

STATE INVESTMENT COMMISSION
September 28, 2006

MINUTES

The State Investment Commission was called to order by Jonathan Miller, State Treasurer, on Thursday, September 28, 2006 in Room 76 of the Capitol Annex at 2:00 p.m. Members present were John Farris, Secretary, Finance and Administration Cabinet; Libby Milligan, proxy for Governor Ernie Fletcher; and Jonathan Miller, State Treasurer.

Treasurer Miller verified that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. Farris and seconded by Ms. Milligan to accept the minutes of the June 19, 2006 meeting. Motion CARRIED.

Dwight Price, Portfolio Manager, Office of Financial Management, presented the portfolio update. He stated that at this time of the year liquidity is the main concern for staff. He pointed out that 75 percent of the Commonwealth's revenue is received in the second half of the year, but is expended evenly throughout the year. Mr. Price stated that in the last three months interest rates have fallen and duration on the portfolio has been running short. Mr. Price indicated staff will continue to monitor the housing market and its affect on the economy.

Steve Jones, Portfolio Manager, Office of Financial Management, discussed the interest rate steepener swaps. He reminded the members that last winter the yield curve inverted (short rates higher than longer rates) and a trade was executed which resulted in \$70,000 of income to the Commonwealth. Mr. Jones stated that since that time the curve has re-inverted and a similar trade was executed. Mr. Jones reported that the trade has resulted in a \$60,000 loss as of close of business September 22, 2006. Mr. Jones indicated that the trade was executed because in a steepening environment, the spreads on various investments are expected to widen resulting in a loss and this trade serves as a partial hedge of that potential.

Mr. Jones informed the members that the TRAN resulted in \$6.6 million net benefit to the General Fund in 2006. Mr. Jones further stated that the fees in the amount of \$300,000 were collected which covers the overhead for the Office of Financial Management. Treasurer Miller asked what the fees were collected for. Mr. Jones indicated that a fee of 5 basis points is charged to manage the TRAN. He further stated that this amount is used to pay the salaries and overhead for the Office of Financial Management. Mr. Jones indicated that the 2007 TRAN will be approximately \$150 million. He stated that the cost of funds on the debt is 3.86 percent and the swap is receiving a fixed rate of 5.61 percent which results in a spread of approximately 180 basis points. Mr. Jones pointed out that the 2007 TRAN should result in a net benefit to the Commonwealth of \$2.5 million.

F. Thomas Howard, Executive Director, Office of Financial Management, stated that the lower income is a result of the ending balance of approximately \$800 million in cash in the General Fund. As a result, staff did not expect the balance in the General Fund to be as negative as in previous years. He pointed out that the IRS limits the amount that can be borrowed based on the projected negative balance in the General Fund.

Secretary Farris asked if the investments versus the floating side of the swap and the debt versus the fixed side of swap were two separate transactions. Mr. Jones indicated that there were three transactions: issuing fixed rate debt; executing the interest rate swap where the Commonwealth receives fixed and pays one month LIBOR; and investing at one month LIBOR assets to match the floating side of the swap.

Mr. Price indicated that the bulk of the earnings results from the fixed side of the swap because the Commonwealth is allowed to keep the arbitrage. Mr. Price indicated that the intent is to make as much money for the Commonwealth as possible and it works best to capture the arbitrage between taxable and tax free.

Mr. Howard indicated that the Kentucky Asset/Liability Commission Semi-Annual report will be available by September 30. Mr. Price indicated that a new member has been named to the Commission and he should be at the next meeting.

With no further business before the Commission, the meeting was adjourned.


Secretary
State Investment Commission