



King County

King County Investment Pool 2006 Annual Report



King County

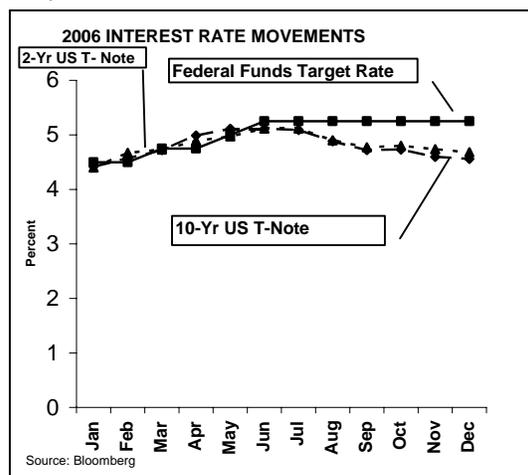
Finance & Business Operations Division

Pool Report Website: <http://www.metrokc.gov/finance//treasury/KCInvestmentPool2006.pdf>

■ 2006 Pool Performance

The King County Investment Pool (the Pool) distributed \$165.6 million to Pool participants in 2006—a 58% increase over the amount distributed in 2005. The average earnings rate for the year was 4.68%. This was a substantial increase from the 3.15% earnings rate for 2005

The increase in the Pool's earnings rate was largely due to the increases in short-term interest rates that occurred in the first half of 2006. These increases were initiated by the Federal Open Market Committee (the FOMC). The FOMC is the component of the Federal Reserve System that is responsible for implementing monetary policy for the United States. Their objective is to maximize employment, while promoting low inflation and moderate long-term interest rates. During the first half of the year, the members of the FOMC continued to express concern that inflationary pressures were building in the economy because of high energy prices, tight labor markets, and strong consumer spending. In an attempt to limit inflationary pressures, the FOMC raised the federal funds target rate by 25 basis points (1/4 of 1%) at each of their first four meetings of the year. This resulted in the federal funds rate reaching 5.25% in June 2006, one percent higher than where it began the year.



During the first half of the year, 2-year and 10-year interest rates also increased in conjunction with the FOMC's actions. However, at its June 2006 meeting the FOMC signaled that future rate increases would be dependent on how strong, or

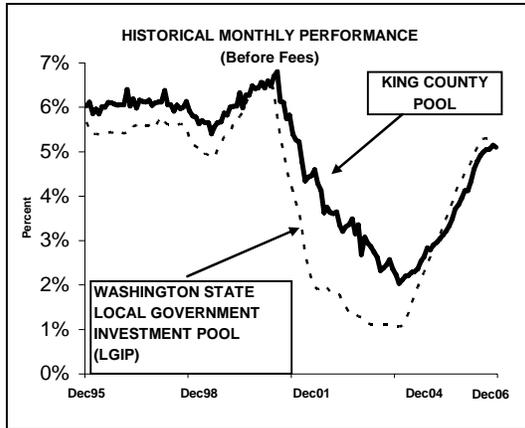
weak, future economic data were. The financial markets correctly anticipated that this might mean a pause in the cycle of rate increases. As the financial markets started building in the expectation that the FOMC may lower rates in the near future, the yield curve became inverted.

...the Pool distributed \$165.6 million to Pool participants in 2006...

An inverted yield curve occurs when longer term interest rates fall below short-term interest rates. This is an unusual event because investors usually demand higher rates on long-term securities to compensate for the higher risk associated with owning longer term assets. Fortunately, there are more periods of economic expansion than contraction, but when the financial markets start anticipating an economic slowdown, the result is often an inverted yield curve.

Some economists predicted that the economy may be heading for a recession because inverted yield curves have often preceded economic slowdowns. However, other economists stated that the unusually low long-term rates were due to excess global liquidity. These economists argued that the countries of the Middle East and Asia were reinvesting the dollars they were generating from oil and trade back into U.S. debt securities, and that this increase in demand was pushing long-term interest rates down.

While the Pool's monthly earnings rate had increased briskly during the first half of 2006, the second half of the year saw a more modest increase. This occurred because, as the markets expected, the FOMC did not increase rates at its August meeting. This put an end to its two year string of rate increases, leaving the federal funds target rate at 5.25%. The FOMC statement released after their meeting justified the pause by noting the moderation in economic growth, the softening housing market, weakness in the manufacturing sector, and their belief that inflation would moderate in the future. The 2-year and 10-year rates continued to fall during the second half of the year. By the end of the year longer term rates were near 4.5%, while the federal funds rate remained at 5.25%.



Although the Pool's earnings rate was 5.1% by year-end, the rate slightly trailed the rate paid by the Washington State Local Government Investment Pool (LGIP). The primary reason for this was that the Pool, by policy, has a longer duration that the LGIP. During periods of rising interest rates, the LGIP's shorter duration allows its yield to reset faster than the Pool's yield can. Since the FOMC had been raising rates for all of 2005 and half of 2006, this made it very difficult for the Pool's yield to keep pace with the LGIP because their securities would mature faster than the Pool's. This allowed them to reinvest at higher rates sooner than the Pool could.

In nine of the past eleven years the Pool's average gross yield has been higher than the LGIP's gross yield.

Over the long-run, the Pool's policy of holding longer dated securities has been successful. In nine of the past eleven years the Pool's average gross yield has been higher than the LGIP's gross yield. And over the last five years, the Pool's gross earnings rate has averaged 83 basis points more than the LGIP's gross yield. In dollar terms, 83 basis points of extra yield over a five year period would generate about \$41,500 in additional revenue for each \$1 million invested.

■ Forecast for 2007 Performance

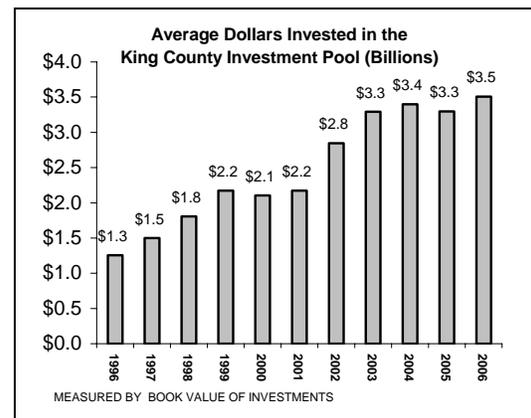
The Pool's gross earnings rate for the first three months of 2007 has averaged nearly 5.2%. This is the highest earnings rate since August of 2001. The Pool's performance for the remainder of 2007 will be strongly dependant on the actions taken by the FOMC. At their first two meeting of 2007, the FOMC left the federal funds target rate at 5.25%. However, at their latest meeting, they surprised most market analysts by changing the language they had been using that discussed future rate hikes. By dropping the phrase that mentioned further rate increases from their statement, they moved closer to a neutral policy: one where the

possibility of a rate cut is just as likely as a rate increase.

However, they are still concerned about the elevated level of core inflation, and if strong consumer spending and low unemployment persist, the FOMC could keep their target rate at 5.25%—or possibly increase rates. But if weakness in the manufacturing and housing markets cause the unemployment rate to increase, and if core inflation moderates as the economy slows, then the FOMC may cut their target rate this year.

...the Pool earnings rate should average between 5.1% and 5.3% for 2007.

The recent mixed economic data and the change in the FOMC's recent language has caused the financial markets to project that FOMC will cut rates by 25 basis points by year-end 2007, which would bring the federal funds target rate to 5.0%. Economists, on average, also expect the FOMC to cut rates in the second half of the year. A recent survey of 71 economists by Bloomberg News shows that they expect the federal funds target to end the year at roughly 5.0%—a cut of 25 basis points. While on average the economists are predicting a cut in rates this year, the range of their forecasts is very wide: the high forecast is 6.0% and the low forecast is 4.0%.



Such a wide divergence of opinions makes it difficult to predict the Pool's earnings rate for this year. However, we believe that under the most likely interest rate scenarios the Pool earnings rate should average between 5.1% and 5.3% for 2007. However, there are several economic issues in the news that could affect this forecast: bankruptcies of over 40 subprime-mortgage lenders, home prices and sales declining at the national level, increased volatility in the stock market, continued turmoil in the Middle East, oil prices over \$60 per barrel, and weak business spending on capital

OVERVIEW OF THE KING COUNTY POOL'S INVESTMENT POLICY				
Investment Types	Max Maturity	Max % Limit	Single Issuer Limit	Minimum Credit Rating
US Treasury	5 Years	100%	None	N/A
Federal Agency	5 Years	50%	50%	N/A
Fed Agency MBS	5 Year WAL	25%	25%	N/A
CD's	5 Years	15%	5%	PDPC ⁽¹⁾
Municipals ⁽²⁾	5 Years	20%	5%	A ⁽³⁾
Bank Notes	5 Years	20%	5%	A ⁽³⁾
Repos	60 Days ⁽⁴⁾	40%	10%	Collateral
Commercial Paper	180 Days	25%	5%	A1/P1 ⁽⁵⁾
BA's	180 Days	25%	5%	Top 50 ⁽⁶⁾
State LGIP ⁽⁷⁾	N/A	None	None	N/A

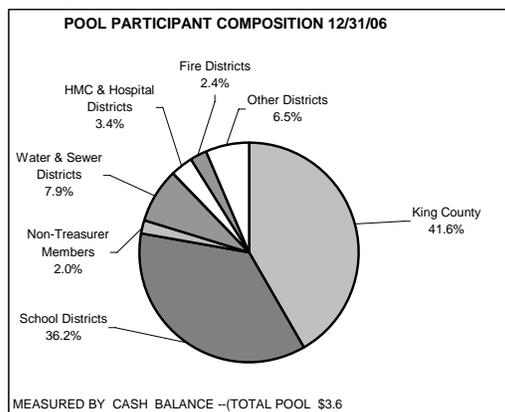
(1) Institution must be a Washington State depository. Treasurers can deposit up to 100% of bank's net worth.
(2) Washington state issuers: general obligations and revenue bonds. Other states: only general obligation bonds.
(3) Must be rated "A" or better by two rating agencies.
(4) 102% collateralized, over 30 days 105%
(5) Must be rated in top credit category by at least two rating agencies. Maturities > 100 days must have "AA" long-term rating.
(6) Bankers' acceptances can only be purchased from the 50 largest banks in the world by asset size.
(7) The state investment pool (LGIP) is a money market-like fund managed by the State Treasurer's Office.

improvements. So far these negatives have been balanced by low unemployment and strong consumer spending, but if the balance swings, we could see much greater shifts in interest rates than we are currently expecting.

■ Pool Participation

The average amount invested in the Pool was \$3.5 billion during 2006—a \$200 million increase from 2005. Several large bond issues and a new Pool participant were responsible for most of this increase. At year-end, King County was the largest participant in the Pool, holding 41.6% of the Pool's assets. School districts were the next largest participant at 36.2%, followed by water and sewer districts at 7.9%.

The Cascade Water Alliance selected King County as its treasurer and joined the Pool in 2006. This would have brought the number of districts to 100, but the merger of two fire districts during the year resulted in the total number of Pool participants remaining at 99. Since all investing districts now use the Pool, it may be a challenge to break the 100 participant mark.



We are also proud to still be able to state that no district has ever terminated participation in the Pool, except for mergers. Pool participants have

stated that the Pool provides them with a safe, convenient, and flexible method of investing their funds, while still providing a good return. For a list of all districts and public authorities participating in the Pool, please see page 7.

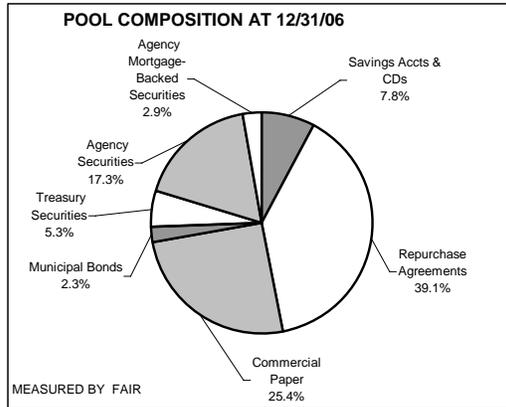
■ Pool Organization

In accordance with Washington State code (RCW 36.48.070), the County's Executive Finance Committee (the EFC) reviews the Pool's investment practices and policies on a regular basis. The Committee consists of the Chair of the County Council, the County Executive, the Chief Budget Officer, and the Manager of the Finance and Business Operations Division (or their designees). All investment activity is subject to written policies approved by the EFC. The Committee monitors pool performance at its monthly meetings. Responsibility for managing the Pool's investments on a daily basis lies within the Cash Management Unit of the County's Treasury Operations Section.

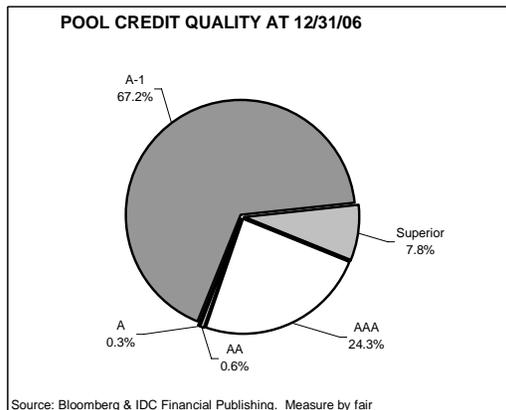
■ Review of Pool Investment Practices

Diversification: The Pool pursues its investment objectives by investing in high-quality securities, including U.S. Treasury, U.S. agency notes and mortgage-backed securities, taxable-municipal notes, commercial paper, certificates of deposits (CDs), repurchase agreements, and the LGIP.

The Pool has policies that limit the maximum amount that can be invested in any one of these sectors. The table above summarizes the Pool's diversification policy, while the following pie chart shows the Pool's actual composition at year-end. Because of the higher yields available in the short-end of yield curve, the Pool was holding about 10% more in repurchase agreements than at this time last year.



Credit Quality: Standard & Poor's has assigned the Pool its highest rating for credit quality, 'AAAF', in recognition of the high-quality investments and counterparties the Pool utilizes. At year-end, the Pool had about 24% of its portfolio invested in 'AAA' quality U.S. Treasury, agency, and municipal securities. About 68% of the Pool's investments were invested in securities or placed with counter-parties that had a short-term rating of at least 'A-1', or its equivalent, which is one of the top ratings for short-term securities.



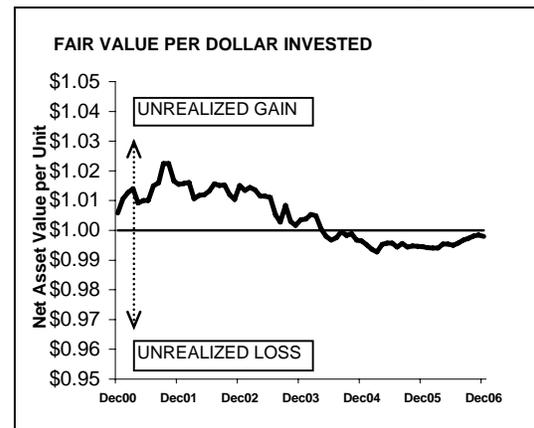
A Nationally Recognized Statistical Rating Organization (NRSRO) such as Standard & Poor's did not rate about 8% of the portfolio's securities. These non-rated investments were composed of CDs and the Pool's investment in the State's LGIP. While this group of investments is not rated by an NRSRO, they are still very safe investments.

Standard & Poor's has assigned the Pool its highest rating for credit quality, 'AAAF'...

CDs are placed only with depositories that are approved by the Public Deposit Protection Commission (PDPC). The PDPC provides security for public treasurers by protecting public deposits that exceed the amount insured by the FDIC. No public funds placed in public depositories have been lost since the Public Deposit Protection Act (RCW 39.58) was created in 1969. As additional

protection, the Pool pays for a service provided by IDC Financial Publishing that monitors the financial condition of these non-rated institutions. At year-end, all issuers of CDs were rated "Superior" by IDC.

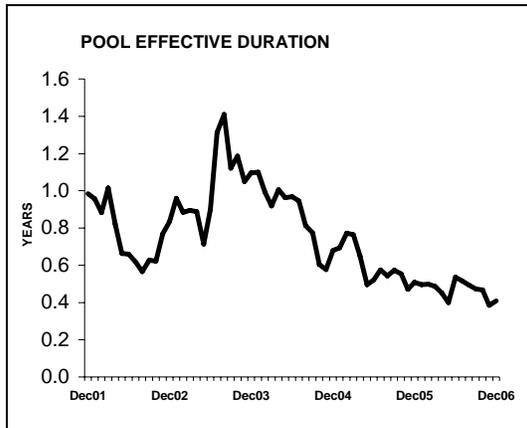
Market Risk: Standard & Poor's has recognized the Pool's conservative investment strategy and low sensitivity to changing market conditions by assigning the Pool a low volatility rating of 'S1'. The Pool limits its exposure to changes in interest rates by managing the effective duration of the Pool. Duration is a measure of a portfolio's sensitivity to changes in interest rates. Portfolios with lower durations are less sensitive to changes in interest rates than portfolios with higher durations. For example, if the yield curve instantaneously shifts by 100 basis points, the market value of a portfolio with a duration of one year will change by approximately 1%. However, a portfolio with a duration of 10 years would see its market value change by about 10%. Ideally, the Pool wants to have a longer duration when rates are falling and a shorter duration when rates are rising.



The Pool's duration and maturity policies help to reduce the variation in the Pool's net asset value. At year-end each \$1 invested in the Pool had a value of \$0.9979. As longer term interest rates decreased during the course of the year, the Pools market value has been generally increasing. The stability of the Pool's net asset value is demonstrated by the low volatility of the Pool's fair value. Over the last seven years the fair value per dollar invested has fluctuated between \$0.99 and \$1.02.

The Pool is managed as two sub-portfolios: the Core portfolio consists of long-term securities with maturities over one year; the Liquidity portfolio consists of securities with a shorter maturity. The average effective duration of the Core portfolio is limited to a range between 1.25

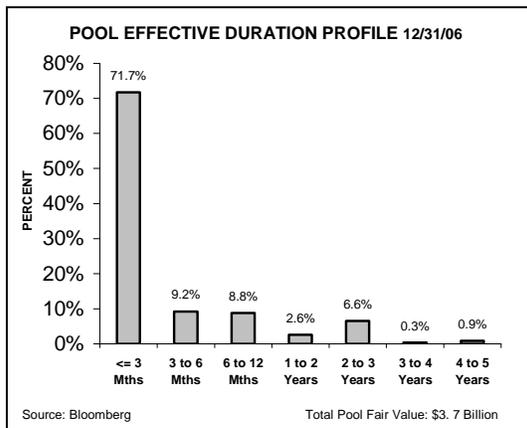
to 3.25 years. Securities purchased in the Core portfolio must have a final maturity no longer than five years. The maximum average duration of the Liquidity portfolio is limited to 120 days.



At year-end, the Pool's combined effective duration was about 0.4 years. Over the prior ten years the Pool's duration has averaged 1.0 years and has ranged from 0.4 to 1.8 years. Because of the rising interest rate environment we have experienced over the last few years, the Pool's strategy has been to keep its duration at the lower end of its historical range. The inverted yield curve has also given us an incentive to keep the Pool's duration shorter because we could earn higher interest rates than we could on longer securities.

The Pool generated nearly \$412,000 in additional income in 2006 from reverse repurchase activity.

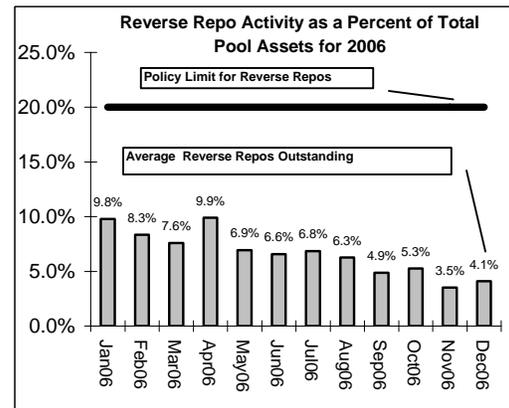
Although the Pool's fair value is calculated on a monthly basis, unrealized gains and losses are not distributed to participants. The Pool distributes earnings using an amortized cost methodology.



Liquidity: The Pool's policy is to maintain sufficient liquidity to meet all anticipated operating requirements. Historical cash flows are used in combination with projected debt service schedules to insure that the Pool has adequate liquidity to

meet all Pool participants' projected needs. At year-end, the Pool had a healthy liquidity position with approximately 72% of the portfolio expected to come due in three months or less.

Leverage: The Pool is authorized to use reverse repurchase agreements. In a reverse repurchase transaction the Pool borrows funds from an approved dealer by pledging securities in its portfolio. It then uses the proceeds of the borrowing to invest in securities that yield more than the borrowing rate. This type of arbitrage transaction generates extra income for the Pool while exposing the Pool to very little risk.



The Pool can only enter into reverse repurchase agreements under the following conservative guidelines:

- No more than 20% of the Pool balance may be reversed out at one time.
- The maturity date of the reverse repurchase must equal the maturity date of the investment.
- The maximum allowable maturity is 180 days.
- Reverses will only be entered into with dealers having a master repurchase agreement with King County.

During 2006, total reverse repurchase agreements outstanding at month-end ranged from 3.5% to 9.9% of the portfolio's total assets—never approaching the 20% policy limit. The Pool generated nearly \$412,000 in additional income in 2006 from reverse repurchase activity. This added 1.2 basis points to the Pool's overall yield during 2006. Ω

For further information or questions regarding King County's Investment Pool, please contact the following individuals:

Mike Smith, CFA
 Investment Officer: 206-296-7311 or Mike.Smith@Metrokc.gov
Scott Matheson
 Cash Mgmt Supervisor: 206-296-7313 or Scott.Matheson@Metrokc.gov

KING COUNTY INVESTMENT POOL PARTICIPANTS

<p>King County All Agencies</p> <p>School Districts Auburn SD No. 408 Bellevue SD No. 405 Enumclaw SD No. 216 Federal Way SD No. 210 Issaquah SD No. 411 Highline SD No. 401 Kent SD No. 415 Lake Washington SD No. 414 Mercer Island SD No. 400 Northshore SD No. 417 Puget Sound ESD No. 121 Riverview SD No. 407 Renton SD No. 403 Seattle SD No. 1 Shoreline SD No. 412 Skykomish SD No. 404 Snoqualmie Valley SD No. 410 Tahoma SD No. 409 Tukwila SD No. 406 Vashon Island SD No. 402</p> <p><i>* Districts joining in 2006</i></p>	<p>Fire Districts Black Diamond Fire District No. 17 Burien Fire District No. 2 Eastside Fire & Rescue No. 10 & 110 Federal Way Fire Department No. 39 KC Fire District No. 20 KC Fire District No. 24 KC Fire District No. 25 KC Fire District No. 27 KC Fire District No. 28 KC Fire District No. 34 KC Fire District No. 37 KC Fire District No. 40 KC Fire District No. 41 KC Fire District No. 43 KC Fire District No. 45 KC Fire District No. 47 KC Fire District No. 50 Mountain View Fire & Rescue No. 44 North Highline Fire District No.11 Northshore Fire Department No. 16 Shoreline Fire Department No. 4 Vashon Island Fire & Rescue No. 13 Woodinville Fire Life & Safety No. 36</p>	<p>Sewer & Water Districts Bryn Mawr-Lakeridge Sewer District Cedar River District No. 108 Coal Creek Utility Covington Water District No. 105 Highlands Sewer District Highline Water District No. 75 KC Water District No. 1 KC Water District No. 20 KC Water District No. 45 KC Water District No. 49 KC Water District No. 54 KC Water District No. 83 KC Water District No. 90 KC Water District No. 111 KC Water District No. 117 KC Water District No. 119 KC Water District No. 123 KC Water District No. 125 KC Water District No. 127 Lakehaven Utility Midway Sewer District Northeast Sammamish Sewer District Northshore Utilities Ronald Wastewater Mgmt District Sammamish Plateau Sewer District Shoreline Water District No. 42 Soos Creek Sewer District Southwest Suburban Sewer District Stevens Pass Sewer District Val-Vue Sewer District Vashon Sewer District Vashon Water District No. 19 Woodinville Water District No. 104</p>	<p>Other Districts Cascade Water Alliance* Cemetery District No. 1 Drainage District No.1 Finn Hill Park District Issaquah Capital Facility Area King County Director's Association King County Law Library King County Library Northshore Parks and Recreation Public Facilities District (Baseball) Puget Sound Air Pollution Control Puget Sound Regional Council Redmond Library Capital Facility Si View Metropolitan Park District Vashon Park District Washington State Risk Pool</p> <p>HMC & Hospital Districts Harborview Medical Center Snoqualmie Valley Hospital No. 4</p> <p>Non-Treasurer Members Evergreen Healthcare (Hospital Dist. 2) Public Stadium Authority (Football) Puget Sound Regional Transit Authority Water & Sewer Risk Management Pool Valley Medical (Hospital Dist. 1)</p>
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**King County Executive Ron Sims
King County Council Chairman Larry Gossett**

**KING COUNTY
2007 EXECUTIVE FINANCE COMMITTEE**

**Bob Ferguson, Councilmember, Chair EFC
Paul Tanaka, County Administrative Officer
Ken Guy, Finance Director
Bob Cowan, Budget Director**

Committee Staff

Phil Sanders, Treasury Operations Manager
Scott Matheson, Cash Management Supervisor
Mike Smith, CFA, Investment Officer

*For further information or questions regarding King County's Investment Pool, please contact Mike Smith at 206-296-7311 or
Mike.Smith@Metrokc.gov*