



To: Delaware Cash Management Policy Board
From: John Krimmel, Partner
Date: April 24, 2018
Subject: Transition to New Architecture Update

Background

The Delaware Office of the State Treasurer (OST) Staff, NEPC and investment managers have been working diligently to transition the Reserve and Liquidity portfolios to the new architecture.

An update was provided to the CMPB at their February 28, 2018 Meeting. Since that meeting, the legacy (terminated) manager's assets have been reconciled and transferred to the existing/new managers as presented in the following table. All assets were transferred by March 5th.

Legacy Manager	Target Manager			Total
	BlackRock	Lazard	Chandler	
Federated	\$ 145,455,626			\$ 145,455,626
Morgan Stanley	155,891,662			155,891,662
Wells		\$ 128,687,112		128,687,112
Insight		126,920,094		126,920,094
Schroder			\$ 199,954,607	199,954,607
Cash Flow		45,000,000		45,000,000
Total	\$ 301,347,288	\$ 300,607,206	\$ 199,954,607	\$ 801,909,101

Note:

Chandler's assets when combined with existing balance (\$103,799,555) resulted in post-transition balance of \$303,754,162

The portfolios have been repositioned or are in the process of being repositioned as of this date. An update on each of the managers follows.

Transition Update

Liquidity Managers – The two liquidity managers, PFM and Wilmington Trust held balances of \$210,058,885 and \$207,387,433 on March 1, 2018. These balances were in line with the \$200,000,000 target balances for the liquidity accounts. Since these portfolios were in line with expectations, there were minimal adjustments needed to bring the portfolios into compliance with the new architecture and guidelines. OST is working with both of these managers to develop a cash liquidity model to estimate anticipated cash needs.



Reserve Managers – each manager is discussed in the following sections.

JP Morgan – Reserve Tier 1 – Government / Credit 1-3 Years A or Better

JP Morgan's opening balance on March 1, 2018 was \$300,986,266. This portfolio's balance was in line with expectations and minimal adjustments were needed to bring the portfolio into compliance with the new architecture and guidelines.

BlackRock – Reserve Tier 2 – Government / Credit 1-5 Years A or Better

BlackRock inherited securities from the Federated and Morgan Stanley portfolios, which were configured to the prior Reserve pool expectations and guidelines. As a result, BlackRock will be reconfiguring assets to a slightly longer duration portfolio.

BlackRock has been slowly repositioning the portfolio in order to minimize realized losses in the portfolio through the end of the current fiscal year. Initial transition moves have been to sell shorter dated Treasury securities and floating rate Treasury notes to buy longer dated mortgages and corporate securities in order to extend duration. In the near term, BlackRock is comfortable with the account positioning, but will rotate some of the corporate exposure (replacements), add to the taxable municipal positions and reduce certain agency exposures.

BlackRock's outlook for the next twelve months is for marginally higher rates and continued strong economic fundamentals. They do identify several potential risks to the markets including US tensions with North Korea and China, NAFTA negotiations, and the upcoming mid-term elections. BlackRock's expectations for returns over this period to range from 2.00% to 2.25%, which incorporate their view that interest rates will move marginally higher over the course of the twelve month time horizon.

Lazard – Reserve Tier 3 – Government / Credit 5-10 Years A or Better

Lazard inherited cash from the Wells and Insight portfolios. Wells and Insight were instructed to liquidate their holdings prior to the transfer, as these assets were configured to the Liquidity portfolio expectations and guidelines.

Lazard's initial moves were to transition the \$255.5 million and \$45.0 million in cash into US treasuries that met interest rate exposure targets based on the Tier 3 Reserve expectations. Since those initial positions were established, the firm has been selectively adding liquid 7-10 year A-rated US corporate securities as well as liquid 1.5-2.0 year AAA-rated asset backed securities. The portfolio currently has a 20% exposure to corporate securities, which is a 7% underweight to the benchmark. Lazard continues to build the corporate exposure in an effort to neutralize the underweight. They are also looking to build the taxable municipal bond exposure over the next several months. The portfolio's current duration is 6.19 years, slightly lower than the 6.36 years duration of the benchmark.

Lazard's outlook for the next twelve months remains constructive on the US economy. They believe that the Federal Reserve is further along in the tightening cycle than many market participants and that terminal Fed Funds rate will be closer to the current break-even inflation rate of 2%. Lazard's unchanging view of the markets leads them a base case return expectation of 3.62%, which incorporates a 1.0% alpha target.

Chandler – Reserve Tier 3 – Government / Credit 5-10 Years A or Better

Chandler inherited securities from the Schroder portfolio, which was configured to the prior Reserve pool expectations and guidelines. These holdings, when combined with their existing



portfolio holdings, bring them in line with the new Reserve architecture target allocation. Chandler will, however, be reconfiguring assets to the longer duration profile.

Chandler has been gradually repositioning the portfolio to the new mandate. The process was slowed due to the volatility that was present during March 2018. Recent abatements in volatility have allowed them to press forward with the repositioning. Initial moves in repositioning have been to marginally increase the credit and agency positions and duration. The most notable changes have been in the agency area where durations have increased from 0.53 years at the start of the reconfiguration to 5.01 years as of April 13, 2018. Chandler expects to have the overall portfolio duration at their target of 6.0 years by the end of June.

Chandler's outlook for the next twelve months is that the shape of the Treasury curve will evolve over the last half of calendar year 2018. This view is supported by the dynamics of a contracting Fed balance sheet and the increased supply of Treasury issuance. This, they believe, will result in a modest steepening of the yield curve. The firm does not foresee any significant changes in credit spreads as a result of corporate stress or distress. Chandler's expectation for the portfolio's return over this period is approximately 2.9%, in line with the yield on the benchmark.

Final Comments

The transition process to the new Portfolio Architecture has been steadily moving ahead. Based upon comments from the managers that were tasked with the largest portion of the reconfiguration, BlackRock, Lazard, and Chandler, we believe that the transition will substantially be completed by June 30, 2018. This does not mean that these three portfolios will be at their terminal positions. We expect continual repositioning to occur throughout the 3rd quarter of calendar year 2018. However, this repositioning will be substantially less than what transpired during the 2nd quarter.

We look forward to discussing the transition in greater details with the CMPB on Wednesday, May 23rd.