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**NOTES TO THE FINANCIAL STATEMENTS**


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**NOTE 3: DEPOSITS AND INVESTMENTS**


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**A. Deposits and Investments with State Treasurer**

Unless specifically exempt, every agency of the State and certain component units are required by General Statute 147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. Certain local governmental units that are not part of the reporting entity are also allowed to deposit money with the State Treasurer. Expenditures for the primary government and certain component units are made by warrants issued by the agencies and drawn on the State Treasurer. The State Treasurer processes these warrants each day when presented by the Federal Reserve Bank. General Statute 147-69.1 authorizes the State Treasurer to invest all deposits in obligations of or fully guaranteed by the United States; obligations of certain federal agencies; specified repurchase agreements; obligations of the State of North Carolina; time deposits with specified financial institutions; prime quality commercial paper with specified ratings; specified bills of exchange or time drafts; asset-backed securities with specified ratings; and corporate bonds and notes with specified ratings.

General Statute 147-69.2 authorizes the State Treasurer to invest the deposits of certain special funds, including the pension trust funds, the State Health Plan, the Disability Income Plan of N.C., the Escheats Fund, the Public School Insurance Fund, the State Education Assistance Authority, and trust funds of the University of North Carolina System, in the investments authorized in General Statute 147-69.1; general obligations of other states; general obligations of North Carolina local governments; asset-backed securities bearing specific ratings; and obligations of any company incorporated within or outside the United States bearing specific ratings. The deposits of the pension trust funds may be invested in all of the above plus certain insurance contracts; group trusts; individual, common or collective trusts of banks and trust companies; real estate investment trusts; limited partnership interest in limited liability partnerships or limited liability companies; and certain stocks and mutual funds.

**External Investment Pool**

To ensure that these and other legal and regulatory limitations are met, all cash deposited with the State Treasurer, except for the UNC Hospitals, Escheat Fund, and bond proceeds investment accounts, is maintained in the Investment Pool. This pool, a governmental external investment pool, consists of the following individual investment portfolios:

*Short-term Investment* – This portfolio may hold any of the investments authorized by General Statute 147-69.1. The Short-term Investment portfolio is the primary cash management account for the State and is managed in such a manner as to be readily convertible into cash. The

primary participants of this portfolio are the General Fund and the Highway Funds. Other participants include the remaining portfolios listed below, universities and various boards, commissions, community colleges, and school administrative units that make voluntary deposits with the State Treasurer.

*Long-term Investment* – This portfolio may hold the fixed-income investments authorized by General Statutes 147-69.1 and 147-69.2. Since the deposits in this fund are typically not needed for day-to-day operations, the investment vehicles used generally have a longer term and higher return than those held in the Short-term Investment portfolio. The primary participants of the portfolio are the pension trust funds.

*Equity Investment* – This portfolio holds an equity-based trust. The State's pension trust funds are the sole participants in the portfolio.

*Real Estate Investment* – This portfolio holds investments in real estate-based trust funds and group annuity contracts. The State's pension trust funds are the sole participants in the portfolio.

*Alternative Investment* – This portfolio holds investments in limited partnerships and equities received in the form of distributions from its primary investments. The State's pension trust funds are the sole participants in the portfolio.

All of the above investment portfolios operate like individual investment pools, except that an investment portfolio may hold shares in other investment portfolios at the discretion of the State Treasurer and subject to the legal limitations discussed above. To this extent, the deposits are commingled; and therefore, the State Treasurer considers all investment portfolios to be part of a single pool, the Investment Pool. The Investment Pool contains deposits from funds and component units of the reporting entity (internal portion) as well as deposits from certain legally separate organizations outside the reporting entity (external portion). This pool is not registered with the Securities and Exchange Commission and is not subject to any formal oversight other than that of the legislative body.

At year-end, the condensed financial statements for the Investment Pool maintained by the State Treasurer were as follows (dollars in thousands):

## NOTES TO THE FINANCIAL STATEMENTS

**Statement of Net Assets**  
June 30, 2006

<b>Assets:</b>	
Cash and cash equivalents.....	\$ 320,050
Other assets.....	411,008
Investments.....	98,791,063
Total assets.....	<u>99,522,121</u>
<b>Liabilities:</b>	
Distributions payable.....	8,844
Other payables.....	25,000
Obligations under securities lending.....	21,667,015
Total liabilities.....	<u>21,700,859</u>
<b>Net Assets:</b>	
Internal:	
Primary government.....	75,592,566
Component units.....	2,027,864
External.....	200,832
Total net assets.....	<u>\$ 77,821,262</u>

**Statement of Operations and Changes in Net Assets**  
For the Fiscal Year Ended June 30, 2006

<b>Revenues:</b>	
Investment income.....	\$ 5,918,457
<b>Expenses:</b>	
Securities lending.....	853,022
Investment management.....	138,335
Total expenses.....	<u>991,357</u>
Net increase in net assets resulting from operations.....	4,927,100
<b>Distributions to participants:</b>	
Distributions paid and payable.....	(4,927,100)
<b>Share transactions:</b>	
Reinvestment of distributions.....	4,928,231
Net share redemptions.....	<u>(1,439,071)</u>
Total increase in net assets.....	3,489,160
<b>Net assets:</b>	
Beginning of year.....	74,332,102
End of year.....	<u>\$ 77,821,262</u>

The external portion of the Investment Pool is presented in the State's financial statements as an investment trust fund. Each fund and component unit's share of the internal equity in the Investment Pool is reported in the State's financial statements as an asset of those funds or component units. Equity in the Short-term Investment portfolio is reported as cash and cash equivalents while equity in the Long-term Investment, Equity Investment, Real Estate Investment, and Alternative Investment portfolios is reported as investments. The internal equity of the pool differs from the amount of assets reported by the funds and component units due to the typical

banker/customer outstanding and in-transit items. Additionally, each fund reports its share of the assets and liabilities arising from securities lending transactions. The State reports the assets and liabilities arising from securities lending transactions for component units as part of the State's agency funds, rather than allocate them to the component units.

Investments in nonparticipating contracts, such as nonnegotiable certificates of deposit, are reported at cost. Other investments held in the Short-term Investment portfolio are reported at amortized cost, which approximates fair value. All other investments are reported at fair value. Fair values are determined daily for the Long-term Investment and Equity Investment portfolios and quarterly for the Real Estate Investment and Alternative Investment portfolios. The fair value of fixed income securities is based on future principal and interest payments discounted using current yields for similar instruments. Investments in real estate trusts, limited partnerships, and the equity trust are valued using market prices provided by the third party professionals. Participants' shares sold and redeemed are determined in the same manner as is used to report investments, and the State Treasurer does not provide or obtain legally binding guarantees to support share values.

Net investment income earned by the Investment Pool is generally distributed on a pro rata basis. However, in accordance with legal requirements, the General Fund receives all investment income earned by funds created for purposes of meeting appropriations. For the fiscal year ended June 30, 2006, \$50.31 million of investment income associated with other funds was credited to the General Fund.

**Deposits**

*Custodial Credit Risk.* For deposits, custodial credit risk is the risk that in the event of a bank failure, the State's deposits may not be recovered. At year-end, the Investment Pool's deposits were not exposed to custodial credit risk.

The State Treasurer's deposit policy for custodial credit risk is limited to complying with the collateralization rules of the North Carolina Administrative Code (Chapter 20 NCAC 7). Deposits to the Investment Pool may be made in any bank, savings and loan association or trust company in the State as approved by the State Treasurer. The North Carolina Administrative Code requires depositories to collateralize all balances that are not insured. The depositories must maintain specified security types in a third party escrow account established by the State Treasurer. The securities collateral must be governmental in origin (e.g., U.S. Treasury, U.S. agency, or state and local government obligations) or the highest grade commercial paper and bankers' acceptances. The market value of the collateral must not be less than the value of the uninsured deposits. The depositories may elect to collateralize deposits separately (dedicated method) or include deposits of the North Carolina local government units in a collateral pool with the State and certain component units (pooling method).

## NOTES TO THE FINANCIAL STATEMENTS

## Investments

At year-end, the Investment Pool maintained by the State Treasurer had the following investments and maturities (dollars in thousands):

Investment Type	Carrying Amount	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More Than 10
<b>Debt securities:</b>					
U.S. Treasuries .....	\$ 11,854,576	\$ 3,146,847	\$ 3,067,309	\$ 1,558,319	\$ 4,082,101
U.S. agencies .....	6,887,071	1,402,136	2,184,900	2,399,668	900,367
Mortgage pass-throughs .....	6,326,147	—	—	—	6,326,147
Domestic corporate bonds .....	8,055,999	—	1,022,814	3,993,519	3,039,666
Securities purchased with cash collateral under securities lending program:					
Asset-backed securities .....	11,764,962	1,991,216	9,773,746	—	—
Repurchase agreements .....	4,435,041	4,435,041	—	—	—
Domestic corporate bonds .....	5,467,012	450,271	5,016,741	—	—
	54,790,808	\$ 11,425,511	\$ 21,065,510	\$ 7,951,506	\$ 14,348,281
<b>Other securities:</b>					
Equity based trust - domestic .....	32,587,628				
Equity based trust - international .....	7,476,717				
<b>Alternative investments:</b>					
Hedge funds .....	901,619				
Private equity investment partnerships .....	574,247				
Stock distributions .....	4,414				
Real estate trust funds .....	2,455,630				
<b>Total investment securities .....</b>	<b>\$ 98,791,063</b>				

Also, the major investment classifications of the Investment Pool had the following attributes at year-end (dollars in thousands):

Investment Classification	Principal Amount	Range of Interest Rates
U.S. Treasuries .....	\$ 11,075,848	2.25%-8.88%
U.S. agencies .....	6,966,786	0.0%-7.13%
Mortgage pass-throughs .....	6,484,376	5.0%-9.0%
Domestic corporate bonds .....	8,039,308	3.45%-9.8%
Securities purchased with cash collateral under securities lending program:		
Asset-backed securities .....	11,764,699	5.07%-5.54%
Repurchase agreements .....	4,435,041	4.67%-5.38%
Domestic corporate bonds .....	5,467,000	5.02%-5.56%
Equity-based trust - domestic .....	n/a	n/a
Equity-based trust - international .....	n/a	n/a

*Equity-based Trust* - The State Treasurer has contracted with an external party (Trustee) to create the "Treasurer of the State of North Carolina Equity Investment Fund Pooled Trust" (the Trust). The State's pension trust funds are the only depositors in the Trust. The State Treasurer employs investment managers to manage the assets, primarily in equity and equity-based securities in accordance with the General Statutes and parameters provided by the State Treasurer. The Trustee maintains custody of the underlying securities in the name of the Trust, services the securities, and maintains all related accounting records. The Trustee also acts as a securities lending agent for the Trust, invests residual cash in a cash sweep fund, and may be temporarily employed as an investment

manager. The State Treasurer maintains beneficial interest in the Trust and no direct ownership of the securities.

*Interest Rate Risk*. Although there is no formally adopted investment policy, as a means of managing interest rate risk, fixed income assets of the Short-term Investment portfolio are invested in a laddered maturity approach that focuses on short maturity securities with ample liquidity. The Short-term Investment portfolio had a weighted average maturity of 1.18 years as of June 30, 2006. Most of the cash and cash equivalents of the major governmental and enterprise funds are invested in this portfolio.

## NOTES TO THE FINANCIAL STATEMENTS

The assets of the Long-term Investment portfolio are primarily invested in securities with maturities longer than five years. The longer maturity range is more sensitive to interest rate changes; however, the longer duration structure of the portfolio provides a better match to the long duration characteristics of the retirement systems' liabilities. At year-end, pensions and other employee benefit plans owned 98% of the Long-term Investment portfolio and the Escheats Fund (included with other governmental funds) owned 1%.

The Long-term Investment portfolio holds investments in Government National Mortgage Association (GNMA) mortgage pass through pools. Critical to the pricing of these securities are the specific features of the cash flows from the interest and principal payments of the underlying mortgages. Therefore, these valuations are very sensitive to the potential of principal prepayments by mortgagees in periods of declining interest rates. Also, included within the Long-term Investment portfolio are U.S. government agencies and corporate bonds which carry call options in which the issuer has the option to prepay the principal at certain dates over the life of the security. As such, these types of securities are more sensitive to the decline in

long-term interest rates as similar securities without call options.

*Credit Risk.* General Statute 147-69.1 specifies the cash investment options for the Short-term Investment portfolio. The statute limits credit risk by restricting the portfolio's corporate obligations, asset-backed securities, and commercial paper to securities that bear the highest rating of at least one nationally recognized rating service and do not bear a rating below the highest by any nationally recognized rating service. General Statute 147-69.2 specifies the cash investment options for the Long-term Investment portfolio. The statute limits credit risk by restricting the portfolio's asset-backed securities and corporate obligations to securities that bear one of the four highest ratings of at least one nationally recognized rating service and do not bear a rating below one of the four highest ratings by any nationally recognized rating service. In the Long-term Investment portfolio, all holdings were rated BBB (or equivalent) or higher at the time of purchase by all three nationally recognized rating agencies.

At year-end, the Investment Pool had the following credit quality distribution for securities with credit exposure (dollars in thousands):

Investment Type	Carrying Amount by Credit Rating - Moody's/S&P/Fitch			
	Aaa/AAA	Aa/AA	A	Baa/BBB
U.S. agencies .....	\$ 6,887,071	\$ —	\$ —	\$ —
Domestic corporate bonds .....	629,264	2,520,314	3,131,702	1,774,719
Securities purchased with cash collateral under securities lending program:				
Asset-backed securities .....	11,764,962	—	—	—
Repurchase agreements .....	4,435,041	—	—	—
Domestic corporate bonds .....	789,730	1,007,071	3,670,211	—
Total .....	<u>\$ 24,506,068</u>	<u>\$ 3,527,385</u>	<u>\$ 6,801,913</u>	<u>\$ 1,774,719</u>

*Custodial Credit Risk.* For an investment, custodial credit risk is the risk that in the event of the failure of the counterparty, the State Treasurer will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. At year-end, the investments purchased with cash collateral under the securities lending program of \$21.67 billion were exposed to custodial credit risk since the securities were held by the counterparty and were not registered in the name of the State Treasurer. As required by contractual agreements, a third party agent holds these assets for the benefit of a dedicated Treasurer's account. This agreement fully indemnifies the Treasurer for any third party defaults or losses. All other investments of the Investment Pool were not exposed to custodial credit risk at year-end and no custodial credit risk policy has been adopted for these investment types.

**NOTES TO THE FINANCIAL STATEMENTS**

*Foreign Currency Risk.* At year-end, the Investment Pool's exposure to foreign currency risk was as follows (dollars in thousands):

Currency	Carrying Value by Investment Type				Total
	Equity	Alternative	Real-Estate		
	Based Trust - International	Investment - Private Equity Investment Partnerships	Trust Fund Investment Partnerships		
Euro .....	\$ 2,007,451	\$ 106,052	\$ 41,410	\$ 2,154,913	
Japanese Yen .....	1,577,484	2,737	—	1,580,221	
Pound Sterling .....	1,150,973	—	—	1,150,973	
Swiss Franc .....	595,278	—	—	595,278	
Hong Kong Dollar .....	217,273	—	—	217,273	
Australian Dollar .....	189,390	—	—	189,390	
New Taiwan Dollar .....	153,727	—	—	153,727	
South Korean Won .....	138,140	—	—	138,140	
Canadian Dollar .....	127,628	—	—	127,628	
Other Currencies .....	651,449	—	—	651,449	
<b>Total .....</b>	<b>\$ 6,808,793</b>	<b>\$ 108,789</b>	<b>\$ 41,410</b>	<b>\$ 6,958,992</b>	

Although there is no formally adopted investment policy, the State Treasurer's investment policy permits up to 13% of the retirement systems' invested assets to be in international securities. At year-end, the retirement systems had approximately 10.2% invested in international securities.

**Securities Lending**

Based on the authority provided in General Statute 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, GNMA's, 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% of the market value of the securities lent, and additional collateral is required if its value falls to less than 100% of the market value of the securities lent. There are no restrictions on the amount of loans that can be made. Substantially all security loans can be terminated on demand by either the State Treasurer or the borrower. 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. 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 to five years, the custodian agent is not permitted to make investments where the weighted average maturity of all investments exceeds 30 days. At year-end, the weighted average maturity of investments was approximately 22 days.

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

*Interest rate risk and credit risk.* The policies for investments purchased with cash collateral under the securities lending program are set forth in the contract with the securities custodian. Contractually, asset-backed securities must bear the highest rating of at least one nationally recognized rating service. The expected maturity shall not exceed five years and securities having a final maturity greater than two years will be in floating rate instruments with interest rate resets occurring at no greater than 90-day intervals to minimize the effect of interest rate fluctuations on their valuations. The securities pledged as collateral for repurchase agreements are limited to securities issued or guaranteed by the U.S. government or its agencies, or specified bank or corporate obligations. As directed by the State Treasurer, repurchase counterparties are limited to specific counterparties with specific dollar limits per counterparty. Corporate bonds and notes, including bank holding company obligations, rated AA must have a final maturity no greater than three years. Securities rated A must have a final maturity no greater than two years. No more than five percent of the cash collateral may be invested in a single issue.

## NOTES TO THE FINANCIAL STATEMENTS

### Bond Proceeds Investment Accounts

The State Treasurer has established separate investment accounts for each State bond issue to comply with Internal Revenue Service regulations on bond arbitrage. A private investment company under contract with the State Treasurer manages these separate accounts. The investments are valued at amortized cost, which approximates fair value. In the State's financial statements, each fund's equity in these accounts is reported as investments.

At year-end, the bond proceeds investment accounts had the following investments and maturities (dollars in thousands):

Investment Type	Carrying Amount	Weighted Average Maturity (Days)
U.S. Agencies .....	\$ 277,338	11
Commercial paper .....	29,600	91
Repurchase agreements .....	215,474	7
Total investments .....	<u>\$ 522,412</u>	

*Interest Rate Risk and Credit Risk.* As established in the contract with the private investment company, all bond proceeds are managed in compliance with General Statute 147-69.1, which limits credit risk as described above, and can only be invested in short-term maturities with the average maturity ranging between overnight to six months based on the liquidity needs of the investment accounts. As of June 30, 2006, Standard and Poor's rated investments in commercial paper and U.S. agencies as A-1 and AAA, respectively.

*Custodial Credit Risk.* Investments purchased with bond proceeds were exposed to custodial credit risk since the securities were held by the counterparty and were not registered in the name of the State Treasurer.

### University of North Carolina (UNC) Hospitals Investment Account

The State Treasurer has contracted with an external party (Trustee) to create the University of North Carolina Hospitals at Chapel Hill Trust (Trust). The UNC Hospitals are the only depositor in the Trust. However, the Trust is a participant of a commingled equity investment fund. The Trustee manages the assets, primarily in equity and equity-based securities in accordance with the General Statutes. The Trustee maintains custody of the underlying securities in the name of the Trust, services the securities, and maintains all related accounting records. The investments are valued at fair market value.

At year-end, the UNC Hospitals investment account maintained by the State Treasurer had the following investments (settled transactions) (dollars in thousands):

Investment Type	Carrying Amount
Other securities:	
Equity based trust - domestic .....	\$ 104,825
Equity based trust - international .....	45,552
Total investment securities .....	<u>\$ 150,377</u>

*Foreign Currency Risk.* At year-end, the UNC Hospitals investment account's exposure to foreign currency was as follows (dollars in thousands):

Currency	Carrying Value by Investment Type
	Equity Based Trust-International
Euro .....	\$ 14,529
Japanese Yen .....	10,357
Pound Sterling .....	9,829
Canadian Dollar .....	3,446
Swiss Franc .....	2,783
Australian Dollar .....	2,236
Hong Kong Dollar .....	1,744
South Korean Won .....	1,326
Swedish Krona .....	994
Other Currencies .....	4,402
Total .....	<u>\$ 51,646</u>

Note: The totals in this table do not agree to the totals disclosed in the investment table above because this foreign currency table includes equities based on trade date while the investment table is reported on settle date.

### Escheat Investment Account

Pursuant to General Statute 147-69.2(b)(12), the State Treasurer has established a separate investment account on behalf of the Escheat Fund. A real estate investment trust under contract with the State Treasurer manages the account.

At year-end, the Escheat Fund invested in a Real Estate account, which held \$20 million in cash. These funds were on deposit at a private investment bank in a short-term investment fund pending transfer into the investment fund on July 3, 2006.

*Custodial Credit Risk.* For deposits, custodial credit risk is the risk that in the event of a bank failure, the State's deposit may not be recovered. At year-end, the deposit held at the private investment bank was exposed to custodial credit risk because it was uninsured and not fully collateralized.

## B. Deposits Outside the State Treasurer

In addition to the pooled deposits maintained by the State Treasurer, other deposits are maintained outside the State Treasurer by the primary government and certain component units. As a general rule, these deposits are not covered by the rules in Chapter 20 NCAC 7 requiring collateralization of uninsured deposits.

**NOTES TO THE FINANCIAL STATEMENTS****Primary Government**

The majority of deposits held outside the State Treasurer were maintained by the Employment Security Commission and the various clerks of superior court. General Statute 96-6 requires that Employment Security Commission funds be deposited with the United States Treasury to the credit of North Carolina. The clerks of superior court do not have a deposit policy for custodial credit risk. At year-end, the bank balances maintained outside the State Treasurer by the primary government were exposed to custodial credit risk as follows (dollars in thousands):

Uninsured and uncollateralized .....	\$	33,640
Uninsured and collateral held by pledging bank .....		13
Uninsured and collateral held by pledging bank's trust department but not in State's name .....		233
Total .....	\$	<u>33,886</u>

**Component Units****(University of North Carolina System and State Education Assistance Authority)**

The University of North Carolina (UNC) System does not have a deposit policy for custodial credit risk. At year-end, the bank balances maintained outside the State Treasurer by the UNC System were exposed to custodial credit risk as follows (dollars in thousands):

Uninsured and uncollateralized .....	\$	177,369
Uninsured and collateral held by pledging bank .....		286
Uninsured and collateral held by pledging bank's trust department or agent but not in State's name .....		11
Total .....	\$	<u>177,666</u>

The State Education Assistance Authority does not have a deposit policy for custodial credit risk. At year-end, the bank balances maintained outside the State Treasurer by the State

Education Assistance Authority were exposed to custodial credit risk as follows (dollars in thousands):

Uninsured and collateral held by pledging bank .....	\$	23,275
Uninsured and collateral held by pledging bank's trust department or agent but not in State's name .....		6,973
Total .....	\$	<u>30,248</u>

**C. Investments Outside the State Treasurer**

Investments in participating investment contracts, external investment pools, open-end mutual funds, debt securities, equity securities, and all investments of the Deferred Compensation Plan are reported at fair value. Investments in certificates of deposit, investment agreements, bank investment contracts, real estate, real estate investment trusts, and limited partnerships are reported at cost. Detailed disclosures about investments held outside the State Treasurer are presented below.

**Primary Government**

At year-end, 77% of investments held outside the State Treasurer were maintained by the Supplemental Retirement Income Plan of North Carolina.

**Supplemental Retirement Income Plan of North Carolina**

The General Statutes place no specific investment restrictions on the Supplemental Retirement Income Plan of North Carolina (the Plan). However, in the absence of specific legislation, the form of governance over the investments would be the prudent-person or prudent-expert rule. These rules are broad statements of intent, generally requiring investment selection and management to be made with prudent, discreet, and intelligent judgment and care. The Plan does not have formal investment policies that address interest rate risk, credit risk, custodial credit risk, concentration of credit risk, or foreign currency risk.

## NOTES TO THE FINANCIAL STATEMENTS

At December 31, 2005, the Supplemental Retirement Income Plan of North Carolina had the following investments and maturities that were maintained outside the State Treasurer (dollars in thousands):

Investment Type	Carrying Amount	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More Than 10
<b>Debt securities:</b>					
Fidelity Intermediate Bond Fund .....	\$ 209,248	\$ —	\$ 209,248	\$ —	\$ —
Prudential Stable Value Fund:					
U.S. Treasuries .....	228,378	25,429	117,001	31,613	54,335
U.S. agencies .....	96,190	—	79,891	9,507	6,792
Collateralized mortgage obligations .....	297,945	42,580	1,731	858	252,776
State and local government .....	2,888	—	—	—	2,888
Asset-backed securities .....	37,225	—	—	5,951	31,274
Money market mutual funds .....	5,119	5,119	—	—	—
Domestic corporate bonds .....	167,623	3,433	80,160	51,810	32,220
Foreign corporate bonds .....	26,612	—	18,290	3,958	4,364
Foreign government bonds .....	8,343	—	3,089	2,412	2,842
	<u>1,079,571</u>	<u>\$ 76,561</u>	<u>\$ 509,410</u>	<u>\$ 106,109</u>	<u>\$ 387,491</u>
<b>Other securities:</b>					
International mutual funds .....	123,429				
Other mutual funds .....	2,106,586				
Prudential Stable Value Fund:					
Amount guaranteed by insurance company .....	17,387				
Total investment securities .....	<u>\$ 3,326,973</u>				

The Prudential Stable Value Fund is a trust product and is comprised of a group annuity contract issued by The Prudential Insurance Company of America and a portfolio of assets owned by the Plan. Principal and accrued interest is guaranteed by The Prudential Insurance Company of America.

*Interest Rate Risk and Credit Risk.* The Fidelity Intermediate Bond Fund, which is unrated, had a weighted average maturity of 4.5 years as of April 30, 2006. In the above table, it is disclosed as an investment with a maturity of one to five years. Of the underlying securities in the Prudential Stable Value Fund with credit risk exposure, \$230.74 million were rated BBB or above by Standard & Poor's and \$633.79 million were unrated.

*Custodial Credit Risk.* The Prudential Stable Value Fund had a custodial credit risk exposure of \$865.2 million because the underlying securities were uninsured, unregistered, and held by the counterparty.

*Concentration of Credit Risk.* More than 5% of the Plan's investment is in collateralized mortgage obligations issued by the Federal National Mortgage Association. These investments were 5.3% of the Plan's total investments.

*Foreign Currency Risk.* The Plan owns two international mutual funds, the American Europacific Growth Fund and the T. Rowe Price International Stock Fund. These funds had a carrying value of \$122.84 million and \$588.56 thousand, respectively, at December 31, 2005.

#### Other Primary Government Investments

The other primary government investments held outside the State Treasurer consisted almost entirely of balances maintained by the North Carolina Public Employee Deferred Compensation Plan (the Plan) and separate investment accounts held by trustees for special obligation debt issues to comply with IRS regulations on bond arbitrage.

General Statute 143B-426.24(j) allows the Deferred Compensation Plan Board to acquire investment vehicles from any company authorized to conduct such business in this State or may establish, alter, amend and modify, to the extent it deems necessary or desirable, a trust for the purpose of facilitating the administration, investment and maintenance of assets acquired by the investment of deferred funds. All assets of the Plan, including all deferred amounts, property and rights purchased with deferred amounts, and all income attributed thereto shall be held in trust for the exclusive benefit of the Plan participants and their beneficiaries.

## NOTES TO THE FINANCIAL STATEMENTS

At year-end, the other primary government investments maintained outside the State Treasurer had the following investments and maturities (dollars in thousands):

Investment Type	Carrying Amount	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More Than 10
<b>Debt securities:</b>					
U.S. Treasuries .....	\$ 696	\$ 104	\$ 406	\$ 163	\$ 23
U.S. Treasury STRIPS .....	873	185	688	—	—
U.S. agencies .....	2,409	158	395	1,849	7
Mortgage pass throughs .....	154	—	24	2	128
Collateralized mortgage obligations .....	58	2	50	6	—
State and local government .....	108	—	99	8	1
Asset-backed securities .....	26	—	—	9	17
Repurchase agreements .....	164,775	153,151	11,624	—	—
Commercial paper .....	586	586	—	—	—
Annuity contracts .....	36,157	—	36,157	—	—
Money market mutual funds .....	5,094	5,094	—	—	—
Mutual bond funds .....	11,219	—	—	11,217	2
Domestic corporate bonds .....	62	—	27	25	10
	<u>222,217</u>	<u>\$ 159,280</u>	<u>\$ 49,470</u>	<u>\$ 13,279</u>	<u>\$ 188</u>
<b>Other securities:</b>					
Other mutual funds .....	610,781				
Real estate investment trusts .....	20,000				
Domestic stocks .....	58,952				
Other .....	557				
Total investment securities .....	<u>\$ 912,507</u>				

*Interest Rate Risk and Credit Risk.* The special obligation debt proceeds are generally invested in repurchase agreements. As established in the debt covenants, repurchase agreements with respect to government obligations can only be entered into with 1) a dealer recognized as a primary dealer by a Federal Reserve Bank with a short-term rating not less than P-1 from Moody's Investors Service (Moody's) and not less than A-1 from Standard & Poor's (S&P) and Fitch Ratings (Fitch); or 2) any commercial bank, trust company, or national banking association rated A or better by Moody's, S&P and Fitch, the deposits of which are insured by the Federal Deposit Insurance Corporation. There are no formally adopted investment policies or debt covenants for special obligation debt proceeds that address interest rate risk.

At year-end, the other primary government investments maintained outside the State Treasurer had the following credit quality distribution for securities with credit exposure (dollars in thousands):

Investment Type	Carrying Amount by Credit Rating - Moody's/S&P/Fitch					
	Aaa/AAA	Aa/AA	A	Baa/BBB	Ba/BB and Below	Unrated
U.S. agencies .....	\$ 2,409	\$ —	\$ —	\$ —	\$ —	\$ —
Mortgage pass throughs .....	128	—	—	—	—	19
Collateralized mortgage obligations .....	28	9	12	3	—	4
State and local government .....	107	1	—	—	—	—
Asset-backed securities .....	26	—	—	—	—	—
Repurchase agreements .....	11,623	—	—	—	—	—
Commercial paper .....	—	—	586	—	—	—
Annuity contracts .....	—	—	—	—	36,157	—
Money market mutual funds .....	4,917	—	—	—	—	177
Mutual bond funds .....	9,737	447	447	336	224	28
Domestic corporate bonds .....	4	11	23	23	1	—
Total .....	<u>\$ 28,979</u>	<u>\$ 468</u>	<u>\$ 1,068</u>	<u>\$ 362</u>	<u>\$ 36,382</u>	<u>\$ 228</u>

## NOTES TO THE FINANCIAL STATEMENTS

**Component Units**

(University of North Carolina System and State Education Assistance Authority)

**University of North Carolina System**

The General Statutes place no specific investment restrictions on the University of North Carolina System (the UNC System). However, in the absence of specific legislation, the form of governance over these investments would be the prudent-person or prudent-expert rule. These rules are broad statements of intent, generally requiring investment selection and management to be made with prudent, discreet, and intelligent judgment and care. The University of North Carolina at Chapel Hill (the University) operates an Investment Fund, which is a governmental external investment pool. The University operates the Investment Fund for charitable, nonprofit foundations, associations, trusts, endowments and funds that are organized and operated primarily to support the University. Separate financial statements for the Investment Fund may be obtained from the University.

At year-end, the UNC System had the following investments and maturities that were maintained outside the State Treasurer (dollars in thousands):

Investment Type	Carrying Amount	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More Than 10
<b>Debt securities:</b>					
U.S. Treasuries .....	\$ 43,386	\$ 5,533	\$ 16,297	\$ 445	\$ 21,111
U.S. Treasury STRIPS .....	2,337	—	2,337	—	—
U.S. agencies .....	38,033	13,325	18,135	2,600	3,973
Mortgage pass throughs .....	68,032	1,292	6,035	13,617	47,088
Collateralized mortgage obligations .....	142,218	—	2,088	6,026	134,104
State and local government .....	2,508	60	2,216	83	149
Asset-backed securities .....	1,991	—	—	1,428	563
Repurchase agreements .....	672	—	672	—	—
Money market mutual funds .....	220,849	220,849	—	—	—
Mutual bond funds .....	175,759	21,661	37,498	108,313	8,287
Domestic corporate bonds .....	36,476	2,057	18,522	1,501	14,396
Foreign corporate bonds .....	9,456	15	5,066	4,361	14
	<u>741,717</u>	<u>\$ 264,792</u>	<u>\$ 108,866</u>	<u>\$ 138,374</u>	<u>\$ 229,685</u>
<b>Other securities:</b>					
International mutual funds .....	79,820				
Other mutual funds .....	425,466				
Investments in real estate .....	56,164				
Real estate investment trusts .....	14,708				
Limited partnerships .....	857,899				
Pooled investments .....	359				
Domestic stocks .....	266,709				
Foreign stocks .....	37,875				
Other .....	610,444				
Total investment securities .....	<u>\$ 3,091,161</u>				

**Limited Partnerships** – The limited partnership positions are primarily held by the University of North Carolina at Chapel Hill. The University uses various external money managers to identify specific investment funds and limited partnerships that meet asset allocation and investment management objectives. The University invests in these funds and partnerships to increase the yield and return on its investment portfolio given the available alternative investment opportunities and to diversify its asset holdings. These investments generally include equity and bond funds. Certain investment funds expose the University to significant amounts of market risk by trading or holding derivative securities and by leveraging the securities in the fund. The University limits the amount of funds managed by any single asset manager and also limits the amount of funds to be invested in particular security classes.

**Interest Rate Risk and Credit Risk.** The constituent institutions of the UNC System generally do not have formal investment policies that address interest rate risk or credit risk. At year-end, the UNC System's investments maintained outside the State Treasurer had the following credit quality distribution for securities with credit exposure (dollars in thousands):

## NOTES TO THE FINANCIAL STATEMENTS

Investment Type	Carrying Amount by Credit Rating - Moody's/S&P/Fitch					
	Aaa/AAA	Aa/AA	A	Baa/BBB	Ba/BB and Below	Unrated
U.S. agencies .....	\$ 13,380	\$ 3,139	\$ —	\$ —	\$ —	\$ 18,576
Mortgage pass throughs .....	4,739	—	—	—	—	62,907
Collateralized mortgage obligations .....	72,433	8,407	38,573	1,275	—	21,482
State and local government .....	2,306	107	—	35	—	60
Asset-backed securities .....	1,457	—	35	499	—	—
Money market mutual funds .....	45,658	—	169,138	—	—	6,053
Mutual bond funds .....	71,971	60,351	17,013	5,790	14,629	6,005
Domestic corporate bonds .....	6,362	1,028	18,140	10,654	292	—
Foreign corporate bonds .....	—	5,026	37	47	4,346	—
Total .....	\$ 218,306	\$ 78,058	\$ 242,936	\$ 18,300	\$ 19,267	\$ 115,083

*Custodial Credit Risk.* The constituent institutions of the UNC System generally do not have formal investment policies that address custodial credit risk. At year-end, the UNC System's investments maintained outside the State Treasurer were exposed to custodial credit risk as follows (dollars in thousands):

Investment Type	Carrying Amount	
	Held by Counterparty	Held by Counterparty's Trust Dept. or Agent but not in State's Name
U.S. Treasuries .....	\$ 12,620	\$ 640
U.S. agencies .....	13,895	—
Mortgage pass throughs .....	15,801	—
Collateralized mortgage obligations .....	9,094	—
Repurchase agreements .....	672	—
Domestic corporate bonds .....	14,245	—
Domestic stocks .....	53,291	—
Foreign stocks .....	281	—
Total .....	\$ 119,899	\$ 640

*Foreign Currency Risk.* The constituent institutions of the UNC System do not have formal investment policies that address foreign currency risk. At year-end, the UNC System's investments maintained outside the State Treasurer were exposed to foreign currency risk as follows (dollars in thousands):

Currency	Carrying Amount	
	Foreign Stocks	Limited Partnerships
Euro .....	\$ 1,607	\$ 21,395
Japanese Yen .....	16,060	667
Pound Sterling .....	—	4,462
Canadian Dollar .....	3,798	—
Singapore Dollar .....	1,624	—
Other Currencies .....	1,569	89
Total .....	\$ 24,658	\$ 26,613

## NOTES TO THE FINANCIAL STATEMENTS

## The State Education Assistance Authority

The State Education Assistance Authority (the Authority) is authorized by the University of North Carolina Board of Governors pursuant to General Statute 116-36.2 to invest its special funds in the same manner as the State Treasurer is required to invest, as discussed in Section A of this note.

*Investments.* In accordance with bond resolutions, bond proceeds and debt service funds are invested in obligations that will by their terms mature on or before the date funds are expected to be required for expenditure or withdrawal.

The Authority does not have a formal investment policy that addresses interest rate risk. The following table presents the fair value of investments by type and investments subject to interest rate risk at June 30, 2006, for the Authority's investments (dollars in thousands):

Investment Type	Carrying Amount	Investment Maturities (in Years)			
		Less Than 1	1 to 5	6 to 10	More Than 10
<b>Debt securities:</b>					
U.S. Treasuries .....	\$ 12,220	\$ —	\$ 386	\$ 7,092	\$ 4,742
Repurchase agreements .....	8,869	—	—	3,657	5,212
Mutual bond funds .....	29,646	—	—	29,646	—
Money market mutual funds .....	489	489	—	—	—
	51,224	\$ 489	\$ 386	\$ 40,395	\$ 9,954
<b>Other securities:</b>					
International mutual funds .....	18,759				
Other mutual funds .....	101,897				
Domestic stocks .....	19,822				
Investment contracts .....	326,611				
Other .....	15,402				
Total investment securities .....	\$ 533,715				

*Credit Risk.* The Authority has formally adopted investment policies for credit risk stating that certain investment obligations shall bear one of the two highest ratings by nationally recognized rating services. As of June 30, 2006, the Authority's investments were rated as follows (dollars in thousands):

Investment Type	Carrying Amount by Credit Rating - S&P	
	Aaa/AAA	Unrated
Repurchase agreements .....	\$ —	\$ 8,869
Money market mutual funds .....	—	489
Mutual bond funds .....	12,431	17,215
Total .....	\$ 12,431	\$ 26,573

*Custodial Credit Risk.* The Authority does not have a formal policy that addresses custodial credit risk. The Authority's investments were exposed to custodial credit risk as follows (dollars in thousands):

Investment Type	Carrying Amount
	Held by Counterparty's Trust Dept. or Agent but not in State's Name
Repurchase agreements .....	\$ 8,869
Domestic Stocks .....	19,822
Total .....	\$ 28,691

*Concentration of Credit Risk.* The Authority places no limit on the amount that may be invested in any one issuer. More than 5% of the Authority's investments are in Trinity Funding, FSA Capital Management, and IXIS Funding. These investments are 33.05%, 10.7%, and 17.45%, respectively, of the Authority's investments.