OFFICE OF THE STATE TREASURER

STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES
Wednesday October, 15, 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, October 15, 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. Larry Castillo, Chief Financial 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
Ms. Jo Ann Chavez, Meyers + Co. CPA

<u>Approval of October 15, 2008 Agenda</u>
Treasurer Lewis requested that agenda item 11 (FY 2007 Financial Audit) be moved before agenda item 3 and motioned for approval of the revised agenda; seconded by Member Bohlin. The motion carried.

Approval of September 10, 2008 Minutes

Treasurer Lewis motioned for approval of the minutes; seconded by Member Padilla-Jackson. The motion carried.

II. COMMITTEE REPORT – FY 2007 Financial Audit

Ms. Jo Ann Chavez of Meyners + Co. presented a review of the fiscal year 2007 audited financial statements, which have been reviewed and accepted by the State Auditor. Ms. Chavez explained the independent auditor's responsibilities: to perform testing procedures to confirm account balances and operations of the Treasurer's Office and to review policies and procedures in order to express an opinion. Meyners + Co. expressed an unqualified opinion of the FY 2007 financial statements, which means that they are materially correct and not misstated. Audit adjustments were presented to STO and DFA, reviewed and accepted so that the accounting system agrees to the audit report. There were no disagreements with management of the Treasurer's Office, no issues were discussed prior to the engagement, and Meyners had no difficulty in performing the audit.

Three findings from FY 2006 carried into the FY 2007 audit and four from FY 2006 were resolved. There were 11 new findings for FY 2007, which were reviewed and responded to by STO. Several FY07 findings were systemic issues related to the new statewide accounting system.

Member Padilla-Jackson asked if any material weakness findings from FY 2006 carried into FY 2007. Ms. Chavez will research and respond to STIC.

Member Cassidy requested clarification about the state's 'self-earning' accounts: how they earn interest and who calculates. Chairperson designee Mevi responded that certain funds, such as the state road fund and several trust funds, are allowed by statutory authority to earn and keep interest and calculation of the interest had been performed by STO until implementation of SHARE when the function was transitioned to DFA. Member Cassidy also inquired on the delay of FY 2007 audits statewide. Ms. Chavez explained that many business processes weren't incorporated into the conversion process and caused a series of delays. She also informed the committee that the FY 2008 audit is underway and expected to be complete by the December deadline.

Member Padilla-Jackson inquired on finding number 2007-02. Ms. Chavez explained that many adjustments were required to correctly record, or correct erroneous, entries and the finding details an aggregate total of entries. Committee and STO staff discussion regarding FY 2008 budget request for SHARE enhancements ensued.

III. INVESTMENT REPORTS- Month and Quarter ending September 30, 2008

Review of September 2008
(Economic and Investment Outlook)

Chairperson designee Mevi explained to the committee that the quarter was dominated by the market events of September and provided a review of other financial market events since the summer of 2007: commercial paper market issues, auction rate securities market failures, near-collapse of Bear Stearns, multiple Fed policy actions, reductions to the target rate, and continuing rumors related to the banking sector. September began relatively normally but within a week FNMA and FHLMC were taken into conservatorship signaling the drastic measures necessary to avert a financial crisis. The next week Merrill Lynch was hastily sold to Bank of America, Lehman Brothers declared bankruptcy, AIG was facing imminent failure, and the resulting near total collapse of the money market fund industry caused a market meltdown. Mr. Scott

Newman provided a chronological review of how the events of September affected STO portfolios. Throughout the month the Treasurer and Deputy Treasurer were provided updates, options, and recommendations while STO portfolio managers continuously monitored the market. Mr. Newman described STO exposure to AIG and STO's decision to hold the $15 million position because the bonds continue to pay interest coupons and, based on AIG's bailout, STO expects that they will mature. Mr. Newman went on to explain STO reaction to news that one of the money market funds utilized by STO for liquidity, The Reserve Primary Fund, had 'broken the buck', dropping below $1 per share to 97 cents per share, due to a run on the fund. The run forced The Reserve to freeze the Primary Fund for seven days. Because STO portfolios didn't have access to this fund during the week of highest operating outflows, it was necessary to sell securities to meet liquidity demands. The Reserve Primary Fund was immediately downgraded from AAA to D by S&P causing the LGIP, which held The Reserve Primary Fund, to be noncompliant with it's S&P AAA rating, and forcing STO to immediately resolve the issue or face a rating downgrade to D. Fearing a run on the LGIP, portfolio managers liquidated all other LGIP institutional money market positions and most of the fixed income positions (realizing a small loss) into cash by week end. A run on the LGIP didn't happen but several other large institutional money market funds began faltering or closed. News of US Treasury and Federal Reserve action to provide money market fund insurance was released by week end and STO was optimistic that the Reserve Primary Fund would be covered. A rating downgrade below AA would cause the LGIP to be noncompliant with state statute. STO decided to sell the LGIP Reserve Primary position to the General Fund CORE portfolio until STO could secure either an in-kind redemption, determine if the Treasury insurance would cover the position, or get sufficient information to determine another course of action. The CORE portfolio sold securities to make the purchase, which took out the short end of the CORE ladder. All General Fund portfolio sales resulted in realized gains. In order to execute some of the sales during the market's turmoil, portfolio managers were forced to accept less than 3 bids but all policy violations were documented. Chairperson Designee Mevi interjected that a newly-documented internal control procedure addressing 'unanticipated market changes' will be presented for discussion later in the meeting.
Member Bohlin began committee discussion regarding the cross trade between the LGIP and the CORE and questioned the transaction's compliance with policy, specifically if the trade was at a market price. Mr. Newman responded that STO made the investment decision based on information available at the time; that a $1 per share in-kind redemption was perceived as a realistic outcome. Portfolio managers were provided The Reserve Primary fund inventory for evaluation, and to identify LGIP-appropriate assets, which they disseminated in preparation for the redemption. Member Bohlin requested that the trade be properly documented to include the email correspondence from The Reserve, account transfer confirmation, wire transfer instructions, and an agreement: either a repurchase agreement, reverse repurchase, or something similar. Even though the intent of STO was to make a transfer between Reserve Primary accounts, the trade is considered 'failed' and, therefore the LGIP still maintains legal ownership of the account. Committee and staff discussion regarding the appropriate documentation and agreement ensued.
Treasurer Lewis requested committee input regarding the notification process under crisis situations. He mentioned that many state entities immediately began inquiring about STO's potential exposures but STO is required to notify STIC and Board of Finance of investment activity first. He also questioned whether providing responses

without complete information would have been prudent. Treasurer Lewis informed the committee that LGIP participants were sent a notification of how market events impacted the portfolio and that it still maintains an AAA rating. Committee discussion regarding communication priorities ensued.

Chairperson Designee Mevi presented a very preliminary range of unrealized losses on The Reserve Primary fund positions: from $11 million to $30 million in total for all STO portfolios based on information collected to date.

Committee members expressed support of the treasurer and staff actions under the circumstances and events of September and the current market.

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 month and quarter ended September 30, 2008.

Mr. Newman highlighted the effect that September sales had on WAM (shortened), CORE duration (lengthened), and monthly yield ($8 million in realized gains increased yield). Additionally, Mr. Newman informed the committee that the Treasurer's Office issuance of TRAN is on hold pending improvement in short-term credit rates.

Member Padilla-Jackson requested future month cash flow projections in addition to current month cash flows.

***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 month and quarter ended September 30, 2008.

Ms. Bargas provided a chronology of September events specific to the LGIP portfolio. She explained to the committee how the asset mix and WAM of the portfolio significantly changed as a result of investment activity in September. Ms. Bargas provided the committee with a copy of the letter sent to LGIP participants with the September statements.

Member Cassidy requested the chronology of events be emailed to STIC members.

Member Bohlin recommended that the September investment report be revised to accurately reflect the cross trade of the Reserve Primary fund position between the LGIP and the CORE.

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 month and quarter ended September 30, 2008.

Mr. Lujan explained to the committee several trades undertaken during the month: selling highly-marketable US Treasuries and reinvesting proceeds into comparable yielding US Agency securities. The sales realized gains.

Summary of Broker Participation
Chairperson designee Mevi presented a summarization of the broker participation for security purchases for September and the fiscal year to date, with additional breakdown by asset type and market.

Economic and Investment Outlook

Note: Economic and Investment Outlook was covered in 'Review of September' above.

IV. CASH MANAGEMENT & COLLATERAL REPORTS: August 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 August 31, 2008.

Collateral Report
Mr. Arsenio Garduño reported that one financial institution was under-collateralized as of August 31 and pledged additional collateral upon notification. All other depositories met their minimum collateral requirements for August 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. Garduño also presented collateral by custodial bank as of September 30, 2008.

Member Cassidy inquired about the status of September quarter-end information being provided by financial institutions and if any problems are being seen. Mr. Garduño replied that it is too early to complete risk assessments for the quarter but nothing unusual has been noticed.

Treasurer Lewis cautioned the committee about questioning on specific financial institutions because it may risk being made public and might be responsible for a run. He requested input from the committee and discussion ensued.

V. STAFF REPORTS
None

VI. COMMITTEE REPORTS

Discussion of proposed changes to Investment Policy
Chairperson Mevi provided follow up to September STIC meeting recommendations. Additionally, the new internal control procedure for 'unanticipated market changes' was presented to the committee for comment. Member Padilla-Jackson suggested that STIC

work on incorporating this authority into the Investment Policy during the current review/revision process.

Follow up items included diversification limits and selection of investments sections of the policy. The first recommendation in section VI.I.3 changes the CD Program limit to 35% of the LIQUIDITY portfolio from a dollar limit of $350 million, and the per institution limit from $30 million to $20 million.

Treasurer Lewis expressed his concern about changing this area of policy before consulting and vetting with the financial institutions for feedback. He recommended that STIC not vote on changing the policy at this point. Chairperson Designee Mevi clarified that the policy is open for discussion only today and these changes incorporate committee recommendations from the last STIC meeting. Treasurer Lewis reiterated that any changes will be conveyed to the concerned parties prior to STIC action and instructed that these specific recommendations be placed on hold.

The second incorporated recommendation from the September STIC discussion relates to section VI.I.7. The diversification limit for political subdivisions under subsection F.2.i of the policy changes the limit to 25% of the total General Fund portfolio.

The third incorporated recommendation in section VI.L.9 restates that competitive selection of CDs and private placement/direct purchases be negotiated at current market rates and eliminates the 95% correlation to comparable money market indices.

A recommended change to section VI.P.3 incorporates the same benchmark reporting requirements as in section VI.R.l.e. – monthly, quarterly, fiscal-year-to-date, and three-year basis – for consistency within the policy.

Chairperson Designee Mevi requested that the committee consider additional recommended changes, including any which the committee feel should provide authorities during unanticipated market events, and provide their suggestions via email by Oct 31.

Member Cassidy commented that the extraordinary events of the past month proved the effectiveness of the current policy. He suggested that the final maturity of tax-exempt securities (under authorized investments VI.F.2.h) be extended from three years to five years and, regarding diversification (VI.I.3), that even though we agree that the CD Program is intended to encourage economic activity, we should also be managing risk by requiring increased collateral levels.

Treasurer Lewis expressed his concern to the committee that, during the two years of his administration, the policy has almost been rewritten and that STIC keeps patching it up. He recommended that STIC spend quality time going over the policy to see if there are any essential major changes needed to strengthen the policy instead of piece meal changes. It should be a working document and not one that is changed every two or three months. He suggested that STIC wait until an investment advisor is under contract who can review the policy and then have STIC review and discuss the policy in a couple of months.

Chairperson Designee Mevi confirmed to the committee that the next discussion of the Investment Policy will be put off until the December STIC meeting.

Approval of recommended Broker/Dealer list

Mr. Scott Newman presented recommended changes to the STO Broker/Dealer list: retain both JP Morgan Chase and Bear Sterns; retain Barclays in place of Lehman Brothers; eliminate Bank of America (retain Merrill Lynch); eliminate Sterne, Agee and Leach; eliminate Vining Sparks *(see following discussion)*; add Oppenheimer; add BNP Paribas; add Compass Bank. The recommended eliminations were based on underperformance and lack of representation. The recommended additions were based on added value in forecasting, strategy, economy expertise, and specific asset type coverage.

Committee discussion on the recommended changes ensued. The committee agreed to retain Vining Sparks (requesting change in coverage) in light of their strong callable agency expertise.

Member Padilla-Jackson requested that approval be conditional upon a written certification from STO addressing that each policy requirement for broker/dealers has been met and the reason for each recommendation. Mr. Newman will provide a written confirmation with explanations.

Member Cassidy motioned for approval of the recommended broker/dealer list, retaining Vining Sparks, and amended to include a written confirmation that the broker/dealers are in compliance with Investment Policy requirements. The motion was seconded as amended by Member Bohlin. The motion carried.

VII. NEXT MEETING

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

VIII. ADJOURNMENT

Member Bohlin motioned to adjourn the meeting, seconded by Treasurer Lewis . The motion carried. The meeting adjourned at 12:00 p.m.

Respectfully submitted by:
Joelle Mevi, Investment Division Director