



Erica of Administrative Services sends a counselor an e-mail notification that a teacher has arrived for a scheduled appointment.

Introduction



Certificate of Achievement for Excellence in Financial Reporting

Presented to

Teachers' Retirement System of the State of Illinois

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2004

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director



Retirement Security for Illinois Educators

Teachers' Retirement System of the State of Illinois

Jon Bauman, Executive Director
2815 West Washington, P.O. Box 19253
Springfield, Illinois 62794-9253

Letter of Transmittal

December 15, 2005

I am pleased to present the *Comprehensive Annual Financial Report* for the Teachers' Retirement System of the State of Illinois (TRS) for the fiscal year ended June 30, 2005. TRS management and staff are responsible for the accuracy and completeness of this report and for ensuring that all material disclosures have been made. To the best of our knowledge, the information presented is a fair and accurate portrayal of the financial position and operations of TRS as of June 30, 2005.

TRS was established by the State of Illinois on July 1, 1939, to provide retirement, disability, and death benefits to teachers at Illinois public elementary and secondary schools outside the city of Chicago.

This report consists of five sections:

- The Introduction Section contains the Certificate of Achievement for Excellence in Financial Reporting, this Letter of Transmittal, a message from our executive director that outlines the major activities of the past year and plans for the future, identification of the TRS Board of Trustees and organizational structure, and consulting and professional service providers.
- The Financial Section contains the Independent Auditors' Report, Management's Discussion and Analysis, the financial statements and related notes, required supplementary schedules, and other supplementary information.
- The Investment Section contains information detailing TRS performance, investment managers, and the TRS investment portfolio.
- The Actuarial Section contains the actuary's letter of certification, actuarial assumptions and methods, the latest actuarial valuation, certain statistical information on active members and benefit recipients, and a plan summary including any changes in the plan.
- The Statistical Section contains information and additional statistical data pertaining to benefit recipients and historical data on revenue and expenses.

Financial Information

A system of internal controls helps TRS to monitor and safeguard assets and promote efficient operations. An annual external audit is conducted by the Illinois Auditor General in addition to regular reviews by our internal auditor. The annual budget for TRS administrative expenses is approved by the Board of Trustees, and financial statements are prepared in accordance with generally accepted accounting principles (GAAP) within the guidelines established by the Governmental Accounting Standards Board (GASB).

Please refer to the Management's Discussion and Analysis for an overview of the financial highlights and a financial analysis of TRS. Major TRS initiatives and accomplishments are contained in the executive director's message.

Revenues and Expenses

The three sources for TRS funding include member contributions, investment income, and employer contributions through state appropriations and payments by school districts. In FY04, TRS received \$4.330 billion from the sale of general obligation bonds by the State of Illinois. Discussion regarding the receipt of the bond proceeds may be found in the Management's Discussion and Analysis and in the Notes to the Financial Statements. TRS expenses include payments of benefits, refunds, and administrative expenses. Negative amounts are enclosed in parentheses () throughout this report.

Revenues (\$ millions)

Source	2005	2004	Increase	
			Amount	% Change
Member contributions	\$762	\$769	(\$7)	(0.9%)
State of Illinois	907	5,361	(4,454)	(83.1)
Employer contributions	148	128	20	15.6
Total investment income	<u>3,330</u>	<u>4,486</u>	<u>(1,156)</u>	<u>(25.8)</u>
Total	<u>\$5,147</u>	<u>\$10,744</u>	<u>(\$5,597)</u>	<u>(52.1%)</u>

Expenses (\$ millions)

Source	2005	2004	Increase	
			Amount	% Change
Benefits payments	\$2,533	\$2,262	\$271	12.0%
Refunds	60	48	12	25.0
Administrative/Other	<u>14</u>	<u>14</u>	<u>0</u>	<u>0</u>
Total	<u>\$2,607</u>	<u>\$2,324</u>	<u>\$283</u>	<u>12.2%</u>

Investments

TRS investments had a 10.8 percent return net of fees for the year. Total investment income for FY05 was \$3,330 million. The TRS trust fund is invested by authority of the Illinois General Assembly under the prudent person rule that requires investments to be managed solely in the interest of TRS members and beneficiaries. The portfolio is fully diversified across different asset classes. Within each asset class there are a number of investment managers to ensure the appropriate mixture across the various investment styles, allowing the portfolio to achieve broad exposure to the market, while minimizing risk. This broad diversification serves as the best defense against the uncertainty of volatile world markets.

The Investment Section of this report contains a summary of the portfolio and investment activities.

Funding

The actuarial value of assets (net assets at market value) was \$34.085 billion at June 30, 2005. Net assets increased \$2.540 billion. TRS's actuarial accrued liability was \$56.075 billion at June 30, 2005, resulting in a funded ratio of 60.8 percent. This funded ratio is a decrease from the funding ratio of 61.9 percent for FY04. TRS's actuarial unfunded liability

increased \$2.587 billion during FY05 to \$21.990 billion at June 30, 2005. The increase in the unfunded liability is partially due to the recognition of the cost of future retirements under the Modified ERO and a higher number of retirements than anticipated.

The Actuarial Section of this report contains the actuary's letter and further information on TRS funding.

Independent Audit

Each year TRS's financial statements, records, and internal controls are examined by special assistant auditors employed by the Illinois Auditor General. In addition, an annual compliance attestation examination is performed to review compliance with applicable statutes and codes. The Independent Auditors' Report on TRS's financial statements is included in the Financial Section of this report.

GFOA Award

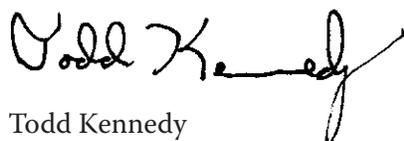
The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to TRS for its *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2004. The Certificate of Achievement is a prestigious national award recognizing excellence in the preparation of state and local government financial reports.

To be awarded the certificate, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report whose contents meet or exceed program standards. This report must satisfy both generally accepted accounting principles and applicable legal requirements. TRS has received a certificate for the last 16 years. We believe our current report continues to meet the program requirements and are submitting it to the GFOA for consideration again this year.

Acknowledgments

Information for this report was gathered by and reflects the combined efforts of TRS staff under the leadership of the Board of Trustees and the executive director. It is intended to provide complete and reliable information as a basis for making management decisions, to determine our compliance with legal provisions, and as a means for determining responsible stewardship of the assets contributed by members and their employers.

This report is provided to members of the General Assembly, all participating employers, and to others by request. The participating employers of TRS form a link between TRS and its members. Their cooperation, for which we are grateful, contributes significantly to our success. We hope this report is both informative and helpful.



Todd Kennedy
Director of Administration



Executive Director Jon Bauman and Director of Administration Todd Kennedy discuss the upcoming year's budget.

A Message from the Executive Director

December 15, 2005

Dear Friends:

Great things are often accomplished by relatively small numbers of people working together toward a great cause. At TRS, a staff of 165 employees shares the common goal of providing retirement security for over 325,000 Illinois educators. It is fitting that this report, which documents our stewardship of your retirement fund, also recognizes the exceptional contributions of the individuals who achieve a high level of stewardship on your behalf.

In various ways, the staff that serves you well year-in and year-out truly accomplished great things in 2005. During the “ERO surge” that increased retirements by 50 percent, our staff maintained a caring, personal and professional commitment to member service. TRS investments returned over 10.8 percent, substantially exceeding the median public fund return. Long-sought legislative goals were achieved and many operational improvements were implemented.

This year’s annual report theme, “Working for you,” salutes our valued workforce. As you view the photos and read the captions, I hope you will appreciate how our staff contributes to the success of the retirement system.

Influx of Retirement Applications Processed Quickly

The possibility that the Early Retirement Option (ERO) might not be extended prompted many members to retire under the existing law. Well over 6,900 members chose to retire, including 3,638 who opted for ERO. Quite remarkably, despite near-record retirements, initial benefit payments commenced in record time. Nearly half of all summer-season retirees received their first check prior to July 1, a substantial improvement over prior years. The advance resulted from noteworthy improvements and changes in the retirement process. For example, members were encouraged to initiate their Personalized Retirement Interview (PRI) much earlier in the year. The PRI itself was made available online in addition to the traditional on-site and telephone interviews. We encouraged school districts to file supplementary reports for retiring members in advance of the actual retirement date so that review and processing would be complete by the member’s expected retirement date. The changes enhanced our efficiency and reduced our reliance on overtime.

Legislative Changes

ERO Extended. A difficult and lengthy effort to extend the Early Retirement Option concluded with reauthorization on a revenue-neutral basis. The modifications will allow the program to continue at least through 2012. The extension includes a “Pipeline” provision for members who notified their employers on or before June 1, 2005 of their intention to retire under the terms of contracts or collective bargaining agreements. These members will be allowed to use the provisions of the law that expired on June 30, 2005.

Disability Return to Work Enacted. A new law allows individuals who have received TRS disability benefits for one year or more to return to part-time, TRS-covered employment if their medical conditions improve. On a limited basis, members may tutor, substitute, or part-time teach for a TRS-covered employer without loss of disability benefits as long as

the combined earnings from teaching and disability benefits do not exceed 100 percent of the salary upon which the benefit was based.

Double-digit Investment Returns

Propelled by strong fourth quarter performance in all asset classes and the strength of the private equity market, the TRS investment portfolio enjoyed another outstanding year in fiscal year 2005. Among the year's major accomplishments:

- TRS's net assets reached \$34 billion at June 30, an all-time high.
- The TRS pension obligation bond (POB) portfolio reached \$1 billion in additional value since its inception two years ago.
- As in four of the last five years, TRS was the top performing Illinois state pension fund.
- TRS investment performance has consistently ranked at or near the top quartile and ranks in the top 10 percent of its peer universe over the last five years.

Working Harder for You

Our commitment to outstanding service is exemplified by the following:

- In response to member requests, Social Security numbers were removed from correspondence and reports.
- The secure area of the TRS Web site was redesigned with more features. Members may update their personalized information, pay TRS balances online, view information from their TRS Benefits Report, and more.
- Retirement, survivor, and disability benefit videos were also added to the Web site.
- A survey of TRS-covered employers gave TRS high marks in all areas. The staff also conducted 93 employer meetings to provide training and discuss issues affecting employers.

In Closing

Each year brings new challenges. For example, the reductions in TRS state funding for fiscal years 2006 and 2007 contained in Public Act 94-0004 will worsen our negative cash flow and increase the dependency upon successful investment performance to maintain financial stability. During the past year, my associates and I were sickened by revelations of misconduct by two former appointed trustees of the fund that extended to a former external counsel. While the revelations in no way implicated TRS or alleged any financial losses or misconduct, our good name was unfairly dishonored. Thankfully, our investment performance and our fundamental integrity remain strong.

Rest assured that the staff of TRS is more than equal to the tests of these and other challenges facing us in the year ahead. We will never stop working for you — the members, annuitants, and employers of TRS.

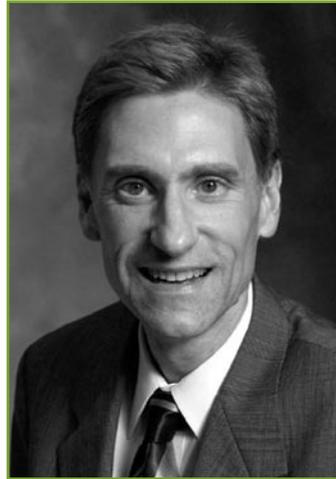
Sincerely,



Jon Bauman
Executive Director

Board of Trustees

As of July 15, 2005



Randy Dunn, President
Springfield



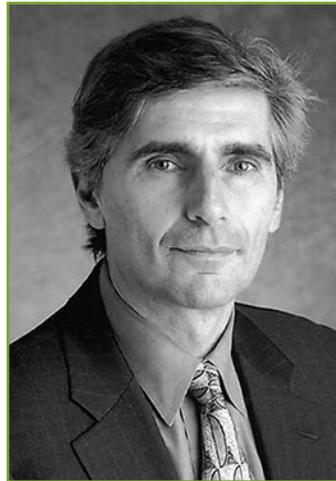
Molly Phalen, Vice President
Rockford



Tony Abboud
Northbrook



James Bruner
Jacksonville



Jack Carriglio
Glenview



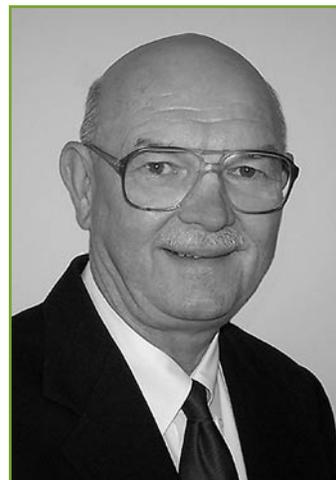
Jan Cleveland
Carmi



Cinda Klickna
Rochester



Sharon Leggett
Evanston



Bob Lyons
Hoffman Estates



Cynthia O'Neill
Carlyle

Organizational Structure

Executive Staff Members as of June 30, 2005

Board of Trustees



Jon Bauman
Executive Director



Kathleen Farney
Director of Research



Tom Gray
General Counsel



Todd Kennedy
Director of
Administration



Gina Larkin
Director of
Human Resources



Kathy Pearce
Communications
Supervisor



Stan Rupnik
Chief Investment
Officer



Stacy Smith
Internal Audits
Manager



Terry Viar
Director of
Member Services



Nick Yelverton
Director of
Government Affairs

Consulting and Professional Services

Actuary

Buck Consultants, an ACS Company
Chicago, Illinois

Benchmarking

Cost Effectiveness Measurement, Inc.
Toronto, Ontario

External Auditors

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

BKD, LLP
Decatur, Illinois

Information Systems

Ashbaugh and Associates, Inc.
Springfield, Illinois

Hupp Information Technologies
Springfield, Illinois

Richard Hale Shaw Group Inc.
Carson City, Nevada

Sikich Gardner & Co. LLP
Springfield, Illinois

CTG Inc. of Illinois
Springfield, Illinois

IBM Corp.
Chicago, Illinois/Boulder, Colorado

Sentinel Technologies
Chicago, Illinois

Weisner Associates Inc.
Minneapolis, Minnesota

Investment Consultants

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

Callan Associates Inc.
(general consultant)
San Francisco, California

Risk Resources
(real estate insurance)
Elmhurst, Illinois

External Legal Counsel

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

Gardner Carton & Douglas
Chicago, Illinois (until Aug. 2004)

Holland + Knight LLP
Chicago, Illinois (beginning Nov. 2004)

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

Sorling, Northrup, Hanna,
Cullen & Cochran, Ltd.
Springfield, Illinois

Cavanagh & O'Hara
Springfield, Illinois

Heyl, Royster, Voelker & Allen
Springfield, Illinois

Jenner & Block LLP
Chicago, Illinois (beginning Nov. 2004)

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

Master Trustee

The Northern Trust Company
Chicago, Illinois