*September 2009

LGIP Extended Asset Option

Several local governments have suggested that The State Treasurer provide LGIP participants an intermediate-term investment option. We are now exploring your potential interest in our providing this option. If enacted the LGIP participants could either invest in the LGIP liquidity or the LGIP extended asset option, or both. This arrangement will mimic the current structure of the State's portfolio.

The State's portfolio is separated into two portions: the *Liquidity* and *Core portfolios*. The *liquidity portfolio* is managed using the same 2a-7 fund guidelines as the current *LGIP*. Both are highly liquid short-term investment vehicles, and have a maximum weighted average maturity of 90 days. Additionally, these funds may not invest in any security with an effective final maturity longer than 397 days. The *core portfolio* carries an average life between 1-3 years, and abides by a separate set of investment guidelines. The *core* invests in treasury and agency securities, focusing mainly within the 1-3 year sector of the yield curve. Due to the longer maturity of the securities held, the core should maintain a higher return over the *liquidity* and *LGIP* portfolios. However, there is more inherent risk with the core's longer average maturity. Securities with longer maturities tend to be more sensitive to movements in interest rates. Potential participants should be aware of the added risks before investing.

A more complete investment pool that will mirror the structure of the State's portfolio will result if the LGIP *Extended Asset Option* is implemented. The goal of this addition is to provide participants with an intermediate option which may be beneficial to participants by providing higher yields relative to the current *LGIP* portfolio. Over a market cycle, the *Treasury Core* has outperformed the *LGIP* on an accrued yield basis, as seen in the graphs below.

	Existing **LGIP – Liquidity Portfolio**	***Proposed*** **LGIP Extended Asset Option Portfolio**
GUIDELINES	2a-7 fund guidelines	Mirrors the Treasury Core
LIQUIDITY	100% liquid	Weekly or monthly
AVERAGE LIFE	No longer than 90 days	1 to 3 years
MAXIMUM LIFE OF MATURITIES	397 days	5 years
NET ASSET VALUE (NAV)	Stable (Always dollar invested)	Variable (May be less than dollar invested)
PERFORMANCE MEASURE	Accrued yield basis	Total return basis
PERFORMANCE BENCHMARK	iMoneyNet	Merrill's 1 to 3 year Government Index
PERFORMANCE EXPECTATIONS	Expected to outperform iMoneyNet government average	Expected to outperform LGIP Liquidity Portfolio over market cycle
RISK	Limited	Core's longer average maturity increases risk to movements in interest rates.

Net Asset Value

Net asset value (NAV) refers to the market value of a portfolio through a share price. It is calculated by taking the total closing market value of all assets held and subtracting all liabilities. The difference is then divided by the total number of outstanding shares to compute the NAV per share. This becomes the share price at which fund shares are sold or redeemed. The SEC allows 2a-7 money market mutual funds to operate on a stable NAV basis and the LGIP also operates in this manner. This means that the value—or share price—of the portfolio is held constant. For the *LGIP*, the NAV is one dollar; for every dollar deposited into the *LGIP*, the participant shall receive the same principal value upon withdrawal. The yield that participants receive is based on the actual earnings, as changes in the market value of the portfolio are not reflected in the yield. The majority of the risk is placed on the *LGIP* rather than the participant. The stable NAV enables the *LGIP* to allow 100 percent liquidity while preserving the principal value. While the actual market value of the portfolio may increase or decrease, the share price of the portfolio remains unchanged. The reason that the SEC allows 2a-7 funds to operate in this manner is that restrictions are placed on the maximum final maturity and the weighted average maturity of the portfolios. Those restrictions allow the funds to safely operate with a stable NAV under normal circumstances.

In contrast to 2a-7 money market mutual funds, bond mutual funds are valued on a variable NAV basis. This means that the value of the fund, represented by the share price, will change based on the behavior of the markets. Those types of funds invest in longer-term securities and have a longer average life than the 2a-7 funds. The longer average life of those portfolios adds a significant amount of market risk. This risk cannot be safely taken on by the fund operators and is passed on to participants in the form of a variable NAV. While historically the extended asset funds have outperformed the 2a-7 funds, there are two important factors to consider. First, there have been times where the 2a-7 funds have outperformed bond funds and second, times when bond fund participants have experienced principal losses.

In order to safely operate an LGIP *Extended Asset Option* it would also need to operate on a variable NAV basis. Thus while one could expect the extended asset option to outperform the liquidity LGIP option over a market cycle, there will be months when this will not be the case. A market cycle is defined as a period of falling interest rates followed by a period of increasing rates. Additionally, because the share price is based upon market value there will be months with negative total returns, i.e., participants would experience a loss in principal. It is important that participants keep this in mind and only put core balances into the longer-term option, i.e., cash not anticipated to be needed to meet cashflow needs for an extended period of time.

Accrued Yield vs. Total Return

To summarize from above, the LGIP performs on an accrued yield basis, which is based upon the yield at which assets were purchased, otherwise referred to as book yield. The *Extended Asset Option* will calculate on a total return basis, which is based upon market value instead of book yield. The table and chart below show the complete performance in both rising and falling interest rate environments and how the State's Treasury core has performed versus the *LGIP.*

Performance by Fund

Accrued Yield basis

	Quarterly	**1 Year**	**3 Years**	**5 Years**	**10 Years**
LGIP	0.317%	0.34%	1.78%	3.04%	2.81%
Treasury Core	4.289%	***3.40%***	***4.66%***	***4.52%***	***4.45%***
Merrill 1-3Y	2.140%	2.33%	3.29%	3.65%	4.01%

**Based on July to June Fiscal Year

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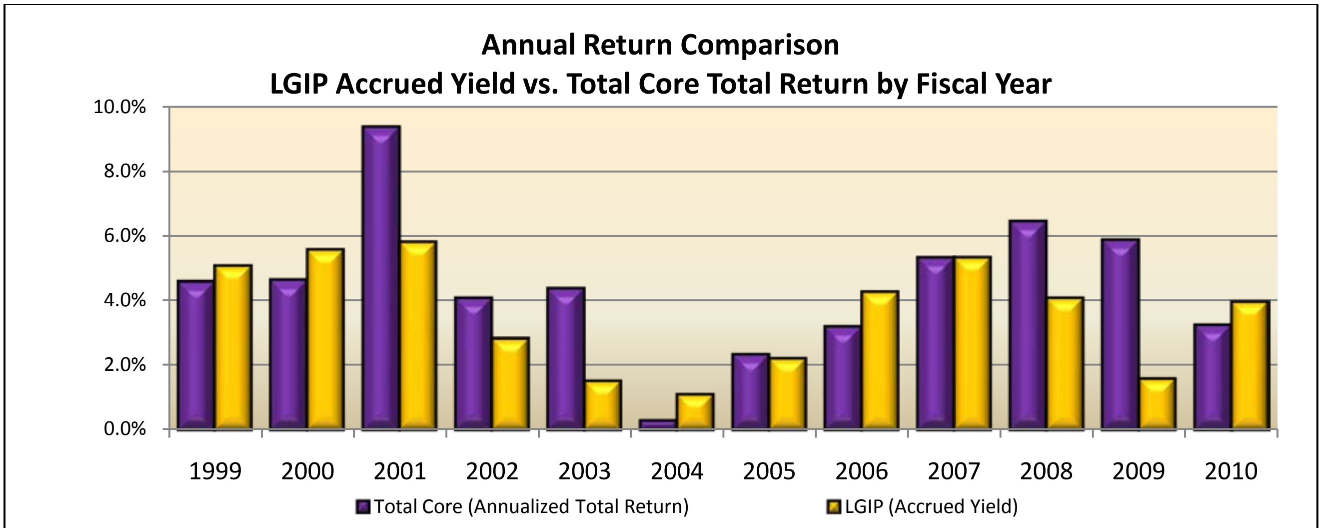

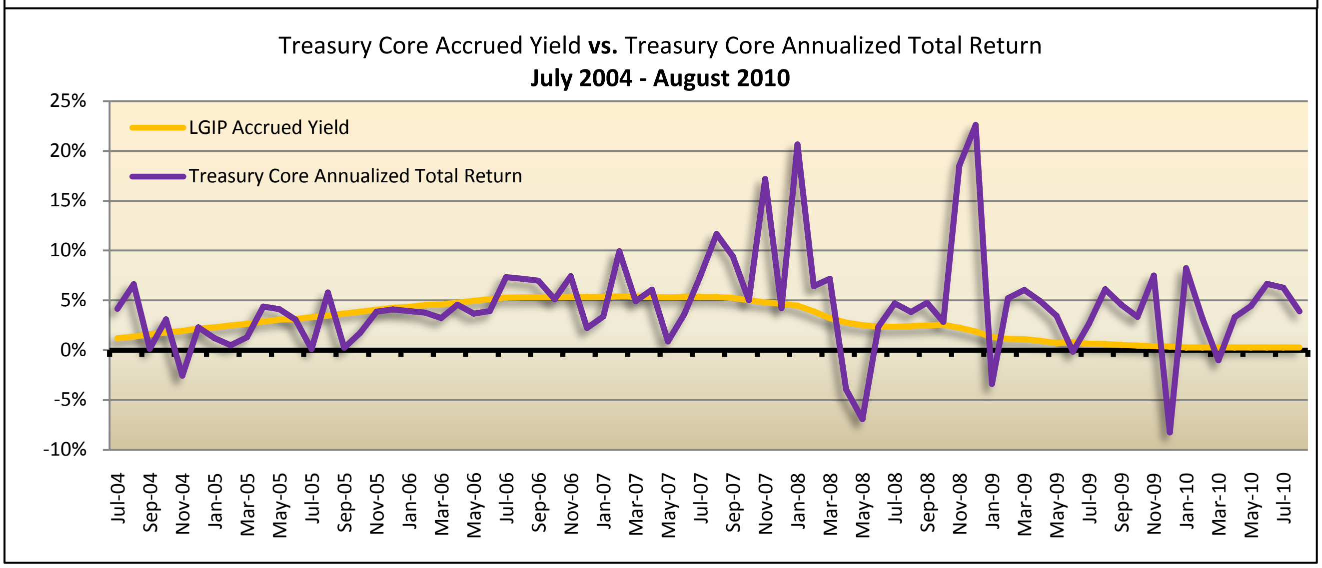

[1] Merrill Lynch 1-3 Year US Government Index is an unmanaged index that tracks the performance of US Treasuries and Agencies having a maturity of at least 1 year and less than 3 years. It is not possible to invest directly in an unmanaged index. DISCLAIMER: Actual performance returns may differ from composite returns due to the size of the account, inception date and other factors. Past performance is not indicative of future results. As in any investment, there is always the potential for gains as well as the possibility of losses.