

#### MEMORANDUM

Date: February 23, 2012

**To:** California State Lottery Commission

From: Robert T. O'Neill

Director

**Prepared By:** Michael Ota, Deputy Director of Finance

Subject: Item 9(e) - Lottery Investment Strategy and Investment Policy

### <u>ISSUE</u>

Pursuant to the California State Lottery's (Lottery's) Investment Policy, the Lottery is required to annually present its investment strategy and Investment Policy to the California State Lottery Commission (Commission) for approval.

- 1. Should the Commission approve the Lottery's investment strategy for 2012 as summarized below?
- 2. Should the Commission approve the amendments to the Lottery's Investment Policy as summarized below?

#### RECOMMENDATION

- Lottery staff recommends the Commission approve an investment strategy that focuses on 1) on-going investment activity in support of SuperLOTTO Plus®, MEGA Millions® and various Scratcher® games and 2) maintenance of the Lottery's Investment Portfolio that includes monitoring and mitigating potential investment risk.
- Lottery staff recommends the Commission approve amendments to the Lottery's Investment Policy to replace references to investment "portfolio restructuring" with broader language that reflects the Lottery's current investment strategy.

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### **BACKGROUND**

As part of the Lottery's on-going investment activity in support of SuperLOTTO Plus, MEGA Millions and various Scratcher games, the Lottery purchases U.S. Treasury securities to fund future payments to jackpot winners electing the annuity prize option. The U.S. Treasury securities are owned and managed by the Lottery within a single annuity prize portfolio (Investment Portfolio) held with the State Treasurer's Office.

On January 29, 2009, the Commission approved an amendment to the Investment Policy that expanded the list of permitted investments for the Lottery's Investment Portfolio to include U.S. Agency and Municipal securities. This approval allowed Lottery staff to restructure its Investment Portfolio with higher yielding investments for the purpose of reducing investment costs and increasing resources to drive higher sales of Lottery products.

The restructuring of the Lottery's Investment Portfolio was completed in June 2010. No additional investment restructuring is contemplated for the near future. The restructuring efforts were performed under the guiding principles of prudent investing and industry practices for the investment of funds managed by a public entity. These guiding principles and industry practices form the framework of the Lottery's investment strategy and portfolio management guidelines as set forth in a comprehensive Investment Policy adopted by the Commission on December 17, 2009 and amended on December 9, 2010.

The Lottery's Investment Policy requires that the Commission review and adopt, by vote, its Investment Policy and investment strategies not less than annually, including the approval of any changes to the Investment Policy.

The discussion below explains the proposed investment strategy for 2012 and minor revisions to the Investment Policy that are being requested for approval by the Commission.

## **DISCUSSION**

### **Investment Strategy for 2012**

On December 9, 2010, the Commission approved an investment strategy for 2011 that focused on 1) the management of on-going investment activity in support of SuperLOTTO Plus, MEGA Millions and various Scratcher games and 2) maintenance of the Lottery's Investment Portfolio that includes monitoring and mitigation of potential investment risk.

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The Lottery purchases U.S. Treasury securities, facilitated by the State Treasurer's Office, to fund future prize payments for annuity prizes. The Lottery's investment in U.S. Treasury securities is a standard business practice for SuperLOTTO Plus, MEGA Millions and various Scratcher games and represents the Lottery's on-going investment activity.

Investment transactions related to maintenance of the Investment Portfolio shall be consistent with industry practices and are limited to ad hoc transactions required for risk management purposes. Investment transactions required to manage risk include discretionary reinvestment of existing securities resulting from credit related events or mandatory calls, rebalancing of investments for purposes of maintaining diversification and managing the Lottery's prize liability reserve.

Lottery staff recommends the Commission approve continuance of the Lottery's 2011 investment strategy for 2012.

### **Investment Policy Amendments**

The Lottery's Investment Policy requires an annual review of the policy to ensure it upholds the Lottery's mission to supplement funding for education. The Investment Policy also requires evaluation and monitoring of the investment portfolio for credit risk and reinvestment risk.

Lottery staff conducted its annual review of the provisions of the Investment Policy and reaffirmed that the guidelines and industry practices specified by the policy are consistent with current principles of prudent investing and standards for the investment of funds managed by a public entity. Additionally, Lottery staff confirmed all of the investments in the Lottery's portfolio are in compliance with the provisions of the Investment Policy. Therefore, no substantive changes to the Investment Policy are proposed.

However, Lottery staff recommends a minor revision to Section X (Reporting) of the Investment Policy. Section X specifies, "A comprehensive report of the Investment Restructuring Program including, but not limited to, related investment activity shall be presented no less than annually to the Commission."

Lottery staff proposes an amendment to Section X of the Investment Policy to replace the reference to a "comprehensive report of the Investment Restructuring Program" with "Annual Investment Portfolio Report". The change is requested because the Lottery essentially closed out the Investment Restructuring Program in June 2010 and does not anticipate any additional portfolio restructuring transactions at this time.

The "Annual Investment Portfolio Report" referenced in the proposed amendment shall present information on the on-going management of the Lottery's Investment

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Portfolio, including the utilization of industry practices to safeguard against potential investment risk. The proposed amendment maintains the requirement to report specific information on investment portfolio restructuring activity should the Commission authorize resumption of such activity in the future.

# Proposed Amendment 1 (as underlined):

An Annual Investment Portfolio Report including, but not limited to, information related to the management of investment risk and the disclosure of investment portfolio restructuring activity, if any, shall be presented to the Commission

Additionally, in the event the Lottery performs investment portfolio restructuring activity, the Lottery shall prepare or cause to be prepared a report affirming the sufficiency of the portfolio cash flow to meet prize payment obligations in connection with each investment portfolio restructuring transaction.

In addition, Lottery staff proposes an amendment to Section IX (Delegation of Authority and Responsibilities) of the Investment Policy. Under the description of responsibilities for the Chief Accounting Officer, staff proposes the words "portfolio restructuring" be replaced with "investment activity." The term "investment activity" broadens the responsibilities of the Chief Accounting Officer in a manner consistent with the Lottery's management of on-going investment activity and reduces the emphasis on investment "portfolio restructuring". This amendment maintains an appropriate level of accountability and control applicable to the responsibilities of the Chief Accounting Officer for a broad range of investment activity, including future portfolio restructuring if authorized by the Commission.

### **Proposed Amendment 2** (as underlined):

Oversees policy execution and ensures relevant investment reports associated with <u>investment activity</u> are reviewed for accuracy and sufficiency and transmitted timely to interested and impacted parties (e.g., State Treasurer's Office). The Chief Accounting Officer prepares annual financial statements that disclose the Lottery's <u>investment activity</u> and reflects the amount of proceeds generated from restructuring, if applicable.

Lottery staff recommends the Commission approve the proposed amendments to Section X (Reporting) and Section IX (Delegation of Authority and Responsibilities) of the Lottery's Investment Policy. A copy of the Investment Policy with the proposed amendments is included as an attachment to this memo.

Attachment