OFFICE OF THE STATE TREASURER

STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES
Wednesday, February 13, 2008

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 St., Bldg. K, Santa Fe, New Mexico, on Wednesday, February 13, 2008.

I. CALL TO ORDER

Roll Call

Members Present:
Mr. James B. Lewis, State Treasurer
Ms. Joelle Mevi, Chairperson Designee, Chief Investment Officer
Ms. Olivia Padilla-Jackson, State Board of Finance Director
Mr. Steven Bohlin, Public Member
Mr. Paul Cassidy, Public Member

Staff Present:
Mr. Mark Valdes, Deputy State Treasurer
Mr. Clarence L. Smith, Chief Operations Officer
Ms. Randilynn Lord, Legal Counsel
Ms. Vickie Brown, Special Assistant
Ms. Kirene Bargas, LGIP Portfolio Manager
Mr. Joaquin Lujan, GF, BPIP Portfolio Manager
Mr. Orlando Romero, State Cash Manager
Mr. Arsenio Garduño, Collateral Manager
Ms. Eliza Anaya, LGIP Account Technician

Guests:
Ms. Stephanie Schardin, Legislative Finance Committee
Mr. Gillis Lang, Department of Finance and Administration
Ms. Barbara Fava, PFM Asset Management LLC (Conference Call)

Approval of February 13, 2008 Agenda
Member Paul Cassidy motioned for approval of the agenda; seconded by Member James Lewis. The motion carried.

Approval of January 9, 2008 Minutes
Member Steven Bohlin motioned for approval of the minutes with noted typographical errors to be corrected; seconded by Member James Lewis. The motion carried

II. INVESTMENT REPORTS- Month Ended January 31, 2008

General Fund Report

Mr. Joaquin Lujan summarized the market value of the General Fund Investment Portfolio, net of TRANs, on January 31, 2008 was $2.33 billion compared to $2.77 billion at the same point last year and $2.60 billion at the same point two years ago. During the month the market value of the portfolio increased 2.5% to $2.33 billion from $2.25 billion on December 31. Purchase yield was 4.34% at month-end, down from 4.73% at December 31. The average term of the portfolio decreased to 332 days from 340 days in December.

During January approximately $75.4 million of Agency bullet securities were purchased for the CORE portfolio. The trades were implemented in order to increase the duration of the CORE and better match its index. LIQUIDITY portfolio investments were allowed to roll into cash with the exception of the renewal of approximatly $30.1 million in certificates of deposit. January earnings were $11.08 million, a .45% increase from December earnings of $11.03 million. Fiscal year-to-date earnings totaled $78.02 million, compared to $84.52 million through the same period last fiscal year. On a yield basis, the General Fund remains above its benchmark with an earned yield of 4.57%, which compares to a 4.32% 2yr CMA/CMT month-end yield. On a total return basis, the CORE lagged its benchmark during January with an annualized total return of 17.64%, compared to 21.92% for the benchmark.

New *Mexi*GROW Local Government Investment Pool (LGIP) Report

Ms. Kirene Bargas informed the committee of the LGIP status. The year-over-year market value of the LGIP portfolio as of January 31 was $1.32 billion, compared to a market value of $792 million at the same period last year and $819 million at the same period two years ago. During the month the market value of the portfolio increased 5.3%, from $1.25 billion in December to $1.32 billion. Participant contributions for January were $132 million; withdrawals totaled $68 million for the month. The gross yield was 4.15% at January 31, a 16% decrease from December month-end of 4.83%. The weighted average maturity at January 31 was 28 days, up from the December 31 weighted average maturity of 10 days.

Ms. Bargas reported that the January investment activity in the LGIP portfolio totaled $271.6 million: $65 million in A-1+ commercial paper with an average term of 65.4 days and $206.6 million in agency securities with an average term of 135.14 days. LGIP earnings for January totaled $5.1 million, a 3.3% increase from December earnings of $4.93 million. Fiscal year-to-date earnings totaled $32.2 million compared to $21.6 million through the same period last fiscal year. The 30-day net yield of the LGIP as of January 25 was 4.64%, outperforming the 30-day net S&P Rated Government Investment Pool (GIP) index (4.37%) by 27 basis points. The 30-day gross yield of the LGIP at January 25, 4.69%, surpassed the 30-day gross S&P Rated GIP index of 4.57%.

The administrative fee assessed to participants for January was 2.9 basis points; fees collected through January 31 totaled $224,013.

Tax Exempt Bonds Proceed Investment Pool (BPIP)
Mr. Joaquin Lujan report that the market value of the Tax-exempt BPIP as of January 31, 2008, was $590.6 million. This compares to a market value of $450.8 million one year ago. During January, the market value of the fund increased 13.1%, to $590.6 million from $518.4 million at December month end. The approximate $72 million increase was the net result of $95 million transfer from the severance tax bonding fund, property tax revenues, interest earnings, and project expenditure draws.

The Tax-exempt BPIP month-end purchase yield and term were 4.67% and 230 days. The month-end yield was 31 basis points above the selected benchmark yield, 4.36%. There were no purchases for the Tax-exempt pool during January. The pool's asset-liability model is undergoing recalibration and matching investments to projected liabilities will continue upon completion of the realignment in early February. Interest earnings for the month totaled $2.28 million, an increase of 5.5% from December earnings of $2.16 million. Fiscal year to date earnings totaled $16.48 million.

Taxable Bond Proceed Investment Pool (BPIP)
Mr. Lujan included in his report that the market value of the Taxable BPIP as of January 31, 2007, was $829.9 million. This compares to a market value of $776.9 million one year ago. During January, the market value of the fund decreased 2.5%, to $829.9 million from $851.4 million at December 31. The approximate $22 million decrease was the net result of monthly project expenditure draws. The Taxable BPIP month-end purchase yield and term were 4.82 % and 276 days. The month-end yield was 16 basis points above 4.65%, which is the month-end yield for the 2-year CMA 12 month moving average index.

Mr. Lujan included in his report that there were no purchases for the Taxable pool during January. The pool's asset-liability model is currently undergoing recalibration and matching investments to projected liabilities will continue upon completion of the realignment in early February. January interest earnings totaled $3.52 million, a 16.1% increase from December earnings of $3.03 million. Fiscal year to date earnings totaled $23.22 million.

Mr. Lujan commented that January's higher interest earnings were a function of a larger asset base, even given lower yields.

Economic and Investment Outlook
Mr. Joaquin Lujan reported that January was another volatile month for financial markets. Equity indices took another leg down, with wide intra day and weekly swings. In part, losses were sparked by fear of impending losses and credit rating downgrades

for financial guarantors, also known as monoline insurers. As monolines strayed from their mainstay, which was backing municipal securities, and ventured into backing mortgage backed securities and collateralized debt obligation deals as well as selling credit default swap protection, rising defaults make their capital base of only $34 billion look paltry compared to their $2.4 trillion in guarantees or liabilities. Here's the chain reaction that has the markets spooked: as defaults grow in insured RMBS and CDO deals, concern grows that monolines lack sufficient capital to make good on their guarantees; as the amount they're on the hook for grows, ratings agencies look likely to strip monolines of their AAA ratings; if monolines lose their AAA ratings; the debt they guaranteed does too; holders of downgraded debt will likely be forced to mark-to market depressed values; and in so far as holders of downgraded debt are mandated to hold AAA rated paper, forced selling ensues, further depressing valuations.
S&P advices that they are set to downgrade ½ trillion dollars worth of RMBS and CDOs as a result. They also estimate that banks stand to lose $256 billion, which is almost 300% more than the amount of losses taken since this past fall. This time around we will see losses from European, Asian, US regional, credit unions and Federal Home Loan Banks. Regardless of the rescue effort underway for the monolines, what's clear is that credit markets and financial institutions are presently starring down the barrel of inordinate systemic and counterparty risk. When asset prices fall, that's one thing; when contract are broken and worthless that's a whole lot worse.

Mr. Lujan commented that in the short term no amount of monetary accommodation or fiscal stimulus can alleviate the tension in the market place. In the next few months we will see financial markets, business, and consumers slog through the accelerating downturn phase of what's clearly a credit boom and bust cycle. The bust sounds something like this…Banks and financial intermediary profits are down, loan loss reserves are up; revolving credit lines (the last life line of the consumer) are down, interest rates are up; applications for credit are being refused. Money managers like fidelity are seeing a huge spike in hardship withdraws from 401ks; payday lenders are migrating to more affluent neighborhoods and investors are paralyzed. As we navigate the waters into the trough we look for answers to what our world will look like after we hit bottom. What forms of lending will survive, what won't survive, how will our lifestyles change? Will the public's view toward government change? Will they ask for more participation and regulation in lending practices, job security, global trade?

Mr. Cassidy commented that issues involving the downgrade of monoline insurers may eventually impact the State's cost of funds which could affect the underlying ratings of municipalities' and/or schools, adversely impacting their ability to fund projects across the state.

III. CASH MANAGEMENT REPORT: Month Ended December 31, 2007

Mr. Orlando Romero reported 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 though the month ending December, 2007.

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. 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 December, 2007.

State funds were held in a total of 479 accounts with a combined balance of $69,558,341. There were two accounts closed and five accounts opened for the month ending December 31, 2007.

Collateral Report
Mr. Arsenio Garduño reported that one depository institution holding public funds for the month ending December 31, 2007 was under collateralized by $345,833.19, due to an end of month maturity. Additional collateral was pledged in January to cover the deficiency. All other depository 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.

Mr. Garduño reported as of January 25, 2008, Compass Bank is collateralizing state deposits at 100%. The bank's net income information, as reported on the call report for the 3rd quarter analysis, only reflected 24 days following the BBVA merger and, due to this abbreviated earning period, resulted in a 100% collateral requirement. The State Board of Finance and the New Mexico State Treasurer's Office requested supplemental information of the bank's pre-merger net income in order to determine if the bank qualified to collateralize at a lower level. Due to confidentiality concerns, however, the bank was unwilling to supply the pre-merger net income information for collateral analysis. Therefore, the collateral requirement remains at the level determined by the last quarterly risk assessment analysis.

Mr. Bohlin asked if the collateral level of Compass Bank was going to be back at 50% now that there is a new quarter. Mr. Garduno responsed that they will more than likely stay at the 100% requirement for one year, until the totals from the 3rd QTR net income roll off their report.

IV. STAFF REPORTS

No state reports at this time

V. COMMITIEE REPORTS

Ms. Barbara Fava of PFM Asset Management presented the investment review for the quarter ended December 31, 2007. Ms. Fava reported that the LGIP is well diversified between money market mutual funds, commercial paper, and federal agencies.
In January, the Federal Reserve aggressively lowered interest rates from 4.25% to 3.00%. In a declining interest rate environment, yields on money market mutual funds typically 'lag' other money market sectors. Ms. Fava recommended that the STO continue to take advantage of this yield advantage by emphasizing money market mutual funds. Federal agencies are extremely expensive, especially those maturing less than 2 weeks. The STO may want to consider selling Federal agencies with 2 weeks remaining to maturity and investing the proceeds into a money market mutual fund. This low risk trade can pick up nearly 135 basis points or $5,200 per $10 million. Securities maturing within 1 year have already priced in aggressive actions by the Federal Reserve, with market sentiment indicating the Federal Funds target rate will fall to 2%. One area of value the STO may want to consider is floating rate corporate notes. PFM has recently seen FRNs issued by Goldman Sachs trading at 3 month LIBOR + 0.65% (3.80%).

Ms. Fava reported on the General Fund Core: During the quarter the STO purchased $130 million of 3 to 5 year U.S. Treasury Notes at an average yield of 3.50% and $21.9 million of 3 to 5 year corporate notes at an average yield of 5.04%. Duration of General Fund Core is 1.27 years compared to the custom benchmark of 1.87 years. During 2007 the Core Portfolio generated an annualized total return of 6.19%, significantly higher than the return on short-term strategies. Performance trailed the benchmark because the portfolio duration was shorter than the duration of the benchmark as interest rates fell. Even though STO extended the duration of the Core Portfolio from 1.06 years to 1.27 years during the quarter, the duration of the Core Portfolio is still only 68% of custom benchmark. If interest rates continue to fall, this duration mismatch will cause the Core Portfolio to under-perform the benchmark. During the quarter, the STO diversified 10% of the portfolio into longer-dated U.S. Treasury obligations which positively impacted the performance of the portfolio as yield spreads between Treasury and Agency securities widened.

Ms. Fava suggested that the STO consider swapping some portion of the Treasury holdings for federal agencies to take advantage of historically wide spreads. Although, given the duration mismatch, the STO should look for opportunities to extend the duration of the portfolio. She suggested waiting for rates to return to the upper-end of the trading range (2.15% or higher on the 2 year U.S. Treasury note) before executing these trades. Given relatively wide spreads, she suggested the STO consider buying additional high-quality corporate obligations or callable federal agencies.

Ms. Fava reported that the General Fund Liquidity portfolio has shown a decline of $197 million since September 30, 2007. The General Fund Liquidity segment is diversified between repurchase agreements and money market mutual funds. The General Fund Liquidity is invested fully in overnight repo. In January, the Federal Reserve aggressively lowered interest rates from 4.25% to 3.00%. PFM's historical cash flow analysis (excluding TRANs) shows a core balance of $1.7 billion. Allowing a maximum of $350 million in CDs, the balance available for longer-term investment is $1.3 billion.

Both BPIPs have been invested to match the projected schedule of debt service payments and project fund expenditures. The Taxable BPIP holds $15 million of U.S. Treasuries. Spreads between Federal Agencies and U.S. Treasuries are quite wide, the STO may want to consider swapping into higher yielding Federal Agencies. The investment objective for tax-exempt bond proceeds should be to maximize the amount of retainable earnings. In general, simply targeting the arbitrage yield may create an opportunity cost. Rationale: interest rates may fall in the future and positive arbitrage earned today can be blended with negative arbitrage in the future. Bona-fide debt service funds are usually exempt from arbitrage rebate. Construction funds may meet a spending exception from arbitrage rebate and be allowed to retain arbitrage profits. Portfolio return can be enhanced by selling U.S. Treasury obligations and purchasing Federal agency securities with similar maturity dates. In the Tax-Exempt BPIP, there are $80 million of U.S. Treasuries maturing in less than 1 year. These swaps can pick-up an average of 60 basis points of yield.

Mr. Bohlin commented that timing is very important; there is no right time to know when to buy, just because of changing rates, and we may need to move fast to take advantage of the spread. A benchmark-driven portfolio needs to be watched for securities falling in and out of the benchmark portfolio.

Ms. Olivia Padilla-Jackson requested that she and Mr. Romero meet to discuss the cash flow spreadsheets that are being sent to STO by Bank of America. Ms. Padilla-Jackson wants to work with STO to fine tune the cash flow analysis.

VI. NEXT MEETING

Wednesday March 12, 2008 at 9:00 a.m.

VII. ADJOURNMENT

Member James Lewis motioned to adjourn the meeting, seconded by Member Olivia Padilla-Jackson. The meeting adjourned at 10:10 a.m.