Management, Inc.  
PFM Asset Management LLC  
PFM Advisors

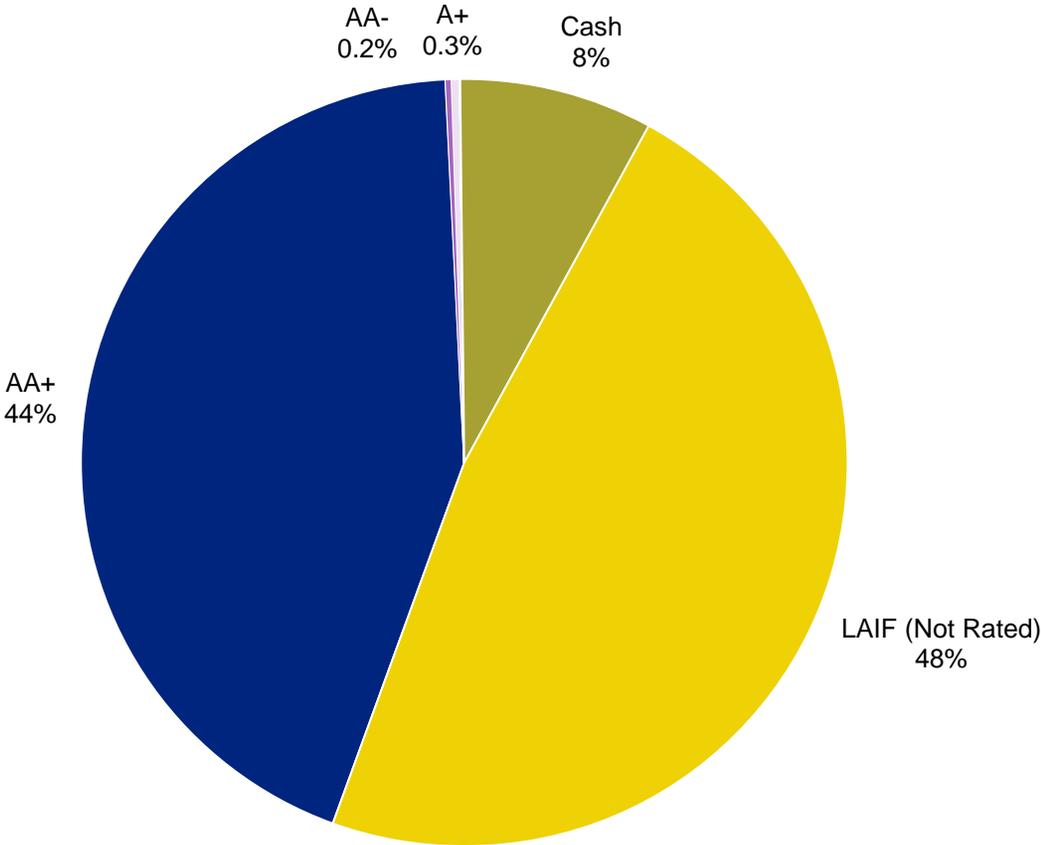
# Portfolio Complies with Government Code and City's Investment Policy

Security Type	Market Value 03/31/14	% of Portfolio	Change Since 12/31/13	% Permitted by Policy	In Compliance
U.S. Treasuries	\$56,441,498	30%	6%	100%	✓
Federal Agencies	\$24,023,737	13%	-4%	100%	✓
<i>Non-Callable</i>	\$20,321,622	11%	-4%		
<i>Callable</i>	\$3,702,115	2%	0%		
Corporate Notes	\$1,494,408	0.8%	0%	30%	✓
<b>Total Securities</b>	<b>\$81,959,642</b>	<b>44%</b>			
LAIF	\$88,105,486	48%	1%	\$50 Million per Account <sup>1</sup>	✓
Cash Deposits	\$15,095,451	8%	-3%	100%	✓
<b>Total Liquidity</b>	<b>\$103,200,936</b>	<b>56%</b>			
<b>Total Investments</b>	<b>\$185,160,579</b>	<b>100%</b>			

Numbers may not add to 100% due to rounding.

1. City maintains three separate LAIF accounts.

# Portfolio Credit Distribution

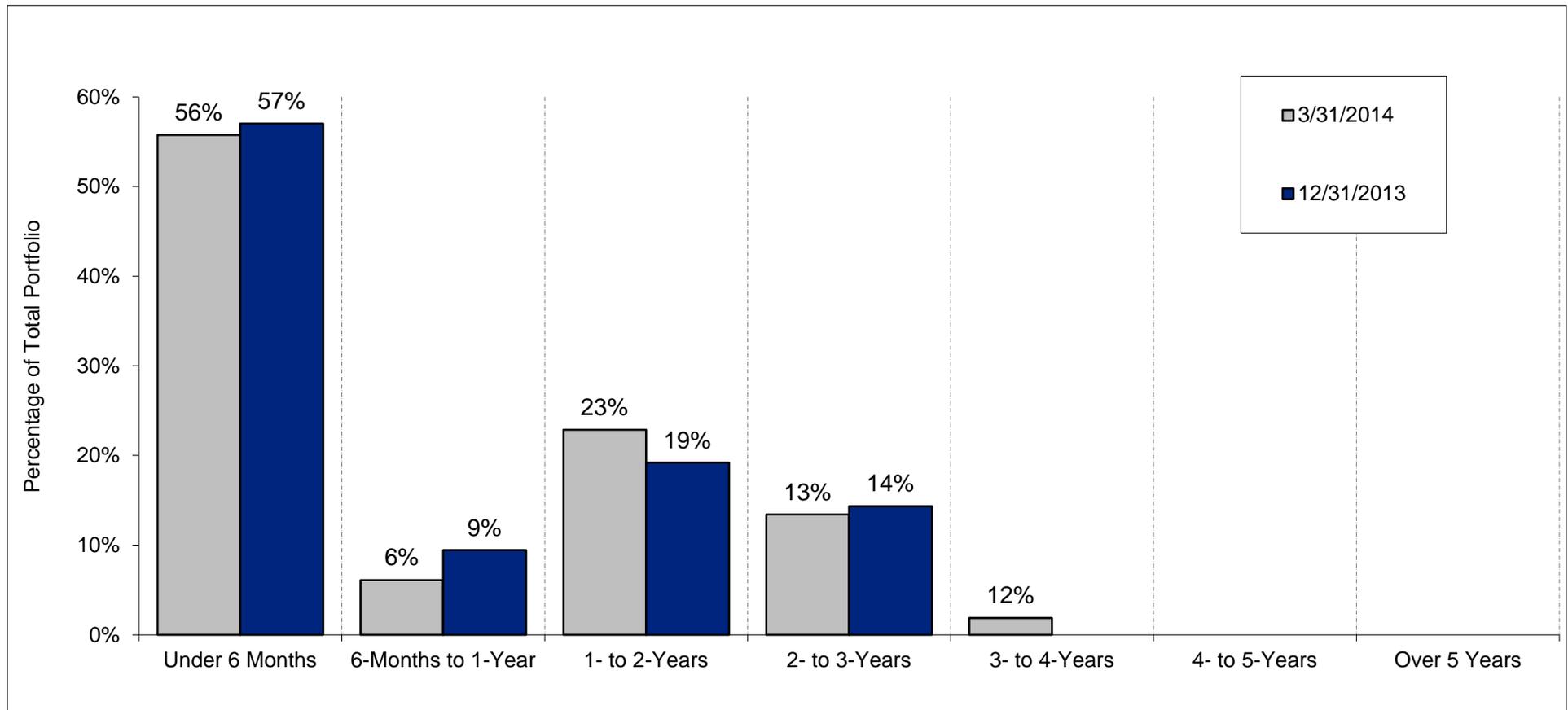


- As of March 31, 2014
- Ratings by Standard & Poor's
- Numbers may not add to 100% due to rounding

# Aggregate Portfolio Maturity Distribution

- On March 19, after interest rates rose due to the FOMC's statement, we extended the duration of the portfolio to 94% of the benchmark's duration by putting a portion of the portfolio in a 3-year security.

Portfolio Maturity Distribution



- Excludes cash and LAIF balances.
- Callable securities in the portfolio are included in the maturity distribution analysis to their stated maturity date, although they may be called prior to maturity.
- Numbers may not add to 100% due to rounding.

# Total Return

- Our conservative stance on duration continued to benefit the portfolio as rates rose at the end of the first quarter.

## Total Return Period Ended March 31, 2014

	Duration	Periodic		Annualized	
		Past Quarter	Past Six Months	Past Year	Since Inception <sup>5</sup>
City of Hayward <sup>1,2,3,4</sup>	1.74	0.15%	0.22%	0.33%	0.36%
Merrill Lynch 1-3 Year U.S. Treasury Index	1.84	0.14%	0.20%	0.38%	0.38%
LAIF <sup>6</sup>	0.00	0.06%	0.13%	0.25%	0.25%

1. Performance on trade date basis, gross (i.e., before fees), in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).

2. Merrill Lynch Indices provided by Bloomberg Financial Markets.

3. Quarterly returns are presented on an unannualized basis.

4. Excludes LAIF and cash balance in performance, duration, and yield computations.

5. Inception date is 9/30/2012.

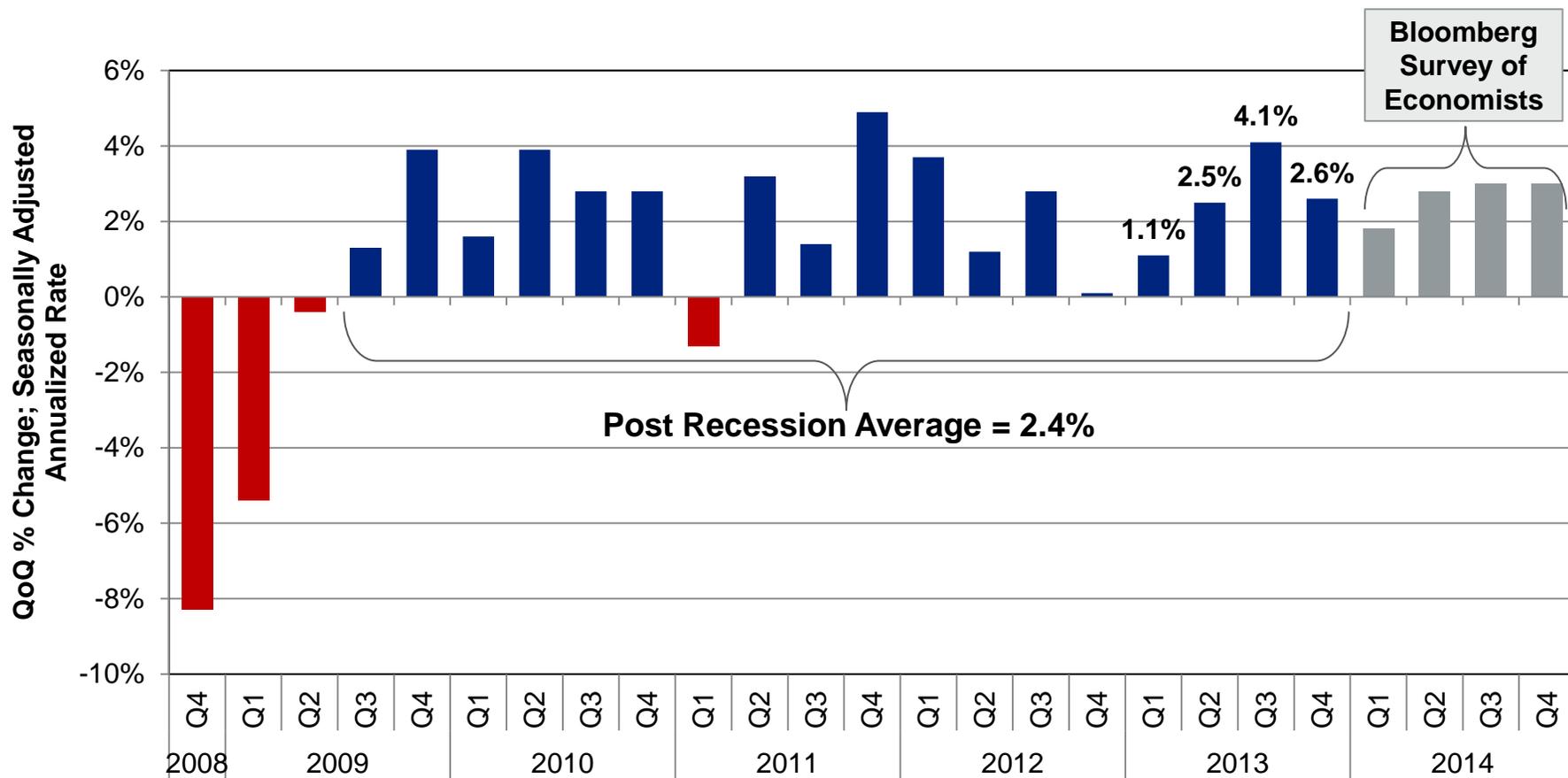
6. California State Treasurer LAIF website.

# Strategy—An In-Depth Look

- All decisions are made in a portfolio context
  - Not just trade by trade, but how each trade effects the overall portfolio structure
  - Focus on “expected return” characteristics
  - Benchmark is an important guide
- **Sector allocation** also very important
  - Increased allocation to corporates has benefitted the City
  - “Credit” continues to provide value
- **Portfolio duration** is a key element of our strategy
  - Particularly important in rising or falling markets
  - Manage through both maturity and selection of security types
- Recently extended duration
  - Partially in response to rising rates
  - Supported by analysis of recent rate trends
  - Steep yield curve provides strong elements of “carry” and “roll-down”

# Economic Growth Remains Moderate

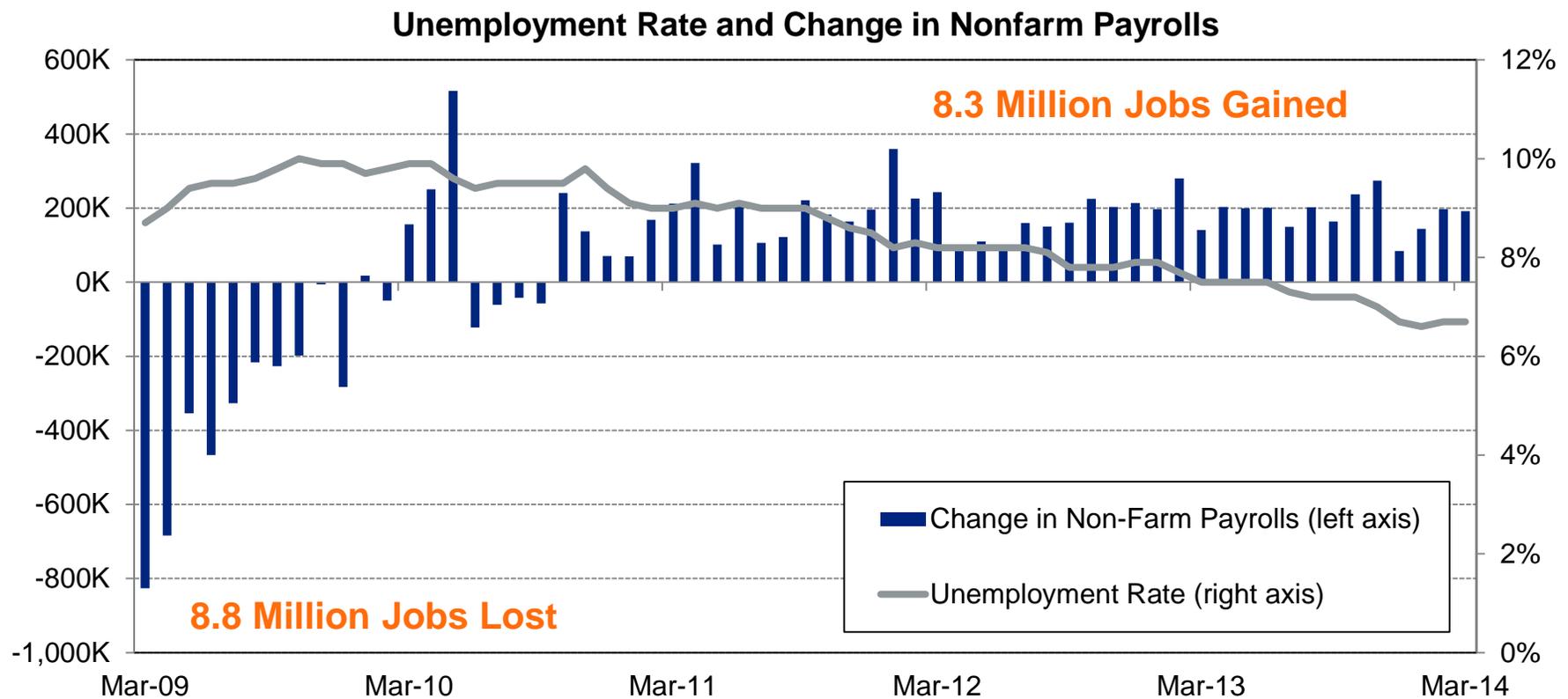
- Fourth quarter GDP was 2.6%, which was slightly less than the consensus estimate of 2.7%.
- Economists have lowered their expectations for first quarter 2014 GDP to 1.8% after several severe winter storms suppressed consumer spending.



Source: Bureau of Economic Analysis

# Labor Market Conditions Continue to Improve

- After several months of sluggish growth, the economy was expected to add 200,000 jobs in March, but fell short with only 192,000 jobs gained.
- The unemployment rate was expected to tick down to 6.6% but remained unchanged at 6.7% as the labor force participation rate rose.

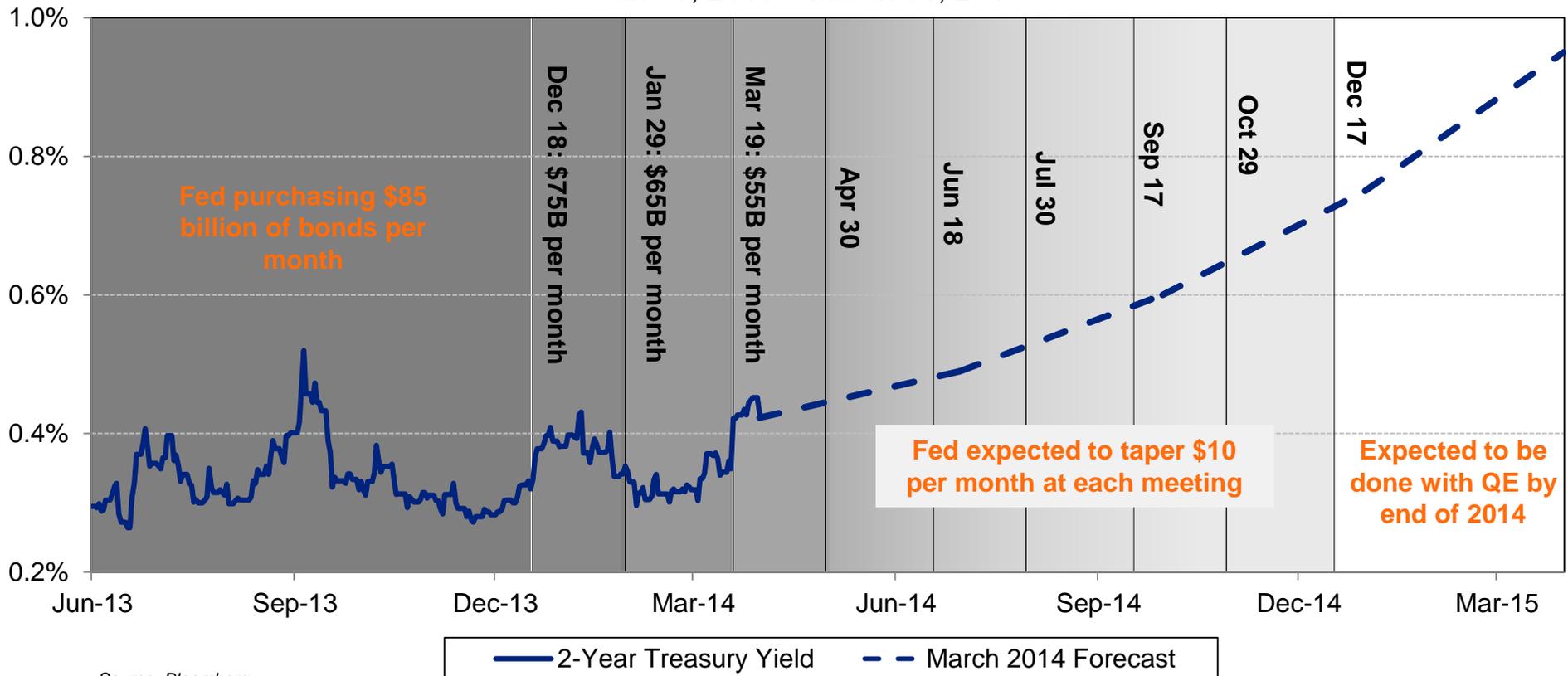


Source: Bureau of Labor Statistics

# Fed Tapers Bond Purchase Program

- The Federal Reserve began tapering its \$85 billion bond purchase program in December 2013. The Fed has now tapered its bond purchase program by \$10 billion at each of its past three meetings.
- Economists expect this tapering to continue at the upcoming Fed meetings. At this pace, Quantitative Easing (QE) will be concluded by the end of 2014.

**2-Year U.S. Treasury Yield and Forecasted Yield**  
June 1, 2013 – March 31, 2015



Source: Bloomberg.

# Highlights from FOMC March 2014 Meeting

- **Economic observations:**

- Economic activity has been hampered by bad weather.
- Labor market improvement has slowed.
- Inflation has been running low.

- **QE3:**

- Fed reduced asset purchases by another \$10 billion per month.
- Fed is still buying \$55 billion per month, which should still support low rates.
- Fed is now considering further exit strategies.

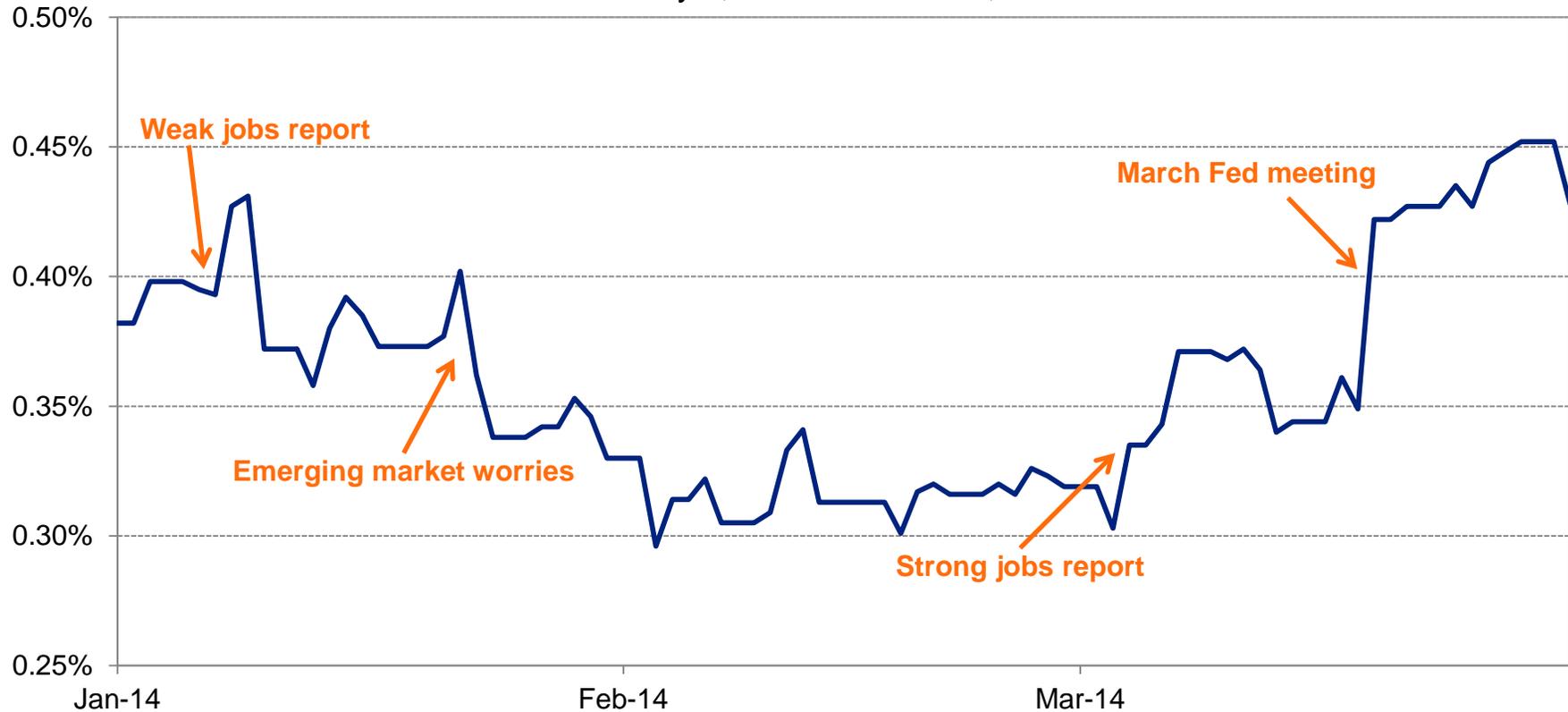
- **Fed Funds Target Rate**

- Numeric unemployment and inflation thresholds have been removed.
- The current target rate will likely remain “for a considerable time after the asset purchase program ends.”
- “Considerable time” may mean as little as six months, depending on economic data.

# Rates Rose on FOMC Statement

- In March, interest rates on Treasuries with maturities of two years and over rose after remarks from Fed Chair Janet Yellen led investors to believe the FOMC would raise rates earlier than previously thought.

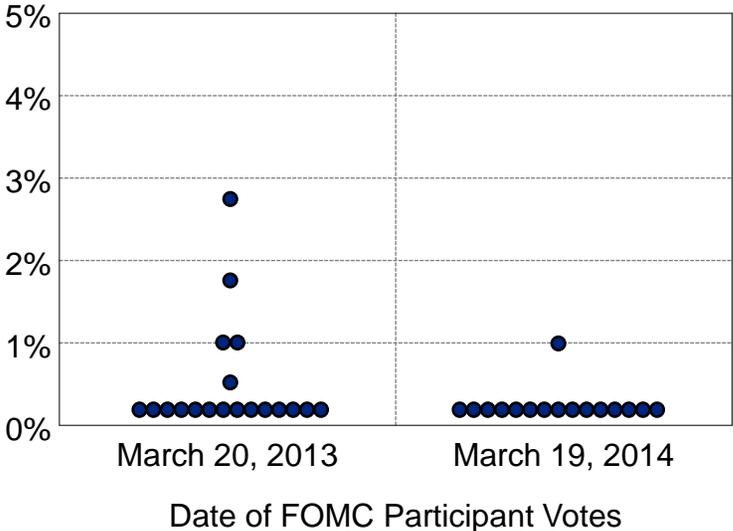
**2-Year U.S. Treasury Yield**  
January 1, 2014 – March 31, 2014



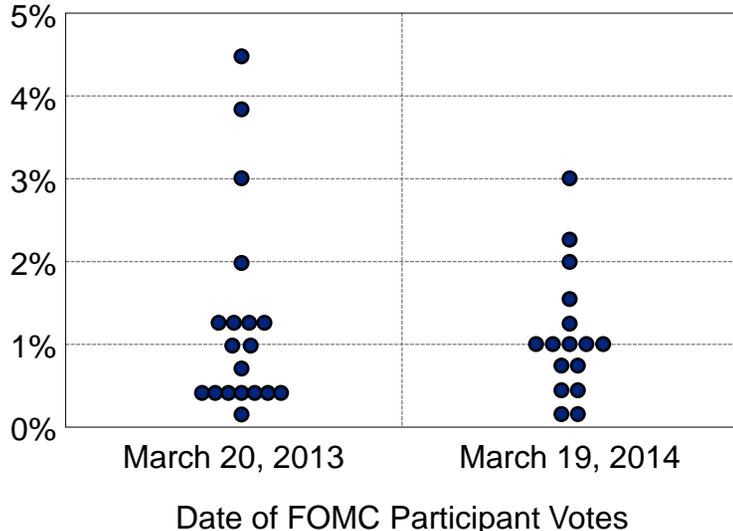
Source: Bloomberg

# FOMC Expectations for Federal Funds Rate Then vs Now

**Targeted Federal Funds Rate  
End of 2014**



**Targeted Federal Funds Rate  
End of 2015**



● Individual FOMC participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year.  
Source: Federal Reserve Open Market Committee.

# A Longer View of Treasury Yields

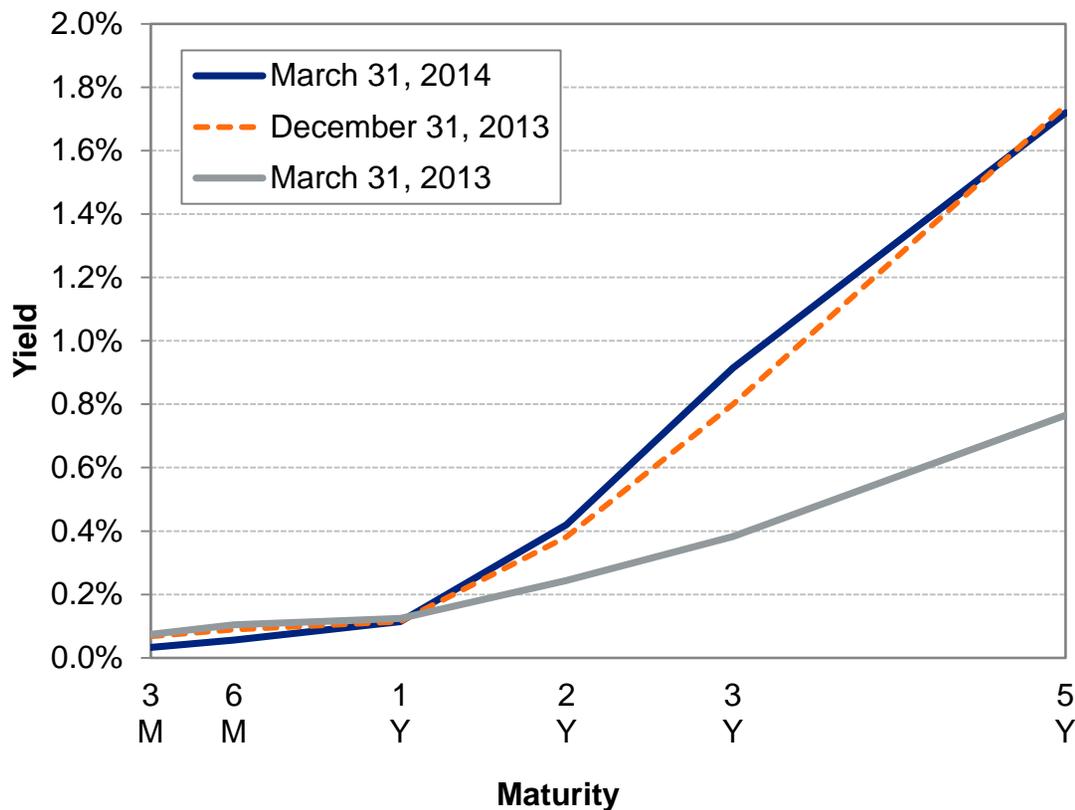
- Despite the increase in rates over the past year, Treasury yields still remain low relative to historical averages.



# Yield Curve Remained Steep

- Long-term yields continued to provide a significant pick-up over short-term yields.

**U.S. Treasury Yield Curve**



Source: Bloomberg

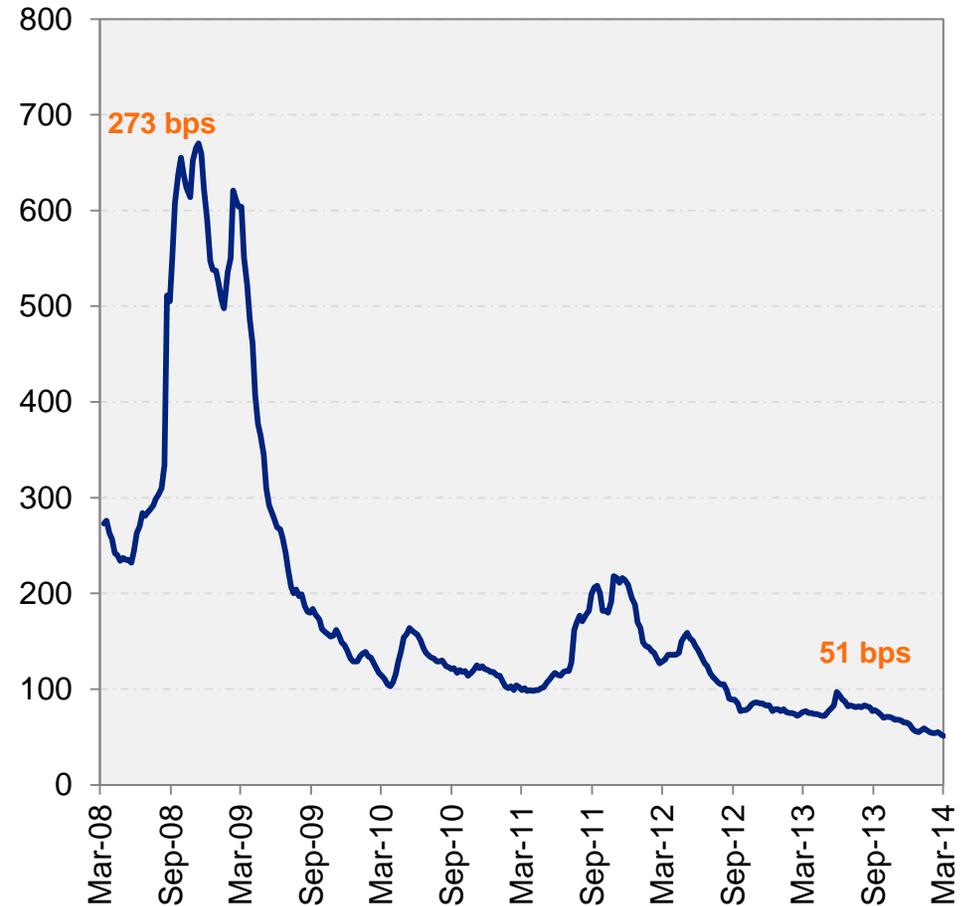
	3/31/13	12/31/13	3/31/14
<b>3 Month</b>	0.07%	0.07%	0.03%
<b>6 Month</b>	0.10%	0.09%	0.06%
<b>1 Year</b>	0.12%	0.11%	0.11%
<b>2 Year</b>	0.24%	0.38%	0.42%
<b>3 Year</b>	0.38%	0.80%	0.91%
<b>5 Year</b>	0.77%	1.74%	1.72%

# Yield Spreads

## Federal Agencies



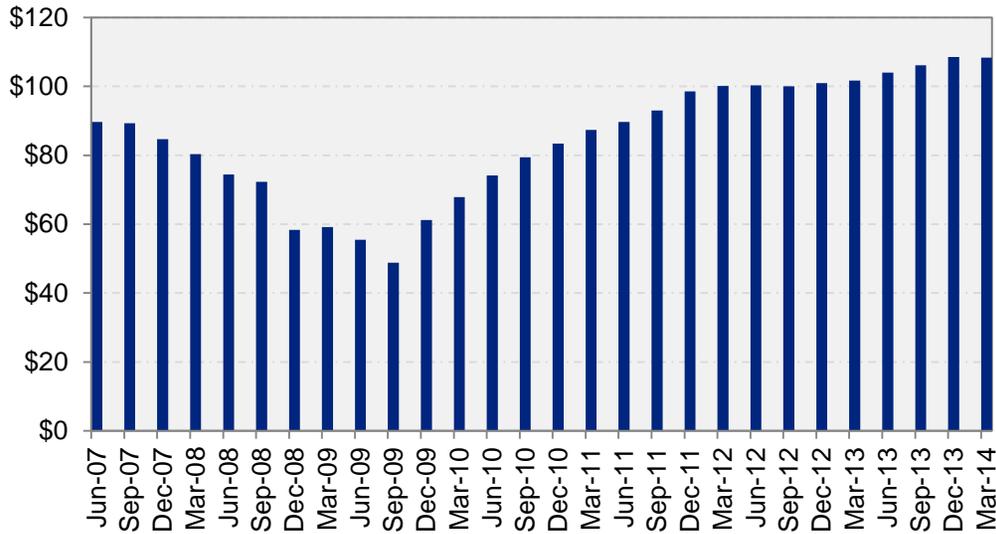
## A-AAA Corporates



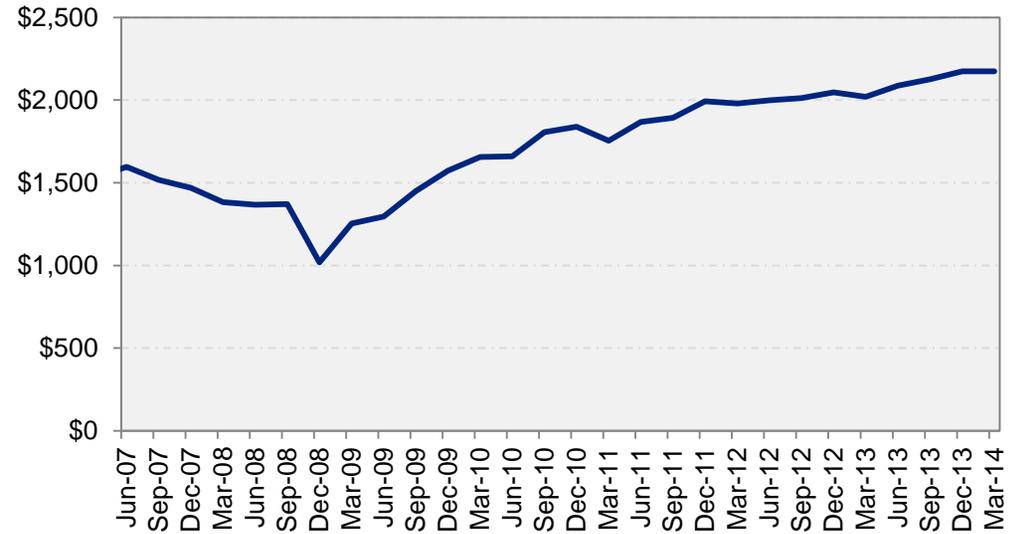
Source: Bloomberg, Merrill Lynch. Spreads represented by ML 1-5 Agency and 1-5 A-AAA Corporate indices.

# Corporate Fundamentals Are Strong

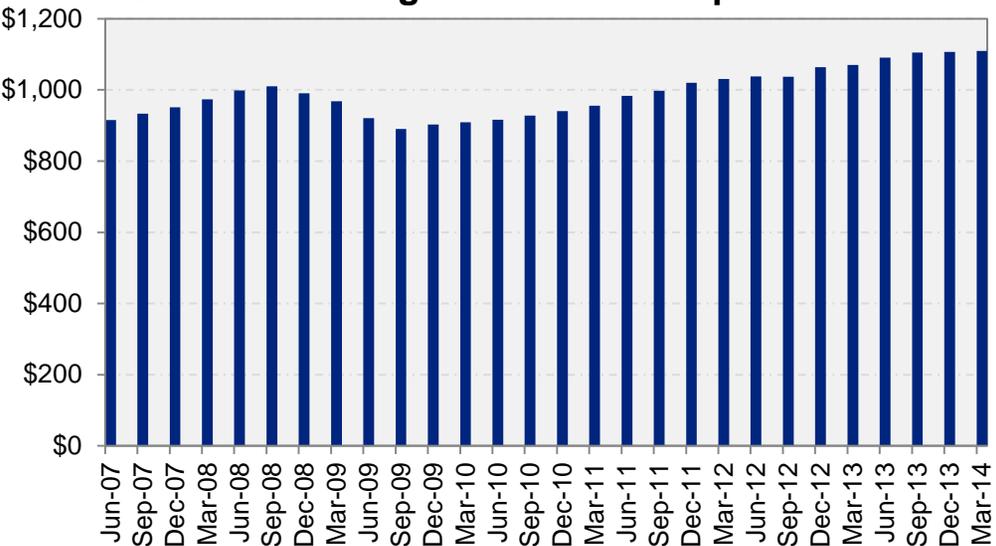
## S&P 500 Earnings per Share



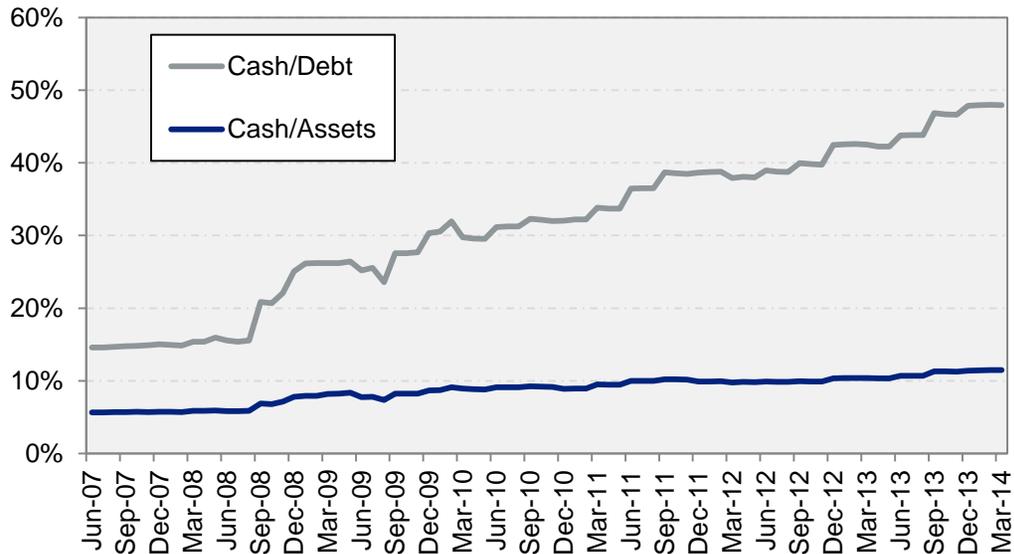
## Corporate Profits (\$ bn)



## S&P 500 Trailing 12-Month Sales per Share



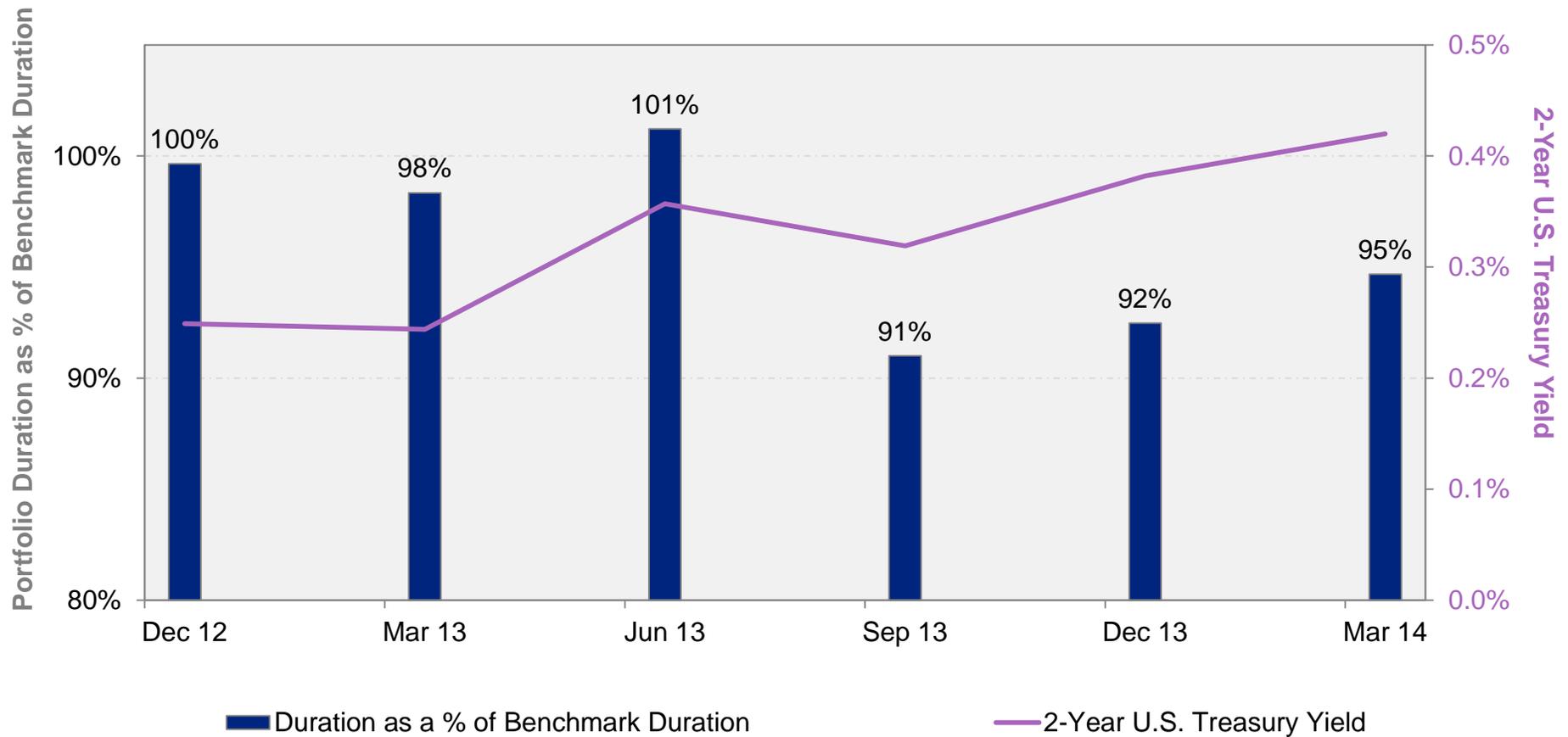
## S&P 500 Balance Sheet Cash & Equivalents



Source: Bloomberg

# We Have Actively Managed Portfolio Duration

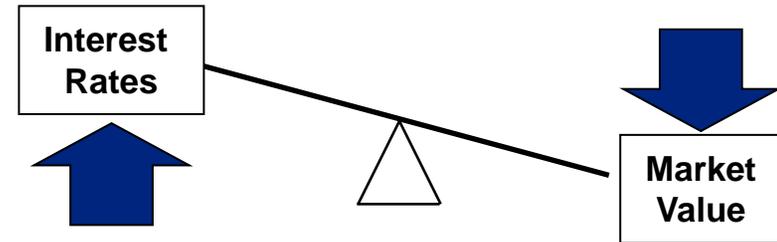
**Portfolio Duration as a Percentage of Benchmark Duration  
vs. 2-Year U.S. Treasury Note Yield**



Sources: Bloomberg; BofA Merrill Lynch Indices

# Rising Rates Impacted Returns

**Return = Yield + Change Market Value**



U.S. Treasury Indices	Total Return - Past Year
3-month	0.07%
6-month	0.18%
1-year	0.26%
1-3 year	0.38%
1-5 year	-0.09%
3-5 year	-0.69%
5-7 year	-2.50%
7-10 year	-3.49%

Sources: Bloomberg; BofA Merrill Lynch Indices  
Period ending 3/31/14

# Technical Analysis: March 7, 2014



Source: Bloomberg

# Technical Analysis: March 11, 2014



Source: Bloomberg

# Technical Analysis: March 20, 2014



Source: Bloomberg

# Technical Analysis: March 25, 2014



Source: Bloomberg

# Sensitivity Analysis

		6 Month Horizon				
		Interest Rate Shock				
U.S. Treasury	Yield	(0.10%)	0.00%	0.20%	0.30%	0.50%
1-Year	0.15%	0.17%	0.12%	0.02%	(0.03%)	(0.13%)
2 Year	0.44%	0.68%	0.53%	0.23%	0.08%	(0.22%)
3-Year	0.93%	1.33%	1.08%	0.58%	0.33%	(0.17%)

		1 Year Horizon				
		Interest Rate Shock				
U.S. Treasury	Yield	(0.10%)	0.00%	0.20%	0.30%	0.50%
1-Year	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%
2 Year	0.44%	0.90%	0.80%	0.60%	0.50%	0.30%
3-Year	0.93%	2.12%	1.92%	1.52%	1.32%	0.92%

As of March 24, 2014

Source: Bloomberg

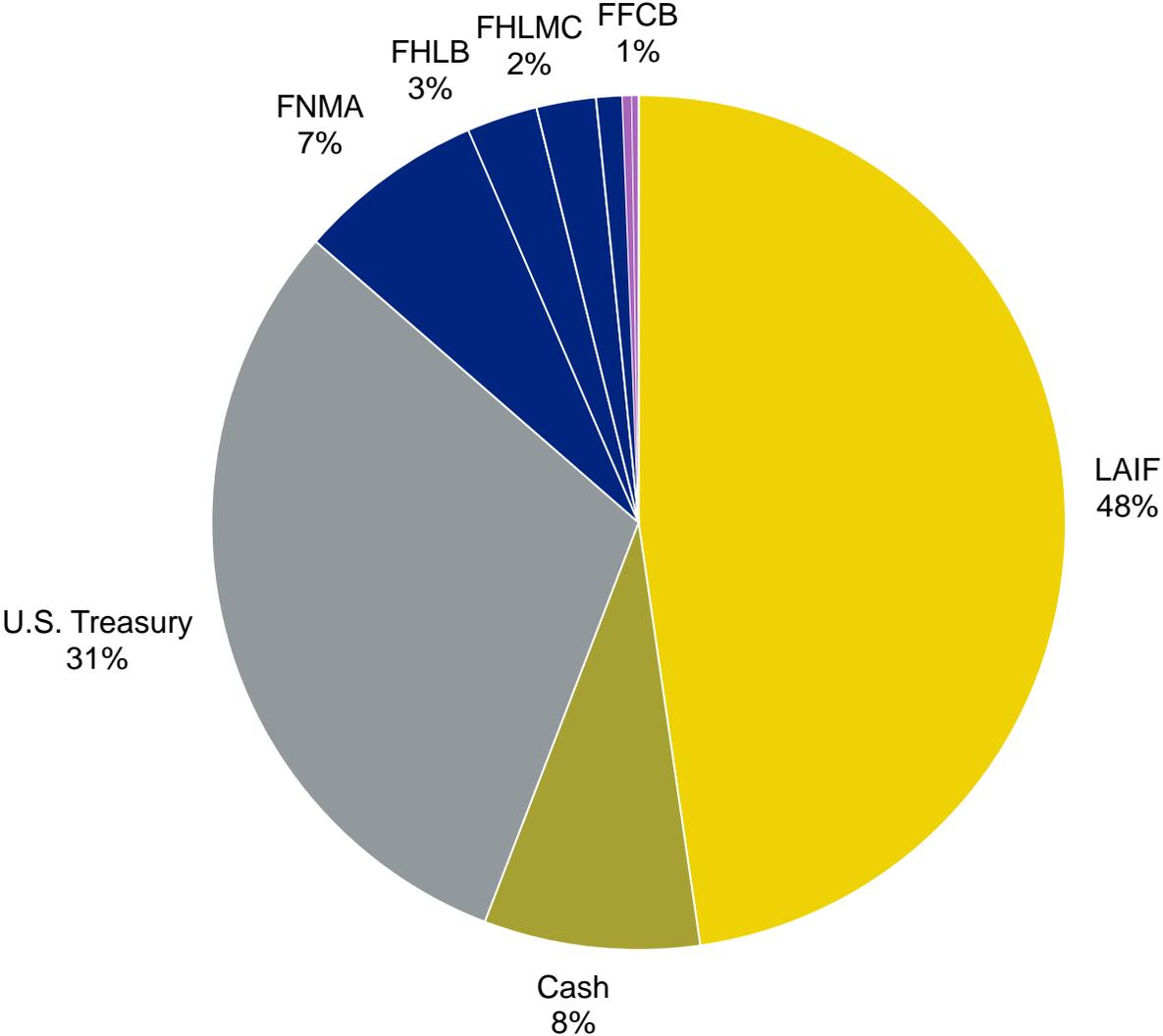
Analysis shows the total return of Treasury securities over select time periods and under various interest rate scenarios.

# Second Quarter 2014 Investment Strategy Themes

- The past 5 years may not be a good roadmap for the next 5 years
  - Economic conditions are improving
  - Extraordinarily easy Fed policy is winding down
  - Yields are expected to rise; 3-7 year range most exposed
  - Some caution with regard to duration, but the yield curve is steep and inviting
- Yield spreads are narrow
  - Most agencies are near record tight levels
  - Corporate yield spreads have mostly recovered from the credit crisis
  - Longer maturities have wider spreads
- Corporate sector still offers best value
  - Extra yield provides favorable income return
  - Extra yield provides partial cushion from rising rates
  - Prefer banks and financials

# Portfolio Issuer Distribution

Corporate Issuers - 0.8%	
Wells Fargo	0.3%
Toyota	0.2%
Apple	0.2%



- As of March 31, 2014
- Numbers may not add to 100% due to rounding

**BILL LOCKYER  
TREASURER  
STATE OF CALIFORNIA**

**LOCAL AGENCY INVESTMENT FUND (LAIF)**

**PMIA Performance Report**

Date	Daily Yield*	Quarter to Date Yield	Average Maturity (in days)
4/3/2014	0.24	0.24	197
4/4/2014	0.24	0.24	197
4/5/2014	0.24	0.24	197
4/6/2014	0.24	0.24	197
4/7/2014	0.24	0.24	196
4/8/2014	0.24	0.24	196
4/9/2014	0.24	0.24	199
4/10/2014	0.24	0.24	200
4/11/2014	0.24	0.24	200
4/12/2014	0.24	0.24	200
4/13/2014	0.24	0.24	200
4/14/2014	0.24	0.24	195
4/15/2014	0.23	0.24	195
4/16/2014	0.23	0.24	197

\*Daily yield does not reflect capital gains or losses

**LAIF Performance Report**

**Quarter Ending 03/31/14**

Apportionment Rate: 0.23%  
 Earnings Ratio: .00000631639966506  
 Fair Value Factor: 1.000317118  
     Daily: 0.23%  
 Quarter To Date: 0.24%  
 Average Life: 185

**PMIA Average Monthly Effective Yields**

**MAR 2014 0.236%**  
 FEB 2014 0.236%  
 JAN 2014 0.244%

Pooled Money Investment Account  
 Portfolio Composition  
 \$57.5 Billion  
 03/31/14

