DRAFT DATED DECEMBER 7, 2020

DECISION PAPER

December 7, 2020

TITLE:

Tahoe Donner Association Investment Policy Revision

RECOMMENDATION:
By Motion:
The Board of Directors adopts the proposed revised Investment Policy.

BACKGROUND:
For the past year, the Investments Working Group of TDA's Finance Committee ("FinCom") has been discussing an update of the Association's Investment Policy ("IP") which was last approved by the TDA Board in 2015 (Resolution 2015-5). The review process was lengthened due to senior management changes at TDA.

This Decision Paper has been prepared by members of the Investments Working Group of FinCom, discussed and approved by the full FinCom at the December 10, 2020 meeting and reviewed by senior management of TDA.

The evolution of investment markets and increased demand for better performance from Tahoe Donner's longer-term fund portfolios (due to persistently low market yields and increased TDA capital investment requirements) are such that a review of and update to the IP are warranted.

The main objective of this IP update is to introduce a number of new alternatives for both short and intermediate term investment of capital within TDA's several funds (Operating, Development, Replacement Reserve and New Equipment) that will (i) increase potential investment yields (with a very modest increase in risk), (ii) enhance our ability to generate asset, issuer and market diversification, and (iii) provide TDA's Director of Finance and Administration ("DFA") with incremental flexibility to administer the portfolio.

As part of our work on this initiative, the Investments Working Group reviewed the investment policies of the Marin County and Nevada County Treasurer's offices. While not HOAs, their conservative investment policy objectives closely match those of TDA. The group also reviewed fixed income research prepared by Capital Advisors Group and Standard & Poor's.

It is important to note that we are not recommending any **material** change to the fundamental investment principles that have been part of TDA's investment portfolio management function for many years. These principles place preservation of capital and safety of funds above the desire for greater investment returns.

The table shown on the next page summarizes the proposed changes to the IP document:

Current IP Section	**Proposed Change(s)**	**Comments**
Investment Objectives	Reworded to provide greater clarity on TDA's investment objectives	TDA has both long and short term funds that have different tenor, liquidity and yield requirements. The four stated objectives are such that judgement is required to make the appropriate trade-offs between them, although protection of the principal amount of investments is also a legal requirement.
Authorized Investment Instruments	Changes (i) the minimum credit rating on corporate bonds from "A2/A" to "A3/A-" which represents a one notch movement, (ii) adds new long term alternatives composed of senior debt of two government sponsored enterprises ("GSEs"), FNMA and FHLMC, and (iii) adds highly rated commercial paper to the investment mix.	Moving to a minimum rating of A3/A- will very modestly increase overall risk while increasing portfolio returns. FNMA and FHLMC, known as "GSEs", offer the safety of US Government debt obligations with a modest yield pick-up. Commercial paper, the short-term equivalent of highly rated corporate debt, presents an opportunity to increase portfolio returns and offers asset and issuer diversification.
Instrument Limitations	Sets out (i) new portfolio concentration and credit ratings limits for corporate bonds, government sponsored entities, and commercial paper, (ii) adds the concept of a single issuer exposure limit, (iii) slightly streamlines approval requirements for longer term and in-compliance investments, and (iv) provides improved guidance to the DFA and Treasurer on when taking portfolio losses might be acceptable.	We have set out reasonable portfolio limits on the new investment options (GSEs, A3/A- rated bonds and A1/P1 commercial paper). The long-term ratings requirements for commercial paper are the same as our new limits on corporate bonds (minimum ratings of A3/A-). We have also introduced the concept of a single issuer/obligor concentration limit of 10% of the relevant fund.
General Administration Responsibilities	Introduces guidance on (i) the selection of TDA banks and brokerage firms, and (ii) custody arrangements for securities held for the benefit of TDA.	The improved guidance on the selection of bank and broker dealer relationships mirrors what we in effect already practice. The security custody arrangements are new provisions that provide enhanced guidance regarding protection of our financial assets.
Maximum tenors	Extends the maximum remaining maturity of corporate bonds to 7 years	Represents a modest increase to risk while expanding the universe of possible investments and gaining some yield pickup.
Sales of investments prior to final maturity	Sets out a consultation process to follow if an early sale is contemplated and specifies the approval authorities is a loss on sale would be incurred.	The previous rule mandating an automatic sale in the event of a ratings downgrade does not provide enough flexibility especially where the remaining term of an investment is relatively short.

Further discussion about the changes to the IP noted in the table above appears below.

1. The proposed changes to the Investment Objectives section are not controversial. They codify what in practice we currently do while managing the portfolio.

2. The most significant of the changes to the Authorized Investment Instruments section is the recommendation for TDA to begin investing in A3/A- rated corporate bonds, government agency debt and commercial paper.

   (a) It is the custom for the major credit rating agencies to attach modifiers to the various bond ratings, such that A rated bonds are split into A+, A and A- (Standard and Poor's) and A1, A2 and A3 (Moody's). The proposal is to broaden the permissible corporate bond ratings to include all A ratings rather than exclude the lowest subset of A ratings.

   There are two ways to explain the modest increase in risk arising from the proposal: by looking at the outright default risk and by looking at the risk of a ratings downgrade which might would force TDA to evaluate whether to sell the bond.

   The following table shows the default risk for A and A- rated bonds over various timeframes from the time the bonds were originally awarded their rating. The data comes from Standard & Poor's and covers the entire period from 1981-2019.

   Percentage by number of global corporate bonds to default within the specified timeframes from the date of the issuance of the original securities rating:

	A rating	**A- rating**
1 year	0.05%	0.06%
2 years	0.14%	0.17%
3 years	0.22%	0.27%
4 years	0.33%	0.38%
5 years	0.46%	0.53%
6 years	0.63%	0.68%
7 years	0.80%	0.90%

The following table shows the percentage by number of bonds being downgraded within one year, again using Standard & Poor's data for 1981-2019. The two things to note are the probability of a downgrade to BBB+/BBB1 which would put the security out of compliance with our IP and the probability of a downgrade to BB+/BB1 which would be below investment grade and significantly reduce the number of investors who would buy a bond at that rating level.

Percentage by number of global corporate bonds to suffer a downgrade within 1 year:

Downgrade to	**A rating**	**A- rating**
A-	6.74%	N/A
BBB+	2.38%	7.23%
BBB	0.86%	1.98%
BBB-	0.27%	0.57%
BB+	0.10%	0.13%
BB	0.10%	0.13%

There are still three rating levels between the bottom of the above table and default.
All else equal, we should expect to earn a superior return by taking on incremental risk as compared to our current corporate bond focus on A2/A corporate bond investments.

(b) The Federal National Mortgage Association ("FNMA" or "Fannie Mae") and the Federal Home Mortgage Corporation ("FHLMC" or "Freddie Mac") are privately owned corporations created by the federal government (via a Congressional charter) to provide liquidity and increase available credit in mortgage markets. Each of FNMA and FHLMC carry long-term senior debt ratings of Aaa/AA+, the same as the US government.

Adding senior ranking debt securities issued by FHLMC and FNMA to the mix of eligible TDA investments enables us to earn a small interest rate premium over US government securities (e.g., US Treasury Notes), typically up to 10 bp but sometimes higher.

It is important to note that GSE debt is not strictly *guaranteed* by the U.S. government. GSE debt is solely the obligation of the issuer (FNMA or FHLMC in this case) and carries slightly greater credit risk than U.S. Treasury securities. However, the strong credit ratings of GSEs, equal to that of the US government, is indicative of the strong implied support of their obligations by the US government.

In summary, GSE bonds give TDA the opportunity to gain a higher return than Treasury bonds, while sacrificing very little in terms of risk or liquidity. We do not see the addition of this investment alternative as controversial; it adds to our ability to diversify investment types though not necessarily investment risk.

(c) Commercial paper is an unsecured form of promissory note that pays a fixed rate of interest. It is typically issued by large banks or corporations to cover short-term requirements and meet short-term financial obligations. As with any other type of bond or debt instrument, the issuing entity offers the paper assuming that it will be in a position to pay both interest and principal by maturity.

Maturities on most commercial paper ranges from a few weeks to months and is generally less than 270 days (due to regulatory purposes). Commercial paper is usually sold at a discount from face value and reflects prevailing market interest rates.

Adding commercial paper as a permissible investment option provides greater diversity to our shorter-term investment program in terms of issuers and asset types while offering slightly better yields than US Treasury bills.

We recommend only investing in commercial paper with a rating of A1/P1, from Moody's and S&P, respectively, the highest short-term ratings available. (Please note that some enterprises with the strongest credit ratings might have a "+" sign appended to their commercial paper rating.) Typically, issuers must have a long-term credit rating of at least A3/A- to qualify for a commercial paper rating of A1/P1. To be congruent with our conservative investment philosophy, we are further requiring that commercial paper issuers that we invest in shall also have an A2/A long term rating.

3. The current TDA IP has a robust set of limitations/controls that well serve our conservative investment objectives. The changes we are recommending in this section are consistent with that conservative approach, and add:

   (a) A limit to the final term to maturity of any new GSE investments to 7 years. In practice we will be buying seasoned issues vs. new debt offerings from either FNMA or FHLMC;

   (b) A new requirement that investments in each of GSE obligations and commercial paper are subject to the 20% maximum limit per fund;

   (c) A new requirement that TDA's exposure to all entities (except for direct obligations of the US government and short-term deposits and CDs issued by financial institutions on TDA's approved list) shall not exceed 10% of the relevant fund's total balance.

   (d) A slight refinement of current approval limits - to improve flexibility and reduce the investment administration burden - such that otherwise permitted investments with a term to maturity of longer than 3 years need only the concurrence of the Treasurer and the DFA, rather than the existing requirement that three members of the TDA Board approve said investment. These investments are still subject to the provisions which stipulate that all Directors shall be notified within 10 days; and

(e) Clearer guidance to the DFA, the Treasurer and the rest of the TDA Board on the subject of selling investments at a loss. Note that selling investments at a loss will now require the approval of one other member of the TDA Board, if the loss exceeds $5,000, in addition to the currently required approval of the Treasurer.

4. The final set of changes to the investment policy provide for:

   (a) Clearer guidance on the selection criteria for banks, brokerage firms and other financial institutions with whom TDA works. This expanded guidance codifies what we are in effect already practicing. We also have inserted a requirement that the DFA and Treasurer annually review the list of financial services providers; and

   (b) Clearer guidance on the custody practices of TDA investments such that they shall be held in "street name" at Depositary Trust Corporation, at approved banks, brokerage firms and third-party custody firms. We also have inserted a requirement that the DFA and Treasurer annually review the list of acceptable custody service providers.

ANALYSIS:

N/A

OUTREACH:

N/A

FISCAL IMPACT:

There is no direct fiscal impact identified.

ALTERNATIVE:

1. Request FinCom to reconsider particular aspects

2. Approve continuing with the existing Investment Policy (Resolution 2015-5)

ATTACHMENTS:

1) Current Investment Policy
2) Redline version of Investment Policy
3) Revised Investment Policy

Prepared by: Terry Watson and Steve Mahoney

Board Meeting Date: _12/18/2020________

General Manager Approval to Place on the Agenda: ________________