

OFFICE OF THE STATE TREASURER

STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES Wednesday, October 11, 2006

The State Treasurer's Investment Committee (STIC) Meeting convened at approximately 10:00 a.m. in the Bob Barth Conference Room at the office of the State Treasurer, 2019 Galisteo Street, Santa Fe, New Mexico, on Wednesday, October 11, 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
Ms. Jane E. Tabor, Public Information Officer
Ms. Laura Montoya, Executive Assistant

Guests:

Ms. Amy Chavez, State Board of Finance Deputy Director
Ms. Stephanie Schardin, Legislative Finance Committee

Approval of October 11, 2006, Agenda

Member Cassidy motioned for approval of the agenda; seconded by Member Bohlin, 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

September 30, 2006, General Fund Monthly Report

Mr. Canavan gave a summary of the General Fund Investment Portfolio stating: the market value, net of TRANs, of the General Fund Investment Portfolio on September 30, 2006, was \$2.57 billion, compared to \$2.32 billion at the same point last year and \$1.89 billion at the same point two years ago. The market value of the General Fund at month end was \$2.57 billion, a decrease of 0.77% from August's \$2.59 billion, and a decrease of 9.2% from July's \$2.83 billion. The yield on the General Fund was 4.88% at month end, up from 4.86% in August. The average term of the portfolio increased to 166.4 days in September, up from 149 days in August. As of September 30, the dollar-

weighted asset mix of the General Fund comprised 67.3% in U.S. agency bonds, 20.8% in the overnight purchase pool, 8.2% in certificates of deposit, and 3.4% in money market funds. Investments made during the month of September included approximately \$200 million in agency bonds laddered out from December 2007 to May 2008. These repurchases reflect implementation of the core target portfolio and core investment plan. Also, \$100 million was redirected from the overnight repo pool to a money market mutual fund. The General Fund earnings for September were \$11.35 million, a decrease of 6.8% compared to August's earnings of \$12.19 million, but an increase of 82.5% over September 2005 earnings of \$6.22 million.

September 30, 2006, Local Government Investment Pool (LGIP) Monthly Report

Ms. Mevi informed the committee of the LGIP status for September activity: the market value of the LGIP portfolio as of September 30 was \$693.64 million, compared to a market value of \$921.0 million at the same period in the prior fiscal year. The market value for the investment portfolio as of September 30 increased 3.7% over the \$668.69 million market value at August 31. The increase in pool balance can be attributed to continued participant response to promotion of the AAA rating, competitive yield, and improving confidence in the State Treasurer's Office. The gross yield of the LGIP portfolio increased 2 basis points to 5.311% at September 30. The weighted average maturity at September 30 was 33 days, slightly down from the August 31 weighted average maturity of 39 days, but still well within the allowable limit of 50 days. At September 30, the portfolio comprised 47.6% in U.S. government agency securities, 31.9% in A-1+ commercial paper, 18.3% in AAA money market funds, 1.6% in CDs and 0.37% in the bank account balance. September investment activity in the LGIP portfolio included the purchase of \$29.9 million in A-1+ commercial paper with an average yield of 5.35% and average term of 25 days. In addition, \$248.5 million in agency discount notes was purchased with an average yield of 5.25% and average term of 61 days. Total LGIP earnings for September were \$2.94 million, a slight increase over August earnings of \$2.90 million. Fiscal year-to-date earnings for the LGIP totaled \$8.72 million compared to \$8.11 million for the same period last fiscal year. The 30-day net yield of the LGIP as of September 30 was 5.255%, outperforming the 30-day net S&P Rated Government Investment Pool index (5.09%) by 16 basis points. The gross 30-day yield of the New MexiGROW LGIP at September 30, 5.311%, paralleled the 30-day gross S&P Rated GIP index of 5.31%. The administrative fee assessed to participants for September was 5.66 basis points. Mr. Brown asked if STO is calibrating based on an annual fee total or on a basis-point and to check if it is in the STO legislation and if not, to place it in there. Ms. Mevi stated that a fourth money market fund was added in September with a portfolio limit of 25%.

Bond Proceeds Investment Pool (BPIP) Report

Mr. Lujan reported to the committee that in total, the portfolio market value of the Bond Proceeds Investment Pool on September 30, 2006, was \$1.17 billion. The market value of the BPIP had a decrease of 2.5% from August's \$1.2 billion. The yield on the BPIP was 4.68% at month end, an increase of 1.1% from 4.64% in August. The dollar-weighted average term of the portfolio increased to 92.2 days in September, up from 74.6 days in August. As of September 30, the dollar-weighted asset mix of the BPIP

comprised 55.8% in the overnight repurchase pool, 28.3% in flexible repurchase agreements, 9.4% in U.S. treasuries, 5% in U.S. agencies, and 1% in commercial paper. The investment activity included the purchase of two U.S. treasury notes, one for \$87 million (par) and the other for \$14.7 million (par). Each purchase was in the approximate amount and matured on the approximate date for July 2007 and September 2007 debt service payments. The yield on both treasury notes was approximately 5%, locking in positive arbitrage for at least one year forward. The BPIP earnings for September were \$3.43 million, a decrease of 2.5% compared to August's earnings of \$3.52 million.

Member Padilla-Jackson and Amy Chavez joined the meeting at 10:20 a.m.

Quarterly Report

Ms. Mevi gave the committee the results of a quarterly report including the investment strategy employed during the past quarter and the strategy planned for next quarter for the General Fund, New MexiGROW LGIP and the BPIP. Also discussed were the asset mix and maturity targets for those three portfolios.

Economic and Investment Outlook

Mr. Canavan reported that the economy is showing signs of slowing with contracting housing and automotive sectors weighing on the economy. Strength remains as other areas in the economy are growing at healthy rates. Corporate profits are at 40-year highs, as are cash balances on corporate balance sheets. The high levels of domestic liquidity in conjunction with high levels of international liquidity provide underlying support to the economy and should stave off the possibility of a dramatic downturn. Mr. Canavan believes it is prudent to extend portfolio duration to protect against possible downturns in the interest rate environment. STO has begun to ladder both the General Fund Portfolio and the Tax-Exempt Bond Pool with plans to continue doing so going forward. It is anticipated that over the course of the next two quarters the General Fund will be fully laddered from 1 to 3 years with an approximate 1.4-year average maturity. Lastly, the current yield curve environment still favors investment in the 30-day to 6-month range over longer-term (1year+) investing.

Though it is anticipated that rates will continue to decline throughout the remainder of 2006, a flattening of the yield curve may not occur until 2007. This situation benefits the New MexiGROW LGIP portfolio which is a short-term money market fund, as well as the liquidity management segments of the General Fund and BPIP portfolios. Chairman Brown applauded the identification and breakout of core from liquidity but noted that there is an excess of cash that must either migrate from the fixed income core or be spent on the projects for which it was intended.

Moving forward

Ms. Mevi discussed six main points including the portfolio segments, benchmarks, investment advisor, annual report, annual audit, and personnel.

III. CASH MANAGEMENT REPORT

State Agency Deposit Balances in Financial Institutions

Mr. Victor Vigil summarized the positive equity ratios in financial institutions for the month ended August 31, 2006. There were no financial institutions that exceeded equity and capital limitations. There was a total of \$100 million in state and non-state funds in financial institutions, \$74 million in state funds and \$26 million in non-state funds. The total number of accounts was 513. Thirteen accounts were opened: nine at the 13th Judicial District, one at PRC, two at HSD and one at AOC; six accounts were closed.

Collateral Report

Mr. Vigil stated that the General Fund CDs for the month ended September 30, 2006 were fully collateralized. Mr. Vigil presented informational graphs to show the flexible repurchase agreements which were collateralized at 102% by Citigroup, Cantor Fitzgerald and Morgan Stanley. Total flex repo collateral was over-pledged by \$2.4 million.

Interest Bearing vs. Non-Interest Bearing Accounts

Mr. Vigil believes that the STO is getting the services needed for the non-interest and interest bearing accounts. As of August 31, 2006, three accounts were under-collateralized at month end: Farmers & Stockmen, Western Bank in Lordsburg and International Bank in Raton. Farmers & Stockmen were in compliance as of September 11, 2006. The other two were also in compliance by the middle of the month. Mr. Brown stated that the STO is covered up to \$100,000 by FDIC. Mr. Cassidy asked where the collateral is held. Mr. Vigil stated that the STO uses Bank of America, Wells Fargo and a third one that was not recalled at the time.¹ In regard to the Local Government Investment Pool, the STO was fully collateralized both at Compass Bank and Valley National in CDs which will eventually be eliminated. The STO will close the main depository account at Wells Fargo next April once all outstanding warrants have reached the one-year stale date.

IV. STAFF REPORTS

Review of General Fund Core Analysis

Mr. Canavan presented the work he and PFM had done on segmenting a core portfolio from the General Fund. Graphic depictions of both analyses are included in the STIC binder under tab 1.

General Fund Investment Plan

A target core portfolio was placed into two columns. One column included the General Fund core target portfolio. The second column is the actual numbers. The STO will keep 15-40% of the core maturing within 0-12 months. The target is 1.4 to 1.7 years weighted average maturity. Mr. Canavan stated that treasuries are more liquid, so more appropriate and better trading vehicle, but he does not envision the STO as a trading account. Mr. Canavan based the information on the asset type and

¹ The other two banks are Independent Bankers Bank and Federal Home Loan Bank.

credit quality from what other states are doing. The STO is trying to achieve a weighted average quality of AA and AAA. Barbara Fava of PFM is looking at the information. Member Mevi stated that the STO will be submitting this target core portfolio investment plan to PFM. Member Cassidy asked if the laddering process would be completed in the next two months or if it would take longer. Mr. Canavan's response was that the STO has roughly three to six month time-frame allotted for action in the portfolio. Member Cassidy asked if there was concern with the AA rating and Mr. Canavan stated there was no concern. Mr. Lujan stated that the target of 6-9 months will not change unless the STO portfolio managers and STIC come together to make that decision. It is a management tool for the strategy to stay connected. Mr. Bohlin stated that the General Fund portfolio is not out of compliance with the investment policy.

Bond Proceeds Investment Pool – Taxable and Tax Exempt

The STO investment team realized that there is one fund and two goals. For tax exempt issues, the objective is to earn just enough positive arbitrage, and the yield restriction would be the highest true interest cost (TIC) of any issue outstanding. For taxable issues, the objective is to maximize earnings. Therefore, two bond proceeds pools have been created.

Forensic Audit Checklist

Mr. Valdes stated that the STO has 123 items on this checklist and 93 were completed. Some of the major improvements include: policy updates on the code of conduct, whistleblower, background check and campaign contributions; a new process through SHARE; LGIP investment strategies; conversion of an investment position from exempt to classified before the end of the year; significant security for IT, changed network to GSD domain and using them as a back up; firewall; security; and BOFA bank operations interface to avoid duplicate warrants and allowing us to flag fraudulent checks. The STO is working on nine incomplete items: development of risk management, accountability after action plans are developed, and disaster recovery plans are in the works. Mr. Vigil stated that unfortunately now that the STO has switched to the SHARE program, there are situations that have arisen that must be addressed and reconciled as best as possible, and policies and procedures must be formulated to improve the process. Mr. Brown requested that the SHARE problem be tracked.

Annual Report ending June 30, 2006

The annual report was distributed to those present. Mr. Valdes brought page 12 of the report to the committee's attention with its pictures of the STIC committee members.

Internal Policies

Three policies were discussed: background check, code of conduct, and the campaign contributions policy. The background check is a newly implemented policy that applies to finalists for fiduciary positions including executive management, investment managers and the IT bureau chief. The STO attorney is working on another policy for all other employees. A job offer will be subject to the applicant's authorization to initiate a state criminal background check with the Department of Public Safety, a

credit history check, and federal and state tax checks in order to qualify for employment with the agency. All criminal background check information will be kept strictly confidential by the human resources bureau chief. Any applicants that are disqualified through this background check process will have the right to appeal to the union.

Proposed revisions to the employee code of conduct policy include a request from the union to exempt employee participation in union activity. The other major change is in the "outside employment" section, number 3, which eliminates the requirement for the agency to approve outside employment.

The third policy, campaign contributions and reporting requirements, was amended to exempt unions from the groups in the policies that are prohibited from making campaign contributions. The union asked that it be exempt in order to contribute to candidates running for state treasurer. The second major change allows an incoming treasurer to consider hiring supporters who are also campaign contributors and are qualified for vacant state treasurer's positions.

All other changes were minor formatting changes to coincide with the New Mexico Administrative Code (NMAC) format.

Member Padilla-Jackson motioned for acceptance of the code of conduct and campaign contributions policies; seconded by Member Bohlin, the motion carried.

V. NEXT MEETING

Wednesday, November 15, 2006, 1:30 p.m.

VI. ADJOURNMENT

Member Mevi motioned for adjournment. Member Bohlin seconded the motion and the meeting adjourned at 11:45 a.m.