



MICHAEL J. MURPHY
State Treasurer

State of Washington
Office of the Treasurer

October 29, 2002

The Honorable Gary Locke, Governor
The Honorable Brian Sonntag, State Auditor
Members of the State Finance Committee
Members of the Joint Legislative Audit and Review Committee
Participants in the Local Government Investment Pool
State of Washington

I am pleased to submit the COMPREHENSIVE ANNUAL FINANCIAL REPORT of the Local Government Investment Pool (LGIP or pool) for the fiscal year ended June 30, 2002. This report has been prepared by the Office of the State Treasurer (OST) as required by Title 43.250.080, Revised Code of Washington (RCW). Responsibility for both the accuracy of the financial data and the completeness and fairness of the presentation, including all disclosures, rests with the Office of the State Treasurer. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the LGIP. All disclosures necessary to enable the reader to gain an understanding of the pool's financial activities have been included.

The report is presented in four sections: Introductory, Financial, Investment, and Statistical. The Introductory Section, which is unaudited, includes this transmittal letter, an OST organizational chart and committee and staff listings. The Financial Section, which is audited, begins with the independent auditors' report and contains management's discussion and analysis, the financial statements of the pool, schedule of investments and certificates of deposit, notes to the financial statements, and a supplementary schedule. The Investment Section, which is unaudited, includes the portfolio charts, position and compliance report, schedule of pool participants, investment policy, LGIP authorized personnel, authorizing statutes, and administrative rules. The Statistical Section, also unaudited, includes selected financial data.

The LGIP is a mechanism whereby political subdivisions, community and technical colleges, the State Board for Community and Technical Colleges, and the State Finance Committee may, at their option, invest temporary cash surpluses and take advantage of the volume and expertise of the state's investment program to earn a competitive rate of return while maintaining the security and liquidity of the funds they manage. The objectives of the State Treasurer's investment program for the pool, in priority order, are safety, liquidity, and return on investment. The pool is operated as a business enterprise within the framework of state laws and regulations using proprietary accounting and following accounting principles generally accepted in the United States of America appropriate for investment companies. This report includes only activity of the pool and does not include data or information related to other state agencies or funds.

Pool Structure

The pool was created by the Washington State Legislature in 1986 and is overseen by the Office of the State Treasurer. Additionally, the State Finance Committee is the administrator of the statute that created the pool and they adopt appropriate rules. The State Treasurer created the Local Government Investment Pool Advisory Committee to provide advice on the operation of the pool. The committee is comprised of 12 members selected from active pool participants (refer to page 11 for the list of advisory committee members). Eight members are appointed by participant associations, and four members are appointed by the State Treasurer.

Economic Conditions and Outlook

Fiscal Year 2002 was characterized as a period of profound economic uncertainty. The year was seen to be the start of a slow recovery from the recession that began in late 1999. The rate cuts that the Federal Reserve (Fed) instituted through its Open Market Committee (FOMC) were the beacon of hope the market was hanging on to resuscitate the ailing economy. Economists remained optimistic that 2002 would be described as a shallow recession.

However, the September 11, 2001 terrorist attacks further damaged the already fragile economy, dashing all hopes for quick recovery. Negative sentiment snowballed into pessimism as the economic deterioration became more pronounced, and companies began estimating losses brought about by the attacks. At the FOMC meeting held right after September 11 the Fed stated succinctly that, “the (attacks) might well have induced a mild downturn in economic activity...reports suggested that heightened uncertainty and sharply reduced confidence had curtailed consumer spending and had intensified the downward trajectory in business capital expenditures.” The Committee nonetheless expressed their optimism that recovery would gather momentum in early 2002 as lower interest rates and a stimulative fiscal policy would induce economic growth.

The economy gained composure during the first two months of 2002 as manufacturing output rose to healthy levels. Consumer spending also snapped back as lower interest rates spurred both the housing and automobile markets. The perceived economic recovery was further strengthened by data on Gross Domestic Product (GDP) output of 6.1% boosted by business spending on equipment and software. This was more significant as this part of the economy had not seen improvement since the start of 2000. When the FOMC bias was changed to neutral, and the threat of rising interest rates became more evident, investors became motivated to sell bonds and turn to the stock market.

But the euphoria did not last long. Corporate scandals from the Enron debacle to the WorldCom fiasco shook investors’ trust in CEOs. The stock market lost ground and the ensuing economic numbers were mixed. FOMC members noted that the perceived economic recovery came from temporary inventory adjustment and not from final demand. Investors, already suffering from losses, decided that the treasury market was again their best shield against uncertainty.

The last two FOMC meetings of Fiscal Year 2002 brought further easing of interest rates as a viable option. The Committee kept their collective view that “the risks continued to be weighted toward further weakness in the future.” The Federal Funds rate remained at a 40-year low of 1.75%. The yield on treasury securities fell further as deteriorating economic outlook and negative returns in the stock market pushed investors toward capital preservation and risk aversion.

Throughout the first half of 2002 the bond market employed yield steepener plays due to uncertainty. The inconclusive economic numbers could not give investors a clear verdict as to whether the economy was about to recover or might experience further weakening. The yield curve became steeper as new accounting scandals and geopolitical tensions gave investors more reason to invest in treasury bonds.

The yield curve remained positively sloped for Fiscal Year 2002. It was shaped by expectations that, although interest rates still had room to fall, they might not continue to decline in the intermediate term, since the Fed Funds rate had already reached an all-time low. After a 300 basis points (bp) drop in Fiscal Year 2001, the Fed Funds rate was down another 200 bp, to 1.75% for Fiscal Year 2002. The two-year notes rallied 139 bp (from 4.21% in FY01 to 2.82% in FY02), five-year notes 86 bp (from 4.89 to 4.03), while the 30-year bond yields dropped by only 26 bp (from 5.76% to 5.50%).

Investors were betting that being on the short-end of the curve would best capture gains remaining in the bond market. In May, the FOMC was still uncertain about the prospects of economic recovery but hopeful that demand would strengthen by the end of 2002. The Fed members generally viewed the weakness as a brief pause to a cyclical recovery rather than further weakening. This assumption was made despite lackluster overall economic performance, and was based on the structural productivity growth the economy as a whole was still experiencing.

Major declines in the equity markets contributed to robust gains in the bond market. The negative effects of major corporate scandals, accounting fiascoes, and investors' lack of trust in major companies' financial health battered stocks creating unprecedented losses in general investors' portfolios--- IRAs and 401(k)s. The Dow Jones Industrial Average, NASDAQ, and S&P 500 suffered double-digit declines of -12%, -32% and -19%, respectively. The result was a selling binge, as investors transferred money into real estate, money market funds, bonds, and direct consumption. Retail sales, boosted by auto sales, were artificially inflated by the 0% financing offered by the Big 3 car manufacturers. The drop in trading volume helped explain investors' general loss of interest in the stock market.

The net return on the LGIP during Fiscal Year 2002 ranged from 4.03 to 1.84 percent, reflective of a targeted Fed Funds Rate that dropped from 3.75 to 1.75 percent during the fiscal year. During the first half of the fiscal year the general strategy was to maintain a fairly long average life in an attempt to lag the drop in the targeted Fed Funds rate as long as possible. However, during the second half of the fiscal year, when the market started to anticipate, and price in, a tightening, the average life was shortened. When it became evident the economy was not turning around as quickly as the market had anticipated and a tightening would not happen any time soon, the average life was lengthened.

Investment Risk Profile

The Local Government Investment Pool is considered extremely low risk. The pool is operated in a manner consistent with the Securities and Exchange Commission's Rule 2a-7 of the Investment Company Act of 1940. Rule 2a-7 funds are limited to high quality obligations with limited maximum and average maturities, the effect of which is to minimize both market and credit risk. The pool's portfolio is comprised of high-quality, highly liquid securities, and its relatively short average maturity reduces the pool's price sensitivity to market interest rate fluctuations. The pool also has a strong degree of asset diversification in order to minimize risk and maintain adequate rates of return.

The pool is managed diligently by professional and dedicated personnel to protect against losses from market and credit changes. However, the pool is not insured or guaranteed by any government. Therefore, the maintenance of principal is not fully assured.

Cash Management

The Office of the State Treasurer operates the Local Government Investment Pool for investing cash in excess of daily requirements. Among the investments authorized by statute are: U.S. Treasury and Agency securities, banker’s acceptances, repurchase agreements, reverse repurchase agreements, commercial paper, and certificates of deposit with qualified public depositories.

Risk Management

The state of Washington operates a risk management liability program pursuant to Title 4.92.130, Revised Code of Washington. The state manages its tort claims as an insurance business activity rather than a general governmental activity. The state management believes it is more economical to manage its risks internally and set aside assets for claims settlement in an Internal Service Fund. The Office of the State Treasurer is assessed an annual premium to fund payment of future tort claims.

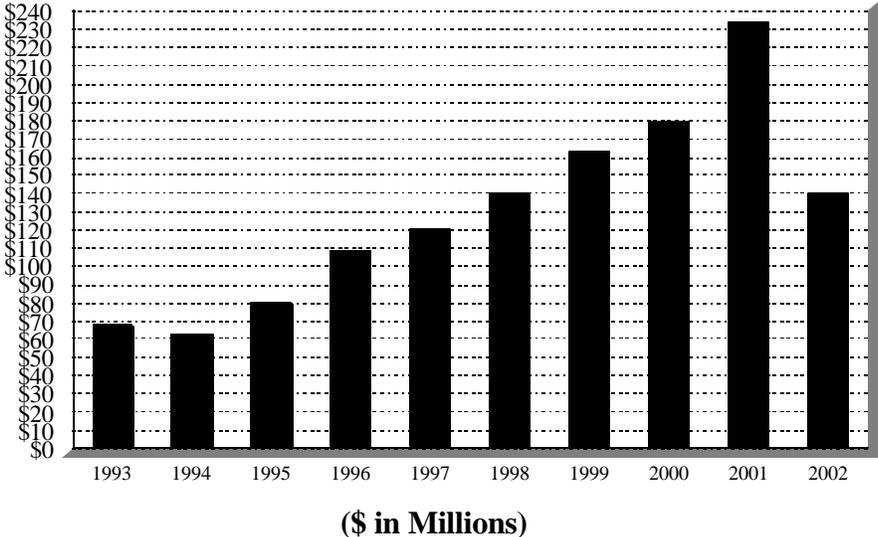
Financial Information

Enterprise Operations

The Local Government Investment Pool is operated as a business enterprise, and its purpose is to provide an investment tool for local governments. No general government functions are managed within the pool or included in this report.

Net investment income for Fiscal Year 2002 totaled \$139.0 million, a decrease of \$94.2 million from the previous fiscal year. Net investment income for the past ten years was as follows:

Net Income



Internal Controls

The state is responsible for establishing and maintaining internal controls designed to ensure that the assets of the state are protected from loss, theft, or misuse, and to ensure that adequate accounting data is compiled to allow for the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America. Internal accounting controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that the cost of controls should not exceed the benefits likely to be derived, and the evaluation of costs and benefits requires estimates and judgments by management. Washington State continues to assess the adequacy of its internal controls and make improvements when weaknesses are found.

The State Treasurer maintains internal controls to protect against the loss of Local Government Investment Pool funds. Staff responsible for oversight of the pool receives daily reports monitoring investment operations to ensure compliance with the terms of the investment policy. In addition, a risk assessment and internal control evaluation is performed annually.

The Office of the State Treasurer currently has 72 employees, of which five work in the Investment Division and ten work in the Accounting and Fiscal Services Division.

External Controls

Washington statutes and the federal Single Audit Act of 1984 require an annual single audit of the state, including its Comprehensive Annual Financial Report, by the Washington State Auditor, an independently elected public official. In addition, the pool contracts for an outside independent audit of the pool's financial statements. The Washington State Auditors' reports on internal controls and compliance with applicable laws and regulations can be found in a separately issued single audit report. The independent auditors' report on the pool's financial statements is included in the financial section of this report.

Other Information

Internet

This report is located on the Internet at <http://www.wa.gov/tre/afr.htm>. The Office of the State Treasurer website, located at <http://www.wa.gov/tre/>, maintains additional information on the LGIP for participants and interested parties, along with other Office of the State Treasurer information.

Awards

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the state of Washington's Local Government Investment Pool for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2001. This was the fifth consecutive year that the governmental unit has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report. This report must satisfy both accounting principles generally accepted in the United States of America and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current Comprehensive Annual Financial Report continues to meet the Certificate of Achievement Program's requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

Acknowledgments

Preparation of this report was accomplished due to the efficient and dedicated services of the Office of the State Treasurer's Accounting and Fiscal Services Division and its Investment Division. A special thank you to Doug Extine, Jill Gravatt, Lisa Hennessy, Ferdinand Pascual and Jen Thun for their administration of the pool, to Wendy Weeks, Cindy Shave and Alberta Quinlan for their accounting of the pool, to Toni Doyle for editing and coordinating this data for publication, and to Darrel Jensen for his continued leadership.

The Comprehensive Annual Financial Report reflects our commitment to the pool participants and to the citizens of the state of Washington to maintain our financial statements and accounting systems in conformance with the highest standards of accountability. Due credit is given to State Treasurer Michael J. Murphy and Assistant State Treasurer Michael Colleran for their commitment to operating the Office of the State Treasurer and the Local Government Investment Pool in a responsible and progressive manner.

Respectfully submitted,

A handwritten signature in cursive script that reads "Elaine Emans".

ELAINE EMANS
DEPUTY STATE TREASURER
STATE OF WASHINGTON