STATE INVESTMENT COMMISSION
DECEMBER 8, 2011
2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission ("the Commission") meeting was called to order on Thursday December 8, 2011, at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Mr. Ed Ross, Commonwealth of Kentucky Controller as proxy for Lori Flanery, Secretary of the Finance and Administration Cabinet; Ryan Keith, proxy for Governor Beshear; and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

OFM Staff Present: Tom Howard, Executive Director, and Secretary to the Commission, Steve Jones, Deputy Executive Director, Dwight Price, Brett Antle, Deputy Executive Director, and Marcia Adams.

Other Guests: Kristi Culpepper from Legislative Research Commission (LRC) and Barbara Fava, Senior Managing Director, PFM Asset Management, LLC.

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 September 16, 2011. A motion was made by Mr. George Spragens and seconded by Mr. Ed Ross to approve the minutes as written. Motion **CARRIED**.

Financial Advisor Request for Proposals (RFP) - Mr. Tom Howard updated the Commission on the authorized Request for Proposals (RFP) for an independent financial advisor. The RFP was issued September 22, 2011, with the due date of September 30, 2011. Staff provided notice to a number of financial advisors that were qualified for such work. Only one timely response was received by the deadline. Treasurer Hollenbach asked if the short time-frame was normal. Mr. Howard replied that this was within statutory requirements and in keeping with the deadlines imposed to provide the Commission with information before the upcoming Legislative Session.

The RFP committee consisted of all merit investment staff, who reviewed the proposal and deemed it responsive. The contract was signed and posted on the procurement website on the 14th of October, 2011. The contract was awarded to PFM Asset Management, LLC, who is the number one governmental financial advisor in the country. Mr. Howard introduced Ms. Barbara Fava, Managing Director of PFM.

Introduction of PFM Asset Management, LLC ~ Ms. Barbara Fava Ms. Fava described the firm's background of over thirty years. PFM has clients in two-thirds of the states providing services including debt advisor, investment management, and investment consulting. PFM manages $40 billion of short fixed-income assets internally, making the company both a practitioner and advisor. Ms. Fava started her career as a portfolio manager before becoming Deputy State Treasurer for Pennsylvania. She has been with PFM for twenty-two years. At PFM, she now primarily works with state governments across the country on their investment practices.

Ms. Fava stated she has already had a productive start on this project with meetings and conference calls with OFM staff. PFM will be comparing oversight the Commission provides to Kentucky's investment with other states. PFM will recommend updates to the statutes and regulations

governing the investment process. The strategy for the Short-Term, Limited-Term, and Intermediate Pools will be reviewed in light of today's market environment. PFM will also review portfolio benchmarks and recommend whether new or different benchmarks should be considered.

Treasurer Hollenbach asked if other states were also undertaking reviews due to the roller-coaster market. Ms. Fava stated that many states seek outside guidance every couple of years and continue to do so. The company noticed in 2008-09 that a few states with distressed periods of investment performance sought advice and guidance on specific issues. Treasurer Hollenbach asked how Kentucky's regulations compared to other states. Ms. Fava replied that some states had more detailed statutes without regulations. Those states then use investment policies, which tend to be broad and written for the lay-person. The Commonwealth's regulations appear to be "in-lieu-of" an investment policy, which means that Kentucky has a different approach than most states.

Treasurer Hollenbach asked if Kentucky is "tying our hands" with extensive regulation and with these revisions will the Commission be able to confront the new realities going forward in the changing world financial markets. Ms. Fava replied that Kentucky's statutes are broad, and very high level, compared to many states, which have highly restrictive statutes. Mr. Howard added that changing regulations requires Staff to provide a draft of changes to the Commission for its approval, before Finance Cabinet General Counsel files with the (Legislative Research Commission's) Administrative Review Committee. The hearing process for that Committee takes a few months. While statutory changes could take years. PFM anticipates presenting a report to the Commission at the next quarterly meeting.

Mr. Howard added that the Kentucky Public Transportation Infrastructure Authority ("KPTIA") hired PFM Asset Management, LLC on the debt advisory side to assist them with the evaluation of the financial plan for the Louisville-Southern Indiana Ohio Bridges Project.

Portfolio Performance - Mr. Price presented a series of graphs to the Commission showing various measures of portfolio performance. The Intermediate Pool graph shows small outperformance of the index two of the past three months with limited tracking error. Mr. Jones discussed the Annual Cash Distributions graph and stated that the graph shows the impact of declining interest rates over the last several years. The Commonwealth's FY 2012 cash distributions will be the lowest during this time period due to the current interest rate environment. The Comparative Yields graph shows the Short Term Pool return compared to a couple of indices. The T-Bill index is the benchmark for this pool as identified in the prospectus. The Fed Funds index is for informational purposes only. The Commonwealth has outperformed those indices in past years until this fiscal year. One of the Commonwealth's impaired securities has taken a loss while not enough interest income has been earned to offset that loss.

The final graph shows the market value of the total portfolio and the level of daily liquidity. The Commonwealth maintains a substantial liquidity position to cover cash outflows. The jagged nature of the graph is due to periodic large transactions during a month, specifically SEEK, Medicare, and payroll disbursements. A recent change in the new Managed Care Program will increase the volatility of the liquidity position. Previously, payments were made to Medicaid vendors weekly with partial reimbursement from the Federal Government later in the day. The new procedure now makes a monthly disbursement to the Managed Care providers, who, in turn, pay the Medicaid providers. These occur on about the fifth business day of the month and today were approximately $287 million. On one occasion, both SEEK and the Managed Care payment disbursement occurred on

the same day, resulting in a $500 million dollar outflow in the morning before partial reimbursement in the afternoon. Staff projects this situation will occur three to four times annually but expect no problems.

Treasurer Hollenbach asked if staff had much interface with the new banking partner. Mr. Jones responded that Chase assigned a team dedicated to the state full-time for the transition period. While some issues arose, Chase has been flexible as issues have risen. The new electronic interface is for wire transfer and balance information is a meaningful improvement. Mr. Price added that the Commonwealth had a $200 million daylight over-draft this morning. The Commonwealth's previous bank could not have handled that transaction.

Linked Deposit Program – Mr. Jones updated the Commission on the Linked Deposit Program. A handout to the Commission identified three banks currently not meeting the guidelines for entering the program. Each of the banks has experienced some minor improvement since the previous meeting. Mr. Jones reminded the Commission that the Commonwealth holds collateral with a market value of 102% of the balance of the loans outstanding. The Commission has the right, but not the obligation, to call the loans identified on the handout. The Commission took no action.

Securities Update - Mr. Price identified the securities in the Securities Lending Portfolio which have been downgraded. In the last quarter, the Commonwealth has received back almost $1 million in principal from the two securities at par and the market values have gone up. These securities continue to make all contractual principal and interest payments. At the current rate of pay-down, they should be fully paid off in about 10 to 15 months.

Mr. Jones discussed the twelve downgraded securities in the direct portfolio. This group has had an addition this month as S&P downgraded SACO 2005-2A from AAA to AA. This group of securities returned $3 million dollars of principal at par and had approximately $3.7 million improvement in unrealized loss. SACO is a conduit currently being used to fund residential mortgages. The Short Term Pool graph presented earlier showed a loss for this fiscal year from the recognized loss on the first security on this list, Countrywide. Staff recommends continuing to hold these securities.

Mr. Spragens moved to extend forbearance for the Commonwealth to continue to hold the list of downgraded securities. The motion was seconded by Mr. Ross. Motion **CARRIED**

With no further business before the committee, the meeting stands adjourned.

Respectfully submitted,

F. Thomas Howard
Secretary