



STATE OF NORTH CAROLINA

FINANCIAL STATEMENT AUDIT REPORT ON

**THE INVESTMENT POOL
OF THE NORTH CAROLINA DEPARTMENT OF
STATE TREASURER
RALEIGH, NORTH CAROLINA**

FOR THE YEAR ENDED JUNE 30, 2001

OFFICE OF THE STATE AUDITOR

RALPH CAMPBELL, JR.

STATE AUDITOR

FINANCIAL STATEMENT AUDIT REPORT ON

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STATE TREASURER**

RALEIGH, NORTH CAROLINA

FOR THE YEAR ENDED JUNE 30, 2001

**RICHARD H. MOORE
STATE TREASURER**

**J. MICHAEL BARHAM
DEPUTY TREASURER, FINANCIAL OPERATIONS DIVISION**



Ralph Campbell, Jr.
State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The Members of the North Carolina General Assembly
The Honorable Richard H. Moore, State Treasurer

This report presents the results of our financial statement audit of the Investment Pool of the North Carolina Department of State Treasurer (the Department) for the year ended June 30, 2001. Our audit was made by authority of Article 5A of G.S. §147.

The accounts and operations of the Investment Pool are an integral part of the State's reporting entity represented in the State's *Comprehensive Annual Financial Report (CAFR)* and the State's *Single Audit Report*. In those reports the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor also presents the audit results on the State's internal control and on the State's compliance with laws, regulations, contracts, and grants applicable to the State's financial statements and to its federal financial assistance programs.

As part of the audit work necessary for the *CAFR* and the *Single Audit Report*, the accounts and operations of the Investment Pool were subject to audit procedures as we considered necessary. In addition, we performed auditing procedures that we considered necessary for us to report on the accompanying financial statements that relate solely to the Investment Pool. The audit procedures were conducted in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States.

The purpose of this report is to present the results of our audit on the accompanying financial statements. A summary of our reporting objectives and audit results are:

1. Objective - Express an opinion on the financial statements.

Results - The financial statements present fairly the amounts and disclosures made in accordance with accounting principles generally accepted in the United States of America. These matters are described in the Independent Auditor's Report on the Financial Statements.

AUDITOR'S TRANSMITTAL (CONCLUDED)

2. **Objective** - Present significant deficiencies, if any, in internal control which could adversely affect the Department's ability to record, process, summarize, and report financial data in the financial statements of the Investment Pool and present instances of noncompliance, if any, with laws, regulations, contracts or grants.

Results - Our tests disclosed no material weaknesses in internal control over financial reporting and no instances of noncompliance, which require disclosure herein under *Government Auditing Standards* issued by the Comptroller General of the United States. These matters are described in the Independent Auditor's Report on Compliance and Internal Control Over Financial Reporting.

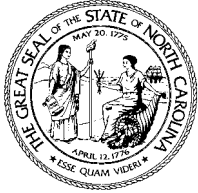
North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.



Ralph Campbell, Jr.
State Auditor

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INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

The Honorable Richard H. Moore, State Treasurer
Raleigh, North Carolina

We have audited the accompanying Statement of Net Assets of the Investment Pool of the North Carolina Department of State Treasurer (the Department), as of June 30, 2001 and the related Statement of Operations and Changes in Net Assets for the year then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Investment Pool as of June 30, 2001, and the results of its operations and changes in net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 30, 2001 on our consideration of the Department's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Schedules 1 and 2 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

A handwritten signature in black ink that reads "Ralph Campbell, Jr.".

Ralph Campbell, Jr.
State Auditor

October 30, 2001

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***The Investment Pool
Statement of Net Assets
at June 30, 2001***

(Dollars in Thousands)

Exhibit A

ASSETS

Investments:	
Repurchase agreements	\$ 230,000
U.S. Treasury notes and bonds	13,210,683
Federal agency notes and bonds	3,907,836
GNMA certificates	4,751,301
Corporate bonds and notes	9,655,057
Domestic equities	31,457
Equity-based trusts	31,716,223
Investments in real estate trust funds	1,016,714
Venture capital investments	39,584
Investment of cash collateral received for securities lent	<u>12,865,287</u>
Total investments	77,424,142
Cash and cash equivalents	247,639
Other assets	<u>433,101</u>
Total assets	<u>78,104,882</u>

LIABILITIES

Obligations under securities lending transactions	12,865,287
Distributions payable	<u>32,320</u>
Total liabilities	<u>12,897,607</u>

NET ASSETS

Net assets external participants	497,149
Net assets internal participants	<u>64,710,126</u>
Total net assets	<u>\$ 65,207,275</u>

The accompanying notes to the financial statements are an integral part of this statement.

***The Investment Pool
Statement of Operations and Changes in Net Assets
For the Year Ended June 30, 2001***

(Dollars in Thousands)

Exhibit B

Revenues	
Income from investments	\$ (747,857)
Income from securities lending	799,140
	<u>51,283</u>
Total operating income	
Less operating expenses	
Treasurer's allocated cost	10,914
External managers' fees	35,522
Securities lending expenses	769,994
Other operating expenses	3,545
	<u>819,975</u>
Total operating expenses	
Net decrease in net assets resulting from operations	<u>(768,692)</u>
Distributions to participants Distributions paid and payable	<u>(6,720,593)</u>
Share transactions	
Reinvestment of distributions paid	6,731,814
Net redemptions of shares	<u>(2,604,939)</u>
Net increase in net assets resulting from share transactions	<u>4,126,875</u>
Total decrease in net assets	
	(3,362,410)
Net assets	
Beginning of period	<u>68,569,685</u>
End of period	<u>\$ 65,207,275</u>

The accompanying notes to the financial statements are an integral part of this statement.

**THE INVESTMENT POOL
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2001**

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

- A. Organization** - The North Carolina Department of State Treasurer is an organizational unit established by the State to manage the people's money. The State Treasurer, an elected official, serves as the State's Chief Investment Officer. As such, the Treasurer is directed by statute to "establish, maintain, administer, manage and operate" investment programs for all funds on deposit, pursuant to the guidance provided in applicable general statutes. The Treasurer "shall have full power as a fiduciary."

In establishing a comprehensive investment management program, the State Treasurer, by utilizing a professional investment staff, has developed an investment strategy for each investment portfolio that recognizes the guidelines of the governing General Statutes while providing diversification as appropriate for its participants. The overall investment objective for the State Treasurer's *Investment Pool* is to generate maximum income consistent with safety of principal.

- B. Financial Reporting Entity** - The *Investment Pool* is an external investment pool sponsored by the Department of State Treasurer on the State's behalf. The external portion of the *Investment Pool*, consisting of funds belonging to entities outside of the State of North Carolina's financial reporting entity, has been included as a separate Investment Trust Fund in the State of North Carolina's *Comprehensive Annual Financial Report*. The internal portion, consisting of funds belonging to the State and its component units, has been included in the various participating funds and component units in the State of North Carolina's *Comprehensive Annual Financial Report*.
- C. Description of the Investment Pool** - The State Treasurer, pursuant to N.C.G.S. 147-69.3(a), operates various investment programs (portfolios) as components of the *Investment Pool*. The State Treasurer's *Investment Pool* is not registered with the Securities and Exchange Commission (SEC) and is not subject to any formal oversight beyond the legislative controls established through statutes. This Pool, a governmental external investment pool, consists of the following individual investment portfolios:

Short-term Investment Portfolio – This portfolio provides the State with a primary cash management program. Invested funds are primarily those of the General and Highway Funds. Other participants include the portfolios listed below and various boards, commissions, community colleges, and

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

school administrative units that make voluntary deposits with the State Treasurer. Net excess balances are invested in short-term securities as authorized by statute and in accordance with the projected future cash flow needs. Because the cash balances are ultimately subject to disbursement upon presentation of valid warrants, the primary considerations in making investments are safety and liquidity while the secondary consideration is income.

Long-term Investment Portfolio – This portfolio provides investments in intermediate and long-term treasury, agency, and corporate bonds. Since the deposits in this portfolio are typically not needed for day-to-day operations, the investment securities used generally have a longer term and higher return than those held in the short-term portfolio. The primary participants of the portfolio are the State’s pension trust funds, internal service funds, other special funds and component units.

Equity Investment Portfolio – This portfolio provides investments in equity-based trusts that are administered by third-party professionals. The trusts invest primarily in common stock and other equities. For these investments the State Treasurer does not own the individual securities but rather has a percentage ownership in the trust. The State’s various pension trust funds are the sole participants in the portfolio.

Real Estate Investment Portfolio – This portfolio provides investments in real estate trusts and group annuity contracts administered by third-party professionals. The State’s various pension trust funds are the sole participants in the portfolio.

Venture Capital Investment Portfolio – This portfolio provides investments in venture capital limited partnerships, the Long-term Investment Portfolio and equities received in the form of distributions from its limited partnership investments. The State’s various pension trust funds are the sole participants in the portfolio.

- D. Measurement Focus and Basis of Accounting** - The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB). The *Investment Pool* follows all applicable GASB pronouncements, as well as applicable private sector pronouncements issued on or before November 30, 1989. The financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

- E. Cash and Cash Equivalents** - This includes the cash in bank and short term certificates of deposit and saving certificates with a maturity date of six months or less. The cash in bank represents the deposits received less warrants cleared as of the date recorded on the bank's depository books.
- F. Obligations Under Securities Lending Transactions** – This liability arises from obligations to return collateral that has been received for securities lent.
- G. Net Assets** – This type classification represents the total net ownership of the participants for moneys deposited and invested by the *Investment Pool*.
- H. Revenues** - Income from Investments is comprised of the gross income recorded on the accrual basis of accounting. Gains and losses as recorded, including the increase in fair value of investments, are included in this classification. It also includes the interest on fixed income securities, which is accrued and recorded daily. Because the investments in the Short-term Investment Portfolio are reported at amortized cost, which approximates fair value, the interest earned by this portfolio is amortized daily using the scientific method. Income from the Equity, Real Estate, and Venture Capital Investment Portfolios is recognized in the period it is reported by the external managers.

Income from Securities Lending represents gross income received from securities lending transactions whereby the *Investment Pool's* custody bank lends securities to broker-dealers and banks.

- I. Operating Expenses** - Treasurer's Allocated Cost covers all direct expenses, such as salary and fringe benefit costs, of the *Investment Pool* that are paid from the State's General Fund. Periodically, each investment portfolio reimburses the General Fund for its applicable share of those expenses. The Long-term, Equity, Real Estate, and Venture Capital Investment Portfolios' applicable shares are based on a fixed percentage (.001%) of ending net assets. The remaining costs are paid by the Short-term Investment Portfolio.

External Managers' Fees are expenses paid directly out of earnings of the *Investment Pool* to third party professionals for investment management services.

Costs associated with securities lending transactions are paid from the gross income earned and are reported separately as securities lending expenses.

Other Expenses include all other separately stated expenses paid directly out of earnings of the Real Estate and Venture Capital Investment Portfolios.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

J. Method Used to Report Investments and Participant Shares – Investments in nonparticipating contracts, such as nonnegotiable certificates of deposit, are reported at cost. Other investments within the Short-term Investment Portfolio are reported at amortized cost, which approximates fair value. The investments held by all other portfolios are reported at fair value, the amount at which a financial instrument could be exchanged in a current transaction between willing parties. The fair values of the Long-term Investment Portfolio are determined daily based on commercial third-party pricing sources. The third-party professional managers supply the fair values of the Equity, Real Estate and Venture Capital portfolios. The Equity Investment Portfolio is priced monthly, and the Real Estate and Venture Capital Investment Portfolios are priced quarterly.

Share prices are determined at the end of the month based on the net asset value of the portfolios divided by the total shares outstanding. Values assigned to individual positions in the *Investment Pool* are determined by the number of shares owned within the portfolios multiplied by the fair value per share of the portfolios. Participant additions and redemptions are reported at net asset value. Even though the State Treasurer manages and/or monitors the above-mentioned portfolios to protect against losses from credit and market changes, the State Treasurer cannot provide any guarantees or assurances to support the participant share values.

K. Distribution of Income - Realized income is allocated monthly by the Short-term, Long-term and Equity portfolios and quarterly by the Real Estate and Venture Capital portfolios to pool participants based on their ownership percentages. Pursuant to N.C.G.S. 147-69.1(d), moneys received from agency accounts must receive allocations of earnings on a pro-rata basis. However, this same statute requires all earnings attributed to agency accounts which are not permitted or required to earn interest to be automatically deposited to the State's General Fund. For the fiscal year ended June 30, 2001, \$71,084,066 of investment income associated with other Pool participants was credited to the General Fund.

L. Investment Policy - The State Treasurer is authorized by North Carolina General Statutes 147-69.1(c) and 147-69.2 to invest in the following:

1. Obligations of or fully guaranteed by the United States and the obligations of certain federal agencies;
2. Repurchase agreements;
3. Obligations of the State of North Carolina;
4. Savings certificates issued by specified savings and loan associations;
5. Certificates of deposit issued by specified banks;

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

6. Shares of or deposits in specified savings and loan associations;
7. Prime quality commercial paper bearing specified ratings;
8. Bills of exchange or time drafts drawn on and accepted by specified commercial banks and eligible for use as collateral by member banks in borrowing from a Federal Reserve Bank;
9. General obligations of other states in the United States;
10. General obligations of cities, counties and special districts in North Carolina;
11. Asset-backed securities (whether considered debt or equity) bearing specific ratings;
12. Obligations of any company incorporated in the United States bearing specified ratings;
13. Notes secured by mortgages insured by the Federal Housing Administration or guaranteed by the Veterans Administration on real estate located within the State of North Carolina;
14. A limited partnership interest in a partnership whose primary purpose is to invest in venture capital or corporate buyout transactions, not to exceed \$30 million;
15. Obligations or securities of the North Carolina Enterprise Corporation, the North Carolina Economic Opportunities Fund, or a limited partnership in which the North Carolina Enterprise Corporation or the North Carolina Economic Opportunities Fund is the only general partner, not to exceed \$20 million;
16. With respect to the Retirement Systems' assets, in addition to all of the above, (a) certain insurance contracts, (b) group trusts, (c) individual, common or collective trust funds of banks and trust companies, (d) certain real estate funds, (e) certain specified preferred or common stocks, and (f) certain mutual funds.

NOTE 2 - DEPOSITS

Unless specifically exempt, every officer and agency of the State is required by N.C.G.S. 147-77 to deposit daily, moneys received, either with the State Treasurer or in an account with a depository institution in the name of the State Treasurer, with a daily report to the State Treasurer.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

The State Treasurer maintains numerous deposit accounts for collecting and disbursing funds. Expenditures for the primary government and certain component units are made by warrants, both paper and electronic, drawn on the State Treasurer, which are issued by the agency receiving the goods and services. On a daily basis, the State Treasurer processes the paper warrants when presented by the Federal Reserve Bank and the electronic warrants when initiated by the issuing agency to fund electronic payments. The deposits in the Short-term Investment Portfolio are immediately available to the depositor, subject only to compliance with the State's budgetary laws. These deposits are reported in the North Carolina *Comprehensive Annual Financial Report* as cash and cash equivalents. Typically, the Short-term Investment Portfolio balances are larger than the cash balances by the amount of warrants issued by the agencies but not yet presented for payment through the banking system.

Agency deposits to the accounts of the State Treasurer and deposits by the State Treasurer may be made in any bank, savings and loan association, or trust company in the State, as approved by the State Treasurer. Depositories are required, in accordance with the rules in the North Carolina Administrative Code, codified as Chapter 20 NCAC 7, to collateralize all balances of the State Treasurer which are not insured. Basically, these rules require that the bank maintains, as collateral in an escrow account established by the State Treasurer with a third-party bank, securities of a type enumerated in the rules, in an amount whose fair value is not less than the amount of the time deposits and the average balance of demand deposits for the preceding quarter or other approved averaging calculation less the allowable deposit insurance on the deposits. Generally, rules require the securities collateral to be governmental in origin (e.g., U.S. Treasury and U.S. agency obligations, or state and local government obligations) or the highest grade commercial paper and bankers' acceptances. Surety bonds and letters of credit issued by the Federal Home Loan Bank are also permitted. Financial institutions generally may elect to collateralize State deposits separately (dedicated method) or to include the deposits of North Carolina local government units in the same collateral pool with the State (pooling method). Financial institutions report quarterly on bank balances and amounts deposited in escrow as collateralization of deposits. Financial institutions also report on amounts secured by insurance and amounts protected by securities. The State maintains no records of the amount of local government deposits that are held by the financial institutions and pooled for collateralization purposes with the State deposits. Since the amounts of local government deposits in the pooling method banks are not known, the State's risk of being under collateralized at any given time is increased. An institution's financial condition may cause the State Treasurer to require that a particular institution utilize the dedicated method exclusively for the protection of public deposits.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

At June 30, 2001, the deposits maintained by the State Treasurer consisted of (expressed in thousands):

	<u>Carrying Value</u>	<u>Bank Balance</u>
Demand	\$ 107,693	\$ 110,800
Time	<u>139,946</u>	<u>139,946</u>
Total Deposits	<u>\$ 247,639</u>	<u>\$ 250,746</u>

As of June 30, 2001, 97% of the balances in financial institutions were deposited under the pooling method. Since institutions are required to comply with the State's collateralization policies and procedures, the State Treasurer considers all of its deposits to be either insured or covered by collateral held by the State's agent.

NOTE 3 - INVESTMENTS

The State's investments are categorized to give an indication of the level of risk assumed by the entity at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the State or its agent in the State's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the selling financial institution's trust department or agent in the State's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by the dealer's trust department or agent, but not in the State's name.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

Investments held by the State Treasurer at June 30, 2001 are (expressed in thousands):

	Carrying Amount (Fair Value)		
	Category		Total Amount
	1	3	
Investments Categorized:			
U.S. government and agency securities:			
Not on loan	\$ 8,532,509	\$ 1,562,583	\$ 10,095,092
On loan for securities collateral	942,461		942,461
Corporate bonds and notes:			
Not on loan	9,012,478	7,248,202	16,260,680
On loan for securities collateral	1,193		1,193
Repurchase agreements	230,000	4,054,502	4,284,502
International bonds	453,910		453,910
Domestic equities	31,457		31,457
Total Investments Categorized	\$ 19,204,008	\$ 12,865,287	32,069,295
Investments Not Categorized:			
Equity-based trusts			31,716,223
Venture capital investments			39,584
Real estate trust funds			1,016,714
Investments held by broker/dealers under securities loans with cash collateral:			
U.S. government and agency securities			12,394,850
Corporate bonds and notes			187,476
Total Investments Not Categorized			45,354,847
Total Pooled Investments			\$ 77,424,142

At fiscal year-end the Treasurer held no investments that met the definition of Category 2 risk. Further, other investment types, such as commercial paper, may have been owned during the year, but the above investment categories includes all material types of investments made during the year.

The *Investment Pool* has four major investment classifications: U.S. government securities, equity-based trusts, corporate bonds and notes and repurchase agreements. At June 30, 2001, these investment classifications had the following attributes (dollars expressed in thousands):

Investment Classification	Amount (Fair Value)	Principal Amount	Range of Interest Rates	Range of Maturity Dates
U.S. government and agency securities:				
U.S. Treasury notes and bonds	\$ 13,210,683	\$ 12,194,126	4.25%-9.125%	31 days - 29 years
GNMA securities	4,751,301	4,742,111	6.0%-9.0%	15 to 29 years
U. S. agency notes and bonds	5,470,419	5,552,835	0%-7.625%	3 days - 28 years
Corporate bonds and notes	16,449,349	16,631,944	3.68%-14.5%	1 day - 34 years
Repurchase agreements	4,284,502	4,338,419	3.7%-6.79%	2 to 24 days
Equity-based trusts	31,716,223	n/a	n/a	n/a

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 4 - SECURITIES LENDING TRANSACTIONS

Based on the authority provided in G.S. 147-69.3(e), the State Treasurer lends securities from its *Investment Pool* to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. The Treasurer's securities custodian manages the securities lending program. During the year the custodian lent U.S. government and agency securities and corporate bonds and notes for collateral. The custodian is permitted to receive cash, U.S. government and agency securities, or irrevocable letters of credit as collateral for the securities lent. The collateral is initially pledged at 102 percent of the market value of the securities lent, and additional collateral is required if its value falls to less than 100 percent of the market value of the securities lent. There are no restrictions on the amount of loans that can be made. Substantially all securities loans can be terminated on demand by either the State Treasurer or the borrower. Securities lent at year-end for cash collateral are presented as unclassified in the preceding schedule of custodial credit risk; securities lent for securities collateral are classified according to the category for the collateral. The State Treasurer cannot pledge or sell the collateral securities received unless the borrower defaults.

The cash collateral received is invested by the custodian agent and held in a separate account in the name of the State Treasurer for the benefit of the State Treasurer and/or the borrowers. The average maturities of the cash collateral investments are less than the average maturities of the securities lent. While cash can be invested in securities ranging from overnight up to two years, the custodian agent is not permitted to make investments where the weighted average maturity of all investments exceeds 90 days. At June 30, 2001, the weighted average maturity of unmatched investments was approximately 18 days.

At year-end, the State Treasurer has no credit risk exposure to borrowers, because the amounts owed to the borrowers exceed the amounts the borrowers owe on the securities borrowed. The securities custodian is contractually obligated to indemnify the Treasurer for certain conditions, the two most important of which are default on the part of the borrowers and failure to maintain the daily mark-to-market on the loans.

Within the Equity Investment Portfolio certain third-party professional managers include within their total investments various mutual funds that have been involved in similar securities lending transactions. The State Treasurer has no direct or indirect control over these transactions and therefore has not included any such transactions within this report.

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

NOTE 5 - OTHER ACCOUNTING DISCLOSURES

- A. The *Investment Pool* is composed primarily of the holdings of the various North Carolina retirement systems. Of all *Investment Pool* assets under management by the State Treasurer, approximately 86% belong to the various retirement systems. The retirement funds by statute may not be used “for any purpose other than retirement system benefits and purposes, administrative expenses, and refunds.” Further, such funds “shall not be applied, diverted, loaned to or used by the State, any State agency, State officer, public officer or public employee.”
- B. The U.S. government and agency securities include mortgage-backed securities issued by an agency of the United States government, the Government National Mortgage Association (GNMA). The State Treasurer invests in these securities to maximize yield while maintaining a high degree of safety. The securities are based on cash flows from payments on underlying mortgages. Therefore, the investment values are sensitive to mortgage prepayments that tend to occur during periods of declining interest rates.

Equity-based trusts in which the State Treasurer has an investment interest may sell on occasion, call options against common stock owned to enhance total earnings of the portfolio. The premiums received are maintained in investment inventory accounts until the option is repurchased in the market, is exercised, or has expired. When the option is repurchased in the market, the position is closed and any resulting gain or loss is shown as a part of income from investments. When the option is exercised, the position is closed and the net premium received is used to increase the gain or reduce the loss realized on the sale of the underlying stock. When the option has expired, the position is closed and the net premium on the option is shown as part of income from investments.

- D. Certain equity-based trusts and venture capital partnerships in which the State Treasurer invests have the authority to invest in warrants for the purchase of common and preferred stock. These warrants do not imply any requirements for future action and have a minimal value.
- E. Certain investment accounts within portfolios that utilize third-party professionals have the authority to invest in collateralized mortgage obligations, financial futures, forwards, options and swaps. For the most part, this authority is not used. However when used, this authority is applicable to investments in real estate or equity-based trusts.

NOTES TO THE FINANCIAL STATEMENTS (CONCLUDED)

- F. The third-party professional managers that are used by the various investment portfolios may on occasion invest short-term cash reserves in mutual funds that utilize collateralized mortgage obligations, financial futures, forwards, options, swaps and other derivative instruments. The State Treasurer does not have control over these transactions and does not consider these transactions to be significant to the *Investment Pool's* operations.

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***The Investment Pool
Schedule of Net Assets by Portfolio
at June 30, 2001
(Dollars in Thousands)***

	<u>Short-Term Portfolio</u>	<u>Long-Term Portfolio</u>
ASSETS		
Investments:		
Repurchase agreements	\$ 230,000	\$ 0
U.S. Treasury notes and bonds	4,714,542	8,496,141
Federal agency notes and bonds	2,553,790	1,354,046
GNMA certificates		4,751,301
Corporate bonds and notes		9,655,057
Domestic equities		
Equity-based trusts		
Investments in real estate trust funds		
Venture capital investments		
Investments in short-term portfolio		103,384
Investments in long-term portfolio		
Investment of cash collateral received for securities lent	<u>4,972,073</u>	<u>7,893,214</u>
Total investments	12,470,405	32,253,143
Cash and cash equivalents	247,639	
Other assets	<u>114,645</u>	<u>295,435</u>
Total assets	<u>12,832,689</u>	<u>32,548,578</u>
LIABILITIES		
Obligations under securities lending transactions	4,972,073	7,893,214
Distributions payable	<u>31,247</u>	<u>1,073</u>
Total liabilities	<u>5,003,320</u>	<u>7,894,287</u>
NET ASSETS		
Net assets external participants	497,149	
Net assets internal participants	<u>7,332,220</u>	<u>24,654,291</u>
Total net assets	<u>\$ 7,829,369</u>	<u>\$ 24,654,291</u>

Schedule 1

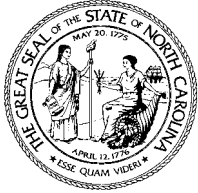
<u>Equity Portfolio</u>	<u>Real Estate Portfolio</u>	<u>Venture Capital Portfolio</u>	<u>Intrapool Eliminations</u>	<u>Total</u>
\$ 0	\$ 0	\$ 0	\$ 0	\$ 230,000
				13,210,683
				3,907,836
				4,751,301
				9,655,057
		31,457		31,457
31,716,223				31,716,223
	1,016,714			1,016,714
		39,584		39,584
329,264	42,508	5,959	(481,115)	
		23,818	(23,818)	
				<u>12,865,287</u>
<u>32,045,487</u>	<u>1,059,222</u>	<u>100,818</u>	<u>(504,933)</u>	<u>77,424,142</u>
23,000		21		247,639
				<u>433,101</u>
<u>32,068,487</u>	<u>1,059,222</u>	<u>100,839</u>	<u>(504,933)</u>	<u>78,104,882</u>
				12,865,287
				<u>32,320</u>
				<u>12,897,607</u>
				497,149
<u>32,068,487</u>	<u>1,059,222</u>	<u>100,839</u>	<u>(504,933)</u>	<u>64,710,126</u>
<u>\$ 32,068,487</u>	<u>\$ 1,059,222</u>	<u>\$ 100,839</u>	<u>\$ (504,933)</u>	<u>\$ 65,207,275</u>

The Investment Pool
Schedule of Operations and Changes in Net Assets by Portfolio
for the Year Ended June 30, 2001
(Dollars in Thousands)

	Short-Term Portfolio	Long-Term Portfolio
Revenues:		
Income from investments	\$ 461,276	\$ 2,830,631
Income from securities lending	320,667	478,473
Total operating income	<u>781,943</u>	<u>3,309,104</u>
Less operating expenses:		
Treasurer's allocated cost	4,155	3,078
External managers' fees		
Securities lending expenses	306,873	463,121
Other operating expenses		
Total operating expenses	<u>311,028</u>	<u>466,199</u>
Net increase(decrease) in net assets resulting from operations	<u>470,915</u>	<u>2,842,905</u>
Distributions to participants		
Distributions paid and payable	<u>(470,915)</u>	<u>(1,870,556)</u>
Share transactions		
Reinvestment of distributions paid	482,458	1,870,234
Net (redemptions) and subscriptions	<u>(1,243,926)</u>	<u>(3,046,138)</u>
Net increase (decrease) in net assets resulting from share transactions	<u>(761,468)</u>	<u>(1,175,904)</u>
Total increase (decrease) in net assets	(761,468)	(203,555)
Net assets		
Beginning of period	<u>8,590,837</u>	<u>24,857,846</u>
End of period	<u>\$ 7,829,369</u>	<u>\$ 24,654,291</u>

Schedule 2

Equity Portfolio	Real Estate Portfolio	Venture Capital Portfolio	Intrapool Eliminations	Total
\$ (4,082,452)	\$ 121,291	\$ (56,554)	\$ (22,049)	\$ (747,857)
<u>(4,082,452)</u>	<u>121,291</u>	<u>(56,554)</u>	<u>(22,049)</u>	<u>799,140</u>
3,547	117	17		10,914
23,759	10,884	879		35,522
	<u>3,038</u>	<u>507</u>		769,994
<u>27,306</u>	<u>14,039</u>	<u>1,403</u>		<u>3,545</u>
<u>(4,109,758)</u>	<u>107,252</u>	<u>(57,957)</u>	<u>(22,049)</u>	<u>(768,692)</u>
<u>(4,311,251)</u>	<u>(82,883)</u>	<u>(6,192)</u>	<u>21,204</u>	<u>(6,720,593)</u>
4,311,251	82,883	6,192	(21,204)	6,731,814
2,025,344	55,000		(395,219)	(2,604,939)
<u>6,336,595</u>	<u>137,883</u>	<u>6,192</u>	<u>(416,423)</u>	<u>4,126,875</u>
(2,084,414)	162,252	(57,957)	(417,268)	(3,362,410)
<u>34,152,901</u>	<u>896,970</u>	<u>158,796</u>	<u>(87,665)</u>	<u>68,569,685</u>
<u>\$ 32,068,487</u>	<u>\$ 1,059,222</u>	<u>\$ 100,839</u>	<u>\$ (504,933)</u>	<u>\$ 65,207,275</u>



Ralph Campbell, Jr.
State Auditor

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**INDEPENDENT AUDITOR'S REPORT
ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

The Honorable Richard H. Moore, State Treasurer
Raleigh, North Carolina

We have audited the financial statements of the Investment Pool of the North Carolina Department of State Treasurer as of and for the year ended June 30, 2001, and have issued our report thereon dated October 30, 2001. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Investment Pool's financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

**INDEPENDENT AUDITOR'S REPORT
ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

This report is intended solely for the information and use of the management of the Department, the Governor, the Office of State Budget, Planning and Management, the Office of the State Controller, and the General Assembly and is not intended to be, and should not be, used by anyone other than these specified parties.



Ralph Campbell, Jr.
State Auditor

October 30, 2001

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Majority Leader of the N.C. Senate
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Minority Leader of the N.C. House of Representatives
N. C. House Speaker Pro-Tem
Director, Fiscal Research Division

December 17, 2001

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