City of Albuquerque, New Mexico
Albuquerque/Bernalillo County Water Utility Authority

Annual Investment Report

Fiscal Year Ended June 30, 2009

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Preface

The City of Albuquerque Treasury Division manages the cash assets of both the City and the Albuquerque/Bernalillo County Water Utility Authority in a commingled pool. While recognizing that during fiscal year 2009 approximately one-third of the portfolio's assets at a given time were property of the Water Utility Authority, for brevity all references herein to ownership and management are to the City only.

City of Albuquerque Investment Strategy

The City seeks to balance three primary objectives for its cash portfolio – maintaining sufficient liquidity to meet financial obligations, earning a market rate of return (subject to permitted investment constraints), and diversifying investments among asset classes to ensure safety of principal. The liquidity goal is achieved by matching investment maturities with the expected timing of obligations. Attainment of a market return is measured by benchmarking the portfolio against a relevant index, such as an appropriate Treasury yield. Finally, diversification (safety) is accomplished through implementation of a strategic asset allocation, derived from modern portfolio theory concepts.

The City consolidates cash from various sources into an internal investment pool, known as fund 920. The City's investment strategy is guided by its investment policy. The policy mandates allowable fixed income asset classes into which City Treasury may invest excess cash. These allowable classes, derived primarily from Section 6-10-10 NMSA 1978, are U.S. Treasuries, U.S. agency securities, as well as repurchase agreements, money market funds, and CDs fully collateralized by U.S. Treasury or agency securities.

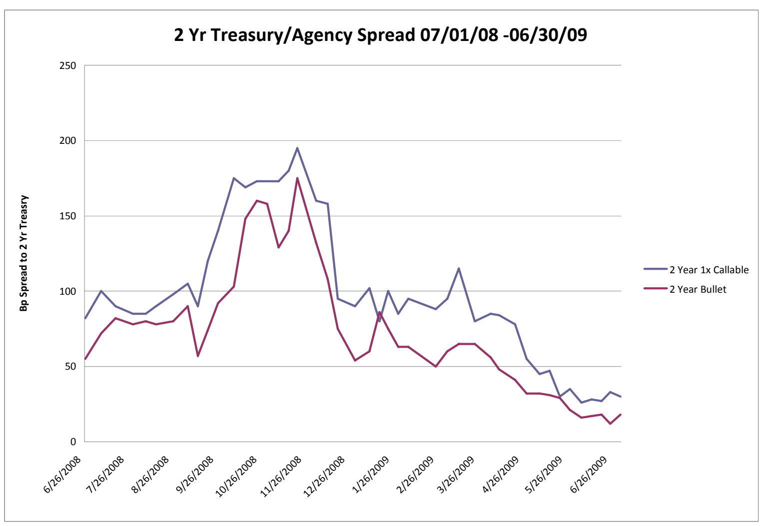
For fiscal year 2009 and beyond, the City bifurcated its portfolio into two components – a Core segment and a Liquidity segment. The Core segment represents a more permanent asset balance, and thus is actively managed based on the City's capital market expectations, in order to optimize total return. Note that the total return computation, unlike nominal yield, incorporates unrealized gains and losses. The Core segment is benchmarked to the 0-3 year U.S. Treasury index. The Liquidity segment is structured foremost to meet cash obligations as they become due. The City cash-matches short-term investments to known capital expenditure requirements, while maintaining a pool to cover daily operations. In addition, the City aspires to achieve a competitive yield on cash.

Market Review & Portfolio Status

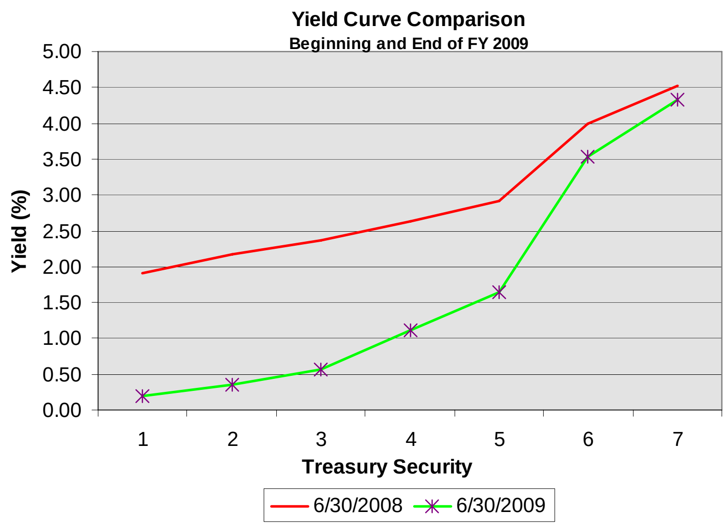
Fiscal year 2009 witnessed the deepening of the worst U.S. recession in almost thirty years. In the fall of 2008 credit markets froze as Bear Stearns, Lehman Brothers, Washington Mutual, and other stalwart financial firms failed, primarily due to exposure to uncollateralized mortgage-backed securities. Investors reacted with a flight to quality by purchasing Treasury securities, thereby driving their prices up and their yields down to levels not seen in fifty years. In September and again in December the 90-day T-bill actually traded at a negative yield during a few trading days.

Meanwhile, the Fed attempted to stimulate the economy by driving down the target Funds rate from 2.00% on 7/1/2008 to effectively 0% by mid-December. It remained at that level throughout the fiscal year.

As the Fed Funds and Treasury rates plummeted, Agency yields declined as well, but not as dramatically. This phenomenon opened up historically large spreads between Agency and Treasury yields of like maturities, as investors viewed Agencies as carrying a credit risk component due to the troubled status of FNMA and FHLMC. As these spreads swelled to well over 100 bps in the 2-year sector, the City seized on this tactical opportunity to capture relative value by buying one- to three-year Agency notes. As spreads contracted in the latter half of the fiscal year, the City's portfolio value rose significantly. $2.9 million of gains were realized through securities sales, which added to interest income. At June 30, 2009 the portfolio held $1.8 million of unrealized gains on securities holdings.



It is evident from the chart above that spreads contracted severely by the end of the fiscal year, signaling the end of the buying opportunity. Meanwhile, the Treasury yield curve shifted dramatically downward during the year, typical of a recessionary environment. Note below that the curve became much steeper by fiscal year-end, however, as short yields remained historically low while long bond yields rose to approach their beginning of year levels. Although continued short-term Treasury demand was driven in large part by shaken confidence in the money markets, the subsequent recovery in market liquidity places considerable pressure on the short end of the curve. As such, during the last quarter of the fiscal year the City built up the Liquidity Segment by not reinvesting in the Agency or Treasury markets as notes were sold, called, or matured. Instead, the City parked much of the portfolio in collateralized bank deposit accounts, some of which provided yields competitive with the 2-year T-note. As fiscal year 2010 unfolds, the City is anticipating the opportunity to re-expand the Core Segment by investing in Agency and Treasury notes in the 2- to 5-year tranches at more competitive yields.



Note that as of June 30, 2009 the City held $6.6 million in a "reserve contingency fund" with the New Mexico State Treasurer's Office (STO). This amount represents the City's portion of the STO Local Government Investment Pool's (LGIP) undistributed position in the Reserve Primary Money Market Fund. Although the City expects to recover some of this amount, a portion is likely to be written down, which will result in a decrease in portfolio yield in fiscal year 2010.

At June 30, 2009 the City held an atypical amount of highly liquid instruments, such as collateralized certificates of deposit, bank money market funds, and overnight repurchase agreements. As Core component Agency notes matured or were called, the City found a declining number of attractive replacement opportunities. By June 30, $556.4 million was held in liquid instruments, with only $292.7 million in Agency and Treasury securities.

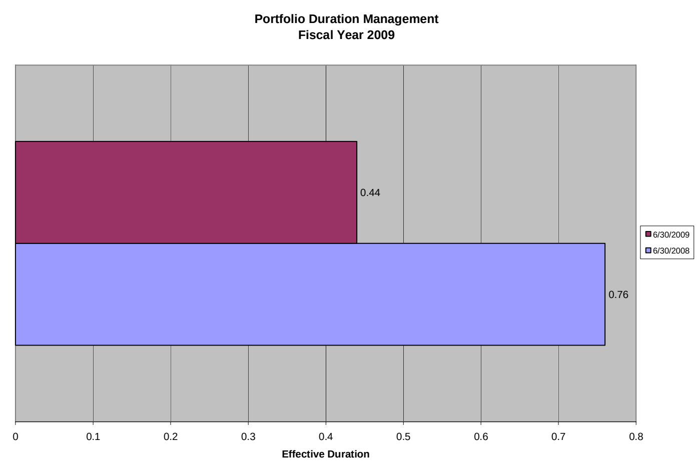
Discussion of Duration

Duration is preferred over weighted-average maturity of the portfolio as a measure of a fixed income portfolio's "life," because it measures the portfolio's sensitivity to changes in market interest rates. The higher the duration, the more acutely the market value of the portfolio will change as interest rates change.

At July 1, 2008 the effective duration of the Core component of the City's portfolio – "effective" meaning adjusted for the imbedded option held by issuers of callable securities – was 0.76 years. Note that the typical duration figure quoted is "modified

Macaulay duration," which ignores optionality. The City prefers the shorter effective duration measure, which reflects the higher reinvestment risk present when issuers have the option to call away a security prior to maturity when market rates decline. By June 30, 2009 Core component duration had decreased to 0.44 as Treasury and Agency yields had declined to the level that many portfolio securities were being called and little value was to be found in replacement securities.

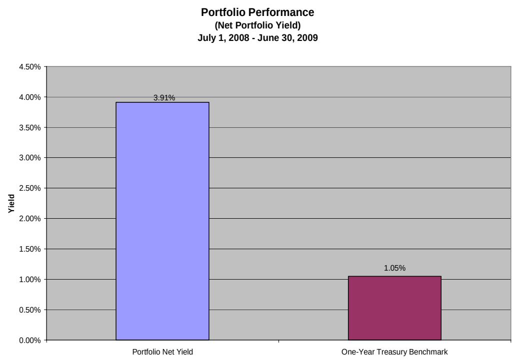
As an example of the impact of duration on portfolio value, consider the long-term target City Core component value of $500 million. Holding other risk factors such as credit quality constant, assume that immediately all market rates increased in a parallel fashion by 1%, or 100 basis points. If the portfolio's duration was 2.0, its value would decrease by $8 million to $490 million. At the City's current effective Duration of 0.44, portfolio value falls by only $2.2 million to $497.8 million. Of course, a decrease in market rates would result in the longer-duration portfolio increasing more in value. However, based on current yield levels (one-year Treasury yield around 0.50%) and other macroeconomic factors, the City believes the likelihood of an increase in interest rates over the next year is higher than either a decrease or status quo.

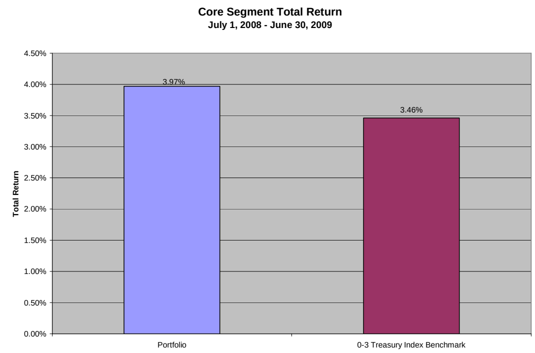


Portfolio Performance

For the year ended June 30, 2009 the portfolio's net yield was 2.91%, exceeding the benchmark average one-year Treasury benchmark yield of 1.05% by 186bps. Note that this yield reflects treatment of realized gains on Agency note sales as interest income. Portfolio out-performance was driven by the success of the City's tactical management as Treasury yields plummeted in the face of the deep recession.

Another measure of performance, which serves as the primary yardstick for the Core segment, is Total Return. Whereas yield measures focus on income received as a proportion of the amount invested, total return takes into account unrealized gains and losses on holdings resulting from market interest rate changes. Since short and intermediate term rates declined throughout the year, the City's agency holdings rose in value. As stated earlier, the City has chosen the U.S. Treasury 0 to 3-Year Index as the relevant total return benchmark. The Core component total return for the fiscal year ended June 30, 2009 was 3.97%, vs. 3.46% for the benchmark.





Portfolio Strategy for FY 2010

The largest investment risks facing the City as it moves into FY 2010 are reinvestment risk and price risk. Since most of the Core component's Agency holdings are callable, if the current market rate environment prevails these issues will be called away and the proceeds invested at lower yields. Conversely, if yields rise during FY 2010 (which we expect) the portfolio's market value will decline as the prices of security holdings fall. In anticipation of yield increases the City is keeping portfolio duration very short and has established price targets for purchasing Agency and Treasury notes in various maturity tranches. We also are monitoring Agency spreads to capture relative value if spreads widen to larger than equilibrium levels. Further, the City is exploring the possibility of investing in non-traditional permissible asset classes, such as commercial paper, money market mutual funds, and CDARS. Overall, the investment goal for the year is to exceed the benchmark yield while maintaining the portfolio's market value above book value.