



M E M O R A N D U M

Date: December 9, 2010

To: California State Lottery Commission

From: Joan M. Borucki
Director

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Subject: Item 9(a) – Lottery Investment Policy and Strategy

ISSUE

The California State Lottery (Lottery) investment strategy and investment policy (Investment Policy) shall be reviewed annually and confirmed or amended by the California State Lottery Commission (Commission).

1. Should the Commission approve the Lottery's current investment strategy?
2. Should the Commission approve an amendment to the Investment Policy?

RECOMMENDATION

1. Lottery Staff recommends the Commission approve the Lottery's current investment strategy.
2. Lottery staff recommends the Commission approve an amendment to the Investment Policy as provided below.

Amendment:

The Commission shall review and adopt, by vote, its Investment Policy and investment strategies not less than annually. All changes to the Investment Policy must be approved by the Commission.

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 by the Lottery and managed by the Lottery within a single annuity prize portfolio (Investment Portfolio) held with the State Treasurer's Office.

In 2009, an opportunity arose to draw a significant amount of unrealized value that materialized in the Lottery's Investment Portfolio. As a global credit crisis engulfed the financial sector due to the deflation of a real estate bubble, the Lottery's investments in U.S. Treasury securities gained in value. Many investors seeking safety and stability flocked to securities issued and backed by the United States government, creating a "flight to quality and liquidity" premium for U.S. Treasury investments owned by the Lottery.

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 securities and Municipal securities. This approval allowed Lottery staff to restructure the Investment Portfolio with higher yielding investments for the purpose of reducing investment costs and increasing resources to drive higher sales of Lottery products.

On May 13, 2009 the Commission approved the award of a contract to Samuel A. Ramirez and Company (Ramirez & Co.) to act as the Lottery's investment advisor/agent in connection with the restructuring of the Investment Portfolio. Through a collaborative effort with Ramirez & Co., the Lottery restructured approximately 68% of the Investment Portfolio's original investments resulting in over \$60 million of investment savings.

The Portfolio Restructuring Project was officially completed in June 2010 with no additional restructuring planned in the near future. The restructuring efforts were performed under the guiding principles of prudent investing and best practices applicable to the investment of funds by public entities. These guiding principles and best 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.

Included in that Investment Policy is a requirement that the Commission review and adopt, by resolution, its Investment Policy and investment strategies not less than annually and the approval shall include any changes made to the Investment Policy.

DISCUSSION

Investment Strategy

With the completion of the portfolio restructuring in June 2010, Lottery staff proposes an investment strategy that is limited to 1) management of on-going investment activity and 2) maintenance of the investment portfolio, including but not limited to the monitoring and mitigation of potential investment risk.

The Lottery purchases U.S. Treasury securities, facilitated by the State Treasurer's Office, to fund future prize payments for annuity prizes. U.S. Treasury security transactions for SuperLOTTO Plus, MEGA Millions and various Scratchers represent the Lottery's on-going investment activity.

Investment transactions related to maintenance of the Investment Portfolio shall be 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 investment.

Lottery staff recommends the Commission approve the Lottery's proposed investment strategy as described above.

Investment Policy Amendment

Lottery staff reviewed the provisions of the Investment Policy and confirmed that the guidelines and best practices specified by the policy, including on-going investment activity and maintenance, are consistent with current principles of prudent investing and standards for the investment of funds by public entities. Additionally, Lottery staff confirmed all of the Investment Portfolio's investments are in compliance with the provisions of the Investment Policy. Therefore, no substantive changes to the Investment Policy are proposed.

However, Section XI. (Adoption of Investment Policy and Periodic Review) of the Investment Policy specifies, "The Commission shall review and adopt, by resolution, its Investment Policy and investment strategies not less than annually and the approving resolution shall designate any changes made to the Investment Policy."

Lottery staff proposes an amendment to the Investment Policy to remove the requirement of the Commission to approve the Lottery's investment strategies and investment policy by "resolution". The Commission's approval of investment

strategies and the Investment Policy, including amendments, would be accomplished by vote which is consistent with the manner in which the Commission approves all other actions proposed by the Lottery.

Proposed Amendment:

The Commission shall review and adopt, by vote, its Investment Policy and investment strategies not less than annually. All changes to the Investment Policy must be approved by the Commission.

No other amendments to the Investment Policy are proposed by Lottery staff at this time.

Lottery staff recommends the Commission approve the proposed amendment to Section XI. (Adoption of Investment Policy and Periodic Review) of the Investment Policy.