

State Investment Commission

March 24, 2014

1:30 p.m. ~ Room 182 ~ Capitol Annex
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on March 24, 2014 at 1:30 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Lori Flanery, Secretary of the Finance and Administration Cabinet; Jane Driskell, proxy for Governor Beshear, and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

Office of Financial Management (“OFM”) Staff Present: Ryan Barrow, Executive Director of OFM, Steve Jones, Deputy Executive Director, Sandy Williams, Deputy Executive Director, Kim Bechtel, Ian Blaiklock, Brian Caldwell, MaryAnn Mullins, and Marcia Hutcherson.

Other Guests: Ed Ross, Controller, Finance and Administration Cabinet, Katherine Halloran, Legislative Research Commission, and Prewitt Lane from Raymond James and Associates.

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

Treasurer Hollenbach called for a motion to approve the minutes from the December 11, 2013, meeting. A motion was made by Secretary, Ms. Lori Flanery and seconded by Mr. George Spragens to approve the minutes. Motion **CARRIED**.

Treasurer Hollenbach recognized Mr. Steve Jones.

Trading Limits – Mr. Steve Jones stated that this Commission has delegated trading authority to OFM staff with limits on the size of individual trades. In December, staff invested the proceeds of the KPTIA (Kentucky Public Transportation Infrastructure Authority) debt issue, which is the funding construction of the Downtown Bridges Project in Louisville. Mr. Jones executed multiple purchases in excess of \$600,000,000 with the largest trade at \$78,000,000 all on one day. Multiple Commonwealth personnel including Ryan Barrow, Executive Director of OFM were aware of the purchases. However, no alerts were triggered by the automated compliance monitoring system because this fell within current limitations. Staff is recommending a change to the current approach to place limitations on purchases by security type per day per staff member rather than limitations of individual trades by staff by security type. Currently there are three levels set by staff seniority with authority for more senior staff to approve exceptions for less senior staff. Staff is proposing the same graduated limits, but limiting the number of transactions in one day and per asset class.

The Commission members and staff engaged in an extended discussion of the matter of compliance procedures. The particular topics included further details on the automated systems, procedures within the Office for monitoring, frequency of violations, flexibility of staff to handle extraordinary events or opportunities, and justification for the limits proposed.

Treasurer Hollenbach called for a motion to approve the proposed Trading Limits starting immediately. A motion was made by Mr. Spragens and seconded by Ms. Jane Driskell to accept the newly established Trading Limits. Motion **CARRIED**.

Mr. Jones pointed out to the Commission members the personnel changes noted at the bottom of the Proposed Trading Limits, specifically the departure of Kurt Kemper and the addition of MaryAnn Mullins.

Direct Repo – Mr. Steve Jones began by explaining tri-party repurchase agreements. The Commonwealth executes an overnight repo in which the counter-party pledges collateral for an overnight loan of cash at a low interest rate. The collateral and cash is held by a third party custodial bank, currently Bank of New York, hence the name tri-party. All of the Commonwealth's currently approved counter-parties are large broker-dealers. After the financial crises, various regulatory agencies are restricting the use of tri-party repo by the broker-dealer community. Staff has been examining the idea of executing repos on a bilateral basis with non-traditional counter-parties, such as regional banks or insurance companies. These transactions will avoid the concerns being expressed by the regulators.

Mr. Jones continued explaining bilateral repo in more detail. The Commonwealth will need to negotiate a Master Repurchase Agreement and Annex with each counter party. The counter parties will need to go through the full credit review process. Collateralization levels will be negotiated based on the credit rating and financial strength of that counter party. Staff will establish an on-going credit monitoring process for all counter parties. Because the Commonwealth will take delivery of collateral directly rather than the tri-party custodian, additional custodial fees of .35 basis points on the market value of the transaction plus certain transactional costs will be incurred. The extra spread to the Commonwealth is anticipated between 10-15 basis points of yield. A system will be sent up for staff to monitor collateralization levels and initiate collateral calls.

Treasurer Hollenbach asked if staff alternate between counter-parties or rely on the terms to be the deciding factor. Mr. Jones replied the current expectation is to have multiple, qualified counter-parties fewer overnight transactions and more week-long terms with staggered terms. Treasurer Hollenbach asked if existing staff would be sufficient to handle the described transition and maintenance. Mr. Jones answered affirmatively, but will need to hire a consultant to identify potential counter parties and market information. The cost is expected to be 1-2 basis points or less. Secretary Flanery asked if once this was set up, would this consultant no longer be needed. Mr. Jones answered that it would be an ongoing relationship for continued negotiations and daily pricing. Treasurer Hollenbach asked if the additional costs would still provide additional returns. Mr. Jones stated that the Commonwealth would see returns of approximately 10 basis points. Mr. Jones indicated that staff would return with a formal proposal at the June meeting.

Bridges Pool – Mr. Steve Jones stated that in December staff invested the proceeds of the KPTIA bonds, funding for the Downtown Bridges Project in Louisville. This pool falls under the purview of the State Investment Commission, however the investments within the pool are restricted and driven by KRS 175D.075, which requires all investments to be "full faith and credit of the United States of America". The portfolio contains all Treasury Securities and were selected with maturities matching the expected draw schedule of the engineers building this project. The longest maturity is December 2016. Staff will not provide performance reporting on this pool as it is not managed in a total return manner nor covered by the same statutes but will provide updates on the pool at subsequent SIC meetings.

Credit Considerations – Mr. Ian Blaiklock discussed the updated list of Corporate Credits for approved investment purchases. Seven non-financial names have been added since December's

meeting and five names removed from the list. Overall, the list has thirty-five financial names and forty-three non-financial names. Treasurer Hollenbach asked if there were any questions. A motion was made by Mr. Spragens and seconded by Secretary Flanery to accept the Approved Credit List as presented. Motion **CARRIED**.

Intermediate Pool Performance – Brian Caldwell directed the Commission members to the Intermediate Term Pool report. The Pool market value has remained stable at approximately 2.5 billion dollars. The Yield to Worst level was 0.603%, which is 0.20% more than the benchmark. Quality remains the same at Aaa. The duration is shorter than the benchmark with liquidity between twenty to forty percent of the pool. Convexity continues to improve from the December meeting where it was -.21 and now is -.09 as of this morning. On the next page, the Portfolio Allocations are shown on the left side with the benchmark on the right. The primary differences are the Portfolio's allocation to Muni, Corporates, and the ABS sectors. The Portfolio Performance page shows the Pool performance versus the Benchmark. For the month of February performance matched the benchmark. For the preceding three months the Pool underperformed by 10 basis points. For the fiscal year-to-date the pool underperformed by 21 basis points with the trailing 1 year under by 50 basis points. The Pool matched the 3-year performance with the 5-year, 10-year, and since inception performance being close to index but still slightly under. Treasurer Hollenbach asked why the Pool chart varies so much from the benchmark chart. Mr. Caldwell replied the Pool is yielding approximately 20 basis points more than the benchmark by investing in spread products which have a higher yield. Mr. Spragens added that the benchmark has roughly 2/3rds allocated to Treasuries which is great for safety but limits returns. Treasurer Hollenbach asked if this was the correct benchmark. Mr. Caldwell stated it was the "reporting benchmark", and Mr. Jones added that an ongoing, multi-year conversation has been on-going about the best benchmark but that staff is not prepared to make a recommendation.

Limited Term Pool Performance – Ms. Kim Bechtel discussed the monthly performance of the Limited Term Pool compared to the Local Government Investment Pool. The first graph shows the Commonwealth consistently out-performing the benchmark. The second page lists all the securities held in the Pool as of February 28, 2014. The next page shows breakdown by security type and credit rating. The next page provides detail on the weighted average maturity and life plus liquidity positions and the Net Asset Value graph is steady as it should be. The largest daily withdrawals are from the University of Kentucky Hospital funds in 2011 and 2013. UK always notifies staff well in advance of those outflows. The largest weekly withdrawals are the same as the daily withdrawals. The largest individual accounts in the portfolio are the Employee Self-Insurance Fund at 25.81 %, UK Building Fund at 21.37 %, and the UK Investment Account at 10.25%.

Staff recommends maintaining the current liquidity requirements of the Pool requiring no action from the Commission. The Commission took no action.

Linked Deposit Program (Country Bank Program) – Ms. Kim Bechtel provided an update on the program and the addition of Bank of McCreary to the non-performing loans section. The bank stated to staff that the increase in non-performing loans was due to one commercial loan. There are on-going negotiations to restructure the business bringing the loan back to performing status. Both Farmer's Deposit Bank and Bank of Columbia have sizable loans they are working through. Both banks non-performing loan status improved from the last report in December. All deposits are fully collateralized to the benefit of the Commonwealth.

Other Business –

Mr. Jones added information about interactions with the Lottery Commission. The Lottery Commission holds approximately \$24,000,000 in an investment portfolio. Given the small size, custodial bank fees were excessive. The Lottery Commission contacted OFM for help. OFM offered, and the Lottery Commission agreed, to have the assets custody in an account under control of OFM. OFM will charge 0.002% of the market value for the service. The Lottery Commission will also participate in the state's securities lending program generating enough income to more than offset the new fee. Mr. Jones stated it was proposed to be 6 basis points with a minimum.

With no further business, the meeting stands adjourned.

Respectfully submitted,



Ryan Barrow
Secretary