



# Return on Investment



ANNUAL INVESTMENT  
PORTFOLIO REPORT  
FISCAL YEAR 2018-19



California Lottery is an Enterprise Fund of the State of California





# California State Lottery

*Committed to enhancing education and supporting local communities*

## **Annual Investment Portfolio Report**

*For the Fiscal Year Ended June 30, 2019*

*Prepared by the Finance Division of the California Lottery*



# California State Lottery

Annual Investment Portfolio Report

For the fiscal year ended June 30, 2019

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March 1, 2020

To the California State Lottery Commission:

I am pleased to provide this Annual Investment Portfolio Report for the fiscal year ended June 30, 2019.

The California State Lottery (Lottery) carefully manages an investment portfolio that is designed to produce investment proceeds to fully fund scheduled payments to annuity prize winners. We keep our investment portfolio safe and secure by investing in strong credit quality investments and maintaining a well-diversified investment portfolio. The utilization of industry practices to manage investment risk ensures the Lottery's investments generate sufficient cash flow needed to fund payments to annuity prize winners.

Currently, our portfolio is comprised of 28.9% municipal bonds, 16.5% agency bonds, and 54.6% U.S. Treasury bonds. Our agency and municipal securities are heavily weighted to shorter durations which equates to each having a faster maturity rate than our holdings of U.S. Treasury bonds. The weighted average maturity for our U.S. Treasury bonds is 10.80 years compared to our agency and municipal bonds at approximately 4.57 years combined.

A vast majority of our jackpot winners continue to elect the cash option and as investments in our portfolio mature, we expect the portfolio to continue to contract in size. The fair market value of our portfolio is approximately \$832 million as of June 30, 2019.

Moving forward, we will continue to manage the risk, quality, and cash flow of the Lottery's investment portfolio to ensure timely annuity payments to our winners are met.

Sincerely,

A handwritten signature in black ink, appearing to read 'K. Law'.

Ken Law  
Investment Officer

## Risk Management

Lottery investments are always guided by prudent investor standards.

### ***Sufficiency of Cash Flow***

The primary objective of Lottery investments is to provide sufficient cash flow to meet annuity prize payment obligations in a timely manner. As a result, the Lottery ensures the investment portfolio is appropriately structured with safe and secure investments that consistently generate proceeds prior to scheduled annuity prize payments.

### ***Safety of Capital***

Safety of capital is another important investment objective of the Lottery. To ensure Lottery investments meet this objective, the Lottery's investment policy requires the use of industry practices for managing investment risk. These industry practices include requirements for strong credit quality and diversification of the investment portfolio.

### ***Strong Credit Rating Requirements***

The investment policy is designed to limit exposure to credit risk associated with investing in municipal securities. Credit risk is tied to the possibility that the issuer of a security fails to make payment of principal or interest within the scheduled time (default). To minimize the Lottery's exposure to a potential default, the investment policy specifies strong credit rating requirements for municipal securities.

The Lottery utilizes municipal credit ratings issued by Moody's, Fitch, or Standard and Poor's. The Lottery's investments are in compliance with credit ratings required by the investment policy.

#### *Moody's Credit Ratings for Investments in Municipal Securities*

Security Description	Moody's Credit Rating	Minimum Credit Rating*
<i>State General Obligation (G.O.) Bonds</i>		
South Carolina G.O. Bond	Aaa	Baa
Massachusetts G.O. Bond	Aa1	Baa
Oregon Pension Obligation Bond	Aa1	Baa
Washington G.O. Bond	Aa1	Baa
California G.O. Bond	Aa3	Baa
Connecticut G.O. Bond	A1	Baa
Illinois Pension Obligation Bond	Baa3	Baa
<i>State Issued Revenue Bonds</i>		
District of Columbia (DC) Income Tax Revenue Bond	Aa1	Aa
New York/New Jersey Port Authority Bond	Aa3	Aa
<i>Local Entity (City/County) Bonds</i>		
Clark County, Nevada G.O. Bond	Aa1	Aa
New York City Transitional Finance Authority Bond	Aa1	Aa
Chicago G.O. Bond	Ba1	Aa

\*Minimum credit ratings are at the time of purchase

## Risk Management (Continued)

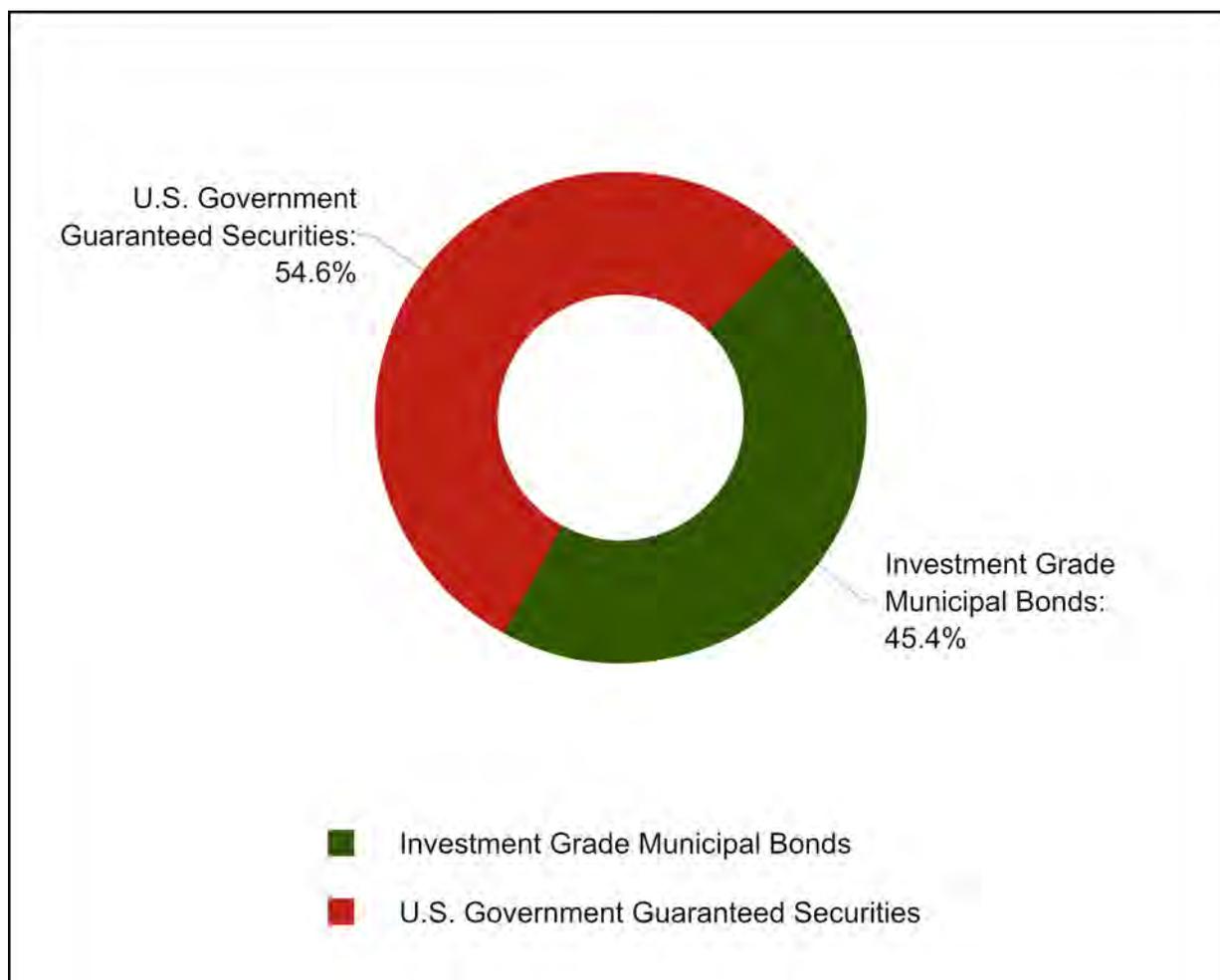
### *Safe and Secure Investments*

Lottery investments are strong credit quality securities that keep the investment portfolio safe and secure.

In addition to strong credit ratings, another indicator of an investment's credit quality is the source of funds available to repay the obligation (Repayment Pledge). Approximately 54.6% of Lottery investments are backed by a Repayment Pledge from the U.S. Government and are considered to be free from credit risk.

Lottery investments in municipal securities are primarily comprised of general obligation (G.O.) debt backed by the full faith and credit of the issuer. G.O. debt is generally considered to be one of the safest categories of municipal securities.

### Composition of Investment Portfolio by Repayment Pledge



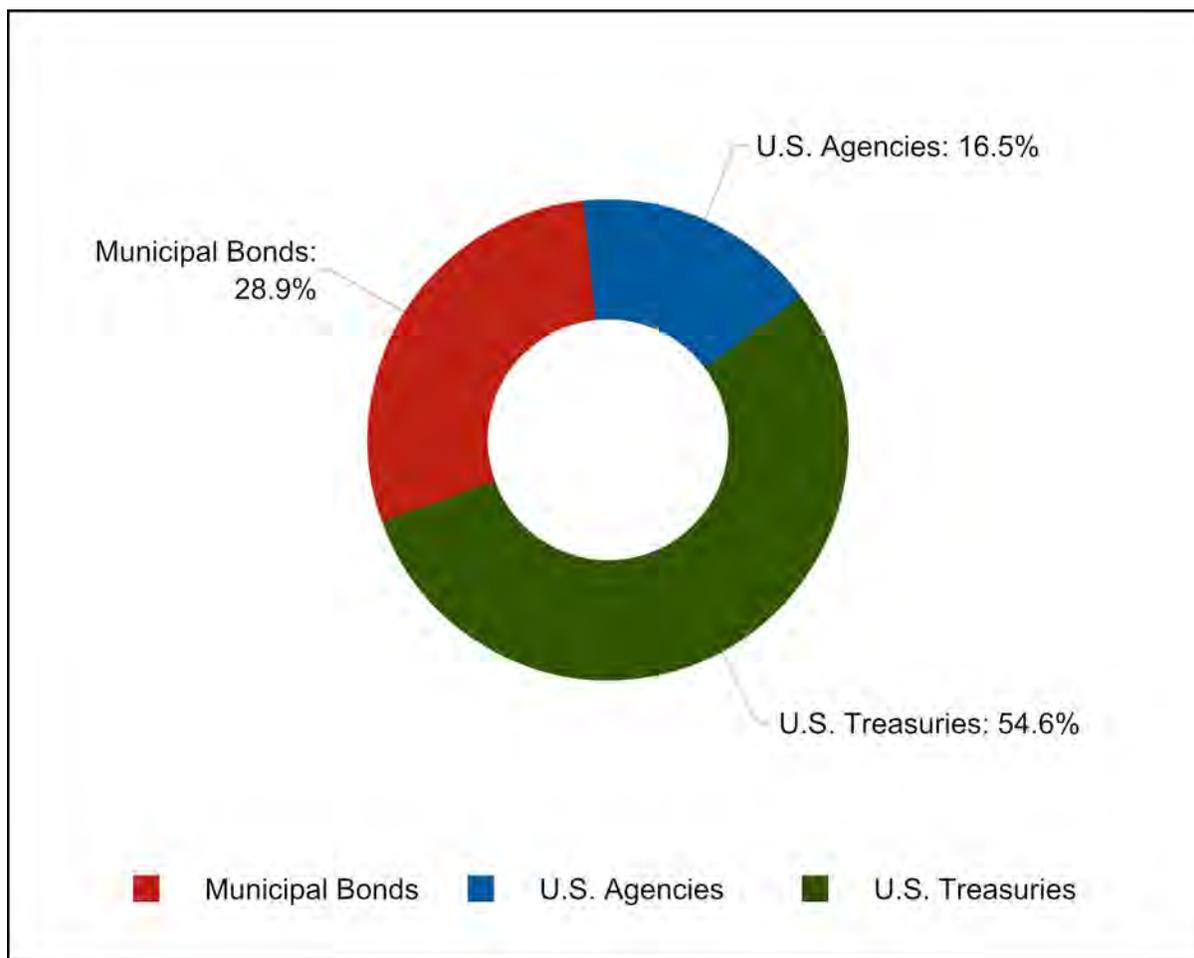
## Risk Management (Continued)

### *Diversification*

Another way the Lottery keeps the investment portfolio safe and secure is by the ownership of a variety of investment securities.

The Lottery's investment portfolio is well diversified with approximately 54.6% allocated to U.S Treasury securities, 16.5% allocated to U.S. agency securities, and 28.9% allocated to investment grade municipal securities. The weighted average maturities for our agency and municipal bonds are approximately 4.57 years; treasury securities are 10.80 years.

**Composition of Investment Portfolio**



## Investment Portfolio

The table below summarizes Lottery investments as of June 30, 2019. All holdings in the investment portfolio are in compliance with the Lottery's investment policy.

As of June 30, 2019, the Lottery's investments consist of the following:

<b>Security Description</b>	<b>Par Value</b>	<b>Cost</b>	<b>Fair Value</b>
<i>Short-Term Bonds*:</i>			
U.S. Treasury Bonds	\$20,045,000	\$17,821,178	\$19,870,625
U.S. Municipal Bonds	39,830,000	39,865,204	40,279,401
Short-Term Bonds Total	\$59,875,000	\$57,686,382	\$60,150,026
<i>Long-Term Bonds:</i>			
U.S. Treasury Bonds	\$572,891,000	\$330,015,941	\$434,412,970
U.S. Agency Bonds	152,025,000	73,318,112	137,161,326
U.S. Municipal Bonds	178,310,000	178,511,642	200,299,590
Long-Term Bonds Total	\$903,226,000	\$581,845,695	\$771,873,886
<b>Total Investments</b>	<b>\$963,101,000</b>	<b>\$639,532,077</b>	<b>\$832,023,912</b>

\*Short-Term securities mature within one year.

The Lottery's investments have weighted average maturities based on the final maturity dates of all investments as follows:

<b>Investments</b>	<b>Years</b>
U.S. Treasury Bond Holdings	10.80 years
U.S. Agency Bond Holdings	4.22 years
U.S. Municipal Holdings	4.91 years

The following table provides information about the Lottery's concentration of credit risk. It shows investments by any one issuer representing five percent or more of the Lottery's total portfolio, and not explicitly guaranteed by the U.S. government.

<b>Issuer</b>	<b>Cost</b>	<b>Fair Value</b>	<b>Percent of Total Portfolio</b>	<b>Moody's Credit Rating</b>
Commonwealth of Massachusetts	\$62,546,830	\$71,340,080	8.57%	Aa1

## Investment Portfolio (continued)

As of June 30, 2019, the fair value of the Lottery's investment portfolio expressed as a percentage of Moody's credit rating categories was as follows:

<i>Moody's Credit Rating</i>	<i>Fair Value</i>	<i>Percent of Total Portfolio</i>
Aaa	\$593,643,905	71.35%
Aa1	140,719,562	16.91%
Aa3	45,712,025	5.49%
A1	28,604,550	3.44%
Baa3	19,084,330	2.29%
Ba1	4,259,540	0.52%
Totals	\$832,023,912	100.00%

<i>Moody's Credit Ratings</i>	<i>Credit Ratings Definition</i>
Aaa	Highest Quality - Minimal Credit Risk
Aa	High Quality - Very Low Credit Risk
A	Upper Medium Grade - Low Credit Risk
Baa	Medium Grade - Moderate Credit Risk
Ba	Speculative Elements - Substantial Credit Risk

Note: Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Ba. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

As the Lottery adds new annuity winners, our focus remains to accumulate U.S. Treasury investments to fund annuitized prize payments. U.S. Treasury investments are guaranteed by the full faith and credit of the U.S. government and continue to add value to the investment portfolio. The Lottery offers a cash option across our product line of annuity games and the majority of our jackpot and top prize winners elect to receive the cash payment option. As a result of this, the accumulation of new U.S. Treasury investments are expected to be lower than in the past and therefore, we anticipate that the portfolio will continue to contract over time.

## Investment Portfolio (continued)

The Lottery continues to maintain a “Buy and Hold” investment strategy to maximize the overall net return of the investment portfolio. During the previous fiscal year, the Lottery added approximately \$41 million par value of U.S. Treasury investments to the portfolio. The “Buy and Hold” strategy allows the Lottery to accumulate U.S. Treasury investments necessary to maintain strong credit standards and diversification of the investment portfolio.

Adherence to strong credit standards and diversification of investments helps to ensure that the Lottery’s investment portfolio remains safe, secure, and can reliably generate sufficient cash flow needed to make scheduled payments to annuity prize winners.

## Looking Forward

The core purpose of the Lottery’s Investment Portfolio is to safeguard the future payment obligations associated with annuitized Lottery prizes. The “Buy and Hold” strategy allows for the steady accumulation of the highest quality securities and provides for a safe and secure revenue stream for these annuity payments. The Lottery remains vigilant in keeping the investment portfolio safe and secure.

The Lottery will continue its focus on building market value in the investment through the accumulation of U.S. Treasury securities for all new annuity prizes. The Lottery currently offers annuity payout options for SuperLotto Plus<sup>®</sup>, Mega Millions<sup>®</sup>, and Powerball<sup>®</sup> jackpots, as well as for the top prize of various Scratchers<sup>®</sup> games.

Further restructuring of the investment portfolio is not planned at this time. However, the Lottery will continue to explore investment opportunities that could utilize the market value premium in Lottery investments to further our mission of maximizing revenues to public education while maintaining a safe and secure investment portfolio.

# INVESTMENT



## Return on Investment Period Comparison



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800.568.8379

ment Comparison

Teams, \$100  
Banking, \$100  
Still-in