Introduction

Photo by TRS Communications

When she retires, Elizabeth will miss the hugs she gets from her students. She looks forward to having more time to serve in her church, acting in the community theatre, substitute teaching and assisting her husband in his contracting business.

Elizabeth Corbit
29 years of service
K, 1st, and 4th grades
Anna Elementary, District 37

*Wisdom begins in wonder * Socrates * Wisdom begins in wonder * Socrates * Wisdom begins in wonder * Socrates *

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Teachers' Retirement System of the State of Illinois

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2003

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.

President

Executive Director

TRS 105 years and still working for you!

Teachers' Retirement System of the State of Illinois
Jon Bauman, *Executive Director*
2815 West Washington, P.O. Box 19253
Springfield, Illinois 62794-9253

Letter of Transmittal

December 15, 2004

I am pleased to present the *Comprehensive Annual Financial Report* for the Teachers' Retirement System of the State of Illinois (TRS) for the fiscal year ended June 30, 2004. TRS management and staff are responsible for the accuracy and completeness of this report and for ensuring that all material disclosures have been made. To the best of our knowledge, the information presented is a fair and accurate portrayal of the financial position and operations of TRS as of June 30, 2004.

TRS was established by the State of Illinois on July 1, 1939, to provide retirement, disability, and death benefits to teachers at Illinois public elementary and secondary schools outside the city of Chicago.

This report consists of five sections:

- The Introductory Section contains the Certificate of Achievement for Excellence in Financial Reporting, this Letter of Transmittal, a message from our executive director that outlines the major activities of the past year and plans for the future, identification of the TRS Board of Trustees and organizational structure, and consulting and professional service providers.
- The Financial Section contains the Independent Auditors' Report, Management's Discussion and Analysis, the financial statements and related notes, required supplementary schedules, and other supplementary information.
- The Investment Section contains information detailing TRS performance, investment managers, and the TRS investment portfolio.
- The Actuarial Section contains the actuary's letter of certification, actuarial assumptions and methods, the latest actuarial valuation, certain statistical information on active members and benefit recipients, and a plan summary including any changes in the plan.
- The Statistical Section contains information and additional statistical data pertaining to benefit recipients and historical data on revenue and expenses.

Financial Information

A system of internal controls helps TRS to monitor and safeguard assets and promote efficient operations. An annual external audit is conducted by the Illinois Auditor General in addition to regular reviews by our internal auditor. The annual budget for TRS administrative expenses is approved by the Board of Trustees, and financial statements are prepared in accordance with generally accepted accounting principles (GAAP) within the guidelines established by the Governmental Accounting Standards Board (GASB).

Please refer to the Management's Discussion and Analysis for an overview of the financial highlights and a financial analysis of TRS. Major TRS initiatives and accomplishments are contained in the executive director's message.

Revenues and Expenses

The three sources for TRS funding include member contributions, investment income, and employer contributions through state appropriations and payments by school districts. In FY04, TRS received $4.330 billion from the sale of general obligation bonds by the State of Illinois. Discussion regarding the receipt of the bond proceeds may be found in the Management's Discussion and Analysis and in the Notes to the Financial Statements. TRS expenses include payments of benefits, refunds, and administrative expenses. Negative amounts are enclosed in parentheses ( ) throughout this report.

Revenues ($ millions)

			Increase	
Source	**2004**	**2003**	**Amount**	**% Change**
Member contributions	$769	$732	$37	5.1%
State of Illinois	5,361	930	4,431	476.5
Employer contributions	128	91	37	40.7
Total investment income	4,486	1,061	3,425	322.8
Total	**$10,744**	**$2,814**	**$7,930**	**281.8%**

Expenses ($ millions)

			Increase	
Source	**2004**	**2003**	**Amount**	**% Change**
Benefits payments	$2,262	$1,999	$263	13.2%
Refunds	48	43	5	11.6
Administrative/Other	14	14	0	0
Total	**$2,324**	**$2,056**	**$268**	**13.0%**

Investments

TRS investments had a 16.5 percent return net of fees for the year. Total investment income for FY04 was $4,486 million. The TRS trust fund is invested by authority of the Illinois General Assembly under the prudent person rule that requires investments to be managed solely in the interest of TRS members and beneficiaries. The portfolio is fully diversified across different asset classes. Within each asset class there are a number of investment managers to ensure the appropriate diversity across the various investment styles, allowing the portfolio to achieve broad exposure to the market, while minimizing risk. This broad diversification serves as the best defense against the uncertainty of volatile world markets.

The Investment Section of this report contains a summary of the portfolio and investment activities.

Funding

The actuarial value of assets (net assets at market value) was $31.545 billion at June 30, 2004. Net assets increased $8.420 billion. TRS's actuarial accrued liability was $50.947 billion at June 30, 2004, resulting in a funded ratio of 61.9 percent. This funded ratio is an increase from the funding ratio of 49.3 percent for FY03. TRS's actuarial unfunded liability decreased $4.406 billion during FY04 to $19.403 billion at June 30, 2004. The receipt of the general

obligation bond proceeds contributed to the decrease in the unfunded liability, which was the purpose of the sale.

The Actuarial Section of this report contains the actuary's letter and further information on TRS funding.

Independent Audit

Each year TRS's financial statements, records, and internal controls are examined by special assistant auditors employed by the Illinois Auditor General. In addition, an annual compliance attestation examination for the previous year is performed to review compliance with applicable statutes and codes. The Independent Auditors' Report on TRS's financial statements is included in the Financial Section of this report.

GFOA Award

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to TRS for its *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2003. The Certificate of Achievement is a prestigious national award recognizing excellence in the preparation of state and local government financial reports.

To be awarded the certificate, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report whose contents meet or exceed program standards. This report must satisfy both generally accepted accounting principles and applicable legal requirements. TRS has received a certificate for the last 15 years. We believe our current report continues to meet the program requirements and are submitting it to the GFOA for consideration again this year.

Acknowledgments

Information for this report was gathered by and reflects the combined efforts of TRS staff under the leadership of the Board of Trustees and the executive director. It is intended to provide complete and reliable information as a basis for making management decisions, to determine our compliance with legal provisions, and as a means for determining responsible stewardship of the assets contributed by members and their employers.

This report is provided to members of the General Assembly, all participating employers, and to others by request. The participating employers of TRS form a link between TRS and its members. Their cooperation, for which we are grateful, contributes significantly to our success. We hope this report is both informative and helpful.

Todd Kennedy

Todd Kennedy
Director of Finance

A Message from the Executive Director

Executive Director
Jon Bauman

December 15, 2004

Be it at home, school, or the office, birthdays are a time for celebration.

Established in 1939 as the successor to the Illinois State Teachers' Pension and Retirement Fund, TRS attained its 65th birthday in July. In keeping with our anniversary theme, "65 and still working for you," we celebrated by processing the applications of new retirees at a record-breaking pace. Staff bettered the 60-day processing standard by a wide margin.

"Celebrating service," our annual report theme, captures the essence of our commitment to you, our valued members. We celebrate not merely as an organization, but as individuals who welcome the opportunity to associate with and serve the active and retired educators of Illinois. Together, let's celebrate the past, examine the present, and anticipate the future.

Celebrate the Past

Beginning with the heart-warming photo on the cover, our report recalls with appreciation the service of teachers from across Illinois. As we reflect on major milestones in the organizational life of TRS, we also recognize dedicated service of the TRS staff that has made these accomplishments possible.

1939 TRS is established to provide better benefits and more secure pensions.

1947 Benefits are improved to attract much-needed teachers to the classroom. An uncertain defined contribution approach was replaced with the security of a defined benefit plan. The new plan protects teachers from market uncertainties and ties benefits to their final average salaries. In addition, the State Retirement Systems Reciprocal Act became law.

1953 Disability benefits improved; member contribution increases to 6 percent.

1959 Members begin contributing 1 percent of their salaries to finance survivor benefits to protect spouses and other loved ones.

1967 First computer system purchased. TRS staff number 32.

1969 Field service program established to take TRS to the membership.

1974 Office established in Northern Illinois.

1975 First online computer system allows counselors immediate access to member information.

1979 TRS occupies its current facilities. Four of the 53 employees on staff at that time are still working at TRS.

1981 Retired teacher health insurance begins with an annual subsidy contribution cap of $3.6 million.

1983 TRS adopts a modern, well-diversified investment strategy. Since making the change, assets have grown from $3.5 billion in 1984 to over $31.5 billion at June 30, 2004. TRS investments have returned an average of 10.94 percent annually over the past 20 years.

1986 New hires begin contributing to Medicare.

1990 Compounding of cost of living increases begins.

1994 State enacts 50-year funding plan, which it has followed faithfully.

1995 Legislation establishes the Teachers' Retirement Insurance Program, rescuing an earlier bankrupt plan.

1998 2.2 formula becomes law, bringing TRS benefits up to the national average for funds not covered by Social Security.

2003 TRS STAR (Serving Teachers And Retirees), an advanced computer system that improved member service capabilities, goes online.

2004 TRIP program made permanent. Members not covered by Medicare have one-time option to begin contributing. A staff of 170 serves nearly 325,000 members.

Examine the Present

Achievements in fiscal year 2004 demonstrate our commitment to planning, personal interaction, and competency.

Serving the membership. We successfully conducted the largest Medicare referendum in U.S. history, offering over 28,000 eligible members the opportunity to opt into Medicare. Our summer retirement season, while one of the largest in history, was among the smoothest, with over half the new annuitants receiving their first checks in July. We credit hard work by the staff and outstanding planning and preparation.

Funding protection. Following a protracted legislative session, TRS received full, certified funding for a tenth successive year. An accord negotiated by the organizations representing active and retired teachers made the Teachers' Retirement Insurance Program (TRIP) permanent. A plan to consolidate the investment functions of the state-funded retirement systems was stopped.

Investing successfully. Assets grew to over $31.5 billion, in part due to the issuance by the state of pension obligation bonds (POB). Careful planning enabled immediate investment of the proceeds, which earned in excess of $600 million in the first year. Overall, the investment program earned a record $4.5 billion, exceeding the POB principal received from the state. Our overall return was 16.5 percent, helping to boost our funded ratio to 61.9 percent, compared to 49.3 percent at June 30 the year before, and 58.5 percent following receipt of the POB proceeds on July 2, 2003.

Working well. The TRS STAR computer system completed its first full year of deployment with only seven hours of downtime, an outstanding reliability record. Over 90 percent of our incoming toll-free member calls were answered and directed to available staff. An Internet-based member remittance system was implemented, saving member and staff time. Publications were improved without increasing costs.

Anticipate the Future

We frequently ask, "How can we do better?" Our planning centers on retaining recognized leadership in caring, professional service in an era that demands ever-increasing use of technology. TRS managers and supervisors gathered recently to creatively develop an approach to meet this goal. Under a theme of "Change is the Opportunity," our employees are developing programs and strategies to better serve the membership in the coming decades.

Technology can be useful, cost-effective and often, coldly impersonal. We intend in the coming years to use substantially more technology to better serve you, but with a strong appreciation of the critical human role in this process. Our personal touch can become warmer, our service more engaged, and our capabilities expanded if we use technology well.

The receipt of over $8 billion in investment income and pension obligation bond proceeds this year enhanced your retirement security. Our funded ratio rose from less than 50 percent to 61.9 percent, but, frankly, this is not good enough. While recent developments suggest a resolve to continue addressing this problem, the pressure to evade the full state funding of TRS and other state pension systems remains high. The 50-year funding plan is more than a statutory mandate; it is a reminder of past mistakes. TRS will pursue strategies that will help members and policy makers understand this complex issue.

TRS will explore initiatives that will contribute to the financial security of career teachers in Illinois. In order for Illinois to provide the best education for our children it is essential that school districts have the tools to recruit and retain teachers that help achieve this goal. Illinois will not be able to compete for the best and the brightest teachers if the benefits that we offer are not competitive in this challenging environment. Retirement security for Illinois educators is more than our purpose statement; it is a part of the complete picture of public education in Illinois.

Special Recognition

John Glennon completed service as a trustee following recent legislation that made him ineligible to remain a member. We appreciate his expertise in the investment and business sides of the system and his strong advocacy of pension obligation bonds.

Stuart Levine resigned from the Board in July. A thoughtful gentleman, he is a noted philanthropist who enjoyed public service. His intellect and kindness will be missed.

Dr. Robert Schiller completed service as State Superintendent of Education and ex-officio President of the Board of Trustees. We value his significant service and contributions to Illinois public education, and we extend our best wishes for much joy and success in his family and personal life.

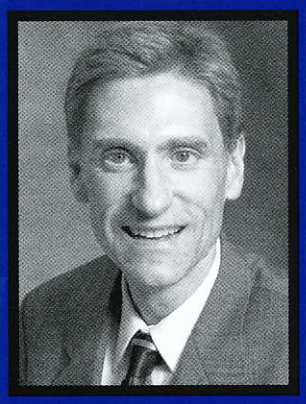
In Closing

TRS and its members share a common purpose – service. As we reflect on our 65 years of service, we do so with the full knowledge that your support of the system is a true blessing. Thank you for your good work and your support.

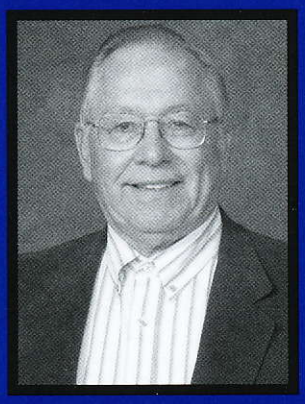
Jon Bauman
Executive Director

Board of Trustees

as of October 1, 2004

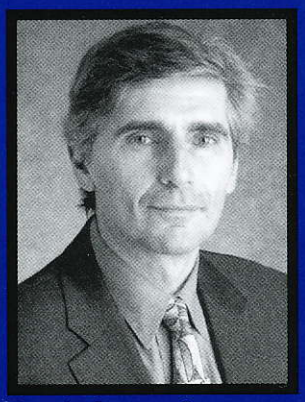


Randy Dunn
President
Springfield



Phillip Schmidt
Vice President
Springfield

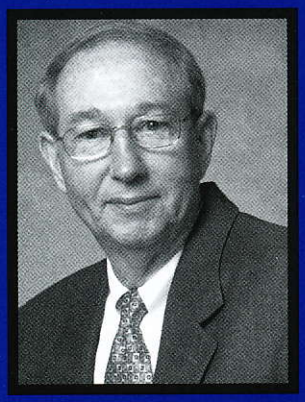
Tony Abboud
Northbrook



Jack Carriglio
Glenview

Cinda Klickna
Rochester

Cynthia O'Neill
Carlyle



James Bruner
Jacksonville

Jan Cleveland
Carmi

Sharon Leggett
Evanston

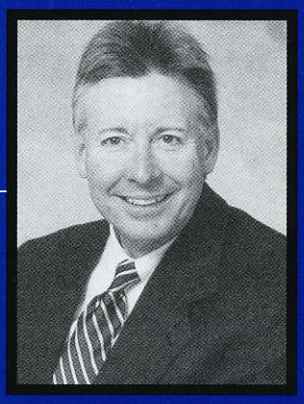
Molly Phalen
Rockford

Organizational Structure

As of November 3, 2004

Board of Trustees

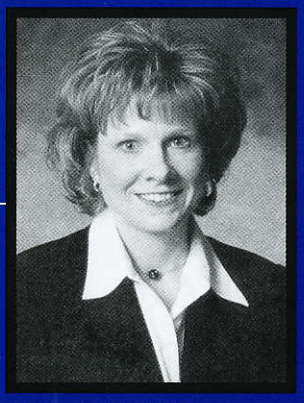
Kathleen Farney
Director of Research



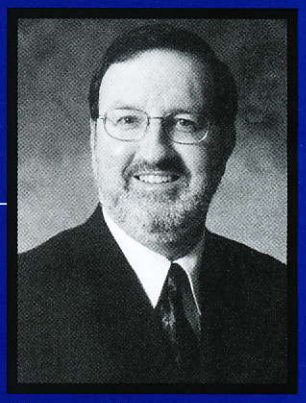
Tom Gray
General Counsel

Todd Kennedy
Director of Finance

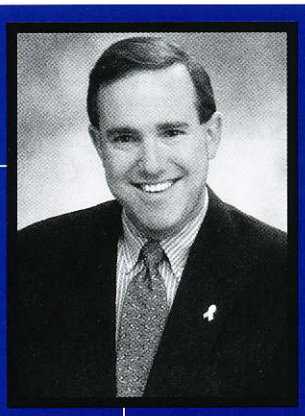
Kathy Pearce
Communications Supervisor



Stacy Smith
Internal Audits Manager

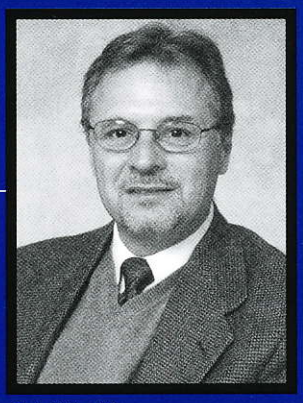


Jerry Viar
Director of Member Services



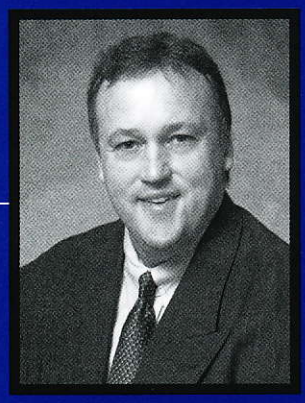
Jon Bauman
Executive Director

Gina Larkin
Director of Human Resources

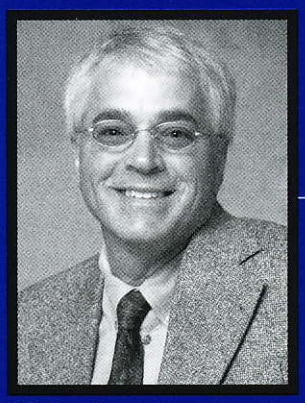


Ed Mabie
Information Systems Officer

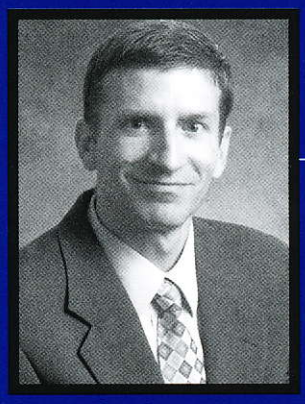
Stan Rupnik
Chief Investment Officer



Nick Yelverton
Director of Government Affairs



Mike Bartletti
Director of Real Estate



Greg Turk
Director of Investments

Consulting and Professional Services

Actuary

Mellon Human Resources & Investor Solutions
Chicago, Illinois

External Auditors

(As special assistants to the Office of the Auditor General)

McGladrey & Pullen, LLP
Schaumburg, Illinois

Information Systems

Ashbaugh and Associates, Inc.
Springfield, Illinois

Compu-Tech, LLC
Springfield, Illinois

IBM Corp.
Chicago, Illinois/Boulder, Colorado

King Technology, Inc.
Chicago, Illinois

Sentinel Technologies
Springfield, Illinois

Ciber, Inc.
Springfield, Illinois

Hupp Information Technologies
Springfield, Illinois

Interactive Intelligence, Inc.
Cincinnati, Ohio

Levi, Ray and Shoup, Inc.
Springfield, Illinois

STL Technology Partners
Bloomington, Illinois

Investment Consultants

(Investment management firms are listed throughout the Investment Section.)

Callan Associates Inc.
(general consultant)
San Francisco, California

Risk Resources
(real estate insurance)
Elmhurst, Illinois

Joseph J. Blake and Associates, Inc.
(real estate appraisals)
Chicago, Illinois

External Legal Counsel

Calhoun Law Group, P.C.
Washington, D.C.

Morris B. Chapman & Associates, Ltd.
Granite City, Illinois

Heyl, Royster, Voelker & Allen
Springfield, Illinois

Lerach Coughlin Stoia & Robbins LLP
San Diego, California (beginning May 2004)

Sorling, Northrup, Hanna, Cullen & Cochran, Ltd.
Springfield, Illinois

Cavanagh & O'Hara
Springfield, Illinois

Gardner Carton & Douglas
Chicago, Illinois

Milberg Weiss Bershad Hynes & Lerach LLP
San Diego, California (until May 2004)

Loewenstein, Hagen & Smith, P.C.
Springfield, Illinois

Master Trustee

The Northern Trust Company
Chicago, Illinois