

STATE INVESTMENT COMMISSION
MARCH 9, 2011
2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission Meeting was called to order on Wednesday, March 9, 2011, at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Lori Flanery, Deputy Secretary and proxy for Jonathan Miller, Secretary of the Finance and Administration Cabinet; John Esham, proxy for Governor Beshear; and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

OFM Staff Present: Tom Howard, Executive Director, and Secretary to the Commission, Steve Jones, Deputy Executive Director, Dwight Price, Kim Bechtel, and Marcia Adams.

Other Guests: Mr. Ed Ross, Commonwealth of Kentucky Controller; Kristi Culpepper from Legislative Research Commission (LRC); and Travis Powell, Attorney, 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 December 13, 2010. A motion was made by Mr. George Spragens and seconded by Ms. Lori Flanery to approve the minutes as written. Motion **CARRIED**.

Market Commentary - Mr. Price explained the stock market has had a huge up move since the last meeting accompanied by unusual turmoil with the Middle East being the primary reason. The economy is strengthening as unemployment has declined although gas is at \$3.50 a gallon, and oil is at \$105-\$120 barrel. The bond market conversely has sold off somewhat, with investors reallocating funds from bonds to stocks. In the last two years, the Commonwealth has moved 20+ basis points higher in yield which is both good news and bad news. New investments are at higher yields but current performance will reflect the decline in prices.

Treasurer Hollenbach asked if there had been noticeable disruption in the actual oil supply or is the market trading on future expectations. Mr. Price answered that Libya had 1.6 million barrels of production a day which is now down to 600,000 barrels a day. However, Saudi Arabia says they will make up the difference, up to 3 million barrels a day. Egyptian oil stays in country so there is no disruption from them. Most economists predict that gas will go up to \$4 a gallon.

The bond market yields would be higher if not for the Federal Government buying everything the Treasury is issuing right now. For instance last week the Treasury sold new 5-year notes. The Federal Reserve bought the entire issuance. After June, when QE2 (Quantitative Easing) ends, the reduction in demand should drive prices down resulting in higher yields. If the economy is unable to sustain itself, there is a possibility of QE3. Mr. Steve Jones added that the Federal Reserve believes the recovery is self-sustaining meaning that there is a low probability of a QE3 unless some other disruption causes major chaos. More clarity should be available by the time of the next quarterly meeting.

Portfolio Performance - Mr. Jones briefed the Commission about the responsibilities of the Office of Financial Management (OFM). In maintaining the state's portfolio, OFM sustains the Commonwealth's liquidity on a daily basis. The first chart, Daily Liquidity, shows the market value

of the Commonwealth's total portfolio on a given day. The lower line is the daily liquidity, the cash available on hand for a given day. This chart shows a jagged line of revenue and large expenditures (like payroll) over the past 3 years. The lower line also shows our liquidity matching the revenue line and this jagged line shows the daily volatility. Mr. Tom Howard stated that this chart is also what the rating agencies look at. They place a premium on liquidity and want to know that the State has the ability to make the payments budgeted in times of financial stress. This demonstrates to them that the Commonwealth has approximately \$1 billion dollars on a given day excluding the day of SEEK (Support Education Excellence in Kentucky) payments.

Mr. Jones continued with the Comparative Yields Chart showing the Short Term Portfolio. This is primarily the General Fund plus the operating accounts for many agencies. It has the most volatile cash flow of any portfolio. This chart shows the returns for Fiscal Year 2006 through the present with Fiscal Year 2011 only through February. The blue column is the short term pool return, the red column is the Federal Fund Rate and the yellow column is the T-Bill Index, the target we manage against.

Mr. Price discussed the Intermediate Pool chart showing the 1-year, 3-year and 5-year terms against its index. This index is 75 percent 0-3 year government bonds, 15 percent T-Bills and 15 percent very short mortgages. The chart shows that the pool has underperformed more in the last year than the previous three years. The reason for this under-performance is that the pool is shorter duration than the index. During the 2008 crisis, the portfolio was moved to a more conservative style. The monthly Investment Reports displays the portfolios performance versus its index. Given the style of management, the portfolio will lag when the index goes up but does better when the index declines. Mr. Jones added that this 5-year period has been a period of falling yields and rising prices, which is the worst scenario for the way the portfolio is structured.

Treasurer Hollenbach asked if our strategy was to lag our index, how much more risk do we have to take to match the index and what does that mean in dollar terms. Mr. Jones responded that as interest rates go up, prices will fall but the portfolio will out-perform. In this scenario, the more conservative strategy actually provides higher income levels. Mr. Price added that if interest rates do go up, the Commission will see the portfolio's performance catch up and out-perform the index. Mr. Howard added that this index was adopted by the Commission in 1998 and that staff is examining possible updates to the index in the future.

Mr. Price stated that with no true index to follow, it has been difficult to meet. We have underperformed in the mortgages because of it. Staff will propose a new index with what our statutes and regulations require. Mr. Jones added that comparing the portfolio's performance to the index shows the level of risk and whether the portfolio managers are straying from the index composition. Portfolio manager's performance is judged through comparison to a peer group. Staff has been unable to identify an appropriate peer group. Mr. Spragens suggested an appropriate peer group would be another selection of states, if they were willing to release that information. Mr. Jones responded that the results would be distorted due to different state's accounting approaches and mix of assets. The comparison would not be apples to apples. Mr. Spragens added that cash flows in Kentucky are different than say California or New York, Mississippi or Montana. Mr. Price related how an intern for OFM from the University of Kentucky sent a survey to all the states and results showed many variables. For instance, some states managed all the money together including, retirement etc. Some states mark to market everyday while others would use book value. There were basically fifty different ways that states managed their money. Mr. Spragens also added that the best

measure of success is past performance. Mr. Price stated that we view our index as the most appropriate way to invest the state's money.

Ms. Lori Flanery asked what continuing education (CE) is required. Mr. Price responded that as a CPA he does have CE requirements each year, but that most appropriate conferences are very expensive. Mr. Jones added that the CFA society only has voluntary CE requirements but these include a minimum number of ethics hours. Mr. Howard stated that the National Association of State Treasurers (NAST) has several appropriate CE courses and every other year had higher level offerings.

Mr. Jones presented the Annual Cash Distribution graph showing the cash the Commonwealth generates in any given year. The chart shows 2007 as the best year for distributing the most cash to state agencies. Since then, each year is declining due to declining balances and declining yields. Eventually these distributions will reach a bottom and then reverse and go up. Every month, the Office has paid a positive cash distribution out to the agencies. Mr. Howard added that the Bond Proceeds Pool was merged with the Intermediate Pool which allows more liquidity. Because all of these graphs are new, staff wanted to explain the content for ease of understanding.

Securities Update - Mr. Price explained the remaining two Asset-Backed Securities are still performing and should mature in approximately 15 months. Originally the unrealized loss on these securities was approximately \$4 to \$5 million dollars. With the continued paydowns and market improvements, the unrealized loss has declined to \$1.9 million. These securities ratings were downgraded in 2008 and are now being looked at for possible upgrade.

Mr. Jones discussed the Down-Graded Securities in the direct portfolio. Two securities have partially missed payments, resulting in a loss of approximately \$864,000. Since the Commission's last meeting, even with those losses, these securities have paid over 2.8 million dollars at par. The unrealized loss and gain has improved by 2.5 million dollars. The other securities are making full principal and interest payments while the problem two are making full interest payments. The securities are paying down approximately 1 million dollars per month at par. Staff believes that continuing to hold will create the most value for the Commonwealth. Mr. Spragens asked if staff expected the two problem securities to delay or to completely miss their principal payments. Mr. Jones stated that staff does not expect to receive those principal payments. Treasurer Hollenbach asked if these two securities were part of previous forbearance approvals and if so would the loss have been greater without forbearance. Mr. Jones stated that they were part of previous forbearance approvals. He continued that the Commonwealth is receiving approximately 80 cents of every dollar of principal and all the interest. The first security could be sold for 61 cents on the dollar resulting in a 40 percent rather than a 20 percent loss.

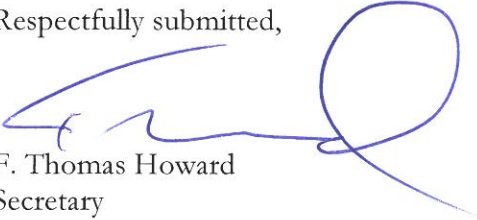
Mr. Spragens moved to extend forbearance for the Commonwealth to continue to hold the list of downgraded securities. The motion was seconded by Ms. Flanery. Motion **CARRIED**

Kentucky Bank Repo Program - Ms. Kim Bechtel updated the Commission with the Linked deposit program. There have been two improved banks and one addition to the list. The Farmer's Bank in Danville had an increase in non-performing loans so they were included on this list. Community Trust has improved and may drop off this list in the future. Ms. Bechtel is regularly monitoring each of the borrowers to confirm their compliance to the program. At this time, Staff recommends that no action be taken to call in these loans.

Other Business - Mr. Howard stated that staff continues to work within the RFP process for a new Custodial Bank. The General Depository contract should be announced on EMARS within a day or two.

With no further business before the committee, the meeting stands adjourned.

Respectfully submitted,

A handwritten signature in blue ink, consisting of a series of loops and a long horizontal stroke.

F. Thomas Howard
Secretary