

MEMORANDUM

Date: May 13, 2009

To: California State Lottery Commission

From: Joan M. Borucki

Director

Prepared By: Michael Ota

Deputy Director of Finance

Subject: Item 9(c) – Contract for Lottery Investment Advisor/Agent

<u>ISSUE</u>

Should the California State Lottery Commission (Commission) approve the award of a contract to Samuel A. Ramirez and Company Inc. to act as an investment advisor/agent for the California State Lottery (Lottery) and accept staff's clarification of the Lottery's amended investment policy?

RECOMMENDATION

Lottery staff highly recommends that the Commission approve the award of the contract to Samuel A. Ramirez and Company Inc. to act as an investment advisor/agent for the Lottery for an amount not to exceed \$4.0 million. The term of the contract will extend through June 30, 2011.

Lottery staff also highly recommends that the Commission accept staff's clarification of the Lottery's amended investment policy.

BACKGROUND

On March 25, 2009, the Commission approved revised Fiscal Year 2008-09 sales goals and the revised Fiscal Year 2008-09 budget for the Lottery. The revised budget reflected projected revenue of \$2.93 billion, only a 5 percent decline from \$3.2 billion estimated in the original Fiscal Year 2008-09 budget. As explained in March, the decline in sales was primarily attributed to the worst recession in a quarter century

combined with poor rollover luck (i.e. low level jackpot levels) in SuperLOTTO Plus® and MEGA Millions® draw games. The Lottery was able to reduce the impact of the draw games sales decline through the successful launch of the "Make Me a Millionaire®" television show, unveiling of our new and improved brand image, recruitment of new retailers in non-traditional trade styles, and focused marketing of the new show's accompanying Scratchers® tickets. The marketing activity that supported the "Make Me a Millionaire" products lifted sales for the entire Scratchers product line.

The revised Fiscal Year 2008-09 budget also included anticipation of \$40 million of additional revenue from the restructuring of the Lottery's investment portfolio. This additional revenue is critical for increasing sales in the current fiscal year by funding a \$5 Scratchers game and additional marketing. The ongoing restructuring is also vital for laying the foundation for increased sales in Fiscal Year 2009-10 and beyond by continuing to fund a \$5 Scratchers game, additional marketing, and business plan projects.

Lottery regulations require the investment of prize funds when the prize won results in regularly scheduled future payments. The Lottery's current investment portfolio is comprised entirely of U.S. Treasury bonds to pay over \$1.8 billion in prizes over the next twenty five years. An unusual opportunity to realize additional revenues through restructuring of the Lottery's investment portfolio is currently possible because of an anomaly in the current financial markets.

The financial markets have experienced significant turmoil, causing investors to seek the most liquid (easy to trade) investments including U.S. Treasury bonds. Due to this "flight to liquidity" the Lottery's currently held U.S. Treasury bond investments have greatly appreciated in value and were recently valued at historically high levels. This market condition creates an opportunity to increase investment returns and generate funds in excess of portfolio requirements by selling the currently held U.S. Treasury bonds and purchasing other high-credit quality, yet higher yielding investments.

On January 28, 2009, the Lottery Commission approved the use of municipal and agency bonds in addition to U.S. Treasury bonds to fund long-term prize payments. The flexibility to use these additional financing vehicles will allow the Lottery to take advantage of the current financial conditions to minimize costs and maximize returns of our investment portfolio.

The scope of investment alternatives, rapidly shifting market conditions, and the requirement to maintain an investment portfolio that guarantees a cash flow to pay prize obligations throughout the restructuring period combine to create a very complicated process that requires technical expertise and management information systems not

currently available within the Lottery. The Lottery pursued an investment adviser/agent with the expertise required to help develop a specific investment restructuring strategy and assist in executing the restructuring transactions.

DISCUSSION

Engagement of Samuel A. Ramirez and Company Inc.

Samuel A. Ramirez and Company Inc. (Ramirez & Co.) is a financial services firm that can offer the Lottery a team of professionals with recent and relevant experience helping governmental agencies restructure U.S. Treasury bond investment portfolios to achieve incremental investment returns while maintaining a high-credit quality criteria. Over the last four months, Ramirez & Co. has restructured approximately \$2 billion of investment portfolios for clients, including state-level agencies, authorities, and not-for-profit hospital systems.

Many of these engagements require the competitive sale of currently held government or government-backed investments and the purchase of new higher yielding but high-credit quality investments (i.e. agency and other government-guaranteed debt). Each of the engagements required strict compliance with sufficiency covenants, meaning the integrity of the investment portfolio had to always be sufficient to pay the defeased bond obligations (similar to the Lottery's policy of defeasing prize obligations with investments).

The Lottery proposes to engage Ramirez & Co. to provide advice and assistance in connection with restructuring of the Lottery's investment portfolio. These services are described in two categories.

The first category includes services as an investment advisor to assist the Lottery in developing the investment restructuring program and subsequent management of the program. The fee for these services totals \$400,000 that will be billed in two installments based on performance milestones. The initial \$200,000 will be paid upon completion of the Lottery's Fiscal Year 2008-09 investment portfolio restructuring goals. The remaining \$200,000 will be paid upon completion of the restructuring of the remainder of the Lottery's investment portfolio.

The second category of services Ramirez & Co. will provide includes representing the Lottery as bidding agent and broker-dealer in the restructuring of the current investment portfolio. The fees for these services are based on the par value and maturity length of the replacement investments that Ramirez & Co. would be assisting the Lottery to purchase.

The contract with Ramirez & Co. would provide for the bidding agent services and the broker-dealer services to be performed throughout the time period necessary to complete the restructuring of the Lottery's current investment portfolio. The total cost of these services would be dependent upon financial market conditions and the resultant strategies employed to maximize the value of the portfolio restructuring. Staff estimates that the total cost of bidding agent and broker-dealer services should be no more than \$3.6 million.

Lottery staff proposes the contract period with Ramirez & Co. to begin May 14, 2009 and end June 30, 2011. Lottery staff believes this period will allow adequate time to complete the restructuring.

Clarification of Lottery Investment Policy

The Commission approved an amendment to the Lottery's annuity investment policy at the January 29, 2009 Commission Meeting. The purpose of the amendment was to allow for the restructuring of our investment portfolio to reduce investment costs and realize a gain.

That January 2009 policy amendment expanded the types of investment instruments that the Lottery could utilize to fund future payments to our annuity prize winners. Prior to the amendment, the Lottery's policy limited investments to U.S. Treasury bonds. The policy was amended to include investments in agency and municipal bonds.

In preparation for trading under this investment policy, we have concluded that additional clarity is recommended for the Lottery's investment policy, identifying the wide array of municipal and agency bond offerings. The following definition of agency and municipal securities represents an updated definition of agency securities as recently adopted by a not-for-profit, tax-exempt corporation created by the Florida legislature. We recommend the Commission's approval of this language, summarized below, as a clarification of the Lottery's permitted investments under the category of agency and municipal securities.

Agency Securities

Agency securities are issued or guaranteed by a federal agency or other Government Sponsored Entity (GSE) acting under federal authority. Some GSE securities are supported by the full faith and credit of the United States. These include 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.

Other GSE securities receive support through federal subsidies, loans, or other benefits. For example, the U.S. Treasury is authorized to purchase specified amounts of securities issued by (or otherwise make funds available to) the Federal Home Loan Bank System, Federal Home Loan Mortgage Corporation, Federal national Mortgage Association, and Tennessee Valley Authority in support of such obligations.

A few GSE securities have no explicit financial support, but are regarded as having implied support because the federal government sponsors their activities. These include securities issued by the Farm Credit System, Financing Corporation, and Resolution Funding Corporation.

Notes issued through the U.S. Government Temporary Liquidity Guarantee Program, whose interest and principal payments are fully and unconditionally guaranteed by the Federal Deposit Insurance Corporation (FDIC) will also be considered agency securities.

Municipal Securities

Municipal Securities are issued by states, counties, cities, and other political subdivisions and authorities.