

State Investment Commission
Minutes
June 10, 2005

The State Investment Commission was called to order by Jonathan Miller, State Treasurer, on Friday, June 10, 2005 in Room 264 of the Capitol Annex at 10:00 a.m. Members present were John Farris, Proxy for Robbie Rudolph, Secretary, Finance and Administration Cabinet; Michael Alexander, proxy for Governor Ernie Fletcher; and Jonathan Miller, State Treasurer.

Treasurer Miller verified that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. Alexander and seconded by Mr. Farris to accept the minutes of the March 29, 2005 meeting. Motion **CARRIED**.

Mr. Dwight Price, Portfolio Manager, Office of Financial Management, indicated that the Federal Reserve has increased interest rates from 1 percent to 3 percent, an increase of 200 basis points. Mr. Price stated that the 10-year Treasury note has decreased by 80 basis points, which was very unusual. Mr. Price stated that this situation may have caused a housing “bubble” but it is not expected to have any effect the economy. Mr. Price indicated that it is anticipated that the Fed will increase rates to 3.25 percent at the end of June and again in August to 3.50 percent. Mr. Price indicated that the housing market has increased due to the fact that mortgages are driven off the 10-year Treasury. Mr. Price predicted that the markets would remain stable during the summer months.

Mr. Jones presented a quarterly update on the TRAN (Tax and Revenue Anticipation Notes) through May 2005. Mr. Jones indicated that at the beginning of the current fiscal year, the Commonwealth borrowed \$500 million and executed an interest rate swap to manage the interest rate risk. Mr. Jones indicated the Note was fixed rate. Mr. Jones further stated that the swap synthetically changed the fixed rate to a floating rate. Mr. Jones stated that swap has earned \$62,000 on the match between the floating rate assets and the floating side of the swap through the end of May 2005. Mr. Jones continued that on the fixed side of the swap versus the fixed payment on the debt, the Commonwealth has realized a profit of \$2.5 million year to date for total combined earnings of approximately \$2.6 million through the end of May. Mr. Jones expects that the transaction will earn over \$3 million by the end of the fiscal year. Mr. Jones further stated that it is anticipated that the Commonwealth will issue a TRAN in fiscal year 2006 with an approximate size of \$500 million.

Mr. Jones discussed the interest rate straddle. He stated that in December volatility in the market was very low and spreads were very tight. Mr. Jones continued that the spreads were expected to widen, which would negatively impact some of the bonds in the Commonwealth’s investment portfolio. Mr. Jones indicated that spreads have continued to tighten and volatility has continued to decrease which means that the bonds in the investment portfolio have experienced a profit. Mr. Jones indicated, however, that the value of the straddle transaction has decreased from \$975,000 to \$609,000. Mr. Jones stated that staff continues to monitor the transaction daily and anticipates the transaction will perform as expected.

Treasurer Miller asked what interest rate the Commonwealth was receiving on the transaction. Mr. Jones indicated that the interest rate was based on the five-year Treasury rather than on the Fed funds. Mr. Price stated that the five-year Treasury Note has not moved as staff anticipated.

Mr. Farris asked if the short-term rates could exceed long-term interest rates? Mr. Price indicated that when this happens it is referred to as an inverted yield curve. Mr. Price stated that normally an inverted curve precedes a recession but that may not be the case at this time. Mr. Jones added that the Fed's threat to raise rates would cool the economy off to make sure that inflation does not get out of hand.

Mr. Price indicated that each year staff reviews the list of brokers/dealers who are approved to conduct business with the Commonwealth. He indicated that Banc One Capital Markets, Arbor Trading, and Kirkpatrick Pettis have been deleted from the list. Mr. Price stated that Banc One Capital Markets merged with J. P. Morgan and Arbor Trading and Kirkpatrick Pettis have not contacted the Commonwealth so they are being deleted from the list of approved broker/dealers.

A motion was made Mr. Farris and seconded by Mr. Alexander to adopt Resolution 2005-01 approving the list of broker/dealers for fiscal year 2006. Motion carried and Resolution 2005-01 was **ADOPTED**.

Mr. Price informed the Commission that the final changes to 200 KAR 14:011 and 200 KAR 14:081 were contained in Attachment D of the Agenda. Mr. Price stated that 200 KAR 14:011 is being revised to add "or an embedded put of less than three years." Mr. Price indicated this was added to allow the Commonwealth to sell the put at a specific time and specific price. Mr. Price explained that periodically there is an opportunity where a security is longer in duration than the final maturity, which for the Commonwealth is three years. Mr. Price further explained that this would allow the Commonwealth to sell the security in three years and to also receive a 5-year yield off the transaction. Mr. Price indicated that 200 KAR 14:081 is being revised to delete the reference to general depository with regard to the state's custodial contract. [Section 5 (2)]. Mr. Price indicated that other changes were language changes made by the Administrative Regulations Committee of the Legislative Research Commission. Mr. Howard indicated that the Committee would review the regulations on Tuesday, June 14, 2005 and there may be other housekeeping changes that the Committee may suggest prior to the meeting but they would not be material changes to the Regulations.

A motion was made by Mr. Alexander and seconded by Mr. Farris to approve the proposed changes in 200 KAR 14:011 and 200 KAR 14:081. Motion **CARRIED**.

Mr. Jones informed the Commission that staff developed a process to run multiple regressions to identifying the spread between two-year Agency and Treasury notes and five-year Agency and Treasury notes. Mr. Jones is using this model to indicate when to buy and sell the securities. Mr. Jones indicated that this process has allowed the Commonwealth to earn approximately \$10,500 on a two-year Treasury Agency trade in less than a week. He also informed the Commission that staff is looking for opportunities in the 5-year Treasury market. Mr. Price stated that the model tracks securities and indicates when staff should buy or sell securities. Mr. Jones also indicated that staff is

working closing with the Kentucky Housing Corporation on hedging pipelines and structuring swaps with their debt issues.

Treasurer Miller asked if the Office of Financial Management had an executive director. Mr. Howard indicated that he is serving as the acting executive director until a new director is named.

With no further business before the Commission, a motion was made by Mr. Farris and seconded by Mr. Alexander to adjourn the meeting. Motion **CARRIED** and the meeting was adjourned.

F. Thomas Howard
Secretary