

PROTECTING THE PROMISE



Annual Financial Report Summary for the Fiscal Year Ended June 30, 2003

A MESSAGE FROM THE EXECUTIVE DIRECTOR

December 15, 2003

We make many promises throughout our lives. Some are easy to keep and quickly fulfilled. Others require determination, conviction, and sustained effort. In marriage, we make a life-long commitment to our partner. As parents, we promise love, nurturing, discipline, and sustenance. In our working lives, we dedicate ourselves to difficult tasks.

As a retirement system, we have dedicated ourselves to protecting the essential promise of retirement security for over 311,000 teachers and retired teachers in Illinois. Illinois educators are fortunate to be served by a defined benefit plan that assures that benefits are never reduced in times of economic crisis, budget woes, or market declines.

During the past year, we opposed proposals to consolidate the investment of the TRS retirement trust fund with other statewide systems. We feel our record of top quartile performance in tough economic times merits the continued independent investment of TRS assets.

A PROMISE OF SERVICE

Within the TRS organization, substantially all of our employees are dedicated to direct service to members and employers, or to supporting those activities. Our recent strategic planning process identified our mission as, "Deliver superior service through skilled staff, innovative technology, and careful investment." It is not accidental that the very first words are "deliver superior service." It is the central focus of all that we do at TRS.

As part of our planning process, we completed several "breakthrough" projects to quickly implement improvements benefiting those we serve. A new *Member Guide* was published and mailed to all active and retired members. A

new *Employer Guide* was provided to all TRS employers. Many of our brochures were revised to better target the information to specific needs. A new, Web-based employer remittance system is much easier to use than the phone-based remittance system or the obsolete paper-based remittance system.

Our service statistics are impressive. For example, we received over 171,000 inquiries through our toll free call center. We held over 140 large group meetings, provided in-office counseling to 7,229 members, and conducted numerous teleconferences to provide individual counseling to members across the state. The annual summer retirement season once again required maximum effort from our staff and technology to initiate 4,300 retirements during a compressed timeframe.

Our efforts will not be successful if they do not meet our members' expectations. During February, we offered 15,000 randomly selected members the opportunity to rate their satisfaction with TRS member services. Overall, respondents viewed our services as either "Excellent" or "Good." In keeping with our determination to provide personalized service in an era of computers and technology, our individual conferences received the highest rating. Over 70 percent characterized this service as excellent. We will work hard to continue to earn your confidence.

A PROMISE OF STEWARDSHIP

Whether the markets are strong or weak, your retirement system seeks to preserve the value of the fund. Our emphasis on capital preservation has been rewarded. As we awaited the return of market stability, the TRS fund maintained its conservative, risk-aware approach, minimized fund losses during an extremely difficult period, and placed well into the

top quartile of large public funds in both 2001 and 2002. Our proactive steps to position the fund for the market's return to more normal times was rewarded as well. For fiscal year 2003, our total return after expenses was 4.9 percent, placing TRS in the top 16 percent of large public pension plans.

Our long-term performance rankings are consistently in the top quartile. Our 10-year return is in the top 10 percent of large public funds. The overall return is 9.0 percent before investment expenses.

Concurrent with the market's return to positive territory, the General Assembly enacted a \$10 billion pension obligation bond program. The program provides the state with a measure of relief with respect to funding of state contributions for fiscal year 2004, while simultaneously providing TRS with an additional \$4.3 billion for immediate investment. The monies, which were received and invested on July 2, 2003, have improved our financial position and funded ratio, which stood at 49.3 percent on June 30, and rose to an estimated 58.5 percent on July 2.

To invest this substantial cash infusion prudently, our investment staff, in consultation with our external investment counsel, conducted performance reviews of all TRS investment managers. The TRS Board of Trustees has approved a strategy to invest the additional monies with many existing active managers that meet our performance expectations, to seek additional firms as appropriate, and to invest a significant portion in index funds offered by The Northern Trust Company. To ensure accountability of the additional assets entrusted to our stewardship, TRS will maintain separate reports covering the performance of pension obligation bond assets.

Money Management Letter, a publication of Institutional Investor, named me as Public Plan Sponsor of the Year. The award reflects the collective achievements of the TRS Board and staff, our investment consultant, and external money managers. In this and the coming years, we pledge to apply our skills, resources, and energy to secure excellent returns and to minimize risk. We will maintain our diversified portfolio approach and our commitment to employing only the best external money managers.

A PROMISE OF INNOVATION

Each year we undertake and complete significant projects to enhance our delivery of services to the membership.

- In January, we inaugurated a new information system. In naming the system, we chose STAR, which stands for "Serving Teachers And Retirees." The effort represents a total re-examination of our business practices to provide technology to meet the needs of our members for many years into the future. Developed primarily by our information technology staff, STAR will improve productivity and will enable us to further improve member services and operational economies.
- We will continue to work with the Governor, the legislature, and our constituent groups to secure permanent funding for the retired teacher health insurance program. The current law will sunset on June 30, 2004, making an early, effective resolution imperative.
- Active teachers who have been employed continuously with the same school district since March 31, 1986, will have a one-time opportunity to make a voluntary decision to pay Medicare taxes to gain program eligibility. The option will be particularly attractive to singles and those married to persons without Social Security coverage who have been unable to earn sufficient Medicare credits. We will provide extensive education materials over the next few months to all members affected.
- We are continuing with phase II of a program to develop a voluntary, TRS-sponsored 403(b) retirement savings plan. Initial surveys of members and employers showed interest that warrants further investigation.

IN CLOSING

During the past year, we have worked hard to demonstrate that retirement security is a vibrant, meaningful promise. Though the work is often demanding, it is rewarding as well. On behalf of the TRS Board and staff, thank you for your support and trust.



Jon Bauman
Executive Director

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BASIC FINANCIAL STATEMENTS

Teachers' Retirement System of the State of Illinois Statement of Plan Net Assets as of June 30, 2003, and 2002

| | 2003 | 2002 |
|--|--------------------------------|--------------------------------|
| Assets | | |
| Cash | \$3,651,963 | \$6,039,088 |
| Receivables and prepaid expenses | | |
| Member payroll deduction | 69,189,321 | 111,106,770 |
| Member contributions | 39,383,845 | 38,806,046 |
| Employer contributions | 7,379,497 | 8,811,602 |
| State of Illinois | 2,965,709 | 651,505 |
| Investment income | 165,638,540 | 233,414,394 |
| Prepaid expenses | 2,212,894 | 410,160 |
| Total receivables and prepaid expenses | <u>286,769,806</u> | <u>393,200,477</u> |
| Investments, at fair value | | |
| Fixed income | 7,314,849,657 | 8,795,239,241 |
| Equities | 12,649,352,623 | 10,126,648,199 |
| Real estate | 2,412,293,598 | 2,202,925,998 |
| Short-term investments | 866,824,921 | 1,201,995,818 |
| Private equity investments | 668,389,537 | 594,153,359 |
| Foreign currency | 23,905,527 | 23,955,458 |
| Total investments | <u>23,935,615,863</u> | <u>22,944,918,073</u> |
| Collateral from securities lending | 2,154,422,658 | 1,897,635,461 |
| Property and equipment, at cost, net of accumulated depreciation of \$6,456,750 and \$6,216,008 in 2003 and 2002, respectively | <u>2,630,930</u> | <u>3,113,533</u> |
| Total assets | <u>26,383,091,220</u> | <u>25,244,906,632</u> |
| Liabilities | | |
| Benefits and refunds payable | 8,633,145 | 7,204,169 |
| Administrative and investment expenses payable | 75,872,933 | 81,017,997 |
| Payable to brokers for unsettled trades, net | 1,019,339,413 | 892,764,293 |
| Securities lending transactions | 2,154,422,658 | 1,897,635,461 |
| Total liabilities | <u>3,258,268,149</u> | <u>2,878,621,920</u> |
| Net assets held in trust for pension benefits | <u>\$23,124,823,071</u> | <u>\$22,366,284,712</u> |



Teachers' Retirement System of the State of Illinois
Statement of Changes in Plan Net Assets
Years ended June 30, 2003, and 2002

| | 2003 | 2002 |
|--|--------------------------------|--------------------------------|
| Additions | | |
| Contributions | | |
| Members | \$732,020,451 | \$681,151,770 |
| State of Illinois | 929,709,762 | 814,739,766 |
| Employers | | |
| Early retirement | 46,773,190 | 41,347,938 |
| Federal funds | 33,354,836 | 26,282,792 |
| 2.2 benefit formula | <u>11,424,437</u> | <u>24,987,416</u> |
| Total contributions | <u>1,753,282,676</u> | <u>1,588,509,682</u> |
| Investment income | | |
| From investment activities | | |
| Net appreciation (depreciation) in fair value | 467,463,329 | (1,461,163,444) |
| Interest | 343,075,998 | 463,758,715 |
| Real estate operating income, net | 184,785,558 | 174,430,870 |
| Dividends | 139,831,006 | 132,356,304 |
| Private equity income | 8,887,682 | 28,036,960 |
| Other investment income | <u>3,560,189</u> | <u>13,640,070</u> |
| Investment activity income (loss) | 1,147,603,762 | (648,940,525) |
| Less investment expense | <u>(92,431,726)</u> | <u>(86,308,190)</u> |
| Net investment activity income (loss) | <u>1,055,172,036</u> | <u>(735,248,715)</u> |
| From securities lending activities | | |
| Securities lending income | 28,660,317 | 59,315,009 |
| Securities lending management fees | (1,420,317) | (2,816,327) |
| Securities lending borrower rebates | <u>(21,559,925)</u> | <u>(45,237,012)</u> |
| Net security lending activity income | <u>5,680,075</u> | <u>11,261,670</u> |
| Total investment income (loss) | <u>1,060,852,111</u> | <u>(723,987,045)</u> |
| Total additions | <u>2,814,134,787</u> | <u>864,522,637</u> |
| Deductions | | |
| Retirement benefits | 1,890,511,562 | 1,660,997,776 |
| Survivor benefits | 88,996,829 | 80,461,343 |
| Disability benefits | 19,113,893 | 18,289,549 |
| Refunds | 43,114,742 | 38,755,604 |
| Administrative expenses | 13,859,402 | 13,487,393 |
| Prior service credits and transfers | <u>0</u> | <u>1,892,343</u> |
| Total deductions | <u>2,055,596,428</u> | <u>1,813,884,008</u> |
| Net increase (decrease) | 758,538,359 | (949,361,371) |
| Net assets held in trust for pension benefits | | |
| Beginning of year | <u>22,366,284,712</u> | <u>23,315,646,083</u> |
| End of year | <u>\$23,124,823,071</u> | <u>\$22,366,284,712</u> |

INVESTMENTS

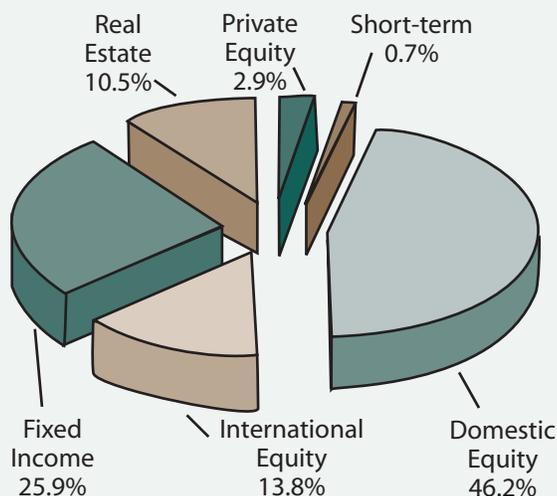
Following nine months of erratic performance by the major stock indices, the well-positioned TRS investment portfolio benefited from improved market conditions. Total returns in fiscal year 2003 exceeded \$1.0 billion, resulting in an increase in total investments and investment receivables to \$24.1 billion.

By preserving capital during difficult times and fine-tuning our investment strategy, TRS reported an impressive 4.9 percent return, net of expenses, for fiscal year 2003, ranking in the top 16 percent of large public pension funds tracked by Callan Associates. Additional performance accomplishments include:

- TRS placed in the top quartile of the Wilshire Trust Universe Comparison Service (TUCS) databases for the one-, three-, five-, and 10-year periods.
- Several national surveys show that the superior TRS investment returns came with substantially less risk than the median major public pension system.

Assets entrusted to TRS stewardship are protected through extensive diversification. Five principal asset classes are used; within each class, the use of multiple asset managers further reduces risk.

Investment Diversification at June 30, 2003



The strong returns secured by TRS came with substantially less risk than other large funds. For fiscal year 2003, Callan Associates reports that over 60 percent of the large funds had higher risk levels than TRS. The ten-year risk profile shows that 84 percent of these funds had higher risk levels.

Investment performance by asset class is shown below for the year ended June 30, 2003, and for three-, five-, and 10-year periods. For the second consecutive year, the highest returns were achieved in the fixed income and real estate asset classes.

Performance Summary (net of fees)

| Asset Class/Index | 2003 | 3 Years | 5 Years | 10 Years |
|-----------------------------------|---------------|---------------|----------------|-------------|
| TRS Total Fund | 4.9% | (0.9%) | 3 . 6 % | |
| 8.4% | | | | |
| TRS Weighted Policy Index | 3.9 | (2.4) | 2.6 | 8.1 |
| CPI (Inflation) | 2.1 | 2.1 | 2.4 | 2.4 |
| TRS Equity - U.S. | 0.5 | (9.1) | (1.3) | 8.7 |
| Russell 3000 Index | 0.8 | (10.5) | (1.1) | 9.7 |
| TRS Fixed Income | 10.7 | 9.2 | 7.0 | 7.2 |
| TRS Weighted Fixed Income Index | 11.1 | 9.4 | 7.2 | 7.0 |
| Lehman Brothers Aggregate Index | 10.4 | 10.1 | 7.5 | 7.2 |
| TRS Equity - International | (5.2) | (10.7) | (1.6) | 4.1 |
| Non-U.S. Equity Index | (4.2) | (12.5) | (2.8) | 3.1 |
| TRS Real Estate | 8.8 | 6.9 | 8.6 | 10.5 |
| Real Estate Property Index | 7.7 | 8.2 | 9.8 | 9.6 |
| TRS Private Equity | (11.4) | (9.9) | 16.4 | 25.7 |
| Russell 3000 Index + 3.0% | 3.8 | (7.7) | 1.9 | 13.0 |
| TRS Short-Term Investments | 1.5 | 3.4 | 4.3 | n/a |
| ML 91-Day Mark to Markets Index | 1.5 | 3.3 | 4.1 | n/a |
| 90-Day T-Bill Index | 1.3 | 2.9 | 3.8 | n/a |

Rates of return are provided by The Northern Trust Company in accordance with AIMR Performance Presentation Standards.

TRS is a careful, long-term investor. The following chart illustrates the growth of \$10,000 since 1982, when TRS investments became subject to the "prudent person rule." This standard requires that investments be managed solely in the interest of fund participants and their beneficiaries. The chart clearly shows the benefit of investing for the long term.

Growth of \$10,000



ACTUARIAL VALUATION

Actuarial results for fiscal year 2003 showed a continued increase in the unfunded liability of the system for future pension benefits. The following table summarizes the actuarial liability, assets, and the funded ratio.

Actuarial Valuation with Market Value Assets (\$ in thousands)

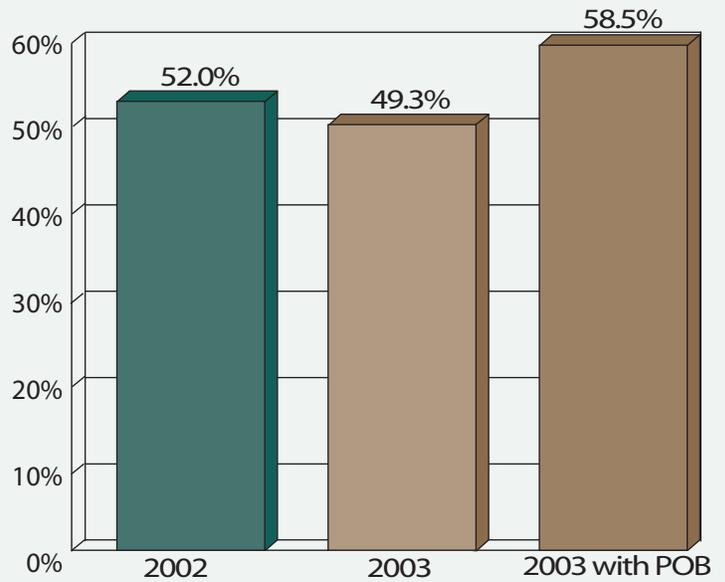
| | Years Ended June 30 | |
|---|---------------------|---------------------|
| | 2003 | 2002 |
| Total actuarial accrued liability | \$46,933,432 | \$43,047,674 |
| Less actuarial value of assets (net assets at market value) | \$23,124,823 | \$22,366,285 |
| Unfunded liability | \$23,808,609 | \$20,681,389 |
| Funded ratio | 49.3% | 52.0% |

The accrued liability is the actuarial value of benefits that have been earned and will be paid to members and their beneficiaries in the future. Much of the increase occurs because active teachers have completed another year of service. Other factors are the continued growth in the teaching work force, plan amendments amounting to \$54 million, and a variety of actuarial factors resulting from salary increases, service and ERO purchases, and retirements attributable to prior periods.

The unfunded liability is the amount of future benefits that are not covered by net assets at market value. Two factors influenced the amount of the unfunded liability at June 30, 2003. The interest cost on the unfunded liability has the practical effect of increasing the unfunded liability. For 2003, this amounted to \$1,758 million, of which \$342 million was covered by the state appropriation. In addition, because actual investment earnings lagged the assumed rate, the unfunded liability grew by an additional \$827 million.

The funded ratio, which shows the percentage of accrued liabilities that is covered by net assets, declined to 49.3 percent at June 30. However, during June 2003, the state of Illinois issued pension obligation bonds (POB) to help increase the assets available for investment by the Teachers' Retirement System, State Employees' Retirement System, State Universities Retirement System, General Assembly Retirement System, and Judges' Retirement System. TRS received a total of \$4,330,373,948 that became available for investment on July 2, 2003. The following table shows the impact on the funded ratio.

Funded Ratio

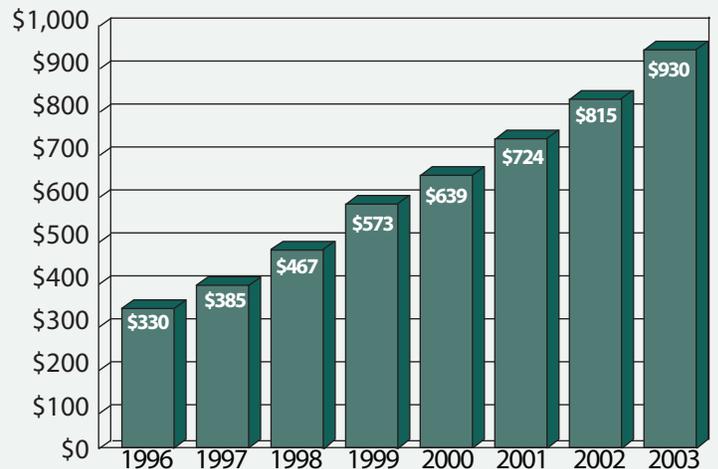


STATE FUNDING

State appropriations for retirement contributions amounted to \$930 million in fiscal year 2003 and were made in accordance with Public Act 88-593. Since 1996, when this funding law took effect, the state has honored the terms of a 50-year funding program. During the first 15 years, contributions are being gradually increased to a level percentage of payroll that will result in TRS attaining a 90 percent funded ratio in 2045.

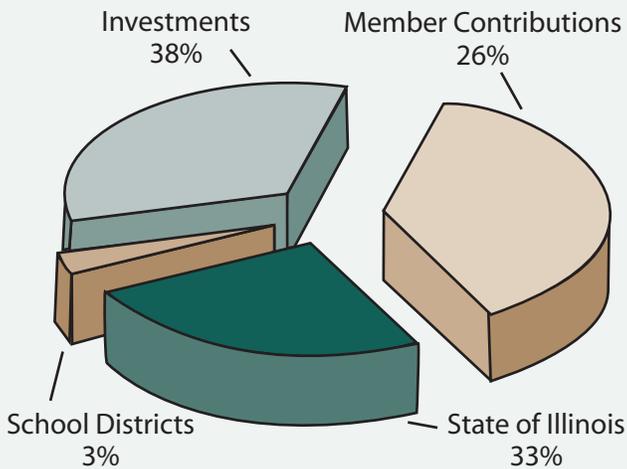
The following table illustrates the substantial increase in state funding since the inception of the program.

Summary of State Appropriations (\$ in millions)

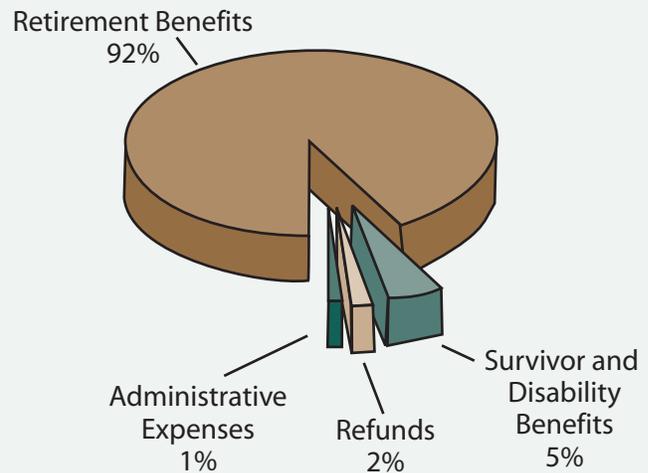


State funding is provided through a continuing appropriation that ensures that amounts required under the funding program are made available each year. It is essential that the integrity of this program be protected and the balance of the funding schedule upheld. This remains a top priority for TRS.

Revenues



Expenditures



FISCAL YEAR HIGHLIGHTS

| | 2003 | 2002 |
|--|-----------------------|-----------------------|
| Active contributing members | 152,117 | 155,979 |
| Inactive noncontributing members | 86,279 | 66,971 |
| Benefit recipients | <u>73,431</u> | <u>67,949</u> |
| Total membership | 311,827 | 290,899 |
| Actuarial accrued liability (AAL) | \$46,933,432,000 | \$43,047,674,000 |
| Less net assets held in trust for pension benefits | <u>23,124,823,000</u> | <u>22,366,285,000</u> |
| Unfunded actuarial accrued liability (UAAL) | \$23,808,609,000 | \$20,681,389,000 |
| Funded ratio (actuarial value of assets/AAL) | 49.3% | 52.0% |
| Total fund investment return, net of fees | 4.9% | (3.2%) |
| Benefits and refunds paid | | |
| Benefits paid | \$1,998,622,284 | \$1,759,748,668 |
| Refunds paid | <u>43,114,742</u> | <u>38,755,604</u> |
| Total | \$2,041,737,026 | \$1,798,504,272 |
| Income | | |
| Member contributions* | \$732,020,451 | \$681,151,770 |
| Employer contributions (includes state of Illinois contributions) | 1,021,262,225 | 907,357,912 |
| Total investment income (loss) | <u>1,060,852,111</u> | <u>(723,987,045)</u> |
| Total | \$2,814,134,787 | \$864,522,637 |

* Includes member payments and accounts receivable under the Payroll Deduction Program.

This publication is a summary of the *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2003. The financial information presented in this report was derived from the *Comprehensive Annual Financial Report* and is in conformity with Generally Accepted Accounting Principles (GAAP). Copies of the *Comprehensive Annual Financial Report*, which has more detailed information, are available at our Web site, www.tr.s.state.il.us, or by calling (800) 877-7896.