

STATE INVESTMENT COMMISSION
JUNE 7, 2011
2 P.M. ~ ROOM 182 ~ CAPITOL ANNEX
FRANKFORT, KENTUCKY

The State Investment Commission Meeting was called to order on Tuesday, June 7, 2011, at 2:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Robin Kinney, proxy for Lori Flanery, Secretary of the Finance and Administration Cabinet; Ryan Keith, proxy for Governor Beshear; George Spragens, President, Farmers National Bank in Lebanon, Kentucky and Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky.

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

Other Guests: Mr. Ed Ross, Commonwealth of Kentucky Controller; and Kristi Culpepper from Legislative Research Commission (LRC).

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 March 9, 2011. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to approve the minutes with the name spelling change noted. Motion **CARRIED**.

Market Commentary - Mr. Price explained that interest rates have fallen to historic lows again and that the stock market is shaky as discussion of a possible double dip recession heats up. With no confidence in the stock market, people cut back on spending. Consumption is roughly 70% of the US economy. The jobs market was okay until the May report with only 54,000 jobs added and an increase in the unemployment rate. This is appearing to be repeating last year's trend of a spring slowdown followed by a fall and winter uptick, but the slowdown is more pronounced. It is difficult to make money when the 2-year Treasury note yields 40 basis points, less than one-half of a percent. Overnight repos on a good day yield 12 basis points. This morning, the yield was 6 basis points.

Mr. Spragens added that there are multiple factors inhibiting the economy and that the ability of the federal government to further support the economy is limited. Fiscal stimulus has reached its limit without new revenue sources. The biggest weapon is monetary policy. Short term interest rates are at their floor and Quantitative Easing (QE2) will expire June 30. There is little political willingness to engage in a third round of quantitative easing because the Federal Reserve already has a significant amount of market risk on its balance sheet and it is questionable whether it really accomplished all it intended to. Mr. Price stated that while it did not generate excess growth, it did prevent the economy from declining further.

Mr. Price added that the Fed is expected to begin withdrawing stimulus in early 2012 but the recent soft patch is pushing that time frame back. Mr. Spragens added that the prediction had been January of 2012, but with the most recent unemployment numbers, the prediction has been pushed back to late spring, 2012.

Portfolio Performance - Mr. Jones discussed the updated graphs of the Commonwealth's portfolios' performance. The Annual Cash Distributions graph displays annual distributions to the agencies beginning in 2006 and fiscal year to date for 2011. The graph shows a peak in 2007 with a

gradual decline since then. This is caused by a combination of declining interest rates and declining cash balances. Less cash invested at a lower rate results in lower income. Though the detail is not evident in this graph, cash distributions were made to agencies each and every month.

The second graph displays comparative yields for the short term, money-market type funds. These returns are compared to the Federal Funds Rate, a familiar index, and the T-Bill Index, the target index for managing the funds. The graph shows that the funds have consistently outperformed the two indices. Mr. Price pointed out that the graph also shows the Federal Funds rate declining from 5 percent in 2007 down to .25 percent now. Treasurer Hollenbach asked if both the T-Bill index and the Federal Funds rate were target indices. Mr. Jones responded that the T-Bill index is the target while the Federal Funds Index should be familiar to the Commission and is included for comparison.

Treasurer Hollenbach asked if the T-Bill index was part of the Commission's regulations. Mr. Jones responded that it is a part of the Prospectus for the particular pool. Staff had previously mentioned updating the Prospectus to more current indices, as this was last done in the late 1990's. Currently more indices, which may be more relevant, are available and staff is in the process of reviewing portfolio analytics systems. After that review is complete, a recommendation of updated indices may be made.

Treasurer Hollenbach asked if other states run their short term money against the same indices as the Commonwealth. Mr. Jones responded that each state has different methods of managing money with different mixes of funds being managed and different asset classes used. Therefore a comparison to other states would not provide meaningful information and the comparison would not be apples to apples. Mr. Tom Howard added that for very short-term funds, the 90-day T-Bill index would be a standard benchmark for most entities.

Mr. Jones continued with the third graph showing the daily liquidity, which rating agencies have expressed increased interest. In light of difficult state budget situations, the top line shows the total market value of the portfolios while the lower line shows the amount invested in same-day cash. The portfolios in total are liquid but this shows the amount available for immediate disbursement. The day to day fluctuations create volatility in the investment positions and create a challenge to manage.

Mr. Price discussed the Intermediate Pool Annualized Yield Difference graph showing monthly yields versus the target index. The target index is composed of 70% Government 1-3 year bonds, 15% mortgages with 0-3 average life, and 15% Treasury Bills. In the last year the portfolio has had a shorter duration than the index to conservatively protect against the possibility of rising interest rates. Because interest rates have fallen, the portfolio has underperformed the index. Treasurer Hollenbach asked about January of this year on the graph that shows the Commonwealth was lower than the index. Mr. Price replied that was a one month mark to market issue. Mr. Howard explained that third party price sources generally use a matrix pricing system which occasionally misrepresents the true value of a particular security.

Treasurer Hollenbach asked for confirmation that because of the conservative precautions in this pool, it is underperforming the index but that it would out-perform if interest rates rose. Mr. Price responded affirmatively and that the out-performance would be more dramatic if rates rose rapidly. Mr. Spragens added that the benefit to holding shorter securities in a rising rate environment is that it allows reinvestment of matured securities at a higher interest rate. Continuing, Mr. Spragens stated

that no matter what the quality of the bond, prices and interest rates are inversely related. As rates rise the price will drop and as rates fall the price will rise. The price change for shorter maturity securities is not as large as for longer securities. Shorter maturities also allow reinvestment at higher rates.

Securities Update - Mr. Price explained the Securities Lending Portfolio still contains the same two down-graded asset-backed securities. These securities continue to make all interest and principal payments with \$1.2 million of principal reduction at par over the last three months. The credit ratings have not changed. With expected performance, the securities should pay off completely in 2014.

Mr. Jones continued with the second page of the handout detailing the down-graded securities in the direct portfolio. All but two securities continue to make timely principal and interest payments and the market values are gradually improving. The other two securities have experienced principal losses although only \$30,000 in the last two months. It appears that the gradual reduction in new loans becoming delinquent may be helping these securities avoid further losses. Staff recommends holding all downgraded securities.

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

Kentucky Bank Repo Program - Ms. Kim Bechtel updated the Commission on the participants in the Linked Deposit Program. Ratios for some of the banks have improved while several others have not. It was noted that each participant pledges collateral equal to the outstanding loan balance plus a haircut. If one of the banks ran into serious difficulty, the Commonwealth's investment is protected with liquid collateral. Treasurer Hollenbach asked what is the benchmark for calling a loan. Mr. Jones answered that this chart shows the benchmarks of loan to deposit ratio of greater than 70% and non-performing loans to capital of greater than 25% for two consecutive quarters. The regulations allow the Commission the option, but not the obligation to call the loans if the ratios are not met for two consecutive quarters.

Treasurer Hollenbach asked if there was any information the Commission needs to proactively request. Mr. Spragens replied that each bank insured by the FDIC (Federal Deposit Insurance Corporation) submits quarterly call reports which are available on the FDIC website. Mr. Jones explained that staff already reviews each bank's financial status using the call reports. Mr. Jon Lawson asked if a loan were to be called, how much time would the bank have to pay off. Mr. Price responded that the Commonwealth has never called in any of these types of loans. Staff recommends that the Commission take no action at this time. The Commission took no action.

Broker-Dealer List - Mr. Price presented the updated Broker-Dealer list of firms which meet the qualifications to conduct brokerage business with the Commonwealth of Kentucky. Every year, the Commission approves the list identifying all of the broker-dealers which the Office of Financial Management may deal with during the next fiscal year. To qualify, a broker must be a primary dealer with the New York Federal Reserve, have over \$100 million in excess capital, or must have a physical presence within the state as outlined in administrative regulation. Two new firms have been added; Guggenheim of Chicago and Scotia Bank, a large Canadian bank. Treasurer Hollenbach asked if these firms pay any fee to be on this list. Mr. Price responded that no fee is involved and

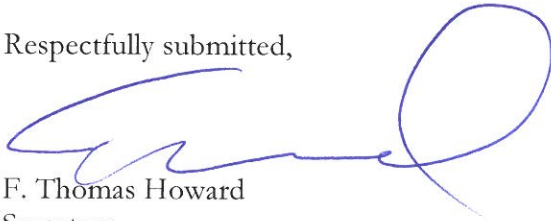
explained that staff reviews annual statements to confirm compliance. Staff recommended approving the list.

Mr. Lawson moved to accept the recommended Broker/Dealer list for Fiscal Year 2012 of firms qualified to do business with the Commonwealth of Kentucky. The motion was seconded by Mr. Spragens. Motion **CARRIED**.

Other Business - Mr. Jones advised the Commission of the completion of the Depository and Custodial Banking RFPs. The Depository Bank contract was awarded to J P Morgan Chase out of the Louisville office and the Custodial Bank contract was awarded to State Street Bank. Staff is diligently working on these transitions. An RFP for a Securities Lending Agent is in process. Staff will have an announcement at the next quarterly meeting.

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

Respectfully submitted,



F. Thomas Howard
Secretary