



**CITY OF KIRKLAND**  
**Department of Finance & Administration**  
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## **MEMORANDUM**

**To:** David Ramsay, City Manager

**From:** Tracey Dunlap, Director of Finance and Administration  
Michael Olson, Treasury Manager

**Date:** August 18, 2006

**Subject:** Council adoption of the City's Investment Policy revisions

### **Recommendation**

Council adopt the attached resolution revising the City of Kirkland Investment Policy (Attachment A).

### **Background**

The City's Fiscal Policies require that an external review of the investment policy and procedures be conducted every two years. The most recent review was completed June 1, 2006 by Davidson Fixed Income Management and is provided as Attachment B.

The review concluded that the investment portfolio structure is in compliance with the City's policy regarding legality, liquidity, safety and return as of March 31, 2006, the date of the portfolio provided for the review. The evaluation also concluded that the policy includes proper constraints to control the risks which are applicable to public fund investing and that the risk exposure of the portfolio is low for interest rate risk, credit risk and reinvestment rate risk.

The review provided a number of policy updates to meet current market standards which are detailed in the review, page 3 item number 4. Most of these changes are included to meet the certification criteria required by the Washington Municipal Treasurer's Association (WMTA). The City will be applying for the WMTA Investment Policy Certification Program after these changes are adopted.

The most notable changes include:

Adding:

- Language allowing the ability to sell a security if needed
- A section on ethics and conflict of interest
- More description for allowable securities
- A section on investment pools and mutual funds
- A section on collateralizations for repurchase agreements
- City Council adoption of the investment policy

Eliminating:

- The requirement that a broker maintain an office in the State of Washington. Due to the consolidation of the broker/dealer community over the past 10 years limiting brokers to those with offices in the State of Washington may unnecessarily limit investment opportunities.

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The review also provided the following recommendations to ensure proper broker relations and to enhance efficiency and improve safeguards related to the investment process.

1. Have the investment committee review the broker dealer relationships checklist annually to ensure best practices.
2. The City should reduce the agency callable exposure to 30% or lower.
3. The City should increase the position sizes to \$2,000,000, \$3,000,000 or even \$5,000,000 in par amounts. This will allow the investment officer to more efficiently manage the portfolio holdings.
4. The City should extend the duration of the overall portfolio as interest rates rise.
5. Consider purchase of Federal National Mortgage Association (FNMA) securities only when there is a beneficial yield over the other names or when the negative news on FNMA ends.

The report and revised policies were reviewed by the finance committee at their July 17 meeting.

# CITY OF KIRKLAND REVIEW

## June 1, 2006

### **1) Review of Investment Policy for consistency with accepted practices.**

The Investment Policy of any organization is the key to a successful investment program. It is the guideline for the investments and encompasses investment constraints, best practices and the risk and return expectations for the City. It provides the City Council with a tool to ensure that their fiduciary responsibilities have been disclosed and are being implemented. It also, provides the City employees with the guidelines that allow them to execute the investment role in an efficient and effective manner.

WMTA (Washington Municipal Treasurer's Association) provides for all public funds to have their investment policy certified by the Association of Public Treasurers. It is recommended that the City submit their policy for certification in the near future. There are eighteen required subjects that must be addressed in the policy to achieve certification:

Requirements	Kirkland Checklist
1. Policy	X
2. Scope	X
3. Prudence	X
4. Objective	X
5. Delegation of Authority <b>(change wording)</b>	<b>0</b>
6. Ethics and Conflicts of Interest	<b>0</b>
7. Authorized Financial Dealers and Institutions	X
8. Authorized and Suitable Investments	X
9. Investment Pools/ Mutual Funds	<b>0</b>
10. Collateralization	<b>0</b>
11. Safekeeping and Custody	X
12. Diversification	X
13. Maximum Maturities	X
14. Internal Control	X
15. Performance Standards	X
16. Reporting	X
17. Investment Policy Adoption	<b>0</b>
18. Glossary	X

**Conclusion:** Policy updates reflect any changes to the investment objectives, changes in statutes and changes in standards. There are updates that are needed in order for the policy to meet current market standards. The specific change recommendations are listed under question number four.

## **2) Review the policy for proper constraints related to risk control of the portfolio.**

Three types of risk are applicable to public fund investing:

1. Credit Risk
2. Reinvestment Rate Risk
3. Interest Rate Risk

Risk controls in place at the City to address the above:

Credit Risk:

The City only invests in high quality securities, Treasury and Agency's as required by Washington Code R.C.W. 35.39.030, R.C. W. 36.29.020 and R.C.W. 39.58.08. These securities are high quality and have very little default risk associated with them.

Reinvestment Rate Risk:

The City has implemented a liquidity/core fund management process that diversifies the maturity structure of the portfolio. A portion of the portfolio is maintained in the LGIP fund to meet daily cash needs while the core funds are invested directly in open market securities. This process of diversification will limit the amount of reinvestment rate risk. The practice of the City is to target 15% of the portfolio balances in the LGIP.

Interest Rate Risk:

All investors that purchase fixed income securities that have maturities longer than 1 month are exposed to price change due to interest rate changes. This exposure is controlled by managing the overall average maturity of the portfolio. The City has a stated maximum average maturity of three years and a maximum maturity of a single issue at 5 years. The practice of the City is to maintain an overall average maturity of the portfolio under 1.5 years.

**Conclusion:** Proper constraints to control the risk of the portfolio are in place.

## **3) Review the policy to determine if industry standards are followed with regard to broker relationships, trading authorizations, etc.**

Industry standards require for all public entities to require a broker/dealer to be approved by the investment committee upon receipt of the entities broker /dealer questionnaire. Also, it is required to have the individual salesperson to certify that the entities investment policy has been read and that annual financials will be provided.

It is also prudent to provide a trading authorization to each broker/dealer that the City transacts business to ensure that only persons allowed to trade on behalf of the City are identified.

**Conclusion:** A check list was submitted to the City regarding broker/dealer questionnaires, certifications and trading authorizations. The policy requires that the financials of all broker/dealers must be provided to investment staff annually, this procedure is in place. However, the practice of maintaining the broker/dealer questionnaire, certification document

and trading authorization is not being implemented and the investment committee should review to determine that this practice is implemented. The checklist is shown below and should be reviewed annually to ensure best practices.

**Annual Review for Broker Dealer Relationships**

**City of Kirkland**

**Date** May 17, 2006

List the current Broker/Dealers that are approved to do business with the City of Kirkland? Under questionnaire, certification and financials, provide the date of the most recent document. Also note the date the trading authorization was sent.

<u>Firm Name</u>	<u>B/D Questionnaire</u>	<u>B/D Certification</u>	<u>Current Financials</u>	<u>Trading Authorization</u>
Washington Mutual Bankno	no		2005	November 2, 2005
Piper Jaffray	no	no	2005	April 5, 2004
Vining Sparks	no	no	2005	no
D.A. Davidson & Co	no	not dated	2005	no
Seattle Northwest Securities	no	no	2005	no
Wells Fargo	no	no	2005	no

**Conclusion:** Utilize the broker dealer questionnaire, certification and trading authorization that is being submitted as attachments with this review. Use the check sheet annually to ensure that the process is in compliance.

**4) Document suggested changes to existing policy.**

All changes are reflected on the following pages titled revision document. The red highlights are the additions, the blue highlights are the deletions and the purple are the changes.

1. Title lines: Note the date of adoption by the council.
2. 2.0 Scope: Add bullet points to fund types and move the last sentence, referring to new funds, as last bullet.
3. 3.0 Objective: add to section 3.1 – in the State of Washington
4. 3.0 Move up the Liquidity priority to 3.2
5. 3.0 Objective: Add section regarding to incorporate the ability to sell a security if need.
6. 4.0 Change the tile from Investment Committee to Delegation of Authority
7. 5.0 Change title from Prudent Person Standard to Prudence
8. 6.0 Add the Ethics and Conflicts of Interest Section
9. 7.0 The broker/dealer community has consolidated over the past 10 years. Consider eliminating the requirement that the broker/dealer has an office in Washington.

10. 7.0 Eliminate the statement that the financial statement is required and expand the verbiage to include financials, Broker/Dealer Questionnaire, Broker Certification and Trading Authorization.
11. 8.0 Add in the Title Suitable.
12. 8.2 change the implicit guarantee to moral obligation. There is no government guarantee on agency securities.
13. 8.0 Replace all municipal corporations with "The City is".
14. 8.2 Add the description of agency securities to GSEs.
15. 9.0 Add a section on Investment pools and Mutual Funds.
16. 10.0 Add a section on Collateralizations for repurchase agreements.
17. 12.0 Add the first line to read, "The City will diversify its investments by security type and institution.
18. 12.0 Add the section "With the exception of U.S. Treasury securities and authorized pools..."
19. 12.0 Eliminate sentence commenting on failure of a transaction.
20. 13.0 Change the title from Maturities to Maximum Maturities.
21. 13.0 Add the maximum weighted average maturity of the total portfolio.
22. Old section 11 – remove the Overall maturity section as it is moved to 13.00
23. 15.0 External Controls – Add the line that investment advisors may be contracted for services as required.
24. 18.0 Add Investment Policy Adoption Section.

# CITY OF KIRKLAND INVESTMENT POLICY

Date 6/1/2006

Adopted:

## REVISIONS DOCUMENT

### 1.0 Policy Statement

It is the policy of the City of Kirkland, "The City" to invest public funds in a manner which provides the highest investment return with maximum security while meeting the daily cash flow requirements and conforming to all state and local statutes governing the investment of public funds.

### 2.0 Scope

This investment policy applies to all financial assets for the City of Kirkland. These funds are accounted for in the City's annual financial report and include:

- General Fund
- Special Revenue Funds
- Capital Project Funds
- Enterprise Funds
- Trust and Agency Funds
- Debt Service Funds
- Any new funds created by the Council unless specifically exempted by the Council

### 3.0 Objective

The primary objectives, in order of priority, for the City of Kirkland's investment activities are as follows:

- 3.1 Legality: The City's investments will be in compliance with all statutes governing the investment of public funds in the State of Washington.
- 3.2 Liquidity: The City's investments will remain sufficiently liquid to enable the city to meet all operating requirements which might be reasonably anticipated.
- 3.3 Safety: Investments of the City will be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. To attain this objective, diversification is required in order that potential losses on individual securities do not exceed the income generated from other investments.
- 3.4 Yield: The City's investments will be designed with the objective of attaining a market rate return throughout budgetary and economic cycles, taking into account the City's investment risk constraints and cash flow characteristics.

Core investments are limited to relatively low-risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall generally be held until maturity with the following exceptions:

- a. A security with declining credit may be sold early to minimize loss of principal.
- b. A security swap that would improve the quality, yield or target duration in the portfolio.
- c. Liquidity needs of the portfolio require that the security be sold.

#### **4.0 Delegation of Authority**

In accordance with City of Kirkland Municipal code, Ordinance No.2455, an Investment Committee was created consisting of the City Manager and Finance Director. Authority is granted to these individuals to invest any portion of the monies in the City's inactive funds or other funds in excess of current needs. The Finance Director may designate a person to coordinate the day to day operations of the investment portfolio.

#### **5.0 Prudence**

Investments will be made with judgment and care, under circumstances then prevailing, which person of prudence, discretion and intelligence would use in the management of their own affairs, not for speculation, but for investment purposes (Prudent Person Standard).

The standard of prudence to be used by investment officials will be the "prudent person" and will be applied in the context of managing an overall portfolio. Investment officers meeting the "prudent person" standard will 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 appropriate action is taken to control adverse developments.

#### **6.0 Ethics and Conflicts of Interest**

Officers and employees involved in the investment process shall refrain from personal business activity that may conflict with the proper execution of the investment program, or may impair their ability to make impartial investment decisions. Employees and investment officials shall disclose to Investment Committee any material financial interests in financial institutions that conduct business within this jurisdiction, and they shall further disclose any personal financial/investment positions that could be related to the performance of the City's portfolio.

#### **7.0 Authorized Financial Dealers and Institutions**

The Investment Committee will maintain a list of financial institutions as required by the Public Deposit Commission (PDC), authorized to provide investment services as outlined in R.C.W. 39.58.080. In addition, a list will also be maintained of approved security broker/dealers selected by credit worthiness, [who maintain an office in the State of Washington](#). No public deposits will be made except in a qualified public depository in the State of Washington. These may include "primary" dealers or regional dealers that qualify under SEC Rule 15C3-1 (uniform net capital rule).

[A current financial statement is required to be on file for any financial institution and broker/dealer with whom the City is investing.](#)

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All brokers/dealers and financial institutions who desire to do business with the City must supply the Finance Director with the following: Annual audited financial statement, proof of National Association of Securities Dealers Certification, certification of having read the City's investment policy and receipt of the City's Trading Authorization. The Investment Committee will conduct an annual review of the financial condition and audit of documents on file.

## 8.0 Authorized and **Suitable** Investments

The City is empowered to invest in the following types of securities:

Eligible investments are only those securities and deposits authorized by statute (RCW 39.58, 39.59, 43.250 and 43.84.080) Eligible investments include:

- Obligations of the U.S. government;  
U.S. Treasury Notes, Bonds and Bills
- Obligations of U.S. government agencies, corporations wholly owned by the U.S. government or any Government Sponsored Enterprises (GSE's):

Specific listing:

Federal Home Loan Bank - FHLB  
Federal Farm Credit Bank-FFCB  
Government National Mortgage Association - GNMA  
Federal Home Loan Mortgage Corporation – FHLMC  
Federal National Mortgage Association – FNMA  
Federal Agricultural Mortgage Corporation- FAMC  
Tennessee Valley Authority – TVA

\* Other issuers may qualify if they meet the above criteria.

- Banker's acceptances purchased on the secondary market rated with the highest short-term credit rating of any two Nationally Recognized Statistical Rating Organizations (NRSROs), at the time of purchase. If the banker's acceptance is rated by more than two NRSROs., it must have the highest rating from all the organizations.
- Commercial Paper, provided that the Finance Director adheres with the policies and procedures of the State Investment Board regarding commercial paper (RCW 43.84.080(7));
- Certificates of deposit with financial institutions qualified by the Washington Public Deposit Protection Commission;
- Local Government Investment Pool, for proceeds of bonds, liquidity funds or other debt obligations;
- Obligations of the State of Washington or its political sub-divisions.
- The City is prohibited from purchasing securities that leverage the portfolio or are used for speculation on interest rates.

## **9.0 Investment pools / Mutual Funds**

The City is allowed to invest in the Washington State Local Government Investment Pool as authorized by City of Kirkland Resolution 3370. The City is restricted from investing in mutual funds by State Statute.

## **10.0 Collateralization**

The City does not actively invest in the repurchase agreements for short term investments. However, if a repurchase agreement is utilized collateralization is required. In order to anticipate market changes and provide a level of security for all funds, the collateralization level will be (102%) of market value of principal and accrued interest. Re-pricing of the collateral should occur daily.

The City chooses to limit the collateral to Treasury and GSE Agency securities only, with a maximum maturity of three years.

Collateral will always be held by an independent third party with whom the entity has a current custodial agreement. A clearly marked evidence of ownership (safekeeping receipt) must be supplied to the entity and retained.

## **11.0 Safekeeping and Custody**

All security transactions, including collateral for repurchase agreements, entered into by the City of Kirkland will be conducted on a delivery-versus-payment (DVP) basis. Securities will be held in safekeeping by a third party custodian designated by a member of the Investment Committee.

## **12.0 Diversification**

The City will diversify its investments by security type and institution. By investing in several different instruments with different issuers, failure of a particular transaction to occur as planned is not likely to cause a major cash flow crisis. The City's policy is to assure that no single institution or security is invested to such an extent that a delay of liquidation at maturity is likely to cause a current cash flow emergency. With the exception of U.S. Treasury securities and authorized pools, no more than 50% of the entity's total investment portfolio will be invested in a single security type, issuer or financial institution. Diversification strategies shall be determined and revised periodically by the investment committee.

## **13.0 Maximum Maturities**

To the extent possible, the City will attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow, or estimated to cash flow needs, the City will not directly invest in securities maturing more than five (5) years from the date of purchase.

The maximum weighted maturity of the total portfolio shall not exceed 3 years. This maximum is established to limit the portfolio to excessive market exposure.

Reserve or Capital Improvement Project monies may be invested in securities exceeding five (5) years if the maturities of such investments are made to coincide as nearly as practicable with the expected use of the funds.

## 11.0 Overall Portfolio Components

The maximum weighted maturity of the total portfolio shall not exceed 3 years. This maximum is established to limit the portfolio to excessive market exposure.

## 14.0 Internal Control

On an annual basis the Investment Committee, in conjunction with the State Auditor's Office, will evaluate conformance with the Investment Policy and audit internal controls. The purpose of these examinations shall be to audit the accountability of the City's Investment Portfolio and to verify that Investment Officials have acted in accordance with the investment policies and procedures.

## 15.0 External Control

The City will have an external review of the investment policy and procedures every 3 years. The City may enter contracts with third party investment advisory firms when their services are required.

## 16.0 Performance Standards

The City of Kirkland's investment portfolio will be designed to obtain a market average rate of return during budgetary and economic cycles, taking into account the City's investment risk constraints and cash flow needs

## 17.0 Reporting Requirements

17.1 The Finance Director shall prepare a quarterly and annual investment report summarizing the activity of the investment portfolio as to types of investments, yields, maturities and other related data.

17.2 Monthly reports will be submitted to the Investment Committee that report market value changes and investment income.

## 18.0 Investment Policy Adoption

The City's investment policy shall be adopted by City Council. The policy shall be reviewed ever three years by the investment committee and modifications shall be submitted and approved by City Council.

### 5) Review the overall portfolio structure.

Purpose: To evaluate the portfolio structure to confirm compliance to the existing policy as of 3/31/06.

<b>Total Portfolio Characteristics By Type</b>		
<u>Investment Type</u>	<u>Market Value</u>	<u>% Portfolio</u>
State Investment Pool	\$10,974,302.70	13.24%
Certificates of Deposit – Bank	\$4,000,000.00	4.83%
Passbook/Checking Accounts	\$1,146,103.32	1.38%
Federal Agency Issues	\$64,824,828.37	78.16%
Treasury Securities	\$ 2,000,000.00	2.38%

<b>Portfolio Characteristics By Maturity Sector</b>		
<u>Maturity</u>	<u>% of Portfolio</u>	
0-1 Year	38.633%	
1-2 Year	48.03%	
2-3 Year	12.15%	
3-4 Year	0.00%	
4-5 Year	1.18%	
Average Maturity	1.17 years	Effective Duration .97

<b>Portfolio Characteristics By Issuer based on Par Amount</b>	
<u>Maturity</u>	<u>% of Portfolio</u>
Cash	14.62%
Certificates of Deposit	4.82%
US Treasury	2.40%
FFCB	20.56%
FHLB	16.48%
FHLMC	21.70%
FNMA	19.33%

**Portfolio Characteristics Compared to Standard Public Fund Benchmark Merrill Treasury  
0-3 year Index**

	YTM	Average Coupon (%)	Average Maturity (Years)	Average Quality	Effective Duration
	----	-----	-----	-----	-----
Kirkland, City of	5.036	4.025	1.17	AGY	0.974
ML 0-3 YR TSY INDEX	4.818	3.677	1.353	TSY	1.279
DIFFERENCE	0.218	0.348	-0.183		-0.305

	PORT	BNCHMK			PORT	BNCHMK	
MATURITY YRS	(%)	(%)	DIFF	EFF DUR	(%)	(%)	DIFF
	----	----	----	-----	----	----	----
0.0-1.0	37.1	33.6	3.5	0.0-1.0	44.6	37.5	7.1
1.0-3.0	61.7	66.5	-4.8	1.0-3.0	54.2	62.5	-8.3
3.0-5.0	1.2	0	1.2	3.0-4.0	1.2	0	1.2
5.0-10.0	0	0	0	4.0-6.0	0	0	0
10.0-20.0	0	0	0	6.0-8.0	0	0	0
20.0 +	0	0	0	8.0 +	0	0	0

  

	PORT	BNCHMK	
CALLS/SINKS/PUTS	(%)	(%)	DIFF
	----	----	----
			-
NONE	54.3	100	45.7
W/DEF CALL	40.7	0	40.7
W/CURR CALL	5	0	5
PRICE TO CALL	0	0	0
W/SINK FUND	0	0	0
W/PUT	0	0	0
PRICE TO PUT	0	0	0

## PORTFOLIO HOLDINGS REPORT

IDENTIFR	Par [000]	Issuer	Coupon	Maturity	Call Date	Acq Date	Book Yield	% Port- M	Eff Dur (Par)	Gain/Loss [000]
00000CM	16120	Pool, CD's, Passbk	4.50	3/31/2006	00/00/0000	00/00/0000	4.75	19.524	0.07	0
3136F3HX	2000	FEDERAL NATL MTG ASSN FEDERAL HOME LN MTG CORP	2.53	4/7/2006	00/00/0000	4/7/2003	2.53	2.451	0.02	-0.62
3128X1HW	2000	MTN	2.125	6/12/2006	00/00/0000	6/12/2006	0	2.425	0.19	-19.38
31331TMF	2000	FEDERAL FARM CR BANKS	2.88	6/29/2006	00/00/0000	12/29/2003	2.88	2.428	0.24	-10
3136F5S2	2000	FEDERAL NATL MTG ASSN	3.26	6/29/2006	00/00/0000	6/29/2004	3.26	2.433	0.24	-8.12
3133MGVA	1730	FEDERAL HOME LN BKS FEDERAL HOME LN MTG CORP	5.25	8/15/2006	00/00/0000	10/18/2001	4.369	2.111	0.36	-3.77
3128X36V	2000	MTN	3.875	12/29/2006	6/29/2006	4/27/2005	3.925	2.424	0.71	-17.9
31359MLU	2000	FEDERAL NATL MTG ASSN	4.75	1/2/2007	00/00/0000	10/7/2004	3.12	2.442	0.73	-30.86
912828DN	2000	UNITED STATES TREAS NTS	3.375	2/28/2007	00/00/0000	2/10/2006	4.625	2.396	0.88	-5.27
31331TB8	2000	FEDERAL FARM CR BANKS	2.9	4/12/2007	4/12/2006	11/30/2005	4.688	2.402	0.99	-8.7
31331SBM	2000	FEDERAL FARM CR BANKS	3.13	4/26/2007	00/00/0000	10/26/2004	3.13	2.405	1.02	-41.24
31331SCK	2000	FEDERAL FARM CR BANKS	3.25	4/27/2007	00/00/0000	10/27/2004	3.25	2.409	1.02	-38.74
31359MVB	2000	FEDERAL NATL MTG ASSN	3.125	5/4/2007	00/00/0000	11/5/2004	3.154	2.402	1.04	-41.23
3128X4BL	2000	FEDERAL HOME LN MTG CORP FEDERAL HOME LN MTG CORP	4	6/1/2007	6/1/2006	6/6/2005	3.75	2.434	0.96	-18
3128X32D	2000	MTN	3.64	7/11/2007	7/11/2006	1/11/2005	3.712	2.398	1.21	-34.46
3133X7XB	2000	FEDERAL HOME LN BKS	3.77	8/9/2007	2/9/2007	8/9/2004	3.77	2.392	1.29	-35.93
3128X4HM	2000	FEDERAL HOME LN MTG CORP	4.5	8/22/2007	8/22/2006	8/22/2005	4.474	2.411	1.19	-19.15
3128X4GU	2000	FEDERAL HOME LN MTG CORP	4.5	8/24/2007	00/00/0000	8/24/2005	4.832	2.424	1.33	-13.36
3133X4VM	2000	FEDERAL HOME LN BKS	3	9/28/2007	00/00/0000	3/28/2004	3	2.351	1.44	-59.38
3136F5RK	2000	FEDERAL NATL MTG ASSN	3.125	10/26/2007	00/00/0000	4/26/2004	3.125	2.384	1.49	-58.74
3133X5ZQ	2000	FEDERAL HOME LN BKS	3.375	10/30/2007	4/30/2006	4/30/2004	3.375	2.394	1.49	-51.88
31359MWS	2000	FEDERAL NATL MTG ASSN	3.375	11/9/2007	00/00/0000	11/9/2004	3.53	2.391	1.52	-47.65
3133XDQW	2000	FEDERAL HOME LN BKS FEDERAL HOME LN MTG CORP	5	11/23/2007	4/23/2006	11/30/2005	5.002	2.456	0.94	-7.93
3128X3FC	2000	MTN	3.75	11/23/2007	5/24/2006	5/24/2004	3.75	2.403	1.53	-42.14
3136F6PG	2000	FEDERAL NATL MTG ASSN	4.5	12/14/2007	00/00/0000	12/14/2004	4.524	2.431	1.6	-18.22
3136F6SB	2000	FEDERAL NATL MTG ASSN	3.77	12/28/2007	6/28/2006	12/28/2004	3.77	2.393	1.62	-43.74
3133XABL	2000	FEDERAL HOME LN BKS	4	2/4/2008	5/4/2006	2/4/2005	4	2.391	1.66	-38.12
3133XAHL	2000	FEDERAL HOME LN BKS FEDERAL HOME LN MTG CORP	4	2/11/2008	5/11/2006	2/11/2005	4.011	2.389	1.68	-38.27
3128X3RQ	2000	MTN	3.875	2/12/2008	8/12/2006	1/27/2005	3.892	2.376	1.74	-48.42
3128X4HK	2000	FEDERAL HOME LN MTG CORP	4.625	8/15/2008	8/15/2006	8/18/2005	4.628	2.412	1.69	-19.92
31331S3K	2000	FEDERAL FARM CR BANKS	4.6	9/8/2008	9/8/2006	9/8/2005	4.611	2.399	1.84	-24.45
31331VCK	2000	FEDERAL FARM CR BANKS	4.9	10/17/2008	1/17/2006	11/17/2005	4.897	2.454	1.54	-18.12
31331VDW	1000	FEDERAL FARM CR BANKS	4.92	10/27/2008	10/27/2006	10/27/2005	5.049	1.226	1.71	-5.64
31331VJN	2000	FEDERAL FARM CR BANKS	5.05	12/8/2008	3/8/2006	12/8/2005	5.047	2.444	1.47	-13.74
31331VNK	1000	FEDERAL FARM CR BANKS	5	1/20/2009	4/20/2006	2/10/2006	5.143	1.213	1.58	-4.36
31331VAS	1000	FEDERAL FARM CR BANKS	4.75	9/28/2010	9/28/2007	3/29/2006	5.379	1.183	3.23	1.37
	82850	Total	3.935	1.17			4.008	100.001	0.97	-886.08

**Legality:** All security holdings are in compliance with City's policy and state and local statutes.

**Liquidity:** Cash and Cash Equivalents including CD's represent 19.54% of the portfolio. This is appropriate and within the policy guidelines of 15%. Securities held with maturities less than one year, including cash is 37.1%, which also provides for liquidity needs.

**Safety:** The portfolio is diversified by maturity and issuer name, providing for prudent safety measures.

**Return:** The book yield on the portfolio is 3.935% and is fair based on the average maturity and purchase dates of the portfolio. The longer investments that were locked in during the low interest rate cycle will keep the book yield lower than pool rates for a period of time. It is important to focus on the long term benefits of the core fund portfolio during longer term budget cycles. The total return of the portfolio for the calendar year was 2.553 compared to the 0-3 year benchmark of 2.103%. The portfolio outperformed during this period due to the shorter average maturity positioning of the portfolio while interest rates were rising.

## 6) Evaluate the risk exposure of the portfolio.

### Interest Rate Risk: Rating - Low

Risk management in public fund investing is targeted at managing the market to market value exposure of the portfolio given interest rate changes. Portfolio duration is the tool that is used to measure this exposure. The City's portfolio principal value will move by approximately \$729M and \$-879M when rates move up or down by 1%.

### PORTFOLIO MARKET VALUE CHANGE BASED ON INTEREST RATE CHANGES

Yield Change (bp)	Total	Price	YTM/C	Dur	USD	
-300	1.95	1.95	2.04	0.46	84173	
-250	1.71	1.71	2.54	0.48	83980	
-200	1.47	1.47	3.04	0.52	83784	
-150	1.21	1.21	3.54	0.61	83562	
-100	0.88	0.88	4.04	0.73	83296	729
-50	0.48	0.48	4.54	0.86	82960	
0	0	0	5.04	0.97	82567	
50	-0.52	-0.52	5.54	1.04	82134	
100	-1.06	-1.06	6.04	1.07	81688	-879
150	-1.6	-1.6	6.54	1.07	81247	
200	-2.12	-2.12	7.04	1.07	80813	
250	-2.65	-2.65	7.54	1.06	80382	
300	-3.16	-3.16	8.04	1.06	79956	

**Credit Risk: Low**

Credit risk is low based on the types of securities that the City is purchasing and the diversification that is being implemented.

**Reinvestment Rate Risk: Low**

Reinvestment rate risk is exposed in a portfolio when there is excess liquidity and or too much callable exposure. The City implements a core/liquidity fund strategy that maintains a minimum balance in targeted liquidity and invests the excess into open market securities. The balance of the core fund and liquidity accounts is an appropriate and diversifying the exposure to reinvestment rate risk. However, the callable exposure is high in this portfolio as over 40% is in callable securities. Note in the table above, how the duration of the portfolio shifts from .97 down to .73 when rates fall 100bp. This illustrates how much influence the callable sector has on the composition of the portfolio without the investment officer making any changes. A balance of callable and non callable securities is important and we recommend at 30% maximum.

**7) Document comments on the structure of the portfolio.**

The overall portfolio positioning has been invested with a shorter duration through the lower rate environment. This has benefited the City in two ways: 1) protected the mark to market exposure 2) provided for maturities coming due to be reinvested at higher rates.

Asset allocation by issuer is appropriate

Call exposure needs to be reduced

**8) List recommendations that will enhance the efficiency and improve safeguards to the investment process.**

The City has implemented a liquidity and core fund strategy to assist in the decision making process. Past analysis identified the appropriate risk profile for the City's core investment to be a 1-3 year treasury structure. This index duration is 1.65. It is important to utilize duration as a key tool in strategy and investment decisions to control risk and manage return. The neutral position for the core fund is 1.65 (the index) . As interest rates move up above the 10 year average the core fund portfolio should move out closer to this target. The current core fund duration is 1.19 as of March 31, 2006.

Recommendation:

1. Reduce the agency callable exposure to 30% or lower.
2. Increase position sizes to \$2,000,000, \$3,000,000 or even \$5,000,000 in par amounts. This will allow the investment officer to more efficiently manage the portfolio holdings.
3. Extend the duration of the overall portfolio as interest rates rise. Note the attached sheet that reviews historical levels. The two year note has a 10 year average rate of 4.28%. Today the market is at 4.96%.
4. News continued to be negative on FNMA yet the market is not pricing FNMA issues at a discount. Look to add FNMA's only when there is a beneficial yield over the other names or when the negative news ends.

RESOLUTION R - 4595

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF KIRKLAND  
ADOPTING A POLICY FOR INVESTMENT OF CITY FUNDS.

WHEREAS, the City Council of the City of Kirkland deems to have City funds invested in secure depositories and maximize returns on these investments; and

WHEREAS, the City Council of the City of Kirkland desires to develop an investment policy to guide the investment of City funds to meet these objectives; and

WHEREAS, the Kirkland City Treasurer has recommended a proposed policy for investment of City funds; and

WHEREAS, the City of Kirkland investment policy has been written in accordance with the Washington Municipal Treasures Model Investment Policy.

NOW, THEREFORE, be it resolved by the City Council of the City of Kirkland as follows:

Section 1. The policy for investment of City funds set forth in the document entitled "City of Kirkland Investment Policy June 1, 2006" which is attached hereto as Attachment A and incorporated herein by this reference as if set forth in full is hereby adopted as official policy for investment of City funds.

Section 2. That the document entitled City of Kirkland Investment Policy June 1, 2006, replaces all previous City of Kirkland Investment Policies.

Passed by majority vote of the Kirkland City Council in open meeting this \_\_\_\_ day of \_\_\_\_\_, 2006.

Signed in authentication thereof this \_\_\_\_ day of \_\_\_\_\_, 2006.

\_\_\_\_\_  
MAYOR

Attest:

\_\_\_\_\_  
City Clerk

**Attachment A*****CITY OF KIRKLAND  
INVESTMENT POLICY****Draft 6/1/2006*

Adopted:

**1.0 Policy Statement**

It is the policy of the City of Kirkland, ("the City") to invest public funds in a manner which provides the highest investment return with maximum security while meeting the daily cash flow requirements and conforming to all state and local statutes governing the investment of public funds.

**2.0 Scope**

This investment policy applies to all financial assets for the City of Kirkland. These funds are accounted for in the City's annual financial report and include:

- General Fund
- Special Revenue Funds
- Capital Project Funds
- Enterprise Funds
- Trust and Agency Funds
- Debt Service Funds
- Any new funds created by the Council unless specifically exempted by the Council

**3.0 Objective**

The primary objectives, in order of priority, for the City of Kirkland's investment activities are as follows:

- 3.1 Legality: The City's investments will be in compliance with all statutes governing the investment of public funds in the State of Washington.
- 3.2 Liquidity: The City's investments will remain sufficiently liquid to enable the city to meet all operating requirements which might be reasonably anticipated.
- 3.3 Safety: Investments of the City will be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. To attain this objective, diversification is required in order that potential losses on individual securities do not exceed the income generated from other investments.

- 3.4 Yield: The City's investments will be designed with the objective of attaining a market rate return throughout budgetary and economic cycles, taking into account the City's investment risk constraints and cash flow characteristics.

Core investments are limited to relatively low-risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall generally be held until maturity with the following exceptions:

- a. A security with declining credit may be sold early to minimize loss of principal.
- b. A security swap that would improve the quality, yield or target duration in the portfolio.
- c. Liquidity needs of the portfolio require that the security be sold.

#### **4.0 Delegation of Authority**

In accordance with City of Kirkland Municipal code, Ordinance No.2455, an Investment Committee was created consisting of the City Manager and Finance Director. Authority is granted to these individuals to invest any portion of the monies in the City's inactive funds or other funds in excess of current needs. The Finance Director may designate a person to coordinate the day to day operations of the investment portfolio.

#### **5.0 Prudence**

Investments will be made with judgment and care, under circumstances then prevailing, which person of prudence, discretion and intelligence would use in the management of their own affairs, not for speculation, but for investment purposes (Prudent Person Standard).

The standard of prudence to be used by investment officials will be the "prudent person" and will be applied in the context of managing an overall portfolio. Investment officers meeting the "prudent person" standard will 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 appropriate action is taken to control adverse developments.

#### **6.0 Ethics and Conflicts of Interest**

Officers and employees involved in the investment process shall refrain from personal business activity that may conflict with the proper execution of the investment program, or may impair their ability to make impartial investment decisions. Employees and investment officials shall disclose to Investment Committee any material financial interests in financial institutions that conduct business within this jurisdiction, and they shall further disclose any personal financial/investment positions that could be related to the performance of the City's portfolio.

## **7.0 Authorized Financial Dealers and Institutions**

The Investment Committee will maintain a list of financial institutions as required by the Public Deposit Protection Commission (PDPC), authorized to provide investment services as outlined in R.C.W. 39.58.080. In addition, a list will also be maintained of approved security broker/dealers selected by credit worthiness. No public deposits will be made except in a qualified public depository in the State of Washington. These may include “primary” dealers or regional dealers that qualify under SEC Rule 15C3-1 (uniform net capital rule).

All brokers/dealers and financial institutions who desire to do business with the City must supply the Finance Director with the following: Annual audited financial statement, proof of National Association of Securities Dealers Certification, certification of having read the City’s investment policy and receipt of the City’s Trading Authorization. The Investment Committee will conduct an annual review of the financial condition and audit of documents on file.

## **8.0 Authorized and Suitable Investments**

The City is empowered to invest in the following types of securities:

Eligible investments are only those securities and deposits authorized by statute (RCW 39.58, 39.59, 43.250, and 43.84.080) Eligible investments include:

- Obligations of the U.S. government;  
U.S. Treasury Notes, Bonds and Bills
- Obligations of U.S. government agencies, corporations wholly owned by the U.S. government or any Government Sponsored Enterprises (GSE’s):

Specific listing:

Federal Home Loan Bank - FHLB  
Federal Farm Credit Bank - FFCB  
Government National Mortgage Association - GNMA  
Federal Home Loan Mortgage Corporation - FHLMC  
Federal National Mortgage Association - FNMA  
Federal Agricultural Mortgage Corporation - FAMC  
Tennessee Valley Authority - TVA

\* Other issuers may qualify if they meet the above criteria.

- Banker's acceptances purchased on the secondary market rated with the highest short-term credit rating of any two Nationally Recognized Statistical Rating Organizations (NRSROs), at the time of purchase. If the banker's acceptance is rated by more than two NRSROs., it must have the highest rating from all the organizations.
- Commercial Paper, provided that the Finance Director adheres with the policies and procedures of the State Investment Board regarding commercial paper (RCW 43.84.080(7));
- Certificates of deposit with financial institutions qualified by the Washington Public Deposit Protection Commission;
- Local Government Investment Pool, for proceeds of bonds, liquidity funds or other debt obligations;
- Obligations of the State of Washington or its political sub-divisions.
- The City is prohibited from purchasing securities that leverage the portfolio or are used for speculation on interest rates.

## **9.0 Investment pools / Mutual Funds**

The City is allowed to invest in the Washington State Local Government Investment Pool as authorized by City of Kirkland Resolution 3370. The City is restricted from investing in mutual funds by State Statute.

## **10.0 Collateralization**

The City does not actively invest in repurchase agreements for short term investments. However, if a repurchase agreement is utilized collateralization is required. In order to anticipate market changes and provide a level of security for all funds, the collateralization level will be (102%) of market value of principal and accrued interest. Re-pricing of the collateral should occur daily.

The City chooses to limit the collateral to Treasury and GSE Agency securities only, with a maximum maturity of three years.

Collateral will always be held by an independent third party with whom the entity has a current custodial agreement. A clearly marked evidence of ownership (safekeeping receipt) must be supplied to the entity and retained.

### **11.0 Safekeeping and Custody**

All security transactions, including collateral for repurchase agreements, entered into by the City of Kirkland will be conducted on a delivery-versus-payment (DVP) basis. Securities will be held in safekeeping by a third party custodian designated by a member of the Investment Committee.

### **12.0 Diversification**

The City will diversify its investments by security type and institution. The City's policy is to assure that no single institution or security is invested to such an extent that a delay of liquidation at maturity is likely to cause a current cash flow emergency. With the exception of U.S. Treasury securities and authorized pools, no more than 50% of the entity's total investment portfolio will be invested in a single security type, issuer or financial institution. Diversification strategies shall be determined and revised periodically by the Investment Committee.

### **13.0 Maximum Maturities**

To the extent possible, the City will attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow, or estimated to cash flow needs, the City will not directly invest in securities maturing more than five (5) years from the date of purchase.

The maximum weighted maturity of the total portfolio shall not exceed 3 years. This maximum is established to limit the portfolio to excessive market exposure.

Reserve or Capital Improvement Project monies may be invested in securities exceeding five (5) years if the maturities of such investments are made to coincide as nearly as practicable with the expected use of the funds.

### **14.0 Internal Control**

On an annual basis the Investment Committee, in conjunction with the State Auditor's Office, will evaluate conformance with the Investment Policy and audit internal controls. The purpose of these examinations shall be to audit the accountability of the City's Investment Portfolio and to verify that Investment Officials have acted in accordance with the investment policies and procedures.

### **15.0 External Control**

The City will have an external review of the investment policy and procedures every 2 years. The City may enter contracts with third-party investment advisory firms when their services are required.

### **16.0 Performance Standards**

The City of Kirkland's investment portfolio will be designed to obtain a market average rate of return during budgetary and economic cycles, taking into account the City's investment risk constraints and cash flow needs

### **17.0 Reporting Requirements**

17.1 The Finance Director shall prepare a quarterly and annual investment report summarizing the activity of the investment portfolio as to types of investments, yields, maturities and other related data.

17.2 Monthly reports will be submitted to the Investment Committee that report market value changes and investment income.

### **18.0 Investment Policy Adoption**

The City's investment policy shall be adopted by City Council. The policy shall be reviewed every two years by the Investment Committee and modifications shall be submitted and approved by City Council.

## GLOSSARY

**BANKERS' ACCEPTANCES (Bas)** – Bankers Acceptances are a form of a loan used in import-export financing transactions which becomes negotiable when accepted by a bank. The issuing bank is liable for the payment at its maturity. Terms vary but normally they are under six months and are purchased on a discount basis.

**BROKER** – A middleman who brings buyers and sellers together and handles their orders generally charging a commission for their services.

**CERTIFICATES OF DEPOSIT** – Instruments issued by a bank specifying that a sum of money has been deposited, payable with interest to the bearer of the certificate on a certain date.

**COMMERCIAL PAPER** - A short – term promissory note issued by a bank holding company, for the purpose of financing current transactions. Issues are sold on a discount basis with maturities up to 270 days.

**DELIVERY VS PAYMENT** – Physical delivery of collateral securities or book entry control in exchange for the cash payment. Under this system funds are not transferred until the securities are delivered. If a third party acts as custodian, funds are released by the custodian only when delivery is accomplished.

**DEPOSITORY** – A bank or financial institution accepting cash deposits and investments.

**DIVERSIFICATION** – Dividing available funds among a variety of securities and institutions so as to minimize market risk.

**FEDERAL CREDIT AGENCIES** - Agencies of the Federal government set up to supply credit to various classes of institutions and individuals, e.g., S&L's, small business firms, students, farmers, farm cooperatives and exporters.

**FEDERAL HOME LOAN BANKS (FHLB)** - The institutions that regulate and lend to savings and loan associations. The Federal Home Loan Banks play a role analogous to that played by the Federal Reserve Banks vis-a-vis member commercial banks.

**FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA)** - FNMA, like GNMA was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing & Urban Development, H.U.D. It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. The corporation's purchases include a variety of adjustable mortgages and second loans in addition to fixed-rate mortgages. FNMA's securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

**GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA OR GINNIE MAE) -**

Securities guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations and other institutions. Security holder is protected by full faith and credit of the U.S. Government. Ginnie Mae securities are backed by FHA, VA, or FMHM mortgages. The term passthroughs is often used to describe Ginnie Maes.

**GOVERNMENT SPONSORED ENTERPRISES (GSE's)** - A group of financial services corporations created by the United States Congress. Their function is to reduce interest rates for specific borrowing sectors of the economy, farmers, and homeowners. The mortgage borrowing segment is by far the largest of the borrowing segments that the GSE's operate in.

**LIQUIDITY** - The length of time required to convert any investment to cash.

**LOCAL GOVERNMENT INVESTMENT POOL** – The aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment and reinvestment.

**MARKET VALUE** – The market value of a security is the price at which the last sale of the same issue was sold.

**MATURITY** – The date upon which the principal or stated value of an investment becomes due.

**PRINCIPAL** – The cost of an instrument on which interest is earned.

**REPURCHASE AGREEMENT** – Range in maturity from overnight to fixed time to open end. Repo's involve a simultaneous sale of securities by a bank or government securities dealer to a city with an agreement for the bank to repurchase the securities at a fixed date at a specified rate of interest.

**SAFEKEEPING** – An arrangement under which an organization's securities are kept in a bank vault or in the case of book entry securities, are held and recorded in the customer's name. Evidence of this arrangement is a safekeeping receipt.

**SECONDARY MARKET** – A market where certain securities may be bought and sold at prevailing market prices after their initial distribution but before their state maturity date.

**TREASURY BILLS** – Short-term marketable securities issued by the U.S. Treasury and secured by the Federal Government and have maximum liquidity.

**TREASURY NOTES AND BONDS** – These are direct obligations of the U.S. Government with maturities from one to ten years on the notes and 10 to 30 years on the bonds.

**YIELD** – The rate of annual return on an investment expressed as a percentage.