



**MICHAEL J. MURPHY**  
*State Treasurer*

# The QUARTERLY

Local Government Investment Pool

First Quarter 2008

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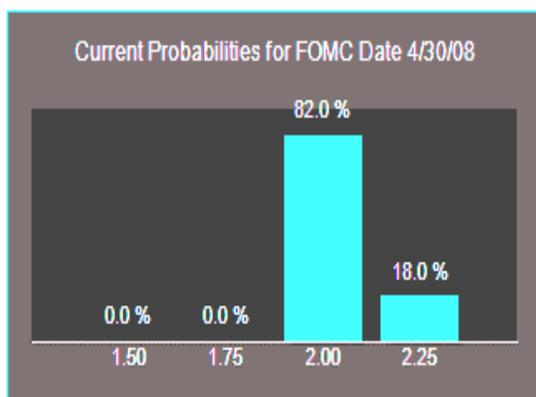
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## The Fed's rate cut overdrive to avert a liquidity trap

The Federal Open Market Committee (FOMC), at their March 18 meeting, cut the federal funds rate by 75 basis points to 2.25 percent as monetary officials try to grapple with a weakening economy and an illiquid financial system brought about by a slumping housing market and the attendant effect on credit products. Investors are at a loss on what to do as the worst kind of credit freeze gripped the global financial system. From London to New York, and other financial centers throughout the world, banks were reluctant to lend to each other. The magnitude of the sub prime lending, and associated losses, has had a distressing effect on the global financial market as most financial institutions were holding some form of paper related to sub prime mortgages, be it in the form of asset-backed paper, SIVs, or a host of different combinations of highly-engineered investment products. As a result, market strategists have started sounding alarm bells that the Fed is approaching the so-called "liquidity trap" trajectory as normal monetary policy has been unable to stimulate a weakening economy.

Chairman Bernanke had to take several extraordinary steps in order to unclog the financial system by announcing a variety of monetary tools and outright market intervention to achieve a semblance of monetary stability. It started by creating a Term-Auction Facility (TAF) in order to inject short-term funding. When TAF was not enough, it created Term Securities Lending Facility (TSLF) and a Primary Dealer Credit Facility (PDCF). All these instruments were intended to foster liquid and functioning financial markets. The Fed's action seems warranted as policy makers tried to prevent the possibility of a financial collapse and a prolonged period of elevated economic distress.

The sub prime fallout has had a spillover effect as write downs of at least \$200 billion did not allay fears of investors from doing any business tainted by bad mortgage papers. Mortgage-linked bonds were treated like the plague, which resulted from both buyers and sellers not willing to accept the said instruments as collateral. It seemed implausible at first but investors were bombarded daily by headline news of further write downs, rumors of companies going under, including bond insurers and broker-dealers, and hedge fund liquidations of bond positions. Basically, confidence crumbled leading to a "financial strike" which led monetary policy makers to rescue the financial system from disintermediation and dislocation. The Fed has performed its classic "lender-of-last-resort" to ease the crisis.



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*continued on page 2*

## Market summary

*from page 1*

The economic outlook has deteriorated and most economists have concluded that the US is actually in recession. Economic indicators have fallen way beyond consensus estimates signaling downside risks which the Fed has acknowledged. The Fed has also showed renewed concern about inflation, which has been further elevated not only by the rise in oil prices but price increases across the board from commodities to services. One only has to fill up a tank or go to your neighborhood grocery store to feel inflation firsthand. The Fed is still optimistic inflation will moderate due to a "projected leveling-out of energy and other commodity prices and an easing of pressure on resource utilization".

The Fed has done a lot of monetary front loading in order to avert a deep recession. Real interest rates have been negative, at -0.15 basis points, with core CPI at 2.4 percent and fed funds at 2.25 percent. Investors are now hoping that both Fed actions and the forthcoming fiscal package worth \$150 billion in tax rebates could stimulate the moribund consumer demand. Investors are anxious to see the Fed successful in bringing financial order and stability to the markets again.

### The Bond Market Outlook

The Fed so far in 2008 has delivered a 200 basis point (bp) cut on the targeted fed funds rate and a 150 bp cut on the discount rate. The Federal Reserve's March 18 statement maintained its easing bias as policy makers highlight their concern more about sluggish economic growth than higher inflation. They stand ready to cut rates further "in a timely manner to address those risks." Fed funds futures have started pricing-in additional rate cuts, taking the fed funds rate to around 1.50 percent by

the end of the next quarter.

Illiquidity has bogged down the market as investors continued to avoid any kind of bonds with credit risks. Swap spreads and agency spreads to treasuries have widened to their historical wises before the Fed bailed out the market through their short-term liquidity facilities after the Bear Stearns announcement. Investors migrated into the safest government securities driving yields down on two-year treasury notes to its lowest 1.48 percent and 3-month T-bills to 0.51 percent. The market's nervousness was reflected through increased volatility. Swings of 10-20 bps on an intraday basis have been common, making it tough for dealers to hedge their positions. Brokers eventually had to widen their bid-offer spreads in a desperate attempt to put some sanity back in their market activity.

Investors will be watching the progress and success of the Fed's lending facility. During its first week of implementation, the borrowing totaled almost \$28 billion. Primary dealers have continued to tap this facility in order to facilitate orderly intermediation. Another initiative that bears watching is lowering of GSEs capital requirement in order to address the current illiquidity in the mortgage market.

The safe way to double your money is to fold it over once and put it in your pocket. ~Frank Hubbard

### LGIP Advisory Committee

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## Why isn't the LGIP Rated?

We have had a number of inquiries recently regarding whether or not the LGIP is rated. A decision was made in the mid 1990s to not pursue a rating and it is fair to ask for the rationale behind that decision.

When Orange County, California went bankrupt in late 1994 it brought a great amount of increased scrutiny over public fund investors throughout the country, by everyone from investors in the pools to the rating agencies. In an effort to calm investors who buy municipal debt, as well as investment pool participants, the rating agencies ramped up their marketing efforts to local government investment pools throughout the country. OST did explore having the LGIP rated and had extensive dialogue with all three of the major rating agencies.

The cost of the rating, back in 1995, was about \$30,000. Since the LGIP is operated as a 2a-7 like money market fund the rating agencies would use the same criteria as they do for the private 2a-7 funds. The risks of investing in 2a-7 funds are primarily credit risk and interest rate risk and the ratings focus on those factors, among other things. With the LGIP, credit risk is not as big an issue so the focal point of the rating agencies was interest rate risk. In order to receive a AAA rating the 2a-7 funds have to restrict their weighted average maturity (WAM) to no longer than 60 days, while SEC restrictions list a maximum WAM of 90 days. Over



a market cycle the cost of the more restrictive rating agency WAM limitation is much more than the \$30,000 cost of the rating. The performance of the LGIP is quite related to management of the WAM. In the latest issue of The Quarterly in the article "LGIP Yields – Where did the 5.25% go?" there is a more in-depth explanation, but here is a recap of the

article. The LGIP yields closely follow the targeted fed funds rate,



but due to the WAM of the LGIP the yields will lag changes in that rate. We manage the portfolio in an attempt to lag those changes as long as possible when the rate is declining and to lag as short as possible when the rate is rising. The degree to which we accomplish that is due to our ability to successfully manage the WAM to coincide with changes in the fed funds rate.

From September 2007 through February 2008 the net LGIP yield has averaged 32 bp above the targeted fed funds rate, which has resulted in additional earnings of \$10.7 million. Had the LGIP been operating under the 60 day WAM limit in the current market the yield would have dropped more quickly than it has. It is hard to say with accuracy how much this would have cost the LGIP participants, but even 1 bp would have been worth \$330,000 over that six-month time period. OST believes that a conservative estimate would be 5 bp.

After extensive unsuccessful conversations with the rating agencies, in an attempt to convince them that this was an unreasonable restriction, OST brought the issue to the LGIP Advisory Committee. Given the presence of the Advisory Committee, the outside independent audit of the LGIP, combined with a conservative investment policy, OST's strong internal monitoring of the portfolio, and the level of disclosure the LGIP already provided, the Committee's view was that the benefits of the rating did not outweigh the costs. They recommended that OST not pursue receiving a rating. The vote was unanimous. If you have further questions or comments please contact OST or an LGIP Advisory Committee member.

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## LGIP Portfolio Management – Yields and Strategy

As the Fed has lowered the targeted Fed funds rate 300 bp over the last 6 months, from 5.25% to 2.25%, the LGIP yield has also dropped, from 5.22% in August 2007 to about 3.10% in March 2008. In August 2007, in anticipation of a possible Fed ease, the LGIP weighted average maturity (WAM) was pushed out past 60 days. This was done in an effort to lag the drop in the funds rate by as long as possible. Since August 2007 the WAM has been between 50 and 65 days. That is why the LGIP yield in February was 3.79% even though the targeted funds rate was 3.00% for the entire month, and even though the overnight investments were being done at around 3.00%. You can expect the LGIP yield to approach the targeted funds rate over the next few months, e.g., if the Fed stops at 2.25% then the LGIP will approach that level. However, if the Fed stops at 2.25% the LGIP would not dip into

the 2.25% range until sometime this summer. Based on Fed fund futures the market is anticipating another 50 bp in cuts, which would take the targeted funds rate to 1.75% by this summer.



Barring unforeseen developments in the market the LGIP portfolio WAM will probably stay between 50 and 65 days for the next few months.

In terms of portfolio composition the portfolio management strategy has changed since last summer. We are now utilizing discount notes and floating rate notes to a greater extent and repos to a lesser extent. This provides a greater degree of liquidity and will allow the LGIP to respond more quickly at such time as the Fed begins to tighten.

### From the LGIP Administrator's Desk:

By Robbi Stedman

Happy 2008! Hope everybody is doing well and getting ready for spring! As most of you know the LGIP chose Bank of America for our bank through an RFP search that was completed last July. Part of the new contract was the decision to move to the BA's new Northwest Platform. This new platform will give us the ability to have access to some technological features that were not available on the previous Hogan platform. The time has finally arrived that we are going to migrate. What this means for you is that the LGIP Account Number has changed. The change will be effective immediately, but please note that the old account will be open for a determined amount of time, but please use the new account ASAP. For the exact changes to the account number you can visit our web site at [www.tre.wa.gov](http://www.tre.wa.gov) and click on the LGIP link. At the top of the LGIP page you will see a link to a memo that describes the changes. We have also sent out a memo to our participants as of March 19. Thank you in advance for prompt response. So, if you do have any suggestions please don't hesitate to contact me at 1-800-331-3284 or [Robbi@tre.wa.gov](mailto:Robbi@tre.wa.gov).



## LGIP Advisory Committee: January 18, 2008 meeting highlights

The LGIP Advisory Committee meeting was held Friday, January 18, 2008, at noon in the State Treasurer's Office, Legislative Building, Olympia, Washington. The following members were present: Barbara Stephenson, Michele Pearson, Toni Habbeggar, Linda Riffe, Morgan Jacobsen, Doug Streeter, Carrie Lewellen, Dani Burton, Dan Underwood, Judi Morris, and Mary Nelson. Treasurer's Office Staff included State Treasurer Michael J. Murphy, Assistant Treasurer Allan J. Martin, Doug Extine, and Robbi Stedman. The following member was absent: Stan Finkelstein.

Treasurer Murphy welcomed and announced Kari Sample, whom the Investment section hired in October to administer the OST CD programs including the Linked Deposit Program. Murphy said that we were excited to have her on board. Kari introduced herself to the committee.

Doug gave an update on the performance of the LGIP. As would be expected, with the decline in the Fed funds rate the LGIP yields have also been declining. The Fed has been dropping the Funds rate since September, from 5.25% to the current rate of 3.50%. The net rates for the Pool for October, November, and December were 4.91, 4.70, and 4.56 percent, respectively. Discussion followed.

The committee discussed the sub prime situation, and its impact on the financial markets, including the distorted relationship between LIBOR and Fed Funds.

Doug discussed the strategy for managing the LGIP portfolio. Currently, the portfolio has an average life of 50 days. Starting in late June last year a shift was made in the portfolio holdings, from a high percentage of short repos to a high percentage of US Agency discount notes. The strategy was to increase the average daily life just a bit and keep repo short at one to two weeks. Doug also discussed how the portfolio was very liquid right now.

Robbi distributed a handout to committee members describing LGIP month-end balance activity for FY 2005, 2006, 2007 and 2008. Discussion took place on how both the LGIP balance was around \$1.3 billion higher than a year ago. Another handout compared the Daily Balances. Robbi talked about how the LGIP

hit its highest balance in history in mid-November at \$7.7 billion. Discussion followed.

For the LGIP Administration portion Robbi discussed how it was 2008 and how much the job of the LGIP Administrator has changed because of all of the technology changes. She gave a TM\$ update and currently 74 percent of our participants are using TM\$. Robbi asked the committee a few questions like "Is there anything that you would like to see in TM\$? Is there anything that you would like to change with the LGIP Advisory Committee Meeting format?" The committee members agreed that there weren't any changes that they would like to see.

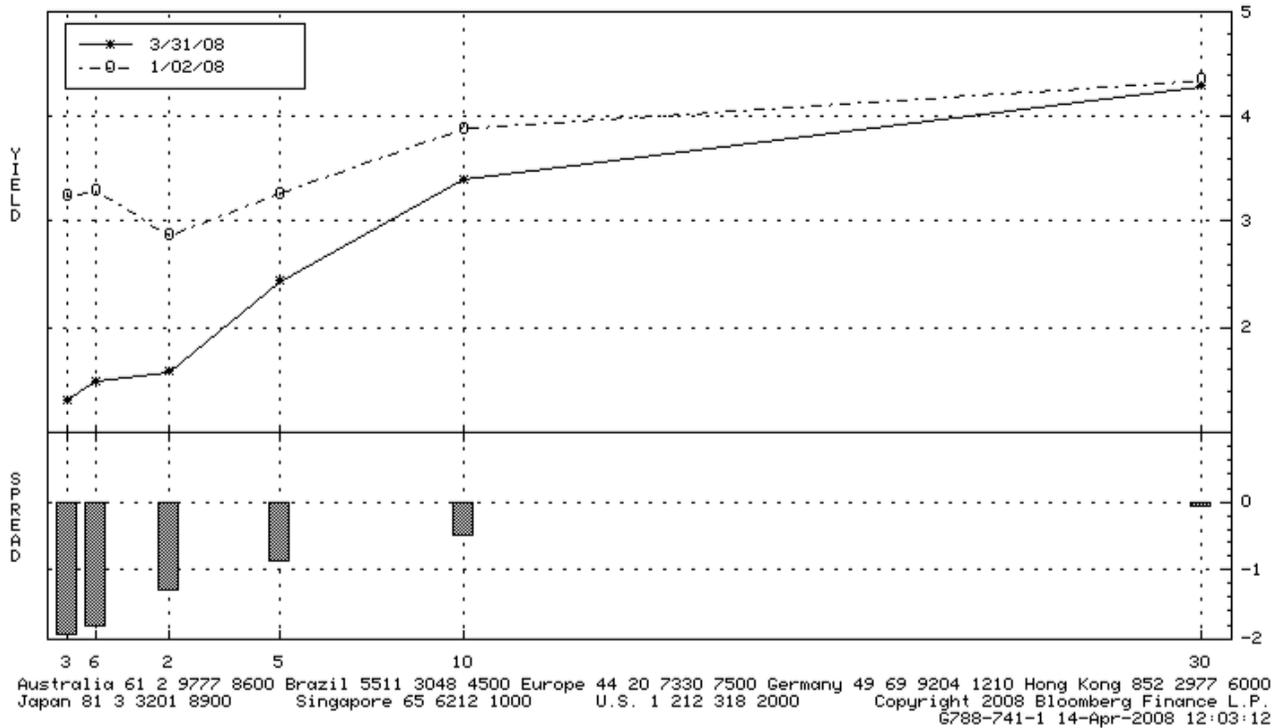
Robbi reviewed the actual fees, expenses, and rebate for FY 2008 utilizing a handout provided to committee members. Based on 6 months of actuals the LGIP is on track to finish with a net fee of around a basis point once again. She estimated the fees to be around \$2,100,000 and the expenses about \$595,000. The expenses are estimated a little higher this year due to salary increases and The Custody RFP. She then provided a hand-out that illustrated the fees and expenses over the last five fiscal years, all of which resulted in a net fee of near 1 bp

Doug then briefed the committee on the due diligence trip to San Francisco with Union Bank of California (UBOC). Three members from local governments along with Doug Extine and Josh Freese will be taking the trip to take a look at the daily operations of UBOC. Doug also mentioned that the transition, which occurred on October 1, 2007, was seamless. He also talked about how the performance of the UBOC securities lending program has thus far exceeded expectations. Discussion followed.

The next meeting will be scheduled on April 25th. The meeting was adjourned at 2:00 p.m.

## HISTORICAL YIELD CURVE

DATE RANGE **1/ 2/08** **3/31/08** MTY RANGE **3M** **30Y**

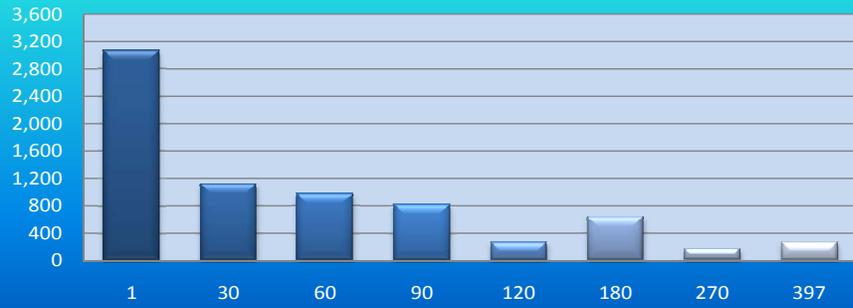


## News.....in brief

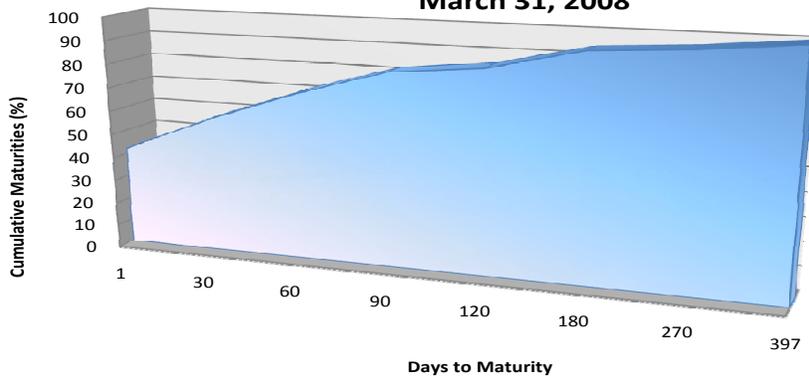
The 53rd Annual WFOA conference will be held from September 16-19, 2008 in Yakima Washington. We put together another group of talented speakers. Our Investment classes will be on September 17, 2008 starting at 11:10. If you would like to find out more information about our classes such as: course descriptions, speaker info and bios, and more please go to the WFOA web site [www.wfoa.org](http://www.wfoa.org). Then select WFOA Conferences and select sessions and you can find us under the "Track" Title of Investments. Hope to see you there!

Custody Due Diligence Trip: April 21-24 of this year the State Treasurer's Office will be accompanied by a few local government officials, Barbara Stephenson (Kitsap County Treasurer), Zemed Yitref (City of Bellevue), and Arif Kanji (Snohomish County), to San Francisco on a due diligence trip to Union Bank of California. Union Bank is the current Statewide Custody Provider and also the custody and securities lending agent for OST.

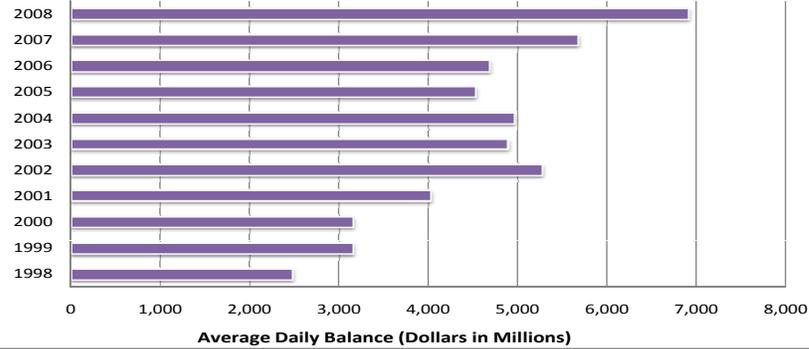
LGIP Maturity Structure  
as of March 31, 2008



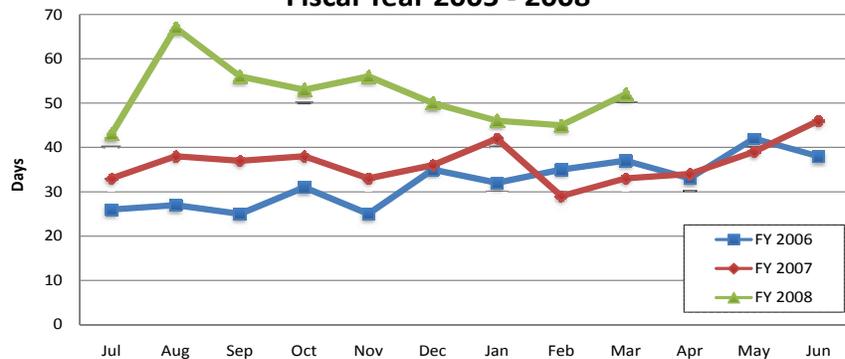
LGIP Cumulative Maturity Structure  
March 31, 2008

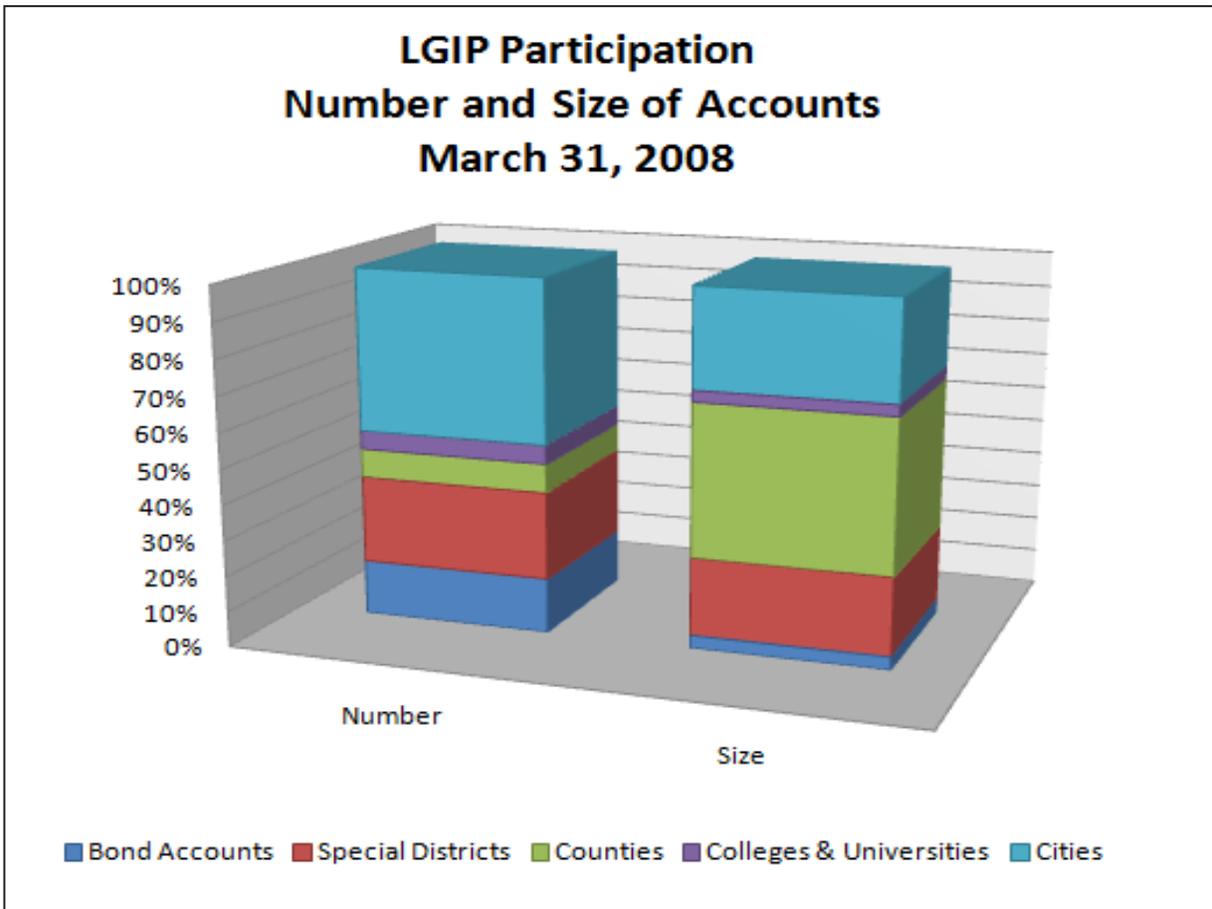
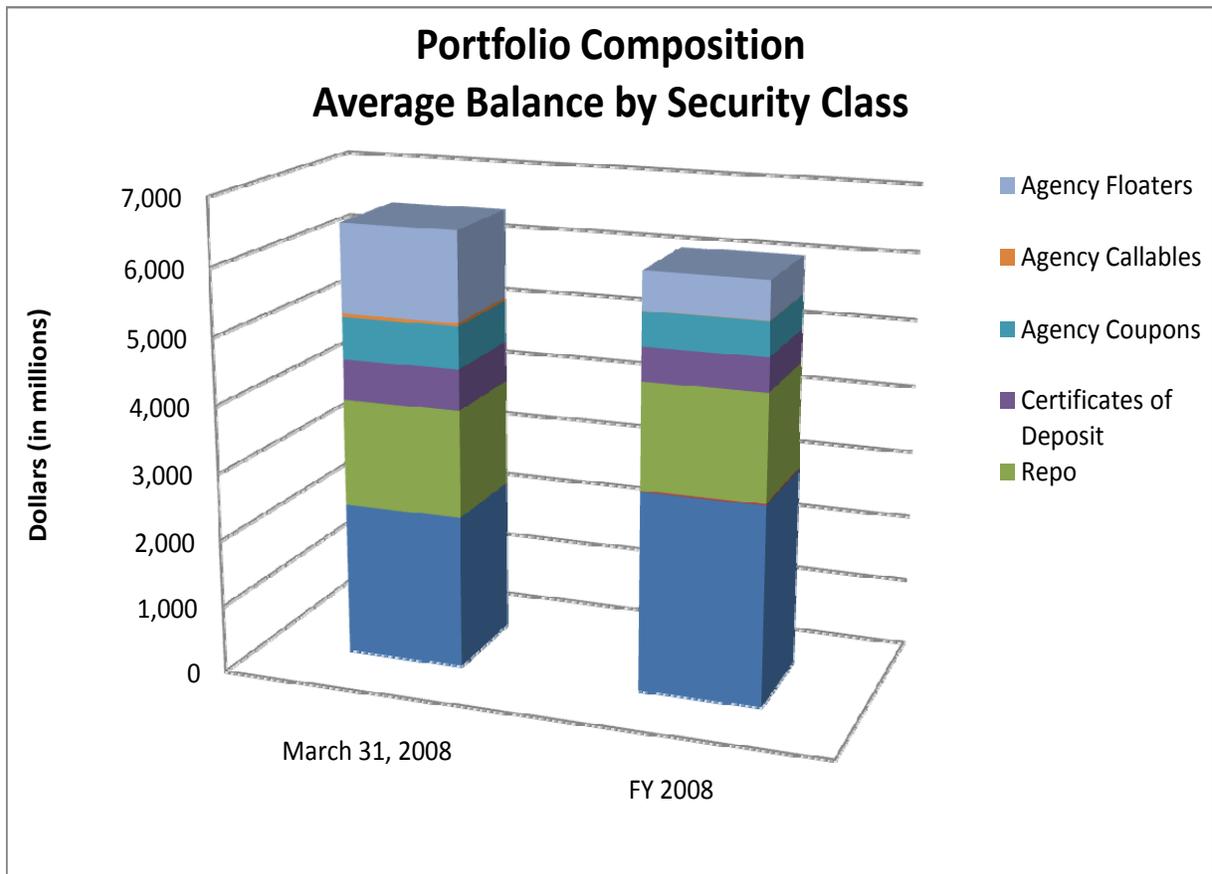


Average Daily Balance History  
By Fiscal Year  
March 31, 2008



Average Days to Maturity  
Fiscal Year 2005 - 2008





**Washington State Local Government Investment Pool  
Position and Compliance Report  
as of 3/31/3008**

| <b>LGIP Portfolio Holdings</b> | <b>Amortized<br/>Cost</b> | <b>Percentage of<br/>Portfolio</b> |
|--------------------------------|---------------------------|------------------------------------|
| Agency Bullets                 | \$ 644,990                | 6.71%                              |
| Agency Callables               | \$ 100,039                |                                    |
| Agency Discount Notes          | 2,404,518                 | 60.05                              |
| Agency Floating Rate Notes     | 1,419,904                 | 11.54                              |
| Agency Variable Rate Notes     | 149,993                   | 1.41                               |
| Certificate of Deposit         | 611,350                   | 7.27                               |
| Interest Bearing Bank          | 394,913                   | 5.50                               |
| Repurchase Agreements          | 1,555,105                 | 7.53                               |
| U.S. Treasury Bills            | 0                         | 0.00                               |
| U.S. Treasury Coupons          | 0                         | 0.00                               |
|                                | <u>\$ 7,280,812</u>       | <u>100.00%</u>                     |

|                                    |                 |
|------------------------------------|-----------------|
| <b>Securities Lending Holdings</b> |                 |
| Repurchase Agreements              | \$ 6,360        |
|                                    | <u>\$ 6,360</u> |

|  |                            |
|--|----------------------------|
| <b>Total Investments &amp;<br/>Certificates of Deposit</b> | <u><u>\$ 7,287,172</u></u> |
|--|----------------------------|

**Policy Limitations**

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.\**

**Size Limitations**

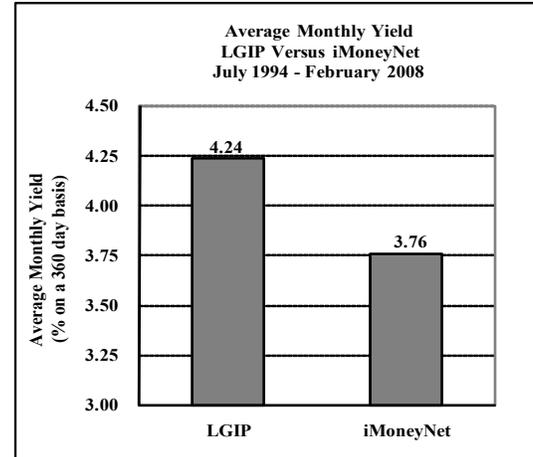
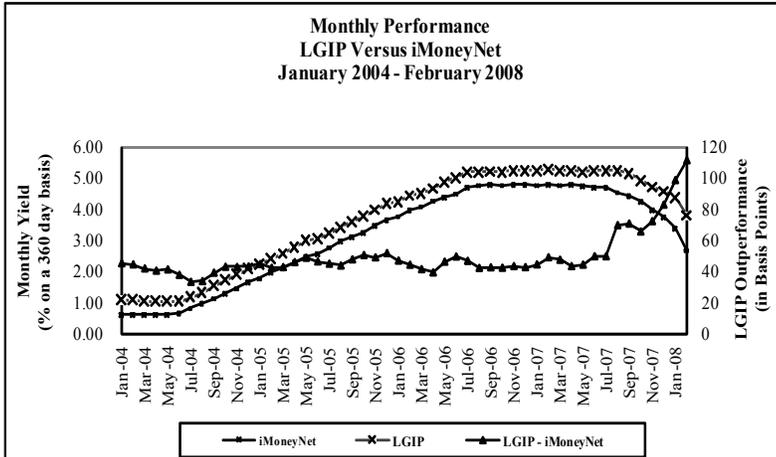
|                                 |              | <b>Percentage of<br/>Portfolio</b> | <b>Policy Limitations<br/>Percentage</b> |
|---------------------------------|--------------|------------------------------------|--|
| Floating Rate and Variable      | \$ 1,569,898 | 21.56%                             | 30%                                      |
| Variable Rate Notes > 397       | 100,000      | 1.37%                              | 10%                                      |
| Other Structured Notes          | 100,039      | 1.37%                              | 10%                                      |
| Term Repo > 30 Days             | 0            | 0.00%                              | 30%                                      |
| Certificate of Deposit          | 611,350      | 8.40%                              | 10%                                      |
| Bankers' Acceptances            | 0            | 0.00%                              | 20%                                      |
| Commercial Paper                | 0            | 0.00%                              | 25%                                      |
| Reverse Repo                    | 0            | 0.00%                              | 30%                                      |
| Security Lending + Reverse Repo | 6,000        | 0.08%                              | 30%                                      |

**Maturity Limitations**

|                                       | <b>Currently</b> | <b>Policy Limitations</b> |
|---------------------------------------|------------------|---------------------------|
| Weighted Average Maturity             | 52 day(s)        | 90 day(s)                 |
| Maximum Maturity                      |                  |                           |
| Bullet Maturities                     | 360 day(s)       | 397 day(s)                |
| Floating Rate and Variable Rate Notes | 711 day(s)       | 762 day(s)                |
| Repos                                 | 7 day(s)         | 180 day(s)                |
| Reverse Repos                         | 0 day(s)         | 90 day(s)                 |

*continued on page 10*

## LGIP Performance Comparison iMoneyNet, Inc. <sup>1</sup> versus Local Government Investment Pool



The chart on the left shows a monthly comparison from January 2004 through March 2008 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to March 2008. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.4 basis points. This translates into the LGIP earning \$246.71 million over what the average comparable private money fund would have generated.

<sup>1</sup> Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, *Money Market Insight*, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

### Position and Compliance Report from page 9

|                   | March 31, 2008      | Total Repo Percentage (20% limit) | Average D-T-M (30 day limit) | Projected Redemptions 4/1/2008 | Projected Position 4/1/2008 |
|-------------------|---------------------|-----------------------------------|------------------------------|--------------------------------|-----------------------------|
| BNP Paribas       | \$ 691,465          | 9.00%                             | 4                            | \$ 391,465                     | \$ 300,000                  |
| Cantor Fitzgerald | 400,000             | 5.00%                             | 1                            | 400,000                        | 0                           |
| Greenwich Capital | 470,000             | 6.00%                             | 1                            | 470,000                        | 0                           |
| <b>Total</b>      | <u>\$ 1,561,465</u> |                                   |                              | <u>\$ 1,261,465</u>            | <u>\$ 300,000</u>           |

**Local Government Investment Pool**  
**STATEMENT OF NET ASSETS**  
**February 29, 2008**  
*(in Thousands)*

**Assets**

|  |                     |
|--|---------------------|
| Investments, at Amortized Cost:  |                     |
| Repurchase Agreements  | \$ 2,012,462        |
| U.S. Agency Securities   | 4,235,351           |
| <b>Total Excluding Securities Purchased But Not Settled</b>                    | <u>\$ 6,247,813</u> |
| Securities Lending Investments, at amortized cost:                             |                     |
| Repurchase Agreements  | \$ 68,498           |
| Total Securities Lending   | 68,498              |
| <b>Total Investments (Settlement Date Basis)</b>                               | <u>\$ 6,316,311</u> |
| <b>Total Investments</b>   |                     |
| Due from Brokers - Securities Purchased But Not Settled,<br>at Amortized Cost: |                     |
| U.S. Agency Securities   | 250,000             |
| <b>Total Due from Brokers</b>  | <u>250,000</u>      |
| <b>Total Investments (Settlement &amp; Trade Date Basis)</b>                   | <u>6,566,311</u>    |
| Interest Bearing Bank Deposits   | \$ 393,921          |
| Certificates of Deposit  | 606,350             |
| Cash   | 501                 |
| Interest Receivable  | 17,900              |
| <b>Total Other Assets</b>  | <u>\$ 1,018,672</u> |
| <b>Total Assets</b>  | <u>\$ 7,584,983</u> |

**Liabilities**

|  |                   |
|--|-------------------|
| Accrued Expenses                               | \$ 406            |
| Obligations under Securities Lending Agreement | 68,498            |
| Investment Trades Pending Payable              | 250,000           |
| <b>Total Liabilities</b>                       | <u>\$ 318,904</u> |

**Net Assets**

|  |                     |
|--|---------------------|
|  | <u>\$ 7,266,079</u> |
| Total Amortized Cost - Settlement Date Basis | \$ 7,316,582        |

**QUARTER AT A GLANCE**  
**December 1, 2007 to February 29, 2008**  
*(in Thousands)*

|                                      |                  |
|--------------------------------------|------------------|
| Total investment purchases:          | \$ 29,549,424    |
| Total investment sales:              | \$ 2,190,218     |
| Total investment maturities:         | \$ 27,313,729    |
| Total net income:                    | \$ 73,739        |
| Net of realized gains and losses:    | \$ 856           |
| Net Portfolio yield (360-day basis): |                  |
|                                      | January 4.3596%  |
|                                      | February 3.7871% |
|                                      | March 3.1354%    |
| Average weighted days to maturity:   | 52 days          |

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