

MEMORANDUM

Date: January 28, 2009

To: California State Lottery Commission

From: Joan M. Borucki

Director

Prepared By: Michael Ota, Deputy Director of Finance

Subject: Item 9(g) – Annuity Investment Policy

ISSUE

Should the California State Lottery Commission (Commission) expand the financing vehicles for the payment of long-term prizes to include municipal and agency bonds?

RECOMMENDATION

California State Lottery (Lottery) Staff recommends approval of the use of municipal and agency bonds in addition to U.S. Treasury instruments to fund long-term prize payments.

BACKGROUND

The U.S. Treasury introduced Separate Trading of Registered Interest and Principal Securities (STRIPS) program in 1985. Each stripped component has a CUSIP (identification) and can be traded separately. The components of stripped Treasuries remain the direct obligations of the U.S. government. A newly issued 30-year Treasury bond can be split into 60 semi-annual coupon payments and 1 principal payment. Both the coupon and principal payments are backed by the full faith and credit of the United States

In 1985, the California Lottery Commission opted to purchase coupon strips.

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DISCUSSION

The California Lottery's investment portfolio exists to meet the payment obligations to our annuity prize winners. Since 1985, the Lottery has purchased zero coupon strips to fund the deferred prize payments. While U.S. Treasury bonds are the least risky instrument available to the Lottery, U. S. Treasury Bonds are not always the most cost effective means to fund the payment of long-term prizes.

The financial markets of late have experienced significant turmoil thus creating a high demand for treasury bonds. Due to the demand, the yields on treasuries have reached a 20 year low. These historic lows have driven the costs up on our investments as there is a lower return on zero coupon bonds.

Currently municipal and agency bonds have very attractive yields yet the Lottery can not utilize these additional instruments and take advantage of the unique market conditions. Although there is a small increase in the risk associated with municipal and agency bonds, the taxing authority and implied governmental promises to pay mitigates market risk. Municipal and Agency bonds are considered a safe investment, second only to U.S. Treasury bonds. Having the ability to leverage municipal and agency bonds can be a cost-effective funding solution as our prize costs can be reduced should the yields on the treasury bonds remain low in these uncertain economic times.

Flexibility in using different financing vehicles such as zero coupon, agency and municipal bonds will allow the California Lottery to minimize our costs and maximize our return when investing for our long-term prizes.