

MEMORANDUM

Montana Board of Investments

Department of Commerce

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To: Board Members

From: Carroll South, Executive Director
Clifford Sheets, Chief Investment Officer

Date: February 13, 2008

Subject: STIP Update & Policy Revision Recommendations

HISTORY

The Short Term Investment Pool (STIP) was created by the Legislature on July 1, 1973 as an investment vehicle to manage state and local government cash. State agencies utilize STIP for accounts that are entitled to retain their interest earnings and have no other options for the investment of their cash. Local governments have other options as permitted by law and use STIP at their discretion.

The STIP investments on June 30, 2007 totaled \$2.8 billion with 479 individual accounts participating throughout the fiscal year, including 193 local government accounts. Since its creation the STIP has provided a convenient way for state and local government agencies to invest and withdraw cash with only 24-hours notice. The pool distributed \$125 million in income to state and local government agencies for Fiscal Year 2007.

Local Government Participation – The law creating STIP and permitting local governments to participate was one of 10 sections contained in legislation to enact the unified investment program required by the new Constitution. There is no “statement of intent” to determine the original legislative intent of the following provision of the law.

“17-6-204(3) The principal and accrued income, and any part thereof, of each and every account maintained for a participant in the pooled investment fund shall be subject to payment at any time from the fund upon request. Accumulated income shall be remitted to each participant at least annually.”

This language seems to provide an implicit guarantee of local government principal held in the STIP. The Board’s legal counsel believes that “principal” in this context means that local governments are entitled to receive their full principal upon request. This provision prevents the Board from taking any action to mitigate the impact of large local government withdrawals.

While the law permits local government to invest in the STIP at their discretion, it appears that the Board has no discretion as to whether it accepts and manages local government funds. This section of the law states:

17-6-204. Investment of local government funds. (1) The governing body of any city, county, school district, or other local government unit or political subdivision having funds which are available for investment and are not required by law or by any covenant or agreement with bondholders or others to be segregated and invested in a different manner may direct its treasurer to remit such funds to the state treasurer for investment under the direction of the board of investments as part of the pooled investment fund.

The net effect of these provisions is that the Board has no control over the deposits or withdrawals of local government funds in the STIP.

LOCAL GOVERNMENT WITHDRAWALS

Shortly after a Bloomberg news article listed the STIP as having Structured Investment Vehicles (SIV's) in its portfolio, several large local governments began withdrawing their STIP investments, essentially closing their accounts. From November 28 through December 7, local government net withdrawals totaled \$356.0 million. Board staff were able to accommodate the large withdrawals without being forced to liquidate securities for two primary reasons. 1) In August, staff began shortening the pool duration and increasing liquidity to ensure that sufficient funds were available to accommodate unpredictable local government withdrawals; and 2) the state funds component remained stable during the period. Through February 4th, local governments had withdrawn \$599 million and deposited \$219 million, for a net reduction of \$380 million. Local government participation has stabilized since the first week in December, while state funds have increased by \$200.0 million. As of February 4, state agency funds comprised 77.4 percent of the pool.

A detailed analysis of the withdrawals found that 41 local government accounts were either closed out completely or the balances reduced significantly - reflecting more than a typical "business as usual" withdrawal. In total, these accounts withdrew \$347.9 million. As of February 4, there remained in the pool 152 accounts ranging in size from \$386.00 to \$54.1 million, with an average size of \$3.4 million.

THE STIP INVESTMENT PORTFOLIO

Sub-prime Mortgages - There has been much media discussion recently of the "sub-prime" mortgage crisis and its impact on both private and public money market type funds. The implication is that funds such as the STIP have large holdings of "sub-prime" mortgages that are defaulting. While the sub-prime problem may have precipitated a much larger global credit problem, sub-prime mortgage exposure has little impact on the STIP portfolio. The portfolio holds no direct sub-prime mortgages and of the total assets backing structured investments, approximately \$12.7 million is comprised of securitized sub-prime mortgages - less than 1.0 percent of the pool.

Structured Investment Vehicles - These investments, usually called SIV's, are now one of the hottest subjects in the financial media. The first SIVs were created in the mid-1980s as bankruptcy-remote entities and were sponsored by large banks or investment managers for the purpose of generating leveraged returns. They do this by earning the spread (differences in yields) between the longer-dated assets purchased and the short-term liabilities issued. The balance sheet of a structured investment vehicle typically contains assets such financial institution debt, commercial and residential mortgages, and other receivables.

Maintaining a high quality asset portfolio is a fundamental part of running a SIV. The purchase of these assets is funded through issued liabilities in the form of commercial paper (CP), medium-term notes (MTNs) and subordinate capital notes. The CP and MTN are given the highest credit ratings (A1/P1 or AAA) from one or more of the three major rating agencies. However, in order to maintain the AAA-rating, SIVs have to demonstrate compliance to a stringent set of operating guidelines that cover a wide range of performance characteristics including projected cash-flows, diversification risks, market rate sensitivity and capital adequacy.

As of February 13, 2008, the STIP portfolio holds \$385.0 million in SIV's. The table below shows the date they were purchased, the investment rating at the time of purchase, the broker, the sponsor, and the maturity date.

<u>Purchase Date</u>	<u>Issue</u>	<u>Ratings</u>		<u>Par</u>	<u>Maturity</u>	<u>Broker</u>	<u>Sponsor</u>
		<u>Moodys</u>	<u>S&P</u>				
01/16/07	Orion	Aaa	AAA	25,000,000	01/16/08	Merrill	Orion
04/20/07	Orion	Aaa	AAA	25,000,000	04/21/08	Merrill	Orion
02/28/07	Parkland	Aaa	AAA	25,000,000	02/28/08	JP Morgan	Bank of Montreal
05/25/07	Parkland	Aaa	AAA	25,000,000	05/27/08	JP Morgan	Bank of Montreal
03/13/07	Courtland	Aaa	AAA	50,000,000	03/13/08	Merrill	Ontario Teacher's Pension
04/30/07	Courtland	Aaa	AAA	25,000,000	04/15/08	Merrill	Ontario Teacher's Pension
04/12/07	Axon	Aaa	AAA	40,000,000	04/14/08	Merrill	Axon
04/16/07	Axon	Aaa	AAA	50,000,000	04/15/08	Merrill	Axon
05/29/07	Harrier	Aaa	AAA	40,000,000	05/29/08	JP Morgan	WestLB
06/06/07	Harrier	Aaa	AAA	40,000,000	06/06/08	JP Morgan	WestLB
06/20/07	Vetra	Aaa	AAA	<u>40,000,000</u>	06/20/08	Lehman	Citibank
Total				<u>385,000,000</u>			

The ratings of these investments when purchased were the highest rating possible and are identical to the ratings for bonds issued by the United States Government. The two rating agencies providing initial ratings for these investments continue to track them closely through the turmoil in the debt markets. The agencies rate not only the investment itself but the assets backing the investments.

The current ratings are shown in the adjacent table. The Axon and Orion investments are currently in a restructuring phase while the trustee holds all the underlying assets. The Harrier investment has a direct line of support from the bank sponsor that effectively makes it a de facto bank obligation, providing significant credit support beyond that derived from the underlying assets

<u>Investment</u>	<u>Moody's</u>	<u>S&P</u>
Axon Financial	B2	D
Cortland Capital	Aaa	AAA
Harrier Finance	Aa1	AAA*
Orion Finance	B1	D
Parkland Finance	Aaa	AAA
Vetra Finance	Aaa	AAA
* Under review with a negative watch		

Type of Assets Backing the SIV's – The SIV investments are backed by the underlying assets listed on the following page.

<u>Asset Type</u>	<u>Amount</u>	<u>Percent</u>
Financial Institution Debt	\$ 169,139	43.93%
Prime Res Mortgage	78,519	20.39%
CDO/CLO/CBO*	53,975	14.02%
Commercial Mortgage	41,637	10.81%
Subprime Res Mortgage	12,730	3.31%
Student Loans	8,823	2.29%
Other	8,667	2.25%
CC Receivables	8,432	2.19%
Plant & Equip Loan/Lease	2,112	0.55%
Corporate Debt	500	0.13%
Consumer Loans	466	0.12%
Total	\$ 385,000	100.00%

* Collateralized Debt Obligations/Loan Obligations/Bond/Bank Obligations

All of the underlying assets continue to have “investment grade” ratings as shown below.

<u>Investment</u>	<u>AAA</u>	<u>AA</u>	<u>A</u>	<u>BBB</u>	<u>Total</u>
Axon Financial	86,580.00	2,610.00	450.00	360.00	90,000.00
Cortland Capital	55,747.50	19,252.50	-	-	75,000.00
Harrier Finance	51,920.00	21,680.00	6,400.00	-	80,000.00
Orion Finance	30,450.00	17,050.00	2,500.00	-	50,000.00
Parkland Finance	22,500.00	25,000.00	2,000.00	500.00	50,000.00
Vetra Finance	38,640.00	1,360.00	-	-	40,000.00
Total	\$ 285,838	\$ 86,953	\$ 11,350	\$ 860	\$ 385,000

SCHEDULE OF SUBSTANTIVE SIV EVENTS

Axon

- October 30, 2007 – S&P downgrades Axon to BBB.
- November 7, 2007 - Staff in a formal report to the Board note that Axon was placed on negative watch by all three rating agencies.
- November 9, 2007 – S&P downgrades Axon further to CCC by S&P.
- November 15, 2007 - Staff send a memorandum to Board members informing them of the downgrade and give a general update of all SIV’s, noting that others had been placed on watch but were still investment grade.
- November 19 – Axon breaches a “NAV” trigger resulting in an automatic liquidation event.
- November 27, 2007 - S&P downgrades Axon to D
- November 28, 2008 - Staff inform the Board of the downgrade and note that all other SIV’s are still investment grade. The memorandum is posted on the Board’s website.
- November 30, 2007 - The Executive Director and Chairman issue a joint press release assuring local governments that the Board would not suspend their withdrawals from the STIP as Florida had done.

- December 11, 2007 - Staff present a report to the Legislative Finance Committee providing an update on local government withdrawals and noted that Axon had been downgraded to D and that a steering committee of senior creditors was being formed. The report was posted on the Board's web site that day.
- December 14 – Moody's downgrades Axon to B2
- January 7, 2008 - Staff presented a STIP report to the State Administration and Veterans' Affairs Committee providing another update on local government withdrawals and reiterated that the Axon investment was in a restructuring phase. The report was posted on the Board's web site that day.
- February 13, 2008 – The underlying Axon portfolio is currently undergoing extensive evaluation by a financial advisor hired by the Security Trustee. All underlying assets are held by the Security Trustee and the vehicle will likely be restructured in some manner.

Orion

- November 30, 2007 – Moody's downgrades Orion to Baa3, which triggers an Automatic Enforcement Event placing the underlying assets in the control of the Security Trustee.
- December 7, 2007 – S&P's maintains an AAA rating but places Orion on negative watch.
- December 11, 2007 - Staff present a report to the Legislative Finance Committee noting that Orion had been placed on watch by S&P's and downgraded to Baa3 by Moody's. The report is sent to the Board, members of the Legislative Audit Committee, and posted on the Board's web site that day.
- January 7, 2008 - Staff present a report to the State Administration and Veterans' Affairs Committee noting that Orion was in a "restructuring mode." The report is sent to the Board, Legislative Audit Committee members, and posted on the Board's web site that day.
- January 14, 2008 – Orion fails to pay notes due on January 14, 2008.
- January 16, 2008 – S&P down grades Orion to "D" due to a technical default triggered by not paying the January 14 note when due.
- January 17, 2008 – Board staff confirm that its \$25.0 million note due on January 16 was not paid and the \$25.0 million is booked as a receivable.
- January 18, 2008 – The Lee Newspapers reports on the Orion default and other STIP issues.
- January 23, 2008 – Moody's downgrades Orion from Baa3 to B1. The downgrade statement notes that the B1 rating reflects the likelihood of a high or full recovery of the notes if the vehicle avoided assets sales. The downgrade notice is sent to the Board.
- January 23, 2008 - Staff appear before the Legislative Audit Committee for approval of the Board's annual financial audit and have a lengthy discussion of the STIP. The downgrade notice is sent to Legislative Audit Committee members.

WHAT IS A SIV RESTRUCTURING?

The SIV documents are complex instruments that generally contain certain provisions that trigger "events." In order to maintain an investment grade rating, the vehicles must demonstrate compliance to a stringent set of operating guidelines that cover a wide range of performance characteristics including projected cash-flows, diversification risks, market rate sensitivity, and pricing of the underlying assets in relation to the liabilities. Once the instrument falls out of compliance with the terms of the guidelines, the security trustee may be required to "take over" the collateral portfolio and exercise total discretion. A restructuring may be driven by a senior creditors' steering committee working closely with the security trustee. The Board is a member of the Orion steering committee but is not a member of the Axon steering committee.

THE STIP INVESTMENT POLICY

As the fiduciary for the Unified Investment Program, the Board establishes broad investment policies for each investment pool and all separate accounts. Investment staff must comply with the approved policies as they carry out the day-to-day securities trading activity. The STIP Investment Policy Statement was revised in August 2006 to include the following provisions applying to Asset Backed Securities (ABS - which includes SIV's). The maximum limit for one issuer was reduced from 5.0 percent to 4.0 percent of the portfolio. The overall limit on ABS was reduced from no limit to 70.0 percent of the portfolio

DID THE POLICY AUTHORIZE STRUCTURED INVESTMENT VEHICLES?

Investment Type - The current STIP Investment Policy authorizes a maximum of 70.0 percent of the portfolio to be invested in Asset-Backed Securities (ABS) of any type. The policy specifically includes "structured investment vehicles" within the definition of ABS. On November 15, 2007 the SIV's comprised 22.6 percent of the portfolio. As of February, 13, 2008 SIV exposure is 17 percent of the portfolio.

Investment Ratings – The policy requires that SIV's be rated triple-A by at least one rating service at the time of purchase. At the time of purchase these investments were rated triple-A by two rating agencies.

Maximum Investment per Issuer – The policy requires that one issuer must be limited to no more than 4.0 percent of the portfolio. When the \$90.0 million Axon securities were purchased (the largest SIV), they comprised 3.67 percent of the STIP portfolio.

Maturity Limit – The policy requires that, with a few exceptions for variable rate or floating rate securities, an investment may not have a maturity date exceeding 397 days from the date of purchase. The longest maturity date for any of the SIV's currently held in the portfolio was 370 days on the purchase date.

Other Policy Provisions – The policy authorizes ABS investments with the following caveat:

"Asset-backed securities (ABS) collateralized by: credit cards, automobile loans, leases and other receivables acceptable to staff in their analysis of this type of structure"

In retrospect, the portfolio manager placed too much confidence in the rating agencies as the primary judges of ABS quality, rather than analyzing the structure and the underlying assets backing the investment. There was a perception that the highest-rated structured securities (AAA-rated SIVs) were impregnable and would not have credit quality problems because the investment ratings were equivalent to US Treasury obligations. Unlike an unsecured corporate credit, there were high quality assets backing the instrument that would maintain their value and ensure the payment of principal at maturity. There was little, if any, look-through or monitoring of the specific underlying collateral and its current status as reported monthly by the investment administrator. The documentation for many of the issues held was not current, or not readily accessible. Also, there was not an approved list per se, but a working list of issuers that were available in the market and met the portfolio manager's personal level of comfort.

IS THE PORTFOLIO CURRENTLY IN COMPLIANCE WITH POLICY?

Recent events beyond the control of Board staff have resulted in the portfolio being out of technical compliance with the Investment Policy. The rating agencies have downgraded two securities in the portfolio to less than “investment grade”, which means they no longer meet the minimum rating requirement.

The policy addresses these contingency events as follows:

“DIVERSIFICATION AND LIMITATIONS OF THE STIP PORTFOLIO

These limitations shall apply at the time of purchase of a security. Should the portfolio fall out of compliance due to downgrades or shrinkage of the total portfolio size, a reasonable cure period (not to exceed 90 days) will be allowed so that compliance can be obtained via maturities or sales at fair market value.”

The Axon investment was downgraded to CCC by S&P on November 9, just two days after the Board last met. The 90 days permitted in the current policy to exercise a reasonable cure expired on February 7, five days before February Board meeting. Given that this investment is in a restructuring phase, staff do not believe it would be prudent to attempt to sell it in the current distressed debt environment. Staff will recommend revisions to this section of the policy to permit some staff discretion under the type of unpredictable environment encountered recently.

The STIP portfolio as of February 1 is shown by sector below in millions.

<u>Sector</u>	<u>Amount</u>	<u>%</u>
Asset-Backed Corporate Paper	\$628,763	27.78%
Structured Investment Vehicles	454,997	20.10%
Corporate Commercial Paper	528,886	23.37%
Corporate Notes	155,000	6.85%
Certificate of Deposits	129,995	5.74%
Government Agencies	274,198	12.12%
Money Market Funds	90,896	4.02%
Repurchase Agreement	<u>502</u>	<u>0.02%</u>
Total	<u>\$2,263,237</u>	<u>100.00%</u>

IMPACT ON THE STIP INVESTMENT PORTFOLIO

There has been no material impact on the assets in the STIP portfolio due to the SIV holdings. The STIP is operated as an “amortized cost” fund, which means that the individual securities in the portfolio are not priced daily, weekly, or monthly, but are held at “cost” until maturity. This accounting methodology is based on the premise that all investments will be “purchased and held” to maturity rather than sold at a loss or gain prior to maturity. This is the only process by which a constant share price can be maintained. If securities were priced daily, there could be a different share value each business day.

All current securities in STIP are held at amortized cost until maturity. The SIV’s currently undergoing restructuring will also be held at cost until the restructuring is complete and the final outcome is known. The unpaid \$25.0 million Orion note is held on the books as a receivable and included in the pool’s Net Asset Value.

RECOMMENDED INVESTMENT POLICY REVISIONS

Proposed staff revisions to the policy are attached. For the most part, the recommendations codify the current day-to-day management policies that were implemented and updated by staff since the debt crises and ensuing market volatility began to surface in August. While the proposed revisions tighten up the day-to-day procedures and operations of the pool, they also provide sufficient flexibility and discretion to ensure that a rigid adherence to the policy would not force staff to take an action that could be deemed imprudent. For example, a forced, untimely sale of a security because of a ratings downgrade or an extended maturity due to a restructuring would not be in the best interest of pool participants. The prudent expert principle law requires the Board among other things to:

“discharge the duties solely in the interest of and for the benefit of the funds forming the unified investment program.”

The first enclosure is a “marked” version that shows the suggested deletions and additions to the existing policy. The second enclosure is a clean copy incorporating the proposed revisions. Also added to the clean copy is a set of definitions describing the different type of investments referenced in the policy.