# Public University Fund
# Investment Policy Amendment

## BACKGROUND

The Public University Fund (PUF) is an investment pool that is administered by Oregon State University on behalf of all Oregon public university participants, pursuant to legislation adopted by the 2014 Legislature. It allows for the state's public universities, including Oregon State University, to have access to a professionally managed investment product that efficiently provides daily liquidity, while accessing longer term fixed income investments. The following Oregon public universities participate in the PUF: Eastern Oregon University, Oregon Institute of Technology, Oregon State University, Portland State University, Southern Oregon University, and Western Oregon University.

The Oregon State Treasury (OST) serves as the investment manager for the PUF. OST is recommending a benchmark change for the PUF's Core Bond Fund holding. Additionally, Oregon State University staff requested OST fixed income investment officers provide recommendations for changes to permitted holdings and maximum sector allocations considering changes to the macro economic environment, low interest rates and the changing fixed income security opportunity set.

## PROPOSED CHANGES

The recommended changes were reviewed by the vice president for finance and administration, in consultation with OSU's associate vice president for finance and controller, director of treasury and the University Shared Services Enterprise's director of treasury management services. Proposed amendments are shown as strikethrough and red text in Exhibit A of Attachment 1 and described as follows:

> **Permitted Holdings:** In Section V, proposed changes include expanding the investment opportunity set for asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) to include the full investment grade spectrum from AAA to Baa3/BBB-. The current policy limits ABS and CMBS security selection to AAA rated.
>
> New permitted holding recommendations include U.S. agency commercial mortgage-backed securities (ACMBS), a sector growing rapidly during the last 10 years, and AAA rated collateralized loan obligations (CLOs). Adding high quality bank loans or CLOs will provide variable-rate security options during periods of rising intermediate-term interest rates.
>
> **Diversification:** In Section VI, the new permitted holding recommendations are added to the diversification list with a maximum allocation of 15% for CLOs and 25% for ACMBS. To accommodate diversification from U.S Treasury Bonds in support of enhanced yield opportunities and a wider opportunity set of high quality fixed income securities, maximum structured product allocations are increased as follows:

| Sector | Current Maximum Exposure | Proposed Maximum Exposure |
|---|---|---|
| Asset Backed-Securities (ABS) | 20% | 25% |
| Commercial Mortgaged-Backed Securities (CMBS) | 10% | 25% |
| Agency Commercial Mortgaged-Backed Securities (ACMBS) | 0% | 25% |
| Collaterialized Loan Obligations (CLOs) | 0% | 15% |

To accommodate the increase in CMBS and ACMBS, the traditional mortgage-backed security maximum allocation will decline from 40% to 25%. The combined allocation to structured product will continue to be restricted to not greater than 50% of the Core Bond Fund's market value.

**Risk:** The average portfolio credit quality statement has been revised to explicitly target a minimum A3/A- rating in Section VIII. This change, for instance, allows the managers to purchase credit opportunities rated BBB with improving fundamentals and prospects for rating increases while maintaining an overall high-quality portfolio of securities.

**Investment Restrictions:** CLOs are removed from the restricted list in Section IX. The recommended inclusion of CLOs to the permitted holdings is limited to the highest quality tranches of AAA rated securities.

**Performance Expectations and Reviews**: Section XII changes include the replacement of the Core Bond Fund's current blended benchmark with the Bloomberg Barclays Intermediate Government/Credit Total Return Index. The recommended benchmark represents an attractive universe of fixed income securities available to intermediate duration fixed income portfolios, thus providing an opportunity to best meet the Core Bond Fund's portfolio objectives of maximizing total return within the stipulated risk parameters.

The recommended index (benchmark) has significantly lower turnover, consequently, the cost to track the benchmark is expected to be lower than the current benchmark over a full market cycle. The recommended index has a similar historical performance profile to the current index when compared over longer periods of time. Additional index details and comparative analysis are provided in Attachment 2.

## RECOMMENDATION

Staff recommend that the Finance & Administration Committee recommend to the Board approval of the amendments to the Public University Fund Investment Policy as provided in Attachment 1.

**RESOLUTION NO. ____**

Oregon State University

# Public University Fund Investment Policy Amendment

## BACKGROUND

Whereas, Oregon State University serves as the Designated University under the Agreement Regarding Administration of the Public University Fund (PUF); and

Whereas, the Board adopted a Public University Fund Investment Policy to guide the prudent investment of participant's funds with the primary objectives of safety, liquidity, and return on investment; and

Whereas, amendments were developed in collaboration with the Oregon State Treasury to update the Public University Fund Investment Policy benchmark and permitted holdings, now, therefore,

Be it resolved, that the Board of Trustees hereby approves the amendments to the Investment Policy, attached hereto as Exhibit A.

This Resolution is effective _________________.

**APPROVED by the Board of Trustees ___________________**

_______________________________________

Secretary to the Board Date

# Oregon State University
# Public University Fund Investment Policy

## I. Purpose

The purpose of this document is to identify the policies for prudent investment of the Public University Fund assets by providing guidelines for suitable investments consistent with the objectives identified in Section III.

The investment policies and practices are based on state law and prudent money management. All funds will be deposited and invested in accordance with this Policy and all statutes and policies governing the Designated University, Public University Fund, Oregon State Treasury and the Oregon Investment Council.

## II. Scope

These rules apply to the investment of funds from all eligible and approved Public University Fund (PUF) participants, and are established under the authority of, and shall not supersede, the requirements established under ORS Chapter 293, ORS 352.450 and the Oregon Investment Council Common University (OIC) Policy INV 407.

## III. Objective

The primary objective of the PUF is capital preservation with a secondary objective to maximize total return over a long-term horizon within stipulated risk parameters.

The PUF should provide adequate liquidity for PUF participants' cash flow requirements based upon participant's annual cash flow forecast submissions for assets on deposit in the PUF. Cash balances in excess of forecast liquidity needs shall be invested into longer dated fixed income securities with the objective to maximize total return over the long term.

## IV. Portfolio Allocation

Portfolio allocation parameters listed in the following table are intended as general guidelines and subject to review by the Designated University staff and their delegates including investment consultants and investment managers.

| Portfolio | Objective | Allocation |
|---|---|---|
| Liquidity | Capital preservation to assure adequate cash for liquidity requirements. | Short-Term<br>Funds invested in the Oregon Short Term Fund (OSTF). Target allocation of funds based upon aggregated university participant annual cash flow forecasts. Absent cash flow forecasts, the target allocation will be based upon a minimum of six months estimated operating expenses. |
| Core | Actively managed to achieve a diversified portfolio of investment grade bonds invested over longer horizons than permitted in OSTF. Based on historical market performance, total returns generated over extended periods are anticipated to be greater than returns realized in shorter-maturity strategies. | Intermediate<br>Investments with a maturity or weighted average life from three years and above. |

## V. Permitted Holdings

1. Securities included in the designated performance benchmark(s) unless explicitly restricted in this policy.
2. The Oregon Short-Term Fund (OSTF). Underlying investments of the OSTF are excluded from restrictions in this policy. The OSTF is governed by the OIC and OST-adopted policies and guidelines as documented in OIC Policy INV 303.
3. Obligations issued or guaranteed by the U.S. Treasury or by U.S. federal agencies and instrumentalities, including inflation-indexed obligations.
4. Non-U.S. government securities and Instrumentalities with a minimum long-term rating of Aa2/AA/AA as rated by two or more of the following rating agencies: Moody's Investors Services, Standard & Poor's DBRS or Fitch Ratings (each a "Rating Agency", collectively "Rating Agencies"), at the time of purchase.
5. Municipal debt with a minimum rating of A3/A-/A- as rated by one or more of the Rating Agencies, at the time of purchase.

6. Corporate indebtedness with minimum investment grade ratings by one or more of the Rating Agencies. For avoidance of doubt, no rating from any of the Rating Agencies may be non-investment grade at the time of purchase.
7. ~~Senior tranches of asset~~ Asset-backed securities ~~rated AAA (or equivalent rated by~~ with minimum investment grade ratings by one or more of the Rating Agencies (Baa3/BBB-/BBB-)~~)~~. For avoidance of doubt, no rating from any of the Rating Agencies may be non-investment grade at the time of purchase.
8. ~~Senior tranches of commercial~~ Commercial mortgage-backed securities (CMBS) ~~rated AAA (or equivalent rated~~ with minimum investment grade ratings by one or more of the Rating Agencies (Baa3/BBB-/BBB-)~~)~~. For avoidance of doubt, no rating from any of the Rating Agencies may be non-investment grade at the time of purchase.
9. U.S. agency residential mortgage-backed securities (MBS), U.S. agency commercial mortgage-backed securities (ACMBS) and U.S. agency commercial mortgage-backed obligations (CMO).
10. Collateralized loan obligations (CLO) rated AAA (or equivalent rating by one or more of the Rating Agencies) at the time of purchase.

## VI. Diversification

The portfolio should be adequately diversified consistent with the following parameters:

1. No more than 3% of portfolio par value may be invested in a single security ~~with the exception of~~ except for obligations issued or guaranteed by the U.S. Treasury or by U.S. federal agencies and instrumentalities; and
2. No more than 5% of portfolio par value may be invested in the securities of a single issuer ~~with the exception of~~ except for obligations issued or guaranteed by the U.S. Treasury or by U.S. federal agencies and instrumentalities.

Maximum market value exposures shall be limited as follows:

| | |
|---|---|
| • U.S. Agency Obligations | 50% |
| • U.S. Corporate Indebtedness | 50% |
| • Municipal Indebtedness | 30% |
| • Asset-backed Securities (ABS) | ~~20~~ 25% |
| • Mortgage-backed Securities (MBS) | ~~40~~ 25% |
| • U.S agency commercial mortgage-backed securities (ACMBS) | 25% |
| • Commercial Mortgage-backed Securities (CMBS) | ~~10~~ 25% |
| • Collateralized loan obligations (CLOs) | 15% |

- Structured Securities (Combined ABS, MBS ~~and CMBS~~, ACMBS, CMBS, and CLOs) 50%

3. Issuer, security, and sector-level restrictions shall not apply to OSTF holdings.

## VII. Counterparties

A list of all broker/dealer and custodian counterparties shall be provided upon request.

## VIII. Risk

1. Maintain ~~an average (measured by market value) credit rating in the Core allocation of no lower than one grade below the designated benchmark. For example, if the Benchmark's average credit quality is Aa2, the~~ a minimum-weighted, average long-term portfolio credit quality ~~of the portfolio should be~~ of no ~~lower~~ less than ~~A2~~ A3/A-.
2. Maintain an average modified duration level of +/-10% of the custom benchmark.

## IX. Investment Restrictions

1. All investments will be in U.S. dollar denominated securities.
2. All investments will be non-convertible to equity.
3. Collateralized debt obligations (CDO)~~, Collateralized Loan obligations (CLO)~~ and Z-tranche investments are not permitted.
4. Investments in Alt-A, non-agency, sub-prime, limited documentation or other "sub-prime" residential mortgage pools are not permitted. No derivative securities are allowed. Structured securities such as ABS, MBS, ~~and~~ CMBS, ACMBS and CLOs shall not be considered as using leverage.
5. Investments in issuers identified by the Carbon Underground 200 published by the Fossil Free Indexes LLC (FFI).
    - This restricted security list will be updated annually at calendar year-end and enforced for all new security purchases.
    - Exposures to issuers added to the Carbon Underground 200 subsequent to purchase may be held to maturity.

## X. Policy Compliance

1. OST Investment Staff will submit a written action plan to the Designated University (as defined in ORS 352.450(3) (a)) regarding any investment

downgraded by at least one rating agency to below investment grade within 10 business days of the downgrade. The plan may indicate why the investment should continue to be held and/or outline an exit strategy.

2. OST Staff will consult with the Designated University, on a pre-trade basis, if an investment trade or trades will result in a cumulative net loss greater than 1% over 3 months prior to trade settlement date.

## XI. Safekeeping and Custody

The assets held in the PUF shall be secured through third-party custody and safekeeping procedures. Bearer instruments shall be held only through third-party institutions.

## XII. Performance Expectations and Reviews

1. Excluding the short-term allocation, the Core allocation is expected to perform in-line with the following custom benchmark:
    - ~~75% Bloomberg Barclays U.S. Aggregate 3-5 Year Index; and~~
    - ~~25% Bloomberg Barclays U.S. Aggregate 5-7 Year Index~~
    - Bloomberg Barclays Intermediate Government/Credit Total Return Index.
2. OST will provide the Designated University with a monthly report of all non-passive compliance violations of this policy's guidelines.
3. Investment reviews between OST investment staff and the Designated University will occur quarterly and focus on the following elements:
    - Performance relative to objectives;
    - Adherence to this policy; and
    - Trading activity.

## XIII. Exceptions

None.

## XIV. Failure to Comply

Failure to comply with this policy may be cause for disciplinary action up to and including dismissal.

# Public University Fund Investment Policy Amendment
# Recommended Benchmark Details

## RECOMMENDATION: UPDATED CORE BOND FUND BENCHMARK

The Oregon State Treasury is recommending a benchmark change for the Public University Fund's Core Bond Fund (Fund) to the Bloomberg Barclays Intermediate Government/Credit Total Return Index. The Oregon Investment Council has approved this benchmark change for similarly managed intermediate fixed income portfolios such as the Oregon Intermediate-Term Fund.

The recommended benchmark represents an attractive universe of fixed income securities available to intermediate duration fixed income portfolios, thus providing an opportunity to best meet the Core Bond Fund's portfolio objectives of maximizing total return within the stipulated risk parameters.

## WHY IS A CHANGE RECOMMENDED?

The current blended index (benchmark) of 75% Bloomberg Barclays U.S. Aggregate 3-5 year Total Return Index and 25% Bloomberg Barclays U.S. Aggregate 5-7 year Total Return Index is an inefficient index for a few key reasons.  First and foremost, the current index contains approximately 50% Mortgage-Backed Securities (MBS), and has been even higher over the past year, while the investment policy maximum allocation is constrained to 40%. As such, there is a large inherent and unnecessary "basis risk" between the benchmark and the Fund that will not be present with the recommended index.

The current indexes large MBS allocation also leads to a more volatile duration measure. Duration (average maturity) is the best interest rate risk measure and the largest risk in fixed income portfolios. Utilizing an index with a lower allocation to MBS will result in a more stable duration, more stable fund holdings, and lower turnover to keep the Fund within its duration guidelines.

Lastly, the current blended index holds bonds between three and seven years while the recommended index holds bonds between zero and 10 years and more aligned with the Fund's guidelines. This wider maturity window also results in lower turnover in the index as bonds flow into and out of the index less frequently than for the current index. The index change is anticipated to result in lower trading costs. As OST migrates all intermediate-term fixed income portfolios to the recommended index, the OST trading desk anticipates institutional pricing will be achieved on fixed income transactions, also resulting in reduced transactional costs for PUF participants.

## BENCHMARK COMPARATIVE ANALYSIS

The recommended benchmark will increase the average portfolio duration (maturity) by 0.55 years. While the recommended benchmark does not provide an allocation to MBS, it is anticipated the Core Bond Fund portfolio strategy will continue to utilize MBS, therefore maintaining a similar yield to the current portfolio of 1.3% yield to worst. The yield to worst metric is used to determine the lowest yield an investor can expect when investing in callable bonds.

The following table provides a comparison of portfolio characteristics and historical performance for the recommended index and current blended index.

**Index Characteristics:**

| | Recommended | Current | +/- |
|---|---|---|---|
| **Duration** | 4.14 | 3.59 | 0.55 |
| **Convexity** | 0.21 | -0.90 | 1.11 |
| **Yield to Worst** | 0.65 | 1.06 | -0.41 |
| **Option-Adjusted Spread** | 27.2 | 43.0 | -15.8 |
| **Credit Rating** | AA/AA- | AA/AA- | No Change |
| **MBS** | 0% | 48% | -48% |
| **Treasuries** | 57% | 29% | 28% |
| **Corporate** | 33% | 17% | 16% |

**Performance Comparison (returns thru 12/8/2020):**

| | Recommended | Current | | | |
|---|---|---|---|---|---|
| **Year** | **Int Gov/Credit** | **BBG Barc 3-5** | **BBG Barc 5-7** | **75/25 Weighted** | **+/-** |
| 2020 YTD | 6.14% | 5.10% | 7.49% | 5.70% | 0.44% |
| 2019 | 6.80% | 6.33% | 7.32% | 6.57% | 0.23% |
| 2018 | 0.88% | 1.14% | 0.90% | 1.08% | -0.21% |
| 2017 | 2.14% | 1.75% | 2.60% | 1.96% | 0.18% |
| 2016 | 2.08% | 2.01% | 1.94% | 1.99% | 0.09% |
| 2015 | 1.07% | 1.57% | 1.25% | 1.49% | -0.42% |
| 2014 | 3.13% | 2.82% | 4.97% | 3.36% | -0.23% |