



MICHAEL J. MURPHY
State Treasurer

State of Washington
Office of the Treasurer

October 24, 2003

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) for the fiscal year ended June 30, 2003. 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 auditor's report and contains management's discussion and analysis, the financial statements of the pool, notes to the financial statements, schedule of investments and certificates of deposit, 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, public colleges and universities, 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 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. The State Finance Committee is the administrator of the statute that created the pool and adopts appropriate rules. The State Treasurer created the Local Government

Investment Pool Advisory Committee to offer counsel on the operation of the pool. The committee includes 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 are appointed by the State Treasurer.

Economic Conditions and Outlook

Fiscal Year 2003 offered investors little respite from the nagging uncertainties that plagued 2002. The economy gained little traction despite fiscal stimuli injected into the system by the government. The economy improved mainly due to consumer spending brought by lower interest rates, which spurred home equity loan extraction and mortgage refinancing. Retail sales, housing activity and government outlays were notable factors that contributed to increased economic activity. However, growth indicators were, at best, lopsided; job creation was almost non-existent. Economists cautioned that the growth in consumer spending could be a temporary effect of tax cuts by the federal government this year. Near-term effects could be very positive, but there is no assurance of sustained recovery.

Most major economic indicators related to consumption enjoyed a significant year-over-year improvement. Defense-related spending also contributed to a Gross Domestic Product (GDP) uptrend. The Federal Open Market Committee (Fed) mentioned favorable factors with potential to propel growth for the second half of 2003, which included “growing consumer confidence, persistence of rapid growth in labor productivity, effects of rising stock market wealth on consumer balance sheets, continued opportunities to extract equity from their homes, and reducing interest service burdens by refinancing mortgages”. These factors led the Federal Reserve to raise their estimate of GDP growth to 2.50-2.75 percent for 2003, and 3.75-4.7 percent for 2004.

Unemployment, the scourge of this recovery, grew to 6.4 percent in FY 2003 from 5.8 percent in FY 2002. The number of short-term job losers and longer-term unemployed was the highest since the 1994 recession. The U.S. has lost more than a million jobs since the recession was declared over in November 2001. The onset of the Iraqi War and its conclusion dampened most firms’ appetite for committing capital in an unstable environment.

At its meeting in June 2003, the Fed cut the targeted federal funds rate from 1.25 percent to 1 percent as insurance against what was described as the “remote possibility” of disinflation or deflation risk. This discussion came about after core consumer price inflation eased noticeably based on a 12-month change. Labor costs were flat and the Fed commented that “... currently elevated levels of unused labor and other resources were likely to persist for an extended period, even if economic growth turned out to be robust.” The output gap, even with acceleration of inflation, could only cause inflation to decline to a lower level as a result of a stagnant job market. This worry prompted the Fed to announce explicitly their accommodative stance toward interest rates for a “considerable” period.

When the Fed released a “no bias” outlook during its March 18 meeting and a “balanced outlook” during the May and June meetings, many economists became agnostics. Skeptics of the current “jobless economic recovery” have questioned the sustainability of strong economic indicators that have generated such optimism, especially in the stock market. Investors have debated whether a jobless recovery might be a boon or a bane in the long-run. It could spur capital investments if consumers continue their pace of spending. Alternatively, it could delay recovery if consumers, without any good prospects of employment, choose to delay purchases for fear of further job losses.

Several issues have potential for a long-term negative impact on the economy, including the country's huge current account deficit (currently estimated at 5 percent of total economy), the fiscal condition of state and local governments, bloated household debt levels, and the inability of businesses to commit new capital. These factors may prevent the economy from improving and negate the stimulative effects of the government's tax cuts. Current account deficits could increase government debt, subsequently increasing bond yields. State and local governments' fiscal positions may force them to push up tax rates to fill gaps in budget deficits. Finally, economists have said consumers' elevated debt levels may compel them to slow down their pace of spending. This kind of uncertainty has already given rise to a stall in capital spending, resulting in reliance on workers' productivity to fill in market demands. Having enumerated the pros and cons of the current economic climate, it is fairly simple to understand why the Fed chose to release balanced risk and growth assessments at its June 25 meeting.

The bond market performed well throughout FY 2003, with the yield curve shifting significantly down across all maturities. The yield on two-year notes dropped by 153 basis points (bp) (from 2.82 percent to 1.29 percent) while the yield on five-year notes went down by 162 bp (from 4.03 percent to 2.41 percent). Meanwhile, 30-year bond yields dropped by 94 bp (from 5.5 percent to 4.56 percent). The impressive performance was supported by the belief that the Fed will continue to lower rates in order to stave off disinflation, and the notion that it will stay accommodative in order to support the fragile economic recovery. The rally reflected investors' sentiment that economic recovery will be a slow process, especially with a difficult job market. Recovery rests on the economy's ability to create jobs and stimulate capital investments.

The equity markets showed impressive gains after experiencing three double-digit declines in the past three years. During FY 2003, the Dow lost 0.49 percent while the NASDAQ and S&P 500 gained 11 percent and 0.25 percent, respectively. However, the DJIA, NASDAQ, and S&P 500 registered calendar year-to-date gains of 9 percent, 22 percent and 12 percent, respectively. Clearly, investors priced in economic recovery only during the second half of FY 2003.

The net return on the LGIP during Fiscal Year 2003 ranged from 1.79 to 1.19 percent, reflecting the drop in the targeted Federal funds rate from 1.75 to 1.00 percent during that time. Throughout the first several months of the fiscal year the market anticipated, and priced in, a tightening in the targeted federal funds rate. The general strategy for the LGIP portfolio during that time was to maintain a shorter average life on the expectation of higher rates. As it became obvious the economy was not improving as the market had anticipated, and the Fed's next move was likely to be an easing rather than a tightening, the average life of the portfolio was lengthened. The federal funds rate was lowered in November and remained steady until late June. In response to steady rates, the LGIP maintained a neutral average life for the remainder of the fiscal year. Regardless of market situations, the LGIP maintains significant liquidity to take advantage of any cheapness in the yield curve and provide liquidity to the LGIP participants.

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 made up 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 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

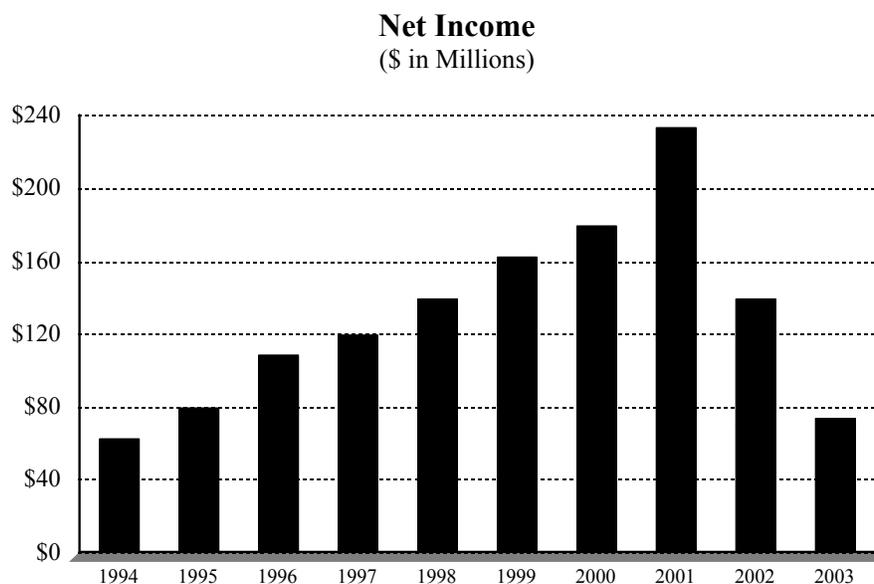
The state of Washington operates a risk management liability program pursuant to Title 4.92.130, RCW. The state manages its tort claims as an insurance business activity rather than a general governmental activity. The state's management believes it is more economical to manage its risks internally and 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 2003 totaled \$73.7 million, a decrease of \$65.3 million from the previous fiscal year. Net investment income for the past ten years was as follows:



Additional information on the financial activity of the pool can be found in Management's Discussion and Analysis.

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. 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 receive 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 70 employees, of which five work in the Investment Division and 10 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 Auditor's reports on internal controls and compliance with applicable laws and regulations can be found in a separately issued single audit report. The independent auditor's 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://tre.wa.gov/LGIP/lgip.htm>. The Office of the State Treasurer website, located at <http://tre.wa.gov/>, 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, 2002. This was the sixth consecutive year LGIP 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,

ELAINE EMANS
DEPUTY STATE TREASURER
STATE OF WASHINGTON