Date: September 13, 2016

To: Mayor Charlie Hales
Commissioner Nick Fish
Commissioner Amanda Fritz
Commissioner Steve Novick
Commissioner Dan Saltzman

From: Jennifer Cooperman, City Treasurer

Cc: Ken Rust, Chief Financial Officer
Investment Advisory Committee Members
Socially Responsible Investment Committee Members

Re: Socially Responsible Investing – Financial Impact Analysis

INTRODUCTION

In October 2013, Council adopted a resolution directing the City Treasurer to not directly invest additional cash assets in Walmart securities, thereby creating the City's Do-Not-Buy-List. In September 2015, Council adopted a resolution adding the securities of the world's top 200 oil and gas and coal companies included on the *Carbon Underground 200* 2015 list to the Do-Not-Buy-List. This current Do-Not-Buy-List expires December 31, 2016, unless extended by Council.

In December 2014, Council created the Socially Responsible Investment Committee (SRIC) to make recommendations about the corporate debt issuers to add to or remove from the City's Do-Not-Buy-List, and to present such recommendations in a report to Council for its consideration.

The purpose of this memo is to provide City Council with a financial analysis of the City's direct investments in corporate debt securities, interest earnings that have been realized on those investments over the past five years, and to recommend that Council not limit investment options that enable the Treasury Division (the "Division") to produce interest income that is used by City bureaus to help fund programs and services.

HISTORY OF THE CITY'S INVESTMENT POLICY REGARDING DIRECT INVESTMENT IN CORPORATE SECURITIES

The City's investments are limited to those authorized under state law. Oregon Revised Statutes (ORS) 294 allows up to 35% of the City's investment portfolio to be directly invested in Aa/AA-rated corporate bonds and A-1/P-1 rated commercial paper, with a 5% limit per issuer. The City's Investment Policy is written in accordance with ORS, reviewed by the State of Oregon's Short Term Fund Board and the City's Investment Advisory Committee, and adopted annually by City Council. The City's Investment Policy includes maturity limits to manage interest rate risk and credit risk.

- Prior to 2009, the City's Investment Policy authorized investments only in A-1/P-1 rated commercial paper, up to 25% of the portfolio, with a 5% per issuer limit.
- In 2009, Council approved the addition of a new investment category: federally-guaranteed corporate bonds up to 3-years' maturity, up to 25% of the portfolio, with a 5% per issuer limit.

- In 2010, Council renamed the commercial paper category to "corporate indebtedness," expanded the category to include Aa3/AA- corporate bonds up to 18-months' maturity, and increased the total category limit to 35% of the portfolio, with a 5% per issuer limit.
- In 2012, Council increased the maximum allowable maturity of corporate bond investments to 3-years.
- In 2013, in accordance with ORS 294, Council expanded the "corporate indebtedness" category to include A3/A- bonds issued by Oregon companies, subject to the category limit of 35% of the portfolio, and the 5% per issuer limit.

CORPORATE ISSUERS ELIGIBLE FOR THE CITY'S DIRECT INVESTMENT

Given the minimum rating and maximum maturity limitations in the City's Investment Policy, there are only approximately 50 issuers of corporate bonds currently eligible for the City's direct investment. The Division identifies eligible issuers by searching on Bloomberg (a financial information system widely used by investors throughout the United States) for all outstanding U.S. corporate bonds rated at least Aa3/AA- (A3/A- for Oregon companies) that will mature in 3-years or less.

Over the last six years, this universe of eligible corporate bond issuers has remained fairly static. Corporations are added if they issue new bonds with 3-years or less to maturity that meet minimum rating requirements; ratings on outstanding bonds with 3-years or less to maturity are upgraded to meet minimum requirements; previously-issued long-term bonds that meet minimum rating requirements reach 3-years or less to maturity. Conversely, corporations are removed as their outstanding bonds mature or are downgraded below minimum rating requirements.

Corporations with short-term liquidity needs may choose to issue commercial paper. At any point in time, there are approximately five to ten corporate commercial paper issuers that qualify for the City's direct investment.

There is no assurance that there will be eligible corporate securities available for purchase when the City is ready to invest its available cash for two primary reasons: not all eligible issuers (those that would meet minimum rating requirements) actively issue new securities within the City's maximum maturity limits; and not all outstanding eligible securities actively trade in the secondary market. Additionally, not all eligible securities offered for sale are priced at good value relative to other investment options that are available to the City at any point in time.

REASONS TO DIRECTLY INVEST IN CORPORATE SECURITIES

Corporate securities provide portfolio diversification and offer additional yield (income) over alternative authorized investments, such as U.S. Treasury and U.S. Agency securities. This additional yield compensates investors like the City for assuming the credit risk of corporate securities.

The Division's analysis of historical interest rate spreads, using the Bank of America Merrill Lynch CVA2 Index*, indicates that 3-year, Aa3-rated corporate bonds have offered an average additional yield of 91 basis points (0.91%) more than comparable U.S. Treasury securities over the period 1997-2016**. Assuming an average portfolio of $1.5 billion fully invested in corporate securities at 35% of the portfolio, this higher average yield translates to $4.7 million in additional investment earnings per year over comparable term investments in U.S. Treasuries.

CITY'S INVESTMENT EARNINGS FROM CORPORATE SECURITIES

The Division's analysis of the City's actual investment earnings for the five-year period FY2012 - FY2016 indicates that corporate securities have averaged 17-32% of the total investment portfolio, and that they have contributed 24-41% of the portfolio's total net investment earnings. Investment earnings in excess of the Division's administrative costs and the City's banking costs are distributed to all City funds.

FISCAL YEAR	Average Portfolio Size	Average Portfolio Assets Directly Invested in Corporates	Corporates as a % of Portfolio	Total Net Investment Earnings	Net Earnings Attributable to Corporates	Corporate Earnings as a % of Total Net Earnings
FY 11-12	$870,631,247	$149,686,375	17%	$5,265,515	$1,264,750	24%
FY 12-13	$932,332,107	$258,075,364	28%	$4,319,360	$1,417,759	33%
FY 13-14	$1,137,021,858	$368,976,898	32%	$5,541,268	$2,109,480	38%
FY 14-15	$1,368,805,644	$442,040,341	32%	$7,491,237	$3,059,357	41%
FY 15-16	$1,531,579,326	$493,642,388	32%	$11,410,165	$4,518,919	40%

RECOMMENDATION

The Division recommends that Council limit the Do-Not-Buy-List to as few names as possible. This will help ensure that the City's already limited eligible universe of corporate issuers stays as broad as possible. Corporate issuers that are removed from the City's eligible universe of investments are not easily replaced, particularly at rates of return that help ensure the City's investment portfolio earns a market rate of return consistent with state law and its Investment Policy. The additional level of investment return associated with the Division's investment in corporate bonds is significant and enables higher amounts of interest income to be realized and distributed to City bureaus

* The Bank of America Merrill Lynch CVA2 Index is composed of 312 corporate bonds rated Aa3 with an average maturity of 2.90 years.
** Minimum 36 basis points (0.36%), maximum 367 basis points (3.67%).