

MINUTES OF MEETING
STATE BOARD OF FINANCE

December 3, 2019

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 1:00 pm, Tuesday, December 3, 2019, pursuant to notice duly given to each member of the Board by the Chairman.

The following members were present:

Larry Walther, Secretary, Department of Finance and Administration
Dennis Milligan, Treasurer of State
Andrea Lea, Auditor of State
Candace Franks, Arkansas Bank Commissioner
Edmond Waters, Arkansas Securities Commissioner
Chad Brown, Representing Governor Asa Hutchinson
Cale Turner, Appointed Member
Jim Bob Britton, Appointed Member

Other present were Jason Brady, T.J. Fowler, Martin Kelly, Damon Dortch, Stacy Peterson, Celeste Gladden, Autumn Sanson, Gary Underwood, and Grant Wallace of the Treasurer's staff; Paul Louthian and Debbie Rogers of the Department of Finance and Administration; Andy Terry, PhD, CFA, and Ashvin Vibhakar, PhD, CFA, professors at the University of Arkansas at Little Rock; Lorrie Trogden, CEO, Arkansas Bankers Association; and Mike Wickline, reporter for the Arkansas Democrat Gazette. 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 August 6, 2019 were approved as

distributed but noted that Mr. Walther's title needed to be changed on future minutes to Secretary, rather than Director.

Chairman Walther recognized State Treasurer Dennis Milligan to present the Treasury Investment Performance Report for the first quarter of fiscal year 2020. The report is included in the minutes as Attachment 1. Treasurer Milligan greeted the Board and started by telling the board that the federal interest rate had been cut twice, for a total of 50 basis points since the board had last met. He also reported that the Treasury had made significant changes to the investment portfolio by scaling back the commercial paper investments and diversifying the long- and short-term portfolios in the first quarter of fiscal year 2020. Treasurer Milligan told the Board that the treasury receipted \$22.6 million in the first quarter of 2020. Treasurer Milligan said the short term portfolio ended the quarter with \$12.7 million, which was comparable to \$13 million that same time in fiscal year 2019. He further explained that the difference was due to reducing the commercial paper holdings by diversifying into new asset classes such as agency discounts and Treasury bills. Treasurer Milligan went on to report that the long term portfolio received \$9.9 million, which was lower than what Treasury received that same time period of fiscal year 2019, which was \$12.4 million. Mr. Milligan explained that the reduction of holdings in commercial paper brought opportunity to diversify the long term portfolio, which was done by restructuring the mortgage backed holdings and adding additional asset classes such as agency variable rate notes, small business loans, CMB's, and callable bonds. He also noted that the decline in the 10 year treasury rate also contributed to the lower receipts that quarter compared to the same time frame in fiscal year 2019. Treasurer Milligan said that between the long and short term portfolios, the quarterly weighted average yield for the first quarter of fiscal year 2020 was 2.37%. Treasurer Milligan reported that the State Treasury Money Management Trust earned \$801,000 as of September 30th at a rate of 2.14%. He went on to explain that it was lower than

the previous year at that time, but that it followed the same curve of the federal interest rate. Treasurer Milligan then discussed how his office, through the use of Bloomberg, was able to monitor the 5 and 10 year Treasury rate and the effect they had on the global markets. He pointed out that he had his team develop a chart that would reflect each time the Fed had meetings and how that affected Treasury rates. Treasurer Milligan concluded that he would continue to challenge his team to diversify the portfolio in ways that prioritize safety of investments first, then liquidity, and then return. Treasurer Milligan ended his presentation asking the Board if there were any questions. There were a couple of follow up questions and discussion about the revenue of the Treasury being derived from investments and the portfolio size of the Treasury being \$4.5 billion. Chairman Walther asked for a motion to accept the Treasurer's report into the record. The motion was made by Candace Franks and seconded by Cale Turner. All members were in favor.

Next, Chairman Walther made a motion to establish that no funds were available for deposit into the State Board of Finance certificate of deposit investment program. The motion was seconded by Jim Bob Britton. All members were in favor.

Chairman Walther then made a motion that the Board direct the Treasurer of State to purchase warrants for the succeeding quarter, January 1, 2020 through March 31, 2020 pursuant to Act 1088 of 2013, and to keep reasonable amounts in demand deposit accounts and money markets during the next quarter for the transactions of the day-to-day activities of the State. The motion was seconded by Edmond Waters. All members were in favor.

Chairman Walther recognized consultants, Dr. Ashvin Vibhaker and Dr. Andy Terry, for the presentation and conclusion of the analysis of the Treasury investment portfolio requested by the Board. The report is included in the minutes as Attachment 2. Dr. Terry first addressed the

Board by thanking the Treasury for the very cordial process and the support they gave to them during the analysis. Dr. Terry and Dr. Vibhaker, after visiting with Treasury staff, felt that the underlying theme was how to make a state-of-the-art Treasury, and adopt practices and procedures that transcend beyond whoever is managing the portfolio. He went on to report on the order of the analysis. The consultants first started with liquidity, which involved looking at cash flows. He added that some recommendations and comments in the report may be moot simply because Treasury had adopted many recommendations already. Dr. Terry started by addressing different cash flow slides showing 2 years of historical data and noted that, in the past and currently, Thursdays were a big positive net cash-in day in the Treasury, due to Medicaid deposits. He stated that Fridays were big negative days, due to fund disbursements, such as DHS and other state agencies, payroll, and vendor payments. Dr. Terry then moved on to a chart that showed a monthly cash flow view. This chart showed that the big net inflow months are the tax payments made typically in January, April, July, and December and the big outflow months were refunds paid out, which were May and early refunds were in February. Dr. Terry concluded there were a few approaches that the Treasury could take moving forward. The first of these approaches was a bucketed approach. The first bucket would be a liquidity bucket, which would serve to meet the short term needs, and would be estimated at \$250-\$500 million depending on what the perfected cash flow model predicted. The second bucket would be the intermediate bucket, that would structure maturities out 1-3 years. The last bucket would be the long-term bucket which would extend maturities out 3-5 years. The last two buckets critically depend on the maturity structure of the liabilities. The recommendation was to work with other agencies to figure out which disbursements critically impact how long investments can go out. Dr. Terry noted that in an upward sloping yield environment the longer you go out, the higher returns typically are. Dr. Terry continued by recommending that the Investment Division expand the

team, and also hold weekly meetings, which he noted is already taking place. Dr. Terry also recommended that additional reporting should be supplemented and given to the Board since they ultimately have the fiduciary duty. Dr. Terry concluded this part by recommending that the board set an appropriate rate of return, a benchmark, and in the event of significant changes in the portfolio, request a rationale for doing so.

Dr. Terry next analyzed the question of active management and was it creating value relative to a more structured and possibly more passive approach? Dr. Terry said there was an extensive historical look into the portfolio, particularly what risks the Treasury is taking. The conclusion was mainly interest rate risks. If interest rates go up, he stated, that is a good thing as one can reinvest at higher yields; the only negative is if one had to sell something too soon, before maturity prices had fallen. He noted, on the flip side, if rates fall, then reinvesting will occur at a lower rate, and one will see a decline. He noted that the portfolio was exposed to that at year end. Dr. Terry goes on to say that the only credit risk in the portfolio is commercial paper and that was discussed in the August meeting, and is being handled by rating limits. Dr. Terry then talked about liquidity risk and the issue of having to sell early to meet liquidity needs; however, he said that the liquidity bucket previously mentioned should take care of that. Dr. Terry continued with prepayment risk which he stated was a real risk for Treasury at year end. He said this is related to mortgage backed securities and CMO's. Dr. Terry moved on to the investment policy statement where he made two recommendations. The first recommendation was to create more of a target sector or asset allocation, and to have limits on duration. That would allow the Treasury to create a target asset allocation and create a benchmark for performance measurement. Dr. Terry's second recommendation was to create an investment operation manual, which would be a high level manual, that would include a compliance piece.

Dr. Terry concluded that he understood that all the information given may seem like a daunting task, but he hoped that Treasury would remember that this is a process, not an end. Treasurer Milligan and Chairman Walther both thanked Dr. Terry and Dr. Vibhaker for their guidance and hard work on the project. Mr. Walther asked for a motion to accept the report into record. Candace Franks made a motion to accept the report and it was seconded by Edmond Waters. All members were in favor.

Mr. Walther then recognized Treasurer Milligan to give updates and comments regarding the UALR recommendations. Mr. Milligan stressed the importance of implementing these recommendations and executing these changes during his last term in office.

Mr. Walther recognized Treasury Senior Investment Manager, Martin Kelly, to present to the Board recommendations of new broker dealers. Mr. Kelly stated that the Treasury had reallocated resources across the broker dealer universe and that each broker dealer was relied on for research and market insight. He recommended the following broker dealers be added: Nomura, Piper Jaffray, MulitBank Securities, Oppenheimer, Lloyd Securities, Mizuho, Mitsubishi, RBC Hilltop, Jefferies International, and FCStone. Mr. Walther asked for a motion to accept Mr. Kelly's recommendation. The motion was made by Jim Bob Britton and seconded by Edmond Waters. All members were in favor.

Mr. Walther recognized T.J. Fowler to discuss the proposed changes in the State Treasury Investment Policy and Money Management Policy pursuant to Act 882 of 2019. Mr. Fowler provided the Board with redlines of both the Treasury Investment Policy and Money Management Trust Fund Investment Policy. These redlines are included in the minutes as Attachments 3 and 4. Mr. Fowler stated that due to the law that recently went into effect, the language in policy would need to be revised. Mr. Fowler first addressed the history of the law

which required that Treasury receive three quotation bids prior to any purchase or sales of securities. Mr. Fowler explained that there were a number of asset types that one cannot receive quotation bids on, mortgage backed securities being one of them. Mr. Fowler stated that new language was drafted to better attain the goals of retaining the optimal pricing value of securities and not showing preference towards any securities broker. Mr. Fowler noted that the redlines of both investment policies that he had provided to the board are identical wording, Treasury Investment Policy (p. 9); Money Management Trust Fund Investment Policy (pp 8-9). Chairman Walther asked for a motion to approve the proposed changes to the Treasury Investment Policy and the Money Management Trust Fund Investment Policy. The motion was made by Candace Franks and seconded by Edmond Waters. All members were in favor.

Chairman Walther again recognized Mr. Fowler to present proposed changes to the Money Management Trust Fund Investment Policy. Mr. Fowler provided the Board with redlines of the policy. These redlines are included in the minutes as Attachment 4. Mr. Fowler explained that two years ago, a fee was granted, and voted on by the Board with which the Treasury used to pay for operations (p 3). Mr. Fowler stated that those fees had now been moved to general appropriations and that a fee taken from participants would no longer be needed, therefore increasing participant returns. Chairman Walther asked for a motion to approve the proposed changes to the Money Management Trust Fund Investment Policy. The motion to approve the proposed changes was made by Jim Bob Britton and seconded by Edmond Waters. All members were in favor.

Chairman Walther then asked Mr. Fowler the status of proposed rule changes addressed in the last quarterly State Board of Finance meeting. Mr. Fowler stated that they had gone through public comment period and it had been documented and sent to the legislature. Mr.

Fowler stated that it was on the agenda for December 18th, and if approved, it would go to full ALC two days later and should be in effect by January 3, 2020.

Mr. Walther then recognized Autumn Sanson to give a compliance report to the Board. Mrs. Sanson started by reviewing the history of this role and stated that the Board wanted to see more of a compliance or internal audit role within the Treasury. Mrs. Sanson stated that she wanted to establish a priority on risk management moving forward. Mrs. Sanson told the board that she, Mr. Louthian, and Debbie Rogers started having weekly meetings to go over the duties and expectations of this role. Mrs. Sanson continued by saying that much research had been done to identify policies and procedures that were lacking and those that needed to be updated within the Treasury. She stated that the Treasurer's office had completed one policy which was the Procedures and Rules for Competitively buying and selling securities. Mrs. Sanson concluded by saying that during the developmental phase of preparing policies and procedures there would not be any written or verbal findings. All concerns, Mrs. Sanson said, would be discussed with the executive staff of the Treasury.

Mr. Walther then stated that the next item on the agenda was a personnel matter and that the Board would go into executive session for discussion. The executive session form is included in the minutes as Attachment 5. Chairman Walther, after resuming the regular quarterly meeting, asks for a motion to approve the recommendation discussed in executive session. Candace Franks makes a motion to give Autumn Sanson, Chief Compliance Officer for the State Board of Finance, a \$5,000 salary increase effective December 14, 2019. The motion was seconded by Edmond Waters. All members were in favor.

Chairman Walther asks if there is any additional business to come before the Board. Seeing no further questions or comments from the Board, Chairman Walther adjourned the meeting.

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.