



MEMORANDUM

Date: September 23, 2021

To: California State Lottery Commission

From: Alva V. Johnson *AVJ*
Director

Prepared By: Nicholas Buchen
Deputy Director, Finance Division

Subject: Item 8(f) – Lottery Investment Policy and Investment Strategy

ISSUE

Pursuant to the California State Lottery's (Lottery) Investment Policy, the Lottery is required to annually present its Investment Strategy and Investment Policy to the California State Lottery Commission (Commission) for approval.

BACKGROUND

As part of the Lottery's ongoing investment activity in support of SuperLotto Plus®, Mega Millions®, Powerball®, and various Scratchers® games, the Lottery purchases U.S. Treasury securities to fund future payments to jackpot and top prize winners electing the annuity prize option. The U.S. Treasury securities are owned and managed by the Lottery within a single annuity prize portfolio (Investment Portfolio) held with the State Treasurer's Office. The attached report provides more information on the Investment Portfolio, including detailed breakouts of the Lottery's investments for the 2020-21 fiscal year.

The Lottery's Investment Policy requires that the Commission review and adopt, by vote, its Investment Strategy and Investment Policy not less than annually, including the approval of any changes to the Investment Policy.

DISCUSSION

The Lottery's current Investment Strategy and Investment Policy focus on: 1) the management of ongoing investment activity in support of draw games and Scratchers games that offer an annuity payout option to winners, and 2) maintenance of the Lottery's Investment Portfolio to monitor and mitigate potential investment risk. This ensures that scheduled payments to annuity prize winners are fully funded.

The Lottery purchases U.S. Treasury securities, facilitated by the State Treasurer's Office, to fund future prize payments for annuity prizes. The Lottery's investment in U.S.

Treasury securities is a standard business practice for SuperLotto Plus, Mega Millions, Powerball, and certain Scratchers games and represents the Lottery's on-going investment activity.

The Lottery ensures that investment transactions related to maintenance of its Investment Portfolio are consistent with industry practices and are 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.

RECOMMENDATION

Lottery staff recommends that the Commission approve with no modifications the Lottery's existing Investment Policy and Investment Strategy for 2021, which focus on: 1) ongoing investment activity in support of SuperLotto Plus, Mega Millions, Powerball, and various Scratchers games and 2) maintenance of the Lottery's Investment Portfolio that includes monitoring and mitigating potential investment risk.

Attachment



Annual Investment Portfolio Report

GOAL:
Generate Cash Flow

CORE PURPOSE:
**Safeguard Future
Payment Obligations**

2021



Committed to enhancing education and supporting local communities

Annual Investment Portfolio Report

For the Fiscal Year Ended June 30, 2021

Prepared by the Finance Division of the California Lottery

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September 1, 2021

To the California State Lottery Commission,

I am pleased to provide this Annual Investment Portfolio Report for the fiscal year ended June 30, 2021.

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 21.4% municipal bonds, 15.8% agency bonds, and 62.8% 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 the U.S. Treasury bonds is 10.16 years compared to the agency and municipal bonds at approximately 3.51 years combined.

During this past year, short-term interest rates remained at historically low levels as the economy steadily rebounded after constricting due to the global coronavirus pandemic. But, the municipal bond market largely weathered the storm with the help of the federal government. Municipal bond issuers benefited from federal funding assistance, budgetary discipline, and diversified revenue streams, all while maintaining rainy day reserves to help buffer against deep economic downturns. The Lottery continues to diligently assess the credit and default risks associated with the municipal securities in our portfolio and performed additional analysis to ensure we are successfully managing risk.

A vast majority of the Lottery's jackpot winners continue to elect the cash option and as the investments in our portfolio mature, we expect the portfolio to continue to contract in size. The fair market value of our portfolio is approximately \$820.8 million as of June 30, 2021, down \$86.5 million from the prior fiscal year-end. The Lottery will continue its focus on building market value through the accumulation of U.S. Treasury securities for all new annuity prizes.

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,

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 an 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.

Safe and Secure Investments

Lottery investments are strong credit quality securities that keep the investment portfolio safe and secure. Approximately 78.6% of Lottery investments are backed by a Repayment Pledge from the U.S. Government and are considered to be free from credit risk.

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 62.8% allocated to U.S. Treasury securities, 15.8% allocated to U.S. agency securities, and 21.4% allocated to investment grade municipal securities. The weighted average maturities for our agency and municipal bonds are approximately 3.51 years; treasury securities are 10.16 years.

PERFORMANCE & ACTIVITY

(For the Fiscal Year Ended June 30)

	FY 18-19	FY 19-20	FY 20-21*
Beginning Par Value	\$955,213,000	\$963,101,000	\$958,801,000
Purchases	60,095,000	59,990,000	18,432,000
Maturities	(52,207,000)	(64,290,000)	(65,109,000)
Ending Par Value	\$963,101,000	\$958,801,000	\$912,124,000
Cost at End of Fiscal Year	\$639,532,077	\$625,460,282	\$587,274,200
Market Change	39,163,769	72,256,522	(55,646,618)
Interest Earned on Investments	30,735,603	29,031,594	28,054,375
Net Return	\$69,899,372	\$101,288,116	(27,592,243)
Return on Investment (ROI)			
Market Change	6.12%	11.55%	(9.48)%
Interest Earned on Investments	4.81%	4.64%	4.78%
Net Return	10.93%	16.19%	(4.70)%

*Based on preliminary unaudited figures for the 2020-21 fiscal year,

The Lottery's investment portfolio consists of municipal bonds, agency bonds, and U.S. Treasury bonds. The Lottery continues to purchase high quality government bonds to fund annuitized grand prize winners and maintains a "Buy and Hold" investment strategy to maximize the overall net return of the investment portfolio. The maturities of the bonds are designed to produce proceeds to fully fund scheduled payments to annuity prize winners.

Market change consists of the realized and unrealized gains or losses on investments. Interest income comes from interest payments and capital gains collected upon a sale or maturity of a security. All Lottery investments are held to maturity to meet the required prize payouts.

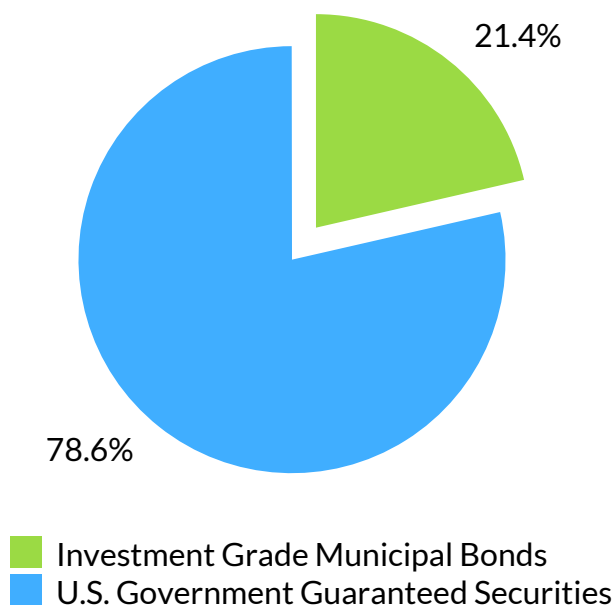
Return On Investments (ROI) measures the annual rate of return of the Lottery's total investment portfolio and doesn't take into account the time value of money. The portfolio has a relatively low annual rate of return by design, since we prioritize security over yield to ensure that guaranteed payments are available for our annuity prizewinners. The negative net return for fiscal year ending 2020-21 is due to bond maturities resulting in loss of earned interest, and rising interest rates which has an adverse affect on the value of bonds.

PORTFOLIO COMPOSITION

Lottery investments in the U.S. Treasury and agency securities are backed by a Repayment Pledge from the U.S. Government and are considered to be free from credit risk. Approximately 78.6% of Lottery investments are backed by a Repayment Pledge from the U.S. Government and are considered to be free from credit risk.

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



The Lottery maintains a reserve fund to serve as an additional financial resource to mitigate credit and reinvestment risk. Currently, the Lottery has \$2,610,981 in reserve for this purpose. The weighted average maturities (WAM) of the bonds are:

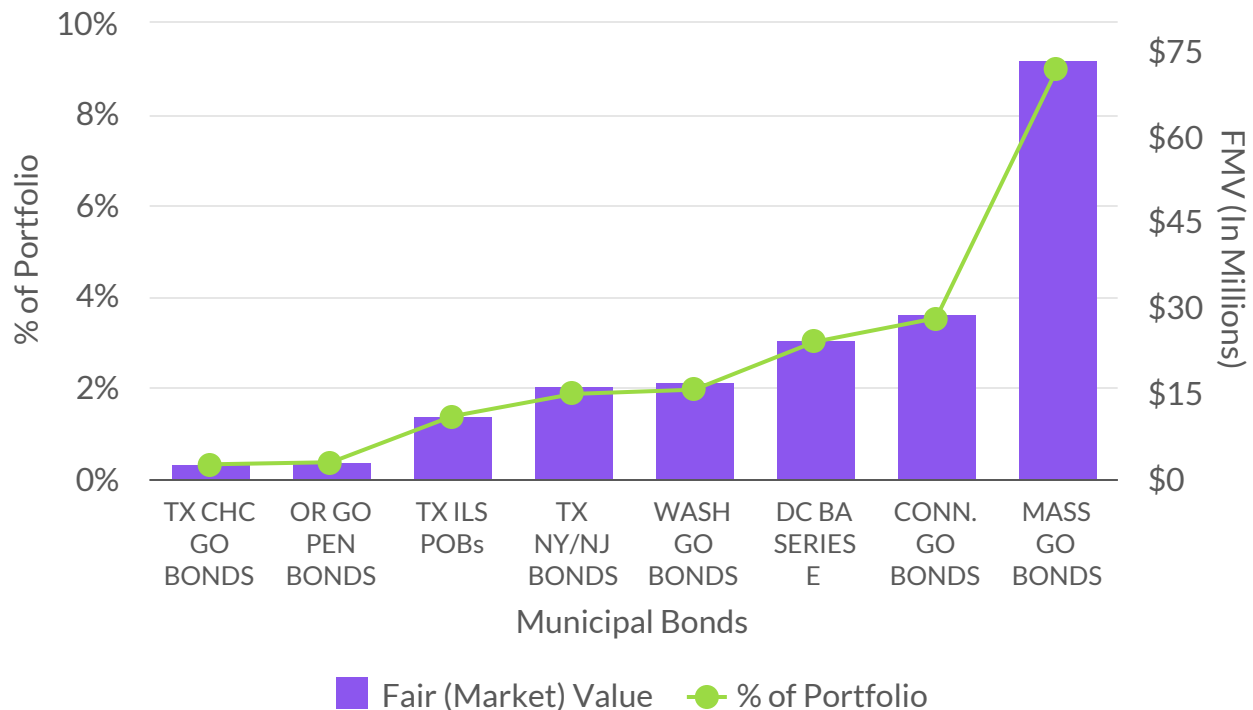
Securities	WAM (years)
Agency Bonds	2.68
Municipal Bonds	4.34
U.S. Treasury Bonds	10.16

DIVERSIFICATION

The Lottery keeps the investment portfolio safe and secure by investing in a variety of securities.

The chart below provides information about the Lottery's concentration of credit risk and diversification as of June 30, 2021. It displays the percentage holding of municipal securities by each issuer in the Lottery's portfolio that are not explicitly guaranteed by the U.S. government.

For diversification purposes, the Lottery's investments in municipal securities do not exceed five percent of the portfolio allocated to a single local municipality or ten percent of the portfolio allocated to a single state based on the fair market value.



Securities	TX CHC GO BONDS	OR GO PEN BONDS	TX ILS POBs	TX NY/ NJ BONDS	WASH GO BONDS	DC BA SERIES E	CONN. GO BONDS	MASS GO BONDS
% Portfolio	0.32%	0.37%	1.38%	1.87%	1.96%	3.01%	3.53%	9.00%
FMV (Millions)	\$2.64	\$3.02	\$11.29	\$15.32	\$16.08	\$24.71	\$28.95	\$73.83

(This presentation is as of fiscal year-end June 30, 2021. The NYC Transitional Finance Authority Bond matured in May 2021.)

BOND ANALYSIS

The table below provides the yield-to-maturity, current yield, and the annual nominal rate of return for municipal bonds. The annual nominal rate of return represents the percentage of profit the Lottery would've earned during fiscal year 2020-21 if municipal securities were sold without taking inflation into account. Currently, all Lottery investments are held to maturity to meet the required prize payouts.

Municipal Bonds	Maturity Date	Yield to Maturity	Current Yield*	Annual Nominal Rate of Return
CONN. GO BONDS	12/1/2021	5.100%	4.999%	1.605%
CONN. GO BONDS	12/1/2023	5.300%	4.756%	3.076%
CONN. GO BONDS	12/1/2029	5.632%	4.432%	3.783%
DC BA SERIES E	12/1/2021	4.793%	4.705%	0.335%
DC BA SERIES E	12/1/2022	4.893%	4.602%	0.334%
DC BA SERIES E	12/1/2023	4.993%	4.519%	0.273%
DC BA SERIES E	12/1/2024	5.093%	4.452%	0.289%
MASS GO BONDS	5/1/2025	4.580%	4.000%	1.305%
MASS GO BONDS	5/1/2026	4.680%	3.979%	1.773%
MASS GO BONDS	5/1/2027	4.760%	3.954%	2.149%
MASS GO BONDS	1/1/2030	5.306%	4.087%	2.297%
OR GO PEN BONDS	6/1/2027	5.892%	4.873%	0.306%
TX CHC GO BONDS	1/1/2029	6.050%	2.756%	11.922%
TX ILS POBs	6/1/2023	4.950%	4.665%	9.521%
TX NY/NJ BONDS	12/1/2024	5.859%	5.022%	2.953%
TX NY/NJ BONDS	12/1/2029	6.040%	4.597%	2.922%
WASH GO BONDS	8/1/2022	4.369%	4.181%	1.409%
WASH GO BONDS	8/1/2023	4.519%	4.164%	1.772%

*Based on Fair Market Value as of June 30, 2021.

High and Low Yields

Securities	High Yields	Low Yields
AGENCY STRIP BONDS	5.510%	4.810%
MUNICIPAL BONDS	6.040%	4.369%
U.S. TREASURY STRIPS	5.890%	0.001%

PORTFOLIO SUMMARY

The portfolio summary provides a snapshot of the Lottery's investments as of June 30, 2021, based on preliminary unaudited figures. The table below summarizes the par value, cost, fair market value for each type of security and indicates what percent each security type represents out of the total portfolio. All holdings in the investment portfolio are in compliance with the Lottery's investment policy.

The Fair Market Value of the Lottery's investment portfolio is approximately \$820.8 million at the end of fiscal year June 30, 2021. The fair value derives from bond purchases, maturities, supply and demand, current economic conditions, and the general perception of risk.

Security Description	Par Value	Cost	Fair Value	% of Portfolio
Agency	\$29,927,000	\$16,121,845	\$29,860,384	3.64%
Muni	7,500,000	7,504,498	7,647,400	0.93%
UST STRIPS	23,629,000	19,979,381	23,625,815	2.88%
Short-Term Total	\$61,056,000	\$43,605,724	\$61,133,599	7.45%
Agency	\$104,149,000	\$46,983,014	\$99,996,257	12.18%
Muni	\$145,045,000	\$145,257,063	\$168,195,758	20.49%
UST STRIPS	\$601,874,000	\$351,428,400	\$491,458,672	59.88%
Long-Term Total	\$851,068,000	\$543,668,477	\$759,650,687	92.55%
Agency	\$134,076,000	\$63,104,859	\$129,856,641	15.82%
Muni	\$152,545,000	\$152,761,561	\$175,843,158	21.42%
UST STRIPS	\$625,503,000	\$371,407,781	\$515,084,487	62.76%
Grand Total	\$912,124,000	\$587,274,201	\$820,784,286	100.00%

During fiscal year 2020-21, the Lottery added approximately \$18.4 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.

FAIR MARKET VALUE BREAKDOWN

More than 80.5% of the Lottery's investments are rated AAA (Highest Quality Rating), and an additional 17.8% are rated low or very low risk, ensuring the investment portfolio is safe and secure.

Moody's Credit Ratings	Fair Market Value	% of Portfolio
Aaa	\$661,018,778	80.54 %
Aa1	101,566,740	12.37 %
Aa3	44,268,950	5.39 %
Baa2	11,290,210	1.38 %
Ba1	2,639,608	0.32 %
Total	\$820,784,286	100.00 %

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

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.

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.

MUNICIPAL CREDIT RATINGS

The Lottery's investment policy is designed to limit exposure to credit risk associated with investing in municipal securities. The investment policy specifies strong credit rating requirements for municipal securities, with at least an AA rating at the time of purchase, to minimize exposure to potential default. The Lottery utilizes municipal credit ratings issued by Moody's Investor Services, Standards & Poor's (S&P), and Fitch, the three main credit rating agencies that comprise approximately 95% of the credit rating market. The table below displays the current credit ratings of the municipal securities held in the Lottery's investment portfolio.

Municipal Securities Holdings	Moody's	S&P	Fitch
<u>State General Obligation (G.O.) Bonds:</u>			
Washington G.O. Bond	Aaa	AA+	AA+
Massachusetts G.O. Bond	Aa1	AA	AA+
Oregon Pension Obligation Bond	Aa1	AA+	AA+
Connecticut G.O. Bond	A3	A+	AA-
Illinois Pension Obligation Bond	Baa2	BBB	BBB-
<u>State Issued Revenue Bonds:</u>			
District of Columbia (DC) Income Tax Rev. Bond	Aa1	AAA	AA+
New York/New Jersey Port Authority Bond	Aa3	A+	A+
<u>Local Entity (City/County) Bonds:</u>			
Chicago G.O. Bond	Ba1	BBB+	BBB-

A credit rating agency assesses the credit risk of specific debt securities or structured financial instruments and, in some cases, the creditworthiness of securities offered by governments. 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, while modifier 3 indicates a ranking in the lower end of that generic rating category. S&P and Fitch uses (+) and (-) symbols to indicate strength of the generic rating category.

Credit Ratings Definition	Moody's	S&P	Fitch
Prime - Minimal Credit Risk	Aaa	AAA	AAA
High Grade - Very Low Credit Risk	Aa	AA	AA
Upper Medium Grade - Low Credit Risk	A	A	A
Lower Medium Grade - Moderate Credit Risk	Baa	BBB	BBB
Non-Investment Grade - Substantial Credit Risk	Ba	BB	BB

(This presentation is as of fiscal year-end June 30, 2021. The NYC Transitional Finance Authority Bond matured in May 2021.)

OVERVIEW

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.

In general, the bond market is volatile and fixed income securities carry interest rate risk. As interest rates rise, bond prices usually fall, and vice versa. Fixed income securities also carry inflation risk, liquidity risk, call risk, credit and default risks for both issuers and counterparties. During the first half of 2021, according to Bloomberg market data, the municipal bond market has outperformed all other highly rated fixed income categories. The strong performance of municipals can be attributed to many factors, such as inflation, rising tax rates and an imbalance of supply and demand. We believe these factors, as well as continuous government fiscal support, will continue in the second half of 2021 setting up another favorable period for the municipal bond market.

The Lottery continuously assesses the risks of our municipal holdings by performing extensive analysis on the bonds in our portfolio. We review city and state budgets, financial statements, updated COVID-19 disclosures, credit ratings, and use Bloomberg's Financial Analysis tool to evaluate the current risk and the probability default of these securities. In addition, we continue to monitor the current state of the economy in regards to the ongoing COVID-19 pandemic to minimize the event risk of the bonds in our portfolio.

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.



**THE CALIFORNIA LOTTERY'S MISSION IS TO MAXIMIZE SUPPLEMENTAL
FUNDING FOR PUBLIC EDUCATION THROUGH THE RESPONSIBLE
SALE OF LOTTERY PRODUCTS.**



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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 from 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 prize winners. 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:

1. U.S. Treasury Obligations (direct or fully guaranteed obligations).
2. U.S. Government Agency or Government-Sponsored Enterprise Securities including, but not limited to, securities issued by the Government National Mortgage Association (GNMA or Ginnie Mae), Small Business Administration (SBA), Federal Housing Administration (FHA), Tennessee Valley Authority (TVA), Export-Import Bank of the U.S., Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), Federal Farm Credit Banks Funding Corporation, Federal Home Loan Banks, and Federal Agricultural Mortgage Corporation.
3. State and Local Government Municipal Securities (Municipal Securities) in the following categories:
 - a. State General Obligation bonds backed by full faith and credit (unlimited tax-backed bonds) with investment-grade ratings.
 - b. State issued bonds backed by faith and credit (limited tax-backed bonds) with ratings at the time of purchase of double A (without respect to modifiers) or higher by Fitch, Moody's or Standard and Poor's.
 - c. General Obligation bonds of a county or local governmental entity with ratings at the time of purchase of double A (without respect to modifiers) or higher by Fitch, Moody's or Standard and Poor's.
 - d. Revenue bonds of a state, county, city or other political subdivision or authority with ratings at the time of purchase of double A (without respect to modifiers) or higher by Fitch, Moody's or Standard & Poor's.

V. Credit and Reinvestment Criteria

To fulfill the investment objectives as described in Section III. Investment Objectives and except as provided in Section VIII. Portfolio Restructuring of this Policy, the Lottery shall maintain a "Buy and Hold" investment strategy, in which the purchased securities are held until maturity at which time the funds are used to pay annuity prizes. In the event an investment security held by the Lottery is subject to a rating change that brings it below the minimum credit ratings at the time of purchase as specified under Section IV. Permitted Investments, the Deputy

Director of Finance or the Assistant Deputy Director of Finance 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. Any such occurrence shall be reported to the Commission in writing within 15 days.

In the event an investment security held by the Lottery is unexpectedly called prior to maturity, the Lottery shall reinvest the proceeds in a security specified under Section IV. Permitted Investments 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 within the Lottery's risk tolerance.

The Lottery's Permitted Investments include 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 or no Credit Risk. The Lottery's Permitted Investments also include Municipal Securities with inherent credit and reinvestment risk. The Lottery shall employ strategies to mitigate such risk, including but not limited to, holding bonds until maturity; reinvesting using available funds in the Lottery's administrative budget; and purchasing bonds to hold in reserve 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:

1. 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.
2. 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 above at any time after purchase, the Deputy Director of Finance or the Assistant Deputy Director of Finance shall determine the course of action to be followed on a case-by-case basis. Any such occurrence shall be reported to the Commission in writing within 15 days.

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 to make additional funding available for public education and generate funds in excess of the portfolio requirements to pay prizes. At such time, the Lottery shall competitively procure a professional financial consultant to guide the restructure effort and shall notify the Commission of the intent to award, even if the dollar amount does not meet the threshold for Commission approval.

Investments resulting from the restructuring shall be competitively bid, but in no case shall the sum of the return on 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 Finance and the Assistant Deputy Director of Finance are authorized to, upon notification to the Commission, 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.

Assistant Deputy Director of Finance: Oversees policy execution and ensures all relevant investment reports associated with investment activity are reviewed for accuracy and sufficiency and transmitted timely to interested and impacted parties (e.g., State Treasurer's Office). The Assistant Deputy Director of Finance 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 Assistant Deputy Director of Finance prepares annual financial statements that disclose the Lottery's investment activity and reflects the amount of proceeds generated from restructuring, if applicable. 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.

Financial Consultant: Provides services including but not limited to advising, planning, and acting as a securities agent to purchase and sell securities on behalf of the Lottery, and in coordination with the California State Treasurer's Office (STO), should the Lottery restructure its investment portfolio. All transactions involved in the restructuring process, including sales of existing securities and purchases of new or replacement securities, must be pre-approved by the Deputy Director of Finance. The Financial Consultant shall advise the Deputy Director of Finance, Assistant Deputy Director of Finance, and the Investment Officer of the expected savings from each proposed transaction, as well as provide an independent assessment of risk. Pursuant to the contract, the Financial Consultant shall provide the Lottery with quarterly financial updates including an updated portfolio cash flow model that reflects the quarter's transactions and analysis of the collective portfolio. A Financial Consultant shall be hired through a competitive bid process. Any contracted Financial Consultant must act in accordance with the Investment Protection Standards for financial conduct as maintained by the STO.

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

An Investment Portfolio Report including, but not limited to, information related to the management of investment risk and the disclosure of investment portfolio restructuring activity, if any, shall be submitted to the Commission not less than annually.

Additionally, in the event the Lottery performs investment portfolio restructuring activity, 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 investment 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, Assistant Deputy Director of Finance, and Investment Officer) may propose policy changes to the Commission at any time. 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.

Periodic Review:

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

REAFFIRMED AND ADOPTED ON THE 23rd DAY OF SEPTEMBER 2021.