

COMMITTEE ON FINANCE

California State University Annual Investment Report

Presentation By

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Summary

This item provides the annual investment report for fiscal year 2015-2016 for funds under the California State University Investment Policy.

Background

Most CSU funds are invested through the CSU Systemwide Investment Fund-Trust (SWIFT) investment portfolio, which was established in July 2007 for the purpose of enhancing centralized cash and investment management. On a daily basis, net investable cash from the Chancellor's Office and campus-controlled bank depository and disbursement accounts is pooled and moved into SWIFT for investment. All SWIFT cash and securities are held by US Bank, the custodian bank for SWIFT, and for investment management purposes the SWIFT portfolio is divided equally between two investment management firms, US Bancorp Asset Management and Wells Fargo Asset Management.

The State Treasurer also provides investment vehicles that may be used for CSU funds. The Surplus Money Investment Fund (SMIF) is used by the State Treasurer to invest state funds, or funds held by the state on behalf of state agencies, in a short-term pool. In order to facilitate certain expenditures, the CSU maintains small amounts of funds with the State that might otherwise be invested in the SWIFT portfolio. The Local Agency Investment Fund (LAIF) is used by the State Treasurer to invest local agency funds. Since 2014-2015, the CSU has not invested funds in LAIF. The year-end results for these two funds are reported in Attachment A.

The California State University Investment Policy in effect during fiscal year 2015-2016 is included as Attachment B.

Market Summary

The financial markets provided many challenges over the last fiscal year, including plunging oil prices, considerable economic slowdown in China, a dramatic rally in the U.S. dollar, uncertainty regarding possible Federal Reserve (Fed) increases in interest rates, and Great Britain's vote to

leave the European Union. While short-term volatility is likely, improvement in the domestic economy, and signs of lower risk abroad would support movement towards market stability in the last half of 2016.

For the fiscal year ending June 30, 2016, U.S. Gross Domestic Product grew 1.2 percent with solid contributions from consumer spending offset by declines in private investment, particularly in the energy sector due to the significant decline in oil and gas prices. Employment conditions continued to strengthen as the unemployment rate fell from 5.3 percent at the end of June 2015 to 4.9 percent at the end of June 2016. Nonfarm payrolls added a healthy 2.5 million jobs in the fiscal year. Inflation remained below the Fed's 2 percent target range.

In December 2015, the Fed increased the federal funds rate of 0.25 percent to a target range of 0.25 - 0.50 percent, eight years to the month since it first lowered rates to the 0.0 - 0.25 percent range. The Fed continues to re-invest all principal proceeds from its investment portfolio in order to maintain the size of its balance sheet. The June 23, 2016 vote for Great Britain to leave the European Union convinced investors that global central banks would remain accommodative to support economic and financial market stability.

Credit market conditions were fairly volatile in the fiscal year, with significant credit spread widening in late 2015 through 2016, due to weak commodity/oil prices and instability in the energy and mining sectors. Companies continued to explore merger, acquisition, and share buyback strategies with less focus on using funds to invest in production activities. Servicing debt is a challenge as they leverage their balance sheets for the benefit of shareholders—all of which eroded credit quality. In general, market liquidity was adequate during the year, but has become more highly correlated with current financial conditions as the ability of Wall Street banks to be reliable market intermediaries is more limited due to regulatory changes.

Investment Account Performance

As of June 30, 2016, the outstanding balance in the SWIFT portfolio totaled \$3.53 billion. The objective of SWIFT is to maximize current income while preserving and prioritizing asset safety and liquidity. Consistent with the California State University Investment Policy and state law, the portfolio is restricted to high quality, fixed income securities.

As of June 30, 2016, the SWIFT portfolio's holdings by asset type were as follows:

US Treasuries	22.00%
US Government Agencies	31.89%
Corporate Securities—Long Term	16.86%
Corporate Securities—Short Term	<u>29.25%</u>
	100.00%

The SWIFT portfolio provided a return of 1.18 percent during the 12 months ended June 30, 2016. This return was greater than the benchmark for the portfolio, which is a treasury based index.

	SWIFT Portfolio	SWIFT Benchmark ¹	LAIF ²
1 Month Return	0.38%	0.44%	N/A
3 Months Return	0.42%	0.41%	0.14%
12 Months Return	1.18%	1.01%	0.43%
Annualized Return since SWIFT Inception	1.35%	1.76%	1.04%

For the year ended June 30, 2016, investment management and custodial fees totaled just under \$1.8 million, or about 0.048 percent (4.8 basis points) on average outstanding balances throughout the year.

Update on Proposed California State University Investment Authority Legislation

As previously presented to the board, staff has been working with key partners in the Assembly, the Senate, the Department of Finance, and the State Treasurer's Office to change the legislation that governs the CSU investments. Because fixed income securities have generated low returns for the CSU over a number of years, the goal of the legislation is to provide the CSU with more investment options and increase earnings on its existing base of funds. This potential for additional revenues would enhance the CSU's ability to address its deferred maintenance and critical infrastructure backlog.

The proposed legislation has received support from the State Treasurer, was approved by the Senate in May 2016, was approved by the Assembly in August 2016, and is now with the Governor pending possible approval.

¹ Bank of America Merrill Lynch 0-3 Year Treasury Index

² LAIF investment returns are provided for reference only

Surplus Money Investment Fund (SMIF)

The Surplus Money Investment Fund (SMIF) is a vehicle used and managed by the State Treasurer to invest State funds, or funds held by the State on behalf of State agencies, in a short-term pool. Cash in this account is available on a daily basis. The portfolio's composition includes Certificates of Deposit and Time Deposits, U.S. Treasuries, Commercial Paper, Corporate Securities, and U.S. Government Agencies. As of fiscal year ended (FYE) June 30, 2016, the amount of CSU funds invested in SMIF was approximately \$133 million.

SMIF Performance		Quarterly Apportionment Yield Rate	
Apportionment Annualized Return		FYE 06/30/07 - FYE 06/30/16	
FYE 06/30/16	0.42%	Average	1.44%
FYE 06/30/15	0.26%	High	5.24%
		Low	0.22%

Local Agency Investment Fund (LAIF)

The Local Agency Investment Fund (LAIF) is a vehicle used and managed by the State Treasurer to invest local agency funds. All investments are purchased at market, and market valuation is conducted quarterly. As of June 30, 2016 there were no CSU funds invested in LAIF.

LAIF Performance		Quarterly Apportionment Yield Rate	
Apportionment Annualized Return		FYE 06/30/07 - FYE 06/30/16	
FYE 06/30/16	0.43%	Average	1.45%
FYE 06/30/15	0.27%	High	5.25%
		Low	0.23%

The California State University Investment Policy

The following investment guidelines have been developed for use when investing California State University (CSU) funds.

Investment Policy Statement

The objective of the investment policy of the CSU is to obtain the best possible return commensurate with the degree of risk that the CSU is willing to assume in obtaining such return. The Board of Trustees desires to provide the chancellor and his designees with the greatest possible flexibility to maximize investment opportunities. However, as agents of the trustees, the chancellor and his designees must recognize the fiduciary responsibility of the trustees to conserve and protect the assets of the portfolios, and by prudent management prevent exposure to undue and unnecessary risk.

When investing CSU funds, the primary objective of the CSU shall be to safeguard the principal. The secondary objective shall be to meet the liquidity needs of the CSU. The third objective shall be to return an acceptable yield.

Investment Authority

The CSU may invest monies held in local trust accounts under Education Code Sections 89721 and 89724 in any of the securities authorized by Government Code Sections 16330 and 16430 and Education Code Section 89724 listed in Section A, subject to limitations described in Section B.

A. State Treasury investment options include:

- Surplus Money Investment Fund (SMIF)
- Local Agency Investment Fund (LAIF)
- State Agency Investment Fund (SAIF)

Eligible securities for investment outside the State Treasury, as authorized by Government Code Section 16430 and Education Code Section 89724, include:

- Bonds, notes, or obligations with principal and interest secured by the full faith and credit of the United States;

- Bonds, notes, or obligations with principal and interest guaranteed by a federal agency of the United States;
 - Bonds or warrants of any county, city, water district, utility district or school district;
 - California State bonds, notes, or warrants, or bonds, notes, or warrants with principal and interest guaranteed by the full faith and credit of the State of California;
 - Various debt instruments issued by: (1) federal land banks, (2) Central Bank for Cooperatives, (3) Federal Home Loan Bank Bd., (4) Federal National Mortgage Association, (5) Federal Home Loan Mortgage Corporation, and (6) Tennessee Valley Authority;
 - Commercial paper exhibiting the following qualities: (1) “prime” rated, (2) less than 180 days maturity, (3) issued by a U.S. corporation with assets exceeding \$500,000,000, (4) approved by the PMIB. Investments must not exceed 10 percent of corporation’s outstanding paper, and total investments in commercial paper cannot exceed 30 percent of an investment pool;
 - Bankers’ acceptances eligible for purchase by the Federal Reserve System;
 - Certificates of deposit (insured by FDIC, FSLIC, or appropriately collateralized);
 - Investment certificates or withdrawal shares in federal or state credit unions that are doing business in California and that have their accounts insured by the National Credit Union Administration;
 - Loans and obligations guaranteed by the United States Small Business Administration or the United States Farmers Home Administration;
 - Student loan notes insured by the Guaranteed Student Loan Program;
 - Debt issued, assumed, or guaranteed by the Inter-American Development Bank, Asian Development Bank, or Puerto Rican Development Bank;
 - Bonds, notes, or debentures issued by U.S. corporations rated within the top three ratings of a nationally recognized rating service;
- B. In addition to the restrictions established in Government Code Section 16430, the CSU restricts the use of leverage in CSU investment portfolios by limiting reverse repurchase agreements used to buy securities to no more than 20 percent of a portfolio.

Furthermore, the CSU:

- Prohibits securities purchased with the proceeds of a reverse repurchase from being used as collateral for another reverse repurchase while the original reverse repurchase is outstanding;

- Limits reverse repurchase agreements to unencumbered securities already held in the purchased with the proceeds of the repurchase (but in any event not more than one year) and;
- Limits reverse repurchase agreements to unencumbered securities already held in the portfolio.

Investment Reporting Requirements

Annually, the chancellor will provide to the Board of Trustees a written statement of investment policy in addition to a report containing a detailed description of the investment securities held by the CSU, including market values.

(Approved by the CSU Board of Trustees in January 1997; and as amended in September 2011 and November 2013)