STATE INVESTMENT COMMISSION
JUNE 12, 2008
MINUTES

The State Investment Commission Meeting was called to order on Thursday, June 12, 2008, at 2:00 p.m. in Room 76 of the Capitol Annex by Todd Hollenbach, State Treasurer. Other members present were Jonathan Miller, Secretary of the Finance and Administration Cabinet; Edmund Sauer, proxy for Governor Steve Beshear; and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

OFM Staff Present: Tom Howard, Executive Director, Steve Jones, Dwight Price, Kim Bechtel, Rob Ramsey and Marcia Adams.

Other Guests: Mary J. Celletti, Deputy Treasurer, Lori Flanery, Deputy Secretary of the Finance and Administration Cabinet, Katherine Halloran, LRC and Ed Ross, Comptroller, Commonwealth of Kentucky.

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. A motion was made by Mr. Spragens and seconded by Jonathan Miller to approve the minutes of the March 20, 2008 meeting as written. Motion **CARRIED**.

Dwight Price, Portfolio Administrator, Office of Financial Management, stated that the market over the last three months has been changing with yields first falling and then rising. Inflation is a concern, which means that interest rates need to rise in order to slow down inflation. Wall Street consensus is that Fed Funds, currently at 2%, will begin rising during the fall. Sub-prime mortgages (lower credit) are tightening, providing more stability to the markets. The Market has become concerned that the country is entering a period of Stagflation, which combines slow growth with high inflation. Inflation is only 3% now, compared to 12% in the 70's. We are probably not in a recession now, but we also are not growing very fast. The Fed's charge is to maximize economic growth, but also flight inflation. Probably the Fed will hold the Funds rate steady through the summer into the early fall.

Treasurer Hollenbach asked what does it mean to "technically" be in recession, is it two consecutive quarters of negative growth? Mr. Price answered yes and noted that you don't actually know until after the fact. The first quarter was low, but we were not negative. The second is not done yet, but it is running very low. However, we won't know until July or August. Mr. Spragens stated that for the last three recessions, we were out of the recession before it was determined that we were in a recession. Steve Jones, Portfolio Administrator, Office of Financial Management, stated the measurement of real GDP growth for the second quarter will come out at the end of July, be revised at the end of August, and be revised again at the end of September. The September number will be used to determine a technical recession. Mr. Price stated the Fed has been in easing mode, which is lowering interest rates. Currently, the Fed says that interest rates are basically neutral but while the risk of inflation has increased lately, they have a balanced bias.

Treasurer Hollenbach questioned whether the Fed really could cut rates further. Mr. Price remarked that Fed Funds are at 2% now and did go down to 1% a few years ago. There are diminishing returns to cutting rates. Historically, cutting interest rates would have helped with the housing, a big component of our economy, but recently mortgage rates have not gone down due to the mortgage crisis. Treasurer Hollenbach asked about the International influence on the market and how it was affecting the Commonwealth. Mr. Price remarked that oil is International and causing a problem with the rise in price. Mr. Jones stated the weakness of the dollar is part of what is affecting oil and a real drag to the economy. The Fed is trying to "talk" the dollar up to reverse the trend of oil price increases. Mr. Price says that the cost of a barrel of oil in Europe is cheaper, because oil is traded in dollars. Currently, the dollar is trading at $1.54 to 1 Euro, which causes oil to be 50% cheaper than here. With the recent flooding in the Midwest Corn Belt, the price of corn is at an all time high. This will cause food to become more expensive. Corn and oil are creating most of this inflation.

Treasurer Hollenbach questioned if the election cycle would affect us. Mr. Jones stated that the outcome of the election would not change the markets. Mr. Spragens said that unless the Federal Reserve had to change their short-term outlook, it probably wouldn't change their short-term rates until after November. They avoid all appearances of impropriety by being for one candidate or the other. If there is any change, it will come in the middle of November after the election.

Kim Bechtel, Office of Financial Management, reported on Auction Rate Securities. Ms. Bechtel stated that many Auction Rate Securities issued by municipalities are being refinanced. Most of the remaining Auction Rate Securities outstanding are issued by student loan corporations. Our Auction Rate Note yields are still above LIBOR. Mr. Jones remarked that there is no way to sell a number of these securities but we are still earning above market rates. We have enough liquidity from other sources, and we will continue to ride these and see what happens. The student loan market is improving as the Department of Education has stepped in with funding. The spreads on student loan asset backed securities have tightened as that market has improved. If this bleeds over to the Auction Rate Securities, we will start to see reductions in these balances.

Mr. Tom Howard, Executive Director, Office of Financial Management, stated that many issuers are filing notice with the SEC that they intend to support their auctions to drive those rates lower. This entire market is in runoff mode and is no longer viable. Ultimately, the credit on these securities is strong since they are backed by federally guaranteed student loans. The ultimate repayment is not in question, but current liquidity is. The difficulty is that alternative variable rate products generally require a credit support mechanism.

Currently, these are very expensive because of difficulties at the banks, which provide the support. We are experiencing that with Kentucky Higher Education Student Loan Corporation on their 7-day VRDO products, which are replacing their auction rate securities. It will take some time to transition between auctions and VRDO products.

Ms. Bechtel added comments about an article describing negotiations between the US Treasury Department on one hand and Goldman Sachs and Lehman Brothers on the other. They are discussing issuing Asset-Backed Commercial Paper. The proceeds will then be used to purchase student loan backed Auction Rate Securities, re-liquefying that market. The ABCP market has had problems since the securities in many cases are backed by sub-prime mortgages, but this structure would ultimately be backed by full faith and credit student loans. This would largely solve our liquidity issues.

Mr. Steve Jones began with updates on our TRAN position for the Fiscal Year through May 31st. On the investments versus the floating rate side of the interest rate swap, we made a little bit of money, as expected. On the fixed side of the swap versus the fixed debt that is outstanding, we expected to do better and have earned roughly four and a half million dollars. Total for the entire TRAN is close to five and a half million dollars of income. We expect by the liquidation date on June 26th, we should be at a 5.8/5.9 sort of income range, which is conservative. Mr. Miller asked if we budgeted for something else. Mr. Jones said we budgeted for five and a half so we are doing better than projected.

We are planning to do this again for fiscal year 2009. We are issuing 400 million dollars of fixed rate debt on Monday, June 16th, with a projected all-in yield of 1.9%. We are going to do an interest rate swap where we receive fixed rate. That market has moved dramatically with expectations of receiving close to 3.5 %. On the asset side we will pay 1-month LIBOR on the floating side of the swap and we will be receiving 1-month LIBOR plus a little on the assets. After we deduct our fee, we should break even. The projections when combined were that we would make 5 million dollars this year. Since those projections were made, the market has moved enough in our favor that the number is closer to 6 million.

Mr. Price commenting on the securities update stated that some securities have been downgraded below where we would be able to purchase them. The regulations are not clear on what should be done under those circumstances. Therefore, we look to the commission for forbearance if we want to hold them. If we want to sell, we do so. This was requested for the first time at our last meeting and the motion carried. These are same securities except for one, which was upgraded. Mr. Price commented that four of the securities listed in the packet were downgraded because FGIC was downgraded. These are now being rated on their own, but are still insured by FGIC, a monoline insurance company. Standing alone, three of the four have a rating of A2 and the fourth one is Aa2. Our asset backed securities need to be AAA rated to be purchased.

Previously these securities were rated AAA based on the FGIC insurance alone. FGIC's rating has now dropped to Baa3, which in turn reduced the particular securities. Mr. Howard noted that we continue to receive principle and interest payments on the securities as agreed.

Treasurer Hollenbach questioned the amortized cost noted on the chart and asked if it is the same as an aggregate cost. Mr. Spragens stated that you normally buy securities with either a discount or a premium. The premium or discount is then amortized over the life of the asset so that at maturity it is valued at par. Mr. Price stated that the accrual or accretion that we have is being booked as we go. We will only recognize the loss if the security is sold. Treasurer Hollenbach asked that the unrealized loss is unrealized because we have not sold but is it a real loss to the value of our portfolio. Mr. Spragens answered with depending on how you look at market values. With his bank's portfolio, he looks at the face value and the odds of getting the face value. He believes the odds of getting the face value on the Commonwealth's securities are excellent. He recommends hanging on to these securities as was agreed last quarter and not recognizing a loss. Mr. Price stated that the corporate securities listed last quarter were Bear Stearns, Sallie Mae, and Washington Mutual. Bear Stearns has been bought by JP Morgan and it is back up to AA. Sallie Mae and Washington Mutual have held their credit ratings. If we had sold them last quarter we would have lost 5.2 million. Currently the unrealized loss is 2.4 million. We have avoided a loss of 2.7 million by holding on to them. They mature so the price should continue to drift toward par. Treasurer Hollenbach asked Mr. Price if it was his recommendation to continue forbearance and retain the securities and Mr. Price responded affirmatively. Treasurer Hollenbach asked if anyone had any reservations or dissention on that point. There were no comments. Mr. Howard said there has been some positive movement in these securities. Sallie Mae has been recapitalizing. They have had access to funding to change their business model and that has been reflected in their price. Washington Mutual will need restructuring. He feels confident in what we have at the current time and that we do not need to absorb a loss

Treasurer Hollenbach questioned the Commonwealth's liquidity overall. He asked if we had any need to liquidate anything to shore that up. Mr. Price stated that these are in the securities lending portfolio. Mr. Jones said we have about 750 million of overnight repo, plus another 350 million in money markets so we can honor a 1.3 billion check today, if needed. We have another billion dollars we could turn into cash tomorrow, if needed. Mr. Jones noted that with the state's budget position and other uncertainties, we would keep the state's liquidity high. Mr. Price noted that at fiscal year end we maintain extra liquidity. Mr. Howard said that it is our most liquid time of year going into our driest time of year. Funds go out with appropriations or allotments throughout the year. We hit a seasonal low in cash around late October or November. Mr. Price stated that from July to December typically, more money is spent than is collected. Property taxes revenues come in December and January, followed by personal income taxes in April, and corporate income taxes in June.

Mr. Jones said that while we have a few securities that do not look good, the good news is that when looking at the entire portfolio we have an unrealized gain as of Wednesday, June 11th, of 4.5 million. We have earnings that have accrued but not paid of 48 million. So far this fiscal year, we have paid out close to 155 million. Mr. Howard noted that the 4 million positive market value position includes those negatives.

A motion was made by George Spragens and seconded by Jonathan Miller to grant the Office of Financial Management (OFM) permission to retain those securities whose ratings have dropped and to sell only when OFM deems it prudent to do so and that to revisit this issue at the next quarterly meeting.

Mr. Price, speaking on the proposed list of broker/dealers, explained that anyone who meets our qualifications and provides financials are included as an approved broker/dealer, however we do not do business with all the listed companies. We have 3 additions this year, CALYON (New York), Jeffries & Company, Inc, (Chicago), and Stifel Nicolas & Co. (Louisville). Mr. Spragens stated that when J P Morgan closed their investment offices in Louisville, most of the employees moved to Stifel Nicolas. Treasurer Hollenbach asked how the companies get on the list. Mr. Price said that OFM requests financials and checks to assure that they are qualified under administrative regulation. Treasurer Hollenbach asked if there were any firms that did not qualify and Mr. Jones stated that he had recently been contacted by three or four small firms that did not qualify. Mr. Howard noted that it is requested by the auditor to acknowledge the entire list by the commission including the new additions. Mr. Spragens made the motion to accept the list. It was seconded by Mr. Miller. Motion **CARRIED**.

No other business and the next meeting in September will be determined later.

A motion was made by Treasurer Hollenbach and seconded by Mr. Miller to adjourn the meeting. Motion **CARRIED**.

Respectfully submitted,

F. Thomas Howard
Secretary