OCTA

July 23, 2018

To: Members of the Board of Directors

From: Darrell E. Johnson, Chief Executive Officer

Subject: Second Quarter 2018 Investment and Debt 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 2018, 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 (OCTA) investment portfolio totaling $1.5 billion as of June 30, 2018. 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 $578.8 million as of June 30, 2018. Approximately 53 percent of the outstanding balance is comprised of Measure M2 (M2) debt, 18 percent is associated with the 91 Express Lanes Program, and 28 percent accounts for the Transportation Infrastructure Finance and Innovation Act (TIFIA) draw of $165 million for the Interstate 405 (I-405) Project.

Economic Summary: The Federal Reserve (Fed) raised the Fed Funds rate for a second time this year in June 2018 by another 25 basis points to a new range of 1.75 percent to two percent. At the Fed meeting in June, Fed officials revised

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the forecast for additional rate hikes for the year from three to four by year-end 2018. According to the minutes from the June 2018 Fed meeting, Fed officials noted a strong economy, but remain vigilant on emerging risks, mostly related to trade tensions and the economy growing too fast. Fed officials expect interest rates to continue to increase, but noted that rates may reach high levels as soon as next year to potentially cause a slowdown in economic growth. The Fed is monitoring the market and change in interest rates as an accurate predictor of past downturns due to the narrowing gap between short- and long-term rates.

Economic growth remained on a strong track for the second quarter of 2018, fueled by business investment, tax cuts, and continued tightening of the labor market which increased consumer spending. The unemployment rate increased to four percent in June, coupled with a 0.2 percent increase in the labor participation rate, representing an increase in workers actively looking for jobs in the strong labor market. Consumer sentiment fell in June due to concerns on trade policies and tariffs that are set to take effect in July 2018. The Consumer Price Index increased, with underlying inflation hitting the Fed's target of two percent for the first time in six years. Nondurable goods purchased increased 0.6 percent, most likely attributed to higher gas prices. Economic indicators are expected to remain strong through year-end 2018, but there is pressure on future economic growth due to potential escalating trade tensions.

Debt Portfolio Activity: No debt service payments were made during the second quarter for M2 or 91 Express Lanes debt. OCTA initiated the first draw on the TIFIA loan for $165 million on April 16, 2018, for the Express Lanes of the I-405 Project. The M2 Program currently has $310.2 million and the 91 Express Lanes Program currently has $103.6 million in outstanding debt. The outstanding balances for each of OCTA's debt securities are presented in Attachment A.

Investment Portfolio Compliance: There were no compliance violations during the quarter. However, a security held in the portfolio managed by Logan Circle Partners fell below the minimum credit requirement. On Friday, June 1, 2018, Moody's downgraded the long-term debt ratings on Union Pacific Corp. to Baa1 from A3. The Treasurer reviewed the position and recommended the security be liquidated. The Treasurer presented his recommendation to the Deputy Chief Executive Officer who concurred. The security was sold on Monday, June 4, 2018.

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, 2018, to the diversification guidelines of the policy.

Investment Portfolio Activity: As of April 12, 2018, the addition of the three new investment management firms was completed. The three new firms are Chandler Asset Management, Logan Circle Partners, and Public Financial Management.

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 ICE/Bank of America Merrill Lynch (ICE/BAML) 1-3 year Treasury (Treasury) and the ICE/BAML 1-3 year AAA-A U.S. Corporate and Government (Corporate/Government) benchmarks. The ICE/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 2018 Investment Policy. For the quarter ending June 30, 2018, the weighted average total return for OCTA's short-term portfolio was 0.35 percent, outperforming the Treasury benchmark return of 0.22 percent by 13 basis points and outperforming the Corporate/Government benchmark return of 0.27 percent by 8 basis points. For the 12-month period ending June 30, 2018, the portfolio's return totaled 0.39 percent, exceeding the Treasury benchmark by 31 basis points and outperforming the Corporate/Government benchmark by 19 basis points for the same period.

Continued Fed tightening has resulted in the market price on securities dropping due to the inverse relationship of fixed-income securities and interest rates. Bonds and interest rates have an inverse relationship, meaning that when interest rates go up, existing bond prices go down, and when interest rates decrease, bond prices increase.

OCTA's investment managers mitigated the impact of rising interest rates 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 over the past year. 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 was the case for each of the four investment managers as well during the twelve-month period.

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 2018 through June 2018.

Attachments

A. Orange County Transportation Authority Outstanding Debt June 30, 2018.
B. Orange County Transportation Authority Investment Policy Compliance June 30, 2018.
C. Orange County Transportation Authority Short-term Portfolio Performance Review Quarter Ending June 30, 2018.
D. Orange County Transportation Authority Short-term Portfolio Performance June 30, 2018.
E. Orange County Transportation Authority Comparative Yield Performance June 30, 2018.
F. Investment Manager Diversification and Maturity Schedules June 30, 2018.
G. Orange County Transportation Authority Portfolio Listing as of June 30, 2018.

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