# Oregon Short Term Fund Board
# MINUTES
March 13, 2007

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| **Location:** | OMFOA/OACTFO Spring Conference<br>Valley River Inn<br>1000 Valley River Way<br>Eugene, OR 97401 |
| **OSTFB Members Present:** | Harvey Rogers, Preston Gates & Ellis<br>Linda Haglund, Office of the State Treasurer<br>Gary Wallis, City of Wilsonville<br>Michelle Hawkins, Linn County Treasurer<br>Deanne Woodring, Davidson Fixed Income Management<br>Bob Woodruff, Nike |
| **OST Staff Present:** | Darren Bond, Director of Finance<br>Perrin Lim, Office of the State Treasurer<br>Judy Whaley-Fultz, Banking Services Manager<br>Heidi Rawe, Executive Support Specialist |

## I. Opening Remarks
By way of introduction, Harvey Rogers gave a brief overview of the responsibilities and duties of the Oregon Short Term Fund Board (OSTF). Each Board member introduced themselves.

## II. Review and Approval of Minutes
**January 31, 2007 Minutes**
**Motion:** Michelle Hawkins moved approval of the January 31, 2007 Minutes. The motion was seconded by Gary Wallis and passed unanimously by the Board.

**March 6, 2007 Minutes (Teleconference)**
**Motion:** Linda Haglund moved approval of the March 5, 2007 Minutes (Teleconference). The motion was seconded by Michelle Hawkins and passed unanimously by the Board.

## III. OSTF Portfolio Review and Market Prospective – Perrin Lim
Perrin Lim presented the OSTF Portfolio Review and Market Perspective (please see attached).

## IV. New Short-Form Investment Policy
Harvey Rogers provided background relating to why a new Short-Form Investment Policy had been created. Some entities recently had the need to invest beyond 18 months. This has been especially true for a number of school districts who had issued very large bonds and wanted to invest the funds out to match their expected construction schedules in hopes of getting a greater return. In order to accommodate this immediate need, the OSTF Board created and approved a new Short-Form Investment Policy to expedite the process and make it simpler for the managers and boards to be able to get the funds invested quickly.

Following Harvey Rogers' introduction, Deanne Woodring gave an informative presentation and introduced the new Short-Form Investment Policy that had been created. She urged everybody with upcoming bond proceeds to start looking at their policies now and confirmed that the new form, as well as policy definitions, were available on the Treasurer's website.

In summary, Harvey Rogers reiterated that the Short-Form Investment Policy is an expedited process to assist in investing bond proceeds only. He also confirmed that a full Investment Policy should be brought before the board at a later date.

## V. LGP/OSTF Investment Policy Review – Josephine County

Josephine County's Investment Policy was presented to the Board by Perrin Lim. He confirmed that Ellen Hanby had worked closely with John Harelson on their Investment Policy. The Treasurer's staff felt it was a good policy. There was some discussion amongst the Board relating to Section XIV of the policy that referred to performance indicators; it was felt that this may need a little more definition. Linda Haglund suggested that entities be clear about performance measures in their portfolio. John Harelson was appreciative of Ellen Hanby's assistance and thanked staff for their help.

## VI. LGP/OSTF Investment Policy Review – Multnomah County

Perrin Lim introduced Multnomah County's Investment Policy to the Board. He noted that it was a thorough policy and did not feel there were any significant items to be noted.

Harry Morton of Multnomah County commented on one element of his policy that he and Ellen Hanby are still working on. This was the topic of risk parameters in the policy relating to the ORS which he wants to quantify in a way that is meaningful. He confirmed that Ellen Hanby is assisting him with this and noted that the policy will be amended again once they come up with a workable way of measuring risk. A discussion ensued relating to this topic. There were no further comments from the Board.

## VII. LGP/OSTF Investment Policy Review – Klamath Falls City School District

Klamath Falls City School District had originally submitted the Standard Investment Policy; however, once the Short-Form Policy had been created and approved by the OSTF Board members, they decided that this would be a simpler option for them. Therefore, Perrin Lim confirmed that Klamath Falls City School District will use the Short-Form Investment Policy instead.

## VIII. Other Business

- Deanne Woodring spoke of a question that has been brought up nationally relating to RFP/Securities being held in one place. The Government Finance Officers Association (GFOA) is looking to suggest that securities should be held at a separate entity from who is doing the work. This is currently not the case. Using the State of Washington as an example, she spoke of how they have gone through a Statewide RFP process to determine one provider who is very cost competitive that entities can utilize, making is simpler for them. After a brief discussion, it was decided that this would be a good topic to add to the agenda for the next OSTF Board Meeting. Michelle Hawkins will assist Deanne Woodring with an outline, as well as talking to the Treasurer's Office with regards to what might be involved.

Meeting was adjourned at 2:50pm

Respectfully submitted,

Heidi C. Rawe
Executive Support Specialist

# Oregon Short-Term Fund Board Meeting
# March 13, 2007
# OSTF Annual Review to OIC (February 28, 2007)

***Market Review and Outlook:***
The US economy enjoyed mixed but generally positive results for most of 2006, which is likely to be the case for 2007, as well. US economic growth estimates for 2007 range between 1.5-3%. Federal Reserve policy remained on hold during the fourth quarter, with the Fed leaving the overnight Federal Funds target rate at 5.25%, having held at this level for the last four FOMC meetings of 2006.

Negative fundamentals:

- Housing market has suffered the most
    - Existing home sales at 3-year low, down 14.4% from their June 2005 high
    - Housing starts down 27% from their January 2006 high
    - Building permits declined every month in 2006 except in December, down 28% from their September 2005 peak
    - Housing prices are declining in many markets, and the rapid pace of mortgage-equity withdrawal has come to an abrupt halt
    - Residential real-estate delinquencies increasing, especially sub-prime mortgages
    - Impact on economy remains uncertain
- Manufacturing activity and business investment have been soft in recent months
- Bond-unfriendly actions, e.g. excessive stock repurchases and leveraged buyouts, are increasing
- Inflation is still a concern
- US dollar remains relatively weak
- Inverted Treasury yield curve historically has led to a weaker economy
- Large US current account deficit
- Accumulation of Treasury securities by foreign central banks
- The new Congress is likely to pass business-unfriendly legislation such as a higher minimum wage and higher taxes

Positive fundamentals:

*Domestic Economy*

- Non-farm payroll gains averaged 187 thousand per month in 2006 and have not experienced a decline since August 2003
- December unemployment rate down to 4.5% from its recent peak of 6.3% in June 2003 and just higher than the October 2006 low of 4.4%
- New home sales have been increasing since July 2006
- Mortgage loan applications have been trending higher since July 2006
- Homebuilders stocks have increased 30% since July 2006
- Real incomes and spending are increasing, albeit at moderate rates
- Consumer confidence has rebounded to near a 2-year high
- Crude oil has declined 22% to $61.05/barrel from its July 2006 peak of $78.40/barrel
- Equity prices continue to increase
- PE ratios are at about their 50-year average

# Oregon Short-Term Fund Board Meeting
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***<u>Market Review and Outlook (continued):</u>***

- Corporate profits remain near record high levels, and balance sheets remain generally strong
- Corporate spreads, including high yield and emerging market debt, are near historic lows
- State and Federal revenues are expanding at double-digit rates over the past two years

*Global Economy*

- Emerging market economies continue to expand and balance sheets continue to improve
- Asian economies are robust
- Japanese and Eurozone economies have strengthened in the past year
- Most foreign central banks are raising interest rates but none are seriously fighting economic growth, providing a positive outlook for longer term inflation prospects.

**Semi-annual Testimony to Congress on State of the Economy and Monetary Policy:**
In Chairman Bernanke's semi-annual testimony to Congress on February 14, 2007, he reiterated the message sent recently by the FOMC, sounding a reasonably confident note on growth and indicating that the FOMC continues to expect core inflation to ease. However, like recent statements, he pointed to inflation as the predominant risk and highlighted the potential need for further tightening.

Chairman Bernanke sounded reasonably upbeat that economic growth would remain solid and overall growth was expected to "expand at a moderate pace this year and next, with growth strengthening somewhat as the drag from housing diminishes." He pointed to "tentative signs of stabilization" in the housing market; although, he noted that weakness in residential investment would likely "weigh on economic growth over the next few quarters as homebuilders continue to reduce their inventories of unsold homes to more-comfortable levels." Despite the housing slowdown, he indicated "overall economic prospects for households remain good," and household finances "appear generally solid." Consumer spending is expected to "expand solidly," although "a little less rapidly than the growth in personal incomes," as households respond to slower wealth gains in the housing market. The labor market is "expected to stay healthy." The business sector was said to be "in excellent financial condition, with strong growth in profits, liquid balance sheets, and corporate leverage near historic lows." The Fed expects capital spending "to expand at a moderate pace."

On inflation, he noted some indications "that inflation pressures are beginning to diminish," but said "it will be some time before we can be confident that underlying inflation is moderating as anticipated." The Fed expects less pass-through from energy prices into core inflation, and that "the contribution from rents and shelter costs should also fall back, following a step-up last year."

Importantly, the FOMC lowered its estimate of GDP growth in 2007, to 2.5-3% from last July's estimate of 3-3.25%, but also reduced its estimate of the unemployment rate at yearend, to 4.5-4.75% from 4.75-5%. In 2008, growth is expected at 2.75-3%, with the unemployment rate holding steady. The Fed continued to expect core inflation of 2-2.25% in 2007, while it expects the core PCE price index to fall to 1.75-2% in 2008.

***Market Review and Outlook (continued):***

The FOMC, thus, has laid out criteria for sustainable expansion. If growth stays at 3% or below, core inflation continues to edge lower, and the unemployment rate does not fall further, the FOMC will likely remain on hold. However, if growth picks up to a 3% or stronger pace, core inflation ticks higher, and the unemployment rate falls further, the FOMC is likely to resume tightening.

Going forward, staff believes that the Fed will remain “on hold” in the near-term, with interest rates likely to stay in the current range until a trend of strength or weakness with economic data emerge. With the market consensus calling for slower growth and a Fed ease later this year, the risk is that growth and/or inflation fail to moderate as expected. A near-term increase in inflation in any or all of the following barometers would pressure the Fed for a resumption of tightening the Fed Funds rate:

| **Inflation Indicator** | **Recent Trend** | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| CPI, YoY | 2.1% | Sept 06 | 1.3% | Oct 06 | 2.0% | Nov 06 | 2.5% | Dec 06 |
| CPI, ex food & energy, YoY | 2.9% | Sept 06 | 2.7% | Oct 06 | 2.6% | Nov 06 | 2.6% | Dec 06 |
| PPI, YoY | 0.9% | Sept 06 | -1.6% | Oct 06 | 0.9% | Nov 06 | 1.1% | Dec 06 |
| PPI, ex food & energy, YoY | 1.2% | Sept 06 | 0.6% | Oct 06 | 1.8% | Nov 06 | 2.0% | Dec 06 |
| Core PCE Deflator, quarterly | 2.1% | 1Q06 | 2.7% | 2Q06 | 2.2% | 3Q06 | 2.1% | 4Q06 |
| Core PCE Deflator, YoY | 2.0% | 1Q06 | 2.2% | 2Q06 | 2.4% | 3Q06 | 2.3% | 4Q06 |
| Core GDP Price Index, YoY | 2.9% | 1Q06 | 3.1% | 2Q06 | 2.9% | 3Q06 | 2.6% | 4Q06 |
| Avg Hourly Earnings, YoY | 3.9% | Oct 06 | 4.2% | Nov 06 | 4.2% | Dec 06 | 4.0% | Jan 07 |
| Employment Cost Index | 2.8% | 1Q06 | 3.0% | 2Q06 | 3.3% | 3Q06 | 3.3$ | 4Q06 |
| Crude Oil, $/barrel | $62.90 | Oct 06 | $65.56 | Nov 06 | $62.38 | Dec 06 | $58.14 | Jan 07 |
| CRB Futures Price Index | 305.87 | Oct 06 | 321.53 | Nov 06 | 307.26 | Dec 06 | 301.22 | Jan 07 |
| ISM Prices Paid Index | 47.0 | Oct 06 | 53.5 | Nov 06 | 47.5 | Dec 06 | 53.0 | Jan 07 |

***Oregon Short Term Fund Information:***

Since the OSTF is a short-term fixed income portfolio, its yield will generally track the rise and fall of the Fed Funds rate and 3 month U.S. Treasury Bills.

The allocation to corporate indebtedness remains close to the maximum 50% allowance (as it has for the past eighteen months) as the fundamentals for corporate credit remain solid.

The approved commercial paper list is periodically revised to include additional high quality credits and to remove those credits that have been downgraded or that are perceived by staff to be downgraded in the future. Staff continues to diligently review the approved credits as well as potential new programs that may add value and safety to the OSTF.

**Strategy:**

Since the Fed began its tightening campaign on June 30, 2004, and through each of the subsequent seventeen 25 basis point rate hikes, the OSTF has been structured with a defensive bias; adjustable rate securities have been a core holding for the fund during this period. After 425 basis points in rate hikes, staff believes that the Fed is close to neutrality and anticipates that the adjustable rate security allocation will modestly decline and be replaced with fixed rate securities. Given the inversion of the yield curve, the risk/reward relationship of fixed rate securities with maturities greater than1 year is greater at this stage versus one and two years ago,

***<u>Oregon Short Term Fund Information (continued):</u>***

due to the negative carry, i.e., levels for 1-3 year securities are lower than securities maturing between 0-3 months. The OSTF maintains a defensive, barbelled structure with the majority of the barbell emphasizing 0-3 month securities and the other end of the barbell allocated to a combination of fixed and floating rate notes (fixed ~ 11%, floating ~ 7%) with maturities between one to three years.

**General Fund:**

In the fiscal year ended June 30, 2006, the General Fund had experienced negative cash balances. The current fiscal year may witness pressure on negative cash balances because of the length of time before the State will have sufficient revenue to cover the overdraft. The OSTF provides liquidity to those state agencies, including the General Fund, with short-term negative cash balances. Presently, compensation for these overdrafts is calculated for every day of an overdraft occurrence at the rate of the current OSTF yield plus a spread of 70 basis points (a decrease from the spread of 80 b.p. for the fiscal year ended June 30, 2006). The spread is based on the three year average of the Merrill Lynch "AA" rated 1-3 year Corporate Bond Index and will be revised at the end of every fiscal year.

Staff has determined that, at the time of the overdraft, the prudent maximum available per state agency will be 1.5% of monies held in the OSTF, with the exception of the General Fund, which will be limited to 10.0% of monies held in the OSTF.

**Securities Lending:**

OSTF securities lending income for the year ending December 31, 2006 amounted to $997.6 thousand versus $526.6 thousand in the prior year, an increase of $470.9 thousand.

**Additional Items:**

In the future, staff intends to work with the OSTF Board and the OIC to further revise and enhance the portfolio investment rules and guidelines (4.02.03).

Also included in the attached report is the State Street Bank list of the December 31, 2006 holdings and the Secretary of State annual audit report including the audited financial statements for the year ending June 30, 2006.

# Oregon Short-Term Fund Board Meeting
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***Portfolio Statistics & Compliance, as of December 31, 2006:***

| **Compliance** | **Policy** | **Actual** | **Par Value** |
|---|---|---|---|
| **Maturity Distribution** | | | |
| Portfolio maturities less than 93 days | > 50% | 62.43% | $5,873,399,000 |
| Portfolio maturities between 93 days & 1 year | | 16.76% | 1,576,435,000 |
| Portfolio maturities greater than 1 year | < 25% | 20.81% | 1,957,480,000 |
| Maturities greater than 3 years | 0% | 0.00% | 0 |
| **Total Maturity Distribution** | | **100.0%** | **$9,407,314,000** |
| **Diversification** | | | |
| Treasury and/or Agency Securities | 0-100% | 49.90% | $4,694,415,000 |
| Commercial Paper (minimum A-1/P-1) | < 50% | 30.14% | 2,834,967,000 |
| Commercial Paper (< A-1/P-1) | 0% | 0.00% | 0 |
| Corporate Bonds | < 25% | 18.98% | 1,785,782,000 |
| Total Corporate Indebtedness | < 50% | 49.12% | 4,620,749,000 |
| Repurchase Agreements | 0-100% | 0.00% | 0 |
| Reverse Repurchase Agreements | 0-100% | 0.00% | 0 |
| Time Certificate of Deposit's | < 20% | 0.98% | 92,150,000 |
| **Total Diversification** | | **100.00%** | **$9,407,314,000** |
| **Top Ten Holdings** | | | |
| 1. Freddie Mac | 33% | 19.53% | $1,837,682,000 |
| 2. Fannie Mae | 33% | 15.46% | 1,453,953,000 |
| 3. Federal Home Loan Bank | 33% | 14.31% | 1,346,293,000 |
| 4. Toyota Motor Credit Corp. CP | 5% | 2.66% | 250,000,000 |
| 5. Morgan Stanley CP and bonds | 5% | 2.60% | 245,000,000 |
| 6. Bear Stearns Companies Inc. CP | 5% | 2.60% | 245,000,000 |
| 7. International Lease Finance Corp CP and bonds | 5% | 2.56% | 240,436,000 |
| 8. Citigroup Inc. CP and bonds | 5% | 2.44% | 230,000,000 |
| 9. Merrill Lynch & Co. Inc. bonds | 5% | 2.35% | 221,449,000 |
| 10. Southern Company & Subsidiaries CP | 5% | 2.15% | 202,100,000 |
| **Total Top Ten Holdings** | | **66.67%** | **$6,271,913,000** |
| **Total Average Credit Quality** | | | |
| **Moody's or Standard & Poor's** | Minimum Aa2 or AA | Aa1/AA+ | |
| **Interest Rate Exposure (adjusted for variable rate securities)** | | | |
| **WAM, exposure in days** | | 136 days | |
| **Fixed versus Floating Weights:** | | | |
| **Fixed Rate** | | 86.53% | $8,140,331,306 |
| **Variable Rate** | | 13.47% | $1,266,982,694 |

***Performance, ending December 31, 2006:***

| | **December** | **3 mos.** | **YTD** | **1 yr** | **2 yrs** | **3 yrs** | **4 yrs** | **5 yrs** |
|---|---|---|---|---|---|---|---|---|
| **OSTF** | 0.43 | 1.33 | 5.05 | 5.05 | 4.09 | 3.20 | 2.73 | 2.60 |
| **91 Day T-Bills** | 0.44 | 1.26 | 4.85 | 4.85 | 3.96 | 3.07 | 2.59 | 2.43 |