ASSET/LIABILITY COMMISSION

SEMI-ANNUAL REPORT

For the period ending December 31, 2004

This is the Kentucky Asset/Liability Commission's ("ALCo") sixteenth semi-annual report pursuant to KRS 56.863 (11) for the period beginning July 1, 2004 through December 31, 2004. This report may be viewed at:

http://ofm.state.ky.us/alcosemi-reports.html

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INTRODUCTION

There were several factors which had an impact on activity during the reporting period. The key themes were:

On the national level

- War in the Middle East continues.
- U. S. economy continues to show signs of recovery.
- State governments display revenue growth.
- The Dow Jones Industrial Average finishes the calendar year at 10,783 up 374 points.

On the state level

- Ratings for appropriation supported debt are removed from watch for possible downgrade.
- First half of fiscal year 2005 General Fund revenues increase 7.8 percent over the same period for fiscal year 2004.

INVESTMENT MANAGEMENT

Market Overview

On June 30, 2004, the Federal Open Market Committee ("FOMC") of the Federal Reserve raised the Fed Funds target rate from 1.00 percent to 1.25 percent and announced that "policy accommodation can be removed at a pace that is likely to be measured". Basically, the FOMC was saying that the rate on Fed Funds was too low, or stimulative, and that they were planning to return the rate to a more neutral, less stimulative, level. Since that time, the FOMC has raised Fed Funds 25 basis points per meeting to 2.25 percent at the December 14, 2004, meeting. They continue to announce that "policy accommodation can be removed at a pace that is likely to be measured".

In the past, when the FOMC has adopted a tightening mode, longer term rates have also risen. Generally, because longer rates are at least partially driven by the expectation of future shorter rates, the longer rates begin moving higher prior to the Fed tightening and stabilize or drop before the Fed is finished. In this case, longer rates have actually declined somewhat. Ten year Treasuries, for example, have fallen from 4.58 percent on June 30, 2004, to 4.22 percent on December 31, 2004. Alan Greenspan, Chairman of the Federal Reserve Board, has labeled this a "conundrum".

There appear to be two explanations for this phenomenon. The first explanation has to do with the trade deficit. During the first nine months of 2001, the trade deficit, as measured by the US Current Account Balance, was $296 billion. During the first nine months of 2004, the same measure was $476 billion (seasonally adjusted). An enormous portion of this trade deficit is being recycled into the US through the purchase of bonds by foreign, primarily Asian, central banks. This huge demand for Treasury bonds has bid the price higher than it otherwise would be. This presents a large potential risk for the US economy. If these central banks ever stop or even slow down buying Treasuries, rates could rise substantially, very quickly.

The second explanation has to do with inflation and inflation expectations. The Consumer Price Index headline index has increased from 1.9 percent year-over-year in December 2003 to 3.3 percent in December 2004. The Core Rate, excluding food and energy, has increased from 1.1 percent to 2.2 percent over the same period. While the Fed provided enormous monetary stimulus, inflation has risen only enough to reach, what is commonly believed to be, the Fed's comfort zone for inflation. Expectations, while difficult to measure precisely, imply that the market expects inflation to remain well contained. There is no need to price an "inflation premium" into the yield of longer bonds, which also helps to hold down the rates.

The positive impact on the "real" economy is reflected in the growth of Real Gross Domestic Product ("GDP"), on a year-over-year basis. GDP was 4.0 percent in the third quarter of 2004, and 3.9 percent in the fourth quarter. Most forecasters expect continued growth at about 3.5 percent, which is close to the long term trend line.

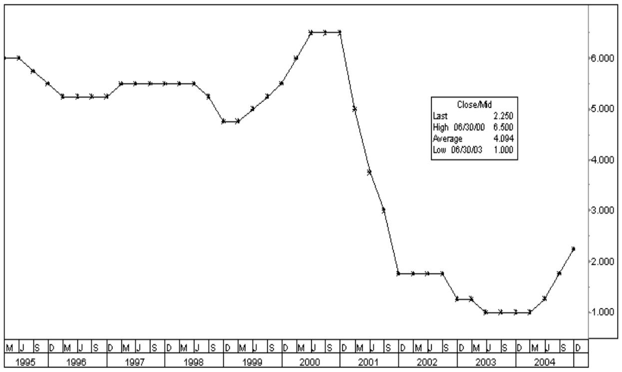
Growth in Non-Farm Payrolls averaged about 160,000 per month during the last six months of 2004. This compares very favorably to the 30,000 per month average during the same time period in 2003. Many forecasters expect job growth to remain at, or slightly above, this level well into 2006.

The forecast going forward from here is relatively benign. The Fed should continue its "measured" tightening, probably into the general ball park of 3.50 percent Fed Funds. Longer term rates should rise as well, but not as much, with the 10 year ending the calendar year somewhere between 4.5 percent and 5 percent. GDP and Employment should continue to grow steadily, at or slightly above trend line.

The largest risk to this forecast is a change in policy by foreign central banks. If they choose to slow or stop purchasing US bonds, rates could rise dramatically, choking off economic growth. The next biggest risk is increasing energy prices. As discussed in previous reports, further increases in energy prices could have substantial negative implications for the economy. Finally, while the geopolitical situation appears to be improving marginally, the possibility of negative shock to the economy remains.

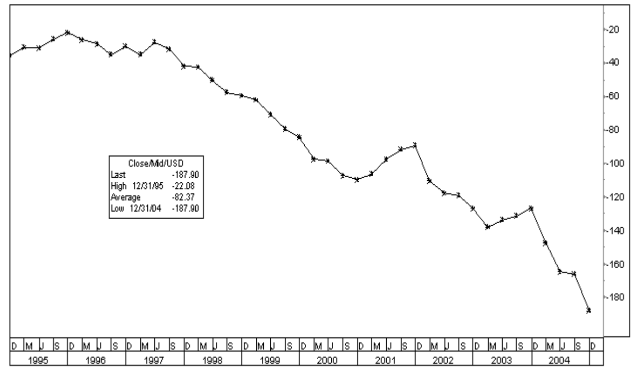
Federal Funds Target Rate

Range 12/31/94 - 12/31/04 FDTR Index Period Q Quarterly



U.S. Current Account Balance

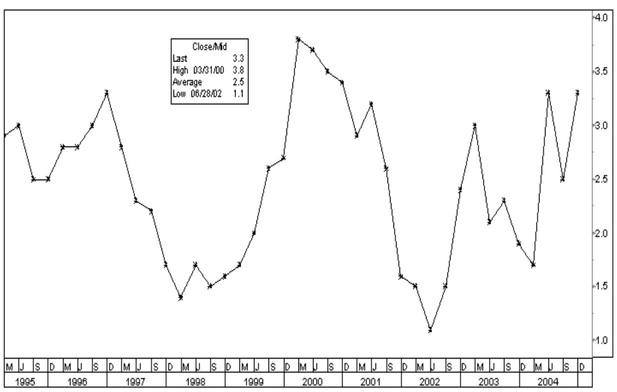
Range 12/31/94 - 12/31/04 USCABAL Index Period Q Quarterly



Consumer Price Index

YEAR-OVER-YEAR INDEX

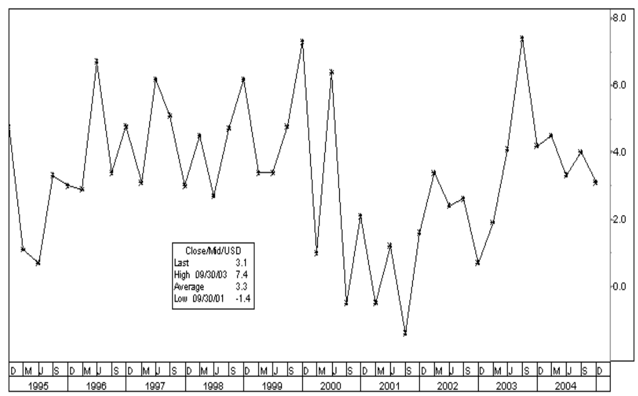
Range 12/31/94 - 12/31/04 CPI YOY Index Period Q Quarterly



Gross Domestic Product

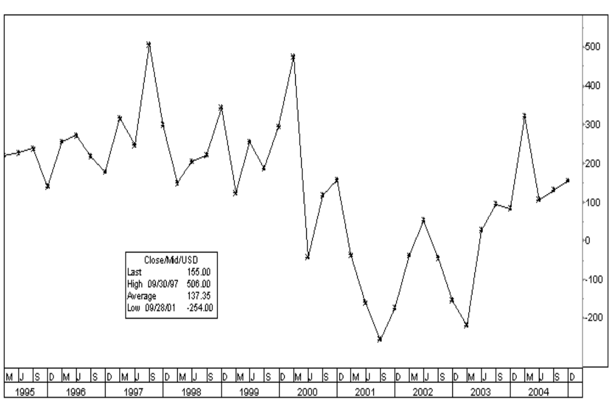
QUARTER-OVER-QUARTER INDEX

Range 12/31/94 - 12/31/04 GDP CQOQ Index Period Q Quarterly



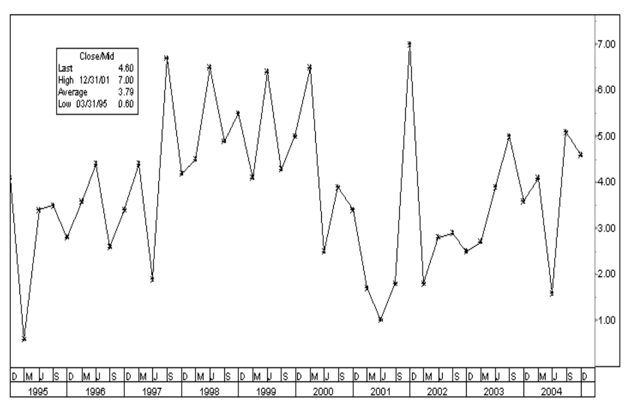
Change in Non-Farm Payrolls

Range 12/31/94 - 12/31/04 NFP TCH Index Period Q Quarterly



Personal Consumption

Range 12/31/94 - 12/31/04 GDPCTOT% Index Period Q Quarterly



Portfolio Management

For the six months ending December 31, 2004, the Commonwealth's investment portfolio averaged $2.6 billion. As of December 31, 2004, the portfolio was invested in U.S. Treasury Securities (11 percent), U.S. Agency Securities (27 percent), Mortgage Pass-Through Securities (2 percent), Collateralized Mortgage Obligations (7 percent), Repurchase Agreements (17 percent), Municipal Securities (7 percent), Corporate Securities (8 percent), Asset-Backed Securities (11 percent) and Money Market Securities (10 percent). The portfolio had a market yield of 2.72 percent and an effective duration of 0.89 years.

The total portfolio is broken down into four investment pools. The pools' balances as of December 31, 2004, were Short Term Pool - $696 million, Intermediate Term Pool - $1.448 million, Bond Proceeds Pool - $429 million and TRAN Pool - $506 million.

Total investment income from all investments, on a cash basis, for the six months ended December 31, 2004, was $74.2 million versus $73.5 million for the six months ended December 31, 2003. On a full mark-to-market basis, investment income was $34 million for the six months ended December 31, 2004, versus $19 million for the six months ended December 31, 2003.

Tax-exempt Interest Rates and Relationships

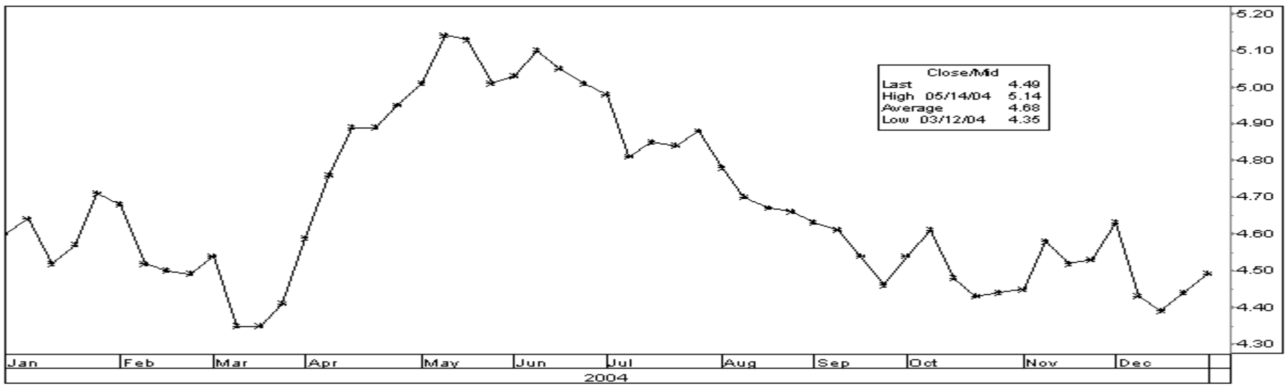
The Bond Buyer 20-year General Obligation Index averaged 4.68 percent for the calendar year 2004. The high was 5.14 in May 2004, the low was 4.35 percent in March 2004, and the year ended with 4.49 percent.

The Bond Market Association ("BMA") Municipal Swap Index averaged 1.23 percent for the year. The high was 1.99 percent in December 2004 and the low was 0.87 percent in March 2004. BMA ended the year with 1.99 percent. The 30-day USD London Interbank Offered Rate ("LIBOR") averaged 1.50 percent for the year. The high was 2.42 percent in December 2004 and the low was 1.09 percent in April 2004. BMA traded as high as 101.8 percent of 30-day LIBOR in January 2004 and as low as 59.7 percent in December 2004.

Bond Buyer 20-year General Obligation Index

BBWK20GO Index

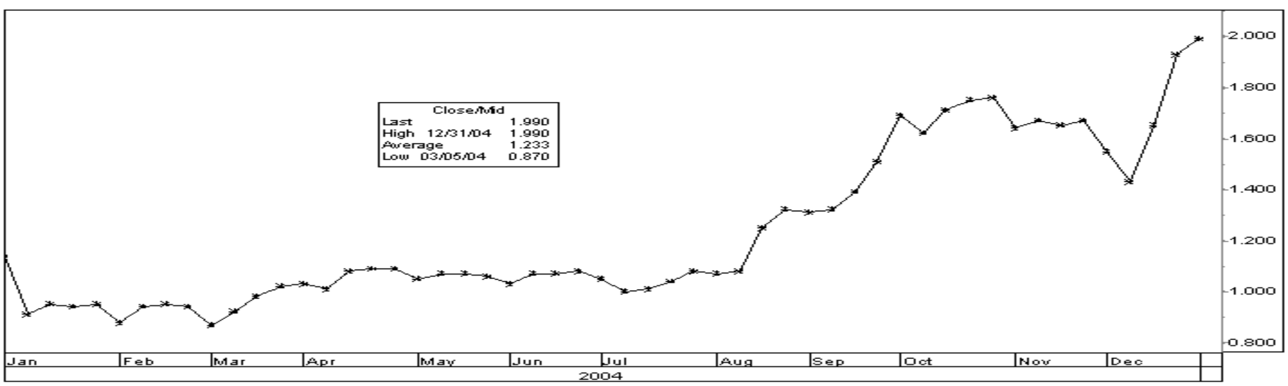
Range 12/31/03 - 12/31/04 Period W Weekly



Bond Market Association "BMA"
Municipal Swap Index

MUNIPSA Index

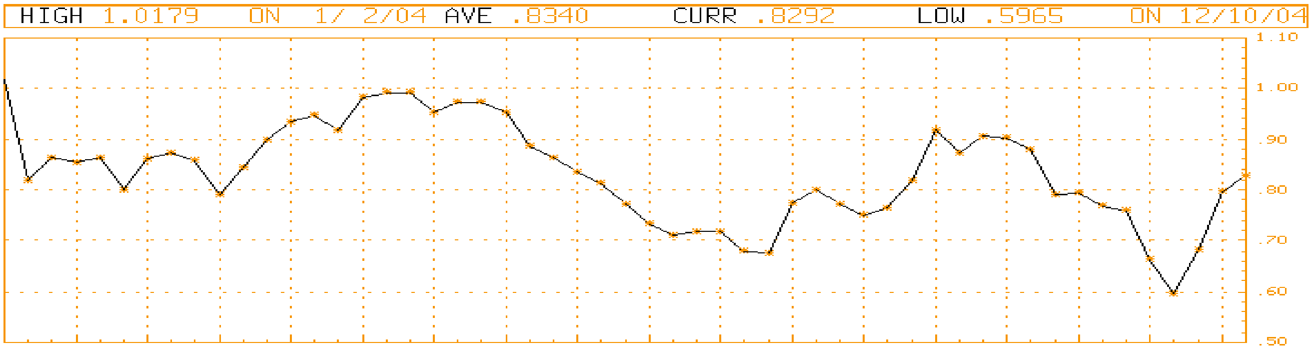
Range 1/ 1/04 - 12/31/04 Period W Weekly



Bond Market Association "BMA" Municipal Swap Index
as a percent of one month LIBOR

RANGE 1/ 2/04 TO 12/31/04

HIGH 1.0179 ON 1/ 2/04 AVE .8340 CURR .8292 LOW .5965 ON 12/10/04



DEBT MANAGEMENT

TAK 2004

The Turnpike Authority of Kentucky ("TAK") issued two series of Economic Development Road Revenue Refunding Bonds (Revitalization Projects) in calendar year 2004. The $16,180,000 Series A was a current refunding of the $16,905,000 Series 1993 remaining outstanding term bond. The refunding generated net present value savings to the Road Fund of $1,046,793 or 6.19 percent of the refunded bonds. The fixed rate noncallable transaction consisted of a bifurcated 2010 maturity. The 2004 Series A was delivered on June 10, 2004 and was insured by the Financial Guaranty Insurance Company.

The 2004 Series B was an advance refunding of the $40,620,000 remaining outstanding Series 2000 bonds maturing after 2011. The $41,510,000 fixed rate bonds were delivered on October 5, 2004. The annual level savings to the Road Fund had a net present value of $1,234,274 or 3.04 percent of the refunded bonds. These bonds were also noncallable with maturities out to 2015. The Series B bonds were insured by Financial Security Assurance Inc.

KLCFCA 2004

The Kentucky Local Correctional Facilities Construction Authority Series 2004 currently refunded the outstanding Series 1994 Bonds. The refunding generated net present value savings of $2,320,062 or 8.02 percent of refunded par. The savings were disbursed among the local governments who were recipients of financial assistance from the Series 1994 bond issue. The transaction was an MBIA Insurance Corporation insured, 10 year, fixed rate transaction.

Ratings Update

The rating community has not taken any action since October 2002 when Standard and Poor's ("S & P") downgraded the state appropriation debt from "AA-" to "A+" with a stable outlook. Although S & P placed the Commonwealth's appropriation supported debt on Credit Watch with negative outlook in June 2004 based upon the lack of a legislatively enacted budget, S & P promptly removed the state from the Credit Watch with negative outlook once the Franklin Circuit Court indicated that the Commonwealth would operate on Governor Fletcher's Public Services Continuation Plan. Moody's rates the state's appropriation supported debt "Aa3" with negative outlook and placed the state on WatchList for possible downgrade in late May 2004, again based on the budget situation. Moody's removed the Watchlist designation on October 15, 2004. Fitch assigns an "AA-" with no expression concerning the outlook.

As outlined in the previous report, rating agency concerns continue to focus on a structurally balanced budget, lack of liquidity and further commitment to replenish the Budget Reserve Trust Fund

Tax and Revenue Anticipation Notes

2004 TRAN. Originally, TRANs were issued at tremendous rate advantages to taxable reinvestment rates, often producing 2 percent excess returns when the General Fund had excess cash and significantly lowering the borrowing cost when the balances were negative. ALCo authorized the 2004 (FY 2005) TRAN program in an amount not to exceed $800 million. On July 13, 2004, $500 million were delivered to mature on June 29, 2005. The 2004 Series A TRANs were sold by Citigroup Global Markets Inc. on July 8, 2004. The fixed rate notes carry a coupon of 3.00 percent to yield 1.55 percent. Net benefit is expected to be approximately $3 million to the General Fund.

Project Notes. There were no ALCo Project Notes issued during the reporting period.

Table of Outstanding ALCo Notes as of December 31, 2004

2001 General Fund Series	$ 22,790,000	Final Maturity 2/01/08
2003 General Fund Series	$123,755,000	Final Maturity 7/15/13
Total	**$146,545,000**	

FINANCIAL AGREEMENTS

As of December 31, 2004, ALCo had five financial agreements outstanding, with a net notional amount exposure of $33.59 million. These transactions are detailed in Appendix A. The only Financial Agreement executed during the period was on August 11, 2004, for the Turnpike Authority of Kentucky ("TAK").

Of the continuing outstanding financial agreement transactions, the first item is a total return swap related to the $56,485,000 July 1, 2009 maturity of the TAK Resource Recovery 1985 Series A Bonds, which bears interest at 6 percent. Staff worked for approximately 18 months to develop this transaction with Morgan Stanley ("MS") and finally executed the trade in April 2001. The 1985A Bonds could not be economically refunded, despite a very low interest rate environment, due to the enormous transferred proceeds penalty associated with the Debt Service Reserve Fund ("DSRF") which is earning approximately 10 percent. MS, bond counsel and the Commonwealth developed a structure whereby the bonds would be called, but not redeemed. Once called, the bonds were sold to MS. ALCo then entered into a total rate of return swap, whereby MS pays ALCo 6 percent (the coupon on the bonds) and ALCo pays to MS, BMA (short-term tax-exempt municipal index) plus a spread (currently 58 basis points) to cover expenses. This transaction provided the synthetic variable rate exposure to offset the asset sensitivity in the balance sheet, i.e. sensitivity to declining interest rates. During the first few weeks of the trade, ALCo booked $147,727 in earnings on the first payment date of July 1, 2001. Rates continued to steadily decline, putting the trade in a very favorable position. Shortly after the events of September 11, 2001, interest rates tumbled dramatically and on September 27, 2001, staff entered into an offsetting trade, locking in a guaranteed spread of 213 basis points. The reversal rate (rate ALCo agrees to pay MS) was 3.87 percent versus the original fixed receiver rate of 6 percent from MS. ALCo has received $3.38 million under the terms of the agreements since inception. The expected total benefit from this transaction to maturity is $7.46 million.

Since the two transactions offset each other for a net notional amount of zero, ALCo collects the difference between the two payments and deposits the proceeds into a swap account held for the benefit of the Road Fund. This account also secures future payments to MS under the agreement, if necessary. ALCo is obligated under the agreement to accumulate a minimum balance of $3 million in the swap account. Once cumulative deposits have achieved that level, funds may be available to offset future debt service payments. Since the bonds are still outstanding and the TAK retains the right to call the bonds at face value (par), the termination value of the swap is essentially the present value of the fixed expenses (13 basis points). In the event that short-term tax-exempt rates rise above the coupon on the bonds, the transaction would be terminated and the bonds would be resold to the marketplace. If the value of the bonds in the market are below par, then ALCo would make a payment from the swap account to MS equal to the difference between the then market value and par. Alternatively, the Road Fund could purchase the bonds as an investment at par. The Road Fund and the TAK get the best of both worlds with this transaction in that they retain the highly valuable DSRF earning 10 percent and lower the cost of borrowing as long as interest rates stay low. In the event that interest rates rise dramatically, then the investment portfolio of the Road Fund will earn significantly more than projected so long as the Road Fund maintains an investable balance equal to or greater than the notional amount of the transaction. For tax purposes, the Total Return Swap must terminate prior to the final maturity of the bonds. Market conditions permitting, a similar type trade would be reestablished for a short period or terminated.

ALCo also entered into an identical transaction with MS for the 5.50 percent bonds due July 1, 2007 of the TAK Toll Road 1986 Series A Bonds with a par amount of $50,920,000. The Toll Road DSRF earns a bit less than the Resource Recovery 1985A bonds and the coupon on the outstanding bonds is also less, but the mechanics are the same.

On July 24, 2001, MS agreed to enter into a total return swap whereby MS would pay ALCo beginning on January 3, 2002, 5.50 percent in exchange for BMA plus 45 basis points (to cover expenses). The trade could not be executed until December 7, 2001, after the call notice for the bonds had been issued. ALCo agreed to pay MS 4.15 percent in exchange for BMA plus 45 basis points, locking in a guaranteed spread of 135 basis points as long as BMA plus 45 basis points remain below the coupon of the bonds of 5.50 percent.

During fiscal year 2003, the Federal Highway Administration awarded the state Transportation Cabinet approximately $13 million, the estimated remaining principal amount of the Toll Road Bonds related to the Toll Roads known as the Hal Rogers Daniel Boone Parkway and the Louie B. Nunn Cumberland Parkway. The award was granted with the understanding that the tolls would no longer be collected and the toll booths removed on these two roads. On July 1, 2003, the Total Return and Fixed Swap transactions were adjusted due to the $12,195,000 partial redemption of the 2007 term maturity of the Toll Road 1986 Series

A Bonds. The $50,920,000 original notional amount was reduced to $38,725,000, with no obligation due from either party with respect to the unwound notional amount as the partial termination occurred on an interest payment date. A swap termination payment on the fixed portion in the amount of $705,000 was paid to MS. The revised present value savings level, factoring in all expenses, is approximately $1.6 million. The net notional amount exposure remains at zero and the market value is par as in the previously described transaction. ALCo has received over $1.2 million to date. The total return portion of the transaction matures July 1, 2005. The position will be re-established or terminated depending upon market conditions.

ALCo entered into a Financial Agreement with MS on August 11, 2004 to synthetically refund on a current basis the TAK Economic Development (Revitalization Projects) 1995 bonds. The trade is to be effective July 1, 2005 for a notional amount of $33,590,000 amortized through 2015. ALCo and TAK agree to pay MS 3.64 percent plus expenses estimated to be 31 basis points. In exchange, MS will pay the Authority BMA, which will closely track the debt service on any variable rate bonds that may be issued as a result of this transaction. At December 31, 2004 the forward swap was valued at ($323,101). The present value of the transaction is expected to be $1,145,472 or 3.50 percent of the refunded bonds on the call date of July 1, 2005.

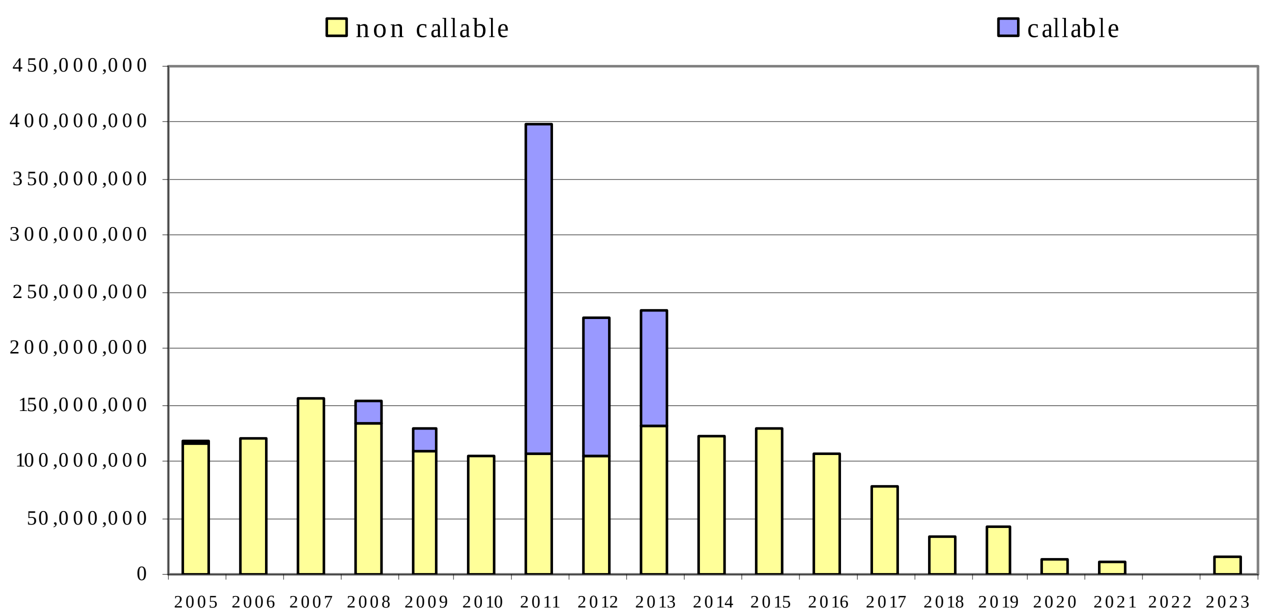
ASSET/LIABILITY MODEL

General Fund

The State Property and Buildings Commission ("SPBC") debt portfolio as of December 31, 2004, had $2,174 million of bonds outstanding with a weighted average coupon of 5.21 percent, modified duration of 4.60 years, and a yield at market of 3.14 percent. The market yield increased by 26 basis points from the prior reporting period while modified duration decreased by .25 years reflecting maturing debt. The callable portion was $560 million and had an average coupon of 5.03 percent. The average coupon reflects investor preference for premium bonds in the current market at a yield lower than corresponding par or discount coupon bonds. In March 2005, SPBC 84 bonds refunded a variety of callable bonds from SPBC 69A, 72, 74, 77 and 79. Details to follow in the next semi-annual report.

The SPBC General Fund debt structure has 27 percent of principal maturing in 5 years and 54 percent of principal maturing within 10 years. This is very close to the rating agencies proposed targets of 27-30 percent due in 5 years and 55-60 percent maturing within 10 years.

Call Analysis
State Property and Buildings Commission Bonds

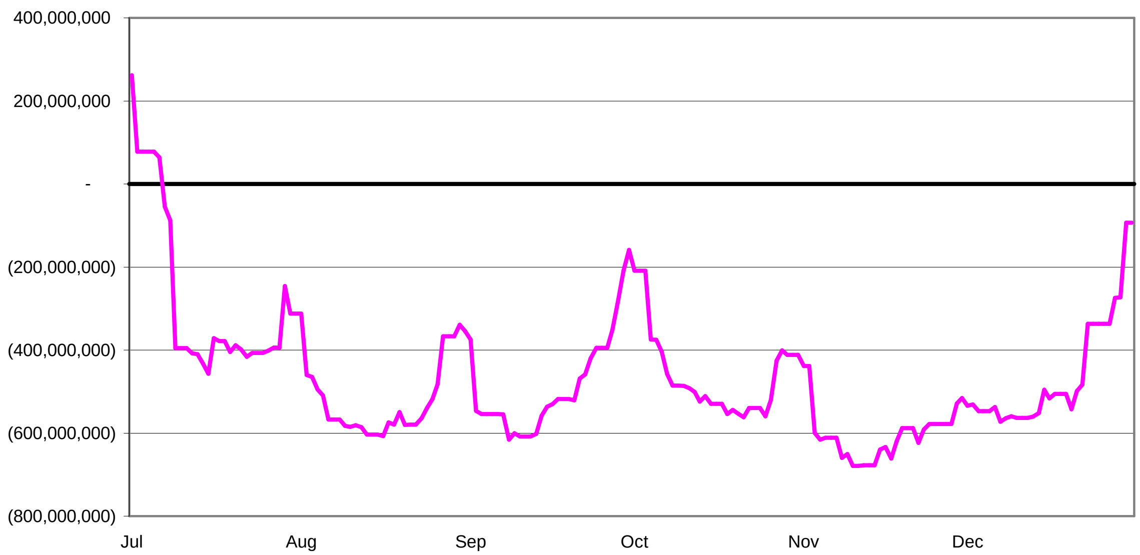


The General Fund for the first six months of fiscal year 2005 had a high balance of $262 million on July 1, 2004, and a low of negative $679 million on November 11, 2004. The average and median balances were a negative $465 million and a negative $518 million, respectfully. Since the General Fund continued to have a negative available cash balance for most of the fiscal year, there is little, if anything that can be done from an asset management viewpoint beyond current actions.

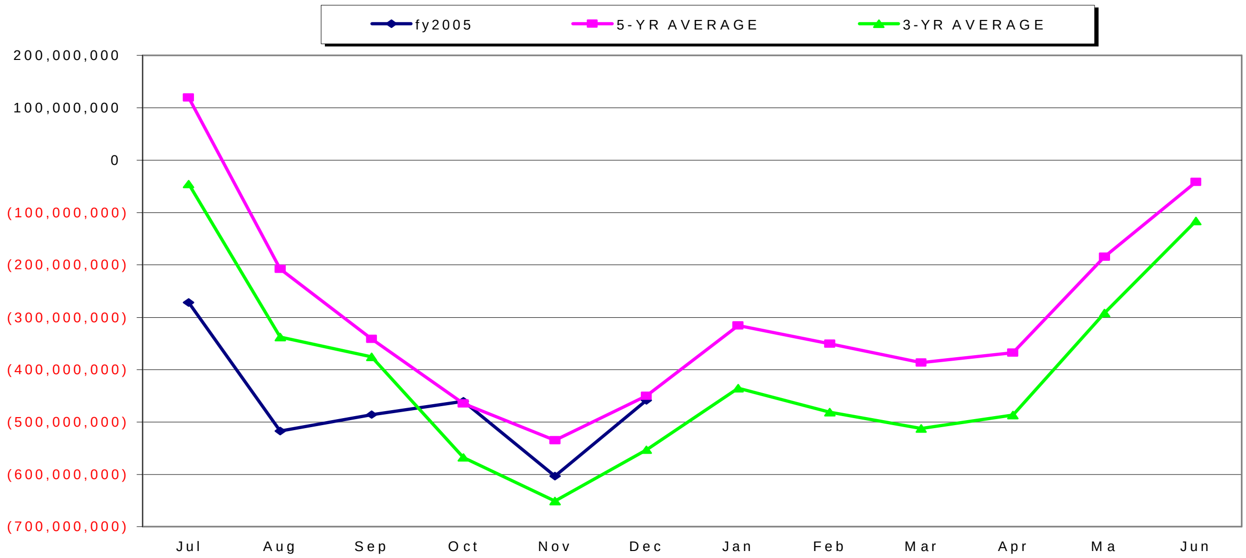
From a liability management perspective, total General Fund debt service, net of reserve fund credits, was $210 million for fiscal year to date 2005.

Net Interest Margin will continue to be negative due to significant fixed rate debt issuance, compressed yield ratios, overall level of investable asset and interest rates as well as the callability of the debt portfolio.

General Fund Available Balance
Fiscal Year 2005
(Excludes TRAN)



General Fund Monthly Average (Excludes TRAN)



Road Fund

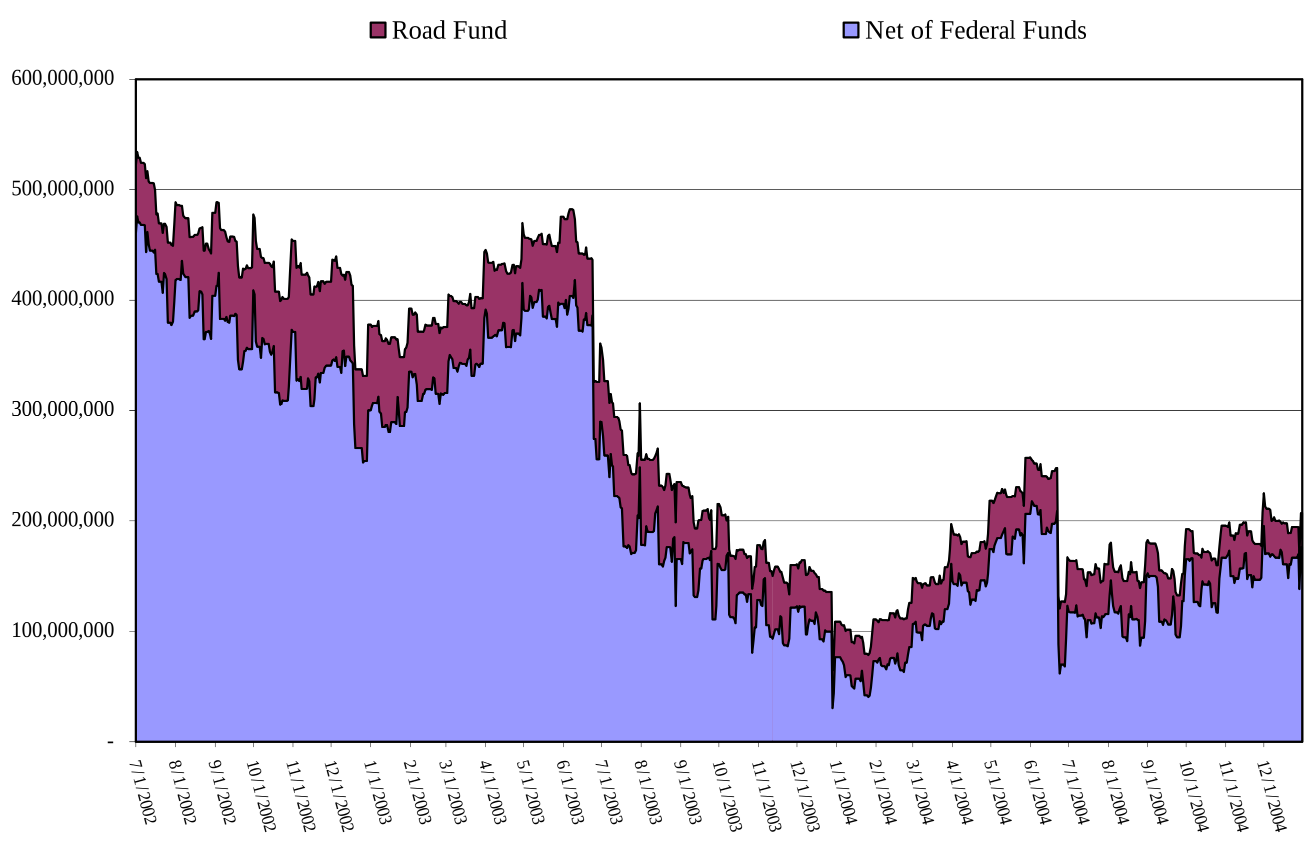
The Road Fund average daily cash balance for the first half of fiscal year 2005 was $172 million compared to $203 million for the first half of 2004. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 1.38 years as of December 31, 2004. The Road Fund earned $1.7 million on a cash basis for fiscal year to date 2005 versus $6 million for the same period in fiscal year 2004. The low level of balances limited the opportunity to implement asset liability management strategies.

As of December 31, 2004, TAK had $704 million of bonds outstanding with a weighted average coupon of 5.19 percent, modified duration of 3.40 years, and yield at market of 2.92 percent. Selected maturities of the Resource Recovery 1985A and Toll Road 1986A bonds with the most economical value were previously synthetically refunded with financial agreements as identified previously. TAK authorized in May 2004 three refunding transactions. The only one remaining for execution is the current refunding of the 1995 Economic Development (Revitalization Projects) Road Revenue Bonds which are currently callable on July 1, 2005.

A financial agreement was executed to synthetically refund the Economic Development 1995 bonds (See Financial Agreements discussion) which is expected to generate $1.145 million of present value savings of the refunded par amount.

Road Fund debt service paid, net of reserve fund credits, to date in fiscal year 2005 was $28 million resulting in a net interest margin (investment income earned less debt service paid) of negative $26 million. The negative amount stems from lower investable balances and a general decrease in interest rates on the investment side and limited callability of fixed rate obligations on the liability side. The depletion of cash balances will make returning to positive territory a difficult hurdle.

Road Fund Available Balance



SUMMARY

ALCo's approach to managing the Commonwealth's interest-sensitive assets and interest-sensitive liabilities continues to produce excellent results.

Investments. At fiscal year end 2003, incremental returns derived from new investment asset classes reached $26.9 million since inception. The program continues but is no longer monitored for incremental value.

Cash Management. Cash management improved dramatically with the implementation of the General Fund TRAN program producing $3.2 million in fiscal year 1998, $4.7 million in fiscal year 1999 and $7.3 million in fiscal year 2000. Economic benefit for fiscal year 2001 was $6.5 million, fiscal year 2002 was $4.3 million and fiscal year 2003 was $0.3 million. No TRAN was issued for fiscal year 2004. The fiscal year 2005 TRAN is expected to produce approximately $3 million in benefits for a cumulative benefit of $29.3 million.

Debt Management. Debt service savings have contributed an estimated $295.8 million in value added since inception.

Total value added since inception in excess of $352 million.

APPENDIX

APPENDIX A

Swap Summary

	TAK RR 85A Total Return	TAK RR 85A Fixed	TAK TR 86A Total Return	TAK TR 86A Fixed	TAK ED 95 Fixed
Fund Source	Road Fund	Road Fund	Road Fund	Road Fund	Road Fund
Hedge	Net Interest Margin	Total Return	Net Interest Margin	Total Return	Hedge
Counter-Party	Morgan Stanley	Morgan Stanley	Morgan Stanley	Morgan Stanley	Morgan Stanley
Counter-Party Ratings*	Aa3/A+/AA-	Aa3/A+/AA-	Aa3/A+/AA-	Aa3/A+/AA-	Aa3/A+/AA-
Termination Trigger	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3
Swap Type	Variable Pay	Fixed Pay	Variable Pay	Fixed Pay	Fixed Pay
Benchmark	BMA	BMA	BMA	BMA	BMA
Reset	Weekly	Weekly	Weekly	Weekly	Weekly
Notional Amount	56,485,000	56,485,000	38,725,000	38,725,000	33,590,000
Amortize (yes/no)	no	no	yes	yes	yes
Execution Date	4/23/2001	9/20/2001	7/24/2001	7/24/2001	8/11/2004
Start Date	5/24/2001	9/27/2001	1/3/2002	1/3/2002	7/1/2005
End Date	7/1/2007	7/1/2009	7/1/2005	7/1/2007	7/1/2015
Fixed Rate pay-(rec)	(6.000%)	3.870%	(5.50%)	4.150%	3.950%
Day Count	30/360	30/360	30/360	30/360	30/360
Payment Dates	Jan. 1 & July 1	Jan. 1 & July 1	Jan. 1 & July 1	Jan. 1 & July 1	Jan. 1 & July 1
Security Provisions	Road Fund Inv.	Road Fund Inv.	Road Fund Inv.	Road Fund Inv.	Road Fund DS
Current Market Valuation December 31, 2004	0.00	0.00	0.00	0.00	(323,101)
Interest Earnings					
Cumulative Prior Periods	147,727	2,811,016	0.00	1,037,831	0.00
Current Period - 12/31/2004	0.00	426,737	0.00	169,076	0.00
Total	147,727	3,237,753	0.00	1,206,907	0.00

* *Moody's, S&P, Fitch*

As of December 31, 2004:

Total Notional Amount Executed

Fund Source Total		Counter Party
General Fund	Road Fund	Morgan Stanley
0	224,010,000	224,010,000

Net Exposure Notional Amount

Fund Source		Counter Party
General Fund	Road Fund	Morgan Stanley
0	33,590,000	33,590,000

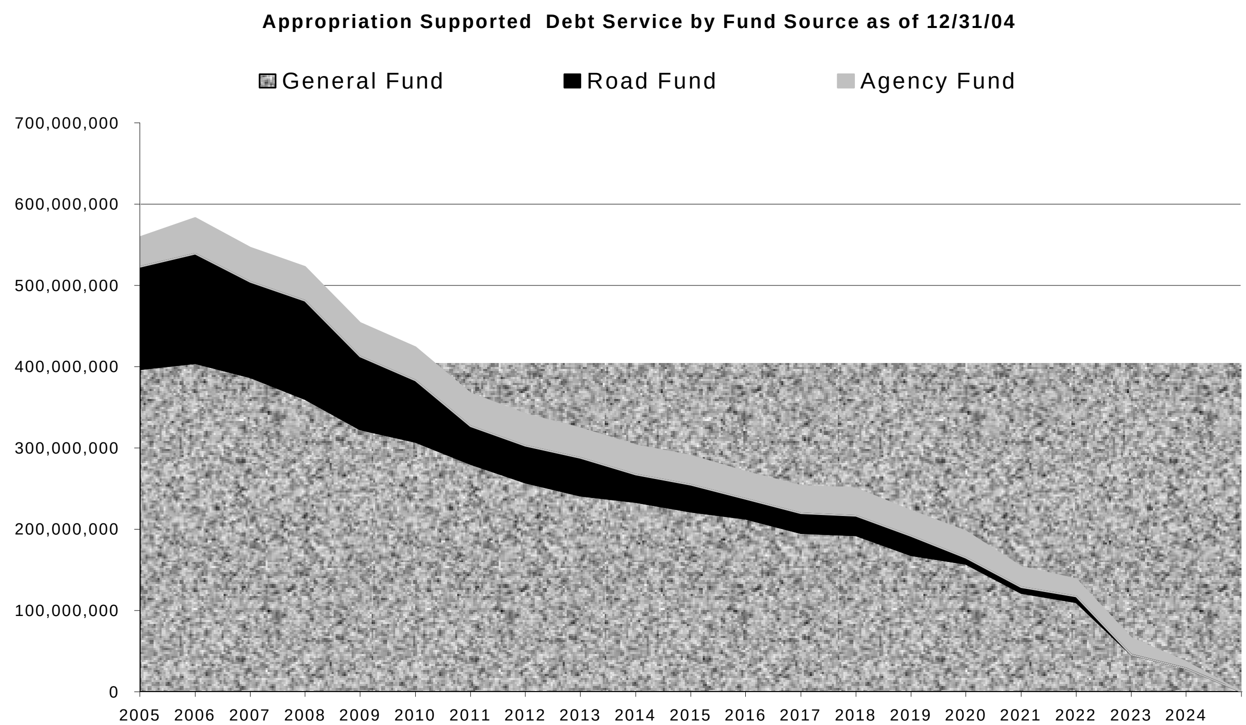
10 Percent Net Exposure

Debt Outstanding		10 Percent	
General Fund	Road Fund	General Fund	Road Fund
2,114,770,772	785,852,631	211,477,077	78,585,263

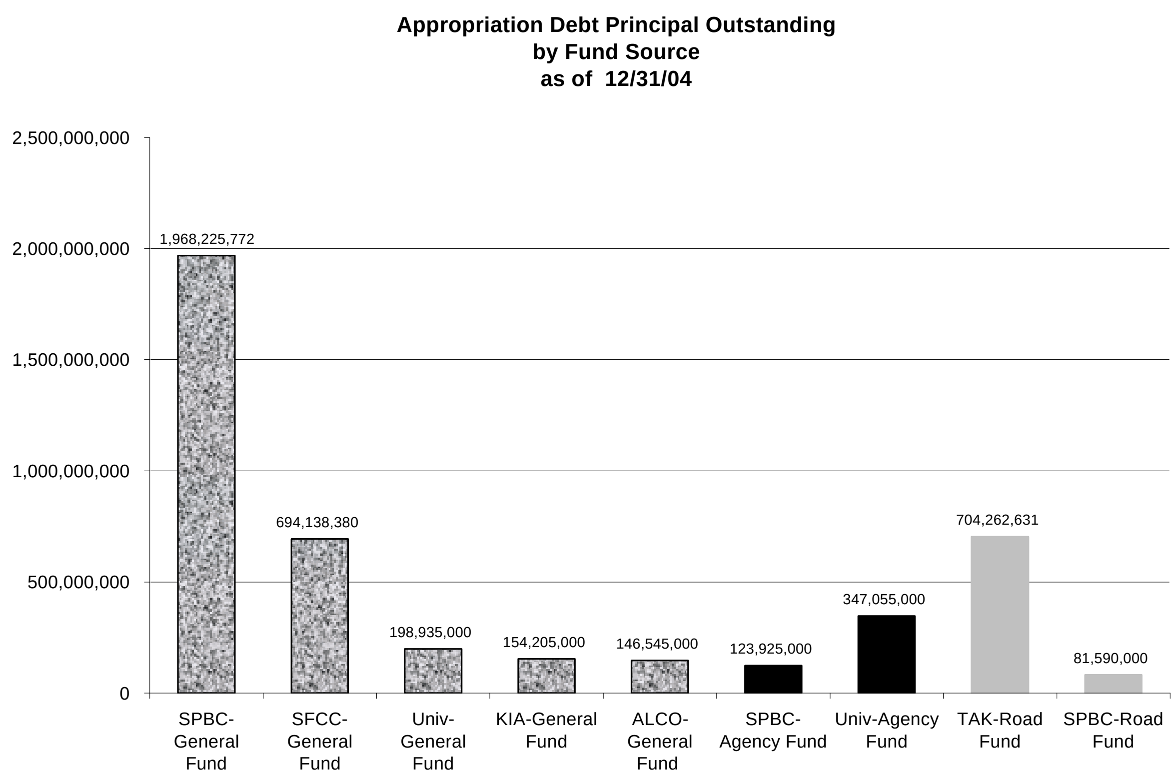
10 Percent Investment Portfolio

Investment Pool Balance		10 Percent	
Other Funds	Net Road Fund	Other Funds	Net Road Fund
2,903,779,235	176,005,856	290,377,923	17,600,586

APPENDIX B



APPENDIX C



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