

OFFICE OF THE STATE TREASURER

STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES
Wednesday September, 10, 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, September 10, 2008.

I. CALL TO ORDER

Roll Call

Members Present:

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

Members Absent:

None

Staff Present:

Mr. Mark Valdes, Deputy State Treasurer
Mr. Orlando Romero, State Cash Manager
Mr. Clarence Smith, Chief Operations Officer
Ms. Randilynn Lord, Legal Counsel
Mr. Scott Newman, General Fund Portfolio Manager
Ms. Kirene Bargas, LGIP Portfolio Manager
Mr. Joaquin Lujan, BPIP Portfolio Manager
Mr. Arsenio Garduño, Collateral Manager
Ms. Hannah Chavez, LGIP Accountant

Guests:

Ms. Becky Gutierrez, LFC analyst
Mr. Gillis Lang, DFA analyst

Approval of September 10, 2008 Agenda

Member Bohlin motioned for approval of the agenda; seconded by Member Olivia Padilla-Jackson. The motion carried.

Approval of July 15, 2008 Minutes

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

II. INVESTMENT REPORTS- Months Ending July 31 and August 31, 2008

General Fund Report

Mr. Scott Newman presented a summarization of the market value, change in balance, investment activity, and interest earnings for the General Fund Investment Portfolio for the months of July and August, 2008.

Mr. Newman informed the committee of the August private placement transaction with NM Education Assistance Foundation: STO purchased \$50 million 7 month bonds with a yield of LIBOR + 50 bp, 3.3%. The transaction was a collaborative effort which satisfied compliance requirements for STO while enabling NMEAF to continue their Fall 2008 student loan program which had become threatend by current market forces.

Member Padilla-Jackson inquired on the outperformance by the G/F CORE to the total return benchmark. Mr. Newman explained that the asset make-up (heavy in agencies) and duration of the portfolio was favorable in the current market environment, reflective in the total return results.

New MexiGROW Local Government Investment Pool (LGIP) Report

Ms. Kirene Bargas presented a summarization of the market value, change in balance, investment activity, and interest earnings for the LGIP portfolio for the months of July and August, 2008.

Bond Proceed Investment Pools (BPIP)

Mr. Joaquin Lujan presented a summarization of the market value, change in balance, investment activity, and interest earnings for the Tax-Exempt and the Taxable Bond Proceed Investment Pools for the months of July and August, 2008.

Member Padilla-Jackson informed the committee that the Board of Finance is implementing a trial period for a three-times per month project draw process instead of the current two-times per month system, which is intended to make disbursement of project reimbursements more efficient.

Member Cassidy inquired on the asset-backed security listed on the Taxable BPIP. Mr. Lujan informed the committee that this type of security is suffering in the current market, it is a auto loan receivable security, but STO is comfortable with the high quality and long-term performance of this type of security.

Summary of Broker Participation

Chairperson designee Mevi presented a summarization of the broker participation for security purchases for July and August, with additional breakdown by asset type and market.

Economic and Investment Outlook

Mr. Joaquin Lujan informed the committee that essentially \$4 to \$6 trillion in housing equity has evaporated over the last year combined with rising food/energy costs, stagnant wages and higher unemployment has resulted in consumer sentiment at all-time lows. Tax rebate is exhausted, export growth will slow as with the rest of the world, local

governments will struggle to balance budgets, and the home price correction will continue. STO believes that the flight to quality bid will continue and that we will be sufficiently rewarded for being long in high quality assets. Mr. Scott Newman explained that the Fed is still confined as to what they can do with fiscally. STO purchased a substantial amount of US agencies in July, before the GSE problems emerged. He reviewed historical spreads to Treasuries and highlighted widening spread occurrences when STO targeted purchases. Mr. Newman explained that futures markets are reflecting no Fed action until the beginning of 2009. The 3 – 4 ½ years offers the greatest opportunities for STO purchasing in the current environment. Mr. Lujan also clarified that recent STO purchases in this area are reflecting large unrealized gains.

Member Bohlin inquired as to the duration ladder. Mr. Newman addressed Member Bohlin's concern by describing a recent trade in which the G/F harvested some of the gains in Agencies by selling out of a short agency security and reinvesting the proceeds in 4 ½ year Treasury.

Member Cassidy informed the committee that high-quality municipal security spreads are also wide to Treasuries and may present an investment opportunity for STO. Member Bohlin agreed that taxable municipal securities have significant value to offer and should be seriously considered for STO portfolios.

Member Padilla-Jackson asked for clarification under policy as to when STO is allowed to liquidate/sell a security. Chairperson Mevi explained that there is no detailed section of the policy defining selling. Member Bohlin informed the committee that under previous policy iterations, STIC incorporated language that allows STO to take advantage of market conditions that may enhance earnings without compromised credit quality or risk profile and adding total return potential. Chairperson Mevi also clarified that, under policy, sales must be competitively transacted. She also stated that STO's investment advisor has repeatedly recommended that STO take trade opportunities when these types of markets have occurred. The topic of market opportunities and passive portfolio management strategy was discussed at length by the committee.

Member Padilla-Jackson suggested that adequate documentation to allow and justify these transactions, both within policy and contained in the trade, be clearly defined and explained.

III. CASH MANAGEMENT & COLLATERAL REPORTS: July 31, 2008

Cash Management Report

Cash Manager 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 ended July 31, 2008.

Mr. Romero informed the committee that the Cash Management Division is undertaking a project to consolidate or eliminate accounts in order to reduce the number of State accounts. STO is working with several agencies to accomplish this goal.

Collateral Report

Mr. Arsenio Garduño reported that three financial institutions were under-collateralized as of July 31 and pledged additional collateral upon notification. All other depositories met their minimum collateral requirements for July 31, 2008. The ratio of collateral required by each institution is a result of a quarterly risk assessment analysis.. Four institutions were required to increase their collateral levels as a result of the June 2008 quarterly risk assessment.

Mr. Garduno presented the committee with reasons for the requirement changes by institution and a briefing on banking sector concerns in general.

Member Lewis informed the committee that STO has been requested to come before the Board of Finance to discuss collateral and banking sector concerns. On the other side, the banks are wondering if there is an arbitrary policy within STO to raise their collateral levels. Staff met with the Independent Bankers last week and Member Lewis will be meeting with the other bank association tomorrow to talk about our banking practices. Member Lewis stated that STO has a responsibility to protect the state's money.

Member Cassidy acknowledged that STO staff proactively took this project on at the Treasurer's request, and inquired if the collateral ratios are adequate and if STO is sure that the risk shown in those ratios is accurate. Mr. Lujan explained the new CD program: 'un-pegged' the rate from US Treasury rates, requiring a market rate on the CD investment; also the collateral pledged HAS to comply with BoF policy, but STO negotiation on rate can incorporate a request for higher collateral level. Mr. Lujan gave examples of how the new measures are managing risk. Mr. Newman stated that STO portfolio managers are uncomfortable with only 50% collateral requirements on state funds but that is what the law requires. STO is asking financial institutions to voluntarily increase collateral levels for CD holdings in exchange for a discount on the rate. STO is also converting to LIBOR as the rate index instead of US Treasury because LIBOR is a proxy for AA level of risk while the treasury rate is a proxy for risk-free return. Prior to a year ago the two indices tracked closely but, as Fed Chairman Greenspan often stated, the market had underpriced risk and last year the spread between the two indices is extremely widened, reflecting the market's recognition of risk. Member Bohlin reminded the committee that the CD Program is required by statute and operated by STO at the behest of the legislature and commended staff on their attempt to incorporate risk into pricing this investment.

Member Cassidy asked if a change to the collateral levels should be something that STO brings to the legislature. Mr. Newman explained that the new CD Program measures are attempting to keep within statutory requirements, without the need for legislative changes. Member Lewis clarified that STO will follow the law. He informed the committee that STO is launching this pilot program and vetting it with the banks, through a collaborative process. He reminded the committee that the CD program has always been intended for 'economic stimulus' and that STO may not have the authority to drive the program in a different direction. Committee discussion ensued.

IV. STAFF REPORTS

None

V. COMMITTEE REPORTS

Discussion of proposed changes to Investment Policy

Chairperson Mevi explained the proposed changes. Diversification limits and selection of investments sections are areas of the policy which were discussed. The first proposed change is in section VI.I.3: limiting the CD Program to the LIQUIDITY portfolio, changing the maximum investment limit for CDs from a dollar amount to a percentage to be consistent with policy language used for other investment types, and to change the per-institution limit from \$30 million to \$20 million. The percentage recommended is 25% of the G/F LIQUIDITY portfolio instead of \$350 million. Deputy Treasurer Valdes pointed out that the proposed percentage of the August month-end balance translated into a dollar amount would equal \$170 million, which is much lower than the current CD balance is \$196 million and that banks would probably not be happy about this proposed limit. Chairperson Mevi stated that the percentage would be assessed on a monthly average balance instead of a end-of-month balance. Mr. Newman directed the committee to the G/F LIQUIDITY month-over-month cash flow graph, emphasizing that due to the wide swings in balances during a month, using an average would be necessary. Member Bohlin pointed out to the committee that, if the portfolio had the maximum \$350 million in CDs, the LIQUIDITY portfolio on August 15th wouldn't have had any money. He asked if the program limit is set by statute, policy, STIC or BoF. Deputy Treasurer Valdes replied that the Board of Finance approves policy introduced by STIC but cannot set the asset limits. Member Cassidy asked about the \$20 million per-institution limit; is it based on a percent of the bank's capital. Member Bohlin recalled that the limits were considered against the bank's capital, but primarily considering only the community banks. Member Padilla-Jackson suggested that the per-institution limit might be better presented as a percentage instead of an amount and Member Bohlin suggested allowing 30% of the LIQUIDITY portfolio for the CD Program. Committee discussion on the topic ensued.

The second proposed change to the policy is in section VI.I.7: establishing a diversification limit for political subdivisions under subsection F.2.i of the policy. The proposed limit is 20% of any individual portfolio. Member Padilla-Jackson asked if this area of the policy it the authorization for STO to purchase State of NM sponge bonds. STO will research and clarify. The suggested limit of 20%, though, would sufficiently cover any single State sponge bond issuance.

The third and last proposed change to the policy is in section VI.L.9: restating that competitive selection of CDs and private placement/direct purchase rates relate to an appropriate market index. Committee discussion ensued. Member Bohlin suggested that the word 'market' be removed from 'current rates' and eliminate the 95% correlation level. Deputy Treasurer Valdes asked the committee if the minimum rate per the Board of Finance Interest Rate Policy (US Treasury) is really an appropriate rate based on current market forces. Member Padilla-Jackson agreed that discussion as to an appropriate rate could be incorporated in the next review of the Interest Rate Policy but also mentioned that the policy rate is a minimum only so that implementing LIBOR may prohibit any rate discounts allowed by STO.

Member Bohlin brought the committee's attention to page 15 and noted that, under the reporting requirements, STO isn't reporting total return on a monthly, quarterly, fiscal year-to-date and three-year against benchmarks. He suggested either incorporating these into the monthly report or changing the policy language in this section and stated that he would like to see monthly, quarterly, annual, and 3-year benchmark comparisons for a total return and a trailing 12-month basis. The committee agreed to send additional comments via email to Chairperson Mevi by September 30.

VI. NEXT MEETING

Wednesday, October 15, 2008 at 9:00 a.m.

VII. ADJOURNMENT

Member Padilla-Jackson motioned to adjourn the meeting, seconded by Member Lewis. The motion carried. The meeting adjourned at 11:15 a.m.

Respectfully submitted by:
Joelle Mevi, Investment Division Director