

## **Short-Term Proceeds Pool Prospectus**

### **OVERVIEW**

The State Investment Commission (the "Commission") is charged with the oversight of the Commonwealth's investment programs pursuant to KRS 42.500. The Commission is comprised of the Governor, the Treasurer, the Secretary of the Finance and Administration Cabinet and gubernatorial appointees who represent the Kentucky Bankers Association. The Commission delegates the day-to-day management of the Commonwealth's investments to the Office of Financial Management. ("OFM").

The Commonwealth's investments have been categorized into two distinct classifications or "pools". The Short-Term Pool consists primarily of General Fund cash balances. The Short-Term Pool is further subdivided into the Short Term Pool and the Limited Term Pool. The Short Term Pool contains only accounts which pay their earnings to the General Fund. The Limited Term Pool contains accounts which do not pay their earnings to the General Fund. Both of these pools are subject to the provision of this prospectus. The Intermediate-Term Pool represents Agency Fund investments, state held component unit and fiduciary fund accounts held for the benefit of others by the state.

The purpose of the investment pools is to provide economies of scale that enhance yield, ease of administration for both the user agencies and OFM, and increased accountability and control.

### **OBJECTIVE**

To earn the maximum level of current income consistent with liquidity and preservation of principal. The pool seeks to maintain a net asset value of \$1.00 per share. There is no assurance that the pool will be able to maintain a stable net asset value of \$1.00.

### **SHARES**

Shares of the fund represent a divisible interest in the underlying securities and are not federally insured or guaranteed by the U.S. Government, Federal Deposit Insurance Corporation or any federal agency. The pool has not been approved by the Securities and Exchange Commission.

## **PERMITTED INVESTMENTS**

All investments shall be permitted investments as defined in KRS 42.500 and as further limited by 200 KAR Chapter 14.

The pool seeks to achieve its objective by investing direct obligations of the United States Treasury, its agencies and instrumentalities, repurchase agreements relating to such obligations issued by approved financial institutions and broker/dealers and in money market instruments including, but not limited to Certificates of Deposit, Commercial Paper, Banker's Acceptances. **See Pool Investment Policies.**

## **RISK**

The pool, as are all fixed income investments held individually or collectively, is exposed to four types of risk:

- 1) Interest Rate Risk: the potential for an increase/decrease in share values based upon decreases/increases in the level of market interest rates.
- 2) Income Risk: the potential for the portfolio's income to rise/fall as interest rates increase/decrease.
- 3) Credit Risk: the potential that a security's issuer will fail to make timely payments of principal and interest.
- 4) Prepayment Risk: the potential for an issuer of a security to call or prepay principal prior to the stated maturity date. This generally occurs as interest rates fall and proceeds from the call are reinvested at a lower rate.

The pool's risk characteristics are as follows:

- 1) low interest rate risk due to the relatively short term maturity constraints;
- 2) high income risk as the short-term maturities must be reinvested at then current market rates;
- 3) low credit risk due to the high quality of investments prescribed by statute; and
- 4) low prepayment risk due to the relatively short-term nature of the securities held.

## **EXPENSES**

The pool is assessed an annualized charge, calculated and deducted daily, of five basis points (.0005) to defray operating expenses associated with the pool. Direct expenses can also be passed on to the pool. A traditional money market fund typically charges between twenty five (.0025) and fifty basis points (.0050) for these services plus expenses.

## **EXPENDITURES**

Funds residing in the pools are available to be spent at any time. OFM requests that it be notified as early as possible of any disbursements that are unusually large for an agency.

## **ACCOUNTING**

The assets in the Short-Term Pool are valued based upon the Amortized Cost Method ("ACM"). The ACM values an instrument at its cost initially and, thereafter, assumes a constant amortization to maturity of any discount or premium. The investment income of the pool is declared daily as income to each qualifying account at the close of the business day. Net income consists of: (i) interest accrued and discount earned (ii) less amortization of premium and expenses. Cash income is distributed monthly.

Income is earned on balances held in accounts which have statutory authority to receive investment income. Negative balances are considered to be borrowed funds from the pool and will be charged at the yield earned by the pool for the duration of the loan. OFM must have access to the enabling legislation or statutory reference to distribute income. Income will be posted to qualified accounts that have a balance in the eMARS system as kept by the Division of Accounts in the Finance and Administration Cabinet. OFM is not responsible for delays or errors in posting of account balances on the MARS system. All inquiries regarding the MARS system should be directed to Statewide Accounting, 702 Capitol Avenue, Room 484, Frankfort, Kentucky 40601. Statements are issued monthly by OFM.

## **YIELDS**

Yields are quoted as annualized monthly and fiscal year to date returns. Yields may be impacted by the timing of deposits and withdrawals from accounts in the eMARS system.

## **SAFEKEEPING**

Investments are held by the state's custodial bank. The current custodial bank is US Bank. The Commonwealth also has a tri-party custodial account with the Bank of New York Mellon to facilitate the execution of repurchase agreements.

## **INVESTMENT POLICIES**

U.S. Treasury and Agency securities with a maturity less than 367 days. No limit, with the exception of Treasury STRIPS and CUBES which shall be limited to ten percent (10%) of the pool.

Repurchase and Reverse Repurchase Agreements collateralized at 102% (marked to market daily) with treasuries, agencies, and qualifying mortgages. The maximum maturity is 367 days and executed with approved broker/dealers and the Kentucky Bank Repurchase Program participants. Such transactions shall be executed with Commonwealth tri-party custodian banks or delivery versus payment at the Commonwealth's custodian bank.

### **OTHER LIMITATIONS**

Mortgage backed securities and collateralized mortgage obligations shall not exceed 25% of total pool assets in aggregate.

Asset-backed securities shall not exceed 20% of total pool assets.

Corporate and Yankee securities shall not exceed 25% of the pool or \$25,000,000 per issuer including money market instruments with certain exceptions.

Non-US sovereign debt shall not exceed 5% of the pool.

The State Investment Commission may waive these limitations through unanimous action.

### **RISK MANAGEMENT**

The Pool may utilize interest rate swaps and over-the-counter Treasury options to hedge the portfolio against fluctuation due to changes in interest rates. The pool will use these securities for bona fide hedging purposes and not for speculative purposes, as defined by the State Investment Commission. Situations where these types of securities will be used to: (1) simulate full investment through the purchase of calls and the sale of puts, (2) limit price fluctuations due to changes in interest rates through the sale of calls and purchase of puts, and (3) stabilize income and duration management through the use of interest rate swaps.

**The State Investment Commission expressly prohibits the use of leverage or the posting of margin.**

Risk Management activities even for bona fide hedging purposes involve elements of risk known as basis risk and counterparty risk..

Basis risk: The risk that the hedge vehicle is not perfectly correlated to the underlying portfolio of securities and that the gains and losses are not perfectly offset against the gains and losses of the securities in the portfolio.

Counterparty risk: The risk that the entity entering into the hedge vehicle fails to perform its obligation under the terms of the agreement. The pool must then reestablish the position to provide the hedge. Market conditions may be different than those when the position was originally established resulting in a higher/lower cost when the position is reestablished. Typically, principal is not at risk, although principal gains and losses representing the net gain or loss in the underlying security may be realized should market conditions move against the portfolio's value.

OFM utilizes industry standard portfolio accounting and risk management software, including marking the portfolio to market daily to minimize basis risk. Counterparty risk is managed by established credit limits for State Investment Commission approved broker-dealers. **See Approved Broker/Dealers.**

## **SECURITIES LENDING**

The pool may lend securities held in the portfolio to broker/dealers approved by the State Investment Commission. Income derived from securities lending will accrue to the benefit of the pool. Currently, the Securities Lending Program is operated on an agency basis with Credit Suisse/First Boston (“CSFB”). The state’s portfolio of treasuries, agencies and corporate bonds are made available to CSFB. Earnings are split 80% to the state and 20% to CSFB.

Previously, and perhaps again in the future, the state has the right to enter into a principal agreement for its Securities Lending Program. A principal agreement would guarantee a stated pay-out for all of the state’s treasuries, agencies and corporate bonds. This contract is bid every two weeks with the best arrangement, whether agent or principal determined at that time.

## **PROHIBITED TRANSACTIONS**

The State Investment Commission prohibits:

- 1) the use of leverage;
- 2) the posting of margin, such as used in the purchase or sale of futures contracts; and

- 3) the purchase of mortgage related interest, or principal only strips, and any inverse floating rate or other similar types of securities deemed inappropriate for governmental use.

## **BROKERAGE TRANSACTIONS**

When selecting brokers and dealers to facilitate the purchase and sale of portfolio instruments, OFM looks for prompt execution of the order at the most favorable price.

## **APPROVED BROKER-DEALERS**

Approved annually by the State Investment Commission

Repurchase Agreements:

- 1) Primary dealers of the Federal Reserve.
- 2) Rates A1-P1 by Standard and Poor's Ratings Group, a division of McGraw Hill and Moody's Investors Service.
- 3) Transaction amounts limited to a dealer's excess net capital. Banks participating in the KY Bank Repurchase Agreement Program and limited to \$25 million or ten percent (10%) of total assets or the bank's capital, whichever is less.

Hedge Vehicles (Swaps and Options):

- 1) Primary dealers of the Federal Reserve with at least \$100 million in excess net capital.
- 2) Rated A1-P1 by Standard & Poor's Ratings Group, a division of McGraw Hill and Moody's Investors Service.
- 3) Transaction amounts limited to dealer's excess net capital.

Delivery versus Payment Transactions:

- 1) Primary dealers of the Federal Reserve rated A1-P1 by S & P or Moody's or broker-dealers with a business nexus in the Commonwealth with \$25 million in excess net capital; or whose trades are guaranteed by a primary dealer of the Federal Reserve and meets the aforementioned rating criteria.

The information contained herein is believed to be accurate, but is not guaranteed.