

ANNUAL INVESTMENT PORTFOLIO REPORT



DATE RANGE

Fiscal Year 2023-24

GOAL

Generate Cash Flow

CORE PURPOSE

Safeguard Future Payment Obligations

calottery

California State Lottery

Annual Investment Portfolio Report

Committed to enhancing education and supporting local communities

Annual Investment Portfolio Report

For the Fiscal Year Ended June 30, 2024

Prepared by the Finance Division of the California Lottery

California State Lottery

Annual Investment Portfolio Report

TABLE OF CONTENTS

LETTER FROM THE INVESTMENT OFFICER	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



California State Lottery

Annual Investment Portfolio Report

September 3, 2024

To the California State Lottery Commission,

I am pleased to provide this Annual Investment Portfolio Report for the fiscal year ended June 30, 2024.

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 to minimize risk and provide a secure revenue stream for annuity prizes. 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 16.5 percent municipal bonds, 7.5 percent agency bonds, and 76.0 percent 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 8.02 years compared to the agency and municipal bonds at approximately 4.79 years combined.

As of June 30, 2024, the inflation rate remained at 3 percent, the same as in June 2023, remaining above the 2 percent target set by the Federal Reserve. As of July 31, 2024, the inflation rate decreased to 2.9 percent. With rates continuing to decline, it is anticipated that the Federal Reserve will begin cutting interest rates, possibly as early as September 2024. The high interest rates are continuing to decrease bond values, particularly longer-term bonds. U.S. long-term Treasury yields have increased: 10-year bonds are up to 4.36 percent from 3.81 percent last year, 30-year bonds increased to 4.51 percent from 3.85 percent, and the 2-year note decreased slightly to 4.71 percent from 4.87 percent. 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 top prize 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 \$568.7 million as of June 30, 2024, down \$77.2 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,

David Dackins
Investment Officer

California State Lottery

Annual Investment Portfolio Report

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 principle 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 83.5% of Lottery investments are backed by a Repayment Pledge from the U.S. Government and are considered to be free from credit risk.

Diversification

The Lottery is investigating opportunities to increase the diversity of the investment portfolio, but remains focused on securing low risk investments, to ensure the safety and security of the annuity payments. The Lottery's investment portfolio consists of 76.0 percent allocated to U.S. Treasury securities, 7.5 percent allocated to U.S. agency securities, and 16.5 percent allocated to investment grade municipal securities. The weighted average maturities for our agency and municipal bonds are 4.79 years combined; treasury securities are 8.02 years.

California State Lottery

Annual Investment Portfolio Report

PERFORMANCE & ACTIVITY

(For the Fiscal Year Ended June 30)

	FY 21-22	FY 22-23	FY 23-24*
Beginning Par Value	\$912,124,000	\$872,617,000	\$867,228,000
Purchases	28,032,000	67,200,000	9,600,000
Maturities	(67,539,000)	(72,589,000)	(85,436,115)
Ending Par Value	\$872,617,000	\$867,228,000	\$791,391,885
Cost at End of Fiscal Year	\$559,225,100	\$550,109,086	\$489,273,584
Market Change	(98,716,480)	(39,929,206)	(15,444,482)
Interest Earned on Investments	26,390,108	25,319,458	23,053,950
Net Return	(72,326,372)	(14,609,748)	7,609,468
Return on Investment (ROI)			
Market Change	(17.65)%	(7.26)%	(3.16)%
Interest Earned on Investments	4.72%	4.60%	4.71%
Net Return	(12.93)%	(2.66)%	1.56%

*Based on preliminary unaudited figures for the 2023-24 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 consider 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 the prior and previous fiscal years are due to bond maturities resulting in loss of earned interest, and rising interest rates which have an adverse effect on the value of bonds. The positive net return for the 2023-24 fiscal year is driven by lower inflation and declining interest rates. This increases the demand for the bonds which drives up their market value.

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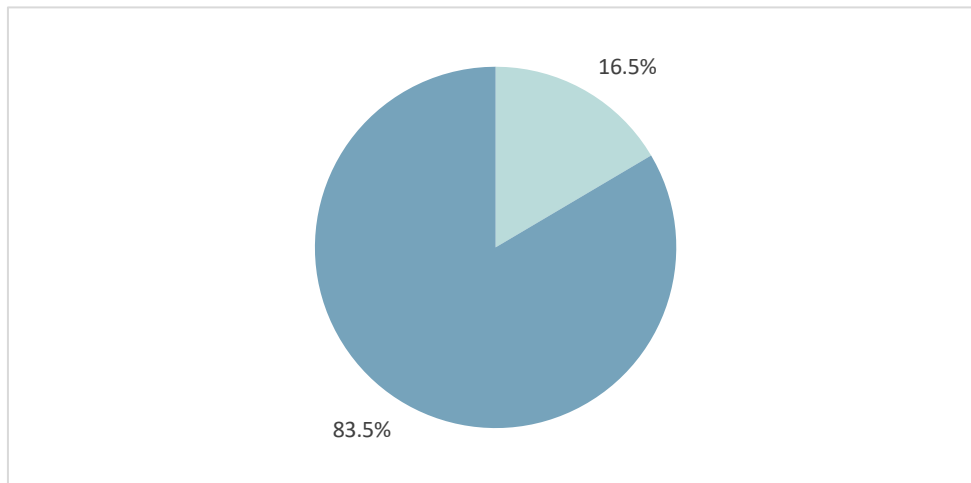
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PORTFOLIO COMPOSITION

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 83.5 percent of Lottery investments are backed by this Repayment Pledge from the U.S. Government.

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 weighted average maturities for the agency bonds are 2.20 years; the municipal bonds are 2.59 years; and treasury securities are 8.02 years. The Lottery maintains a reserve fund to serve as an additional financial resource to mitigate credit and reinvestment risk. Currently, the Lottery has \$1,888,260 in reserve for this purpose.



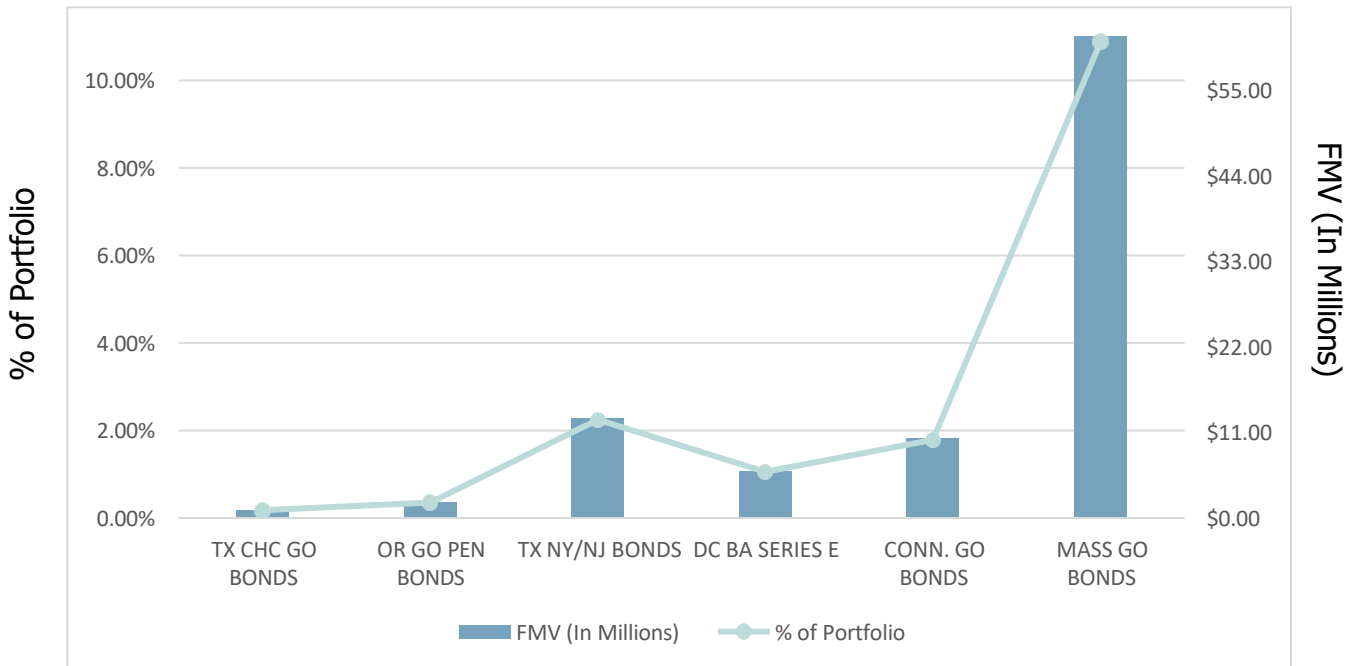
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Annual Investment Portfolio Report

DIVERSIFICATION

The diversification of the Lottery’s portfolio has decreased as municipal and agency bonds continue to mature. While the Lottery continues to investigate opportunities to diversify its portfolio, given the current market volatility, the Lottery has focused on securing U.S. Treasury securities for new annuity winners, taking advantage of the low to no credit risk these securities provide.

The chart below provides information about the Lottery’s concentration of credit risk and diversification as of June 30, 2024. 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. The table below shows investments by any one issuer representing 10 percent or more of the Lottery’s total portfolio that are not explicitly guaranteed by the U.S. government.



Municipal Bonds

Issuer	Cost	Fair Value	Percent of Total Portfolio	Moody's Credit Rating
Commonwealth of Massachusetts*	\$ 62,546,830	\$ 61,919,280	10.89%	AA+

*The percentage of holding for each of the four MASS. GO BONDS are less than 5 percent. The combined total is over 10 percent mainly due to the diminishing size of the Lottery’s portfolio as bonds mature and more top prize winners choose cash instead of the annuity option.

California State Lottery

Annual Investment Portfolio Report

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 have earned during fiscal year 2023-24 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	12/1/2029	5.632%	5.539%	3.775%
DC BA SERIES E	12/1/2024	5.093%	5.098%	5.530%
MASS GO BONDS	5/1/2025	4.580%	4.608%	5.341%
MASS GO BONDS	5/1/2026	4.680%	4.705%	5.347%
MASS GO BONDS	5/1/2027	4.760%	4.766%	5.352%
MASS GO BONDS	1/1/2030	5.306%	5.231%	4.401%
OR GO PEN BONDS	6/1/2027	5.892%	5.812%	5.204%
TX CHC GO BONDS	1/1/2029	6.050%	6.052%	6.944%
TX NY/NJ BONDS	12/1/2024	5.859%	5.852%	5.520%
TX NY/NJ BONDS	12/1/2029	6.040%	5.746%	4.078%

*Based on Fair Market Value as of June 30, 2024.

High and Low Yields

Securities	High Yields	Low Yields
AGENCY BONDS	5.510%	5.450%
MUNICIPAL BONDS	6.040%	4.480%
U.S. TREASURY BONDS	5.890%	0.333%

California State Lottery

Annual Investment Portfolio Report

PORTFOLIO SUMMARY

The portfolio summary provides a snapshot of the Lottery's investments as of June 30, 2024, based on preliminary unaudited figures. The table below summarizes the par value, cost, and fair market value for each type of security and indicates what percent each security type represents out of the total portfolio.

The Fair Market Value of the Lottery's investment portfolio is approximately \$568.7 million at the end of fiscal year June 30, 2024. 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	\$11,508,000	\$4,994,559	\$11,291,942	1.99%
Municipal Bonds	\$38,500,000	\$38,521,751	\$38,353,825	6.74%
Treasury Bonds	\$35,082,000	\$25,266,018	\$34,367,900	6.04%
Short-Term Total	\$85,090,000	\$68,782,328	\$84,013,667	14.77%
Agency Bonds	\$36,193,000	\$13,728,318	\$31,178,450	5.48%
Municipal Bonds	\$54,979,885	\$55,051,397	\$55,499,819	9.76%
Treasury Bonds	\$615,129,000	\$351,711,541	\$398,012,938	69.99%
Long-Term Total	\$706,301,885	\$420,491,256	\$484,691,207	85.23%
Agency Bonds	\$47,701,000	\$18,722,877	\$42,470,392	7.47%
Municipal Bonds	\$93,479,885	\$93,573,148	\$93,853,644	16.50%
Treasury Bonds	\$650,211,000	\$376,977,559	\$432,380,838	76.03%
Grand Total	\$791,391,885	\$489,273,584	\$568,704,874	100.00%

During fiscal year 2023-24, the Lottery's par value decreased \$75.8 million due to bond maturities and top prize winners choosing the cash option instead of the annuity option.

California State Lottery

Annual Investment Portfolio Report

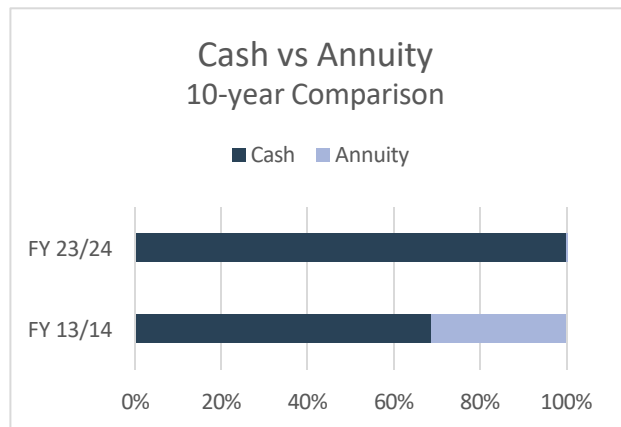
FAIR MARKET VALUE BREAKDOWN

The Lottery strives to maintain a strong credit standard of the investment portfolio by purchasing investments with the highest quality ratings. Approximately 83.5 percent of the Lottery's investments are rated AAA (Highest Quality Rating), and an additional 16.3 percent are rated low or very low risk, ensuring the investment portfolio is safe and secure. With less than 0.2 percent 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	\$474,851,230	83.50%
Aa1	\$69,910,832	12.29%
Aa3	\$22,933,075	4.03%
Baa3	\$1,009,737	0.18%
Total	\$568,704,874	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. Most of our jackpot and top-prize winners elect to receive the cash payment option. In 2023-24 there were 39 Scratchers annuity game winners of whom 37, approximately 95 percent, selected the cash option. The Lotto games had a combined total of 22 winners who all selected the cash option. In comparison, in 2013-14 the cash option was selected approximately 69 percent of the time. 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.

California State Lottery

Annual Investment Portfolio Report

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 percent 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><i>State General Obligation (G.O.) Bonds:</i></u>			
Massachusetts G.O. Bond	Aa1	AA+	AA+
Oregon Pension Obligation Bond	Aa1	AA+	AA+
Connecticut G.O. Bond	Aa3	AA-	AA-
<u><i>State Issued Revenue Bonds:</i></u>			
District of Columbia (DC) Income Tax Rev. Bond	Aa1	AAA	AA+
New York/New Jersey Port Authority Bond	Aa3	AA-	AA-
<u><i>Local Entity (City/County) Bonds:</i></u>			
Chicago G.O. Bond	Baa3	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, 2024.

California State Lottery

Annual Investment Portfolio Report

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. 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 of default on these securities.

As inflation continues to trend downward, and the bond market strengthens, the Federal Reserve is expected to cut interest rates, possibly as early as September. High interest rates have resulted in decreased bond values, particularly for longer-term bonds, as interest rates are cut the bond values will increase. The Lottery will continue to monitor market trends and assess the credit and default risks of municipal bonds for opportunities to further diversify our portfolio as our current bonds mature.

Currently, the Lottery remains focused on securing US Treasury bonds for new annuity winners. Further restructuring of the investment portfolio is not planned currently. 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 GENERATE SUPPLEMENTAL FUNDING FOR PUBLIC EDUCATION FROM ELEMENTARY SCHOOLS TO UNIVERSITIES. WITH HONESTY AND INTEGRITY, THE LOTTERY BUILDS A BETTER TOMORROW FOR STUDENTS AND OUR COMMUNITIES THROUGH THE RESPONSIBLE SALES OF ENTERTAINING LOTTERY PRODUCTS.



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