



Douglas La Follette, *Secretary of State*
Matt Adamczyk, *State Treasurer*
Brad D. Schimel, *Attorney General*

101 E. Wilson Street
2nd Floor
PO Box 8943
Madison, WI 53708-8943

608 266-1370 INFORMATION
608 266-0034 LOANS
608 267-2787 FAX
bcpl.wisconsin.gov

Jonathan Barry, *Executive Secretary*

AGENDA

July 25, 2016

2:00 P.M.

Board of Commissioners of Public Lands
101 E. Wilson Street, 2nd Floor
Madison, Wisconsin

Routine Business:

- 1) Call to Order
- 2) Approve Minutes – July 5, 2016 (Attachment)
- 3) Approve Loans (Attachment)

Old Business:

None

New Business:

None

Routine Business:

- 4) Future Agenda Items
- 5) Executive Secretary's Report
 - Investment Report – 2nd Quarter 2016
- 6) Adjourn

AUDIO ACCESS INFORMATION

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**BOARD MEETING
JULY 25, 2016**

**AGENDA ITEM 2
APPROVE MINUTES**

Attached for approval are the minutes from the July 5, 2016, board meeting.

Board Meeting Minutes
July 5, 2016

Present were:

Doug La Follette, Commissioner
Matt Adamczyk, Commissioner
Brad Schimel, Board Chair
Jonathan Barry, Executive Secretary
Tom German, Deputy Secretary
Richard Sneider, Loan Analyst and
Chief Investment Officer
Vicki Halverson, Office Manager
Brian Hellmer
Mark Ready

Secretary of State
State Treasurer
Attorney General
Board of Commissioners of Public Lands
Board of Commissioners of Public Lands
Board of Commissioners of Public Lands

Board of Commissioners of Public Lands
UW – Madison School of Business
UW – Madison School of Business

ITEM 1. CALL TO ORDER

Board Chair Schimel called the meeting to order at 2:02 p.m.

ITEM 2. APPROVE MINUTES – JUNE 20, 2016

MOTION: Board Chair Schimel moved to approve the minutes; Commissioner La Follette seconded the motion.

DISCUSSION: None.

VOTE: The motion passed 3-0.

ITEM 3. APPROVE LOANS

Executive Secretary Barry reported that the loans had been reviewed for proper public purpose.

Municipality	Municipal Type	Loan Type	Loan Amount
1. Bayfield Bayfield County Application #: 02016207 Purpose: Finance water main and street projects	City Rate: 3.50% Term: 20 years	General Obligation	\$101,706.79
2. Bayfield Bayfield County Application #: 02016208 Purpose: Finance water main project	City Rate: 3.50% Term: 20 years	General Obligation	\$140,000.00
3. Bayfield Bayfield County Application #: 02016209 Purpose: Refinance BCPL loan #2016020	City Rate: 3.50% Term: 13 years	General Obligation	\$90,138.36

4.	Bayfield Bayfield County Application #: 02016210 Purpose: Refinance BCPL loan #2016023	City Rate: 3.50% Term: 18 years	General Obligation	\$94,693.72
5.	Bayfield Bayfield County Application #: 02016211 Purpose: Refinance BCPL loan #2016017	City Rate: 3.50% Term: 19 years	General Obligation	\$712,599.10
6.	Green Lake Green Lake County Application #: 02016214 Purpose: Purchase industrial park land	City Rate: 2.50% Term: 5 years	General Obligation	\$175,000.00
7.	Harrison Calumet and Outagamie Counties Application #: 02016213 Purpose: Purchase snow plow truck	Village Rate: 2.50% Term: 5 years	General Obligation	\$250,000.00
8.	Ontario Vernon County Application #: 02016206 Purpose: Finance street project	Village Rate: 2.50% Term: 5 years	General Obligation	\$25,000.00
9.	Pleasant Springs Dane County Application #: 02016217 Purpose: Finance road projects	Town Rate: 2.50% Term: 1 years	General Obligation	\$75,000.00
10.	Waupaca Waupaca County Application #: 02016212 Purpose: Finance 2016 capital projects	City Rate: 3.00% Term: 6 years	General Obligation	\$545,000.00
11.	West Allis - West Milwaukee, Et. Al. Milwaukee and Waukesha Counties Application #: 02016215 Purpose: Finance capital improvement projects	School Rate: 3.00% Term: 10 years	General Obligation	\$3,000,000.00
TOTAL				\$5,209,137.97

MOTION: Board Chair Schimel moved to approve the loans; Commissioner La Follette seconded the motion.

DISCUSSION: Commissioner Adamczyk expressed concern that loan customers are allowed to refinance existing State Trust Fund Loans (STFL) with a new loan in order to capture lower interest rates.

Commissioner La Follette asked if this has to be allowed and if a STFL can be refinanced more than once. Executive Secretary Barry replied that it does not have to be allowed and loans can be refinanced more than once. He added that customers are required to borrow additional funds in order to refinance an existing loan. While the

policy could be reviewed and evaluated, not allowing STFLs to be refinanced in-house could result in a loss of income to the portfolio if customers refinance with another lending institution.

VOTE: The motion passed 2-1. Commissioner La Follette and Board Chair Schimel voted aye; Commissioner Adamczyk voted no.

ITEM 4. DISCUSS DRAFT INVESTMENT POLICY AND ASSET ALLOCATION MODEL

Board Chair Schimel introduced Brian Hellmer and Mark Ready from the UW-Madison School of Business and thanked them for their input and assistance in helping the Board's staff develop an investment policy and asset allocation model.

Executive Secretary Barry said that BCPL was granted prudent investment authority by the legislature in 2015. In order to utilize this authority in a careful and prudent manner, the Board must adopt an investment policy. He added that staff was not asking for the Board's approval at the meeting but rather allow time for them to review the draft policy and submit questions and suggestions. Perhaps within a month the Board would be ready to approve a final policy.

Richard Sneider explained that an investment policy would:

- guide future investment decision-making because the Prudent Investment Standard allows for more investment options;
- provide a guide for all future investments and ensure long-term prudence by current and future Commissioners and agency staff;
- create the opportunity for the Board to earn capital gains while reducing risk by establishing a "smoothing fund;" and
- put more Trust Fund principal to work, thereby increasing earnings for the beneficiaries.

The draft investment policy presented to the Board was developed with the following in mind:

- beneficiaries rely on a stable, sustainable income distribution to support K-12 public school libraries;
- distributions to beneficiaries can only be made from income earnings as the State Constitution requires School Trust Fund principal be retained in the trust; and
- the rate of growth of the Common School Fund's principal from unclaimed property and fees, fines and forfeitures has declined, which impacts the amount of monies available for investing.

Executive Secretary Barry said that minimum annual earnings distributions of 3.5% of trust fund principal balances had been established as a target to meet beneficiaries' expectations. He asked Mr. Sneider to explain the smoothing fund. Mr. Sneider said that a segregated fund (i.e., smoothing fund) would be established using income earnings above the targeted 3.5%. These funds could then be used to supplement distributions during years when income does not meet the targeted annual distribution.

Commissioner La Follette inquired about the timing of the earnings distribution and whether retaining the earnings in the smoothing fund was permitted. Deputy Secretary German replied that the while the state constitution requires that fund earnings be distributed annually, the distribution occurs mid-year so any earnings received after that time would be retained for future distribution. Mr. Sneider added that once the smoothing fund becomes fully developed, the distributable earnings might very well exceed the 3.5% target and would be based on distributions over the last five years.

The Commissioners, staff and professionals from the UW-Madison School of Business discussed the risk/return characteristics surrounding the expanded investment authority and how to mitigate the risks while generating returns.

Commissioner Adamczyk expressed his desire that SWIB (State of Wisconsin Investment Board) invest a portion of School Trust Funds for the Board and cited information indicating that their average return on investments over the past 20 years was 7.4%. His preference would be to limit investments in State Trust Fund Loans (STFL) and allow SWIB to invest those funds. Executive Secretary Barry said that the Board was providing a service to local governments and school districts with competitive rate loans while earning a good rate of return with very low risk. He added that the investment policy was necessary whether the School Trust Funds are invested by staff or SWIB.

Commissioner La Follette noted that there were two aspects to the July 5 meeting and those included whether the Board agreed with the draft investment policy and, if adopted, establishing an asset allocation model for investments. He asked staff what action the Board needed to take, if any. Board Chair Schimel replied that no action would be taken on the matter at this time and the Commissioners should review the policy further. The Board could take action at a future meeting, perhaps in a month.

Commissioner La Follette asked Brian Hellmer and Mark Ready for their comments. Mr. Hellmer said the draft policy takes advantage of the new investment opportunities allowed by the legislation while establishing a fund with limited earnings volatility from year-to-year. In regards to State Trust Fund Loans, the relationship between the earnings and risk in this investment is very favorable and having a portion of the portfolio's assets in this investment is desirable. While deposits to the Common School Fund from fees, fines and forfeitures, and unclaimed property have not kept pace with inflation, investing in instruments that result in capital gains would help to increase the principal of the Trust Funds.

The Commissioners discussed how best to diversify the fund investments and whether that would be managed by staff or an outside entity. Mr. Sneider said that cost is an important factor when retaining an investment firm to manage the Board's assets but a passively-managed index fund could be a cost effective alternative.

Board Chair Schimel noted that staff had record investment earnings over the last couple years in spite of the low interest rate environment. He asked what type of activity, other than low interest rates, would trigger the use of the smoothing account. Mr. Sneider replied that investing a significant portion of Trust Funds in non-incoming producing assets. Deputy Secretary German noted that 10-year Treasury bond interest rates are at an all-time low and the expanded investment authority provides additional options for investing in instruments that earn higher rates of return.

Commissioner Adamczyk said statutes allow for the sale of State Trust Fund Loans and asked about the logistics involved should the Board choose to sell them. Mr. Sneider said the loans could be packaged into a security and sold to an investor.

Commissioner Adamczyk said he had talked to officials in the Governor's office and Legislature about the possibility of BCPL investing in real estate; specifically, constructing or purchasing buildings that would house state agencies and then leasing the building to state agencies. Board Chair Schimel noted that any lease revenues would be offset by building maintenance costs. Asked if legislation had been drafted, Commissioner Adamczyk said no but he had discussions with a Legislator who would be willing to assist with that. The Commissioners and staff discussed the pros and cons of such a venture.

ITEM 5. FUTURE AGENDA ITEMS

None.

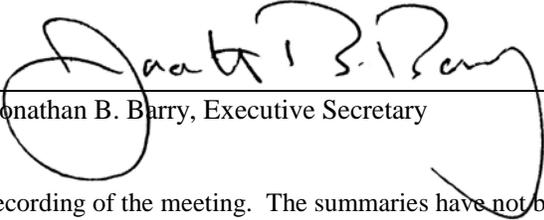
ITEM 6. EXECUTIVE SECRETARY'S REPORT

Nothing to report.

ITEM 7. ADJOURN

MOTION: Commissioner Adamczyk moved to adjourn the meeting; Commissioner La Follette seconded the motion.

The meeting adjourned at approximately 3:35 p.m.



Jonathan B. Barry, Executive Secretary

These minutes have been prepared from a recording of the meeting. The summaries have not been transcribed verbatim.
Link to audio recording: ftp://doafpt1380.wi.gov/doadocs/BCPL/2016-07-05_BCPL-BoardMtgRecording.mp3

**BOARD MEETING
JULY 25, 2016**

**AGENDA ITEM 3
APPROVE LOANS**

Municipality	Municipal Type	Loan Type	Loan Amount
1. Brandon Fond Du Lac County Application #: 02017008 Purpose: Purchase sewer jetter	Village Rate: 3.00% Term: 10 years	General Obligation	\$50,000.00
2. Grant Clark County Application #: 02016218 Purpose: Purchase road grader	Town Rate: 3.00% Term: 10 years	General Obligation	\$218,200.00
3. Liberty Manitowoc County Application #: 02017001 Purpose: Finance road construction and repair	Town Rate: 2.50% Term: 3 years	General Obligation	\$234,000.00
4. Marion Shawano and Waupaca Counties Application #: 02017009 Purpose: Purchase property and reconstruct alley/parking lot	City Rate: 3.00% Term: 10 years	General Obligation	\$250,000.00
5. Menasha Calumet, Outagamie and Winnebago Counties Application #: 02017003 Purpose: Finance property acquisition and facility improvements	School Rate: 3.00% Term: 10 years	General Obligation	\$3,000,000.00
6. Mishicot Manitowoc County Application #: 02017007 Purpose: Finance road maintenance	Village Rate: 2.50% Term: 5 years	General Obligation	\$25,500.00
7. Richfield Washington County Application #: 02017002 Purpose: Construct municipal building	Village Rate: 3.50% Term: 20 years	General Obligation	\$1,000,000.00
8. Shiocton Outagamie County Application #: 02017005 Purpose: Finance fire hall updates	Village Rate: 3.00% Term: 7 years	General Obligation	\$45,000.00

<u>Municipality</u>	<u>Municipal Type</u>	<u>Loan Type</u>	<u>Loan Amount</u>
9. Summit Waukesha County Application #: 02017004 Purpose: Finance 2016 capital improvements	Village Rate: 2.50% Term: 5 years	General Obligation	\$325,000.00
10. Whiting Portage County Application #: 02017006 Purpose: Finance street improvements	Village Rate: 2.50% Term: 2 years	General Obligation	\$70,000.00
TOTAL			\$5,217,700.00

**BOARD MEETING
JULY 25, 2016****AGENDA ITEM 5
EXECUTIVE SECRETARY'S REPORT****BCPL Trust Fund Investment Management
Investment Report - Second Quarter 2016****Executive Summary**

BCPL investment performance continues to exceed benchmark returns. After adjusting returns for differences in both credit quality and average maturity, BCPL-managed portfolios had a **yield 1.22% more than our benchmark**. This difference in yield means that beneficiaries earned \$3.27 million more than would have been generated by an investment in the benchmark portfolio during the second quarter. This investment performance equates to an annualized **\$13.1 million in interest earnings above benchmark returns** that is attributable to the BCPL asset management team.

Not included in the above income calculations is a 19.6% increase in total unrealized gains within the bond portfolio during the second quarter. Total unrealized gains now total over \$23 million, an increase of 4.6% above the initial cost of these investments.

Q2 Investment Highlights and Outlook

Interest rates continued to plummet during the second quarter, with the yield on the benchmark 10 year Treasury declining from 1.77% to 1.47%. Immediately following the end of the quarter, rates plunged to a record low of 1.323% (nearly 1% lower than seen at the end of 2015), and have since recovered to around 1.58%.

Treasury securities continue to provide a safe haven for institutional investors worldwide, while growing concerns about a slowdown in global economic activity continues to provide downward pressure on market interest rates. Brexit and further acts of terrorism have contributed to interest rate volatility.

Loan demand remains strong and relative yields on the loan portfolio continue to impress. The average interest rate on loans is 3.85% with an average maturity of slightly less than 6.5 years. A comparable Treasury security yielded only 1.17% at the end of the second quarter.

With interest rates remaining near historic lows (causing bond prices to be relatively high), staff finds it difficult to uncover good values in the current municipal and farm credit bond markets. Approval of a new investment policy may provide additional opportunities for investment of cash reserves and increasing expected investment returns.

Summary and Benchmark Comparison

The overall expected yield of funds managed by BCPL was 3.39% at the end of second quarter, a slight increase against the backdrop of plummeting worldwide interest rates. This result was primarily due to our investment in Wisconsin Center District bonds and an increase in the total BCPL State Trust Fund Loan portfolio, which have excellent yields relative to cash held within the State Investment Fund.

The best measure for comparing investment performance against our benchmark is the SEC yield, which provides a standard methodology that is available for the mutual funds and bond market indexes that comprise our benchmark. Adjustments to account for our better average credit rating and longer maturity increase the BCPL yield to 1.22 % greater than benchmark returns.

BCPL Investment Summary

2nd Quarter 2016

as of June 30, 2016

Portfolio Summary		Total Assets	Expected Yield ¹	SEC Yield ²	Average Credit Quality ³	Weighted Avg Maturity
Total BCPL Managed Financial Assets		\$ 1,073,672,102	3.39%	3.22%	Aa1	9.41
Benchmark Performance ⁴				2.52%	A1	8.79
BCPL Investments						
		% of Total BCPL Managed Assets				
Bonds		45.61%				
BCPL State Trust Fund Loans		36.97%	3.86%	3.51%	Aa2	14.44
Cash and Cash Equivalents ⁵		17.41%	3.85%	3.85%	Aa1	6.44
			0.46%	0.46%	Aaa	0.29
Total BCPL Managed Investments		100.00%	3.39%	3.22%	Aa1	9.41
Benchmark Components						
		Weighting				
S&P Long Intermediate Term Taxable Municipal Bond Index ⁶		60.00%	2.83%	3.37%	Aa2	9.96
S&P U.S. Treasury Bill Index ⁷		10.00%	0.23%	0.21%	Aaa	0.23
Wisconsin Tax-Exempt Bond Mutual Funds (combined) ⁸		30.00%	N/A	1.58%	Baa2	9.30
Total Benchmark		100.00%		2.52%	A1	8.79
Important Notes on Following Page						
Prepared by Richard Sneider						

Notes to BCPL Benchmark Comparison:

- 1 **Expected Yield** is the weighted average yield to the redemption date for each bond, and assumes that issuers will redeem bonds at the earliest possible date, when it is in their best interest given current market interest rates. Also called 'yield-to-worst', this number is equal to the lower of the 'yield to call' and 'yield to maturity' for each investment in the portfolio.
- 2 **SEC Yield** - The SEC yield should not be confused with the expected yield on invested funds. The SEC yield will vary substantially with market conditions because it is calculated using the current market value of assets, and the value of fixed income assets fluctuates with market interest rates. For example, although interest payments produced by an individual bond remain constant following the issuance of the bond, the SEC yield on this bond will increase with market interest rates solely because the value of the bond decreases (yield = income/value). If all bonds are held to maturity, the actual return to the investor would equal the "yield to maturity at cost". This calculation is not provided for benchmark components and is therefore not included in this comparison. Many investors prefer to use "yield to worst", which calculates the return using the lower of the "yield to call" and "yield to maturity". The most appropriate method to compare bond portfolios is to look at **Total Return**, which combines both income and changes in the market value of the underlying assets (see note 8 below). BCPL does not have the ability to use Total Return as a method of comparison because the Trust Fund Loan Portfolio has never been valued. Rather, the SEC Yield is used for comparison because it is a standardized methodology for calculating yield as required by the Securities and Exchange Commission for all mutual funds and provides a means to compare BCPL managed funds to a simple benchmark. The SEC yield is a close approximation to the net yield to maturity of the fund using the current market value of the fund, and is calculated as the yield to the investor (after fund expenses and fees) during the previous 30 days assuming all bonds are held to maturity. The SEC Yield for the State Investment Fund is for the most recent month available.
- 3 **Average Credit Quality** - Except for the BCPL loan portfolio, all average credit quality ratings shown equal the weighted average credit rating of individual securities held within each portfolio. A rating for the loan portfolio is provided to improve the ability to compare BCPL managed funds to other funds. The Aa1 rating presumed for the loan portfolio is considered reasonable, as there has not been a single default in the State Trust Fund loan program since inception in 1871, and BCPL has the statutory right and requirement to cure any future default by intercepting state aid otherwise due the borrower. Mutual Fund credit quality is provided by Morningstar. The global long-term rating scale of Moody's Investor Services begins at 'Aaa' for obligations judged to be of the highest quality, subject to the lowest level of risk. The ranking in order from highest to lowest quality then includes: Aa, A, Baa, Ba, B, Caa, Ca, and C. Ratings from Aa to Caa are modified with 1,2, or 3 to provide a high, middle and low ranking within each alphabetic category. 'Investment-grade' securities have ratings of Baa3 or higher.
- 4 **Benchmark Components and Weighting** - Due to the unique set of BCPL authorized investments consisting primarily of the BCPL State Trust Fund Loan Program, and bonds issued by the State of Wisconsin and Wisconsin municipalities and school districts, there are no managed funds that perfectly match the characteristics of the BCPL portfolio. However, the chosen benchmark components provide the best opportunity to compare BCPL investments to funds managed by other professionals. The justifications of including individual benchmark components are provided below. Component weighting begins with an estimate of average liquidity levels required throughout the year, with additional factors including an estimate of the proportion between taxable and tax-exempt project funding, and the use of current taxable and tax-exempt bond yields in developing program interest rates.
- 5 **Cash** - Cash and cash equivalents includes all investments in the State Investment Fund and Farm Credit adjustable rate notes, and all funds managed by ADM in FDIC-insured deposit accounts.
- 6 **S&P Long Intermediate Term Taxable Municipal Bond Index** - This taxable municipal bond index is included as a benchmark component because it properly reflects the investment strategies of BCPL managed Trust Funds, including both the direct investment in taxable municipal bonds and the influence of taxable bond yields on the development of loan program interest rates. The S&P Long Intermediate Term Taxable Municipal Bond Index matches the weighted average maturity and duration of total BCPL managed funds fairly well, although BCPL maintains better average credit quality. This index is comprised of all taxable bonds issued by any state (including the Commonwealth of Puerto Rico and U.S. territories such as the U.S. Virgin Islands and Guam) with an investment grade rating (minimum S&P BBB- or Moody's Baa3), a minimum par amount of \$1 million, and remaining maturity between 5 and 15 years. Average credit quality level is not published by S&P, but was calculated at the weighted average rating of amounts held within the separate S&P AAA, AA, A, and BBB Rated Taxable Municipal Bond Indices using a formula developed by Schwab Portfolio Center, the portfolio analysis software used by BCPL. Overall, a weighting of 60% is appropriate given the average levels of cash and tax-exempt investments held by the Trust Funds throughout the year.
- 7 **S&P U.S. Treasury Bill Index** - The U.S. Treasury Bill Index represents the average cash position held by the Trust Funds throughout the year, and is included because BCPL maintains significant levels of liquidity needed to fund expected trust fund loan demand over the next 3-6 months. The amount of portfolio liquidity (cash) varies significantly throughout the year, and is impacted by factors including the interest rate environment, the absence of prepayment penalties within the loan program, and the statutory payment structure requiring annual loan payments on March 15 each year. The S&P U.S Treasury Bill index is a market weighted index that includes all U.S. Treasury Bills with maturities ranging from 0-12 months. Because an index is not a managed portfolio, but only a collection of securities within a specific set of criteria, management expenses are not included. Overall, a weighting of 10% for this benchmark component is appropriate given the average levels of cash held by the Trust Funds throughout the year.
- 8 **Wisconsin Tax-Exempt Bond Funds** - Tax-exempt bond funds are included as a benchmark component for three reasons: BCPL invests directly in tax-exempt bonds when available at acceptable terms; a significant portion of loans made through the BCPL State Trust Fund Loan Program fund projects that would qualify as tax-exempt; and current tax-exempt bond yields are an important factor in the construction of loan program interest rates. There are three bond mutual funds that invest primarily in Wisconsin State and Municipal Bonds, investments that are similar to the securities approved for BCPL investment. These funds are sponsored by Wells Fargo, Nuveen and Nationwide Ziegler, and there are significant differences between the management of these mutual funds and BCPL trust funds. All three mutual funds are limited to tax-exempt investments, a universe of securities that generally provide lower yields than the taxable instruments favored by BCPL. On the other hand, all three of these funds invest substantial amounts in bonds that have considerable default risk including bonds issued by the Commonwealth of Puerto Rico, community development revenue bonds, hospital revenue bonds, and other bonds types not available within the risk parameters of the BCPL investment authority. Overall, a weighting of 30% for this benchmark component is appropriate given the level of Trust Fund investment in tax-exempt instruments and the influence of tax-exempt bond rates on the interest rates charged within the loan program.
- 9 **Total Return Analysis** - A total return analysis including the periodic change in asset values in addition to earnings would provide a more comprehensive and accurate comparison between the returns generated by BCPL managed funds and our benchmark. However, total return analysis requires accurate asset valuation in order to provide a reasonable basis for measuring management performance. A significant portion of BCPL managed assets are invested in loans to municipalities and school districts through the BCPL State Trust Fund Loan Program. BCPL has never sold a trust fund loan and has always held these investments to maturity. There is currently no formula or model available to determine an accurate market value of the loan portfolio. Should BCPL sell loans in the future and establish a secondary market in BCPL State Trust Fund Loans, total return analysis may provide an improvement over the current method of yield comparison as the model for measuring BCPL investment performance against the appropriate benchmarks.