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Asset/Liability Commission

Semi-Annual Report

For Period Ending June 30, 1999



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Paul E. Patton, Governor

**John P. McCarty, Secretary
Finance and Administration Cabinet**

**Gordon L. Mullis, Secretary
Asset/Liability Commission**

Pursuant to KRS 56.863(11), the Office of Financial Management and Economic Analysis is required to report to the Capital Projects and Bond Oversight Committee and the Interim Joint Committee on Appropriations and Revenue on a semiannual basis, by September 30 and March 31 of each year, the following: (a) a description of the Commonwealth's investment and debt structure; (b) the plan developed to mitigate the impact of fluctuating revenue receipts on the budget and fluctuating interest rates on the interest-sensitive assets and liabilities of the Commonwealth; (c) the principal amount of notes issued, redeemed and outstanding and a description of all financial agreements entered into during the reporting period; and (d) a summary of gains and losses associated with financial agreements and any other cash flow strategies undertaken by the commission to mitigate the effect of fluctuating interest rates during each reporting period.

This report is for the period January through June of fiscal year 1999.

To request additional copies of this report, contact Tom Howard at (502) 564-2924.

INTRODUCTION

This is the Kentucky Asset/Liability Commission's ("the Commission") fifth semi-annual report under KRS 56.863 (11) for the period beginning January 1, 1999 through June 30, 1999. Key themes during the second half of FY99 were:

- Surprising strength of the domestic stock market and economy.
- The Federal Reserve Bank increased the Federal Funds Rate and the Discount Rate.
- Lower total return on investments as a result of rising interest rates.
- Modest new money debt issuance in anticipation of need for the Council on Postsecondary Education.
- Refunding opportunities were limited, but successful despite rising interest rates.
- Looking ahead, transaction activity for the Commission will increase dramatically during the first half of FY 2000, with the availability of debt service for capital projects authorized in the FY98-00 budget.

INVESTMENT MANAGEMENT

Market Overview

Taxable: Our forecast of interest rates during the period was neutral in light of the liquidity crisis that erupted during the third calendar quarter of 1998, resulting from declining foreign markets and hedge fund activity. At that time the Federal Reserve lowered the Federal Funds Rate to 4.75% to provide needed confidence and liquidity to the marketplace and adopted a "neutral" posture. The theory among economists was that the drag from deflationary forces abroad would keep the domestic economy in check over the near term and thus a favorable outlook for interest rates over the period. Despite these influences, the U.S. stock market and economy have continued to show amazing strength fueling consumer demand, especially in housing and equity investments. This growth has been largely supported by increased wealth from equity valuations and wage gains in a tight labor market.

The bond market views the strength of wages and increasing asset prices with a jaundiced eye, looking for signs of inflation in every economic release. A rebound in oil prices from extremely depressed levels, strong retail sales, wage increases and a slight dip in worker productivity during the period gave the bond market the chills and sent interest rates roughly one percent higher across the board in anticipation of a Federal Reserve tightening move. The Fed responded on June 30, “tapping the brakes”, with a one-quarter of a percent increase. Many of the fixed income traders on Wall Street were hoping for a one-half percentage increase, consequently market expectations continued to erode bond prices after the rate hike. As of this writing, the Federal Reserve voted on August 24, 1999 to increase the Federal Funds Rate and the Discount Rate an additional one-quarter of one percent, while adopting a neutral stance.

Treasury Yields

Short-term fixed income investment yields (two-year Treasury) began the period near the low of 4.44% before rising to a high of 5.72% just prior to the end of the reporting period. The average was 31 basis points higher than the previous period at 5.06%. The benchmark 30-year Treasury Bond averaged 5.59%, with a high of 6.16% and a low of 5.06% .

Yield Relationships

The benchmark for all domestic fixed income investments including tax-exempt securities is the relationship to U.S. Treasury securities. Over the year, that relationship has changed dramatically as evidenced by the indicative yield spreads in Table 1.

TABLE 1

<u>Month</u>	<u>5 YR UST</u>	<u>5 YR US Agency</u>	<u>15 YR MBS</u>
October 1995	5.81%	+21	+84
November 1996	5.83	+25	+84
November 1997	5.84	+28	+73
September 1998	4.21	+54	+181
July 1999	5.85	+66	+123
<u>Month</u>	<u>10 YR UST</u>	<u>10 YR AA Corp. Agency</u>	<u>15 BQ Muni</u>
October 1995	6.02%	+70	+173
November 1996	6.04	+61	+134
November 1997	5.87	+79	+130
September 1998	4.42	+126	+180
July 1999	5.90	+139	+136

Source: J. C. Bradford & Company, Fixed Income Research, August 16, 1999.

UST—Securities issued by the United States Treasury, secured by the full faith and credit of the U.S. Government.

US Agency – Securities issued by agencies, instrumentalities and corporations of the U.S. government.

MBS – Mortgage backed securities issued by U.S. agencies, such as Fannie Mae or Freddie Mac.

AA Corp – High quality securities issued by domestic corporations.

BQ Munis – Bank qualified municipal securities issued by local governments and schools.

Spreads are expressed in basis points (.0001).

Table 1 clearly displays that the relationship of fixed income securities to Treasury securities has changed dramatically in recent months. Much of the increase in spread is attributable to increased issuance by corporations and state and local governments, reduced Treasury issuance and a sharp reduction (75%-80%) in the willingness of Wall Street dealers to hold high levels of inventory.¹

Increased supply of corporate and non-federal government debt may be related to increased wealth and the ability to afford long-term investment, the opportunity to issue debt at relatively low interest rates (before any significant increase) and the need to raise funds in advance of any potential year 2000 disruptions. Reductions in Treasury issuance are the direct result of the federal surplus. Wall Street's inventory levels may be the single most important factor in spread widening as it directly impacts the liquidity of owning any security other than a Treasury. The reduction in fixed income risk tolerance from Wall Street seems to contradict the aura we have come to envision from the Street's oldest and most prestigious firms. Such literary works as Michael Lewis' *Liar's Poker* paints a picture of swashbuckling traders who were willing to make a market and risk hundreds of millions of dollars to make obscene profits by taking advantage of both short-term and longer-term market discrepancies. But mergers among financial institutions, the conversion from partnership to equity and even the Internet has changed the way that salespersons, traders, executives and shareholders are ultimately compensated and as a result influenced the debt markets. The impact of these factors appears to be increasing the financing cost of corporate and municipal debt on a relative basis when compared to Treasuries. If this movement is more than a temporary phenomenon, then the question becomes are Treasuries the correct benchmark in establishing market value for the Commonwealth's investment and debt portfolios?

Tax-exempt: The Bond Buyer 20 General Obligation Index continued to trade at relatively high yield ratios for most of the period, ranging from approximately ninety-nine percent of Treasuries to a low equaling the five-year average at eighty-seven percent in mid-June. Absolute yields were a high of 5.45 % at June 24, 1999 and a low of 4.96% in late January. The Bond Buyer 20 GO averaged 5.125% for the period. Rising interest rates in the municipal sector have been welcomed by retail investors who have stepped up purchases in recent weeks recognizing the excellent value of tax-exempt securities when compared to other investment products. Institutional demand has been tepid, due to widening spreads in the taxable corporate sector. Institutional investors have been net sellers of municipals because they can't take advantage of the full tax-exemption and are purchasing higher yielding corporate securities.

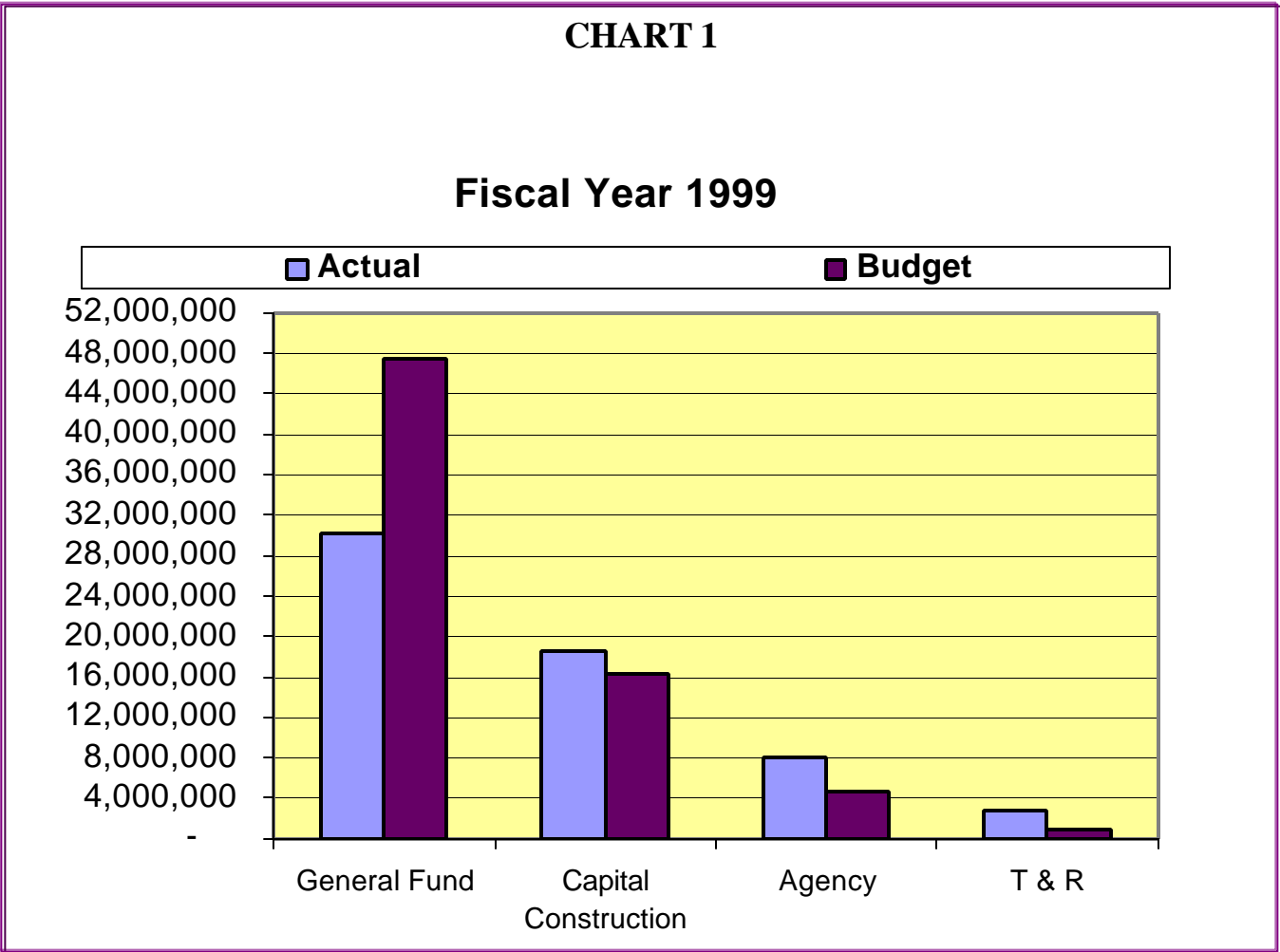
The short-term tax-exempt market as measured by the 7-day Bond Market Association ("BMA") Municipal Swap Index ranged from a low of 2.17% to 3.96% and finished the period at 3.42%. The BMA averaged 3.08% or approximately 61% of one-month U.S. Dollar LIBOR (London Interbank Offered Rate for 30-day U.S. dollar deposits in London by major banks). LIBOR has been substituted for Treasury Bills because of the issues previously discussed and due to the depth and acceptance of LIBOR as a money market benchmark.

Portfolio Management: The Commonwealth's investment portfolio averaged \$3,382.7 million for FY99. As of June 30, 1999, the portfolio was invested in U.S. Treasury securities (17%), U.S. Agency securities (32%), Municipal securities (4%), Corporate securities (11%), U.S. Agency Mortgage Backed Securities and Collateralized Mortgage Obligations (10%), Asset Backed Securities (4%), Repurchase Agreements (20%) and Money Market Securities (2%). The portfolio had a current yield of 5.72% and duration of 1.56 years.

¹ J. C. Bradford & Company, Fixed Income Research, August 16, 1999.

The total portfolio is broken down into four investment pools. The balances in the pools as of June 30, 1999 were the Short-term Pool (\$605.7 million), the Intermediate-term Pool (\$2,187.8 million), the Long-term Pool (\$349.5 million) and the Bond Proceeds Pool (\$239.2 million). See Exhibit I, the June 30, 1999 Monthly Investment Income Report.

The Commonwealth's investments earned \$152.4 million or 4.81% on a total return basis through fiscal year end. The decrease in total return is directly attributable to lower than anticipated cash balances and the rising interest-rate environment during the second half of FY99. When interest rates rise, the market value of fixed income securities decreases. Total return calculations include unrealized gains and losses from changes in market value in the rate of return for a given period of time. The General Fund portion of that amount was \$33.7 million on a cash basis. New asset classes authorized under House Bill 5 of the 1997 First Extraordinary Session of the General Assembly contributed \$3,782,706 of which \$862,910 belongs to the General Fund for FY99. Mortgages added the bulk of the earnings, generating \$2.4 million, while corporate securities added \$1.3 million. The increased duration attributable to the Long-term Investment Pool added \$795,289 in income, which is attributable to the Budget Reserve Trust Fund (\$474,664) and the Road Fund (\$320,625) during the period. Chart 1 shows the distribution of actual versus budgeted investment income by fund.



DEBT MANAGEMENT

TABLE 2

Kentucky Asset/Liability Commission Debt Summary

TRAN	Amount Issued	Amount Outstanding*	Dated Date	Maturity Date	Coupon	Price	Yield
1998 Series A	\$200,000,000	\$ -0-	07/01/1998	06/25/1999	4.50%	100.883	3.57%
1998 Series B	\$100,200,000	\$ -0-	09/17/1998	06/25/1999	4.00%	100.504	3.33%
1999 Series A	\$300,000,000	\$ -0-	07/01/1999	06/28/2000	4.25%	100.839	3.375%

Project Notes	Authorized Amount	Amount Outstanding*	Initial Date	Maturity Date	Initial Coupon	Price	Yield**
General Fund							
1998 First Series	\$157,000,000	\$134,400,000	02/04/1998	06/30/2001	3.7%	100.000	3.23%
1998 Second Series	\$126,500,000	\$126,500,000	11/05/1998	11/01/1999	3.50%	100.528	2.95%
1999 First Series	\$ 44,195,000	\$49,195,000	03/01/1999	03/01/2006	4.00%	99.375	4.144%
1998 Agency Fund							
	\$110,000,000	\$28,305,000					
UK Stadium		\$25,260,000	09/02/1998	06/30/2002	3.55%	100.00	3.25%
Morehead H & D		\$ 3,045,000	04/21/1999	06/30/2002	3.20%	100.00	3.20%

*Amount outstanding as of June 30, 1999.

**Yield is a weighted average over life.

Tax and Revenue Anticipation Notes:

1999 TRAN. The Commission authorized the FY2000 TRAN program in an amount not to exceed \$401 million. On July 1, 1999 \$300 million was issued to mature on June 28, 2000 and is expected to generate approximately \$3 million in net benefit to the General Fund. The expenditure test was met on September 1, 1999. The 1999 TRAN program was marketed by Salomon Smith Barney, Inc.

The 1998 Series A and B TRANs matured on June 25, 1999. The IRS expenditure test for each series was met on August 10, 1998 and September 17, 1998, respectively. The net benefit from the 1998 TRAN was \$4,686,524.

Project Notes:

1998 General Fund First Series. The Commission issued its first series of General Fund supported Project Notes on February 4, 1998 to fund approximately \$156 million in capital construction projects authorized during the FY96-98 biennium. The notes have a stated final maturity of June 30, 2001 and are offered by Bear, Stearns & Company in the Commercial Paper Mode. The notes are supported by a

direct-pay letter of credit issued by the New York branches of Landesbank Hessen-Thüringen Girozentrale and Bayerische Vereinsbank AG, two of Germany's leading banks. The Project Notes receive a rating based upon the credit facility providers' strength and are rated Aa2/VMIG1 by Moody's and AA+/F1+ by Fitch. As of June 30, 1999, \$134.4 million in Notes were outstanding which will cover remaining expenditures. From February 4, 1998 through June 30, 1999 the absolute yield decreased another 20 basis points from the last semi-annual report, but the yield versus the benchmark widened 5 basis points due to increased credit spreads. Table 3 provides a summary of the comparative cost of capital for this series of Notes. This series of Project Notes will be converted to permanent financing in January or February 2000 through the issuance of State Property and Buildings Commission Revenue Bonds, Project 65 to be offered by Merrill Lynch.

TABLE 3

Cost of Funds

Weighted Average Coupon:	3.23%
Remarketing Fees:	.06%
<u>Credit Facility Fees:</u>	<u>.21%</u>
Average Cost of Funds	3.50%

Comparative Yield

Weighted Average Coupon:	3.23%
<u>Average BMA Index</u>	<u>3.31%</u>
Difference	.09%

Versus Fixed Rate Financing

Weighted Average Coupon:	3.23%
<u>Bond Buyer 20-year GO (2.5.98)</u>	<u>5.11%</u>
Difference	1.88%

The indices in Table 3 do not include remarketing and credit facility fees, so the comparison is made on a net yield basis.

1998 General Fund Second Series. The Commission issued the second series of General Fund supported Project Notes on November 5, 1998 to fund \$126,898,000 of Surplus Expenditure Plan ("SEP") projects authorized in the FY98-00 budget. This series of Notes was issued as a one-year fixed rate note to yield 2.95%. A variety of factors came into play in selecting a fixed rate note structure over the variable rate structures employed for the First Series and the Agency Fund Series. The primary influence was the liquidity crisis discussed previously, which resulted in significantly higher credit facility fee bids. The impact of the higher fees pushed the effective yield on a variable rate deal significantly above a simple one-year fixed rate note. A contributing factor was the fact that most of the SEP projects are grant payments, which will be spent in a lump sum and in a relatively short time frame. This permitted the Commission to fund the entire project amount up-front and take advantage of the difference between the yield on taxable investments and the tax-exempt coupon on the notes until the proceeds are spent. These notes will be converted to permanent financing by State Property & Buildings Commission Revenue Bonds Project 64 to be issued in early September. Lehman Brothers sold the Notes and the bonds will be offered by Merrill Lynch.

1999 General Fund First Series. On March 17, 1999 the Commission delivered \$49,195,000 of fixed rate Project Notes to permanently fund the University Research Equipment Pool, Commonwealth Virtual University and Library and technology for the Kentucky Community and Technical College System.

The transaction was structured with seven annual serial maturities to match the expected useful life of the equipment with the Notes and debt service appropriations. As mentioned in the previous report this transaction employed an unusual optional redemption provision rarely seen in municipal transactions, that being a 4-year call option at par. Normally, a note with such a call provision would carry a significant yield premium over non-callable notes. Due to inefficiencies in the market and strong retail demand at that time for short-term paper with yields of 4% or more, the Notes were able to be sold at levels equivalent to non-callable notes. This was a highly successful transaction that will influence future transactions of the Commission and other appropriation supported issuers. Salomon Smith Barney sold the Notes.

1998 Agency Fund Series. The projects consist of the Agency Bond Pool (\$35 million) and approximately \$63.1 million in line item agency funded bond projects, including the UK Stadium Expansion, UK Rural Health Center, EKV Law Enforcement Training Facility, KHEAA Building and the River Authority Lock and Dam Improvements. Participants in the Agency Bond Pool (state universities) have the option of using this program to meet their financing needs and, as a result, only a portion of the \$35 million may initially be funded through this program. It is anticipated that all of the \$63.1 million line item Agency Fund projects will receive their initial funding through this program. Ultimately the line item projects will receive permanent financing from the issuance of State Property and Buildings Commission Revenue Bonds. These bonds will be supported entirely by restricted agency receipts. This program offers the same benefits as the General Fund program to state universities and other agencies, which previously did not have access to such a financing mechanism. The Agency Fund Project Notes (“Notes”) are supported by a direct-pay letter of credit issued by Commerzbank AG (VMIG1/Aa3 by Moody’s, SP-1+ by S&P and F-1+/AA- by Fitch) and marketed by Lehman Brothers, Inc.

The initial series of Notes, in the amount of \$25,260,000, was delivered in September 1998 to fund the UK stadium expansion. These notes will capitalize interest until September 1, 1999, when the project is available for use and revenues have been collected to service the obligation. On September 1, 1999, the Notes will be split into two series, a tax-exempt Series A Notes and a taxable Series C Notes. The Series C Notes result from private use of portions of the facility. A second series of Notes, in the amount of \$3,045,000 were issued on behalf of Morehead State University to fund housing and dining projects on April 21, 1999. Through June 30, 1999, the weighted average yield on the Notes was 3.25%, plus remarking fees of 6 basis points and credit facility fees of 20 basis points provides for a cost of funds for the period of 3.52% versus the average BMA Index of 3.31%.

Chart 2 on Page 8 shows the difference between long-term and short-term tax-exempt interest rate indices on a percentage basis. Chart 3 on page 9 compares each of the ALCo Bond Anticipation Note programs weighted average coupons to the Bond Market Association Swap Index, which is the baseline, and the difference is basis points.

FINANCIAL AGREEMENTS

The Commission had one financial agreement outstanding as of June 30, 1999, which was entered into on August 3, 1998 with Merrill Lynch & Co. to synthetically advance refund a portion of State Property and Buildings Commission Project 40 (Second Series) Revenue Bonds that were not otherwise refundable. The Commission will receive a variable rate, equal to the rate on its variable rate notes that will refund the SPBC bonds, in exchange for making a fixed rate payment beginning on November 1, 2001. This type of transaction is also known as an interest rate swap. The value of this transaction varies daily with changes in market rates of interest, as do all fixed income securities. As of June 30, 1999 that contract had a market value of \$1,224 versus (\$447,137) at the end of the prior period.

CHART 2
Bond Buyer 20-year GO vs. BMA Index

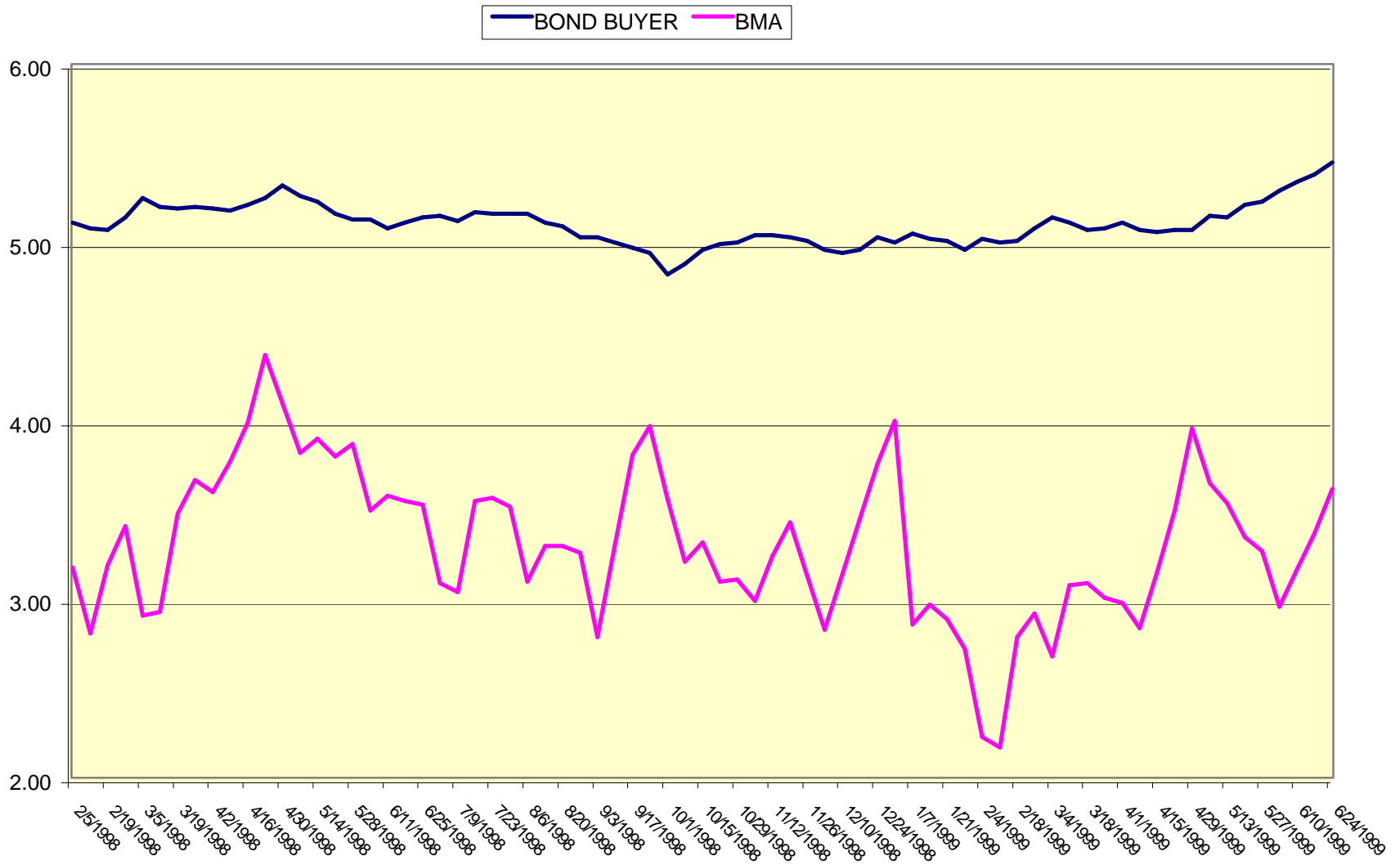
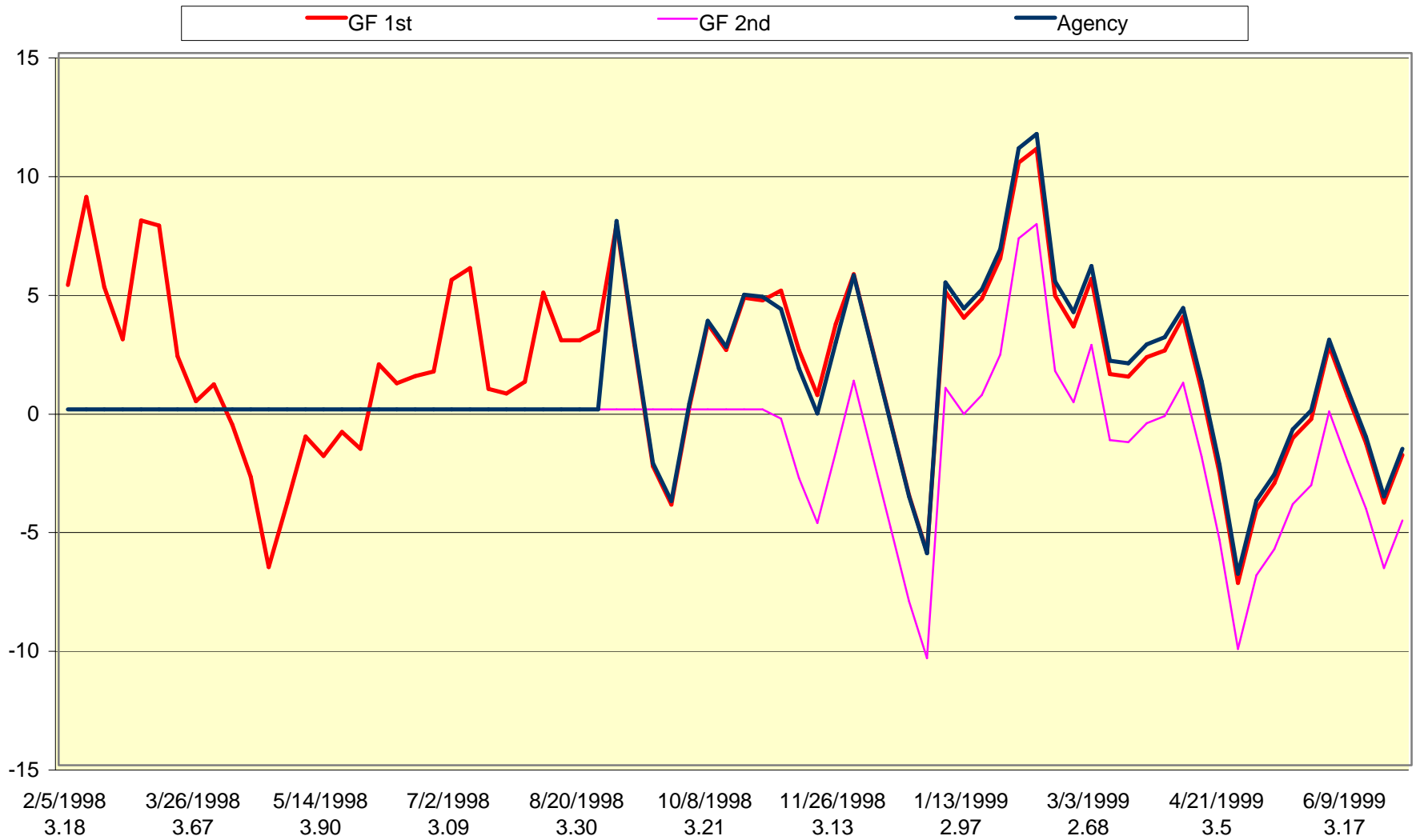


CHART 3
ALCo Notes vs. BMA Index



The positive market value is reflective of the general increase in interest rates, as the Commission has contracted to pay a fixed rate that is now below the current market rate. There is no realized gain or loss on the swap unless it is terminated prior to maturity.

In this particular transaction the Commonwealth makes fixed rate payments. If interest rates increase, our swap increases in value and conversely, if interest rates decrease, our swap has less value (meaning the bonds could be refunded at more attractive levels). If the swap were to obtain a substantial positive market value, then it is likely that the swap would be terminated to collect the real savings in today's dollars. The Commission would then look to current refund the bonds on the call date for additional savings, if market rates were favorable. In any event, the SPBC will not pay any more than the coupon on the existing series of bonds. This effectively locks in the savings level with an opportunity to create additional savings. Alternatively, if the market value of the swap is negative, it is possible that the swap might be terminated at a loss and new bonds issued at a lower rate to offset the loss and preserve the original savings target. Factors that would influence the Commission's decision to terminate a swap would be a dramatic increase in credit facility fees and expenses, the slope of the tax-exempt yield curve, forward delivery premiums and the ratio of tax-exempt securities to Treasuries.

The Commission is evaluating the merits of using several different financial agreement structures to provide additional value to the investment and debt management programs of the state. First, the Commission, in conjunction with the State Investment Commission, is evaluating replacing the interest rate swap for a portion of the investment assets that matures July 9, 1999. Second, the Commission is evaluating the purchase of an interest rate cap or other similar vehicle to hedge the issuance of State Property and Building Commission Revenue Bonds Project 65, which is expected to be sold in January or February 2000. The Commission is also exploring utilizing an interest rate swap, based upon a percentage of LIBOR, to convert a future issuance of Project Notes in a seven-day variable rate demand note mode to a synthetic short-term fixed rate to achieve additional debt service savings. All transactions are dependent upon acceptable documentation and market conditions, which are not present at this time.

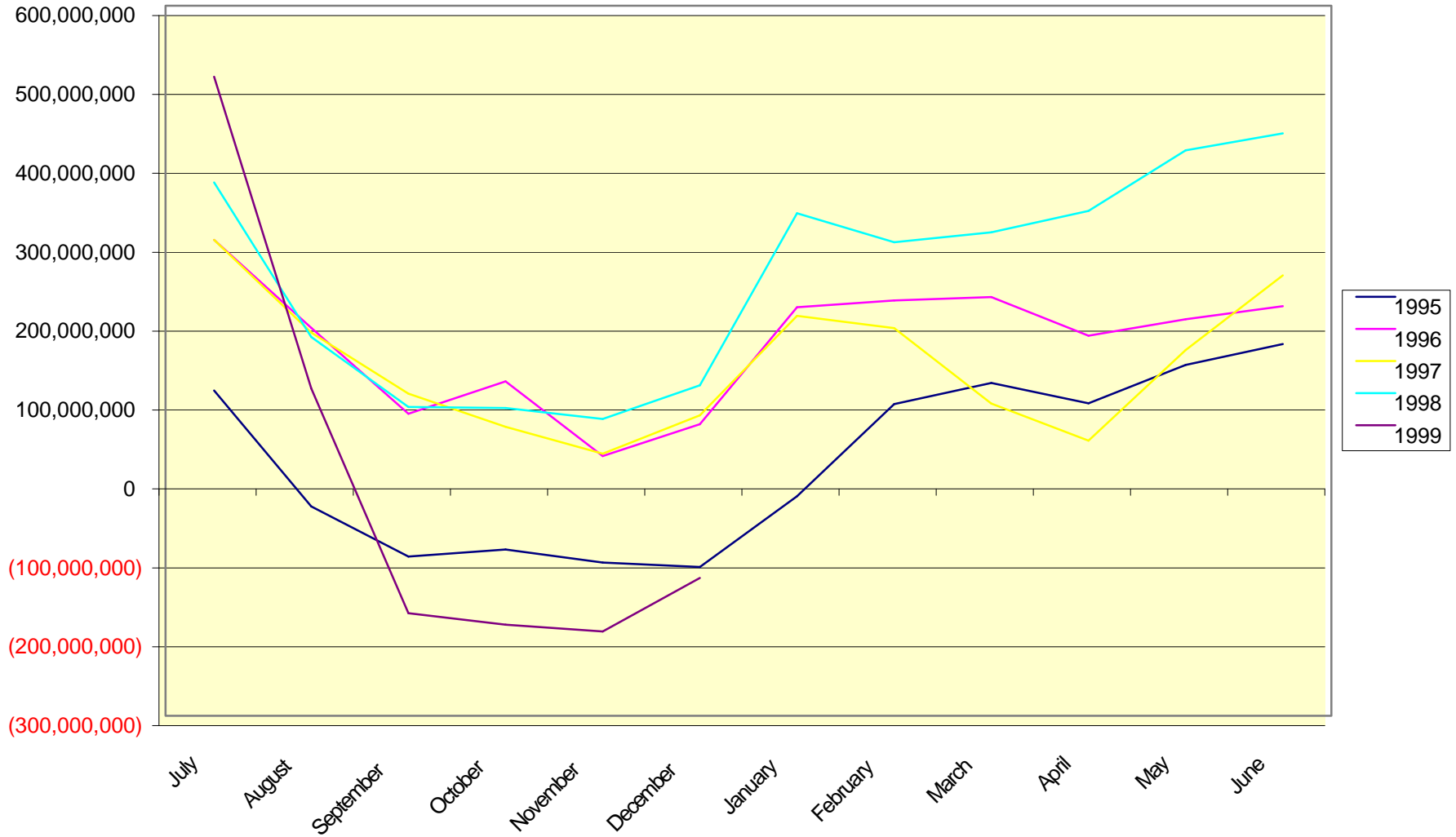
ASSET/LIABILITY MODEL

Progress with an asset/liability model to study the magnitude of the impact of changes in interest rates on the balance sheet, particularly the liability side, has been very frustrating. The program that was acquired to perform these computations for the investment portfolio had a difficult time determining the proper relationships for tax-exempt securities from an issuer standpoint. As some progress was being made the software vendor eliminated the product and all support, forcing staff to reevaluate a limited and generally expensive list of products. Additionally, staff turnover has delayed certain aspects of establishing a valid model. At present, the most cost-effective option is an add-on product provided by one of our existing investment software vendors. The primary emphasis of this product is investment analytics, which will be very beneficial in managing the investment portfolio, however, its use for liability management has yet to be determined.

GENERAL FUND MODEL

The General Fund continues to be subject to seasonal fluctuations consistent with historical expenditure and receipt patterns, however, the magnitude has changed due to adjustments for the timing of the SEEK payments and the movement of Surplus Expenditure Plan moneys. Chart 4 compares the last five fiscal years.

Chart 4
General Fund Monthly Average



Including the Budget Reserve Trust Fund, the high balance for FY99 occurred on July 1 at \$727.1 million and the low on September 17 at minus \$328.0 million. The General Fund ended the year with a balance of \$487.8 million. The average and median balances were a negative \$15.1 million and a negative \$31.1 million, respectively. For purposes of calculating the available balance for the TRAN computation, \$172.9 million of the Budget Reserve Trust Fund can be excluded. Taking into account this adjustment the balances were as follows: the high was \$554.2 million on July 1, the low was minus \$500.9 million on September 17, the average was negative \$157.8 and the median was negative \$204.0 million. The ending balance on an adjusted basis was \$314.9 million. Since \$150 million of the Budget Reserve Trust Fund is invested in the Long-term Investment Pool the adjusted balances more accurately reflect the actual cash balance in the General Fund. Adding back the difference between the excludable portion and the amount invested in the Long-term Investment Pool, the actual ending balance would be a positive \$337.8 million. Since the General Fund continued to have a negative average cash balance for most of the period there is little, if anything, that can be done from an asset management viewpoint beyond current actions.

From a liability management perspective, there was one economic refunding of State Property and Buildings Commission bonds during the period that generated average annual debt service savings of \$116,130 from FY2000 through FY2015. FY99 total present value debt service savings amounted to \$1,293,900. Total General Fund debt service, net of reserve fund credits, was \$124,108,870 in FY99 and when compared against General Fund investment income of \$33.7 million, provides a net interest margin of negative \$90.4 million.

1999 General Fund Project Notes – Second, Third and Fourth Series will be issued beginning in August, September and October, respectively. These issues will provide construction financing for the balance of 1998-2000 capital construction projects authorized by the General Assembly. All three series will be sold under multi-modal indentures, which will allow the Commission to raise funds under a daily, weekly, commercial paper, fixed rate or indexed interest rate mode. The Second Series will fund \$133,902,000 in projects and be secured by a direct-pay letter of credit issued by Credit Local de France, offered by

Merrill Lynch. The Third Series will provide financing for \$136,509,000 in projects and be secured by a stand-by letter of credit issued by Bayerische Landesbank Girozentrale, offered by PaineWebber. The Fourth Series will finance \$132,139,000 of projects and is expected to be sold in an index based mode by Salomon Smith Barney without credit enhancement as the Commission seeks to find new, more diverse and efficient ways of entering the capital markets.

ROAD FUND MODEL

The Road Fund average daily balance for FY99 was \$662 million. Of that average amount, \$517 million was invested in the Intermediate-term Investment Pool and \$145 million in the Long-term Investment Pool. The duration of the respective pools was 1.81 years and 2.82 years as of June 30, 1999. The Road Fund earned \$35,589,594 on cash basis during FY99. The Road Fund continues to have substantial liquid assets, which are immune from the seasonal fluctuations experienced by the General Fund due to structural revenue receipt differences.

Given the increase in interest rates, there are no opportunities to refund any of the Turnpike Authority's existing debt, however, a financing team is in place should the opportunity arise. As discussed in previous reports, the Road Fund's best opportunity to manage its balance sheet is in the form of a construction financing program with short-term variable rate debt, which can be used to offset some of the variability and unpredictability of short-term investment returns. Currently, the Commission is working on documentation to establish three short-term multi-modal indentures for the FY98-00 Road Fund bond funded authorizations.

The First Series will fund \$75 million of road projects secured by a stand-by letter of credit issued by Morgan Guaranty Trust Company and be offered by Salomon Smith Barney in late September. The Second Series will fund the remaining \$125 million road authorization secured by a stand-by letter of credit issued by Westdeutsche Landesbank Girozentrale and offered by Lehman Brothers in mid-October. The Third Series will finance the \$68 million Road Fund portion of the Transportation office building. A structure has not been determined, but will be offered by Merrill Lynch probably in early November.

SUMMARY

The Commission's approach to managing the Commonwealth's interest-sensitive assets and interest-sensitive liabilities continues to produce the expected results:

- **Investments:** incremental returns derived from new investment asset classes are \$3.8 million for FY99 and \$5.1 million since inception.
- **Cash Management:** has improved dramatically with the implementation of the General Fund Tax and Revenue Anticipation Note program producing \$3.3 million in FY98 and \$4.7 million in FY99 for a total of \$8 million.
- **Debt Management** activities have contributed an estimated \$3.9 million in value-added.
 1. Funded initial construction at a lower cost of capital than utilizing internal resources that would have earned a taxable rate of return or long-term fixed rate financing. Estimated value of \$2.1 million (\$68.4 million average outstanding x rate differential (5.3% short-term pool yield -3.227% project note yield) /12x17).

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2. 1998 General Fund First Series. Maximized the amount of allowable arbitrage earnings by borrowing amounts reasonably expected to be expended, which provided an estimated value of \$.4 million $(\$13.5 \text{ million average advance borrowing} \times (5.13\% \text{ bond proceeds pool yield} - 3.227\%) / 12 \times 17)$.
 3. 1998 General Fund Second Series. Maximized the amount of allowable arbitrage by borrowing the amount reasonably expected to be spent, which provided an estimated value of \$.5 million. $(\$73 \text{ million average advanced borrowing} \times (4.52\% - 3.5\%) / 12 \times 8)$.
 4. Synthetic advanced refunding of SPBC 40 (Second Series) using a delayed start interest rate swap produced \$0.8 million as of the execution date.
 5. 1999 General Fund First Series provided an estimated savings of \$.2 million attributable to the unique call feature.

- **Total value added since inception, \$17 million.**

EXHIBITS

- I. June 30, 1999 Monthly Investment Income Report.
- II. General Fund Available Balance.
- III. Appropriation Supported Principal Outstanding by Issuer at June 30, 1999.
- IV. Appropriation Supported Debt Service by Fund Source at June 30, 1999.

EXHIBIT I

**MONTHLY
INVESTMENT
INCOME
REPORT**

JUNE 1999

**The Office of Financial Management
And Economic Analysis**

Date: 7/31/99

**PORTFOLIO SUMMARY
POOLS**

	TYPE	MARKET VALUE	MARKET YIELD (%)	DURATION (Years)	PERCENT of TOTAL	STATUTORY LIMIT
Treasuries						
	Bills	0.00	0.00	0.00	0.00	
	Treasury Notes	586,941,073.00	5.53	2.00	17.77	
	Sub-total	586,941,073.00	5.53	2.00	17.77	
Agencies						
	Notes	1,031,525,829.00	6.08	2.18	31.15	
	Discounts	14,925,000.00	4.94	0.07	0.45	
	Sub-total	1,046,450,829.00	6.06	2.14	31.60	
Municipals						
		132,789,990.00	6.33	2.23	4.01	
Corporates						
		377,945,125.00	6.15	1.81	11.40	25%
Mortgages						
	Pools	75,003,287.00	6.65	2.58	2.52	
	CMO's	245,106,202.00	6.38	2.00	7.43	
	Sub-total	320,109,489.00	6.44	2.13	9.95	25%
Asset Backs						
		125,190,190.00	6.17	1.31	3.35	20%
Repurchase Agreements						
	Overnight	567,000,000.00	5.01		17.12	
	< 30 days	64,993,176.00	4.87		1.96	
	< 60 days	344,930.00	4.50		0.01	
	< 90 days	33,203.00	4.39		0.00	
	< 1 year	5,108,163.00	4.26		0.15	
	< 2 years	5,500,000.00	5.71		0.17	
	> 2 years	109,296.00	4.25		0.00	
	Flex Repos					
	Sub-total	643,088,768.00	5.05		19.41	
Money Market Securities						
	Commercial Paper	62,250,000.00	4.92	0.12	1.88	A1-P1
	Bankers Acceptances	0.00	0.00	0.00	0.00	
	Certificates of Deposit	1,123,797.00	4.37	0.61	0.03	
	Sub-total	63,373,797.00	4.92	0.12	1.88	20%
TOTALS		3,295,889,261.00	5.79	1.60	100.00	

Date: 7/31/99

**PORTFOLIO SUMMARY
SHORT TERM POOL**

	TYPE	MARKET VALUE	MARKET YIELD (%)	DURATION (Years)	PERCENT of TOTAL	STATUTOI LIMIT
Treasuries						
	Bills	0.00	0.00	0	0.00	
	Treasury Notes	0.00	0.00	0	0.00	
	Sub-total	0.00	0.00	0	0.00	
Agencies						
	Notes	53,600,000.00	4.98	106	8.43	
	Discounts	10,000,000.00	4.79	15	1.57	
	Sub-total	63,600,000.00	4.95	91	10.01	
Corporates						
		26,640,000.00	5.18	164	4.19	
Municipals						
		0.00	0.00	0	0.00	
Repurchase Agreements						
	Overnight	483,118,000.00	5.01		76.01	
	< 30 days	0.00	0.00		0.00	
	< 60 days	0.00	0.00		0.00	
	< 90 days	0.00	0.00		0.00	
	< 1 year	0.00	0.00		0.00	
	< 2 years	0.00	0.00		0.00	
	> 2 years	0.00	0.00		0.00	
	Flex Repos					
	Sub-total	483,118,000.00	5.01	1	76.01	
Money Market Securities						
	Commercial Paper	62,250,000.00	4.92	44	9.79	A1-P1
	Bankers Acceptances	0.00	0.00	0	0.00	
	Certificates of Deposit	0.00	0.00	0	0.00	
	Sub-total	62,250,000.00	4.92	44	9.79	
TOTALS		635,608,000.00	5.00	21	100.00	

Date: 7/31/99

**PORTFOLIO SUMMARY
INTERMEDIATE TERM POOL**

	TYPE	MARKET VALUE	MARKET YIELD (%)	DURATION (Years)	PERCENT of TOTAL	STATUTOI LIMIT
Treasuries						
	Bills	0.00	0.00	0.00	0.00	
	Treasury Notes	443,815,000.00	5.57	1.92	21.19	
	Sub-total	443,815,000.00	5.57	1.92	21.19	
Agencies						
	Notes	783,610,085.00	6.14	2.15	37.60	
	Discounts	0.00	0.00	0.00	0.00	
	Sub-total	783,610,085.00	6.14	2.15	37.60	
Municipals						
		108,904,767.00	6.31	2.15	5.23	
Corporates						
		316,849,125.00	6.21	1.80	15.19	25%
Mortgages						
	Pools	52,457,886.00	6.45	2.12	2.55	
	CMO's	191,359,853.00	6.33	1.79	9.24	
	Sub-total	243,817,739.00	6.36	1.86	11.79	25%
Asset Backs						
		105,190,190.00	6.22	1.30	4.37	20%
Repurchase Agreements						
	Overnight	0.00	0.00		0.00	
	< 30 days	64,993,176.00	4.87		3.12	
	< 60 days	344,930.00	4.50		0.02	
	< 90 days	33,203.00	4.39		0.00	
	< 1 year	5,108,163.00	4.26		0.25	
	< 2 years	5,500,000.00	5.71		0.26	
	> 2 years	109,296.00	4.25		0.01	
	Flex Repos					
	Sub-total	76,088,768.00	4.88		3.65	
Money Market Securities						
	Commercial Paper	0.00	0.00	0.00	0.00	A1-P1
	Bankers Acceptances	0.00	0.00	0.00	0.00	
	Certificates of Deposit	1,123,797.00	4.37	0.61	0.05	
	Sub-total	1,123,797.00	0.00	0.00	0.00	20%
TOTALS		2,079,399,471.00	6.01	1.90	100.00	

Date: 7/31/99

**PORTFOLIO SUMMARY
LONG TERM POOL**

	TYPE	MARKET VALUE	MARKET YIELD (%)	DURATION (Years)	PERCENT of TOTAL	STATUTORY LIMIT
Treasuries						
	Bills	0.00	0.00	0.00		
	Treasury Notes	87,095,000.00	5.78	3.02	24.75	
	Sub-total	87,095,000.00	5.78	3.02	24.75	
Agencies						
	Notes	101,526,000.00	6.28	3.10	28.88	
	Discounts	0.00	0.00	0.00	0.00	
	Sub-total	101,526,000.00	6.28	3.10	28.88	
	Municipals	23,885,223.00	6.40	3.26	6.76	
	Corporates	34,456,000.00	6.36	2.84	9.81	25%
Mortgages						
	Pools	24,786,985.00	7.07	3.50	8.78	
	CMO's	58,485,000.00	6.51	2.64	15.22	
	Sub-total	83,271,985.00	6.68	2.90	24.00	25%
	Asset Backs	20,000,000.00	5.87	1.38	5.69	20%
Repurchase Agreements						
	Overnight	808,000.00	5.01		0.23	
	< 30 days	0.00	0.00		0.00	
	< 60 days	0.00	0.00		0.00	
	< 90 days	0.00	0.00		0.00	
	< 1 year	0.00	0.00		0.00	
	< 2 years	0.00	0.00		0.00	
	> 2 years	0.00	0.00		0.00	
	Flex Repos					
	Sub-total	808,000.00	5.01		0.23	
Money Market Securities						
	Commercial Paper	0.00	0.00	0.00	0.00	A1-P1
	Bankers Acceptances	0.00	0.00	0.00	0.00	
	Certificates of Deposit	0.00	0.00	0.00	0.00	
	Sub-total	0.00	0.00	0.00	0.00	20%
TOTALS		351,042,208.00	6.24	2.87	100.00	

Date: 7/31/99

PORTFOLIO SUMMARY BOND PROCEEDS POOL

TYPE	MARKET VALUE	MARKET YIELD (%)	DURATION (Years)	PERCENT of TOTAL	STATUTORY LIMIT
Treasuries					
Bills	0.00	0.00	0.00		
Treasury Notes	56,031,073.00	5.31	1.10	24.88	
Sub-total	56,031,073.00	5.31	1.10	24.88	
Agencies					
Notes	92,789,474.00	6.04	2.56	38.61	
Discounts	4,952,000.00	5.25	0.13	2.07	
Sub-total	97,741,474.00	5.95	2.40	40.68	
Municipals					
	0.00	0.00	0.00	0.00	
Mortgages					
Pools	0.00	0.00	0.00	0.00	
CMO's	0.00	0.00	0.00	0.00	
Sub-total	0.00	0.00	0.00	0.00	
Asset Backs					
	0.00	0.00		0.00	
Repurchase Agreements					
Overnight	83,074,000.00	5.01		34.44	
< 30 days	0.00	0.00		0.00	
< 60 days	0.00	0.00		0.00	
< 90 days	0.00	0.00		0.00	
< 1 year	0.00	0.00		0.00	
< 2 years	0.00	0.00		0.00	
> 2 years	0.00	0.00		0.00	
Flex Repos					
Sub-total	83,074,000.00	5.01		34.44	
Money Market Securities					
Commercial Paper	0.00	0.00	0.00	0.00	NONE ALLOWED
Bankers Acceptances	0.00	0.00	0.00	0.00	
Certificates of Deposit	0.00	0.00	0.00	0.00	
Sub-total	0.00	0.00	0.00	0.00	
TOTALS	236,846,547.00	5.49	1.27	100.00	

Investable Balances

For the Month of July 1999

<u>Pool</u>	Average Daily Balances	
	<u>Month</u>	<u>Fiscal Year to Date</u>
Long Term	350,445,532	350,445,532
Short Term	662,467,059	662,467,059
Intermediate	2, 119,239,847	2, 119,239,847
Bond Proceeds	239,908,460	239,908,460
Previous Investments	<u>151,289,324</u>	<u>151,289,324</u>
Grand Total	<u>3,523,350,222</u>	<u>3,523,350,222</u>

Investment Income

Through July 1999

Pool	Month		Fiscal Year to Date	
	Amount	Yield *	Amount	Yield **
Long Term	696,106	2.35%	696, 106	2.35%
Short Term	2,780,997	4.96%	2,780,997	4.96%
Intermediate	5,219,213	2.91%	5,219,213	2.91%
Bond Proceeds	<u>618,939</u>	<u>3.05%</u>	<u>618,939</u>	<u>3.05%</u>
Grand Total	<u>9,315,254</u>	<u>3.26%</u>	<u>9,315,254</u>	<u>3.26%</u>

* Yield is calculated on a total return basis. Total return consists of the accrual of interest and the gain or loss incurred from valuing the securities to market value. Total return, divided by average daily balance, divided by actual days, multiplied by actual number of days in the fiscal year.

** Yield is calculated on a total return basis. Total return consists of the accrual of interest and the gain or loss incurred from valuing the securities to market value. Total return (fiscal YTD), divided by the weighted average of the monthly average daily balances, divided by the actual days (fiscal YTD), multiplied by the actual number of days in the fiscal year.

CASH DISTRIBUTION

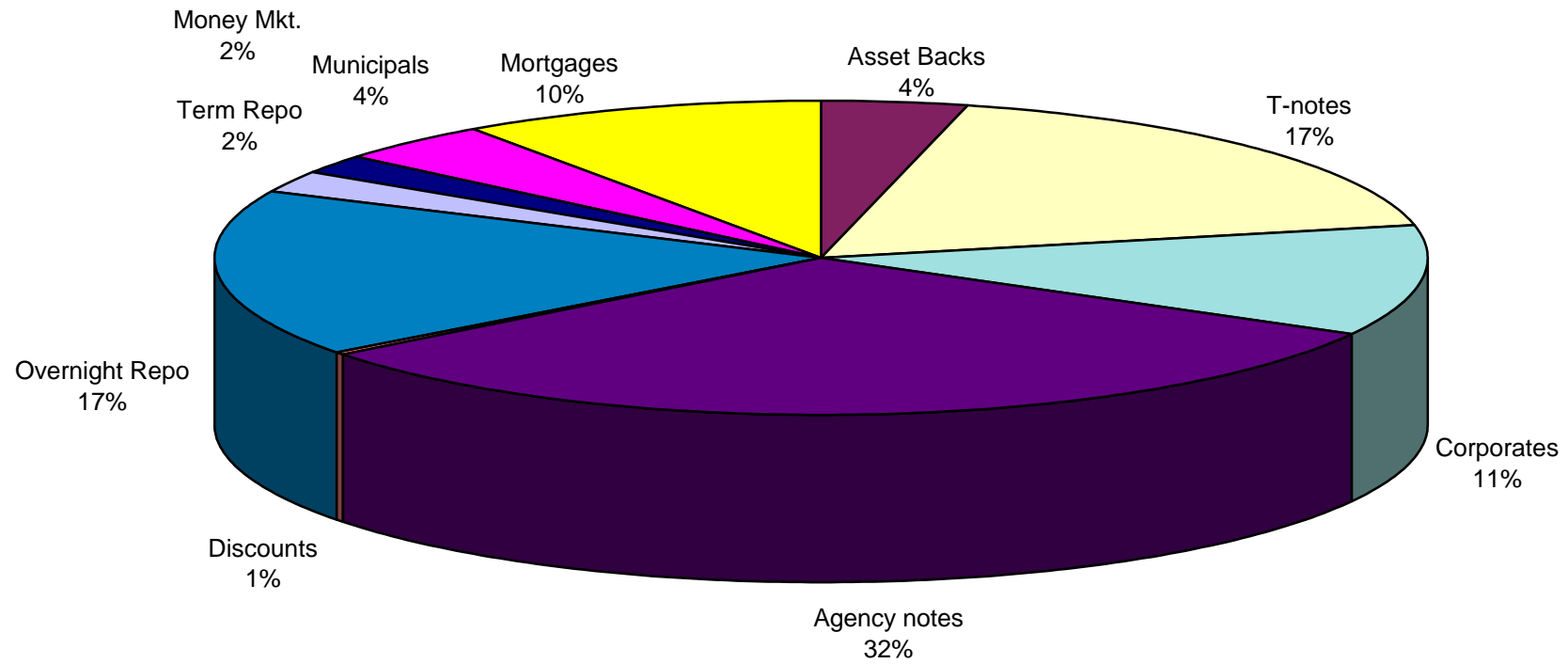
July 1999

		<u>Month</u>		<u>YTD</u>	
	Actual	Budget	Actual	Budget	
General Fund	2,630,711	1,463,385	2,630,711	1,463,385	
Capital Con.	1,426,575	743,750	1,426,575	743,750	
Agency	390,956	350,000	390,956	350,000	
T&R	209,413	65,625	209,413	65,625	

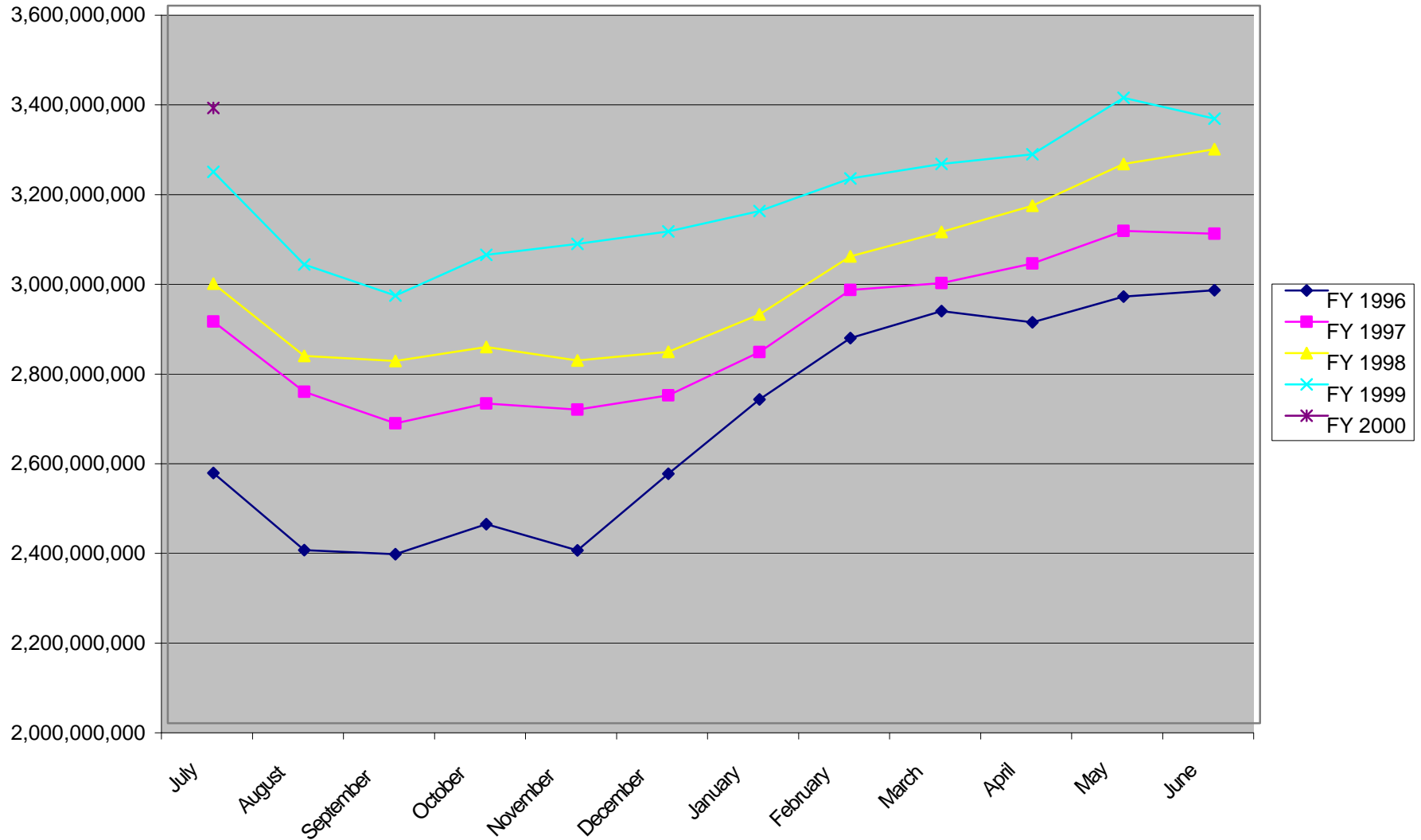
**ACCRUED
EARNINGS**
July 1999

		<u>Month</u>		<u>YTD</u>	
	Actual		Budget	Actual	Budget
General Fund	2,234,401		1,463,385	2,234,401	1,463,385
Capital Con.	1,159,736		743,750	1,159,736	743,750
Agency	476,066		350,000	476,066	350,000
T&R	186,249		65,625	186,249	65,625

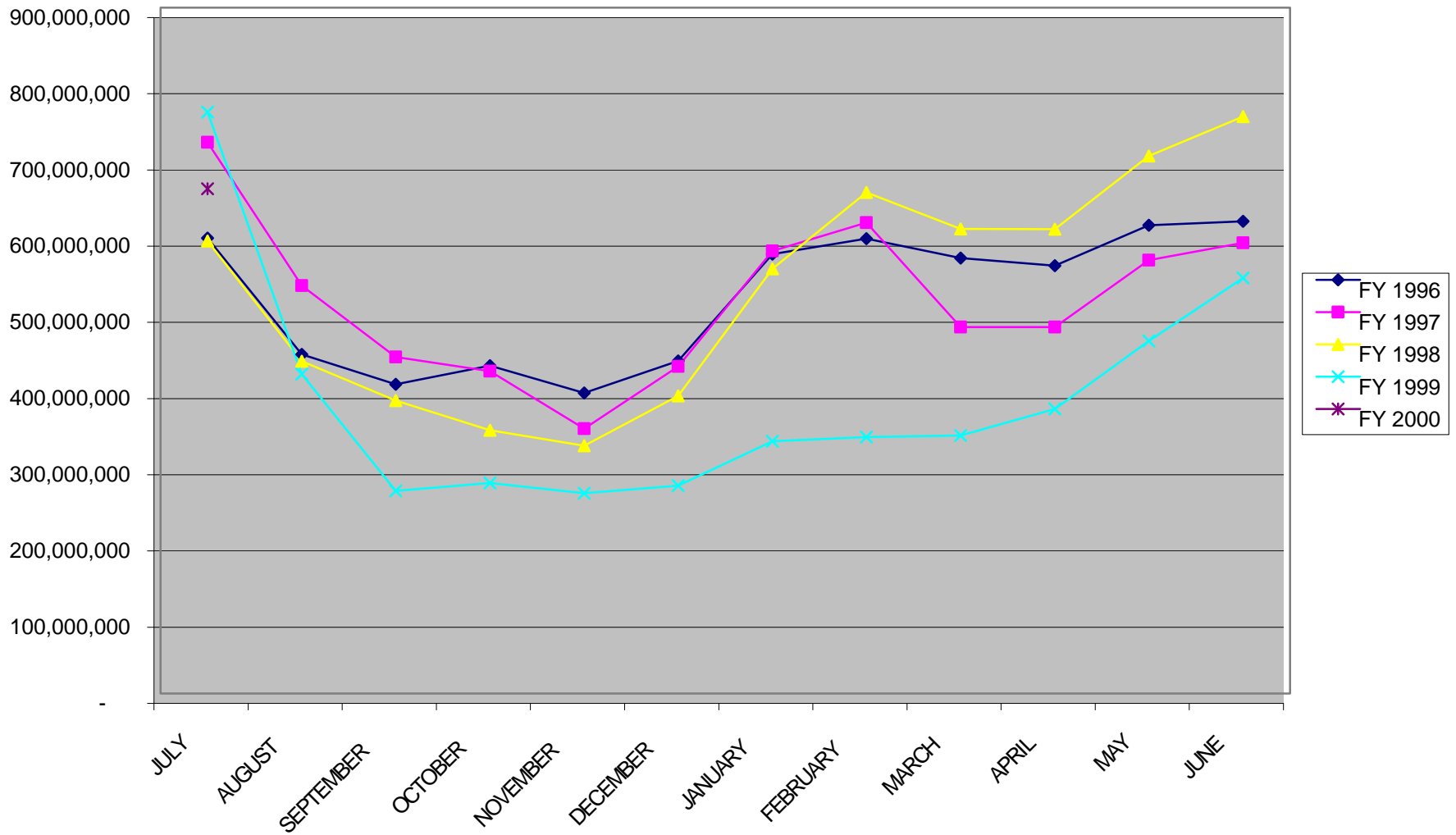
DISTRIBUTION OF INVESTMENTS JULY 1999



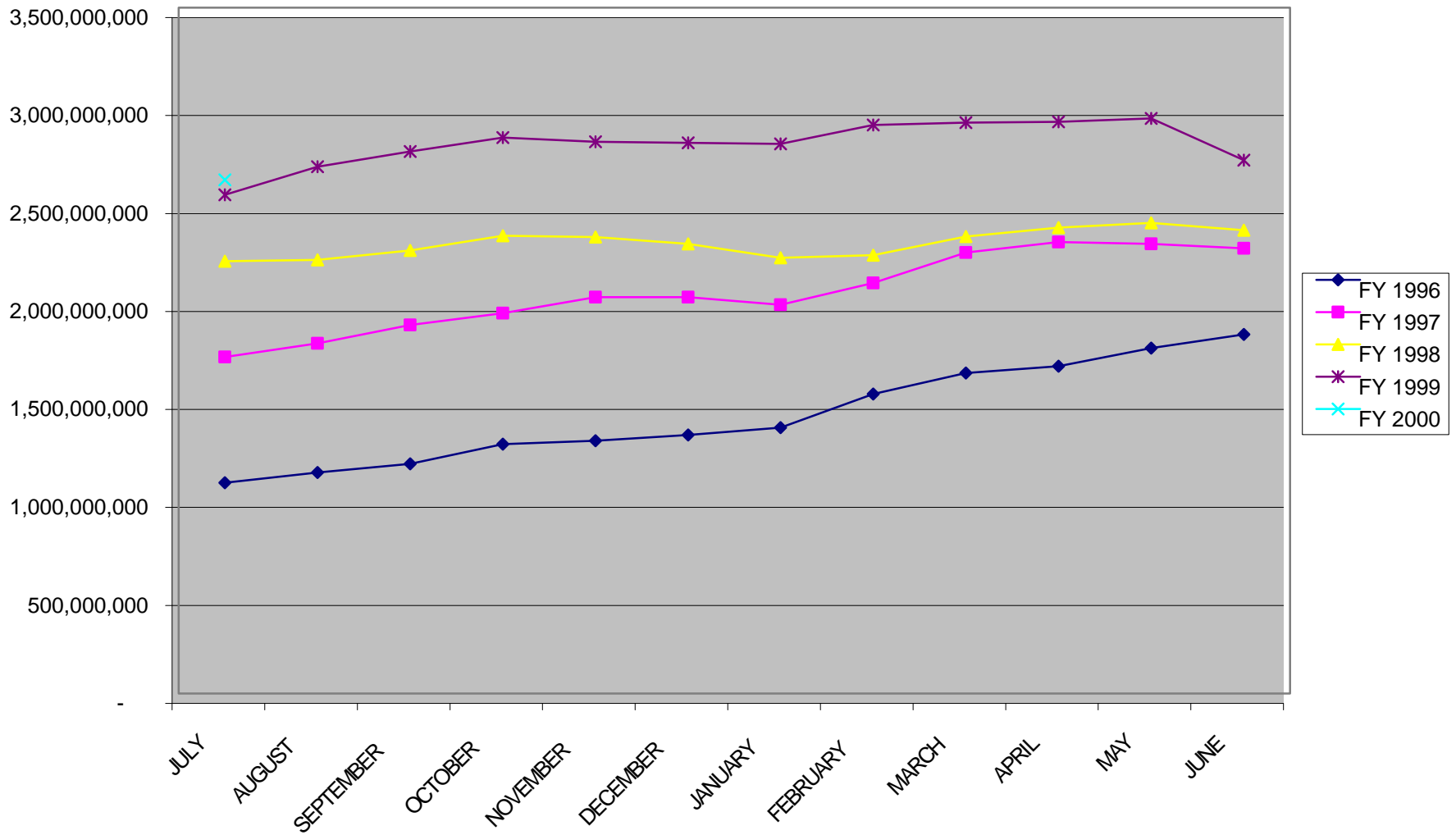
INVESTABLE BALANCES



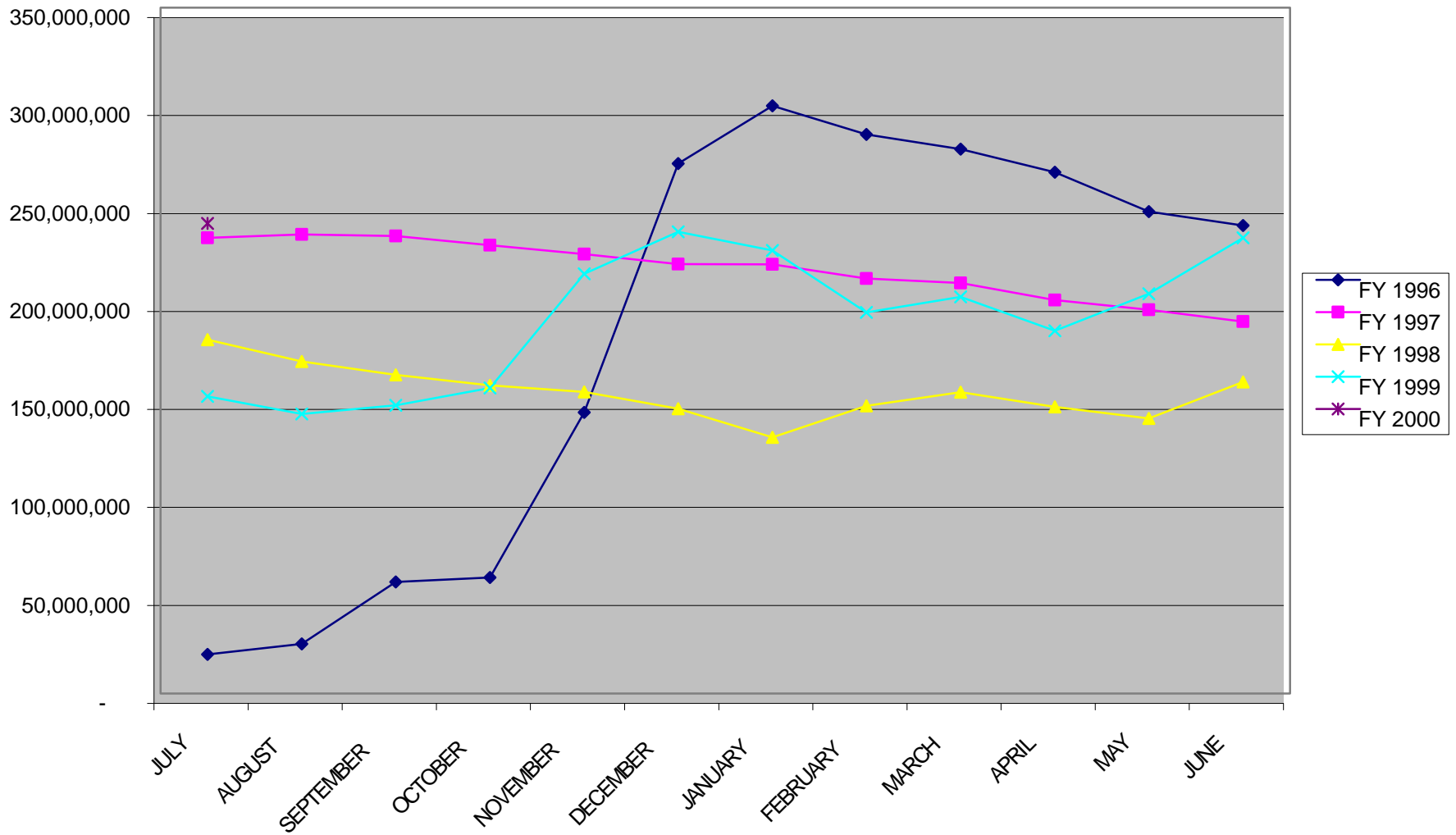
SHORT TERM POOL INVESTABLE BALANCES



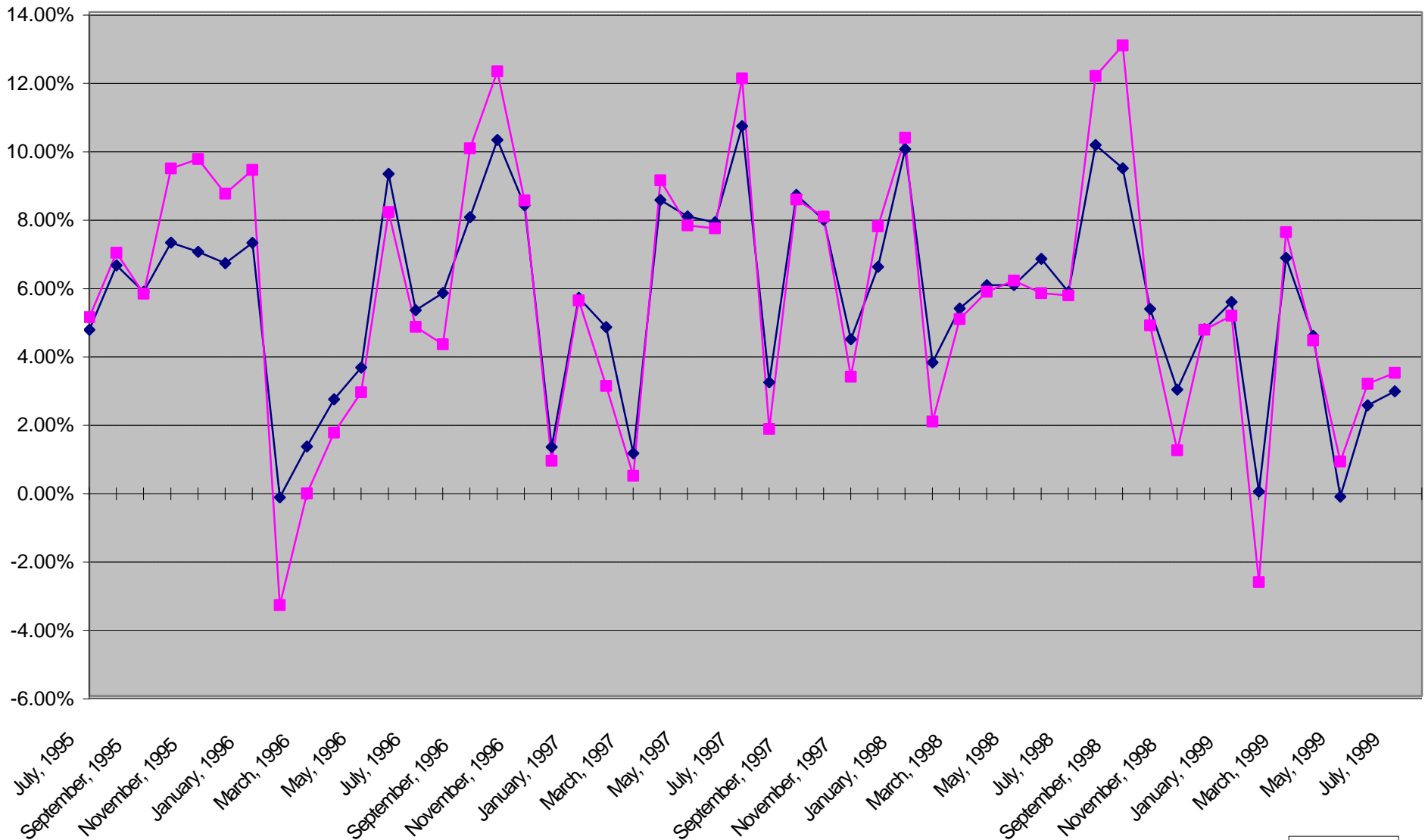
INTERMEDIATE - LONG TERM POOL INVESTABLE BALANCES



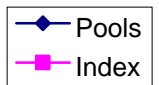
US TREASURY-AGENCY INVESTABLE BALANCES



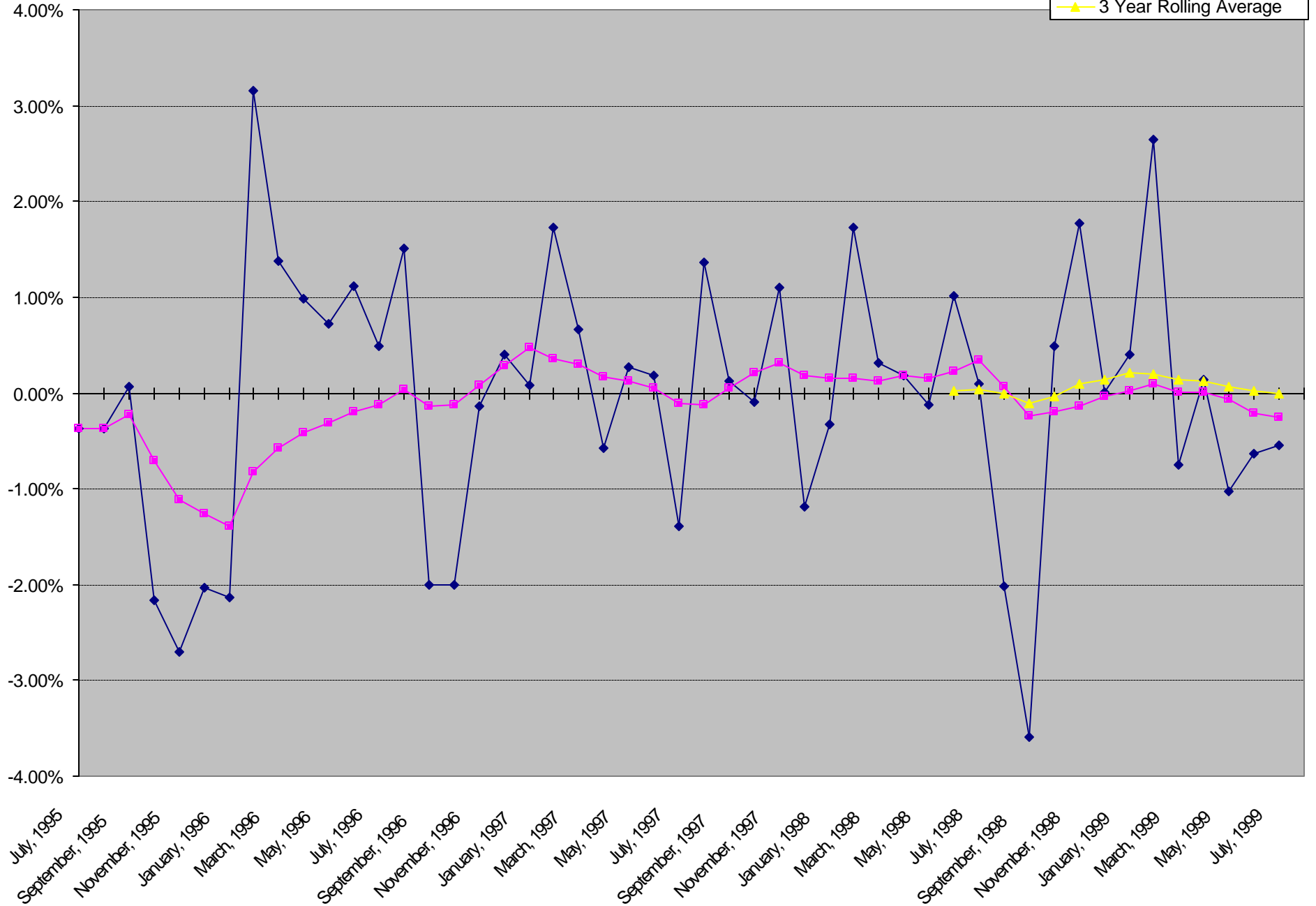
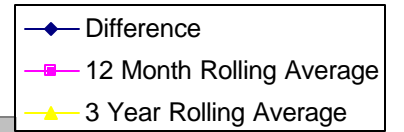
INTERMEDIATE POOL ANNUALIZED YIELD



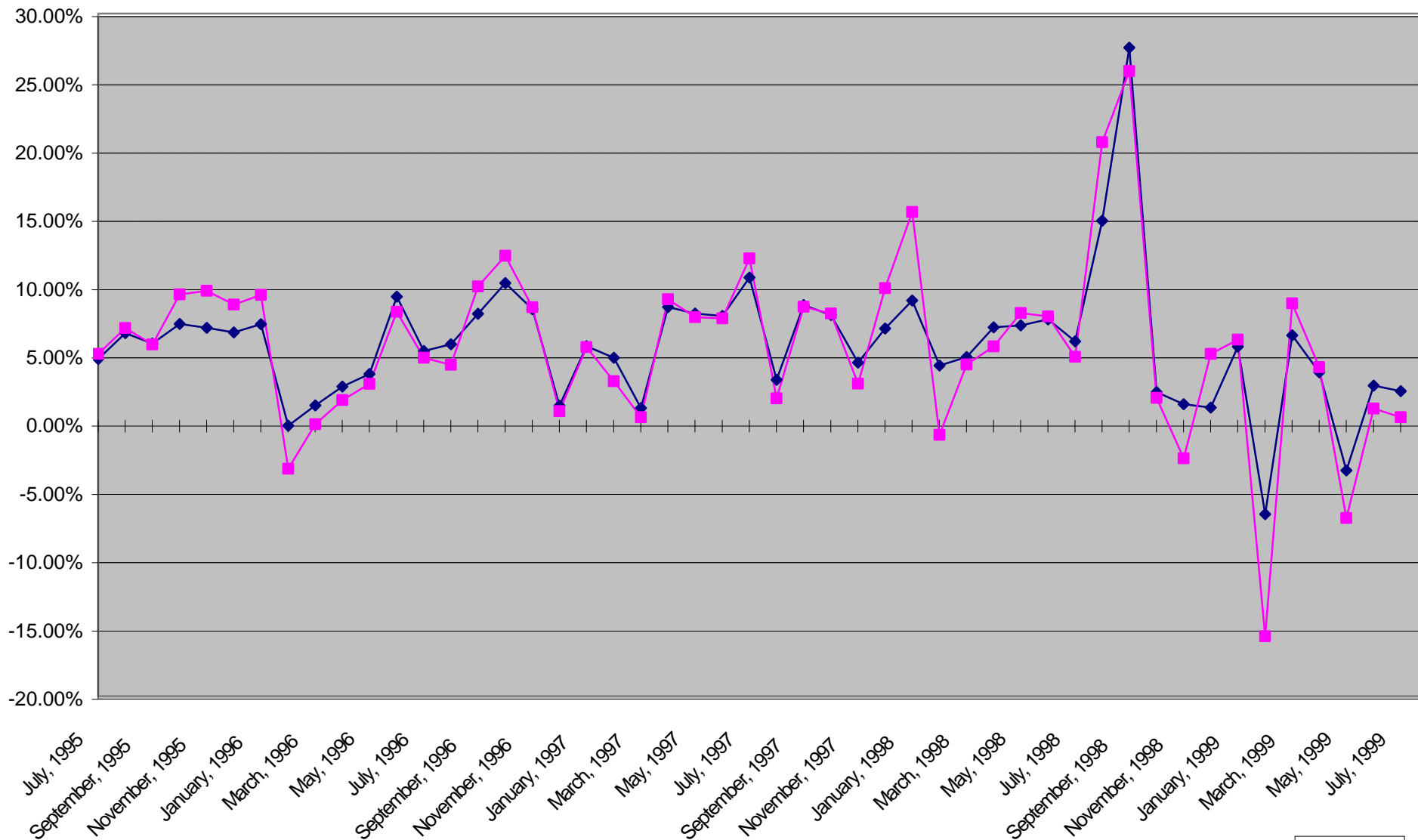
Index consists of 70% Government 1-3 year, 15% Mortgage 0-3 and 15% money market



INTERMEDIATE POOL ANNUALIZED YIELD DIFFERENCE



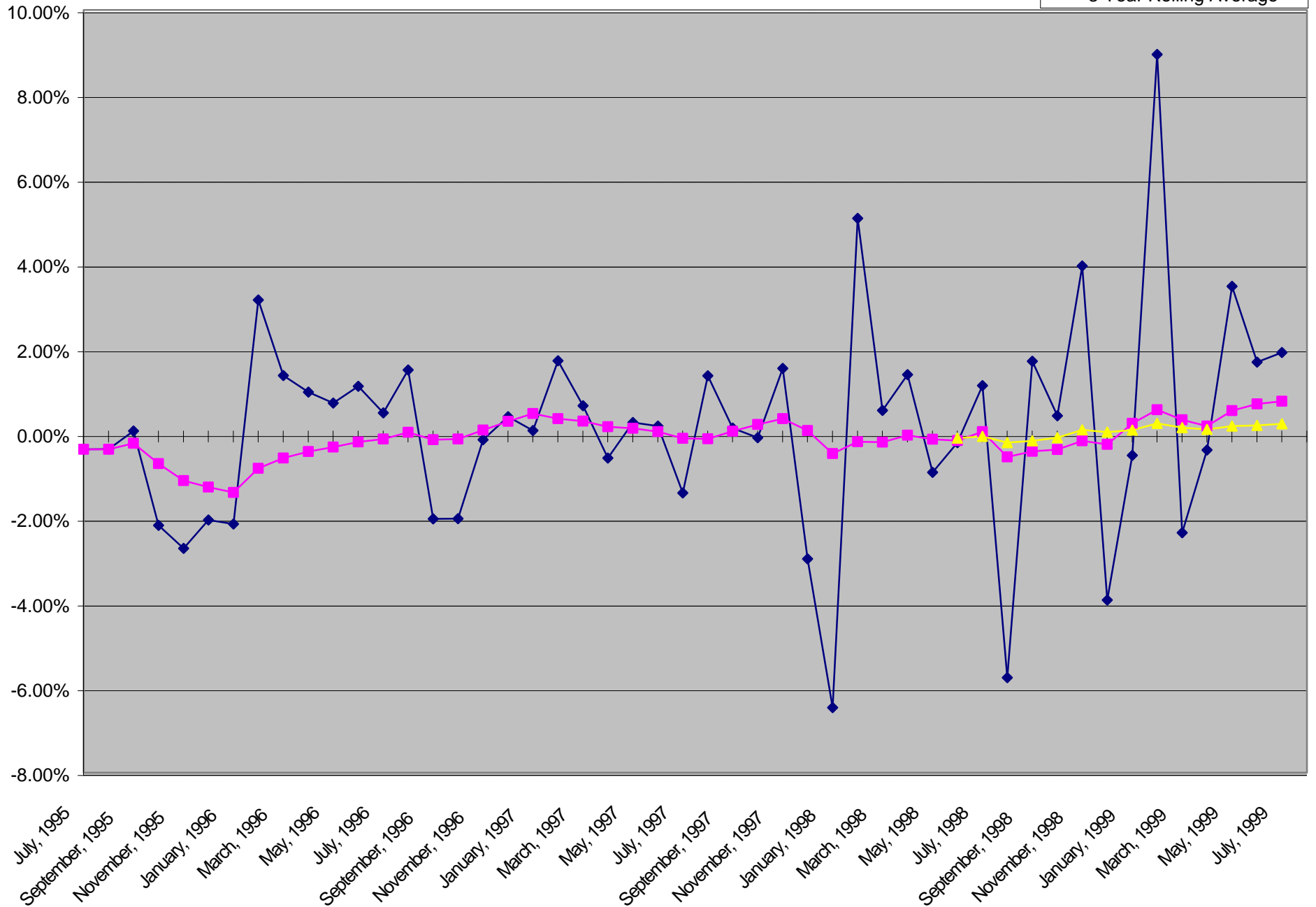
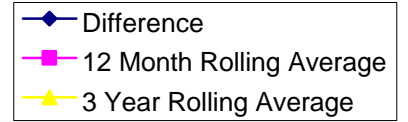
LONG TERM POOL ANNUALIZED YIELD



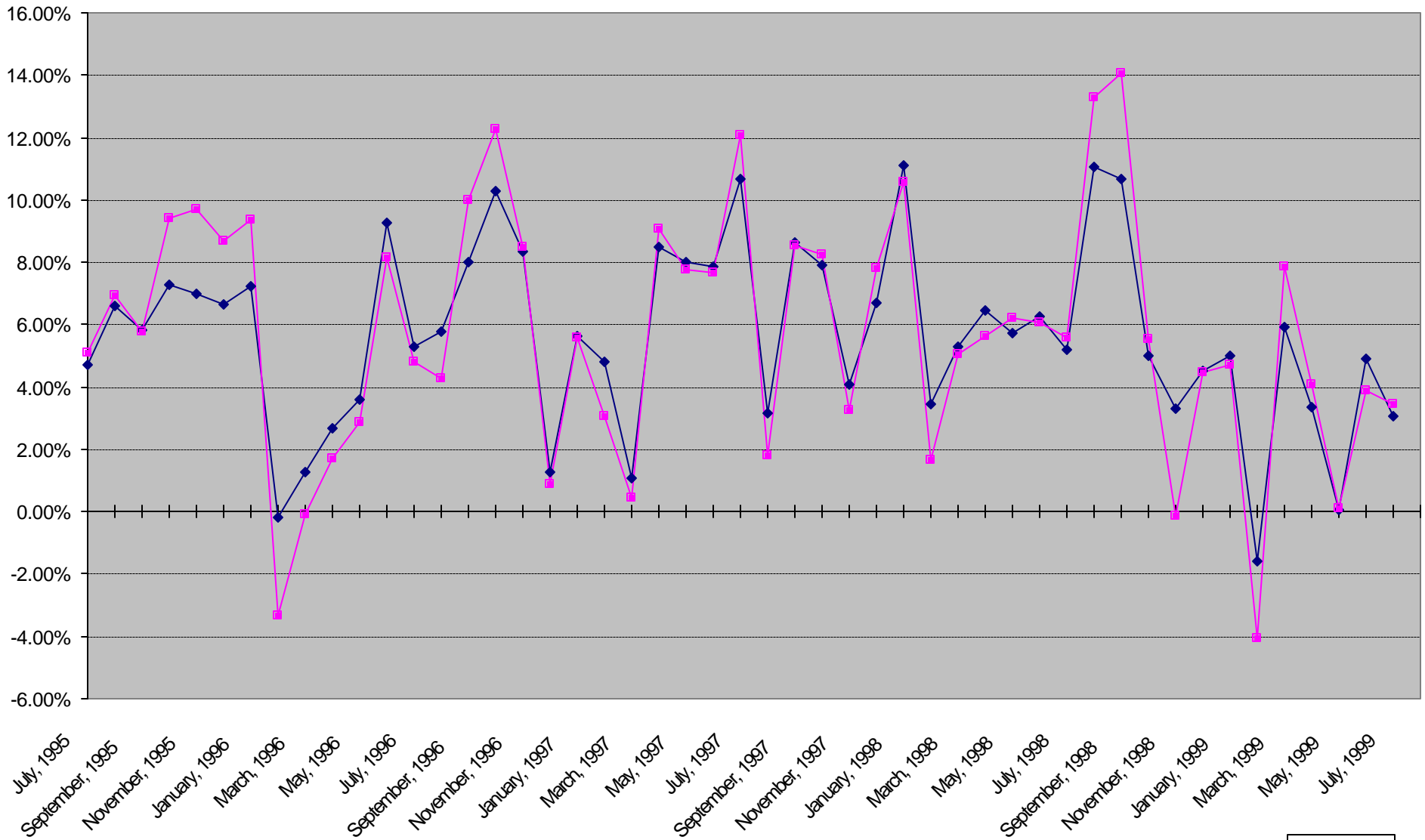
Index consists of 85% Government 1-10 year, 10% Mortgage 0-3 and 5% US Corporate 1-10



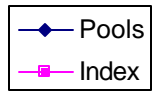
LONG TERM POOL ANNUALIZED YIELD DIFFERENCE



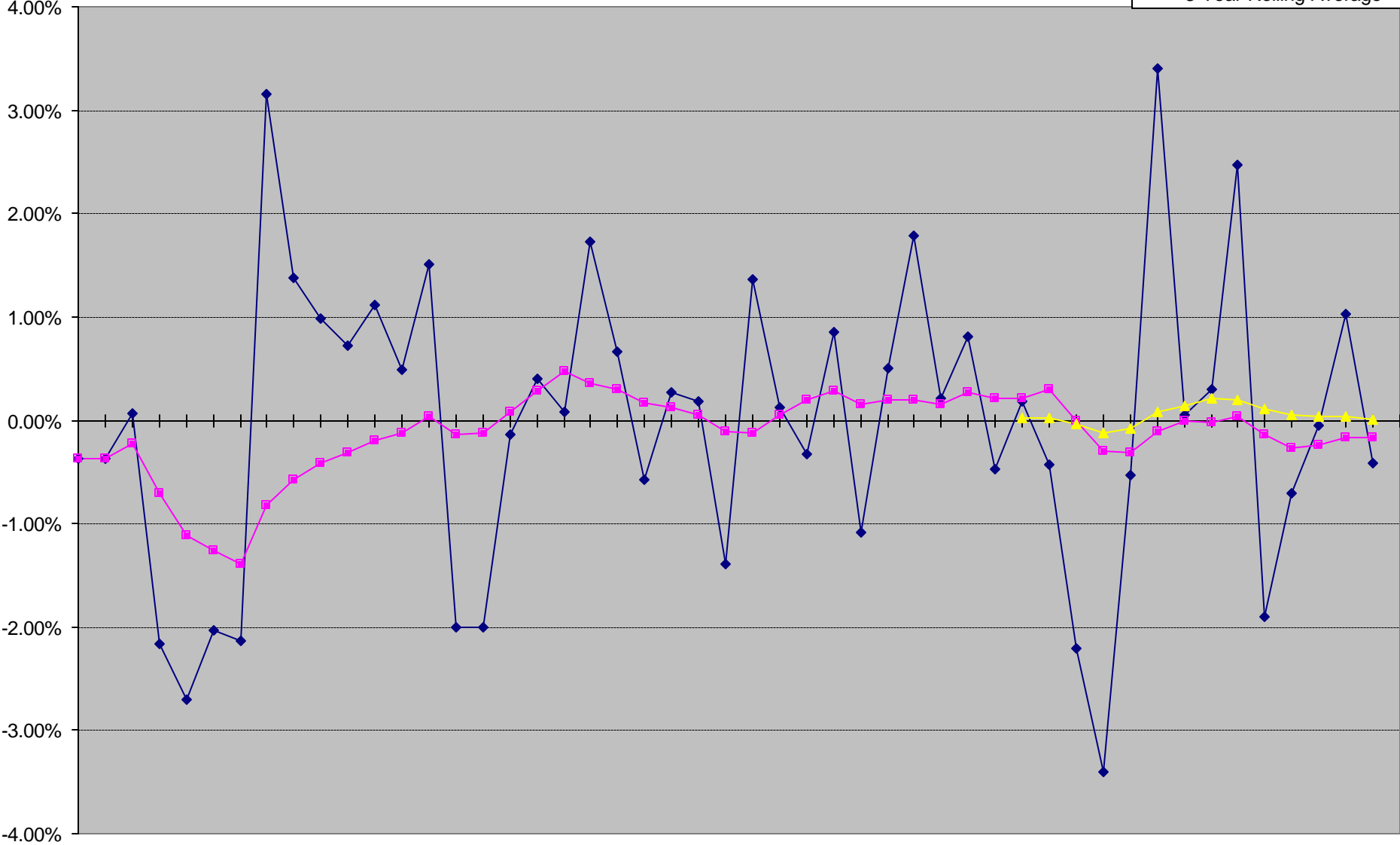
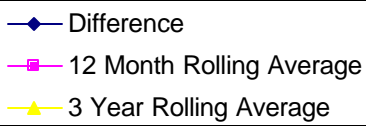
BOND PROCEEDS POOL ANNUALIZED YIELD



Index consists of 85% Government 1-3 year and 15% money market



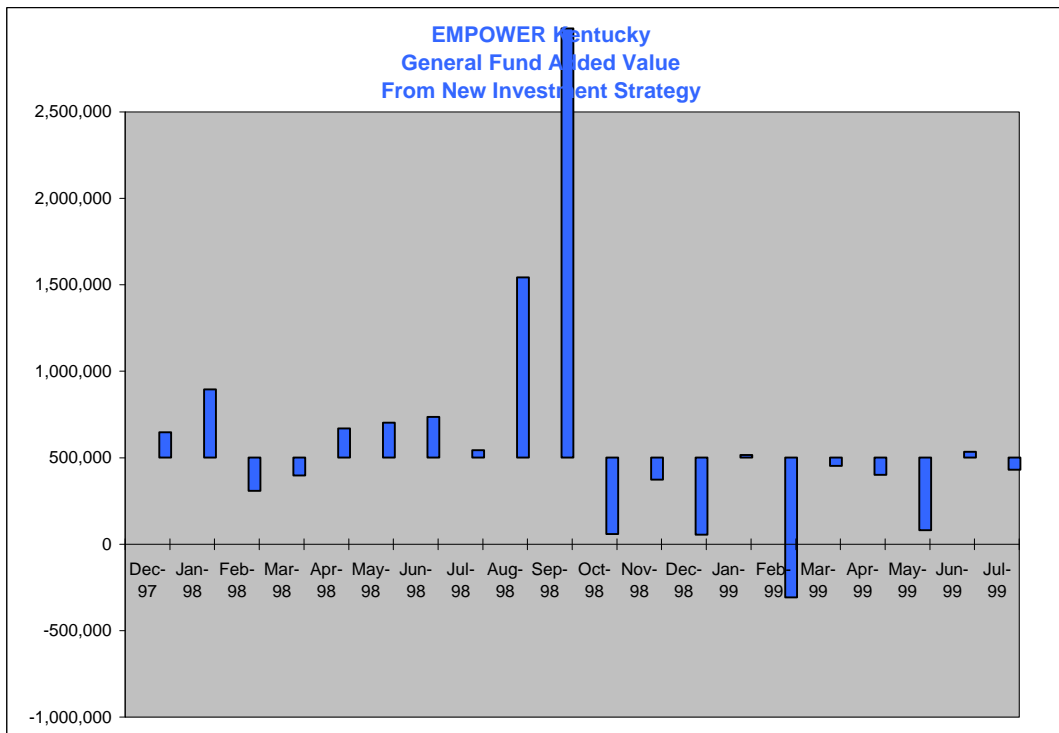
BOND PROCEEDS POOL ANNUALIZED YIELD DIFFERENCE



July, 1995
September, 1995
November, 1995
January, 1996
March, 1996
May, 1996
July, 1996
September, 1996
November, 1996
January, 1997
March, 1997
May, 1997
July, 1997
September, 1997
November, 1997
January, 1998
March, 1998
May, 1998
July, 1998
September, 1998
November, 1998
January, 1999
March, 1999
May, 1999
July, 1999

EMPOWER Kentucky
Added Value from New Investment Strategy
Total Return Basis

	BRTF Long-term Pool	General Fund Share of Added-Value
FYE 6/30/98:	844,071	664,615
Jul-98	42,050	25,913
Aug-98	1,040,624	640,596
Sep-98	3,986,448	2,480,615
Oct-98	-696,294	-442,960
Nov-98	-194,794	-128,580
Dec-98	-697,724	-446,891
Jan-99	24,856	14,432
Feb-99	-1,786,031	-809,580
Mar-99	-112,994	-48,446
Apr-99	-236,251	-101,251
May-99	-971,228	-421,228
Jun-99	76,002	32,669
FYE 6/30/99:	474,664	795,289
Jul-99	-163,541	-70,208
FYE 6/30/00 YTD:	-163,541	-70,208



EMPOWER Kentucky
Added Value from Additional Security Types
Cash Basis

	MBS/CMO/ABS	Corporates	Total Added-Value	General Fund Share of Added-Value
FYE 6/30/98:	1,014,606	318,534	1,333,140	261,195
Jul-98	127,020	26,430	153,450	34,469
Aug-98	129,029	77,567	206,596	27,436
Sep-98	124,924	78,099	203,023	27,022
Oct-98	128,644	86,754	215,398	28,246
Nov-98	163,960	95,811	259,771	28,449
Dec-98	158,649	101,977	260,626	28,133
Jan-99	156,147	102,424	258,571	25,503
Feb-99	271,156	115,822	386,978	115,078
Mar-99	308,874	111,706	420,580	116,144
Apr-99	256,583	118,073	437,498	118,110
May-99	323,705	194,360	518,065	166,653
Jun-99	297,933	164,218	462,151	147,667
FYE 6/30/99:	2,446,624	1,273,240	3,782,706	862,910
Jul-99	287,709	151,269	438,978	152,958
FYE 6/30/00 YTD:	287,709	151,269	438,978	152,958

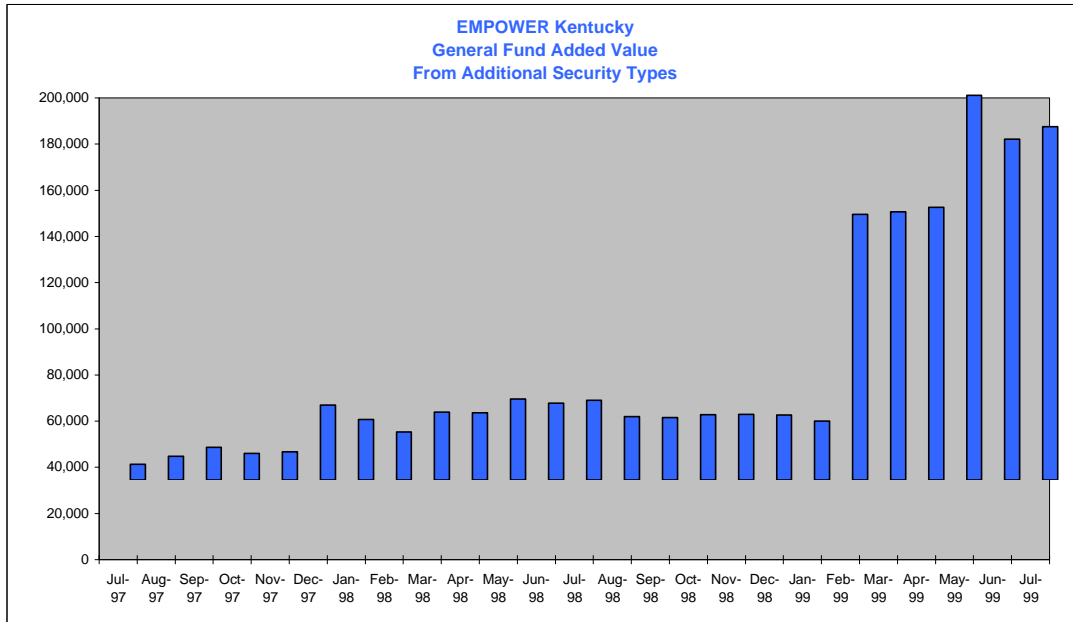


EXHIBIT II

**General Fund Available Balance FY99
(Includes Budget Reserve Trust Fund)**

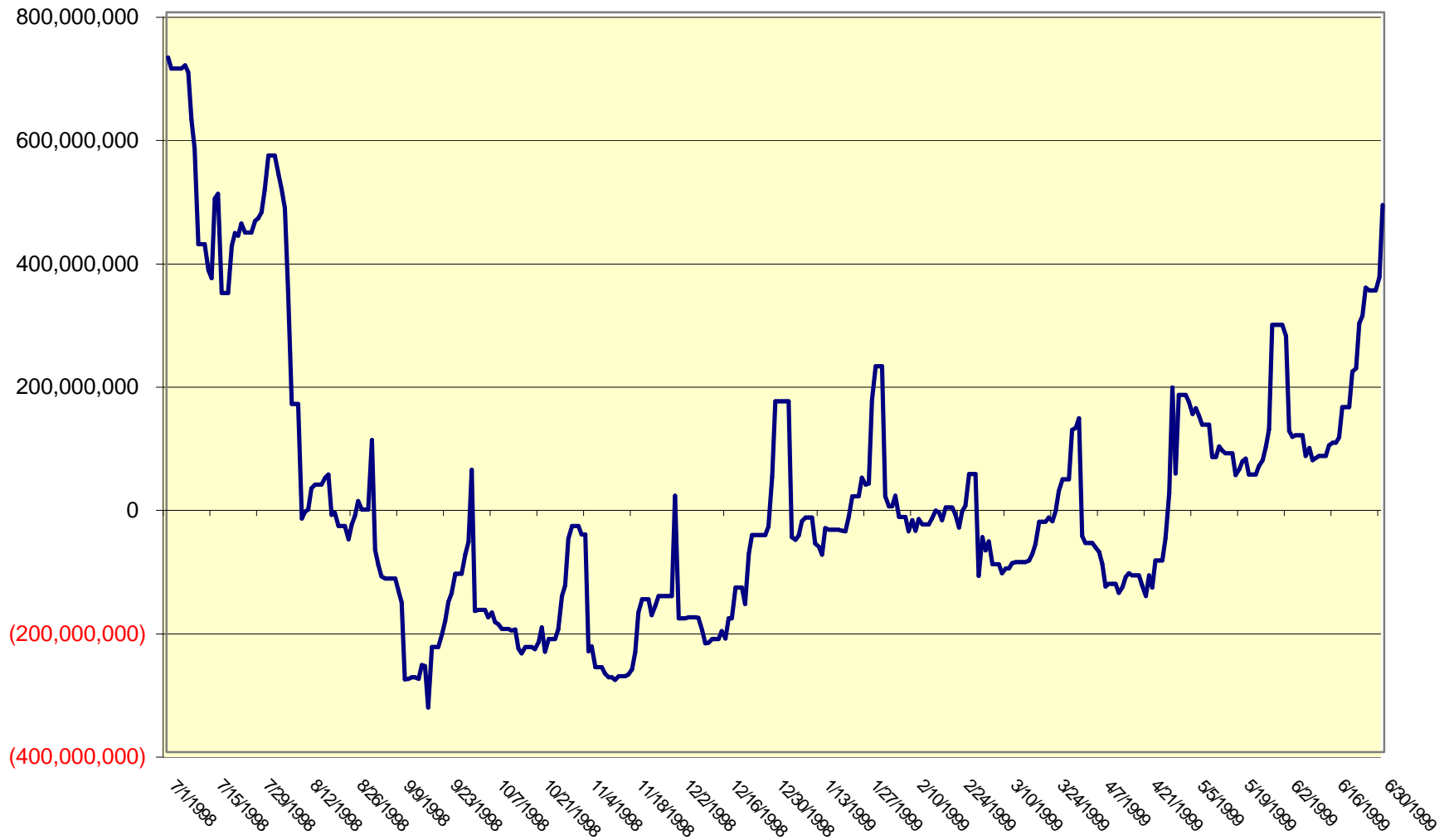
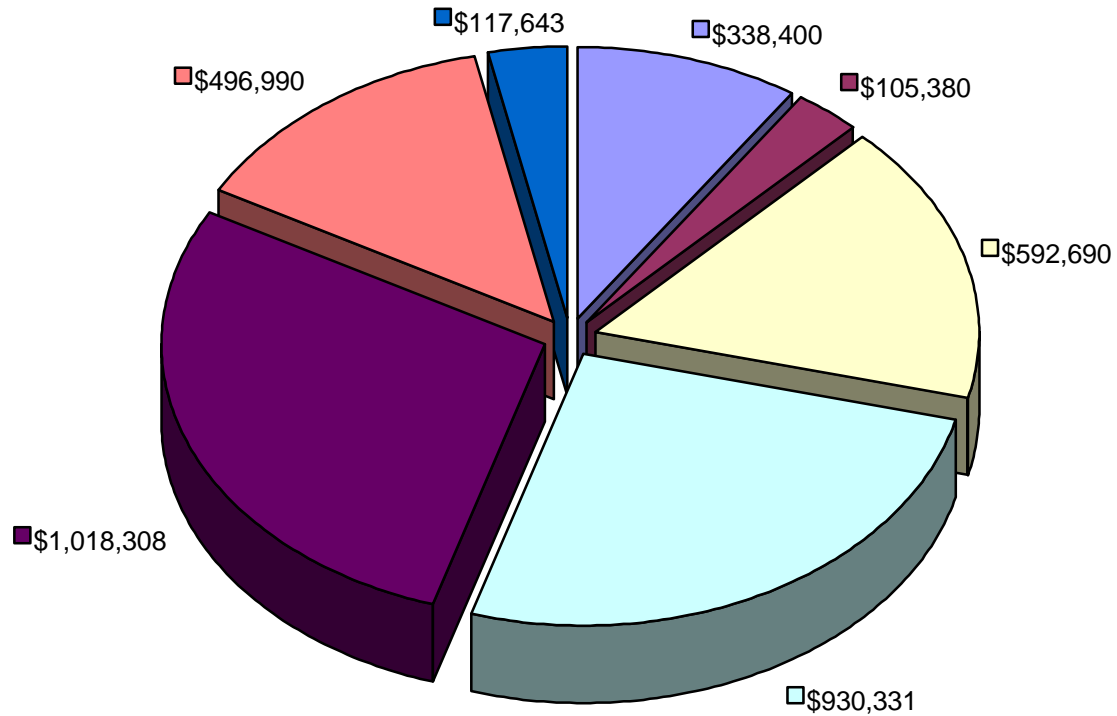


EXHIBIT III

**Appropriation Supported Bonds/Notes
Principal Outstanding at June 30, 1999
(000)**



- KY Asset/Liability Commission
- School Facilities Construction Commission
- Turnpike Authority of KY
- University Housing & Dining and Hospital

- KY Infrastructure Authority
- State Property and Buildings Commission
- University Consolidated Educational

EXHIBIT IV

Appropriation Supported Bonds Debt Service (000)

