To: Delaware Cash Management Policy Board – Investment Subcommittee

From: John Krimmel, Jennifer Appel, and Kevin Leonard

Date: August 4, 2021

Subject: Annual Review of Investment Guideline Changes

Background

Annually, OST Staff and NEPC review the Delaware Office of the State Treasurer Statement of Objective and Guidelines for the Investment of State of Delaware Funds (the "Guidelines"). In addition to Staff and NEPC review, we solicited potential changes to the Guidelines from the six fixed income managers during our update calls held earlier this year. Those suggestions were included in our Memo dated April 19, 2021, at which time we indicated that we would be reviewing the three most frequently cited suggestions. These were:

- Increasing the Private Placement (Rule 144A) limits from the current 15% maximum,
- Revisiting the current Split Ratings Approach, and
- Revisiting agency, mortgage and asset-backed securities definitions and limits.

The remaining sections of this memorandum briefly discuss the Guideline suggestions, the rationale for the considering these suggestions, and culminates in recommendation for changes, where appropriate.

Private Placement (Rule 144A) Limit Increase

Increasing the Rule 144A securities limit was cited four times in our discussions. Both Liquidity Managers, PFM and Wilmington Trust, requested the change, along with two of the Reserve Managers. The Liquidity Managers noted in their request that Rule 144A securities account for more than 80% of the issuance in the Commercial Paper (CP) market. These managers indicated that a modest increase in the limit to 25% would significantly increase their opportunity set for short-term corporate securities.

As a reminder, most 144A issuers are high quality corporations that utilize the private placement market to reduce the issuance costs normally associated with a full registration process. The short-term nature of these debt instruments are such that ongoing issuance costs would be passed along to investors in the form of reduced yields.

All 144A investments would remain subject to the current credit quality (6.3.4.1) and issuer limits (6.3.4.2) in the Guidelines.

<u>NEPC recommends that the Liquidity Accounts 144A maximum investment limit be increased to 25% from the current 15% level.</u>

Allow Split Ratings

Split rated securities are addressed in the Guidelines (11.1.10) and read as follows: "Where these Guidelines require at least two NRSRO ratings for a security, the lowest such rating control." Modifying the Guidelines to allow for split rated securities was cited four times during the manager conversations. Further, several of the managers noted that the current indices series, the Intercontinental Exchange / Bank of America (ICE BofA), includes split rated securities if they pass a threshold level using a formulaic approach developed by the index provider. Their proprietary approach, while somewhat nebulous, permits a split rated security if a weighted average score of the rating agencies exceeds a minimum threshold.

<u>NEPC believes that the current approach to utilize the lower rating for controlling purposes in the Guidelines is appropriate, and no changes are recommended at this time.</u>

Agency, Mortgages and Asset-Backed Securities

There were a total of five comments related to Agency, Mortgage-Backed, and Asset-Backed securities. These comments were received from four of the six managers that are addressed below.

Agency Securities –

The first request was to increase the current US Government Agencies limit from its current 50% maximum and 20% individual issuer limits permitted by the Guidelines (6.3.2.2 and 7.3.2.2). <u>NEPC believes that the 50% maximum and 20% individual issuer limits for US Government Agencies are appropriate, and no changes are recommended at this time.</u>

A second request was to allow Foreign Agency securities. Supranational Organizations and International Agencies are permitted under the Guidelines (6.3.11 and 7.3.11) provided they meet the meet the quality rating requirements contained in the Guidelines (6.3.11.1 and 7.3.11.1). The Guidelines (6.3.11.2 and 7.3.11.2) limit the exposure to Supranational Organizations and International Agencies to 25% maximum and 10% issuer limits. <u>NEPC believes the current Guidelines allow for the requested securities and that the 25% maximum and 10% individual issuer limits are appropriate, and no changes are recommended at this time.</u>

A third request was to allow Canadian Province issues. Canadian Treasury Bills and Canadian Agency Securities are permitted under the Guidelines (6.3.7, 6.3.8, 7.3.7 and 7.3.8) if they are US dollar denominated. Canadian Treasury Bills are permitted up to a 25% maximum (7.3.7.2 and 8.3.7.2). Canadian Agency securities are permitted if they are "insured as to principal and interest by the Canadian Government" (6.3.8.1 and 7.3.8.1) subject to a 25% maximum and 10% single agency limit (6.3.8.2 and 7.3.8.2). As the current Guidelines are silent on Canadian Province issues, the interpretation is that they are not permitted. <u>NEPC believes that if Canadian Province issues meet the "insured as to principal and interest by the Canadian Government" clause that they be considered Canadian Agency Issues. If the bonds do not meet the "insured as to principal and interest by the Canadian Government" clause that they remain an impermissible investment.</u>

Mortgage-Backed Securities –

A request was made to expand the current approved lists of mortgage-backed security investments which includes Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and Federal Home Loan Corporation (FHLMC) pass-through mortgage securities. Additionally, there was a request to increase the current maximum limit as specified in the Guidelines (7.3.9.2 and 8.3.9.2). NEPC believes that the current list of approved mortgage-backed security investments and maximum position limits remain appropriate, and no changes are recommended at this time.

Asset-Backed Securities –

A request was made to expand the current approved lists of asset-backed securities, which includes "securities collateralized by pools of auto loan receivables, credit card receivables, and equipment loans…". Additionally, there was a request to increase the current maximum limit as specified in the Guidelines (7.3.10.2 and 8.3.10.2). NEPC believes that the current list of approved asset-backed security investments and maximum position limits remain appropriate, and no changes are recommended at this time.