



MICHAEL J. MURPHY  
State Treasurer

State of Washington  
Office of the Treasurer

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October 3, 2007

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, 2007. 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.

Management's Discussion and Analysis (MD&A) immediately follows the independent auditor's report and provides a narrative introduction, overview and analysis of the basic financial statements. The MD&A complements this letter of transmittal 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 OST. The State Finance Committee is the administrator of the statute that created the pool and adopts appropriate rules. The State Treasurer created the LGIP Advisory Committee to offer counsel on the pool's operation. 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, in priority order, are safety, liquidity and return on investment. The LGIP is operated as a business enterprise within the framework of state laws and regulations. This report includes only activity of the LGIP and does not include data or information related to other state agencies or funds.

## Economic Review and Outlook

### The Year in Retrospect

Fiscal Year 2007 was a year characterized by the push-and-pull of rate watchers wanting to know if the Federal Reserve (Fed) had reasons to cut or hike interest rates. It was a difficult year to establish bets as economic indicators were robust but inflation threatened to clip the US economy's wings toward a path of stable growth. There were also ominous signs that the housing problems have not fully shown its deleterious effects towards economic growth.

The economy started strong as growth coming from corporate earnings provided a lot of optimism that despite elevated energy prices, the US was able to produce beyond investors' expectations. Inflation expectations were elevated mainly because of two reasons; (1) higher energy and commodity prices and (2) rising labor costs. The Fed's iterations were about an economy reaching almost full employment and resource capacity utilization was also running at its highest. The Consumer Price Index (CPI) figure has been registering inflation at the highest end of the Fed's comfort zone at the time when extraneous factors were almost pushing the Fed's tolerance level. The Fed decided to keep its language intact with the emphasis on "elevated inflation risk" for the first half of calendar year (CY) 2007 suggesting vigilance in hiking fed funds rate when necessary. However, the second half of CY 2007 showed that the other parts of the economic equation threatened to derail growth. Housing was the economy's *Achilles heel*. The *subprime* problem snowballed into something that threatened not only the housing sector but the economy as a whole. The magnitude of the problem was intertwined with the decade of cheap money available to both consumers and investors. The *subprime* debacle created a global financial illiquidity crisis that brought mortgage companies and hedge funds into bankruptcy.

As the economic outlook continues to unfold, investors will be watching intently the negative effects of the current housing slump to consumer spending, employment, and business capital investment. The economy has seen a slow down during the end of the fiscal year as investors have conformed to the consensus that, at the current juncture, the threat to an economic slowdown has become the Fed's current concern more than the threat of inflation. The current stimulus to the change in economic outlook is the liquidity crunch brought about by the current financial turmoil in the mortgage market.

What has changed? The Fed has started easing rates at the time of this writing as a testament on how the "subprime" debacle has materially changed the Fed's economic outlook. The fed funds rate stands at 4.75% and the discount rate is at 5.25%. The surprise 50 basis point rate cut was intended to "help to forestall the adverse effects (of financial market disruptions) on the economy." The Fed has implicitly stated that economic growth for the rest of 2007 might be below par of what most economists are expecting.

Although inflation risks remain, the Fed seems to be quite concerned about the negative effects of financial market disruptions to the overall economy. Housing starts fell to the lowest level in August 2007 with both housing starts and permits falling to levels last seen in 1995. Concomitant to the housing downturn, consumers are under heavy pressure from rising energy prices and higher mortgage costs. Business capital spending will incur higher costs of capital as raising cheap money has been a difficult undertaking after financial markets experienced a period of brief illiquidity. Gross Domestic Product (GDP) forecast for CY 2007 has been around 1.8-2.0 percent brought by a decelerating economic growth in the second half. Investors are less confident about future prospects as falling productivity growth, rising labor costs and higher energy prices will take a toll on any economic projections. Former Fed Chairman Alan Greenspan has given a 30% probability that the economy could go into recession.

The good news about inflation is that most economic projections believe that inflation has topped out and should soon experience a dip within the Fed's inflation comfort zone of 1.0-2.0 percent. Core Personal Consumption Expenditures (PCE) should be below 2.0 percent for the second half of 2007. Investors will be watching the negative effects of higher energy and commodity prices and how an economic slowdown could cancel out higher demand.

### **The Bond Market Outlook**

Federal Reserve Chairman Ben Bernanke has responded to the current financial market disruption by cutting interest rates by 50 basis points to head off potential economic weaknesses arising from the credit crunch. The Fed's September rate cut was more than what the market expected. The forward rate curve has immediately priced-in succeeding rate cuts in the remainder of 2007 to a 4.50 percent terminal rate by December 2007.

The bond market should be looking for a steeper curve in expectations of more rate cuts. These expectations could alleviate the current market illiquidity as the Fed's initial cut showed assurance that they are willing to do what is necessary to address current market problems. The Fed is viewed as very proactive right now by the market which could in turn bring back investors' confidence and appetite for fixed income products. It has been common knowledge that demand for US treasuries and agencies in 2007 has declined both from the institutional side (foreign central banks and investors) and domestic buyers.

Investors will likely extrapolate further rate cuts depending on the economy's outlook. Portfolios will probably extend duration that could also bid up the long-end part of the yield curve. Investors look to keep curve steepening trade for at least till the end of fiscal year 2007.

### **Investment Risk Profile**

The LGIP is considered extremely low risk. It 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 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 LGIP also has a strong degree of asset diversification to minimize risk and maintain adequate rates of return.

The LGIP 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**

OST 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 depositories.

### **Risk Management**

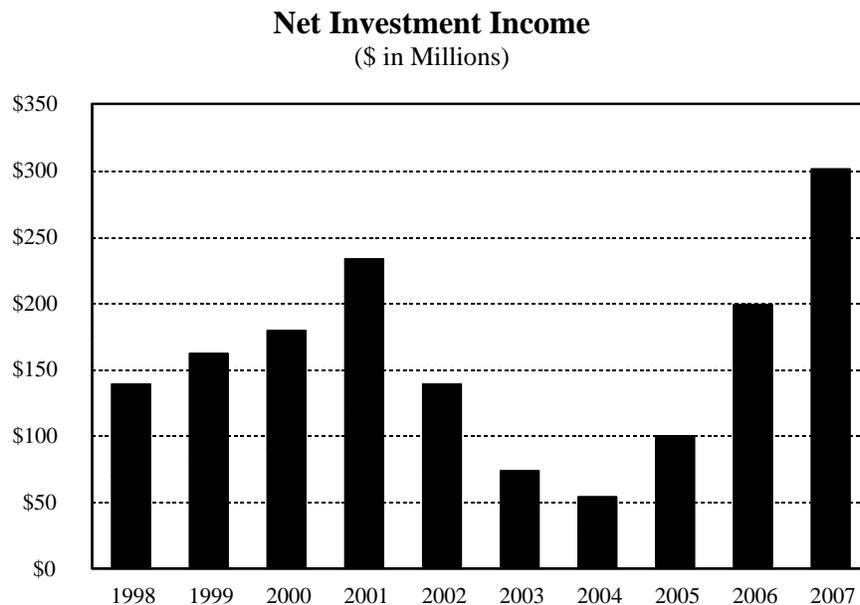
The state of Washington (the "State") operates a risk management liability program pursuant to RCW 4.92.130. The State manages its tort claims as an insurance business activity, rather than a general governmental activity. The State's management believes it is more economical to manage its risks internally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

## Financial Information

### Operations

The investment activity 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.

Total Investment Income less administrative expenses (“Net Investment Income”) for Fiscal Year 2007 totaled \$301 million, an increase of \$102 million from the previous fiscal year. Net investment income for the past ten years was as follows:



Additional information on the financial activity 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 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 Treasurer’s Office currently has 63 employees. Five work in the Investment Division and nine work in the Accounting and Fiscal Services Division.

**Independent Audit**

Peterson Sullivan, PLLC has issued an unqualified (“clean”) opinion on the financial statements for the fiscal year ended June 30, 2007. The independent auditor’s report is located at the front of the financial section.

**Additional Information****Internet**

This CAFR is available on the Internet at the Treasurer’s website (<http://tre.wa.gov>). Additional information 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, 2006. This was the tenth 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**

The preparation of this report was accomplished due to the efficient and dedicated services of many individuals in OST’s Accounting and Fiscal Services Division and its Investment Division. Due credit is given to State Treasurer Michael J. Murphy and Assistant State Treasurer Allan J. Martin 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