OCTA

*October 22, 2018*

***To:*** Members of the Board of Directors

***From:*** Darrell E. Johnson, Chief Executive Officer

***Subject:*** Third 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 third quarter of 2018, July through September, 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 September 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 $573 million as of September 30, 2018. Approximately 54 percent of the outstanding balance is comprised of Measure M2 (M2) debt, 17 percent is associated with the 91 Express Lanes Program, and 29 percent accounts for the Transportation Infrastructure Finance and Innovation Act draw of $165 million for the Interstate 405 Project.

Economic Summary: The Federal Reserve (Fed) raised the Fed Funds rate for a third time this year in September 2018 by another 25 basis points to a new range of 2 percent to 2.25 percent. At the Fed meeting in September, Fed officials revised the forecast for one more rate hike in December, three in 2019, and one in 2020. The Fed's monetary policy normalization remains on track as evidenced by the strong labor market, higher inflation, and steady growth. Benchmark yields moved higher in September across the curve, with the two-year Treasury yield at 2.82 percent, a rise of 19 basis points, the five-year Treasury yield at 2.95 percent, a rise of 21 basis points, and the ten-year Treasury yield at 3.06 percent, a rise of 20 basis points from the prior month.

On the economic data front, economic growth remained on a strong track for the third quarter of 2018, with full-year growth expected to reach three percent for the first time since 2005. Fixed-income markets were driven mostly by macro developments, central bank activity, and volatility in the tech market rather than economic data. Trade volatility continued through September due to trade policy concerns, but the United States (U.S.) ability to reach an agreement with Mexico and Canada represents an encouraging sign, although uncertainty remains with China and the European Union.

The unemployment rate fell to 3.7 percent in September, the lowest level since 1969. The U.S. economy added 230,000 jobs in September, the largest gain in seven months. Activity in the U.S. service sector rose to the highest level on record, boosted by increased spending, the Institute of Supply Management reported nonmanufacturing activity at 61.6 in September. Oil prices have increased to near four-year highs for the year as the U.S. prepares to enact oil sanctions against Iran in November, with analysts forecasting increased prices to $90 a barrel as global supply tightens. Turkey's inflation rate hit its highest point in 15 years, as a currency crisis continues to unfold and the central bank reported increased prices of 24.5 percent in September from a year earlier.

Debt Portfolio Activity: On August 15, 2018, OCTA remitted a debt service payment for the 91 Express Lanes in the amount of $10.8 million. Of this amount, $5.8 million was used to retire principal. As of September 30, 2018, $97.8 million is outstanding on the 91 Express Lanes Tax-Exempt Bonds.

Also occurring on August 15, 2018, OCTA remitted a debt service payment to M2 investors in the amount of $10.3 million. The total amount remitted represented interest on the M2 debt. Principal payments for the M2 Program are paid in February each year. As of September 30, 2018, the M2 Program currently has $310.2 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 Thursday, August 9, 2018, Fitch placed Alabama Power Company on Rating Watch Negative with a rating of A+. 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 Tuesday, August 14, 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 September 30, 2018, 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 Intercontinental Exchange (ICE)/Bank of America Merrill Lynch (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 September 30, 2018, the weighted average total return for OCTA's short-term portfolio was 0.40 percent, outperforming the Treasury benchmark return of 0.20 percent by 20 basis points and outperforming the Corporate/Government benchmark return of 0.30 percent by 10 basis points. For the 12-month period ending September 30, 2018, the portfolio's return totaled 0.47 percent, exceeding the Treasury benchmark by 43 basis points and outperforming the Corporate/Government benchmark by 27 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 12-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 July 2018 through September 2018.

***Attachments***

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

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