State Investment Commission
Minutes
March 20, 2006

The State Investment Commission was called to order by Jonathan Miller, State Treasurer, on Monday, March 20, 2006 in Room 76 of the Capitol Annex at 1:30 a.m. Members present were John Farris, proxy for Robbie Rudolph, Secretary, Finance and Administration Cabinet; Libby Milligan, proxy for Governor Ernie Fletcher; and Jonathan Miller, State Treasurer.

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

A motion was made by Mr. Farris and seconded by Ms. Milligan to accept the minutes of the December 13, 2005 meeting. Motion **CARRIED**.

Dwight Price, Office of Financial Management, discussed the trading limits for staff of the investment section. Mr. Price indicated that in the past the trading limits were designated for individuals (Dwight Price, Steve Jones, and Kim Bechtel) in the investment section. Mr. Price indicated that the proposed change would designate trading limits for individual positions (portfolio managers, money market trader) rather than individuals. Mr. Price continued that the trading limits for Steve Jones will increase slightly but the others will remain the same.

F. Thomas Howard, Executive Director, Office of Financial Management, stated that the change would allow for consistency in the ability to execute transactions without breaking protocol if one individual is not available to make a specific trade.

A motion was made by John Farris and seconded by Libby Milligan to accept the change in the trading limits for the investment section of the Office of Financial Management. Motion **CARRIED**.

Steve Jones, Office of Financial Management, presented an update on the TRAN. Mr. Jones stated that the Commonwealth borrowed $600 million in Tax and Revenue Anticipation Notes on a fixed rate basis at the beginning of the current fiscal year with a maturity date of June 28, 2006. Mr. Jones stated that an interest rate swap for the majority of the Notes was entered into on which the Commonwealth synthetically turned the Notes into floating rate Notes. Mr. Jones further indicated that when comparing the investments to the floating side of the swap, the Commonwealth has earned approximately $2 million to date. Mr. Jones indicated that when comparing the cost of the debt versus the fixed rate on the swap the Commonwealth has made approximately $2.4 million to date for a total of approximately $4.5 million including the investment fee. Mr. Jones stated that the TRAN is on track and predicted that total earnings on the TRAN will be approximately $6 million by the end of the fiscal year.

Mr. Farris asked if that was earnings of approximately $4 million on $600 million of Notes. Mr. Jones indicated that was correct. Mr. Farris asked what debt versus fixed swap meant (theoretically). Mr. Jones explained that the Commonwealth issued fixed rate bonds with a cost of funds on the bonds of 2.67 percent. Mr. Jones further explained that the Commonwealth also entered into an interest rate swap with UBS Financial Services, Inc. ("UBS") in which they agreed to pay the Commonwealth a fixed rate on $538,000,000 and the Commonwealth will pay UBS a floating rate on $538,000,000, which is one month LIBOR. He stated that the Commonwealth is receiving a fixed rate of 3.81 percent and is paying a floating rate of one-month LIBOR on the Notes which results in a spread of approximately 100 basis points.

F. Thomas Howard, Executive Director, Office of Financial Management, indicated that the fixed rate Notes are tax-exempt and the swap is taxable which allows the Commonwealth to pick up the spread.

Mr. Price indicated that the transaction is a permissible arbitrage transaction (taxable vs. tax free). Mr. Price continued that if the transaction occurs within a fiscal year, the IRS allows the Commonwealth to keep the interest on the transaction with certain constraints. Mr. Howard stated that the TRAN lowers the borrowing costs of the General Fund. Mr. Price indicated that the General Fund expends evenly over 12 months, but collects a substantial amount in April and June. This results in a negative balance for the General Fund. Mr. Price stated that in previous years, the General Fund borrowed money from state agencies during the first 6-8 months of the year at taxable rates. The IRS will allow states to borrow tax free as long as a deficit exists. Mr. Howard also indicated that there are limitations on what assets can be purchased and it is much easier to purchase large blocks of floating rate paper than it is to buy fixed rate paper.

Mr. Farris asked if a decrease in the rate would result in a decrease in profits for the Commonwealth. Mr. Price indicated that a decrease in the rate would not result in a decrease in profits on the TRAN for the Commonwealth. Mr. Price continued that the only concern is the spread and added that as rates go up the spread widens. Mr. Jones indicated that the only risk to the portfolio would be a mark-to-market loss at the end of the fiscal year when the outstanding investments must be sold to pay off the Notes. Mr. Jones indicated that currently the assets are experiencing a mark-to-market gain and that is not expected to change.

Mr. Farris asked what the rate for one month LIBOR was. Mr. Howard indicated that the rate was 4.58 percent.

Mr. Jones discussed Attachment C the Yield Curve Steepener Trade. He informed the Commission members that the yield curve has flattened a great deal over the past several months and basically the interest rate on the two-year Treasury note and the five-year Treasury note are yielding the same rate (flat yield curve). Mr. Jones stated that it is expected that at some point in the future the five-year Treasury note will be higher than the two-year Treasury note and the curve will steepen. He continued that if that occurs, the spread on a number of assets in the Commonwealth's portfolio will be affected. Mr. Jones added that several interest rate swaps have been put into position that will provide income to the Commonwealth if the curve steepens as expected. Mr. Jones stated that the first position was entered into in December 2005 with Goldman Sachs and the second position was entered into in February 2006 with Merrill Lynch. Mr. Jones stated that both positions have earned the Commonwealth total interest of $19,234.14 through March 2006. Mr. Jones pointed out, however, that the yield curve is flatter than when the Commonwealth entered into the trades which has resulted in an approximate $2,000 mark-to-market loss for a total profit of $17,234.41. Mr.

Jones believes that the curve will steepen and when that occurs the Commonwealth will earn $7,000 for each basis point of steepening. Mr. Jones stated that staff will continue to monitor market conditions regularly at each repricing point on the floating rate swap and make a decision on to how to proceed if necessary.

With no further business before the Commission, a motion was made to adjourn the meeting. Motion **CARRIED.**

F. Thomas Howard, Secretary
State Investment Commission