To: Cash Management Policy Board Investment Committee

From: Jonovan Sackey, Jennifer Appel, Kevin Leonard

Date: July 12, 2024

Subject: 2024 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.

Liquidity Managers

PFM

PFM indicated that there had been no significant changes within the firm or dedicated investment team, although the firm did reference the acquisition of PFM by US Bank two years ago. Presently they operate as separate investment entities but are currently looking at ways to combine teams and resources.

PFM highlighted the increasing likelihood of a soft landing for the U.S. economy, crediting a resilient labor market, higher wages, and strong consumer spending to start the year. The asset-backed securities (ABS) sector was the strongest-performing sector, supported by optimism surrounding the strength of the U.S. consumer. Incremental income from ABS investments remains attractive and PFM's fundamental outlook for the sector remains positive. Yield spreads across most investment grade sectors continued to tighten, while diversification across the spread sectors bolstered relative performance. The negotiable CDs sector was the largest sector-add during Q1.

As of June 30, 2024, the portfolio had a duration of 0.57 years, compared to 0.41 for the benchmark duration. The current yield reflects 5.44%, exceeding the benchmark yield by 20 basis points. PFM views the ICE BofA Indices as suitable for the State's portfolio, although noted that other clients also utilize the Bloomberg suite of indexes for similar mandates. Regarding the State's current mandate, PFM proposed establishing a new rating threshold to incorporate the BBB-tier. Additionally, the investment team suggested incorporating some implementation around split ratings. The PFM team believes the guidelines are not prohibitive otherwise and there is sufficient flexibility to operate.

Wilmington Trust

Wilmington Trust indicated that there had been no significant changes to the investment organization, the assigned investment team, the investment philosophy, or the approach since the last annual update with Delaware OST staff and NEPC.

Wilmington mentioned that the approach at the start of the year was to pursue opportunities further down the yield curve to lock in yields over 5%. With fewer rate cuts priced in and with the benchmark yield now well above 5%, the Wilmington team has still been able to identify relatively attractive yields in the mid-5% range that they will take advantage of until there is a clearer idea around the timing and magnitude of potential rate cuts.

As of June 30, 20224, the portfolio duration was 0.80 years – almost double that of the benchmark at 0.41 years. The portfolio yield also sits slightly above the benchmark (5.33 versus 5.24). Wilmington described near-term credit market conditions as very strong, citing an extremely liquid market, even as credit spreads remain near historically tight levels across credit qualities. Wilmington also noted that both investment grade credit and high yield have seen a huge uptick in new issuances.

The sole guideline change Wilmington recommends is to increase the current 25% limitation on 144A securities up to 30%, particularly within the ARPA fund. The commercial paper market is mostly 144A and Wilmington often finds itself up against that upper limit within the ARPA portion. With drawdowns from ARPA likely having to stay shorter moving forward, this is a shift that Wilmington suggests the State considers. Wilmington iterated that FINRA Rule 4210 should not have any impact on the portfolio, as Wilmington rarely incorporates Agency papers over 1-year in duration (only callable papers).

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, the assigned investment team, the investment philosophy, or the approach since the last annual update with Delaware OST staff and NEPC.

JP Morgan highlighted the current uncertainty surrounding rate cuts this year but expects the job market to cool down and inflation to gradually soften in the second half of the year. If current market conditions sustain, no significant changes will be made to the portfolio's positioning. The firm's strongest conviction currently lies within its forecast for AAA-rated ABS securities. The portfolio benefited from an overweight position within corporate bond financial sector relative to the benchmark (29% versus 11%), stating that this area of the market continues to offer the greatest value. Underweights in the industrials and utilities sectors were also additive to performance.

During Q1, JP Morgan transitioned from a long duration position to a neutral duration position relative to the benchmark, with the belief that the market is fairly priced (1.82 years versus 1.76 years). The portfolio yield sits just above the benchmark (5.04 versus 4.91). The portfolio maintains underweight allocations to Treasuries and Corporate Credit.

As far as policy guideline changes, JP Morgan suggested an increase to the 10% limit on ABS and MBS within the portfolio. Additionally, increasing the two-year average life limit on ABS products would be beneficial, as the average life of most new AAA-rated issues is about 2.75 years. These new issuances tend to be cheaper than the secondary market, and a limit increase to 2.5 years would be additive. With respect to the portfolio's associated benchmark, JP Morgan does utilize the Bloomberg Barclays Indices internally, while much of the client base is managed to the ICE BofA Indices. Lastly, JP Morgan expects no challenges in being able to operate around the newly passed FINRA Rule 4210.

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

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

BlackRock expects to see a slowdown in GDP growth throughout the rest of 2024, projecting a 1.9% YoY change from December 2023. The firm believes that while there has been a softening in the labor market, this dynamic alone is not enough to derail the economy on a macro-level. Blackrock doubts that the U.S. will revert to a neutral level for nominal rates of 2.5%, noting that markets are reasonably priced at the moment.

The portfolio has remained close to neutral on duration positioning relative to the benchmark over the last year (currently 2.58 years versus 2.51 years), and portfolio yield slightly exceeds the benchmark (4.83 versus 4.78). Investment grade credit was a key contributor throughout 2023, although BlackRock reduced the allocation to investment grade securities by 3-4% in order to reduce spread duration. However, the portfolio still maintains an overweight position in this sector and continues to earn carry over the benchmark.

The first guideline change BlackRock proposed was to increase the 10% limit on ABS and MBS. Additionally, the team suggested adjusting restrictions around both the average life and type of ABS allowed within the portfolio.

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

Chandler noted that there had been no significant changes to the investment organization, the assigned investment team, the investment philosophy, or the approach since the last annual update with Delaware OST staff and NEPC.

Chandler's core view is that inflation will soften again; its base case projection for the Core PCE Index is that it will finish +2.8% YoY at the end of 2024. Chandler predicts positive, but below-trend, growth for the remainder of the year, because of softening retail sales and a reduced consumer savings rate. The firm expressed concern with the specific length of time the yield curve has remained inverted, making it difficult for banks to raise organic capital. Chandler believes this will be primary focus for the Federal Reserve (Fed) and predicts that the yield curve will no longer be inverted by year-end.

Duration distribution within the portfolio reflects as overweight the 7–10-year portion of the curve, underweight the 5–7-year portion, and overweight the 3–5-year portion. Current total portfolio

duration is in line with the benchmark (6.08 years versus 6.07 years). New investments are primarily taking place in the 7–10-year part of the curve, and the team expects to see an increase in exposure to that sector, particularly with the goal of maintaining a longer duration than the benchmark. Chandler noted that the allocation to Treasuries is high, as the firm does not currently see many great alternative options in the Agency and Mortgage spaces to diversify those holdings.

With respect to the portfolio's benchmark, Chandler is very comfortable working with the ICE BofA Indices, as they do for most of their clients. With respect to FINRA Rule 4210, Chandler does not anticipate this having an impact due to a low level of mortgage securities within the portfolio. Chandler stated that one change they would make to the current mandate would be to increase the duration of purchasable securities from 10 years to 11 years. Most new issuances of bank bonds are 11-year bonds that are callable at 10 years; as a result, Chandler is unable to participate in new issuances and cannot purchase these bonds until they are at least a year old.

No other recommendations to change the policy were provided based on the State's current desired level of risk. Chandler mentioned that if the State ever did decide to take on more risk in the portfolio, next steps might include expanding its mandate to allow BBB-rated bonds or even adding a small exposure to equities.

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

Lazard noted that there had been no significant changes to the investment organization, the assigned investment team, the investment philosophy, or the approach since the last annual update with Delaware OST staff and NEPC.

Lazard's view is that, while the Fed remains committed to reducing long-term assets from its balance sheet, quantitative tightening will taper sometime this year and end next year. The firm believes the Fed will react quickly if inflation reaccelerates at any point. Lazard mentioned that while state governments continue to benefit from Federal aid, caution is warranted as these funds continue to be spent and the impact of higher interest rates on revenues remains uncertain. Lazard also highlighted potential liquidity concerns in the face of market volatility, as the market's ability to absorb abrupt changes in trading flows is structurally challenged due to bank regulations.

The current portfolio yield sits below the benchmark (4.46 versus 4.61), and the portfolio duration is 5.81 years compared to 6.07 years for the benchmark. Lazard's investment team agrees that the ICE BofA is an appropriate index to manage the portfolio to. No changes to the current mandate were brought forward, and Lazard believes it can effectively operate within the stated guidelines.

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				

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

In the section below, we have provided NEPC's recommendations on the various proposed guideline changes. We will work with OST Staff and continue discussions around the topics highlighted in the table above:

- NEPC recommends lifting the Private Placement (144a) security limit from 25% to 30% in order to benefit from areas that have significant issuance levels such as commercial paper programs
- We do not recommend the State change guidelines to permit BBB-rated securities, as the additional level of risk does not align with the portfolio's mandate of liquidity, capital preservation, and downside protection.
- NEPC sees no issue in increasing the two-year average life limit on ABS products, as funds will still be managed to the duration of the benchmark
- We agree with the State to maintain ABS limit to 10%, so as to remain in compliance with respect to FINRA Rule 4210
- In response to Chandler, NEPC recommends allowing the purchase of securities with duration up to 11 years, as this expands the investable opportunity set and the portfolio will still be managed to the benchmark duration

We look forward to discussing this memo with the Investment Committee and Cash Management Policy Board at their upcoming meetings. In the meantime, please reach out with any questions you may have regarding the memo or the individual manager meetings.