



# LGIP QUARTERLY MEETING & CONFERENCE CALL

8.1.2013

OFFICE OF THE ARIZONA STATE TREASURER



# AGENDA

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- **LGIP Performance**
- **Endowment Performance and Distributions**
- **State Cash Flow**
- **Guest Presentation:**  
**Market Overview and Investment Strategies, Jim Palmer, CFA, Chief Investment Officer, U.S. Bancorp Asset Management, Inc.**
- **Q & A**



# INVESTMENT PHILOSOPHY

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**SAFETY**

*before*

**LIQUIDITY**

*before*

**YIELD**



# EARNINGS FOR FY 2013

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**\$127,575,916**



# LOWER MANAGEMENT FEES

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**Starting August 1, 2013, all management fees are reduced 8.3% from 6 basis points to 5.5 basis points.**





# LGIP PERFORMANCE

Q4 FY2013



# YIELDS: JULY 1, 2011 – JULY 31, 2013

### UST 2-Year Note



### UST 3-Year Note



### UST 5-Year Note



### UST 10-Year Note



# POOL 5

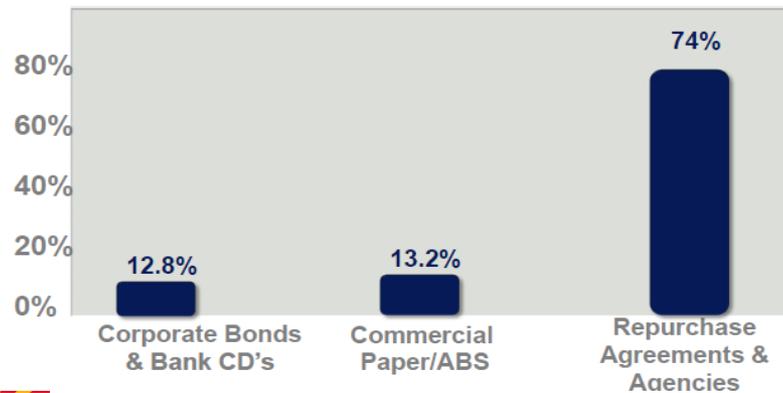
- \$1.19 Billion Assets as of 6/30/2013
- Net Asset Value - \$1.000 6/30/2013
- Diversified investments weighted to highly rated Commercial Paper, Repurchase Agreements, and Agency/Treasuries
- Short-term rates continued to be choppy in the past quarter and overnight repo rates have been extremely low. Will be adding more short corporate bonds and asset-backed securities.
- Keep daily liquidity in the 10-30% range
- Maintained the highest rating possible from S&P

## Liquidity

Weighted Average Maturity: 25 days on 6/30/2013

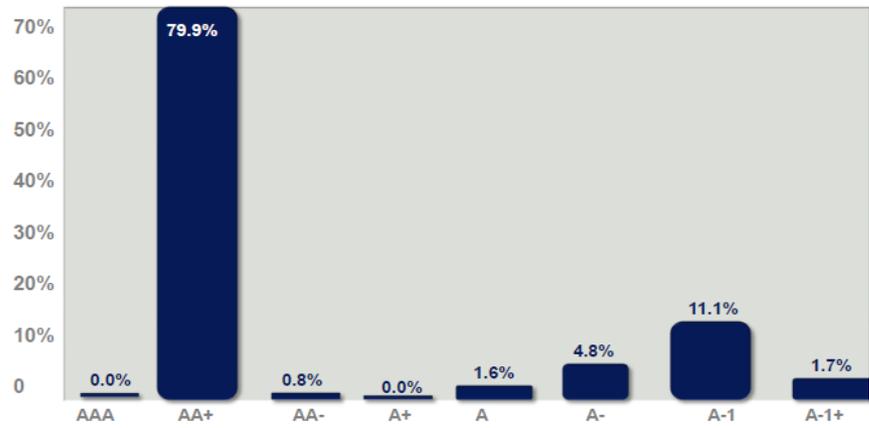
**DURATION:** 100% from 0-1 yrs

**ASSET MIX:**



## Safety

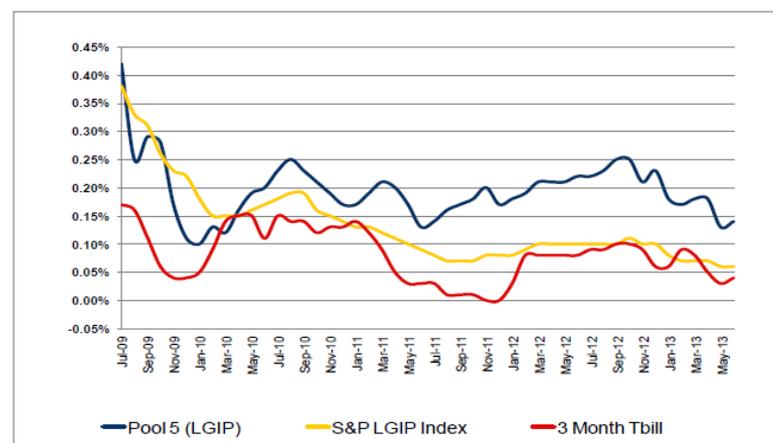
Continues to receive highest rating from Standard & Poor's: AAAf/S1+



## Yield

.20% FYTD

.08% FYTD (S&P LGIP Index)



# POOL 7

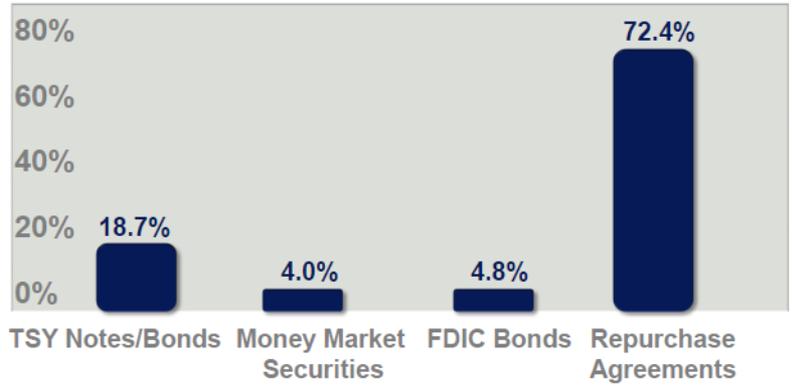
- \$1.17 Billion Assets as of 6/30/2013
- Net Asset Value - \$ 1.000 6/30/2013
- Short-term rates have been choppy as market absorbs new cash and overnight repo rates have been very low this summer.
- Looking to ladder treasuries/repo and other full faith and credit products up to 13 month horizon
- WAM will remain short and stay under 90 days to minimize interest rate risk.

## Liquidity

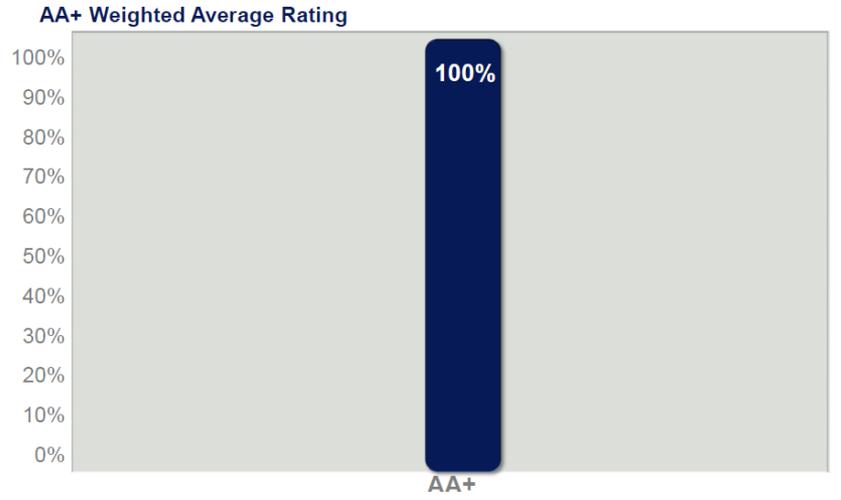
Weighted Average Maturity: 15 days on 6/30/2013

**DURATION:** 100% from 0-1 yrs

### ASSET MIX:



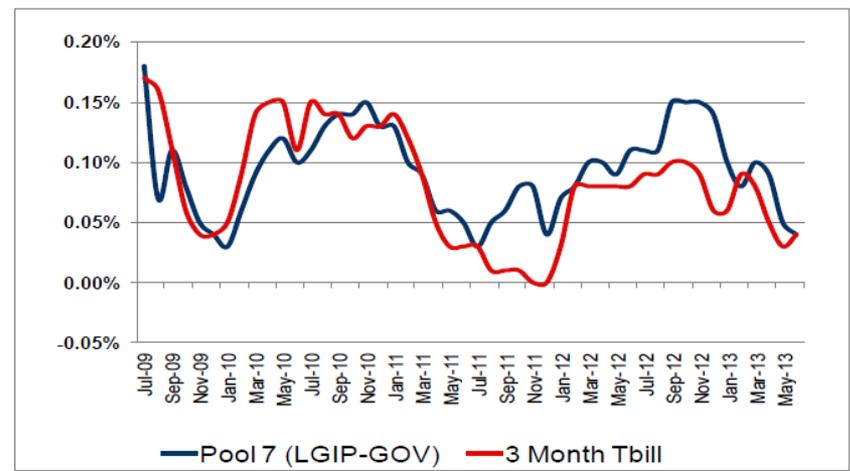
## Safety



## Yield

.11% FYTD

.08% FYTD (90 DAY T BILL)



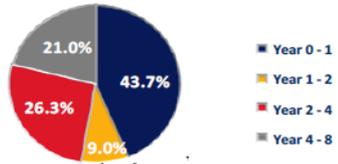
# POOL 500

- \$289.1 million in assets as of 6/30/2013
- Floating Net Asset Value - \$1.0288 6/30/2013
- Will continue to invest in assets that provide a prudent diversification that takes advantage of prevailing market opportunities
- Keep maximum exposure to any credit below 2.5%
- Continue to target duration at one year less than the benchmark with 10% to 30% of the fund in liquid short term securities

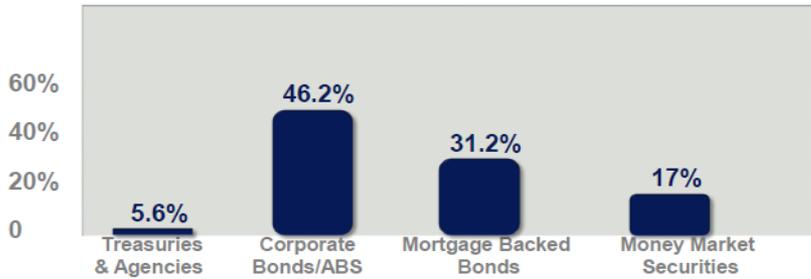
## Liquidity

Effective Duration: 1.99 years on 6/30/2013

DURATION:

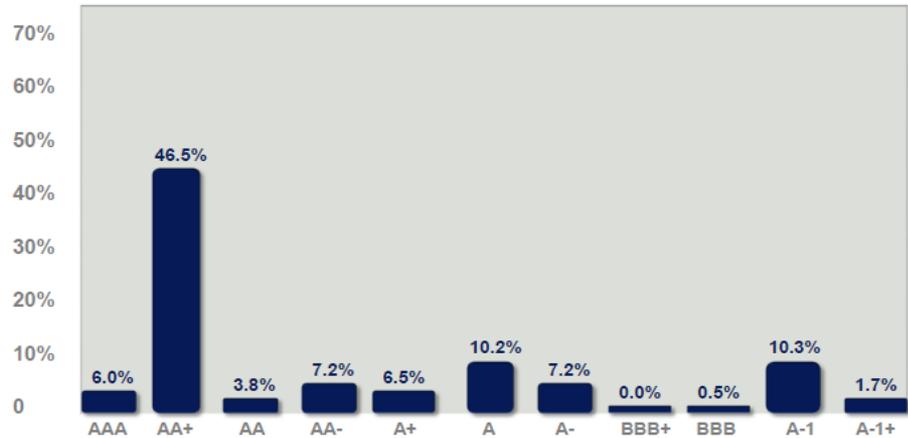


ASSET MIX:



## Safety

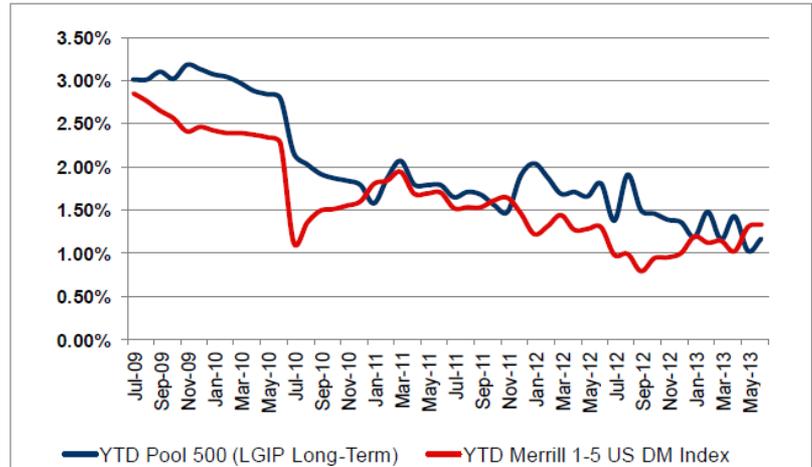
AA Weighted Average Rating



## Yield

1.37% FYTD

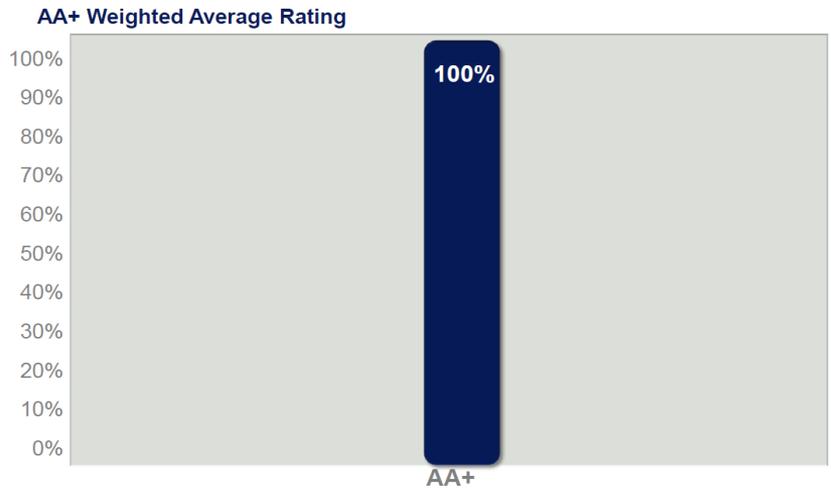
1.06% FYTD (Index)



# POOL 700

- \$231.3 million in assets as of 6/30/2013
- Floating Net Asset Value - \$ 1.0017 6/30/2013
- Strategy is to invest in a mix of 1-5 year US Treasuries, GNMA Mortgages and FDIC Paper
- All securities backed by US Government
- Continue to target duration at one year less than the benchmark and overweight GNMA mortgage back securities as there is not a lot of options for full faith and credit bonds

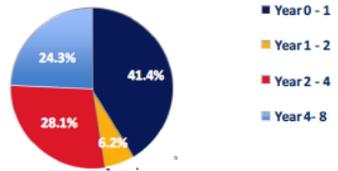
## Safety



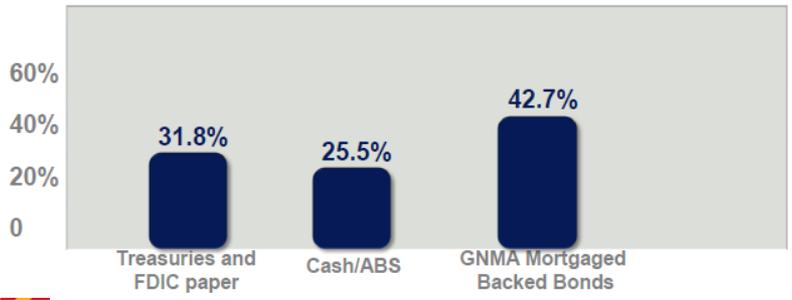
## Liquidity

Effective Duration: 2.12 years on 6/30/2013

DURATION:



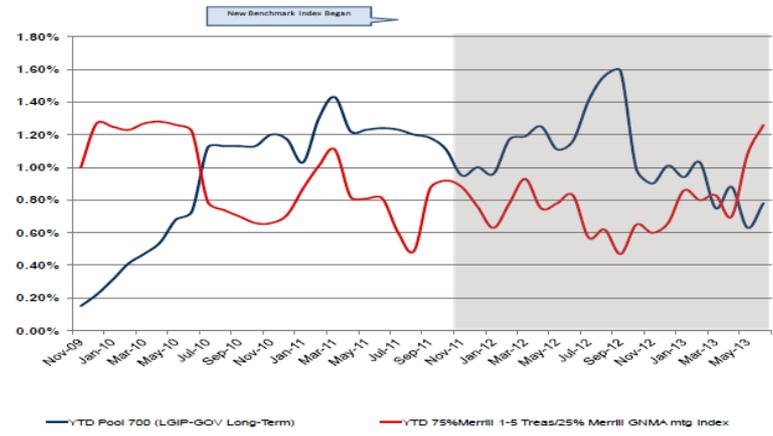
ASSET MIX:



## Yield

1.04% FYTD

0.76% FYTD (Index)





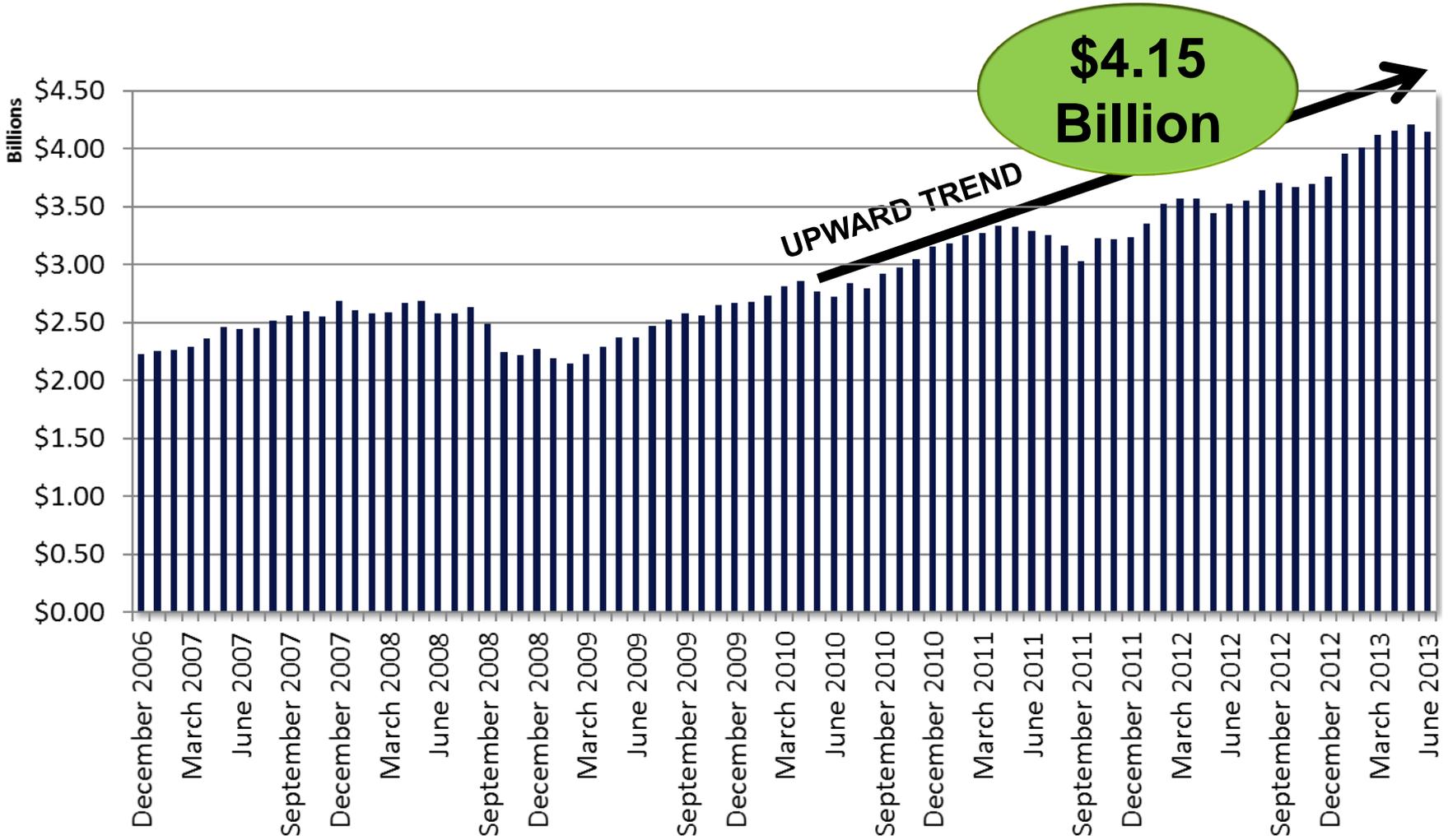
# ENDOWMENT PERFORMANCE

Q4 FY2013

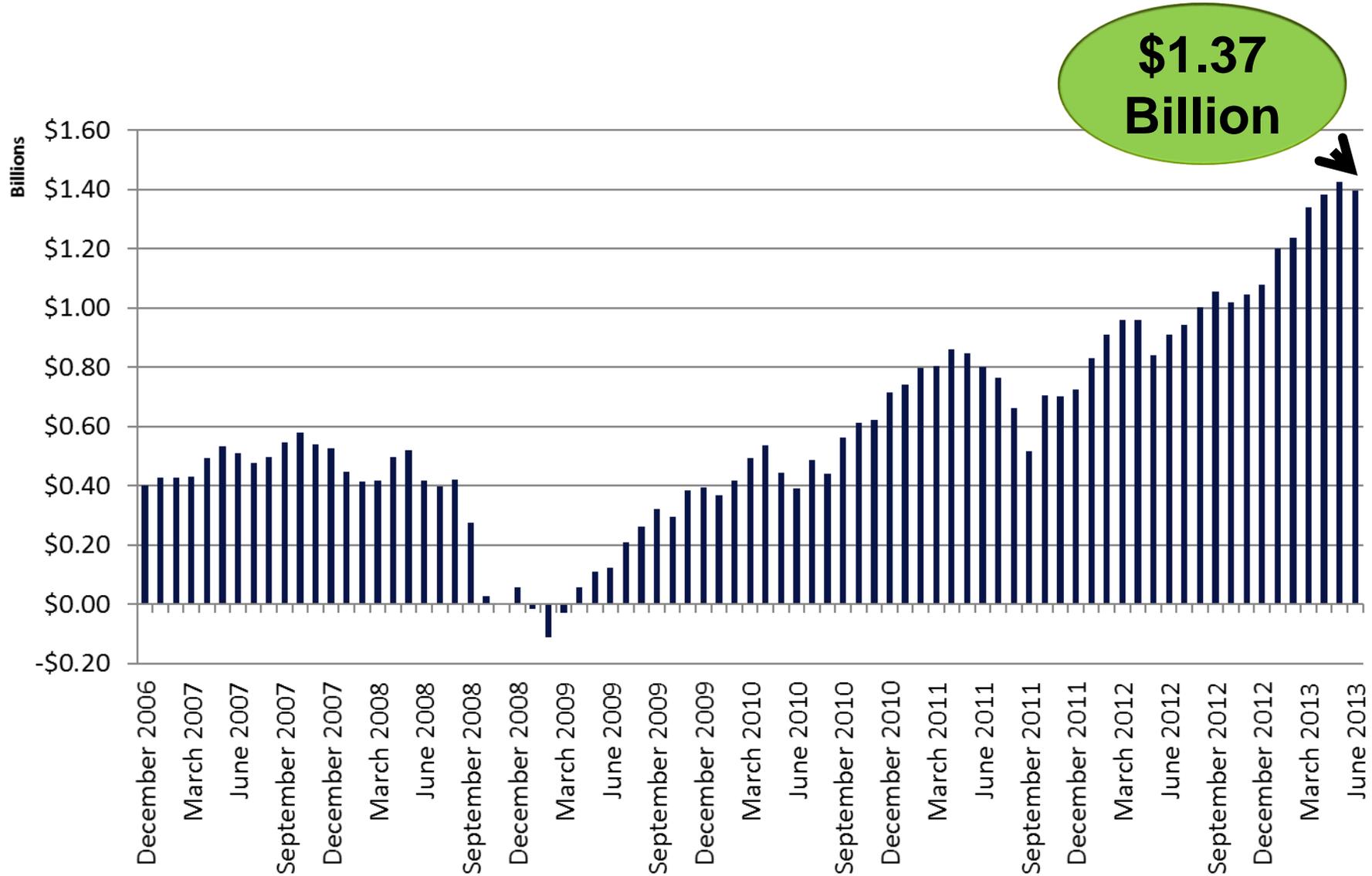
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# ENDOWMENT MARKET VALUE

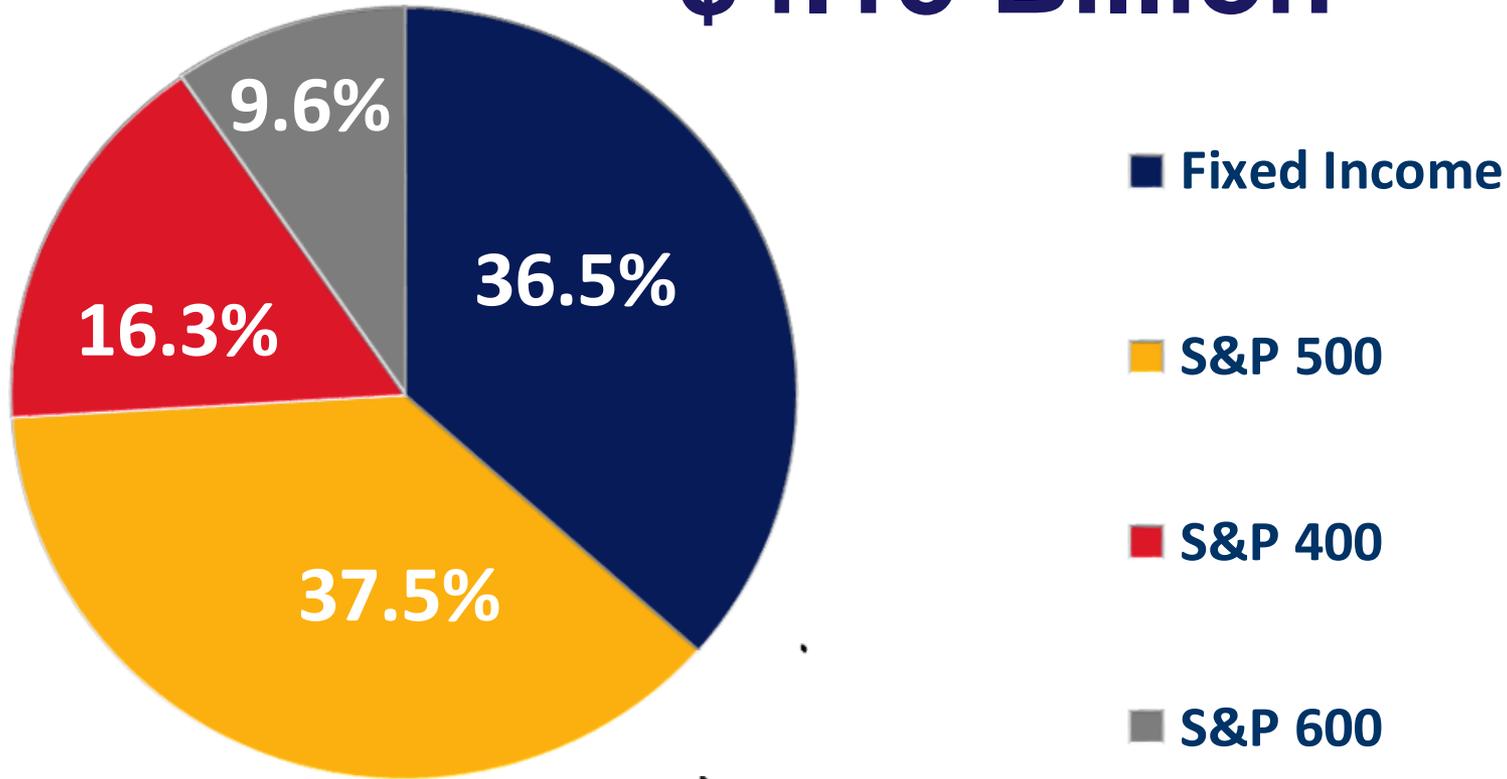


# ENDOWMENT UNREALIZED GAINS



# ENDOWMENT ASSET ALLOCATION

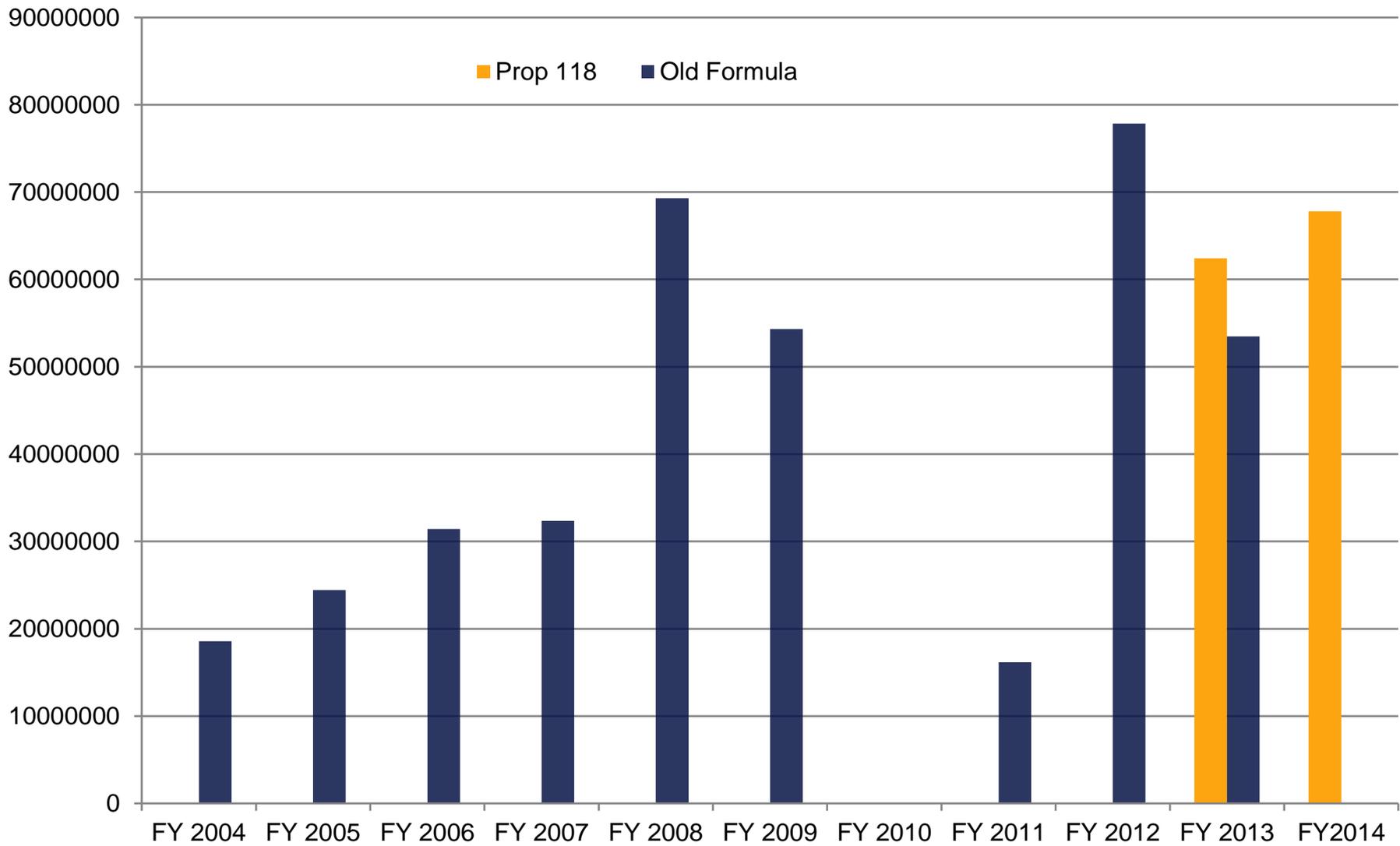
## \$4.15 Billion



As of 6/30/2013



# K-12 DISTRIBUTIONS





# STATE CASH FLOW

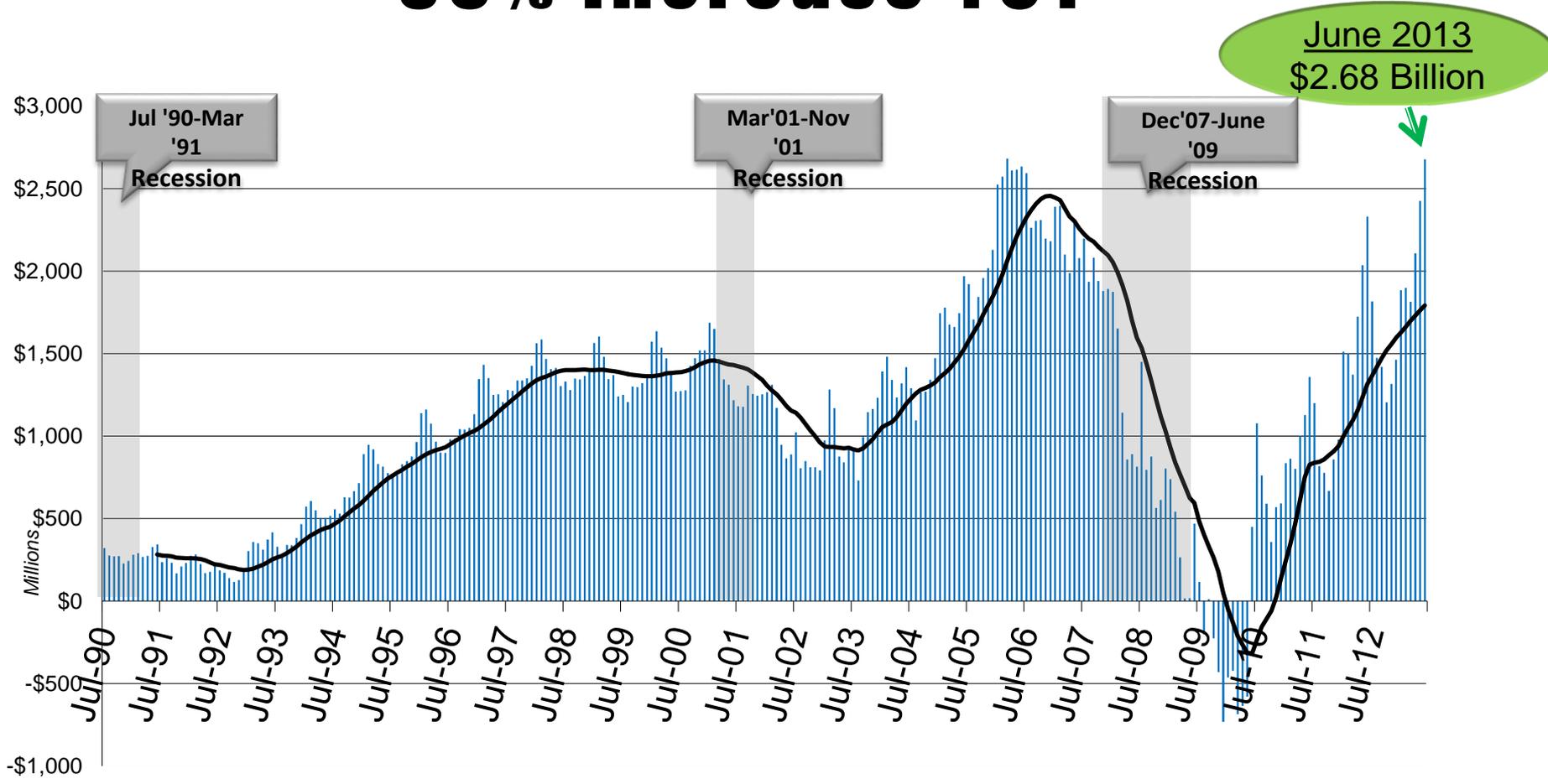
OFFICE OF THE ARIZONA STATE TREASURER



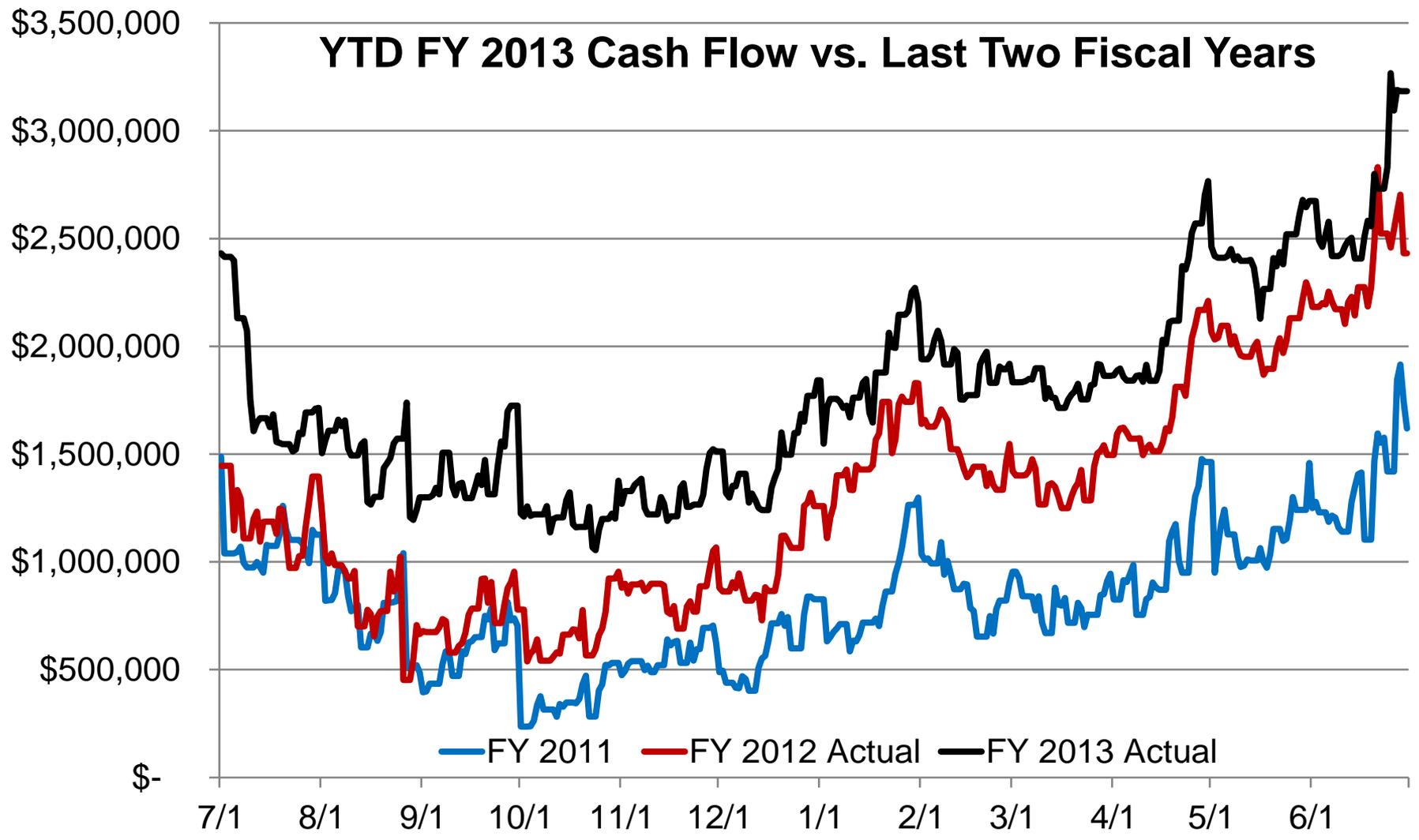
# STATE CASH FLOW

TOTAL OPERATING ACCOUNT AVERAGE MONTHLY BALANCE

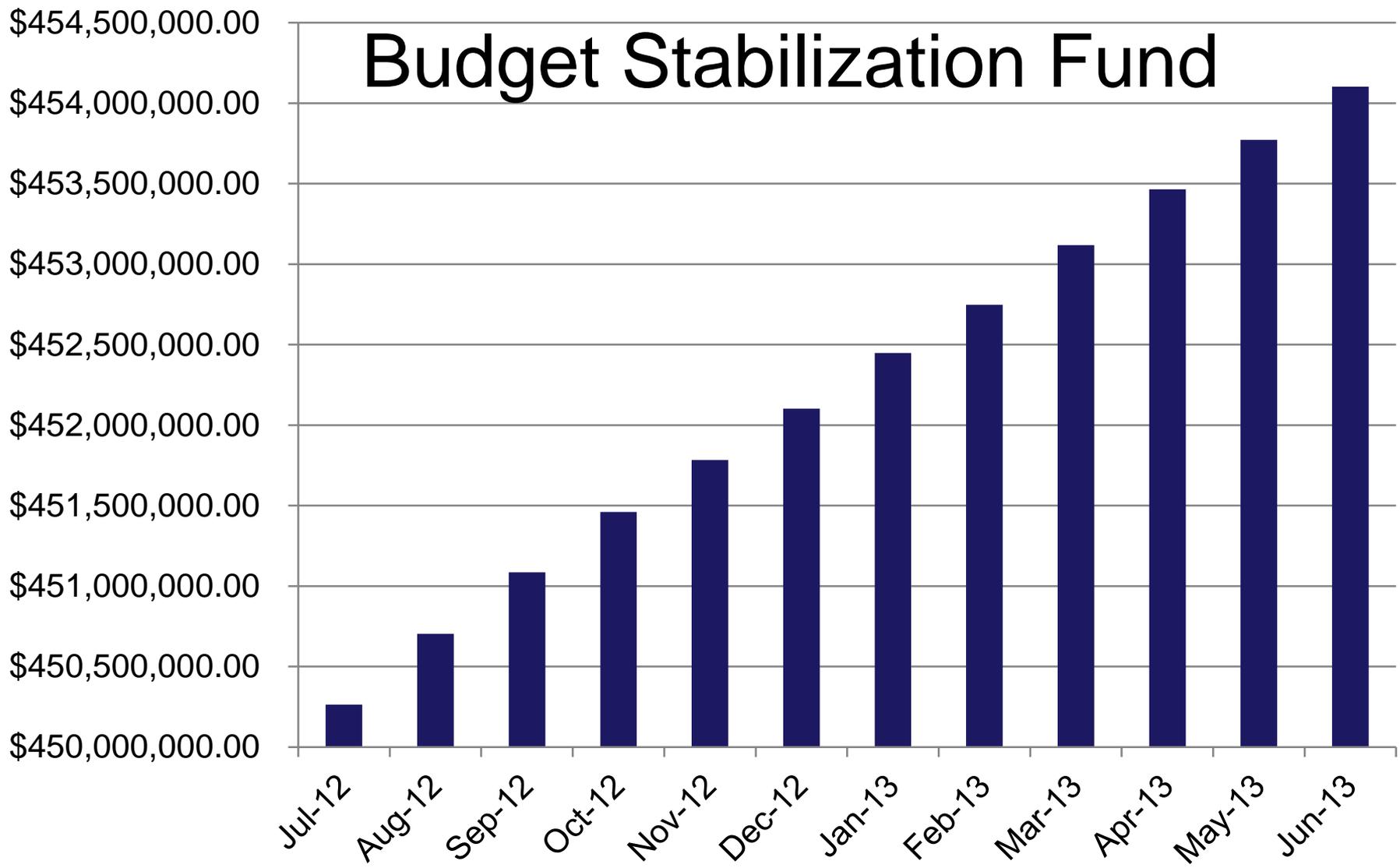
**36% increase YOY**



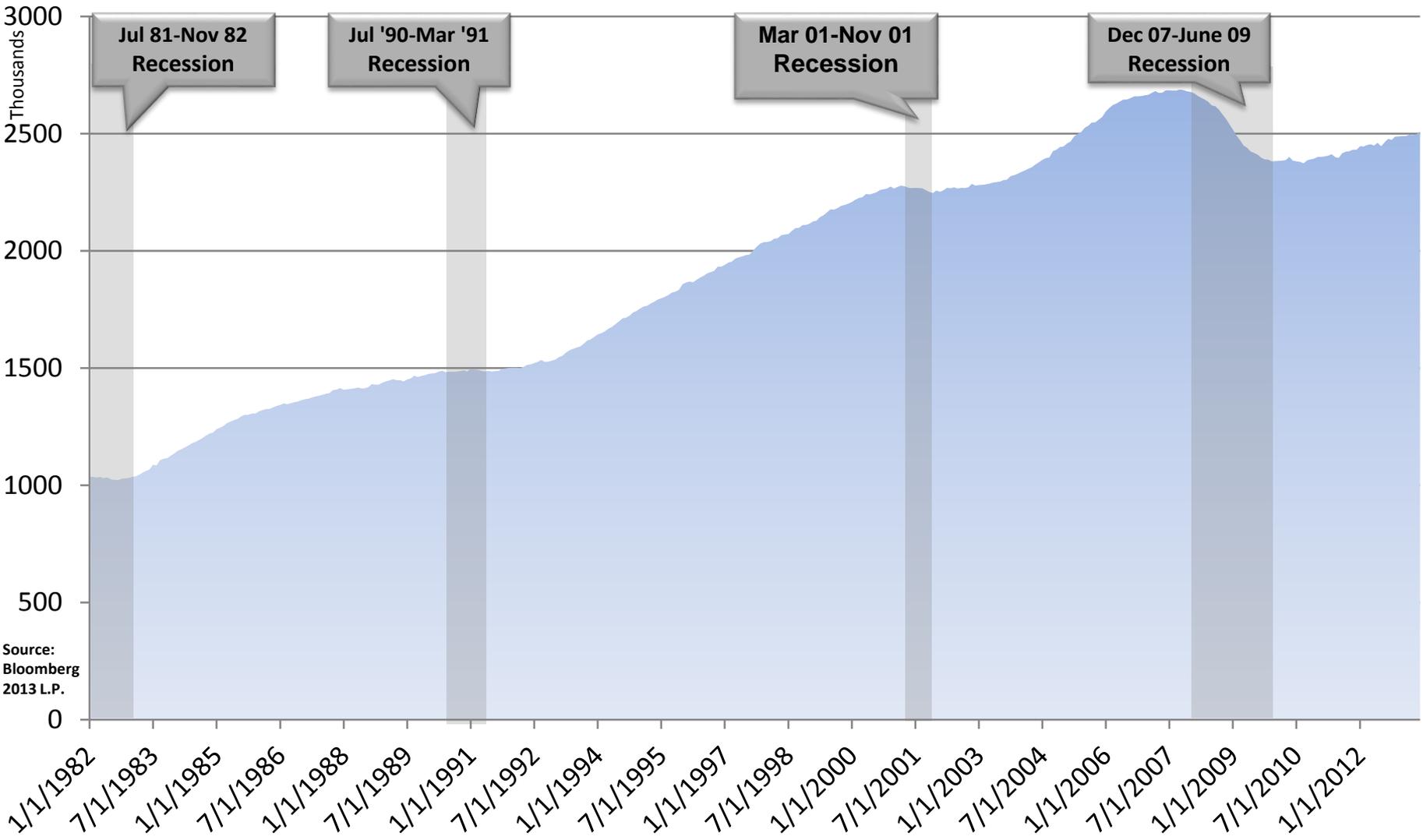
# STATE CASH FLOW



# STATE CASH FLOW



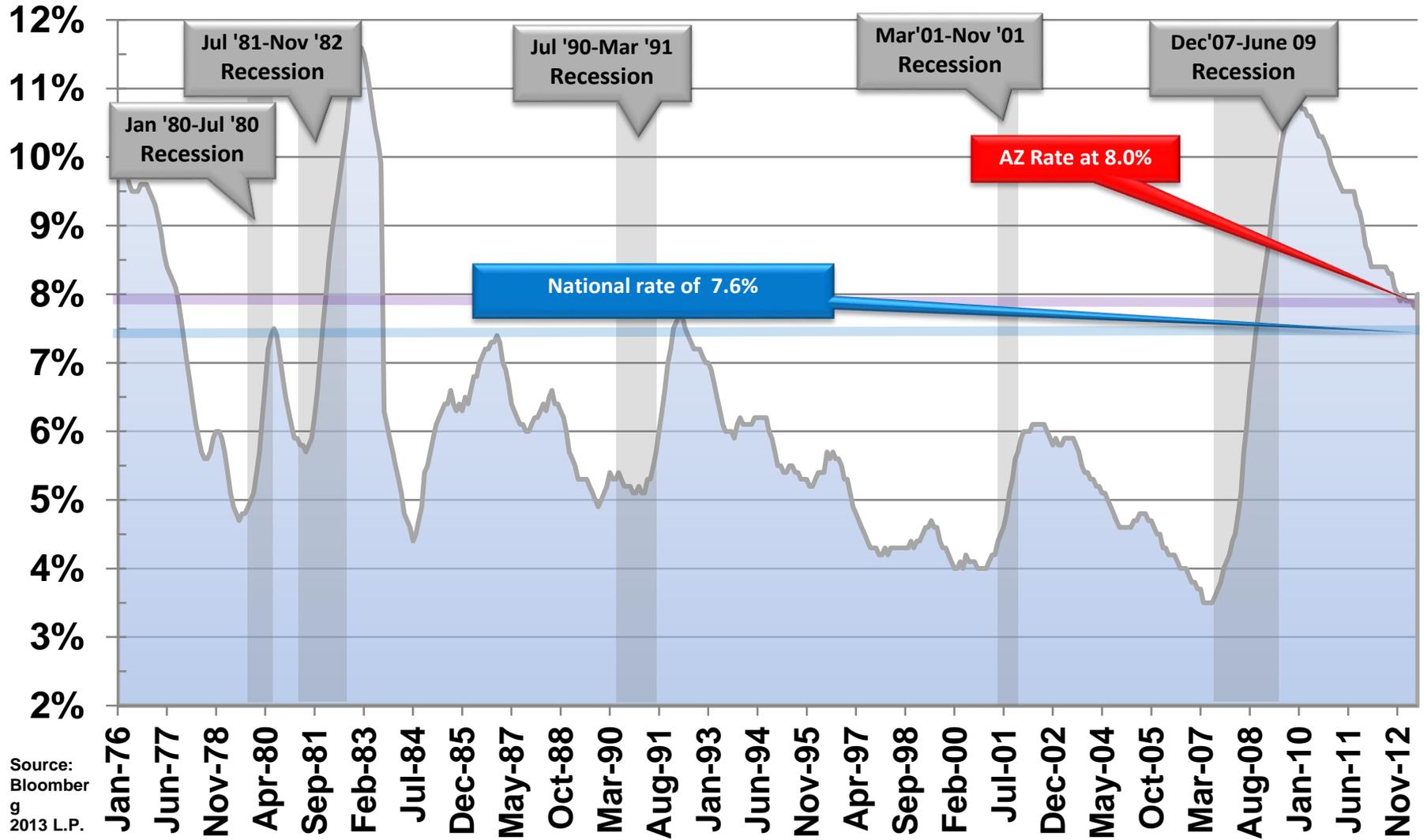
# AZ NON-FARM EMPLOYMENT



Source:  
Bloomberg  
2013 L.P.



# AZ UNEMPLOYMENT AT 8.0%

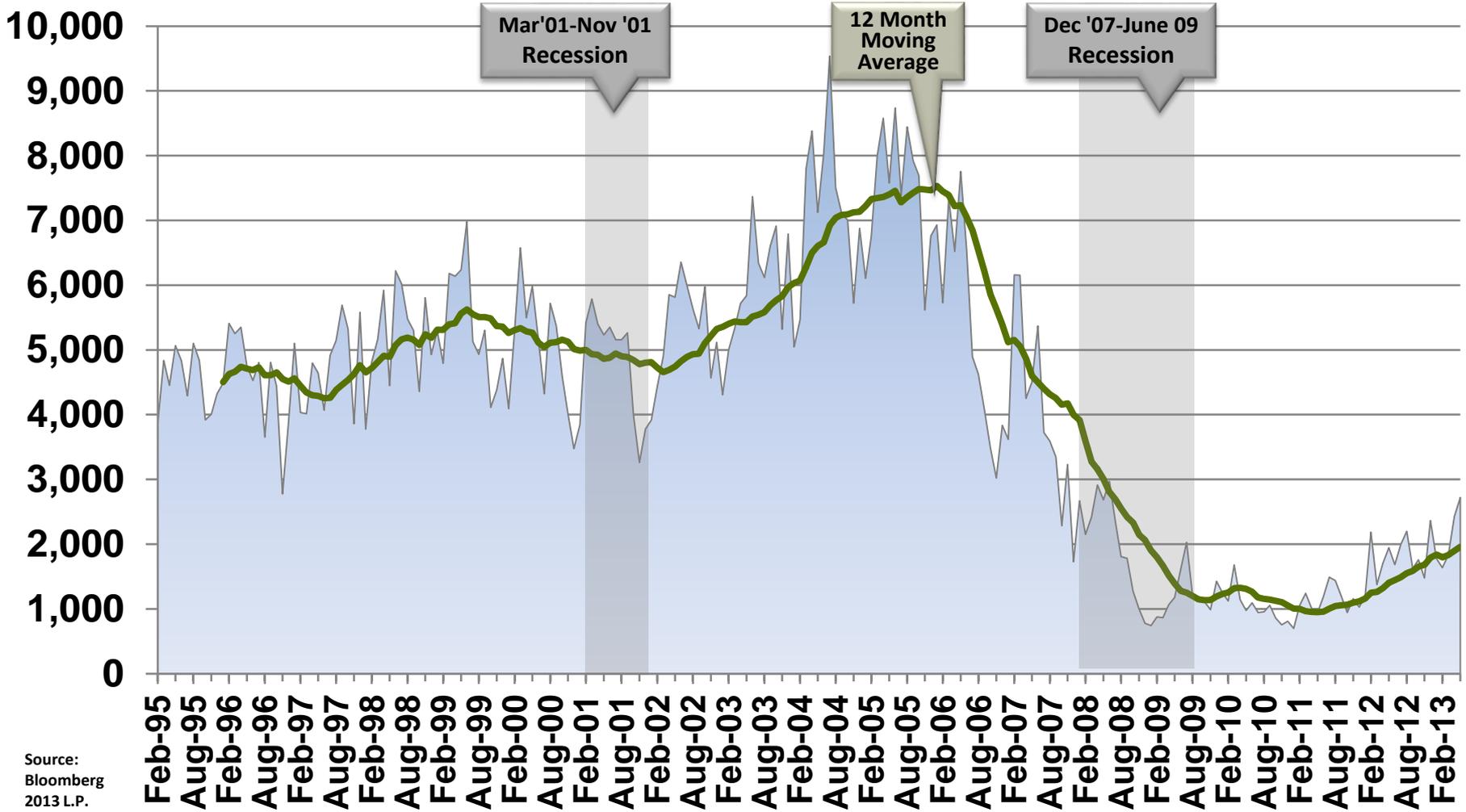


Source: Bloomberg 2013 L.P.



# AZ HOUSING PERMITS

Total Monthly Arizona Residential Building Permits Jan. 1995 to May 2013

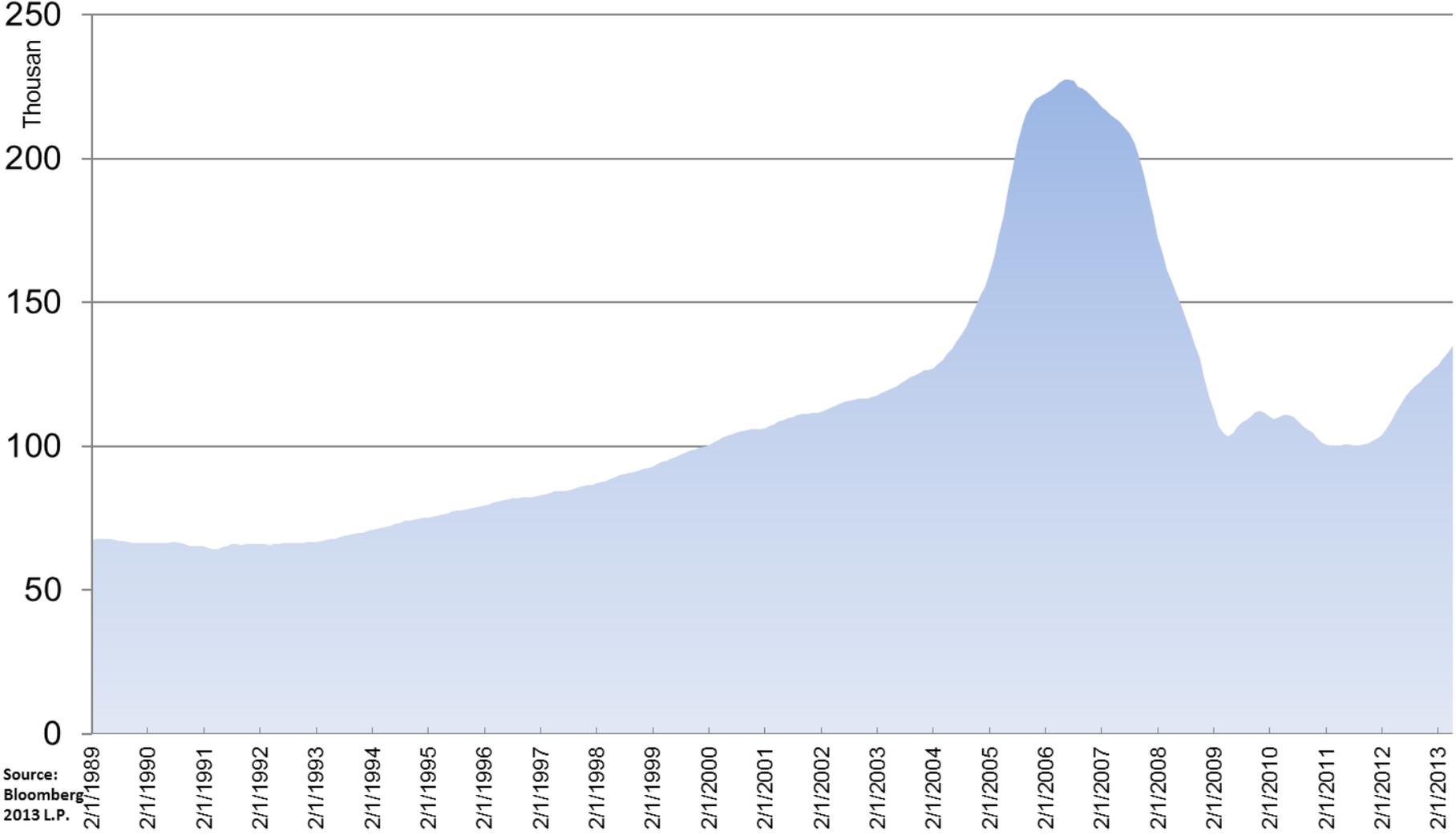


Source:  
Bloomberg  
2013 L.P.



# AZ HOUSING PRICES

## S & P/Case Schiller Housing Price Index for Phoenix



Source:  
Bloomberg  
2013 L.P.





# Special Presentation

**Jim Palmer, CFA**

Chief Investment Officer  
US Bancorp Asset Management, Inc.

OFFICE OF THE ARIZONA STATE TREASURER





Asset Management, Inc.

# Arizona State Treasurer's Office

## LGIP Quarterly Meeting

Presentation By:

Jim Palmer, CFA  
Chief Investment Officer  
612.303.3434

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# Market Conditions

## Fed/Central Bank Policy

- As recently as the June 19, 2013 FOMC statement, the Fed made no official changes to key policies put in place at the beginning of the year.
  - The federal funds rate will be targeted at 0.0% to 0.25% as long as the Unemployment Rate remains above 6.5% and inflation does not exceed 2.5%.
  - The Fed will continue to make asset purchases of approximately \$85 billion per month.
- Speculation over timing of the Fed tapering asset purchases.
  - Fed's slight upgrade to economic forecast.
  - Chairman Bernanke's comment that the Fed could taper purchases in 2013 should economic conditions continue to improve.
  - Increasingly vocal dissent from some Fed officials over the efficiency and need for large scale asset purchases.
- Foreign Central Banks continue to add stimulus.
  - Bank of Japan has implemented a massive monetary stimulus program with a goal to achieve 2% inflation.
  - European Central Bank continues expansionary policies and encourages structural economic reforms.

# Market Conditions

## Economic Growth

- U.S. economic data has recently been mixed.
  - Economic growth expected to be in the 1 to 2% range for the remainder of 2013.
  - Employment data improved noticeably in Q2 vs. Q1.
  - The Unemployment Rate remained steady at 7.6% in Q2, but underlying components improved.
    - Household Employment up 772k jobs / Labor Force up 807k workers.
  - Housing recovery has been a source of strength in the U.S.
  - ISM Manufacturing and Non-manufacturing Indices both fell in Q2, indicating slower growth – not recession.
  - Inflation remains well inside Fed's upside hurdles. Core PCE Index up 1.1% year-over-year in May.
- U.S. economic data viewed through the prism of its impact on future Fed policy.
- Global growth continues to be a source of concern for the markets.
  - European growth remains anemic, hindering progress on sovereign debt and deficit issues.
  - Financial market concerns over growth and bank liquidity in China become more pronounced.

# Market Conditions

## Credit Market Challenges

- Speculation about the future path of Fed policies, with near term concerns over the tapering of asset purchases, led to higher interest rates impacting bond prices, bond fund outflows, levered investors and market liquidity.
- Market liquidity for some asset classes has been reduced due to regulatory changes and recent market volatility.
- Investor concerns over European sovereign and bank debt have been muted over the past several quarters.
  - Core problems of low growth, high unemployment and deteriorating deficits remain.
  - Europe has received greater attention from investors in the past few weeks.
- Rating agency risk remains, but wide-scale downgrades have been completed for the most part.
- U.S. fiscal policy
  - Tax increases and budget sequestration have significantly reduced the federal budget deficit.
  - Federal debt ceiling is predicted to be reached in late October / early November.

# Strategies

## Yield Curve

- Anticipation of the Fed tapering its asset purchases has dramatically steepened the yield curve and increased interest rate volatility from the end of April through July 24<sup>th</sup>.
  - 2-year Treasury yields have risen 14.1 bps from 0.209% to 0.350% and reached a recent high of 0.407% on June 25<sup>th</sup>.
  - 5-year Treasury yields have risen 70.2 bps from 0.677% to 1.379% and reached a recent high of 1.614% on July 5<sup>th</sup>.
- In the same period, yields on very short money market instruments such as repos, agency discount notes, Treasury bills and commercial paper fell to below 10 bps.
- 3-month LIBOR has fallen almost 18 bps to 0.264% bps over the past 12 months.
- Relative value of the current yield curve is dependent upon one's view of future Fed policy.

## Duration Management

- Given the very low yields of money market instruments and our expectation that the Fed will not raise rates before 2015, we would recommend being neutral to long portfolio benchmarks for portfolios with duration targets of one year and less.
- Long-run view suggests risks are still skewed toward higher interest rates.
  - Argues for being short to portfolio benchmarks for portfolios with greater than one year duration.
- Interest rate volatility presents tactical opportunities to add yield through duration extension.

# Strategies

## Sectors

- **Treasuries**

- Current absolute rates and yield curve are relatively attractive vs. the previous 3 to 12 months.
- As expected, liquidity for U.S. Treasuries remains exceptionally strong.

- **Agencies**

- Spreads on bullet agency securities are very tight to their U.S. Treasury counterparts.
- Callable option-adjusted spreads (OAS) have recently widened, presenting better investment opportunities than in previous quarters.

- **Corporates**

- Despite a slight deterioration in balance sheet fundamentals, bank and industrial credit quality remain strong.
- Market technicals remain favorable with new issue debt seeing considerable demand.
- Corporate spreads widened in May and June as market volatility increased.

# Strategies

## Sectors

- **Asset-Backed Securities (ABS)**

- Underlying ABS credit quality continues to be impressive for all sectors including credit cards, autos and equipment leases.
- ABS spreads have widened, increasing the attractiveness of the sector.

- **Agency MBS**

- Higher pre-pay speeds over the last 12 months have in general had a negative impact on the sector.
- The recent rise in interest rates and speculation over the Fed tapering asset purchases have slowed refinancing which may translate into slower pre-pay speeds and extension risk for MBS.

# Disclosure

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# QUESTIONS?

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