The King County Investment Pool Advisory Panel

Report on the King County Investment Pool

May 2008

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Summary

The King County Investment Pool Advisory Panel was created by the King County Council for the purpose of undertaking a comprehensive review of the King County Investment Pool.

The Panel interviewed County staff, reviewed written records, consulted with outside sources, and relied on its members' own professional expertise. This review led to a number of findings and recommendations, summarized below.

The Panel recommends that the County take rapid and forceful action to bring its investment function in line with industry best practices.

We find the failure to invest in modernizing the investment function has contributed to significant deficiencies, including:

- Unnecessary exposure to investment and operational risk;
- Inadequate measures of performance and risk;
- Lost opportunities to improve investment results;
- Inherent conflicts of interest within the governing structure;
- Insufficient transparency and communication with management and participants; and
- Inaccurate accounting for participant principal and interest.

Given these deficiencies, the Panel considered whether the County should discontinue operation of the investment pool. However, we believe that the investment pool provides a significant benefit to the taxpayers of King County and should be continued in accordance with industry best practices.

To bring the investment pool in line with industry best practices, we recommend the County focus on three key areas:

1) **Governance:** The investment pool should institute a fiduciary governing structure and clearly identify investment objectives for the pool.

2) **Infrastructure:** The investment pool should make substantial infrastructure and operational improvements in areas including custody, technology, accounting, and credit analysis.

3) **Accountability:** The investment pool should adopt metrics to measure performance and hold management accountable, and it should improve participant communications and transparency.

We recommend outsourcing the management of the investment pool. We believe it is the most cost-effective, efficient, and timely strategy for achieving critically needed improvements. Under an outsourcing model, the County and participants would establish the governing structure, which would set investment policies, select service providers, and monitor performance. However, the day-to-day management of the investment portfolio would be contracted out to a Securities and Exchange Commission registered, fixed-income investment manager.

If the County chooses to continue to directly manage the investment pool, the Panel has identified a set of needed actions. However, the Panel is skeptical that the County's direct management can provide the same results as outsourcing.

We recommend the County act as soon as possible to implement changes in the investment pool's operations. In addition, the County should act immediately to bifurcate the investment pool, creating a separate pool for the impaired investments.[1] This action is necessary to effectively manage and accurately account for the impaired investments.

We recommend that the County Council consider the following actions:

- Create a new governance structure for the investment pool.
- Direct the new governance structure or existing Executive Finance Committee to act as a fiduciary.
- Direct the Executive to create an action plan for bringing the investment pool in line with industry best practices.

[1] As defined by the impaired investment policy adopted by the EFC on December 17, 2007, an investment is considered impaired when: a) its credit quality is rated below investment grade, b) a default has occurred on payment at maturity, or c) an enforcement event, as defined by the investment's program documents, has occurred. At the time of this report, the investment pool holds four impaired investments. See Appendix I – Impaired Investment Policy.

King County Investment Pool Advisory Panel

John Rose, Chair

Mr. Rose is the former President and Chief Executive Officer of Seattle-Northwest Securities Corporation, the region's largest underwriter of bonds. He is also past Chairman and a current member of the Board of Trustees for the Nature Conservancy's Washington State chapter, and he served as the King County Budget Director in the early 1980's. He is the current Mayor of the Town of Beaux Arts Village and a member of the Board of Directors of McAdams Wright Ragen brokerage firm. Mr. Rose is a graduate of Princeton University and pursued graduate studies at The University of Chicago. He has held securities licenses including Series 7, 24, 52, 53, and 63.

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Most recently, Mr. Dobrowolski was the Senior Vice President and Division Executive of Market Risk for Washington Mutual. He has also worked as a Portfolio Manager for GE Financial Assurance, a unit of General Electric, a Financial Risk Management Specialist for the International Finance Corporation, a member of the World Bank Group, and Vice President of Structured Products for Greenwich Capital, a unit of the Royal Bank of Scotland. He has 30 years of experience in capital markets, derivatives, risk management, and portfolio management. Mr. Dobrowolski holds a BS in economics from Rutgers College and has pursued an MS in Economics from the University of London. He has held securities licenses including Series 3, 7, and 63. In addition, Mr. Dobrowolski is a member of the Finance Committee of the Rainier Club and serves on the Management Committee at the Pocock Rowing Center.

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Acknowledgements

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Introduction

The King County Investment Pool

The King County Investment Pool is an approximately $4.5 billion local government investment pool designed to enable King County and other public entities within the County to invest their financial reserves. The investment pool's stated objective is to "attain an acceptable market rate of return for its members throughout budgetary and economic cycles, while preserving and protecting member's capital."[2]

Originally created in 1989 for the purpose of investing County funds, the investment pool is now open to all taxing districts for which King County serves as Treasurer, as well as other public authorities within the County (with the exception of incorporated cities). Today, the pool has nearly 100 participants, including school, fire, sewer, water, library, and other districts within King County, and holds the reserves for approximately 250 separate County funds including Public Transportation, Health and Human Services, and Solid Waste.

Motion 2007-0502: Creating the King County Investment Pool Advisory Panel

The recent financial markets turmoil and the global "credit crunch" have had a direct impact on the King County Investment Pool. Between August 2007 and January 2008, four of the investment pool's holdings in Structured Investment Vehicle (SIV) commercial paper defaulted, totaling $207 million, or approximately 5 percent, of the investment pool's assets. These impaired investments[3] presented the investment pool with unprecedented decisions and raised questions about whether the investment pool's current policies, structures, and systems were sufficiently robust given today's challenging market conditions.

In response, the King County Council passed Motion 12595 in October 2007, creating the King County Investment Pool Advisory Panel. Comprised of three appointed experts from the financial industry, the Advisory Panel was charged with undertaking a comprehensive review of the King County Investment Pool. Specifically, the Advisory Panel was asked to review the investment pool's goals, policies and practices, portfolio, governing structure, and relationship with participants. The Advisory Panel was not asked to determine whether past implementation of the Panel's recommendations would have resulted in different investment decisions in specific cases.

Appointed in November 2007, the Advisory Panel began a series of fact finding briefings in December 2007 with the management team of the investment pool, including the members of the Executive Finance Committee, Finance and Business Operations Division staff, and County Council staff. In January, the Advisory Panel established a targeted work program to ensure that its review covered the relevant aspects of the investment pool. The Advisory Panel then conducted research and additional briefings with County staff, pool participants, and outside experts through May 2008.

[2] Section 210.1, Investment Policies, King County Investment Pool.

[3] As defined by the impaired investment policy adopted by the Executive Finance Committee on December 17, 2007, an investment is considered "impaired" when: a) its credit quality is rated below investment grade, b) a default has occurred on payment at maturity, or c) an enforcement event, as defined by the investment's program documents, has occurred. At the time of this report, the investment pool holds four impaired investments. See Appendix I: Impaired Investment Policy.

This report presents the findings of that research and offers a series of recommendations. Based on best practices in the industry, these recommendations will strengthen the investment pool and enable it to achieve its stated goals in today's ever changing and increasingly sophisticated financial markets. The report is not intended as an audit of past decisions. Rather, the correct usage of this report is prospective. We are recommending changes for the future operations and governance of the investment pool.

The following section presents a high level summary of the report's findings, with the proceeding sections laying out the specific recommendations in greater detail.

Key Findings

It is the view of this Panel that the County's investment function falls short of industry best practices due to insufficient resources, infrastructure, and expert oversight. We recommend that the County take rapid and forceful action to bring its investment function in line with industry best practices.

While the investment pool has served the County and its participants well in the past, generating consistent returns and avoiding material losses, our review found that there is a significant gap between the investment pool's current practices and industry best practices. In the nearly two decades since the pool was formed, financial markets have become significantly more sophisticated, requiring superior systems and tools to manage assets. The investment pool's resources and infrastructure have not kept pace with this growing complexity, with many systems and practices remaining largely unchanged since inception. As a result, today, the Investment Pool is deficient in a number of ways, including:

- Unnecessary exposure to investment and operational risk;
- Inadequate measures of performance and risk;
- Lost opportunities to improve investment results;
- Inherent conflicts of interest within the governing structure;
- Insufficient transparency and communication with management and participants; and
- Inaccurate accounting for participant principal and interest.

Until recently, unusually favorable market conditions, with falling interest rates and few credit problems, have allowed the investment pool to avoid major problems. Today's markets have changed, and the pool's deficiencies increase the risk of a reoccurrence of the recent impaired investment experience. As such, the County should take action to rapidly bring the investment function in line with industry best practices.

We chose industry best practices as the standard by which to evaluate the King County Investment Pool. These are the practices found in the competitive and tightly regulated private sector and demanded by sophisticated and successful private investors. We believe that the County's ratepayers and taxpayers should be served by investment practices that meet the same standards they would expect in the management of their own private funds.

To meet industry best practices, the investment pool must make a number of major changes in three key areas:

1) **Governance:**

   Create a true fiduciary governing body, which provides representation from all participants and enhances the expert advice provided to decision makers. This governing body should set clearly defined goals for the asset management of the pool.

2) **Infrastructure:**

   Substantially enhance the pool's infrastructure, with up-to-date technology, enhanced accounting, consolidated assets with a single custodian, a credit analysis system, improved internal controls, relevant legal expertise, and sufficient staffing to eliminate operational risk.

3) Accountability:

Establish a system of metrics to evaluate investment pool performance and enhance transparency, accountability, and communications with the governing body and pool participants.

To implement these changes, the investment pool has two main options:

1) "Buy It"

We recommend that the County outsource the management of the investment pool. A professional fund manager would have the systems, staffing, expertise, and infrastructure in place to readily manage the investment pool's portfolio in accordance with industry best practices. We believe outsourcing is the most cost-effective, efficient, and timely way to close the investment pool's current gap with best practices.

The "buy it" option maintains the County's control over the investment pool. The investment pool's governing body sets policy goals and explicit guidelines that the professional fund manager must follow. The fund manager is held accountable for the performance of the portfolio. This accountability may reduce the County's liability in this area, while the ability to hire and fire a fund manager enhances the County's control.

The outsourcing option would include a continued need for County staff involvement in the investment function. As the Government Finance Officers Association (GFOA) points out, the County would need to retain its "fiduciary responsibility for the safety and liquidity of government funds."[4] Additionally, County staff would remain responsible for a number of issues, including overseeing the fund manager, coordinating the governing body, ensuring compliance, and carrying out cash management functions.

Our discussions with the County's Prosecuting Attorney's Office indicate that current law, including King County Charter Section 850, would preclude the County from contracting out the investment function as the County Treasurer cannot delegate the responsibility for the investment of funds to a non-County employee.

A discussion with a private law firm with experience working with investment fund managers confirmed that the County currently lacks clear authority to delegate its discretionary investment authority to a third party investment manager. However, there is no restriction on the County's authority to hire an external fund manager to advise the County Treasurer in the selection of investments. In addition, so long as the County does not surrender its discretionary investment authority, the County can use an external manager to execute trades approved by the County Treasurer. While the question of what constitutes approval may require some further study, it will be addressed through familiar tools such as investment policy guidelines and communication on cash flows and trading activity. Additionally, review of existing models of how jurisdictions with similar delegation restrictions contract with external fund managers may be reviewed. In the industry, this type of intermediate relationship is termed an "Investment Advisory" or "Sub-Advised" relationship.

[4] "Selection of Investment Advisors for Non-Pension Fund Assets (2003 and 2007) (CASH)," *Government Finance Officers Association Recommended Practice,* Government Finance Officers Association (March 2, 2007).

We recommend that the County conduct the necessary research and establish an advising relationship with an external fund manager to reap the benefits provided by a manager such as credit analysis, investment research, risk analytics, timely execution of trades, and block trading. This interim step will result in a large improvement over current circumstances. It does not however provide the County and its participants with the full protection of a discretionary investment advisory relationship.

We thus further recommend that the County pursue changes in state law to allow County treasurers to fully delegate their responsibility to invest funds to an external fund manager. The legislative changes could be guided by the existing statute that allows the Washington State Investment Board to delegate discretionary management of retirement plan assets to an external fund manager. We recommend that the County seek action by the state legislature on this issue at the earliest possible date, including the possibility of an emergency bill in the upcoming legislative session to be effective February 2009.

2) "Build It"

Alternatively, the County could "build" up its current in-house investment function, making substantial infrastructure and staffing investments to bring the investment pool in line with industry best practices. Time is a significant drawback to this option, as it may take the County a number of years to acquire the needed staff and infrastructure improvements. Further, the Panel is skeptical that the County's direct management can provide the same results as outsourcing.

If the County pursues the "build-it" option, we recommend that the County outsource elements of the investment function on an interim basis until internal capacity is ready. Additionally, we recommend that the County immediately acquire investment advisory services from an SEC registered investment manager and investment consultant acting in a fiduciary capacity. These interim steps will enable the County to immediately achieve best practices in critical areas, while providing time to conduct a full business review of the investment pool, assess specific needs, and research the feasibility of bringing services in house.

We recognize that under either option the needed changes in the investment pool will likely require increased expenditures. However, the investment pool has a dedicated fee revenue stream that can be used to cover these expenses. Additionally, we believe these expenditures will result in lower risks and enhanced returns, soundly generating additional dollars for all participants.

The report that follows describes our specific recommendations for changes we believe are needed to close the gap between the investment pool's current practices and industry best practices. The report covers:

- Governance
- Investment Goals
- Infrastructure
- Metrics
- External Relations

Additionally, the report provides a number of actions that should be taken immediately in regards to the investment pool's impaired investments. It concludes with a recommendation that the

County establish a plan for bringing the investment pool in line with industry best practices (see page 7) and conduct an in-depth review of the integration of the County's investment function with other treasury and cash management services.

Recommended Elements of King County Investment Pool Action Plan

Impaired Investments:

1) Bifurcate the investment pool.
2) Hire a qualified external manager to manage the restructuring process.

Governance:

In short term:

1) Establish fiduciary responsibility of the EFC.
2) Hire external expertise to guide EFC.
3) Update investment policies.

In longer term:

4) Adopt a new governance structure with fiduciary responsibility that includes representation from non-County participants and industry experts.

Infrastructure:

1) Consolidate assets within one central repository—a bank custodian.
2) Improve accounting procedures and institute an annual outside audit.
3) Hire an external fund manager – "Buy It" – automatically addresses many of the most pressing infrastructure challenges:
   - *Investment Goals:* The manager will work with the investment pool to establish appropriate investment goals and objectives.
   - *Credit Analysis:* The manager will have an in-house credit analysis process and credit analysts.
   - *Technology:* The manager will have access to the latest technology, automating the investment process and reporting.
   - *Metrics:* The manager will work with the investment pool to establish performance metrics and will be held accountable for performing against them.
   - *Staffing:* The manager's staff will eliminate "key man risk," while the manager will have access to legal support.
   - *Internal Controls:* The manager will have a system of internal controls and will work with the investment pool to ensure coordination with in-house internal controls.

Accountability and External Relations:

1) Review fee structure.
2) Improve communications, including enhanced reports and website.
3) Seek reinstatement of a top rating by a Nationally Recognized Statistical Rating Organization.

Governance

We recommend that the Investment Pool establish a governance structure which can act as a fiduciary for all participants.

Background

Currently, the Executive Finance Committee (EFC) is the governing body for the investment pool. Established by the King County Code (4.10.050) as the "County Finance Committee," the EFC is comprised of four statutory members—the County Executive, the Director of the Finance and Business Operations Division, the Director of the Office of Management and Budget, and the Chairperson of the County Council. Under the Revised Code of Washington (36.48.070), the EFC has the authority to approve County investment and debt policy, and it holds monthly meetings to provide policy direction to the Director of the Finance and Business Operations Division. Specifically, the EFC votes on the purchase limits for each type of asset, the maximum average duration of the portfolio, and other investment policies, such as the impaired investment policy adopted in December 2007.

It is this Panel's opinion that the current EFC structure presents three significant challenges:

1) It is not an adequate fiduciary.
2) It does not provide policy makers with adequate access to expert advice.
3) It does not allow representation from all participants.

Fiduciary Responsibility

Industry best practices dictate that the investment pool be governed by a fiduciary body.[5] In 1997, the Government Accounting Standards Board (GASB) issued a statement that identified two types of local government investment pools:

1) *Internal Pools* – All of the investments belong to one government entity. The entity's different funds may be commingled in the pool.

2) *External Pools* – The investments belong to a number of different governmental entities, with earnings allocated to the individual accounts of the various participants. An external pool is sponsored and managed by a private or governmental entity who has the fiduciary responsibility to manage the pool in accordance with a stated investment policy.[6]

Under these definitions, the investment pool is an external pool, and King County has fiduciary responsibility. A fiduciary standard prescribes that the governing body act solely in the interest of pool participants and treat all participants equitably. A fiduciary's responsibilities include:

- Duty to avoid any and all conflicts of interest.
- Duty to act prudently.
- Duty to provide diversification.
- Duty to be accountable to all participants.

[5] These best practices are drawn from the Uniform Prudent Investor Act (UPIA), the Employee Retirement Income Security Act (ERISA), the Securities and Exchange Commission (SEC), and the Government Accounting Standards Board (GASB).
[6] "GASB 31: TECHNICAL REPORT FOR LOGIC," Patterson & Associates, available online at http://www.patterson.net/gasb31.shtml.

Avoid Conflicts of Interest

We recommend that the governing structure be modified to eliminate inherent conflicts of interest.

The current EFC structure presents a challenge in meeting the duty to avoid conflicts of interest. All four members of the governing body are King County representatives. As such, they have an inherent alignment with King County's interests, which may not always match those of other pool participants. For example, King County has an interest in maintaining a sufficient general fund to conduct County business. This interest may influence EFC decisions regarding the amount of general fund revenue spent on pool operations, whether to bifurcate the pool,[7] or the fees charged to participants for investment services. Despite good intentions by EFC members, the structure sets up this conflict of interest, creating at the very least a perception problem for King County and its ability to fulfill its fiduciary duty to act for the exclusive benefit of all participants. These potential conflicts of interest are operational in nature. Investment decisions are made on a pro rata basis for the good of all participants. However, there may be apparent conflicts if the investment pool purchases securities issued by pool participants. We recommend the County prohibit the purchase by the investment pool of securities issued by pool participants.

Act Prudently

We recommend that the governing body be supported by a set of external investment professionals.

A fiduciary is charged with acting as a prudent expert. According to this standard, the investment function duties must be executed under the care, skill, prudence, and diligence of an individual familiar with such matters. A fiduciary who lacks this expertise is required to hire it. While the investment pool is currently managed by an individual with the requisite expertise, the EFC as the governing body should also have this expertise. Comprised of elected officials and appointed County employees, the EFC structure does not provide the needed level of technical and financial expertise to adequately fulfill the duty of a prudent expert.

Provide Diversification

We recommend that the governing body avoid categorical restriction and promote diversification.

Diversification reduces the risk of large losses for investment pool participants, and it is a fiduciary's duty to ensure adequate diversification. As a corollary, fiduciaries are prohibited from categorical restriction. That is, fiduciaries are required to focus on risk and return tradeoff rather than adopt hard and fast rules about investments in particular asset classes. The EFC's recent decision to halt the purchase of commercial paper raises potential conflicts with the duty to provide diversification.

Accountability to All Participants

We recommend that the governing body be held directly accountable to all participants.

With a duty to act in the interest of all participants and to treat all participants' interests equitably, a fiduciary should be held accountable to all participants. The existing EFC structure does not provide the necessary accountability. The members of the EFC are neither selected by nor held directly accountable to the non-County pool participants, whose assets currently comprise approximately 60 percent of the investment pool's portfolio. Additionally, there are no formal

[7] Bifurcation involves creating a separate pool to contain impaired investments. See discussion on page 37.

channels for participants to weigh-in on the policy decisions of the investment pool. The problem of accountability is accentuated by the fact that most participants do not have any practical alternatives to the investment pool—they must either join the investment pool or take on the task of managing their own funds.[8]

Ideal Fiduciary: King County Investment Pool Board

We recommend the creation of a King County Investment Pool Board in order to establish a governing structure that will act as a fiduciary for the investment pool participants. This Board would be independent, with its membership comprised of a balance of stakeholders, including both County and non-County participants. The Board would be responsible for establishing the policies and investment guidelines for the pool, hiring fund managers and other service providers, selecting appropriate benchmarks for the portfolio, and monitoring the performance of the portfolio and its management.

This Board would be supported by professional investment advice from external sources. Given the magnitude of the funds invested in the investment pool and the sophistication of today's financial markets, it is imperative that the investment pool's decisions be informed and guided by high-level financial expertise. Financial professionals can provide expert advice on the selection of asset classes for the investment pool, policies and procedures, the establishment of appropriate benchmarks to monitor performance, and the determination of investment strategy.

Specifically, we recommend that three financial experts be appointed to the Board. We recommend that these appointees be compensated for their service to ensure the Board can recruit the area's leading experts. Additionally, we recommend that the Board retain the services of an independent, registered institutional investment consultant to provide objective financial advice. This individual can present the latest investment pool data and its relationship to the established benchmarks, ensuring that the Board can adequately assess the pool's performance and hold managers accountable. The consultant would also monitor and update investment policies, ensuring that the investment pool stayed current with changing industry best practices.

Depending on the County's decision to "build" or "buy," the policy direction of the Board would be executed by either King County's in-house investment function or an external fund manager.

Other Options

We recognize that the creation of the King County Investment Pool Board as described above would represent a departure from current practice and may require changes in state and local statutes. We believe it is imperative for the governing body to quickly move towards a fiduciary structure, specifically by reducing potential conflicts of interest and enhancing the presence of financial expertise in the decision making process. As such, we recommend that the County Council consider pursuing modifications in the relevant statutes to allow this new governing structure.

Additionally, in the short term, the County could consider:

- Extending EFC membership to representatives chosen by pool participants.

[8] For participants for whom King County serves as Treasurer, investments must be placed through the County. Participants can either join the investment pool or direct the County to place individual investments on their behalf.

- Adopting a motion that explicitly charges the EFC with fiduciary responsibility for the investment pool.
- Hiring a registered institutional investment consultant, acting in a fiduciary capacity, to provide expert advice to the EFC.
- Appointing financial experts to serve as an on-going advisory committee to the EFC.

In sum, we recommend that the County pursue the necessary steps in both the short term and the long term to create a governing structure that can adequately act as a fiduciary for all investment pool participants.

Investment Goals

We recommend that the investment pool governing body clearly define investment goals for the pool.

Background:

The Government Finance Officers Association's Recommended Practice report on Local Government Investment Pools (LGIPs) cites two basic portfolio types:[9]

1) *Constant Net Asset Value Funds:*
   Like a money market mutual fund, these investment pools provide investors with a constant Net Asset Value (NAV) of $1. Known also as "dollar in, dollar out" funds, these pools invest in short term, lower-risk securities, and experience no change in the dollar value of investors' principal. These investment pools prioritize liquidity over higher returns.

2) *Variable Net Asset Value Funds:*
   By contrast, this type of investment pool seeks to achieve higher returns, with liquidity being a lower priority. These pools invest in longer-term securities, resulting in greater fluctuation in the dollar value of each investor's principal as interest rates change. Investors cannot expect that a "dollar in" will equal a "dollar out" and must have reduced liquidity constraints.

The GFOA recommends that potential investors pay close attention to the investment goals of a prospective LGIP to determine whether the pool operates as a constant or variable NAV fund. This information is "essential" to assessing whether a pool is appropriate for a liquidity or long-term strategy.

King County Investment Pool: A Hybrid

The King County Investment Pool operates as a hybrid of these two types of funds by managing two portfolios with separate goals within the investment pool:

1) *Liquidity Portfolio* – This portfolio is managed similarly to a constant NAV, or money market, fund and is designed to meet liquidity needs.

2) *Core Portfolio* – This portfolio has investments in longer term securities, although unlike other variable NAV funds, this portfolio is not marked-to-market daily.[10] The core portfolio is divided into two subfunds: 1) a short term bond fund and 2) a mortgage-backed securities fund.

To the participants of the investment pool, this portfolio distinction is not apparent. Participants do not choose one portfolio or another; their funds are in both and performance reports show one fund.

[9] "Use of Local Government Investment Pools (LGIPs) (2007) (CASH)," *Government Finance Officers Association Recommended Practice,* Government Finance Officers Association (March 2, 2007).
[10] Longer term securities are held at amortized cost using straight line amortization, rather than the more accurate scientific amortization.

What is Marking-to-Market?

Marking-to-Market is the practice of periodically adjusting the value of a portfolio's investments to reflect any changes in their fair market value. The fair market values are obtained from a reputable independent source and marked-to-market reports are shared with participants and the governing body. By valuing investments at their current price, marking-to-market provides a picture of the portfolio's liquidation value. That is, if all investments had to be sold today, how much cash would they generate?

Example: An investor purchases a 5-year Treasury Security with a 5 percent coupon and a $1 million par value. This security pays 5 percent, or $50,000, in annual interest income over its life, and will return $1 million in principal at the end of the 5 years. Suppose however, that several months after the purchase, interest rates have risen to 6 percent, making this security less valuable. According to an independent source, the investor determines the market value of his security is now $930,000. While the investor will still receive $1 million at the end of 5 years, if the security had to be sold today, it would only generate $930,000. For accounting purposes, the security should then be reported on the balance sheet at its fair market value of $930,000, representing a $70,000 marked-to-market loss.

This unrealized loss, or "paper loss," may cause some discomfort among investors. However, transparency in investment accounting is essential to understanding the risks in any portfolio. Discomfort can be alleviated through education.

Source: Anastopoulos, Sofia, *Investing, An Elected Official's Guide.* Government Finance Officers Association, 2007.

It appears this hybrid portfolio structure creates confusion about the investment pool's investment objectives. The County is attempting to achieve the goals of both types of funds—participants enter and exit the pool on a "dollar in, dollar out" basis, while investments are made in longer term securities to achieve a higher return. The mixed strategy results in neither strategy being executed well. There are not sufficient controls to ensure a constant NAV of $1, while the returns fall short of most variable NAV funds.

1) County fund managers view the pool as having elements of both a variable NAV fund and a constant NAV fund. The investment pool does not promise its participants that a "dollar in" equals a "dollar out." However, in practice, participants deposit and withdraw funds under "dollar in, dollar out" assumptions. Despite this practice, no procedures are in place to ensure a constant NAV, and assets are invested in longer term securities that are not consistent with a constant NAV strategy. Additionally, the investment pool does not perform either a weekly mark-to-market, which would be best practices for a money fund, or a daily mark-to-market, which is required of a variable NAV fund.

2) Pool participants view the investment pool as both. Participants expect to receive a dollar out for every dollar they put in. However, they also expect the higher returns that are provided by investing in longer term securities that are only appropriate for a variable NAV portfolio.

3) Third party experts recognize that the investment pool cannot be both. Standard and Poor's rating agency rated the investment pool as a short term bond fund (AAAf) with a variable NAV. It was not rated as a $1.00 money market fund (AAAm). This distinction does not appear to have been communicated with participants.

Choose one

The risks associated with earning higher returns are not consistent with the risks that should be undertaken when maintaining a constant NAV of $1. The relatively benign interest rate and credit environment of the past decade have enabled the County to operate this hybrid structure without incident,[11] successfully balancing the competing liquidity and return expectations of participants. However, this hybrid structure presents a problem in the face of credit and market risk.

We recommend that the investment pool replace this hybrid structure with either a money market fund with a constant NAV of $1.00 or an "enhanced cash" fund with a variable NAV:

- Money Market Fund: Moving to a money market fund, or constant NAV fund, would enable participants to expect a dollar out for every dollar they invest. Participants would receive a lower expected yield compared with a variable NAV fund, and the fund could no longer make long term investments. To manage a money market fund in line with GASB and best practices, the investment pool must adopt weekly (rather than monthly) marks-to-market to monitor the NAV. If the variation between the mark-to-market value and the constant NAV level of $1 varies by more than $0.0025, policy guidelines should require an appropriate course of action to bring the value back to $1.

- Variable NAV fund: Moving to a variable NAV or short-term bond fund structure would yield higher returns for participants. To manage an "enhanced cash" or short-term bond fund in line with best practices, the investment pool would require enhancements including the adoption of daily (rather than monthly) mark-to-markets to calculate the NAV. Given the increased price volatility and sophistication required to manage a variable NAV fund, we recommend this option only be chosen if the County outsources the management of the investment pool.

In our discussions with finance staff, a concern was raised that participants may be wary of the volatility involved in a variable NAV fund. Participants may not tolerate short term losses to achieve longer term gains. Loss aversion can be reduced by educating participants and ensuring that their views are aligned with the objectives of the investment pool. For example, we find that the investment pool is already subject to the volatility of a variable NAV fund. S&P assigned the investment pool a volatility rating of S1, indicating that the investment pool has an aggregate risk level equivalent to a portfolio comprised of government securities maturing within 1.8 years. If participants' appetite calls for less risk, volatility should be reduced to S1+, indicating a level of risk commensurate with a portfolio of government securities maturing in one year or less. [12]

Additionally, a reserve fund could be established to manage losses. Each year, a portion of the pool's fees could be allocated to this reserve fund, and the fund could be used to offset any realized losses in the investment pool, helping to smooth volatility over time.

Alternative Option: Operate Two Funds

We also considered the option of two separate funds: a constant NAV fund and a longer term variable NAV fund. Each fund would have separate and distinct goals, and participants would

[11] According to information provided by Finance Staff, the current impaired investments are the only major incident to date in the life of the investment pool.
[12] "Funds Rating Criteria: Fund Volatility Rating Criteria," Standard and Poor's (February 2, 2007).

allocate their funds between the two. Each fund would be reported separately and appropriate benchmarks would be chosen for each. The major benefit of this structure is that it would eliminate a "one size fits all" portfolio set up, enabling participants to address their particular liquidity needs and appetites for risk.

Discussions with Finance Staff uncovered several potential disadvantages to this structure:

1) *Internal Arbitrage*
   Participants could take advantage of the two different rates of return by transferring money between the funds. This problem could be fixed through a series of rules that would make arbitrage difficult.

2) *Operational Constraints*
   Running two separate funds would be more complicated and require accounting and portfolio management system upgrades.

3) *Cash Management Concerns*
   Allowing districts to allocate holdings between two funds would require more input from districts and require districts to pay closer attention to their cash needs.

4) *Arbitrage Law:*
   Federal law limits the returns that governments can retain from the investment of tax-exempt bonds proceeds. As a result, participants often do not value greater returns on their capital funds. By contrast, they want to maximize return on their operating funds, which face liquidity constraints. As such, the two fund structure may not meet the needs of participants.

Educate Participants

We recommend that the hybrid approach be abandoned in favor of a structure with a clear set of investment objectives. Once chosen, an education campaign should be undertaken to ensure that all relevant parties are aware of the investment objectives. Participants must have realistic expectations for liquidity and returns and a greater sense of the risks present in the portfolio. Together, clear investment objectives and better informed participants will enhance accountability.

Infrastructure

We recommend that the King County Investment Pool's infrastructure be brought in line with industry best practices.

Specifically, we recommend:

- *Technology upgrades to automate reporting and certain aspects of the investment process.*
- *Consolidation of assets within one central repository, or custodian bank.*
- *Establishment of a credit analysis process.*
- *Development of improved internal controls.*
- *Updated written investment pool policies and procedures.*
- *Improved staffing structures to eliminate operational risk.*
- *Improved accounting procedures.*
- *Institution of an annual outside audit.*

Background: The Daily Investment Process

Currently, the investment process is comprised of 5 steps, each of which is carried out by the County's Investment Officer (IO) each business day.

The Daily Investment Process

1) *Review Cash Profile:*
   Each day, the Investment Officer (IO) analyzes the investment pool's "cash profile," assessing how much cash is available to invest. To conduct this analysis, the IO reviews a manually-created spread sheet that consolidates data from a number of sources, enabling the IO to track historic cash flows and balances.

2) *Determine Liquidity Needs:*
   Once the amount of available cash is determined, the IO assesses whether there are any immediate cash needs among pool participants or County funds and adjusts the cash profile accordingly.

3) *Perform Market Analysis:*
   Now ready to invest, the IO reviews potential purchases, screening multiple data sources to determine the current security offerings of various banks and dealers. Although portfolio yield maximization is desired, it is not the ultimate deciding factor. A higher yield must be balanced by duration, diversification, and credit quality goals.

4) *Check Policy Constraints:*
   Once purchase options are identified, the IO verifies whether each of the options is eligible for purchase under the investment policies and diversification and duration limits of the portfolio. The yields and credit risk ratings of eligible purchases are then compared, with the IO identifying those securities with the greatest marginal benefits.

5) *Purchase Securities:*
   With the analysis complete, the IO purchases the security through a bank or broker dealer. After the trade is executed, the Cash Management Supervisor signs off on the trade before it is passed to the investment assistant for settlement.

Our review of the daily investment process and its supporting infrastructure led us to a number of recommendations to help the investment pool close the gap with industry best practices.

Technology:

We recommend investments in technology to automate portions of the investment process and reporting.

It is the Panel's opinion that the investment pool's technology is 12 to 25 years behind current industry standards. The outdated technology hampers every aspect of the investment process from decision making and portfolio optimization to accounting, reporting, and communications.

Investments in technology will benefit the pool by:

- Optimizing returns
- Providing improved and faster reporting
- Reducing operational risk
- Increasing staff productivity
- Eliminating paper waste

Automate the Daily Investment Process

The investment pool should automate its daily investment process and portfolio management system. Currently, investment positions must be manually integrated into a single spreadsheet in order for the IO to have a complete picture of the pool's portfolio. This reliance on manual input requires significant staff time, introduces operational risk into the portfolio, and reduces opportunities to optimize returns.

More specifically, the cash profile and liquidity assessment steps depend on historic, rather than real-time, data, which could result in inaccurate assessments of the available cash balance. A participant's past spending patterns may not be an accurate predictor of future spending, particularly as spending may include large capital projects. At the market analysis stage, the decentralized sources of data can lead to a sub-optimal set of purchase options, while the lack of "real time" credit information can contribute to the purchase of riskier investments. The manual nature of the policy constraint check is subject to human error, potentially resulting in policy violations. Finally, the manual integration of all of the components of the portfolio requires valuable staff time, with the IO spending several hours each day compiling reports, rather than analyzing the market and portfolio.

In short, the investment pool's current practices are not consistent with best practices for managing portfolios of comparable size, and technology upgrades are needed as soon as possible. Specifically, the investment pool should have automated cash reports, daily mark-to-markets, and portfolio reporting systems. Additionally, the pool should invest in portfolio management software that generates an expanded number of performance measures, including convexity, volatility, and credit, to create a more comprehensive assessment of optimization and risks.[13] In essence, the IO should receive a set of timely, comprehensive reports that show precisely how much money is available for investment. Freed from manual data entry, the IO can then focus his or her time more productively on investing.

In addition, investments in technology will reduce the need for printouts and faxes, eliminating paper waste, saving energy, and lowering the County's carbon footprint.

"Build" vs. "Buy"

The recommended technological investment brings the "build it" or "buy it" question into sharp focus. The County can either "build" the technological infrastructure by purchasing the various systems and software requirements. Or, the County can "buy it," contracting with an external service provider, such as a registered investment manager or a custodian, who has these system capabilities in place.

"Buying" this technology provides a number of benefits over "Building":

- Immediacy: The investment pool needs to implement this technology as soon as possible. Contracting with an external service provider can quickly achieve this goal, while buying these systems and hiring and training internal staff to use them will be a longer process.

- Support: By contracting out, the County would not incur the costs of supporting the technology, including trouble-shooting, installation, or system failure.

- Automatic Upgrades: The investment pool would automatically benefit from any enhancements to the systems without having to purchase upgrades. Given the speed of innovation in the financial industry, this benefit is significant.

- Cost Recovery: Rather than competing for general fund dollars to make a capital investment in technology, contracting out for these services would be included in the operating budget of the investment pool and covered by investment pool fees. These costs would not be vulnerable to annual County budget decisions, but would instead become part of an essential service.

- Potentially Lower Costs: External management fees will tend to decline over time as private sector competition drives down fees and the external manager's asset base continues to grow, reducing its "per unit" costs.

Given these benefits, we recommend that the investment pool "buy" these technological services.

[13] Although outside the scope of our report, upgrades to the treasury and banking functions would increase the availability and reliability of real time data for investable cash.

Custodian Bank:

We recommend that the investment pool consolidate all assets in a single custodian bank.

A custodian bank is a third-party bank that safeguards financial assets and provides services including pricing, arranging the purchase and sale of securities, collecting interest income on assets, managing cash transactions, and providing reports on all transaction activities. The use of a single custodian is best practice in the industry. According to the GFOA, "holding securities in a centralized fashion makes reporting, tracking, and reconciliation easier."[14]

Currently, while the investment pool has a custodian bank, all assets are not held in this single repository. For example, bank deposits and tri-party repurchase agreements are run through numerous banks, with staff managing 5 or more bank accounts at any one time. This set up creates a fractured reporting environment, creating auditing and reconciliation challenges. Additionally, multiple accounts must be manually compiled to create an overview of the portfolio, reducing productivity and increasing the risk of clerical error.

Additionally, because the investment pool does not have all of its assets with a single custodian, it cannot effectively utilize many of the services provided by custodian banks. For example:

- *Cash Sweep*[15] – Custodian banks offer an automatic sweep of cash each day into an over-night interest bearing account, ensuring that all dollars are invested each night. Currently, the investment pool is not using this automatic function, rather relying on a manual process to invest residual cash. This manual system is subject to clerical error and operational risk, potentially reducing returns.

- *Mark-to-market pricing* – Custodian banks offer periodic mark-to-market pricing of a portfolio, providing an external check on the value of the portfolio. The County is not currently taking full advantage of this important quality control opportunity.

- *Compliance reporting* – Custody systems provide compliance reporting to ensure that all purchases conform to investment policies. Some systems include the ability to prohibit execution of non-complying trades. The current investment process does not utilize this service, relying on a manual check by the Investment Officer during the investment process.

- *Securities Lending* – Custodian banks have securities lending programs that could better facilitate the investment pool's use of reverse repurchase agreements, leading to higher returns and superior risk controls.

[14] Anastopoulos, Sofia, *Investing: An Elected Official's Guide*, Government Finance Officers Association (October 2007) 74.

[15] The most commonly used cash sweep vehicles are money market mutual funds. According to Finance Staff, use of these funds is prohibited by Washington State law. Our research indicates that Washington State stands alone in its prohibition of mutual funds. However, even if use of mutual funds is prohibited, we find that custodians can provide bank deposit and tri-party repo cash sweeps.

Trade Date Accounting

We recommend that the investment pool adopt trade date accounting to accurately reflect total pool assets, enhance trading opportunities, and enable the pool to obtain the highest quality custodial service.

Despite the size of the investment pool's portfolio, our research found that a number of the industry's top custodians would not accept the investment pool's business due to the pool's use of settlement date accounting. Trade date accounting (not settlement date) is best practice in the field because it accurately reflects the total assets legally owned (see sidebar). The investment pool's use of settlement date accounting generates more risk than the industry's best custodians, or the County, should entertain.

Settlement Date vs. Trade Date Accounting

Settlement date accounting records transactions on the date the purchase is paid for or the sale proceeds are received (the settlement date). Trade date accounting records transactions on the date that they are entered into (the trade date).

Trade date accounting is best practice for the accounting of financial instruments. It enables an entity to have an accurate picture of its holdings. For example, suppose a $1 million security has been purchased through a trade, but not yet settled. Settlement date accounting would inaccurately show that that $1 million was still available for investment. By contrast, by showing the pending purchase, trade date accounting would recognize that that sum is committed. Settlement date accounting would inaccurately state the holdings of the portfolio by not including this new security. Trade date accounting would state the holdings accurately and correctly state the pool's cash position.

Trade date accounting is especially important on the West Coast, where the local time is three hours behind East Coast financial markets. The time difference makes "same day" settlement less attractive due to the risk that securities will not be delivered in a timely manner. Additionally, many high quality securities are not available on a same day settlement date basis, limiting the universe of potential securities, and in turn, potential returns. To minimize risk and maximize return, the investment pool should have the ability to make trades where the trade and settlement dates are not the same, making trade date accounting imperative.

Credit Analysis Process

We recommend that the investment pool develop an internal capacity to analyze credit.

Credit analysis is the process of evaluating the creditworthiness of a security issuer. That is, before making an investment, credit analysis determines the counterparty's ability to pay principal and interest in a timely manner.

Best practices in the money market industry dictate that credit quality assessments should be based on two tests:

1) An objective test, such as the ratings issued by a Nationally Recognized Statistical Rating Organization (NRSRO), and

2) A subjective test, based on the credit analysis performed by the investment manager's staff.

Both elements are vital. While ratings provide a valuable indicator of the credit risk of an asset, they cannot tell the full story. For example, suppose security X and security Y are both assigned the same rating, but security Y offers a higher yield. Given that higher yields may be correlated with higher risks, the rating alone does not provide sufficient information to evaluate the marginal benefit of each security. Internal credit analysis enables the IO to differentiate between these assets and make a subjective decision on which one best fits the investment objectives.

The investment pool's current credit analysis system is not consistent with these best practices or with the regulatory requirements governing SEC registered money market mutual funds. The investment pool primarily depends on a security's credit rating as assigned by one or more of the NRSROs—Moody's, Standard and Poor's, or Fitch—to assess its risk and return. The investment pool does not subscribe to any of the NRSROs, and instead, the IO relies on secondary sources for these ratings. The process does not include a subjective test.

To come in line with best practices, the investment pool should substantially enhance its credit analysis capability. This step would provide a necessary level of credit risk protection for investment pool participants. Additionally, more comprehensive credit analysis is likely to lead to better returns.

A credit underwriting process should include several components:

1) *Credit Analysts*
Given the size of the portfolio and its asset types, the investment pool should have access to at least 2 to 3 full time credit analysts to analyze counterparties. At a minimum, these employees should have earned a CPA and/ or CFA designation and have five years of experience.

2) *Credit List*
The investment pool management should have an approved credit list, reflecting those securities that have been determined to be good credit risks and approved for purchase. Credit analysts recommend which counterparties should be included on the list. A credit committee approves the names on the list.

3) *Credit Committee*
A credit committee comprised of fixed income experts should meet at least monthly to review and approve the credit list. Procedures should be established for emergency, intra-period meetings.

4) *Data Analytics*
The credit analysts should have access to the data and market information needed to perform a robust credit analysis on each of the securities and asset types in the pool's portfolio. The investment pool should subscribe to the data and analytic services provided by the NRSROs.

As with other infrastructure elements, the investment pool could chose to "build" or "buy" this credit analysis system. If the investment pool hired an external fund manager, the manager would

perform credit analysis as part of its contract. If the pool decided to build this capability, several credit analysts would need to be hired, a credit committee of fixed income experts formed, and data analytics purchased.

Of note, credit analysis is needed whether the investment pool employs an "active" management strategy or a more "passive," buy-and-hold strategy. While it may be tempting to assume that passive strategies do not require the same attention as active strategies, credit analysis is arguably more important in a passive strategy where a portfolio holds investments until maturity, extending the time the portfolio is exposed to a particular credit risk. Moreover, under either strategy, the portfolio manager must pay close attention to credit and other risk analytics.

Active vs. Passive Investment Strategies

Active Investment Management: "a dynamic management approach that attempts to identify opportunities that will enable the portfolio's return to beat the market."

Passive Investment Management: The goal of this strategy is to "attain an average market rate of return." A "buy and hold" strategy is an example of passive management. This strategy involves purchasing securities and holding them to maturity, rather than actively trading them at an earlier date.

Source: Anastopoulos, Sofia, *Investing, An Elected Official's Guide,* Government Finance Officers Association, 2007.

Internal Controls

We recommend that the investment pool develop improved internal controls.

Internal controls are vital to protecting public funds against potential malfeasance or inappropriate decision-making. We recommend that the investment pool review its system of internal controls to ensure that it includes the following elements:

1) Regularly updated written investment procedure guidelines. According to the Government Finance Officers Association (GFOA), these written investment procedures should "detail the steps of the investment process, the level of authorization needed for each step, as well as the types of investments allowed."[16] GFOA further recommends that these procedures be reviewed annually and periodic surprise audits conducted. The Pool does not appear to have specific procedure guidelines. Some elements of these guidelines are contained in the investment policies, which have not been updated since 1997. In 2006, the investment pool provided a description of procedures to Standard and Poor's rating agency as part of the rating process.

2) Segregation of duties. According to GFOA, "having one person perform all aspects of the investment transaction increases the government's exposure to fraud as well as inaccurate reporting." As such, the investment, credit, reporting, and accounting functions of the investment pool should all be separated. The daily investment process should be handled by more than one staff person, reports verified by someone other than the purchaser of securities, and periodic mark-to-market valuations of the portfolio should be conducted by an outside party. Currently, the investment pool's investment officer is solely responsible for the bulk of these duties.

[16] Anastopoulos 71.

3) Written contracts for all service agreements. The investment pool should maintain up-to-date written agreements with any broker-dealers, custodians, investment advisors, and banking services providers with which it conducts business. Scheduling an annual review of service agreements will ensure compliance.

Investment Policies:

We recommend that the investment pool update its written investment policies.

The Government Finance Officers Association (GFOA) strongly advocates that each government establish a well-written investment policy that is updated regularly. Such a policy provides "the foundation for investing by assigning responsibility, identifying objectives and risk parameters, and addressing issues involving the investment process." GFOA further views an investment policy as a "working document" that invites a government to carefully consider its investment goals and organize its investment function to reach those goals. As such, governments should review and update their policies once a year.

The last major review of the King County Investment Pool's investment policies was conducted in 1997. We recommend that the investment pool review and update its investment policies as soon as possible and add a provision that requires a review at established intervals.

While we did not perform a comprehensive review of the investment policies, we would recommend that the County revisit its policies in the following areas:

- *Standard of Prudence* –Ensure the adopted standard matches the prudent investor rule established by the Uniform Prudent Investor Act of 1994.
- *Investment Instruments* – In accordance with the Uniform Prudent Investor Act, the "legal list" approach to authorized investment instruments and purchase limits should be replaced with a guidelines-based approach.
- *Pool Structure* –Update this section to reflect any changes resulting from the recommended adoption of investment goals.
- *Performance Measurement and Reporting*– Enhance this section (see Metrics p. 27).
- *Dealer Selection Policy*–Enhance this section to include better metrics and clear criteria for evaluating dealers with whom the pool conducts business.
- *Diversification Policy*—Enhance and update this section to include an explicit statement of risk tolerance and defined parameters to manage risk. In line with best practices, we recommend the policies be changed to prohibit the purchase of individual debt obligations issued by the county or any participant.
- Several new sections are needed:
    - *Governance*
    - *Credit Analysis Process*
    - *Credit Support Agreement Policy*

Of note, in our discussions with Finance staff, we learned that existing Washington State law may impede the County's ability to update the investment policies to include the purchase of financial instruments that would be in accordance with best practices for comparable investment pools. These instruments include money market mutual funds, out-of-state negotiable CDs, medium term notes, taxable out-of-state revenue bonds, and a greater allocation to commercial paper. We recommend that the County pursue changes in state law to update the relevant RCWs.

Accounting

We recommend that the investment pool adopt the accounting practices established by the Securities and Exchange Commission for similar fund types. Additionally, we recommend an annual audit of the investment pool.

Adopt SEC Accounting Requirements

Local government investment pools are exempt from the regulatory requirements of the Securities and Exchange Commission (SEC) due to a governmental exclusion clause.[17] While this exemption allows the investment pool more flexibility, participants are not protected by established regulatory standards. To reduce participant risk, we recommend that the investment pool adopt the accounting and other required SEC practices of funds with investment objectives similar to those of the investment pool.

For example, if the investment pool moves to a constant NAV or money-market type fund, the pool should run its accounting according to the best practices established by the SEC. Money market mutual funds are subject to rule 2a-7 under the Investment Company Act of 1940, which limits their investments to high quality, short-term, U.S. dollar-denominated debt instruments. These funds are required to maintain a dollar-weighted average portfolio with a maturity of not more than ninety days, and generally may not purchase instruments with maturities of more than 397 days. All of these policy constraints help to ensure that the portfolio's NAV will not drift from a value of $1.

Valuing the Portfolio

When valuing the portfolio, we recommend the pool adopt accounting methodology that is consistent with its chosen investment goals.

If a variable NAV structure is chosen, we recommend that the value of the portfolio be determined through mark-to-market. Marking-to-market is considered best practice accounting in the financial industry for longer-term portfolios.

If a constant NAV, or money fund, structure is chosen, amortization and accretion may be used to determine the investment value of securities. A weekly mark-to-market pricing procedure should also be adopted for accounting purposes. The investment pool may choose to mark to market daily for risk management purposes.

Amortization and Accretion

When a security is bought at more than its face value, a part of this premium is periodically written off through *amortization* in order to bring the value of the security to face value, or par value, at maturity. For securities purchased below face-value at a discount, the reverse is true and is called *accretion.*

Currently, the investment pool uses straight-line amortization and accretion. According to accounting staff, the County's systems support scientific amortization, but it has never been used. In accounting, scientific amortization is preferable to straight-line amortization because it more accurately reflects the movement of securities towards their maturity date. This improved accuracy reduces the risk that the portfolio is inaccurately priced. Given the improved accuracy of the scientific method, we recommend that the investment pool use scientific amortization.

[17] "Use of Local Government Investment Pools (LGIPs) (2007) (CASH)" *Government Finance Officers Association Recommended Practice,* Government Finance Officers Association (March 2, 2007).

Annual Audit

We recommend that the investment pool receive a periodic audit by an auditing firm that has specialized knowledge of SEC registered fixed income mutual funds.

Currently, the investment pool receives an annual audit from the state auditor as part of the state's audit of the County's overall financial statements (RCW 43.09.260). While this audit is beneficial, we believe that the investment pool would benefit from an audit focused solely on the investment pool. This audit should be conducted periodically by an outside auditing firm with a substantial fixed-income mutual fund auditing practice. These audits would likely result in process improvements and ensure that investment pool practices are current as financial markets and accounting principles evolve. Best practice in the industry would call for an outside audit every year.

We further recommend that this annual audit become a part of the contractual agreement with investment pool participants to ensure it is regularly carried out.

In addition to an annual outside audit, we recommend that the County institute periodic internal control audits. According to the GFOA, these audits are considered a vital part of the internal control process for the investment function. Specifically they help to "verify that controls are functioning properly and in compliance with the investment policy."[18]

Timeliness of Reporting

We recommend the investment pool produce more timely reports for participants.

Following the end of each month, a participant's yield is calculated and reported. In the industry, these reported yields are available on a next day basis. The King County investment pool does not report participant yields for up to two weeks after the end of the month. Our discussions with Finance staff revealed that this reporting delay is largely due to technological constraints. We recommend these constraints be removed, and the investment pool institute timely monthly reporting.

Staffing

We recommend that the investment pool reexamine its staffing model to eliminate "key man" risk and ensure sufficient legal support.

Key Man Risk

Currently, the investment process depends on the operational and investment knowledge of the Investment Officer (IO). This set up introduces a large degree of "key man" risk. That is, if something should happen to the IO, operations would be in jeopardy.

The pool's "key man" risk is somewhat mitigated through staffing, with a Cash Management Supervisor who can perform the IO's duties. When the IO is not available, the Cash Management Supervisor assumes responsibilities for portfolio management. Care is taken to ensure that absences are coordinated between the two positions, with vacation time, for example, scheduled

[18] Anastopoulos 76.

appropriately. However, should the Cash Management Supervisor and IO both be unable to perform the investment function, the County does not have another staff member who is adequately trained to assume the duties.

Further, the IO is a Chartered Financial Analyst (CFA), and best practices would dictate that the IO's back-up also hold this credential. Currently, the Cash Management Supervisor position is not required to be a CFA.

The County should reexamine its staffing models to eliminate "key man" risk. Hiring additional staff and cross-functional training can help alleviate some of the risk. In the context of the "build it" or "buy it" decision, our recommendation to hire an external fund manager, who would have a large staff, would eliminate this risk.

Legal Support

The investment pool's current legal support is provided by the King County Prosecuting Attorney's Office. It is our understanding that the PAO does not have a securities and trust law specialist—a specialty that is invaluable when dealing with the legal questions that are likely to arise in the context of the investment pool.

We recommend that the investment pool enhance its current legal support structure, either by budgeting sufficient funds to obtain specialized legal counsel or by contracting with an external fund manager who will have specialized counsel both in-house and through contracts with external firms.

Metrics

Metrics are parameters used to measure a process and its results. A system of metrics establishes a procedure for quantifying, measuring, and interpreting results. When applied to investment portfolio management, metrics enable:

1. An ability to measure the performance of investment decisions,
2. A quantification of the risks in a portfolio's holdings,
3. A quantification of "what if" scenarios, and
4. An identification of returns adjusted for risk.

Our review found that the investment pool's current metrics framework is inadequate, simplistic, and potentially misleading. As a result, it is difficult to assess the performance of the pool.

We recommend that the investment pool immediately implement a set of metrics that produces transparency regarding risk and expected returns and enables appropriate performance measurement.

As the investment pool develops its set of metrics, we recommend that the investment pool seek guidance from the SEC and the Global Investment Performance Standards developed by the CFA Institute. Representing best practices in the field, these organizations offer standardized, international, and industry-wide principles that provide investment managers with guidance on how to calculate and report investment results, enabling comparison across the industry. Verification and accuracy are importance elements stressed by both organizations.

Performance Metrics

Performance metrics are a valuable tool for quantifying and analyzing the results of the investment decision-making process. They allow an unbiased quantitative assessment of the investment activities undertaken by the investment manager. We find the investment pool's current performance metrics to be inadequate:

- The chosen benchmarks are inappropriate.
- The chosen risk metrics are simplistic.
- The current reports are insufficient.

Benchmarks

We recommend the investment pool adopt one market benchmark and one peer universe benchmark for the entire portfolio. The chosen benchmarks should be consistent with the pool's chosen investment goals.

A key component of performance metrics is the establishment of benchmarks, or targets, against which portfolio performance can be measured. Currently, the investment pool's portfolio is measured against three benchmarks, one for each of the three "sub" portfolios of the investment pool:

Benchmark

A benchmark is a standard against which a security, investment portfolio, or investment manager can be measured.

A benchmark is typically an index of securities or average of portfolios that have similar credit, asset, and duration characteristics of the entity being measured.

- The liquidity portfolio is measured against the Washington State Local Government Investment Pool (WALGIP) and the IBC/ Donoghue Money Fund Report.
- The core portfolio is measured against the Merrill Lynch 1-4.99 Year Treasury Index.
- The mortgage-backed portfolio is measured against the Merrill Lynch 0-5 Year WAL Mortgage Index.

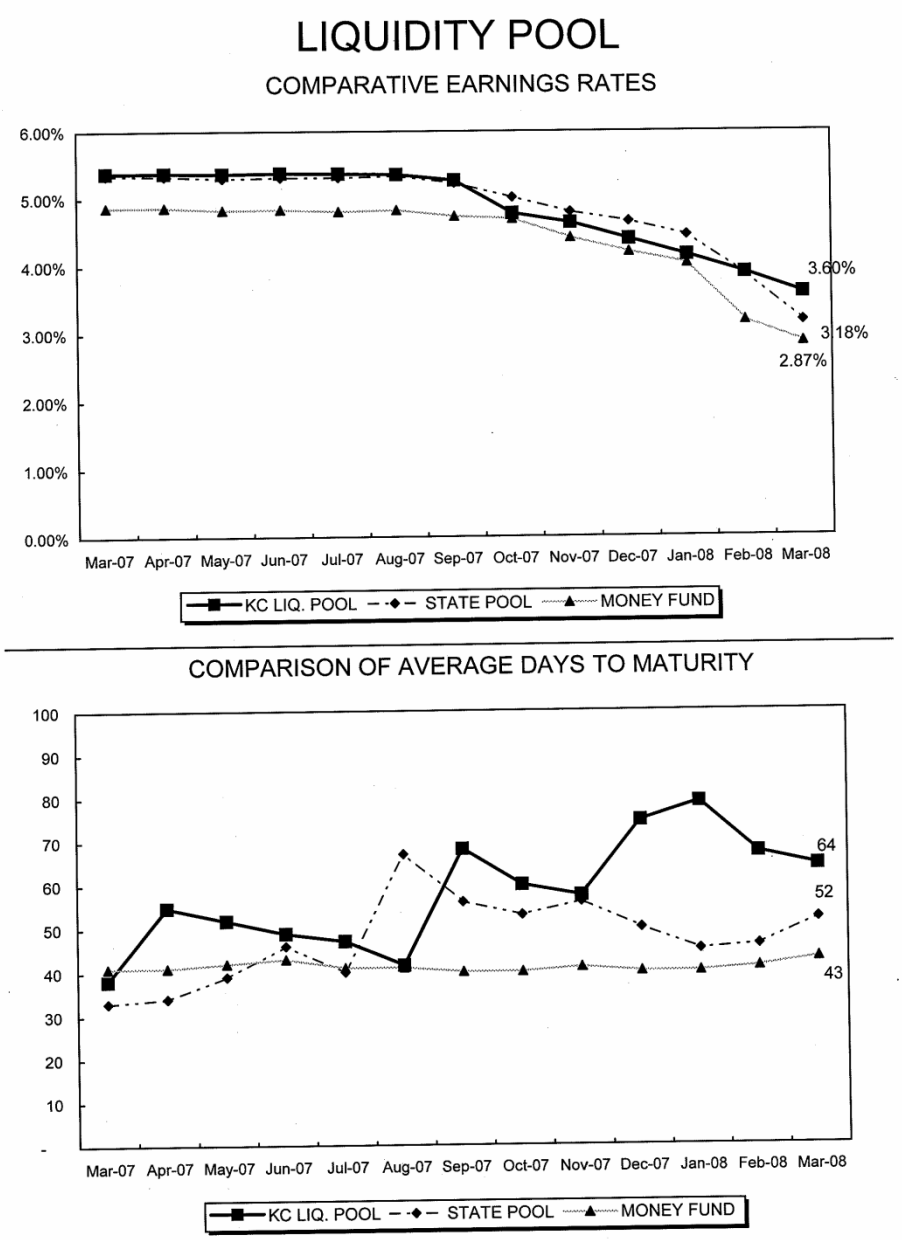
We find these benchmarks are inconsistent with the investment goals of the pool. As a result, they do not accurately evaluate the investment pool's performance and should be replaced with more meaningful benchmarks.

Liquidity Portfolio
The liquidity portfolio is compared to the Washington State Local Government Investment Pool (WALGIP) and the IBC/Donoghue Money Fund Report[19]. However, the investment pool has higher credit risk and higher price sensitivity than these benchmarks. Additionally, the investment pool is not a constant NAV pool, making these comparisons with constant NAV pools inappropriate. As a result, using these benchmarks could result in a misleading interpretation of yield. For example, at first glance, the investment pool's yield appears to have been in line with the WALGIP. Given the greater price risk, however, matching the returns of the WALGIP could indicate that the investment pool is underperforming.

Additionally, this report compares a seven day money fund average yield (IBC/ Donoghue) to monthly yields (WALGIP and KCIP). This time period inconsistency creates a potential for misreporting and would not meet private sector reporting regulations. Seven day yields should be compared to seven day yields, and monthly yields with monthly yields.

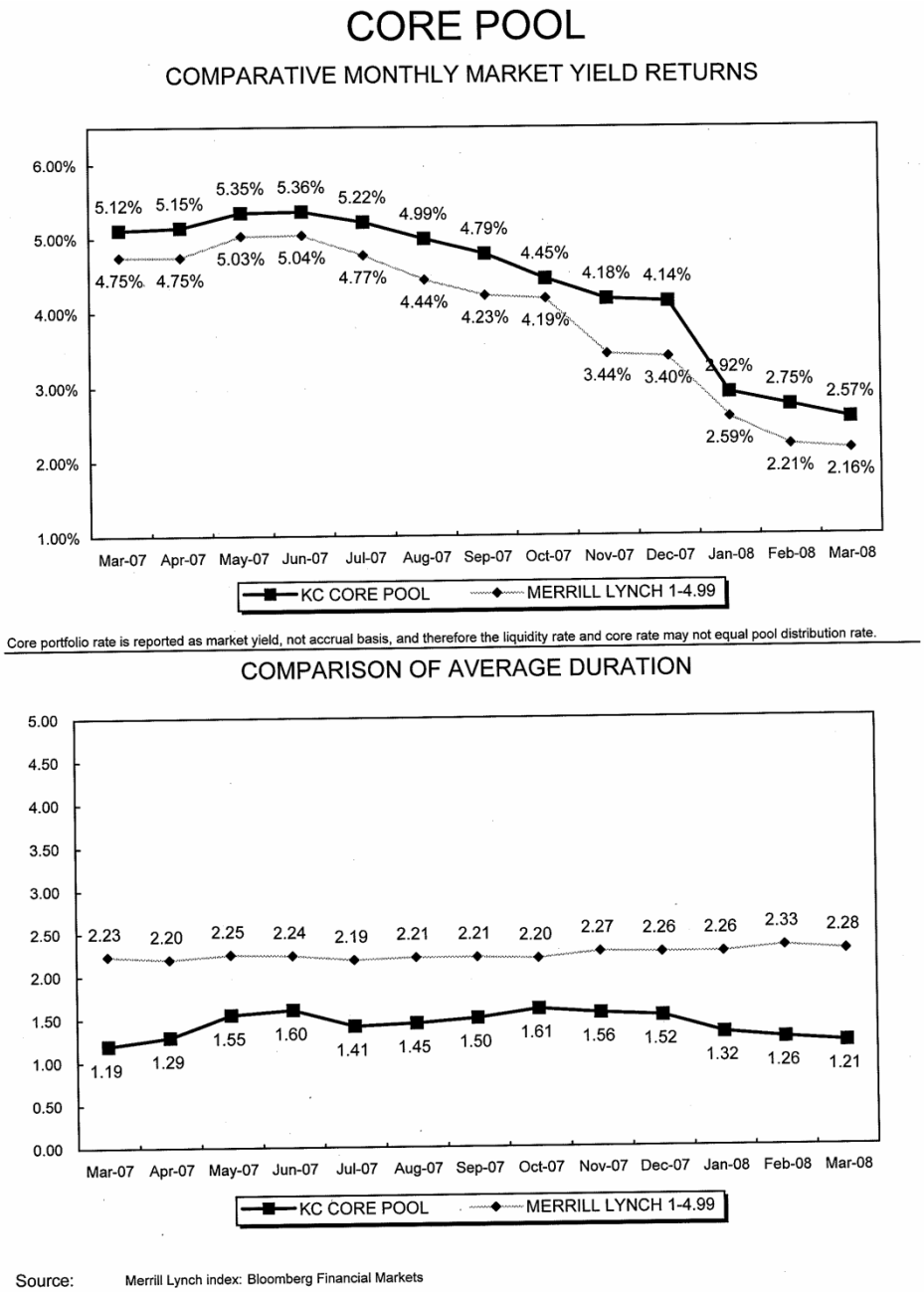
Finally, the report's labeling is imprecise, causing potential confusion by participants. For example, the labeling does not identify whether the seven day yield presented is an "effective yield" or an "annualized yield." An "annualized yield" will be greater because it includes the effects of compounding. Precision and formula disclosures are vital to ensuring transparency.

[19] The IBC/Donoghue Money Fund Report was rebranded to IBC Financial Data in 1998 and again to iMoneyNet, Inc. Index in 2000. The reports do not detail which iMoneyNet series is used as a benchmark.



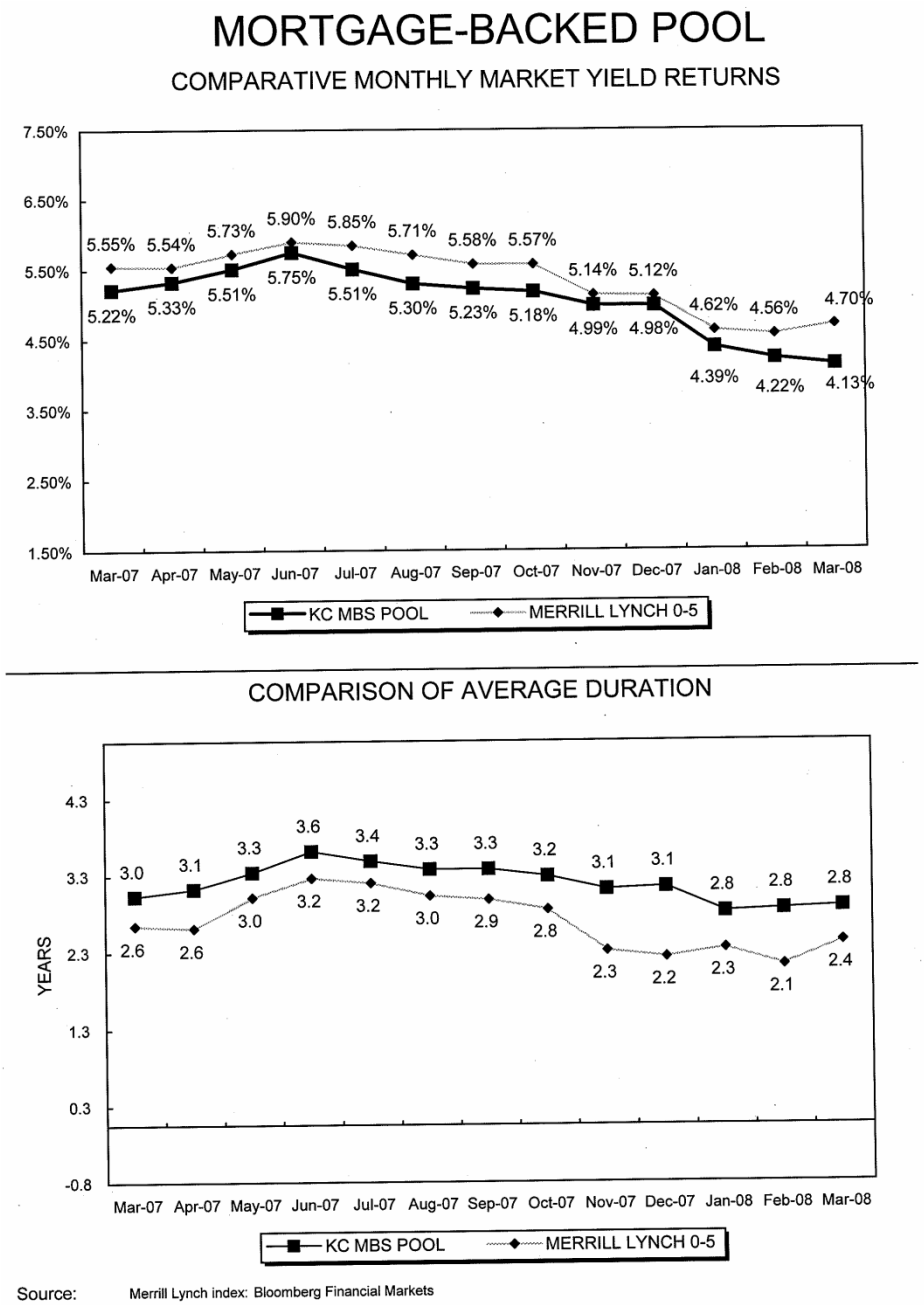
Core Portfolio

The core pool is compared to the Merrill Lynch 1-4.99 Year Treasury Index. The investment pool has a much shorter duration and higher credit risk than the index, making comparison inappropriate. For example, the index's average duration remains consistently near 2.2 years, while the investment pool fluctuates between 1.2 and 1.6 years. While the monthly yields of the pool exceed the benchmark, this outperformance could be due to the investment pool's level of credit risk and/or its purchase of callable bonds—not due to better investment decisions.



Mortgage-backed Portfolio

The mortgage-backed portfolio is currently measured against the Merrill Lynch 0-5 Year Mortgage WAL Index. This benchmark does not appear consistent with the risk tolerance cited by the investment policies, and the investment pool has a longer duration than the index, indicating more price sensitivity. As such, it is difficult to interpret the investment pool's lower return compared to the benchmark. Investors typically expect a higher yield with higher price volatility when the credit quality is comparable.



Source: Merrill Lynch index: Bloomberg Financial Markets

Establish Appropriate Benchmarks

The Panel recommends that the investment pool adopt benchmarks that better reflect its investment goals. Best practices would mandate the selection of two benchmarks for the entire portfolio:

1) Market Benchmark: An index of securities with similar credit, asset, and duration characteristics, and

2) Peer Universe Benchmark: An average of managed portfolios with similar credit, asset, and duration characteristics.

The market benchmark illuminates how the investment manager performed versus an unmanaged, passive portfolio. The peer universe benchmark illustrates how the investment manager performed versus the competition, i.e. other investment pools with similar risk characteristics.

Currently, the investment pool's three benchmarks are not consistent with these best practices. The current benchmarks do not clearly reflect the credit, asset, and duration characteristics of the investment pool. In part, the mismatch stems from a lack of clarity around the investment pool's investment goals and the appropriate portfolio structure to achieve those goals (see discussion on page 11).

We recommend that the investment pool establish clear goals and then choose benchmarks that reflect those goals:

1) *Money Fund:* If the pool chooses to operate as a money fund, we recommend the adoption of the Merrill Lynch 3 Month Treasury Bill Total Return Index as the market benchmark. Several vendors provide institutional peer universe benchmarks including, but not limited to, iMoneyNet, Morningstar, Russell, and Standard and Poor's.

2) *Variable NAV Fund*: If the pool chooses to operate as an enhanced cash fund, we recommend a blended market benchmark. Specifically, we recommend adoption of a benchmark not longer than 50% of the Merrill Lynch 3 Month Treasury Bill Total Return Index plus 50% of the Merrill Lynch 1-3 Year Treasury Index. A taxable enhanced cash peer universe benchmark is recommended.

We believe these benchmarks are appropriate given the risk preferences of the pool as revealed during our discussions with Finance staff. The investment pool seeks to have no negative returns on an annual basis. As shown in the table (on page 33), the 3-month and 1-3 year Treasury have not experienced an annual negative return since at least 1992. While no guarantee of future returns, this historical data suggests that a blend of these two indexes are appropriate for the investment pool.

The blended benchmark targets a one year duration, yet allows the manager to take advantage of yield curve opportunities for higher returns. Specifically, the one year maximum duration would allow the investment pool to meet Standard and Poor's S-1+ volatility rating which represents less price risk than the S-1 volatility rating previously assigned to the Pool. Additionally, the blended benchmark produces a higher total return than merely using a one year Treasury index.

Historic Returns

January 1992 to June 2006

Treasury Index	Months with a positive return	Months with a negative return	Quarters with a negative return	Years with a negative return	Annual Return	Standard Deviation
3m	174	0	0	0	4.00%	0.14%
6m	174	0	0	0	4.20%	0.15%
12m	159	15	1	0	4.40%	0.25%
1-3y	140	34	3	0	4.90%	0.48%
3-5y	120	54	5	1	5.90%	1.08%

Source: Bloomberg

Of note, when selecting the recommended benchmarks, we assumed that the investment pool would adopt our recommendation to outsource pool management and delegate investment decision making to an external manager. If this recommendation is not implemented, due to the current inadequate infrastructure and expertise, we recommend that the investment pool operate as a money fund and adopt a 100 percent 3 Month Treasury Bill Total Return Index as the appropriate market benchmark.

Recommended Benchmarks Depend on Valuation and Management

	Money Fund	Variable NAV Fund
Internal Management	Recommended: • Merrill Lynch 3 Month Treasury Bill Total Return Index • Average Institutional Taxable Money Fund Total Return Peer Universe	Not Recommended
External Management	Recommended: • Merrill Lynch 3 Month Treasury Bill Total Return Index • Average Institutional Taxable Money Fund Total Return Peer Universe	Recommended: • 50% of the Merrill Lynch 3 Month Treasury Bill Total Return Index plus 50% of the Merrill Lynch 1-3 Year Treasury Index • Average Institutional Taxable Enhanced Cash Fund Total Return Peer Universe

Risk Management

Comprehensive Set of Risk Metrics

Risk management is a process in which risks are measured, monitored, and then managed within the guidelines established by the investment policy. To have an effective risk management program, the investment pool must:

1) Measure all of the risks in the pool,
2) Monitor these risks daily to ensure compliance with policy limits, and
3) Manage the risks to optimize risk adjusted returns.

The current metrics used to measure, monitor, and manage risk in the investment pool are overly simplistic, limited to a single duration measure. Best practices require the use of a variety of risk metrics, including mortgage prepayment, convexity, credit, and volatility risk. These metrics quantify the risks contained in the investment pool, enabling them to be monitored and managed. A comprehensive set of risk metrics is needed whether the investment strategy is "active" or "passive." For example, even if the investment officer does no active trading of the portfolio and is entirely "passive," changing interest rates and market conditions continue to affect the portfolio and necessitate analysis.

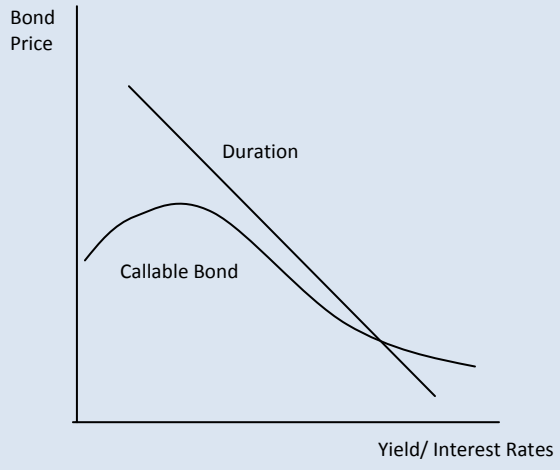
Risk metrics are especially important in light of the mortgage securities and callable agencies currently held by the investment pool. The current metrics do not measure the risk created by the $700 million of callable agency bonds in the portfolio.[20] Callable bonds generate higher returns, but also involve higher risks, because they allow the issuer to "call back" the underlying security if interest rates fall.[21] To obtain the "call" option, the issuer provides the purchaser a higher yield on the investment. However, if the bond is called back early, the purchaser must reinvest in a lower interest rate environment, potentially generating lower returns. This risk is not inconsequential. In the past, insurance companies have experienced financial loss and solvency concerns as a result of excessive

Duration and Convexity

Duration is a linear measure, or first derivative, of how the price of a bond changes in response to interest rate changes. However, as interest rates change, bond prices are not likely to change linearly, but instead change over some curved function of interest rates. As the price function becomes more curved, duration become a less accurate measure of interest rate sensitivity. Convexity becomes a key measure.

Convexity is a measure of the curvature, or second derivative, of how the price of a bond varies with changes in the interest rate. Convexity measures how the duration of a bond changes as interest rate change.

Example: Convexity Matters for Callable Bonds



[20] "Portfolio Review Report on King County Investment Pool," PFM Asset Management LLC, April 24, 2008.
[21] In these cases, the purchaser has written an option (derivative) to the issuer. Of note, it is unclear whether the current investment policy allows derivative activity.

callable bond purchases. The risk associated with these callable agency bonds should be measured, monitored, and reported monthly to the EFC and participants.

Adopt Risk Limit Framework

Using this expanded set of risk metrics, the investment pool should develop a robust risk limit framework. This framework would set limits on each of the risk measures and impose these limits on the investment pool, ensuring that investment decisions are consistent with risk tolerance. For example, a volatility limit might trigger a purchase halt on callable agency bonds if purchasing another bond would lead to volatility exposure beyond the investment pool's risk threshold.

Risk frameworks are used across the industry, with portfolio managers adhering to a comprehensive set of risk parameters in their daily investment process. Presently, the investment pool has a simplistic framework, which relies on duration and the investment guidelines imposed by state law. We recommend that this framework be expanded to include a more comprehensive set of risk metrics, including convexity.

Implement Stress Testing

Stress tests estimate the potential impact of a particular set of market conditions on a portfolio's value. In addition to a daily review of risk metrics, stress tests can serve as an early warning system against potential losses. For example, a stress test could be run to test the likely impact on the value of the investment pool of a 200 basis point credit spread between U.S. Agency Securities and U.S. Treasury Securities. [22] The stress test would quantify the credit spread, showing the investment manager the sensitivity of the portfolio's value to this type of change in the market. By quantifying risk under various "what if" scenarios, stress tests provide an invaluable risk management tool.

There are two types of stress tests, each with benefits and drawbacks:

1) *Stochastic:* Provides valuable information about the distribution of expected returns over thousands of potential market paths. It is computing intensive and sometimes misleading due to the dependence on modeling inputs.

2) *Deterministic:* More easily implemented and more intuitive. However, it has a limited number of results and a heavy reliance upon input choices.

With a comprehensive set of risk metrics, deterministic stress testing is easily implemented. We recommend it be implemented as soon as possible. However, we recommend the investment pool obtain both stress testing models if available.

Reports

We recommend the investment pool adopt more comprehensive and transparent reports. We find the current reporting inadequate and, in some cases, misleading. The Executive Finance Committee receives a monthly package containing reports on each of the three "sub" portfolios, measuring their performance against the benchmarks. However, these reports do not identify which assets are allocated to each portfolio, and market yield is reported rather than the accrual yield that is

[22] This event occurred in the first quarter of 2008 due to secondary market credit concerns about agency securities.

actually paid to participants. Moreover, the information contained in these reports is insufficient to assess performance and manage risk. For example, the March 2008 report lists the impaired investments at face value, despite the fact that their market value is significantly below face value.

We recommend the investment pool overhaul its current reporting practices and move to a best practices form of reporting that quantifies all risks and uses appropriate benchmarks. Ideally, the investment pool should institute a daily risk management report, which summarizes all of the quantified risks discussed above. This report can be used to assist in the investment decision-making process. Additionally, the monthly report to the EFC should be enhanced to include the expanded set of risk metrics, including convexity. These upgraded reports will enable a monthly assessment of the effectiveness of investment decisions. With improved reporting, the investment pool can provide more transparency and better insight around investment activities.

Contract for Reporting

We recommend that the investment pool contract with a third party to provide this comprehensive reporting. For example, many custodial banks offer reporting services that include a comprehensive set of risk measures. Having an independent external party responsible for reporting would address a number of issues:

1) *Eliminate operational risk* – Currently, the same employee who manages the portfolio generates the reports, creating operational risk. As part of a "segregation of duties" internal controls policy, the same person should not make investments and produce reports.
2) *Free up staff time* – Currently, the reporting process is highly manual, creating considerable strain on the Finance staff and taking away from the Investment Officer's focus on portfolio management.
3) *Instant access to portfolio metrics* – As part of the reporting services, the third party provider can readily provide the comprehensive set of metrics needed to assess the pool's performance and manage risk.

Conclusion

The various metrics recommended in this section to quantify risks and returns should by no means be considered a complete list of metrics. Rather, it represents what would be a "good start" towards establishing a more sophisticated and comprehensive performance metrics system. As the management of the investment pool becomes more sophisticated, additional measures should be instituted.

Impaired Investments

We recommend the immediate bifurcation of the investment pool into a performing pool and an impaired pool.

Pool Bifurcation

The presence of four impaired investments in the investment pool creates several challenges:

1) Transparency: Currently, there is no clear delineation between the impaired and performing investments, creating ambiguity around participants' access to the impaired funds.
2) Yield Calculations: These impaired investments earn no interest, dragging down the pool's rate of return for all funds, including those that entered the pool after the impairment date.
3) Principal Calculations: The impaired investments complicate the ability to accurately account for each participant's principal. From the EFC report dated April 24, 2008, it appears that new investors are purchasing $0.98 worth of securities for $1.00.[23]
4) Rating: Rating agencies are unable to rate the pool because of a lack of information on the impaired investments.
5) Future Restructuring: Restructuring negotiations about how to repay the holders of these impaired investments may lead to the issuance of long term securities that are inconsistent with current policy guidelines.

"Bifurcating" the pool would address these inaccuracies and deficiencies. Bifurcation would divide the pool into two pools: one containing the impaired investments and one containing all other performing investments.

Background: Florida LGIP

A bifurcation strategy was successfully implemented by the State of Florida's Local Government Investment Pool (LGIP). Last fall, as credit markets became distressed, six percent of Florida's investments became impaired. In November, its investors began an unprecedented "run on the pool," withdrawing billions of dollars and creating a liquidity crisis. In response, the state bifurcated the pool into two pools: Pool A contained assets that were highly rated, and Pool B contained impaired and risky assets.

This strategy rapidly restored the viability of Florida's investment pool. We believe it is an appropriate strategy for the handling of impaired investments.

Benefits Beyond Liquidity

Bifurcation solved a liquidity crisis for Florida. King County does not face a short term "run on the pool": contracts constrain when participants can exit the pool, and the newly adopted impaired investment policy requires all members to proportionally share in any losses, further reducing the

[23] "King County Investment Pool Fair Value Report," Executive Finance Committee Meeting Packet (April 24, 2008) p. 18.

probability of a "run" on the investment pool.[24] However, we believe that unless the challenges created by the impaired investments are addressed, liquidity could become a longer term problem for the investment pool if participants decide not to invest the proceeds of new bond issuances in the investment pool.

Bifurcation can help avoid any future liquidity crisis and provides additional benefits:

- Accurate yield:

  The impaired investment policy adopted in December by the Executive Finance Committee eliminated any principal impact of the impaired investments on "new" monies, that is, funds that are deposited after an impairment event. Currently, while these monies are protected from losses of principal, their interest earnings are negatively affected by the impaired investments.

  The impaired investments earn a zero yield, slightly weighing down the overall yield of the pool. For example, if the other 95 percent of the pool's assets earn 4.5 percent, the impaired investments reduce the total yield to 4.3 percent. While this yield is appropriate for certain existing monies whose earnings should take into account their share of the impaired investments, it is 0.2 percent lower than it should be for new monies that have no stake in the impaired investments. For example, if Bellevue School District invests its recent voter-approved $545 million bond issuance in the investment pool,[25] it could lose as much as $1.1 million in interest in a single year under the current structure.

  Bifurcating the pool would address this problem. With two pools, two separate yields would be calculated—one for the performing pool and one for the impaired pool. New monies would be added to the performing pool and receive the appropriate yield. Ensuring this accurate yield would carry out an important element of the County's fiduciary duty to correctly invest on behalf of all participants.

- Accurate principal:

  Under the investment pool's current hybrid approach to portfolio management, participants transfer funds in and out of the investment pool under "dollar in, dollar out" assumptions. As discussed previously, these assumptions are problematic and become more so with the presence of the impaired investments. The current market value of the impaired investments is between $0.40 and $0.60 on the dollar, reducing the overall value of the investment pool's portfolio to approximately $0.98 on the dollar.[26] This two percent deviation from a dollar complicates the ability to accurately account for each participant's principal.

- Transparency:

  Bifurcating the pool would create an improved level of transparency about the impaired investments and their implications for each district's funds. By segregating the four impaired assets into a separate pool, each member could clearly identify its share of the four investments, eliminating any ambiguity about the availability of these funds. Additionally, it would provide a

[24] Finance Staff prepared a draft briefing paper on this topic. See Appendix II: Draft Issue Paper: Segregating the County's Investment Pool.
[25] Thompson, Lynn, "Bellevue backing school building measure," *The Seattle Times* (March 12, 2008).
[26] "March 2008 Investment Summary," Executive Finance Committee, April 24, 2008.

clear division for new monies, ensuring they had no links to the impaired pool. Finally, it would enhance transparency around each pool's valuation.

- Restructuring Agreements:

  Bifurcation could ease the implementation of restructuring agreements for each of the four impaired investments. Restructuring agreements may take several forms, including the issuance of a new "restructured" security that will pay back principal over several years. With bifurcation, these "restructured" assets would be kept separate from the performing pool until they mature, at which point the money would be allocated proportionally to each member's account in the performing pool. This system would protect the integrity of the impaired investment policy, maintaining the equitable division of any realized losses or gains on these impaired assets and protecting new monies from exposure to a restructured security.

- Reinstitution of Pool Rating:

  In January 2008, S&P suspended its AAA rating of the investment pool, citing a lack of information about the impaired investments. While S&P may reinstate the pool's rating once restructuring agreements are reached, the restructuring process will likely take months or years to complete.

  Bifurcation could result in a more timely reinstatement of the pool's rating. In initial discussions, S&P has indicated that if the pool were bifurcated, the agency would likely restore a high rating to the performing pool. It would not rate the impaired pool.

The disadvantage of bifurcation appears to be the operational costs of splitting the pool in two. According to Finance staff, bifurcation would double the number of funds needed to be maintained. Transfers between the two pools would require a substantial amount of paper work, including processing an inter-fund transfer form for each of the 792 funds in each pool. This administrative work would require significant time and manual processing, and according to Finance staff, the current investment software cannot be easily reconfigured to administer a bifurcated pool.

The benefits of bifurcation, especially the treatment of new monies entering the pool, are compelling. We believe the enhanced transparency, potential for a reinstated pool rating, and the advantages in implementing restructuring agreements significantly outweigh the increased administrative burden. While the administrative costs are real, the presence of substantial manual paper processing in the investment pool's operations only suggests that the County's investment system is outdated and in need of replacement. Moreover, the current use of a manual process for handling the impaired investments could lead to inadvertent errors.

Finance staff has also raised the concern that by restricting access to certain funds over a long period of time, bifurcation may lead to cash flow impacts for districts, particularly for capital project funds. For example, if a school district relied on payments from its capital fund to build a school, restricting access to these funds could potentially delay completion of the capital project. We believe this problem could be addressed through other means, including borrowing between a district's funds. In the example, the school district's operating fund could lend money to the capital fund to ensure the school was completed on time.

Restructuring Options

Each of the four impaired investments is currently involved in "restructuring" negotiations. Managed by a "trustee" bank or receiver, these negotiations bring together the investors and other interested parties to discuss how senior investors will be paid back from the sale or "restructuring" of the securities that supported the original investment. The Panel understands that the investment pool will be given a number of options from which to choose, such as a cash out, a long-term security that will pay back the full principal at its maturity date, or perhaps even a slice of the underlying asset-backed and mortgage-backed securities that will pay the investment pool back as cash flows are received by the trustee.

When the investment pool is offered the restructuring options, we recommend that the investment pool make its decision based on a sophisticated quantification of each option completed by a qualified, independent third party. A thorough analysis of the underlying securities should be performed by a firm with a core competency in asset-backed securities. The firm's analysis should include, but not be limited to:

1) Quantification of each option, adjusted for time and risk.
2) Risk assessment for each option.
3) Liquidity of each option on the secondary market.
4) Consistency with current investment guidelines.

Ideally, the investment pool would hire a registered, institutional investment manager with fixed income and credit analysis expertise to manage the impaired investments, including the restructuring process. This manager would be appointed as a fiduciary responsible to all participants and authorized to make decisions regarding the various restructuring options.

Finally, to ensure that the public and all participants understand how and why the eventual decision was determined, the decision making process should be clearly documented, including all resources and research utilized. The County must take steps to ensure that no actual or potential conflicts of interests are perceived.

External Relations

The Panel considered several topics involving the County's external relations, including:

- Formal inclusion of participants in policy making process
- Communications
- Fees charged to participants
- Pool rating

Formal Inclusion

We recommend the creation of formal channels to include participants in the investment pool's policy making process.

The investment pool's current governance structure does not include representation by non-County pool participants. In addition to the fiduciary challenges raised previously in this report, the lack of formal inclusion for participants generates a number of problems:

- Participants do not have an adequate understanding of the investment pool's goals, risks, and performance.

- Participants do not engage until they perceive a problem. This sudden engagement creates communication challenges for the County.

- With no formal mechanism to influence policy decisions, participants view exiting the pool as their only option when disagreements arise. If participants leave the investment pool to invest on their own, inefficiencies arise, generating higher costs and lower returns for tax payers.

To ameliorate these problems, we recommend the creation of formal channels to include participants in the policy-making process. This inclusion will encourage participants to become better informed and more invested in the success of the investment pool.

As previously discussed, we recommend that participants be formally included in the governance structure through the creation of an independent board or the expansion of the Executive Finance Committee. Additionally, we recommend that the investment pool hold an annual meeting with all participants. This meeting would provide a formal forum to discuss the performance of the pool and receive input from participants on investment objectives and strategies for the coming year.

Communications

We recommend that the investment pool improve communications.

Reporting

We recommend that the investment pool enhance its reporting on investment performance. According to GFOA, reporting is essential to the investment function. "Reports help to instill a sense of disclosure and openness and serve to keep the public informed about the government's

investment program."[27] Reporting is an important tool to communicate with the governing body, the participants, and the public, and it takes on greater significance during market fluctuations.

Currently, the investment pool provides monthly reports to each participant. These reports include information on:

- Each Fund: balances, credits, debits, interest earnings, and fees; and
- Overall Investment Pool: investments by type and as percentage of portfolio, average duration, monthly rate of return for last 12 months, and current net asset value.

Additionally, more detailed reports are provided to the Executive Finance Committee. These include information on issuers, actual earnings versus budgeted earnings, and comparisons of yield and maturity to various benchmarks. While these reports are informative, they are not consistent with best practices in reporting. Moreover, participants have expressed a desire for more comprehensive reports.

We recommend that the investment pool enhance its reporting to be consistent with best practices. Following the recommendations provided by the GFOA, reports should include:

1) *Investments by type and as a percentage of the total portfolio;*
2) *Listing of issuers;*
3) *Cost of each investment (dollar amount invested), its yield to maturity (both at cost and at market value), accrued interest, and maturity date;*
4) *Market value of each investment (marked-to-market);*
5) *Par value of each investment;*
6) *Total returns for prior periods, including monthly, quarterly, year-to-date, and annual; as well as three, five, and ten year annualized.*
7) *Comparison of current incomes against forecasted or budgeted income projections;*
8) *Investments by maturity date;*
9) *Average weighted yield to maturity of the portfolio, including comparison to applicable benchmarks;*
10) *Percentage of the total portfolio held by each institution; and*
11) *Principal and type of investment by fund.*[28]

On-line Access to Information

We recommend that the County develop a web site for its investment pool to provide participants and the public better access to information about the investment pool. The site could include general information about the investment pool, an up-to-date copy of the investment pool policies, and the monthly reports on the pool's overall performance. Press releases and notices for upcoming meetings could be posted. Additionally, participants could access their monthly reports on the site, via secure web access. This electronic posting would yield cost savings by replacing the need to mail out paper reports each month.

[27] Anastopoulos 96.
[28] Adapted from Anastopoulos 97.

Investment Pool Fees:

We recommend that the investment pool review its fee structure and determine a set of fees that are:

1) *Sufficient to cover the costs of providing high quality investment services.*
2) *Transparent and updated regularly.*
3) *Comparable to or lower than market rate fees.*
4) *The same for all participants.*

In the course of our review of the Investment Pool, a central issue raised by non-County participants was the investment pool's fee structure. Participants expressed concern that the fee structure was not transparent and did not seem commensurate with the services provided.

Background

In 2007, the total fee revenue collected from all participants—County and non-County—was $6.1 million. The investment pool charges non-County participants a fee of 15 basis points, or 0.0015 percent, of each participant's average daily balance. These fees are established through inter-local agreements with each of the non-County participants. County fund participants are charged 20 basis points, or 0.0020 percent, of their average daily balance. At the March 2008 Executive Finance Committee meeting, the EFC voted to bring these fees in line with non-County participants. Effective May 1, 2008, all participants are charged 15 basis points, with the exception that the current expense fund is not charged a fee.[29]

Finance staff reported that the 15 basis point fee was established in 1995 when the investment pool was expanded to include non-County district participants.[30] Expanding the investment pool provided benefits for both the County and the districts, generating efficiency gains in the investment process, reducing costs, and increasing the potential for greater diversification and earnings. However, expanding the investment pool also eliminated several sources of revenue for the King County general fund:

1) *Investment Placement Fee* – Prior to the expansion of the investment pool, districts were required to contact the King County Treasurer and request that their cash reserves be placed in a specific investment for a specific duration. For each of these "placed investments," Washington State Law (RCW 36.29.020) permits the County treasurer to collect a fee of five percent of the investment's earnings, up to a maximum of $50 per year per investment.

2) *Interest Earnings on Uninvested Cash Balances* –To protect against unforeseen operational needs, districts would leave 2 to 3 percent of their cash reserves uninvested. Washington State Law (RCW 36.29.020) authorizes the County to invest these idle cash balances and deposit any earnings in the County's current expense fund to be used for general purposes.

After the expansion of the investment pool, districts would no longer have to ask the Treasurer to purchase individual investments. Moreover, the liquidity provided by the investment pool enabled districts to invest 100 percent of their cash balances without jeopardizing their operational needs. In short, expanding the investment pool eliminated these revenue sources for the County while

[29] According to Finance Staff, the current expense fund is not charged a fee because the fees are paid to the current expense fund. In our opinion, all participants and funds should pay a fee for consistency, transparency, and accuracy in accounting.
[30] See Appendix III: Draft Issue Paper: Investment Pool Fees and Options.

providing benefits to the participants. To offset the lost revenue, a "break even" investment pool fee of 15 basis points was established so that the expansion of the pool was revenue neutral for King County.

Review Needed

The fee structure has not been reviewed since it was established in 1995. Given the growth of the investment pool over the last 13 years and participants' current concerns, we recommend that King County review the fee and consider establishing an updated structure based on five guiding principles:

1) Recover Costs: Fees should cover the costs of providing participants with investment services that reflect industry best practices.

2) Transparency: The composition of the fees should be transparent and clearly communicated to all participants.

3) Competitive: Fees should be comparable or lower than what is charged in the marketplace for the same level of investment service. Under current State law, most participants do not have an alternative to King County's investment services. This "monopoly" status places a special obligation on the County to ensure that its fees are competitive with market rates. For participants who do have investment alternatives, providing them with competitive fees and services is vital as other participants and taxpayers will suffer if these participants choose to leave the investment pool.

4) Equality: Each participant's fee should be calculated at the same rate.

5) Sustainability: Fees should be based on a percent of assets under management rather than a fixed dollar amount.

We recommend this guideline approach as opposed to providing a specific fee recommendation, as our research revealed there is no generally accepted pricing system for local government investment pools. In a nationwide survey of more than 100 local government investment pools, fees ranged from 0 to 58 basis points and varied significantly by type of fund, sponsorship, management, and amount of assets. [31] The guideline approach will lead to the adoption of a fee structure that meets both the County and the participant's interests. Under our proposed governance structure, the Board, acting as the participants' fiduciary, should set the fee.

Pool Rating

We recommend that the investment pool seek to reinstate a top rating by a Nationally Recognized Statistical Rating Organization (NRSRO).

Background

The King County Investment Pool was first rated by Standard & Poor's rating agency, one of the NRSROs, in January 2006. The investment pool received an AAAf rating, indicating S&P's opinion

[31] Krasner, Michael, *Government Investment Pools: 2007 Update of Investment Strategies, Facts, Figures and Trends,* iMoneyNet Special Report, (July 2007).

that the Pool provides the highest level of protection against losses from credit defaults. The pool maintained this rating until January 2008, when S&P suspended the rating, citing a lack of sufficient information on the investment pool's four impaired investments. Without this information, S&P could not "provide a current assessment of the entire pool."[32]

Before the suspension, the investment pool was among 77 local government investment pools (LGIP) rated by S&P in 27 states.[33] An additional 23 LGIPs in 9 states are rated by Fitch, another NRSRO. S&P charges the investment pool $16,000 a year for its rating services.

Advantages

We recommend that the County take steps to reinstate a top rating with a NRSRO. Reinstatement of this rating carries a number of advantages:

1. Outside Validation: A rating provides a third-party stamp of approval. Rating agencies review the investment pool's policies, procedures, and portfolio and assess the level of risk. Once a pool is rated, holding reports and summary statistics are reviewed monthly (or weekly, if a money market type of pool), providing a regular third party check. The process validates that the pool has sound practices and policies in place to protect investors' principal and sends an important signal to investors.

2. Source of third-party information: Rating agencies periodically update their findings on the LGIPs that they rate. These press releases provide important third-party sources of information for participants and the public.

3. GASB standards: In 2003, the Government Accounting Standards Board (GASB) issued Statement Number 40, *Deposit and Investment Risk Disclosures,* addressing the disclosure of the various types of risk associated with the investment and deposit of public funds. Included in GASB 40 was a requirement that governments disclose the rating of any external investment pool in which they invest. If the investment pool is unrated, the government should disclose this fact. Although Statement 40 does not require governments to invest in rated investment pools, nor require investment pools to obtain a rating, reporting participation in a rated pool represents best practices. According to GFOA, "pool ratings can provide an additional method of due diligence" when governments are determining whether to invest in an investment pool. [34]

4. Maintenance of King County Bond Ratings: The investment pool is an important source of liquidity that is examined by NRSROs when assessing King County's bond ratings. For example, recent events involving the impaired investments led Fitch to place the County's bond rating on negative credit watch.[35] Restoration and maintenance of the AAA rating on the investment pool will shore up the County's credit quality and help to preserve the AAA rating on its bonds.

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[32] "King County Investment Pool 'AAA/S1' Rating Suspended; County Rating Affirmed," *Ratings,* Standard and Poor's (January 18, 2008).
[33] "List of Rated Government Investment Pool," *RatingsDirect*, Standard & Poor's, November 30, 2007 and discussion with Joel C. Friedman, Standard & Poor's (February 2008).
[34] "Use of Local Government Investment Pools (LGIPS) (2007) (CASH)," Government Finance Officers Association Recommended Practice, Government Finance Officers Association (March 2, 2007).
[35] "Fitch Places King County, Washington's $1.51B GOs on Rating Watch Negative," Fitch Ratings Press Release, October 24, 2007.

In sum, the rating is consistent with best practices and enhances outside confidence in the investment pool. Given these advantages and the relatively low cost associated with receiving a rating, the investment pool should continue to be rated by a NRSRO.

Conclusion

The King County Investment Pool falls short of industry best practices in a number of areas, including governance, infrastructure, and accountability. This shortfall creates unnecessary risk for the County and participants, reduces potential returns, and runs counter to transparent government.

We believe local government investment pools serve an important public good. By pooling the cash reserves of numerous small districts and county funds, the King County Investment Pool can generate efficiencies and economies of scale that benefit the taxpayers of King County. If operated in line with best practices, the investment pool will increase the returns for public monies, while reducing the risk of loss.

The risk in any investment pool is related to its returns. Investment pools with investment goals that are designed to generate higher returns will take on a higher risk, no matter how prudently investment decisions are made. We believe the recommendations in this report, if adopted, will enable the County to more effectively manage risk; but risk cannot be eliminated.

In conclusion, we repeat our recommendation that the County take rapid and forceful action to bring its investment function in line with industry best practices.

A Road Map is Needed

This report makes a number of recommendations on how to bring the investment pool in line with industry best practices. While the panel strongly recommends "buying" needed services from an external fund manager, we have also tried to provide instruction on what it would take to "build" services internally. As a result, this report leaves the County with a number of decisions to make about the future operations and governance of the investment pool.

We recommend that the County immediately create an action plan that lays out the specific steps the County will take to bring the pool in line with industry best practices. The plan should include goals and deadlines for addressing the investment pool's current challenges. At the end of six months, we recommend that the County assess the plan and how well the actions taken to date are addressing the stated goals. This review should measure how well the investment pool has closed the gap between its current practices and best practices and highlight those areas that need additional attention.

Recommended Elements of King County Investment Pool Action Plan

Impaired Investments:

1) Bifurcate the investment pool.
2) Hire a qualified external manager to manage the restructuring process.

Governance:

In short term:

1) Establish fiduciary responsibility of the EFC.
2) Hire external expertise to guide EFC.
3) Update investment policies.

In longer term:

4) Adopt a new governance structure with fiduciary responsibility that includes representation from non-County participants and industry experts.

Infrastructure:

1) Consolidate assets within one central repository—a bank custodian.
2) Improve accounting procedures and institute an annual outside audit.
3) Hire an external fund manager – "Buy It" – automatically addresses many of the most pressing infrastructure challenges:
   - *Investment Goals:* The manager will work with the investment pool to establish appropriate investment goals and objectives.
   - *Credit Analysis:* The manager will have an in-house credit analysis process and credit analysts.
   - *Technology:* The manager will have access to the latest technology, automating the investment process and reporting.
   - *Metrics:* The manager will work with the investment pool to establish performance metrics and will be held accountable for performing against them.
   - *Staffing:* The manager's staff will eliminate "key man risk," while the manager will have access to legal support.
   - *Internal Controls:* The manager will have a system of internal controls and will work with the investment pool to ensure coordination with in-house internal controls.

Pool Participant Relationship:

1) Review fee structure.
2) Improve communications, including enhanced reports and website.
3) Seek reinstatement of a top rating by a Nationally Recognized Statistical Rating Organization.

Efficiency Assessment

While outside the scope of our review, we believe the cash management operations of the County should be seamlessly integrated with the investment function. We recommend that the County hire an external consultant to perform an audit of the entire Treasury Services function to ensure that the cash management and investment functions work together efficiently.

Finally, we recommend that the investment pool conduct a business review every 3 years. The dynamics of the financial industry and its speed of innovation demand active and regular review of the investment pool. These periodic reviews will ensure that the pool maintains sound business practices over time and optimizes returns for taxpayers.

Appendix I

EFC Adopted December 17, 2007

210.9 Impaired Investment Policy

1.0 Purpose

1.1 This policy is adopted by King County's Executive Finance Committee to address the treatment of impaired investments, as defined in Section 2.0, consistently with applicable law and the terms of the investment agreements with pool members. The policy addresses how to provide fair and equitable treatment of pool members' interests in the event one or more of the pool investments becomes impaired.

1.2 The policy specifically addresses situations involving pool members who are completely withdrawing from the pool or who are removing substantial funds from the pool prior to the distribution of any realized loss.

1.3 The policy amends King County Investment Policy Section 210 by adding a new subsection 210.9 titled "Impaired Investment Policy."

2.0 Definitions

2.1 Impaired Investment: An investment is deemed to be "impaired" when: (a) its credit quality is rated below investment grade by Standard & Poor's, Moody's and/or Fitch; (b) a default has occurred on payment at maturity; or (c) an enforcement event, as defined in the investment's program documents, has occurred. An impaired investment is also referred to as "distressed."

2.2 Unrealized Loss: A loss calculated using the fair value of the investment, but which has not been realized through a transaction such as the sale of a security. It is also referred to as a "paper loss." An unrealized loss is not distributed to pool members.

2.3 Realized Loss: A loss that is recognized when investments are sold for a price lower than the carrying value or it is determined that the investment has no value and therefore it is not possible to sell the security at any price. This loss is distributed to pool members.

2.4 Fair Value: This is the amount at which an investment is being exchanged in a current transaction between willing parties. In conditions where market pricing is not available, other generally recognized valuation methodologies may be used.

2.5 Par Value: This refers to the nominal or face value of a security. The par value is the amount the issuer is obligated to pay the investor when the security matures.

3.0 Goals

The policy is intended to serve the following goals among others:

3.1 Seek Options to Recover Principal: The pool will first seek options that allow for the recovery of the principal value of the impaired investment over time, thereby avoiding a realized loss. Any selected option must be justified in terms of risk, cost/benefit, and legal soundness.

3.2 Distribute Any Realized Loss Fairly and Equitably: If a loss must be realized, the loss will be distributed in a manner that is fair and equitable to pool members, as set forth in this policy.

3.3 Protect New Monies Entering Pool: The pool will seek to isolate a realized loss impact in such a way that new monies entering the pool after an investment is deemed impaired will not be factored into the calculation and distribution of the realized loss.

3.4 Prevent a Run on the Pool: The county will not allow members to exit the pool or remove substantial balances from the pool in order to avoid loss exposure, thereby undermining the confidence of remaining pool members. The county will ensure that those pool members completely exiting the pool or withdrawing substantial funds from the pool are required to leave sufficient funds in the pool to offset the maximum potential future realized loss on any investment that is impaired at the time of withdrawal or exit.

4.0 Distributing a Realized Loss—Holding Period Method

4.1 A realized loss will be apportioned based on each pool members' average cash balance from the time the impaired investment was acquired through the date the investment is deemed impaired. This is referred to as the "holding period" for the impaired investment.

4.1.1 Example: An impaired commercial paper investment acquired on April 18, 2007 enters into an accelerated enforcement event on October 17, 2007. If the total realized loss to the pool is $10 million and a pool member has an average cash balance equal to 1 percent of the pool during this time period, then the pool member is apportioned $100,000 for the loss.

4.2 This treatment of losses protects new monies which enter the pool after the date an investment is deemed impaired from being exposed to a realized loss associated with an impaired investment.

4.2.1 Example: If a pool member had a $50 million bond issue that was placed in the pool after the date an investment is deemed impaired, then this new $50 million would not be part of the member's average cash balance during the

designated holding period for the purpose of calculating their share of the realized loss.

5.0 Pool Members Exiting Pool Prior To Realized Loss Distribution

5.1 Members who request a compete withdrawal of funds from the pool prior to a realized loss must first ensure that their request is consistent with their signed investment agreement, including prior notification requirements.

5.2 Retainage for Loss Coverage: The county will require the exiting pool member to retain sufficient funds in the pool to cover any future realized loss on an impaired investment. The county will calculate the pool member's pro rata share of an estimated 100 percent loss of the par value of the impaired investment using the holding period method set forth in section 4.0. This amount will be deducted from the requested withdrawal of funds and will be retained by the pool until such time that the pool recovers the full par value of the investment or distributes a realized loss. If a realized loss is less than the amount being retained by the pool to cover losses, this difference will be reimbursed to the exiting pool member at the time the realized loss is allocated to pool members.

5.2.1 Example: A pool member requests the withdrawal of $10 million on the anniversary date of their pool agreement and provides proper advance notice. The pool member has an average cash balance equal to 1 percent of the total pool assets during a defined holding period for an impaired investment. The par value on the impaired investment is $50 million. The amount retained by the pool to cover any loss is $500,000 (1 percent x $50 million). Therefore, the net withdrawal payment is $9.5 million ($10 million - $500,000 retained for loss coverage). Of the $500,000 retained by the pool, all or a portion of this amount will be returned to the exiting pool member depending on whether the full par value is eventually repaid to the pool.

5.3 If the county is issued a new security (or securities) as part of a restructuring solution for an impaired investment, then the full retainage amount will be returned to the pool member upon the full maturity payment of the new security (or securities). Also, if a restructuring solution results in periodic cash flow payments or the partial repayment of the par value of an impaired investment, these payments will be distributed to pool members.

5.4 Pool members will continue to receive interest earnings, as set forth in their investment agreements, on the amount of their retainage for loss coverage.

6.0 Pool Members Removing Substantial Funds Prior To Realized Loss Distribution

6.1 Members who request withdrawals of their cash balances must make the request consistent with their signed investment agreement, including prior notification requirements.

6.2 Retainage for Loss Coverage: Prior to approving the request, the county will calculate the amount of funds that must be retained in the pool to cover the pool member's share of any future realized loss on an impaired investment. The retainage for loss coverage will be calculated and applied in the same manner as Section 5.0.

7.0 Accounting and Financial Reporting for Impaired Investments

7.1 The Governmental Accounting Standards Board (GASB) promulgates accounting guidance. GASB 31 Accounting and Financial Reporting for Certain Investments and for External Investment Pools, provides guidance for investment accounting. Additionally, GASB also provides guidance through questions and answers in its annual comprehensive implementation guides.

7.2 In accordance with GASB 31, the investments in the county investment pool are reported in the county's year-end financial statements at fair value. That valuation takes into account any impaired investments.

7.3 If fair value is not determined by quoted market prices, the GASB Implementation Guideline suggests the security's value be estimated. This estimate calculation requires professional judgment and use of valuation techniques. In these cases, the County will obtain an estimate of the fair value from an investment bank of high reputation and solvency.

7.4 All investment income, including changes in the fair value of investments is recognized as revenue in the county's statement of activities. Negative investment income is reported as negative revenue.

7.5 GASB 31 does not mandate the manner, frequency or method of the distribution of investment earnings. The county, as the pool sponsor, determines the distribution methodology.

7.5.1 Based on longstanding past practice, the county only distributes realized gains and losses to pool members. The county does not distribute unrealized gains or losses on its investments.

8 Period of Applicability

8.1 This policy reflects applicable statutes, GASB 31 and standard accounting practices, the terms of the agreements with pool members and the actual practices that have been followed in the past management of the pool and therefore applies to all withdrawals, exits, or other events that fall within its subject matter scope.

Appendix II

DRAFT ISSUE PAPER: SEGREGATING THE COUNTY'S INVESTMENT POOL
Prepared by Finance and Business Operations Division Staff

February 6, 2008

Introduction and Purpose

This paper explores the feasibility of segregating the County's investment pool so that the pool's impaired assets in commercial paper are held in a pool that is separate from other highly rated pool assets.

The first section provides background on the State of Florida's Local Government Investment Pool and the reasons their pool managers decided to bifurcate their pool. The second section explores whether these same reasons are applicable to the circumstances surrounding the county's investment pool. Apart from Florida's rationale for bifurcation, the third section explores other possible reasons for segregating the county's assets. The final section highlights the administrative impacts of managing two pools.

Background: State of Florida Experience

Florida's pool managers closed the original pool to all redemptions on November 29, 2007 in order to address an unprecedented "run on the pool" situation where pool many pool members were exiting the pool on short notice. The pool was faced with a crisis situation where it could no longer honor all redemptions without selling longer term securities at a severe loss. The liquidity in the pool was limited to cash flows from the underlying securities and investors did not have immediate access to cash from the pool.

To address the crisis, Florida hired BlackRock as a financial advisor and BlackRock recommended dividing the pool into two parts. Pool A contains all of the money market assets that remain highly rated and are not impaired (86 percent of assets). Pool B consists of assets in default, impaired or having a significant credit risk (14 percent of assets).

Based on a presentation made to the State Board of Administration, Florida segregated its pool for three primary reasons:

- To provide immediate cash liquidity, with conditions, for investors.
- To ensure that problem assets are clearly identified and segregated.
- To restore confidence in pool management and emerge with a viable ongoing pool structure.

Pool A is considered the ongoing cash fund for investors and was established to provide greater freedom for investors to manage their own liquidity needs, with some initial restrictions on redemptions. Pool members can redeem amounts equal to 15 percent of their current balance or

$2 million, whichever was greater. These restrictions were designed to phase out over time as market conditions changed and as confidence in pool management was restored.

All assets assigned to Pool B had uncertain values because they had defaulted, had extended payout times, or were subject to elevated credit risks. Investors were told that shares in Pool B were not subject to redemption until such time that restructuring proposals with new maturity dates were established. Pool managers indicated that investors should receive some level of recovery from this pool because most of the underlying assets in the impaired investment programs were still performing (i.e., underlying loans were continuing to pay and generating cash).

Does Florida's rationale for a split pool apply to King County's situation?

This section examines each of the reasons Florida split its pool and whether these reasons are relevant for the county investment pool.

- *To provide immediate cash liquidity, with conditions, for investors.*

The county has not experienced any cash liquidity problem as a result of four impaired investments that comprise 5 percent of the total pool. The county was also able to avoid a "run on the pool" as a result of three factors that were not evident in the Florida situation.

First, previously established pool agreements only allowed pool members to exit on a defined anniversary date thereby preventing rapid exits. Second, the county serves as the *ex officio* treasurer for 95 out of 100 districts in the pool, which means that the bulk of pool members who might choose to exit must still work with the county to execute investment requests and strategies. Third, the county's Executive Finance Committee adopted an impaired investment policy that would treat all pool members fairly and equitably in the event of any financial losses. This policy further reduced the incentive for any pool member to leave the pool to avoid exposure on an impaired investment because any financial losses are eventually allocated on a *pro rata* basis to all pool members who were a part of the pool when the impairment occurred.

- *To ensure that problem assets are clearly identified and segregated.*

Investors in Florida's pool had significant concerns about pool managers downplaying risk and not being completely transparent about impaired holdings. Placing all defaulted or credit impaired assets into Pool B allowed Florida to demonstrate its transparency regarding all assets that were problematic.

The county pool has been very transparent and open with its pool members since the global credit market crunch emerged in late August 2007. Detailed email reports have been sent out monthly and as conditions changes. There have also been many in-person meetings and telephone conference with districts to discuss the situation and answer questions. To date, there have been no suggestions or expressed interests from the county's pool members to have a segregated pool.

- *To restore confidence in pool management and emerge with a viable ongoing pool structure.*

Florida was faced with a situation where it could not meet expected demands for cash redemptions and was forced to temporarily close their pool. This left many questions for investors and state officials about whether the original pool could actually survive with the same structure going forward.

The long term viability of the county pool has not been an issue. The county pool's exposure to the impaired investments is limited and manageable at 5 percent of total pool assets. The county is not in a situation where it is imperative that the pool be split into two parts in order to sustain the long term viability of the pool.

Exploring Other Reasons for a Split Pool

This section examines two other reasons for dividing the county investment pool.

- *To restore the S&P pool rating for the highly rated assets.*

In mid-January 2008, S&P took the temporary action to suspend their rating of the county's pool pending the outcome of enforcement events associated with each impaired investment. At this time, the county fully expects to see its AAAf rating restored as restructuring proposals are publicly announced and executed on each impaired investment. In addition, all three national credit rating agencies have determined that the impaired investments are manageable given the magnitude of the county's financial reserves and therefore have no material impact on the county's overall bond ratings.

The credit analysts from S&P have stated that by segregating the pool's assets, they would likely restore a high rating to the pool with the highly rated assets and not assign a rating to the other pool with the impaired assets. This would provide a means of re-establishing the pool rating without having to wait for the outcome of the various restructuring proposals.

- *To enable the county to distribute a yield for new monies entering the pool that is not weighted down by the impaired assets.*

The adopted impaired investment policy states that new monies invested in the pool after an investment is declared impaired will not be subject to the calculation of a financial loss. This protects new bond monies and other large sums which enter the pool today from being considered as part of a district's average pool balance for loss distribution purposes.

However, by keeping all impaired investments as part of a single pool, the main impact on new monies is that the yield on the pool is weighted down to a small degree by the non-yielding impaired investments. For example, if the pool's average monthly yield on 95 percent of its highly rated assets is at 4.5 percent and this is combined with a zero yield on 5 percent of its impaired assets, then the blended yield distributed to pool members will be 4.3 percent on both existing funds and any new monies. By splitting the pool, all new monies entering the pool after an investment was impaired would receive the benefit of the higher yield rate of 20 basis points.

It is important to point out that the potential negative aspect of the impaired investments acting as a small anchor on the pool yield may be offset, to some degree, by the pool's practice of distributing amortized interest earnings, especially in today's market. For example, new bond monies entering the pool today will immediately benefit from this month's pool distribution at a higher rate of return when compared to investing in say the state's pool at a lower yield. This is because the new bond monies benefit from many of the longer term investments already in the county portfolio which are yielding a higher rate of return.

In each district's investment agreement, a pool member also can exercise their option to not have new monies enter the pool and to have the county execute investments separately for these monies. This is sometimes done for new bond funds where a district wants to lock in a specific interest rate over time. This flexibility in the pool agreement may offset a district's concern about moving bond monies into the pool at a yield that is potentially weighted down by the impaired investments.

The impact on existing monies in the pool (which already have exposure to the impaired investments) is the same regardless of whether the pool is split or not. This is because the overall yield distribution accounts for each districts "share" of the impaired investments and the net result is a 4.3 percent yield, with 95 percent of investments earning 4.5 percent and the impaired investments earning zero in the near term.

Administrative Implications and Complexities of a Split Pool

Splitting the pool will add a layer of complexity to the investment process that must be balanced against the potential benefits. The complexity translates into an increased time commitment and fairly extensive manual paper processing for county staff who are already spread very thin in Treasury Operations. Furthermore, the county's legacy investment system cannot be easily reconfigured to make a bifurcated pool easier to administer.

There are 792 separate fund in the county treasury and splitting the pool requires that a new "sub-fund" be created for each of these funds. An interfund transfer form would have to be manually prepared to move the $207 million of impaired "shares" into each one of the sub-funds.

In the split pool environment, we would handle interest earnings distribution in the same manner as the Florida pool. A distribution to the highly-rated pool would be made to the original 792 funds while a distribution to the sub-funds in the impaired pool would only be made as the pool receives cash payments from restructurings. Each cash payment would entail hundreds of interfund transfer forms. With four impaired investments and the possibility that cash payments could be made over a long period of time, this will create an extra workload burden in both the short and long term.

The intent of the county's impaired investment policy was to ensure that districts maintained an amount in their collective funds, not necessarily individual funds, to offset the maximum loss exposure on impaired investments. By bifurcating the pool and moving $207 million to sub-funds, there could be unintended consequences that restrict a district's liquidity.

For example, say that a fire district plans to acquire a new fire truck costing $1 million and this expense reflects almost the total amount in the district's capital fund. Splitting the pool would require us to move $50,000 of the district's current pool shares into the impaired pool where it could not be used to help pay for the purchase of the new fire truck. This type of restriction on a district's liquidity would likely create questions and concerns that would not surface under the administration of a single pool.

Staff Recommendation

[to be completed]

Appendix III

DRAFT ISSUE PAPER: INVESTMENT POOL FEES AND OPTIONS
Prepared by Finance and Business Operations Division Staff

February 28, 2008

1.0 Introduction

In early December 2007, representatives from the Issaquah and Lake Washington School Districts raised questions about the reasonableness of the 15 basis point fee charged to each local district as part of their participation in King County's investment pool.[36] The county's representatives agreed to review the fees and propose options that could be considered by the county's Executive Finance Committee (EFC) in early 2008.

This issue paper provides background information about the formation of the county's pool and the basis for the current fees; highlights the pool's historical performance and treasury services provided to districts; summarizes survey results from other government investment pools; and presents a range of conceptual fee options based on the survey information. The paper is intended to assist the EFC in its deliberations regarding a possible new fee structure. It is also intended to solicit input from interested district officials and the King County Council's Investment Advisory Panel, which is currently reviewing the county's investment practices and policies. The next steps in the review and decision making process are summarized at the end of the paper.

2.0 Background

Prior to allowing local districts to be part of the county's investment pool in 1995, local districts were required to monitor their daily cash balances and request that the county treasury invest their residual cash. The investment process consisted of each district determining the amount and duration of funds to be invested and then asking the county to select an appropriate security for their portfolio. The county would decide on the type of security based on state law and policies established by the county. For this service, state law permitted the county to collect a fee of five percent of the earnings, with an annual maximum of fifty dollars, on each transaction authorized by the governing body.

This method of investing for each separate fund was time consuming for both the county's treasury staff and the financial staff of the districts. Most districts would instruct the county to acquire investments using 97 to 98 percent of their cash balances, effectively leaving 2 to 3 percent of their cash un-invested. According to state law, this un-invested idle cash left in the county treasury could be invested for the benefit of the county's general fund. In 1993, the general fund earned approximately $1.3 million in interest from the un-invested cash balances of the various districts.

[36] The Issaquah and Lake Washington School Districts were speaking on behalf of the School Investment Coalition which also includes Bellevue School District, the Puget Sound Educational Services District, the Washington Schools Risk Management Pool, and the Tacoma School District (note that the Tacoma School District is not a member of the county pool).

In 1994, the Finance Division completed a report examining the costs and benefits of expanding the investment pool to include outside districts. Up until this time, the investment pool had only included the county's funds. The report highlighted several key benefits for expanding the pool including time savings for placing investments, reduced transaction costs, increased interest earnings, and additional portfolio diversification. From the district's point of view, they were most interested in increased earnings and having 100 percent of their cash fully invested on a daily basis. The main concern, from the county's perspective, was that the county would no longer obtain the revenues from the idle cash left by each district as un-invested in the county treasury. This lost revenue to the general fund was viewed as a significant "opportunity cost" associated with the expansion of the investment pool.

County officials wanted to ensure that the pool could be expanded in a manner that was revenue-neutral for the county, while still achieving the overall benefits of pooling investments for the county and the interested districts. To address this desired outcome, the Finance Division recommended a service fee that would account for both the pool's annual operating costs, as well as the opportunity costs associated with lost revenue to the county's general fund. The service fee that achieved this goal was 15 basis points (.15%), which was applied to the average cash balances of each district fund in the pool. Starting in 1995, the county entered into interlocal agreements with districts who accepted the new fees as a condition of voluntarily joining the county's investment pool.

In 1996, the county council's auditor staff reviewed the underlying basis of the investment fee and its applicability to existing state law governing pooled funds. Auditor staff had expressed concerns about whether the county could charge a service fee that exceeded the "actual expenses" to establish and administer the pool. The audit report recommended that the Finance Division seek an opinion from the county's Prosecuting Attorney's Office (PAO) clarifying the statutory requirement expressed in RCW 36.29.024. In a follow up audit report, the county auditor confirmed that a 1996 opinion issued by the PAO found no conflicts with RCW 84.29.024 for the existing investment fee.

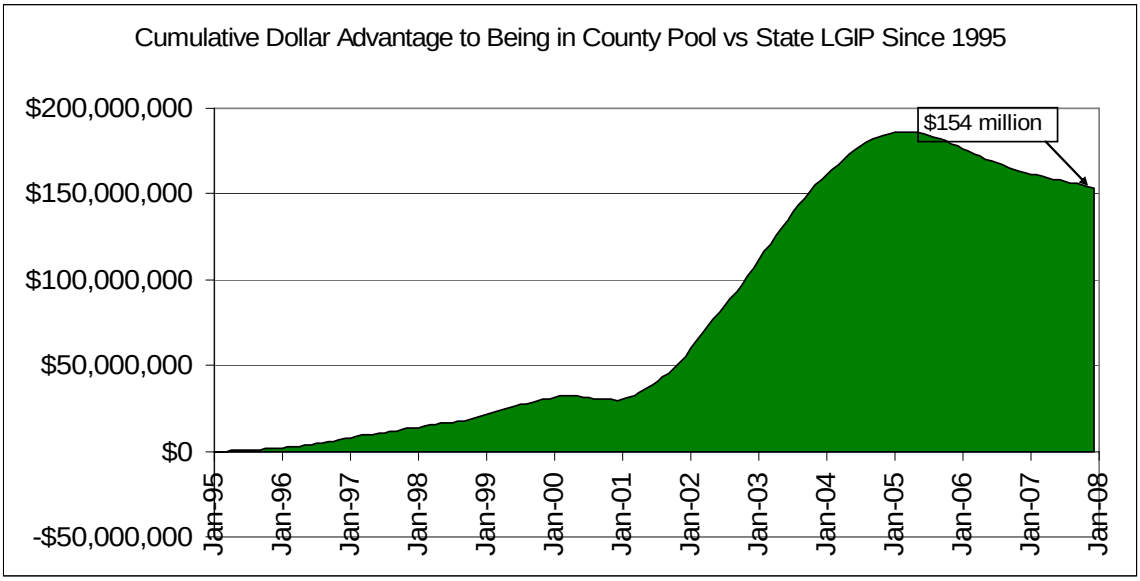
The table below indicates cash balances, annual earnings and fees paid in 2007 by local districts, using the15 basis point fee as applied to average daily cash balances. To illustrate the benefits of pooling, the third column highlights estimated earnings under the pre-pooling assumption that 2 to 3 percent of a district's cash remains un-invested.

Districts by Category	Pool Cash Balance as of 12/31/07	Actual Annual Interest Earnings 2007 (with Pool)	Estimated Annual Earnings 2007 Assuming No Pool (2.5% un-invested)	Pool Fees Paid 2007
School Districts	1,875,720,846	80,732,289	78,713,982	$2,332,892
Water Districts	133,821,892	6,814,845	6,644,474	$199,275
Fire Districts	92,854,156	4,608,905	4,493,682	$135,007
Sewer Districts	162,279,574	8,701,145	8,483,616	$249,498
Hospital Districts	49,346,782	2,434,707	2,373,839	$71,388
KC Library System	80,675,571	4,623,701	4,508,108	$135,220
Harborview	194,671,082	7,329,563	7,146,324	$215,285
Cascade Water	37,652,802	1,997,565	1,947,626	$58,384
Miscellaneous	37,869,291	3,182,788	3,103,218	$95,672
All Local Districts	**2,664,891,996**	**120,425,508**	**117,414,869**	**$3,492,621**

3.0 Investment Pool Performance and Treasury Services Provided to Districts

--Pool Performance:

The track record of the county pool has been outstanding, earning a safe and respectable 5 percent average rate of return for the past 13 years. The county pool uses the state's local government investment pool (LGIP) as one of several performance benchmarks. The table below depicts the cumulative dollar advantage that the county's pool members received in interest earnings by investing in the county's pool rather than the state's pool from January 1995 to January 2008. The $154 million is the net cumulative advantage after accounting for fees in both pools. This translates into an annual net benefit of about $12 million per year, or 48.5 basis points, for the districts in the county's investment pool.



It is important to note that the table does not reflect any potential financial losses from four impaired commercial paper investments that account for 5 percent of the holdings in the county pool. However, even if the impaired investments are valued at their distressed "fair value" price at year-end 2007, the estimated cumulative loss of $83 million is more than offset by the $154 million net advantage of being in the county pool versus the state pool since 1995.[37]

--Treasury Services and Costs to Districts:

The county provides an array of traditional treasury services to those local districts for which the county is their designated treasurer under state law. These traditional services include the following:

- Cash management, which includes daily electronic payments, investment portfolio management, daily investment transactions, investment banking services and pool financial reports.

[37] The estimated unrealized loss on the four impaired investments is $83 million which is approximately 40 percent of the maximum loss exposure of $207 million.

- Debt management, which includes administration of short and long term debt financing, recordkeeping, and periodic bond payments.
- Disbursements, which include issuing, redeeming and the daily reconciliation of warrants.
- Banking services, including general banking and public depository services via competitively bid contracts.
- Local improvement district services, including billing, collection, delinquency follow up, and foreclosure proceedings.

The costs directly related to the investment pool are recoverable via the investment pool fees paid by each district. However, state law does not allow the county to assess a separate administrative fee for all of the non-investment services mentioned above. Consequently, those local districts which choose to exercise their authority to become their own treasurer must take into account the marginal cost of providing such services on their own. The following table provides a conservative (low-end) estimate of the cost of treasury services associated with local district funds.

Cost of Treasury Services to Districts*	2008 Cost Estimate
Cash Management (mostly investment related)	427,222
Debt Management	78,846
Disbursements	393,940
Banking Services and Depository	35,428
Local Improvement Districts	42,172
Total	**$977,607**

*Estimated from Finance rate model. Excludes cost of services to County Funds.

4.0 Survey Results

--National Survey:

A 2007 survey conducted by iMoneyNet classified 109 government investment pools by category. The survey recorded investment fees, interest earnings, average maturity dates, and overall investment objectives. A combination of state pools and county pools from across the United States were part of the survey, including the King County investment pool.

The survey divided pools into categories based on whether there is a fluctuating net asset value (NAV) and the average duration of each pool's investments as follows: MMF is a money market fund with a stable NAV of $1 per share and an average maturity of 90 days or less; MMF Plus is a money market fund with stable NAV of $1 per share and an average maturity of greater than 90days and less than 1 year; Ultrashort is a short term bond fund with a variable NAV and durations of 1 to 3 years; and Intermediate Bond is a

medium term bond fund with a variable NAV and durations of 3 to 5 years. King County's investment pool is classified in the "ultrashort" bond fund category.

The following table summarizes investment pool fee averages and ranges across the various pool categories.

Category of Fund	Average Fee All Pools	Average Govt Sponsor	Average Private Sponsor	Range of Fees
Money Market Fund (MMF)	21.94	6.96	30.99	0.0 to 58.0
Money Market Fund-Plus (MMF-Plus)	14.39	13.44	16.75	0.0 to 40.0
Short Term Bond Fund (Ultrashort)*	13.80	10.46	25.50	3.6 to 28.0
Intermediate Bond Fund	16.54	13.31	23.00	12.5 to 23.0
All Pools	**20.01**			

*King County Pool is in this category
Source: iMoneyNet 2007 Survey of 109 state and county pools

As illustrated by the table, King County's fee is in line with the national average for all investment pools, as well as comparable Ultrashort investment pools.

The iMoney Net survey found that pools managed by private consultants or investment firms rather than county or state practitioners tend to have higher fees. Similarly, pools privately sponsored by investment firms or banks rather than publicly sponsored by state or county agencies tend to have higher pool fees. This data indicates that if several large districts were to form their own pool and have it managed by a private investment firm, the costs would likely be more than the fees currently paid to the county pool.

--Washington State Counties Survey:

In January 2008, County staff also conducted an email survey of the fees charged by other county pools in Washington State. The survey requested information about the nominal fee levels as well as a brief description of the service levels and investment practices tied to the fees. The following table highlights the key similarities and differences in fees and related cash management services.

County	Basis Points	Is there a daily tax distribution to local districts?	Is 100% of local district's cash from each fund invested daily?	When is cash deducted for warrants?
Clark	8-9	No	No	Date of issue
Grant	7	No	No	Date of issue
Kitsap	8	*Yes*	No	*When cleared*
Spokane	3.5	No	*Yes*	One day before clearing
Thurston	5	No	*Yes*	Date of issue
WallaWalla	5	No	*Yes*	Date of issue
Whatcom	4.5	Yes	No	*When cleared*

Yakima	4.275	No	No	Date of issue
King County	15 (established by interlocal agreements)	*Yes*	*Yes*	*When cleared*

From this brief survey, the county pool is the only pool among those surveyed that guarantees its pool members the dual benefit that tax distributions and residual cash balances are fully invested on a daily basis without delay.

Some county pools distribute property tax receipts once or twice per month to local districts in their pool, effectively earning their county the interest on district monies prior to the distribution dates. For members of its pool, King County collects the tax receipts in a central fund and later does a "look back" credit of the interest earnings so that each district's funds are earning interest on the day those funds were initially received by the county, not on the day they were eventually distributed to the districts. This is a significant benefit to districts because if tax receipts were distributed either bi-monthly or monthly, the loss in earnings to district pool members would be in the range of $920,000 to $1.8 million per year. In other words, the benefit of this practice for local districts is equal to 4 to 8 to basis points of added earnings each year.

Other county pools require their local districts to periodically "call in" their amounts to be invested and do not ensure that 100 percent of each fund's cash balances are invested daily. The King County pool automatically monitors district cash flows and sweeps the residual cash of each fund on a daily basis to ensure that 100 percent of these funds are earning interest. Again, this is an important benefit for districts which, prior to their involvement in the pool, were leaving an average of 2 to 3 percent of their funds un-invested. Using current pool balances, the value of the sweep benefit to district pool members is in the range of $2.3 to $3.5 million per year. In terms of basis points, and assuming an interest rate of 5 percent, the basis point value to the districts would be 10 to 15 annually.

For warrants, unlike most other counties surveyed, King County does not deduct cash until warrants clear the bank. This practice provides added "float" that further increases investment earnings for the districts. The benefit of this added float is worth approximately $838,000 for all districts or 3.6 basis points per year.

5.0 Options for Pool Fees

This section addresses optional fee structures or methods that could be applied to the county pool. The fee methodologies are organized into several categories: simple fee, component fee, sliding fee, and hybrid fee. This categorization is reflective of the variety of fee structures in the 2007 iMoneyNet survey. This section also presents an option that would allow districts to invest designated funds in the state pool under certain conditions.

--Simple Fee:

The county's current 15 basis point fee is an example of a simple fee structure. The iMoneyNet survey indicates many government pools have such a fee structure that is a simply stated "flat fee" amount without elaboration or additional breakdowns. Each jurisdiction would have to be contacted to obtain further information about how their fee was derived.

In general, every 1.0 change in basis point, either up or down, results in a cumulative district fee change of $233,000. For example, if the current fee were to be reduced from 15 to 14 basis points, the fee revenues from districts would decline from $3,492,621 to $3,259,780.

The county's treasury staff can explore many variations off of the simple fee structure. A variation mentioned by the school districts includes the concept of giving capital project funds a "discounted' rate compared to other funds. The underlying rationale for such a discount on capital funds has been expressed by some of the large school districts which assert that they have been presented with opportunities to invest longer term capital and bond funds outside the county pool over longer maturities, at reduced fee levels. If the county can lower its fees on these funds, this would make such outside investment opportunities less attractive to the districts. Consequently, the districts would not have the incentive to ask the county to leave new capital or bond funds outside of the county's investment pool, which is an option currently allowed as part of the interlocal investment agreements.

--Component Fee:

As the name implies, a component fee is divided into multiple cost categories that are essentially rolled up into a single basis point fee. From the iMoneyNet survey, a component fee schedule may include specific charges, measured in basis points, for any or all of the following investment services:

- Financial Advisor: This is the cost associated with an outside consultant or firm with expertise in public sector investment practices and strategies. Fees for this type of service can vary widely depending on the level and complexity of the services provided. For example, a financial advisor who performs detailed credit analysis on securities will be more expensive than an advisor who examines the holdings in a portfolio once a quarter. From the iMoneyNet survey, cap levels are sometimes attached to these services and there can be rebates if actual expenses are less than planned. Further research is needed to determine how such a service and related fee would apply to the county's pool.

- Administrator: This is the actual cost of administering the pool on a day to day basis. Fees can vary widely, largely depending on whether the administrator is a private firm/consultant or a public entity. From the iMoneyNet survey, fees charged by external administrators from banks or private financial firms were higher than fees charged by state or county administrators. This cost would typically cover staffing resources, supervision, benefits, investment systems, banking services, and overhead charges. Similar to financial advisor services, cap levels and rebates can apply.

- Banking Custodian: This is the cost of banking services associated with investment transactions and reports. This fee is either shown separately or can be combined as part of the administrator costs.

- Marketing Agent: Some government pools have a small basis point fee charged for advertising and marketing services.

- Sponsorship and/or Governance: Some state and county pools charge an ongoing sponsorship fee to pool members. When the county first allowed districts to join the pool in 1995, the county was

concerned about lost revenues tied to un-invested cash balances and therefore charged a fee that would be revenue-neutral to the county. This can be viewed as an example of a sponsorship fee for establishing the pool. Some pools also assess a fee for costs associated with pool governance, including appointed members of finance or credit committees.

- Insurance and/or Reserve for Losses: A few pools charge a fee that is used to pay for insurance on specific types of securities such as commercial paper. Others assess several basis points to add dollars to a reserve fund that is designed as the initial funding source for absorbing actual losses.

- Special Legal, Consulting and Auditing Services: Many pools indicated there were separate charges for legal consultation, special financial consulting and annual auditing services. The county's hiring of attorneys and special financial consultants associated with the impaired investments would be examples of such services.

The underlying rationale for a component fee schedule is that it more clearly delineates cost factors that result in the total fee for pool members. Any increases or decreases in annual costs associated with the various service components would be transparent and easily explained to pool members. Such a fee method would, however, entail additional administrative work as there would likely need to be detailed accounting of planned versus actual costs with adjustments either upward or downward at year-end. There would also need to be an investment system in place for more elaborate accounting of the costs and related fee components.

--Sliding Fee:

A sliding fee schedule entails charging a different amount to each district based on average daily cash balances in the pool. Districts with large sums invested would receive an economy of scale discount compared to districts with smaller cash balances.

The following example of a sliding fee schedule that averages 18 basis points is from the Pennsylvania Local Government Investment Trust/ARM:

- 20 basis points on first $300 million in average daily net assets;
- 16 basis points for assets from $300 to $500 million; and
- 14 basis points for assets exceeding $500 million.

--Hybrid Fee:

A hybrid fee typically combines features of the component and sliding fee schedules so that the fee for various service components are reduced for large amounts invested. Hybrid fees can be complex to administer if there is not an automated investment system that reduces the burden of calculations.

As an example, the Alaska Municipal League Investment Pool charges 28 basis points using the following breakdown:

- Financial Adviser: 9 basis points on first $100 million; 8 basis pints on next $150 million; 5 basis points thereafter.

- Administration: 12.5 basis points on first $100 million; 10 basis points on next $150 million; 9 basis points thereafter.
- Custodian Bank: 5 basis points.
- Sponsor: 4.5 basis points on first $100 million; 7.5 basis points on next $100 million; and 4 basis points thereafter.

--State Pool Option:

The school districts have asked the county whether they could choose to invest any portion or all of their cash balances in the state's Local Government Investment Pool (LGIP). While the county pool has historically used the LGIP as part of its overall investment portfolio, the county had previously not allowed King County districts to directly participate in the LGIP for three reasons:

- Risk of Arbitrage: The LGIP operates a money market fund, while the county pool operates like a short-duration bond fund. The yield on both pools is directly impacted by monetary actions taken by the Federal Reserve (i.e., the Fed). In general, when the Fed is lowering rates to stimulate the economy, the LGIP's yield drops below the county pool's yield. On the other hand, when the Fed is raising rates to dampen economic activity, the LGIP's yield can exceed the county pool yield. A district that has access to both pools could have the best of both worlds by moving funds back and forth between the LGIP and county pool. The ability of districts to easily shift money between the two investment pools would increase the risk and lower the long-term return of both pools.

- Investment System Limitation: While the county's current investment system can track investments in the LGIP for one account, it lacks the functionality to track multiple accounts. This has been viewed as a technical obstacle.

- Interlocal Agreement Restrictions: The interlocal investment agreements voluntarily entered into between the county and each district in the mid-1990s reinforced the fact that the agreements were long-term commitments. Pool members were given the option when signing their agreements to designate any funds which would not be placed in the pool and could therefore be invested separately outside the pool. The vast majority of districts indicated that all their funds were to be invested in the county's pool.

However, given the interest in this option, Treasury staff is reexamining this issue and is in the process of evaluating the possible options. For example, the following process may be possible:

1. Districts Designate Funds to be Invested in State's LGIP: Each district normally has four to six funds with investable cash balances. For any single fund, the district would have to choose whether to have the fund invested in the LGIP or in the county pool. Districts would not be allowed to use both the LGIP and the county pool in order to protect both pools from disruptive movements of monies between the pools. A district would be required to make a five year commitment for any fund they choose to be in the LGIP. This commitment could be implemented via an amendment to a district's interlocal investment agreement.

   This restriction is necessary if the county pool is to maintain the ability to invest in securities with a maturity greater than one year. Without such a restriction, districts could switch in and out of both

pools on an annual basis. The negative impact on the county pool would be two-fold. First, the county pool could be faced with the situation of having to sell investments before maturity to accommodate districts that wanted to move money to the LGIP, and this could result in selling securities at a loss to the detriment of all districts. Second, to reduce the probability of having to sell securities before maturity, the county pool would have to hold more short-term assets and this would result in lower county pool earnings in the future. As shown previously, the county pool's longer duration has allowed it to earn a higher rate of return compared to the LGIP over the past 13 years, so holding more short-term investments would damage the county pool's future performance.

2. Districts Provide Direction to County Treasury: A district that selects the LGIP as its investment choice for one or more funds, would need to direct the county treasury to transfer monies to and from the LGIP for each designated fund. Any idle cash left in the district's county fund would earn no interest and could be invested for the benefit of the county's general fund as permitted by current state law (RCW 36.29.020)

3. Districts Comply with State LGIP Policies: A district that selects the LGIP as its investment choice for one or more funds must comply with the policies established by the LGIP. Currently the LGIP policies include the following stipulations:
   - $5,000 minimum transaction size.
   - One-day notification on transactions of $10 million or more.
   - Transactions over $1 million must be requested prior to 9 am on the day of the transaction.
   - Transactions under $1 million must be requested prior to 10 am on the day of the transaction.

   Note that the timeframes above do not account for county staff time to process such requests. Therefore, the county will have to modify these requirements slightly to allow for the adequate notification and time to process and consolidate individual district requests.

4. Districts Pay Administrative/Transaction Fee Allowed by RCW to County Treasury: In addition to the fees charged by the LGIP, the districts utilizing the LGIP may be assessed a fee by the county to carry out these transactions for designated funds. State law currently allows county treasurers to charge five percent of the earnings, with an annual maximum of fifty dollars, on each transaction authorized by the governing body (RCW 36.29.020).

6.0 Next Steps in Review and Decision Making Process

This issue paper is designed to brief the EFC on the basis for the current pool fee charged to local districts and optional fee structures. The next step in the process is to allow EFC members, as well as interested district officials and the Council's Investment Advisory Panel members, to review this information and make comments or suggestions.

The EFC can then direct staff to develop more specific recommendations that can be reviewed and discussed at the next regularly scheduled EFC meeting on March 27th. The goal is to have the EFC reach a consensus decision on a fee structure no later than the first half of 2008.

As the EFC looks forward to the next steps in the review process, it is important to keep in mind the following considerations that will influence discussions and decision making on fees:

- The current fees are part of negotiated interlocal agreements and therefore, any change to the fee structure would require a change to the agreements, either through an amendment to the current contract or the issuance of a new contract.

- Rather than narrowly focus on nominal fee amounts associated with investments, it will be important to consider the full range of cash management services, service levels and tangible economic benefits provided to districts as part of the EFC's consideration of alternative fee options.

- While this issue paper focuses on fees charged to local districts in the pool, a review of the fairness of fees charged to county funds should be factored into the overall analysis.

- In the course of their review of the county investment pool, the Council's Investment Advisory Panel may generate recommendations to invest in infrastructure and other resources which would improve the pool's overall performance. The EFC should consider these recommendations when evaluating the appropriate fee structure in the short and long term.

Appendix IV

Draft Discussion Paper: "How Much Will It Cost?"
Investment Pool Advisory Panel
May 15, 2008

How Much Will It Cost?

Build It		Buy It	
County is Budget Constrained		*Outside Manager Provides Value Added, Representative Strength of Size*	
AUM Assumption	**$ 4,000,000,000.00**	**$ 4,000,000,000.00**	**Fees decline as assets under management grow.**
Portfolio Management			
2 Investment Officers	**$ 300,000.00**	**Included**	**2+ Portfolio Managers (15 yr average experience)**
3 Credit Analysts	**$ 330,000.00**	**Included**	**11+ Credit Analysts**
Credit Committee Members	**$ 150,000.00**	**Included**	**20+ Member Credit Committee (12 yr average experience)**
Investment Committee	**$ 150,000.00**	**Included**	**25+ Member Investment Committee (10 year average experience)**
2 Investment Assistants	**$ 120,000.00**	**Included**	**7+ Backup Portfolio Managers (15 yrs average experience)**
2 Economists	**$ 400,000.00**	**Included**	**2+ Economists (Chief Investment Strategist & Senior Economist) (20+ years experience)**
Legal	**$ 150,000.00**	**Included**	**3+ In house attorneys, Outside specialized securities counsel**
Insurance			
Fiduciary, E&O	**$ 100,000.00**	**Included**	
Subscriptions			
Market, Credit, Performance	**$ 500,000.00**	**Included**	**Bloomberg, Capital Management Sciences (portfolio management and analytic system), Datastream, First Call Research system, Investor Tools (portfolio analysis system), Proprietary Invest with Liquidity (accrual, valuation and compliance strategy system), Knight Ridder (informational database), Municipal Market Data Line, Stone & McCarthy Research, Bridgewater Associates, Moody's Investors Credit Service, Standard and Poor's Credit Service, Thompson Bank Watch Credit Service, "Fast" balance sheet pro-forma system, Proprietary Horizon Analysis Tables Wall Street Research (including various economists), iMoneyNet, Crane's Data, Morningstar, Russell, Fitch**
Portfolio Tools			
Analytical/Risk Systems	**$ 200,000.00**	**Included**	**7+ Risk Analysts plus risk analytic systems**
Custody (incl. unitization)	**$ 200,000.00**	**Included**	**12+ Administrators**
Continuing Education	**$ 30,000.00**	**Included**	**Onsite training, webinars, short duration and market updates**
Pool Communication			
Manager	**$ 100,000.00**	**Included**	**2+ Relationship Managers**
Secured Website	**$ 100,000.00**	**Included**	**36+ Techology Developers, Analysts and Engineers**
Accounting			
GASB Compliant	**$ 100,000.00**	**Included**	**Online GASB Compliant Reporting**
Overhead Allocation	**$ 287,000.00**	**NA**	
Benefits, Systems, Management, Rent, Telephone, Utilities (increases annually)			
Annual Cost	**$ 3,217,000.00**	**$ 2,400,000.00**	**Fees decline as assets under management grow.**
Annual Basis Point Cost	**8**	**3 - 6**	**Range 3-6 basis points**

**** An additional benefit provided by the "Buy It" option is that historically, external fund managers have taken steps to make participants whole following a devaluation of securities. The "Build It" option above does not quantify the cost of providing comparable capital support. Historically, this cost has been between 2 and 5 percent of the value of the portfolio ($80 to $200 million on a $4 billion portfolio).**