

Public School Employees' Retirement System

# Investment Section



**COMMONWEALTH OF PENNSYLVANIA  
PUBLIC SCHOOL EMPLOYEES RETIREMENT SYSTEM**

ALAN H. VAN NOORD, CFA  
Chief Investment Officer

## Investment Overview

### Authority and Fiduciary Standard

The Board has the responsibility to invest funds of the System in accordance with guidelines and limitations set forth in the Code and other applicable state law. As fiduciaries, the members of the Board and Staff must act solely in the interests of the members of the System and for the exclusive benefit of the System's members. In performance of their duties, the members of the Board and Staff delegated with investment authority shall be held to the Prudent Investor Standard.

The Prudent Investor Standard, as articulated in the Code, means "the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital."

The Prudent Investor Standard requires a trustee to act prudently and with caution, discretion, loyalty, and care but does not restrict the assets in which the Board can invest. Under the Prudent Investor Standard, which recognizes modern portfolio theory, the Board's investment and management decisions with respect to individual assets shall be considered in the context of the portfolio as a whole and as part of an overall investment strategy, and not in isolation. No specific investment or course of action, taken alone, shall be considered inherently prudent or imprudent. This Standard recognizes the trade-off between risk and return.

### Policies and Objectives

The Board is responsible for the formulation of investment policies for the System. The overall investment objectives of the System are as follows:

- **Return Objectives** – the overall return objective is to realize a return sufficient to achieve funding adequacy on an inflation-adjusted basis. Funding adequacy is achieved when the actuarial market value of assets is at least equal to the System's projected benefit obligations. The System has a return objective of meeting or exceeding the targeted actuarial rate of return (currently 8.5%) over the long-term. In addition, the Board has the following broad objectives:
  1. The assets of the System shall be invested to maximize the returns for the level of risk taken; and,
  2. The System shall strive to achieve a return that exceeds the Policy Index (the Policy Index is a custom benchmark created based on the Board-established asset allocation structure to generate a return that meets the actuarial rate of return assumption).

- **Risk Objectives**

1. The assets of the System shall be diversified to minimize the risk of losses within any one asset class, investment type, industry or sector distribution, maturity date, or geographic location. Failure to do so could impair the System's ability to achieve its funding and long-term investment goals and objectives; and,
2. The System's assets shall be invested so that the probability of investment losses (as measured by the Policy Index) in excess of 12% in any one year is no greater than 2.5% (or two standard deviations below the expected return).

To achieve these objectives, the Board meets at least once per year to review the overall asset allocation plan and investment policies for the System. Implementation of investment policies is accomplished through the use of external investment management firms who act as agents for the System and through internal investment managers. The Board also retains various investment consultants to assist with the formulation and implementation of investment policies.

## **Operations**

The Board provides oversight of investment activities through the Finance Committee that makes recommendations to the Board. The Finance Committee generally conducts eight meetings per year and may meet more frequently as needed. Investment Office staff, as well as external investment advisors, internal investment managers, and Investment Accounting staff, assist the Board in achieving investment objectives and monitoring compliance with investment policies. For the fiscal year ended June 30, 2006, Wilshire Associates Incorporated (Wilshire) served as the general investment consultant to assist the Board in formalizing investment objectives, establishing an asset allocation plan, conducting investment advisor searches, reviewing performance, and commenting on compliance with investment policies. In addition, the Board utilized Courtland Partners, Ltd. as a real estate consultant and Portfolio Advisors, LLC as an alternative investment consultant. Alternative investments generally consist of investments in private debt, private equity, and venture capital limited partnerships. Investment Office staff implement the investment decisions within the Investment Policy Statement, Objectives and Guidelines regarding asset allocation, security selection, and other objectives directed by the Board.

The Board employs both external investment management firms and internal investment managers to manage the investment portfolio of the System. At year end, 40 external investment management firms were managing \$30.9 billion in assets of the System, \$19.3 billion in assets were managed by the System's internal investment managers, and the remaining \$8.5 billion in assets were managed by numerous developmental, alternative investment, and real estate managers. The performance of each external investment management firm and each internal manager is monitored quarterly against a pre-established benchmark as well as the performance of its peer group.

## **Asset Allocation**

The Board reviews the long-term asset allocation targets of the System at least annually, usually in the first quarter of the calendar year. The Board will consult with its actuary, consultants, Investment Office staff, and other sources of information it deems appropriate in formulating the asset allocation plan. The Board believes that the level of risk assumed by the System is largely determined by the Board's strategic asset allocation plan. The Board, in determining its long-term asset allocation, shall take the following factors into consideration:

- The System's investment time horizon;
- The demographics of the plan participants and beneficiaries;
- The cash flow requirements of the System;
- The actuarial assumptions approved by the Board;
- The funded status of the System;
- The Board's willingness and ability to take risk; and,
- The employers' (Commonwealth and school districts) financial strength.

In establishing the asset allocation for the System, the Board considers capital market expectations for expected return, volatility, and asset class correlations as prepared by its general investment consultant. The current long-term, top-down asset allocation targets of the Board are discussed in the following paragraphs.

The long-term target allocation as of June 30, 2006 included an equity target allocation of **60.0%** consisting of publicly traded stocks. Specific targets have been established for U.S. equity exposure (30.0%) and international equity exposure (30.0%). During the latter half of the fiscal year ending June 30, 2006, the Board approved a change to the U.S. and international equity target allocations eliminating the home country bias. Eliminating the home country bias had the effect of decreasing the target U.S. equity exposure from 40% to 30% and increasing the target international equity exposure from 20% to 30%. Within the U.S. equity target, the portfolios are diversified between large, small and micro capitalization investment managers, and growth and value investment managers. The international equity exposure includes both developed and emerging markets portfolios.

The fixed income target allocation of **22.0%** consisted of U.S. core fixed income exposure (12.6%), Treasury Inflation-Protected Securities exposure (5.0%), specialty fixed income exposure (1.1%), and global fixed income exposure (3.3%). Within these categories, all sectors of the bond market are represented. Specialty fixed income is comprised of a high yield portfolio.

The real estate target allocation of **7.0%** consisted primarily of opportunistic limited partnerships and publicly traded real estate securities.

Alternative investments had a target of **11.0%**. The primary vehicle used to invest funds in this asset class is the limited partnership. The partnerships are established by individual management groups that have been selected by the System for the purpose of investing in and managing private equity and unlisted subordinated debt positions on behalf of PSERS and other limited partners.

Finally, unallocated cash of the System has an asset allocation target of **0.0%** since cash historically represents the lowest returning asset class over time.

## Investment Results

As of June 30, 2006, the fair value of the investment portfolio was \$58.7 billion, an increase of \$5.8 billion over last year's value. This increase came primarily from net investment income (\$7.9 billion) and net changes in other investment assets and liabilities (\$0.5 billion), which were partially offset by benefit payments in excess of member and employer contributions (\$2.6 billion). The investment portfolio, as invested, was composed of 62.4% common and preferred stocks (equity), 21.7% fixed income investments, 6.8% real estate, and 9.1% alternative investments at June 30, 2006. The table on page 74 illustrates a more detailed description of the investment portfolio's asset classes in dollars and as a percentage of the total investment portfolio.

The past fiscal year saw positive market returns across all major asset classes except domestic fixed income securities. Markets that enjoyed particularly strong returns included international equities (developed, small cap, and emerging markets) and real estate. International equities were up 28.40% during the fiscal year according to the Morgan Stanley Capital International (MSCI) All-Country World Index (ACWI) ex. U.S., an international equity index. International small capitalization equities, which are included in PSERS International Stock Portfolios, were up 31.23% according to the S&P/Citigroup Global ex. U.S. Extended Market Index. Emerging market equities, a sub-sector of the MSCI ACWI ex. U.S., were up 35.90% during the fiscal year according to the MSCI Emerging Markets Index. The strength in these markets can be partially attributed to the strength in commodity prices during the past fiscal year, especially oil. In addition, strong economic growth and corporate profits have also driven these markets to higher levels. Publicly traded real estate securities were up 21.87% during the fiscal year according to the Dow Jones (DJ) Wilshire Real Estate Securities Index. Strengthening fundamentals and attractive yields have helped to drive returns in this segment of the market. The DJ Wilshire 5000 Index, a domestic equity index, returned 9.92% for the fiscal year. All of these gains came in the first three quarters of the fiscal year as strong corporate profits flowed through to share prices. However, the markets were down almost 2.00% in the fiscal fourth quarter as rising interest rates and commodity prices outweighed continued strong economic growth, stable consumer confidence, and a falling unemployment rate.

The Lehman Aggregate Bond Index, a domestic bond index, was down 0.81% while the Lehman Global Aggregate Bond Index, a global bond index, was up 0.27%. Returns in these indexes were weak as the Federal Reserve increased rates eight times during the fiscal year increasing the Federal Funds rate from 3.25% to 5.25%.

As a result of the strong positive returns from equities, real estate, and alternative investments, the System was able to generate a total return of 15.26% for the one-year period ended June 30, 2006. This return exceeded the total fund Policy Index return of 11.96% by 330 basis points. Annualized total returns for the three- and five-year periods ended June 30, 2006 were 15.90% and 8.67%, respectively. These returns exceeded the total fund Policy Index returns for the three- and five-year periods ended June 30, 2006 by 299 and 174 basis points, respectively. As of June 30, 2006, the System had posted positive returns in 12 of the past 13 quarters.

Wilshire calculates the total investment return of the System as well as the performance of each external investment management firm and each internal investment manager employed by the Board to invest the System's assets. Performance is calculated using a time-weighted return methodology.

The following table provides the System's total investment return for each major asset class and the total portfolio, including, where applicable and available, respective benchmark indexes used by asset class and median performance by asset class:

|  | Annualized Total Returns (%)<br>Net of Fees<br>Ended June 30, 2006 |              |              |
|--|--|--------------|--------------|
|  | 1 Year   | 3 Years      | 5 Years      |
|  | <b>PSERS Total Portfolio</b>                                       | <b>15.26</b> | <b>15.90</b> |
| Total Fund Policy Index  | 11.96  | 12.91        | 6.93         |
| Median Public Defined Benefit Plan (DBP) Fund Universe (Wilshire Database)   | 10.66  | 12.35        | 6.85         |
| <b>PSERS Domestic Stock Portfolios</b>                                       | <b>9.66</b>  | <b>13.19</b> | <b>4.74</b>  |
| Dow Jones Wilshire 5000 Index  | 9.92   | 12.98        | 4.02         |
| Median Public DBP Fund Universe - Domestic Equities (Wilshire Database)      | 9.66   | 13.16        | 4.02         |
| <b>PSERS International Stock Portfolios</b>                                  | <b>30.81</b>   | <b>26.44</b> | <b>12.41</b> |
| MSCI All-Country World Index Ex. U.S.  | 28.40  | 25.77        | 11.85        |
| Median Public DBP Fund Universe - International Equities (Wilshire Database) | 27.29  | 24.11        | 10.84        |
| <b>PSERS Domestic Fixed Income Portfolios</b>                                | <b>0.14</b>  | <b>4.00</b>  | <b>6.37</b>  |
| Lehman Brothers Aggregate Index  | (0.81)   | 2.05         | 4.97         |
| Median Public DBP Fund Universe - Domestic Bonds (Wilshire Database)         | 0.11   | 3.26         | 5.69         |
| <b>PSERS Global Fixed Income Portfolios</b>                                  | <b>1.11</b>  | <b>4.75</b>  | <b>8.90</b>  |
| Lehman Brothers Global Aggregate Index                                       | 0.27   | 4.09         | 8.27         |
| Median Public DBP Fund Universe - Global Bonds (Wilshire Database)           | 0.37   | 5.52         | 9.84         |
| <b>PSERS Real Estate*</b>  | <b>38.60</b>   | <b>29.15</b> | <b>18.86</b> |
| Blended Real Estate Index**  | 20.63  | 17.46        | 13.35        |
| Median Public DBP Fund Universe - Real Estate (Wilshire Database)            | 20.40  | 19.32        | 14.40        |
| <b>PSERS Alternative Investments*</b>  | <b>22.17</b>   | <b>22.56</b> | <b>10.66</b> |
| Venture Economics Median Return, Vintage Year Weighted***                    | 11.78  | 8.65         | 2.78         |
| Median Public DBP Fund Universe - Private Equity (Wilshire Database)         | 26.35  | 18.69        | 6.91         |

\* Returns reported on a one-quarter lag, except for publicly traded real estate security investments.

\*\* Returns presented are a blend of the DJ Wilshire Real Estate Securities Index (20%) and the NCREIF Index (80%). The NCREIF Index is reported on a one-quarter lag.

\*\*\* Returns presented are on a one-quarter lag.

The System also is involved in a securities lending program administered by Mellon Bank N.A. This program provides incremental income to the System by lending securities in the System's portfolio to securities dealers in exchange for either cash collateral, which can be reinvested to generate income, or non-cash collateral plus a cash fee. This program generated \$23.0 million in additional income during the year.

## Accomplishments

The System's returns during the fiscal year ended June 30, 2006 not only exceeded its total fund Policy Index, but also placed the System in the top 10% of all public defined benefit pension funds in the country as measured by Wilshire. Strong returns such as these can be attributed to the combined efforts of the Board, the System's Investment Office and Investment Accounting staff, and its external consultants and investment advisors. Without their efforts, accomplishments such as this would not be possible.

The System continued its multi-year project to implement an independent accounting book of record for the System's investment transactions and holdings. In FY 2006, the System completed its conversion of all public market portfolios to its internal accounting software provided by Financial Control Systems, Inc. and began work on converting its real estate and alternative investment portfolios from an Excel-based accounting system to the internal accounting software. The System expects to complete the conversion of all remaining portfolios and develop various management reports in 2007.

## Summary

The System had a tremendous fiscal year ended June 30, 2006, as the returns generated by the System were in the top 10% of all public defined benefit pension plan returns. Strong returns generated in domestic and international equity markets, real estate, and alternative investments helped produce outstanding results for the System. For the fiscal year ended June 30, 2006, the System exceeded its targeted actuarial rate of return of 8.5% on a one-, three-, and five-year basis. In addition, we continue to believe that the System's asset allocation is structured to generate a long-term return that meets or exceeds the targeted actuarial rate of return assumption of the System for years to come.



Alan H. Van Noord, CFA  
Chief Investment Officer

**Portfolio Summary Statistics**  
**Asset Allocation**  
**As of June 30, 2006**  
(Dollar Amounts in Thousands)

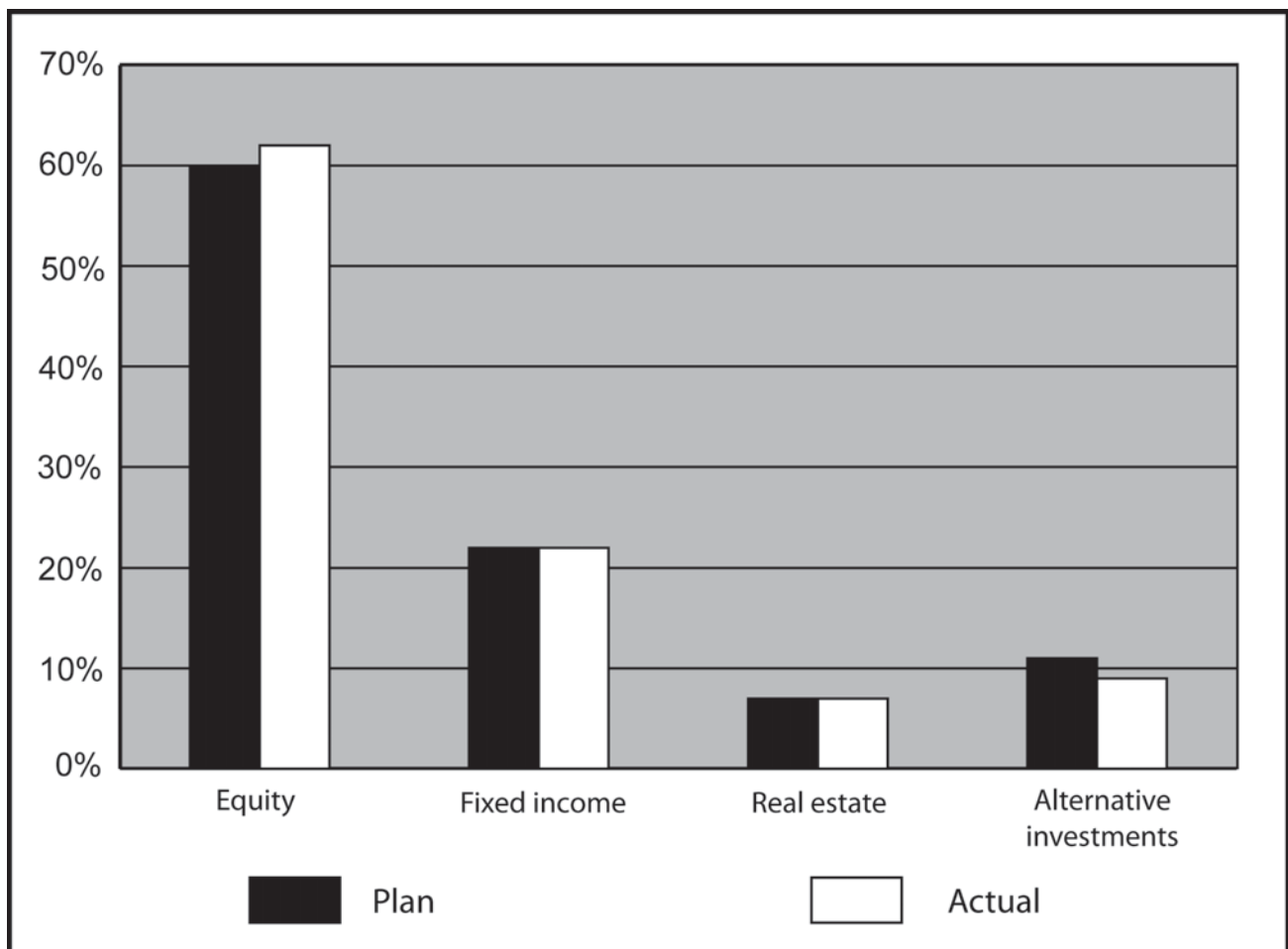
| <b>Pension investments</b>                                       | <b>Fair Value (\$)</b> | <b>% Fair Value</b> |
|--|------------------------|---------------------|
| <b>Common and preferred stock (Equity):</b>                      |                        |                     |
| Domestic common and preferred stock                              | \$ 13,647,660          | 24.0%               |
| Collective trust funds   | 6,272,121              | 11.0%               |
| International common stock                                       | 13,032,195             | 22.8%               |
| Subtotal per Statement of Plan Net Assets                        | 32,951,976             | 57.8%               |
| Net Asset Allocation Adjustment*                                 | 2,615,444              | 4.6%                |
| <b>Total Common and preferred stock - Asset Allocation Basis</b> | <b>35,567,420</b>      | <b>62.4%</b>        |
| <b>Fixed income:</b>   |                        |                     |
| Domestic mortgage-backed securities                              | 5,670,890              | 9.9%                |
| U.S. government and agency obligations                           | 3,152,963              | 5.5%                |
| Domestic corporate and taxable municipal bonds                   | 2,880,975              | 5.1%                |
| Miscellaneous domestic fixed income                              | 170,880                | 0.3%                |
| Collective trust funds   | 304,949                | 0.5%                |
| International fixed income                                       | 1,781,539              | 3.1%                |
| Subtotal per Statement of Plan Net Assets                        | 13,962,196             | 24.4%               |
| Net Asset Allocation Adjustment*                                 | (1,566,567)            | (2.7)%              |
| <b>Total Fixed income - Asset Allocation Basis</b>               | <b>12,395,629</b>      | <b>21.7%</b>        |
| <b>Real estate:</b>  |                        |                     |
| Equity real estate   | 2,255,291              | 4.0%                |
| Directly-owned real estate                                       | 287,108                | 0.5%                |
| Subtotal per Statement of Plan Net Assets                        | 2,542,399              | 4.5%                |
| Net Asset Allocation Adjustment*                                 | 1,327,514              | 2.3%                |
| <b>Total Real estate - Asset Allocation Basis</b>                | <b>3,869,913</b>       | <b>6.8%</b>         |
| <b>Alternative investments:</b>                                  |                        |                     |
| Private equity   | 3,634,938              | 6.4%                |
| Private debt   | 992,673                | 1.7%                |
| Venture capital  | 573,161                | 1.0%                |
| <b>Total Alternative investments - Asset Allocation Basis</b>    | <b>5,200,772</b>       | <b>9.1%</b>         |
| <b>Pension investments - Asset Allocation Basis</b>              | <b>\$ 57,033,734</b>   | <b>100.0%</b>       |
| Pension investment receivables\payables                          | 1,503,978              |                     |
| <b>Pension investments per Statement of Plan Net Assets</b>      | <b>\$ 58,537,712</b>   |                     |
| <b>Postemployment Healthcare investments</b>                     | <b>\$ 181,557</b>      | <b>100.0%</b>       |

\* - Includes Short-term investments which are allocated to the asset class of the investment manager which holds them, reclassifications of certain investments between asset classes and investment receivables\payables to adjust the Statement of Plan Net Assets' classification to the basis used to measure Asset Allocation. See the table and graph which follow.



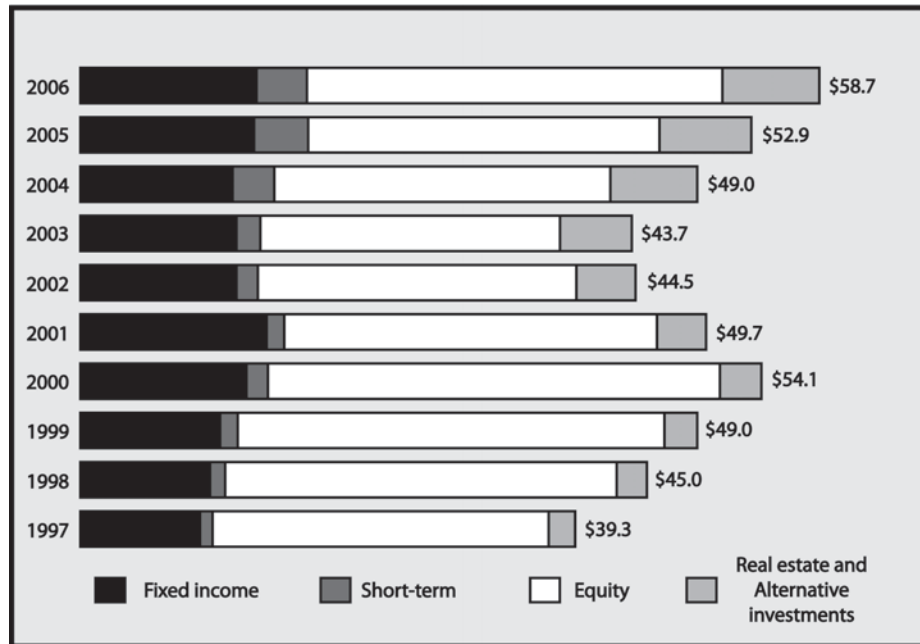
**Comparison of Actual Portfolio Distribution  
to Asset Allocation Plan  
As of June 30, 2006**

| <b>Asset Category</b>               | <b>Plan</b> | <b>Actual</b> |
|-------------------------------------|-------------|---------------|
| Common and preferred stock (Equity) | 60%         | 62%           |
| Fixed income                        | 22%         | 22%           |
| Real estate                         | 7%          | 7%            |
| Alternative investments             | 11%         | 9%            |
| Total                               | 100%        | 100%          |



## Portfolio Distribution 10 Year Trend

(Fair Value - Dollar Amounts in Billions)



The following lists of portfolio detail statistics present the ten largest holdings by descending order of fair value for the largest asset classes. Information on the complete holdings of the System is available by writing to the Public School Employees' Retirement System, Office of Financial Management, P. O. Box 125, Harrisburg, PA 17108.

### Domestic Common and Preferred Stock

#### 10 Largest Holdings in Descending Order by Fair Value

As of June 30, 2006

(Dollar Amounts and Shares in Thousands)

| Description  | No. of Shares | Fair Value (\$)   |
|--|---------------|-------------------|
| Security Capital Preferred Growth                                  | 9,674         | 385,298           |
| Exxon Mobil Corporation  | 4,334         | 265,878           |
| General Electric Company   | 7,499         | 247,176           |
| Citigroup Inc.   | 3,602         | 173,776           |
| Bank of America Corporation  | 3,285         | 158,032           |
| Microsoft Corporation  | 6,328         | 147,437           |
| Johnson & Johnson  | 2,195         | 131,539           |
| Procter & Gamble Company   | 2,335         | 129,831           |
| Pfizer Inc.  | 5,278         | 123,873           |
| ProLogis   | 2,249         | 117,237           |
| <b>Total of 10 Largest Holdings</b>                                |               | <b>1,880,077</b>  |
| <b>Total System Holdings - Domestic Common and Preferred Stock</b> |               | <b>13,647,660</b> |

## Collective Trust Funds - Common and Preferred Stock

### 10 Largest Holdings in Descending Order by Fair Value

As of June 30, 2006

(Dollar Amounts and Shares in Thousands)

| Description  | No. of Shares | Fair Value (\$)  |
|--|---------------|------------------|
| Barclays Global Investors EAFE Equity Index  | 18,227        | 3,030,398        |
| Bridgewater Pure Alpha Fund II Ltd.  | 511           | 570,723          |
| First Quadrant Global Macro Fund Ltd.  | 5,485         | 554,296          |
| AQR Offshore Multi-Strategy Fund Ltd.  | 6             | 526,775          |
| Barclays Global Ascent Ltd.  | 500           | 502,552          |
| Barclays Global Investors MSCI Emerging Markets Index Fund                         | 13,867        | 376,652          |
| Martin Currie Business Trust Global Emerging Markets Fund                          | 26,008        | 256,441          |
| Barclays Global Investors Structured Tier Emerging Market Index                    | 6,972         | 192,700          |
| Barclays Global Investors Canada Alpha Tilts Fund                                  | 3,377         | 95,122           |
| Martin Currie Business Trust Pan European Mid Cap Fund                             | 3,439         | 65,160           |
| <b>Total of 10 Largest Holdings</b>  |               | <b>6,170,819</b> |
| <b>Total System Holdings - Collective Trust Funds - Common and Preferred Stock</b> |               | <b>6,272,121</b> |

## International Common Stock

### 10 Largest Holdings in Descending Order by Fair Value

As of June 30, 2006

(Dollar Amounts and Shares in Thousands)

| Description   | No. of Shares | Fair Value (\$)   |
|---|---------------|-------------------|
| Royal Bank of Scotland                                    | 4,331         | 142,432           |
| Glaxosmithkline PLC                                       | 4,745         | 132,614           |
| UBS AG  | 1,072         | 117,261           |
| Unicredito Italiano SpA                                   | 14,675        | 114,835           |
| Mitsubishi UFJ Financial Group, Inc.                      | 8             | 114,701           |
| BP PLC  | 9,615         | 112,125           |
| Vodafone Group PLC  | 49,679        | 105,896           |
| Sumitomo Mitsui Financial Group, Inc.                     | 10            | 105,668           |
| ING Groep   | 2,439         | 95,838            |
| Takeda Pharmaceutical Company Ltd.                        | 1,532         | 95,425            |
| <b>Total of 10 Largest Holdings</b>                       |               | <b>1,136,795</b>  |
| <b>Total System Holdings - International Common Stock</b> |               | <b>13,032,195</b> |

**Domestic and International Fixed Income**  
**10 Largest Holdings in Descending Order by Fair Value**  
**As of June 30, 2006**  
**(Dollar Amounts and Shares in Thousands)**

| Description  | Maturity Date | Interest Rate (%) | Par Value(\$)<br>or No. of Shares | Fair Value (\$)   |
|--|---------------|-------------------|-----------------------------------|-------------------|
| U.S. Treasury - Inflation Index  | 07/15/13      | 1.875             | 287,033                           | 275,741           |
| U.S. Treasury - Inflation Index  | 07/15/12      | 3.000             | 218,405                           | 224,907           |
| U.S. Treasury - Inflation Index  | 01/15/25      | 2.375             | 178,703                           | 173,928           |
| U.S. Treasury - Inflation Index  | 04/15/28      | 3.625             | 133,142                           | 157,986           |
| U.S. Treasury - Inflation Index  | 04/15/10      | 0.875             | 153,561                           | 144,857           |
| U.S. Treasury - Inflation Index  | 04/15/29      | 3.875             | 106,387                           | 131,636           |
| U.S. Treasury - Inflation Index  | 01/15/15      | 1.625             | 140,422                           | 130,906           |
| U.S. Treasury - Inflation Index  | 01/15/11      | 3.500             | 124,423                           | 130,144           |
| U.S. Treasury - Notes  | 05/15/08      | 3.750             | 123,300                           | 120,184           |
| U.S. Treasury - Notes  | 09/30/06      | 2.500             | 117,000                           | 116,245           |
| <b>Total of 10 Largest Holdings</b>                                    |               |                   |                                   | <b>1,606,534</b>  |
| <b>Total System Holdings - Domestic and International Fixed Income</b> |               |                   |                                   | <b>13,962,196</b> |

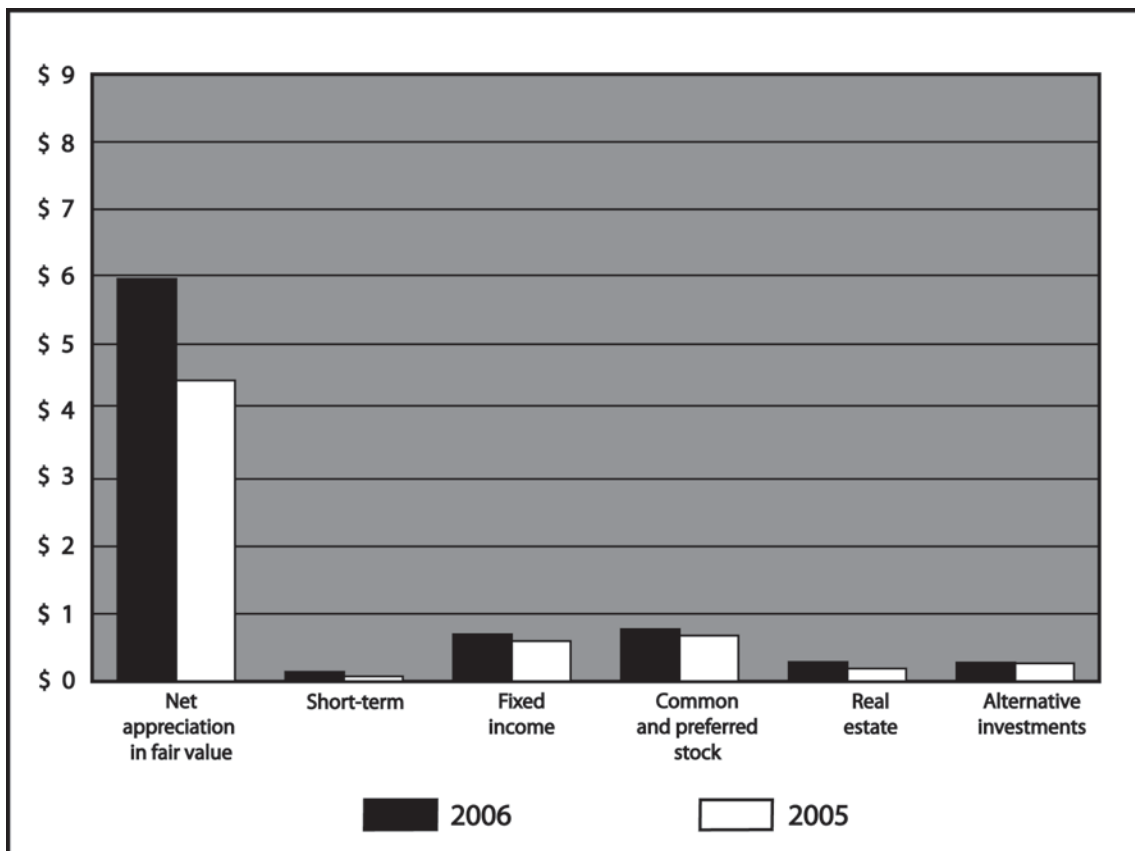
**Postemployment Healthcare Investments**  
**10 Largest Holdings in Descending Order by Fair Value**  
**As of June 30, 2006**  
**(Dollar Amounts in Thousands)**

| Description  | Maturity Date | Interest Rate (%) | Par Value (\$) | Fair Value (\$) |
|--|---------------|-------------------|----------------|-----------------|
| PA Treasury Short-Term Investment Fund                               | Various       | Various           | 87,116         | 87,116          |
| M & T Bank Repurchase Agreement                                      | 07/01/06      | 4.324             | 14,802         | 14,802          |
| M & T Bank Repurchase Agreement                                      | 07/01/06      | 4.508             | 10,922         | 10,922          |
| FNMA Discount Note   | 07/21/06      | 4.814             | 6,959          | 6,959           |
| FHLMC Discount Note  | 07/05/06      | 4.743             | 4,970          | 4,970           |
| FHLMC Discount Note  | 08/02/06      | 5.000             | 4,968          | 4,968           |
| FNMA Guaranteed REMIC 1994-43 Class PH                               | 09/25/23      | 6.350             | 4,064          | 4,093           |
| FNMA Discount Note   | 02/09/07      | 4.150             | 3,500          | 3,480           |
| FHLMC Multiclass 2489 Class PD                                       | 02/15/31      | 6.000             | 3,300          | 3,298           |
| FNMA Guaranteed REMIC 2002-9 Class C                                 | 06/25/30      | 6.500             | 2,270          | 2,272           |
| <b>Total of 10 Largest Holdings</b>                                  |               |                   |                | <b>142,880</b>  |
| <b>Total System Holdings - Postemployment Healthcare Investments</b> |               |                   |                | <b>181,557</b>  |

**Comparison of Investment Activity Income**  
**For Fiscal Years Ended June 30, 2006 and 2005**  
(Dollar Amounts in Thousands)

| <b>Investing Activities</b>                   | <b>2006</b>         | <b>2005</b>         |
|---|---------------------|---------------------|
| Net appreciation in fair value of investments | <b>\$ 5,968,866</b> | <b>\$ 4,462,384</b> |
| Short-term                                    | <b>136,791</b>      | 71,796              |
| Fixed income                                  | <b>694,888</b>      | 594,809             |
| Common and preferred stock                    | <b>771,276</b>      | 676,549             |
| Real estate                                   | <b>285,333</b>      | 187,178             |
| Alternative investments                       | <b>273,808</b>      | 265,355             |
| <b>Total investment activity income</b>       | <b>\$ 8,130,962</b> | <b>\$ 6,258,071</b> |

(Dollar Amounts in Billions)



Brokers' fees on equity investment transactions for the fiscal year ended June 30, 2006 were \$28.2 million. The System has commission recapture contracts with several brokers. These contracts generally stipulate that the brokers rebate a percentage of commissions earned on investment transactions directly to the System. During the fiscal year ended June 30, 2006, the System earned \$2.8 million from a commissions recapture program. A list of the brokers receiving fees in excess of \$100,000 during the fiscal year follows.

**Summary Schedule of Brokers' Fees**  
**(Cumulative Fiscal Year Amounts Exceeding \$100,000)**  
**Fiscal Year Ended June 30, 2006**

| <b>Broker Name</b>              | <b>Fees<br/>Paid (\$)</b> | <b>Broker Name</b>              | <b>Fees<br/>Paid (\$)</b> |
|---------------------------------|---------------------------|---------------------------------|---------------------------|
| Merrill Lynch                   | 2,124,697                 | Liquidnet Inc.                  | 409,552                   |
| UBS Warburg                     | 1,629,570                 | Credit Lyonnais Securities      | 391,558                   |
| Citigroup/Salomon               | 1,601,083                 | Macquarie                       | 367,116                   |
| J. P. Morgan, Inc.              | 1,528,220                 | Jefferies & Company Inc.        | 294,076                   |
| Credit Suisse First Boston      | 1,399,238                 | Cantor, Fitzgerald & Company    | 288,435                   |
| Goldman Sachs & Company         | 1,387,357                 | Instinet Corporation            | 265,938                   |
| Morgan Stanley & Company        | 1,205,709                 | Daiwa Securities                | 249,785                   |
| Deutsche Bank                   | 1,194,601                 | Weeden & Company                | 200,293                   |
| Bear, Stearns & Company         | 1,109,045                 | UNX                             | 179,538                   |
| Lehman Brothers                 | 1,105,654                 | HSBC Securities Inc.            | 177,874                   |
| Barclays Global Investors       | 955,896                   | Susquehanna Financial Group     | 177,874                   |
| Nomura Securities International | 734,705                   | Bank Of America                 | 176,927                   |
| Dresdner                        | 688,988                   | Mizuho Securities               | 167,352                   |
| SG Securities                   | 653,985                   | Sanford Bernstein & Company     | 158,979                   |
| Jones & Associates              | 600,701                   | BNY Brokerage                   | 157,430                   |
| ABN AMRO                        | 531,120                   | Execution Services Incorporated | 113,649                   |
| Knight Securities               | 492,441                   | Cazenove Inc.                   | 108,693                   |
| ITG Securities LTD              | 484,013                   |                                 |                           |

**Professional Consultants  
External Investment Advisors  
As of June 30, 2006**

**Domestic Enhanced Equity Index Managers**

- Acorn Derivatives Management Corporation
- AQR Capital Management, LLC
- Barclays Global Investors
- Bridgewater Associates, Inc.
- First Quadrant, LP
- Pacific Investment Management Company
- Smith Breeden Associates, Inc.

**Domestic Style-Oriented Small Cap Equity Managers**

- Boston Company Asset Management, LLC (The)
- Emerald Advisors, Inc.
- First Pacific Advisors, Inc.
- Mellon Equity Associates
- NorthPointe Capital
- Wellington Management Company, LLP
- William Blair & Company, LLC

**Enhanced Domestic Mid Cap Equity Manager**

- Barclays Global Investors

**Domestic Micro Cap Equity Managers**

- Donald Smith & Company, Inc.
- NorthPointe Capital
- Oberweis Asset Management, Inc.
- Thomson Horstmann & Bryant, Inc.
- Turner Investment Partners

**Publicly Traded Real Estate Securities Managers**

- Morgan Stanley Investment Management, Inc.
- Security Capital Research & Management, Inc.

**Non-U.S. Emerging Market Equity Managers**

- Batterymarch Financial Management, Inc.
- Boston Company Asset Management, LLC (The)
- Templeton Investment Counsel, Inc.
- Wellington Management Company, LLP
- William Blair & Company, LLC

## Professional Consultants (Continued)

### Non-U.S. Large Cap Equity Managers

- AllianceBernstein Institutional Investment Management
- Baillie Gifford Overseas Ltd.
- Barclays Global Investors
- Boston Company Asset Management, LLC (The)
- Marathon Asset Management Limited
- Martin Currie, Inc.
- Mercator Asset Management, LP

### Non-U.S. Small Cap Equity Managers

- Acadian Asset Management
- AXA Rosenberg Investment Management
- Boston Company Asset Management, LLC (The)
- GlobeFlex Capital, LP
- Wasatch Advisors, Inc.

### Currency Hedge Manager

- Pareto Investment Management Limited

### Domestic Fixed Income Managers

- Aberdeen Asset Management, Inc.
- BlackRock Financial Management, Inc.
- Delaware Investment Advisers
- Pacific Investment Management Company
- Western Asset Management Company

### High Yield Fixed Income Manager

- MacKay-Shields Financial Corporation

### Treasury Inflation-Protected Securities Managers

- Bridgewater Associates, Inc.
- Brown Brothers Harriman & Co.

### Global Fixed Income Managers

- Aberdeen Asset Management, Inc.
- Fischer Francis Trees & Watts, Inc.
- Rogge Global Partners

### Real Estate Advisors

- Charter Oak Advisors, Inc.
- GF Management, Inc.



**Professional Consultants (Continued)****Real Estate Advisors (Continued)**

- Grosvenor Investment Management U.S., Inc.
- L&B Realty Advisors, LLP
- Laureate Capital, LLC

**Real Estate Partnerships**

- ARCap Diversified Risk CMBS Fund I & II, LLC
- AvalonBay Value Added Fund, LP
- Berwind Investment Partnership IV, V, & VI
- Blackstone Real Estate Partners V.TE.1, LP
- BPG Co-Investment Partnership, LP
- Carlyle Realty Partners III & IV, LP
- CSFB Strategic Partners II & III RE, LP
- DLJ Real Estate Capital Partners II & III, LP
- Fortress PSERS Investment, LP
- Hines U.S. Office Value Added Fund, LP
- LF Strategic Realty Investors I & II, LP
- Legg Mason Real Estate Capital I & II, Inc.
- Lehman Brothers/PSERS Real Estate, LP
- Lehman Brothers Real Estate Pension Partners II, LP
- Lubert-Adler Real Estate Fund II, III, IV, & V, LP
- Morgan Stanley Real Estate Fund II, LP
- Morgan Stanley Real Estate Fund IV Special Domestic, LP
- Morgan Stanley Real Estate Fund IV & V, Special International, LP
- O'Connor North American Property Partners, LP
- Peabody Global Real Estate Partners, LP
- PRISA
- ProLogis North American Industrial Fund, LP
- Stockbridge Real Estate Fund, LP
- UBS RESA
- Westbrook Real Estate Fund, LP
- Whitehall Street Real Estate, LP III, V, V-S, & VII
- William E. Simon & Sons Realty Partners, LP

**Farmland Advisor**

- Prudential Agricultural Group

**Private Equity/Venture Capital Partnerships**

- ABS Capital Partners II, LP
- Adams Capital Management, LP
- Aisling Capital II, LP
- Allegheny New Mountain Partners, LP
- APA/Fostin Venture Fund I
- Baring Asia Private Equity Fund III, LP
- Bastion Capital Fund, LP

## Professional Consultants (Continued)

## Private Equity/Venture Capital Partnerships (Continued)

- Bear Stearns Merchant Banking Partners II, LP
- BG Media Investors, LP
- Blue Point Capital Partners (B), LP
- Bridgepoint Capital II Partnership, LP
- Bridgepoint Europe IA, IIA, & IIIA, LP
- Bruckmann, Rosser, Sherrill & Company, LP
- Catterton Partners V, LP
- Clarity Partners, LP
- Co-Investment 2000 Fund, LP (The)
- Co-Investment Fund II, LP (The)
- Commonwealth Venture Partners I & II
- Credit Suisse First Boston Equity Partners, LP
- Credit Suisse First Boston International Equity Partners, LP
- Crestview Capital Partners, LP
- Cross Atlantic Technology Fund I & II, LP
- CSFB Strategic Partners II & III-B, & III-VC, LP
- Deutsche European Partners IV, LP
- DLJ Merchant Banking Partners III, LP
- DLJ Strategic Partners, LP
- Dubin Clark Fund II, LP
- Edgewater Growth Capital Partners, LP
- Edgewater Private Equity Fund III, LP
- Edison Venture Fund II & III
- Evergreen Pacific Partners, LP
- Franklin Capital Associates III, LP
- Furman Selz Investors II & III, LP
- Graham Partners Investments (B), LP
- Green Equity Investors II, LP
- Greenwich Street Capital Partners II, LP
- Grotech Partners IV
- GS Mezzanine Partners, LP
- Halifax Capital Partners, LP
- Heritage Fund I, LP
- Jefferies Capital Partners IV, LP
- Jefferson Partners Fund IV (PA), LP
- KBL Partnership, LP
- KRG Capital Fund I, II & III, LP
- Landmark Equity Partners II, III, IV, & V
- Landmark Mezzanine Partners, LP
- Lehman Brothers Communications Investors, LP
- Lehman Brothers Merchant Banking Partners II, LP
- Lehman Brothers Venture Partners 2003-P, LP
- Lexington Capital Partners I, LP
- Lindsay, Goldberg & Bessemer, LP
- LLR Equity Partners I & II, LP
- Milestone Partners II, LP
- Morgan Stanley Dean Witter Capital Partners IV, LP
- NEPA Venture Fund II

**Professional Consultants (Continued)****Private Equity/Venture Capital Partnerships (Continued)**

- New Mountain Partners, LP
- New York Life Capital Partners, I, II & III, LP
- P/A Fund (The)
- PAI Europe III & IV, LP
- Palladium Equity Partners II-A, LP
- Pennsylvania Early Stage Partners I & II, LP
- Perseus-Soros BioPharmaceutical Fund, LP
- Platinum Equity Capital Partners-A, LP
- PNC Equity Partners, LP
- Quadrangle Capital Partners I & II, LP
- Quaker BioVentures, LP
- SCP Private Equity Partners I & II, LP
- Spectrum Equity Investors, LP
- StarVest Partners, LP
- Sterling Capital Partners, LP
- Sterling Venture Partners, LP
- Sunrise Capital Partners, LP
- TDH III, LP
- Technology Leaders, LP
- TL Ventures III, LP
- TPG Partners I, II & V, LP
- U.S. Equity Partners I & II, LP
- Wicks Communications & Media Partners, LP
- Willis Stein & Partners, LP

**Private Debt Partnerships**

- Avenue Special Situations Fund II, III & IV, LP
- Avenue Asia Special Situations Fund II & III, LP
- Cerberus Institutional Partners, LP (Series Two and Three)
- Chrysalis Capital Partners, LP
- Gleacher Mezzanine Fund, LP
- Gold Hill Venture Lending 03-A, LP
- GSC Partners CDO Investors III & IV, LP
- GSC Recovery II & III, LP
- NYLIM Mezzanine Partners Parallel Fund, LP

**Developmental Fund Managers**

- Charter Financial Group, Inc.
- Conestoga Capital Advisors
- Connors Investor Services, Inc.
- Denali Advisors, LLC
- EDMP, Inc.
- Global Capital Management, Inc.
- Hanseatic Management Services, Inc.

**Professional Consultants (Continued)**

**Developmental Fund Managers (Continued)**

- Hesperides Capital Management, LLC
- John Hsu Capital Group, Inc.
- Opus Capital Management
- Piedmont Investment Advisors
- Piedra Capital, Inc.
- Profit Investment Management
- Pugh Capital Management, Inc.
- Shah Capital Management, Inc.
- Smithbridge Asset Management, Inc.
- Snow Capital Management, LP
- Tucker Hargrove Management, Inc.
- West Chester Capital Advisors

**Alternative Investment Consultant**

- Portfolio Advisors, LLC

**Custodian and Securities Lending Agent**

- Mellon Bank N.A.

**Investment Accounting Application Service Provider**

- Financial Control Systems, Inc.

**Investment Evaluator and General Investment Consultant**

- Wilshire Associates Inc.

**Proxy Voting Agent**

- Glass, Lewis & Co., LLC

**Real Estate Investments Consultant**

- Courtland Partners, Ltd.