

STATE INVESTMENT COMMISSION
SEPTEMBER 11, 2008
MINUTES

The State Investment Commission Meeting was called to order on Thursday, September 11, 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, Secretary to the Commission, Steve Jones, Dwight Price, and Marcia Adams.

Other Guests: Ed Ross, Comptroller, Commonwealth of Kentucky and Mary John Celletti, Deputy Treasurer.

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 June 12, 2008. A motion was made by Mr. George Spragens and seconded by Mr. Edmund Sauer to approve the minutes of the June 12, 2008 meeting as written. Motion **CARRIED**.

Market Update - Dwight Price, Portfolio Manager, Office of Financial Management. During the last week, Fannie Mae and Freddy Mac were placed in conservatorship by the US Treasury due to inadequate capital levels. This has helped both agency and mortgage spreads as the market now views the debt to have stronger government support.

Mr. Price also explained that Lehman Brothers, the fifth largest Wall Street brokerage firm, is discussing some type of restructuring. Their stock was down 65% yesterday and is down further today. Moody's is threatening to down grade the firm, which will affect the willingness of other firms to trade with them.

Treasurer Hollenbach asked if Lehman's problems are related to the mortgage crisis. Mr. Price responded that they are. In the restructuring, Lehman is considering splitting the company into two components. Most of their bad assets, primarily mortgages and real estate, will be placed in a new firm called Spinco or REI. The problem is that these assets are being valued in the \$80 to \$90 range when they are only worth about \$40. Additionally, Lehman will sell Neuberger Berman, their money management subsidiary, to attract additional capital.

Mr. Jones added that liquidity is the key issue. There simply are no buyers for mortgage related assets, but that forced sales from CLO's are pushing prices so low that they no longer make economic sense. Investments are trading purely on fear with no regard for technical factors.

Treasurer Hollenbach asked if Washington Mutual was just a few steps behind. Mr. Prices answered that they were reaffirmed at BBB yesterday by S&P. Mr. Jones added most of what is on WAMU's balance sheet will be the actual loans as opposed to securitized investments. The accountants allow them to not mark those loans to market. This buys time as the losses are stretched over time. The question is whether they can generate enough profitable business to offset the eventual losses.

Auction Rate Notes - Mr. Jones stated that the New York Attorney General has sued a number of Wall Street firms over marketing of auction rate securities. Seven have settled with them. The basis of the suit is lack of full disclosure at the time of sale. The settlements have involved a small fine paid and the agreement to purchase the securities back from retail customers at par. Following that, they will work on cleaning up the rest of the market. Bank of America has repurchased one position which the state held at par. With the remaining positions, the state is locked in holding an illiquid security at an above-market yield.

Treasurer Hollenbach asked how this impacts our portfolio. Mr. Jones answered that we hold about \$120 million of auction rate securities. This money is locked-up in securities which can not be sold, but earn an above market rate. Mr. Howard stated that the bulk of these are federally insured student loans which carry little credit risk. The problem is entirely liquidity. As refinancings pick up there should be a slow run off of these securities.

TRAN - Mr. Jones discussed last fiscal year's TRAN. With a \$350 million dollar position, we were able to earn roughly \$5,919,000. This exceeds our projections by roughly \$400,000. Mr. Jones stated that we did another TRAN for this fiscal year. We issued \$400 million in notes with a coupon of 3% and an all-in cost of funds of 1.9%. We executed an interest rate swap with UBS with the same notional amount as the note issuance. We will receive a fixed rate of 3.29% and pay 1 month Libor. Our expectation is roughly \$5.5 million of income for this fiscal year. For the first 2 months, we have earned a little over \$300,000 matching the assets to the floating side of the swap and about \$775,000 on the fixed side of the swap versus the notes for a total of roughly \$1.1 million. This is ahead of expectations.

Securities Update - Mr. Price discussed holdings in the securities lending portfolio. The first five securities discussed are asset-backed securities and have not changed since last meeting. These are securitized packages of mutual fund fees. Each of these securities is insured by FGIC. Since FGIC was downgraded, these securities were also downgraded. Again, these securities continue to perform making all expected principal and interest payments. They should all be paid off at par by 2012.

The two Corporates are the same as last time. First, Washington Mutual has been affirmed with a BBB credit rating. This security matures in May 2009. This security is senior bank debt which is the strongest type of debt issued.

Treasurer Hollenbach questioned whether Washington Mutual had a national footprint. Mr. Price answered and Mr. Jones added that their deposit base is mostly west coast but their mortgage production is nationwide. Mr. Price continued that Sallie Mae remains stable and is performing.

Mr. Jones said that the second page shows securities held in our portfolio which have been downgraded. In most of these cases, the security in question had credit support in the form of insurance. As the insurers have been downgraded, the securities they insure are downgraded. In each case, the securities are making full principal and interest payments. Mr. Price added that the short average life shows that most of the principal will be coming back very quickly. Treasurer Hollenbach asked if this information was for a vote on forbearance and Mr. Jones remarked affirmatively. Mr. Spragens added that if an investor has cash to invest at this time, everything is at a bargain basement price out there.

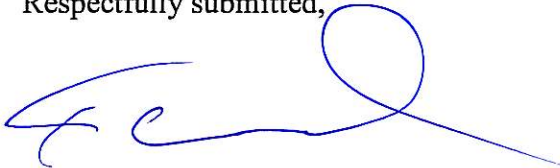
Treasurer Hollenbach asked if this was the list of securities that have fallen below our requirements. Mr. Price answered affirmatively. Mr. Jones reminded the commission of the resolution this commission adopted that staff would bring this list of downgraded securities that the Commonwealth owns to the commission so staff has the option to continue to hold these. Mr. Spragens made the motion to accept the list of seventeen downgraded securities for forbearance. It was seconded by Mr. Miller. Motion **CARRIED**.

No other business at this time

Discussion commenced for scheduling the next meeting on December 11, 2008 at 2 p.m. and has been agreed to by the commission and so noted.

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

Respectfully submitted,



F. Thomas Howard
Secretary