



MICHAEL J. MURPHY
State Treasurer

State of Washington
Office of the Treasurer

October 25, 2005

The Honorable Christine O. Gregoire, 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, 2005. 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 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.

Economic Review and Outlook

The Year in Retrospect

Fiscal Year 2005 was a turning point for the U.S. interest rate cycle. Investors saw the federal funds rate rise from 1.25% to 3.25%. Federal Reserve Chairman Greenspan initiated the "measured" pace approach in raising rates in order to achieve stability in economic growth and lessen the risk of inflation. The economic assessment was "balanced" as opposed to the "balanced with risk of disinflation" in October 2003.

The economic outlook has definitely turned around from the usual cynicism that investors exhibited during the last economic cycle. There were plenty of signs that the U.S. economy was coming out of its trough. Unemployment and the fear of disinflation came to pass as businesses, both on the local and national level, saw robust signs of a turnaround. The unemployment rate went down from a nine-year high of 6.4% to 5%. Businesses started hiring again as economic profits gained its highest share of GDP in 37 years. The first-half real GDP for 2005 increased by 3.6%, despite rising energy prices that initially threatened to stunt economic growth. Consumer spending and rising real estate prices induced a demand-driven economy supported by low long-term rates that suggested a low risk premium attached to inflation. FY 2005 could be the beginning of an economy transitioning from a period of economic uncertainty to a sustainable expansion partly due to a sign of renewed optimism and the Federal Open Market Committee's (Fed) monetary accommodation.

The Fed's monetary policy of raising rates in a "measured" pace created a "yield conundrum" of lower long-term rates in a period of interest rate tightening. The result of this phenomenon created a yield curve which has become flatter as short-term rates moved higher. Initially, this created fear in the market since there was a belief that lower bond yields foreshadows a weaker economic prospect. Treasury yields in the long-end of the market fell in the face of stronger economic growth from 5.29% to 4.46% and the 10-year notes similarly declined from 4.59% to 4.23%. The short-end, however, reflected the "measured" rate hikes by the Fed, with the yield on 2-year notes rising from 2.68% to 3.91%.

Greenspan in his last required appearance to the Congress before his term expires gave some light to his own "conundrum". He said, "...the flat yield curve reflects an excess of intended saving over investment". The lower yields "can be ascribed to expectations of lower inflation, a reduced risk premium resulting from less inflation volatility and a smaller real term premium that seems due to a moderation of the business cycle". The economy was driven by the same factors last year, namely consumer spending and rising home prices. It was still the same old vicious cycle of having lower rates that created home equity extraction, which in turn boosted real estate and construction spending. Business capital expansion was still lackluster compared to the growth coming from consumer spending.

What has really changed between FY 2004 and 2005 is the sense of optimism with regards to the direction of the economy. Job creation has seen a slow and steady recovery, both in the manufacturing and service sectors. The sustained GDP growth, despite oil at \$60 a barrel, showed the U.S. economy's resilience. Consumer spending averaged 3.4%, which could be construed as a sign that consumer optimism was very robust.

Although faced by a rising interest rate environment, residential investment grew at a pace of almost 10%, which fueled more of the “feel good” sentiment shared by both consumers and business owners. All these signs bode well for the U.S. economy to sustain its growth.

The optimism that the economy would be able to establish a stronger recovery for 2005 was reflected by low interest rates which was the market’s way of manifesting its sense of confidence. As long as interest rates remain low and the economy continues to generate employment, solid gains in 2005 could carry over into 2006.

The caveats to this economic optimism are energy prices and rising interest rates. Consumers will probably be a bit more cautious as both factors mentioned hit their pocketbooks directly. Oil has gone up to more than \$60 a barrel and the daily rise in retail gas prices has been in the headlines for weeks. Retail stores have already warned that store sales have suffered and are wary of making long-term projections on store sales. Interest rates also have been following Mr. Greenspan’s ‘measured pace’ approach, which could derail the housing sector’s stellar growth. In retrospect, most of the growth in the domestic economy came from housing and construction activities that have spawned a lot of warnings from noted economists regarding the current “housing bubble”.

In the long-run, monetary policies implemented by the Fed will define next year’s economic direction. The Fed has repeated that there is still policy accommodation that needs to be taken away in order to attain its twin objectives of sustained economic growth and price stability.

The Bond Market Outlook

Fed Chairman Alan Greenspan has been very transparent about their goal of taking away monetary accommodation at a ‘measured pace’. The bond market, in turn, has reacted quite positively by having an orderly back-up in yields. The orderly rate hikes that the Fed implemented has the effect of diluting the risk premium in the market and its corresponding volatility. There was a consensus that the Fed might halt rate hikes when the Fed fund rate reaches 4.00-4.25%.

Investors continue to expect a series of rate hikes for the remainder of CY 2005. However, rising energy prices have created a degree of economic uncertainty. Inflation has also been a major concern since consumers have been complaining about the incessant price increases in various commodities and services. Producers have been more vocal about passing costs to consumers due to the effect of rising energy prices.

Equity markets have been quite robust reflecting the general positive outlook on the economy. The Dow, NASDAQ, and S&P 500 registered gains of 0.65 %, 1.09%, and 6.31%, respectively during FY 2005. The performance of the equity markets has been lackluster as investors were torn between inflation concerns and the country’s economic resilience. Investors have shown cautious optimism regarding the country’s fragile economic recovery.

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 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.

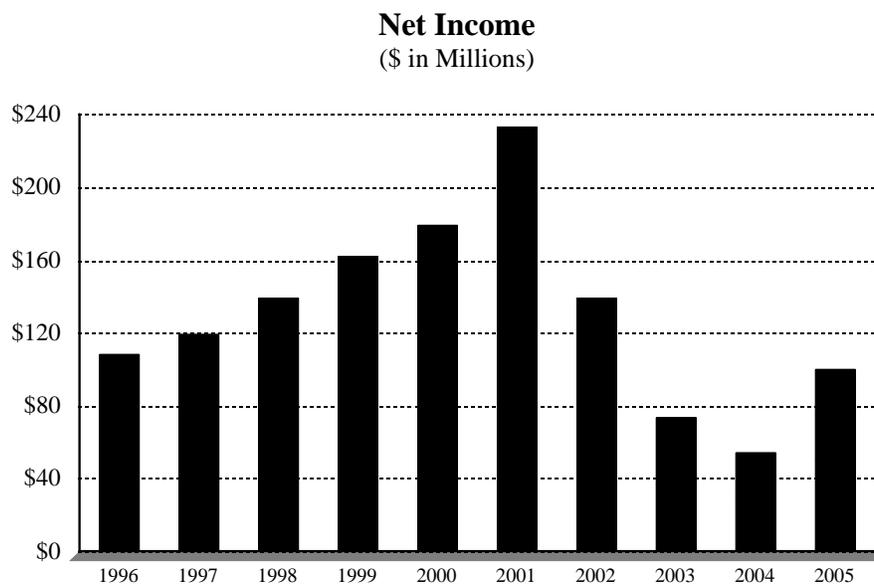
Financial Information

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 2005 totaled \$100 million, an increase of \$46 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 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 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 nine 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 of America 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, 2004. This was the eighth 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 generally accepted accounting principles 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, Jen Thun, Robbi Stedman, Joshua Freese, and Ferdinand Pascual for

their administration of the pool, to Cindy Shave and Alberta Quinlan for their accounting of the pool, to Toni Doyle for editing and coordinating this data for publication, and Wendy Weeks for her leadership in preparing this report.

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,

D. DARREL JENSEN
DEPUTY STATE TREASURER
STATE OF WASHINGTON