

Report on Investments

3rd Quarter, 2021

Economic Review

3Q21. During the quarter, the Delta variant caused consumer sentiment to wane, return-to-office plans to be postponed, and ICUs to fill up again. Supply bottlenecks, material shortages, high energy and commodity prices, labor shortages and wage increases put pressure on prices, resulting in the highest rates of inflation in decades. Even though pandemic-era supplemental unemployment benefits ended in early September employment growth still lagged expectations, despite a record number of job openings and rising wages. US economic growth, as measured by GDP, slowed more than expected and was significantly lower than the previous two quarters.

The Federal Reserve (Fed) started the quarter insisting inflation was transitory, saying they were waiting for employment and emphasized patience. But, by the end of the quarter they change their view, admitting inflation was higher and lasting longer than expected and speculation began that they will soon begin to remove stimulus to combat it. Their plan to remove stimulus will most likely start in 2021 and begin with tapering the amount of Treasuries and Mortgage-backed securities they purchase each month (currently \$120 billion), this process is expected to be done in mid-2022. A second phase of the Fed's plan to reduce stimulus is rate hikes, this will depend on progress on employment and may begin in later 2022 or 2023. This is a year earlier than expected a few months ago. The financial markets are concentrating on the potential rate hike timeline.

The financial markets generally looked past Covid for the first two months of the quarter as strong consumer demand, strong corporate earnings and continued Fed support pushed equity markets higher. But the market tone changed in late September, volatility increased as inflation fears grew and investors became more worried about price pressures effecting corporate earnings, consumer consumption and economic growth. Politics also came into play as we bumped up against a debt ceiling and a large spending plan was being debated in congress. In late September the S&P 500 suffered a 5% pullback, which wiped out most of the index gains from July and August. Intermediate fixed-income yields increased slightly predicting future rate hikes.

Future. The next three months will bring much needed clarity around the pandemic, inflation, Fed policy, Federal spending, and taxes. The Fed is expected to begin tapering in 2021 and begin hiking short-term interest rates in mid-2022 to 2023. Intermediate and longer-term fixed-income yields are expected to increase slowly over the next few quarters, but this is hard to predict as COVID or persistent inflation could slow growth hold these yields down longer.

Council Impact. The Council's short-term portfolio earnings continue to be hurt by low short-term interest rates. A rate hike by the Fed would immediately benefit portfolio earnings. The long-term portfolio will experience price depreciation if intermediate yields increase, but in the longer run higher rates will increase earnings. Because the Council is a buy and hold investor price decreases on holdings are on paper only. To avoid locking in current low interest rates for a long term and to minimize price loss should interest rate rise, the Council is maintaining duration shorter than the benchmark for the long-term portfolio. The pullback of the equity markets in late September hurt the performance of the OPEB Trust for the quarter, but equity markets have since recovered.

Investment Results & Strategy

Short-Term Portfolio

3Q21 Results: The Short-term portfolio outperformed its benchmark during the second quarter with a total return of 0.009%, versus a .001% total return for its benchmark, the Crane AAA Government Institutional Money Fund index. The portfolio has outperformed its benchmark an average of .04% over the past 12 months. The \$961 million portfolio was invested in U.S. Treasury Bills (\$450 million, 47%), government money market funds (\$302 million, 31%), and U.S. Government Agency Discount Notes (\$209 million, 22%). Investments range from 0-7 months in length and the portfolio has a duration of .103 years, which is slightly longer than its benchmark duration of .08 years. The average yield of the portfolio has remained steady over the past two quarters at .04%.

4Q21 Strategy: Portfolio earnings continue to be hurt by the extremely low short-term interest rates that have existed since the Fed lowered short-term rates to 0% in March 2020. Projections are the Federal Reserve will begin to raise short interest rates in 2022 or 20223, which will immediately benefit portfolio earnings. The Council monitors interest rates daily. The portfolio invests available cash to earn income and is managed around Council's cash flow needs. Maturities are matched to large outflows such as capital expenditures, payroll, and debt service. The Council maintains diversification using high quality short-term securities in accordance with MN. Statutes Chapter 118A.

Long-Term Portfolio

3Q21 Results: The Long-term portfolio also outperformed its benchmark during the third quarter. Total return was .064%, versus a .007% total return for its benchmark, the BAML Agency Master Index. Outperformance was due to the portfolio having a shorter duration than the benchmark, as interest rose during the quarter the portfolio did not realize as much price depreciation as the longer duration index. The portfolio also benefitted from price stability of CD holdings and strong relative price performance of its municipal bond holdings. Duration was extended slightly during the quarter to take advantage of a steepening yield curve and higher yields in the 2-7 year range. Duration was 2.48 years compared to 2.37 years in the prior quarter. With the benchmark having a duration of 3.99 years, the portfolio still maintains a defensive position against rising interest rates. The \$478 million portfolio was invested in U.S. Government Agency securities (\$288 million, 60%), municipal bonds (\$59 million, 12%), U.S. Treasury Notes (\$110 million, 23%), Certificate of Deposits (\$18 million, 4%), and ~1% combined in government money funds and mortgage-backed securities.

4Q21 Strategy: The 2-7 year portion of the yield curve continued to steepen and provides opportunity to increase portfolio yields. Over the next few quarters the Council will be working to purchase more Certificates of Deposits with qualifying local community banks and credit unions that have a successful track record of supporting minority and female owned small businesses, affordable housing, and community development. The portfolio will remain defensive against rising rates with a duration shorter than the benchmark.

Longer Strategy: As we move into 2022 and 2023, we will continue to watch the progress of the post COVID-19 economic recovery, inflation, and changes to Federal Reserve policy. We will take advantage of any yield curve steepening and/or a rise in interest rates to increase earnings. Rising interest rates may lead to negative total returns in the interim, but the Council is a buy and hold investor and does not plan to realize price loss.

EFPMs – Hedging Accounts

3Q21 Results: Fuel prices continued to rise, which resulted in a net realized gain on the Council's diesel futures contracts at quarter end. The gains for the quarter were higher than the net gain at the end of the 2nd quarter (\$491,396 quarterly net realized gain in 3Q21, compared to \$89,149 in 2Q21). Unrealized gains, however, were lower than last quarter, coming in at \$1,473,839, compared to last quarter's unrealized gain of \$3,730,259. The value of the futures contracts was \$26.5 million. Hedging is used to smooth fuel price volatility and bring budget certainty to Transit.

OPEB

3Q21 Results: The Trust had a small positive return of .30% for the quarter which slightly underperformed its Equity/Fixed Income blended benchmark return of .369%. The trust has a strong average annual return of 13.2% over the last five years. During the quarter, just over \$13 million was withdrawn from the trust to pay for OPEB costs. As a result, trust value decreased from \$348.9 million to \$336.9 million. Trust investments were allocated 67% to the SBI S&P 500 Index pool, 30% to U.S. Treasury and Agency securities, and 3% to the SBI money market pool. For the quarter, the S&P 500 Index pool returned .57%, Treasury and Agency securities returned -.03%, and the money market pool .02%.

4Q21 Strategy: The trust has a target allocation of 60% equities and 40% fixed income/cash, occasional adjustments are made to re-align with this target. An updated actuarial study is expected to be completed in the 4th quarter which will be reviewed, along with divisional OPEB liability funding levels, to determine if the current target allocation remains appropriate.

Longer Strategy: The OPEB Trust portfolio contains assets set aside to fund future OPEB liabilities and has a long-term investment horizon. The trust uses equity market exposure to realize the higher historical average returns of the equity markets over the long run. This may increase volatility and the trust may experience positive and negative value changes. The Council may reduce allocation to the equity index pool as liability funding improves. The Council is currently withdrawing trust assets to help fund employee OPEB benefit distributions.