NEPC, LLC

To: Cash Management Policy Board Investment Committee

From: Alexandra Sollers, Jennifer Appel, Kevin Leonard

Date: July 20, 2023

Subject: 2023 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 relayed potential Investment Guideline enhancements to their mandates managed on behalf of the Delaware OST.

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 by manager.

Liquidity Managers

PFM

PFM indicated that there had been no significant changes to the investment organization, assigned investment team, investment philosophy, or approach since the last comprehensive update between Delaware OST staff and NEPC.

PFM highlighted the recently attractive opportunity set for debt issuance following the U.S. Senate's decision to suspend the debt ceiling. An increase in outstanding T-Bill issuance over the last six weeks has resulted in more opportunities within the Treasury space and may lead to wider spreads in the front of the curve.

PFM believes the Federal Reserve is close to hitting peak interest rates, and manages the portfolio duration to be close to half of a year. The portfolio continues to maintain significant positions in CDs, Treasuries, Agencies and Supranationals. Over 2023, the portfolio has decreased its allocation to US Treasurys, Supranationals, commercial paper, and has increased allocations to Agencies and corporate credit.

Wilmington Trust

Wilmington Trust has indicated there has been no significant changes to the assigned investment team, investment philosophy, or approach since the last comprehensive review with OST and NEPC. From an investment organization perspective, Wilmington relayed the sale of the collective trust investment business to Madison Dearborn Partners, which occurred at the end of 2022. Dominic D'Eramo, former head of Fixed Income and Sr. VP at Wilmington Trust, joined Madison Dearborn Partners with the sale of the collective investment trust business.

Wilmington Trust highlighted the volatility seen in the first half of 2023, especially in the short end of the market. Concerns around banking stress stemming from smaller regional banks and rate hike expectations have been driving volatility. While the equity market has had a significant outperformance year-to-date, and tight credit spreads in the fixed income market reflect muted near-term recessionary concerns.

Portfolio duration is close to that of its benchmark (0.42 years versus 0.41 years). 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 there had been no significant changes to the investment organization, assigned investment team, investment philosophy, or approach since the last comprehensive review with Delaware OST staff and NEPC.

JP Morgan highlighted the recent financial distress caused by turmoil within the regional banking sector, and the impact it has had on exposing economic vulnerability in the face of rapidly increasing interest rates. The portfolio did hold a 2% allocation to regional banks, which has been vetted with their credit analysts, but ultimately was a drag on the portfolio's performance.

JP Morgan's portfolio duration is slightly short of their performance benchmark (1.8 years versus 1.9 years). The portfolio maintains an overweight allocation to high quality corporate credit, and underweight allocations to US Treasuries, US Agencies, and non-corporate credit.

BlackRock – Tier 2 Reserve Manager (1-5 Years)

BlackRock relayed that there had been no changes to the investment organization, assigned investment team, investment philosophy, or approach since the last comprehensive review with Delaware OST staff and NEPC.

BlackRock believes that while U.S. economic volatility has mostly subsided, concerns remain as increasing rates have uncovered areas of weakness, such as what was seen within regional banking sector earlier this year. Rates are currently being pushed up by a hawkish Federal Reserve, creating an opportunity within T-bills, however the firm believes that central banks may be nearing the end of the hiking cycle. BlackRock believes that inflation has peaked, but strong shelter inflation numbers are likely to keep levels elevated until mid-2023.

The portfolio saw spread widening versus the benchmark due to tactical regional allocations as the portfolio holds more supranational holdings than the benchmark due to restrictions on purchasing foreign entities given Delaware's mandate. Portfolio spread duration is above that of the benchmark (1.3 years versus 0.7 years), and portfolio yield is slightly elevated compared to the benchmark (4.6 versus. 4.5) due to option-adjusted spreads.

Chandler – Tier 3 Reserve Manager (5-10 Years)

Chandler noted that there had been no significant changes to the investment organization, assigned investment team, investment philosophy, or approach since the last comprehensive review. The firm continues to grow its staff, and as a result several promotions and additions to the firm, has added three new assistant portfolio managers who will be working under the oversight of more senior members of the team. As of June 2023, the firm had approximately 44 employees.

Chandler’s view is that the Federal Reserve may pause rate hikes at any moment, and holding rates at this level could result in more restrictive financial conditions throughout the remainder of the year. Chandler believes employment numbers remain very robust due to demographic dislocations resulting from the pandemic and expects positive growth, though below trend, throughout the remainder of 2023.

Compared to the benchmark, the portfolio is more concentrated around the7-year point given the liquidity seen in this part of the curve. Chandler is currently more focused on the 7–10-year segment of the curve as new money is added to the portfolio. The portfolio holds a handful of securities inside the 5-year portion of curve and aims to swap out these securities once cash flows are more stable. Consequently, portfolio duration is slightly below that of the benchmark (5.9 years versus 6.2 years).

Lazard – Tier 3 Reserve Manager (5-10 Years)
Lazard noted that there had been no significant changes to the assigned investment team, investment philosophy, or approach since our last comprehensive review. Ken Jacobs announced he will be stepping down as Lazard’s CEO. He will be replaced by Peter Orszag, who currently runs the advisory unit of the bank. Joe Ramos continues to be the lead Portfolio Manager on the Delaware portfolio. Michele Donnelley has replaced Nina Osenbroch as relationship manager for the Delaware OST Reserve accounts.

Lazard’s view looking toward the second half of 2023 remains cautious as many of the general themes that persisted throughout 2022 continue to guide the markets: elevated short-term US Treasury rates, an inverted yield curve, sticky inflation, and the Fed tightening financial conditions. While the short end of the yield curve has been heavily anchored by easy Fed policy, Lazard believes that the Fed is nearing the end of this cycle. Fallout from regional banking failures and the tightening of consumer credit helps restrict financial conditions and slow the pace of growth and inflation. Given relatively low yields on the long end of the curve compared to the short end, Lazard noted the inverted curve may indicate market concerns that the Fed’s tightening path will be long and steep, and potentially overshoot and derail the economy.

Given the constraint of being a 5-to-10-year portfolio, Lazard has positioned the portfolio for a bull flattening of the curve by underweighting the 10-year curve point. This has led to a portfolio that has a shorter duration than the benchmark (5.8 years versus 6.2 years). Lazard is seeking additional opportunities in Taxable Municipal bonds, which has been limited by the term structure and issue size of outstanding debt in that market and by the relative expensiveness of those bonds that fit naturally within Delaware’s mandate.

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.

	PFM	Wilmington Trust	JP Morgan	BlackRock	Chandler	Lazard
Increase 144a Limits		Y	Y	Y		Y
Carve Out Commercial Paper from 144a Restrictions				Y		
Allow Split Ratings			Y	Y		
Increase Agency Limits		Y		Y		
Loosen Forced Liquidation Requirements	Y	Y	Y	Y		Y
An Increase Average Life Restrictions				Y		
Expand ABS Definition			Y	Y		
Benchmark Change						
Increase ABS & MBS Limits	Y	Y	Y	Y		Y
Allow Derivatives			Y	Y		
Allow BBB Securities			Y	Y	Y	
Maturity Restrictions					Y	
Corporate Debt Ratings Requirements	Y					

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 forced liquidation requirements
- 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.