NEPC, LLC

To: Cash Management Policy Board Investment Committee

From: John Krimmel, Jennifer Appel, Kevin Leonard

Date: April 19, 2021

Subject: 2021 Liquidity & Reserve Manager Due Diligence Meetings

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Background
Members of the Delaware Office of the State Treasurer (OST) Staff and NEPC met with the six investment management firms charged with implementing the fixed income portfolio structure for the Delaware OST. The purpose of the meetings was to discuss any significant changes to the investment management organizations, team members, and investment process, along with receiving updates on current portfolio positioning, potential portfolio positioning changes, and current market conditions. Further, the investment management firms provided an update on their activities related to the recent guideline changes, as well as surveying potential Investment Guideline enhancements.

The remainder of this memo summarizes the findings during these meetings. The memo has been structured between the Liquidity and Reserve components of the portfolio, along with a final section discussing potential Investment Guideline enhancements.

Liquidity Managers
PFM
PFM indicated that there had been no significant changes to the investment organization, assigned investment team, investment philosophy, or approach since our last comprehensive review. The investment team continues to grow with Christy Fletcher joining the short-term (enhanced cash) team over the past twelve months.

The firm's market outlook for the short end of the curve remains unchanged. PFM believes that the front end of the yield curve is anchored in the 0.00% - 0.25% range until 2022 at the earliest. They believe the Federal Reserve remains committed to a stable short-term rate and is willing to let inflation run a bit higher than its targeted 2%. As a result, asset prices in liquidity markets remain very stable. The portfolio is currently positioned to take advantage of the steepness on the front end of the yield curve. The portfolio has a duration longer than comparable 6-month Treasury portfolio, which results in a nearly 30 basis point yield advantage. The portfolio has significant positions in CDs, Treasuries, Agencies and Supranationals. The portfolio also has an underweight position in mortgages as they view them as being expensive.

Wilmington Trust
Wilmington Trust updated OST and NEPC regarding their announced acquisition of Peoples United Bank, headquartered in Bridgeport, Connecticut, in an all stock deal. Post-acquisition, M&T (Wilmington Trust's parent) will hold 72% of the outstanding shares and Peoples United Bank will hold the remaining 28%. The acquisition, which is targeted to

close in the 4th quarter 2021, will result in the 11th largest bank in the US as both entities have significant footprints on the East coast.

There will be no significant changes to the investment management division, as Wilmington Trust had a significantly larger institutional and trust asset management business. The firm also announced that Jack Beeson, who headed up the Capital Markets Division, would be retiring after 38 years with the bank. Mr. Beeson will be replaced by Ms. Abby Merzenski, who has been serving as the organization's Chief Financial Officer.

There have been no significant changes to the assigned investment team, investment philosophy, or approach since our last comprehensive review.

Wilmington Trust highlighted the impact of the recent economic stimulus resulting from the COVID pandemic. The firm believes that the most recent $1.9 billion will aid mainly state and local government entities, while providing some modest relief to individuals and households. The firm is cognizant that this additional money in the system will likely push inflation above the Federal Reserve's targets stated target of a 2% average inflation level in the 3rd and 4th quarter of 2021, which should then move back down into the target range during calendar year 2022 after the pent up demand for goods and services abates.

Wilmington Trust's portfolio remains positioned for a steady state position on the front end of the yield curve. They believe that this environment will remain throughout calendar year 2022 even though inflation may increase. The firm's view is that the longer end of the yield curve is range-bound and will trade at or near the recently elevated levels.

The portfolio remains positioned with a duration longer than other comparable enhanced cash mandates to take advantage of the steepness of the yield curve, while maintaining adequate liquidity and high-quality holdings in the portfolio. The portfolio's largest positions are held in agency mortgages, corporate bonds, and commercial paper.

Reserve Managers

JP Morgan – Tier 1 Reserve Manager (1-3 Years)

JP Morgan noted that had been no significant changes to the investment organization, assigned investment team, investment philosophy, or approach since our last comprehensive review.

JP Morgan noted that the recent stimulus has increased the money supply and has resulted in increasing the back end of the yield curve from its historic low yield levels. They believe the drivers of this increase are the successful results and distribution of the COVID vaccines, massive stimulus by global central banks, and increasing optimism by businesses and consumers. The firm also noted that the "lower for longer" position of the Federal Reserve is likely to remain for at least another year, if not longer. As a result of the current environment, they view the potential for longer dated yield increases as elevated.

JP Morgan's portfolio duration is short of their performance benchmark (1.7 years versus 1.9 years), while maintaining an overweight to high quality corporate credit. The portfolio remains underweight US Treasury, ABS and mortgage securities, noting that these are all at or above fair value on a relative basis. The firm believes that short end of the yield curve will likely rise prior to early- to mid-2023 and will continue to modify their positioning as appropriate.

BlackRock – Tier 2 Reserve Manager (1-5 Years)
BlackRock noted that there had been no changes to the investment philosophy, or approach since our last comprehensive review. They did review changes to the investment structure that were put into place last year. The firm shifted the short duration fixed income management to being included under its Fundamental Fixed Income platform. The move was to align all of the non-cash fixed income teams under the same strategy and investment platform. New members to the team during this transition included Akiva Dickstein, Portfolio Manager, and Ludwig Murek, Product Strategist.

The firm noted in its outlook and positioning sections that they believe the Federal Reserve may lift the Fed Funds rate towards the end of calendar year 2022, which they believe to be the result of the recent stimulus and significant economic growth over the next year. They do, however, believe that the 5-year Treasury Note at ~0.9% is fairly priced and that it will likely trade in a range of 0.6% to 1.2% over the next year. Major investment themes the firm covered included global economic recovery prospects, rising inflation expectations, and a steepening yield curve.

BlackRock's portfolio positioning reflects these views and they noted that their portfolio's duration would remain slightly short of the benchmark duration (2.6 years versus 2.7 years) due to the "fair value" of the current 5-year Treasury Note. The firm remains overweight select sectors in corporate markets as some sectors have not fully recovered from the sell off in March 2020. BlackRock has selectively added to its investment grade financials, industrials, and municipal holdings while trimming its Treasury, agency and agency MBS positions.

Chandler – Tier 3 Reserve Manager (5-10 Years)
Chandler noted that had been no significant changes to the investment organization, assigned investment team, investment philosophy, or approach since our last comprehensive review. The firm continues to grow, and as a result several promotions (role changes) would be occurring to reflect the growth. Ms. Nicole Dragoo is being promoted to President to manage the firm's operational aspects, while Mr. Joseph Kolinsky will be elevated to Chief Compliance Officer - backfilling Ms. Dragoo's former position. These changes, while recent, follow on to 2021's changes where William Dennehy (Delaware's lead PM), Jason Schmitt, and Scott Prickett were elevated to Deputy Chief Investment Officer. Martin (Marty) Cassell remains as the firm's Chief Investment Officer. The firm will also be adding a senior Portfolio Manager in mid-April to support the firm's recent and future asset growth.

The firm's outlook and positioning remain largely unchanged over the past six months. Chandler continues to believe that the worldwide economic growth, led by the US, will remain strong. This view has been supported by significant economic stimulus and accommodative central banks. The firm does not see any significant near-term policy changes that would disrupt continued growth. As a result of this outlook, Chandler's view is that the back end of the yield curve, 5 years and beyond, will continue to see modest yield increases. The portfolio remains positioned for this environment, and they noted that the short duration position (6.2 years versus 6.7 years) has been the primary source of excess returns since late summer 2020. Chandler also noted that increased yields in the corporate sector would likely result in higher corporate downgrades later this year.

Chandler recently saw one of its securities, Oracle, downgraded by one of the rating agencies due to the perception that a new issuance would likely tax the firm's ability to repay its debt. While the firm was downgraded by one of the rating agencies and not the others, Chandler was able to take advantage of the new issuance and trade the security out at a strong price, resulting in a small gain. They used this example to illustrate how quickly a strong company can move from an A rating to BBB – perhaps a harbinger of the next six to twelve months in the credit markets.

Lazard – Tier 3 Reserve Manager (5-10 Years)
Lazard noted that had been no significant changes to the investment organization, assigned investment team, investment philosophy, or approach since our last comprehensive review. Joe Ramos continues to be the lead Portfolio Manager on the Delaware portfolio.

The firm's outlook and portfolio positioning remain cautious. Lazard noted the market consensus and Federal Reserve's current posture that short-term interest rates will remain steady into mid- to late-2023, while economic activity continues to increase. The firm continues to believe that global central banks will support their local economies, while continuing to implement policies to facilitate smooth functioning of financial markets. The firm is cognizant that numerous companies may not be able to operate at investment grade levels in the future, and that default rates could approach double digit levels. The portfolio is positioned with these themes in mind, resulting in a shorter duration (6.2 years versus 6.7 years) and an overweight to US Treasuries and select taxable municipal securities. Offsetting the above benchmark Treasury positions are underweights to US corporates, US agencies, and asset-backed securities.

Potential Guideline Enhancements
The table on the following page summarizes comments that were received related to potential Investment Guideline enhancements. Major themes are captured along with the frequency in which they were cited by the six investment managers.

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Several of these suggestions, we believe, are worthy of discussion and consideration in the next annual guideline revision process. We will be working with OST Staff to further develop a document to focus the discussion on topics such as:

- Considering lifting the Private Placement (144) levels in areas that have significant issuance levels such as commercial paper programs
- Revisiting the current split ratings approach versus the index (benchmark) constituent approach
- Revisiting agency, mortgage, and asset-backed securities definitions and limits

We look forward to discussing this memo with the Investment Committee and Cash Management Policy Board at their upcoming meetings in May.