

OFFICE OF THE STATE TREASURER

STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES Wednesday, November 15, 2006

The State Treasurer's Investment Committee (STIC) Meeting convened at approximately 1:30 p.m. in the Bob Barth Conference Room at the office of the State Treasurer, 2019 Galisteo Street, Santa Fe, New Mexico, on Wednesday, November 15, 2006.

I. CALL TO ORDER

Roll Call

Members Present:

Mr. Douglas Minge Brown, State Treasurer
Ms. Joelle Mevi, State Cash Manager
Mr. Steven Bohlin, Public Member (teleconference)
Mr. Paul Cassidy, Public Member
Ms. Olivia Padilla-Jackson, State Board of Finance Director (1:45pm)

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:

Mr. James B. Lewis, State Treasurer Elect
Mr. Larry Castillo
Mr. Matt Schaeffer, Bank of America
Ms. Amy Chavez, State Board of Finance Deputy Director
Ms. Stephanie Schardin, Legislative Finance Committee
Ms. Barbara Fava, PFM, Investment Advisor (teleconference)
Mr. Dave Calvert, Employee of PFM (teleconference)
Mr. David Paul, Financial Advisor to the STO (teleconference)

Approval of November 15, 2006, Agenda

Member Cassidy motioned for approval of the agenda; seconded by Member Mevi, the motion carried.

Approval of October 11, 2006, Minutes

Member Bohlin motioned for approval of the minutes after amended to eliminate commas from page 3, the first and second line under the Economic and Investment Outlook section; seconded by Member Cassidy, the motion carried.

II. INVESTMENT REPORT

October 31, 2006, General Fund Monthly Report

Mr. Canavan gave a summary of the investment activity for the General Fund portfolio. The market value, net of TRANS, of the General Fund Investment Portfolio, on October 31, 2006, was \$2.60 billion, compared to \$2.37 billion at the same point last year and \$1.94 billion at the same point two years ago. The market value of the General Fund at month-end was \$2.60 billion, an increase of 1.1% from September's \$2.57 billion and an increase of 0.38% from August's \$2.59 billion. The yield on the General Fund was 4.91% at month-end, up from 4.88% in September. The average term of the portfolio decreased to 139.7 days, down from 166.4 days in September. As of October 31, the dollar-weighted asset mix of the General Fund was comprised of 62.6% in U.S. agency bonds, 19.5% in the overnight repurchase pool, 7.9% in certificates of deposit, 6.5% in commercial paper, and 3.3% in money market mutual funds. October investment activity in the General Fund included the purchase of \$197.16 million in commercial paper with an average yield of 5.35% and an average term of 7.6 days. The maturity of these investments was cash matched to November disbursements. The General Fund earnings for October were \$11.65 million, an increase of 2.6% over September earnings of \$11.35 million and an increase of 72.5% over October 2005 earnings of \$6.75 million. Fiscal year-to-date earnings totaled \$47.7 million compared to \$25.2 million through the same period last fiscal year. Member Padilla-Jackson asked about the target duration of the general fund portfolio. Mr. Canavan stated that there is no target duration but there was a target maturity and average maturity. Mr. Brown stated the STO is taking the General Fund into a core and also into a liquidity component and, in that context, asked what the target maturity would be of the core segment. Mr. Canavan stated the target maturity would be 1.7 years but is currently far below that. The time frame of the liquidity segment fluctuates between 22 days and 45 days, essentially being a money market fund. Member Padilla-Jackson asked when looking at the fact that the average term of the portfolio is 139.7 down from 166, how does that fit in with the other targets. Mr. Canavan stated that the goal is to roll out a portfolio and that hasn't yet been started.

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

Member Mevi informed the committee of the LGIP status for October activity. The market value of the LGIP portfolio as of October 31 was \$689.39 million, compared to a market value of \$873.29 million at the same period in the prior fiscal year and \$1.290 billion at the same period two years ago and a decrease of 0.6% from the \$693.64 million market value at September 30. The nominal decrease in pool balance is reflective of small fluctuations that occurred during the past two months but, overall, the pool is considered stable. The gross yield of the LGIP portfolio decreased 2.8 basis points to 5.28% at October 31. The weighted average maturity at October 31 was 21 days, down from the September 30 weighted average maturity of 33 days, and still within the allowable limit of 50 days. At October 31, the portfolio was comprised of 41.7% in U.S. government agency securities, 24.6% in A-1+ commercial paper, 31.6% in AAA money market funds, 1.6% in CDs, and 0.4% in the bank account balance. October investment activity in the LGIP portfolio included the purchase of \$60 million

in A-1+ commercial paper with an average yield of 5.33% and average term of 31 days. In addition, \$40 million in agency discount notes was purchased with an average yield of 5.24% and average term of 146 days. Total LGIP earnings for October were \$3.06 million, a slight increase over September earnings of \$2.94 million. Fiscal year-to-date earnings for the LGIP totaled \$11.77 million compared to \$10.55 million through the same period last fiscal year. The 30-day net yield of the LGIP as of October 31 was 5.23%, outperforming the 30-day net S&P Rated Government Investment Pool (GIP) index (5.10%) by 13 basis points. However, the 30-day gross yield of the *New MexiGROW* LGIP at October 31, 5.28%, trailed the 30-day gross S&P Rated GIP index of 5.32% by 4 basis points. The administrative fee assessed to participants for October was 5.5 basis points. The average maturity is 21 days but the STO is looking at expanding that average maturity.

Bond Proceeds Investment Pool (BPIP) Report

Mr. Lujan reported to the committee that there are two pools. The first, Taxable Bond Proceeds Investment Pool, had a market value as of October 31, 2006 of \$691.8 million. The yield was 4.7% and the term was 77 days. It was comprised of 61% in the overnight repurchase pool, 28% in flex repurchase agreements and 11% in commercial paper. A large part of the pool is cash flow. Approximately \$5.9 million was drawn down for project expenditures. Earnings totaled \$2.79 million. On October 31, there was a legacy flex repurchase agreement worth approximately \$7.45 million which was yielding 2.25%.

The second pool, Tax-Exempt Bond Proceeds Investment Pool, had a market value of \$492.1 million. The yield and term at the end October were 4.73% and 85.1 days, respectively. The Tax-Exempt BPIP was comprised of 44.3% in the overnight repurchase pool, 25.9% in flex repurchase agreements, 22.4% in U.S. Treasuries and 7.3% in U.S. Agency securities. No purchases were made during October. Approximately \$9.05 million was drawn down for projects; \$1 million was deposited from property tax revenue; and \$21.3 million was withdrawn for debt services payment. The yield was 4.73%, eleven basis points above the highest arbitrage yield of any bond issue in the fund. The proposed benchmark is to earn just enough positive arbitrage on all issues. Member Padilla-Jackson commented that there is going to be an unusual number of withdrawals in the BPIP, totaling over \$70 million. She added there is a need to make sure that communication with the Public School Authority takes place to find out why there was such a major anomaly. Chairman Brown stated that if the decision to lock-in longer occurs, we need to be able to calibrate for such variations in fund draws.

Economic and Investment Outlook

Mr. Canavan presented the Economic Outlook reporting that there is an economic slowdown occurring. The reported Gross Domestic Product for October was 1.8%, a declining growth rate. With a slowdown in consumer expenditures, personal income growth finally surpassed consumption expenditures. The STO is evaluating the underlying support to see if some of the portfolios can be restructured. Over the next forty-five days, the STO investment bureau anticipates rolling out the General Fund core portfolio. Member Mevi mentioned that with both portfolios, the General Fund and the Bond Proceeds Investment Pool, the STO has been working with the

investment accounting software providers to classify all the investments within those portfolios in order to be capable of reporting the core segment, a liquidity segment and different tiers for the BPIP.

III. CASH MANAGEMENT REPORT

State Agency Deposit Balances in Financial Institutions

Mr. Victor Vigil discussed the statutory reporting process regarding depository accounts. The State Cash Manager needs to submit to the State Board of Finance a report showing state fund balances in each financial institution established pursuant to section 8-6-3.1 NMSA 1978. Additionally, the State Treasurer's Office 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. Mr. Vigil stated that for the month ending September 30, 2006, there was a total of \$103,759,221 in state funds with 5 accounts closed and a total of 568 accounts. Non-state funds totaled \$26,967,741 with 7 accounts opened and 271 accounts total.

Collateral Report

Mr. Vigil stated that the month ended October 31, 2006 all institutions were collateralized. There are four financial institutions which there is no collateral required because their financial institutions deposits are covered by FDIC insurance. In regard to the General Fund, there are two banks that currently hold CD's with the LGIP. They will be maturing shortly and 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.

Interest Bearing vs. Non-Interest Bearing Accounts

Mr. Vigil stated that there were \$30,499, 357 non-interest bearing accounts; interest bearing accounts totaled \$73,309,862; and interest received totaled \$262,166. Mr. Vigil stated that the higher balances may be related to process changes resulting from the SHARE conversion but the impact is difficult to ascertain at this time.

IV. STAFF REPORTS

Quarterly Performance Review- PFM

Ms. Barbara Fava gave a presentation to the committee. She stated that the LGIP performance has now caught up with its benchmark. She discussed in detail the New MexiGROW LGIP performance. Since July 2004, the LGIP has trailed the S&P LGIP Index by an average of 0.15% (gross of fees). Performance relative to other professional money managers has dramatically improved in recent months. Calendar year-to-date assets are down approximately 45% compared to 2004. Asset growth in the month of September 2006 was the highest since December 2004. The weighted average maturity (WAM) of the LGIP declined from a high of 272 days in July 2004 to 33 days in September 2006. Since April 2006, the WAM has been below 60 days. The longest maturity in the portfolio is 2 ½ months. Commercial paper in the three-month area is a good value right now. The overnight repurchase agreement yield is

competitive to both federal agency discount rates and money market funds. The recommendation is to extend weighted average maturity to 30 days. Member Padilla-Jackson asked if S&P put out a similar index for state treasurer funds. Ms. Fava said that there are a couple of state treasuries that have their funds rated but she has never seen an index of them. What she has seen is other state treasurers using the LGIP index. Member Cassidy asked how often she speaks to STO staff in regard to changes in recommendation. Ms. Fava stated she is willing to work with staff in any way that makes sense. All recommendations are done quarterly. Member Mevi explained why overnight repos were not appropriate for use by the LGIP until recently: Cantor Fitzgerald as a counterparty was not S&P rated. Now that Morgan Stanley has been contracted for overnight repos, there are three rated counterparties.

Ms. Fava stated that the General Fund shows strong seasonality with balances peaking in May and June and seasonal low balances in October. PFM did not project continual growth in the General Fund balance. The General Fund consists of four components: the Core Management Segment (\$1.3 billion), CD program (\$350 million, TRANS (\$400-550 million) and Liquidity Management Segment (\$350-800 million). At the end of September, the STO purchased \$190 million of 1 to 1 ½ year maturities at an average yield of 5.10%. The target duration can go longer than 20 days. The recommendations include implementing accounting changes to permit separate tracking of the Liquidity Management Segment and the Core Management Segment; establish an official benchmark for each segment; target duration; and, gradually increase allocation to Core holdings by \$900 million and Liquidity Management Segment. Member Bohlin stated the economy is going through a soft landing and that he believes that the STO is not taking on a long duration time which is not a lot of risk. Mr. Canavan stated that the target portfolio will be rolled-out in 45 days and asked the committee if they would feel more comfortable with dollar cost averaging into the market. He would like the portfolio to be at 1.7 years weighted average maturity.

In regard to the BPIP, recommendations include to continue to ladder the bond proceeds with expected disbursements and match monthly and semi-annual liabilities. Also, the target duration for the Taxable Pool is 5-12 months and the Tax-Exempt Pool target duration is 9 months to 3 years. Mr. Lujan agrees with the recommendation from PFM. Member Padilla-Jackson asked if three years was appropriate given bond expenditures; Mr. Lujan affirmed that it was. A bond issue usually takes three years to spend all the proceeds on projects. The STO knows that it takes longer than three years, so three years is a conservative approach.

General Fund Benchmark

Chairman Brown stated the STO tries to adjust the portfolio from time to time and ride it out, not trying to outperform the market. The original recommendation was to use a more diversified benchmark. Total return is only one way to measure the risk in a portfolio. It is a good way to reflect what is going on in the market. Chairman Brown asked which of the two indices made more sense for the STO to use as a General Fund Benchmark. Ms. Fava stated that the STO policy allows for security terms of up to five years, which makes sense to choose Custom Index 2. If the STO does not want to go beyond three years, then Custom Index 1 makes more sense. Though the indices are

different, the returns are very similar. The difference is from quarter to quarter. Chairman Brown stated he does not believe a benchmark ought to be regarded as a target portfolio because we are going to change our asset allocation from time to time and we are not going to want to change our benchmark for a number of years in order to have a basis of comparison. Chairman Brown suggested the committee select one or two benchmarks. Member Cassidy suggested that the committee should select one index and stick with it. The state has so much liquidity right now that we should be looking at the longer average duration and reaching out beyond three years if it is appropriate at the time. Member Bohlin agreed with Member Cassidy and added that the committee extend the maturity in the policy to give STO the opportunity to have a longer portfolio for that Core, defined what the Core looks like and believes that extending maturities outward will give a significantly better portfolio performance than just rolling overnight repos. Member Bohlin suggested 20-25% in the 0-1 year Treasury Index; 60% in the 1-5 year Federal Agency; and 15-20% on the callable Federal Agency. Chairman Brown asked if 25%; 60%; 15% sounded appropriate. Member Bohlin stated he truly believes that we need to check with the total return benchmark and then get an idea if your manager is out of line or why he is over-performing or under-performing. Chairman Brown stated he concurs and would like a total return index to be part of the solution and be part of STO's standard reporting, but would like a constant maturity benchmark also for the reason of extreme volatility on a month to month of basis of the total return index. Chairman Brown stated he is not against a total return benchmark but against having only a total return benchmark for internal performance. Mr. Canavan stated after reviewing other state treasuries, those that only have total returns benchmarks, do not put them out to the public either for discretion or to avoid confusion. Member Bohlin motioned to adopt the 15% 0-1 year Treasury, 70% 1-5 year Federal Agency, and 15% 1-5 year Federal Agency (option only) on a total return basis then do parallel tracking for that same ratio, applying the same indices on a constant maturity basis/yield basis. Member Cassidy seconded the motion; all in favor, the motion carried.

Approval of Tax & Revenue Anticipation Note Fin. Plan

David Paul, STO financial advisor, joined via tele-conference in for this discussion. The Tax and Revenue Anticipation Notes (TRANS) are authorized under the IRS guidelines with respect to tax revenues to enable governments to finance working capital deficits that occur from time to time in operations. In the state of New Mexico, this financing has been done for the last eight or nine years with respect to the periodic and structural deficit in the appropriations of the General Fund. There is an ongoing deficit in that fund that is the product of the timing of revenue. The IRS rules provide that a deficit can be countered without regard to other funds that might be available to cover those deficits as long as those other funds are not in suspense accounts that are subject to repayment in the event that they are used, or subject to legislative action in order to expend them. The deficits that occur tend to occur toward the end of the month. Because they would like to close the bond sale before Christmas, it was suggested that the Treasurer's resolution be signed earlier than next week because there is a thirty day waiting period.

Expanded Broker/Dealer List

The broker/dealer list was reviewed by Regulations and Licensing and has passed all background checks. Mr. Canavan asked for a more in-depth background check for the firms to determine patterns of behavior, which will not be complete until January 2007. Member Padilla-Jackson asked if the STO would be trading with these entities while they are still under investigation. Mr. Canavan left the decision to the STIC. Member Padilla-Jackson reminded the committee that they would need to get approval from the Board of Finance as well before investing with the new firms. Mr. Canavan explained his reasoning for requesting a more in-depth background check than what is necessary by policy. Member Bohlin received clarification that all of the firms are complying with the current investment policy. Member Cassidy suggested that the committee add on the new brokers to the list. Member Cassidy motioned that the committee approve the registered representatives for Cantor Fitzgerald, Merrill Lynch and Morgan Stanley and that the existing firms go through the same process that these three firms went through. Member Mevi seconded; all in favor; the motion carried. The committee agreed that the policy should be reviewed.

Policy Update: Campaign Contributions, Code of Conduct & Background Check

Chairman Brown asked Mr. Lewis what his ideas were on the Campaign Contributions Policy. Mr. Lewis stated he would like to take a look at the policy before giving feedback. Member Padilla-Jackson motioned to adopt the policies; Member Mevi seconded; all in favor; the motion carried.

V. NEXT MEETING

Wednesday, December 13, 2006, 10:00 a.m.

VI. ADJOURNMENT

Member Padilla-Jackson motioned for adjournment. Member Bohlin seconded the motion and the meeting adjourned at 3 p.m.