

MINUTES OF MEETING
STATE BOARD OF FINANCE
SEPTEMBER 24, 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 10:30 a.m., Thursday, September 24, 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
Marjorie Greenberg, Representing Governor Asa Hutchinson
David Smith, Representing Arkansas Securities Commissioner Edmond Waters
Susannah Marshall, Representing Arkansas Bank Commissioner Candace Franks
Cale Turner, 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, Melissa Corrigan, Larry Tate, Gary Ballard, and Celeste Gladden of the Treasurer's staff; Christian Olson of the Governor's staff; John Ahlen of the Auditor's staff; Ricky Quattlebaum of the Department of Finance and Administration; and Andy Babbitt of the Division of Legislative Audit.

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 June 2, 2015 were approved as distributed.

Chairman Walther began by welcoming a new Board member, Cale Thomas. Mr. Thomas was appointed by Speaker of the House Jeremy Gillam on September 22nd, to serve in the vacated seat of Mr. Al Hamilton, as a representative of the CPA community. Following Mr. Thomas's introduction to the Board, all members went around the table and introduced themselves.

The Chairman then addressed the next item on the agenda, a list of annual and quarterly motions to be brought before the Board, to be approved in a block motion. The Board members were provided with a list of these motions prior to the meeting to review. They are as follows:

Annual Motions:

1. Approve the record keeping systems of the Treasurer of State with the accounts recorded using the cash basis of accounting as necessary in its daily transactions with adjusting entries to be made at each fiscal year end to properly report the operating results of the Treasurer of State on the accrual basis of accounting which is consistent with generally accepted accounting principles (GAAP).
2. Approve the record keeping and reporting requirements of the Treasurer of State , to include at the minimum the following reports:
 - a. Ledger Balance and Activity (Daily and Monthly)
 - b. Fund Transactions by Type (Daily and Fiscal Year-to-Date)
 - c. Checks Charge Off Detail by Line Item (Daily and Fiscal Year-to-Date)
 - d. Safekeeping Inventory (Daily)
 - e. Trust Fund Certificates of Deposit (Daily)
 - f. Collateral Sufficiency (Daily)
 - g. Demand Account Balances (Daily)
 - h. Money Market Balances (Daily and Monthly)
 - i. Return on Investment (Monthly and Fiscal Year-to-Date)
3. Approve the overall rate of return to be the range of 1.25% to 1.50%. A monthly report of the actual rate of return compared to the projected rate of return shall be made to the Board of Finance.
4. Approve the current Collateralization Policy of the Treasurer of State.
5. Approve the Code of Ethics for the members of the Board of Finance and the Code of Ethics and criminal background checks for the current employees of the Treasurer of State.
6. Amend the Investment Policy to establish the following *minimum* Certificate of Deposit Rates:

1 Month	0.20%
3 Months	0.30%
6 Months	0.40%
9 Months	0.50%

Quarterly Motions:

1. To establish that no funds are available for deposit into the State Board of Finance Certificate of Deposit Investment Program
2. That the Board directs the Treasurer of State to purchase warrants for the succeeding quarter and to keep reasonable amounts in demand deposit accounts and money markets during the next quarter for transaction of day to day activities.

The Chairman addressed the Board and asked if there were any questions. Mr. Keith Konecny asked what was the previous target rate of return on investments? Mr. Ed Garner responded it was 0.8-1.2%, and has subsequently been raised to meet the actual returns of the Treasury investments at the present time. There were no further questions from the Board. Mr. Al Harkins made a motion to approve these motions before the Board in a block, and the motion was seconded by Mr. Gabe Holmstrom. All members were in favor.

Chairman Walther then recognized State Treasurer Dennis Milligan to present the Treasury Investment Performance Report. This report, "Investments Operations and Projections - Third Quarter 2015", is included in the Minutes as Attachment 1. Treasurer Milligan told the Board that since campaigning for the office of Treasurer of State and subsequently taking over the office, he knew the highest level of scrutiny would be within the Investment Division. He explained that the mission of the Treasury is to ensure adequate operating liquidity and then maximize returns on investments, and he challenged his team to take a more active management style and to do more in house analysis to better manage the taxpayer's money. He told the Board that this is being accomplished in three stages. First, the investment team recommended investing in commercial paper. With the approval of the State Board of Finance, the team was able to begin investing in A1/P1 and A2/P2 commercial paper. This has earned over 3.4 million since January. The next phase was reviewing relationships with banks holding Treasury demand accounts. Demand accounts have earned over \$448,000 this year. In addition, the investment team has been able to take advantage of a new investment option, Insured Cash Sweep accounts. With the initial investment, these accounts have earned over \$105,000. The third phase was to begin investing in mortgage-backed securities, with the approval of the State Board of Finance in June, this effort has just begun, and with only a portion of the portfolio invested these securities have earned over \$1.3 million. Treasurer Milligan added that these results were accomplished without experiencing any increase in interest rates and also the life of the portfolio has

been shortened. He explained to the Board that through these efforts the Treasury has been able to build upon the efforts started under Treasurer Robinson to track the cash flow of the Treasury. The team is constantly reevaluating and updating the cash flow model to better manage, project, and invest funds. Treasurer Milligan told the Board that he is extremely proud of Ed Garner, Autumn Sanson, and the rest of the Investment Division and Treasury staff, who have worked very hard to make these returns possible. He then invited Ms. Sanson to come before the Board and give further details on the progress of the Treasury portfolio.

Ms. Sanson began by reiterating that very little cash flow analysis was done in the prior administrations, but during Treasurer Robinson's time, staff began developing relationships with state agencies that had the most activity. This gave staff the ability to see consistent inflows and outflows, which led to implementing new short term investments, such as commercial paper. She explained that when Treasurer Milligan came into office he implemented a more active approach and a more willingness to use technological tools such as Bloomberg and other analytical software. Ms. Sanson told the Board about new investment instruments the team has utilized. The first, commercial paper, is a debt-issue by an entity that has a fixed maturity date that runs from 1-270 days. Typically, this type of debt is issued to fund a company's short term working capital. The Treasury currently buys A1-P1 paper going out to 180 days and A2-P2 paper going out to 90 days. She noted that a good example of this type of paper is CenterPoint Energy. Ms. Sanson stated that the current average yield on commercial paper is 55 basis points. She referred the Board to Chart 6 in the Report, which shows the commercial paper earnings for 2015 year-to-date. The second instrument Ms. Sanson told the Board about, demand accounts, are checking accounts that earn interest. She stated that some of the account's main functions are day-to-day activity, such as state warrants coming in or out, or the transactions related to the CD program. Some accounts are just used as a liquidity alternative to commercial paper or money markets. She explained that at the beginning of the year, banking relationships were reassessed, and the Treasury has been able to capture better yields on those

accounts and new relationships were started. Ms. Sanson told the Board that these types of accounts help support liquidity needs tremendously and are currently earning 46 basis points. Ms. Sanson then turned the presentation over to Mr. Ed Garner to give an overview of the total earnings for the short-term portfolio.

Mr. Garner addressed the Board and said that he was going to go over some of the other new components of the portfolio. He first talked about the Insured Cash Sweep account. Insured Cash Sweep (ICS) is an account with the Bank of the Ozarks and a vendor, Promontory Interfinancial Network, with clearing through Bank of New York Mellon. The Treasury has deposited approximately 125 million dollars into this account, which was then dispersed to banks throughout the nation in amounts under the FDIC insured limit. Mr. Garner referred the Board to Chart 9 in the Report. He stated that the gold bar in the chart is the ICS account, and is the most liquid part of the portfolio. Mr. Garner told the Board that the Treasury has spread deposits across demand accounts in a number of banks, and in the event of a shortfall or variation in the cash flow analysis, there is an ability to withdraw small amounts off the top of each of their deposits. The bank sees that money as long-term, even though there are no commitments to that, which has allowed negotiation of higher rates. Mr. Garner told the Board that the Treasury currently has approximately 200 million in demand accounts and 125 million in ICS accounts, and with the ICS account paying 53 basis points, the range of earnings between demand and ICS is 46 - 53 basis points. Mr. Garner then referred the Board to Chart 10. He explained that in the prior administrations, money markets were where all of the liquidity of the portfolio was held. In January, the earnings on the money market totaled \$5,300, and as the Treasury moved funds out of money markets and into commercial paper, these amounts decreased. Last month, \$11 was earned on the remainder in the money markets. He continued explaining Chart 10 which comprises the short-term portfolio, “the money came out of the money markets and started going into commercial paper (blue bar) and we saw the earnings, then we added

the demand accounts (green bar), and in the last few months about mid-June we added the ICS account (gold bar).” He then referred the Board to Chart 11, for a short-term portfolio comparison for the months of January – August in years 2013 - 2015. In the chart, the blue line represents 2013, the green line 2014, and the red line 2015.

Mr. Garner then moved on to talk about the long-term portfolio. He reminded the Board that in the last meeting, it was discussed that the long-term portfolio was jeopardy due to long bonds being called, and he told the Board at that time he felt that mortgage-backed securities were an ideal fit for the Treasury’s long term portfolio. Mortgage-backed securities not only yield better returns, but they pay interest and principal monthly. The long-term portfolio had consisted of agency bonds, which were either callable bonds or step-up bonds. He told that Board that if you look at money management firms nationwide, not many of them use these types of securities. What the Treasury had was termed a “negatively-convexed” portfolio. The long-term bond portfolio in January was 2.4 billion and it was earning approximately 85 basis points on average. In April that dropped to 2.1, and in June to 1.6, because the bonds with good yields were being called away. Mr. Garner stated that in June, the investment team began making the move into mortgage-backed securities, selling the agency bonds and purchasing agency mortgage-backs. He pointed the Board to a handout in their packet, an example of one of these swaps. This handout is included in the Minutes as Attachment 2. He explained, “in the Bloomberg printout, we analyze the mortgage back securities across various rates of pre-payment speed. On this trade we purchased about 6.4 million dollars of mortgage backed securities, paying \$105-1/2, at a coupon of 4.5%. Using this analysis, and vector analysis which lets you put in prepayment speeds in any months, can allow us to determine worst case scenario, which is at what prepayment speeds cause a negative return. At that point, we do not buy those bonds. But, we modeled the cash flow of this bond and the average yield on this one was about 2.5% at current speeds. So, we sold out of 7/8th coupon FNMA’s, and the sellout yield on the next page was 93 basis points, and picked up agency mortgage backs earning above 2% across various scenarios.”

Mr. Garner then referred to Chart 13 in the Report, Mortgage-Backed Securities Earnings. He said that when the investment team began in June, earnings were around 173K. The real push began in August, and as of now, the Treasury has about 700 million in mortgage-backed securities, and about 600 million left in the old bonds. During the first half of the month, the mortgage-backed securities portion of the long portfolio has earned one million dollars. He then referred to the next slide, Chart 14 in the Report, which a combination of Long Term and Mortgage-Backed Earnings. He stated that as a result of calls you see the earnings begin to drop because that money comes back and ends up in the liquidity portfolio. Then you see the addition of mortgage-back securities. Next, he referred to Chart 15, Total Activity Review. The blue line is the ICS account, the yellow line is demand accounts, and the green line is commercial paper. He explained, "you can see the decreasing return of the long term portfolio as agency bonds are called and we swap out. The red line is the earnings of the mortgage-backs, this is going to continue to move up." Mr. Garner told that Board that the investment team has shortened the average life of the entire portfolio, increased the earnings of the portfolio, and cash flow is extremely high. The portfolio is prepared for higher interest rates. Mr. Garner then turned the presentation back over to Treasurer Milligan to conclude.

Treasurer Milligan addressed the Board and referred them to Chart 16 in the Report. He explained that the chart represents a comparison, year-to-date, for the return on the entire portfolio. Treasury investments are approximately 2.5 million ahead of where they were at this point in 2014, and approximately 2.3 million ahead of where they were at this point in 2013. He moved on to the next slide, Chart 17 in the report, and told the Board that this chart represents a projection for the earnings for the rest of the year. The investment team is conservatively projecting earning the taxpayers of Arkansas 25 million on the entire portfolio. This would be an increase of approximately 6 million more than the past two years. Treasurer Milligan then told the Board how he and the investment team plan to proceed. The portfolio will continue to be reviewed and reevaluated, fine

tuning the cash flows and the investment strategy to be active and responsive to the market, and to secure the greatest returns at minimal risk and the greatest liquidity. He then thanked the Board for their cooperation, trust, and flexibility, which allows the Treasury to serve the taxpayers of Arkansas. Treasurer Milligan said that he and the investment team would take any questions from the Board.

Mr. Harkins stated that he did not have any questions but said he was very impressed with the presentation and the performance of the team. Chairman Walther agreed and stated that he has been very pleased with the way Board meetings have been conducted and with how information has been presented. He said that his team at DF&A has worked very well with the Treasury staff.

Next, after the question was raised by Mr. Konecny, there was some discussion about business being offered to and done with local banks. Treasurer Milligan, Ms. Sanson, and Mr. Garner all assured the Board that every effort is made to keep business local. Ms. Sanson reminded the Board that the Treasury operates a CD Trust Program that is offered exclusively to banks in Arkansas. Mr. Garner stated that when bonds are sold, they are sold to the highest bidder, without preference to in-state or out-of-state. The bond purchases are typically specific securities, and it is not possible for all brokers to offer the same bond, but the business is spread amongst 16 brokers, and a lot of it is done locally.

Being no more questions from the Board, the Chairman asked for a motion to approve the Treasury Investment Performance Report, and accept it into the record. The motion was made by Mr. Konecny and seconded by Ms. Greenberg. All members were in favor.

Next, the Chairman recognized Ed Garner again to discuss the next item on the agenda, a report of new broker/dealers. Mr. Garner told the Board that the Treasury has begun transacting business with a new broker/dealer, Incapital, out of Chicago. He explained to the Board that Incapital is a firm that specializes in step-up agency securities, and has been the best bidder on the agency bonds that the Treasury has been liquidating. Mr. Garner reported to the Board that all required paperwork is on file for this new broker/dealer. Mr. Harkins made a motion to accept the report of the

new broker into the record, the motion was seconded by Ms. Greenberg, and all members were in favor.

To conclude, the Chairman asked if there was any other or new business to be brought before the Board. There being no further business, the Chairman declared the meeting adjourned.

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.