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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, 2009 and 2008, as listed in the table of contents. These financial statements are the responsibility of 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, 2009 and 2008, 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 subjected 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, 2009  
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, 2009, 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, 2009, 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, 2008 to June 30, 2009, 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, along 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 -26.54% for the fiscal year ended June 30, 2009 (FY 2009), -2.82% for the fiscal year ended June 30, 2008 (FY 2008) and 22.93% for the fiscal year ended June 30, 2007 (FY 2007).

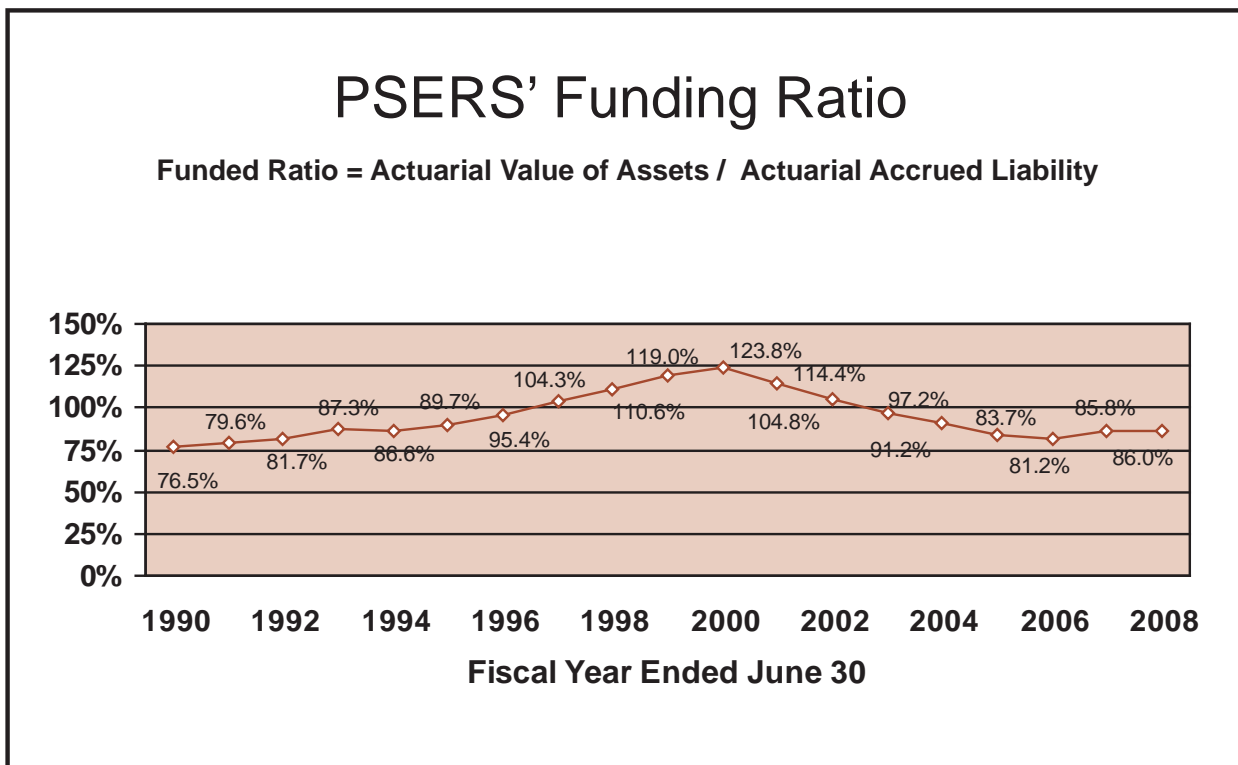
## Management's Discussion and Analysis (Continued)

- PSERS' total plan net assets decreased by \$19.5 billion from \$62.7 billion at June 30, 2008 to \$43.2 billion at June 30, 2009. 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 for both periods is primarily attributable to net investment loss and payment of pension benefits and administrative expenses combined that exceeded member and employer contributions.
- PSERS' funded ratio as of the latest actuarial valuation dated June 30, 2008 increased from 85.8% at June 30, 2007 to 86.0% at June 30, 2008. The increase is primarily due to experience gains on investment assets that were partially offset by liability losses, assumption changes, and by contributions that were less than the normal cost plus interest on the unfunded liability. The funded ratio at June 30, 2006 was 81.2%.
- Total member contributions increased from \$1.04 billion in FY 2008 to \$1.09 billion in FY 2009. Total member contributions also increased from FY 2007 to FY 2008. The increases for both periods were due to a slight increase in the average member contribution rate and an increase in the active member payroll.
- Total employer contributions decreased from \$834.9 million in FY 2008 to \$608.4 million in FY 2009. The net decrease is primarily attributable to a decrease in the total employer contribution rate from 7.13% in FY 2008 to 4.76% in FY 2009. Total employer contributions increased from FY 2007 to FY 2008 and were primarily attributable to an increase in the total employer contribution rate from 6.46% in FY 2007 to 7.13% in FY 2008.
- Total PSERS' benefit expense remained consistent at \$4.9 billion in FY 2009 and FY 2008 as higher monthly benefits from an increase in the overall number of retirees and beneficiaries receiving benefits were offset by lower lump sum payments due to a decrease in the number of new retirees in FY 2009. The lower number of new retirees in FY 2009 is consistent with national trends as people delayed retirement due to the significant decline in world financial markets and the global economic recession. Benefit expense increased by \$600 million from \$4.3 billion in FY 2007 to \$4.9 billion in FY 2008. The increase was primarily attributable to an increase in the number of retirees and beneficiaries receiving benefits and an increase in the average benefit paid per annuitant.
- Total administrative expenses increased by \$2.0 million from \$49.3 million in FY 2008 to \$51.3 million in FY 2009. The increase is attributable to greater costs and increasing membership within the member funded Health Options Program. 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 were within PSERS' budgeted amounts for each of the fiscal years.

## Management's Discussion and Analysis (Continued)

**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 funded status. The most recent actuarial valuation reports that PSERS is 86.0% funded as of June 30, 2008. The results of operations for FY 2009 will be reflected in the actuarial valuation for the year ended June 30, 2009. Due to the normal lag time for completion of the actuarial valuation, the resulting funded status will be available at the end of the 2009 calendar year and will be reported in the financial statements for the fiscal year ended June 30, 2010 (FY 2010). Based on the investment losses in FY 2009, the funded ratio at June 30, 2009 is expected to decline. In addition, as a result of the impact of FY 2009 investment losses, PSERS' State Accumulation Account had a negative balance at June 30, 2009 (See Note 3). Employer contributions and investment earnings will be used to reduce the deficit in this Account in the future. A twenty-year history of PSERS' funded status follows:



Management's Discussion and Analysis (Continued)

**Analysis of Plan Net Assets**

<u>Summary of Plan Net Assets:</u>	(Dollar Amounts in Thousands)				
	<u>FY 2009</u>	Increase (Decrease)	<u>FY 2008</u>	Increase (Decrease)	<u>FY 2007</u>
<b>Assets:</b>					
Receivables	\$ 1,355,001	\$ (902,691)	\$ 2,257,692	\$ 490,786	\$ 1,766,906
Investments	43,343,935	(20,548,285)	63,892,220	(4,634,313)	68,526,533
Securities lending collateral pool	1,591,720	(3,255,279)	4,846,999	(3,959,980)	8,806,979
Capital assets	530	(135)	665	(205)	870
<b>Total Assets</b>	<b>46,291,186</b>	<b>(24,706,390)</b>	<b>70,997,576</b>	<b>(8,103,712)</b>	<b>79,101,288</b>
<b>Liabilities:</b>					
Payables and other liabilities	1,492,426	(1,999,527)	3,491,953	720,348	2,771,605
Obligations under securities lending	1,591,720	(3,255,279)	4,846,999	(3,959,980)	8,806,979
<b>Total Liabilities</b>	<b>3,084,146</b>	<b>(5,254,806)</b>	<b>8,338,952</b>	<b>(3,239,632)</b>	<b>11,578,584</b>
<b>Plan Net Assets</b>	<b>\$ 43,207,040</b>	<b>\$(19,451,584)</b>	<b>\$ 62,658,624</b>	<b>\$ (4,864,080)</b>	<b>\$ 67,522,704</b>
<b>Summary of Changes in Plan Net Assets:</b>					
<b>Additions:</b>					
Contributions	\$ 1,729,857	\$ (172,579)	\$ 1,902,436	\$ 128,832	\$ 1,773,604
Net investment income (loss)	(16,198,312)	(14,422,727)	(1,775,585)	(14,478,306)	12,702,721
<b>Total Additions</b>	<b>(14,468,455)</b>	<b>(14,595,306)</b>	<b>126,851</b>	<b>(14,349,474)</b>	<b>14,476,325</b>
<b>Deductions:</b>					
Benefit expense	4,931,854	(9,827)	4,941,681	621,241	4,320,440
Administrative expenses	51,275	2,025	49,250	(1,232)	50,482
<b>Total Deductions</b>	<b>4,983,129</b>	<b>(7,802)</b>	<b>4,990,931</b>	<b>620,009</b>	<b>4,370,922</b>
<b>Changes in Plan Net Assets</b>	<b>\$(19,451,584)</b>	<b>\$(14,587,504)</b>	<b>\$ (4,864,080)</b>	<b>\$(14,969,483)</b>	<b>\$ 10,105,403</b>

**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)

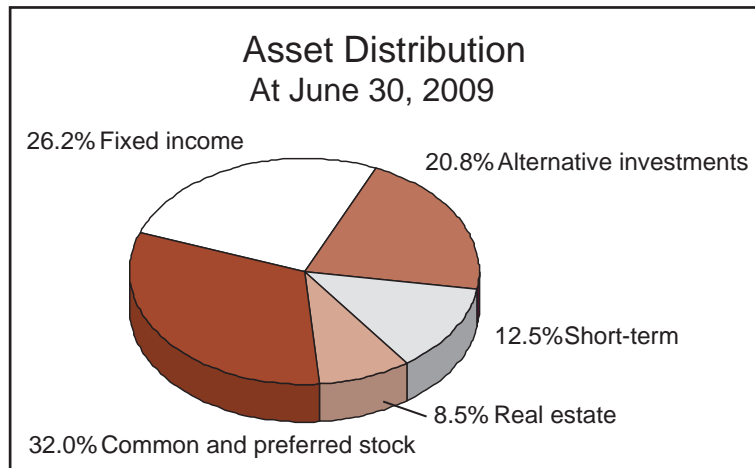
PSERS had a very challenging fiscal year ended June 30, 2009, as the System generated negative absolute returns. The worst economic contraction since the Great Depression led to a large decrease in U.S. Gross Domestic Product, an increase in the U.S. unemployment rate and the failure of several large financial institutions including the federal government takeover of Fannie Mae and Freddie Mac, the Lehman Brothers and Washington Mutual bankruptcies, and the federal government bailout of AIG and Citigroup. These extremely difficult economic conditions led to negative returns for equity, real estate and commodities around the world. For FY 2009, PSERS' rate of return on investments was -26.54%. The FY 2009 investment return trailed PSERS' total fund policy index of -20.67%. The annualized rate of return over the past three and five-year periods ended June 30, 2009 was -4.26% and 2.68%, respectively. The return for the three-year period trailed the total fund policy index returns by 151 basis points while the return for the five-year period exceeded the total fund policy index returns by 17 basis points. The annualized rate of return for the ten and twenty-five-year periods ended June 30, 2009 was 3.28% and 9.23%, respectively. PSERS' long-term actuarial investment rate of return assumption was 8.00% at June 30, 2009.

PSERS' Board of Trustees (Board) decreased the actuarial investment rate of return assumption from 8.50% to 8.25% effective for the June 30, 2008 actuarial valuation. The Board also decreased the rate of return assumption further from 8.25% to 8.00% for the June 30, 2009 actuarial valuation. The changes made by the Board lowered PSERS' rate of return assumption to the median investment rate of return assumption used by most public pension funds and provided a more realistic outlook on the future earnings potential of the Fund. The 0.5% decrease in the rate of return assumption allowed PSERS to modify its asset allocation plan during FY 2009 to achieve its new return target with lower overall risk. Some of the asset allocation changes are already reflected in the table and chart which follow as the Fund has reduced its overall exposure to equities and increased its combined allocation to short-term and fixed income investments at June 30, 2009.

Management's Discussion and Analysis (Continued)

The asset distribution of PSERS' investment portfolio at June 30, 2009, June 30, 2008 and June 30, 2007, at fair value, including postemployment healthcare assets, was:

<u>Asset Class</u>	(Dollar Amounts in Thousands)					
	<u>2009</u>	<u>%</u>	<u>2008</u>	<u>%</u>	<u>2007</u>	<u>%</u>
Short-term	\$ 5,398,729	12.5	\$ 4,215,171	6.6	\$ 4,164,010	6.1
Fixed income	11,333,549	26.2	17,984,233	28.2	15,919,998	23.2
Common and preferred stock	13,883,372	32.0	27,875,324	43.6	38,715,473	56.5
Real estate	3,699,353	8.5	4,951,840	7.8	3,887,986	5.7
Alternative investments	9,028,932	20.8	8,865,652	13.8	5,839,066	8.5
<b>Total</b>	<b>\$ 43,343,935</b>	<b>100.0</b>	<b>\$ 63,892,220</b>	<b>100.0</b>	<b>\$ 68,526,533</b>	<b>100.0</b>



Short-term investments (cash and cash equivalents) increased by \$1.2 billion from \$4.2 billion in FY 2008 to \$5.4 billion in FY 2009. Due to the uncertainties in the equity and fixed income markets, PSERS built up its short-term investment fund during FY 2009. During FY 2009, PSERS brought the management of its short-term investment fund in-house. This fund had been previously managed by the Pennsylvania Treasury Department. Fixed income investments fell by \$6.7 billion from \$18.0 billion in FY 2008 to \$11.3 billion in FY 2009 because of allocation reductions as well as market value depreciation. Similarly, common and preferred stock investments dropped by \$14.0 billion from \$27.9 billion in FY 2008 to \$13.9 billion in FY 2009. The decrease was primarily the result of significant deterioration in the domestic and international equity markets in addition to funds being transferred out of the asset class. Real estate investments declined by \$1.3 billion from \$5.0 billion in FY 2008 to \$3.7 billion in FY 2009 due to substantial market value depreciation which was offset in part by net allocation increases to new and existing real estate partnerships. Alternative investments rose by \$100 million from \$8.9 billion in FY 2008 to \$9.0 billion in FY 2009 as a result of contributions to new and existing partnerships which were almost entirely negated by the downturn in value of partnership portfolio holdings.



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

Short-term investments remained stable at \$4.2 billion from FY 2007 to FY 2008. Fixed income investments increased by \$2.1 billion from \$15.9 billion in FY 2007 to \$18.0 billion in FY 2008 mostly due to a few key investment managers shifting a large portion of their direct common and preferred stock holdings to fixed income while gaining equity exposure through the use of futures and total return swaps. 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 fixed income 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.

**Securities Lending**

Securities lending collateral pool and obligations under securities lending decreased from \$4.8 billion in FY 2008 to \$1.6 billion in FY 2009 due to a significant decline in both the number of securities on loan and the market value of those securities for which cash collateral was provided. Non-cash collateral is not reflected in the Statement of Plan Net Assets.

The System experienced a net loss of \$26.8 million from securities lending activities in FY 2009 as a result of the decline in valuation of certain securities purchased with cash collateral by the lending agent. Because of the heightened risk associated with the sudden downturn in the market in FY 2009, restrictions were placed on the lending of particular securities in PSERS' portfolio and the risk profile of the investments permitted in the collateral pool was reduced.

**Contributions**

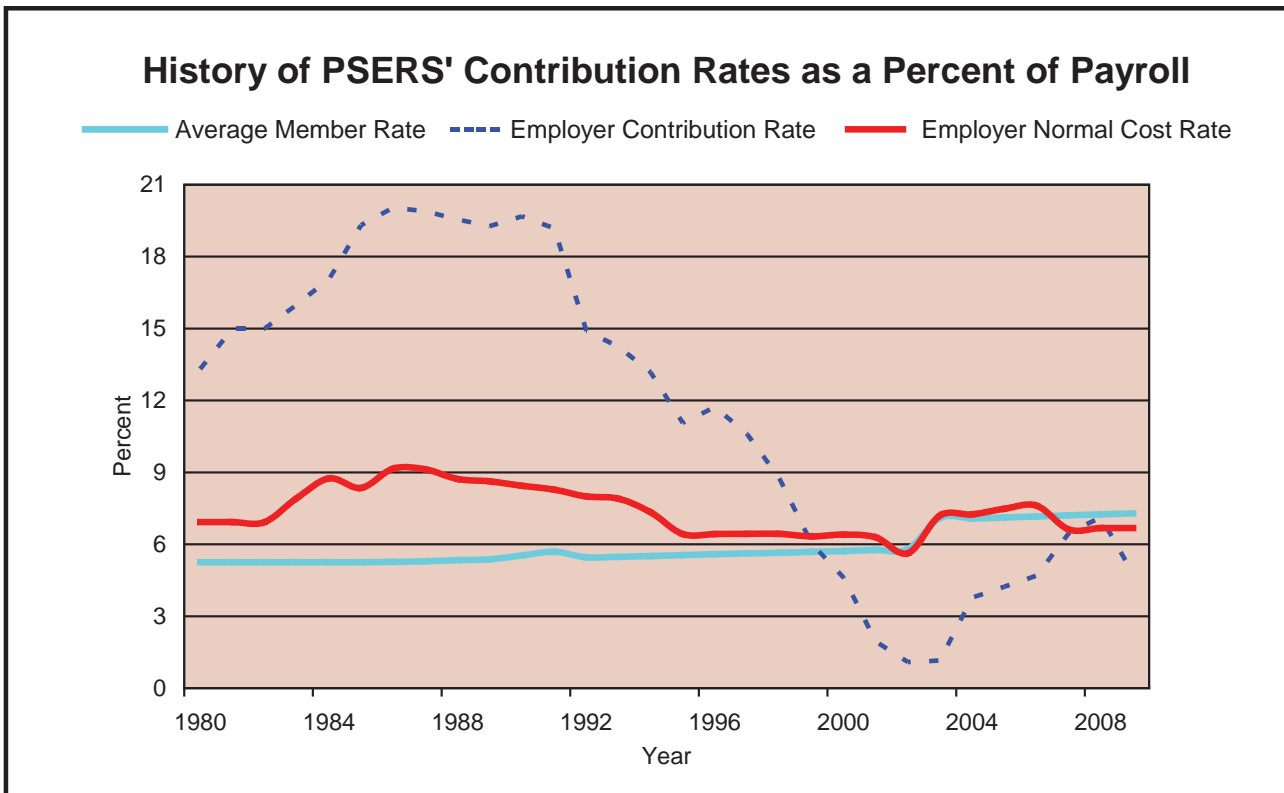
Employer pension contributions decreased by \$237.6 million from \$753.5 million in FY 2008 to \$515.9 million in FY 2009 due to a decrease in the employer pension contribution rate from 6.44% in FY 2008 to 4.00% in FY 2009. Employer pension contributions increased by \$94.0 million from \$659.5 million in FY 2007 to \$753.5 million in FY 2008 due to the increase in the employer pension contribution rate from 5.72% in FY 2007 to 6.44% in FY 2008.

Member pension contributions increased by \$31.5 million from \$879.6 million in FY 2008 to \$911.1 million in FY 2009 as a result of the increase in total active member payroll and an increase in the average member contribution rate from 7.25% in FY 2008 to 7.29% in FY 2009. 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 an increase in the average member contribution rate from 7.21% in FY 2007 to 7.25% in FY 2008.

Management's Discussion and Analysis (Continued)

The employer contributions for health insurance premium assistance increased by \$11.2 million from \$81.3 million in FY 2008 to \$92.5 million in FY 2009 due to an increase in the employer health insurance premium assistance contribution rate from 0.69% in FY 2008 to 0.76% in FY 2009. 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 (Ctrs) for Medicare and Medicaid Services (Svcs) to PSERS HOP increased from \$28.4 million in FY 2008 to \$31.6 million in FY 2009.

A thirty-year history of PSERS' Contribution Rates follows:



**Management's Discussion and Analysis (Continued)****Projected Fiscal Year 2012-2013 (FY 2013) Employer Contribution Rate Increase**

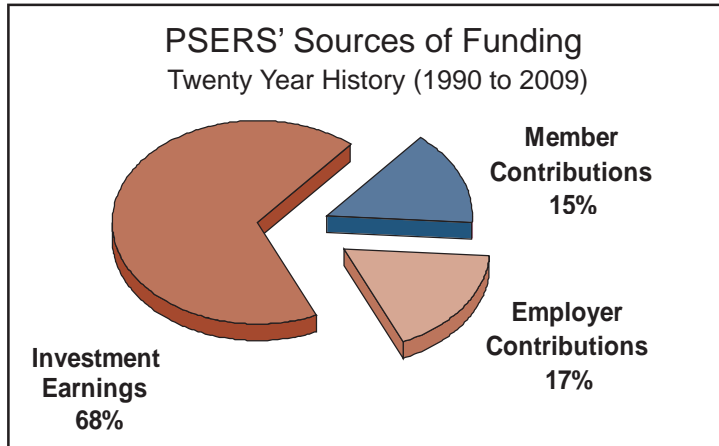
One of the most widely publicized issues at PSERS over the past several years has been the employer contribution rate increase that is projected to occur in FY 2013 fiscal year. The rate increase was first reflected in the June 30, 2003 actuarial valuation. This valuation took into consideration the actuarial impact of the pension benefit enhancement enacted in 2001 (Act 9 of 2001), a major downturn in the investment markets between 2001 and 2003 and a series of legislative actions (Act 38 of 2002 and Act 40 of 2003) that changed the basic funding methodologies for PSERS and suppressed the employer contribution rate below the employer normal cost rate and average member contribution rate for a period of ten years as displayed in the previous chart on the History of PSERS' Contribution Rates. The employer normal cost is the expected contribution from employers to fund on-going liabilities if all other actuarial assumptions are met and the unfunded liability is zero.

Previously, PSERS' investment returns for the four years ended June 30, 2007 had reduced the projected FY 2013 employer contribution rate by more than 50%, from a high of 27.73% to the projected rate of 11.23% as of June 30, 2007 valuation. Over the past year, however, the sharp downturn in the economy that contributed to the -26.54% return for FY 2009 combined with PSERS' -2.82% investment return for FY 2008 has essentially eliminated any past progress made in reducing the FY 2013 projected rate increase. The June 30, 2009 actuarial valuation will not be completed until December 2009, but based upon PSERS' performance through June 30, 2009, the projected rate increase in FY 2013 is now expected to exceed the original projection of 27.73%. The majority of the projected FY 2013 rate increase is devoted to the payment of unfunded liabilities that have accumulated since 2001.

**Investment Income**

Net investment income (loss) changed by \$14.4 billion from \$(1.8) billion in FY 2008 to \$(16.2) billion in FY 2009, which correlates to the decrease in the investment rate of return from -2.82% for FY 2008 to -26.54% for FY 2009. Net investment income (loss) decreased by \$14.5 billion from \$12.7 billion in FY 2007 to \$(1.8) billion in FY 2008, which is consistent with the decrease in the investment rate of return from 22.93% for FY 2007 to -2.82% for FY 2008. Despite the recent negative performance, as depicted in the following chart, investment earnings provided 68% of PSERS' funding over the past twenty years. Employer contributions and member contributions provided 17% and 15%, respectively, of PSERS' funding over the past twenty years. 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.

## Management's Discussion and Analysis (Continued)

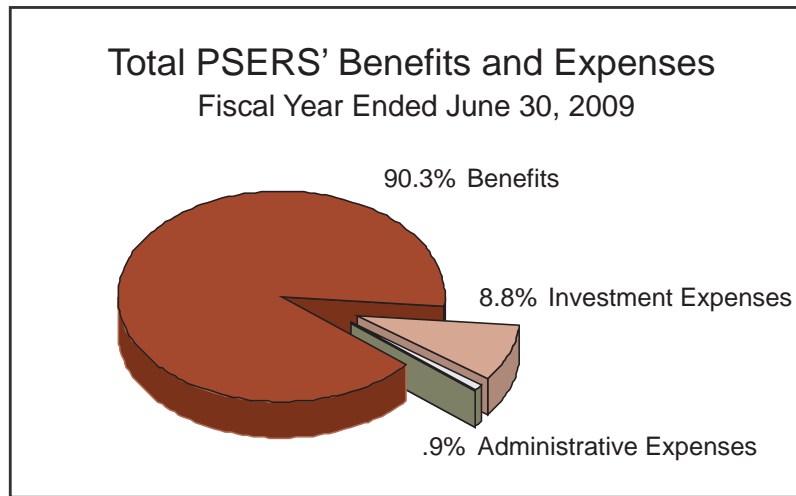
**Total PSERS' Benefits and Expenses**

The primary source of expense during FY 2009 was for the payment of benefits totaling \$4.9 billion. As the following chart on PSERS' Benefits and Expenses reflects, benefit expenses comprised over 90% of the total expenses of the Fund in FY 2009. Total PSERS' benefit expense remained consistent at \$4.9 billion in FY 2009 and FY 2008 as higher monthly benefits from an increase in the overall number of retirees and beneficiaries receiving benefits were offset by lower lump sum payments due to a decrease in the number of new retirees in FY 2009. The lower number of new retirees in FY 2009 is consistent with national trends as people delayed retirement due to the significant decline in world financial markets and the global economic recession. Benefit expense increased by \$600 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.

Investment expenses increased by \$78.5 million from \$399.1 million in FY 2008 to \$477.6 million in FY 2009 mainly due to a rise in management fees in the private market asset classes. The higher fees were essentially the result of new investments made in alternative investment and real estate partnerships during FY 2009 and 2008. 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 are reported as a reduction in net investment income (loss) on the Statements of Changes in Plan Net Assets.

Management's Discussion and Analysis (Continued)

Administrative expenses increased by \$2 million from \$49.3 million during FY 2008 compared to \$51.3 million during FY 2009. The increase was attributable to greater costs and increasing membership within the member funded Health Options Program. Administrative expenses for FY 2007 totaled \$50.5 million.



## Statements of Plan Net Assets

June 30, 2009 and 2008

(Dollar Amounts in Thousands)

	2009			Totals
	Pension	Postemployment Healthcare Premium Assistance	Health Options Program	
<b>Assets:</b>				
Receivables:				
Members	\$ 244,327	\$ 6,353	\$ 30	\$ 250,710
Employers	172,099	31,289	-	203,388
Investment income	362,058	201	57	362,316
Investment proceeds	522,405	-	-	522,405
Ctrs for Medicare & Medicaid Svcs	-	-	3,339	3,339
Miscellaneous	6,211	484	6,148	12,843
<b>Total Receivables</b>	<b>1,307,100</b>	<b>38,327</b>	<b>9,574</b>	<b>1,355,001</b>
Investments, at fair value:				
Short-term	5,204,418	67,268	127,043	5,398,729
Fixed income	11,333,549	-	-	11,333,549
Common and preferred stock	13,883,372	-	-	13,883,372
Real estate	3,699,353	-	-	3,699,353
Alternative investments	9,028,932	-	-	9,028,932
<b>Total Investments</b>	<b>43,149,624</b>	<b>67,268</b>	<b>127,043</b>	<b>43,343,935</b>
Securities lending collateral pool	1,591,720	-	-	1,591,720
Capital assets (net of accumulated depreciation of \$10,933)	530	-	-	530
<b>Total Assets</b>	<b>46,048,974</b>	<b>105,595</b>	<b>136,617</b>	<b>46,291,186</b>
<b>Liabilities:</b>				
Accounts payable and accrued expenses	81,483	338	1,575	83,396
Benefits payable	345,669	143	13,182	358,994
Premium advances	-	-	15,414	15,414
Investment purchases and other liabilities	1,034,622	-	-	1,034,622
Obligations under securities lending	1,591,720	-	-	1,591,720
<b>Total Liabilities</b>	<b>3,053,494</b>	<b>481</b>	<b>30,171</b>	<b>3,084,146</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits</b>				
(Schedules of funding progress are presented on Required Supplemental Schedule 1)	\$42,995,480	\$ 105,114	\$ 106,446	\$43,207,040

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

## Statements of Plan Net Assets

June 30, 2009 and 2008

(Dollar Amounts in Thousands)

	2008			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
<b>Assets:</b>				
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
Ctrs for Medicare & Medicaid Svcs	-	-	45	45
Miscellaneous	2,518	1,052	5,694	9,264
<b>Total Receivables</b>	2,228,211	29,205	5,970	2,263,386
Investments, at fair value:				
Short-term	4,033,430	67,400	114,341	4,215,171
Fixed income	17,984,233	-	-	17,984,233
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
<b>Total Investments</b>	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
<b>Total Assets</b>	70,786,354	96,605	120,311	71,003,270
<b>Liabilities:</b>				
Accounts payable and accrued expenses	84,108	332	2,929	87,369
Benefits payable	490,692	488	13,884	505,064
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
<b>Total Liabilities</b>	8,312,928	820	30,898	8,344,646
<b>Net assets held in trust for pension and postemployment healthcare benefits</b>				
(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 Changes in Plan Net Assets

Years ended June 30, 2009 and 2008

(Dollar Amounts in Thousands)

	2009			Totals
	Pension	Postemployment Healthcare		
		Premium Assistance	Health Options Program	
<b>Additions:</b>				
Contributions:				
Members	\$ 911,118	\$ -	\$ 178,801	\$ 1,089,919
Employers	515,889	92,493	-	608,382
Ctrs for Medicare & Medicaid Svcs	-	-	31,556	31,556
<b>Total contributions</b>	<b>1,427,007</b>	<b>92,493</b>	<b>210,357</b>	<b>1,729,857</b>
Investment income:				
From investing activities:				
Net depreciation in fair value of investments	(17,007,821)	(363)	-	(17,008,184)
Short-term	55,161	2,269	1,528	58,958
Fixed income	587,007	-	-	587,007
Common and preferred stock	500,001	-	-	500,001
Real estate	92,515	-	-	92,515
Alternative investments	75,776	-	-	75,776
Total investment activity income (loss)	(15,697,361)	1,906	1,528	(15,693,927)
Investment expenses	(477,520)	(45)	-	(477,565)
Net income (loss) from investing activities	(16,174,881)	1,861	1,528	(16,171,492)
From securities lending activities:				
Securities lending income	55,574	-	-	55,574
Securities lending expense	(82,394)	-	-	(82,394)
Net loss from securities lending activities	(26,820)	-	-	(26,820)
Total net investment income (loss)	(16,201,701)	1,861	1,528	(16,198,312)
<b>Total Additions</b>	<b>(14,774,694)</b>	<b>94,354</b>	<b>211,885</b>	<b>(14,468,455)</b>
<b>Deductions:</b>				
Benefits	4,639,297	83,206	181,035	4,903,538
Refunds of contributions	20,369	-	-	20,369
Net transfer to State Employees' Retirement System	7,947	-	-	7,947
Administrative expenses	35,639	1,819	13,817	51,275
<b>Total Deductions</b>	<b>4,703,252</b>	<b>85,025</b>	<b>194,852</b>	<b>4,983,129</b>
<b>Net increase (decrease)</b>	<b>(19,477,946)</b>	<b>9,329</b>	<b>17,033</b>	<b>(19,451,584)</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits:</b>				
Balance, beginning of year	62,473,426	95,785	89,413	62,658,624
Balance, end of year	\$ 42,995,480	\$ 105,114	\$ 106,446	\$ 43,207,040

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



**Statements of Changes in Plan Net Assets**  
 Years ended June 30, 2009 and 2008  
 (Dollar Amounts in Thousands)

	2008			Totals
	Pension	Postemployment Healthcare Premium Assistance	Health Options Program	
<b>Additions:</b>				
Contributions:				
Members	\$ 879,598	\$ -	\$ 159,563	\$ 1,039,161
Employers	753,532	81,317	-	834,849
Ctrs for Medicare & Medicaid Svcs	-	-	28,426	28,426
<b>Total contributions</b>	<b>1,633,130</b>	<b>81,317</b>	<b>187,989</b>	<b>1,902,436</b>
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	(3,763,649)	268	-	(3,763,381)
Short-term	142,381	2,525	4,288	149,194
Fixed income	820,338	-	-	820,338
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
<b>Total net investment income (loss)</b>	<b>(1,782,628)</b>	<b>2,755</b>	<b>4,288</b>	<b>(1,775,585)</b>
<b>Total Additions</b>	<b>(149,498)</b>	<b>84,072</b>	<b>192,277</b>	<b>126,851</b>
<b>Deductions:</b>				
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
<b>Total Deductions</b>	<b>4,718,073</b>	<b>85,579</b>	<b>187,279</b>	<b>4,990,931</b>
<b>Net increase (decrease)</b>	<b>(4,867,571)</b>	<b>(1,507)</b>	<b>4,998</b>	<b>(4,864,080)</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits:</b>				
<b>Balance, beginning of year</b>	67,340,997	97,292	84,415	67,522,704
<b>Balance, end of year</b>	<b>\$ 62,473,426</b>	<b>\$ 95,785</b>	<b>\$ 89,413</b>	<b>\$ 62,658,624</b>

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

## Notes to Financial Statements

Years Ended June 30, 2009 and 2008

### 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, 2009, there were 742 participating employers, generally school districts. Membership as of June 30, 2008, the most recent year for which actual amounts are available, consisted of:

Currently employed members:		
Vested	181,000	
Nonvested	<u>92,000</u>	
<b>Total currently employed members</b>		<b>273,000</b>
Retirees and beneficiaries currently receiving benefits	173,000	
Inactive members and vestees entitled to but not receiving benefits	<u>101,000</u>	
<b>Total retirees and other members</b>		<b><u>274,000</u></b>
<b>Total number of members</b>		<b><u><u>547,000</u></u></b>

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.

**Notes to Financial Statements (Continued)**

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.

**(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.

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.

## Notes to Financial Statements (Continued)

**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 is determined using the entry age normal actuarial funding method. This method determines the amount of contributions necessary to (1) fully fund all current costs, (also known as normal cost), which represents the estimated amount necessary to 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 4.76% and 7.13% of qualified compensation for the years ended June 30, 2009 and 2008, 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 0.76% and 0.69% for the years ended June 30, 2009 and 2008, respectively.

**Notes to Financial Statements (Continued)****iii. Funding Status and Annual Required Contributions (ARC)**

As of June 30, 2008, the most recent actuarial valuation, the plan was 86.0% funded. The actuarial accrued liability for benefits was \$70.9 billion, and the actuarial value of assets was \$61.0 billion, resulting in an unfunded accrued liability of \$9.9 billion. The covered payroll of active members was \$11.9 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 83.2%.

For fiscal year ended June 30, 2009, the ARC was \$1.76 billion. The actual employer contributions for fiscal year ended June 30, 2009, net of purchase of service contributions, were \$503.2 million resulting in a 29% 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.

**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 30 year period specified by GASB 25. 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, 2008, a 30 year level dollar open amortization method was used.

## Notes to Financial Statements (Continued)

**(b) Asset Valuation Method**

For actuarial purposes, assets are valued using a five-year moving market average value that will recognize the 8.25% 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, 2008, the date of the most recent actuarial valuation include:

- Investment return – 8.25%, 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.

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 actuarial assets are subtracted from this present value to arrive at the funded or unfunded actuarial accrued liability.

## Notes to Financial Statements (Continued)

**(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 and 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 actual 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).

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

As of June 30, 2008, the most recent actuarial valuation, the plan was 8.5% funded. The actuarial accrued liability for benefits was \$1.1 billion, and the actuarial value of assets was \$95.8 million, resulting in an unfunded accrued liability of \$1.0 billion. The covered payroll of active members was \$11.9 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 8.7%.

For fiscal year ended June 30, 2009, the ARC was \$107.1 million. The actual employer contributions for fiscal year ended June 30, 2009 were \$92.5 million resulting in an 86% 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 multi-year presentations of funding status and ARC to illustrate their trends over time.

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.

**Notes to Financial Statements (Continued)****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). At June 30, 2009 and 2008 PSERS recorded \$10,423,000 and \$11,143,000, respectively, in IBNR which is included in benefits payable.

Effective January 1, 2006, PSERS made significant changes to the HOP, in response to the Medicare Modernization Act. PSERS entered into an Employer/Union Entity contract with the Centers for Medicare and Medicaid Services (CMS) to operate a voluntary Medicare Prescription Drug Plan (PDP). Monthly contributions are received from CMS covering the 40,500 participants in the PDP in addition to the monthly prescription drug premiums paid by the participants. 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 reported. 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.



**Notes to Financial Statements (Continued)****(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 and for properties not appraised, the present value of the projected future net income stream is used. Real estate owned investments are reported net of related debt borrowed against the market value of the property. As of June 30, 2009 and 2008, \$132,000,000 in line of credit advances were netted against the related property valuation. The line of credit balance is due on March 9, 2012. The line is payable at an interest rate equivalent to the lender's commercial paper rate plus 100 basis points and is collateralized by certain fixed income investments of the System.

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.

**Notes to Financial Statements (Continued)****(D) Benefits Payable**

Benefits payable identifies the obligations of the System, on an accrual basis, at the end of the fiscal year. It includes the estimated retirement and death benefits payable, and the HOP IBNR (incurred but not reported) claims for PSERS' members or members' beneficiaries.

**(E) Compensated Absences**

The System uses the accrual basis of accounting for measuring liabilities related to vacation leave, sick leave, and other compensated absences. 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, 2009 and 2008, \$3,222,000 and \$3,013,000, 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.

**(F) Premium Advances**

Premium advances in the fiscal year ended June 30, 2009 and 2008 are for HOP premiums related to health care coverage provided in calendar year 2009 and 2008, respectively.

**(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 rollover 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 2008 and 2009 were \$230,000 and \$245,000, 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 2008 and 2009 were \$185,000 and \$195,000, respectively.

## Notes to Financial Statements (Continued)

### (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. The System has had no insurance claims during the past three fiscal years.

### (I) Reclassifications

Certain 2008 amounts have been reclassified in conformity with the 2009 presentation.

### (J) Members' Receivables

Members' receivables include an amount for members' obligations to the System for the purchase of service credit of \$164,892,000 and \$166,951,874 at June 30, 2009 and 2008, respectively. 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 members' employer establishes a payroll deduction process. The members' employer then forwards monthly 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 purchase of service receivables extend beyond one year. An estimated \$144,278,000 of the \$244,327,000 members' pension receivables at June 30, 2009 are expected to be collected by the System subsequent to June 30, 2010. At June 30, 2008, an estimated \$152,000,000 of the \$253,356,000 members' pension receivables was expected to be collected by the System subsequent to June 30, 2009.

### (K) Adoption of New Accounting Standards

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.

### Notes to Financial Statements (Continued)

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.

### 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 8.25% 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.

## Notes to Financial Statements (Continued)

**(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.

**(F) Pension and Postemployment Healthcare Net Assets**

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

	<b>(Dollar Amounts in Thousands)</b>	
	<b>2009</b>	<b>2008</b>
Pension:		
State accumulation account	\$ (5,608,486)	\$ 16,392,728
Members' savings account	11,087,345	10,532,683
Reserve for retirement account	<u>37,516,621</u>	<u>35,548,015</u>
	<u>\$ 42,995,480</u>	<u>\$ 62,473,426</u>
Postemployment healthcare:		
Health insurance account	\$ 105,114	\$ 95,785
Health insurance program account	<u>106,446</u>	<u>89,413</u>
	<u>\$ 211,560</u>	<u>\$ 185,198</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)	
	2009	2008
<b>Pension investments:</b>		
<b>Short-term:</b>		
Pennsylvania Treasury Short-Term Investment Fund	\$ -	\$ 2,405,509
PSERS Short-Term Investment Fund	4,253,396	-
Other domestic short-term	696,019	1,249,875
International short-term	255,003	378,046
	<b>5,204,418</b>	<b>4,033,430</b>
<b>Fixed income:</b>		
Domestic mortgage-backed securities	3,740,617	6,612,701
U.S. government and agency obligations	1,416,505	1,980,626
Domestic corporate and taxable municipal bonds	2,271,173	4,240,211
Miscellaneous domestic fixed income	456,144	604,069
Collective trust funds	2,529,667	2,294,869
International fixed income	919,443	2,251,757
	<b>11,333,549</b>	<b>17,984,233</b>
<b>Common and preferred stock:</b>		
Domestic common and preferred stock	3,073,854	8,995,463
Collective trust funds	3,929,724	4,808,851
International common and preferred stock	6,879,794	14,071,010
	<b>13,883,372</b>	<b>27,875,324</b>
<b>Real estate:</b>		
Equity real estate	3,493,360	4,673,806
Directly-owned real estate	205,993	278,034
	<b>3,699,353</b>	<b>4,951,840</b>
<b>Alternative investments:</b>		
Private equity	5,047,201	5,752,298
Private debt	3,283,060	2,371,506
Venture capital	698,671	741,848
	<b>9,028,932</b>	<b>8,865,652</b>
<b>Pension investments at fair value</b>	<b>\$ 43,149,624</b>	<b>\$ 63,710,479</b>
<b>Postemployment healthcare investments:</b>		
Premium Assistance:		
Pennsylvania Treasury Short-Term Investment Fund	\$ -	\$ 19,627
PSERS Short-Term Investment Fund	27,063	-
Other domestic short-term	40,205	47,773
	<b>67,268</b>	<b>67,400</b>
Health Options Program:		
Pennsylvania Treasury Short-Term Investment Fund	-	60,962
PSERS Short-Term Investment Fund	84,683	-
Other domestic short-term	42,360	53,379
	<b>127,043</b>	<b>114,341</b>
<b>Postemployment healthcare investments at fair value</b>	<b>\$ 194,311</b>	<b>\$ 181,741</b>

## 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 \$42,360,000 and \$53,379,000 at June 30, 2009 and 2008, respectively, and are under the custody of M&T Bank which has an A- rating by Standard and Poor's (S&P) and an A3 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, 2009 and 2008 the System had no single issuer that exceeded 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 were 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 a 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 29.5% of the investment portfolio. The fixed income target allocation consists of:

- An allocation of 16.5% of the portfolio has been made to the domestic core plus and high yield segments of the fixed income asset class benchmarked to the Barclays Capital 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 Barclays Capital 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 3.0% of the portfolio has been made to the global core plus fixed income asset class benchmarked to the Barclays Capital 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 BB- or better.
- An allocation of 5% of the portfolio has been made to cash benchmarked to the Merrill Lynch U.S. Treasury Bill 0-3 Months 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.



## Notes to Financial Statements (Continued)

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 lowest credit quality at June 30, 2009 and 2008.

<b>Quality Rating</b>	<b>(Dollar Amounts in Thousands)</b>	
	<b>2009 Fair Value</b>	<b>2008 Fair Value</b>
AAA	\$ 4,434,124	\$ 8,436,260
AA	672,450	1,435,628
A	888,204	1,824,267
BBB	812,151	1,593,709
BB and below	895,804	904,053
NR*	<u>7,433,485</u>	<u>5,748,497</u>
<b>Total Exposed to Credit Risk</b>	<b>15,136,218</b>	<b>19,942,414</b>
<b>U.S. Government Guaranteed**</b>	<b><u>1,596,060</u></b>	<b><u>2,256,990</u></b>
<b>Total Fixed Income and Short-Term Investments</b>	<b><u>\$ 16,732,278</u></b>	<b><u>\$ 22,199,404</u></b>

\* Not Rated securities include \$2,529,667 and \$2,294,869 in collective trust funds at June 30, 2009 and 2008, respectively. Also included are \$4,365,142 in the PSERS Short-Term Investment Fund at June 30, 2009 and \$2,486,098 in the Pennsylvania (PA) Treasury Short-Term Investment Fund at June 30, 2008, pooled investment funds for which ratings were unavailable. The pools are comprised of short-term, high credit quality securities which include money market funds, commercial paper, 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 percent. 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.

## Notes to Financial Statements (Continued)

At June 30, 2009 and 2008, the System's fixed income portfolio had the following option-adjusted durations by fixed income sector:

Investment Type	(Dollar Amounts in Thousands)			
	2009		2008	
	Option-Adjusted Duration	Fair Value	Option-Adjusted Duration	Fair Value
Domestic mortgage-backed securities	1.7	\$ 3,740,617	2.8	\$ 6,612,701
U.S. government and agency obligations	3.6	1,416,505	7.1	1,980,626
Domestic corporate and taxable municipal bonds	3.0	2,271,173	2.7	4,240,211
Miscellaneous domestic fixed income	0.4	456,144	0.5	604,069
Fixed income collective trust funds	4.3	2,529,667	3.3	2,294,869
International fixed income	3.8	919,443	5.3	2,251,757
PA Treasury Short-Term Investment Fund	-	-	0.2	2,486,098
PSERS Short-Term Investment Fund	0.1	4,365,142	-	-
<b>Total fixed income &amp; Short-Term Investment Funds</b>	<b>2.1*</b>	<b>15,698,691</b>	<b>3.1*</b>	<b>20,470,331</b>
<b>Total adjustments for futures contracts</b>	<b>0.1**</b>	<b>-</b>	<b>0.1**</b>	<b>-</b>
<b>Total fixed income &amp; Short-Term Investment Funds</b>	<b>2.2**</b>	<b>\$ 15,698,691</b>	<b>3.2**</b>	<b>\$ 20,470,331</b>

\* The option-adjusted duration of 2.1 and 3.1 at June 30, 2009 and 2008, respectively, for the total fixed income and Short-Term Investment Funds 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 and Short-Term Investment Funds duration upward by 0.1 at June 30, 2009 and 2008.

### 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. For the year ended June 30, 2008, the System also reduced the exposure to currency risk by hedging to a target of 30% of MSCI EAFE Index country currencies to the U.S. dollar. The currency hedge program was discontinued during FY 2009. At June 30, 2009 and 2008 PSERS had the following non-U.S. currency exposure:

Notes to Financial Statements (Continued)

**2009**  
(Dollar Amounts in Thousands)

Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Total Fair Value
Euro	\$ 1,047,301	\$ 269,565	\$ 1,247,221	\$ 92,495	\$ 2,656,582
Japanese yen	1,254,289	55,862	-	182,435	1,492,586
British pound sterling	1,078,529	31,998	6,776	86,898	1,204,201
Hong Kong dollar	566,206	-	-	2,429	568,635
Australian dollar	347,456	1,879	-	44,524	393,859
Swiss franc	378,039	-	-	(3,390)	374,649
Canadian dollar	407,085	2,761	4,304	(41,540)	372,610
South African rand	167,544	-	-	51,311	218,855
Brazil real	124,471	17,867	-	25,069	167,407
Indian rupee	109,516	314	-	44,161	153,991
Other non-U.S. currencies	<u>886,940</u>	<u>89,209</u>	<u>-</u>	<u>(63,368)</u>	<u>912,781</u>
<b>Total</b>	<b><u>\$ 6,367,376</u></b>	<b><u>\$ 469,455</u></b>	<b><u>\$ 1,258,301</u></b>	<b><u>\$ 421,024</u></b>	<b><u>\$ 8,516,156</u></b>

**2008**  
(Dollar Amounts in Thousands)

Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Currency Hedge**	Total Fair Value
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-U.S. currencies	<u>1,967,199</u>	<u>27,047</u>	<u>-</u>	<u>(6,613)</u>	<u>(416,793)</u>	<u>1,570,840</u>
<b>Total</b>	<b><u>\$ 13,075,678</u></b>	<b><u>\$ 1,582,292</u></b>	<b><u>\$ 1,271,512</u></b>	<b><u>\$ 845,075</u></b>	<b><u>\$ (5,497,630)</u></b>	<b><u>\$ 11,276,927</u></b>

\* Includes investment receivables and payables.

\*\* The currency hedge program was discontinued during FY 2009.

## Notes to Financial Statements (Continued)

**(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 System.

As of June 30, 2009 and 2008, 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, 2009 and 2008, 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, 2009 and 2008.

For the year ended June 30, 2009, cash collateral is invested in one of two short-term collateral investment pools, the first of which is denominated in U.S. dollars and the second in Euros. Each collateral investment pool is managed by the lending agent, is segregated from all other clients of the lending agent, and is not subject to custodial credit risk. For the year ended June 30, 2008, cash collateral was invested in the lending agent's short-term investment pool which was not segregated from other clients and was 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 15 days and 25 days at June 30, 2009 and 2008, respectively. During the fiscal year ended June 30, 2009, the mismatch between the maturities of the investments made with cash collateral and the maturities of the securities loans may have posed some interest rate risk to the System. During the fiscal year ended June 30, 2008, the relationship between the maturities of the investment pool and the System's loans was affected by the maturities of the securities loans made by other entities that used the lending agent's pool, which the System could not 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.

## Notes to Financial Statements (Continued)

During the fiscal year ended June 30, 2009, certain securities purchased with cash collateral by the lending agent declined significantly in value, resulting in a net loss to the System from the securities lending program. The System acquired new securities for the collateral pool during the fiscal year ended June 30, 2009 to replace the value lost on the securities that had been purchased by the lending agent.

As of June 30, 2009, the fair value of loaned securities was \$2,109,420,000, which includes \$584,108,000 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 \$2,232,432,000 of which \$1,591,720,000 was cash. 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.

### 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. The System generally enters into transactions only with high quality institutions. 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.

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, 2009 and 2008 (in thousands):

	2009	2008
Futures contracts – long	\$ 3,310,264	\$ 11,962,986
Futures contracts – short	1,806,480	5,046,611
Foreign exchange forward and spot contracts, gross	6,266,360	20,668,439
Options – calls purchased	1,198,018	154,767
Options – puts purchased	766,916	322,841
Options – calls sold	972,583	159,300
Options – puts sold	827,220	501,896
Swaps – total return type	3,658,970	2,570,616
Swaps – interest rate	1,382,764	826,124

### Notes to Financial Statements (Continued)

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, 2009 and 2008 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 \$6,266,360,000 of foreign currency contracts outstanding at June 30, 2009 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of \$3,609,991,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of \$2,656,369,000. The \$20,668,439,000 of foreign currency contracts outstanding at June 30, 2008 consist of "buy" contracts of \$8,391,990,000 and "sell" contracts of \$12,276,449,000. The unrealized loss on contracts of \$(10,398,000) and \$(94,298,000) at June 30, 2009 and 2008, 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 \$3,800,000,000 of the MSCI EAFE Index currencies to U.S. dollars. The currency hedge program was discontinued during FY 2009.

**Notes to Financial Statements (Continued)**

Swap agreements provide for periodic payments at predetermined future dates between parties based on the change in value of underlying securities, indexes or interest rates. During the year ended June 30, 2009 and 2008, the System entered into total return type swaps and interest rate swaps. Under the total return type swap arrangements, the System receives the net return of certain equity securities or indexes in exchange for a short-term rate minus a spread or a predetermined fixed charge. The receivable (payable) on the total return type swap contracts of \$32,464,000 and \$(184,438,000) at June 30, 2009 and 2008, 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 15, 2009 to May 28, 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 \$10,314,000 and \$8,238,000 at June 30, 2009 and 2008, 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 October 31, 2009 to April 1, 2010.

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, 2009 and 2008 is \$2,295,709,000 and \$2,574,096,000, 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 or on its website: [www.sers.state.pa.us](http://www.sers.state.pa.us).

## 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 3.29% at June 30, 2009, 3.28% at June 30, 2008 and 3.23% at June 30, 2007. The System's contributions to SERS for the years ended June 30, 2009, 2008 and 2007 were \$625,000, \$602,000 and \$534,000, 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 2008-2009 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, 2009. The Valuation indicated overall Annual Required Contributions of \$603,186,000, with the System's allocated portion at \$2,486,000. The actuarial valuation is available at the Office of the Budget's website: [www.budget.state.pa.us](http://www.budget.state.pa.us).

### **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**  
**Schedules of Funding Progress\***  
(Unaudited - See Accompanying Auditor's Report)  
(Dollar Amounts in Millions)

Pension						
	(1)	(2)	(3)	(4)	(5)	(6)
Valuation as of June 30	Actuarial accrued liabilities (AAL)	Actuarial value of assets	(Funded) Unfunded actuarial accrued liabilities (FAAL) or UAAL (1) - (2)	Ratio of assets to AAL (2) / (1)	Covered payroll	(FAAL) or UAAL as a percentage of covered payroll (3) / (5)
2008	\$ 70,845.6	\$ 60,922.1	\$ 9,923.5	86.0%	\$ 11,921.5	83.2%
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%

Premium Assistance						
	(1)	(2)	(3)	(4)	(5)	(6)
Valuation as of June 30	Actuarial accrued liabilities (AAL)	Actuarial value of assets	(Funded) Unfunded actuarial accrued liabilities (FAAL) or UAAL (1) - (2)	Ratio of assets to AAL (2) / (1)	Covered payroll	(FAAL) or UAAL as a percentage of covered payroll (3) / (5)
2008	\$ 1,133.0	\$ 95.8	\$ 1,037.2	8.5%	\$ 11,921.5	8.7%
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**  
**Schedules of Employer Contributions**  
(Unaudited - See Accompanying Auditor's Report)  
(Dollar Amounts in Thousands)

**Pension**

<b>Year ended June 30</b>	<b>Annual Required Contributions</b>	<b>Actual Employer Contributions</b>	<b>Percentage Contributed</b>
2009	\$ 1,761,295	\$ 503,227	29%
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%

**Premium Assistance**

<b>Year ended June 30</b>	<b>Annual Required Contributions</b>	<b>Actual Employer Contributions</b>	<b>Percentage Contributed</b>
2009	\$ 107,097	\$ 92,493	86%
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, 2009  
(Dollar Amounts in Thousands)

	Administrative Expenses (1)	Investment Expenses (2)	Total
<b>Personnel costs:</b>			
Salaries and wages	\$ 14,710	\$ 3,387	\$ 18,097
Social security contributions	1,146	251	1,397
Retirement contributions	486	139	625
Employees' insurance contributions	4,363	543	4,906
Other employee benefits	783	723	1,506
<b>Total personnel costs</b>	<b>21,488</b>	<b>5,043</b>	<b>26,531</b>
<b>Operating costs:</b>			
Investment managers' fees	-	464,641	464,641
Custodian fees	-	569	569
Specialized services	19,444	1,418	20,862
Rental of real estate, electricity	1,414	182	1,596
Consultant fees	1,135	3,357	4,492
Treasury and other Commonwealth services	1,635	162	1,797
Postage	1,326	-	1,326
Contracted maintenance and repair services	560	17	577
Office supplies	394	81	475
Rental of equipment and software	1,248	248	1,496
Printing	482	-	482
Travel and training	189	10	199
Telecommunications	581	14	595
Equipment (not capitalized)	240	4	244
Miscellaneous expenses	995	1,819	2,814
<b>Total operating expenses</b>	<b>29,643</b>	<b>472,522</b>	<b>502,165</b>
<b>Fixed charges:</b>			
Depreciation	144	-	144
<b>Total operating expenses</b>	<b>\$ 51,275</b>	<b>\$ 477,565</b>	<b>\$ 528,840</b>

(1) Includes administrative expenses of \$1,819 related to Postemployment Healthcare Premium Assistance and \$13,817 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2009.

(2) Includes investment expenses of \$45 related to Postemployment Healthcare Premium Assistance for fiscal year ended June 30, 2009 and does not include \$23,636 in capitalized broker commissions for the fiscal year ended June 30, 2009.

**Supplemental Schedule 2**  
**Summary of Investment Expenses**  
 Year Ended June 30, 2009  
 (Dollar Amounts in Thousands)

	<u>Assets under management*</u>	<u>Fees</u>
<b>External management</b>		
Domestic equity	\$ 752,000	\$ 7,272
International equity	4,799,000	38,786
Fixed income	7,438,000	57,424
Real estate	4,327,000	98,735
Alternative investments	7,509,000	185,432
Absolute return	3,231,000	64,416
Commodities	1,833,000	12,576
<b>Total external management</b>	<b>29,889,000</b>	<b>464,641</b>
<b>Total internal management</b>	<b>13,305,000</b>	<b>8,998</b>
<b>Total investment management</b>	<b>\$ 43,194,000</b>	<b>\$ 473,639</b>
Custodian fees		569
Consultant fees		3,357
<b>Total investment expenses</b>		<b>\$ 477,565</b>

\* Net asset value of investments at June 30, 2009; investments are classified on an asset allocation basis.

**Supplemental Schedule 3**  
**Schedule of Payments to Non-Investment Consultants**  
Year Ended June 30, 2009  
(Payment Amounts Greater than \$50,000)

<u>Consultant</u>	<u>Fees</u>	<u>Services Provided</u>
CoreSource, Inc.	\$ 9,984,091	Postemployment healthcare benefits administration and claims adjudication
Vitech Systems Group, Inc.	3,704,440	NPAS project development
The Segal Company	2,233,306	Actuarial services and consulting for HOP and prescription drug plan
Rx Solutions, Inc.	1,611,620	Administration of postemployment health-care benefits and prescription drug plan
Buck Consultants LLC	557,001	Pension benefit actuarial services
Independent Pharmaceutical Consultants, Inc.	425,362	Administration of postemployment health-care benefits and prescription drug plan
Clifton Gunderson LLP	135,820	Financial audit of pension system and postemployment healthcare programs
Gunther International LTD	111,650	Communication and mailing services

