

FINANCIAL



1983

The System's Comprehensive Annual Financial Report, reviewed by the Government Finance Officers Association of the United States and Canada, was awarded its first *Certificate of Achievement for Excellence in Financial Reporting*. PSERS has won this award for 25 consecutive years, 1983 through 2007.



Independent Auditor's Report

The Board of Trustees
Public School Employees' Retirement System
Harrisburg, Pennsylvania

We have audited the accompanying financial statements of the Public School Employees' Retirement System (PSERS), a component unit of the Commonwealth of Pennsylvania as of and for the years ended June 30, 2008 and 2007, as listed in the table of contents. These financial statements are the responsibility of the PSERS' management. 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, PSERS' plan net assets as of June 30, 2008 and 2007, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and Required Supplemental Schedules of Funding Progress and Employer Contributions (Schedules 1 and 2) are not a required part of the financial statements, but is supplemental information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. The Supplemental Schedules 1 through 3 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Supplemental Schedules 1 through 3 have been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, are presented fairly, in all material respects, in relation to the basic financial statements taken as a whole.

The Chairman's Report, Introductory Section, Investment Section, Actuarial Section and Statistical Section as listed in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The Chairman's Report and the Introductory, Investment, Actuarial and Statistical Sections have not been subject to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

Clifton Gunderson LLP

Baltimore, Maryland
September 25, 2008

Offices in 17 states and Washington, DC





Management's Discussion and Analysis

Management's Discussion and Analysis (MD&A) of the Commonwealth of Pennsylvania Public School Employees' Retirement System (PSERS) for the fiscal year ended June 30, 2008, provides a narrative summary of PSERS' financial position and performance, including highlights and comparative data. The MD&A is presented as required supplemental information to the financial statements and should be read in conjunction with the financial statements, the notes to financial statements and the supplementary schedules.

Overview of Financial Statements

PSERS is primarily responsible for administering a defined benefit pension plan for public school employees in the Commonwealth of Pennsylvania. PSERS also administers two postemployment healthcare programs, the Health Insurance Premium Assistance Program (Premium Assistance) and the Health Options Program (HOP), for its annuitants. The financial statements present the financial activities for the pension plan and the two postemployment healthcare programs.

The *Statements of Plan Net Assets* provide a snapshot of the financial position of PSERS at June 30, 2008, including comparative amounts for the prior year.

The *Statements of Changes in Plan Net Assets* summarize PSERS' financial activities that occurred during the fiscal period from July 1, 2007 to June 30, 2008, including comparative amounts for the prior year.

The *Notes to Financial Statements* provide additional information that is essential to a full understanding of the financial statements. The notes are an integral part of the financial statements and include detailed information not readily evident in the basic financial statements such as accounting policies, with plan membership and benefits and summary disclosures of selected financial data.

The *Required Supplemental Schedules* immediately following the notes to financial statements provide two schedules showing historical information concerning the funded status of PSERS and the employer contributions. These schedules emphasize the long-term nature of the pension and premium assistance plans and show the progress of PSERS in accumulating assets sufficient to pay benefits when due.

The remaining supplemental schedules provide additional detailed information concerning the operating expenses, investment expenses and payments to non-investment consultants. All of this supplemental information is considered useful in understanding and evaluating the financial activities of PSERS.

Financial Highlights

- ◆ The rate of return on investments was -2.82% for the fiscal year ended June 30, 2008 (FY 2008), 22.93% for the fiscal year ended June 30, 2007 (FY 2007) and 15.26% for the fiscal year ended June 30, 2006 (FY 2006).





Management's Discussion and Analysis (Continued)

- ◆ PSERS' total plan net assets decreased by \$4.8 billion from \$67.5 billion at June 30, 2007 to \$62.7 billion at June 30, 2008. The decrease is primarily attributable to net investment loss and payment of pension benefits and administrative expenses combined that exceeded member and employer contributions. PSERS' total plan net assets increased by \$10.1 billion from \$57.4 billion at June 30, 2006 to \$67.5 billion at June 30, 2007, the highest fiscal year-end total in PSERS' history. The increase was attributed to net investment income and member and employer contributions combined that exceeded the payment of pension benefits and administrative expenses.
- ◆ PSERS' funded ratio as of the latest actuarial valuation dated June 30, 2007 increased from 81.2% at June 30, 2006 to 85.8% at June 30, 2007. This is the first increase in the funded ratio since FY 2000. The increase is primarily due to experience gains on assets and liabilities that occurred during the year that were partially offset by contributions less than the normal cost. The primary driver of the experience gains on assets was the favorable investment performance from FY 2003 to FY 2007. The funded ratio at June 30, 2005 was 83.6%.
- ◆ Total member contributions increased from \$1.0 billion in FY 2007 to \$1.04 billion in FY 2008 due to a slight increase in the average member contribution rate and an increase in the active member payroll. Total member contributions also increased from FY 2006 to FY 2007 because of the same factors.
- ◆ Total employer contributions increased from \$746.3 million in FY 2007 to \$834.9 million in FY 2008. The net increase is primarily attributable to an increase in the total employer contribution rate from 6.46% in FY 2007 to 7.13% in FY 2008. Total employer contributions increased from FY 2006 to FY 2007 due to an increase in the total employer contribution rate from 4.69% to 6.46%.
- ◆ Total PSERS' benefit expense increased by \$600.0 million from \$4.3 billion in FY 2007 to \$4.9 billion in FY 2008. The increase is primarily attributable to an increase in the number of retirees and beneficiaries currently receiving benefits and an increase in the average benefit paid per annuitant. Benefit expense also increased by \$200.0 million from FY 2006 to FY 2007 due to an increase in the number of retirees and beneficiaries currently receiving benefits.
- ◆ Total administrative expenses decreased by \$1.2 million from \$50.5 million in FY 2007 to \$49.3 million in FY 2008 primarily due to lower administrative expenses for Premium Assistance and HOP. Administrative expenses increased by \$1.9 million between FY 2006 and FY 2007 primarily due to higher administrative expenses for Premium Assistance and HOP. Administrative expenses were within PSERS' budgeted amounts for each of the fiscal years.

Funded Status

PSERS uses an actuarial reserve type of funding that is financed by member contributions, employer contributions and earnings from invested assets. An independent actuarial valuation of PSERS' actuarial assets and liabilities is performed annually. As part of this valuation, the progress toward funding pension obligations of PSERS is measured by comparing the actuarial value of assets to the actuarial accrued liability. This measurement is referred to as the funded ratio or



**Management's Discussion and Analysis (Continued)**

funded status. The most recent actuarial valuation reports that PSERS is 85.8% funded as of June 30, 2007. The results of operations for FY 2008 will be reflected in the actuarial valuation for the year ended June 30, 2008. Due to the normal lag time for completion of the actuarial valuation, the resulting funded status will be available at the end of the 2008 calendar year and will be reported in the financial statements for the fiscal year ended June 30, 2009 (FY 2009).

Analysis of Plan Net Assets

Summary of Plan Net Assets:	(Dollar Amounts in Thousands)				
	FY 2008	Increase (Decrease)	FY 2007	Increase (Decrease)	FY 2006
Assets:					
Receivables	\$ 2,257,692	\$ 490,786	\$ 1,766,906	\$ 180,343	\$ 1,586,563
Investments	63,892,220	(4,634,313)	68,526,533	9,807,264	58,719,269
Securities lending collateral pool	4,846,999	(3,959,980)	8,806,979	2,469,806	6,337,173
Capital assets	665	(205)	870	227	643
Total Assets	\$ 70,997,576	(8,103,712)	\$ 79,101,288	12,457,640	66,643,648
Liabilities:					
Payables and other liabilities	3,491,953	720,348	2,771,605	(117,569)	2,889,174
Obligations under securities lending	4,846,999	(3,959,980)	8,806,979	2,469,806	6,337,173
Total Liabilities	8,338,952	(3,239,632)	11,578,584	2,352,237	9,226,347
Plan Net Assets	\$ 62,658,624	\$ (4,864,080)	\$ 67,522,704	\$ 10,105,403	\$ 57,417,301
Summary of Changes in Plan Net Assets:					
Additions:					
Contributions	\$ 1,902,436	\$ 128,832	\$ 1,773,604	\$ 245,874	\$ 1,527,730
Net investment income (loss)	(1,775,585)	(14,478,306)	12,702,721	4,760,082	7,942,639
Total Additions	126,851	(14,349,474)	14,476,325	5,005,956	9,470,369
Deductions:					
Benefit expense	4,941,681	621,241	4,320,440	204,575	4,115,865
Administrative expenses	49,250	(1,232)	50,482	1,853	48,629
Total Deductions	4,990,931	620,009	4,370,922	206,428	4,164,494
Changes in Plan Net Assets	\$ (4,864,080)	\$ (14,969,483)	\$ 10,105,403	\$ 4,799,528	\$ 5,305,875

Investments

PSERS is a long-term investor and manages the pension fund with long-term objectives in mind. A primary element of PSERS' investment philosophy is that diversification among various asset classes is the best way to achieve its goals. PSERS makes estimates of future long-term market returns and establishes an asset allocation plan taking into account the risk associated with each asset class as well as the financial objectives of the Fund.





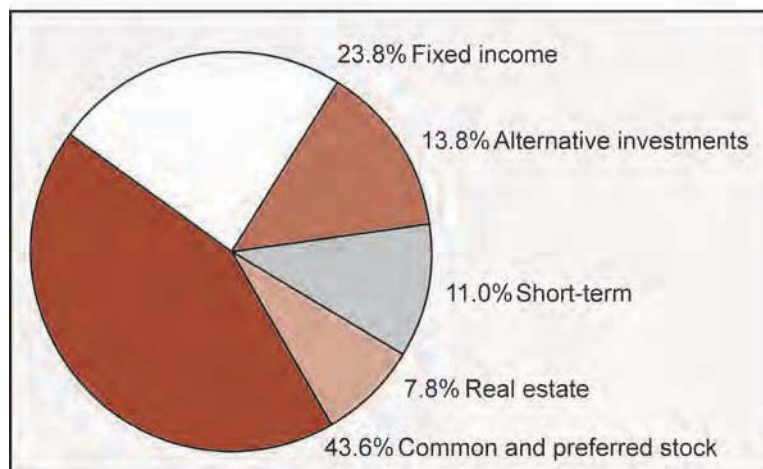
Management's Discussion and Analysis (Continued)

The System had a very challenging fiscal year ended June 30, 2008, as the System generated negative absolute returns. The deflating housing bubble, weakening economy, soaring commodity prices, weakening U.S. dollar, and rising inflation led to negative returns for U.S. and international equity markets and real estate. For FY 2008, PSERS' rate of return on investments was -2.82%. The FY 2008 investment return trailed PSERS' total fund policy index of -1.84% and placed PSERS' performance in the 2nd quartile of the Public Fund Universe prepared by the System's investment consultant, Wilshire Associates Inc. (Wilshire). The annualized rate of return over the past three and five-year periods ended June 30, 2008 was 11.25% and 13.21%, respectively. These returns exceeded the total fund Policy Index returns for the three- and five-year periods ended June 30, 2008 by 208 and 240 basis points, respectively, and placed PSERS performance in the top decile of the Public Fund Universe prepared by Wilshire for both time periods. The annualized rate of return for the ten-year period ended June 30, 2008 was 7.76%. PSERS' long-term actuarial investment rate of return assumption is 8.50%.

The asset distribution of PSERS' investment portfolio at June 30, 2008, June 30, 2007 and June 30, 2006, at fair value, including postemployment healthcare assets, was:

Asset Class	(Dollar Amounts in Thousands)					
	2008	%	2007	%	2006	%
Short-term	\$ 7,022,511	11.0	\$ 4,164,010	6.1	\$ 4,061,926	6.9
Fixed income	15,176,893	23.8	15,919,998	23.2	13,962,196	23.8
Common and preferred stock	27,875,324	43.6	38,715,473	56.5	32,951,976	56.1
Real estate	4,951,840	7.8	3,887,986	5.7	2,542,399	4.3
Alternative investments	8,865,652	13.8	5,839,066	8.5	5,200,772	8.9
Total	\$ 63,892,220	100.0	\$ 68,526,533	100.0	\$ 58,719,269	100.0

Asset Distribution At June 30, 2008



Management's Discussion and Analysis (Continued)

Short-term investments (cash and cash equivalents) increased by \$2.8 billion from \$4.2 billion in FY 2007 to \$7.0 billion in FY 2008. The significant rise in short-term investments was primarily due to a few key investment managers shifting a large portion of their direct common and preferred stock holdings to short-term while gaining equity exposure through the use of futures and total return swaps. Fixed income investments decreased by \$700.0 million from \$15.9 billion in FY 2007 to \$15.2 billion in FY 2008 mostly due to allocation decreases to this asset class which were partially offset by several investment managers shifting a portion of their short-term investments to fixed income. Common and preferred stock investments decreased by \$10.8 billion from \$38.7 billion in FY 2007 to \$27.9 billion in FY 2008. This decline was primarily the result of negative returns in the domestic and international equity markets, allocation reductions to the asset class and certain investment managers shifting a substantial portion of their common and preferred stock investments to short-term as described above. Real estate investments increased by \$1.1 billion from \$3.9 billion in FY 2007 to \$5.0 billion in FY 2008 due to net allocation increases to new and existing real estate partnerships which were offset in part by market value depreciation. Alternative investments increased by \$3.1 billion from \$5.8 billion in FY 2007 to \$8.9 billion in FY 2008 due almost entirely to the addition of new investment partnerships and drawdowns of commitments to existing partnerships which were partially offset by distributions.

Short-term investments at the close of FY 2007 increased by \$100.0 million from \$4.1 billion in FY 2006 to \$4.2 billion in FY 2007. Short-term investments remained high as the Fund continued to maintain a portion of its fixed income allocation in cash and cash equivalents due to favorable short-term yields and a relatively flat yield curve at the end of FY 2007. Fixed income investments increased by \$1.9 billion from \$14.0 billion in FY 2006 to \$15.9 billion in FY 2007 due to favorable investment returns partially reinvested in fixed income, additional allocations to the asset class and as the result of several investment managers shifting a portion of their short-term investments to fixed income. Common and preferred stock investments increased by \$5.7 billion from \$33.0 billion in FY 2006 to \$38.7 billion in FY 2007. The increase was primarily due to strong positive returns in the domestic and international equity markets that were reinvested in the asset class. This increase was partially offset by allocation reductions to the asset class during FY 2007 in accordance with PSERS' asset allocation plan. Real estate investments increased by \$1.4 billion from \$2.5 billion in FY 2006 to \$3.9 billion in FY 2007 due to very strong returns and net allocation increases to new and existing real estate partnerships. Alternative investments increased by \$600.0 million from \$5.2 billion in FY 2006 to \$5.8 billion in FY 2007 due to the addition of new investment partnerships, drawdowns of commitments to existing partnerships and market value appreciation.

Securities Lending

Securities lending collateral pool and obligations under securities lending decreased from \$8.8 billion in FY 2007 to \$4.8 billion in FY 2008 due to a decrease in the amount of securities on loan and a decrease in the use of cash as collateral for securities on loan. Use of non-cash collateral increased from FY 2007 to FY 2008. Non-cash collateral is not reflected in the Statement of Plan Net Assets.

Net Income from securities lending activities increased from \$25.9 million in FY 2007 to \$48.9 million in FY 2008 due to an increase in the demand for domestic equity securities during volatile markets in FY 2008, an increase in spreads on loans and improved loan efficiencies due to the increased use of automated lending systems by PSERS' lending agent.



Management's Discussion and Analysis (Continued)

Contributions and Investment Income

Employer pension contributions increased by \$94.0 million from \$659.5 million in FY 2007 to \$753.5 million in FY 2008 due to the increase in the employer pension contribution rate from 5.67% in FY 2007 to 6.44% in FY 2008. Employer pension contributions increased from \$456.9 million in FY 2006 to \$659.5 million in FY 2007 due to the increase in the employer pension contribution rate from 4.00% in FY 2006 to 5.72% in FY 2007. Member pension contributions increased by \$24.3 million from \$855.3 million in FY 2007 to \$879.6 million in FY 2008 as a result of the increase in the total active member payroll and the average member contribution rate increasing from 7.21% in FY 2007 to 7.25% in FY 2008. Member pension contributions increased by \$27.7 million from \$827.6 million in FY 2006 to \$855.3 million in FY 2007 due to an increase in the total active member payroll and the average member contribution rate increase from 7.16% in FY 2006 to 7.21% in FY 2007. The employer contributions for health insurance premium assistance decreased by \$5.5 million from \$86.8 million in FY 2007 to \$81.3 million in FY 2008 due to the decrease in the employer health insurance premium assistance contribution rate from 0.74% in FY 2007 to 0.69% in FY 2008. Contributions from the Centers for Medicare and Medicaid Services (CMS) increased from \$27.8 million in FY 2007 to \$28.4 million in FY 2008.

Net investment income (loss) decreased by \$14.5 billion from \$12.7 billion in FY 2007 to (\$1.8) billion in FY 2008, which correlates to the decrease in the investment rate of return from 22.93% for FY 2007 to -2.82% for FY 2008. The annual investment returns for FY 2007 and FY 2006 were strong at 22.93% and 15.26%, respectively. Net investment income (loss) also includes investment expenses as a deduction. The "Total PSERS Benefits and Expenses" section that follows includes an analysis of investment expenses.

In the 2003 actuarial valuation, the employer contribution rate was projected to sharply increase to 27.73% of payroll for the 2012-2013 fiscal year. In the subsequent time period, PSERS has experienced a strong five-year performance in its investment returns. Despite the -2.82% return for FY 2008, PSERS return for the five years ended June 30, 2008 was 13.21%. Factoring in this strong investment performance over the past five years, the 2012-2013 employer contribution rate projection is expected to be below 17.00% of payroll upon completion of the 2008 actuarial valuation. The sub-17.00% of payroll rate represents a substantial improvement over the original projection of 27.73% of payroll.

Total PSERS' Benefits and Expenses

The primary source of expense during FY 2008 was for the payment of benefits totaling \$4.9 billion. This compares to benefit expense of \$4.3 billion during FY 2007 and \$4.1 billion for FY 2006. Benefits expense increased in FY 2008 and FY 2007 due to an increase in the number of annuitants each year and an increase in the average benefit payment per annuitant. Investment expenses increased by \$85.3 million from \$313.8 million in FY 2007 to \$399.1 million in FY 2008 due primarily to an increase in management fees in private markets. The higher fees were almost entirely a result of new investments made in alternative investment and real estate partnerships during FY 2008. Investment expenses increased by \$102.5 million from \$211.3 million in FY 2006 to \$313.8 in FY 2007 due primarily to increased manager fees in public and private markets. The higher fees were due to increases in the total Fund value as well as new investments in various

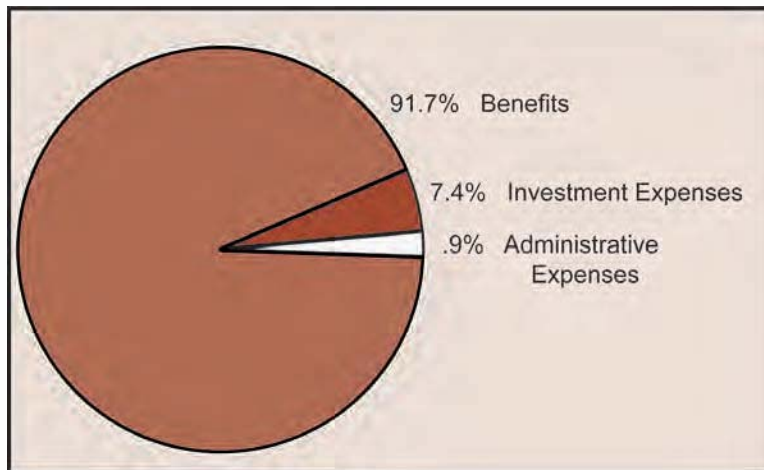




Management's Discussion and Analysis (Continued)

portable alpha strategies and private market partnerships, which have higher manager fees. Investment expenses are reported as a reduction in net investment income (loss) on the Statements of Changes in Plan Net Assets. Administrative expenses decreased by \$1.2 million from \$50.5 million during FY 2007 compared to \$49.3 million during FY 2008. The decrease was due to lower administrative expenses for Premium Assistance and HOP. Administrative expenses for FY 2006 totaled \$48.6 million.

Total PSERS' Benefits and Expenses Fiscal Year Ended June 30, 2008





Statements of Plan Net Assets

June 30, 2008 and 2007

(Dollar Amounts in Thousands)

	2008			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
Assets:				
Receivables:				
Members	\$ 253,356	\$ 1,076	\$ 55	\$ 254,487
Employers	269,581	26,878	-	296,459
Investment income	238,484	199	176	238,859
Investment proceeds	1,464,272	-	-	1,464,272
Miscellaneous	2,518	1,052	45	3,615
Total Receivables	2,228,211	29,205	276	2,257,692
Investments, at fair value:				
Short-term	6,840,770	67,400	114,341	7,022,511
Fixed income	15,176,893	-	-	15,176,893
Common and preferred stock	27,875,324	-	-	27,875,324
Real estate	4,951,840	-	-	4,951,840
Alternative investments	8,865,652	-	-	8,865,652
Total Investments	63,710,479	67,400	114,341	63,892,220
Securities lending collateral pool	4,846,999	-	-	4,846,999
Capital assets (net of accumulated depreciation of \$10,789)	665	-	-	665
Total Assets	70,786,354	96,605	114,617	70,997,576
Liabilities:				
Accounts payable and accrued expenses	84,108	332	2,929	87,369
Benefits payable	490,692	488	8,190	499,370
Premium advances	-	-	14,085	14,085
Investment purchases and other liabilities	2,891,129	-	-	2,891,129
Obligations under securities lending	4,846,999	-	-	4,846,999
Total Liabilities	8,312,928	820	25,204	8,338,952
Net assets held in trust for pension and postemployment healthcare benefits (Schedules of funding progress are presented on Required Supplemental Schedule 1)	\$62,473,426	\$ 95,785	\$ 89,413	\$62,658,624

The accompanying notes are an integral part of the financial statements.



**Statements of Plan Net Assets****June 30, 2008 and 2007**

(Dollar Amounts in Thousands)

	2007			Totals
	Pension	Postemployment Healthcare Premium Assistance	Health Options Program	
Assets:				
Receivables:				
Members	\$ 256,932	\$ 545	\$ 77	\$ 257,554
Employers	234,947	28,152	-	263,099
Investment income	229,320	387	401	230,108
Investment proceeds	1,013,317	-	-	1,013,317
Miscellaneous	2,802	26	-	2,828
Total Receivables	1,737,318	29,110	478	1,766,906
Investments, at fair value:				
Short-term	3,983,285	68,869	111,856	4,164,010
Fixed income	15,919,998	-	-	15,919,998
Common and preferred stock	38,715,473	-	-	38,715,473
Real estate	3,887,986	-	-	3,887,986
Alternative investments	5,839,066	-	-	5,839,066
Total Investments	68,345,808	68,869	111,856	68,526,533
Securities lending collateral pool	8,806,979	-	-	8,806,979
Capital assets (net of accumulated depreciation of \$10,656)	870	-	-	870
Total Assets	78,890,975	97,979	112,334	79,101,288
Liabilities:				
Accounts payable and accrued expenses	78,742	292	1,404	80,438
Benefits payable	201,916	395	11,913	214,224
Premium advances	-	-	14,602	14,602
Investment purchases and other liabilities	2,462,341	-	-	2,462,341
Obligations under securities lending	8,806,979	-	-	8,806,979
Total Liabilities	11,549,978	687	27,919	11,578,584
Net assets held in trust for pension and postemployment healthcare benefits				
(Schedules of funding progress are presented on Required Supplemental Schedule 1)	\$67,340,997	\$ 97,292	\$ 84,415	\$67,522,704

The accompanying notes are an integral part of the financial statements.





Statements of Changes in Plan Net Assets

Years ended June 30, 2008 and 2007

(Dollar Amounts in Thousands)

	2008			Totals
	Pension	Postemployment Healthcare Premium Assistance	Health Options Program	
Additions:				
Contributions:				
Members	\$ 879,598	\$ -	\$ 159,563	\$ 1,039,161
Employers	753,532	81,317	-	834,849
Centers for Medicare & Medicaid Services	-	-	28,426	28,426
Total contributions	1,633,130	81,317	187,989	1,902,436
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	(3,763,649)	268	-	(3,763,381)
Short-term	204,577	2,525	4,288	211,390
Fixed income	758,142	-	-	758,142
Common and preferred stock	763,615	-	-	763,615
Real estate	437,880	-	-	437,880
Alternative investments	167,052	-	-	167,052
Total investment activity income (loss)	(1,432,383)	2,793	4,288	(1,425,302)
Investment expenses	(399,098)	(38)	-	(399,136)
Net income (loss) from investing activities	(1,831,481)	2,755	4,288	(1,824,438)
From securities lending activities:				
Securities lending income	319,107	-	-	319,107
Securities lending expense	(270,254)	-	-	(270,254)
Net income from securities lending activities	48,853	-	-	48,853
Total net investment income (loss)	(1,782,628)	2,755	4,288	(1,775,585)
Total Additions	(149,498)	84,072	192,277	126,851
Deductions:				
Benefits	4,636,340	84,335	175,136	4,895,811
Refunds of contributions	28,713	-	-	28,713
Net transfer to State Employees' Retirement System	17,157	-	-	17,157
Administrative expenses	35,863	1,244	12,143	49,250
Total Deductions	4,718,073	85,579	187,279	4,990,931
Net increase (decrease)	(4,867,571)	(1,507)	4,998	(4,864,080)
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	67,340,997	97,292	84,415	67,522,704
Balance, end of year	\$ 62,473,426	\$ 95,785	\$ 89,413	\$ 62,658,624

The accompanying notes are an integral part of the financial statements.





Statements of Changes in Plan Net Assets

Years ended June 30, 2008 and 2007

(Dollar Amounts in Thousands)

	2007			Totals
	Pension	Postemployment Healthcare		
		Assistance	Health Options Program	
Additions:				
Contributions:				
Members	\$ 855,322	\$ -	\$ 144,185	\$ 999,507
Employers	659,545	86,763	-	746,308
Centers for Medicare & Medicaid Services	-	-	27,789	27,789
Total contributions	1,514,867	86,763	171,974	1,773,604
Investment income:				
From investing activities:				
Net appreciation in fair value of investments	10,457,473	88	-	10,457,561
Short-term	181,462	2,517	5,821	189,800
Fixed income	713,257	-	-	713,257
Common and preferred stock	1,019,322	-	-	1,019,322
Real estate	334,264	-	-	334,264
Alternative investments	276,350	-	-	276,350
Total investment activity income	12,982,128	2,605	5,821	12,990,554
Investment expenses	(313,726)	(32)	-	(313,758)
Net income from investing activities	12,668,402	2,573	5,821	12,676,796
From securities lending activities:				
Securities lending income	419,762	-	-	419,762
Securities lending expense	(393,837)	-	-	(393,837)
Net income from securities lending activities	25,925	-	-	25,925
Total net investment income	12,694,327	2,573	5,821	12,702,721
Total Additions	14,209,194	89,336	177,795	14,476,325
Deductions:				
Benefits	4,044,435	82,031	169,784	4,296,250
Refunds of contributions	18,180	-	-	18,180
Net transfer to State Employees' Retirement System	6,010	-	-	6,010
Administrative expenses	35,239	2,790	12,453	50,482
Total Deductions	4,103,864	84,821	182,237	4,370,922
Net increase (decrease)	10,105,330	4,515	(4,442)	10,105,403
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	57,235,667	92,777	88,857	57,417,301
Balance, end of year	\$ 67,340,997	\$ 97,292	\$ 84,415	\$ 67,522,704

The accompanying notes are an integral part of the financial statements.





Notes To Financial Statements

June 30, 2008 and 2007

1. Organization and Description of the System

(A) Organization

The System was established on July 18, 1917, under the provisions of Pamphlet Law 1043, No. 343 as a governmental cost-sharing multiple-employer plan that provides retirement allowances and other benefits to its members. Membership in the System is mandatory for nearly all qualifying public school employees in the Commonwealth of Pennsylvania (Commonwealth). At June 30, 2008, there were 739 participating employers, generally school districts. Membership as of June 30, 2007, the most recent year for which actual amounts are available, consisted of:

Currently employed members:		
Vested		175,000
Nonvested		<u>89,000</u>
Total currently employed members		264,000
Retirees and beneficiaries currently receiving benefits		168,000
Inactive members and vestees entitled to but not receiving benefits		<u>109,000</u>
Total retirees and other members		<u>277,000</u>
Total number of members		<u>541,000</u>

All members are fully vested in their individual balance in the Members' Savings Account which is described in Note 3.

The System is established by state law as an independent administrative board of the Commonwealth, which is directed by the Public School Employees' Retirement Board (the Board) that exercises control and management of the System, including the investment of its assets. The System's board has fifteen members including the Commonwealth's Secretary of Education, the State Treasurer, the Executive Director of the Pennsylvania School Boards Association, two members appointed by the Governor, six elected members (three from among the System's certified members, one from among the System's noncertified members, one from among the System's annuitants, and one from among school board members in Pennsylvania), two members from the Senate, and two members from the House of Representatives.

The State Treasurer is the custodian of the System's fund. The retirement plan of the System is a contributory defined benefit plan for which the benefit payments to members and contribution provisions by employers and employees are specified in the Pennsylvania Public School Employees' Retirement Code (the Code). Changes in benefit and contribution provisions for the retirement plan must be made by legislation. Pursuant to state law, all legislative bills and amendments proposing to change the System's retirement plan are to be accompanied with an actuarial note prepared by an enrolled pension actuary providing an estimate of the cost and actuarial effect of the proposed change.

Based upon criterion of financial accountability as defined by governmental accounting standards, the System is considered a component unit of the Commonwealth of Pennsylvania financial reporting entity and is included in the Comprehensive Annual Financial Report of the Commonwealth of Pennsylvania.



Notes to Financial Statements (Continued)

(B) Pension Plan

i. Pension Benefits

Under the provisions of the 1975 revision of the Code by the Pennsylvania General Assembly, members are eligible for monthly retirement benefits upon reaching (a) age 62 with at least 1 year of credited service; (b) age 60 with 30 or more years of credited service; or (c) 35 or more years of service regardless of age.

Benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member's final average salary (as defined in the Code) multiplied by the number of years of credited service. In most cases after completion of five years of service, a member's right to the defined benefit is vested and early retirement benefits may be elected. Under certain features of the System, active members may purchase credit for various types of prior school and non-school service on a lump-sum, installment purchase basis, or through an actuarially calculated benefit reduction.

In addition to regular retirement benefits, the System also provides for disability retirement benefits and death benefits. Participants are eligible for disability retirement benefits after completion of five years of credited service. Such benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member's final average salary (as defined in the Code) multiplied by the number of years of credited service, but not less than one-third of such salary nor greater than the benefit the member would have had at normal retirement age. Members over normal retirement age may apply for disability benefits. Certain exceptions apply to normal disability retirements.

Death benefits are payable upon the death of an active member who has reached age 62 or who has at least five years of credited service. Such benefits are actuarially equivalent to the benefit that would have been effective if the member had retired on the day before death.

Members with credited service in the Commonwealth of Pennsylvania State Employees' Retirement System (SERS) may elect to transfer service to the Public School Employees' Retirement System upon commencement of employment in the public school system. Similarly, a member with credited service in the System may transfer such service to SERS upon becoming a member of that system.

Upon termination of a member's employment in the public school sector, the member's accumulated contributions plus interest are refundable from the Members' Savings Account which is described in Note 3.

ii. Contributions

The contribution policy is set by the Code and requires contributions by active members, employers, and the Commonwealth. The System's funding policy provides for periodic employer and Commonwealth contributions at actuarially determined rates, expressed as a percentage of annual covered payroll, such that they, along with employee contributions and an actuarially determined rate of investment return, are adequate to accumulate assets to pay retirement benefits when due. Level percentage of payroll employer contribution rates are determined using the entry age normal actuarial funding method. This method determines the amount of contributions necessary to (1) fully fund all current costs, which represents the estimated amount necessary to



Notes to Financial Statements (Continued)

pay for the benefits earned by the employees during the current service year; and (2) liquidate the prior service cost for service earned prior to the current service year and subsequent benefit increases, which represents the amount necessary to fund accrued liabilities over the appropriate amortization periods.

Contribution rates for active members are set by law (redefined with the provisions of Act 9 of 2001) and are dependent upon members' class. In most cases, the contribution rates based on qualified member compensation are as follows:

Membership Class T-C	Active members hired before July 22, 1983	5.25%
Membership Class T-C	Active members hired on or after July 22, 1983	6.25%
Membership Class T-D	Active members hired before July 22, 1983	6.50%
Membership Class T-D	Active members hired on or after July 22, 1983	7.50%

Active members newly hired after July 1, 2001, the effective date of Act 9 of 2001, are automatically Class T-D. The contribution rates for all members in Membership Class T-D were effective January 1, 2002.

The total contribution rate for the employers and the Commonwealth was 7.13% and 6.46% of qualified compensation for the years ended June 30, 2008 and 2007, respectively. According to requirements established in Act 29 of 1994, the Commonwealth reimburses school entity employers a portion of the employer contributions paid to the System. The Commonwealth remits employer contributions for employers other than school entities directly to the System. All contributions from employers and the Commonwealth are shown as employer contributions on the Statements of Changes in Plan Net Assets.

A portion of each employer and Commonwealth contribution to the System is set aside for the funding of the health insurance premium assistance program. The premium assistance contribution rate is set at a level necessary to establish reserves sufficient to provide premium assistance payments for all participating eligible members for the subsequent fiscal year. The portion of the total contribution rate for employers and the Commonwealth used to fund premium assistance was 0.69% and 0.74% for the years ended June 30, 2008 and 2007, respectively.

iii. Funding Status and Annual Required Contributions (ARC)

As of June 30, 2007, the most recent actuarial valuation, the plan was 85.8% funded. The actuarial accrued liability for benefits was \$66.5 billion, and the actuarial value of assets was \$57.1 billion, resulting in an unfunded accrued liability of \$9.4 billion. The covered payroll of active members was \$11.4 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 82.7%.

For fiscal year ended June 30, 2008, the ARC was \$1.85 billion. The actual employer contributions for fiscal year ended June 30, 2008 was \$753.5 million resulting in a 41% contributed rate.

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplemental Information following the notes to the financial statements provide multiyear presentations of funding status and ARC to illustrate their trends over time.





Notes to Financial Statements (Continued)

iv. Actuarial Assumptions and Methods

(a) Funding Method

For purposes of determining pension contributions under the PSERS Code, the entry-age normal actuarial cost method of valuation is used in determining benefit liabilities and normal cost. The outstanding balance of the unfunded accrued liability as of June 30, 2001 and the decrease in the unfunded accrued liability due to the actuarial asset method change provided by Act 38 continue to be amortized over a 10-year period, with level dollar funding, beginning July 1, 2002. The increases in the unfunded accrued liability due to the July 1, 2002 and July 1, 2003 cost-of-living adjustments provided by Act 38 were both recognized at June 30, 2002 and continue to be amortized over a 10-year period, with level dollar funding starting on July 1, 2003 and July 1, 2004, respectively. All other changes in the unfunded accrued liability at June 30, 2001 and June 30, 2002, including the Act 9 benefit changes, are amortized over a 30-year period, with level dollar funding starting on July 1, 2002, and July 1, 2003, respectively. Post June 30, 2002 gains and losses, and changes in the unfunded accrued liability resulting from changes in actuarial assumptions and methods, are amortized over a 30-year period with level dollar funding. In addition Act 40 also provided a 4.00% floor on the employer pension rate.

For purposes of determining the annual required contributions under GASB 25, the same funding method is used as for pension funding, except that (i) the 4% pension floor is not taken into account and (ii) in fiscal years in which the amortization requirements of the PSERS Code result in an equivalent single amortization period that is longer than the maximum allowable period specified by GASB 25 (40 years for fiscal years ending on or before June 30, 2006; and 30 years for subsequent fiscal years), the GASB 25 amortization payment will be set equal to the level dollar amount that will amortize the unfunded accrued liability over a period equal to the maximum allowable period specified by GASB 25. For the fiscal year ended June 30, 2007, a 30 year level dollar open amortization method was used.

(b) Asset Valuation Method

For actuarial purposes, assets are valued using a five-year moving market average value that will recognize the 8.5% actuarial expected investment return immediately and spread the difference between actual and expected investment return (beginning with fiscal year ending June 30, 2001) over a period of five years (adopted as of June 30, 2001). Previously, PSERS immediately recognized interest and dividends when earned, and recognized realized and unrealized gains and losses on the market value of assets over a three-year period.

(c) Actuarial Assumptions

Significant actuarial assumptions employed by the actuary for funding purposes as of June 30, 2007, the date of the most recent actuarial valuation include:





Notes to Financial Statements (Continued)

- ◆ Investment return – 8.5%, includes inflation at 3.25%
- ◆ Salary increases – 6.00%, which reflects an allowance for inflation of 3.25%, national productivity of 1%, and merit or seniority increases of 1.75%
- ◆ Amortization method – level dollar funding
- ◆ Benefit payments – no postretirement benefit increases assumed in the future
- ◆ Multiple Decrement Tables – mortality, vesting, retirement age, and withdrawal estimates are based upon tables provided by the actuary

The System's actuarial values are calculated separately for retirees and beneficiaries and for active and inactive members. The actuarial present value of benefits to be paid to retirees and beneficiaries currently receiving benefits and deferred survivor beneficiaries, whose benefits have been determined, is calculated using the assumptions noted above. The Reserve for Retirement Account with interest credited thereon at an annual rate of 5.50% is compared to the actuarial accrued liability for the remaining lifetimes of the retirees and beneficiaries and any deficiency is then funded by a transfer from the State Accumulation Account. Consequently, all such determined benefits are fully funded.

The actuarial accrued liability for active and inactive members is calculated on the projected benefit basis using the entry-age normal actuarial cost method under which the present value of each member's expected benefit payable at retirement or death is determined. The assets of the Members' Savings Account, State Accumulation Account and the fair value adjustment are subtracted from this present value to arrive at the funded or unfunded actuarial accrued liability.

(C) Postemployment Healthcare Plans

i. Health Insurance Premium Assistance Program

(a) Health Insurance Premium Assistance Benefits

The System provides a Health Insurance Premium Assistance Program (premium assistance) for all eligible annuitants who qualify or elect to participate. Under this program, employer contribution rates for premium assistance are established to provide reserves in the Health Insurance Account that are sufficient for the payment of premium assistance benefits for each succeeding year. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. To receive premium assistance, eligible annuitants must obtain their health insurance through either their school employer or the PSERS' Health Options Program (HOP).



Notes to Financial Statements (Continued)

(b) Funding Status and Annual Required Contributions (ARC)

As of June 30, 2007, the most recent actuarial valuation, the plan was 9.2% funded. The actuarial accrued liability for benefits was \$1.1 billion, and the actuarial value of assets was \$97.3 million, resulting in an unfunded accrued liability of \$1.0 billion. The covered payroll of active members was \$11.4 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 8.4%.

For fiscal year ended June 30, 2008, the ARC was \$101.4 million. The actual employer contributions for fiscal year ended June 30, 2008 was \$81.3 million resulting in a 80% contributed rate.

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplemental Information following the notes to the financial statements provide multiyear presentations of funding status and ARC to illustrate their trends over time.

(c) Actuarial Assumptions and Methods

The health insurance liability and funding provisions of the PSERS Code differ from the GASB disclosure requirements. As a result, there are different determinations of actuarial liability and contribution requirements for GASB accounting purposes and for Commonwealth funding purposes. For purposes of funding, the actuarial liability equals the assets in the health insurance account, and the contribution required is the amount necessary to establish reserves sufficient to provide premium assistance payments to all participating eligible annuitants during the fiscal year that immediately follows the year the employer contribution is made. For GASB accounting purposes, the actuarial liability has been determined under the entry age actuarial cost method, and the ARC is equal to the entry age normal cost for health insurance plus an amount that will amortize the entry age unfunded actuarial liability for health insurance over a period of 30 years. The entry age actuarial cost method was selected for this calculation because it meets the GASB parameters for determining actuarial liability and normal cost, and is the cost method specified by the PSERS Code for the PSERS pension plan.

ii. Health Insurance Program (HOP)

The HOP is a PSERS-sponsored voluntary health insurance program for the sole benefit of annuitants of PSERS, spouses of annuitants, survivor annuitants and their dependents. Benefits are provided by managed care providers or by PSERS self-funded fee for service plans. All retirees are eligible to participate in the Enhanced or Basic Options (indemnity plans) regardless of their residence. The managed care plans are available to retirees residing in the plan's service area. The HOP is funded exclusively by the premiums paid by its participants for the benefit coverage they elect. The hospital, medical/surgical and major medical benefits of the Enhanced and Basic Options are self-funded. PSERS uses a third-party administrator to process these claims. An independent actuarial consulting firm sets the rates for the self-funded benefits so that the combination of contributions and the claims fluctuation reserve equal 125% of expected annual incurred claims. The HOP maintains a reserve for claims that are incurred but not reported (IBNR).



Notes to Financial Statements (Continued)

At June 30, 2008 and 2007, PSERS recorded \$11,143,000 and \$10,665,000, respectively, in IBNR which is included in benefits payable.

Effective January 1, 2006, PSERS made significant changes to HOP, in response to the Medicare Modernization Act. PSERS entered into an Employer/Union Entity contract with the Centers for Medicare and Medicaid Services to operate a voluntary Medicare Prescription Drug Plan (PDP). Monthly contributions are received from CMS covering the 38,600 participants in the PDP. The PSERS pension fund assets are not available to fund or satisfy obligations of the HOP.

2. Summary of Significant Accounting Policies

(A) Basis of Accounting

The financial statements of the System are prepared on the accrual basis of accounting under which expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of their trade date. Member and employer contributions are recognized in the period for which employees' salaries are earned. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

The accounting and reporting policies of the System conform to accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions and deductions in plan net assets during the reporting period. Actual results could differ from those estimates.

(B) Investments

The System's investments are reported at fair value. Fair value is the amount that the System can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Short-term securities are carried at cost, which approximates fair value, unless they have published market prices or quotations from national security exchanges or securities pricing services, in which case they are valued at the published market price. Fixed income securities and common and preferred stocks are generally valued based on published market prices and quotations from national security exchanges or securities pricing services. Securities which are not traded on a national security exchange are valued by the respective fund manager or other third parties based on similar sales.

Directly-owned real estate investments are primarily valued based on appraisals performed by independent appraisers or, for properties not appraised, at cost or the present value of the projected future net income stream. Real estate owned investments are reported net of related debt borrowed against the market value of the property. As of June 30, 2008 and 2007, \$132,000,000 in line of credit advances were netted against the related property valuation. The line of credit balance is due on March 14, 2009. The line is payable at an interest rate equivalent to the lender's commercial paper rate plus 40 basis points and is collateralized by certain fixed income investments of the System.





Notes to Financial Statements (Continued)

For alternative investments which include private equity, private debt, venture capital and equity real estate investments where no readily ascertainable market value exists, management, in consultation with the general partner and investment advisors, has determined the fair values for the individual investments based upon the partnership's most recent available financial information. Futures contracts, foreign exchange contracts, and options are marked-to-market daily with changes in market value recognized as part of net appreciation/depreciation in the fair value of investments. Initial margin requirements for such financial instruments are provided by investment securities pledged as collateral or by cash.

Collective trust fund investments (CTF) consist primarily of domestic and international institutional funds. The funds do not pay interest or dividends to shareholders and reinvest all income earned on securities held by the fund. The fair value of CTF is based on the reported share value of the respective fund. CTF are managed by state chartered banks for which various state banking departments have regulatory oversight and investment advisors for which the Securities and Exchange Commission has regulatory oversight.

Investment expenses consist of investment manager fees and those administrative expenses directly related to the System's investment operations. Unsettled investment sales are reported as investment proceeds receivable and unsettled investment purchases are included in investment purchases and other liabilities.

(C) Capital Assets

Capital assets, consisting primarily of data processing equipment and software, are recorded at historical cost. The System depreciates capital assets using the straight-line method over an estimated useful life of seven years.

(D) Benefits Payable

Benefits payable identifies the obligations of the System, on an accrual basis, for the estimated retirement and death benefits payable to PSERS' members or members' beneficiaries at the end of the fiscal year. It also includes the HOP \$11,143,000 IBNR claims reserve as well as the offsetting prescription drug rebate in the amount of \$5,700,000.

(E) Compensated Absences

The System uses the accrual basis of accounting for measuring vacation leave, sick leave, and other compensated absences liabilities. Employees of the System are paid for accumulated vacation leave upon termination or retirement. Retiring employees of the System that meet service, age, or disability requirements are paid between 30% and 100% of sick days available at retirement, up to 163 maximum days paid. As of June 30, 2008 and 2007, \$3,013,000 and \$2,762,000, respectively, was accrued for unused vacation and sick leave for the System's employees and included in "Accounts payable and accrued expenses" on the Statements of Plan Net Assets.





Notes to Financial Statements (Continued)

(F) Participant Premium Advances

Premium advances in 2008 are for HOP premiums related to health care coverage to be provided in 2008. Premium advances in 2007 are for HOP and CMS premiums related to health care coverage and prescription drug coverage provided in 2007.

(G) Federal Income Taxes

The Internal Revenue Service (IRS) issued a determination letter dated March 3, 1978 which stated that the plan and its underlying trust qualify under the provisions of Section 501(a) of the *Internal Revenue Code* (IRC) and therefore are exempt from federal income taxes. The plan has been amended since receiving that determination letter. Additionally, the IRS issued a 1982 ruling which concluded that the fund and the board are integral parts of the Commonwealth, and are therefore not subject to federal income tax. In the opinion of management, the System has operated within the terms of the plan and remains qualified under the applicable provisions of the IRC.

Federal tax legislation was enacted in 2001 that modified the rules for making rollovers to or from pension systems and also established maximum amounts of retirement benefits that can be paid from pension systems. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded the opportunity for members to roll over funds received from PSERS at retirement to a wider variety of plans including, but not limited to, 403(b) tax sheltered annuities and government sponsored 457 deferred compensation plans. The Act permits the rollover of after-tax contributions from PSERS. EGTRRA provided for periodic increases in the annual compensation limits for qualified retirement plans.

The annual compensation limits for 2007 and 2008 were \$225,000 and \$230,000, respectively. EGTRRA also provided for periodic increases in the annual benefit limits for qualified defined benefit plans. The maximum annual defined benefit limits at age 62 for 2007 and 2008 were \$180,000 and \$185,000, respectively.

(H) Risk Management

The System is exposed to various liabilities and risks of loss, including, without limitation, the ordinary risks of investment losses, risks related to theft or destruction of assets, liabilities resulting from injuries to employees, and liabilities resulting from court challenges to fiduciary decisions. As an administrative agency of the Commonwealth of Pennsylvania, the System is accorded sovereign immunity. For claims not shielded by sovereign immunity, the System participates in certain Commonwealth pooled insurance programs and requires asset managers to carry certain insurance coverage for the protection of the System. The System has implemented a self-insurance program for fiduciary and director and officer liability coverage. During the past three fiscal years, insurance settlements did not exceed insurance coverage.

(I) Reclassifications

Certain 2007 amounts have been reclassified in conformity with the 2008 presentation.



Notes to Financial Statements (Continued)

(J) Members Receivables

Member's receivables include an amount for members' obligations to the System for the purchase of service credit in the amount of \$166,951,874. Members have a variety of options to remit purchase of service payments:

- Remit a lump sum payment.
- Request an installment plan from one to seven years where the member's employer establishes a payroll deduction process. The member's employer then forwards quarterly payments of the withheld amounts to PSERS.
- Accept an actuarial reduction debt through which the amount of the purchase plus accumulated interest will reduce the member's retirement or death benefit.
- Rollover funds from an eligible distribution.

Because members have control over the timing of their remittances to the System, many purchases of service receivables extend beyond one year. An estimated \$152,000,000 of the \$253,356,000 members pension receivables at June 30, 2008 are expected to be collected by the System subsequent to June 30, 2009.

(K) Adoption of New Accounting Standards

During the year ended June 30, 2007 the System adopted Governmental Accounting Standards Board Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* ("GASB 43"). GASB 43 established reporting standards for the annual financial reports of postemployment benefit plans other than pension plans. These reporting requirements apply to the Health Insurance Premium Assistance Program. The adoption of GASB 43 required the System to include disclosures for premium assistance in the Required Supplemental Information's Schedule of Funding Progress and Schedule of Employer Contributions.

In June 2004 the Governmental Accounting Standards Board issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions* ("GASB 45"). GASB 45 changed how Other Postemployment benefits (OPEB) costs are reported by employer governments, charging employer OPEB costs during the periods when employees render services. The System adopted this Statement during the year ended June 30, 2008.

During the year ended June 30, 2008 the System adopted Governmental Accounting Standards Board Statement No. 50, *Pension Disclosures*, an amendment of GASB statements 25 and 27 ("GASB 50"). GASB 50 was issued by the Governmental Accounting Standards Board to amend financial statement note disclosures and required supplementary information for pension plans to be consistent with applicable standards under GASB 43 and GASB 45.



Notes to Financial Statements (Continued)

3. Description of Accounts

The Code requires the System to maintain the following accounts which represent reserves held for future and current benefit payments as follows:

(A) State Accumulation Account

The State Accumulation Account is credited with the contributions of the Commonwealth and the employers. Additionally, interest earnings of the System (after crediting the Members' Savings Account with 4% interest and the reserve for retirement with 5.50% statutory interest) are credited to this account. Each year, the necessary amounts, as determined by the actuary for the payment of retirement, disabilities, and death benefits, are transferred from the State Accumulation Account to the Reserve for Retirement Account increasing the reserve credit to the 8.5% valuation assumption rate determined by the actuary. All administrative expenses necessary for the operation of the System, except for premium assistance and HOP expenses, are paid from the State Accumulation Account.

(B) Members' Savings Account

The Members' Savings Account is credited with all contributions made by active members of the System. Interest is added to the member's individual account at an annual rate of 4%.

Upon death or retirement of a member, the accumulated contributions plus interest are transferred to the Reserve for Retirement Account for subsequent payment of benefits.

(C) Reserve for Retirement Account

The Reserve for Retirement Account represents the amounts transferred from the Members' Savings and State Accumulation Accounts, plus additional contributions made by the Commonwealth and employers for the payment of supplemental annuities and cost-of-living increases. All death, disability, and retirement benefits are paid from this account. Annual interest of 5.50% is credited to the Reserve for Retirement Account.

(D) Health Insurance Account

The Health Insurance Account is credited with contributions of the Commonwealth and the employers for the health insurance premium assistance program. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. The Health Insurance Account pays all administrative expenses necessary to operate the health insurance premium assistance program.

(E) Health Insurance Program Account

The Health Insurance Program Account is credited with contributions from members of the HOP and from CMS. All benefits related to the HOP (premium payments to the insurance companies and self-funded benefits) are paid from this account. The Health Insurance Program Account pays all administrative expenses necessary to operate the HOP.



**Notes to Financial Statements (Continued)****(F) Pension and Postemployment Healthcare Net Assets**

Net assets held in trust for pension and postemployment healthcare benefits at June 30 follows:

	(Dollar Amounts in Thousands)	
	2008	2007
Pension:		
State accumulation account	\$ 16,392,728	\$ 25,839,716
Members' savings account	10,532,683	10,183,433
Reserve for retirement account	<u>35,548,015</u>	<u>31,317,848</u>
	<u>\$ 62,473,426</u>	<u>\$ 67,340,997</u>
Postemployment healthcare:		
Health insurance account	\$ 95,785	\$ 97,292
Health insurance program account	<u>89,413</u>	<u>84,415</u>
	<u>\$ 185,198</u>	<u>\$ 181,707</u>

4. Investments**(A) Summary of Investments**

The Board has the responsibility to invest and reinvest available funds of the System in accordance with the guidelines and limitations set forth in the Code and other applicable state law. The Board accomplishes the daily management of the System's investments through investment advisors who act as agents for the System and through internal investment managers.

The Board invests the funds of the System using the Prudent Investor Standard, as articulated in the Code, which 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 Board has adopted its investment policy to formally document investment objectives and responsibilities. This policy, as well as applicable state law, establishes guidelines for permissible investments of the System.





Notes to Financial Statements (Continued)

A summary of the fair value of investments at June 30 follows:

	(Dollar Amounts in Thousands)	
	2008	2007
Pension investments:		
Short-term:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	\$ 2,405,509	\$ 3,148,246
Other domestic short-term	3,955,811	724,343
International short-term	479,450	110,696
	6,840,770	3,983,285
Fixed income:		
Domestic mortgage-backed securities	5,389,010	6,190,646
U.S. government and agency obligations	1,785,467	2,608,384
Domestic corporate and taxable municipal bonds	3,277,625	3,633,248
Miscellaneous domestic fixed income	290,847	150,039
Collective trust funds	2,294,869	1,202,848
International fixed income	2,139,075	2,134,833
	15,176,893	15,919,998
Common and preferred stock:		
Domestic common and preferred stock	8,995,463	15,185,715
Collective trust funds	4,808,851	4,564,836
International common and preferred stock	14,071,010	18,964,922
	27,875,324	38,715,473
Real estate:		
Equity real estate	4,673,806	3,566,959
Directly-owned real estate	278,034	321,027
	4,951,840	3,887,986
Alternative investments:		
Private equity	5,752,298	4,140,276
Private debt	2,371,506	1,093,256
Venture capital	741,848	605,534
	8,865,652	5,839,066
Pension investments at fair value	\$63,710,479	\$68,345,808
Postemployment Healthcare investments:		
Premium Assistance:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	\$ 19,627	\$ 21,363
Other domestic short-term	47,773	47,506
	67,400	68,869
Health Options Program:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	60,962	66,538
Other domestic short-term	53,379	45,318
	114,341	111,856
Postemployment Healthcare investments at fair value	\$ 181,741	\$ 180,725





Notes to Financial Statements (Continued)

(B) Deposit and Investment Risk Disclosures

i. Deposits

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, the System would not be able to recover the value of the deposits. The State Treasury Department is the custodian of the System's fund. State Treasury Department deposits must be held in insured depositories approved by the Commonwealth's Board of Finance and Revenue and must be fully collateralized.

The System, through its third party administrator, maintains certain bank deposits for the operation of its voluntary health insurance program. These deposits are not required to be collateralized by statute or policy. These deposits totaled \$53,379,000 and \$45,318,000 at June 30, 2008 and 2007, respectively, and are under the custody of M&T Bank which has an A- Deposit/Debt rating by Standard and Poor's (S&P) and an A2 rating by Moody's Investor Services (Moody's).

ii. Investment Risks

The System's investments may be subject to various risks. Among these risks are concentration of credit risk, custodial credit risk, credit risk, interest rate risk, and foreign currency risk. The policies addressing each one of these risks, discussed in more detail below, are contained within the Investment Policy Statement, Objectives, and Guidelines reviewed and approved annually by the Board. Due to the level of risk associated with certain investments, it is possible that changes in the values of investments may occur in the near term and that such changes could materially affect the amounts reported in the Statements of Plan Net Assets.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of the System's investment in a single issuer. As of June 30, 2008 and 2007 the System has no single issuer that exceeds 5% of total investments. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments are excluded.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System would not be able to recover the value of investment or collateral securities that are in the possession of an outside party. In accordance with a contractual relationship between the Commonwealth's Treasury Department and its custodial agent, substantially all investments, where securities are used as evidence of the investment, are held by the custodian in book-entry form in the System's name. Those investments are defined as insured or registered investments for which the securities are held by the System or its agent and, therefore, have very minimal level of custodial credit risk. The remaining investments, which do not have securities that are used as evidence of the investment, are primarily in collective trust funds and limited partnerships, which include real estate and alternative investments.





Notes to Financial Statements (Continued)

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by nationally recognized statistical rating organizations (NRSRO) such as Fitch Investor Services (Fitch), Moody's, and S&P. Annually, the Board establishes an asset allocation plan. This plan manages the overall credit risk of the fixed income asset class through a clearly defined long-term asset allocation policy. This policy establishes a long-term target allocation of the fixed income asset class at 22% of the investment portfolio. The fixed income target allocation consists of:

- An allocation of 13.0% of the portfolio has been made to the domestic core plus and high yield segments of the fixed income asset class benchmarked to the Lehman Brothers U.S. Universal Index. The domestic core plus allocation is composed of primarily investment grade, relatively liquid, public domestic bonds with an overall weighted-average NRSRO credit rating of A or better while the high yield allocation focuses on less liquid public non-investment grade fixed income securities with an overall weighted-average NRSRO credit rating of BB+ or less;
- An allocation of 5% of the portfolio has been made to the Treasury Inflation-Protected Securities (TIPS) segment of the fixed income asset class benchmarked to the Lehman U.S. TIPS Index and composed of primarily government issued TIPS with an overall weighted-average NRSRO credit rating of AA or better;
- An allocation of 4.0% of the portfolio has been made to the global core plus fixed income asset class benchmarked to the Lehman Brothers Multiverse Index composed of primarily investment grade, relatively liquid U.S. and non-U.S. public bonds with an overall weighted-average NRSRO credit rating of A or better.

The following table discloses aggregate market value by credit quality rating category. Many securities have ratings from more than one NRSRO and sometimes those ratings differ from one NRSRO to another. The data listed below uses the rating (expressed as S&P equivalent); available from Fitch, Moody's and/or S&P that indicates the greatest degree of risk at June 30, 2008 and 2007.

Quality Rating	(Dollar Amounts in Thousands)	
	2008 Fair Value	2007 Fair Value
AAA	\$ 8,436,260	\$ 7,608,036
AA	1,435,628	907,907
A	1,824,267	1,254,699
BBB	1,593,709	1,291,445
BB and below	904,053	957,173
NR*	<u>5,748,497</u>	<u>5,206,707</u>
Total Exposed to Credit Risk	19,942,414	17,225,967
U.S. Government Guaranteed**	<u>2,256,990</u>	<u>2,858,041</u>
Total Fixed Income and Short-Term Investments	<u>\$ 22,199,404</u>	<u>\$ 20,084,008</u>





Notes to Financial Statements (Continued)

* Not Rated securities include \$2,294,869 and \$1,202,848 in collective trust funds at June 30, 2008 and 2007, respectively. Also included are \$2,486,098 and \$3,236,147 at June 30, 2008 and 2007, respectively, in the Pennsylvania (PA) Treasury Domestic Short-Term Investment Fund (STIF), a pooled investment fund for which ratings were unavailable. The STIF pool is comprised of short-term, high credit quality securities which are mainly U.S. Treasuries, agencies or repurchase agreements.

**Comprised of U.S. government and agency obligations explicitly guaranteed by the U.S. government and not considered to have credit risk.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of a fixed income investment. The System manages its interest rate risk by diversifying the fixed income portfolio and maintaining the fixed income portfolio at an effective duration range between 65 and 135 percent of the benchmark index.

Duration is a measure of the approximate sensitivity of a bond's value to interest rate changes. The higher the duration, the greater the changes in fair value when interest rates change. For example, a duration of 4.0 would mean that, given a 100-basis point change up/down in rates, a bond's price would move down/up approximately 4.0%. PSERS measures interest rate risk using option-adjusted duration, which recognizes the fact that yield changes may change the expected cash flows due to embedded options.

At June 30, 2008 and 2007, the System's fixed income portfolio had the following option-adjusted durations by fixed income sector:

Investment Type	(Dollar Amounts in Thousands)			
	2008		2007	
	Option-Adjusted Duration	Fair Value	Option-Adjusted Duration	Fair Value
Domestic mortgage-backed securities	3.2	\$ 5,389,010	3.3	\$ 6,190,646
U.S. government and agency obligations	7.8	1,785,467	6.6	2,608,384
Domestic corporate and taxable municipal bonds	3.4	3,277,625	3.0	3,633,248
Miscellaneous domestic fixed income	0.7	290,847	1.0	150,039
Fixed income collective trust funds	3.3	2,294,869	4.2	1,202,848
International fixed income	5.5	2,139,075	5.2	2,134,833
PA Treasury Domestic Short-Term Investment Fund	0.2	<u>2,486,098</u>	0.1	<u>3,236,147</u>
Total fixed income & PA Treasury Domestic Short-Term Investment Fund	3.5*	17,662,991	3.4*	19,156,145
Total adjustment for futures contracts	<u>0.1**</u>	—	<u>0.1**</u>	—
Total fixed income & PA Treasury Domestic Short-Term Investment Fund	<u>3.6**</u>	<u>\$ 17,662,991</u>	<u>3.5**</u>	<u>\$ 19,156,145</u>





Notes to Financial Statements (Continued)

* The option-adjusted duration of 3.5 and 3.4 at June 30, 2008 and 2007, respectively, for the total fixed income & PA Treasury Domestic Short-Term Investment Fund portfolio is calculated by weighting the option-adjusted duration of each investment type by market value.

** Fixed income investment managers enter into futures contracts to adjust the durations of their portfolios as a whole rather than any particular investment type within the portfolio. In total, the futures contracts have adjusted PSERS' total fixed income & PA Treasury Domestic Short-Term Investment Fund portfolio duration upward by 0.1 at June 30, 2008 and 2007.

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. As part of the System's program to manage risk and enhance returns, the System invests in non-U.S. markets. Investment managers in non-U.S. equity and global fixed income may hedge their non-U.S. foreign currency exposure back to U.S. dollars. The System also reduces the exposure to currency risk by hedging to a target of 30% of MSCI EAFE Index country currencies to the U.S. dollar. At June 30, 2008 and 2007 PSERS had the following non-U.S. currency exposure:

Currency	2008					Total Fair Value
	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Currency Hedge	
Euro	\$ 2,911,313	\$ 872,140	\$ 1,245,999	\$ 561,554	\$ (2,281,603)	\$ 3,309,403
British pound sterling	2,682,672	231,969	6,745	(60,345)	(1,256,994)	1,604,047
Japanese yen	2,425,174	179,157	-	(3,819)	(1,177,085)	1,423,427
Canadian dollar	943,768	131,162	18,768	(119,393)	-	974,305
Australian dollar	594,116	7,352	-	241,340	(248,944)	593,864
Hong Kong dollar	704,625	-	-	3,799	(116,211)	592,213
Swedish krona	157,499	112,328	-	142,750	-	412,577
South Korean won	266,245	-	-	26,443	-	292,688
Singapore dollar	271,740	18,010	-	(20,947)	-	268,803
Brazil real	151,327	3,127	-	80,306	-	234,760
Other non-US currencies	1,967,199	27,047	-	(6,613)	(416,793)	1,570,840
Total	\$ 13,075,678	\$ 1,582,292	\$ 1,271,512	\$ 845,075	\$ (5,497,630)	\$ 11,276,927



Notes to Financial Statements (Continued)

Currency	2007					
	(Dollar Amounts in Thousands)					
	Equity	Fixed Income	Alternative Investments	Short-Term*	Currency Hedge	Total Fair Value
Euro	\$ 4,543,147	\$ 924,033	\$ 720,273	\$ (232,932)	\$ (1,864,314)	\$ 4,090,207
British pound sterling	3,330,681	242,722	67,078	596,752	(864,825)	3,372,408
Japanese yen	3,096,446	218,152	-	(177,619)	(1,056,235)	2,080,744
Australian dollar	779,589	7,225	-	244,290	-	1,031,104
Canadian dollar	845,365	127,283	15,675	(120,701)	-	867,622
Hong Kong dollar	856,048	-	-	6,503	(86,725)	775,826
South Korean won	529,302	12,076	-	38,661	-	580,039
Swedish krona	475,061	75,172	-	(64,834)	-	485,399
New Zealand dollar	13,059	14,251	-	316,422	-	343,732
Taiwan dollar	298,257	-	-	40,574	-	338,831
South African rand	305,065	-	-	10,776	-	315,841
Norwegian krone	169,799	3,156	-	129,486	-	302,441
Other non-US currencies	<u>2,544,082</u>	<u>99,498</u>	<u>-</u>	<u>(697,691)</u>	<u>(363,529)</u>	<u>1,582,360</u>
Total	<u>\$ 17,785,901</u>	<u>\$ 1,723,568</u>	<u>\$ 803,026</u>	<u>\$ 89,687</u>	<u>\$ (4,235,628)</u>	<u>\$ 16,166,554</u>

* Includes investment receivables and payables.

(C) Securities Lending

In accordance with a contract between the Commonwealth and its custodial agent, the System participates in a securities lending program. Under this program, the custodian, acting as the lending agent, loans securities (equities, fixed income issues and money market instruments) to independent brokers and dealers in exchange for collateral in an amount not less than 102% of the fair value of any securities loaned except for non-U.S. corporations for which 105% of the fair value is required. For Euro fixed income debt issues, for which the Commonwealth receives Euros as collateral and international fixed income debt issues denominated in U.S. dollars, the collateral required to be exchanged is in an amount not less than 102% of the fair value of any securities loaned. Collateral is marked-to-market daily. If the fair value of the collateral held falls below the minimum guidelines for securities loaned, additional collateral is obtained. In lieu of certain approved securities or cash, the borrower may deliver to the lending agent irrevocable bank letters of credit as collateral. If the collateral obtained consists in whole or in part of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the Commonwealth.



Notes to Financial Statements (Continued)

As of June 30, 2008 and 2007, the System had no credit risk exposure to borrowers because the amounts the System owed the borrowers exceeded the amounts the borrowers owed the System. Under the securities lending program, the lending agent provides indemnification to the Commonwealth if the same borrowers fail to return the underlying securities (and the collateral is inadequate to replace the loaned securities) or fail to pay income distributions on them. There were no losses during the fiscal years ended June 30, 2008 and 2007, resulting from a default of the borrowers or the lending agent.

All securities loans can be terminated on demand by either the System or the borrower, although the average term of the loan is one day. There were no term loans as of June 30, 2008 and 2007.

Cash collateral is invested in the lending agent's short-term investment pool and is not subject to custodial credit risk. The System's income from securities lending represents its pro-rata share from participating in the program. The weighted-average maturity of the investments in the pool was 25 days and 36 days at June 30, 2008 and 2007, respectively. The relationship between the maturities of the investment pool and the System's loans is affected by the maturities of the securities loans made by other entities that use the lending agent's pool, which the System cannot determine. The System cannot pledge or sell collateral securities received unless the borrower defaults. In the event of a default, the lending agent may use the collateral to replace the loaned securities.

As of June 30, 2008, the fair value of loaned securities was \$7,465,573,000, which includes \$2,939,093,000 of loaned securities, which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$8,053,669,000 of which \$4,846,999,000 was cash. As of June 30, 2007, the fair value of loaned securities was \$9,843,769,000, which includes \$1,345,657,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$10,209,493,000 of which \$8,806,979,000 was cash.

5. Derivative and Other Similar Investments

The System enters into a variety of financial contracts, which include options and futures. The System also enters into foreign exchange positions, such as forward and spot contracts to obtain or hedge foreign currency exposure; swap agreements to gain exposure to certain sectors of the equity and fixed income markets; collateralized mortgage obligations (CMOs); other forward contracts, and U.S. Treasury strips. The System is not a dealer, but an end-user of these instruments. The contracts are used primarily to enhance performance and reduce the volatility of the portfolio. The System is exposed to credit risk in the event of non-performance by counterparties to financial instruments. As the System generally enters into transactions only with high quality institutions, no losses associated with counterparty nonperformance on derivative financial instruments have been incurred. Legal risk is mitigated through selection of executing brokers and review of all documentation. The System is exposed to market risk, the risk that future changes in market conditions may make an instrument less valuable. Exposure to market risk is managed in accordance with risk limits set by senior management, through buying or selling instruments or entering into offsetting positions.





Notes to Financial Statements (Continued)

The notional or contractual amounts of derivatives indicate the extent of the System's involvement in the various types and uses of derivative financial instruments and do not measure the System's exposure to credit or market risks and do not necessarily represent amounts exchanged by the parties. The amounts exchanged are determined by reference to the notional amounts and the other terms of the derivatives.

The following table summarizes the aggregate notional or contractual amounts for the System's derivative financial instruments at June 30, 2008 and 2007 (in thousands):

	2008	2007
Futures contracts – long	\$ 11,962,986	\$ 11,887,271
Futures contracts – short	5,046,611	4,528,407
Foreign exchange forward and spot contracts, gross	20,668,439	21,675,965
Options – calls purchased	154,767	1,622,129
Options – puts purchased	322,841	278,896
Options – calls sold	159,300	1,675,223
Options – puts sold	501,896	363,893
Swaps – total return	2,570,616	949,347
Swaps – interest rate	826,124	183,000

Futures contracts are contracts in which the buyer agrees to purchase and the seller agrees to make delivery of a specific financial instrument at a predetermined date and price. Gains and losses on futures contracts are settled daily based on a notional (underlying) principal value and do not involve an actual transfer of the specific instrument. Futures contracts are standardized and are traded on exchanges. The exchange assumes the risk that a counterparty will not pay and generally requires margin payments to minimize such risk. In addition, the System enters into short sales, sales of securities it does not presently own, to neutralize the market risk of certain equity positions. Initial margin requirements on futures contracts and collateral for short sales are provided by investment securities pledged as collateral and by cash held by various brokers. Although the System has the right to access individual pledged securities, it must maintain the amount pledged by substituting other securities for those accessed. The value of securities pledged and the amount of cash held at June 30, 2008 and 2007 represent a restriction on the amount of assets available as of year-end for other purposes.

Option contracts provide the option purchaser with the right, but not the obligation, to buy or sell the underlying security at a set price during a period or at a specified date. The option writer is obligated to buy or sell the underlying security if the option purchaser chooses to exercise the option. The System generally uses exchange listed currency, index, stock, and futures options. The System has authorized an investment manager to write covered call stock index option spreads up to a notional amount of \$1,500,000,000.

Foreign exchange contracts involve an agreement to exchange the currency of one country for the currency of another country at an agreed-upon price and settlement date. The contracts reported above primarily include forwards. The \$20,668,439,000 of foreign currency contracts outstanding at June 30, 2008 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of \$8,391,990,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of \$12,276,449,000.





Notes to Financial Statements (Continued)

The \$21,675,965,000 of foreign currency contracts outstanding at June 30, 2007 consist of “buy” contracts of \$9,327,473,000 and “sell” contracts of \$12,348,492,000. The unrealized gain (loss) on contracts of \$(94,298,000) and \$26,459,000 at June 30, 2008 and 2007, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The System has authorized an investment manager to manage a currency hedge portfolio consisting of foreign exchange spot and forward contracts, currency futures, and currency options to hedge up to a notional amount of \$7,000,000,000 of the MSCI EAFE Index currencies to U.S. dollars.

Swap agreements provide for periodic payments at predetermined future dates between parties based on the change in value of underlying indexes or interest rates. During the year ended June 30, 2008 and 2007, the System entered into total return swaps and interest rate swaps. Under the total return swap arrangements, the System receives the net return of certain equity indexes in exchange for a short-term rate minus a spread. The payable on the total return swap contracts of \$(184,438,000) and \$(7,110,000) at June 30, 2008 and 2007, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The contracts have varying maturity dates ranging from August 13, 2008 to April 15, 2010. Interest rate swap agreements involve the exchange by the System with another party of their respective commitments to pay or receive interest, e.g. an exchange of floating rate payments for fixed rate payments with respect to a notional amount of principal. The System uses interest rate swaps as the most cost-effective way to gain exposure to certain sectors of the fixed income market. The receivable on the interest rate swap contracts of \$8,238,000 and \$2,424,000 at June 30, 2008 and 2007, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The contracts have varying maturity dates ranging from July 31, 2008 to December 10, 2008.

The System also invests in mortgage-backed securities (MBS) such as CMOs and MBS forwards to maximize yields. These securities are sensitive to prepayments of mortgages, which may result from a drop in interest rates. The MBS forwards are subject to credit risk in the event of nonperformance by counterparties. The fair value of CMOs at June 30, 2008 and 2007 is \$2,574,096,000 and \$2,566,980,000, respectively.

The System invests in U.S. Treasury strips which essentially act as zero coupon bonds and are subject to market volatility from a rise or drop in interest rates.

Through certain collective trust funds, the System also indirectly holds various derivative financial instruments. The collective trust funds invest in futures and options thereon; forward foreign currency contracts; options; interest rate, currency, equity, index, and total return swaps; interest-only strips; and CMOs, to enhance the performance and reduce the volatility of their portfolios.

6. Pension Plan for Employees of the System

The System contributes to the Commonwealth's State Employees' Retirement System (SERS), a cost-sharing multiple-employer defined benefit pension plan. SERS provides retirement, death, and disability benefits to plan members and beneficiaries according to Commonwealth statute. SERS issues a publicly available financial report that can be obtained by writing to SERS, 30 N. Third Street, P. O. Box 1147, Harrisburg, Pennsylvania 17108-1147.



Notes to Financial Statements (Continued)

The contribution requirements of plan members and the System are mandated by Commonwealth statute. Most SERS plan members are required to contribute 5% or 6.25% of their annual covered payroll depending upon service class. The System is required to contribute at an actuarially determined rate. The rates applied to annual covered payroll were 3.28% at June 30, 2008, 3.23% at June 30, 2007 and 2.37% at June 30, 2006. The System's contributions to SERS for the years ended June 30, 2008, 2007 and 2006 were \$602,000, \$534,000 and \$418,000, respectively, which were equal to the required contributions each year.

7. Postemployment Healthcare Plan for Employees of the System

The System participates in the Commonwealth's Retired Employees Health Program (REHP). The REHP is a single-employer plan and provides certain healthcare benefits to qualifying individuals meeting specified age and/or service requirements. The Commonwealth's Office of Administration (OA), in its sole discretion, determines available REHP benefits on an ongoing basis. REHP funding is arranged among OA, the Governor's Budget Office and the Pennsylvania Employees' Benefit Trust Fund (PEBTF). The PEBTF is a third-party administrator for the REHP under the provisions of an Administrative Agreement between OA and PEBTF.

A portion of OPEB costs for retiree healthcare benefits are charged as a component of payroll expenditures on a 'pay-as-you-go' basis. The 2007-2008 costs were charged at the rate of \$240/employee/bi-weekly pay period. Plan members who retired after June 30, 2005 contribute to the plan based on a percentage of their final annual gross base salary at the time of retirement. Plan member contribution rates vary based on retirement date.

In May 2008 the Commonwealth released an Actuarial Valuation of its Post-Retirement Medical Plan as of February 2008 covering the fiscal year ended June 30, 2008. The Valuation indicated overall Annual Required Contributions of \$590,460,000, with the System's allocated portion at \$2,433,000. The Governor's Budget Office states that the Commonwealth's policy is to fully fund the \$590 million ARC. Included in the Valuation is an estimate of the REHP's Schedule of Funding Progress for the Fiscal Year ended June 30, 2008. It reflects a funded ratio of .52% on an estimated covered payroll of \$3,559,000,000. The actuarial valuation is available at the Office of the Budget's website at: <http://www.budget.state.pa.us/budget/cwp/view.asp?A=3&Q=213853>

8. Litigation and Contingencies

The System is subject to various threatened and pending lawsuits. These lawsuits include issues related to benefit calculations and eligibility. It is the opinion of management that the ultimate liability arising from such threatened and pending litigation will not have a material effect on the financial position of the System. The System is exposed to various other liabilities and risks related to fiduciary responsibilities of directors and officers.



Required Supplemental Schedule 1 Schedule of Funding Progress*

(Unaudited – See Accompanying Auditor’s Report)

(Dollar amounts in millions)

Pension

Valuation as of June 30	(1) Actuarial accrued liabilities (AAL)	(2) Actuarial value of assets	(3) (Funded) Unfunded actuarial accrued liabilities (FAAL) or UAAL (1) – (2)	(4) Ratio of assets to AAL (2) / (1)	(5) Covered payroll	(6) (FAAL) or UAAL as a percentage of covered payroll (3) / (5)
2007	\$ 66,495.8	\$ 57,057.8	\$ 9,438.0	85.8%	\$ 11,410.3	82.7%
2006	64,627.3	52,464.7	12,162.6	81.2%	11,419.0	106.5%
2005	61,129.4	51,122.1	10,007.3	83.6%	10,527.7	95.1%
2004	56,978.1	51,949.6	5,028.5	91.2%	10,030.7	50.1%
2003	54,313.3	52,770.0	1,543.3	97.2%	9,652.9	16.0%
2002	51,693.2	54,193.1	(2,499.9)	104.8%	9,378.9	(26.7)%

Premium Assistance

Valuation as of June 30	(1) Actuarial accrued liabilities (AAL)	(2) Actuarial value of assets	(3) (Funded) Unfunded actuarial accrued liabilities (FAAL) or UAAL (1) – (2)	(4) Ratio of assets to AAL (2) / (1)	(5) Covered payroll	(6) (FAAL) or UAAL as a percentage of covered payroll (3) / (5)
2007	\$ 1,058.1	\$ 97.3	\$ 960.8	9.2%	\$ 11,410.3	8.4%
2006	1,056.2	92.8	963.4	8.8%	11,419.0	8.4%

* The amounts reported in the Schedule of Funding Progress do not include assets or liabilities for the HOP.

Each time a new benefit is added which applies to service already rendered, an “unfunded accrued liability” is created. The laws governing PSERS require that these additional liabilities be financed systematically over a period of future years. Also, if actual financial experiences are less favorable than assumed financial experiences, the difference is added to unfunded accrued liabilities.

In an inflationary economy, the value of the dollar is decreasing. In this environment, employees pay in greater dollar amounts, resulting in a dollar increase in unfunded accrued liabilities. This occurs at a time when the actual substance of these items may be decreasing. Looking at just the dollar amounts of unfunded accrued liabilities can be misleading. Unfunded accrued liabilities divided by active employee payroll provides an index which clarifies understanding. The smaller the ratio of unfunded liabilities to covered payroll, the stronger the system. Observation of this relative index over a period of years will give an indication of whether the system is becoming financially stronger or weaker.



Required Supplemental Schedule 2 Schedule of Employer Contributions

(Unaudited – See Accompanying Auditor’s Report)
(Dollar amounts in thousands)

Pension

Year ended June 30	Annual Required Contributions	Actual Employer Contributions	Percentage Contributed
2008	\$ 1,852,238	\$ 753,532	41%
2007	1,708,821	659,545	39%
2006	1,328,373	456,878	34%
2005	945,107	431,556	46%
2004	321,091	321,091	100%
2003	20,831	20,831	100%

Premium Assistance

Year ended June 30	Annual Required Contributions	Actual Employer Contributions	Percentage Contributed
2008	\$ 101,352	\$ 81,317	80%
2007	94,970	86,763	91%

The Board adopted all contribution rates as recommended by the Actuary pursuant to the prevailing provisions of the Retirement Code for each year.

Supplemental Schedule 1 Schedule of Operating Expenses

Year Ended June 30, 2008
(Dollar Amounts in Thousands)

	Administrative Expenses (1)	Investment Expenses (2)	Total
Personnel costs:			
Salaries and wages	\$ 14,077	\$ 2,833	\$ 16,910
Social security contributions	1,144	219	1,363
Retirement contributions	481	121	602
Employees' insurance contributions	4,282	496	4,778
Other employee benefits	625	956	1,581
Total personnel costs	20,609	4,625	25,234
Operating costs:			
Investment managers' fees	-	386,614	386,614
Custodian fees	-	495	495
Specialized services	17,638	2,342	19,980
Rental of real estate, electricity	1,708	142	1,850
Consultant and legal fees	740	3,189	3,929
Treasury and other Commonwealth services	1,968	143	2,111
Postage	1,388	-	1,388
Contracted maintenance and repair services	446	17	463
Office supplies	724	21	745
Rental of equipment and software	913	314	1,227
Printing	717	-	717
Travel and training	311	59	370
Telecommunications	573	10	583
Equipment (not capitalized)	1,069	14	1,083
Miscellaneous expenses	230	1,151	1,381
Total operating expenses	28,425	394,511	422,936
Fixed charges:			
Furniture and fixtures	25	-	25
Depreciation	191	-	191
Total fixed charges	216	-	216
Total operating expenses	\$ 49,250	\$ 399,136	\$ 448,386

- (1) Includes administrative expenses of \$1,244 related to Postemployment Healthcare Premium Assistance and \$12,143 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2008.
- (2) Includes investment expenses of \$38 related to Postemployment Healthcare Premium Assistance for fiscal year ended June 30, 2008 and does not include \$27,270 in capitalized broker commissions for the fiscal year ended June 30, 2008.

Supplemental Schedule 2 Summary of Investment Expenses

Year Ended June 30, 2008
(Dollar Amounts in Thousands)

	Assets under management*	Fees
External management		
Domestic equity	\$ 5,887,000	\$ 68,780
International equity	10,776,000	55,379
Fixed income	10,002,000	33,886
Real estate	5,904,000	79,884
Private equity and debt	7,276,000	113,567
Venture capital	742,000	19,143
Commodities	3,175,000	15,975
Total external management	43,762,000	386,614
Total internal management	18,942,000	8,444
Total investment management	\$ 62,704,000	\$ 395,058
Custodian fees		495
Consultant and legal fees		3,189
Miscellaneous expenses		394
Total investment expenses		\$ 399,136

* Net asset value of investments at June 30, 2008



Supplemental Schedule 3 Schedule of Payments to Non-Investment Consultants

Year Ended June 30, 2008
(Payment amounts greater than \$50,000)

<u>Consultant</u>	<u>Fees</u>	<u>Services Provided</u>
CoreSource, Inc.	\$ 9,155,102	Postemployment healthcare benefits administration and claims adjudication
The Segal Company	2,789,611	Actuarial services and consulting for HOP and prescription drug plan
Vitech Systems Group, Inc.	2,358,645	NPAS project development
Rx Solutions, Inc.	1,725,318	Administration of postemployment healthcare benefits and prescription drug plan
Independent Pharmaceutical Consultants, Inc.	551,192	Administration of postemployment healthcare benefits and prescription drug plan
Buck Consultants LLC	502,196	Pension benefit actuarial services
Gunther International LTD	322,968	Communication and mailing services
Clifton Gunderson LLP	117,000	Financial audit of pension system and postemployment healthcare programs

