

MINUTES OF THE
OFFICE OF THE STATE TREASURER
STATE TREASURER'S INVESTMENT COMMITTEE

REGULAR MEETING
Santa Fe, New Mexico
9:00 AM, March 10, 2009

The Regular Meeting of the State Treasurer's Investment Committee (STIC) was called to order by Mr. Mark Valdes, Chairman Designee, on this date at approximately 9:05 AM in the Bob Barth Conference Room at the office of the State Treasurer, 2019 Galisteo Street, Building K, Santa Fe, New Mexico.

ROLL CALL

A quorum was present, as follows:

Members Present:

Mr. Mark Valdes, Chairman Designee and Deputy State Treasurer
Mr. Steven Bohlin, Public Member
Mr. Paul Cassidy, Public Member
Mr. Scott Newman, Interim Chief Investment Officer
Ms. Olivia Padilla-Jackson, Director, Board of Finance

Members Excused:

Mr. James B. Lewis, State Treasurer

Staff Present:

Ms. Kirene Bargas, LGIP Portfolio Manager
Mr. Ron Crespin, Finance and Budget Bureau Chief
Ms. Randilynn Lord, Attorney
Mr. Arsenio Garduño, Collateral Manager
Mr. Joaquin Lujan, BPIP Portfolio Manager
Mr. Orlando Romero, State Cash Manager

Others Present:

Mr. Gillis Lang, DFA Economist
Ms. Stephanie Schardin, Deputy Director, Board of Finance
Mr. Dan White, LFC Analyst

1. APPROVAL OF AGENDA

**Member Bohlin moved approval of the Agenda, seconded by Member Cassidy.
The motion was voted on and passed 5-0 by voice vote.**

2. APPROVAL OF FEBRUARY 11, 2009, MINUTES

Member Padilla-Jackson moved approval of the Minutes of February 11, 2009, seconded by Member Cassidy. The motion was voted on and passed 5-0 by voice vote.

INVESTMENT REPORTS

Month ended February 28, 2009

3. General Fund Investments

Mr. Newman presented a summarization of the investment activity as of February 28, 2009. The market value of the General Fund Investment Portfolio, net of TRANS, was \$1.701 billion, down from \$2.05 billion at January 30. This compares to \$2.23 billion at the same point last year and \$2.57 billion at the same point two years ago. The market value of the portfolio decreased 16.93% to \$1.701 billion, down from \$2.05 billion at January 30. This decrease was due primarily to outflows outpacing inflows to the Liquidity portfolio.

The purchase yield was 1.93% at month-end, up from 1.68% in January. The weighted average term of the portfolio increased to 566 days. Effective duration of the CORE segment was 1.69 years, which is 92% of the benchmark's duration, 1.84 years.

During January, there were five purchases for the CORE portfolio with an aggregate par value of \$165 million. Both Treasury bills and TLG corporate bonds were purchased. Additionally, two TLG corporate securities were sold during the period, realizing gains of \$1.42 million. These sales amounted to an aggregate par amount of \$40 million. There were three purchases of CDs in the Liquidity portfolio with an aggregate par value of \$15 million.

February earnings were \$4.40 million, representing a 56% decrease from January earnings of \$10.00 million, which were inflated due to gains realized on the sales of securities. Fiscal year earnings total \$57.21 million, compared to \$87.96 million through the same period last fiscal year.

The General Fund outperformed its benchmark with an earned yield of 3.09%, compared to a 2.43% two-year CMA/CMT 12-month moving average month-end yield. Annualized total return for the CORE was 9.87% for the month of February, while the benchmark realized an annualized total return of 6.51%.

Mr. Newman commented about the announcement made two weeks ago about the reserve primary fund and how it was addressed within the LGIP. The reserve primary fund announced it would create a special reserve fund from the remaining assets to reserve against potential and pending legal costs, potential damages and potential losses. At the same time, they indicated they would continue making distributions of principal to participants, and the remaining would be the reserve amount, funds frozen indefinitely because those proceeds would be paid out after legal issues are settled.

With regard to how the General Fund is impacted, Mr. Newman made the point that, as far as his understanding goes, the State Treasurer is one of the few funds in the state exceeding revenue forecasts.

Mr. Newman added that, at this point there are only estimates of any loss incurred within the portfolios that will not be known until all funds are distributed and how long the legal process takes. He commented this is a question for the accountants to come up with a plan to reserve against the losses and realize them over a certain period of time, not all at once.

Chair Valdes added that a reserve was set up for the LGIP. Being that the General Fund portfolio has other self-earning accounts and various other reserves, it would be important for the State Treasurer's Office (STO) to sit with the DFA and LFC and determine how to account for the Reserve Primary Fund action. It will be important to determine as soon as possible how to account for the reserve in monthly interest earning allocations.

Mr. Newman added that every mutual fund registered with the SEC has in its prospectus that they are allowed to use fund assets to defend against lawsuits.

4. LOCAL GOVERNMENT INVESTMENT POOL (LGIP)

Mr. Newman reported the market value of the LGIP portfolio was \$1.32 billion, compared to a market value of \$1.43 billion at the same period last year and \$806 million at the same period two years ago. During the month, the market value of the portfolio decreased by 8.33%, from \$1.44 billion at January month end to \$1.32 billion, due primarily to participant withdrawals outstripping participant contributions. The gross yield was .5887%, a 45% decrease from January month end of 1.08%. The weighted average maturity declined to 28 days, down from the weighted average maturity of 29 days and within requirement of 60 days or less.

Investment activities in the LGIP portfolio totaled \$636 million in purchases and \$61 million in sales. Purchases included \$50 million in TLGP-CP, \$525 million in Treasury Bills, and \$61 million in Agencies. During the month there was an agency security sale of \$61 million. LGIP earnings for February totaled \$1.1 million, a 15% decrease from January earnings of \$1.3 million. Fiscal year-to-date earnings totaled \$17.4 million, compared to \$36 million through the same period last fiscal year.

The 30-day net yield of the LGIP was .990%, outperforming the 30-day net S&P Rated Government Investment Pool (GIP) index by 17 basis points. The 30-day gross yield of the LGIP was 1.04%, outperforming the 30-day gross S&P Rated GIP index of 1.00%. There was no administration fee assessed to participants for February.

Based upon the announcement on February 26 by the Reserve, the Reserve Primary Fund loss amortization plan that had been instituted has been discontinued. Also with that, the LGIP had a large position in the Reserve Primary Fund.

Member Cassidy said that he appreciated Mr. Newman sending out the ratings report, and said it was very appropriate. He said they need to recognize they will not reach the benchmarks.

Mr. Newman added that two other funds, Colorado and Florida, took similar measures and also bifurcated their portfolios that had exposure. Their manner was different in that they took out the anticipated loss on their position, and his understanding is that they were put on negative watch by the S&P.

He asked for comments from the committee on managing the portfolio going forward and whether they should maintain a more conservative management style in the portfolio.

Member Bohlin commended Mr. Newman on setting aside in the side pocket the reserve position for the expected loss. In terms of how the LGIP should be run in the future, in the past he has spoken of his dislike for how much was in money market mutual funds. It is not that he dislikes them, but that it basically leaves running the fund to somebody else. The STO was caught because someone else managed the money and they had Lehman paper. If it does cause for a slightly lower yield, he said he would rather see management of the portfolio done by the manager, meaning the STO, which is the proper course going forward.

Member Cassidy said he would prefer to err on the side of a more conservative type of investments to avoid these situations going forward.

Mr. Joaquin Lujan said the LGIP is a good example of what is important about the current thinking across all portfolios. They have said this is how they estimate losses and this is how it is smoothed. They have tried to stay invested in primary funds to boost yields to meet the amortization. It is important to remember this is a non-performing asset now and earnings are going to the General Fund and BPIP participants.

Member Padilla-Jackson stated that the same discussion has to be had on the General Fund and the BPIP sides. When talking about investment strategy, she felt it important in terms of the overall approach to err on the side of caution on the General Fund and to have more discussion about what limits to take into account. She said she would like to see more Treasury investments.

Mr. Newman replied that he appreciated the concerns. A lot was learned from September on different levels regarding fund management in both BPIP and General Funds. Their management style has become much more conservative in terms of assets being bought; and in particular, they have become conscious of different variables associated with individual securities that are bought. They are making sure everything they buy has no hair on it any longer, they are not taking smaller deal sizes to pick up a couple extra basis points, and they are sacrificing things that do have a little extra yield. They are asking questions that were implied in the past.

He asked Member Padilla-Jackson about her comfort with the size of position taken in commercial paper.

Member Padilla-Jackson said that she felt a great job was done in managing credit over the past year. She noticed the BPIP investment in TLGP paper of over 50% and commented that the policy statement had a 35% restriction for an agency position.

Member Bohlin said he does not have a problem with that. There is some liquidity premium that is being priced into those but not a credit issue. He agreed that there is a 35% policy in place for any single agency position.

Mr. Newman asked the members of the committee for the corrective action they would like to take.

Member Padilla-Jackson said she was advised by Marty Daly that it does not mean they have to liquidate immediately, but eventually have to get back down to the policy limit.

Mr. Lujan said it is appropriate to ask that question for clarity. It has a 20% risk wave that people have to carry on their books just like an agency, but it has FDIC like a Treasury, but vastly more liquidity in TLGP paper, so they erred on the side of being closer to a treasury than an agency.

Following discussion with input from most of the members regarding the portfolio managers' interpretation of the rule and whether this falls under investments permitted by policy and how they are insured, Member Padilla-Jackson suggested that the language be modified and the policy clarified. She said that her preference would be to clarify the policy to provide a specific section for TLP with its own limit or bring it down to 40%, which is the limit for corporate bonds.

Ms. Lord requested a more formal interpretation from Member Padilla-Jackson for the amendments to the policy.

6. BOND PROCEEDS INVESTMENT POOL (BPIP)

Mr. Lujan reported that the market value of the Tax-exempt BPIP was \$604.3 million, roughly in line to the \$600.2 million one year ago and higher than the \$463.1 million two years ago. The market value of the fund decreased by 1.1% to \$604 million from \$611 million at January month end.

The Tax-exempt BPIP month-end purchase yield and term were 2.21% and 1.81 years. The month-end yield was 66 basis points below the two-year constant maturity agency index (12-month moving average) 2.87%. There were three sales of FDIC insured corporate bonds (TLGP) and one sale of a Federal Home Loan agency bond during January, realizing a total gain of \$1.87 million on an aggregate par amount of \$60 million. Proceeds were reinvested into TLGP FRNs and used to service March debt payments.

Interest earnings for the month totaled \$3.13 million, an increase from January earnings of \$1.48 million. Fiscal year-to-date earnings totaled \$15.67 million.

The market value of the Taxable BPIP was \$873.2 million, compared to a market value of \$827.5 million one year ago and \$773.3 million two years ago. During February, the market value of the fund decreased to \$873.2 million from \$993.5 million at January month end. The Taxable BPIP month-end purchase yield and term were 2.56% and 2.06 years. The month-end yield was 31 basis points below 2.87%, which is the month-end yield for the two-year Constant Maturity Agency 12-month moving average index.

There were five purchases of floating rate TLGP notes and three sales of fixed rate TLGP notes during February, with an aggregate par amount of \$150 million. In short, these trades realized gains in fixed rate bonds while repositioning into floating rate bonds in an up-rate environment.

Mr. Lujan reported that February interest earnings totaled \$3.06 million, an increase from January earnings of \$1.74 million. Fiscal year-to-date earnings totaled \$20.64. He added that

they do not have access to \$26.9 million, which is the reserve position that is not performing, but the earnings take that into account.

Member Padilla-Jackson asked if the potential loss of \$27 million is being reflected in the principle account.

Mr. Newman explained it is important to recognize that the reserve primary fund is positioned through all five portfolios as being a non-performing asset as opposed to referring to it as a potential loss.

6. SUMMARY OF BROKER PARTICIPATION

Mr. Newman presented a summarization of the broker participation for security purchases for February and the fiscal year to date, with additional breakdown by asset type and market.

7. ECONOMIC AND INVESTMENT OUTLOOK

Mr. Newman presented a brief economic and investment outlook and there followed a short discussion on how the members view the future of the economy and investment strategies.

CASH MANAGEMENT AND COLLATERAL REPORTS

8. STATE AGENCY DEPOSIT BALANCES IN FINANCIAL INSTITUTIONS AND INTEREST VS. NON-INTEREST BEARING ACCOUNTS – JANUARY 31, 2009

Mr. Orlando Romero reported that, pursuant to section 8-6-3.1 NMSA 1978, the State Cash Manager shall submit to the State Board of Finance a report showing state fund balances in each Financial Institution established pursuant to this section. He presented a summary of State Agency Accounts in each institution through the month ending January 31, 2009.

Additionally, the STO is required to report to the State Board of Finance any Financial Institution that exceeds certain equity capital and deposit ratios and notify all state agencies who maintain State Fund Deposits within those institutions of the violation. The agencies are advised not to make any new deposits to those accounts until the violations are corrected. Pursuant to section 6-10-24.1 NMSA 1978, there were no Financial Institutions exceeding the statutory limitations on equity capital and deposit ratios for the month ending January 31, 2009.

Mr. Romero reviewed the State Agency Depository Account Summary and pointed out the state funds balance for 288 accounts had a value of \$28,057,853. The non-state funds balance for 175 accounts had a total value of \$20,142,313. There were a total of 463 accounts. One account was closed during January and five were opened. Of the five, four were for the Judicial District Court and one was for the State Engineer's Office.

9. COLLATERAL REPORT ON AGENCY DEPOSITS & CDs – JANUARY 31, 2009

Mr. Arsenio Garduño reported there were four depository institutions holding public funds for the month ending January 2009 that were out of compliance with their collateral compliance.

Compass Bank, Union Savings Bank, and Charter Bank were due to a change in the collateral requirement. My Bank in Belen was due to a new deposit account that was opened up on the last day of the month. All institutions pledged sufficient collateral to cover this deficiency. All other institutions holding public funds met the minimum collateral requirements. The ratio of collateral required by each institution is a result of a quarterly risk assessment analysis.

For the quarter review ending December 31, 2008, institutions that did not meet collateral requirements to pledge at a 50% collateral level for the state funds held in their financial institution were Bank 34, Bank of the West, Compass Bank/Albuquerque, Bank of America, First Community Bank, Charter Bank, Union Savings Bank and First Federal Bank. During a risk assessment analysis on depository institutions for the fourth quarter, it was noted the earnings are still declining in depository institutions holding public funds. Increases in non-performing loans and decreases in assets and deposits contributed to the decline in earnings. Five institutions had a change in the percentage of collateral required, bringing the total of institutions that are required to collateralize state fund deposits at 100% to eight.

Mr. Garduño reviewed banking sector concerns and reported that fourth quarter earnings of 2008 produced a net loss of \$26.2 billion at commercial bank and savings institutions for the first time since the fourth quarter of 1990. Almost one in four institutions (23.4%) was unprofitable in 2008, and almost two out of every three institutions (62.5%) reported lower full-year earnings in 2007.

The FDIC has 252 banks on their “problem bank list” for the fourth quarter of 2008, up from 171 in the third quarter and 76 in the fourth quarter of 2007. The assets of the problem institutions rose from \$116 billion to \$159 billion. During the quarter, 78 institutions were absorbed in mergers and 12 institutions failed. For all of 2008 there were 98 new charters, 292 mergers, 25 failures and 5 assistance transactions. So far in 2009 there have been 16 failed institutions. At this rate, nearly 100 institutions could collapse by year’s end. With the rise in bank failures FDIC is considering imposing a one-time “emergency” fee and increasing regular fees on U.S. banks to replenish for insuring customers’ deposits.

Member Padilla-Jackson asked if any of the STO’s banks were on the list. Mr. Garduño explained that the FDIC does not publish the names of the institutions that are on the list for fear it would cause a run on the bank.

Member Padilla-Jackson asked about Bank of America.

Mr. Garduño replied that a letter has been issued to Bank of America stating they are disqualified and revoked as a third party custodian, but that will not happen until a new custodian is in place so that the collateral is always safe at a custodial bank. In this environment where the net income of banks has decreased substantially, Bank of America merged and bought bigger institutions, which threw off their assets in three consecutive quarters.

Ms. Lord clarified that the agreement with Bank of America will not terminate until the effective date of an agreement with the new custodial agent, which has been identified and notified.

COMMITTEE REPORTS

10. ANNUAL FINANCIAL AUDIT, FY-2008 – JO ANN CHAVEZ, MEYNER + COMPANY LLC

Ms. Jo Ann Chavez, the manager on the audit for Meyners + Company LLC, presented the fiscal year 2008 STO audit report. Ms. Chavez said that she had an exit conference with the State Treasurer and staff on December 15, 2008, and met with the State Board of Finance Audit Committee to report the audit. She stated she would briefly cover significant areas within the audit.

The opinion rendered on the State Treasurer's Financial Statements was unqualified, which means the books and records of STO are materially correct as they stand as regards operating and service and investment activities. There are certain required communications made to the Treasurer and his staff that outlines Meyners' responsibility to conduct an audit and report any instances of noncompliance with rules, regulations, policies, and whether there are accounting errors that need to be reported by STO.

Ms. Chavez stated there were no changes in existing policies from 2007 to 2008. There were some year-end adjustments that were required and provided to the State Treasurer and staff. They were identified and provided to the Department of Finance and Administration for review and approval.

There were no disagreements with management during the conduct of the audit, and there were no difficulties encountered during the performance of the audit.

Ms. Chavez briefly reviewed some of the findings stated in the audit report.

A finding from the 2007 audit and carried over to 2008 is a material weakness in the automatic reconciliation process between fiscal bank activity and cash management modules. There are certain transactions that require STO to manually resolve. Those processes have not been fully defined and DFA is still working on defining them.

A finding carried forward was the development of a contingency plan for alternative processing in the event of loss of the information technology system because the STO did not receive full funding to complete the project.

A finding repeated from the prior year was that warrants issued by the state are not stale dated. Basically dates when warrants were issued is greater than one year and the bank is still honoring the checks. The STO is monitoring a process to put in place a system that will stale date warrants that were issued over a certain period of time.

A repeat finding is that there were five instances during the course of FY 2008 when the state's bank account was overdrawn with Bank of America. This was caused when an agency did not notify STO of certain transactions that were going to occur; and when the overnight investment was made, there was not sufficient funds to cover the transaction. It is a matter of working with the agencies so it is clear what cash needs are so there are not overdrafts that occur.

With regard to findings that have continued over, Member Bohlin asked Ms. Chavez if the STO has been responsive in trying to get them resolved.

Ms. Chavez stated that most of the findings from FY 07 are systemic problems or business problems that have not been defined and will continue to be a finding. It is a matter of prioritizing the tasks with DFA to work through the processes in place. Most of the other findings require working with other agencies in resolving problems.

Chair Valdes noted that many of the findings are related to the state's SHARE system, which is not within the STO's control, nor are there direct appropriations available to make the changes to SHARE. The STO will continue to work with the DFA, which will receive a copy of the audit.

Member Bohlin asked Ms. Chavez if she felt there were any findings absolutely critical to be resolved quickly and asked what she felt could be done about the bank to book reconciliation finding.

Ms. Chavez agreed that the material weakness that requires manual research is critical to the process that needs to be addressed. She noted that the auto reconciliation process and contingency plan are more critical than some of the others.

Chair Valdes stated that the STO is moving along with the contingency plan. The QMOE line has been installed from Galisteo Road to the office and the system will be complete in a number of months. The offsite location is the Attorney General's office in Albuquerque, which has equipment and a server to put it in place. This is the first true disaster recovery plan the STO has installed, other than delivery of tapes to the State Archives Office.

Mr. Crespin added that the finding on the reversion to the General Fund has been cleared up and the IT disaster recovery plan is on a fast track to be completed in the next two months

Mr. Romero said that his department had been making some headway with DFA on most of the issues, however, the contact at DFA left and no one is assigned to that position. He said it is frustrating because the STO has no control over the things that need to be corrected and they are showing up on its audit. The majority of the findings are business functions and the STO does not have authority over other state agencies to implement them. Two findings are functional issues in SHARE that need to be fixed.

Member Padilla-Jackson said that she will facilitate a meeting on the audit issues. Chair Valdes confirmed it would be helpful to sit down to get moving on some of the audit findings.

Member Cassidy asked if the audit was on time.

Chair Valdes replied that he was pleased the audit deadline was met and the audit was submitted by December 15, 2008. STO will now have to go through the RFP process to select another audit firm because Meyners + Company has performed the audit for the maximum timeframe of three years under the audit rule. They can still propose and if selected, perform the audit for another three years, after which time they would have to rotate off. The draft of the RFP is in place and ready to send to CPA firms that are recommended to do state agency audits.

Member Padilla-Jackson referred to the control of the information system and asked if it is the investment accounting system and if SHARE is a component of that.

Ms. Chavez replied it would be best to talk with the STO information officer, who would know what is on the server and what is being stored. The SHARE component is housed externally and is part of DFA, but anything internal is vulnerable to interruption.

With regard to Member Padilla-Jackson's questions about verifying the balances of self-earning accounts, Chair Valdes stated that, since they are looking at balances of the prior fiscal year when the independent auditor is doing the work at the other state agencies, after the year ends, there has been a significant amount of time before DFA does a close of the accounting period. Until that close occurs, agencies have the ability to go in with a journal entry, which would impact the cash balances.

Member Padilla-Jackson commented that it is interesting that going to a consolidated accounting system, which appeared to be a plus, has led to a finding in the STO because it cannot verify balances, which may be one of many other things that need to be amended in the statutes because of SHARE.

OTHER

NEXT MEETING

The next meeting of the STIC will be at 9:00 AM, Wednesday, April 15, 2009.

ADJOURNMENT

Its business completed, the State Treasurer's Investment Committee adjourned the meeting at approximately 11:30 AM.

Respectfully Submitted by:

Mark F. Valdes, Chairman Designee and Deputy State Treasurer