State Investment Commission

September 25, 2013
1:00 p.m. ~ Room 182 ~ Capitol Annex
Frankfort, Kentucky

The State Investment Commission ("the Commission") meeting was called to order on September 25, 2013, at 1:00 p.m. in Room 182 of the Capitol Annex by Todd Hollenbach, Kentucky State Treasurer. Other members present were Lori Flanery, Secretary of the Finance and Administration Cabinet; Mary Lassiter, proxy for Governor Beshear; Jon Lawson, President, Bank of Ohio County, Beaver Dam, Kentucky and George Spragens, President, Farmers National Bank in Lebanon, Kentucky.

Office of Financial Management ("OFM") Staff Present: Ryan Barrow, Executive Director, and Secretary to the Commission, Steve Jones, Deputy Executive Director, Sandy Williams, Deputy Executive Director, Kim Bechtel, Kurt Kemper, Ian Blaiklock, and Marcia Adams.

Other Guests: Ed Ross, Controller, Finance and Administration Cabinet, Jane Driskell, State Budget Director, Joshua Nacey from Legislative Research Commission (LRC), and Brian Caldwell, future OFM Staff member who will start on October 1st.

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 the June 14, 2013, meeting. A motion was made by Mr. George Spragens and seconded by Mr. Jon Lawson to approve the minutes. Motion **CARRIED**.

Treasurer Hollenbach recognized Mr. Steve Jones who began by informing the Commission that the Securities Update will no longer be a part of the meeting. All securities which the Commission previously granted forbearance to hold have been liquidated. While a full accounting of the economic impact to the Commonwealth of holding these securities will be available at the next meeting, it is estimated that the impact is in excess of $60,000,000.

Intermediate Pool Performance – Mr. Steve Jones began by discussing the Intermediate Pool Performance Report. The first chart shows the annualized return for the pool and the benchmark. In May and June, the benchmark was negative and the Pool underperformed the benchmark. July bounced back to positive returns for both while August also showed negative returns. This is also apparent on the next chart for Annualized Yield Difference. The Fundamentals chart shows that the Pool yield is higher than the benchmark, the duration is shorter, and the pool is more negatively convexed. The securities held by the Commonwealth are shorter in maturity on average than those in the benchmark but have more optionality. When interest rates rise dramatically and rapidly, as occurred in May, June and August, optionality causes the duration or maturity to extend generating unrealized market losses. However, the higher yield creates more margin to absorb unrealized losses.

At the end of May, the Intermediate Pool yield was 39 basis points, the lowest it has ever been. On May 21st Chairman Ben Bernanke of the Federal Reserve Board indicated that beginning in September, the Federal Reserve would begin to slow the rate of purchase of long term securities, commonly termed tapering. The following 6 weeks was the most rapid increase in longer term rates over such a short period of time. Because the yield on the portfolio was so low, there were not enough interest earnings to offset the unrealized losses this increase in rates caused in May and June. Rates moved in favor of the pool in July but rose again in August. While September information is not included in the package, the Fed decision not to taper in September has resulted in recovery of all of the August and one third of the June losses.

The Contribution to Duration chart provides further detail on the portfolio. The chart shows that Agency Securities are approximately 43% of the pool, and Mortgage-Backed Securitized Securities are 13% of the pool, meaning that 56% of the pool has negative convexity. At the end of May, these two components comprised 65% of the pool. Staff is endeavoring to further reduce the convexity risk within the pool.

Treasurer Hollenbach asked if optionality is a hedging program. Mr. Jones replied with an example. The Office could purchase a 2-year agency security with no optionality and collect coupons every six months until maturity when the principal is returned or the Office could buy a 2-year agency security with a 1-year call meaning that in 1 year, the agency has the right to pay back the principal. Treasurer Hollenbach confirmed that the call is at the discretion of the issuing agency. Mr. George Spragens explained that the same thing happens with Mortgage Backed Securities. If interest rates fall, the mortgage borrowers within the underlying pool have the option to refinance their mortgage which results in return of principal to the owner of the security. If rates rise, the opportunities to refinance will be limited meaning that the security will extend as there will be less early return of principal.

Limited Term Pool Performance – Ms. Kim Bechtel discussed the monthly performance of the Limited Term Pool compared to the S&P Local Government Investment Pool benchmark. The first graph shows the Commonwealth consistently out-performing the benchmark. The second page lists all the securities held in the Pool as of the end of August, 2013. The next graph shows a breakdown by ratings and sector distributions. The fourth page shows the weighted average liquidity and maturity levels of the Pool. The required liquidity and maturity limits have been met. The NAV (Net Asset Value) chart shows that the shadow NAV (Market Value) has been consistently near 1.0. Any divergence above or below .0025 would require staff to notify the Commission. To date, the maximum divergence has been 0.000182. The liquidity analysis memo shows the largest daily and weekly withdrawals plus the largest funds within the pool. Staff recommends maintaining the 15% daily and 30% weekly liquidity requirements. No action from the Commission is needed if there is no change in requirement. The Commission took no action.

Cash Considerations – Mr. Kurt Kemper detailed the re-occurring events which impact the Commonwealth's cash balances. The seasonal pattern is steady outflows throughout the year with larger inflows for property taxes in December, personal income taxes in April, and corporate income taxes in June. The low point in cash balance generally occurs in the middle of November. The table at the bottom of the page shows the re-occurring weekly events of $6-$8 million net Medicaid payments out every Tuesday and $1-$40 million payments in from the federal government for the transportation cabinet. The monthly events are as follows: 1) debt outflows on the 1st business day of the month for a varying amount, 2) school outflows on the 4th business day of roughly $200 million, 3) Medicaid outflows of $80-$100 million on the 8th, 4) payroll outflows of $40-$50 million on the 15th and 30th, and 5) lottery inflows of $15-$20 million on the last business day of the month. Mr. Lawson asked about the size of debt payments. Mr. Kemper answered that they have varied from a few hundred thousand to over $110 million.

Credit Considerations – Mr. Ian Blaiklock discussed the Approved Credit List. This is the list of credits which the Commission has approved in which staff may invest. Staff is recommending that Abbott Laboratories and AstraZeneca be added for debt issues, and that the Bank of Montreal and Barclays be added for repurchase agreements. Staff is also recommending that Bristol-Myers Squibb be removed. Mr. Spragens asked how many names on the list does the Commonwealth actually invest in. Mr. Jones replied that it is approximately one-third of the list. Treasurer Hollenbach asked if staff was considering the new additions on the list for future purchases. Mr. Blaiklock replied in reviewing the pharmaceutical industry, it made sense to include these two companies

A motion was made by Mr. Spragens and seconded by Mr. Lawson to accept the Credit Considerations for Purchase List as presented. Motion **CARRIED**.

Trading Limits – Mr. Jones reported to the Commission that with staffing changes and the future addition of Brian Caldwell, trading authorizations needed to be updated. The proposed changes show the size of transactions each investment staff member will be able to perform in each market segment. The recommended levels are noted as Senior Portfolio Manager, Junior Portfolio Manager, and Money Market Trader with the appropriate staff designations by experience.

A motion was made by Mr. Lawson and seconded by Mr. Spragens to accept the Trading Limits effective October 1, 2013, as presented. Motion **CARRIED**.

Linked Deposit Program – Ms. Kim Bechtel discussed the financial condition of four banks currently participating in the Linked Deposit Program. The two of greater concern are the Bank of Columbia and the Deposit Bank of Carlisle with non-performing loans to capital ratios of 50% and 45% respectively. Ms. Bechtel reminded the Commission members that all these loans are well collateralized and that no action is required. Treasurer Hollenbach questioned whether Bank of Carlisle should be removed. Finance Secretary Flanery suggested following up on the Treasurer's question and communicating with the banks. Mr. Lawson added that the collateral values protected the Commonwealth from credit risk. Mr. Spragens added that Call Reports are available on the FDIC (Federal Deposit Insurance Corporation) website. Mr. Jones stated that staff already reviews the Call Reports. Treasurer Hollenbach asked staff to communicate with the banks on the list by the December meeting and report back to the Commission No action was taken by the Commission at this time.

With no further business, the meeting stands adjourned.

Respectfully submitted,

Ryan Barrow
Secretary