

# OFFICE OF THE STATE TREASURER

## STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES

Wednesday, April 11, 2007

The State Treasurer's Investment Committee (STIC) meeting convened at approximately 9:00 a.m. in the Bob Barth Conference Room at the Office of the State Treasurer, 2019 Galisteo Street, Santa Fe, New Mexico, on Wednesday, April 11, 2007.

### I. CALL TO ORDER

#### Roll Call

##### **Members Present:**

Mr. James B. Lewis, State Treasurer

Ms. Joelle Mevi, Chief Investment Officer (Chairperson Designee)

Ms. Amy Chavez, State Board of Finance Deputy Director (Designee)

Mr. Steven Bohlin, Public Member

Mr. Paul Cassidy, Public Member

##### **Staff Present:**

Mr. Mark Canavan, Senior Investment Officer

Mr. Joaquin Lujan, Investment Officer

Mr. Orlando Romero, State Cash Manager

Mr. Arsenio Garduño, Collateral Financial Analyst

Ms. Vickie Brown, Special Assistant to the State Treasurer

##### **Guests:**

Ms. Stephanie Schardin, Legislative Finance Committee

#### Approval of April 11, 2007, Agenda

Member Cassidy motioned for approval of the agenda; seconded by State Treasurer Lewis, the motion carried.

#### Approval of March 14, 2007, Minutes

State Treasurer Lewis motioned for approval of the minutes; seconded by Member Designee Chavez, the motion carried.

### II. INVESTMENT REPORTS – Month and Quarter Ended March 31, 2007

#### General Fund Report

Mr. Canavan summarized the investment activity for the General Fund portfolio. The market value, net of TRANs, of the General Fund Investment Portfolio on March 31, 2007, was \$2.40 billion compared to \$2.56 billion at the same point last year and \$2.01 billion at the same point two years ago. During March the market value of the portfolio decreased 6.25% to \$2.40 billion from \$2.56 billion in February. The March month-end balance represents a 13.35% decrease from January's month-end \$2.77 billion. The yield was 5.06% at month-end, up from 5.04% at the end of February. The average term of the portfolio increased to 188.5 days from 176.6 days at February month-end.

The month-end portfolio holdings were 58.37% in U.S. Agency bonds, 20.42% in the overnight repurchase pool, 7.7% in certificates of deposit, 3.22% in money market mutual funds, and 10.29% in commercial paper. \$556.6 million of investments were purchased for the month: \$23.9 million of certificates of deposit were purchased or renewed for the CD portfolio; \$320 million of commercial paper was purchased to cash match disbursements; and an additional \$40 million was invested in the money market fund to buffer against unanticipated withdrawals in the Liquidity portfolio. \$172.7 million of U.S. Agency securities were also purchased, \$92.7 million for the TRANs redemption portfolio and \$80 million for the Core portfolio. The earnings for March were \$12.76 million, an increase of 1.01% from February earnings of \$12.63 million and an increase of 36.32% over March 2006 earnings of \$9.36 million. Fiscal year-to-date earnings totaled \$110 million compared to \$65.5 million through the same period last fiscal year.

**Investment Strategy Employed During the Past Quarter**

Mr. Canavan informed the Committee that STO continued implementation of a portfolio ladder strategy for the Core portfolio. Agency purchases during the quarter range in maturity from August 2008 to March 2010. The Liquidity Management portfolio continued to cash match commercial paper investment to known cash disbursement dates. High levels of excess reserves were held in the Liquidity portfolio during the quarter to buffer against unforeseen draws or cash flow timing issues. These excess reserves were held in the money market mutual fund and overnight repurchase agreement.

**Investment Strategy Plan for the Next Quarter**

Mr. Canavan further stated that STO will continue to extend portfolio duration in both the Core and Liquidity portfolios. It is anticipated that excess reserves will be drawn down in favor of building the core portfolio. Investment for the Core portfolio will place maturities to fill in a portfolio ladder slightly biased to a 2- to 3-year time horizon. At this juncture, STO will not deploy assets into the 4- and 5-year time horizon. The Liquidity portfolio will continue cash matching recurring monthly expenditures while maintaining a \$100 million to \$200 million buffer.

**Asset Mix and Maturity Targets**

Currently, the State Treasurer's Investment Committee's benchmark choice targets a weighted average maturity for the General Fund Core portfolio of 1.9 to 2.1 years. Asset mix targets remain weighted to the purchase of agency securities for the Core portfolio and commercial paper investments for the Liquidity portfolio.

Member Cassidy asked if there were any issues identified during the Sub-prime mortgage analysis. Mr. Canavan informed the Committee that commercial paper portfolios, in order to be cost-effective, are diversified across multiple industries. There were a few slightly high-risk exposure items that STO will be backing out of; however, most of the items present an effective exposure of zero. Mr. Cassidy further asked if any of our issues were down-graded. Mr. Canavan informed the Committee that none of the issues were down-graded.

**New MexiGROW Local Government Investment Pool (LGIP) Report**

Chairperson Designee Mevi informed the committee of the LGIP status. The year-over-year market value of the LGIP portfolio as of March 31 was \$861.6 million, compared to a market value of \$823 million at the same period last year and \$1.29 billion at the same period two years ago. During March the market value of the portfolio increased 6.8%, from \$806.6 million in February to \$861.6 million. Participant contributions were \$85.5 million and withdrawals were \$31.9 million.

The gross yield was 5.32% at March 31, an increase from the 5.30% at February 28. The weighted average maturity at March 31 was 16 days, down from the February 28 weighted average maturity of 32 days and within the S&P set limit of 50 days. The month-end portfolio holdings were 13.5% in U.S. government agency securities, 29.5% in A-1+ commercial paper, 56.8% in AAA money market funds, and 0.2% in the bank account balance. March investment activity in the LGIP portfolio included the purchase of \$60 million in A-1+ commercial paper with an annualized yield of 5.35% and average term of 14 days.

LGIP earnings for March totaled \$3.7 million, a 12% increase from February earnings of \$3.3 million. Fiscal year-to-date earnings for the LGIP totaled \$28.7 million compared to \$23.3 million through the same period last fiscal year. The 30-day net yield of the LGIP as of March 31 was 5.25%, outperforming the 30-day net S&P Rated Government Investment Pool index (5.14%) by 11 basis points. The 30-day gross yield of the LGIP at month-end, 5.32%, trailed the 30-day gross S&P Rated GIP index of 5.35% by 3 basis points. The administrative fee assessed to participants for March was 4.5 basis points; fees collected through March totaled \$288,000.

#### **Investment Strategy Employed During the Past Quarter**

In compliance with the S&P AAAm rating maintenance criteria that the asset mix and asset types purchased for the portfolio be at least 50% A-A+ (or AAA) rated with the remaining 50% being A-1 (or AA) rated, the portfolio maintained at least 95% of A-A+ rated investments. The weighted average maturity was maintained at 50 days or less. Maturity dates of purchased securities were laddered by week to provide constant cash inflows; however, the money market funds were the primary instrument used for liquidity needs due to their competitive short-term rates.

#### **Investment Strategy Plan For the Next Quarter**

Compliance with rating criteria will continue to mandate the investing strategy for the LGIP. Investment in high-quality commercial paper will be revisited once internal STO research into the underlying assets of these securities had determined that exposure to sub-prime mortgages, if any, is minimal. Investment in agency discount notes will be utilized for longer term investments and/or when investment in CP is maximized. AAA rated money market funds will continue to be used for investment, taking advantage of the favorable short-term rates while they last. Additionally, the overnight repurchase pool will be re-introduced to the LGIP as a secondary liquidity investment.

#### **Asset Mix and Maturity Targets**

The WAM for the LGIP will be maintained at 50 days or less, but primarily staying within 30 days while short-term rates are favorable. Asset allocation will fluctuate between commercial paper; agency discount notes, money market funds and the overnight

repurchase pool depending on the most favorable yield and portfolio investment compliance limits. Commercial paper will be utilized for shorter-term maturities, agency discount notes for longer-term maturities, and money for liquidity and investment when advantageous.

Member Cassidy recommended that a listing of the top 20 LGIP participants be provided at some point in time during the year. Chairperson Mevi informed Committee members that a monthly activity report is generated which identifies the top 10 participants by percentage as required by the S&P. She stated that she will provide Committee members a copy of the report. Chairperson Mevi also informed the Committee that Santa Fe County issued bonds in the amount of \$25 million during the month of March and Las Cruces schools participated in the Pool.

### **Bond Proceeds Investment Pools (BPIP) Report**

Mr. Lujan reported that the market value of the Tax-exempt BPIP as of March 31, 2007, was \$565.4 million. During March the market value of the fund increased 22.1% from \$463.1 million to \$565.4 million. Earnings for the month were \$2.39 million. The March 31 yield was 5.07% and the term was 90 days. The Tax-exempt BPIP yield at March 31, 5.07%, was 45 basis points above the highest arbitrage yield limit of any bond issue in the fund, 4.62%, which is also the selected benchmark. The breakdown of month-end portfolio holdings was 42.8% in the overnight repurchase pool, 5.1% in flexible repurchase agreements, 46.8% in U.S. Treasury notes and bills, and 5.3% in U.S. Agency bonds. No purchases were made during March. The market value of the Taxable BPIP as of March 31, 2007, was \$729.9 million. During March the market value of the fund decreased 5.9%, from \$773.3 million to \$729.9 million. Interest earnings for March totaled \$3.03 million. The month-end yield was 5.02% and the term was 308 days.

March 31 benchmark yields were:

5.08%: 2-year Constant Maturity Agency 12-month moving average; and,

4.81%: Merrill Lynch custom index: 10% of the 0-3 year Treasury and 90% of the 1-3 year Agency. The breakdown of month-end portfolio holdings was 15.4% in the overnight repurchase pool, 5.0% in flex repurchase agreements, 50.3% in U.S. Agency notes and bonds, 2.0% in U.S. Treasuries, and 27.3% in money market mutual fund shares.

No purchases were made during March.

### **Investment Strategy Employed During the Past Quarter**

Mr. Lujan further informed the Committee that investments for the Tax-exempt BPIP were targeted toward a) matching debt service liabilities into 2008, and b) matching estimated project draw liabilities in the amount of \$15 million per month. Investments for the Taxable BPIP were targeted toward a) matching project draw liabilities up to three years out, and b) extending portfolio weighted average maturity toward a 1.5 year mark. The portfolios' weighted average maturities and maturity schedules (see packet) reflect implementation of these strategies.

Member Cassidy asked if the proceeds from bond sales were deposited during the month of March. Mr. Lujan confirmed that deposits were made during March. Member Cassidy

also asked if the proceeds from the bond sales were left in overnight because of high precede sales. Mr. Lujan informed the Committee that deployment of the funds would occur within the next two (2) to three (3) months.

**Investment Strategy Plan for the Next Quarter**

Outstanding bond proceeds in the Tax exempt BPIP recently grew by \$143 million due, in part, to the 2007 General Obligation bond issuance. Outstanding bond proceeds in the Taxable BPIP recently grew by \$170 million due, in part, to the latest Sponge Bond issuance. The planned investment strategy for the next quarter is to incrementally invest the proceeds to march draw down liabilities associated with these issuances.

**Asset Mix and Maturity Targets**

The WAM in both portfolios has increased since last quarter and it is expected that each portfolio will reach its targeted WAM within the next six months. In a declining interest rate environment it is most profitable to extend WAM, locking in higher rates for longer periods of time. While both BPIP portfolios will implement this strategy, progress may be delayed, or cautioned, by statistically abnormal and volatile project draws like those experienced lately. The asset mix of the tax-exempt portfolio will remain heavily comprised of U.S. Treasury Securities, as returns in this sector are sufficient to earn arbitrage profits in excess of the maximum arbitrage yield limit of 4.623%. The asset mix of the Taxable portfolio will continue to evolve into primarily U.S. Agency securities as lower earning flexible repurchase contracts mature and are replaced by securities earning in the 4.70% to 5.30% range.

Chairperson Mevi informed the Committee that the Broker purchases volume is reported each month of the year and she presented information on the fiscal year-to-date totals.

Member Cassidy asked if STO is in the process of conducting an annual review of the Brokers as per the Investment policy. Chairperson Mevi informed the Committee that per Treasurer Lewis' recommendation, Mr. Canavan is currently working on a formal internal process to evaluate and authorize Brokers. Treasurer Lewis stated that he desires a review of current Broker procedures to ascertain if current processes and policies need to be modified.

Member Cassidy further asked if the State Board of Finance has conducted their annual review of the STO investment policy. Chairperson Mevi informed the Committee that she is currently reviewing the policy for Committee review and modification. The policy will be presented for review by the Committee within the next couple of months.

**Monthly Economic and Investment Outlook**

Mr. Lujan reported that slowing productivity growth, rising labor costs, and signs of renewed commodity pressure suggest that inflation levels could persist longer than what is currently expected by many market participants. While the most recent inflation indicators by no means reveal a smoking gun, underlying components continue to warrant a cautionary view. Specifically, components of PPI reveal evidence of firms testing their pricing power, which will continue as corporate profits level off, unit labor costs rise, and product markets tighten. Furthermore, Owner's Equivalent Rent, which has increased

4.4% y-o-y and adds significantly to elevated CPI levels, shows no sign of moderating, even as condos and homes in the 'for sale' market enter the rental market. Watching inflation is like looking in the rear-view mirror, but until such underlying trends abate, inflation risk continues to demand full attention.

"Tentative signs of stabilization" in the housing market have given way to what is now described as an "ongoing correction." Ongoing foreclosures and tightening lending standards related to sub prime woes threaten to add supply, limit demand and, thus, pressure prices. Market participants are acutely aware that housing prices have potential to fall further. Unlike share prices, however, housing prices rarely plunge in nominal terms. If housing prices can avoid a steep dive, then consumption will not suffer greatly, as long as jobs and wages grow.

Mr. Lujan further presented bottom line assessments of the markets. The labor markets are strong. Robust payroll, hours worked, and wages point to reliable wage and income growth in 2007. The consumer is on solid footing. Retail sales, personal income, and confidence remain relatively robust. Both core CPI and PCE price inflation remained elevated into 2007. With unemployment at a low of 4.5% rising labor costs, and lower productivity growth, firms will be hard pressed to offset costs without increasing prices in an already tight product market. The manufacturing deceleration of late 2006 is clearly an adjustment to a pace of expansion that is necessarily less rapid (not negative) than that from mid-2003 to mid-2006. Recent weakness in business investment and capital goods orders threatens to pull manufacturing lower, however. The housing correction is ongoing, as opposed to stabilizing. Risks in this sector include 1) that slowing housing demand will dampen residential construction and detract from GDP (realized and ongoing); 2) that price deceleration leaves owners unable to use their homes as ATMs and thus depresses spending (abated); and 3) that a sustained period of exuberance gives way to a supply-and-demand correction in unforeseen ways (emerging). Presently, stage three manifests itself in the form of foreclosures, ARM resets, tighter lending standards/legislation, and falling prices. Slower economic growth in 2007 is likely, as the residential construction recession continues. Business investment is weaker than expected and will detract further from growth estimates should current weaknesses persist. Current derivative market prices indicate the expected future and most likely path of the Fed Funds Target Rate is a decrease to 5.0% at the August 2007 FOMC meeting and a further decrease to 4.75% at the October meeting.

Mr. Lujan also stated although economic growth continues to slow, we believe the Fed will retain its anti-inflation bias and, thus, remain on hold through much of the year. The Federal Funds target rate is determined first and foremost by the Fed's dual mandate, price stability, and maximum sustainable employment, not housing recessions, not stock market slides, or any other similar market event. Short of conclusive evidence of a reversal in either price stability or sustainable employment growth, the Fed, like it or not, remains stuck between a rock (persistent inflation) and a hard place (slowing economic growth). Conservative investment strategies and the discipline to implement those strategies are most valuable during times of significant market volatility and uncertainty. As such, all three STO funds continue their laddered approach, investing and maturing in every market environment. The General Fund Core continues to systematically extend WAM; the LGIP continues to adhere to S&P' AAA ratings criteria; and the BPIP continues to asset/liability

match. Investment in high-quality commercial paper will recommence once internal STO research conclusively determines its sub-prime mortgage debt exposure, which, so far, is effectively zero.

### **III. CASH MANAGEMENT REPORT – Month Ended February 28, 2007**

#### **State Fund Deposit Activity for the month ending February 2007**

Mr. Orlando Romero presented a summary of State Agency Accounts in each institution through the month ending February, 2007. He stated that there were no institutions exceeding the statutory limitations on equity capital and deposit ratios for the month ending February 2007. State funds for month ending February 2007 included 297 funds with a total balance of \$62,414.940; the non-State funds totaled 204 accounts with a total balance of \$25,540.494; total State agency balances were \$87,955.434, and the total number of accounts was 501; there were eight (8) accounts closed during the period and seven (7) accounts opened during the same timeframe.

#### **Collateral Report**

Mr. Garduño stated that no financial institutions exceeded the statutory limitations on equity capital and deposit ratios at February 2007; all met the minimum collateral requirement of their quarterly risk assessments. Mr. Garduño also presented information on the Custodial Holdings as of Quarter Ending March 31, 2007, pointing out that both Letters of Credit and Kansas Surety Co. do not require custodial holdings

**Announcement** – Treasurer Lewis thanked Chairperson Mevi for the improvements made to the meeting agenda and presentations, acknowledging also the participation of STO Investments staff members. He also commended Ms. Mevi for the leadership that she is providing. Treasurer Lewis further stated that he is “taking a back seat” to conducting the meetings, preferring instead to allow the Chief Investment Officer and her staff of professionals to continue to lead the meetings.

### **V. NEXT MEETING**

Wednesday, May 9, 2007, 9:00 a.m.

### **VI. ADJOURNMENT**

Member Lewis motioned to adjourn the meeting; seconded by Member Cassidy, the meeting adjourned at 9:40 a.m.