



August 29, 2016

Report to Council and City Manager

Submitted by: Brian Carlson, Finance Director

Re: June Permanent Fund Transactions

SUMMARY:

During the month of June, staff initiated a number of Permanent Fund transactions, representing:

- Annual or periodic rebalancing pursuant to Investment Policy Statement
- Liquidations to fund the 1.5% annual General Fund operating appropriation
- Initial investment in a new/additional real estate fund manager (Morgan Stanley)

The timing of one of the liquidations (UBS Real Estate, July 1) was not aligned with a deadline associated with the new Morgan Stanley investment (June 29). In addition, staff was informed by UBS that the July 1 liquidation would raise only one-third of the requested total of \$6 million, with the balance to be remitted at the end of September.

These factors created an imbalance between the Permanent and General funds, as well as a number of issues pertaining to policies and procedures, authority, and efficient use of invested city funds. This report will detail the timeline and the steps taken, the policy implications, and a preview of the proposed remedial actions to be addressed via policy modifications and/or future council action.

BACKGROUND:

Rebalancing: The Permanent Fund assets are allocated among several asset classes, such allocation being governed by the *Investment Policy Statement (IPS)*. The IPS allocations are expressed as *targets* and *limits*. Re-balancing transactions are typically initiated annually.

1.5% Appropriation: Pursuant to City Charter, 1.5% of the Permanent Fund value is annually appropriated to the General Fund for operations. The 2016 appropriation totals \$2.56 million.

New Real Estate Investment (Morgan Stanley): Late in 2015, the Permanent Fund Committee recommended further diversification of its real estate holdings by liquidating approximately

half of its *UBS* investment, and investing \$8.5 million with Morgan Stanley. Unlike ordinary mutual funds, securitized real estate investments like *UBS* and Morgan Stanley often have a queue for new or additional investments (*nine months in this instance with Morgan Stanley*), and often require advance notice of liquidations (*two months in this instance with UBS*).

All of the above-referenced transactions were scheduled to be concluded at the end of June.

TIMELINE:

June 7 – Staff detailed the transactions and expected timeline to the Permanent Fund Committee, with the usual caveat that the final amounts may change slightly to reflect the ongoing daily price fluctuations between June 7 and June 30.

June 8 – Staff is notified by *Morgan Stanley* that the investment deadline is June 29.

June 13 – Staff is notified by *UBS* that the redemption proceeds will settle on July 1, and that of the requested \$6 million redemption, only \$1.6 million will be remitted, with the balance remitted at the end of third quarter.

June 30 – All transactions except for the *UBS* redemption are complete. The net of the rebalancing, general fund appropriation and new investment leaves an imbalance between the Permanent and General funds, represented as a PAYABLE and RECEIVABLE, respectively, in the amount of \$6.46 million.

July 1 – *UBS* remittance of \$2.06 million (not \$1.6 million) is received. This reduced the imbalance to \$4.4 million.

ANALYSIS:

The scenario described above left staff with a number of problematic options, including:

1. **Postpone the Morgan Stanley Investment** – this would have put the City back in the queue for new investments, and any gains or losses during the new queue period would be foregone by the Permanent Fund. It would also impact Morgan Stanley's scheduled cash flows, as the City had committed to the new investment nine months earlier.
2. **Float the new investment from other Permanent Fund liquidations:** this would involve either a follow-up meeting with the Committee prior to June 28th, or a unilateral action by the Finance Director. It also would establish variances from the allocation *targets*.
3. **Float the new investment from the General Fund and review with Permanent Fund Committee at a follow-up meeting:** This was the route chosen by staff, as it resulted in the least impact to the underlying funds. The PAYABLE and RECEIVABLE are booked to the Permanent and General funds, respectively, and are cancelled upon receipt of the outstanding liquidation requests.

POLICY IMPLICATIONS

This scenario and the resulting transactions reveal policy implications which were discussed during the Permanent Fund Committee meeting. Of primary concern was whether the Finance Director has the authority to create a RECEIVABLE, effectively a loan to the Permanent Fund, or whether Council can do the same, as it is arguably *debt*. Other issues include whether the General Fund should receive interest for the transaction from the Permanent Fund, and where authorization and governing language for such transactions reside.

Attempts to resolve these questions prior to the transaction deadlines would have necessitated some other course of action (*1 or 2, above*).

NEXT STEPS:

Though it was not explicitly agreed to or recommended by the Permanent Fund Committee, Staff will immediately initiate additional liquidations from Permanent Fund sub-accounts sufficient to eliminate the PAYABLE to General fund. This can be done while remaining within the allocation *limits* established in the IPS, though the *targets* will be missed until October when the outstanding UBS liquidation request is remitted in full.

Staff will also review pertinent code, charter, policy, and IPS language, and will propose changes to same so as to clarify procedures in such a situation, despite the circumstances being unusual and unlikely to repeat.

Initial review of procedures suggest that clarifying language can be added to distinguish between investments that are immediately liquid (open-market vehicles) and those that are not (subscription-based vehicles), with explicit instruction to absorb any imbalance *only* from other Permanent Fund investments. Staff will try to include this discussion along with adoption of the revised IPS on the September 20th agenda.