

MINUTES OF MEETING
STATE BOARD OF FINANCE

February 4, 2020

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 am, Tuesday, February 4, 2020, pursuant to notice duly given to each member of the board by the Chairman.

The following members were present:

Dennis Milligan, Treasurer of State
Andrea Lea, Auditor of State
Keith Konecny, Appointed Member
Candace Franks, Arkansas Bank Commissioner (by telephone)
Edmond Waters, Arkansas Securities Commissioner
Chad Brown, Representing Governor Asa Hutchinson
Cale Turner, Appointed Member
Jim Bob Britton, Appointed Member
Clay Conly, Appointed Member

Others 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; and Mike Wickline, reporter for the Arkansas Democrat Gazette. Mr. Louthian serving as Chairman in the absence of Governor Hutchinson and the absence of Secretary Larry Walther, called the meeting to order with recognition of a quorum.

Minutes of the meeting held on December 3, 2019 were approved as distributed.

Mr. Louthian introduced Rob Romanik as a new employee to the Investment team in the Treasurer's office and briefly discussed his employment history.

Mr. Louthian then recognized State Treasurer Dennis Milligan to present the Treasury Investment Performance Report for the second quarter of fiscal year 2020. The report is included in the minutes as Attachment 1. Treasurer Milligan greeted the board and began by reviewing how the office has begun to improve their investment strategy and procedures following the recommendations of an independent panel approved by this board. He continued by explaining that the office has moved away from concentration of assets and diversified the Treasury portfolio into different types of fixed income securities. He explained that this allows Treasury to meet the objectives set forth by the State Board of Finance and ensures a steady income source for the state. He continued to go over the earnings for the period by saying that the Treasury earned \$23.4 million in the second quarter of FY2020, for a total of \$46 million for the first half of FY2020. Treasurer Milligan continued by explaining that the Federal Open Market Committee was holding interest rates steady and providing a lot of liquidity. He stated that bond yields are lower and the Treasury yield curve for the foreseeable future is flat and referenced a chart shown to the board. Treasurer Milligan also commented that local banks here in Arkansas contributed low to moderate growth and revenue performance bonuses to a lower federal interest rate, which also factored into the Treasury's receipted earnings. He continued by reporting that the short term portfolio ended the second quarter with \$10 million dollars receipted. Treasurer Milligan reported that the long term portfolio ended the quarter with \$13.3 million dollars receipted. He stated that number was higher than the most recent two years, pointing out that earnings were \$11.9 million in FY2019 and roughly \$8.5 million in FY2018. Treasurer Milligan further commented that the Treasury was investing directly in Arkansas by recently purchasing municipal bonds. He stated that they will continue to look to invest in bonds tied to education, as they had with the University of Arkansas, Arkansas State University

and in the city, county, and state public projects such as roads and utilities. The Treasurer continued by explaining that they struggle with low yield returns tied to past investments into collateralized mortgage obligations or CMO's, which was 30 percent of the total portfolio and were purchased at a premium that was based upon the assumption that interest rates were going to continue to climb. He stated that the rates have since declined and that was roughly \$1.5 billion dollars that had seen a steady decline in yield. He told the board that as prepayments on mortgages continued to increase, people refinanced their homes at lower rates. Treasurer Milligan stated that the Federal Reserve and the market should continue to hold rates steady, therefore allowing the Treasury to work out of those investments over the next 18 months. The Treasurer continues by reviewing the Money Management portfolio, telling the board that as of December 31, it earned a little over \$673,000 at a rate of 1.73 percent. He told the board that investors are cautious worldwide. With current events ever changing, and the varying geopolitical factors at play, the market's in a holding pattern. He explained that with a flattened yield curve, they are focusing on purchasing bonds that have a shorter duration. The Treasurer explained that they have diversified the portfolio to invest in CMO's with lower premiums and purchased floating rate instruments that offer a more favorable structure. He stated the strategy will continue to prioritize safety and liquidity and fine tune their approach with an ever-changing market. Treasurer Milligan explained that since the fall, they have taken on the challenge of change in both the markets and with their internal investment team via policies, as well as personnel. Treasurer Milligan concluded his report by asking if there were any questions from the board. The question of diversification was raised and the potential loss of returns and how that will affect the next quarter. Treasurer Milligan asks that Martin Kelly, Senior Investment Manager, would expand on that. Mr. Kelly explained that February was going to be weak simply because the discount convention was exposed to a lot of Actual/360, so at 29 days as opposed to 30 or 31, that would cost the Treasury. He further explained that rates are lower at

reinvestment and the current virus has taken 55 basis points almost across the board. He told the board that he felt the Treasury will be okay in the next quarter with rates low and prepayments profit possibly increasing, but he thinks the final quarter of fiscal year 2020 may be a struggle for the Treasury relative to where they are right now. The board asks Mr. Kelly if he feels that with the changes that have taken place with the portfolio the credit risk has lowered. Mr. Kelly explained that the credit risk is down substantially due to an actively approved credit list. Mr. Louthian, seeing no additional questions, asks for a motion to approve the Treasurer's report. The motion was made by Keith Konecny and was seconded by Commissioner Waters. All members were in favor.

Next Mr. Louthian recognized Mr. Kelly to update the board about Investment operations and trading. Mr. Kelly began by telling the board that Treasury funds have been placed in more liquid accounts. Demand and money markets, he stated, are vital to managing daily commitments. He explained that the Federal Reserve has reinstated quantitative easing by cutting the Treasury bill rate three times since last fall and most European banks and most developed countries are trading at or near zero, causing competition for the triple A rating. He stated that with that change the Treasury chose assets that are a counterbalance to the existing portfolio position to help manage the effective duration and convexity risk that Treasury had based their broader exposure to mortgages on. Mr. Kelly told the board that the Treasury is more broadly allocated than it has ever been. He stated the range includes agency commercial backed mortgages, which are primarily multifamily housing units, to regular apartment buildings and senior housing. Mr. Kelly explained another strategy of the Treasury, which is agency callable bonds issued by Fannie Mae, Freddie Mac, the Federal Home Loan Bank, and Federal Farm Credit Bank to fund their operations. He stated that because they are callable, the Treasury would trade them as a money market adjunct because they are repurchasing at only a three month call. He stated that his anticipation is that a call would be exercised during the course of Treasury's immediate

holding period, which gives the Treasury a good return for the three months that it is aboard the balance sheet. He said that much of what the Treasury had outstanding at this moment had been called as of that morning and they are placed into Treasury cash until they find alternative investments for them. Mr. Kelly explained that Treasury reduced their call risk and prepayment risk by moving into fixed rate agencies with semiannual calls. Mr. Kelly concluded by asking the board if they have any questions. A question was raised regarding the recent buy of municipal bonds and what types they were. Mr. Kelly replied that they were all education, including University of Arkansas, Arkansas State University and Pulaski Tech. Mr. Louthian, seeing no additional questions, asked for a motion to accept the report. The motion was made by Clay Conly and seconded by Commissioner Waters. All board members were in favor.

Next Mr. Louthian recognized T.J. Fowler, Legal Counsel for the State Treasury, to go over the duties and responsibilities, including legal responsibilities of the State Board of Finance. The presentation and Board Member Handbook are included in the minutes as Attachment #2.

Next, Mr. Louthian made a motion to establish that no funds are available for deposit into the State Board of Finance certificate of deposit investment program. The motion was seconded by Keith Konecny. All members were in favor.

Mr. Louthian then made a motion that the board direct the Treasurer of State to purchase warrants for the succeeding quarter, April 1, 2020 through June 30, 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 Clay Conly. All members were in favor.

Next, Mr. Louthian asked for consideration to add additional brokers to the Treasury's broker list. Those companies were Baird & Co, Incorporated, and Mischler Financial. A motion was made by Jim Bob Britton to accept the new brokers and seconded by Commissioner Waters. All members were in favor.

Mr. Louthian then recognized Autumn Sanson, Chief Compliance Officer, for an update and report on compliance within the Treasury. Mrs. Sanson first addressed the ongoing review and identification of policies within the Treasury. She stated that many policies had been completed and would be held for approval until other policies had been reviewed to minimize the burden on the board. Mrs. Sanson continued by outlining the process of starting an Operations Manual and her appreciation to DFA and CAFR for the help with implementation. She goes on to tell the board that the establishment of this manual would be a six to eight-month process and would be written in phases. She stated that she would update the board throughout the process. Mrs. Sanson then asked if there were any questions. Mr. Louthian stated to the board that this document will be owned by the Treasury, and he had checked with Legislative Audit before the board meeting to be clear about that assessment. He stated that Mrs. Sanson would assist the Treasury with writing the document and then it will be brought to the board to vote on. Mr. Louthian asked for a motion to accept Mrs. Sanson's report. A motion was made by Jim Bob Britton and seconded by Keith Konecny. All members were in favor.

Mr. Louthian asked if there was any additional business to come before the board. Seeing no further questions or comments from the board, Mr. Louthian adjourned the meeting.