MICHAEL J. MURPHY
State Treasurer

State of Washington
Office of the Treasurer

August 28, 2006

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

I am pleased to submit this Comprehensive Annual Financial Report (CAFR) of the State of Washington Local Government Investment Pool (LGIP) for the fiscal year ended June 30, 2006. This report has been prepared by the Office of the State Treasurer (OST) as required by Revised Code of Washington (RCW) 43.250.080.

Responsibility for the accuracy of the financial data and the completeness and fairness of the presentation, including all disclosures, rests with management of 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.

This CAFR is presented in four sections:

1. Introductory Section includes this letter of transmittal, an organizational chart, advisory committee members and key personnel.
2. Financial Section includes the independent auditor's report, management's discussion and analysis (MD&A), the financial statements and notes to the financial statements, schedule of investments and certificates of deposit, and schedule of reconciliation of assets.
3. Investment Section includes an administrative overview, portfolio charts, position and compliance report, schedule of pool participants, investment policy, authorizing statutes, and administrative rules.
4. Statistical Section includes various tables and graphs.

MD&A immediately follows the independent auditor's report and provides an overview and analysis of the LGIP's basic financial statements. This letter of transmittal is designed to compliment the MD&A and should be read in conjunction with it.

Profile of the LGIP
The LGIP 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. Eight members are appointed by participant associations, and four are appointed by the State Treasurer.

The LGIP is a mechanism whereby political subdivisions (local governments), 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 security and liquidity. 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. 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 2006 was marked by Chairman Alan Greenspan's departure and the start of Chairman Ben Bernanke's tenure as the Federal Reserve's (Fed) most powerful man. The year was also a terminal point from a series of expected 25 basis point rate hikes and the beginning of rate "pause" speculations.

The economy was in a delicate balance of continuing a strong growth path or a drastic slowdown. Companies have continued to meet earnings expectations in a robust corporate environment. Business capital outlays, which have been a missing component of growth the last couple of years, have shown strong resurgence, unaffected by higher interest rates. Cash balances of private and public companies have grown to unexpected levels. Most company executives have been on the lookout for opportunistic investments in order to bring down costs. The only sector that has shown vulnerability was housing, construction, sales and peripheral areas related to housing. Investors have started to worry at the onset of contracting aggregate demand, due to the weak housing sector ravaged by higher mortgage rates. A feeble housing sector could cripple consumers who are suffering from the twin evils of higher interest rates and higher energy prices. The Fed hopes for a scenario where growth moderates and inflation declines to a more subdued level.

The Federal Reserve has started its "data-dependent" mode after fed funds rate reached five percent. The Federal Open Market Committee (FOMC) members have stated that although economic growth remains strong, they still need to address inflation risks, which depends on the "evolution of the economic outlook" based on economic data forthcoming. After 17 consecutive rate hikes, the initial robust economy has shown initial signs of exhaustion. Was it higher interest rates or higher energy and commodity prices that held in the reins of the US economic workhorse?

What has changed? The economic and inflation outlook seem to be at odds with their respective trajectory. The Fed is hoping that with its rate hikes and a prospective rate "pause", the economy could take stock and achieve a "soft" landing in 2007. The biggest concern by investors and business leaders is the rapid decline of the residential real-estate market. Home construction, sales and refinancing were the biggest factors contributing to wealth for the past couple of years. Wealth creation was the saving grace that extricated the US economy from recession. With mortgage rates rising, investors are worried the economy will grow at a below-average rate or worse and suffer from a recession.

A marked increase in economic indicators suggests a current slowdown in the US economy. Growth slowed remarkably during the last quarter of calendar year 2006, to almost half the numbers posted during the first quarter, due to declining personal consumption. Real GDP (Gross Domestic Product) is expected to be 3.25-3.40 percent in calendar year 2006 and 2.70% in 2007 as consumer activity takes a hit from cooling housing prices and rising inflation. The core PCE (personal consumption expenditures) rate has jumped to an annualized rate of 2.90%, which is way beyond the Fed's comfort level. This gives some Fed watchers ammunition that the 25 basis point rate hikes may come to a halt or a pause. However, some investors are not discounting possible rate hikes in Fiscal Year 2007 to quell lingering inflation fears.

Inflation has also been creeping up beyond what the Fed deems to be a reasonable band of 1.00-2.00 percent. Rising energy and commodity prices have been the usual suspects, but other components of the CPI (consumer price index) have shown inflation pressures as well. Rents, for an example, rose with prospective homebuyers putting off plans to acquire houses due to higher interest rates. Adding pressure to the rental market was the inadequate supply of apartments due to condo-conversions during the housing boom. Adding to investors' woes were labor unit costs, which have risen during the year, while labor productivity started showing signs of a slowdown too. Creeping inflation has been a source of constant anxiety for investors since the Fed indicated its willingness to pause. Judging from the dynamics of these factors, the Fed's "data-dependency" mode appears a prudent way for them to assess the monetary policy needed vis-à-vis the economic outlook implied by incoming economic indicators.

The Bond Market Outlook

Federal Reserve Chairman Ben Bernanke continued the policy of measured rate hikes during the first half of Fiscal Year 2006. A yield curve inversion developed toward the end of Fiscal Year 2006, which haunted the market, as there was a belief that this action was an omen of an impending recession. The "worst case-scenario" was that the US economy might not be able to achieve a soft-landing due to weaker economic growth numbers or stronger inflation rate. Investors believe that the Federal Reserve will monitor closely the stream of economic data going forward in order to address problems with the appropriate monetary policy. "Data-dependency" will affect the market as outlooks could change based on differing economic numbers.

Investors are still uncertain if the "pause" marked the end of this round of tightenings. Some think easing will start as soon as 2007, due to weak economic growth, and others look for a few more rate hikes due to higher inflation rates. The yield curve inversion seems to favor a pause or a possible interest rate ease in the future.

Equity markets have been quite robust, a reflection of the general positive outlook on the economy. The Dow Jones Industrial average, NASDAQ, and S&P 500 registered gains of 8.52%, 5.60% and 6.62%, respectively. The equity markets have priced-in modest earnings growth for most of Fiscal Year 2006, supported by robust consumer spending and higher capital investments. Company earnings growth are expected to taper-off in Fiscal Year 2007, as higher interest rates, weaker housing market, and higher energy costs are slowly affecting corporate fundamentals across different sectors.

Investment Risk Profile

The LGIP 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 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 LGIP 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 (the "State") operates a risk management liability program pursuant to RCW 4.92.130. 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.

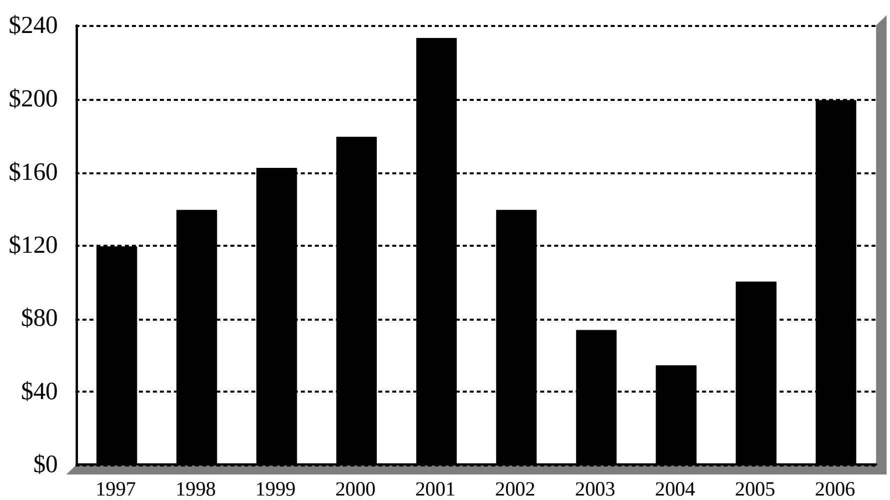
Financial Information

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 LGIP is operated as a business enterprise and its primary 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 2006 totaled $199 million, an increase of $99 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 the MD&A.

Internal Controls
The State is responsible for establishing and maintaining internal controls designed to ensure that the assets 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 conformance with generally accepted accounting principles. 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. Management continues to assess the adequacy of its internal controls and make improvements when needed.

The State Treasurer maintains internal controls to protect against the loss of LGIP 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 63 employees. Five work in the Investment Division and nine work in the Accounting and Fiscal Services Division.

Independent Audit
The LGIP contracts with Peterson Sullivan, PLLC to conduct an independent audit of the pool's financial statements. The independent auditor has issued an unqualified ("clean") opinion on the financial statements for the fiscal year ended June 30, 2006. The independent auditor's report is located at the front of the financial section.

Other Information

Internet
This CAFR is available on the Internet at the Treasurer's website (http://tre.wa.gov). Additional information on the LGIP for participants and interested parties is also available at this site.

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, 2005. This was the ninth consecutive year that the LGIP has achieved this prestigious award. In order to be awarded a Certificate of Achievement, OST had to publish an easily readable and efficiently organized CAFR that satisfied both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. OST believes this CAFR continues to meet the Certificate of Achievement Program's requirements and will submit it to the GFOA to determine its eligibility for another certificate.

Acknowledgments
Preparation of this CAFR was accomplished due to the efficient and dedicated services of many individuals in the Office of the State Treasurer's Accounting and Fiscal Services Division and its Investment Division. 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 LGIP in a responsible and progressive manner.

This CAFR reflects our commitment to pool participants and citizens of the State of Washington to maintain financial statements in conformance with the highest professional standards.

Sincerely,

SHAD PRUITT
DEPUTY TREASURER