

Intermediate Term Investment Fund



JUSTIN P. WILSON
Comptroller

JASON E. MUMPOWER
Chief of Staff

Independent Auditor's Report

Members of the General Assembly
Members of the State Funding Board
The Honorable David H. Lillard, Jr., Treasurer

Report on the Financial Statements

We have audited the accompanying statement of fiduciary net position of the Intermediate Term Investment Fund, an investment trust fund of the State of Tennessee, as of June 30, 2017, the related statement of changes in fiduciary net position for the year then ended, and the related notes to the financial statements, which collectively comprise the Intermediate Term Investment Fund's basic financial statements.

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 audits. We conducted our audits 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

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no such opinion. An audit also includes evaluating the appropriateness of accounting principles used and 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. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the State Funding Board. We do not believe that the Comptroller's service in this capacity affected our ability to conduct an independent audit of the Intermediate Term Investment Fund.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net position of the Intermediate Term Investment Fund of the State of Tennessee as of June 30, 2017, and the changes in fiduciary net 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 A.1., the financial statements present only the Intermediate Term Investment Fund, an investment trust fund, and do not purport to, and do not, present fairly the financial position of the State of Tennessee, as of June 30, 2017, 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. 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 March 8, 2018, on our consideration of the Intermediate Term Investment Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts and other matters. The purpose of that report is 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 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 Intermediate Term Investment Fund's internal control over financial reporting and compliance.



Deborah V. Loveless, CPA, Director
Division of State Audit
March 8, 2018

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Intermediate Term Investment Fund Statements of Fiduciary Net Position June 30, 2017

ASSETS

Cash and Cash Equivalents	\$	17,306,344
Investment income receivable		89,033
Investments (at fair value)		<u>45,181,168</u>
TOTAL ASSETS	\$	<u>62,576,545</u>
 LIABILITIES AND NET POSITION		
NET POSITION HELD IN TRUST FOR POOL PARTICIPANTS	\$	<u>62,576,545</u>

See accompanying Notes to the Financial Statements

Intermediate Term Investment Fund Statements of Change in Fiduciary Net Position For Fiscal Year Ended June 30, 2017

OPERATIONS

Investment income	\$	295,182
Expenses		<u>31,563</u>
NET INVESTMENT INCOME		<u>263,619</u>
TOTAL INCREASE IN NET POSITION		263,619
NET POSITION, BEGINNING OF YEAR		<u>62,312,926</u>
NET POSITION, END OF YEAR	\$	<u>62,576,545</u>

See accompanying Notes to the Financial Statements

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Intermediate Term Investment Fund Notes to the Financial Statements June 30, 2017

A. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Reporting Entity

The Intermediate Term Investment Fund (ITIF) is an external investment pool sponsored by the State of Tennessee. All funds in the ITIF at June 30, 2017 consist of funds belonging to entities outside of the State of Tennessee Financial Reporting Entity, and have been included as a separate investment trust fund in the Tennessee Comprehensive Annual Financial Report.

2. Measurement Focus and Basis of Accounting

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB) 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, regardless of the timing of related cash flows.

3. Cash and Cash Equivalents

Cash that cannot be immediately invested in securities, or that is needed for operations, is deposited in the State Pooled Investment Fund sponsored by the State of Tennessee and administered by the State Treasurer. This classification also includes short-term investments with a maturity date within three months of the date acquired by the State.

4. Method Used to Report Investments and Participant Shares

The ITIF is not registered with the Securities and Exchange Commission (SEC) as an investment company. Through the investment policy adopted by the Funding Board of the State of Tennessee (Funding Board), the fair value of investment positions in the ITIF is determined daily based on the fair value of the pool's underlying portfolio. Accordingly, the investments of the ITIF are reported at fair value on the statement of fiduciary net position. Securities traded on a national exchange are valued at the last reported market prices. In accordance with investment policy, purchases and redemptions are limited to the first working day of each quarter. During the fiscal year ended June 30, 2017, the State had not obtained or provided any legally binding guarantees to support the value of participant shares. The State of Tennessee, or any other state or federal agency, does not guarantee that a participant will receive the value of its investment or interest thereon upon redemption of its shares. The State of Tennessee has not obtained a credit quality rating for the ITIF from a nationally recognized credit ratings agency.

The fair value of assets held at June 30, 2017 represents the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Assets held are categorized for fair value measurement within the fair value hierarchy established by Generally Accepted Accounting Principles (GAAP). The hierarchy is based on the valuation inputs used to measure the fair value of the asset and give the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

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- Level 1 - Unadjusted quoted prices for identical assets or liabilities in active markets that can be accessed at the measurement date.
- Level 2 - Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; assets or liabilities that have a bid-ask spread price in an inactive dealer market, brokered market and principal-to-principal market; and Level 1 assets or liabilities that are adjusted.
- Level 3 - Valuations derived from valuation techniques in which significant inputs are unobservable.

Investments where fair value is measured using the Net Asset Value (“NAV”) per share have no readily determinable fair value and have been determined to be calculated consistent with FASB principles for investment companies.

Where inputs used in the measurement of fair value fall into different levels of the hierarchy, fair value of the instrument in its entirety are categorized based on the lowest level input that is significant to the valuation. This assessment requires professional judgement and as such management developed a fair value committee that worked in conjunction with our custodian and investment professionals to make these valuations. All assets held were valued individually and aggregated into classes so to be represented in the table below.

Short-term securities generally include investments in money market-type securities reported at cost plus accrued interest.

Debt and debt derivative securities classified in Level 2 are valued using a bid-ask spread price from multiple independent brokers, dealers, or market principals, which are known to be actively involved in the market.

Investments Measured at Fair Value For Fiscal Year Ended June 30, 2017 *Expressed in Thousands*

Investments at Fair Value	GAAP Hierarchy Level 2
Agency Securities	\$ 45,181
TOTAL INVESTMENTS AT FAIR VALUE	45,181
Cash and Cash Equivalents	17,306
Investment Income Receivable	89
TOTAL ASSETS	\$ 62,576

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B. DEPOSITS AND INVESTMENTS

The ITIF is authorized by statute to invest funds in the investment instruments specified under statutes for the State Pooled Investment Fund (SPIF), and to invest funds in the State Pooled Investment Fund (SPIF), in accordance with policy guidelines for the ITIF as approved by the Funding Board. The current policy of the Funding Board for the ITIF gives the Treasurer approval to invest funds in bonds, notes, and treasury bills of the United States or other obligations guaranteed as to principal and interest by the United States or any of its agencies, obligations guaranteed as to principal and interest by the federal home loan mortgage corporation, federal national mortgage association, student loan marketing association and other United States government-sponsored corporations, prime commercial paper, prime bankers' acceptances, and repurchase agreements for obligations of the United States or its agencies. The investment in derivatives and equity investments of any type is prohibited. Under the ITIF's investment policy, the SPIF may be used for the purpose of cash administration, but shall not be used for the purpose of investment.

The current policy of the Funding Board for the SPIF gives the Treasurer authority to invest in collateralized certificates of deposit in authorized state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, and various U.S. Treasury and Agency obligations. The State Pooled Investment Fund is also authorized to enter into securities lending agreements in which U.S. Government Securities may be loaned for a fee. The loaned securities are transferred to the borrower by the custodial agent upon simultaneous receipt of collateral securities. The State Pooled Investment Fund is not rated by a nationally recognized statistical ratings agency. The investment policy and required risk disclosures relative to the State Pooled Investment Fund are presented in the State Pooled Investment Fund Report.

At June 30, 2017 the ITIF's investments consisted of United States government agency securities of \$45,181,167 at fair value and \$45,450,000 at par value. Interest rates on the securities ranged from 1.05% to 2.10%, and the number of days to maturity ranged from 147 to 1,804 days.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The ITIF's investment policy requires that prime banker's acceptances must be issued by domestic banks with a minimum AA long term debt rating or foreign banks with an AAA long term debt rating by a majority of the designated rating services that have rated the issuer. The short-term debt rating must be at least A1 or the equivalent by all of the rating services that rate the issuer. Commercial paper should be rated in the highest tier by all rating agencies that rate the paper. Commercial paper on a credit rating agency's negative credit watch list cannot be purchased under the investment policy. The policy requires that a credit analysis report on the corporation be prepared prior to acquisition of the commercial paper. Repurchase agreements must be done with primary dealers in government securities which have executed a master repurchase agreement with the State. Credit quality ratings for the ITIF's investments in debt securities as of June 30, 2017 consisted of \$45,181,167 in fair value of securities implicitly guaranteed by the United States government but not rated by Standard and Poor's ratings agency.

Concentration of Credit Risk

A concentration of investments in any one single issuer of debt securities presents a greater risk for loss in the event that the issuer fails on its obligations. It is the policy of the ITIF to diversify the investment portfolio in order to reduce the risk of loss resulting from over-concentration of assets in a specific maturity, a specific issuer, or a specific class of securities. Commercial paper acquisitions are monitored by policy to assure that no more than five percent (5%) of the portfolio market value at the date of acquisition, is invested in prime commercial paper of a single issuing corporation. The total holdings of an issuer's paper should not represent more than five percent (5%) of the issuing corporation's total outstanding commercial paper. Furthermore, purchases of prime commercial paper shall not exceed thirty-five percent (35%) of the fund's market value at the date of acquisition. In addition, the ITIF's investment policy limits the book value of prime banker's acceptances to five percent (5%) of the total book value of

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the pool and limits such investments in any one commercial bank to the lesser of five percent (5%) of the portfolio's book value or \$25 million. The ITIF had the following investment amounts and percentages of total investments, in organizations representing five percent (5%) or more of total investments, excluding those organizations whose issues are explicitly guaranteed by the United States government, and investments in mutual funds, external investment pools, and other pooled investments:

Issuing Organization	Fair Value	% Total Investments
Federal Home Loan Banks	\$ 21,389,887	47.3%
FHLMC	15,898,240	35.2%
FNMA	7,893,040	17.5%

Interest Rate Risk

Interest rate risk is the risk that future changes in prevailing market rates of interest will have an adverse effect on the fair value of debt investments. The fair values of securities with long terms to maturity may be highly sensitive to interest rate changes. The ITIF's investment policy with respect to maturity states that the dollar weighted average maturity of the Fund shall not exceed three (3) years, and that no security will be bought with a remaining life of over five (5) years. The maximum time period from the date of acquisition to maturity of government or agency securities may not exceed five (5) years. Prime commercial paper, including asset-backed commercial paper, shall not have a maturity that exceeds two hundred seventy (270) days. Individual repurchase agreement transactions shall not have a maturity that exceeds ninety (90) days. Prime banker's acceptances must have an original maturity of not more than two hundred seventy (270) days to be eligible for purchase, with the intent to hold to maturity, however they may be traded in the secondary market to maintain liquidity. At June 30, 2017, the effective duration of the ITIF's debt securities was 2.609 years.

C. OTHER ACCOUNTING DISCLOSURES

Description of the Intermediate Term Investment Fund

Pursuant to Tennessee Code Annotated, Section 9-4-608, the Funding Board was authorized to establish the Intermediate Term Investment Fund (ITIF) to provide a longer-term investment vehicle than the State Pooled Investment Fund (SPIF) for funds in the custody of a department or agency of the state, or a county trustee. The ITIF is administered by the State Treasurer within the guidelines established by the Funding Board, and the responsibility for the day-to-day administration of the ITIF, in accordance with investment policy, has been assigned to appropriate investment officials within the Treasury Department. Participants in the ITIF are advised to only invest monies in the pool that are not needed for short term liquidity, due to the daily pricing of the pool to the market and the potential for significant price volatility. Participants in the ITIF may include the general fund of the State and any department or agency of the State which is required by court order, contract, state or federal law or federal regulation to receive interest on invested funds, and which are authorized by the State Treasurer to participate in the ITIF. In addition, a county legislative body may authorize the county trustee to invest county funds in the ITIF. By statute, any entity that is eligible to participate in the State Pooled Investment Fund may participate in the ITIF. As indicated in Note 1 above, the ITIF is not registered as an investment company with the SEC. Investment in the ITIF is voluntary and participants may invest any amount for any length of time in the ITIF.

Participants' shares are sold and redeemed at a value based upon the daily fair value per share of the pool's underlying investments. For the fiscal year ended June 30, 2017 an administrative fee of .05 percent was charged against each participant's average daily balance to provide funding for administrative expenses to operate the ITIF.