

OFFICE OF THE STATE TREASURER

STATE TREASURER'S INVESTMENT COMMITTEE (STIC) MEETING MINUTES
Wednesday, October 10, 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 St., Bldg. K, Santa Fe, New Mexico, on Wednesday, October 10, 2007.

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. Paul Cassidy, Public Member
Mr. Steven Bohlin, Public Member

Staff Present:

Mr. Mark Canavan, Senior Portfolio Manager
Mr. Joaquin Lujan, Portfolio Manager
Mr. Arsenio Garduño, Collateral Manager
Mr. Orlando Romero, State Cash Manager
Ms. Kirene Bargas, LGIP Portfolio Manager
Ms. Hannah Chavez, LGIP Accountant

Guests:

Ms. Stephanie Schardin, Legislative Finance Committee
Ms. Alexis Lotero, Department of Finance and Administration
Mr. Gillis Lang, Department of Finance and Administration

Approval of October 10, 2007, Agenda

Member Steve Bohlin motioned for approval of the agenda; seconded by Member James Lewis. The motion carried.

Approval of September 12, 2007 Minutes

Member James Lewis motioned for approval of the minutes; seconded by Member Paul Cassidy. The motion carried.

II. INVESTMENT REPORTS- Month and Quarter Ended September 30, 2007

General Fund Report

Mr. Mark Canavan summarized the investment for the General Funds Portfolio. The market value of the General Fund Investment Portfolio, net of TRANs, on September 30, 2007 was \$2.37 billion compared to \$2.58 billion at the same point last year and \$2.34 billion at the same point two years ago. During the month the market value of the portfolio increased 2.2% to \$2.37 billion from \$2.32 billion on August 31. The September month-end balance represents a 9.9% decrease from July's month-end balance of \$2.63 billion. The yield was 5.00% at month-end, down from 5.10% at August 31. The average term of the portfolio increased to 297 days from 268 days at August month-end.

The month-end portfolio holdings were 52.3% in U.S. Agency bonds, 13.3% in the overnight repurchase pool, 9% in certificates of deposit, 3.6% in money market mutual funds, 17.9% in commercial paper, and 3.9% in corporate bonds. \$542 million of investments were purchased for the month: \$17 million of certificates of deposit were purchased or renewed for the CD portfolio; \$7 million of U.S. Agency securities were purchased for the TRAN redemption fund; \$440 million of direct obligation commercial paper was purchased; lastly, \$94.5 million of corporate bonds were purchased for the General Fund Core Portfolio. Earnings for September were \$10.74 million, a decrease of 5.0% from August's earnings of \$11.3 million and a decrease of 5.8% from September 2006 earnings of \$11.4 million. Fiscal year-to-date earnings totaled \$34 million compared to \$36.1 million through the same period last fiscal year.

Mr. Canavan reported the Investment strategy employed during the past quarter. General Fund Investments during the quarter were laddered for the Core segment and cash-matched to known liabilities for the liquidity segment. Investment in ABCP was selective over the quarter, allowing most ABCP to roll off the portfolio and be replaced with direct obligations. Liquidity is being redeployed into the ABCP space as underlying collateral pools are analyzed and shock tested. For the Core portfolio, the global liquidity crisis of August and September opened significant opportunity to invest in credits as spread product widened to multi-year highs. At quarter end, core investments were scaled into investment grade corporate securities in the finance, brokerage, and banking sectors. Core segment purchases during the quarter ranged from 24 months to 5 years in maturity.

The investment strategy plan for the next quarter: excess cash in the liquidity segment of the portfolio will be drawn down for investment in term securities that will continue to be cash matched to liabilities. Occasional weighting to either side of the portfolio's maturity targets may occur as market or economic conditions warrant. Investments in the General Fund core segment will continue to be scaled into spread product as opportunities arise. The portfolio will continue investing beyond the 36-month time horizon. As credit spreads widen, it is anticipated that investment in high-grade asset-backed securities may be initiated on a selective basis.

Asset Mix and Maturity targets for the next quarter: Mr. Canavan stated that the liquidity segment of the portfolio will continue to target a weighted average maturity (WAM) of 21 to 45 days, remaining either short or long of that target as either the market or the state's

liquidity needs dictate. Commercial paper will continue to be purchased for the portfolio, with a preference given to direct-offer CP. As opportunities arise, the fund may purchase agency callable securities, deep in the money, trading to the call as a means of diversifying asset mix while maintaining yield. The core segment of the portfolio was significantly underweight its maturity and duration targets. This condition will subside as investment continues into the 48 and 60 month portion of the curve. Portfolio laddering will continue with emphasis placed on selective buying into weakness. The portfolio should reach duration of 1.5 to 1.7 years during the upcoming quarter.

Member Olivia Padilla-Jackson commented on the graphs and made suggestions regarding the general fund year-over-year balances and quarterly performance data tables.

New MexiGROW 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 September 30 was \$1.013 billion, compared to a market value of \$694 million at the same period last year and \$921 million at the same period two years ago. During the month the market value of the portfolio decreased 1.2%, from \$1.025 billion in August to \$1.013 billion. Participant contributions for September were \$40.3 million. Withdrawals during September totaled \$54.5 million. The gross yield was 5.35% at September 30, a .4% decrease from August month-end of 5.37%. The weighted average maturity at September 30 was 24 days, down from the August 31 weighted average maturity of 31 days and within the S&P-set limit of 50 days.

The month-end portfolio holdings were 10.36% in U.S. government agency securities, 9.36% in A-1+ commercial paper, 80.22% in AAA money market funds, and .06% in the bank account balance. LGIP earnings for September totaled \$4.48 million, a .67% increase from August earnings of \$4.45 million. Fiscal year-to-date earnings totaled \$13.3 million compared to \$8.7 million through the same period last fiscal year. The 30-day net yield of the LGIP as of September 21 was 5.30%, outperforming the 30-day net S&P Rated Government Investment Pool (GIP) index (5.07%) by 23 basis points. The 30-day gross yield of the LGIP at month-end, 5.36%, surpassed the 30-day gross S&P Rated GIP index of 5.3%. The administrative fee assessed to participants for September was 3.8 basis points; fees collected through September 30 totaled \$96,001.

Ms. Bargas summarized the investment strategy employed during the past quarter, plans for the next quarter, and the asset mix and maturity targets. 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-1+ (or AAA) rated with the remaining 50% being A-1 (or AA) rated, the portfolio maintained at least 99% of A-1+ rated investments. The weighted average maturity (WAM) was maintained at 50 days or less, averaging a 28 day WAM during the quarter. Maturity dates of purchased securities were laddered by week to provide constant cash inflows; however, the money market funds continued to be the primary instrument used for liquidity needs due to their competitive short-term rates. Purchase of A-1+ commercial paper was restricted to only direct-issue CP during August, with no purchases of this asset type since. Purchases of longer-term agency securities with call features were continued during the quarter in order to enhance the overall pool yield.

The annual review of the LGIP portfolio by S&P was conducted on July 25 with the AAAm rating being renewed and several compliance criteria relaxed.

Investment strategy plan for the next quarter: Ms Bargas reported the compliance with rating criteria will continue to mandate the investing strategy for the LGIP. Investment in agency discount notes will be utilized for shorter-term investments. Callable agency securities will be utilized to enhance yields and extend WAM, AAA rated money market funds will continue to be used for liquidity cash flows. The use of an overnight repurchase pool is still being formalized with Colombia Management and, as yet, an estimated launch date has not been provided. Investments in A-1+ commercial paper will be restricted to direct issue only. More active investment in fixed income term securities is planned for the next quarter.

Asset Mix and Maturity targets: WAM for the LGIP will be maintained at 60 days or less as the recent annual rating review allowed for a 10-day WAM expansion and, with yield curve normalization, will allow the portfolio to take advantage of higher longer-term yields. Asset allocation will fluctuate between direct issue commercial paper, agency discount notes and callable bonds, money market funds, and the overnight repurchase pool depending on the most favorable yield and portfolio diversification compliance limits. Commercial paper and agency discount notes will be utilized for shorter-term maturities, agency callable securities for longer-term maturities, and money markets for liquidity needs.

Member Steve Bohlin questioned why LGIP is limiting itself to direct issue commercial paper. In reply, Chairperson Mevi stated that her comfort level with regard to commercial paper purchase is uncertain until more complete CP issuer research is completed. Therefore, she would rather purchase directly from a corporation so as to have 'on balance sheet'-type securities in the LGIP portfolio. Member Mevi also reminded the committee; LGIP is able to invest in the overnight repurchase but is being set back due to Colombia Management's delay in contracting with S&P rated counterparties. Cantor Fitzgerald, a STO repo counterparty, was not S&P rated which left only two acceptable counter parties, and two is not enough offers to comply with policy. LGIP is in the process of approving other counterparties but the process is taking longer than expected. Member Paul Cassidy questioned having money in money markets rather than overnight repos, and asked what the difference is between yields. Chairperson Mevi responded that the overnight is at a 4.79% while money market yields are ranging from a 5.09% - 5.32%, even in the aftermath of the recent fed fund rate decrease. LGIP is comfortable with the money market yields at the time being.

Tax Exempt Bonds Proceed Investment Pool (BPIP)

Mr. Joaquin Lujan report that the market value of the Tax-exempt BPIP as of September 30, 2007, was \$539.8 million. During September the market value of the fund decreased 6.7%, from \$579.1 million at August 31 to \$539.8 million at September 30. The approximate \$39 million decrease was the net result of property tax revenues, interest earnings, and project expenditure draws. Interest earnings for the month totaled \$2.36 million, down from August earnings of \$2.54 million. Fiscal year to date earnings totaled \$7.50 million. The Tax-exempt BPIP month-end yield and term were 5.16% and 211 days. The month-end yield was 80 basis points above the selected benchmark, 4.36%, which is the highest arbitrage yield limit of any bond issue in the fund.

Month-end portfolio holdings included U.S. Agency Bonds (40.1%); shares in AAA rated institutional money market funds (29.6%); U.S. Treasury Bills and Notes (24.1%); and units in the overnight repurchase pool (6.2%). Investment activity during September included the purchase of \$11 million in U.S. agency securities.

Taxable Bond Proceed Investment Pool (BPIP)

Mr. Lujan included in his report that the market value of the Taxable BPIP as of September 30, 2007, was \$775.7 million. During September the market value of the fund decreased 7.7%, from \$841 at August 31 to \$775.7 million at September 30. The approximate \$65 million decrease was the result of monthly project expenditure draws. Interest earnings for the month totaled \$3.22 million, down from August earnings of \$3.54 million. Fiscal year to date earnings totaled \$10.46 million. The Taxable BPIP month-end yield and term were 5.20% and 291 days. The month-end yield was 17 basis points above the 2-year CMA index (5.03%); and 80 basis points above the Merrill Lynch 10% 0-3 year Treasury/90% 1-3 year Agency custom index (4.40%).

Month-end portfolio holdings included U.S. Agency Notes and Bonds (65.0%); AAA rated institutional money market fund shares (21.9%); overnight repurchase pool (8.4%); corporate bonds (2.4%); U.S. Treasury bills and notes (2%); and flex repurchase agreements (.2%). Investment activity during the September included the purchase of \$5 million in U.S. Agency bonds.

Mr. Lujan informed the committee of the investment strategy employed during the past quarter, investment strategy plan for the next year, and the asset mix and maturity targets. The investment strategy employed during the past quarter was to have both Bond Proceeds Investment Pools investing assets to either a) match debt service liabilities, or b) match estimated project draw liabilities. The amount and timing of outstanding bond issues determine the 'liability schedule' which, in turn, determined the maturity schedule (i.e., ladder) as well as the target weighted average maturity (WAM) of the portfolio. At the end of the quarter both pools were short their targets as investment of July's new issue proceeds totaling \$369 million continues into Q4. The overarching investment consideration this quarter was to lock in rates on short, high quality government securities as a) investors flocked to quality during August and b) the FOMC was forced to reduce the fed funds target rate and the market continues to price in future rate cuts.

What remains of July's new issue proceeds will be invested during the next quarter, with a focus on increasing portfolio allocations of high quality corporate and asset backed securities. The plan is to invest remaining proceeds/cash aggressively so that by December, when new issue proceeds once again shorten WAM, portfolios avoid cash drag as the yield curve steepens and money market rates fall.

The actual WAM of each portfolio will meet, if not exceed, target WAM during the next quarter, working away at excess liquidity. The risk of holding excess cash (falling money market rates) in the next three to six months exceeds the benefit (liquidity) given the added cushion that both portfolios currently mark substantial unrealized gains in high quality, liquid securities should an anomalously large project draw exceed modeled estimates and portfolio cash flows and require a sale of assets.

Anecdotally, it should be noted that October marks the one year anniversary of the BPIP investment program, which in the last year has increased annualized interest earnings from about \$51 million to \$68 million (a 33% increase) on the same base of about \$1.2 billion in bond proceeds.

Economic and Investment Outlook

Mr. Mark Canavan summarized the economic and investment outlook to the committee. The cut in Fed Funds appears to have been motivated as a means to ease negative carry, bolster faltering real estate, and migrate or ward off impending leverage unwinds. Mr. Canavan stated that on September 18th the FOMC initiated a 50 basis point cut in the discount rate and a 50 basis point cut in the Fed Funds rate, the first cut in Fed Funds since June of 2003. In part due to the FOMC rate cut, liquidity and confidence returned to the markets. Overnight rates came down, the rate of asset backed commercial paper redemption slowed; equity markets rallied and corporate bond new issuance hit a new record with \$112 billion issued.

With September's return of liquidity, many market participants may be lulled into believing that normalcy had returned. There is a high probability, however, that challenges to the liquidity of the financial system will continue for a significant period of time. The adoption of Basel II accounting requires that firms set aside reserves when holding securities. With the amount of ABCP absorbed in September these reserves requirements are likely to grow substantially. Furthermore, Basel II allows for the holding assets at cost if those assets are AAA rated. Should retained interests and assumed assets of CP be downgraded, reserve requirements will increase and the assets will no longer be eligible to be held at cost but must be carried at market. This could lead to substantial additional write downs which in turn would further pressure sources of global liquidity. By some estimates the orderly unwinding of assets from CDOs, CLOs, and other asset backed markets and derivatives could take years.

In addition to recent market turmoil, residential real estate markets are likely to suffer well into the future. The current subprime mortgage crisis is the result of poor underwriting standards compounded by a higher interest rate environment just as adjustable rate mortgages are due to reset. Even if rates should come down, however, there is a larger problem looming for residential markets: between 2009 and 2010 the baby boomer generation begins to enter the retirement phase of the life cycle. Barring a large influx of new immigrants, there will not be enough consumers entering the residential markets to support existing home prices.

While the Federal Reserve and most market participants anticipate continued moderate growth into 2008, there are many countervailing forces with which the markets and Federal Reserve will have to contend. Should more cuts to Fed Funds and the discount rate be needed, the dollar is likely to weaken even further below what are currently historically low levels. Additional weakening of the dollar inflates imports and has the potential to monetize what are already high commodity prices. Additional rate cuts also come with a moral hazard. Market participants may interpret the Fed's actions to mean they do not need to de-lever their portfolios to reduce risk. In fact, for some, the Fed's

easing will be seen as carte blanche to re-lever portfolios and continue the high risk behavior that is in part to blame for the current crisis.

The Taxable Bond Proceeds Investment Pool began selectively investing in the corporate space in August. As opportunities arise, it is anticipated the Taxable BPIP will layer in further purchases of spread product to enhance yield and diversify asset mix.

For the General Fund Core portfolio \$94.5 million of corporate bonds were purchased at September's high spreads. These purchases ranged from 24 to 60 months in maturity and targeted investments in insurance, banking, and brokerage. Further investment in spread product is planned going forward. Investments will be made as opportunities arise and as analysis of the liquidity and collateral pool history of various asset backed securities is finalized.

The General Fund Liquidity pool will continue to cash match investments to known disbursements of the State. As efforts to detail State cash flows in tandem with the State's fiscal agent come to fruition, the investment structure of the pool may be modified. Direct corporate obligation commercial paper will continue to be purchased. Purchase of ABCP will resume as programs are tested for asset liability structure, collateral pool history, and the strength of a program's liquidity support.

The LGIP will continue to roll assets using Agency securities, money market funds, and direct obligation commercial paper. While the most recent S&P ratings review of the LGIP confirmed the funds best of breed rating and allowed the LGIP to begin purchase of A1/P1 rated commercial paper, the fund will continue to purchase exclusively A1+/P1/F1+ rated programs.

Discussion was held regarding constant maturity/total return on the general fund with members Olivia Padilla- Jackson, Steven Bohlin, Paul Cassidy and Chairperson Joelle Mevi.

III. CASH MANAGEMENT REPORT: Month Ended August 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 August, 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 of the violations within those institutions. 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 August, 2007.

State funds totaled 287 accounts with an amount of \$71,755,497. 193 non-state fund accounts totaled an amount of \$28,948,526. There were eight accounts closed and three accounts opened for the month ending August 31, 2007.

Mr. Romero informed the Committee of several initiatives that the Cash Management Division is currently undertaking: 1) 53% of state and non-state accounts reflect Judicial District Courts. A review and analysis of all accounts is planned to establish a work plan which will include qualifying criteria for opening accounts. 2) Specifically working with courts and CFOs using Peoplesoft deposit and system entry functions so as to revert the systematic tracking of litigant funds back to judicial courts. 3) Working with fiscal agent bank on a service included under the contract: developing a cash flow module. Member Olivia Padilla-Jackson is interested in the cash analysis progress be reported at future STIC meetings and would like an update on the bank reconciliation.

Collateral Report

Mr. Arsenio Garduño reported on the collateral review by financial institution. There were no financial institutions out of compliance for the month ending August 2007; all institutions met the minimum collateral requirement of their quarterly risk assessments. The flexible repurchase agreement collateral report for the month ended September 30, 2007 reported that Citigroup was in full compliance for the month of September. The balance for Citigroup was \$1.1 million in flexible repurchase and \$3.5 million collateral pledged.

IV. STAFF REPORTS

Broker/Dealer List

Mr. Mark Canavan reported the Broker/Dealer list to the committee which consisted of twenty primaries and five alternative firms. Three replacement representatives for existing broker/dealer firms were reviewed. Four new firms were added to the primary list, with an emphasis to minority-owned firms, so that the list was expanded from 16 firms to twenty. The remaining five firms make up the alternate list which will be used to replace broker/dealers if they must be removed from the primary list. The committee had an in-depth discussion regarding the proposed changes and agreed not to limit the authorized list to twenty but to incorporate all the firms researched and approved do business with STO. Chairperson Joelle Mevi reviewed and summarized the discussion with the committee for consensus that all 25 brokers/dealers be incorporated onto the primary list. Member Steve Bohlin motioned for approval for the broker/dealer list and member Olivia Padilla-Jackson seconded the motion. The motion carried.

V. NEXT MEETING

Wednesday, November 14, 2007 9:00 a.m.

VI. ADJOURNMENT

Member Steve Bohlin motioned to adjourn the meeting, seconded by Member Paul Cassidy; the meeting adjourned at 10:53 a.m.