



State of Oregon

**OREGON LOCAL GOVERNMENT
INTERMEDIATE FUND**

An Investment Pool of the State of Oregon

Financial Statements

For the Year Ended June 30, 2018

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OREGON LOCAL GOVERNMENT INTERMEDIATE FUND
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Office of the Secretary of State

Dennis Richardson
Secretary of State

Leslie Cummings, Ph.D.
Deputy Secretary of State



Audits Division

Kip R. Memmott, MA, CGAP, CRMA
Director

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Independent Auditor's Report

The Honorable Kate Brown, Governor of Oregon
The Honorable Tobias Read, State Treasurer
Oregon Investment Council

Report on the Financial Statements

We have audited the accompanying financial statements of the Oregon Local Government Intermediate Fund, an external investment pool of the State of Oregon, as of and for the year ended June 30, 2018, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Oregon Local Government Intermediate Fund as of June 30, 2018, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1, the financial statements of the Oregon Local Government Intermediate Fund, an external investment pool of the State of Oregon, are intended to present the financial position and the changes in financial position of only the Oregon Local Government Intermediate Fund. They do not purport to, and do not, present fairly the financial position of the Oregon State Treasury or the State of Oregon as of June 30, 2018, or the changes in their financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated August 29, 2018, on our consideration of the Oregon State Treasury’s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Oregon State Treasury’s internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Oregon State Treasury’s internal control over financial reporting and compliance.

Office of the Secretary of State, Audits Division

State of Oregon
August 29, 2018

State of Oregon
OREGON LOCAL GOVERNMENT INTERMEDIATE FUND

Statement of Net Position

June 30, 2018

(Dollars in Thousands)

| | |
|---|-------------------|
| Assets: | |
| Cash and Cash Equivalents | \$ 1,539 |
| Investments | 218,154 |
| Accrued Interest Receivable | 1,371 |
| Security Lending Collateral (Note 3) | 1,111 |
| Total Assets | <u>222,175</u> |
| Liabilities: | |
| Accrued Expenses | 77 |
| Payable for Investments Purchased | 5,394 |
| Obligations Under Security Lending (Note 3) | 1,111 |
| Total Liabilities | <u>6,582</u> |
| Net Position: | |
| Held in Trust for Participants | 215,593 |
| Total Net Position | <u>\$ 215,593</u> |

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

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State of Oregon
OREGON LOCAL GOVERNMENT INTERMEDIATE FUND

Statement of Changes in Net Position
For the Year Ended June 30, 2018

(Dollars in Thousands)

| | |
|---|------------|
| Additions: | |
| Investment Income (Loss), Net of Expenses (Notes 1, 4) | \$ (176) |
| Total Additions | (176) |
| Deductions: | |
| Security Lending Borrowers' Rebate Expense | 12 |
| Security Lending Agent Fee Expense | 5 |
| Total Deductions | 17 |
| Participant Account Transactions: | |
| Participants' Contributions | 4,802 |
| Net Increase as a Result of Participant Transactions | 4,802 |
| Change in Net Position Held in Trust for Participants | 4,609 |
| Net Position - Beginning | 210,984 |
| Net Position - Ending | \$ 215,593 |

The accompanying notes are an integral part of the financial statements

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OREGON LOCAL GOVERNMENT INTERMEDIATE FUND

Notes to Financial Statements

June 30, 2018

(1) Summary of Significant Accounting Policies

Reporting Entity The Oregon Local Government Intermediate Fund (“Fund”) is an intermediate term fixed income investment vehicle. The Oregon Short Term Fund and several local governments participate in this program, thus it is an external investment pool as defined in Statement No. 31 of the Governmental Accounting Standards Board, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*.

The Fund is not registered with the U.S. Securities and Exchange Commission as an investment company. The State’s investment policies are governed by Oregon Revised Statutes and the Oregon Investment Council (Council). The State Treasurer is the investment officer for the Council and is responsible for all funds entrusted to the Oregon State Treasury (OST). These funds must be invested, and the investments managed, as a prudent investor would, exercising reasonable care, skill and caution. Investments in the Fund are further governed by guidelines approved by the Council, establishing diversification percentages and specifying the types and maturities of investments. The Fund guidelines permit securities lending transactions as well as investments in repurchase and reverse repurchase agreements. Fund guidelines are discussed in greater detail in the Investments section of Note 2.

The Fund is authorized under ORS 294. Standards for investment of the Fund may be found in ORS 293.701 to 293.857. Pursuant to ORS 294, local governments meeting requirements established by OST have the opportunity to participate in this investment fund subject to application and subsequent approval by the OST. The portion of the Fund belonging to external participants is reported in an investment trust fund in the State’s Comprehensive Annual Financial Report.

Basis of Accounting These statements are prepared using the economic resources measurement focus and the accrual basis of accounting. Trade date accounting is observed, which means that purchases and sales of securities are recorded on the day the trade takes place with a corresponding payable to or receivable from the broker. Changes in the fair value of investments are recognized daily. The fair value of investments is determined daily and is equal to market price.

Cash and Cash Equivalents Investments with original maturities of three months or less are considered cash equivalents and are reported at amortized cost, which approximates fair value. Cash Equivalents also include any cash held with the custodian.

Investments Investments with remaining maturities of less than ninety days are carried at amortized cost, provided that the fair value of these instruments is not significantly affected by the impairment of the credit standing of the issuer or by other factors. Amortized cost approximates fair value. Investments with longer maturities are carried at fair value.

Participants’ equity; distributions of interest The value of each participant’s investment is determined on a proportional basis to the net market value of the entire portfolio. Shares of the Fund represent a divisible interest in the net value of underlying investments, accrued income and expenses. Interest income and capital gains are not distributed to participants but are reflected in the underlying net position.

OREGON LOCAL GOVERNMENT INTERMEDIATE FUND

Notes to Financial Statements

June 30, 2018

(2) Investments

Investments On June 30, 2018, the Fund reported investments of \$219,693,608, of which \$1,539,173 is classified as Cash and Cash Equivalents on the Statement of Net Position. The Fund’s guidelines establish the Fund’s permitted investments and parameters for managing the various types of risk associated with these investments (see the current portfolio guidelines at <http://www.oregon.gov/treasury/Divisions/Investment/Pages/OLGIF.aspx>.) The different risks will be discussed below.

Schedule of Investment Characteristics

(Dollars in Thousands)

| <u>Investment Type</u> | <u>Par Value</u> | <u>Reported Amount</u> | <u>Weighted Average Coupon</u> | <u>Weighted Average Modified Duration</u> |
|---------------------------------------|-------------------|------------------------|--------------------------------|---|
| Cash and Cash Equivalents | \$ 1,539 | \$ 1,539 | 2.16 | 0.00 |
| Asset-Backed Securities | 7,437 | 7,381 | 2.48 | 0.59 |
| Federal Agency Debt | 3,910 | 3,832 | 1.73 | 2.23 |
| Commercial Mortgage-Backed Securities | 8,079 | 8,124 | 3.40 | 2.62 |
| Municipal Debt | 864 | 873 | 3.46 | 0.10 |
| Corporate Debt | 96,152 | 95,264 | 3.21 | 2.95 |
| U.S. Treasury | 104,780 | 102,680 | 1.55 | 2.57 |
| Total | \$ 222,761 | \$ 219,693 | 2.39 | 2.64 |

Reported Amount is a combination of amortized cost and fair value. See Note 1.

A. Interest rate and Credit risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The risk is managed by limiting the duration of investments held by the Fund. The portfolio guidelines require that the portfolio maintain a weighted average duration, a measure of interest rate risk, of +/- 20% (percent) relative to the duration of the Barclays Capital 1-5 Year Government/Credit Index (Benchmark). The duration for the Fund and the Benchmark at June 30, 2018 was 2.64 years and 2.70 years, respectively. The maximum maturity for any single investment should not be greater than 10.25 years from settlement date, with exceptions for asset-backed securities, mortgage-backed securities, and commercial mortgage-backed securities. These securities use weighted average life (WAL) as a proxy for maturity and are limited to a WAL of five years, or less, at the time of purchase.

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. The Fund’s guidelines require that all investments meet minimum ratings requirements at the time of purchase. Minimum required ratings are subject to investment type as dictated by the Fund’s guidelines.

Corporate notes and municipal debt must be rated investment grade or higher at time of purchase. Foreign government securities are required to have a minimum credit rating from S&P of AA-, Moody’s of Aa3, or Fitch of AA-. Structured securities such as asset-backed and mortgage-backed securities must be rated AAA at the time of purchase.

OREGON LOCAL GOVERNMENT INTERMEDIATE FUND
Notes to Financial Statements
June 30, 2018

Fund guidelines allow securities downgraded below investment grade to be retained at the discretion of the external manager. At no time should the weighted, average credit quality of the Fund be more than one rating category below that of the Benchmark. At June 30, 2018 the weighted average credit quality of both the Fund and of the Benchmark was AA. Rating groups, determined using the lowest actual rating from S&P or Moody's, are shown below:

Interest Rate Risk and Credit Risk
(Dollars in Thousands)

| Investment Type | Weighted Average Modified Duration | Reported Amount | AAA | AA | A | BBB | BB |
|---------------------------------------|---|--------------------|-------------------|------------------|------------------|------------------|-----------------|
| Asset-Backed Securities | 0.59 | \$ 7,381 | \$ 7,381 | \$ - | \$ - | \$ - | \$ - |
| Federal Agency Debt | 2.23 | 3,832 | - | 3,832 | - | - | - |
| Commercial Mortgage-Backed Securities | 2.62 | 8,124 | 8,124 | - | - | - | - |
| Municipal Debt | 0.10 | 873 | 873 | - | - | - | - |
| Corporate Debt | 2.95 | 95,264 | 3,084 | 8,246 | 37,716 | 39,687 | 6,531 |
| U.S. Treasury | 2.57 | 102,680 | 102,680 | - | - | - | - |
| Total | | \$ 218,154 | \$ 122,142 | \$ 12,078 | \$ 37,716 | \$ 39,687 | \$ 6,531 |

B. Custodial credit risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the fund will not be able to recover the value of an investment or collateral securities in the possession of an outside party. The Fund's investments are delivered to and held by a third-party custodian, which holds the Fund's securities in the State of Oregon's name. All trades where applicable are executed by delivery vs. payment (DVP) to ensure that securities are deposited in an eligible financial institution prior to the release of funds.

C. Concentration of credit risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a fund's investment in a single issuer. The Fund guidelines provide that the maximum that may be invested in any one issuer, as a percentage of the Fund's total investments is three percent, excluding U.S. Treasuries or U.S. Federal Agencies or instrumentalities. The Fund may invest up to 100 percent in those securities. On June 30, 2018, the Fund did not hold investments with any one issuer that exceeded these limits.

D. Foreign currency risk

The Fund guidelines prohibit investments that are not U.S. dollar-denominated; therefore, the Fund is not exposed to this risk.

OREGON LOCAL GOVERNMENT INTERMEDIATE FUND

Notes to Financial Statements

June 30, 2018

(3) Securities Lending

The OST has authorized its custodian to act as its agent in the lending of the Fund's securities pursuant to a form of loan agreement, in accordance with Fund investment policies. There have been no significant violations of the provisions of the securities lending agreement. The State's securities lending agent lent short-term and fixed income securities and received as collateral U.S. dollar-denominated cash. Borrowers were required to deliver cash collateral for each loan equal to not less than 102 percent of the market value of the loaned security. The State has the ability to impose restrictions during the year on the amount of the loans that the securities lending agent made on its behalf, but did not impose any such limits during the year ended June 30, 2018. The State is fully indemnified by its securities lending agent against losses due to borrower default. There were no losses during the year from the failure of borrowers to return loaned securities.

The Fund's lending agent uses a fund to reinvest cash collateral received on behalf of the OLGIF and other Oregon state agencies managed by the OST, exclusive of the Oregon Public Employees Retirement Fund. Effective January 2014, the guidelines for the reinvestment of cash collateral were revised with further constraints to reduce overall risk. The balances of securities on loan, cash collateral received and invested collateral at market value are presented in the schedule below.

Schedule of Securities Lending Balances

(Dollars in Thousands)

| | Securities on Loan at Fair Value | Collateral Received | Invested Cash Collateral at Fair Value |
|----------------|---|--------------------------------|---|
| U.S. Treasury | \$ 806 | \$ 822 ¹ | \$ - |
| Corporate Debt | 4,107 | 4,193 ² | 1,111 |
| Total | <u>\$ 4,913</u> | <u>\$ 5,015</u> | <u>\$ 1,111</u> |

1. U.S. Treasury \$822

2. Cash Collateral \$1,111 and Corporate Debt \$3,082

The State and borrowers maintained the right to terminate all securities lending transactions on demand. As a consequence, the maturities of investments made with cash collateral generally do not match the maturities of the securities loans. As of June 30, 2018, the State had no credit risk exposure to borrowers related to securities on loan.

(4) Management and Administrative Fees

In accordance with ORS 293.718, the OST may deduct monthly 0.435 basis points of the most recent market value of assets under management for administration. For the year ended June 30, 2018 the OST charged the Fund a monthly rate of 0.435 basis points based on assets under management in the Fund. Portfolio management was administered by a third-party asset manager during the year ended June 30, 2018 and management fees are deducted from investment income before distributions to participants. Fees and other expenses charged to the Fund totaled \$258,302 for the year ended June 30, 2018.

OREGON LOCAL GOVERNMENT INTERMEDIATE FUND

Notes to Financial Statements

June 30, 2018

(5) Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Observable inputs are developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs are developed based on the best information available about the assumptions market participants would use in pricing the asset. The classification of securities within the fair value hierarchy is based upon the activity level in the market for the security type and the inputs used to determine their fair value, as follows:

- Level 1 – Unadjusted quoted prices for identical instruments in active markets.
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable.
- Level 3 – Valuations derived from valuation techniques in which significant inputs are unobservable.

Fair Value Measurements

(Dollars in Thousands)

| | Assets and Liabilities at Fair Value as of June 30, 2018 | | | |
|---------------------------------------|---|-------------------|----------------|-------------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Investments: | | | | |
| Asset-Backed Securities | \$ - | \$ 7,381 | \$ - | \$ 7,381 |
| Federal Agency Debt | - | 3,832 | - | 3,832 |
| Commercial Mortgage-Backed Securities | - | 8,124 | - | 8,124 |
| Municipal Debt | - | 873 | - | 873 |
| Corporate Debt | - | 95,264 | - | 95,264 |
| U.S. Treasury | - | 102,680 | - | 102,680 |
| Total | \$ - | \$ 218,154 | \$ - | \$ 218,154 |

The Fund's investments, other than those with remaining maturities of fewer than ninety days, are valued using the latest bid prices or evaluated quotes from independent pricing vendors. The third-party vendors use a variety of methods when pricing these securities that incorporate relevant observable market data to arrive at an estimate of what a buyer in the marketplace would pay for a security under current market conditions. Investments with remaining maturities of fewer than ninety days are carried at amortized cost, which approximates fair value. All of the Fund's investments at June 30, 2018 are considered level 2.

OTHER REPORTS

Office of the Secretary of State

Dennis Richardson
Secretary of State

Leslie Cummings, Ph.D.
Deputy Secretary of State



Audits Division

Kip R. Memmott, MA, CGAP, CRMA
Director

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Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed In Accordance with *Government Auditing Standards*

The Honorable Kate Brown, Governor of Oregon
The Honorable Tobias Read, State Treasurer
Oregon Investment Council

We have audited, 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, the financial statements of the Oregon Local Government Intermediate Fund, an external investment pool of the State of Oregon, as of and for the year ended June 30, 2018, and the related notes to the financial statements and have issued our report thereon dated August 29, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Oregon State Treasury's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Oregon State Treasury's internal control. Accordingly, we do not express an opinion on the effectiveness of Oregon State Treasury's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Oregon Local Government Intermediate Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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 or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Office of the Secretary of State, Audits Division

State of Oregon
August 29, 2018