

REPORT ON THE STATE POOLED INVESTMENT FUND

For The Fiscal Year Ended June 30, 2016



PREPARED FOR THE
STATE FUNDING BOARD

November 17, 2016

PREPARED BY
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TABLE OF CONTENTS

I.	Compliance with Investment Policy	
	• Portfolio Composition	1
	• Liquidity	2
II.	Portfolio Performance	3
III.	Review of Investment Policy	6
IV.	Investment Plan	6
V.	Cost of Administration	7
VI.	Largest Holdings	7

CHARTS AND TABLES

Average Portfolio Composition	1
Average Daily Invested Balances	2
Average Days to Maturity	2
Income Earned for 2015-2016	3
SPIF Investment Earnings	4
FOMC Meeting History	4
SPIF Yields by Asset Type	5
Comparison of Net Yields	5
Comparison of Average Days to Maturity	6
Largest Holdings at June 30, 2016	7

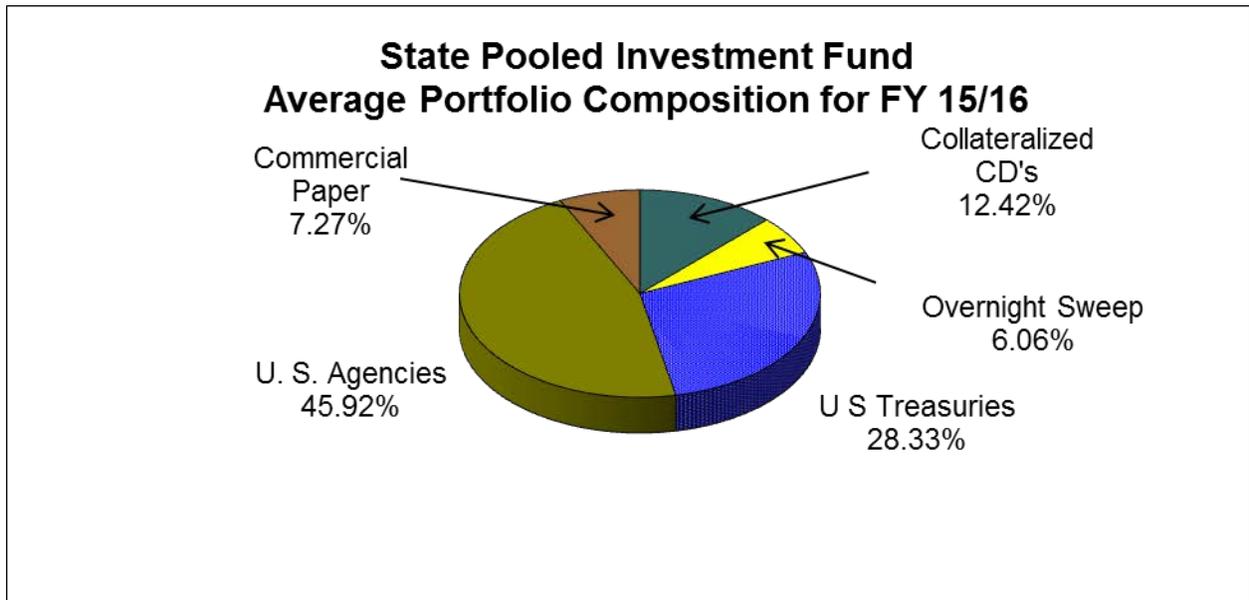
TENNESSEE TREASURY DEPARTMENT
State Pooled Investment Fund Report
For the fiscal year ended June 30, 2016

I. COMPLIANCE WITH INVESTMENT POLICY

The investment policy for the State Pooled Investment Fund is set by the State Funding Board. The board is composed of the Governor, Commissioner of Finance and Administration, Comptroller, Secretary of State, and Treasurer. The investment objective for the state pooled investment fund is to obtain the highest available return on investments consistent with the preservation of principal, while maintaining sufficient liquidity for state expenditures and other withdrawals from the state pooled investment fund.

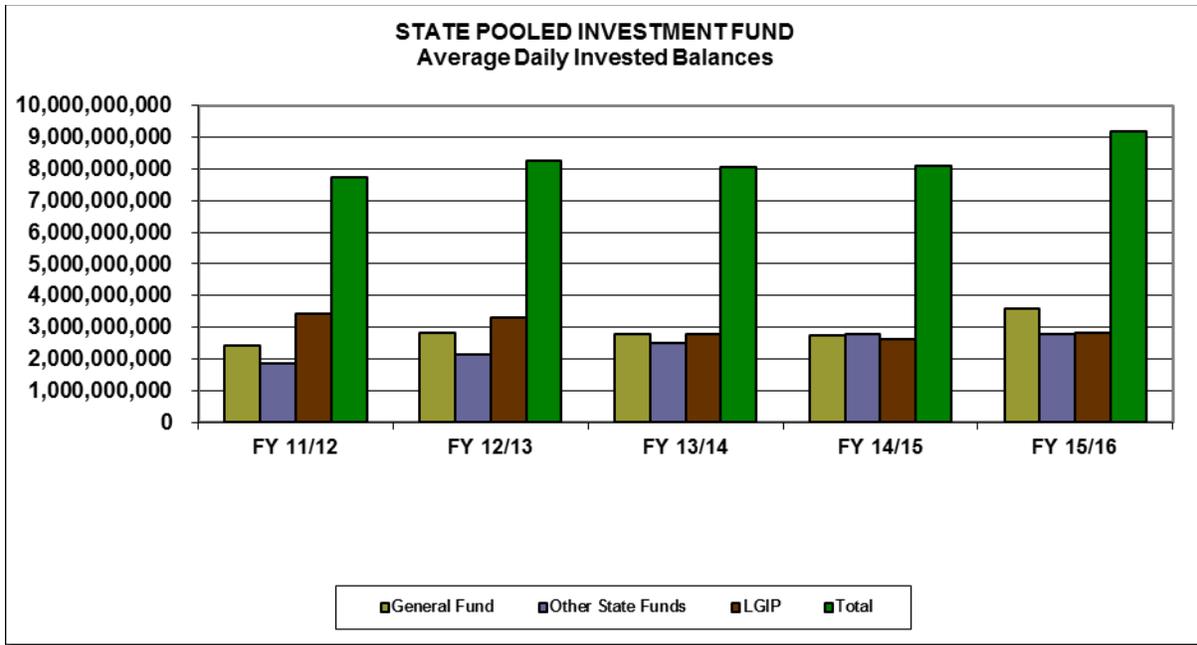
Portfolio Composition

The State Pooled Investment Fund had a monthly average of \$ 9.18 billion invested for the fiscal year ended June 30, 2016. The following chart shows the composition of the average portfolio.



The reduced availability of commercial paper that meets the strict credit quality requirements of the SPIF is evidenced by the 7.27% average investment during the fiscal year. Bank demand for State funds has increased slightly, but is still down from levels before the financial crisis in 2008. Six years ago, there was no exposure to US Treasuries in the SPIF, but lack of other quality investments pushed the exposure to 28.33% for the year.

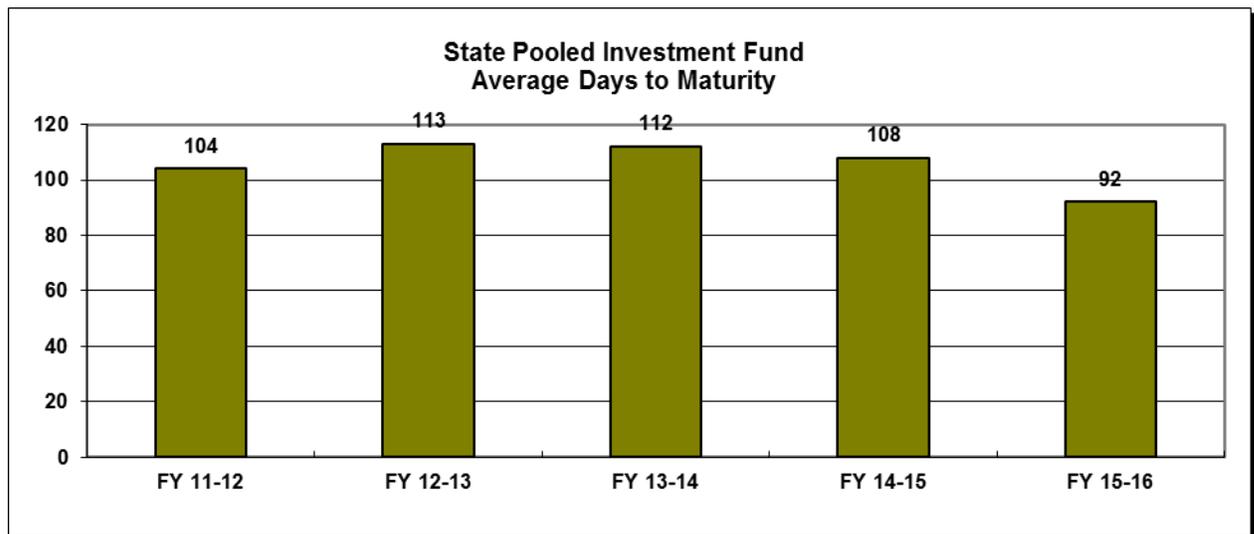
The following chart shows the average monthly balances in the state pooled investment fund for the last five years. At 6/30/16, the LGIP balance comprised 27.6% of the state pooled investment fund. The actual balance of funds available to invest on behalf of the General fund (Unrestricted Accounts) increased to record levels in 2016, growing from \$3.61 billion at 6/30/15 to \$4.93 billion at 6/30/16.



Liquidity

Until recently, the SPIF operated in a manner consistent with the Security and Exchange Commission's Rule 2a7 of the Investment Company Act of 1940. Until 2010, this rule required a dollar weighted average portfolio maturity of 90 days or less and a maximum maturity of any single investment of 397 days or less. In 2010, the SEC made further modifications that allow a dollar weighted average maturity of either 60 days or 120 days, based upon reporting methods used. The SEC made further changes to Rule 2a7 in 2014 that go into effect in October 2016. GASB implemented Statement 79 in December 2015 that allows government funds to report at amortized cost and transact at a stable dollar. The State Funding Board voted to change the Investment Policy to be in compliance with GASB 79. The liquidity requirements under the revised investment policy require no more than 60 days weighted average maturity, no more than 120 days weighted average life, and 397 days maximum maturity on any single investment.

The following chart shows the dollar weighted average maturity of the SPIF over the past five years.

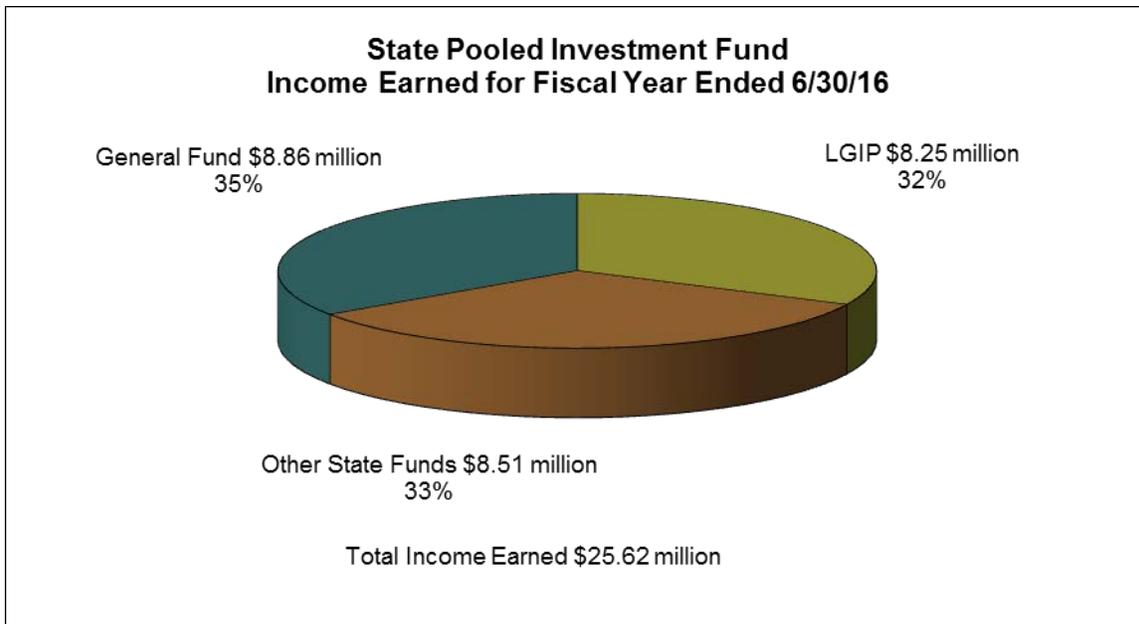


The additional liquidity requirements in GASB 79 require that no more than 5% of the portfolio can be invested in illiquid securities, at least 10% of the portfolio must be invested in daily liquid assets, and at least 30% of the portfolio must be invested in weekly liquid assets. At June 30, 2016, the SPIF had 0% invested in illiquid securities, 40.7% was invested in daily liquid assets, and 66.2% was invested in weekly liquid assets.

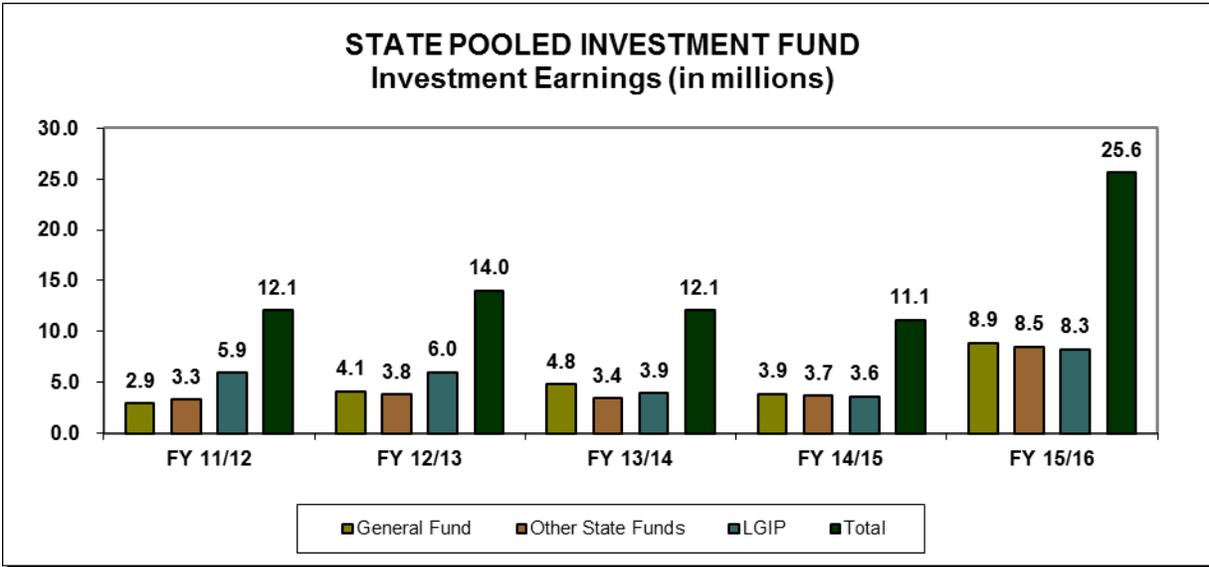
Stress Test Results: The stress tests conducted during FY16 revealed that in each case the portfolio could handle the largest 5-day withdrawal in the history of the fund AND tolerate an interest rate shift of 1.50% without declining in value more than .05% (considered “breaking the buck”). The tests also showed that the portfolio could handle the liquidation of the ten (10) largest LGIP participants in a single day AND tolerate an interest rate shift of 1.25% without declining in value more than .05%. After the investment policy change, the portfolio was actually able to handle each of the scenarios listed above AND tolerate interest shifts in excess of 300 basis points. The scenarios tested are unlikely and near improbable, but that is the reason for the tests. The SPIF is able to handle these scenarios due to the policy restrictions for liquidity and maturity.

II. PORTFOLIO PERFORMANCE

Income earned on the portfolio during the fiscal year ended June 30, 2016 totaled \$25.62 million (estimated). The distribution of earnings as shown on the following pie chart was \$8.86 million to the General fund; \$8.25 million to the LGIP; and, \$8.51 million to Other State funds (accounts specified by statute, court order or regulation to receive interest earnings on their balances). *(amounts shown are estimates and are unaudited as of this writing)*



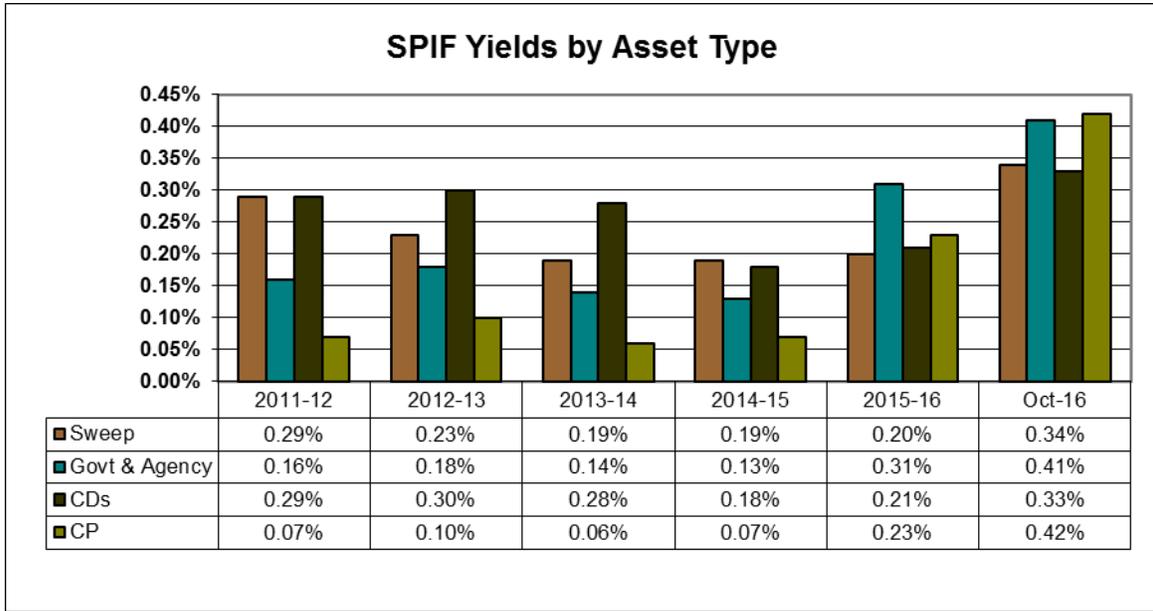
The monies in the SPIF represent the liquid working capital available to the State of Tennessee to cover expenditures until additional revenues are collected. Earnings of the state pooled investment fund for the last five years are shown in the following chart. (amounts shown for current fiscal year are estimated and unaudited as of this writing)



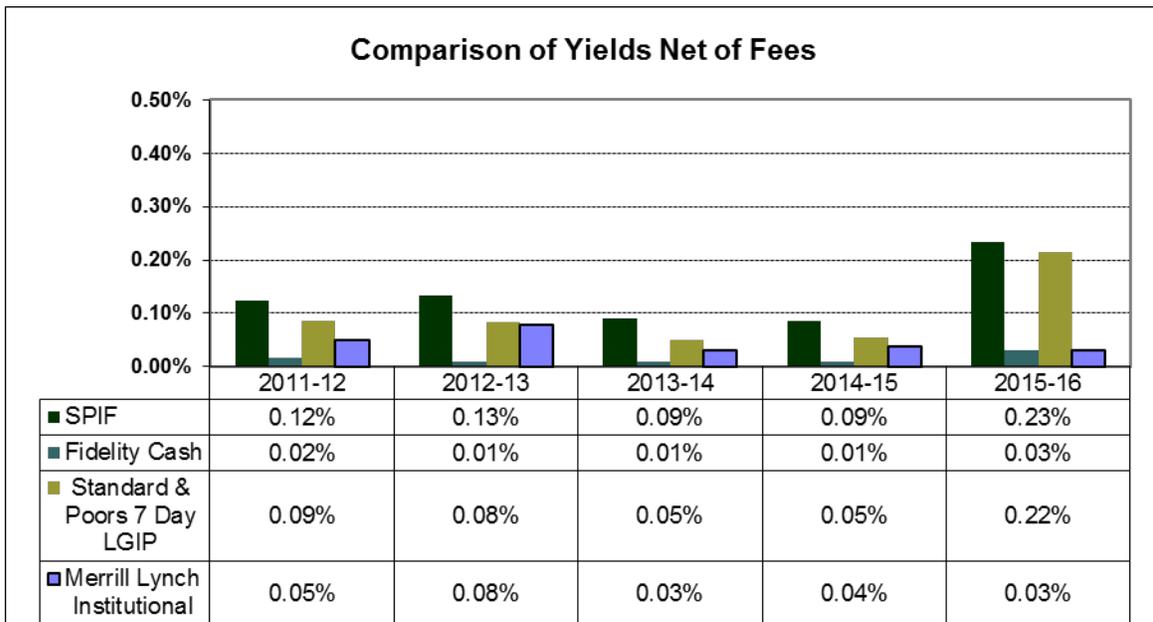
The fed funds target rate was lowered on 12/16/08 to a range of 0% to 0.25% and remained at that level until 12/15/15 when the rate was raised to a range of .25% to .50%. There is a increasing possibility that there could be another rate hike in the next few months, maybe as soon as the December 2016 meeting. The chart below shows the actions taken at each of the meetings for the last eighteen months.

FOMC Announcement Date	Fed Funds Target Rate	Direction	Amount of Change	Primary Credit Rate	Economic Assessment
04/29/2015	0 to 0.25%	None	None	3.25%	Growth Risk
06/17/2015	0 to 0.25%	None	None	3.25%	Growth Risk
07/29/2015	0 to 0.25%	None	None	3.25%	Growth Risk
09/17/2015	0 to 0.25%	None	None	3.25%	Growth Risk
10/28/2015	0 to 0.25%	None	None	3.25%	Growth Risk
12/15/2015	.25 to .50%	Increase	.25%	3.50%	Growth Risk
01/27/2016	.25 to .50%	None	None	3.50%	Growth Risk
03/16/2016	.25 to .50%	None	None	3.50%	Growth Risk
04/27/2016	.25 to .50%	None	None	3.50%	Growth Risk
06/15/2016	.25 to .50%	None	None	3.50%	Growth Risk
07/27/2016	.25 to .50%	None	None	3.50%	Growth Risk
09/21/2016	.25 to .50%	None	None	3.50%	Growth Risk
11/02/2016	.25 to .50%	None	None	3.50%	Growth Risk

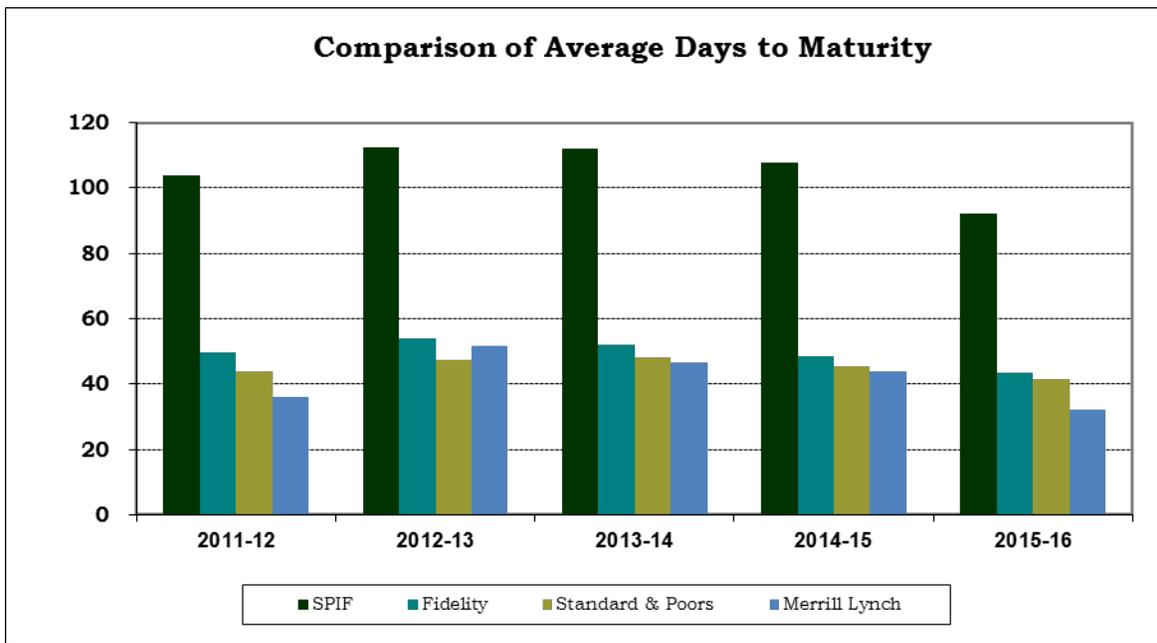
The following chart contains the average yields earned by asset type within the SPIF for the last five years and for the month of October, 2016.



The State Pooled Investment Fund is actively managed within the Treasury Department. Standard and Poor's provides a rating service for LGIP funds and calculates an index return for the rated funds. The following chart compares the average yield of the SPIF (net of administrative fee) to that index and also to the net yield of two well recognized money market funds governed by SEC Rule 2a7, Fidelity Cash Reserves Fund and the Merrill Lynch Institutional Fund.



The following chart indicates how the average days to maturity of the State Pooled Investment Fund compares to the average maturity of the Standard and Poor's rated funds index, Fidelity Cash Reserves Fund, and the Merrill Lynch Institutional Fund.



III. INVESTMENT POLICY REVIEW

Implementation of GASB Statement 79 required an extensive re-write of the Investment Policy for the State Pooled Investment Fund. The Board voted on April 7 to adapt the necessary changes to ensure that the SPIF was in full compliance with GASB. While the content and the appearance of the SPIF Investment Policy changed, the actual day-to-day operation of the SPIF did not need to make a lot of changes. The changes improve transparency and liquidity without having a negative impact on performance. One of the more significant changes is the recognition of the reset date as the maturity date for floating-rate securities. GASB also requires more frequent reporting that includes the shadow price, daily and weekly liquidity, and weighted average maturity and weighted average life of the portfolio.

IV. INVESTMENT PLAN

Eight years ago, the FOMC lowered the Fed Funds rate to a range of zero to 0.25%. On December 15, 2015, the FOMC raised the rate to a range of .25% to .50%. As of the date of this report, there is a high probability that the FOMC will raise the rate again in December, possibly to a range of .50% to .75%. This means that earnings from the SPIF will remain low during the next fiscal year. Staff will continue to seek ways to generate as much revenue as possible and remain in compliance with the Investment Policy. Staff will continue to maintain a diversified portfolio of CDs, bank deposits, US Government obligations, and commercial paper. The yield curve, actions taken by the Federal Reserve Bank, regulatory changes, and other market conditions will be considered when managing the asset mix and average maturity of the portfolio. Even though actions by the FOMC and the SEC continue to limit inventory and push rates lower, the SPIF remains a safe investment for state funds and monies invested by local government officials. There has been no loss of funds due to credit exposure and no liquidity concerns.

V. COST OF ADMINISTRATION

The cost to operate the SPIF was \$4.44 million for the year ended June 30, 2016. The costs of operations are funded from a 4 basis point charge for assets invested (fees were lowered by Treasurer from 5 basis points in January 2016). Most money market funds charge substantially more than 4 basis points. Also, the costs of operations include more than investment management. The 4 basis points finances:

- Investment of portfolio
- Maintenance of collateral
- Collateral pool administration
- Cash concentration
- Bank reconciliations and resolution of reconciling items
- LGIP program
- Warrant reconciliation
- Accounting and recordkeeping
- Support cost such as internal audit, payroll, personnel, etc.

VI. LARGEST HOLDINGS AT JUNE 30, 2016 BY CATEGORY

Treasuries and Agencies

1. US TREASURIES	\$2,676,000,000
2. FHLB	2,534,510,000
3. IBRD	1,252,280,000
4. FFCB	940,500,000
5. FNMA	473,832,000

Commercial Paper

1. BNP Paribas	\$300,000,000
2. Exxon Mobil	200,000,000
3. Totota Motor Credit	125,000,000
4. General Electric	100,000,000

Bank CD's

1. Regions Bank	\$300,000,000
2. Franklin Synergy Bank	300,000,000
3. Pinnacle	270,000,000
4. B B & T	200,000,000
5. First TN Bank	100,000,000