

# INTRODUCTION



**THREE FIRST NATIONAL**  
**CHICAGO, ILLINOIS**

# 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, 2005

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



Retirement Security for Illinois Educators

## 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, 2006

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, 2006. 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, 2006.

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 Introduction Section contains the Certificate of Achievement for Excellence in Financial Reporting, this Letter of Transmittal, a message from our executive director, 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 basic 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 results, 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 plan participants 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. TRS expenses include payments of benefits, refunds, and administrative expenses. Negative amounts are enclosed in parentheses ( ) throughout this report.

### Revenues (\$ millions)

Source	2006	2005	Increase/(Decrease)	
			Amount	% Change
Member contributions	\$799	\$762	\$37	4.9%
State of Illinois	534	907	(373)	(41.1)
Employer contributions	124	148	(24)	(16.2)
Total investment income	<u>3,993</u>	<u>3,330</u>	<u>663</u>	19.9
<b>Total</b>	<b><u>\$5,450</u></b>	<b><u>\$5,147</u></b>	<b><u>\$303</u></b>	<b>5.9%</b>

### Expenses (\$ millions)

Source	2006	2005	Increase/(Decrease)	
			Amount	% Change
Benefits payments	\$2,877	\$2,533	\$344	13.6%
Refunds	58	60	(2)	(3.3)
Administrative/Other	<u>15</u>	<u>14</u>	<u>1</u>	7.1
<b>Total</b>	<b><u>\$2,950</u></b>	<b><u>\$2,607</u></b>	<b><u>\$343</u></b>	<b>13.2%</b>

## Investments

TRS investments had an 11.8 percent return net of fees for the year. Total investment income for FY06 was \$3,993 million. The TRS trust fund is invested by authority of the Illinois Pension Code 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 mixture 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 \$36.585 billion at June 30, 2006. Net assets increased \$2.500 billion. TRS's actuarial accrued liability was \$58.997 billion at June 30, 2006, resulting in a funded ratio of 62.0 percent. This funded ratio is an increase from the funding ratio of 60.8 percent for FY05. Despite significant actuarial gains due to FY06 investment returns, TRS's actuarial unfunded liability increased \$0.422 billion during FY06 to \$22.412 billion at June 30, 2006. The increase in the unfunded liability is mainly due to two factors: state contributions were too low to cover the cost of benefits earned by active members during the year, and no state contributions were made toward reducing or stabilizing TRS's longstanding unfunded liability.

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 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, 2005. 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. A Certificate of Achievement is valid for a period of one year only. TRS has received a certificate for the last 17 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.



Jana Bergschneider  
Director of Administration

# A Message from the Executive Director

*Prefer diligence before idleness  
unless you esteem rust over brilliance  
~ Plato  
427-247 BC*

December 15, 2006

Dear Friends:

As stewards of your retirement trust fund, TRS follows a consistent “due diligence” investment approach to assure that all contingencies are considered and all decisions are made with prudence and wisdom. Diligence is a part of our culture. Diligence leads to superior results in our investments, but equally important, in our service to members.

I am privileged to share an optimistic message with you. TRS members reported high satisfaction with our service, investment returns continued to rank in the top 25 percent of large public plans, and we continued to hold administrative costs below other Illinois state-funded systems. Outstanding investment returns enabled in an increase in our funded ratio, even though the State of Illinois reduced its contributions by \$524 million in an effort to balance the state budget. We work hard and we strive for the best, making apt our annual report theme, “Diligently Pursuing Excellence.” The impressive buildings that illustrate this report are part of TRS’s real estate portfolio. I hope you enjoy seeing tangible examples of our stewardship of your retirement funds.

## Pursuing the Best Each Time We Meet

Whether meeting members in the office, by telephone, or at one of our many field meetings, our member services personnel seek to provide the best service possible. Over 96 percent of members returning response cards rated our service “highly satisfactory.” A new telephone system has helped reduce the average wait time for a member service representative to less than one minute. TRS uses the very best technology that allows us to retain our commitment to personal service. Although implementation challenged our staff, improved service and options for future improvements made the effort worthwhile. Our commitment to service extends to the employer community, who were served by 14 regional seminars and 38 individual meetings.

## Achieving Investment Excellence

As in seven of the past 10 years, TRS investments recorded double digit returns. The total return after all expenses was 11.8 percent in FY06, compared to 10.8 percent in FY05. This consistent performance once again placed TRS in the top quartile of large public funds in the Wilshire Trust Universe Comparison Service (TUUCS). This impressive record underscores the wisdom of our diversified investment approach. Noteworthy accomplishments include:

- Fund assets were \$36.6 billion, a 7.3 percent increase and an all-time high.
- As in five of the last six years, TRS was the best performing Illinois state pension fund.
- International equity produced an impressive 27.3 percent one-year return.
- Private equity provided a one-year return in excess of 20 percent for the second consecutive year. The 10-year return is 19.5 percent.
- TRS secured a \$13 million settlement for losses arising from the WorldCom bankruptcy.

## Securing Legislative Accomplishments

Two legislative measures illustrate our diligence in securing needed legislation and assisting the General Assembly in its work. TRS worked productively to extend the 120-day post-retirement employment limitation. Our assistance role culminated in the enactment of Public Act 94-1057, which exempts certain types of salary adjustments from the requirement that employers pay the additional pension cost of salary increases in excess of 6 percent.

Last year's passage of Public Act 94-0004, which extended and modified the Early Retirement Option (ERO) and established new limitations on and contributions for certain sick leave and end-of-career salary adjustments, presented numerous challenges. TRS sought and achieved near-perfect consensus with all affected parties on rules to implement the legislation. Other challenges included adapting our information systems and providing up-to-the minute information to our members and their employers.

The TRS legal staff took a key role in negotiating a rulemaking to implement recently enacted changes in the QILDRO law. The law governs the division of public pension benefits in cases of marital dissolution.

## Facing Challenges

As in life, TRS faced challenges and disappointments. Recent events involving a former trustee and a former outside counsel who breached the high standard we expect of those who serve TRS left us angered and disheartened. A sacred trust was betrayed. While the extensive media coverage makes an extended discussion unnecessary, I want to reassure you of three important points. First, at no time were any TRS assets used to fund illegal payments allegedly sought from current and potential TRS investment managers. Not one penny of TRS money was ever lost or put at risk by this scheme. Second, TRS has actively cooperated in the investigation, providing information, documents, and testimony. Finally, our investment process and the fundamental honesty of our staff, our current Board of Trustees, and the professional investment community proactively discourages and discovers such unethical behavior.

At TRS, we never consider our mission accomplished or our task completed. Rather, we work with diligence to better our record and improve our service.

Sincerely,



Jon Bauman  
Executive Director

# Board of Trustees

As of December 1, 2006



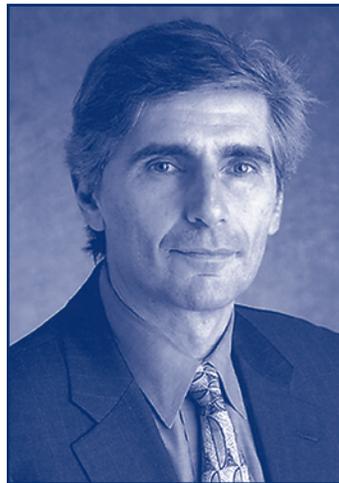
**Christopher A. Koch, Ed.D.**  
Interim President  
Bloomington



**Molly Phalen,**  
Vice President  
Rockford



**James Bruner**  
Jacksonville



**Jack Carriglio**  
Glenview



**Jan Cleveland**  
Carmi



**Cinda Klickna**  
Rochester



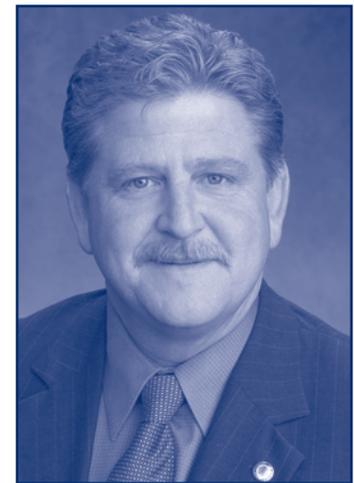
**Sharon Leggett**  
Evanston



**Bob Lyons**  
Hoffman Estates



**Cynthia O'Neill**  
Carlyle



**William Orrill**  
Carbondale

# Organizational Structure

Executive Staff Members as of December 1, 2006

## Board of Trustees



**Jon Bauman**  
Executive Director



**Jana Bergschneider, CPA**  
Director of  
Administration



**Andrew Bodewes**  
Director of  
Government Affairs



**Kathleen Farney**  
Director of  
Research



**Eva Goltermann**  
Public Information  
Officer



**Tom Gray**  
General Counsel



**Gina Larkin**  
Director of  
Human Resources



**Kathy Pearce**  
Communications  
Supervisor



**Stan Rupnik, CFA**  
Chief Investment  
Officer



**Stacy Smith, CPA**  
Internal Audits  
Manager



**Terry Viar**  
Director of  
Member Services

# Consulting and Professional Services

## Actuary

Buck Consultants, an ACS Company  
*Chicago, Illinois*

## External Auditors

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

BKD, LLP  
*Decatur, Illinois*

## Information Systems

Canaudit, Inc.  
*Simi Valley, California*

IBM Corp.  
*Chicago, Illinois/Boulder, Colorado*

SBC Datacomm  
*Saginaw, Michigan*

VeriSign, Inc.  
*Toronto, Ontario*

Hupp Information Technologies  
*Springfield, Illinois*

Pro-Tech Search, Inc.  
*Petersburg, Illinois*

Sentinel Technologies  
*Chicago, Illinois*

## Investment Consultants

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

Callan Associates Inc.  
(real estate consultant)  
*San Francisco, California*

R.V. Kuhns & Associates, Inc.  
(general consultant)  
*Portland, Oregon*

Risk Resources  
(real estate insurance)  
*Elmhurst, Illinois*

## External Legal Counsel

Barnes & Thornburg LLP  
*Chicago, Illinois*

Cavanagh & O'Hara  
*Springfield, Illinois*

Heyl, Royster, Voelker & Allen  
*Springfield, Illinois*

Howard & Howard Attorneys PC  
*Peoria, Illinois*

Lerach Coughlin Stoia  
Geller Rudman & Robbins LLP  
*San Diego, California*

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

Foley & Lardner LLP  
*Chicago, Illinois*

Holland & Knight LLP  
*Chicago, Illinois*

Jenner & Block LLP  
*Chicago, Illinois*

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

## Master Trustee

The Northern Trust Company  
*Chicago, Illinois*