MICHAEL J. MURPHY
State Treasurer

State of Washington
Office of the Treasurer

October 25, 2004

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, 2004. 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 (MD&A), 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 an administrative overview, 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.

This letter of transmittal is designed to compliment the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the auditor's report.

Profile of the Pool

The pool was created by the Washington State Legislature in 1986 and is managed and operated solely 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.

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.

Economic Review and Outlook

The Year in Review

Fiscal Year (FY) 2004 began with a great deal of skepticism regarding the direction of the economy. Despite the country's lackadaisical economic growth, many investors were hopeful that the economy would turnaround and show more solid proof of recovery. The same worries continued to bog down the economy--- unemployment and disinflation. The unemployment rate started at a nine-year high of 6.40 percent and disinflation, although not evident, had some market spectators very concerned because of the Japanese deflation phenomenon of the last decade. However, the second-half of FY 2004 provided a picture of a better economy. Unemployment went down to 5.60 percent and disinflation worries turned into inflation concerns. Indeed, FY 2004 staged a comeback after a series of economic mirages in 2003.

The first half of the year was very disappointing as tax cuts created only a short-lived stimulant. At the same time as most economic indicators were saying that there was some kind of recovery, the unemployment rate went up to its highest level of the cycle. Economists found out later in the year that the much-vaunted growth figures came from consumer spending. Most of the gain in consumer spending came from the administration's tax cuts and from mortgage refinancing. Refinancing was a very attractive option for homeowners as a means of extracting cash from their properties since the housing sector benefited from the low-interest rate environment.

Most companies were also very reluctant to commit capital because the business environment was still clouded with uncertainty. Productivity for the most part filled the void left by businesses unwilling to commit new money. The rise in productivity enabled companies to produce more without hiring additional workers. Technology played a large role in allowing companies to increase their efficiency rates.

The gloomy outlook held by most economists was based on the fact that the economy did not produce a significant amount of jobs at a time when most of the fiscal and monetary stimulants were in full force. The decline in the unemployment rate from 6.40 percent to 5.70 percent by the end of the second quarter of FY 2004 belied the fact that payroll reports came in below market expectations. A lot of unemployed workers dropped off the radar after collecting their last employment checks. Outsourcing became the most controversial topic before Christmas time.

The Federal Reserve had expressed concern about the feeble economic recovery and stated that it would leave interest rates low for a 'considerable period" of time, which investors took as a signal that rate hikes were still remote from the Committee's collective economic assessment.

The second half of FY 2004 saw a marked turnaround from the dour state of the US economy seen during the first half of the year. Jobs, the be all and end all for most market players, came back very strongly which created worry that the Federal Reserve might deem it necessary to change their highly accommodative stance. Many people believed that job creation was a lagging indicator because most economic numbers pointed to a very robust economic trajectory. Many investors believed that, sooner rather than later, most companies would be willing to crank up their hiring as demand outpaced supply. In fact, there was also a common belief that their optimism bore weight as the Federal Reserve warned that they could take out the "considerable period" in their statement when deemed necessary.

Gross Domestic Product (GDP) growth during FY 2004 was 3.0 percent, which was weaker than the 4.1 percent rise in FY 2003. At first glance, the GDP numbers certainly looked weaker, but further scrutiny revealed that the growth came from business investment which had been sorely lacking during the previous year. Business investment contributed approximately 19 percent of the total growth in GDP which, coupled with strong consumer spending, made most investors very optimistic. The second half of FY 2004 provided the economy an average of 238,000 new jobs every month, in stark contrast to the 61,000 a month decline in 2003. With all these developments occurring towards the end of FY 2004, the Federal Reserve promptly changed its tone from a "considerable period" to a "measured pace" language of monetary accommodation. In layman's parlance, the Federal Reserve signaled its intentions of raising interest rates (take out accommodation) as the economy rebounded from its long slumber.

The economic landscape changed considerably during the second half of FY 2004. The fear of deflation which prompted the Federal Reserve to cut rates down to 1 percent was gone. Employment growth rebounded and productivity slowed, which closed the much talked-about output gap, giving rise to inflation worries. Inflation worries came from stronger demand, excess liquidity, higher operating costs, and a rise in oil prices. Energy costs had risen dramatically, with oil prices reaching $46 a barrel in the world market by the end of FY 2004.

The end of FY 2004 saw the fed funds rate move up from 1.00 percent to 1.25 percent, and many Federal Open Market Committee (FOMC) members indicated that the Federal Reserve's goal was to bring the fed funds level back to neutral. The "measured pace" was a catchall phrase that the Federal Reserve would probably raise rates depending upon the threat of inflation. It also meant that Chairman Greenspan would want to take out the accommodative nature of the Federal Reserve's monetary policy without economic disruption.

During the second half of FY 2004, investors became resigned to the fact that interest rates would rise, albeit at a "measured pace", for the rest of FY 2004 and probably continue upward in FY 2005 to target a neutral fed funds rate. A tighter monetary policy could be seen if evidence of rising growth and inflation materialize. Fed Chairman Alan Greenspan on several occasions stated that interest rate hikes depend upon their prognosis of inflation vis-à-vis economic growth.

Economic Risks

The risks to this outlook are that job growth could remain very tentative and energy costs could derail the global economy. Higher energy costs could dampen consumer spending, leading to a vicious cycle of business slowdown, subsequently spoiling the economy's momentum. Of great concern is the potential for terrorist attacks which could also trigger a rise in risk premiums in the cost of doing business. As the 2004 elections approach, terrorist attacks can not be discounted.

The economy is still very fragile as both the budget and current account deficit soar. Financing the deficit is one of the more serious problems in a period of rising interest rates. This fundamental problem is exacerbated by the current build-up of the costs in Iraq. Considering how resilient the economy was during FY 2004, economists are more optimistic that FY 2005 will see the economy on more solid ground. The risks mentioned are what most investors are watching since those factors could change the economic landscape.

Bond Market Outlook

The bond market has experienced a back-up in yields since the Fed started raising interest rates. Two-year notes started the year at 1.30 percent and ended the year at 2.68 percent, reflective of the changing interest rate environment. The three and five-year notes also experienced a significant rise in yields of approximately 140 basis points (bp). These back-ups have priced-in an aggressive Fed taking away much of its monetary accommodation. The longer 10-year and 30-year maturities had a less amplified move of 106 bp and 73 bp, respectively, as they benefited from investors putting on flattening trades in order to cushion their portfolios.

Investors continue to expect a series of rate hikes for the remainder of FY 2005. Economic reports suggest that the economy is improving, albeit in a very haphazard manner. Announcements of economic numbers have shown both weak and strong indicators which do not help investors in forming a general observation about the economy. The Federal Reserve Board, however, has been quite optimistic and reiterated their belief that the economy will stay on track and that most conflicting signals arise from transitory factors such as energy prices.

Equity markets have been quite robust, reflecting the general positive outlook on the economy. The Dow Jones Industrial average, NASDAQ, and S&P 500 registered substantial gains of 18.6%, 26.7%, and 19.1%, respectively, for FY 2004. There was a general belief that the economy had the momentum to build on its gains. The equity markets have all faltered at the onset of FY 2005 due to weaker employment numbers and energy prices, as earlier discussed. Most analysts have subsequently readjusted company earnings forecasts to reflect the current perceived earnings slowdown. However, economists are still in consensus that the economy will maintain its upward course.

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 treasury 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 depositaries.

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.

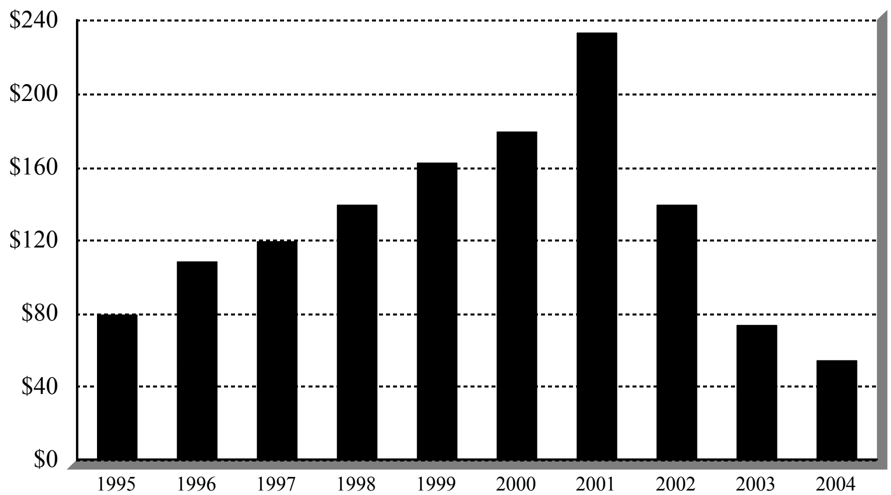
Financial Information

Operations
The investment activity for the pool is guided by an investment policy, approved by the State Treasurer and operates under the standard of the prudent investor.

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 2004 totaled $54.4 million, a decrease of $19.3 million from the previous fiscal year. Net investment income for the past ten years was as follows:

Net Income
($ in Millions)



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 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 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, 2003. This was the seventh 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