STATE OF MONTANA BOARD OF INVESTMENTS
SHORT-TERM INVESTMENT POOL FINANCIAL STATEMENTS

(UNAUDITED)

SHORT-TERM INVESTMENT POOL

MONTANA
BOARD OF INVESTMENTS

Financial Statements
For the year ended
June 30, 2017
(Unaudited)

STATE OF MONTANA BOARD OF INVESTMENTS
SHORT-TERM INVESTMENT POOL
STATEMENT OF FIDUCIARY NET POSITION
AS OF JUNE 30, 2017
(in thousands)

Assets	
Dividend and interest receivable	$ 2,365
Investments at fair value	2,986,616
Total assets	2,988,981
Liabilities	
Income due participants	2,758
STIP reserve	24,234
Total liabilities	26,992
Net position	$ 2,961,989

STATE OF MONTANA BOARD OF INVESTMENTS
SHORT-TERM INVESTMENT POOL
STATEMENT OF CHANGES IN FIDUCIARY NET POSITION
FOR FISCAL YEAR ENDING JUNE 30, 2017
(in thousands)

Additions	
Purchases by participants	$ 7,569,840
Investment earnings	
Net investment earnings:	
Net change in unrealized appreciation (depreciation) on investments	(93)
Dividend/interest income	17,185
Amortization/accretion	10,721
Other investment income	7,793
STIP reserve expense	(11,091)
Net investment earnings	24,515
Administrative expenses	(914)
Security lending income	70
Security lending expense	(31)
Total additions	7,593,480
Deductions	
Sales by participants	7,418,315
Income distributions to participants	23,733
Total deductions	7,442,048
Change in net position	151,432
Net position - beginning of year	2,810,557
Net position - end of year	$ 2,961,989
Units Outstanding	2,961,500
Unit Value (not in thousands)	$ 1.000165

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

NOTES TO FINANCIAL STATEMENTS

FOR THE FISCAL YEAR ENDED JUNE 30, 2017

1. HISTORY AND ORGANIZATION

The Montana Board of Investments (Board) was created by the Legislature to manage the Unified Investment Program established by the State Constitution. The Board created the Short-Term Investment Pool (STIP) to allow qualifying funds, per sections 17-6-201, 202, and 204, MCA, to participate in a diversified pool. State agencies with accounts that retain their interest earnings are legally required to invest in STIP. Local governments entities can be statute voluntarily participate in STIP. The Board manages the Investment Program pursuant to the "Prudent Expert Principle" mandated by State law, which requires an investment manager to:

(a) discharge the duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;
(b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so; and
(c) discharge the duties solely in the interest of and for the benefit of the funds forming the unified investment program.

Funds may be invested in STIP for one or more days. STIP investments and the income are owned by the participants and are managed on their behalf by the Board.

STIP is presented in the Fiduciary Statement of Net Position at fair value. The investment activity reported within these financial statements become part of the governmental, proprietary and fiduciary fund categories of the State of Montana's Comprehensive Annual Financial Report.

Beginning with the period ending June 30, 2017, single-year financial statements were prepared. In past years, comparative financial statements were prepared. This change does not result in a restatement of beginning net asset value for the period ending June 30, 2017.

The STIP financial statements are included in the Board's Unified Investment Program financial statements, which are audited by the Montana Legislative Auditor. These stand-alone STIP financial statements are for informational purposes only and are not separately audited. The Board's audited annual financial information is available from the Board at 2401 Colonial Drive 3rd Floor, PO Box 200126, Helena, MT 59620-0126 or by calling 406-444-0001. The Board's information can also be found on the Board's website at www.investmentmt.com.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

New Accounting Guidance Implemented
GASB State 79 - Certain External Investment Pools and Pool Participants required the Board to elect between accounting for STIP assets in one of two allowable methods: either to continue to account for securities within the STIP pool at an amortized cost basis or change to a fair value basis. In October 2015, staff recommended and the Board approved that the STIP portfolio for financial reporting purposes would be on a fair value basis. Based on this allowable election, the Board implemented GASB Statement 79 as it pertained to recording on a fair value basis beginning with the year ended June 30, 2016.

Type of Investments
STIP investments are primarily in short-term, high quality, fixed income securities with a maximum maturity of 397 or less. Variable rate securities shall have a maximum maturity of 2 years. STIP shall maintain a dollar-weighted average portfolio maturity of 60 days or less. This Pool is managed to preserve principal while providing 24-hour liquidity for state agency and local government participants.

Basis of Accounting
The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting.

Valuation and Timing
Investments are reported at fair value on a trade date basis. Quoted market prices, when available, have been used to value investments. The fair values for securities that have no quoted market prices represent estimated fair value.

The net change in fair value of investments consists of the realized gains or losses and the unrealized increase or decrease in fair value of investments during the year. Realized gains and losses on sales of investments are computed based on the difference between the sales price and the original cost of the investment sold. Unrealized gains and losses are computed based on changes in the fair value of investments between years. Interest income is recognized when earned. Income due participants is recorded on the date due to participants.

Included in the Pool of the investment portfolio, cash, receivables for securities sold but not yet settled, and dividend/interest receivables. Included in the liabilities are payables for securities purchased but not yet settled, income due participants, and other miscellaneous payables.

Pool Participant Units
Pool units are purchased and sold similar to individuals investing in mutual funds. The STIP participants purchase and sell units, at $1 per unit, at the participant discretion.

Distributable Income
STIP income is comprised of accrued interest and amortization of discount. On the first working day of each month, the STIP income due participants is distributed.

Investment Expenses
The Legislature sets the maximum management fee the Board may charge the accounts it manages. The maximum fee is set at the aggregate level at the beginning of each fiscal year. The Board allocates the aggregate fees across the Pools and investments managed outside the Pools. Custodial bank fees are paid by a statutory appropriation from the state general fund. The Board allocates custodial bank fees across the Pools and accounts invested outside the Pools and deposits the funds required to pay the fee in the general fund. The State Treasurer then pays the monthly custodial bank fees from the general fund. Investment expenses charged to STIP was $914 thousand, of which $667 thousand was for board fees and $247 thousand for custodial bank fees. The STIP investment expense ratio was 0.03%.

3. SECURITIES LENDING

As of October 2016, STIP was no longer participating in the security lending program. STIP did not have securities on loan as of June 30th. Security lending income and expense entries were recorded through October 2016.

The Board is authorized by law to lend its securities and has contracted with the custodial bank, State Street Bank and Trust, “the Bank”, to lend the Board’s securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The Bank is required to maintain collateral equal to 102 percent of the fair value of domestic securities and 105 percent of the fair value of international securities while the securities are on loan. On any day, including June 30th, the markets may move in a positive or negative direction resulting in under or over collateralization. The Bank compensates for market movement by recalculating on the following business day to meet the collateralization requirements. The Board and the Bank split the earnings, 80/20% respectively, on security lending activities. The Board retains all rights and risks of ownership during the loan period. State Street Indemnifies the Board’s credit risk exposure to the borrowers.

During fiscal year 2017, the Bank lent Board public securities and received as collateral: U.S. dollar cash; U.S. Government and government sponsored agency securities; U.S. corporate debt securities and structured securities rated AA-/Aa3 or higher; sovereign debt securities of the G10 nations; and debt securities issued by certain supranational agencies. The Bank does not have the ability to sell collateral securities unless the borrower defaults.

The Board imposed no restrictions on the amount of securities available to lend during fiscal year 2017. There were no failures by any borrowers to return loaned securities or pay distributions thereon during the period that resulted in a declaration and notice of Default of the Borrower. There were no losses during fiscal year 2017 resulting from a borrower default.

The cash collateral received for each loan was invested, together with the cash collateral of other qualified plan lenders, in two investment funds, the Quality D Short Term Investment Fund or the Security Lending Quality Lending Trust Fund. During March 2017, participation in both funds was transitioned into the Navigator Securities Lending Government Money Market portfolio. STIP was only invested in the Securities Lending Quality Trust Fund until October 2016.

The Board and the borrowers maintained the right to terminate all securities lending transactions on notice. Because the securities lending transactions were terminable at will, their duration did not generally match the duration of the investments made with the cash collateral received from the borrower. At year-end 2017, State Street Bank indemnified the Board’s credit risk exposure to borrowers. The average duration was 8 days and the average weighted final maturity was 49 days within the Navigator portfolio.

Through October 2016, the security lending gross income was $70 thousand with expenses of $31 thousand for net income of $39 thousand.

4. INVESTMENT RISK DISCLOSURES

Custodial Credit Risk

Custodial credit risk is the risk that, in the event of the failure of the counterparty to a transaction, the Board will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. Per policy, the Board’s custodial institution must hold short-term and long-term credit rating by at least one NRSRO with a minimum requirement of A1/P1 (short-term) and A3/A-1 (long-term).

Investments

As of June 30th, all the public securities as well as securities held by the separate public equity account managers were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board’s custodial bank, State Street Bank.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of any single investment per issuer name. Investments explicitly guaranteed by the U.S. Government are excluded from the concentration of credit risk requirement. The U.S. government extended the explicit guarantee to certain government agencies such as Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (FHLMC-Freddie Mac). The Board had no concentration of credit risk exposure to Fannie Mae and Freddie Mac. Concentration risk was within the policies as set by the board.

The STIP IPS limits concentration of credit risk exposure by limiting portfolio investment types to 3% in any issuer with the exception of US Treasury and US Agency securities as well as any repurchase agreements with a financial institution.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. Except for U.S. Government securities, the pools' fixed income instruments have credit risk as measured by major credit rating services. The Board's STIP investment policy statement (IPS) specifies that STIP will utilize credit ratings, issued by at least two of the national recognized statistical rating organizations (NRSRO), to assist in the monitoring and management of credit risk. The purchase of STIP securities other than US government or US Agency obligations are restricted to those which are pre-approved.

The U.S. Government guarantees the U.S. Government securities directly or indirectly. Obligations of the U.S. Government or obligations explicitly guaranteed by the U.S. Government are not considered to have credit risk and do not require disclosure of credit quality per GASB Statement No. 40.

Asset-backed securities in STIP portfolios are based on the cash flows from principal and interest payments emanating from a Trust containing a pool of underlying auto loan, credit card or other receivables. These securities, while sensitive to prepayments due to interest rate changes, generally have less credit risk than unsecured bonds. Their credit risk is based on the structure itself rather than balance sheet risk. This includes such factors as default rates, overcollateralization, and quality of collateral.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Per the STIP IPS, "the STIP portfolio will minimize interest rate risk by:

1) structuring the investment portfolio so securities mature to meet cash requirements for ongoing operations thereby normally avoiding the need to sell securities on the open market prior to maturity;
2) maintaining a dollar-weighted average portfolio maturity (WAM) of 60 days or less (for this purpose, the date to the next coupon reset date will be used for all floating or variable rate securities; and
3) STIP will maintain a reserve account."

The STIP portfolio held certain variable rate issues. Interest payments on these securities are based on an underlying reference rate, e.g., LIBOR.

STIP investments are categorized to disclose credit risk and weighted average maturity (WAM). Credit risk reflects the weighted security quality rating by investment type as of the June 30 report date. If a security investment type is unrated, the quality type is indicated by NR (not rated). Although the STIP investments have been rated by investment security type, STIP, as an external investment pool, has not been rated. The short-term credit ratings as provided by S&P's rating services. An A1+ rating is the highest short-term rating by the S&P rating service. STIP interest rate risk is determined using the WAM method. The WAM measure expresses investment time horizons – the time when investments are due or reset and payable in days, months or years – weighted to reflect the dollar size of the individual investments within an investment type. The WAM, calculated in days, for the STIP portfolio is shown on the following table.

STIP Credit Quality Ratings and Weighted Average Maturity as of June 30, 2017
(in thousands)

Security Investment Type	Fair Value	Credit Quality Rating*	WAM in Days
Treasuries	$ 124,774	A-1+	80
Asset Backed Commercial Paper	1,089,830	A-1	25
Corporate Commercial Paper	356,122	A-1	63
Corporate Notes	369,751	A-1+	78
Certificates of Deposit	484,113	A-1+	35
U.S. Government Agency	389,807	A-1+	24
Money Market Funds (Unrated)	24,219	NR	1
Money Market Funds (Rated)	148,000	A-1+	1
Total Investments	$ 2,986,616	A-1	39

*Credit Quality Rating is weighted.

Legal and Credit Risk

The Federal National Mortgage Association and Federal Home Loan Mortgage Corp. remain in conservatorship from September 7, 2008.

In August 2011, S&P downgraded the U.S. AAA bond rating to AA+.

5. FAIR VALUE MEASUREMENTS

The Board categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles as follows:

- Level 1—Quoted prices for identical assets or liabilities in active markets.
- Level 2—Prices determined using inputs, other than quoted prices included within Level 1, that are observable for an asset or liability, either directly or indirectly.
- Level 3—Prices determined using unobservable inputs.

STIP has the following fair value measurements as of June 30th:

STIP Investments Measured at Fair Value
(in thousands)

	June 30, 2017	Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable (Level 3)
Investments by fair value level				
Fixed income investments				
Treasuries	$ 124,774	$ 124,774		
Asset Backed Commercial Paper	1,089,830		$ 1,089,830	
Corporate Commercial Paper	356,122		356,122	
Corporate Notes	369,751		369,751	
Certificates of Deposit	484,113		484,113	
U.S. Government Agency	389,807		389,807	
Total investments by fair value level	$ 2,814,397	$ 124,774	$ 2,689,623	
Investments measured at cost				
Money Market Funds (Unrated)	24,219			
Money Market Funds (Rated)	148,000			
Total investments measured at cost	172,219			
Total investments managed	$ 2,986,616			

Fixed income investments classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities. Fixed income investments classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices.

6. STIP RESERVE

In November 2007, the STIP Reserve account was established. The STIP reserve account may be used to offset losses within the STIP portfolio. STIP distributes income to STIP participants based on accrued interest and discount amortization, net of fees and STIP reserve expense. The STIP Reserve is detailed as follows:

STIP Reserve (in thousands)	2017
Beginning balance	$ 13,143
Other income	
Accrued interest	15
Recovery from sale of SIV related assets	7,774
Realized gains on sale of any STIP asset	19
Daily reserve accrual	3,283
Total reserve expense	$ 11,091
Ending balance	$ 24,234

In the fiscal year ended June 30, 2007, the Board purchased four Structured Investment Vehicle (SIV) securities held in the STIP portfolio with a combined amortized cost of $140 million, representing 5.02% of the total portfolio. These securities were purchased from two different issuers. Both issuers received the highest investment grade rating by two rating agencies at the time purchase and as of June 30, 2007. Both issuers of these SIV securities declared insolvency events in fiscal year 2008. In June and December 2009, the Board applied $21 million, in total, from the STIP reserve to the outstanding principle balances. In May 2016, the Board wrote-off the entire remaining outstanding SIV balance of $23.6 million against the STIP reserve. The Board does not make any assumptions on recovery related to the SIV assets. Any further flows of either principal or interest will be deemed as recovery monies and be applied to the STIP reserve. Refer to Note 7 – Subsequent Events for additional detail.

7. SUBSEQUENT EVENTS

From July 1, 2017 until October 6, 2017, the Board has received recovery payments associated with the SIV related assets in the amount of $1.3 million, representing $0.8 million of principle and $0.5 million of interest. Refer to Note 6 – STIP Reserve for further information.