

MINUTES OF MEETING
STATE BOARD OF FINANCE

JUNE 2, 2015

A meeting of the State Board of Finance of the State of Arkansas was held in the Conference Room, Office of the Treasurer of State, Suite 275, Victory Building, Little Rock, Arkansas, at 10:00 a.m., Tuesday, June 2, 2015, pursuant to notice duly given to each member of the Board by the Chairman.

The following members were present:

Larry Walther, Director, Department of Finance and Administration
Dennis Milligan, Treasurer of State
Andrea Lea, Auditor of State
Edmond Waters, Arkansas Securities Commissioner
Luther Guinn, Representing Arkansas Bank Commissioner Candace Franks
Al Hamilton, Appointed Member
Gabe Holmstrom, Appointed Member
Al Harkins, Appointed Member
Keith Konecny, Appointed Member

Others present were Jim Harris, Grant Wallace, Gary Underwood, Autumn Sanson, Ed Garner, and Celeste Gladden of the Treasurer's staff; Rett Hatcher and Christian Olson of the Governor's staff; John Ahlen of the Auditor's staff; Justin Meatte of the Division of Legislative Audit; Ed Armstrong of the Attorney General's office; Michael Wickline of the Arkansas Democrat Gazette; and a KATV news team.

Larry Walther served as acting Chairman in the absence of Governor Hutchinson and called the meeting to order with recognition of a quorum.

Minutes of the meeting held on March 24, 2015 were approved as distributed.

Chairman Walther recognized State Treasurer Dennis Milligan to present the Treasury Investment Performance Report. Treasurer Milligan presented two charts to the Board. The first, 2015 Rate of Return for Short Term Investments, is included in the Minutes as Attachment 1. The

second, 2015 1Q/2Q Daily Liquidity Return, is included in the Minutes as Attachment 2. Treasurer Milligan told the Board that the two charts represent the phenomenal numbers the Investment Division has been able to achieve since February. He explained: in the month of February short-term investments earned \$182,000, in March earnings increased to \$237,000, in April earnings increased to \$419,000, and in May earnings increased to \$677,000. Treasurer Milligan told the Board that these numbers far surpass the past performance of around \$36,000 per year in total earnings.

Mr. Al Harkins asked if the increase in earnings was due to a volume increase versus a rate increase. Treasurer Milligan answered, that yes, the increase is due to volume, because in the past the money was not invested. Mr. Keith Konecny stated that he read in the Minutes of the last meeting that a different approach has been taken in the investment strategy. Mr. Milligan responded that yes, that is correct, and he asked Mr. Ed Garner to elaborate. Mr. Garner told the Board that in the last meeting the Board approved the addition of A2P2 commercial paper, and as indicated in the chart, when this change was implemented there was a noticeable spike in investment earnings. He explained further that the monies are invested by analyzing the cash flows of the Treasury and making projections to invest money on inflows to cover the outflows. He stated that all of the A2P2 commercial paper securities are invested for 90 days or under in maturity, and it is an everyday effort to manage the rolling maturity dates.

Mr. Edmond Waters asked, since interest rates haven't changed, whether this strategy requires taking on additional credit risk or interest rate risk. Mr. Garner answered and that yes, to some degree there is credit risk, although the risk is minimal because the commercial paper is the highest rated commercial paper in the marketplace. He explained further that the monies were being placed in a money market, earning only one basis point, which carries some risk in terms of redemption and liquidity, so there are different types of risk but they are of comparable risk. Mr. Waters asked what is the maximum maturity of the commercial paper investments? Mr. Garner answered that the maximum is 90 days. Mr. Waters stated to the Board that he wanted to reiterate that when rates are

historically low like they are right now, the temptation is to take on more interest rate risk or credit risk, and the Board needs to be aware of doing so. Mr. Garner responded that the level of investments being made represent the highest level of investment quality, and the investment strategy is not an attempt to increase returns by taking on additional credit risk.

Chairman Walther asked the Board if there were any questions of Treasurer Milligan or Ed Garner. There being none, he asked for a motion to add the Investment Performance Report to the official record of the Board of Finance. Mr. Harkins made a motion to add the Report to the record and the motion was seconded, with all members in favor.

Chairman Walther called upon Autumn Sanson to present the next agenda item, the Broker/Dealer Guidelines. These guidelines are included in the Minutes as Attachment 3. Ms. Sanson explained to the Board that the guidelines are a stand-alone document, created to comply with Act 1088, which requires that the Board establish eligibility requirements for investment depositories and securities brokers. The document will also be provided as a reference to broker/dealers who would like to do business with the Treasury. Chairman Walther asked if these are current guidelines that are being used, or if they are being changed? Ms. Sanson replied that these are the guidelines that are being used and have been for a quite a long time. Mr. Gabe Holmstrom asked if these guidelines will exclude anyone who is currently doing business with the Treasury. Ms. Sanson replied no, they will not. He asked if it will open up the Treasury to new brokers. She replied, that yes, they will. Mr. Harkins asked that if in that situation, would those new brokers be brought to the Board for approval? Ms. Sanson answered that yes, they will be brought before the Board.

Chairman Walther asked for any further questions or a motion from the Board. Mr. Harkins made a motion to accept the Broker/Dealer Guidelines as written. The motion was seconded by Treasurer Milligan and all members were in favor.

Next, Chairman Walther called upon Ed Garner to present the next item on the agenda, consideration of an amendment to the Treasury Investment Policy regarding maturity date restrictions.

This Amendment is included in the Minutes as Attachment 4, sections (II) (D), Investment Restrictions. Mr. Garner told the Board that the Investment Division is proposing a change to the average maturity of the portfolio from 5 years to 10 years, which is part of the recommendations made by Hewitt Ennis Knupp, because the investment policy was a little restrictive. Mr. Garner stated that the current target based on interest rate expectations will be much less, a target of 5-7 years, as the goal is not to gain return by significantly extending the portfolio by maturity at this time. He continued, explaining that there will be an exception – the expected maturity of any security will not exceed 10 years – that will be the final maturity date and in most cases in the portfolio now there is a final maturity date and it is within 5 years, so to be consistent the final maturity will not exceed 10 years with the exception of the following: Arkansas Capital Corporation bonds, State Board of Finance bonds, and State Building Services Certificate of Indebtedness. He explained that the use of mortgage backed securities with an average life will be added, and the average life will be used as the final maturity date. He explained that by definition of average life, mortgage backed securities are securities where the cash flow, principal and interest, pass through and they begin paying much like a loan would so some of the investment begins to pay off immediately, unlike final maturity or bullet bonds. The average life of those securities is treated as the maturity. When these securities are priced they are priced to benchmarks as an average life in terms of risk and so the average life will be used for pass-through type securities.

Mr. Konecny asked for clarification of the average maturity, if a security cannot exceed 10 years, then how can the average maturity of 10 years be achieved? Mr. Garner responded by explaining the average maturity of the entire portfolio will not exceed 10 years, which encompasses the commercial paper and the mortgage-backed securities. The final maturity of a pass-through security is the exception, it could exceed 10 years, but the average life of that pass-through security could not exceed 10 years. Mr. Harkins suggested a change to the proposed amendment to state “the

average maturity of the entire portfolio” rather than simply the “average maturity”. Mr. Garner agreed that this would be an appropriate change.

Mr. Waters asked if this meant that a mortgage-backed security could have a final maturity of 15-20 years, and he expressed concern that there was temptation to take on interest rate risks. Mr. Garner answered that yes, a final maturity could be longer than 10 years, but average life would be less than 10.

After some continued discussion about the risk involved in lengthening maturity dates, Mr. Garner offered the Board an analysis he had available that might help to assuage concerns if they would like for him to present it. The Board agreed to see the presentation. The documents included in this presentation are included in the Minutes as Attachment 5.

A summary of the report Mr. Garner gave the Board, is as follows: he told the Board, the first page, top left hand corner, is considered the long portfolio. It is the obligation of the Treasurer to maintain liquidity to pay the warrants and to the extent that cash flows exceed that it can be modeled to show that we won't need them anytime soon that forms the basis of going out longer and achieving a better return. The total PAR of the longer term portfolio, the bonds, is about 1.6 billion, of that about 99% of those are agencies purchased for higher yield. The next box down you will see that we have 56% callable agencies, 21% of non-callable agencies, and 21% step-ups. The risk we have right now is an interest rate risk, about 76% are callable, and this is one of the reasons you see the spike in liquidity – they are being called. If you will look at the next page, the bonds that you see in yellow are eligible to be called. If you look at the coupon rates, in the middle of that page, you will see that some of our coupons – 1% bonds, .875% bonds - you see in pink at the very top, those bonds are going to be called shortly. There's one that yields 87.5 basis points, right now our current return on commercial paper is 60 basis points. So, this page and the next page represent the interest rate risk of the long term, 1.6 billion dollar portfolio. If interest rates remain where they are the portfolio will be called within the year. We will be flush with cash and our earnings will drop significantly. Many of

the bonds in the portfolio now are step-ups. With step-ups there is a promise of an interest rate and the agency has the option to either call the bond or pay a higher interest rate at the next step or call date. Investors look at that and think that they are protected from interest rate moves and what happens is if it is in the agency's best interest they call the bonds and if it is in their best interest to leave them with you they leave them with you. The performance of these bonds in a portfolio is very poor. What potentially would happen is that we don't get called, and that would happen if interest rates rise and we would have an entire portfolio of agency step-up bonds at rates that underperform in a rising interest rate market. We've analyzed alternatives to this and that is the reason for these additions. What you are looking at now is a summary of moving out of one of these step-ups and into a very short mortgage-back security. The recommendations I've made about the securities we would move into are US congress created, government sponsored enterprise agencies - Fannie Mae, Freddie Mac, and Ginnie Mae - fully guaranteed principal and interest by these agencies. Professionally managed portfolios tend to not have a preponderance of step-ups or callable bonds. We made the investment in analytical software to model these securities and model their cash flows and we will be making investments in premium mortgage backed securities to enhance that cash flow, because these securities perform well in a rising interest rate environment. Whereas, remaining in the pools that we are in now in a rising interest rate environment would be devastating to the return of the portfolio. If you look at the last page it's easy to demonstrate this. The bottom axis is the yield change. The blue line are the step-ups, to sell those and move into the green line which is the mortgage-back security at 2.5 years average life, the pick-up is approximately 80 basis points, a yield of approximately 1.5% versus what we are in now at .75%. If you look at the red line, that is the difference between the two. If the step-up gets called and all the money goes into cash and for the purposes of this model, we assume the cash flow from both securities by comparison would go into 6-month Treasuries. You see in a rising interest rate environment, the blue line which is what we have now, the cash flow from that never, never catches up with the cash flow of the securities that I am proposing that we move into. In

a declining interest rate market you're still protected. In a declining interest rate market, all of those in the yellow go away. In a rising interest rate environment they underperform the current market, and that term is called negative convexity. The pickup in yield is not the optimum reason for doing this, it is the exposure to underperformance, charted on the previous page, which is called negative convexity. In other words your interest rate risk to underperform in all circumstances of the step-up is negative 1.1 and moving into the 2.5 average year life pool it drops to negative 0.22. This is critical for this portfolio to maintain return. We will be able to enhance the return of the portfolio making this move. I could conservatively say we would increase the return at current state by about 5 million dollars over the next year by making this move into these assets. Again, your concern about the long average life, that is not the direction I am moving or making the suggestion to move in. This is a 2.5 year average life, we have some other securities that I've modeled that go out as far as 5 years, but essentially, I'm trying to upgrade the investment policy as far as ratings, enhance the return, and really lessen the interest rate risk rather than assuming more.

Mr. Waters asked Mr. Garner if the case is that the Investment Division wants the ability to go longer but won't be doing it at the present time? Mr. Garner responded affirmatively and stated that if we feel interest rates are very high, it would be better to extend longer. This is not that time. That is not the reason for the wording of the investment policy. Last month we had about 300 million dollars of bonds called that were paying 80 basis points or higher, and this past month we had 100 million called, and in June the projections are for 300 million dollars of maturities out of the long portfolio. This longer, better earning, long term portfolio is slated to go away. We are having to invest cash every week, if it matures today I don't go beyond a week because I don't want to impact the investment policy.

Mr. Harkins asked if the need to invest this cash every week is due to calls and maturities? Mr. Garner responded affirmatively and stated that the average return got as high last month as 94 basis points, then dropped to 84 and that drop will continue, because what is eventually going to be

left in the long-term portfolio will be the Treasuries, which are 25-30 basis points. We can make this shift and be in bonds, because we are going to buy premiums, they cash flow principal and interest monthly, and we will begin reinvesting that in higher rates. That's why the interest rate risk of what I am proposing is actually lower. The negative convexity, the impact, and the returns are better. The credit is essentially the same.

Mr. Walther asked if the daily liquidity return, which is rather high right now, will continue to occur until the ability is there to invest in these additional longer term securities? Mr. Garner responded that the Treasury will continue to have cash flow out of the long term portfolio into the short term portfolio, which has begun to really increase in the last 30 days. He stated that the Treasury will continue to maintain approximately a billion dollars in the liquidity portfolio because that is the ultimate priority, to maintain that liquidity, and we are going to continue invest money in our commercial paper program. But, our return at this point is at the lowest yields that I have experienced. It could go up if interest rates rise but we probably won't have 1.3 billion in commercial paper, but if we don't do something then we would be forced to extend into current permissible securities which I think would not be wise even with an outlook of a year at higher interest rates. Making those solid extensions without cash flow to reinvest would begin to impact our returns.

Mr. Harkins commented that, in his opinion, interest rates are not going up significantly in the next 2-3 years, and he feels the Board would be safe with the proposed practice. Mr. Waters also commented that he felt the proposal was on the right track, and is prudent, with the understanding that rates can't go down much more so where else can they go but up, eventually.

Chairman Walther asked the Board if there were any more questions or a motion to come before the Board concerning the requested amendment. Treasurer Milligan made a motion to approve the amendment as written. Auditor Lea asked if the motion is to approve the amendment with the proposed change to the wording in regards to the average maturity of the "entire portfolio". Chairman Walther responded affirmatively. Mr. Harkins seconded the motion and all were in favor.

Chairman Walther again called upon Ed Garner to present the next item on the agenda, consideration of an amendment to the Treasury Investment Policy establishing guidelines for out-of-state municipal bonds. This Amendment is included in the Minutes as Attachment 4, sections (II) (D) Treasury Funds Policy, Eligible Investments and (IV) (D) State Treasury Money Management Trust Fund Policy, Eligible Investments.

Mr. Garner explained to the Board that Act 1088 allows the purchase of out-of-state general obligation bonds without regard to rating. Investing in non-rated GO's of a territory would not be prudent. In the first bullet point, a rating restriction has been added. Act 1088 also allows the Treasury to make investments in bonds that are not general obligations, which are the full-faith credit and taxing power of the instrumentality. In putting in the second bullet point - obligations of the states of the United States, political subdivisions, municipalities, etc. - this allows for revenue bonds. Mr. Garner continued by stating that the Investment Division is not advocating buying revenue bonds, which would not be allowed under Act 1088, however what is allowed under Act 1088 is that the Treasury can buy bonds that are fully guaranteed by US congress created agencies, principal and interest. There is a niche in the housing bond market – this would allow investments in that niche. The housing bonds are rated AA and above and all of the cash flow, all of the loans, all of the paper, are 100% by government sponsored entities created by Congress. He continued, this is in line with Act 1088 and it would allow us to participate in that niche. These bonds basically function the same way as mortgage-backed securities. However, because they are niche, and they are municipal bonds, the yield is significantly higher. There are several large banks in the area that have done very well exploiting that niche and the Treasury would like the ability to use those bonds the same way we use the other investments, with the same maturity and average life restrictions that the Board just enacted.

Chairman Walther asked for any questions or a motion from the Board. Mr. Harkins made a motion to approve the Amendment as written. The motion was seconded by Mr. Waters and all were in favor.

Chairman Walther called upon Grant Wallace to present the next agenda item, the consideration of the Treasurer of State employee job qualifications and minimum standards for FY16. The FY16 Job Qualifications are included in the Minutes as Attachment 6. Mr. Wallace explained to the Board that the position qualifications and standards are being matched up with the appropriations bill for FY16 which included changes to the position titles, and there is an increase to the qualifications and standards for the positions of Deputy Chief of Staff and Assistant Chief of Staff, which are currently occupied by Jason Brady and Grant Wallace, respectively. Auditor Lea asked if the appropriations bill has been passed. Chairman Walther answered that yes, the appropriations bill was passed in regular session. The Chairman asked for any questions or a motion from the Board. Treasurer Milligan made a motion to approve the FY16 Job Qualifications. The motion was seconded by Mr. Waters and all were in favor.

For the last Agenda item the Chairman made the following statement: “As Chairman of the Board of Finance, I would like to make a motion that the Board direct the Treasurer of State to purchase warrants for the succeeding quarter pursuant to Act 1088 of 2013 and to keep reasonable amounts in demand deposit accounts and money markets during the next quarter for the transaction of day to day activities.” The motion was seconded by Mr. Waters and all were in favor.

To conclude, the Chairman asked if there were any further issues to be brought before the Board. There being no further business, the Chairman accepted a motion to adjourn.

ATTEST:

Secretary of the State Board
of Finance of the State of Arkansas

Acting Chairman of the State Board
of Finance of the State of Arkansas

Secretary’s Note: All documents pertaining to the issues considered are filed in the permanent records of the State Board of Finance.