

**STATE INVESTMENT COMMISSION
MINUTES**

December 19, 2001

The State Investment Commission meeting was called to order by Jonathan Miller, State Treasurer, on December 19, 2001 at 2:00 p.m. in Room 264 of the Capitol Annex. Other members present were Orson Oliver, Bank of Louisville; and T. Kevin Flanery, Secretary, Finance and Administration Cabinet.

Treasurer Miller confirmed that a quorum was present and that the press had been notified of the meeting. A motion was made by Mr. Oliver and seconded by Secretary Flanery to approve the minutes of the September 26, 2001 meeting.

Gordon L. Mullis, Executive Director, Office of Financial Management ("OFM"), provided a brief economic update for the Commission members. Mr. Mullis indicated that housing starts and building permits are up very strongly. The National Association of Homebuilders Index has increased in the largest jump since 1996. The CPI remained unchanged in November, however, the core rate was up exclusive of food and energy. The economic factors that continue to affect Kentucky are production and capacity utilization. Production fell in November for the fourteenth straight month. Capacity utilization is down from the revised October numbers, and as a result the manufacturing sector has declined by .2 percent. One tenth of the decline was in durable goods with a .3 percent drop in non-durable goods. Sales, however, were up in October and recently it was announced that for the first twenty-four day period of the Christmas season, sales were ahead of last year. The University of Kentucky released their economic forecast, which indicated recovery was expected, but predicted that Kentucky's economy will recover at a slower pace than the U.S. economy. The Governor's Office of Economic Analysis indicated the Kentucky economy would not show significant signs of recovery until the latter part of FY03. Mr. Mullis further indicated that durable manufacturing continues to keep Kentucky behind the national economy. Mr. Mullis stated that Kentucky remains on target to meet the revised estimates of the Consensus Forecasting Group.

Orson Oliver, President, Bank of Louisville, presented information to the Commission members from the October 2001 Federal Reserve Meeting in St. Louis, Missouri. Mr. Oliver indicated that this conference was an international affair with most of the G8 nations represented. Chairman Greenspan opened the conference by stating from an economic standpoint the world changed in February 1994 when the Open Market Committee began practicing transparency. After 1994 the Fed began releasing press releases which have evolved over the years to contain code language that indicated to economists the exact state of the economy. A German economist studied how the markets performed in comparison to what the Federal Open Market Committee actually did in the meetings and concluded that as a result of transparency, the three-month Fed Funds future contract predicts rate changes with a 97 percent accuracy

rating. The six-month fed funds future contract has a 61 percent accuracy rating.

Mr. Oliver continued that most of the comments from the world economists indicated that the Fed has done as much as possible to stimulate the economy and that interest rates would not be lowered again. The economists felt recovery would begin in the second quarter of calendar year 2002 as a result of the fiscal stimulus package that the federal government would put into the economy by additional spending, tax cuts and changes in tax policy.

Mr. Oliver suggested that the Commission invite William T. Gavin, Vice President of the research department of the Federal Reserve Bank of St. Louis to a meeting to talk to the membership about the economy. Mr. Mullis indicated that an invitation would be forthcoming, most likely in the second quarter after the General Assembly adjourns.

Mr. Dwight Price, Portfolio Manager, presented a portfolio update to the Commission members. Mr. Price indicated that the portfolio continues to perform close to the benchmark. Attachment A is a summary of the Commonwealth's securities in each pool. Mr. Price pointed out that he prefers to run the duration shorter, which allows the portfolio to perform better if the market doesn't move.

Mr. Mullis discussed Item V, Custodial Bank. Mr. Mullis indicated that for a number of years the Commonwealth has engaged in a relationship with the Bank of New York for custodial services through Farmers Bank, the holder of the state depository contract. Over the last eighteen months, the Commonwealth has been attempting to upgrade access to its account with the Bank of New York to secure an internet-based platform to assist in the daily processing and reporting requirements. Mr. Mullis further indicated that the Bank of New York has not provided services necessary to meet these requirements and has not addressed the concerns of Mr. Price in a timely manner. Subsequently, Farmers Bank was contacted and asked to identify custodial banks that can provide these services. Chip Banks of Farmers Bank contacted several banks that provide custodial services and the information obtained was provided to the members. After review of the information provided by Chip Banks, staff is recommending that the Commission members approve Resolution SIC-01-03 allowing staff to negotiate with Credit Suisse First Boston to extend their present contract until such time as a custodial relationship with State Street Bank is negotiated. Mr. Mullis added that this is an unusual situation in that the State Investment Commission is not the contracting party for the general depository bank. However, staff's suggestion that securities lending be combined with custodial services allows the State Investment Commission to acknowledge that combining those services is in the long-term best interest of the Commonwealth.

Mr. Mullis indicated that State Street Bank has offered pricing and a level of service that will be more beneficial to the Commonwealth than those being offered by the Bank of New York. State Street Bank has indicated they can provide daily information which will allow staff to perform the functions to stay within the context of the MARS reporting system and to meet the requirements necessary to satisfy the Auditor of Public Accounts. State Street Bank will also provide benchmarking and performance data that is not currently available from the Bank of New York.

Mr. Oliver inquired if these services would be provided solely through State Street Bank or would another bank be involved. Mr. Price indicated that State Street Bank would be the sole provider and that information could be accessed through a web page.

Mr. Mullis informed the Commissions members that under the MARS system, the Office of Financial Management is the custodian of all information relative to the investments of the Commonwealth. One of the responsibilities of staff is to balance with Treasury and Farmers Bank and the system need to be flexible and provide the access to information to perform these balances. Mr. Mullis indicated that he wanted the Commission members to be comfortable with the direction that staff will be moving in this regard as it changes the securities lending relationship. Mr. Mullis continued that Credit Suisse has been contacted and is agreeable to a two-to-three month extension of their contract until the relationship between the Commonwealth and State Street Bank has been successfully negotiated.

Mr. Oliver inquired if the Commonwealth had experienced any clearing problems with the Bank of New York and if so, had those problems been resolved. Mr. Price did indicate that the Commonwealth had experienced some clearing problems but the problems have been resolved.

Treasurer Miller asked if a motion was necessary to approve the extension of the Credit Suisse contract until State Street Bank could begin as the custodial bank. Mr. Mullis indicated that approval of Resolution 01-03 would subsume the Commission's agreement with staff's recommendation to contract with State Street Bank to provide custodial banking services as well as becoming the securities lending provider.

Treasurer Miller stated that is his practice to abstain from matters that require business contracts. Mr. Mullis indicated that Farmers Bank will actually enter into the contract with State Street Bank and no Commission members will actually sign the contract with State Street Bank.

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A motion was made by Orson Oliver and seconded by Secretary Flanery to adopt Resolution 01-03. **MOTION CARRIED.**

Mr. Mullis directed the Commission members to the handout that illustrated several indices that staff will be able to use to determine how well the portfolio is performing when compared to the index. Mr. Price felt it was an added value to be able to show how the Commonwealth's portfolio is performing compared to other fixed income portfolios.

Treasurer Miller asked when staff would have access to these indices. Mr. Price indicated that June would be the target date for the transfer to State Street Bank. Treasurer Miller asked if comparison to other state's performance would be possible. Mr. Price indicated that State Street was one of the largest custodial banks for governments and should have information on other states.

Mr. Oliver asked if the Commonwealth's performance numbers are AMIR compliant, and Mr. Price indicated they were with one exception and that is that the interest is calculated on a settle date rather than a trade date.

Mr. Price informed the Commission members that the last page of the attachment was a chart that compares the Commonwealth's risk versus returns against the risk and returns of other companies. Mr. Price pointed out that because of the constraints on what can be purchased, the risk to the portfolio is minimal when compared with other companies.

With no further business before the Commission, a motion was made by Mr. Oliver and seconded by Secretary Flanery to adjourn the meeting.

Respectfully submitted,

Gordon L. Mullis, Secretary
State Investment Commission