



Introduction



2012



GOVERNMENT FINANCE OFFICERS ASSOCIATION

Certificate of Achievement
for Excellence
in Financial Reporting

Presented to

Teachers' Retirement System
of the State of Illinois

Executive Director / CEO



LETTER OF TRANSMITTAL

December 18, 2013

To the Board of Trustees and TRS Members:

We are pleased to present the *Comprehensive Annual Financial Report (CAFR)* for the Teachers' Retirement System of the State of Illinois (TRS) for the fiscal years ended June 30, 2013 and June 30, 2012. The presentation of this year's report mirrors the stylistic and functional upgrades made during 2013 to the TRS website – <http://trs.illinois.gov>. A newly redesigned interactive platform provides the latest information on TRS's finances and pension issues facing Illinois, as well as tools to help members and employers do business with TRS.

The 2013 CAFR reveals that despite its standing as one of the 50 largest retirement systems in the United States and one of the top 100 funds worldwide, TRS continues to face significant financial challenges in the future unless the State of Illinois takes action to counteract decades of consistent underfunding by state government. Going forward, these financial challenges undermine the state's legal and moral responsibility to make retirement promises that can be kept and to fully fund these promises.

According to a media analysis based on assets, TRS currently ranks 41st among both public and private United States pension systems, holding \$39.9 billion in assets at the end of fiscal year 2013. However, if TRS had been properly funded over the last 74 years, TRS would be among the 10 largest U.S. systems. These facts underscore the extent of the problem.

By all accounts, the long-term funded status of TRS is worst in the nation. TRS's funded ratio at the end of the fiscal year stood at 40.6 percent, on an actuarial basis, with a total long-term unfunded liability of \$55.7 billion. The obligations owed members over the next several decades have increased by 162 percent since 2000. However during the same period, TRS assets grew by only 63 percent.

TRS remains a major entity in institutional investing and the world economy, but over time its growing unfunded liability will increasingly threaten its sustainability for all members – those that are retired and those who are active educators. A large unfunded liability threatens investment returns that are vital to the retirement system's security.

For the last two years TRS has played a leading role in pinpointing and explaining the steep challenges faced by the state's five public pension systems. Led by the Board of Trustees, TRS has consistently warned that a growing pension debt and state government's consistent inability to provide actuarially adequate funding will lead to calamity in less than 25 years. As this CAFR is being readied, members of the Illinois General Assembly continue to debate controversial legislation that could result in changes to funding for pensions and to retirement benefits. Without any changes to correct the imbalance between spending and revenue, TRS predicts that obligations could exceed resources as early as 2034.

In 2012 the TRS Board of Trustees approved a resolution that not only recognized the threat to our members, but set forth a five-point foundation for any change to the pension code designed to secure the future. The five cornerstones of future security for TRS pensions would:

1. Require the use of standard actuarial practices and formulas instead of alternate calculations and practices required by state law that artificially lower state funding levels.

2. Require a legal guarantee that ensures state government fully funds TRS and the other public pension funds in the future.
3. Amend state law to fix a serious financial inequity in the benefits and funding for Tier II pensions that significantly penalizes those members over time and masks the true underfunded status of Tier I benefits.
4. Ensure that any changes in the pension code made by the General Assembly are uncomplicated and easy to administer fairly to all our members.
5. Require that any changes to the pension code adhere to Article 13, Section 5 of the Illinois Constitution – the pension protection clause.

Ensuring the long-term stability and strength of TRS will enable it to keep the promises made by the State of Illinois for a secure retirement. In good times and bad, TRS has maintained trusted relationships with generations of educators and has never defaulted on any promises.

TRS has more than fulfilled its duty to properly manage the money entrusted to it by our members. At the end of fiscal year 2013, TRS investments returned 12.8 percent, net of fees, outperforming the System's custom benchmark of 12.5 percent. More importantly, TRS's 30-year investment return exceeded 9 percent, which outperformed the long-term assumed rate of return of 8 percent.

The state's promise of a secure retirement is vital to school teachers and communities in every corner of Illinois. TRS pensions provide our members with a stable income during their golden years that allow them to continue to be involved members of society. Moreover, TRS members continue to contribute to the Illinois economy. TRS benefits support economic activity that creates more than 32,000 jobs throughout the state and provide an annual economic stimulus in excess of \$4.4 billion.

TRS is required by law to publish a *CAFR* annually with information about the System's financial condition, investment methods and performance, actuarial conclusions that determine financial needs and statistical information about members, school districts, revenues and benefits. TRS management and staff are responsible for the accuracy of this report and for ensuring that all material disclosures have been made. TRS recognizes that the limitations of internal controls must be considered. These controls are designed to provide reasonable assurance regarding the safekeeping of assets, the reliability of financial records, the appropriate segregation of duties and responsibilities and the use of sound accounting and financial practices. The concept of reasonable assurance recognizes that the cost of a control should not exceed the benefits likely to be derived and that the valuation of costs and benefits requires estimates and judgments by management. The objective of internal controls at TRS is a reasonable, not absolute, assurance that the System's financial statements are free of material misstatements. Three internal auditors are employed to continually review and determine that all laws, rules, policies and procedures are followed.

Profile of TRS

TRS was established by the State of Illinois on July 1, 1939, to provide retirement, disability, and death benefits to teachers employed by Illinois public elementary and secondary schools outside the city of Chicago. A 13-member Board of Trustees governs TRS. The Board includes the state superintendent of education, six representatives of the public who are appointed by the governor, four members of TRS who are elected by active teachers, and two retired members who are elected by annuitants. The Board of Trustees appoints the executive director, who is responsible for the effective administration of TRS.

The annual budget for TRS administrative expenses is prepared by staff and approved by the Board of Trustees. The TRS annual operating budget request is prepared in conjunction with a review of the long-range strategic plan.

Financial Information

Our staff issues a CAFR within six months of the close of each fiscal year. The report contains financial statements presented in conformity with generally accepted accounting principles (GAAP) applied within guidelines established by the Governmental Accounting Standards Board (GASB).

A system of internal controls helps us monitor and safeguard assets and promote efficient operations. Each year TRS's financial statements, records, and internal controls are examined by a professional accounting firm who serves as 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 Auditor's Report on TRS's financial statements is included in the Financial Section of this report.

Generally accepted accounting principles require that management provide a narrative introduction, overview, and analysis to accompany the financial statements in the form of a Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The MD&A can be found immediately following the report of the independent auditors.

Revenues and Expenses

The three sources of TRS funding include member contributions, investment income, and employer contributions through state appropriations and payments by school districts. TRS expenses include payments of benefits, refunds, and administrative expenses. Negative amounts are shown in parentheses () throughout this report.

Revenues (\$ millions)

Source	2013	2012	Increase	
			Amount	% Change
Member contributions	\$922	\$918	\$4	0.4%
State of Illinois	2,703	2,406	297	12.3
Employer contributions	157	155	2	1.3
Total investment income	<u>4,562</u>	<u>224</u>	<u>4,338</u>	1,936.6
Total	<u>\$8,344</u>	<u>\$3,703</u>	<u>\$4,641</u>	125.3%

Expenses (\$ millions)

Source	2013	2012	Increase	
			Amount	% Change
Benefits payments	\$4,893	\$4,554	\$339	7.4%
Refunds	89	84	5	6.0
Administrative/Other	20	19	1	5.3
Total	<u>\$5,002</u>	<u>\$4,657</u>	<u>\$345</u>	7.4%

TRS staff and the Board of Trustees remain vigilant in our efforts to improve the retirement system's funded status for our current and future members. We continue to invest prudently and in a disciplined manner for the benefit of our membership and for the long-term success of the retirement system. The TRS Board and staff believe the overall investment strategy remains sound and appropriate for our circumstances.

Investments

The TRS investment portfolio returned 13.5 percent, gross of fees, for the fiscal year ended June 30, 2013. Total TRS investment assets increased approximately \$2.9 billion during the year.

The TRS trust fund is invested by authority of the Illinois Pension Code under the "prudent person rule," requiring investments to be managed solely in the interest of fund participants and beneficiaries. The TRS Investment

Policy guides TRS's investments. Investment principles include preserving the long-term principal of the trust fund, maximizing total return within prudent risk parameters, and acting in the exclusive interest of TRS members.

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

Funding

During the year ended June 30, 2013, the funded ratio of the Teachers' Retirement System decreased from 42.1 percent to 40.6 percent. The actuarial value of assets at year end was \$38.2 billion and the actuarial accrued liability was \$93.9 billion. The decline in the funded ratio was due to an increase in the liability mainly due to the continued phase-in of prior investment losses. Under the smoothing methodology required by Public Act 96-0043, differences between actual and expected investment earnings are recognized prospectively over a five-year period. The actuarial value of assets now recognizes 100 percent of the 2009 losses, 80 percent of the 2010 gains, 60 percent of the 2011 gains, 40 percent of the 2012 losses, and 20 percent of the 2013 gains, compared to the actuarially assumed rate of return.

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

Major Initiatives

In fiscal year 2013, TRS initiated and continued several initiatives that benefited our members and enhanced the retirement system:

- An extensive document imaging project designed to digitize approximately 398,000 hard-copy member records containing an estimated 11 million images. The new record system will help prevent identity theft and the unintended loss of records. Once member records are converted, the project will begin digitizing files from the Employer Services and Investment Departments.
- Improvements to the System's interaction with members, stakeholders and the public. The re-designed TRS website greatly improved the functionality and usefulness of the site for members. An extensive reconfiguration of the retirement system's call center in Springfield will enhance direct service to members. A new larger office in Lisle will improve member outreach in northern Illinois. New software improves the Freedom of Information Act process for members and the public.
- A commitment to environmental stewardship. The document imaging project greatly reduces the amount of paper used in the day-to-day operations. All materials for TRS Board meetings for the first time are being delivered electronically, eliminating thousands of pieces of paper for each meeting and the staff time needed for production and duplication.
- Extensive analysis and actuarial calculations on proposed pension legislation for state officials, legislators, policymakers and stakeholders regarding the impact of various ideas and concepts on benefits and system funding.
- The integration of new financial reporting guidelines established by the Governmental Accounting Standards Board for use in fiscal year 2014, along with an education program to help members, stakeholders and the media understand the rationale, use and limitations of the new procedures.

All of these initiatives are pursued with one goal in mind: to better serve our members, whether they are 25 or 100 years of age. We are committed to earn their trust. We know they look to us to keep the retirement promises made to them. That requires us to be honest about the threats to these promises. We are committed to being a source of clarity in a world filled with uncertainty and are grateful for the trust placed in our care.

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, 2012. This was the 24th consecutive year that the government has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

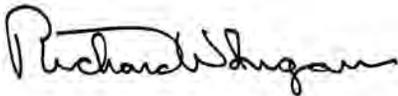
A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

Acknowledgements

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 of determining responsible stewardship of the assets contributed by members and their employers.

This report is made available to members of the General Assembly, participating employers, and to other interested persons by request. The participating employers of TRS form a link between TRS and its members. Their cooperation contributes significantly to our success. We hope all recipients of this report find it informative and useful. This report is also available to the general public on our website, <http://trs.illinois.gov>.

We would like to take this opportunity to express our gratitude to staff, professional consultants, and others who have worked so diligently to ensure TRS's successful operation.



Richard Ingram
Executive Director



Jana Bergschneider, CPA
Director of Administration

BOARD OF TRUSTEES As of December 1, 2013



Front row, left to right:

Vice President Sharon Leggett; Rainy Kaplan; Cinda Klickna; Marcia Campbell and Cynthia O'Neill

Back row, left to right:

Michael Busby; Mark Bailey; Executive Director Dick Ingram; Enrique M. Vasquez; Bob Lyons; President Christopher A. Koch, Ed. D.

Shown at right: Sonia Walwyn



Sonia Walwyn

EXECUTIVE CABINET MEMBERS As of December 1, 2013



Front row, left to right:

Director of Research Kathleen Farney, CEBS; Senior Assistant General Counsel Cynthia Fain; Director of Administration Jana Bergschneider, CPA; Director of Human Resources Gina Larkin; Executive Assistant Sue Billington and Assistant to the Executive Director Tammy Green

Back row, left to right:

Director of Member Services Sally Sherman; Communications Manager Kathy Boehme; General Counsel Tom Gray; Director of Outreach Rich Frankenfeld; Executive Director Dick Ingram; Chief Investment Officer Stan Rupnik, CFA; Director of Communications Dave Urbanek; Information Systems Officer Ed Mabie and Director of Internal Audit Stacy Smith, CPA, CIDA

CONSULTING AND PROFESSIONAL SERVICES

Actuary

Buck Consultants, LLC
Chicago, Illinois

Master Trustee

State Street Bank and Trust Company
Boston, Massachusetts

External Auditors

(Special assistants to the Office of the Auditor General)

McGladrey LLP
Schaumburg, Illinois

Securities Lending Agent

Citibank, N.A.
New York, New York

Information Systems

Brent Ozar Unlimited
Beaverton, Oregon

Sentinel Technologies
Chicago, Illinois

**Laserfiche Corporate
Headquarters**
Long Beach, California

**SunGard Availability
Services**
Chicago, Illinois

McAfee
Chicago, Illinois

Investment Consultants

Callan Associates Inc.
(Real estate)
San Francisco, California

Risk Resources
(Real estate
insurance consulting)
Elmhurst, Illinois

**R.V. Kuhns &
Associates, Inc.**
(General investment)
Portland, Oregon

**TorreyCove Capital
Partners LLC**
(Private equity)
La Jolla, California

Legislative

Leinenweber Baroni & Daffada Consulting LLC
Springfield, Illinois

Co-Investment Advisors

LP Capital Advisors, LLC
(Private equity)
Sacramento, California

**Real Asset Portfolio
Management LLC**
(Real estate)
Portland, Oregon

Legal Services

Bingham McCutchen LLP
Hartford, Connecticut

**Loewenstein Hagen &
Smith PC**
Springfield, Illinois

Cavanagh & O'Hara
Springfield, Illinois

Mayer Brown LLP
Chicago, Illinois

Holland & Knight LLP
Chicago, Illinois

**Morgan Lewis &
Bockius LLP**
New York, New York

**Howard & Howard
Attorneys PLLC**
Peoria, Illinois

**Robbins Geller Rudman
& Dowd LLP**
San Diego, California

Jackson Walker LLP
Austin, Texas

Sorling Northrup
Springfield, Illinois

Kopec White & Spooner
Springfield, Illinois

**ORG Portfolio
Management LLC**
(Real estate)
Cleveland, Ohio

Stout Risius Ross, Inc.
(Private equity)
Los Angeles, California