



OFFICE OF THE ARIZONA STATE TREASURER

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Investment Summary | April 2018

Outlook |

Economic data continues to show a growing economy with spending on business equipment up 5.5% and intellectual property investment up 11% in the first quarter. Gross Domestic Product for the 2nd quarter is expected to come in at 3% on top of the 2.2% in the 1st.

We expect another quarter point rate hike on June 12 and we have more than \$1.5 billion flowing out of our pools in early July to pay the K-12 rollover, bond payments for some agencies and local governments. The state is also prepaying some public safety pension obligations in July which will affect cash balances.

Strategy: Keep Duration Short |

Due to the combination of large outlays of funds in early July and the expected Federal Reserve continuing to raise rates it has been beneficial to keep duration short. We anticipate rates to rise in June, September and possibly December. And, we expect rates will increase further so we will increase duration after the July payments by 20% and after the expected September rate hike, increase duration another 40%.

Alternative Scenario: Geopolitical Uncertainty |

If the Federal Reserve changes current plans to normalize rates we will adapt accordingly. Geopolitical concerns would also cause to change course with potential European financial crisis re-emerging in Italy, Spain and Portugal. Election in Turkey and Mexico are also being watched and any unrest would cause a flight to US assets, pushing down rates. Other emerging markets to watch are Argentina, Malaysia as well as China and the Korean peninsula.

State Agency Investment Pools Balances |

	April 30, 2018	July 31, 2017	FY Change
Pool 2 FF&C	\$1,069,481,42	\$893,982,531	+175,498,894
Pool 3 Internal	2,279,742,236	1,410,749,796	+868,992,440
Pool 3 External	105,099,596	104,450,097	+649,499
Pool 4 Gov.	1,041,001,267	961,249,082	+79,752,185
Pool 10 Internal	997,509,456	956,963,338	+40,546,118
Pool 10 External	167,161,468	255,729,368	-88,567,900
Pool 12 CAWCD	376,209,030	367,096,808	+9,112,222
Pool 16 ECDHB	348,189,653	354,034,704	-5,845,051
TOTAL STATE AGENCY	\$6,384,394,133	\$5,304,255,729	+1,080,138,404

Local Government Investment Pools (LGIP) Summary

Strategy: Highly Liquid for Participant Withdraws |

The LGIP will continue its short duration strategy and take advantage of interest rate hikes throughout the pools. We anticipate the short-term rates rising in 2018. Overall participant activity has seen growth of over \$600 million in assets under management since the beginning of the fiscal year. Liquidity for our participants will be our focus through the fiscal year end.

LGIP Investment Pools Balances |

	April 2018	July 2017	FY Change
Pool 5 LGIP	\$1,709,329,296	\$1,127,769,761	+581,559,535
Pool 7 LGIP FF&C	1,348,656,018	1,310,707,855	+37,948,163
Pool 500 LGIP Med.	356,294,360	319,952,281	+36,342,079
Pool 700 LGIP Med FF&C	146,910,169	145,957,694	+952,475
TOTAL LGIP	\$3,561,189,843	\$2,904,387,591	+656,802,252

Endowment Summary

Strategy: Maintain Overweight in Small Cap |

Our strategy of being overweight in SmallCap stocks continues to add to our performance. As SmallCap stocks have historically outperformed over long periods of time, our position has taken advantage of this return. Our 10% target is approximately three times more than the SmallCap exposure of the S&P 1500 total market cap. As this fund is invested in perpetuity, our goal is take advantage of this historic outperformance over time. Since inception, our SmallCap exposure has returned 13%, outperforming the MidCap exposure at 9.58%, our LargeCap exposure at 5.05% and our fixed income return of 4.58%.

We will continue to invest in the individual components of the various indices per our investment policy.

Strategy: Keep Duration Short and Add Convexity |

Fixed Income Strategy – Strategy has been to be very defensively positioned on a duration basis such that Pool 205 performs well in a rising rate environment. Presently the portfolio is positioned to perform best in a “bear-steepener” scenario and a “bear-flattener” scenario.

As the portfolio has benefitted tremendously versus the benchmark FYTD, we will look to lock in relative performance and add more convexity and duration as global economic factors may be changing with European and emerging market weakness. The price of a positively convex security will rise more for a downward move in interest rates than its price declines for an equal upward move in rates.

To do this, we plan to incrementally add longer fixed rate bond positions to hedge against an economic downturn, or any possible credit-driven market dislocations, by adding UST duration at the margin and possibly swapping out of some corporate exposure. Due to larger Prop 123 monthly distributions, pool duration will extend naturally if our equity portfolios do not realize large appreciation and subsequent cash rebalancing back into our fixed income portfolios. Bearing this in mind, and combined with rising interest rates, we have kept our duration shorter than the benchmark by 2.26 years at 3.80 years (-0.01 MOM) versus 6.06 (unch. MOM) for the SBBIG Index – the difference will begin to shrink in coming months.

- Pool 123 mechanism working well (2-3 months laddered liquidity)

Endowment Monthly Land Sale Proceeds |

- \$22.7+ MM in April.
- \$14.4 MM vs May.
- + \$85.9 MM FYTD.

Endowment Performance Report |

➤ Total Endowment:

- Total Market Value \$5.78B; Down \$2.7 MM MOM; Up \$209 MM YOY.
- Unrealized Gains \$2.93B; \$305 MM YOY.
- MOM outperformed aggregate benchmark by +10bps.
- YTD outperformed aggregate benchmark by +34bps.
- FYTD 6.21% versus benchmark at 6.00%; +21bps.
- Portfolio standard deviation 6.29 versus benchmark at 6.41.; Portfolio is less risky/volatile versus benchmark.

➤ Equity Pools:

- Pool 201 LargeCap Equity virtual match of the index -1bp MOM.
- Pool 203 MidCap Equity outperformed S&P 400 by +4bps MOM.
- Pool 204 SmallCap Equity lagged the S&P 600 by -11bps MOM.
- Pool weightings are within policy tolerance.

➤ Fixed Income Pools:

- Pool 205 -0.44% versus SBBIG Index at -0.73% MOM.
- Pool 205 outperformed SBBIG Index by +29bps MOM; +99bps YTD.
- Pool 123 outperformed benchmark by +2bps MOM; +5bps FYTD.