



# Information Item

**Date: August 17, 2009**

To: Mayor and City Council  
From: Carol Swindell, Director of Finance  
Subject: Investments in Corporate Bonds

## **Introduction**

This report provides information regarding the City's investment in corporate bonds including actions taken to mitigate portfolio risk in response to the deteriorating economy and financial markets.

## **Background**

The value of the City's pooled investment portfolio as of the end of June 2009 was approximately \$517 million. In addition, another \$103.6 million in funds from legal settlements with oil companies related to Charnock Well contaminations is held in an escrow account for construction and operation of a new water treatment facility (Water Treatment Account). These funds are invested separately from the pooled portfolio, but under the same legal and policy guidelines, and thus considered part of the City's total investment portfolio.

City investments are made in accordance with State law and the City's Investment Policy (the Policy). The primary objectives of City investments are safety and liquidity (in that priority). The third objective of City investments is to earn a market rate of return after the primary objectives of safety and liquidity have been achieved. Under both State law and the Policy, a maximum of 30% of the City's portfolio can be invested in corporate bonds. Furthermore, the bonds must be rated "upper medium investment grade" (rating of A) or better at the time of purchase.

## **Discussion**

The City first began buying corporate notes in August 2003 as an alternative to federal agency securities as a way to diversify the portfolio while also increasing the portfolio's yield. Since that time, the City has purchased approximately \$204 million in corporate bonds for the City portfolio and \$28 million for the Water Treatment Account portfolio.

Historically, yields on corporate securities tend to be higher than agency bullets (non-callable securities) of similar maturity by twenty to forty-five basis points (a basis point is one hundredth of one percent) depending on the bond's rating and maturity length. The reason for this "spread" is implied additional risk. However, as noted above, State law and the Policy require all corporate bonds to have a minimum rating of A at the time of purchase, which is considered "Upper Medium Investment Grade" and is generally considered safe under normal conditions in the economy and financial markets.

The impact of corporate investments on City interest earnings can be estimated by looking at the historic difference, or "spread" between corporate bonds and other types of investments in which the City would typically invest. The average spread of AAA corporates over federal agency non-callable (bullet) securities is about twenty basis points (0.2%). Applying this spread to an assumed average portfolio size of \$500 million with 15% of the portfolio in corporates (the average percentage between August 2003 and the end of 2007), the City would receive an additional \$150,000 per year annually in interest income ( $\$500 \text{ million} \times 15\% \times 20 \text{ basis points}$ ). Bonds with ratings below AAA would have a larger spread and generate additional interest earnings.

However, markets are not static. In 2007, the City began to increase the share of corporates in response to increasing spreads. For example, as of November 30, 2007, the corporate share of the portfolio had increased to 28% as the spread between AAA financial corporates and agencies had increased to 47 basis points for two year maturities (101 basis points for A rated corporates). Using the same methodology as

above, the implied annual earnings pickup if all securities were rated AAA would be \$658,000 (\$500 million x 28% x 47 basis points).

City staff continually monitors the ratings of all corporate bonds and is proactive in reacting to negative changes in corporate bond ratings. As the economy began to slow in early 2008, staff became concerned with the safety of certain bonds issued by companies that either had their credit rating downgraded or showed other signs of financial instability which resulted in declines in the value of the bonds. In order to ensure the Investment Policy's prime objective of safety, staff began to sell certain bonds where it was deemed that the credit risk of these bonds exceeded prudent levels.

Between March 2008 and June 2009, the City disposed of corporate bonds with a book value of \$101.3 million: \$77.3 million from the City portfolio and \$24.0 million from the Water Treatment account. Due to the value declines, many of the sales resulted in capital losses. Where possible, some bonds were sold at a capital gain to offset a portion of the losses. The net result of the corporate sales was a capital loss of \$5.3 million (\$4.7 million for the City and \$0.6 million for the Water Treatment Account), which represents less than 1% of the total portfolio value.

The majority of these sales occurred between March 2008 and July 2008, several months before the meltdown in the credit markets. The sales of bonds issued by Lehman Brothers (\$18 million) and Washington Mutual Bank (\$5 million) before these firms failed and the bonds became virtually worthless protected the portfolio from more extensive losses later and increased overall portfolio safety. A number of public agencies still hold these bonds and have sought restitution from the Federal Government for their losses, but to this point have been unsuccessful in that attempt. To further illustrate the prudence of these sales, the actual sales proceeds received by the City from all corporate bond sales is \$14.3 million more than the current market value these bonds. The value of the Lehman Brothers and Washington Mutual bonds would not likely have been recoverable since the bonds are in default. In addition, the

City sold a CIT Group, Inc. (CIT) bond in March 2008 because of concerns about the company's financial position. In the past several months, CIT has been close to bankruptcy and is in the process of restructuring its debt. The current market value of the bond is approximately \$0.6 million less than what the City received for the sale.

### **Current Strategy**

City staff believes that under current economic conditions it is prudent to avoid investing in corporate bonds except those guaranteed by the Federal Government's Temporary Liquidity Guarantee Program (TLGP) as described below. In addition to the sales, maturing corporate issues have been replaced with other types of investments, and no new purchases of traditional corporate bonds have been made since January 2008. To further strengthen the portfolio's safety, the City has purchased a new class of AAA rated FDIC-guaranteed bonds issued by financial corporations under the new Temporary Loan Guarantee Program (TLGP). These bonds are backed by the full faith and credit of United States Government and thus are considered essentially risk free. As of June 30, 2009, the amount of corporate bonds owned has been reduced to about \$58.1 million or 9.3% of the combined portfolio. Excluding the FDIC-guaranteed bonds (\$51 million), the portion of the portfolio invested in traditional corporate bonds has been reduced to only 1.1% of the portfolio. Staff believes that these bonds are relatively safe and there is no urgent need to sell at this time, but will continue to monitor the market and the credit condition of these bonds and evaluate them for potential sale if needed.

### **Conclusion**

The City has responded to unprecedented conditions in the economy and the financial/credit markets by taking steps to reduce the City's investment portfolio's credit risk exposure; specifically, lowering the portfolio's allocation of corporate bonds. Although these actions have resulted in short-term capital losses, they have protected the long term financial stability of the City by strengthening the security of the portfolio and avoiding losses resulting from corporate bankruptcies. Current strategy is to refrain from purchasing any additional corporate bonds (with the exception of the FDIC-

guaranteed bonds) until the economy and financial markets stabilize and returned to a normal growth pattern. In addition, staff will continue monitor the remaining corporate bonds and will take appropriate action if needed.

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