

OFFICE OF THE STATE TREASURER

STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES Wednesday, September 13, 2006

The State Treasurer's Investment Committee (STIC) meeting convened at approximately 10:00 a.m. in the conference room at the office of the State Treasurer, 2019 Galisteo Street, Santa Fe, New Mexico, on Wednesday, September 13, 2006.

I. CALL TO ORDER

Roll Call

Members Present:

Mr. Douglas Minge Brown, State Treasurer
Ms. Joelle Mevi, State Cash Manager
Ms. Olivia Padilla-Jackson, State Board of Finance Director
Mr. Steven Bohlin, Public Member
Mr. Paul Cassidy, Public Member

Staff Present:

Mr. Mark Valdes, Assistant State Treasurer
Mr. Victor Vigil, Assistant State Cash Manager
Mr. Mark Canavan, Portfolio Management Bureau Chief
Mr. Joaquin Lujan, Investment Officer
Mr. Ron Crespin, Finance Bureau Chief
Ms. Judy Espinosa, Compliance Officer
Ms. Laura Montoya, Executive Assistant

Guests:

Ms. Amy Chavez, State Board of Finance Deputy Director
Ms. Stephanie Schardin, Legislative Finance Committee
Mr. William Mueller, DFA Economist

Approval of September 13, 2006, Agenda

Member Cassidy motioned for approval of the agenda; seconded by Member Bohlin, the motion carried. Member Mevi motioned to change item 15 on the agenda from an action item to informational; seconded by Member Cassidy, the motion carried.

Approval of September 13, 2006, Minutes

Member Bohlin motioned for approval of the minutes; seconded by Member Cassidy, the motion carried.

II. INVESTMENT REPORT

August 31, 2006, General Fund Monthly Report

Mr. Canavan gave an executive summary of the General Fund Investment Portfolio stating: the market value of the General Fund Investment Portfolio on August 31, 2006, was \$2.59 billion, compared to \$2.25 billion in the previous month. The market value of the General Fund at month end was \$2.59 billion, a decrease of 8.4% from July's \$2.83 billion, and a decrease of 6.1% from June's \$2.76 billion. The yield on the

General Fund was 4.86%, up from 4.84% in July. The average term of the portfolio decreased to 149 days in August, down from 155 days in July. As of August 31, the dollar weighted asset mix of the General Fund was comprised of 66.2% in U.S. Agencies, 4.1% commercial paper, 21.5% in the overnight repurchase pool, 8.2% in certificates of deposit and 0.16% in corporate bonds. There was no investment activity to report for the month of August due to working on the portfolio core and benchmark. The General Fund earnings for August were \$12.19 million, a decrease of 3% compared to July's earnings of \$12.57 million but an increase of 47.6% over August 2005 earnings of \$6.38 million.

August 31, 2006, Local Government Investment Pool (LGIP) Monthly Report

Ms. Mevi informed the committee of the LGIP activity for July and August. The market value as of August 31 was \$668.69 million, compared to a market value of \$1.027 billion at the same period from the last fiscal year. The market value for the investment portfolio as of August 31 increased 1.0% over the \$662.3 million market value at July 31. The increase in Pool balance can be attributed to participant response to promotion of the AAA rating and a much-improved, competitive yield. Chairman Brown asked that the STIC committee be included in the distribution list for STO press releases. The average yield increased 28 basis points to 5.291% at August 31. The weighted average maturity was 39 days, slightly up from July 31 weighted average maturity of 34 days, but still within the allowable limit of 50 days. August investment activity included the purchase of \$132.9 million in A-1+ commercial paper with an average yield of 5.436% and average term of 84 days. Also, \$81.73 million in agency discount notes was purchased with an average yield of 5.245% and average term of 60 days. The total LGIP earnings for August were \$2.90 million, a slight increase over July earnings of \$2.88 million. Fiscal year-to-date earnings totaled \$5.78 million compared to \$2.22 million for the same period last fiscal year. Chairman Brown asked how our Pool ranks among peer states. Member Mevi stated that we are seventh in the nation of several investment pools that are being tracked by "TRACS Financial" which does a survey at the end of every month to evaluate placement.

Bond Proceeds Investment Pool (BPIP) Report

Mr. Lujan reported to the committee that, in total, the portfolio market value of the BPIP is approximately \$1.2 billion, which includes \$362 million in bond proceeds held pursuant to flexible repurchase agreements. Chairman Brown asked if flex repos are an appropriate investment for this fund. Mr. Lujan stated that they are. Mr. Lujan stated that \$30 million, on average, is disbursed for projects per month with a standard deviation of \$12 million, STO has seen highs of \$47 million and lows of \$12 million. In July, there were anomalies due to the transition to SHARE. Most of the bond proceeds were in the overnight repurchase agreements.

Economic and Investment Outlook 250-400

The STO has been speaking of extending maturity since May of 2006. Now that a Core portfolio has been established, a buy and hold philosophy has been determined and benchmarks have been adopted; STO will be purchasing securities beyond 12 months. Now that Core issues have been addressed, the STO will be restructuring the portfolio and extending duration to 1.5 years. This restructuring will take from 3 to 6 months to

complete. Given the current economic and interest rate scenario, all efforts will be made to accomplish this restructuring in the shortest timeframe practicable.

III. CASH MANAGEMENT REPORT

State Agency Deposit Balances in Financial Institutions

Mr. Victor Vigil summarized the positive equity ratios in financial institutions for the months of June and July 2006. There were no financial institutions that exceeded those limitations on equity, capital and deposit ratios. For June, there were 512 agency accounts for a total of \$59 million. The state funds totaled \$36.2 million and \$23.5 million was non-state funds. There were 12 accounts that closed and 17 were opened.

The decrease of accounts in June was due to the 13th Judicial Court because most of their accounts are litigant accounts and not state accounts. They are funneling through our system to get Treasurer approval even though they are considered non-state funds. We are looking at adding these litigant accounts to our Local Government Investment Pool (LGIP) to see if they are eligible for that program. Discussion took place among the members to see if this would be possible.

Collateral Report

For the month of June, state agency depository accounts were fully collateralized at all financial institutions. As seen on page 73, most of the financial institutions were at a 50% collateral requirement which means they are stable. There are three categories: 100%, 75% and 50%. Any bank at 50% is in a strong position and doesn't necessarily have to provide more collateral for deposits. For June and July, Bank of America was the only financial institution that was under collateralized. At July 31, Bank of America was under-collateralized. STO addressed that and they are now fully collateralized. For June and July, all General Fund CD's were sufficiently collateralized, a total portfolio of \$243.8 million.

Interest Bearing vs. Non-Interest Bearing Accounts

For the month of July, STO had more interest bearing accounts than non-interest bearing accounts. STO is working to keep the non-interest bearing accounts to a minimum. STO has heard from agencies that there are too many service fees with Bank of America and that they would like to move their accounts to another bank. STO allows that as long as they are not charged more fees at another bank.

IV. OTHER BUSINESS

Approval of General Fund Performance Benchmark

Ms. Barbara Fava, Managing Director of Public Financial Management, phoned in to discuss the investment strategy of the selection of a benchmark. She stated that PFM recommends performance benchmarks for clients based on the targeted maturity range of the portfolio and the target asset allocation. The STO desires to structure a portfolio with a duration of approximately 1.5 years. Unfortunately, there is no standard benchmark of U.S. Treasury and/or Federal Agency securities with a duration of 1.5 years. The combined Treasury/Agency benchmarks are not static; they change over time.

PFM's benchmark recommendation for STO is to consider one of two custom benchmarks with a duration of approximately 1.5 years. The first is the Custom Index 1 which is 20% of the Merrill Lynch 0-1 year treasury index and 80% of the Merrill Lynch 1-3 year treasury index. The second is the Custom Index 2 which consists of 45% of the Merrill Lynch 0-1 year treasury index and 55% of the Merrill Lynch 1-5 year treasury index. If the STO continues to limit new purchases to a final maturity of 3 years, Custom Index 1 may be the best choice. If the STO plans to use its latitude to purchase securities out to 5 years, Custom Index 2 may be more appropriate. Both custom indices are reported on a total return basis. Ms. Fava stated that if STO were to pick either benchmark today, the benchmarks should have a duration of a year and a half. In the interim, Ms. Fava suggests that STO track other benchmarks that can transition to the STO strategy.

Mr. Canavan discussed the "Benchmarking for the STO Buy and Hold Portfolio." He stated that STO priorities are safety, liquidity and return, in that order. Other characteristics include buy and hold strategy; investment grade securities; 1-5 year permitted maturity (1-3 historically); and limited ability to manage duration and average maturity. Through the usage of graphs, Mr. Canavan explained the consistency of reporting and revenue projection. Mr. Canavan felt that the appropriate benchmark for the General Fund Portfolio would be that which is a constant maturity benchmark as opposed to a total return benchmark. Given the considerations and differences between constant maturity and total return benchmark, the committee felt it was appropriate to consider the factors more thoroughly and deferred taking action.

Commercial Paper Approved Credit List

Mr. Lujan stated that each fund manager has implemented a commercial paper watch list. He included a printout for illustrative purposes indicating the contents of the watch list. Essentially, there is a list of commercial paper that has either been bought or that STO owns and is connected real time to Bloomberg through which STO receive updates from three ratings agencies that include program rating, the watch list and the outlook. Member Cassidy asked if STO has considered full flex repos. Mr. Lujan stated that STO has not. Stephanie Schardin stated flex repos are inappropriate except in the case of certain bond proceeds.

General Fund Core Analysis

Mr. Canavan presented the General Fund Core Analysis. This included two analyses, one completed by Mr. Canavan, the other by Public Finance Management (PFM). Both analyses identified that the core portion of the General Fund is approximately \$1.3 billion.

Bond Proceed Investment Pool – Investment Plan & Benchmarks

Mr. Lujan presented a graphical representation of the BPIP. This graphical representation included the mechanics of the inflows and outflows into the pool giving the STIC better representation of bond pool money. Mr. Lujan presented BPIP fund prospectus detailing the objective of the fund and the investment plan.

FY 2005 Audit Report

Mr. Ron Crespin stated that the audit report for FY 2005, prepared by Accounting & Consulting Group, LLP, found no fraudulent findings. He stated that there were 16 findings, six of which were of the forensic audit performed by Deloitte and that the audit report is on the STO website. Mr. Crespin stated that Meyners & Co. was awarded the new contract and will begin quarterly audits on investments September 30, 2006.

Local Government (BPIP) Proposed Legislation

Ms. Mevi summarized the changes made through proposed legislation that STO would like to present to the legislature next session. She stated that there are some areas that were made more general and make the use of the fund more flexible by adding a medium term fund that would be used for bond proceeds by local governments, and the STO would pay for arbitrage services. Proposed changes include: language change from "short term investment fund" to "participating government investment fund," and eliminate the wording of "tribes and pueblos" to "participating entities. Also, the general fund would be allowed to invest in the LGIP to allow additional liquidity in the overnight repo and to compliment the other money market funds that STO approves for eligible investments. STO is also recommending elimination of the 180-day limit and instead allow a rollover which is how, in practice, it is being used. Chairman Brown stated that STO should make sure that there is policy in place to enable transfers from the general fund to the LGIP. Mr. Cassidy asked if there were any way to eliminate sections B and C of the existing statute on public funds to give communities more flexibility. Chairman Brown stated that there is too much opposition from the banking industry at this time for that to occur.

Internal LGIP Policy

Ms. Mevi stated that this is an existing policy. The compliance requirements have been expanded and incorporated for the Standard & Poor's rating. The remainder of the policy pertains to how participants can join the LGIP.

Compliance Report

Ms. Judy Espinoza stated that the creation of the compliance officer position was as a result of the scandal and necessary Deloitte standards. Ms. Espinoza reported compliance with the investment policy. Ninety-nine percent of the STO employees have signed a certification of understanding regarding the Code of Conduct Policy, Campaign Contributions Policy and the Whistleblower Policy. The STO Background Check Policy is near completion and will be signed by those employees that are in top management and investment positions. STO is in the process of reviewing all polices to see which need to be eliminated, updated or revised. STO is also working with the Records and Archives Department to adhere to the New Mexico Administrative Code on those policies which affect outside entities. There are some STO employees who have attended the NMAC training to accomplish the task. The STO Administrative Services Policy compliance check list for the budget process was prepared and adhered to.

V. NEXT MEETING

Wednesday, October 11, 2006, 10:00 a.m.

The November 15, 2006 meeting will begin at 1:30 p.m.

VI. ADJOURNMENT

Member Padilla-Jackson motioned for adjournment. Member Cassidy seconded the motion and the meeting adjourned at 12:30 p.m.