OCTA

July 24, 2017

To: Members of the Board of Directors

From: Darrell Johnson, Chief Executive Officer

Subject: Second Quarter 2017 Debt and Investment Report

Overview

The California Government Code authorizes the Orange County Transportation Authority Treasurer to submit a quarterly investment report detailing the investment activity for the period. This investment report covers the second quarter of 2017, April through June, and includes a discussion on the Orange County Transportation Authority's debt portfolio.

Recommendation

Receive and file the Quarterly Debt and Investment Report prepared by the Treasurer as an information item.

Discussion

The Treasurer is currently managing the Orange County Transportation Authority's (OCTA) investment portfolio totaling $1.47 billion as of June 30, 2017. The portfolio is divided into two managed portfolios: the liquid portfolio for immediate cash needs and the short-term portfolio for future budgeted expenditures. In addition to these portfolios, OCTA has funds invested in a debt service reserve fund for the 91 Express Lanes.

OCTA's debt portfolio had an outstanding principal balance of $427.14 million as of June 30, 2017. Approximately 74 percent of the outstanding balance is comprised of Measure M2 debt, and 26 percent is associated with the 91 Express Lanes Program.

Economic Summary: The Federal Reserve (Fed) raised its benchmark rate on June 14, 2017 for the third time in seven months, bringing the range to 1 percent and 1.25 percent.

The increase in rates was expected, as wide-spread strength in economic indicators continues. While not a shift in policy, Fed officials are now talking more about rising asset prices, including housing and equity markets. The discussion over United States (U.S.) monetary policy has been focused for months on whether policy makers should take their signal from falling unemployment, which has boosted the case for rate hikes, or sluggish inflation, which has made the case for leaving rates at their current levels. Rising asset prices could introduce the element of financial stability into the mix, strengthening the argument to keep tightening policy. Commercial real-estate valuations relative to operating income have reached historic highs, and bond yields have remained near historic lows. Fed projections call for one more rate increase this year.

First quarter Gross Domestic Product was revised upward to a 1.4 percent annualized rate (forecast and previous estimate were 1.2 percent) led by consumer spending and trade. Analysts estimate the U.S. economy will grow at a 3 percent rate in the April to June period. Cooling automobile sales and a housing sector limited by a low inventory of affordable homes will remain headwinds for the economy the rest of this year.

The labor market continues to strengthen while businesses are retaining workers instead of eliminating them. The continued low level of unemployment claims suggests there is tremendous difficulty finding skilled labor. Since it is such a costly and lengthy process to find and train workers, businesses are opting to hold on to their current employees rather than furlough workers and run the risk of having to be short-staffed when demand accelerates.

Debt Portfolio Activity: No debt service payments were made during the second quarter. The outstanding balances for each of OCTA's debt securities are presented in Attachment A.

During the quarter, OCTA continued with its pursuit of a Transportation Infrastructure Finance and Innovation Act loan for the I-405 Improvement Project. Investment grade ratings of "BBB-" were received from Kroll Bond Rating Agency and Standard and Poor's. On June 29, 2017, the Council on Credit and Finance recommended approval of OCTA's loan to the Secretary of Transportation (Secretary). It is expected that the Secretary will execute the loan agreement in July 2017.

Investment Portfolio Compliance: There was one compliance violation during the quarter. On May 23, 2017, Moody's downgraded its ratings of Schlumberger Holdings. The portfolio managed by JP Morgan contained a corporate medium-term note (MTN) with a par value of $630,000, maturing

December 21, 2020. OCTA's investment policy requires that corporate MTNs maintain an "A" rating by two of the three Nationally Recognized Statistical Rating Organizations. In the event a security falls below that level, the decision to retain the security until maturity or liquidate the security shall be approved by the Treasurer. The security was sold the next day at a gain. Further, the action shall be noted in the monthly OCTA Investment and Debt Programs report.

OCTA continues its policy of reviewing the contents of the investment portfolio on a weekly basis to ensure compliance for each day of the week. Attachment B provides a comparison of the portfolio holdings as of June 30, 2017, to the diversification guidelines of the policy.

Investment Portfolio Performance Versus Selected Benchmarks: OCTA uses Clearwater Analytics to calculate performance for each manager within the respective portfolios. The performance reports calculate monthly total rates of return based upon the market value of the portfolios they manage. The securities are marked-to-market daily based on pricing data provided by the custody banks.

OCTA has calculated the total returns for each of the investment managers for short-term operating monies and has compared the returns to specific benchmarks as shown in Attachment C. Attachment D contains an annualized total return performance comparison by investment manager for the previous two years. Attachment E provides a five-year yield comparison between the short-term investment managers, Orange County Investment Pool, and Local Agency Investment Fund.

The returns for OCTA's short-term operating monies are compared to the Bank of America Merrill Lynch (BAML) 1-3 year Treasury (Treasury) and the BAML 1-3 year AAA-A U.S. Corporate and Government (Corporate/Government) benchmarks. The BAML 1-3 year indices are among the most commonly used short-term fixed-income benchmarks. Each of the four managers invests in a combination of securities that all conform to OCTA's 2017 Investment Policy. For the quarter ending June 30, 2017, the weighted average total return for OCTA's short-term portfolio was 0.32 percent, outperforming the Treasury benchmark return of 0.17 percent by 15 basis points and outperforming the Corporate/Government benchmark return of 0.26 percent by six basis points. For the 12-month period ending June 30, 2017, the portfolio's return totaled 0.26 percent, exceeding the Treasury benchmark by 37 basis points and outperforming the Corporate/Government benchmark by 11 basis points for the same period.

Total return performance for the quarter was positive; however, the returns for the trailing 12 months for the BAML Treasury benchmark were negative, 0.11 percent. The Corporate/Government benchmark and each of the four investment managers remained positive in spite of recent Fed tightening. As yields rise, the market value of fixed-income securities falls. Total return is the interest earned during a given period of time, plus or minus any market gains or losses, both realized and unrealized. OCTA's investment managers added value by investing in high-quality, non-government fixed-income securities with higher yields during the period. Evidence of this may be seen in a direct comparison of the two benchmarks used by OCTA. The Corporate/Government benchmark clearly maintained a performance advantage, and was less affected by the rise in interest rates than the treasury-only benchmark, due to the additional yield generated by non-government securities. This is the case for each of the four investment managers as well.

Investment Portfolios: A summary of each investment manager's investment diversification, performance, and maturity schedule is provided in Attachment F. These summaries provide a tool for analyzing the different returns for each manager.

A complete listing of all securities is provided in Attachment G. Each portfolio contains a description of the security, maturity date, book value, market value, and yield provided by Clearwater Analytics.

Cash Availability for the Next Six Months: OCTA has reviewed the cash requirements for the next six months. It has been determined that the liquid and the short-term portfolios can fund all projected expenditures during the next six months.

Summary

As required under the California Government Code, the Orange County Transportation Authority is submitting its quarterly debt and investment report to the Board of Directors. The report summarizes the Orange County Transportation Authority's debt and investment activities for the period April 2017 through June 2017.

Attachments

A. Orange County Transportation Authority Outstanding Debt June 30, 2017.
B. Orange County Transportation Authority Investment Policy Compliance June 30, 2017.
C. Orange County Transportation Authority Short-term Portfolio Performance Review Quarter Ending June 30, 2017.
D. Orange County Transportation Authority Short-term Portfolio Performance June 30, 2017.
E. Orange County Transportation Authority Comparative Yield Performance June 30, 2017.
F. Investment Manager Diversification and Maturity Schedules June 30, 2017.
G. Orange County Transportation Authority Portfolio Listing as of June 30, 2017.

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