

State Investment Commission

December 11, 2013

1:00 p.m. ~ Room 182 ~ Capitol Annex
Frankfort, Kentucky

The State Investment Commission (“the Commission”) meeting was called to order on December 11, 2013, at 1:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Lori Flanery, Secretary of the Finance and Administration Cabinet; Jane Driskell, proxy for Governor Beshear; Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

Office of Financial Management (“OFM”) Staff Present: Steve Jones, Deputy Executive Director, Sandy Williams, Deputy Executive Director, Kim Bechtel, Kurt Kemper, Ian Blaiklock, Brian Caldwell, and Marcia Adams.

Other Guests: Ed Ross, Controller, Finance and Administration Cabinet.

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

Treasurer Hollenbach called for a motion to approve the minutes from the September 25, 2013, meeting. A motion was made by Mr. Jon Lawson and seconded by Mr. George Spragens to approve the minutes. Motion **CARRIED**.

Treasurer Hollenbach recognized Mr. Steve Jones.

Forbearance Security Analysis – Mr. Steve Jones began by discussing the analysis of the forbearance process this Commission approved since 2009 on a quarterly basis until the last meeting in December, 2013. The economic recovery to the Commonwealth due to forbearance was approximately \$103,200,000. This indicates how dire the market became during the financial crisis and how it has recovered since 2009. Treasurer Hollenbach confirmed with staff that the analysis of the securities started with the first inclusion on the forbearance list until their sale or payoff. Mr. Jones confirmed affirmatively. Mr. Spragens stated that the process was an exercise in understanding the difference of a performing asset over a marketable asset.

Intermediate Pool Performance – Brian Caldwell directed the Commission members to the Fundamentals report of the Intermediate Term Pool, specifically 3 of the columns. The Yield to Worst column shows the Pool at 0.607% compared to the Benchmark of 0.621%, just a slight difference of -0.014%. The Effective Duration shows the Pool at 1.311 years compared to the Benchmark of 1.819 years, a difference of -0.508, or roughly one half-year short. This represents a defensive position with guarding against the expectation of rates moving higher in the future. The Convexity column shows the Pool at -0.213 compared to the Benchmark of -0.080, a difference of -0.133. At the previous meeting, the difference was -0.27, showing a reduction in Convexity risk.

Treasurer Hollenbach stated that many people have been expecting rates to rise in the future but the future keeps getting pushed back. Mr. Caldwell responded that the market is reacting to tapering of security purchases by the Federal Reserve and expecting interest rates to normalize at a higher level. Mr. Spragens added that the assumption of the public is that “tapering” means the Federal Reserve ended the bond buying program, but that is not the case. They will still be purchasing securities, but

not doing it as rapidly. Mr. Jones added that the Federal announcement may not be an increase in interest rates, but over 2-3, years as they move to a more neutral position, interest rates should move higher.

The Contribution to Duration chart provides further detail on the portfolio. Mr. Caldwell directed the Commission to the Fixed-Income Sector represented in the Portfolio. The major sectors include the U.S. Government at 55% of the total, Credit at 6%, Securitized, including MBS, CMO, and ABS at 16%, Municipals, including Taxable at 1%, and the final sector, representing cash and other money market instruments, at 22%. Mr. Jones stated that though the Pool is below the yield of the Benchmark, primarily due to higher cash levels as staff manages through some cash-flow needs.

A graph showing the Pool performance as of November is shown with blue representing the Pool, Red showing the Benchmark, and green showing the difference. For November, the Pool underperformed by seven basis points but outperformed by 9 basis points over the 3 months ended in November. The portfolio has underperformed the benchmark by 10 basis points on a fiscal year-to-date basis and by 36 basis points of a 1 year basis. The 3-year, 5-year, 10-year, and since inception date of July 1995 are right on the Index. Over short time periods will vary between positive and negative but over complete market cycles the variances will be minimal as represented by the 3, 5, 10 year, and since inception numbers.

Limited Term Pool Performance – Ms. Kim Bechtel discussed the monthly performance of the Limited Term Pool compared to the benchmark of S&P Local Government Investment Pool. The first graph shows the Commonwealth consistently out-performing the benchmark. The second page lists all the diversified securities held in the Pool as of the end of November, 2013. Staff maintains a sizeable Repo balance due to cash flow needs. The next graph shows a breakdown by ratings and sector distributions, well within parameters. The fourth page shows the weighted average liquidity and maturity levels of the Pool. The Weighted Average Maturity (WAM) is just over 40 days...

The NAV (Net Asset Value) chart shows that the shadow NAV (Market Value) has been consistently near 1.0. Any divergence above or below .0025 would require staff to notify the Commission. To date, the maximum divergence has been 0.000182. The liquidity analysis memo shows the largest daily and weekly withdrawals plus the largest funds within the pool. Staff recommends maintaining the 15% daily and 30% weekly liquidity requirements. Treasurer Hollenbach noted that the breakdown of investments shows many foreign holdings and asked if those are more expensive for the Commonwealth. Mr. Jones answered that it is the debt of domestic subsidiaries of foreign entities which are held in the United States.

Ms. Bechtel continued with the information on the largest one day withdrawals and the largest individual accounts in the Pool. Mr. Jones reminded the Commission of the liquidity need to be able to cover any withdrawal from the pool and pointed out that staff is notified prior to a withdrawal from any of the largest funds.

Treasurer Hollenbach asked about the proposed Securities and Exchange Commission (SEC) reforms to Money Market Mutual Funds. Mr. Jones replied that the proposal has passed the comment phase with the SEC reviewing the thousands of comments. This Commission did comment in opposition to the reforms. Very few comments were in favor of the changes. There is no specific time-frame for the SEC to announce their decision. In addition, it would be approximately two years for implementation giving time to act accordingly.

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

Cash Considerations – Mr. Kurt Kemper detailed the re-occurring events which impact the Commonwealth's daily cash balances. The July balance is inflated due to fiscal year end while the November balance is low due to the seasonal nature of cash inflows. The seasonal nature of cash flows are driven primarily by property taxes in December, personal income tax in the April, and corporate taxes in June. Staff generally makes investments with a consideration of liquidity needs over the next 2 to 3 months.

Credit Considerations – Mr. Ian Blaiklock discussed the Approved Credit List. This is the list of credits the Commission has approved for investment. Staff is recommending removing several companies and adding two new entities to the list; Bank of America for Repurchase Agreements and UBS for Debt. The removals are listed at the bottom. Mr. Lawson asked if the removals were based on staff analysis or requested by the companies. Mr. Blaiklock answered that it was due to staff analysis of financial statements. Treasurer Hollenbach asked about Goldman Sachs' removal from the list. Mr. Blaiklock replied that the parent company was downgraded to a BBB rating, below guidelines.

A motion was made by Mr. Spragens and seconded by Mr. Lawson to accept the Approved Credit List as presented. Motion **CARRIED**.

Mr. Lawson asked about the ratings on the Louisville Bridges Project Bonds and the federal funding. Ms. Sandy Williams explained that the project includes a loan from TIFIA (Transportation Infrastructure and Finance Innovation Act) a federal agency that assists in financing large infrastructure projects. Mr. Spragens asked what portion of the entire project is Kentucky's responsibility. Secretary Flanery replied that Ryan Barrow was currently working on the financing and will provide that information when it is available. Mr. Lawson remarked that other Kentucky bonds were rated higher than the Bridges and wondered about the disparity. Mr. Jones explained that the ratings depend on the revenue source behind the financing. For example, Road Fund bonds have a segregated revenue source (gas taxes, motor vehicle taxes, and federal highway funds) providing higher ratings. The only support for the Bridges Project will be the toll revenues which provides a lower rating.

Linked Deposit Program – Ms. Kim Bechtel discussed the financial condition of four banks currently participating in the Linked Deposit Program. During the reporting period, Bank of Columbia's non-performing loans to capital ratios increased. Staff spoke with the bank, who felt they had adequate reserves in place and anticipate a six-month period to be in compliance.

Ms. Bechtel reminded the Commission members that all these loans are well collateralized and that no action is required. Treasurer Hollenbach questioned the Bank of Carlisle. Ms. Bechtel stated the bank name has changed to Farmer's Deposit Bank and merged with Cynthiana. Mr. Jones stated that one non-performing loan has been resolved that shows on this report. They expect to be in compliance by the first quarter of 2014.

Ms. Bechtel stated that staff is still watching the other two banks, Clinton Bank and Bank of Jamestown, but reminds the Commission that the loans are well collateralized. She also explained that the Commission has right, but not the obligation to call these loans but staff recommends continuing to hold these loans. No action was taken by the Commission at this time.

Mr. Jones informed the Commission that with the Louisville Bridges Project Bond sale there will be in new investment pool created consisting of approximately \$540,000,000 of project funds. The statutes governing these investments are different than other funds overseen by the Commission. For example, the cash investment will be a Treasury only Money Market Mutual Fund rather than sharing of repurchase agreements with the other pools. These funds will be held by the same custodial bank but segregated into a different account.

With no further business, the meeting stands adjourned.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read 'R. Barrow', is written over the typed name.

Ryan Barrow
Secretary