



Annual Investment Portfolio Report

GOAL:
Generate Cash Flow

CORE PURPOSE:
Safeguard Future
Payment Obligations

2022





Committed to enhancing education and supporting local communities

Annual Investment Portfolio Report

For the Fiscal Year Ended June 30, 2022

Prepared by the Finance Division of the California Lottery

TABLE OF CONTENTS

INTRODUCTION	5
RISK MANAGEMENT	6
PERFORMANCE & ACTIVITY	7
PORTFOLIO COMPOSITION	8
DIVERSIFICATION	9
BOND ANALYSIS	10
PORTFOLIO SUMMARY	11
FAIR MARKET VALUE BREAKDOWN	12
MUNICIPAL CREDIT RATINGS	13
OVERVIEW	14

September 1, 2022

To the California State Lottery Commission,

I am pleased to provide this Annual Investment Portfolio Report for the fiscal year ended June 30, 2022.

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 20.9% municipal bonds, 13.8% agency bonds, and 65.3% 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 9.25 years compared to the agency and municipal bonds at approximately 2.88 years combined.

During this past year, annual inflation has risen to historic highs, affecting everyday costs such as groceries, housing, and gasoline. To combat soaring prices, the Federal Reserve has raised interest rates for the first time since 2018 and rising interest rates are anticipated to continue with the Fed considering a 75-basis point rate hike. Increased interest rates result in decreased bond values, particularly longer-term bonds. U.S. long-term Treasury yields have dropped: 10-year bonds are down to 2.75% from 2.98% last year, 30-year bonds are down to 2.98% from 3.20%, and the 2-year note has dropped to 3.21% from 3.25%. 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 \$695.6 million as of June 30, 2022, down \$125.2 million from the prior fiscal year-end. The Lottery will continue to 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,

Carleen Missildine
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 79.1% 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 65.3% allocated to U.S Treasury securities, 13.8% allocated to U.S. agency securities, and 20.9% allocated to investment grade municipal securities. The weighted average maturities for our agency and municipal bonds are approximately 2.88 years; treasury securities are 9.25 years.

PERFORMANCE & ACTIVITY

(For the Fiscal Year Ended June 30)

	FY 19-20	FY 20-21	FY 21-22*
Beginning Par Value	\$963,101,000	\$958,801,000	\$912,124,000
Purchases	59,990,000	18,432,000	28,032,000
Maturities	(64,290,000)	(65,109,000)	(67,539,000)
Ending Par Value	\$958,801,000	\$912,124,000	\$872,617,000
Cost at End of Fiscal Year	\$625,460,282	\$587,274,200	\$559,225,100
Market Change	72,256,522	(55,646,618)	(98,716,480)
Interest Earned on Investments	29,031,594	28,054,375	26,390,108
Net Return	\$101,288,116	(27,592,243)	(72,326,372)
Return on Investment (ROI)			
Market Change	11.55%	(9.48)%	(17.65)%
Interest Earned on Investments	4.64%	4.78%	4.72%
Net Return	16.19%	(4.70)%	(12.93)%

*Based on preliminary unaudited figures for the 2021-22 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.

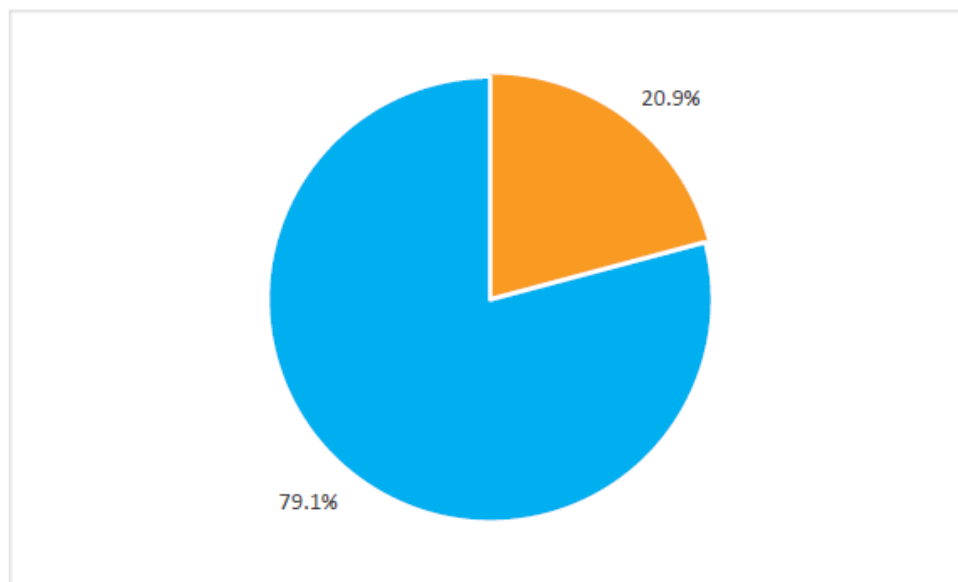
Return On Investments (ROI) measures the annual rate of return of the Lottery's total investment portfolio and doesn't take into account the time value of money. The portfolio has a relatively low annual rate of return by design, since we prioritize security over yield to ensure that guaranteed payments are available for our annuity prize winners. The negative net returns for fiscal years ending 2020-21 and 2021-22 is due to bond maturities resulting in loss of earned interest, and rising interest rates which have 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 79.1% 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



- Investment Grade Municipal Bonds
- U.S. Government Guaranteed Securities

The Lottery maintains a reserve fund to serve as an additional financial resource to mitigate credit and reinvestment risk. Currently, the Lottery has \$2,488,116 in reserve for this purpose. The weighted average maturities (WAM) of the bonds are:

Securities	WAM (years)
Agency Bonds	2.26
Municipal Bonds	3.50
U.S. Treasury Bonds	9.25

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, 2022. 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
% of Portfolio	0.22%	0.38%	0.83%	1.95%	2.18%	2.95%	3.04%	9.31%
FMV (Millions)	\$1.54	\$2.67	\$5.74	\$13.53	\$15.14	\$20.54	\$21.17	\$64.78

(This presentation is as of fiscal year-end June 30, 2022. The TX ILS POBs Bond had a partial maturity in June 2022.)

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 loss the Lottery would have netted during fiscal year 2021-22 if municipal securities were sold without taking inflation into account. The net loss would have resulted from a decrease in the Fair Market Value of the investments. 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	12/1/2023	5.300%	5.156%	-2.990%
CONN. GO BONDS	12/1/2029	5.632%	5.173%	-9.892%
DC BA SERIES E	12/1/2022	4.893%	4.845%	-0.408%
DC BA SERIES E	12/1/2023	4.993%	4.870%	-2.692%
DC BA SERIES E	12/1/2024	5.093%	4.892%	-4.536%
MASS GO BONDS	5/1/2025	4.580%	4.452%	-6.141%
MASS GO BONDS	5/1/2026	4.680%	4.507%	-7.738%
MASS GO BONDS	5/1/2027	4.760%	4.548%	-9.091%
MASS GO BONDS	1/1/2030	5.306%	4.877%	-12.106%
OR GO PEN BONDS	6/1/2027	5.892%	5.514%	-6.766%
TX CHC GO BONDS	1/1/2023	6.050%	5.956%	-1.931%
TX CHC GO BONDS	1/1/2029	6.050%	5.932%	-1.557%
TX ILS POBs	6/1/2023	4.950%	4.914%	-0.406%
TX ILS POBs	6/1/2023	4.950%	4.914%	-0.406%
TX NY/NJ BONDS	12/1/2024	5.859%	5.551%	-4.504%
TX NY/NJ BONDS	12/1/2029	6.040%	5.376%	-9.887%
WASH GO BONDS	8/1/2022	4.369%	4.362%	0.044%
WASH GO BONDS	8/1/2023	4.519%	4.459%	-2.460%

*Based on Fair Market Value as of June 30, 2022.

High and Low Yields

Securities	High Yields	Low Yields
AGENCY BONDS	5.510%	4.810%
MUNICIPAL BONDS	6.040%	4.370%
U.S. TREASURY BONDS	5.890%	0.004%

PORTFOLIO SUMMARY

The portfolio summary provides a snapshot of the Lottery's investments as of June 30, 2022, 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 \$695.6 million at the end of fiscal year June 30, 2022. The fair value derives from bond purchases, maturities, supply and demand, current economic conditions, and the general perception of risk. The cost of Municipal Bonds is adjusted for the amortization of premiums and discounts included in the original purchase price.

Security Description	Par Value	Cost	Fair Value	% of Portfolio
Agency Bonds	\$30,188,000	\$15,530,232	\$29,877,130	4.30%
Municipal Bonds	14,765,000	14,745,344	14,855,381	2.13%
Treasury Bonds	25,766,000	21,102,851	25,517,459	3.67%
Short-Term Total	\$70,719,000	\$51,378,427	\$70,249,970	10.10%
Agency Bonds	\$73,961,000	\$31,452,782	\$65,997,642	9.48%
Municipal Bonds	\$124,445,000	\$124,657,835	\$130,257,407	18.73%
Treasury Bonds	\$603,492,000	\$351,736,056	\$429,084,048	61.69%
Long-Term Total	\$801,898,000	\$507,846,673	\$625,339,097	89.90%
Agency Bonds	\$104,149,000	\$46,983,014	\$95,874,772	13.78%
Municipal Bonds	\$139,210,000	\$139,403,179	\$145,112,788	20.86%
Treasury Bonds	\$629,258,000	\$372,838,907	\$454,601,507	65.36%
Grand Total	\$872,617,000	\$559,225,100	\$695,589,067	100.00%

During fiscal year 2021-22, the Lottery's par value decreased approximately \$39.5 million due to bond maturities and jackpot winners choosing the cash option instead of the annuity option.

FAIR MARKET VALUE BREAKDOWN

The Lottery strives to maintain a strong credit standard of the investment portfolio by purchasing investments with the highest quality ratings. More than 81.3% of the Lottery's investments are rated AAA (Highest Quality Rating), and an additional 17.6% are rated low or very low risk, ensuring the investment portfolio is safe and secure. Only 1.1% are rated as moderate to substantial risk. While the risk of default is minimal, the Lottery seeks to balance this risk by holding bonds to maturity and maintaining a diverse portfolio.

Moody's Credit Ratings	Fair Market Value	% of Portfolio
Aaa	\$565,618,880	81.32 %
Aa1	87,988,830	12.65 %
Aa3	34,699,875	4.98 %
Baa1	5,741,610	0.83 %
Ba1	1,539,872	0.22 %
Total	\$695,589,067	100.00 %

The Lottery currently offers annuity prizes for the Lotto games (SuperLotto Plus®, Mega Millions®, and Powerball®), as well as for the top prize of various Scratchers® games. The Lottery will continue to focus on securely building market value in our 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.

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. For 2021-22 there were 30 Scratchers annuity game winners of whom 24 selected the cash option. The Lotto games had a combined total of 8 winners who all selected the cash option. As a result of winners selecting the cash option, the accumulation of new U.S. Treasury investments is 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 – Matured	Aaa	AA+	AA+
Massachusetts G.O. Bond	Aa1	AA	AA+
Oregon Pension Obligation Bond	Aa1	AA+	AA+
Connecticut G.O. Bond	Aa3	A+	AA-
Illinois Pension Obligation Bond	Baa1	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	AA-	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	Aa1	AA	AA
Upper Medium Grade - Low Credit Risk	Aa3	A	A
Lower Medium Grade - Moderate Credit Risk	Baa1	BBB	BBB
Non-Investment Grade - Substantial Credit Risk	Ba1	BB	BB

This presentation is as of fiscal year-end June 30, 2022.

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.

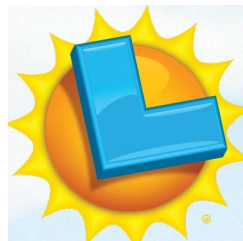
In general, the bond market is volatile and fixed income securities carry interest rate risk. As interest rates rise, bond prices usually fall, and vice versa. Fixed income securities also carry inflation risk, liquidity risk, call risk, credit and default risks for both issuers and counterparties. During the first half of 2022, 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 2022 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, credit ratings, and use Bloomberg's Financial Analysis tool to evaluate the current risk and the probability default of these securities.

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.**



700 North Tenth Street • Sacramento • CA• 95811
www.calottery.com
800.568.8379