



M E M O R A N D U M

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Date: December 17, 2009

To: California State Lottery Commission

From: Joan M. Borucki  
Director

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Deputy Director of Finance

Subject: Item 9(a) – Investment Policy Revision

**ISSUE**

Should the California State Lottery Commission (Commission) approve the investment policy, as amended?

**RECOMMENDATION**

California State Lottery (Lottery) staff recommends approval of the investment policy, as amended (Investment Policy), to provide Lottery staff with a comprehensive guide with respect to the management of the annuity prize investment portfolio.

**BACKGROUND**

The Commission approved a previous amendment to the investment policy on January 29, 2009 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 for the purpose of reducing the costs of investments 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, Inc. (Ramirez & Co.) to act as the Lottery's investment advisor/agent in connection with the investment portfolio restructuring. At this time, the Lottery also clarified the specific types of U.S. Agency securities and municipal securities that would be considered for the investment portfolio restructuring effort.

## ***Attachment I***

### **California State Lottery Investment Policy**

#### **I. Statutory Authority**

Pursuant to Government Code Section 8880.25.5, the Lottery Commission may invest funds on deposit in the State Lottery Fund within or outside the State Treasury System and purchase and sell securities, including entering into bond purchase agreements with the state to purchase state general fund obligations, or invest in other evidence of indebtedness issued by the state, including but not limited to, notes or warrants.

#### **II. Scope**

The scope of this investment policy applies to funds held in the State Lottery Fund, including funds invested to provide for future payments to annuity prize winners and funds invested in a reserve fund for future payments to annuity prize winners.

#### **III. Investment Objective**

The California State Lottery (Lottery) shall invest funds in the State Lottery Fund utilizing prudent investor standards.

The principle objectives of the Lottery's investment program are safety of principal and timeliness of payments to Lottery prizewinners. Investments shall be undertaken in a prudent manner that seeks to ensure the preservation of capital within the overall portfolio, while mitigating credit, reinvestment, and interest rate risk. The Lottery's investment portfolio shall be structured so that investments mature in amounts sufficient to meet required prize payouts on dates immediately prior, or as near prior as practicable, to prize payment dates.

This Investment Policy is also driven by the goal to utilize the resources from the Lottery's investment portfolio to the maximum benefit of public education. The Lottery shall seek opportunities to enhance the financial return of the Lottery's

investment portfolio that are consistent with the principle objectives of the Lottery's investment program.

#### **IV. Permitted Investments**

Pursuant to the approval of the Lottery Commission, permitted investment securities (Permitted Investments) shall include fixed rate debt obligations in the following categories:

- U.S. Treasury Obligations (direct or fully guaranteed obligations)
- U.S. Agency Securities including, but not limited to, securities issued by the Government National Mortgage Association, Small Business Administration, Farm Credit system, Financial Assistance Corporation, Department of Housing and Urban Development, Export-Import Bank, and Overseas Private Investment Corporation, Federal Home Loan Bank System, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Tennessee Valley Authority, Farm Credit System, Financing Corporation, and the Resolution Trust Funding Corporation.
- State and Local Government Municipal Securities (Municipal Securities) in the following categories:
  1. State General Obligation bonds backed by full faith and credit (unlimited tax-backed bonds) with investment-grade ratings
  2. State issued bonds backed by faith and credit (limited tax-backed bonds) with ratings of double A (without respect to modifiers) or higher by Fitch, Moody's or Standard and Poor's
  3. General Obligation bonds of a county or local governmental entity with ratings of double A (without respect to modifiers) or higher by Fitch, Moody's or Standard and Poor's
  4. Revenue bonds of a state, county, city or other political subdivision or authority rated double A (without respect to modifiers) or higher by Fitch, Moody's or Standard & Poor's

#### **V. Credit and Reinvestment Criteria**

In the event an investment security held by the Lottery is subject to a rating change that brings it below the minimum credit ratings specified under Section IV. (Permitted Investments) of this Investment Policy, the Deputy Director of Finance or the Chief Accounting Officer shall determine the course of action to be followed on a case-by-case basis, considering such factors as the reason for the ratings change, prognosis for recovery or further rating downgrades and the market price of the investment security.

In the event an investment security held by the Lottery is called prior to maturity, the Lottery shall reinvest the proceeds in a security specified under Section IV. (Permitted Investments) of this Investment Policy in an amount sufficient to meet required prize payouts on dates immediately prior, or as near prior as practicable, to prize payment dates.

## **VI. Credit and Reinvestment Risk Management**

The Lottery shall evaluate and monitor its investment portfolio for credit risk and reinvestment risk associated with a credit rating downgrade or exercised call and shall ensure that levels of credit and reinvestment risk inherent to the types of securities in the investment portfolio are managed or cause to be managed within the Lottery's risk tolerance.

The Lottery's Permitted Investments includes U.S. Treasury Obligations backed by the full faith and credit of the United States and U.S. Agency Securities (Agency Securities) possessing an implicit guarantee by the United States. U.S. Treasury Obligations and Agency Securities are generally viewed to possess minimal Credit Risk, if any. The Lottery's Permitted Investments also includes Municipal Securities with inherent credit and reinvestment risk and the Lottery shall mitigate such credit and reinvestment risk from available funds in the Lottery's administrative expense budget. At the election of the Lottery, a credit reserve fund may be established to serve as an additional financial resource to mitigate credit and reinvestment risk.

## **VII. Diversification of Investments in Municipal Securities**

For purposes of diversification, the Lottery's investments in Municipal Securities shall be subject to the following investment allocation limits based on fair market value:

- Securities of a single local municipality or issuer (e.g. a County, City or Authority) shall not exceed 5% of the total portfolio at the time of purchase. Investment allocation limits shall not apply to securities issued by the State of California.
- Securities of issuers located in a single state shall not exceed 10% of the total portfolio at the time of purchase. Investment allocation limits shall not apply to securities issued by the State of California.

Should the fair market value of an investment in a Municipal Security exceed the applicable investment allocation limits specified in this Investment Policy, the Deputy Director of Finance or the Chief Accounting Officer shall determine the course of action to be followed on a case-by-case basis.

### **VIII. Portfolio Restructuring**

Pursuant to Lottery Policy and within the scope of the California Lottery Act, the Lottery may restructure the Lottery's investment portfolio in order to increase investment returns and generate funds in excess of the portfolio requirements to pay prizes.

Investments resulting from the restructuring shall be competitively bid, but in no case shall the sum of the investments be less than annual prize obligation due annuity prize winners.

Except for opportunities that will utilize the resources from the Lottery's investment portfolio to the maximum benefit of public education, the Lottery shall hold all securities obligated to prize liabilities to maturity.

### **IX. Delegation of Authority and Responsibilities**

The Lottery Commission has authorized the Lottery Director to carry out all activities necessary to comply with this Investment Policy.

#### **Delegation of Authority:**

Pursuant to the delegation authority of the Lottery Director, the Deputy Director of the Finance Division and the Chief Accounting Officer are authorized to approve portfolio restructuring transactions proposed by the Lottery's financial consultant (Financial Consultant) and to approve the appropriate transaction materials including bid/offer/security swap forms.

#### **Responsibilities:**

**Commission:** Provides guidance and direction regarding the utilization of net proceeds resulting from the management of the Lottery's investment portfolio. Such guidance shall be in accordance with the purpose and intent of the California State Lottery Act.

**Director:** Maintains fiduciary responsibility over the Lottery's investment portfolio, transactions and proceeds. The Director shall supervise and administer all

policies related to the funding of annuity prize payments and the restructuring of the Lottery's investment portfolio per Commission guidance and direction.

Deputy Director of Finance: Manages the Lottery's investment program. The Deputy Director of Finance develops the annual budget and executes investment strategies to generate the anticipated net proceeds. This includes authorizing the sale and purchase of securities that meet Commission-approved investment parameters. The Deputy Director of Finance reviews the investment policy on an annual basis to ensure all amendments are incorporated and ensures the current policy upholds the Lottery's mission to supplement funding for education.

Chief Accounting Officer: Oversees policy execution and ensures all relevant investment reports associated with portfolio restructuring are reviewed for accuracy and sufficiency and transmitted timely to interested and impacted parties (e.g., State Treasurer's Office). The Chief Accounting Officer ensures all related accounting transactions are recorded in accordance with Generally Accepted Accounting Principles and are consistent with Article 7 of the Lottery Act pertaining to the State Lottery Fund. The Chief Accounting Officer prepares annual financial statements that disclose the Lottery's portfolio restructuring and reflects the amount of proceeds generated from restructuring. This officer also ensures the timely transfer of net proceeds to the California State Lottery Education Fund, as prescribed in Government Code Section 8880.65 of the Lottery Act.

Investment Officer: Maintains responsibility for the daily operations of the investment program and ensures all related activities are performed in accordance with established policies and internal controls for the program. The Investment Officer oversees policy execution, reviews and manages the Lottery's investment portfolio, evaluates market conditions and provides management with an analysis of the current portfolio and the individual trades previously executed.

All participants in the investment process shall seek to act responsibly as custodians of public funds. The Investment Officer will avoid any transaction that might impair public confidence in the Lottery. The investment program shall be designed and managed with a degree of professionalism which is worthy of that public trust.

## **X. Reporting**

A comprehensive report on the Investment Restructuring Program including, but not limited to, related investment activity shall be presented not less than annually to the Commission.

Additionally, 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 portfolio restructuring transaction.

**XI. Adoption of Investment Policy and Periodic Review**

Investment Policy Adoption:

The Director of the Lottery or designee (including the Deputy Director of Finance, Chief Accounting Officer and Investment Officer) may propose policy changes to the Commission at any time. 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.

Periodic Review:

This Investment Policy shall be reviewed annually and confirmed or amended by the Commission.

**PASSED AND ADOPTED ON THE \_\_\_\_\_ DAY OF \_\_\_\_\_, 2009.**

**APPROVED BY:**

\_\_\_\_\_  
DEPUTY DIRECTOR FOR FINANCE, CALIFORNIA STATE LOTTERY

\_\_\_\_\_  
DATE

The Lottery has collaborated with Ramirez and Co. to further amend the Lottery's Investment Policy to provide clear and comprehensive guidelines for managing the Lottery's investments. The revised Investment Policy is presented as Attachment I of this issue memo.

## **DISCUSSION**

The principal objectives of the Lottery's investment program are safety of principal and timeliness of payments to Lottery prizewinners (i.e. ensuring investments provide the necessary cash flow to fund annuity prize payments.) Within this framework, and with Commission approval, the Lottery revised its Investment Policy to take advantage of opportunities to reduce the cost of investments and increase resources available to drive higher sales of Lottery products.

The Lottery has restructured portions of its Investment Portfolio by divesting existing investments in U.S. Treasury obligations and purchasing U.S. Agency securities and municipal securities. The specific types of instruments eligible for consideration for the Lottery's Investment Portfolio are delineated in the Investment Policy under "Permitted Investments" and are limited to what are considered to be the safest types of bond investments.

Investments in U.S. Treasury obligations and U.S. Agency securities are generally viewed to carry minimal risk. However, while the municipal securities asset class is considered to be among the safest investments, there are risks inherent to investing in municipal securities that are not present with U.S. Treasury obligations and U.S. Agency securities. Therefore, the Lottery has proposed amendments to the Investment Policy to manage risk within the Investment Portfolio. The amendments to the Investment Policy were developed in collaboration with Ramirez and Co. and incorporate best practices for the management of a public fund.

### **Types of Risk**

The proposed amendments to the Investment Policy address two types of risk – credit risk and reinvestment risk.

Credit risk is tied to the possibility that the issuer of an investment fails to make a payment of principal or interest within the scheduled time. In this case, the Lottery would be required to take action to restore the scheduled cash flow for annuity prize payments.

Reinvestment risk is present under two scenarios. The first scenario contemplates a situation where the Lottery held investment's credit rating falls below a minimum rating and the Lottery elects to sell the investment. The second scenario involves when an investment is "called" or paid back in full prior to the original maturity. In both cases, the Lottery would be required to reinvest proceeds from the original investments to restore

the scheduled cash flow for annuity prize payments. The possibility exists that the Lottery would be subjected to higher investment costs at the time of reinvestment.

While both types of risk are minimal for the Lottery's "Permitted Investments," the amended Investment Policy addresses how those risks will be assessed and mitigated.

### Mitigation of Risks

The general approach to mitigate risks for the Lottery's investments is a "buy and hold" strategy. This means one of the primary goals of the investment portfolio restructuring efforts is choosing instruments that are intended to be held until maturity. In addition, the proposed Investment Policy addresses credit and reinvestment risk by prescribing the best practices described below.

Credit risk is managed by requiring investments to have a minimum credit "rating" based on the nationally recognized rating agencies Fitch, Moody's and Standard and Poor's. As an example, the Investment Policy proposes that for municipal securities, local government issuers must have a minimum credit rating of "double A" and state issued General Obligation bonds must have a minimum credit rating of "triple B."

Credit risk and reinvestment risk is also managed through diversification of the investment portfolio. This can be achieved by limiting the concentration of investments of a specific issuer or within a geographic area. The Investment Policy proposes diversification by establishing investment limits in municipal securities by issuer (5% of the investment portfolio) and geographic location/state (10% of the investment portfolio).

The investment guidelines described above are designed to limit the Lottery's risk exposure. However, these guidelines do not eliminate all financial risks. The Investment Policy proposes two methods of mitigating credit risk and reinvestment risk to ensure funds are available to pay annuity prize winners. The first strategy is to utilize the Lottery's administrative expense budget as the backstop to restore the cash flow for annuity prize winners should there be a financial event that requires replacement of investment instruments in the Lottery's portfolio.

The second strategy is to establish a separate reserve fund to be managed as an additional financial resource to address credit risk and reinvestment risk. This strategy is considered a best practice for the management of public funds and is strongly recommended by the Lottery's financial consultant, Ramirez and Co. The option to establish a reserve fund has been incorporated in the Investment Policy. Lottery staff is currently working with Ramirez and Co. to develop a structure for a proposed reserve fund as well as a methodology to monitor and maintain an appropriate reserve amount.

Conclusion

Based on collaboration with Ramirez and Co. and an assessment of best practices for the investment of public funds, staff recommends approval of the proposed revisions to the Lottery's Investment Policy as presented in Attachment I.